Q4 2022 MICRO OPPORTUNITIES STRATEGY UPDATE

By Nathan Fredrick

For the past year the Riverwater Micro Opportunities Strategy performed roughly in line with its benchmark, the Russell 2000 Index. During market drawdowns, micro-cap companies are usually hit harder than the overall market, with few places to hide. Many names are illiquid and when investors want to sell out, it can dramatically impact the stock price regardless of fundamentals. We were coming off a period where micro caps saw many multibaggers. Today's environment presents fewer opportunities for significant gains (short term exponential returns), owing to a new restrictive Federal Reserve policy, a more difficult funding market, and a slowing economy.

It was a tough year for microcap companies that were money losing, had high debt levels, and/or possibly needed to raise new capital. We had names in the portfolio that we really liked, and still believe will have a good future, but were not yet profitable. We had to part ways with some of these companies throughout the year because of funding concerns or profitability being pushed out.

The good thing about down markets is the ability to sift through the rubble and find babies that were thrown out with the bathwater (apologies for the double idioms). There is no better place to do this than microcap land, especially with many investors trying to chase the same venture capital deals for outsized gains in a money-losing business model or in an outright fraud scheme like FTX. Looking at microcap companies is like VC investing in the public market but without having to pay 2 and 20. Plus large asset managers don't take the time to look here because they couldn't build a position that matters. Here is where we believe our opportunity lies. We look where others are not.

There are many companies with interesting technologies, good business models, and high ROIC niche businesses in the micro-cap space. They are usually small because no one looks at them or takes the time to do the due diligence. Now, don't get me wrong there is also plenty of fraud and nonsense here, but hopefully these can be weeded out. We don't get every call right and some story stocks don't turn out in the end, but when they do you can get some serious outperformance compared to large cap and even medium cap companies. This was proven out in the strategy with the three companies taken out during the year: USA Truck Inc., Meridian Biosciences Inc., and Channeladvisor Corporation. While 2022 was a tough year overall and 2023 could start out the same again, we believe now is the best time to start finding those gems in micro-cap land.

Company Deep Dive: Tecnoglass

One example of an undervalued company is Tecnoglass (TGLS), which is one of our favorite names now and a recent purchase. It trades at 8x our 2023 earnings estimate, has a clean balance sheet with leverage at .4x EBITDA, and is run by a vested management team that is founder-led and committed to ESG principles.

Tecnoglass, listed and traded in the US with manufacturing and headquarters in Colombia, is a leading glass window manufacturer in the commercial space (read high-rise buildings). While this may be the first time you've heard of Tecnoglass, odds are good that you've been an unwitting user. In fact, I only just realized last month that the windows in the building my parents have lived in for the last 15 years are Tecnoglass.

The company has enormous structural advantages; energy, labor and transportation costs are all lower versus their competitors. Shipping to the East coast of the US is more efficient to do by sea from Colombia than by land in the US.[1]

Having just toured the TGLS factory in Colombia, we can vouch for the efficiencies, but the proof is in the pudding. The pudding in this case is their operating margins. Over the last 12 months, they put up 28.7% operating margins vs. their top two public competitors, Apogee at 5.6% and PGT Innovations at 11.3%. If TGLS was priced comparably to other industrial companies with similar operating margins, the stock would have to double or triple from current levels.[2]

Tecnoglass has a large backlog of orders worth close to a year's sales as commercial projects that slowed during the pandemic are now ramping back up. This gives us confidence in cash flows over the next year even with a slowing economy. And if the commercial backlog reverses, we still believe that residential housing will drive double digit growth on its own as the company expands its residential penetration. The company produced $85.8mm of residential revenue in Q3 2022 vs. $59.4mm the year before and just $19mm in 2020.

Tecnoglass has only been in the residential market for a few years but with their advantaged cost structure and ever-increasing distribution network we expect them to take a good portion of market share.

Finally, solar technology is being developed to generate electricity from windows. Think about that! If the technology can be scaled in a cost-effective way, the replacement market will expand markedly in both volume and price. And Tecnoglass is preparing to capitalize on that opportunity when it arises.

We are confident in the near-term outlook with their backlog, the medium-term with the residential opportunity, and the long-term with the solar opportunities.

[1] It is 36% cheaper to ship by sea than to ship from the Midwest to major coastal cities. With the trade imbalance between the US and Colombia, there are consistently more empty containers going back to the US which keeps rates perpetually low.

[2] There are 48 industrial companies with greater than 20% operating margins that are levered less than 2.5x and have a market cap greater than $200M. Eliminating commodity-based companies drops the list to 41. The average operating margin for the 41 is 27% and they trade on average at 21x FY1 earnings. We think TGLS can make $4/share in 2023 (the street is at $3.36). If valued comparably to similarly profitable Industrials the stock would be worth $84 vs. the current market price of $30.

Top Detractors

The top detractors in Q4 2022 were Lifecore Biomedical (LFCR) and First Internet Bancorp (INBK). Lifecore had a tough quarter, having failed to sell their entire food business (avocado and olive oil businesses remain), and be considered a pure play biomedical company. This put a damper on plans to focus solely on their injectable business, the gem within the company. Lifecore is a leading contract manufacturer of hyaluronic based injectable drugs, which now comprise 55% of all drugs in development and are growing at a double-digit rate. LFCR will be on the watch list to sell if we don't see them make progress selling the food business. First Internet Bancorp had bad quarterly earnings results that missed analyst expectations. Specifically, INBK saw weaker net interest margins driven by higher funding costs from higher interest rates and more competition for deposits. Additionally, INBK partners with many fintech companies that also had rough years. This contributed to INBK's subpar performance.

Top Contributors

The top contributors in Q4 2022 were Mayville Engineering Company Inc. (MEC) and Tecnoglass Inc. (TGLS). MEC was the top contributor to performance in the quarter with a few catalysts coming together all at the same time. The new CEO Jagadeesh (Jag) Reddy started communicating with the street and was able to give a presentation at the Baird industrial conference. Many investors must have liked what they heard because the stock took off. Cheap valuation in the mid-single digit P/E range, combined with good visibility in 2023 with almost year-long customer backlogs, and potential lawsuit win against Peloton (PTON) for around $50 million, set up a perfect storm to the upside for MEC. TGLS (see Deep Dive above) was the other top performer.

Sales

We sold three names in Q4 2022: Channeladvisor Corporation (ECOM), Atomera Inc. (ATOM), and Lee Enterprises Inc. (LEE). ECOM was bought by a private equity group. ATOM was sold because it looked like the sales cycle was taking longer than expected with OEMs and foundries. We still think the technology is interesting but now it looks like they will need to raise more money in the near term. LEE was sold because they delayed the filling of their 10-K, reportedly to allow management to evaluate deficiencies in connection with its internal control over financial reporting. This was a small position and, with this news, we would not add to the name. LEE was doing a good job transforming to a digital news franchise, but accounting issues are an automatic sell for us.

Additions

We added two new names to the micro-cap fund in the quarter: Iradimed Corporation (IRMD) and Information Services Group, Inc. (III). Founded in 1992 by Chairman, President, and Chief Executive Officer, Roger Susi, Iradimed (IRMD) designs, manufactures, and sells non-magnetic MRI infusion pumps and patient monitors to hospitals and acute care facilities around the world. IRMD's non-magnetic devices allow for easy transport and enhanced safety of patients moving to and from the MRI department since their monitoring and infusion pumps can be used in proximity to the MRI machines. Currently, IRMD is the only company with this technology. IRMD's next generation pump (at FDA now) will allow greater adoption even outside of the MRI department, growing the addressable market. The recurring revenue stream from the disposable IV tubes used in the IV pumps accounts for 30% of revenues today. Our expectation is for 8-10% revenue growth and 12-15% earnings growth over the next 3-5 years. Additionally, we are engaged with Mr. Susi about IRMD's ESG efforts.

Information Services Group, Inc. (III) is a leading global technology research and advisory firm. A trusted business partner to more than 800 clients, including more than 75 of the top 100 enterprises, III is committed to helping corporations, public sector organizations, and service and technology providers achieve operational excellence and faster growth. The firm specializes in digital transformation services, including automation, cloud and data analytics; sourcing advisory; managed governance and risk services; network carrier services; technology strategy and operations design; change management; market intelligence and technology research and analysis. III's business transformed during the pandemic, as did most companies that could move to a work from home model. Now with the pandemic behind us, we believe a hybrid model of work from home is here to stay. These secular growth trends will ensure that III has growth drivers well into the future. Also, a hidden gem within the business is its proprietary data sets and market intelligence they have gathered over thirty years.

We also added to names we already own that we have high confidence in and saw an opportunity in the market selloff: Docebo Inc. (DCBO), Mayville Engineering Company inc. (MEC), Tecnoglass Inc. (TGLS), Limoneira Company (LMNR), First Internet Bancorp (INBK), and Anika Therapeutics Inc. (ANIK).

(Chart showing Micro Opportunities Strategy Largest Contributors and Detractors on next page).

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MICRO Opportunities Strategy
Largest Contributors and Detractors – Q4 2022

5 Best - Absolute Contribution				
Ticker	**Company**	**Average Weight**	**Contribution**	
MEC	Mayville Engineering	3.36%	190	bps
TGLS	Tecnoglass Inc.	4.29%	158	bps
PERI	Perion Network Ltd.	5.81%	153	bps
AMRK	A-Mark Precious Metals	4.52%	96	bps
ANIK	Anika Therapeutics, Inc.	4.24%	94	bps
	5 Best Total	**22.22%**	**691**	**bps**

5 Worst - Absolute Contribution				
Ticker	**Company**	**Average Weight**	**Contribution**	
FIBK	First Internet Bancorp	2.70%	-77	bps
LCOR	Lifecore Biomedical, Inc.	2.78%	-74	bps
III	Information Services Grp.	1.02%	-42	bps
ATOM	Atomera, Inc.	0.88%	-39	bps
LMAT	LeMaitre Vascular, Inc.	3.27%	-34	bps
	5 Worst Total	**10.65%**	**-266**	**bps**

Contribution reflects the impact of performance and the portfolio weight to total portfolio return.

Data shown is from a representative account of the Strategy Name Composite. All Returns Are Gross-of-Fees. Included as supplemental information and complements a full disclosure presentation, which can be found in the appendix section of this presentation. Reader should not assume that investments in the securities identified were or will be profitable. Timing differences of purchases and sales may have a modest impact on the actual contribution numbers presented. The holdings identified do not represent all the securities purchased, sold, or recommended. The calculation's methodology along with details on all holding's contribution to the overall account's performance during the measurement period are available upon request. Past performance does not guarantee future results.

MICRO Opportunities Strategy
Largest Contributors and Detractors – YE 2022

5 Best - Absolute Contribution				
Ticker	**Company**	**Average Weight**	**Contribution**	
USAK	USA Truck, Inc.	2.77%	294	bps
VIVO	Meridian Bioscience, Inc.	4.07%	175	bps
ECOM	Channeladvisor Corp.	1.74%	162	bps
TGLS	Tecnoglass Inc.	3.60%	136	bps
FBIZ	First Business Financial	4.18%	86	bps
	5 Best Total	**16.36%**	**853**	bps

5 Worst - Absolute Contribution				
Ticker	**Company**	**Average Weight**	**Contribution**	
HBIO	Harvard Bioscience, Inc.	3.61%	-363	bps
AKTS	Akoustis Technologies, Inc.	2.65%	-228	bps
FARM	Farmer Bros. Co.	3.84%	-211	bps
MIGI	Mawson Infrastructure	0.58%	-194	bps
INFU	InfuSystem Holdings, Inc.	3.47%	-194	bps
	5 Worst Total	**14.15%**	**-1190**	bps

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