Q4 2022 RIVERWATER SUSTAINABLE VALUE UPDATE

By Adam Peck

Having some fun

It has rarely been this fun to be a value investor. To be clear, it is never fun to lose money for clients. However, value investors lost a lot less than their growth counterparts this year.

I imagine losing less money for value investors probably feels somewhat like footballer Kylian Mbappe's performance in the World Cup final for France. Mbappe was only the second player to EVER score three goals - a hat trick - in a final and, unfortunately for him, the only one to do it and still lose. A hat trick is a rare and difficult feat and something to be proud of, but a loss is a loss.

Our benchmark, the Russell 2500 Value Index, rose 9.6% in the quarter and declined 14% for the year. Our SMID strategy outperformed for both the fourth quarter and the year. We consider that our "hat trick."

It was an important year for Riverwater to outperform. First, we have historically done well in bear markets and strive to maintain that track record.

More importantly, 2022 was the year that "ESG" became politicized. Its detractors have used this past year (way too short of a time to judge any strategy!) as one proof point that investments with a focus on ESG will underperform their peers, despite evidence to the contrary.[1] Riverwater's focus on ESG allows us to understand risks and opportunities presented by E, S, and G factors, which can meaningfully affect companies and their performance. Additionally, unlike many sustainable, or ESG-focused investors, Riverwater does not exclude energy (except for coal), but rather invests in the cleanest fossil fuel companies that are moving their portfolios toward greener energy. Energy happened to be the only sector in the Russell with a positive return, which also helped our portfolio return.

With over six years under our belt, we have outperformed in every bear market- which now adds up to three.

So why are we having fun? I can't remember anytime over the last 20 plus years when there were this many undervalued companies across multiple industries. There are always some, but usually they either have bad balance sheets or are focused in an industry with very poor fundamentals. Today, however, there are many high-quality companies trading at multiples that don't reflect their true long-term value.

[1] Advisor Perspectives featured an article we wrote about why we believe ESG will endure. Click here to read the article.

Strategy Top Detractors

Our two worst performers were ICF International (ICFI) and Haemonetics (HAE). Neither stock was down more than 10% and we are not concerned with the negative performance. ICF ended the year down just 3.6% and we just bought HAE in early December. Three weeks is not enough time to make any comments on stock attribution.

Strategy Top Contributors

Our two best performers were Crocs (CROX) (its second quarter in a row) and Atkore (ATKR). Both rallied nicely in Q4 2022. The one similarity with both is how deeply undervalued they were at the start of the quarter. Crocs was trading at just 7x earnings for 2022 and Atkore was trading at 3.6x 2022's earnings. Even with both making strong gains, we believe there is upside given they are both still cheap and have positive future sales outlooks.

Strategy Additions and Sales

We were busy in the fourth quarter as we recycled the tax loss harvesting done in Q3. We bought in total six new names: Tecnoglass (TGLS), RH (RH) (see deep dive on RH below), Haemonetics (HAE), Evercore (EVR), Lincoln Electric (LECO) and Limoneira (LMNR). We added to one position - Crocs (CROX) and sold Virtu (VIRT) and Northwestern Corp (NWE).

Portfolio Positioning

We feel comfortable with the portfolio positioning. We do not have any large sector bets and are within a 5% weighting compared to our benchmark for all but one sector, Real Estate, where we are underweight by 7%. We've increased our exposure to the Consumer sector with the addition of Crocs and RH, as well as our weight in Industrials where we have added four new names this year – TGLS, LECO, BLDR and AZZ. On average those names trade at less than 10x 2023's earnings estimates. We think the markets will remain volatile in the first quarter with uncertainty driven by both the Federal Reserve and a weakening global economy. We are confident in our holdings' positioning and outlooks and believe small caps are setting up for both positive absolute and relative performance as 2023 unfolds.[2]

Company deep dive: RH

One of the most important traits of a great consumer company (young or old) and stock is to create, grow and sustain a brand. A strong brand must be easily recognizable, create a positive emotion, and represent quality as well differentiation. Very few companies can do this successfully *(Nike and Apple quickly come to mind)*, let alone sustainably, and fewer are able to continuously refresh a brand. It is difficult enough to create and sustain a brand; it is even more difficult to successfully enable a brand to penetrate and flourish within an established demographic.

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[2] For more about why we are bullish on small-caps, click here.

RH (RH), formerly Restoration Hardware, is in the process of creating a global brand which aims to embody a prestigious lifestyle by promoting prestigious furniture, lighting, textiles, bath ware, décor and outdoor furnishings. The high end and ultra-high end furnishing market is relatively unestablished from a scale perspective and is operating in a very fragmented market on a global basis. RH top-rated designers showcase its global brand on its website, in its printed source book, and in the company's stunning stores and galleries which are located predominantly in the US today and expanding globally. RH currently operates 120 stores of which 67 are galleries. These galleries are often housed in renovated, historically significant buildings, with multi-level floor plans featuring products in settings as they might appear in one's home. Additionally, RH operates high-end restaurants in its galleries that drive traffic to the stores. The restaurant itself has become a destination, its own unique culture within a RH gallery. RH is a good example of a company that satisfies Riverwater's three pillars for inclusion in portfolios: superior business, exceptional management, and attractive valuation.

Pillar One: Superior Business

RH meets our first pillar as a superior business, its moat being that it operates in a whitespace with few competitors and its customer base is willing to spend top dollar. Given its competitors thought CEO Gary Friedman was crazy for opening large galleries and creating an ecosystem of white glove service, they are far behind RH in competing for the ultra-rich customer. In 2021, RH reached a peak of >30% return on invested capital and had EBITDA margin of ~ 30%. While these were peak pandemic numbers and likely were a result of the company over earning during that time, we believe these numbers can be achieved again with new store conversions to galleries and international growth.

Pillar Two: Exceptional Management Teams

Our second pillar is an exceptional management team, in this case visionary CEO Gary Friedman, who joined as CEO in 2008. (RH was founded in 1980 and first went public in 1998.) While some investors are turned off by Gary, he should get the benefit of the doubt having proven this business model in the US when most thought he was crazy. We appreciate his commitment to the vision and focus on the customer. Another aspect of his management style we like is his honesty. He was one of the first CEOs to call the downturn in housing early in 2022. He also has moved back the opening of RH England since he did not think it was ready. This makes him more credible in our eyes when he says anything to the public.

Pillar Three: Attractive Valuation

Our third pillar is attractive valuation. While earnings power will be depressed next year, analyst numbers for FY'24 have come down significantly. RH's forward P/E has averaged 18x and has been as high as 30x. RH is currently trading at 15x on what we believe to be trough EPS. Gary has always liked to compare RH to trade like a luxury brand: to him, luxury brand = luxury multiple. LVMH is the gold standard in the luxury market and has achieved a >30x P/E multiple.

2023 Catalysts:

1. Global expansion is key to the next leg of the RH story. It will start this summer with the opening of RH England, which will be a gallery at the Historic Aynhoe Park, a 73-acre estate designed in 1615. RH's international strategy is not to just open a store in a city but open up the entire country. Gary thinks all the UK could do $50 - $250 million in revenue. For context, it is estimated that the NYC location can do over $100 million in sales a year. So, the high end of his estimate seems to be within reach. The total international opportunity is $20 -$25 billion with little competition from other high end home furnishings stores. The international market is much more fragmented than the US market. RH is also under construction on RH Paris, The Gallery on the Champs-Élysées, scheduled to open in 2024, and RH London, The Gallery in Mayfair scheduled to open in 2024-25. RH has also secured locations in Milan, Madrid, Munich, Dusseldorf, and Brussels, some of which will also open in 2024 and 2025.
2. US store growth and upgrades offer opportunity. For example, RH San Francisco recently opened. There are currently 35 legacy galleries in operation. An interesting feature of RH is that there is no need to advertise in the US; instead, the source book with new products is mailed to target customers. While Gary will say that RH has no competition in the luxury space, traditional high-end furniture comps are Williams Sonoma and Arhaus. While its competitors will offer promotions and deep discounts, RH will hold pricing similar to other luxury brands.
3. New product launches will also be key to RH's success in 2023. RH Contemporary, which Gary calls "the most compelling new collection in our history," launches in 2023. A new source book and the first since before the pandemic will also come out. RH Guesthouse in New York, a revolutionary new hospitality concept for travelers seeking privacy and luxury, will open. RH Aspen will be an entire RH ecosystem that caters to every aspect of luxury a wealthy person could ask for.
4. RH also has a large buyback authorization at $2 billion dollars. This is about a fourth of the enterprise value of the company. RH appears to get more active in the buyback at under $250 a share, putting a natural floor on the stock price. Plus, the float is relatively small with the two top holders, Gary Friedman and Berkshire Hathaway, owning a little over 20% of the company, combined.

Risk

- A big pushback we receive is that US brands do not do well in European markets. This is true for luxury apparel brands, but RH is moving into a whitespace that is not occupied by a current European brand like LVMH. Also, 80% to 90% of interior designers in the UK know RH. Investor relations has mentioned that some RH customers are already foreign buyers going to US stores. While they don't give any hard numbers on this, they are confident about moving into new European cities based on this data.

- Too many initiatives that could take focus away from core business. RH has a lot of irons in the fire, and everything runs through Gary. He has built a good team and they are well paid, but it could be difficult to pull off so many new launches.
- Macro environment will be difficult for housing in the near term. Gary has not minced his words on the quarterly conference call about how bad he thinks the economy is, so we will be listening to him closely on when he believes it will turn.

(Chart showing Riverwater Sustainable Value Strategy Largest Contributors and Detractors on next page).

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Sustainable Value Strategy
Largest Contributors and Detractors – Q4 2022

5 Best - Absolute Contribution			
Ticker	**Company**	**Average Weight**	**Contribution**
ATKR	Atkore Inc	5.07%	184 bps
CROX	Crocs, Inc	3.92%	181 bps
LOPE	Grand Canyon Education	3.86%	99 bps
VVV	Valvoline, Inc.	3.22%	87 bps
CIEN	Ciena Corporation	3.48%	86 bps
	5 Best Total	**19.55%**	**637 bps**

5 Worst - Absolute Contribution			
Ticker	**Company**	**Average Weight**	**Contribution**
ICFI	ICF Company	4.60%	-38 bps
HAE	Haemonetics Corp	0.71%	-18 bps
EVR	Evercore Inc.	1.37%	-9 bps
TGLS	Tecnoglass Inc.	0.19%	-2 bps
LECO	Lincoln Electric Holdings, Inc.	0.93%	-1 bps
	5 Worst Total	**7.80%**	**-68 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.

Sustainable Value Strategy
Largest Contributors and Detractors - YE 2022

5 Best - Absolute Contribution				
Ticker	**Company**	**Average Weight**	**Contribution**	
CROX	Crocs, Inc.	1.95%	206	bps
FSLR	First Solar, Inc.	2.65%	189	bps
SNEX	StoneX Group Inc.	3.87%	173	bps
IRDM	Iridium Communications	3.70%	126	bps
REGI	Renewable Energy Group,	0.83%	101	bps
	5 Best Total	**12.99**	**795**	**bps**

5 Worst - Absolute Contribution				
Ticker	**Company**	**Average Weight**	**Contribution**	
HASI	Hannon Armstrong Sustainable Infrastructure Capital, Inc.	2.08	-209	bps
INFU	InfuSystem Holdings, Inc.	2.42	-189	bps
CIEN	Ciena Corporation	4.02	-184	bps
JLL	Jones Lang LaSalle Inc	3.34	-181	bps
CASH	Pathward Financial, Inc.	1.33	-131	bps
	5 Worst Total	**13.18**	**-895**	**bps**

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