RIVERWATER PARTNERS

Q1 2023 MICRO OPPORTUNITIES STRATEGY UPDATE

By Nathan Fredrick

The Riverwater Micro Opportunities Strategy outperformed the Russell 2000 Index in Q1, which felt like a condensed business cycle. The quarter started off strong, but ended with a banking crisis that remains unresolved. We have shared more thoughts on this issue in our main letter.

We believe the pipeline of companies to look at has never been better. Many of the high flying stocks/IPOs/SPACs that came public over the last two years have now fallen into microcap territory. Many high-profile stocks that went public in the last two years have fallen into microcap territory, providing us with hundreds of opportunities to explore. While many of these companies should not have gone public, there are some with strong fundamentals that were unfairly dragged down. Additionally, some of the names that were previously too big for Micro have now sold off indiscriminately and now could be potential investments.

While we remain optimistic, we have observed some froth in the market, particularly in meme-type stocks and highly speculative companies. Our holdings skew more quality than speculative. We believe it is reasonable to be cautious at this point, while investing in companies we believe have visibility in future earnings or unique opportunities.

In volatile markets, it is often wise to prioritize preserving capital over chasing big gains and adopting a get-rich-quick mentality, as we discussed in our previous letter. This notion is illustrated by an interesting golf statistic that compares the average number of birdies per round between PGA professionals and scratch golfers, who are top-level amateurs with a handicap of approximately zero. According to Shot Scope data, the average scratch golfer has 2.67 birdies per round, while PGA professionals have 3.63, a noticeable but not as significant difference as one might expect. So, what distinguishes PGA players from scratch golfers? PGA players avoid catastrophic holes that can derail their entire game, while scratch golfers may not. Similarly, in the current investing landscape, consistency and avoiding excessive risk and potential blowups are crucial. While there will be better opportunities to take on more risk in the future, our focus for now is on avoiding big losses.

In our previous letter, we discussed our strategy of identifying promising businesses amidst market downturns, and we are pleased to report that this quarter we have discovered several such opportunities. Among them, two companies exhibit steady, high return on invested capital (ROIC) at reasonable valuations, while two others are innovative technology firms with strong backing that may see significant growth if their products gain traction. Our investment philosophy remains grounded in our three-pronged approach of seeking out exceptional management teams, superior businesses, and attractive valuations. We are currently researching several more potential investments, and we are optimistic that 2023 will be another year of compelling opportunities and continued outperformance.

Company Deep Dive: Centrus Energy

There is an ongoing debate within the ESG and renewable energy communities regarding nuclear energy. While we are too young to recall the anti-nuclear protests of the past, it seems that fewer people today are staunchly against nuclear energy. In fact, nuclear energy may find common ground among politicians as a reliable source of baseload energy, national security, and a step towards net zero emissions. Even left-leaning film director Oliver Stone produced a documentary on nuclear energy, which he showcased at the World Economic Forum this year. Many of the negative views of nuclear energy stem from past failures such as Chernobyl, Three Mile Island, and Fukushima. However, over the last 70 years, these three accidents caused a total of 90 deaths. While every life is important, compared to other carbon energy sources, nuclear has been by far the safest. For reference, hydro energy has had 1,400 deaths, and coal is the highest at 100,000.[1] There is also a debate on what to do with nuclear waste, but that seems to be a little overblown. We are not saying that it is not an issue, but one that is solvable in a safe way.

While there is a debate about what to do with nuclear waste, it is a solvable issue. Furthermore, there have been numerous advancements in nuclear technology that make it safer and cheaper. The conflict between Russia and Ukraine has highlighted the importance of energy sources for countries. Europe, for example, struggled last year to find replacements for natural gas purchased from Russia, which led to a return to coal or more expensive LNG. Nuclear energy could solve many of these problems, unfortunately Germany has still decided to close its nuclear power plants. Japan has planned to restart some of its nuclear power plants that were previously shut down. North America has sufficient uranium to support the western world, but it lacks the necessary enrichment facilities, which brings us to our newest investment.

Centrus Energy (LEU) is a trusted supplier of enriched uranium and services for the nuclear power industry, which offers a reliable source of carbon-free energy. LEU's core business is selling enriched uranium to power plants for use in producing energy. This side of the business has a billion dollar order book and supply agreements all the way out to 2030. The optionality in the business, and what we are most excited about, is that LEU has been working to pioneer production of HALEU (High Assay Low Enriched Uranium) in the US, paving the way for a new generation of HALEU fueled reactors. HALEU is a high-performance nuclear fuel component expected to be essential for many advanced reactor and fuel designs developed for commercial and government purposes. Nine of ten

[1] https://www.engineering.com/story/whats-the-death-toll-of-nuclear-vs-other-energy-sources

advanced nuclear reactor designs selected for funding under the DOE's Advanced Reactor Demonstration Program will rely on HALEU. Low enriched uranium is enriched up to 5% with uranium-235 and HALEU is enriched between 5% and 20%. For reference, weapons-grade uranium has an enrichment level of up to 99%.

We believe that this call option with LEU is about to become profitable. The company has secured a $150 million contract with the Department of Energy to start producing HALEU this year. Plus, they have the option to extend the contract nine years, which is estimated to be worth $90 million a year annually. These DOE contracts are just the tip of the iceberg, and the commercial demand could be much higher. In 2020, the Nuclear Energy Institute (NEI) surveyed US advanced reactor developers to estimate potential HALEU demand through 2035. The findings suggest a total market value of $1.6 billion/year by 2030 and $5.3 billion/year by 2035. This is significant since the United States lacks its own enrichment programs, and LEU would be the first. The barriers to entry in this industry are enormous, as one would expect. Starting an enrichment business without government approval is a sure way to get a visit from the FBI. This gives LEU a significant advantage over any potential new entrants in the market.

Recently, the stock price of LEU has gone down due to its correlation with the uranium price, which has suffered because of recession fears in the commodity market. However, the more significant reason for the weakness is the introduction of a bipartisan bill by Senate and House Committee leaders to ban Russian uranium imports. This bill is crucial because Russia (TENEX) provides most of the enriched uranium to the world. If Russia stops supplying uranium, LEU has other sources, but it would be more expensive. The Transitional Supply Agreement, which allows TENEX to sell low enriched uranium to the US until 2028, is likely to have a carve-out in the final bill. The importance of LEU's new HALEU business for US energy policy is apparent in this scenario.

LEU's financials can be volatile quarter to quarter, depending on enriched uranium delivery to its utility customers. As HALEU production reaches full capacity in 2024, LEU's financials should stabilize. Because LEU's supply is based on a fixed price, the company can earn more money by signing contracts with utilities as uranium prices rise. LEU is a unique business that is crucial to the energy industry for the foreseeable future. Furthermore, significant innovation is expected in the nuclear space in the next decade, and LEU is poised to lead the industry.

Top Detractors

The top detractors this quarter were First Western Financial Inc. (MYFW) and First Internet Bancorp (INBK). (Maybe we should stop buying companies with "First" in their names?) It is not surprising that the financial sector, and banks specifically, were the worst performers this quarter. Four of the bottom five detractors were banks, and the banking sector experienced a run of panic selling, affecting small regional banks the most. We believe our banks have different deposit bases than Silicon Valley Bank and have additional revenue streams from non-interest income. While our companies will have their net interest margins compressed from higher funding costs, we believe it is not prudent to panic sell at the lows. We will listen intently to management's handling of the turmoil in the upcoming earnings season. For a more in-depth analysis of the banking crisis, please refer to Riverwater's main letter.

Top Contributors

The top contributors for Q1 2023 were Perion Network Ltd. (PERI) and Tecnoglass Inc. (TGLS). PERI is a global advertising technology company that assists brands, agencies and publishers with advertising solutions. Additionally, it has a partnership with Microsoft's Bing, which integrated ChatGPT during the quarter, potentially driving more traffic to Bing and benefiting PERI. Moreover, PERI continues to beat and raise quarterly earnings, with roughly $420 million in cash/cash equivalents on the balance sheet and no long-term debt. TGLS has now been a top contributor for two consecutive quarters (see Q4 2022 Update for a deep dive on the company if you would like to learn more). This quarter, TGLS benefited from strong financial results, leading to another beat and raise quarter. The housing sector stocks also benefited from lower rates in the quarter.

Sales

In the quarter we sold three names: Gladstone Commercial Corporation (GOOD), Lifecore Biomedical Inc. (LFCR), and InfuSystem Holdings Inc. (INFU).

GOOD, which is an office and industrial real estate investment trust (REIT), had been a long-time constituent of our portfolio. It had a consistent track record of delivering steady performance and attractive dividend yield. Their founder and CEO often concluded earnings calls by stating how financially strong they are and how they had never cut the dividend, not even in the Great Financial Crisis. However, in the last quarter, the company surprised the market by cutting its dividend. This was contrary to what they had communicated to us, and it raised concerns about the company's future prospects. Hence, we decided to sell our position in GOOD.

In our last quarter letter, we highlighted LFCR as a potential sell candidate. This quarter, we decided to divest our holding in LFCR due to the persistent overhang from their food business, high debt levels, and the potential need for capital raising. While we acknowledged the potential of their contract manufacturing of hyaluronic-based injectable drugs business, the negative factors affecting the stock had become too pronounced for us to maintain our position.

INFU sells infusion pumps and operates in two segments, Integrated Therapy Services and Durable Medical Equipment Services. The management team had set ambitious goals for the company, which were not realized, and the strategy was consistently being revised.

Additionally, there were too many consecutive quarterly earnings misses, which led us to believe that the company was not performing as expected. As a result, we decided to sell our position in INFU.

Additions

In the quarter we added four new names to the micro-cap strategy: International Money Express Inc. (IMXI), Terran Orbital Corporation (LLAP), CRA International Inc. (CRAI), and Centrus Energy Corp. (LEU).

IMXI operates a money transfer or remittance company under the Intermex brand, based out of Miami, FL, with most of its customers from the Florida area. The company is expanding into Texas and California, which they believe could double the size of the company over the long run. IMXI's customers are foreign or migrant workers who work in the USA and send money back home. Its two main Latin American corridors are Mexico and Guatemala, with Mexico alone doing roughly $60 billion a year in remittances. The stock trades at a low teens forward P/E multiple with high teens sales growth and high teens ROIC. We believe it should trade at a higher multiple once investors realize that the digital remittance offerings are not as strong a competitor as the market thinks. IMXI also offers its own digital solution. On the ESG front, remittances rank number 17 in the UN SDGs because they are critical to finding work abroad and sending funds home for economically disadvantaged people.

We started a small position in LLAP, which manufactures and sells satellites for the aerospace and defense industry, as well as for commercial uses in the United States. More than 50,000 satellites will be launched this decade, most with a high replacement rate based on three to five years of useful life. LLAP is agnostic on who they manufacture satellites for and already has an anchor customer in Lockheed Martin, which also invested in the company. Recently, the company signed a contract for $2.4 billion dollars to build satellites for Rivada Space Networks. The industry has seen significant consolidation at much higher valuations, and LLAP is one of the last free-standing outsourced manufacturers. We started this as a small position because with much of this hyper growth ahead of them, it is possible they will need to raise money to build out capacity. However, they will receive milestone payments when Rivada Space Networks' constellation is approved by regulators.

CRAI provides economic, financial, and management consulting services in the US, the UK, and internationally. It advises clients on economic and financial matters pertaining to litigation and regulatory proceedings and guides corporations through business strategy and performance related issues. The regulatory environment will stay complex and large for the foreseeable future in both the USA and EU. This will provide a consistent stream of work for CRAI. They will also have an opportunity to expand in the APAC region over time, which will open another large market to them. CRAI trades at a mid to high teens forward

P/E multiple with a mid teens ROIC. If the economy does slow down, CRAI will be able to weather the storm better than most due to their large cap clients and steady work flow.

LEU is a name we have owned in the past and also highlighted in our deep dive stock pitch above.

(Disclosures and chart showing ESG Micro Cap Opportunities Strategy Largest Contributors and Detractors on next page).

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Micro Opportunities Strategy
Largest Contributors and Detractors – Q1 2023

5 Best - Absolute Contribution			
Ticker	Company	Average Weight	Contribution
PERI	Perion Network Ltd	5.67%	245 bps
TGLS	Tecnoglass Inc.	5.37%	163 bps
HBIO	Harvard Bioscience, Inc.	2.63%	141 bps
LMNR	Limoneira Company	4.60%	138 bps
IRMD	IRadimed Corp.	3.24%	99 bps
	5 Best Total	**21.51%**	**786 bps**

5 Worst - Absolute Contribution			
Ticker	Company	Average Weight	Contribution
MYFW	First Western Financial, Inc.	3.77%	-128 bps
INBK	First Internet Bancorp	2.69%	-91 bps
FBIZ	First Business Fncl Svcs, Inc.	4.14%	-75 bps
LEU	Centrus Energy Corp. Class A	2.07%	-69 bps
TALO	Talos Energy, Inc.	3.46%	-66 bps
	5 Best Total	**16.13%**	**-429 bps**

Disclosures:

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 of 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.