Q1 2023 SUSTAINABLE VALUE STRATEGY UPDATE

By Adam Peck

The first quarter of the year began with a strong rally in small caps, benefiting from the January effect that saw the sector up double digits in the first month. History suggests that when small caps are up more than 6% in January, 90% of the time they end the year up with an average return of 30%, making for an optimistic start to the year.

However, this optimism was short-lived as the Russell 2000 fell 8% by mid-March due to investors' concerns about multiple bank failures. This was the 23rd worst week on record for the Russell 2000, falling in the bottom 1% of the index's 2,309 weeks of performance history. Despite this setback, the upshot is that future returns are historically strong after very bad weekly returns.

The Sustainable Value strategy outperformed its benchmark the Russell 2500 Value in the quarter. Outperformance was primarily driven by positive stock selection. The two sectors that stood out were Industrials and Financials. The Financial sector was the worst performing sector in the quarter but our financial holdings were actually up in aggregate. We only own one bank, Cullen/Frost Bankers, Inc. (CFR), which was our worst performer in the quarter; however, three of our five financial holdings rose in the quarter.

Cullen/Frost is a bank we have owned since the inception of our strategy. The bank has been around since 1868 and has weathered several crises, including the Great Depression and the Texas energy crisis of the 1980s. (Frost is the only top ten Texas bank to survive the economic crisis of the 1980s without needing federal assistance or being merged). It made it through the Great Financial Crisis without losing money and remains focused on only serving communities in Texas. If Texas were its own country it would be the 9th largest in the world between Canada and Italy. Cullen/Frost has been rated the #1 bank in Texas by J.D. Power for the last 13 years straight. The more impressive streak is they have been profitable for over twenty years, maintaining profitability through the Great Recession.

We are very confident in the safety and security of the bank's balance sheet. Cullen/Frost has one of the most liquid balance sheets for a bank its size. This is evident by: 1) It has an extremely low loan to deposit ratio at just 38% vs. your typical bank at anywhere between 75-100%; 2) 53.6% of those deposits are uninsured, but it has over $12 billion in cash and $18 billion in short-term securities which would cover close to 100% of any potential uninsured deposit outflow; and 3) The bank is asset sensitive and has avoided investing in long-term debt since 2020. The amount of unrealized losses on their balance sheet is less than 5% of their equity capital.

We remain confident in Cullen/Frost despite the weakness in the quarter and the headwinds for the industry. We are comfortable with our bank underweight, but would look to add should we find the right opportunity.

A stock we did add to in the quarter was Plexus (PLXS). Plexus has been partnering with companies to create the products that build a better world since 1979 and has operations in the Americas, EMEA, and Asia Pacific. It provides Electronics Manufacturing Services (EMS), consisting of Design and Development Engineering, Manufacturing and Aftermarket Services.

Headquartered in Neenah, Wisconsin, Plexus has operations in the Americas, EMEA, and Asia Pacific. The company's global footprint is putting manufacturing closer to where its customers want their supply chain to be. This allows Plexus to provide service excellence to its customers, delivering timely, innovative, comprehensive solutions throughout a product's lifecycle.

PLXS serves three main end markets: (1) 46% Industrial (semiconductor and test/measurement, automation/robotics, transportation and energy management, networking communications); (2) 41% Health Care (imaging, monitoring, robotic-assisted surgery, diagnostics, genomics, cell therapy); (3) 13% Aerospace and Defense (commercial aircraft, business jets, unmanned aerial vehicles, military aircraft, aviation and mass transit security, satellite communications, counter-terror intelligence).

PLXS's end markets require high reliability, regulatory approval, and innovative engineering. Execution and partnerships matter, making customers less price sensitive. They seek long-term relationships, typically lasting 10-15 years. These engagements are linked to several secular trends, which should offer 9-12% annual revenue growth, insulating the company somewhat from the general macroeconomic environment.

PLXS has a stated goal to deliver "5 and 5.5 by 2025" - $5 billion revenue and 5.5% operating margin by 2025. The company just reported its first $1B revenue quarter and now has capacity in place to serve $5 billion in revenue. PLXS targets and prices its contracts for 5% EBITDA margins. Additionally, management incentive comp is tied to 15% ROIC.

PLXS agreements are cost-plus, which allows PLXS to be insulated from inflation. While this traditionally applied only to material inputs, all agreements now include wage inflation protection, beginning immediately. This will be a tailwind in the first half of this year.

We expect PLXS to grow revenue 10-12% and EPS 12-15% over the next 3-5 years. The company has a backlog of $1.5 billion and an opportunity funnel of $3.6 billion, providing good visibility. The company has historically experienced a 50-70% win rate on new business, and does not bid business at lower than 5% EBITDA margins. Trading at 13.5X its fiscal 2023 consensus EPS estimate of $6.70, the shares are attractively valued at a below-market and below-peer multiple.

PLXS has fully embraced sustainability by focusing on its energy and water use, waste reduction, greenhouse gas emissions, and corporate culture. Additionally, its design services endeavor to promote circularity to limit the raw materials going into a product, prolonging product lifespan, and capture materials for recycling at the end of life, making its business by its nature one that promotes sustainability.

We were not overly active during the quarter. We only initiated one other new name and sold out of two: Builders FirstSource (BLDR) and Infusystems (INFU). While we had a nice gain in BLDR, we sold it due to the risk posed by its already-recessionary end markets, which are unlikely to recover anytime soon in light of higher interest rates. We finally gave up on Infusystems after having trimmed it last year. We eventually lost confidence in their ability to execute.

We anticipate the economy will slowdown as the year progresses, primarily driven by higher interest rates. We are also expecting volatility in the markets with the impending debt ceiling this summer. We have reviewed the portfolio and feel good about Riverwater's ability to weather a weaker economy, both operationally and financially. All of our companies are profitable, and most have very strong balance sheets - except for one or two companies that have improving cash flows and are reducing their debt. We will monitor their progress closely.

As always thank you for your trust and confidence and please reach out with any questions.

(Disclosures and chart showing Sustainable Strategy Largest Contributors and Detractors on next page).

Sustainable Value Strategy
Largest Contributors and Detractors – Q1 2023

5 Best - Absolute Contribution			
Ticker	Company	Average Weight	Contribution
ATKR	Atkore Inc	6.06%	121 bps
FSLR	First Solar, Inc.	2.68%	116 bps
TGLS	Tecnoglass Inc.	3.17%	97 bps
IRDM	Iridium	3.25%	96 bps
CROX	Crocs, Inc.	5.23%	81 bps
	5 Best Total	**20.39%**	**511 bps**

5 Worst - Absolute Contribution			
Ticker	Company	Average Weight	Contribution
CFR	Cullen/Frost Bankers, Inc.	4.18%	-94 bps
TALO	Talos Energy, Inc.	2.76%	-59 bps
BRCC	BRC Inc Class A	1.60%	-51 bps
INFU	InfuSystem Holdings, Inc.	1.25%	-29 bps
JLL	Jones Lang LaSalle Inc.	2.69%	-21 bps
	5 Worst Total	**12.48%**	**-254 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.