RIVERWATER PARTNERS

Q3 2023 MICRO OPPORTUNITIES STRATEGY UPDATE

By Nathan Fredrick

The Micro Opportunities Strategy slightly underperformed its benchmark, the Russell 2000, in the third quarter. Both the market and our portfolio had big intra quarter swings. The Russell 2000 rallied in the first half of the quarter followed by a sell-off as the quarter came to a close. Our earnings season saw a lot of volatility in company announcements, mostly to the downside. Even companies that were able to beat saw sell-offs, possibly because investors thought it was peak earnings. We did have a good close to the quarter and were able to pick up some ground since we are more defensively positioned and one holding almost doubled in the second half of the quarter.

Macro Environment Matters

While we are bottom up stock pickers, we pay attention to how the macro environment impacts our companies (Adam discussed the rise in interest rates in this quarter's Market Update for more information on that topic). In the last Micro Opportunities Update we discussed how the market was now pricing in a "no landing" scenario. This quickly changed with the Federal Reserve now steadfast on higher-for-longer interest rates. Higher rates combined with rising oil and a strong US dollar, have historically made for a tough environment for companies' future earnings. Luckily smallcaps are less impacted by a strong dollar than large multinationals since their sales are overwhelmingly in the US. Whether we have a hard or soft landing does not particularly matter that much as our portfolio positions should be set for either scenario.

The current macro backdrop makes it difficult for smallcaps to outperform large. We highlighted the relative performance ratio of smallcaps to large caps in the last letter and smallcaps continue to underperform. We are not calling a bottom to this ratio as it has widened since the last quarter, but if you have a three to five year time frame, we believe the odds are good that smallcaps will outperform.

Sectors Matter Too But There Is More to the Story

Since we run concentrated portfolios, we are better able to pick winners within each sector, so being overweight in a sector that we are bearish on might not be the whole story. For example, if you were overweight financials coming into the year, you would say that was a bad idea based on the banking crisis we had in March. However, within financials we were underweight banks and had more exposure to other parts of financials that are performing better (insurance and investment banks/brokerages).

The sectors we favor are healthcare, industrials, and energy. However, irrespective of sector, we like stocks that have underearned over the last few years, have growth tailwinds even with the current macro backdrop, and good earnings visibility. Healthcare is a sector that has underearned since the pandemic and is finally seeing a resurgence of volumes/procedures.

Healthcare

Even in downturns, healthcare has historically had great pricing power giving it good visibility on earnings. We did a write up on one of our favorite healthcare companies LeMaitre Vascular, Inc. (LMAT) last quarter if you would like to learn more. Our healthcare names have been some of the best performing names in our portfolio this year. In the microcap universe, we can find some interesting niche companies that are under followed by the larger market participants.

Industrials

Another sector we like is industrials. Similar to healthcare, the microcap industrials universe has many niche companies with good returns on capital and are under-followed. The tailwinds for this sector are still elevated backlogs and fiscal stimulus with the infrastructure bill and the IRA. Many of these names saw their earnings crater during the pandemic and will see a longer recovery than most anticipate. For example, the housing market has been much stronger than many had expected given how high interest rates are. This has happened for a few reasons but a large one is a structural under supply of housing that will persist well after this hard or soft landing is over.

Energy (not just oil and gas)

A new favored sector is energy. When most hear this they think of oil and gas, but there are other aspects of energy that we are bullish on, particularly uranium. The quick story on uranium is there is an under supply of uranium pounds in the market to meet current demand. Bringing new pounds to market is very difficult operationally and/or geopolitically unsavory (Russia is a large player here.) Utilities are the major buyer of uranium and will be an inelastic buyer of pounds in the market once this deficit starts to get bad. Utilities' number one priority is keeping the lights on, not buying uranium at a reasonable price. An interesting aspect of utilities buying uranium is that the price could double from here and the end customer that receives the energy would not see an impact on their bill. This is in contrast with natural gas, where spiking prices will be passed onto the end user.

On the oil and gas front, we believe higher for long is just not for the Federal Reserve and interest rates. Similar undersupply dynamics are currently playing out in these markets as well. Plus, the Russia Ukraine war is still impacting the market and we are heading into the winter months. We did our deep dive on an interesting energy company below, one that not only benefits from rising oil and gas prices but also has an undiscovered industrial business that the market is missing.

Company Deep Dive: Newpark Resources (NR)

In investing, there is more than one way to generate consistent returns on a dollar invested. The most common is to buy quality companies that consistently grow their revenues and earnings over time. Another practice is to buy distressed assets that have a visible catalyst and be patient while the market realizes their value.

Newpark Resources (NR) is one such company with a viable catalyst. NR evaluated its model and is in the process of making a significant change. This change should benefit shareholders over time.

NR has two segments: Fluid Systems and Industrial Solutions. At the end of calendar year 2022, Fluid Systems represented more than 70% of revenue, but less than 35% of profit. Profit peaked almost ten years ago in 2014! The Fluid Systems segment is their legacy segment providing fluid services for oil and gas companies. Importantly, this segment is in decline as NR customers implement efficiencies that decrease the need for NR's solutions. The oil and gas end market is highly cyclical as customer spending is directly correlated to commodity price movements. The resulting volatility and uncertainty in earnings makes it difficult to provide consistent financial guidance for investors. It also complicates the ability for those investors to assign a consistent multiple upon which to value the company.

While NR could continue to invest in the Fluids Systems division by creating scale and trying to increase market share, they decided to divest the assets. This past June, NR announced they are exploring strategic alternatives for their Fluids Systems division. While this strategy does have some risks, including the potential loss of customers and employees, the reward could be significant as they can reinvest the capital into their remaining business, the Industrial Segment. The current strength in the oil and gas market will make it easier for NR to sell the fluids business and potentially receive a better-than-expected price. The working capital alone is worth $200 million and we think this is a realistic number that they could receive for the business. They have existing net operating losses and so no taxes will be due.

The Industrial Solutions segment is focused on supplying recyclable mats to the utilities sector. Their mats provide access to locations that need heavy machinery and lack roads, like transmission towers. Increasing their focus in the Industrial Solutions segment makes sense for several reasons. The Industrial segment produces composite matting rental equipment which is 100% recyclable and offers significant economic and environmental benefits for their customers. They have cited that 27,400 tons of CO_2 have been saved by using their lighter weighted mats vs. wood alternatives.

The composite matting disrupts and displaces the timber mat market which, until now, has been the predominant player. NR estimates that they will save hundreds of thousands of trees when companies use their composite matting. Companies need to have a greater awareness of their environmental footprint, and this is one way of controlling the overall impact.

Power infrastructure and utility spending is expected to increase in the low double digits for the foreseeable future. Industrial Solutions is also much more profitable than the Fluids business and generates mid 30s EBITDA margins. This compares to their Fluids segment that rarely earns its cost of capital. Lastly, it allows NR to have exposure to a customer base that is more consistent and recurring with their spending.

We are investing in NR as a quality company that we believe is obscured by a poor performing asset. We believe Industrial Solutions is the future of NR offering recurring revenue, long term visibility and less cyclicality than the Fluid business. The industrial mat business is an asset where we see strong revenue and earnings growth for many years to come.

Top Detractors

The top detractors in Q3 2023 were Tecnoglass (TGLS) Akoustis Technologies, Inc. (AKTS).

Tecnoglass was the largest detractor to performance in the quarter. We think it is just having a breather after being a top contributor for much of the last year. Please see our deep dive report done in Q4 2022 for our thesis and detail on the company. Tecnoglass currently trades at only 8x earnings, with sales growth of 18% over the last five years and capacity to continue growing. They have a rock solid balance sheet at only .2x net debt to EBITDA. We think they can maintain growth even in a slowing housing market as they take share from higher cost competitors. We recently met with the CFO and came away confident in their ability to execute their expansion into the residential market.

Akoustis Technologies, Inc. (AKTS). AKTS is an emerging semiconductor company that has very interesting technology in the RF space, but ran into growing pains. Specifically, they have yet to receive funds from the Chip Act that would have propelled their growth by funding the buildout of their fab in New York state. This increased the likelihood they would need to raise money in the future. We have since sold out of this company

Top Contributors

The top contributors in Q3 2023 were Centrus Energy Corp. (LEU) and Talos Energy Inc. (TALO). LEU was by far our best performer in the quarter falling just shy of doubling. We did a deep dive on the stock in the Q1 2023 Micro Opportunities Update if you would like to learn more. The reason LEU performed so well was their announcements on progress in producing HALEU (High-Assay Low-Enriched Uranium)[1] and potential offtake agreements for the HALEU with some well financed companies. Towards the end of the quarter, the price of uranium started to skyrocket on fears that production would not meet demand.

The spot price of uranium is not very liquid so panic buying by utilities can move the price significantly. This in turn lifted the entire uranium space, which is already small compared to other commodity markets.

TALO was the second best outperformer in the quarter, benefitting from the price of oil moving higher due to Saudi Arabia cuts in production, the continued Russia Ukraine war, and no further drains from the SPR. We continue to see upside in the price of oil as long as these dynamics stay intact. Downside to this thesis could be a deal between the US and the Saudis that brings barrels back to the market or a more severe recession that hits demand hard.

Sales

In the quarter we sold four names: First Western Financial, Inc. (MYFW), Luxfer Holdings PLC (LXFR), Zevia PBC (ZVIA), and Akoustis Technologies, Inc. (AKTS).

We sold MYFW as ten-year interest rates began their upward trajectory, anticipating increased stress on the banking system and prompting us to reduce our exposure in that sector. The banks that remain in the portfolio, we believe, are more immune to rising interest rates and a little more defensive as they have more non-interest income and shorter duration securities.

LXFR was sold because we believe the company's long-term earnings per share goals are too aggressive in this environment and will need to be adjusted. There were no catalysts in the foreseeable future for them and we found a more interesting industrial in ASLE.

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[1] HALEU is uranium that has been enriched so that the concentration of the fissile isotope U-235 is between 5 and 20 percent of the mass of the fuel. This is higher than the 3 to 5 percent U-235 concentration, or "assay," of Low-Enriched Uranium that fuels the existing fleet of light water reactors. It is still far below the 90 percent assay used to make weapons or power the U.S. Navy's fleet of nuclear submarines and aircraft carriers. Just 750 grams of HALEU, or 3 TBSP, can meet the average American's energy needs for life.
https://www.centrusenergy.com/what-we-do/nuclear-fuel/high-assay-low-enriched-uranium/#whatishaleu

ZVIA had recent growing pains as an emerging carbonated soft drink company. We were and still are big fans of their new CEO who is turning around their operations, marketing and branding - a large task for any sized company. We thought it would take longer to reach profitability than management articulated and we were unsettled when the CFO left the company. We've stepped to the sidelines, but are continuing to follow the company's progress. Our sale of AKTS is discussed above.

Additions

In the quarter we added four names to the micro-cap strategy: AerSale Corporation (ASLE), Atomera Incorporated (ATOM), The Real Good Food Company, Inc. (RGF), and Newpark Resources, Inc. (NR)

AerSale Corporation (ASLE) provides aftermarket commercial aircraft, engines, and its parts to passenger and cargo airlines, leasing companies, original equipment manufacturers, and government and defense contractors. Not only will ASLE's core business benefit from an increase in air travel as it recovers from the pandemic but also from Boeing and Airbus returning to full production. This helps companies like ASLE with more retirement aircraft inventory to buy, refurbish, and sell. We are most excited about a potential new product called AerAware, which is an advanced flight vision system that enables pilots to see through low visibility conditions by presenting advanced imaging technology along with real-time aircraft primary flight systems data onto a head-wearable display. The total addressable market could be in the billions of dollars and save airlines millions of dollars in costs to divert planes to other airports.

Atomera Incorporated (ATOM) is a semiconductor materials and intellectual property licensing company focused on deploying its proprietary technology into the $450+ billion semiconductor industry. ATOM's Mears Silicon Technology ("MST") increases performance and power efficiency in semiconductors and can be implemented using equipment already deployed in semiconductor manufacturing facilities. In April 2023, STMicro (STM) became the first semiconductor company to sign a production agreement to implement ATOM's MST process into its fabs. The royalty opportunity at STM could approach $3.5 million on just 1% of STM's current revenue. We believe the STM opportunity will be greater than that, and that ATOM will be successful in signing additional production customers on the heels of STM, making the long-term opportunity tremendous for this capital light business model.

The Real Good Food Company, Inc. (RGF) was founded in 2016 as an innovative, high-growth, branded, health- and wellness-focused frozen food company. RGF sells "delicious and convenient comfort foods" designed to be high in protein, low in sugar, and made from gluten and grain-free ingredients. RGF offers options across breakfast, lunch, dinner, and snacking occasions. RGF is currently hitting an inflection point as it rolls out more products at Walmart, making them EBITDA positive in the second half of the year. The management team has a history of success and sold their previous company at a large profit. We think they will do it again.

Newpark Resources, Inc. (NR), see company deep dive above for more information about NR.

(Disclosures and chart showing strategy largest contributors and detractors on next page).

Micro Opportunities Strategy
Largest Contributors and Detractors – Q3 2023

5 Best - Absolute Contribution			
Ticker	Company	Average Weight	Contribution
LEU	Centrus Energy Corp. Class A	4.93%	268 bps
TALO	Talos Energy, Inc.	3.93%	55 bps
VECO	Veeco Instruments Inc.	5.35%	39 bps
PWP	Perella Weinberg Partners Class A	2.76%	36 bps
CCB	Coastal Financial Corporation	2.74%	20 bps
	5 Best Total	**19.71%**	**418 bps**

5 Worst - Absolute Contribution			
Ticker	Company	Average Weight	Contribution
TGLS	Tecnoglass Inc.	6.45%	-268 bps
AKTS	Akoustis Technologies, Inc.	1.32%	-158 bps
ANIK	Anika Therapeutics, Inc.	3.20%	-102 bps
ZVIA	Zevia PBC Class A	0.72%	-85 bps
IMXI	International Money Express, Inc.	2.37%	-82 bps
	5 Worst Total	**14.06%**	**-695 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.