

Q3 2023 SUSTAINABLE VALUE STRATEGY UPDATE

By Adam Peck

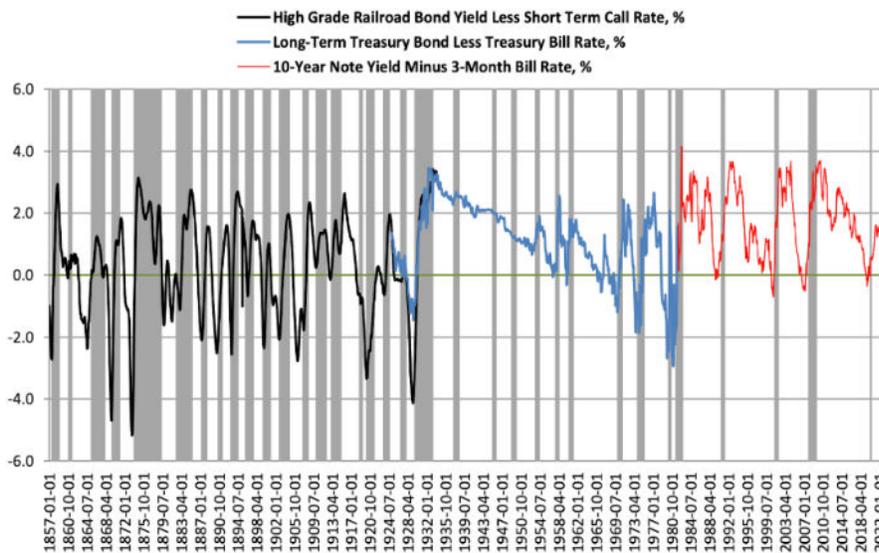
In Q3 2023, the Riverwater Sustainable Value Strategy outperformed its benchmark, the Russell 2500 Value Index. September lived up to its reputation as the worst month of the year for markets, with the Russell 2500 Value landing in the red for the quarter. August was a rough month as well. The combined two-month period was one of the ten worst for the Russell 2000 Index. The good news is that on average the top ten worst two month returns were followed by positive quarters 100% of the time with an average return of 7.8%.*

**Our friends at Furey Research Partners also analyzed years when the market was up through July and then negative in August and September. In those years the 4th quarter had an average return of 3.8% and was up 67% of the time.*

Macro Landscape

A plethora of factors likely contributed to the weak stock market this quarter. First and foremost was the Fed stating that short-term interest rates would be higher for longer at their last meeting. Add on additional factors like government shutdown fears, oil prices approaching \$100 a barrel, increasing strikes across multiple industries and a slowing global economy and it's not hard to find justification for the weakness.

While we spend the majority of our time looking for stocks that will outperform regardless of what the economy is doing, we do not ignore macro drivers. In fact, we pay particular attention to the yield curve, initial unemployment claims, and Leading Economic Indicators (LEI).



Source: Roth MKM

provided by Roth MKM, uses High Grade Railroad bonds in place of US Treasuries before

Inverted yield curves are indications of weakening economic trends. Above is a history of yield curves dating back over 150 years. The data,

the Great Depression. Of the 28 instances of inversions going back to 1857, we had recessions 27 times. This would suggest at a minimum that now is not a time to take excessive risk. We continue to focus on companies that earn their cost of capital, have strong balance sheets and positive fundamentals.

Strategy Additions

The **Carlyle Group (CG)** is a global investment firm with deep industry expertise deploying private capital across three business segments: Global Private Equity, Global Credit and Global Investment Solutions. CG is a classic value investment that trades at an absolute and relative low valuation to the market and its peers. A new CEO, Harvey Schwartz, joined the company this year with a background as COO of Goldman Sachs and a plan to improve operations. CG has trailed its peers in moving into faster growth markets, particularly credit and capital markets. This has hurt CG's margins over the last year, but we believe margins are bottoming and inflecting to improve over the coming year, closing the gap with peers. On the ESG front, CG has taken significant steps by becoming a signatory of the United Nations backed Principles for Responsible Investment (UNPRI) and has enhanced the integration of ESG within the investment teams and portfolio companies. This includes conducting ESG assessments included in most of CG's investment decisions, utilizing proprietary due diligence tools in the private equity and credit segments.

Evertec (EVTC) is a leading full-service transaction processing business in Puerto Rico, the Caribbean and Latin America, providing a broad range of merchant acquiring, payment services and business process management services. EVTC is a good example of what we look for in valuation and a superior business. EVTC trades at a low teens multiple to earnings and a high single digit free cash flow yield. Not only is it cheap relative to the market and its peers, but it can also produce a low twenties ROIC with plenty of opportunity for reinvestment in the business. The reason EVTC has a low multiple is its historically large focus on Puerto Rico (63% of sales now and already down from 80% last year). That is starting to change as EVTC invests in the higher growth areas of LATAM, which can grow in the high teens compared to mid single digits for Puerto Rico. EVTC is one of the more diverse companies we own with the leadership team having a gender breakdown of 47% female and 53% male, as well as 99% of the workforce and management team being ethnically Hispanic.

Modine Manufacturing (MOD) designs and manufactures thermal management products. Modine operates through two primary segments: Climate Solutions and Performance Technologies. The Climate Solutions segment provides climate-controlled solutions and components including heat transfer products, HVAC and refrigeration products along with data center cooling solutions. The Performance Technologies segment designs and manufactures air and liquid-cooled technology for vehicular, stationary power, and

industrial applications and provides thermal solutions to zero-emission and hybrid commercial vehicle and automotive customers. In December 2020, a new CEO was brought in and focused on "growth by shrinking," or a more concentrated portfolio. This is being done via their 80/20 plan, or the Pareto Principle, focusing on 80% revenue from 20% of their products. So far, this approach is bearing fruit and we think it will continue to do so. The company is still not recognized for what it has accomplished as we bought it at a low teens multiple of earnings.

Amdocs (DOX) is an industry-leading provider of enterprise software and managed services to Tier-1 and Tier-2 telecommunications carriers. Given the mission-critical nature of the DOX solution, it has a high customer retention rate and high recurring revenue. The TAM for DOX has grown to \$60B from \$30B because its customers can now monetize features that upgraded (5G, Cloud, Digitized) networks allow. This has enabled the company's revenue growth rate to go to 5-7% from 2-3% historically. Additionally, the company has long embedded best practice as it relates to material ESG factors. Trading at its historic average of 2.2x revenue and at the lower end of its historic P/E ratio, along with its defensive characteristics, we believe the stock has potential for above-market price appreciation with lower downside risk.

Amkor Technology, Inc. (AMKR) provides outsourced semiconductor packaging and test services, which include design, package characterization, test and wafer bumping services. The company is recognized as a key partner by its major semiconductor and OEM partners to serve the ever-changing and increasingly-complex nature of semiconductor production and packaging—particularly for emerging technologies such as AI. Its broad geographic footprint (only major player outside of China) and excellent workforce enable AMKR's customers to regionalize and optimize supply chains. AMKR trades at a significant discount to its semiconductor equipment peers, offering the potential for outperformance as it executes on its strategy and earns recognition from the market.

Stock Sales

We sold **StoneX (SNEX)** for a gain as we thought there was more opportunity in Carlyle. We sold **Valvoline (VVV)** for a gain as we felt the value was close to fully realized after the Dutch tender and separation of their two businesses. **Hannover (THG)** was sold as we wanted to take advantage of the tax loss and we feel increasingly uncomfortable with the heightened level of catastrophes impacting their business. Finally we sold **FMC (FMC)** for a gain after losing confidence in their ability to backfill their leading products which will come off patent in the near future. FMC was one of our original holdings when we started the strategy seven years ago.

Top and Bottom Contributors

Our top contributor was **CNX Resources (CNX)**. CNX is a natural gas producer based in Pittsburgh, PA, with acreage in the Marcellus Shale. CNX rallied along with the price of oil and to a lesser extent the price of natural gas.

We do not think the market has figured out yet that CNX has optimized the return on and return of capital.

CNX hedges the vast majority of their production no matter the going price. This creates more stable cash flows over time. In Q2 of this year, they posted their 14th consecutive quarter of FCF generation. With those cash flows, they have bought back their stock at what they (and we) believe are significantly undervalued levels. Over the last 11 quarters, they repurchased approximately 30% of their outstanding shares. The stock trades at about 9x free cash but it is still not favored on Wall Street with only two out of 15 analysts rating it a buy.

They are environmental leaders with the lowest methane intensity basin in the country and have goals to lower their intensity by over 50% from 2021 levels by 2024. They have active operations to reduce methane from other industries by capturing waste gas from nearby mining operations which captures far more methane than they emit from their gas activities.

Tecnoglass (TGLS) 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.

Company deep dive: LOPE

Grand Canyon Education, Inc. (LOPE) is an education services company dedicated to serving colleges and universities. LOPE has developed significant technological solutions, infrastructure, and operational processes to provide services to universities on a large scale. LOPE's most significant university partner is Grand Canyon University, the only broad based private university in Arizona.

LOPE meets our three-pillar process with a superior business, attractive valuation, and exceptional management. LOPE offers a more compelling value proposition to students based on tuition relative to other alternatives. LOPE has been able to maintain tuition levels at Grand Canyon University for the last 14 years at \$16,500 per year. With scholarships, the

average student spends only \$9,200 per year! Compare this to industry standard tuition rates with increased tuition on average of 12% per year since 2010, and 16% per year for private universities. The average annual tuition for private university is now up to \$39,400 this school year.¹

LOPE focuses on recruiting high quality students and boasts a high graduation rate relative to other universities. They have a strong brand as a Christian school (dry campus), with fantastic corporate partnerships, new facilities, relevant degrees for the current economy and an up-and-coming athletic department that drives students to the school. The Lopes Men's basketball team has made it to March Madness twice in the last three years. While winless heretofore, we believe a successful run will be a huge marketing boost for the brand. LOPE currently has a little over 25,000 students on campus and is aiming to enroll 50,000 in the future.

In 2018 LOPE acquired Orbis, a healthcare focused education provider focused on Nursing. Orbis has allowed LOPE to partner with other universities that serve a growing market with secular tailwinds from a need for more skilled nursing. Additional university partners would provide client diversification benefits and leverage LOPE's scale.

LOPE's superior business model has led to excellent financial numbers. Their returns on invested capital (ROIC) are close to 30%, which is even better than pre-pandemic levels of roughly 20%. Not only does LOPE have some of the best ROIC numbers in the industry, but it also trades at an attractive valuation. Sell side analysts currently have LOPE earning roughly \$7.50 in earnings in 2024 resulting in a P/E multiple of 16, a discount to its historical multiple and the market as well. However, during earnings growth cycles LOPE can trade at a P/E multiple greater than 20x. We believe they are entering a double-digit earnings growth period for the next few years that will warrant a much higher multiple given their superior returns on capital.

In the current macroeconomic backdrop LOPE is also attractive. In an environment with economic uncertainty, LOPE stands out for their earnings visibility, sticky customers, and long-term growth potential. This gives us confidence in holding the stock through turbulent times since we have confidence earnings will not decline based on the economic winds.

The seasoned management team at LOPE has been in place since 2008. It is almost unheard of to have a CEO, CFO and COO all be in the same seat for that long. We have known the team for over ten years and have made at least six visits to their campus over that time. We can see firsthand the more than \$2 billion dollars invested into the campus. They have a good track record of capital allocation!

¹ <https://educationdata.org/college-tuition-inflation-rate>

This can be seen by management consistently growing the company's sales at a ten-year CAGR of 6% and an EPS CAGR of 10%. They have also focused their entire tenure on LOPE's mission of supporting higher education for a broad spectrum of careers and access for all socioeconomic students.

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

A handwritten signature in blue ink, appearing to be the name 'Adam', with a stylized, wavy line extending to the right.

Adam

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

Sustainable Value Strategy
Largest Contributors and Detractors – Q3 2023

5 Best - Absolute Contribution			
Ticker	Company	Average Weight	Contribution
CNX	CNX Resources Corporation	4.52%	106 bps
WAL	Western Alliance Bancorp	3.91%	75 bps
LOPE	Grand Canyon Education, Inc.	3.86%	48 bps
CIEN	Ciena Corporation	3.56%	44 bps
MOD	Modine Manufacturing Company	1.43%	36 bps
5 Best Total		17.28%	309 bps

5 Worst - Absolute Contribution			
Ticker	Company	Average Weight	Contribution
TGLS	Tecnoglass Inc.	3.64%	-151 bps
IRDM	Iridium Communications Inc.	2.47%	-74 bps
CROX	Crocs, Inc.	3.08%	-65 bps
FMC	FMC Corporation	1.52%	-59 bps
SJM	J.M. Smucker Company	3.43%	-55 bps
5 Worst Total		14.14%	-404 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.