RIVERWATER PARTNERS

Introduction

The Sustainable Value Strategy outperformed its benchmark for the quarter and year-to-date period. (Click here for Q2 2024 Factsheet with detailed performance reports).

This positive performance comes despite a challenging quarter for small cap stocks, where only the utilities sector saw gains. The Federal Reserve's reluctance to cut rates and the limited exposure of small caps to the burgeoning Artificial Intelligence (AI) sector have presented headwinds.

While the anticipated reversal of small caps' underperformance relative to large caps did not materialize this quarter, we remain confident in the long-term potential for small caps to outperform. The current outperformance of the S&P 500, driven by AI and large-cap technology stocks, is largely due to the significant capital requirements for AI development, which has excluded smaller players.

Despite this, pockets of opportunity exist for small caps supplying AI hyperscalers in chip development and data center construction. We discuss our exposure to these areas below.

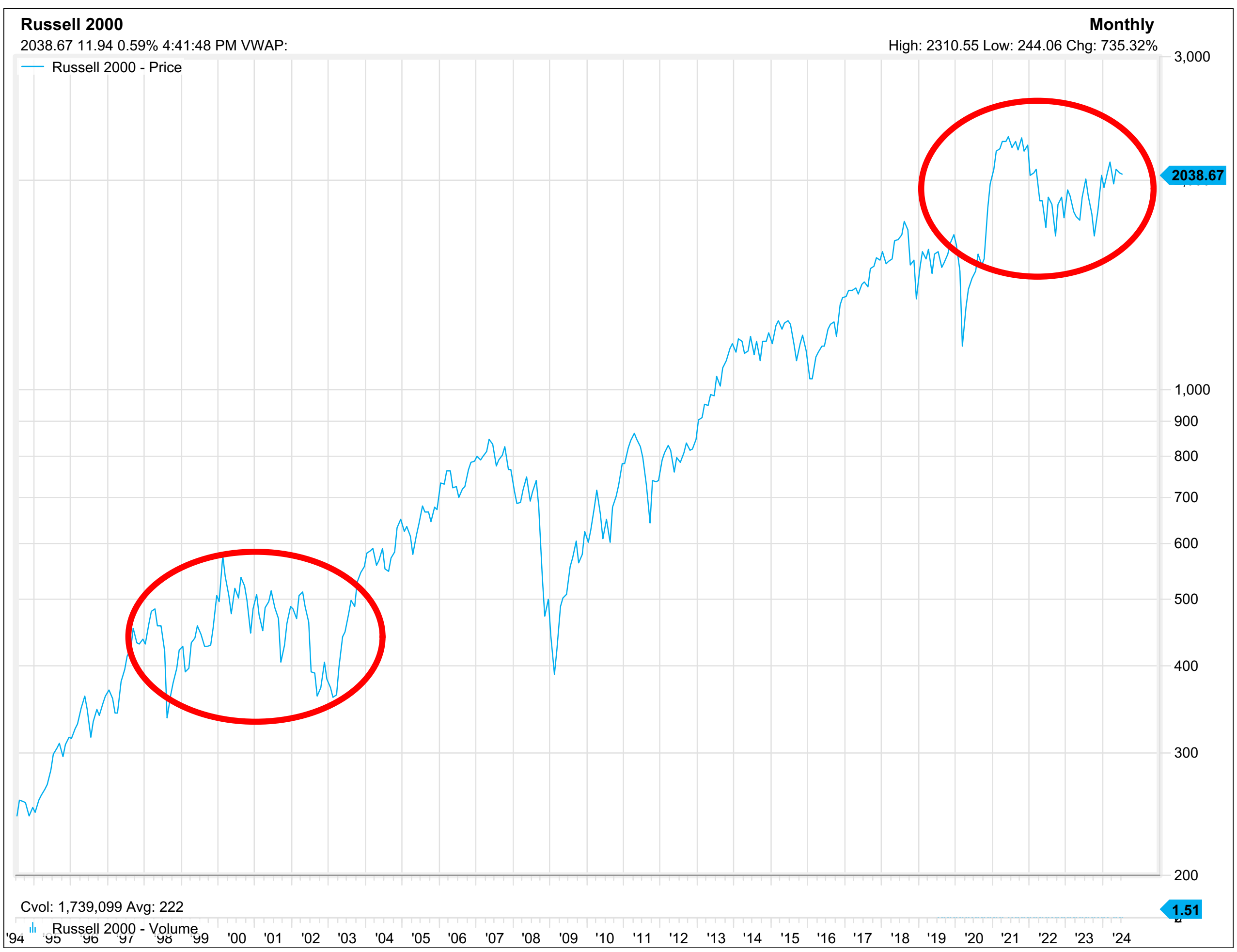

Chart source: Factset

The Russell 2000's stagnation since early 2021 marks the longest stretch of negative returns since the 1998-2003 period. Importantly, unlike the previous period, which included the tech bubble bursting, 9/11, and a recession, the current stagnation has occurred without a major economic shock. This unprecedented situation reinforces our belief that the relative underperformance of small caps is nearing its end, with potential for a multi-year bull market to follow. The chart below illustrates that the past period of subpar performance had been followed by a multi-year bull market.

Positioning

We believe the Sustainable Value Strategy is positioned for continued economic growth, with a significant focus on the industrial and technology sectors, which constitute nearly 40% of the strategy's weight. We are overweight these sectors relative to our benchmark, as they have been our top performers this year and we believe we are positioned to benefit significantly from the AI expansion.

We believe there is tremendous opportunity across all sectors to use AI to improve productivity and growth for companies. However, the rapid development and acceptance of AI have left most management teams unprepared to implement it effectively. In a recent survey by Adecco and Oxford Economics, 61% of C-suite executives said AI would be a “game changer,” but almost all of them admitted they were not in a position to take advantage of AI because their teams lacked the necessary skills and know-how.
We actively engage with management teams to assess their AI strategies and preparedness, often finding responses to be vague and echoing industry-wide concerns.

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Technologies (AMKR), Modine Manufacturing (MOD), and Veeco Instruments (VECO). These companies support either the creation of AI semiconductors (AMKR & VECO) or the maintenance of data centers that run AI (MOD). While none of these companies are exclusively tied to AI, they have benefited from the AI tailwind.

Portfolio Attribution

We aim to keep our sector weights aligned with our benchmarks, focusing on generating alpha by selecting the best stocks within each sector. This quarter, approximately 90% of our outperformance was driven by security selection. Given that 10 of the 11 sectors were down for the benchmark, this outcome aligns with our historical trend of outperforming in weak markets. We managed to achieve gains in 7 of 11 sectors, contributing to a positive allocation effect.

Our worst performer was Atkore Inc (ATKR). We conducted a deep dive on the company in our last quarterly letter and remain confident in the company's long-term prospects. The recent weakness is attributed to temporary setbacks in the solar sector due to a delayed ramp-up of a manufacturing facility and weakness in the HDPE market due to telecom-related business challenges. As detailed in our previous letter, we believe these issues are short-lived and trust management's assessment that both sectors will rebound in the new fiscal year starting this October.

Atkore has generated, on average, over $500 million in free cash flow each of the last three years, recently initiated a dividend and has been actively repurchasing significant amounts of stock at what we consider attractive levels. With minimal debt, solid growth prospects and a current valuation of 8x this year’s earnings and 7.2x management’s guidance for FY 2025 earnings, we remain confident in Atkore.

Veeco Instruments Inc (VECO) was the best-performing stock in the second quarter. It's challenging to find companies in the small-cap space that are leveraged to the AI phenomenon; however, VECO has emerged as a key supplier of the AI arms race, providing essential equipment for the production of AI chips and servers.

Veeco is an innovative manufacturer of semiconductor process equipment. In simple terms, VECO makes the machines that make the chips that go into everything. VECO traditionally specialized in equipment used to make memory and storage products (DRAM, hard disk drives, etc.), which tends to be a very cyclical business. Because of this, VECO historically traded at a discount to its peers. VECO's acquisition of Ultratech in 2017 brought laser annealing technology in-house, an important step in the manufacture of leading-edge semiconductors. New design wins at leading semiconductor fabs further solidified VECO's position as a vital supplier across the semiconductor manufacturing landscape. Its ability to produce leading-edge chips going into iPhones, wearables, AI servers (NVIDIA chips), etc. enabled VECO's business to grow through the memory downturn of 2021-22.

Today, the insatiable need for storage/retrieval of data used by AI servers has significantly increased the need for memory and storage, which is VECO's legacy business. Combined with VECO's recent entry into annealing and other leading-edge process steps, VECO has become an extremely important supplier to companies across the semiconductor manufacturing spectrum.

We first bought shares in late 2022 and added to the position in early 2023. We purchased at a low teens earnings multiple. While the multiple has expanded, it remains at a discount to the market and technology sector. We believe VECO's strong market position will drive sustained revenue, earnings, and share price growth in the long term.

Strategy Additions and Sales

This quarter, we did not initiate any new positions but added to our holdings in LPX (LPX), Amkor (AMKR), Amdocs (DOX), and Charles River (CRL). We sold our positions in Evertec (EVTC), New York Community Bank (NYCB), and Hudson Technologies (HDSN), each at a capital loss. These positions were relatively small, representing around 1% each of the portfolio, as we had not fully committed to them before losing confidence in their business outlooks.

While Hudson Technologies provided a weak outlook last quarter, we remain bullish on its long-term fundamentals. However, the sale was triggered by a 30% capital loss as the stock breached our downside limit. Despite this, we still see potential in the company and may consider re-entering this position in the future.

Company Deep Dive: Limoneira (LMNR)

Limoneira, a company with a rich history dating back to 1893, stands out not only for its longevity but also for its commitment to environmental stewardship and sustainable business practices. We believe the company's stock is significantly undervalued, with potential upside of 50-100%.

While the business itself might not seem exciting at first glance, its longevity and 15% market share in the US lemon industry—up from just 4% in 2011—speaks volumes about the quality of its operations. However, the primary reason for our enthusiasm is that the market has not appropriately valued their extensive holdings of land and water rights.

Limoneira has publicly stated that the value of their agricultural land and water rights is between $450-$550 million. Additionally, the sale of less productive agricultural land to developers, along with their development joint venture, is expected to be worth another $100-$150 million over the next six years. The company also holds close to $100 million in equity in their real estate JV, with $15 million of that expected to be distributed.

Considering these assets at fair value, Limoneira's total value could reach as much as $800 million. After subtracting debt, this translates to approximately $41 per share, significantly higher than the current market price of around $20.

To address the significant discount at which the company trades relative to its fair market value, the board of directors has engaged investment banker Stephens Inc. to explore strategic alternatives. We anticipate an announcement before year-end, as the company initiated this process last December. Even without a transaction, we see upside potential as the management team focuses on improving operations, monetizing non-core real estate assets, and enhancing cash flows.

As part of this effort, they have modernized their packing facility to transition from growing their own lemons to packaging and marketing lemons for third parties. While revenues remain the same, this transition aims to provide more stable and consistent cash flows.

Limoneira is also pivoting towards avocado production, a more profitable segment with growing demand in the United States. Over the past ten years, US avocado consumption has grown at a 4.4% CAGR, reaching 8.7 pounds per person annually. In comparison, avocado consumption in Mexico is 23.5 pounds per person per year! While it is unlikely that the US will reach Mexico's consumption rate in the near future, we believe that US avocado consumption will continue to increase.

The management team has outlined various operational initiatives that they believe could potentially improve cash flows by up to $30 million over the next seven years. If these improvements materialize, a 50% increase in cash flows within three years seems achievable, potentially translating to a 50% increase in stock value.

We also commend Limoneira's commitment to sustainability, with 44% of its operations now powered by renewable energy, up from over 30% the previous year. Additionally, the company uses high-efficiency irrigation systems for 85% of its water usage, conserving water and supporting sustainable agricultural practices.

Limoneira exemplifies the potential for a company to achieve both financial success and positive environmental impact. We believe the company's focus on renewable energy, efficient water use, and strong management make it a compelling long-term investment opportunity.

As always thank you for your trust and confidence and
questions.

Adam Peck
Founder & CIO

Sustainable Value Strategy
Largest Contributors and Detractors – Q2 2024

5 Best - Absolute Contribution			
Ticker	Company	Average Weight	Contribution
VECO	Veeco Instruments Inc.	4.57%	130 bps
AMKR	Amkor Technology, Inc.	2.16%	60 bps
LMNR	Limoneira Company	5.09%	36 bps
IDCC	InterDigital, Inc.	3.52%	35 bps
EVR	Evercore Inc. Class A	4.02%	34 bps
	5 Best Total	**19.36%**	**295 bps**

5 Worst - Absolute Contribution			
Ticker	Company	Average Weight	Contribution
ATKR	Atkore Inc	5.15%	-178 bps
CRL	Charles River Laboratories International	2.30%	-66 bps
CG	Carlyle Group Inc	2.31%	-37 bps
AGM	Federal Agricultural Mortgage Corp	4.60%	-35 bps
CFR	Cullen/Frost Bankers, Inc	2.28%	-21 bps
	5 Worst Total	**16.64%**	**-337 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 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.