Wasatch Micro Cap Growth—U.S. Strategy

JANUARY 31, 2023

January Was a Strong Month for Micro-Caps, as We Look Forward to Improved Margins for Consumer Holdings

OVERVIEW

During January, the Micro Cap Growth—U.S. strategy managed by Wasatch Global Investors for Qantas Superannuation Limited gained 9.18% and outperformed the benchmark Russell Microcap® Index, which rose 5.72%. These returns are denominated in Australian dollars. In U.S. dollars, the returns were higher due to gains in the Australian dollar vs. USD in January.

The strategy's primary sources of strength relative to the benchmark were stock selections in differentiated growth companies, which are currently outperforming. In addition, an overweight position in IT and consumer stocks also lifted returns.

We believe many firms will continue to face headwinds in the consumer space. Though many of the stocks remain depressed, we look forward to improving margins for companies as they move past the significant commodity chain cost pressures in recent years, coupled with problems in supply chain logistics. During the month, we bought more shares of **Chuy's Holdings, Inc. (CHUY)**—which specializes in enchiladas, fajitas, tacos, burritos and combination platters, complemented by a variety of appetizers, soups and salads as well as several homemade sauces. We also added to our stake in **Purple Innovation, Inc. (PRPL)**—a direct-to-consumer retailer of mattresses and bedding.

Many stocks are beginning to issue earnings reports for 2022. Yet, we're seeing some stocks rise even after the underlying company reports a negative result. We feel the reason may be that there's so much negativity already priced into stocks that investors are willing to buy on any hint of positivity.

DETAILS OF THE MONTH

Boot Barn Holdings, Inc. (BOOT) was the top contributor to strategy performance in January. We've recently added to our position in western and work wear retailer, anticipating improved margins for it and other consumer firms. The company's revenue levels have remained strong, even compared to Covid peaks when consumers put excess funds to work on buying goods, not services. Boot Barn, which sells boots,

jeans, shirts, hats and other products, is also benefiting from a consumer trend of wearing western wear spurred by the popularity of the television show Yellowstone. In addition, the company recently announced it expects sales in fiscal 2022 to double from the prior year, helped by the rollout of new stores and higher sales in existing locations.
BOOT: Boot Barn Holdings Inc Stock Price Quote - New York - Bloomberg
Boot Barn Holdings, Inc. Announces Third Quarter Fiscal Year 2023 Financial Results - Bloomberg

Helios Technologies, Inc. (HLIO), which develops and manufactures hydraulic and electronic control products., was another strong performer during the month. Helios benefited from solid demand for its products from the auto industry. Strong demand also lifted another of our holdings, **XPEL, Inc. (XPEL)**, a developer and producer of automotive protection products, including window and cut-to-fit protective film for the painted surfaces of automobiles.

Helios Technologies Inc - Company Profile and News - Bloomberg Markets
XPEL Inc - Company Profile and News - Bloomberg Markets

Heritage-Crystal Clean, Inc. (HCCI) also gained in January. HCCI provides parts cleaning and waste management services to the manufacturing and vehicle service sectors. Management continues making the right long-term strategic moves for the company. The company is also gaining market share in the growing field of vacuum trucking, which provides efficient, environmentally conscious removal and disposal of coolants, oily waters, sludges, and other contaminated water sources. The company is also involved in the expanding field of cleaning up and removing per- and poly-fluoroalkyl substances, known as PFAS, from water sources. Older PFAS are no longer manufactured in the U.S. because they have been linked to serious medical conditions and environmental harm. But because they have been used for decades and are resistant to degradation, they have appeared in the water supplies of major cities. The potential market for cleaning up PFAS could be in billions of dollars.
Heritage-Crystal Clean, Inc. and Battelle to Collaborate on PFAS Destruction for Wastewater | Business Wire

Paragon 28, Inc. (FNA) was one of the most significant detractors from results during January. Paragon is a medical device company offering products for foot and ankle ailments, such as fore-foot plating, hind-foot plating, medical screws, custom bone wedges, and other surgical instruments. Shares fell after the company announced a secondary offering late in the month. Though we had been reducing our holdings, we acquired more shares after the stock decline. The company previously announced that 2022 revenue was expected to rise 23% from the year earlier. As a result, we added to our position after the stock decline.
Paragon 28 Announces Preliminary Unaudited Revenue for Fourth Quarter and Full-Year 2022 - Bloomberg

Vintage Wine Estates Inc. (VWE) was a detractor from strategy performance in January. The wine producer has faced margin pressure because of supply chain issues in glass and declining sales for their core Layer Cake brand of wine. Though we have been trimming our stake, we still own some shares as we believe the management team is righting the ship, including updating the marketing and branding for their core Layer Cake wine. We feel the stock is currently undervalued, assuming management can get the economic model to where it should be, though that may take a few quarters.

OUTLOOK

We generally feel good about the portfolio’s current makeup, though we’re eager to receive data points from management through year-end earnings reports in the coming weeks. We remain overweight in IT, an industry where many firms have been focused on growth over profits over the past several years. With IT investors now looking for profitability, we believe more significant returns will come from the technology companies that will start showing profitability sooner than expected.

Rising interest rates are not a concern for our portfolio, as most of our holdings have higher-quality balance sheets and are positioned in growth markets that are not overly sensitive to rate fluctuations.

We attended the recent ICR conference of over 200 consumer-focused companies. Most firms are bracing for lower demand from consumers, though they carry the benefit of having increased prices coupled with lower prices for commodities and improved logistics. Even if revenues are pressured, firms should enjoy improved margins and free cash generation from selling down inventory. Still, if consumer demand falls sharply due to a recession and firms resort to deep promotions, we could see weaker results.

Still, the environment is improving for stock picking after three years of investors putting money into sectors instead of individual companies. As investors turn to individual stock performance, our differentiated ability to find superior stocks and businesses should allow us to find opportunities in good companies, regardless of the macro environment.

Thank you for the opportunity to manage your assets.