July 12, 2021

Dear Investors,

The Headwaters Capital portfolio returned +8.5% gross (+8.3% net) during Q2 21 compared to a +7.5% return for the Russell Mid Cap Index.

<table>
<thead>
<tr>
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<th>Q2 21</th>
<th>YTD '21</th>
<th>Since Inception 1/4/2021</th>
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</thead>
<tbody>
<tr>
<td>Headwaters Capital (Gross)</td>
<td>8.5%</td>
<td>9.4%</td>
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<tr>
<td>Headwaters Capital (Net)</td>
<td>8.3%</td>
<td>9.0%</td>
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<tr>
<td>Russell Mid Cap Index</td>
<td>7.5%</td>
<td>16.3%</td>
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*Note: Individual SMA performance may differ from the results presented above.

A brief discussion of the stocks that impacted performance is included below, along with an overview of the trading activity during the quarter.

**Portfolio Performance:**

**Top Contributor: Bentley Systems (BSY) +38%**. Bentley is the leading provider of computer-aided design (CAD) software for infrastructure engineers. BSY’s software is a critical tool for engineers during all phases of the infrastructure lifecycle beginning with design and construction and continuing post-construction with ongoing simulation and monitoring. BSY’s software is used for all types of infrastructure including roads, bridges, rail, utility (transmission and distribution, water, wastewater). BSY’s stock outperformed during the quarter as the company would be a beneficiary of Biden’s proposed infrastructure bill that is forecast to double federal spending on infrastructure over the next 5 years. Approximately 2/3rds of BSY’s revenues come from the public sector, so BSY is well positioned to benefit from these higher spending levels. BSY has also increased both the size and pace of acquisitions during the first 6 months of 2021, which has been viewed favorably by the market as these acquisitions provide complementary software solutions to BSY’s already comprehensive software platform.

**Top Detractor: Inspire Medical Systems (INSP) -7%**. Inspire’s underperformance during the quarter was largely driven by Q1 results where the company raised full year revenue guidance by less than expected combined with commentary that the company might increase spending, which would delay the company’s path to breakeven profitability. I believe management’s full year revenue guidance is conservative based on the cadence of new center openings combined with positive utilization trends seen during Q1. Additionally, following the release of Q1 results, Anthem (second largest health insurer) announced that they would begin providing insurance coverage for INSP’s sleep apnea product, which should provide additional support for revenue growth later in the year.

**Trading Activity**

**Sells:** I exited the position in Masimo (“MASI”) during the quarter. Masimo is the leader in SET pulse oximeters (device that is placed on your finger to measure oxygen levels) that are used in medical settings. The sell decision was driven by delayed new product roll-outs and slower uptake of new products that have been introduced. While I believe the core business for MASI will continue to perform well, I’m concerned that revenue growth from new products will be slower to materialize and could pressure the company’s premium valuation.

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1 The composite performance (“portfolio” or “strategy”) is calculated using the return of a representative portfolio invested in accordance with Headwaters Capital’s fully discretionary accounts under management opened and funded prior to January 1, 2021. The performance data was calculated on a total return basis, including reinvestments of dividends and interest, accrued income, and realized and unrealized gains or losses. The returns also reflect a deduction of advisory fees, commissions charged on transactions, and fees for related services.
Buys: Abcam, PLC (see below)

**Abcam, PLC ("ABCM"): The Amazon of Antibodies Matures into a Leader in Scientific Innovation**

**Summary Thesis**

1) **Antibody Innovation Supports Continued Market Share Gains**: Transition from third party antibody distributor to high quality antibody manufacturer improves competitive advantage of ABCM and supports continued market share gains.

2) **Product Mix Shift Drives Gross Margin Expansion**: Transition to in-house antibodies drives gross margin expansion as in-house products carry substantially higher gross margins than third party antibodies (85% versus 65%).

3) **Leverage of Recent Strategic Investments**: Recent investments to support in-house antibody development and commercial applications have severely depressed operating margins. Moderation of investment spend in 2022 combined with revenue growth will lead to operating margin expansion and progress toward 2024 operating margin goals.

4) **Prioritization of Capital Allocation for Growth**: ABCM cancelled its dividend in early 2020 and recently cross-listed into the US, evidence that the company is looking to be more aggressive with capital deployment for both organic and inorganic growth.

**Research Use Only Antibody Market**

Before diving into Abcam, it will be useful to provide an overview of research use only (RUO) antibodies, which currently account for 94% of ABCM’s sales. An antibody is a protein produced by the immune system when it detects a harmful substance, called an antigen. Each antibody binds to only one specific protein, which allows scientists to use antibodies as a detection tool for identifying, marking and measuring very specific targets.

![Antibodies Diagram](image)

**Source:** *Lumen: Polyclonal and Monoclonal Antibody Production*

Antibodies are a critical tool for future medical advancements given that protein identification is often one of the first steps in developing new drugs and therapies. Antibodies are differentiated by the specificity of the antibody, the robustness of the antibody and the repeatability of the antibody to bind to a target. Basically, a scientist wants to know that if he/she purchases an antibody, the product will correctly identify the target and only that target, can identify it in a measurable manner and can identify the target consistently in multiple experiments. Lower quality antibodies mean that an experiment may not work and can often lead to costly delays in research.
RUO antibodies are produced by injecting a lab animal with an antigen, harvesting the antibodies after they are produced by the animal's immune system, and then reproducing these antibodies in a lab. ABCM is specifically known for its recombinant antibody portfolio, which clones the gene sequence of different antibodies and does not require the use of lab animals. Recombinant antibodies are more specific and consistent than those produced in animals as the production of antibodies in animals can be subject to small genetic mutations over time. Recombinant antibodies have been ABCM’s fastest growing product line and, given the superior quality of these antibodies, are key to the company's planned expansion into diagnostic and clinical applications.

Abcam Company Overview

Abcam was founded in 1998 in Cambridge, UK with a goal of digitizing the purchasing process in the research use antibody market, which was previously a paper catalog industry. Over a number of years, ABCM developed the deepest online catalog of antibodies (100% third-party), introduced a robust digital marketing strategy and ensured reliable and fast delivery of its products, hence the title "Amazon of Antibodies." As the RUO antibody industry matured, ABCM’s competitors developed their own websites and improved their digital marketing efforts, which has eroded ABCM’s initial competitive advantage as the sole online supplier of RUO antibodies. Nonetheless, ABCM continues to be the industry leader in RUO antibodies as it possesses the largest catalog of antibodies (160k SKUs), a reputation for quality products and fast and reliable delivery times.

In response to more online competition, ABCM decided that it needed to evolve from being an online reseller of third-party antibodies to being a developer of its own in-house antibodies that could be differentiated in the marketplace. ABCM realized that the best way to differentiate its in-house portfolio of products was to produce the highest quality antibodies and then validate this quality through citations in academic work and scientific validation methods (knock-out validation/cell editing). Given that researchers often reference academic studies when selecting an antibody for an experiment, these citations serve as free advertising for ABCM products as this research validates the quality of ABCM’s products. ABCM actually provides links to these papers on its website as a way to encourage selection of its antibodies. As shown below, ABCM has steadily gained market share in research citations, which is a useful leading indicator for future revenue growth.

Abcam has a diverse customer base (750k customers), no customer concentration, and recurring revenues given that once an antibody is identified for a specific target, that antibody becomes the industry standard tool for that particular target. The chart below shows ABCM’s revenue disaggregated by year of catalog introduction and is a great illustration of the recurring and long-tail nature of ABCM’s revenues. As a competitor of ABCM’s explained, each new product grows for approximately 5 years following introduction and then becomes an annuity stream for the company.
In addition to the strategic decision to develop its own portfolio of antibodies, ABCM also made the decision to leverage its antibody expertise in the research market to begin offering clinical and diagnostic antibodies. The quality and consistency of ABCM’s recombinant antibody portfolio are particularly well-suited for these commercial applications where antibodies must be produced at scale and have increased regulatory oversight related to quality and consistency of the product. Examples of applications for ABCM’s antibodies in commercial agreements include diagnostic tests and antibody based therapeutic treatments. ABCM began investing in these commercial opportunities in 2013 and progress here has been slow given the emerging nature of many of these applications combined with the long timeline for FDA approval of novel diagnostic tests and therapeutics. ABCM currently has 20 FDA approved products that are being used by partners and has worked on over 2,000 specific projects since launching this initiative. Revenues from commercial applications only account for 6% of ABCM’s revenues and are inherently difficult to forecast. However, if a therapeutic or diagnostic tool is approved using one of ABCM’s antibodies, the revenue impact could be significant. Additionally, given that these commercial deals are often license agreements, the revenue would be highly accretive to profitability.

**Abcam Financial Profile: High Margin Annuity Streams**

Abcam has an ~20% market share in the core $1.5B RUO antibody market. Antibody tools and related reagents represent an additional $1.5B market opportunity where ABCM has a small, but growing share thanks to the introduction of its own immunoassays. The combined $3B antibody market has historically grown at a 4% CAGR, but industry growth is heavily dependent on academic funding trends.
Underpinning the long-term growth trajectory of the antibody market is continued growth in academic funding and advances in medical tools that have allowed researchers to interrogate cells at a deeper level and, consequently, identify more proteins that can be targeted by antibodies. ABCM has consistently grown faster than the market with a 9% organic revenue CAGR over the last 5 years compared to industry growth of 4%. Market share gains have been achieved through the introduction of new antibodies to its online catalog, increased industry adoption of recombinant antibodies and growing validation of ABCM’s products via research citations and scientific methods. Market share gains are expected to continue as ABCM continues to invest heavily to introduce new in-house antibodies that have been well received by the market.

In addition to consistent organic growth, ABCM has also been a steady acquirer with 13 acquisitions completed over the last decade. Most of these acquisitions have been small, tuck-in type deals that either add a technology capability or broaden ABCM’s product portfolio. More recently, the acquisitions of BrickBio and Expedeon have added conjugation tools, a complementary product to antibodies that identify antibodies with a color and allow for better measurement as part of the research process. Conjugation products should be an easy cross-sell for ABCM given that 80% of antibody customers use a conjugation agent with an antibody. I expect M&A to become an even more important part of the ABCM growth opportunity in the future. ABCM ceased paying a dividend in early 2020 and made the decision to cross-list into the US later in the year, which will allow broader access to equity financing from US investors. Both of these decisions indicate that the company is looking to retain and raise additional capital to capitalize on future growth opportunities.

ABCM’s product portfolio carries a high gross margin of ~70% that is forecast to expand as in-house products become a greater mix of sales. In-house products have gross margins in the mid 80% range compared to third-party products with gross margins in the mid-60% range. In-house products have grown to 50% of catalog sales compared to 28% in 2013 and will continue to outgrow third-party products, which supports additional gross margin expansion going forward.

In conjunction with ABCM’s revenue growth initiatives, the company has invested heavily in new IT systems, manufacturing capacity and people. As a result, ABCM’s operating margin has contracted significantly from 32% in FY ’18 to 13% in FY ’20. All of this margin compression was due to planned investments as operating expenses increased 65% over this 2-year period. ABCM laid out the rationale for these investments at its capital markets day in late 2019 and also illustrated the path back to a low 30’s operating margin once these investments were leveraged by FY ’24.
Critical to the original path back to low 30’s operating margins was investment spend moderating beginning in 2022 and revenue growth to leverage this spend. Investment spend is still expected to moderate next year; however, investment spend has trended slightly higher than originally expected leading to lower margins than forecast. Exacerbating the margin compression was the closure of academic labs due to COVID, which negatively impacted revenue and resulted in more significant margin pressure than originally expected in 2020 (note revenues were still flat in 2020, highlighting the durability of ABCM’s revenues). Consequently, ABCM lowered the low end of its revenue target and extended the timing of achieving this target by 6 months to CY ’24.

ABCM should be able to reach the middle of this revenue range (£450mm) by CY ’24 as increased research funding, market share gains and small tuck-in acquisitions are supportive of a 13% revenue CAGR. Due to the aforementioned investment spend and delayed revenue growth due to COVID, reaching the low 30’s operating margin target by 2024 will likely be difficult. However, gross margin expansion from a greater mix of in-house products combined with a moderation in operating expense growth should support an operating margin of 26% in 2024 with a path to 30% beyond 2024. Assuming a 20x EBITDA multiple for this business (M&A multiples supportive, strategic asset), ABCM can compound our capital a 12% CAGR over the next 4 years. Importantly, this is a very achievable base case with the potential for even greater returns if any of ABCM’s commercial products see broad adoption, which would likely support revenue at the high end of management’s guidance and operating
margins in the low 30's. As I mentioned earlier, forecasting commercial revenue is very difficult, but I don't believe success from any of these commercial opportunities are currently factored into ABCM's valuation.

Summary

ABCM has a diverse portfolio of critical RUO antibodies that generate a high margin, annuity like stream of revenue for the company. ABCM has evolved from a pure online distributor of third-party antibodies to a leading developer of in-house antibodies, which has supported steady market share gains for the company. ABCM’s own portfolio of high-quality antibodies not only cements its ongoing leadership in the RUO antibody market, but has also opened the door to commercial applications for its products. Recent investments to support the long-term growth profile of the company have severely depressed operating margins, but I believe 2022 will be an inflection point where ABCM demonstrates that it can begin making progress on its 2024 revenue and margin targets.

As always, feel free to contact me if you have any questions about your portfolio.

Sincerely,

Christopher Godfrey
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Investing in small- and mid-size companies can involve risks such as less publicly available information than larger companies, volatility, and less liquidity. Investing in a more limited number of issuers and sectors can be subject to greater market fluctuation. Portfolios that concentrate investments in a certain sector may be subject to greater risk than portfolios that invest more broadly, as companies in that sector may share common characteristics and may react similarly to market developments or other factors affecting their values.

Past performance does not guarantee future results.