HEADWATERS CAPITAL

October 8, 2021

Dear Investors,

The Headwaters Capital portfolio returned +3.0% gross (2.8% net) versus a -0.9% decline for the Russell Mid Cap index in Q3 2021. A brief discussion of the stocks that impacted performance is included below, along with an overview of the trading activity during the quarter.

	Q3 '21	YTD '21	Since Inception (1/4/2021)
Headwaters Capital (Gross)	3.0%	12.6%	12.6%
Headwaters Capital (Net)	2.8%	12.0%	12.0%
Russell Mid Cap Index	-0.9%	15.2%	15.2%

**Performance for the Headwaters Capital portfolio has been calculated by Liccar Fund Services for the period presented above.*
***Individual SMA performance may differ from the results presented above.*

Portfolio Performance:

Top Contributor: SPS Commerce (SPSC) +62% SPS Commerce is a provider of supply chain software called electronic data interchange (EDI) that is used by suppliers of large retailers (Costco, Walmart, Bass Pro Shops, etc). SPSC's software helps to automate and streamline the order fulfillment process for retailers and their suppliers by enabling the exchange of real time information between the two parties, which allows for better inventory management and more efficient shipping (drop-ship v. direct to store). SPSC is a beneficiary of the trend toward omnichannel retail where customers expect multiple order fulfillment options (in-store, delivery, buy online pick up in store) and more complex supply chains as both trends require increased collaboration between the retailer and their suppliers. In conjunction with Q2 results, SPSC raised its long-term revenue guidance forecast, which was well received by the market given lingering concerns that customers had temporarily adopted SPSC's software during COVID to enable drop-shipping. In reality, SPSC's software is a sticky product that streamlines the fulfillment process and will be increasingly used throughout the omnichannel retail supply chain.

Top Detractor: Fair Isaac Corporation (FICO) -21%. FICO declined during the quarter due to concerns that the FICO score will play an increasingly smaller role in the consumer credit ecosystem. Comments from multiple press outlets as well as upstart lending platforms implied that consumer lenders are moving away from using the FICO score as part of their credit decisioning process. However, I believe much of this narrative is either misunderstood or was already known by the market. The rapid adoption of buy now pay later (BNPL) payment options, which don't require the use of a credit score, have added further fuel to the narrative of the FICO score's obsolescence. I believe BNPL is actually expanding credit access as opposed to taking share from credit cards, but this remains to be seen. A third concern is pending decisions from the FHFA which could allow the use of alternative credit scores for GSE backed mortgages. While all three of these items are clearly an overhang for the stock, I continue to believe the FICO score will remain the dominant credit score for the consumer lending ecosystem. As noted in previous letters, the FICO score represents a consistent, independent and low-cost score that all industry participants (consumers/lenders/regulators) can utilize. Furthermore, the FICO score is deeply embedded into the consumer lending ecosystem, creating high switching costs for migrating to an alternative score with minimal (if any) benefits.

[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.

www.headwaterscapmgmt.com • cg@headwatersmgmt.com
Tel: 404-285-0829

Trading Activity

Sells: The LendingTree ("TREE") sell decision was driven by a number of concerning trends that have materialized in 2021. Data from TREE's customers and competitors suggests that TREE is losing market share in the lead-generation space for consumer financial products. TREE's entrance into new industry verticals (Medicare) combined with management turnover provide further evidence that the company is struggling in an increasingly competitive environment. Revenue pressure from softening mortgage refinance volumes and declining advertising budgets from auto insurers are also likely to be headwinds for TREE in the near-term. The summation of these developments led to the decision to exit the position.

Buys: Transcat ("TRNS"). See below.

Transcat ("TRNS") – Behind the Scenes Enabler of Instrument Precision

Summary Thesis

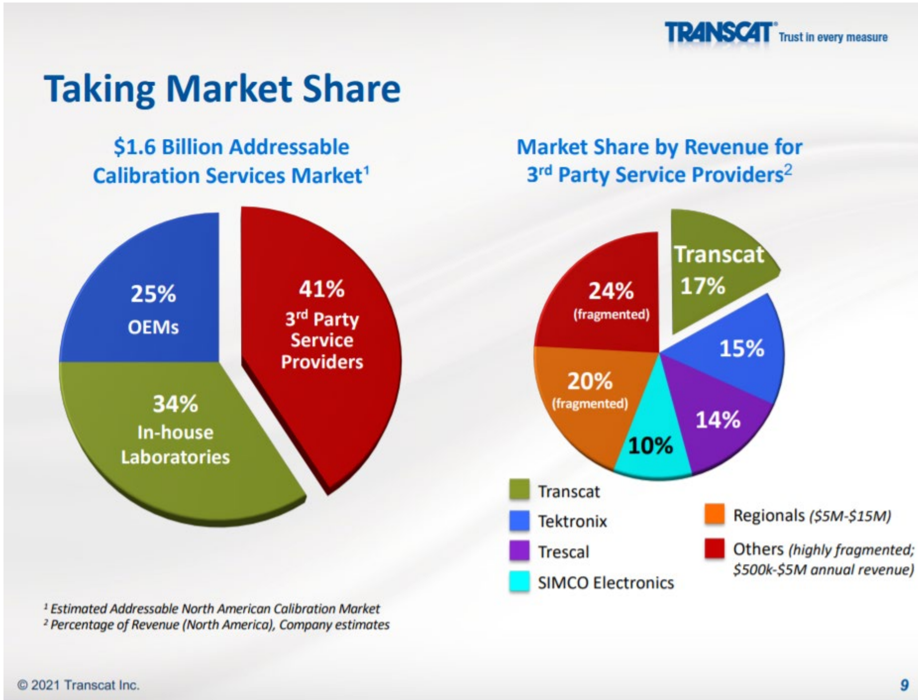
1) Recurring service revenue from regulatory mandated instrument calibrations. Market growth in the mid-single digits combined with market share gains support high single digit organic revenue growth.
2) Preferred industry acquirer with ample M&A opportunities and financial capacity for transactions leads to double digit total revenue growth.
3) Margin expansion via software enabled productivity improvement.
4) Management experience in the industry.

Company Overview

Transcat ("TRNS") provides accredited inspection and calibration services for test and measurement instruments primarily in the life sciences and industrial industries. TRNS serves clients in industries where instrument inspection is highly regulated by governing bodies (e.g. FDA, FAA) and where the cost of equipment failure is high. Calibration and testing services generally encompass temperature, pressure, flow and electrical variables of the equipment and instruments used in the manufacturing processes of their clients. As an example, consider an instrument that is used as a measurement tool in the pharmaceutical manufacturing process. The FDA requires high precision from this instrument and, as such, requires that the instrument be tested for precision at regular intervals (typically ranges from 3 -24 months). This creates a steady stream of regulatory mandated recurring service revenue for TRNS. In addition to inspection and calibration services, TRNS is also a distributor of testing equipment. The distribution segment serves as a valuable lead generation pipeline for future service revenue, but is unlikely to be a growth vector for TRNS as the company is solely focused on growing higher margin service revenues. Representative customers include Merck, Johnson & Johnson and Parker Hannafin.

Small, Niche Industry Limits Competition & Supports Organic Growth

Unlike many of the industries in which Headwaters Capital portfolio companies operate, the market size for instrument testing services is relatively small. TRNS estimates that the total addressable market (TAM) for instrument testing services is only $1.6B and grows annually at a mid-single digit rate. TRNS is the market leader with only 7% market share, which highlights the fragmented nature of the industry. TRNS made the decision a number of years ago to focus primarily on the life sciences industry (pharma, med devices) as most of its competitiors were focused on the aerospace and defense and industrial end markets.



Source: Transcat Investor Presentation (9/13/2021)

In addition to the small TAM, another barrier to entry is the high level of regulatory scrutiny of calibration services, which requires services to be performed by certified technicians with a high level of industry expertise. The majority of Transcat's services are accredited by internationally recognized oversight organizations, which ensures that TRNS' services meet the highest quality standards. The relatively small TAM for equipment calibration services combined with the broad expertise required to service this niche market actually creates a moat around Transcat's business as this market tends to fly under the radar of larger companies. Tektronix, the second largest player in the industry is a perfect example of this dynamic. Tektronik operates as a small segment of publicly traded Fortiv ("FTV"). FTV has focused on growing other parts of its portfolio and, as a result, has seen its market share of instrument testing services decline from 22% in 2013 to 15% currently. Additionally, there have been no new entrants of any meaningful size in the market over the last 10 years.

Despite the relatively small market size, industry dynamics are supportive of a dominant service provider as the business requires scale in the form of geographic coverage and breadth of instrument expertise to serve many of the larger equipment clients. Transcat's singular focus on the instrument testing industry, national footprint and diverse equipment expertise positions the company well to become this scale service provider by taking market share from both in-house laboratories and other 3rd party providers. In-house laboratories have gradually ceded market share for years as they realize that equipment testing is not a core competency and that this service is better performed by an outsourced provider with broad instrument expertise. Transcat has capitalized on this outsourcing trend by organically growing its portfolio of outsourced lab work to 20 labs compared to none 5 years ago. COVID has put a temporary pause on the outsourcing trend given that companies are hesitant to allow outside contractors into facilities. As COVID subsides, management expects renewed growth from laboratory outsourcing.

Industry Roll-Up Opportunity: Transcat is the Advantaged Consolidator

As discussed above, scale is an advantage in this industry given that a broad geographic footprint and breadth of equipment expertise can be a key differentiator in the market. Given the benefits of scale, the market is well suited for consolidation as the current fragmented market consists of a number of companies that only offer local or single service offerings. In an effort to deliver a more comprehensive service offering, Transcat has been an active acquirer of these smaller assets to fill in testing or geographic gaps in the company's portfolio. Acquisitions are easily integrated into the Transcat portfolio and management noted that there are usually technician efficiency improvements and other cost initiatives that can ultimately improve the profitability of the acquired companies.

TRNS has seen little competition for acquisitions from 3rd party competitors or private equity, which provides an opportunity for the company to be the preferred acquirer in the industry. As noted above, Tektronik has been less focused on the instrument service market and is not active in the M&A market. Trescal was previously an active consolidator of the market (primarily internationally), but has since retreated following its purchase by the Ontario Municipal Pension fund in 2017. Given the scale required to operate in this industry, competition from private equity is also limited as these players are less likely to invest the time and money necessary to build a platform company that will ultimately serve such a small market. With minimal competition for these assets, TRNS can acquire companies at attractive valuation multiples, generally in the 6-10x EBITDA range.

Management has been vocal about increasing its focus on acquisitions going forward. As evidence of this strategic focus, the company recently hired a new head of business development and a CFO with M&A expertise. From a financial perspective, the company doubled the capacity of its revolver in July and has room to take on more debt given a current leverage ratio of 1.0x versus a maximum targeted ratio of 3.0x. Interestingly, management recently noted the potential to expand into adjacent industries with similar regulatory and high cost of failure dynamics, which could expand the M&A opportunity set.

Software-Enabled Margin Expansion

In addition to strong top line growth, Transcat has further room for margin expansion via technician productivity improvements. Key to the margin expansion will be the rollout of automated testing and calibration software that the company acquired in 2019. TRNS has spent the last 3 years developing and testing the automation software to validate it for commercial use. The company plans to begin utilizing this automation technology in 2022 and currently believes that 35% of its portfolio can be calibrated via automated software. By automating calibration services, TRNS enables its technicians to more efficiently service instruments, which improves the productivity and increases the capacity of each technician. The benefit of this technician productivity improvement is twofold. First, it should enable technicians to handle more volume per day, which will lead to higher margins for the company. Additionally, increased technician capacity should also lead to an acceleration of revenue growth as management has noted that the biggest governor on organic revenue growth is the availability and capacity of trained technicians.

TRNS has additional margin expansion opportunities from continued technician productivity initiatives that have been a focus of the company for the last 3 years. M&A will also be margin accretive to the extent that the acquisitions bring services that were previously outsourced, in-house.

Management Expertise

CEO Lee Rudow has been involved in the equipment testing industry for over 30 years. Mr. Rudow started his career as the founder and CEO of Davis Inotek, which was sold to Danaher in 2008 and later spun out as the Tektronix division (discussed above) of Fortiv. Following the sale of Davis Inotek, Mr. Rudow was the COO of SIMCO, another large competitor of Transcat's. Mr. Rudow joined Transcat in 2011 and was promoted to CEO in 2013. He has been the driving force behind the decision to concentrate on serving on the life sciences industry and to focus the company on its services segment as opposed to the distribution segment. Mr. Rudow's industry experience and expertise not only serves him well to lead TRNS, but should also benefit the company via unique M&A opportunities given his connections in this small industry.

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Investment Summary

TRNS is well positioned to take market share in the instrument calibration market through organic growth and the roll-up of smaller competitiors. High single digit organic revenue growth is achievable through a combination of market growth from its life sciences and industrial customers and market share gains. Visibility into this revenue growth is high given the regulatory mandated nature of Transcat's services combined with the secular growth from the end markets which TRNS serves. Organic growth will be supplemented with a steady stream of acquired revenue from companies that seamlessly fit into the Transcat portfolio. Margin expansion on top of this revenue growth supports projected annual EBITDA growth of 15%. TRNS has minimal CAPEX needs, which leads to strong FCF generation that can be used to fund its growing M&A pipeline. With net debt currently at ~1.0x EBITDA, the company has debt capacity to fund larger transactions if it chooses.

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

Sincerely,

Christopher Godfrey

www.headwaterscapmgmt.com • cg@headwatersmgmt.com
Tel: 404-285-0829

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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.

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Past performance does not guarantee future results.