HEADWATERS
CAPITAL

February 2, 2022

Dear Investors,

The Headwaters Capital portfolio returned +4.7% gross (4.5% net) compared to a +6.4% gain for the Russell Mid Cap index in Q4 2021. A brief discussion of the stocks that impacted performance is included below, along with an overview of the trading activity during the quarter.

	Q1 '21	Q2 '21	Q3 '21	Q4 '21	2021	Since Inception (1/4/2021)
Headwaters Capital (Gross)	0.8%	8.6%	3.0%	4.7%	17.9%	17.9%
Headwaters Capital (Net)	0.6%	8.4%	2.8%	4.5%	17.1%	17.1%
Russell Mid Cap Index	8.1%	7.5%	-0.9%	6.4%	22.6%	22.6%

**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.*

2021 Performance Review

I am pleased with the +17.9% total return for the HCM portfolio in 2021, a year when overall market returns masked significant divergences in performance for companies underlying the broader market indices (see appendix for more detail). After trailing the Russell Mid Cap index by 7.4% in Q1 '21 due to the historic divergence in performance between value and growth (discussed in detail in the Q1 letter), the portfolio outperformed the same index by 3.7% for the remainder of the year.

The HCM portfolio is designed to be an all-weather portfolio that can perform in any market environment, ultimately delivering attractive returns through a cycle. Despite a preference by the market in 2021 for the current hot themes of inflation and commodities, I believe it is best to avoid chasing these themes since they do not fit within the investment framework of the portfolio (sustainable, long-term earnings growth). In fact, the performance of the portfolio over the last 9 months of the year demonstrates that owning a concentrated portfolio of quality businesses can outperform the market even when this "investment style" is out of favor. More importantly, the earnings growth delivered by the companies in the HCM portfolio are more durable than the cyclical earnings generated by the market leaders of 2021, which will allow the HCM portfolio to compound the returns generated in 2021 for years to come (and do so in a tax efficient manner). While I certainly would prefer to outperform the market every year, sometimes it is equally as important to minimize potential long-term damage to client capital that can be caused by chasing short-term performance.

Q4 '21 Portfolio Review:

Top Contributor: Transcat ("TRNS") +43%. Transcat, which was added to the portfolio during Q3 '21, was the biggest contributor to portfolio performance during Q4. TRNS announced earnings that exceeded expectations during the quarter, primarily in the ervice segment where revenue and margins continue to demonstrate strong trends. Management also provided upbeat commentary surrounding potential growth from larger lab customers, which have paused all outsourcing activity since the onset of COVID.

[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.

Top Detractor: Bentley Systems ("BSY") -20%. Bentley, which was the top performer in Q2 '21, sold off in conjunction with the broader sell-off in high growth and high multiple software names. Unlike some of the other software names that declined during the quarter, BSY has a history of generating strong free cash flow, has a strong competitive moat around its software and has good visibility into both near-term and long-term revenue growth. More specific to BSY, the company announced an acquisition of a smaller company for a lofty multiple, which also pressured the stock.

Trading Activity

Sells: Cardlytics ("CDLX"). The CDLX position was sold during the quarter as it had become an opportunity cost in the portfolio. CDLX was a small position at the beginning of the year and has subsequently underperformed throughout the year due to a couple of poor strategic acquisitions along with a depressed spending environment from its customer base. The acquisitions were particularly concerning given that the company has not articulated a clear strategic rationale for the deals and have delayed the company's path to profitability given that both of the acquired companies are generating losses. Given the small size of the position and the need for capital for more attractive investment opportunities, the entire CDLX position was sold during the quarter.

Buys: Cerence ("CRNC"). See below. Note that this was a small position at the beginning of the year due to concern around auto production issues and the unknown duration of these delays. Share price weakness during Q4 as a result of continued auto production delays provided an opportunity to add to the position.

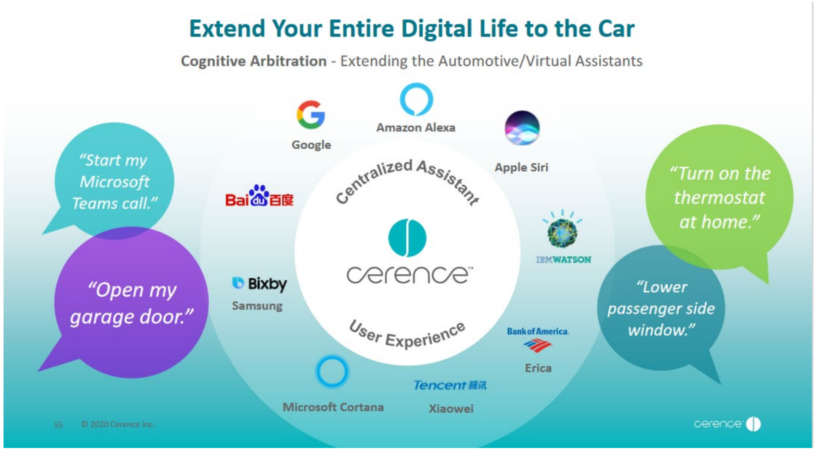
Cerence ("CRNC") – The Switzerland Technology Platform Driving Digital Penetration in Autos

Summary Thesis

1) Industry leading voice recognition technology combined with auto OEM integration expertise. Cerence's software is highly flexible and customizable and owned by each auto OEM, which serves to differentiate Cerence's technology from big tech competition.
2) Increased voice assistant penetration and cross-selling of new internet connected services drives sustained revenue growth through both volume growth and ARPU uplift.
3) TAM expansion through entrance into adjacent mobility markets provides additional revenue growth optionality.
4) High visibility into future revenue given OEM design wins take multiple years to reach start of production.
5) High margin license business with minimal CAPEX requirements drives strong FCF conversion that is set to inflect higher beginning in FY '22.

Company Overview

Cerence is a developer of software that powers voice commands and internet enabled services in automotive vehicles. Cerence is best known as the white label solution behind voice assistants in autos via its industry leading speech recognition and natural language understanding technology ("Hey Mercedes… turn up the volume"). The voice assistant software operates on an edge network inside the vehicle, meaning that the software can run without an external connection to the internet. The Company is increasingly developing similar voice services that rely on cloud-connections to deliver an enhanced consumer experience in the vehicle. Examples of the cloud-connected services include Cerence Pay, which delivers voice-enabled payments in the car, and Smart Home Connectivity, which enables drivers to control a multitude of home devices. Cerence has relationships with all of the major global auto OEMs.



Cerence Analyst Day Presentation (2-18-20)

Cerence originally operated as a division of Nuance Communications, but was spun out in 2019 as Nuance recognized the limited synergies between the auto and healthcare end markets. The spin allowed Cerence dedicated capital and resources to serve an auto OEM market that requires deep integration and customization.

Technology Lead in Auto Connected Services

Consumers have increasingly grown comfortable with voice assistants in their daily lives and have also come to expect continuous connectivity to all aspects of their digital lives. Despite these trends in the consumer electronic market, the auto market has been slower to adopt these services given a more complex environment for deploying these solutions. However, OEMs are increasingly viewing voice enabled services and increased digital connectivity as key differentiators in the marketplace. As such, penetration of connected vehicles continues to increase as these services not only enhance the driver experience, but also enhance safety as they facilitate improved driver focus and minimize distracted driving.

Voice enabled services in vehicles require a higher level of technical expertise than home digital assistants (Alexa, Siri, Google) given the presence of more ambient noise that can interfere with speech recognition. Cerence, through its speech signal enhancement technology that neutralizes ambient noise, is the leader in speech recognition technology for the auto market and can offer this technology in over 70 languages. In addition to this industry leading voice recognition technology, voice assistants also require extensive connections to over 200 sensors in the car to actually enable the voice commands. This complex ecosystem of connectivity that requires deep collaboration with both OEMs and Tier 1 suppliers demonstrates why Cerence is better positioned as an independent company that can dedicate all of its resources to this complicated end market. As a result of Cerence's superior voice recognition technology and automotive expertise, Cerence currently commands ~80% market share of the voice enabled market. Cerence faces minor competition from two niche players, iFlytek (China) and SoundHound (US), but remains the clear *global* leader in the third-party voice enabled market.

With its lead in voice recognition technology cemented and the market approaching saturation in the next 5 years, Cerence has recently introduced complementary technologies to the core voice assistant software in the form of cloud connected services. Cerence has taken advantage of improvements in computing power and internet connectivity to enable cloud connected services in the car. Examples of new services include voice enabled payments (Cerence Pay), Tour Guide and Home Services. These services are typically purchased by the OEM for an initial term (e.g. 5 years) and can be renewed by the owner upon expiration of the contract.

Cerence is also expanding into adjacent mobility markets and has identified 2-wheel vehicles, elevators, farm equipment, school buses and cruise ships as potential new markets. While details on these adjacent markets were limited at the Company's 2020 investor day, CRNC provided an update on its Q3 and Q4 2021 calls that it has won new contracts in both the 2-wheel and elevator markets as well as an unidentified third market. These new contract wins will begin contributing to revenue in 2022.

The auto market is still in the early phase of enabling connected services and mobility markets outside of automotive have yet to adopt many of these same services. The runway for both new services and even new modalities (facial recognition, gesture recognition, etc) is long and presents sustainable new growth opportunities for Cerence beyond management's 2024 long-term guidance.

Big Tech Competition

Despite Cerence's dominance in the auto market, there is a pervasive threat from Amazon, Apple and Google who already have ubiquitous products in the consumer digital assistant landscape. Consumers have broadly adopted these brands as part of their daily lives and big tech is increasingly looking to penetrate the automotive market. While big tech's desire to enter the auto market appears to be an inevitable competitive threat, Cerence's role as a neutral, third-party platform acts as a moat against these large tech companies, who are increasingly viewed as competitors by the OEMs given their broader auto ambitions. OEMs are hesitant to allow the fox (tech companies) into the hen house (OEMs) in the near-term for two reasons. First, OEMs want to control the consumer experience in the car and ensure that consumers have brand loyalty to the OEM and not the technology solution ("Hey Mercedes," not "Hey Google"). Second, by allowing big tech to run the operational layer, OEMs cede control of the valuable data collected by the platform. The quote below from Cerence's OEM partner, Mercedes-Benz, is a good example of the mindset for OEMs toward big tech platforms:

> "Our device is the car. Our platform, you can also say the operating system, is MBUX. And on top of that, we built our own voice assistant, Hey Mercedes! So if you compare that to the industry view - let's take a tech giant, let's take Apple. The device is the iPhone, the platform is iOS and the system is Siri. We see it exactly the same way. And this shows to you that we have our own strategy here, means we are not looking for third-party solution or an out-of-the-box solution. **We develop our own ecosystem, our own system here, and we need it customized and being a perfect fit for our brand and our portfolio."** - Cerence Investor Day (2-18-20)

Even if OEMs were comfortable with the competitive threat from the big tech players, it is unclear that the tech companies are well suited to serve as a single, global platform for vehicles across the world. Cerence uses the example that while Apple's Siri and Amazon's Alexa are well known domestically, these companies do not have the same brand appeal globally that would enable an OEM to utilize them as the single digital platform across an entire portfolio of vehicles. Even domestically, US drivers have different preferences between the big 3 tech platforms, which discourages OEMs from tying themselves to a single digital platform.

Whereas tech companies are competitors to the OEMs, Cerence plays the role of Switzerland as a neutral partner enabling OEMs to have maximum customization, ownership and flexibility of the voice interface. Cerence provides OEMs a high level of customization that helps preserve and enhance the OEM brand as part of the car experience. Furthermore, through utilization of Cerence's technology, all of the data gathered by the platform is owned by the OEMs, which would not be the case if the OEMs utilized a big tech platform. On top of the customization and data ownership benefits, Cerence's technology can also co-exist with almost any other third-party application (Amazon Music, Spotify, Google Maps, etc), which effectively makes the operating system open architecture.

Summary Thesis

Cerence serves as the key enabler of growing technology adoption in vehicles through its industry leading voice recognition technology and growing portfolio of connected services. Recent connected services design wins represent the beginning of a secular trend toward more connected services in not only automotive markets, but also adjacent mobility markets. The Company's role as a neutral third-party supplier of software that is owned and customized by its OEM partners creates a defensible competitive advantage that protects the company from similar big tech offerings. CRNC's close relationship with OEMs combined with the lag time from design win to production provides CRNC with a highly visible backlog of revenues for many years into the future. Outside of its core automotive market, CRNC is also seeing growing adoption of its products in new markets such as motorcycles and elevators, with additional new markets likely to be added in the future. Utilizing a 25x FCF multiple on FY '24 free cash flow yields a $124 price target, or +63% upside from the current price of $76.

If I have not already spoken with you about the performance of your account in 2021, I will be reaching out to you shortly. As always, feel free to contact me if you have any questions about your portfolio.

Sincerely,

Christopher Godfrey

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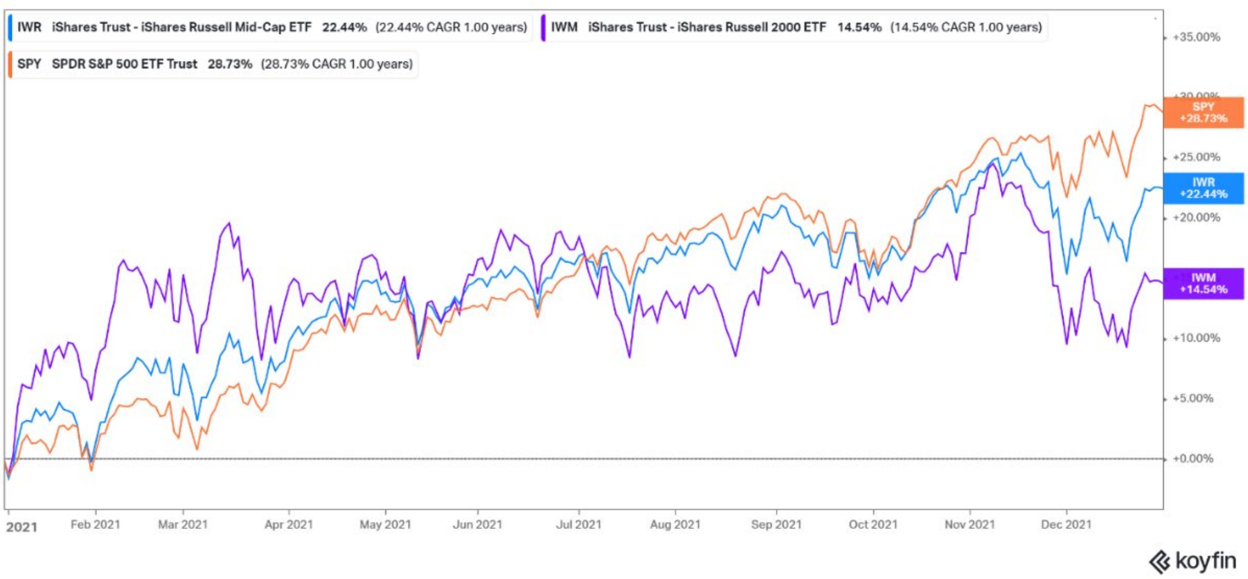
Appendix – 2021 Market Themes

As I mentioned at the beginning of the letter, overall market returns masked significant divergences in stock performance by market cap and investment style. A brief discussion of the two biggest themes from 2021 are presented below.

1) Market returns for 2021 were led by large cap stocks, which meaningfully outperformed smaller cap stocks.

2021 Performance by Market Cap

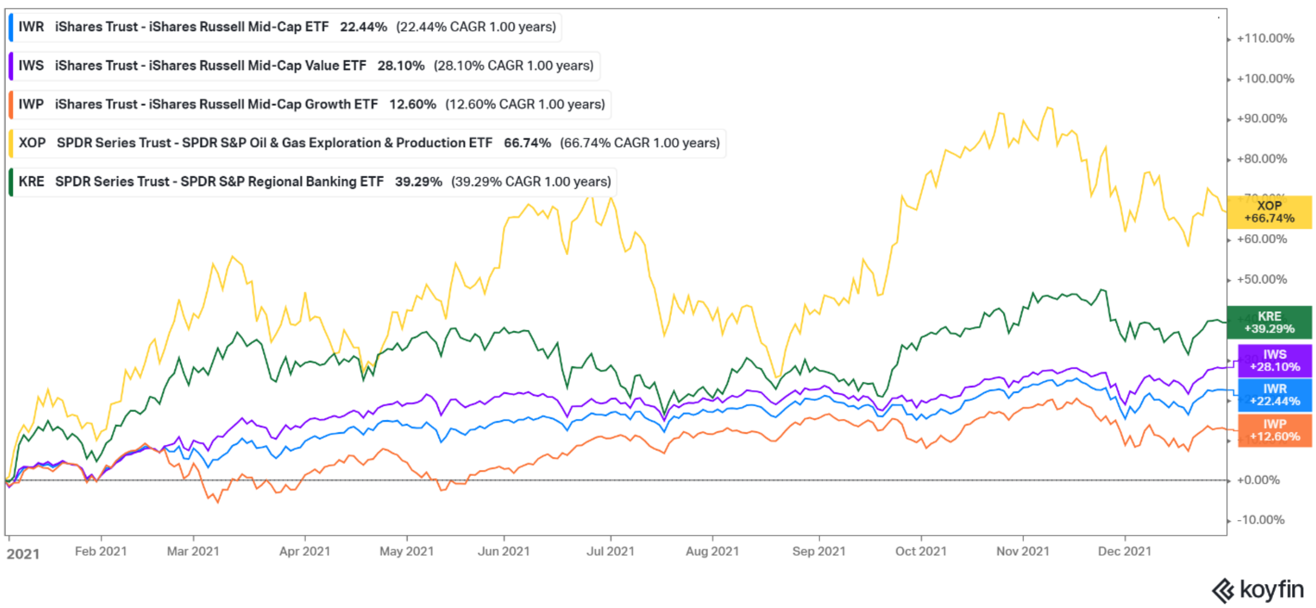


For reference, I have shown the average market cap of each of the indices shown above compared to the average market cap of the HCM portfolio.

2021 Performance by Market Cap		
	2021 Returns	Avg. Market Cap ($ Billions)
Russell 2000 (Small Cap)	14.5%	$ 3.6
Russell Mid Cap	22.6%	$ 23.5
S&P 500 (Large Cap)	28.7%	$ 83.4
HCM Portfolio	**18.0%**	**$ 8.0**

2) Specific to the Russell Mid Cap index (benchmark index for the HCM portfolio) value stocks (+28.1%) meaningfully outperformed growth stocks (+12.6%). Value outperformance was led by oil and gas companies and banks, which are levered to highly cyclical commodity prices and interest rates that drive significant volatility in earnings for these companies. As explained in previous letters and above, these are generally not attractive investments for this portfolio.

2021 Russell Mid Cap Index Performance by Style



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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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