April 5, 2024

Dear Investors,

The Headwaters Capital Management, LLC ("Headwaters Capital," "Headwaters," or the "Firm") portfolio returned +10.6% (+10.4% net) during Q1 2024 compared to a +8.6% return for the Russell Mid Cap Index over the same period. A brief discussion of the performance and trading activity during the quarter is presented below.

Headwaters Capital Returns:

	Q1 24	YTD '24	LTM (3/31/24)	Cumulative Since Inception (1/4/2021)
Headwaters Capital (Gross)	10.6%	10.6%	41.6%	35.7%
Headwaters Capital (Net)	10.4%	10.4%	39.7%	31.6%
Russell Mid Cap Index	8.6%	8.6%	22.3%	29.0%

**Performance for the Headwaters Capital portfolio has been calculated by Liccar Fund Services from 1/4/2021-12/31/2023.*

***Performance for the Headwaters Capital portfolio has been calculated by Longs Peak Advisory Services from 1/1/2024-3/31/2024.*

****Performance presented is that of a representative account invested in the strategy. Individual SMA performance may differ from the results presented above.* [1]

Performance Discussion – Q1 2024

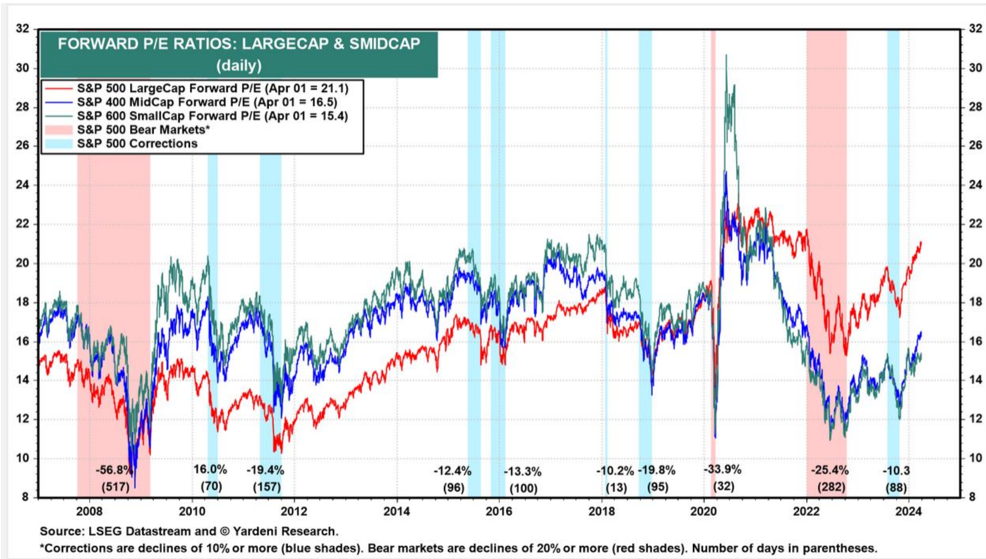
Q1 was another strong quarter for the equity markets broadly, with gains again led by large caps (S&P 500 +10.4% v. Russell 2000 +5.0%). The Headwaters portfolio outperformed the Russell Mid Cap benchmark due to positive stock selection (see below). Market performance during Q1 '24 was characterized by three themes that carried over from Q4 '23.

1) Confidence that interest rates have likely peaked, but with increasing evidence that the Fed will keep rates elevated for longer to bring inflation down to its targeted 2% level.
2) The economy remains resilient in the face of higher rates, supporting GDP and earnings growth.
3) AI, AI, AI.

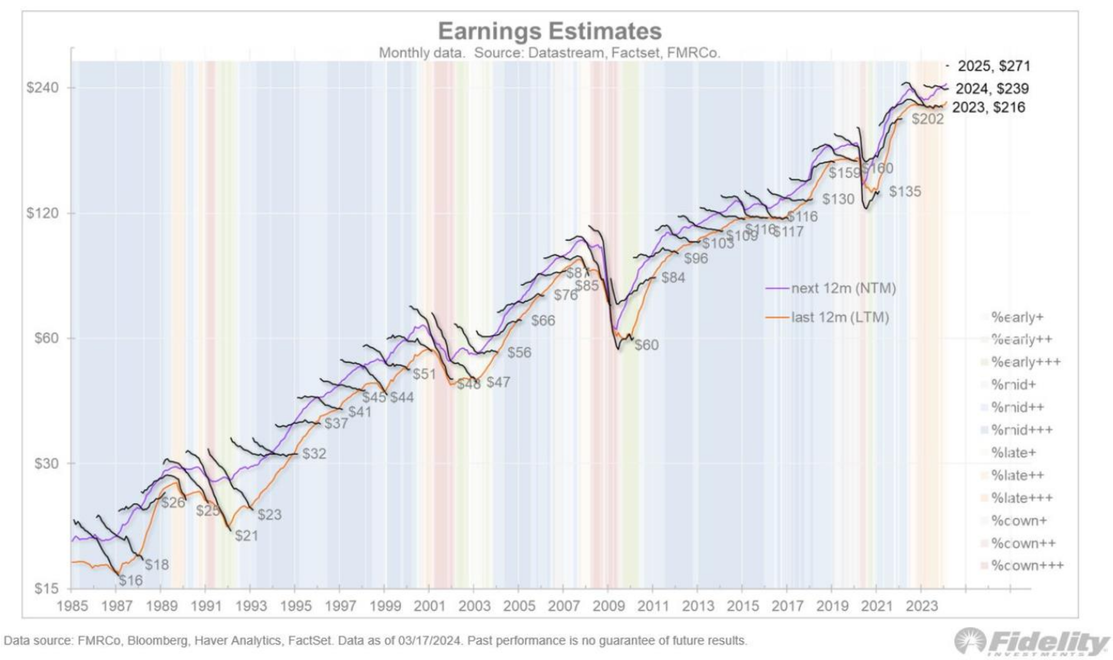
The last six months provide a great example of the virtues of staying invested in the equity market as timing market moves remains extraordinarily difficult given market whims and behavioral biases. While the headline +42% performance for the Headwaters portfolio over the last twelve months might imply a straight line for achieving these results, the path was far from linear. Many readers may have missed that we experienced a stealth bear market in small caps during this period with a -18% decline for the Russell 2000 from 7/31/23-10/27/23 (this doesn't technically meet the definition of a 20% decline required for a bear market, but I think you get the point). It's hard to know when the market is going to turn, but when it does, it happens quickly and the magnitude of the move often catches people by surprise (discussed in the Q2 22 letter). The initial move never feels justified based on fundamentals at the time, making it very difficult psychologically to invest after the market begins to rebound. However, the market is forward looking and prices in future economic realities, not current conditions. With the benefit of hindsight, this cycle played out in classic fashion following the significant correction the market experienced from July-October.

[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. For further information about the total portfolio's performance, please contact Headwaters at the email address listed.

If we rewind to October 2023, inflation data continued to run hot and consensus expected the Fed would continue hiking interest rates to bring inflation down to its targeted 2% level. The economy looked fragile as spending (corporate and consumer spending) was normalizing from post-pandemic exuberance. Another forgotten data point is that we just experienced the third longest manufacturing downturn in history, implying that we have already seen significant corrections in large parts of the economy. The forecast for elevated and increasing interest rates was not only pressuring valuation multiples (light blue shaded area in the chart below), but also EPS estimates for 2023 and 2024 as the prospect of a full-blown recession seemed plausible.



Source: Yardeni Research



Source: Fidelity Investments

The chart above is messy, but it does a great job illustrating how earnings estimates changed throughout 2023 (revised lower and basically flat when compared to 2022) and how 2024 and 2025 EPS are poised to grow from this earnings trough. I wish I had a similar chart for small caps, but suffice it to say, small caps are generally more economically sensitive than large caps.

Contrary to consensus expectations, data was released in early November that suggested inflation had peaked, thus providing support for lower interest rates and higher equity valuations. When combined with explicit messaging from the Fed that further rate hikes were unlikely, the market quickly priced in higher equity valuations in the final two months of 2023 (see chart above). During Q1 '24, the baton for market returns has been passed to earnings growth, as it has become increasingly evident that 2023 was likely the near-term earnings trough for the market and earnings are poised to grow in both 2024 and 2025. This earnings growth has the potential to drive future market returns following the swift valuation reset in Q4 '23.

The point of this discussion is merely to provide the facts surrounding the recent performance of the market and highlight the difficulty in correctly predicting the macro while also avoiding natural behavioral biases. Instead, remaining patiently invested in the market and, more specifically, quality companies should generate positive long-term returns for investors, although it will no doubt come with short-term volatility.

While this feels like the point in the cycle where the market is due for a pullback, I continue to believe there are plenty of fundamental reasons to remain optimistic. The reality is market valuations look reasonable, especially as earnings continue to grow. Leading economic indicators such as rising PMIs, robust hiring, consumer confidence, etc. are supportive of the earnings growth outlook. Small caps trade at cheaper valuations than the entire 2013-2019 time-period, creating plenty of attractive investment opportunities in individual companies. While these factors underpin the positive bias toward the market in general, the objective of the Headwaters Capital portfolio remains focused on finding quality businesses that can compound returns at rates exceeding these broader market gains. There will no doubt be unexpected twists and turns going forward, but I hope recent experience helps shed light on the long-term investment philosophy of the Headwaters portfolio and the justification for keeping the portfolio fully invested (<5% cash).

Q1 '24 Portfolio Review:

Top Contributor: UFP Technologies ("UFPT") +47%: UFPT had a strong fourth quarter as revenue from its top customer in the medical end market continued to exceed expectations due to market share gains with this customer. During the first quarter, this customer also signed a five-year supply agreement with UFPT, which provides increased visibility and certainty of future revenue. Additionally, as UFPT has grown, the stock has gained interest from larger shareholders thanks to increased analyst coverage. This has supported multiple expansion as the market begins to appreciate UFPT's significant business transformation over the last three years (see Q3 2022 letter for more details).

Top Detractor: Qualys ("QLYS") -13%: QLYS underperformed during Q1 as Microsoft announced that it will be sunsetting its partnership with Qualys effective May 1st. While a clear negative headline, the ultimate financial impact is likely to be modest with only a 1% headwind to revenue growth in 2024. More importantly, cybersecurity threats continue to proliferate and QLYS' vulnerability management tool remains a critical solution within the cybersecurity ecosystem. In addition to healthy end market demand and an industry leading product, QLYS continues to release new products and functionality that should support ~10% revenue growth for many years. The company currently has 8% of its market cap in cash (and no debt) and, after adjusting for this cash balance, is trading at a 4.5% free cash flow yield.

Trading Activity
Buys: Climb Global Solutions ("CLMB")
Sells: None.

Climb Global Solutions: The Middle Man for the Middle Man

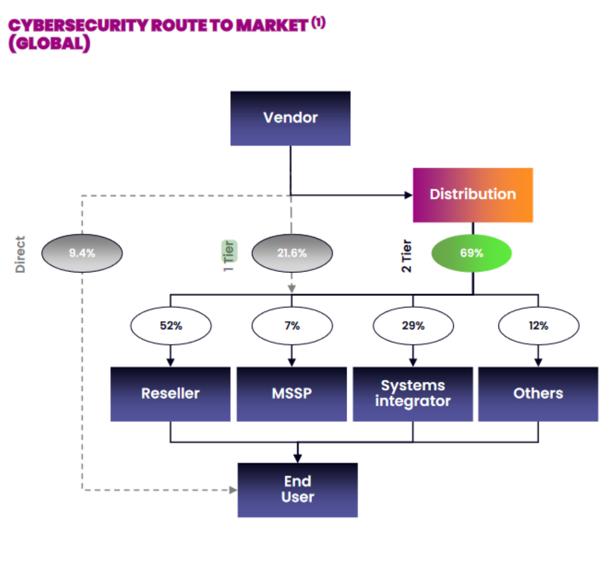
Summary Investment Thesis

1) Niche Cybersecurity and Data Center Software Distributor with Vertical Specific Expertise
2) Focus on Cybersecurity and Data Center End Markets along with Faster Growing Vendors Supports Double Digit Organic Billings Growth; Programmatic M&A Will Supplement Organic Growth
3) Attractive Financial Profile Given Capital Light Nature of Software Distribution and Minimal CAPEX Requirements
4) CEO with Impressive Industry Experience and Track Record

Company Overview

Climb Global Solutions is a specialty IT distributor focused on cybersecurity and data center software. CLMB differentiates itself from broadline distributors such as Arrow, TD Synnex or Ingram Micro through deep expertise with the limited number of products it distributes. CEO Dale Foster orchestrated this focused distribution strategy when he took over as CEO, reducing the number of vendors on the company's line card from 455 to 100. As a result, CLMB now serves as a more focused partner, dedicating all its sales and marketing expertise to a smaller list of vendors. CLMB acts as an outsourced sales force for its partners given their expertise with the products they distribute. Unlike many technology distributors, hardware only accounts for 6% of the company's adjusted gross billings, which has positive working capital and ROIC implications (discussed below). While the top 20 vendors account for ~70% of CLMB's sales, the company has a focused strategy of adding smaller companies with strong growth prospects to its line card. CLMB's vendor expansion strategy is achieved through organic new partnership agreements as well as through acquisitions of distributors with high growth vendor relationships.

Industry Structure
CLMB participates in the two-tier distribution part of the IT market. Whereas large vendors can go direct to end users thanks to their scale and broad product awareness, smaller vendors require the expertise of distributors to bring products to market. A slide from one of CLMB's European competitors, Exclusive Networks, lays out the market structure well (note the percentages are specific to the cybersecurity market, but the general market structure applies to the broader IT distribution market).

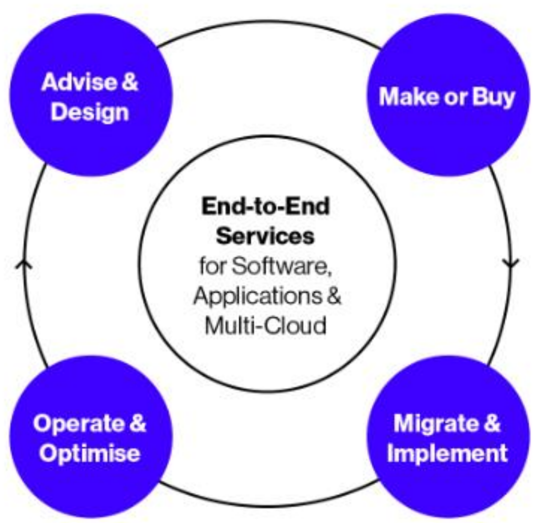


Effectively, large well-known products are bought and thus can be sold directly to end users or to the reseller/solutions integrator level. Smaller and up and coming products require more sales expertise, which is where CLMB fits in as an outsourced sales team for its software vendors. PFPT described the relationship well during a 2016 conference call, which highlights the durability of this industry structure.

> "Now when I first arrived at Proofpoint, I got a lot of questions from all of you on what are you doing with the channel? What's the opportunity in the channel? And I have spent 1/3 of my career on direct sales. I spent 2/3 of my career working with the channel. I had to confess I'd rather work with the channel for the simple reason, it's a force multiplier. If you've got 100, 1,000 or 10,000 salespeople, your teams can get 10x larger if you get it right with the channel. And so what we've said a few years ago is we would relaunch the program. We did do that in just January of 2015… We'd rather -- I'd rather have less partners that really invest with Proofpoint. I don't want hundreds that don't care about Proofpoint. I want to have a select few that really spend time and invest with us. And in return, we'll invest back with them to ensure that we have strong growth and profitable growth together. And so we've made a lot of progress in, frankly, a short amount of time. Many of these logos you saw last year, companies like CDW, SHI. Optiv is a tremendous partner. NTT, formerly Integralis in Europe has been a great partner, but we've added some new logos to the board this year… Exclusive Networks is an interesting one and that they are one of Palo Alto's largest distributors and we signed them on in Europe. We're excited about the opportunity that, that represents. And then Ingram, we did tell you last year our intent to bring Ingram online. We did do that in Q4 this year. So it's still early days. But of course, Ingram opens up. We didn't have distribution in North America, so now all of the different solution providers that are regional in nature we can scale much easier as we move forward."
>
> *Proofpoint Analyst Day: June 8, 2016*

Digging deeper into CLMB's position in the market, it's helpful to distinguish between a pure distributor and a value-added reseller. A value-added reseller ("VAR") such as SoftwareOne or Softcat specializes in advising, designing, purchasing and implementing a software package for clients. See SWON's diagram below.

Unique end-to-end client value proposition



Source: SoftwareOne Annual Report (2022)

CLMB, on the other hand, is just a specialized distributor that sells to this part of the value chain. The value proposition for software vendors is clear as they don't have to invest in a sales force and can leverage CLMB's broad customer reach. VARs also value CLMB's expertise as they are focused on more comprehensive solutions for customers and can utilize CLMB for specific point products. For example, CLMB was recognized by CDW as a Channel Partner of the Year in 2023, highlighting the symbiotic relationship between these two parts of the IT distribution market. Similar to NSIT (another portfolio holding of Headwaters Capital), the growing complexity of the IT landscape benefits the company as more vendors look to specialty distributor partners like CLMB as a go to market solution and VARs require this specialty expertise as part of their solutions integration.

CLMB's top vendor relationships include Solarwinds and Sophos. As discussed above, CLMB also has relationships with many smaller, private companies such as Vast Data, Wasabi and Extrahop, to name a few.

Financials

CLMB is unique in the specialty distribution space given that it focuses almost exclusively on software distribution. Consequently, CLMB does not carry inventory as license delivery does not require physical possession like a traditional hardware distributor. This means that CLMB's business is far more capital efficient than traditional hardware distributors (or distributors in almost any industry) as it does not carry this working capital burden and does not require investment in a physical distribution network. License delivery also minimizes inventory obsolescence risk given lack of physical possession. As a result, CLMB operates with negative net working capital, a key driver of the 30% ROIC for the business. Due to the favorable net working capital attributes of CLMB's business and the limited CAPEX requirements, CLMB generates strong free cash flow.

Management has a stated goal of doubling adjusted gross billings by 2026. Given the demand backdrop for cybersecurity broadly combined with CLMB's focus on higher growth vendors, organic revenue should grow at a +10% CAGR throughout the forecast period. Organic growth will be supplemented with M&A to reach the stated target of doubling AGB's by 2026. CLMB has ample capacity for M&A thanks to a $35mm net cash balance along with strong free cash flow. Similar to other companies owned in the Headwaters Capital portfolio, CLMB's M&A ambitions are more than just financial engineering, they are also sound strategic uses of capital. Acquisitions can broaden CLMB's geographic reach, add key vendors to CLMB's line card, and/or deepen relationships with existing vendors.

Management

Dale Foster (CEO) is an industry veteran who joined CLMB six years ago after leaving Ingram Micro. Dale sold his previous company, Promark, to Ingram Micro in 2012 and remained with Ingram until his transition to CLMB. Dale joined CLMB to run a similar playbook to the one he executed at Promark. He recognized that CLMB had tremendous growth potential given that the company had neglected investing in vendor relationships and had eschewed M&A. The combination of adding faster growing vendors along with a focused M&A strategy has transformed the growth profile of CLMB.

To assist with M&A, Dale hired Drew Clark as CFO due to his extensive experience with acquisitions in roles at previous companies. Given his previous history, I wouldn't be surprised if Mr. Foster sought to sell the company in a few years. The software focus combined with targeted relationships with newer vendors would be very attractive to any of the broadline players or other specialty distributors. Additionally, the strong cash flow and net cash position could make this an ideal PE acquisition and PE has had significant interest in the space historically (Exclusive was owned by Permira).

Valuation

CLMB doesn't have any pureplay public comps in the US. CLMB's closest comparable company is Exclusive Networks (EXN.FR) in France, who currently trades at 10x EV/EBITDA multiple. Similar to CLMB, EXN is a distributor of cybersecurity products and has customer concentrations with legacy cybersecurity vendors FTNT and

PANW. However, 25% of EXN's sales are hardware related, which should yield a lower multiple given the working capital and obsolescence risk associated with this revenue. CLMB is also more heavily exposed to the US and given premium multiples for US domiciled companies, provides further justification that CLMB should trade at a premium to EXN. The problem with using EXN.FR as a comp is that it has limited trading history since it came public in 2021 (at the height of market euphoria and company fundamentals) and I prefer to look at valuation history pre-COVID. Without this data, it's helpful to think about CLMB's valuation more broadly relative to the IT distributor landscape.

CLMB clearly deserves a premium multiple to broadline distributors given stronger revenue growth rates due to the cybersecurity focus and lower working capital/higher ROIC because of its pure play software focus. Broadline distributors have historically traded in the 6-8x EV/EBITDA range, suggesting a floor valuation of 8x. As explained above, the software focus suggests a more appropriate comparable could be Softcat or SoftwareOne, although CLMB doesn't have the services offering of these two companies. SWON has suffered from operational mis-steps since coming public in 2019, which has depressed its multiple. SWON's UK focus has been a headwind to its valuation and the company currently trades at 9x EBITDA (and the company recently rejected a takeover offer from Bain at this multiple). SFC.LN trades at a significant premium (18x EBITDA) given consistent double digit revenue growth, strong returns on capital and a diversified customer and vendor base. CLMB is unlikely to achieve SFC.LN's multiple in the near term given customer and vendor concentrations, but it does highlight upside to current valuations as the business matures.

CLMB currently trades at an 8x EV/EBITDA multiple, but I believe the business should trade in the 10-12x range as the cybersecurity and data center focus supports a faster growth rate than broader IT spend. The pure software focus also generates a return on capital profile that is superior to peers. As customer concentration diminishes over the next few years via a combo of M&A and faster growth from smaller vendors, I expect the company will trade toward the upper end of this valuation range. CLMB is also an attractive acquisition target for larger distributors and the multiple required to consummate a transaction would need to come at a premium to these peers. This provides further justification for a 10-12x EBITDA multiple for CLMB.

Assuming CLMB can approach its target of doubling AGB's by 2026, this would support EBITDA of $45mm in 2026. Even after utilizing cash flow for M&A, cash balances would actually grow over this time period. Assuming a 10x EBITDA multiple supports a $110 stock price, or a +26% CAGR from the share price at initial purchase ($58). Assuming a 12x EBITDA multiple supports a $130 stock price, or a +34% CAGR.

As always, if you have any questions about the portfolio or the market, please do not hesitate to contact me.

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.

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