BARON CAPITAL

Randy Gwirtzman and Laird Bieger: Positioning for a small cap rebound

This is an edited version of a July 19, 2022, Q&A with Randy Gwirtzman and Laird Bieger, portfolio managers of Baron Discovery Fund. To access the recording, please visit our website.

Executive Summary

- This is what we call a "baby in bathwater" market, in which smaller stocks in riskier sectors such as Health Care, Technology and Consumer Goods are thrown out.
- We're long-term investors, focused on quality companies with great management, competitive advantages, and big market opportunities.
- For an emerging growth, small cap strategy like ours, an economic downturn is never the sweet spot. But these periods do create opportunities for those with patience who can come out the other side of this with significant outperformance. We see this as a chance to buy high-quality companies at half-off, which allows us to position the portfolio and capitalize on that rebound.

Can you give us a quick summary on the Fund's second quarter performance?

Randy Gwirtzman: It was a tough quarter; the Fund was down 22.7%. This is what we call a "baby in bathwater" market, in which smaller stocks in riskier sectors such as Health Care, Technology and Consumer Goods are thrown out.

In our portfolio, many of the positive contributors were driven by mergers and acquisitions (M&A). We acquired two companies including **SailPoint Technologies Holdings, Inc.**, a cybersecurity identity company, and **American Campus Communities, Inc.**, which is a REIT for college campus housing. A couple of Tech companies and a Health Care company did reasonably well in the quarter as well.

As for detractors, what drove down stock prices was anticipatory concern in a negative economic environment. For example, **Rexford Industrial Realty, Inc.** was impacted by concern of a recession delivering less industrial space. **Progyny, Inc.**, a benefits company oriented around fertility, had an interesting situation where the Dobbs case, which overturned Roe v. Wade, was at top of mind for investors in whether some states with laws to automatically outlaw abortion might outlaw in-vitro fertilization as well.

What defines and differentiates your process?

Randy Gwirtzman: We're long-term investors, focused on quality companies with great management, competitive advantages, and big market opportunities. We differentiate the fund in two ways: (1) We "invest in reverse" by using our experience to identify the best companies first and then pick dynamic market opportunities to invest when we think that evaluation is correct; (2) we use risk management principles to try to balance the overall portfolio.

Valuation is critical to us. On a long-term basis, we manage our portfolio in different ways: (1) if stocks rise to levels that are too high, we trim or even sell out; (2) we evaluate position sizing to keep from having too much exposure to any individual stock; (3) we balance the industries within the portfolio; and (4) we have a mix of high-growth, growth and other companies.

Then we do due diligence. We spend a lot of time on calls with industry experts, consultants, the companies, and their competitors, to understand what's going on at the ground level and make sure that our investment thesis has not changed. In some cases, it may have improved.

What are the portfolio's current sector weightings?

Randy Gwirtzman: We are overweight in Technology by about 4%. We're finding some incredible values in this sector with very high-quality companies that we believe are relatively less affected by recessionary factors. We're a bit underweight in the Consumer sector – we're very concerned about what will happen in this sector, particularly as you see the consumer confidence indices tipping into a recession. We're about 2% overweight in Industrials, mostly due to our investment in the Defense industry, which is about 6% of the portfolio.

We don't invest in cyclicals, specifically in Energy, Materials or Utilities. That means we'll underperform a bit when Energy is up significantly. High Growth is about 39% of the portfolio. These are 20+% growers, and we have a lot of companies growing 75-100%. The growth portion of the portfolio is about 40%. Those are the "growth at a reasonable price" companies. They may be growing 10-15%, but they are growing margins, which we believe can earn our 15% target return on them.

Let's turn to themes and individual stocks.

Randy Gwirtzman: Theme-wise, we're excited about a lot of our companies' involvement in digital transformation, which has been accelerated by the pandemic. It's really the increased use of digital technology and moving to the cloud, as opposed to running your own data centers, or running on spreadsheets. Similarly, movement of application software to the cloud. Considering the war in Ukraine, Russia is highlighting Defense spending recently, and NATO countries are starting to spend more to what they're supposed to, to 2% of GDP. We think that will benefit companies like **Mercury Systems, Inc.** and **Kratos Defense & Security Solutions, Inc.**

Medical Technology, post-COVID, is another strong theme — procedural catchups for patients who postponed having surgeries during the height of the pandemic. Some positions in this theme are **Axonics, Inc.**, a company that treats incontinence with implants, and **Silk Road Medical, Inc.**, that focuses on clearing carotid arteries and thus preventing strokes.

Then we have supply chain normalization. Semiconductor chips are getting back into the market, as we're hearing anecdotally from car companies. That means that chips can be supplied down to our smaller companies. This correction should benefit companies like **Inogen, Inc.**, a medical device company that makes portable oxygen concentrators, and **Advanced Energy Industries, Inc.**, an industrial company that has high-end power supplies for semiconductor manufacturers including data centers, equipment manufacturers, medical device manufacturers, and communications companies. The 5G rollout is a big theme for them.

We have companies that are not correlated to what we think is the market. For example, **Montrose Environmental Group, Inc.** which does environmental clean-up – a theme that's only increasing. Another example is **Axon Enterprise, Inc.** which outfits police and federal agents with tasers, body cams, and software to collect video evidence. Cybersecurity is another growing theme and we have multiple stocks leveraged to it. Then we have the post-COVID consumer, a large theme that's a bit murky coming into this potential recession. We're trying to pick companies that we think are trading at good valuations and have better stability in a market where the consumer might get hurt by rising prices.

As mentioned earlier, Progyny is an in-vitro fertilization and leading fertility benefits management company. They work with corporations to provide benefits and insurance to their employees having fertility issues. Progyny has a nationwide network of doctors that they've curated and pay directly. As a result doctors like working with them, which we believe contributed to the company's previous growth of 50%. This year, we think that growth has normalized to a standard 30%. The company is forecasting a billion dollars in revenues for 2023, trading at 16x cash flow.

Couchbase, Inc. is a database company. It has a high-end way of allocating its resources across different servers and memory, which makes it useful for rapid and high-volume transactional purposes. It's at $150 million in revenues, compared to their competitor **MongoDB, Inc.**, which has $800 million in revenues. The company is growing in the low twenties right now, however we think this can change to 25-30%. It's trading at only 2.7x 2023 sales, 1.7x 2025. We haven't seen valuations like this since 2015. We think that high-end companies in this space trade for four times that.

We recently had a company called **SalePoint Technologies Inc.**, that we sold for 11x forward sales. It was growing 20%, but I believe Couchbase has a bigger market and an ability to grow faster than 25%, perhaps even 30-40% once their cloud products catch on. That's a $700 million market value company.

A new stock for the quarter is **ASGN Incorporated**, a company that provides IT staffing and IT services. It's growing very nicely at a low double-digit, but when they do M&A, we think it can grow 15% over time. It's about $4.5 billion market cap, trading at 7x 2023 EBITDA and 4x 2026. It's trading at very low multiples because people are concerned about the placement side of the business, which going into recession they think could go down. However, these are very high-end IT workers – if ASGN can't place the worker at a firm, it can put them onto projects as consultants. There's a lot of synergy inside the business. The company generates a huge amount of free cash flow – on enterprise value including all debt, it's trading at a 7.7% cash flow yield. On just the market value, if you take leverage out, it's trading 8.7% pre-cash flow yield for 2023. These are our estimates, with the Street's a bit lower. It's high-quality, it's exciting, and it's cheap. We're happy to upgrade quality and cash flow in our portfolio.

Another new company we bought is **GitLab Inc.**, a company that helps software developers coordinate the production of software integration for big firms while ensuring the security, stability, and functionality of said software when customer facing. It has a $9.5 billion market value, and we believe it will be free cash flow positive in 2023. It trades at 13x sales next year, but it's growing at 75% a year. It's $400 million in revenues in 2022, growing to $640 million in 2023. Their biggest competitor is **Microsoft Corporation**, which owns a company called **GitHub, Inc.** that is probably 50-100% bigger in revenues, but caters mostly to Microsoft's own Azure Cloud Web Service; whereas GitLab works across all hyperscalers and is a more open environment. We're glad to be able to buy a high-quality company like this when it's a small cap.

Laird, tell us about a few opportunities you're seeing.

Laird Bieger: To begin, I'll reiterate that for an emerging growth, small cap strategy like ours, an economic downturn is never the sweet spot. But these periods do create opportunities for those with patience who can come out the other side of this with significant outperformance. We see this as a chance to buy high-quality companies at half-off, which allows us to position the portfolio and capitalize on that rebound.

The Cheesecake Factory, Inc. is a company Baron Capital has been interested in since I started in 2000; I have a long history with the company and know it very well. Today, the stock is a little over $27. In 2019, pre-COVID, it earned $2.61. If you were to go back and look at that period, there are companies trading at less than 11x earnings. Historically, this is a business that trades at about 16x earnings. As we look at 2022, the Street consensus today is at around $2.82 cents. If that number were to come to fruition, it would be trading at less than 10x earnings. But we don't think that number is. We do think there's probably some downward earning revisions to come, especially as we get to the fourth quarter.

We went back to look at the downturn in '01, '02, '00 as well the Great Financial Crisis as potential downside scenarios. When you take that all into account, we think the downside scenario for earnings this year is probably around $2.50, which as a realistic outcome would have the stock trading at around 11x earnings. We did the same for 2023, using those prior recessionary periods, offset by steps the company's taking to deal with food inflation, the result was the same. While it's a bit murky looking out to 2023, we think that the number is similar to 2022: $2.50. Again, at today's price, you're looking at a company trading at 11x, our downside scenario earnings. While it will only be making $2.50, it's still generating real free cash flow. The company pays a 4% dividend that can be well covered while keeping the balance sheet in good shape, and has one convertible bond, but it's not due until 2026. We think of earnings power over the next couple of years and had initially thought $3.50 was realistic for 2023, as we look out a couple years, given their unit growth, we now think $4 is a realistic number.

If we just assume that it's going to trade close to the 16x that it's traded at historically, then we have a $60 stock.

The moral of this story from our perspective is that this is a "when" not "if" this stock doubles scenario. I don't know if it will be on 2024 earnings or 2025 earnings, but I do know that getting paid 4% on a company that's going to double over a short period of time, emerging from this recessionary period, is exactly the kind of name that we want to be in.

A second example is a company that I would say is in the worst bucket to be in as far as small-cap emerging growth companies: Businesses that are cash flow negative. **Alkami Technology Inc.** provides small bank and credit unions with cloud-based software solutions. The company is down over 50% from its highs, but it burns free cash flow and will continue to do so until the end of 2023. This is an interesting business in that it has never missed a quarter since coming public a couple years ago. In addition, its businesses are doing very well. The yield curve (until very recently) has been working in their favor. We haven't seen credit write-offs or other things that would give you pause as to what expectations are for future IT investments.

If you're a small bank or credit union, you realize that upgrades are needed to serve your customers in the best possible fashion. This is a business that we think can grow 25+% over the next few years and is currently trading at a little over 4x revenues, whereas it got as low as around 2.5x. Historically, these are the kind of companies that trade in the 6x or 6.5x times revenue multiple. Certainly, if you were to stop the growth tomorrow you could probably immediately get to a mid-20s EBITDA margin, implying that the business is probably trading at 15x EBITDA or a mid-teen multiple of EBITDA if you stop the growth, which this business won't do. It does give you a sense of downside because what we've seen in the past, especially with these software companies, is if they get too cheap, private equity will come in and buy them, which will slow the growth and cash flow to multiple.

If this company can trade back to 6x revenues, we think the stock has about 60% upside over the next couple of years. The balance sheet is in fantastic shape; we think the cash bottoms out at around a $100 million dollars at the end of next year. Even if the company were to miss that goal by a quarter or two, its balance sheet is more than enough where it could survive multiple years of cash burn and still be around. Adding all that up, despite the fact the stock is down, we think it'll rebound the fastest when the market does finally turn.

Can you expand on your view of Inogen and CareDX?

Randy Gwirtzman: Inogen is a medical device company that makes portable oxygen concentrators for people with breathing disorders and is one of the market leaders in the space, with about 40% market share. It replaces big cylindrical tanks that need to be delivered. Ultimately, those delivery networks will disappear as they lose incremental market share. There'll be a tipping point at which these portable oxygen concentrated companies accelerate growth dramatically. We had a problem with Inogen in that they couldn't get certain computer chips, normally costing a dollar or two, now upwards of $200 due to the scarce inventory. The company had a lot of inventory of mostly complete oxygen concentrators with excess demand, and was choosing who to send completed devices to as they get these computer chips. As the supply issues eases, Inogen will be able to fill demand and re-accelerate growth. Currently, the company's trading for about 19x cash flow to 2023. It's a $26 stock that has $3.5 million of cash on the balance sheet, and no debt. Trading for 19x cash flow, but that's under earning. That's only at 5% margins; we think it will do 15-20% over time. On 2026 numbers, it's trading at 3x cash flow. This should trade at least 15x and we think it could be a five bagger over time as markets normalize.

CareDx, Inc. is a transplant diagnostics company. It's the market leader and pre cash flow positive, just like Inogen. It's a $1.2 billion market cap, $900 million enterprise value company. The stock is trading at $22 with $6 of cash on balance sheet and it's trading right now at 2.5x sales for 2022, 2.2x next year's sales and 1.4x 2026 sales. Diagnostic companies at the peak would trade at 10x to 12x sales. It has multiple tests on the market, and I believe it will retain most of its share. The market is not hugely penetrated. We think the market next year maybe is a third penetrated. By 2026, we will get to possibly 40-45% of the market penetrated among all players.

What are your thoughts on Biotech in the current market environment?

Randy Gwirtzman: Biotech is almost a free cash flow negative venture, at least in the small-cap universe it is, so we're very careful of it. Generally, we're avoiding Biotech, because we like businesses in which we can confidently predict revenues. We only own one company that's a Biotech firm, **Revance Therapeutics, Inc.** The company is coming out with a Botox-type product that's based on botulinum toxin, but lasts twice as long. We're waiting for FDA approval that's supposed to occur either late Q3 or early Q4. A soft launch of the product is expected this year. The product is appearing to be useful, not only for aesthetics but for therapeutic uses as well. We see value in that and believe it could be worth many times where it's trading at right now.

Lastly, can you discuss your views on The Beauty Health Company?

Laird Bieger: **The Beauty Health Company**, for those who don't know, is also known as HydraFacial, which is their primary division. It's sitting on a lot of cash, and we expect the company to make an acquisition at some point, which will be interesting for our position. The question that people are asking most is how much a recession will impact the company's core customer — a woman in her twenties and thirties; historically, we've seen this type of customer being more resilient than the average customer. It's our belief that the company remains early in its rollout and still has an opportunity to continue expanding.

Recently, the company launched a new machine called Syndeyo. Existing customers are incentivized to upgrade with company provided discounts for the new product. We foresee some disarray in the financials this quarter, potentially spilling into next quarter. That's the only piece of the business that I think is going to be tricky to navigate. But all these are short-term issues. It's our belief too, that it's worth it to give discounts, to get the new machine in place. We believe that once we get through the noise of this upgrade cycle, things will clean up from an earnings and revenues perspective and we can continue to grow off that base.

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Baron Discovery Fund's annualized returns for the Institutional Shares as of June 30, 2022: 1-year, -40.44%; 3-year, 5.75%; 5-year, 9.43%; Since Inception (9/30/2013), 12.03%. Annual expense ratio for the Institutional Shares as of September 30, 2021, was 1.05%. The **Russell 2000 Index**'s annualized returns as of June 30, 2022: 1-year, -33.43%; 3-year, 1.40%; 5-year, 4.80%; Since Fund Inception, 6.56%. The **S&P**

500 Index's annualized returns as of June 30, 2022: 1-year, -10.62%; 3-year, 10.60%; 5-year, 11.31%; Since Fund Inception, 11.85%.

The performance data quoted represents past performance. Past performance is no guarantee of future results. The investment return and principal value of an investment will fluctuate; an investor's shares, when redeemed, may be worth more or less than their original cost. The Adviser reimburses certain Baron Fund expenses pursuant to a contract expiring on August 29, 2032, unless renewed for another 11-year term and the Fund's transfer agency expenses may be reduced by expense offsets from an unaffiliated transfer agent, without which performance would have been lower. Current performance may be lower or higher than the performance data quoted. For performance information current to the most recent month end, visit www.BaronFunds.com or call 1-800-99BARON.

The Fund's 3- and 5-year historical performance was impacted by gains from IPOs and there is no guarantee that these results can be repeated or that the Fund's level of participation in IPOs will be the same in the future.

Risks: Specific risks associated with investing in smaller companies include that the securities may be thinly traded and more difficult to sell during market downturns. Even though the Fund is diversified, it may establish significant positions where the Adviser has the greatest conviction. This could increase volatility of the Fund's returns. The Fund may not achieve its objectives.

The discussion of market trends is not intended as advice to any person regarding the advisability of investing in any particular security. The views expressed in this document reflect those of the respective writer. Some of our comments are based on management expectations and are considered "forward-looking statements." Actual future results, however, may prove to be different from our expectations. Our views are a reflection of our best judgment at the time and are subject to change at any time based on market and other conditions and Baron has no obligation to update them.

Portfolio holdings as a percentage of net assets as of June 30, 2022, for securities mentioned are as follows: Rexford Industrial Realty – 3.3.%; **Advanced Energy Industries, Inc.** – 2.7%; **Inogen, Inc.** – 1.7%; **Axonics, Inc.** – 3.2%; **Progyny, Inc.** – 1.6%; **Mercury Systems, Inc.** – 5.2%; **Kratos Defense & Security** – 1.7%; **Silk Road Medical, Inc.** – 2.0%; **The Beauty Health Company** – 2.2%; **Axon Enterprises, Inc.** – 2.0%; **Montrose Environmental Group, Inc.**– 1.8.%; **Couchbase, Inc. , Inc.** – 2.2%; **ASGN, Incorporated** – 1.6%; **GitLab, Inc.** – 2.1%; **The Cheesecake Factory, Inc.** – 1.6%; **Alkami Technology, Inc.** – 1.6%; **CareDx** – 1.4%; **Revance Therapeutics, Inc.** – 1.6%

Baron Discovery Fund had no investment in **American Campus Communities, Inc.** or **SailPoint Technology Holdings, Inc.** as of June 30, 2022.

Top 10 holdings as of June 30, 2022

Holding	% Holding
Mercury Systems, Inc.	5.2
Kinsale Capital Group, Inc.	5.0
Rexford Industrial Realty, Inc.	3.3
Axonics, Inc.	3.2
Definitive Healthcare Corp.	2.9
Boyd Gaming Corporation	2.8
Floor & Décor Holdings, Inc.	2.8
Advanced Energy Industries, Inc.	2.7

SiteOne Landscape Supply, Inc.	2.4
Endava plc	2.3
Total	32.6

Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.

Non-mutual fund products are available to institutional investors only.

The **Russell 2000® Growth Index** measures the performance of small-sized U.S. companies that are classified as growth and the **S&P 500 Index** of 500 widely held large cap U.S. companies. Russell Investment Group is the source and owner of the trademarks, service marks and copyrights related to the Russell Indexes. Russell is a trademark of Russell Investment Group. The indexes and the Fund include reinvestment of dividends, net of withholding taxes, which positively impact the performance results. The indexes are unmanaged. Index performance is not Fund performance; one cannot invest directly into an index.

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