



Randy Gwirtzman and Laird Bieger: Our small-cap growth outlook

This is an edited version of a January 19, 2023, webinar with Randy Gwirtzman and Laird Bieger, portfolio managers of Baron Discovery Fund. To access the recording, please visit [our website](#).

Executive Summary

- We believe this market environment bodes well for small-cap growth as an asset class.
- Small-cap growth tends to lead out of a recession.
- We continue to do what we always do: buy high-quality companies at the right price to strive for targeted 15%+ returns (obviously this is not a guarantee), do it in a risk managed way, and create for our investors the best possible opportunity for success.

Introduction

Randy Gwirtzman and Laird Bieger have managed the small-cap growth equity Baron Discovery Fund since its 9/30/2013 inception. The strategy is fundamentally focused with an emphasis on what we believe are high-quality companies with strong management teams, sustainable secular growth opportunities, and significant competitive advantages.

Randy, can you give us a summary of the fourth quarter and what may lie ahead?

Randy Gwirtzman: The Fund was mostly flat with an increase of 0.22%. The Russell 2000 Growth Index (the "Index"), the Fund's benchmark, was up 4.13% for the period.

Laird calls this a "baby with the bath water" environment. People are risk-off at any cost. They're throwing out good stocks along with lower quality stocks, and because this asset class is less liquid than large caps, investors tend to oversell.

Looking ahead, we believe this market environment bodes well for small-cap growth as an asset class. From an economic standpoint, we see signs that we're closer to the end of this turmoil than the beginning. Leading inflationary indicators have declined materially following the aggressive interest rate hikes of 2022.

Valuations in the asset class and for individual stocks in our portfolio are attractive. It's rare for the small-cap growth asset class to have a lower multiple on forward earnings and cash flow estimates than the S&P 500. Typically, because this asset class tends to grow faster than the S&P, we would expect a premium multiple.

Regarding the market, small-cap growth tends to lead into a recession, but it also leads out. I don't think we'll have to wait for earnings to bottom for the Federal Reserve to start lowering rates. And when the market rallies, we think small-cap growth will rally hard.

It's going to be bumpy, but I think in the end, particularly given our long-term view of the markets and compelling valuations, we're going to be in good shape.

What sectors have added or detracted from the Fund's recent performance?

Randy Gwirtzman: About 25% of our underperformance was caused by lack of investments in Energy and Materials. That's by design. We believe those sectors tend to be more cyclical and we focus on secular growth.

In the Consumer Discretionary sector, we did slightly better than the Index. Companies like **Boyd Gaming**

Corporation and **The Cheesecake Factory, Inc.** did well. In Financials, we were up 1.1% versus unchanged performance in the Index. We own an insurance company called **Kinsale Capital Group, Inc.** that did well in the quarter.

The companies that did most poorly were in Health Care. That sector finished about 6% below the Index. One of the worst performers was **Revance Therapeutics, Inc.**, a pharma company that makes a Botox competitor that lasts twice as long. The company was up 100% in Q3 but was down last quarter. When the company pre-announced Q4 revenue numbers that were 10x better than the Street expected, the stock bounced up again. Another poor performer was **CareDx, Inc.**, a diagnostic company for transplants. However, we still think it is a great franchise that is compellingly cheap and with a free cash flow break-even, almost \$300 million of cash on the balance sheet, and a \$600 million market cap.

How is the portfolio currently allocated?

Randy Gwirtzman: Typically, we're evenly balanced with the Russell 2000 Growth Index in terms of industry allocation. That said, we are currently about 14% overweight in Information Technology. We see some valuations, particularly in software and semiconductor stocks, that are very compelling. We haven't changed our allocation significantly, but the Index allocation has gone down. In Health Care, we're slightly underweight by almost 4%, mostly because we don't own biotech. Also, a lot of Health Care stocks have maintained decent valuation multiples as opposed to other sectors like Industrials and IT, which have seen massive multiple compression. That's because investors tend to view Health Care as more secular and less affected by the overall economy. We're about 2% overweight in Industrials, thanks to compelling individual growth stories. Our Industrials companies tend to have a tech component, and we see potential for sizeable upside. Our holdings within the sector also include aerospace and defense companies **Mercury Systems, Inc.** and **Kratos Security & Defense Solutions, Inc.**, which we view as less cyclical.

We balance our portfolio among high-growth, growth, and "other" stocks. Currently, we have about 45% in the high-growth bucket, 26% in growth, and about 24% in other. We define high-growth as 20%+ growers, growth includes companies that we believe can achieve 10%-15% growth by increasing margins and cashflow and expanding multiples, and other are stocks we view as relatively non-correlated to the overall market. They may be a spinoff, a restructuring, or perhaps a misunderstood "fallen angel" with high growth potential. About 4% of the portfolio is in cash. That's on the higher end of where we've been historically.

Beyond individual stocks and valuations, we focus on risk management and balancing the portfolio. We try to offset some of the risk of the higher tech allocation with more GARP (growth at the right price) names and higher-quality companies that are more mature in terms of cash flow. About 73% of our companies are cashflow positive.

Tell us about some individual stocks that you find especially compelling, and why.

Laird Bieger: I'll start with two companies we really like.

Chart Industries, Inc. manufactures equipment used in the production and storage of hydrocarbon industrial gases — things such as heat exchangers, cold boxes, and cryogenic components. There was a lot of excitement around this area in 2022, especially because of the Russia/Ukraine conflict. Europe needs a lot of liquified natural gas (LNG) terminals to reduce dependence on gas from Russia. Chart should be a prime beneficiary of incremental LNG growth within Europe. In the fourth quarter, the company announced the acquisition of another manufacturer that serves similar end markets but specializes in different products such as compressors, blowers, and ventilation equipment. The market did not receive the acquisition well, largely because of the leverage involved, and the stock was down about 50% in the weeks following the announcement.

Unlike the naysayers, we are excited about the opportunity created by the acquisition, which we believe will happen in the second quarter of 2023. First, the deal is accretive to margins, EPS, and free cash flow in the first full year. Second, the purchase opens access to new customers, commercial projects, and geographies essential to growing the company. Most importantly, the company gains greater competitive positioning. It will operate in growth markets such as clean power, water, food, and industrials — the fastest growing areas within the markets it serves.

Chart issued both equity and debt to do the deal. There's some stress around the leverage, which will be above 4x the closing price, but we believe the company will generate significant free cash flow in the first year. Dispositions could potentially reduce that leverage to less than 2.5x within two years of closing.

Our numbers are significantly lower than management's guidance. Net, it's around a \$6 billion market cap with around \$4 billion of debt, which represents enterprise value of a little more than \$10 billion. We anticipate EBITDA in the first full calendar year, 2024, of a little over \$1 billion dollars. We believe that's worth around 12x, which translates to a stock price of about \$200. The stock right now is around \$126, so we are looking at a return greater than 50%.

Boyd Gaming Corporation is a casino company with 28 gaming entertainment facilities in 10 states. It also owns 5% of FanDuel, the nation's leading sports book operator. It has about a \$6 billion market cap and if you include and adjust for its leases, around \$3.5 billion of debt. That's just under \$10 billion of enterprise value.

The interesting thing about Boyd -- and I think what the Street is missing -- is that it's modeling EBITDA down 7% in 2023 given the economic backdrop. Our estimate for EBITDA is flat in 2023, not down. While we are also modeling a slowing of consumer spend, we believe there are some incremental EBITDA opportunities not reflected in the Street and buy-side consensus. Those opportunities include a new management contract for a casino in Sacramento, California; a new project in downtown Las Vegas that stands to benefit from an overflow of demand from the Strip; and a recent acquisition called Pala Interactive, that should allow Boyd to put the Stardust online casino on its own platform (currently it's on the FanDuel platform). We believe that is going to add another incremental \$20 million of EBITDA. Finally, looking out to next year, the company is investing in a casino called Treasure Chest, which we think adds another incremental \$30 million of EBITDA that we don't think is properly reflected in analyst assessments.

All told, we believe EBITDA will be flattish, free cash flow yield will be in the low double digits for 2023, and the company will pay its 1% dividend and buy back 8%-10% of its stock. Our target is around \$170 over the next 18 months; the stock is currently just below \$60 [as of January 19, 2023].

Randy Gwartzman: Couchbase, Inc. does non-relational databases, unlike the old Oracle-style databases where everything's fixed in rows and columns. This is a more freeform type of database. Couchbase competes with a company called MongoDB. We think the market for these non-traditional database providers is at least \$8 billion. Couchbase reported \$155 million in revenues in 2022, growing nearly 25% per year. We think those revenues will triple to \$450 million over the next five years. That's our investment horizon. The company currently trades at 2.4x sales.

Couchbase has a small market cap at \$600 million, with \$180 million in cash. We think the company is funded well. It's a high-gross-margin business, more than 80%. The accelerant, which we will start to see over the next year, is that it is now on all three major cloud provider platforms. A couple of years ago, it was a product that had to be installed and maintained by customers onsite. Being a pure cloud product makes it much easier to deploy and implement, and it can charge more because it is providing not only the software but infrastructure services as well. It is much easier to implement because it's virtually managed. The stock now trades at about \$13. As we look out to 2027, at just 4x sales (which is relatively low in the scheme of fast-growing software) we believe it can be a \$47-\$50 stock.

CareDx, Inc. is a leading provider of heart, lung, and kidney transplant diagnostics — matching organ donors with recipients, as well as post-transplant monitoring. This is a \$770 million market cap company with \$290 million on its balance sheet. That means a third of its entire market cap is cash; there is no debt. It's currently trading at 1.3x sales. The company has been growing reasonably well, although it was impacted somewhat by lower transplant volumes due to COVID. Those numbers are starting to rebound, and several developments should accelerate the growth of organ transplants, including improved transportation and some movement to approve organs that have previously been non-approvable out of an overabundance of caution. We believe, particularly with regard to kidney transplants, that the opportunity is only about 15% penetrated. CareDx is the market leader, currently used in 70% of kidney centers and 90% of heart transplant centers. Their competitors have struggled to make a lot of inroads, and the nephrologists and centers we've spoken with told us that they prefer the service provided by CareDx over those competitors.

Two factors caused the stock to go down. First, the company moved from Medicare to Medicare Advantage, which is provided by private commercial insurers. This move has resulted in reimbursement delays, even though it's required. As a result, arrears have extended along with accounts receivable collections. CareDx is trying to get commercial coverage for its tests; meanwhile it's running the tests for commercial patients even though it knows it won't be reimbursed. It wants to establish a historical account of how effective the tests are. There's no doubt from all the experts we've spoken with, and from a recent CMS (Centers for Medicare and Medicaid Services) panel, that CareDx's product is the gold standard as opposed to biopsy. Another concern is that CMS is questioning whether the tests are given too frequently and if the costs are too high. We don't believe either are true, but even in a worst-case scenario we see almost no downside from current prices. Given where the stock's trading now, about \$14, our four-year estimates give us a stock price of \$56.

What are your closing thoughts?

Randy Gwartzman: 2022 was a historically tough year, but we are optimistic – particularly about the second half of 2023 and going forward. We continue to do what we always do: buy high-quality companies at the right price to strive for targeted 15%+ returns (obviously this is not a guarantee), do it in a risk-managed way, and create the best possible opportunity for success.

Investors should consider the investment objectives, risks, and charges and expenses of the investment carefully before investing. The prospectus and summary prospectuses contain this and other information about the Funds. You may obtain them from the Funds' distributor, Baron Capital, Inc., by calling 1-800-99BARON or visiting www.BaronFunds.com. Please read them carefully before investing.

Baron Discovery Fund's annualized returns for the Institutional Shares as of December 31, 2022: 1-year, (35.12)%; 3-years, 4.17%; 5-years, 7.61%; and Since Inception (9/30/2013), 11.37%. Annual expense ratio for the Institutional Shares as of September 30, 2022, was 1.06%. The **Russell 2000 Growth Index's** annualized returns as of December 31, 2022: 1-year, (26.36)%; 3-years, 0.65%; 5-years, 3.51%; and Since Fund Inception (9/30/2013), 6.69%. The **S&P 500 Index's** annualized returns as of December 31, 2022: 1-year, (18.11)%; 3-years, 7.66%; 5-years, 9.42%; and Since Fund Inception (9/30/2013), 11.45%.

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 may reimburse certain Fund expenses pursuant to a contract expiring on August 29, 2033, 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 December 31, 2022, for securities mentioned are

as follows: - **Boyd Gaming Corporation** – 3.5%; **The Cheesecake Factory, Inc.** – 1.4; **Kinsale Capital Group, Inc.** – 4.6; **Revanche Therapeutics, Inc.**- 1.6; **CareDX, Inc.** 1.6; **Mercury Systems, Inc.** – 2.7; **Kratos Security & Defense Solutions, Inc.** – 1.7; **Chart Industries, Inc.** – 2.0; **Couchbase, Inc.** – 2.2.

Top 10 holdings as of December 31, 2022

Baron Discovery Fund

Security Name	% of Net Assets
Kinsale Capital Group, Inc.	4.6
Axon Enterprise, Inc.	3.6
Boyd Gaming Corporation	3.5
Axonics, Inc.	3.5
Advanced Energy Industries, Inc.	3.2
Rexford Industrial Realty, Inc.	3.1
Silk Road Medical, Inc.	2.9
Mercury Systems, Inc.	2.7
SiteOne Landscape Supply, Inc.	2.6
Floor & Decor Holdings, Inc.	2.4
Total	32.1

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

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. All rights in the FTSE Russell Index (the “Index”) invest in the relevant LSE Group company which owns the Index. Russell® is a trademark of the relevant LSE Group company and is used by any other LSE Group company under license. Neither LSE Group nor its licensors accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. 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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Free cash flow yield is a financial solvency ratio that compares the free cash flow per share a company is expected to earn against its market value per share.

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