

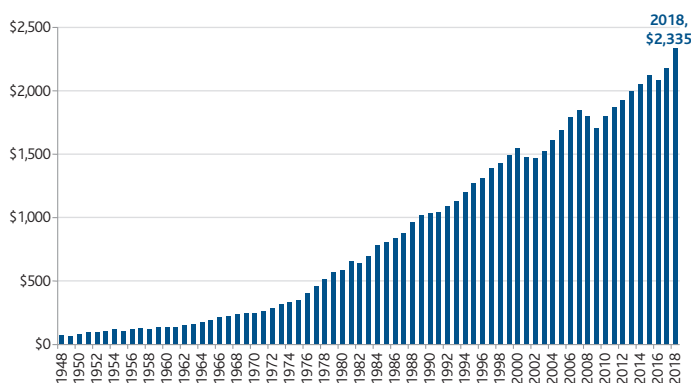
Finding Secular Growth Stocks in Industrials

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The U.S. economy has come a long way since 1936, when Charlie Chaplin's classic comedy *Modern Times* depicted industrialization as synonymous with modernity. Today's economic drivers are more readily evoked by films like *The Social Network*, the 2010 movie about the genesis in a Harvard dorm of the global social network juggernaut Facebook. Most casual observers probably do not regard the United States as a major manufacturing powerhouse anymore.

Yet this perception is, simply put, wrong. It is true that manufacturing as a percentage of overall GDP has steadily declined over the decades, from more than 25% in the 1950s to about 11% today. However, this decrease is more of a reflection of the rise of other sectors – especially technology and internet-related – rather than a drop in manufacturing on an absolute basis. As the graph below demonstrates, even while it may seem like the U.S. has been shifting to an intellectual property-based services-focused post-industrial economy, in nominal terms, manufacturing's contribution to U.S. GDP has actually increased over the past 70 years. The U.S. is still the second largest producer of industrial output in the world, ranked behind only China.

U.S. Manufacturing – Value Added (\$bn)



Source: Bureau of Economic Analysis

The GICS Industrials sector encompasses a wide range of manufacturers and the companies that work with them. It is broken down into three main categories: capital goods, commercial and professional services, and transportation. The sector is massive and varied, spanning aerospace & defense, building products, electrical equipment, machinery, distributors, airlines, rail and trucking, and service providers to these and other industries.

As stock pickers, we consider the breadth and diversity of the Industrials sector an advantage in finding promising investment

opportunities that others may overlook. For example, conventional wisdom would have it that Industrials is a cyclical sector whose performance is highly sensitive to macroeconomic conditions. In addition, perhaps in keeping with the widespread (but, as noted above, mistaken) notion that manufacturing is declining in the U.S., investors also tend to view Industrials as a mature sector with limited opportunities for growth.

While other investors may accept both these generalizations on their face, we have successfully discovered and invested in numerous Industrials companies that benefit from secular trends driven by fundamental changes that create a wave of new demand and provide consistent growth in the face of market volatility. We look for businesses with sustainable competitive advantages that will help them weather all stages of the economic cycle. We also favor companies with differentiated technologies and/or products or services with high barriers to entry that are leaders in their respective markets.

Continuous Compounders

Within the Industrials sector, one of our key themes centers on what we call continuous compounders – companies that consistently generate incremental wealth for shareholders through a combination of profitable operations and effective capital deployment. While their end markets vary widely, they share a number of features in common.

The continuous compounders we favor generate substantial free cash flow driven by capital expenditure-light business models. They operate a diverse portfolio of niche businesses serving high growth specialized markets. They focus on high quality products with minimal commoditization, which offers the potential for pricing power and growth that is faster than their respective end markets. The products are key to customer operations while representing a low percentage of overall costs, which reduces the potential for switching. Finally, these companies are managed by experienced leadership who emphasize continual improvement in cost structure and the use of free cash flow to acquire and integrate companies to generate additional growth.

Among our investments in continuous compounders, **IDEX Corporation (IEX)** is best known for its expertise in highly engineered fluidics systems and components, as well as in fire and safety products such as the Jaws of Life rescue and recovery tool.

Roper Technologies, Inc. (ROP) produces engineered products and solutions that include information networks, medical products and software, and SaaS-based trading solutions. A third



holding, **Nordson Corp. (NDSN)**, is a leading producer of precision dispensing equipment for applying adhesives, sealants, and coatings; and technology-based systems for curing and surface treating processes. While its end markets range from food products and diapers to smartphones and semiconductors, precise dispensing technology is the common element marking Nordson's business units. Internationally, we own **Bidvest Group Ltd. (BVT SJ)**, a South African holding company with investments in defensive, asset-light businesses across distribution, logistics, financial services, and other industries.

Aerospace & Defense

The aerospace and defense (A&D) sub-industry of the Industrials sector includes manufacturers of civil or military aerospace and defense equipment, parts, or products (including defense electronics and space equipment). On a macro level, the sub-industry is non-cyclical, as air travel is a consumer discretionary category that follows a more modest cycle than the industrial/business capex cycle, and defense is counter-cyclical, as the government may use defense spending to stimulate growth. A&D has enjoyed steady growth in recent years driven primarily by military budgets and global air travel. While the space is dominated by large familiar names like Lockheed Martin and Northrup Grumman, we prefer to find and invest in smaller stocks that are tapping into long-term secular growth trends.

Within A&D, we focus on pockets of growth such as technology. For example, we own **Mercury Systems, Inc. (MRCY)**, which provides electronic subsystems to major defense contractors. The company is known for high quality products delivered on time and on budget, which is critically important for missile defense, radar, and electronic warfare applications. In addition to the existing market of about \$2 to \$2.5 billion, we think another \$10 billion of business could be outsourced to providers such as Mercury, providing the company with a multi-year growth opportunity.

We also like the after-market replacement parts business for its high margins and recurring cash flow. **TransDigm Group, Inc. (TDG)** is an aircraft parts manufacturer whose products are custom designed and approved by the Federal Aviation Administration. It is typically the sole supplier of 75% of the parts it manufactures. While the company earns a modest return on original equipment parts, it earns large margins on after-market replacement parts on airframes that stay in service for decades. Since its founding two decades ago, TransDigm has been one of the most reliable performers in the industry and one of the best aerospace stocks to own. **HEICO Corporation (HEIA)**, a manufacturer of aircraft parts and electronic system sub-components, is another strong outperformer, with the stock nearly quadrupling over the past five years. It has about half of the market for non-OEM parts that are roughly 40% cheaper. With global airline travel growing more than 6% annually and defense budgets accelerating due to an increasingly challenging geopolitical environment, we think the growth engine for both these stocks will continue to hum.

We also own a number of non-A&D names whose end market, or a significant percentage of their market, is in A&D. For example, **RBC Bearings Incorporated (ROLL)** is an industrial machinery company

that makes highly engineered bearings, tapping into the same market as TranDigm and HEICO. Another industrial machinery company, **Albany International Corp. (AIN)**, which was founded more than a century ago as a felt manufacturer, has a rapidly growing division that supplies engineered composites used to help make aircraft lighter. **Emergent BioSolutions Inc. (EBS)** is a biotechnology company that supplies the U.S. government with anthrax and smallpox vaccines, which are stockpiled in the event of an outbreak. These vaccines have a limited shelf life, giving Emergent the opportunity to tap into a steady source of recurring business. It can then use this cash flow for accretive acquisitions and expansion into new markets.

Research & Consulting Services

It may seem odd that the Industrials sector includes companies that provide services as opposed to products, but the initial logic behind their inclusion is that they serviced other industries within the sector, and as a result their performance tended to be correlated. While this is no longer the case with many of these service businesses, as stock pickers, we are not all that concerned about which sector or sub-industry they may happen to fall into.

Within the research and consulting sub-industry, we believe many of the most promising growth opportunities lie with subscription-based businesses, whose clients pay a recurring price at regular intervals for access to a service or product. Examples include **CoStar Group, Inc. (CSGP)**, **Verisk Analytics, Inc. (VRSK)**, and **Clarivate Analytics plc (CCC)**. While these businesses may target different end markets, they all play key roles in their clients' daily workflows, creating sticky customer relationships and high switching costs.

These companies start with a highly valuable proprietary asset (such as a unique data set) and then build robust analytical tools that helps end users apply the underlying data to everyday business problems. The proprietary information and accompanying analytical tools eventually become a critical part of the end users' day-to-day workflow, creating a sticky business model with meaningful pricing power and high levels of recurring revenue. Since much of the required investment is in collecting the underlying data and creating the analytical tools, these businesses tend to have high operating leverage ("build it once, sell it many times"), with sales of new subscriptions carrying high incremental margins. Finally, thanks to contracts that are often paid in cash up front, these companies generate significant levels of free cash flow, which is available for paying down debt, repurchasing stock, paying dividends to shareholders, or investing in future growth.

CoStar is an information and marketing services provider to the commercial real estate industry. The company has spent 25 years building a proprietary database and employs a large research staff to continuously update this data, creating immense barriers to entry. The company monetizes its data through subscriptions to analytical tools which are deeply integrated into clients' workflows. Ongoing investments in R&D and an expanding sales force should allow CoStar to sell an expanded array of tools to new and existing customers. Additionally, assets like LoopNet, Apartments.com, Apartment Finder and ForRent extend CoStar's reach into marketing services and

multifamily lead generation, creating vast incremental opportunities. Finally, the company's high fixed cost base creates significant operating leverage, which should help drive margins to at least 40% over the next several years.

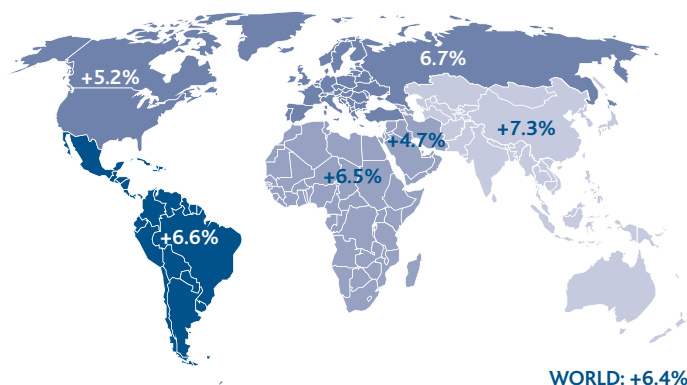
Verisk helps insurers, financial institutions, and energy companies better understand and manage their risks and optimize their decision-making processes by using advanced technology such as the latest remote sensing and machine learning technologies along with cloud computing to collect, interpret, and analyze data sets in real time and at scale. Its contributory databases and deep integration in client workflow create competitive advantages that allow for best-in-class margins and strong organic growth and capital deployment opportunities. Business digitization is becoming ever more important across all industries and in such a world, Verisk's data should become even more valuable to clients.

Clarivate provides comprehensive intellectual property and scientific information that allow a variety of clients (academia, governments, corporations, and the legal community) to discover, protect, and commercialize new research, content, patents, and brands. The company became public in early 2019 and has an attractive information services business model. We believe the relatively new CEO is doing a good job and the company is well positioned to achieve accelerating organic revenue growth (supplemented with incremental acquisitions), expanding margins, and improved free cash flow conversion.

International Transportation

We are not major investors in the domestic transportation sub-industry as it is a difficult business in which to compete and grow, in our view. The airline space demonstrates why this is the case. The industry is highly leveraged to the price of fuel and cost of unionized labor, both of which can be unpredictable. Competition differentiation is achieved mostly through route maps – on heavily trafficked routes (e.g., NYC to Chicago) airlines compete primarily on price, which creates margin volatility and inconsistent returns. Finally, the space is dominated by entrenched legacy mega-players that, when combined with limited airspace and regulatory requirements, create formidable barriers to entry for younger, growth-oriented airlines.

Growth in Air Travel in 2018



Source: International Civil Aviation Authority

Abroad, it is a different story. As seen in the graphic above, global demand for air travel is currently increasing at more than 6% per year, driven in large part by the emerging markets' expanding middle class. We own **Copa Holdings, S.A. (CPA)**, a leading Latin American airline. Its hub is in Panama City, which allows Copa to reach all major destinations on the continent. By capitalizing on underserved markets and the competitive advantages of its hub, Copa has consistently been one of the world's most well-operated and profitable airlines. We think Copa is well-positioned to benefit from the considerable improvement in purchasing power of the middle class in Latin America.

In Europe, we own **Ryanair Holdings plc (RYA)** and **Wizz Air Holdings plc (WIZZ.LN)**. Europe is the most decentralized airline region in the world, a legacy of a time when each country (a total of 50) had its own flag carrier. As the industry consolidates, it has opened opportunities for new, well-managed, low-cost entrants to take market share from legacy carriers saddled with an inefficient cost structure. Low-cost carriers are also growing at a faster pace than the world average, according to the International Civil Aviation Authority.

Ryanair is a low-cost, non-flag carrier that operates over 300 aircraft and flies over 90 million passengers per year. The company has the highest per-passenger profit margins of any airline in Europe, in large part due to its strategic use of lower-cost airports that facilitate quicker turnaround. The company has also been entering into low-cost traffic deals with airports that we think will create strong earnings growth over time.

Wizz is a low-cost airline operating in Central and Eastern Europe (CEE), with a passenger mix that is roughly 50% CEE and 50% tourist traffic from Western Europe. We think Wizz will benefit from increasing travel demand driven by rising GDP in the CEE region as well as the availability of low-cost air travel provided by the airline, something previously unavailable in much of the region.

Conclusion

Don't be fooled by labels. Investors who accept at face value the widely held view of Industrials as a cyclical, low-growth sector may be missing out on significant secular growth opportunities. It is a broad and diverse sector, with companies operating in a wide variety of niches and end markets. As fundamental, bottom-up investors, we consider the Industrials sector a key source for investment ideas. We have successfully found and invested in Industrials stocks for many years, and expect to continue to do so for years to come.

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 writers. 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.

Risks: All investments are subject to risk and may lose value.

Portfolio holdings as a percentage of net assets as of June 30, 2019 for securities mentioned are as follows: **IDEX Corporation** – Baron Asset Fund (1.8%); **Roper Technologies, Inc.** – Baron Asset Fund (2.2%); **Nordson Corp.** – Baron Small Cap Fund (0.5%); **Bidvest Group Ltd.** – Baron Emerging Markets Fund (1.1%); **Mercury Systems, Inc.** – Baron Small Cap Fund (1.7%), Baron Discovery Fund (3.2%); **TransDigm Group, Inc.** – Baron Small Cap Fund (2.3%); **HEICO Corporation** – Baron Partners Fund (0.9%*); **RBC Bearings Incorporated** – Baron Small Cap Fund (1.0%); **Albany International Corp.** – Baron Growth Fund (0.1%); **Emergent BioSolutions Inc.** – Baron Discovery Fund (1.7%); **CoStar Group, Inc.** – Baron Asset Fund (2.7%), Baron Growth Fund (6.8%), Baron Opportunity Fund (2.5%), Baron Partners Fund (15.7%*), Baron Focused Growth Fund (16.2%), Baron Real Estate Fund (1.5%); **Verisk Analytics, Inc.** – Baron Asset Fund (4.4%), Baron Opportunity Fund (1.0%); **Clarivate Analytics plc** – Baron Small Cap Fund (1.5%); **Copa Holdings, S.A.** – Baron International Growth Fund (1.2%), Baron Emerging Markets Fund (1.2%); **Ryanair Holdings plc** – Baron International Growth Fund (1.2%); **Wizz Air Holdings plc** – Baron Emerging Markets Fund (0.5%).

* % of long positions. Portfolio holdings are subject to change. Current and future portfolio holdings are subject to risk.

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