BARON SECOND QUARTER 2016
INSIGHT

Finding Growth in Industrials

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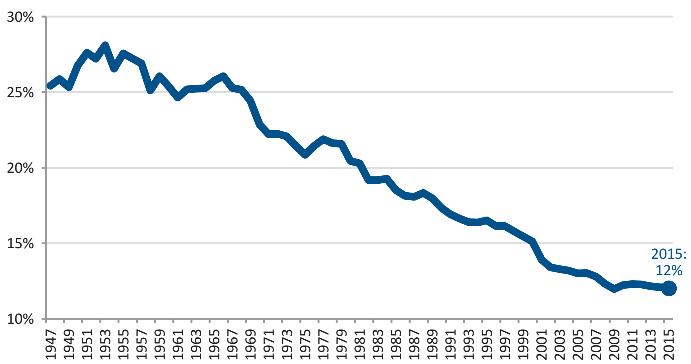
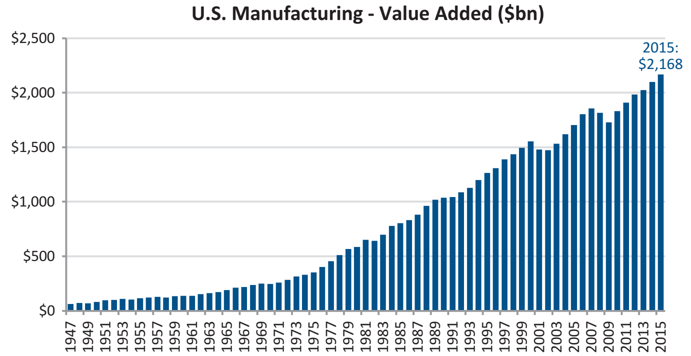
In *Modern Times*, Charlie Chaplin's masterful 1936 comedy, industrialization was depicted as synonymous with modernity, and, in many ways, at the time it was. In the years that followed, however, the U.S. economy gradually evolved. As seen in the chart below, manufacturing as a percentage of overall GDP has steadily declined over the decades, and currently stands at about 11% today.

U.S. Manufacturing as a % of Total GDP



Source: Bureau of Economic Analysis

U.S. Manufacturing - Value Added ($bn)



Source: Bureau of Economic Analysis

However, the decrease in the percentage of overall GDP is more of a reflection of the rise of other sectors rather than a drop in manufacturing. As the second graph above demonstrates, in nominal terms, manufacturing's contribution to GDP actually increased during the same period. The Industrials sector, which is comprised of manufacturers and distributors of capital goods, commercial supplies and services providers, and transportation service providers, remains a significant contributor to the domestic economy.

Most investors view Industrials as a mature sector with stable earnings but limited opportunities for growth. This may be the case overall, but we believe pockets of significant growth exist in every sector, including Industrials. We believe we have identified a unique subset of companies within the Industrials sector that are positioned for growth, driven by secular trends or company-specific characteristics, or in many cases, both. We look for businesses with sustainable competitive advantages that will help allow them to weather all stages of the economic cycle, strong balance sheets, and experienced management. Within Industrials in particular, we favor companies with differentiated technologies and/or products with high barriers to entry that are leaders in their respective markets.

Continuous compounders

One of our key growth themes centers on continuous compounders, or companies that consistently generate incremental wealth for shareholders through a combination of profitable operations and effective capital deployment. While their end markets range widely, these companies share a number of features in common, including high returns on capital driven by asset light business models, top line growth, and limited financial leverage.

In addition, the continuous compounders we favor all 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. Their 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** is best known for its expertise in highly engineered fluidics systems and components, as well as its expertise in fire and safety products such as the Jaws of Life rescue and recovery tool. Another investment, **Roper Technologies, Inc.**, produces engineered products and solutions that include information networks, medical products and software, and software-as-a-service-based trading solutions. A third holding, **Nordson Corp.**, is a leading producer of precision dispensing equipment for applying

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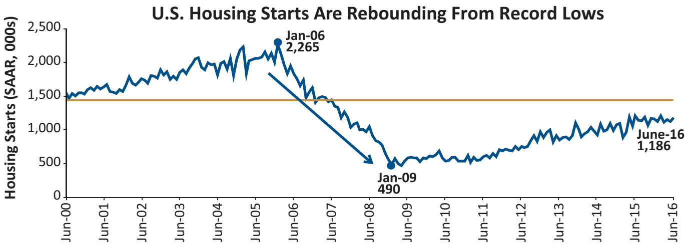
adhesives, sealants, and coatings; and technology-based systems for curing and surface treating processes. While its end markets range from food products and diapers to smartphones and semiconductors, precise dispensing technology is the common element that characterizes Nordson's business units. Internationally,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

Building product manufacturers

Over the last several years, the U.S. housing market has begun to rebound from depressed levels in the aftermath of the sub-prime mortgage crisis and recession of 2008-09. As illustrated in the chart below, new residential housing construction, which fell approximately 80% from peak levels of 2,265,000 units in 2006 to 490,000 units in 2009, now stands at 1,186,000. New home sales in 2015 were up 14%. For the first half of 2016, new home sales grew 9%. Building permits for single family homes, which are a leading indicator of construction, were up 7% in 2015 and 10% in the first half of this year.



Source: US Census Bureau

Though housing activity is improving, we believe it remains at unsustainably low levels relative to population growth and household formation. Housing starts today are well below the 60-year average of 1.5 million and less than half of the 2.5 million housing starts of 1972, while the U.S. population has grown by more than 100 million since that time. With a current run-rate of 592,000 annually, we think sales of new single-family homes will continue to climb given annual population growth of three million people.

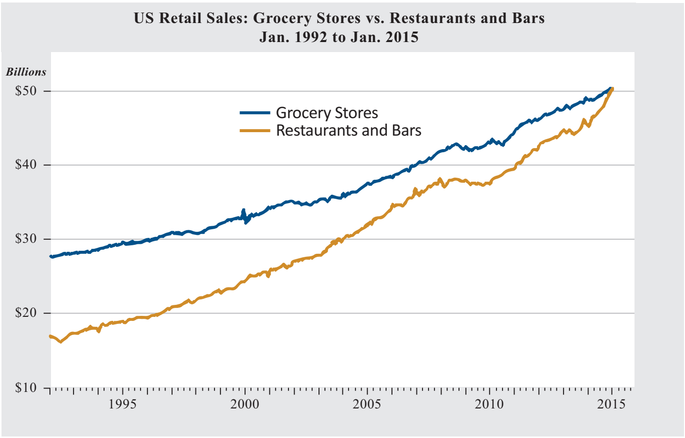
We are invested in a number of companies that manufacture building products used in residential construction, including composite decking manufacturer **Trex Company, Inc.**, door manufacturer **Masonite International Corp.**, and flooring company **Mohawk Industries, Inc.** While each has exposure to the rebound in residential real estate, we also like these names because their businesses are not solely dependent on an improvement in new home sales as they generate revenue from the residential repair and remodeling and commercial construction end markets as well. Each of these vertically integrated companies is a leader in its market, with an experienced management team, a track record of operational discipline and innovation, and a strong balance sheet.

We see additional, company-specific drivers of potential growth. Trex, as the pioneer and leader in composite decking, is benefiting from secular growth as composite continues to take share from wood because of its low maintenance needs. Trex also has a low cost advantage from its use of recycled raw materials, which it is applying to new products. Masonite is benefiting from recent industry consolidation, resulting in improved pricing power and margin potential. Finally, Mohawk (which is classified under Consumer Discretionary: home furnishings), has what we believe to be a real competitive advantage in its significant distribution network.

We are also invested in **Acuity Brands, Inc.**, North America's leading provider of innovative lighting systems. With solid brands and an extensive agency network, we believe Acuity stands to benefit from secular demand for more energy-efficient lighting, generated by government regulations and tax savings in the near term and significant cost savings in the long term. Acuity services the commercial real estate construction industry, and with lighting comprising 21% of energy use in commercial buildings, we see additional potential growth driven by the trend toward "smart" buildings and cities, and the retrofit opportunity for older, less efficient structures.

Foodservice companies

Across the globe, eating habits are changing. As seen in the chart below, in the U.S., the gap between sales at restaurants and bars and spending at grocery stores has been narrowing for the past two decades, with the former surpassing the latter for the first time in 2015. The biggest beneficiaries of this trend have been the fast food, deli food, and pizza restaurants favored by millennials, who are more likely to eat out than the older baby-boomer generation. Internationally, fast food and chain restaurants are growing as a result of underpenetration and the expanding middle class in emerging markets (who eat out more frequently as disposable income grows).



Source: US Census Bureau

We are invested in two foodservice equipment companies that we believe are well positioned to profit from the world's evolving eating habits. **The Middleby Corp.** manufactures cooking and warming equipment for commercial restaurants and institutional kitchens, as well as food processing and residential kitchen equipment. Middleby's top-tier brands enjoy leading market positions. The company uses technological innovations to design and manufacture differentiated equipment for which customers are willing to pay a premium. It has a history of acquiring leading brands and technologies, including Viking Range, AGA Rangemaster Group plc, and most recently, Lynx Grills, and using its business expertise to improve their financial performance. Since 2001, Middleby has been led by Selim Bassoul, a passionate manager with a highly regarded leadership style who is widely credited with turning the company around.

We invested in **Manitowoc Foodservice, Inc.**, after its March 4, 2016 spinoff from its parent company, a restructuring designed to unlock the value of the parent's less cyclical foodservice equipment business from its highly cyclical crane business. Like Middleby, Manitowoc is focused mainly on commercial and institutional foodservice operators, with leading positions in more than half of its brands. It manufactures and distributes an integrated portfolio of hot and cold category products and supplies. We believe the spinoff will allow Manitowoc's new management team to focus exclusively on the core food equipment business and lift margins to industry levels through organic growth and restructuring. In addition, we think opportunity exists for Manitowoc to consolidate a fragmented industry.

Distribution companies

Distributors source and deliver supplies from producers to users. Demand for distribution services has increased as manufacturers seek to consolidate their vendor base and reduce inventory levels through automation tools provided by distributors. Our thesis on the distribution space is one of large industry fragmentation with meaningful market share opportunities for the biggest players, pricing power as a result of industry consolidation, increasing complexity of supply chains, and margin opportunities from scale, sourcing, and internal technology initiatives.

Fastenal Co. is a leading distributor of nuts, bolts, and threaded fasteners to manufacturers and contractors throughout North America. Since expanding its inventory mix over the last decade, Fastenal has taken market share from competitors as customers increasingly select the company as their exclusive supplier. Still, Fastenal has just 3% share of the large and fragmented industrial supplies space, leaving considerable room for expansion. The company's recent vending initiative has grown to 50,000 automated machines directly embedded within customer facilities. These machines dispense frequently consumed products such as gloves and safety glasses directly at the point of use, an industry innovation that has helped Fastenal generate greater savings and accountability for customers, while driving industry-leading sales growth for itself.

We are also invested in **SiteOne Landscape Supply, Inc.,** the largest wholesale distributor of landscape supplies in the U.S. The company operates a network of 477 branches in 44 states, offering a broad selection of products, including irrigation equipment, fertilizer, nursery goods, hardscapes and outdoor lighting. SiteOne is the market leader in an attractive industry with exposure to an improving market, and is also benefiting as increasing numbers of home owners treat outdoor space as an extension of their living space, with increasing investment in patios, decks and yards. The company is experiencing accelerated growth, yet with less than 10% of a fragmented market, we see significant potential for consolidation opportunities and accretive deals.

Internationally, we favor distributors that we think are positioned to leverage the increasing globalization of the supply and distribution chain to their benefit. As this chain expands across countries and even continents, superior handling of the logistics can provide a key competitive advantage.

We currently own **MonotaRO Co. Ltd.** within the Industrials sector. Japan-based MonotaRO is an online distributor of machine tools, engine parts, and consumables for maintenance, repair, and operations (MRO) activity in Japan and is a strategic supply chain partner to Japanese businesses. U.S.-based W.W. Grainger is the company's majority owner. Its online business model avoids the fixed costs of store-based competitors and allows it to pass on cost savings to its customers. We expect MonotaRO to continue to grow its share of the Japanese MRO segment and expand and compete in other large markets such as Korea.

Conclusion

As growth investors, we believe that innovation and invention are the keys to growth within the Industrials sector. We think we have found a set of unique businesses within the sector each of which is leveraging innovations in products, services, and business models to tap into these growth opportunities.

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Portfolio holdings as a percentage of net assets as of June 30, 2016 for securities mentioned are as follows: **IDEX Corporation** – Baron Asset Fund (1.4%); **Roper Technologies, Inc.** – Baron Asset Fund (1.6%); **Nordson Corp.** – Baron Small Cap Fund (1.0%); **Bidvest Group Ltd.** – Baron Emerging Markets Fund (1.0%); **Trex Company, Inc.** – Baron Growth Fund (1.1%); **Masonite International Corp.** – Baron Growth Fund (1.6%), Baron Real Estate Fund (3.0%); **Mohawk Industries, Inc.** – Baron Real Estate Fund (5.6%); **Acuity Brands, Inc.** – Baron Small Cap Fund (3.4%); **The Middleby Corp.** – Baron Asset Fund (1.2%), Baron Growth Fund (3.3%); **Manitowoc Foodservice, Inc.** – Baron Small Cap Fund (0.6%); **Fastenal Co.** – Baron Asset Fund (1.4%), Baron Partners Fund (2.5%*), Baron Focused Growth Fund (2.5%); **SiteOne Landscape Supply, Inc.** – Baron Small Cap Fund (0.7%); **MonotaRO Co. Ltd.** – Baron International Growth Fund (1.3%).

Portfolio holdings may change over time.

* % of Long Positions

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