Mike Lippert: Durability to withstand a disconnect in the market

This is an edited version of a May 4, 2022, Q&A with Mike Lippert. To access the video replay, please visit our website.

Mike Lippert is the Head of Technology Research and portfolio manager of Baron Opportunity Fund and Baron High Growth Strategy. He has over 20 years of investment and research experience.

Executive Summary

- The downturn has been painful for high-growth investors like us. But we stay with what has made us successful long-term investors. The secular growth trends we're investing in are not going anywhere, and we believe the prospects for our portfolios over the long term are extremely attractive.
- We look for companies that we believe will grow faster for longer. Those companies have been the best investments for us over time.
- Durability is key. We favor companies with durable revenues, cash flow streams, and long-term growth opportunities.
- Our top holdings and largest overweight positions are companies that trade at reasonable multiples of free cash flow. We are balancing that by adding to names we think of as long-term winners. This allows us to build positions in companies we expect to own well into the future.

Q&A with Mike Lippert

Growth stocks have taken a beating. How are you and your analysts responding?

There's a real disconnect right now between valuations and the business fundamentals we emphasize in the portfolio. By and large, across the Baron Opportunity Fund portfolio, fundamentals are strong.

"What are you doing?" is a logical question. We are managing our portfolio consistent with our philosophy, our strategy, and the Baron investment process. We look for companies we believe will grow faster for longer. Those companies have been the best investments for us over time.

At the same time, we're making tactical moves. During a down market, which I've experienced a few times in my career, we look to improve the quality of your portfolio. To do that, we sell or reduce less compelling names to buy what we believe are more compelling names. Durability is key. We want companies with durable revenues, cash flow streams, and long-term growth.

What criteria define "faster for longer"?

We want companies with large total addressable markets [TAMs] or even multiple TAMs. **Amazon.com, Inc.**, for example, started as an online book seller. It eventually grew its platform to sell virtually everything. Now it's also a leading information technology company with Amazon Web Services.

To capture that kind of opportunity, we focus on businesses with durable competitive advantages. We do extensive due diligence before we invest and continually during the entire time we are investors. Then we prepare proprietary models based on what we believe these businesses will do and how they will grow their top line and bottom line, and we assign reasonable multiples. We determine what we believe to be appropriate long-term median multiples for businesses based on type and sector.

Can you give a couple of examples of the disconnect between fundamentals and stock prices?

I'll start with **Microsoft Corporation.** For the first quarter, total revenue was up 18%; Microsoft Cloud, which includes applications and infrastructure, was up 32%; and Azure was up 49%, which was an acceleration. Guidance beat Wall Street expectations on every metric, with Azure continuing to grow at the high 40% level.

ServiceNow, Inc. is a "faster for longer" company. Subscription revenue grew 29% in the first quarter, which was a quarterly high. The company generated free cash flow margins of 45%. Management guided for the business to accelerate at a $7 billion scale, with 28.5% growth in subscription revenues versus 28% last year. I wouldn't be surprised if that number is even higher at year-end. We spoke with the CEO about a sustained demand environment for the enterprise. He told us that, "[w]hile there are significant challenges in the world, we have not seen a material impact on our business. To the contrary, the challenges have underscored the urgency of investment in digital businesses. Businesses are shifting investments to technologies that get them to the right outcomes faster. For example, just two years ago, one third of businesses were getting done in digital format. Today it's two thirds. In two years, it'll be 90%. If you don't go digital fast, you lose."

Gartner, Inc. is a company we've owned for a long time. It provides research subscription services. Its core business grew 16%. What it calls the "annual contract value" for its existing technology business is growing 14%. When it acquired its "business solutions" division a few years ago, it projected growth of 20%. No one believed it. It's growing 24%. Despite the environment, Gartner raised guidance on every metric. When we spoke with management, they said, "[p]erformance is strong across the business. We have vast untapped market opportunity. We generate significant free cash flow, and we can continue to return that to shareholders."

ZoomInfo Technologies Inc. is our most significant overweight relative to the benchmark. We've owned it since its IPO. The company has exceptionally robust revenue growth and free cash flow generation. Even today at an early stage, it grew revenues by 58% with organic growth of 49%. Operating margins were just a hair below 40%. Free cash flow margins were above 40%. Again, it raised guidance on every metric and it announced an eight-figure deal with Google in the quarter.

You mentioned in your quarterly letter that you did some tax-loss harvesting with Shopify. Can you speak to that?

Shopify, Inc. is the leading platform for merchants to build ecommerce sites as well as omnichannel business. We think that part of its business is going to grow quickly for many years. Right now, ecommerce has tough compares. During the height of the pandemic, when no one was going to a store, the numbers for ecommerce were exceptionally high, and, in fact, unsustainable. So, this year's numbers, which are more normalized, look less impressive by comparison. That means Shopify is in a difficult situation because it's comparing against the mid-COVID period. In addition, management announced it is investing in its own version of Amazon Prime, which will support its merchants and improve the consumer experience. Because this investment will penalize short-term profits, the market reacted negatively. As long-term shareholders, we see a positive profile for what we believe to be a truly differentiated company that is incredibly innovative and investing in growth. We have a small position. We sold some stock, took the tax loss, and have started building it back.

Can you discuss your sell discipline and what leads you to sell a stock?

We will sell a stock when something undercuts our long-term thesis. For example, in the first quarter, electronic payment company **PayPal Holdings, Inc.** announced some management turnover alongside a major change in its business model. We concluded our thesis no longer held and we should exit the company.

We will also sell – or trim -- when a stock gets expensive compared with our long-term estimates. An example is **Datadog, Inc.** The stock reached roughly 40 times revenue at a certain point. While we like the company, when we modeled it out four or five years, at that price, we didn't see ourselves making much money, so we sold. With the recent pullback we've been buying the stock on weakness.

Looking at mega-growth themes, what are your thoughts on the metaverse theme?

The metaverse is essentially using technology to form a virtual world. Virtual reality is part of the metaverse. Facebook (now **Meta Platforms, Inc.**) is investing a huge amount of money in different things people might do in the virtual world. We think **Apple, Inc.** and **Alphabet, Inc.** will also be building those worlds. Another part of the metaverse is augmented reality, which is adding something to the real world. For example, you may be walking down the street and your phone will pop up information about a building or a treasure you can find if you're playing an augmented reality game. **Snap Inc.,** which we own, is the leader in augmented reality.

Then there are companies building the technology behind the metaverse. Our principal investment here is **NVIDIA Corporation.** NVIDIA is a leader in the technology for digital twins, or omniverse simulation. For any real world object or system, you can create a digital twin in the virtual world. For example, you can design a car virtually before you build it out physically. Or, if you want to make changes to a distribution center, you model them on the digital twin first to simulate how it will work in real life. Whatever the project — a plant, a car, an airplane — you can simulate it in the virtual world, test it, and then build it in the real world. Digital twins enhance productivity and efficiency in building, maintaining, and fixing things.

Another big theme for you is electric vehicles [EVs]. Can you comment on Rivian?

We've been investors in EVs for many years. We first invested in **Tesla, Inc**. around 2014. Tesla proved that electric cars are truly differentiated. Other than Tesla, we passed on everything until **Rivian Automotive, Inc.** We concluded Rivian would emerge as a significant player in EV and invested in it when it was still private. Tesla will likely remain the leader but the EV market is big enough for more than one winner. Rivian will probably never reach the scale of Tesla, but it has the benefit of following in Tesla's footsteps. Many of its executives came from Tesla. Unfortunately, Rivian started production at the worst possible time, coming up against industry-wide supply chain issues that delayed its production ramp. In addition, Rivian launched a price increase campaign that was not well communicated or received by existing reservation holders. The stock took a major hit as a result.

The company will spend more money this year, and we had to change our model from what we had at the time of its November 2021 IPO. But we still see tremendous long-term upside in Rivian stock. Three to five years from now, I think we will look back at it as a very successful investment.

What about infrastructure? Have you considered charging station companies?

We've met with all the players but have not invested in any of the stand-alone charging station businesses. Tesla will build its own. Rivian plans to do a combination, working with other networks and building its own.

Do you have a favorite theme?

As I said earlier, the durability of revenue, cash flow streams, and growth prospects is essential. The software-as-a-service space offers that durability. You can't do business in today's world without software. You need software in every aspect of your business: the back office, the front office, application databases, and cybersecurity. Once you subscribe to software from Microsoft, ServiceNow, Datadog, **MongoDB, Inc., CrowdStrike**, **Inc.,** etc., it's hard to switch and almost impossible to turn off. Especially with valuations as cheap as they are at the moment, this is a space I'm really leaning into.

Can you talk about your valuation methodology?

First, we do all the qualitative work to research potential investments. Then we prepare valuation models. I tell the analysts, "Don't model the sell side, don't model a number that will justify you walking into my office and saying, 'Buy this stock.' Model what you believe." You have to defend your assumptions. How are you building the revenues? The cash flow? We look at unit-level economics, key characteristics, whether it's gross margins or sales efficiency or other things, to build these models. We spend a lot of time on these details.

One of the things I've been doing as Head of Technology Research is benchmarking our models against historical models for industries and other best-in-class companies. We know a model's not going to be perfect. But does our modeling on CrowdStrike make sense versus our modeling on MongoDB or Datadog?

As for multiples, we work with our risk and analytics group to look at peer groups in different industries. How did they trade historically given different interest rate environments, markets, growth profiles, or maturity levels? That data helps us determine a reasonable range of multiples for a business of that type. Then we determine the unique valuation, the right multiple for that company. We have different multiples for different companies based on our assessment of qualitative factors like the size of the TAM, the strength of their competitive advantages, the efficiency of their go-to-market, and the margin profile. We generate price targets that are one, two, three, four, and five years out. We also do some work on downside. If we're slightly off, what could the numbers be?

Final thoughts?

A downturn like this is painful when you're going through it. But we stick with what has made us successful long-term investors. The trends we're investing in are not going anywhere. We believe the picture for our portfolios over the next three, five, 10 years is extremely attractive.

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 Opportunity Fund's annualized returns for the Institutional Shares as of March 31, 2022: 1-year, -6.52%; 5-years, 27.19%; 10-years, 17.26%; Since Inception (2/29/2000), 9.80%. Annual expense ratio for the Institutional Shares as of September 30, 2021, was 1.05%. The **S&P 500 Index**'s annualized returns as of March 31, 2022: 1-year, 15.65%; 5-year, 15.99%; 10-years, 14.64%; Since Fund's Inception (2/29/2000), 7.62%.

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.

Performance for the Institutional Shares prior to 5/29/2009 is based on the performance of the Retail Shares, which have a distribution fee. The Institutional Shares do not have a distribution fee. If the annual returns for the Institutional Shares prior to 5/29/2009 did not reflect this fee, the returns would be higher.

The Fund's 1-, 3-, and 10-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: Securities issued by small and medium sized companies may be thinly traded and may be more difficult to sell during market downturns. Companies propelled by innovation, including technology advances and new business models, may present the risk of rapid change and product obsolescence, and their success may be difficult to predict for the long term. 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 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 March 31, 2022, for securities mentioned are as follows: **Amazon.com, Inc.** – 6.3%; **Microsoft Corporation** – 11.9%; **ServiceNow, Inc.** – 1.9%; **Gartner, Inc.** – 2.9%; **ZoomInfo Technologies Inc.** – 3.7%; **Shopify, Inc.** – 0.7%; **Datadog, Inc.** – 1.0%; **Alphabet Inc.** – 8.5%; **NVIDIA Corporation** – 4.2%; **Tesla, Inc.** – 4.5%; **Rivian Automotive, Inc.** – 3.8%; **MongoDB Inc.,** -- 1.3%; **CrowdStrike, Inc.** – 1.5%, Snap Inc – 1.3%.

As of March 31, 2022, Baron Opportunity Fund held no stock in **PayPal Holdings, Inc., Apple, Inc., Meta Platforms, Inc.**

Top 10 holdings as of March 31, 2022

Holding	% Assets
Microsoft Corporation	11.9
Alphabet Inc.	8.5
Amazon.com, Inc.	6.3
Tesla, Inc.	4.5
NVIDIA Corporation	4.2
Rivian Automotive, Inc.	3.8
ZoomInfo Technologies Inc.	3.7
Gartner, Inc.	2.9
argenx SE	2.7
Visa, Inc.	2.5
Total	51.0

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.

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