



Randy Gwartzman and Laird Bieger: Our Best Small-Cap Ideas

This is an edited version of an October 27, 2021, Q&A with Randy Gwartzman and Laird Bieger, Portfolio Managers of Baron Discovery Fund. To access the recording, please dial 800-633-8284, passcode #2199778.

Introduction

Q&A with Randy Gwartzman and Laird Bieger

- Applying the Baron investment approach to small caps
- Fund performance, turnover, and flows
- Investment themes: Our best ideas
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- **Inogen, Inc.** – growth at a reasonable price
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Introduction

Randy Gwartzman and Laird Bieger have managed the small-cap growth equity Baron Discovery Fund since its 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.

Baron Discovery Fund has received Morningstar's Silver Rating and has a 5-Star Overall Morningstar Rating™ as of 9/30/2021.

Morningstar calculates the Morningstar Small Growth Category Average performance and rankings using its Fractional Weighting methodology. Morningstar rankings are based on total returns and do not include sales charges. Total returns do account for management, administrative, and 12b-1 fees and other costs automatically deducted from fund assets.

For the period ended 9/30/2021, Baron Discovery Fund received a 5-Star Morningstar Rating™ for its Overall and 5-Year Rating, and a 4-Star Morningstar Rating™ for its 3-Year Rating. The Morningstar Ratings are based on the Morningstar Risk-Adjusted Return measures of 575, 575, and 506 funds in the category, respectively. This Morningstar Rating is for the Institutional share class only; other classes may have different performance characteristics.

Q&A with Randy Gwartzman and Laird Bieger

For those who may be unfamiliar with your strategy and process, can you give a brief overview?

Laird Bieger: Like all Baron strategies, Discovery takes a long-term view on investing. We look to double our investment in approximately five years. We are fundamental bottom-up investors, which means we do deep due diligence on all our names. What gets us excited is finding companies whose potential the rest of Wall Street has yet to recognize.

From a risk management perspective, we focus on short-, medium-, and long-term valuations. We constantly update those valuations in real time, so when a company gets to the upper end of our five-year valuation, we'll trim the position.

From a portfolio construction standpoint, we tend to keep positions with the highest potential upside, but also the highest risk, as our smallest positions. More fully developed, lower upside/lower risk companies are the larger positions within the Fund.

Could you please re-cap the third quarter?

Laird Bieger: The last quarter was interesting in that we were down a little over 5% but still about 60 basis points better than our benchmark. The market was reacting to the Delta variant, which has been a speed bump for the economic recovery. As a result, the market ceded some upside, which affected us as well.

It's our belief that we are now back on track. Company management tells us things are getting better, not worse. And yet, while we feel good about demand and revenue growth as we look out to 2022, our outlook on expenses is more muted. We see pressures almost everywhere: commodity costs, metals and packaging costs, logistics costs, and oil and gas prices. Labor is another factor. In addition to inflated labor costs in many of the companies we own, labor availability is still a concern. While we're enthusiastic about the outlook for our companies for next year, those challenges remain.

As for year-to-date performance, we're up about 8.3% as of 9/30/2021, which is a little under 6% better than the benchmark. Beta continues to be about 1.0 across the 1-, 3-, and 5-year timeframes. Up/down capture continues to be around 113% and 87%, respectively, on a 3- and 5-year basis.

Turnover for the portfolio on a 3-year basis is running around 45%. Active share continues to be about 95%. We look at companies on a bottom-up fundamental basis and steer clear of any kind of top-down type portfolio construction. The weighted average market cap of the Fund is \$4.4 billion.

Fund flows have been solid, with about \$600 million coming in so far this year on a net basis. Assets under management are a little over \$2 billion. We believe the ultimate capacity of the strategy is around the weighted average market cap of the benchmark, which currently is about \$3.8 billion.

How do concerns around inflation and the disruption of logistics and labor markets influence your outlook and decision making?

Randy Gwartzman: Our portfolio is structured thematically for secular growth with long-term durability. We don't let the tail wag the dog, jumping from sector to sector when more cyclical sectors start working. For example, energy prices have gone up dramatically. We're also seeing financials do very well as people anticipate interest rates rising and want to buy spread businesses. We're underweight those sectors because of their cyclicity. And yet when they're working, they're working. If we are a touch behind the market on any given day, that can happen because those sectors could be outperforming. We don't think this is a long-term phenomenon. This too shall pass, in terms of inflation and some of these other issues.

All that is a prelude to what we own and why we're excited about it. The themes where we find our best ideas include:

Health care: We like companies that deliver lower costs, better patient care, and competitive advantages. For example, we own **Silk Road Medical, Inc.**, which has a medical device that cleans carotid arteries to prevent stroke in a minimally invasive way. It's a fantastic \$60 million company addressing a billion-dollar market. I think revenues can grow 10 times over the next five to seven years. In specialty diagnostics, we are investors in **CareDx, Inc.**, an organ transplant diagnostics company with \$10 billion-plus potential total addressable market. It brings in a few hundred million dollars in revenue now and the market leader. I think it will continue to grow and do well.

Cybersecurity: Identity management, or ensuring that networks aren't breached, is big business. We already own a few names and recently invested in another new name in identity management. We're following this theme very closely and doing a ton of due diligence because it is highly competitive. We think the companies we own in the space have great, reasonably priced products, which is important because a lot of software is very expensive now.

Semiconductors: Obviously, there's a shortage of semiconductors and production capacity. We own **Ichor Holdings, Ltd.**, which produces components for semiconductor, large-equipment companies like Applied Materials and Lam Research. We own **Nova Measuring Instruments Ltd.**, which does measurement and quality control. That's a great theme. And we own actual semiconductor companies, which are targeting some of the biggest growth areas like automotive, where everybody knows there's currently a massive undersupply of chips. We are invested in **indie Semiconductor, Inc.**, whose solutions are applied to advanced driver assistance systems and electrifications, and **Allegro MicroSystems, Inc.**, a global leader in sensing and power semiconductor technology.

Advanced industrials: We own a company called **Kornit Digital Ltd.**, which provides digital printing solutions for textiles. When we first invested, the company was mainly providing a better solution for printing t-shirts and apparel like that. Then it expanded to help power Amazon's online store. Now it's printing large textiles on rotor rolls, which mean it can handle a much wider range of clothing and home furnishing fabrics. It's now moving into the next phase, which is the digitization of printing. It's almost like printing in the cloud where you can spread your resources, do just-in-time printing, make sure that there's no waste. Now you're much more efficient, you're saving money for the companies, you're being green. Kornit has taken this little t-shirt printing machine and made it into a worldwide digital distribution network that I don't think anybody's going to be able to touch.

3D printing: We own a couple of 3D printing companies, one of which is **Velo3D, Inc.** This company can print parts that were never before possible. Customers use Velo3D printers to create the most difficult parts in a single piece. SpaceX uses Velo3D printers to help build its rocket engines. A lot of defense and aerospace companies are using Velo3D products as well. We think Velo3D could grow from \$25 million in revenue this year to what could be a \$500 million company in a few years as it ramps its product line and customer base.

I could go on about other themes we are excited about, like environmental services, next-generation software, database software, residential digitization, and digital advertising, all of which is the next phase of where we are right now.

Any other highlights?

Randy Gwartzman: I want to talk about a company we invested in when it had its IPO in July. It's a database software company called **Couchbase, Inc.** This is a company with a \$1.5 billion market cap, while the market for the type of database it serves is about \$8 billion. With the old-style database, called a relational database, you had to create all the individual fields and know in advance exactly what you wanted to include. If you needed to add something after the database was up and running, it was quite

complex. Relational databases are good for certain use cases, but where the data is more free-flowing and you want to change things on the fly, they are not ideal. NoSQL databases, in contrast, offer more flexibility than traditional relational databases. Since their design does not require a schema, they offer rapid scalability to manage large and typically unstructured data sets. Couchbase is a NoSQL database. We believe it has certain advantages over its competitors. It's faster, more accurate, more effective at how it manages lossless data, and it allows people to search in the same way they are used to searching in a relational database. This functionality allows customers to easily transition database management teams from the old to the new. That's an important distinction because, where the NoSQL market is about \$8 billion growing to \$20 billion, the relational database market is over \$30 billion growing to around \$60 billion. While the new market is growing by about 25% per year, there's also substantial share to take from the old market.

Couchbase is currently bringing in \$125 million in revenues per year. We estimate its CAGR at about 30%. Its competitor, MongoDB, is at \$800 million in annual revenue with a CAGR of 40%. We think Couchbase has better technology. It's not well-known and it trades, on a valuation basis, at nine times revenue, and at seven times projected revenue for 2023. We think that 12 times is the right number for these types of software companies. So, a stock that's trading at \$35 or \$36 per share should be worth \$90 in four to five years.

This is the kind of opportunity that gets us excited. And that's why Laird and I invest our own money in the portfolio. We hope to take everybody else along for the ride.

Can you comment on the SmartRent, Inc., investment?

Laird Bieger: SmartRent is part of our residential digitization theme. Today, most households still use manually controlled keys, locks, thermostats, and lights. We believe we're going to see a massive shift to digitization of these features over the next decade, and this shift is going to start in multifamily housing.

SmartRent is a software platform for multifamily building owners to manage these devices digitally. The most popular device today, by far, is smart locks. A smart lock, for example, allows a resident to remotely open a lock for a babysitter, or a building owner to remotely open a lock for a potential resident that wants to tour an apartment. Other digitization solutions include thermostats, leak detection, and lighting. For example, you can have a detection sensor for a water leak. Obviously, the earlier a water leak is detected, the less damage will occur and more money you'll save.

Today SmartRent is the leader in retrofitting manually controlled features with digitized solutions. A competitor is the leader in new construction, but we believe the retrofit market is much, much larger. The company has retrofitted 211,000 units to date. Just within its existing customers, which include 15 of the top 20 residential multifamily owners, there's an opportunity for 3.5 million units. That's a long runway of growth. It has over 600,000 units in backlog, so there is clear visibility as far as converting these units into what we call a smart unit.

The total market in multifamily housing alone is 32 million units in the U.S. There is also the international market and other markets it hasn't even started to touch on, including student housing, senior living, and single-family homes. There is at least a decade-plus growth opportunity for this company, so we are in the very early stages. Over the next five years -- our forecast horizon -- we think the stock could more than a double just with multifamily housing.

In your quarterly letter, you say that Inogen, Inc. is trading at bargain prices. What metrics do you evaluate to make that statement?

Randy Gwartzman: Inogen is a medical device company that makes portable oxygen concentrators for chronic respiratory patients. Its product is a replacement for tank cylinders that must be delivered to people's houses.

In the near term, we look at the EBITDA to sales ratio, but over the long term, we look at the enterprise value to cash flow ratio. Inogen was hurt by the pandemic and some component issues, so growth slowed a bit last year. We think its growth rate has reaccelerated to the low teens this year. The company has a \$1.5 billion market value but \$1.2 billion enterprise value because it has \$250 million of cash on the balance sheet. Revenue, we think, will grow from \$350 million to \$550 million over the next five years. Most importantly, EBITDA has been flat this year because of some supply chain issues and additional hiring of salespeople now that we're starting to come out of the pandemic. EBITDA peaked at 20% in 2017, so we think high teens is not unrealistic.

According to our projections, in 2025 -- our five-year look -- the stock is trading at 12 times cash flow. We think it should trade at around 20 times cash flow because cash flow should grow 25% to 30% or more over the next few years.

The total addressable market is \$3 billion to \$4 billion, based on 2.5 million to 3 million patients at \$1,200 to \$1,500 per patient. Portable oxygen concentrators only comprise about a quarter of the market. We think that percentage will not only continue to grow, but there will be a tipping point at which growth accelerates because tank delivery is a fixed operating cost business. At some point when you start losing patients, your marginal profitability starts to get painful for those companies. There could be a wholesale shift to portable oxygen concentrators, and we want to be around when that happens. We want to buy the stock at a reasonable price. For a medical device company, trading at 3 to 3.5 times EBITDA sales, it is under-earning from a margin perspective. In a few years, when other investors come to recognize the value of this company, when we will already own it. We view Inogen as the ultimate "growth at a reasonable price" kind of company.

In your quarterly letter you discuss exiting Zymergen Inc. during the quarter. Could you describe what happened? Were you surprised by the news?

Randy Gwartzman: Yes, it was a total surprise. Zymergen had exciting prospects. It is a synthetic biologic company, where they grow microbes instead of using petroleum-based products to create chemicals that make plastics. They were supposed to sell products into the semiconductor industry, including certain coatings and screen plastics and films. They had other products for skin care, mosquito repellent, and the like.

A few months after the IPO, Zymergen said it was having production problems. The CEO got fired. We originally invested in the company in part because a key board member is the former CEO of Illumina, Inc. He's incredibly accomplished and we've got a lot of experience with him. I think he was as shocked as we were.

I've never seen this happen before. You have to be prepared for negative news, but quite honestly it was a mistake, pure and simple. We exited the position because it's not clear whether they can fix what's gone wrong to get its product to customers or how long it will take for the company to ultimately produce revenue.

Occasionally this happens. You get these bolts from the blue. And that's exactly why for a company like Zymergen, we keep our position size small. The weighting was well under 1%, somewhere between 50 to 70 basis points.

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Baron Discovery Fund's annualized returns for the Institutional Shares as of September 30, 2021: 1-year, 35.93%; 5-years, 25.55%; Since Inception (9/30/2013), 20.03%. Annual expense ratio for the Institutional Shares as of September 30, 2020, was 1.08%. The **Russell 2000 Growth Index's** annualized returns as of September 30, 2021: 1-year, 33.27%; 5-years, 15.34%; Since Fund Inception (9/30/2013), 11.97%.

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 YTD, 1-, 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 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 September 30, 2021, for securities mentioned are as follows:

Silk Road Medical, Inc. – 1.7%; **CareDx, Inc.** – 1.7%; **Ichor Holdings, Ltd.** – 1.2%; **Nova Ltd.** – 1.3%; **indie Semiconductor, Inc.** – 1.8%; **Allegro MicroSystems, Inc.** – 1.1%; **Kornit Digital Ltd.** - 1.8%; **Velo3D, Inc.** – 0.7%; **Couchbase, Inc.** – 1.5%; **SmartRent, Inc.** – 1.6%; **Inogen, Inc.** – 1.4%.

As of September 30, 2021, the Fund did not hold shares of **Zymergen Inc.**

Top 10 holdings as of September 30, 2021

Holding	% Assets
Endava plc	2.7
The Beauty Health Company	2.6
Future plc	2.3
Mercury Systems, Inc.	2.2
S4 Capital plc	2.2

Progyny, Inc.	2.1
Floor & Decor Holdings, Inc.	2.1
Axonics, Inc.	2.0
Kinsale Capital Group, Inc.	2.0
Advanced Energy Industries, Inc.	2.0
Total	22.2

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

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The Analyst Rating scale is Gold, Silver, Bronze, Neutral, and Negative. For active funds, a Morningstar Analyst Rating of Gold, Silver, or Bronze reflects the Manager Research Group's expectation that an active fund will be able to deliver positive alpha net of fees relative to the standard benchmark index assigned to the Morningstar category. The level of the rating relates to the level of expected positive net alpha relative to Morningstar category peers for active funds. For passive funds, a Morningstar Analyst

Rating of Gold, Silver, or Bronze reflects the Manager Research Group's expectation that a fund will be able to deliver a higher alpha net of fees than the lesser of the relevant Morningstar category median or 0. The level of the rating relates to the level of expected net alpha relative to Morningstar category peers for passive funds. For certain peer groups where standard benchmarking is not applicable, primarily peer groups of funds using alternative investment strategies, a Morningstar Analyst Rating of Gold, Silver, or Bronze reflects the Manager Research Group's expectation that a fund will deliver a weighted pillar score above a predetermined threshold within its peer group. Analyst Ratings ultimately reflect the Manager Research Group's overall assessment, are overseen by an Analyst Rating Committee, and are continuously monitored and reevaluated at least every 14 months.

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