

Delving Into Our Mid Cap Sustainable Growth Strategy

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OUR NUANCED MID CAP SUSTAINABLE GROWTH STRATEGIC APPROACH

At Kayne Anderson Rudnick, our Mid Cap Sustainable Growth (MCSG) strategy is firmly entrenched alongside all of our quality investment strategies.

While this piece is meant to be instructive and to shed light on the nuanced differences of our MCSG strategy, our approach shares the same investment DNA as all of our other strategies. They are all rooted in the same shared investment philosophy.

First and foremost, we strive to identify companies whose products or services exhibit differentiation that is protectable from the onslaught of competition over time. We believe this will result in a business model that currently produces, or will produce, over the next three to five years, exemplary financial metrics.

This is the key to any successful long term, high-quality investment at KAR.

That said, let's explore what we identify as some of the key differences and characteristics of this strategy:

- The mid-cap growth asset class has a more competitive benchmark than small caps, necessitating a slightly tailored approach in order to identify opportunities for alpha.
- The acuity of the innovation and disruption cycles of companies in this asset class requires vigilance.
- Companies in this universe have deeper and broader Wall Street sell-side coverage, making estimates more important.
- Resultant willingness to take smaller initial positions (1%-3%) in emerging businesses to mitigate the elevated execution risk found during early-stage, heavy-investment, high-growth periods in a company's lifecycle.
- Marked emphasis on quality companies combined with upside revenue and earnings potential early-stage, heavy-investment, high-growth periods in a company's lifecycle.

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A MORE COMPETITIVE BENCHMARK WARRANTS A TAILORED APPROACH

The Russell MidCap Growth Index is more competitive than the comparable small cap benchmarks, necessitating a slightly tailored approach from our end.

Broadly speaking, the Russell Midcap Growth Index is a much higher quality and less volatile benchmark than the Russell 2000 Growth Index. In the Russell 2000 Growth index, 49% of the names are unprofitable¹.

However, in the Russell Midcap Growth just 25% of the names are unprofitable¹, which from our standpoint means there are more “good businesses” to choose from.

Put simply, mid-cap growth is a more efficient asset class.

ACUITY OF INNOVATION AND DISRUPTION CYCLES

Another feature unique to the mid-cap growth asset class that requires vigilance is the acuity of innovation and disruption cycles. Every industry goes through waves of innovation and disruption over time. Some are slow moving (media streaming, industrial automation) while others are like a bolt of lightning (the smart phone) that changes everything almost overnight.

At times of heightened innovation and disruption, companies can rapidly increase in value as the market assesses the possibility that the innovation and disruption that they have developed will turn them into a much larger company in the years to come. These companies can skip the small-cap universe altogether and these disruption waves can lead to multi-year outperformance of certain cohorts of stocks that can drive returns of an index and result in meaningful underperformance if missed.

Today we believe the innovation and disruption cycle is in overdrive, enabled by technology. Examples include cloud, mobility, artificial intelligence/machine learning, financial technology, and even health-care technology where advances in understanding the human genome enabled by genomic sequencing has kick-started development of novel drug classes like immune-oncology, cell-/gene-therapy and gene editing.

Frequently, disruption involves a business strategy of heavy upfront investing which obscures long-term profitability. As a general trend, many of these disruptive companies are staying private longer and by the time they have an IPO, they already have a mid cap or larger capitalization.

IMPORTANCE OF WALL STREET ESTIMATES

Another critical tenant of investing up the market-cap spectrum is the importance of Wall Street estimates. Many names in our universe have broader and deeper sell-side coverage than small-caps so those analysts’ estimates set a bar that heavily influences stock performance. It is not uncommon that our companies are covered by 20+ analysts. Their published estimates are largely dictated by corporate guidance and the market prices these stocks based on that information.

Therefore, we complement our typical evaluation of company quality and valuation with analysis of consensus expectations and the likelihood financial results will exceed those expectations over time. Our goal is to identify estimates that we believe are significantly different from what actual results will be.

That said, the sustainability of growth over time, as well as the source of that sustainability, are what constitute the majority of our research efforts. It is our belief that sustainable business models combined with consistently exceeding Wall Street estimates leads to significant stock outperformance over any reasonable period of time.

¹. As of June 30, 2020.

UNIQUE PORTFOLIO CHARACTERISTICS

What's more, our MCSG Strategy is distinct in its number of holdings, which is approximately 25-50 names versus the stated 25-35 range for other KAR small-cap strategies. In keeping with that, we are willing to take smaller initial positions (1%-3%) in emerging businesses to mitigate the elevated execution risk found during early-stage, heavy-investment, high-growth periods in a company's lifecycle. We find the upside in the names we get right can be markedly significant.

Due to the fact that many of our holdings are in a heavy discretionary investment mode, our portfolio characteristics may differ from our small-cap strategies. For example, a company investing aggressively upfront will tend to have a much higher P/E ratio than a more mature, high-margin business. Disruptive companies with shorter operating histories will also tend to have higher earnings volatility than more mature, stable businesses with long operating histories.

As our growing companies mature, we believe their financial characteristics will become very similar to the mature businesses held here at KAR. Once these mature financial metrics are reported, many of these disruptive companies will likely fall into the large-cap universe. Recent examples in our MCSG portfolio include Zoetis, Illumina and Workday.

HEAVY INVESTMENT

Company	Monster Beverage	CoStar Group	Workday	Okta	Paycom Software	Teladoc Health
Ticker	MNST	CSGP	WDAY	OKTA	PAYC	TDOC
Date Purchased by MCSG	8/14/12	2/21/14	10/24/14	4/7/17	5/12/15	9/19/17
Market Cap at Purchase	10,370	5,712	8,853	1,521	2,158	1,751
Operating Margin at Purchase	27%	12%	-33%	-41%	11%	-51%
Current Operating Margin*	34%	34%	13%	-8%	37%	-13%
Current Market Cap*	36,557	27,988	44,030	24,950	17,837	15,095

Data is obtained from FactSet Research Systems and is assumed to be reliable. Past performance is no guarantee of future results.

**As of June 30, 2020.*

THE STORY OF WORKDAY

The story of Workday illustrates how we applied these concepts in the past. Workday offers cloud-based Human Capital Management (HCM) and financial management software where it competes with well-established incumbents like Oracle (ORCL) and SAP.

We believed Workday's product had a litany of sustainable differences that would allow it to gain share of the \$50B+ enterprise resource planning (ERP) software market and that, at maturity it would be a very profitable business (like many other software companies).

Workday's single instance database is hosted in the cloud and accessible from anywhere one can get an internet connection, which obviates the need for clunky on-premise systems which are extremely costly to install, maintain, scale, and update. When it IPO'ed in 2012 Wall Street pegged Workday's ultimate market opportunity at roughly a 10% share as it was competing with strong incumbents who had "sticky" customers.

Based on our understanding of the product and the value proposition, we felt Workday could take much more share. Currently (just 7.75 years later), Workday has already captured that 10% share and now Street estimates have the company maturing at 20%-30% share of the market. Incidentally, we still believe its legacy competitors cannot re-architect their offerings to fulfill the needs of modern IT infrastructure.

We want to own businesses with high competitive barriers that are or will be high-quality businesses. And we do, in fact, own some of the businesses that are hallmarks of other KAR strategies, but we complement them with innovative and disruptive companies.

We own these names in relatively concentrated portfolios over long periods of time with low turnover similar to the other KAR strategies (average turnover was 25% over the previous five years ending June 30, 2020).

SAME INVESTMENT DNA

As we draw to a close, we want to re-emphasize that this strategy has the same investment DNA as all of our other offerings. In other words, the MCSG strategy has more similarities than differences compared to our other strategies.

At KAR, we believe, and have always believed, that purchasing high-quality businesses with competitive protections at attractive valuations will achieve excess returns over a complete market cycle.

We bring this investment philosophy to life with our MCSG strategy and in all that we do.

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