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DF Dent Small Cap Growth Strategy

April 2019 Commentary

The S&P 500's 13.65% gain for the first quarter was its best quarterly gain in nearly a decade and its best start to the year since 1998. U.S. equities bounced back after the fourth quarter's 13.52% decline, led by a dovish Fed and increasing optimism on a trade deal with China. The U.S. economy is in good shape as evidenced by solid economic growth and a labor market that remains resilient.

Portfolio Thoughts

	1Q19	YTD 2019
Small Cap Growth (gross)	17.27%	17.27%
Small Cap Growth (net)	17.04%	17.04%
Russell 2000 Growth Index	17.14%	17.14%

For the first quarter of 2019, D.F. Dent's Small Cap Growth strategy slightly underperformed the Russell 2000 Growth Index after fees. The slight underperformance was driven by negative stock selection mainly in the Technology sector, led by EventBrite (EB). Stock selection in the Health Care and Industrial sectors also held back performance. Sectors where stock selection positively impacted the portfolio included the Consumer Discretionary, Consumer Staples, and Financial sectors. The Small Cap Growth strategy added two names to the portfolio in the first quarter, Trupanion Inc. and Coupa Software. The strategy exited four names in the first quarter, Mindbody, Inc., MSC Industrial Direct Co., Redfin Corp. and WageWorks Inc. The Small Cap Growth strategy ended the first quarter with 49 names in the portfolio.

New Additions to the Portfolio:

- **Coupa Software (COUP)** is a leading provider of cloud-based business spend management (BSM) software. The company provides businesses with tools to track, analyze, and optimize their spending and related processes. Customers can also transact with vendors directly through the company's platform. We believe Coupa will continue to grow the BSM software market and that its competitive advantages will become increasingly robust as the company leverages its scale and massive data advantage to continually offer new products to benefit customers. We believe that the combination of new customer acquisitions and cross-selling of additional tools to current customers should allow Coupa to grow revenue in excess of 30% for several years and that free cash flow and earnings should grow at significantly higher rates as the company leverages its cost structure.

- **Trupanion (TRUP)** is a leading pet insurance company operating in a large underpenetrated market with a differentiated go-to-market strategy and a vertically-integrated business model. Unlike many other pet insurance companies, Trupanion offers just one simple benefit-rich product that covers 90% of the vet's invoice. Therefore, we expect Trupanion to gain significant share as the pet insurance penetration rate in North America expands from the current 1%-2% to a mid- to high-single-digit penetration rate, as seen in many Western European countries. We expect Trupanion to grow its revenue and earnings power in the low-20% range annually over the intermediate term.

Positions exited in the portfolio:

- **Mindbody Inc. (MB),** the leading technology platform for the fitness, beauty and wellness services industries, was acquired by Vista Equity Partners, a leading investment firm focused on software, data and technology-enabled businesses. The transaction was for approximately $1.9 billion, or a 68% premium to MB's close price when the deal was announced.

- **MSC Industrial Direct Co. (MSM)** a distributor of maintenance and repair products, has been losing market share, which we ascribe to poor execution by management. A large salesforce re-alignment has taken too long to gain traction and in the meantime customers are fulfilling orders elsewhere. Longer term, we worry that this is not a distribution business that adds a lot of value through service, which makes it more susceptible to on-line competition where price transparency reigns.

- **Redfin Corp. (RDFN)** is a residential real-estate brokerage aiming to disrupt an $80 billion market with a differentiated business model. While significant potential exists for the company to continue to take share, we are concerned that short-term headwinds around weakening housing markets and increased marketing spend will more than offset those gains and distract from the long-term opportunity. Given our believe that it may be multiple quarters before the company shows positive momentum in a number of key metrics, we chose to exit our position and redeploy capital into investments in which we have higher near- and long-term confidence.

- **WageWorks (WAGE**) is an administrator of consumer-directed benefit accounts for employers. WAGE has been under scrutiny for issues stemming from its delayed 2017 10-K filing. WAGE and its auditors continued to review the company's financial statements and its revenue recognition policies. While we believe WAGE is largely past its accounting issues, we had lost confidence in the previous management team and did not believe that the new management team has righted the ship. In addition, our projected revenue and EPS growth rates for WAGE have declined over the past 6 months, reducing our expected return to levels we found unattractive.

Ticker	1Q19	Contribution To Return
	5 Largest Contributors	**5.13**
W	Wayfair, Inc. Class A	1.33
TECH	Bio-Techne Corporation	1.07
HEI.A	HEICO Corporation Class A	1.05
PRO	PROS Holdings, Inc.	0.96
NOVT	Novanta Inc	0.73
	5 Largest Detractors	**-1.29**
HCSG	Healthcare Services Group, Inc.	-0.55
EB	Eventbrite, Inc. Class A	-0.44
VAPO	Vapotherm, Inc.	-0.12
CMD	Cantel Medical Corp.	-0.09
WDFC	WD-40 Company	-0.08

The top three contributors during 1Q were:

- **Wayfair (W)**, the leading online furniture and home goods retailer, reported strong 4Q results beating both revenue and gross margin expectations. While Wayfair stock is quite volatile, the business is not nearly as volatile as the stock with all of the Key Performance Indicators trending in the right direction. Most investors view Wayfair as a traditional retailer rather than a platform and infrastructure provider that allows for a great customer experience. We continue to like Wayfair's long-term growth prospects and industry leading position. In the future, we hope to take advantage of the volatility in Wayfair's stock price and opportunistically add to our existing position.

- **Bio-Techne Corp. (TECH)**, designs and manufacturers best-in-class reagents and instruments for the life science research and clinical diagnostics markets. The stock outperformed due to a strong 4Q18 earnings report, supported by healthy performance in most of its business segments. In addition, management provided 2019 outlook indicating the current strong business momentum will likely continue. TECH has a healthy balance sheet and may continue to supplement strong organic growth with acquisitions with good strategic fit. We believe over time the company's organic growth will likely accelerate further and margins will expand.

- **HEICO Corp. (HEI.A)** designs and manufactures products for the aerospace, defense and electronics markets. The stock outperformed in 1Q19 after reporting very strong financial results and raising guidance for 2019. Both revenue and earnings beat consensus estimates. The company's Flight Support Group and Electronics Technologies Group both reported very strong organic growth. In addition, both gross margin and operating margin expanded modestly. We believe HEICO is a very good business managed by talented owner-operators and we expect its steady growth to continue.

The top three detractors during 1Q were:

- **Healthcare Services Group, Inc. (HCSG)** provides housekeeping, laundry and dietary services to long-term care facilities. HCSG traded off in 1Q19 because it issued weak 4Q18 results and provided a mixed outlook for 1Q19, to a large extent as a result of the financial difficulties of some of its customers. In addition, the company received an SEC inquiry regarding the company's rounding practices used in its EPS calculation. However, we believe the long-term outlook of this business has not changed, and most of the headwinds the company is facing will prove to be transitory. We believe HCSG can achieve its gross margin goal of 14% within the first half of 2019 and its revenue growth will start to re-accelerate in the second half of 2019. In addition, weak share price performance has made the stock's valuation much more reasonable relative to its own historical multiples. We continue to hold our positions in HCSG and believe the future risk-reward profile is attractive.

- **EventBrite, Inc. (EB)** is a software company serving the event planning market. Its cloud-based software is used by event creators of all sizes to manage event registration, ticketing, onsite sales, marketing, analytics, and other related functions. EB's stock was weak in the first quarter despite reporting healthy results. The company gave weak guidance implying revenue growth will be significantly lower than the target of 20% plus. The weak outlook is caused by issues related to the integration of the recently acquired TicketFly business, and could negatively impact the business for several quarters. However, we continue to believe the company is still early in its growth and has several significant ongoing growth initiatives that should bring growth back to 20% or more within the next 12 months.

- **Vapotherm, Inc. (VAPO),** a manufacturer of ventilatory support systems for hospital patients suffering from respiratory distress, reported its first quarter as a public company, with results and guidance in line with the growth framework the company laid out during its November 2018 IPO. There was no material news in the quarter that would explain the stock's relatively weak performance. We believe due to the stock's limited public float, share prices are susceptible to meaningful movements on fairly small trading volumes. We remain focused on the longer-term outlook for Vapotherm's products, which we believe to be promising given the product's significantly improved patient comfort with similar clinical outcomes to the incumbent solutions. As awareness and adoption grow, we believe the stock has the potential to meaningfully outperform the market.

Market Thoughts

We have often commented that liquidity is the lifeblood of the markets. Last fall the Federal Reserve indicated a policy of raising interest rates and shrinking its balance sheet. We believe this contributed to the sharp decline in the stock market in the fourth quarter.

At the end of the year, in the face of trade tensions and the government shutdown, the Fed reversed course and indicated it would not be increasing interest rates in the immediate future and would be considering a temporary halt in the planned reduction of its balance sheet. At the same time the European Central Bank indicated it would hold interest rates at current levels at least through the end of the year. We believe these accommodative moves contributed to the strong equity performance in the first quarter.

So where do we go from here? Given the recent economic slowing in both the United States and abroad, we believe that the Fed and other central banks are going to take a more cautious near-term stance and err on the side of being accommodative rather than restrictive. Currently, the Fed does not expect to raise interest rates this year (always subject to change) and plans to stop shrinking its balance sheet by the fall. Therefore, overall liquidity should not pose a headwind to financial markets for the foreseeable future.

But what about the slowing economy? Absent a Black Swan event, we see little to suggest that a recession is imminent. Few cyclical areas of the economy are meaningfully overextended. Recessions are rarely sparked when the Fed is in a neutral or accommodative position. The rising Chinese stock market bodes well for an improving Chinese economy, which should help Europe and emerging economies. We believe the current soft patch will pass and that economies worldwide should show improved growth. While some of this news is likely discounted in the strong first quarter equity performance, improved economies should provide further support for financial assets. Stocks with good earnings results should continue to reward investors albeit at a much slower rate than in the recent past.

As economies recover, attention at some point will return to the possibility of less accommodative Fed policy. With unemployment low and wages rising, inflation should tick upward absent strong productivity gains. This should eventually force the Fed's hand toward tightening and could spark an eventual recession. Together with political uncertainty as the 2020 election approaches, we could have a recipe for increased market turbulence.

Longer-term, we continue to expect equity returns to be more measured over the next decade. We believe the catalysts of above-trend equity returns since the early 1980s- falling interest rates, rising corporate profit margins, increased debt leverage, and falling tax rates- are largely tapped out and have some risk of retracing their steps. With the tide less in investors' favor, stock selection will be critical. We continue our focus on owning high-quality, "deep moat" companies with proven business models, strong pricing power, and talented and ethical management teams. We see this strategy driving strong long-term returns in a lower-return environment.

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We appreciate the confidence you have placed in D.F. Dent and Co. We will continue to work diligently on your behalf.