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DF Dent Small Cap Growth Strategy

July 2019 Commentary

U.S. equities had a strong second quarter with the S&P 500 index gaining 4.3%. The index's first half return of 18.5% represented the strongest 1H since 1997 and led all asset classes amidst slowing global growth. This year's rebound from the weak fourth quarter of 2018 has been better than we expected, aided in part by generally solid corporate earnings and the Federal Reserve's pivot to a more accommodative stance.

Portfolio Thoughts

	2Q19	YTD 2019
Small Cap Growth (gross)	11.61%	30.91%
Small Cap Growth (net)	11.42%	30.48%
Russell 2000 Growth Index	2.75%	20.36%

For the second quarter of 2019, D.F. Dent's Small Cap Growth strategy outperformed the Russell 2000 Growth Index. The strategy's outperformance was due to strong stock selection and was fairly broad-based. The leading sectors where stock selection positively impacted the portfolio were the Technology, Health Care, Industrials and Financials sectors.

The Small Cap Growth strategy added one new name during the quarter - Trex Company, Inc. The strategy exited two names in the second quarter – Blackbaud, Inc and Ultimate Software Group, Inc. The Small Cap Growth strategy ended the second quarter with 48 names in the portfolio.

Positions Added in the Portfolio:

- **Trex Company, Inc. (TREX)** is the leading brand for composite decking in the U.S. with approximately 50% market share. Wood is still the material of choice for 80%+ of decks in the U.S. due to its lower cost, and we see a long runway for composites to gain more share. Trex is the low cost manufacturer because its process uses 95% recycled material. Trex's low cost operations and industry-leading scale, produce attractive gross margins in the low 40s% and operating margins in the mid-20s%. The company recently introduced a lower priced product which we expect will accelerate the shift from wood to composites. Finally, the management team has successfully executed a turnaround of this business which was on the verge of bankruptcy in 2008. Today, the company has no debt and a vastly improved portfolio of outdoor living products which include railings, fencing, furniture and outdoor lighting.

Positions Exited in the Portfolio:

- **Blackbaud, Inc. (BLKB)** sells software solutions to non-profit organizations. With its roots in fundraising, BLKB has expanded its offerings into adjacent areas, mostly via acquisition. We sold the stock, after a four-year-plus ownership period, for several reasons: (1) BLKB's steep valuation seems to discount a dramatic, near-term acceleration in organic revenue growth, which we lack high conviction in, (2) we received disappointing feedback from numerous customers regarding BLKB's product quality and customer service, (3) we sense that BLKB's markets may be getting more competitive, and (4) meaningful recent stock sales by senior executives, around current prices, reduce our confidence. We were able to redeploy the capital into higher conviction names this quarter.

- **Ultimate Software Group, Inc. (ULTI),** a leading provider of cloud-based human capital management software, was acquired by an investor group led by Hellman & Friedman. The transaction was for $11 billion, or $331.50 per share, a 19% premium at the time of the announcement.

Ticker	2Q19	Contribution To Return
	5 Largest Contributors	**4.66**
PRO	PROS Holdings, Inc.	1.48
HEI.A	HEICO Corporation Class A	0.82
OKTA	Okta, Inc. Class A	0.79
JBT	John Bean Technologies Corporation	0.79
BRKS	Brooks Automation, Inc.	0.78
	5 Largest Detractors	**-0.92**
KIDS	OrthoPediatrics Corp.	-0.32
HCSG	Healthcare Services Group, Inc.	-0.19
MGPI	MGP Ingredients, Inc.	-0.16
EB	Eventbrite, Inc. Class A	-0.16
LMAT	LeMaitre Vascular, Inc.	-0.10

The top three contributors during 2Q19 were:

- **PROS Holdings, Inc. (PRO)**, a leading provider of pricing software and B-to-B e-commerce solutions, reported strong 1Q19 results and increased most guidance metrics for the year. The meaningful guidance increases, unexpected so early in the year, were due to strong bookings activity and earlier-than-expected "go-lives" of several new relationships. PRO continues to benefit from rapid growth in data-driven and dynamic corporate pricing strategies, rapid growth in B-to-B e-commerce, and increased partner-driven sales of PRO products. We attended PRO's Outperform customer conference in Las Vegas in May and, there and separately, received generally favorable customer feedback. We continue to be bullish about the company's prospects. Given the recent multiple expansion, however, we trimmed our position during 2Q19.

- **HEICO Corporation (HEI.A)** designs and manufactures aerospace, defense, and electronic products. Its stock outperformed in 2Q19 as the company reported strong quarterly results and raised full year guidance. The business is experiencing strong organic growth as well as healthy margin expansion. Management commented that current business conditions were the best they had seen in the company's 29 year history. Furthermore, HEICO has been very active in the past year making acquisitions and still has the financial capacity to do more. These acquisitions typically are very value creative and add to the company's earnings power. Over the long-term, we continue to believe HEICO is a well operated business based on proven strategies by an excellent management team.

- **Okta, Inc. (OKTA)** is a leader in the Identity and Access Management (IAM) industry. In the past few quarters, the company has seen significant acceleration in the number of large organizations signing customer contracts with high (greater than $100k) Annual Contract Value (ACV). The rollout of its two new products - Advanced Server Access and Access Gateway - is likely to help Okta sustain this trend as its identity solutions become more attractive to large enterprises that tend to operate in a hybrid cloud environment. Okta's core market of workforce identity management is very large and its customer identity management business could be equally large, if not larger. Management has executed well on Okta's operational strategy while continuing to integrate small tuck-in acquisitions that enhance customer value proposition and reduce churn. We believe Okta is very well-positioned to maintain its leadership in the nascent IAM industry and grow its revenues and earnings power at an attractive rate for a long period of time. Given the recent multiple expansion, however, we trimmed our position during 2Q19.

The top three detractors during 2Q19 were:

- **OrthoPediatrics Corp. (KIDS)** is the leading manufacturer and distributer of orthopedic devices specifically designed for pediatric patients. The company's stock underperformed during the quarter because the company reported "in-line" results as opposed to its typical "beat." This, combined with a relatively full valuation, led the market to temper its enthusiasm for the stock. However, the lower-than-expected growth rate in 1Q was caused by a temporary weakness in an isolated market, and that market has since rebounded nicely. We don't believe there have been any fundamental changes to the company's investment merits and its business still has plenty of drivers to sustain its healthy pace of growth.

- **Healthcare Services Group, Inc. (HCSG)** provides housekeeping, laundry, and dietary services to long-term care facilities. Its stock struggled in 2Q19 as the company reported a disappointing quarter with weak revenue growth and accounts receivable reserve bookings. This was caused by financial difficulties at some of HCSG's customers. However, we believe the worst is likely over for HCSG's business as the company has already achieved its gross margin target of 14% and has put in place resources needed to return to higher revenue growth going forward. Most of HCSG's largest customers have gone through financial restructuring, reducing the risk of significant additional reserve bookings. Meanwhile, HCSG has no debt and pays a 2.6% dividend yield that is sustainable.

- **MGP Ingredients, Inc. (MGPI)** is a leading supplier of distilled spirits in the U.S., accounting for nearly 70% of the rye whiskey production and almost 50% of the outsourced bourbon production. MGPI's stock was weak in the quarter as sales of aged whiskey came in below expectations. Part of the dislocation in quarterly results was simply timing. MGP has been waiting for its 2015 vintage whiskey to reach 4 years old in 2019, when it can sell it for three times the price of new distillate (unaged whiskey). We are confident that as the year progresses, aged whiskey sales will accelerate and help management deliver on its vision for 15%-20% operating income growth. We added to the position during the quarter.

Notes From The Road

At D.F. Dent, we spend significant time traveling to visit companies and to meet with management teams. These trips are vital to our research process given our emphasis on finding ethical and talented management teams running high quality businesses. Going to company headquarters helps us determine if a management team is exceptional. These visits allow us to observe how they operate, interact with their team, treat employees, and think about growth opportunities.

We recently had a team of portfolio managers and analysts travel to visit two companies. They saw two very different companies managed by very different types of leaders. Company A has a strong core product that is essentially a monopoly. The company also has significant momentum in new products which expand its market and should lead to a larger, more stable, and more profitable business over time. While we have a generally favorable view of the business, we are less impressed with management. We believe management's strategy and recent execution have been sound, but we have concerns related to ego, aggressiveness, and lack of frugality. In addition to concerns around valuation, these misgivings reduce our confidence in the stock and, as such, we have opted to pass on investing in the company.

Company B has slower growth than Company A, but we believe it is an excellent business with a wide moat. There is a secular tailwind to the business and significant share gain potential, which we believe should lead to steady, repeatable growth for many years. And importantly, the favorable view of management we have developed throughout our research was reinforced in our meeting. Management articulates a clear strategy, and their operational expertise and execution have been commendable. We are also impressed by their humility and cultivation of a strong corporate culture. They are the type of people we would be proud to tell our clients that we have entrusted with their money. This seems to be a clear D.F. Dent company, and our only question is whether current valuation offers a sufficient risk-adjusted expected return.

These road trips are valuable because they allow us visit companies and see managements in person. It is a continuous process of critical thinking comparing our existing portfolio names to companies we don't own. The result is a portfolio of high quality growth companies run by excellent management teams, which we believe will outperform the general market over the long term.

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We were pleased to welcome Chris Gryniewicz to the firm in May as an Associate Analyst. Chris has earned his CFA and has six years of investment experience, having previously served as a senior equity research associate at Manning & Napier. We have been impressed by Chris's capabilities and look forward to his contributions in the years ahead.

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