EQUITY

Medium Size, Large Opportunity:
Where to Look?

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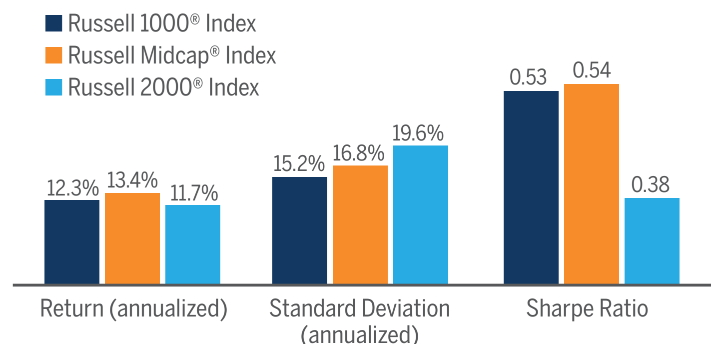
theAdvisory Investment Insights and Thoughts from Brown Advisory

We believe U.S. mid-caps offer attractive historical performance and a broad swatch of companies with sound fundamentals. In fact, we believe that, today, many of the cutting-edge companies that growth investors seek reside in the mid-cap universe. Perhaps most importantly, we believe the midcap range offers investors a reprieve from two risks that have grown in other market segments: increased concentration in large-cap benchmarks and deteriorating quality in the small-cap universe. Our mid-cap growth strategy focuses on two types of companies: durable business models that will likely be "stronger-for-longer" and those in which we identify a catalyst for the development of such strength, businesses that are "good-getting-better." We illustrate each of these types of investments and the in-depth due diligence process involved in identifying them with case studies in Edwards Lifesciences and Catalent, respectively.

U.S. mid-cap stocks, as measured by the Russell Midcap® Index (RMG), have a strong long-term performance record. Broad equity market indices capturing the segment have outperformed their larger and smaller counterparts over time—in both absolute and risk-adjusted terms—and over multiple market cycles (Exhibit 1). While past performance may be eye-catching, we believe the diversity of high-growth high-quality opportunities generated by recent market trends offers a compelling reason for investors to revisit their non-large-cap exposure.

Exhibit 1: Historical Return, Risk and Sharpe Ratio for Small-, Mid- and Large-Caps



Note: Data as of September 30, 2021 and starting on December 28, 1978, earliest available data for Russell core indices. Past performance is not indicative of future results. Source: FactSet®.

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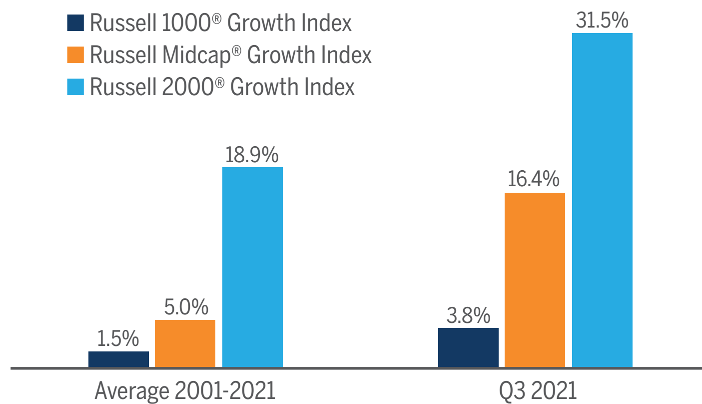
Currently, with more than 2,000 companies boasting market caps between $2 billion and $50 billion, this vast and eclectic segment of the U.S. equity market combines high-quality large-cap characteristics with the high-growth potential of small-caps. Many mid-sized companies are migrating through a crucial juncture of their lifecycles. While not fully mature, mid-caps often have well-established business models, access to capital, experienced management teams and a foothold in their industry, yet their full growth potential may be unrealized. Over time, successful mid-caps can compound for years in this wide market-cap range, evolve into large-caps, or become the acquisition targets of more mature companies.

Exhibit 2: Weight of Non-Earners in Small-, Mid- and Large-caps, Historical Average vs. Q3 2021



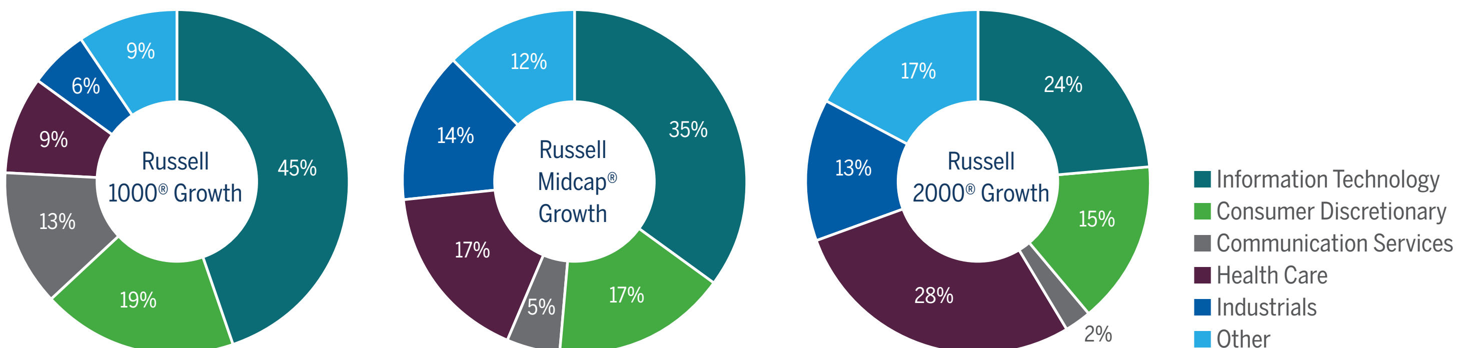
Note: Data as of September 30, 2021. Source: Jefferies.

In addition to potentially attractive performance and fundamental characteristics of many mid-sized companies, we believe mid-cap investors can avoid two risks that have grown in other segments of the U.S. equity market: the increased concentration in large-cap benchmarks and the deteriorating quality in the small-cap universe. Over the past few years, investors have increasingly crowded into a handful of trillion-dollar tech companies; Apple, Microsoft, Alphabet, Amazon, and Facebook currently comprise 37% of the Russell 1000® Growth Index (R1G). Adding in the next two largest companies, Tesla and NVIDIA, that top-end tilt rises to 42%. The top five holdings in the RMG comprise just over 6% of the index, and only two are in the technology sector.[1]

On the smaller end of the U.S. equity market we continue to observe deterioration in the quality of the universe. Outperformance of unprofitable companies, coupled with healthy capital markets activity in the biotech/pharma sub-sector over several years, has driven the weight of nonearners in the Russell 2000® Growth Index (R2G) to all-time highs (Exhibit 2). Concurrently, the weight of biotech in the index has ballooned from 9% at beginning of 2005 to close to 16% as of the end of the third quarter of 2021. As shown in Exhibit 2, the weight of non-earners in the RMG is about half that of the R2G and, for context, we are meaningfully underweight this category in our small cap growth strategy.

Investors may instinctively flock to small-caps for growth, innovation and portfolio beta. We believe that today, many of those cutting-edge-company seekers may actually find more of what they are looking for in the mid-cap universe. The R2G and RMG experienced a decrease in the size of cyclical sectors (consumer discretionary, energy, financials, industrials and materials) since 2005.

Exhibit 3: Sector Composition



Note: Data as of September 30, 2021. Sectors are based on GICS® classifications. Source: FactSet.®
Total values may not equal 100% due to rounding.

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However, sector weights shifted in different directions, generating different types of opportunities in small- and mid-caps (Exhibit 3). Health care's weight in the R2G grew as a result of the dramatic increase in the number of early-stage biotech firms, with fortunes that could hinge on the results of one or two clinical trials. Meanwhile, mid-caps captured technology companies that grew and/or went public with bigger market caps. This includes innovative internet companies like Match and Pinterest; high-quality vertical software companies like Cadence and Autodesk; cutting-edge security firms like Okta, CrowdStrike and SentinelOne; cloud software companies like Coupa and DocuSign; and infrastructure companies like Snowflake, Dynatrace and Datadog. As a result, technology's weight in the RMG expanded, while health care remained approximately steady. The R1G, as discussed above, has experienced remarkable growth in the information technology and communication services sectors (both technology related), which, in conjunction, represent 58% of the benchmark. In contrast, the combined information technology and communication services represent 40% of the RMG.[2]

Capital markets activity mimics this trend. Mid-caps are experiencing an increase in primary market activity, from high-quality companies staying private for longer that are now going public in the mid-cap range. According to data from Jefferies, approximately 24% of the more than 625 IPOs since 2019 (excluding SPACs) priced in the mid-cap range (as defined by the Russell Index market cap bands each year) compared to approximately 4% in 2005. In contrast, since 2019, the mid-cap range captured public offerings from businesses that stayed private for years such as SentinelOne, Marqeta, Oatly, Bumble, Qualtrics, DoorDash, Airbnb, Palantir, Unity and Snowflake.[3]

Meanwhile, IPO activity in the biotech sector has burgeoned in the sub $1 billion market-cap range. Only 6% of the over 220 IPOs in 2005 were in the biotech/pharma sector. In contrast, approximately 27% of the over 625 IPOs since 2019 were in those healthcare sub sectors.[4]

Identifying companies that can outperform amid this marquee swath of the market is no easy feat. Like with small-caps, many mid-sized companies tout growth potential, but the process whereby it materializes may be non-linear and occasionally falter entirely. Other times, growth comes at the expense of profits and scale, and never translates to shareholder returns. Occasionally, business prospects are recognized so quickly that a company's enterprise value compounds through the entire mid-cap range in one or two years. Assessing the growth potential, quality and scalability of these companies is therefore crucial for investors considering non-large-caps.

Our due diligence process is built on Brown Advisory's small-cap heritage, a solid foundation developed over the 15 years of experience in the space, and implemented by a large team of analysts and portfolio managers. Our investment process seeks to combine primary-source work (interviewing management teams, scouring SEC filings and building detailed financial models, among others) with secondary-source interviews (including customers, competitors, suppliers and vendors, as well as leveraging Brown Advisory's connections). In our effort to screen hundreds of companies per year through this protocol, we seek to continuously augment our institutional knowledge of the U.S. "non-large-cap" space to help better understand secular trends and anticipate changes across industries.

We believe that our mid-cap growth strategy is perhaps best described as a non-large-cap approach, as it spans a wide range of capitalizations, from small-caps to companies that are compounding out of the small-cap range, into mid-caps, and even beyond. This flexibility allows us to drive growth through a wider market cap range to help generate portfolio returns over multiyear periods.

The portfolio generally holds two types of companies: durable business models that will likely be "stronger-for-longer" and those in which we identify a catalyst for the development of such strength—businesses that are "good-getting-better." We discuss two companies in the healthcare sector that we believe illustrate each category next.

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Stronger-for-Longer: Edwards Lifesciences

We believe that Edwards Lifesciences exhibits all the qualities we seek in small- and mid-cap "compounders." Perhaps more importantly, it illustrates why we find the broadly defined non-large-cap category so attractive—it lets us capture innovation-led growth in smaller companies as they graduate into the mid-cap category and prospects sustain or even brighten, not dim. Thus, holding winners as they compound through the mid-cap range lets investors capture meaningful additional gains when things go right.

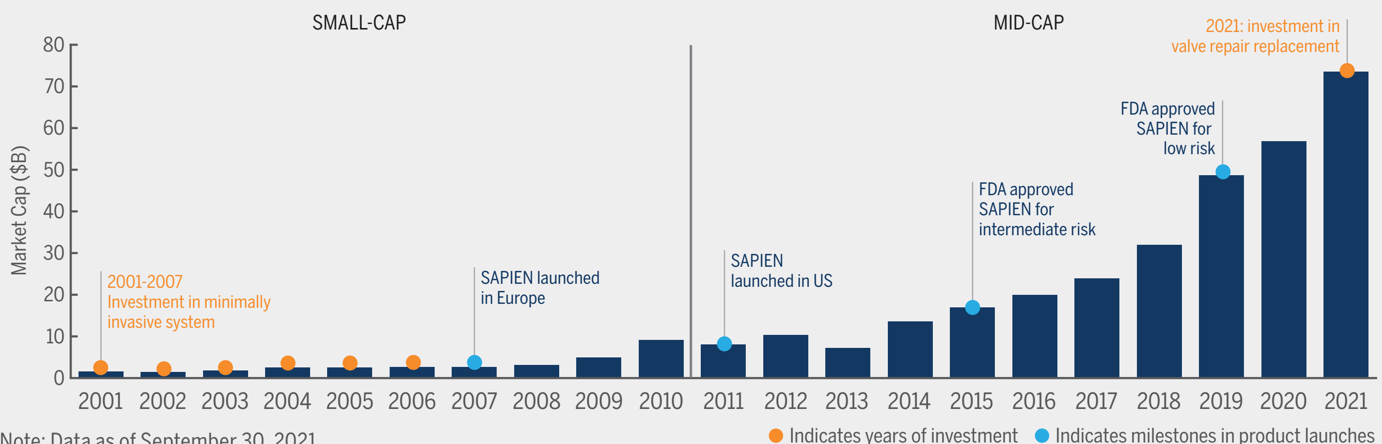
Edwards has driven innovation in heart valve replacements for decades, benefiting patients. Starting with mechanical replacements in the 1960s, Edwards pivoted to tissue valves in the 1970s made from pig hearts. It eventually settled on aortic valves with superior qualities made from cow pericardium in the 1980s. Uptake of Edwards' valves used during open-heart surgery (dubbed surgical aortic heart valve replacement, or SAVR) drove 8% annual sales growth from 2001 to 2007. The medical device maker was an attractive small-cap investment during that period; its share-price climbed 17% annually despite a heavy research burden on its profits.[5]

During that six-year stretch as a smaller company, Edwards invested heavily in a minimally invasive system to replace failing aortic valves via a catheter, eliminating the need for open-heart surgery and improving recovery time and patient experience. Introduced in Europe in 2007 and then the U.S. in 2011, Edwards' transcatheter aortic valve replacement (TAVR) system under the SAPIEN brand expanded the valve market to high-risk patients who might not survive the perils of open-heart surgery. As TAVR started to grow in that new patient niche, Edwards crossed the transom from small- to mid-cap in the years leading up to the U.S. introduction of SAPIEN, exiting 2011 with an $8 billion market value (Exhibit 4).

As the device maker amassed reams of clinical data, the FDA approved the use of SAPIEN for intermediate-risk (2015) and low-risk (2019) patients with severe symptomatic aortic stenosis. That expanded Edwards' market opportunity from a couple hundred thousand potential patients to over 800,000 and allowed it to start taking share from SAVR. All the while, the company maintained greater than 50% share of the global TAVR market despite competitive introductions thanks to its constant innovation. TAVR uptake, coupled with market expansion and supported by defensibly high market share, sparked an acceleration in Edwards' enterprise-value gains. Since SAPIEN's U.S. introduction (2011), Edwards' revenue growth averaged 11%, its pretax profit climbed 14% per year, and the company's share price compounded 26% annually.[6]

Today, despite Edwards' $66 billion market cap, we see similar prospects. We think worldwide TAVR sales could continue to grow at a double-digit clip through 2025 within current indications (severe symptomatic aortic stenosis) as product awareness grows and durability data piles up, driving market penetration higher from its currently tame approximately 25%. Meanwhile, Edwards and its competitors are studying the safety, efficacy and durability of TAVR in less severe and even asymptomatic cases of aortic stenosis. These indications could double the addressable market again in three to five years. Finally, Edwards is investing in products that address minimally invasive mitral and tricuspid valve repair and replacement. While these devices might only generate $80 million of sales in 2021 (out of approximately $5 billion overall for Edwards), the market opportunity could eventually eclipse that of aortic valve repair and potentially power Edwards' growth beyond 2025 or 2030.[7]

Exhibit 4: A Long History of Investing in and Benefitting from Innovation



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Source: FactSet®, company sources, and Brown Advisory.

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Good-Getting-Better: Catalent

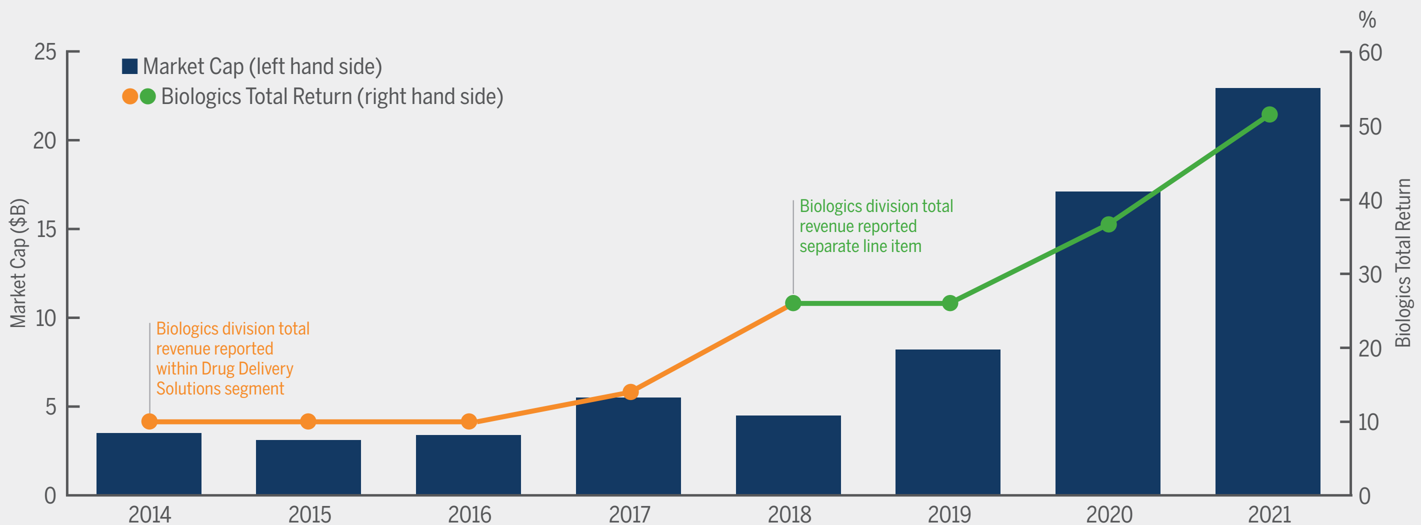
In addition to straight compounders, we often find high-quality, sizable businesses in the mid-cap range that we believe are getting even better. Catalent is a quintessential example. The company manufactures drug dosage forms (pills, quick-dissolve tablets and prefilled syringes, among others) for pharmaceutical companies. This contract development and manufacturing organization (CDMO) pushed low- to mid-single-digit percentage organic revenue growth for years as drug companies outsourced more and more manufacturing to specialized firms from a low base of about 20% of total spend.[8] When we started underwriting the company in 2016, operations generated a commendable but unremarkable low-teens margin and return on total capital.

However, that was not the entire story. Catalent was also nurturing a biologics manufacturing and packaging business that we believe boasted more attractive qualities. In 2016—and today—that division enjoyed better secular trends, faster market growth (low-teens percentage) and higher margins (mid-30% potential EBITDA margin compared with mid-20s for Catalent's other businesses). Fortunately for us, it only comprised 14% of sales in its fiscal year ending June 2017 and at the time, management buried the division's results in a segment called Drug Delivery Solutions (Exhibit 5).[9]

Through organic growth, meaningful acquisitions, and contracts from COVID-19 vaccine manufacturers, Catalent's biologics division has grown meaningfully over the last five years. After the company bought Cook Pharmica in 2017, biologics jumped to 26% of Catalent's revenue in its fiscal year ending June 2018. After the addition of gene therapy leader Paragon Bioservices in 2019, the division burgeoned to 37% of sales in fiscal year 2020. Including the addition of cell-therapy CDMO MaSTherCell and numerous COVID-19 mRNA vaccine contracts, the division generated 52% of corporate revenue in Catalent's most recent quarter and posted a 33% EBITDA margin, which we believe demonstrates its attractive scalability.[10]

During this transformation, management increased the company's long-term growth and margin targets meaningfully. Meanwhile, Catalent's market value climbed from approximately $4 billion in mid-2017 to over $18 billion four years later; its share-price returned 32% per annum during that same period. As it stands today—with half its business from biologics—we see a path to mid teens profit growth and further gains for shareholders over the next several years.[11]

Exhibit 5: Growth and Increased Transparency in Reporting for the Biologics Division



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CONCLUSION

Mid-cap stocks have delivered better risk-adjusted performance than both small- and large-caps (as measured by the Sharpe ratio) over the past four decades. They have done so by combining the most attractive features of small- and large-caps' performance profile: strong absolute returns, like small-caps, and lower volatility, like large-caps.

We believe that the mid-cap segment of the U.S. equity markets is even more appealing following an increase in concentration in large-cap benchmarks and a deterioration of quality in the small-cap space.

The diversity of high-quality high-growth investment opportunities in the mid-cap universe allows us to construct a portfolio comprising a diversity of investments that we believe can compound earnings and outperform the broad market over time.

Seeking to identify the best mid-cap investment opportunities requires thorough due diligence to assess a company's opportunity, the leaders who will execute on that potential and the business' ultimate scalability. We believe constructing a concentrated portfolio of the most attractive opportunities in this space with high active share and low turnover offers investors the best way to access to this dynamic and attractive segment of U.S. equities.

BROWN ADVISORY MID-CAP GROWTH STRATEGY

We strive to harness the power of compounding to produce attractive risk-adjusted returns over a full market cycle. We do this by owning approximately 60 small- and mid-cap companies that could grow their enterprise values meaningfully over the next several years. We believe these compounders possess similar characteristics we call the 3Gs– durable growth, sound governance and scalable go-to-market strategies. Simply put, we think investors can earn strong returns by buying companies that express these traits at reasonable prices and holding them for years.

Target companies typically address large markets with secular growth tailwinds and demonstrate an ability to gain share profitably. We find growth endures with the confluence of these two trends. We look for trustworthy, capable management teams with a history of shareholder-friendly capital allocation. Finally, we seek to invest in business models that could generate high and/or growing returns on capital. This philosophy generally leads us to own higher-quality, less cyclical businesses uncovered through our team's deep fundamental research. In addition to that diligence, we strive to mitigate risk through our valuation sensitivity, appropriate portfolio diversification and employing a structured sell discipline.

OUR "3G" INVESTMENT FILTER

GROWTH

Opportunity
- Durability
- Large and/or growing market
- Market leader or share gainer
- Differentiated business model

GOVERNANCE

Execution
- Trust & Transparency
- Capable, shareholder-friendly management
- Diverse and appropriate Board structure
- Well-structured, aligned incentives

GO-TO-MARKET

Economic Profit
- Higher ROIC
- Highly valuable incremental revenue
- High and/or rising margins and returns
- Capital efficient

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1. All data as of September 30, 2021. Source: FactSet®
2. Ibid.
3. All data as of September 30, 2021. Source: Jefferies.
4. Ibid.
5. Source: company data as of September 30, 2021.
6. Ibid.
7. Ibid.
8. Ibid.
9. Ibid.
10. Ibid.
11. Ibid.

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An investor cannot invest directly into an Index. Definitions of indices used are below.

The **Russell 1000® Index** measures the performance of the large-cap segment of the US equity universe. It is a subset of the Russell 3000® Index and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership.

The **Russell Midcap® Index** measures the performance of the mid-cap segment of the US equity universe. The Russell Midcap® Index is a subset of the Russell 1000® Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership.

The **Russell 2000® Index** measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.

The **Russell 1000® Growth Index** measures the performance of the large-cap growth segment of the US equity universe. It includes those Russell 1000® companies with higher price-to-book ratios and higher forecasted growth values.

The **Russell Midcap® Growth Index** measures the performance of the midcap growth segment of the US equity universe. It includes those Russell Midcap® Index companies with higher price-to-book ratios and higher forecasted growth values.

The **Russell 2000® Growth Index** measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000 companies with higher price-to-value ratios and higher forecasted growth values.

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Sharpe Ratio is a statistic developed by Nobel laureate William F. Sharpe and is used to help investors understand the return of an investment compared to its risk. The ratio is the average return earned in excess of the risk-free rate per unit of total risk (measured by standard deviation).

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