Small Cap Growth Market Update

The Elite Eight

The Magnificent Seven and their products are both household names amongst consumers (aside from Nvidia, which is not broadly known by consumers for what it produces as much as for what its products enable) and stocks that are at the top of mind for investors.

Within the Small Cap Growth asset class, we have some equally spectacular companies, but they do not share the same market cache. To highlight some of them and in recognition of the NCAA's March Madness, we'll dub them "the Elite Eight". At the end of this introduction to our Small Cap Universe's elite stocks, we will provide some comparisons of the two sets of companies and their stocks.

Deckers Outdoor (DECK)

Most will not know the name of the company, but at the mention of their top two footwear brands, the light bulb will go on: UGG boots and HOKA athletic shoes. The UGG brand took off in the early 2000s, partly due to savvy branding that included endorsements by the likes of Kate Hudson, Sarah Jessica Parker, Cameron Diaz, Leonardo DiCaprio, and Jennifer Lopez.

Deckers bought HOKA athletic shoes in 2013 at a time when the brand had sales of $10 million annually. The brand was initially embraced by ultra-marathoners for their high levels of cushion and stability. The brand's original high-cushion models are now accompanied by lighter weight shoes that retain much of the brand's cushion, including versions of their shoe for lightweight training, racing, and track.

Management of Deckers continues to do an excellent job of expanding brands through thoughtful use of marketing, investment in distribution including the direct-to-consumer channel, and leveraging of relationships with distribution partners including Amazon and big box retailers. The company posted over $4 billion in sales in 2023 and while its company name is not recognized in households, its two signature brands certainly are.

Medpace Holdings (MEDP)

Sometimes, the best way to invest in a particular growth industry is indirectly. Such is the case with development stage biotech and pharmaceutical companies. By development stage, we mean companies that are in the research phase of developing a new drug or technology for the treatment of human ailments or diseases. They don't have an FDA-approved product yet, and they are spending investor dollars in the hope of discovering the next great cure or treatment. The Russell 2000 Growth Index is filled with literally hundreds of these companies, and investing in them individually is like buying lottery tickets … the outcomes are binary. Even if the company does achieve FDA approval for one of its candidate products, the challenges of converting from a research company to an operating company are difficult, and, if they successfully navigate that process, the product's intellectual property faces an expiration date, creating a new set of challenges. The returns on the stocks in this industry as a group over the long-term are close to zero, with extreme levels of volatility.

Medpace Holdings is a clinical research organization that benefits directly from the increasing amount of funding that flows into biotech and pharmaceutical development. When investors pour money into the next potential cure for lung or breast cancer for example, that money has a high likelihood of finding its way to Medpace, which provides turnkey solutions to conducting the Phase I, II, and III trials on the path to product approval by the FDA. Medpace only focuses on potential customers that are looking for a full turnkey solution. In other words, they don't cater to big pharma. Rather, they are focused on the development and maintenance of relationships with the startups to which much of the research dollars are flowing. The company continually invests in human capital to facilitate growth and take on more customers. Medpace has grown revenue from $273 million 10 years ago to $1.9 billion in 2023.

Kinsale Capital (KNSL)

One of the most powerful advantages that a business can enjoy is cost advantage in a price sensitive industry. Michael Kehoe, CEO of Kinsale Capital, was fully aware of this when he left James River fifteen years ago as its chief underwriting officer to form Kinsale. He saw how bloated most insurance companies were, and he believed he could build a better mouse trap with a common-sense approach to the Excess & Surplus insurance industry. He built Kinsale with only one physical office in Richmond, Virginia, and used technology to ensure efficiency in the business. He runs his company lean, enjoying a 20-point advantage in his selling, general, and administrative costs relative to the goliaths that he competes against, such as Chubb and Lloyd's of London.

Excess & surplus insurance is a risky business. When you hear the term "E&S", think builders risk insurance (helping builders protect against damage to their construction project before they deliver it to the buyer) or errors & omissions insurance (which protects investment advisors against trading errors). Michael's training as a chief underwriter ensures the focus on understanding the industry verticals in which he operates and making sure that the risk profile of the company is well measured and diversified.

Kinsale has enjoyed 38% compounded top-line growth during its ten years as a public company, which has flowed through fully to the bottom line.

e.l.f. Beauty (ELF)

e.l.f. Beauty makes cosmetics that utilize natural ingredients, that avoid cruelty to animals in testing or manufacturing and offer a great value proposition to consumers. Skincare is a $200 billion business worldwide. e.l.f. Beauty is just getting started with penetrating the industry, with great success in distribution through Target, where it has close to 20% share, and the company is starting to replicate this success at Walmart and Ulta Beauty. It has also started to expand internationally.

e.l.f. Beauty continues to grow, not just by distribution partners and geography, but by introducing new products through internal research and development and acquisitions of like-minded companies.

e.l.f Beauty will post sales of about a $1 billion for the fiscal year ending March 31. The company has tapped into the younger generations' desire for environmentally friendly products with savvy consumer engagement across various social media platforms.

Comfort Systems (FIX)

Comfort Systems installs HVAC, electrical, and plumbing systems for industrial and commercial buildings. We became interested in the company several years ago, because it was driving growth as a consolidator of small local and regional sole proprietorships. In the 1970s and 80s, there were many HVAC installers that were started by industrious engineers that built solid businesses around the country. Comfort Systems has been a willing provider of liquidity for these small businesses.

Comfort Systems has continued its growth not only through geographical expansion but through building out its expertise with respect to its engineering and technological capabilities with respect to the full guts of commercial and industrial buildings. The reshoring of manufacturing in the U.S. and the buildout of U.S. industrial capacity has fueled further growth for the company. Capability is in short supply after many decades of offshoring, and Comfort Systems is in a position to choose the projects in which it wants to be involved.

Commercial and industrial construction in the U.S. has tripled in the past three years from $75 billion in 2020 to $225 billion in the past twelve months. Since the beginning of 2021, over $600 billion worth of mega-projects have been announced for construction, including data centers, chip manufacturing facilities, EV plants, battery manufacturing facilities, solar and LNG facilities, and pharmaceutical plants. Ground has only broken on about 25% of these projects, so much of the work remains in the future.

The outlook for commercial construction and engineering companies in the U.S. looks, well, very constructive.

Shockwave (SWAV)

Shockwave helps to solve a medical problem for many individuals who suffer from calcification of the arteries. Arterial vascular disease takes various forms including blockages that can potentially lead to strokes or heart attacks and calcification of the arteries which can potentially lead to ruptures. Such conditions were universally treated by using stents with balloons on the end that cleared the pathways. While the stents used a measure of force that had been useful for clearing blockages, it also introduced a risk when calcification had occurred. Simply bullying one's way through an artery is dangerous when the vessels have hardened due to calcium buildup. Shockwave developed a new type of stent, which gained FDA approval three years ago, that utilizes a sonic transmission to gently break up calcifications. The treatment is not only more effective than the prior method, but it is significantly safer. To quote one arterial-vascular surgeon, "this is a game changer".

Shockwave has achieved over 75% penetration across A-V surgery centers in the U.S., but its penetration within each center has only scratched the surface. Meanwhile, international opportunities remain in the early stages of penetration.

Shockwave revenues are up elevenfold since 2020.

Paylocity (PCTY)

Paylocity simplifies payroll processing and benefits management for both HR departments and employees. Employee and pay data is submitted online using the company's software, and employees receive information about their paychecks electronically. Incumbent companies such as ADP and Paychex continue to have significant market share and many customers that use legacy systems which are more cumbersome and more costly.

Why don't ADP and Paychex broadly rollout more technologically efficient and cheaper solutions to all of their customers? In a word, "profit". The companies would cannibalize most of their highly profitable customer relationships quickly in an effort to compete more effectively. In the meantime, they continue to lose share to the likes of Paylocity.

Paylocity has posted annualized revenue growth of 33% over the last ten years. In absolute terms, revenue has grown from $77 million to $1.3 billion during that period.

Tenable (TENB)

I think that most consumers have become curious about artificial intelligence or "AI", since the introduction of ChatGPT just a year and a half ago, although the term "curious" may be an understatement. The range of feelings regarding AI are more accurately described as extending from exhilaration to panic. The potential uses for AI seem to be endless. Optimists see the potential for productivity gains that remind us of the first industrial revolution. Pessimists imagine a future that conjures up images portrayed in the film "2001: A Space Odyssey" or Aldous Huxley's classic novel, "Brave New World".

I can assure you that cyber-security officers in companies across the world are leaning toward the terrified camp, as they usually do. Nevertheless, cyber-security software firms such as Tenable have the full attention of their customers and prospects. This highly respected software company, which focuses on cyber-security threats, only became profitable in 2020. The company has more than tripled funds from operations during the past three years.

Table 1: The "Elite Eight"

	Market Cap ($ billions)	Projected Revenues for 2024 ($ millions)	Forward Price to Earnings Ratio	3 Year Revenue/Share Growth	3 Year EPS Growth
Deckers	23.4	4,200	30.4x	89%	101%
Medpace	12.4	2,189	36.5x	136%	111%
Kinsale Capital	12.2	1,564	33.9x	156%	281%
e.l.f. Beauty	11.2	993	57.1x	168%	319%
Comfort Systems	11.1	6,552	28.5x	86%	128%
Shockwave	9.4	921	49.6x	877%	296%
Paylocity	9.2	1,389	25.3x	113%	214%
Tenable	5.5	903	41.5x	59%	125%
Total	11.8	2,339	37.9x	211%	197%

Source: Renaissance Research, FactSet

Table 2: The "Magnificent Seven"

	Market Cap ($ billions)	Projected Revenues for 2024 ($ millions)	Forward Price to Earnings Ratio	3 Year Revenue/Share Growth	3 Year EPS Growth
Microsoft	3,086	244	31.6x	51%	51%
Apple	2,675	383	25.0x	44%	45%
Nvidia	2,298	109	34.4x	203%	487%
Amazon	1,822	642	39.9x	45%	63%
Meta	1,274	135	24.5x	74%	54%
Alphabet	1,728	343	19.5x	82%	67%
Tesla	565	112	53.3x	172%	201%
Total	1,921	281	32.6x	96%	138%

Source: Renaissance Research, FactSet

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REFERENCED INDEX

(Indices are unmanaged and are not available for direct investment.)

Russell 2000 Growth Index—The Russell 2000 Growth Index is composed of the smallest 2,000 of the 3,000 largest U.S. companies based on total market capitalization with higher price-to-book ratios and higher forecast growth values.

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