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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Investing in Innovative Small Caps with Organic Revenue Growth

ROBERT DROBINSKI is a Partner and Portfolio Manager for Growth Strategies at Foundry Partners, LLC. He started in the industry in 1996 and joined Foundry Partners in 2016. Previously, he worked for Arbor Capital Management. He received a B.A. in economics and psychology from Concordia College and an MBA from University of Minnesota's Carlson School of Management.

SECTOR — GENERAL INVESTING

TWST: Could you tell me a little bit about the firm?

Mr. Drobinski: Sure. We are, what I would call, an investment boutique. We've got multiple strategies. We have some value strategies in Cleveland, Ohio, which are totally separate teams. And then, I run a small-cap growth fund, and we're located in Minneapolis.

TWST: Is there a unique investment philosophy at the firm?

Mr. Drobinski: Our product is called the Alpha Small Cap Growth strategy, and I think we're unique in that we have a very long-standing investment philosophy that's based on investing in innovative, organic-revenue-growth companies with uniquely profitable business models and appropriately financed balance sheets. And we do it with a very disciplined and defined and repeatable investment process that's able to capture that philosophy. And we deliver results pretty uniquely in that we capture the majority of the upside, but we really focus on protecting the downside but maintaining the characteristics of a small-cap growth fund.

TWST: Did you want to highlight a stock that you find interesting now?

Mr. Drobinski: Sure. A name we've owned for a while, it's called **HealthEquity** (NASDAQ:HQY). And it's a technology platform that serves the HSA — health savings account — market. And they bring together the health savings custodians, health plans, employers and the plan participants. And we expect it should be a very big market opportunity the next several years as more employers move to high-deductible plans, and as a result, more employees participate in HSAs. And consequently, as more employees participate in HSAs, they start to contribute more and more into the plans, and then those plans continue to grow due to the compounding of interest rates as it's invested in interest-rate-bearing securities.

We call this a multiplicative growth opportunity due to the multiple levers of growth. So in other words, more companies go for a high deductible, you have more employees in the plan, the more employees put more money in the plan, those dollars continue to increase based on compounding interest rates. And so we like that long-term multiple-growth-driver opportunity. It's been a core holding for us since about 2015, and we plan to continue to hold that for the next several years.

TWST: Is the country starting to search for options to the current health insurance situation? Will health savings accounts continue to be of interest to policymakers as well as businesses, and that could help the company?

Mr. Drobinski: Yes. We view that as all upside. As your readers know, there was the potential as a part of the Affordable Care Act to mandate more of the high-deductible plans. That ended up not happening. So there's no mandate for the high-deductible plans, but there's still a growing transition and conversion to the high-deductible plans as we're just like every other part of the economy trying to tie the cost of the service to the person who actually benefits from the service, so making us all more responsible for the cost of our health care. This helps connect us to the cost in the delivery of the health care and makes us more responsible. So like I said, there's just been more and more employers moving to the high-deductible plans as a way to help manage the health care costs, and then for the employee to manage that high-deductible plan has been moving more and more to HSAs.

If the government ever wanted to get really serious about health care reform instead of insurance reform, which we've had through the Affordable Care Act, I really think a plan like the high-deductible plans and corresponding HSAs would be a great way to accomplish that. And in health care, we look for win-win scenarios. And when you can save the health care system dollars and you can increase the outcomes of the health care — provide better outcomes — and the business is able to make a

profit, we call that a win-win scenario. And **HealthEquity** is one of those scenarios as they have tools that they provide for the participants to help them make better, more informed health care decisions.

TWST: So down the road, that company might benefit if, for example, they increase the amount that consumers could put in one of these health savings accounts rather than the limits that they have now, and that would probably help the company as well as the consumers?

Mr. Drobinski: Yes, absolutely. As those, like I said, as those dollar contributions go up, there's really a multiplicative impact because you're putting more dollars in, and then those dollars are invested in some sort of interest-bearing investment, and so then those higher balances compound to future higher balances. It's really a great tool for retirement as it's a really tax-advantaged plan, the HSAs. And I think as people became more aware of the tax benefits of the HSAs, I think people really began viewing them as a great source of future savings, just like a 401(k).

TWST: Did you want to mention another company?

Mr. Drobinski: A newer name we purchased, we bought it in 2018, is called **Box Incorporated** (NYSE:BOX). They're a leader in cloud-based solutions for enterprise content management. They're basically benefiting from a pretty dramatic shift from on-premise storage solutions to a move into the cloud. And I'm sure almost everybody is familiar with the cloud. Consumers have moved to the cloud over the last five years, and enterprises have really participated in that over the last five, eight years, and we think that will continue into the future.

Highlights

Robert Drobinski discusses Foundry Partners, LLC's Alpha Small Cap Growth strategy. Mr. Drobinski uses a long-standing philosophy to invest in innovative companies with organic revenue growth. He looks for companies with uniquely profitable business models and appropriately financed balance sheets. Mr. Drobinski uses a disciplined, defined and repeatable process to capture the majority of the upside but protect on the downside. Mr. Drobinski believes small caps will be a great place to be over the next 10 years.

Companies discussed: HealthEquity (NASDAQ:HQY); Box (NYSE:BOX); Alphabet (NASDAQ:GOOG); Amazon.com (NASDAQ:AMZN); Dropbox (NASDAQ:DBX); The Ultimate Software Group (NASDAQ:ULTI); Apple (NASDAQ:AAPL); Boeing Co. (NYSE:BA); General Electric Company (NYSE:GE); Hexcel Corporation (NYSE:HXL) and Airbus SE (OTCMKTS:EADSY).

technology companies for over 20 years, and there's been an evolution to the cloud from 15, 20 years ago with client service, and then we moved to this software-as-a-service, off-premise software delivery, now to what we're generally calling the cloud. And over that 15 years, initially, there was a reluctance to reside data on the same machine.

And so a lot of times what these storage companies will do is, they have these big servers that are very underutilized. And so part of the push to the cloud was, we can utilize these servers more if we put more customers on a server. So instead of one company having to buy a server and be 20% utilized, a cloud company can buy that server and have it be 80% or 90% utilized. But initially, people didn't even want to reside on the same piece of hardware.

And I think just being educated over the last several years — a lot of first movers also have taken that fear away. And I think as consumers have moved to the cloud, as I'm sure we all store our photos on **Google** (NASDAQ:GOOG) or **Amazon** (NASDAQ:AMZN) or **Dropbox** (NASDAQ:DBX) or something, I think that those decision-makers have started to become more and more comfortable with the security layers that the cloud providers can offer. That's their livelihood. Their livelihood depends on keeping that information secure. And so the cloud providers take the security very seriously. And I think that's what's led to the adoption. As you pointed out, it's really just been the last few years that enterprises have really started to move to the cloud en masse.

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And we think in particular with **Box**, we've been able to buy it at a price where we have two to three times upside over the next few years compared with limited downside. And the Alpha Small Cap Growth strategy, we like to try to buy and invest in leaders that are going to have three to five years of growth in very large market opportunities, like **Box** and **HealthEquity**, and utilize a buy discipline that protects our downside, and we feel that the upside then will take care of itself.

TWST: Basically, most sectors of the economy have gone into the cloud for their storage. There was some reluctance initially, where there was sensitive information like health information or legal information or financial, but a lot of those sectors have followed other companies into the cloud.

Mr. Drobinski: Yes, you're correct. I've been investing in

TWST: We've been talking about small cap. What are the opportunities with small cap now in particular? Why might investors want to include that as part of their portfolios?

Mr. Drobinski: We think small cap is going to be a great place to be over the next 10 years in particular, even right now on a short-term basis with all the worries over China and a trade war, those tensions. Small cap is primarily domestic. And we think that the U.S. is positioned to be the real leader in global growth over the next 10 years. And we think with our businesses, small caps stand to benefit, and in particular, with our investment style in the Alpha Small Cap, we're really disciplined with our buy points.

What we're really focused on is delivering the majority of the upside in an upside move in the market but protecting your capital on

the downside. And so there is some pretty simple mathematical principles there — if you can protect your capital, that you'll have more to grow over time and that you can win over longer periods of time. I really think that small-cap growth will be positioned very well over the next several years as the cost of accessing capital potentially rises over the next five to 10 years. And then, like I said, in particular with our unique investment philosophy and our proprietary process to implement that, we think that Alpha Small Cap Growth is positioned to really benefit over the next five to 10 years.

1-Year Daily Chart of HealthEquity

Chart provided by www.BigCharts.com

TWST: And I guess too a lot of the small-cap companies are focused on very specific products or services as opposed to a big company like GE. That broad focus can end up having an impact later on the company. Is that something you've seen too?

Mr. Drobinski: Yes. I've been a small-cap investor and working in small cap since about 1996. I've gotten to visit and see companies early in their lives and really get to see trends emerge and invest in companies that no one outside of the business would even know who they are. I remember meeting, probably 15 years ago, a small company that was inventing a camera to put on a cellphone, and everyone is saying, "Well, who in the heck would take a picture with their cellphone?" But look at how that's evolved over 15 years.

It's really fun because we get to invest in those companies and see that innovation. And we tend to invest in companies that have a little bit broader of a growth driver than, just like you said, the larger conglomerates.

If you take, for example, **Apple** (NASDAQ:AAPL), which has been a very successful company obviously. We've owned companies that have been suppliers to **Apple**. We've owned companies that do screens. We've owned companies that do 3D sensing and facial recognition. And what's really been fun over the years is nobody else even knows who those companies are. But they all know who **Apple** is, and they all know that they can unlock their screen by looking at it. And we've been able to invest in some of those companies when they're very small, and they get much larger because of benefiting from being pulled along by companies like **Apple**.

TWST: They sort of find their own niche with some of these bigger companies supplying them or working in tandem with them?

Mr. Drobinski: Correct. It's like so many things in life. Does **Apple** want to focus on developing the chip to have the best facial recognition, or do they want to develop an ecosystem and build recurring service revenue, etc.? So small companies can get in there and be the

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1-Year Daily Chart of Box

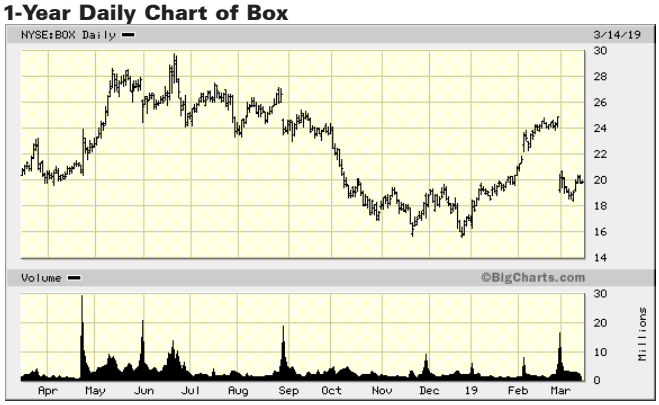

Chart provided by www.BigCharts.com

TWST: And I guess too that, often, small-cap companies can merge with each other, or they can get acquired by a bigger company, and investors like to follow those mergers and acquisitions. Is that another benefit?

Mr. Drobinski: Yes. We've been the beneficiary of that over the years. The year 2015 was a very big year with seven or eight takeouts within our portfolio. I think last year we had two or three. We had a nice one, to your point, early in 2019. Early this year, we had **Ultimate Software** (NASDAQ:ULTI) taken out at a value of about $11 billion. And that's a software company that we've owned. Basically, we bought it as about a $400 million or $500 million software company and have owned it for 11 or 12 years, and it ultimately got taken out at $11 billion. And during that time, it was able to grow recurring revenues at about a 20% clip per year with margin expansion each year.

You can find some really unique businesses in small cap. And what we want to try to do is find those unique businesses, like an **Ultimate Software**, that we can own and find them when they're small. And then, we love to own them for five, 10 years. And if **Ultimate** would have stayed independent, I think it would have continued to grow, but the management team decided to sell it and take it private, but it is another source of alpha within a portfolio.

To be clear, our focus is on finding these companies, buying them at prices where we think we have more upside than downside and own them for longer periods. We don't speculate on investing in a company because we think it will be acquired.

experts. And that's a theme throughout our portfolio, whether it's a supplier to **Apple** or the aerospace industry — it is one where **Boeing** (NYSE:BA) and **GE** (NYSE:GE) aren't innovating and coming up with great new technologies or resources or lighter material or carbon fiber composite material.

They're using firms such as **Hexcel Corp.** (NYSE:HXL), which is a name we've owned for six or seven years, that have developed composite material that **Boeing** and **Airbus** (OTCMKTS:EADSY) can then integrate into their plane designs and use for 20 years. **Hexcel** is the one that actually has the innovation and product in research and R&D dollars, and really that's how **Hexcel** grows and survives. But we all benefit from it because **Boeing** then uses it and implements it, and their planes are lighter, and as the cost of fuel goes up, etc., our airline tickets can be more affordable, and as the world travels, there are all the benefits to society and business.

It's really fun over the years to get to invest in those companies. And really that's where the innovation is happening, with these smaller companies, because they're the ones whose lifeblood is focused on that research and development in coming up with a disruptive product or service.

TWST: Changing direction, at the end of last year, there was a correction in the market, and things have bounced back for some companies in the beginning of this year. What does the rest of the year look like? And what do you think are some of the issues for investors?

Mr. Drobinski: I think it'll be interesting to see how the remainder of the year plays out. In small cap, we're two months into the year, and we're up nearly 20%. And so I don't know if you can annualize that and say we're going to be up 120% for the year. I think just, again, some simple historic analysis would suggest that the remainder of the year could be flat to modestly up from 20%. If you finished a full year up 20%, it would be a good year, and we've already gotten that in two months.

I think the interesting thing about this move off of the low is it's really been generated by kind of a very politically influenced Federal Reserve, and that has been kind of bullied into maintaining low interest rates for an extended period. And the moves haven't necessarily been supported by underlying fundamental factors as much as kind of a macro risk on a low-interest-rates-forever-type mentality in the market.

And that's an environment where an investor like us, we struggle to find new ideas or buy points in a market with really elevated kind of expectations and valuations, and we're trying to buy and invest in companies that we have, like I said, a minimum of two to three times upside to downside for a three- to five-year investment horizon. I think the challenge is, if you're really a long-term investor, I think the challenge is trying to perform and invest in an environment like this that has really kind of been souped up by a Federal Reserve that's kind of being mandated by the President, which is fairly unprecedented in the history of the Fed.

TWST: Do you get the feeling that investors are watching what the Fed does pretty carefully, the investors you deal with?

Mr. Drobinski: We deal with pretty sophisticated investors. We have all institutional-level investors. They do it for a living; they're in it every single day. And I think they're like us, as they're aware of what the Fed is doing. It's very important. And your readers probably know this, the term structure of the global financial markets are largely set from this targeted rate that our Federal Reserve system sets. And so obviously, it's important to price your equities based off of the assumptions you're making on that fed funds rate, and so everybody watches it.

But we have investors that have plans that they're thinking out 10, 20, 50 years of a livelihood of the plan that they manage. They're not worried about trying to pick and make sure they have the highest-momentum cloud software stock in 2019. They want to make sure that they're investing with a manager that can provide value over decades.

TWST: Do you think, too, with institutional investors, they're kind of concerned about minimizing risk, and so whatever they're investing for, it has the money that it needs to have to provide the services that they need to provide, such as with pension plans or other types of institutional investments?

Mr. Drobinski: Absolutely. That's the foundation of what they do for a living. Again, I get this great insight because a lot of those guys are our clients, and so I get a chance to sit down and meet with probably tens if not hundreds of those plan sponsors over the years. And so it's interesting to hear and see those plan sponsors because they allocate more broadly than I allocate.

I allocate capital solely within a small-cap universe, but the clients that I get a chance to meet and interact with are investing in a broad array of asset classes. Some of them very risky to low risk, but that institutional investor can choose to invest in what may be perceived as a higher-risk investment because it is a set proportion of their portfolio, and they're willing to accept that risk for the expected return.

The individual investor, an investor like myself, that's focused on just small cap, I think the individual investor is probably more concerned with 10- and 15-year returns as well. But I guess, unfortunately, a lot of advisers to that individual investor probably are advising more solely on the past 12 months' performance versus thinking out 10 years.

TWST: Thank you. (ES)

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