BARON INSIGHT

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The Impact of Millennials on the Consumer Discretionary Sector

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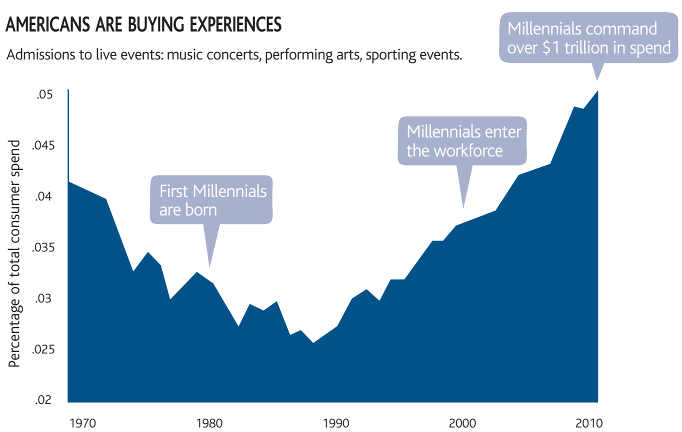
The emergence of the millennial consumer is among today's most important secular trends. Usually defined as the generation born from the early 1980s to late 1990s, millennials range in age from about 18 to 35, making them a key demographic whose tendencies have a growing influence on equity markets, particularly in the Consumer Discretionary sector. In some ways, millennial spending habits represent an enigma to investors seeking to capitalize on shifting consumer preferences. Finding opportunities among a generation that shuns homeownership yet embraces $15 açaí bowls and $700 music festival tickets can be challenging, but we believe millennials are driving fundamental changes and unlocking promising investable themes in the Consumer Discretionary space.

The Experience Economy

With the emergence of the millennial demographic, material ownership has ceded the spotlight to a mentality that prioritizes experiences over possessions. Since 1987, the share of consumer spending on live experiences and events relative to total U.S. consumer spending has increased 70%. More than ever, people value creating memories via shareable experiences, sustaining the growth of an economy driven by their consumption.

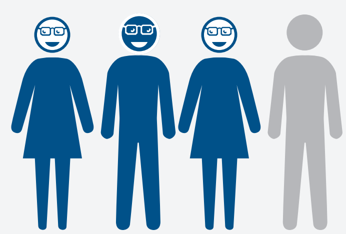


Data: U.S. Department of Commerce, Bureau of Economic Analysis

Against the backdrop of the digital age, the secular shift away from materialism has facilitated the growth of an experience economy where interesting destinations and activities practically amount to social currency. Now that memories can be appreciated by friends, family, and followers across the interactive landscape of social media, the "cool factor" of unique personal experiences is amplified, a dynamic we think will benefit companies catering to a market in search of shareable, Instagram-worthy moments.

One such company is **Vail Resorts, Inc.**, America's largest ski resort operator. While weekend getaways to snow-covered mountains have long been popular, we believe skiing represents exactly the kind of activity that appeals to evolving consumer tastes. Vail's resorts offer visitors the chance to experience some of the world's best backcountry terrain, and the company has invested in technology that enables riders to track their performance on the slopes and share their experiences with friends. Moreover, Vail has demonstrated the ability to convert destination skiers into annual season pass holders via its Epic Pass, which offers unlimited access to 19 resorts in the U.S., Canada, and Australia. Pass sales are growing at around 10% per year, and we view recent acquisitions, as well as ski school, dining, and Vail's newly introduced Military Epic Pass, as drivers of future growth.

Experiences Over Things



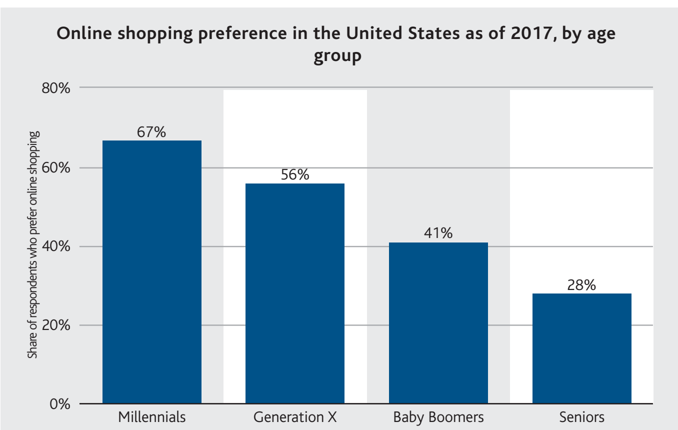
More than 3 in 4 millennials would choose to spend money on a desirable experience or event over buying something desirable.

Source: Harris Poll for Eventbrite

Predictably, experience-hungry consumers are not restricting their travels to the mountains, and we believe players across the travel industry stand poised to benefit. Two companies we think meet that description are global cruise line operators **Norwegian Cruise Line Holdings, Ltd**. and **Royal Caribbean Cruises Ltd.** After all, ships present voyagers with a diverse menu of activities, and few landscapes beg to be Instagrammed like the high seas. While popular opinion might dictate that cruises mostly attract elderly travelers and large families, we think investors underappreciate industry efforts to target younger customers and accommodate changing tastes. For instance, last year, Royal Caribbean spent $120 million transforming its Mariner of the Seas ship, even installing a bungee trampoline attraction integrating virtual reality. According to CEO Michael Bayley, the improvements were made with the goal of "growing a market and attracting the next generation." As the industry continues to modernize, we think fundamentals remain attractive, too. With demand rising 7%-to-8% per year, growth is outpacing supply, a positive trend we predict will continue for several years to come.

A 2017 poll conducted by Expedia Media Solutions, Expedia's advertising arm, found that millennials travel more than any other generation. Naturally, we think leading online travel agencies **Booking Holdings, Inc.** and **Expedia Group, Inc.**, which spearheaded the digitization of the travel industry and the shift to online booking, stand to benefit from the growing demand for experiences and any corresponding travel among millennials. Price comparison features, large inventories, and the ability to book lodging, air travel, and car rentals via a consolidated platform represent significant competitive advantages, and we believe these companies can thrive in the digitally dependent experience economy.

Digitization & the Shift to Online Retail

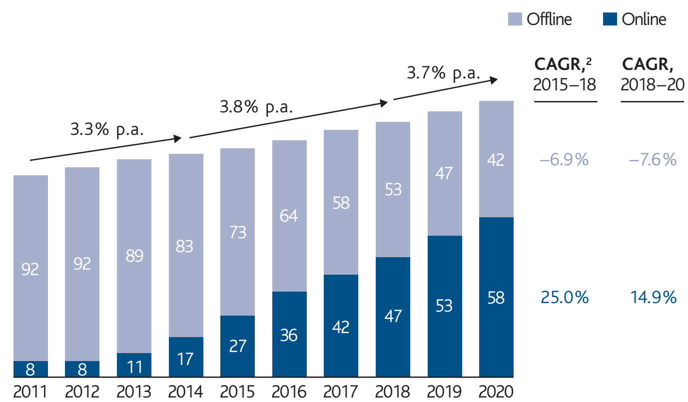


Source: BigCommerce, Statista 2018

Of course, even millennials must buy material goods occasionally, and when they do, they turn to the internet more than any other demographic. Over the last decade, no company has changed the landscape of the Consumer Discretionary sector more than **Amazon.com, Inc.** The retail behemoth has revolutionized the way consumers shop for everything from sneakers to groceries, and is now the poster child for the meteoric rise of e-commerce. We think millennials' preference for shopping and transacting online sets Amazon up for exactly the kind of sustainable success in which we seek to invest. Moreover, while Amazon has evolved into the default platform for online shoppers, we note that e-commerce still only represents around 14% of total retail sales, leaving room for further penetration over time. We also see several other verticals as areas for future growth. In particular, we believe Amazon Web Services, Amazon's industry-leading cloud infrastructure business, offers investors a unique opportunity to capitalize on robust secular growth stories in both e-commerce and cloud computing.

Importantly, retail is not the only area the Consumer Discretionary sector has felt the effects of digitization. From hotels to car dealerships, businesses have been forced to adapt to changes brought about by a combination of innovative technology and evolving consumer preferences. The restaurant industry is no exception, as mobile ordering and online delivery platforms have upended the takeout and delivery experiences. We think restaurant delivery aggregator **JUST EAT plc**, which operates in the U.K. and across South America and Europe, is poised to continue gaining share internationally. In what is known as a winner-take-most industry, JUST EAT stands out as a high-quality, high-growth business with high returns on incremental capital invested, excellent conversion of earnings to cash flow, a defensible position as a market leader, and a service that offers compelling value to restaurants and consumers. Combined with its appeal to millennials in search of a hassle-free meal ordered electronically and delivered rapidly, we think these characteristics make JUST EAT a promising growth investment.

Total addressable classic food-delivery market,[1] %



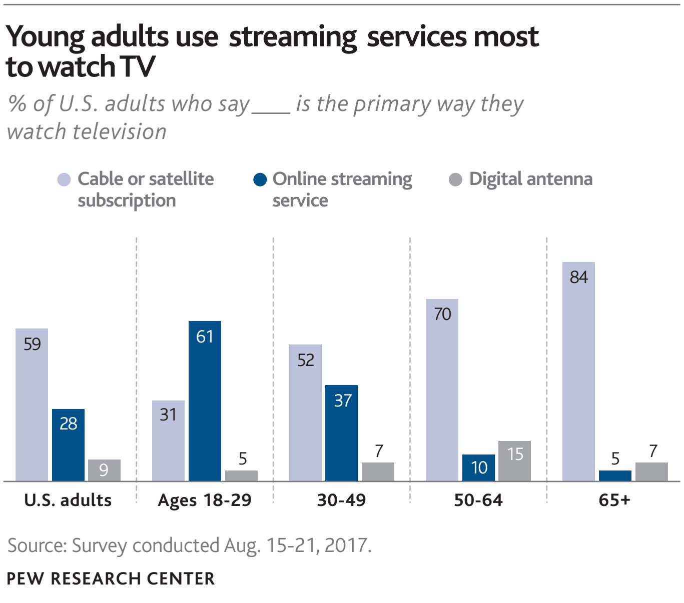
1 For selected countries only.
2 Compound annual growth rate.

McKinsey&Company

*p.a. = per annum

The Leasing Economy

As preferences that govern how we transact and consume continue evolving, ownership is falling out of favor. Millennials are spurning mortgages for rentals and monthly car payments for Uber and Lyft as collaborative consumption fuels the rise of a leasing economy. This trend is particularly evident in media consumption, as online subscription services are eliminating the need for customers to purchase the movies they watch, the albums they listen to, and the books they read. We think companies charging a flat fee for access to massive content repositories, such as **Netflix, Inc.**, are positioned to succeed among a generation with an aversion to ownership.



In a survey conducted by the Pew Research Center in 2017, 61% of participants ages 18 to 29 reported that online streaming services were the primary way they watched TV. Given such strong appeal with young consumers, we believe Netflix's streaming business could one day boast 90 million domestic subscribers (and twice as many internationally). In our opinion, the company's substantial (and growing) subscriber base constitutes a significant competitive advantage, as it allows Netflix to amortize content spend over time. As evidenced by last year's battle between Disney and Comcast to acquire Fox, the scale of content and assets required to compete with Netflix globally continues to rise. Considering how closely its business model aligns with millennial preferences, we think that should contribute to meaningful share price appreciation over time.

Though it isn't technically classified by GICS as a Consumer Discretionary company, **Spotify Technology S.A.** represents a similar investment to Netflix in many ways. Spotify is the global leader in music streaming, with approximately 42% market share and over 70 million paying subscribers. Spotify's large subscriber base, which we estimate could grow to 250 million users over time, has enabled the creation of a two-sided marketplace: a platform for creators to monetize their work and a digital repository for music consumers. Longer term, we expect the company to improve margins through negotiations with music labels and artists and continue capitalizing on millennial appetite for subscription services.

The Takeaway

As investors in search of companies with significant growth opportunities and sustainable competitive advantages, we see a lot to like in the Consumer Discretionary sector. With millennials currently representing over a quarter of the U.S. population, we believe their tendencies will play an increasingly large role in the performance of consumer stocks over time. Digitization and the growth of the experience and leasing economies are a few secular developments we have identified within Consumer Discretionary. We believe these trends are highly compatible with our long-term, fundamental investment process, and we think we are well positioned to capitalize as they continue to manifest.

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Portfolio Holdings as a Percentage of Net Assets, 12/31/18

	Baron Asset Fund	Baron Growth Fund	Baron Focused Growth Fund	Baron Partners Fund	Baron Opportunity Fund	Baron Fifth Avenue Growth Fund	Baron Real Estate Fund	Baron Global Advantage Fund	Baron Discovery Fund	Baron Durable Advantage Fund
Vail Resorts, Inc.	4.4	8.1	14.1	7.6*						
Booking Holdings, Inc.	1.5					3.1				2.2
Expedia Group, Inc.	1.1				1.7					
Amazon.com, Inc.					6.0	15.3		4.9		
JUST EAT plc									0.7	
Netflix, Inc.					1.2					
Norwegian Cruise Line Holdings, Ltd.				0.8*			2.6			
Royal Caribbean Cruises Ltd.							2.4			
Spotify Technology S.A.					0.7					

Portfolio holdings may change over time.

* % of long positions.

As of 12/31/18, Baron Small Cap Fund, Baron International Growth Fund, Baron Emerging Markets Fund, Baron Energy and Resources Fund, Baron Real Estate Income Fund, and Baron Health Care Fund did not own any of the securities listed above.

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