Small Cap Core Growth
Portfolio Commentary
3rd Quarter 2020

Markets in the 3rd quarter of 2020 continued their upward climb off the March lows, nudging the Russell 2000 Growth Index back into positive territory for the year. Weekly unemployment claims fell below one million for the first time since the pandemic struck, as the economy slowly opens from the pandemic restrictions. Promising news on potential vaccines for COVID-19 and better treatments for those that are infected has helped buoy confidence as well. While corporate earnings fell sharply in Q2 from a year earlier, the pain for most companies was less severe than analysts had feared.

The Granahan Small Cap Core Growth strategy continued to perform well in this environment, as the composite had a net-of-fee return of +12.8% in the 3rd quarter, significantly above the +7.2% return of its Russell 2000 Growth benchmark. Year-to-date, the strategy's +26.0% net-of-fee return is well ahead of the Index's +3.9% return.

In the quarter, two of the top relative contributors were also in the top five last quarter, and both represent the info tech sector and the Core Growth LifeCycle category: **Digital Turbine** (APPS) and **Enphase Energy** (ENPH). Digital Turbine offers a software platform to mobile carriers that allows for apps to be pre-installed on a phone when it is activated either as a new phone or a used phone. The company reported strong Q2 results and outlook despite weak handset demand, as their mobile carrier partners have benefited from increased spending by app providers who want access to new phone initiations. Enphase uses ASIC technology to adjust solar microinverters for each application intelligently, a major breakthrough in the solar marketplace that has allowed them to take major market share. We have had to trim the position because of size.   **Immunomedics** (IMMU, Pioneer, healthcare) has agreed to be acquired by Gilead Sciences for a 108% premium. Last quarter the Immunomedics's lead drug for the treatment of third line triple-negative breast cancer, Trodelvy, was approved by the FDA. Another Pioneer in the top five, **Vericel** (VCEL, healthcare) is a regenerative medicine company with commercial products for knee injuries and severe burns. Vericel's business was slowed during the lockdown but showed a significant recovery in the quarter as people felt more comfortable with moving forward on their knee surgeries. On the burn side of Vericel's business, the company filed for a new burn treatment procedure that should be a material driver to long-term growth. The strong earnings recovery and improved long-term growth outlook served as catalysts for the stock, and we maintain our position. **Evolent Health** (EVH, healthcare) is the lone Special Situation in the top five. Evolent's stock recovered in the quarter as the base Medicaid reimbursement rates for Kentucky Region A – where its partner plan Passport has most of its covered members – will receive a 4.3% rate increase. The increase equates to an incremental $80M of annual premium revenue just a year after rate cuts contributed to a $60M loss for the company. We are buying more of the stock.

The largest detractors to performance in the quarter were from the information technology sector. Special Situation **Limelight Networks** (LLNW) underperformed in 3Q after strong performance in the first half of the year and subsequent profit-taking in stocks that were beneficiaries of the COVID work-from-home policies. Pioneer **Cloudera** (CLDR) is an open-source software platform that transforms vast amounts of complex data and analytics into actionable business insights. The stock rose before the company's earnings announcement and then sold off on beat-of-consensus metrics and raised guidance. Cloudera is at the beginning of its rollout of a new cloud customer data platform that supports hybrid private/public solutions for its large customer installed base. We are maintaining our position, as we believe good execution and traction warrants a multiple more in line with that of its peer group. Rounding out the quarter's bottom five are three Core Growth holdings: Ciena Corp., Euronet Worldwide, and Pure Storage. **Ciena** (CIEN) is a leading global vendor of optical networking systems and communications infrastructure. The worldwide lockdowns due to COVID have reduced the near-term outlook as deployments by service providers have been delayed. The longer-term secular growth drivers of 5G deployment, favorable industry dynamics, and the company's share-gaining strategy remain intact; we are adding to our position. **Euronet Worldwide** (EEFT) enables electronic payments and transaction processing solutions for financial institutions and consumers. Euronet's business was disrupted by the global lockdown, a drop off in travel, and a rise in unemployment. The company has pared back both fixed and variable expenses in the near term while continuing to invest and prioritize R&D to capitalize on its digital transformation and gain market share. We have added to position on weakness as we believe EEFT will gain share and scale as its business recovers. **Pure Storage** (PSTG) is a leading provider of software-defined and all flash data storage solutions for the enterprise. Despite the COVID headwinds the company is facing in the near term, the longer-term drivers remain intact., including new products that will increase the addressable market, continued market share gains, a large installed base, and a greater mix of recurring revenues and improved sales productivity. We are using the weakness in the stock price to add to our position.

Year-to-date, three of the top performers are from the info tech sector: **Enphase Energy** and **Digital Turbine** (both Core Growth), and **Limelight Networks** (Special Situation). Consumer discretionary holding, **Etsy** (ETSY, Core Growth), and healthcare holding, **Immunomedics** (Pioneer), round out the top five. On the negative side, four of the five largest detractors are Special Situation holdings: **Newmark Group** (NMRK, real estate), **BGC Partners** (BGCP, financials), **Ring Energy** and **ProPetro Holding Corp** (REI, PUMP, energy). Core Growth holding, **Euronet Worldwide** (info tech), is also in the bottom five year-to-date. We have increased our position in Euronet, reduced Ring Energy, and have sold ProPetro.

Attribution

In the quarter, its notable that there were only three sectors in the Russell 2000 Growth Index that beat the total return for the Index itself: consumer discretionary, industrials, and consumer staples. This return profile is very different than the first half of the year where returns for the Index were driven by the information technology and healthcare sectors. As is typical in most environments, the Small Cap Core Growth portfolio's 3rd quarter performance was driven by stock selection, with strong selection in healthcare, energy, and info tech. Good selection in communication services and consumer staples also assisted performance. The portfolio's underweight position in the healthcare sector boosted relative performance, while the overweight positions in info tech and energy slightly offset the strong selection here. The lack of exposure to utilities was a plus. Stock selection in industrials, consumer discretionary, materials and financials weighed on performance. Relative performance in consumer discretionary was also hurt by our underweighting of the sector. Consumer discretionary stocks in the Index that did well in the quarter were work-from-home beneficiaries like Overstock.com and Restoration Hardware.

GIM utilizes LifeCycle diversification (Pioneer, Core Growth and Special Situation) to help mitigate risk. In the 3rd quarter, the Core Growth category soundly outperformed the benchmark, the return for the Pioneer category was in-line with the Index, and Special Situations lagged.

Weightings

GIMI's bottom-up process leads us to maintain our overweight in information technology, and we are also overweight versus the benchmark in energy, and slightly so in communication services. We are underweighted to the Index in all other sectors with consumer discretionary and consumer staples as the largest underweights.

Themes

The year 2020 has seen a record number of IPO's for Special Purpose Acquisition Companies ("SPAC"), as almost three times more money has been raised for SPACs year-to-date versus all of 2019. Traditionally, SPACs have been referred to as "blank-check" companies with an associated negative connotation in the investment world. However, given the current environment and the arduous process required for a company to go public, investors' views of SPACs have changed. At a JMP conference in early September, Andrew Boyd (former Head of Global Equity Capital Markets at Fidelity and founder of Bramalea Partners) said he is a proponent of the SPAC, as he believes the market for public listings has lacked innovation for quite a while and the reverse merger is a refreshing change of pace. The pandemic has made IPO road shows, where companies introduce themselves and their mission to investors, difficult and has lengthened what was already a lengthy process. SPACs can raise money more quickly in an IPO, and the proceeds then sit in a trust earning interest. The SPAC's sponsors (generally knowledgeable investors or experienced management teams) search for an operating company with which to merge, and negotiate a deal. Today, many SPACs are brought public with the company targeted for purchase already in place. Once the transaction closes, the SPAC ceases to exist, and the merger target becomes publicly traded. SPACs typically have a deadline of two years to close a deal. If a deal is not completed, the cash is returned to shareholders, which provides a benign downside risk. Granahan has purchased several SPACs over the last few years: **Porch** (home services platform), **Alta Equipment** (industrial and construction equipment rentals), **Organogenesis** (advanced wound care), **One Spa World** (cruise ship spas), and **DermTech** (early detection of skin cancer).

A carbon footprint is the total amount of greenhouse gases (including carbon dioxide and methane) that are generated by our actions. The average carbon footprint for a person in the United States is 16 tons, one of the highest rates in the world. Globally, the average is closer to 4 tons. There are two ways to achieve a carbon-neutral footprint: 1) balance carbon dioxide emissions with carbon removal, and 2) reduce emissions by shifting to renewable energy sources and changing industrial processes. The scientific community believes that the best chance to avoid a 2℃ rise in global temperatures is to reduce the average global carbon footprint per year to under 2 tons by 2050. Over 70 countries have pledged to reach carbon neutrality by this date. Certainly, this is a major tailwind for any company that can help with this effort. We have several companies in the portfolio that address reducing emissions through renewable energy or changing industrial processes: **Enphase Energy**, **Vicor Corp**., **Plug Power**, **Canadian Solar**, **Ballard Power**, **Chart Industries** and **Power Integrations**.

Bioprocessing is the manufacturing process that uses living cells to produce innovative medicines, and this process is very well positioned for significant growth over the next several years. Monoclonal antibody drugs, a class of drugs that stimulate the immune system to fight disease, have provided a steady base of growth for the industry; more recently, the wave of expected gene therapy drug approvals, and COVID-19 vaccines and therapeutics, will lead to significant expansion in the manufacturing capacity of the industry. This year has seen an unprecedented level of commitment to expand capacity – Samsung Biologics is building a $2B "Super Plant" that alone will increase capacity by 30%. In our portfolio, **Repligen**, a pure-play on bioprocessing, is one of the biggest beneficiaries of the manufacturing buildout. Repligen's next-generation products allow bioprocessing plants to incorporate disposable technologies in their new manufacturing processes that will in turn increase production yield, reduce costs, and, importantly, reduce downtime between runs from 7-10 days to less than 24 hours.

In addition to using bioprocessing, the pending wave of gene therapy drugs will also require specialized storage and shipping services. So, in addition to the required manufacturing buildout, biostorage, specialized freezers, preservation products, and cold-storage shipping services are all required to commercially launch this new class of drugs. Two of our portfolio companies, **Brooks Automation** and **CryoPort**, offer a variety of services to meet the demands of the drug manufacturers launching these products.

Macro

On the negative side of the macro ledger, global case growth for COVID has risen, causing concern about self-quarantining and possible additional lock downs. The Fed has given a muddled message on monetary support and has signaled that fiscal stimulus is needed to keep the US economy from falling into recession (or worse), while the President and Congress are at a stalemate over a stimulus package. US political tensions have ratcheted higher as the election nears, *and* President Trump has been diagnosed with COVID. Finally, inflation expectations have moved higher since late September, though they are still very low. Despite these headwinds, earnings revisions have been sharply higher, and the ISM manufacturing survey beat expectations to reach its highest point since 2018, moving up to 56 from 54.2 in July and 41.5 in April. As a reminder, anything above 50 is an expansion. Last week GDP growth increased +35%, and that was before a positive employment report. However, GDP was down 30% in Q1, so up 35% is still down for the year. Consumer spending in up strongly with particular strength in vehicle and home sales.

Outlook

It is unclear how the pandemic will impact companies' sales cycles over the longer-term but Q3 will provide much insight into the balance between the impediments of social distancing and the efficiencies of virtual communications. Sales cycles may decrease with the efficiencies from virtual video conferencing or, conversely, could increase simply due to cash-preservation initiatives as a result of customer prudence to maintain capital reserves. The overall distribution of the impact from the pandemic varies widely based on the industry and company, and there certainly will be winners and losers that can be separated into the need-to-have category and the nice-to-have category when it comes to goods and services.

In terms of valuation and fundamentals, there is much talk about small cap growth (SCG) stocks relative to small cap value (SCV) stocks diverging much like the Tech Bubble. While SCG relative valuation is elevated, it is nowhere near the peak of the Tech Bubble. When we look at sales growth, ROE and cash flow margin differences, we find SCG posting better numbers across most areas, which is significantly different than the Tech Bubble fundamental case. SCG cash flow margins are +2% higher than SCV (with the difference continuing to rise) and the average SCG stock is generating +$15m more cash flow over a 12-month period than the average SCV stock. SCG sales growth and ROE are also superior to SCV, which was not the case in 2000. As always, GIM will focus on finding and vetting the SCG companies that demonstrate these superior fundamental factors, and use our disciplined tools to invest in the stocks of these companies when risk/reward is attractive.