GRANAHAN INVESTMENT MANAGEMENT INC

Granahan Small Cap Focused Growth Strategy
Portfolio Manager Commentary
1st Quarter 2021

Q1 Performance Discussion:
A little more than a year ago, amidst the severe market downturn, the Covid-19 pandemic suddenly changed the way virtually every company operated. In general, these "work-from-anywhere" changes provided a tailwind for the Focused Growth strategy with its emphasis on secular growth companies that are disrupting the status quo. This began to reverse in Q4 2020 as value-oriented indices began outperforming their growth counterparts. In Q1 2021, this trend widened, and the Russell 2000 Value Index had its 2nd best relative quarter *ever* versus the Russel 2000 Growth (+21.2% versus +4.9%). Financials, energy, and industrials stocks, a large component of value indices, surged based on signs of an economic recovery, the rise in interest rates and indications of inflation. Most of the factors that were tailwinds in 2020 became fierce headwinds as investors favored value stocks over growth, cyclical growth companies over secular growth companies, and short duration assets over long duration. Also outperforming were highly levered companies, those positioned to benefit from higher interest rates, stocks with a lower Price/Earnings multiple on 2021 earnings, and stocks that underperformed in 2020. Simply put, there was a rotation from stocks of companies that were absolute or relative beneficiaries of the Covid-19 pandemic, to stocks of companies that will benefit as the world opens up.

For the first quarter 2021, the Granahan Focused Growth composite was down, -0.54% net-of-fees, underperforming the +4.88% return for the Russell 2000 Growth Index. On a sector level, as noted, cyclical sectors performed best; sector returns within the Russell 2000 Growth benchmark were led by consumer discretionary, +18.0%; industrials, +12.5%; consumer staples, +11.3%; and energy, +11.3%. Within the Index, technology underperformed with a return of +2.1%, as did healthcare at -2.4%.

The Focused Growth strategy's underperformance in the quarter was due to stock selection. Selection weighed on performance across the board, as we were not exposed to the more cyclical companies in the top performing sectors, nor other cyclical industries (e.g., banks and materials). Selection detracted most in energy (our one holding, a clean energy name, was down), consumer discretionary (online learning companies), and technology. The one bright spot in selection was in healthcare where our minimal exposure of two holdings had good relative performance.

Largest Relative Detractors:

1) LivePerson (LPSN): There was no specific news or negative developments that we have uncovered. The stock price decline appears due to the general factor rotation discussed above. We added to our position on the pullback.
2) Paycom (PAYC): Similar to LivePerson, there have been no developments of which we are aware, although we slightly trimmed our investment in PAYC shares as we felt near-term opportunities were a bit better in other investments.
3) eHealth (EHTH) had a negative return for the portfolio even though the stock was up 3% for the Index, as we eliminated the position during the quarter. The sale was based primarily on reduced conviction in management's ability to execute in an increasingly competitive environment.

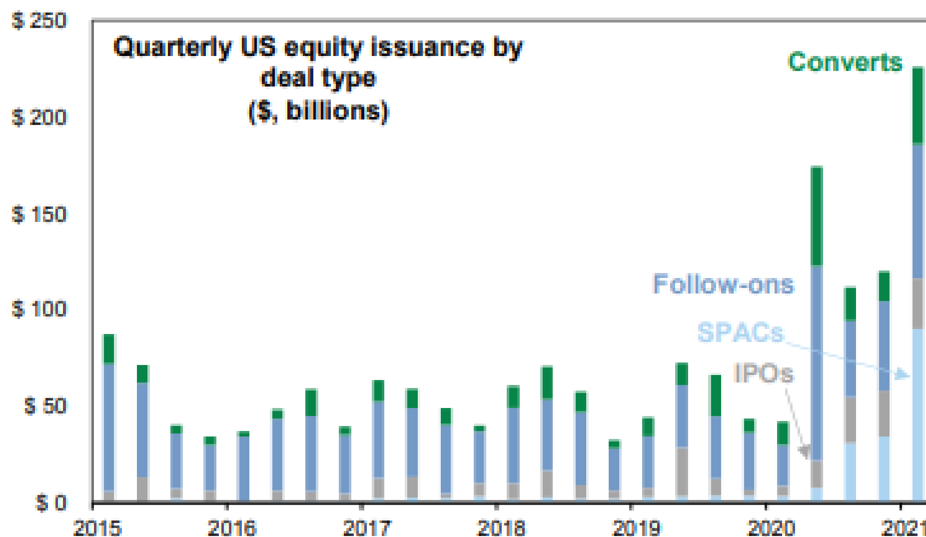
Top Relative Contributors:

1) Sprout Social (SPT) offers a platform for companies to manage their online social presence. In the wake of SPT's strong rise in the quarter and over the past 15 months, we have reduced our position size based on expected return and risk/reward.
2) Magnite (MGNI) shares rose as the company announced the acquisition of SpotX. The acquisition consolidates Magnite's position as the leading sell-side platform adtech, particularly in the rapidly growing arena of connected TV (CTV). We maintain a relatively large position in the stock.
3) Axon (AXON) was up on strong Q4 results and a positive outlook for 2021. We continue to hold a large position in AXON shares.

The Portfolio's Value was Essentially Unchanged in Q1…*Sounds like a Mundane Three Months?*

Well…not exactly. Beyond the dramatic "factor" shifts discussed above, the first quarter of 2021 was anything but mundane. We had an unusually significant regime change in U.S. political leadership both in the White House and Congress (and let's not forget the US Capital insurrection on January 6th). Brexit's long-awaited cutover occurred on January 31st, shares of Gamestop (GME) rose 908% thanks to Robinhood's band of merry retail investors storming the hedge fund complex castle, and a relatively blasé rise of just 98% in Bitcoin in the quarter. We also saw 226 special-purpose acquisition companies (SPACs) go public in Q1, along with 65 traditional IPOs.

Exhibit 7: First-quarter 2021 set a record for US equity issuance
as of March 31, 2021



Source: Dealogic, Goldman Sachs Global Investment Research

SPACs represent a route for a company to go public that is an alternative to a traditional IPO. In a SPAC, a publicly traded shell company is formed to identify and acquire a target operating company. This path carries with it many plusses, minuses, and ripple effects – the discussion of which I'll leave for another time (for more on how SPACs work, [here's a good primer]). The pace of SPAC IPOs and of existing public SPACs announcing target acquisitions has slowed sharply in recent weeks. In most cases, SPACs require additional financing to acquire their desired targets. This typically comes in the form of a PIPE (Private Investment in Public Equity), and lately institutional PIPE investors are getting indigestion from too much supply. In addition, the Securities Exchange Commission (SEC) is showing signs it plans greater scrutiny on SPACs.

Source: Boston Globe 4/12/21

While the number of SPACs and traditional IPOs will ebb and flow, it feels likely that, after a long period in which the number of public companies in the small/smid cap arena has generally trended down, the trend has begun to reverse. And while most of these newly public companies will not be Desert Island-worthy, some will be. This is exciting. We are currently invested in two companies that have "de-SPAC'd" in the past 4 months. The first is **Porch.com (PRCH)**, a software and marketing platform for the residential real estate market that I believe has a substantial runway to grow both organically and through selective acquisitions. The other is **View, Inc. (VIEW)**, a leading manufacturer of smart windows that automatically adjust tinting to minimize heat and glare. We are also invested in one company set to de-SPAC this month, **dMY Technology Group II (DMYD)**. dMy is acquiring Genius Sports, a company that provides data, technology, and services behind sports, betting, and media globally. We also own a small position in **Executive Network Partnering Corp (ENPC)**, a SPAC that has yet to announce a target.

Near-term Ahead: Hopefully a New Normal in the U.S. and Beyond

I'm cautiously optimistic that the US is within sight of when life will shift to the new normal. President Biden recently announced that all adults in the US should be eligible for vaccination by April 19th. Significant risks remain in the form of B.1.1.7 Covid variants, as well as anti-vaccination stances by far too many Americans. I wouldn't be surprised if we see some version of the "Roaring 20's." People are desperate to travel, eat out, see friends and relatives, party, attend concerts and sporting events, and a whole lot more. I expect this will persist for some time as people generally seek to make up for lost time, adopt a YOLO perspective, and spend money that has been saved or granted during the pandemic. This should also lead to robust earnings recoveries for many of the obvious beneficiaries (e.g., hotels, airlines, travel companies, restaurants and companies in the restaurant supply chain, infrastructure products and services companies).

So the Roaring 20's…But For How Long? And Then What?

Although we're still awaiting the actual roaring 20's, and the accompanying surge in spending and profits, Wall Street has already anticipated it. Many recovery stocks are selling at all-time highs and discounting strong 2022 and even 2023 earnings. Consistent with my long-held belief that I cannot consistently market time, we've not tried to rotate into cyclicals. While, had I gotten the timing and stock selection right, this would have produced better performance over the past six months, the question I'd be facing is: "OK, is now the time to rotate back?" I do not know the answer to that.

If we are on the brink of where the US was 100 years ago, and society is about to spend 2021-2029 traveling, partying, and spending like it's 1921-1929, a portfolio of airlines, hotel, and restaurant stocks is likely to do well for some time to come. But my darn crystal ball has yet to work properly, so I don't know whether or not we're in store for such a decade. But I can say unequivocally two things:

1) I have almost 100% confidence that I'd detract value if I tried to time a rotation in/out/in of growth/value, say, 100 times. And if I can't add value if I tried to do something 100 times, why would I think that I can do so in this, or any other particular, instance? The answer, as Charles D. Ellis wrote in his classic book *Winning the Loser's Game*, is that I can't…so I don't.

2) Thankfully, I believe we do not have to try and win the loser's game. The first step and "North Star"" of the Focused Growth's process is to identify companies we believe are Desert Island-worthy – i.e., if stranded on a desert island for 5-10 years, when we are rescued, these Desert Island-worthy companies would be many times larger when we return. This is because they are fundamentally well-positioned for sustained secular growth (in contrast to companies that might be currently well-positioned to enjoy cyclical growth). Step two in our process – rather than going away to a desert island – is to employ a valuation discipline centered on a probability-weighted expected return and risk/reward methodology. Step three is careful portfolio construction that factors in conviction, risk/reward, and diversification. And step four involves various elements of risk management. This four-part process has proven to be durable over time in producing good investment returns for our clients in most market environments. Not all, but most. It is my belief that it can continue to do so over most intermediate to long-term time periods.

I should also note that the above perspective of, "I can't consistently add value predicting, but thankfully, I don't feel it is necessary" also applies to the possibilities that inflation may pick up or interest rates may continue to rise. The companies in which we are investing are compounding their top lines at 15-20-25+ percent, and in most cases compounding their bottom line faster than that. If inflation were to pick-up, given that such companies are providing strong value propositions to their customers, they will likely be able to pass through such inflation in the form of price increases. If interest rates were to continue to rise, this would impact the discount rate investors should be willing to pay for future earnings. That said, I believe that high and sustainable secular growth, even in a higher rate environment, is a solid path to long-term outperformance.

Recent Portfolio Changes

As I have discussed before, in periods of volatility – when stock prices shift around more than usual – the portfolio tends to shift around a bit more than typical. This was the case in Q1 and resulted in sales of complete positions –
Hubspot (HUBS), Coupa (COUP), ZScaler (ZS), One Medical (ONEM), Lemonade (LMND)
and additions to the portfolio –
Grand Canyon Education (LOPE), Cricut (CRCT), Bumble (BMBL), Euronet Worldwide (EEFT).
In addition, there were shifts in the weights of stock holdings, both up –
Etsy (ETSY), Kornit (KRNT), Axon (AXON)
and down –
Enphase (ENPH), Sprout Social (SPT)).

Each company and stock is evaluated on its own merits. However, a general thread in many (though not all) of these trades is that, given the increased supply of prospective stocks to buy in small/SMID cap (per SPAC/IPO discussion above), and the move we have seen in interest rates, I think near-term valuations will be a bit more important going forward.

A Few Podcasts and a Documentary I've Enjoyed of Late

Capital Allocators - Ted Seides' four episode series "Crypto for Institutions" is worth the four hour investment.

Business Breakdowns - Interview with Alex Danco from the Money team at Shopify provides a unique angle at how this remarkable company got to where it is, explores where it is going, and discusses important roadmap implications for e-commerce broadly.

HBR After Hours - I really enjoy this podcast in which Harvard Business School professors and hosts Youngme Moon, Mihir Desai, and Felix Oberholzer-Gee discuss and debate businesses, business concepts, and often some cool tidbits on current events. Try this one on Restaurants and Food, and this one on how Occupy Wall Street is occupying Wall Street.

The Twenty Minute VC - I could list a long list of listen-worthy episodes, but you might start with this terrific interview with Etsy CEO Josh Silverman.

Derek Delgaudio's In & Of Itself - I can't pigeonhole this "documentary" into a neat category. Suffice to say, if you watch it and don't find it worth your time, let me know and I'll refund your money.

Summary

As always, on behalf of the entire team at Granahan Investment Management, thank you for entrusting us with the management of your capital. Please note that it is managed alongside our own. I hope your new normal comes soon and is all you dream it to be.

Sincerely,

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