SMALL CAP CORE GROWTH

Portfolio Comments
March 31, 2021

The consequences of the ongoing pandemic persist by way of supply chain disruptions, capacity constraints, surging inflation, and labor shortages. These factors made for the worst January start on record for the Russell 2000 Growth Index. February brought war in Ukraine along with soaring energy prices, adding to pressure on stocks. The quarter ended down -12.63% for the Russell 2000 Growth Index, and Granahan's Small Cap Core Growth portfolio fared slightly worse at -14.07%, losing to the Index by 144 basis points.

The business environment has become more challenging, as rising interest rates and persistent inflation weigh on margins. Investors have become more cautious and, therefore, are unwilling to pay higher multiples for the strong growth exhibited by many of our companies. Multiples have been dramatically cut. The poorest performing names this quarter were two Pioneers, **Veracyte** and **Porch**, and three Core Growth names, **Kornit**, **Digital Turbine** and **InMode**. **Kornit Digital** develops, designs and markets innovative digital printing solutions globally for the printed textile industry. They seek to revolutionize the industry by facilitating the transition from analog textile printing processes to digital, no-waste methods of production. The company laid out its 5-year plan, targeting $1B in revenues in 2026 and operating margins in excess of 20%. New product introductions are weighing on short-term margins, but longer-term, these new products, consumables and services are likely to fuel Kornit towards their revenue target and improve operating margin leverage. We have seen significant multiple contraction and believe in the company's plans for strong growth; we are adding to the position. **Veracyte** is a genomic testing company with tests addressing eight of the top ten cancers. Cancer testing volumes came under renewed pressure due to Omicron. While VCYT delivered stronger than expected financial results, many of our Pioneer stocks saw weakness given macro concerns. We have selectively increased our VCYT position given our outlook for a strong recovery. We anticipate testing volumes normalizing throughout the year. **Porch Group** is a recent IPO that provides software and services for those that are moving. The company needed to clean up accounting around its acquired insurance business to improve the quality of revenue recognition going forward. Results appeared weaker than expected as they are using net revenues rather than gross revenues. We are adding to the position. **Digital Turbine** came under pressure along with other digital advertisers due to the changes in Google's new Privacy Sandbox initiative. Their Ignite software marries brands and audiences without the need for Google influence. While the bulk of revenue is currently from mobile devices, the opportunities in TV, Internet of Things (IoT), payments and autos are on the horizon. We are holding our position. **InMode** has developed technologies that fill a treatment gap between non-invasive and invasive aesthetic procedures. Its margins are among the highest in the medical technology sector and allow for strong free cash flow. The company announced that revenue growth would slow to 20% going forward, down from 2021's torrid growth of 75%. The stock is currently selling at 16X 2022 estimates, which we believe are low. We have added to the position.

We have two Special Situation names that drove positive performance: **Limelight** and **Evolent**. Core Growth names **Euronet**, **Enphase** and **HealthEquity** rounded out the top five positive performers. **Limelight Networks**, a content delivery network, is embarking on a transformation guided by a recent restructuring that included a new CEO. Financial results have seen a meaningful rebound from depressed levels due to improved network performance which has led to market share gains. Additionally, the company is expanding into more attractive areas of the networking market, especially security. Two strategic acquisitions have been announced over the past six months. The new strategic direction and improved financial results were drivers to the strong stock performance in Q1. We have increased our position given our confidence in the new direction of the company, as the stock sells at a meaningful discount to peers. **Evolent,** a provider of healthcare delivery and payment systems, has stabilized its customer base over the past few years, including recently re-signing its largest client, driving over 100% net revenue retention. Evolent's solutions allow its customers to benefit from lower costs, improved outcomes, and improved access by facilitating a technology value-based approach to delivering healthcare. The Clinical Solutions business has grown robustly, and we expect continued sustainable growth supported by cross-selling opportunities. We are trimming on position size. **Euronet Worldwide** is an industry leader in providing secure electronic financial transaction solutions. They operate one of the largest independent ATM networks in Europe, are the world's largest payment network for prepaid mobile top-up and are the third largest global money transfer company. We have increased conviction in its earnings recovery because of declining pandemic fears and increasing European travel, as well as their technology innovation and disruption as a digital Fintech leader. We are maintaining our position. **Enphase**, manufacturer of solar power inverters, rebounded nicely from last quarter when fear surrounding California's stated intention to reduce incentives for residential solar weighed on the stock. We are holding a smaller position as we wait for Washington's decision regarding tariffs on solar panels. **HealthEquity** is a leading provider of consumer defined benefit plans, like Flexible Spending Accounts (FSA) and Health Savings Accounts (HSA). The company has been negatively impacted by Covid and lower interest rates; however, the stock rallied sharply this quarter as investors gained confidence in an expected recovery. Increased healthcare spending and higher interest rates both point to much stronger financial results for the next several years. We maintained our position during the quarter.

Attribution

As mentioned above, a collapse in multiples caused major price changes in many of our secular, high growth companies. Kornit in Industrials was the poster child here, causing this sector to fare poorly in stock selection. Healthcare suffered from poor stock selection as well. Soaring oil prices caused by the war in Ukraine did not favor our underweight in Energy and Materials. Stock selection in Communications was a penalty, and our lack of Utility exposure and underweight in Real Estate hurt marginally. Information Technology was the portfolio's largest contributor to relative outperformance, though our overweight offset some of the positive gain. Selection in Financials and an underweight in Consumer Discretionary were positive influences on performance this quarter. Special Situations represented the strength in the portfolio and Core Growth companies matched the performance of the Index. Pioneers struggled.

Weights

Changes in the portfolio weightings versus last quarter are minor with the exception of Information Technology rising 2%. This weighting is on par with our overweight versus a year ago and up slightly from last quarter as the Index weight has dissipated. Healthcare is interesting, as our weighting has remained level year over year, but the Index weight has dropped by 800 basis points, making our position now an overweight versus an underweight to the Index. As we have noted, Healthcare stocks have been under tremendous pressure over the last twelve months. We remain underweight in Consumer Discretionary and Staples, as well as Industrials. Financials and Communications Services are slightly overweighted. We have no exposure to Energy and Utilities according to the GICS sectors.

We have added to the Pioneer category by 1% (32% total weight) over the course of the last several months, adding to our innovators that have suffered from valuation decline. We sold some winners in the Special Situation category to fund these Pioneer purchases. Special Situations are now 18% of the portfolio, down from 19%. Core Growth has remained flat from last quarter at 49%.

Themes

Almost every company in Silicon Valley talks about the power and sustainability of "digital transformation," or the shift of businesses and processes into the cloud realm. Digital transformation is real, even though many think of this as an overused buzzword. Large cap companies like Microsoft, Amazon and Google grew over 40% in the fourth quarter of 2021 providing cloud platforms and services. In our portfolio, **Pure Storage**, which is a leading provider of data storage solutions for enterprises, experienced a similar growth rate. Any company looking at updating their systems to invest in data is a potential customer of Pure Storage. The company is taking share in a large $65B+ storage market, introducing more products and services, and benefitting from a strong channel presence with customers migrating to the Cloud. The trend is more obvious in software as a service (SaaS) expansion of cloud-based offerings such as **Workiva**, **Zeta**, **Sprout Social** and **Veritone**, all companies in our portfolio. Our IT consulting companies, **Perficient**, **Globlant,** and recent add, **Grid Dynamics**, are also being hired to lead companies through this digital transformation.

As companies are embracing new technologies, adopting cloud platforms, and digitally transforming, our security software companies are helping them better protect their IT environments from increasingly more innovative and sophisticated hackers. Cybersecurity risks are constantly highlighted in the press, and the flight to zero-trust architectures has become critically important for corporations and individuals, especially after hacks like those at Solarwinds, AWS, and Microsoft. The war in Ukraine exacerbates the cyber risks. A recent Gartner forecast calls for growth of 10% for security products in 2022. Enterprises are also coping with increasing turnover and a more distributed workforce, putting even more pressure on IT and security professionals. Granahan's portfolio is overweighted in security software versus the Index. **Cyberark**, **Rapid7**, **Qualys**, **Varonis** and **Radware** are focused on integration, automation and streamlining responses to help reduce the labor required without sacrificing the efficacy of overall security.

In healthcare, we are seeing a shift to precision medicine; an innovative approach to therapies that factor in individual genes, environments, and lifestyles to create tailored medicines which aim to treat disease more effectively. We leveraged the quarter's volatility to add to our positions which benefit from this trend, including **Olink Holding**, **Castle Biosciences**, and several other biotechnology holdings. We also saw improved performance this quarter from some of our healthcare stocks that were disrupted last year due to Covid. We expect stocks, like **Vericel, HealthEquity, SI-BONE**, and **Aerie Pharmaceuticals** to continue to see improved performance as Covid subsides.

Macro Environment

A tightening yield curve, spikes in oil prices, and inflation running at its highest level in 40 years have some worried we could be entering a period of stagflation. Other observers have pointed to the fact that higher oil prices and inverted yield curves have often preceded recessions. In fact, higher oil prices in 1987, 1996, 2011 or 2018 did not spark a recession, and in many cases a recession did not follow an inverted yield curve. Monetary policy is still eased, which could allow the economy to absorb some of the pain that comes from higher oil prices. Possibly one of the largest negatives today is the Ukrainian war. We've seen the short-term impact on oil supplies and pricing, but we can't predict the longer-term implications.

Despite the litany of negative factors underpinning the economy, growth has been strong in the US, although it is beginning to weaken. As of March 21st, nominal retail sales were up 18%, and bank loans were taking off as people hurried to take advantage of low interest rates before the hike. There is $2 trillion in consumer excess savings from staying home during the pandemic. Unemployment claims are at an all-time low. We'll have to wait and see which macro factors have the greatest impact on future results.

Outlook

Furey Research examined what worked the last time the U.S. went through a protracted stagflation (1974-1982) when inflation ran at nearly 9% per year while GDP grew at only 2% per year. The good news is that small-cap managers, both growth and value, were among the top performers. Furey has also done work that shows small cap companies usually outperforming large caps during rising bond yield environments. (Furey March 9, 2022)

Technically, the Russell 2000 Growth Index has experienced a bear market, as the low of March 11, 2022 marked a 31.1% decline from November 8, 2021. All the gathering dark clouds surrounding macroeconomic change have caused investors to re-evaluate their stock ownership. Investors haven't had to contend with high inflation in decades, and a war in Europe has only added to uncertainty.

What we do know right now is that valuations for companies in our portfolio have come down significantly since the November 8th high in the Russell 2000 Growth Index. Evercore ISI Research has postulated that the stage is possibly set for small cap outperformance because of "attractive valuation with the next twelve-month P/Es now below average in a market still generally expensive." (Evercore 3/7/22) Earnings growth rates have come down slightly in many of our companies as they have decided to spend more on future growth while they too are experiencing higher prices in labor and materials. Companies with strong competitive positions are able to pass along higher prices, but of course, there is a lag.

We remain patient, strategic growth investors focused on our process with the goal of providing long-term outperformance for our clients.