GRANAHAN INVESTMENT MANAGEMENT

GLOBAL SMALL CAP

Portfolio Comments
June 30, 2022

Distinguishing Features

GIM builds the Global Small Cap portfolio from the bottom-up; country and sector weightings are secondary to stock selection, with the US allocation at least 50% of the overall portfolio. As of 6/30/2022, the Global Small Cap portfolio had the US underweight relative to the MSCI World Small Cap (net) benchmark, 53.6% versus 58.2%, primarily due to the valuation differential; Japan is the other meaningful underweight (5.7% versus 10.1%). Canada represents the largest country overweight relative to the benchmark (6.9% versus 4.1%). We are overweight the Nordic region (6.3% versus 4.2%) and India (2.2% versus 0).

With respect to sectors, the portfolio continues its substantial overweight position in Information Technology, 29.9% versus 11.4% for the benchmark. The portfolio is also overweight Healthcare (20.3% versus 9.6%). As is typical for the portfolio, the largest underweight positions continue to be in Real Estate (2.6% versus 10.2%) and Financials (11.0% versus 13.7%). We currently have no exposure to Energy, Materials, Utilities or Consumer Staples.

Commentary

Market Environment

The contradicting dynamics of this market are confounding. Inflation is rampant, rates are rising, consumer and business sentiment are hitting or nearing all-time lows, and supply chains are a mess. Meanwhile, the unemployment rate remains low and many of our companies are experiencing a demand environment that in no way resembles a recession. If GDP growth posts a negative result in Q2, we are technically already in a recession. Market prognosticators, company CEOs, and others have shared their educated guesses on the probability of an economic downturn, but the fact is, no one knows what the coming months and quarters will bring. It is this inability to correctly and consistently predict market conditions that reinforces why Granahan focuses on company fundamentals over the long term. The small cap growth market has been declining since May 2021, seemingly discounting many of these negative scenarios. The Russell 2000 Growth Index has an average P/E on lowered next twelve months earnings estimates of 17.5x, down from its 32.5x a year ago, offering investors compelling valuations for high quality, sustainable growth companies.

With so much of the market focused on the immediate term, we believe the opportunity lies in taking a longer-term view. Our level of conviction is high that the companies in the portfolio have attractive growth opportunities that will eventually be rewarded. We are maintaining our investment discipline and focusing on what our companies can control – earnings. We are buying and adding to stocks in the portfolio whose investment case does not require a positive multiple rerating higher. Our belief in the compounding of their earnings growth over several years will drive outperformance relative to the investable universe.

Performance Discussion

The second quarter of 2022 continued to be characterized by a shift away from high-growth companies. Valuation multiples compressed further as interest rates, inflation, and supply chain disruption weighed on relative performance. The fear of recession is now prevalent across the market, more acute in Europe than in the US, and earnings estimates broadly are likely to fall in the coming months. Granahan's Global Small Cap strategy returned -12.26% in Q2, lagging the MSCI World Index benchmark's return of -6.41%. Defensive sectors, including Staples and Utilities, and Energy, areas of the market that we typically avoid given low sustainable growth, were the top 3 performing sectors in the period. Our significant overweight in Technology, a sector that underperformed the benchmark by over 450bps due primarily to sentiment shifts, was an ~80bps drag from an allocation perspective.

While cyclical factors certainly can impact our companies, the secular tailwinds, company-specific growth initiatives and strong balance sheets help limit the negative impact relative to the rest of the market. As growth becomes harder to come by, we believe our companies' fundamentals are sound. The team at Granahan maintains its focus on investing in growth potential over the next 3-5 years.

Stock selection was poor across the board, impacting performance by ~630bps. Real Estate was the exception, posting an insignificant contribution to performance due to Altus Group, a cloud-based software provider for commercial real estate. The other sectors negatively impacted performance to varying degrees. Financials was the largest detractor at ~240bps. **Silvergate** represented the most significant impact on the portfolio. The bank is a leading provider of innovative financial infrastructure solutions to the digital currency industry. While the prices of digital currencies were under severe pressure, Silvergate is not exposed to price changes but instead facilitates institutional adoption of these assets. The digital currency market is still in its infancy, and we expect Silvergate to benefit as regulations are implemented and as the overall market matures. **Lending Tree** was weak during the quarter as refinance mortgage activity slowed with the increase in interest rates. While the company was founded on this business, it has meaningfully expanded to be an online consumer financial marketplace connecting consumers with mortgage, credit card, insurance companies. The valuation of the company is now at a 5-year low, and we believe it is very attractive given the long-term secular growth of digitalization of financial services.

Technology detracted from performance by ~160bps. Apart from Nutanix, the top 5 worst relative performers in Technology all continue to have positive estimate revisions. We believe the majority of underperformance can be explained by the shift away from growth stocks; in other words, sentiment rather than fundamental-based issues. **Nutanix** sold off after its outlook for the quarter was well below expectations. The company provides storage and server virtualization software to enterprises. Given the supply chain issues at customers, sales will be temporarily interrupted until they can get new servers for which NTNX's software operates.

Industrials also performed poorly during the quarter. **Kornit**, a manufacturer of digital printers for the garment industry, was a significant detractor. A beneficiary of COVID, the company is experiencing delays in new orders as ecommerce activity normalizes and customers take a more cautious view of the near-term outlook. In addition, Amazon, the company's largest customer, has experienced delays in opening new facilities due to supply chain challenges which has impacted order patterns. It is difficult to find a company with such an attractive combination of secular tailwinds and superior competitive positioning. We remain confident that Kornit will be an important contributor to performance in the coming years and will be evaluating when to add to our position to capture that alpha.

Healthcare was also a drag on performance in the quarter (~90bps) despite companies reporting financial results in-line or ahead of expectations. There has been an overall sell-off in healthcare that continued in Q2, especially impacting our Pioneer companies that are investing in their businesses. We are confident in the long-term growth drivers of precision medicine and next generation bioprocessing and have used the weakness to increase our weightings in stocks like **Veracyte** and **Biolife** Solutions.

Other large detractors included **Revolve Group** and **Money Forward**. Revolve Group, a next-generation online fashion retailer with a niche focus on Millennial and Gen Z women, has posted impressive growth over the last 2 years as the brand has been incredibly hot. COVID helped to accelerate the shift to buying online at the expense of department stores and other brick-and-mortar retailers. With the increased angst related to inflation and a potential recession, investors have rotated away from companies dependent on consumer spending. Regardless of whether demand slows in the coming months, we believe the long-term outlook remains compelling. The company has a sustainable competitive advantage related to its technology, influencer-based marketing strategy, and merchandising model (i.e., test-and-repeat process that limits inventory markdown risk). A stock that had traded above 50x EV/EBITDA as recently as August 2021 is now only 12x, offering attractive risk/reward.

Money Forward is a cloud-based SaaS provider of accounting and related software to consumers and small/medium-sized businesses, similar to Intuit's Quickbooks in the US. Differentiation for the company centers on best-in-class customer acquisition due to strong relationships with accounting firms and superior, cloud-native technology. Over 80% of revenue is recurring and the company is consistently growing 30-40% organically. However, investment spending has remained high as the company seizes the opportunity to penetrate the market and gain scale, all to position itself for many years of cross-selling additional products and functionality. The rotation away from Pioneer-type growth stocks has been particularly difficult for Money Forward's stock. However, the fundamental momentum at the company continues unabated. Consensus revenue estimates continue to increase. After reaching 28x EV/Revenue, the stock currently trades at a highly attractive 8x next year's revenue.

From a regional perspective, the Netherlands was our largest contributor (14bps) with the only other positive countries being India and Norway. A key contributor in the Netherlands was **Alfen NV**, a provider of equipment such as EV charging stations and smart grid systems and components that enable the multi-decade energy transition in the Nordics and the rest of Europe. Most of the notable regional attribution was negative. The US accounted for more than half of the underperformance of the portfolio with several stocks detracting in a meaningful way; **Silvergate Capital, Lending Tree** and **Revolve Group** were the top 3. Japan underperformed by ~130bps tied primarily to Money Forward and **Raksul**, a business-to-business digital marketplace that is disrupting the status quo in industrial markets. Raksul is experiencing some slowdown in demand driven by COVID lockdowns in Japan and macro-related weakness. Israel rounds out the top 3 detracting countries due primarily to Kornit Digital.

With respect to LifeCycles, all three categories underperformed the benchmark with less differentiation relative to previous periods. There was nowhere to escape the brutal downturn this quarter. Core Growth and Pioneer categories, both known for high growth companies with above-market valuation multiples, accounted for the vast majority of underperformance, primarily due to higher weights in the portfolio. Unsurprisingly given the rate environment, Pioneers, which typically are unprofitable or underearning, posted the worst returns during the quarter. Of the 16 companies that are categorized as Pioneers, only 1 outperformed the benchmark.

The largest detractors during the quarter were Core Growth companies Silvergate Capital (Financials), Kornit Digital (Industrials), Lending Tree (Financials), and Revolve Group (Consumer Discretionary). **Money Forward** (Technology), a Pioneer name, rounds out the top 5 largest detractors.

On the positive side, the top five contributors to the strategy were Core Growth names with the exception of one Pioneer: **James River Group** (Financials), **908 Devices** (Technology; Pioneer), **OSI Systems** (Technology), **RBC Bearings** (Industrials), and **Healthequity** (Healthcare).

Positioning

While the reasons to believe a recession is coming have been well documented, other aspects of the economy continue to show strength. The labor situation remains strong with unemployment low and jobs outnumbering those that are searching for work. Due to the supply chain constraints, current demand, in many areas of the economy, is not being fully met. Backlogs have been building as a result. Any slowing of demand may not be horrible given the inflation situation and need for deliveries to catch up to orders. And a reemergence of COVID could change everything. The inability to accurately and consistently predict how these dynamics will play out argues for an investment approach solely focused on company fundamentals and secular growth drivers. From a positioning standpoint, not much has changed. We continue to seek out quality businesses that are compounding strong growth over long periods of time. Trying to time the market is an incredibly difficult skill and not one on which we spend our time and effort.

The meaningful rotation away from high-growth companies continues to present compelling risk/reward opportunities. We added **RS1 Group** to the portfolio during the quarter. RS1 is a highly differentiated, value-added industrial distributor with a scale advantage, superior technology, and strong management team that values a strong company culture. The long-term strategy is focused on implementing more digital into the business, expanding to higher-margin, value-added services, and consolidating the market with sensible M&A. Sustainability is not just a section in an annual report or presentation, but something they live and breathe.

Outlook

The current small-cap bear market has coincided with a period of solid company fundamentals and growing profits. Small-cap growth profits grew significantly over the last twelve-month period in which the small-cap growth index fell 33%. This divergence has led to a significant reduction in small-cap valuations. The market is forecasting a slowdown in revenue and earnings growth for the next several years, but even cutting growth rates significantly from the 66% we have seen over the last year to 20%, valuations look extremely interesting. The Russell 2000 Growth Index now has an average PE on the lowered next twelve months earnings estimates of 17.5x, down from its 32.5x valuation a year ago. We are adding to stocks in the portfolio that do not need for a lift in valuation to justify the investment case, as the compounding of their earnings growth should bring positive results to their stock prices. The risk, of course, is that we could be wrong on our earnings estimates.

At the forefront of many investors' minds are questions concerning inflation, Fed policies, recession and when will the market recover. Based on our decades of investment experience, a market low is impossible to predict, and frankly, trying to answer these questions may be counterproductive. What we do know is that returns from bear market bottoms have been exceptionally strong historically, and it's not uncommon for the market's best days to soon follow the worst. Our focus is on talking with the management teams at our companies to ensure they have strong secular growth prospects that help others transform processes and increase productivity.

As always, we appreciate and thank you for trusting Granahan with the management of your capital.

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<u>*Disclosure:*</u>

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