FOCUSED GROWTH

Portfolio Comments
September 30, 2023

The Third Quarter of 2023 - A Rough Quarter Both Absolute and Relative

Granahan's Focused Growth strategy fell -9.5% in Q3, underperforming the Russell 2000 Growth benchmark, which was down -7.3% in the quarter. In terms of attribution, the underperformance relative to the Russell 2000 Growth benchmark was the result of negative stock selection (-268 basis points), offset slightly by allocation (+39 basis points). Sector wise, net contribution was negative in Energy (-131 basis points), Technology (-94 basis points), and Industrials (-69 basis points.) The only meaningful positive sector contribution was from Health Care (+109 basis points). I discuss the top three positive and negative contributors for the quarter below, and later in this letter highlight other impacts to the portfolio and the changes we've made in response to recent results and stock prices of our portfolio holdings.

The Three Largest Relative Contributors in Q3 Were:

- ***Sprout Social** (SPT) - Sprout is a leading SAAS solution for enterprises to manage their social presence. By the end of the quarter, the stock had appreciated 8% and our investment contributed 103 basis points to performance. However, it was far from a straight line. The company's Q2 results had just one blemish in what was otherwise a very strong quarter--yet the stock retreated almost 20%. In fact, the "blemish" wasn't even that if looking beyond the next 3-6 months. The company has announced it is de-emphasizing (and all but exiting) the low-end social media management market. I view this as a very good thing as Sprout has had very good success in the mid and enterprise segments. In fact, in Q2, the company grew Annualized Recurring Revenue (ARR) in the mid-market +35% and in the Enterprise market + > 50%. There were other factors, but all told, the decline in the stock left our expected return and risk/reward more attractive. With our fundamental research leading us to high conviction, we added to our position, which helped performance as the stock recovered during the later part of the quarter.*

- ***WW International** (WW) - Under the WeightWatchers brand, WW operates digital and in-person weight loss programs, and through its acquisition of Sequence in early 2023 moved into helping eligible consumers receive and manage GLP-1 weight loss medication. WW shares rose 65% and contributed 69 basis points to performance in Q3 as the company reported that its WeightWatchers membership grew sequentially from Q1 to Q2 for the first time since becoming a public company in 2001. We believe the combination of the WeightWatchers programs and brand, together with Sequence's clinical capabilities, gives the company significant potential to benefit from the proliferation and adoption of GLP-1 weight loss drugs. We hold an average-size position in WW shares.*

- ***Axon** (AXON) - Axon is a mission-driven company which sells products, platforms, and services designed to improve law-enforcement, reduce social conflict, enable a fair and effective justice system, and aspirationally, with its Taser non-lethal weapon, aims to "obsolete the bullet." AXON* *shares rose 2% in Q3, contributing 68 basis points to performance. As the stock was weak going into the company's Q2 report, we increased our position to capitalize on a more favorable risk/reward. The company went on to report very strong Q2 results, and the stock recovered to settle in a bit higher than it was entering the quarter. The company remains well positioned, with what we believe is a very large opportunity in front of it, and we maintain a large investment in AXON shares.*

The Three Largest Relative Detractors in Q3 Were:

- ***Magnite** (MGNI) - Shares of this sell-side advertising platform provider fell -45% in Q3, negatively impacting performance by 71 basis points as the company reported poor results reflecting a weaker than expected ad market. We cut back the position choosing to put more of the portfolio weight in stocks in which we have greater conviction. MGNI remains in the portfolio at a relatively small weight.*

- ***Paycom** (PAYC) – The company provides payroll and human capital management software for small, medium, and increasingly large companies. During its Q2 conference call, Paycom reduced guidance for the second half and the stock fell 19% in Q3 hurting performance by 74 basis points. Despite the lower price, we reduced the position. We believe the issue that modestly hurt Paycom's Q2 and H2 outlook (slower than hoped for conversion of the remaining customers to the company's BETI offering) is disappointing, though not thesis destroying. However, we are a bit more cautious regarding continued choppiness over the next two quarters and chose to essentially trade out of some Paycom into Paylocity (PCTY), which saw its expected return and our conviction improve after its strong June quarter report.*

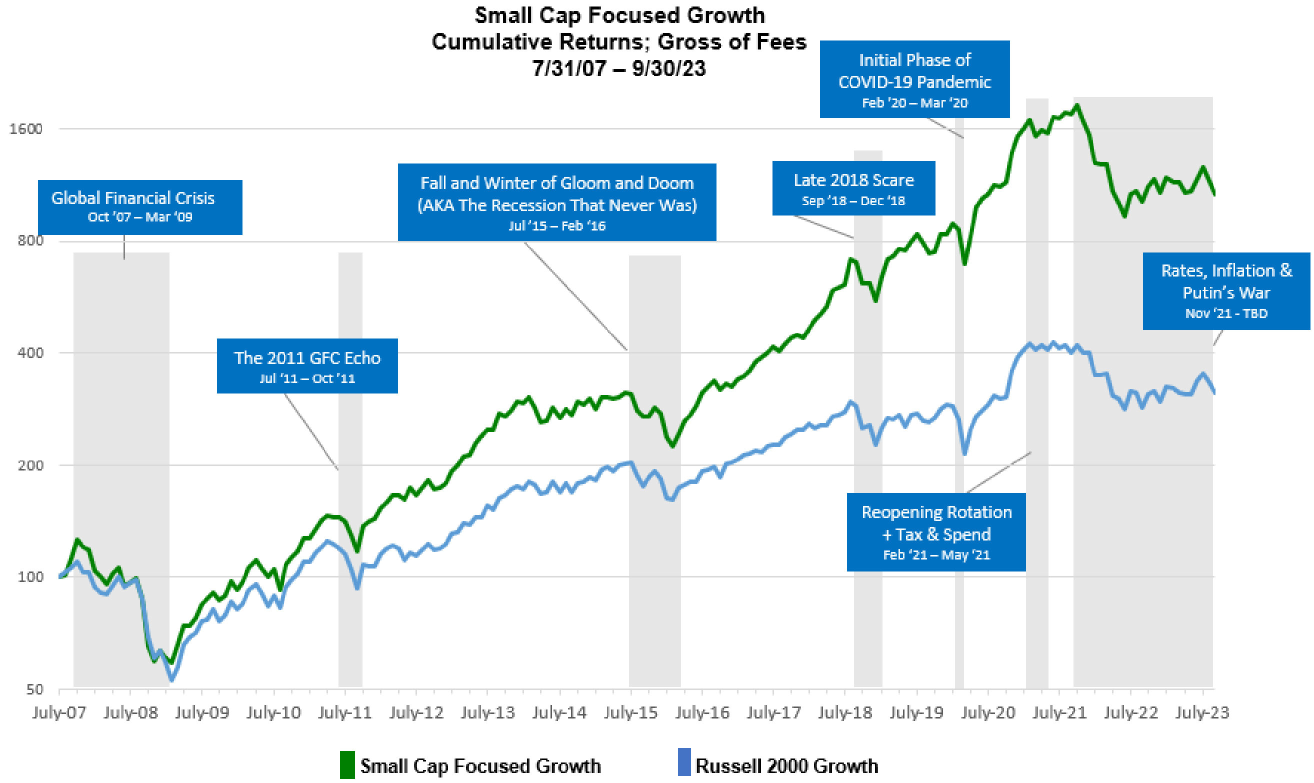
- ***Phreesia** (PHR) - The company provides medical offices with a platform to conduct patient intake and payment processing more efficiently, as well as present opt-in advertising to targeted patients. PHR shares fell 40% and hurt performance by 65 basis points as Q2 results were modestly disappointing and investors are growing increasingly skeptical that Phreesia can hit its intermediate financial targets. Sharing this skepticism, we cut back the position to a relatively small one.*

Can the Focused Growth Philosophy and Process Generate Good Future Returns?

A client recently asked how I felt about our philosophy and process given we are approaching two years of rough absolute and relative performance. I responded that I very much understand the frustration. Having been investing in small cap growth stocks for 35+ years, I have gone through a number of periods of difficult performance. And, as I've noted before, each one feels bad. The current one certainly does as it is now the longest downturn since the inception of the Focused Growth strategy in 2007.

However, I believe that the philosophy and process underlying the focused growth strategy remains sound, relevant, and has excellent odds of continuing to produce strong absolute and relative investment returns over most intermediate and long-term time periods.

Granahan Focused Growth: Largest Drawdowns Since Inception



Past performance is no guarantee of future results. This information is supplemental to the complete performance results and disclosures.
The SCFG Composite returns are used 7/31/07 – 9/30/23.

To review, the central philosophy behind the Focused Growth strategy is to identify companies capable of sustaining growth for the next 5-10 years. We call these "desert-island-worthy" companies, with the idea being that if you send us to a desert island for 5-10 years, when we return, the companies would be much larger. That is not to say these "secular growth" companies are immune to the broader economy or cycles--they are not. However, we seek to invest in companies in which growth over the longer term is largely within their control. We then marry this company analysis with securities analysis centered on a probability-weighted expected return methodology, and then carefully construct the portfolio, and manage risk on an ongoing basis.

Executing this process starts with owning companies capable of sustaining 15%+ growth over the next several years. As noted above, these companies are not immune to the broader economy and growth in the current environment has certainly become more difficult for most companies. That said, the companies in which we are investing: a) are nonetheless still growing meaningfully; and b) ones that we believe have large opportunities for growth ahead of them in the future.

Please see a few paragraphs below where I discuss other recent portfolio moves and list our 15 largest holdings, each of which I believe to be desert island worthy.

With McCarthy Out, GOP Scrambles to Find New Leader

Why 8% Mortgage Rates Aren't Crazy

Bond Selloff Threatens Hopes for Soft Landing

The Largest U.S. Healthcare Strike on Record Just Began

Why Consumers Are Mad About Inflation Even Though It Has Fallen

U.S. Funding Cutoff Threatens Ukraine's Economic Stability

What About All Those Macro Headwinds?

A few macro factors are currently dominating the headlines and asset returns. For example, I first drafted this section on October 4th, 2023. The headlines above are all from *that day's* Wall Street Journal. And this was before Hamas' horrific attack on Israel on October 7th, 2023.

As noted above, after identifying companies we believe to be desert island worthy, the second part of our process focuses on owning stocks we deem attractive using a valuation methodology centered on probability-weighted expected returns. As a reminder, the basic equation underlying stock valuations is that the present value of an equity reflects the discounted value of all future cash flows.

$$\text{Present Value} = \frac{\text{FV}}{(1+r)^n}$$

Source: Investopedia

FV = Future Value

r = Rate of return (which in turn is made up of a risk-free rate (say U.S. Treasuries) + Risk Premium

n = Number of periods

A range of macro factors have significantly altered investors' current view of secular growth stocks. Interest rates have not only driven up U.S. Treasury yields, making them relatively more attractive, but this has also contributed to raising the discount rate investors demand for future earnings. This particularly impacts secular growth companies as more of their current value is based on future earnings. Other factors currently contributing to higher risk premiums for longer duration stocks are broad concerns which call into question the timing and amount of future corporate cash flows: prospects of a recession, the impact of interest rates on business, debt and the economy, the health of the U.S. consumer, budget deficits, political uncertainty in Washington, wars in Ukraine and now Israel, general risk aversion, and inflation. Together, these factors have conspired to where investors have been inclined to put their capital in places other than small/smid-cap secular growth stocks.

The companies in which we are investing are generally "under-earning." Today this is being viewed very unfavorably by investors.

I have a different point of view. My view is that not only is this not a *bad thing,* I believe it is in fact the *right thing* to do—provided companies can invest in projects, people and products with sufficiently high expected returns. While the factors above raise the bar for those expected returns, as well as make some alternatives relatively more attractive to investors (i.e., U.S. Treasuries), there are nonetheless still very attractive investments to be made.

Pendulums on Wall Street tend to swing to extremes. At the moment, it strikes me that the psychology is such that in many cases near-term earnings are being over-valued, while future earnings are being undervalued. The pendulum has swung from "Growth At Any Price" to "I don't care what they might earn in 2025, I care about trailing GAAP P/E." This happens, and herein I believe lies opportunity. In the next section I devote an unusually large amount of ink to various investments in the portfolio and list the portfolio's top 15 holdings. My aim in doing so is to give a sense of both the attractive size of the opportunities these companies have, their business momentum despite the macro challenges discussed above, and how we are taking advantage of stock price moves in the current environment.

Taking Advantage of The Market's Current Short-Termism

As discussed in the attribution section above, in Q3, we used stock price changes to increase our holdings in investments such as **Sprout Social** (SPT) and **Paylocity** (PCTY), while reducing positions in **Paycom** (PAYC) and **Magnite** (MGNI). We made changes to a number of other large holdings as well, including several companies that declined meaningfully despite reporting strong Q2 results. These are discussed below:

- **Genius Sports** (GENI). The stock fell from $8.20 to $5.00, which hurt performance by 37 bps in Q3. However, the company reported very strong Q2 results. Furthermore, we expect strong revenue and EBITDA growth, with free cash flow to follow in 2024. In our expected return model, the base case (most likely case) is that Genius will grow EBITDA 10X in 3 years. If they are able to do this, I believe that the stock is going to be multiples higher than it is today. We bought more.

- **Zeta Global** (ZETA) - Despite the stock dropping from $9.50 to $8.01, this investment had a modest positive contribution in Q3 (+24bps), as we added value from tactile trading during the quarter. While the stock was down, results were not. In 2023, we believe the company will grow revenue 23% and EBITDA 51%, and that Zeta has excellent prospects to continue to post exceptional growth in sales, EBITDA, and free cash flow for the foreseeable future. We bought more.

- **Toast** (TOST) - TOST shares fell 17% in Q3 contributing a negative 48 basis points in the quarter. However, the company reported very strong Q2 results which were well ahead of consensus. We continue to believe the company has excellent prospects for continued high revenue growth and margin expansion. While we trimmed the position believing other opportunities were more compelling, TOST remains a top 10 holding.

- Others - Several other companies in which we hold large positions also reported strong Q2 results only to see their shares fall during the quarter, including **Axon** (AXON), **SPS Commerce** (SPSC), **Paylocity** (PCTY) and **HubSpot** (HUBS).

New Holdings - We also added three new stocks to the portfolio in the quarter:

1. **Oddity** (ODD) – A direct-to-consumer health and beauty company going to market under the *Il Makiage* and *Spoiled Child* brands. Revenue is expected to grow 53% this year and reach $500M from $0 five years ago. Margins are expanding, and the stock sells at 10X GAAP EBITDA, with a 7.3% free cash flow yield. We have been buying shares as the price has come down and currently own a mid-sized position.

2. **Vertex** (VERX) – A must have enterprise tax compliance software. The company has steady mid-teens revenue growth, attractive margin improvement, strong free cash flow, and an attractive valuation.

3. **Klaviyo** - (KVYO) - A recent IPO. Klaviyo's marketing technology platform helps businesses grow by effectively using first party data to deliver highly personalized and coordinated engagement and consumer experiences across multiple digital channels. We estimate that the company will grow revenue by over 50% this year, and another 35% next year, with strong growth in profits and free cash flow as well. However, it is a small position in the portfolio based on its expected return and risk/reward at current prices.

Focused Growth: Top 15 Holdings

Below are the top 15 holdings in the Focused Growth portfolio, representing just over 70% of the portfolio. The opportunities and the network/scale effects these companies enjoy remain in place. I believe many of the portfolio companies will likely be many times larger in 5-10 years, and their stocks are likely to follow.

1. Sprout Social	**6.** Paycom	**11.** Globant
2. Axon	**7.** CoStar Group	**12.** Workiva
3. Genius Sports	**8.** Toast	**13.** HealthEquity
4. SPS Commerce	**9.** Evolent Health	**14.** Hubspot
5. Zeta Global	**10.** Paylocity	**15.** RB Global

This Too Shall Pass

To sum it up, the glass on small/SMID secular growth stocks is currently being looked at by investors as quite empty. Attention and capital are being focused on all sorts of other places from U.S. Treasuries and other fixed income investments, to the Magnificent 7 (AAPL, FSFT, GOOG, AMZN, NVDA, TSLA, META), to AI, E&P and oil services stocks. However, I believe that investors will at some point decide it's safe (and even desirable) to go back and swim in the small/smid-cap secular growth waters. The good news is that we aren't counting on this (i.e., multiple expansion), nor do we need multiple expansion to happen in order to earn attractive returns from here (again, see examples above). However, based on my 35+ years investing in secular growth small-cap stocks, I believe there is at least a decent probability that it occurs, which is helpful to factor in from an asset allocation perspective. While impossible to predict timing with any certainty, if/when the pendulum swings back towards small and smid-cap stocks, the reaction is likely to be swift.

Chemistry, Copilot, Cinema, Crypto and Commencement

Before signing off, below are some books, movies, and videos you might enjoy if you want a break from the news of the day:

- Lessons in Chemistry - A novel by Bonnie Garmus which tells the entertaining, inspiring and eye-opening story of Elizabeth Zott, a brilliant chemist in the 1960's who has to constantly fight through misogyny and other hurdles to simply practice her profession.

- Microsoft CEO Satya Nadella's Copilot introduction - This video gives one a sense of how AI is being brought to the masses circa now in Windows 11 and across Microsoft's ubiquitous *Office* suite.

Two Fab Indie Films:

- Past Lives - Greta Lee gives an Oscar-worthy performance as Nora, a young woman reconnected with her childhood sort-of-boyfriend Hae Sung 12 years after she has moved from Seoul to New York. Original, creative and entertaining. Watch it.

- Flora & Son - John Carney's (*Once, Sing Street*) musical comedy-drama in which Flora (Eve Hewson) tries to keep her son Max (Orén Kinlan) out of trouble on the streets of Dublin. While doing so, she takes up guitar lessons over Zoom with an American instructor (Joseph Gordon-Levitt) and it all somehow works wonderfully.

A two-fer From Michael Lewis

- Going Infinite - Unless you’ve been living under a rock, you're no doubt aware of the trial of crypto tycoon Sam Bankman-Fried. You're probably also aware that Michael Lewis' book was released on October 3, 2023 to coincide with the trial’s commencement. Lewis is getting flack for what some call his flattering profile of Bankman-Fried such as this front page of the NY Times Sunday Business section piece. Read the book yourself and draw your own conclusions. It is a fascinating story regardless, and one Lewis tells with his exceptional storytelling skill.

- And if you want a bit more from Michael Lewis, check out his 13-minute 2012 Princeton Baccalaureate address. While he doesn't mention the subject of Effective Altruism that is very much at the center of the FTX/Sam Bankman-Fried story, he does foreshadow it in my opinion.

Thank You

As always, on behalf of the entire team at Granahan Investment Management, I'd like to express my gratitude for entrusting us with the management of your capital. Please note that it is managed alongside our own.

Sincerely,

Drew

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