GRANAHAN INVESTMENT MANAGEMENT INC

SMALL CAP SELECT

Portfolio Comments
September 30, 2023

Distinguishing Features

GIM builds the Small Cap Select portfolio from the bottom-up; sector weightings are secondary to stock selection. At quarter-end, the Small Cap Select portfolio was overweight in Health Care, Industrials, Technology, and Communications Services versus the Russell 2000 Growth benchmark. The portfolio is equal weight the benchmark in Consumer Staples underweight in all other sectors. We have no exposure to Real Estate, Materials, or Utilities.

Market Environment

It was a rough quarter for the stock market. All Indices suffered losses this quarter, battered by surging oil prices and fears that the Fed's higher-for-longer rates strategy means another hike this year. Also weighing on investor minds was the US government shutdown, which is now temporarily resolved.

There are many concerns creating a wall of worry for stocks to climb, however will inflation continue to decline despite higher oil prices, a stabilizing China, and a temporarily averted government shutdown? So far, we have had a resilient US consumer, but this consumer now has to deal with higher mortgage rates, student loan paybacks, higher gasoline prices, and the UAW strike perhaps driving the price of cars higher. The massive spending and subsidies from the Federal government targeted at upgrading the nation's roads and bridges, expanding domestic manufacturing of semiconductors, and modernizing the electrical grid could blunt a downturn from the recession that the consensus believes is likely. The big questions today are: 1) will the Fed continue to raise rates 2) will the Fed lower interest rates next year and 3) will the Fed conquer inflation without triggering a recession?

Performance & Attribution

The Granahan Small Cap Select strategy returned -13.8% in the quarter, underperforming the -7.3% return of its Russell 2000 Growth benchmark. Strong selection in Health Care and Consumer Discretionary contributed positively to the strategy's relative performance for the quarter. Our largest penalties came from selection in Communication Services, Financials, and Information Technology.

The largest detractors for the quarter were **Magnite** (Communication Services, Core Growth), **indie Semiconductor** (Technology, Pioneer), **Euronet Worldwide** (Financials, Core Growth), **Kornit Digital** (Industrials, Core Growth), and **Harmonic** (Technology, Special Situation).

- **Magnite**: One of our strongest performers last quarter, Magnite was hit by a weaker than expected ad market this quarter. Their digital advertising technology solution has been taking share of the connected TV market, which is a higher margin business. We are holding the stock.
- **indie Semiconductor**: Indie, a chip manufacturer for automobiles, was penalized during the quarter when two major design enhancements were pushed from 2023 to 2024. They counteracted that news by announcing a landmark win with Bosch that could create a very significant revenue

opportunity through the rest of the decade. We believe the long-term outlook remains positive. We are holding our position.

- **Euronet Worldwide:** In June, the company reported a change in how much money travelers were withdrawing from European ATMs, likely due to the overall higher cost of travel. While the stock is trading at a significantly lower valuation than it has historically, and the long-term growth prospects are still compelling in the company's other services, we've reduced our position size in favor of higher conviction names.

The largest contributors were **Grid Dynamics** (Technology, Special Situation), **Chart Industries** (Industrials, Special Situation), **Castle Biosciences** (Health Care, Pioneer), **thredUP** (Consumer Discretionary, Pioneer), and **Array Technologies** (Technology, Core Growth).

- **Grid Dynamics:** The valuation of **Grid Dynamics**, a digital transformation consulting firm, became very compelling after a tough second quarter where margins came under pressure from acquisition-related, benched headcount and foreign exchange headwinds. The company is a beneficiary of AI related projects which is an upside driver to growth. We have trimmed on the rebound in the stock.

- **Chart Industries, a** manufacturer of highly engineered equipment used in the hydrocarbon and specialty gas industries, completed a large acquisition last year that drove the stock down. They have made good progress on debt reduction and have a strong outlook. We have added to the position as valuation in comparison to peers is compelling.

- **Castle Biosciences** is a diagnostics company improving health through innovative tests that guide care decisions for patients with cancer. The company has a portfolio of tests for skin cancers, Barrett's esophagus, and mental health conditions. During the quarter, Castle Biosciences' stock rose as investor concerns eased regarding the reimbursement outlook facing both the company and industry. We increased our position as we are gaining confidence in the significant value Castle's skin cancer tests provide and its attractive long-term growth outlook.

With respect to LifeCycle categories this quarter, Special Situations outperformed the benchmark while Core Growth and Pioneers lagged.

Positioning

We are seeing the emergence of two issues that we believe are tied together. The first, which has been a drag on performance this year because of higher interest rates delaying residential adoption, is our overweight in Clean Energy companies. We remain convinced that the clean energy push, particularly on the utility level scale, is going to progress forward. We are holding most of our positions and taking advantage of this downturn in the stocks to strategically add to positions.

Secondly, most of the new companies in the portfolio center around industrial exposure. This includes companies with projects associated with new manufacturing in the United States and companies with exposure to data center spending which is very robust. Immense data sets are being processed and analyzed at a scale never seen before. This massive data-driven approach demands expansive computational resources and infrastructure. Data centers are increasingly facing the challenge of meeting the burgeoning demands of energy intensive AI tasks. Our new name, SPX Corp, which manufactures cooling systems and power transformers, is a good example of a company helping data centers cope with this explosion in demand.

Outlook

Valuation on our portfolio has come down. In many cases, but not all, reported earnings have been better than expected. It is almost always the case that misses are hurt disproportionately versus the gains that stocks realize when they beat expectations. Response to earnings was extreme in this regard. There were modest positive moves in stocks on very strong earnings and brutal stock moves downward on misses. We even saw a number of stocks report strong earnings, only to go down in their wake. While there are more headwinds to growth broadly, the companies in the GIM portfolios are ones we believe can sustain strong secular growth.