FOCUSED GROWTH

Portfolio Comments
December 31, 2023

In the fourth quarter of 2023, the Granahan Focused Growth portfolio's return (+12.2%) was roughly in line with the benchmark return (+12.8%). While we generated an attractive double-digit return (+10.0%) for the full year in 2023, this meaningfully lagged the return of the Russell 2000 Growth benchmark (+18.7%). Below I discuss attribution for both the fourth quarter and the year.

Attribution for Q4 2023
Granahan's Focused Growth strategy rose +12.2 % in Q4 compared to the benchmark's +12.8% return. The first month of the quarter was significantly different than the last two months of the quarter. In October, the portfolio lost -9.0% absolute and -1.3% relative to the benchmark. I am cautiously encouraged by the portfolio's absolute and relative performance in November and December in which the portfolio gained +23.3% compared with the benchmark's +22.2%. Some of the top-performing sectors in the fourth quarter were Real Estate, Financials and Healthcare, which make up some of the lowest industry exposure in the Focused Growth portfolio. Stock selection across sectors was modestly negative (-134 basis points) for the quarter, with Technology being the lone meaningful detractor (-206 basis points).

Q4 Largest Relative Contributors:

- **Axon (AXON)** - Axon is a mission-driven company designed to improve law-enforcement efficiency and efficacy, reduce social conflict, enable a fair and effective justice system, and aspires, with its Taser non-lethal weapon, to "obsolete the bullet". AXON contributed +130 basis points to performance in the wake of very strong Q3 results and forward guidance. While we have trimmed the position, we maintain a large position in AXON shares.
- **Porch (PRCH)** - Porch provides software, insurance, and other services for the residential housing market. PRCH shares contributed +118 basis points to performance on the heels of strong Q3 results and investor optimism regarding a rebound in housing sales in 2024. We have a small/medium-sized position in PRCH.
- **Oddity Tech Ltd. (ODD)** -Oddity is a direct-to-consumer company targeting the health and beauty market which combines machine learning, AI, and molecule discovery aimed at better product/customer matching and an overall better consumer experience. The company currently has two brands in market, *Il Makiage* and *Spoiled Child*. ODD shares contributed +98 basis points as the company reported strong Q3 results and raised guidance for Q4. While we sold some stock on the rise, we maintain a mid-sized position in ODD.

Q4 Largest Relative Detractors:

- **Paycom (PAYC)** - Paycom sells payroll services and human capital management (HCM) software to small and medium enterprises. This was a long-term holding in the portfolio which multiplied many times since we originally purchased the stock at $35 per share in early 2016. But it overstayed its welcome in the portfolio. PAYC shares dropped sharply in Q4, hurting performance by -183 basis points. This was the second consecutive quarter in which Paycom had a big negative earnings surprise. Here is what happened. Approximately three years ago Paycom introduced a module called Beti to enable self-service, a feature that tends to lead to better customer satisfaction and retention. The company has been migrating existing customers to Beti during this timeframe, and as of about a year and a half ago, all *new* customers were on Beti. The company announced on its Q2 call that it was reducing H2 guidance as it was taking sales resources from cross-selling and re-directing them to its efforts to migrate the remaining *existing* clients onto Beti. This hit the stock hard.

We cut the position, but it was still a large holding going into the Q3 report. Why? The explanation for the Q2 miss made sense; we believed (and continue to believe) that a large greenfield opportunity exists for Paycom and the rest of the industry, and Paycom has had a stellar record of performance since its IPO 10 years ago. Unfortunately, Paycom's Q3 results were soft, and the cuts to Q4 and 2024 guidance were shockingly bad (consensus growth for 2024 was 20%, the company guided to 11%) causing major negative estimate revisions and the stock to drop 38%. The company's explanation is that while Beti is a benefit to customers and results in better customer experience and satisfaction, it significantly reduces errors in processing. These errors lead to corrections that, without Beti, generate significant fees for Paycom (i.e., payroll voided checks, correction payroll runs, tax adjustments, etc.). Paycom is now saying that as Beti adoption with clients has grown, this fee cannibalization is significant (although they would not quantify the magnitude). Thus, the company materially reduced its forward guidance. This, frankly, was a big surprise to me and to the Street broadly (hence the stock reaction). We eliminated the position in the wake of Q3, based on the materially lower outlook for 2024 and greatly diminished trust in this management team.

- **Paylocity (PCTY)** – Similar to Paycom, Paylocity also sells payroll services and human capital management (HCM) software to small and medium enterprises. PCTY shares fell 9% in Q4 which hurt the portfolio's performance by -81 basis points. Although Paylocity reported FY Q1 (September) results and guidance that were generally in line with expectations, investors are concerned Paylocity's growth will slow in upcoming quarters due to recessionary and employment headwinds. We believe such concerns are overblown and hold a medium-size position in the stock.

- **WW International (WW)** – WW is the holding company for Weight Watchers. WW shares fell 22%, detracting -69 basis points to performance. Q3 results were mixed. The company's base subscribers grew, although more digital subscribers with longer subscriptions resulted in a revenue shortfall. The company's new Sequence clinical business performed modestly better than expectations. We have eliminated our position in WW shares. While we believe the company has a unique opportunity to leverage its strong brand, customer base, and goodwill to help a segment of weight-conscious consumers navigate the GLP-1 weight loss journey, the same trends driving the opportunities for its clinical business (GLP-1) are challenging its core Weight Watchers subscription revenue.

Attribution for the Year 2023
As noted above, for 2023 as a whole, Granahan's Focused Growth strategy rose +10.0% in 2023 compared to the benchmark's return of +18.7%.

It was a rough year both in terms of things within our control and those outside of our control. I have discussed both in detail in prior commentaries, but the short versions are:

Things Outside of our Control – For the companies in the Focused Growth portfolio, more of their current valuations are tied to future earnings. For most of 2023, higher interest rates and greater uncertainty caused investors to demand higher discount rates on future earnings which acted as a headwind for the portfolio. In addition, as widely discussed, investors' strong preference for the largest tech companies (i.e., the Magnificent 7) took wind, focus, and capital from smaller growth names.

Things Within our Control – Unfortunately, along with the above-mentioned headwinds, we did not execute well and had three large holdings go against us. These three are discussed below along with the three largest contributors:

2023 Largest Relative Contributors:

- **Axon (AXON)** – Axon is a mission-driven company designed to improve law-enforcement efficiency and efficacy, reduce social conflict, enable a fair and effective justice system, and aspires, with its Taser non-lethal weapon, to "obsolete the bullet." AXON shares rose +55% and contributed +265 basis points to performance. The company continues to execute exceptionally well on most fronts and we believe it remains superbly positioned and going after a very large opportunity. While we have trimmed the position, we maintain a large position in AXON shares.
- **HubSpot (HUBS)** – HubSpot has evolved from its origins as a point marketing application product, to become a software platform serving a broad range of needs for the SMB market. HUBS shares rose +102% and the stock contributed +261 basis points to performance in 2023. The company is navigating a challenging SMB market well, expanding its product offering, investing in adding AI elements to its tools that we expect to have near-term benefits to customers, all while significantly expanding its profit margins. We have taken significant profits in HUBS shares but maintain a mid-sized position in the stock.
- **SPS Commerce (SPSC)** – SPSC shares rose +52% and contributed 194 basis points to performance. SPS put up consistently strong results in 2023 and conducted a smooth and successful search for a new CEO. We have meaningfully cut back our investment in SPSC shares but maintain a mid/large position in the stock.

Largest Relative Detractors:

- **Paycom (PAYC)** – PAYC shares fell 54% in 2023 hurting performance by -345 basis points. The challenges Paycom faced in 2023 are detailed above.
- **Etsy (ETSY)** – Etsy operates a global online marketplace connecting sellers and consumers of unique and creative goods. ETSY shares fell 34% in 2023 and contributed -328 basis points to performance. Etsy has not yet reported Q4 results, but based on current estimates the company is actually likely to report EBITDA for 2023 slightly ahead of where expectations were a year ago. Thus, the 35% drop in the stock represents a significant contraction in the company's multiple of earnings. As we've detailed in the past, Etsy almost tripled its buyer base during the pandemic. It has done a good job keeping the vast majority of those customers, but the company is clearly finding it harder to grow from this much larger base. Our belief has been that Etsy was likely to reaccelerate growth, but our conviction in this opinion has waned. We have sharply reduced the position and currently maintain just a small holding in ETSY shares.
- **Enphase (ENPH)** – Enphase is a leading provider of complete solar systems primarily for the residential power market. After rising 47% in 2022, ENPH shares fell -67% in 2023 and contributed – 259 basis points to relative performance. We exited the position in Q3 believing that despite earnings estimates being cut hard year-to-date, further meaningful cuts were likely. While we believe the company's long-term future remains bright and there may be another opportunity to own ENPH shares, we remain on the sidelines.

As Was the Case in 2023, We Expect 2024 Will Be About the E – We Just Need to Get the E Right and Minimize the Detractors

The macro environment remains uncertain – as always. Among the known unknowns are the resilience of the consumer and the broader economy, inflation, the direction and level of interest rates, developments in the wars in Ukraine and the mid-east, and the 2024 US presidential election. And, of course, we will no doubt be faced with additional macro curve balls as the year progresses. However, as was the case in 2023, I don't think the macro is likely to drive absolute returns for the portfolio. In last year's Q4 letter I predicted while 2022 was about the P/E, the key to 2023 was to get the E right. This was an accurate prediction. And while the companies we owned largely grew their earnings (on average 20%), what caused the negative performance relative to the benchmark were disappointing results from several large holdings (although as noted above, Etsy is likely an exception to this).

This is a humbling profession. After several strong years of absolute and relative performance (capped by an exceptional 2020 which returned +83% vs. the +35% benchmark), the past three years have been far less rewarding. As noted in prior commentaries, much of this poor absolute and relative performance has been multiple contraction caused by higher interest rates and greater uncertainty–which combine to reduce investor appetite for longer duration growth stocks. However, we have also shot ourselves in the foot much more than I would like. To mix metaphors, if one goes up to bat one will undoubtedly make outs – but the hit rate is crucial in investment management just as it is in baseball. Since 11/15/21 the Focused Growth portfolio is down -35%, vs. the Russell 2000 Growth down -20%, underperforming by 15%. Of this, 11% is due to three stocks (KRNT -4.9, ETSY -3.8, PAYC – 2.1). We are going to have stocks that don't work out. But this is too much. We need to do better.

Looking Ahead

The companies in the Focused Growth portfolio are pursuing large opportunities, have very strong customer value propositions, are growing their top lines at a healthy level (mid-teens on average), and are generally expanding margins which should lead to even faster earnings growth. Again, I believe the key to 2024 will continue to be getting the E right. On this score, the companies in the portfolio are estimated to grow EBITDA roughly 30% on average in 2024 – and this excludes a few outliers with extreme growth and a few that are projected to go from negative EBITDA to positive EBITDA. I believe if we get the E right, the portfolio will generate good returns in 2024.

Below are the top 15 holdings in the portfolio. I welcome discussion about any of these (or other) holdings:

1. Sprout Social (SPT)
2. Axon Enterprises (AXON)
3. Genius Sports (GENI)
4. Zeta Global Holdings (ZETA)
5. Toast, Inc (TOST)
6. Evolent Health (EVH)
7. CoStar Group (CSGP)
8. SPS Commerce (SPSC)
9. Paylocity Holding (PCTY)
10. Globant SA (GLOB)
11. Smartsheet, Inc. (SMAR)
12. Victory Capital Holdings (VCTR)
13. Indie Semiconductor (INDI)
14. Double Verify Holdings (DV)
15. Workiva (WK)

Some Content You Might Enjoy

My content suggestions for this quarterly letter start with Football, Football, and More Football:

- Welcome to Wrexham - Netflix's very entertaining series documenting Hollywood stars Rob McElhenney and Ryan Reynolds attempts to turnaround the historic (oldest football club in Wales, third oldest professional football team in the world) Wrexham Red Dragons.
- Beckham - Also on Netflix, this excellent three-part series follows the legendary David Beckham's rises and falls, both professionally and personally.
- LoveSac (a portfolio holding) Founder/CEO Shawn Nelson interviews Urban Meyer on his Podcast *Let me Save you 25 Years* - The former head coach of THE Ohio State University football team trades lessons learned from the playing field and business world.

Three Books:

- Salt, Fat, Acid, Heat by Samin Nosrat - Not sure how I missed this, but thanks to my son-in-law Roger I've very much enjoyed exploring the techniques that Alice Waters' protégé, Samin Nosrat, details in this super helpful cooking guide.
- My Name is Barbra - I enjoyed listening to Barbra Streisand read her autobiography. OK, even for a fan it is admittedly way too long, but I happily stayed with it. Worth the money alone is Chapter 24 in which Streisand gives you the inside scoop on her classic film with Robert Redford "The Way We Were". I'm itching to see the extended cut version of that film which she remade for its 50th Anniversary last year (insider tip on this inside scoop, this chapter is excerpted in the October, 2023 issue of *Vanity Fair*).
- How to Know a Person - NY Times columnist David Brooks shares insights from his journey to "seeing others deeply and being deeply seen." It is full of useful tips on how to *really* focus on getting to know other humans.

And One Film

- Society of the Snow on Netflix. If you are feeling as though your life is tough, take a couple of hours and watch this gripping and very well-made film telling the true story of a 1972 plane crash in the Andes. What the survivors (and non-survivors) persevered to try and come home alive is absolutely awe inspiring.

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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