GLOBAL SMALL CAP

Portfolio Comments
March 31, 2024

Distinguishing Features

GIM builds the Global Small Cap portfolio from the bottom-up; sector and geographic weightings are secondary to stock selection. The Global Small Cap strategy is overweight Information Technology, Health Care, Communication Services, and Consumer Discretionary versus the MSCI World Index Small Cap benchmark. The strategy is underweight in all other sectors. The portfolio has no exposure to Utilities or Energy.

Market Environment

Recent economic data highlight that the U.S. economy remains resilient. Commodity prices and yields have increased in response to the underlying strength of the economy. Geopolitical risks have risen as trade tensions with China have increased and the continuation of conflicts in Ukraine and Israel cause trepidation. These dynamics have created volatility within the financial markets especially as investors debate the Federal Reserve's position on inflation, and when and whether they will cut rates. A strong job market and elevated wage inflation could delay the Federal Reserve's first cut in interest rates from current expectations for a June cut. While small caps saw a meaningful recovery off the October lows, we expect continued volatility until there is more clarity on the economy. Given the economic strength, the strongest performing sectors in the quarter were Technology, Energy, and Industrials.

While strong economic growth and a solid labor market in the U.S. has lowered expectations regarding the timing and magnitude of rate cuts by the Fed, developed markets in Europe remain in stagnation; GDP was flat in Q4 2023 and contracted in Q3 2023. The divergence in growth rates and paths to more normal inflation levels could lead to differing central bank policy actions. This week, ECB President Christine Lagarde said that "we are not assuming that what happens in the euro area will be the mirror of what happens in the United States." In contrast, Japan raised its rates for the first time in 17 years, signaling a meaningful shift from a highly accommodative monetary policy. The Japanese economy is finally emerging from a long period of deflationary pressure. Combined with the government's pressure on companies to improve corporate governance (e.g., more independent board members, returning cash to shareholders, reducing poison pills), Japan is undergoing structural changes that elevate its attractiveness to global investors. That being said, capital efficiency and profitability remain meaningfully below the U.S. and Europe.

	ROE	Net profit margin	Asset turnover	Leverage	Gross profit margin
Japan	9.1%	5.9%	0.52	2.9	24.2%
US	17.9%	10.6%	0.46	3.6	46.6%
Europe	14.1%	8.4%	0.39	4.3	32.9%

Data as of Dec. 29, 2023. The measures for Japan, U.S. and Europe are based on the constituents of the MSCI Japan, MSCI USA and MSCI Europe Indexes, respectively.

Performance Discussion

In the fourth quarter, the Granahan Global Small Cap strategy returned 4.0%, slightly underperforming the Core Index return of 4.5%. The quarter started off strong, however, hotter inflation figures and increasing concerns regarding Fed policy weighed on our long duration companies in March. Although the allocation effect on the portfolio was de minimis, the Energy sector hurt performance by 30bps due to the 22% rise in crude oil prices during the quarter.

Special Situations outperformed the benchmark while Pioneers dragged on performance. Core Growth performed roughly in line with the Index.

Top Contributors:

- **Kinsale Capital (KNSL US)** is an excess & surplus insurance underwriter. The company has a technological advantage relative to peers allowing for strong revenue growth through market share gains at high levels of profitability. The company delivered a very strong earnings report, and we used the strength in the stock to trim our position.
- **Vericel (VCEL US)** is a healthcare company that develops human cell therapies used to treat cartilage damage and extensive burns. The company provided a robust outlook for the next couple of years and expects a meaningful ramp in profitability. We have trimmed our position given the current valuation that is beginning to reflect the long-term growth opportunity.
- **Pure Storage (PSTG US)**, a leading provider of flash memory storage solutions to enterprise customers. The company is a disruptor leading to market share gains as flash memory takes share from hard disk drives commonly used in the large $65B storage market. The company is seeing strong adoption of its technology with its subscription-based business recently gaining momentum while also securing a large deal with a leading GPU service provider as AI serves as a tailwind for its business. We added to our position during the quarter.
- **Nutanix (NTNX US)**, a developer of enterprise cloud platforms, continues to execute incredibly well. The company is experiencing strong demand from a more diversified customer base (e.g., government contracts). AI is likely providing a slight sentiment boost. More importantly, the recent pivot to balance growth with profitability has been well-received by investors, leading to multiple expansion over the last few quarters. Nutanix continues to be one of our larger holdings.
- **CTS Eventim (EVD GR)**, the largest live event ticketing platform in Europe, continues to perform better than market expectations. The sustainability of strong growth, a function of artists and attendees renewed thirst for live entertainment post-COVID, continues to be underappreciated by investors. The structural supply/demand situation is driving consistent positive earnings revisions and the network effect inherent in the business is shining through. We continue to own the company at an above-average weighting.

Top Detractors:

- **BayCurrent Consulting (6532 JP)** offers comprehensive IT-related consulting services in Japan with a remarkably consistent revenue growth rate of ~30% over the last four years, a return on invested capital over 35%, and strong competitive position. Baycurrent is the epitome of the type of Core Growth company in which Granahan seeks to invest. To capitalize on the continued strong client demand and to facilitate expansion into adjacent IT services, the company is investing to grow its employee base. This strategic move combined with the wind-down of two major projects is temporarily weighing on utilization rates, consultant pricing and margins. While our confidence in the long-term sustainability of earnings growth remains as high as ever, we trimmed our position as we wait for earnings momentum to return.

- **WNS Holdings (WNS US)** is a provider of business process outsourcing and a longtime holding at Granahan. The company is experiencing somewhat of a perfect storm comprised of 1) a client loss due to trouble with the customer operations and, 2) a delay in starting work on a highly contested Top 3 insurance client that WNS won recently. In the context of investor fear related to whether AI replaces a significant amount of work that WNS performs, the multiple has significantly declined to almost ~2.5 standard deviations below its historical average; 11x down from average of ~20x. We have a high degree of confidence that AI will prove to be a net benefit to WNS' business and that the company will outperform low expectations over the next few years.

- **10x Genomics (TXG US),** is a life sciences company providing equipment and consumables used to interrogate biology in single-cell resolution and spatial context, enabling the advancement of genomics research. The stock came under pressure given the early-stage nature of the company that is investing heavily in this next generation of equipment. We have used the weakness in the stock to increase our position given the robust long-term outlook as momentum continues in their spatial imaging platform and with the introduction of new products in 2024.

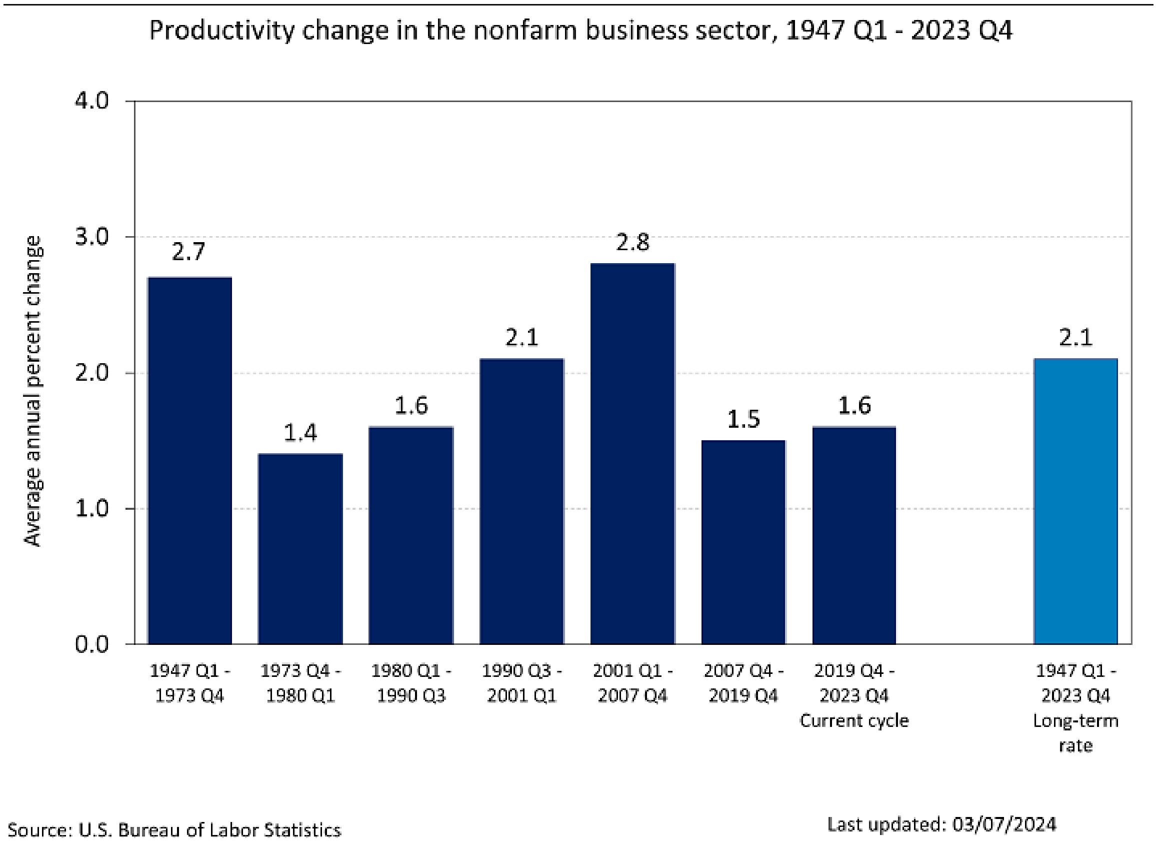
- **908 Devices (MASS US)**, a life sciences tools company, was under pressure in 1Q despite financial results in line with our expectations. We believe the pressure on the stock was a result of the significant strength in 4Q23 and was related to the trading dynamics of a small cap healthcare company during the first quarter. The company is focused on miniaturized mass spectrometry technology that brings powerful chemical analysis capabilities to the point of need. There is a significant long-term opportunity in the development and production of next generation drug therapies. We maintain our position.

- **Keyword Studios (KWS US)** is a one-stop-shop game development outsourcing company with a dominant position in the industry, especially with the large game publishers. The gen AI narrative continues to weigh on sentiment. The uncertainty has been amplified by a slowdown in spending on game content in 2023 driven by a weaker macro and high inflation, and the writer's strike. We expect improving demand in 2024 to allay some of those fears and the stock to return to a more reasonable valuation. In fact, earnings revisions inflected higher after the most recent earnings report. At 11x P/E, this consistent 15%+ earnings grower trades at ~2 standard deviations below its historical average.

A few sector themes worth discussing:

1. AI is having contrasting impacts on the portfolio. Companies such as **Nutanix** (a developer of enterprise cloud platforms), **Pure Storage** (disrupter in the enterprise storage market), and **NextDC** (Australian data center operator) are feeling some tailwinds from AI proliferation although each has also been executing extremely well. Alternatively, the market has overreacted, in our opinion, to the impact of AI on companies such as **WNS Holdings** (business process outsourcing company), **Keyword Studios** (video game services outsourcing company) and **Fiverr** (digital platform connecting freelancers with buyers of services). In those cases, investors have decided that AI will erode the businesses rather than potentially drive additional growth. Our differentiated view is that AI will be like many other efficiency and productivity-driven technologies that have been introduced in the past. For example, in 2016, McKinsey claimed that up to 70% of corporate tasks would be

automated by Robotic Process Automation (RPA) technology, similar tasks to that which are outsourced to companies like **WNS**. However, WNS' growth rate accelerated to a 12% CAGR from a 5% CAGR for the 5 years. We believe that AI is a gamechanger to many businesses, but more from a productivity standpoint than a replacement for humans. The improvement in productivity could rival the late 1990's/early 2000's when productivity gains increased to ~2.5% per year.



2. After a key contributor to performance last quarter, stock selection in Health Care detracted in the first quarter of 2024 (-103bps). Our holdings generally posted solid results from the most recent quarter and guidance for 2024, including those that underperformed such as **10x Genomics** and **908 Devices**. We view the underperformance as a partial reversal of a strong showing in Q4 and related more to the fluctuating views on Fed policy than underlying fundamentals.

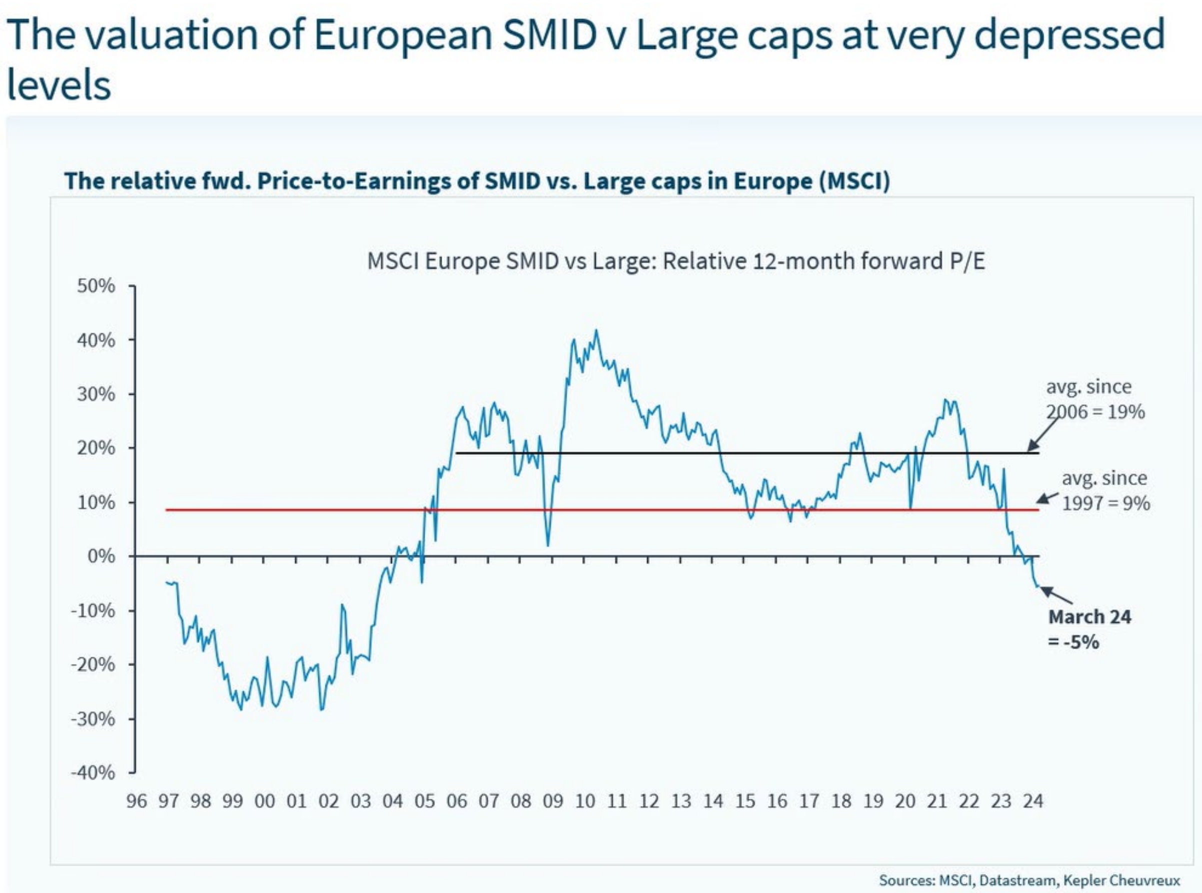
Commentary

As we transition away from a period of rapid rate increases, volatility remains high. We continue to focus on what we can control rather than trying to predict Fed policy, inflation, or other macro factors. As usual, we are intently focused on finding compelling secular growth companies at attractive risk/reward profiles. And, we have added an advanced technology tool to help improve our risk management capability. In other words, our team remains highly committed to the same investment discipline that has served us well for over three decades.

We added three new companies to the portfolio this quarter. **10x Genomics**, a provider of instruments, consumables, and software for the analysis of biology at substantial resolution and scale, is maturing into a more stable recurring revenue business with an accelerating growth profile and sizeable margin expansion opportunity. **Bel Fuse**, an underfollowed manufacturer of products that power, protect and connect electrical circuits, is undergoing a transformation to a more diversified business with a higher growth and profitability profile that, in our view, the market is currently underappreciating. **Faro Technologies** manufactures 3D measurement, imaging, and realization solutions for industrial and construction markets. After years of mis-execution, the new management team has implemented self-help that will meaningfully improve the profitability and capital returns of the business. As the company emerges from a period of weak demand, we expect greatly improved operating leverage to drive a re-rating in the stock. Faro Technologies and Bel Fuse are both Special Situations while 10x Genomics is a Pioneer.

Outlook

Since Granahan's inception in 1985, relative valuation of small cap companies versus large has only been lower one other time, which was at the bottom of the Covid bear market. This is the case not only in the US but also overseas (see chart). Despite the recent rise in yields adding pressure to small cap growth stocks, fundamentals in the companies we own remain compelling, with the prospect of normalizing interest rates and improving financial conditions providing an additional tailwind for performance. We believe this supports a strong growth outlook over the next couple of years.



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