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Finding fixable and lovable stocks: A study in partnership

From the Field

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Key Insights

- Our close relationship with Company A, an innovative tech firm facing near-term challenges, is a good illustration of how we implemented our "fixable and lovable" investment strategy.
- We believed that if Company A's end markets could recover at the same time new products were launched without additional capex, it would see significant improvements.
- While short-term risks are present in the current environment, Company A is seeing accelerating success with new product launches and has commenced a formal project outlining its expectation for strong revenue growth.

Often we find opportunities to invest in companies that are facing challenges—and occasionally controversies—that deter other investors, resulting in attractive valuation entry points. From there, we deploy our analysis, patience, pattern recognition, and partnership as part of our "fixable and lovable" strategy.

The fixable part of this strategy is to identify stocks with self-improvement potential that is not dependent on market conditions (although we do, of course, aim to use macro weakness to our advantage). The lovable test seeks to answer the question: Could this stock go from being disregarded to becoming a core compounding holding with a premium valuation?

This approach accomplishes two things: First, it amplifies the stock upside potential beyond the repair in earnings per share and free cash flow (FCF). Second, it helps reduce the likelihood of value traps that are natural hazards of value investing. We often find the confluence of fixable and lovable in situations where there also is cyclical weakness but there also is potential for secular strength that the market cannot yet appreciate because of negative newsflow.

Company A: An innovative firm with room for improvement

Recently, an opportunity arose to work closely with a company as part of our fixable and lovable strategy. The company

As value investment managers, what do we look for?

(Fig. 1)

- Market leaders with defendable capability, technology, or cost advantages
- Businesses that are not operating at their full potential
- Contrarian opportunities to step in to FCF disruptions arising from capex cycles
- Businesses with balance sheet durability and flexibility
- Attractive valuations

Capex = Capital Expenditures.
Source: T. Rowe Price.

in question, which we will refer to as Company A, has a very long track record of innovation in the materials science field that has led to numerous world-changing inventions spanning across data communications, consumer electronics, and even pharmaceutical applications. As part of our lovable test, we often ask: Would the world care if this company didn't exist? After following Company A for many years, we believe the answer is a resounding "yes."

Several years ago, the opportunity to invest in Company A arose after its main businesses experienced end-market weakness simultaneously despite a history of diversified performance. In addition to these challenges, Company A's penchant for innovation and recent capacity additions gave investors pause over future capital allocation during a period of stress that could pressure FCF. Further, significant foreign exchange pressures were building, creating financial statement restatement risk. However, our analysis indicated that these problems could be fixed.

Internal partnership supports external partnership

Following analyst Anna Nussbaum's recommendation to incept positions, Portfolio Manager Vincent DeAugustino followed a familiar path of engagement with Anna and Company A. This led to multiple road trips over a three year period to Company A's headquarters, research center, and numerous factories—many of which are located in small communities.

This combination of financial analysis and deep field work gave us a far greater appreciation for the investments Company A had undertaken and the new applications it was seeking to address, particularly in the data communications space. We also detected an early change in Company A's capital allocation trajectory. If Company A's end markets could recover at the same time new products were launched without the need for additional capital expenditures, we believed it should see a powerful inflection in FCF and return on invested capital (ROIC)—which were not anticipated by the market given the present challenges.

We partnered with our Investments Data Insights (IDI) team to quantify the historical stock outcomes when companies experienced similar FCF and ROIC improvement trajectories. While our analyses are normally used for the sole purpose of informing our own investment decisions, we will, when appropriate, share our insights with portfolio companies. In this case, our longstanding relationship with Company A led to an invitation to present to the CFO and others from the financial team after our initial discussions.

We partnered further to augment the IDI data with investment case studies where we had observed similar patterns in the past. This presentation allowed Anna and Vincent to share how Company A fit into the analysis and where there were opportunities to improve capital allocation and address investor concerns—namely, that Company A's innovation could command pricing power,

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> – Vincent DeAugustino
> Portfolio Manager, Mid-Cap Value Fund

focus was needed on project selection to deliver incremental FCF when revenues normalized, and that foreign exchange risk was a barrier for many investors.

That presentation and our subsequent discussions with the CEO boosted our confidence in our investment thesis, which supported increasing our investment in Company A.

Early progress

Over the past year, Company A's end markets have begun to recover and contract renegotiations have resolved foreign exchange restatement risk, although ongoing wider market issues continue to pose challenges. While these cyclical improvements are positives for the stock, we're more deeply encouraged by other developments. Company A is seeing success with new product launches and has commenced a formal project outlining its expectation for strong revenue growth to drive high incremental margins without a ramp in capital expenditures.

Company A has also communicated a commitment to, and has begun returning excess capital to shareholders given this significant ramp in FCF. At the end of January 2025 Company A's stock had gained almost 70% from the year-ago period before falling back during the ongoing market correction that started earlier this year. On 24 April, the stock was up 36% relative to 24 April 2024.

Partnership, not activism

It is important to stress that we regard our work with Company A as a collaboration—this was not an activist situation in which we were seeking to pressure the company into taking a particular course of action. Partnership between Anna and Vincent, including both financial analysis and time in the field, led to a deeper relationship with Company A within the balance of our responsibilities to our clients.

To conclude, through our journeys to identify fixable and lovable stocks, we lean in to challenges among companies that we think can reemerge stronger and, in the process, command improved valuations. When analysts and portfolio managers join forces, we can build relationships with companies along this journey that give us the confidence to build larger positions to benefit our clients.

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> – Anna Nussbaum
> Investment Analyst

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