Our first two Research Perspectives notes covered topics that were easier for value investors to pick on in an overvalued market like today's. Let's go in a different direction for this one. While our last note mentioned overvalued "Never Let You Down" stocks, what about stocks that feel like the opposite of that on Business, People and Price? We were struck by a list of "shortable" companies with the premise that what has been bad will stay bad:

Problems at 100 Long-Term Underperformers

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MAY 01, 2025 · PAID

The steadiest alpha often hides in plain sight: businesses that have trailed the market for decades and show no sign of catching up.

Source: The Bear Cave Newsletter

We are not fans of the term "value trap" because it is so after the fact for something that is not working. However, we remain fans of Charlie Munger's quote: "All I want to know is where I'm going to die, so that I never go there." The aforementioned list was filled with many bad companies to avoid. True value hounds know what we are talking about: companies selling at ~10x free cash flow (FCF), often in the 5-8x EBITDA (earnings before interest, taxes, depreciation and amortization) range, but with too much leverage and not enough growth. Stocks like this have gotten too many value investors too many times. Management at these companies will often have a story to tell and enough people to believe it for a while. We think there are more strikeouts than good at bats here, but there are also enough home runs to tantalize the contrarian value investor. Continuing to hold a few investments like this after our 3 Rules changes in 2022 is a regret of the last 3 years, in a time when we have been overall pleased with where we are going. We believe our portfolios today have less of this weakness than we have ever had in our history, which is why we did well in the volatility of mid-Feb through April of this year and have had our confidence grow on future returns in more volatile markets.

Two key questions are: "How leveraged is too leveraged?" to avoid a stock even if it looks undervalued, and "How much growth is enough growth?" to turn a cheap-looking stock into a great investment. These questions are linked and not able to be answered precisely. After learning some lessons, we can say that there must be growth in FCF/share in absolute terms over the next few years to invest. You simply cannot own something in the public markets that is going to decline forever. In the shorter term, you need more growth than the market expects over the next year or two to time the investment right. We would prefer steady, demand-driven growth vs. companies trying to squeeze blood from a rock with overly aggressive pricing and/or already peak margins. The less leverage the better to us, but the more growth in FCF/share coming, the more willing we will be to take on leverage. Once leverage starts going over 3x net debt/EBITDA (acknowledging that EBITDA converting to FCF is what matters, so not all EBITDA is created equal), our bar for investing starts getting much higher. Said another way, we have learned to get less enticed by a levered, static value, even if it has a nice price to value (P/V). A less levered, growing company with a better price to enterprise value (P/EV) often has a better path to value realization. Companies on offense can create their own positive outcomes in ways that do not translate to spreadsheets and AI-driven extrapolations.

Another important point about investing in growing, properly leveraged companies is that doing so makes it easier to make hard decisions in tough times. Making the right buy or sell call in a volatile market or after a rough earnings report is not easy, but it gets a little easier when the company is on offense and therefore does not need to sell assets and/or "change the culture" from a position of weakness. Of course, everyone wants great investments that grow from a position of strength, so we thought it would be helpful to talk through two examples that are different than they appear at the moment.

Our first stock to discuss is Mattel. This is a company that we bought too early in 2017. Back then, it was not producing enough FCF, nor was it growing enough, nor was its balance sheet in a good position. While a DCF (discounted cash flow model) made it look cheap, we could have timed our investment much better. The good news is that it is a different, better company today, and our hard-won knowledge of this name is worth something. On the Business, the company was too unfocused with weaker brands and struggling sales channels (think Toys "R" Us) in the pre-Covid era. Now, over 80% of Mattel's value comes from growing power brands like Hot Wheels, Barbie and Uno. Tariff drama in the short term allows Mattel to reinforce its position as a strong partner with the right retailers over the long run. Growth can move up and down quarter to quarter in a business like this, but from here we believe that the trendline will be up, and any big content hits like next year's Masters of the Universe movie are additional upside. The People situation has also improved since we first invested. We are grateful for current CEO Ynon Kreiz's work over the last several years to get the company back to a proper leverage level and begin to buy material amounts of stock at great prices. That said, we wonder how much longer Mattel can remain an independent, publicly traded entity at this Price. There has been rumored interest from private equity funds; Hasbro and Mattel could finally merge in some form; non-traditional buyers like media companies could be interested in Mattel's valuable intellectual property. In the meantime, we have a stock we believe to be worth $25-30+/share and trading at or below 10x our estimate of FCF, all for something that has historically performed well during tough economic times since parents do not like to skimp on their kids.

Tripadvisor, Inc. (TRIP) is a more recent investment, and one of the rare stocks worth looking at on the bad list of 100 referenced above. Like Mattel, a key but slow-moving change on the Business is that the mix of the value has shifted from the company's namesake website and app to the much faster growing Viator and TheFork assets. While it is likely that you are aware of the Tripadvisor brand, Viator's leading position in "experiences" bookings (think guided tours or other vacation activities) and TheFork's strong position in European restaurant bookings (think OpenTable or Resy in the USA) get less attention. We like it when 25% or less of the value is 75% or more of the (misguided) headlines, and we believe that is what we have here. Margins are still not optimized at Viator or TheFork, and we would suggest you ask a hotel executive if brand Tripadvisor itself is about to rapidly go to zero. The People situation at TRIP is likely driving towards a resolution. For many years after TRIP's spin-off from Expedia (which we briefly owned successfully in 2011), Liberty Media had effective control of TRIP but in a convoluted structure that rightfully depressed TRIP's valuation. Earlier this year, this structure was finally simplified. As part of this process, TRIP entertained offers for the whole company that led to some fascinating proxy reading in which multiple parties likely had serious interest in the company well above our entry Price in the low-mid teens per share. Our value is above $25 per share (which is still less than 2x revenues), and we think the right buyer could pay significantly more. Additionally, we would argue that the company is underleveraged at the moment. While we like the large share repurchase this year and recent operational improvements under relatively new CEO Matt Goldberg, we also think it is interesting that the company has attracted interest from multiple activist shareholders. In the event of rougher macroeconomic times, we believe there is a unique floor for the stock from multiple forces.

Thank you for reading. We believe the best way to connect is through meaningful discussions about companies, so please reach out to info@seasset.com if you would like to continue the conversation.