

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Ingevity Generates Strong Free Cash Flow From a Niche Franchise



DAVID SCHUSTER is the Portfolio Manager for Brown Advisory's Small-Cap Fundamental Value strategy. Prior to joining Brown Advisory in 2008, he was a Managing Director for the financial institutions mergers and acquisition advisory group of Citigroup and a Managing Director in the M&A practice of Lazard Freres. Mr. Schuster received his BSBA from Georgetown University. After graduating from college, he served as an officer in the United States Army.

SECTOR — GENERAL INVESTING

TWST: Let's start with an overview of Brown Advisory's Small-Cap Fundamental Value strategy. What would you note that differentiates the investment strategy?

Mr. Schuster: The Small-Cap Fundamental Value strategy was started right at the beginning of 2009. I joined Brown Advisory in the early part of 2008, before the Great Financial Crisis came and really hit hard.

I joined with the intent of starting the small-cap value strategy. My background before joining Brown Advisory was as an investment banker in New York, doing corporate finance and a lot of mergers and acquisitions (M&A). I really thought that there was an interesting opportunity in the small-cap space. The asset class is attractive over a long time period.

One of the reasons a lot of people talk about is the inefficiencies in the market, and I think a lot of those are reasonably well understood, but there is also a fair bit of M&A activity that occurs in the space.

The thought process early on was to leverage my background advising boards and management teams by taking that focus and applying it to the public markets. The intent was not necessarily trying to find companies that were takeover candidates, some sort of special situations fund or something like that, but really focusing on companies that might have the financial characteristics that would be attractive to a potential acquirer, whether that be strategic or private equity.

The strategy is focused on free cash flow, with the idea that ultimately that is what is going to be attractive to either private equity or to a strategic buyer.

So, that served as the initial thesis for the strategy, and we've held to that over the intervening period.

TWST: The skew toward value, how does that play into the strategy?

Mr. Schuster: When we talk about value, we are first and foremost looking for companies that are generating high levels of free cash flow, but we are also combining that with a focus on finding companies that are trading at inexpensive valuations. What that translates into for us is doing a real granular look at the financial statements, really understanding what the drivers of the business are.

In the small-cap space, there are oftentimes a lot of companies that are either misunderstood because of people's perceptions of the company, maybe they are not well covered, or there might be some nuance around the balance sheet or the income statement that people just aren't really appreciating from a valuation perspective.

We are looking for companies, as I said, that are generating that free cash flow, but also that we are buying at what we think are attractive levels. Typically, for a lot of the companies we are thinking about things on an EV-to-EBITDA basis.

TWST: What does the research and investment process look like for you? How do you take your initial universe and whittle that down to real candidates and actual holdings?

Mr. Schuster: It's obviously a broad universe of companies. Going into the process we know that there are going to be a lot of names and potential investments that we are going to look at that aren't going to meet our criteria, and that's fine.

We use a mix of sources to come up with new ideas. We have a pretty well-tenured team of analysts, and really what we are trying to do is quickly identify companies that meet those criteria that we are looking for, and then start to do a deep dive in terms of things that are available to small-cap investors, things like onsite visits and lots of discussions with the management teams.

What we've found is, oftentimes some of the companies that we have initially looked at over the years may not meet our criteria, but by interacting with the same team and the same company over and over again over the years, you find that those companies may become more interesting opportunities and find their way into the portfolio.

It's a relatively concentrated portfolio. As of December 31, 2025, there was about \$2 billion in the strategy, with 61 investments in the portfolio. The turnover is typically anywhere from three to five years in terms of a horizon. What we find is, once we find an idea it usually takes us anywhere from a couple of weeks to a couple of months to finalize our research and then make the actual investment decision to put it into the portfolio.

We don't have any hard and fast rules about any individual sectors. It really is a portfolio that is built from the bottom up of individual ideas that are working through the investment process.

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TWST: With that said, are you seeing certain themes or trends or sectors that have been especially strong performers recently, or that represent an especially fruitful area of opportunity right now?

Mr. Schuster: A lot of companies in the materials sector have been under pressure over the last couple of years. A lot of companies in the health care space have been under pressure. So, I would say those are two areas we think are particularly fruitful right now, where we are finding some interesting ideas.

But really, I would say the universe is so broad and wide that we are able to find ideas across the board, so we are spending time in each and every sector.

TWST: Can you tell us about a few interesting ideas, some examples of companies in the portfolio?

Mr. Schuster: Of course. One of our largest investments right now is a company called **Ingevity** (NYSE:NGVT). It's a good example of a company that's generating attractive levels of free cash flow but still trading at a low valuation. It's a little bit under \$2.5 billion of market cap.

Just because you are a small-cap company doesn't mean that you don't have an attractive franchise, and I would say **Ingevity** has an attractive franchise. Their core business, they're a leader in providing and selling activated carbons in these honeycombs that are sold to the auto and truck market. They're used to reduce emissions.

It's a small, niche-y product, but they have probably 90% market share across the globe. There are probably a billion of their products in service, literally across the world. The business has attractive margins; you're looking at EBITDA margins north of 50%.

Obviously, over the last couple of years there's been a lot of pressure, concern around electric vehicles (EVs) and the demise of the internal combustion engine, and that has been one factor that has put a lot of pressure on the stock.

The other thing that had happened was they had embarked on an M&A program that was unsuccessful. About a year and a half ago, they brought in a new CEO who has really worked to clean up the portfolio and has been exiting a lot of non-core businesses and refocused the business just on its core elements. And to give you a sense, we think the business next year will probably do \$350 to \$360 million of EBITDA.

Compared to today's stock price, which is about \$65, if you took the cash that's on the balance sheet, the cash from some of these asset sales, and then put what we'd call a reasonable multiple on the earnings power of this business, you get to \$100 to \$120 per share, so really attractive upside.

At the same time, they're not sitting on this cash. They are actively out in the market buying back their shares, which we think from an owner's perspective will increase our return at the end of the day as they reduce the total number of shares.

TWST: Is there another one you can talk about?

Mr. Schuster: I mentioned the health care space. Another smaller company is called **Guardian Pharmacy** (NYSE:GRDN). It's about an \$800 million market cap. Once again, small company but attractive franchise. They are one of the largest pharmacies serving patients who live in assisted living facilities in the country. They probably service about one in four residents.

1-Year Daily Chart of Guardian Pharmacy



Chart provided by www.BigCharts.com

If you think about the elderly population, they are living in assisted living facilities and taking multiple medications multiple times a day. Guardian packages all the medications that this population needs and facilitates it in a way that helps the staff deliver those medications to the patients.

It's a business that doesn't need a lot of capital to grow, and they are able to take this dominant position and just continue to grow. It has attractive margins and overall trading at what we would consider not an expensive stock by any measure.

TWST: How do you see the current environment in terms of M&A activity? What are you expecting this year for the small-cap space?

Mr. Schuster: It's interesting. Over a long period, if you go back years and years, you would see anywhere from 3% to 5% of the Russell 2000® index getting taken out in M&A transactions. As I mentioned, that was one of the initial things I thought was really fascinating about the small-cap space.

I would say year to date, the M&A activity has been a little bit muted. We have certainly seen that in our portfolio. But I think when we go back over the last couple of years, with the new administration our initial expectation was that you would have a burst of M&A activity. We really haven't seen that yet.

I think a big part of that was just boards and management teams being concerned about the general economic environment, certainly around tariffs, and some of the question marks that has created for management teams to try to think through their own businesses.

When we think about how things will settle out going forward, our expectation is that things will get back into a more normalized cadence of M&A activity as people get a little bit more comfortable around the economy and some of the things that are coming out of the tax bills and so forth.

And so, our expectation is that we'll start to see a more normalized level of M&A activity, as management teams start to feel like they have some level of certainty around their own business prospects.

TWST: What about investor sentiment in small-cap stocks? Is that picking up, or bound to pick up after quite a few years of focus on the other end of the market cap spectrum?

Mr. Schuster: The small-cap space does run in these long trends. You can see sometimes these trends are seven, eight, 10 years long. This last 10 years or so, as you point out, certainly the large-cap space has dominated returns. As we talk to clients, that seems to be something that they have all seen, and a big question is, how long before that rotation might change?

We were thinking through the last couple of years, and especially in the middle of 2023 and the end of 2024 it started to feel like it was starting to shift back to small and certainly back to value. Although, the advent of AI really captured investors' imagination, and we have seen small once again trail.

I think what we have seen toward the latter part of 2025 and certainly into 2026 is that finally there are a lot of investors who have looked at some of the extremes that we're at.

One of the statistics we look at is small caps as a percentage of the S&P 500®. Right now, according to Furey Research Partners, we are just a little bit under 6%. The long-term average is under 11%. So, that has caught people's attention and refocused them.

I don't spend a lot of time thinking about the valuations or the business prospects of the Mag 7¹, but certainly the magnitude of the market cap that's in those versus the small-cap sector is quite stark.

So, we've certainly talked a lot about it, but what's interesting is we have actually started to see it. Year to date, small caps are up pretty

materially relative to the broader market, and since the early part of last year we have seen small caps finally outperform.

I don't want to be calling a turn for small or calling a turn for a rotation into value, but what we know is when those do happen, the relative returns that can be generated in the small-cap space can be quite significant for quite some period of time. I think that's one of the reasons why our clients think of using small cap and small cap value as part of a broader portfolio to capture some of that excess return.

TWST: Is there anything in particular you're doing to best position the portfolio this year and/or manage and mitigate risk?

Mr. Schuster: We think about risk as absolute destruction of value. One of the things that we really focus on is leverage. Smaller companies just can't carry the same amount of leverage as larger companies. A lot of corporations have built up leverage since the Great Financial Crisis. We think that is a risk.

One of the types of scenarios or environments where we have tended to do well is when companies that are highly levered are under a lot of pressure. Whether that's a credit scare or pressure on corporate balance sheets, the quality of both the portfolio franchises as well as the actual balance sheets tends to give a lot of tailwinds to the performance of the strategy.

So, that is probably our primary focus when we think about risk: making sure that we adhere to that quality bias, and that is both from a franchise perspective and also from a balance sheet perspective.

TWST: To wrap up, do you have any advice you might share with readers about investing in small caps in general?

Mr. Schuster: I think the small-cap space often gets treated with one brush. What we find, having a rigorous process, is that we're able to find attractive companies that are generating high-single-digit free cash flow yields, that have some growth prospects, and we're able to take those and aim to generate attractive returns in really any kind of economic environment.

It boils down to a) having the right philosophy, and b) a team and a process that can implement that philosophy and process to build a portfolio of attractive investments.

Obviously the small-cap space has been under pressure for a long period of time. We're always optimistic, because we've seen these long periods in the past where small caps have been out of favor, and then quickly that tide can shift and can really create some attractive returns for our investors.

TWST: Thank you. (MN)

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¹Magnificent Seven stocks: Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla.

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The portfolio information is based on a representative Brown Advisory Small-Cap Fundamental Value account.

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