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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Analyzing Financial Statements to Understand the Health of a Business

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TIMOTHY S. KANG, Senior Vice President and Senior Research Analyst, joined Olstein Capital Management, L.P. in April 2006. Previously, he held the position of Vice President/Equity Research Analyst with Citigroup Asset Management covering Asia ex-Japan financial companies and assisted in covering U.S. banks. Prior to Citigroup, Mr. Kang was an Assistant Vice President at PPM America, where he was a member of the high yield bank loan team working on private bank loan transactions. Before that, he was a senior auditor at Arthur Andersen, LLP. Mr. Kang holds a M.S. in accountancy from DePaul University and a B.S. in speech with a concentration in economics from Northwestern University in Evanston.

SECTOR — GENERAL INVESTING

TWST: Gentlemen, it has been several years since we spoke; kindly bring us up to speed on Olstein Capital Management.

Mr. Heyman: In terms of our investment approach, we continue to do what we've always done. We look for good, financially strong companies whose stock prices have been, in our opinion, unfairly punished by short-term factors. This could be, for example, missed earnings estimates, overreaction to financial results, poor management decisions, changes in regulation or, as we're seeing now, strong negative sentiment regarding the overall market and economic outlook.

We look to buy companies that we believe are trading at a 30% or greater discount to our estimate of their intrinsic value. To get that discount or value, we often buy into the negativity that surrounds the company. We don't define ourselves as contrarian investors or buy a company's stock just because it is out of favor. We buy a company because we believe the market does not recognize the value of the company based on its ability to generate future free cash flow.

We think that the current market, characterized by volatility and uncertainty, is providing us with a tremendous amount of opportunities on a company-by-company basis. We don't pretend to be able to predict markets. We are much better at understanding and getting behind the numbers of individual businesses to make educated investment decisions.

TWST: Tell us about the Olstein All Cap Value Fund and how it's evolved recently.

Mr. Heyman: Right now, I think short-term thinking and trading activity are dominating markets, giving us the opportunity to identify compelling investment ideas. We believe that many investors, because of economic and market uncertainty, are chasing a handful of momentum names and ignoring or disregarding a broad range of good companies trading at very attractive prices. In many cases, we believe that the market does not recognize the value of a company that we see — a value based on a company's ability to generate future free cash flow.

For every company and potential holding in the Olstein All Cap Value Fund portfolio, we undertake a forensic analysis of the company's financial statements and public documents: the 10-Ks, 10-Qs, proxies and shareholder letters to determine the quality of its earnings, the success of its business strategy, the sustainability of its performance and impact of management decisions on future free cash flow. Frankly, we'd rather spend our time with the company financials than talking to management. Company managements tend to be promotional, upbeat and very positive about the future. We feel that spending time with the financial statements gives us an edge to better understand a business and its challenges.

Highlights

Eric R. Heyman and Timothy S. Kang discuss Olstein Capital Management and the Olstein All Cap Value Fund. Mr. Heyman and Mr. Kang look for financially strong companies that are trading at a 30% or more discount to their intrinsic value. While they often buy into companies that they feel are being unfairly punished by short-term factors, Mr. Heyman and Mr. Kang don't consider themselves to be contrarian investors. When analyzing potential holdings, Mr. Heyman and Mr. Kang study a company's financial statements and public documents to help them understand the business and its challenges. Their goal is to value a company and estimate how much free cash flow it could generate.

Companies discussed: Qualcomm (NASDAQ:QCOM); Spirit Airlines Incorporated (NASDAQ:SAVE); Ryanair Holdings plc (NASDAQ:RYAAY); Southwest Airlines Co. (NYSE:LUV); Invesco Ltd. (NYSE:IVZ) and Zimmer Biomet Holdings (NYSE:ZBH).

Our analysis focuses on how a company's operations generate sustainable free cash flow, the ongoing level of investment required to maintain or grow free cash flow and how free cash flow is used to enhance shareholder value. The goal of our company-specific analysis is to determine a reliable estimate of how much free cash flow a business could generate over a business cycle so that we can value the business as accurately as possible.

TWST: What's the advantage of your all-cap value strategy, relative to a more focused approach, on specific company size?

Mr. Heyman: This is a short answer. Since the All Cap Value Fund can identify and invest in value opportunities regardless of market capitalization, we believe we offer our investors a distinct advantage over a strategy with an opportunity set limited to a specific market-cap range. We can pursue great investment opportunities anywhere in the market since we are not restricted by a company's size.

TWST: The All Cap Value Fund has gone from 75 to 88 names. Why do you like that number?

Mr. Heyman: We don't start out with a specific holdings target for the portfolio; we only buy a company after it has met our strict criteria. We buy stocks based on discounts, the risk/reward relationship as well as the opportunities we see in individual businesses. Ideally, we want to buy a company at a 30% discount to our estimate of its intrinsic value. We build positions and control weightings in the portfolio based on discounts. It's not a top-down approach; it's a bottom-up approach. The number of holdings will go up or down depending on opportunities, values and discounts that we're finding.

TWST: What sectors or markets do you think are currently undervalued and present opportunities?

Mr. Kang: We have a few areas that we would like to highlight amongst various names we have in the All Cap Value Fund portfolio. The first one is in the retail space. Currently, there are very compelling valuations within the retail space.

We believe that many investors misunderstand the cash flow generation of traditional brick-and-mortar retailing concepts. People are saying there is little to no value in brick-and-mortar concepts because they believe it is an antiquated channel and have therefore shifted their investment focus toward online retailing only. In fact, traditional retailers have incredible cash flow generation and are actually adapting to the realities of online competition through the adoption of omnichannel distribution models as well. This misunderstanding of the evolution of traditional retail brands is presenting itself through compelling valuations in retail that we are currently taking advantage of.

Another sector that is currently being discounted due to uncertainty about interest rates, currencies and global growth concerns are asset managers. What we see here, despite all these uncertainties, is a growing secular need for financial advice. There is a large amount of unmanaged cash that is sitting on the sidelines, whether it's from an individual or from a retirement perspective or on corporate balance sheets that we believe is currently undermanaged. We see that as a long-term growth area that we are taking advantage of in terms of compelling values right now.

Also, we find that there is a lot of multiple compression in terms of valuation within the overall market, whether it's in retail or the financials that we've spoken about. We're also seeing it in industrials and materials, where the overall market sentiment, due to volatility and fears of slowing growth, has overly discounted a lot of good, solid companies in favor of momentum names. We are taking advantage of a general market malaise that is letting us find compelling values.

There are other themes, whether its increased volume in the health care sector due to the Affordable Care Act or volume increases from preventive care, which is a secular theme that we're taking advantage of. Overall, in our portfolio, we are seeing really high free cash flow yields, and we are always looking at free cash flow yield as a primary indicator of good, cash-flow-generating companies trading at compelling prices.

TWST: Why do you believe it is vital to read financial statements?

Mr. Kang: We find that analyzing financial statements provides us an edge in understanding the health of a business. Through our forensic analysis of financial statements, we really understand how a company generates free cash flow, as well as those elements that are core to the company's business model. We not only develop conviction in a company's ability to generate cash flow, we also develop a deeper understanding of how a company is performing, what they've done wrong and what needs to be done for the company to improve or close the valuation gap that has created our buying opportunity.

We review all public filings. We dig into the footnotes looking for changes in accounting policies, revenue recognition practices, and further details on accounts receivables, inventories and other line items in the financial statements. These public documents really paint a very clear picture as to how a company is doing and what a company needs to do in order to benefit its shareholders.

By studying a business and understanding the accounting, we can assess the quality of the earnings and make adjustments that reflect the economic reality of that business. For us, understanding the economic reality of a company is one of the most important elements to determining a reliable valuation for that company. As our forensic analysis reveals deviations between reported or GAAP-based earnings versus economic reality, it provides us with real insight into management's reporting biases and, ultimately, the impact of management decisions on future cash flows.

We rarely talk to management, so our analysis gives us a clear understanding of what management is really doing, not what management is saying, and it allows us to assess management's performance. Once we finally make a decision to purchase a stock after our rigorous analysis, we also set high benchmarks for management's performance and what steps we believe management needs to take in order to close the valuation gap.

TWST: Why is free cash flow crucial?

Mr. Heyman: From our perspective, free cash flow is the lifeblood of a business and is the primary determinant of a company's value. For us, companies aren't just stock symbols; behind those stock symbols are real businesses that need to generate free cash flow. We prefer to buy companies that either generate or have the near-term potential to generate free cash flow since it provides a margin of safety for our investments.

Companies that generate excess cash flow also have the potential to enhance value in other ways, by increasing dividend payments, repurchasing company shares, reducing outstanding debt, through strategic acquisitions or by withstanding an economic downturn without adopting harmful short-term strategies. A company with free cash flow can also invest in the business without relying on capital markets or debt to finance its growth initiatives.

TWST: Can you elucidate to us what the difference is between GAAP and economic reality?

Mr. Kang: In reporting GAAP-based earnings, companies have wide discretion, which includes many assumptions about the future. Because company management has a vested interest in putting its best foot forward, the numbers produced under GAAP often leave room for unrealistic assumptions and ambiguous numbers. The goal of our forensic analysis of financial statements is twofold: one, to assess the economic reality of a business by making adjustments that we believe eliminate management's reporting biases and, two, to identify positive or negative factors that we believe are likely to affect future free cash flow. For us, narrowing the difference between GAAP and economic reality improves our ability to conservatively assess future free cash flow and, ultimately, determine a reliable value for a company.

Since Bob Olstein introduced his quality-of-earnings approach over 40 years ago, we have been refining our forensic analysis of financial statements and our valuation models to not only identify good value-investing opportunities but to also understand what a company needs to do in order to achieve its valuation. I think that — along with our free cash flow modeling, understanding of accounting issues and the quality of a company's earnings — our analytical process makes it very clear how a company's strategic choices can close the valuation gap between the current stock price and its intrinsic value.

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TWST: Tell us about your sell discipline.

Mr. Heyman: Before we invest in a company, we conduct thorough due diligence. We analyze the financials. We identify positive and negative factors about the company and review what we like about the business. As part of the buy decision for a company, we set up a strategy for holding the stock in our portfolio, which includes reasons to sell.

This is important because when you commit to paper what would derail the investment thesis, it keeps you grounded. We acquire our stocks based on what is a discount to intrinsic value, and what we feel are steady, reliable and sustainable estimates of free cash flows. We also set up a strategy as to what could derail the company — for example, if they made a big acquisition outside of their core business. A sell decision could also be based on the company reaching its full intrinsic value or our seeing a better opportunity in another name.

I think that the key is that every stock we buy has a valuation, and if we feel that is approaching our value, we will decrease our position accordingly. Unless something changes or we see different prospects going forward, that should cause us to revalue the company. If we don't like what management is doing and feel that the company is on the wrong track or that we made a mistake in our investment thesis, we will also exit a position. I think that's why it's important to follow the balance sheets and the cash flows: to make sure that your thesis is being supported by the financial results each quarter, and that our expectations of the company's strategic execution and financial performance are being met.

TWST: Within your sell discipline, what would be a red flag for you?

Mr. Heyman: If we see a company deviating from its strategy or plan, or what we think they should be doing, that would be a red flag. As we said before, we set high benchmarks for management's performance and what steps we believe management needs to take in order to close the valuation gap that created our buying opportunity. Through our intensive analysis and development of reasons to sell, we know what would start to bother us as investors.

So if we see a company that has a decent balance sheet, then they go out and buy another business, and they take on a lot of debt, that may be a red flag. Sometimes a company taking on debt to buy back stock might be a red flag because we think they have better uses for their cash. Pursuing or throwing money after what we feel is a bad strategy or after a bad business, when they should consider the possibility of selling that business, could be a red flag. It might be a change in leadership. With all these things, you really have to do the initial work of understanding what you want, why you want it, what type of business it is.

Mr. Kang: If a company changes its accounting policies without any kind of notice or an auditor issues a qualified opinion, or if there are increasing deviations between GAAP and economic reality, those things from our way of looking at companies would automatically be red-flagged.

TWST: Can you give me an example of a company you sold because of a red flag and one you bought because a green flag indicated it to be at a compelling value?

Mr. Kang: An example of stock we sold due to red flags is **Qualcomm** (NASDAQ:QCOM). Our initial thesis for **Qualcomm** focused on the company's ability to reap benefits from the evolution of the cellphone market and the chips, and that they were going to be able to benefit from the cash flow that they were generating from their intellectual property. As we held the company in our portfolio, we became less comfortable with their competitiveness within the chip-manufacturing part of their business and saw that it was a lot more vulnerable than we initially thought.

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1-Year Daily Chart of Spirit Airlines Incorporated

Chart provided by www.BigCharts.com

We found that the drivers behind the collection of cash from their intellectual property business were a lot more politically motivated, and it was difficult to ascertain future free cash flow from that kind of business. Because we found our thesis to be a bit unpredictable, we ended up selling it at $64. At that time, we had a valuation of about $68. It happened to be a good sale because ultimately the stock came down to $50.

Mr. Heyman: We will come back and look at **Qualcomm**. They have a good balance sheet, they are free cash flow generators, but you know, at the time, the risk/reward was not in our favor to keep the stock in the portfolio. So when we feel like we are no longer bringing an edge, we never fall in love with the stock. It has corrected, so we are constantly going back and relooking at it and testing our thesis to make sure or to see if it's something that we may be interested in buying again.

Mr. Kang: An example of a green flag would be **Spirit Airlines** (NASDAQ:SAVE), which is an ultra-low-cost airline operator. Their strategy is to create new markets using what we believe is a proven business model, whether it's from **Ryanair** (NASDAQ:RYAAY) or the early days of **Southwest** (NYSE:LUV), or other niche airlines with the ultra-low-fare type of plan. **Spirit** operates around 73 planes, with plans to be at around 150 in about five or six years. Their competitive advantage is they are a low-cost operation. They can pick and choose different routes, pick and choose different areas to go to. Their cost to fly is 20% to 50% lower than larger carriers. They have a young fleet.

1-Year Daily Chart of Invesco Ltd.

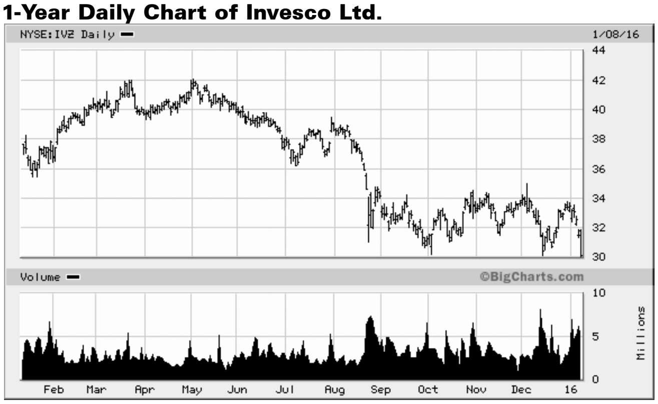

Chart provided by www.BigCharts.com

We feel that with the level of free cash flow they can generate on a normalized basis, which is about $3.60 per share, that at this current price, it is a compelling business model with growth in capacity around 15% to 20% over the next five or six years. The market is currently discounting airlines very heavily, fearing a return to historical irrational pricing behavior and previous overreliance on debt, but we believe that the airlines are currently structured in a more rational manner than in the past and that **Spirit** in particular is a niche grower within a more rationally structured industry as well.

TWST: You also like Invesco. Tell us about this holding.

Mr. Kang: Invesco (NYSE:IVZ) goes along with our view of asset managers on a secular basis. We find that Invesco is a well-respected wealth manager, and its operating leverage is tied to a global recovery. While current conditions are unfavorable with a market slowdown, rising interest rates and fluctuating currencies pressuring the stock price, we believe that, over the longer term, it will go up to more than $50. **Invesco's** solid distribution and infrastructure, with well-regarded funds, will allow for increased asset gathering, operating leverage and growth of free cash flow. We see the stock as being $50 or better.

TWST: What about Zimmer Biomet Holdings?

Mr. Heyman: Zimmer (NYSE:ZBH) is a great example of a company with a significant potential for future growth. They are a leading medical device company specializing in orthopedics, dentals, spinal implants, hip and joint replacement. They are the number-one player in the $16 billion global reconstructive surgery market and spend approximately 5% of sales on R&D. They bought **Biomet** in June of this year and have really expanded the breadth of their product offerings, which will provide a number of cross-selling opportunities.

What's nice about this acquisition in particular is that these companies' headquarters are in the same area. **Zimmer** also has a successful track record of integrating acquisitions — eight acquisitions since 2003 — to maximize benefits to shareholders. The integration and consolidation are going to be easier, and they are going to get much more cost synergies going forward. We also expect that the free cash flow will be used to reduce the debt. Our value for **Zimmer Biomet** is around $140 per share.

TWST: In the current global economic context, which is characterized by volatility and slowing growth, what misconceptions spurred on by the media or other factors might lead the average investor astray? What advice would you give to them?

Mr. Heyman: The first thing is that you really have to know what you own. You have to have an understanding of how the company's operations generate sustainable free cash flow, and what factors, both positive and negative, have the potential to affect future free cash flow. You should understand the financials, look at the financial statements. There are a lot of documents that can help you to become more educated on how the business functions, how it generates cash, what the products are, which will help you avoid pitfalls.

Secondly, the average investor should not be led astray by short-term focus and negative market psychology. I've been with the Olstein funds now for almost 20 years, and if you understand a business and how it functions, that's the opportunity that you can take advantage of, especially in a market like this when there is a lot of good businesses being thrown to the side or sold along with bad businesses. I think the media and Internet gets the best of people's emotions because they focus on the near term, and everything has to be sensationalized. If you are not grounded and really don't understand what you own, it's very easy to get shaken out of what could be potentially good investments.

I know in my 20 years, the market has been shaken by interest rates rising or lowering, Syria, Russia, Ukraine, Greece, North Korea and employment numbers, elections, fiscal cliffs, U.S. ratings, health care reform, etc. You can't predict the timing of these outcomes. What you really have to do is understand the businesses that you own. I truly believe that the stock prices are much more volatile than business valuations, and if you can take advantage, if you understand the business valuations and you have time, you should be looking at things over a business cycle. When there is a mispricing of a business, you should take advantage of that mispricing since the underlying value of a business is much less volatile than its stock price.

TWST: Thank you. (KK)

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The Olstein All Cap Value Fund follows a value-oriented investment approach. However, a particular value stock may not increase in price as the Investment Manager anticipates and may actually decline in price if other investors fail to recognize the stock's value or if a catalyst that the Investment Manager believes will increase the price of the stock does not occur or does not affect the price of the stock in the manner or to the degree that the Investment Manager anticipated. Also, the Investment Manager's calculation of a stock's private market value involves estimates of future cash flow which may prove to be incorrect and, therefore, could result in sales of the stock at prices lower than the Fund's original purchase price. There is no assurance that the fund will achieve its investment objective.

The above represents opinion, and is not intended to be a forecast of future events, a guarantee of future results, or investment advice. The references to securities are not buy or sell recommendations, but are intended to be descriptive examples of the fund's investment philosophy and are subject to change. Do not make investments based on the securities referenced. As of 12/31/16, the Olstein All Cap Value Fund maintained a position in the following securities referenced above, and is subject to change: Spirit Airlines Inc. (1.0%); Invesco LTD (1.7%); and Zimmer Biomet Holdings Inc. (1.9%). As of 12/31/16, the Olstein All Cap Value Fund did not maintain a position in the following securities referenced above, and is subject to change: Qualcomm Inc., Ryanair Holdings PLC., and Southwest Airlines Co.

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