ticker

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Strategic in Corporate Turnarounds

Investors tend to punish first and ask questions later as soon as small-cap stocks stumble. However, these smaller companies can overcome temporary problems and regain their growth profile if management stays focused on building the business. Eric R. Heyman, portfolio manager of the Olstein Strategic Opportunities Fund, is a patient investor looking for long-term turnaround investment opportunities.

Eric R. Heyman
Director of Research and Portfolio Manager

Eric Heyman, Executive Vice President, Portfolio Manager, and Director of Research of Olstein Capital Management and Co-Portfolio Manager of the Olstein Strategic Opportunities Fund and Olstein All Cap Value Fund, joined Olstein Capital Management in January 1996, within months of the firm's inception. Eric has served as a Research Analyst since 1999 and was named Director of Research in 2005. He has been Co-Portfolio Manager of the Olstein Strategic Opportunities Fund since its inception in November 2006 and was named Co-Portfolio Manager of the Olstein All Cap Value Fund in October 2008. Previously he was an Accountant with Norstar Energy, a subsidiary of Orange and Rockland Utility. Eric holds a B.B.A. in Accounting from Pace University.

What is the history and mission of the fund?

Over its 10-year history, the Olstein Strategic Opportunities Fund has emphasized investments in turnaround situations, where companies face unique strategic challenges. We believe equity markets tend to overreact and sharply penalize small- to mid-size companies that encounter problems or stumble in the face of Wall Street's unrelenting expectations for constant growth. The market's short-term reaction to such situations often creates compelling investment opportunities for the long-term value investor.

How is the fund different from its peers?

Our fund is different in two ways. First, while most investors tend to think of the fastest growing companies, like a Google or a Facebook, we focus on finding value in companies facing temporary problems or in need of operational turnarounds.

The second differentiator is our focus on the quality of earnings. Our investment process seeks to add value primarily through a bottom-up security selection process. We believe that a forensic analysis of a company's financial statements—a full understanding of the balance sheet, income statement and regulatory filings and their footnotes—is the best way to understand the quality of its earnings, the success of its strategy, the sustainability of what it is trying to accomplish, and the impact of management's decisions on cash flows.

We believe that is more useful than management's forecasts, earnings guidance or personal visits. We think our focus on a company's ability to generate free cash flow allows us to identify many investment opportunities that are overlooked by the market.

What core principles guide your investment philosophy?

We are value investors. So we believe in the logic of buying the common stocks of good businesses at material discounts to their intrinsic value. Our universe of investable stocks includes good companies that are facing adverse competitive, industry or economic issues, or companies that have temporarily faltered and have been, in our opinion, overly punished by the market.

Wall Street exerts considerable pressure, especially on small companies, to meet short-term earnings expectations on a quarter-by-quarter basis, and often fails to perceive a company's long-term value. It usually reacts to problems by punishing a company's stock, and that creates compelling opportunities for

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us. We are a patient investor willing to allow a company the necessary time to correct what we believe is a temporary problem.

We believe excess cash flow is the lifeblood of a business and the primary determinant of its market value. Excess cash flow has the potential to enhance shareholder value through increased dividend payments, repurchasing company shares, reducing outstanding debt, engaging in a strategic acquisition, or withstanding an economic downturn without adopting harmful short-term strategies to the core value of the business.

Our forensic analysis of financial statements helps us make reliable valuations based on future free cash flows; determine if a company's accounting policies reflect business reality; assess a company's quality of earnings; make accounting adjustments to eliminate management biases; and identify positive or negative factors that may affect future cash flow. The point is to really determine the economic value of a business.

What is your investment process?

We want to thoroughly understand how each company's operations generate free cash flow because that is what we focus on; we want to understand their business model, strategy, future prospects, and management. We do a bottom-up fundamental analysis of financial statements focusing on the balance sheet and income statement, a cash flow analysis and an ongoing analysis on a regular basis of financial filings and other public disclosures including 10-Ks, 10-Qs, proxy filings, annual reports and public announcements.

We believe we have two organizational strengths: our emphasis on the quality of earnings and our team-driven approach. When we analyze financial statements we make adjustments to their reported earnings to eliminate what we believe are management biases or unrealistic assumptions. Our forensic accounting analysis allows us to hone important data inputs for our valuation models, and also provides keen insights into factors that are vital for success in turnarounds and may be indicative of changes in future earnings. That's what we mean by the quality of earnings.

Second, we have a team-driven approach. We work within the realm of the Russell 2500 Index; we use either a qualitative bottom-up analysis or a quantitative screening process only to identify untested ideas. But whether an idea is uncovered through a quantitative screen or an obscure trade publication or a government filing, the real work begins with our team doing a forensic analysis of target companies, starting with their financial statements.

We produce a thorough, written analysis and research report that discusses the fundamentals of the company's business, the industry economic conditions, the competitive dynamics and framework for assessing future operations and cash flow, the assumptions in the underlying valuation. These reports also compare our valuation analysis to historical market prices and provide a detailed scenario analysis showing the best, worst, and likely case for appreciation based on differing future cash flows and economic environments.

Olstein's initial analysis filters potential investments to eliminate companies that are either fully valued or that have serious structural, financial, or secular problems, rather than those that are simply not performing to their full potential. First a company must successfully pass the initial phase of the analysis by demonstrating normalized free cash flow potential that is not properly valued by the market. Our next step is to develop a deeper understanding of the sustainability and reliability of that free cash flow potential under different scenarios.

An extensive forensic analysis looks at the footnotes and the regulatory filings, to hone what we believe are the company's normalized cash earnings, the capabilities and the fiscal conservatism of the management team, and finally, the quality of its earnings.

Next comes the detailed analysis using several discounted free cash flow valuation metrics. We test the range of values, the current market reality, and the company's historical earnings performance. Then we further test our valuations through extensive scenario analysis that assigns probabilities to the best- and worst-case scenarios. We know the economy and the markets don't stay stagnant; you have to constantly test your thesis and estimates of free cash flow.

Finally, we pitch the stock to the Chief Investment Officer, who ultimately decides if it will be included in the firm's buy list. Then the portfolio managers determine where and how it fits into the portfolio.

Can you cite an example to illustrate your process?

A great example is Harman International Industries, Inc., a provider of audio and infotainment systems for the automotive, consumer, and professional markets. We followed this company for many years, reading shareholder letters and communications from Sidney Harman, the co-founder of Harman Kardon. He was an entrepreneurial visionary in the car stereo and sound systems industry, a guy who really cared about the company, people, and technology. But where he fell short was that he didn't manage the business for the shareholders.

For us Harman was a turnaround story where a new CEO served as a catalyst for sharpening the company's performance by controlling costs through better supply chain management, realizing purchasing power, consolidating the company's global manufacturing & engineering footprint and reducing functional costs while at the same time expanding activities into all auto market segments.

In July 2007 Dinesh Paliwal was hired as president and CEO of Harman International Industries. Paliwal's view was that Harman was a great business with a great product but it needed to be managed for the shareholders, too; there has to be a balance. He believed that it was a great company, that info-entertainment is the key to moving your cell phone and your office and your internet connection into a safe car environment. He spent a lot of money and time building relationships with big automotive companies, promising them a full solution with a scalable platform. But Paliwal didn't stop there; he knew that his product had to be the best product in the vehicle, and it had to be good enough to last for five years. So he started signing long-term contracts and producing a terrific optionality and a reliable product.

With him streamlining the manufacturing process, a money-losing operation slowly but surely started to turn around. Whatever he said he was going to do, he did. Margins increased dramatically. When we bought the stock at $30 we thought it was a $45 stock. In November 2016, Samsung agreed to acquire the company at $112 a share. We continue to reduce the position with the deal expected to close in mid-year.

That's a typical Olstein turnaround story, where we were patient and took a long-term view, and the company's management team backed up everything it promised with quarter-by-quarter improvement. Not every quarter was the best, but we saw the cash flows coming through, and the stock price appreciating over time. Over a six- or seven-year time horizon Harman's business transformation added incredible intrinsic value, and created wealth and value for its shareholders.

Would you share another example?

Another example is VWR Corporation, a leading provider of products, services and solutions to laboratory and production facilities in the pharmaceutical, biotechnology, industrial, education, government and healthcare industries. VWR is a spin-out from Merck that private equity firm Madison Dearborn Partners took public in October 2014. Madison Dearborn still owns approximately 35% of the Company and continues to reduce their holdings. Since these transactions, VWR has managed to increase its profitability and effectively de-lever the balance sheet. The company continues to focus on de-leveraging though a combination of debt pay and productivity improvements.

What makes VWR attractive to us are its value proposition, diverse product set and attractive market potential. The company's sales of consumables, chemicals and services that are recurring in nature constitute approximately 80% of total sales. While the distribution of products is at the core of VWR's revenues, the differentiating factor is the company's breadth and depth of supply, independence, private label products and customized solutions that effectively outsource client's non-core functions. The company sells over 1 million SKUs and has more than 100,000 customers across 34 countries with the US representing approximately 55% of revenues. In the fragmented global market for laboratory suppliers, VWR currently has a 9% market share with plenty of room to grow in an industry that is currently over $51 billion in annual sales volume growing at approximately 3% per year globally. The company's clients are highly dependent on VWR's products that are key components in critical processes such as new drug development, regulatory and safety testing, and laboratory testing. In addition, some of the products the company offers are subject to complex and stringent regulations that act as a substantial barrier to entry.

We believe that as the company continues to deleverage and capitalizes on the strengths of its business model to grow, its stock will reach our intrinsic value of $35 per share. The company's stock is currently trading around $26 per share.

How do you construct your portfolio?

Our portfolio is built on a stock-by-stock basis, so each company has to earn a position in the portfolio based on our estimates of free cash flow and what the discounts are. The fund's portfolio invests in between

Olstein Strategic Opportunities Fund

Company	The Olstein Funds
Symbol	OFSAX (Class A) OFSCX (Class C)
Address	4 Manhattanville Road Purchase, NY 10577
Phone	800-799-2113
Website	www.olsteinfunds.com

Source: Company Documents

35 and 55 holdings—over the past 10 years we have averaged about 43 holdings—but our portfolio is highly concentrated in our top 20 positions.

The top 20 positions usually make up 50% of the portfolio and range between 2.5% to 5% in position size. The rest are smaller positions where we are either reducing the size of the position because it's getting closer to fully valued, or taking smaller positions because we don't have that full discount.

What is your buy-and-sell discipline?

Our buy discipline is based on a team effort, an exhaustive review of the analyst's work by the investment team. We reserve the right to make sure we don't love any stock. We always treat stocks as an investment based on our intrinsic value and the discount.

We have a strict sell discipline based on cash flow valuations rather than price momentum—that's the required discipline of a value investor. As holdings reach their valuation levels they are sold and monies are reinvested in existing holdings or new investment ideas, or held in cash until we find something in which to invest. Every portfolio holding, as well as every company listed on the fund's buy list and watch list, is reviewed and revalued each quarter as the company files quarterly or annual reports, 10-Qs, 10-Ks.

We also monitor each company's news, its progress toward specific goals, and market conditions or factors likely to affect its performance. We review and reevaluate companies as conditions change or new information is available. Such a reevaluation may result in increasing or decreasing a position, or in some instances it leads to a sale.

Is your portfolio turnover significant?

For the calendar year ended December 31, 2016, the fund's portfolio turnover was 52.7%, which is about average for the past five years. That doesn't necessarily mean we are eliminating names altogether, though we may do that if they get to full value or our investment thesis changes. But we also might be taking names up or down based on their discount to intrinsic value.

How do you define and manage risk?

For small and mid-sized companies we are less concerned with overall market volatility and more concerned with the predictability of sustainable free cash flow. So instead of focusing on market risk or reacting to predictions of market movements, we try to reduce the risk of capital impairment by assessing a company's business and the strength of its balance sheet by identifying the factors likely to affect future cash flow and by buying stock at a significant discount to our determination of the company's value. We assess business risk by focusing on how the company's operations generate free cash flow and the factors that are likely to impact future cash flows, as opposed to stock price movements.

We believe the best way to reliably estimate sustainable free cash flow is through a thorough understanding of a company's operations and strategies, and the effectiveness of the management team as stewards of the company's capital. This is especially true in small or mid-sized companies that are facing strategic choices and challenges due to Wall Street's consistent pressure for growth.

Our main concern in managing risk is the probability of permanent loss of capital. We always look at the downside risk first, because it can destroy long-term performance. We manage the overall risk on a stock-by-stock basis as we build the portfolio, through an extensive due- diligence process that helps us understand any dislocation of underlying value. But first and foremost we seek to mitigate risk by buying stocks at a 30% discount to our intrinsic value, where, in our opinion, a lot of the bad news or short-term negativity is already built into the stock price.

While we are willing to take market risk, because that creates opportunity, we avoid company-specific financial risk. We tend to avoid companies that have to adopt short-term strategies. We also watch position size in the portfolio and have a strict sell discipline based on discounts and intrinsic value; that is a big part of risk control. And we are constantly looking at the probability of the risk-reward that each investment presents.

Our process is based on the discount to intrinsic value. So if our intrinsic value is $50 and we buy at $35, as a company gets closer to our intrinsic value we'll take money off the table, because our risk reward is not the same. And if it falls below, we might add to it. That dictates the position and helps control the risk of an individual investment.

Do you view market capitalization as important?

The Olstein Strategic Opportunities Fund focuses on the small- to mid-capitalization segments of the market because they offer a significant number of investment opportunities that are misunderstood, mischaracterized or simply ignored by many investors. Companies on a growth trajectory that have temporarily stumbled, or need to adapt their strategy through a focused turnaround effort or need an infusion of senior leadership talent to take the company to the next level are great opportunities for us.

It is probably harder for a larger company to maintain a high annual growth rate than it is for a small company—even one facing challenges. Macy's is a great example of this. When we bought Macy's years ago, their market cap was around $4 billion before growing, as it overcame its challenges, to $24 billion its market cap at the time we exited the position. We would love for all of our companies to go from $1 billion to $20 billion. T

This information should be preceded or accompanied by a current prospectus, which contains more complete information, including investment objectives, risks, charges and expenses of the Olstein Funds and should be read carefully before investing. A current prospectus may be obtained by calling (800) 799-2113 or visiting the Olstein Funds' website at www.olsteinfunds.com.

The Olstein Funds 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.

An investment in a portfolio containing small- and mid-cap companies is subject to additional risks, as the share prices of small- and mid-cap companies are often more volatile than those of larger companies due to several factors, including limited trading volumes, products, financial resources, management inexperience and less publicly available information. The activist strategy invests in stocks of underperforming companies and any shareholder activism might not result in a change in performance or corporate governance. These stocks could also experience less liquidity and higher share price and trading volume volatility than stocks of other companies.

The above represents opinion, and is not intended to be a forecast of future events, a guarantee of future results, or investment advice. Any references to securities (including valuation opinions) 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 3/31/17, the Olstein Strategic Opportunities Fund maintained a position in the following securities referenced above, and is subject to change: VWR Corp. (2.8%). As of 3/31/17, the Olstein Strategic Opportunities Fund did not maintain a position in the following securities referenced above, and is subject to change: Alphabet Inc. (Google), Facebook Inc., Samsung Electronics, Harman International and Macy's Inc. Positions in other portfolios managed by the investment manager may differ.

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