Value in Turnaround Situations

Small- to mid-sized companies that have 'hit the wall' or stumbled are generally neglected by investors, especially as negative news starts filtering in. Eric R. Heyman, portfolio manager of the Olstein Strategic Opportunities Fund, screens for companies whose financial resources and management heft can help them overcome strategic challenges and short-term problems reflected in their stock price.

Eric R. 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 of the company and the fund?

Olstein Capital Management was established in 1995 with an investment style focused on selecting out-of-favor companies with the help of fundamental investing principles.

We recognized that the market systematically overlooks small- and mid-cap companies that face strategic challenges or critical choices and that is where the opportunity lies in creating wealth for our clients. So, we launched the Olstein Strategic Opportunities Fund on November 1, 2006, with the sole focus on companies that have fallen out of favor with investors in that market cap range due to, what we believe, are temporary, fixable problems. Since its inception, the fund has grown to $200 million in assets under management.

How would you describe your investment philosophy?

We look for turnaround situations, or for companies with strong products or services that have either stumbled or that are facing strategic challenges and lack of investor confidence.

A key element of our philosophy is that we treat each company as a business and closely examine its cash flow, balance sheet, and quality of earnings before determining its value. We consider ourselves investors in a business rather than in a stock; therefore, we evaluate the company as if we are buying the entire business. However, these companies should also be trading at material discounts to our estimate of their intrinsic value, because we believe the price you pay for them truly matters.

We believe that free cash flow is the driving force behind any business. If a company does not generate sustainable free cash flow, it does not have opportunities to create value, to buy back stock, or to make acquisitions. So, we look at free cash flow adjusted for capital expenditures and working capital, and we ask what type of free cash flow this business can generate.

Assessing the quality of earnings, accounting practices, footnote disclosures, company's recognition of revenue policies, how it manages working capital and its pension liability accounting, are some of the core factors to making good investment decisions, especially for companies that are going through a difficult period.

What is your investment strategy?

Investment ideas can come from anywhere and we like to stay curious at all times. In our view, this type of intellectual business curiosity is critical for idea generation. Our team always pays attention to everything, even to details such as what airline people are flying on, where they go out to eat, or what clothes they wear.

"In making the stock selection decision, we look first at the downside risk, because that can destroy long-term performance. If on the downside we have a clean balance sheet, decent management, a decent product portfolio and the right discount, I am quite positive about my long-term performance outlook."

In addition, we look for portfolio candidates through our quantitative screening for companies that are buying back stock, have excess depreciation over capital expenditures, return on equity, and stocks trading at a low valuations to normalized free cash flow. Through the financial statements, we want to understand how a company is run and how we can effectively evaluate management performance.

We also read shareholder letters issued as far as five years back, aiming to see how management has positioned the company and delivered on previous strategic goals, how the business has worked for its shareholders, and how that has impacted the quality of earnings.

Not only do the balance sheet, financial statements and accompanying footnotes indicate the financial strengths and weaknesses; they also show the level of disclosures and help us in understanding how shareholder friendly management is. The higher the level of material disclosures, the greater the level of conviction we have in the company's financial statements.

Our investment process is collaborative and involves all our team members. Our daily morning meetings are designed to discuss various stocks and strategies in the portfolio as well as any other ideas that emerge from our research.

Could you illustrate your research process using a company example?

As we look for ideas everywhere, the key part of our research is to build business models and tighten our assumptions about business metrics that we are interested in. Although we listen to what management has to say, we have come to believe that the company management generally offers a rather optimistic outlook. Consequently, we spend a lot of time building an overview of our own assumptions of what is realistic for a particular business.

A good example would be Integra LifeSciences Holdings Corp, which we initially discovered through our voracious reading habit. The company represents a real operational turnaround. It is a medical device company with strong market positions in wound care, soft tissue medicine, nerve repair, and surgical instruments. Our research showed that they rank first or second in terms of market share across their product portfolio.

We found that even though the previous management team had spent a lot of time buying companies, they did not spend the time required for integrating the businesses. However, the new CEO, who came from Baxter, initiated a turnaround plan that, in our opinion, would better position the company for future growth.

Integra had many issues at the time, but we believed that they could all be fixed. Our research showed that the company had a portfolio of top quality products, but the business was simply mismanaged. Eventually, the new CEO reduced the manufacturing facilities from 30 to 15, cut down the inventory management systems by half, and resolved most of the FDA-related issues.

We saw that the company had a solid balance sheet, so we knew there were no underlying financial issues to worry about. We felt that the CEO had a good plan to focus on his turnaround. As he started to implement his plan, the stock price appreciated, as the earnings power of the business became much clearer. We bought the stock at $48 on our estimate that it could be worth $77 per share over the next two years.

Would you share another example?

Daktronics, Inc, the maker of electronic scoreboards for stadiums and billboards, is a full solution provider that offers comprehensive display systems. As a small company, it actually struggles to meet the demand from stadiums and highways for new technology. While the demand is strong, their manufacturing facilities are often at full capacity. As a result, the company has to pay overtime and outsource part of the production to third parties to meet the demand. Apparently, this situation has put a lot of pressure on the margins and on the overall business.

This is a case of a company with a product line that is in demand and appreciated by its customers, but it is also struggling with short-term capacity problems and properly pricing a premium product. They have an impeccable balance sheet with no debt and $1.50 per share in cash; and the stock is trading around $10.

If our analysis is correct, we are buying a business with a 10% normalized free cash flow yield. If it can fix the temporary manufacturing issues, the stock can appreciate 50% from current levels.

When we look over a longer-term horizon, the next three-to-five years, the company has the right product, the right balance sheet, and the right management team to realize our estimated intrinsic value.

In making the stock selection decision, we look first at the downside risk, because that can destroy long-term performance. If on the downside we have a clean balance sheet, decent management, a decent product portfolio and the right discount, I am quite positive about my long-term performance outlook.

What is your portfolio construction process?

Our goal is to build the portfolio with businesses that are mis-priced or selling at discounts to their intrinsic value. It is important to stress that our portfolio construction process considers one position at a time.

If a business meets our research criteria after our due diligence process, we sit down to discuss the name. The team debates the stock's intrinsic value, the discount and whether the stock deserves a position in the portfolio. If it does, we also discuss the appropriate allocation for it. Then, as a portfolio manager, I develop my overview of how the stock fits into the portfolio.

Typically, the portfolio consists of 50 names, but we have flexibility with the number of holdings. We could make the portfolio more diversified or more concentrated based on the discounts available in existing and potential holdings. Our individual position size can go up to 10% of the portfolio, but most often our position size is in the 3% range, with the top 20 names generally comprising 50% of our holdings.

For benchmarking purposes we use the Russell 2500 Index, but we spend little time looking at the benchmark. Instead, we stick to our investment process and it is more important to us to build a portfolio of businesses that are trading at a discount of at least 30% to their intrinsic value.

What is your buy/sell discipline?

Over the last three years, our portfolio turnover has been around 80%. We do not go in and out of names because we buy businesses with a longer-term horizon and we work with strict valuations. We constantly evaluate the size of our positions. For example, if we buy a stock at a 30% discount and then it increases in value and trades at a 15% discount, we might sell half the position.

Another reason for replacing a stock would be if the company gets acquired or draws significant interest from private equity investors—something that we experienced seven times in 2014. When you own good businesses with solid balance sheets that are leaders in their field or have a strong differentiation from competitors, value gets created over time. Either the company builds the value, or another business acquires the company.

One of the biggest mistakes an investor can make is in treating the business like a stock and in thinking that one can make money while sitting on cruise control. We believe that you have to spend a lot of time investigating businesses, accounting policies, and cash flows. Our goal is to own undervalued names, and if companies are taken over or have reached their intrinsic value, we will replace them with companies with better risk/reward metrics.

Do employees invest in Olstein funds?

At Olstein, we believe in eating our own cooking. Our management and staff cannot buy individual stocks and we all invest in Olstein funds. We are all personally invested in the funds that we manage, which aligns our interest with that of shareholders.

How do you define and manage risk?

There is no magic way to control risk. I feel that the true way to manage risk is doing your due diligence on the individual business to understand how that business works. Then, one can take a conservative approach towards the balance sheet. Understanding how the company utilizes the free cash flow and staying disciplined in how much you pay for a business, that is, buying it at the right discount, are some of the methods that we use to mitigate risk.

In addition to our own due diligence and understanding of each individual investment, we also manage risk through position sizes. The individual size depends on our belief in the prospects of the business, the type of discounts we are presented with, and the structure of the balance sheet and sustainability of the company's cash flow. Our positions are smaller in newer companies that we are still learning about or in companies trading at smaller discounts to intrinsic value.

Please see important disclosures on the following page.

Olstein Strategic Opportunities Fund

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

Source: Company Documents

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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.*

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