Value Investor INSIGHT
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Wealth of Experience

INVESTOR INSIGHT

Robert Olstein
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"We can feel the same emotions as the small investor – when you're in that state of mind, don't do a thing."

In our last conversation [*VII*, September 28, 2005], you talked about having managed through five market corrections of 25% or more. How does the correction of 2008 and early 2009 compare?

Robert Olstein: I've been in the business for 43 years and have never been through a period so scary. In many ways, the system failed. That's obviously an uncomfortable situation for an investor.

Let me provide some perspective on why I say that. Our investment strategy is based on buying at a discount to the intrinsic value of a company, which arises when there are concerns about the company, its industry or the market overall. So we were buyers in 1998 of drilling companies when oil was at $10 per barrel, because we didn't believe oil would possibly stay at $10 per barrel and the prices of the stocks were well below the salvage value of the equipment. When capital was being pulled out of the insurance industry after 9/11, we looked ahead to the better pricing environment in the future that would result. When McDonald's stock was in the mid to low teens in 2003 and everyone was concerned that its growth was over, we saw that as an opportunity for it to pull back on investment spending and work on increasing profitability at the store level. We still have it in the portfolio at close to $70.

Move ahead to 2008 when panic goes into financial stocks after Bear Stearns has to be "saved." I see that all happening and get interested, since I've seen that kind of panic before. We analyze something like Citigroup, down from $60 to $23, and conclude that its basic spread business – the difference between where it borrows money and where it lends it – is generating $3.75 per share in earnings. Reserves had been raised to an all-time high, and we think they're marking down assets too much based on market pricing that has unhinged from reality. We think the stock is worth at least in the low $30s.

Then Lehman goes under and all bets are off. Confidence in the system is shot and we're looking at a nasty period of deleveraging and massive capital raises. We blew out of every financial we owned – including, in addition to Citi, things like Morgan Stanley, Goldman Sachs and American Express – taking huge losses even though we had gotten in after they were already down 50%. Our discipline of stepping up when we thought the market was overreacting – the playbook that had worked my entire career – did not work because our thesis that the government would not allow a big bank to fail was wrong.

In the end, does that make me question the discipline? No. Never say never, but I would be very surprised if we see again in our lifetimes the unique set of circumstances that played out from the fall of 2008 through the spring of 2009. You can't throw out your whole strategy because of a once-in-a-lifetime event.

Have you made any less-dramatic adjustments in how you do things?

RO: We do have a new rule: Any position with more than 2.5:1 total assets to shareholders' equity is an official exception to our methodology. If it is an exception, its size in the portfolio is capped at a low level. We also won't have more than 10% of the portfolio overall in such exceptions. The rationale is simple: When you're wrong with a leveraged business model, even if you got a bigger discount, the descent in the stock price can just be too fast and too damaging.

Your flagship fund is up more than 80% since last year's low. What's been your strategy as it has risen from the depths?

RO: All the forced selling gave us opportunities we hadn't seen for some time to buy large, well-capitalized blue chips like

Coca-Cola, Procter & Gamble, Intel and Microsoft. We were getting at least 30% discounts to intrinsic value on stocks that for 30 years had been too expensive, and which we expected to hold up much better if the market had stayed in the tank.

Another theme we went after were healthcare companies that would be primary beneficiaries of more patients entering the system. That led us to companies like Becton, Dickinson and Covidien, which make a lot of their money from reusable medical products. Also, while we stayed away from the large banks, we did buy asset managers such as BlackRock, AllianceBernstein and Legg Mason, which we thought would do very well as the market stabilized and eventually turned up.

That has all worked pretty well. Are the easy finds gone?

RO: The discounts are now down to 10-15%, but we're still using high-quality megacaps as stabilizers of the portfolio. They typically pay solid dividends, and are more exposed to growth outside the U.S. that we expect will far exceed growth in the U.S. It's actually amazing to me how overpriced so many small and mid-cap stocks are today relative to companies like Intel and Microsoft. Why would you pay 30x earnings for an economically vulnerable company with a mediocre balance sheet while walking away from Intel at 10x earnings? It just makes no sense to me.

We're not just in the biggest names in technology. Teradata [TDC], which is in the data-warehousing and data-mining business, has an impeccable balance sheet and can grow revenues at least at a high single digit rate going forward, but relative to the prices being paid in the market, it trades at a 25% discount to what we think it's worth.

Consistent with our strategy over time, we're also finding opportunity in companies for which reported earnings appear to underestimate cash-generating power. A great example is Macy's [M], which we bought at $6, $7 and $8, but even at today's price [of $22] trades at less than 8x estimated 2010 free cash flow of around $2.80, after adding back excess depreciation. That's a free cash flow yield of nearly 13%.

You've typically found upside in potential turnarounds. Are you still counting on that with Harman International [HAR]?

RO: This is a classic opportunity for us. The company sells a wide range of audio and infotainment systems for auto, consumer and professional markets. It had been a highflier in the mid-2000s, with the stock going from $30 (split-adjusted) to around $120, which is where a private equity deal to buy it was announced in 2007. The deal fell through and the economy tanked, taking the shares below $15 at the height of the crisis.

We had followed Harman for some time and were impressed with the innovation of its products and its growth prospects, but always thought it was poorly managed. The founder, Sidney Harman, had ruled with an iron fist and just wasn't the guy to manage it as it grew so big. After one failed attempt at a new CEO, the board hired Dinesh Paliwal in mid-2007, and he finally started putting in place the basic operating discipline the company desperately needed – closing

INVESTMENT SNAPSHOT

Harman International
(NYSE: HAR)

Business: Develops, manufactures and markets audio and electronic systems, primarily to automotive, professional and consumer markets in the United States.

Share Information
(@5/27/10):

Price	**32.71**
52-Week Range	16.93 – 53.36
Dividend Yield	0.0%
Market Cap	$2.27 billion

Financials (TTM):

Revenue	$3.21 billion
Operating Profit Margin	2.4%
Net Profit Margin	(-1.0%)

Valuation Metrics
(@5/27/10):

	HAR	S&P 500
Trailing P/E	n/a	17.7
Forward P/E Est.	35.2	13.2

Largest Institutional Owners
(@3/31/10):

Company	% Owned
Fidelity Mgmt & Research	8.4%
Capital World Inv	7.3%
Artisan Partners	5.3%
Vanguard Group	4.6%
Wellington Mgmt	4.2%

Short Interest (as of 5/14/10):

Shares Short/Float	2.4%

THE BOTTOM LINE

A broad-based operational restructuring should give the company significant operating leverage as it benefits from market-share gains and a general recovery in its primary automotive markets, says Robert Olstein. At a reasonable 15x the $3.50 per share he believes the company can earn by 2012, the stock would be worth at least $50.

Sources: Company reports, other publicly available information

high-cost factories, dumping unprofitable product lines, being more disciplined about capital allocation, and instilling an ethic of cost-control and productivity that had never been there. The problem was that the results of all that got overwhelmed by the terrible economy.

How early did you buy into the turnaround plan?

RO: We started building our position last September at approximately $30 per share. Revenues tied to the auto business account for about 70% of the total, and we like, number one, that automobile consumers continue to demand more sophisticated entertainment systems, and number two, that Harman is proving to be the go-to provider. Through the downturn it took market share and it has announced several new-business wins, particularly in China and elsewhere in Asia. As they take share in an auto-sale market that continues to revive, the operating leverage built into the company should generate much higher profits.

With the shares now around $32.70, how are you looking at valuation?

RO: By 2011 or 2012, we believe the company on revenues of around $4.2 billion should be earning at a rate of maybe $3.50 per share. That's up from around $1 per share estimated for the fiscal year ending in June 2010, but only assumes the company gets back to 8-9% operating margins, vs. the 12% at which it's operated in the past.

If we're right about earnings, we think the business will deserve a multiple of 15x or so, which would translate into a share price of at least $50 in the next 18 to 24 months.

What's the downside if you're wrong?

RO: The balance sheet is in excellent shape, with net cash of $240 million. With all the operating efficiencies, we see $2 per share in earnings as a bad-case scenario, for which we'd expect the market – or an acquirer looking to buy what is truly a unique product portfolio – to pay at least a 14x multiple. That gives us a downside only in the high $20s.

You've made your name assessing the quality of earnings. In general, how high is that quality today?

RO: It's actually about as high as I can remember. That's partly a function of the market not being overly frothy – usually the higher the market goes, the more people stretch to justify their stock prices. Balance sheets today are very liquid and I'm as likely to find companies with free cash flow above reported earnings than below, which is not typically the case.

When we spoke last time, you said: "This is not nuclear physics, but the hard part is to stick to your guns when the crowd's running over you." Was that particularly hard this last time?

RO: It's never easy. We lost some longtime clients, one of which delicately referred to me as a "washed-up All Star" as the market was going down. It's not possible to avoid it eating at you emotionally when the market is going against you.

One critical thing I've learned, however, is that whenever I'm the least bit emotional, I don't make decisions. We can all feel the same emotions as the small investor – when you're in that state of mind, don't do a thing. VII

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