Olstein
The Olstein Funds

NOTES ON VALUE INVESTING

FINDING VALUE IN CORPORATE TURNAROUNDS

Corporate turnarounds are among the most intriguing of investment opportunities: They offer both the potential of market-beating performance and the satisfaction that comes with backing an underdog and then seeing it prevail—of finding value where others did not.

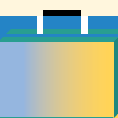
When following a corporate-turnaround investment strategy, an investor should possess high levels of both insight and foresight, a two-year supply of antacid and the psychological balance to withstand the highs and lows that develop along the road. And there will be highs and lows. Unfortunately, the risks of a turnaround-oriented investment strategy are just as notable as the potential. The fact is, many companies ultimately prove unable to respond effectively to the competitive, structural or financial changes that led to their decline in the first place.

The prudent investor should be aware that turnaround companies may represent potential value traps. While most industries and/or companies endure varying degrees of performance problems, many are not able to implement the changes needed to achieve a successful transformation that creates lasting shareholder value. Thus, before making a decision to invest, it is imperative to look for specific financial, competitive and structural characteristics that signal that the problems are temporary. And even companies that do reestablish their performance after an extended period of decline may find their stocks held back by negative market psychology.

Success Factors

When evaluating the investment potential of a company experiencing problems, first consider if the company is well positioned to achieve the type of transformation that creates shareholder value (a company's ability to return sustainable free cash flow). Start by analyzing these company-specific factors:

The core business. Determine whether the company has a viable core business and a sustainable competitive advantage that could enable it to thrive again. For many companies, decline occurs slowly over a prolonged period as its products, services or operating methods become less relevant to the market. The first step in analyzing whether a turnaround is a realistic possibility is to determine whether a company has a viable core business, but is struggling with temporary setbacks that can be addressed—or a core business that has experienced a serious decline with an uncertain outcome.



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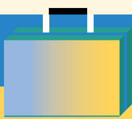
The balance sheet. A company's balance sheet must be healthy enough to withstand a rocky turnaround period. Strengthening the company's balance sheet and cash position is the first order of business for a turnaround, and can provide the company with valuable strategic options. To improve the balance sheet, companies embarking on a turnaround often take strategic actions that may have negative short-term implications. The short-term focus of market participants, especially Wall Street analysts, usually penalizes such actions (and heavily), even when they may be in the company's best long-term interests. The astute investor should try to take advantage of these short-term misperceptions.

Clean accounting. A thorough review of financial statements over the past three to five years can reveal if management has masked the scope and depth of the company's problems. During troubled times, it's extremely important to judge the quality of management by its commitment to the turnaround strategy as well as the conservatism and transparency of its financial reporting and how effectively it communicates the company's economic reality. Undertake an in-depth, forensic analysis of financial statements to determine if the company's accounting policies reflect the economic reality of the business. Assess the quality of the company's earnings, make accounting adjustments to eliminate management bias, and identify positive or negative factors that may affect future cash flow. If the company's financial statements, disclosures and related communications do not reflect reality or transparency, avoid the investment or look for a new management team to implement the turnaround.

What went wrong. An important part of analyzing a turnaround situation as a potential investment is to understand the severity of the company's problems. Some factors contributing to a decline may stem from the company itself, including weak top management; lack of management depth and expertise; a weak or uninvolved board of directors; unrealistic or creative accounting practices; failure to keep pace with market trends; poor allocation of capital; too much debt; or insufficient operating controls. Other problems may come from outside the company, such as economic shifts creating headwinds for the business, social change, technological change or government regulatory constraints. Carefully evaluate the many factors that may have contributed to a company's decline, determine the severity of these factors and assess what corrective measures the turnaround strategy must pursue to successfully redefine the business.

Management and decision making quality. Although articulation of a viable turnaround plan is important, management's actions are far more important. Judge the decision-making skills and leadership of a company's management team. Management must recognize the true extent of the company's problems and identify solutions that are in the best interests of shareholders. An inferential analysis of a company's financial statements and accompanying footnotes will help determine whether management's actions have resulted in real progress toward a turnaround. Analyze inventories, receivables, liquidity ratios, free cash flow statements, etc., looking for early warning of a positive change in earnings. A company that recognizes that senior management may lie at the root of its problems and is willing to reverse direction and make necessary changes to get back on track is more likely to undergo the type of transformation that will create shareholder value.

Free cash flow. Free cash flow is the lifeblood of a business, and this is especially true in turnarounds. The ability of management to take control over the cash flow pipeline and make vital internal investment decisions often determines the ultimate success of the turnaround strategy. A company's articulated strategy should demonstrate the ability to generate or greatly improve free cash flow in two years or less. Focus on how operations will be able to create sustainable free cash flow; the level of investment required to right the company and eventually grow the business; and how much cash should be available to investors as the company stabilizes.



AVOID COMPANIES THAT OFFER CORE PRODUCTS, PRICING STRUCTURES AND DISTRIBUTION MECHANISMS THAT ARE OUT OF SYNC WITH THEIR COMPETITIVE ENVIRONMENT.

Failures and Value Traps

Several factors will severely diminish a company's chance for achieving a successful turnaround. If you encounter one or more of them during your analysis, you may decide that the company's risk/reward profile is not suitable, or is likely to result in a classic value trap. Specific situations to avoid include:

Lack of transparency/poor governance. The cornerstone of a solid research process is the exhaustive analysis of financial statements, footnotes and other public disclosures and filings. If your research does not reveal a strong corporate governance structure; a commitment to accounting conservatism and transparency; and a willingness to portray the company's economic reality, you can reasonably assume that the company lacks the discipline needed to achieve a successful turnaround.

Ineffective management. Managements that are inconsistent, unwilling to judge their performance against previously stated objectives and too focused on temporary fixes cannot serve as catalysts for desperately needed change. Factors to consider when weighing the effectiveness of a management team include:

- they contributed to the company's decline;
- they exhibit poor decision- making and leadership skills;
- they lack the expertise needed to succeed in the company's market;
- they report to a weak, uninvolved board of directors.

Multiple turnaround attempts. Failed previous attempts to get a company back on track usually point to more serious problems that an investor should avoid, including a poorly conceived strategy, noncompetitive products and services or a lack of resources to implement change.

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Insufficient financial resources and controls. Companies that do not have a strong balance sheet may not survive a rocky turnaround period intact. If a company lacks significant resources or does not exert proper control over existing resources through cash flow analysis, debt restructuring, working capital improvements, meaningful cost reduction efforts, appropriate profitability analysis or elimination of "creative accounting," it is likely to undermine its chances for turnaround success.

Weak core products and services. The corporate graveyard is full of companies that failed to respond to dramatic changes in the economic, competitive or technological landscape. As a company fails to adapt, its products and services become less relevant to the market. Avoid companies that offer core products, pricing structures and distribution mechanisms that are out of sync with their competitive environment.

Why do some complex corporate turnarounds succeed, while others don't? Four characteristics increase the odds of a successful turnaround investment. First, a company has to identify realistic, achievable alternatives for correcting its course. It may need to redefine its business boundaries, strategy, operations, financial management and organizational structure. Second, the company must make a priority of stabilizing its operations. Third, it will need a capable, skilled management team—which probably will entail bringing in a new senior management team with specific turnaround skills. Fourth, investors should look for a stock priced at a significant discount (40% or more) to the company's private market value.

Even if these characteristics are in place, achieving the desired investment outcome requires commitment, discipline and patience. You may have to ride out intermittent periods of frustration and excitement as strategic alternatives unfold. In most cases, it can be 12 to 24 months or longer before a turnaround produces concrete positive results. Thus, an investor who's bought into a potential turnaround needs to stay the course during the intermittent periods of disappointment and negative psychology, while awaiting the strategic actions that will dispel the negative clouds.

The preceding commentary represents the opinion of the Manager and is not intended to be a forecast of future events, a guarantee of future results or investment advice. 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 by visiting the Fund's Website at www.olsteinfunds.com.

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