# What You Can Learn From Shareholder Letters

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### Article Highlights

- A thorough review of shareholder letters provides a way to judge the effectiveness of management's decisions and overall performance.
- Read for "heat"—looking for trigger words that may signal a noteworthy change likely to affect the company's cash flow.
- Also look for a realistic discussion of objectives and expectations and a discussion of the benchmarks management uses.

**One of the fundamental tenets of our investment philosophy at Olstein Capital Management is that a forensic analysis of a company's financial statements, regulatory filings and accompanying footnotes reveals the quality of a company's earnings, the success of its strategy, the sustainability of its performance and the impact of management decisions on future free cash flow. We believe that a forensic analysis of company balance sheets, income statements, and other regulatory filings is more useful when assessing a company's ability to produce future free cash flow than management forecasts, earnings forecasts, or company visits.**

While most investors usually pore over the pages and pages of financial data that companies provide, they often overlook or skim the Letter to Shareholders at the beginning of each annual report. Investors also often fail to adequately read earnings releases, conference call transcripts, the quarterly SEC filing Form 10-Q, other SEC filings (e.g., Form 8-K, proxy statements, etc.) and company press releases. These communications contain valuable information, some of which we uncover by "reading between the lines" looking for "heat" or other subtle messages. Shareholder letters and earnings-related reports usually discuss the company's recent performance and its future prospects and may provide a more detailed discussion of the strategy that management believes is the right course for the company to follow. A careful reading enables us to determine whether management emphasizes the importance of financial strength, cash flow, working capital controls and the company's competitive position within its industry. A good shareholder letter, in our opinion, describes how the company's strategic planning process anticipates and responds to the ever-changing economic, industry or competitive environment and thus provides insight into the quality of management and their commitment to creating meaningful shareholder value over time.

## The Importance of Reviewing Shareholder Letters in Today's Economic Environment

A thorough review of the shareholder letter has become indispensable for gaining insight into a company's priorities during the tumultuous economic environment of the past several years and provides a valuable way of judging the effectiveness of management's decisions and overall performance during these difficult times. Never has the adage, "when the going gets tough, the tough get going," been truer than during the past three years.

Over the past several years we have focused, first and foremost, on management's discussion of the company's financial strength and the potential of short-term decisions to materially affect longer-term value creation. We have sought to answer several related questions, including:

- In its letters to shareholders, does management adequately discuss the company's financial strength, debt levels, cash flow, working capital needs and cost controls? Does the discussion signal ongoing or growing problems with cash flow, cost controls, and ultimately, the company's financial strength?

- How does management discuss challenges to operations posed by the recession? Has management reacted to the changing conditions? Has the company favored across-the-board cost-cutting that may put the company at a strategic disadvantage during the economic recovery?
- In the face of recession, has the company continued to invest in or pulled back from initiatives that will improve its competitive position or operations during the economic recovery?
- Do measures undertaken within the past year reveal a significant break from the company's strategy from one, two, or three years ago?

The degree to which a company acknowledges the challenges posed by the recent recession, and discusses its response to those challenges, not only reveals a great deal about management's capabilities and credibility, but also highlights those management decisions or shifts in strategy that are likely to affect the company's future cash flow. These subtle shifts may generate investment ideas for further research, prompt a reassessment of our investment thesis for an existing holding, or signal a potential buying opportunity in a company that our research team has been following and monitoring for some time.

## Reading for "Heat": What We Look For

While the Great Recession has underscored the importance of undertaking a methodical reading of shareholder letters in order to identify and understand factors that may affect future free cash flow, we believe investors should adopt this practice in all market environments and under all economic conditions. Whether we are grading the performance of an existing company in our portfolio or monitoring a company we have been following as a potential investment, we read shareholder letters for "heat"—looking for trigger words that, in our experience, may signal a noteworthy change likely to affect the company's cash flow and thus its future value. We also look for a degree of consistency with prior communications, a realistic discussion of the objectives and expectations for company performance, and a discussion of shareholder-focused benchmarks that management uses to judge its performance. It is important for us to see a frank discussion of either the key issues a company faces or the problems it needs to solve. When there are no references to problems or issues that management believes are important, we become concerned that management may be stonewalling or has an unrealistic view of its business environment.

### Continuity

To understand what management emphasizes, minimizes or omits in a shareholder letter, develop an appropriate historical context by reading a succession of letters from the previous three to five years and evaluate the continuity of management's communications from year to year. Within the past several years, has management articulated a clear strategy that it believes the company should pursue? Are there marked shifts in the discussion of strategy or approach to management from year to year? Are there significant inconsistencies in content or messages from year to year? And most importantly, are there changes in direction or strategy from previous years that can have a material impact on future revenues, costs and free cash flow?

### Realistic Expectations

It is important to assess the overall tone of the letter and judge how candidly management discusses issues facing the company. A careful reading of the shareholder letter should not only focus on what management chooses to emphasize (i.e., the company's successes and its challenges or missteps) but also what management chooses to omit or minimize. Are management's projections regarding future growth reasonable and achievable? Does management provide a realistic understanding of the company's growth prospects and role within its industry based on changes taking place in the economic or industry environment? Does the language in the chairman's or CEO's letter effectively describe strategic challenges the company faces? Do discussions of future plans acknowledge past problems or failures?

### Appropriate Benchmarks

We pay special attention to how management frames its financial results and discusses progress toward previously stated goals and objectives. It is also important for management to discuss operating results in the context of the company's strategy. Does management define specific benchmarks for judging its success and are those benchmarks suitably rooted in the company's financial performance? Does the shareholder letter adequately discuss how the company uses its capital and place the appropriate emphasis on returns on invested capital? How do the company's results stack up against its peers?

## Building the Big Picture to Support Investment Decisions

To fully appreciate and evaluate a company's strategy and performance, understand that shareholder letters and other communications from management represent one part, albeit an integral part, of an investor's due diligence process. A series of thoughtful, honest, credible letters alone shouldn't lead to an investment or stock purchase. Rather, it should generate further research and analysis focused not only on the company's most recent performance but also on projections for future performance and why management believes the company can achieve those projections.

When evaluating shareholder letters and other communications, an investor should understand and evaluate the company's strategy and build a framework for judging management's ability to effectively execute that strategy. The reason for owning a company's stock must be in the forefront of an investor's

## Analyzing Results and the Quality of Earnings

Here is a sampling of the forensic analysis we undertake to analyze a company's results and the quality of its earnings for valuation purposes.

1. Using the company's cash flow statements, we begin by reconciling the difference between free cash flow and reported earnings under accrual accounting. (Accrual accounting records revenues, expenses and income when the transaction occurs, as opposed to when the cash is actually received or spent.) The smaller the difference between free cash flow and reported earnings, the higher the quality of earnings.
2. Our next step is to look at a company's footnote on taxes, which reconciles the differences between earnings reported to shareholders under accrual accounting and earnings reported to the IRS under the cash basis of accounting. The lesser the difference, the higher the quality of the company's earnings. We are skeptical if the company reports strong earnings growth but is not paying much more in taxes.
3. We then analyze receivables and inventories to determine changes in each relative to changes in sales. Inventories or receivables increasing faster than sales could be early warning alerts of future slowdowns.
4. We always compare depreciation provisions to capital expenditures when assessing sustainable free cash flow, the potential for future growth and management's ability to create shareholder value.
5. The next step in our quest to measure the quality of earnings is to look for non-recurring factors that have contributed to or reduced earnings. We measure whether or not earnings have been helped or hindered by monitoring historical changes in reserve accounts or determining whether bad debt provisions are temporarily above or below normalized amounts.
6. Balance sheet ratios, especially relating to debt and returns on equity, are carefully assessed to determine a company's ability to withstand temporary problems or an economic downturn without adopting harmful short-term strategies.
7. A final important factor that we consider is the repetitiveness of so-called non-recurring losses, which we believe represent corrections to historical financial statements.

mind when validating the content of the company's shareholder communications. Only then will an investor be able to identify subtle strategic shifts that may alter the risk/reward profile of an existing investment or change the underlying thesis for an investment.

As investors who are doggedly focused on free cash flow, we read shareholder letters looking to answer two key questions: (1) what positive or negative factors arose during the reporting period that may affect future free cash flow; and (2) is management deploying the company's free cash flow in ways that will benefit long-term shareholders? We also look for clear evidence that key elements of our investment thesis demonstrated the progress we anticipated for the reporting period. Absent such progress, we expect management to address the problems or issues that affected the company's performance, specifically those investment metrics that form the foundation of our thesis. For us, a truly informative letter—instead of one that is simply well-written—not only provides a frank discussion of the company's operating results and those factors that hindered or helped free cash flow, it also explains management's decisions regarding the use of cash. This allows an investor to measure management's progress regarding the company's stated goals and determine if management decisions regarding deployment of the company's cash align with the investor's reasons for owning the company's stock.

### Do the Numbers Tell the Same Story?

Our review of shareholder letters depends greatly on our forensic analysis of company balance sheets, income statements, and other regulatory filings. For us, the story told through a company's ongoing communications—in shareholder letters, earnings announcements and press releases—must correspond to the story that emerges from financial statements and regulatory filings. Investors should be wary of the overly upbeat, promotional language that characterizes many shareholder letters. Conversely, some shareholder letters may use vague language as a way of avoiding the specific nature of setbacks or serious problems. To cut through the gloss or public relations spin that may characterize a shareholder letter, one must continually review a company's quarterly 10-Q filings as well as company announcements and press releases.

Form 10-Q, also known as a quarterly report, is a specific filing required of all U.S. publicly traded companies that, although unaudited, must conform to specific SEC reporting requirements. Through Form 10-Q, a company reports financial results for the previous three months as well as any significant changes or events during the previous quarter. Information for the final quarter of a firm's fiscal year is included in the annual 10-K, so only three 10-Q filings are made each year. Forms 10-Q and 10-K contain financial statements, a management's discussion, and a list of material events that have occurred with the company (such as a stock split or acquisition). Since companies must file 10-Qs within 40 days of the end of a fiscal quarter (companies with total value of publicly traded shares below $75 million have 45 days to file), they afford investors a timely opportunity to examine a company's latest financial results and uncover clues about how business is going.

We undertake a thorough analysis of a company's 10-Qs and 10-Ks as part of our process for monitoring a current or potential investment and re-value each company we follow based on the financial statements provided in the quarterly report. Through our analysis of 10-Qs, we determine the quality of a company's earnings and the economic realism of management's assumptions. We seek to eliminate management's reporting biases by making the appropriate adjustments to reported earnings data for input into our valuation models.

After examining the company's earnings, revenues, units sold, debts, expenses and other key performance metrics to determine if they are in line with management's projections, an investor should refer to the Management's Discussion and Analysis section of the 10-Q and 10-K for an explanation of why the company was able or unable to meet its objectives for the reporting period. Anything out of the ordinary that happened during the quarter should also be detailed in Management's Discussion and Analysis. In many respects this section of the 10-Q and 10-K provides one of the best ways to substantiate the content of the chairman's and chief executive officer's letters in the annual report since it analyzes the company's most recent results in relation to prior periods and discusses management's current outlook.

Given the SEC's expectation that a company's Management's Discussion and Analysis should present an explanation of a company's financial statements that enables investors to see the company through the eyes of management, the discussion in this section often provides valuable information about the quality and the potential variability of a company's earnings and cash flows. Such discussions are usually more forthright than the glossier content of the chairman's or CEO's letters to shareholders and should be used to verify or supplement the story that emerges from those letters.

## Conclusion

While the cornerstone of a solid research process is an exhaustive analysis of 10-Qs, 10-Ks, footnotes and other public disclosures and regulatory filings, we believe an inferential reading of the shareholder letter, especially those parts that can be verified by the financial data contained later in the annual report or in other regulatory filings, is one of the best ways to assess the quality of a company's earnings and identify subtle strategic shifts that could indicate future changes in base earnings power.

When approached with a healthy combination of skepticism and enthusiasm, a thoughtful review of shareholder letters and publicly available documents can not only help an investor avoid overvalued situations, but also be used to uncover undervalued gems. ➤

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