

# THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

## Analyzing a Company's Ability to Generate Free Cash Flow



**ERIC R. HEYMAN** is Executive Vice President, Portfolio Manager and Director of Research of Olstein Capital Management, L.P., and Portfolio Manager of the Olstein Strategic Opportunities Fund and Olstein All Cap Value funds. Previously, he was an accountant with Norstar Energy, a subsidiary of Orange and Rockland Utility. He received a degree in accounting from Pace University.



**TIMOTHY S. KANG**, Senior Vice President and Senior Research Analyst, joined Olstein Capital Management, L.P. in April 2006. Previously, he held the position of Vice President/Equity Research Analyst with Citigroup Asset Management, covering Asia ex-Japan financial companies and assisted in covering U.S. banks. Prior to Citigroup, Mr. Kang was an Assistant Vice President at PPM America, where he was a member of the high yield bank loan team working on private bank loan transactions. Before that, he was a senior auditor at Arthur Andersen, LLP. Mr. Kang holds an M.S. in accountancy from DePaul University and a B.S. in speech with a concentration in economics from Northwestern University in Evanston, Illinois.

### SECTOR — GENERAL INVESTING

**TWST:** Could you tell me a little bit about the firm?

**Mr. Heyman:** Sure. At Olstein Capital Management, we are value investors who look for solid businesses that have been unfairly punished by short-term factors, whether that's an earnings miss, poor management decisions, regulatory challenges or overall negative market sentiment. We consistently find that many small-to-midsize companies face strategic challenges often as a result of unrealistic expectations for growth, or they fall below investors' radar because they are underfollowed by Wall Street.

We believe free cash flow is the primary determinant of a company's value as an ongoing enterprise. We identify solid businesses and determine the extent of challenges a company faces by focusing on its ability to generate free cash flow. For every potential investment, we undertake a detailed forensic analysis of shareholder communications, company financial statements, public filings and footnotes to determine the quality of a company's earnings. Due to our emphasis on the quality of earnings, we make adjustments to reported earnings to eliminate

management biases. Our process helps us identify positive and negative factors that we believe may mask or obscure the company's true cash flow potential.

**TWST:** And does the firm have an overarching investment philosophy?

**Mr. Kang:** Yes. In addition to the process Eric just described, we believe there are three factors that differentiate our fund, the Olstein Strategic Opportunities Fund, from its smid peer group: first, our focus on turnaround situations and companies facing strategic challenges; second, our emphasis on the quality of earnings and an intensive company-specific analysis of financial statements and public filings; and third, our in-depth assessment of the company's ability to generate free cash flow.

When most investors think of investing in small- to midcap-sized companies, they tend to think of fast-growing companies or finding the next high flyer. While it's great to find that one success story, the reality is that most companies misstep as they grow. So we're focused on a different type of company, those small-to-midsize, or smid, companies with strong products

or services that have stumbled — usually due to Wall Street's demands for constant growth. Our approach to finding value in companies with temporary issues or companies that need an operation turnaround makes us very different from our peers in the smid space.

The second factor that differentiates us is our emphasis on the quality of earnings. One of the fundamental tenets of Olstein's investment philosophy is that in today's world of information overload, a forensic analysis of a company's financial statements, regulatory filings and accompanying footnotes is the best way to determine 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 sheet, income statements and other regulatory filings is more useful when assessing a company's ability to produce free cash flow than management forecasts, earnings guidance or personal visits.

Lastly, our in-depth analysis and valuation approach, which focuses on a company's ability to generate free cash flow, allows us to identify a great many investment opportunities often overlooked by the market. We also believe that this critical element of our analytical process becomes especially important during periods of excessive market volatility. Our ability to identify and focus on those factors likely to affect the company's future prosperity — its future free cash flow — keeps us from getting caught up in the excessive noise and fear that characterizes turbulent market environments. We filter a great deal of noise, mainly the onslaught of market and top-down economic news, forecasts and data, by focusing on the resiliency of a company's business model during both favorable and unfavorable economic environments.

**TWST: Did you want to highlight a company that you find interesting now?**

**Mr. Heyman:** The first one is **Blue Bird** (NASDAQ:BLBD). **Blue Bird** is an iconic brand and is a leading independent designer and manufacturer of school buses, serving the U.S. and Canadian markets. They have over 30% market share across their product suite. They are also growing their overall market share as the dominant player in the alternative fuel space, where they have 70% market share.

School buses are America's largest mass transit system, transporting 26 million kids to schools on a daily basis on

550,000 buses. We see several positive forces driving earnings growth over the medium term. The housing price recovery is driving higher school tax revenues, which benefits **Blue Bird's** key customers. There is growth in student enrollment, as well as an aging fleet of buses out there that need to be replaced.

The average age of the fleet is around 12 years versus the long-term average of nine years. In fact, there are 150,000 buses on the road right now that are over 15 years old. We see a compelling need for growth in production because the average age of buses in service will continue to increase unless annual unit production surpasses to more than 46,000 per year versus the current production of 35,000.

In addition to the cyclical growth, the real story here is that **Blue Bird** is the leading player capitalizing on the secular growth of alternative fuel, propane-powered buses. These buses are significantly cheaper to operate and maintain as well as cleaner-

operating vehicles than buses with traditional diesel engines. They also have offerings in gasoline, compressed natural gas and, most recently, electric.

### Highlights

*Eric R. Heyman and Timothy S. Kang discuss Olstein Capital Management, L.P. and the Olstein Strategic Opportunities Fund. Mr. Heyman and Mr. Kang are value investors. They look for solid smid businesses that have been unfairly punished by short-term factors. Mr. Heyman and Mr. Kang believe free cash flow determines a company's ongoing value. Their in-depth analysis of a company's ability to generate cash flow allows them to identify opportunities that are overlooked by the market.*

*Companies discussed: Blue Bird Corp. (NASDAQ:BLBD); Ford Motor Company (NYSE:F); Cummins (NYSE:CMI); Home BancShares (NASDAQ:HOMB); Prestige Consumer Healthcare (NYSE:PBH); Hain Celestial Group (NASDAQ:HAIN); PepsiCo (NASDAQ:PEP); Campbell Soup Company (NYSE:CPB); Dine Brands Global (NYSE:DIN) and Choice Hotels International (NYSE:CHH).*

1-Year Daily Chart of Blue Bird Corp.



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

As I stated before, they have over 70% share of the alternative fuel bus market. Less than 15% of school districts have even purchased alternative-fuel-powered buses at this point. So there is a long secular runway. Some 38% of their sales in 2018 were alternative fuel buses, with the remaining being traditional diesel vehicles. They have exclusive relationships with **Ford** (NYSE:F) and **ROUSH CleanTech** for propane and gas

engines and transmissions, and a deal with **Cummins** (NYSE:CMI) in the electric space.

Despite the inherent seasonality of school bus deliveries, the company has been a consistent free cash flow generator over the years, which will allow them to continue to repay debt, buy back stock and grow their business. We think the company has earnings power of \$1.75 per share and free cash flow of around \$1.50 per share after capital expenditures, leading to a company that we believe is worth somewhere around \$28 a share. The company currently is selling at around \$19.

**TWST: And do you think there's the will in communities to go for some of these alternative-type buses?**

**Mr. Heyman:** Absolutely. We're seeing greater demand for green technologies as well as greater concern for the environment. I think that it's definitely something that communities and districts want to pursue.

***"From a macroeconomic perspective, we find that the company's end markets are attractive, with total health care spending expected to reach nearly \$5 trillion by 2021, which is about an annualized 5% growth rate from current levels. Additionally, we believe that an increasing percentage of consumers are opting for home remedies as an effective lower-cost option."***

**TWST: And did you want to mention a second company?**

**Mr. Kang:** The second company is **Home BancShares** (NASDAQ:HOMB). It's a regional community bank group, operating out of Arkansas, and has branches in Florida, Alabama and other areas. The bank has about 170 branches currently. The company historically has taken advantage of FDIC-assisted acquisitions and other types of distressed situations to add branches and books of business to expand its customer base and geographic footprint.

The bank operates with a higher-touch neighborhood banking strategy, relying on local knowledge and relationships, and gives each regional management team relative autonomy with lending authority, but with companywide tools and risk monitoring. We believe that this strategy allows for better customer service, more robust credit monitoring and multiproduct relationships. We also believe that this strategy allows for stronger organic growth and deposit growth than its peer group with a normalized growth rate expected to be in the mid-single digits. Also, the company operates with an underlevered balance sheet with adequate credit reserves covering nonperforming and delinquent assets.

So when we saw that there was a softness in earnings due to storms in Florida, we saw a discount in the stock. The company did the right thing for the local community, meaning the bank issued deferments on loans and other things in the impacted areas, but had to take some reserves against those possible losses, eating into earnings. However, we found that this was an

opportunity to actually purchase the stock. And we believe that as Florida and adjacent areas continue to recover and the company continues to execute with its locally minded business model, the intrinsic value gap should close. We believe **Home BancShares** has earning power of \$1.85 or more, and the stock is worth more than \$30, currently trading at \$20.

**TWST: Do you think the bank might be doing some mergers and acquisitions in the future, or is it going to basically grow organically or possibly stay about where it is now in size?**

**Mr. Kang:** We believe with its underlevered balance sheet, you have a lot of options, including small bolt-on acquisitions as well as the capital to grow organically. So we gravitate toward stronger balance sheets, and that's the kind of optionality this bank has with either one of those avenues of growth.

**TWST: And did you want to mention another company?**

**Mr. Kang:** **Prestige Brands** (NYSE:PBH) is an over-the-counter health care company with highly recognizable products, covering a broad spectrum of health care needs from feminine care, eye care, dental care and various pain remedies. The brands include Clear Eyes, Chloraseptic, Sucrets, Efferdent, Monistat, Summer's Eve and more. We like the business model because its products are lower priced and consumable, and the company itself has low capital requirements as the manufacturing is largely outsourced.

From a macroeconomic perspective, we find that the company's end markets are attractive, with total health care spending expected to reach nearly \$5 trillion by 2021, which is about an annualized 5% growth rate from current levels. Additionally, we believe that an increasing percentage of consumers are opting for home remedies as an effective lower-cost option. For instance, instead of making an appointment and going into a doctor's office for a prescription, a patient would go to a local pharmacy or purchase online an over-the-counter medicine to treat their allergy or cold or some other ailment. These items are cheaper than the copay for a doctor's visit, and treatment could start immediately. Over the long term, we feel like these secular forces bode well for the suite of products at **Prestige**.

The key controversy in the stock is the inventory shift from brick and mortar to online. Distributors are managing down inventory levels as this shift is occurring, leading to recent underwhelming sales growth for **Prestige**. However, we believe

these issues are temporary, and the end-market brand and consumption levels remain healthy. So as the company's sales better reflect the underlying consumption levels, we believe the company will resume its steady cash flow generation that we expect to be used for advertising, product innovation and debt paydown. We believe that when this happens, our intrinsic value of more than \$43 will be realized.

**1-Year Daily Chart of Hain Celestial Group**



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

***“However, once the company has streamlined its portfolio and demonstrated the ability to grow organically, the business becomes an attractive takeover target for a larger consumer packaged company looking for growing brands to add to their portfolio in the health food space.”***

**TWST:** And in some ways, because it's in the health care sector, if there were a correction or something worse in the market, would this be somewhat of a defensive stock because people are still going to need health care products, even if the economy gets corrected or is going through some changes?

**Mr. Kang:** Yes, that's certainly a consideration and a strength of the company. Consumption of its products isn't dependent on economic swings. We're not saying that it's countercyclical, but it certainly has a far steadier revenue stream potential than a very economically sensitive company.

**TWST:** And did you want to mention another company?

**Mr. Heyman:** Hain Celestial (NASDAQ:HAIN) is a classic Olstein turnaround situation. Hain is one of the first movers in the healthy organic foods and snacks space. The portfolio of brands currently stands around 55 with approximately 20 brands that have number one or two market position in their respective category. Core brands include Celestial Seasonings tea, Terra Chips, BluePrint juices, Arrowhead Mills and Earth's Best.

Hain was founded by a charismatic, hard-charging entrepreneur named Simon Irwin, who built the company through acquisitions over several years. However, as the company grew, so did its operating and financial complexity. The company outgrew its original infrastructure and the skill set of its entrepreneurial

leader. This led to inefficiencies in several areas, including management, marketing, financial controls, cost structure and distribution. It became clear that someone with a greater focus on operational controls, distribution and attention to detail would be necessary to take the business to the next level.

As expected, Mr. Simon stepped down and was replaced by Mark Schiller, an industry veteran with prior experience at PepsiCo (NASDAQ:PEP) and who was most recently the Chief Commercial Officer at Pinnacle Foods. Often, founder-led businesses can find themselves hamstrung when the founder steps down but stays on the board, which can prevent the incoming CEO from pursuing new strategies. Irwin's departure from the board was a key signal to us that the incoming CEO would have the latitude to make changes, however drastic, to turn around the business.

Mr. Schiller started to add fresh blood in key management roles and recently reset earnings expectations, clearing the decks for a turnaround. He intends to build off the Project Terra cost-cutting program that was put in place under Simon Irwin and will additionally look to divest noncore brands, rationalize SKUs and more efficiently spend on growth initiatives for core brands. For us, a back-to-basics strategy is a tried-and-true plan in revitalizing a

consumer packaged goods company, a strategy that was also used at Snyder's-Lance, a former Olstein holding, before they were acquired by Campbell Soup (NYSE:CPB) in March of 2018.

The company, in our view, is materially underearning from a margin perspective, both on an absolute basis and relative to its peers. We see a smaller, more focused company with a higher margin profile as the turnaround takes hold. We see normal earnings power of \$1.50 using the current sales base and north of a 10% EBIT margin. Assuming the company can return to low-single-digit growth, we estimate an intrinsic value north of \$25, with the company currently selling at \$19.

However, once the company has streamlined its portfolio and demonstrated the ability to grow organically, the business becomes an attractive takeover target for a larger consumer packaged company looking for growing brands to add to their portfolio in the health food space. Based on a private market value and comparable transactions, Hain could be worth \$40 a share in a transaction.

**TWST:** Does there continue to be interest by consumers to get healthier options for foods and snacks?

**Mr. Heyman:** Absolutely. I mean, the market has become more competitive, but I think that there is a clear direction in favor of health and wellness across all demographics.

**TWST:** And do you want to mention one final company?

**Mr. Heyman:** Sure. The last one is **Dine Brands** (NYSE:DIN). It's one of the largest full-service restaurant companies in the world through their two very well-known brands: IHOP and Applebee's. Outside of a recent strategic purchase of 69 Applebee's stores from an underperforming franchisee, the company operates an entirely franchised business model. IHOP is an iconic restaurant in the family dining segment and is known for their pancakes, while Applebee's is the leader in the casual dining segment with a focus on being the local neighborhood bar and grill destination. So both IHOP and Applebee's are number one in their respective categories, with over 1,800 stores in each concept.

While IHOP has been a steady performer over the past several years, Applebee's has struggled to improve traffic and move same-store sales in a positive direction. That's the opportunity. The company suffered from industry pressures as well as brand-specific issues that resulted from menu changes that alienated their core customer base. This led to a complete overhaul of management.

**Dine Brands** hired an industry veteran, John Cywinski, to turn Applebee's around, who did a great job when he was at the company 10 years prior. The company also named Steve Joyce as CEO. Steve served as a **Dine Brands** board member with intimate knowledge of the company's issues when he was chosen as CEO. He was previously CEO at **Choice Hotels** (NYSE:CHH).

To improve results, they worked on every touch point of the brand to set it apart from the crowd and become a destination in the neighborhood grill and bar market. This included guest experience, simplifying the menu and kitchen operations, food quality, building on the bar and beverage business, building a to-go business and improving the back-to-basics marketing message as well as their value proposition. With the help of their smart and resilient franchisee partners, the changes have begun to resonate with their customers, and they are enjoying increasing same-store sales momentum.

As a franchisor, **Dine Brands** generates substantial free cash flow that is far less volatile than restaurant-level operators coupled with a solid dividend, equating to about 2.8% yield. We believe the earnings and free cash flow power is north of \$7, and the business is worth around \$130.

**TWST: Is there anything that might happen with the company in the next year or two that investors might be curious about?**

**Mr. Heyman:** I think that the back-to-basics strategy that they're continuing to build on is what's going to drive the stock price to the company's intrinsic value. I think it's this back-to-basics message and connecting with their customer base that are keys to a successful turnaround. When you have a business like this, you have to continue to produce offerings or have offerings that are going to drive customers into your stores.

**TWST: Changing direction a bit, at the end of last year, we saw a correction in the market. What impact do you**

**think that has on investors now as they look to the rest of this year and into next year?**

**Mr. Heyman:** I would say that one of the big-picture things we're starting to see is a return to thoughtful stock selection and, more specifically, value investing, which we believe will continue in 2019. It's not so much a shift from one style of investing to another, a shift from growth to value, but an emphasis on stock selection, a move to a more rational approach to evaluating a company's operations and future prospects. We think more investors will start to question the market's emphasis on topline growth and momentum and look at a company's ability to generate free cash flow.

**TWST: Is there anything we didn't talk about you care to mention, either about the firm or some trends out there?**

**Mr. Kang:** A couple of trends that we're seeing in the smid space. From our perspective, there are always shifts in sentiment or economic headwinds that usually hit the stocks of smaller companies much harder than larger-cap companies. Right now, we think the smid space is compelling. We're seeing deep discounts of approximately 30% in the smid space with free cash flow yields of 10% to 12%. And we think smid companies will be ongoing beneficiaries of changes in tax policies and have less direct exposure to trade wars and a strengthening U.S. dollar.

Also, it's not so much trends or shifts in sentiment that impact the type of smid companies that we invest in; rather, it's a prevailing mindset of many investors that favor fast-growing companies, looking for constant topline growth. And as I said before, when most investors think of investing in small-to-midsize companies, they think of fast-growing companies, finding the next high-flying concept or technology. This emphasis on growth, frequently growth at any cost, creates a lot of investment opportunities in good companies that have temporarily stumbled in pursuit of that growth.

This becomes especially true during periods of increased market volatility. When the stocks of these good companies fall, sometimes quite a bit, it creates interesting opportunities with significant upside potential, and we're always looking for those types of opportunities.

**TWST: Thank you. (ES)**

**ERIC R. HEYMAN**  
**EVP, Portfolio Manager & Director of Research**  
**TIMOTHY S. KANG**  
**SVP & Senior Research Analyst**  
**Olstein Capital Management, L.P.**  
**4 Manhattanville Road**  
**Purchase, NY 10577**  
**(800) 799-2113 — TOLL FREE**  
**www.olsteinfunds.com**  
**email: info@olsteinfunds.com**

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*An investment in a portfolio containing small- and mid-cap companies, particularly those facing strategic challenges, 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. These stocks could also experience less liquidity and higher share price and trading volume volatility than stocks of other companies.*

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