A BUSINESS LOVE STORY

What is a good business, what's a mediocre business, what's a bad business and why?
"Time is a friend of the good business and the enemy of the mediocre." –Buffett

A) Business Love Story

In 1983, the smartest investor in the world fell in love with one of the smartest businesswomen in the world. His name was Warren. He was 54. Her name was Rose. She was 90.

He gave her a check for $55 million and she gave him 90% of her life's biggest achievement--the Nebraska Furniture Mart ("NFM").

"Our evaluation of the integrity of Mrs. B and her family was demonstrated when we purchased 90% of the business: NFM had never had an audit and we did not request one; we did not take an inventory nor verify the receivables; we did not check property titles. We gave Mrs. B a check for $55 million and she gave us her word. That made for an even exchange."

Buffett ("WB") had this to say about Ms. Blumkin a few years later:

One can be successful in business if they have desire and energy. Any IQ over 125 is wasted in business or investments. WB visited Wal-Mart last week in Bentonville, Arkansas (Wal-Mart headquarters). At Wal-Mart ordinary people are doing extraordinary things. Susan Jacques is the CEO of Borsheim's Jewelry (a Berkshire Hathaway company). **She lacks a college degree**, but her leadership has energized her employees. Rose Blumkin (Mrs. B) (started Nebraska Furniture Mart – now a Berkshire Hathaway company) was a Russian émigré who did not speak any English. She learned the language from her 5-year old daughter who would teach her mother the English words she learned that day in school. **Business schools should study Mrs. B.** *(But, of course, they don't!)* Her business today has revenues of $350 million. Mrs. B could outperform the CEO of any Fortune 500 company. She loved her work so much, that she kept price tags on her furniture at home to remind her of her business. WB discourages his top managers from retiring by telling them that Mrs. B died one year after she retired (at age 103**). If you told Mrs. B the dimensions of a room in feet, she could immediately tell you how many square yards of carpet it needs.** She even successfully defended herself in court when a competitor sued her for charging prices that were too low. She told the judge that she paid $2 per sq. yd. for a carpet, and sold it for $3.98 per sq. yd. (vs. $5.98 for a competitor). She told the judge that if she raised prices she would be robbing her customers. "*How much should I rob my customers?"* The judge dismissed the case.

Price Paid

Buffett's purchase price values the business at $61 million in 198. If Buffett bought 90% of the business for $55 million then the balance of 10% is priced at 5.5 million for a total of $60.5 million.

In 1983 earnings before taxes were $3.8 million and earnings after taxes were $1.5 million.

Pre-tax paid by Buffett was 16 times

Post-tax P/E paid by Buffett was 41 times

Did he overpay?

By 1993 NFM was earning pre-tax profits of $21 million.
This translates into a 34% earnings yield on original valuation of 61 million.

Today, NFM is the largest and the most profitable furniture retail business in USA.

*Obviously, Buffett was focused on the **future earnings and cash flows** of the business not what it HAD earned. But what gave him such confidence? He had probably observed Ms. Blumkin and her store for many years. Buffett will tell us further on in this discussion.*

MUNGER ON CAUSES OF EXTREME SUCCESS

"Extreme success is likely to be caused by some combination of the following factors:

1. Extreme maximization or minimization of one or two variables. Example, Costco or our furniture and appliance store (NFM with sales per square foot)
2. Adding success factors so that a bigger combination drives success, often in nonlinear fashion, as one is reminded by the concept of breakpoint and the concept of critical mass in physics. Often results are not linear. You get a little bit more mass, and you get a lollapalooza result.
3. An extreme of good performance over many factors. Example, Toyota or Les Schwab.
4. Catching and riding some sort of big wave. Example, Oracle."

WHY IS NFM A WONDERFUL BUSINESS?

Buffett's 1983 Letter:

"Today NFM generates over $100 million of sales annually out of one 200,000 square-foot store or $500 per square foot. No other home furnishings store in the country comes close to that volume. That single store also sells more furniture, carpets, and appliances than do all Omaha competitors combined. (Why are sales per square foot important?)

"One question I always ask myself in appraising a business is how I would like, assuming I had ample capital and skilled personnel, to compete with it. I'd rather wrestle grizzlies than compete with Mrs. B and her progeny. They buy brilliantly, they operate at expense ratios competitors don't even dream about, and they then pass on to their customers much of the savings. It is the ideal business—one built upon exceptional value to the customer that in turn translates into exceptional economics for its owners."

The Wal-Mart Model

Feedback loop: low prices as reflected by low margins attract more customers to the stores, which enables the stores to generate high sales per square foot (high asset turnover ratios), and get scale advantages in the form of low prices from suppliers, which are passed on to the customers in the form of low prices.

Buffett's 1984 Letter:

"Last year NFM's net sales increased by $14.3 million, bringing the total to $115 million, all from the one store in Omaha. That is by far the largest volume produced by a single home furnishings store in the United States. In fact, the gain in sales last year was itself greater than the annual volume of many good sized successful stores. The business achieves this success because it deserves this success. A few figures will tell you why.

"In its fiscal 1984 10-K, the largest independent specialty retailer of home furnishings in the country, Levitz, in that year, operated at a gross margin of 44.4% (that is, on average, customers paid it $100 for merchandise that had cost it $55.60 to buy).

"The gross margin at NFM is not much more than half that. NFM's low mark-ups are possible because of its exceptional efficiency: operating expenses (payroll, occupancy, advertising, etc.) are about 16.5% of sales versus 35.6% at Levitz. (If NFM's gross margin is 20% then if pays $55 for furniture, the price to consumers is $66 or a whopping $34 less (34%) than Levitz). NFM has a HUGE pricing advantage over its competitors.

"Such savings enable NFM to constantly widen its geographical reach and thus to enjoy growth well beyond the natural growth of the Omaha market." Buffett saw that NFM essentially had a monopoly within its geographical reach—that could expand due to its reputation of large variety and extreme savings.

Buffett's 1989 Letter

NFM and Borsheim's follow precisely the same formula for success:

- Unparalleled depth and breadth of merchandise at one location;
- The lowest operating costs in the business;
- The shrewdest of buying, made possible in part by the huge volumes purchased;
- Gross margins, and therefore prices, far below competitors', and
- Friendly personalized service with family members on hand at all times."

ARE THERE "FUNCTIONAL EQUIVALENTS" OF NFM?

Dell (in the PC era), GEICO, Wal-Mart, Costco

"There's nothing esoteric about GEICO's success: The company's competitive strength flows directly from its position as a low-cost operator. Low costs permit low prices, and low prices attract and retain policyholders. The final segment of a virtuous circle is drawn when policyholders recommend us to their friends. GEICO gets more than one million referrals annually and these produce more than half of our new business, an advantage that gives us enormous savings in acquisition expenses--and that makes our costs still lower." –Buffett.

Wal-Mart vs. Costco

Availability
Membership
Markups
Payroll costs

Measures of Economic Performance

Growth in revenues?
Market share?
Growth in Profits?
Growth EPS?

Buffett does not care much about growth in EPS unless capital is earning above its true cost of capital. As he says, "The lack of skill that many CEOs have at capital allocation is no small matter: After ten years on the job, a CEO whose company annually retains earnings equal to $10 of net worth will have been responsible for the deployment of more than 60% of all the capital at work in the business.

Years	**$100.00**	**Net Worth**
1	$10.00	Retained
2	$11.00	Retained
3	$12.10	Retained
4	$13.31	Retained
5	$14.65	Retained
6	$16.10	Retained
7	$17.70	Retained
8	$19.48	Retained
9	$21.43	Retained
10	$23.57	Retained
	$159.34	Total Capital

MEASURES OF ECONOMIC PERFORMANCE

"The primary test of managerial economic performance is the achievement of a high earnings rate on equity capital employed (without undue leverage, accounting gimmickry, etc.) and not the achievement of consistent gains in earnings per share. In our view, many businesses would be better understood by their shareholder owners, as well as the general public, if managements and financial modified the primary emphasis they place upon earnings per share, and upon yearly changes in that figure." –Buffett

Buffett on Best Businesses

"The business is wonderful if it gives you more and more money every year without putting up anything-or by putting up very little. And we have some businesses like that.

A business is also wonderful if it takes money, but where the rate at which you re-invest the money is very satisfactory.

Buffett on Worst Businesses

The worst business of all is the one that grows a lot, where you are forced to grow just to stay in the game at all and where you are re-investing the capital at a very low rate of return."

QUESTIONS TO ASK:

Why is this company earning high returns on capital?

Quantitative answer lies in the DuPont formula
High margins and high capital turnover (low capital intensity) – ITC's tobacco business.
High margins and low capital turnover (high capital intensity e.g. shipping)
Low margins and high capital turnover e.g. Wal-Mart but see what happened to IBP.

What models combine to produce its extraordinary profitability and/or scale?

WHY would it continue?

HOW LONG can it last?

Is this a fluke, a short-lived first mover advantage, or is it likely to last very long?

What forces will cause these results to stop occurring? (Backward thinking).

MOATS

"What we're trying to find is a business that for one reason or another-because it's the low cost provider in some area, because it has a natural franchise due to its service capabilities, because of its position in the consumer's mind, because of a technological advantage or any kind of reason at all—has this moat around it.

"However all moats are subject to attack in a capitalistic system. If you have a big castle out there, people are going to try to figure out how to get to it. And most moats aren't worth a damn in capitalism.

"And we try to figure out why the castle is still standing and what's going to keep it standing or cause it not to be standing five, ten, or twenty years from now. What are they key factors? How permanent are they? And how much do they depend on the genius of the lord in the castle?" *Buffett thinks hard about the qualitative aspects of the franchise.*

Continuum: Strong Franchise--weak franchise/strong business--weak business.

BUFFETT ON FRANCHISE VALUE

"Time is a friend of the good business and the enemy of the mediocre." –Warren Buffett.

Importance of Earnings Retention.

Earnings per share = Asset turnover x Return on sales x Leverage x Book Value per share.

EPS = (Sales/Assets) x (Net Income/Sales) x (Assets/Net worth) x (Net worth/Shares outstanding).

- EPS will not grow simply because of sales growth because sales figure is numerator in component 1 and denominator in component 2. Only through increase in any component or a reduction in shares outstanding will result in an increase in EPS.
- Aggressive management can boost turnover only up to a point.
- Return on sales margin cannot be increased indefinitely because of regulation and competition.
- Leverage too has a limit.
- Only book value per share which can rise unceasingly through earnings retention can be a source of sustainable growth in EPS.
- But we've already seen that not all earnings—retention—caused EPS growth is good.
- You also need high incremental return on capital.

COMMODITY BUSINESSES

Commodity product + overcapacity = poor fundamental economics

Prime candidates for profit troubles.
Exceptions: Administered prices or costs creating insulation from market forces.

This administration can be carried out:
1. Legally through government intervention
2. Illegally through collusion, or
3. "Extra legally" through cartelization (with tag-along benefits for non cartel operators) – e.g. OPEC.

"If, however, costs and prices are determined by full-bore competition, there is more than ample capacity, and the buyer cares little about whose product or distribution services he uses, industry economics are almost certain to be unexciting. They may well be disastrous."

"Hence the constant struggle of every vendor to establish and emphasize special qualities of product or service."

This works with some products, but not with all products.

Differentiation not meaningful in many industries
Importance of sustainable and significant cost advantage
A marketing prof's definition of differentiation vs. a fin prof's definition.

Importance of low-cost advantage
What happens when the cycle is down?
You are the last man standing—you can buy the weaker on your terms—you can add capacity at a fraction cost---Tobin's Q much less than 1.
The weaker players end up with a leveraged balance sheets and lenders force sales to strong competitors.

A marketing prof's definition of differentiation vs. a fin prof's definition. For most commodity businesses which do not possess a wide, sustainable cost advantage the equation is: Persistent over-capacity without administered prices (or costs) = poor profitability.

Over-capacity may eventually self-correct, either as capacity shrinks (e.g. bankruptcies) or demand expands.

Business cycle

Rebound to prosperity frequently produces a *pervasive enthusiasm for expansion* that, within a few years, again creates over-capacity and a new profitless environment.

WHAT TO LOOK FOR IN A GREAT BUSINESS?

A high return on capital which is sustainable – pricing power, low cost advantage etc.

Ability to deploy incremental capital at high rates of return i.e. growth prospects.

Ability to self-fund growth and avoid dilution.

Growth is not absolutely necessary – because dividend payout can be increased.

If you can self fund growth then it means you don't need access to outside capital markets. So you have low debt-lots of cash on balance sheet—staying power.
If you have growth opportunities then you can lower dividend payout ratio.
Also, a good price to make it a good long term investment.

WHAT TO LOOK FOR IN A BAD BUSINESS?

A low return on capital. Growth. Inability to fund growth with consequential effects on quality of balance sheet.

We can extract and pull together Buffett writings on his past and current investments to glean lessons for our own investments.

In this case study, Buffett found a fanatic who loved her business and operated it extremely efficiently while becoming the lowest cost producer/distributor where price and variety are critical aspects of customer value. This low cost model has been a template for Buffett's investments in GEICO.

Share what you have learned in this and other Buffett investments.