

WARREN BUFFETT & THE WASHINGTON POST

BY MAX OLSON

There is no question that Warren Buffett is one of the greatest investors of all time. To study his investment methods, there are the Berkshire Hathaway annual letters, biographies, and dozens of other books written on the subject of value investing. But, Buffett's specific investments are rarely examined within the context of the time he made the purchase—and without the benefit of hindsight. To more fully understand Buffett's past successes, “reverse engineering” his purchases is essential. One investment in particular interested me, both because I like the business and because it is one of the only investments Buffett made where he disclosed an estimate of intrinsic value. That business is The Washington Post Company.



Warren Buffett and close friend Katherine Graham, chairman of the Washington Post from 1973 to 1991.

BACKGROUND

Buffett began acquiring shares of the Washington Post in early 1973, and by the end of the year held over 10 percent of the non-controlling “B” shares. After multiple meetings with Katherine Graham (the company's Chairman and CEO), he joined the Post's board in the fall of 1974.

According to Buffett's 1984 speech *The Superinvestors of Graham-and-Doddsville*, in 1973, Mr. Market was offering to sell the Post for \$80 million. Buffett also mentioned that you could have “...sold the (Post's) assets to any one of ten buyers for not less than \$400 million, probably appreciably more.” How did Buffett come to this value? What assumptions did he make when looking at the future of the company? **Note:** All numbers and details in this article are from the 1971 and 1972 annual reports and “Buffett: The Making of an American Capitalist” by Roger Lowenstein.

ANALYSIS

The purpose of this exercise is to reverse engineer Buffett's analysis of the Washington Post Company—in oth-

er words, to construct a reasonable analysis given the facts as of 1973 that will lead us to the same conclusion Buffett arrived at. Before I began my research, I thought it would take much longer to come to a conclusion than it actually did. After reading the annual reports and doing some outside research on the company and its history, I had a pretty good feel for how the business worked.

In 1973, the Washington Post Company consisted of three distinct segments: the flagship newspaper, Newsweek magazine, and five television/radio stations. The Washington Post (like most other local papers at this time) had a strong, durable competitive advantage that was certain to increase in the future. The paper had a dominant share of the Washington D.C. market. But, despite its commanding market share, the business side was flagging. As a business, The Washington Post was underperforming other major metropolitan dailies.

Newsweek also had competitive advantages—though they were not as great

as those enjoyed by a dominant big city newspaper. At the time, Newsweek held a 30% share of the readership contested by the three leading news magazines. In 1973, the Post's other operating segment, network-affiliated TV stations, had extremely high barriers to entry due to government regulation. As a result, profit margins at these stations were quite robust.

From 1971 to 1972, the Washington Post Company's total revenue grew a little over 13 percent. Advertising revenue in the newspaper segment had grown almost 20 percent while magazine ad sales grew 8 percent. Pre-tax margins improved from 8 percent in 1971 to about 10 percent in 1972. These were both about 1 to 2 percent lower than their average in prior years. According to Lowenstein's book, the Post's margins were significantly lower than those of most other big city newspapers in the early 1970s.

Because of the relative steadiness of the Post's operations, I attempted to es-

timate the future cash flows adjusting for growth, margins, and return on capital. I tried to use reasonable assumptions that Buffett might have made at the time. I tried, as best I could, to prevent my knowledge of the company's post-1973 performance from contaminating my thinking.

I assumed top-line (sales) growth of 12 percent for the next five years, 8 percent for the five years after that, and 4 percent in perpetuity. I thought there was a good chance margins would improve (at that time Katherine Graham began to focus her attention on improving operations); so, I also assumed after-tax margins went up 2 percent over these years. This would push the company's after-tax return on invested capital to 25 percent, which I used as the incremental return on capital in perpetuity. In other words, for every dollar of reinvestment in the future (4 percent per year), the Washington Post Company would earn a 25 percent profit.

After performing the discounted cash flow calculation, I came up with an equity value of about **\$380 million** using a 10 percent required rate of return. Without messing around with the inputs too much, this was fairly close to Buffett's \$400 million figure. Judging by the balance sheet alone, the company's book val-

ue and approximate replacement cost were \$80 million and \$100 million respectively. This means that when Buffett made his purchase of the Washington Post Company, Berkshire was paying no more than 100 to 125 percent of book value and less than replacement value for a growing company with a large moat to protect its profits. This low purchase price was Buffett's "margin of safety." The Washington Post's franchise and growth value alone was almost \$300 million, more than triple the price of the stock. Even if I lowered my assumptions to be more conservative, the value of the business comes nowhere near as low as the price the stock was selling for.

CONCLUSION

The importance of sustainable competitive advantages ("large moat") played a major role in the value of this investment. However, the above-average stock performance was made possible by the bargain price that Buffett paid. If it wasn't for the extreme market irrationality at the time, Buffett wouldn't have had the opportunity to buy such a great business at such a great price. Mr. Market was in a terrible mood and Buffett used that to his advantage.

So, what was Buffett's rate of return

on his investment in the Washington Post Company? Using my estimated cash flows, the approximate annual rate of return after an eleven-year holding period would have been 28 percent. According to Lowenstein's book, Berkshire's original \$10 million investment from 1974 had grown to \$205 million in 1985, for an annual return of 32 percent. In other words, my guess was fairly close. During this time, Buffett had convinced the Post to buy back almost 40 percent of shares outstanding; these purchases (at undervalued prices) substantially enhanced returns. Over the same 11-year period, the S&P 500 returned 16 percent including dividends.

I will end this article with two relevant quotes from Buffett's 1984 speech:

[On beta] "I have never been able to figure out why it's riskier to buy \$400 million worth of properties for \$40 million than \$80 million. And, as a matter of fact, if you buy a group of such securities and you know anything at all about business valuation, there is essentially no risk in buying \$400 million for \$80 million, particularly if you do it by buying ten \$40 million piles of \$8 million each."

[On margin of safety] "You don't try and buy businesses worth \$83 million for \$80 million. You leave yourself an enormous margin. When you build a bridge, you insist it can carry 30,000 pounds, but you only drive 10,000 pound trucks across it. And that same principle works in investing." ♦