See's Candies Case Study Prepared by John Chew

This case is compiled from various sources and, though repetitive, there are important lessons in this case. ***This case along with Buffett's "Inflation" Article is critical for your understanding.*** *This purchase was the big shift in approach for Buffett because he left behind his focus of "cigar-butt" investing (buying below asset or liquidating value) and moved into franchise investing. He bought companies whose main value would be earned in the future (See's, Coke, Gillette, etc.).*

Describe the competitive advantages of See's. Could this be a faster growing business if See's sold though other marketing channels? How does Buffett analyze this business? What price did Buffett pay and why?

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Short background on *See's Candies*

(Source: The Warren Buffett CEO: Secrets from the Berkshire Hathaway Managers by Robert P. Miles (2002)

See's Candies is particularly interesting because of both the business and the operating managers. Mr. *Huggins* was not part of the founding family and didn't participate directly in the ownership of the company. Therefore, he could well serve as a model of what *Berkshire* management will be like 50 years from today.

See's Candies is often described by *Warren Buffett* as the perfect business. It was one of the first wholly owned businesses purchased by Berkshire and was the first investment for which vice chairman *Charlie Munger* influenced *Buffett* to pay a premium for quality. It was the first multigenerational family-owned business to be added to the *Berkshire* family of businesses. It was also the first Berkshire-owned consumer franchise with a built-in ability to raise prices from 50 cents a pound during the 1929 stock market crash to $12 per pound today *(2002)*. Without the *See's Candies* purchase, there may not have been a major investment in *Coca-Cola* 20 years later. With superior management, sustainable competitive advantages, scarcity of close substitutes, ability to raise prices without losing customers, high profits, low capital investment, and extraordinary returns on capital, it's the perfect business for any student of business, management, and investment.

See's Candies fulfills all the criteria *Buffett* looks for. The business is profitable and has no debt. It has a solid franchise brand name and is a multigenerational family business that maintains uncompromising business values. A long-term management team is in place, and the company is able to grow without any additional influx of capital. Critical to *See's Candies*' success has been the management by *Chuck Huggins*.

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Factors behind success:

Offering greater insight into the investment process and management tenets of *Chuck Huggins*, *Buffett* wrote, "*See's* has a one-of-a-kind product 'personality' produced by a combination of its candy's delicious taste and moderate price, the company's total control of the distribution process, and the exceptional service provided by store employees. *Chuck* rightfully measures his success by the satisfaction of our customers, and his attitude permeates the organization. Few major retailing companies have been able to sustain such a customer-oriented spirit, and we owe *Chuck* a great deal for keeping it alive and well at *See's*.

The secret to investment success is a durable competitive advantage based on a franchise. The motivation that causes a consumer to buy and consume chocolate was the same 50 years ago and will be the same 50 years from now. *(Human habit and psychology).*

Two management tenets that *Huggins* insisted on early to ensure *See's* survived when other retail candy stores failed:

1. Concentrate the efforts of all employees in all departments to attain ever-increasing excellence in customer services and product quality.

2. Never compromise quality ingredients or quality service over profits.

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See's Candies Teaches a Lesson from Damn Right! Behind the Scenes with Berkshire Hathaway Billionaire Charlie Munger (2000).

See's Candies—with its motto "quality without compromise" –represents more to *Munger* than an after-dinner delicacy. The acquisition of *See's Candies* was among the earliest deals that he and *Warren Buffett* did together and it was one of the first companies they purchased outright. But most important, the experience of *See's Candies* taught *Charlie* and *Warren* a lesson that caused a major improvement to their investment style.

In 1972, using the float of *Blue Chip Stamps*, *Buffett* and *Munger* acquired the small Los Angeles-based *See's Candies* for $25 million. It was a major step for *Charlie* and *Warren* because it was their biggest purchase up to that time.

It was big news in California, where *See's* black and white candy shops are part of the local culture. A 16-year-old *Cher* was working at *See's* when she met *Sonny Bono* and left her job to move in with him as his housekeeper.

Mary See was 71 when she opened a small, Los Angeles neighborhood candy shop in 1921, although she had the help of her son Charles.

Charles A. See had been a pharmacist in Canada, but changed careers after his two pharmacies were destroyed when a forest fire swept through the town where he did business. He took up work as a chocolate salesman and dreamed of starting his own candy company using recipes developed by his mother. In 1921, he moved his family, including his widowed mother, *Mary*, from Canada to Pasadena, the beautiful and refined Los Angeles suburb that *Charlie* would later adopt as home. During the 1920s, Los Angeles was a booming city of 500,000 residents. It wasn't an easy go for the *See*s, since there were hundreds of competitors. *See* and his partner, *James W. Reed*, decided to concentrate on building a reputation with a high-quality product.

When the stock market crashed in 1929 and the Great Depression hit, *See's* was forced to cut the price of a pound of candy from 80 cents to 50 cents. He survived by persuading landlords to reduce his rents, arguing that lower rent was better than no rent. But he also had an opportunity to expand his markets as other candy-makers went bankrupt. A second crisis came during WWII when sugar was rationed. Rather than compromise quality with inferior ingredients or altered recipes, *See's* decided to produce as much high quality candy as possible with the ingredients that were allocated to the company and no more. Customers lined up around the block to buy the limited supply of chocolates, and once the supply was gone, the shop closed for the day. No matter what time the store closed the sales staff was paid for a full day of work. This turned out to be a smart marketing ploy, since the waiting crowds added to the candy stores cache.

See's was already 30 years old when *Charles Huggins* joined the company in 1951. The head office was then in Lois Angeles. But *Huggins* started in the San Francisco facility. When *Harry See*, *Mary's* grandson, took over the company after his brother's death, *Huggins* was given responsibility for expanding the company's business. *Harry See*, *Huggins* said, "He enjoyed life tremendously, was a world traveler, established vineyards in Napa Valley. After a while the family decided collectively to sell the company and cash in their chips. *Chuck Huggins* was coordinator and liaison for that.

"We started in the spring of 1970. We had a couple of very serious suitors, such as a big-four sugar company from Hawaii that owned *C&H* and others. The family wanted a pretty heady ransom for the company and that dissuaded several buyers."

One company began an in-depth due diligence, examining the business, its many contracts, and so on, to the extent that even *Huggins* thought they were overly meticulous. "At the eleventh hour, literally at midnight the day before they were to sign the purchase agreement, they backed out. No harm was done, except the energy I expended. We've kept in touch for years, they were such nice fellows," said *Huggins*.

About that time, *Robert Flaherty*, an investment advisor to *Blue Chip*, heard that the premier chocolate chain was for sale. He contracted *William Ramsey*, a *Blue Chip* executive, who was enthusiastic about buying *See's. Ramsey* called *Buffett* from Flaherty's office.

"Gee, *Bob*," *Buffett* said. "The candy business. I don't think we want to be in the candy business." For some reason, the phone line then went dead. *Ramsey* and *Flaherty* hurriedly tried to call *Buffett* back. Finally, after the secretary misdialed the number and several minutes elapsed, the reconnected. Before they could speak *Buffett* burst out: "I was taking a look at the numbers. Yeah, I'd be willing to buy *See's* at a price."

Warren immediately flew out to visit *Harry See*.

That was in November 1971, recalled *Chuck Huggins*. There were two things to be resolved—how much to pay and how the business would be run. *Warren* said, '*Harry*, we need to talk to you about the price privately.' *Warren* then said to *Harry*, 'if we go through with this, we don't run companies. I need to know who will run the company.'"

"*Harry* looked around the room and saw me, and said, '*Chuck* will.'.

Warren explained to *Huggins* that first the purchase had to be settled, but, "if that happens, here are a couple of things that are expected. First, we want you to run *See's* as president and CEO, and second, we don't want any *Sees* left with a relationship to the company. Some of the people have been around for a long time. Make a settlement and they can go their way."

Huggins said *Warren* and *Charlie* wanted him to have full control. "We want you to maintain company ethics and standards," said *Buffett*.

The *See* family was asking $30 million. But because of *See's* low book value, *Buffett* and *Munger* decided not to go above $25 million. The talks ended, but later *See* called back and accepted the $25 million. *Munger* and *Buffett* purchased *See's Candies* on Jan. 3, 1972, paying three times book value, something they'd never done before.

See's makes more than half of its profits at Christmas.

"While *Blue Chip* owned us, it was clear *Warren*, *Charlie,* and *Rick* were the owners," said *Huggins*. *Warren* said, "Do what you've been doing. Let us know if there are danger signs, trouble, but just keep us informed. Figure out some way to do that.' He said, 'If you can build on what the *See* family has done, make it more grand that would be good.'"

Then *Buffett* added an observation about the candy itself, **"You're priced well below the market."**

Huggins' immediate challenge was to convince loyal customers that *See's* would not change under the new owners.

Once the dust settled, *See's* started expanding into markets in Missouri, Texas, and Colorado and even as far away as Hong Kong. *Sees* participated in the 1982 World's Fair in Knoxville, Tennessee, and the exhibit was such a success that *See's* opened a shop in Knoxville.

During the same period, the Retail Clerk's Union attempted to organize the sales force in the stores. *See's* since has triumphed in four attempts to organize by the Retail Clerk's Union, mainly by paying higher than union-scale wages.

At one time, *See's* came under attack by a major candy producer from the Midwest. In 1973, *Russell Stover Candies* (which traditionally was sold through other retailers) went heavily into their own stores. They decided to put on a campaign with *See's* and beat us out in our own marketplace," recalled *Huggins*. "They put in stores that looked exactly like *See's,* called *Mrs. Stover's*. They duplicated our identity and tried to grab out market. Of course, I informed *Charlie* and *Warren* about that fact."

Munger said, "If they are infringing on our trade mark in any way, we can go after them." *Stover's* eventually backed off.

Part of *See's* competitive advantage is that it is a leader in its market. "In some businesses, the very nature of things is a sort of cascade toward the overwhelming dominance of one firm," said *Munger*. "It tends to cascade to a <u>winner-take-all</u> result. And these advantages of scale are so great for example, that when *Jack Welch* came into *GE*, he just said, "To hell with it. We're either going to be number one or number two in every field we're in or we're going to be out." That was a very tough-minded thing to do, but I think it was a correct decision if you're thinking about maximizing shareholder wealth."

***Munger* went on, "*See's* has stayed out of a lot of traps."**

"The ordinary candy company puts in <u>too many</u> stores," *Charlie* continued. "You have this huge overhead you're carrying through July and August, and you just can't get well at Christmas. **But *See's* has always had the discipline of knowing their own business.** That's harder on the employees, by the way. They have this huge crunch in the stores at Christmas, but it is part of the secret of *See's.*

"And of course the fanaticism about the quality of the product and service is the heart and soul of the business. I love the fact that this room is full of long time customers and long time suppliers. You get suppliers who are good and who are trusted because they deserve trust, and you behave the same way toward your own customer, then you are a little part of a civilization that is a **seamless web of deserved trust**. This is the way the world ought to work. It is a better example for everyone else. It is the right way to build up a state or a civilization. It was marvelous for us to become associated relatively early in our business careers with a culture that was so fundamentally sound. It is Ben Franklin (or his business philosophy) all over again, alive and well at *See's* after all these years."

See's Candies—with its motto "quality without compromise"—represents more to *Munger* than an after-dinner delicacy. The acquisition of *See's Candies* was among the earliest deals that he and *Warren Buffett* did together and it was one of the first companies they purchased outright. **But most important, the experience of *See's* taught *Charlie* and *Warren* a lesson that caused a major improvement in their investment style.**

"*See's Candies*," reminisces *Munger*. "It was acquired at a <u>premium</u> over book (value) and it worked. *Hochschild, Kohn*, the department store chain *(in Baltimore)*, was bought at a <u>discount</u> from book and liquidating value. It didn't work. Those two things together helped <u>shift</u> our thinking to the idea of paying higher prices for better businesses."

When they bought *See's Charlie* and *Warren* still were bottom fishers. But as they learned and as the business grew, change was necessary. "You could once find value by just rooting around in the less traveled parts of the world—the pink sheets—you'd find a lot of opportunity," said *Charlie*.

It was only luck that *Blue Chip* was able to buy *See's* at the price they paid. *Munger* credits *Al Marshall* for giving the final push toward the correct decision. *Ira Marshall* said you guys are crazy—there are some things you should pay up for, like quality businesses and people. You are underestimating quality. We listened to the criticism and changed our mind. **This is a good lesson for anyone: the ability to take criticism constructively and learn from it.** If you take the indirect lessons we learned from *See's*, you could say *Berkshire* was built on constructive criticism.

"If they had wanted to just $100,000 more for *See's,* we wouldn't have bought it," said *Munger*. "We were that dumb back then."

Even so, "**When we bought the business, almost nobody was having much success selling boxed chocolates except *See's,* and we wanted to know why that was, and if the success was sustainable," said *Buffett*.**

When *See's* turned out to be an excellent, ongoing business, *Munger* and *Buffett* realized how much easier and pleasanter it was to buy a good business and just let it roll along, then to buy a deeply discounted but struggling business and spend time, energy , and sometimes more money setting it straight.

"If we hadn't bought *See's,* we wouldn't have bought Coke," said *Buffett*. "So thank *See's* for the $12 billion. **We had the luck to buy the whole business and that taught us a whole lot.** We've had windmills, well, I've had windmills. *Charlie* was never in the windmill (Dempster Manufacturing) business. I've had second rate department stores, pumps, and textile mills…." which he decided were nearly as problematic as the windmills..

Munger says he and *Buffett* should have seen the advantages of paying for quality much earlier. "I don't think it's necessary to be as dumb as we were."

See's is a slow grower, but its growth is steady and reliable—and best of all, it doesn't take additional infusions of capital. At *Berkshire*, *Warren* and I raised the prices of *See's Candies* a little faster than others might have. You will get a few opportunities to profit from finding under pricing. **There are actually people out there who don't price everything as high as the market will easily stand.** And once you figure that out, it's like finding money in the street—if you have the courage of your convictions.

"We've tried 50 different ways to put money into *See's,* "explained *Buffett*. "If we knew a way to put additional money into *See's* and produce returns a quarter of what we're getting out of the existing business, we would do it in a second. We love it. We play around with different ideas, but we don't know how to do it.

Munger added, "By the way, we really shouldn't complain about this because we've carefully selected a bunch of businesses that just drown in money every year."

***Munger* told *Berkshire* shareholders that there are a large number of businesses in America that throw off lots of cash, but which cannot be expanded very much.** To try to expand would be throwing money down a rat hole, he said. Such businesses don't stir acquisition desires in most corporations, but they are welcome at *Berkshire* because he and *Buffett* can take the capital invest it profitably elsewhere.

From *See's*, said *Munger*, "We've learned that the ways you think and operate must involve time-tested values. Those lessons have made us buy more wisely elsewhere and make many decisions a lot better. So we've gained enormously from our relationship with *See's.*

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1983 Letter to Berkshire Shareholders

See's Candies Shops

The financial results at *See's* continue to be exceptional. The business possesses a valuable and solid consumer franchise and a manager equally valuable and solid.

In recent years *See's* has encountered two important problems, at least one of which is well on its way toward solution. That problem concerns costs, except those for raw materials. We have enjoyed a break on raw material costs in recent years though so, of course, have our competitors. One of these days we will get a nasty surprise in the opposite direction. In effect, raw material costs are largely beyond our control since we will, as a matter of course; buy the finest ingredients that we can, regardless of changes in their price levels. We regard product quality as sacred.

But other kinds of costs are more controllable, and it is in this area that we have had problems. On a per-pound basis, our costs (not including those for raw materials) have increased in the last few years at a rate significantly greater than the increase in the general price level. It is vital to our competitive position and profit potential that we reverse this trend.

In recent months much better control over costs has been attained and we feel certain that our rate of growth in these costs in 1984 will be below the rate of inflation. This confidence arises out of our long experience with the managerial talents of *Chuck Huggins*. We put *Chuck* in charge the day we took over, and his record has been simply extraordinary, as shown by the following table:

52-53 Week Year Ended About December 31	*Sales Revenues*	*Operating Profits after Taxes*	*Number of Pounds of Candy Sold*	*Number of Stores Open at Year End*
1983 (53 weeks) ...	$133,531,000	$13,699,000	24,651,000	207
1982	123,662,000	11,875,000	24,216,000	202
1981	112,578,000	10,779,000	24,052,000	199
1980	97,715,000	7,547,000	24,065,000	191
1979	87,314,000	6,330,000	23,985,000	188
1978	73,653,000	6,178,000	22,407,000	182
1977	62,886,000	6,154,000	20,921,000	179
1976 (53 weeks) ...	56,333,000	5,569,000	20,553,000	173
1975	50,492,000	5,132,000	19,134,000	172
1974	41,248,000	3,021,000	17,883,000	170
1973	35,050,000	1,940,000	17,813,000	169
1972	31,337,000	2,083,000	16,954,000	167

The other problem we face, as the table suggests, is our recent **inability to achieve meaningful gains in pounds sold.** The industry has the same problem. But for many years we outperformed the industry in this respect and now we are not.

The poundage volume in our retail stores has been virtually unchanged each year for the past four, despite small increases every year in the number of shops (and in distribution expense as well). Of course, dollar volume has increased because we have raised prices significantly. But we regard the most important measure of retail trends to be units sold per store rather than dollar volume. On a same-store basis (counting only shops open throughout both years) with all figures adjusted to a 52-week year, poundage was down .8 of 1% during 1983. This small decline was our best same-store performance since 1979; the cumulative decline since then has been about 8%.

Quantity-order volume, about 25% of our total, has plateaued in recent years following very large poundage gains throughout the 1970s.

We are not sure to what extent this flat volume - both in the retail shop area and the quantity order area - is due to our pricing policies and to what extent it is due to static industry volume, the recession, and the extraordinary share of market we already enjoy in our primary marketing area. Our price increase for 1984 is much more modest than has been the case in the past few years, and we hope that next year we can report better volume figures to you. But we have no basis to forecast these.

Despite the volume problem, *See's* strengths are many and important. **In our primary marketing area, the West, our candy is preferred by an enormous margin to that of any competitor.** In fact, we believe most lovers of chocolate prefer it to candy costing two or three times as much. (In candy, as in stocks, price and value can differ; price is what you give, value is what you get.) The quality of customer service in our shops - operated throughout the country by us and not by franchisees is every bit as good as the product. Cheerful, helpful personnel are as much a trademark of *See's* as is the logo on the box. That's no small achievement in a business that requires us to hire about 2000 seasonal workers. We know of no comparably-sized organization that betters the quality of customer service delivered by *Chuck Huggins* and his associates.

Because we have raised prices so modestly in 1984, we expect *See's* profits this year to be about the same as in 1983.
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Goodwill and its Amortization: The Rules and the Realities

See's Candies used as an example

This appendix deals only with economic and accounting Goodwill – not the goodwill of everyday usage. For example, a business may be well liked, even loved, by most of its customers but possess no economic goodwill. (AT&T, before the breakup, was generally well thought of, but possessed not a dime of economic Goodwill.) And, regrettably, a business may be disliked by its customers but possess substantial, and growing, economic Goodwill. So, just for the moment, forget emotions and focus only on economics and accounting.

When a business is purchased, accounting principles require that the purchase price first be assigned to the fair value of the identifiable assets that are acquired. Frequently the sum of the fair values put on the assets (after the deduction of liabilities) is less than the total purchase price of the business. In that case, the difference is assigned to an asset account entitled "excess of cost over equity in net assets acquired". To avoid constant repetition of this mouthful, we will substitute "Goodwill".

Accounting Goodwill arising from businesses purchased before November 1970 has a special standing. Except under rare circumstances, it can remain an asset on the balance sheet as long as the business bought is retained. That means no amortization charges to gradually extinguish that asset need be made against earnings.

The case is different, however, with purchases made from November 1970 on. When these create Goodwill, it must be amortized over not more than 40 years through charges – of equal amount in every year – to the earnings account. Since 40 years is the maximum period allowed, 40 years is what managements (including us) usually elect. This annual charge to earnings is not allowed as a tax deduction and, thus, has an effect on after-tax income that is roughly double that of most other expenses.

That's how accounting Goodwill works. **To see how it differs from economic reality**, let's look at an example close at hand. We'll round some figures, and greatly oversimplify, to make the example easier to follow. We'll also mention some implications for investors and managers.

Blue Chip Stamps bought ***See's*** early in 1972 for $25 million, at which time *See's* had about $8 million of net tangible assets. (Throughout this discussion, accounts receivable will be classified as tangible assets, a definition proper for business analysis.) This level of tangible assets was adequate to conduct the business without use of debt, except for short periods seasonally. *See's* was earning about $2 million after tax at the time, and such earnings seemed conservatively representative of future earning power in constant 1972 dollars.

Thus our first lesson: **businesses logically are worth far more than net tangible assets when they can be expected to produce earnings on such assets considerably in excess of market rates of return. The capitalized value of this excess return is economic Goodwill.**

In 1972 (and now) relatively few businesses could be expected to consistently earn the 25% after tax on net tangible assets that was earned by *See's* – doing it, furthermore, with conservative accounting and no financial leverage. It was not the fair market value of the inventories, receivables or fixed assets that produced the premium rates of return. Rather it was a combination of intangible assets, particularly a pervasive favorable reputation with consumers based upon countless pleasant experiences they have had with both product and personnel.

Such a reputation creates a **consumer franchise** that allows the value of the product to the purchaser, rather than its production cost, to be the major determinant of selling price. Consumer franchises are a prime source of economic Goodwill. Other sources include governmental franchises not subject to profit regulation, such as television stations, and an enduring position as the low cost producer in an industry.

Let's return to the accounting in the *See's* example. *Blue Chip's* purchase of *See's* at $17 million over net tangible assets required that a Goodwill account of this amount be established as an asset on *Blue Chip's* books and that $425,000 be charged to income annually for 40 years to amortize that asset. By 1983, after 11 years of such charges, the $17 million had been reduced to about $12.5 million. *Berkshire*, meanwhile, owned 60% of *Blue Chip* and, therefore, also 60% of *See's*. This ownership meant that *Berkshire's* balance sheet reflected 60% of *See's* Goodwill, or about $7.5 million.

In 1983 Berkshire acquired the rest of *Blue Chip* in a merger that required purchase accounting as contrasted to the "pooling" treatment allowed for some mergers. Under purchase accounting, the "fair value" of the shares we gave to (or "paid") *Blue Chip* holders had to be spread over the net assets acquired from Blue Chip. This "fair value" was measured, as it almost always is when public companies use their shares to make acquisitions, by the market value of the shares given up.

The assets "purchased" consisted of 40% of everything owned by *Blue Chip* (as noted, Berkshire already owned the other 60%). What Berkshire "paid" was more than the net identifiable assets we received by $51.7 million, and was assigned to two pieces of Goodwill: $28.4 million to *See's* and $23.3 million to Buffalo Evening News.

After the merger, therefore, Berkshire was left with a Goodwill asset for *See's* that had two components: the $7.5 million remaining from the 1971 purchase, and $28.4 million newly created by the 40% "purchased" in 1983. Our amortization charge now will be about $1.0 million for the next 28 years, and $.7 million for the following 12 years, 2002 through 2013.

In other words, different purchase dates and prices have given us vastly different asset values and amortization charges for two pieces of the same asset. (We repeat our usual disclaimer: we have no better accounting system to suggest. The problems to be dealt with are mind boggling and require arbitrary rules.)

But what are the economic realities? One reality is that the amortization charges that have been deducted as costs in the earnings statement each year since acquisition of *See's* were not true economic costs. We know that because *See's* last year earned $13 million after taxes on about $20 million of net tangible assets – a performance indicating the existence of economic Goodwill far larger than the total original cost of our accounting Goodwill.

In other words, while accounting Goodwill regularly decreased from the moment of purchase, economic Goodwill increased in irregular but very substantial fashion.

Another reality is that annual amortization charges in the future will not correspond to economic costs. It is possible, of course, that *See's* economic Goodwill will disappear. But it won't shrink in even decrements or anything remotely resembling them. What is more likely is that the Goodwill will *increase* – in current, if not in constant, dollars – because of inflation.

That probability exists because true economic Goodwill tends to rise in nominal value proportionally with inflation. To illustrate how this works, let's contrast a *See's* kind of business with a more mundane business. When we purchased *See's* in 1972, it will be recalled, it was earning about $2 million on $8 million of net tangible assets. Let us assume that our hypothetical mundane business then had $2 million of earnings also, but needed $18 million in net tangible assets for normal operations. Earning only 11% on required tangible assets, that mundane business would possess little or no economic Goodwill.

A business like that, therefore, might well have sold for the value of its net tangible assets, or for $18 million. In contrast, we paid $25 million for *See's*, even though it had no more in earnings and less than half as much in "honest-to-God" assets. Could less really have been more, as our purchase price implied? The answer is "yes" – *even if both businesses were expected to have flat unit volume* – as long as you anticipated, as we did in 1972, a world of continuous inflation.

To understand why, imagine the effect that a doubling of the price level would subsequently have on the two businesses. Both would need to double their nominal earnings to $4 million to keep themselves even with inflation. This would seem to be no great trick: just sell the same number of units at double earlier prices and, assuming profit margins remain unchanged, profits also must double.

But, crucially, to bring that about, both businesses probably would have to double their nominal investment in net tangible assets, since that is the kind of economic requirement that inflation usually imposes on businesses, both good and bad. A doubling of dollar sales means correspondingly more dollars must be employed immediately in receivables and inventories. Dollars employed in fixed assets will respond more slowly to inflation, but probably just as surely. And all of this inflation-required investment will produce no improvement in rate of return. The motivation for this investment is the survival of the business, not the prosperity of the owner.

Remember, however, that *See's* had net tangible assets of only $8 million. So it would only have had to commit an additional $8 million to finance the capital needs imposed by inflation. The mundane business, meanwhile, had a burden over twice as large – a need for $18 million of additional capital.

After the dust had settled, the mundane business, now earning $4 million annually, might still be worth the value of its tangible assets, or $36 million. That means its owners would have gained only a dollar of nominal value for every new dollar invested. (This is the same dollar-for-dollar result they would have achieved if they had added money to a savings account.)

See's, however, also earning $4 million, might be worth $50 million if valued (as it logically would be) on the same basis as it was at the time of our purchase. So it would have gained $25 million in nominal value while the owners were putting up only $8 million in additional capital – **over $3 of nominal value gained for each $1 invested.**

Remember, even so, that the owners of the *See's* kind of business were forced by inflation to ante up $8 million in additional capital just to stay even in real profits. Any unleveraged business that requires some net tangible assets to operate (and almost all do) is hurt by inflation. Businesses needing little in the way of tangible assets simply are hurt the least.

And that fact, of course, has been hard for many people to grasp. For years the traditional wisdom – long on tradition, short on wisdom – held that inflation protection was best provided by businesses laden with natural resources, plants and machinery, or other tangible assets ("In Goods We Trust"). It doesn't work that way. Asset-heavy businesses generally earn low rates of return – rates that often barely provide enough capital to fund the inflationary needs of the existing business, with nothing left over for real growth, for distribution to owners, or for acquisition of new businesses.

In contrast, a disproportionate number of the great business fortunes built up during the inflationary years arose from ownership of operations that combined intangibles of lasting value with relatively minor requirements for tangible assets. In such cases earnings have bounded upward in nominal dollars, and these dollars have been largely available for the acquisition of additional businesses. This phenomenon has been particularly evident in the communications business. That business has required little in the way of tangible investment – yet its franchises have endured. During inflation, Goodwill is the gift that keeps giving.

But that statement applies, naturally, only to true economic Goodwill. Spurious accounting Goodwill – and there is plenty of it around – is another matter. When an overexcited management purchases a business at a silly price, the same accounting niceties described earlier are observed. Because it can't go anywhere else, the silliness ends up in the Goodwill account. Considering the lack of managerial discipline that created the account, under such circumstances it might better be labeled "No-Will". Whatever the term, the 40-year ritual typically is observed and the adrenalin so capitalized remains on the books as an "asset" just as if the acquisition had been a sensible one.

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If you cling to any belief that accounting treatment of Goodwill is the best measure of economic reality, I suggest one final item to ponder.

Assume a company with $20 per share of net worth, all tangible assets. Further assume the company has internally developed some magnificent consumer franchise, or that it was fortunate enough to obtain some important television stations by original FCC grant. Therefore, it earns a great deal on tangible assets, say $5 per share, or 25%.

With such economics, it might sell for $100 per share or more, and it might well also bring that price in a negotiated sale of the entire business.

Assume an investor buys the stock at $100 per share, paying in effect $80 per share for Goodwill (just as would a corporate purchaser buying the whole company). Should the investor impute a $2 per share amortization charge annually ($80 divided by 40 years) to calculate "true" earnings per share? And, if so, should the new "true" earnings of $3 per share cause him to rethink his purchase price?

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The Predictability of *See's*

Obviously all businesses change to some extent. Today, *See's* is different in many ways from what it was in 1972 when we bought it: It offers a different assortment of candy, employs different machinery and sells through different distribution channels. But the <u>reasons</u> why people today buy boxed chocolates, and why they buy them from us rather than from someone else, are virtually unchanged from what they were in the 1920s when the *See* family was building the business. Moreover, these motivations are not likely to change over the next 20 years, or even 50.

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Question: **You covered half of it which is trying to understand a business and buying a business. You also alluded to getting a return on the amount of capital invested in the business. How do you determine what is the <u>proper price</u> to pay for the business?**

***Buffett*:** It is a tough thing to decide but I don't want to buy into any business I am not terribly sure of. So if I am terribly sure of it, it probably won't offer incredible returns. Why should something that is essentially a cinch to do well, offer you 40% a year? We don't have huge returns in mind, but we do have in mind not losing anything. We bought *See's Candies* in 1972, *See's Candies* was then selling 16 million pounds of candy at a $1.95 a pound and it was making 2 bits a pound or $4 million pre-tax. We paid $25 million for it—6.25 x pretax (16% pre-tax earnings yield) or about 10x after tax. It took no capital to speak of. When we looked at that business—basically, my partner, *Charlie*, and I—we needed to decide if there was some <u>untapped pricing power</u> there. Where that $1.95 box of candy could sell for $2 to $2.25. If it could sell for $2.25 or another $0.30 per pound that was $4.8 on 16 million pounds, which on a $25 million purchase price was fine. We never hired a consultant in our lives; our idea of consulting was to go out and buy a box of candy and eat it.

What we did know was that they had <u>share of mind</u> in California. There was something special. Every person in Ca. has something in mind about *See's Candies* and overwhelmingly it was favorable. They had taken a box on Valentine's Day to some girl and she had kissed him. If she slapped him, we would have no business. As long as she kisses him, that is what we want in their minds. ***See's Candies* means getting kissed. If we can get that in the minds of people, we can raise prices.** I bought it in 1972, and every year I have raised prices on Dec. 26th, the day after Christmas, because we sell a lot on Christmas. In fact, we will make $60 million this year. We will make $2 per pound on 30 million pounds. Same business, same formulas, same everything--$60 million bucks, and it still doesn't take any capital.

And we will make more money 10 years from now. But of that $60 million, we make $55 million in the three weeks before Christmas. And our company song is: "What a friend we have in Jesus." (Laughter). It is a good business. Think about it a little. **Most people do not buy boxed chocolate to consume themselves, they buy them as gifts—somebody's birthday or more likely it is a holiday.** Valentine's Day is the single biggest day of the year. Christmas is the biggest season by far. Women buy for Christmas and they plan ahead and buy over a two or three week period. Men buy on Valentine's Day. They are driving home; we run ads on the Radio. Guilt, guilt, guilt—guys are veering off the highway right and left. They won't dare go home without a box of Chocolates by the time we get through with them on our radio ads. So that Valentine's Day is the biggest day.

Can you imagine going home on Valentine's Day—our *See's Candies* is now $11 a pound thanks to my brilliance. And let's say there is candy available at $6 a pound. Do you really want to walk in on Valentine's Day and hand—she has all these positive images of *See's Candies* over the years—and say, **"Honey, this year I took the low bid."** And hand her a box of candy. It just isn't going to work. So in a sense, there is <u>untapped pricing power</u>—it is not price dependent.

If you are *See's Candies*, you want to do everything in the world to make sure that the experience basically of giving that gift leads to a <u>favorable reaction</u>. It means what is in the box, it means the person who sells it to you, because all of our business is done when we are terribly busy. People come in during those weeks before Christmas, Valentine's Day and there are long lines. So at five o'clock in the afternoon some woman is selling someone the last box candy and that person has been waiting in line for maybe 20 or 30 customers. And if the salesperson smiles at that last customer, our moat has widened and if she snarls at 'em, our moat has narrowed. We can't see it, but it is going on everyday. But it is the key to it. It is the total part of the product delivery. It is having everything associated with it say, *See's Candies* and something pleasant happening. That is what business is all about.

Question: If I have every bought a company where the numbers told me not to. How much is quantitative and how much is qualitative?

Buffett: The best buys have been when the numbers almost tell you not to. **Because then you feel so strongly about the product**. And not just the fact you are getting a used cigar butt cheap. Then it is compelling. I owned a windmill company (*Dempster Mills Manufacturing*) at one time. Windmills are cigar butts, believe me. I bought it very cheap, I bought it at a third of working capital. And we made money out of it, **but there is no repetitive money to be made on it. There is a one-time profit in something like that. And it is just not the thing to be doing. I went through that phase. I bought streetcar companies and all kinds of things.** In terms of the qualitative, I probably understand the qualitative the moment I get the phone call. Almost every business we have bought has taken five or ten minutes in terms of analysis. We bought two businesses this year.

Everybody has got a different circle of competence. The important thing is not how big the circle is, the important thing is the size of the circle; the important thing is staying inside the circle. And if that circle only has 30 companies in it out of 1000s on the big board, as long as you know which 30 they are, you will be OK. And you should know those businesses well enough so you don't need to read lots of work. Now I did a lot of work in the earlier years just getting familiar with businesses and the way I would do that is use what *Phil Fisher* would call, the "Scuttlebutt Approach." I would go out and talk to customers, suppliers, and maybe ex-employees in some cases. Everybody. Every time I was interested in an industry, say it was coal, I would go around and see every coal company. I would ask every CEO, "If you could only buy stock in one coal company that was not your own, which one would it be and why? You piece those things together, you learn about the business after awhile.

Funny, you get very similar answers as long as you ask about competitors. If you had a silver bullet and you could put it through the head of one competitor, which competitor and why? You will find who the best guy is in the industry. So there are a lot of things you can learn about a business. I have done that in the past on the business I felt I could understand so I don't have to do that anymore. The nice thing about investing is that you don't have to learn anything new. You can do it if you want to, but if you learn *Wrigley's* chewing gum forty years ago, you still understand *Wrigley's* chewing gum. There are not a lot of great insights to get of the sort as you go along. So you do get a database in your head.

(Source: Buffett Lecture to the University of Florida, 1998)
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Warren used *See's Candies* to explain inflation and the consumer monopoly. In 1972, *See's* was earning around $2 million on $8 million of net tangible assets. That means that *See's* plant and equipment and inventory produced, after all expenses and taxes, $2 million in net earnings. The company was earning 25% on its net tangible asset base ($2 million / $8 million = 25%).

Berkshire paid roughly $25 million for *See's* which equates to an after tax return of 8% ($2 million / $25 million = 8%). Compare this to government bonds in 1972 which were paying a pretax rate of return of 5.8%, and *See's* after-corporate-income-tax annual rate of return of 8% doesn't look too bad. *(Note comparison.)*

Now let's say that a steel manufacturer with poorer economics than *See's* produced $2 million in net earnings, on $18 million in net tangible assets.

Two different businesses, both with net earnings of $2 million. The difference is that *See's* produces its $2 million on a net tangible asset base of $8 million and the steel manufacturer produces its $2 million on a net tangible asset base of $18 million.

Now add in inflation. Over the next ten years, prices double, as do sales and earnings. Thus both our businesses experience a doubling of earnings, to $4 million. It's easy to figure out because all you have to do is sell the same number of units at the new inflated price, which everybody pays for with their new inflated salary.

But there is a problem. Equipment wears out and eventually needs to be replaced. When these two companies go to replace their net tangible asset bases, the one that had a base of $8 million, *See's*, is going to have to come with $16 million. Prices doubled not only for candy but for plants and equipment. But the steel manufacturer with a net tangible asset base of $18 million is going to have to come with $36 million.

The steel manufacturer is going to require $20 million more of investment ($36 million - $16 million) to produce the amount of earnings equivalent to *See's*.

Think of the advantages a business has if it almost never has to replace its plant and equipment and has the capacity to produce high rates of return on a small net tangible asset base—as *See's* does. *(Source: <u>Buffettology</u> by Mary Buffett, 1997)*

When *Berkshire* paid $25 million for *See's*, it was reporting $4.2 million a year in pretax net earnings. This equates to *Berkshire*'s earning an initial pretax annual return of 16.8% ($4.2 million / $25 million = 16.8%). By 1999, *See's* had $74 million in pretax net earnings, which equates to a 296% pretax return against a 1972 purchase price of $25 million. *See's* managed to grow its pretax earnings at an annual rate of 11.2% due in part to inflation and an increase in the number of its retail outlets. *(Source: <u>The New Buffettology</u> by Mary Buffett, 2002)*

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In 1982, *Buffett* was offered $125 million to sell *See's*--five times the 1972 purchase price or equivalent to 20% CAGR. *Buffett* decided to pass. A wise decision. Over the last eleven years, *See's* has returned to *Berkshire* $212 million—cash—in after-tax earnings. During that same period, *See's* required $44 million in capital expenditures, roughly equal to the $39 million that it depreciated and amortized. *(Source:* <u>The Warren Buffett Way</u> *by Robert Hagstrom, Jr., 1995*

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From <u>Valuegrowth Investing</u> *by Glen Arnold: See's Candies*

The *See's Candies* Shops story illustrates the benefits that can flow from a company that has a **powerful market position, excellent management and only a small need for additional capital as it grows sales and profits.** An affiliate company of *Berkshire (Blue Chip Stamps)* bought control of *See's*, a West Cost manufacturer and retailer of boxed-chocolates, in 1972. The sellers were asking for $40 million. The company had $10 million of excess cash and so the true offering price was $30 million. *Munger*, who through his own inv3estment fund had an interest in *Blue Chip Stamps* and therefore *See's*, and *Buffett* had not yet fully developed their investment philosophy based on the value of an economic franchise. *Buffett*, in particular, was still strongly influenced by Graham's ideas. This meant that they refused to offer $30 million as *See's* had a mere $7 million of tangible net assets. The highest they would go was $25 million. Fortunately, the sellers accepted the offer.

Over the next 20 years annual pre-tax profits increased from $4.2 million to $42.4 million. This may sound impressive, but before judgment is passed the analyst needs to know how much extra capital was needed to produce it. Take, for example, a steel producer with $4.2 million profit making use of $40 million of capital. Conventional investors may value this company more highly than *See's*, given the additional asset backing (assuming similar profit projections). However, Buffett would value the steel producer at much less because of its great need for additional capital as it grows. Let's imagine that both firms increase output and profit by ten-fold. The steel producer is now producing profits of $42 million while making use of $400 million of capital. *See's* produces the same profit, but its capital has risen from $7 million to $70 million (in this hypothetical and simplified case). The steel producer has had to come up with an additional $360 million to invest in plant machinery etc., while *See's* needed only $63 million. Compared with the steel company *See's* can distribute an <u>extra</u> $297 million to shareholders to invest elsewhere.

In actual fact *See's* has been so well managed that 20 years after purchase by *Berkshire* it operated comfortably with only $25 million of net worth. The starting capital base of $7 million was supplemented with only $18 million of reinvested earnings. Profits rose ten-fold to $42.4 million, but capital usage has risen less than four-fold. This allowed *See's* to distribute an astonishing $410 million to shareholders over those 20 years. Not bad for a $25 million investment.

***See's* has pricing power because of a high reputation for the quality of its product and service given to customers.** This pricing power was largely untapped in 1972, but with the arrival of *Chuck Huggins* it was exploited forcefully. At the same time *Huggins* bore down on costs and capital employed, producing the wonderful economics described above. At the same time *Huggins* bore down on costs and capital employed, producing the wonderful economics described above. Some indications of the way that *Huggins* delivered those returns can be seen in Table 1 below covering the first ten years, 1973-82. He did not go for large scale store openings. Nor did he try to increase the sales figures dramatically by, say, reducing prices. **The number of pounds of candy sold per store barely budged during the decade, but the price per pound rose significantly.** *See's* stuck to its niche and grew the profit margins on a very restricted capital investment program. If only more managers could resist the temptation to expand outside of those areas of activity (and geography) where they have competitive advantage, spending vast sums in the process and producing poor returns on capital.

Table 1: *See's Candies* Shops Data

Year Ended	Revenues	Profit after taxes	Number of pounds of candy sold	Number of stores open at year end
31 Dec. 1982	123.7m	$12.7	24.2m	202
31 Decd 1973	$35.1m	$2.1	17.8m	169

Over the 27-year period to 19999 See Candy's earned a total of $857 million pre-tax and it still requires very little capital. *Chuck Huggins* is still there at the age of 74. *Buffett* has noted a law—to be called *Huggins* law: when *Huggins* was 46 *See's* made approximately 10 per cent of his age expressed in millions. When he reached 75 the ratio was 100 percent. *Buffett* says that after discovering this mathematical relationship '*Charlie* and I now become giddy at the mere thought of *Chuck*'s birthday'.

Buffett's Mention of *See's Candies* in Letters to Shareholders of *Berkshire Hathaway, Inc.*

1984 Letter

***See's Candies* Shops, Inc.**

Below is our usual recap of *See's* performance since the time of purchase by *Blue Chip Stamps*:

52-53 Week Year Ended About December 31	*Sales Revenues*	*Operating Profits After Taxes*	*Number of Pounds of Candy Sold*	*Number of Stores Open at Year End*
1984	$135,946,000	$13,380,000	24,759,000	214
1983 (53 weeks) ...	133,531,000	13,699,000	24,651,000	207
1982	123,662,000	11,875,000	24,216,000	202
1981	112,578,000	10,779,000	24,052,000	199
1980	97,715,000	7,547,000	24,065,000	191
1979	87,314,000	6,330,000	23,985,000	188
1978	73,653,000	6,178,000	22,407,000	182
1977	62,886,000	6,154,000	20,921,000	179
1976 (53 weeks) ...	56,333,000	5,569,000	20,553,000	173

1975	50,492,000	5,132,000	19,134,000	172
1974	41,248,000	3,021,000	17,883,000	170
1973	35,050,000	1,940,000	17,813,000	169
1972	31,337,000	2,083,000	16,954,000	167

This performance has not been produced by a generally rising tide. To the contrary, many well-known participants in the boxed-chocolate industry either have lost money in this same period or have been marginally profitable. To our knowledge, only one good-sized competitor has achieved high profitability. The success of *See's* reflects the combination of an exceptional product and an exceptional manager, *Chuck Huggins*.

During 1984 we increased prices considerably less than has been our practice in recent years: per-pound realization was $5.49, up only 1.4% from 1983. Fortunately, we made good progress on cost control, an area that has caused us problems in recent years. Per-pound costs - other than those for raw materials, a segment of expense largely outside of our control - increased by only 2.2% last year.

Our cost-control problem has been exacerbated by the problem of modestly declining volume (measured by pounds, not dollars) on a same-store basis. Total pounds sold through shops in recent years has been maintained at a roughly constant level only by the net addition of a few shops annually. This more-shops-to-get-the-same-volume situation naturally puts heavy pressure on per-pound selling costs.

In 1984, same-store volume declined 1.1%. Total shop volume, however, grew 0.6% because of an increase in stores. (Both percentages are adjusted to compensate for a 53-week fiscal year in 1983.)

See's business tends to get a bit more seasonal each year. In the four weeks prior to Christmas, we do 40% of the year's volume and earn about 75% of the year's profits. We also earn significant sums in the Easter and Valentine's Day periods, but pretty much tread water the rest of the year. In recent years, shop volume at Christmas has grown in relative importance, and so have quantity orders and mail orders. The increased concentration of business in the Christmas period produces a multitude of managerial problems, all of which have been handled by *Chuck* and his associates with exceptional skill and grace.

Their solutions have in no way involved compromises in either quality of service or quality of product. Most of our larger competitors could not say the same. Though faced with somewhat less extreme peaks and valleys in demand than we, they add preservatives or freeze the finished product in order to smooth the production cycle and thereby lower unit costs. We reject such techniques, opting, in effect, for production headaches rather than product modification.

Our mall stores face a host of new food and snack vendors that provide particularly strong competition at non-holiday periods. We need new products to fight back and during 1984 we introduced six candy bars that, overall, met with a good reception. Further product introductions are planned.

In 1985 we will intensify our efforts to keep per-pound cost increases below the rate of inflation. Continued success in these efforts, however, will require gains in same-store poundage. Prices in 1985 should average 6% - 7% above those of 1984. Assuming no change in same-store volume, profits should show a moderate gain.

1985

I am merging the discussion of *Nebraska Furniture Mart*, *See's Candies* Shops, and *Buffalo Evening News* here because the economic strengths, weaknesses, and prospects of these businesses have changed little since I reported to you a year ago. The shortness of this discussion, however, is in no way meant to minimize the importance of these businesses to us: in 1985 they earned an aggregate of $72 million pre-tax. Fifteen years ago, before we had acquired any of them, their aggregate earnings were about $8 million pre-tax.

While an increase in earnings from $8 million to $72 million sounds terrific - and usually is - you should not automatically assume that to be the case. **You must first make sure that earnings were not severely depressed in the base year.** If they were instead substantial in relation to capital employed, an even more important point must be examined: **how much additional capital was required to produce the additional earnings?** ***(Normalize Earnings and Calculate ROIC).***

In both respects, our group of three scores well. First, earnings 15 years ago were excellent compared to capital then employed in the businesses. Second, although annual earnings are now $64 million greater, the businesses require only about $40 million more in invested capital to operate than was the case then.

The dramatic growth in earning power of these three businesses, accompanied by their need for only minor amounts of capital, illustrates very well the power of economic goodwill during an inflationary period (a phenomenon explained in detail in the 1983 annual report). The financial characteristics of these businesses have allowed us to use a very large portion of the earnings they generate elsewhere. Corporate America, however, has had a different experience: in order to increase earnings significantly, most companies have needed to increase capital significantly also. The average American business has required about $5 of additional capital to generate an additional $1 of annual pre-tax earnings. That business, therefore, would have required over $300 million in additional capital from its owners in order to achieve an earnings performance equal to our group of three.

When returns on capital are ordinary, an earn-more-by-putting-up-more record is no great managerial achievement. You can get the same result personally while operating from your rocking chair. just quadruple the capital you commit to a savings account and you will quadruple your earnings. You would hardly expect hosannas for that particular accomplishment. Yet, retirement announcements regularly sing the praises of CEOs who have, say, quadrupled earnings of their widget company during their reign - with no one examining whether this gain was attributable simply to many years of retained earnings and the workings of compound interest.

If the widget company consistently earned a superior return on capital throughout the period, or if capital employed only doubled during the CEO's reign, the praise for him may be well deserved. But if return on capital was lackluster and capital employed increased in pace with earnings, applause should be withheld. A savings account in which interest was reinvested would achieve the same year-by-year increase in earnings - and, at only 8% interest, would quadruple its annual earnings in 18 years.

The power of this simple math is often ignored by companies to the detriment of their shareholders. Many corporate compensation plans reward managers handsomely for earnings increases produced solely, or in large part, by retained earnings - i.e., earnings withheld from owners. For example, ten-year, fixed-price

stock options are granted routinely, often by companies whose dividends are only a small percentage of earnings.

An example will illustrate the inequities possible under such circumstances. Let's suppose that you had a $100,000 savings account earning 8% interest and "managed" by a trustee who could decide each year what portion of the interest you were to be paid in cash. Interest not paid out would be "retained earnings" added to the savings account to compound. And let's suppose that your trustee, in his superior wisdom, set the "pay-out ratio" at one-quarter of the annual earnings.

Under these assumptions, your account would be worth $179,084 at the end of ten years. Additionally, your annual earnings would have increased about 70% from $8,000 to $13,515 under this inspired management. And, finally, your "dividends" would have increased commensurately, rising regularly from $2,000 in the first year to $3,378 in the tenth year. Each year, when your manager's public relations firm prepared his annual report to you, all of the charts would have had lines marching skyward.

See's

At *See's* we continue to get store volumes that are far beyond those achieved by any competitor we know of. Despite the unmatched consumer acceptance we enjoy, industry trends are not good, and we continue to experience slippage in poundage sales on a same-store basis. This puts pressure on per-pound costs. We now are willing to increase prices only modestly and, unless we can stabilize per-shop poundage, profit margins will narrow.

1986

At *See's*, sales trends improved somewhat from those of recent years. Total pounds sold rose about 2%. (For you chocaholics who like to fantasize, one statistic: we sell over 12,000 tons annually.) Same-store sales, measured in pounds, were virtually unchanged. In the previous six years, same store poundage fell, and we gained or maintained poundage volume only by adding stores. But a particularly strong Christmas season in 1986 stemmed the decline. By stabilizing same-store volume and making a major effort to control costs, *See's* was able to maintain its excellent profit margin in 1986 though it put through only minimal price increases. We have *Chuck Huggins*, our long-time manager at *See's*, to thank for this significant
achievement.

See's has a one-of-a-kind product "personality" produced by a combination of its candy's delicious taste and moderate price, the company's total control of the distribution process, and the exceptional service provided by store employees. *Chuck* rightfully measures his success by the satisfaction of our customers, and his attitude permeates the organization. Few major retailing companies have been able to sustain such a customer-oriented spirit, and we owe *Chuck* a great deal for keeping it alive and well at *See's*.

See's profits should stay at about their present level. We will continue to increase prices very modestly, merely matching prospective cost increases.
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1987

At Berkshire, however, my appraisal of our operating managers is, if anything, understated. To understand why, first take a look at page 7, where we show the earnings (on an historical-cost accounting basis) of our seven largest non-financial units: Buffalo News, Fechheimer, Kirby, Nebraska Furniture Mart, Scott Fetzer Manufacturing Group, *See's Candies*, and World Book. In 1987, these seven business units had combined operating earnings before interest and taxes of $180 million.

By itself, this figure says nothing about economic performance. To evaluate that, we must know how much total capital - debt and equity - was needed to produce these earnings. Debt plays an insignificant role at our seven units: Their net interest expense in 1987 was only $2 million. Thus, pre-tax earnings on the equity capital employed by these businesses amounted to $178 million. And this equity - again on an historical-cost basis - was only $175 million.

If these seven business units had operated as a single company, their 1987 *after*-tax earnings would have been approximately $100 million - a return of about 57% on equity capital. You'll seldom see such a percentage anywhere, let alone at large, diversified companies with nominal leverage. Here's a benchmark: In its 1988 Investor's Guide issue, Fortune reported that among the 500 largest industrial companies and 500 largest service companies, only six had averaged a return on equity of over 30% during the previous decade. The best performer among the 1000 was Commerce Clearing House at 40.2%.

Of course, the returns that Berkshire earns from these seven units are not as high as their underlying returns because, in aggregate, we bought the businesses at a substantial premium to underlying equity capital. Overall, these operations are carried on our books at about $222 million above the historical accounting values of the underlying assets. **However, the managers of the units should be judged by the returns they achieve on the underlying assets; what we pay for a business does not affect the amount of capital its manager has to work with.** (If, to become a shareholder and part owner of Commerce Clearing House, you pay, say, six times book value, that does not change CCH's return on equity.)

Three important inferences can be drawn from the figures I have cited. First, the current business value of these seven units is far above their historical book value and also far above the value at which they are carried on Berkshire's balance sheet. Second, because so little capital is required to run these businesses, they can grow while concurrently making almost all of their earnings available for deployment in new opportunities. Third, these businesses are run by truly extraordinary managers. The Blumkins, the Heldmans, *Chuck Huggins*, Stan Lipsey, and Ralph Schey all meld unusual talent, energy and character to achieve exceptional financial results.

For good reasons, we had very high expectations when we joined with these managers. In every case, however, our experience has greatly exceeded those expectations. We have received far more than we deserve, but we are willing to accept such inequities. (We subscribe to the view Jack Benny expressed upon receiving an acting award: "I don't deserve this, but then, I have arthritis and I don't deserve that either.")

Gypsy Rose Lee announced on one of her later birthdays: "I have everything I had last year; it's just that it's all two inches lower." As the table shows, during 1987 almost all of our businesses aged in a more upbeat way.

There's not a lot new to report about these businesses - and that's good, not bad. Severe change and exceptional returns usually don't mix. Most investors, of course, behave as if just the opposite were true. That is, they usually confer the highest price-earnings ratios on exotic-sounding businesses that hold out the promise of feverish change. That prospect lets investors fantasize about future profitability rather than face today's business realities. For such investor-dreamers, any blind date is preferable to one with the girl next door, no matter how desirable she may be.

Experience, however, indicates that the best business returns are usually achieved by companies that are doing something quite similar today to what they were doing five or ten years ago. That is no argument for managerial complacency. Businesses always have opportunities to improve service, product lines, manufacturing techniques, and the like, and obviously these opportunities should be seized. But a business that constantly encounters major change also encounters many chances for major error. Furthermore, economic terrain that is forever shifting violently is ground on which it is difficult to build a fortress-like business franchise. **Such a franchise is usually the key to sustained high returns.**

The Fortune study I mentioned earlier supports our view. Only 25 of the 1,000 companies met two tests of economic excellence - an average return on equity of over 20% in the ten years, 1977 through 1986, and no year worse than 15%. These business superstars were also stock market superstars: During the decade, 24 of the 25 outperformed the S&P 500.

The Fortune champs may surprise you in two respects. First, most use very little leverage compared to their interest-paying capacity. Really good businesses usually don't need to borrow. Second, except for one company that is "high-tech" and several others that manufacture ethical drugs, the companies are in businesses that, on balance, seem rather mundane. Most sell non-sexy products or services in much the same manner as they did ten years ago (though in larger quantities now, or at higher prices, or both). The record of these 25 companies confirms that making the most of an already strong business franchise, or concentrating on a single winning business theme, is what usually produces exceptional economics.

Berkshire's experience has been similar. **Our managers have produced extraordinary results by doing rather ordinary things - but doing them exceptionally well. Our managers protect their franchises, they control costs, they search for new products and markets that build on their existing strengths and they don't get diverted. They work exceptionally hard at the details of their businesses, and it shows.**

See's Candies

Chuck Huggins continues to set new records at *See's*, just as he has ever since we put him in charge on the day of our purchase some 16 years ago. In 1987, volume hit a new high at slightly Under 25 million pounds. For the second year in a row, moreover, same-store sales, measured in pounds, were virtually unchanged. In case you are wondering, that represents improvement: In each of the previous six years, same-store sales had fallen.

Although we had a particularly strong 1986 Christmas season, we racked up better store-for-store comparisons in the 1987 Christmas season than at any other time of the year. Thus, the seasonal factor at *See's* becomes even more extreme. In 1987, about 85% of our profit was earned during December.

Candy stores are fun to visit, but most have not been fun for their owners. From what we can learn, practically no one besides *See's* has made significant profits in recent years from the operation of candy shops. Clearly, *Chuck*'s record

at *See's* is not due to a rising industry tide. Rather, it is a one-of-a-kind performance.

His achievement requires an excellent product - which we have - but it also requires genuine affection for the customer. *Chuck* is 100% customer-oriented, and his attitude sets the tone for the rest of the *See's* organization.

Here's an example of *Chuck* in action: At *See's* we regularly add new pieces of candy to our mix and also cull a few to keep our product line at about 100 varieties. Last spring we selected 14 items for elimination. Two, it turned out, were badly missed by our customers, who wasted no time in letting us know what they thought of our judgment: "A pox on all in *See's* who participated in the abominable decision...;" "May your new truffles melt in transit, may they sour in people's mouths, may your costs go up and your profits go down...;" "We are investigating the possibility of obtaining a mandatory injunction requiring you to supply...;" You get the picture. In all, we received many hundreds of letters.

Chuck not only reintroduced the pieces, he turned this miscue into an opportunity. Each person who had written got a complete and honest explanation in return. Said *Chuck*'s letter: "Fortunately, when I make poor decisions, good things often happen as a result...;" And with the letter went a special gift certificate.

See's increased prices only slightly in the last two years. In 1988 we have raised prices somewhat more, though still moderately. To date, sales have been weak and it may be difficult for *See's* to improve its earnings this year.

1988

See's Candies sold a record 25.1 million pounds in 1988. Prospects did not look good at the end of October, but excellent Christmas volume, considerably better than the record set in 1987, turned the tide.

As we've told you before, *See's* business continues to become more Christmas-concentrated. In 1988, the Company earned a record 90% of its full-year profits in December: $29 million out of $32.5 million before tax. (It's enough to make you believe in Santa Claus.) December's deluge of business produces a modest seasonal bulge in Berkshire's corporate earnings. Another small bulge occurs in the first quarter, when most World Book annuals are sold.

Charlie and I put *Chuck Huggins* in charge of *See's* about five minutes after we bought the company. Upon reviewing his record, you may wonder what took us so long.

1989

At *See's Candies* we had an 8% increase in pounds sold, even though 1988 was itself a record year. Included in the 1989 performance were excellent same-store poundage gains, our first in many years.

Advertising played an important role in this outstanding performance. We increased total advertising expenditures from $4 million to $5 million and also got copy from our agency, Hal Riney & Partners, Inc., that was 100% on the money in conveying the qualities that make *See's* special.

1990

At *See's*, physical volume set a record in 1990 - but only barely and only because of good sales early in the year. After the invasion of Kuwait, mall traffic in the West fell. Our poundage volume at Christmas dropped slightly, though our dollar sales were up because of a 5% price increase.

That increase, and better control of expenses, improved profit margins. Against the backdrop of a weak retailing environment, *Chuck Huggins* delivered outstanding results, as he has in each of the nineteen years we have owned *See's*. *Chuck's* imprint on the business - a virtual fanaticism about quality and service - is visible at all of our 225 stores.

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1991 *Berkshire* Annual Report

Twenty Years in a Candy Store

We've just passed a milestone: Twenty years ago, on January 3, 1972, *Blue Chip Stamps* (then an affiliate of *Berkshire* and later merged into it) bought control of *See's Candies* Shops, a West Coast manufacturer and retailer of boxed-chocolates. The nominal price that the sellers were asking - calculated on the 100% ownership we ultimately attained - was $40 million. But the company had $10 million of excess cash, and therefore the true offering price was $30 million. *Charlie* and I, **not yet fully appreciative of the value of an economic franchise**, looked at the company's mere $7 million of tangible net worth and said $25 million was as high as we would go (and we meant it). Fortunately, the sellers accepted our offer.

The sales of trading stamps by *Blue Chip* thereafter declined from $102.5 million in 1972 to $1.2 million in 1991. But *See's Candies* sales in the same period increased from $29 million to $196 million. Moreover, profits at *See's* grew even faster than sales, from $4.2 million pre-tax in 1972 to $42.4 million last year.

For an increase in profits to be evaluated properly, it must be compared with the incremental capital investment required to produce it.

On this score, *See's* has been astounding: The company now operates comfortably with only $25 million of net worth, which means that our beginning base of $7 million has had to be supplemented by only $18 million of reinvested earnings ($25 - $7). Meanwhile, *See's* remaining pre-tax profits of $410 million were distributed to *Blue Chip*/*Berkshire* during the 20 years for these companies to deploy (after payment of taxes) in whatever way made most sense.

In our *See's* purchase, *Charlie* and I had one important insight: We saw that the business had **untapped pricing power**. Otherwise, we were lucky twice over. First, the transaction was not derailed by our dumb insistence on a $25 million price. Second, we found *Chuck Huggins*, then *See's* executive vice-president, whom we instantly put in charge. Both our business and personal experiences with *Chuck* have been outstanding. One example: When the purchase was made, we shook hands with *Chuck* on a compensation arrangement - conceived in about five minutes and never reduced to a written contract - that remains unchanged to this day.

In 1991, *See's* sales volume, measured in dollars, matched that of 1990. In pounds, however, volume was down 4%. All of that slippage took place in the last two months of the year, a period that normally produces more than 80% of annual profits. Despite the weakness in sales, profits last year grew 7%, and our pre-tax profit margin was a record 21.6%.

Almost **80% of *See's* sales come from California** and our business clearly was hurt by the recession, which hit the state with particular force late in the year. Another negative, however, was the mid-year initiation in

California of a sales tax of 7%-8% (depending on the county involved) on "snack food" that was deemed applicable to our candy.

Shareholders who are students of epistemological shadings will enjoy California's classifications of "snack" and "non-snack" foods:

Taxable "Snack" Foods	Non-Taxable "Non-Snack" Foods
Ritz Crackers	Soda Crackers
Popped Popcorn	Unpopped Popcorn
Granola Bars	Granola Cereal
Slice of Pie (Wrapped)	Whole Pie
Milky Way Candy Bar	Milky Way Ice Cream Bar

What - you are sure to ask - is the tax status of a *melted* Milky Way ice cream bar? In that androgynous form, does it more resemble an ice cream bar or a candy bar that has been left in the sun? It's no wonder that *Brad Sherman*, Chairman of California's State Board of Equalization, who opposed the snack food bill but must now administer it, has said: "I came to this job as a specialist in tax law. Now I find my constituents should have elected Julia Child."

Charlie and I have many reasons to be thankful for our association with *Chuck* and *See's*. The obvious ones are that we've earned exceptional returns and had a good time in the process. Equally important, ownership of *See's* has taught us much about the evaluation of franchises. **We've made significant money in certain common stocks because of the lessons we learned at *See's* .**
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Additional Lessons from *Berkshire's* purchase of private companies like *See's Candies*.

There is also a **tax aspect** to these acquisitions. By buying an entire company *Berkshire* can avoid a level of taxation on the economic growth of the business. Let's look at the economics of *See's Candies*.

Suppose *See's Candies* was a publicly traded company before *Berkshire* bought it and that instead of buying the entire company *Berkshire* bought only 10% of the outstanding shares. Every time *See's* earns $1 it has to pay a 34% corporate income tax, which reduces it to $0.66. This after-tax $0.66 either gets retained and added into *See's* shareholders' equity pot or is paid out as a dividend. If *See's* pays out to *Berkshire* the $0.66 and it is added to the equity pot, it will increase the value of its business and ultimately the price of its shares. If at some time in the future *Berkshire* wants to unlock the increased value of *See's* accumulated retained earnings, it would have to sell its *See's* shares, which means that its profits from the sale would be subject to a capital gains tax of 35% on the difference between what it paid for the stock and what it sold for. So if *Berkshire* paid $10 a share for *See's* and sold it for $25 a share, it would have to pay a capital gains tax on the $15 in profits ($25 - $10 = $15).

But since *Berkshire* bought all of *See's* , instead of just 10%, then any earnings *See's* pays out to *Berkshire* will be exempt from the 14% tax on dividends. If *Berkshire* decides to sell it, the amount of earnings that *See's* retained during *Berkshire*'s ownership will for tax purposes be added to *Berkshire*'s purchase price for *See's*. In this scenario, if *Berkshire* paid $10 a share for *See's* and retained $8 a share, its basis for capital gains taxes would increase to $18 a share ($10 + $8 = $18). Thus, if it sold *See's* for the equivalent of $25 a share, it would have to pay a capital gains tax on only $7 of the $15 in profits ($25 - $18 = $7). Though this may not *See*m like much per share, if *Berkshire* really did sell *See's* , it could equate to a savings of approximately $25 million—the price *Berkshire* originally paid for the company! **Sometimes it's better to eat the whole cake rather than take a few nibbles.**

See's and *The Pampered Chef* offer certain tax advantages over the purchase of minority interests in publicly traded businesses. *(Source: The New Buffettology by Mary Buffett, 2002)*
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Challenges for *See's Candies*

Like most businesses, *See's Candies* has some ups and downs. Candy sales are affected by the economy, as well as by other events, such as the Persian Gulf War in 1990, which decreased traffic in the malls, where most of *See's* stores are located. **In addition, efforts to expand the business into Colorado, Missouri, and Texas in the late 1980s—80 percent of the stores are located in California—were considerably less successful than had been hoped, and *See's* quickly pulled out of those markets.** In the early 1990s, even though the company was earning considerable profits, *See's* chose to close a dozen of its 218 stores because those profits had begun to drop.

Like all traditional storefront candy companies, *See's* business is very seasonal—an impulse purchase—except at Christmas, Valentine's, Easter, Mother's Day, and Father's Day when *See's* is a destination purchase. The company does almost half of its annual business, which represents 90 percent of the company's profits, during November and December. The end-of-the-year holiday sales are crucial, as *Warren Buffett* explained to Berkshire Shareholders in 1984: "We always earn significant sums on the Easter and Valentine's day periods, but pretty much tread water the rest of the year." The variations in sales over the course of the year require variations in staffing, and the number of employees goes from approximately 2,000 during most of the year to 6,700 during the peak sales period.

See's now has 200 company-owned stores in 11 states, licenses in airports, and *See's*-managed "holiday gift centers" throughout the east cost and Midwest. The company sells more than 30 million pounds of chocolate every year. Nevertheless, like all CEOs, *Chuck Huggins* worries about competition. When the company was started in the 1920s, and even in thought the 1950s, it had numerous competitors—*Barton's, Fannie May, Russell Stover* and *Fannie Farmer*, among others—but most have lone since gone out of business or out of store sales. Even so, *Huggins* is extremely conscious of the fact that the company still faces considerable competitions. "I consider our biggest current—and future—competitor to be *Godiva,*" he says. "They are opening more stores, and they have exposure in both domestic and foreign markets. There are now over 150 locations and they've done a terrific job of positioning themselves. Most people think they're made in Europe, " he notes, "even though they're really made by the Pepperidge Farm division of Campbell Soup Company in Reading, Penn." *Huggins* believes *See's* insistent on maintaining quality, old-fashioned service, and good prices—*See's Candies* price half as much per pound as *Godiva's*—has enabled the company to not only survive but to flourish.

(Source: The Warren Buffett CEO: Secrets from the Berkshire Hathaway Managers *by Robert P. Miles (2002)*

Pilgrimage, Part X: On The Cheap from Mathews

(or a critique of milking companies for cash instead of pushing for growth). Do you agree with his assessment? Why or why not? What are the major differences between See's and Starbucks? Discuss.

Unexpired Time, Blinking Screens and What Might Have Been

Warren Buffett takes pride in his cheapness.

"My suits are expensive, they only look cheap on me," he likes to say, being as self-deprecating as he is tight-fisted.

Cheapness defines more than his personal proclivities, however; it also defines his investment style. For not only

is Buffett cheap, but, as the CEO of a deep-pocketed insurance giant named Berkshire-Hathaway, he buys *entire companies cheap*.

And those companies, once in the Berkshire fold, adopt his personal and professional proclivities: they *spend* cheap—the better to generate excess cash for the great *Warren Buffett* to invest…cheap.

How cheap *is Warren Buffett*?

In his 2006 letter to shareholders—which runs 24 pages, so seriously does he take his own advice that a CEO should communicate directly to "*the people who gave him the money*"—*Buffett* re-tells the story of Berkshire-Hathaway's $8.6 million purchase of National Indemnity from Jack Ringwalt, 40 years ago;

"Jack was a life-time friend of mine and an excellent, but somewhat eccentric, businessman… When we were due to close the purchase at Charlie's office, Jack was late. Finally arriving, he explained that he had been driving around looking for a parking meter with unexpired time."

Far from being annoyed at the delay, says *Buffett*, he was delighted:

"That was a magic moment for me. I knew then that Jack was going to be my kind of manager."

I suspect the "magic moments" of most public company CEOs run more towards the thrill of a successful initial public offering, or a blockbuster major mega-merger announcement, or the first time they were served a dry martini on the corporate jet—**not from hearing about the search for unused time on a parking meter.**

But that's *Warren Buffett*. And, hey, it's worked: he is, after all, the most successful investor in the world.

Still, is penny-pinching for the sake of penny-pinching always a good thing when it comes to running a business?

Is the CEO in the story, who drove around the block looking for unexpired time on a parking meter (and the story must be true, because from what we have seen, the streets of Omaha do have a lot of parking meters on them), the kind of CEO who's going to maximize the value of a business not just in the short-term, but also in the very, very long term?

Some readers will, no doubt, answer with an emphatic "Yes" and quickly name a relevant example.

My own personal favorite is probably *Great Lakes Chemical*, the Indiana-based bromine producer that expanded and adapted over the years into a large, yet still notoriously tight-fisted specialty chemicals company.

I recall the CEO of a Great Lakes competitor telling me, with awe, about a visit to Great Lakes' bare-bones corporate office, where the lights in the conference room were operated by *an old-fashioned light timer*, like the timers that control heating lamps in hotel bathrooms.

Not only did Great Lakes save money on their lighting bills, he pointed out, but "the meetings were real short," what with executives having to get up to turn the lights back on every ten minutes or so.

Now, if you're thinking the Great Lakes Chemical people sound like *Warren Buffett*'s kind of managers, you're right. **Berkshire-Hathaway bought 7% of the company in 1999**—a move that paid off six years later, when Great Lakes sold out to a competitor.

Still, while the Great Lakes Chemical *stock* provided *Warren Buffett* and others with an excellent return on their investment, the Great Lakes Chemical *company* didn't survive.

Could both the company and its stock have done even better if there'd been less focus on the utility bill and more focus on new growth opportunities? In the long run, is running a business on the cheap—cheapness for cheapness' sake—a good thing or a bad thing?

That question pops into my head as we follow a long line of cars snaking into the Nebraska Furniture Mart parking lot, which is actually many parking lots of various sizes and shapes connecting the huge buildings—and by "huge" I mean *airplane hanger size*-huge—that comprise the Midwest's largest home furnishings store.

The buildings are scattered in such a random fashion across 77 acres of what used to be prairie that it feels as if each time they outgrew a building, somebody decided to put up the next building right *here*, without much forethought as to how it all fit with any of the others.

It reminds me of nothing so much as an old-fashioned lumberyard.

We park in the general vicinity of the electronics store, which Nebraska Furniture Mart opened in 1995. Large flags on the nearby lamp-posts display various electronics brand names, simultaneously enticing shoppers into the store, as well as reminding them where they parked.

The entirely unintended effect of these flags, however, is to plainly age the place, for there is not a single new or even semi-new brands that electronics shoppers care about these days—Garmin, for example, or LG or even iPod.

Instead they are older, stodgy brands such as IBM and Hewlett Packard and Maytag and Whirlpool. Some of the brands no longer even exist in any meaningful fashion. The one near our car, for example, reads "Compaq."

They might as well advertise Underwood Typewriters.

That out-of-dateness sets the tone for the entire place, which, while every bit as big and eye-popping as *Buffett*'s fond mentions in his annual shareholder letters, is fraying around the edges—like a Wal-Mart Super Center three or four years after the grand opening.

And we haven't even gone *inside* yet.

Not helping matters, I will admit, is our having to go through the clumsy manual door-locking sequence of this GM rental car, nor is it a plus that when we start walking towards the main entrance we witness the oddest sight of the entire day: a middle-aged couple changing their clothes in the dubious privacy of Nebraska's Largest Parking Lot.

I am not making that up.

The husband and wife have obviously come a long way to attend the shareholder's meeting—their minivan is *packed* with gear—and they appear to be changing into more formal attire for a shareholder reception being readied under a big white tent that rises on a far corner of the Furniture Mart property.

Yet they are doing it—at least the husband is, muscle shirt and all—while standing under the flipped-up hatch of the minivan. We move on quickly, before we can see what the wife might be planning.

Once inside, the electronics store seems like an extremely huge, but extremely basic, electronics store. The prices on a few familiar items appear to be nothing very special, although we are not here to conduct an in-depth price check.

Nevertheless, the place does project a deep-discount feel that gives a shopper the impression they could do

no better, and probably a whole lot worse, elsewhere.

The cash registers are busy, and easily one-third of the adult shoppers are wearing their plastic Berkshire-Hathaway "shareholder" badges. They wear the badges not out of mere habit, but because they will get a steep discount on their shopping here this weekend.

As *Buffett* noted in his shareholder letter with pride, Nebraska Furniture Mart generated $30 million of revenue during the 2005 shareholder meeting weekend—almost 10% of this location's annual total sales (there are two other Marts: one in Kansas City, and another in Des Moines).

Which, I suspect, makes Berkshire-Hathaway the only public company to routinely earn a profit on its annual meeting.

Nevertheless, the merchandizing is familiar to anyone who has shopped in a Best Buy or a Frye's—aisles of CDs, DVDs, telephone products, boom-boxes, stuff. There is a small but crowded iPod display and an empty Microsoft Zune display.

Then we reach the heart of the store, which consists of two giant, crowded aisles along which big screen televisions are displayed, floor to near-ceiling level. Given *Buffett*'s own innate, er, cheapness, it makes sense that Berkshire-Hathaway's own shareholders would be savvy enough to cash in their discount on the biggest dollar value item in the joint.

After all, why waste it on a DVD?

We squeeze through browsers, customers and clerks to the far end of the store and make our way back down an adjacent aisle with the computer displays—a relatively bare-bones but decent offering that includes Macs. This strikes me as fairly impressive, since Best Buy only recently got authorization from Cupertino to roll them out.

Still, the general warehouse-type aura of the store feels out-of-date, particularly now that most electronics stores are *down*sizing, not upsizing.

After all, an aisle or two of music CDs can be carried on an iPod these days, and Volkswagen-sized stereo systems have shrunk to the approximate width and length of a beer can.

It's not merely that big is no longer better: big is no longer necessary at all.

Even Best Buy, which helped drive the supersizing of American electronics retailing, is cutting its prototype store size by one-third.

It is while contemplating this that I come upon something else far more unsettling at a nearby register. The Nebraska Furniture Mart computer monitor on which one of the sales people is checking something for a potential customer is an ancient, pre-Windows type of screen—the kind with block white letters and a blinking white cursor.

I haven't seen this kind of ancient point-of-sales software in a large chain in so long I can't remember where I last saw it. Dollar General, maybe?

Of course, not having the latest and greatest software isn't necessarily a sign of back-office chaos. For all I know, the Nebraska Furniture Mart computer systems might offer every piece of vital information a sales person or an accounts payable staffer needs, at a keystroke.

But I doubt it.

And I doubt it even less when we move on and I see an open door to a small room, which contains a bunch of less-than-cutting-edge servers stacked on cluttered shelving. Makes me wonder not only how up-to-date this place really is, but how secure the systems might be.

Retailing has, after all, come a long way since 1983 when *Buffett* bought Nebraska Furniture Mart on a handshake from Rose Blumkin, the late Russian immigrant whose motto—"Sell Cheap and Tell the Truth"—could, with a minor adjustment (replace the "Sell" with "Buy") be *Buffett*'s own.

And electronics retailing has come even further, what with the constant downward spiral in prices, fickle consumer tastes, accelerating product cycles and the rise in online shopping.

Disappointed and not having spent a dime, we head outside and cross a busy driveway to the Main Event—the furniture store.

It is big, cavernous and long. *Very* long. The longest store I have ever walked through.

Fully loaded showrooms meld into one after another—a seemingly endless display of sofas, recliners, tables, and chairs. And that's before we even get to the lighting area, which appears to offer every fixture ever created since Thomas Edison patented the thing.

Which reminds me: here we see even *more* of those old-fashioned computer screens with blinking white cursors at the customer service desks.

There is no doubt the shoppers are here—whether they are University of Nebraska students getting ready for summer school or Berkshire-Hathaway shareholders loading up on discounted La-Z-Boys.

And there is no doubt the place has grown from the single-store brainchild of Rose Blumkin—"Mrs. B," as she is reverently known—to a three-store Midwest home furnishings powerhouse.

But why, I wonder, is the Nebraska Furniture Mart not a national phenomenon?

Why, 74 years after its modest beginnings, are there only three stores in the entire United States?

"Well," you might say, *"this was a family-owned Nebraska retailer in the middle of nowhere, with a limited product line and no Wall Street big shots pulling the strings—so what's wrong with three stores and a half-billion or so in very profitable sales?"*

Not a thing, certainly—except that another family-owned Nebraska retailer in the middle of nowhere, with a limited product line and no Wall Street big shots pulling the strings managed to rack up over $2 billion in very profitable sales last year, its 45th year in business.

Like Nebraska Furniture Mart, this retailer operates huge stores in out-of-the-way places (ever hear of Hamburg, Pennsylvania?) and puts the customer first.

Unlike the Mart, however, this company's stores are modern, lively and fun to shop, even if you couldn't care less about hunting or fishing gear—which is what they sell. There's even an *ice-fishing* department, if you can believe it.

That company is *Cabela's.*

And if a retailer of hunting and fishing gear (U.S. market size: $30 billion) could grow into a $2 billion enterprise,

why—with a little more capital investment over the years—couldn't Nebraska Furniture Mart, which sells *home furnishings*, for goodness sake (U.S. market size: $250 billion), be a whole lot bigger than a mere half billion or so by now?

Lest readers think I am picking unfairly on Nebraska Furniture Mart, the question also holds for ***See's Candies***, I think.

In 1994, *See's* sold $216 million worth of chocolates and sweets, mostly in the western half of the U.S., earning $28 million after-tax.

Of that, *See's* spent a modest $4 million on expansion and turned in the $24 million balance to Berkshire-Hathaway for *Warren Buffett* to invest as he saw fit.

That same year, another west-coast company sold $284 million worth of consumables in shops mostly on the west coast, on which it earned $10 million after taxes.

Unlike *See's*, however, this company was growing: it spent *$136 million* on expansion and didn't pay a penny of dividends to its shareholders.

Today, *See's* is still a west-coast business, with about 200 shops and, I am guessing, perhaps $500 million in sales generating as much as $75 million in cash for Berkshire-Hathaway.

That other west-coast firm, however, now has over 13,000 shops around the world, sold nearly $8 billion worth of coffee last year and generated almost $1 billion in pre-tax profits.

I am talking, of course, about Starbucks.

Both Starbucks and *See's* make an excellent product, have an excellent brand name and earn excellent returns on capital. The biggest difference, as far as I can see, is that one invested their capital to grow; the other invested it, well, in other companies.

I am reminded of *Charlie Munger*'s remark earlier today, when he said, *"If a business is good, it will carry a lousy management."*

How long, I wonder, can a good business carry an owner who does not reinvest in that business?

It is a question that, until our walk through the cavernous halls of the Nebraska Furniture Mart, had not occurred to me.

Time to go. It has been a long day.

End