A Dozen Things Warren Buffett and Charlie Munger Learned From See's Candies

November 25, 2016

This is my 200th blog post. I thought it would be most fitting given the milestone to write about a topic related to Munger and Buffett.

One of the most important decisions in the history of Berkshire was the acquisition of See's Candies in 1972. Buffett has called See's Candies "the prototype of a dream business." Berkshire's purchase of a boxed candy business founded by the See family in California fundamentally changed the investing world because it changed the way Buffett and Munger thought about investing. While you may never have the chance to own a business like See's

Candies, by better understanding the nature of a dream business you can more easily find a business to invest in that shares some of its positive attributes.

For anyone not familiar with the company, Bloomberg provides a helpful summary: “See’s Candies produces and retails boxed chocolates. The company was founded in 1921 and has store locations in the United States and internationally. See’s Candies operates as a subsidiary of Berkshire Hathaway.”

1. Buffett: “It’s one thing to own stock in a Coca-Cola or something, but when you’re actually in the business of making determinations about opening stores and pricing decisions, you learn from it. We have made a lot more money out of See’s than shows from the earnings of See’s, just by the fact that it’s educated me.” “If we hadn’t bought See’s, we wouldn’t have bought Coke. So thank See’s for the $12 billion. We had the luck to buy the whole business and that taught us a whole lot.” 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."

What Buffett is saying is that the more you know about business the better investor you will be (and vice versa). The best way to learn about business is to actually run one or at least work in one. As Will Rogers once said: "Good judgment comes from experience, and a lot of that comes from bad judgment." It is the feedback loop between success and failure and various decisions and actions that are part of operating a business that gives the business executive or investor the best education. Reading about X, Y or Z aspects of business is helpful but there is nothing quite like the education that comes from being in the driver's seat and having personal responsibility for actual business outcomes.

2. Munger: "If we'd stayed with the classic Graham, the way Ben Graham did it, we would never have had the record we have. And that's because Graham wasn't trying to do what we did." "See's was the first high-quality business we ever bought." "After nearly making a terrible mistake not buying See's, we've made this mistake many times. We are apparently slow learners." "If See's had asked $100,000 more, Warren and I would have walked — that's how dumb we were.

[Munger's friend] 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." "The main contribution of [buying See's Candies] was ignorance removal. If we weren't good at removing ignorance, we'd be nothing today. We were pretty damn stupid when we bought See's – just a little less stupid enough to buy it. The best things about Berkshire is that we have removed a lot of ignorance. The nice thing is we still have a lot more ignorance left. Another trick is scrambling out of your mistakes, which is enormously useful. We have a sure to fail department store. A trading stamp business sure to fold and a textile mill. Out of that comes Berkshire. Think about how we would have done if we had a better start." "See's Candies was acquired at a premium over book (value) and it worked. Hochschild, Kohn, the department store chain (in Baltimore), was bought at a discount from book and liquidating value. It didn't work.

Those two things together helped shift our thinking to the idea of paying higher prices for better businesses."

What Munger is talking about above (in addition to the importance of humility) is the idea that a business with superior quality bought at the right price can still be a bargain consistent with the principles of value investing. This evolution of the value investing system to consider quality in valuing a business is arguably Munger's greatest contribution to Berkshire. Munger knew that value investing had to evolve since the "cigar butt" types of businesses that Graham liked to buy started to disappear as years passed since the Great Depression. Munger recognized that "Grahamites … realized that some company that was selling at 2 or 3 times book value could still be a hell of a bargain because of momentum implicit in its position, sometimes combined with an unusual managerial skill plainly present in some individual or other, or some system or other. And once we'd gotten over the hurdle of recognizing that a thing could be a bargain based on quantitative measures that would have horrified Graham, we started thinking about better businesses." For Munger, not considering the quality of the underlying business when buying an asset is far too limiting: "The investment game always involves considering both quality and price, and the trick is to get more quality than you pay for in price. It's just that simple." "We've really made the money out of high quality businesses. In some cases, we bought the whole business. And in some cases, we just bought a big block of stock. But when you analyze what happened, the big money's been made in the high quality businesses. And most of the other people who've made a lot of money have done so in high quality businesses." "If you can buy the best companies, over time the pricing takes care of itself."

3. Buffett: "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."

How do Munger and Buffett assess quality? This passage from the 1992 Berkshire Chairman's letter set out the key test: "Leaving the question of price aside, the best business to own is one that, over an extended period, can employ large amounts of incremental capital at very high rates of return. The worst business to own is one that must, or will, do the opposite – that is, consistently employ ever-greater amounts of capital at very low rates of return." A recent presentation from Broyhill Asset Management points out:

> "See's sold 16 million pounds of candy in 1972. In 2007, it sold 31 million pounds. That's a growth rate of about 2% annually. Yet the business created tremendous value. How? Because it generated high returns on invested capital and required little incremental investment. Growth creates value only when a business can invest at incremental returns higher than its cost of capital. The higher return a business can earn on its capital, the more cash it can produce, the more Value is created. Over time, it is hard for investors to earn returns

that are much higher than the underlying business' return on invested capital."

4. Munger: "There are actually businesses, that you will find a few times in a lifetime, where any manager could raise the return enormously just by raising prices—and yet they haven't done it. So they have huge untapped pricing power that they're not using. That is the ultimate no-brainer. Disney found that it could raise those prices a lot and the attendance stayed right up. So a lot of the great record of Eisner and Wells came from just raising prices at Disneyland and Disneyworld and through video cassette sales of classic animated movies. At Berkshire Hathaway, Warren and I raised the prices of See's Candy a little faster than others might have." Buffett: "We bought See's Candy in 1972, See's Candy 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 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 untapped pricing power 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.”

Buffett believes: “The single most important decision in evaluating a business is pricing power. If you’ve got the power to raise prices without losing business to a competitor, you’ve got a very good business. And if you have to have a prayer session before raising the price by 10 percent, then you’ve got a terrible business.” Buffett and Munger found an asset in the form of See’s that has retained tremendous pricing power over the years. That means See’s has a moat. It is not an unlimited moat geographically as will be discussed below, but where the moat exists it is very strong.

5. Buffett: “Buy commodities, sell brands has long been a formula for business success. It has produced enormous and sustained profits for Coca-Cola since 1886 and Wrigley since 1891. On a smaller scale, we have enjoyed good fortune with this approach at See’s Candy since we purchased it 40 years ago.” “When we bought See’s Candies, we didn’t know the power of a good brand. Over time we just discovered that we could raise prices 10% a year and no one cared. Learning that changed Berkshire. It was really

important.” “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 Candy 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 Candy 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 untapped pricing power—it is not price dependent.” “What we did know was that they had share of mind in California. There was something special. Every person in California has something in mind about See’s Candy 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 Candy 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 make more money 10 years from now. But of that $60 million, we make $55 million in the three weeks before Christmas.

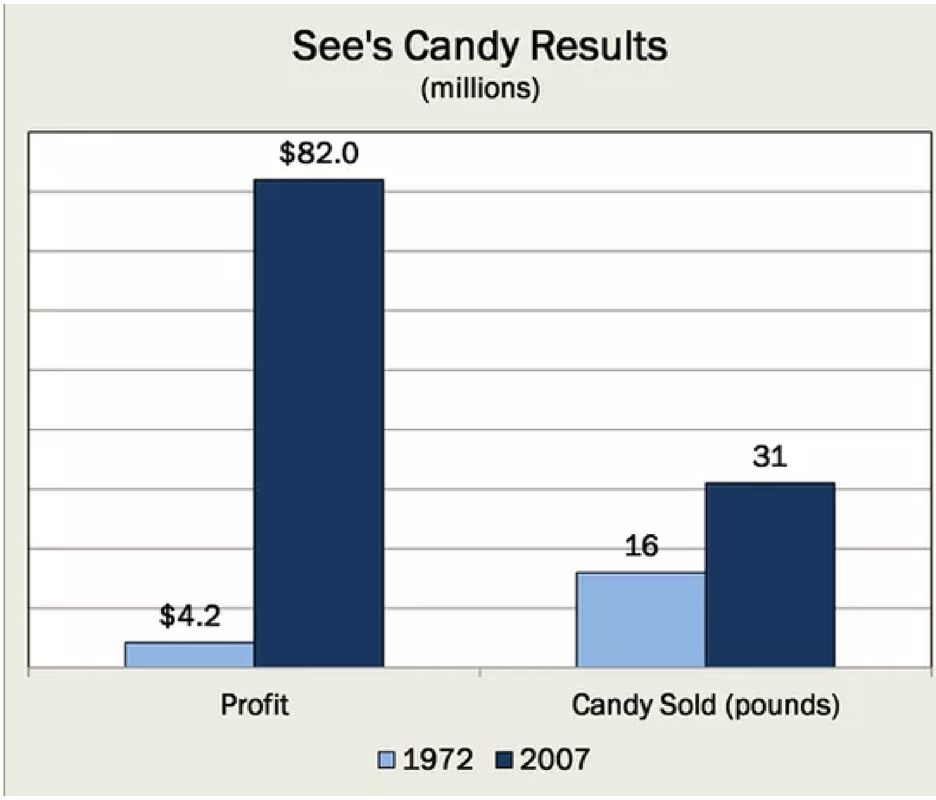
The See's acquisition taught Munger and Buffet about the power of a brand to create a moat. Munger has pointed out:

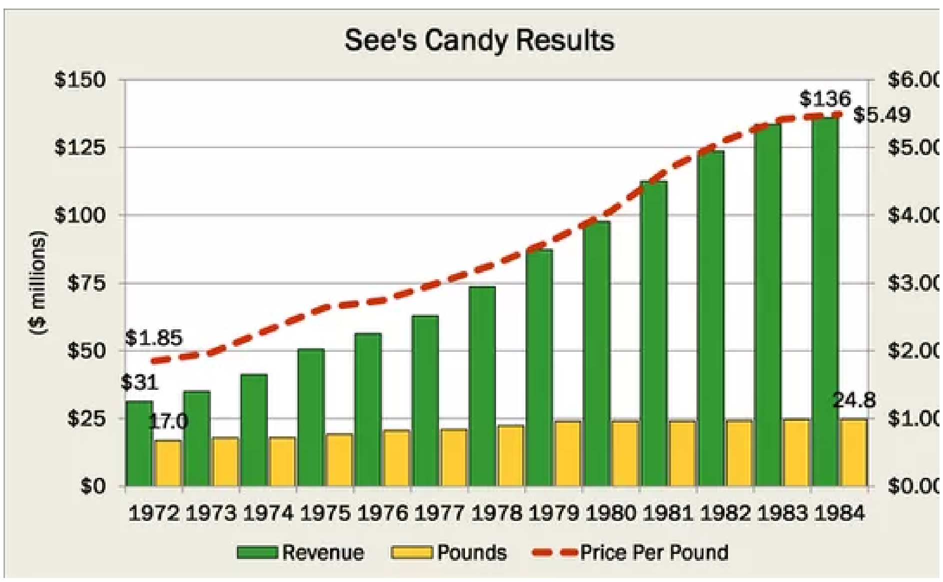
> "The informational advantage of brands is hard to beat. And your advantage of scale can be an informational advantage. If I go to some remote place, I may see Wrigley chewing gum alongside Glotz's chewing gum. Well, I know that Wrigley is a satisfactory product, whereas I don't know anything about Glotz's. So if one is $.40 and the other is $.30, am I going to take something I don't know and put it in my mouth – which is a pretty personal place, after all – for a lousy dime? So, in effect, Wrigley, simply by being so well-known, has advantages of scale – what you might call an informational advantage. Everyone is influenced by what others do and approve. Another advantage of scale comes from

> psychology. The psychologists use the term 'social proof'. We are all influenced – subconsciously and to some extent consciously – by what we see others do and approve. Therefore, if everybody's buying something, we think it's better. We don't like to be the one guy who's out of step. Again, some of this is at a subconscious level and some of it isn't. Sometimes, we consciously and rationally think, 'Gee, I don't know much about this. They know more than I do. Therefore, why shouldn't I follow them?' All told, your advantages can add up to one tough moat."

One question relevant right now is whether the power of national brands versus local brands is decreasing due to transparency created by the Internet. In any event, over the years the power of a brand when combined with commodity inputs has created a powerful combination. "In 1972, See's sold 16 million pounds of candy, and 35 years later, it stood at 32 million, meaning it gained just 2% a year, but it's profit rose by 9% a year":

Source: Motley Fool Berkshire Hathaway Annual Letters.





6. Buffett: "The boxed-chocolates industry in which it operates is unexciting: Per-capita consumption in the U.S. is extremely low and doesn't grow. Many once-important brands have disappeared, and only three companies

have earned more than token profits over the last forty years. Indeed, I believe that See's, though it obtains the bulk of its revenues from only a few states, accounts for nearly half of the entire industry's earnings." "You cannot destroy the brand of See's Candies. Only See's can do that. You have to look at the brand as a promise to the customer that we are going to offer the quality and service that is expected. We link the product with happiness. You don't see See's candy sponsoring the local funeral home. We are at the Thanksgiving Day Parades though." "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.)"

If you grew up in a home that bought See's Candies (mostly on the West Coast, especially in California) and your experiences around that candy have very favorable associations, you will pay more for a box bearing the See's Candies brand. By contrast, someone who grew up in the east cost of the United States will not attribute as much value to that brand since they do not have those same experiences. For this reason, See's Candies has found it hard to expand regionally and has done so very slowly. What See's Candies sells is not just food, but rather an experience that is usually offered in the form of a gift." A perceptive writer in an Israeli newspaper points out:

> "Warren suggests getting your brand into the "gift market" because people don't give second-class gifts. If you price your new whiskey brand at 5 percent less than the leading brand, you'll have a hard time gaining customers. "The higher-priced one is both better known and more expensive," reasons the customer. "Why get something inferior just to save a few dollars?" This is especially true when the product will be a gift; no one wants to be seen as second class. The new whiskey would actually market itself more successfully in Grey Goose style: as a premium brand with a matching package that helps the potential buyer overcome much of his hesitancy. "Even though I've never had it before, it looks elegant and costs just a bit more than the brand I was planning to buy. It makes an impressive-looking gift that my host would enjoy. I'll give it a try," the thinking goes."

That See's Candies sells boxed candy mostly bought as gifts is a fundamental way that is business differs from other businesses that sell something that people eat. Buffet points out:

> "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 untapped pricing power—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 favorable reaction. 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 every day. 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."

7. Buffett: "The ideal business is one that takes no capital, and yet grows. And there are a few businesses like that, and we own some." Buffett [in 2007]: "Two factors helped

to minimize the funds required for operations. First, the product was sold for cash, and that eliminated accounts receivable. Second, the production and distribution cycle was short, which minimized inventories. Last year See's sales were $383 million, and pre-tax profits were $82 million. The capital now required to run the business is $40 million. This means we have had to reinvest only $32 million since 1972 to handle the modest physical growth – and somewhat immodest financial growth – of the business. In the meantime pre-tax earnings have totaled $1.35 billion. All of that, except for the $32 million, has been sent to Berkshire (or, in the early years, to Blue Chip)." "We've tried 50 different ways to put money into See's. 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: "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."

Some businesses just can't profitably put more cash or capital to work even though their underlying business at its existing scale is sound.

This is why Buffet insists that all cash is allocated by him to the highest and best use within Berkshire. This avoids what Buffett calls the "institutional imperative" about which Buffett writes:

> "Rationality frequently wilts when the institutional imperative comes into play. For example: (1) As if governed by Newton's First Law of Motion, an institution will resist any change in its current direction; (2) Just as work expands to fill available time, corporate projects or acquisitions will materialize to soak up available funds; (3) Any business craving of the leader, however foolish, will be quickly supported by detailed rate-of-return and strategic studies prepared by his troops; and (4) The behavior of peer companies, whether they are expanding, acquiring, setting executive compensation or whatever, will be mindlessly imitated."

8. Buffett: "After paying corporate taxes on the profits, we have used the rest to buy other attractive businesses. Just as Adam and Eve kick-started an activity that led to six billion humans, See's has given birth to multiple new streams of cash for us. (The biblical command to 'be fruitful and multiply' is one we take seriously at Berkshire.)"

When a given Berkshire portfolio company (for example, See’s Candies) generates cash, that cash is rarely invested in more See’s Candies stores, manufacturing plants or acquisitions since the return on capital would be lower than other alternatives within Berkshire. Because of Berkshire’s corporate structure, Buffett is able to move that cash from See’s Candies to the greatest opportunity on a tax efficient basis (without paying the tax that would be imposed if See’s Candies paid a dividend or See’s shares were sold and the money the reinvested). Buffett elaborates: “because we still have this ability to redistribute money in a tax-efficient way within the company, we can reallocate it to where it will earn a higher return than shareholders may on their own.” Sometimes the best way to appreciate a business like see’s is to contrast it with the opposite example, as Munger does here: “There are two kinds of businesses: The first earns 12%, and you can take it out at the end of the year. The second earns 12%, but all the excess cash must be reinvested — there’s never any cash. It reminds me of the guy who looks at all of his equipment and says, ‘There’s all of my profit.’ We hate that kind of business.”

9. Munger: “It takes almost no capital to open a new See’s candy store. We’re drowning in capital of our own that has almost no cost. It

would be crazy to franchise stores like some capital-starved pancake house. We like owning our own stores as a matter of quality control.”

Wesley Gray and Tobias Carlisle write in their book *Quantitative Value:* ***“***Finding a genuine franchise is as worthwhile as it is difficult. As the See’s Candies example demonstrates, franchises are valuable because they can pay out capital to owners without affecting their ability to grow, or they can compound the capita; of the business by reinvesting it year after year. Sustainable, high return business like See’s Candies are forgiving investments. They throw off a great deal of capital every year.” Munger believes: “There are worse situations than drowning in cash and sitting, sitting, sitting. I remember when I wasn’t awash in cash — and I don’t want to go back.”

10. Buffett: “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.”

Charlie Munger is also not a fan of consultants. He is famous for saying: “I have never seen a management consultant’s report in my long life that didn’t end with the following paragraph: ‘What this situation really needs is more management consulting.' Never once. I always turn to the last page. Of course Berkshire doesn't hire them, so I only do this on sort of a voyeuristic basis. Sometimes I'm at a non-profit where some idiot hires one." Munger has offended just about everyone at some point so consultants are part of a large club. Having said that, cold calling Buffett or Munger in an attempt to sell them consulting services is unwise.

11. Munger: "Some great businesses have very volatile returns – for example, See's usually loses money in two quarters of each year – and some terrible businesses can have steady results." Buffett: 'Our company song is: —What a friend we have in Jesus."

If you are willing to buy a business that has volatile profits from quarter you may find the purchase price to be a bargain since others may be frightened by what they deem as "risk." Munger has said this is a considerable willingness to accept volatile results from quarter to quarter is a considerable advantage in investing.

12. Munger: "We wrote a one-page deal with Chuck Huggins when we bought See's and it's never been touched. We have never hired a compensation consultant." "I'd rather throw

a viper down my shirt front than hire a compensation consultant."

The most important task in capital allocation for Buffett and Munger is to take cash generated by a company like See's Candies and deploy it to the very best opportunity at Berkshire. Buffett's view on the importance of capital allocation easily stated:

> "Charles T. Munger, Berkshire Hathaway's vice-chairman, and I really have only two jobs… One is to attract and keep outstanding managers to run our various operations. The other is capital allocation."

Occasionally Munger and Buffett find a person on who has such superior talent that they really don't need much of a moat. This situation is rare, but it does happen.

> "Occasionally, you'll find a human being who's so talented that he can do things that ordinary skilled mortals can't. I would argue that Simon Marks – who was second generation in Marks & Spencer of England – was such a man. Patterson was such a man at National Cash Register. And Sam Walton was such a man. These people do come along – and in many cases, they're not all that hard to identity. If they've got a

> reasonable hand – with the fanaticism and intelligence and so on that these people generally bring to the party – then management can matter much. However, averaged out, betting on the quality of a business is better than betting on the quality of management. In other words, if you have to choose one, bet on the business momentum, not the brilliance of the manager. But, very rarely, you find a manager who's so good that you're wise to follow him into what looks like a mediocre business."

Sometimes you have both a moat and a great manager, and as Mae West once said: "Too much of a good thing can be wonderful."

Finally, here is Janet Lowe quoting Munger talking about See's in her book *Damn Right* (the best step-by-step account of the See's acquisition is in Lowe's book). She quotes Munger talking at a See's company event as follows:

Notes:

The Investments blog:
http://theinvestmentsblog.blogspot.com/2013/and-munger-on-sees-candy.html?m=1

> There are a million business traps. You can get sloppy, you can get alcoholic, you can get megalomania, you can not understand your own limitations. There are a million ways to gum it up. To survive and prosper as long as this company has—started by a woman who was 71 [years old], that I really like. And it's an amazing example. See's has stayed out of a lot of traps."
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> "The ordinary candy company puts in too many 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's 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 just 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."[1]

Don't Confuse Cheap with Value:
http://www.broyhillasset.com/wp-content/uploads/2016/11/2016.10-BAM-Dont-Confuse-Cheap-with-Value-Final.pdf

The Secrets of See's Candies:
http://fortune.com/2012/08/22/the-secrets-of-sees-candies/

Warren Buffett Bought This Company for $25M:
http://www.fool.com/investing/general/2014/07buffett-bought-this-company-for-25-million.aspx