QUALITY WITHOUT COMPROMISE

See's Candies, Warren Buffett and the perfect investment.

BY MAX OLSON

William Ramsey, an executive at Blue Chip Stamps, stood in the office of Robert Flaherty as they both awaited a call. Moments earlier, Flaherty attempted to persuade Warren Buffett, majority owner of Blue Chip, to consider purchasing See's Candy Shops Inc., a popular West Coast candy maker. Buffett turned them down—up until then, he was used to buying boring businesses on the cheap: banks, textile mills and insurance companies. Ramsey however, thought See's was a great buy, and desperately tried to get Buffett back on the phone. Their secretary finally got hold of Buffett at his home in Omaha. He had reviewed the numbers, and liked what he saw.

After consulting with Charlie Munger, Buffett's friend and business partner, they were willing to make an offer. This would be Buffett's biggest investment to date, and he wasn't one to overpay for anything—the deal almost fell through during negotiations, but the sellers finally accepted their proposal. The final price was $35 per share. With one million shares outstanding and $10 million in cash on the books, the net purchase price was $25 million. Blue Chip Stamps now owned 67.3 percent of See's Candy Shops, with the remainder purchased from about 2,200 public holders in the months after. But one thing remained unfinished: who would run the company? Buffett made it clear upfront that they wouldn't be calling the shots at See's. Suggested by the previous owner, Buffett, Munger and a friend named Rick Guerin met with Charlie Huggins—executive vice president and twenty-year veteran of See's. After three hours of discussion, Buffett knew that Huggins was the man for the job.

THE HISTORY

The first See's Candy shop was opened in Pasadena, California in 1921 by Charles See and his mother, Mary See. Each made their own contributions: Mrs. See used the recipes she had created over the past fifty years of candy making; Charles had studied the methods of a successful chain of candy shops in their native Canada.

Many customers remember the stores for their signature black and white motif, which started at this first store and was designed to resemble Mary See's home kitchen. Under the leadership of Charles See, the company steadily grew throughout California. They successfully navigated the business through the Great Depression and World War II, when sugar was severely rationed and customers lined up around the block to buy See's limited amount of chocolates. By the time Charles died in 1949, the company had seventy-eight stores and two manufacturing plants: the original in Los Angeles, and a second in San Francisco.

Through the next two decades See's Candy was run by Charles' two sons, Laurance and Harry See. The brothers expanded the shops into neighboring states and grew the number of locations to over 150 by the end of the '60s. Two years after the death of Laurance See, his younger brother Harry no longer desired to run the business and sought to pursue other interests (he owned a vineyard in Napa Valley). After over a half century of family ownership, See's was put up for sale. One of the several interested parties was Robert Flaherty, investment advisor to Blue Chip Stamps.

The sale was finalized in 1972, and See's Candy Shops was now a subsidiary of Blue Chip. Not long after, Blue Chip would be folded into Berkshire Hathaway and See's would become one of the first members of Warren Buffett's cash generating conglomerate. At first, employees and customers were worried that the new owners would change See's for the worst. When the purchase was first publicized in the local papers, everyone now knew who the buyer was, and people didn't have a lot of respect for them (Blue Chip had recently been through an antitrust case). Charlie Huggins was in charge of the transition, and recalled that he spent a lot of time "… dealing with customers who were concerned, mad that the family had sold and now [they were] in the hands of a company that would ruin See's." Angry patrons would send hate mail—claiming the candy was bad, and See's had somehow changed it. It took Huggins almost two years to convince loyal customers and employees that nothing had changed, and that product quality and customer service would be better than ever.

In the first year of operation under new ownership, See's sold about seventeen million pounds of candy for just over $31 million. This number continued to grow steadily under the shrewd management of Charlie Huggins. Fourteen years after his promotion, Huggins remained modest. "Our candy is a third of the price of say, Godiva chocolates," he told a local paper. "They do a wonderful packaging job, though. Consumers seem to think that if the box is beautiful, the candy inside must be just as good. But quality wise, we feel that we're at least their equal."

At the close of the twentieth century, See's Candies had expanded to over two-hundred-fifty black-and-white shops across the United States, a majority of which were located in California. Since the acquisition, this represented an average of over three successful store openings a year. Customers purchased thirty-three million pounds of candy annually, giving the company earnings of $73 million on $306 million in sales (to put this in perspective, thirty-three million

pounds of candy equated to almost one-pound of candy per resident of California at the time).

THE MANAGER

Charles N. Huggins regularly made inspections of the See's factories—calling workers by their first names and taste testing chocolates, carefully "measuring" their quality and consistency. Naturally, See's encourages *all* employees to eat as much candy as they like. It's Huggins' belief that any employee who loves a certain variety of candy will express that love in their work, and ultimately to the customers.

Chuck was born in Vancouver, Canada and first began working at See's in 1951, when he was twenty-six years old. His first supervisor was Ed Peck, the general manager in San Francisco. As the company expanded, Huggins continued to work his way up the ranks, earning the trust of the See family. By the time Huggins was handed the role of Chief Executive Officer in 1971, he had worked in various positions at the company for over two decades. Almost immediately, Warren Buffett knew that Huggins was the right man for the job: "It took me fifteen seconds to decide to make Chuck C.E.O. and President, and to this day I wonder why it took so long." There is no doubt that without Charlie at the helm, See's wouldn't be where it's at today.

Over the years Huggins led by the following management tenets: 1) *Concentrate the efforts of all employees to attain ever-increasing excellence in customer service and product quality*; and 2) *Never compromise quality ingredients or service over profits*. Commenting on his style of management, Huggins listed a number of traits that were essential to his success: the ability to solve problems, the desire to learn, curiosity, discipline, creativity and patience.

Huggins was a "Level 5" leader, as characterized by Jim Collins in the book "Good to Great," in all respects. He was an insider who knew the business well and was fanatically driven toward results. He channeled ambition into the company, not himself, and blended personal humility with strong professional will. Asked to explain See's business, Huggins said, "It's about the customers. It's about making sure the customer is pleased, whatever it may take, no matter how outrageous. … There are certain things we do inadvertently… where we dissatisfy the customer. And when that happens, we always admit that we blew it, and ask what we can do to make it right. And then we stand on our heads until we get that done."

THE MOAT

Quality is one of the most important aspects of See's advantage over competitors and a key element in the marketing of their products. See's chocolates are all preservative-free, and each box has the date and location in which it was filled so that the customer can see that they are getting the freshest product. Ingredients from suppliers are carefully examined by Quality Assurance teams at the factories for microbiologic compliance and purity. The See's Candy brand name is the moat that ensures See's will continue to be the dominant chocolate producer on the West Coast for years to come.

Commenting on these advantages, Charlie Munger says that "…in some businesses, the very nature of things is a sort of cascade toward the overwhelming dominance of one firm. It tends to cascade into a winner-take-all result." Product quality is just one of the many contributors (albeit a very important one) to the brand—along with customer service, store image and the public's mental perception of the product. A few non-candy examples illustrate this point: Most people would much rather be seen drinking their latte from a cup brandishing the green Starbucks logo than from some other generic brand. A loving husband could probably find a diamond necklace for his wife a lot cheaper off the internet—but if he handed her a similar necklace encased in a robin's-egg-blue box from Tiffany & Co., she'd *know* that he loved her. And likewise, come February 14, your significant other won't think twice about where that heart-shaped box of chocolates will come from—after noticing the See's "Famous Old Time" Candies logo on the front, the box doesn't even need to be opened.

Marketing plays a huge role in this perception. Customers know that the three-word motto "Quality Without Compromise" is not taken lightly at See's. Buffett constantly reminded Charlie Huggins about what they were *really* selling—"Maybe the grapes from a little eight-acre vineyard in France are really the best in the whole world, but I have always had a suspicion that about 99% of it is in the telling and about 1% is in the drinking." In 1989, after an 8% year-over-year increase in pounds sold (a very high number for same-store growth); Buffett explained that shrewd advertising was the cause. That year, advertising expenditures had been increased from $4 million to $5 million. "When business sags," says Buffett, "we spread the rumor that our candy acts as an aphrodisiac. Very effective. The rumor, that is; not the candy."

Another reason that See's was able to grow so successfully throughout the years was their astute real estate planning. During the 1950s, population growth in California resulted in an even larger increase in suburban development. It was during this period of suburban expansion that the modern day shopping mall was born. Laurance See recognized the potential of malls and expanded See's into new developments locally, and for the first time, outside of California. For stand-alone stores, the See brothers would attempt to place them on the shady side of downtown roads, assuming that people are more likely to walk on that side of the street when it's hot outside. Through-

out the years, See's has been very careful not to expand too quickly and only open a location when it makes sense. "The ordinary company puts in too many stores," says Charlie Munger. "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."

In hindsight, See's would become one of Warren Buffett's most important investments. The company had all the traits that he would later look for when making a purchase: a family owned, well managed business with strong competitive advantages and little need for additional capital. ♦

PART II

See's Candies was a fantastic business. Buffett and Munger couldn't have asked for much better. With Chuck Huggins, the See's brand name, and the superior economics of the candy industry, they got the whole package for $25 million. But ultimately, the success of any investment comes down to the price paid relative to the value received. Was paying 12.5 times after-tax earnings justifiable? In hindsight, the investment turned out to be more than acceptable. Assuming See's Candy could have been sold in 1999 for the same 12.5 times multiple, and factoring in the approximate cash that it distributed over the years, Berkshire Hathaway's pre-tax internal rate of return would be just under 35 percent. This is for a period of *twenty-eight years* during which the S&P 500 returned 14 percent annually, including dividends.

One can learn only so much by assessing investments through the rearview mirror. Nassim Nicholas Taleb, author of "The Black Swan," says it best: "History seems clearer and more organized in history books than in empirical reality." To attempt to avoid this retrospective distortion, I find it best to examine investments within the context of when they were purchased. In this situation, the evolution of Buffett and Munger's investment methods played a key role in their decision to purchase See's Candies.

THE GOODWILL

When Warren Buffett began his investing career, he paid little attention to qualitative factors in investment decisions. Buying tangible assets for much less than they were worth was his bread and butter. Benjamin Graham, Buffett's mentor, played a large role in these views. Graham taught that investments should be made only when the business can be purchased at a large discount to its tangible value (hard assets like cash, inventory and property).

Toward the later years of the Buffett Partnership, Buffett began to move away from buying companies solely on a quantitative basis. In 1968, he wrote to his partners, "When I am dealing with people I like, in businesses I find stimulating (what business isn't?), and achieving worthwhile overall returns on capital employed (say, 10-12%), it seems foolish to rush from situation to situation to earn a few more percentage points." This transition was brought about by a combination of Buffett's experience in dealing with struggling businesses, and the growth in his base of capital to invest. Other influences on this change of style were Philip Fisher, author of "Common Stocks and Uncommon Profits," and Buffett's partner, Charlie Munger. Munger has cited See's role in the evolution of Buffett's investment thinking:

> See's Candy was acquired at a premium over book [value] and it worked. Hochschild, Kohn, the department store chain, 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.

Munger's point was that it's much easier to buy a good business and watch it grow, than to buy a deeply discounted but struggling business and spend time, energy, and more money setting it straight. When estimating the intrinsic value of a business, there are two categories of assets that must be valued: physical/tangible assets, and intangibles like economic Goodwill. Valuing the latter is the tricky part, and isn't just a matter of checking the balance of "Goodwill" on the balance sheet. Buffett discussed the nature of economic Goodwill, using the See's purchase as an example, in the 1983 Berkshire Hathaway Annual Report:

> 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.

When a company earns a market rate of return (or "cost of capital" in finance textbooks) on its invested capital, it should be worth the market value of its net tangible assets—no more, no less. But when a business like See's Candy can sustain high returns on capital, it should be valued much higher than its tangible net-worth (depending on the extent of the excess returns). The difference between this tangible book value and true intrinsic value is what Buffett calls economic Goodwill. If it were recorded as an asset on the balance sheet, it would represent intangibles like See's brand name, its "mind share" among customers, and other aspects of See's competitive advantages (detailed in Part I). Unlike property and equipment, this asset requires little in the way of maintenance expenditures—as long as See's keeps doing what they're doing, economic Goodwill won't degrade with time. With minimal reinvestment, this Goodwill should continue to produce excess profits well into the future.

Although never putting this concept fully into practice, Benjamin Graham was no stranger to economic Goodwill. In his book "Security Analysis," Graham writes:

> It may be pointed out that under modern conditions the so-called "intangibles," e.g. goodwill or even a highly efficient organization, are every whit as real from a dollars-and-cents standpoint as are buildings and machinery. *Earnings based on these intangibles may be even less vulnerable to competition* than those which require only a cash investment in productive facilities. Furthermore, when conditions are favorable *the enterprise with the relatively small capital investment is likely to show a more rapid rate of growth*. Ordinarily it can expand its sales and profits at slight expense and therefore grow more rapidly and profitably for its stockholders than a business requiring a large plant investment per dollar of sales. [*My emphasis*]

THE GROWTH

At the time of purchase in 1972, See's Candy had $8 million in net tangible assets and after-tax earnings of $2 million, giving it a return on invested capital of 25 percent. To justify the $25 million price tag, See's would have to not only sustain their excellent performance,

but grow the business and generate sufficient free cash flows to fund future growth. Regarding the second criteria, See's passed with flying colors. Growth in earnings was another issue, but let's first examine the benefits of a high return on capital business.

Compared to a company that has a low or average return on its assets, See's has the ability to grow sales with little need for additional capital. Even *without* growth, physical assets of any business will need to be replaced over time whether motivated by competition or continuous inflation. Sales growth through *any* method will eventually require a subsequent increase in working capital. And when this time comes, See's will have to put only a small portion of its earnings back into the business—which yields greater free cash flow and hence more value to owners. At this point, the astute reader may ask: why not reinvest all the profits, and grow at a much faster rate than those with lower returns? Depending on the business, this is usually the preferable option. But at See's, growth is more difficult (more below) and would come at the cost of sacrificing profit. Buffett has commented that they've tried many times to put more money into See's—but to no avail. Return on invested capital may continue to improve, but return on *incremental* capital invested is what matters most for a growing business. And with Warren Buffett allocating capital, current profitability won't be sacrificed for diminishing rates of return. In the 1991 Berkshire Annual Report, Buffett talked about See's and the allocation of its free cash flow:

> 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. 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.

As mentioned in Part I, over a period of twenty-seven years after the acquisition, See's had an average of three net store openings a year (since then almost a fifth of total stores have been closed). This may sound like sufficient enough growth, but compare this to modern-day examples like Starbucks—which last year alone opened 2,199 stores. One cause of this discrepancy is the growth rate of each industry—unlike See's, Starbucks practically created the market for their product and they continue to grow into it. (The market for premium chocolates is expected to reach $1.8 billion in 2008.) The slow growth rate frustrated Buffett at times as he remarked that they "…regard the most important measure of retail trends to be units sold per store rather than dollar volume." Despite this volume problem, See's was able to grow earnings in other ways: the most important of them being the ability for the "dollar volume" to rise whilst the unit volume remained steady.

The most basic determinates of revenue are price and volume. To grow sales and consequently earnings, you'll have to either raise prices, or sell more products. Early on Buffett realized that See's was well suited to grow through the former method. "In our See's purchase," he commented in the 1991 Annual Report, "Charlie and I had one important insight: We saw that the business had untapped pricing power." Customers aren't shopping at See's because of its low prices. As long as *quality* is uncompromised, paying a dollar more than you did last Valentine's Day isn't a problem. If costs of ingredients go up, prices go up. Inflation? Not a problem at See's. This ability to continually raise prices without interruption in unit sales is a tremendous advantage over products in other industries. Over the years, these price increases have supplied a majority of the close to 9 percent compounded growth in earnings—despite the second-rate growth in store base and unit volume.

Advertising is another way to maintain and grow a business's Goodwill. One advantage that See's and other candy companies have is they can distribute marketing costs over a shorter amount of time. Instead of selling ads throughout the year, the holiday season is all that's necessary. Over half of annual chocolate sales are made between Thanksgiving and New Year's Eve. The month of December alone accounts for about 90 percent of annual profits. During Christmas and Easter, the See's factory in San Francisco gets several *tanker trucks* full of melted chocolate on a daily basis (See's was the first candy company to come up with this method of delivery).

See's Candy was the ultimate example of paying a fair price for a quality business (it's when people are willing to pay *any* price for a quality business that gets them into trouble). The qualitative factors are many, but the combination of high returns on capital and steady growth through price increases played a key role in the success of the investment. So the next time you're given the opportunity to invest in a business of similar quality to See's—at a price of only twelve-and-a-half times earnings—don't hesitate to back up the truck. ♦