Analyzing Buffett‘s Investments: Lessons Learned

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CONFIDENTIAL
A few words about myself and Shareholder Value Management AG

- Live and work in Frankfurt, Germany with my family
- Since 2013 I have worked as a portfolio manager at Shareholder Value Management AG
- Previously to that, I worked at a Family Office in Munich

Investment Philosophy:
- Fundamental Value Investing
  - Economic Moat (looking for businesses that will continue being successful in 5+ years)
  - Business Owner
  - Margin of Safety
- EUR 2.2 billion under management, global investment strategy but with a stronger weighting in Europe
Today, I would like to share 3 key learnings from a personal project that culminated in a book published by Columbia University Press in 2016.

**Presentation Agenda**

<table>
<thead>
<tr>
<th>Time</th>
<th>Topics</th>
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<tbody>
<tr>
<td>5 min.</td>
<td>Project Background</td>
</tr>
<tr>
<td>9 min.</td>
<td>Lesson 1: Quality of Information</td>
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<tr>
<td>9 min.</td>
<td>Lesson 2: Consistency in Revenue and Earnings Growth</td>
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<tr>
<td>9 min.</td>
<td>Lesson 3: Frameworks and the Circle of Competence</td>
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<tr>
<td>8 min.</td>
<td>Question &amp; Answers</td>
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Background: The book is titled “Inside the Investments of Warren Buffett: 20 Cases” and was originally intended as a personal project

- Started in 2011, originally as a personal project to analyze Buffett’s investments in detail
- Motivation was that I had lots of anecdotal information about Buffett’s investments, but few actual financials and operating metrics
- Focus was on what an investor at the time of the investments could’ve seen in those companies Buffett invested in rather than on Buffett
Methodology: What did I look at?

### Direct Source Documents
- Annual Reports
- Company documents
- Anything else I could find from industry associations etc.

### Buffett Documents
- Annual shareholder letters
- Partnership letters
- Other books

### Investments Over Time

<table>
<thead>
<tr>
<th>Partnership Years</th>
<th>Berkshire Early Years</th>
<th>Berkshire Later Years</th>
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<tbody>
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<td>Salomon Inc.</td>
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<td>Coca-Cola</td>
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</tbody>
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**20 Investments in Total**
3 Step process to get to learnings

Finding Source Documents
- Libraries, Company requests, SEC

Analyzing Businesses
- Researching industries, competitors

Learnings Drawn
- Many learnings, some specific, some general
Lesson #1: Quality of information is central in making a good investment
What is meant with quality of information is central in making a good investment? What is high quality information?

A. Looking at the companies Buffett invested in, what jumps out is the high quality information that can be found on them:

  - Detailed – operating metrics in addition to financial
  - Relevant – not just financials but supporting evidence for key investment thesis
  - Objective – often times from 3rd parties

B. Came amongst other things from:

  - Insightful annual reports
  - Industry association data
  - Competitor reports
Example 1: An abundance of reliable objective data could be found for Burlington Northern Santa Fe (BNSF) at every level.
Example 2: Objective detailed information like circulation numbers can be found for the Buffalo Evening News and newspapers in general.

- Circulation #’s
- Public documents
- Third party sources (incl. News Assoc.)
Example 3 (Contra): Senior plc. presents detailed financial information, but little operating or competitive data most critical to the investment case.

- Lots of financial data, segmented every which way, but few operating metrics
- Little information about competition
So make sure that you can find detailed, relevant and objective data on the companies you are considering an investment in.

**What to look for?**
- **Detailed** – operating metrics over time that can be analyzed
- **Relevant** – not just financials but supporting evidence for key investment thesis
- **Objective** – often times from 3rd parties

**Where to look?**
- Insightful annual reports
- Industry association data
- Competitor reports

**Examples**
- BNSF: all operating metrics over time for company and all relevant competitors
- **American Express**: development numbers of travelers cheques
- **Coca-Cola**: sales numbers per country, over years
- **Buffalo News**: circulation numbers, competitor numbers

**Focus on Industries with abundant objective data**
- Media
- Insurance
- Transportation

It’s critical to be aware of the level of information one has and whether its objective and sufficient to support one’s investment thesis.
Lesson #2: Consistency of revenue and earnings growth are probably even more important than high growth or high returns on capital in determining a good investment.
Everyone knows that Buffett looks for high quality companies with consistent financials, but how consistent were those financials?
Example 1: When Buffett invested in American Express in 1964, it had revenues and earnings that had grown 10 years out of 10.

Ten Year Review

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<tbody>
<tr>
<td>Revenues from operations</td>
<td>$18,144,000</td>
<td>$106,418,000</td>
<td>$137,771,000</td>
<td>$177,776,000</td>
<td>$218,400,000</td>
<td>$256,800,000</td>
<td>$290,400,000</td>
<td>$324,100,000</td>
<td>$356,100,000</td>
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<td>Profit on sale of assets</td>
<td>$209,000</td>
<td>$1,174,000</td>
<td>$2,028,000</td>
<td>$2,100,000</td>
<td>$2,100,000</td>
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<td>$2,100,000</td>
<td>$2,100,000</td>
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<tr>
<td>Operating expenses</td>
<td>$98,190,000</td>
<td>$53,350,000</td>
<td>$63,000,000</td>
<td>$63,000,000</td>
<td>$63,000,000</td>
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<tr>
<td>Provision for U.S. and foreign income taxes</td>
<td>$7,830,000</td>
<td>$4,715,000</td>
<td>$1,283,000</td>
<td>$1,650,000</td>
<td>$2,093,000</td>
<td>$2,532,000</td>
<td>$3,045,000</td>
<td>$3,655,000</td>
<td>$4,297,000</td>
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<tr>
<td>Net income</td>
<td>$12,514,000</td>
<td>$11,266,000</td>
<td>$10,313,000</td>
<td>$9,204,000</td>
<td>$9,204,000</td>
<td>$9,204,000</td>
<td>$9,204,000</td>
<td>$9,204,000</td>
<td>$9,204,000</td>
</tr>
<tr>
<td>Net Income per Share</td>
<td>$2.11</td>
<td>$2.32</td>
<td>$2.57</td>
<td>$2.67</td>
<td>$2.67</td>
<td>$2.67</td>
<td>$2.67</td>
<td>$2.67</td>
<td>$2.67</td>
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<tr>
<td>Dividends declared per share</td>
<td>$1.20</td>
<td>$1.20</td>
<td>$1.20</td>
<td>$1.20</td>
<td>$1.20</td>
<td>$1.20</td>
<td>$1.20</td>
<td>$1.20</td>
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<tr>
<td>Number of shares outstanding at year end</td>
<td>27,673,000</td>
<td>24,085,000</td>
<td>21,266,000</td>
<td>23,814,000</td>
<td>23,814,000</td>
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Revenues grew 10/10 years from 1964 to 1973.
Net income grew 10/10 years from 1964 to 1973.

 otras recomendaciones
Example 2: Coca-Cola (1988)

($ in millions except per share data)

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<tbody>
<tr>
<td>Summary of operations</td>
<td></td>
<td></td>
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<tr>
<td>Gross profit</td>
<td>4.025</td>
<td>3.523</td>
<td>2.970</td>
<td>2.704</td>
<td>2.476</td>
<td>2.288</td>
<td>2.161</td>
<td>2.046</td>
<td>1.794</td>
<td>1.569</td>
<td>1.222</td>
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<td>Selling, administrative, and general expenses</td>
<td>2.665</td>
<td>2.446</td>
<td>2.163</td>
<td>1.855</td>
<td>1.648</td>
<td>1.515</td>
<td>1.441</td>
<td>1.366</td>
<td>1.150</td>
<td>0.967</td>
<td>0.694</td>
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<td>Provisions for restructured operations and disinvestment</td>
<td>36</td>
<td>180</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Operating income</td>
<td>1.324</td>
<td>0.897</td>
<td>0.807</td>
<td>0.849</td>
<td>0.828</td>
<td>0.773</td>
<td>0.720</td>
<td>0.680</td>
<td>0.644</td>
<td>0.602</td>
<td>0.528</td>
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<td>Interest income</td>
<td>207</td>
<td>139</td>
<td>145</td>
<td>131</td>
<td>90</td>
<td>119</td>
<td>85</td>
<td>56</td>
<td>46</td>
<td>41</td>
<td>32</td>
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<tr>
<td>Interest expense</td>
<td>279</td>
<td>197</td>
<td>190</td>
<td>127</td>
<td>77</td>
<td>76</td>
<td>34</td>
<td>30</td>
<td>10</td>
<td>7</td>
<td>6</td>
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<tr>
<td>Equity income</td>
<td>118</td>
<td>156</td>
<td>164</td>
<td>117</td>
<td>84</td>
<td>46</td>
<td>20</td>
<td>14</td>
<td>18</td>
<td>17</td>
<td>19</td>
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<tr>
<td>Other income (deductions), net</td>
<td>—</td>
<td>33</td>
<td>66</td>
<td>12</td>
<td>2</td>
<td>11</td>
<td>–20</td>
<td>–13</td>
<td>–7</td>
<td>–18</td>
<td>–12</td>
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<tr>
<td>Gain on sale of stock by former subsidiaries</td>
<td>40</td>
<td>375</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
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<td>—</td>
</tr>
<tr>
<td>Income from continuing operations before income taxes</td>
<td>1.410</td>
<td>1.403</td>
<td>0.992</td>
<td>0.982</td>
<td>0.927</td>
<td>0.873</td>
<td>0.771</td>
<td>0.707</td>
<td>0.691</td>
<td>0.635</td>
<td>0.561</td>
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<tr>
<td>Income taxes</td>
<td>494</td>
<td>469</td>
<td>314</td>
<td>360</td>
<td>374</td>
<td>379</td>
<td>339</td>
<td>313</td>
<td>306</td>
<td>284</td>
<td>251</td>
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<tr>
<td>Increase from continuing operations</td>
<td>916</td>
<td>934</td>
<td>678</td>
<td>622</td>
<td>553</td>
<td>494</td>
<td>432</td>
<td>394</td>
<td>386</td>
<td>351</td>
<td>310</td>
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<tr>
<td>Net income</td>
<td>916</td>
<td>934</td>
<td>722</td>
<td>629</td>
<td>559</td>
<td>512</td>
<td>482</td>
<td>422</td>
<td>420</td>
<td>375</td>
<td>331</td>
</tr>
</tbody>
</table>

Revenues grew 9/10 years from $ 2.7 billion to 7.7 billion (3x)
Net income grew 9/10 years from $ 331 million to $916 million (3x)

Revenues grew 10/10 years from $ 567K to $ 5.7 million (10x)
Net income grew 7/10 years from $ 32K to $ 165K (5x)
Buffett looks for “high quality” companies, but what stands out here is the extreme consistency in earnings/revenues those companies had.

**What do consistent financials look like?**

- Companies that grew revenues and earnings something like 8 or 9 years out of the past 10 years
- < than approximately 5% of investment universe depending on how you define it
- A criteria that seemed to fullfil a great number of Buffett’s later investments

**So What?**

- Importance is not so much just the perfect financials
- The key is that this often (although not always) gives strong evidence that there are very favorable structural and long term growth drivers for a company
American Express

- For AMEX, the growth in cashier cheques and credit cards continued not just until 1974, or 84, but well into the 1990s.
- Number of cashier cheques used increased until 1996.

Coca-Cola

- For the decade after 1988, Coke grew revenues 10% p.a., income 14% p.a.
- The decade after was slower growth, but per capita consumption of Coke products in most countries increased well into the 2000s.
- Today, Mexico has the highest per capita consumption of Coke at > 700 fluid oz.

US Air

- Investment was into preferred convertible shares (preferred dividend yield 9.25%).
- Debt, operating leases, unionized wages combined with price competition after deregulation soon caused major problems for the company. Ultimately, this investment was profitable for Buffett, but is well-known as a mistake.
- Air travel did increase.

SOURCE: CapitalIQ, Statista
Okay, consistency in revenue and earnings are important, but why are they more important than high ROTCE or high growth?

- **High ROTCE**: No growth = very little benefit to having a high ROTCE
- **High Growth**: High growth in any year is not a good indicator of a long term structural growth driver
Lesson #3: Remember your individual Circle of Competence
The concept of a “Circle of Competence” is simple

“What an investor needs is the ability to correctly evaluate selected businesses. Note that word “selected”: You don’t have to be an expert on every company, or even many. You only have to be able to evaluate companies within your circle of competence. The size of that circle is not very important; knowing its boundaries, however, is vital.”

Warren Buffett

SOURCE: 1996 Berkshire Hathaway annual letter to shareholders
Looking at Buffett’s investments, it is very clear that Buffett goes back to the same industries over and over.

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- **Same Industry**
  - Insurance
  - Media
  - Financial Company
Going back to the same industries or types of investments means you can reuse the frameworks for investments.

**Newspapers**
- Circulation metrics
- Subscription economics (churn)
- Customer Acquisition costs

**Retail/Branded products**
- Like for likes
- Store economics
- Branding

**Finance Companies**
- ROE/ROA
- Loan development
- Overdue loans

**Insurance**
- Reserve development tables
- Combined/expense ratios
- Investment returns
Just to Recap…

**Lesson Learned**

**Learning #1**
Quality of information is central in making a good investment

**Learning #2**
Consistency of revenue and earnings growth are probably even more important than high growth or high returns on capital in determining a good investment

**Learning #3**
Remember your individual *Circle of Competence*
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Thank you!
And time for a few Questions

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