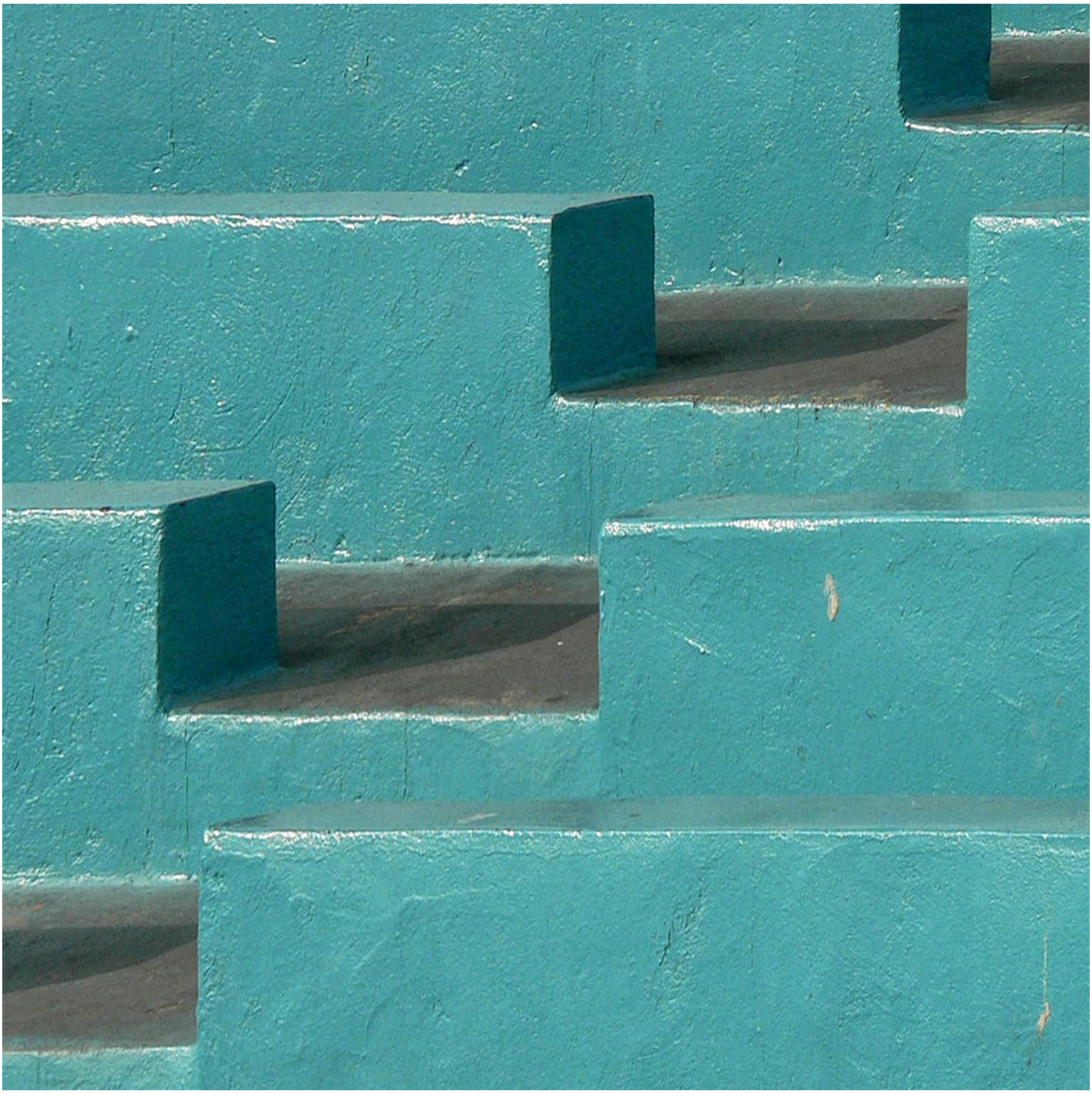
LeadershipReview
Robert Heller's
Masterclasses

Warren Buffet 2

Buying Companies



Buying Companies

Whether or not you will ever purchase a business, or sell one, the principles, as taught by Warren Buffett, are valuable because you can apply them equally to investing in shares and to valuing a company as a prospective employee.

HELPING MANAGERS TO WIN

Buffett has developed a highly effective approach to business management through buying companies and helping their managers to win outstanding results. As with his investing in stocks, Buffett rarely diverts from three clearly articulated principles:

THREE KEY PRINCIPLES OF BUSINESS PURCHASE

1. Buy good businesses at fair prices.
2. Insist on the seller offering a price.
3. Look for evidence of consistent earning power.

Investment in the broadest sense

Even if you do not become a strict follower of Buffett, always have clear, effective criteria for your investment decisions, and always stick to those guidelines. If you are considering buying part of a business - that is, investing in stocks - study this Masterclass to enhance your abilities and success as an investor.

The principles are also a good guide to whether you should join a particular company. You are, in effect, an investor. You are investing part of your life - your most, valuable possession - in the employer. Use the Buffett approach to see whether the company is likely to give you full value in return. Unless it can, look for a better "investment" elsewhere.

When looking for a new employer, people are naturally anxious. Be just as cautious when making any decisions about the value of a company. Buffett, a superb acquirer, has written: "we face the inherent problem that the seller of a business practically always knows far more about it than the buyer". Remember that.

STICK TO GUIDELINES

Most managers who buy other companies do far worse than Buffett. That is because they depart from his guidelines, despite their crystalclear logic. Buffett's advice adds up to a series of "don'ts".

BUY ON BENEFICIAL TERMS

– Do not pay a premium over the intrinsic value of the business.

– Do not get swayed by emotion rather than reason.

– Do not use “funny figures” to make the buy appear better.

– Do not buy a company simply because it is cheap.

– Do not use shares in an acquisition if you will not get full value in return.

– Do not pay attention to the seller’s forecasts of future earnings.

Full obedience to these “don’ts” would prevent most mergers and acquisitions from taking place: Buffett would welcome this. He believes that, however seductive the “strategic” motives, you should buy only on terms that benefit you financially. But truly beneficial deals are hard to find and execute, which is why you should be especially careful.

MEASURING MOTIVES

There will always be more companies available than you can buy, whatever you can afford. You must also consider management capability; it is all too easy to “bite off more than you can chew”. You will rarely find that mergers and acquisitions go as smoothly as you hoped, or yield all the financial benefits that were expected by the time they were expected. So, what are your motives?:

Do you find making this deal more fun than running the business, and is that why you are interested?

Are you pursuing the deal because you have a strategic purpose in mind?

If so, how exactly will achieving that purpose enhance the intrinsic value of the business?

If not, why are you considering the deal at all?

1. Assessing management

When considering whether to buy a business, Buffett, not surprisingly, looks for managers who are much like himself. That naturally makes it much easier for him to "like, trust, and admire" them, which he regards as three necessities.

ESSENTIAL QUALITIES OF A MANAGER

To earn Buffett's liking, trust, and respect, managers must show that they possess three essential qualities, all of which are exemplified by Buffett. They must be able to live up to the following statements:

- "I am candid with everybody with whom I have dealings - shareholders, colleagues, employees, customers, and others."
- "I am rational in all my management decisions and actions, analyzing every situation dispassionately before deciding on what is best."
- "I resist the 'institutional imperative' - I do what I think is right, rather than what others are doing."

Can you honestly say the same? If not, why not? Write down the reasons, and consider what changes you can make to pass the triple standard. There is no excuse for falling short.

PRODUCING RESULTS

When considering a potential purchase, rule out any company with top managers who do not tell the whole truth, who do not think and act logically, or who follow the herd. Then look at the company's track record. Good management should produce good results.

CHARACTERISTICS OF GOOD MANAGEMENT

- Always puts the owners' interests before management's.
- Shows consistent increases in sales and profits from operations.
- Achieves above-average returns.
- Reinvests profits very effectively.
- Acts to ensure that long-term growth prospects are favourable and will be achieved.

THE QUALITY ISSUE

The quality of financial results is all-important. How were the high return on equity and superior profit margins achieved? Was it through heavy debt?

Buffett prefers companies with minimal borrowings, and so should you. Do high margins result from good management or from a monopoly?

Only take an interest in companies in which quality is high. High price plus high quality should be profitable, although it is inherently unstable, since it invites competition and narrows the market.

THE THREE GOLDEN POLICIES

1 Minimize costs

2 Maximize sales

3 Optimize ratio of sales to capital

Following these three golden policies is a sign of well-focused management, guaranteeing a company a high return on equity, high ownerearnings, good margins, and a good return on reinvested capital. Such results all point to a company that will be a good potential investment; it takes good management to mine so much gold, and a good investor to share the mining.

2. Managing managers

How well managers run a business before acquisition must be less important than how they run the company afterwards, when it has become your property. To make the most of your purchase, learn the most effective ways of managing the managers.

ESTABLISHING TRUST

When you buy a business, in effect you hire the managers in place. You can take one of three attitudes towards them:

THREE POSSIBLE ATTITUDES

1 . I do not trust these people to do a proper job, and will replace them with my own nominees.

2. I do not trust these people to do a proper job, but will control them tightly to ensure that they do.

3. I do trust these people to do a proper job, and will let them get on with it in their own way.

For Buffett, the first two attitudes would rule out the acquisition. It rarely makes sense to buy a company whose managers you cannot trust.

Ask yourself the following three questions:

– Is this person competent to do the job?

– If "no", why did I keep them?

– If "yes", why am I refusing to let them show their competence?

A POLICY OF NON-INTERFERENCE

Buffett does not interfere with a manager's work, even when he thinks he knows better. This is crucial. There are two quite separate jobs: running the business, and running the people who do it. Buffett restricts the latter to a very few vital functions, including approval of capital expenditure, approval of top management rewards, and making the top appointments. The key word here is "approval": the managers come up with the plans and you, after due questioning, agree to the idea, revised or not. Ensure your managers tell you bad news as soon as they know it; otherwise they should be free to seek your advice as much or as little as they like.

3. Building the business

Buffett judges a business on its ability to sustain superior organic growth, developing the existing business and markets powerfully, and expanding into new products and geographic areas continuously in ways that enhance the intrinsic value.

LINK REWARD TO RESPONSIBILITY

Buffett allows his business managers so much room in which to manage because he wants them to build the business as if it were their own. Top managers often pay lip-service to this idea, but the reality is very different. Rewards, like share options and bonuses, tend to be linked to the performance of the whole company.

Buffett argues that nobody should be rewarded for results that are outside his or her control. If people create greater wealth from their direct responsibilities, share that wealth with them directly, giving both due reward and the incentive to optimize "organic growth".

ORGANIC GROWTH

Your business can grow in several ways. Does it:

- Sell more year-by-year to existing customers by:
  (a) increasing demand, for existing products and/or services?
  (b) improving existing products and/or services?
  (c) introducing new products and/or services?
- Sell more year-by-year to new customers by:
  (a) widening the demand for existing products and/or services?
  (b) cashing in on the appeal of improved products and/or services?
  (c) introducing new products and/or services?

Supervise growth by insisting on full, regular financial reports that tell you how the company is performing on the same clear criteria that persuaded you to buy. Never be fuzzy. If everyone knows what is expected of them, then you can safely expect that what you want will be achieved.

ANALYSIS

If you have not answered YES to every part of the above questions, something is wrong. Draw up plans for filling the gaps these answers reveal in your organic strategy.
It is possible to fill gaps by acquisition, but that only makes sense if you follow Buffett's strict rules of purchase.