There's Scary Money in the Candy Business

We hope you had a safe and enjoyable time last weekend celebrating Halloween—a time of silly costumes, scary movies, and candy. Lots and lots of candy. So what better time to think about the economics of our favorite candy store, and see what investment lessons we can learn in the process?

Our story begins in 1921 when Charles See moved from Canada to Los Angeles and decided, along with his mother Mary and his wife Florence, to open a candy shop. The sparkling clean, black and white store was designed to resemble Mary See's home kitchen. The See's Candies shop was known for its unusually high-quality candy, and it immediately gained wide acceptance.

From that single store in LA, the company steadily grew in the 20's and 30's. By 1936, See's expanded to San Francisco and, as California grew, the See's family continued opening up shops throughout the state.

In 1972, Warren Buffett and his partner Charlie Munger saw in See's "the prototype of a dream business," and they bought the company through Berkshire Hathaway's eventual subsidiary Blue Chip Stamps. So what exactly did Buffett and Munger see *(no pun intended)* in See's Candies to call it a "dream business"?

Scary Business Metrics

The boxed-chocolate business is definitely not an exciting one. In fact, it seems like a poor business on its surface. The first negative element is that per-capita chocolate consumption in the United States is low and stagnant. Second, Americans' taste for chocolate is regionalized. And strike three is that it is a highly seasonal business: a bad holiday season could sink your entire year.

The table below shows See's growth, in terms of pounds of candy sold and the number of stores, in the first twelve years after Berkshire bought it. (Berkshire reported these figures at the time but, as See's became an ever smaller part of the growing Berkshire empire, less data was given about its performance after this time frame.) The number of stores grew by only about 2% per year, and the amount of candy sold grew just over 3%, meaning that the number of pounds on a per-store basis grew only 1% annually. This is not torrid growth we're talking about here.

Year	Thousands of lbs.	# of Stores
1984	24,759	214
1983	24,651	207
1982	24,216	202
1981	24,052	199
1980	24,065	191
1979	23,985	188

Year	Thousands of lbs.	# of Stores
1978	22,407	182
1977	20,921	179
1976	20,553	173
1975	19,134	172
1974	17,883	170
1973	17,813	169
1972	16,954	167
Avg. Annual Growth	*3.2%*	*2.1%*

Source: Berkshire Hathaway annual reports

In fact, if you look at the most recent five-year period in the table, from 1979 through 1984, though the company-wide sales continued to increase slightly, the number of pounds See's sold on a per-store basis actually decreased.

The second negative characteristic is that chocolate tastes appear to be localized. What people love on the East coast is different than what people love in the West coast. Though it has tried from time to time, See’s has had a difficult time growing beyond its home base of California. Even today, more than 90 years after the founding of the brand, the bulk of its business comes from just a handful of Western states.

And finally, boxed chocolates are highly seasonal. While Valentine's Day and Easter provide some uplift in sales, See’s earns more than 90% of its annual profit in the single month of December. It loses money in most other months. The capital constraints of the business fluctuate a great deal, hitting a low right after Christmas.

So, what could there possibly be to like? Why did Warren and Charlie refer to this as a "dream business"?

Pricing Power

What Buffett and Munger correctly and shrewdly recognized was that the See’s brand, despite its negative characteristics of being a seasonal, localized, low-growth business, had something else which was enormously powerful: untapped pricing power. See’s could increase the price of its chocolate every year, and people would still buy it. After all, if a young boy wanted to impress his beloved on Valentine's Day, would he buy a box of delicious, high-quality See's for a certain price, or would he buy the Acme brand because it cost 75 cents less?

The table below shows the impact of pricing power in that same twelve year period as before. During that time frame, sales in dollar terms increased at a very respectable 13% average per year, while after-tax profit advanced by almost 17% per year. That is certainly something to salivate about.

Year	Sales ($K)	Profit ($K)
1984	135,946	13,380
1983	133,531	13,699
1982	123,662	11,875
1981	112,578	10,779
1980	97,715	7,547
1979	87,314	6,330
1978	73,653	6,178
1977	62,886	6,154
1976	56,333	5,569
1975	50,492	5,132
1974	41,248	3,021
1973	35,050	1,940
1972	31,337	2,083
Avg. Annual Growth	*13.0%*	*16.8%*

Source: Berkshire Hathaway annual reports

Commenting on untapped pricing power, permit us to go on a small tangent here. One of us recently traveled to Orlando and experienced this phenomenon first-hand. Twenty years ago, you could buy a 4-day ticket to the Disney theme parks, and it automatically allowed you to “hop” between parks (e.g., you could attend Magic Kingdom in the morning and then spend your afternoon at EPCOT). Additionally, any unused days of a multi-day ticket did not expire: you could use them at any point in the future. Nowadays, however, if you want a “hop” option on your ticket, you have to pay extra. If you want a “no expiration” option, you have to pay extra. And of course, all of this is in addition to the price increase of the ticket itself, which happens almost every year. That is pricing power in action.

A Very Sweet Deal

Going back to See’s, though, there is even more financial sweetness that is not apparent from the numbers above. When Berkshire bought See’s, pre-tax earnings were a little less than $5 million, but the capital then required to conduct the business was $8 million. Thus, the company was earning an enormous 60% pre-tax on invested capital. Two factors helped to minimize the funds required for operations: (1) the product was sold for cash, which eliminated accounts receivable, and (2) the production and distribution cycle was short, which minimized inventories.

We estimate that the capital now required to run the business is less than $50 million. That means that, in the ensuing four decades since Berkshire's initial purchase, it has had to invest about $40 million to handle the modest physical growth of the business. In 2011, Berkshire reported that See's earned pre-tax profits of $83 million, meaning that its return on capital has increased from an enormous 60% to an unbelievable 166%.

If you were to sum up the pre-tax earnings Berkshire has realized from owning See’s in the last 40 or so years, it would be about $1.7 *billion*.

Let us now ask you an important question. If, in 1972, someone had offered to sell See's Candies to you, and you had the full knowledge that you would only have to invest a further $40 million over the next four decades, and that you would be able to reap profits of $1.7 billion during that time, what is the maximum price you would have paid?

If you had invested your money in a broad stock market index in 1972 and held on for the next four decades, you would have compounded your money at almost exactly 10% per year. To get that same return from owning See's, you could have paid up to $100 million for it back in 1972. That is, you could have paid about 3x the revenue or about 50x the after-tax profits for the company at the time, and still made out with a respectable annual return of 10% on your money.

Or, say you wanted to earn 15% per year. We estimate that you could have paid up to $55 million initially. Or maybe you'd prefer to have earned 20% on your money over the last four decades? You could have paid $34 million in that case.

But Berkshire's actual purchase price of the company back in 1972 was just $25 million. Imagine: a $25 million initial investment, plus an incremental $40 million over the years to upgrade your machinery and build new stores, would have earned you cumulative pre-tax profits of nearly $2 billion. Oh, and the annualized return on that investment works out to about 24%. Talk about a sweet deal.

These figures are mind-blowing, and they illustrate what makes See's a "dream" business. There are not many companies like that in Corporate America, especially ones trading at the bargain price that Berkshire was able to pay. Typically, companies that increase their earnings at a rate similar to See's require hundreds of millions of dollars to finance their growth, because growing businesses have working capital needs that increase proportional to sales and significant requirements for fixed asset investments. Being able to grow steadily, without needing large cash infusions along the way, is the hallmark of a great business.

Conclusion

Next time you consider buying a business, be it a private one or one listed publicly on the stock market, remember See's Candies. Pay attention to the pricing power of the business and its return on invested capital. In the meantime, go enjoy some of your leftover Halloween candy.

FELIPE

Felipe Garcia, CFA
Chief Investment Officer
INKWELL CAPITAL LLC

Aaron

Aaron Byrd, CFA
President
INKWELL CAPITAL LLC