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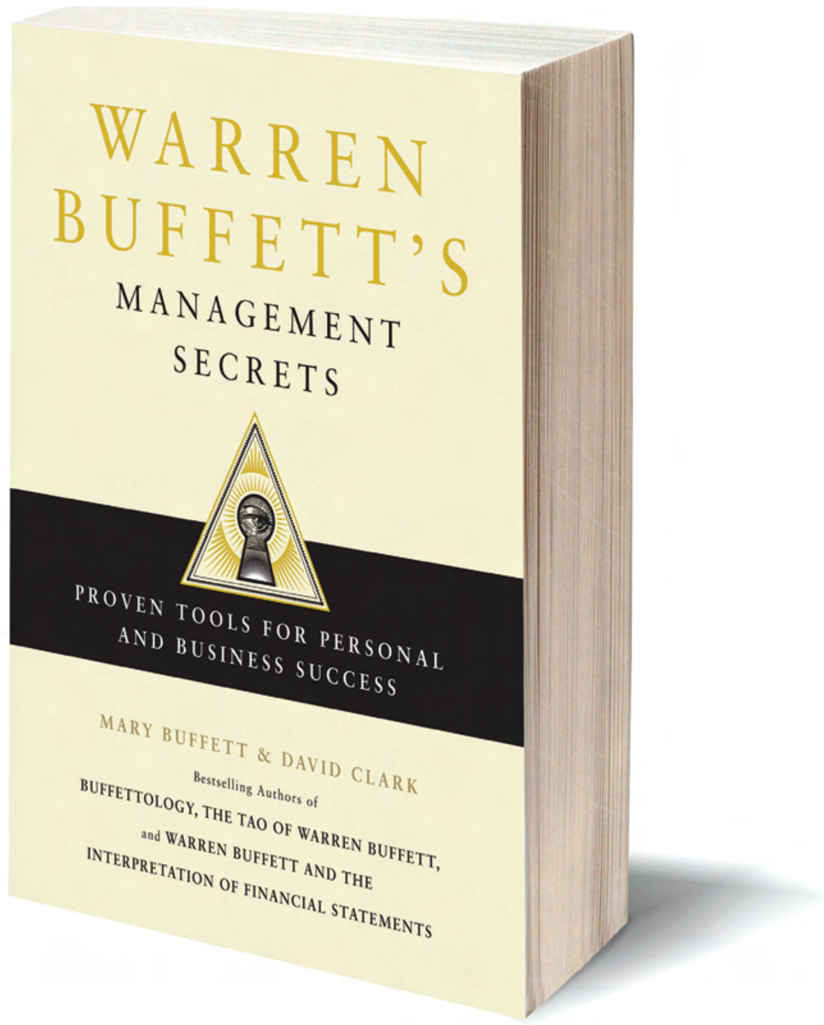

An American paragon in the field of finance and investment, Warren Buffett stands alone. And when the Oracle of Omaha speaks, everyone listens. This month, our book excerpt is from the brand-new title *Warren Buffett's Management Secrets* by Mary Buffett and David Clark. This book is the pair's sixth title about the financial strategies and thought processes of Warren Buffett. What makes their books popular is the use of plain language and easy-to-understand examples. You don't have to be a financial expert to understand the message. The following excerpt is from the opening of their latest book. — *the editors*

STEP ONE

Pick the Right Business to Work For

Working for the right business can mean the difference between a successful, high-paying career or a life of drudgery. It can also mean the difference between a successful long-term investment and one that earns nothing. Warren has discovered that certain kinds of companies have inherent business economics so great that even a bad manager will look good working for them. These are the companies that he wants to own, and these are the kinds of companies that we want to work for. Warren has identified a number of characteristics to help us identify these wonderful businesses, which is where we will begin.

Chapter 1
How to Find the Kind of Business That Offers the Greatest Career Opportunities

"There is a huge difference between the business that grows and requires lots of capital to do so and the business that grows and doesn't require capital."

— *Warren Buffett*

This is one of the keys to understanding Warren's success as a long-term investor and business manager. Businesses with superior economics working in their favor tend to burn considerably less capital than they earn. This is usually because they produce a brand-name product that never has to change, or because they provide a key service that allows them to charge higher prices, which gives them better profit margins.

With a brand-name product that never has to change, the company doesn't have to spend large sums of money on research and development, nor does it have to constantly retool its plant and equipment to implement design changes. Therefore, it can use the same plant and equipment over and over again, year after year, until the equipment finally wears out. All the money it saves can be used to expand the business without having to burden the company with additional debt or the selling of new shares. The capital needed for growth is generated internally. All of this, of course, helps make the managers of these super companies look brilliant!

Certain companies have inherent business economics so great that even a bad manager will look good working for them.

An example: A company like Coca-Cola never has to spend billions of dollars redesigning its product or retooling its manufacturing plants to stay ahead of the competition. This leaves it plenty of money to spend on such fun things as buying other companies and paying big bonuses to its managers. A company like General Motors, on the other hand, which produces automobiles that change in style almost every year, has to spend billions on new designs and retooling its plants to keep its models competitive with the Fords and Toyotas of the world.

Which one of these companies would you rather work for — the one that is internally generating tons of excess cash or the one that is internally burning tons of cash? The one with the excess cash, of course, because that excess cash makes management look good, which means that they get to pay themselves generous bonuses at the end of the year.

And getting paid more money is always a good thing.

Companies With a Durable Competitive Advantage

Warren believes that the best company to own, invest in, or work for — the one that offers the greatest opportunity for career advancement, job security, and the long-term making of money — is a company that has what Warren calls a durable competitive advantage. These super companies have a near lockdown on their market. What this means to us is that these companies have products and services that never really change, are easy to sell, and own a piece of the consumer's mind. This equates to higher profit margins and inventory turnover, which means these companies are often awash in cash.

On the other side of the coin, there are companies with lousy economics that are very difficult businesses for us ever to look good in. They tend toward boom-and-bust cycles that make you a star one moment and out of a job the next.

So the businesses that offer us the greatest employment advantage are the ones with some kind of durable competitive advantage working in their favor. Warren has figured out that these super companies come in three basic business models: they either (1) sell a unique product, (2) sell a unique service, or (3) are the low-cost buyer and seller of a product or service that the public is consistently in need of.

Let's take a good look at each of these three kinds of super businesses and discover the employment opportunities that they offer.

Companies that sell a unique product: This is the world of Coca-Cola, Pepsi, Wrigley, Hershey, Coors, Guinness, Kraft, Merck & Company, Johnson & Johnson, Procter & Gamble, and Philip Morris. Through the process of customer need and experience, and promotion by advertising, these companies have established the stories of their products in our minds and we immediately think of their products when we go to satisfy a specific need. Want to chew some gum? You might think of Wrigley. Feel like having a cold beer after a hot day on the job? You might think of Budweiser or Coors. For the last 284 years the Irish, on cool rainy evenings, have thought of pints of Guinness and a warm fire at the local pub. And Philip Morris has made a fortune selling Marlboro cigarettes all over the world.

Warren likes to think of these companies as owning a piece of the consumer's mind, and when a company owns a piece of the consumer's mind it never has to change its products, which, as you will find out, is a good thing. And it also gets to charge higher prices and sell more of its products, which means bigger profit margins and higher inventory turnover, which equates to a larger bottom line on its income statement. These companies are easy to identify because they have consistent and strong yearly earnings, and little or no debt on their balance sheets.

> *When a company owns a piece of the consumer's mind, it never has to change its products.*

From an employment perspective, these special companies offer us the easiest opportunity to rise to managerial superstardom. They are awash in cash, which means that they can pay generous salaries and huge bonuses, and they also have the money to buy other businesses and create new businesses, which means that there is plenty of opportunity for a young manager to excel. Believe it or not, things really do go better with a Coke, including your career.

Companies that sell a unique service: This is the world of Moody's, H&R Block, Amex, ServiceMaster, and Wells Fargo. Like lawyers and doctors, these companies sell services that people need and are willing to pay for — but unlike lawyers and doctors, these companies are institutional specific as opposed to people specific. When you think of getting your taxes done, you think of H&R Block, you don't think of Jack, the guy at H&R Block who does your taxes. The economics of selling a unique service can be phenomenal. A company doesn't have to spend a lot of money on redesigning its products, nor does it have to spend a fortune building a production plant and warehousing its wares. And firms selling unique services that own a piece of the consumer's mind can produce even better margins than firms selling products. Being a manager in one of these businesses can be a high-paying, rewarding career, with few of the financial ups and downs that plague other businesses. Just compare the operations histories of H&R Block and a company like GM. No matter how bad the recession, people still need help filing their taxes — there is never a recession in the tax-filing business. But with a company like GM the whims of the economy can be devastating in just a short amount of time. The management team of H&R Block will never stay awake nights worrying about union demands, too much debt, or the buying whims of the public. The same cannot be said for the management team of GM.

Companies that are the low-cost buyer and seller: This is the world of Wal-Mart, Costco, Nebraska Furniture Mart, Borsheim's Fine Jewelry, and the Burlington Northern Santa Fe. Here big margins are traded for volume, with the increase in volume more than making up for the decrease in profit margins. The key here is to be the low-cost buyer, which allows you to get your margins higher than your competitors' and still be the low-cost seller of a product or service. Here the reputation of being the best price in town lures in consumers.

In Omaha, if you need a new stove for your home, you go to the Nebraska Furniture Mart for the best selection and the best price. Want to ship your goods cross-country? The Burlington Northern can give you the best deal for your money. Live in a small town and want the best selection with the best prices? You go to Wal-Mart.

Out of the three business models just discussed, the low-cost buyer and seller offers the fewest opportunities for career advancement. The continued stress of having to keep costs low puts great pressure on management and tends to keep salaries low, yet these businesses still offer better employment and management opportunities than do the mediocre businesses that do not fit into one of these three categories.

Now that we know the general model for the "perfect" business to work for, let's look at their economic picture a little more closely so we can tell who is who and what companies are our tickets to that very rewarding career. We have selected three very simple economic tests to use to help determine if the company in question is one of those special companies with a durable competitive advantage.

Chapter 2
Three Quick Tests for Identifying the Best Company to Work For

1. Per-Share Earnings Test

One of the quickest ways to check the economics of a potential employer is to check the company's yearly per-share earnings figures. This is easy to do if the company is a publicly traded entity, difficult to do if it is not.

While no one yearly per-share figure can be used to identify a company with a durable competitive advantage, per-share earnings for a ten-year period can give us a very clear picture of whether or not the company has a long-term competitive advantage working in its favor. What Warren looks for is a per-share earnings picture, over a ten-year period, that shows consistency and an upward trend. Something that looks like this:

'08 $2.95
'07 $2.68
'06 $2.37
'05 $2.17
'04 $2.06
'03 $1.95
'02 $1.65
'01 $1.60
'00 $1.48
'99 $1.30

This shows Warren that the company has consistent earnings that are showing a long-term upward trend, which is an excellent sign that the company in question has some kind of long-term competitive advantage working in its favor and potentially would be a great company to work for. Consistent earnings are usually a sign that the company is selling a product or a mix of products that don't need to go through the expensive process of change. The upward trend in earnings means that the company's economics are strong enough to allow it either to make strategic expenditures to increase market share through advertising and an expansion in operations or to increase per-share earnings by the use of stock buybacks.

The companies that Warren stays away from and that probably offer poor employment prospects have an erratic yearly earnings picture that looks like this:

'08 $2.50
'07 $(0.45) loss
'06 $3.89
'05 $(6.05) loss
'04 $6.39
'03 $5.03
'02 $3.35
'01 $(1.77) loss
'00 $(6.68) loss
'99 $8.53

Erratic earnings, which in boom years can create a winning illusion, can later mean a company is a loser.

This shows a downward trend, punctuated by losses, which tells Warren this company is in a fiercely competitive industry prone to booms and busts. The boom increases demand, which increases prices. To meet demand the company increases production, which increases supply, which increases costs and eventually leads to an excess of supply in the industry and to falling prices. The company, once profitable, now starts to lose money, until it has to cut production and costs. There are thousands of companies like this, and their erratic earnings, which in boom years create the illusion that the company is a winner, eventually make the company a loser. It is hard to look like a managerial superstar when every few years the company's inherently lousy economics destroy your results.

The company with consistent earnings that show an upward trend is the company that offers the best prospects for profitable long-term employment and a rewarding career. But the company with the erratic earnings picture, while quick to hire in the boom years, is also quick to fire in the lean years. This boom-and-bust pattern makes the company difficult to work for since there is no long-term stability in its economic picture.

2. The Debt Test

Another sign of a great business to work for is a company with the absence of, or low levels of, long-term debt. Companies that make a lot of money don't need to carry high debt loads since the surplus of cash allows them to be self-financing. These are the companies that make good long-term employers because they have the cash to pay good salaries and the financial wherewithal to weather a recession with flying colors.

The no/low-debt companies are easy to spot, as long as you gauge the debt load of a particular business relative to its industry. As a general rule, a debt load in excess of five times its net earnings is a good indication that it is not a company with a durable competitive advantage.

High levels of debt tell us that: (1) the business is in a highly competitive industry where constant change has created high capital demands, or (2) the company is highly leveraged. What this means to us is that if we go to work for one of these businesses, the cost of servicing the debt will eat up any excess cash and leave little for salary increases and bonuses. It also means that there will be little excess capital for growing the business or acquiring new businesses, which means that there will be little growth in managerial opportunities. And if the economy goes into a recession, these will be the first companies that fire employees, in an attempt to cut costs before they go under. Not exactly the company that you want to be staking your career on.

3. The Gross Margin Test

Another way to tell if a company has a durable competitive advantage, which would help make it a great company to work for, is to look at the company's Gross Profit Margin. To figure out the company's Gross Profit Margin, we have to look at the company's income statement — which is a financial report for a period of time that shows whether the company made or lost money.

Specifically we have to take the company's revenue and subtract the company's Cost of Goods Sold, which will give us the company's Gross Profit. Now, if we divide the company's Gross Profit by its revenue, we will get the company's Gross Profit Margin. Let's take a closer look:

Income Statement

Revenue	10,000
Cost of Goods Sold	-6,000
Gross Profit	4,000

Now, if we subtract from the company's total revenue the amount reported as its Cost of Goods Sold, we get the company's reported Gross Profit. As an example: Total Revenue of $10 million less Cost of Goods Sold of $6 million, equals a Gross Profit of $4 million. Then, to get the Gross Profit Margin, we take the gross Profit of $4,000 ÷ Revenue $10,000 = Gross Profit Margin, which equals 40%.

Warren is looking for companies that have some kind of durable competitive advantage — businesses that he can profit from over the long run — which make them fantastic companies to work for. What he has found is that companies that have excellent long-term economics working in their favor tend to have consistently higher Gross Profit Margins than those that don't. Let us show you.

Gross Profit Margins of companies that Warren has already identified as having a durable competitive advantage: Coca-Cola shows a consistent Gross Profit Margin of 60% or better; the bond-rating company Moody's, 73%; the Burlington Northern Railroad, 61%; and the very chewable Wrigley Gum, 51%.

Contrast these excellent businesses with several companies that we know have poor long-term economics, such as the in-and-out-of-bankruptcy United Airlines, which shows a Gross Profit Margin of 14%; troubled automaker General Motors, which comes in at a weak 21%; the once-troubled but now-profitable U.S. Steel, at a not-so-strong 17%; and Goodyear Tire — which runs in any weather but a bad economy — stuck at a not-very-impressive 20%.

In the tech world — a field Warren stays away from because he doesn't understand it — Microsoft shows a consistent Gross Profit Margin of 79%, while Apple comes in at 33%. These numbers indicate that Microsoft produces better economics selling operating systems and software than Apple does selling hardware and services.

What creates a high Gross Profit Margin is the company's durable competitive advantage. It allows companies the freedom to price the products and services well in excess of their Cost of Goods Sold. Without a competitive advantage, companies have to compete by lowering the price of the product or service they are selling, which of course lowers their profit margins and therefore their profitability. It also lowers their ability to raise salaries and give big bonuses, and it diminishes the companies' capacity to expend capital on new businesses and to survive a recession.

In Summary

There are other tests that we can run to help us determine if the company in question has a durable competitive advantage, and we outline those tests in great detail in our book *Warren Buffett and the Interpretation of Financial Statements*. But for the quick and dirty, the three tests described in this chapter will serve us well when we need to assess whether or not the company offering us a job is one of those great businesses that will take us down the path to a successful and very rewarding career, or if it is a mediocre business that will enslave us to a life of low wages, few opportunities, and little or no job security.

While it is within the realm of possibility for a great company, over time, to turn into a mediocre one — this happened to the newspaper industry — it is a very rare event for a mediocre business to turn into a great one. So if you find yourself working for a company with poor inherent economics, it is better to get out now than to stick around year after year waiting for things to change.

***Warren Buffett's Management Secrets* is the sixth book written by Mary Buffett and David Clark about the guru's philosophies.**