BUFFETT'S Promise of Permanence

Warren Buffett's writer and editor of choice, **LAWRENCE CUNNINGHAM,** tells Brunswick's **KEVIN HELLIKER** how the legendary investor has acquired hundreds of subsidiaries – and never sells them

My brother Paul loves working at Nebraska Furniture Mart, a furniture store started in 1937 by a Belarus immigrant named Rose Blumkin. What my brother finds appealing is that even though the founder is deceased, and even though NFM has expanded beyond Omaha to Iowa, Kansas and Texas, and even though it ranks as the nation's largest home-furnishings store, it very much remains a family-run business. On any number of occasions in the Kansas City store where my brother works, he has shaken hands with Ron Blumkin, a grandson of the founder who serves as chairman of NFM.

"It's a family business," says my brother.

When I ask whether he's aware that Warren Buffett's Berkshire Hathaway owns NFM, he laughs. "That might be an urban myth," he says.

After starting out as an investment vehicle that took large positions in undervalued stocks, Buffett's Berkshire Hathaway evolved into a prodigious acquirer of a peculiar sort. Questions fundamental to most acquirers – such as how to merge two corporate cultures? – don't apply to Berkshire, because a strong culture is crucial to Buffett's interest in a company. To other acquirers, mediocre management may be a mark of opportunity. For Buffett it is a deal breaker.

These peculiarities make Berkshire the acquirer of choice for companies that want everything – the proceeds of a sale and benefits of a deep-pocketed parent – without losing their independence. Outside of Buffett himself, no one knows more about Berkshire's acquisition strategy than Lawrence Cunningham, a George Washington University Professor of Law who is Buffett's favored chronicler. Besides serving as editor of *The Essays of Warren Buffett* – a perennial bestseller – Cunningham in 2014 wrote *Berkshire Beyond Buffett*, a treatise on why the company will prosper once its chief executive, now 87 years old, is gone.

Cunningham's argument is simple. Berkshire will remain vibrant without Buffett because each of its 300-some individual units or subsidiaries is well managed. If it weren't, Buffett wouldn't have bought it in the first place.

When you write about Berkshire, you talk about direct and indirect subsidiaries. How many are there in total?

About 60 direct subsidiaries, and at the next level there are probably 240 companies. So around 300 in all. It depends on how you – how Warren – counts it. Scott Fetzer is a direct subsidiary, for instance, but in his annual report Warren will list out 12 of their divisions for some reason. (Laughs) I think he does that because Scott Fetzer was one of his early acquisitions, and he pays a lot of attention to those individual subsidiaries.

Is there a standard way that one of these acquisitions comes about? Is it Warren Buffett approaching a company or vice versa?

It's almost always the company or an agent approaching Warren. He's managed to create a network and a reputation that generates lots of overtures from the other side. And he can be very selective. In my book, I list at least 14 where the seller family wrote or called him directly. And he'll answer the phone. He'll open your mail and respond. There's another cluster where some intermediary who knew the selling family and who knew Warren made an introduction. And there's a third category where friends or relatives made the introduction.

There's another category that I call stranger. Someone just sends him a fax. Or in the case of FlightSafety International, a Berkshire shareholder who was also a shareholder of FlightSafety wrote a letter to Warren's outside attorney. And his lawyer passed it along. For the most part, he just sits back and waits for the phone to ring.

Is there an example of Berkshire making the overture?

Warren actually initiated the Scott Fetzer deal. Someone was making a hostile bid, and Warren read about it in *The Wall Street Journal*, and he called the CEO and said, "If you want a friendly acquisition, give me a call."

If I'm the subject of a hostile takeover, why would a call from Warren Buffett appeal to me?

A manager facing a hostile takeover knows that the bidder has reasons to terminate management, throw out the board, install new people, take the whole company in a new direction. Warren's the exact opposite. The manager will stay in place, have autonomy, independence, very little oversight. And so if you love your business, you want to run it even if someone else owns it, he's the perfect buyer.

Hasn't he bought some companies out of bankruptcy? Wouldn't a company's need for bankruptcy protection raise questions about management?

Those cases are very much the exception. Warren isn't hunting regularly in the bankruptcy courts for opportunities. In the case of Fruit of the Loom, management got caught flat-footed by some shipping challenges and cheaper labor costs overseas, and just needed more time than was available. Once the price got low enough, Warren saw there was brand strength and customer loyalty.

What percentage of these acquisitions would you estimate are family-owned businesses?

Before 20 years ago, it was the majority. It's now a minority. And that's partly to do with size and scale.

"THEY ACCEPTED BERKSHIRE'S BID BECAUSE OF THAT PROMISE OF PERMANENCE AND AUTONOMY. AND THEY LEFT $25 MILLION ON THE TABLE"


ILLUSTRATION: THOMAS FUCHS

Before 1997 or thereabouts, Berkshire's acquisitions tended to be in the $100 million range. They didn't often get above $1 billion. You had many more medium- to small-sized companies in that sweet spot. And they tended to be family-owned and operated. They're the perfect kind of seller; the owners typically have some interest in preserving a legacy, maintaining a family name and continuity among generations of managers. They welcomed that commitment to autonomy. Berkshire's other commitment is to permanence. Berkshire hasn't sold an acquired subsidiary in 40 years.

That's amazing.

It is. Warren came to realize that a lot of sellers will accept a commitment of permanence in exchange for some economic consideration. As he has developed a reputation for permanent ownership, sellers have shown a willingness to charge less. I give a couple of examples in *Berkshire Beyond Buffett*. The Child family who owned RC Willey, a home furnishings company, were at the third-generation stage, and it was time for a change. But they were very interested in both autonomy and continuity for the nephews coming up and permanence for that family name. And they went on to the market and solicited and obtained bids, one of which was from Goldman Sachs for $200 million and one was from Berkshire for $175 million. Both were all cash. And Bill Child told me he sat around, met with the family and they talked it over and they accepted Berkshire's bid. And they accepted Berkshire's bid because of that promise of permanence and autonomy. And left $25 million on the table.

Their vindication is that, nearly 23 years later, the Childs still run that company. They don't have to do a lot of reporting and they have virtually no oversight from Warren. They've had interactions with Warren over questions like, "Should we expand into this state or buy property here?" And they've had a great relationship over it. It has grown, it has expanded, and the family still runs it.

Is that promise of permanence delivered over a handshake or actually written into the deal?

It's over a handshake. It's never written into the deal. It is an interesting thing, that it's not written anywhere. As a corporate lawyer, I would never advise writing that into a deal. But he's got a long record of keeping his word, and he has made the promise on video, when Berkshire bought Benjamin Moore Paints. Benjamin Moore has a localized distribution system of independent dealers to sell their paint. And the distributors were very nervous about Berkshire's acquisition. He made a video that was distributed to all of them, giving that assurance that we buy for keeps and we're not going to sell you, we're not going to change that business model. And so, even though it's not legally binding, it's so ingrained in the culture – and he's just truthful.

And anybody who has doubt can call other sellers, other people who have sold to him.

Are management changes ever needed?
The Pampered Chef went through a difficult patch. That's a company that sells kitchen utensils, typically through Tupperware-type parties at homes, among friends. And it was a great business model in the '90s. But it faced serious problems as its demographics shifted to online shopping, and Millennials are just a different social milieu where that sort of home party isn't as popular. So they faced a very serious challenge, but Warren stuck with it. The founder, Doris Christopher, wanted to step down. She wanted to do other things, she was in her late 60s, and so she did, and they hired somebody else. And the headwinds were still strong. And Warren thought Doris really has the genes for this and the chemistry and the history. So he called her back from retirement. And she tried to reestablish the conviction among the sales force that they could do this and how to adapt to the online world. And she got it back on track. And then she still wanted to retire. (Laugh)

And so he did manage to persuade an executive in Omaha, Tracy Britt Cool, a young whippersnapper from Harvard Business School, to take charge of the Pampered Chef. And as I understand it she's got it right now. It was partly about distribution strategy, partly product mix. Making those parties appealing again. The key is, he held onto it.

Would he ever sell a subsidiary?
He does have two rules that he's stated for 40 years that, if triggered, he'll sell. One is because he is a fiduciary. Berkshire's got to look out for shareholder interests. It can't just be a welfare center for corporate orphans. First, the permanence commitment is binding so long as the business has sufficient cash flows. It can't just hemorrhage cash. A business can't be in a coma or dead. It can be struggling, but it's got to at least have that cash flow. Second, it's got to have labor peace. That's not a big problem with most companies. It's come up a couple of times. NetJets – the fractionally owned aircraft business – employs very expensive, highly skilled pilots. And they exerted real pressure against management. Management though was pushing back. They had a real gap. Pilots protested at the annual meetings, took out ads in *The Wall Street Journal* and were a very strong and loud voice. They built a lot of pressure around NetJets and it even reached, I think, to Warren. But they ultimately managed to calm it down, get an accommodation. Watching that, I thought, this is going to be one of those exceptions. If this labor unrest persists, this will be grounds for selling. But it never even got close to that.

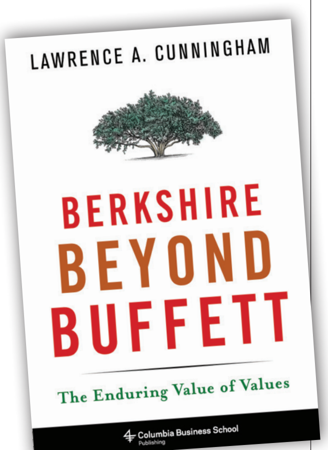
Is the promise of permanence a reason to believe in Berkshire beyond Buffett?
Yup. That's my argument in the book. Everyone who has studied it recognizes that that permanence commitment is an important source of value at Berkshire over time. My research supported the conclusion that this commitment to permanence will be sustained. And mainly that's because it has been injected into the culture, into the corporate DNA. It's molecular, it's fundamental. Everyone gets it. Certainly, the entire board of directors – who will be responsible for picking the next CEO – fully, completely, comprehensively embrace that principle.

Likewise, within the executive ranks, the managers of most of these companies receive that commitment or have made it in turn to subsidiaries they acquire. And so none of them will have any propensity to break that commitment.

And the third group are the shareholders, who obviously elect the board of directors. These are very unusual shareholders in corporate America. They've got a much longer-term outlook than average. Their holding periods are longer. Share turnover is lower. They're not so fixated on quarterly or even annual results. They're looking really at five, 10, 15 years. There are very few index investors in Berkshire.

Do you think Berkshire could ever become the target of an activist?
Could a Nelson Peltz or a Carl Icahn or a Bill Ackman take a shot at Berkshire? I don't think so. Nothing is impregnable. It's not impossible. But the culture around the board, the managers and the existing shareholders, is so strongly committed and aligned with this idea of permanence that it just seems unlikely. And the businesses themselves all tend to be in the top of their respective industries.

KEVIN HELLIKER, a Pulitzer Prize-winning journalist, is Editor-in-Chief of the *Brunswick Review*.



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