

EPISODE 144

Read the Business Like an Owner

The slide shows profit up, and your request for two new hires gets turned down because cash is tight. How can both be true at once? Warren Buffett's answer starts with a box of chocolates — See's Candies, bought for twenty-five million dollars in 1972 — and a question he called owner earnings: how much of this profit could you actually take out without the business shrinking? This episode gives you four moves to read your numbers like an owner.

KEY STRATEGIES & IDEAS

1. The Two Numbers That Disagree

Picture the budget review. The slide shows profit up — and your request for two new hires gets turned down because cash is tight. You walk out wondering how both of those things can be true at once. The numbers said healthy. The bank account said otherwise. And the honest answer in that moment is usually that you do not know: you can read the profit line. You cannot yet read the business.

2. A Box of Chocolates

Warren Buffett and Charlie Munger's company bought See's Candies, a California candy company, for twenty-five million dollars in 1972. Buffett later admitted he nearly blew the deal — the seller wanted thirty million, and he would not go above twenty-five. At the time, the company had thirty million dollars in sales and pre-tax earnings of less than five million, on just eight million dollars of capital to run the business: sixty percent pre-tax on the capital invested. Thirty-five years later, sales were three hundred and eighty-three million — more than twelve times where they started — and the capital needed was still only forty million. They had reinvested just thirty-two million, and almost all of the earnings went straight to Berkshire. The growth was mostly price, not volume: sixteen million pounds of candy in 1972, thirty-one million in 2007, about two percent a year — a pound went from under two dollars to over twelve. Buffett called businesses like this savings accounts: the great one pays an extraordinarily high rate of interest, and the rate rises as the years pass. The gruesome one pays a poor rate and keeps asking you to deposit more. Chuck Huggins ran See's on those economics for thirty-four years.

3. Owner Earnings

The question comes from Buffett's 1986 letter to Berkshire shareholders. He called it owner earnings: reported earnings, plus the non-cash charges, minus the cash the business has to spend every year just to stay in place. Depreciation is the big one — the accountants spread the cost of a machine over its life, but the cash left years ago. Add those charges back, then subtract what it really costs each year to keep the business competitive and its volume intact. Buffett proved it with one company shown two ways: when Berkshire bought Scott Fetzer, the same business was reported under the old accounting at forty point two million dollars of earnings — and under the new

purchase accounting at twenty-eight point six million. Same business, same cash. The gap — eleven point six million — was newly created non-cash charges, and the real upkeep figure was close to eight point three million, not nineteen point nine. The owner earnings were identical, so the value was identical.

4. Vaguely Right

Buffett's own verdict on that gap was blunt: the accountants' job is to record, not to evaluate. The evaluation job falls to investors and managers. He also borrowed a line from Keynes — he would rather be vaguely right than precisely wrong — because the upkeep number has to be a guess. That is the honest part: owner earnings is a judgement, not a formula you can hide behind. Jeff Bezos put it his own way: 'Our ultimate financial measure, and the one we most want to drive over the long-term, is free cash flow per share.' Different words, same discipline. Profit is a promise. Cash is the proof.

5. Two Levels Up

Read every number like an owner asking one question: how much of this profit could I actually take out without the business shrinking? If you cannot answer that, you do not yet understand the number. And for every new dollar of earnings you are chasing, ask how much new capital has to go in first. If the answer is a little, you have found a See's. If the answer is a lot, you have found a business that will keep asking for deposits — and you should say so out loud before the top table commits the money.

The picture: The budget review. The slide shows profit up — and your request for two new hires gets turned down because cash is tight. You walk out wondering how both of those things can be true at once.

ACTION & REFLECTION STEPS

- [ ] **Step one — read the profit.** Start with the reported earnings, add back the non-cash charges, and you have the cash the business produced before upkeep.

Reported earnings, and the non-cash charges to add back:

- [ ] **Step two — price the upkeep.** Work out what your unit spends every year just to hold its ground — the equipment, the systems, the renewals. If that number is bigger than the depreciation on the books, your reported profit is overstating what the owner really earned.

What we spend each year just to hold our ground:



SKIP LEVEL

strategic leadership for leaders ready to think two levels up

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- [ ] **Step three — follow the cash.** Ask who funds your growth. See's customers paid cash on the day, so growth never starved the business. Amazon's suppliers funded its growth the same way, because Amazon collected from customers before it paid its suppliers. If your growth means more inventory sitting on shelves and more invoices waiting to be paid, that growth is eating cash even while the profit line rises.

Who funds our growth — and what it costs us:

- [ ] **Step four — ask the capital question.** For every new dollar of earnings you are chasing, how much new capital has to go in first? If the answer is a little, you have found a See's. If the answer is a lot, you have found a business that will keep asking for deposits — and you should say so out loud before the top table commits the money.

The next dollar of earnings we are chasing, and the capital it needs first:

Think two levels up. — Maya & Marcus

Joe Dutkiewicz

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