

Case Study – Dempster Mill Manufacturing Company



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Ask yourself.....Who is My Most Valuable Client?

Dempster Mill:

Dempster is an undervalued stock when he bought five years back, and now Buffett would like to convert it in to Control situation, He was on board four years back, it shows that any operation Buffett does is not overnight, it's a fruit of many years hard work.

Buffett own around 80% of the company, Buffett like to calculate the controlling stack value at year end, because old partners are selling and new partners are buying on that same price.

The estimated value should not be, what Buffett hope what it would be worth rather Buffett estimate, the business sold under current conditions that should be the estimated price for old and new partners to buy or sell.

Dempster is a manufacturer of farm implements and water systems, Sales in 1961 of about \$9 million. Operations have produced only nominal profits in relation to invested capital during recent years. This reflects the poor management situation.

Dempster Mill (Data Source: Buffett 1961 Letter)			
Year	1961		
Sales	\$ 9	million	
Profit	Nominal		
Net Worth	\$ 4.5	Million	
Book Value	\$ 75	Per Share	
Working capital / Share	\$ 50		
Buffett Valued at Year end	\$ 35	Per Share	This is the fair value for Old & New Partners
Buffett Acquired at	\$ 28	Per Share	

Buffett has 73% of portfolio holding in Dempster Mill, the company's main business is in farm equipment, water systems, water well supplies and plumbing lines.

The problem with Dempster was the sales of the company was not growing, low inventory level and no profits in invested capital, it's a classic case of value trap, where you get a value in stock purchase in relation to price, but the business itself is bad, or management is not capable to turnaround the business.

Buffett bought this company in August 1961 at an average price of \$28 per share, having bought few stocks at \$16, but majority of purchase was done at \$30.25 per share. Buffett take control of the company, and he

was not bothered about the general stock price, he bothered about the value of assets.

		(000's omitted)	30-Nov-61		
Assets	Book Figure	Valued @	Adjusted Valuation	Liabilities	
Cash	\$166	100%	\$166	Notes Payable	\$1,230
Accts. Rec. (net)	\$1,040	85%	\$884	Other Liabilities	\$1,088
Inventory	\$4,203	60%	\$2,522		
Ppd. Exp. Etc	\$82	25%	\$21		
Current Assets	\$5,491		\$3,593	Total Liabilities	\$2318
Cash Value Life ins., etc..	\$45	100 Est net auction value	\$45	Net Worth per Books:	\$4,601
Net Plant Equipment	\$1383		\$800	Net Work as Adjusted to Quickly Realizable Value	\$2120
Total Assets	\$6919		\$4438		
				60146 Adj. Value Per Share	

Source: Buffett Partnership Letters (Date: 18 January 1963)

The above picture is the consolidated balance sheet of Dempster Mill, Buffett use *appropriate discounts to the various assets*, these valuation based on their *non earning assets* and not access on the *basis of potential*, but on the basis of what Buffett *thought sales would produce on that date*. Buffett thinks the fair value of the Business is at \$35.25 per share.

As cash valued at 100%, Account receivable valued at 85%, Inventory Valued at 60%, Ppd Exp valued at 25%, Cash valued at 100%, finally the value per share determined at \$35.25.

Dempster financial year ends at November 30th. Value per share was \$35.

Initially Buffett works with the old management, for effective use of capital, better margin, reduction of overhead, these efforts were fruitless, after six months, it becomes obvious that old management not committed and they were unwilling towards Buffett's objective. Buffett looks for the change in management.

Entry of Intelligent Fanatics Mr. Harry Bottle (Man Of The Year)

Buffett rarely asked advice, but finally that April he took the situation up with his friend Munger while he and Susie were visiting Los Angeles.

“We were going to dinner with the Grahams and the Mungers, Susie and I. We met them at the Captain’s Table on El Segundo in L.A. During the dinner, I’m telling Charlie, ‘I’m in this mess with this company; I’ve got this jerk running Dempster, and the inventories keep going up and up.’” Munger, who dissected his law clients’ businesses and thought like a manager, said immediately, “Well, I know this guy that used to bring around tough situations out here. Harry Bottle.” He knew of Bottle through an acquaintance who specialized in business turnarounds. (Source: The Snowball Warren Buffett and the Business of Life by Alice Schroeder)

Harry Bottle, comes in picture, to solve the problem of Dempster mills. Buffett meet Harry in Los Angeles on 17 April 1962, Buffett presented a deal which provide rewards based on objective achievement. 23 April he was appointed as president of the company.

		(000's omitted)	30-Nov-62		
Assets	Book Figure	Valued @	Adjusted Valuation	Liabilities	
Cash	\$60	100%	\$60	Notes Payable	\$0
Marketable Securities	\$758	Mrkt Dte 31/12/1962	\$834	Other liabilities	\$346
Accts. Rec. (net)	\$796	85%	\$676	Total liabilities	\$346
Inventory	\$1634	60%	\$981		
Cash value life ins.	\$41	100%	\$41	Net Worth: Per Books	\$4077
Recoverable Income Tax	\$170	100%	\$170		
Ppd. Exp. Etc.	\$14	25%	\$4	As Adjusted to quickly realizable values	\$3125
				Add: proceeds from potential exercise of option to Harry Bottle	\$60
Current Assets	\$3,473		\$2766	Shares outstanding	60146
Misc. Invest	\$5	100%	\$5	Add: shs. Potentially outstanding under optio 2000	
				Total Shares	62146
Net Plant Equipment	\$945	Est. net auction value	\$ 700	Adjusted value per Share	\$ 51.26
Total Assets	\$4423		\$3471		

Source: Buffett Partnership Letters (Date: 18 January 1963)

Harry is unquestionably the man of the year. Every goal we have set for Harry has been met, and all the surprises have been on the pleasant side. He has accomplished one thing after another that has been labelled as impossible, and has always taken the tough things first. Our breakeven point has been cut virtually in half, slow moving or dead merchandise has been sold or written off, marketing procedures have been revamped, and unprofitable facilities have been sold. The results of this program are partially shown in the balance sheet below, which, since it still represents nonearning assets, is valued on the same basis as last year.

Harry Bottle done a great job, as Buffett points out three facts,

1) Net worth reduce, by writedowns of Inventory, Fixed Assets by \$550000, Converted assets to cash

2) Converted Assets of manufacturing business (which has been a poor business) to a business which we think is a good business --securities. Buffett bought more securities by selling the assets.

3) *By buying assets at a bargain price, we don't need to pull any rabbits out of a hat to get extremely good percentage gains. This is the cornerstone of our investment philosophy:*

“Never count on making a good sale. Have the purchase price be so attractive that even a mediocre sale gives good results. The better sales will be the frosting on the cake.”

		(000's omitted)			
Assets	Book Figure	Valued @	Adjusted Valuation	Liabilities	
Cash	\$186	100%	\$186	Notes Payable	\$1,230
Accts. Rec. (net)	\$1,040	85%	\$884	Other Liabilities	\$1,088
Inventory	\$4,203	60%	\$2,522		
Ppd. Exp. Etc.	\$82	25%	\$21		
Current Assets	\$5,491		\$3,593	Total Liabilities	\$2,318
Cash Value Life Ins.	\$45	100 Est net auction value	\$45	Net Worth per Books:	\$4,601
Net Plant Equipment	\$1383		\$800	Net Worth as Adjusted to Quickly Realizable Value	\$2120
Total Assets	\$6919		\$4438	Shares outstanding 60146 Adj. Value Per Share	\$35.25

Source: Buffett Partnership Letters (Date: 18 January 1963)

		(000's omitted)			
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Marketable Securities	\$758	Mrkt Dte 31/12/1963	\$834	Other Liabilities	\$346
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Inventory	\$1834	60%	\$981		
Cash value life ins.	\$41	100%	\$41	Net Worth: Per Books:	\$4077
Recoverable Income	\$170	100%	\$170	As Adjusted to quickly realizable values	\$3125
Ppd. Exp. Etc.	\$14	25%	\$4	Add: proceeds from potential exercise of option to Harry Bottle	\$60
Current Assets	\$3,473		\$2,766	Shares outstanding	60146
Misc. Invest	\$5	100%	\$5	Add: shs. Potentially outstanding under optio 2000	
				Total Shares	62146
Net Plant Equipment	\$945	Est. net auction val	\$700	Adjusted value per Sha	\$51.26
Total Assets	\$4423		\$3471		

Source: Buffett Partnership Letters (Date: 18 January 1963)

Points to Note
 1) Net Worth Reduce
 2) Marketable Securities Increases
 3) Value Per Share Increase from \$35.25 to \$ 51.26
 4) Total Assets Reduces

Step 2
 Converted Assets of manufacturing business (which has been a poor business) to a business which we think is a good business --securities. Buffett bought more securities by selling the assets.

Step 1
 Net worth reduce, by writedowns of Inventory, Fixed Assets by \$550000, Converted assets to cash (But where is the cash.. cash is not increase)

By buying assets at a bargain price, we don't need to pull any rabbits out of a hat to get extremely good percentage gains. This is the cornerstone of our investment philosophy:

“Never count on making a good sale. Have the purchase price be so attractive that even a mediocre sale gives good results. The better sales will be the frosting on the cake.”

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(Click here to Enlarge the image)

Dempster received unsecured term loan of \$ 1250000, these funds with funds freed after selling of assets, will be more than the \$35 per share, which was the Buffett's purchase price per share. The present valuation of \$16 per share in the manufacturing operation and \$35 in security operation.

We, of course, are devoted to compounding the \$16 in manufacturing at an attractive rate and believe we have some good ideas as to how to accomplish this. While this will be easy if the business as presently conducted earns money, we have some promising ideas even if it shouldn't.

It should be pointed out that Dempster last year was 100% an asset conversion problem and therefore, completely unaffected by the stock market and tremendously affected by our success with the assets. In 1963, the manufacturing assets will still be important, but from a valuation standpoint it will behave considerably more like a general since we will have a large portion of its money invested in generals pretty much identical with those in Buffett Partnership, Ltd. For tax reasons, we will probably not put workouts in Dempster. Therefore, if the Dow should drop substantially, it would have a significant effect on the Dempster valuation. Likewise, Dempster would benefit this year from an advancing Dow which would not have been the case most of last year.

There is one final point of real significance for Buffett Partnership, Ltd. We now have a relationship with an operating man which could be of great benefit in future control situations. Harry had never thought of running an implement company six days before he took over. He is mobile, hardworking and carries out policies once they are set. He likes to get paid well for doing well, and I like dealing with someone who is not trying to figure how to get the fixtures in the executive washroom gold-plated.

Harry and I like each other, and his relationship with Buffett Partnership, Ltd. should be profitable for all of us.

		(000's omitted)	30-Nov-63		
Assets	Book Figure	Valued @	Adjusted Valuation	Liabilities	
Cash	\$144	100%	\$144	Notes payable (paid 7/3/63)	\$125
Marketable Securities	\$1772	Mkt. 6/30/1963	\$2029	Other Liabilities	\$394
Accts. Rec. (net)	\$1262	85%	\$1073	Total Liabilities	\$519
Inventory	\$977	60%	\$586		
Ppd. Exp. Etc.	\$12	25%	\$3	Net Worth Per Book	\$4582
Current Assets	\$4167		\$3835	As adjusted to quickly realizable values	\$4028
Misc. Invest	\$62	100%	\$62	Shares Outstanding	62146
Net plant & equipment	\$872	Est. net auction value	\$650	Adjusted value per Share	\$64.81
Total Assets	\$5101		\$4547		

Source: Buffett Partnership Letters (Date: 10 July 1963)

Last year Buffett called Harry Bottle is “man of the year” Harry, did extraordinary job, by converting unproductive assets into cash, which used in buying undervalued securities, This year turned under-utilized assets in to cash, and made remaining assets productive. (Cash increases from \$60 to \$144)

Few points to note

- 1) Cash increases from \$60 to \$144 than previous year
- 2) Marketable securities bought more from \$758 to \$1772 than previous year
- 3) Inventory reduces (by selling it) from \$1634 to \$977
- 4) Net worth per book increase from \$4077 to \$4582
- 5) Value per share increases from \$51.25 to \$64.81
- 6) Net plant equipment reduces from \$945 to \$872, by selling unproductive equipment.

If you compare 30 November 1963 figure to 30 November 1961 figure, there was a huge change, In terms of marketable securities, Inventory (\$4023 in 1961 to \$977 in 1963) Total liabilities decrease from \$2318 to \$519 and the most important value per share increases from \$ 35.25 to \$64.81 it's an 83.58% increase in three years. It's an outstanding change, it's a complete turnaround of the business, that's why, Harry Bottle was “Man of the year”

One sidelight for the fundamentalists in our group: B.P.L. owns 71.7% of Dempster acquired at a cost of \$1,262,577.27. On June 30, 1963 Dempster had a small safe deposit box at the Omaha National Bank containing securities worth \$2,028,415.25. Our 71.7% share of

\$2,028,415.25 amounts to \$1,454,373.70. Thus, everything above ground (and part of it underground) is profit. My security analyst friends may find this a rather primitive method of accounting, but I must confess that I find a bit more substance in this fingers and toes method than in any prayerful reliance that someone will pay me 35 times next year's earnings.

BPL owns 71.7% of Dempster at cost of \$1262577.27, Now on 30 June 1963, Dempster Mills has securities worth \$2028415.25 BPL 71.7% share of \$2028415.25 amounts to \$1454373.70 thus, everything above purchase cost is profit.

Buffett friends thinks it's a primary method of accounting, But Buffett confess that *I find a bit more substance in this fingers and toes method than in any prayerful reliance that someone will pay me 35 times next year's earnings.*

This is the simple thinking that you don't need to over calculate the numbers in investing, your own simple calculation can give better results.

Harry was the perfect man for the job. I have recited his triumphs before and the accompanying comparative balance sheets speak louder than any words in demonstrating the re-employment of capital.

	11/30/61	7/31/63 (unaudited)
Cash	\$166,000	\$89,000
US Gov't Securities – at cost		\$289,000
Other marketable securities – at market (which exceeds cost)		\$2,049,000
Total Cash and Securities	\$166,000	\$2,436,000
Accounts receivable (net)	\$1,040,000	\$864,000
Inventory	\$4,203,000	\$890,000
Prepaid expenses, etc.	\$82,000	\$12,000
Current Assets	\$5,491,000	\$4,202,000
Other Assets	\$45,000	\$62,000
Net Plant and Equipment	\$1,383,000	\$862,000
Total Assets	\$6,919,000	\$5,126,000
Notes Payable	\$1,230,000	
Other Liability	\$1,088,000	\$274,000
Total Liabilities	\$2,318,000	\$274,000
Net worth		
60,146 shs. 11/30/61		
62,146 shs. 7/31/63	\$4,601,000	\$4,852,000
Total liabilities and net worth	\$6,919,000	\$5,126,000

Source: Buffett Partnership Letter Dated: 18 January 1964

Harry:

(1) Took the inventory from over \$4 million (much of it slow moving) to under \$1 million reducing carrying costs and obsolescence risks tremendously;

(2) Correspondingly freed up capital for marketable security purchases from which we gained over \$400,000

(3) Cut administration and selling expense from \$150,000 to \$75,000 per month;

(4) Cut factory overhead burden from \$6 to \$4.50 per direct labor hour;

(5) Closed the five branches operating unprofitably (leaving us with three good ones) and replaced them with more productive distributors;

(6) Cleaned up a headache at an auxiliary factory operation at Columbus, Nebraska;

(7) Eliminated jobbed lines tying up considerable money (which could be used profitably in securities) while producing no profits;

(8) Adjusted prices of repair parts, thereby producing an estimated \$200,000 additional profit with virtually no loss of volume; and most important;

(9) Through these and many other steps, restored the earning capacity to a level commensurate with the capital employed.

In 1963, the heavy corporate taxes we were facing (Harry surprised me by the speed with which he had earned up our tax loss carry-forward) coupled with excess liquid funds within the corporation compelled us to either in some way de-incorporate or to sell the business.

We set out to do either one or the other before the end of 1963. De-incorporating had many problems but would have, in effect, doubled earnings for our partners and also eliminated the problem of corporate capital gain tax on Dempster securities.

At virtually the last minute, after several earlier deals had fallen through at reasonably advanced stages, a sale of assets was made. Although there were a good many wrinkles to the sale, the net effect was to bring approximately book value. This, coupled with the gain we

have in our *portfolio of marketable securities*, gives us a realization of *about \$80 per share*. Dempster (now named First Beatrice Corp. - we sold the name to the new Co.) is down to almost entirely cash and marketable securities now. On BPL's yearend audit, our First Beatrice holdings were valued at asset value (with securities at market) less a \$200,000 reserve for various contingencies.

I might mention that we think the buyers will do very well with Dempster. They impress us as people of ability and they have sound plans to expand the business and its profitability. We would have been quite happy to operate Dempster on an unincorporated basis, but we are also quite happy to sell it for a reasonable price. *Our business is making excellent purchases -- not making extraordinary sales.*

Harry works the same way I do -- he likes big carrots. He is presently a limited partner of BPL, and the next belt-tightening operation we have, he's our man.

The Dempster saga points up several morals:

(1) Our business is one *requiring patience*. It has little in common with a portfolio of *high-flying glamour stocks* and during periods of popularity for the latter, we may appear quite stodgy.

It is to our advantage to have securities do nothing price wise for months, or perhaps years, why we are buying them. This points up the need to measure our results over an adequate period of time. We suggest three years as a minimum.

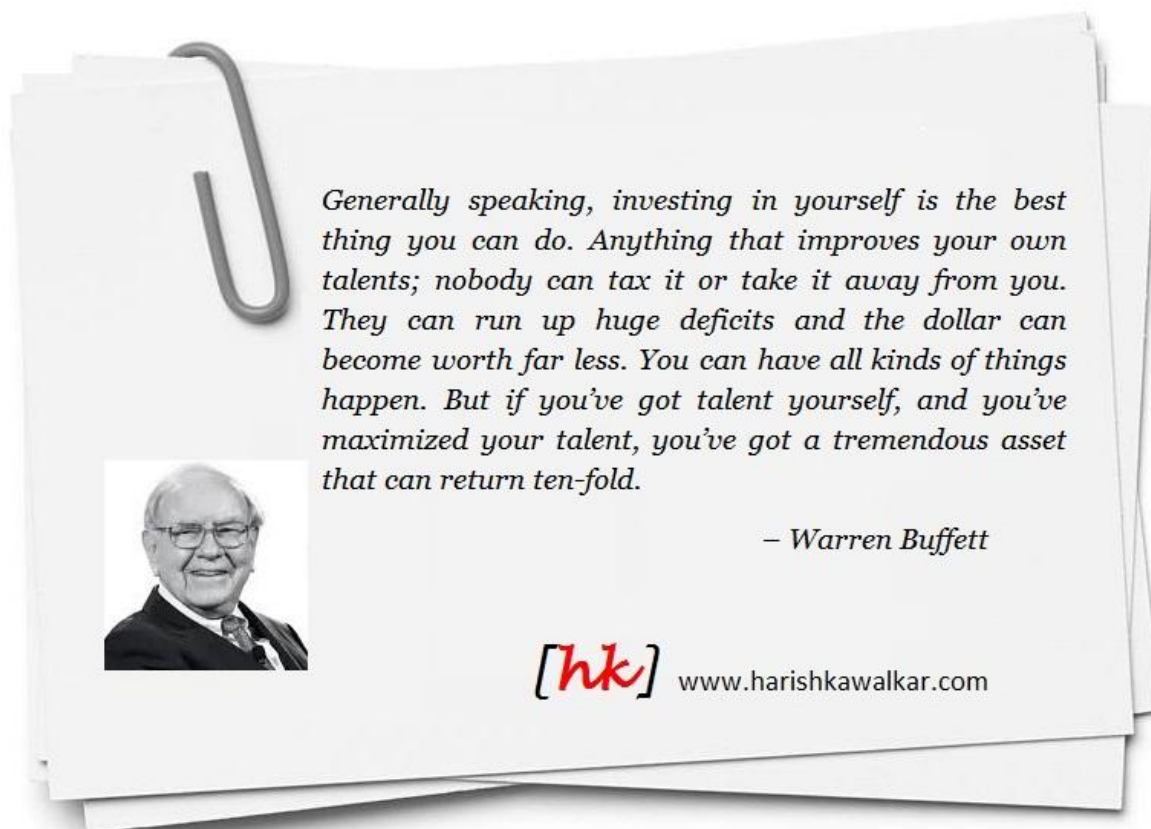
(2) We cannot talk about our current investment operations. Such an *open-mouth policy could never improve our results and in some situations could seriously hurt us*. For this reason, should anyone, including partners, ask us whether we are interested in any security, we must plead the "5th Amendment."

What you learn from Dempster Mill?

Please write back to me... on harish.kawalkar@gmail.com

Acknowledgement

I write on my blog regularly, few advices are close to my heart.. Warren Buffett Famously Says....



The main aim is to maximize the knowledge, few years back when I start reading, I am enjoying it, but after few days I start to forget or lose interest in it, so I start taking notes, on letter pad, the journey start, one of my friend suggest me, why not you start blogging it? It can help others; I take time on this idea, finally the blog start after few months of discussion.

As Charlie Munger said

"I constantly see people rise in life, who are not the smartest, sometimes not even the most diligent, but they are learning machines. They go to bed every night a little wiser than they were when they got up and boy does that help, particularly when you have a long road ahead of you."

- Charlie Munger



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Who's my most valuable client?

Few years back I was reading **"The Snowball Warren Buffett and the Business of Life"** where I strike the question, Who is my most valuable client?

"Charlie, as a very young lawyer, was probably getting \$20 an hour. He thought to himself, 'Who's my most valuable client?' And he decided it was himself. So he decided to sell himself an hour each day. He did it early in the morning, working on these construction projects and real estate deals. Everybody should do this, be the client, and then work for other people, too, and sell yourself an hour a day."

- Source (Snowball)



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The biggest inspiration behind my personal Investment Education and I own lot to Warren Buffett, Charlie Munger, Sanjay Bakshi & Mohnish Pabrai

Bibliography

1) Buffett Partnership Letters

About The Author

Thanks for reading this Case Study

My Name is Harish Kawalkar, living in Pune, India, I am a general guy, not clever, smart or genius, whatever I do on the blog, is what I think is important and useful.

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