CIBC Wood Gundy

Revisiting Warren Buffet's Investment in Coca-Cola

In 1988 and 1989, Warren Buffett invested over US$1 billion of Berkshire Hathaway Inc.'s funds in shares of Coca-Cola Co. (NYSE:KO). Today, Warren Buffett is recognized as one of the greatest investors of all time. We thought it would be interesting to review the facts relating to this investment, as it has been one of the most significant decisions of his investing career. Warren Buffett's investment style is often characterized as purchasing companies that appear extremely cheap based on valuation ratios, but this is an oversimplification. According to Robert Hagstrom's 2005 book *The Warren Buffett Way*, Buffett paid an average of fifteen times earnings, twelve times cash flow, and five times book value for the shares of Coca-Cola.

In the five years before Buffett started buying, the share price had increased an average of 18 per cent per year. Contrary to his popular reputation, Buffett was unable to purchase any Coca- Cola shares at distressed prices. Yet he purchased so many Coca- Cola shares that they became 35 per cent of Berkshire's common stock portfolio and amounted to 6.3 per cent of Coca-Cola's outstanding common shares. So, why did Buffett see value in Coca-Cola shares? There were three key reasons. First, Coca-Cola was a durable, high-quality business with an extremely strong brand and competitive position. Second, he had confidence in the ability of the company's management to improve the business and behave in a shareholder-friendly manner. Management at the time was refocusing on profitability and selling off underperforming business segments. Management was also repurchasing shares and increasing the dividend annually. Third, he correctly perceived that the company still had massive international growth opportunities ahead of it. While the company already had a global distribution network at the time, there were many populous emerging markets that were not yet saturated with the company's products.

These reasons come through in Buffett's comments on Coca-Cola in Berkshire Hathaway Inc.'s 1989 Chairman's letter to shareholders: "After drifting somewhat in the 1970s, Coca-Cola had in 1981 become a new company with the move of Roberto Goizueta to CEO. Roberto, along with Don Keough, first rethought and focused the company's policies and then energetically carried them out. What was already the world's most ubiquitous product gained new momentum, with sales overseas virtually exploding." Buffett's analysis was correct. By the end of 1989, the Coca-Cola shares purchased for just over US$1 billion had a market value of US$1.8 billion. On December 31, 2000, Berkshire's Coca-Cola shares were valued at US$12.2 billion, and on December 31, 2012, they were worth US$14.5 billion. The vast majority of those shares had been purchased back in 1988 and 1989, as Berkshire's year-end 2012 cost of those shares is stated as only US$1.3 billion.

Although the rate of Coca-Cola's share price appreciation has slowed in recent years, the shares have paid a significant dividend for the entire period of ownership. Also, Buffett's decision to hold the shares indefinitely has been very tax-efficient for Berkshire, as large capital gains taxes would have been payable upon any sale. All value-oriented investors can learn from Warren Buffett's Coca-Cola purchase. If we only look for statistically cheap stocks, we will miss some of the best investment opportunities. It is essential to understand companies' competitive positions and future business prospects and to take note of shareholder-friendly actions by management.

Michael H.F. Armstrong *BA, CIM, FCSI*
Portfolio Manager

Andrey Schmidt *BA, LLB*
Investment Advisor

This article was first published in Sounding Board, the official monthly publication of The Vancouver Board of Trade.