

CASE STUDY

Is Coca-Cola the "Perfect" Business?

What does a perfect business look like? For Warren Buffett and his partner Charlie Munger, vice-chairman of Berkshire Hathaway, Inc., it looks a lot like Coca-Cola. To see why, imagine going back in time to 1885, to Atlanta, Georgia, and trying to invent from scratch a nonalcoholic beverage that would make you, your family, and all of your friends rich.

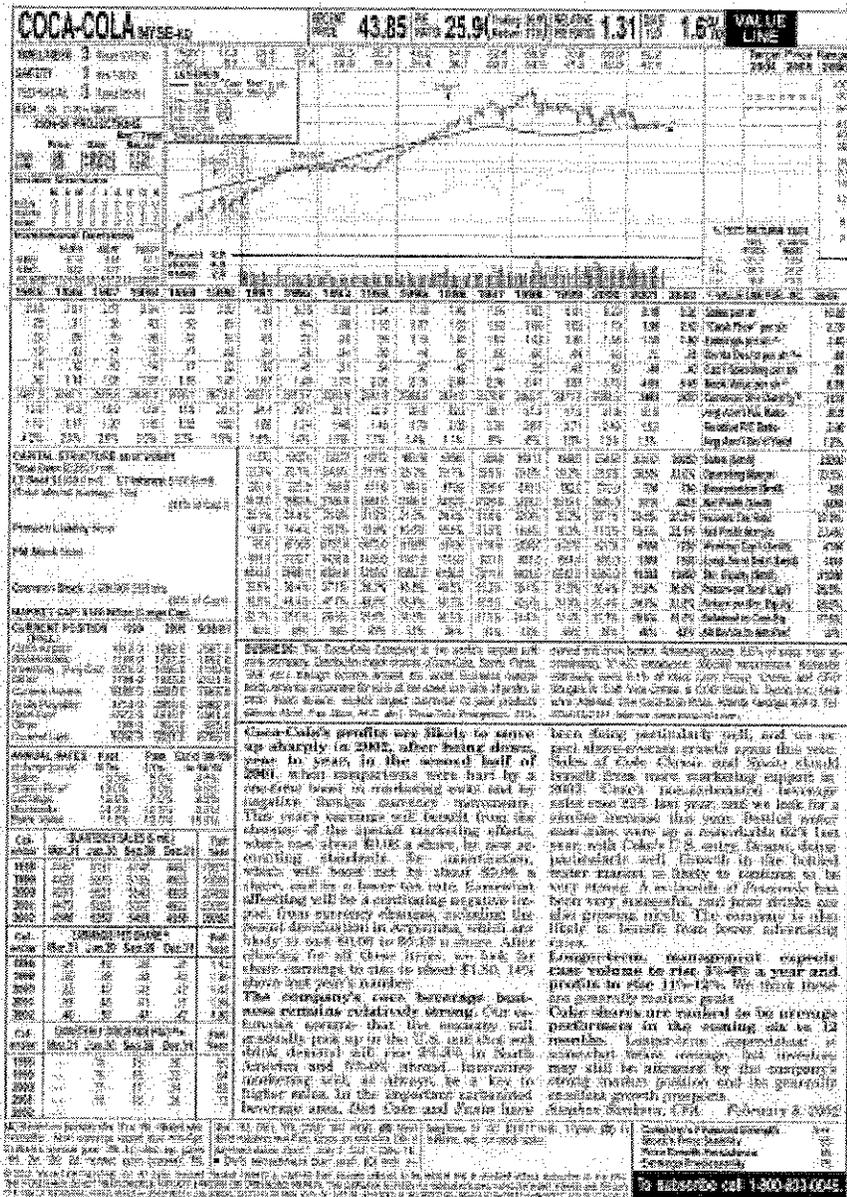
Your beverage would be nonalcoholic to ensure widespread appeal among both young and old alike. It would be cold rather than hot so as to provide relief from climatic effects. It must be ordered by name—a trademarked name. Nobody gets rich selling easy-to-imitate generic products. It must generate a lot of repeat business through what psychologists call conditioned reflexes. To get the desired positive conditioned reflex, you will want to make it sweet, rather than bitter, with no after-taste. Without any after-taste, consumers will be able to drink as much of your product as they like. By adding sugar to make your beverage sweet, it gains food value in addition to a positive stimulant. To get extra-powerful combinatorial effects, you may want to add caffeine as an additional stimulant. Both sugar and caffeine work; by combining them, you get more than a double effect—you get what Munger calls a lollapalooza" effect.

Additional combinatorial effects could be realized if you design the product to appear exotic. Coffee is another popular product, so making your beverage dark in color seems like a safe bet. By adding carbonation, a little fizz can be added to your beverage's appearance and its appeal. To keep the lollapalooza effects coming, you will want to advertise. If people associate your beverage with happy times, they will tend to reach for it whenever they are happy, or want to be happy. (Isn't that always, as in "Always Coca-Cola"?) Make it available at sporting events, concerts, the beach, and at theme parks—wherever and whenever people have fun. Enclose your product in bright, upbeat colors that customers tend to associate with festive occasions (another combinatorial effect). Red and white packaging would be a good choice. Also make sure that customers associate your beverage with festive occasions. Well-timed advertising and price promotions can help in this regard—annual price promotions tied to the Fourth of July holiday, for example, would be a good idea.

To ensure enormous profits, profit margins and the rate of return on invested capital must both be high. To ensure a high rate of return on sales, the price charged must be substantially above unit costs. Because consumers tend to be least price sensitive for moderately priced items, you would like to have a modest "price point," say roughly \$1–\$2 per serving. This is a big problem for most beverages because water is a key ingredient, and water is very expensive to ship long distances. To get around this cost-of-delivery difficulty, you will not want to sell the beverage itself, but a key ingredient, like syrup, to local bottlers.

FIGURE 1.4

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By selling syrup to independent bottlers, your company can also better safeguard its "secret ingredients." This also avoids the problem of having to invest a substantial amount in bottling plants, machinery, delivery trucks, and so on. This minimizes capital requirements and boosts the rate of return on invested capital. Moreover, if you correctly price the key syrup ingredient, you can ensure that the enormous profits generated by carefully developed lollapalooza effects accrue to your company, and not to the bottlers. Of course, you want to offer independent bottlers the potential for highly satisfactory profits in order to provide the necessary incentive for them to push your product.

You not only want to “leave something on the table” for the bottlers in terms of the bottlers’ profit potential, but they in turn must also be encouraged to “leave something on the table” for restaurant and other customers. This means that you must demand that bottlers deliver a consistently high-quality product at carefully specified prices if they are to maintain their valuable franchise to sell your beverage in the local area.

If you had indeed gone back to 1885, to Atlanta, Georgia, and followed all of these suggestions, you would have created what you and I know as The Coca-Cola Company. To be sure, there would have been surprises along the way. Take widespread refrigeration, for example. Early on, Coca-Cola management saw the fountain business as the primary driver in cold carbonated beverage sales. They did not foretell that widespread refrigeration would make grocery store sales and in-home consumption popular. Still, much of Coca-Cola’s success has been achieved because its management had, and still has, a good grasp of both the economics and the psychology of the beverage business. By getting into rapidly growing foreign markets with a winning formula, they hope to create local brand-name recognition, scale economies in distribution, and achieve other “first mover” advantages like the ones they have nurtured in the United States for more than 100 years.

As shown in Figure 1.4, in a world where the typical company earns 10 percent rates of return on invested capital, Coca-Cola earns three and four times as much. Typical profit rates, let alone operating losses, are unheard of at Coca-Cola. It enjoys large and growing profits, and requires practically no tangible capital investment. Almost its entire value is derived from brand equity derived from generations of advertising and carefully nurtured positive lollapalooza effects. On an overall basis, it is easy to see why Buffett and Munger regard Coca-Cola as a “perfect” business.

- A. One of the most important skills to learn in managerial economics is the ability to identify a good business. Discuss at least four characteristics of a good business.
- B. Identify and talk about at least four companies that you regard as having the characteristics listed here.