Philadelphia & Reading

A Case Study in Capital Allocation

GRAHAM-NEWMAN CORPORATION

NEW YORK

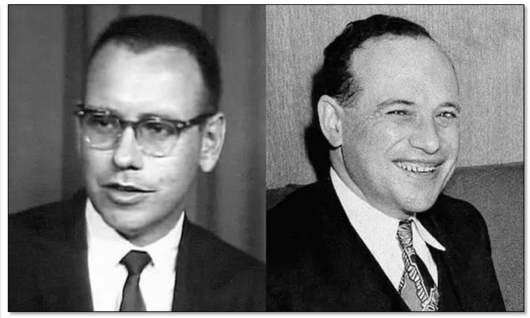
INVESTMENTS IN SECURITIES

JANUARY 31, 1955

OTHER SECURITIES-COMMON STOCKS (Continued)

Industrials (continued)

No. of shares		MARKET VALUE JAN. 31,1955
	Forward	$1,463,367
1,300	Greif Bros. Cooperage Class A	32,988
1,400	Gruen Watch Company	20,650
500	Hart, Schaffner & Marx	16,062
900	Hercules Motors Corporation	17,325
1,000	International Packers Ltd.	15,875
100	Jenkins Brothers (Non-voting)	3,450
1,800	Kalamazoo Stove & Furnace Co.	4,050
300	I. B. Kleinert Rubber Company	6,262
200	Mandel Bros., Inc.	1,375
25	Marshall-Wells Company	6,975
900	Miami Copper Co.	35,550
220	Millers Falls Co.	5,995
2,200	Monterey Oil Company	76,175
1,900	Mohawk Rubber Co.	27,787
2,000	Moore Handley Hardware Co.	13,750
600	Motor Products Corp.	13,050
4,368	Nathan Straus-Duparquet, Inc.	25,662
1,300	National Department Stores Corporation	24,050
2,300	New York Merchandise Co., Inc.	24,150
40,000	Philadelphia & Reading Coal & Iron Co.	550,000
2,500	Pressed Metals Co.of America,Inc.	33,750
5,075	Publicker Industries, Inc.	58,362
7,600	Reo Holding Corp.	213,750
1,500	Rockwood & Co.	137,250
800	Reliable Stores Corporation	23,500
2,500	Reliance Manufacturing Co.	34,375
500	Sargent & Co.	7,125
800	Schenley Industries, Inc.	19,800
220	Shuron Optical Company, Inc.	8,855
100	Singer Manufacturing Co.	4,100
1,000	Spiegel, Inc.	11,625
945	Timely Clothes, Inc.	16,065
1,450	Todd Shipyards Corporation	89,900
1,350	Tyer Rubber Company	17,212
500	Willys Overland Motors, Inc. (stubs)	1,665
		$3,061,882



P&R

PHILADELPHIA AND READING CORPORATION

A Case Study in Capital Allocation: Philadelphia & Reading

In 1955, Ben Graham took control of P&R. Over the next 12 years, Graham transformed P&R from a failing coal mine into a high-return holding company.

Here's why P&R was Buffett's:
- Largest investment
- Berkshire template

BUSINESS & PRODUCTS

This is one of the leading producers of anthracite coal. The total production from the company's owned lands, controlled lands and other lands, and by tenants, in 1949 amounted to about 20% (1948, 21%) of the total of the industry. Anthracite coal is used chiefly for domestic heating purposes, particularly in the northeastern section of the country. Also produces briquets.

In addition to marketing its own product, company purchases and markets anthracite and bituminous coal and other solid fuels produced by others. Company leases certain of its lands to other producers, and leases from others lands from which it and lessees produce anthracite coal.

Company's principal markets for anthracite are the New England and Middle Atlantic States and Eastern Canada. Secondary market includes Middle Western States.

Anthracite Production (net tons):

	Company	[1]Others	Total
1954	3,742,039	1,138,653	4,880,692
1953	4,008,765	2,208,829	6,217,594
1952	5,182,566	2,704,439	7,887,005
1951	5,005,064	3,946,026	8,951,090
1950	4,933,930	3,659,383	8,593,313
1949	4,915,541	3,133,753	8,049,294
1948	6,639,923	4,787,942	11,427,865
1947	7,078,698	4,108,001	11,186,699
1946	7,169,884	4,687,861	11,857,745

HISTORY

Incorporated in Pennsylvania on Jan. 1, 1945, as consolidation of predecessor of same name and its wholly-owned subsidiary, Reading Iron Co. Predecessor was incorporated in Pennsylvania in May, 1871, as Laurel Run Improvement Co.; name changed in Dec., 1871. On Feb. 26, 1937, predecessor filed petition in U. S. District Court for Eastern District of Pennsylvania for reorganization under section 77B of Bankruptcy Act. On June 2, 1942, court approved a reorganization plan, and on July 10, 1944, after various amendments, confirmed plan as amended (for details see

P. & R. was being run, as Hyland described it later, "as a fine old nonprofit institution like the Girard School" by a board dominated by Philadelphia Main Liners. Nevertheless, the fine old nonprofit institution had done pretty well from 1946 on, thanks to World War II, which had artificially inflated the demand for anthracite, delayed the conversion of heating facilities to gas and oil, and created a profitable foreign market.

P&R was "a leading producer of anthracite coal." Anthracite was a dying market that had been "artificially inflated" by a postwar boom. And the boom allowed P&R to do "pretty well from 1946 on" despite management that ran the company "like a fine old nonprofit."

Enter Ben Graham

PHILADELPHIA & READING, INC.

(in thousands except per share amounts)

	Year ended December 31,				
	1952	1951	1950	1949	1948
Net sales	67,696	73,379	69,721	65,748	87,764
year-over-year	*-8%*	*5%*	*6%*	*-25%*	*13%*
Gross profit	4,462	2,738	4,446	3,812	6,106
gross margin	*7%*	*4%*	*6%*	*6%*	*7%*
Operating profit	1,530	81	2,017	1,323	3,646
operating margin	*2%*	*0%*	*3%*	*2%*	*4%*
Net profit	2,854	6,046	4,800	3,682	5,985
Shares outstanding	1,409	1,428	1,428	1,428	1,428
Net profit per share	2.03	4.23	3.36	2.58	4.19
Return on beginning shareholders' equity	6%	14%	11%	9%	15%
Cash & investments	4,154	6,854	6,143	5,172	5,341
Receivables	8,819	7,421	5,677	4,913	5,832
Inventories	8,427	6,751	6,547	6,743	8,030
Prepaid	665	398	472	548	396
Current assets	22,066	21,423	18,839	17,376	19,599
Property, plant & equipment, net	29,855	29,472	32,334	31,553	30,093
Goodwill & other	1,685	1,542	1,510	1,730	2,789
Total assets	53,605	52,436	52,683	50,659	52,481
Payables	4,240	4,060	3,449	2,914	3,639
Accrued & other	1,951	1,395	3,349	2,740	4,911
Current liabilities	6,191	5,455	6,798	5,654	8,550
Deferred taxes & other	1,460	861	824	1,261	1,137
Debt, including short-term	1,050	1,850	2,424	3,194	3,425
Equity	44,904	44,271	42,638	40,551	39,369
Total liabilities & equity	53,605	52,436	52,683	50,659	52,481
Net current asset value per share	10.52	9.89	6.73	5.97	5.34
Shareholders' equity per share	31.87	31.00	29.86	28.21	27.33
Share price — high	20.50	17.50	16.38	19.88	21.38
Share price — low	15.63	13.00	11.63	11.13	14.00

"I kept saying to myself that a man is a fool to buy anything but P. & R. —it was *my* kind of conservative, foolproof, blue chip: a profitless company in a failing industry with no growth in sight.

foreign market. And it was tailored to Graham's specifications for an attractive investment. The book value of the stock in 1952 was $31.87 and the stock was selling in the $15-to-$20 range. There was plenty of elbowroom for smart management to make immediate improvements in operating efficiency. The company was carrying enormous inventories of coal on the ground (about $5 million worth), which could be reduced forthwith. Most important, P. & R. was slowly liquidating itself and was increasingly overcapitalized. Through depreciation and depletion, the property account was being converted into current assets, and the company had almost no long-term debt.

Why'd Graham like P&R?

Three reasons: "room for smart management to make improvements"; an "overcapitalized" balance sheet and "enormous" inventories; and an $18 stock vs $2 of EPS and $32 of equity.

"It was tailored to Ben Graham's specifications as an attractive investment."

GRAHAM-NEWMAN CORPORATION

NEW YORK

INVESTMENTS IN SECURITIES

JANUARY 31, 1953

No. of Shares		MARKET VALUE JAN. 31, 1953
	OTHER SECURITIES-COMMON STOCKS (Continued)	
	Industrials (continued)	
	Forward	$3,482,125
4,500	De Vilbiss Company	84,938
600	Diamond T Motor Car Co.	7,950
1,000	Dictograph Products Co., Inc.	5,625
2,500	Easy Washing Machine Corporation-Class B	40,312
45,950	Flagg Utica Corp. (x)	218,262
1,500	General Cigar Co.	28,500
240	Gisholt Machine Company	3,810
500	Grief Brothers Cooperage Corp. Series "A"	8,187
500	Hart Schaffner & Marx	11,562
400	Hercules Motors Corporation	7,400
300	Howe Scale Company	1,762
600	Jenkins Brothers (Non-Voting)	13,425
900	Jones & Lamson Machine Co.	34,088
1,500	Kalamazoo Stove & Furnace Company	12,000
300	I. B. Kleinert Rubber Company	4,875
2,400	Lamson Corporation	20,400
1,000	Lit Brothers	16,500
1,500	Mandel Bros., Inc.	9,562
1,400	Manhattan Shirt Company	32,200
25	Marshall-Wells Company	7,350
400	Miami Copper Co.	10,650
2,300	Monterey Oil Company	402,500*
1,400	Namm's-Loeser's, Inc.	5,600
4,000	Nathan Straus-Duparquet, Inc.	25,000
2,300	National Department Stores Corporation	33,062
2,300	New York Merchandise Co., Inc.	19,550
600	New York Shipbuilding Corporation-Participating	11,475
1,000	New York Shipbuilding Corporation-Founders	19,250
600	Pacific Mills	16,050
21,100	Philadelphia & Reading Coal & Iron Co.	377,162
1,400	Real Silk Hosiery Mills, Inc.	19,075
900	Reliable Stores Corporation	26,887
1,000	Rice-Stix, Inc.	26,750
200	Sargent & Company	3,800
220	Shuron Optical Company, Inc.	7,040
945	Timely Clothes, Inc.	12,521
450	Tyer Rubber Company	14,625
1,500	Wealdon Corporation	29,812
500	Youngstown Sheet & Tube Company	22,938
		$5,134,580

liquidating itself and was increasingly overcapitalized. Through depreciation and depletion, the property account was being converted into current assets, and the company had almost no long-term debt.

Graham bought 60,000 shares of P. & R. at $18 for Graham-Newman Corp., one of the partners' highly successful, closely held investment trusts. A number of New York investors had moved in with Graham to pick up another 60,000 shares, and subsequently Graham-Newman bought 40,000 more shares, at lower prices. There was not, however, any group organized behind Graham to stage a raid. And that he had anything so crude in mind as liquidat-

No spot for a mere theoretician

Despite all the hallmarks of a "Graham-Newman situation," a man of lesser faith than Hyland might have been discouraged by what he soon learned about Graham's tribulations inside the company. Whatever Graham intended, it soon became painfully apparent that P. & R.'s foreign business was falling apart with the recovery of the European coal industry, that the brief bulge in domestic demand for anthracite was collapsing, and that anthracite was once again resuming its thirty-year-old downhill slide. P. & R.'s sales slumped from $67,700,000 in 1952 to $57,130,000 in 1953, profits from $2,840,000 after taxes to $100,000. But P. & R.'s management kept on digging and piling up coal, despite declining markets and suicidal price wars.

Graham paid $18 for P&R in 1952. But "whatever Graham intended, it soon became painfully apparent that P&R's foreign business was falling apart, that the brief bulge in domestic demand was collapsing and that anthracite was once again resuming its thirty-year-old downhill slide."

PHILADELPHIA & READING, INC.

(in thousands except per share amounts)

	Year ended December 31,						
	1954	1953	1952	1951	1950	1949	1948
Net sales	46,457	57,134	67,696	73,379	69,721	65,748	87,764
year-over-year	*-19%*	*-16%*	*-8%*	*5%*	*6%*	*-25%*	*13%*
Gross profit	(388)	2,361	4,462	2,738	4,446	3,812	6,106
gross margin	*-1%*	*4%*	*7%*	*4%*	*6%*	*6%*	*7%*
Operating profit	(3,297)	(635)	1,530	81	2,017	1,323	3,646
operating margin	*-7%*	*-1%*	*2%*	*0%*	*3%*	*2%*	*4%*
Net profit	(2,807)	214	2,854	6,046	4,800	3,682	5,985
Shares outstanding	1,409	1,409	1,409	1,428	1,428	1,428	1,428
Net profit per share	(1.99)	0.15	2.03	4.23	3.36	2.58	4.19
Return on beginning shareholders' equity	-8%	0%	6%	14%	11%	9%	15%
Cash & investments	3,343	1,591	4,154	6,854	6,143	5,172	5,341
Receivables	6,535	8,167	8,819	7,421	5,677	4,913	5,832
Inventories	9,402	10,623	8,427	6,751	6,547	6,743	8,030
Prepaid	663	552	665	398	472	548	396
Current assets	19,943	20,933	22,066	21,423	18,839	17,376	19,599
Property, plant & equipment, net	21,644	29,091	29,855	29,472	32,334	31,553	30,093
Goodwill & other	1,241	1,610	1,685	1,542	1,510	1,730	2,789
Total assets	42,828	51,634	53,605	52,436	52,683	50,659	52,481
Payables	3,353	2,980	4,240	4,060	3,449	2,914	3,639
Accrued & other	833	983	1,951	1,395	3,349	2,740	4,911
Current liabilities	4,185	3,963	6,191	5,455	6,798	5,654	8,550
Deferred taxes & other	1,763	1,767	1,460	861	824	1,261	1,137
Debt, including short-term	50	1,750	1,050	1,850	2,424	3,194	3,425
Equity	36,830	44,154	44,904	44,271	42,638	40,551	39,369
Total liabilities & equity	42,828	51,634	53,605	52,436	52,683	50,659	52,481
Net current asset value per share	11.15	10.80	10.52	9.89	6.73	5.97	5.34
Shareholders' equity per share	26.14	31.33	31.87	31.00	29.86	28.21	27.33
Share price — high	14.00	18.75	20.50	17.50	16.38	19.88	21.38
Share price — low	7.50	8.88	15.63	13.00	11.63	11.13	14.00

Hyland now regards as a puritanical antipathy toward investment and speculation. Hyland has often mused since then on the prevalence of this view among intellectuals, and deplores it because, he feels, it makes them mere observers of one of the great currents of modern U.S. life. He himself is now in the current up to his neck.

"A fine old nonprofit institution"

What Hyland mainly observed was that the dead hand of Hyland tradition had led to an unproductive use of capital and was throttling his personal cash flow. He began in 1950 selling off the real estate, and at the same time began studying the writings of Benjamin Graham, the dean of value analysts and then a partner of Jerome Newman. Graham's *The Intelligent Investor*, *Security Analysis*, and other works Hyland came to regard as "among the most intelligent books I have ever read."* Then, in 1951, with about $30,000 capital and with Graham's theories about undervalued stocks very much in mind, he began investing. Tom Hyland had two basic rules: "no diversification, no so-called blue chips."

It was in 1952 that Tom Hyland suddenly became interested in Philadelphia & Reading, largely because he learned that his mentor, Benjamin Graham, had taken a position in the company. Graham and Newman had made fortunes through their shrewd moves in and out of other special situations. In the depression they had liquidated failing New England textile mills at a considerable profit; they had bought American Tube Works and sold it to Phelps Dodge at a nice profit, too. In the postwar years they had bought and sold several properties, including the Atlantic Gulf & West Indies Steamship Lines, which Newman split up and disposed of to various buyers. When Hyland learned that Graham-Newman had moved into the P. & R. situation, he assumed along with the financial world generally that Graham must have some plans for the company, such as liquidating some of its assets.

** Ex-partner Newman says rather tartly, "We had a very good thing in the 1930's, then Ben had to go and write a book about it, and now everybody knows how to do it" (i.e., find undervalued stocks).*

But did Hyland, back on his Maryland farm, find this discouraging? Not at all. Hyland perversely became more interested than ever in P. & R. stock. In his opinion, if it had been undervalued at $18, when Graham took a position, then it was even more of a bargain when it fell to $13 in 1953. Hyland further reasoned that the situation had to get worse, and the worse it got, the more probable it was that *someone*, sometime, would do something. He was also intrigued by P. & R.'s 350 million tons of anthracite waste and figured that someday someone might do something about *that*. Sure enough, early in 1954 the situation did get worse. With sales still dropping and with the company headed into the red, the stock dropped below 10 (it hit a low of 7½), which put the price below the net current assets per share ($11).

"Catastrophic" results pushed the stock down from $18 to $7. The decline, along with the fact that "Graham had made fortunes through shrewd moves in and out of other situations," attracted coattail investors who "followed him into P&R."

One of those investors: Warren Buffett

He paid close attention to what was going on in the back where the partners—Ben, Jerry, and Mickey—worked. Ben Graham was on the board of Philadelphia and Reading Coal & Iron Company, and Graham-Newman controlled the company. Warren had discovered this stock on his own, and by the end of 1954 he had put $35,000 into it. Warren eavesdropped with fascination.[18] Philadelphia and Reading actually wasn't worth much as a business. But it was throwing off extra cash, which it could use to transform itself into a better business by buying another company.

"I was just a peon sitting in the outer office. They bought the Union Underwear Company for Philadelphia and Reading Coal and Iron, creating what became Philadelphia and Reading Corporation.[19] That was the beginning of the company's transformation into something more diversified. I was not in the inner circle, but I was terribly interested, knowing something was going on."

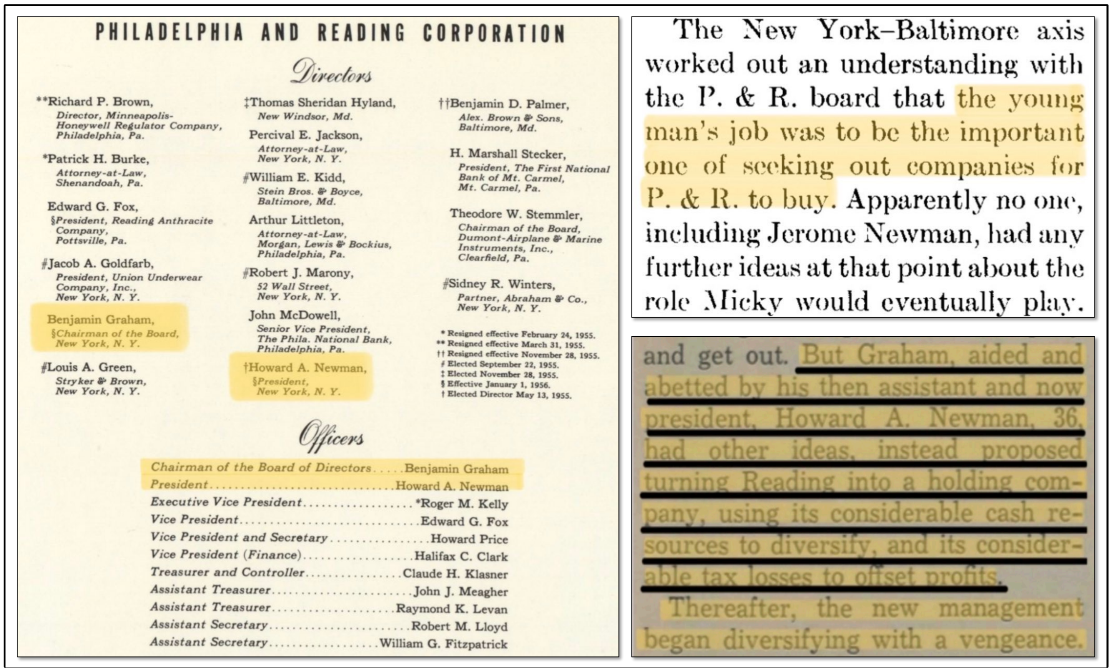
What Warren was learning about by keeping his ears open was the art of capital allocation—placing money where it would earn the highest return. In this case, Graham-Newman was using money from one business to buy a more profitable business. Over time, it could mean the difference between bankruptcy and success.

Transactions like this made Warren feel that he was sitting on the windowsill looking in at high finance as it was taking place. Yet, as he soon found, Graham did not behave like anyone else on

He had never needed motivation to try to work his capital as hard as possible, and now he sat in the office at Buffett-Falk with his feet on his desk, searching systematically through the Graham and Dodd book for more ideas.[8] He found a stock, Philadelphia and Reading Coal & Iron Company. He bought Philadelphia and Reading Coal & Iron shares himself and sold them to his aunt Alice and Chuck Peterson. When the stock immediately dropped to $9 a share, he saw that as a reason to buy even more.

12. In the letter to David Elliott noted above (February 5, 1955), Buffett explains that Rockwood is his second-largest position (after Philadelphia & Reading, which he did not disclose) and writes that Pritzker "has operated quite fast in the past. He bought the Colson Corp. a couple years ago and after selling the bicycle division to Evans Products sold the balance to F. L. Jacobs. He bought Hiller & Hart about a year ago and immediately discontinued the pork-slaughtering business and changed it into a more or less real estate company." Pritzker, he writes, "has about half the stock of Rockwood, which represents about $3 million in cocoa value. I am quite sure he is not happy about sitting with this kind of

Buffett started buying P&R in 1953. He bought more when the stock fell to $9. And "by the end of 1954 he had put $35K into it," making P&R his "largest position" and accounting for more than 35% of his net worth.



PHILADELPHIA AND READING CORPORATION

Directors

**Richard P. Brown,
Director, Minneapolis-Honeywell Regulator Company, Philadelphia, Pa.

*Patrick H. Burke,
Attorney-at-Law, Shenandoah, Pa.

Edward G. Fox,
§*President, Reading Anthracite Company, Pottsville, Pa.*

#Jacob A. Goldfarb,
President, Union Underwear Company, Inc., New York, N. Y.

Benjamin Graham,
§*Chairman of the Board, New York, N. Y.*

#Louis A. Green,
Stryker & Brown, New York, N. Y.

‡Thomas Sheridan Hyland,
New Windsor, Md.

Percival E. Jackson,
Attorney-at-Law, New York, N. Y.

#William E. Kidd,
Stein Bros. & Boyce, Baltimore, Md.

Arthur Littleton,
Attorney-at-Law, Morgan, Lewis & Bockius, Philadelphia, Pa.

#Robert J. Marony,
52 Wall Street, New York, N. Y.

John McDowell,
Senior Vice President, The Phila. National Bank, Philadelphia, Pa.

†Howard A. Newman,
§*President, New York, N. Y.*

††Benjamin D. Palmer,
Alex. Brown & Sons, Baltimore, Md.

H. Marshall Stecker,
President, The First National Bank of Mt. Carmel, Mt. Carmel, Pa.

Theodore W. Stemmler,
Chairman of the Board, Dumont-Airplane & Marine Instruments, Inc., Clearfield, Pa.

#Sidney R. Winters,
Partner, Abraham & Co., New York, N. Y.

* Resigned effective February 24, 1955.
** Resigned effective March 31, 1955.
†† Resigned effective November 28, 1955.
# Elected September 22, 1955.
‡ Elected November 28, 1955.
§ Effective January 1, 1956.
† Elected Director May 13, 1955.

Officers

Chairman of the Board of Directors.....Benjamin Graham
President.....Howard A. Newman
Executive Vice President.....*Roger M. Kelly
Vice President.....Edward G. Fox
Vice President and Secretary.....Howard Price
Vice President (Finance).....Halifax C. Clark
Treasurer and Controller.....Claude H. Klasner
Assistant Treasurer.....John J. Meagher
Assistant Treasurer.....Raymond K. Levan
Assistant Secretary.....Robert M. Lloyd
Assistant Secretary.....William G. Fitzpatrick

The New York–Baltimore axis worked out an understanding with the P. & R. board that the young man's job was to be the important one of seeking out companies for P. & R. to buy. Apparently no one, including Jerome Newman, had any further ideas at that point about the role Micky would eventually play.

and get out. But Graham, aided and abetted by his then assistant and now president, Howard A. Newman, 36, had other ideas, instead proposed turning Reading into a holding company, using its considerable cash resources to diversify, and its considerable tax losses to offset profits.

Thereafter, the new management began diversifying with a vengeance.

Graham took over P&R in May 1955. He "proposed turning it into a holding company, using its considerable cash resources to diversify, and its considerable tax losses to offset profits." And he gave his partner's son Howard Newman the job of finding "companies for P&R to buy."

the President's Letter

During 1955, the year herein reviewed, fundamental policy changes were instituted in order to re-establish Philadelphia and Reading as a profitable business enterprise.

Our heavy losses of the past few years made it obvious to your Board of Directors that the preservation and enhancement of our corporate assets required bold and decisive steps over the next few years. The highlights of these steps during 1955 were:

1. Our corporate charter was amended to permit activities other than coal mining. To reflect our new objectives, our name was changed from The Philadelphia and Reading Coal and Iron Company to Philadelphia and Reading Corporation.

2. We acquired as of August 31 the profitable and well-managed Union Underwear Company, Inc.

3. We planned and prepared for a major internal reorganization to be effective January 1, 1956, in order to (a) more effectively manage our coal business through a wholly owned subsidiary, Reading Anthracite Company, which acts as agent for Philadelphia and Reading Corporation; and (b) to clearly reflect the establishment of Philadelphia and Reading Corporation as a holding and management company. Reading Anthracite Company will manage our coal business and execute our over-all policy with respect to coal operations. In this connection, Mr. Edward G. Fox, formerly President of Philadelphia and Reading, was elected President of Reading Anthracite Company to enable him to devote his full time to the coal business. As of January 1, 1956, Mr. Benjamin Graham was elected Chairman of the Board of Directors, and Mr. Howard A. Newman was elected President and chief executive officer of the Philadelphia and Reading Corporation.

With these major changes in effect, the decks are now cleared for the action necessary to implement our present basic policy, which is:

1. To gradually reduce the amount of our assets committed to the anthracite coal business to a sum appropriately commensurate with reasonably expectable profits.

2. To employ our corporate resources to the greatest extent possible in the further acquisition of profitable business enterprises. These acquisitions will be very carefully chosen to insure insofar as possible (a) a substantial return on our investment; (b) excellent continuing management; (c) stability of earnings.

With respect to UNION UNDERWEAR COMPANY, INC., a few remarks are pertinent here. Union is the Nation's largest producer of men's and boys' underwear. Most of its product is sold under the internationally known "Fruit of the Loom" trade-mark as authorized by license. Mr. Jack Goldfarb, who founded Union Underwear in 1926 and whose ability is respon-

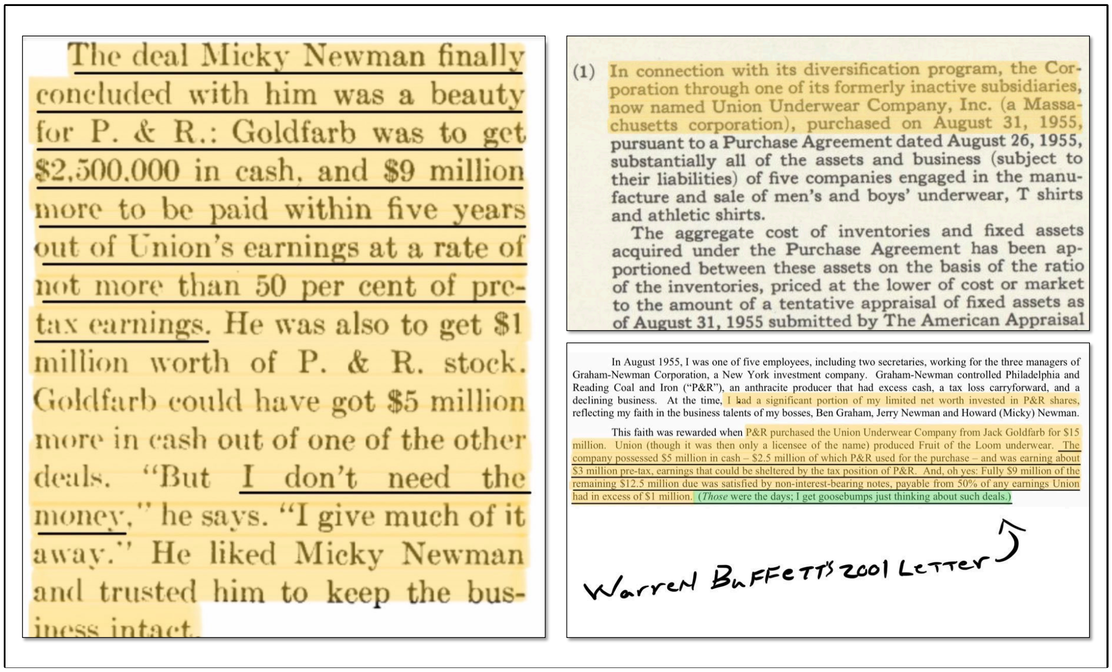
1

Casting about for likely companies that P. & R. might buy, the Newmans remembered a man they had once met, named Jacob A. Goldfarb, president of Union Underwear Co. of New York. Jack Goldfarb's is one of the great suc-

make out. His Union Underwear is actually the biggest maker of men's underwear in the country (volume in 1955 was better than $27 million).

The Newmans looked up Goldfarb. The timing couldn't have been better. Goldfarb, then sixty, was worried that his business might be liquidated if he died. He had talked

Newman approached Jack Goldfarb about selling Union Underwear. The company licensed the Fruit of the Loom brand and was "the biggest maker of men's underwear in the country." "The timing couldn't have been better," and Newman struck a "beauty" of a deal.



The deal Micky Newman finally concluded with him was a beauty for P. & R.: Goldfarb was to get $2,500,000 in cash, and $9 million more to be paid within five years out of Union's earnings at a rate of not more than 50 per cent of pre-tax earnings. He was also to get $1 million worth of P. & R. stock. Goldfarb could have got $5 million more in cash out of one of the other deals. "But I don't need the money," he says. "I give much of it away." He liked Micky Newman and trusted him to keep the business intact.

(1) In connection with its diversification program, the Corporation through one of its formerly inactive subsidiaries, now named Union Underwear Company, Inc. (a Massachusetts corporation), purchased on August 31, 1955, pursuant to a Purchase Agreement dated August 26, 1955, substantially all of the assets and business (subject to their liabilities) of five companies engaged in the manufacture and sale of men's and boys' underwear, T shirts and athletic shirts.
The aggregate cost of inventories and fixed assets acquired under the Purchase Agreement has been apportioned between these assets on the basis of the ratio of the inventories, priced at the lower of cost or market to the amount of a tentative appraisal of fixed assets as of August 31, 1955 submitted by The American Appraisal

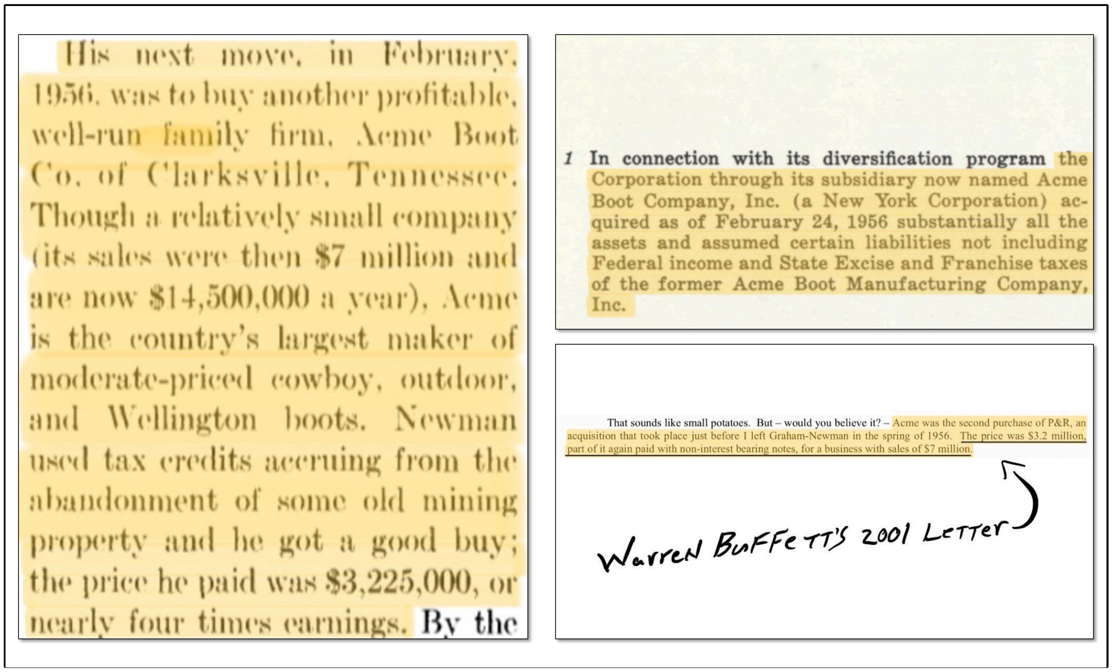
In August 1955, I was one of five employees, including two secretaries, working for the three managers of Graham-Newman Corporation, a New York investment company. Graham-Newman controlled Philadelphia and Reading Coal and Iron ("P&R"), an anthracite producer that had excess cash, a tax loss carryforward, and a declining business. At the time, I had a significant portion of my limited net worth invested in P&R shares, reflecting my faith in the business talents of my bosses, Ben Graham, Jerry Newman and Howard (Micky) Newman.

This faith was rewarded when P&R purchased the Union Underwear Company from Jack Goldfarb for $15 million. Union (though it was then only a licensee of the name) produced Fruit of the Loom underwear. The company possessed $5 million in cash – $2.5 million of which P&R used for the purchase – and was earning about $3 million pre-tax, earnings that could be sheltered by the tax position of P&R. And, oh yes: Fully $9 million of the remaining $12.5 million due was satisfied by non-interest-bearing notes, payable from 50% of any earnings Union had in excess of $1 million. (*Those* were the days; I get goosebumps just thinking about such deals.)

Just how beautiful?

P&R paid $12.5M (net) for $3.0M of pre-tax earnings. And they financed $9.0M of the $12.5M with a non-interest-bearing seller note "payable from 50% of any Union earnings in excess of $1M."

The deal was so good it gave Warren "goosebumps."



His next move, in February, 1956, was to buy another profitable, well-run family firm, Acme Boot Co. of Clarksville, Tennessee. Though a relatively small company (its sales were then \$7 million and are now \$14,500,000 a year), Acme is the country's largest maker of moderate-priced cowboy, outdoor, and Wellington boots. Newman used tax credits accruing from the abandonment of some old mining property and he got a good buy; the price he paid was \$3,225,000, or nearly four times earnings. By the

1 **In connection with its diversification program** the Corporation through its subsidiary now named Acme Boot Company, Inc. (a New York Corporation) acquired as of February 24, 1956 substantially all the assets and assumed certain liabilities not including Federal income and State Excise and Franchise taxes of the former Acme Boot Manufacturing Company, Inc.

That sounds like small potatoes. But – would you believe it? – Acme was the second purchase of P&R, an acquisition that took place just before I left Graham-Newman in the spring of 1956. The price was \$3.2 million, part of it again paid with non-interest bearing notes, for a business with sales of \$7 million.

Warren Buffett's 2001 Letter

It gets better.

A month after the Union deal closed, P&R bought Acme Boot, "the country's largest maker of moderate-priced cowboy, outdoor and Wellington boots." They paid four times earnings and financed 50% of the purchase price with a non-interest-bearing seller note.

PHILADELPHIA & READING, INC.

(in thousands except per share amounts)

	Year ended December 31,										
	1958	1957	1956	1955	1954	1953	1952	1951	1950	1949	1948
	(Warren Buffett's largest holding as of February 1955; Graham-Newman gained control in May 1955)										
Net sales	76,279	80,446	79,154	47,677	46,457	57,134	67,696	73,379	69,721	65,748	87,764
year-over-year	*-5%*	*2%*	*66%*	*3%*	*-19%*	*-16%*	*-8%*	*5%*	*6%*	*-25%*	*13%*
Gross profit	16,809	18,141	14,900	1,975	(388)	2,361	4,462	2,738	4,446	3,812	6,106
gross margin	*22%*	*23%*	*19%*	*4%*	*-1%*	*4%*	*7%*	*4%*	*6%*	*6%*	*7%*
Operating profit	9,432	10,771	8,069	(1,882)	(3,297)	(635)	1,530	81	2,017	1,323	3,646
operating margin	*12%*	*13%*	*10%*	*-4%*	*-7%*	*-1%*	*2%*	*0%*	*3%*	*2%*	*4%*
Net profit	7,256	6,625	4,761	(1,387)	(2,807)	214	2,854	6,046	4,800	3,682	5,985
Shares outstanding	1,173	1,161	1,226	1,364	1,409	1,409	1,409	1,428	1,428	1,428	1,428
Net profit per share	6.19	5.71	3.88	(1.02)	(1.99)	0.15	2.03	4.23	3.36	2.58	4.19
Return on beginning shareholders' equity	17%	17%	14%	-4%	-8%	0%	6%	14%	11%	9%	15%
Mining	31,279	37,320	41,779	38,199	46,457	57,133	67,696	73,380	69,720	65,748	87,765
Manufacturing	45,000	43,125	37,375	9,477	-	-	-	-	-	-	-
Net sales	76,279	80,445	79,154	47,676	46,457	57,133	67,696	73,380	69,720	65,748	87,765
Royalty & other	2,896	1,817	1,675	619	547	923	1,546	6,283	5,151	4,209	6,072
Revenues	79,175	82,262	80,829	48,295	47,004	58,056	69,242	79,663	74,871	69,957	93,837
Mining	3,831	3,475	2,311	(1,388)	(2,807)	214	2,854	6,046	4,800	3,682	5,985
Manufacturing	3,425	3,150	2,450	1	-	-	-	-	-	-	-
Net profit	7,256	6,625	4,761	(1,387)	(2,807)	214	2,854	6,046	4,800	3,682	5,985
Other gains (losses), net of taxes	-	-	3,887	(1,728)	(4,517)	(113)	(17)	(1,700)	-	-	-
Total net profit	7,256	6,625	8,648	(3,115)	(7,324)	101	2,837	4,346	4,800	3,682	5,985
Shareholders' equity	49,305	43,696	38,898	33,066	36,830	44,154	44,904	44,271	42,638	40,551	39,369
shareholders' equity per share	*42.05*	*37.64*	*31.74*	*24.25*	*26.14*	*31.33*	*31.87*	*31.00*	*29.86*	*28.21*	*27.33*
Share price — high	72.00	31.50	29.38	19.00	14.00	18.75	20.50	17.50	16.38	19.88	21.38
Share price — low	27.13	21.25	17.00	12.25	7.50	8.88	15.63	13.00	11.63	11.13	14.00
Dividends per share	1.60	-	-	-	-	0.60	1.40	1.90	1.90	2.50	2.00
payout ratio	*26%*	*0%*	*0%*	*0%*	*0%*	*396%*	*69%*	*45%*	*57%*	*97%*	*48%*

Wall Street has watched, almost with an air of unbelief, the market performance of the Philadelphia & Reading Corp. Some of the facts pertinent to the rise in its stock have been well publicized—such as the fact that this dilapidated old miner of hard coal lost $3 million in 1955 on $48 million in sales, and last year, on $76 million worth of business, made an after-tax profit of $7 million. This year P. & R. has been doing business at a rate that will push sales to about $130 million.

nearly four times earnings. By the end of 1956, thanks to the Acme and Union purchases, sales had bounced up to $79 million, and P. & R. was back in the black with $8,650,000 post-tax profits (because of tax-loss carry-forwards that year, the company paid less than $1 million in income taxes).

"Wall Street watched with an air of unbelief."

Over the next three years, Graham and Newman's capital allocation transformed P&R from a "dilapidated old miner" losing $3M a year to a growing holding company with $7M of profits and a 17% return on equity.

The worse the news about Philadelphia & Reading, the more enthusiastic the egghead became about investing in it. "So I bought and bought." Today he has a profit of about 1,200 per cent, and is a power on the board.

million. Its stock, which could have been bought at $7.50 a share only five years ago, would cost you about $50 today —after a two-for-one split. Another well-publicized fact is

Philadelphia & Reading

(Warren Buffett's P&R investment to 1959 hold date)

	CAGR (1959-1954)	Sale (1959)	Purchase (1954)
Shareholders' equity per share	6%	42.05	31.33
Multiple	53%	2.4	0.3
Share price	62%	100.00	9.00
Multiple of invested capital			11.1
Dividends to invested capital			0.2

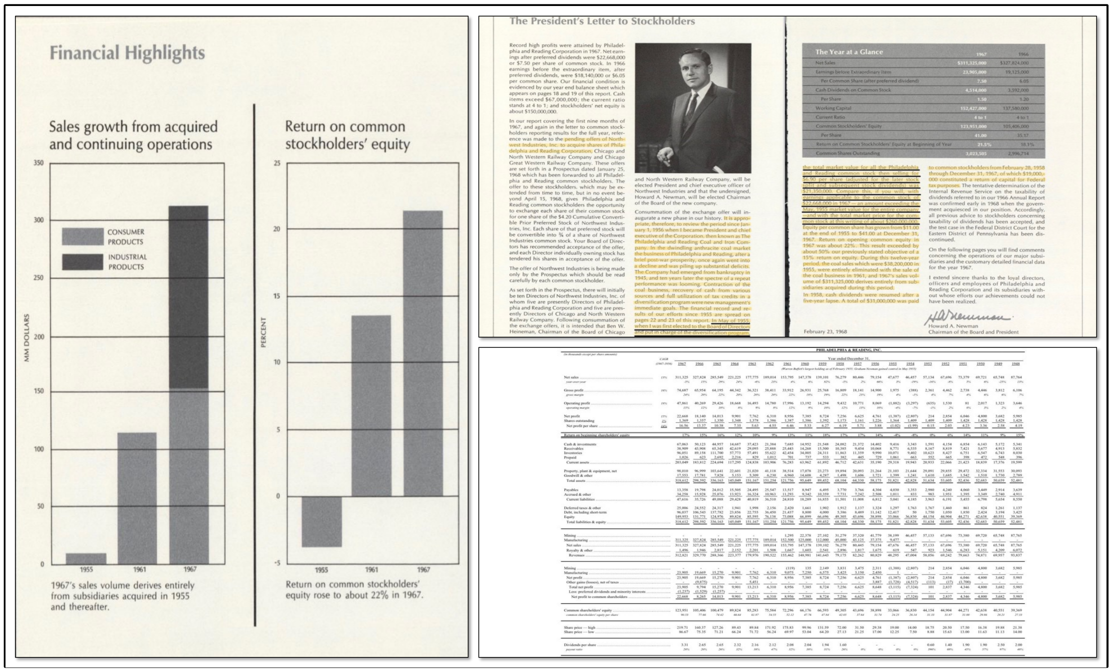
Philadelphia & Reading

(Graham-Newman's P&R investment to 1959 hold date)

	CAGR (1959-1952)	Sale (1959)	Purchase (1952)
Shareholders' equity per share	5%	42.05	31.87
Multiple	27%	2.4	0.6
Share price	33%	100.00	18.00
Multiple of invested capital			5.6
Dividends to invested capital			0.1

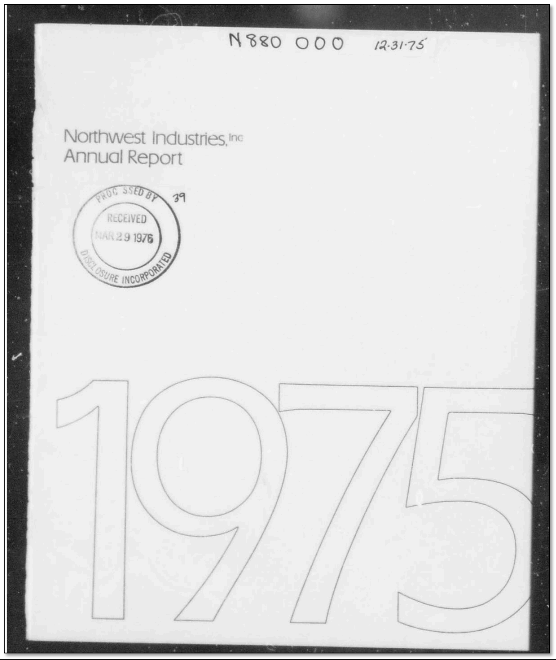
At a $9 purchase price, Buffett paid 2.3X 1956 EPS of $3.88 and just 1.3X the $7.06 EPS after tax carryforwards. EPS grew to $6.19 in 1958 and the multiple expanded to mid-teens. By early 1959, P&R's stock traded above $100 a share.

Buffett's return (est):
- 11.1X MOIC
- 62% IRR



Newman continued to build P&R into a diversified holding company, buying everything from toy makers to steel mills. Then in 1968, Newman and Graham sold P&R to Northwest Industries.

Graham-Newman's return (est):
- 11.8X MOIC
- 18% IRR



The second category involves the managerial superstars — men who can recognize that rare prince who is disguised as a toad, and who have managerial abilities that enable them to peel away the disguise. We salute such managers as Ben Heineman at Northwest Industries, Henry Singleton at Teledyne, Erwin Zaban at National Service Industries, and especially Tom Murphy at Capital Cities Communications (a real managerial "twofer", whose acquisition efforts have been properly focused in Category 1 and whose operating talents also make him a leader of Category 2). From both direct and vicarious experience, we recognize the difficulty and rarity of these executives' achievements. (So do they; these champs have made very few deals in recent years, and often have found repurchase of their own shares to be the most sensible employment of corporate capital.)

Your Chairman, unfortunately, does not qualify for Category 2. And, despite a reasonably good understanding of the economic factors compelling concentration in Category 1, our actual acquisition activity in that category has been sporadic and inadequate. Our preaching was better than our performance. (We neglected the Noah principle: predicting rain doesn't count, building arks does.)

We have tried occasionally to buy toads at bargain prices with results that have been chronicled in past reports. Clearly our kisses fell flat. We have done well with a couple of princes — but they were princes when purchased. At least our kisses didn't turn them into toads. And, finally, we have occasionally been quite successful in purchasing fractional interests in easily-identifiable princes at toad-like prices.

Northwest Industries' 70s game plan

Not everyone loves Ben Heineman but it's hard to dislike the company's record

Ben Heineman's Shrewd Poker Game

Starting with a relatively weak hand, he has already won a sizable pile of chips for his Chicago & North Western Railway. Now, playing his cards shrewdly and carefully, he's after far bigger stakes: the creation of a giant Middle Western railroad system.

Northwest Industries went on to compound in the mid-teens for the next two decades. And Buffett called Northwest's CEO Ben Heineman a "managerial superstar" in his 1981 Berkshire letter.

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N880000

NORTHWEST INDUSTRIES, INC.
6300 Sears Tower
Chicago, Illinois 60606

NOTICE OF SPECIAL MEETING OF STOCKHOLDERS
To Be Held July 26, 1985

To the Stockholders of Northwest Industries, Inc.:

NOTICE IS HEREBY GIVEN that a Special Meeting of Stockholders ("Special Meeting") of Northwest Industries, Inc., a Delaware corporation ("Northwest"), will be held on Friday, July 26, 1985, at 10:00 A.M., local time, in the First Chicago Center, One First National Plaza, Chicago, Illinois, for the following purposes:

(1) To consider and vote upon a proposal to approve and adopt an Acquisition and Merger Agreement, dated as of April 10, 1985 ("Merger Agreement"), among Farley/Northwest Acquisition Corporation, a recently-formed Delaware corporation ("Farley Acquisition"), Farley/Northwest Subsidiary Corporation, a recently-formed Delaware corporation and wholly-owned subsidiary of Farley Acquisition ("Farley Subsidiary"), Farley Metals, Inc., a Delaware corporation which controls Farley Acquisition and Farley Subsidiary ("FMI"), and Northwest, which provides for the merger ("Merger") of Northwest with and into Farley Acquisition; all as more fully described in the attached Proxy Statement/Prospectus. Approval and adoption of the Merger Agreement will constitute the adoption of a plan of complete liquidation of Northwest under Section 337 of the Internal Revenue Code of 1954, as amended. Certain terms of the Merger Agreement are summarized in the attached Proxy Statement/Prospectus and the Merger Agreement is attached as Annex I to the Proxy Statement/Prospectus. The terms of the 13½% Cumulative Exchangeable Preferred Stock to be received in the Merger by Northwest's common stockholders (other than Farley Acquisition) are attached as Annex II to, and are described in, the Proxy Statement/Prospectus. The Proxy Statement/Prospectus and the Annexes thereto are part of this Notice. Information about the common stock of Lone Star Steel Company also to be received in the Merger by such holders is contained in the Prospectus dated June 24, 1985, which accompanies the Proxy Statement/Prospectus.

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(2) To transact such other business as may properly come before the Special Meeting or any adjournments or postponements thereof.

Only holders of record of Northwest Common Stock and of shares of Series D $7.50 Cumulative Preferred Stock at the close of business on May 29, 1985, the record date for the Special Meeting, are entitled to notice of and to vote at the Special Meeting and any adjournments or postponements thereof.

To assure that your interests will be represented, whether or not you plan to attend the Special Meeting in person, please complete, date and sign the enclosed proxy (holders of Northwest Common Stock should complete the *white* proxy card; holders of shares of Series D $7.50 Cumulative Preferred Stock should complete the *blue* proxy card) and return it promptly in the enclosed return envelope, which requires no postage if mailed in the United States.

Holders of Northwest Common Stock who wish to receive cash in the Merger for a portion of their shares must elect the Cash Option Provision of the Merger (as described in the attached Proxy Statement/Prospectus). IF YOU WISH TO TAKE ADVANTAGE OF THE CASH OPTION, YOU MUST COMPLETE THE ENCLOSED FORM OF ELECTION AND RETURN IT IN THE ENCLOSED ENVELOPE TO BANKERS TRUST COMPANY, THE EXCHANGE AGENT FOR THE MERGER, SO THAT IT IS RECEIVED NO LATER THAN 5:00 P.M. (NEW YORK CITY TIME) ON JULY 25, 1985.

By Order of the Board of Directors,

R.J. HILL
Secretary

Chicago, Illinois
June 28, 1985

OCT 9 1985

PLEASE EXECUTE, DATE AND RETURN THE ENCLOSED PROXY PROMPTLY, WHETHER OR NOT YOU INTEND TO BE PRESENT AT THE SPECIAL MEETING.

NEITHER THIS TRANSACTION NOR THESE SECURITIES HAVE BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION. THE COMMISSION HAS NOT PASSED UPON THE FAIRNESS OR MERITS OF THIS TRANSACTION NOR UPON THE ACCURACY OR ADEQUACY OF THE INFORMATION CONTAINED IN THIS PROXY STATEMENT/PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS UNLAWFUL.

Northwest Industries 6.09% Stake Is Bought

The following table shows our 1984 yearend net holdings in marketable equities. All numbers exclude the interests attributable to minority shareholders of Wesco and Nebraska Furniture Mart.

No. of Shares		*Cost*	*Market*
		(000s omitted)	
690,975	Affiliated Publications, Inc.	$ 3,516	$ 32,908
740,400	American Broadcasting Companies, Inc.	44,416	46,738
3,895,710	Exxon Corporation	173,401	175,307
4,047,191	General Foods Corporation	149,870	226,137
6,850,000	GEICO Corporation	45,713	397,300
2,379,200	Handy & Harman	27,318	38,662
818,872	Interpublic Group of Companies, Inc.	2,570	28,149
555,949	Northwest Industries	26,581	27,242
2,553,488	Time, Inc.	89,327	109,162
1,868,600	The Washington Post Company	10,628	149,955
		$573,340	$1,231,560
	All Other Common Stockholdings	11,634	37,326
	Total Common Stocks	$584,974	$1,268,886

In 1985, Ben Heineman sold Northwest Industries to William Farley.
Buffett bought Northwest pre-buyout as an arbitrage.

John Holland was responsible for Fruit's operations in its most bountiful years. In 1996, however, John retired, and management loaded the company with debt, in part to make a series of acquisitions that proved disappointing. Bankruptcy followed. John was then rehired, and he undertook a major reworking of operations. Before John's return, deliveries were chaotic, costs soared and relations with key customers deteriorated. While correcting these problems, John also reduced employment from a bloated 40,000 to 23,000. In short, he's been restoring the old Fruit of the Loom, albeit in a much more competitive environment.

Stepping into Fruit's bankruptcy proceedings, we made a proposal to creditors to which we attached no financing conditions, even though our offer had to remain outstanding for many months. We did, however, insist on a very unusual proviso: John had to be available to continue serving as CEO after we took over. To us, John and the brand are Fruit's key assets.

I was helped in this transaction by my friend and former boss, Micky Newman, now 81. What goes around truly does come around.

FRUIT OF THE LOOM®

Our operating companies made several "bolt-on" acquisitions during the year, and I can't resist telling you about one. In December, Frank Rooney called to tell me H.H. Brown was buying the inventory and trademarks of Acme Boot for $700,000.

That sounds like small potatoes. But – would you believe it? – Acme was the second purchase of P&R, an acquisition that took place just before I left Graham-Newman in the spring of 1956. The price was $3.2 million, part of it again paid with non-interest bearing notes, for a business with sales of $7 million.

After P&R merged with Northwest, Acme grew to be the world's largest bootmaker, delivering annual profits many multiples of what the company had cost P&R. But the business eventually hit the skids and never recovered, and that resulted in our purchasing Acme's remnants.

In the frontispiece to *Security Analysis*, Ben Graham and Dave Dodd quoted Horace: "Many shall be restored that now are fallen and many shall fall that are now in honor." Fifty-two years after I first read those lines, my appreciation for what they say about business and investments continues to grow.

acme

Farley spun out Fruit of the Loom from Northwest in 1987. But leverage, environmental liabilities and mismanagement led to a 1999 Chapter 11 filing. Berkshire bought the assets out of bankruptcy in 2001 for $835M. That same year, Buffett bought Acme Boot for $700K.

Sources

- The Egghead, the Upstart and Old P&R (Carl Rieser)
- The Red and the Black (Forbes)
- The Snowball (Alice Schroeder)
- Berkshire Hathaway Chairman’s Letters (Warren Buffett)

Contact

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