Figure 4.1.

was committing fraud. Allied went bankrupt, and the warehouse, when collecting the collateral, realized that the tanks that it had thought were filled with valuable salad oil were instead filled with seawater. With an estimated liability of up to $150 million, Allied and the American Express subsidiary filed for bankruptcy protection. Whether American Express, the parent company, was liable was uncertain. Nevertheless, fearing damage to American Express's reputation, CEO and President Howard Clark issued a statement that American Express felt morally bound to see that such liabilities were satisfied.[1]

The word on the street was that American Express could face insolvency. Its stock, which had been trading at $60 per share before the news, dropped to $35 per share by early 1964 amid much bad publicity.[2] One comment often made about American Express was that it faced "*unknown and potentially enormous liabilities.*" In addition to the bad publicity, American Express shareholders sued Howard Clark when he offered the creditors $60 million to settle claims, which the shareholders judged to be an unnecessary fulfillment of a moral obligation. In comparison to the book value of American Express at the time, which was $78 million, this seemed like a very large sum.

According to Lowenstein's account, Buffett, sensing potential opportunity beneath the scandal, carefully began his primary research. He spoke to customers and vendors in Omaha, including restaurants and restaurant customers, to see if their using habits had changed. He also went to banks and travel agencies, and he even spoke to competitors. Everywhere he went, the conclusion he drew was that the use of American Express travelers cheques and credit cards seemed to be steady despite the scandal. He surmised that American Express would continue operating as is, that reputational damage was not likely to be permanent, and that the brand seemed very strong and synonymous with the product. He also concluded that the company was unlikely to go insolvent.[3]

It is important to look at how an investor may have pictured American Express at the time. (See tables 4.1 through 4.3 for a reproduction of several key pages of the 1963 American Express annual report, including the consolidated financial statements.[4]) As we can see, in the section titled the *Ten Year Financial Summary,* on pages four and five of the report, American Express publishes a full ten-year history of its income financials. We notice immediately how strong a business American Express was in the decade preceding 1963.

From 1954 to 1963, American Express's revenues grew from $37 million to $100 million. Even more impressive, in no single year during this period did revenues decline from the previous year. The picture for income per share and total book value of the company mirrored that of the revenues; income per share grew from $1.05 to $2.52, and book value increased from $42 million to $79 million. Hence on a per annum (p.a.) compounded basis, revenues increased 12 percent p.a., and net earnings increased 10 percent p.a. in the previous nine years.

During the year ending December 31, 1963, American Express delivered net earnings of exactly $11.2 million ($2.52 per share for each of the 4.46 million shares outstanding) on revenues of $100.4 million. The profit before tax (it reported "income before United States and foreign income taxes") was at $16.0 million. With a simple calculation, this translates to an operating margin of about 16 percent and a net profit margin of about 11 percent, both metrics, suggesting nice profitability.

At first glance, based on just the financial numbers, American Express looked like it was running well on all cylinders and had been doing so for quite some time. To really understand a business, however, and to determine whether it is truly a quality business, one must look at more than just financials. To understand American Express's business and how it delivered such good financial results year after year, it is important to analyze the operating segments of the company and the competitive environment in which these sub-businesses were operating.

In its 1963 annual report, American Express discusses its operating segments in a fair level of detail. In total, the report details ten separate businesses. Unfortunately, American Express at the time did not break down the size and margins of each business areas. Still, from the order and depth of the discussion, one can clearly infer which businesses are the core businesses, and which the secondary businesses. From largest to smallest in scale, the businesses included travelers cheques, money orders, utility bills, travel, credit cards, commercial banking, foreign remittances, freight, Wells Fargo, Hertz, and warehousing.

Before I discuss the workings of the major businesses, it should be noted that with ten separate operating segments, American Express was not a simple business in the traditional sense of one business involved in one clear activity. Nevertheless, if we anlayze each business individually, we can be reassured that an inquisitive investor should understand both businesses because they are based on business models and people rather than complex technology.

The largest business, which is also discussed first in the report, was the travelers cheque business. American Express sold paper checks that customers who are to travel abroad could purchase at numerous locations before departure, and which would subsequently be accepted at both venues and banks abroad. These venues and banks would then exchange these checks for foreign currency. American Express collected cash and a small fee from customers, while in turn providing them with a network of international banks and venues where their finances would be accepted without question. To encourage more international merchants to accept this product, American Express paid a small commission to the merchants for accepting their travelers cheques.

At the time, the main alternative to American Express travelers cheques was a letter of credit from a bank. A customer, the same international traveler for example, would go to a bank and, using a combination of deposits, collateral, or previous relationship, would ask the bank to issue a letter of credit. The customer would then present this letter of credit to a foreign bank, which would either provide the customer with foreign currency or otherwise enable the customer to make payments while abroad.

The travelers cheque has several key advantages over the letter of credit. First, while travelers cheques were very simple to purchase at any American Express affiliate, the process of getting a letter of credit depended on the specific issuing bank and usually involved significant paperwork and took several days. Because it was less complex, American Express's solution usually also entailed fewer transaction costs. Compared to cash, travelers cheques could be easily replaced when stolen and hence offered an additional protection for travelers.