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Building a Circle of Competency - Part II

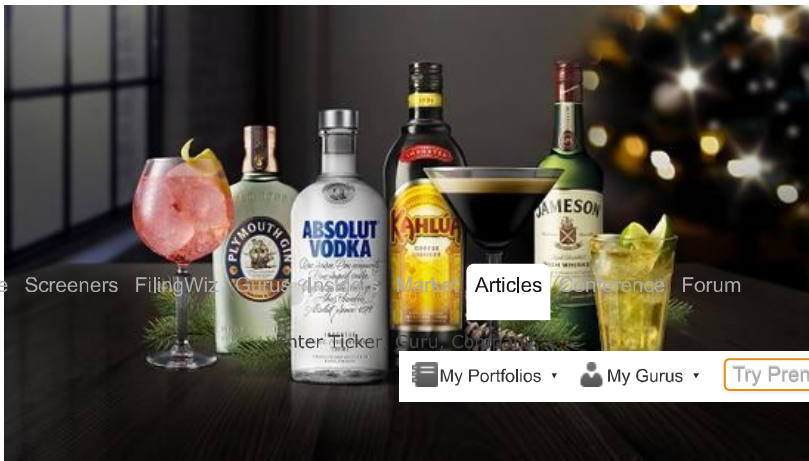
My journey in building a circle of competency in the spirits industry

December 06, 2017 | About: [DEO +0%](#) [BF/B +0%](#) [CPR +0%](#) [PDRDF +0%](#) [RCO +0%](#) [LVMUY +0%](#)

In my [previous article](#), I shared my experiences of struggling to build a circle of competency in the pharmaceutical industry. As a comparison, today I'd like to discuss another circle of competency I have been trying to build – in spirits companies. It has been a very different experience. I hope you'll find the comparison interesting.

I first wrote about two spirits companies on this forum in 2013 and 2014 – Brown Forman ([BF/B](#)) and Kweichow Maotai (SH:600519). When I first researched Brown Forman and Kweichow Maotai, I had a different research process – researching one company at a time. All I did was read the annual reports, some transcripts and some articles. I had tasted both Jack Daniel's and Feitian Maotai so I thought I was familiar with the products of both companies. My analysis was very simple and straightforward. I didn't have any special insights at all.

- [DEO 30-Year Financial Data](#)
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Then a trip during the summer of 2015 changed my view on how to research spirits companies. I had planned to spend a week in the Philadelphia area with a colleague to visit a few companies. We are both admirers of [Tom Russo \(Trades, Portfolio\)](#) and since Tom's office at Gardner Russo & Gardner is not too far away from Philly, we took a shot and reached out to Tom to see if we could visit him while we were in the area. To our great pleasure and surprise, Tom agreed to meet us in his office in Lancaster.

We knew Tom is the expert on spirits companies so we wanted to bring a bottle of liquor. However, neither of us really knew much about different types of spirits. We went to a liquor store and picked up a bottle of Tito's Vodka. When Tom greeted us, we presented him with the bottle. Amazingly, Tom immediately told us the story of the guy who founded Tito's. Tom also shared with us his experiences meeting with the management team of Kweichow Maotai and a few other spirits companies. We were blown away by his in-depth knowledge of many spirits and liquor brands all around the world.

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Symbol	Company	Current Price	Change (%)
CP	Canadian Pacific Railway Ltd	\$ 174.84	-4.69 (-2.61%)
		\$ 46.67	-1.09 (-2.28%)
		\$ 54.66	-1.16 (-2.08%)
UNP	Union Pacific Corp	\$ 137.53	-1.43 (-1.03%)
DAL	Delta Air Lines Inc	\$ 54.76	-0.45 (-0.82%)
NSC	Norfolk Southern Corp	\$ 138.05	-0.57 (-0.41%)
UAL	United Continental Holdings Inc	\$ 70.29	-0.29 (-0.41%)
CSX	CSX Corp	\$ 60.87	-0.14 (-0.23%)
BRK.A	Berkshire Hathaway Inc	\$ 299,740.00	535.00 (0.18%)
BRK.B	Berkshire Hathaway Inc	\$ 199.67	0.16 (0.08%)
Summary			-0.96%

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comfortable with the pharmaceutical companies, I would start building a circle of competency in the spirits industry. Earlier this year, I felt like I had come to a point where I could spend less time on the pharmaceutical industry and start the compounding project on spirits companies. My game plan was to download the annual reports of the past 20 years and sellside reports of all the major global spirits companies. Fortunately there are only a few of them – Brown Forman (BF/B), Campari (CPR), Diageo (NYSE:DEO), Pernod Ricard (PDRDF), Remy Cointreau, (RCO), Beam Suntory and LVMH Moet Hennessy Louis Vuitton (LVMUY). I also downloaded the annual reports of all the major Chinese baijiu companies.

While reading all of the reports, I also watched many YouTube videos – most of them are expert reviews of different spirits. I especially liked the reviews by a German guy who uploaded many videos on Scotch whiskeys. The nosing, the tasting, and the stories of the distilleries, all of them are fascinating. I found a great deal of useful information from the videos.

But watching videos is not enough, I realized I had to visit liquor stores. Therefore, for a few months, I would visit a liquor store every week. Whenever I was in a liquor store, I went through all the brands one by one, observed what people were buying, talked to the owners to understand what they liked, what brands were selling well and what distributors they used. I would also purchase one or two bottles during each visit. Once home, I would nose and taste the spirits while watching the YouTube reviews. This way I could appreciate the brands much better. It's amazing how knowledgeable compounds. A few months ago I couldn't even tell the different types of whiskeys. Now I'm familiar with most of the brands and tasted quite a few them.

Observing what spirits different customer groups purchase is also very interesting. For instance, I've noticed that most women would go straight to the flavored vodka section and grab a bottle very quickly. On the other hand, many men would spend some time in front of the Scotch section before making any decision. These observations helped me understand why Diageo (NYSE:DEO) and Pernod Ricard (PDRDF) have struggled in the U.S vodka market during recent years and why the Irish Whiskey Jameson has been selling so well. It also helped me understand why Brown Forman would purchase Glenfiddich. The great thing about the spirits business is that you can easily access the customers and the liquor store owners. And usually the liquor store owners know a lot about the business and they are passionate about the business. So it's easy to strike up a good conversation.

After just a few months of readings, tastings and observing trips, I've become fascinated by the spirits industry. When I read the annual reports of Diageo (NYSE:DEO) and Brown Forman (BF/B), I have a much better appreciation. Moreover, I'm starting to get a feel of what the economics of these businesses will look like in the next five to 10 years during normal times, good times and bad times. I know I'm not there yet, but I feel more confident that I can build a competency for spirits companies if I spend more time.

Revisiting Li Lu:

Now let us revisit what Li Lu said:

A certain industry might have characteristics that make it different than others. In certain industries you might have better prospects than others. Find the best of the players in the industry and the worst players. And see how they perform over time. And if the worst players perform reasonably well relative to the great players — that tells you something about the characteristics about the industry. That is not always the case but it is often the case. Certain industries are better than others. So if you can understand a business inside out you can then eventually extend that to understanding an industry. If you can get that insight, it is enormously beneficial. If you can then concentrate that on a business with superior economics in an industry with superior economics with good management and you get them at the right price — the chances are that you can stay for a very long time.

There are some industries and companies that are predictable. If you spend enough time doing the research, gaining experiences in the industry, you will find out that you really can tell how the business will behave in the next 10 years during normal times, good times and bad

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DEO Price Chart



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amount of commitment but you may still be much ignorant even if you spend much time for many years.

Conclusion

As you can probably tell by now, businesses in both the spirits industry and the pharmaceutical industry have very attractive economics. However, building a circle of competency in the spirits industry is much easier than building a circle of competency in the pharmaceutical business. My experiences have shown that it doesn't matter which industry you pick. To paraphrase Li Lu, we should let our personal interests define our circle of competence. For me, spirits and pharmaceuticals happen to be two industries that attract my personal interests. For you, it could be insurance companies. It could be industrial companies. Whatever industry you pick, the most important thing is to build a circle, stay in that circle and act decisively when the opportunities present themselves.

About the author:

Grahamites

A global value investor constantly seeking to acquire worldly wisdom. My investment philosophy has been inspired by Warren Buffett, Charlie Munger, Howard Marks, Chuck Akre, Li Lu, Zhang Lei and Peter Lynch.

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DrakeMcHugh - 4 months ago [Report SPAM](#)

Great article. Spirits is arguably the better lon term business in terms of stability of future cash flows. At an existential level: aren't Spirits and Pharmaceuticals pretty much the same? They both change the way people feel...



Grahamites - 4 months ago

DrakeMcHuge - Thanks for the nice words. Great point ,come to think about it, spirits and pharmaceuticals are very similar. They do change the way people feel, some people need them occasionally, some need them all the time, and some never. Both cash cows and great businesses in general.



Goodwalkspoiled - 4 months ago [Report SPAM](#)

I'm not convinced personal interests readily translate into understanding the economics of certain industries. If the economics are complex, one might not grasp the factors and variables involved well enough to make informed investing decisions. For example, you may love cars and trucks, or trains. That doesn't mean you know anything about automotive economics, car manufacturing, the aftermarket, etc. And just because you love trains, it doesn't mean you know anything about railroads, ground transportation, freight, etc. Personal interests

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