Berkshire Hathaway: A Safe, High-Quality, Growing Company With 30% Upside Over the Next Year

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The Basics

- Stock price (5/4/17): $249,540
  - $166.34 for B shares
- Shares outstanding: 1.64 million
- Market cap: $409 billion
- Total assets (Q4 '16): $621 billion
- Total equity (Q4 '16): $286 billion
- Book value per share (Q4 '16): $172,108
- Repurchase maximum price (1.2x book): $206,530
- Downside to the Buffett repurchase put: 17%
- P/B: 1.45x
- Float (Q4 '16): $92 billion
- Revenue: $224 billion
- Berkshire Hathaway today is the 11th largest company in the world (and 4th largest in the U.S.) by revenues

History

History

- Berkshire Hathaway today does not resemble the company that Buffett bought into during the 1960s
- It was a leading New England-based textile company, with investment appeal as a classic Ben Graham-style "net-net"
- Buffett took control of Berkshire on May 10, 1965
- At that time, the company had a market value of about $18 million and shareholder's equity of about $22 million

The Berkshire Hathaway Empire Today

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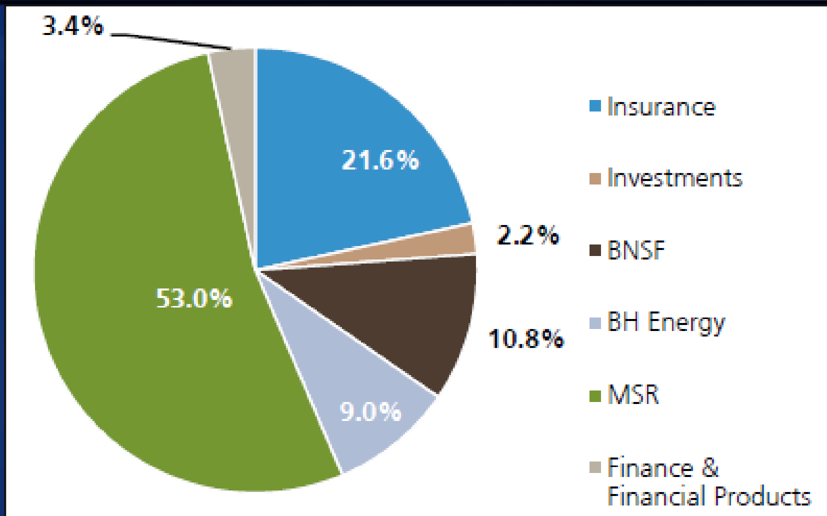
Stakes in Public Companies Worth $1B+

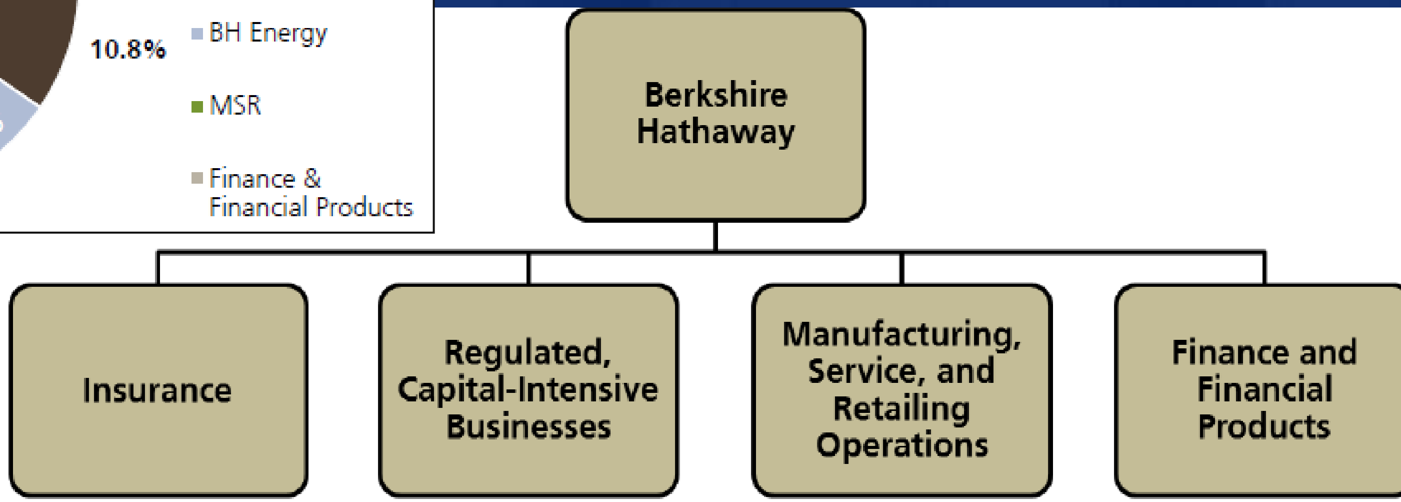
Company	Shares	Price	Value ($B)
Kraft Heinz	325.6	$89.70	$29.2
Wells Fargo	500.0	$55.18	$27.6
Coca-Cola	400.0	$43.66	$17.5
IBM	81.2	$159.05	$12.9
American Express	151.6	$78.33	$11.9
Bank of America	700.0	$23.85	$11.7
Apple	61.2	$146.53	$9.0
Phillips 66	74.6	$78.24	$5.8
U.S. Bancorp	101.9	$52.31	$5.3
Moody's	24.7	$119.40	$2.9
Delta Airlines	54.9	$48.64	$2.7
Goldman Sachs	11.4	$226.59	$2.6
Southwest Airlines	43.2	$58.34	$2.5
DaVita	38.6	$65.24	$2.5
Charter Comm.	6.8	$322.60	$2.2
Sanofi	22.2	$98.34	$2.2
United Continental	26.6	$74.91	$2.0
General Motors	50.0	$33.15	$1.7
USG	43.4	$28.99	$1.3
Verisign	13.0	$90.56	$1.2
Liberty Global	31.5	$34.20	$1.1
Bank of NY Mellon	21.7	$47.61	$1.0

Notes: Share count as of 12/31/16 13-F; Stock prices as of 5/4/17. Excludes holdings (if any) in POSCO and BYD. BofA net of $5B.

The Berkshire Hathaway Empire Today (2)

Revenues (2015)





- GEICO
- General Re
- BH Reinsurance Group
- BH Primary

- BNSF
- BH Energy

- McLane Company
- Manufacturing businesses
- Service and retailing businesses
- Duracell
- Precision Castparts

- Clayton Homes
- ULTX
- XTRA
- Other leasing and financing activities

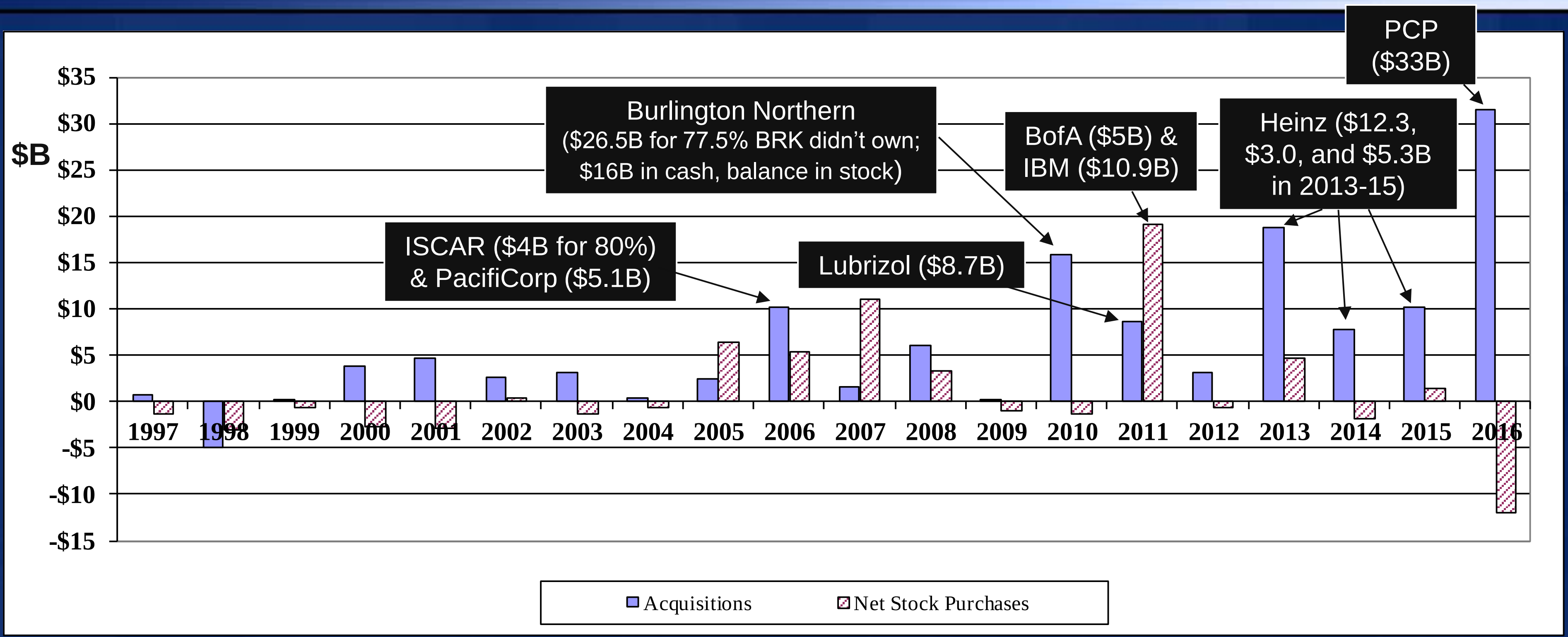
Source: UBS analyst report, 3/28/16.

Earnings of Non-Insurance Businesses Have Soared

Earnings before taxes*	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Insurance Group:													
GEICO	970	1,221	1,314	1,113	916	649	1,117	576	680	1,127	1,159	460	462
General Re	3	-334	526	555	342	477	452	144	355	283	277	132	190
Berkshire Reinsurance Group	417	-1,069	1,658	1,427	1,222	250	176	-714	304	1,294	606	421	822
Berkshire H. Primary Group	161	235	340	279	210	84	268	242	286	385	626	824	657
Investment Income	2,824	3,480	4,316	4,758	4,896	5,459	5,145	4,725	4,454	4,713	4,357	4,550	4,482
Total Insurance Oper. Inc.	**4,375**	**3,533**	**8,154**	**8,132**	**7,586**	**6,919**	**7,158**	**4,973**	**6,079**	**7,802**	**7,025**	**6,387**	**6,613**
Non-Insurance Businesses:**													
Burlington Northern Santa Fe							3,611	4,741	5,377	5,928	6,169	6,775	5,693
Berkshire Hathaway Energy	466	485	1,476	1,774	2,963	1,528	1,539	1,659	1,644	1,806	2,711	2,851	2,973
McLane Company	228	217	229	232	276	344	369	370	403	486	435	502	431
Manufacturing				436	733	686	813	992	3,911	4,205	4,811	4,893	6,211
Service & Retailing	1,787	1,921	3,297	3,279	3,014	1,028	3,092	3,675	1,272	1,469	1,546	1,720	1,820
Finance and financial products	584	822	1,157	1,006	771	653	689	774	1,393	1,564	1,839	2,086	2,130
Total Non-Insur. Oper. Inc.	**3,065**	**3,445**	**6,159**	**6,727**	**7,757**	**4,239**	**10,113**	**12,211**	**14,000**	**15,458**	**17,511**	**18,827**	**19,258**
Total Operating Income	**7,440**	**6,978**	**14,313**	**14,859**	**15,343**	**11,158**	**17,271**	**17,184**	**20,079**	**23,260**	**24,536**	**25,214**	**25,871**

* In 2010, Berkshire changed this table from "Earnings before income taxes, noncontrolling interests and equity method earnings" to "Earnings before income taxes".
** Non-insurance businesses were recategorized in 2014, so figures prior to 2012 are not comparable.

Buffett, Combs and Weschler Are Putting Berkshire's Cash to Work at a Healthy Clip



- Buffett is doing a good job investing – the latest examples being Precision Castparts, Kraft and Duracell– but the cash is coming in so fast (a high-class problem)!
  - Berkshire will generate free cash flow equal to the $32.7 billion paid for PCP in ~2 years
- Markets have a way of presenting big opportunities on short notice
  - Junk bonds in 2002, chaos in 2008
  - Buffett has reduced the average maturity of Berkshire's bond portfolio so he can act quickly

Valuing Berkshire

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"Over the years we've…attempt[ed] to increase our marketable investments in wonderful businesses, while simultaneously trying to buy similar businesses in their entirety." – 1995 Annual Letter

"In our last two annual reports, we furnished you a table that Charlie and I believe is central to estimating Berkshire's intrinsic value. In the updated version of that table, which follows, we trace our two key components of value. The first column lists our per-share ownership of investments (including cash and equivalents) and the second column shows our per-share earnings from Berkshire's operating businesses before taxes and purchase-accounting adjustments, but after all interest and corporate expenses. The second column excludes all dividends, interest and capital gains that we realized from the investments presented in the first column." – 1997 Annual Letter

Year	Investments Per Share	Pre-tax Earnings Per Share Excluding All Income from Investments
1967	$ 41	$ 1.09
1977	372	12.44
1987	3,910	108.14
1997	38,043	717.82

"In effect, the columns show what Berkshire would look like were it split into two parts, with one entity holding our investments and the other operating all of our businesses and bearing all corporate costs." – 1997 Annual Letter

Buffett's Comments on Berkshire's Valuation Lead to an Implied Historical Multiplier of ~12x

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Year	Investments Per Share	Pre-tax EPS Excluding All Income From Investments	Year-End Stock Price	Intrinsic Value	Implied Multiplier
1996	$28,500	$421	$34,100	$34,100	13
1997	$38,043	$718	$46,000	$46,000	11
1998	$47,647	$474	$70,000	$54,000	13
1999	$47,339	-$458	$56,100	$60,000	

- 1996 Annual Letter: "Today's price/value relationship is both much different from what it was a year ago and, as Charlie and I see it, more appropriate."
- 1997 Annual Letter: "Berkshire's intrinsic value grew at nearly the same pace as book value" (book +34.1%)
- 1998 Annual Letter: "Though Berkshire's intrinsic value grew very substantially in 1998, the gain fell well short of the 48.3% recorded for book value." (Assume a 15-20% increase in intrinsic value.)
- 1999 Annual Letter: "A repurchase of, say, 2% of a company's shares at a 25% discount from per-share intrinsic value...We will not repurchase shares unless we believe Berkshire stock is selling well below intrinsic value, conservatively calculated...Recently, when the A shares fell below $45,000, we considered making repurchases."

Estimating Berkshire's Value: 2001 – 2016

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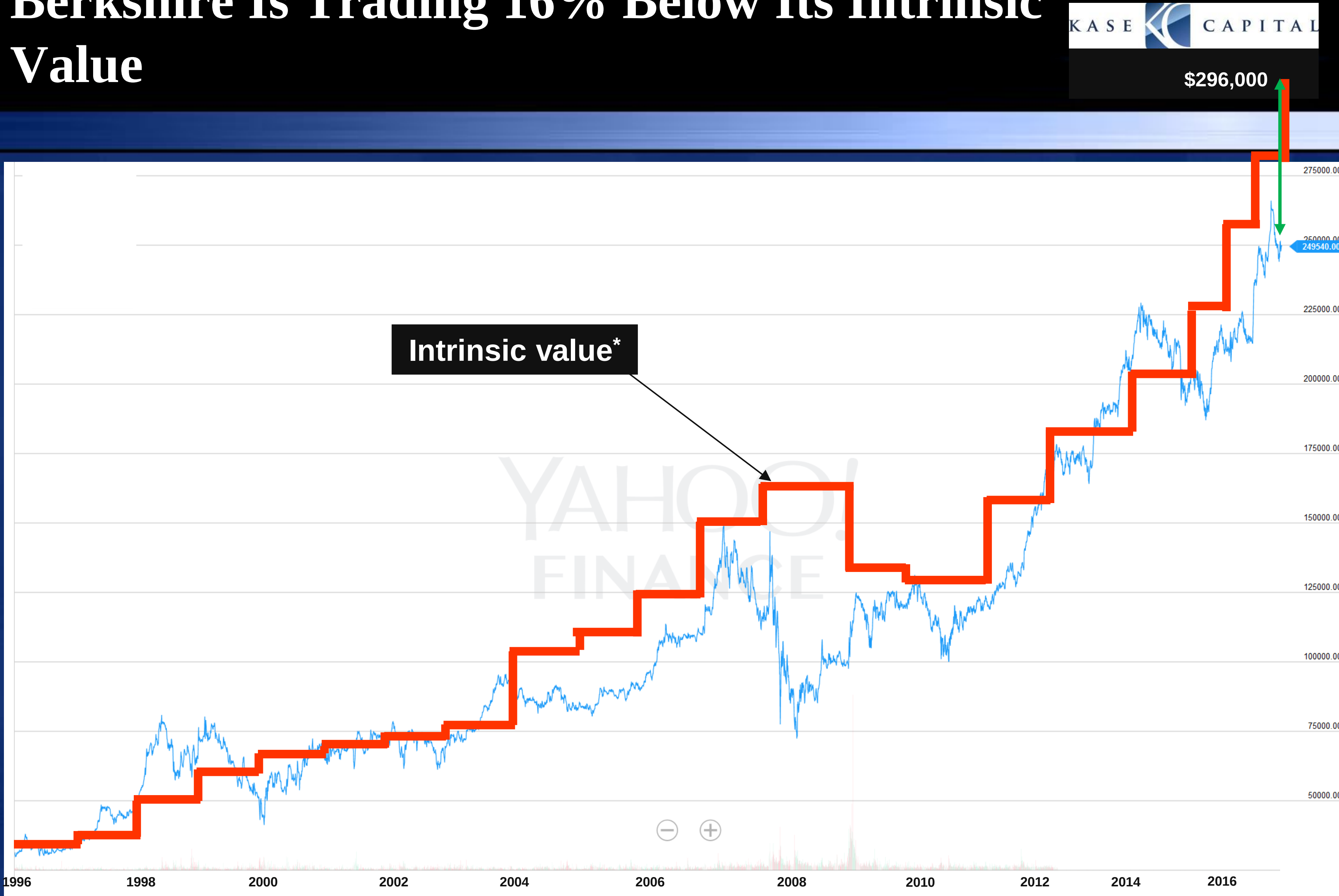
Year End	Cash and Investments Per Share	Pre-tax EPS Excluding All Income From Investments[1]	Intrinsic Value Per Share[2]	Subsequent Year Stock Price Range
2001	$47,460	-$1,289	$64,000	$59,600-$78,500
2002	$52,507	$1,479	$70,255	$60,600-$84,700
2003	$62,273	$2,912	$97,217	$81,000-$95,700
2004	$66,967	$3,003	$103,003	$78,800-$92,000
2005	$74,129	$3,600	$117,329	$85,700-$114,200
2006	$80,636	$5,300	$144,236	$107,200-$151,650
2007	$90,343	$5,600	$157,543	$84,000-$147,000
2008	$75,912	$5,727	$121,728	$70,050-$108,100
2009	$91,091	$3,571	$119,659	$97,205-$128,730
2010	$94,730	$7,200	$152,330	$98,952-$131,463
2011	$98,366	$8,000	$178,366	$114,500-$134,060
2012	$113,786	$8,700	$200,786	$139,610-$178,275
2013	$129,253	$9,716	$226,413	$163,038-$229,374
2014	$140,123	$12,051	$260,633	$192,200-$224,880
2015	$159,794	$12,304	$282,834	$189,640-$249,711
2016	$168,509	$12,746	$295,969	?

1. Unlike Buffett, we included a conservative estimate of normalized earnings from Berkshire's insurance businesses: half of the $2 billion of average annual profit over the 12 years prior to 2014, equal to $600/share prior. Starting in the 2015 AR, Buffett began to include all insurance earnings, so this is reflected in 2014 and 2015 earnings. Both we and Buffett exclude investment income.
2. Historically we believe Buffett used a 12 multiple, but given compressed multiples during the downturn, we used an 8 in 2008-2010 and 10 since then.

Berkshire Is Trading 16% Below Its Intrinsic Value



* Investments per share plus 12x pre-tax earnings per share through 2007, then an 8x multiple from 2008-2010, and a 10x multiple thereafter.

12-Month Investment Return

- Current intrinsic value: $296,000/share
- Plus 6% annual growth of intrinsic value of the business
- Plus ~$10,000/share cash build over next 12 months
- Equals intrinsic value in one year of $324,000
- 30% above today's price

Catalysts

- Continued earnings growth of operating businesses
- Likelihood of meaningful acquisitions
- New stock investments
- Additional cash build
- Share repurchases (if the stock drops to 1.2x book or below; it's currently at 1.45x)

Berkshire's Share Repurchase Program (1)

- On September 26, 2011, Berkshire announced the first formal share repurchase program in Berkshire's history, and only the second time Buffett has ever offered to buy back stock
- It's unusual in three ways:
    1. There's no time limit
    2. There's no dollar cap
    3. Buffett set a price: "…no higher than a 10% premium over the then-current book value of the shares. In the opinion of our Board and management, the underlying businesses of Berkshire are worth considerably more than this amount…"
- On December 12, 2012, Berkshire increased the limit to 1.2x book and announced that it had repurchased $1.2 billion in one transaction
- Book value per share at the end of 2016 was $172,108
- Thus, a 20% premium means that Buffett is willing to buy back stock up to $206,530, 17% below the current price

Berkshire's Share Repurchase Program (2)

- It confirms that Buffett shares our belief that Berkshire stock is undervalued
  - He wouldn't be buying it back at a 20% premium to book value if he thought its intrinsic value was, say, 30% above book
  - On the first page of the 2015 annual letter, he wrote "Berkshire's intrinsic value *far* exceeds its book value. That's why we would be delighted to repurchase our shares should they sell as low as 120% of book value. At that level, purchases would instantly and meaningfully increase per-share intrinsic value for Berkshire's continuing shareholders."
  - Our estimate is $296,000/share or 1.72x book value
- Buffett put a floor on the stock: he was clear in numerous interviews after the program was announced that he is eager to buy back *a lot* of stock – and he has plenty of dry powder to do so:
  - Berkshire has $71 billion of cash (excluding railroads, utilities, energy, finance and financial products), plus another $23 billion in bonds (nearly all of which are short-term, cash equivalents), which totals $94 billion
  - On top of this, the company generated $19.6 billion in free cash flow in 2016 – in other words, ~$1.6 billion is pouring into Omaha every *month*
  - The Sept. 2011 press release noted that "repurchases will not be made if they would reduce Berkshire's consolidated cash equivalent holdings below $20 billion," so that leaves $74 billion to deploy (and growing by $1.6 billion/month), equal to 18% of the company's current market cap
    - It's unlikely, however, that Buffett would repurchase anything close to this amount, as some of the cash and bonds are held at various insurance subsidiaries, plus Buffett likely wants to keep plenty of dry powder to make acquisitions and investments
  - In summary, Buffett could easily buy back $50 billion of stock *and* still have plenty of dry powder for other investments

Risk: Who Will Replace Buffett?

- When Buffett is no longer running Berkshire, his job will be split into two parts: one CEO, who has not been named, and a small number of CIOs (Chief Investment Officers)
  - A CEO successor (and two backups) have been identified, but not publicly named
  - Two CIOs have been named already, Todd Combs and Ted Weschler, both of whom are excellent investors
- Nevertheless, Buffett is irreplaceable and it will be a significant loss when he no longer runs Berkshire for a number of reasons:
  - There is no investor with Buffett's experience, wisdom and track record, so his successors' decisions regarding the purchases of both stocks and entire businesses might not be as good
  - Most of the 80+ managers of Berkshire's operating subsidiaries are wealthy and don't need to work, but nevertheless work extremely hard and almost never leave thanks to Buffett's "halo" and superb managerial skills. Will this remain the case under his successors?
  - Buffett's relationships and reputation are unrivaled so he is sometimes offered deals and terms that are not offered to any other investor – and might not be offered to his successors
  - Being offered investment opportunities (especially on terms/prices not available to anyone else) also applies to buying companies outright. There's a high degree of prestige in selling one's business to Buffett (above and beyond the advantages of selling to Berkshire). For example, the owners of Iscar could surely have gotten a higher price had they taken the business public or sold it to an LBO firm

Aren't We Concerned About the Uncertainty of Berkshire After Buffett?

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Answer: Not really, for three primary reasons:

1. Buffett isn't going anywhere anytime soon. We think it's at least 80% likely that Buffett will be running Berkshire for five more years, and perhaps 50% likely he'll be doing so for 10 more years
   - Buffett turned 86 on Aug. 30th, 2016, is in excellent health, and loves his job
   - There are no signs that he is slowing down mentally – in fact, he appears to be getting better with age
   - A life expectancy calculator (http://calculator.livingto100.com) shows that Buffett is likely to live to age 93 – and we'd bet on the over
2. The stock is undervalued based on our estimate of intrinsic value, which does not include *any* Buffett premium
   - We simply take investments/share and add the value of the operating businesses, based on a conservative multiple of their normalized earnings
   - The value of the cash and bonds won't change, and Wells Fargo, Kraft Heinz, Coke, American Express, Burlington Northern, GEICO, etc. will continue to generate robust earnings even after Buffett is no longer running Berkshire
3. Buffett has built a powerful culture that is likely to endure

Berkshire's Culture Is Powerful and Unique: "A Seamless Web of Deserved Trust"

- Berkshire operates via extreme decentralization: though it is one of the largest businesses in the world with approximately 360,000 employees, only *25* of them are at headquarters in Omaha
  - There is no general counsel or human resources department
- "By the standards of the rest of the world, we overtrust. So far it has worked very well for us. Some would see it as weakness." – Charlie Munger, 5/14
- "A lot of people think if you just had more process and more compliance — checks and double-checks and so forth — you could create a better result in the world. Well, Berkshire has had practically no process. We had hardly any internal auditing until they forced it on us. We just try to operate in a seamless web of deserved trust and be careful whom we trust." – Munger, 5/07
- "We will have a problem of some sort at some time…300,000 people are not all going to behave properly all the time." – Warren Buffett, 5/14
- "Behavioral scientists and psychologists have long contended that 'trust' is, to some degree, one of the most powerful forces within organizations. Mr. Munger and Mr. Buffett argue that with the right basic controls, finding trustworthy managers and giving them an enormous amount of leeway creates more value than if they are forced to constantly look over their shoulders at human resources departments and lawyers monitoring their every move." – NY Times, 5/5/14

Why Doesn't Buffett Identify His Successor Now?

We agree with Buffett's decision not to name his successor for three reasons:

1. It would place enormous pressure and expectations on this person, which is unnecessary and counterproductive;
2. It might be demotivating for the candidates who were not chosen; and
3. Who knows what will happen between now and the time that a successor takes over (which could be more than a decade)?
   - Maybe the current designee falls ill, leaves Berkshire, performs poorly, or makes a terrible mistake (e.g., David Sokol)
   - Or what if another candidate (perhaps one of the two backup successors today) performs incredibly well, or Berkshire acquires a business with a fantastic CEO, and Buffett and the board decide that another candidate is better?
   - By not naming Buffett’s successor now, Buffett and the board will be able to switch their choice without the second-guessing and media circus that would occur if the successor had been named

The Real Buffett Risk

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- Buffett is often asked (as are we): "What would happen to the company (and stock) if you got hit by a bus (i.e., die suddenly)?"
  - If it happened tomorrow, our best guess is that the stock would fall 15% (which might give Berkshire the opportunity to buy back a lot of stock)
  - But this isn't likely. Not to be morbid, but most people don't die suddenly from something like an accident or heart attack, but rather die slowly: their bodies (and sometimes minds) gradually deteriorate
  - A far greater risk to Berkshire shareholders is that Buffett begins to lose it mentally and starts making bad investment decisions, but doesn't recognize it (or refuses to acknowledge it because he loves his work so much) and the board won't "take away the keys", perhaps rationalizing that a diminished Buffett is still better than anyone else
  - Buffett is aware of this risk and has instructed Berkshire's board members, both publicly and privately, that their most important job is to "take away the keys" if they see him losing it
  - We trust that both Buffett and the board will act rationally, but also view it as our job to independently observe and evaluate Buffett to make sure we're comfortable that he's still at the top of his game. Today, we think he's never been better

An Analogy with Apple & Steve Jobs

- The most comparable example of a business that, like Berkshire, is closely associated with its legendary founder and CEO is Apple
  - As Steve Jobs' health began to fail, he assumed fewer day-to-day responsibilities, passing them to top lieutenants
  - Jobs resigned as CEO on Aug. 24, 2011 and died exactly six weeks later
  - Apple's stock declined less than 1% on the first trading days after both his retirement and death, as this chart shows:

Other Risks

- The single biggest risk is that as Berkshire gets larger and Buffett gets older, investors value the stock at a lower and lower multiple of earnings and book value, such that even if intrinsic value continues to grow, the stock goes nowhere for an extended period
- A recession impacts Berkshire's earnings and stock portfolio materially
- A market decline leads to losses in shorter-duration derivatives such as credit-default swaps and/or equity index puts
- A very large investment goes awry
- A major super-cat event costs Berkshire many billions

Conclusion: Berkshire Has Everything I Look for in a Stock: It's Safe, Cheap and Growing at a Healthy Rate

- Extremely safe: Berkshire's huge hoard of liquid assets, the quality and diversity of its businesses, the fact that much of its earnings (primarily insurance and utilities) aren't tied to the economic cycle, and the conservative way in which it's managed all protect Berkshire's intrinsic value, while the share repurchase program provides downside protection to the stock
- Upside: trading 16% below intrinsic value (without giving any credit to immense optionality), with 30% upside over the next year
- Downside: Only 17% downside to 1.2x book value, which is where Buffett it will to buy the stock, thereby putting a floor on it.
- Growing: Intrinsic value is growing at roughly 6-8% annually

Appendix

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Berkshire Is Becoming Less of an Investment Company and More of an Operating Business

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Yearend	*Per-Share Investments*	*Period*	*Compounded Annual Increase in Per-Share Investments*
1970	$ 66		
1980	754	1970-1980	27.5%
1990	7,798	1980-1990	26.3%
2000	50,229	1990-2000	20.5%
2010	94,730	2000-2010	6.6%

Year	*Per-Share Pre-Tax Earnings*	*Period*	*Compounded Annual Increase in Per-Share Pre-Tax Earnings*
1970	$ 2.87		
1980	19.01	1970-1980	20.8%
1990	102.58	1980-1990	18.4%
2000	918.66	1990-2000	24.5%
2010	5,926.04	2000-2010	20.5%

Source: 2010 annual letter.

Buffett Invested Large Amounts of Capital During the Downturn in 2008

Investment/Commitment	Amount (Bn)	Comment
Mars/Wrigley	$6.5	
Auction rate securities	$6.5	Q2 event; sold much in Q3
Goldman Sachs	$5.0	Plus $5B to exercise warrants
Constellation Energy stock and preferred	$5.7	Sold for a $1.1B gain incl. breakup fee
Marmon	$4.5	The remaining 34.6% not owned by BRK was purchased from 2011-14
General stock purchases	$3.3	Full year; net of sales
Dow/Rohm & Haas	$3.0	
General Electric	$3.0	Plus $3B to exercise warrants
Fed. Home Loan Disc. Notes	$2.4	Q2 event; sold much in Q3
Tungaloy	$1.0	Iscar acquisition
Swiss Re unit	$0.8	Plus sharing agreement
ING reinsurance unit	$0.4	
Other businesses purchased	$3.9	
TOTAL	**$46.0**	Plus $8B to exercise GS & GE warrants

Note: Does not include capital committed to Berkshire's bond insurance business, Berkshire Assurance

Don’t Overlook Munger – He Is a Genius in His Own Right

Favorite Mungerisms

- The more hard lessons you can learn vicariously, instead of from your own terrible experiences, the better off you will be…So the game is to keep learning.
- What is elementary, worldly wisdom? Well, the first rule is that you can't really know anything if you just remember isolated facts and try and bang 'em back. If the facts don't hang together on a latticework of theory, you don't have them in a usable form. You've got to have models in your head. And you've got to array your experience – both vicarious and direct – on this latticework of models.
- Most people are trained in one model and try to solve all problems in one way. You know the old saying: To the man with a hammer, the world looks like a nail. This is a dumb way of handling problems.
- Our experience tends to confirm a long-held notion that being prepared, on a few occasions in a lifetime, to act promptly in scale, in doing some simple and logical thing, will often dramatically improve the financial results of that lifetime. If you took our top 15 decisions out, we’d have a pretty average record.
- As Jesse Livermore said, “The big money is not in the buying and selling…but in the waiting.”
- There’s always been a market for people who pretend to know the future. Listening to today’s forecasters is just as crazy as when the king hired the guy to look at the sheep guts.
- All I want to know is where I’m going to die, so I’ll never go there.
- No wise pilot, no matter how great his talent and experience, fails to use his checklist.
- In my whole life, I have known no wise people (over a broad subject matter area) who didn’t read all the time – none, zero.

Don't Overlook Munger – He Is a Genius in His Own Right (2)

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Favorite Mungerisms

- We have never given a damn whether any quarter's earnings were up or down. We prefer profits to losses, obviously, but we're not willing to manipulate in any way just to make some quarter look a little better.
- To say accounting for derivatives in America is a sewer is an insult to sewage.
- We think there should be a huge area between what you're willing to do and what you can do without significant risk of suffering criminal penalty or causing losses. We believe you shouldn't go anywhere near that line.
- Our approach has worked for us. Look at the fun we, our managers, and our shareholders are having. More people should copy us. It's not difficult, but it looks difficult because it's unconventional.
- If you rise in life, you have to behave in a certain way. You can go to a strip club if you're a beer-swilling sand shoveler, but if you're the Bishop of Boston, you shouldn't go.
- Spend each day trying to be a little wiser than you were when you woke up. Discharge your duties faithfully and well. Step by step you get ahead, but not necessarily in fast spurts. But you build discipline by preparing for fast spurts. Slug it out one inch at a time, day by day. At the end of the day, if you live long enough, most people get what they deserve.
- To learn more about/from Munger, I highly recommend two books, Poor Charlie's Almanack (of which I was a contributor) and Seeking Wisdom: From Darwin to Munger