Berkshire Hathaway Inc. (BRK.A)

Berkshire Hathaway's persistent financial success bears testament to the talent of Warren Buffett.

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Greggory Warren, CFA does not have a position in this stock.

Date of Analysis	Dec 22, 2010
Price as of Analysis	$120171

Stock Price ($)

Morningstar Rating	★★★
Last Closing Price	$125300.00
Fair Value	$135000
Consider Buy	$94500.00
Consider Sell	$189000.00
Business Risk	Below Avg
Economic Moat	Wide
Industry	Insurance - Reinsurance
Sector	Financial Services
Ticker	BRK.A

Data as of last close: 03/31/2011

Thesis

Berkshire Hathaway's wide moat has been built on the firm's track record of acquiring and managing a portfolio of businesses with enduring competitive advantages. Whether through direct ownership of individual companies, or via significant stock holdings, famed value investor Warren Buffett has looked to acquire firms with consistent earnings power that generate above average returns on capital, have little to no debt, and have solid management teams. Once purchased, these businesses tend to remain in Berkshire's portfolio, with sales occurring rarely. Buffett strives to raise capital as cheaply as possible to support Berkshire's ongoing investments and measures the success of the portfolio by per-share growth in intrinsic value. Book value per share, which is the main proxy used to measure the intrinsic value of the firm, has increased 20% per year on average over the last 45 years. Given the current size of its operations, the biggest hurdle facing Berkshire will be its ability to consistently find deals that not only add value but are large enough to be meaningful. The other major issue facing the firm is the longevity of Buffett and managing partner Charlie Munger, both of whom are octogenarians. Berkshire's most important business continues to be its insurance operations. Not only do they contribute a significant portion of the firm's profits but they also generates low-cost float (the temporary cash holdings arising from premiums being collected well in advance of future claims), which remains a major source of funding for investments. Berkshire underwrites insurance through three main units: GEICO, General Re, and Berkshire Hathaway Reinsurance. GEICO, which is the third largest auto insurer in the United States, relies on direct selling to consumers, which has given it some cost advantages over some of its competitors. While this practice has become more common, GEICO was a pioneer in the channel and continues to generate solid underwriting profits and negative cost of float for Berkshire. The firm's two other large insurance arms are both reinsurers. For a premium, they will assume all or part of an insurance or reinsurance policy written by another insurance company. General Re is one of the largest reinsurers in the world based on premium volume and shareholder capital, while Berkshire Hathaway Reinsurance's claim to fame is its ability to take on large amounts of super-catastrophe underwriting, which covers events like terrorism and natural catastrophes. These unique policies often contain large tail risks which few companies (other than Berkshire itself with its strong balance sheet) have the capacity to endure. When priced appropriately, though, these types of transactions can generate favorable long-term returns on capital for the firm. Berkshire's noninsurance operations include a wide array of businesses from Burlington Northern Santa Fe (railroad) to MidAmerican Energy (energy generation and distribution), McLane (food distribution), Marmon (manufacturing), Shaw Industries (carpeting), Benjamin Moore (paint), Fruit of the Loom (apparel), Dairy Queen (restaurant), and See's Candies (food retail). Of the more than 70 noninsurance businesses in its portfolio, the two largest contributors to Berkshire's operating earnings are Burlington Northern, which the firm acquired in full in February 2010, and MidAmerican, in which Berkshire maintains an 89.5% stake (having initially added the company to its holdings in 2005). Buffett's move into such debt-heavy, capital intensive businesses as railroads and utilities is a marked departure from other investments, which have tended to require less capital investment and have had little to no debt on their books. While running railroads and utilities requires massive reinvestment, Berkshire has entered these businesses because they can earn decent returns on incremental investments, ensuring that the large amounts of cash generated by other operating businesses are reinvested in value-creating projects. And while the company does consolidate the debt of these two

Valuation

Our fair value estimate for Berkshire Hathaway's Class A shares is $135,000 per share, equivalent to 1.5 times the firm's reported book value of $90,823 on Sept. 30, 2010. Over the last decade, Berkshire's Class A shares have traded in a range of 1.1-1.9 times book value, with a median value of 1.6 times. Our fair value estimate is derived from a sum-of-the-parts methodology, which values the different pieces of Berkshire's portfolio separately, then combines them to arrive at a total value for the firm. We estimate that Berkshire's insurance operations are worth $82,000 per Class A share. We expect premium growth at GEICO to remain strong in the near term, as direct sold insurance continues to take share from traditional agency-sold policies. We expect that

Close Competitors	TTM Sales $Mil	Market Cap $Mil
Berkshire Hathaway Inc. (BRK.A)	136,185	205,675
Progressive Corporation	14,963	13,947
Everest Re Group, Ltd.	4,706	4,800
Renaissance Re Holdings, Ltd.	1,225	3,645

Morningstar data as of March 31, 2011.

growth to normalize over time, though, as the market reaches equilibrium. Given the fierce competition among auto insurers, we don't expect underwriting margins to expand too much. Margins at the reinsurers are also likely to come under pressure over the next couple of years as catastrophe losses return to more normal levels. In aggregate we expect earned premium revenue growth of 5% per year on average over our forecast horizon, in line with the average rate of annual growth reported over the last decade. As for the firm's noninsurance subsidiaries, we estimate that Berkshire's manufacturing, service & retailing operations are worth $18,000 per Class A share. The economic downturn has been hard on the businesses in this segment, but there have been signs of life this year as revenue and profitability have improved (albeit from depressed levels). We expect the segment to return to 5% average annual revenue growth longer term, with operating margins in the 6%-7% range. Berkshire's old utilities and energy segment morphed into the railroad, utilities and energy division with the firm's purchase of Burlington Northern earlier this year. We estimate that this segment is worth $29,000 per Class A share. After the initial boost from Burlington Northern, we believe that revenue growth will ultimately moderate to around 5% per year with operating margins of around 22% overall (based on margins of 24% for Burlington Northern and 18%-20% for MidAmerican Holdings). Finally, we estimate that Berkshire's finance and financial products division is worth $6,000 per Class A share. We assume only a modest recovery in this business, which is tied to the housing market, longer term.

Risk

Berkshire is exposed to large potential losses through its insurance operations. While the company believes its super-catastrophe underwriting will generate solid long-term results, the volatility of this particular line of business, which can subject the firm to especially large amounts of losses, could be high. That said, Berkshire maintains much higher capital levels than other insurers, which we believe helps mitigate some of the risk. Several of the firm's key businesses--insurance, energy generation and distribution, and rail transport--operate in industries that are subject to higher degrees of regulatory oversight, which could impact such things as future business combinations and the setting of rates charged to customers. Berkshire is also exposed to foreign currency, equity price, and credit default risk through its various investments and operating companies. The firm's derivative contracts, in particular, can impact Berkshire's earnings and capital position, especially during volatile markets, given that they are recorded at fair value and, therefore, periodically updated to record the changes in the value of these contracts. Many of the firm's noninsurance operations, meanwhile, are exposed to the cyclicality of the economy, with results typically suffering during economic slowdowns and recessions. Finally, Berkshire is highly dependent on two key employees, Warren Buffett and Charlie Munger, for almost all of its investment and capital allocation decisions. With both men now in their eighties, it has become increasingly likely that our valuation horizon will end up exceeding their expected life spans. We also believe that investment returns and capital-allocation quality are likely to deteriorate under new management.

Bulls Say

- Berkshire Hathaway's book value per share increased at a compound annual growth rate of 20.3% from 1965 to 2009, compared to a 9.3% total return for the S&P 500 Index.
- Berkshire's long-term track record has also been fairly consistent, with the company reporting annual declines in book value per share in only two years--2001 and 2008.
- At the end of the third quarter of 2010, Berkshire had $66 billion in float from its insurance operations. The firm's cost of float remains negative, which is a meaningful benefit for Berkshire because it means that the company is being paid to hold other people's money.
- Berkshire's strong balance sheet allowed it to take full advantage of opportunities in the months leading up to and following the collapse of the credit and equity markets in 2008, making lucrative investments in Goldman Sachs, General Electric, Swiss Re, and Wrigley.
- The acquisition of Burlington Northern, completed in

February of 2010, should add close to $15 billion to Berkshire's top line, with operating income increasing by $3.5 billion as a result of the deal.

Bears Say

- Given the current size of its operations, the biggest hurdle facing Berkshire will be its ability to consistently find deals that not only add value but are large enough to be meaningful.
- Investments made in Goldman Sachs, General Electric, Swiss Re, and Wrigley are in the process of being paid off, which would not only impact investment income but leave Berkshire in the position of having to reinvest the proceeds in less lucrative offerings.
- Berkshire's insurance business faces highly competitive and cyclical markets and will occasionally produce large losses. It also has highly uncertain liabilities, including potential asbestos claims, which might ultimately cost more than the firm has stated.
- With Lou Simpson, who has run GEICO's investment portfolio for the last 30 years, retiring at the end of 2010, and Warren Buffett and Charlie Munger both octogenarians, Berkshire is closer than it has ever been to losing much of the top investing talent that has been responsible for its long track record of success.
- Berkshire is a large conglomerate, and its reported results are complicated by the firm's size and frequent acquisitions. This makes our fair value more uncertain and subject to estimation error.

Financial Overview

Financial Health: Berkshire's financial strength was tested by the collapse of the credit and equity markets in 2008, which ultimately led to the company losing its AAA credit rating during 2009. That said, Berkshire remains one of the most financially sound companies we cover, with the firm managing its risk through diversification and a conservative capital position. In its insurance operations, Berkshire carries large levels of equity and cash relative to other insurers, which should offset potential losses. The firm generally seeks to run its operating companies and make ongoing investments without an over-reliance on debt. In instances where it finds it necessary to issue debt, Berkshire strives to do so on a long-term fixed-rate basis. While consolidated debt levels have risen significantly over the last five years, much of it is tied to two of its noninsurance subsidiaries--MidAmerican Energy and Burlington Northern Santa Fe--and is not explicitly guaranteed by Berkshire. That said, all or substantially all of the assets of these two subsidiaries can be pledged or encumbered to support or otherwise secure the debt. Berkshire does not, nor does it anticipate, paying a shareholder dividend or repurchasing its shares. The company also tends not to issue stock that it believes would be dilutive to existing holders (although Berkshire did issue both Class A and Class B shares to consummate the Burlington Northern transaction in February 2010).

Company Overview

Profile: Berkshire Hathaway is a holding company with a wide collection of subsidiaries engaged in a number of diverse business activities. The firm's core business is insurance, run primarily through GEICO (auto insurance), General Re (reinsurance), Berkshire Hathaway Reinsurance and Berkshire Hathaway Primary Group. The company's other businesses are made up of a collection of finance, manufacturing and retailing operations, along with railroads, utilities and energy distributors. Berkshire's ...

Management: Warren Buffett has been chairman and CEO of Berkshire Hathaway since 1970. Charlie Munger has served as vice chairman of the firm's board of directors since 1978 and has been chairman and CEO of Berkshire subsidiary Wesco Financial since 1984. Berkshire has two classes of common stock, with Class B shares holding 1/1,500th of the economic rights of Class A shares, and only 1/10,000th of the voting rights. Warren Buffett is Berkshire's largest shareholder, with a 30% voting stake and 24% economic interest in the firm. While there are many aspects of Berkshire's corporate governance that fall short of our standards, such as having the chairman and CEO roles combined, Buffett has been one of the strongest stewards of investor capital we have ever seen, consistently aligning his own interests with those of shareholders. This makes it all that more important that his legacy remains intact once he no longer runs the firm. Succession was not formally addressed by Buffett until 2005, when he noted that his three main jobs--chairman, chief executive, and chief investment officer--would likely be handled by one chairman (expected to be his son, Howard Buffett), one CEO (with at least three internal candidates identified), and three or more external hires (reporting to directly to the CEO) to manage the investment portfolio. With David Sokol, chairman of MidAmerican Energy and chairman and CEO of NetJets, presumed to be the current frontrunner for the CEO job, and Berkshire bringing in Todd Combs, a little-known hedge fund manager, to handle a portion of the firm's investment portfolio, the company has been taking steps toward filling the vacancies that will emerge once Buffett departs. The real question, though, is whether or not they will ever be able to replace the significant advantages that have come from having an investor of his caliber, with the knowledge and connections that he has acquired over the years, running the show.