Berkshire Hathaway Inc B BRK.B

Barring Major Stock Investments or Acquisitions, Berkshire's Cash Hoard Will Continue to Grow

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Business Strategy and Outlook 06/07/2019

We think two big concerns--first, that Berkshire Hathaway's size will prevent it from growing at a decent clip in the future and, second, that the company's shares will get pummeled once Warren Buffett no longer runs the show--have kept some investors on the sidelines. While we do not expect Berkshire to be able to consistently increase its book value per share at a double-digit rate going forward--a feat the firm achieved six times during 2009-18--we think the company is still capable of increasing book value per share at a high-single- to low-double-digit rate annually. This should leave returns solidly and consistently above Berkshire's cost of capital, which is what we expect from companies with wide economic moats.

As for succession planning, Buffett's three main roles--chairman, CEO, and investment manager--are expected to be split once he departs. Our long-standing view has been that Buffett's son, Howard Buffett, will serve as nonexecutive chairman and that Ted Weschler and Todd Combs will serve as co-investment managers of Berkshire's investment portfolio. As for the CEO role, we think there are two fine candidates in Ajit Jain and Greg Abel, both of whom would bring unique insights to the role. Our preference, though, would be to have Jain take control of all of Berkshire's insurance operations, while Abel (who has experience with both operations and acquisitions) fills the role of chief executive.

With investment opportunities few and far between these days, the company does face another near- to medium-term issue--bulging cash balances that (absent any sizable deals) will need to be returned to shareholders. While Buffett has been clear about share repurchases being his preferred option (relative to dividends) for reducing excess cash balances (not dedicated to acquisitions or stock investments) down the road, we expect him to be just as cost-conscious when buying back Berkshire's shares as he has been with other investments historically. As long as the company's shares trade closer to the firm's five-year average multiple of 1.48 times book value per share, we think share repurchases are less likely.

Economic Moat 06/07/2019

Berkshire's wide economic moat is more than just a sum of its parts, although the parts that make up the whole are fairly moaty in their own regard. The company's insurance operations--Geico, General Re, Berkshire Hathaway Reinsurance Group, and Berkshire Hathaway Primary Group--remain important contributors to the overall business. Not only do the insurance operations account for around one third of Berkshire's pretax earnings (and close to 40% of our estimate of the company's fair value), but they also generate low-cost float--the temporary cash holdings that arise from premiums being collected in advance of future claims, which is a major source

Morningstar's Take BRK.B

Analyst

Price 06-07-2019	**Fair Value Estimate**	**Uncertainty**
205.81 USD	243 USD	Medium
Consider Buy	**Consider Sell**	**Economic Moat**
170.1 USD	328.05 USD	Wide

Stewardship Rating
Exemplary

Bulls Say

- Book value per share, which is a proxy for measuring changes in Berkshire's intrinsic value, increased at an 18.7% CAGR during 1965-2018, compared with a 9.7% return for the S&P 500 TR Index.
- Berkshire's stock performance has been equally strong, increasing at a 20.5% CAGR during 1965-2018. The shares increased at an 11.5% (12.2%) CAGR during 2014-18 (2009-18), compared with an 8.5% (13.1%) average annual return for the S&P 500 TR Index.
- At the end of March 2019, Berkshire had $124 billion in insurance float. The cost of the firm's float has been negative for much of the past decade.

Bears Say

- Given the size of its operations, Berkshire's biggest long-term hurdle will be its ability to consistently find deals that not only add value but are large enough to be meaningful.
- Another big issue facing the firm is the longevity of chairman and CEO Warren Buffett (who turns 89 at the end of August 2019) and managing partner Charlie Munger (who turned 95 in early January 2019).
- Berkshire's insurance business faces competitive and highly cyclical markets that occasionally produce large losses, and much of its other operations are economically sensitive and focused on U.S. markets.

Competitors BRK.B

More...

Name	Price	% Chg	TTM Sales $ mil
Berkshire Hathaway Inc B	**$205.81**	**0.51**	**255,924**
Berkshire Hathaway Inc A	$309,265.00	0.44	255,924
Allianz SE	$230.75	1.67	122,118
Allianz SE ADR	$23.16	1.25	122,118
AXA SA ADR	$25.28	1.08	113,883
AXA SA	$25.12	-0.48	113,883

of funding for investments. That said, from an economic moat perspective, we don't believe the insurance industry is particularly conducive to the development of sustainable competitive advantages. While there are some high-quality companies operating in the industry (with Berkshire having some of the best operators in the different segments where it competes), the product that insurers sell is basically a commodity, with excess returns being difficult to achieve on a consistent basis.

Buyers of insurance are not inclined to pay a premium for brands, and the products themselves are easily replicable. Competition among insurance firms is fierce, and participants have been known to slash prices or simply undercut competitors to gain market share. Insurance is also one of the few industries where the cost of goods sold (signified by claims) may not be known for years, providing an incentive for companies to sacrifice long-term profitability in favor of near-term growth. In reinsurance, this dynamic can be even more pronounced, as losses in this business tend to be large in nature and may not be realized for years after a policy is written. Insurers can, however, develop sustainable cost advantages by either focusing on less commodified areas of the market or by developing efficient and/or scalable distribution platforms. What they can't do is gain a sustainable competitive advantage through investing, even when gains are the result of the investing prowess of someone like Buffett. We believe insurers that consistently achieve positive underwriting profitability are better bets in the long run, as insurance profitability tends to be more sustainable than investment income.

Geico has made strides with its direct-selling operations, moving from a position as the fourth-largest private auto insurer in the U.S. at the end of 2003 (with 5% of the market) to the second-largest underwriter at the end of 2018 (with just over 13% of the market). Much like its closest competitor, Progressive, Geico has set itself apart from the rest of the industry by its scale in the direct-response channel. While scaling is typically difficult for insurance companies, personal line insurers like Geico and Progressive have been better at spreading fixed costs over a wider base, as their business models do not require as much human capital and specialized underwriters as other insurance lines. This has been reflected in Geico's expense ratio, which averaged around 15% during 2014-18, leaving it more than 800 basis points below the industry average and around 500 basis points better than Progressive's direct auto insurance business. Geico has, however, trailed its closest peer on an underwriting basis, with Progressive producing a combined ratio of 93.1% on average during 2014-18 compared with Geico's average annual combined ratio of 96.8%. Given the similarity in their auto insurance operations, though, as well as the level and consistency of their profitability, we think that Geico, much like Progressive, has a narrow economic moat around its operations.

We do not believe Berkshire's reinsurance arm--composed of the old General Re reinsurance operations and BHRG--has an economic moat. For a premium, reinsurers assume all or part of an insurance or reinsurance policy written by another insurer. While any insurance company can underwrite reinsurance, a handful of larger companies--Munich Re, Swiss Re, Hannover Re, Lloyd's, and Berkshire Hathaway--hold sway over the lion's share of the global reinsurance market. The policies underwritten by reinsurers often contain large long-tail risks that few companies have the capacity to endure, and when priced appropriately, they can generate favorable long-term returns. That said, reinsurers compete almost exclusively on price and capital strength, making it almost impossible to build structural cost advantages. More important, losses in the reinsurance market are lumpy and may not be realized for years after a policy is written, magnifying the importance of disciplined and accurate underwriting skills. While Berkshire's reinsurance arm is unique in that it has the luxury of walking away from business when an appropriate premium cannot be obtained--something that peers cannot always do--its underwriting profitability has been less consistent (due to the nature of the risks being underwritten) and much narrower than Berkshire's other insurance operations. The company sticks with reinsurance because it generates large amounts of float that can be invested for longer periods of time than short-tail lines like auto insurance. While our standard view on reinsurance is that firms operating in this segment cannot carve out economic moats, we think Berkshire's reinsurance arm comes closer than most.

We believe BHPG, which has been Berkshire's most profitable insurance business for over a decade, benefits from a narrow economic moat around its operations. What is all the more remarkable about this achievement is that BHPG is a conglomeration of multiple insurance operations--including National Indemnity's primary group, Medical Protective Company, U.S. Investment Corporation, and Applied Underwriters--that offer coverage as varied as workers' compensation and commercial auto and property coverage. It is also where the company's Berkshire Hathaway Specialty Insurance business resides. Formed in June 2013, this business is focused on U.S. excess and surplus lines, looking to take advantage of the growing demand for tailored insurance. We view this as a net positive for Berkshire's insurance operations overall, as we've long believed that insurers that are able to focus on the least commodified areas of the insurance market, such as excess and surplus lines, are much more likely to generate consistent underwriting profitability.

Of the more than 70 noninsurance businesses that make up the remainder of Berkshire's operating subsidiaries, Burlington Northern Santa Fe and Berkshire Hathaway Energy, combined as Railroad, Utilities, and Energy on the company's balance sheet, are the next largest contributors to the firm's profitability and overall value, typically generating more than one third of pretax earnings (and 30% our fair value estimate) for the firm. The most interesting thing about these two businesses is that neither one was a major contributor to Berkshire's pretax earnings just over a decade ago. Buffett's shift into such debt-heavy, capital-intensive businesses as railroads and utilities has represented a marked departure from many of Berkshire's other acquisitions over the years, which have tended to require less ongoing capital investment and have had little to no debt. By definition, these higher-capital businesses will have lower returns than the asset-light businesses Berkshire has acquired. That said, were Buffett to focus on buying more asset-light companies with fewer capital investment needs, it would leave his successors with even greater levels of cash to reinvest in the longer term. During 2014-18, the firm generated an average of $21.8 billion annually in free cash flow. The amount of excess cash Buffett would have needed to find a home for would have been meaningfully higher had Berkshire purchased similar-size companies to BNSF and BHE with similar cash flow profiles that were not investing close to $10 billion on average annually collectively in their own property and equipment.

With BNSF, which was acquired in full in February 2010, Berkshire picked up a Class I railroad operator--an industry designation for a large operator with an extensive system of interconnected rails, yards, terminals, and expansive fleets of motive power and rolling stock. We believe the North American Class I railroads benefit from colossal barriers to entry because of their established, practically impossible-to-replicate networks of rights of way and continuously welded steel rail. While barges, ships, aircraft, and trucks also haul freight, railroads are by far the lowest-cost option when no waterway connects the origin and destination, especially for freight with low value per unit weight. That said, customers have few choices and thus wield limited buyer power, with most Class I railroads operating as duopolies and some being a monopoly supplier to the end client in many markets. This provides the major North American Class I railroads with efficient scale. Believing that railroad operators like BNSF will continue to leverage their competitive advantages of low cost and efficient scale to generate returns on invested capital in excess of their cost of capital over the long run, we have awarded them wide moat ratings.

As for Berkshire Hathaway Energy, which Buffett built up through investments in MidAmerican Energy (supplanting a 76% equity stake taken in early 2000 with additional purchases that have raised its interest to 90.9%), PacifiCorp (acquired in full during 2005), NV Energy (acquired in full at the end of 2013), and AltaLink (acquired in full at the end of 2014), we think the business overall is endowed with a narrow economic moat. While BHE has picked up pipeline assets--which have wide-moat characteristics--the majority of its revenue and profitability (and ongoing capital investment) are driven by its three main regulated utilities: MidAmerican Energy, PacifiCorp, and NV Energy. We think that regulated utilities cannot establish more than a narrow moat around their businesses, even with their difficult-to-replicate networks of power generation, transmission, and distribution, given that their rates, as well as their returns, are set by state and federal regulators.

While Berkshire's manufacturing, service, and retailing operations are the next-largest contributor to pretax earnings as well as our overall estimate of the value of the firm, they comprise a wide array of businesses operating in more than a handful of different industries. Unlike BNSF and BHE, both of which file quarterly and annual reports with the Securities and Exchange Commission, there is little financial information available on the firms operating in this segment. For past deals like Lubrizoil (2011) and Precision Castparts (2015), we've generally had a good sense of the operating profitability and moat characteristics of the operations (with both firms having narrow economic moats), but once they were folded into the manufacturing, service, and retailing segment, it became more difficult to conduct a proper assessment. Given Buffett's penchant for acquiring companies that have consistent earnings power, generate above-average returns on capital, hold little debt, and are run by solid management teams, though, we believe the businesses that make up the segment are collectively endowed with a narrow economic moat. While the recession (and collapse of the housing market) that followed the 2008-09 financial crisis affected many of these businesses, they all benefited from being under the Berkshire umbrella, which allowed them to recover on their own terms.

With Buffett running Berkshire on a decentralized basis, the managers of the company's operating subsidiaries are empowered to make their own business decisions. In most cases, the managers running Berkshire's subsidiaries are the same individuals who sold their firms to Buffett, leaving them with a vested interest in the businesses they run. Barring a truly disruptive event in their industries, we expect these firms to continue to have the same advantages that attracted Buffett to them in the first place. That does not mean that there won't be subsidiaries whose competitive advantages diminish over time (exemplified by the demise of the textile manufacturer that Berkshire Hathaway derives its own name from), it's just that the large collection of moaty firms that reside within Berkshire's manufacturing, service, and retailing operations, as well as its finance and financial products division, is more likely to maintain a narrow economic moat in aggregate, even as a few firms along the way succumb to changing competitive dynamics within their industries.

Fair Value and Profit Drivers 06/07/2019

We've increased our fair value estimate slightly for Berkshire Hathaway to $243 per Class B share. With the company's book value expected to grow at a high-single- to double-digit rate both this year and next, our new fair value estimate is equivalent to 1.48 and 1.35 times our estimates for the company's book value at the end of 2019 and 2020, respectively. For some perspective, during the past five (10) calendar years, Berkshire's shares have traded at an average of 1.48 (1.41) times the company's trailing calendar year-end book value per share. We use a 9% cost of equity in our valuation. We use a sum-of-the-parts methodology to derive our fair value estimate. Our valuation for Berkshire's insurance operations (which includes its equity investment holdings) is $91 per Class B share. Our five-year forecast, which includes both reported and forecasted catastrophe-related losses, has earned premium growth averaging 8.9% per year during 2019-23, with the insurance group's combined ratio averaging 95.0% annually. During the past five (10) calendar years, earned premiums have grown 9.4% (8.4%) on average annually, with the operations maintaining a combined ratio of 96.8% (95.8%) on average. Our fair value estimate for the company's BNSF railroad operations of $50 per Class B share assumes that unit volumes increase at only a 0.7% CAGR during 2019-23 (dragged down by the ongoing secular decline in coal), with freight revenue expanding 3.5% on average annually and the company's operating ratio reaching 60.4% by the end of 2023. For Berkshire's utilities and energy division, our fair value estimate of $19 per Class B share assumes constructive rate-case outcomes for each of the division's U.S. regulated utilities, which should generate results that are near their allowable returns on equity over the next five years. Our valuation for Berkshire's manufacturing, service, and retail operations (which now includes the old finance and financial products segment) is equivalent to $83 per Class B share. This assumes average annual revenue growth of 4.0% during 2019-23, with pretax operating margins averaging around 8.5% annually. Although the MSR segment has provided plenty of opportunity to deploy capital through acquisitions and internal investments, our expectations are for more modest levels of investment going forward, with the unit impacted by an anticipated slowdown in the U.S. economy, as well.

Risk and Uncertainty 06/07/2019

Berkshire is exposed to large potential losses through its insurance operations. While the company believes its catastrophe and supercatastrophe underwriting can generate solid long-term results, the volatility of these business lines, which have the potential to subject the firm to especially large losses, tends to be high. Berkshire maintains much higher capital levels than almost all other insurers, though, which we believe mitigates much of this 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 have an impact on future business combinations, as well as the setting of rates that are charged to customers. On top of that, many of the firm's noninsurance operations are exposed to the cyclicality of the economy, with results typically suffering during economic slowdowns and recessions.

Berkshire is also exposed to foreign currency, equity price, and credit default risk through its various investments and operating companies. The company's derivative contracts, in particular, could affect the firm's earnings and capital position, especially during more volatile markets, given that they are recorded at fair value and are, therefore, updated periodically to reflect the ongoing changes in the value of these contracts. The contracts remaining at year-end 2018 will expire from 2019 through 2025.

Berkshire depends on two key employees, Warren Buffett and Charlie Munger, for almost all of its investment and capital-allocation decisions. With Buffett turning 89 in late August 2019 and Munger turning 95 in early January 2019, it has become increasingly likely that our valuation horizon will end up exceeding their life spans, with the quality of investment returns and capital allocation likely to deteriorate under new management.

Stewardship 06/07/2019

Warren Buffett has been the chairman and CEO of Berkshire Hathaway since 1970. Charlie Munger has served as the company's vice chairman since 1978. 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. Buffett is Berkshire's largest shareholder, with a 31.0% voting stake and a 16.5% economic interest in the firm (based on our estimates following his July 2018 annual charitable donations). Buffett has been a strong steward of investor capital, consistently aligning his own interests with those of shareholders, with Berkshire's wide economic moat derived in part from the success that he has had in melding the firm's financial strength and underwriting ability with his own investment acumen.

Buffett's stewardship has allowed Berkshire to increase its book value per share at an estimated compound annual growth rate of 18.7% during 1965-2018, compared with a 9.7% return for the S&P 500 TR Index. The firm has not only increased its book value per share at a double-digit rate annually 42 separate times during 1965-2018 but has reported declines in its book value just twice during the past 54 years (in 2001 and 2008). While Buffett recently attempted to beg investors off book value per share growth, stating in Berkshire's recent annual report that the "metric has lost the relevance it once had," we still view it as a valuable (if flawed) gauge for assessing changes in intrinsic value--that is, until such time that Berkshire is buying back a ton of stock. Until then, we expect the firm to increase book value per share at a high-single-digit to low-double-digit rate--comfortably above its cost of capital--much as we've seen since the start of the millennium.

Given the impressive long-term track record that Buffett and Munger have put together while at the helm at Berkshire, it is important that much of what they've built remains intact once they depart the scene. Succession was not formally addressed by the company until 2005, when Berkshire noted that Buffett's three main jobs--chairman, chief executive, and chief investment officer--would be handled by one chairman (expected to be his son, Howard Buffett), one CEO (with candidates identified but not revealed), and several external hires (reporting directly to the CEO) to manage the investment portfolio. While we have clarity on the investment side of things, with Todd Combs and Ted Weschler expected to be the only outside hires to work with Berkshire's investment portfolio, questions linger over who the firm's next CEO will be.

We continue to envision the main role of the next chief executive at Berkshire to be one of capital allocator in chief. With all of the company's operating businesses managed on a decentralized basis, eliminating the need for layers of management control and pushing responsibility for each business down to the subsidiary level, Buffett has had the freedom to focus on managing the firm's investments and making capital-allocation decisions. He has noted at times, though, that the job requires more than just investment prowess and, as such, he would not advocate for a candidate to run Berkshire who only had investing experience, with no operational experience to speak of. Buffett has also been vocal about the next CEO coming from within the company's ranks.

We believe Ajit Jain, who was added to Berkshire's board at the start of 2018 and gained the title of Vice Chairman-Insurance Operations, and Greg Abel, who also joined the board and was elevated to Vice Chairman-Noninsurance Business Operations, are the top two candidates to replace Buffett. While Jain is probably the first name the board might turn to, we think Berkshire would be better served longer term having him focus on overseeing the entire insurance business (which his new position allows him to do). While Jain's experience has primarily been on the underwriting side of the business, his success there has been built on his ability to avoid making "dumb decisions" rather than making "brilliant" ones.

If the firm's next CEO is expected to do nothing more than act as a caretaker for the business, tending to the needs of the managers of the different subsidiaries, overseeing the actions of the investment managers handling the company's investment portfolio, and dealing with the capital-allocation and risk assessments that need to be made along the way, then we could not think of a better candidate than Jain. The only problem is that Jain has been on the record several times saying he does not want the job, which is the main reason we regard Abel--who not only brings with him the operational experience of running Berkshire Hathaway Energy for many years but has a ton of experience doing acquisitions--as the most likely choice to succeed Buffett.

Overview

Profile:

Berkshire Hathaway is a holding company with a wide array of subsidiaries engaged in diverse activities. The firm's core business segment is insurance, run primarily through Geico, General Re, Berkshire Hathaway Reinsurance Group, and Berkshire Hathaway Primary Group. The company's next largest segment includes Burlington Northern Santa Fe (railroad) and Berkshire Hathaway Energy (utilities and energy distributors), followed closely in size and importance by its manufacturing, service, and retailing operations (which includes five of Berkshire's largest noninsurance pretax earnings generators: Clayton Homes, Iscar/International Metalworking, Lubrizol, Marmon, and Precision Castparts).