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Berkshire Hathaway's strong balance sheet and management structure give it an edge in acquisitions.



by
 Gregory
 Warren, CFA
 Sector Strategist

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Analyst Note 11/08/2017

A flurry of natural catastrophes and associated flooding led to unusually high claims levels for personal auto insurers in the third quarter. However, looking at the underlying results we're still seeing a significant deviation in growth and profitability for the major players, as the industry continues to adjust to a more general rise in claims. We believe the third quarter highlighted the different competitive situations that the

leading auto insurers face, as distribution channels shift and the impact of telematics potentially starts to show. Following a review of third-quarter results, we are maintaining our fair value estimates and moat ratings for Allstate, Progressive, and Travelers. We continue to believe Progressive is the best-positioned company in the group, but that Travelers offers the best relative value right now.

Investment Thesis 06/01/2017

We think two big concerns--beliefs that Berkshire Hathaway's size will prevent it from growing at a decent clip in the future and that the company's shares will get pummeled once Warren Buffett no longer runs the show--have not only kept some investors on the sidelines but also put a ceiling on the share price, which has rarely risen above 1.5 times book value per share in the eight-plus years since the global equity markets bottomed out during the 2008-09 financial crisis.

While we believe Berkshire is unlikely to consistently increase its book value per share at a double-digit rate--something that happened 10 times during 2001-16--we think it will continue to increase book value per share at a high-single-digit to low-double-digit rate of growth going forward. This will leave results solidly and consistently above Berkshire's cost of capital, which is what we've come to expect from companies with wide economic moats.

As for succession planning, we expect Buffett's three main roles--chairman, CEO, and investment manager--to be split after his retirement. 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. We think there are two fine candidates for the CEO role--Ajit Jain and Greg Abel--both of whom would bring unique insights to the role; our preference would be to have Jain take control of all of Berkshire's insurance operations, while Abel (who has tons of operational and acquisitions experience) fills the role of chief capital allocator.

With investment opportunities few and far between, the company continues to build up large amounts of cash on its balance sheet, which we think (absent legitimate

Morningstar's Take BRK.B

Analyst

Price 11-10-2017	Fair Value Estimate	Uncertainty ⓘ
183.68 USD	193 USD	Medium

Consider Buy ⓘ	Consider Sell ⓘ	Economic Moat ⓘ
135.1 USD	260.55 USD	Wide

Stewardship Rating ⓘ
 Exemplary

Bulls Say

- Book value per share, which is a good proxy for measuring changes in Berkshire's intrinsic value, increased at a 19.0% compound annual growth rate during 1965-2016, compared with a 9.7% return for the S&P 500 TR Index.
- Berkshire's stock performance has been equally strong, increasing at a 20.8% CAGR during 1965-2016. The shares increased at a 16.3% CAGR during 2012-16, compared with a 14.7% CAGR for the S&P 500.
- At the end of the first quarter, Berkshire had \$105 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 and scale of its operations, Berkshire's biggest hurdle longer term will be its ability to consistently find deals that not only add value but are large enough to be meaningful.
- The other big issue facing the firm is the longevity of chairman and CEO Warren Buffett (who turns 87 in August) and managing partner Charlie Munger (who turned 93 in January).
- Berkshire's insurance operations face competitive and highly cyclical markets that occasionally produce large losses, and much of its other operations are economically sensitive and focused more on U.S. markets.

Competitors BRK.B

More...

Name	Price	% Chg	TTM Sales \$ mil
Berkshire Hathaway Inc B	\$183.68	-0.44 ↓	241,574
Berkshire Hathaway Inc A	\$275,660.00	-0.32 ↓	241,574
AXA SA	\$29.25	0.45 ↑	153,940
AXA SA ADR	\$29.44	-0.03 ↓	153,940
Allianz SE ADR	\$23.27	-1.77 ↓	128,727
Allianz SE	\$232.00	-0.72 ↓	128,727

investment opportunities) should be dedicated to dividends and share repurchases longer term. While Berkshire's share-repurchase policy is well known, we believe the firm could easily return one third of its annual free cash flow to shareholders. At the very least, the firm should consider a large one-time special dividend, returning a decent amount of excess cash to shareholders.

Economic Moat 06/01/2017

Berkshire's wide economic moat is more than just a sum of its parts. That said, 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--continue to be important contributors to the overall business. Not only do the insurance operations (sans the investment in Kraft Heinz) account for around one third of Berkshire's pretax earnings (and 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 of funding for investments. 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 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 many 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 the losses in this business tend to be large in nature and may not be realized for years after a policy is written. Insurers can develop sustainable cost advantages, though, by either focusing on less commodified areas of the market or by developing efficient and/or scalable distribution platforms. What they cannot do is gain a sustainable competitive advantage through investing, even when those 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. a decade ago (with 7% of the market) to the second-largest underwriter at the end of 2016 (with a 12% share). 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 over the past five years has averaged around 17%, leaving it more than 700 basis points below the industry average and around 400 basis points better than Progressive. Geico has, however, trailed its closest peer on an underwriting basis, allowing Progressive to produce a combined ratio of 94% on average the past five years, compared with Geico at 96%. Given the similarity in their 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 two reinsurance arms--General Re and BHRG--have economic moats. For a premium, reinsurers will assume all or part of an insurance or reinsurance policy written by another insurer. While any insurance company can technically write 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, 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 arms are unique in that they have the luxury of walking away from business when an appropriate premium cannot be obtained--something their peers cannot always do--their underwriting profitability has been less consistent (due to the nature of the risks that they are underwriting) and much narrower than Berkshire's other insurance businesses. The company sticks with reinsurance because it generates greater amounts of float that can be invested for longer periods 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 two reinsurance arms have come closer than most.

We believe BHPG, which has been Berkshire's most profitable insurance business the past 10 years, benefits from a narrow economic moat around its operations. What is all the more remarkable about this is the fact that BHPG is a conglomeration of multiple insurance operations--including National Indemnity's primary group, Medical Protective Co., U.S. Investment Corp., and Applied Underwriters--that offer coverage as varied as workers' compensation and commercial auto and property coverage. It is also where the company's latest new venture--Berkshire Hathaway Specialty Insurance--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 Berkshire's remaining subsidiaries, Burlington Northern Santa Fe and Berkshire Hathaway Energy are the next two largest contributors to the firm's profitability and overall value, generating around 30% of pretax earnings (and our fair value estimate) for the firm. The most interesting thing about these two particular businesses is that neither of them was a major contributor to Berkshire's pretax earnings 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 his 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 over the years. That said, were Buffett to focus on buying more asset-light companies with fewer capital reinvestment needs, it would leave his successors with even greater levels of cash to reinvest longer term. During the past three calendar years, the firm generated an average of \$17.3 billion annually in free cash flow and is on pace to generate at least \$20 billion in free cash flow during 2017. The amount of excess cash that Buffett would have needed to find a home for would have been meaningfully higher had Berkshire purchased similar-size companies such as BNSF and BHE with similar cash flow profiles that were not investing more than \$4 billion each on average in their own property and equipment the past five calendar years.

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 90.0%), 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 annual and quarterly 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 and Precision Castparts, we've had a pretty good sense of the operating profitability and moat characteristics of the operations (with both firms viewed as having narrow economic moats), but once they were folded into this 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 that the businesses that make up the manufacturing, service, and retailing segment are collectively endowed with a narrow economic moat. The same could also be said for Berkshire's finance and financial products segment, which includes Clayton Homes (manufactured housing and finance), CORT Business Services (furniture rental), Marmon (rail car and other transportation equipment manufacturing, repair and leasing), and XTRA (over-the-road trailer leasing). While the recession (and collapse of the housing market) that followed the 2008-09 financial crisis affected many of these businesses, we believe they have 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 its operating subsidiaries are empowered to make their own business decisions. In most cases, the managers running Berkshire's subsidiaries are the same individuals who originally sold their firms to Buffett, leaving them with a vested interest in the businesses they are running. 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 firms within Berkshire 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.

Valuation 07/14/2017

We've increased our fair value estimate for Berkshire Hathaway's Class B shares to \$193 per share from \$187 to reflect changes in our assumptions about revenue, investment market gains and profitability since our last update. This new fair value estimate is equivalent to 1.6 times Berkshire's reported book value per share of \$119 at the end of the first quarter. With book value per share expected to expand at a high-single- to double-digit rate this year and next, our fair value estimate is

equivalent to 1.5/1.4 times projected book value at the end of 2017/2018, respectively. Our fair value estimate does include an eventual reduction in the statutory U.S. federal income tax rate to 25% (from 35%). Absent tax reform, our fair value estimate would be \$188 per Class B share. We use a sum-of-the-parts methodology to derive our fair value estimate. Our value for Berkshire's insurance operations increased to \$64 per Class B share from \$62, primarily due to changes in our market expectations for the investment portfolio. Our assumptions also include gradually improving underwriting results, slightly higher yields on the credit portfolio (as interest rates increase over time), and a lower statutory tax rate. Berkshire's investment in Kraft Heinz, which we value separately from the insurance operations, is worth \$10 per Class B share. Our fair value estimate for BNSF increased 3% to \$41 per Class B share. This valuation assumes a faster recovery in coal volume (to a more normalized secular rate of decline), increased expectations about operating income growth and returns on invested capital, as well as a decrease on the firm's tax rate longer term. As for the company's utilities and energy division, our fair value estimate for Berkshire Hathaway Energy fell slightly to \$17 per Class B share, given the dilution from the Oncor bid. It also assumes that any benefit from a lower statutory tax rate gets passed on directly to customers. Our fair value estimate for Berkshire's manufacturing, service, and retail operations increased 3% to \$55 per Class B share and assumes mid-single-digit annual revenue growth and high-single-digit operating margins during 2017-21. As for the firm's finance and financial products division, our fair value estimate increased slightly to \$6 per Class B share after we raised some of our long-term expectations and incorporated the Oakwood Homes and Home Capital Group investments into the segment.

Risk 06/01/2017

Berkshire is exposed to large potential losses through its insurance operations. While the company believes its supercatastrophe underwriting can generate solid long-term results, the volatility of this particular line of business, which has 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 some 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 cyclicity of the economy, with results typically suffering during economic slowdowns and recessions.

Berkshire is exposed to foreign currency, equity price, and credit default risk as well through its various investments and operating companies. Its derivative contracts, in particular, can affect the company's earnings and capital position, especially during volatile markets, given that they are recorded at fair value (and are, therefore, updated periodically to reflect changes in the value of these contracts).

Berkshire depends on two key employees, Warren Buffett and Charlie Munger, for almost all of its investment and capital-allocation decisions. With Buffett turning 87 in August and Munger having turned 93 in January, 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.

Management 07/14/2017

Warren Buffett has been chairman and CEO of Berkshire Hathaway since 1970. Charlie Munger has served as 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 32.7% voting stake and a 17.9% economic interest in the firm.

He 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 a compound annual rate of 19.0% during 1965-2016, 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 41 separate times during 1965-2016, but it has reported declines in its book value just twice during the past 52 years (in 2001 and 2008). Even with the firm's overall results being affected by the 9/11 terrorist attack and the 2008-09 financial crisis during the first decade of the new millennium, Berkshire still generated double-digit rates of annual growth in its book value per share seven times during 2001-10. While we think the firm is unlikely to consistently increase its book value per share at a double-digit rate going forward, given the ever-increasing size and complexity of its operations, we believe it can increase book value per share at a high-single-digit to low-double-digit rate of growth during the next five years, much as we've seen since the start of the new millennium.

Given Buffett's impressive long-term record, it is important that much of what he has built over the years will remain intact once he is gone. Succession was not formally addressed by Berkshire until 2005, when the company 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 will be the firm's next CEO.

We continue to envision the main role of the next chief executive to be one of capital allocator in chief. With all of Berkshire'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 (and whoever follows him as CEO should have) the freedom to focus on managing the investments in the firm's portfolio and making capital-allocation decisions. Buffett has, however, noted that the job requires more than investing prowess and that he would not want to put someone in charge of Berkshire who only had investing experience, with no operational experience to speak of. He has also been vocal about the fact that the next CEO will come from within the company's ranks.

At this point, we believe that Ajit Jain, who heads Berkshire Hathaway Reinsurance Group, is the board of directors' first choice to run the company once Buffett steps down. Not only does Jain understand risk better than anyone else at Berkshire, but Buffett has admitted on countless occasions that Jain has "probably made a lot more money" for the firm than Buffett has over the years. 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 decisions 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 that he does not want the job. This is the main reason we regard Greg Abel--who not only brings with him the operational experience of running Berkshire Hathaway Energy for many years but also a ton of experience doing acquisitions--so highly. With insurance still being such a complex and integral part of Berkshire's operations, it makes more sense, in our view, for Jain to stay put longer term, eventually overseeing all of Berkshire's insurance operations, and have Abel assume the CEO role once Buffett leaves the scene.

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 second-largest segment includes Burlington Northern Santa Fe (railroad) and Berkshire Hathaway Energy (utilities and energy distributors). The rest of Berkshire's operations consist of finance, manufacturing, service, and retailing firms.

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