Berkshire Hathaway's Ever-Expanding Cash Hoard Is Its Biggest Near- to Medium-Term Performance Issue

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With wide-moat Berkshire Hathaway's fourth-quarter and full-year operating results being more or less in line with our expectations, we are leaving our $360,000 ($240) per Class A (B) share fair value estimate in place. Full-year operating revenue increased 3.3% to $247.8 billion. Including the impact of investment and derivative gains/losses, Berkshire's top line decreased 6.9% to $225.4 billion. With expenses increasing at a slower rate than revenue and the company seeing a marked improvement in insurance underwriting profitability (aided by the lapping of a difficult catastrophe year in 2017), full-year pretax operating earnings (excluding the impact of investment and derivative gains/losses and other events) increased 36.4% year to year to $29.2 billion. Including the impact of investment and derivative gains/losses and other adjustments, full-year net earnings (aided by a reduction in the U.S. corporate income tax rate from 35% to 21%) declined 91.1% to $4.0 billion.

Book value per Class A equivalent share, which the firm has historically pointed to as a good proxy for measuring changes in Berkshire's intrinsic value, increased just 0.4% year to year to $212,503, affected by a $3.0 billion noncash loss arising from an impairment of Berkshire's equity interest in Kraft Heinz and a $20.6 billion loss associated with changes in unrealized capital gains on the insurer's investment holdings. The company closed out 2018 with $111.9 billion in cash and cash equivalents, up from $103.6 billion at the end of the third quarter, which should have left Berkshire with around $90 billion in dry powder to be used for investments, acquisitions, share repurchases, and dividends. While the company engaged in very little acquisition activity last year, Berkshire dedicated $43 billion (funded by $19 billion of equity sales) to marketable equities last year and spent another $1.3 billion on share repurchases.

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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 1.45 times book value per share, we think share repurchases are unlikely.

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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 (excluding the investment in Kraft Heinz) generally 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. 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 2017 (with a 13% 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 averaged
around 16% during 2013-17, leaving it more than 800 basis points below the
industry average and around 500 basis points better than Progressive. Geico has,
however, trailed its closest peer on an underwriting basis, allowing Progressive to
produce a combined ratio of 93% during 2013-17 compared with Geico at 97%.
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 reinsurance arm--consisting of the old General Re
business 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 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 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 2013-17, the firm generated an
average of $20 billion annually in free cash flow. 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 to BNSF and BHE with similar cash
flow profiles that were not investing more than $4 billion each on average annually in
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 90.4%), 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. The same could 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, 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 02/20/2019**

We've increased our fair value estimate for Berkshire Hathaway to $240 per Class B share from $220. With book value expected to grow at a high-single-digit rate this year and next, our new fair value estimate is equivalent to 1.45 and 1.32 times our estimates for book value per share at the end of 2019 and 2020, respectively. For some perspective, during the past five (10) calendar years, the company's shares have traded at an average of 1.45 (1.35) times trailing book value. 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 is $83 per Class B share. Our five-year forecast, which includes both reported and forecasted catastrophe-related losses, continues to include an improvement in underwriting results, with earned premium growth averaging 6.2% (9.4%) per year and the insurance group's combined ratio averaging 95.5% (95.8%) annually during 2018-22 (2019-22). Berkshire's investment in Kraft Heinz, which we value separately from the insurance operations, is worth $9 per Class B share. Our fair value estimate for the company's BNSF railroad operations is $52 per Class B share. This valuation assumes a more normalized volume outlook for the railroad following a strong year period of recovery during 2017-18. We expect unit volume to increase at a 1.9% CAGR during 2018-22, with freight revenue expanding 5.0% on average annually and the company's operating ratio reaching 61.2% by the end of 2022. For Berkshire's utilities and energy division, our fair value estimate of $19 per Class B share assumes constructive rate-case outcomes for the division's U.S. regulated utilities, which should generate results that are near their allowed returns on equity over the next five years. Our valuation for Berkshire's manufacturing, service, and retail operations is $70 per Class B share. This valuation assumes revenue grows 4.6% annually during 2018-22, with pretax operating margins expanding 20 basis points annually on average over the course of our projection period. 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. As for the firm's finance and financial products division, our fair value estimate is $7 per Class B share.

**Risk and Uncertainty 02/20/2019**

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 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 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.
Berkshire depends on two key employees, Warren Buffett and Charlie Munger, for almost all of its investment and capital-allocation decisions. With Buffett turning 88 in late August 2018 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 02/20/2019**

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 19.1% during 1965-2017, compared with a 9.9% 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 1965-2017 but also reported declines in its book value just twice during the past 53 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 millennium.

Given Buffett's impressive long-term track record of increasing both book value per share and the value of Berkshire's own shares over the years, it is important that much of what he has built remains 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 the firm's next CEO will be.

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 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 investing 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 continue to 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 second-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. The rest of Berkshire's portfolio consists of its finance and financial products segment, which is involved in manufactured housing and finance, furniture rental, and rail car and other transportation equipment manufacturing, repair, and leasing.