Berkshire Hathaway Inc Class B BRK.B | ★★★★

Sheer size and Warren Buffett's ultimate departure will limit Berkshire's returns longer term.

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Morningstar's Editorial Policies

Analyst Note 12/31/2013

We recently noted that Berkshire Hathaway CEO Warren Buffett was likely to be pleased with the acquisitions his firm has announced during 2013 (which included Heinz, NV Energy, and a spattering of other smaller firms by Berkshire's subsidiaries), but that we expected him to highlight the need to invest the company's growing cash hoard into more permanent holdings. Therefore, we were not too surprised to see the firm announce another deal Monday. Still, its purchase of Phillips Specialty Products, a business that makes chemicals to improve the flow potential of pipelines, from Phillips 66 for around $1.4 billion will do little to reduce Berkshire's cash balance, which we expect to total around $50 billion at year-end, as the insurer is swapping around 19 million shares of Phillips 66's common stock that it already owns for the chemical firm. Berkshire held 27.2 million shares of the energy company's shares (worth $1.6 billion) at the end of the third quarter of 2013. Once the deal closes in the first half of 2014, Phillips Specialty Products will be rolled into Berkshire's Lubrizol operations, which are housed in the insurer's manufacturing, service, and retailing segment. Given that Berkshire is swapping equity that it already owns in Phillips 66 for this business, we do not expect the deal to have a material impact on our fair value estimates of $215,000 per Class A share and $143 per Class B share or our wide moat rating.

Investment Thesis 12/30/2013

Our two biggest concerns about Berkshire Hathaway continue to be the firm's ability to expand the business (given its current size and the need to consistently find deals that not only add value but also are large enough to be meaningful) and the company's planning for the day when Warren Buffett no longer runs the show (given that both he and Charlie Munger are octogenarians).

While the firm is likely to continue to putting money to work in value-creating projects in the near to medium term, much as it has in the past, we think the huge sums of cash Berkshire generates and maintains on its balance sheet will ultimately limit its ability to produce outsize returns. Over the past year alone, the company has seen its cash balance increase from $47 billion to $50 billion (which is earning next to nothing), even after it committed $12 billion to the purchase of Heinz. Much of this has been due to the fact that Berkshire continues to see capital that was lent out at extremely lucrative rates to several different companies during the 2008-09 financial

Morningstar's Take BRK.B

Analyst

Price 01-10-2014	Fair Value Estimate	Uncertainty
114.97 USD	143 USD	Medium
Consider Buy	**Consider Sell**	**Economic Moat**
100.1 USD	193.05 USD	Wide

Stewardship Rating
Exemplary

Bulls Say

- Book value per share, which is the best proxy for measuring changes in Berkshire's intrinsic value, increased at a compound annual rate of 19.7% from 1965 to 2012, compared with a 9.4% total return for the S&P 500 TR Index.
- Berkshire's long-term 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 2013, Berkshire had $77 billion in float from its insurance operations. The cost of float has been negative for the past decade.

Bears Say

- Given the size of its existing operations, the biggest hurdle facing Berkshire will be its ability to consistently find deals that not only add value but also are large enough to be meaningful.
- The other big issue facing the firm is the longevity of chairman and CEO Buffett and managing partner Munger, both of whom are octogenarians.
- Berkshire's insurance operations face highly competitive and

  cyclical markets and occasionally will produce large losses. It also has highly uncertain liabilities, including potential asbestos claims, which could cost more than the firm has stated.

Competitors BRK.B

More...

Name	Price	% Chg	TTM Sales $ mil
Berkshire Hathaway Inc Class B	**$114.97**	**-0.30** ↓	**179,821**
Berkshire Hathaway Inc Class A	$172,540.00	-0.25 ↓	179,821
AXA SA ADR	$27.82	0.68 ↑	165,713
Allianz SE	$176.55	1.08 ↑	139,764
Allianz SE ADR	$17.77	1.48 ↑	139,764
American International Group Inc	$52.22	0.21 ↑	63,245

crisis come back to firm.

We expect that Buffett, who was disappointed to not land any big deals in 2012, will be pleased with the acquisitions announced during 2013, which included NV Energy and a collection of other smaller firms by Berkshire's subsidiaries, but will also highlight the need to reinvest the capital that keeps coming into the coffers into more permanent holdings. We continue to believe that future investments will skew more toward capital-intensive businesses like Burlington Northern Santa Fe and MidAmerican Energy Holdings, if only because these types of investments help to reduce the number of capital-allocation decisions that individuals other than Buffett will need to make in future periods.

The other major issue facing Berkshire is the continued lack of clarity that investors have on the company's succession plans. While Buffett did acknowledge this past year that the board has a CEO candidate selected (and two backups at the ready), this has done little, in our view, to quell investor concerns about the impact that Buffett's ultimate departure will have on the firm.

Economic Moat 12/30/2013

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 most important business continues to be its insurance operations. Not only do they contribute a fair amount of its pretax earnings, but they also generate low-cost float (the temporary cash holdings that arise from premiums being collected well in advance of future claims)--a major source of funding for Berkshire's investments. We do not believe the insurance industry itself is all that conducive to the development of sustainable economic moats, though. Even with all of the advantages Berkshire has with its own operations, it insurance businesses--composed primarily of property and casualty insurance and reinsurance--benefit from no more than a narrow economic moat. While much can be made of Buffett's investment abilities, represented by the more or less "permanent" stock investment portfolio that exists within Berkshire's insurance operations, our belief is that insurance companies create durable competitive advantages only through insurance profitability, achieved through superior underwriting abilities and/or some sort of cost advantage.

Of the more than 70 noninsurance businesses that make up Berkshire's remaining collection of operating subsidiaries, Burlington Northern Santa Fe and MidAmerican Energy Holdings Company are the next two largest contributors to Berkshire's pretax earnings and collectively account for around one fourth of 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 earnings a decade ago, with Buffett's shift into such debt-heavy, capital-intensive businesses as railroads and utilities representing a marked departure from many of his other investments, which have tended to require less ongoing capital investment and have had little to no debt on their books. Buffett entered into these businesses, despite the fact that they would require massive amounts of capital reinvestment, because they could earn decent returns on incremental investments longer term.

With BNSF, which was acquired in full by Berkshire in February 2010, the firm picked up a Class I railroad operator, which is 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 that 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. Also, rail customers have few choices and thus wield limited buyer power, highlighting the fact that most railroads operate as a duopoly in most markets, and that some may even be a monopoly supplier to the end client in many cases.

Believing that North American Class I railroads like BNSF will 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 MEHC, which Berkshire built up through investments in MidAmerican Energy (supplanting a 76% equity stake taken in early 2000 with additional purchases that have raised its interest up to 89.8%) and PacifiCorp (acquired by MEHC in full during 2005), we think the business overall is endowed with a narrow economic moat. While MEHC has picked up some pipeline assets, which can have wide-moat characteristics, the majority of its revenue and profitability (and ongoing capital investment) continues to be driven by its two main regulated utilities--MidAmerican Energy and PacifiCorp. Regulated utilities, have had, in our view, a more difficult time establishing 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 and the overall value of the firm, they comprise a wide array of businesses operating in more than a handful of different industries. Unlike BNSF and MEHC, 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. Given Buffett's penchant for acquiring companies that have consistent earnings power, generate above-average returns on capital, have little debt, and are run by solid management teams, we believe these businesses are collectively endowed with a narrow economic moat. The same could also be said for Berkshire's finance and financial product segment, which includes Clayton Homes (manufactured housing and finance) and CORT Business Services (furniture rental). While the disruption caused by the 2008-09 financial crisis and the collapse of the housing market may have affected these businesses, much like it did some of Berkshire's other subsidiaries--like Benjamin Moore, Shaw, Acme, and Johns Manville--there are moaty characteristics in these subsidiaries.

With Buffett running Berkshire on a decentralized basis, the managers of these operating subsidiaries are empowered to make their own business decisions. In most cases, these managers are the same individuals who originally sold their firms to Buffett, leaving them with a vested interest in the businesses they are running, such that barring a truly disruptive event in their industries these firms are likely 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 (exemplified most ironically by the textile manufacturer that Berkshire Hathaway derives its own name from)--it's just that the large collection of moaty firms that reside in Berkshire's noninsurance/railroad/utility operations is more likely to maintain a narrow moat in aggregate, even as a few firms along the way succumb to changing competitive dynamics in their industries.

Adding up all of the firm's operating subsidiaries leaves Berkshire with a fairly solid narrow economic moat, with many wide-moat characteristics existing within the portfolio. What has traditionally put the firm over the top, though, has been its ability to take the excess cash flows generated by these different businesses (as well as the float that is provided by its insurance operations) and invest them back into projects that have tended to earn more than the Berkshire's cost of capital. While a company's management team by itself is not sufficient, in our view, to create an economic moat, it can add to, as well as detract from, the competitive advantages that may exist for a firm. In Berkshire's case, Buffett and Munger have been integral to the company's success over the past 50 years. Their ability to take the cash generated by Berkshire's various operations and consistently invest it back into projects that have on average earned more than the firm's cost of capital has, in our view, allowed Berkshire to build a wide economic moat.

Valuation 12/30/2013

Our fair value estimate for Berkshire Hathaway's Class B shares is $143 per share, which is equivalent to 1.7 times Berkshire's reported book value per Class B share of $85 at the end of the third quarter of 2013. With book value per share expected to grow 15% for the full year and another 12% next year, our fair value estimate is equivalent to 1.6 times book value at the end of 2013 and 1.5 times book value at the end of 2014.

We arrive at our overall fair value estimate using a sum-of-the-parts methodology, which values the different pieces of the company's portfolio separately and then combines them to arrive at a total value for the firm. We estimate that Berkshire's insurance operations are worth $71 per Class B share. While the firm's insurance operations have struggled with underwriting profitability this past year, primarily due to lost business and catastrophe losses in its reinsurance arms, they continue to generate impressive gains with the investment portfolio. We expect underwriting profitability to improve in 2014, with the firm's insurance operations posting more normalized levels of profitability in future years.

We estimate that Berkshire's railroad, utilities, and energy operations are worth $35 per Class B share, with BNSF continuing to account for the lion's share of the valuation for these two businesses. BNSF has benefited from increased rail volume (especially in industrial products, which includes petroleum shipments) and from higher average revenue per car/unit this past year, both of which we expect to continue in the near to medium term.

Berkshire's utilities and energy operations--combined under MEHC--continue to invest for the future, committing capital to existing infrastructure improvements, as well as to acquisitions like the purchase of NV Energy (which is expected to close in the first quarter of 2014). As a result, we expect above-average levels of revenue growth in the near to medium term, followed by more normalized levels of growth and profitability as MEHC digests its acquisitions and continues to operate as one of the stalwarts in Berkshire's portfolio.

Our fair value estimates for Berkshire's manufacturing, service, and retailing operations, as well as for its finance and financial products division, remain in place at $31 and $6 per Class B share, respectively.

Risk 12/30/2013

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 losses, could be high. Berkshire maintains much higher capital levels than almost all other insurers, however, which we believe helps to mitigate 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 and the setting of rates charged to customers. Berkshire also is 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 affect

Berkshire's earnings and capital position, especially during volatile markets, given that they are recorded at fair value and, therefore, are 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.

The company also depends heavily on two key employees, Buffett and Munger, for almost all of its investment and capital-allocation decisions. With both men now in their 80s, it has become increasingly likely that our valuation horizon will end up exceeding their expected life spans, with the expectation being that investment returns and capital-allocation quality will deteriorate under new management. The 2011 departure of David Sokol, who many had assumed would be Berkshire's next CEO, has raised serious questions as well about the firm's internal controls and, to some extent, tarnished its legacy of strong ethical behavior.

Management 12/30/2013

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 35% voting stake and 21% economic interest in the firm. He has been a strong steward of investor capital, consistently aligning his own interests with those of shareholders, and Berkshire's economic moat is derived primarily 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 19.7% from 1965 to 2012, compared with a 9.4% total return for the S&P 500 TR Index. While the 15% increase in Berkshire's book value per share that we forecast for 2013 will fall short of the 30% increase seen in the benchmark index (which includes dividends as well as price appreciation), it will mark only the 10th time in the past 49 years that this has happened. It should be noted, though, that in nine of those ten years the S&P 500 posted gains in excess of 15% (much like we're seeing this year). The company has never had a five-year period of underperformance relative to the benchmark, but given the gains we've seen in the S&P 500 during 2013, that streak will end as well this year.

Given the impressive long-term record that Buffett has put together, it is even more important that his legacy remains intact once he no longer runs the firm. Succession was not formally addressed by Berkshire until 2005, when the firm 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 one candidate already identified but not revealed), and three or more external hires (reporting directly to the CEO) to manage the investment portfolio. While we have gained a little more clarity about the plan for the investment side of the business, with Todd Combs and Ted Weschler likely to be the only outside hires brought in to take responsibility for the investment portfolio, questions linger over who will step into the CEO role.

At this point, our best guess is that Ajit Jain, who heads up Berkshire Hathaway Reinsurance Group, will run the company once Buffett steps down. Not only does Jain understand risk better than just about 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 period that Jain has been with Berkshire. 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--attributes that have kept him in good stead with Buffett over the years.

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 that run all of the different subsidiaries, overseeing the actions of the investment managers that handle the company's investment portfolio, and dealing with the capital-allocation decisions and critical risk assessments that need to be made in any given year, then we could not think of a better candidate within Berkshire than Jain. That last point is an important one, since Buffett has said on more than a few occasions that it would be highly unlikely for the next CEO at Berkshire to come from outside the firm. He has also noted that the board of directors would gladly support Jain as the company's next chief executive if he decided to seek the post. The problem is that Jain has been on the record several times saying that he does not want the job, which is the main reason for the ongoing speculation about other potential candidates for the CEO role at Berkshire.

Regardless of which individual takes the helm once Buffett has stepped down, we think the next chief executive is going to feel far more pressure from shareholders and analysts than Buffett has ever been subjected to, especially with regards to capital-allocation decisions and the firm's lack of a dividend. As such, the real long-term question for investors is whether the individual who succeeds him can replace the significant advantages that have come with having an investor of Buffett's caliber, with the knowledge and connections he has acquired over the years, running the show.

Overview

Profile:

Berkshire Hathaway is a holding company with a wide array of subsidiaries engaged in a number of diverse 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 second-largest segment includes Burlington Northern Santa Fe (railroad) and MidAmerican Energy (utilities and energy distributors). The rest of its operations comprise finance, manufacturing, and retailing operations.