BERKSHIRE HATHAWAY

In Search of the "Buffett Premium" (Sample Edition)

The corporate identity of Berkshire Hathaway will always be inextricably linked to the remarkable career and investment track record of Warren Buffett. Mr. Buffett's tenure at the company has spanned nearly five decades and has transformed a dying textile business into one of the world's largest and most respected conglomerates with operations ranging from insurance, utilities, and railroads to candy, underwear and bricks. Berkshire is not only respected based on its impressive financial results, but also due to the unique business philosophy that often makes the company the only logical buyer for high quality family businesses. While Mr. Buffett has shown no signs of stepping down anytime soon, his 80th birthday last year increased speculation regarding succession.

In this report, we consider succession issues as well as evaluate Berkshire Hathaway's intrinsic value in search for any evidence of a "Buffett Premium". Based on current business fundamentals, we estimate the intrinsic value of Berkshire at between $150,000 and $170,000 per Class A share.

Ravi Nagarajan
The Rational Walk LLC

March 1, 2011

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The Rational Walk website may be accessed at http://www.rationalwalk.com. Additional information regarding Berkshire Hathaway and other investment topics may be found on The Rational Walk. Ravi Nagarajan is Managing Editor of The Rational Walk.

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In Search of the "Buffett Premium"

"I think the top guy won't be as smart as Warren. But it's silly to complain: What kind of world is this that gives me Warren Buffett for 40 years and then some bastard comes along who's worse?" [1]

-- Berkshire Hathaway Vice Chairman Charles T. Munger

The typical chief executive of a major American corporation may have a demanding job, but his or her efforts tend to be mostly anonymous from the perspective of the average citizen who does not closely follow business news. The exceptions involve a handful of "celebrity CEOs" who have name recognition similar to the most important political and cultural figures in society. Individuals like Steve Jobs, Bill Gates, Jack Welch, and many others are widely recognized and almost synonymous with the companies they have been associated with.

Warren Buffett is perhaps the most visible example of a CEO who has captured the attention of the public at large. During the height of the financial crisis in the fall of 2008, Mr. Buffett's comments on the economy were accorded as much respect as the pronouncements from the White House, Treasury, or the Federal Reserve, and perhaps more so. Through his investment activities, Mr. Buffett had the power to bestow a "seal of approval" on businesses like Goldman Sachs and General Electric that meant far more to markets and investors than any amount of bailout funds from the government.

Given Mr. Buffett's investment track record, name recognition, and obvious management skills, it is unsurprising that investors viewed his eightieth birthday in August 2010 with trepidation. While Mr. Buffett is reportedly in excellent health and has no plans to step down as Chairman and CEO of Berkshire Hathaway, the human condition makes it obvious that at some point the company's succession plan will be triggered.

While it is self-evident that Mr. Buffett's successor cannot possibly replicate his skill set, it is not satisfactory to simply make this observation and conclude that Berkshire Hathaway will not continue to prosper in the future. While many executives may take satisfaction in the fact that they cannot be replaced, the truly great manager is one who builds a business and corporate culture that can be sustained by successors. Mr. Buffett has certainly attempted to do so, but has he succeeded?

Contrary to popular belief, Berkshire Hathaway is not simply a closed end mutual fund managed by Warren Buffett. While Mr. Buffett's unique skills have created tremendous value for shareholders over the past forty-six years, the company has evolved into a holding company owning subsidiaries engaged in a wide range of activities. Berkshire's most important operating segment is insurance. GEICO, General Re, and Berkshire Hathaway Reinsurance Group form the core of the insurance subsidiaries and generate large amounts of "float" that can be invested on behalf of shareholders. Berkshire's other subsidiaries are engaged in a wide variety of manufacturing, transportation, utility, service, and diverse retail operations.

Berkshire Hathaway's subsidiaries are run as independent entities with managers responsible for operating decisions. Mr. Buffett is responsible for providing oversight for each subsidiary CEO but he has a reputation for having a hands-off management approach when it comes to operations. Capital allocation is another matter. Rather than delegating capital allocation decisions to each subsidiary CEO, Mr. Buffett takes charge of the free

cash flow generated by each subsidiary and reallocates capital either across Berkshire's existing operating subsidiaries, to investments in marketable securities, or by purchasing additional operating subsidiaries. This practice is a major competitive advantage, particularly when a capital allocator of Mr. Buffett's caliber is in charge of the process.

We will attempt to shed light on the factors that matter the most when it comes to evaluating Berkshire Hathaway's business operations and estimating intrinsic value. Of course, this involves a careful analysis of Berkshire's historical financial results and future prospects, but a critical variable involves the special skill set that Warren Buffett brings to the table. For the remainder of Mr. Buffett's tenure at Berkshire Hathaway, shareholders will benefit from his unique and irreplaceable talents.

No one can predict how long Mr. Buffett will remain at Berkshire Hathaway, but we can attempt to identify areas where his special talents are adding value for shareholders and will not be easily replicated by his successor. The question of whether Berkshire Hathaway's stock price implies a "Buffett Premium" hinges on whether investors are paying a price today for the incremental value Mr. Buffett will provide to the company for an indeterminate number of years into the future.

We will argue that the value derived from the following activities will be particularly difficult for Berkshire Hathaway to replace once Mr. Buffett is no longer involved in running the company:

1. **Acquisitions of family-run businesses.** Many of Berkshire Hathaway's most successful acquisitions have involved family businesses run by founders who wish to protect their legacy and are attracted to Berkshire rather than to private equity buyers or the pursuit of an initial public offering. Sellers have often been willing to accept less than "top dollar" due to the benefits of selling to Berkshire. While a significant part of the motivation for these family run businesses will remain as long as Berkshire's unique corporate culture remains intact, the intangible benefits of "selling to Warren Buffett" will not likely extend to selling to his successor. When Warren Buffett decides to purchase a business, the decision forever puts a "stamp of approval" on the legacy of the founder. It is nearly certain that this intangible ego-enhancing factor for potential sellers will dissipate once Mr. Buffett is no longer in charge of capital allocation. However, a mitigating factor is that as Berkshire grows, fewer potential acquisitions will involve buying businesses directly from founders or their direct descendants due to increasing minimum purchase sizes.

2. **Opportunistic Investments in Times of Distress.** When Goldman Sachs and General Electric agreed to the terms of Berkshire's investments in the fall of 2008, part of the motivation involved a need for capital but Mr. Buffett's "stamp of approval" was likely to have been an even greater factor. While Mr. Buffett's successor will have the financial wherewithal to make similar commitments, it is questionable whether the intangible benefits of the cash infusion would be as beneficial for the recipients. Therefore, the terms of such investments may be less favorable. In addition, Berkshire's Board of Directors and shareholders may not be willing to give as much latitude to the next CEO when it comes to making such investments. Although the 2008 financial crisis is already receding into the rear view mirror, at the time of Berkshire's cash infusions into Goldman Sachs and General Electric, few perceived the investments as "slam dunks".

3. **Overall Capital Allocation.** Berkshire Hathaway's unique approach to capital allocation allows the company to redirect free cash flow from subsidiaries that lack growth prospects into subsidiaries or new investments where attractive opportunities exist. Mr. Buffett's role at Berkshire will be split into three parts in the future: Chairman, Chief Executive Officer, and Chief Investment Officer. While the selection of Todd Combs to serve as one of potentially many investment managers received a great deal of attention in October 2010, the question of who will succeed Mr. Buffett as CIO is still an open question. While it is very reasonable to assume that a capable individual will take over, it is unreasonable to assume that his or her capabilities will approach Mr. Buffett's when it comes to capital allocation. In addition, the working relationship between the future CEO and CIO is also unknown at this point and close collaboration will be required to optimize results. Good working relationships of this type are rare and often fraught with peril.

Mr. Buffett's 2010 letter to shareholders made it clear that the individual or individuals charged with managing Berkshire's portfolio will be consulted when it comes to capital allocation matters but the Chief Executive, with oversight from the board, would have the final say over all decisions. Some analysts have questioned whether this means that Berkshire will not have a CIO role. However, we interpret the statement simply to mean that any future CIO would report to the CEO which is what we had assumed in the past as well.

An important question facing investors is whether Berkshire Hathaway's current share price implicitly assumes that Warren Buffett's irreplaceable skills will be available to the company for a number of years into the future. While achieving exact mathematical precision for the extent of this added value is not possible, we can use conservative assumptions when evaluating each of Berkshire's areas of value. If investors use conservative assumptions when deciding how much to pay for shares, substantial upside may be realized over the coming years as Mr. Buffett continues to add incremental value beyond what his successor could deliver. Rather than paying a "Buffett Premium", investors may receive a free "Buffett Option" for any superior achievements yet to come in Mr. Buffett's career. We would note that concerns over succession planning at Berkshire have existed for well over a decade and this has not stopped Mr. Buffett from continuing to add value well beyond normal retirement age.

At recent market prices, Berkshire Hathaway appears to be undervalued when evaluated using multiple valuation models. We will argue that there is no "Buffett Premium" in Berkshire's current quotation. Additionally, we will explain why Berkshire Hathaway is more prepared for eventual management succession than most large companies. However, first we will take a step back and briefly look at Warren Buffett's investment philosophy as it developed during his early years. We will then evaluate Berkshire Hathaway's key drivers of value and come up with a range of intrinsic value using three valuation models.

The following table presents our estimate of Berkshire Hathaway's intrinsic value per A share based on three valuation models:

Valuation Method	Intrinsic Value per A Share
Float Based Approach	$170,000
"Two Column" Approach	$154,000
Multiple of Book Value Approach	$150,000

Exhibit 1: Valuation Summary

While we believe that the float based valuation approach is the most appropriate measure of Berkshire Hathaway's intrinsic value, the "two column" and multiple of book value approaches are presented as well in an attempt to provide a range of value. We estimate Berkshire Hathaway's range of intrinsic value at $150,000 to $170,000 per Class A share or $100 to $113 per Class B share. Class B shares have the economic rights of 1/1500 of a Class A share.

Based on the closing quotation of Berkshire Hathaway Class A stock of $131,300 on February 28, 2011, the company is trading moderately below our low range of intrinsic value and significantly below the high range. Since we consider the float based approach to most accurately measure intrinsic value, we view the low end of the range as the lowest conceivable estimate of fair value. In our view, a substantial margin of safety exists for shareholders based on Berkshire's current quotation.

From Cigar Butts to Business Supermodels

There are numerous books and publications that provide detailed accounts of the history of Berkshire Hathaway as well as Warren Buffett's life and career. Additionally, it is impossible to fully understand Berkshire without studying the life and career of Vice Chairman Charles T. Munger. A list of resources for those interested in a comprehensive history of the company and its leaders is provided as an appendix to this report. This section attempts to provide some context regarding the remarkable early history of Berkshire Hathaway and the evolution of Warren Buffett's investment approach.

Warren Buffett's Early Investment Philosophy

Warren Buffett's early investment philosophy was largely based on the principles developed by Benjamin Graham. Mr. Buffett has stated on many occasions that his view of investing changed dramatically when he first read Mr. Graham's book, *The Intelligent Investor*, in early 1950[1]. Up to that point, Mr. Buffett had read every book on investing available at the Omaha public library but none were as compelling as Mr. Graham's straight forward approach summarized in the phrase: "Margin of Safety".

Benjamin Graham's approach is more fully documented in *Security Analysis* which, in contrast to *The Intelligent Investor,* is primarily aimed at professional investors. Mr. Graham's process involves examining securities from a quantitative perspective and making purchases only when downside risks are minimized. This approach rarely involved speaking to management since doing so could adversely influence the analyst's impartial view of the data. In particular, Mr. Graham was a proponent of purchasing stocks selling well under "net-net current asset value" arrived at by taking a company's current assets and subtracting *all liabilities*. In such cases, the buyer was paying nothing for the business as a going concern and had some downside protection due to liquid assets far in excess of all liabilities.

Mr. Buffett was able to leverage the "deep value" approach advocated by Benjamin Graham throughout the 1950s. In the five year period ending in 1961, the Buffett Partnerships trounced the Dow Jones Industrial average with a cumulative return of 251 percent compared to 74.3 percent for the Dow[2]. While Mr. Buffett employed multiple strategies, one approach involved finding companies that fit the "cigar butt" mold, meaning that they had "one puff left" and could be purchased at a deep bargain price. Companies such as Sanborn Map and Dempster Mill Manufacturing were textbook cases where Benjamin Graham's investment approach could be applied.

Mr. Buffett began to acquire shares of Berkshire Hathaway, a struggling New England textile manufacturer, in late 1962. While Berkshire Hathaway was trading well under book value at the time, Mr. Buffett would later say that book value "considerably overstated" intrinsic value[3]. In this section we take a brief look at Dempster Mill and Berkshire Hathaway as examples of the "cigar butts" Mr. Buffett favored at the outset of his career and then turn our attention to Berkshire's transformation with the purchase of National Indemnity in 1967 and a shift to higher quality businesses with the purchase of See's Candies in 1972. While the merits of investing in "cigar butts" cannot be denied, it is safe to say that Berkshire Hathaway would be a fraction of its current size had Mr. Buffett not turned his attention to higher quality "business supermodels" by the early 1970s.

Tilting At Windmills

Warren Buffett was at least fifty years ahead of the times if his goal was to buy into a "trendy" business when his partnership began to accumulate shares of Dempster Mill Manufacturing Company in 1956. Dempster was in the business of manufacturing and selling windmills and various types of farm equipment and was headquartered in Beatrice, Nebraska, a small town not far from Omaha. The company was a classic "cigar butt" and was selling for $18 per share at a time when book value was $72 per share[4].

The Buffett Partnership continued to slowly accumulate shares of Dempster until Mr. Buffett controlled more than 70 percent of the outstanding shares by the middle of 1961. The stake accounted for a fifth of the partnership's total assets. Although Dempster was a cheap business from a price to book value basis, the company was struggling to generate an acceptable return on invested capital. After Mr. Buffett assumed the Chairman role at Dempster, he was faced with decision to either liquidate the business or to fix the company as a going concern. Faced with uncooperative management that appeared unwilling to change course, Mr. Buffett recruited Harry Bottle, an experienced operating manager, to implement a number of changes that dramatically reduced the capital requirements of the ongoing business. As a result, the company was significantly overcapitalized by mid-1963.

The goal of the reorganization was to allow Mr. Buffett to redeploy assets from an underperforming manufacturing business with a poor return on capital toward more productive uses. In 1963, Dempster's operating business was sold and excess cash and securities not required to run the business were distributed to shareholders. Ultimately, the Buffett Partnership nearly tripled its investment and netted a $2.3 million profit[5].

While the final result turned out to be highly profitable for the partnership, by all accounts the process of achieving this result was unpleasant for Mr. Buffett for a number of reasons. First, the outcome depended in part on "fixing" a business that had been underperforming for years. It was only after hiring Mr. Bottle that a turnaround took place. Second, the process involved layoffs and led to heavy criticism of Mr. Buffett in Beatrice since Dempster was a large employer[6]. Although these layoffs and other cost cutting measures almost certainly prevented a bankruptcy and a loss of *all* of Dempster's jobs, the reputational damage of taking the steps to fix an ailing business could not have been pleasant. One of the unpleasant tasks associated with fixing a business often involves making changes at the top, and by all accounts this was a bruising process at Dempster. The process apparently did not go smoothly because Mr. Buffett later received a letter from the wife of the former CEO accusing him of being "abrupt and unethical" and destroying her husband's self confidence. Mr. Buffett's long standing aversion to firing employees may date back to this incident.[7]

It is often possible to fix a business that is fundamentally sound and suffers from poor management, but sometimes any attempt to do so ends up simply "tilting at windmills". At the end of the restructuring process, Dempster survived, many jobs were saved, and the partnership had funds to redeploy elsewhere[8]. However, Mr. Buffett would soon take control of another manufacturing business where the problems ultimately could not be fixed: Berkshire Hathaway.

Berkshire Hathaway: A $200 Billion Mistake?

Berkshire Hathaway, as it existed in 1963 when the Buffett Partnership became the company's largest shareholder, was a *cheap company* from a quantitative perspective but it was not a *good company* in terms of operating a business that had durable competitive advantages. In fact, over the next two decades, Berkshire Hathaway continued to make modest investments in the textile mills but would never gain sufficient traction to face off against overseas competitors with lower cost structures.

Textiles are a commodity business and the low cost producer has the advantage. Mr. Buffett later characterized his purchase of Berkshire Hathaway as a significant mistake, perhaps not so much because of the initial purchase as the decision to continue operating the mills for another two decades in the face of high opportunity costs[9]. However, while Berkshire's textile mills were doomed to eventual failure, a period of profitability appeared in the mid to late 1960s that presented Mr. Buffett with the opportunity to reinvest cash flows into more attractive opportunities[10].

Above all else, Mr. Buffett is a master *capital allocator*. He could see the troubles brewing in textiles and, despite attempts by Berkshire's textile managers to obtain capital for new investments, Mr. Buffett chose to deploy the funds elsewhere. This approach was controversial, but the history of Berkshire's competitors shows that aggressive capital expenditures would only have delayed a decline temporarily and at great cost to shareholders. Large capital outlays could provide a cost advantage for a short time, but eventually competitors purchased similar equipment and the real benefits flowed to the customer in the form of lower prices. This never ending cycle could only end in value destruction for shareholders.

National Indemnity – The Turning Point

Berkshire Hathaway's entry into the insurance business with the purchase of National Indemnity in 1967 was a transformational event for the company[11]. The textile business, despite the temporary period of profitability, required significant capital investments to continue to remain competitive. In contrast, insurance operations that are well run generate significant cash in the form of "float".

Float represents funds that are held by an insurance business between the time when policyholders submit payment and when funds are eventually paid out to settle claims. As long as underwriting practices are sound, float represents a low cost means of funding investments. Exceptional insurance businesses routinely generate cost free or negative cost float. By purchasing National Indemnity, Berkshire was on its way to transforming from a textile manufacturer *consuming* large amounts of capital at low to negative rates of return into an insurance powerhouse *generating* large amounts of float for investment in other businesses offering better prospects of high returns.

In late 2010, Mr. Buffett reflected on purchasing National Indemnity for Berkshire Hathaway rather than setting up a new entity. While the great transformation of Berkshire Hathaway from a dying textile manufacturer to an immense conglomerate had begun, buying Berkshire to begin with was still a mistake. In fact, at the time of the

interview, Mr. Buffett estimated that Berkshire would be worth *twice* its then-$200 Billion value without the "textile anchor":

> ***"But the truth is I had now committed a major amount of money to a terrible business. And Berkshire Hathaway became the base for everything pretty much that I've done since. So in 1967, when a good insurance company came along, I bought it for Berkshire Hathaway. I really should—should have bought it for a new entity.***
>
> ***Because Berkshire Hathaway was carrying this anchor, all these textile assets. So initially, it was all textile assets that weren't any good. And then, gradually, we built more things on to it. But always, we were carrying this anchor. And for 20 years, I fought the textile business before I gave up. If instead of putting that money into the textile business originally, we just started out with the insurance company, Berkshire would be worth twice as much as it is now."***[12]

See's Candies – Adjusting Graham's Approach

Few Californians can recall a holiday season when See's Candies were not a prominent part of the festivities. The brand is so powerful in California and other western states that many consumers would never think of buying a competing product. See's Candies is a textbook example of a company with a formidable economic "moat". Such companies have built up brand identity that simply cannot be replicated by new entrants even in cases where significant capital investments are made[13].

Berkshire Hathaway Vice Chairman Charles Munger has been widely credited with convincing Warren Buffett that there are certain situations where deviating from Benjamin Graham's "deep value" approach can be justified. Mr. Munger has rebutted[14] the notion that his influence was a deciding factor in Mr. Buffett's overall record, but many accounts of the events surrounding the See's Candies purchase supports the conclusion that Mr. Munger deserves much credit for shifting Berkshire's bias from cigar butts selling at a "bargain price" to excellent businesses selling at a "fair price" [15].

See's Candies is the perfect example of a business that produces an excellent return on equity year after year but requires very little capital investment in order to sustain the "moat" that makes such returns possible. When Berkshire purchased See's Candies for $25 million in 1972, the company only had $8 million of net tangible assets. However, See's was earning approximately $2 million after tax at the time[16]. $17 million of the $25 million purchase price could not be accounted for by assets on See's balance sheet but represented the value attributed to intangible "brand equity". Brand equity is not an asset that a strict practitioner of Benjamin Graham's investing approach would be willing to pay for. However, the presence of brand equity simply cannot be denied based on the results that would follow after Berkshire's acquisition.

Over the first twenty years of Berkshire's ownership of See's Candies, sales increased from $29 million to $196 million while pre-tax profits grew from $4.2 million to $42.4 million. However, that is not even the most amazing part of the story. What is more remarkable is that Berkshire Hathaway only had to reinvest $18 million of retained earnings over that twenty year period while $410 million of cumulative pre-tax earnings were sent back to Berkshire for redeployment in other investments[17]. Fast forward to 2007, the latest year for which data has been provided: See's sales were $383 million with pre-tax profits of $82 million. Total capital employed to run the business was $40 million, meaning that only $32 million of retained earnings had to be invested over 35 years. Pre-tax earnings from 1972 to 2007 amounted to a total of $1.35 billion[18].

There have been many other key turning points in the history of Berkshire Hathaway but the decision to pay a "premium price" for See Candies in 1972 may best symbolize the transformation of Mr. Buffett's approach toward investing. This is perfectly summarized in Mr. Buffett's 1992 Letter to Shareholders[19]:

> ***"In my early days as a manager I, too, dated a few toads. They were cheap dates - I've never been much of a sport - but my results matched those of acquirers who courted higher-priced toads. I kissed and they croaked.***
>
> ***After several failures of this type, I finally remembered some useful advice I once got from a golf pro (who, like all pros who have had anything to do with my game, wishes to remain anonymous). Said the pro: "Practice doesn't make perfect; practice makes permanent." And thereafter I revised my strategy and tried to buy good businesses at fair prices rather than fair businesses at good prices." – Warren Buffett***

Berkshire Hathaway is the company it is today because Mr. Buffett stopped kissing toads like Dempster Mill and the original Berkshire textile business and started aggressively pursuing supermodels like See's Candies instead even if they were more "expensive dates". Ultimately, the advantages of buying "cigar butts" with a couple of puffs left pales in comparison with the cumulative benefits offered by excellent businesses that have the ability to compound returns at high rates for years or decades.

The Collector

Investor Who Piled Up $100 Million in the '60s Piles Up Firms Today

Warren Buffett Considers His New Life More Fun; The Country-Club Caper

From Stamps to Newspapers

Warren Buffett worked in relative obscurity for most of his early career but his success began to attract attention by the 1970s. While Mr. Buffett had not reached celebrity status at that point, readers of the Wall Street Journal should have been familiar with him based on a front page article that appeared on March 31, 1977 entitled *The Collector*.

Our research of Wall Street Journal archives yielded several mentions of Berkshire prior to 1977 but *The Collector* was the first that detailed Warren Buffett's investment philosophy and track record. Berkshire's stock, the predecessor of today's "A" Shares, closed at $95 on the day of the article. Excerpts from the article and a link to the original are available at the following link: http://bit.ly/e2KvLR.

As we shall see, Berkshire Hathaway in 2011 is comprised of a broad array of subsidiaries operating in many lines of business and it is fair to characterize many of them as excellent franchises – even as "business supermodels". Over the years, Berkshire Hathaway did acquire some businesses that, in retrospect, did not deliver expected results, but the bias for most of the past four decades has been toward acquiring excellent businesses.

Fortunately for today's shareholders, kissing toads is a practice Warren Buffett abandoned long ago.

The Washington Post

While the distinction between buying "cigar butts" and "business supermodels" is important, one should not forget the fact that, at times, it may be possible to achieve the best of both worlds in an investment. When this occurs, the investment can take on the characteristics of what Berkshire Hathaway Vice Chairman calls the "Lollapalooza Effect".

The early 1970s were characterized by economic, political, and social unrest that contributed to the bruising 1973-74 bear market which, at the time, was the worst in the post-war period. Just a few years earlier, Warren Buffett had closed his investment partnership in 1969 after feeling "out of step with present conditions". By 1974, Mr. Buffett was telling Forbes that he felt like "an oversexed guy in a harem."

Perhaps one reason for his change in sentiment was Berkshire Hathaway's opportunistic investment in The Washington Post Company in 1973. As Mr. Buffett would later recall in *The Superinvestors of Graham-and-Doddsville*, the market capitalization of The Washington Post was $80 million at a time when the value of the business on a conservative sum-of-the-parts basis was in excess of $400 million.

Mr. Buffett took a seat on the Post's board of directors in 1974 and became a close friend and confidant of Katharine Graham, the Post's Chairman and CEO. Under Mr. Buffett's guidance, the Post repurchased a significant amount of stock which further increased Berkshire's percentage ownership of the company.

According to Roger Lowenstein's book *"Buffett: The Making of an American Capitalist",* Berkshire Hathaway's $10 million investment in The Washington Post was worth $205 million by the time Mr. Buffett left the Post's board in 1985. By the end of 2010, the stake was worth over $759 million. Mr. Buffett later rejoined the Post's board but recently decided to not seek re-election at the Post's annual meeting in May 2011.

In recent years, the core newspaper business has been in decline, but the Post has diversified into for-profit education, an industry that has been under increasing attack. However, Mr. Buffett's loyalty to the Post remains intact and he has stated that "We're going to keep every share of stock we have."

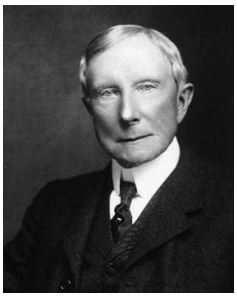
For an excellent brief summary of Berkshire's investment in the Washington Post, we recommend Max Olson's paper, *Warren Buffett & The Washington Post:* http://bit.ly/ewfNK8

Buffett Seizes Opportunities During Financial Crisis

"There are worse situations than drowning in cash and sitting, sitting, sitting. I remember when I wasn't awash in cash — and I don't want to go back." — Berkshire Hathaway Vice Chairman Charlie Munger

If an investor following the literary tradition of Rip Van Winkle had fallen asleep at the start of 2008 and rose from his slumber in early 2011, he could be forgiven for looking at the level of the Standard & Poor's 500 and thinking that not much had changed over the past three years. For more sentient investors, the past three years have been quite a bit less boring. The United States economy has endured the most severe recession since the Great Depression of the 1930s while the major market averages fell by more than half before staging a steep recovery that few anticipated during the depths of the crisis.

In October 1929, John D. Rockefeller Sr. responded to the stock market crash by buying a million shares of Standard Oil of New Jersey and issuing a press release stating in part: "These are days when many are discouraged. In the ninety years of my life, depressions have come and gone. Prosperity has always returned, and will again. Believing that the fundamental conditions of the country are sound, my son and I have been purchasing sound common stocks for some days."[1] Unfortunately, Rockefeller's timing left something to be desired and his family's net worth declined significantly during the subsequent recession, but at the time his statement inspired confidence in the economy.



John D. Rockefeller Sr

In the fall of 2008, Warren Buffett wrote an op-ed article for The New York Times that had many close parallels with John D. Rockefeller's statement nearly eighty years earlier. Mr. Buffett's article, entitled *"Buy American. I Am."* acknowledged the serious turmoil facing the country but indicated that he had confidence in the American economy and was purchasing American stocks for his personal account[2].

> ***"A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful. And most certainly, fear is now widespread, gripping even seasoned investors. To be sure, investors are right to be wary of highly leveraged entities or businesses in weak competitive positions. But fears regarding the long-term prosperity of the nation's many sound companies make no sense. These businesses will indeed suffer earnings hiccups, as they always have. But most major companies will be setting new profit records 5, 10 and 20 years from now."***
>
> ***-- Warren Buffett, New York Times op-ed, October 16, 2008.***

Mr. Buffett indicated that his personal account, which had been invested entirely in government bonds, would soon be 100 percent in United States equities if prices continued to become more attractive. He clearly stated that there was no way to predict where stocks would be in a month or a year but that prices would recover substantially well before widespread positive sentiment returned. As it turns out, it is a good thing his goal was not to predict the short term direction of the market because he was several months too early in terms of identifying the market bottom which finally arrived in March 2009. However, at the time his statement did have a brief positive impact on market sentiment.

In this section, we briefly examine three of Warren Buffett's major investment moves during the financial crisis both in terms of results delivered for Berkshire and the impact of his statements and actions on market sentiment in general and the perceived stability of the investees in particular. While Mr. Buffett's comments on purchases in the public equity markets proved to be well founded, the combined power of his prestige and Berkshire's hefty cash position were most evident in purchases of securities unavailable to ordinary investors.

Goldman Sachs

Although the definitive history of the financial crisis will probably only appear several years from now, it seems safe to consider the events of mid September 2008 to represent the peak of the crisis and the point at which the entire financial system was at the precipice of disaster. Within a span of several days, Fannie Mae and Freddie Mac were placed into conservatorship, Lehman Brothers was left with no choice but to file for bankruptcy, and Merrill Lynch was forced into the arms of Bank of America[3].

In this highly charged environment, *all* financial institutions operated under a cloud of suspicion. The most common question at the time was not *whether* another major institution would fail, but *which* bank was the next domino in what seemed like an unstoppable chain reaction.

On September 21, 2008, Goldman Sachs announced that it would convert to a Bank Holding Company subject to regulation by the Federal Reserve[4]. Two days later, Berkshire Hathaway announced that it would invest $5 billion in Goldman Sachs[5]. Media reports at the time highlighted the importance of Warren Buffett's vote of confidence in Goldman Sachs as being equally important to the capital infusion[6].

On October 1, 2008, Berkshire purchased $5 billion of perpetual preferred shares in Goldman paying a 10 percent annual dividend and also received warrants to buy $5 billion in common stock at a strike price of $115 per share. Goldman has the right to repurchase the preferred shares at any time for a 10 percent premium although approval to execute the buyback is subject to permission from the Federal Reserve. The warrants expire on October 1, 2013[7]. Warren Buffett insisted that Goldman's top executives agree to limit their personal sales of Goldman common stock until the preferred shares are redeemed or three years had passed from the date of Berkshire's investment[8].

At the time that Berkshire's investment was announced, Goldman also announced an intention to issue $2.5 billion of common stock to the public. On September 29, 2008, Goldman was able to complete a public offering of 46.75 million shares at $123 per share for proceeds of $5.75 billion[9]. On October 28, 2008, Goldman Sachs issued $10 billion of preferred stock to the United States Treasury which paid a 5 percent annual dividend and came with warrants exercisable for ten years at a strike price of $122.90 per share. The overall terms of the government's investment were clearly not as favorable as Berkshire's investment[10].

Berkshire's investment in Goldman Sachs was executed at favorable terms precisely because Warren Buffett's "seal of approval" helped to establish confidence that convinced the financial markets that Goldman would be

among the survivors of the financial crisis. This confidence shored up Goldman's stock price in the days following the announcement facilitating the $5.75 billion equity issuance to the public. It is highly doubtful that Goldman Sachs would have been able to raise capital through an issue of common stock at $123 per share without Warren Buffett's vote of confidence. Debate continues regarding whether Goldman Sachs was truly at risk of failing in September 2008, but few would disagree with the observation that Warren Buffett's involvement was critical to dissipating a cloud of suspicion that plagued Goldman during those turbulent weeks.

During the fourth quarter of 2008, financial turbulence continued and the price of Goldman's common stock fell to under $48 intraday on November 21, 2008. While the benefit of hindsight might suggest that Mr. Buffett could have extracted more favorable terms by waiting several more weeks prior to investing, this ignores the stabilizing impact of Berkshire's investment during the darkest days of the crisis in September and October 2008 and presumes that history would have been unaltered absent Berkshire's investment. The reality could have been far worse.

In recent months, many analysts have predicted that Goldman Sachs would soon be permitted to redeem Berkshire's preferred stock investment and may even pursue a buyback of up to 10 percent of its common stock[11]. The combination of the availability of cheaper capital and a likely desire of Goldman executives to eliminate the personal restrictions on share liquidations imposed by Berkshire may lead to repayment in the first half of 2011. Goldman Sachs will have to pay a 10 percent premium of $500 million as part of the process. Berkshire will retain the warrants to purchase $5 billion of Goldman common stock at the $115 strike price and will likely hold these warrants until expiration in October 2013. The warrants are currently comfortably in the money.

General Electric

Based on the public statements made by General Electric's management in September 2008, the company had no pressing need for outside capital. After issuing a press release revising 2008 earnings guidance on September 25, GE Chairman and CEO Jeffrey Immelt indicated in a conference call that raising additional equity was not on the table[12]. Mr. Immelt told the analysts on the call that he felt secure regarding the strength of the company, overall liquidity, and the state of the balance sheet.

Only a few days later, General Electric announced plans to offer $12 billion of common stock to the public as well as Berkshire Hathaway's $3 billion investment in newly issued GE perpetual preferred stock carrying a dividend of 10 percent and callable after three years at a 10 percent premium. Berkshire also received warrants to purchase $3 billion of common stock at a strike price of $22.25 per share, exercisable at any time over a five year term[13]. Mr. Buffett again insisted that company executives including Mr. Immelt refrain from selling more than 10 percent of the common stock they held until either the date when the preferred stock is redeemed or three years had passed from the date of Berkshire's investment. The transaction closed on October 16, 2008[14].

Notably, the title of GE's press release referred to *Warren Buffett* announcing an investment in the company rather than more accurately stating that *Berkshire Hathaway* was making the investment. Clearly, this announcement was specifically intended to increase confidence in GE and to facilitate the planned $12 billion

equity sale to the public which closed on October 7, 2008. The following quote from Mr. Buffett illustrates the vote of confidence in GE's management:

> ***"GE is the symbol of American business to the world. I have been a friend and admirer of GE and its leaders for decades. They have strong global brands and businesses with which I am quite familiar. I am confident that GE will continue to be successful in the years to come."***

If Mr. Buffett's vote of confidence in Goldman Sachs served to instill confidence in America's financial system, the investment in General Electric had a similar effect on GE's global industrial businesses and also may have helped to alleviate some of the fears surrounding GE Capital.

General Electric's common stock price fell precipitously over the five months following Berkshire's investment and eventually traded under $7 for a brief period in early March 2009. As of late February 2011, GE's stock remains slightly below the strike price on Berkshire's warrants but the potential remains for the warrants to generate significant profits for Berkshire since expiration will not occur until October 2013.

Swiss Re

On March 23, 2009, Berkshire Hathaway invested CHF 3 billion in a convertible preferred security issued by Swiss Re. The preferred security was in addition to Berkshire's January 2008 investment in 3 percent of Swiss Re common stock as well as a quota-share reinsurance agreement in which Berkshire assumed 20 percent of Swiss Re's property/casualty business over a five year period ending in 2012. At the time of Berkshire's investment in the convertible preferred, Swiss Re was in danger of losing its AA rating due to heavy investment portfolio losses suffered during 2008. Berkshire's capital infusion helped to instill confidence in Swiss Re's future prospects. At the time, Warren Buffett was quoted as being "delighted" with the deal[15].

Although the investment carried an interest rate of 12 percent, Swiss Re had the right to defer interest payments and could opt to pay interest using shares rather than cash. The investment provided Berkshire with conversion rights but the conversion price was above Swiss Re's stock price at the time of the deal and Swiss Re retained the right to redeem the instrument at a premium to prevent future dilution. In early November 2010, Berkshire and Swiss Re agreed to terms for the redemption of the security[16]. On February 17, 2011, Swiss Re confirmed that the final repayment took place in January 2011[17].

This transaction was far from risk free due to the subordinated status of the instrument compared to Swiss Re's other debt obligations. However, the deal has produced excellent results for Berkshire. In exchange for a CHF 3 billion initial outlay, Berkshire received an aggregate total of CHF 4.42 billion in interest payments, redemption premium, and repayment of the original principal.

We estimate that the annualized internal rate of return was approximately 25.8 percent when expressed in Swiss Francs. However, the Swiss Franc has significantly appreciated over the past two years. Assuming that Berkshire converted interest payments and the redemption proceeds to US Dollars on the date the Swiss Francs were received, we estimate the annualized internal rate of return at approximately 37 percent. The exhibit on the following page shows the timing of the cash flows.

Date	Cash Flow (CHF Millions)	Exch. Rate (CHF/USD)	Cash Flow (USD Millions)	Description
3/23/2009	(3,000)	1.12856	(2,658)	Initial Investment
9/23/2009	180	1.02300	176	Interest Payment
3/23/2010	180	1.05932	170	Interest Payment
9/23/2010	180	0.98611	183	Interest Payment
11/25/2010	180	1.00038	180	Redemption - 1st Installment
1/10/2011	3,700	0.96858	3,820	Redemption - 2nd Installment
Net Cash Flow Totals	**1,420**		**1,870**	
Annualized IRR	**25.8%**		**37.0%**	

Exhibit 2: Berkshire's Swiss Re Investment Results [18]

The original term sheet specified that Swiss Re would have to pay a 40 percent premium if redemption took place prior to the second anniversary of the transaction and 20 percent thereafter. However, Berkshire agreed to accept a 20 percent premium although Swiss Re had to pay interest for Q1 2011 in full.

Other Investments

In addition to the three investments we have discussed, Berkshire Hathaway also made significant investments in Dow Chemical and Wrigley during 2008 and 2009. On April 1, 2009, Berkshire invested $3 billion in Dow Chemical perpetual preferred stock paying dividends of 8.5 percent. Berkshire's investment helped to facilitate Dow's acquisition of the Rohm and Haas Company. The preferred stock is convertible into Dow common stock at an effective price of $41.32[19]. On October 6, 2008, Berkshire made an investment in Wrigley comprised of $4.4 billion of 11.45 percent subordinated notes due 2018 and $2.1 billion of Wrigley preferred stock[20]. The investments provided the financial backing to facilitate the acquisition of Wrigley by Mars Inc.

While future CEOs of Berkshire Hathaway are very likely to have the cash required to pursue large deals during periods of financial turmoil, it is clear that the terms of Berkshire's transactions during the 2008-2009 financial crisis were substantially enriched by the intangible benefit of obtaining Warren Buffett's stamp of approval. Therefore, investors who wish to evaluate whether a "Buffett Premium" exists in the current price of Berkshire Hathaway stock should focus on whether the company's current valuation assumes that future deals will be available on similar terms. This is a question we will examine in more detail once our valuation of Berkshire is complete.

Valuation Approach

One of the mistakes many investors make involves attempting to estimate the value of a business with excessive precision. Indeed, the quest for exact mathematical precision in finance has led to models such as the Capital Asset Pricing Model that are elegant but use suspect variables such as Beta (a measure of stock price volatility) as a proxy for risk to arrive at estimates of where a stock should trade[1].

In our view, risk involves the possibility of *permanent loss of capital* rather than stock price volatility. Stock markets are known for extreme volatility and are driven by periods of greed and fear that often has little to do with underlying business fundamentals. Unfortunately, precise academic definitions of risk and valuation are inadequate when it comes to arriving at intrinsic value estimates.

The valuation of any business is theoretically represented by the cash the business will generate over its remaining life discounted to present value to account for the time value of money. Since the future is necessarily uncertain, one cannot hope to arrive at a precise number for the value of a business. Instead, the goal should be to arrive at a reasonable *range of value* for a business. The decision to purchase a business should only be made if it can be obtained at a significant discount relative to intrinsic value. Warren Buffett describes the concept of intrinsic value as follows[2]:

> ***"Intrinsic value is an all-important concept that offers the only logical approach to evaluating the relative attractiveness of investments and businesses. Intrinsic value can be defined simply: It is the discounted value of the cash that can be taken out of a business during its remaining life.***
>
> ***The calculation of intrinsic value, though, is not so simple. As our definition suggests, intrinsic value is an estimate rather than a precise figure, and it is additionally an estimate that must be changed if interest rates move or forecasts of future cash flows are revised. Two people looking at the same set of facts, moreover—and this would apply even to Charlie and me—will almost inevitably come up with at least slightly different intrinsic value figures. That is one reason we never give you our estimates of intrinsic value. What our annual reports do supply, though, are the facts that we ourselves use to calculate this value." – Warren Buffett***

There are numerous approaches that have been used to estimate Berkshire Hathaway's intrinsic value. In our view, the most compelling model involves evaluating Berkshire Hathaway's insurance float as the main driver of value. This method was first developed by Alice Schroeder and Gregory Lapin in their well known report on Berkshire Hathaway published in 1999[3]. We will use this basic framework as the primary valuation technique throughout this report. One limitation of the "float based" model is a high level of sensitivity to the variables used in the analysis. Therefore, a conservative set of assumptions will be used to come up with a range of intrinsic value rather than an exact figure. In addition, we provide a sensitivity analysis to illustrate the impact of key variables on the calculation of intrinsic value.

While we believe that the "float based" model is the most intellectually valid approach, it is not without controversy. Critics point out that float based valuations, even when conservative assumptions are used, can produce intrinsic value estimates that Berkshire's share price has failed to consistently achieve over long periods of time. Therefore, we will also present two more traditional valuation yardsticks for Berkshire Hathaway.

First, we will examine the "two column"' approach that many Berkshire shareholders believe was implicitly endorsed by Warren Buffett in his shareholder letters. In Berkshire Hathaway's 2008 Letter to Shareholders, Mr. Buffett stated that he believes that Berkshire has two main areas of value[4]:

> ***"Berkshire has two major areas of value. The first is our investments: stocks, bonds and cash equivalents. At yearend [2008] those totaled $122 billion (not counting the investments held by our finance and utility operations, which we assign to our second bucket of value). About $58.5 billion of that total is funded by our insurance float.***
>
> ***Berkshire's second component of value is earnings that come from sources other than investments and insurance. These earnings are delivered by our 67 non-insurance companies, itemized on page 96. We exclude our insurance earnings from this calculation because the value of our insurance operation comes from the investable funds it generates, and we have already included this factor in our first bucket."***

Second, we will look at Berkshire Hathaway's reported book value per share and attempt to draw some conclusions regarding intrinsic value based on the historical relationship between book value and market value. Book value per share is a problematic yardstick because it only captures the value of intangible assets (goodwill) at historic purchase prices and gives no credit to economic goodwill at subsidiaries that have built up over many decades. Nevertheless, according to Mr. Buffett the *change in book value* can serve as a rough proxy for *changes in intrinsic value* over time[5]:

> ***"Book value far understates Berkshire's intrinsic value, a point true because many of the businesses we control are worth much more than their carrying value. Inadequate though they are in telling the story, we give you Berkshire's book-value figures because they today serve as a rough, albeit significantly understated, tracking measure for Berkshire's intrinsic value. In other words, the percentage change in book value in any given year is likely to be reasonably close to that year's change in intrinsic value."***

Since an exact figure for intrinsic value cannot be reasonably calculated, our goal is to arrive at a conservative range of values and draw appropriate conclusions regarding the current stock price. In keeping with the theme of the report, we will also consider whether the methodology used to arrive at these estimates assumes a "Buffett Premium" that could be at risk if a management change occurs sooner than investors anticipate.

To Continue Reading *Berkshire Hathaway: In Search of the "Buffett Premium"* visit The Rational Walk's website to purchase the full report:

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