Berkshire Hathaway - BUY

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Berkshire Hathaway has built one of the most successful investment track records in history. Led by Warren Buffett and Charlie Munger, Berkshire has compounded at 20.8% since 1965. The Berkshire successes and stories are legendary, but this report will examine the long-lasting system, culture, and mindset that make Berkshire and Warren Buffett truly great. Buffett's consistency and methodical approach has set up a system that will benefit investors for decades.

Berkshire evolved from a Warren Buffett dependent model to a diverse group of quality operating businesses. Headquartered in Omaha, NE, Berkshire intentionally avoids the noise of the major financial cities. From its early beginnings as a textile mill, Berkshire primarily grew through an expanding insurance empire. The textile mill, which Buffett called his biggest investment mistake, provided the vehicle to make acquisitions in the insurance industry. Today, the company spans multiple operating businesses, leading insurance companies, and a significant investment portfolio. Berkshire owns over ten companies that would be included in the Fortune 500 if they were standalone companies.[1]

Overall, Berkshire is a cornerstone holding for our investors. Imagine partnering with the world's greatest investor at no management fee with equal rights and profit splits. It's run by two of America's great capital allocators. It owns a collection of businesses unparalleled in the corporate America. The wit, wisdom, and ethical behavior are unmatched in a greedy and short-term focused world. Buffett and Munger have created an enduring enterprise that will succeed long after they are both gone.

Berkshire Hathaway is attractively valued with significant downside protection. Given the low interest rate environment and overvalued assets in most markets, Berkshire is a great opportunity for long-term investors.

Berkshire Hathaway		**7/1/2016**
Investment Type		Earnings Power
Industry		Conglomerate
Ticker		BRK.A
Price		$213,620
Shares		1.65M
52 Week Range		$186,900-221,985
Market Cap		$352.3B
Long-term Debt		$101.5B
Enterprise Value		$401.6B
ROE		9.8%
	Value	Upside/Downside
Best Case Valuation	$271,038	27%
Base Case Valuation	$232,318	9%
Worst Case Valuation	$185,854	-13%

Thesis/Advantages

- **Exceptional capital allocation**
- **High quality operating companies**
- **Significant investment float**
- **Capital protection during a crises**
- **Diversified earnings power**
- **Unmatched investment returns over 50 years**
- **Provider of capital and preferred partner**

Risks

- **Continuity – leadership after Warren Buffett and Charlie Munger**
- **Exposure to insurance tail-risk**
- **The size of Berkshire limits investment opportunities**
- **Large bet on the future success of American business**
- **More focus on capital intensive businesses**
- **Concentrated investment portfolio**

Segments/Operations

Operating Companies: The Powerhouse Six

Berkshire owns six businesses that Buffett refers to as the "Powerhouse Six". In 2015, these companies (excluding PCC – acquired in 2016) earned $13.1 billion.[2] These six companies, in addition to the insurance operations, will be the major drivers of investment returns going forward.

1. **Burlington Northern Santa Fe Railroad (BNSF)**

   BNSF is one of the largest U.S. railways, moving about 17% of America's freight.[2] BNSF commits significant capital to building its rail network and service capability. Rails are a vital component to the U.S. transportation industry. In addition, new rail capacity cannot be created overnight. This factor creates a moat around its business. Buffett continues to praise BNSF CEO Matt Rose, who continues to guide the railroad to best-in-class performance. BNSF recorded $22 billion of revenue and $4.2 billion of net income in 2015.[2]

2. **Berkshire Hathaway Energy (BHE)**

   BHE are the utility assets of Berkshire. The assets cover both foreign and domestic energy generation. BHE is leader in renewable energy, generating 7% of the U.S.'s wind energy and 6% of its solar energy.[3] BHE is a capital intensive industry. BHE runs a safe and effective utility business. They have exceptional relationships with regulators and customers and continue to invest significant capital to grow the energy business. BHE recorded revenue of $18 billion and earnings of $2.1 billion in 2015.[3]

3. **Marmon**

   The Marmon group is a collection of 185 manufacturing businesses and generates approximately $8 Billion in revenue.[4] Marmon is grouped into four companies: Marmon Energy Services, Engineered Components, Food, Beverage, & Water Technologies, and Retail & Highway Technologies.

4. **Lubrizol**

   Founded in 1928, Lubrizol is a specialty chemicals manufacturer with annual revenues of $7 billion.[5] The company specializes in additives, advanced materials, and oilfield solutions.[6] Berkshire bought Lubrizol in 2011.

5. **IMC**

   IMC is an Israeli-based manufacturer of cutting tools. Comprised of 15 companies, IMC is another Berkshire company that benefits from best in class manufacturing, production, and leadership. Buffett has called IMC's CEO, Jacob Harpaz, the "da Vinci of his craft."[7] Berkshire acquired the business in 2013.

6. **Precision Castparts**

Precision Castparts (PCC) was purchased in early 2016 for $32 billion. PCC is a leading manufacturer of critical and complex aeronautical components. These highly engineered components are mission critical and create a significant barrier to entry. They won't be swapped for a slightly cheaper competitor products. The company's products and moat fit well with Buffett's preference for great businesses with long-term staying and pricing power.

PCC will excel under the Berkshire Hathaway system. CEO Mark Donegan has led PCC since 2002 and is largely responsible for the growth and success of the company.[7] Buffett praised Donegan's leadership and Berkshire shareholders are fortunate have Mark at the helm.

Insurance Group

Insurance Operations

The Berkshire insurance segment comprises GEICO, General Re, Berkshire Hathaway Reinsurance Group, and the Berkshire Hathaway Primary Group. Insurance profitability is driven by two factors: underwriting profit and investment returns. Berkshire's insurance managers have led Berkshire to several years of profitable underwriting, ensuring that the policies are properly priced for future risks.

In fact, Berkshire's underwriting profit totaled $26 billion over the past 13 years![8] Most insurance competitors are lucky to break-even long-term. Berkshire's insurance companies are run conservatively and avoid aggressive pricing when the markets become irrational. Historically, Buffett managed the investments, but now delegates about $9 billion each to Todd Combs and Ted Weschler.[9] Both managed hedge funds before joining in 2010 and 2011, respectively.[10]

Insurance Float

Buffett has $87.7 billion of investment "float" to invest. Float is insurance money that is collected today that will be paid out in the future. Berkshire is able to invest that money for free and earn a positive spread. In essence, Berkshire has been paid (through consistent underwriting profits) to invest free money (the float). It's a clear double-win for shareholders. Berkshire's float has grown from $39 million in 1970 to $87.7 billion in 2015.[11] This record amount of float is an enormous advantage for Buffett and shareholders. He has used this free capital to generate market beating annual returns over the past 50 years.

The Five Enduring Moats of Berkshire Hathaway

Unlike most companies, there isn't one product, process, or attribute that explains Berkshire's success. It's rare to find a company that has more than one of these factors. It's nearly impossible to find a company that has them all. Berkshire is that one.

1. The Berkshire Culture

Berkshire continually emphasizes the importance of maintaining a long-term focus, protecting your reputation, and avoiding the common sins of the corporate world. Buffett has preached for decades on the importance of ethical behavior and not losing a "shred of reputation." While financial success is important, Berkshire doesn't push incentives to bend the rules in order to meet short-term earnings targets or growth expectations.

In addition, Buffett does not meddle in the business operations. He explicitly avoids telling the CEOs what to do. While he may consult on an acquisition, he otherwise leaves management alone to run the business as they see fit. As one manager stated, "No one else gives a company this kind of freedom."[12]

Managers are able to avoid the pressure to perform over the short-term. The excess short-term focus for most companies causes them to engage in risky behavior and forego valuable investments just to make quarterly earnings. Managers offer near unanimous feedback that Buffett focuses on timeframes up to 50 years.[13]

2. Permanent Capital

One underappreciated feature of Berkshire is the concept of permanent capital. Berkshire never has to rely on outside funding or the threat of investors pulling their money. When times get tough, Berkshire has the capital to invest at depressed prices. Buffett's insistence on huge cash buffers and high quality companies further cements the staying power of the business. While other companies "optimize" their balance sheets with leveraged buybacks and destructive acquisitions, Buffett builds cash and dry powder, knowing that exceptional opportunities are soon to follow.

3. Quality Operating Businesses

Berkshire has transformed from being dependent on Warren Buffett's stock picking to a company focused on operating businesses. Buffett has transitioned from buying "net-nets" and "cigar butts" to finding businesses that have defendable moats and staying power. Shareholders benefit as their investment grows with the intrinsic value of these businesses. Buffett's stock picking is less important than in the past. Berkshire is a collection of successful companies that will continue to drive earnings power well into the future. Since these business are run autonomously, Buffett's absence will not affect the long-term power of these companies.

4. Provider of Liquidity

Because of Buffett's insistence on high cash levels, Berkshire is one of the few firms able to provide liquidity during a crises. During the 2009 financial crises, he put billions of dollars to work as market panic spread. Buffet's reputation puts Berkshire as the preferred partner during a crises. Berkshire was in the enviable position of providing liquidity and capital to various companies punished by the crises: Bank of America, Goldman Sachs, Harley-Davidson, GE, etc. Berkshire's ability to avoid speculative excesses and capitalize on market panic allows the company to be lender of last resort. As the lender of last resort, Buffett is ruthless at extracting value from firms that overextend themselves. As a shareholder, you want to be on Buffett's side during a crises.

5. Flight to Safety

Berkshire Hathaway is a rare company that can grow and be defensive when the world is falling apart. The defensive nature of the operating business and high level of cash/investments allows Berkshire to not only perform well during a downturn, but emerge stronger. Berkshire is a diversified and defensive company that can offset much of the economic exposure contained in most investor portfolios.

Share buyback

Buffett is one of the rare CEO's willing to buy when the stock price is down. He publicly states he will buy at 1.2x book value. Most CEO's buy back shares when cash and confidence are high, leading to overvalued repurchases that destroy shareholder value. Buffett believes that 1.2x book value is a reasonable level of undervaluation. Buffett is one of the few CEOs who think about repurchases in the right way. Shareholders can invest confidently that Buffett will add value with repurchases and provide a solid floor for the stock price.

Valuation/Earnings Power

The valuation of Berkshire can be broken down into two parts: the value of the investment portfolio and the value of the operating businesses.

(in millions) per share	Value	Multiple	Total Value
Investment Portfolio	$159,794	1.0x	159,794
Pre-tax Operating Earnings	$12,304	10x	123,040
Total Value			282,834
Price Today			213,620
Price to Value			.75

Berkshire is also attractive on a simple price/book valuation. There is adequate downside protection with the share buyback at 1.2x book value. As Berkshire has become less driven by insurance operations and more dependent on the operating companies, the price/book metric becomes less useful. However, the metric still provides a decent estimate to gauge attractiveness.

Price/Book Valuation	Current	Downside	Base	Upside
Price/Book Multiple	1.38x	1.2x	1.50x	1.75x
Price Per Share	$213,620	$213,620	$213,620	$213,620
Book Value Per Share	$154,879	$185,854	$232,318	$271,038
% Upside/Downside		-13.0%	8.8%	26.9%

Risks

The obvious risk is the future passing of Warren Buffett. Even though Berkshire is less reliant on Buffett, Berkshire still gets "the call" during market panics because Buffett is willing and able to make a deal on the spot. Buffett's consistency and reputation allows other companies to make a handshake deal, knowing Warren will stick to his word. While other counterparties need weeks of legal due diligence, Buffett can make a deal immediately. Unfortunately, his future successor will not have quite the same reputation and ability to extract as much value.

A successor to Buffett has not been named. Veteran Berkshire managers Ajit Jain and Greg Abel are names mentioned as possibilities. Regardless of the successor, the Berkshire brand and financial power will still capture significant opportunities that competitors can't match.

In a survey, a number of subsidiary managers responded that they are confident that the culture will continue long after Buffett dies. As one respondent noted, "The more I interact with the board at Berkshire and other Berkshire managers, the more confident I am in the future of Berkshire post Warren."[14]

Charlie Munger stated, "Provided that most of the Berkshire system remains in place, the combined momentum and opportunity now present is so great that Berkshire would almost surely remain a better-than-normal company for a very long time even if (1) Buffett left tomorrow, (2) his successors were persons of only moderate ability, and (3) Berkshire never again purchased a large business."[15]

Conclusion

Although the past returns of Berkshire will not be replicated, shareholders still benefit from the growth in underlying businesses and the permanent operating culture Buffett has built. While there are concerns on Buffett's successor, these concerns are outweighed by the enormous advantage of the Berkshire structure. Berkshire is an attractive opportunity without even considering Warren Buffett.

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Appendix:

Berkshire's Performance vs. the S&P 500

Year	Annual Percentage Change in Per-Share Book Value of Berkshire	in Per-Share Market Value of Berkshire	in S&P 500 with Dividends Included
1965	23.8	49.5	10.0
1966	20.3	(3.4)	(11.7)
1967	11.0	13.3	30.9
1968	19.0	77.8	11.0
1969	16.2	19.4	(8.4)
1970	12.0	(4.6)	3.9
1971	16.4	80.5	14.6
1972	21.7	8.1	18.9
1973	4.7	(2.5)	(14.8)
1974	5.5	(48.7)	(26.4)
1975	21.9	2.5	37.2
1976	59.3	129.3	23.6
1977	31.9	46.8	(7.4)
1978	24.0	14.5	6.4
1979	35.7	102.5	18.2
1980	19.3	32.8	32.3
1981	31.4	31.8	(5.0)
1982	40.0	38.4	21.4
1983	32.3	69.0	22.4
1984	13.6	(2.7)	6.1
1985	48.2	93.7	31.6
1986	26.1	14.2	18.6
1987	19.5	4.6	5.1
1988	20.1	59.3	16.6
1989	44.4	84.6	31.7
1990	7.4	(23.1)	(3.1)
1991	39.6	35.6	30.5
1992	20.3	29.8	7.6
1993	14.3	38.9	10.1
1994	13.9	25.0	1.3
1995	43.1	57.4	37.6
1996	31.8	6.2	23.0
1997	34.1	34.9	33.4
1998	48.3	52.2	28.6
1999	0.5	(19.9)	21.0
2000	6.5	26.6	(9.1)
2001	(6.2)	6.5	(11.9)
2002	10.0	(3.8)	(22.1)
2003	21.0	15.8	28.7
2004	10.5	4.3	10.9
2005	6.4	0.8	4.9
2006	18.4	24.1	15.8
2007	11.0	28.7	5.5
2008	(9.6)	(31.8)	(37.0)
2009	19.8	2.7	26.5
2010	13.0	21.4	15.1
2011	4.6	(4.7)	2.1
2012	14.4	16.8	16.0
2013	18.2	32.7	32.4
2014	8.3	27.0	13.7
2015	6.4	(12.5)	1.4
Compounded Annual Gain – 1965-2015	19.2%	20.8%	9.7%
Overall Gain – 1964-2015	798,981%	1,598,284%	11,355%

Notes: Data are for calendar years with these exceptions: 1965 and 1966, year ended 9/30; 1967, 15 months ended 12/31. Starting in 1979, accounting rules required insurance companies to value the equity securities they hold at market rather than at the lower of cost or market, which was previously the requirement. In this table, Berkshire's results through 1978 have been restated to conform to the changed rules. In all other respects, the results are calculated using the numbers originally reported. The S&P 500 numbers are **pre-tax** whereas the Berkshire numbers are **after-tax**. If a corporation such as Berkshire were simply to have owned the S&P 500 and accrued the appropriate taxes, its results would have lagged the S&P 500 in years when that index showed a positive return, but would have exceeded the S&P 500 in years when the index showed a negative return. Over the years, the tax costs would have caused the aggregate lag to be substantial.

About Elgethun Capital Management, Inc.

Elgethun Capital Management is a fee-based, fiduciary Registered Investment Advisory (RIA) firm established in 2003. We are registered with the Securities & Exchange Commission (SEC) and subject to their audit reviews. We are independently owned and operated. As of June 30, 2016, we had approximately $360 million dollars under management/advisement. Our clients are high-net-worth individual investors and institutional investors.

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