An Octogenarian and Nonagenarian Walk into a Room Pt. 2

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SUMEET GOEL

ACQUISITION STRATEGY

I was lucky enough to have spent time with a few Berkshire Hathaway portfolio company CxO's during my time in Omaha — from organized meetings to fortuitous seats on flights. What struck me most in these conversations was the consistency in their stories around joining the Berkshire Hathaway family.

One CEO had gone through an extensive 9 month sales process, driven by his equity sponsors — an amalgam of PE and hedge funds. And nothing came of it — no bids that were at an acceptable level. The CFO of the company happened to have a connection to Berkshire, and lobbed in a call when it was clear that they weren't going to go with any of the bidders from the process. That Berkshire connection asked the CFO to send over info on a Friday. On Monday, Warren called the CEO directly. On Tuesday, the CEO and CFO were in his office. On Wednesday, the CEO had a 1-page offer letter at the level required. The deal closed shortly thereafter. No request for the data room, no multi-month diligence process, no customer interviews, no back and forth on the price, no contingencies.

Now, two quick things to note: (a) I've sanitized the story above a fair amount for public consumption and (b) I'm sure that there was some diligence done by Berkshire Hathaway after Warren sent over the letter — I'm not naïve to think that such decisions are made based solely on a one hour meeting. But no matter how much salt you take the story with, it is still nothing like what any of us are used to.

Another Berkshire Hathaway CxO that I spoke with corroborated the story, saying that their company was acquired in much the same way.

One of my favorite quotes of the day occurred when Munger was asked about Berkshire Hathaway's lightweight diligence process that really focuses just on the CEO (the General Manager of the business in their mind) — why don't you spend the months and months on diligence like everyone else does? Munger's classic response: "How many people who have been happily married verified the birth certificate of their partner before they married?"

OWNERSHIP & EXECUTIVE COMP

Going hand-in-hand with this acquisition approach is their overall strategy on their portfolio. These guys are not private equity investors looking to turn companies in 3-5 years. They are true buy and hold investors. They want businesses with solid performance and strong cash flows (I assume to better feed the beast — another Mungerism: "In the whole history of Berkshire Hathaway, we've lived in a torrent of cash").

As such, Warren ignores EBITDA as a measuring stick for performance. He tends to focus on Operating Income in evaluating an acquisition as well as evaluating his own managers. The theory is that EBITDA misaligns incentives — the "BITDA" part encourages leverage, high capital expenditures and short-term earnings focus without thinking about long-term repercussions and long-term growth potential.

To that end, it sounds like CEOs get compensated according to that approach as well. As a Berkshire Hathaway CEO, there is no big exit, no big liquidity event down the road. There is typically no equity in the business; Warren and Charlie generally own it 100%. As a CEO you get your salary and you get a bonus, which is most often tied to the operating performance of your business. And when you do a bolt-on acquisition, the hurdle for your bonus is increased proportionally based on your purchase price as a multiple of that acquired company's operating earnings. (Again, details sanitized a bit here).

Of course this is a great incentive-aligning approach for Warren, and very well might work for the CEO who then operates in Warren and Charlie's orbit, and who will never want to leave...but may have adverse effects on the ability of that CEO to hire top tier talent, 1-2 levels down.

In this day and age, how does one of their consumer-facing companies hire a kick-ass head of e-commerce (and the team to support it) without some sort of back end exit opportunity? Not sure and something I will push on next year.

Separately from this, and something shared by the senior executives I spoke with, was that Warren asks his CEO for the same two things when he acquires a business. The first is an envelope with a piece of paper inside. On that paper should be the name of your successor if you get hit by a bus. If need be, that envelope will be opened and that name will be used. Again, not sure if Warren has an actual filing cabinet with 70 envelopes inside, but the visual and message it conveys is quite interesting.

The second item has to do with acquisitions. Warren asks to be informed about any acquisitions that the company takes on. Broadly speaking, a CEO has freedom to make acquisitions that they think are good for business at a price that they think is acceptable, but worth noting that because the CEO's incentive comp is based on a percentage of that purchase price, he is obviously incentivized to get as low a price as possible.

Also, we shouldn't be totally Pollyanna about this concept of freedom as one CEO noted that he shared details about a potential acquisition and his target price to Warren and was told by Warren that he shouldn't go above a certain (lower) number. Of course the CEO objected and suggested that they would lose the deal. Of course Warren told him that he was okay losing the deal. Of course the CEO was disappointed, but put in the offer at the "Warren price". And, of course...they got the deal.

Look out for Part 3 later this week, which will contain some final observations gleaned from my time in Omaha (Spoiler: Bill Gates makes an appearance).