What Do Warren Buffett and Randy Moss Have in Common? Straight Cash, Homey

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SUMEET GOEL

Last year was my first visit to the land of Omaha and the Berkshire Hathaway Annual Meeting, and I took it all in, from the stadium teeming with people to the merchandise being hawked everywhere. It was a fascinating experience. So fascinating, in fact, I wrote a three-part treatise on it. And so much so that I had to go back again this year.

Much like the second time you see a movie (and in my case, the 30th time with certain ones from the 70s and 80s), you experience it differently and pick up on nuances you may have missed the first time. If last year was about taking everything in and absorbing the Berkshire Hathaway experience, this year was about diving in to how Berkshire Hathaway actually works and where it goes from here. For those not familiar, here's a quick rundown:

THE ORIGINS OF BERKSHIRE HATHAWAY

Berkshire Hathaway began as the merger of two textile companies in 1955, but Warren Buffett's involvement didn't begin until 1962 when he started to buy shares, thinking that the company was undervalued. At this time, Buffett was practicing the philosophy of "Cigar Butt Investing," which as you can guess is based on the idea of a cigar butt. People throw them out before they are completely done so if you find one, although it might not be pretty, it's still good for a final free puff or two. He would abandon this idea as the company grew and move towards a philosophy of targeting companies with room for growth at a good price. The history of Berkshire Hathaway has been covered in much more detail and with much more eloquence than I could ever muster. And that's not the point of this article. But if you want to do a deep dive on the history of Berkshire Hathaway, you can read more here. Go ahead — I'll be here when you get back.

WHAT IS BERKSHIRE HATHAWAY TODAY?

Berkshire Hathaway wholly owns over a dozen companies, while having ownership stakes in over a dozen other public ones. The combined holdings make up today's Berkshire Hathaway, the publicly traded entity (NYSE: BRK).

WHO RUNS BERKSHIRE HATHAWAY?

It's easy to say that it's all Warren & Charlie, especially given that they maintain a corporate team of… wait for it…TWENTY-FIVE employees that oversee all of these investments and ownership stakes. And while Warren is superhuman to most, this lack of a big corporate team also underscores the other part of how BRK is run — the CEO managers of each of those wholly-owned portfolio companies.

I've had the chance to speak to a few of these senior executives and they all explain the same thing. They are given the freedom to make their own decisions and run the companies how they see fit, with limited management from Warren. That being said, it's fascinating to learn how Warren uses just a couple of levers in structuring CEO compensation to incentivize actions and get everyone to row in the same direction without his explicit involvement.

Berkshire Hathaway also has two managers who handle the investment portfolio, Ted Weschler and Todd Combs. Again, the day to day operations of BRK have also been written about extensively and in a more comprehensive way than I could ever do it— here are some examples.

HOW DOES BERKSHIRE HATHAWAY MAKE MONEY?

Ahhh, now here's where it gets really interesting. You see all of those companies on the left hand side of the graphic above? Warren effectively does a cash sweep from each of those businesses, every 30 days. His laser focus over the decades has been on operating earnings — not EBITDA, eyeballs, or any other metric that has been in vogue at any given time — as the esteemed Mr. Moss might say — straight cash, homey.

How much is that monthly sweep?

Warren Buffett takes $1.6 billion in cash out of these companies.

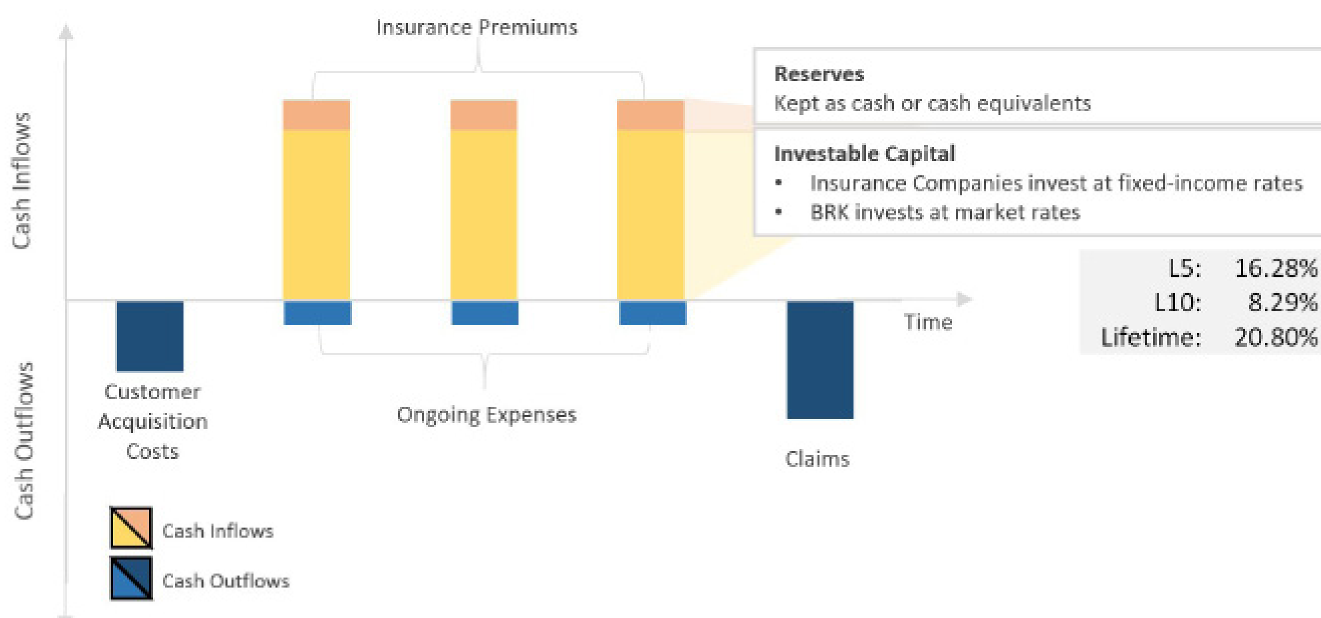
How is that possible? Well, while all of the businesses throw off cash of some amount and send their 'tithe' back to the mothership each month, the historical jewels in the crown have been his insurance holdings — GEICO, GenRe, Berkshire Hathaway GUARD Insurance Companies, Berkshire Hathaway Specialty Insurance, and United States Liability Insurance Group. The combination of size and industry economics make for an incredible 1-2 punch that has always powered the BRK engine.

Here's how your traditional insurance company works (see illustration below):

They take in premiums to insure you for future losses — home, life, car, catastrophic events, etc. Then they plan on having those premiums cover eventual losses that arise from those events over time. There is typically a big time gap between the acquisition of those premiums and the payout of those claims, if they ever arise. This cash held during the duration is called the float. During that time, regulations require the insurance company to keep a fixed percentage of the float on hand as cash reserves for unforeseen events that aren't adequately reserved for by actuarial tables (think Hurricane Sandy). The majority, however, is typically invested.

So your typical insurance company makes money one or two ways, depending on how well they're running their underwriting operations and business. First is the underwriting margin – the industry metric is the Combined Ratio (CR):

$$\text{Combined Ratio} = \left(\frac{\text{Losses} + \text{Expenses}}{\text{Premiums}}\right)$$



As an insurance company, when your CR is below 100%, you are making a margin on your underwriting – you're taking in more in premiums than you're paying out in claims and the expenses to run the business. When your CR is above 100%, you're losing money on your core business.

So how do you make money when your CR is above 100%? Well, that's the second way. The float is invested by the insurance company.

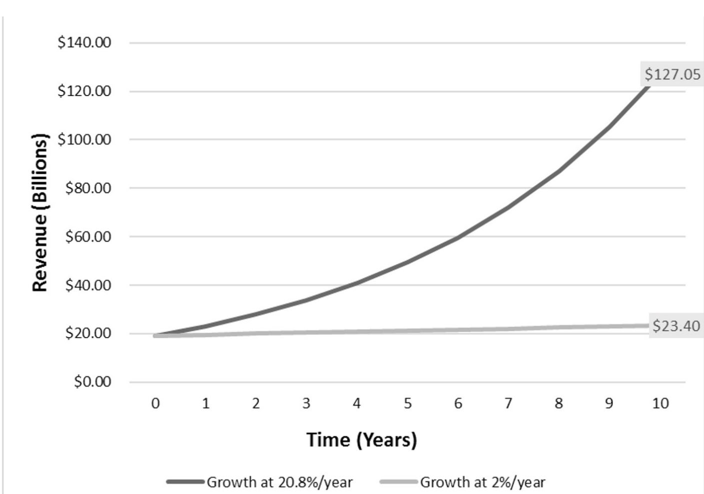
And with BRK, the insurance companies have been quite effective at keeping their CR below 100%, effectively allowing Warren to have a weighted average cost of capital (WACC) at insanely low levels. When you couple that low WACC with Warren's purchasing prowess, the BRK 1-2 punch has been the most formidable investing machine that the world has ever seen.

Over the last 50 years, Warren has been able to invest at an annual rate of return of 20.8%. Every year. For 50 years.

Albert Einstein is most well-known for his theory of relativity — the old $E=mc^2$ equation. But amongst finance aficionados, he is probably more popular for this one (although whether it can truly be ascribed to him is an oft-debated subject): "Compound interest is the eighth wonder of the world. He who understands it, earns it...he who doesn't...pays it."

The following chart approximates what 2016's sweep will be worth in 10 years at that historical rate of return, compared to a 2% growth from more traditionally conservative ways of investing float. The numbers speak for themselves.

Growth from Monthly Sweeps

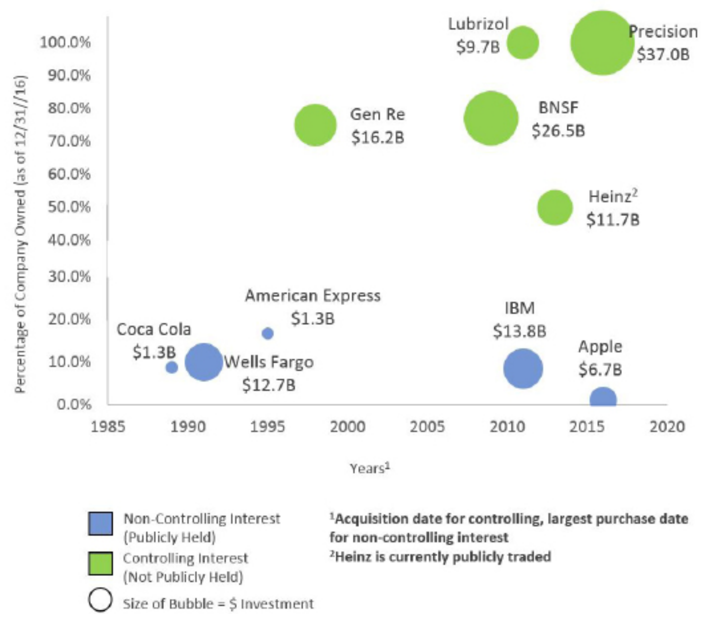


SO NOW WHAT?

The interesting thing is, after all this time, Buffett has been so good at investing that he can't deploy the cash as fast as it's coming in. At first, to offload this cash, he started to take more stakes in larger companies — not controlling stakes, but enough to grant him influence and put his big dollars to work.

But after that, he still had too much cash coming in, so he had to begin making big bets by taking controlling interests in large companies.

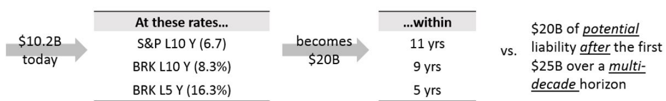
BRK's Significant Investments
Top 5 Controlling and Non-Controlling Interests



Berkshire Hathaway acquired Precision Castparts in 2016 for $32 billion. In the 2016 annual meeting, Buffett himself said that he likely wouldn't have bought into Precision Castparts in previous years, but that he had too much cash on hand and had to put it to work. Try as he might, Warren could not aggressively follow the guidance of his mentor Randy Moss and pay cash for everything, because in his mind, there weren't the right deals to be had. So the cash has been growing and growing.

With these vast amounts of cash on hand, Berkshire Hathaway has found itself with some unique business opportunities not available to anyone else. The most notable recent one is their deal with AIG. AIG, struggling with the volatility of their earnings and recent reserve development that was working against them, worked out a deal where they paid Berkshire Hathaway $10.2 billion today in exchange for Berkshire taking on $20 billion of AIG's potential risk down the line. More specifically, Berkshire Hathaway agreed to cover 80% of AIG's net losses in excess of the first $25 billion, with a maximum liability of $20 billion. Munger admitted at the conference that "It's intrinsically a dangerous kind of activity, but that's one of its attractions." Their thinking is that they'll have an extra $10.2 billion today that can be used for takeovers and stock investments that will offset any eventual payout they will owe. As Buffett said, it all comes down to "how fast we pay out the money." Even with the risk, analysts at Credit Suisse estimate that the total projected benefit of the deal will come out to about $8 billion for Berkshire Hathaway. Not too shabby.

No matter how you slice it, the deal looks to be a big win for Berkshire Hathaway:



Given that the $20B liability is comprised of potential losses over a multi-decade span, and only after the first $25B in potential losses is paid out, you can see why BRK made the deal. In fact, it seems like such a no-brainer, you wonder why no one else was in on it. Well that's where scale comes into play. As Warren put it, "We were actually the only insurance operation in the world who would write that size of a contract and where it would be satisfactory to the other party."

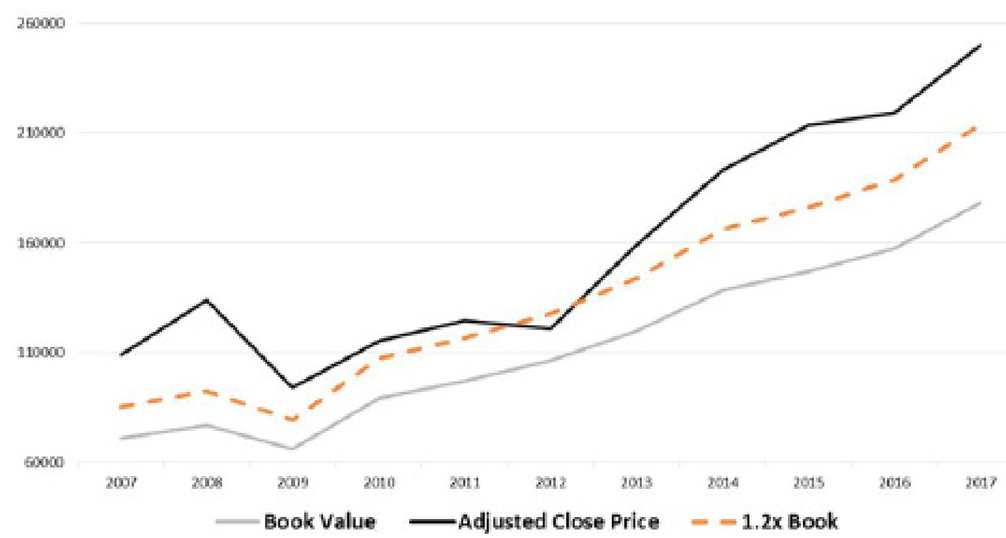
So with $94 billion in cash as of last month, and, by the time you read this, probably north of $96 billion (what have *you* done in the last 30 days?), what does the Oracle do now?

Well, conventional wisdom would say that he has three options.

1. Buy back stock — Buffett has long said that if the A share price drops to 120% of book value, he will buy back stock. But it's currently selling at 146% of book value, so this is highly unlikely, though not out of the question. He has said that the 120% number isn't a hard and fast rule and he might be willing to raise that limit, but based on historical precedent, it's probably a relatively safe bet that this isn't happening anytime soon.
2. Pay a dividend — if he really, truly believes that he can't put $100 billion to work in the markets today, that would be the correct thing to do. What are the chances of this though? In the entire history of the company, Buffett has paid a dividend only once, in 1967, and he later joked that he must have been in the bathroom when that decision was made. Although Buffett champions investing in companies that pay dividends, he does not believe in the practice for Berkshire Hathaway. His reluctance makes sense though. From an investor perspective, would you rather get paid back money to personally invest in the market, or leave it in the hands of the man who has driven the stock price of Berkshire Hathaway from $275 in 1980 to almost $250,000 today?
3. Buy — his historical path. As Buffett himself said, "If we find a really big deal, that makes compelling sense, we're going to do it." The question here is what?

Cigar butts come back into play here a little bit. He has moved on from the concept of those cigar butts where he could get a few free puffs for zero cost, but the philosophy of gaining that incremental value remains. The market is up 230% in the 8+ years since early 2009. There was some flatness in 2011 and a slight hiccup in

BRK-A Stock Performance



Year	Market-to-Book
2007	153%
2008	174%
2009	142%
2010	129%
2011	129%
2012	113%
2013	133%
2014	140%
2015	145%
2016	139%
2017	140%

Data: Yahoo! Finance and Ycharts.com

2015, but it has been a sustained bull market, one which doesn't lend itself to Warren's philosophy of finding undervalued assets with strong earnings. Neither the multiples being paid for deals on the private side nor the premiums being paid in the public markets, lend themselves to the sort of valuations that Warren is attracted to. Berkshire Hathaway more or less puts valuation 'ceilings' on acquisitions by its portfolio companies, based on multiples of earnings, that I would consider to be tough to execute against in today's valuation environment. If you apply that same thinking to the next large-scale BRK acquisition or investment, it would seem to me that some sort of significant market correction would be necessary for Warren to have BRK jump into a deal on its own.

Which brings me to my next line of thinking... We can only surmise, but if you look at recent history, he has partnered with 3G, a firm that I'm guessing 10 years ago he would have lumped in with the rest of the PE industry that he abhors so much. Buffett has faced criticism for this partnership though because his "man of the people" image seems to conflict with the fact that people lose jobs wherever 3G goes. He managed to successfully evade these questions at the Annual Meeting: when pressed about whether 3G fits in with the Berkshire Hathaway philosophy, he said that one of Berkshire Hathaway's tenets is increased productivity and that he liked 3G because they are good at increasing productivity. It also doesn't hurt that they have made him a ton of money on Heinz.

This got me thinking about where he might strike next, and more specifically, if he might strike in partnership with 3G. He didn't seem enamored with having to put big bucks to work on Precision Castparts in 2016, and perhaps the "solo approach" might not be his preferred modus operandi at this juncture.

So I turned my attention to 3G. If you look at the deals that 3G is known for, and the areas where BRK has gotten involved, you can start to see a pattern.

In addition to this, 3G/BRK backed Heinz-Kraft's $30+ billion bid for Unilever earlier this year, and were rumored to be interested in acquiring Mondelez in a separate deal.

3G Capital focuses on consumer-facing, branded businesses, primarily in food & beverage. These are labor intensive, geographically diverse enterprises where their operational improvement, zero-based budgeting, and similar value-creation efforts seem to bear the most fruit for them.

3G Capital Deals

Date	Company	Industry
2004	InBev	Food & Beverage
2008	Anheuser-Busch	Food & Beverage
2010	Burger King	Restaurants
2013	Heinz*	Food Processing
2014	Tim Horton's*	Restaurants
2014	Restaurant Brands Intl*	Restaurants
2015	Kraft-Heinz*	Food Processing

*indicates partnership with Berkshire Hathaway

Now, let's look at BRK's portfolio:

Stakes in Companies Worth $1B+

Company	Shares (M)	% Owned	Value ($B)
Kraft Heinz	325.4	26.7%	$28.4
Wells Fargo	500	10.0%	$27.6
Coca-Cola	400	9.3%	$16.6
IBM	81.2	8.5%	$13.5
American Express	151.6	16.8%	$11.2
Apple	61.2	1.1%	$7.0
Phillips 66	74.6	14.4%	$6.4
U.S. Bancorp	101.9	6.0%	$5.2
Moody's	24.7	12.9%	$2.3
Delta Airlines	54.9	7.5%	$2.7
Goldman Sachs	11.4	2.9%	$2.7
Southwest Airlines	43.2	7.0%	$2.2
Charter Comm.	6.8	2.5%	$2.0
Sanofi	22.2	1.7%	$1.8
United Continental	26.6	8.4%	$1.9
USG	43.4	29.7%	$1.3

Source: BRK Annual Report

One company in particular stands out here: Coca-Cola. Berkshire Hathaway is the single largest shareholder of Coca-Cola with 400 million shares (9.3% of the company). It's a huge company to swallow ($194B market cap) and it's trading at a 32x multiple, with a significant debt load, so this is definitely not a slam dunk.

But I can't get past all of my thoughts above. It just feels like it is the sort of thing that works for him, for 3G, and for their combined holdings. Not to mention, he's an avid drinker (and promoter!) of its product.

Not so coincidentally, Anheuser-Busch was briefly rumored to be flirting with the idea of a Coca-Cola takeover bid in 2016, following the approval of their merger with SABMiller. While the debt load taken on with the merger might make the acquisition of Coca-Cola unfeasible on its own, someone with significant cash holdings could easily make it happen. And remind me again, who owns Anheuser-Busch?

Also not so coincidentally, Buffett's son Howard was on the Board and recently stepped down. Some argue that Howard leaving the Board could be to make it easier for Berkshire Hathaway to divest its interest in the company, but could this actually be a signal that Berkshire Hathaway is looking to acquire it? Food (and Beverage?) for thought.

Special thanks to Phil Terry and Whitney Tilson for facilitating my introduction to BRK over these past few years.

"I don't see how anybody can feel better than I feel. I'm one quarter Coca-Cola." — Warren Buffett

"There's no evidence that I will any better reach 100 if I had lived on broccoli and water (instead of Coca-Cola)." — Warren Buffett