WARREN E. BUFFETT, 1995

On August 25, 1995, Warren Buffett, the CEO of Berkshire Hathaway, announced that his firm would acquire the 49.6 percent of GEICO Corporation that it did not already own. The $2.3 billion deal would give GEICO shareholders $70.00 per share, up from the $55.75 per share market price before the announcement. Observers were astonished at the 26 percent premium that Berkshire Hathaway would pay, particularly since Buffett proposed to change nothing about GEICO, and there were no apparent synergies in the combination of the two firms. At the announcement, Berkshire Hathaway's shares closed up 2.4 percent for the day, for a gain in market value of $718 million.[1] That day, the S&P500 Index closed up 0.5 percent.

The acquisition of GEICO renewed public interest in its architect, Warren Buffett. In many ways he was an anomaly. One of the richest individuals in the world (with an estimated net worth of about $7 billion), he was also respected and even beloved. Though he had accumulated perhaps the best investment record in history (a compound annual increase in wealth of 28 percent from 1965 to 1994)[2] Berkshire Hathaway paid him only $100,000 per year to serve as its CEO. Buffett and other insiders controlled 47.9 percent of the company, yet he ran the company in the interests of all shareholders. He was the subject of numerous laudatory articles and three biographies[3], yet he remained an intensely private individual. Though acclaimed by many as an intellectual genius, he shunned the company of intellectuals and preferred to affect the manner of a down-home Nebraskan (he lived in Omaha), and a toughminded investor. In contrast to other investment "stars," Buffett acknowledged his investment failures quickly and publicly. Though he held an M.B.A. from Columbia University and credited his mentor, Professor Benjamin Graham, with developing the

[1]The change in Berkshire Hathaway's share price at the date of the announcement was $609.60. The company had outstanding 1,177,750 shares.

[2]Buffett's initial cost per share in Berkshire Hathaway in 1965 was about $17.578. On August 25, 1995, the price per share closed at $25,400.

[3]Robert G. Hagstrom, Jr., *The Warren Buffett Way*, (New York: John Wiley & Sons, 1994). Andrew Kilpatrick, *Of Permanent Value: The Story of Warren Buffett*, (Birmingham: AKPE, 1994). Roger Lowenstein, *Buffett: the Making of An American Capitalist*, (New York: Random House, 1995).

philosophy of value-based investing that guided Buffett to his success, he chided business schools for the irrelevance of their theories of finance and investing.

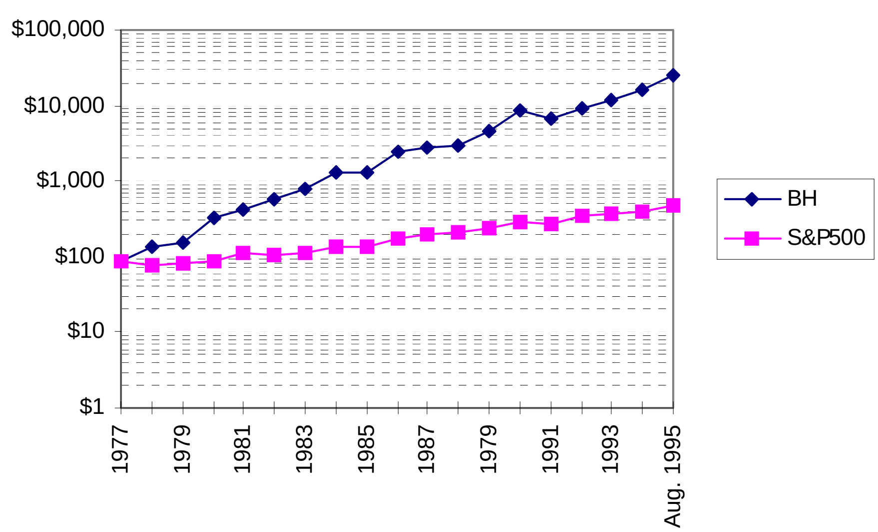
Numerous writers sought to distill the essence of Buffett's success. What were the key principles that guided Buffett? Could these be applied broadly in the late 1990s and into the 21st century, or were they unique to Buffett and his time? From an understanding of these principles, analysts hoped to illuminate Berkshire Hathaway's acquisition of GEICO. Under what assumptions would this acquisition make sense? What were Buffett's probable motives in the acquisition? Would the acquisition of GEICO prove to be a success? How would it compare to the firm's other recent investments in Salomon Brothers, USAir, and Champion International?

Berkshire Hathaway, Inc.

The company was incorporated in 1889 as Berkshire Cotton Manufacturing, and eventually grew to become one of New England's biggest textile producers, accounting for 25 percent of the country's cotton textile production. In 1955, Berkshire merged with Hathaway Manufacturing and began a secular decline due to inflation, technological change, and intensifying competition from foreign competitors. In 1965 Buffett and some partners acquired control of Berkshire Hathaway, believing that the decline could be reversed. Over the next 20 years it became apparent that large capital investments would be required to remain competitive and that even then the financial returns would be mediocre. In 1985, Berkshire Hathaway exited the textile business. Fortunately, the textile group generated enough cash in the initial years to permit the firm to purchase two insurance companies headquartered in Omaha: National Indemnity Company and National Fire & Marine Insurance Company. Acquisitions of other businesses followed in the 1970s and 1980s.

The investment performance of a share in Berkshire Hathaway had astonished most observers. In 1977 the firm's year-end closing share price was $89.00. On August 25, 1995, the firm's closing share price was $25,400.00. In comparison, the annual average total return on all large stocks from 1977 to the

Share Price of Berkshire Hathaway vs. S&P500 Index



end of 1994 was 14.3 percent.[4] Over the same period, the Standard & Poor's 500 Index grew from 107 to 560. Some observers called for Buffett to split the firm's share price, to make it more accessible to the individual investor. He steadfastly refused.

In 1994, Berkshire Hathaway described itself as "a holding company owning subsidiaries engaged in a number of diverse business activities."[5] **Exhibit 1** gives a summary of revenues, operating profits, capital expenditures, depreciation, and assets for the various segments. By 1994, Berkshire's portfolio of businesses included:

- *Insurance Group*. The largest component of Berkshire's portfolio focused on property and casualty insurance, on both a direct and reinsurance basis. The investment portfolios of the Insurance Group included meaningful equity interests in ten other publicly-traded companies. The equity interests are summarized in **Exhibit 2**, along with Berkshire's share of undistributed operating earnings in these companies. Because the earnings in some of these companies could not be consolidated with Berkshire's under GAAP rules, Buffett published Berkshire's "look-through" earnings[6]—as shown in Exhibit 2, the share of undistributed earnings of major investees accounted for 40-50 percent of Berkshire's total "look-through" earnings. **Exhibit 3** summarizes investments in convertible preferred[7] stocks that Berkshire Hathaway had made in recent years, serving as a "white squire" to major corporations—each of these firms had been the target of actual or rumored takeover attempts.
- *Buffalo News*. A daily and Sunday newspaper in upstate New York.
- *Fechheimer*. A manufacturer and distributor of uniforms.
- *Kirby*. A manufacturer and marketer of home cleaning systems and accessories.
- *Nebraska Furniture*. A retailer of home furnishings.
- *See's Candies*. A manufacturer and distributor of boxed chocolates and other confectionery products.
- *Childcraft and World Book*. A publisher and distributor of encyclopedias and related educational and instructional material.
- *Campbell Hausfeld*. A manufacturer and distributor of air compressors, air tools, and painting systems.
- *H.H. Brown Shoe Company; Lowell Shoe, Inc., and Dexter Shoe Company.* The manufacture, import, and distribution of footwear.

[4]Reported in *Stocks, Bonds, Bills, and Inflation, 1994* (Chicago: Ibbotson Associates), 10.

[5]Berkshire Hathaway, Inc. *Annual Report, 1994,* 6.

[6]"Look-through" earnings was calculated as the sum of Berkshire's operating earnings reported in its income statement, plus the retained operating earnings of major investees not reflected in Berkshire's profits, less tax on what would be paid by Berkshire if these earnings had been distributed to Berkshire. (The presentation used a 14 percent tax rate, the rate Berkshire paid on dividends it received.)

[7]Convertible preferred stock was preferred stock that carried the right to be exchanged by the investor for common stock. The exchange, or "conversion" right was like a call option on the common stock of the issuer. The terms of the convertible preferred stated the price at which common shares could be acquired in exchange for the principal value of the convertible preferred stock.

In addition to these businesses, Berkshire owned an assortment of smaller businesses[8] generating about $400 million in revenues.

Berkshire Hathaway's Acquisition Policy

The GEICO announcement renewed general interest in Buffett's approach to acquisitions. **Exhibit 4** gives the formal statement of acquisition criteria contained in Berkshire Hathaway's 1994 Annual Report. In general, the policy expressed a tightly disciplined strategy that refused to reward others for actions that Berkshire Hathaway might just as easily take on its own. Therefore, analysts scrutinized the criteria to assess where they might offer winning ideas to Buffett.

One prominent example to which Buffett referred was Berkshire Hathaway's investment in Scott & Fetzer in 1986. The managers of Scott & Fetzer had attempted a leveraged buyout of the company in the face of rumored hostile takeover attempt. When the Labor Department objected to the company's use of an Employee Stock Ownership Plan to assist in the financing, the deal fell apart. Soon the company attracted unsolicited proposals to purchase the company, including one from Ivan F. Boesky, the abitrageur. Buffett offered to buy the company for $315 million (which compared to its book value of $172.6 million.) Following the acquisition, Scott & Fetzer paid Berkshire Hathaway dividends of $125 million, even though it earned only $40.3 million that year. In addition, Scott & Fetzer was conservatively financed, going from modest debt at the acquisition to virtually no debt by 1994. **Exhibit 5** gives the earnings and dividends for Scott & Fetzer from 1986 to 1994. Buffett noted that in terms of return on book value of equity, Scott & Fetzer would have easily beaten the Fortune 500 firms.[9] The annual average total return on large company stocks from 1986 to 1994 was 12.6 percent.[10]

Buffett's Investment Philosophy

Warren Buffett was first exposed to formal training in investing at Columbia University where he studied under Professor Benjamin Graham. The coauthor of a classic text, *Security Analysis*, Graham developed a method of identifying undervalued stocks (i.e., stocks whose price was less than "intrinsic value"). This became the cornerstone of the modern approach of "value investing." Graham's approach was to focus on the value of assets such as cash, net working capital and physical assets. Eventually, Buffett modified that approach to focus also on valuable franchises that were not recognized by the market.

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[8]These included companies in conduit fittings, marketing motivational services, retailing fine jewelry, air compressors, sun and shade control products, appliance controls, zinc die cast fittings, automotive compounds, pressure and flow measurement devices, fractional horsepower motors, boat winches, cutlery, truck bodies, furnace burners, compressed gas fittings, and molded plastic components.

[9]This exempts from the comparison firms emerging from bankruptcy in recent years. Buffett's observation was made in Berkshire Hathaway's 1994 Annual Report.

[10]Reported in *Stocks, Bonds, Bills, and Inflation.*

Over the years, Buffett had expounded his philosophy of investing in his CEO's letter to shareholders in Berkshire Hathaway's annual report. By 1995, these lengthy letters had accumulated a broad following because of their wisdom and their humorous, self-deprecating tone. The letters emphasized the following elements:

1. *Economic reality, not accounting reality.* Financial statements prepared by accountants conformed to rules that might not adequately represent the *economic* reality of a business. Buffett wrote

> . . . because of the limitations of conventional accounting, consolidated reported earnings may reveal relatively little about our true economic performance. Charlie and I, both as owners and managers, virtually ignore such consolidated numbers. . . . Accounting consequences do not influence our operating or capital-allocation process.[11]

Accounting reality was conservative, backward-looking, and governed by generally accepted accounting principles (GAAP). Investment decisions, on the other hand, should be based on the economic reality of a business. In economic reality, intangible assets such as patents, trademarks, special managerial know-how, and reputation might be very valuable, yet under GAAP, they would be carried at little or no value. GAAP measured results in terms of net profit; in economic reality, the results of a business were its *flows of cash*.

A key feature of Buffett's approach defined economic reality at the level of the business itself, not the market, the economy, or the security—he was a *fundamental analyst* of a business. His analysis sought to judge the simplicity of the business, the consistency of its operating history, the attractiveness of its long-term prospects, the quality of management, and the firm's capacity to create value.

2. *The cost of the lost opportunity.* Buffett compared an investment opportunity against the next best alternative, the so-called "lost opportunity." In his business decisions, he demonstrated a tendency to frame his choices as "either/or" decisions rather than "yes/no" decisions. Thus, an important standard of comparison in testing the attractiveness of an acquisition was the potential rate of return from investing in common stocks of other companies. Buffett held that there was no fundamental difference between buying a business outright, and buying a few shares of that business in the equity market. Thus, for him, the comparison of an investment against other returns available in the market was an important benchmark of performance.

3. *Value creation: time is money.* Buffett assessed intrinsic value as the present value of future expected performance.

[11]Berkshire Hathaway, Inc. *Annual Report, 1994*, 2.

> [All other methods fall short in determining whether] an investor is indeed buying something for what it is worth and is therefore truly operating on the principle of obtaining value for his investments . . . Irrespective of whether a business grows or doesn't, displays volatility or smoothness in earnings, or carries a high price or low in relation to its current earnings and book value, the investment shown by the discounted-flows-of-cash calculation to be the cheapest is the one that the investor should purchase.[12]

Enlarging on his discussion of "intrinsic value," Buffett used an educational example:

> We define intrinsic value as the discounted value of the cash that can be taken out of a business during its remaining life. Anyone calculating intrinsic value necessarily comes up with a highly subjective figure that will change both as estimates of future cash flows are revised and as interest rates move. Despite its fuzziness, however, intrinsic value is all-important and is the only logical way to evaluate the relative attractiveness of investments and businesses.
>
> To see how historical input (book value) and future output (intrinsic value) can diverge, let's look at another form of investment, a college education. Think of the education's cost as its "book value." If it is to be accurate, the cost should include the earnings that were foregone by the student because he chose college rather than a job. For this exercise, we will ignore the important noneconomic benefits of an education and focus strictly on its economic value. First, we must estimate the earnings that the graduate will receive over his lifetime and subtract from that figure an estimate of what he would have earned had he lacked his education. That gives us an excess earnings figure, which must then be discounted, at an appropriate interest rate, back to graduation day. The dollar result equals the intrinsic economic value of the education. Some graduates will find that the book value of their education exceeds its intrinsic value, which means that whoever paid for the education didn't get his money's worth. In other cases, the intrinsic value of an education will far exceed its book value, a result that proves capital was wisely deployed. In all cases, what is clear is that book value is meaningless as an indicator of intrinsic value.[13]

To illustrate the mechanics of this example, consider the hypothetical case presented in **Exhibit 6**. Suppose an individual has the opportunity to invest $50 million in a business—this is its "cost" or "book value." This business will throw off cash at the rate of 20 percent of its investment base each year. Suppose that instead of receiving any dividends, the owner decides to reinvest all cash flow back into the business—at this rate the "book value" of the business will grow at 20 percent per year. Suppose that the investor plans to sell the business for its "book value" at the

[12]Berkshire Hathaway, Inc. *Annual Report, 1992,* 14.
[13]Berkshire Hathaway, Inc. *Annual Report, 1994,* 7.

end of the fifth year. Does this investment create value for the individual? One determines this by discounting the future cash flows to the present at a cost of equity of 15 percent—suppose that this is the investor's opportunity cost, the required return that could have been earned elsewhere at comparable risk. Dividing the present value of future cash flows (i.e., Buffett's "intrinsic value") by the cost of the investment (i.e., Buffett's "book value") indicates that every dollar invested buys securities worth $1.23. Value is created.

Consider an opposing case, summarized in **Exhibit 7**. The example is similar in all respects except for one key difference: the annual return on the investment is 10 percent. The result is that every dollar invested buys securities worth $0.80. Value is destroyed.

Comparing the two cases in Exhibits 6 and 7, the difference in value creation and destruction is driven entirely by the relationship between the expected returns and the discount rate: in the first case, the spread is positive; in the second case, it is negative. Only in the instance where expected returns equal the discount rate will "book value" equal intrinsic value. In short, book value or the investment outlay may not reflect economic reality: one needs to focus on the prospective rates of return, and how they compare to the required rate of return.

4. *Measure performance by gain in intrinsic value, not accounting profit.* Buffett wrote:

> Our long-term economic goal . . . is to maximize the average annual rate of gain in intrinsic business value on a per-share basis. We do not measure the economic significance or performance of Berkshire by its size; we measure by per-share progress.[14]

The gain in intrinsic value could be modeled as the value added by a business above and beyond a charge for the use of capital in that business. The gain in intrinsic value was analogous to "economic profit" and "market value added," measures used by analysts in leading corporations to assess financial performance. Those measures focus on the ability to earn returns in excess of the cost of capital.

5. *Risk and discount rates.* Conventional academic and practitioner thinking held that the more risk one took, the more one should get paid. Thus, discount rates used in determining intrinsic values should be determined by the risk of the cash flows being valued. The conventional model for estimating discount rates was the Capital Asset Pricing Model (CAPM) which added a risk premium to the long-term risk-free rate of return (such as the U.S. Treasury bond yield).

Buffett departed from conventional thinking, by using the rate of return on the long-term (e.g., 30-year) U.S. Treasury bond to discount cash flows.[15] Defending this practice, Buffett argued

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[14]Ibid., 2.

[15] The yield on the 30-year U.S. Treasury bond on August 25, 1995 was 6.86 percent. The beta of Berkshire Hathaway was 0.95.

that he avoided risk, and therefore should use a "risk-free" discount rate. His firm used almost no debt financing. He focused on companies with predictable and stable earnings. He or his vice chairman, Charlie Munger, sat on the boards of directors where they obtained a candid, inside view of the company and could intervene in decisions of management if necessary. Buffett wrote:

> I put a heavy weight on certainty. If you do that, the whole idea of a risk factor doesn't make sense to me. Risk comes from not knowing what you're doing.[16]

We define risk, using dictionary terms, as "the possibility of loss or injury." Academics, however, like to define "risk" differently, averring that it is the relative volatility of a stock or a portfolio of stocks—that is, the volatility as compared to that of a large universe of stocks. Employing data bases and statistical skills, these academics compute with precision the "beta" of a stock—its relative volatility in the past—and then build arcane investment and capital allocation theories around this calculation. In their hunger for a single statistic to measure risk, however, they forget a fundamental principle: it is better to be approximately right than precisely wrong.[17]

6. *Diversification.* Buffett disagreed with conventional wisdom that investors should hold a broad portfolio of stocks in order to shed company-specific risk. In his view, investors typically purchased far too many stocks rather than waiting for the one exceptional company. Buffett said,

> Figure businesses out that you understand, and concentrate. Diversification is protection against ignorance, but if you don't feel ignorant, the need for it goes down drastically.[18]

7. *Investing behavior should be driven by information, analysis, and self-discipline, not by emotion or "hunch."* Buffett repeatedly emphasized "awareness" and information as the foundation for investing. He said, "Anyone not aware of the fool in the market probably is the fool in the market."[19] Buffett was fond of repeating a parable told him by Benjamin Graham:

> There was a small private business and one of the owners was a man named Market. Every day Mr. Market had a new opinion of what the business was worth, and at that price stood ready to buy your interest or sell you his. As excitable as he was opinionated, Mr. Market presented a constant distraction to his fellow owners. "What does he know?" they would wonder, as he bid them an extraordinarily high price or a depressingly low one. Actually, the gentleman knew little or nothing. You may be happy to sell out to him when he quotes you a ridiculously high price, and

[16] Quoted in Jim Rasmussen, "Buffett Talks Strategy with Students," *Omaha World-Herald,* January 2, 1994, 26.

[17] Berkshire Hathaway *Annual Report, 1993,* and republished in Andrew Kilpatrick, *Of Permanent Value, The Story of Warren Buffett* (Birmingham: AKPE, 1994), 574.

[18] Quoted in *Forbes,* October 19, 1993, and republished in Andrew Kilpatrick, *Of Permanent Value, The Story of Warren Buffett,* 574.

[19] Quoted in Michael Lewis, *Liar's Poker* (New York: Norton, 1989), 35.

> equally happy to buy from him when his price is low. But the rest of the time you will be wiser to form your own ideas of the value of your holdings, based on full reports from the company about its operations and financial position.[20]

Buffett used this allegory to illustrate the irrationality of stock prices as compared to true intrinsic value. Graham believed that an investor's worst enemy was not the stock market, but oneself. Superior training could not compensate for the absence of the requisite temperament for investing. Over the long term, stock prices should have a strong relationship with the economic progress of the business. But daily market quotations were heavily influenced by momentary greed or fear, and were an unreliable measure of intrinsic value. Buffett said,

> As far as I am concerned, the stock market doesn't exist. It is there only as a reference to see if anybody is offering to do anything foolish. When we invest in stocks, we invest in businesses. You simply have to behave according to what is rational rather than according to what is fashionable.[21]

Accordingly, Buffett did not try to "time the market" (i.e., trade stocks based on expectations of changes in the market cycle)—his was a strategy of patient, long-term investing. As if in contrast to "Mr. Market," Buffett expressed more contrarian goals: "We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful."[22] Buffett also said, "Lethargy bordering on sloth remains the cornerstone of our investment style,"[23] and
"The market, like the Lord, helps those who help themselves. But unlike the Lord, the market does not forgive those who know not what they do.[24]

Buffett scorned the academic theory of capital market efficiency. The Efficient Markets Hypothesis (EMH) held that publicly known information was rapidly impounded into share prices, and that as a result, stock prices were "fair" in reflecting what was known about a company. Under EMH, there were no bargains to be had and trying to outperform the market would be futile. "It has been helpful to me to have tens of thousands turned out of business schools taught that it didn't do any good to think," Buffett said.[25]

> I think it's fascinating how the ruling orthodoxy can cause a lot of people to think the earth is flat. Investing in a market where people believe in efficiency is like playing bridge with someone who's been told it doesn't do any good to look at the cards.[26]

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[20]Originally published in Berkshire Hathaway *Annual Report, 1987.* This quotation was paraphrased from James Grant, *Minding Mr. Market* (New York: Times Books, 1993), xxi.

[21]Peter Lynch, *One Up on Wall Street* (New York: Penguin Books, 1990), 78.

[22]Berkshire Hathaway *Annual Report, 1986,* 16.

[23]Berkshire Hathaway *Annual Report, 1990,* 15.

[24]Berkshire Hathaway *Letters to Shareholders, 1977-1983,* 53.

[25]Quoted in Andrew Kilpatrick, *Of Permanent Value,* 353.

[26]Quoted in L. J. Davis, "Buffett Takes Stock," *New York Times,* April 1, 1990, 16.

8. *Alignment of agents and owners.* Explaining his significant ownership interest in Berkshire Hathaway, Buffett said, "I am a better businessman because I am an investor. And I am a better investor because I am a businessman."[27]

As if to illustrate this sentiment, he said,

> A managerial "wish list" will not be filled at shareholder expense. We will not diversify by purchasing entire businesses at control prices that ignore long-term economic consequences to our shareholders. We will only do with your money what we would do with our own, weighing fully the values you can obtain by diversifying your own portfolios through direct purchases in the stock market.[28]

For four of Berkshire's six directors, over 50 percent of their family net worth was represented by shares in Berkshire Hathaway. The senior managers of Berkshire Hathaway subsidiaries held shares in the company, or were compensated under incentive plans that imitated the potential returns from an equity interest in their business unit, or both.

GEICO Corporation

Berkshire Hathaway began purchasing shares in GEICO in 1976, and by 1980 had accumulated a 33 percent interest (34.25 million shares) for $45.7 million. During the period from 1976-1980, GEICO's share price had been hammered by double-digit inflation, higher accident rates, and high damage awards that raised the costs of its business more rapidly than premiums could be increased. By August 1995, that stake had grown to 50.4 percent of the firm's shares (because GEICO had repurchased some of its own shares while Berkshire had maintained its holdings) and the original stake of $45.7 million had grown in value to $1.9 billion.[29] Also, GEICO had paid an increasing dividend each year (see **Exhibit 8**). From 1976 to 1994, the average annual total return on large company stocks was 13.5 percent.[30]

In explaining the decision to acquire the rest of the shares in GEICO, Buffett noted:

- The firm was the seventh-largest auto insurer in the United States, underwriting policies for 3.7 million cars.

- The firm's senior managers were "extraordinary" and had an investment style similar to Buffett's. These managers would add depth to Berkshire Hathaway's senior management bench and provide continuity in case anything happened to Buffett (age 65) or Munger (age 72).

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[27] Quoted in *Forbes*, October 19, 1993, and republished in Andrew Kilpatrick, *Of Permanent Value*, 574.
[28] "Owner-Related Business Principles" in Berkshire Hathaway *Annual Report 1994*, 3.
[29] This assumes the pre-announcement GEICO share price of $55.75.
[30] Reported in *Stocks, Bonds, Bills, and Inflation, 1994*, 10.

- The firm was the lowest-cost insurance provider in the industry.

Some analysts sought to test the suitability of Buffett's $70 per share offer for GEICO using the discounted cash flow approach. On July 7, 1995, *Value Line Investment Survey* published a forecast of GEICO's dividends[31] and future stock price within a range of possible outcomes:

Table 1. *Value Line* Forecast Information

		Low End of Range	High End of Range
Forecasted Dividends	**1996**	$1.16	$1.16
	1997	$1.25	$1.34
	1998	$1.34	$1.55
	1999	$1.44	$1.79
	2000	$1.55	$2.07
Forecasted Stock Price in 2000		$90.00	$125.00

Value Line also presented evidence consistent with a cost of equity for GEICO of 11 percent.[32] GEICO had outstanding 67,889,574 shares as of April 30, 1995.

Analysts noted that the timing of Berkshire Hathaway's bid followed closely Walt Disney Company's bid to buy Capital Cities/ABC for $19 billion. Since some of the proceeds would be in cash, Berkshire Hathaway would need to reinvest the funds elsewhere.

[31]GEICO paid dividends quarterly, though *Value Line* presented only an annual forecast. Annual figures are given here for simplicity.

[32]Analysts used the Capital Asset Pricing Model to estimate GEICO's cost of equity. *Value Line* estimated GEICO's beta at 0.75. (In comparison, Berkshire Hathaway's beta was 0.95.) The equity market risk premium was about 5.5 percent. And the risk-free rate estimated by the yield on the 30-year U.S. Treasury bond was 6.86 percent.

Conclusion

Conventional thinking held that it would be difficult for Warren Buffett to maintain his record of 28 percent annual growth in shareholder wealth. Buffett acknowledged that "A fat wallet is the enemy of superior investment results."[33] He stated that it was the firm's goal to meet a 15 percent annual growth rate in intrinsic value. Would the GEICO acquisition serve the long-term goals of Berkshire Hathaway? Was the bid price appropriate? What might account for the share price increase for Berkshire Hathaway at the announcement?

[33]Quoted in Garth Alexander, "Buffett Spends $2bn on Return to His Roots," Times Newspapers Ltd., August 17, 1995.

Exhibit 1
WARREN E. BUFFETT, 1995
Business Segment Information,
Berkshire Hathaway, Inc.
(dollars in millions)

Segment	Revenues		Pretax Opng. Profit**		Capital Expenditures		Depreciation		Identifiable Assets	
	1994	1993	1994	1993	1994	1993	1994	1993	1994	1993
Insurance	$1,437	$1,591	$639	$961	$0.9	$1.2	$0.9	$0.8	$18,494	$16,127
Candy	216	201	47	40	4.1	4.3	4.1	4.1	69	70
Encyclopedias	191	199	24	19	0.1	0.7	1.4	1.5	76	75
Home-cleaning systems	207	193	44	41	1.0	1.5	4.2	5.3	42	49
Home furnishings	245	209	17	21	22.6	5.3	6.2	2.7	128	101
Newspaper	151	145	54	50	5.2	3.6	2.2	1.9	48	45
Shoes	609	370	76	40	17.9	4.4	10.2	5.2	673	642
Uniforms	151	122	14	13	4.6	1.0	2.5	1.8	95	88
Other	639	568	*(192)	60	10.7	13.0	18.0	17.3	1,712	2,324
Total	$3,847	$3,599	$722	$1,246	$67.1	$35.0	$49.6	$40.5	$21,338	$19,520

*Includes pretax charge of $269 representing an other-than-temporary decline in value of investment in USAir Group, Inc. Preferred Stock.
** Before interest expense.
N.B. Columns may not sum to the total because of rounding.
Source: Berkshire Hathaway *Annual Report* 1994.

Exhibit 2

WARREN E. BUFFETT, 1995

Major Investees of Berkshire Hathaway, and
"Look-Through Earnings"
(dollars in millions)

Berkshire's Major Investees	**Berkshire's Approximate Ownership at Yearend**		**Berkshire's Share of Undistributed Operating Earnings (in millions)**	
	1994	**1993**	**1994**	**1993**
American Express Co	5.5%	2.4%	$25	$16
Capital Cities/ABC	13.0	13.0	85	83
Coca-Cola	7.8	7.2	116	94
Federal Home Loan Mtge.	6.3	6.8	47	41
Gannett	4.9	—	4	—
GEICO	50.2	48.4	63	76
Gillette	10.8	10.9	51	44
PNC Bank	8.3	—	10	—
Washington Post	15.2	14.8	18	15
Wells Fargo	13.3%	12.2%	73	53
Berkshire's share of undistributed earnings			$492	$422
Hypothetical tax on these earnings			(68)	(59)
Reported operating earnings of Berkshire			606	478
Total "Look-through" earnings of Berkshire			$1,030	$841

Source: Berkshire Hathaway *Annual Report* 1994, p. 13.

Exhibit 3

WARREN E. BUFFETT, 1995

Berkshire's Investments in Private Purchases
Of Convertible Preferred Stocks

	Dividend Rate	Year of Purchase	Cost ($mm)	Market Value ($mm at Dec. 1995)
Champion International Corp.[1]	9.25%	1989	$300	$388
First Empire State Corp.[2]	9.00	1991	40	110
The Gillette Company[3]	8.75	1989	600	2,502
Salomon Inc[4]	9.00	1987	700	728
USAir Group, Inc.[5]	9.25	1989	358	215

Source: Berkshire Hathaway, *Annual Report*, 1995, p. 16.

[1] The Champion International issue could be converted into common shares at $38.00 per share. At August 25, 1995, Champion International's common share price was $57.50. By December 31, 1995, Champion's share price had fallen to $42.75.

[2] The First Empire issue could be converted into common shares at a conversion price of $78.91 per share. First Empire has the right to redeem the issue beginning in 1996. At August 25, 1995, First Empire's common share price was $184.50.

[3] The Gillette issue could be converted into common stock at $25.00 per share, and carried a mandatory redemption by Gillette after 10 years. In February 1991, following the highly successful introduction of the Sensor razor, Gillette announced that it would redeem the issue at $31.75, which effectively forced Berkshire to convert its holding into common stock. Berkshire converted, and received 12 million common shares, or 11 percent of Gillette's total shares outstanding. At August 25, 1995, Gillette's share price was $43.00.

[4] The Salomon issue could be converted into common stock at $38.00 per share. If Berkshire did not convert the preferred stock, Salomon would redeem it over five years, beginning October 1995. At August 25, 1995, Salomon's common share price was $37.125.

[5] The USAir issue could be converted into common shares at $60 per share. If Berkshire did not convert the series into common stock, USAir would have to redeem the preferred in ten years. At August 25, 1995, the USAir common share price was $8.50.

Exhibit 4

WARREN E. BUFFETT, 1995

Berkshire Hathaway Acquisition Criteria

"We are eager to hear about businesses that meet all of the following criteria:

1. Large purchases (at least $10 million of after-tax earnings),
2. Demonstrated consistent earning power (future projections are of no interest to us, nor are "turnaround" situations),
3. Businesses earning good returns on equity while employing little or no debt,
4. Management in place (we can't supply it),
5. Simple businesses (if there's lots of technology, we won't understand it),
6. An offering price (we don't want to waste our time or that of the seller by talking, even preliminarily, about a transaction when the price is unknown).

The larger the company, the greater will be our interest: we would like to make an acquisition in the $2-3 billion range.

We will not engage in unfriendly takeovers. We can promise complete confidentiality and a very fast answer—customarily within five minutes—as to whether we're interested. We prefer to buy for cash, but will consider issuing stock when we receive as much in intrinsic business value as we give.

Our favorite form of purchase is one fitting the pattern through which we acquired Nebraska Furniture Mart, Fechheimer's, Borsheim's, and Central States Indemnity. In cases like these, the company's owner-managers wish to generate significant amounts of cash, sometimes for themselves, but often for their families or inactive shareholders. At the same time, these managers wish to remain significant owners who continue to run their companies just as they have in the past. We think we offer a particularly good fit for owners with such objectives and we invite potential sellers to check us out by contacting people with whom we have done business in the past.

Charlie and I frequently get approached about acquisitions that don't come close to meeting our tests: We've found that if you advertise an interest in buying collies, a lot of people will call hoping to sell you their cocker spaniels. A line from a country song expresses our feeling about new ventures, turnarounds, or auction-like sales: "When the phone don't ring, you'll know it's me."

Besides being interested in the purchase of businesses as described above, we are also interested in the negotiated purchase of large, but not controlling, blocks of stock comparable to those we hold in Capital Cities, Salomon, Gillette, USAir, and Champion. *We are not interested, however, in receiving suggestions about purchases we might make in the general stock market.*"

Source: Berkshire Hathaway *Annual Report*, 1994, p. 21.

Exhibit 5

WARREN E. BUFFETT, 1995

Scott & Fetzer, Book Value of Equity,
Earnings, and Dividends, 1986-1994

	Beginning Book Value	Earnings	Dividends	Ending Book Value
1986	$172.6	$40.3	$125.0	$87.9
1987	87.9	48.6	41.0	95.5
1988	95.5	58.0	35.0	118.5
1989	118.5	58.5	71.5	105.5
1990	105.5	61.3	33.5	133.3
1991	133.3	61.4	74.0	120.7
1992	120.7	70.5	80.0	111.2
1993	111.2	77.5	98.0	90.7
1994	$90.7	$79.3	$76.0	$94.0

Source: Berkshire Hathaway, *Annual Report*, 1994, p. 7.

Exhibit 6

WARREN E. BUFFETT, 1995

Hypothetical Example of Value Creation

Assume:

- 5–year investment horizon, when you liquidate at “book” or accumulated investment value
- initial investment is $50 million
- no dividends are paid, all cash flows are reinvested
- ROE = 20%
- Cost of equity = 15%

Year	0	1	2	3	4	5
Investment or **Book** Equity **Value**	50	60	72	86	104	124

Market Value (or “Intrinsic Value”) = PV @ 15% of 124 = $61.65

Market/Book = $61.65/50.00 = 1.23

Value created: $1.00 invested becomes $1.23 in market value.

Source: Casewriter analysis.

Exhibit 7

WARREN E. BUFFETT, 1995

Hypothetical Example of Value Destruction

Assume:

- 5–year investment horizon, when you liquidate at "book" or accumulated investment value
- initial investment of $50 million
- no dividends are paid, all cash flows are reinvested
- ROE = 10%
- Cost of equity = 15%

Year	0	1	2	3	4	5
Investment or **Book** Equity **Value**	50	55	60	67	73	81

Market Value (or "Intrinsic Value") = PV @ 15% of $81 = $40.30.

Market/Book = $40.30/50.00 = 0.80

Value destroyed: $1.00 invested becomes $0.80 in market value.

Source: Casewriter analysis.

Exhibit 8

WARREN E. BUFFETT, 1995

GEICO Dividend Payment History
(dollars in millions, except per-share figures)

Year	GEICO Dividend Per Share	Total Dividends To Berkshire Hathaway
1976	$0.00	$0.00
1977	0.01	0.34
1978	0.04	1.37
1979	0.07	2.40
1980	0.09	3.08
1981	0.10	3.43
1982	0.11	3.77
1983	0.14	4.80
1984	0.18	6.17
1985	0.20	6.85
1986	0.22	7.54
1987	0.27	9.25
1988	0.33	11.30
1989	0.36	12.33
1990	0.40	13.70
1991	0.46	15.76
1992	0.60	20.55
1993	0.68	23.29
1994	$1.00	$34.25

Note: Total dividends to Berkshire were estimated by multiplying the per share dividend times 34.25 million shares, Berkshire's holdings in GEICO. This presentation assumes that all of Berkshire's shares in GEICO were acquired in 1976.

Source of annual dividends per share: *Value Line Investment Survey*.