

AMERICA'S MOST ADMIRABLE COMPANIES

The Value Machine

What is Berkshire Hathaway about? Start with a combination of a very profitable operating company, insurance in a big way, and a crazy quilt of other businesses--plus a CEO who invests its money and has a long-standing claim to being the best in the world.

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A small quiz, if you don't mind: Kindly describe what each of the companies in the top ten of the Most Admired does.

Most readers could breeze through eight of these paragons. They're into megastores (Wal-Mart) and securities brokerages (Schwab) and computer chips (Intel) and so on. General Electric is tougher to parse: It's financial services, but also a TV network and an electrical equipment and aerospace empire, soon to include Honeywell. But the real puzzler is No. 7, Berkshire Hathaway of Omaha. Using a sharp No. 2 pencil, could you please write 500 words on that company's business?

If you're like many people, you couldn't get past four of them: "That's Warren Buffett's company." It would take a Berkshire groupie, of whom there are carloads, to elucidate the fine points: What we've got here is a highly unusual combination of a very profitable operating company--insurance in a big way, plus a crazy quilt of other businesses--and a CEO, now 70, who invests its money and who, in that department, has a strong, long-standing claim to being the best in the world.

In the 36 years that Buffett has run the company, Berkshire's per-share book value--the performance statistic that best describes the success of an insurance company--has grown, on average, by more than 23% a year. There have been a couple of ugly lurches, notably a terrible year in 1999, but in 32 of the 36 years Berkshire's per-share results have beaten the total return of the S&P 500, often by miles. Berkshire's stock, which Buffett wouldn't dream of splitting--he sends birthday greetings to friends that say, "May you live until Berkshire splits"--has tracked the company's success and then some. In those same 36 years, it has gone from about \$12 a share to a year-end price of \$71,000, which is an annual growth rate of 27%.

Famous though this record may be, even many of the business people who vote for the Most Admired don't understand the machinery behind Berkshire's value proposition. A few may not even connect with the fact that they're voting--lawdy!--for an insurance company. But clearly they like something: This is the fifth straight year that Berkshire has made the top ten.

We now interrupt this account for some disclosure: I'm an admirer too, and a longtime friend of Buffett's, and perennial editor of his annual report (though he's

most certainly the writer), and a Berkshire shareholder for decades. Buffett and I have talked forever about collaborating on a book about his business career--in terms of words actually written, this has been all hat and no cattle--and as a result I have had unusual access to his thinking.

What I know at this moment is that Berkshire had a remarkable year in 2000, in ways largely unrecognized. I'm not talking about the stock, although that's what most Berkshire followers were looking at. While tech stocks were skyrocketing early in the year, Berkshire was tanking. It got all the way down to \$40,800 in March, when, says Buffett, "we were on that other list--the Most Admired by Short-Sellers." The stock then came back to that \$71,000, which from the bottom was a gain of 74%. (In late January the stock was \$68,000.) The rebound left Berkshire climbing 26.6% for the calendar year--in a down year for most companies, including seven of the ten at the top of the Most Admired list.

So what! The real story is what was going on in the company, not the stock. In a grand sweep of allocating capital--which has been his greatest talent--Buffett completed or initiated the purchase of no fewer than eight companies. We're not talking stocks here (though some of the lot were publicly owned) but rather entire companies.

One of the acquisitions, U.S. Liability of Wayne, Pa., adds to Berkshire's insurance empire. The others contribute new swatches to the Berkshire crazy quilt, being in businesses as ludicrously diverse, and as old economy, as bricks and boots (Justin Industries of Fort Worth) and fine jewelry (the Ben Bridge chain, headquartered in Seattle) and carpets (Shaw Industries of Dalton, Ga.). The purchase price, in total, was \$8 billion. That's an amount dwarfed by the \$22 billion in stock that Berkshire paid for reinsurer General Re in 1998. But the \$8 billion paid for the pieces of eight was almost all cash. That's a lot of cash--more than five times as much, for example, as the \$1.5 billion that Berkshire put some years ago into its biggest stock investment ever, American Express. None of the \$8 billion, furthermore, was borrowed. Buffett just reached into the big bucket of cash equivalents he's been patiently sitting with, and handed over the money.

When all the acquisitions are complete, Berkshire will have more than doubled the number of its employees and added about \$13 billion in revenues--although \$5 billion of that, from MidAmerican Energy, will not be consolidated because of regulatory restrictions. Even so, when Berkshire's 2000 revenues are reported, they ought to be close to \$30 billion. This year, for the first time, Berkshire will be among the top 50 companies on the FORTUNE 500 list. The company's profits should be in the range of \$3 billion, including significant capital gains that Berkshire realized during the year, from the sale of certain stocks whose identity Buffett hasn't yet disclosed.

Buffett never set out to climb into the upper reaches of the FORTUNE 500 list. Neither did he have some grand plan for acquisitions--"other than answering the phone," he says--as he entered 2000. The truth is, when it comes to creating value for investors, he doesn't see the world the way many chief executives do. He doesn't focus on his company's stock price; on a given day, he may not know where it stands. He is not searching for synergy; he likes to buy businesses that generate healthy earnings and leave them alone. And he is a switch hitter: He has always shown a willingness to buy whole businesses or, alternatively, to buy portions of businesses in the stock market. It's just that in 2000 he went on a kind of buying binge in the whole-company camp.

And was he concurrently putting new capital into the stock market? No. He's been buying some junk bonds, among them Finova's (but not Consec's, even though some publications recently reported he was). He was, however, a net

seller of stocks in 2000, and in each of the four years before as well. This retreat fits his well-known opinion that future returns from stocks can't begin to match those that investors earned in the 1980s and '90s (see "Mr. Buffett on the Stock Market," in the fortune.com archive). Among the stocks he's known to have chopped in the past few years are McDonald's and Disney.

In fact, for all his renown as a stock picker, Buffett has long preferred to have Berkshire grow not by buying stocks that go up, which is what most people would assume, but by adding businesses. Yes, that can add problems too--he's had some--but he'd still rather head in that direction.

The preference is emotional, in that he likes dealing with the managers of Berkshire's subsidiaries and building a real, working business. And the preference is often economic as well, because of taxes. Imagine that (1) a subsidiary of Berkshire, such as See's Candies, makes \$10 million after-tax, and that (2) Coca-Cola simultaneously makes \$125 million after-tax, which would mean Berkshire's share of that--given that it owns 8% of Coke--would be \$10 million. The \$10 million earned by See's is totally Berkshire's. The Coke \$10 million, however, is ensnared: To capture that money Berkshire must pay additional taxes, either on Coke dividends it receives or on capital gains it realizes upon selling Coke shares (it has never sold any). If the opportunities for reinvesting capital within Coke are sufficiently good, which means that the profits "belonging" to Berkshire will grow, Buffett happily accepts the tax toll. But otherwise he has no problem identifying the \$10 million earned inside as what he'd like to have.

He likes cash of all kinds, of course, and in Berkshire he has built a machine that produces prodigious amounts of it. The engine in the machine is the company's insurance business, which yields that wonderful thing called "float"--money an insurer can invest while it's holding premiums that will eventually go to pay claims. The businesses Buffett buys with his available funds become parts of the machinery too, generating cash for further investment.

As for what he buys: Buffett likes companies at sensible prices--which leaves him avoiding the auctions investment bankers run--that throw off cash and have capable, honest, and trustworthy people running them. He wants substantial earnings, for sure, but cares not at all whether they are consistent: "I'd rather have a lumpy 15% return on capital," he has often said, "than a smooth 12%." And he wants businesses that he can understand and that are not subject to major change. It is the rapid change in technology that has kept him away from tech investments. He feels that he cannot be sure how much cash flow a tech company will be producing ten years from now, so he stays away.

To get good companies at good prices, it helps to be perceived as a great owner, and Buffett has that reputation. He has piled up furniture retailers more or less by word of mouth--the first one in Omaha, the next in Utah, then Texas, then Massachusetts, then Iowa. For some sellers Berkshire is a refuge, a place to land when, say, some members of a family that controls a private company want cash and others wish to keep running the business. To the latter Buffett promises independence and respect and then--barring some irreconcilable problem that just has to be dealt with--delivers on the commitment. "We don't have any MBAs running around telling these people what to do," Buffett says. "And God knows I wouldn't know what to tell them." To public companies that may also have a family reason for selling, or that just want to escape the cold world of regrettable stock prices, unrealistic quarterly demands, and unfriendly suitors, he is equally a haven.

These are acquisition parameters that have logic in any year. But 2000 had a

tightening financial character that gave Berkshire an edge in buying companies. The money available for purchases of companies got short as the year went on, with junk bonds tough to sell and big equity investors skittish. In fact, a New York investment banker visiting Buffett told him that he thought of Berkshire as the only investor in the country that could lay out \$5 billion for an equity position.

There is no better example of Berkshire's edge--and of Buffett's agility in exploiting it--than the Johns Manville purchase, the eighth acquisition of the year. Manville's profile in 2000 included \$2 billion in revenues from insulation and roofing products, more than \$200 million in profits, and a controlling stockholder--a trust that had been set up in Manville's bankruptcy days to assume its asbestos liabilities. In mid-2000 a buyout group made a deal to acquire the company for \$2.8 billion. But Manville's business later went into a cyclical slide, and the buyers ran into financing problems. They bowed out Dec. 8, a Friday. Among those left stranded was Manville's CEO, Charles "Jerry" Henry, who had been set to participate in the buyout and was looking forward to getting divorced from the trust.

Buffett and the man he's long called his partner, Berkshire's vice chairman, Charles Munger (who lives in Los Angeles), had been wishfully watching the Manville action from the wings. And three days later, on Monday, they called the trust and offered \$2.2 billion for Manville, cash on the barrel. They had a deal, negotiated by phone, in 24 hours and an announcement Dec. 20. That afternoon, Jerry Henry went before Manville's Denver employees and announced, to cheers, "There is a Santa Claus. But he's not located at the North Pole, my friends. He's in Omaha."

Henry, 59, has since met with Buffett in Omaha, for about six hours. He went into the meeting, Henry says, thinking about plans he had to retire and ready to say "I'm gone" if he got any clue that he couldn't work with Buffett. Instead, he says, he emerged from the meeting charged up: "I came out totally committed to making this thing work. It's easy to see what happens with Buffett's companies. You end up saying you don't want to let this guy down."

For this article, I talked to the heads of all eight of the companies Berkshire bought. I heard no complaints about their new owner, just compliments. True, there's no reason these people should publicly grouse about their boss, especially to one of his friends. But it's also true that I heard stories from the sellers about money renounced, just so a Berkshire deal could be made.

Ed Bridge, 44, the fourth-generation co-head of Ben Bridge Jeweler, got to thinking a couple of years ago, in a period when he was ill, that he should sell his family's much treasured, privately owned company. He considered an IPO, or an LBO, or selling to a "strategic" buyer, meaning someone in a related business. But he also got a push toward Berkshire from Barnett Helzberg of Kansas City, who'd sold his own jewelry store business to Buffett in 1995. Bridge couldn't quite see why Buffett would be interested in his relatively small company, described by Bridge as "65 doors in 11 Western states." Bridge nonetheless talked by phone to Buffett early last year and then sent him some financial data. Back came Buffett's enthusiastic reply, recalled by Bridge as "You guys are great, great, great."

Things then moved toward a deal. But a strategic buyer heard that Bridge might be selling and began edging up to an offer. "I think," says Bridge, "that we probably could have received 20% more from this buyer than we got from Berkshire. But I also think we would have destroyed the business if we had gone that way." So in early May he and Buffett agreed on the details of a deal (including a price not being made public). They didn't shake hands, because they hadn't ever met at that point. That suited Buffett just fine--"I buy companies all

the time over the phone," he told Bridge--but Bridge really wanted to see this fellow personally. He got the chance later in May, when Buffett, on his way to a Microsoft conference, stopped to do a Bridge visit.

The managers and employees that he talked to that day got hours of his attention: He has great stamina when doing something he likes. They also got a dose of the usual Buffett: bespectacled, Midwestern looks; carelessly combed gray hair; unbuttoned suit coat, suspenders, and probably the same tie he'd worn for a month straight; plain talk dressed in metaphors. One directive Buffett gave that day is familiar to many of his companies: "Just keep on doing what you're doing. We're never going to tell a .400 hitter how to change his batting stance."

Bridge also recalls that, as he and Buffett drove past a See's Candies store, Buffett reeled off its dollar sales. To Bridge's marveling at this feat of memory, Buffett replied, "Well, I love numbers." That made Bridge think back to what the head of a Berkshire subsidiary had warned when Bridge inquired about Buffett: "Don't show him any number you don't want him to see, because he'll remember it."

Buffett's buying binge naturally raises a question: How have his past acquisitions performed? Generally they have been very successful, but not all have been unequivocal winners. General Re, his \$22 billion purchase of 1998, has slogged through a tough reinsurance market and been hurt by its own pricing mistakes. It's working its way out of those and had improved results in 2000, but some insurance analysts have argued that Buffett goofed in making this purchase. He himself mourns any deal that must be made in stock, as this one was, because he so dislikes relinquishing pieces of ownership in Berkshire. But he says he is confident Gen Re will turn into a valuable Berkshire asset.

In Buffett's noninsurance companies--the manufacturers, retailers, and service companies, in other words--the profit margins generally look good, especially considering that these businesses are largely mundane. In 1999 the companies made \$700 million pretax on \$5.7 billion in revenues. After-tax, their margin was around 7.7%, which was well above the FORTUNE 500's median of 5%.

Furthermore, the managers of many Berkshire subsidiaries work under compensation agreements that encourage them to hold their use of capital to a minimum--and to zip any spare dollars off to Omaha headquarters. ("That's why," says Buffett, "I always come down to the office on Saturday to personally open the mail.") Once the dollars get to headquarters, by the way, they don't go to paying Buffett: His Berkshire salary is \$100,000 a year and not set to rise. On the other hand, he owns 31% of Berkshire's stock, recently worth about \$32 billion, so we won't feel sorry for him.

In his manufacturing lineup, Buffett's biggest disappointment has been Dexter Shoe, a Maine company he bought in the early 1990s for some \$440 million in stock. Encountering severe foreign competition, Dexter tried hard to stick with U.S. plants, and all it got for its pains was drastically reduced profits, and then losses. Making the kind of statement he has had very little experience with, Buffett will say in his annual report that he clearly overpaid for Dexter and that he compounded the mistake by paying in stock. He will add that he does not consider Dexter's management to have been at fault.

But he has had to deal occasionally with other situations in which management was patently the problem and in which he has had to resort to firing people. Some of the problems have arisen in companies he's bought from families, in which the older, highly competent managers initially in charge do not have children with comparable abilities (which may be, he recognizes, the reason the

elders decided to sell). He hit that kind of trouble at Fechheimer, a Cincinnati manufacturer of uniforms that Berkshire bought in 1986, when it was run by two brothers in their mid-60s. One brother then retired, and the other, the CEO, became ill. The CEO's son took over but couldn't cut the mustard and was ousted. Years went by with no CEO settled upon. Finally, in 1999, Buffett made a rare attempt to cross-pollinate, making a manager from one of his insurance companies, Brad Kinstler, the head of Fechheimer. "And he's just terrific," says Buffett, relievedly. "We may have to try this kind of thing more often."

The vigor with which Buffett goes at fixing up his machine, or doing anything that involves Berkshire, belies his 70 years. Nonetheless, his age is a subject that often preys on the minds of the company's shareholders. Their concern is rational, given what Berkshire is. First, it is a fine collection of assets, whose value would survive Buffett's not being around. Second, it is his skill at investing the cash flow from these assets--and this talent is probably irreplaceable.

The age topic got special attention last summer when Buffett underwent an operation to remove several polyps (all benign) in his colon. He recovered quickly, resumed his morning run on a treadmill, and returned to eating hamburgers, French fries snowed under by salt, and the occasional Dairy Queen sundae, all washed down by Cherry Cokes.

Nonetheless, the operation drove the press to review what he had said in his annual report about management succession. If he were to die today, his 46-year-old son, Howard, chairman of an agricultural equipment firm in Assumption, Ill., and also a working farmer (see "Reaping a Biotech Blunder"), would become nonexecutive chairman of Berkshire. The sweeping job that the boss does now would be split between two people. Louis Simpson, 64, who manages the investments of Berkshire's GEICO subsidiary, would probably take over Berkshire's portfolio. The job of overseeing Berkshire's operating subsidiaries would go to some insider whom Buffett has selected but not identified publicly. In an October article, the Wall Street Journal speculated that three executives in Berkshire's subsidiaries had the lead: Ajit Jain, 49, who works with Buffett in constructing big, arcane insurance deals; Tony Nicely, 57, head of GEICO; and Richard Santulli, 56, CEO of Executive Jet.

Buffett says any one of them could do his job better than he can--"but don't let that get around." He has a solution anyway: "Forget about splitting the stock; we're just going to split my age."

The fact is that it's hard to take any discussion of successors seriously because Buffett (and his doctor) consider his health good, and he simply plans to keep doing his job indefinitely. He loves his work--loves it! So does Jack Welch, of course, but GE has retirement rules and Berkshire doesn't. Buffett sent Welch a kidding reminder of that recently, after Welch, 65, made a comment to the Financial Times about age: "There is nothing worse than seeing the old, drooling chairman sitting in the seat." Buffett faxed that sentence to Welch with a scrawled message: "Jack, we don't tolerate this sort of talk at Berkshire. I keep Charlie on-stage"--that would be vice chairman Munger, 77, on the stage at Berkshire's annual meeting--"so the stockholders know it could be worse."

It may seem odd to ask a 77-year-old whether he thinks his 70-year-old friend is still sharp, but that's what we did recently with the aforesaid Charlie, who is recognized as astute by all who know him. Does he see, we asked Munger, any diminution of Buffett's mental powers or ability to think outside the box? Munger first came through with a totally typical monosyllabic answer: "No." Prodded to elaborate, he said the Buffett of today might just be "a little better" than the Buffett of all the yesterdays. "Because he knows more," Munger says. "Now, I've watched enough people age to know that things can happen pretty fast. Some

people go along at 90 miles an hour, and then--like an orange tree does--they go into a quick decline. So you can't make extrapolations. But I don't see the slightest diminution in Warren's mental powers." Munger adds that Berkshire has built up a reputational advantage. "That gives you shortcuts," he says. "We basically made a deal to buy Johns Manville without meeting any of the people."

To those who know him, it also seems that Buffett keeps coming up with fresh ideas. They don't have much to do with product innovation, unless you count his dedication to helping See's pick new lollipop flavors. But Berkshire has repeatedly dealt with its shareholders in an innovative way: giving them an "owner's manual" that states Berkshire's operating principles; permitting them to personally determine (based on how many shares each has) where Berkshire's charitable contributions should go; even structuring an annual meeting that permits shareholders five hours of opportunity to ask the bosses, Buffett and Munger, any business-related question they want.

And, of course, the annual meeting in Omaha is itself unique. Around 10,000 shareholders turn up, many from abroad, for an entire weekend of festivities: a baseball game at which Buffett throws the first pitch, usually poorly; out-of-control shopping ("I hope," says Buffett) at Borsheim's, Berkshire's Omaha jewelry store; and those hours of Buffett and Munger teaching, because that's what it is, at the meeting itself.

In sum, this is a company that thinks first and foremost about its shareholders--though there may be one point on which Buffett and some of his flock disagree. Other than Buffett, I have never met a CEO who didn't think his stock was undervalued. Buffett, however, has gone through periods--one was in 1998, when Berkshire rose above \$80,000--in which he felt the stock was overpriced. And he agonized about it, because he does not like to think of Berkshire shareholders as either buying or selling at prices that are significantly out of line with what he views as a zone of fairness. "I'll say this," he said recently. "I'm bothered more by Berkshire getting too high than too low." Will this heresy get him ejected from the top ten of the Most Admired?

For Berkshire shareholders the fresh ideas that probably matter most are those that come out of the company's core insurance company, National Indemnity. Over the years the insurer has built a worldwide reputation for its willingness to write a policy covering just about any risk, of almost any size (though the company always caps its exposure), if the premium is satisfactory. Figuring the odds on these policies is a joint project of Buffett and Ajit Jain--both eminently suited to the game--and the two sometimes take Berkshire into weird territory. It would require pages to discuss that terrain fully, but here's an example: Last year they wrote a policy protecting Grab.com against having to pay a \$1 billion prize (with a present value of \$170 million), a lure that Grab.com used to attract millions of people to its Internet site, so as to gather information about them that would be useful to marketers. The game for visitors to the site was to pick seven numbers between one and 77; bulletins warned that the odds against anybody's picking the right seven were formidable. Nobody knew that better than Buffett and Jain, and in fact no one did win. But obviously somebody could have, which would have put a huge hole in Berkshire's earnings. "I wouldn't have thrown a party if we had had to pay off," says Buffett, "but we take well-judged chances like that all the time. That's what we do that almost no one else is willing to do."

Jain, whose office is in Connecticut, is someone who has actually seen a change in Buffett. In the early '90s the two used to talk almost every night around nine, Omaha time, about the day's insurance happenings. Then Buffett started playing bridge on the Internet, and that's where he normally is now at nine. Jain says the change is okay: "We just talk now before or after the bridge game."

Having frequently played bridge with Buffett, both as partner and opponent, I have come to think that his bridge style, in some ways, resembles his business and investing style (though he is far harder on some of his bridge partners than on his managers). In bridge he does not employ some of the modern bidding conventions that most players accept as standard. He knows all the odds in the game, and both bids and plays his hands with them in mind. He is analytical and focused when playing, and he keeps getting better--though he's not what bridge folk call expert. When he makes a stupid mistake, he tends to be hard on himself. "I can't believe I did that," he said recently after one hand. "That was incredible." The self-accusatory remark reminded me of something he once said about his mistakes in business: "It wouldn't matter to me that nobody else knew. I'd know."

The record shows there can't have been too many of those mistakes. And given continued good health, Buffett is likely to keep on burnishing the record as well. An interesting fact about Berkshire at the moment is that its three largest stock holdings--Coke, American Express, and Gillette--all have new CEOs (Douglas Daft at Coke; Kenneth Chenault at American Express; and James Kilts, a Nabisco executive who was just hired at Gillette). That will give Buffett something to watch. And as he says, with relish, "I've got all these wonderful companies that we own to look at."

He also still has cash. "This place reminds me of Mickey Mouse as the Sorcerer's Apprentice in Fantasia," he says. "His problem was floods of water. Ours is cash." The stuff never burns a hole in Buffett's pocket--patience is one of his strengths. Now that he's into serial buying, though, you wouldn't want to lay odds--unless you covered yourself with a Berkshire insurance policy--that he won't strike again.

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