

May 2016

## Berkshire Hathaway 2016 AGM

Omaha, Nebraska



### *Extraordinary Management, The Internet and Energy*

I had the privilege of travelling for the fourth time to the 2016 Berkshire Hathaway Annual Shareholders Meeting in Omaha, Nebraska last week. The 2015 event was the 50th anniversary of the Warren Buffett / Charlie Munger "Profitable Partnership" at Berkshire Hathaway and the crowd at an estimated 44,000 was out of control. So this year the company invited Yahoo Finance to live-stream the meeting for the first time. Despite this, there was still a great sense of adventure and celebration at the meeting... without the unnecessary large crowds.



We'd all come too far to miss out on a good seat, so the day started at 4 a.m. Standing second from the front of the line with friends and like minded investors from Australia, and out of the rain, we were ready for the doors to open. When they did and the chaos subsided, we'd managed to get front row seats, and we knew we were set for another great day!

The live-stream, I'm guessing, would have reached out to millions of supporters, shareholders and students, eager to learn from two of the world's greatest investors, Warren Buffet (WB) now 85 and Charlie Munger (CM), an amazing 92 years of age.

WB: *"We arranged the online version so more shareholders could see Charlie and I at work and so business owners in other countries could become more familiar with Berkshire".*

Despite the live-stream, the format remained the same: three hours of questions, a one hour break and then another three hours of questions, followed by the AGM. The Exhibition Hall again featured most of Berkshire Hathaway's main investments including Coca-Cola, Brooks, BSNF Railway, See's Candy, Nebraska Furniture Mart, Benjamin Moore Paints, Clayton Homes, ACME Brick Company, BRK Energy and Kraft-Heinz, just to name a few.

In 2013, the meeting revolved around a specific theme on how the US Economy was tracking. In 2014, the emphasis was more on how to buy a business and in 2015, we were educated further on how to practice patient, long-term value investing.

Following the 2016 meeting I will share my key takeaways from the day with you as there was, as always, some great insights and learnings from the company and their managers. This year I was drawn in by three themes in particular, Extraordinary Management, The Internet and Energy. Three very important, and topical elements of investing, especially in today's markets.

I hope you enjoy reading these notes as much as I enjoyed attending the meeting. Oh, and as it was live streamed, exclusively by Yahoo Finance, you too, as they say "are able to witness Chairman and CEO Warren Buffett and his right-hand man Charlie Munger share their unscripted views on the company, the markets, the economy, corporate governance and even happiness," by simply following the link to <https://finance.yahoo.com/brklivestream>

As with previous years, I'd like to note that this was a self-funded trip with no expense to BKI Investment Company.

Tom Millner, May 2016



## *Paying a high multiple - for a quality business, or extraordinary management*

One of the first questions of the day was focused on the recently acquired business Precision Castparts Corp (PCP). PCP was established in 1953 and specialises in the manufacturing of castings, fasteners and forged components for the aerospace, gas and defence sectors. In 2015 it was ranked 322<sup>nd</sup> on the Fortune 500 list. In January 2016 BRK completed the take over of PCP at a share price of \$235, 21.2% higher than the market had valued the stock the day prior to the BRK bid back in August 2015. At \$235 per share it placed PCP on multiple of 17.5 times projected 12-month profits, valuing the company at an Enterprise Value of \$37.2bn. This was BRK's single biggest investment after the BNSF Railroad investment of \$27bn back in 2010. Also interesting to note was that the \$37.2b investment was made in cash and that Precision Castparts is estimated to contribute only approx 10% to BRK's Operating Profit.

This recent purchase has continued to diversify BRK away from insurance, but further into areas that it knows well. BRK are not new to the aerospace and gas sectors with existing investments including Net Jets and Berkshire Hathaway Energy.

WB and CM are usually known for buying undervalued companies at the bottom of the cycle. One of the most rehashed quotes from Buffett is *"Price is what you pay; Value is what you get"*. But this time it seemed different. He recently told CNBC that *"This is a very high multiple for us to pay"*. So the first question of the day from the sell side analysts Jonathan Brandt from Ruane, Cunniff and Goldfarb was understandably about their largest investment and the "high multiple" paid.

WB's answer was an eye opener for me, and while a lengthy one, was totally focused on management. It seemed as though he couldn't emphasise this point enough. Bottom line is that BRK are happy to pay up for good management, not just a good business.

*WB: "You covered the most important asset in your question. Mark Donegan who runs Precision Castparts is an extraordinary manager, I mean Charlie and I have seen a lot of managers over the years and I would almost rank Mark one of a kind."*

*"I would say that there are certainly now no disadvantages of that company being a subsidiary of Berkshire and not being a public company, and I think he would say, and I think Charlie and I would agree with him that over time there will be some significant advantages, I think for one thing he can now spend 100% of his time on figuring out better things to do with aircraft engines. It was always his first love to be thinking about that, but he also had to be spending his time explaining quarterly earnings to analysts and negotiating bank lines and that sort of thing. So his time like all of our managers can be spent on what makes most sense to them. He doesn't have to waste his time on anything that isn't productive, and running a public company you do waste your time on many things and at times it can be unproductive, so I would say we have taken the best asset from Precision Castparts and made it even more valuable to that company."*

*CM: "In the early days we used to make wise assed remarks and Warren would say that we would buy a business that an idiot could manage because at some point an idiot will... The world has gotten harder so we had to learn a new, better way of operating. Our businesses need good managers so they remain superior businesses. I'd say we've got as good now as picking superior managers as we did in the old days of picking the no brainer businesses."*

In a company statement following the acquisition, Chief Executive Mark Donegan stated that, *"We see a unique alignment between Warren's management and investment philosophy and how we manage PCP for the long term."*

There were further questions on other managers during the day and in particular on Ajit Jain, BRK's, main insurance manager, and an individual that many say could take over as CEO once Buffett retires. The main questions revolved around what would happen if "we lost him."

WB responded by saying *"There's not another Ajit in the house," but then went on to say that "others have added significant value to Berkshire as well".*

While we were in Omaha we also had the pleasure of again having two hours with Ron Blumkin, President and COO of Nebraska Furniture Mart. Ron is the Grandson of the American legend, Rose Blumkin (Mrs. B), the co-founder of Nebraska Furniture Mart (now 80% owned by Berkshire Hathaway). Talking about good managers, the Blumkins are now well into their fourth generation. We met Great Grandson of Mrs B, Ryan Blumkin last year (Vice President of Real Estate Development), and this year we were lucky enough to be introduced to Andy Shefsky (Customer Engagement Analyst). On the topic of succession and looking forward Ron simply told us that *"You can learn from the past, you can build on the past, but you always have to look to the future... don't ever get complacent, always look to the next big thing, people always need a challenge to stay focused".*

We were also unbelievably fortunate to be given the same presentation that Ron had presented to a round table on "Learnings" presented to the managers of BRK. Buffett ensured that the NFM team relayed the learning lessons, their mistakes and their opportunities to the entire BRK senior managers the morning prior to the BRK AGM so everyone could learn. Learnings, mistakes, growth opportunities discovered by NFM in the opening of outlets in Kansas City and Dallas were shared with all. The act of passing wisdom on to the entire BRK team was a stroke of genius, and the fact we were given a glimpse into it was very special.

### *The Internet - its huge, I mean really huge!*

WB and CM have acknowledged how important the internet has become for many of their investments, and talking to many of these managers throughout the day it become very obvious how import it really is. In multiple discussions with these managers, Amazon was referred to as the online leader, an inspiration and was talked about almost as passionately as investors refer to Berkshire itself.

While they get it and know how important it has become to driving sales and hitting consumer satisfaction targets, there seems to be a cautious tone with WB and CM as there was in the Dot.Com era. It's almost as if they are saying, let's use it, work with it, but let's not be the guys that help create it. Behind every online offering still needs to be a really good, sound business and management team. The internet won't solve everything.

A question from the floor, one of the better questions during the day, hit this issue head-on. *"The internet's rapid growth has led to companies moving away from "push marketing" an approach where the company tries to reach the consumer, to "pull marketing," or making the consumer come to the company."*

WB: *"The development you refer to is huge, I mean really huge and it's not just Amazon, but Amazon is a huge part of it. What Amazon has achieved in such a short period of time is remarkable. The number of satisfied customers they have developed is huge.*

WB: *"We don't make any decisions without always thinking long and hard about what the world will look like in 5, 10, 20 years from now with that powerful, that hugely powerful trend in mind. We don't look at it and try and beat them at their own game, they are better than we are. We're not going to try to "out-Bezo", Bezos," (referring to Amazon CEO Jeff Bezos).*

WB: *"It doesn't worry us for a majority of our businesses, but it has become a huge economic trend that 20 years ago wasn't on anyone's radar screen, but lately it's been on everybody's radar screen. Many haven't even figured out how to counter it or even how to be able to participate in it. It's a hugely powerful trend... a big, big force. The internet has already disrupted plenty of people and it will disrupt more."*

CM: *"Berkshire has already been helped by the internet. Berkshire's retailers are so strong they are not particularly vulnerable to web retailers like Amazon."*

Management at the Brooks exhibition stand confirmed these comments later in the day. They also stated that many customers were now focused on lower end runners with a general pricing point of US\$100-US\$120 (traditionally their sweet spot has been at ~US\$150). Brooks has spent many years in developing a quality product for runners and say they won't be forced into cutting prices under that US\$100 level to chase volume, despite pressures coming from on-line retailers. *"Apparel sales have been very difficult, but runners are still strong with a big shift in the of number of sales done directly online or through online suppliers. More and more customers are using the "try/send back" option on the Internet"*.

Justin Boots management disused similar trends – *"Once a client knows their size and their fit, we're seeing many of the repeat orders coming from the internet."*

## **Energy - coal, oil, gas or switching to renewable energy?**

At last years AGM there was a sound discussion on renewable energy and this theme continued into this years meeting. Berkshire Hathaway Energy has assets of over US\$84b, 11.6m total electric and gas customers and employs over 21,000 staff. They have sourced energy traditionally from coal and natural gas but have invested approximately \$32bln into solar and wind projects over the last couple of years. With this investment into renewables, BRK Energy is targeting a reduction in coal generation by 11% in 2020 and by 57% by 2030.

While talking to Gregory Abel, Chairman, President and CEO of BRK Energy, he said *"coal contribution to the group is falling, however coal's importance in our balanced portfolio can not be denied. Despite the change in mix of gas, coal and now renewables, coal still plays a large role in helping us deliver low-priced, reliable energy to our customers."*

As far as an investment goes, it still doesn't seem as though the renewables are washing their face. WB simply added as a final point that *"Renewables are not yet at the stage where they can compete with traditional methods without receiving subsidies from the government."*

CM: *"We are doing way more than other people in switching to renewable energy. I want to shift more to renewables as I believe that one day we will run out of hydrocarbons. I'm on the greens side, but I'm there for a different reason"*

There was a question from the floor about the price of oil and how it may influence the actions of the Federal Reserve. WB answered the question by saying that *"traditionally lower oil prices have generally been good for the U.S. Economy, since the country is a net importer of crude.... Oil is a big part of our economy, but the economy overall has continued to make progress even as oil has declined."*

When discussing whether they take the price of oil into account when an investment decision was made WB was a little more blunt... *"We haven't the faintest idea of the future price of oil... No investment is ever made on commodity price predictions."*

BRK Energy had operating earnings fall 16% to US\$1.2b over the first quarter of 2016, while BNSF Railroad experienced an 8% fall so far this year on slumping demand from exporters of foods, oil, gas and coal. WB noted that *"rail volumes probably will continue to be down, almost certainly will be down, the balance of the year."*

## **Other Topics of Interest**

**Diversity** - WB *"Diversity isn't one of my goals. We are looking for people who are business savvy, shareholder oriented and have a special interest in Berkshire; and we've found people like that... There are roughly 25 people in Berkshire's headquarters here in Omaha, they are fantastic and I hope there's no turnover. We try and make Berkshire head office a place where everyone helps each other... Current Directors are not in it for the money. We are not interested in board members who are looking for a salary."*

**Competition** - WB *"We're not worried about if one of our competitors outperforms us in one quarter."*

CM: *"You'll always have competition, and if you disagree with somebody, you should be able to state their case way better than they can. If you can't, just shut up."*

**High Fees** - In 2008 Buffett and fund of funds hedge fund manager Protégé Partners made a 10 year, \$1m bet on whether a simple "unmanaged" S&P Index Fund would outperform a group of 5 Hedge Fund Managers charging as Buffett put it "high management and performance fees".

After 8 years the unmanaged Index Fund is in front, with a cumulative return of 65.7% compared to 21.9%. Buffett went on to say that the payments of the large fees to the group of managers is *"a huge anchor on investment returns."* He went on to say that *"those results sound like a terrible result from the hedge funds, but it's not a terrible result for the hedge fund managers."*

WB: *"We have two exceptional fund managers here at Berkshire who each manage US\$9b. If they were to charge two and twenty (2% management fee with a 20% outperformance fee), which is not uncommon, each year they would walk away with \$180m each, merely just for breathing. Its an unbelievable compensation scheme."*

WB: *"There's been far, far, far more money made by people in Wall Street through salesmanship abilities than through investment abilities."*

BKI's MER is only 0.17%, lower than almost all Index Funds and we don't charge performance fees. Lucky! or I would have been squirming in my seat as Buffett spent 10 minutes unloading on "hyperactive" fundies from Wall Street.

### *Gauging the US Economy - who is saying what*

In addition to the insights from Warren Buffett and Charlie Munger, I spent quite a bit of time on both the Friday and Saturday talking to managers of the various Berkshire owned companies also at the meeting. As a follow up from previous visits, the insights into how the US economy is placed is also of interest and an important lead indicator of many investments back here in Australia.

The consensus view from the retail operators Brooks, Nebraska Furniture Mart, Kraft-Heinz, The Coca-Cola Company and Justin Boots was that sales had flattened and the consumer has become even more value orientated. Many retailers are obviously margin focused, having to report into Buffett, with many speaking about being able to reduce lines of product and improve supply chain efficiencies. Managers of Kraft-Heinz in particular spoke about how they had spent a lot of time focusing on core products, analyzing data to *"discover their products"* (what works / what doesn't). And I dare say its not the market to be sitting on the fence, if products are not selling they will be cut from the offering.

Manufacturing was mixed with the Precision Castparts crew very positive about the current and future environment. However, BNSF Railroad volumes were flat for the year, especially in the 2nd half with low coal, oil and natural gas prices as well as a high US Dollar impacting exports quite significantly. 2016 is expected to be a "difficult year" for export volumes for both BNSF and the US export market in general.

The housing market seems to be tracking very well with positive comments coming from Clayton Homes and Acme Bricks, while paint distributor Benjamin Moore & Co were very upbeat saying *"we are seeing a very strong housing market, in both new build and refurbishments."* During the meeting Buffett also said *"low interest rates have lead to a strong property sector and property is being sold at very low cap rates. While its not as attractive as it was in 2012, still I do not see a nationwide bubble in residential real estate now at all."*

Berkshire 1st Quarter results were presented to the meeting and confirmed views of that from the BRK stable. First Quarter Operating Profits have fallen 12% compared with a year ago, with the main drag coming from the Railroad and Insurance businesses.

When Munger was asked about the state of the US Economy, the 92 year old simply added *"Microeconomics is what we do, macroeconomics is what we have put up with."*

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