

WARREN AND WALL BUFFETT STREET

The Best of Frenemies



Lawrence A. Cunningham

IN 1965, when 35-year-old Nebraskan Warren Buffett took control of Berkshire Hathaway, Inc., a dying New England textile company, the local press portrayed him as a Wall Street takeover artist: a liquidator of the sort that inspired Danny DeVito's fiendish character in "Other People's Money." True, Buffett acquired Berkshire on the cheap—for a fraction of its \$22 million book value of \$19.24 per share—and eventually shuttered the mills. But he has always campaigned vigorously against hostile bids, heavy borrowing, asset flipping and other controversial Wall Street practices.

Buffett became a vocal critic of Wall Street, as he favored cash to debt, held companies for the long term and defended trustworthy managers against short-term pressures. His oratory sounded more like the high-minded defender of the corporate bastion in "Other People's Money," played by Gregory Peck, than an apostle of greed. Speaking as the reluctant interim chairman of Salomon after its 1991 bond trading scandal, for instance, Buffett famously broadcast to Congress a new credo given to his Wall Street bankers: "Lose money for the firm, even a lot of money, and I will be understanding; lose reputation for the firm, even a shred of reputation, and I will be ruthless."

In addition to steady criticism, however, Buffett has also been a vital friend to Wall Street. His stint as Salomon chairman followed from Berkshire's "white squire" stake in the investment bank, designed to deter a hostile takeover bid. The year was 1987, when Salomon's largest shareholder grew frustrated with management and flirted with selling a 12% block to Ron Perelman, the corporate raider who had recently seized control of Revlon. Fearful of being next, Salomon CEO John Gutfreund turned to Buffett, who pledged fidelity while buying a sizable issue of convertible preferred stock yielding 9%.

Buffett's cultivation of a reputation for offering hands-off long-term capital dates back to 1973 when Berkshire accumulated a stake in The Washington Post Co. Buffett vowed loyalty to CEO Kay Graham, who soon asked him to join the board. In 1986, Buffett went further when Berkshire took a large position in Capital Cities/ABC, giving its managers, Dan Burke and Tom Murphy, proxy power to vote Berkshire's shares as they saw fit. During that era of hostile takeovers, Berkshire and Buffett likewise backed managers against raiders at companies such as Champion and Gillette, and defeated Ivan Boesky's run at Scott Fetzer, paying \$315 million to acquire the conglomerate, which Berkshire still owns to this day.

Wall Street values Buffett's reputation along with Berkshire's balance sheet. In the 25 days after the 2008 collapse of Lehman Brothers, Berkshire invested \$15.6 billion in numerous companies, when most of corporate America was starved for credit. For one, Berkshire staked \$5 billion for preferred stock in Goldman Sachs, paying a 10% dividend and redeemable for a 10% premium. Berkshire also got an option to buy a similar amount of Goldman common stock at \$115 per share, below the market price of \$125, making it "in the money."

In 2011, after the crisis passed, Goldman redeemed the preferred. So Berkshire earned a few years of dividends plus the buyback premium, adding to \$1.8 billion. In early 2013, Berkshire exercised its option to buy Goldman common. Rather than pay the \$5 billion cash price (then worth \$6.4 billion), Berkshire took stock valued at the difference of \$1.4 billion. Berkshire's total gain on its \$5 billion investment was \$3.2 billion, 64% in a few years—along with 3% of Goldman's common stock it still owns.

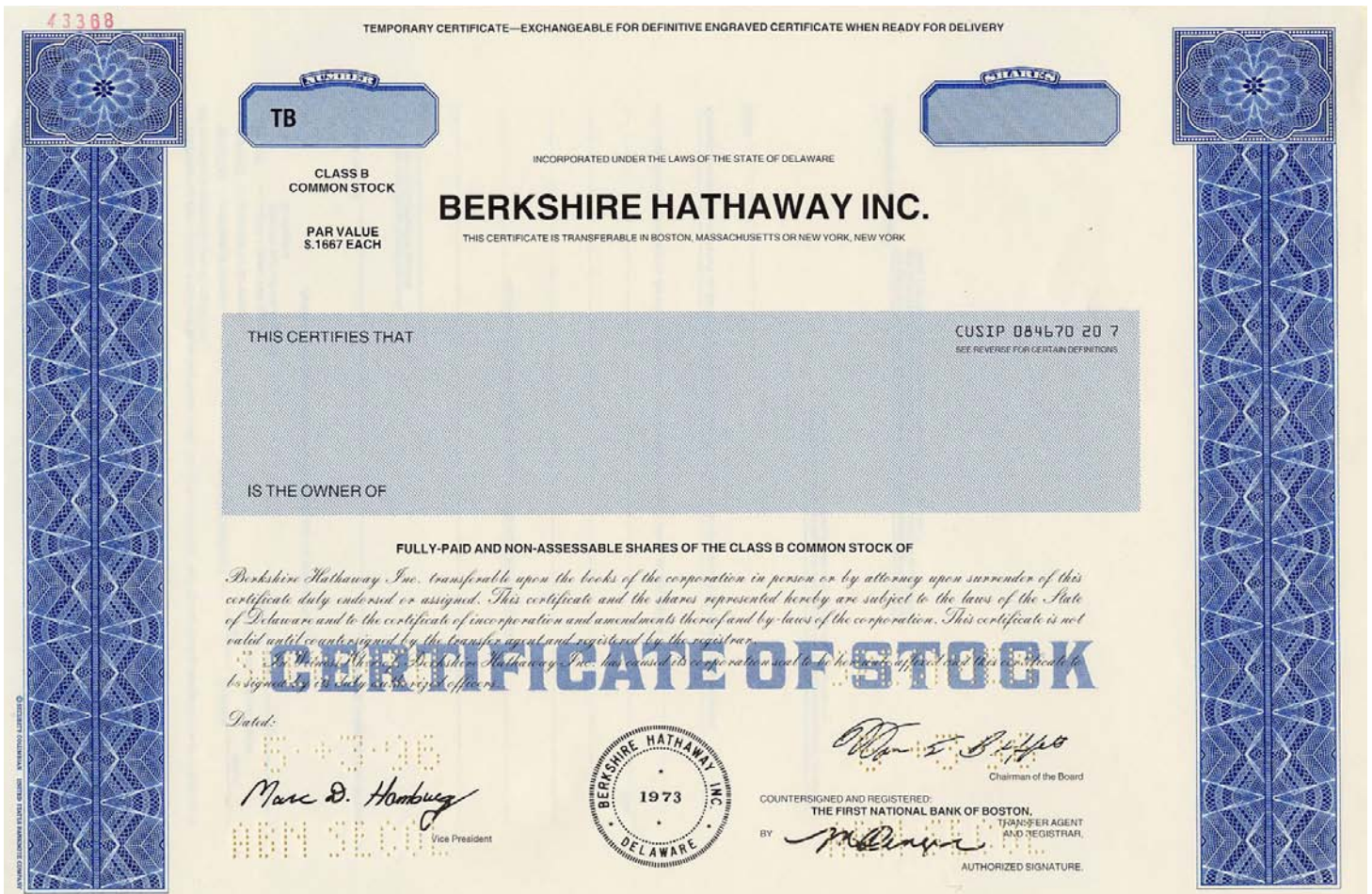
Meanwhile, Bank of America continued to struggle to the point where, in 2011, it likewise turned to Berkshire for a \$5 billion investment. Berkshire received preferred stock paying a 6% dividend and redeemable for a 5% premium. In addition, Berkshire obtained warrants to purchase 700 million shares of the bank's common stock at a per share exercise

price of \$7.14, or just under \$5 billion. Such a stake is worth more than twice that today (\$11.2 billion at the stock's recent price of \$16) and would represent a greater than 6% interest in the bank. If Berkshire exercises the warrants in 2021, on the eve of expiration, it will add to an investment portfolio already boasting such big stakes in venerable institutions of finance, including American Express, Moody's Investor Service and Wells Fargo.

Berkshire and Buffett have always been bullish on corporate America, yet they behave quite differently from most managers and their Wall Street advisers alike. For instance, unlike most American corporations and their financiers, Berkshire shuns debt as costly and constraining. Since 1967, the preferred form of leverage has arisen from internal insurance operations. Customers pay premiums up front in exchange for claims to be paid later, if at all, and insurers get to invest the proceeds, called float, in the interim. Float offers more attractive leverage than debt since there are no coupons, due dates, covenants—or Wall Street bankers and fees. Berkshire now owns marquee companies in the insurance field, including National Indemnity, GEICO and Gen Re, and commands float exceeding \$85 billion.

In typical takeovers, whether by strategic buyers across corporate America or financial buyers from Wall Street, acquirers always intervene, invariably change strategy and frequently replace management. Berkshire's opposite tack makes it an attractive alternative for sellers of businesses seeking autonomy. They also relish Berkshire's sense of permanence, particularly compared to Berkshire's rivals from Wall Street's private equity funds. In private equity's leveraged buyouts, businesses face not only leverage and intervention, but the funds charge high fees and make quick exits, meaning rapid change followed by a sale. Berkshire, in contrast, imposes no fees and has not sold a subsidiary in 40 years.

While Wall Street sponsored hostile bidders and junk-bond buyouts to break up vast conglomerates, Buffett was not only defending corporate managers but



Rare specimen Class B stock certificate from Berkshire Hathaway Inc., printed in 1996.

Courtesy of Scrippophily.com — The Gift of History.

building Berkshire into one of the largest conglomerates in history. Today, in addition to an investment portfolio of two dozen stocks worth more than \$100 billion, Berkshire is comprised of 65 different wholly-owned subsidiaries, nine of which would be *Fortune* 500 companies standing alone. The conglomerate is worth more than \$500 billion with a per share book value exceeding \$100,000 — marking a 20% compound annual growth rate from Buffett's assumption of control.

Berkshire's Clayton Homes subsidiary is the nation's largest builder and financier of manufactured housing, most sold to lower income Americans. On Wall Street, Clayton repackages substantial portions of its loans into mortgage-backed securities. In 2008, investors in other securitized mortgage loans faced steep defaults, due to lax lending practices of originators along with poor quality control during the securitization process. But Clayton's securitized loans fully performed, repaying all

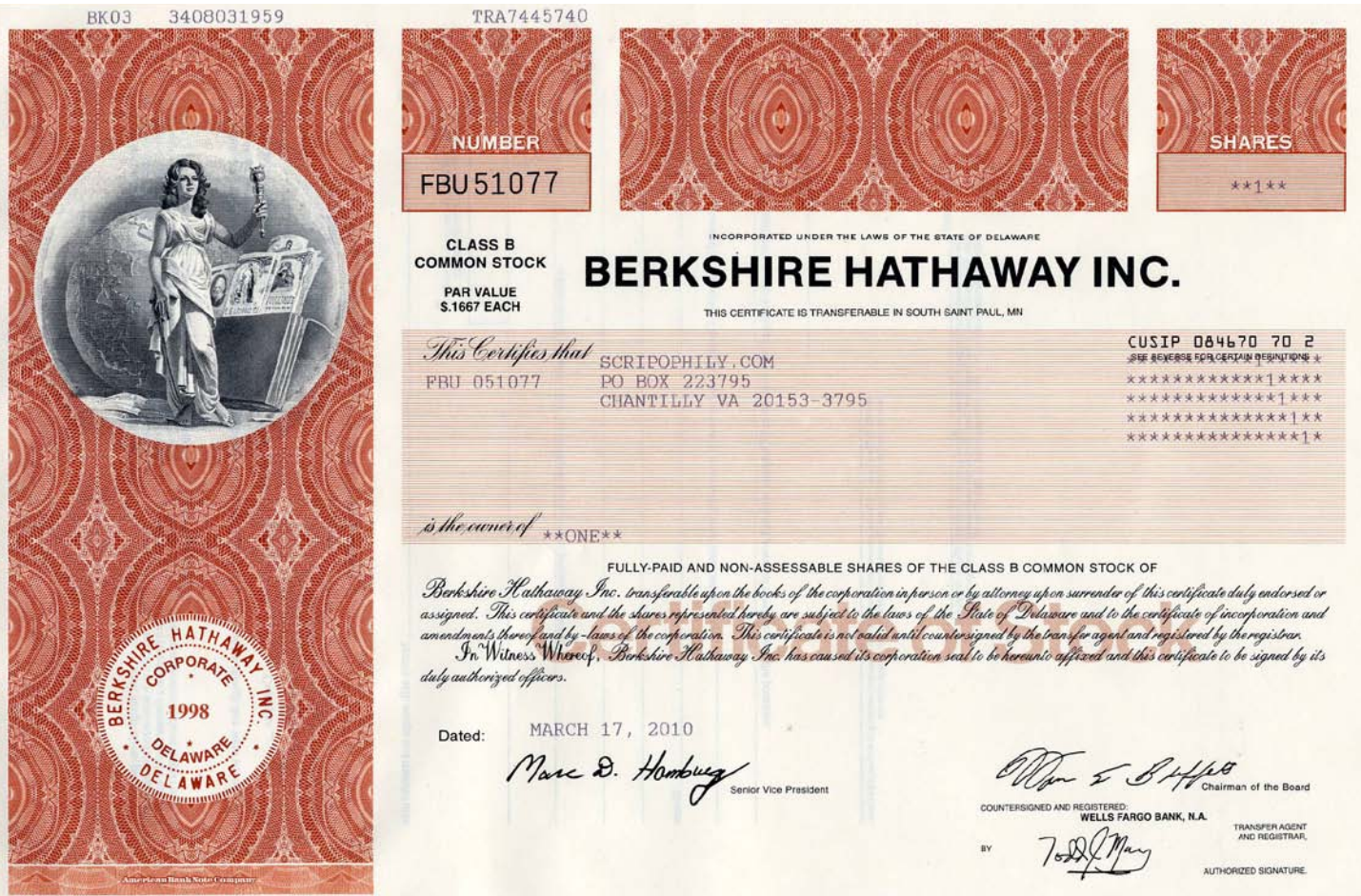
principal and interest. It is not because of customer credit quality, which is weak, but because despite low credit scores, Clayton only lends to borrowers on terms they likely can repay — based on an examination of assets and income and without escalating “teaser” interest rates.

Berkshire's unique practices do not always succeed. Take its aversion to middlemen in the acquisitions arena. Berkshire does not scout for deals but rather “waits for the phone to ring,” as Buffett puts it. Buffett evaluates opportunities alone or with advice only from Vice Chairman Charlie Munger, foregoing the professionals that most companies hire to conduct due diligence. While the practice has generally yielded strong results, costly mistakes have occurred, ranging from the total loss of \$443 million paid in 1993 using Berkshire stock for a disintegrating shoe maker to a \$1 billion after-tax loss on debt Berkshire staked in 2007 on a failed leveraged buyout of Texas utility companies.

Berkshire's \$22 billion 1999 acquisition of Gen Re, also paid in Berkshire stock, dramatized the pitfalls: unbeknownst to Buffett when Berkshire bought Gen Re, its underwriting standards had deteriorated, its derivatives book had become bloated and its exposure to catastrophic risks was unduly concentrated. Without Berkshire, Gen Re's losses covering the 9/11 terrorist attacks on New York's Financial District would likely have rendered it insolvent.

Consider Buffett's trust-based philosophy of granting managers unbridled autonomy. While lauded within the company and responsible for much of Berkshire's success at the subsidiary level, costly management shifts sometimes result. Costs are revealed in several well-publicized CEO departures, including multiple successive resignations within several years at each of Benjamin Moore, Gen Re and NetJets.

The most dramatic departure occurred in 2011 when David Sokol, widely seen as a likely successor to Buffett, was caught



Berkshire Hathaway Inc. stock certificate, dated March 17, 2010.

front-running: a form of insider trading in which he bought shares in a publicly traded stock, Lubrizol, ahead of pitching the company as a Berkshire acquisition candidate. While the scandal prompted questions about Berkshire's lack of formal vetting and grooming of top executives, Buffett's response also raised eyebrows. After Buffett learned of Sokol's front running, he drafted a press release himself. The release, which spoke of Sokol's "extraordinary" contributions to Berkshire and expressed Buffett's opinion that Sokol had done nothing illegal, drew sharp criticism, given Buffett's traditional high standard of rectitude.

The approach reflected Buffett's antipathy to corporate bureaucracy, which similarly translates into substantial net savings, but with costs. For instance, Berkshire has no centralized departments such as communications, human resources or legal. Yet such frugality can leave subsidiaries flatfooted in response to the inevitable investigative

journalism targeting them. One such exposé attacked Berkshire's practice of generating substantial funds from float, suggesting it gives personnel at National Indemnity perverse incentives to avoid or delay paying legitimate claims—even in bad faith.

Another piece challenged Clayton Homes, arguing that its employees pressure customers into unaffordable financing arrangements and follow up with aggressive collection practices. After publication, both subsidiaries and Berkshire corrected errors in the stories, but the damage had been done. A full-time professional who makes engagement with journalists a top priority would likely have altered the shape of the original reports, a better outcome than the thrust and parry that now defines the public record. Berkshire acts as if it is small, but it is a Goliath to reporters and readers alike.

Buffett is critical of Wall Street and other financial intermediaries primarily for unnecessary complexity and

corresponding costs. His core message for Wall Street remains valuable: simplicity. Parsimony and frugality underpin the Berkshire model which, while imperfect, has delivered substantial net gains, thanks to these hallmarks: investment in reputation; commitment to trust, loyalty and autonomy; avoiding hostile or leveraged acquisitions; self-reliance in corporate administration; and permanent ownership of subsidiaries.

Fifty years after Buffett took control of Berkshire, the 85-year-old Omaha denizen still has much to offer Wall Street, in capital and wisdom alike. He is certainly more Peck than DeVito. 💰

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