CASE 1

Warren E. Buffett, 2005

On May 24, 2005, Warren E. Buffett, the chairperson and chief executive officer (CEO) of Berkshire Hathaway Inc., announced that MidAmerican Energy Holdings Company, a subsidiary of Berkshire Hathaway, would acquire the electric utility PacifiCorp. In Buffett's largest deal since 1998, and the second largest of his entire career, MidAmerican would purchase PacifiCorp from its parent, Scottish Power plc, for $5.1 billion in cash and $4.3 billion in liabilities and preferred stock. "The energy sector has long interested us, and this is the right fit," Buffett said. At the announcement, Berkshire Hathaway's Class A shares closed up 2.4% for the day, for a gain in market value of $2.55 billion.[1] Scottish Power's share price also jumped 6.28% on the news;[2] the S&P 500 Composite Index closed up 0.02%. **Exhibit 1** illustrates the recent share price performance for Berkshire Hathaway, Scottish Power, and the S&P 500 Index.

The acquisition of PacifiCorp renewed public interest in its sponsor, Warren Buffett. In many ways, he was an anomaly. One of the richest individuals in the world (with an estimated net worth of about $44 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 for Berkshire Hathaway of 24% from 1965 to 2004),[3] Berkshire paid him only $100,000 per year to serve as its CEO. While Buffett and other insiders controlled 41.8% of Berkshire Hathaway, he ran the company in the interests of all shareholders. "We will not take cash compensation, restricted stock, or option grants that would make our results superior to [those of Berkshire's investors]," Buffett said. "I will keep well over 99% of my net worth in Berkshire. My wife and I have never sold a share nor do we intend to."[4]

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[1]The per-share change in Berkshire Hathaway's Class A share price at the date of the announcement was $2,010. The company had 1,268,783 Class A shares outstanding.

[2]The per-share change in Scottish Power's share price at the date of the announcement was (British pounds) GBP27.75. The company had 466,112,000 shares outstanding.

[3]In comparison, the annual average total return on all large stocks from 1965 to the end of 2004 was 10.5%. *Stocks, Bonds, Bills, and Inflation 2005 Yearbook* (Chicago: Ibbotson Associates, 2005), 217.

[4]Warren Buffett, Annual Letter to Shareholders, 2001.

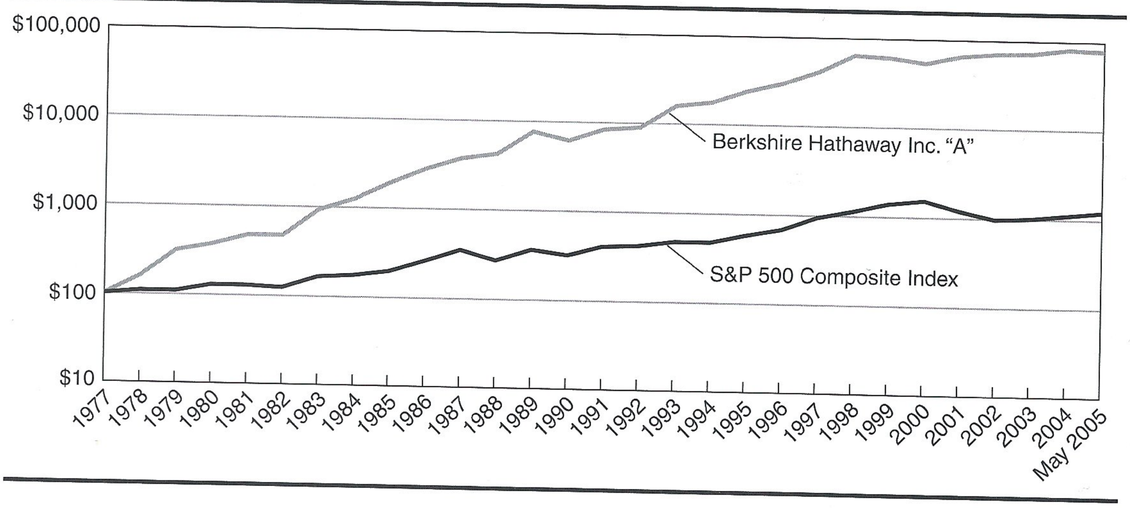
Buffett was the subject of numerous laudatory articles and at least eight biographies, yet he remained an intensely private individual. Though acclaimed by many as an intellectual genius, he shunned the company of intellectuals and preferred to affect the manner of a down-home Nebraskan (he lived in Omaha) and a tough-minded investor. In contrast to investing's other "stars," Buffett acknowledged his investment failures both quickly and publicly. Although he held an MBA from Columbia University and credited his mentor, Professor Benjamin Graham, with developing the philosophy of value-based investing that had guided Buffett to his success, he chided business schools for the irrelevance of their finance and investing theories.

Numerous writers sought to distill the essence of Buffett's success. What were the key principles that guided Buffett? Could those principles be applied broadly in the 21st century, or were they unique to Buffett and his time? From an understanding of those principles, analysts hoped to illuminate the acquisition of PacifiCorp. What were Buffett's probable motives in the acquisition? What did Buffett's offer say about his valuation of PacifiCorp, and how would it compare with valuations for other regulated utilities? Would Berkshire's acquisition of PacifiCorp prove to be a success? How would Buffett define success?

Berkshire Hathaway Inc.

Berkshire Hathaway was incorporated in 1889 as Berkshire Cotton Manufacturing, and eventually grew to become one of New England's biggest textile producers, accounting for 25% of the United States' 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 its financial decline could be reversed.

Berkshire Hathaway "Class A" vs. S&P 500 Composite Index



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. 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; Berkshire Hathaway exited the textile business in 1985.

The investment performance of a share in Berkshire Hathaway had astonished most observers. In 1977, the firm's year-end closing share price was $102; on May 24, 2005, the closing price on its Class A shares reached $85,500. Over the same period, the Standard & Poor's 500 Index grew from 96 to 1,194. Some observers called for Buffett to split[5] the firm's share price to make it more accessible to the individual investor. He steadfastly refused.[6]

In 2004, Berkshire Hathaway's annual report described the firm as "a holding company owning subsidiaries engaged in a number of diverse business activities."[7] Berkshire's portfolio of businesses included:

- **Insurance:** The largest component of Berkshire's portfolio focused on property and casualty insurance, on both a direct and a reinsurance basis (for example, GEICO, General Re).
- **Apparel:** Manufacturing and distribution of a variety of footwear and clothing products, including underwear, active-wear, children's clothes, and uniforms (for example, Fruit of the Loom, Garan, Fechheimer Brothers, H.H. Brown Shoe, Justin Brands).
- **Building products:** Manufacturing and distribution of a variety of building materials, and related products and services (for example, Acme Building Brands, Benjamin Moore, Johns Manville, MiTek).
- **Finance and financial products:** Proprietary investing, manufactured housing and related consumer financing, transportation equipment leasing, furniture leasing, life annuities and risk management products (for example, BH Finance, Clayton Homes, XTRA, CORT, Berkshire Hathaway Life, and General Re Securities).
- **Flight services:** Training to operators of aircraft and ships, and providing fractional ownership programs for general aviation aircraft (for example, FlightSafety, NetJets).
- **Retail:** Retail sales of home furnishings, appliances, electronics, fine jewelry, and gifts (for example, Nebraska Furniture Mart, R.C. Willey Home Furnishings, Star

[5] A split was an increase in the number of a firm's outstanding shares that did not cause a change in the shareholders' equity. A two-for-one split would entail a 50% reduction in the stock's price at the time of the split. Company directors authorized stock splits to make the company's shares affordable to a broader range of investors.

[6] In 1996, Berkshire Hathaway issued Class B shares, which had an economic interest equal to 1/30th and a voting interest equal to 1/200th that of the firm's Class A shares.

[7] Berkshire Hathaway Inc., 2004 Annual Report, 1.

Furniture Company, Jordan's Furniture, Borsheim's, Helzberg Diamond Shops, Ben Bridge Jeweler).

- **Grocery distribution:** Wholesale distributing of groceries and nonfood items (for example, McLane Company).
- **Carpet and floor coverings:** Manufacturing and distribution of carpet and floor coverings under a variety of brand names (for example, Shaw Industries).

Berkshire also owned an assortment of smaller businesses[8] generating about $3 billion in revenues. **Exhibit 2** gives a summary of revenues, operating profits, capital expenditures, depreciation, and assets for Berkshire's various business segments. The company's investment portfolio also included equity interests in numerous publicly traded companies, which are summarized in **Exhibit 3.** In addition, the company owned about $21.4 billion of foreign exchange contracts at year end, spread among 12 currencies. Prior to March 2002, neither Buffett nor Berkshire had ever traded in currencies, but Buffett had developed serious concerns about the United States' large current account deficits, and he hoped that his currency bets would offset the growing pressure on the dollar.

Buffett's Investment Philosophy

Warren Buffett was first exposed to formal training in investing at Columbia University where he studied under Professor Benjamin Graham. A coauthor of the classic text *Security Analysis,* Graham developed a method of identifying undervalued stocks (that is to say, stocks whose prices were less than their intrinsic value). This became the cornerstone of modern 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 unrecognized by the market.

Over the years, Buffett had expounded his philosophy of investing in his chairperson's letter to the shareholders in Berkshire Hathaway's annual report. By 2005, those 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 [Munger,

[8]These included Scott Fetzer, a diversified manufacturer and distributor of commercial and industrial products; Buffalo News, a newspaper publisher in western New York; International Dairy Queen, which licensed and serviced a system of 6,000 Dairy Queen stores; See's Candies, a manufacturer and distributor of boxed chocolates and other confectionery products; Larson-Juhl, which designed, manufactured, and distributed custom picture-framing products; CTB International, a manufacturer of equipment and systems for the poultry, hog, egg production, and grain industries; and the Pampered Chef, a direct seller of kitchen tools.

> Buffett's business partner] and I, both as owners and managers, virtually ignore such consolidated numbers. . . . Accounting consequences do not influence our operating or capital-allocation process.[9]

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 expertise, 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 to 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 the 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 "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 the 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:

> [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.[10]

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.

[9]Berkshire Hathaway Inc., 2004 Annual Report, 2.

[10]Berkshire Hathaway Inc., 1992 Annual Report, 14.

To see how historical input (book value) and future output (intrinsic value) can diverge, let us 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 non-economic 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.[11]

To illustrate the mechanics of this example, consider the hypothetical case presented in **Exhibit 4.** 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% 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% per year. Suppose that the investor plans to sell the business for its book value at the 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%. 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 5.** The example is similar in all respects, except for one key difference: the annual return on the investment is 10%. The result is that every dollar invested buys securities worth $0.80. Value is destroyed.

Comparing the two cases in **Exhibits 4** and **5,** 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 the 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:

[11]Berkshire Hathaway Inc., 1994 Annual Report, 7.

> Our long-term economic goal . . . is to maximize Berkshire's 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. We are certain that the rate of per-share progress will diminish in the future—a greatly enlarged capital base will see to that. But we will be disappointed if our rate does not exceed that of the average large American corporation.[12]

The gain in intrinsic value could be modeled as the value added by a business above and beyond the charge for the use of capital in that business. The gain in intrinsic value was analogous to the 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 (for example, 30 year) U.S. Treasury bond to discount cash flows.[13] Defending this practice, Buffett argued 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 chair, Charlie Munger, sat on the boards of directors, where they obtained a candid, inside view of the company and could intervene in managements' decisions if necessary. Buffett once said, "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."[14] He also wrote:

> 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 databases 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.[15]

[12]Berkshire Hathaway Inc., 2004 Annual Report, 74.

[13]The yield on the 30-year U.S. Treasury bond on May 24, 2005, was 5.76%. The beta of Berkshire Hathaway was 0.75.

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

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

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 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.[16]

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."[17] Buffett was fond of repeating a parable told to 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 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 operation and financial position.[18]

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.[19]

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

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[16]Quoted in *Forbes* (19 October 1993). Republished in Andrew Kilpatrick, *Of Permanent Value,* 574.

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

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

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

contrarian goals: "We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful."[20] Buffett also said, "Lethargy bordering on sloth remains the cornerstone of our investment style,"[21] 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."[22]

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 the 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.[23]

> 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.[24]

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."[25]

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.[26]

For four of Berkshire's six directors, over 50% 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.[27]

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[20] Berkshire Hathaway Inc., 1986 Annual Report, 16.
[21] Berkshire Hathaway Inc., 1990 Annual Report, 15.
[22] Berkshire Hathaway Inc., Letters to Shareholders, 1977–1983, 53.
[23] Quoted in Andrew Kilpatrick, *Of Permanent Value,* 353.
[24] Quoted in L. J. Davis, "Buffett Takes Stock," *New York Times,* 1 April 1990, 16.
[25] Quoted in *Forbes* (19 October 1993). Republished in Andrew Kilpatrick, *Of Permanent Value,* 574.
[26] "Owner-Related Business Principles," in Berkshire Hathaway's 2004 Annual Report, 75.
[27] In April 2005, the U.S. Securities and Exchange Commission interviewed Warren Buffett in connection with an investigation into the insurance giant AIG and its dealings with Berkshire Hathaway's General Re insurance unit. Buffett reported that he had questioned General Re's CEO about the transactions with AIG, but that he never learned any details.

MidAmerican Energy Holdings Company

MidAmerican Energy Holdings Company, a subsidiary of Berkshire Hathaway Inc., was a leader in the production of energy from diversified sources, including geothermal, natural gas, hydroelectric, nuclear power, and coal. Based in Des Moines, Iowa, the company was a major supplier and distributor of energy to over 5 million customers in the United States and Great Britain. Through its HomeServices of America division, MidAmerican also owned the second-largest full-service independent real-estate brokerage in the United States. **Exhibit 6** provides condensed, consolidated financial statements for MidAmerican for the years 2000 through 2004.

Berkshire Hathaway took a major stake in MidAmerican on March 14, 2000, with a $1.24 billion investment in common stock and a nondividend-paying convertible preferred stock.[28] This investment gave Berkshire about a 9.7% voting interest and a 76% economic interest in MidAmerican. "Though there are many regulatory constraints in the utility industry, it's possible that we will make additional commitments in the field," Buffett said, at the time. "If we do, the amounts could be large."[29] Subsequently, in March 2002, Berkshire acquired another 6.7 million shares of MidAmerican's convertible stock for $402 million, giving Berkshire a 9.9% voting interest and an 83.7% economic interest in the equity of MidAmerican (80.5% on a diluted basis).

At the time of Berkshire's initial investment in MidAmerican, Buffett explained that acquisitions in the electric utility industry were complicated by a variety of regulations, including the Public Utility Holding Company Act of 1935 (PUHCA), which was intended to prevent conglomerates from owning utilities and to impede the formation of massive national utilities that regulators could not control. This regulation made it necessary for Berkshire to structure its investment in MidAmerican such that it would not have voting control. Buffett had said he was eager to have PUHCA scaled back, and that if it were repealed he would invest $10 billion to $15 billion in the electric utility industry.[30]

PacifiCorp

For the past several years, Berkshire Hathaway had been unsuccessful in identifying attractive acquisition opportunities. In 2001, Buffett addressed the issue head-on in his annual letter to shareholders:

> Some years back, a good $10 million idea could do wonders for us (witness our investment in the *Washington Post* in 1973 or GEICO in 1976). Today, the combination of *ten* such

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[28]Berkshire acquired 900,942 shares of common stock and 34,563,395 shares of convertible preferred stock of MidAmerican. 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.

[29]Berkshire Hathaway Inc., 1999 Annual Report, 11.

[30]Rebecca Smith and Karen Richardson, *Wall Street Journal,* 25 May 2005, A1.

ideas and a triple in the value of *each* would increase the net worth of Berkshire by only ¼ of 1%. We need "elephants" to make significant gains now—and they are hard to find.[31]

By 2004, Berkshire's fruitless search for "elephants" had begun to take its toll. In his annual letter that year, Buffett lamented his failure to make any multibillion-dollar acquisitions, and he bemoaned Berkshire's large cash balance that had been accumulating since 2002. "We don't enjoy sitting on $43 billion of cash equivalents that are earning paltry returns," Buffett said. "What Charlie [Munger] and I would like is a little action now."[32]

The announcement that Berkshire's wholly owned subsidiary, MidAmerican Energy Holdings Company, would acquire PacifiCorp seemed to indicate that Buffett had found an "elephant." PacifiCorp was a leading, low-cost energy producer and distributor that served 1.6 million customers in six states in the western United States. Based in Portland, Oregon, PacifiCorp generated power through company-owned coal, hydrothermal, renewable wind power, gas-fired combustion, and geothermal facilities. The company had merged with Scottish Power in 1999. **Exhibit 7** presents PacifiCorp's most recent financial statements.

The PacifiCorp announcement renewed general interest in Buffett's approach to acquisitions. **Exhibit 8** gives the formal statement of acquisition criteria contained in Berkshire Hathaway's 2004 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. Analysts scrutinized the PacifiCorp deal for indications of how it fit Berkshire's criteria. Several noted that the timing of Berkshire Hathaway's bid closely followed Duke Energy's bid to acquire Cinergy for $9 billion. The PacifiCorp deal was expected to close after the federal and state regulatory reviews were completed, sometime in the next 12 to 18 months.

Exhibit 9 provides company descriptions and key financial data for comparable firms in the regulated electric utility business. **Exhibit 10** presents a range of enterprise values and equity market values for PacifiCorp implied by the multiples of comparable firms.

Conclusion

Conventional thinking held that it would be difficult for Warren Buffett to maintain his record of 24% 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% annual growth rate in intrinsic value. Would the PacifiCorp acquisition serve the long-term goals of Berkshire Hathaway? Was the bid price appropriate? Because PacifiCorp was privately held by Scottish Power, how did Berkshire's offer measure up against the company's valuation implied by the multiples for comparable firms? What might account for the share price increase for Berkshire Hathaway at the announcement?

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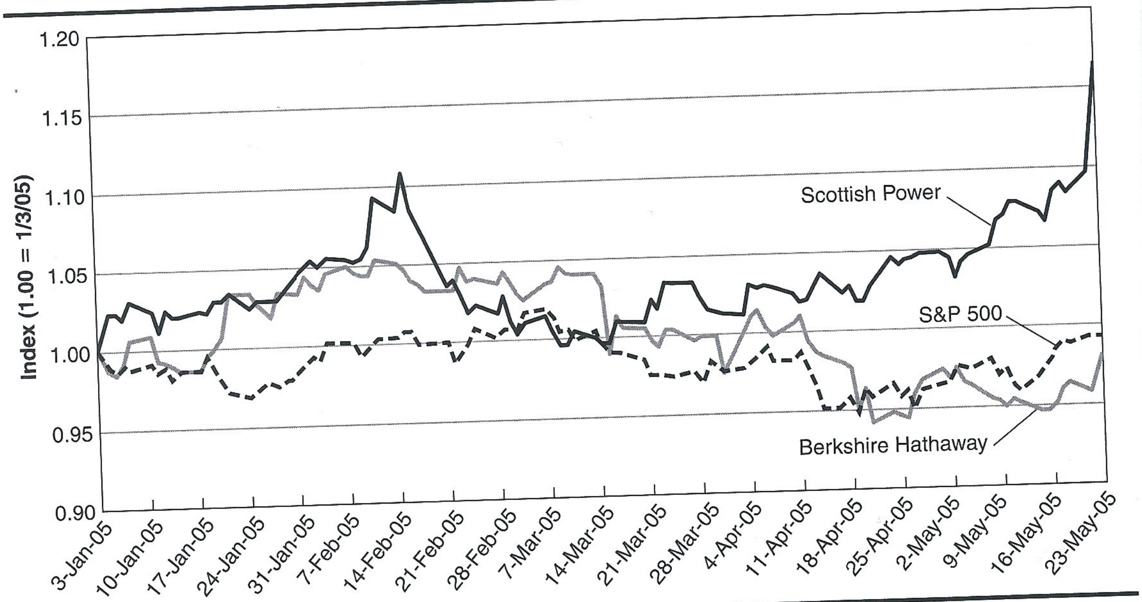
[31]Berkshire Hathaway Inc., 2001 Annual Report, 17.

[32]Berkshire Hathaway Inc., 2001 Annual Report, 17.

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

EXHIBIT 1 | Relative Share Price Performance of Berkshire Hathaway "Class A" & Scottish Power plc vs. S&P 500 Index (January 3, 2005–May 23, 2005)



Source of data: Datastream.

EXHIBIT 2 | Business Segment Information for Berkshire Hathaway Inc. (dollars in millions)

Segment	Revenues		Earnings (loss) before Taxes		Capital Expenditures		Depreciation[1]		Identifiable Assets	
	2004	2003	2004	2003	2004	2003	2004	2003	2004	2003
Insurance	$23,927	$24,731	$4,375	$4,941	$ 52	$ 55	$ 52	$ 63	$114,759	$109,004
Apparel	2,200	2,075	325	289	51	71	52	51	1,582	1,523
Building products	4,337	3,846	643	559	219	170	172	174	2,803	2,593
Financial products	3,774	3,045	584	619	296	232	183	161	30,086	28,338
Flight services	3,244	2,431	191	72	155	150	146	136	2,823	2,875
Grocery distribution	23,373	13,743	228	150	136	51	107	59	2,349	2,243
Retail	2,601	2,311	163	165	126	106	56	51	1,669	1,495
Carpet & floor coverings	5,174	4,660	466	436	125	120	99	91	2,153	1,999
Other businesses	3,213	3,040	465	486	41	47	44	43	1,875	1,813
Total	$71,843	$59,882	$7,440	$7,717	$1,201	$1,002	$911	$829	$160,099	$151,883

[1]Excludes capital expenditures that were part of business acquistions.

Source of data: Berkshire Hathaway Inc., 2004 Annual Report.

EXHIBIT 3 | Major Investees of Berkshire Hathaway (dollars in millions)

Company	Shares	% of Co. Owned	Cost[1] ($mm)	Market ($mm)	
American Express Company[2]	151,610,700	12.1	$1,470	$ 8,546	17%
The Coca-Cola Company[2]	200,000,000	8.3	1,299	8,328	16%
The Gillette Company[2]	96,000,000	9.7	600	4,299	14%
H&R Block, Inc.	14,350,600	8.1	223	703	32%
M&T Bank Corporation	6,708,760	5.8	103	723	14%
Moody's Corporation	24,000,000	16.2	499	2,084	24%
PetroChina "H" shares	2,338,961,000	1.3	488	1,249	39%
The Washington Post Company	1,727,765	18.1	11	1,698	1%
Wells Fargo & Company[2]	56,448,380	3.3	463	3,508	13%
White Mountain Insurance	1,724,200	16.0	369	1,114	33%
Others			3,531	5,465	65%
Total Common Stocks			$9,056	$37,717	

[1]This was both Berkshire's actual purchase price and tax basis; GAAP "cost" differed in a few cases because of write-ups or write-downs that had been required.

[2]Buffett referred to this group of companies as Berkshire Hathaway's "Big Four." Berkshire invested $3.83 billion in the four through multiple transactions between May 1988 and October 2003; on a composite basis, Berkshire's dollar-weighted purchase date was July 1992. By year-end 2004, Berkshire held these interests, on a weighted basis, for about 12.5 years.

Source of data: Berkshire Hathaway Inc., 2004 Annual Report, 16.

EXHIBIT 4 | 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
- return on equity = 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) = Present value @ 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: Case writer analysis.

EXHIBIT 5 | 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
- return on equity = 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) = Present value @ 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: Case writer analysis.

EXHIBIT 6 | MidAmerican Energy Holdings Co.: Condensed Consolidated Financial Statements (*dollars in millions*)

	2000	2001	2002	2003	2004
Balance sheets					
Assets:					
Properties, plants, and equipment, net	$ 5,349	$ 6,537	$10,285	$11,181	$11,607
Goodwill	3,673	3,639	4,258	4,306	4,307
Other assets	2,659	2,450	3,892	3,658	3,990
	$11,681	$12,626	$18,435	$19,145	$19,904
Liabilities and shareholders' equity:					
Debt, except debt owed to Berkshire	$ 5,919	$ 7,163	$10,286	$10,296	$10,528
Debt owed to Berkshire	1,032	455	1,728	1,578	1,478
Other liabilities and minority interest	3,154	3,300	4,127	4,500	4,927
	10,105	10,918	16,141	16,374	16,933
Shareholders' equity	1,576	1,708	2,294	2,771	2,971
	$11,681	$12,626	$18,435	$19,145	$19,904
Income statements					
Operating revenue and other income	$ 4,013	$ 4,973	$ 4,903	$ 6,143	$ 6,727
Costs and expenses:					
Cost of sales and operating expenses	3,100	3,522	3,092	3,913	4,390
Depreciation and amortization	383	539	530	603	638
Interest expense – debt held by Berkshire	40	50	118	184	170
Other interest expense	336	443	640	716	713
	3,859	4,554	4,380	5,416	5,911
Earnings before taxes	154	419	523	727	816
Income taxes and minority interests	73	276	126	284	278
Earnings from continuing operations	81	143	397	443	538
Loss on discontinued operations	—	—	(17)	(27)	(368)
Net earnings	$ 81	$ 143	$ 380	$ 416	$ 170

Source of data: Berkshire Hathaway regulatory filings.

EXHIBIT 7 | PacifiCorp Consolidated Financial Statements (*dollars in millions*)

	Year Ended March 31, 2004	Year Ended March 31, 2005
Balance sheets		
Assets:		
Current assets	$ 756.4	$ 1,214.3
Properties, plants, and equipment, net	9,036.5	9,490.6
Other assets	1,884.2	1,816.0
	$11,677.1	$12,520.9
Liabilities and shareholders' equity:		
Current liabilities	$ 1,074.3	$ 1,597.7
Deferred credits	$ 3,706.3	$ 3,868.3
Long-term debt and capital lease obligations	3,520.2	3,629.0
Preferred stock subject to mandatory redemption	56.3	48.8
	8,357.1	9,143.8
Shareholders' equity	3,320.0	3,377.1
	$11,677.1	$12,520.9
Income statements		
Operating revenue and other income	$ 3,194.5	$ 3,048.8
Costs and expenses:		
Operating expenses	2,147.8	1,955.5
Depreciation and amortization	428.8	436.9
Income from operations	617.9	656.4
Interest expense	224.4	236.2
Income from operations before income tax expense	393.5	420.2
Cumulative effect of accounting change	(0.9)	—
Income tax expense	144.5	168.5
Net income	$ 248.1	$ 251.7

Source of data: PacifiCorp 10-K regulatory filing.

EXHIBIT 8 | Berkshire Hathaway Acquisition Criteria

We are eager to hear *from principals or their representatives* about businesses that meet all of the following criteria:

1. Large purchases (at least $75 million of pretax earnings unless the business will fit into one of our existing units).
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 price is unknown.)

The larger the company, the greater will be our interest: We would like to make an acquisition in the $5 billion to $20 billion range. *We are not interested, however, in receiving suggestions about purchases we might make in the general stock market.*

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. *We don't participate in auctions.*

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."

Source: Berkshire Hathaway Inc., 2004 Annual Report, 28.

EXHIBIT 9 | Comparable Regulated Energy Firms

			Price Per Share				(Dollars in Millions)									
	Beta	Shares O/S (millions)	Low	High	Div. Per Share	S&P Rating	Total Assets	Total Liabilities	Cash and equiv.	ST Debt	LT Debt	Net Debt	Rev	EBITDA	EBIT	Net Income
Alliant Energy Corp.	0.85	115.74	$23.50	$28.80	$ 1.01	na	$ 8,275	$ 5,470	$276	$ 243	$2,300	$2,267	$2,959	$ 752	$ 420	$164
Cinergy Corp.	0.85	187.53	$34.90	$42.60	$ 1.88	BBB+	$14,982	$10,804	$165	$1,179	$4,228	$5,242	$4,688	$1,198	$ 738	$404
NSTAR	0.70	106.55	$22.70	$27.20	$ 1.13	A	$ 7,117	$ 5,633	$ 23	$ 311	$2,101	$2,389	$2,954	$ 702	$ 455	$190
SCANA Corp.	0.75	113.00	$32.80	$39.70	$ 1.46	na	$ 8,996	$ 6,430	$120	$ 415	$3,186	$3,481	$3,885	$ 861	$ 596	$264
Wisconsin Energy Corp.	0.70	116.99	$29.50	$34.60	$ 0.83	BBB+	$ 9,565	$ 7,043	$ 36	$ 439	$3,240	$3,643	$3,431	$ 857	$ 530	$306
PacifiCorp	na	312.18	na	na	na	na	$12,521	$ 9,144	$199	$ 270	$3,629	$3,700	$3,049	$1,093	$ 656	$252

ALLIANT: Alliant Energy's utilities, Interstate Power and Light (IPL), and Wisconsin Power and Light (WPL) provided electricity to more than 970,000 customers and natural gas to about 412,000 customers in four states.

CINERGY: Its traditional operating units generated, transmitted, and distributed electricity to more than 1.5 million customers and natural gas to 500,000 in Ohio, Indiana, and Kentucky. Cinergy had agreed to be acquired by utility behemoth, Duke Energy, in a $9 billion stock swap.

NSTAR: Utility holding company transmitted and distributed electricity to 1.4 million homes and businesses in Massachusetts; also served some 300,000 natural-gas customers. The company marketed wholesale electricity, operated liquefied natural-gas processing and storage facilities, provided district heating and cooling services, and offered fiber-optic telecommunications services.

SCANA: The holding company served more than 585,000 electricity customers and 690,000 gas customers in South and North Carolina and the neighboring states through utilities South Carolina Electric & Gas and Public Service Company of North Carolina.

WISCONSIN ENERGY: The company's utilities provided electricity to nearly 1.1 million customers and natural gas to 1 million customers in eastern and northern Wisconsin and Michigan's Upper Peninsula.

Sources of data: Value Line Investment Survey; Standard & Poor's (case writer's analysis).

EXHIBIT 10 | Valuation Multiples for Comparable Regulated Energy Firms

	(Dollars in Millions)				Enterprise Value as Multiple of:				MV Equity as Multiple of:	
	MV Equity	Enterprise Value	Book Value	EPS	Rev	EBIT	EBITDA	Net Income	EPS	Book Value
Alliant Energy Corp.	$3,333	$ 5,600	$2,805	$ 1.42	1.89x	13.33x	7.45x	34.15x	20.33x	1.19x
Cinergy Corp.	$7,989	$13,231	$4,178	$ 2.15	2.82x	17.93x	na	32.75x	19.77x	1.91x
NSTAR	$2,898	$ 5,287	$1,484	$ 1.78	1.79x	11.62x	7.53x	27.83x	15.25x	1.95x
SCANA Corp.	$4,486	$ 7,967	$2,566	$ 2.34	2.05x	13.37x	9.25x	30.18x	16.99x	1.75x
Wisconsin Energy Corp.	$4,048	$ 7,691	$2,522	$ 2.62	2.24x	14.51x	8.97x	25.13x	13.23x	1.61x
Median	$4,048	$ 7,691	$2,566	$ 2.15	2.05x	13.37x	8.25x	30.18x	16.99x	1.75x
Mean	$4,551	$ 7,955	$2,711	$ 2.06	2.16x	14.15x	8.30x	30.01x	17.11x	1.68x
Implied Value of PacifiCorp[1]			$3,377	$ 0.81	$6,252 $6,584	$8,775 $9,289	$9,023 $9,076	$7,596 $7,553	$4,277 $4,308	$5,904 $5,678

[1]Implied values for PacifiCorp's enterprise value and market value of equity are derived using the median (top) and mean (bottom) multiples of the comparable firms.

Sources of data: Value Line Investment Survey; Standard & Poor's (case writer's analysis).