Berkshire's Cash 'Problem'

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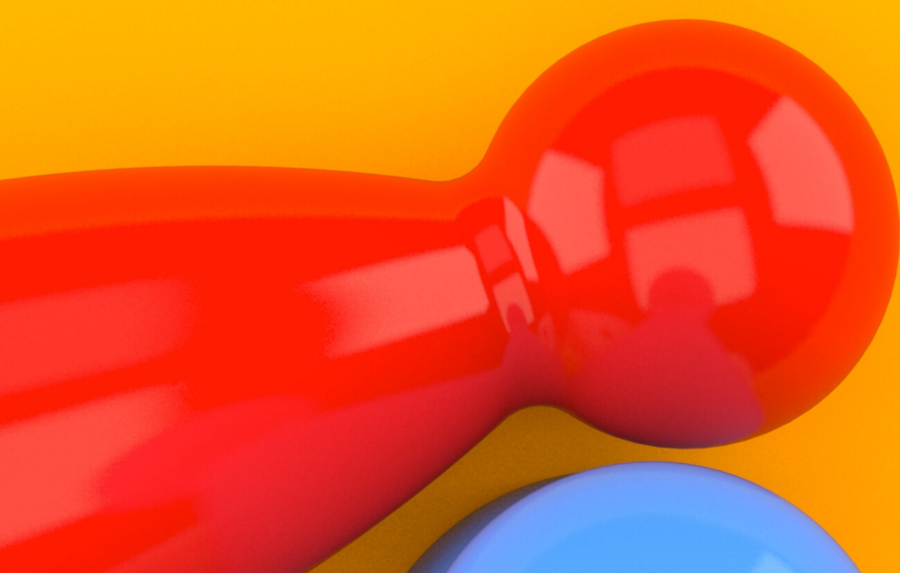
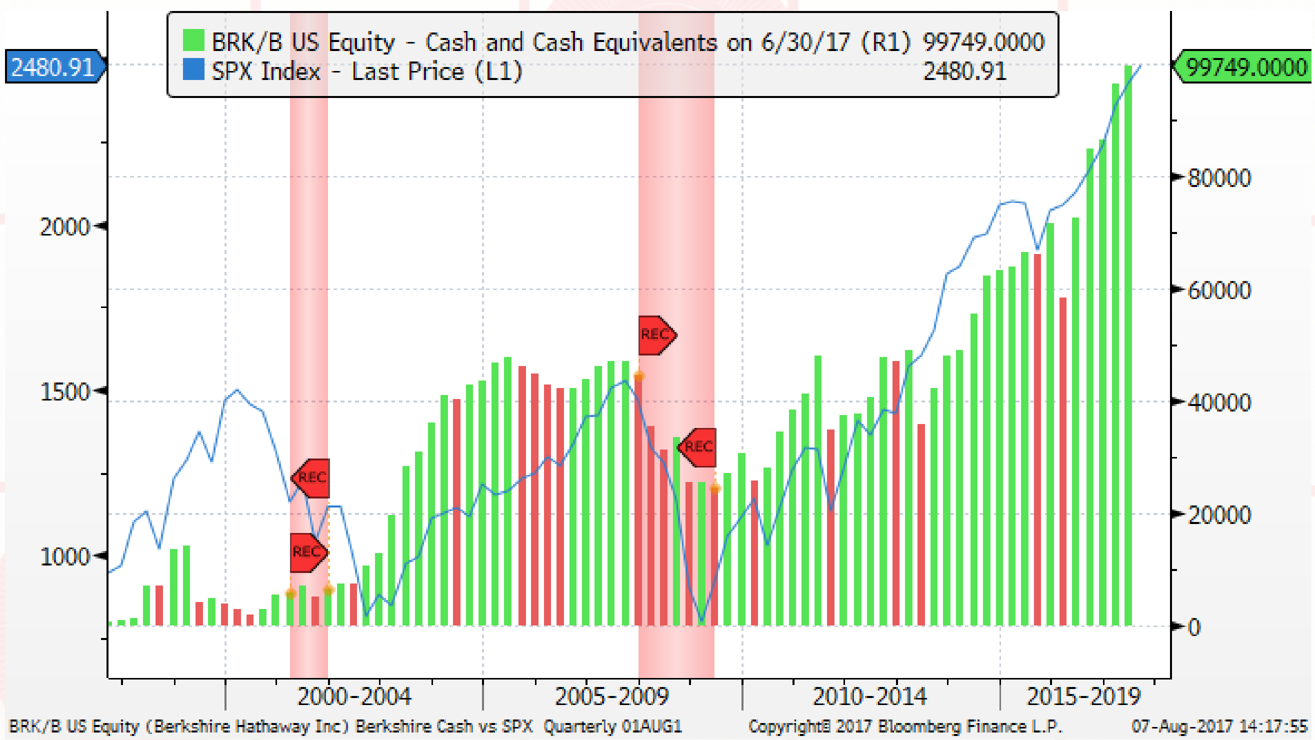


Berkshire Hathaway has been accumulating cash, waiting for the perfect opportunity to deploy it in a way that would maximize shareholder value. Berkshire ended the quarter with a personal record of cash and equivalents of over $135 billion. Part of the reason this cash pile has built up is that U.S. stocks are generally considered expensive in the current market. In Warren's annual letter in February, he stated that a lack of attractive pricing "proved a barrier to virtually all deals we reviewed in 2017". Berkshire Hathaway's hesitance should be a signal that stocks are generally expensive as Berkshire's cash position has been an effective proxy for market levels over history. As seen in the chart below, the company increased the cash position leading up to two of the most recent market crashes (2000 and 2008).

*https://www.silverlightinvest.com/blog/when-cash-king



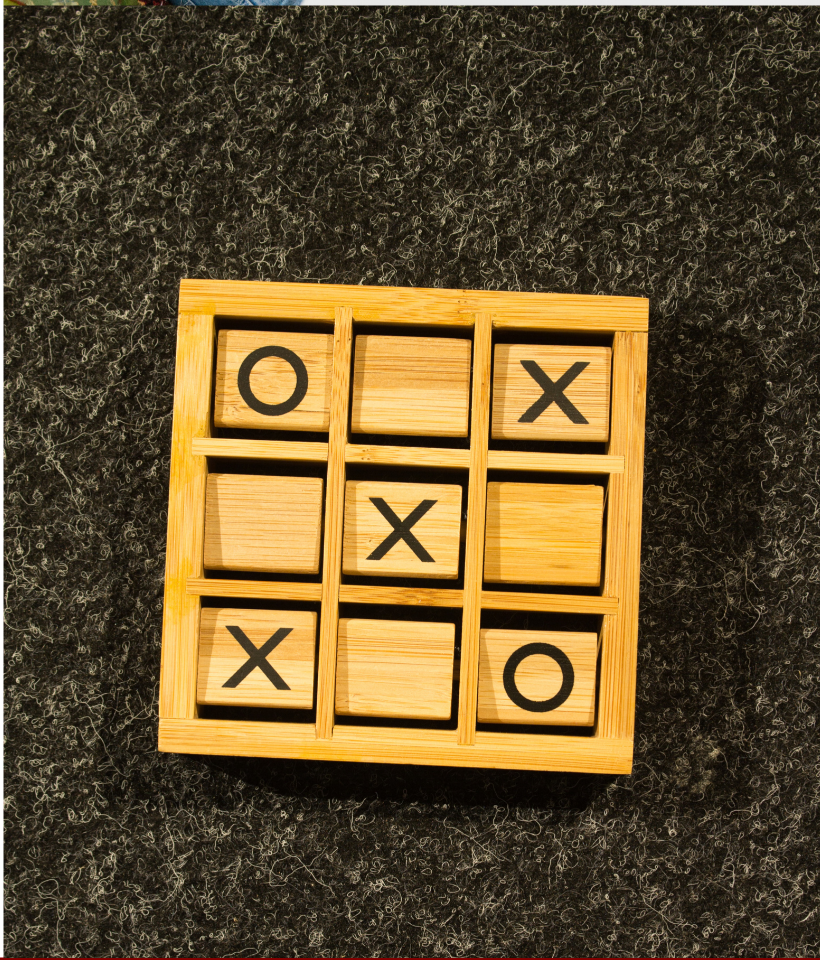
Too much cash a good problem to have?

Berkshire Hathaway ended Q3 2019 with about $135 billion in cash and equivalents, but management only wants to keep approximately $20 billion in cash. So how do you spend approximately $115 billion in a way that returns value to the company and the shareholders? That's what Warren Buffett and others at Berkshire are trying to figure out. Adding to the problem is that cash continues to pour in, and Berkshire could quite possibly have a total of $150 billion by the end of the year!

So what to do with the cash, given that it's not earning much with low interest rates (therefore dragging on potential returns), that will maximize shareholder value?

Berkshire has a few options of what they can do:

1. Initiate a share repurchase program
2. Start paying a dividend
3. Purchase other company's shares on the open market
4. Pay-off debt
5. Acquire other businesses
6. Private placements
7. Utility capital expenditures
8. Do nothing



Initiate a share Repurchase Program

Share Class	3-Month Daily Average Volume	Last Price	Dollar Value at Last Price
A	285	$333,600.00	$95,076,000.00
B	3,562,092	$222.57	$792,814,816.44
Combined			$887,890,816.44

When Berkshire announced a change to its share repurchase policy in July to allow share repurchases "below Berkshire's intrinsic value, conservatively determined", B shares were trading around $191. Those shares closed on August 14, 2018 at $205.83, or about 7.8% higher.

The higher share price makes a repurchase less attractive, but it still may be a worthwhile option.

There is also the question of how Berkshire should repurchase shares. Trading volume is not very high for an approximately $541 billion company. It's actually less than $1 billion per day:

$115 billion/($887.89 million/day) = 129.5 days

This means that Berkshire has enough cash to have repurchased every share of reported volume over the last three months. This represents approximately 16% of all shares. If they tried to limit themselves to 5% of the volume so as to not too greatly distort the demand for shares, it could take Berkshire several years to spend $115 billion, and that is without factoring in all the additional cash that would have accumulated over the buyback period.

Initiate a share Repurchase Program

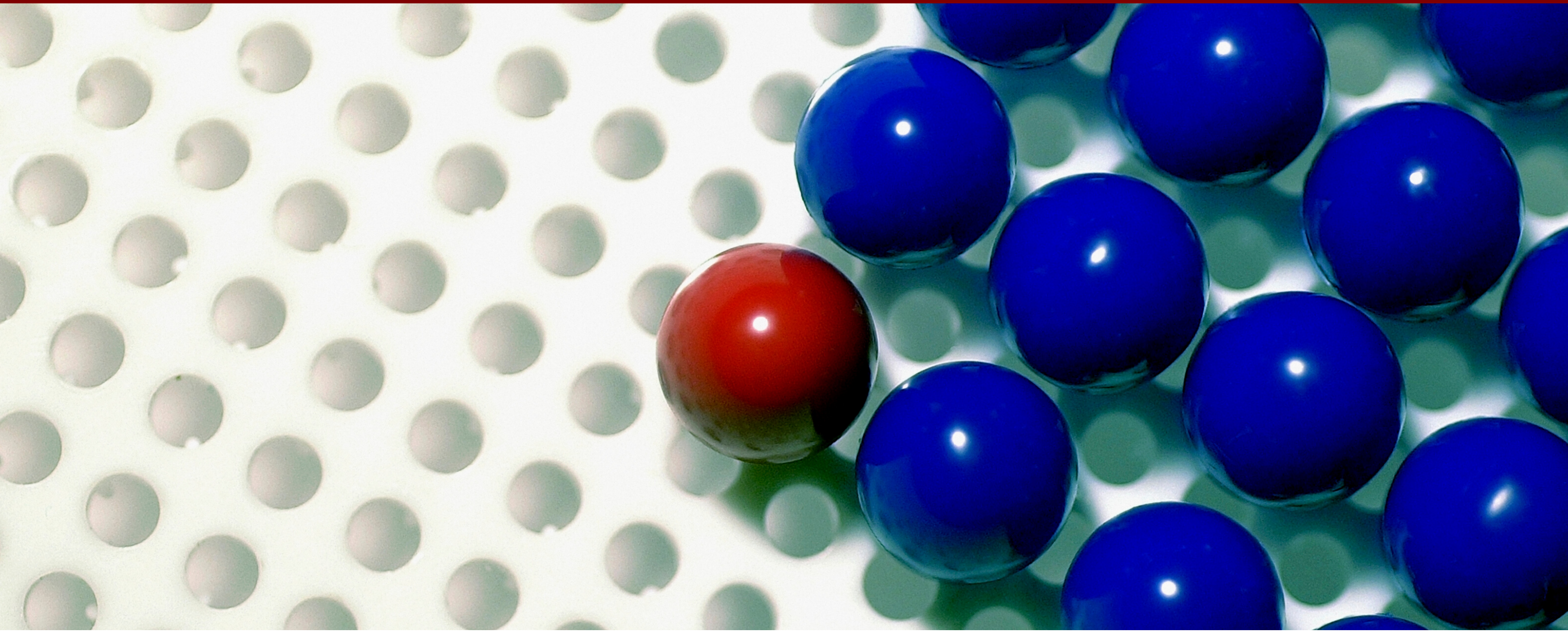
A reverse auction buyback could resolve the issue and take advantage of several institutions that own large blocks of shares. Berkshire would put out a press release to say:

- They want to buy back up to 300 million "B" shares - or the equivalent in “A” shares (about $60 billion worth of stock).
- Let them know if you have at least 500k "B" shares (or equivalent “A’ shares) you want to sell.
- Let them know the lowest price you're willing to accept.

Berkshire could then sort through and choose the offers that are most attractive and set a maximum price they (Berkshire) would be willing to pay. It could then offer that amount to all offers that meet their criteria until they have bought back the set goal.

Many institutions (and perhaps some wealthy individuals) may want to sell a big block of shares but be concerned that the market price would fall in the face of sharply increased supply. A reverse auction would let them unload a large number of shares quickly at a known (or better) price. Simultaneously, it would allow Berkshire to deploy a lot of capital very quickly.

Start paying a Dividend



At first glance, there is something simple and egalitarian about a dividend. It eschews a lot of the speculation and gaming over what price Berkshire will pay to repurchase its own shares. It gives every investor a proportional cash payment at the same time.

People who need the cash wouldn't need to worry about selling what might be a major investment. People who don't want the cash could simply reinvest for more shares. The main downside lies in the tax code. Dividend income is generally taxed at a higher rate than capital gains. Also, investors with a volatile marginal rate can time their sales to control when they pay capital gains.

Some long-time investors have shares in certain trusts well-suited to hold securities that will appreciate over many years, but poorly suited to hold securities that generate dividends or interest (given high tax rates on income).

A few shareholders proposed in 2014 that Berkshire should consider paying a dividend. They put the matter before shareholders, presumably to demonstrate that the sentiment was widespread. Class B shareholders rejected the proposal 47:1. Class A shareholders rejected the notion 89:1.

There is also a question of fiduciary duties. Shareholders would want Berkshire's management focused on how they should invest Berkshire's cash.

Purchase other Company's Shares on the Open Market

Berkshire's portfolio has been heavily weighted to domestic equities. Apple Inc has become a favorite in recent years.

However, the total market cap of US public equities is currently 144.2% of GDP. Historically, that's a fairly high valuation, and Berkshire's size means it's generally limited to buying the stocks of large companies.

One option would be for Berkshire to purchase more in the way of foreign equities, but many developed foreign markets also trade at high valuations.

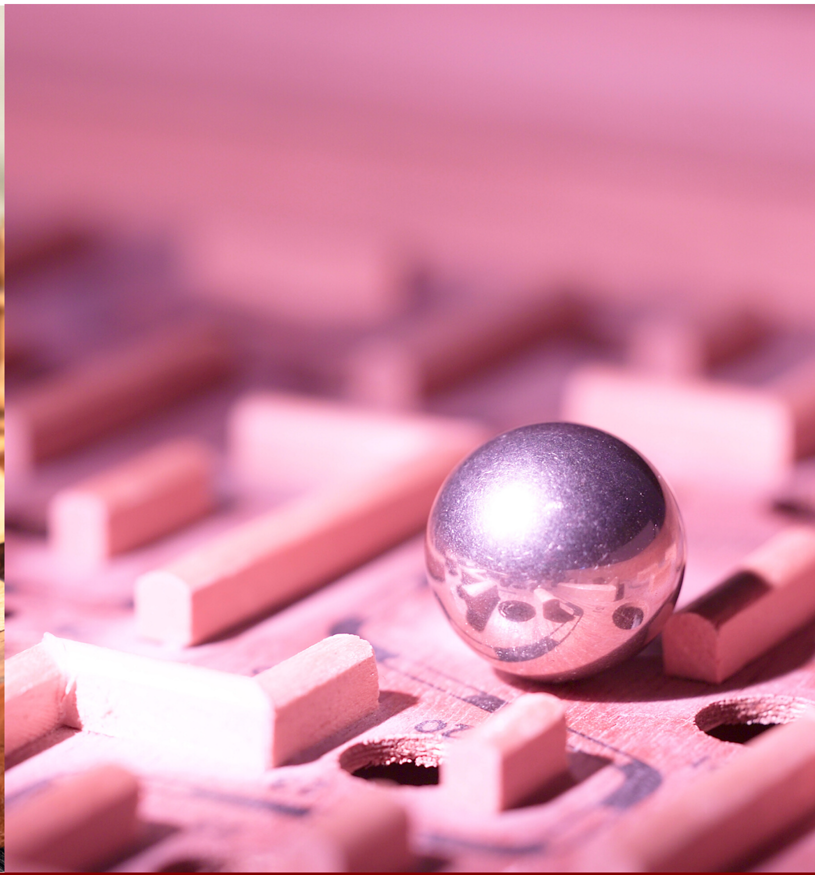
Pay-off Debt

Berkshire could choose to retire debt. However, with 30-year corporate bonds yielding approximately 3.6%, doing so is unlikely. Berkshire may have limited options, but they aren't that bad. Being part of the Berkshire empire generally means anything that is worth refinancing can be refinanced pretty easily.

Acquire other businesses

Acquiring companies outright has been a favorite strategy of Berkshire in the past. However, with market valuations high and capital plentiful, Berkshire could quite easily find shareholders reluctant to sell at a price Berkshire is willing to pay. Sellers may also be incentivized to seek out competing offers, and Berkshire generally avoids bidding wars.

Subsidiaries will make bolt-on acquisitions; these will most likely be too small to significantly reduce Berkshire's excess cash.



Private Placements

In a booming economy, not a lot of large companies that would interest Buffett are willing to give Berkshire a special deal for the capital or confidence he would contribute (through, perhaps, some sort of debt/preferred share/warrant investment).

Maybe General Electric Company could use the support, but don't know the company's operations well enough to speculate what sort of terms Berkshire would need, or how interested Buffett would be.

Berkshire is so massive that only a few private companies could accommodate an investment of the size that Berkshire would find worthwhile. Berkshire lent money to help Mars buy Wrigley, but the Mars family has since repurchased Berkshire's small preferred interest.

In late 2018, Berkshire extended a $2 billion 7% credit facility to Seritage Growth Properties. That gives Berkshire a reasonable (for this market) return with minimal risk. However, any undrawn amounts only earn 1%, and it would take many such deals to make much of a dent in Berkshire's excess cash.

Utility Capital Expenditures/Do Nothing and Wait

Utility Capital Expenditures

One reasonable option would be to continue to expand BH Energy's solar and wind electric utility investments. The current and future demand for clean power is evident, giving Berkshire some visibility as to future earnings. Also, utilities are a business Berkshire can invest billions in for a reasonable return largely independent of stock valuations.

However, unless Berkshire purchases projects that are already operating or in development, it's not something they can pour billions into overnight.

Do Nothing and Wait

This is why we like Berkshire. Berkshire could also just continue to accumulate cash more quickly than it uses it. If management thinks an economic downturn or some sort of market panic would present better opportunities, waiting could make sense.

But it's worth remembering that many such opportunities tend to be small. $20 billion, even $30 billion, would be enough for most deals. If some exceptional $100 billion deal came along, Berkshire could always borrow money for a short time, if necessary. With its financial strength, lenders would be eager.

[1] https://www.investors.com/news/berkshire-hathaway-warren-buffett-easier-to-buy- back-stock/
[2] http://berkshirehathaway.com/qtrly/2ndqtr18.pdf
[3] https://finance.yahoo.com/quote/BRK-B?p=BRK-B
[4] https://finance.yahoo.com/quote/BRK-A?p=BRK-A&.tsrc=fin-srch
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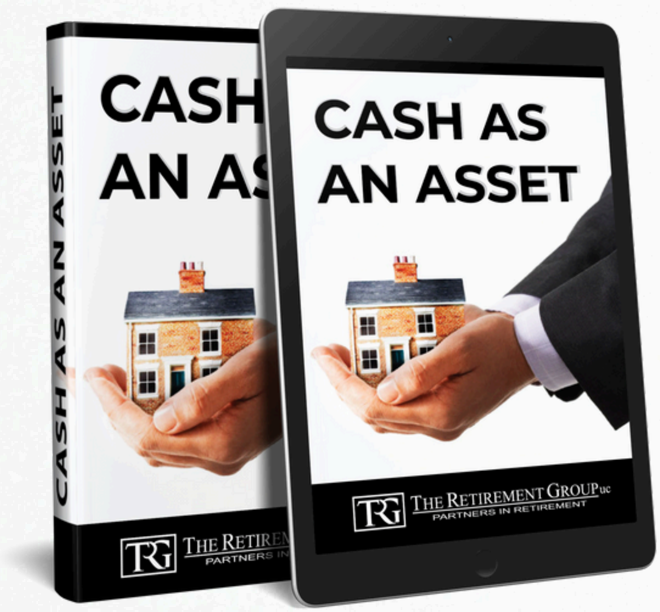
[6] https://www.bloomberg.com/news/articles/2018-07-17/berkshire-lifts-cap-on-stock-buybacks-as-buffett-faces-cash-pile
[7] https://www.gurufocus.com/stock-market-valuations.php
[8] https://fred.stlouisfed.org/series/AAA

For more Financial information, check out these resources...



Cash as an Asset

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