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Jessica Salzar
University of Nebraska - Lincoln

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Berkshire Hathaway Inc. Strategic Audit

An Undergraduate Honors Thesis
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By
Jessica Salzar, BSBA
Finance
College of Business

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Professor:
Samuel Nelson

Abstract
Berkshire Hathaway is an extremely successful, well-known company. With Warren Buffett approaching retirement, it is important that the company prepares its stakeholders and is strategically prepared. What must be determined is whether or not Berkshire Hathaway needs to implement a new strategy or continue doing what it is already doing. This strategic audit analyzes Berkshire Hathaway's company history, internal and external environment, competitive advantages, and organizational structure. After the analysis of Berkshire Hathaway, several strategy alternatives are considered, ending with a strategic recommendation, implementation plan, and contingency plan.

Company Background
Berkshire Hathaway was founded in the 19th century through a merger of two Massachusetts cotton mills. Known to invest in struggling companies, Warren Buffett invested in the company and took control of Berkshire Hathaway in the 1960s. Warren transformed this company into a conglomerate by purchasing National Indemnity and several other insurance companies. By acquiring insurance companies, Berkshire Hathaway is capable of using its available reserve, which is money provided from its insurance subsidiaries in the form of premiums that has not been paid out to claims, to acquire additional companies. It is common for Warren to acquire struggling companies and place them back on an upward trend. Berkshire Hathaway has large positions in several Fortune 500 companies that successfully maintain or increase dividends every year. Berkshire Hathaway, on the other hand, has only paid out dividends once in 1967; shareholders accept this and continue to invest in the company because the stock's price consistently increases. Berkshire Hathaway stock has risen from $275 in 1980 to $308,530 in 2018. Shareholders are receiving incredible capital gains, so dividends are not crucial to them. By shareholders sacrificing dividends, they are allowing Berkshire Hathaway to reinvest the money thus providing the company with more potential for success and growth.

Another unique aspect about Berkshire Hathaway is the company has never done a Class A stock split because Warren Buffett believes stock splits encourage speculation. As a result, investors tend to keep their Berkshire Hathaway shares for a long period of time. Rather than doing stock splits, Buffett created a Class B stock. The Class B stock is valued at 1/30 the value of the Class A stock. The Class B stock is more suitable for an index that attempts to estimate the value of the market, whereas the "Class A stock is too expensive and too sparsely held to make an effective index component (G, McFarlane)." The current overall strategy of Berkshire Hathaway is comparable to how investors search for companies and purchase shares from the companies that they deem valuable; however, Berkshire Hathaway buys the entire company rather than just a few shares. Through 40 years of implementing this strategy, the company has become an extremely successful conglomerate with no other companies close in comparison (G, McFarlane).

External PEST Analysis
Before acquiring new companies or making investments, it is vital for Berkshire Hathaway to take potential systematic political risks into consideration. Before making any investments, a few factors must be taken into consideration. These factors include but are not limited to the political stability of the country in which the acquisition is taking place, the integrity of politicians, the

chance of corruptive acts, business laws enforced in the particular country, trade barriers, taxation, and the risk of military invasion. These political factors are significant to consider because they may impact the profitability or even the chances of survival of the company under consideration. Due to Berkshire Hathaway being a multinational, it must consider political factors that affect both the United States and the countries in which Berkshire Hathaway has operations in or may trade with.

Additionally, Berkshire Hathaway must consider economic factors because changes in economic factors, such as the inflation rate or exchange rate, may either be extremely profitable for the company or result in a large loss. The economic factors that are significant for Berkshire Hathaway to consider before making investments are the type of economic system in the economy in which an investment is being considered, the rate of GDP growth, interest rates, the efficiency of the financial markets, exchange rates, and unemployment rates. These factors predict whether or not an investment will allow Berkshire Hathaway to experience growth, profits, lower costs, greater investments, or vice versa.

An important external aspect to consider is the social impact on Berkshire Hathaway. Social factors impact Berkshire Hathaway in both its operations and marketing. By understanding its customers, Berkshire and its subsidiary companies are able to design their products and marketing messages specifically for its customers and the community, giving the company an advantage. The social factors that affect Berkshire Hathaway and shape its operations and marketing include demographics, class distribution, educational background, environmental standards, and the level of health standards. Being familiar with these social factors allows Berkshire Hathaway to target its customers effectively and in a relatable way and to gain prestige by following the current norm of being sustainable and environmentally efficient.

With its rising presence, technology is a crucial aspect for companies to consider because technology can either cause a company to prosper or completely destroy it. Berkshire Hathaway is an old company thus has operated through several technological revolutions and has been successful in responding to new technology. The company recognizes the need to constantly innovate in terms of technology. New technology can completely alter an industry, so it is vital that Berkshire keeps up with technological advancements to prevent from falling behind. Technological factors that are significant for Berkshire Hathaway to consider include technological developments made by competing companies, the performance of new technology implemented by Berkshire and how easily the technology can be mimicked by competitors, the effect of Berkshire's new technological advancements on its competitors, and the potential impact of technology on Berkshire and its competitors costs and profits ("Berkshire").

Porter's Five Forces External Analysis

The bargaining power of buyers is considered to be relatively high. If there is a recession for example, customers will not be able to afford Berkshire products, so Berkshire and its subsidiary companies will suffer from decreased demand. This decreased demand will require Berkshire and its companies to lower prices in order to maintain its customer base. Berkshire must respond to customer demand in regards to prices (J, Kepler). In contrast, the threat of new entrants for the overall company is low because the barriers to entry in the financial industry are high due to it being expensive and difficult to develop strong distribution channels, which are required in this industry. Without strong distribution channels, it is too expensive to move products, and the sunk costs are high. Entering this industry is difficult and expensive, and there is no guarantee for success or returns. In terms of Berkshire's subsidiary businesses, there are low barriers to entry, so the threat of new entrants is high. Berkshire Hathaway is affected by the competitors of its subsidiary companies. Both foreign and domestic competitors of the subsidiary companies may negatively affect Berkshire Hathaway's operations and profits (A, Kasi).

Due to high competition among the suppliers, the bargaining power of suppliers is low for Berkshire Hathaway; however, if something occurs that causes the availability of raw materials from suppliers to be limited or the prices of the raw materials to increase, Berkshire Hathaway may be negatively affected. Berkshire Hathaway faces intense competition, resulting in an extremely high threat of substitutes. Berkshire Hathaway's portfolio consists of several insurance companies, and the competition among insurance companies is extremely high, so Berkshire must remain competitive in terms of rates. This applies to Berkshire's subsidiary companies in other competitive industries as well. The competitive rivalry within Berkshire's industry is high because its subsidiary companies face steep competition. Intense competition can cause Berkshire's companies to lose market share and struggle financially, negatively affecting Berkshire as an entire company (J, Kepler).

Internal Analysis

Berkshire Hathaway is viewed as a successful and prestigious company. A main reason for this is because it is controlled by Warren Buffett, a respected man in the financial industry. His company has several strengths. Warren Buffett is known for his smart investment decisions, resulting in his company gaining popularity and interest from investors. Investing in Berkshire Hathaway allows investors to benefit from Warren Buffett's wise investment decisions. The company's financials display Buffett's successful investment decisions. The company has experienced substantial financial growth in the past five years. From 2013 to 2017, net revenue increased by 60 billion, while net income more than doubled. The success of Berkshire Hathaway is due to its large, diversified business portfolio, consisting of more than 60 companies. The portfolio is made up of companies in several different industries with two of the largest being insurance and freight rail transportation. Additionally, the acquisitions made by Berkshire have allowed the company to grow substantially in size and perform exceptionally well (A, Pratap).

Although Berkshire Hathaway has a large list of strengths, the company has weaknesses as well. Decision making is extremely limited in the company, Warren being the main decision maker. The reason for this is to reduce the number of mistakes; however, this leads to several problems. A main problem is that Warren is aging and will not be at the company much longer. Additionally, having one person make decisions for an entire company commonly leads to mistakes or missed investment opportunities. Making decisions in a group allows for several opinions and further discussion, which leads to a more reasonable, thought out decision (A, Pratap).

Competitive Advantage

It is clear that Berkshire Hathaway has a sustainable competitive advantage in its industry. The company has several competitive advantages, Warren Buffett being a main one. Buffett's investment expertise as well as his lifestyle and personality have set Berkshire Hathaway apart from its competitors for over 50 years and will for the next few; however, it is important that the company recognizes this will not last forever. Taking this into consideration, Warren has recruited additional investment expertise, Ted Weschler and Todd Combs, which has led to another competitive advantage. These investors have proved to be extremely talented in the past few years. Warren Buffett's investment expertise as well as his skilled recruits provides the company with a distinctive competency because the investment decisions of these individuals is considered to be the best in the industry. Berkshire's diversified portfolio also provides the company with a competitive advantage. Due to Berkshire's portfolio being largely diversified, when one industry is struggling, the other businesses in the portfolio offset the struggling businesses, allowing for Berkshire to maintain its stability. The industries that make up the portfolio provide the company with a competitive advantage because many are industries people will constantly use and need, such as energy and insurance.

Due to Warren Buffett's extremely talented capital allocation methods, his business model is one that cannot be easily duplicated, providing the company with another competitive advantage. Buffett comprises his company's portfolio with many subsidiaries, intensely diversifying the portfolio; and while one company may require extensive capital, others do not need any due to already being mature companies. The mature companies provide Berkshire with profits without the need to reinvest these profits. These profits are used in the industries that are unable to produce enough profits to fulfill their capital requirements. Buffett allocates capital where it is most needed. Warren Buffett's business model and portfolio are considered distinctive competencies because no competitors can provide a comparable model or portfolio. Additionally, Berkshire's large presence in the insurance industry allows it to make a great deal of money from float, which is the money provided by the insurance subsidiaries from premiums that have yet to be paid out in claims, allowing the company to grow substantially through further investments. A main sustainable competitive advantage for Berkshire is its cash on hand; Buffett prefers to keep $10 billion in cash in case he comes across unexpected opportunities or setbacks, but he typically has much more than $10 billion after considering both cash and liquid assets. Berkshire's success and reputation has allowed the company to be able to easily access capital. Berkshire's access to float, cash, and capital provides the company with a comparative advantage because it has access to resources its competitors cannot obtain as easily (S, Maranjian).

Leadership Structure

Warren Buffett is in charge of the leadership structure at Berkshire Hathaway. The Omaha headquarters consists of only 25 people. Warren is at the top of the pyramid, making the majority of Berkshire's capital allocation decisions. He consults vice chairman Charlie Munger on some larger decisions. The two investors he recruited, Todd and Ted, manage 10 billion dollars of each of Berkshire's securities. Five officers in Omaha manage the 60 direct subsidiaries. One officer oversees the law firm "that handles Berkshire's acquisitions and securities work (L, Cunningham)." Each subsidiary is operated independently but has a small board for support, typically 5 people. The CEO of each subsidiary sits on the board of his/her company, and Warren is on the boards of larger or riskier subsidiaries. Berkshire has decentralized as a result of its extreme growth, "pushing main functions down to the subsidiary level, splitting acquired businesses further, and pushing senior managers up further (L, Cunningham)."

The leadership structure at Berkshire Hathaway has proven successful for several decades and will continue to be successful in the future. By allowing the subsidiary companies to run their businesses how they want, the subsidiaries are able to perform efficiently and optimally. The 25 people at the Omaha headquarters office are able to focus on larger decisions by not having to focus on smaller subsidiary decisions, allowing Berkshire Hathaway to focus on continuous growth and future investment decisions. Warren Buffett having complete control of the company may be viewed as a problem; however, he runs the company fairly and does not take advantage of his power. For the past 20 years, Warren Buffett has earned a salary of $100,000, only 1.87 times the median pay of average Berkshire employees (M, Miller). After observing average CEOs salaries at much less successful companies, this is a shocking revelation. Warren provides his company with a strong, reputable culture and cares for his employees. It is clear he is not in it for the money; he strives for success for his company and deserves to be in charge.

Strategy Alternatives

Berkshire Hathaway is an extremely successful company and is projected to continue on an upward trend in the future, so continuing to operate the company exactly how it is currently operating is one strategy alternative. Berkshire Hathaway is continuously acquiring or investing in new companies, further diversifying its portfolio. Warren Buffett is preparing the company for his retirement by training and preparing new investors to take over after he leaves. The company has market dominance due to its comparative advantages in terms of access to cash, float, and equity markets; and Berkshire has several distinctive competencies, such as talented investors, an unbeatable business model, and a diversified portfolio that has displayed exceptional performance. Berkshire's distinctive competencies and comparative advantages prove that the company has not only one but several competitive advantages. The company is doing well, so it is possible to continue to pursue the same strategy, ensuring the company will be stable and successful.

Every financial expert knows that in order to receive a bigger return, more risk must be taken. Berkshire Hathaway is doing exceptionally well, but the number of investment and acquisition opportunities is declining, so the growth and success of the company is marginally declining or remaining stagnant from year to year. In order to grow substantially in size and financially, Berkshire needs to change its strategy. Changing its strategy is risky because the company has been run the same way for decades, proving successful, so implementing a new strategy causes Berkshire to lose a sense of stability. Warren Buffett currently makes all of Berkshire's acquisition and large investment decisions. With retirement approaching Warren Buffett, it may be beneficial for him to begin to include his two new recruits, Todd and Ted, in the company's larger decisions, rather than limiting them to manage 10 billion dollars of each of Berkshire's securities. Another strategy alternative for Berkshire Hathaway is to give the two new investors more autonomy and power in the larger company decisions, preparing them for Warren's retirement. This exposes Berkshire Hathaway to risk because the company has always trusted Warren Buffett to make good decisions, but giving the new recruits independence in making big decisions increases the chance of mistakes and bad investment decisions on a larger level.

The third strategy alternative is to begin to pay dividends. In the past, shareholders have accepted the fact that they do not receive dividends due to Berkshire's incredible stock price increases throughout the years; however, over the past twenty years, Berkshire shares have only been slightly ahead of the S&P index. In order to keep shareholders happy, it is important to provide them with more of a return, so a payout may be beneficial. A dividend payout is possible for Berkshire considering the company has $109 billion in cash as of March 2019 (A, Bary). With Buffett approaching retirement, it is vital that the company focuses on maintaining shareholders by gearing their trust and loyalty more towards the company rather than Buffett himself.

The last strategy alternative consists of being more flexible with acquisition decisions. Buffett has made several comments hinting at the decreasing number of investment opportunities, and this is a way to combat this problem. Warren favors "elephant"-size acquisitions, but he has not completed many large acquisitions since 2010 when he acquired Burlington Northern. With a decreasing number of "elephant"-size acquisition opportunities, it may be beneficial for Berkshire to remove its no-auction policy. Warren has prohibited Berkshire from participating in corporate auctions, and the company is struggling as a result because selling companies are reluctant to sell to Berkshire without Berkshire offering other things in addition to cash. Berkshire refuses to pay in any way other than cash, and selling companies do not have a reason to view Berkshire's cash as more valuable than any other companies. Berkshire can potentially benefit from being more flexible and beginning to compete with other companies at auctions and on deals because this will open Berkshire up to more investment opportunities, allowing for further growth and success (A, Bary).

Strategy Recommendation

In order to evaluate the strategy alternatives and their potential effects on Berkshire Hathaway, I utilized the Rumelt Evaluation Method, which uses four evaluation criteria: consistency, adaptability, competitive advantage, and feasibility. I chose this method because all four criteria seemed vital to Berkshire. Berkshire has always focused on consistency in terms of strategy, growth, financials, and leadership structure. In terms of adaptability, the company has had to adapt to new technologies, social or economic trends, and industry trends. Berkshire is known to have always had a competitive advantage, and it is significant that the company maintains this competitive advantage in order to maintain its market dominance. I deemed feasibility as a significant criterion because it must be possible and realistic to implement any strategy (S, Quain).

Taking these four criteria into consideration, I decided Berkshire should take on the risk and implement a new strategy. Over the past two decades, the company has begun to show less impressive results, and in order to prevent from falling behind and losing its market dominance, the company needs to make some changes. I believe Berkshire Hathaway would benefit from implementing a mix of two of the strategy alternatives, giving Todd and Ted more independence and power and being more flexible in terms of acquisitions. Giving Todd and Ted more power in larger decision making will allow shareholders to see and trust that the company is going to be in good hands after Warren Buffett retires. By gaining shareholder trust, it will not be necessary to pay dividends because the investors will believe that Todd and Ted can continually increase the stock price. In order to increase the stock price and continue to succeed financially, Todd and Ted must become more flexible in terms of acquisitions because the company is running out of investment opportunities. If Berkshire does not become more flexible, the company will run out of investment opportunities thus will no longer grow in size and performance. The company will continue to face a gradual decrease in growth every year, eventually leading to shareholders selling their shares and the company going under.

Strategy Implementation

With Warren Buffett approaching the age of 88, it is obvious that he will no longer be at Berkshire Hathaway either due to retirement or passing away. Berkshire must implement this new strategy as soon as reasonably possible. **Figure 1** below displays a timeline for implementing both strategies.

Figure 1: Strategy Implementation Timeline

Fiscal Year: 2019	March 31-June 30	June 30-Sept. 30	Sept. 30-Dec. 31
Strategy 1: Todd and Ted receive more power and independence	Allow Todd and Ted to shadow/assist Buffett in larger decision making	Todd and Ted begin to make decisions alone under the supervision of Buffett	Todd and Ted are granted the power to make decisions alone
Strategy 2: Berkshire becomes more flexible in regard to its acquisition decisions	Berkshire begins to take steps in becoming more flexible in terms of acquisitions (research/contracts)	Berkshire lifts all restrictions on acquisitions and begins to search for new opportunities	Berkshire begins participating in corporate auctions and competing on deals for acquiring companies

Contingency Plan

What if the new strategy does not turn out successful? Berkshire must be prepared for negative results if it takes on the risk of implementing a new strategy, so the company must have a contingency plan. The company has maintained its success and growth for several decades by following the same strategy, so this new strategy can either provide the company with substantial growth and place Berkshire on an even stronger upward trend, or the new strategy can turn out unsuccessful for Berkshire and result in losses and place the company on a downward trend. The company has been on an upward trend for as long as investors can remember, so the opposite would result in drastic reactions; however, the company can simply go back to its normal strategy and operations if this occurs. Berkshire Hathaway has proven it is able to maintain growth and positive financial performance, so the company can reassure its stakeholders by announcing that they are returning back to normal operations and will reverse the downward trends in the near future. It may take a few months, but the company will eventually return to its normal performance. This may attract new investors as well because investors will view the stock as attractive and underpriced if the company is planning on returning to better performance in the future. If Berkshire Hathaway is forced to return to its normal strategy, it must work extremely hard to find "elephant"-size investment opportunities in order to achieve growth for the company. There is potential for negative results from implementing this new strategy, but by taking this risk, Berkshire Hathaway is opening itself up to potential for growth and outstanding financial results that will benefit the shareholders substantially.

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