

Client Letter October 2002

Omaha Cash Flow

This is an attempt to rearrange the numbers published in Berkshire Hathaway's Annual Reports for the last ten years. The numbers are the same but hopefully they are presented here in a fashion that provides some new insight into value of the company.

One question is an attempt to try to find a logical basis to place a value on Berkshires float and to decide if all or a portion of this float should be added to Berkshires cash flow when trying to arrive at a figure for intrinsic value.

One of the ironies of studying Berkshire

Hathaway is that while Buffett's loves simple companies that are easy to understand, he has as his masterpiece created one of the most complex business structures in American business.

Don't get me wrong. I'm not complaining, I love analyzing Berkshire, the things you learn struggling through the Berkshire annual report make it easier to understand all the other companies you own.

Table One is an attempt to show total revenue and estimate the rate of growth of this revenue. Estimates of

Table One - Revenue

	Mid-America (80%)	Berkshire	Total
1992		\$2,977	\$2,977
1993		\$3,599	\$3,599
1994		\$3,847	\$3,847
1995		\$4,563	\$4,563
1996		\$10,500	\$10,500
1997		\$10,430	\$10,430
1998		\$13,832	\$13,832
1999		\$24,028	\$24,028
2000	\$3,940	\$34,006	\$37,158
2001	\$5,061	\$37,668	\$41,717
2002 (Est.)	\$6,000	\$39,000	\$43,800

Berkshire's Revenue has grown at an average rate of 30.8% per year over the last 10 years. Compared to 30.5% for Microsoft, 21.5% for Intel and 4% for General Electric.

this year's revenues are basically six months figures times two.

To the revenue figures from the annual report I have added 80% of the revenue of Mid American Energy since that represent Berkshire equity percentage.

The average growth rate of Revenue the ten year period is 30.8%, not bad for a company the represents an eclectic bunch of boring businesses.

It is interesting to note that Microsoft's revenue growth for the last ten years has averaged 30.5%; General

Table Two Investment Income

Year	PreTax	After Tax
1992	\$495	\$305
1993	\$354	\$321
1994	\$418	\$349
1995	\$874	\$416
1996	\$778	\$593
1997	\$916	\$704
1998	\$1,049	\$731
1999	\$2,314	\$1,764
2000	\$2,686	\$1,946
2001	\$2,765	\$1,968
2002 (Est.)	\$2,800	\$2,000

Electric's revenue has grown at 4% per year, and Intel's at 21.5%.

A lot of this growth has come from two insurance acquisitions, GEICO in 1996; and GenRe in late 1998. I do not expect Berkshire's Revenue to continue this rate of growth. Buffett has said that he does not expect Berkshire to be able to grow at 15% in the future. The biggest problem is size, cash is pouring into Omaha at a rate (maybe \$200 million per week) that it will make it impossible to invest that money as fast as it comes in. On the other hand but Berkshire does have a huge pile of cash ready for large acquisitions, and a good bear market could easily add a bunch

Table Three Income from Operating Businesses

	Pre Tax	After Tax
1992	\$210	\$123
1993	\$225	\$133
1994	\$275	\$165
1995	\$249	\$191
1996	\$360	\$226
1997	\$631	\$311
1998	\$635	\$389
1999	\$830	\$513
2000	\$1,505	\$996
2001	\$2,271	\$1,470
2002 (Est.)	\$3,160	\$2,260

of new revenue.

In this connection I consider Berkshire an almost perfect long term hedge against a market crash. The worse the market gets the more it allows Buffett to add long term value to Berkshire.

Table Two shows the growth of Berk-

shires investment Income for the last ten years. This is basically dividend and interest income for the portion if the float that has been invested in Stocks and fixed income securities. It includes only money actually received and does not include any look through earnings for the common stocks.

The growth rate for this investment income has been 21% per year.

Table Three lists the total income from Berkshires 40 some odd operating businesses. We separated these items on these two tables from the information provided in the Annual Reports. Since 1998 and the merger with General Re Buffett has been raising reserves for the insurance business and that has tended to obscure the growth the operating businesses.

Investment income is growing at 21% per year and the income from operating businesses is expanding at 33% per year

Table Three includes all of the profit from the operating businesses plus 80% of the profit of Mid-American Energy. This Income has compounded for the last ten years at an annual rate of 33%. If you look at these three tables together, you can begin to get a clue about the value of the contribution of Berkshire's Insurance float to its intrinsic value.

What you see is an enterprise made up conservative business, none of which any inclination toward rapid growth yet the overall enterprise is growing very rapidly.

This magic is possible because of low cost leverage provided by the float, and without it, it is difficult to see how

Table Four Sources of Cash Flow (After Tax)

	Investment Income	Operating Business	Realized Gains	Total
1992	\$305	\$123	\$36	\$464
1993	\$321	\$133	\$363	\$817
1994	\$349	\$165	\$62	\$576
1995	\$416	\$191	\$118	\$725
1996	\$593	\$226	\$1,605	\$2,424
1997	\$704	\$311	\$704	\$1,719
1998	\$731	\$389	\$1,553	\$2,673
1999	\$1,764	\$513	\$886	\$3,163
2000	\$1,946	\$996	\$2,392	\$5,334
2001	\$1,968	\$1,470	\$842	\$4,280
2002 (Est.)	\$2,000	\$2,260	\$210	\$4,470

Table four shows totals for annual cash generated by three sources, but does not include any operational earnings from the insurance business, or any look through earnings from the stock portfolio.

Realized gains totaled \$8.56 billion for the ten year period, for an average of \$856 million per year. For the five years from 1997 to 2001 realized gains totaled \$6.38 billion or an average of \$1.28 billion per year.

The total cash generated over this period from these three sources was \$22.18 billion, where as the GAAP net earnings were \$14.99 billion.

This leaves us with the question, what happened to the rest of the cash? Part of the answer to this question can be found in **Table Five**. Losses and Loss Adjustment Expenses are listed on the Earnings Statement as Expense but it is not all a cash expense. It includes not only expenses that were paid during the current year but also an estimate of all future payments that will have to be

the enterprise would be able to grow any faster than the under-lying pieces.

It is impossible to arrive at a figure for the internal growth of the pieces, but I doubt that it is over 12%-13%. This would seem to be about the level of growth Buffett is comfortable with from an operating company. Any attempts to grow a business faster than this, can lead to mergers that do not work or other capital allocation blunders.

**For the ten years listed
the cash flow from items
on Table Four exceeded
net income by \$7.18
billion**

Table Five Non Cash Expenses

	Losses & Loss Adj. Expenses	Claims Paid	Non-cash Insurance Ex- penses
1992	\$688	\$476	\$212
1993	\$450	\$456	-\$6
1994	\$565	\$267	\$298
1995	\$612	\$290	\$322
1996	\$3,089	\$2,680	\$409
1997	\$3,420	\$3,012	\$408
1998	\$4,040	\$3,753	\$287
1999	\$12,518	\$8,180	\$4,338
2000	\$17,332	\$10,479	\$6,853
2001	\$18,398	\$9,801	\$8,597
2002 (Est.)	\$14,000	\$10,000	\$4,000

Table Six Omaha Cash Flow

	Earnings before investment gain	Increase In Float	Omaha Cash Flow
1992	\$407	\$395	\$802
1993	\$834	\$334	\$1,168
1994	\$665	\$432	\$1,097
1995	\$670	\$551	\$1,221
1996	\$884	\$410	\$1,294
1997	\$1,197	\$391	\$1,588
1998	\$1,277	\$290	\$1,567
1999	\$671	\$2,544	\$3,215
2000	\$936	\$2,573	\$3,509
2001	-\$47	\$7,637	\$7,590
2002 (Est.)	\$3,700	\$6,000	\$9,700

this is because he has so much cash. He has the money he gets from writing new insurance, the cash flow from investments, and operating companies, even in a bad year like last year the cash paid out for insurance claims is only a fraction of the money coming in. In 2001 actual claims paid (\$9.8 billion) was only 40.3% of the inflow from premiums, pre-tax investment income, realizes gains; and income from operating companies (\$24.3 billion).

So how do we value float? I say lets make it easy and just say that when it gets to Omaha it turns into Cash flow.

Table Six shows Omaha Cash Flow or money flowing into Kiewit Plaza from all different sources. It is estimated at 9.7 billion for 2002 and shows a growth rate of 25% per year. Maybe we can use this figure to estimate intrinsic value, it is not perfect but it does value the insurance float, and it is certainly better than trying to discount per share net. This method shows that Berkshire, even at present levels is **not** overvalued. We know that Berkshire was overvalued in 1998 at \$80,000+ because Buffett was using the stock as currency to buy GenRe, and we know that it was undervalued in March 2000 at \$45,000 because Buffett was offering to buy it for that. Three years of 25% growth of cash flow would put that point of under valuation at somewhere around \$90,000 in the first quarter of next year.

made for losses that occurred during the current year

"Claims paid" is the actual amount of cash payments that were made during the year both for losses that occurred this year and also for payments made for losses that occurred in prior years (It is taken from a table on page 37 of this Years Annual Report).

If we subtract the first column from

the second column we get column three, Non Cash Insurance. This not exactly the same as the growth of float during the year but it is close.

Clearly insurance accounting is a strange vehicle were liabilities may, or may not be liabilities, and after-tax cash flow can become an expense

Float which Buffett uses to buy stocks, bonds, and companies, shows up on the balance sheet as a liability, but acts like an asset. It seems as thought Buffett is an accounting alchemist, he can turn a liability into an Asset.

Buffett made the following comment at the 2001 Annual Meeting, "... we don't look at insurance float 100% the same as we look at equity, **but we look at it as largely tantamount** to equity because we had so much equity that we could afford to do it that way."

In other words Buffett can use the cash flow he gets from float the same as uses cash flow he gets from any other source. The reason he can do

**So how do we value insurance float?
Lets make it easy and just say that when it gets to Omaha it turns into cash flow**