

The Power of Float

It is very easy in this day and age to be overcome by skepticism, so as I was reading Berkshire's First Quarter Report I had stop and remind myself that this was Berkshire Hathaway, that this was Warren Buffett's company and that he would prefer to record cash flow as non taxable float, and maintain his insurance reserves at a level that will minimize his reported income. The numbers were quite good, better in fact than a lot of the reports from the dotcoms and tech darlings that commanded triple digit PE ratios three years ago.

This is the man that during the recent beloved bubble was doing the opposite of everyone else. Instead of pushing creative accounting to pump the stock, he was penalizing earnings by adding to insurance reserves. As People have pointed out, not only are the numbers good, the quality of these numbers is probably superior to anything you will see elsewhere. Buffett believes that un-taxed float is better than after tax earnings, and so is willing to forgo the pleasure of an over priced stock.

For my October 2002 Letter I Set up several Tables to study Berkshire's Ten year financial results. I have updated these Tables to show the final figures for 2002 and added estimates for 2003.

1. Revenue

Since 1992 Berkshires revenues have grown from \$2.9 Billion to an estimated \$68 billion for 2003. This represents an average annual growth rate of 33%

Table One - Revenue			
	Mid-America	Berkshire	Total (Berkshire + 80% Of Mid-American)
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	\$34,889	\$38,041
2001	\$5,061	\$38,643	\$42,692
2002	\$4,968	\$42,353	\$46,327
2003 (Est)	\$7,900	\$61,900	\$68,000

These Tables are an attempt to rearrange the numbers published in the Berkshire Hathaway Annual Reports. The numbers are the same but hopefully they are presented here in a fashion that provides a little different perspective.

Table One shows Berkshire's total revenue. In the third column (I added in 80% of the revenue for MidAmerica Energy). It is interesting that in the first Quarter of 1995 Berkshire had net operating income of 144 million. In the first Quarter of this year Mid-America Energy had operating net of \$106 million.

For the 2003 revenue estimate I assumed the same rate of growth for the year as occurred in the first quarter, then added in 11.6 billion representing six months of revenue for the Clayton Homes and McLane acquisitions.

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Table Two shows that After Tax Investment Income has grown from \$305 million in 1992 to an estimated \$2.4 billion in 2003. This is an annual growth rate of 21%. This is income that is generated by the insurance operations and basically dividend and interest income.

Year	Pre Tax	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	\$3,050	\$2,000
2003 (Est)	\$3,623	\$2,428

2. Operating Businesses

In terms of fastest growing Companies, our operating companies if ranked independently would place number five right behind Starbucks in a list of the fastest growing large cap American Equities

	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	\$3,713	\$2,484
2003 (Est)	\$5,324	\$3,567

Table Three is the Income from operating businesses, and shows Income from these wholly owned companies has grown from \$123 million in 1992 to an estimate of \$3.6 billion for 2003. This represents an average annual increase of 36%. The five year results are even more spectacular with an average annual increase 56% per year.

2003 Earnings were estimated by taking the rate of growth of the first quarter and applying them to the whole year

Revenues from these businesses was 17.3 Billion in 2002 and will clearly get a big kick from the McLane acquisition. McLane with revenues of 22 billion and Clayton Homes with \$1.2 Billion will more that double the revenue of the operating companies. Also this will leave the operating companies with 65%

to 70% of Berkshire total revenue, the first time that this figure has been much above 50%.

If the operating companies actually earn \$3.6 billion this year, and if they were ranked as an independent company, it would place them somewhere between IBM (Number 22) and Home Depot (Number 21) on the list of most profitable American Companies. IBM has a five year growth rate of 8.5%, a ten year record of 12% per year annual growth, and a total market value of \$154 Billion. Home Depot has a five year growth rate of 26% per year and a market capitalization of \$67 billion.

In terms of fast growing Companies, our operating companies if ranked independently would place number 5, right behind Starbucks in a list of the fastest growing large cap American Equities

3. After-Tax Income

For the last 11 years Berkshire's after-tax earnings have grown at an average annual rate of 29%.

So we have an eclectic group for old economy companies none of which is likely to be capable of a growth rate beyond the low teens, wedded to an old economy insurance operation. Gen Re grew earnings at 13% per year in the ten years prior to its acquisition, GEICO managed 14% per year prior to the merger.

	After Tax Earnings	Increase In Float
1992	\$407	\$395
1993	\$656	\$334
1994	\$420	\$432
1995	\$611	\$551
1996	\$2,489	\$410
1997	\$1,901	\$391
1998	\$2,830	\$290
1999	\$1,557	\$2,544
2000	\$3,328	\$2,573
2001	\$795	\$7,637
2002	\$4,286	\$5,716
2003 (Est)	\$6,920	\$5,200
12 Year Total	\$26,200	\$26,473

Yet by some magic this group has morphed into a growth monster of prodigious proportions. Table Four shows that if the present trend continues Berkshire's after tax income this year would equal \$6.9 billion up from \$407 million in 1992. This means for the last 11 years Berkshire's after-tax earnings have grown at an average annual rate of 29%.

Clearly, in my mind, an important part of the magic that is the responsible is Float. The reason Berkshire can grow its earnings 29% year is all that nice cash flow that is pouring into Kiewit Plaza (a couple of years ago Buffett was quoted as bragging that he had to deal with \$100 million a week. From the first Quarter report it appears his

problem is getting worse. My guess is the flow is now more like \$200 million a week.

Of course all float is not born equal. Float is leverage and as such it can be used as an instrument of destruction. Lots of insurance companies have used their float to dig themselves a grave. Most well run insurance companies use their float to buy bonds. Berkshire clearly has found a way to get a better returns but it can be dangerous in the wrong hands and is clearly not a trick that most insurance companies should try.

Accordingly I do not claim that float should routinely be lumped with earnings to arrive at cash flow when valuing insurance companies, but at the same time it seems foolish ignore the contribution float has made to Berkshire's growth..

Table Four also shows that in the 11 years ending December 2003 Berkshire will have grown its float by \$26.4 billion. This in terms of cash flowing to Omaha figure is very close to the 26.2 billion received from after tax earnings.

If internal growth is indeed something like 10% to 12% then the rest of that 29% per year growth is coming from investing after-tax earnings and float. Just for argument sake lets spit the credit equally

4. Cash Flow

In last 11 years Earnings from operating companies has grown by 36% per year, but in the last 5 years (the period since the GenRe merger) the growth rate has ramped up to 56% per year

The best argument that I can make for including float growth with earnings to arrive at free cash flow for Berkshire is a retrospective one. If you did not include float for the last twelve years, and particularly since the GenRe acquisition began increasing float and penalizing reported earnings, how would it have been possible make a logical estimate that the company was going to grow after-tax earnings by 29% per year? In last 11 years Earnings from operating companies have grown by 36% per year, but in the last 5 years (the period since the GenRe merger) the growth rate has ramped up to 56% per year. Looking at the numbers the only clue to the spectacular growth to come. Was the big bump in float growth beginning early in the period.

My argument is not a technical one, but based simply on pragmatism. If do not include Float growth in cash flow how the hell can you make a reasonable guess about future earnings. Going forward this point may become even more important.. Warren said at the Annual meeting that float was not going to continue to grow as fast in the future. Many of Warren's predictions are just under promising or attempts to talk the stock down, but when he said that float would not continue is current rapid growth he got my attention. First because of Charlie's comment that the marginal value of new float was very low because for low returns on their cash, then there was Warren's promise that insurance float was likely to be cost free for the next five years. This is a very positive statement, and could lead to lots of happy earnings surprises in the next five years. But it may also

indicate that they are pretty happy with the insurance they have now have, but they will not be writing much new business any time soon.

What does this mean? I think it is likely that the next five years will be different than the last five, with after tax earnings increasing rapidly and float growth going flat. Under these conditions looking at earnings alone will lead to analysis that overestimates Berkshires potential for future growth. Adding Float growth to earnings and comparing these figures to levels of the last five years is likely to give you a better picture of future.

In my opinion Berkshire is currently undervalued because rapid growth of cash flow for last five years will allow strong earnings for the next five years. It is also possible that as the market begins to recognize this earnings growth Berkshire will become overvalued because earnings are very strong but the growth of float has flattened.

Finally I would like to add that my estimates for earnings assume another catastrophe free year.