Introduction

Berkshire Hathaway is an accident. No one planned it out. No strategic plan was ever devised. With many unusual features, from its governance to its philosophy, Berkshire is unique in corporate history. And from humble roots in 1965, Berkshire is now one of the largest corporations the world has ever seen.

The company and its iconic leader, Warren E. Buffett, became famous for savvy stock picking through the 1990s, acquiring lucrative minority stakes in public companies, including American Express, Coca-Cola, the Washington Post Company, and Wells Fargo. Today, Berkshire is a huge conglomerate with wholly owned businesses in every artery of commerce, finance, and manufacturing. For example, Berkshire owns the second most popular car insurer in the United States (GEICO), one of the major transcontinental railroads in North America (Burlington Northern Santa Fe), two of the biggest reinsurers in the world (Gen Re and National Indemnity), a global energy supplier (Berkshire Hathaway Energy, formerly known as MidAmerican Energy), and pacesetters in fields as different as diamonds and mobile homes.

If Berkshire were a country, and its revenues its gross domestic product, the company would be among the top fifty world economies, rivaling Ireland, Kuwait, and New Zealand. If it were a state, Berkshire would rank thirtieth, in the cohort of Iowa, Kansas, and Oklahoma. Its subsidiaries employ more than 300,000 people—about the population of Pittsburgh. Among American corporations, Berkshire Hathaway is outsized only by a handful of behemoths the scale of ExxonMobil and Walmart (in both of which Berkshire owns a minority interest). Berkshire's cash alone—$40 billion or more in recent years—exceeds the total assets of all but the largest one hundred American corporations.

Berkshire has outperformed the broader stock market for its shareholders 80 percent of the time, often by double digits. Through 2013, Berkshire's average annual gain was 19.7 percent, more than double that of the Standard & Poor's 500 index, a cross-section of public company stocks. With a market value of $300 billion, Berkshire has generated considerable wealth, direct and indirect, for employees, customers, suppliers, and other constituencies.

Thanks to Berkshire, Buffett is a mega-billionaire, and fellow shareholders are multi-millionaires and billionaires.[1] Berkshire subsidiaries are the progenitors of thousands of millionaires too, and not just the founders or senior executives.[2] Ordinary citizens have accumulated great wealth through the many business opportunities these enterprises feed: distributors of Benjamin Moore paints, sales center managers at Clayton Homes,[3] franchisees of Dairy Queen restaurants,[4] kitchen consultants for the Pampered Chef,[5] and direct sellers of products made by the Scott Fetzer Companies, whether Kirby vacuums, World Book encyclopedias, or Ginsu knives.

Despite Berkshire's substantial achievements, what has remained a mystery is how Berkshire functions so successfully given that it is made up of such a diverse group of subsidiaries. On the surface, there seems to be no common ground among them. Besides a portfolio of minority interests in scores of public companies, Berkshire wholly owns fifty significant direct subsidiaries, which, in turn, own another two hundred subsidiaries. The Berkshire corporate empire encompasses more than five hundred entities engaged in hundreds of different lines of business (a list appears in the appendix to this book).

Most are low-tech, such as Acme Brick, which makes and distributes bricks, whereas others are high-tech, like FlightSafety, which uses complex flight simulators to train airline pilots, and MiTek, which manufactures advanced engineering devices for the construction industry. Some, including Gen Re and National Indemnity, provide sophisticated financial services to multinational corporations like Ford Motor Company and PepsiCo, whereas others, like Clayton Homes, make simple loans to middle-class

Americans buying manufactured housing. Within Berkshire there are several nested conglomerates like the Marmon Group and Scott Fetzer—the former engaged in more than one hundred lines of business—and many small family firms, like Fechheimer Brothers, which makes police uniforms as well as a line of Berkshire Hathaway activewear.

Diverse as they are, a close look at Berkshire's subsidiaries and the company's goals in acquiring them reveals distinctive common traits. The most important filter Berkshire applies when evaluating a potential acquisition is whether a company has ways to protect its ability to earn profits. Management experts refer to these as "barriers to entry," making it difficult for competitors to take market share away. Professor Michael Porter coined the phrase "sustainable competitive advantage" to convey a similar idea about the durability of business value.[6] Buffett draws on medieval imagery, portraying a business as a "castle" and such barriers and advantages as "moats," the water-filled ditches dug around castles to defend against invaders. One prevailing common trait of Berkshire's subsidiaries is that all have a moat.

At Berkshire, barriers to entry are strong for companies such as Burlington Northern Santa Fe Railway and Berkshire Hathaway Energy, whose operations are so costly to replicate that they achieve "natural monopolies"—those in which society benefits if rendered by a single operator rather than multiple competitors because the required investment is so large in relation to the payoffs. Other Berkshire companies maintain competitive advantages through close customer relationships. For example, Lubrizol's chemists collaborate with equipment manufacturers and oil company customers on new products, while logistics mavens at McLane, a wholesale grocer and distributor, partner with retail customers on store operations. Brand loyalty is the moat for Brooks (running shoes), Fruit of the Loom (underwear), Justin (cowboy boots), NetJets (fractional aircraft ownership services), and See's (candies).

Every business needs a moat to endure and prosper. Berkshire has to have one in order to beat out rivals for acquisitions and investments. If each Berkshire subsidiary must have a moat, it invites asking: What is Berkshire's moat? A tempting answer is Warren Buffett; the argument that I will make in this book, however, is that there is much more to it. This stands to reason: mortality means no *person* can be a moat, because that would not be a durable advantage.

Some treat Buffett's identity as a negative for Berkshire's future. For instance, the credit rating agency Fitch has long highlighted as a risk for

Berkshire that Buffett is a "key man" and that Berkshire's "ability to identify and purchase attractive operating companies is intimately tied to Buffett."[7] When you cannot separate the identity of a company from its leader, the company's durability is doubtful.[8]

On the contrary—a company often proves its sustainability by prospering through a succession of senior leaders, even iconic ones. Burlington Northern Santa Fe (BNSF), an amalgamation that dates to 1849, illustrates this. Among its earliest leaders was nineteenth-century railroad magnate James J. Hill, who stressed that a company achieves "permanent value" only when "it no longer depends on the life or labor of any single individual."[9] Examples abound in the dozen multigeneration family businesses among Berkshire subsidiaries. These include subsidiaries in their fifth or fourth generations and many in their third or second. This is an impressive concentration of longevity since most family businesses fail; only 30 percent succeed to the second generation, 15 percent to the third, and just 4 percent to the fourth.[10]

Leadership transitions need not be smooth to vouch for corporate durability. Numerous Berkshire subsidiaries have had high turnover in the corner office, both before and after joining Berkshire. In the recent past, during Berkshire's ownership, there have been several abrupt chief executive switches within a few years at Benjamin Moore, Gen Re, and NetJets, among others. To quote a more recent BNSF executive, reflecting on the tribulations the company faced in its first century and a half: "It's a wonderful company, and the fact that it has survived so much and is still in the position it's in is a tribute to what a good company it really is and the people in the company."[11]

So, Berkshire's moat cannot be Warren Buffett. A tempting possibility, then, is the power and financial resources of Berkshire's insurance companies. They command considerable moats, GEICO by being the low-cost car insurer and Gen Re and National Indemnity by commanding reputations for prudent underwriting of risk and immense financial strength. All generate premium volume well in excess of claims. This produces investable funds at no cost—called "float" because the premiums are held by the insurer until claims are paid. On the other hand, no insurance company is immune from disaster, and both GEICO and Gen Re have experienced life-threatening difficulties in their histories. The insurance companies are impressive, however, and the float they generate provides ample capital for investment in sister subsidiaries and securities of other companies. But the insurance subsidiaries *contribute* to Berkshire's moat rather than define it.

Likewise, Berkshire's investment securities widen Berkshire's moat but do not constitute it because, even without them, Berkshire would be formidable. Berkshire's sizable long-term common stock holdings once represented a large portion of its financial picture, but today they are a fraction (one-fifth of assets, one-tenth of revenues).[12] Moreover, despite the permanency of many such holdings, Berkshire does not control its investees as it controls its subsidiaries. Berkshire still owns every subsidiary acquired since 1970; among the hundreds of securities reported in its portfolio over the years, however, some no longer exist (e.g., F. W. Woolworth), others were taken over (e.g., Beatrice Foods, General Foods), and many equity positions were sold (e.g., Freddie Mac, McDonald's, The Walt Disney Company). Investments strengthen Berkshire's fortress but, as with the insurers, they are only part of the story.

What, then, is Berkshire's moat? The answer: Berkshire's distinctive corporate culture. Berkshire spent the last five decades acquiring a group of wholly owned subsidiaries of bewildering variety but united by a set of distinctive core values. The result is a corporate culture unlike any other. And this is Berkshire's moat.

Berkshire's culture offers value in its business acquisitions, and this enhances Berkshire's competitive position versus rival buyers. To give one of many cases, in 1995, Berkshire acquired RC Willey, a family-owned furniture retailer, for a price 12.5 percent less than a rival bid; Berkshire paid $175 million, *besting* offers exceeding $200 million.[13] The owners chose Berkshire because of cultural values, including its reputation for integrity, how it gives its managers operational autonomy, and its commitment to holding the subsidiaries it acquires forever.[14]

The exchange of values is a two-way street. In 2011, Berkshire acquired Burlington Northern Santa Fe Railway, a widely held public company then in the S&P 500 (Berkshire replaced it after the acquisition). It paid $100 per share even though Buffett said it was worth closer to $95.[15] Many observers were confounded but the value of values explains the 5 percent gap. When buyers and sellers both value a specific set of intangibles, as Berkshire and its subsidiaries do, the upshot is a wider price band within which a deal can be done.[16]

It is common in corporate acquisitions to coax agreement on price by thoughtful understanding of each side's goals. If two sides cannot agree on price, for instance, a seller may offer to retain some contingent liabilities, or a buyer may propose to leave out some intellectual property assets (like patents). Given differing valuations of such elements—different appetites and risk profiles—such trading can induce agreement on price.[17]

Berkshire, by contrast, creates scenarios in which intangibles substitute for money. Benjamin Graham, Buffett's intellectual patriarch and author of renowned books on investing, taught Buffett to hunt for investments where price was significantly less than value, delivering a margin of safety.[18] Price is what you pay; value is what you get, usually measured by earnings or net assets.

With Berkshire, you have to increase the value side of the equation beyond earnings and net assets to include the intangible cultural traits. People value such things differently—just as buyers and sellers value contingent liabilities and patent technology differently.

Berkshire deserves credit for this achievement of value creation. It is as if Buffett found that applying Graham's price–value margin of safety left too small a pool of potential acquisitions. So he perfected a business model in which the element of value increased. This enables Berkshire to pay a lower price for any given value or to accept paying a premium, depending on relative appetites and profiles.

While Buffett perfected this model at Berkshire, the value of these values transcends any one person. Berkshire's subsidiaries likewise enjoy economic value as the result of their intangible values, as their stories in this book illustrate, and the shared values among them form a distinct and enduring corporate culture for Berkshire.