

# BERKSHIRE HATHAWAY INC.

February 26, 1982

*To the Shareholders of Berkshire Hathaway Inc.:*

Operating earnings of \$39.7 million in 1981 amounted to 15.2% of beginning equity capital (valuing securities at cost) compared to 17.8% in 1980. Our new plan that allows stockholders to designate corporate charitable contributions (detailed later) reduced earnings by about \$900,000 in 1981. This program, which we expect to continue subject to annual evaluation of our corporate tax position, had not been initiated in 1980.

## *Non-Controlled Ownership Earnings*

In the 1980 annual report we discussed extensively the concept of non-controlled ownership earnings, i.e., Berkshire's share of the undistributed earnings of companies we don't control or significantly influence but in which we, nevertheless, have important investments. (We will be glad to make available to new or prospective shareholders copies of that discussion or others from earlier reports to which we refer in this report.) No portion of those undistributed earnings is included in the operating earnings of Berkshire.

However, our belief is that, in aggregate, those undistributed and, therefore, unrecorded earnings will be translated into tangible value for Berkshire shareholders just as surely as if subsidiaries we control had earned, retained - and reported - similar earnings.

We know that this translation of non-controlled ownership earnings into corresponding realized and unrealized capital gains for Berkshire will be extremely irregular as to time of occurrence. While market values track business values quite well over long periods, in any given year the relationship can gyrate capriciously. Market recognition of retained earnings also will be unevenly realized among companies. It will be disappointingly low or negative in cases where earnings are employed non-productively, and far greater than dollar-for-dollar of retained earnings in cases of companies that achieve high returns with their augmented capital. Overall, if a group of non-controlled companies is selected with reasonable skill, the group result should be quite satisfactory.

In aggregate, our non-controlled business interests have more favorable underlying economic characteristics than our controlled businesses. That's understandable; the area of choice has been far wider. Small portions of exceptionally good businesses are usually available in the securities markets at reasonable prices. But such businesses are available for purchase in their entirety only rarely, and then almost always at high prices.

## *General Acquisition Behavior*

As our history indicates, we are comfortable both with total ownership of businesses and with marketable securities representing small portions of businesses. We continually look for ways to employ large sums in each area. (But we try to avoid small commitments - "If something's not worth doing at all, it's not worth doing well".) Indeed, the liquidity requirements of our

insurance and trading stamp businesses mandate major investments in marketable securities.

Our acquisition decisions will be aimed at maximizing real economic benefits, not at maximizing either managerial domain or reported numbers for accounting purposes. (In the long run, managements stressing accounting appearance over economic substance usually achieve little of either.)

Regardless of the impact upon immediately reportable earnings, we would rather buy 10% of Wonderful Business T at X per share than 100% of T at 2X per share. Most corporate managers prefer just the reverse, and have no shortage of stated rationales for their behavior.

However, we suspect three motivations - usually unspoken - to be, singly or in combination, the important ones in most high-premium takeovers:

- (1) Leaders, business or otherwise, seldom are deficient in animal spirits and often relish increased activity and challenge. At Berkshire, the corporate pulse never beats faster than when an acquisition is in prospect.
- (2) Most organizations, business or otherwise, measure themselves, are measured by others, and compensate their managers far more by the yardstick of size than by any other yardstick. (Ask a *Fortune 500* manager where his corporation stands on that famous list and, invariably, the number responded will be from the list ranked by size of sales; he may well not even know where his corporation places on the list *Fortune* just as faithfully compiles ranking the same 500 corporations by profitability.)
- (3) Many managements apparently were overexposed in impressionable childhood years to the story in which the imprisoned handsome prince is released from a toad's body by a kiss from a beautiful princess. Consequently, they are certain their managerial kiss will do wonders for the profitability of Company T(arget).

Such optimism is essential. Absent that rosy view, why else should the shareholders of Company A(cquisitor) want to own an interest in T at the 2X takeover cost rather than at the X market price they would pay if they made direct purchases on their own?

In other words, investors can always buy toads at the going price for toads. If investors instead bankroll princesses who wish to pay double for the right to kiss the toad, those kisses had better pack some real dynamite. We've observed many kisses but very few miracles. Nevertheless, many managerial princesses remain serenely confident about the future potency of their kisses - even after their corporate backyards are knee-deep in unresponsive toads.

In fairness, we should acknowledge that some acquisition records have been dazzling. Two major categories stand out.

The first involves companies that, through design or accident, have purchased only businesses that are particularly well adapted to an inflationary environment. Such favored business must have two characteristics: (1) an ability to increase prices rather easily (even when product demand is flat and capacity is not fully utilized) without fear of significant loss of either market share or unit volume, and (2) an ability to accommodate large dollar volume increases in business (often

produced more by inflation than by real growth) with only minor additional investment of capital. Managers of ordinary ability, focusing solely on acquisition possibilities meeting these tests, have achieved excellent results in recent decades. However, very few enterprises possess both characteristics, and competition to buy those that do has now become fierce to the point of being self-defeating.

The second category involves the managerial superstars - men who can recognize that rare prince who is disguised as a toad, and who have managerial abilities that enable them to peel away the disguise. We salute such managers as Ben Heineman at Northwest Industries, Henry Singleton at Teledyne, Erwin Zaban at National Service Industries, and especially Tom Murphy at Capital Cities Communications (a real managerial "twofer", whose acquisition efforts have been properly focused in Category 1 and whose operating talents also make him a leader of Category 2). From both direct and vicarious experience, we recognize the difficulty and rarity of these executives' achievements. (So do they; these champs have made very few deals in recent years, and often have found repurchase of their own shares to be the most sensible employment of corporate capital.)

Your Chairman, unfortunately, does not qualify for Category 2. And, despite a reasonably good understanding of the economic factors compelling concentration in Category 1, our actual acquisition activity in that category has been sporadic and inadequate. Our preaching was better than our performance. (We neglected the Noah principle: predicting rain doesn't count, building arks does.)

We have tried occasionally to buy toads at bargain prices with results that have been chronicled in past reports. Clearly our kisses fell flat. We have done well with a couple of princes - but they were princes when purchased. At least our kisses didn't turn them into toads. And, finally, we have occasionally been quite successful in purchasing fractional interests in easily-identifiable princes at toad-like prices.

### *Berkshire Acquisition Objectives*

We will continue to seek the acquisition of businesses in their entirety at prices that will make sense, even should the future of the acquired enterprise develop much along the lines of its past. We may very well pay a fairly fancy price for a Category 1 business if we are reasonably confident of what we are getting. But we will not normally pay a lot in any purchase for what we are supposed to bring to the party - for we find that we ordinarily don't bring a lot.

During 1981 we came quite close to a major purchase involving both a business and a manager we liked very much. However, the price finally demanded, considering alternative uses for the funds involved, would have left our owners worse off than before the purchase. The empire would have been larger, but the citizenry would have been poorer.

Although we had no success in 1981, from time to time in the future we will be able to purchase 100% of businesses meeting our standards. Additionally, we expect an occasional offering of a major "non-voting partnership" as discussed under the Pinkerton's heading on page 47 of this report. We welcome suggestions regarding such companies where we, as a substantial junior partner, can achieve good economic results while furthering the long-term objectives of present owners and managers.

Currently, we find values most easily obtained through the open-market purchase of fractional positions in companies with

excellent business franchises and competent, honest managements. We never expect to run these companies, but we do expect to profit from them.

We expect that undistributed earnings from such companies will produce full value (subject to tax when realized) for Berkshire and its shareholders. If they don't, we have made mistakes as to either: (1) the management we have elected to join; (2) the future economics of the business; or (3) the price we have paid.

We have made plenty of such mistakes - both in the purchase of non-controlling and controlling interests in businesses. Category (2) miscalculations are the most common. Of course, it is necessary to dig deep into our history to find illustrations of such mistakes - sometimes as deep as two or three months back. For example, last year your Chairman volunteered his expert opinion on the rosy future of the aluminum business. Several minor adjustments to that opinion - now aggregating approximately 180 degrees - have since been required.

For personal as well as more objective reasons, however, we generally have been able to correct such mistakes far more quickly in the case of non-controlled businesses (marketable securities) than in the case of controlled subsidiaries. Lack of control, in effect, often has turned out to be an economic plus.

As we mentioned last year, the magnitude of our non-recorded "ownership" earnings has grown to the point where their total is greater than our reported operating earnings. We expect this situation will continue. In just four ownership positions in this category - GEICO Corporation, General Foods Corporation, R. J. Reynolds Industries, Inc. and The Washington Post Company - our share of undistributed and therefore unrecorded earnings probably will total well over \$35 million in 1982.