BERKSHIRE HATHAWAY INC.

March 3, 1983

To the Stockholders of Berkshire Hathaway Inc.:

Operating earnings of $31.5 million in 1982 amounted to only 9.8% of beginning equity capital (valuing securities at cost), down from 15.2% in 1981 and far below our recent high of 19.4% in 1978. This decline largely resulted from:

(1) a significant deterioration in insurance underwriting results;

(2) a considerable expansion of equity capital without a corresponding growth in the businesses we operate directly; and

(3) a continually-enlarging commitment of our resources to investment in partially-owned, nonoperated businesses; accounting rules dictate that a major part of our pro-rata share of earnings from such businesses must be excluded from Berkshire's reported earnings.

It was only a few years ago that we told you that the operating earnings/equity capital percentage, with proper allowance for a few other variables, was the most important yardstick of single-year managerial performance. While we still believe this to be the case with the vast majority of companies, we believe its utility in our own case has greatly diminished. You should be suspicious of such an assertion. Yardsticks seldom are discarded while yielding favorable readings. But when results deteriorate, most managers favor disposition of the yardstick rather than disposition of the manager.

To managers faced with such deterioration, a more flexible measurement system often suggests itself: just shoot the arrow of business performance into a blank canvas and then carefully draw the bullseye around the implanted arrow. We generally believe in pre-set, long-lived and small bullseyes. However, because of the importance of item (3) above, further explained in the following section, we believe our abandonment of the operating earnings/equity capital bullseye to be warranted.

Non-Reported Ownership Earnings

The appended financial statements reflect "accounting" earnings that generally include our proportionate share of earnings from any underlying business in which our ownership is at least 20%. Below the 20% ownership figure, however, only our share of dividends paid by the underlying business units is included in our accounting numbers; undistributed earnings of such less-than-20%-owned businesses are totally ignored.

There are a few exceptions to this rule; e.g., we own about 35% of GEICO Corporation but, because we have assigned our voting rights, the company is treated for accounting purposes as a less-than-20% holding. Thus, dividends received from GEICO in 1982 of $3.5 million after tax are the only item included in our "accounting"earnings. An additional $23 million that represents our share of GEICO's undistributed operating earnings for 1982 is totally excluded from our reported operating earnings. If GEICO had earned less money in 1982 but had paid an additional $1 million in dividends, our reported earnings would have been larger despite the poorer business results. Conversely, if GEICO had earned an additional $100 million - and retained it all - our reported earnings would have been unchanged. Clearly "accounting" earnings can seriously misrepresent economic reality.

We prefer a concept of "economic" earnings that includes all undistributed earnings, regardless of ownership percentage. In our view, the value to all owners of the retained earnings of a business enterprise is determined by the effectiveness with which those earnings are used - and not by the size of one's ownership percentage. If you have owned .01 of 1% of Berkshire during the past decade, you have benefited economically in full measure from your share of our retained earnings, no matter what your accounting system. Proportionately, you have done just as well as if you had owned the magic 20%. But if you have owned 100% of a great many capital-intensive businesses during the decade, retained earnings that were credited fully and with painstaking precision to you under standard accounting methods have resulted in minor or zero economic value. This is not a criticism of accounting procedures. We would not like to have the job of designing a better system. It's simply to say that managers and investors alike must understand that accounting numbers are the beginning, not the end, of business valuation.

In most corporations, less-than-20% ownership positions are unimportant (perhaps, in part, because they prevent maximization of cherished reported earnings) and the distinction between accounting and economic results we have just discussed matters little. But in our own case, such positions are of very large and growing importance. Their magnitude, we believe, is what makes our reported operating earnings figure of limited significance.

In our 1981 annual report we predicted that our share of undistributed earnings from four of our major non-controlled holdings would aggregate over $35 million in 1982. With no change in our holdings of three of these companies - GEICO, General Foods and The Washington Post - and a considerable increase in our ownership of the fourth, R. J. Reynolds Industries, our share of undistributed 1982 operating earnings of this group came to well over $40 million. This number - not reflected at all in our earnings - is greater than our total reported earnings, which include only the $14 million in dividends received from these companies. And, of course, we have a number of smaller ownership interests that, in aggregate, had substantial additional undistributed earnings.

We attach real significance to the general magnitude of these numbers, but we don't believe they should be carried to ten decimal places. Realization by Berkshire of such retained earnings through improved market valuations is subject to very substantial, but indeterminate, taxation. And while retained earnings over the years, and in the aggregate, have translated into at least equal market value for shareholders, the translation has been both extraordinarily uneven among companies and irregular and unpredictable in timing.

However, this very unevenness and irregularity offers advantages to the value-oriented purchaser of fractional portions of businesses. This investor may select from almost the entire array of major American corporations, including many far superior to virtually any of the businesses that could be bought in their entirety in a negotiated deal. And fractional-interest purchases can be made in an auction market where prices are set by participants with behavior patterns that sometimes resemble those of an army of manic-depressive lemmings.

Within this gigantic auction arena, it is our job to select businesses with economic characteristics allowing each dollar of retained earnings to be translated eventually into at least a dollar of market value. Despite a lot of mistakes, we have so far achieved this goal. In doing so, we have been greatly assisted by Arthur Okun's patron saint for economists - St. Offset. In some cases, that is, retained earnings attributable to our ownership position have had insignificant or even negative impact on market value, while in other major positions a dollar retained by an investee corporation has been translated into two or more dollars of market value. To date, our corporate over-achievers have more than offset the laggards. If we can continue this record, it will validate our efforts to maximize "economic" earnings, regardless of the impact upon "accounting" earnings.

Satisfactory as our partial-ownership approach has been, what really makes us dance is the purchase of 100% of good businesses at reasonable prices. We've accomplished this feat a few times (and expect to do so again), but it is an extraordinarily difficult job - far more difficult than the purchase at attractive prices of fractional interests.

As we look at the major acquisitions that others made during 1982, our reaction is not envy, but relief that we were non-participants. For in many of these acquisitions, managerial intellect wilted in competition with managerial adrenaline The thrill of the chase blinded the pursuers to the consequences of the catch. Pascal's observation seems apt: "It has struck me that all men's misfortunes spring from the single cause that they are unable to stay quietly in one room."

(Your Chairman left the room once too often last year and almost starred in the Acquisition Follies of 1982. In retrospect, our major accomplishment of the year was that a very large purchase to which we had firmly committed was unable to be completed for reasons totally beyond our control. Had it come off, this transaction would have consumed extraordinary amounts of time and energy, all for a most uncertain payoff. If we were to introduce graphics to this report, illustrating favorable business developments of the past year, two blank pages depicting this blown deal would be the appropriate centerfold.)

Our partial-ownership approach can be continued soundly only as long as portions of attractive businesses can be acquired at attractive prices. We need a moderately-priced stock market to assist us in this endeavor. The market, like the Lord, helps those who help themselves. But, unlike the Lord, the market does not forgive those who know not what they do. For the investor, a too-high purchase price for the stock of an excellent company can undo the effects of a subsequent decade of favorable business developments.

Should the stock market advance to considerably higher levels, our ability to utilize capital effectively in partial-ownership positions will be reduced or eliminated. This will happen periodically: just ten years ago, at the height of the two-tier market mania (with high-return-on-equity businesses bid to the sky by institutional investors), Berkshire's insurance subsidiaries owned only $18 million in market value of equities, excluding their interest in Blue Chip Stamps. At that time, such equity holdings amounted to about 15% of our insurance company investments versus the present 80%. There were as many good businesses around in 1972 as in 1982, but the prices the stock market placed upon those businesses in 1972 looked absurd. While high stock prices in the future would make our performance look good temporarily, they would hurt our long-term business prospects rather than help them. We currently are seeing early traces of this problem.

Long-Term Corporate Performance

Our gain in net worth during 1982, valuing equities held by our insurance subsidiaries at market value (less capital gain taxes payable if unrealized gains were actually realized) amounted to $208 million. On a beginning net worth base of $519 million, the percentage gain was 40%.

During the 18-year tenure of present management, book value has grown from $19.46 per share to $737.43 per share, or 22.0% compounded annually. You can be certain that this percentage will diminish in the future. Geometric progressions eventually forge their own anchors.

Berkshire's economic goal remains to produce a long-term rate of return well above the return achieved by the average large American corporation. Our willingness to purchase either partial or total ownership positions in favorably-situated businesses, coupled with reasonable discipline about the prices we are willing to pay, should give us a good chance of achieving our goal.

Again this year the gain in market valuation of partially-owned businesses outpaced the gain in underlying economic value of those businesses. For example, $79 million of our $208 million gain is attributable to an increased market price for GEICO. This company continues to do exceptionally well, and we are more impressed than ever by the strength of GEICO's basic business idea and by the management skills of Jack Byrne. (Although not found in the catechism of the better business schools, “Let Jack Do It” works fine as a corporate creed for us.)

However, GEICO's increase in market value during the past two years has been considerably greater than the gain in its intrinsic business value, impressive as the latter has been. We expected such a favorable variation at some point, as the perception of investors converged with business reality. And we look forward to substantial future gains in underlying business value accompanied by irregular, but eventually full, market recognition of such gains.

Year-to-year variances, however, cannot consistently be in our favor. Even if our partially-owned businesses continue to perform well in an economic sense, there will be years when they perform poorly in the market. At such times our net worth could shrink significantly. We will not be distressed by such a shrinkage; if the businesses continue to look attractive and we have cash available, we simply will add to our holdings at even more favorable prices.

Sources of Reported Earnings

The table below shows the sources of Berkshire's reported earnings. In 1981 and 1982 Berkshire owned about 60% of Blue Chip Stamps which, in turn, owned 80% of Wesco Financial Corporation. The table displays aggregate operating earnings of the various business entities, as well as Berkshire's share of those earnings. All of the significant gains and losses attributable to unusual sales of assets by any of the business entities are aggregated with securities transactions in the line near the bottom of the table, and are not included in operating earnings.

	Earnings Before Income Taxes	Net Earnings After Tax

	Total		*Berkshire Share*		*Berkshire Share*	
	1982	*1981*	*1982*	*1981*	*1982*	*1981*
			(000s omitted)			
Operating Earnings:						
Insurance Group:						
Underwriting	$(21,558)	$ 1,478	$(21,558)	$ 1,478	$(11,345)	$ 798
Net Investment Income ...	41,620	38,823	41,620	38,823	35,270	32,401
Berkshire-Waumbec Textiles	(1,545)	(2,669)	(1,545)	(2,669)	(862)	(1,493)
Associated Retail Stores ..	914	1,763	914	1,763	446	759
See's Candies	23,884	20,961	14,235	12,493	6,914	5,910
Buffalo Evening News	(1,215)	(1,217)	(724)	(725)	(226)	(320)
Blue Chip Stamps - Parent	4,182	3,642	2,492	2,171	2,472	2,134
Wesco Financial - Parent ..	6,156	4,495	2,937	2,145	2,210	1,590
Mutual Savings and Loan ...	(6)	1,605	(2)	766	1,524	1,536
Precision Steel	1,035	3,453	493	1,648	265	841
Interest on Debt	(14,996)	(14,656)	(12,977)	(12,649)	(6,951)	(6,671)
Other*	2,631	2,985	1,857	1,992	1,780	1,936
Operating Earnings	41,102	60,663	27,742	47,236	31,497	39,421
Sales of securities and unusual sales of assets ..	36,651	37,801	21,875	33,150	14,877	23,183
Total Earnings - all entities	$ 77,753	$ 98,464	$ 49,617	$ 80,386	$ 46,374	$ 62,604

* Amortization of intangibles arising in accounting for purchases of businesses (i.e. See's, Mutual and Buffalo Evening News) is reflected in the category designated as "Other".

On pages 45-61 of this report we have reproduced the narrative reports of the principal executives of Blue Chip and Wesco, in which they describe 1982 operations. A copy of the full annual report of either company will be mailed to any Berkshire shareholder upon request to Mr. Robert H. Bird for Blue Chip Stamps, 5801 South Eastern Avenue, Los Angeles, California 90040, or to Mrs. Jeanne Leach for Wesco Financial Corporation, 315 East Colorado Boulevard, Pasadena, California 91109.

I believe you will find the Blue Chip chronicle of developments in the Buffalo newspaper situation particularly interesting. There are now only 14 cities in the United States with a daily newspaper whose weekday circulation exceeds that of the Buffalo News. But the real story has been the growth in Sunday circulation. Six years ago, prior to introduction of a Sunday edition of the News, the long-established Courier-Express, as the only Sunday newspaper published in Buffalo, had circulation of 272,000. The News now has Sunday circulation of 367,000, a 35% gain - even though the number of households within the primary circulation area has shown little change during the six years. We know of no city in the United States with a long history of seven-day newspaper publication in which the percentage of households purchasing the Sunday newspaper has grown at anything like this rate. To the contrary, in most cities household penetration figures have grown negligibly, or not at all. Our key managers in Buffalo - Henry Urban, Stan Lipsey, Murray Light, Clyde Pinson, Dave Perona and Dick Feather - deserve great credit for this unmatched expansion in Sunday readership.

As we indicated earlier, undistributed earnings in companies we do not control are now fully as important as the reported operating earnings detailed in the preceding table. The distributed portion of non-controlled earnings, of course, finds its way into that table primarily through the net investment income segment of Insurance Group earnings.

We show below Berkshire's proportional holdings in those non-controlled businesses for which only distributed earnings (dividends) are included in our earnings.

No. of Shares or Share Equiv.		*Cost*	*Market*
		(000s omitted)	
460,650 (a)	Affiliated Publications, Inc.	$ 3,516	$ 16,929
908,800 (c)	Crum & Forster	47,144	48,962
2,101,244 (b)	General Foods, Inc.	66,277	83,680
7,200,000 (a)	GEICO Corporation	47,138	309,600
2,379,200 (a)	Handy & Harman	27,318	46,692
711,180 (a)	Interpublic Group of Companies, Inc.	4,531	34,314
282,500 (a)	Media General	4,545	12,289
391,400 (a)	Ogilvy & Mather Int'l. Inc.	3,709	17,319
3,107,675 (b)	R. J. Reynolds Industries	142,343	158,715
1,531,391 (a)	Time, Inc.	45,273	79,824
1,868,600 (a)	The Washington Post Company	10,628	103,240
		$402,422	$911,564

All Other Common Stockholdings	21,611	34,058
Total Common Stocks	$424,033	$945,622

(a) All owned by Berkshire or its insurance subsidiaries.

(b) Blue Chip and/or Wesco own shares of these companies. All numbers represent Berkshire's net interest in the larger gross holdings of the group.

(c) Temporary holding as cash substitute.

In case you haven't noticed, there is an important investment lesson to be derived from this table: nostalgia should be weighted heavily in stock selection. Our two largest unrealized gains are in Washington Post and GEICO, companies with which your Chairman formed his first commercial connections at the ages of 13 and 20, respectively After straying for roughly 25 years, we returned as investors in the mid-1970s. The table quantifies the rewards for even long-delayed corporate fidelity.

Our controlled and non-controlled businesses operate over such a wide spectrum that detailed commentary here would prove too lengthy. Much financial and operational information regarding the controlled businesses is included in Management's Discussion on pages 34-39, and in the narrative reports on pages 45-61. However, our largest area of business activity has been, and almost certainly will continue to be, the property-casualty insurance area. So commentary on developments in that industry is appropriate.

Insurance Industry Conditions

We show below an updated table of the industry statistics we utilized in last year's annual report. Its message is clear: underwriting results in 1983 will not be a sight for the squeamish.

	Yearly Change in Premiums Written (%)	*Yearly Change in Premiums Earned (%)*	*Combined Ratio after Policy-holder Dividends*
1972	10.2	10.9	96.2
1973	8.0	8.8	99.2
1974	6.2	6.9	105.4
1975	11.0	9.6	107.9
1976	21.9	19.4	102.4
1977	19.8	20.5	97.2
1978	12.8	14.3	97.5
1979	10.3	10.4	100.6
1980	6.0	7.8	103.1
1981 (Rev.)	3.9	4.1	106.0
1982 (Est.)	5.1	4.6	109.5

Source: Best's Aggregates and Averages.

The Best's data reflect the experience of practically the entire industry, including stock, mutual and reciprocal companies. The combined ratio represents total operating and loss costs as compared to revenue from premiums; a ratio below 100 indicates an underwriting profit, and one above 100 indicates a loss.

For reasons outlined in last year's report, as long as the annual gain in industry premiums written falls well below 10%, you can expect the underwriting picture in the next year to deteriorate. This will be true even at today's lower general rate of inflation. With the number of policies increasing annually, medical inflation far exceeding general inflation, and concepts of insured liability broadening, it is highly unlikely that yearly increases in insured losses will fall much below 10%.

You should be further aware that the 1982 combined ratio of 109.5 represents a "best case" estimate. In a given year, it is possible for an insurer to show almost any profit number it wishes, particularly if it (1) writes "long-tail" business (coverage where current costs can be only estimated, because claim payments are long delayed), (2) has been adequately reserved in the past, or (3) is growing very rapidly. There are indications that several large insurers opted in 1982 for obscure accounting and reserving maneuvers that masked significant deterioration in their underlying businesses. In insurance, as elsewhere, the reaction of weak managements to weak operations is often weak accounting. ("It's difficult for an empty sack to stand upright.")

The great majority of managements, however, try to play it straight. But even managements of integrity may subconsciously be less willing in poor profit years to fully recognize adverse loss trends. Industry statistics indicate some deterioration in loss reserving practices during 1982 and the true combined ratio is likely to be modestly worse than indicated by our table.

The conventional wisdom is that 1983 or 1984 will see the worst of underwriting experience and then, as in the past, the "cycle" will move, significantly and steadily, toward better results. We disagree because of a pronounced change in the competitive environment, hard to see for many years but now quite visible.

To understand the change, we need to look at some major factors that affect levels of corporate profitability generally. Businesses in industries with both substantial over-capacity and a "commodity" product (undifferentiated in any customer-important way by factors such as performance, appearance, service support, etc.) are prime candidates for profit troubles. These may be escaped, true, if prices or costs are administered in some manner and thereby insulated at least partially from normal market forces. This administration can be carried out (a) legally through government intervention (until recently, this category included pricing for truckers and deposit costs for financial institutions), (b) illegally through collusion, or (c) "extra-legally" through OPEC-style foreign cartelization (with tag-along benefits for domestic non-cartel operators).

If, however, costs and prices are determined by full-bore competition, there is more than ample capacity, and the buyer cares little about whose product or distribution services he uses, industry economics are almost certain to be unexciting. They may well be disastrous.

Hence the constant struggle of every vendor to establish and emphasize special qualities of product or service. This works with candy bars (customers buy by brand name, not by asking for a "two-ounce candy bar") but doesn't work with sugar (how often do you hear, "I'll have a cup of coffee with cream and C & H sugar, please").

In many industries, differentiation simply can't be made meaningful. A few producers in such industries may consistently do well if they have a cost advantage that is both wide and sustainable. By definition such exceptions are few, and, in many industries, are non-existent. For the great majority of companies selling "commodity"products, a depressing equation of business economics prevails: persistent over-capacity without administered prices (or costs) equals poor profitability.

Of course, over-capacity may eventually self-correct, either as capacity shrinks or demand expands. Unfortunately for the participants, such corrections often are long delayed. When they finally occur, the rebound to prosperity frequently produces a pervasive enthusiasm for expansion that, within a few years, again creates over-capacity and a new profitless environment. In other words, nothing fails like success.

What finally determines levels of long-term profitability in such industries is the ratio of supply-tight to supply-ample years. Frequently that ratio is dismal. (It seems as if the most recent supply-tight period in our textile business - it occurred some years back - lasted the better part of a morning.)

In some industries, however, capacity-tight conditions can last a long time. Sometimes actual growth in demand will outrun forecasted growth for an extended period. In other cases, adding capacity requires very long lead times because complicated manufacturing facilities must be planned and built.

But in the insurance business, to return to that subject, capacity can be instantly created by capital plus an underwriter's willingness to sign his name. (Even capital is less important in a world in which state-sponsored guaranty funds protect many policyholders against insurer insolvency.) Under almost all conditions except that of fear for survival - produced, perhaps, by a stock market debacle or a truly major natural disaster - the insurance industry operates under the competitive sword of substantial overcapacity. Generally, also, despite heroic attempts to do otherwise, the industry sells a relatively undifferentiated commodity-type product. (Many insureds, including the managers of large businesses, do not even know the names of their insurers.) Insurance, therefore, would seem to be a textbook case of an industry usually faced with the deadly combination of excess capacity and a "commodity" product.

Why, then, was underwriting, despite the existence of cycles, generally profitable over many decades? (From 1950 through 1970, the industry combined ratio averaged 99.0. allowing all investment income plus 1% of premiums to flow through to profits.) The answer lies primarily in the historic methods of regulation and distribution. For much of this century, a large portion of the industry worked, in effect, within a legal quasi-administered pricing system fostered by insurance regulators. While price competition existed, it was not pervasive among the larger companies. The main competition was for agents, who were courted via various non-price-related strategies.

For the giants of the industry, most rates were set through negotiations between industry “bureaus” (or through companies acting in accord with their recommendations) and state regulators. Dignified haggling occurred, but it was between company and regulator rather than between company and customer. When the dust settled, Giant A charged the same price as Giant B - and both companies and agents were prohibited by law from cutting such filed rates.

The company-state negotiated prices included specific profit allowances and, when loss data indicated that current prices were unprofitable, both company managements and state regulators expected that they would act together to correct the situation. Thus, most of the pricing actions of the giants of the industry were “gentlemanly”, predictable, and profit-producing. Of prime importance - and in contrast to the way most of the business world operated - insurance companies could legally price their way to profitability even in the face of substantial over-capacity.

That day is gone. Although parts of the old structure remain, far more than enough new capacity exists outside of that structure to force all parties, old and new, to respond. The new capacity uses various methods of distribution and is not reluctant to use price as a prime competitive weapon. Indeed, it relishes that use. In the process, customers have learned that insurance is no longer a one-price business. They won’t forget.

Future profitability of the industry will be determined by current competitive characteristics, not past ones. Many managers have been slow to recognize this. It’s not only generals that prefer to fight the last war. Most business and investment analysis also comes from the rear-view mirror. It seems clear to us, however, that only one condition will allow the insurance industry to achieve significantly improved underwriting results. That is the same condition that will allow better results for the aluminum, copper, or corn producer - a major narrowing of the gap between demand and supply.

Unfortunately, there can be no surge in demand for insurance policies comparable to one that might produce a market tightness in copper or aluminum. Rather, the supply of available insurance coverage must be curtailed. “Supply”, in this context, is mental rather than physical: plants or companies need not be shut; only the willingness of underwriters to sign their names need be curtailed.

This contraction will not happen because of generally poor profit levels. Bad profits produce much hand-wringing and finger-pointing. But they do not lead major sources of insurance capacity to turn their backs on very large chunks of business, thereby sacrificing market share and industry significance.

Instead, major capacity withdrawals require a shock factor such as a natural or financial “megadisaster”. One might occur tomorrow - or many years from now. The insurance business - even taking investment income into account - will not be particularly profitable in the meantime.

When supply ultimately contracts, large amounts of business will be available for the few with large capital capacity, a willingness to commit it, and an in-place distribution system. We would expect great opportunities for our insurance subsidiaries at such a time.

During 1982, our insurance underwriting deteriorated far more than did the industry’s. From a profit position well above average, we, slipped to a performance modestly below average. The biggest swing was in National Indemnity’s traditional coverages. Lines that have been highly profitable for us in the past are now priced at levels that guarantee underwriting losses. In 1983 we expect our insurance group to record an average performance in an industry in which average is very poor.

Two of our stars, Milt Thornton at Cypress and Floyd Taylor at Kansas Fire and Casualty, continued their outstanding records of producing an underwriting profit every year since joining us. Both Milt and Floyd simply are incapable of being average. They maintain a passionately proprietary attitude toward their operations and have developed a business culture centered upon unusual cost-consciousness and customer service. It shows on their scorecards.

During 1982, parent company responsibility for most of our insurance operations was given to Mike Goldberg. Planning, recruitment, and monitoring all have shown significant improvement since Mike replaced me in this role.

GEICO continues to be managed with a zeal for efficiency and value to the customer that virtually guarantees unusual success. Jack Byrne and Bill Snyder are achieving the most elusive of human goals - keeping things simple and remembering what you set out to do. In Lou Simpson, additionally, GEICO has the best investment manager in the property-casualty business. We are happy with every aspect of this operation. GEICO is a magnificent illustration of the high-profit exception we described earlier in discussing commodity industries with over-capacity - a company with a wide and sustainable cost advantage. Our 35% interest in GEICO represents about $250 million of premium volume, an amount considerably greater than all of the direct volume we produce.

Issuance of Equity

Berkshire and Blue Chip are considering merger in 1983. If it takes place, it will involve an exchange of stock based upon an identical valuation method applied to both companies. The one other significant issuance of shares by Berkshire or its affiliated companies that occurred during present management's tenure was in the 1978 merger of Berkshire with Diversified Retailing Company.

Our share issuances follow a simple basic rule: we will not issue shares unless we receive as much intrinsic business value as we give. Such a policy might seem axiomatic. Why, you might ask, would anyone issue dollar bills in exchange for fifty-cent pieces? Unfortunately, many corporate managers have been willing to do just that.

The first choice of these managers in making acquisitions may be to use cash or debt. But frequently the CEO's cravings outpace cash and credit resources (certainly mine always have). Frequently, also, these cravings occur when his own stock is selling far below intrinsic business value. This state of affairs produces a moment of truth. At that point, as Yogi Berra has said, "You can observe a lot just by watching." For shareholders then will find which objective the management truly prefers - expansion of domain or maintenance of owners' wealth.

The need to choose between these objectives occurs for some simple reasons. Companies often sell in the stock market below their intrinsic business value. But when a company wishes to sell out completely, in a negotiated transaction, it inevitably wants to - and usually can - receive full business value in whatever kind of currency the value is to be delivered. If cash is to be used in payment, the seller's calculation of value received couldn't be easier. If stock of the buyer is to be the currency, the seller's calculation is still relatively easy: just figure the market value in cash of what is to be received in stock.

Meanwhile, the buyer wishing to use his own stock as currency for the purchase has no problems if the stock is selling in the market at full intrinsic value.

But suppose it is selling at only half intrinsic value. In that case, the buyer is faced with the unhappy prospect of using a substantially undervalued currency to make its purchase.

Ironically, were the buyer to instead be a seller of its entire business, it too could negotiate for, and probably get, full intrinsic business value. But when the buyer makes a partial sale of itself - *and that is what the issuance of shares to make an acquisition amounts to* - it can customarily get no higher value set on its shares than the market chooses to grant it.

The acquirer who nevertheless barges ahead ends up using an undervalued (market value) currency to pay for a fully valued (negotiated value) property. In effect, the acquirer must give up $2 of value to receive $1 of value. Under such circumstances, a marvelous business purchased at a fair sales price becomes a terrible buy. For gold valued as gold cannot be purchased intelligently through the utilization of gold - or even silver - valued as lead.

If, however, the thirst for size and action is strong enough, the acquirer's manager will find ample rationalizations for such a value-destroying issuance of stock. Friendly investment bankers will reassure him as to the soundness of his actions. (Don't ask the barber whether you need a haircut.)

A few favorite rationalizations employed by stock-issuing managements follow:

(a) "The company we're buying is going to be worth a lot more in the future." (Presumably so is the interest in the old business that is being traded away; future prospects are implicit in the business valuation process. If 2X is issued for X, the imbalance still exists when both parts double in business value.)

(b) "We have to grow." (Who, it might be asked, is the "we"? For present shareholders, the reality is that all existing businesses shrink when shares are issued. Were Berkshire to issue shares tomorrow for an acquisition, Berkshire would own everything that it now owns plus the new business, but *your* interest in such hard-to-match businesses as See's Candy Shops, National Indemnity, etc. would automatically be reduced. If (1) your family owns a 120-acre farm and (2) you invite a neighbor with 60 acres of comparable land to merge his farm into an equal partnership - with you to be managing partner, then (3) your managerial domain will have grown to 180 acres but you will have permanently shrunk by 25% your family's ownership interest in both acreage and crops. Managers who want to expand their domain at the expense of owners might better consider a career in government.)

(c) "Our stock is undervalued and we've minimized its use in this deal - but we need to give the selling shareholders 51% in stock and 49% in cash so that certain of those shareholders can get the tax-free exchange they want." (This argument acknowledges that it is beneficial to the acquirer to hold down the issuance of shares, and we like that. But if it hurts the old owners to utilize shares on a 100% basis, it very likely hurts on a 51% basis. After all, a man is not charmed if a spaniel defaces his lawn, just because it's a spaniel and not a St. Bernard. And the wishes of sellers can't be the determinant of the best interests of the buyer - what would happen if, heaven forbid, the seller insisted that as a condition of merger the CEO of the acquirer be replaced?)

There are three ways to avoid destruction of value for old owners when shares are issued for acquisitions. One is to have a true business-value-for-business-value merger, such as the Berkshire-Blue Chip combination is intended to be. Such a merger attempts to be fair to shareholders of *both* parties, with each receiving just as much as it gives in terms of intrinsic business value. The Dart Industries-Kraft and Nabisco Standard Brands mergers appeared to be of this type, but they are the exceptions. It's not that acquirers wish to avoid such deals; it's just that they are very hard to do.

The second route presents itself when the acquirer's stock sells at or above its intrinsic business value. In that situation, the use of stock as currency actually may enhance the wealth of the acquiring company's owners. Many mergers were accomplished on this basis in the 1965-69 period. The results were the converse of most of the activity since 1970: the shareholders of the *acquired* company received very inflated currency (frequently pumped up by dubious accounting and promotional techniques) and were the losers of wealth through such transactions.

During recent years the second solution has been available to very few large companies. The exceptions have primarily been those companies in glamorous or promotional businesses to which the market temporarily attaches valuations at or above intrinsic business valuation.

The third solution is for the acquirer to go ahead with the acquisition, but then subsequently repurchase a quantity of shares equal to the number issued in the merger. In this manner, what originally was a stock-for-stock merger can be converted, effectively, into a cash-for-stock acquisition. Repurchases of this kind are damage-repair moves. Regular readers will correctly guess that we much prefer repurchases that directly enhance the wealth of owners instead of repurchases that merely repair previous damage. Scoring touchdowns is more exhilarating than recovering one's fumbles. But, when a fumble has occurred, recovery is important and we heartily recommend damage-repair repurchases that turn a bad stock deal into a fair cash deal.

The language utilized in mergers tends to confuse the issues and encourage irrational actions by managers. For example, "dilution" is usually carefully calculated on a pro forma basis for both book value and current earnings per share. Particular emphasis is given to the latter item. When that calculation is negative (dilutive) from the acquiring company's standpoint, a justifying explanation will be made (internally, if not elsewhere) that the lines will cross favorably at some point in the future. (While deals often fail in practice, they never fail in projections - if the CEO is visibly panting over a prospective acquisition, subordinates and consultants will supply the requisite projections to rationalize any price.) Should the calculation produce numbers that are immediately positive - that is, anti-dilutive - for the acquirer, no comment is thought to be necessary.

The attention given this form of dilution is overdone: current earnings per share (or even earnings per share of the next few years) are an important variable in most business valuations, but far from all powerful.

There have been plenty of mergers, non-dilutive in this limited sense, that were instantly value destroying for the acquirer. And some mergers that have diluted current and near-term earnings per share have in fact been value-enhancing. What really counts is whether a merger is dilutive or anti-dilutive in terms of intrinsic business value (a judgment involving consideration of many variables). We believe calculation of dilution from this viewpoint to be all-important (and too seldom made).

A second language problem relates to the equation of exchange. If Company A announces that it will issue shares to merge with Company B, the process is customarily described as "Company A to Acquire Company B", or "B Sells to A". Clearer thinking about the matter would result if a more awkward but more accurate description were used: "Part of A sold to acquire B", or "Owners of B to receive part of A in exchange for their properties". In a trade, what you are giving is just as important as what you are getting. This remains true even when the final tally on what is being given is delayed. Subsequent sales of common stock or convertible issues, either to complete the financing for a deal or to restore balance sheet strength, must be fully counted in evaluating the fundamental mathematics of the original acquisition. (If corporate pregnancy is going to be the consequence of corporate mating, the time to face that fact is before the moment of ecstasy.)

Managers and directors might sharpen their thinking by asking themselves if they would sell 100% of their business on the same basis they are being asked to sell part of it. And if it isn't smart to sell all on such a basis, they should ask themselves why it is smart to sell a portion. A cumulation of small managerial stupidities will produce a major stupidity - not a major triumph. (Las Vegas has been built upon the wealth transfers that occur when people engage in seemingly-small disadvantageous capital transactions.)

The "giving versus getting" factor can most easily be calculated in the case of registered investment companies. Assume Investment Company X, selling at 50% of asset value, wishes to merge with Investment Company Y. Assume, also, that Company X therefore decides to issue shares equal in market value to 100% of Y's asset value.

Such a share exchange would leave X trading $2 of its previous intrinsic value for $1 of Y's intrinsic value. Protests would promptly come forth from both X's shareholders and the SEC, which rules on the fairness of registered investment company mergers. Such a transaction simply would not be allowed.

In the case of manufacturing, service, financial companies, etc., values are not normally as precisely calculable as in the case of investment companies. But we have seen mergers in these industries that just as dramatically destroyed value for the owners of the acquiring company as was the case in the hypothetical illustration above. This destruction could not happen if management and directors would assess the fairness of any transaction by using the same yardstick in the measurement of both businesses.

Finally, a word should be said about the "double whammy" effect upon owners of the acquiring company when value-diluting stock issuances occur. Under such circumstances, the first blow is the loss of intrinsic business value that occurs through the merger itself. The second is the downward revision in market valuation that, quite rationally, is given to that now-diluted business value. For current and prospective owners understandably will not pay as much for assets lodged in the hands of a management that has a record of wealth-destruction through unintelligent share issuances as they will pay for assets entrusted to a management with precisely equal operating talents, but a known distaste for anti-owner actions. Once management shows itself insensitive to the interests of owners, shareholders will suffer a long time from the price/value ratio afforded their stock (relative to other stocks), no matter what assurances management gives that the value-diluting action taken was a one-of-a-kind event.

Those assurances are treated by the market much as one-bug-in-the-salad explanations are treated at restaurants. Such explanations, even when accompanied by a new waiter, do not eliminate a drop in the demand (and hence market value) for salads, both on the part of the offended customer and his neighbors pondering what to order. Other things being equal, the highest stock market prices relative to intrinsic business value are given to companies whose managers have demonstrated their unwillingness to issue shares at any time on terms unfavorable to the owners of the business.

At Berkshire, or any company whose policies we determine (including Blue Chip and Wesco), we will issue shares only if our owners receive in business value as much as we give. We will not equate activity with progress or corporate size with owner-wealth.

Miscellaneous

This annual report is read by a varied audience, and it is possible that some members of that audience may be helpful to us in our acquisition program.

We prefer:

(1) large purchases (at least $5 million of after-tax earnings),

(2) demonstrated consistent earning power (future projections are of little interest to us, nor are "turn-around" situations),

(3) businesses earning good returns on equity while employing little or no debt,

(4) management in place (we can't supply it),

(5) simple businesses (if there's lots of technology, we won't understand it),

(6) an offering price (we don't want to waste our time or that of the seller by talking, even preliminarily, about a transaction when price is unknown).

We will not engage in unfriendly transactions. We can promise complete confidentiality and a very fast answer as to possible interest - customarily within five minutes. Cash purchases are preferred, but we will consider the use of stock when it can be done on the basis described in the previous section.

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Our shareholder-designated contributions program met with enthusiasm again this year; 95.8% of eligible shares participated. This response was particularly encouraging since only $1 per share was made available for designation, down from $2 in 1981. If the merger with Blue Chip takes place, a probable by-product will be the attainment of a consolidated tax position that will significantly enlarge our contribution base and give us a potential for designating bigger per-share amounts in the future.

If you wish to participate in future programs, we strongly urge that you immediately make sure that your shares are registered in the actual owner's name, not a "street" or nominee name. For new shareholders, a more complete description of the program is on pages 62-63.

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In a characteristically rash move, we have expanded World Headquarters by 252 square feet (17%), coincidental with the signing of a new five-year lease at 1440 Kiewit Plaza. The five people who work here with me - Joan Atherton, Mike Goldberg, Gladys Kaiser, Verne McKenzie and Bill Scott - outproduce corporate groups many times their number. A compact organization lets all of us spend our time managing the business rather than managing each other.

Charlie Munger, my partner in management, will continue to operate from Los Angeles whether or not the Blue Chip merger occurs. Charlie and I are interchangeable in business decisions. Distance impedes us not at all: we've always found a telephone call to be more productive than a half-day committee meeting.

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Two of our managerial stars retired this year: Phil Liesche at 65 from National Indemnity Company, and Ben Rosner at 79 from Associated Retail Stores. Both of these men made you, as shareholders of Berkshire, a good bit wealthier than you otherwise would have been. National Indemnity has been the most important operation in Berkshire’s growth. Phil and Jack Ringwalt, his predecessor, were the two prime movers in National Indemnity’s success. Ben Rosner sold Associated Retail Stores to Diversified Retailing Company for cash in 1967, promised to stay on only until the end of the year, and then hit business home runs for us for the next fifteen years.

Both Ben and Phil ran their businesses for Berkshire with every bit of the care and drive that they would have exhibited had they personally owned 100% of these businesses. No rules were necessary to enforce or even encourage this attitude; it was embedded in the character of these men long before we came on the scene. Their good character became our good fortune. If we can continue to attract managers with the qualities of Ben and Phil, you need not worry about Berkshire’s future.

Warren E. Buffett
Chairman of the Board