Berkshire Hathaway Q3 2008 Notes

Summary

Berkshire posted EPS of $682 in Q3 2008 compared to $2942 in Q3 2007, a decline of 77%. Operating earnings per share in Q3 2008 came to $1,335 per share compared to $1,655 per share in Q3 2007, a decline of 19.3%. Berkshire posted investment and derivatives losses of $653 per share in Q3 compared to a $1,287 per share gain in the year earlier period. Investment and derivatives gains/losses on a quarterly basis are not indicative of business performance and therefore Berkshire management focuses on operating earnings per share to judge the health of the insurance and other operating companies.

Book Value per Share

During the first nine months of 2008, Berkshire's net worth declined from $120.73 billion to $120.15 billion. However, during October 2008, market movements resulted in an additional $9 billion decline to net worth. Book Value per share at year end 2007 was $78,008. Book value per share on 9/30/2008 was $77,555. The $9 Billion in decline in October results in an approximate $5,800 impact on book value per share; however, retained earnings during October are likely to mitigate the impact of that decline on book value. Book value at 10/31 is probably around $72,000 per share. At current prices ($113K on 11/7/08), Berkshire trades around 1.57 times book value compared to 1.82 times book value on 12/31/2007.

Investment and Derivatives Results

Although quarterly changes in investment and derivatives results are not meaningful in terms of analyzing underlying business health, accounting rules create some interesting impacts to the results. Accounting rules require that <u>unrealized</u> gains or losses from most derivative contracts impact earnings. However, unrealized gains or losses from investments normally do not impact earnings but instead are recognized only upon sale.

During the first nine months of 2008, Berkshire's derivatives had a pre tax loss of $2.21 Billion. The most significant derivatives exposure involve equity index put option contracts entered into by Berkshire in exchange for $4.85 Billion in cash. Currently, these derivatives carry a liability of $6.72 Billion indicating a recorded loss to date of $1.87 Billion. However, these "European" style options are only exercisable at maturity and the first contract does not expire until 2019. In the meantime, no collateral is required and Berkshire has the $4.85 Billion available for investment. Barring a prolonged market meltdown, it is highly likely that the put options will expire worthless upon expiration of the contracts. Despite this likely outcome, short term market movements in equity indexes are reflected in Berkshire earnings each quarter which introduces significant volatility into quarterly earnings which must be ignored in order to evaluate underlying business health.

Berkshire Appears Fully Invested

On September 30, Berkshire held $27,899 Million in cash, excluding cash held by the financial products and utility segments. Since the end of Q3 2008, Berkshire has closed on the following transactions:

Date	Investment	Amount (Billions)
10/6/08	Fixed maturity and equity securities in connection with the Wrigley/Mars merger agreement	$6.5
10/1/08	Goldman Sachs perpetual preferred stock (with common stock warrants attached)	$5.0
10/16/08	General Electric perpetual preferred stock (with common stock warrants attached)	$3.0

In addition to these investments, Berkshire expects to invest $3 Billion in convertible preferred stock issued by Dow Chemical in connection with the acquisition of Rohm and Hass, which should close in early 2009. Berkshire also entered into an agreement to acquire Constellation Energy for $4.7 Billion and this transaction should close in Q2 2009.

Taking into account the investments made in October and committed to for Q1/Q2 of 2009, Berkshire appears to be fully invested since Buffett has stated that $10 billion in cash is the lowest level he is comfortable with. While it is true that there are nearly $30 Billion in bonds on the balance sheet, I am not sure that these bonds are available for sale. In all, it appears that Berkshire is nearly fully invested at this time.

<u>Insurance Subsidiaries</u>

Berkshire's insurance subsidiaries suffered from softening pricing and natural disasters in Q3 2008. Underwriting Q3 net earnings decreased to $81 Million from $486 Million in Q3 2007. For the first nine months of the year, underwriting earnings decreased to $622 Million from $1,719 Million during the prior year period.

GEICO posted $3,150 Million in earned premiums in Q3 2008 compared to $2,999 Million in Q3 2007. However, pre tax underwriting gain declined to $246 Million in Q3 2008 from $335 Million in Q3 2007 due to higher loss and loss adjustment expenses. The loss ratio of 74.1% exceeded the loss ratio of 70.8% in 2007. Included in the higher losses were higher levels of catastrophe losses in 2008 compared to 2007. Underwriting expenses declined to $554 million in Q3 2008 from $575 Million in Q3 2007, mitigating some of the impact of higher loss expenses.

General Re's pre tax underwriting gain declined to $54 Million in Q3 2008 from $157 Million in Q3 2007. This was due to a large decline in the results of the property/casualty business which was slightly offset by better results in the life/health business. Increased underwriting discipline in 2008 resulted in lower premiums earned but likely had a positive overall impact on results since inadequately priced risks were rejected. Catastrophe losses in Q3 includes the impact of Hurricanes Ike and Gustav. Berkshire reports that $186 million of YTD losses at General Re were due to Gustav, Ike, along with winter storms in Europe in Q1 2007.

Berkshire Hathaway Reinsurance Group reported a $166 Million pre tax underwriting loss in Q3 2008 compared to a $183 pre tax underwriting gain in Q3 2007. Results were negatively impacted by $350 Million in Gustav/Ike losses in the catastrophe and individual risk business along with $535 Million in Gustav/Ike losses in the other multi-line business (mainly participation in Lloyds Syndicates). A bright spot in BHRG results is the mono-line financial guarantee insurance company, Berkshire Hathaway Assurance Corporation, which began operations in Q1 2008 and is now licensed in 49 states. BHAC produced $315 million in written premiums in the first nine months of 2008 and has received the highest rating available from two credit agencies.

Investment income declined to $809 Million in Q3 2008 from $922 Million in Q3 2007 primarily due to lower interest rates on short term investments compared to the same period in 2007. Berkshire notes that the Wrigley, Goldman, and GE securities acquired in October 2008 will result in pre tax income of $1.4 Billion per annum which is substantially greater than the earnings to be expected on the short term instruments liquidated to acquire these new investments.

<u>Non Insurance Subsidiaries</u>

MidAmerican earnings applicable to Berkshire for Q3 2008 were $324 Million, down from $354 Million in Q3 2007. Revenues for Q3 2008 were $3,298 Million compared to $3,150 Million in the prior year period. Berkshire currently owns 88.2% of MidAmerican. The increases in revenue were due mainly to higher per unit cost of gas sold which was passed on to consumers. Increases revenues were more than offset by higher fuel and maintenance costs and higher interest expense. In addition, the real estate brokerage subsidiary of Mid American had earnings of $6 Million in Q3 2008 compared to $23 Million in Q3 2007 due to the real estate market conditions in the US.

Marmon earned $247 Million in Q3 2008 on revenues of $1,878 Million. Marmon was acquired by Berkshire on March 18, 2008. Marmon results for the first nine months of 2008 were relatively unchanged from the same period in 2007.

McLane Company earnings increased to $68 Million in Q3 2008 from $50 Million in the prior year period. Revenues increased to $7,634 Million in Q3 2008 from $7,293 in the prior year period. McLane realized improved margins in 2008 compared to 2007 due to price changes on certain categories of grocery products and a surcharge on heavy liquids sales.

Shaw Industries earnings declined steeply to $49 Million in Q3 2008 from $125 Million in the prior year period. Shaw experienced declines in carpet volumes offset partially by higher selling prices. Results were adversely impacted by higher costs for raw materials which are largely petrochemical based as well as the ongoing real estate market downturn. Carpet sales often track real estate transaction activity as consumers re-carpet homes after purchase.

Other Manufacturing businesses include building products, apparel, Forest River (RVs), CTB, and Iscar Metalworkings along with many other smaller manufacturers. Earnings declined to $478 Million in Q3 2008 from $567 Million in the prior year period. Forest River experienced a particularly steep decline of 32% in revenues likely due to continued economic turbulence in the United States. Building products were impacted by the downturn in the housing market and general economic conditions were poor for the companies in this segment.

Other Service businesses include Net Jets, Flight Safety, TTI, Business Wire, Pampered Chef, Dairy Queen, Buffalo News, and smaller subsidiaries. Pre tax Earnings declined to $260 Million from $295 in the prior year period. Results were positively impacted by the TTI results while several of the other service businesses including Net Jets, The Pampered Chef, and Buffalo News generated lower pre tax earnings compared to 2007. While specific results for Net Jets are not disclosed, I suspect that there could have been a significant decline in Q3 given the turmoil in the financial markets.

Retail operations include home furnishing and jewelry retailers as well as See's Candies. Pre Tax earnings declined to $11 Million from $33 Million in the prior year period mainly due to deteriorating economic conditions and poor consumer confidence resulting from the credit and housing crisis.

<u>Summary</u>

Berkshire Hathaway continues to have a very solid financial condition and has posted respectable results despite the meteorological and financial hurricanes of Q3 2008. Despite the natural disasters, the overall insurance group is still posting underwriting gains, meaning that the cost of Berkshire's massive float continues to be negative. Much of this can be attributed to Berkshire's excellent track record of rejecting inadequately priced risks. While the operating company results have declined compared to prior year results, this is to be expected given the downturn in the US Economy and can be attributed to cyclical factors impact all of American business. Berkshire's opportunistic investments in General Electric and Goldman Sachs in Q3 should prove to be very profitable even if the warrants are not exercised over the next five years, and there is additional upside if they are. The "headline" numbers indicating a decline in earnings of 77% are skewed by the derivatives mark to market losses which are meaningless in the short run and ignore the very strong probability that no payments will ever be made on these contracts which still have an average maturity of 13. 5 years.

While the book value per share of Berkshire has declined by an estimated 8% in 2008 through 10/31/08, much of this is due to the current depressed state of the equity markets worldwide. Assuming a gradual economic recovery in 2009 and 2010, Berkshire's results should improve significantly going forward. At year end 2007, I estimated Intrinsic Value using the float based model at around $170K per share. Even assuming a 10% drop in intrinsic value since 12/31/2007, Berkshire is still certainly worth in excess of $150K per share. I anticipate that Berkshire should trade between $120K and $140K until the current economic crisis is perceived to be past, with shares quickly catching up to intrinsic value by 2010.