# Berkshire Hathaway buys Insurer Alleghany for $11.6bn

### *Introduction*

Berkshire Hathaway has agreed to buy insurance company Alleghany Inc in a deal worth $11.6bn. The purchase, once completed, would be one of the five biggest acquisitions in Berkshire's records and will put some of the firm's $146.7bn of cash and cash equivalents to work after a nearly six-year wait for a large deal. The all-cash acquisition of Alleghany will expand Berkshire's already sizable insurance holdings, inclusive of well-known brands such as Geico automobile insurance. The importance of the insurance business for Berkshire Hathaway is vital. Buffett often refers to insurance "float" to indicate the stable flow of premiums to an insurance company, that can be used to fuel investments and acquisitions. The insurance business generates cash, at a low cost of capital, to use for other revenue-producing endeavors. The investment of the float has been Berkshire's primary tool for growth over the past years.

### *About Berkshire Hathaway*

Berkshire Hathaway is an American holding company based in Omaha, run by chair and CEO Warren Buffett. As of March 30, 2022, Berkshire Hathaway has a market capitalization of over $790 bn, making it one of the largest publicly-traded companies in the world. The holding company owns several private businesses, diversified among different sectors. Looking at the subdivision of revenues, it is useful to distinguish 6 main segments: Insurance, Manufacturing, Railway, Energy, Mclane, Service, and Retailing. The 26% of total revenues, as of 31 December 2021, comes from the insurance business, followed by Manufacturing (25%) and Mclane (18%).

Total revenue and EBT for these segments in FY 2021 were $276.4bn and $32.2bn respectively. This does not include gains and losses from Berkshire's portfolio of investments and derivatives. Berkshire Hathaway also owns a significant portfolio of equity securities and derivatives. Some of the company's most relevant equity holdings include Apple, American Express, and Bank of America. The investment portfolio recorded $78.5bn in FY2021, up 92.8% from the preceding result of $40.7bn in FY2020.

Berkshire Hathaway is listed on NYSE, and divided into 2 main share classes: Class A and Class B. Class A shares are known for their high trading price, set at $536,440 per share as of March 30, 2021. The company said that the COVID-19 pandemic adversely impacted nearly all of its business operations in 2020. The growth in Berkshire's revenue and earnings in FY2021 is a reflection of the company's ongoing recovery from the pandemic shock, and there's still uncertainty about the real impacts of the COVID pandemic on several products' long-term demand.

### *About Alleghany Corporation*

Alleghany Corporation owns and supports certain operating subsidiaries and investments. The Company's segments include reinsurance, insurance, and Alleghany Capital. Although the company's main sources of revenue are reinsurance and insurance operations and investments, it also generates revenues and earnings from a portfolio of non-financial businesses that are managed through its subsidiary Alleghany Capital. Alleghany Capital's investments are divided into either industrial businesses or non-industrial businesses.

In addition to Alleghany capital, there are three other operating companies: TransRe, RSUI, and CapSpecialty.

TransRe offers clients the expertise necessary to create programs across the full spectrum of property and casualty risks, through its principal subsidiaries Transatlantic Reinsurance Company, TransRe London Limited, and TransRe Europe S.A.

RSUI Group, Inc. is a leading underwriter of wholesale specialty insurance. Working exclusively with wholesales intermediaries, RSUI provides a range of insurance products, such as property, professional liability, and management liability coverage to several companies nationwide.

CapSpecialty offers a full inventory of specialty lines, including commercial property, casualty, surety, and professional lines with a particular focus on small businesses.

Looking at FY2021 financial results, net earnings attributable to Alleghany stockholders increased to $1035m from $102m. Earnings before income taxes for Alleghany Capital were $291.7m in 2021, compared with $146.0m in 2020 and $111.1m in 2019. The company is listed on the NYSE, trading at $844.55 as of 31 March 2022, with a total market capitalization of $11.36bn and a P/E Ratio of 11.31.

### *Deal Structure*

Berkshire agreed to pay $848.02 in cash per Alleghany share, representing a 25% premium over the 18th March closing price, and a 29 percent premium to Alleghany's share price over the past 30 days. The price Berkshire is paying is at a 26% premium to Alleghany's book value as of December 31, 2021. With an equity value of $11.6bn, the takeover is Berkshire's biggest in six years and will be paid for in cash.

The deal is expected to close in the fourth quarter of 2022. While it has been approved unanimously by the board of both companies, it is subject to approval by Alleghany's shareholders and by several regulatory agencies. In addition, Alleghany has a 25-day "go-shop" period in which the company can seek a superior deal with a different potential acquirer.

### *Deal Rationale*

Over the recent years Warren Buffett has openly expressed frustration in his search for a large deal. Consequently, his conglomerate was left with $146.7bn of cash and cash equivalents at the end of last year. Although Alleghany isn't quite the "elephant-sized acquisition" that Berkshire CEO Warren Buffett has long sought, this acquisition represents his largest purchase since the 2016 deal for Precision Castparts.

Berkshire has a significant experience in insurance sector as it already owns Geico auto insurance, General Re reinsurance and others that consistently account for more than 20% of operating profit at Berkshire and have been driving growth in recent years. It is worth noting that insurance companies typically collect money or premiums before knowing the costs of claims. Therefore, such companies have access to large amounts of cash which they are free to deploy until policyholder claims come through. The difference described above between premiums collected and claims paid out is called the insurance float. It has been a significant contributor behind the success of Berkshire Hathaway. Warren Buffett's long-time strategy involves using insurance float as leverage when investing in stocks and private companies. Additionally, for most insurers, the cost of float is usually around a few percentage points as premiums received are not enough to cover the claims. However, Berkshire's historical cost of float has been positive. This makes Alleghany a perfect fit as it will help Berkshire with building its cash position for long-term investment opportunities.

As well as being involved in a number of different insurance businesses, Alleghany also operates as a conglomerate, similarly to Berkshire; it owns a steel company, a toy manufacturer and a funeral services firm, among others. It comes therefore as no surprise that both boards of directors pointed to the similarities between the two business models as one of the grounds for the transaction.

The acquisition also has a personal touch. Joseph Brandon, the CEO of Alleghany since December 2021, led General Re from 2001 to 2008 and is a long-time friend of Warren Buffet who publicly welcomed an opportunity to work with Brandon once again. This in turn may suggests a strong alignment regarding the strategy and culture of the future conglomerate.

For Alleghany, the deal provides substantial value to stockholders, but also support, resources and expertise opening new opportunities for the company and its operating businesses. Through the acquisition, Alleghany may improve its ratings due to the vast financial resources and financial flexibility of Berkshire which will in turn make the insurer more attractive for customers.

However, some investors are questioning the premium offered by Berkshire. They agree that the deal would be accretive to Berkshire's intrinsic value, but they point to the fact that Alleghany's valuation has been depressed by volatility in the reinsurance sector and weather-related losses in recent years. Consequently, they find the premium offered by Berkshire to be small and the company to be worth more than 126% of the book value. Indeed, the price offered ranks in the bottom half of property insurance deals over the past six years based on price-to-book ratio. As the 25 days long go-shop period will take place, the investors are citing other potential bidders that include insurers Markel, W.R. Berkley and Chubb, as well as Loews which owns a controlling stake in property and casualty insurer CNA Financial.

### *Market Reaction*

As the transaction was unanimously approved by the board of directors of both companies, shares of Alleghany increased nearly 25% after the announcement. Berkshire's Class A shares rose 2.3% to reach $525,000 and close at their all-time high. It is usually the case that the acquirer's stocks fall after the announcement, especially when the potential transaction involves payment in the form of its own shares, effectively diluting shares for current shareholders. As Berkshire will pay entirely in cash, such a situation will not occur, and this information was certainly welcomed by the conglomerate's investors. In addition, the transaction is expected to add $14bn of insurance float for Berkshire.

### *Advisors*

Goldman Sachs & Co. LLC is serving as financial advisor and Willkie Farr & Gallagher LLP as legal advisor to Alleghany. Munger, Tolles & Olson LLP is serving as legal advisor to Berkshire Hathaway. As usual, Berkshire did not employ a financial advisor. It is worth noticing that the company has subtracted almost $2 per share from its offer, which totally accounts for $27m. The sum is equal to the advisory fee charged by Goldman Sachs, this makes the shareholders of Alleghany the only ones who are burdened with it.

TAGS: Berkshire Hathaway, Insurance, Warren Buffet, Alleghany, Acquisition