A rare misstep from the ‘Oracle of Omaha’?

The big Idea: Legendary investor Warren Buffett is known for his stellar returns and his ability to spot value others overlook. But in striking a deal to acquire aerospace supplier Precision Castparts Corp. for $37.2 billion, did the Berkshire Hathaway chairman and chief executive make a rare misstep? In recent years, Berkshire Hathaway’s ability to beat the Standard & Poor’s 500-stock index has declined. In his desire to grow Berkshire Hathaway and to deploy its sizable cash balance, did Buffett overpay for a company that caught his eye? Or has the “Oracle of Omaha” once again figured out something the rest of us missed?

The scenario: In August 2015, Berkshire Hathaway announced its largest deal ever — it would acquire Precision Castparts Corp., an Oregon-based manufacturer of parts primarily for the aerospace industry. When the deal was announced, Buffett praised the $10 billion supplier’s chief executive, Mark Donegan, as “the da Vinci of his craft.” On the surface, the acquisition was signature Buffett, reflecting his taste for well-run, dominant enterprises producing consistent results. PCC is an extraordinarily strong industrial brand, with a diversified customer base that includes oil and gas producers and power station customers in addition to airlines. But the purchase price? It was $200 per share, plus PCC’s debt. Appearing on CNBC shortly after the deal was announced, Buffett himself admitted this was a “very high multiple” to pay.

The resolution: Using conventional forecasting, Buffett overpaid for PCC. The price doesn’t square with valuation by multiples or by Buffett’s own stated goals that an asset’s financial value should equal its discounted cash flows. Further, large corporate acquisitions like this have tended to correlate with value destruction, not creation. When the deal was announced, investors seemed to agree, lopping 11 percent off Berkshire Hathaway’s stock price, a loss of $4.05 billion. But to decide the case just on these facts is to overlook Buffett’s acumen and track record. Value is in the eye of the beholder, after all, and Buffett is a particularly successful beholder. Buffett has said he considers “economic reality” over accounting statements, and he values business simplicity, managerial expertise and reputation highly. The airline industry — PCC’s major sector — is, to pardon the pun, flying high these days. Consumer travel is way up, and airlines companies are spending aggressively to retool their fleets for fuel efficiency and environmental sustainability. All of these factors benefit PCC’s business and its profitability. But will it be enough to justify the purchase price? Will the PCC deal eventually pay off?

The lesson: What Buffett has achieved (22.8 percent compound annual stock growth, 1974 to 2015) is superlative. History shows that it’s extraordinarily difficult to beat the market over time and that nearly all investors, even if they have a stellar year or two, revert to the mean over the long term. Buffett, of course, has been a notable exception. Can he sustain it? Two things are for certain. First, Buffett, 86, isn’t showing any signs of backing off ambitious deals. Last month, the Omaha billionaire helped engineer Kraft Heinz’s (ultimately unsuccessful) $143 billion bid for Unilever. Second, higher stakes mean, well, higher risks. Even if Buffett’s 2015 bet on PCC proves to be correct, the need to deploy larger amounts of money invites larger-scale missteps. As Buffett once famously said, “A fat wallet is the enemy of superior investment results.”

— Robert F. Bruner

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