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Succession Planning Risk

It is a remarkable achievement to create a business from the bottom up. It is almost unheard of to have a firm driven by a sole entrepreneur pass smoothly to the next generation of managers. There are many reasons for this, but most experience culture shifts that are bumpy. Everything from the simple entitlements of the old regime like having fresh flowers delivered daily to the founder refusing to give up control can make a transition challenging. Top employees who bided their time, often for years, feel cheated that the company was not really turned over to them as promised. Others are exposed as being in one position higher than they are qualified for.

How can an employee prepare to take over management of a firm? By working in a variety of functional areas, both managing products and reporting results, you gain expertise and perspective not found by those whose experience has been concentrated in one silo. The manager also needs to have a network independent of the founder within the company and within the industry so the founder does not try to influence the senior management team. This does not mean that the successor should not be loyal to the founder, just that you don't want to rely exclusively on the predecessor's network as they will be absolutely loyal to that person. You will need to bring in your own team.

A case study currently playing out, and likely holding back returns, is Berkshire Hathaway and the David Sokol saga. Berkshire is based in Omaha, although most of the actual jobs are located elsewhere. The company's annual meeting was held in early May and I attended (full disclosure – I own shares). David Sokol had been considered the heir apparent to manage the operations of Berkshire. Much of the buildup to the meeting, and the meeting itself, related to the Lubrizol acquisition and Sokol's role in it. As reported in the general media, an investment bank brought a number of investment ideas to Sokol. He liked the value profile of Lubrizol and pitched it to Warren Buffett, who did not show interest. Sometime during this period Sokol bought and then sold shares in the stock. The investment bank set up a meeting for Sokol, assuming he was acting as a conduit for Berkshire, to meet with the Lubrizol CEO. That meeting went well, and Sokol pitched the idea again to Buffett. Prior to this meeting he purchased a material amount of shares for his personal account. He mentioned that he owned shares to Buffett but not the extent or the timing of the purchase. This is the action the SEC is investigating. In my opinion there is no question that this is insider trading. Had someone from the investment bank done the same that person would have been fired immediately and would expect to go to jail. I don't understand the difference here and will be interested to see how the SEC rules and their reasons. Initially Buffett supported Sokol, but it quickly became obvious that he had to go.

What made this an event that has held back the Berkshire stock price (my opinion) in 2011 relative to the market is that Sokol was the “chosen one”. There are other contenders, but Buffett had already started to pass along responsibility and special projects to him. He had recently shaken up the operations at NetJets and was asked to comment publicly at several of the earlier Berkshire annual meetings (the annual “Woodstock for Capitalists” that draws upwards of 20,000 devotees to Omaha each year). Buffett prides himself on the culture at Berkshire, but these developments makes one wonder how much he understands the firm’s culture himself. Managers are incented to return 15% returns to the home office. When you have firms that cash out but the senior management team remains in place, then the culture can continue. Increasingly the original managers at Berkshire are retiring and new managers are taking over the reins. There is a shorter leash with these managers, but those that succeed will receive new responsibilities. With the chair (Buffett) and vice-chair (Charlie Munger) both at least 80 years old, succession planning is very important. Buffett still controls enough votes that he plans to cast his son, Howard Buffett, in the role as chairman after he is gone but it is unclear how well prepared he is for such a task. I think it would be useful to bring in an experienced manager to provide oversight, with no role in capital allocation. That is where Sokol got into trouble. Buffett did not name him publicly so he appears to have felt the need to impress the boss with investment tips. I don’t know if any previous ideas had been presented by Sokol. It is clear that Berkshire must do a better job of self reporting manager trades in firms where they are considering taking positions. They have a stated policy on this but do not enforce it (at least not in the past).

How can Berkshire Hathaway aid succession planning as they move toward the inevitable transition? While there are several very capable managers in place, BRK should add staff at the home office that reach across the organization. It is one thing to be lean, but another to let the culture get away from you and destroy everything built so far. This unit could be positioned as a strategic planning area and led by a chief risk officer. While the CEO remains responsible for risk matters, this area could focus on emerging risks, how various internal business units interact with each other at the global level, and help identify areas that would make sense strategically due to diversification or internal expertise. By visiting the various companies under the Berkshire umbrella the CRO would get a feel for the strength of the culture and where it needs to be improved.

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