The Weakness in Berkshire's Succession Plan

The shareholder vote on Coke’s (KO) compensation plan last week was disappointing in several ways. The plan itself is overly generous to management, contemplating as it does up to 500 million of share issuance to executives depending on certain performance targets. KO’s proxy statement revealed that it could transfer up to 14.2% of the company, around $24 BN in value, to participants in the plan. I wrote about this a couple of weeks ago. KO is a great company to be sure, but is not exactly synonymous with great new products or high growth. Over the past ten years EPS has grown at 7.7% p.a., which is not bad for such a big company but hardly the stuff of innovation. In recent years EPS growth has slowed.

KO enjoys operating margins solidly above 20% and only needs to reinvest a fraction of its operating cashflow back into the business. Consequently, last year they returned around $1.92 per share to investors through dividends and buybacks. It would seem that the first objective of management should be to continue improving the great business they’re running, building on a unique franchise that’s been around since 1892. It’s not that the company could be run by a ham sandwich (as Warren Buffett did NOT say, although he knows who did), but every day when they turn on the lights the company is going to generate almost $130 million in revenue. They don’t need a Steve Jobs.

So the compensation plan seemed unnecessarily generous for the purpose of overseeing this highly profitable franchise. That it passed the recent shareholder vote so overwhelmingly was a disappointment.

A second disappointment was Warren Buffett’s reaction to the compensation issue. Berkshire Hathaway (BRK) owns 9% of KO, and has at least that much influence over an issue like this. Yet it turned out that Berkshire abstained on the vote. He told Becky Quick on CNBC that he loved Coke and didn't want to vote against management, even though he disapproved of the plan. It was a surprising admission that he didn't want to rock the boat although he still expressed his view.

So the third disappointment is my speculation of how Warren Buffett, as strong a proponent of equitable returns to shareholders as anyone out there, came to offer such a limp reason for his inaction on this issue. Buffett's not on the board of KO, his son Howard Buffett is. Further, Warren admitted that he hadn't reviewed the compensation plan in detail until prompted to by David Winters, like us an investor in KO and BRK. Evidently son Howard had not seen anything to dislike in the plan when it was presented to the board nor had he found it worthwhile to raise the issue with his father. To me it looks as if Warren didn't want to embarrass his son Howard by voting shares against a plan that his son the KO director had endorsed.

Howard is a farmer, but he is one day slated to become non-executive Chairman of BRK when the great man himself is no longer with us. Warren has described his son's value as maintaining the culture of the conglomerate his father and Charlie Munger built. Howard's a controversial choice, not at all obviously suited to run any corporation even as a figurehead. Warren Buffett's clearly made many astute decisions in his life, although he's modest enough to admit to the occasional mistake too. The time when we'll learn how well he has managed succession management is sadly getting closer although hopefully still a long way off. We still own BRK and probably will for a long time. But our ownership is in spite of this one element of Berkshire's succession planning, not because of it.