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Berkshire Hathaway is Safe and Cheap

I own Berkshire Hathaway stock. In fact, it's a stock I bought recently for the first time ever, despite following it for years. I think earlier this year it became (and to a large extent still is) far too cheap. It's not a stock that I think has huge upside, but it is a stock that I think has no downside. (That said, I do think there is enough upside to get plenty excited). In proper investment parlance, the risk/reward of BRK is tremendous.

BRK is one of the most talked about stocks in the value investing community, and so I was hesitant to even put a post together, but as I read through the annual report and 10-K a couple weeks ago, I jotted down four main reasons why I think Berkshire is an attractive investment at these prices.

I'll outline some comments in this post stating why I like the company and the current stock price, and then in a future post or two I might discuss in more detail a few things I noted while reading the annual report and 10-K.

Berkshire is attractive for four general reasons:

- **Cash-rich balance sheet**
- **Strong earning power**
- **Capital allocation** (Buffett's potential to capitalize on downturns)
- **Current stock price**—Almost $100 of cash and investments per share and less than 7 times earnings for good businesses with above average ROE's and a history of strong earnings growth

Note: everything related to per share numbers will be in B shares (which are 1/1500th of A shares).

Cash-rich Balance Sheet

Adjusting for the recent Precision Castparts acquisition which was finalized after 12/31/15, Berkshire has $98 per share in cash and investments. The balance sheet has an excess cash hoard of around $40 billion, and this cash pile grows at a rate of around $1.25 billion per month (this adds around $15 billion, or $6 per share of cash to the balance sheet each year that Buffett can reallocate or just let build).

Consider this: at the current rate that free cash is building up inside Berkshire, it will take just over 5 quarters to make back the entire amount of cash they used to fund the PCP acquisition (the largest in BRK history).

The balance sheet is one huge competitive advantage for Berkshire. Should trouble develop in the economy or if markets fall apart, Berkshire has the opportunity to create enormous value for shareholders by lending money to firms in need (and extracting a heavy toll for such funding), making acquisitions, buying stocks on the cheap, or even using a few months' worth of free cash flow to buy back BRK stock if it trades much lower than the current quote.

Strong and Diversified Earning Power

Unlike many conglomerates, BRK has built a collection of quality compounding machines that produce copious amounts of cash flow that grows over time at a steady clip.

Insurance Businesses

Berkshire's insurance business (with over $110 billion of stated net worth) is not only the largest insurance company in the world, but also one of the most profitable. It has produced 13 consecutive years of underwriting profits, and while this yearly streak will come to an end at some point as insurance markets continue to soften, over time these collection of assets will remain very profitable. Over this 13-year run the insurance businesses have produced a total of $26 billion of pretax profits for Berkshire and currently hold $88 billion in float—money that has been paid by policyholders and reserved by Berkshire for future claims.

This float is listed on the balance sheet as a liability, but in reality—as long as the insurance business continues to collect premiums and underwrite profitably—it is a valuable asset.

Buffett illustrates this value by calling float a revolving fund—each day Berkshire pays out millions of dollars of claims, which reduces float. But each day millions of dollars of new business is written, which adds to float. As long as policies are written profitably (premiums collectively offset claims and operating expenses), and as long as new premiums coming in replace claims going out, then float will be both interest-free and won't have to be paid back.

As Buffett said in the recent letter:

> *"Owing $1 that in effect will never leave the premises—because new business is almost certain to deliver a substitute—is worlds different from owing $1 that will go out the door tomorrow and not be replaced."*

So $1 of float is listed on the liabilities side of the balance sheet alongside $1 of debt—but the former is not only free but actually produces profits and will never have to be paid back. This is one reason why Buffett feels the book value (which counts this $88 billion as a full liability) understates the economic value of Berkshire.

Operating Businesses

Berkshire's "Big Five" (BNSF, BH Energy, Marmon, Lubrizol, and Iscar) earned $13.1 billion pretax in 2015. This will soon be the "Big Six" as PCP will be included this year, and if we assume PCP's earnings this group made over $15 billion. Buffett puts this in perspective in his letter by pointing out that a decade ago only BH Energy existed at Berkshire, and made less than $400 million. So close to $15 billion of earning power has been created in the last decade with virtually no dilution (5 of the Big 6 were purchased all-cash, and BNSF required a minor issuance of new shares).

Earning Power per Share

Including the underwriting profits (but excluding dividend and interest income) from the insurance businesses, BRK had about $8.20 per share in pretax profits in 2015. If we assume no earnings growth and include the pretax income that Berkshire will receive from PCP, we get to roughly $9 per share of pretax earnings.

Buffett has often talked about the intrinsic value of Berkshire Hathaway and how he and Charlie Munger think about it. They basically think of BRK's value in two buckets: cash/investments per share and earnings per share. Since 1970, investments per share have compounded at 18.9% annually and earnings per share have grown at 23.4% per year. So it's no surprise that BRK's intrinsic value and stock price have also compounded at 20% or so for the past half century.

Of course, these rates of compounding are history, but we can still look at the two buckets and clearly see a huge margin of safety from not only a fortress balance sheet but also an earnings machine that is getting very low valuations at the current stock price.

Attractive Current Valuation

For $140 per share, we are getting $98 of cash and investments, and roughly $9 per share of pretax earning power. So backing out the investments per share, we are paying roughly 4.5 times pretax earnings for Berkshire's businesses.

At Berkshire's tax rate of around 30%, this is a P/E of around 6.5 for a diversified group of quality businesses that produce above average returns on equity and—as a group—are growing their earning power. Seems like a good bet.

Buffett once said he likes to pay 10 times pretax earnings for good businesses. I think this is because he thinks the businesses he buys can a) grow their earning power over time, and b) are probably worth somewhat more than 10 times pretax earnings.

At the current price, we're getting these businesses for half of this general rule of thumb.

Book Value

> *"Today, the large—and growing—unrecorded gains at our "winners" make it clear that Berkshire's intrinsic value far exceeds its book value. That's why we would be delighted to repurchase our shares should they sell as low as **120% of book value**. At that level, **purchases would instantly and meaningfully increase per-share intrinsic value for Berkshire's continuing shareholders**." –2015 Shareholder Letter (emphasis mine)*

One reason why Berkshire's book value understates the intrinsic value is that businesses that Berkshire buys never get marked higher, despite as a group growing earning power each year and becoming much more valuable as time goes on.

Another reason Berkshire's true value far exceeds its book value is the insurance business. Earlier I mentioned the value of the float (which is listed as a liability), but we can also look at the asset side of the insurance balance sheet, where $15 billion of goodwill has been sitting since 2000 and has never been marked higher, despite float (and earning power) tripling during that time.

> *"Charlie and I believe the true economic value of our insurance goodwill—what we would happily pay for float of similar quality were we to purchase an insurance operation possessing it—to be far in excess of its historic carrying value. Indeed, almost the entire $15.5 billion we carry for goodwill in our insurance business was already on our books in 2000. Yet we subsequently tripled our float. Its value today is one reason—a huge reason—why we believe Berkshire's intrinsic business value substantially exceeds its book value."*

Berkshire's current book value (using the current price for KHC shares) is around $105 per share. The stock price is around $140, or roughly 1.3 times book, just a touch above the 1.2x level where Buffett thinks is significantly undervalued and would buy back shares.

One thing to consider: just from cash building up throughout the year, book value will grow to around $111 per share by year end. Who knows what the $98 investment portfolio will do in the next year, but over time I would expect this to grow at rates similar to the S&P 500, or say 6-8% annually. But assuming no change in the investments per share, we still get to around $111 per share in book value just through retained earnings by year end. This puts the level Buffett would be willing to buy shares at around $133. And it continues to grow from there as earnings continuing building up. In less than 2 years the current stock price will be less (possibly much less) than 1.2

times book value even if the investment portfolio goes nowhere. Time is the friend of the wonderful business.

While it's certainly possible for the stock price to fall below (maybe significantly below) this hypothetical buyback price over temporary short-term periods, over time I think there is very little chance of losing any money at the current price. If the S&P drops 25%, BRK will certainly fall as well. But if BRK stays much below $125 or so for very long, Buffett will likely begin buying shares, which will be very positive for earning power per share and also value per share. *(Note: Don't think of this as a "Buffett put"—he has no interest in "propping up" the stock. He's willing to buy shares at 1.2 times book because he thinks that is a bargain price that is much below intrinsic value).*

I think the current price is cheap, but the mid-120's was a no-brainer.

Buffett's Reputational Value

Berkshire can create value based on Buffett's name and reputation. This is especially true during troubled times (see GE, BAC, GS deals to name a few). But even in normal times, Buffett's name has created enormous value for shareholders, as he can partner with owner/operators like 3G at attractive terms. Consider the 3G partnership that started with Heinz and is now Kraft Heinz (KHC):

Buffett invested a total of:

- $9.5 billion in common stock
- $8.0 billion in preferred stock
- $17.5 billion total

This total investment of $17.5 billion is now worth $33 billion, and has achieved an **IRR of around 45%**.

(Berkshire owns 325.4 million shares of KHC that is currently valued at $25.1 billion before reserving for taxes—and this resulted from a $9.5 billion initial investment).

Berkshire has also collected around $1.5 billion of dividends from the preferred stock.

By the way, this $33 billion of value is carried on BRK's books at $23 billion, so this is an additional $10 billion gap between book value and intrinsic value.

To Sum It Up

Berkshire is a fortress that's undervalued. It's too big to become a home run, but one of my favorite investment situations is where I see almost no chance of permanent downside and very high chances of decent gains over the next couple years. I was buying BRK thinking there was virtually no chance of losing money and a decent chance at 50% gains in 3 years. Sometimes, the market corrects itself quickly, which has the impact of "pulling forward" two or three years' worth of gains in a year or so.

But while we wait for the upside to occur, Berkshire is a safe and cheap stock whose value will actually increase in the event of the "black swan", a bear market in stocks, or an economic recession.

John Huber is the Managing Member and Portfolio Manager of Saber Capital Management, LLC, an investment firm that manages separate accounts for clients. Saber employs a value investing strategy with a primary goal of patiently compounding capital for the long-term.

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