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ValueLine: Berkshire Hathaway

By Roger Montgomery

PORTFOLIO POINT: A 50 for one split in his Berkshire Hathaway shares puts a slice of the world's greatest investor more affordable. But is it good value?

Believing completely in my valuation model and approach, I now only read about "the world's greatest living investor" Warren Buffett and his legendary Berkshire Hathaway investment company on rare occasions.

Perhaps I should pay more attention, because each deal or media appearance is worthy of further scrutiny. The recent well-reported $US26 billion buyout of railway company Burlington Northern Santa Fe was no exception.

This largest-ever Buffett investment, combined with a strong Australian dollar and a controversial 50-for-1 split of the Berkshire B class shares (which lowers their share price from $US3325 per share to about $US67) makes a back-of-the-envelope valuation of Berkshire Hathaway an interesting exercise. The request I received during the week to value Berkshire was thus met with some enthusiasm.

Announcing the Burlington Northern bid surprised investors by reversing a long-held view that splitting shares was blatant share price promotion. Which, by the way, it remains.

Still, as the world's second-richest man – after Bill Gates of Microsoft – Warren Buffett has his fans. Deservedly, he has carved out a reputation as a formidably intelligent investor with an equal dose of the temperament and patience missing in many professional investors (see *Buffett buys the growth locomotive*, page 5).

Happy to go for long periods without any action, Buffett is the consummate value investor, although luckily for him the vast number of companies traded in the US has meant there has always been a steady stream of opportunities.

But Buffett also has his critics: A staunch advocate of return on equity, his detractors complain that on this measure, he has recently failed his own test.

While the change in book value of Berkshire Hathaway has substantially beaten the index over 45 years and over the past nine, his critics claim that return on equity has not achieved anything like the 20% recorded in previous decades.

A quick bit of theory is relevant here. First, if you take the reported earnings of Berkshire Hathaway and simply divide that number by equity, the return on equity you will obtain – about 7.5% today – is not a true measure of the entity's economic performance. Berkshire Hathaway's reported earnings includes dividends received from the shares it owns in its portfolio but not its share of the total earnings.

If Berkshire Hathaway owns 20% of another listed company that itself earns $100 million, Berkshire doesn't report the $20 million it arguably owns. Second, if a company pays no dividends and issues no new shares, the rate of change in book value should be equivalent to the rate of return on equity.

Working backwards, the inverse must also be true; the average annual compounded rate of growth in Berkshire's book value – its equity – is equal to its return on equity. We can thus approximate the true rate of return on equity by examining the actual rate of change in book value.

The importance of these facts must necessarily affect the intrinsic value of Berkshire Hathaway. A number I can estimate and a number that largely depends on the future rate of return on equity.

Intrinsic value will not increase by the attractive rate it has in the past unless returns on equity of the past can be maintained as the book value of the company continues to expand. The law of large numbers applies here.

It is relatively easy to achieve 20% on $1 million – I can think of two stocks right now that will do that for you over the next two years (and I'll be writing about these companies in the coming weeks) but achieving 20% on the $US118 billion of book value Berkshire has today will be a lot more difficult. That is why Buffett needs elephants, and elephants at the right price.

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In the four or five decades since 1964, book value has grown by a compounded rate of 20.1 percent, a startling effort and because of the high rate of return on equity that it reflects, each dollar retained has created more than a dollar of long-term market value. That is why the share price of Class A shares now stands at over $US100,000 per share. (Class A shares are for the institutions and wider market, while Class B are for retail investors.)

But Buffett has always warned that in the future the massive amounts of capital at his disposal means that while you and I have a universe of thousands of companies that can have a material positive impact on our wealth, his investment universe is a few hundred at best. He needs elephants, and if he doesn't get them his return on equity must inevitably fall.

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Recently return on equity has averaged 7.5%.

The bid for the Texas-based railroad and rail transport business Burlington Northern Sante Fe, at $US100 per share or 33% above the last traded price, suggests that there is now one less target in the investible universe.

I will run through the Burlington Northern acquisition in a moment, but before I do it is worth noting the reasons for the acquisition. First, there is the bet on a long-term recovery in the United States economy. Second, there are the improved economics when 40-foot containers can be stacked two-high on parallel tracks. Third is a long-term bet on rising oil prices.

When diesel fuel rises in price it raises the cost of running trains but it also raises the cost of running trucks by a factor of four.

On my valuation, Burlington Northern is worth somewhere between $US122 and $US133 per share. While Buffett has been criticised for paying more than the current share price, in reality and based on the current return on equity, he appears to have purchased well. He should also be able to boost earnings and return on equity by lending Berkshire's AAA credit rating.

In valuing the shares, there is the A-class, which trade over $US100,000 each and the B-class to which I referred earlier. The simplest way for me to convey the value is to estimate an A-Class equivalent valuation. And to cut to the chase, the value – based on an assumed 12% return on equity (optimistic perhaps) – is approximately $US108,000.

Given that the B-class shares are as an investment 1/30th the value and are about to be split 50-for-1, the value of them based on the optimistic return on equity is $US72. If, however, you assume that Berkshire Hathaway continues to achieve the average 7.5% returns on equity it has recently, the valuation falls dramatically because Buffett is retaining profits and generating a rate of return on them that is less than I can achieve elsewhere.

In such circumstances, the only price to pay is a discount to the forecast $US82,000 per-share book value of the company – about $35 per post-split B-class share. ◆

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NOTE: When I added Commonwealth Bank to the ValueLine portfolio at $46.51, some readers were disturbed by the valuation of about $50 attached to my decision. It has subsequently been the best-performing bank. To avoid any further angst and because the market looks forward, I have now updated all my valuations to reflect 2010 forecasts and you will notice some material upgrades. Please note that these do not represent a prediction of where the price is heading. For what it is worth, the market looks a little expensive.

The ValueLine portfolio as at November 10, 2009

Company	Buy Price	Price Today	Est value	Margin of Safety	Shares bought	Invested ($)	Capital value ($)	Divs rec	Total return	Total return
JB Hi-Fi	14.8	21.5	25.76	16.5%	845	$12,500	$18,159	0.29	$5,904	47.23%
Cochlear	56.36	62.26	56.3	-10.6%	102	$5,744	$6,345	0.95	$698	12.15%
CSL	31.81	32.07	32.87	2.4%	163	$5,197	$5,240	0.4	$108	2.07%
Woolworths	26.16	28.2	26.85	-5.0%	206	$5,377	$5,797	0.56	$534	9.94%
Reece	17.8	23.52	14.83	-58.6%	236	$4,209	$5,562	0.33	$1,431	33.99%
Platinum Asset Mgt	4.06	5.91	3.95	-49.6%	854	$3,467	$5,047	0.12	$1,682	48.52%
CommBank	46.51	55	52.81	-4.1%	215	$10,000	$11,825	0	$1,825	18.25%
Since July 1										
Security Value									$57,974	
Cash Value										$56,635
Total Value										$114,609
Total Return ($)									$14,609.28	
Return Invested (%)									30.27%	
Total Return (%)									14.61%	
XAO Change									20.80%	
Outperformance of invested portion										9.47%
Outperformance of total portfolio										-6.19%
Under observation										
Company	**July 1 price**	**Price today**	**Est value**	**Margin of safety***				**Divs rec**		**Total return**
ISOFT	0.635	0.815	0.19	-328.9%						-28.35%
Amcor	4.79	5.52	3.63	-52.1%						-15.24%