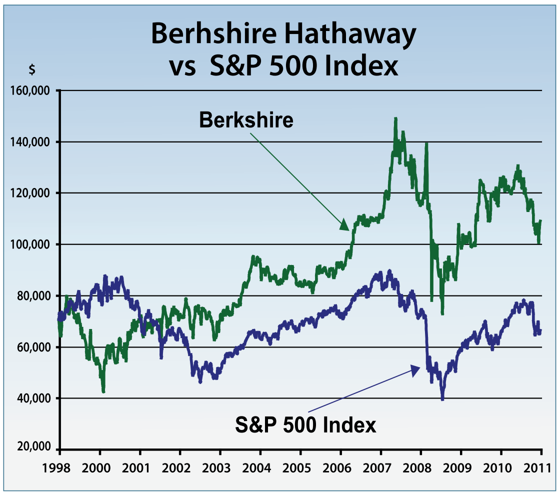
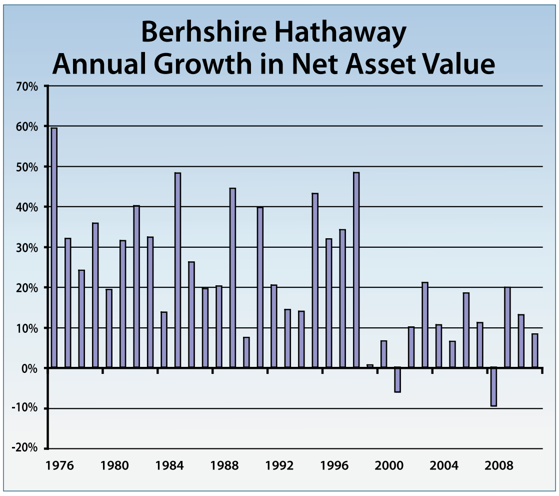
Berkshire Hathaway - a Value Stock ?

Berkshire Hathaway's shares (BRKA & BRK-B) trade on only a small premium to their underlying net asset value (shareholder funds), which is a highly unusual occurrence. The board of Berkshire Hathaway is clearly of the same view and has recently obtained the authority from shareholders to buy-back shares at a premium of between 0-10% of net asset value. At $73 a share (B shares), the stock is currently trading on a 12% premium to the 2010 net asset value (NAV) or 5-6% to an estimate of the 2011 NAV.

It has been a long time since Berkshire Hathaway shares have traded anywhere near their net asset value i.e. the balance sheet worth. And a quick perusal of Berkshire's 2010 Annual Report provides some figures and facts to back up what appears to be a fairly compelling long-term value investment opportunity.



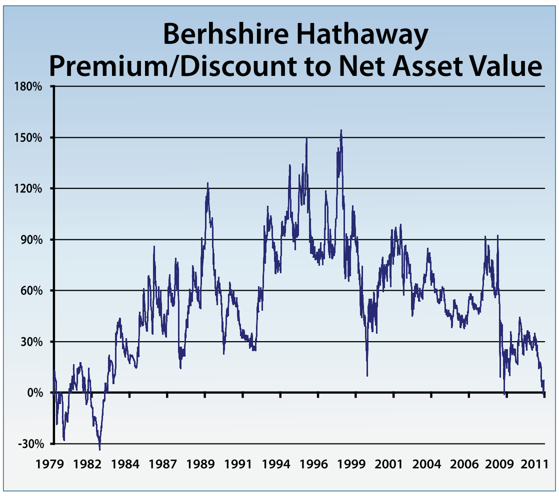
Although the US stock market peaked in late 1999, Berkshire's share price (top chart) has shown progress over that same timeline. The out-performance is a pale shadow of what the company achieved from 1965 to 2000 but it has continued to outperform, nonetheless.



The middle chart highlights the growth in Berkshire's net asset value (NAV) from 1976 to 2011 inclusive. Recent growth rates have slowed but have still been between 10-20% annually with the exceptions of down years in 2001 and 2008.

An examination of the group's 2010 Annual Report highlights a number of relevant points;

- Shareholders' funds were $157.3 billion or $95,453 per share ($64 per B share)
- Cash holdings were $38 billion
- After tax earnings were £12 billion



The last chart highlights the price-to-net asset value that Berkshire has traded at since 1979. At the current share price, the shares are trading at a 12% premium to 2010's net asset value and a 5-6% premium to an estimate of net asset value for 2011 of $170 billion (or $103,300 per 'A' share: $69 per 'B' share). Since the early 1980s, when Buffett's record started to stand out, the shares have generally traded at a premium to NAV of between 30-150%. The shares briefly traded at NAV in 2008 and again recently.

After Tax Earnings Understated

In Buffett's 2010 letter to shareholders, he highlighted that the after tax earnings power of the business is circa $12 billion and that one can make a couple of adjustments to this figure;

- while interest income on investments in Goldman Sachs, General Electric and Swiss Re will soon disappear, the group's construction and building materials earnings have good recovery potential and there is further upside if/when dividend income from Wells Fargo returns to normal levels. All in, these could add circa €1 billion to earnings in time.

- the group has cash balances of $38 billion earning practically zero interest. Interest rates will eventually go up or Berkshire will reinvest the cash in higher-earning assets. Either scenario will add to its long-term earnings power. Buffett has stated that he will keep circa $10 billion on hand at all times suggesting that Berkshire has $28 billion of spare resourses to be deployed. A return of even 7% after tax would contribute a further $2 billion to earnings.

Combined, this could add a further €3 billion to Berkshire's earnings power and suggests that Berkshire's assets, as things stand, can deliver after tax earnings of $15 billion. That would represent a 9.6% after tax return on 2010 net assets of $157.3 billion. Given the quality and likely growth attached to that earnings stream, one could argue that you have a bond-like asset with a near double-digit initial earnings yield, which should continue to grow. To an investor who pays a 12% premium over the 2010 net asset value, then the starting earnings yield is still an attractive 8.6%. The attractions of an earnings yield with both defensive and growth characteristics appear fairly obvious. In comparison to a 2% yield from US 10-year government bonds, which offer no growth and hardly have the same credit worthiness, the opportunity or value on offer is even more striking.

Dealing with the Elephant in the Room

Of course, some of the de-rating of the shares reflects underlying concerns about what happens when Buffett is no longer at the helm. He has threatened to direct the company from the grave which he says brings new meaning to the phrase 'thinking outside the box'. I believe two sensible observations can be made when Buffett is no longer around;

- Firstly, he will have left behind a collection of world beating companies that will continue to pour out earnings and cash flows for years to come;

- Secondly, while it is unlikely that anyone of Buffett's calibre will be there to reinvest those cash flows as well as he has done for forty-six years now, the board will have other options for re-deploying the cash flows. These options include;

    - share buy-backs - which would underpin growth in net asset value as well as providing a floor under the share price near net asset value.

    - paying a dividend - if 50% of earnings were paid out by way of dividend today, the dividend yield would be circa 4.3% (based on $15 billion of earnings power).

For these reasons, I would not fear Berkshire Hathaway post Buffett. For sure, the stellar track record of the past is most unlikely to be repeated. But, at the current share price, investors appear to be pricing in no growth - and that looks way too bearish.

In fact, Berkshire looks capable of growing its earnings and intrinsic value (book value) at a minimum rate of 7-9% per annum from here. There are a number of reasons why:

1) US corporate profits have grown at a rate of 5-6% per annum in the past fifty years. This rate of growth in US corporate earnings may slow in the years ahead but it appears safe to assume Berkshire will grow at a higher rate than average, given the strength of its businesses;

2) The 'interest-free' leverage from Berkshire's access to its insurance companies' free floats, currently $66bn and equivalent to 42% of shareholders' funds, is likely to continue to boost earnings growth even further.

Conclusion: The current 12% premium to shareholders' funds that Berkshire's shares trade at neither recognises the sustainability of a high earnings yield, nor the likely continued above average growth in that earnings yield.

The B Shares (BRK-B) Trade at a Lower Price

Investors can buy the B shares which trade at 1/1500th of the price of the A shares (or $73 a share). This should suit investors with more modest means than institutional investors. Owners of the 'B' shares can also attend the annual general meeting in Omaha, Nebraska which takes place every May.

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