Valuing Berkshire Hathaway

If you're into this kind of thing, which is to say that examining financial statements is a source of stimulating mental gymnastics, figuring out the value of Berkshire Hathaway (BRK) could keep you entertained. BRK released their third quarter's earnings over the weekend. It's an insurance company transforming itself into an operating business as Whitney Tilson has pointed out before. It's true that the acquisition of Burlington Northern has pushed their non-insurance operating earnings to a new level. Breaking the company into its two pieces (insurance and non-insurance) and adding its securities portfolio is an interesting exercise.

Non-insurance businesses generated pre-tax operating income of $5.4BN during the first nine months of the year. There are many moving parts, but assume positive surprises will net out with negatives and you get $7.3BN of full-year pre-tax earnings. Most insurance companies operate an underwriting loss (i.e. they only reach profitability because of investment earnings on the float) but BRK seeks to make a profit on underwriting. Averaging the past two years and annualizing the result generates $765MM in pre-tax operating income. In fact over the past eight years underwriting has produced $17BN, or over $2BN per year. These two add up to $8BN of pre-tax income, after 35% tax $5.2BN.

Using the S&P500's trailing P/E multiple of 13 values this at $68BN. This is the value of Berkshire's insurance underwriting and disparate operating businesses but excluding investment income.

But in addition, BRK has an investment portfolio consisting of marketable securities, non-public investments and cash worth $147 BN. Adding this cash and investment portfolio to the businesses above produces $215BN, compared with BRK's current market capitalization of $190BN, or in other words the company’s valued at a 12% discount.

Aspen Reinsurance noted that around $95BN of global reinsurance capacity has gone following many events from the earthquakes in Japan and New Zealand to weather-related losses in the U.S. and Australia. Given a harder market (i.e. one of rising premiums given the reduced industry capacity) it’s not unreasonable to expect BRK’s underwriting results to improve next year. If they get back to the eight year average, the company’s worth almost $230BN or is at a 17% discount.

This is a summary of how we look at BRK. It seems to trade at a conglomerate discount. But their underlying businesses are going well, they’re buying back stock and they had their most active quarter of investing in fifteen years, putting almost $21BN to work. We think it remains an attractively priced investment.