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.

Savour the Moment

Sometimes you feel as if you’d like the world to stop right where it is. For most investors, arriving at work and checking their portfolios over coffee this morning should be one of the most pleasant beverages they’ve consumed in many months. After the misery of the third quarter culminating in September’s testing of every reasonable investment thesis, sanity is finally returning. The Europeans have avoided disaster; the Germans have crammed voluntary losses on the banks (who have only themselves to blame for owning so much Greek debt in the first place). The banks say they will recapitalize through retained earnings rather than dilutive secondary offerings. The EFSF will be stretched as needed (although details are still sketchy). Life as we knew it can resume, and risk assets are cheap. Enjoy the view, like gazing across a beautiful vista on a sunny day. Touch the moment and savour it. Of course there are problems, and the moment won't last. But for now, just look and let September's nightmare recede.

So having done that, what's next? Well, having engineered a voluntary loss of 50% on holders of Greek debt and thereby avoiding an actual default, the market for sovereign credit default swaps (CDS) appears superfluous. Cautious buyers of Greek debt (were there ever any?) who bought credit insurance (i.e. CDS) have found it a waste of money. Sovereign defaults are at the end of the day as much political as credit events. Rating agency assessments of countries are political judgments, and maybe we're witnessing the end of one corner of the CDS market. Bankers have warned that reduced hedging opportunities will reduce the appetite of banks to extend credit – that may not be a wholly bad outcome given the amount of poorly conceived credit they've extended in the past. But reduced credit in the near term combined with Europe-wide fiscal retrenchment will stifle growth.

For our part, the main challenge to investors remains finding a fair alternative to the paltry yields offered in fixed income. Senior loans continue to be an attractive sector. The ING Prime Rate Fund (PPR) yields close to 6% and closed at a 7% discount to its NAV. When I spoke to one of the co-PMs a couple of weeks ago he felt fairly sanguine about defaults barring a European disaster which, at that time couldn't be ruled out. Meanwhile, high-grade corporate bonds at around 4% with no growth require conditions close to but just short of deflation to turn out well. The gap between the 8% earnings yield on the S&P500 and 2.25% ten-year treasury bonds is somewhat narrower than a month ago but still historically wide. Today is probably not the day to jump into equities, but at a calmer moment they still look like a more attractive long-term investment than bonds. The after-tax return on $100 in ten year treasuries can be beaten by a combination of $80 in 0% cash and only $20 in 2.2% dividend yielding stocks assuming as little as 4% dividend growth. Bonds are at yields that only a QE emboldened government could love.

In equities we remain fully invested. Natural gas E&P names continue to represent the more volatile sector of our Deep Value Equity portfolio. Devon Energy (DVN) is barely above the value of its proved reserves. We continue to believe Gannett (GCI) is very cheap at 6X earnings or less than five times free cashflow. And Microsoft (MSFT) remains attractive at less than 7X earnings net of cash (less debt) on balance sheet. MSFT has been cheap for many, many months. It’s not exciting to be an investor – far from it. But it continues to be reliably profitable.

Disclosure: Author is Long PPR, DVN, GCI, MSFT

The Quiet Buying of Shale Gas Assets

The FT notes in an article this morning how M&A activity in the shale gas arena reached almost $50BN during the third quarter, a 135% jump on a year ago. Some deals were large and notable, such as Kinder Morgan’s (KMP) purchase of El Paso. Others took place out of the spotlight, but what is clearly taking place is a growing acknowledgment by the major energy companies that domestic natural gas in the U.S. will represent an increasingly important source of energy production. It’s here in the U.S., it’s cleaner than other fossil fuels (though global warming is yesterday’s story) and it’s persistently cheap. They very success of so many E&P companies in drilling for natural gas has depressed its price, helping consumers but hurting profitability. When Petrohawk sold their business to BHP Billiton it confirmed CEO Floyd Wilson's oft-stated belief that the assets Petrohawk owned better belonged within a larger company with a lower cost of capital. That statement really is the key to the natural gas story. In a time of abundant and cheap natural gas, the company that has the lowest overall cost structure (including the cost of financing the necessary capex) will win.

As an investor, you have to choose carefully though, and definitely avoid companies that use too much leverage. As a result we've never invested in Chesapeake (CHK). Aubrey McClendon is a great cheerleader for the industry but has exhibited a wholly different risk appetite in the past than we would like. We continue to like Comstock (CRK) a name that's fallen too far. We also think Devon Energy (DVN) is a solid investment trading as it does close to the value of its proved reserves (providing a cheap option on likely but not yet proven assets) and with half its revenues now coming from crude oil production. It's also all onshore, having divested its offshore and non-U.S. assets in recent years.

But Master Limited Partnerships (MLPs) also allow an interesting angle on the development of shale gas assets. Once the gas is extracted it needs to be processed, refined, transported and stored. This is to a large degree what drove KMP's acquisition of El Paso; positioning for the huge infrastructure investments required to move natural gas from under the ground to the U.S. consumer. I found it interesting that earlier this month JPMorgan initiated research coverage of MLPs. They used to cover them but the analyst left several years ago and they dropped their emphasis on the sector. But JPMorgan estimates $130BN in capital investment over the next ten years as the industry responds to a shifting mix of fuels to provide energy. The tax status of MLPs precludes them from retaining much of their earnings, so new projects are usually funded with freshly raised debt or equity capital. For an investor this imposes discipline on management, since a poorly conceived project won't easily attract cheap financing. JPMorgan no doubt sees an attractive long term fee opportunity. Meanwhile, there are ways to participate in shale gas development for the equity investor through E&P companies and the income seeking investor through MLPs. The sector has also recovered strongly from the sell-off in equity markets through September – the Alerian MLP Index (AMZ) is back within 5% of its high reached in April. 6% distribution yields and steady growth help.

Monday Morning Thoughts, October 24th

There's an interesting article in the Wall Street Journal highlighting that banks are increasingly the first source of funds for takeovers – providing more funds that the high yield bond market. Kinder Morgan's recent acquisition of El Paso is cited as an example, but there's increasing evidence that banks are increasing their risk appetite. The Fed's confiscatory interest rate policies are steadily squeezing people out of riskless assets where there's no return to be made. In our Fixed Income strategy we continue to own senior loan closed end funds such as Blackrock Defined opportunity Fund (BHL) and ING Prime Rate Trust (PPR). The prices on this sector had dropped more than 20% over the past six months, through lower NAVs and prices shifting from a premium to a discount.

Hedge funds are nervously waiting – not for the publication of my book, The Hedge Fund Mirage, but instead to see how big redemptions are going in to the end of the year. The WSJ has an article noting poor performance by some very large funds (Paulson, Maverick and Kingdon amongst others). Hedge fund investors are apparently maintaining their strategy of momentum investing even though it has served them so poorly over the years. Adding to winners and redeeming from losers. There aren't many hedge fund investors who seek out under-performing managers.

We invested in Transocean (RIG) on Friday in our Deep Value Equity strategy. We had previously owned the largest owner of offshore oil rigs last year following the Gulf of Mexico oil spill when its stock traded down substantially on fears of enormous legal liability. Such fears were unfounded and the stock recovered. We exited although well before its high. In recent months concerns of economic slowdown as well as BP's lawsuit have depressed the stock price which is now trading more than 30% below the market value of its rigs (according to research from JPMorgan). There's considerable room for error around such estimates, but this provides a greater margin of safety than on other names in its peer group. In addition with consensus estimates for $5.26 per share in earnings next year it appears attractively priced. BP's lawsuit will no doubt continue to be a cloud over them for some time, but with $17BN in market cap and $25BN in enterprise value they're big enough to handle even a $1BN legal settlement. It also pays a $3.16 dividend which gives it a yield of almost 6%.

We continue to own Gannett Co (GCI). It has been an unrewarding experience so far. It's true they're in the hated newspaper business which continues to shrink every quarter, but they also own broadcasting and digital franchises which look much more attractive. The problem is their publishing division is their biggest, notably the newspaper USA Today. But they are consistently profitable and trade at less than 6X earnings which are expected to grow modestly next year (helped by election-related TV advertising and continued double-digit growth in their online businesses). We'd like to see them buy back more stock but cashflow from operations regularly exceeds $700 million per year (compared with their market cap of 2.7BN), and with minimal capex needs they've been paying down debt. Perhaps the improved lending climate noted above will induce a private equity buyer to acquire what we think is a very cheap company.

Disvlosure: Author is Long BHL, PPR, RIG, GCI

Why Comstock Resources Has Fallen Too Far

In sorting through the wreckage of the past quarter's bear market, I've spent some time reviewing Comstock Resources (CRK). We own CRK – we liked it at $30 a share truth be told, although we did have the good sense to lighten up the position at those heady levels. CRK is a natural gas E&P name drilling for shale gas mainly in East and South Texas and North Louisiana. We've long liked natural gas as a replacement for coal in fuelling America's power plans. It is cheap, abundant, clean(er) and here, in the U.S. But the very abundance of natural gas has depressed its price for some years now and forced the E&P companies exploiting it to operate at successively lower costs. CRK qualifies, in that it has estimated extraction costs of around $1.26 per MCF (thousand cubic feet) although that continues to fall. It also has manageable debt. They operate in a similar area to Petrohawk, which was acquired earlier this year by BHP Billiton. We think CRK may ultimately be acquired, although today's market environment offers much less immediate prospect of that given the difficulty of financing acquisitions.

Meanwhile, CRK's stock price recently sank as low as $14 (and even now has only rebounded to just over $16). At current prices you can buy the entire company for less than $800 million. Assuming they can realize $1.25 per MCF on the proved reserves of 1.05 TCFE (trillion cubic feet equivalent), and after adjusting for debt net of cash the company is trading for approximately the value of its proved reserves alone. This doesn't account for their reserve potential which could be 3-5 times as much again. CRK's problem is that the market always worried they won't have enough cashflow to fund their drilling program and as a result will need to come to the market for additional equity , and this along with the disappearance of any imminent takeover explain the precipitous drop in the stock. The company believes they will fund all their capex needs from internally generated cashflow, and they expect to spend $610 million on capex (i.e. drilling new wells) in 2011 for which they don't expect to tap the equity market. In addition they have $400 MM in unused credit through their bank revolver.

I've met Roland Burns and chatted with him several times over the past year. We think this stock offers an attractive risk/return at current prices, and will be looking for opportunities to add to our position.

Disclosure: Author is Long CRK

Range Resources and the Pennsylvania Superior Court

Yesterday a court ruling in Pennsylvania cast doubt on the title of thousands of shale gas leases, as reported in

Bloomberg . Range Resources (RRC) is as heavily invested in the Marcellus shale area, which includes Pennsylvania, as any other company out there. The company is well run and we like the management. The stock has also been exceptionally buoyant recently on takeover rumors. However, this news will likely put any potential acquisition on hold until the title issues are resolved, either by the Pennsylvania State Supreme Court or through state legislation. We are not currently invested in RRC although had been invested until recently when the U.S. Geologic Survey revised down their forecast of total reserves available in the Marcellus (which runs from NY State to Tennessee). This may create an opportunity to invest at lower prices once the story has had some time to play out.

Natural Gas and the Marcellus Shale

There always seems to be something to say on this topic. Although natural gas E&P companies typically represent 15-20% of our Deep Value Equity strategy, they provide disproportionate volatility but have also provided very good returns. The U.S. Geological Survey (USGS) is a Federal agency that gathers information and publishes research on the environment and natural resources A week ago they published a report on the amount of natural gas in the Marcellus Shale, an enormous area which runs from New York State to Alabama. They estimated that the “mean undiscovered natural gas resource” in this region is 84 TCFE (trillion cubic feet equivalent). They use the mean because the science isn’t certain and they have various forecasts with different levels of certainty. 84 TCFE is a lot of gas, roughly four times annual U.S. consumption. But this estimate is sharply lower than previous ones, and as a result the Energy Information Agency (EIA) whose job it is to forecast available energy resources, said it would slash its previous forecast of Marcellus availability by 80%. The EIA is deferring to the scientists at the USGS.

Range Resources (RRC) has long been a core holding of ours. The company is largely focused on extracting natural gas from the Marcellus Shale where it was one of the early movers. We like the company very much. It's run by smart people who understand their business and is focused on increasing shareholder value. RRC has among the most efficient operating structures of any of its peers, and perhaps the cheapest F&D (Finding and Development) costs in the Marcellus. Current President and COO Jeff Ventura will be taking over from John Pinkerton as CEO in January in what will probably be a seamless transition. Jeff has an engineering background and has led their successful activities in the Marcellus to this point.

RRC reports total resource potential of 40-56 TCFE, of which 22-32 TCFE is in the Marcellus (and mostly in Pennsylvania). When the EIA was forecasting around 400 TCFE in the entire Marcellus area, this seemed fine. However, the revised 84 TCFE figure probably can't be reconciled with RRC's forecast (which is an estimate of resource potential, not proved reserves). We wouldn't bet against RRC. They've been extracting increasing volumes of natural gas from this area for a long time and know the geology well. But Chesapeake Energy (CHK) estimates they have 93 TCFE of potential ("unrisked, unproved" is their definition). Something's going to have to give. An intriguing possibility is that if the Marcellus ultimately delivers less than expected, other shale plays could be substantially more valuable given the resultant drop in long term natural gas supply. For our part, while we continue to like RRC we recently shifted into Devon Energy (DVN), which provides more diversified natural gas exposure and is also a very well run company. DVN's market cap is approximately equal to its proved reserves (i.e. potential reserves are not reflected in the price). They have very little debt, are buying back stock and should earn $6-7 per share next year which makes an attractive multiple given their $67 price. DVN is in many different unconventional natural gas areas, but not in the Marcellus. The Marcellus Shale story no doubt has more chapters to come.