

Our Favorite Stock Idea: Berkshire Hathaway

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Value Investing Congress

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History

- Berkshire Hathaway in 2005 does not resemble the company that Buffett bought into during the 1960s
- Berkshire was a leading New England-based textile company, with investment appeal as a classic Ben Graham-style “net-net”
- Buffett took control of Berkshire on May 10, 1965
- At that time, Berkshire had a market value of about \$18 million and shareholder's equity of about \$22 million

The Berkshire Hathaway Empire Today



6 Largest Stakes in Public Companies

The Washington Post

Moody's Investors Service

The Basics

- Stock price (11/15/05): \$89,990
 - \$2,960 for B shares
- Shares outstanding: 1.54 million
- Market cap: \$139 billion
- Total assets (Q3 05): \$196.7 billion
- Total equity: \$89.5 billion
- Book value per share: \$58,100

Recent Performance of Key Business Units

	<u>Revenues (\$M)</u>				<u>Pre-Tax Earnings (\$M)</u>			
	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>TTM</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>TTM</u>
Insurance:								
GEICO	6,670	7,784	8,915	9,818	416	452	970	1,199
General Re	8,500	8,245	7,245	6,491	(1,393)	145	3	(300)
Berkshire Hathaway Reinsurance	3,300	4,430	3,714	3,896	547	1,047	417	(867)
Berkshire Hathaway Primary Group	712	1,034	1,211	1,349	32	74	161	171
Investment Income	<u>3,067</u>	<u>3,238</u>	<u>2,842</u>	<u>3,333</u>	<u>3,050</u>	<u>3,223</u>	<u>2,824</u>	<u>3,312</u>
Total insurance group	22,249	24,731	23,927	24,887	2,652	4,941	4,375	3,515
Apparel	1,619	2,075	2,200	2,270	229	289	325	350
Building products	3,702	3,846	4,337	4,705	516	559	643	748
Finance and financial products	2,234	3,045	3,774	4,247	726	619	584	694
Flight Services	2,837	2,431	3,244	3,533	225	72	191	174
McLane Company	-	13,743	23,373	23,930	-	150	228	233
Retail	2,103	2,311	2,601	2,700	166	165	163	187
Shaw Industries	4,334	4,660	5,174	5,520	424	436	466	484
Other Businesses	2,375	3,040	3,213	3,171	381	486	465	468
TOTAL	41,453	59,882	71,843	74,963	5,319	7,717	7,440	6,853

Valuing Berkshire

“Over the years we've...attempt[ed] to increase our marketable investments in wonderful businesses, while simultaneously trying to buy similar businesses in their entirety.”

– 1995 Annual Letter

“In our last two annual reports, we furnished you a table that Charlie and I believe is **central to estimating Berkshire's intrinsic value**. In the updated version of that table, which follows, we trace our two key components of value. The first column lists our per-share ownership of investments (including cash and equivalents) and the second column shows our per-share earnings from Berkshire's operating businesses before taxes and purchase-accounting adjustments, but after all interest and corporate expenses. The second column excludes all dividends, interest and capital gains that we realized from the investments presented in the first column.” – 1997 Annual Letter

<u>Year</u>	<u>Investments Per Share</u>	<u>Pre-tax Earnings Per Share Excluding All Income from Investments</u>
1967	\$ 41	\$ 1.09
1977	372	12.44
1987	3,910	108.14
1997	38,043	717.82

“In effect, the columns show what Berkshire would look like were it split into two parts, with one entity holding our investments and the other operating all of our businesses and bearing all corporate costs.” – 1997 Annual Letter

Buffett's Comments on Berkshire's Valuation Lead to an Implied Multiplier of Approximately 12

<u>Year</u>	<u>Investments Per Share</u>	<u>Pre-tax EPS Excluding All</u>		<u>Intrinsic Value</u>	<u>Implied Multiplier</u>
		<u>Income From Investments</u>	<u>Year-End Stock Price</u>		
1996	\$28,500	\$421	\$34,100	\$34,100	13
1997	\$38,043	\$718	\$46,000	\$46,000	11
1998	\$47,647	\$474	\$70,000	\$54,000	13
1999	\$47,339	-\$458	\$56,100	\$60,000	

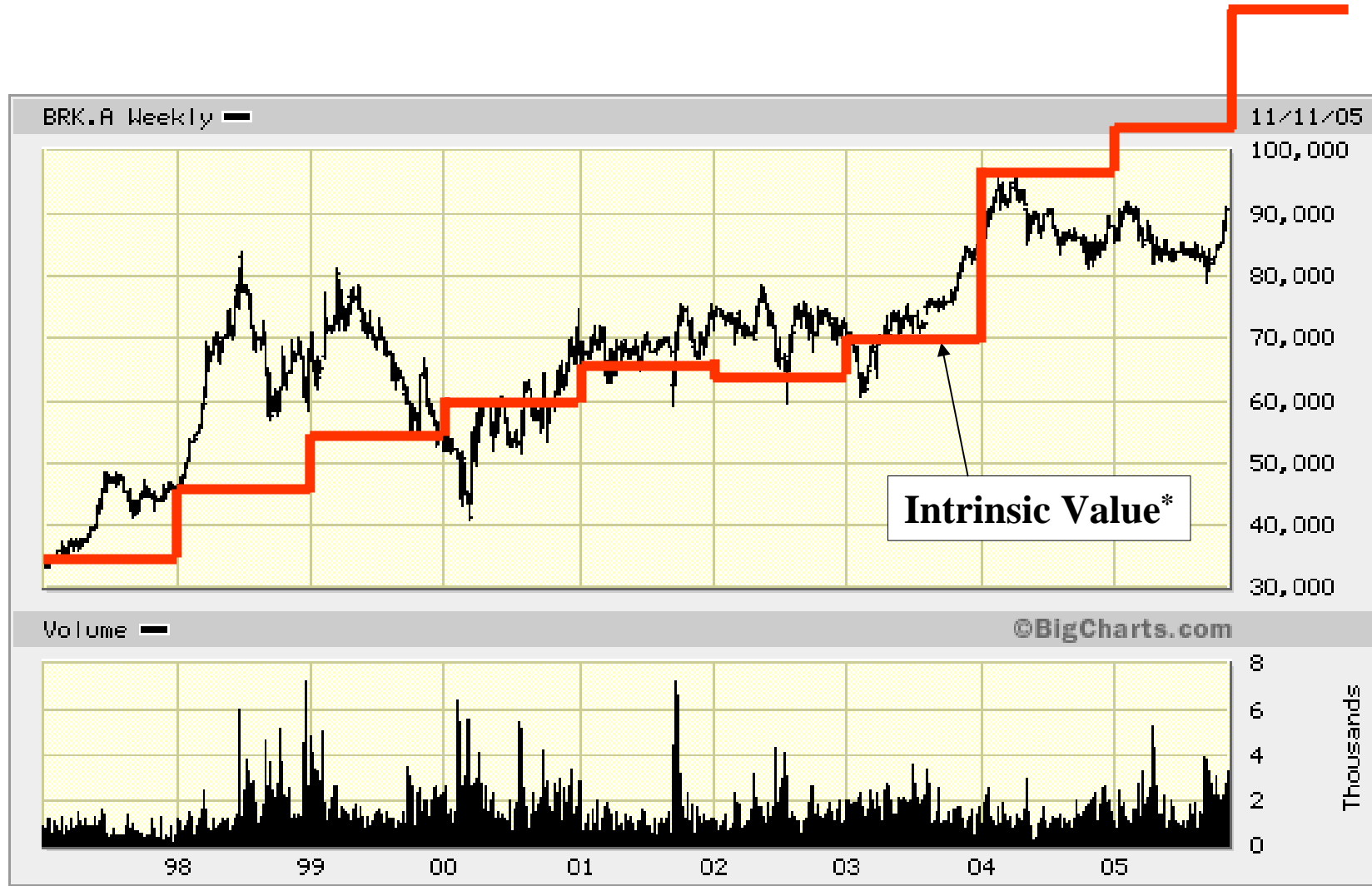
- 1996 Annual Letter: "Today's price/value relationship is both much different from what it was a year ago and, as Charlie and I see it, more appropriate."
- 1997 Annual Letter: "Berkshire's intrinsic value grew at nearly the same pace as book value" (book +34.1%)
- 1998 Annual Letter: "Though Berkshire's intrinsic value grew very substantially in 1998, the gain fell well short of the 48.3% recorded for book value." (Assume a 15-20% increase in intrinsic value.)
- 1999 Annual Letter: "A repurchase of, say, 2% of a company's shares at a 25% discount from per-share intrinsic value...We will not repurchase shares unless we believe Berkshire stock is selling well below intrinsic value, conservatively calculated...Recently, when the A shares fell below \$45,000, we considered making repurchases."

Applying the 12 Multiple: 2001 – 2006 Estimate

<u>Year</u>	<u>Investments Per Share</u>	<u>Pre-tax EPS Excluding All Income From Investments</u>	<u>Intrinsic Value Per Share</u>	<u>Subsequent Year Stock Price Range</u>
2001	\$47,460	-\$1,289	\$64,000	\$59,600-\$78,500
2002	\$52,507	\$1,479	\$70,000	\$60,600-\$84,700
2003	\$62,273	\$2,912	\$97,000	\$81,000-\$95,700
2004	\$66,967	\$3,003	\$103,000	\$78,800-\$92,000
2005 est.	\$75,000	\$2,400	\$104,000	?
2005 est.*	\$75,000	\$3,600	\$118,000	?

* Adjusted for estimate of normalized super-cat losses.

A Large and Rare Gap Has Emerged Between Berkshire's Share Price and Its Intrinsic Value



* Investments per share plus 12x pre-tax earnings per share (excluding all income from investments) for the prior year. Final bar is adjusted for estimate of normalized super-cat losses.

Berkshire Is As Cheap Today As March 2000

The Only Time Buffett Has Ever Offered to Repurchase Shares

	<u>1999</u>	<u>2004</u>	<u>Growth</u>	<u>1999 value</u>	<u>Implied 2004 Value</u>
Book Value Per Share	\$37,801	\$55,824	48%	\$60,000	\$88,607
Revenues (TTM)	\$24,028	\$74,382	210%	\$60,000	\$185,738
Operating Earnings	\$2,450	\$7,677	213%	\$60,000	\$188,008
Cash Flow	\$4,200	\$9,200	119%	\$60,000	\$131,429

Valuation Approach #2: Pro-Forma Earnings

- Market cap: \$139B – cash (\$41B) = \$98B
- 2004 earnings, excluding interest on cash: \$7.2B
- Plus 2004 look-through earnings after cash distributions: \$1.2B
- Equals total pro-forma earnings of \$8.4B
- P/E: \$98B / \$8.4B = 11.7x

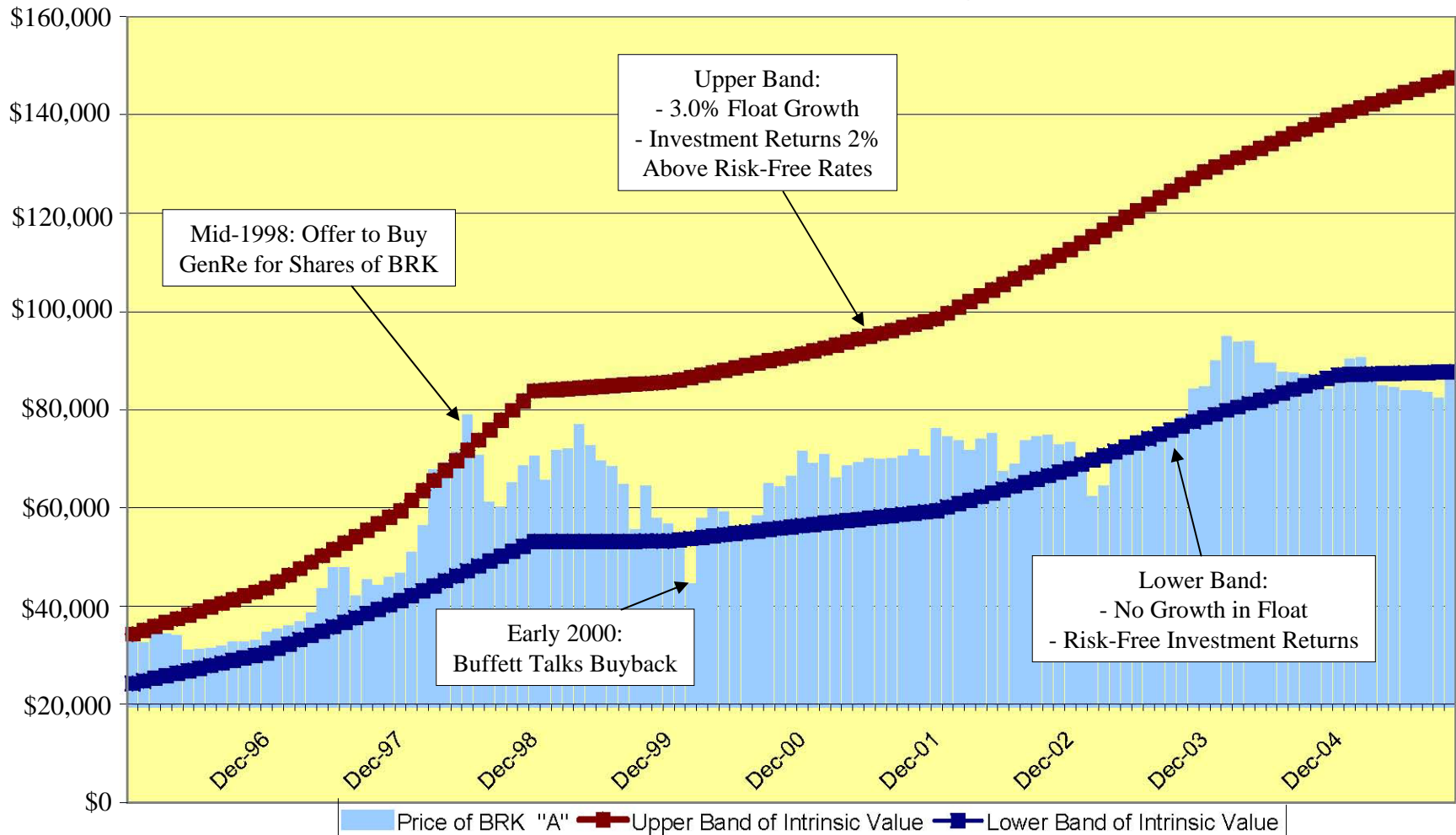
Another Way to See That Berkshire Is Currently Trading at 12-13x Pro-Forma Earnings:

Assume Hypothetical Acquisition of Anheuser-Busch

- What if Berkshire used its \$41B of cash to buy Anheuser-Busch?
 - BUD's current market cap is \$33.5B (stock price: \$43), so Berkshire would pay a 22% premium
- Add BUD's \$2.2B of net income to Berkshire's \$8.4 billion of pro-forma earnings = total pro-forma earnings of \$10.6B
- Market cap today is \$139B, so dividing by \$10.6B = a P/E of 13

Valuation Approach #3: Float-Based Valuation

By Fairholme Capital Management, LLC



Can Buffett Put Berkshire's Money to Work?

	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005 Run Rate</u>
Acquisitions	\$4,880	\$2,629	\$3,213	\$414	\$2,400
MidAmerican Acquisition		\$5,300			\$8,500
Net Equity Purchases	-\$2,806	\$621	-\$806	\$822	\$8,000
Loans and Financings		\$2,581			
Other Investments		\$1,700			
Junk Bonds	\$1,000	\$7,000			
Total Investments	\$3,074	\$19,831	\$2,407	\$1,236	\$18,900

- He's doing a good job – but the cash is coming in so fast!
 - A high-class problem
- Markets have a way of presenting big opportunities on short notice
 - Junk bonds in 2002; cheap blue-chip stocks in 2005
 - Buffett has reduced average maturity of bond portfolio so he can act quickly

12-Month Investment Return

- Current intrinsic value:
\$120,000/share
- Cash build over next 12 months:
\$5,000/share
- Equals intrinsic value of \$125,000
- 39% premium to today's price

We Own Five-Year LEAPs

- Current intrinsic value: \$120,000/share
- Intrinsic value in five years, assuming growth of 10% annually: \$193,000
- Five-year LEAP with \$80,000 strike price costs \$30,000 today.
- Value in five years: $\$193,000 - \$80,000 = \$113,000$
- 3.8x return, or 30.4% compounded annually

Catalysts

- Resolution of investigations
- Very strong super-cat pricing
- Disclosure of new equity investments
- Additional cash build
- Potential for large acquisition
- Consolidation of MidAmerican
- \$5B GAAP gain on Gillette acquisition

Risks

- No catalysts
 - Intrinsic value continues to grow nicely
- Investigations
 - “Warren Buffett is an exemplar” – Eliot Spitzer, 10/05
- Buffett’s health
 - In good health; turned 75 on Aug. 30th
 - Strong board and succession plan in place
 - Little Buffett premium in stock today
- Major super-cats
 - “During the five-minute talk with Mr. Jain, conversation turned to Mr. Buffett's decision last year to slash Berkshire's exposure to "super cats," or catastrophic events. "If this year's hurricanes had happened last year, or two to three years ago [before Mr. Buffett cut the exposure], what percentage more would our losses have been?" Mr. Buffett asked Mr. Jain. "One-hundred percent, worst case," Mr. Jain replied.” – WSJ, 11/12/05
- Can’t find place to invest cash
 - This can change quickly
 - There are worse things than sitting on a lot of cash
 - Buffett has said Berkshire will distribute cash if he doesn’t think he can allocate it

Conclusion

- Cheap stock: 75-cent dollar, giving no value to immense optionality
- Extremely safe: huge cash and other assets provide downside protection
- Strength, stability and certainty lend themselves to levered investment through LEAPs