Berkshire Hathaway - It is Unlikely I'll Invest In BRK Soon

Despite being a large business, Berkshire is simple as an investment; you just need to know the key factors about it to understand the most likely investing outcome. Those key factors are its business quality, valuation/price and then the most important thing, investment timing and sizing.

BUSINESS QUALITY/NO RISK

Berkshire is a financial fortress made to last and compound over time. Buffett and Munger know that most businesses go bankrupt over time and therefore Berkshire is structured in a way not to allow going bust. By having $123 billion in cash and cash equivalents, you can be pretty sure that all the possible insurance obligations will be covered even in the worst-case scenario, thus Berkshire won't go bust that easily.

Part I Financial Information
Item 1. Financial Statements
BERKSHIRE HATHAWAY INC.
and Subsidiaries
CONSOLIDATED BALANCE SHEETS
(dollars in millions)

	September 30, 2022 (Unaudited)	December 31, 2021
ASSETS		
Insurance and Other:		
Cash and cash equivalents*	$ 28,869	$ 85,319
Short-term investments in U.S. Treasury Bills	76,332	58,535
Investments in fixed maturity securities	18,602	16,434

BRK cash position - Source: [BRK Q3 2023 Financial Statement]

If a business doesn't go bust, it can compound over time. For long-term compounding Buffett likes to invest in great businesses with strong cash flows at a fair price. Those businesses include Apple, Burlington Northern, Geico, Bank of America, Coca-Cola and many more...

Shares	Company	Percentage of Company Owned	12/31/21 Cost*	Market
			(in millions)	
151,610,700	American Express Company	19.9	1,287	24,804
907,559,761	Apple Inc.	5.6	31,089	161,155
1,032,852,006	Bank of America Corp.	12.8	14,631	45,952
66,835,615	The Bank of New York Mellon Corp.	8.3	2,918	3,882
225,000,000	BYD Co. Ltd.**	7.7	232	7,693
3,828,941	Charter Communications, Inc.	2.2	643	2,496
38,245,036	Chevron Corporation	2.0	3,420	4,488
400,000,000	The Coca-Cola Company	9.2	1,299	23,684
52,975,000	General Motors Company	3.6	1,616	3,106
89,241,000	ITOCHU Corporation	5.6	2,099	2,728
81,714,800	Mitsubishi Corporation	5.5	2,102	2,593
93,776,200	Mitsui & Co., Ltd.	5.7	1,621	2,219
24,669,778	Moody's Corporation	13.3	248	9,636
143,456,055	U.S. Bancorp	9.7	5,384	8,058
158,824,575	Verizon Communications Inc.	3.8	9,387	8,253
	Others***		26,629	39,972
	Total Equity Investments Carried at Market		$ 104,605	$ 350,719

BRK's stock portfolio end 2021 - Source: BRK 2021 Letter

As the business is well known, let's focus the trickier part, valuation.

VALUATION/PRICE

As shown above, Berkshire is Berkshire, the key question to answer is at what price it fits your portfolio. For that, we need to get to Berkshire's 'true earnings' as Buffett likes to say, then we can make a valuation and understand the price at which it would fit your portfolio.

Earnings

In a stable economy Berkshire makes approximately $7 billion in free cash flow/profit per quarter like it did in the last quarters, thus $28 billion per year.

	Third Quarter		First Nine Months	
	2022	2021	2022	2021
Revenues of Operating Businesses				
Insurance:				
Underwriting:				
GEICO	$ 9,808	$ 9,604	$ 29,169	$ 28,073
Berkshire Hathaway Primary Group	3,485	2,964	9,916	8,373
Berkshire Hathaway Reinsurance Group	5,517	5,159	15,304	14,868
Investment income	1,683	1,339	5,331	4,212
Total insurance	20,493	19,066	59,720	55,526
BNSF	6,693	5,790	19,301	17,000
BHE	7,531	7,013	20,032	19,022
Manufacturing	19,000	17,496	57,193	50,821
McLane	13,569	12,612	39,346	36,529
Service and retailing	9,567	8,679	28,299	25,614
	76,853	70,656	223,891	204,512
Reconciliation of segments to consolidated amount				
Corporate, eliminations and other	81	(73)	33	(216)
	$ 76,934	$ 70,583	$ 223,924	$ 204,296

	Third Quarter		First Nine Months	
	2022	2021	2022	2021
Earnings (Loss) Before Income Taxes of Operating Businesses				
Insurance:				
Underwriting:				
GEICO	$ (759)	$ (289)	$ (1,424)	$ 1,360
Berkshire Hathaway Primary Group	(281)	(23)	53	349
Berkshire Hathaway Reinsurance Group	(110)	(708)	1,013	(1,298)
Investment income	1,678	1,337	5,322	4,205
Total insurance	528	317	4,964	4,616
BNSF	1,884	2,029	5,844	5,667
BHE	1,321	1,375	2,561	2,797
Manufacturing	2,883	2,445	8,735	7,595
McLane	112	(8)	270	179
Service and retailing	1,202	1,110	3,536	3,234
	7,930	7,268	25,910	24,088
Reconciliation of segments to consolidated amount				
Investment and derivative gains (losses)	(13,465)	4,921	(82,362)	38,015
Interest expense, not allocated to segments	(99)	(128)	(303)	(386)
Equity method investments	441	377	1,048	775
Corporate, eliminations and other	1,076	46	2,920	241
	$ (4,117)	$ 12,484	$ (52,787)	$ 62,733

BRK income statement business by business - Source: BRK Q3 2023 Financial Statement

To the earnings from the owned businesses, you can add approximately $8 billion per year in earnings that the businesses in stock market portfolio earn but don't pay in dividends which is the income part not accounted for in Berkshire's financial statements. As Berkshire doesn't own more than 50% of those businesses, accounting rules state that those earnings are not consolidated into its financial reports.

Example: Berkshire owns 5.6% of Apple where Apple's trailing twelve months net income is $99.8 billion. Thus, Bekrhire's share of Apple's profits is $5.6 billion. However, as Apple has a 14.8% dividend payout ratio, only the dividend is accounted for into Berkshire's financial statements, approximately $820 million.
The remaining $4.8 billion are not accounted for and can be considered hidden earnings. If we add the other companies that don't pay out all their profits into dividends like American Express, we quickly surpass $8 billion in hidden earnings. You can read more about the way Berkshire's manages earnings in their Owner Related Business Principles, principle number 6:

6. *Accounting consequences do not influence our operating or capital-allocation decisions. When acquisition costs are similar, we much prefer to purchase $2 of earnings that is not reportable by us under standard accounting principles than to purchase $1 of earnings that is reportable. This is precisely the choice that often faces us since entire businesses (whose earnings will be fully reportable) frequently sell for double the pro-rata price of small portions (whose earnings will be largely unreportable). In aggregate and over time, we expect the unreported earnings to be fully reflected in our intrinsic business value through capital gains.*

We have found over time that the undistributed earnings of our investees, in aggregate, have been fully as beneficial to Berkshire as if they had been distributed to us (and therefore had been included in the earnings we officially report). This pleasant result has occurred because most of our investees are engaged in truly outstanding businesses that can often employ incremental capital to great advantage, either by putting it to work in their businesses or by repurchasing their shares. Obviously, every capital decision that our investees have made has not benefitted us as shareholders, but overall we have garnered far more than a dollar of value for each dollar they have retained. We consequently regard look-through earnings as realistically portraying our yearly gain from operations.

Bekrshire's Owner Related Business Principles

To sum up, on a yearly basis, we are at $36 billion of earnings or better to say value creation. Let's go to valuation.
Note: you need to adjust Berkshire's earnings for the changes in value of the stock market portfolio under the account 'investment and derivative gains (losses) - totally wrong accounting there but that is the law, even Warren discussed that in almost every letter. Berkshire's reported earnings move up and down depending on the swings on the stock market in relation to its stock portfolio. That is obviously irrelevant for long-term investors.

Valuation

If the average earnings are $36 billion with likely growth of an average 6% in the future based on the assumption that Berkshire will continue to reinvest all its profits and target returns on investment of 8 to 10% as Charlie and Warren often stated, where I deduct two percentage points to account for recessions over time.

If we make a short intrinsic value exercise, using a 10% discount rate and various terminal multiples we get to the following valuations for Berkshire.

COMPARATIVE TABLE'!A1

												Terminal Value	Growth rate	
Scenario 1	BRK INCOME IN BILLIONS	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2032	6%	next 5 years
normal case	36,00	38,16	40,45	42,88	45,45	48,18	51,07	54,13	57,38	60,82	64,47	912,32	6%	5 to 10 years
	PV(10%)											351,74	10%	Discount rate
	INTRINSIC VALUE	351,74											15,0	Terminal multiple

												Terminal Value	Growth rate	
Scenario 2	BRK INCOME IN BILLIONS	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2032	8%	next 5 years
best case	36,00	38,88	41,99	45,35	48,98	52,90	57,13	61,70	66,63	71,96	77,72	1799,10	8%	5 to 10 years
	PV(10%)											693,63	10%	Discount rate
	Present value sum	693,63											25,0	Terminal multiple

												Terminal Value	Growth rate	
Scenario 3	BRK INCOME IN BILLIONS	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2032	5%	next 5 years
worst case	36,00	37,80	39,69	41,67	43,76	45,95	48,24	50,66	53,19	55,85	58,64	837,72	5%	5 to 10 years
	PV(10%)											322,98	10%	Discount rate
	Present value sum	322,98											15,0	Terminal multiple

Scenario	Probability	PV	Part
Scenario 1 (normal case)	0,6	351,74	211,04
Scenario 2 (best case)	0,2	693,63	138,73
Scenario 3 (worst case)	0,2	322,98	64,60
Stock Price		Sum	414,36

Disclaimer: This is just for educational purposes and not for investing advice!

MADE BY STOCK MARKET RESEARCH PLATFORM

SVEN CARLIN RESEARCH PLATFORM

BRK Stock Valuation - Source: Sven Carlin (free template download)

In my normal case scenario, with growth of 6% per year and where its valuation reverses to the historical mean of 15, expecting a 10% investment return per year, Berkshire is extremely overvalued and it should fall almost 50% to offer a 10% yearly investing return.

To justify the current market perspective on Berkshire, if one would expect a 10% return going forward, it should grow at 8% and then have a 25 PE ratio which is very unlikely.
If I adjust my expected return or the discount rate to 6%, put a more likely PE ratio of 17 and allow for 8% growth per year, also a stretch in my opinion, but only in such an exuberant scenario one could say BRK would be fairly valued at the moment.

												Terminal Value	Growth rate	
Scenario 2	BRK INCOME IN BILLIONS	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2032	8%	next 5 years
best case	36,00	38,88	41,99	45,35	48,98	52,90	57,13	61,70	66,63	71,96	77,72	1223,39	8%	5 to 10 years
	PV(6%)											683,14	6%	Discount rate
	Present value sum	683,14											17,0	Terminal multiple

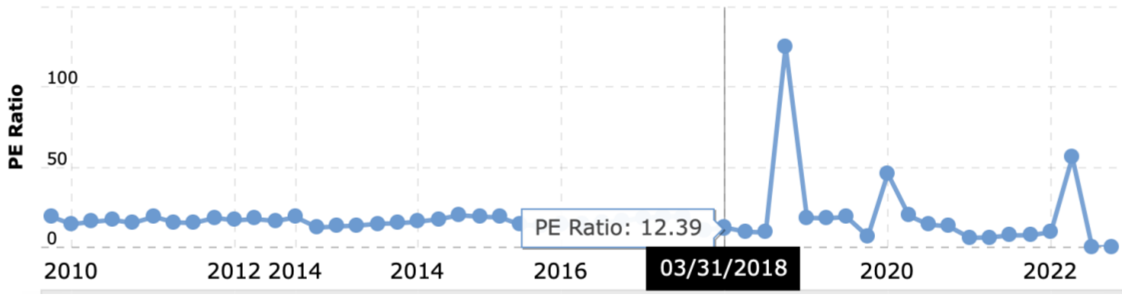
BRK's Stock Valuation Justifying Current Market Value

A 6% return is not bad for most people, but likely not worth the risk of a worst-case scenario. If Berkshire grows just 5% per year going forward and then get a PE ratio of 15, the terminal market capitalization 10 years from now would be $837 billion for a miserable 2% yearly investing return.

At current levels, it is likely investing in Berkshire will lead to positive returns over time. That is not bad given BRK's quality and low risk, but still, one should mind the best exposure to one's portfolio as it is unlikely the returns will be as good as those were in the past.

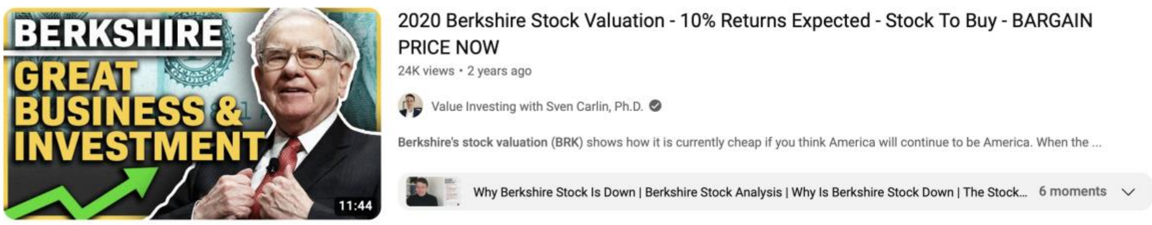
Investment timing and portfolio exposure

The average historical PE ratio for Berkshire is 15. In exuberant times it reaches 20 and falls to 10 in panicky times when the predominant mantra is that Buffett is old and has lost his touch. (we can't use the PE ratio from 2019 onwards due to the change in accounting for profits - has to be adjusted)



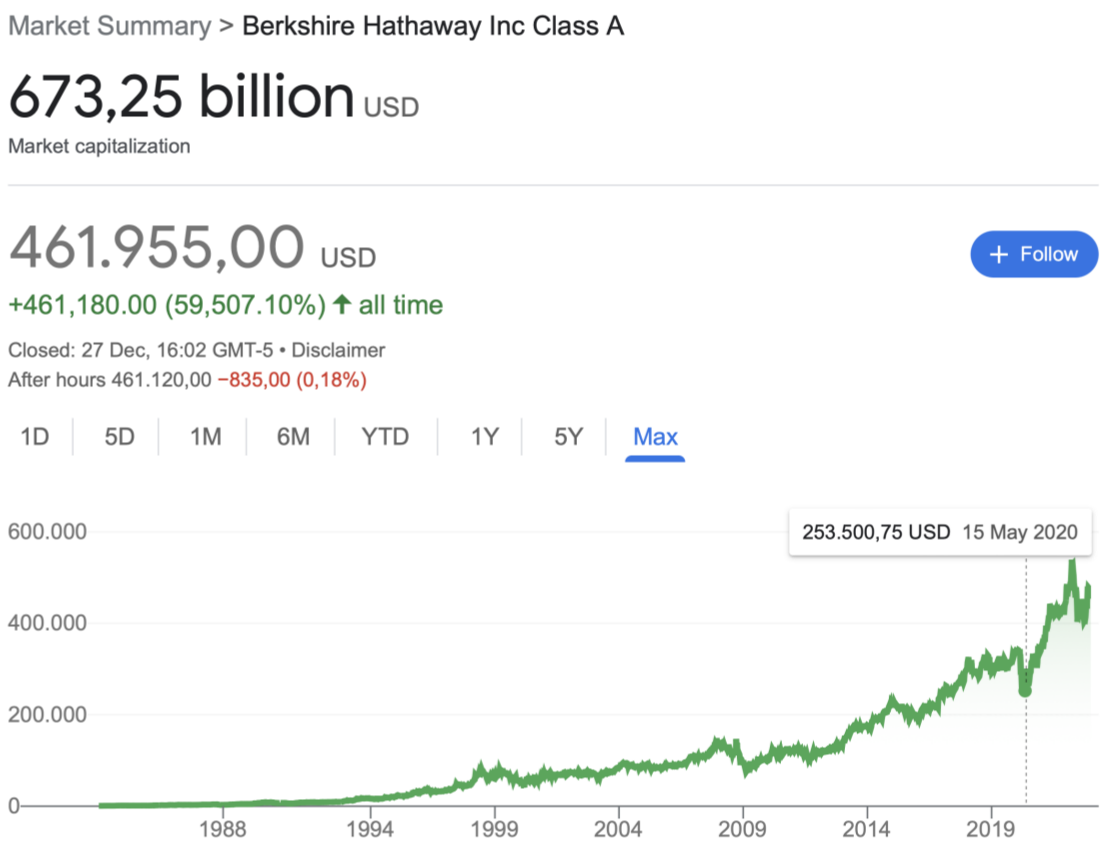
BRK historical valuation - Source:

If we use a PE ratio of 10, BRK is a great buy at a market capitalization of $360 billion. We were close to that in period from March to May 2020 as I said in [March of 2020](#):



BRK March 2020 Video

But now, we are far from the March 2020 values and therefore the investing risk is much higher while the returns ahead will clearly be lower.



BRK.A stock price and market capitalization

What Has To Happen For Me To Own Berkshire

To invest in BRK stock with low risk and the highest return possible, it is better to buy BRK when the PE ratio of its average earnings is around 10. I would define BRK's average earnings as what it makes in a good business year. In the next recession, earnings should be lower and the market might react negatively creating a better buying opportunity. Now, BRK is closer to the higher range of its historical PE valuation and the market is currently paying a premium for its quality. Thus, the returns are likely to be lower in the future.

You might think that given Berkshire's quality, at a PE ratio of 10, I would load the truck with BRK stock. Not that fast because if there is a recession, it is very possible that BRK will drop 50% to a PE ratio of 10. But, if a recession happens, there could be much better risk and especially reward opportunities out there. As the economy gets back on track, BRK stock might double, but if you buy something else, you might have better returns.

In May of 2020, I bought more of Ternium than BRK and given that is a cyclical, when the cycle reverts you can expect better and faster returns than what BRK offers. Of course, it is more volatile, but if you know what you are doing, the risks might be equal and the returns much higher.

The only possibility for me to own BRK is a 2000 situation when the market was infatuated with dot-com stocks and trashed BRK and Buffett. Only is such a situation, where there are no other opportunities, BRK stock might be attractive to me.

To conclude, from an absolute return perspective BRK is an amazing buy at a PE ratio of 10, but at that point, from a relative perspective it could still be expensive given that other things might be much cheaper and offer much better reward opportunities for slightly higher risks. As always, the best time to buy BRK stock is when headlines discuss how Buffett lost his touch.

Light on tech, heavy on banks — has Warren Buffett lost his touch?

The famed stockpicker had his worst performance versus the S&P 500 in a decade in 2019, and 2020 is shaping up to be nearly as bad

FT

Financial Times
Eric Platt in New York

Published Jun 30, 2020 • 6 minute read

8 Comments

Instead of taking advantage of the coronavirus crisis that hit markets in March, Warren Buffett was a casualty. PHOTO BY RICK WILKING/REUTERS FILES

June 2020 - Financial Times - BRK up 74% vs. 26% for the S&P 500 since
To conclude, Berkshire is one of the best businesses out there and will certainly compound your money over the next decades. Also, it will be a good investment if you don't have better, but I think that with a bit of effort one can find better. If you can't, then sure, BRK stock is one of the best investments you can make out there!