Strong 2Q earnings for Berkshire Hathaway – An Added Value Play for US Equity Exposure

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Led by the legendary investor Warren Buffett,
Berkshire Hathaway (BRK) Inc., is a holding company that owns subsidiaries engaging in diverse business activities across various industries. In our Thinking Man's note in May, we recommended that clients looking for added value to their US Large Cap core holding substitute part of this exposure with Berkshire Hathaway stock- because of the company's positioning to play the US economic recovery and access to a portfolio of private companies selected by the world's leading investor. On Friday, August 2nd, the company reported strong second quarter earnings, and we continue to believe that the company is well positioned to add value to an investor's US equity portfolio.

We live in a world with a sluggish US recovery, a potential hard landing in China, and Europe bottoming-out from the worst recession in post WWII history. The macro environment, while improving from recent years past, is still delicate.
The equity markets over the past few years have been strong-but it's important to note that during the last 3 years, companies were able to squeeze profit margins quite dramatically, while sales growth has been on average quite sluggish. During 2013, the S&P 500 index return of almost 20% has then been mainly explained by an expansion in the market multiple (i.e. valuations in the equity market). We think that the US equity market will continue experiencing market multiple expansion. We may start to be concerned when we get to a multiple of 18X (from 16X today), which we guess may occur during the first year of monetary policy tightening (please do not confuse with monetary policy "tapering").
Thus, it becomes more and more important to find companies that still offer growth at attractive valuations. During the 2Q13, S&P 500 companies posted quite sluggish top and bottom-lines: year-over-year 2Q13 profits rose by an average of 3.6% while sales grew by 1.2%.[1] Let's contrast that with Berkshire Hathaway that just posted 2Q13 profits rising 49% while sales grew by 16% year-over-year (yoy). Excluding the impact of gains on investments and derivatives, revenue increased 12% yoy.[1]

The Thinking Man's Approach

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Last week, Berkshire Hathaway announced its second quarter earnings and reported very strong sales and earnings growth- with 49% growth year-over-year in profits and 16% growth in sales. For the same period- the S&P 500 reported 3.6% growth in profits and 1.2% growth in sales. Berkshire Hathaway has benefitted from its portfolio of high quality privately held companies and exposure to sectors which are benefitting from the stabilization of the US economy. We recommend clients substitute 10% of their US equity large cap exposure for Berkshire Hathaway.

In this sense, we re-iterate (as we published in The Thinking Man's May note) our thesis that Berkshire Hathaway constitutes a good opportunity to substitute up to 10% of a client's US Large Cap exposure for several reasons:

1. BRK is well positioned to take advantage of the US economic recovery, especially in financials, housing and railroads.

   These segments of the business reported strong earnings results for the second quarter and have positive outlooks. The financial and financial product segments reported an 11% yoy earnings increase. The manufacturing, service, and retailing segment (which includes many of the consumer products and housing businesses) reported sales increases of 16% yoy. Burlington Northern Santa Fe- which has been a star performer (especially in industrial products and petroleum shipments) increased revenues by 5% yoy.

2. Further realization of profits from past investments and derivatives

   Investment and derivates are having a strong impact on the profits of the business- as demonstrated by their impact on earnings in 2Q13

3. Private equity portfolio of BRK is a catalyst of value for shareholders

   Some analysts estimate that in 2013, 70% of BRK's earnings will come from this private portfolio, and only 30% from the publicly traded equity portfolio.[1] Given that we are likely entering an environment where US equities will be approaching full value levels- exposure to privately held companies provides investors an attractive opportunity.

4. Further accretive acquisitions

   In 2012, Berkshire Hathaway made 26 acquisitions, a record year. They are continuing to be active in acquisitions in 2013- as BRK laid out $12.3B for its investment in Heinz, and $2.1B for additional stakes in Iscar (a dynamic full line supplier of precision carbide metal working tools) and Marmon (a global diversified industrial company). Warren Buffet said he believes his future acquisitions - which have in the past included large multi billion dollar deals that have been increasingly scarce- will include more transactions which are smaller in size. Rather than wait for the "elephants" he can hunt down, he is more willing to look actively to use Berkshire's cash and invest in smaller transactions that he hopes will increase the company's earnings.

[1] Bloomberg data as of August 9, 2013. 448/499 companies reporting
[1] Morningstar Institutional Equity Research
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Lastly, with BRK's book value per Class A share at $122,900 (or $82 per class B share), Buffet would now be willing to step in and buy back stock up to $147,500 per class A share (or $98 per class B share), implying a floor on the company's shares around 15% below current prices.

While the stock has significantly outperformed the S&P 500 index this year, we believe that it will continue to provide value to an investor's US equity portfolio. The strong results of second quarter re-iterate our thesis that the business is well positioned. Mr. Buffet's plans to widen BRK's scope of acquisitions to include smaller deals signals that the company's private equity portfolio will continue to grow- an attribute we like as it provides immense value to investors.

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