

Warren buffet case essay sample



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A) What is the possible meaning of the changes in stock price for GEICO and Berkshire Hathaway on the day of the acquisition announcement?

Specifically, what does the \$718 million gain in Berkshire's market value of equity imply about the intrinsic value of GEICO?

Valuation of GEICO

Warren Buffet bought the company of GEICO for 70\$ per share, which he estimated to an appropriate price for the purchase of the company. Warren Buffet is focused on the future cash flow that GEICO may generate, and use this to value the company before a purchase of stocks. The acquisition of GEICO shows that Warren Buffet had a big confidence in the company, which he also mentions in the note: * Seven largest auto insurer.

* Extraordinary senior managers that may provide additional depth to Berkshire Hathaway's senior management bench *the lowest-cost insurance provider in the industry.

Warren Buffet believed that GEICO was undervalued on the stock market and that they were stronger than what the current stock price said. He had also had his eyes on the company since as early as 1951, when he made his first investment in the company. GEICO was a company that Buffett were comfortable with and which he had followed closely for over four decades, which follows his investment philosophy to aim for long-term investments. With the insight in the company and the way that GEICO performed businesses compared to other insurance companies it had performed very well previously. NYTimes reported on the 26th of August, 1995 that “ Geico, the country's sixth-largest car insurer, has been a solidly profitable company

in recent years with a good record for low losses and low expenses in comparison with others in its business. These results have been possible because the company bypasses agents, selling directly to the consumer, concentrating on low-risk drivers.” Baltimore sun reported on the same day regarding GEICO “ In the years since, Geico has become known as an extremely picky underwriter, undercutting competitors for the business of drivers with clean records but demanding far higher premiums from customers who have had even one driving violation.

It also has among the lowest administrative costs in the insurance business because it sells most policies over the phone without using insurance agents.” The intrinsic value of the company was higher than the book value that had deteriorated due to inflation and costs. Los Angeles Times also mention in their article the day after the announcement from Buffett that analysts speculated in that by acquiring GEICO, Buffett tried to groom a successor. Warren Buffett, 65 years at this time, tried to find a stable management team for Berkshire Hathaway in case of that he would have to step down. The acquisition of GEICO was thereby not just an investment in a company that made good profits, but also an investment for Berkshire Hathaway to remain stable in the future with a good management team. According to the Autobiography about Warren Buffett, “ The Snowball”, the payment for the stocks in GEICO was done in shares in Berkshire Hathaway. Instead of lowering the capital that Berkshire Hathaway had in direct cash, and paying with shares of his own company, there was no direct negative cash flow out from Berkshire Hathaway. (Page 747) Walt Disney Company:

Walt Disney Company announced three weeks before the Buffett announcement that they intended to acquire the stocks in Capital Cities/ABC for \$19 Billion dollars. With the 13% ownership of the Capital Cities/ABC, the result was going to be a gain of approximately \$2 billion dollars for Berkshire Hathaway that they then would be able to reinvest. The capital gain on the sales of Capital Cities would more or less finance the acquisition of GEICO.

Berkshire Hathaway Stock:

The Berkshire Hathaway A stock closed on the 24th of August 1995 at \$24, 800 and on the 25th of August at \$25, 400. In August up to the announcement, the Berkshire Hathaway had been closing at an average of \$24, 753. This shows that the announcement had a direct impact of the stock price. The reason for the increase in the stock price in Berkshire Hathaway was dependant on several factors. With the GEICO stock rising with \$12. 875 to \$68. 625 on the New York Stock Exchange, Geico Hathaway gained approximately \$440 million on their 34. 25 million shares in GEICO. With the gain from the upcoming deal with Walt Disney Company, as well as the publication of the Value Line Forecast for GEICO, it is understandable that the Berkshire Hathaway stock rose. Another factor that also comes into play in this case is the famous track record of Warren Buffett when it comes to investing. Conclusion: The increase in Berkshire Hathaway was a response from the markets valuation of GEICO Company to increase, the reinvestments of the money that would be gained on the future sales of Capital Cities/ABC, as well as the markets trust in Warren Buffett's investments to be successful.

B) How well has Berkshire Hathaway performed? In the aggregate? In its investment in Scott & Fetzer? In its investments in earlier purchases of GEICO stock? In its investments in convertible preferred securities?

Berkshire Hathaway has a very good proven track record, due to the investments in stable companies that may provide a good future cash flow. With the average of a 28% annual increase in wealth. Note in “ The Snowball (cpt 46 note 52) Berkshire Hathaway annual letter, 1985. The deal was \$320 million in cash and the rest in assumed debt and other costs. “ Scott Fetzer Holders Clear Sale of Company,” Wall Street Journal, December 30, 1985. In Berkshire’s 2000 annual report, Buffett points out that BRK netted \$1.03 billion from its net purchase price of \$230 million. According to Exhibit 5 we can estimate returns on stock for each year from 1986 to 1994 and annual growth rate on earnings per share.

Scott and Fetzer|

Stock return| Growth on earnings|

23%| 0|

55%| 121%|

61%| 119%|

49%| 101%|

58%| 105%|

46%| 100%|

58%| 115%|

70%| 110%|

87%| 102%|

average growth| 109%|

growth since 1986| 197%|

This gives us really good numbers to define company's performance in acquiring of Scott's and Fetzer stocks with average return on share of 56% and average growth rate of 109% with a total growth from 1986 to 1994 of 197%. With the GEICO stock rising with \$12. 875 to \$68. 625 on the New York Stock Exchange, Geico Hathaway gained approximately \$440 million on their 34. 25 million shares in GEICO. During the period from 1976 to 1980 GEICO stock price was seriously damaged by inflation and various other factors. In 1995 original stake of 45, 7 million grew to 1, 9 billion dollars which is . GEICO paid increased dividends per share from 1976 to 1994 with average return on stock of 13, 5%. Concerning preferred securities, we estimated return on securities throughout their holding period till 1995 when most of those stocks would be converted into common shares or redeemed by issuers with contracted redeemed price: Corp| Preferred Stock Return|

CIP| 39%|

First Empire| 184%|

Gillette| 326%|

Salomon| 13%|

USAir Grp| -31%|

According to these numbers Berkshire's investments on average made 106% before 1995 when convertible part strikes in. Valuing return after 1995 is a question of opportunistic cost decision.

D) Based on Value Line's forecast information, what is the range of possible intrinsic values for GEICO? What questions might you have about this estimated range?

Cost of equity of 11

1996| \$1. 16| $PV = 1.16 / (1.11) = 1.05$ |

1997| \$1. 25| $PV = 1.25 / 1.11^2 = 1.01$ |

1998| \$1. 34| 0. 98|

1999| \$1. 44| 0. 95|

2000| \$1. 55| 0. 92|

Forecast Stock price | \$90| 53. 41|

Current Stock Value=

$1.05 + 1.01 + 0.98 + 0.95 + 0.92 + 53.41 = \58.32

1996| \$1. 16| $PV = 1.05$ |

1997| \$1. 34| $PV = 1.09$ |

1998| \$1. 55| 1. 13|

1999| \$1. 79| 1. 18|

2000| \$2. 07| 1. 23|

Forecast stock price | \$125| 74. 18|

Current Stock Value= $1.05 + 1.09 + 1.13 + 1.18 + 74.18 = \79.85

Questions:

1. What assumption did they make in forecasting dividends and growth rate?
2. Why even after the publication of the survey , the stock price did not change? Estimated growth rates from table 1. Value line Projection;

$$1. 55/1.16 = (1+g)^4$$

$$g = 7.5\% \text{ (low -end)}$$

$$2. 07/1.16 = (1+g)^4$$

$$g = 15.58\% \text{ (high-end)}$$

$$g = k - D/p$$

$$g = 11\% - 1.16/55.75$$

$$g = 8.91\% \text{ (market growth rate)}$$

$$g = 11\% - 1.55 * (1 + 0.0751) / 90 = 9.15\%$$

$$g = 11\% - 2.07 * (1 + 0.1558) / 125 = 0.0908 * 100 = 9.08\%$$

Buffett's reason for doing this investment is that most probably he expected a growth rate of more than 9%.

E) Please critically assess Buffett's investment philosophy, and prepare to identify points where you agree and disagree with him.

1. Economic reality, not accounting reality

* In a very elegant way, Warren Buffet is correct in his assumption.

Accounting standards are designed to take an otherwise insurmountable volume of information of every company, and convey it in a concise and quickly digestible format. By definition, this process must sacrifice some degree of informational accuracy and dept. 2. The cost of the lost opportunity

* Warren Buffet agrees with a long standing economic tenet that states: "rational choices are made by comparing the outcome to the opportunity cost of the next best alternative". This is consistent with a logical and rational decision making process. 3. Value creation: time is money

* The cornerstone to fundamental analysis is the Net Present Value of the discounted cash flow for a company. The pros are that it is a simple and easy to understand measure of economic performance, and also conveys what the present value is of what the business owner can expect to earn. The negative side to this measurement is that it is highly subjective. Whoever is doing the measurement must essentially make guesses about the size and duration of future growth rates, leading to a highly subjective “ touch and feel” Net Present Value solution.

4. Measure performance by gain in intrinsic value, not accounting profit * Intrinsic value vs. accounting profit is a very strong analytical tool. Nominal values are only useful when considered what the alternatives are, or real values. A 10% return is only valuable so long as the market is getting <10% return, and vice versa.

5. Risk and discount rates/Diversification

* It is true that the more an investor knows about a company, the more certain that investor can be about that companies future. However, Warren Buffet argues that eliminating idiosyncratic risk through in-depth research into a single company is a stronger tool than diversification. If every investor had the access to information that Warren Buffet does, through sitting on the board of directors or having close relationships with key decision makers, then a stronger case could be made. Unfortunately this is not the case. Diversification can still be used as a tool to protect an investor; a force majeure cannot be predicted through company research just as macroeconomic risks cannot be deduced no matter how well an investor understands a single company.

6. Investing should be done through analyses, not hunch

* Any rational decision maker will strongly agree with this statement. Warren buffet however goes on to chide the efficient market hypothesis and market timing, which is contestable. While both have flaws, they have been proven in cases as useful tools. Statistical techniques for identifying market trends are generally highly profitable before being revealed to the rest of the market, and dollar cost averaging can be used to mitigate trading risk. Ironically, many of these tools are used through logical analysis rather than hunch.

7. Alignment of agents and owners

* The pros to aligning agents and owners are in accountability. Agents are given a disincentive to profit at the cost of the owners, since they are themselves the owners. Warrant Buffet's salary is only 100k for serving as CEO, so the majority of his compensation is directly tied to performance of Berkshire Hathaway. This is an elegant tool to address the moral hazard between ownership and control. The downside is that the owners are subject to the preferences to those in control, precluding a manger from catering to an owner who may hold a divergent interest.