Book value vs. intrinsic value

Letters: 1992, 1994, 2018 · Difficulty: Intro

Summary

Book value is what the balance sheet says shareholders' equity is; **intrinsic value** is the discounted value of the cash a business will produce. Because assets are recorded at historical cost and internally built value is not recorded, the two can differ widely. In 2018 Buffett stopped using book value as Berkshire's headline measure.

1992 letter

Chairman's Letter - 1992 BERKSHIRE HATHAWAY INC. To the Shareholders of Berkshire Hathaway Inc.: Our per-share book value increased 20.3% during 1992. Over the last 28 years (that is, since present management took over) book value has grown from $19 to $7,745, or at a rate of 23.6% compounded annually. During the year, Berkshire's net worth increased by $1.52 billion.

…

Our management - visibly in heat - quickly capitulated. The owner of the acquiree then insisted on one other condition: "You must promise me," he said in effect, "that once our merger is done and I have become a major shareholder, you'll never again make a deal this dumb." You will remember that our goal is to increase our per-share intrinsic value - for which our book value is a conservative, but useful, proxy - at a 15% annual rate. This objective, however, cannot be attained in a smooth manner.

…

Whether appropriate or not, the term "value investing" is widely used. Typically, it connotes the purchase of stocks having attributes such as a low ratio of price to book value, a low priceearnings ratio, or a high dividend yield. Unfortunately, such characteristics, even if they appear in combination, are far from determinative as to whether an investor is indeed buying something for what it is worth and is therefore truly operating on the principle of obtaining value in his investments. Correspondingly, opposite characteristics - a high ratio of price to book value, a high price-earnings ratio, and a low dividend yield - are in no way inconsistent with a "value" purchase.

Similarly, business growth, per se, tells us little about value.

…

Even so, there is an important, and difficult to deal with, difference between the two: A bond has a coupon and maturity date that define future cash flows; but in the case of equities, the investment analyst must himself estimate the future "coupons." Furthermore, the quality of management affects the bond coupon only rarely - chiefly when management is so inept or dishonest that payment of interest is suspended. In contrast, the ability of management can dramatically affect the equity "coupons." The investment shown by the discounted-flows-of-cash calculation to be the cheapest is the one that the investor should purchase - irrespective of whether the business grows or doesn't, displays volatility or smoothness in its earnings, or carries a high price or low in relation to its current earnings and book value. Moreover, though the value equation has usually shown equities to be cheaper than bonds, that result is not inevitable: When bonds are calculated to be the more attractive investment, they should be bought.

…

Our shareholders think and behave like rational long-term owners and view the business much as Charlie and I do. Consequently, our stock consistently trades in a price range that is sensibly related to intrinsic value. Additionally, we believe that our shares turn over far less actively than do the shares of any other widely-held company.

…

Contributions made through the program were $7.6 million, and 2,810 charities were recipients. I'm considering increasing these contributions in the future at a rate greater than the increase in Berkshire's book value, and I would be glad to hear from you as to your thinking about this idea. We suggest that new shareholders read the description of our shareholder-designated contributions program that appears on pages 48-49.

1994 letter

To the Shareholders of Berkshire Hathaway Inc.: Our gain in net worth during 1994 was $1.45 billion or 13.9%. Over the last 30 years (that is, since present management took over) our per-share book value has grown from $19 to $10,083, or at a rate of 23% compounded annually. Charlie Munger, Berkshire's Vice Chairman and my partner, and I make few predictions.

…

Over time, however, we believe it highly probable that the sort of businesses we own will continue to increase in value at a satisfactory rate. Book Value and Intrinsic Value We regularly report our per-share book value, an easily calculable number, though one of limited use. Just as regularly, we tell you that what counts is intrinsic value, a number that is impossible to pinpoint but essential to estimate. For example, in 1964, we could state with certitude that Berkshire's per-share book value was $19.46.

However, that figure considerably overstated the stock's intrinsic value since all of the company's resources were tied up in a sub-profitable textile business. Our textile assets had neither going-concern nor liquidation values equal to their carrying values. In 1964, then, anyone inquiring into the soundness of Berkshire's balance sheet might well have deserved the answer once offered up by a Hollywood mogul of dubious reputation: "Don't worry, the liabilities are solid." Today, Berkshire's situation has reversed: Many of the businesses we control are worth far more than their carrying value. (Those we don't control, such as Coca-Cola or Gillette, are carried at current market values.) We continue to give you book value figures, however, because they serve as a rough, albeit significantly understated, tracking measure for Berkshire's intrinsic value.

Last year, in fact, the two measures moved in concert: Book value gained 13.9%, and that was the approximate gain in intrinsic value also. We define intrinsic value as the discounted value of the cash that can be taken out of a business during its remaining life. Anyone calculating intrinsic value necessarily comes up with a highly subjective figure that will change both as estimates of future cash flows are revised and as interest rates move. Despite its fuzziness, however, intrinsic value is allimportant and is the only logical way to evaluate the relative attractiveness of investments and businesses.

To see how historical input (book value) and future output (intrinsic value) can diverge, let's look at another form of investment, a college education. Think of the education's cost as its "book value." If it is to be accurate, the cost should include the earnings that were foregone by the student because he chose college rather than a job. For this exercise, we will ignore the important non-economic benefits of an education and focus strictly on its economic value.

…

The dollar result equals the intrinsic economic value of the education. Some graduates will find that the book value of their education exceeds its intrinsic value, which means that whoever paid for the education didn't get his money's worth. In other cases, the intrinsic value of an education will far exceed its book value, a result that proves capital was wisely deployed. In all cases, what is clear is that book value is meaningless as an indicator of intrinsic value.

Now let's get less academic and look at Scott Fetzer, an example from Berkshire's own experience. This account will not only illustrate how the relationship of book value and intrinsic value can change but also will provide an accounting lesson that I know you have been breathlessly awaiting. Naturally, I've chosen here to talk about an acquisition that has turned out to be a huge winner.

2018 letter

Berkshire’s Performance vs. the S&P 500 Annual Percentage Change Year in Per-Share Book Value of Berkshire in Per-Share Market Value of Berkshire in S&P 500 with Dividends Included 1965 ..... 23.8 49.5 10.0 1966 ..... 20.3 (3.4) (11.7) 1967 ..... 11.0 13.3 30.9 1968 ..... 19.0 77.8 11.0 1969 ..... 16.2 19.4 (8.4) 1970 ..... 12.0 (4.6) 3.9 1971 ..... 16.4 80.5 14.6 1972

..... 21.7 8.1 18.9 1973 ..... 4 . 7 (2.5) (14.8) 1974
..... 5 . 5 (48.7) (26.4) 1975 ..... 21.9 2.5 37.2 1976
..... 59.3 129.3 23.6 1977 ..... 31.9 46.8 (7.4) 1978
..... 24.0 14.5 6.4 1979 ..... 35.7 102.5 18.2 1980
..... 19.3 32.8 32.3 1981 ..... 31.4 31.8 (5.0) 1982
..... 40.0 38.4 21.4 1983 ..... 32.3 69.0 22.4 1984
..... 13.6 (2.7) 6.1 1985 ..... 48.2 93.7 31.6 1986
..... 26.1 14.2 18.6 1987 ..... 19.5 4.6 5.1 1988
..... 20.1 59.3 16.6 1989 ..... 44.4 84.6 31.7 1990
..... 7 . 4 (23.1) (3.1) 1991 ..... 39.6 35.6 30.5 1992
..... 20.3 29.8 7.6 1993 ..... 14.3 38.9 10.1 1994
..... 13.9 25.0 1.3 1995 ..... 43.1 57.4 37.6 1996
..... 31.8 6.2 23.0 1997 ..... 34.1 34.9 33.4 1998
..... 48.3 52.2 28.6 1999 ..... 0 . 5 (19.9) 21.0 2000
..... 6 . 5 26.6 (9.1) 2001 ..... (6.2) 6.5 (11.9) 2002
..... 10.0 (3.8) (22.1) 2003 ..... 21.0 15.8 28.7 2004
..... 10.5 4.3 10.9 2005 ..... 6 . 4 0 . 8 4 . 9 2006
..... 18.4 24.1 15.8 2007 ..... 11.0 28.7 5.5 2008
.....

…

Over time, Charlie and I expect them to deliver substantial gains, albeit with highly irregular timing. ********** Long-time readers of our annual reports will have spotted the different way in which I opened this letter. For nearly three decades, the initial paragraph featured the percentage change in Berkshire's per-share book value. It's now time to abandon that practice. The fact is that the annual change in Berkshire's book value – which makes its farewell appearance on page 2 – is a metric that has lost the relevance it once had.

Three circumstances have made that so.

…

Charlie and I expect that reshaping to continue in an irregular manner. Second, while our equity holdings are valued at market prices, accounting rules require our collection of operating companies to be included in book value at an amount far below their current value, a mismark that has grown in recent years. Third, it is likely that – over time – Berkshire will be a significant repurchaser of its shares, transactions that will take place at prices above book value but below our estimate of intrinsic value. The math of such purchases is simple: Each transaction makes per-share intrinsic value go up, while per-share book value goes down.

That combination causes the book-value scorecard to become increasingly out of touch with economic reality. 3 In future tabulations of our financial results, we expect to focus on Berkshire's market price.

…

Predictions of that sort have never been a part of our activities. Our thinking, rather, is focused on calculating whether a portion of an attractive business is worth more than its market price. ********** I believe Berkshire's intrinsic value can be approximated by summing the values of our four asset-laden groves and then subtracting an appropriate amount for taxes eventually payable on the sale of marketable securities. You may ask whether an allowance should not also be made for the major tax costs Berkshire would incur if we were to sell certain of our wholly-owned businesses.

Source: Warren E. Buffett, Letters to Berkshire Hathaway Shareholders: 1992, 1994, 2018 (berkshirehathaway.com/letters). Excerpts © Berkshire Hathaway Inc., all rights reserved; reproduced in part for non-commercial teaching. "…" marks skipped text. The summary is original course material by Jaeyoon Yu; not affiliated with or endorsed by Berkshire Hathaway Inc.