Holland Views

BRKA US $305k – HOLD; FFH CN: $611 – BUY; EXO IM $57 – BUY; MRL US $1,060 – HOLD

Rare birds, that float

What is a float company? At its core, it is simply a well-run insurance business that judiciously uses its insurance income as a source of permanent capital for investing. The best float businesses thus enjoy both excellent underwriting and capital allocation track records – that's why they are so rare to find. Done well, float businesses can offer excellent, geared returns for equity holders. Insurance businesses are common, but successful float businesses amongst them are extremely rare.

Over the last month we have spent a considerable amount of time attending shareholder meetings and studying what we consider to be the world's best 'float' companies, namely; Berkshire Hathaway, Fairfax Financial, Markel and Exor.

Fig.1 Compounding in action – book value per share of three notable float companies

Source: Holland Advisors

In this note, we review our stance on these four businesses. Whilst the beauty of the float model lies in its simplicity, in truth, much complexity lies beneath. Simplicity in all things is good, but some of the owner-managers of these businesses (*including* Messrs Buffett and Munger) continue to over-simplify the story. We also acknowledge that a zero/low interest rate world has become a real headwind for these businesses' returns. A prudent purchase price however brings a margin of safety. We are thus drawn to either low-valued float businesses with good track records (Fairfax) or those with diversified income streams and NAV discounts (Exor).

In this note, we:

1. Recap on the traits and attractions of a 'float' business model
2. Consider the imbalance that exists in shareholder disclosure for all these businesses
3. Update company valuations and give context on capital and interest rate cycles

Float Businesses for Dummies (a guide for the rest of us)

Float businesses are simple on paper but, like most financial businesses, far more complex and gritty in real life. "Simple, but not easy", as the saying goes. Below we discuss a number of generic factors that we think are relevant in assessing these businesses. Without wanting to dumb things down too much, and with apologies to those already well versed, please allow us to recap with a Dummy's Guide to Float Businesses!

There are two key aspects to float businesses: insurance underwriting and investing.

1. **Underwriting:** Float businesses – above all else – need to write insurance premia profitably (or generate a 'combined ratio' below 100%). However, doing so on a regular and sustainable basis is much harder in reality not least due the intense competition in insurance markets. In an effort to differentiate, the best companies often seek-out specialist or niche areas in the insurance or reinsurance markets that gives them slightly greater pricing power and ideally, scale. Such market power can also derive from being the lowest-cost operator with Berkshire's GEICO being the best example of this. Combining a stream of uncorrelated insurance premia has been a key part of Berkshire Hathaway's phenomenally consistent insurance operation profits (having the genius that is Ajit Jain at the helm helps too!). Other companies such as Fairfax are now achieving consistent underwriting profits also.

   > *"it is important to recognize that underwriting is more than risk selection and pricing. It requires a comprehensive set of capabilities across hard and soft skills, qualitative judgments about future industry performance, and rigorous portfolio management to avoid markets where even great underwriting cannot compensate for unfavorable conditions. Underwriting performance is also influenced by exogenous factors, such as the business development activities with distribution partners to generate consistent and attractive submission flow*." – **McKinsey review of P&C insurers, 2019**[1]

2. **Investing:** The second part of the float business model is the profitable investment of the resulting insurance float (along with the company's own equity capital). The beauty of this, usually growing, pool of capital is that it is akin to permanent capital and can be managed like a closed-end fund.

   It's not a free lunch though – crucially this capital must be invested within the guidelines of local insurance regulators in terms of the chosen investment's asset duration and its liquidity etc. (credit ratings agencies also bring significant influence to bear here too). Each insurance business will have its own restrictions depending on its local regulatory regime, the type of insurance liabilities it has assumed and magnitude of its capital base. In other word's one float company's allowable investment mandate cannot necessarily be directly compared to another.

The beauty of float businesses for their equity shareholders is that investment returns need only be good rather than great to still deliver excellent equity returns (ROE's) at the group level. That's because not only are they investing OPM (other people's money), but in many cases, they are , in effect, being paid to use that money via the underwriting profits, what Buffett calls a "negative cost of float"! As stated above Fairfax also now looks to be generating a sustainable negative cost of float also.

[1] 'From art to science: The future of underwriting in commercial P&C insurance' – McKinsey https://www.mckinsey.com/industries/financial-services/our-insights/from-art-to-science-the-future-of-underwriting-in-commercial-p-and-c-insurance?cid=soc-web

The simple maths that has driven good long-term returns on equity and thus c.15-20% long term rises in book value at the company level of Berkshire, Fairfax and Markel (as seen in Fig.1) goes something like this:

1. Let's assume say, shareholder equity of $100 + Float of $200 = total investments of $300
2. A prudent 5% return on those total investments (5% ROA) generates c.$15 return. Thus, the Return on Equity ROE that results is 15%.
3. Higher investment returns (ROA) and notably, insurance profits (i.e. combined ratio <100% or again, what Buffett calls a 'negative cost of float') would add to such a return. Different levels of leverage (i.e. total investments/shareholder equity) also have a positive effect. This might bring our 5% ROA up to a c.20% ROE. Simple, but not easy!
4. Of $300 of total investments, 25% might be in equities – the rest in bonds.

We argue that the ability to generate a relatively low-risk c.15% ROE in today's low interest rate world is very attractive indeed although we also concede later that those same very low interest rates are becoming a major impediment for float businesses which are required to hold significant proportion of bonds in their portfolios in order to match liability duration and satisfy regulatory requirements.

Communicating complex businesses vs. 'dumbing down'

"Everything should be made as simple as possible, but no simpler." – **Albert Einstein**

As investors and analysts that have travelled to a number of these companies' investor meetings over the years (from Omaha to Toronto and Turin), a number of points become clearer if we look at these businesses dispassionately:

- Combining multiple well-run insurance operations and an investment portfolio inevitably means these businesses are quite complex both to run and to communicate to investors. Central to the complexity is the nature of liabilities taken-on and opaqueness of capital constraints both in terms of magnitude of capital and how it is allowed to be allocated by the regulators/credit rating agencies.
- The result of this is that, without exception, for each of the four companies mentioned, we experience shareholder communication, which if compared against other sectors, could be considered somewhat superficial, especially at the AGM type events rather than on conference calls.

  Case in point, have you ever seen an *aggregate* long-term return on investment metric (such as that in Fig.2 for Fairfax) disclosed by Berkshire?
- Due to the successful past performance of a number of these entities, and in truth due to the heavily aligned nature of management with shareholders, investors too often give the management a 'pass', so transparency and communication remains opaque.
- Nowhere perhaps is this more evident than in Omaha where very little negative thinking or discussion on Berkshire ever occurs (we have been guilty of drinking this Kool-Aid ourselves at times in the past).

  Buffett says he wrote this year's annual letter as if the target reader was his sister, but with due respect to Doris, perhaps she is not as concerned with the nuances of Berkshire's investment portfolio as we are.

Complexity is a fact of life but there are different ways for investors to deal with it

Insurance is a complex business. Our float companies are especially complex in that many are participating in more esoteric areas of both insurance (catastrophe, reinsurance, runoff etc.) and investments (private equity, hybrid debt, real estate, emerging markets, derivatives etc. etc.).

We acknowledge this complexity with our eyes wide open but there are two ways of looking at it perhaps. On the own hand, the closer we look at float businesses, the more we realise that they are perhaps best run either as very small specialist niche insurers with a good aligned investor or when much bigger perhaps part of a slightly more diversified group. This became evident to us at both the Fairfax and Berkshire AGMs this year.

- For example, one of **Fairfax's** limitations is currently its equity base size (and thus its corresponding capital buffers), which limits its investing options a little. The scale of the company's equity investments (25% of total) are constrained somewhat by the credit rating currently enjoyed by the business, that it wishes to retain. Float businesses like Berkshire have excess capital and thus wider investing options.

  > *"We're roughly at the upper end of our limit with respect to (equity) exposure, given the rules and regulations and that – that each of our regulators have in the insurance and reinsurance companies that we operate. So we're roughly at the top end of that range, Andrew*" – **Paul Rivett, Fairfax COO, Q4 2018 analyst call**

  We note what were Fairfax's Equity portfolio to perform better, this in itself would create more excess capital. This somewhat continuous feedback benefit of investment success suggests to us a more compelling case for compounding businesses to make up a bigger portion of the Fairfax equity portfolio than is currently the case.

- However, the reverse is also true, **Berkshire** in 2019, due to its size, is arguably less of a *classical* float model and is now more of a conglomerate, thus its growth outlook is more limited. But that same diversity of income gives its excess capital and means it can invest more in equities and also underwrite bigger insurance risks due to its scale!

- Reflecting on this, we have reconsidered our attitude to **Exor** who cannot be considered a pure-play float business – yet. As such, perhaps Exor's current mix of industrial and insurance assets is perhaps actually a more powerful combination that we might have originally assessed at the time of the Partner Re purchase.

Neither model is right nor wrong, diversified or focused, but it is easy to see why each company over time looks for growing scale and diversity of income streams. Investing success also adds to capital which in turn enables the company to be less constrained in future investments.

Markel case study – when complexity bites back

Into this complexity discussion we bring **Markel** – another float business with a good and long track record as shown in Fig.3 (and in per Fig.1 on the front page). We are wondering whether Markel maybe serves as a useful case study in when a company can take on too much complexity.

Fig.3: Markel investments: 6.3% cagr – a solid track record in investing

ANNUAL TAXABLE EQUIVALENT TOTAL INVESTMENT RETURNS

	Years Ended December 31,					Five-Year Annual Return	Ten-Year Annual Return
	2018	2017	2016	2015	2014		
Equities	**(3.5)%**	25.5%	13.5%	(2.5)%	18.6%	**9.7%**	**14.9%**
Fixed maturities[1]	**1.3%**	3.4%	2.4%	1.6%	6.5%	**3.0%**	**4.3%**
Total portfolio, before foreign currency effect	**(0.7)%**	9.2%	5.0%	0.5%	8.9%	**4.5%**	**6.4%**
Total portfolio	**(1.0)%**	10.2%	4.4%	(0.7)%	7.4%	**3.9%**	**6.3%**
Invested assets, end of year (in millions)	**$19,238**	$20,570	$19,059	$18,181	$18,638		

[1] Includes short-term investments, cash and cash equivalents and restricted cash and cash equivalents.

Source: Markel 2018 annual report

As Markel has sought better investment returns and diversity it has invested in Markel Ventures, a pot of capital that is investing in smaller (but we note often family-run) private businesses.

Markel has long had a 'copy Berkshire' modus operandi and broadly it has been successful in doing so as per Fig.1, but the Venture division clearly adds both further complexity and a lack of disclosure for investors (at least Buffett's early whole-company acquisitions could be looked-at in isolation both at the time of purchase and for a while thereafter).

Added to that, Markel recently bought specialist insurer Nephelia, what is termed an Insurance Linked Securities (ILS) business[2]. The detail of this division's activities we will not go into[3] here but in essence ILS is a form of ultra-Catastrophe reinsurance which has become a very 'fashionable' market in recent years. Perhaps it was a red flag that AIG undertook a very similar acquisition of another ILS business shortly before Markel, perhaps not. Either way, Markel shareholders recently discovered that Nephelia had been seriously under-provisioning.

We might suggest that the recent acquisitions in this area might have been misjudged, or if kinder, poorly timed. These acquisitions (on top of its existing Catco position) now make Markel a market leader in the ILS field with a 20% share. Post the problems the most recent acquisition has thrown up, the CEO, Tom Gaynor, recently stated that this area was *"a new pillar of growth for the business"*. Gaynor also asked shareholders to *"stay tuned – we are learning and figuring it out*". Whilst we admire his honesty, in truth such statements do not fill us with confidence. Surely 'figuring it out' was a pre -purchase job!

Whilst the core drivers of Markel are still those outlined in the 'simple float model' earlier on page one, we cannot help wonder if this business has not become too complex for investors to fully keep track of. Does it now require a genius to run it and if so, we are not happy with that requirement? Tom Gaynor, we assess is a very capable Investor, but no genius. As such we would have been far happier for its operations to have been kept simpler (a la Fairfax). Until recently Markel has traded at a strong premium to its book value as many investors have extrapolated it past returns. Whilst part of that premium has now eroded we still conclude that other float models offer a better rewards vs their risks. Some might argue that Berkshire's reinsurance business is no less complex to which we might reply, "fair enough but there are not many Ajit Jains in the world!"

[2] Nephelia is a so-called insurance-linked fund manager (a CatCo i.e. catastrophic reinsurance business) with c$12bn of assets.

[3] Details here: http://www.markelcorp.com/-/media/investor-relations/letters-to-shareholders/2018.pdf

Love is blind (aka giving owner-managers a 'free pass')

In truth, we find only a very small number of investors that have the time or inclination to really understand the intricacies of all the interlocked drivers of these float business. Many more investors just enjoy the ride that the like of Warren Buffett and Tom Gaynor have given them. As they seek to do so looking at such companies' pasts to understand their future is of course instructive, but it does not always provide all the answers.

Like others, we have travelled to Omaha over the years and admired and learned a great deal from Warren and Charlie. In recent years however, we feel a number of important points were not given sufficient air time by commentators:

1. Deploying capital successfully has become much harder and by definition, Buffett and Munger are now unarguably less effective at it due to Berkshire's scale and their age. Yes, they can deploy the occasional $10bn to help fund an M&A deal faster than anyone else in the world, but such opportunities are rare.

   The main capital allocation requirement at Berkshire is the purchasing of outright companies and in truth the more recent experiences of Kraft and Precision Castparts illustrate that this is not perhaps the easy game for them it once was. However, their folksy style, worldly wisdom and remarkable lifetime of compounding mean they get a "pass" on this critique from investors. We are mildly uncomfortable about this.

   We observe only that the next management team of this company will have to now take over quite soon, due to undeniable life expectancies. We do not expect those individuals to find investors quite so tolerant as to failures of capital deployment. In this area of succession, we believe Buffett and Munger have made errors. Vanity has sadly played a part. They just enjoy the Omaha love-ins too much to share the spotlight maybe?

   Being a great business manager/investor/underwriter when you are supported and protected by your high-profile boss is one thing but doing so under the spotlight of the world will be much much harder. That Berkshire has some great people and great businesses we do not contest. But that its future CEO(s) will find Mr Market the pushover it is today when it comes to communication and capital allocation scrutiny, we think very unlikely. The analogies are plentiful, following Alex Ferguson at Man Utd comes to mind. Upon Ferguson's retirement, most reasoned that surely the Man United's brand, its standing and financial clout meant its success would continue to an extent post his departure? The reality has been very very different (Four managers in only six years). Also "Simple, but not easy" perhaps?!

2. A similar love affair we think was (until recently) evident in Markel. At its shareholder meetings many investors would ask well researched questions to try to better understand the drivers of the business only to receive what in other industries would be considered a fob-off/'let me tell you a story' answer. Again, we feel that at extreme points of positive sentiment in these businesses' investors are mostly just extrapolating past returns rather than really pressing CEO's to be accountable.

To take the contrary view most of these companies are run by highly aligned owner managers and they cannot be taken over. Whilst it should be expected that this can lead to great really long-term focused decision making, it could also mean that some CEO's feel somewhat less accountable. Or perhaps they are just trying to help the average investor in the audience by not delving into a level of complexity that would only confuse many of them. We suspect a mixture of all these points is true for this group of companies but as questioning investors, we must be attuned to this issue and keep pushing such company managers (aligned or not) to tell us more. We also must be careful with the Kool-Aid!

Company Valuations: Mispricings and Margins of Safety

It is valuation that ultimately provides the true margin of safety for investors in these complex businesses. For such bond-heavy vehicles, valuations need to be taken in the context of the interest rate and capital cycles.

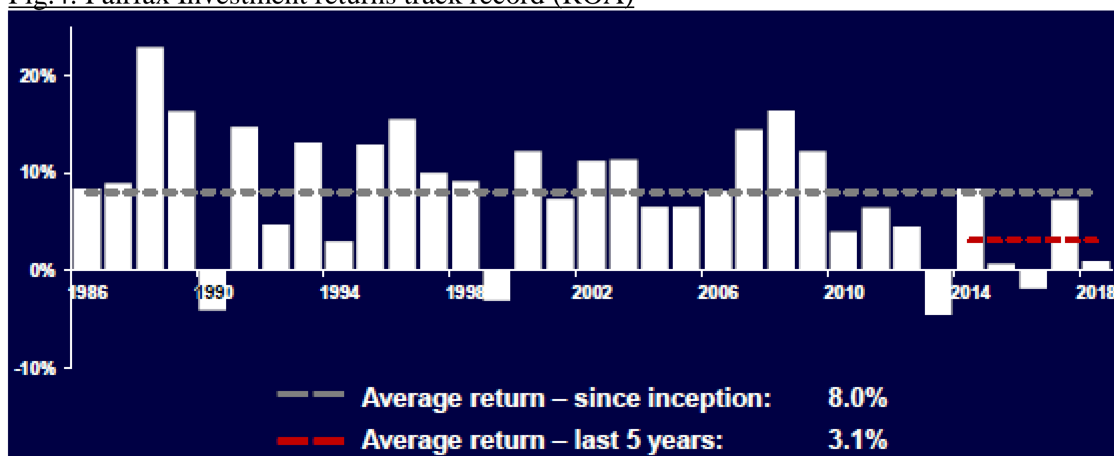
Mispricing those returns – when volatility of returns is the investor's friend

The earlier simplified example showed how a float business might generate a 15-20% ROE from a modest 5% investment return (ROA). However, in all but very exceptional cases (such as Berkshire in the 1980's) actual real-world ROEs tend to be much more very lumpy.

So even if the *average* ROE might turn out to be 15% over time, investors find valuing such a company on what is, to them, a seemingly theoretical (and indeed often never reported) figure very hard to do during periods of volatility.

An example is Fairfax's below par equity returns in 2013-2018 as shown in Fig.4 that have caused Mr Market to doubt its compounding ability. As such investors have looked for other yardsticks. More often than not, this has been Book Value per share due to the metrics comparative stability (see again Fig.1).

Fig.4: Fairfax Investment returns track record (ROA)



Source: Fairfax, 2019 AGM

Bear in mind: a company that reports a (through the cycle) 15% ROE that trades say at 1x book value is effectively being valued at a PE of 6.6x (100/15). **For a business that that has the power to, in effect, compound earnings at 15% such a valuation looks far too cheap.** Additionally, such insurance businesses are natural cash generators as the capital they require to generate each year's profits is already siting on the balance sheet at the start of the year. Thus each year's *incremental* profit can either be re-invested or used to repurchase shares. If the latter course is taken clearly there is huge value accretion as the company stock is being re-purchased is at very low valuation levels.

Re-investing for scale

With investing/capital allocation being one of the two core skills required to run a successful float business it is not surprising that high quality investors are attracted to the task. Aside from Buffett, the investment acumen of Prem Watsa or Tom Gaynor are rightly assessed by most as being of a high quality; John Elkann is too – albeit more as an industrialist in his short but impressive career.

Investors of this calibre fully understand the power of buying back stock that sits on say a notional PE of 7x when future compounding of profits is anticipated. As such, that many of these companies have in the past chosen not to do this (i.e. buy back stock) but deploy capital in their business perhaps speaks to the level of opportunity for future growth they have assessed as available to them. However as some of these companies have now reached a level of overall scale

(in Berkshire's case) or global underwriting critical mass (in Fairfax's case) the maths behind potential stock re-purchasing becomes far more real and relevant. In future we think it very plausible that these companies are likely to be sizable buyers of their own shares. (Please see our valuation work on Fairfax to better understand how this could powerfully drive future shareholder returns). In short, we think Mr Market's low rating (1x P/book) for Fairfax is an attractive opportunity (more on this later).

Valuation is thus the counter-balance (margin of safety) to complexity

On our office wall we have some inspirational quotes to keep us on the straight and narrow. Here are two:

"Think independently"
"Pay only a reasonable price, even for excellent businesses"

For all the attractions of the seemingly simple float model that we have outlined thus far, we think investors should still only buy these businesses when they think they can understand them and crucially, when they are being offered for a reasonable price. Whilst we have done less work on Markel that the other three businesses, we think that maybe today it does not pass these two tests. Exor and Fairfax, we think, do.

This is partly due to Exor's/Fairfax valuation discount vs. Sum of the Parts or future earning power. It is also due to an easier understanding of each company and a slightly more sceptical current wider investor attitude towards them (hence the value offered). In each case investor have plausible reasons to be sceptical. These being either due to Prem Watsa and team's recent poorer investment performance or due to Exor's unproven/unknown expertise in the insurance area/other asset values. Therein lies the opportunity.

As for Berkshire, we attach our annual valuation update on the float 'gorilla'. Interestingly, on a consistent basis, 2018 saw the slowest YoY growth in intrinsic value since we began our annual valuation exercise in 2012. The quality of Berkshire's fully-owned industrial assets and the scale of this 'grove' of businesses vs. the overall group suggest the shares are nearer fair value though they obviously still have future compounding characteristics. That said we cannot help wondering if there is not a better time to buy Berkshire shares in the coming years post Buffett's death and a new CEO struggling to fill his shoes. The backstop is of course sizeable buy backs. More on this below.

Interest rate cycle - ZIRP a major headwind for floats

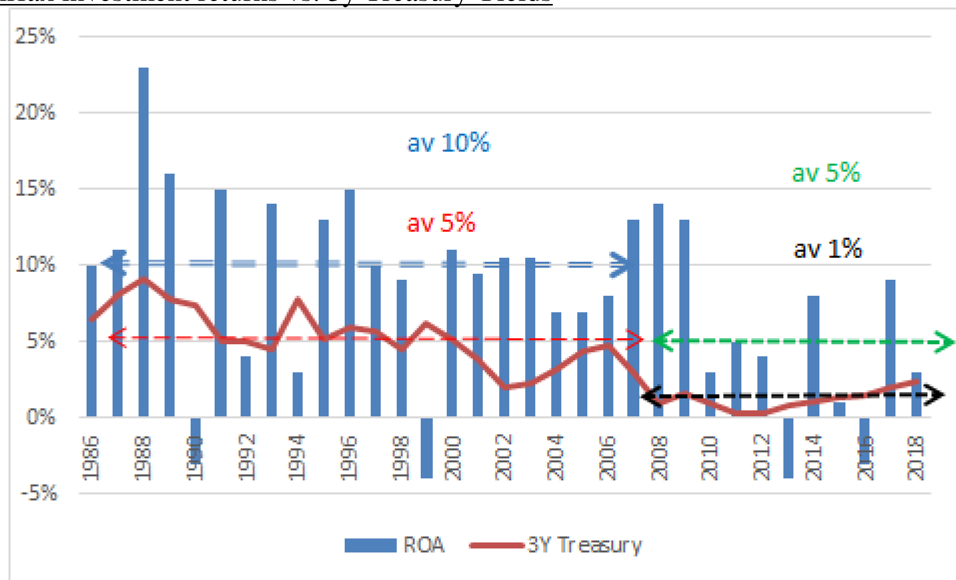
When attending meetings with these companies one trend become clear: a far greater proportion of management communication and investor questions is often disproportionately focused on the smallest part of their investment portfolio – namely equities.

This was very much evident in our trip to Toronto in April to attend the Fairfax Financial AGM. In Toronto there is good access to Prem Watsa and his team and Watsa is far better at getting his line managers more involved with presenting to investors than Buffett – which we applaud and appreciate. That said, there is still a tendency by both investors and the company to revert to discussing equity positions at length, even though they are only 25% of total investment. There is of course good reason for this, after all, getting a 3y treasury bond to talk about itself is hardly a crowd puller! That said we think the equity investment chat at all these company meetings obscures a headwind to these companies that should be more widely discussed. Our point being the following: if you are seeking to make say a 6% Investment return (ROA) in order to make a 15% ROE as Fairfax does (with a 95% combined ratio) and if 75% of your total investment are in bonds or cash yielding 3%, then by definition, your likelihood of achieving that ROA target in the near term is diminished.

By our estimations even if Fairfax were to achieve 15% Return on its c.$10bn equities pool from here it today, overall investment returns (on $40bn) would still be closer to 5% (rather than 6%) **thus a ROE of 12% would be more realistic**. The reason for the shortfall is simple: the returns available of cash and bonds book (75% of total investments) are currently 3% at Fairfax). These are suppressed in today's low interest rate world. Therefore, we think it worthwhile considering past and present investment returns in the context of short term interest rates.

There are many discussions that take place amongst investors about differing investing styles. For example, Markel has shifted to franchise investing of late whilst Fairfax continues down the road of deep-value (the former recently being more successful and thus rewarded by shareholders than the latter). However, we think the role of short-term bond and the prevailing rates on offer actually plays a bigger part.

Fig 5: Fairfax investment returns vs. 3y Treasury Yields



Source: Holland Advisors

Fig.5 puts some context around various past investment track records of these companies, using Fairfax as an example. It shows the average Return on investment assets (not ROE). This can be seen to be c.10% pa for the years 1986-2007, but only 5% since then. That 3y treasury bonds yielded 3% and 1% during these respective periods was important when c.70% of the companies invested assets were in bonds.

With this concept in our heads we could perhaps re-visit the 'genius of Berkshire and Buffett' in the 1980's: In our simple float model from Page 1, investing insurance float ($200) and equity ($100) in the 1980's backdrop with 3y treasuries and equity return rates on offer of say 6% and 12% and 75% and 25% invested respectively in each asset class what are the outcomes? An ROE of c.23% would have resulted!! This is we think a remarkable finding the reason for which being almost entirely the 6% available short term bond returns. That Berkshire was thus mispriced during much of that period (1 to 1.5x Book) is with hindsight clear to see. Today however, mispricings are however somewhat more subtle.

Important observations

Were short term interest rates to fall and stay low, Markel may have trouble earning the level of ROA and thus ROE that its still premium rating anticipates. Conversely whilst we now accept that in Fairfax case a shorter-term outlook for ROE/Book value growth of 12% is more plausible than the companies stated long term 15% target (see our IRR calculation on this below), were short term interest rates to get to 4% then Fairfax 15% RoE target might be far more easily achievable even without a drastic change in the fortunes of its equity investments. Were such a

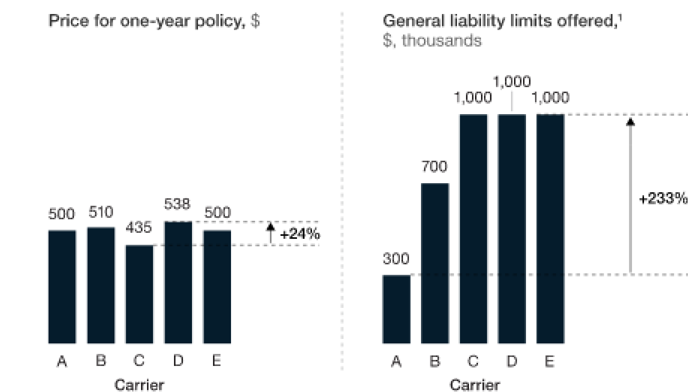
cycle to occur now, a time when Fairfax (or others) have achieved the request scale in its underwing operations it would be fair to expect the company to be a sizable and regular re-purchaser of its own stock. Such re-purchases would be powerfully accretive as our previous work has shown.

The Capital Cycle cannot be ignored either

Much is made (in sector investor commentary) of the lasting low interest rate environment and the effect they have had on bringing new capital into the insurance market.

Fig.6 A bit like airlines, not all insurers price rationally either!

A comparison of carriers found significant differences in price and coverage.



[1]Included limits: general liability per occurrence, $300,000 to $1 million; general liability annual aggregate, $300,000 to $2 million; medical, $10,000; employment practices liability, $10,000.

Source: McKinsey, 'The future of underwriting in commercial P&C', Feb 2019

Whilst this is true, we understand that the vast majority of this new money has gone into crowded sectors like catastrophe re-insurance rather than specialist lines that require longer standing operational capabilities. That the likes of Fairfax, Berkshire and Partner Re have mostly reported positive underwriting profits during this capital inflow points to their underwriting discipline and thus the quality of the insurance operations they have now established.

That said, who are we to argue with Ajit Jain?

> Ajit Jain, to whom we owe a lot for sharing his insights into the industry with us, has been very clear publicly that "what was a very lucrative business is no longer a very lucrative business going forward". We made our investment in PartnerRe with a clear understanding of these realities.

Source: John Elkann in the Exor press release to announce the bid for Partner Re, 2015

Our interest rate recovery scenario earlier is perhaps interesting as it assumes that underwriting ratios are unaffected by any interest rate recovery, but of course in reality if insurers were making more money on the investment portfolio, they could also choose to price premiums more keenly. Alternatively, as swing Capital leaves the sector the inverse could occur. If taking a long term view, we would be prepared to state that on average float company ROE's are today at the lower end of likely returns, both due to their portfolio interest rate exposure and that many could (in a harder market) write more business that they are today. Shareholders who now do not overpay for them might get such upside in returns for free.

Conclusions/Company valuations

We try to make our research pieces actionable and get to the point. In this piece we have chosen to be a little more reflective. This is because we think there is some subtlety required in understanding these float companies properly. We conclude to still like/love the float model and seek out new companies that may profit from it. That said in these four leading companies we

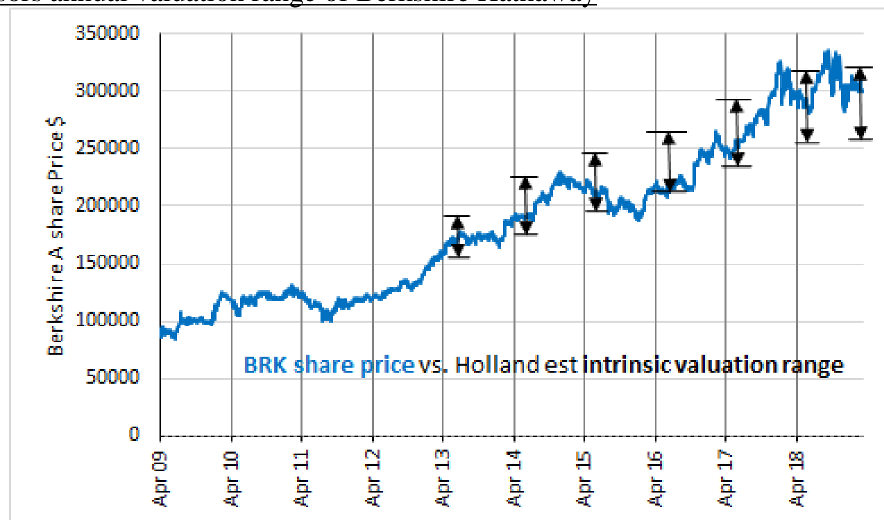
also still demand value at the time of purchase and to be circumspect of investor love affairs with CEO's that can lead to potentially dangerous short cuts. The more we reflect and think on the Interest rate cycle the more we think these companies are huge potential beneficiaries (the lasting scale of which, were it to occur we think would surprise investors).

In the rather long Appendix of this piece readers will find the following company analysis.

Berkshire Hathaway

Figure 7 below shows the summary of our now 7 years of valuation work on Berkshire. We continue to value the company looking at its combination of owned company profits – on which we put a 15x multiple and then assign a valuation for the investment portfolio. As can be seen after an average 6y growth rate of c.10% pa there was little change in the group value this year.

Fig.7: Holland Advisors annual valuation range of Berkshire Hathaway



Source: Holland Advisors

As was stated by one commentator in Omaha this year. Berkshire is becoming a 'protect your money' stock rather than 'make money' stock – we tend to agree. Its collection of assets and managers is impressive still and the power of the buybacks that will most likely follow Buffett's death[4] with support the shares/ add value to remaining holders – Hold.

Exor

Our updated Sum of the Parts for Exor is attached in the Appendix. That the business remains on a -25% discount to this easily calculated value is a fact. The SOTP also includes Partner Re at a very reasonable valuation of 1x Book value. In separate work we also believe Fiat to be significantly undervalued. In time we think Exor will find ways to exit less attractive capital-intensive sectors via asset sales or joint ventures redeploying this capital in higher return business. As the group's credibility continue to grow we also the -25% discount will be reduced. **We remain buyers of Exor and think it should be a core holding for investors.**

Fairfax

Attached are two simple scenarios that show the compounding power of a businesses like Fairfax were it to compound book value per share at 15% pa or 12% pa. In both cases 75% of excess cash generated is assumed to be used to buy back shares (as is the companies' stated intention). Also

[4] Apologies to Mr Buffett for such morbid words – of course we wish the man continued health – our purpose here is just to be brutally honest about his inevitable succession after his long and successful tenure.

assumed is that at the end of the 7y period the group shares are valued just a little more generously at 1.3x book (vs. 1x today). The resulting investor IRR's are 21% and 17% respectively. In past Fairfax pieces we have outlined 15% as a plausible company ROE. Having more closely looked at the business's current sensitivity to Bond Yields we now assume this will be more like 12%. The 17% investor IRR that this results in is still very attractive. As stated earlier, the future sensitivity to a higher interest rate environment we think could be powerful lifter of both company returns and the share rating.

Markel

As stated above whilst we admire what Markel has built in its mini-Berkshire model of the last 20 years we think the complexity that has been added by the combination of the Ventures and ILS divisions will be interesting to watch pan out. For the record we will rate it, for now a Hold.

Conclusion

As we researched and wrote this report, the essence of these float businesses constantly stared us in the face. That essence is a tension between the simplicity of the float model which we have long admired and the underlying complexity of the financial engineering that underpins it. Our work also reminded us of the tailwind that insurers have enjoyed in the bull markets of the last thirty five years. Not to take anything from Buffett and Munger, but it's clear to us now that their timing was impeccable – i.e. there has never been a better time to have been running a float business than 1980-2010. The powerful drivers of these business models still exist and are often not fully appreciated by many investors – the devil, as we have tried to illustrate – is in the detail.

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The Directors and employees of Holland Advisors may have a beneficial interest in some of the companies mentioned in this report via holdings in a fund that they also act as advisors to.

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Appendix 1

Fairfax Valuation

- Assuming 75% payout ratio
- Price/book value rising to 1.3x
- 15%/12% ROE

Fig.A: Simple (normalised) Fairfax Financial compounding model for 15% ROE

	year	1	2	3	4	5	6	7
End period BV	100	104	108	112	116	120	125	129
ROE	15%	15%	15%	15%	15%	15%	15%	15%
resulting Profit		15	15.6	16.1	16.8	17.4	18.0	18.7
retention ratio	25%	25%	25%	25%	25%	25%	25%	25%
profit retained		3.75	3.9	4.0	4.2	4.3	4.5	4.7
Profit Paid out in SBB		11.25	11.7	12.1	12.6	13.0	13.5	14.0
Amount of shares cancelled		5.6	5.0	4.4	3.6	3.2	2.9	2.6
Sprcie								
Share price/BVPS	1.0x	1.0x	1.0x	1.1x	1.1x	1.1x	1.1x	1.3x
Implied PE								
SII	50	44	39	35	31	28	25	23
Share price	2	2.3	2.7	3.5	4.1	4.7	5.4	7.4
BVPS	2	2.3	2.7	3.2	3.7	4.3	4.9	5.7
		16.9%	16.9%	16.9%	15.6%	15.6%	15.6%	15.6%
			IRR(3y)	20.7%			IRR(7y)	20.6%
	PE	6.9x	6.9x	7.6x	7.6x	7.6x	7.6x	9.x

Fig.B: Simple (normalised) Fairfax Financial compounding model for 12% ROE

	year	1	2	3	4	5	6	7
End period BV	100	103	106	109	113	116	119	123
ROE	12%	12%	12%	12%	12%	12%	12%	12%
resulting Profit		12	12.4	12.7	13.1	13.5	13.9	14.3
retention ratio	25%	25%	25%	25%	25%	25%	25%	25%
profit retained		3	3.1	3.2	3.3	3.4	3.5	3.6
Profit Paid out in SBB		9	9.3	9.5	9.8	10.1	10.4	10.7
Amount of shares cancelled		4.5	4.1	3.7	3.1	2.8	2.6	2.4
Sprcie								
Share price/BVPS	1.0x	1.0x	1.0x	1.1x	1.1x	1.1x	1.1x	1.3x
Implied PE								
SII	50	46	41	38	35	32	29	27
Share price	2	2.3	2.6	3.2	3.6	4.0	4.5	6.0
BVPS	2	2.3	2.6	2.9	3.3	3.6	4.1	4.6
		13.2%	13.2%	13.2%	12.2%	12.2%	12.2%	12.2%
			IRR(3y)	16.8%			IRR(7y)	16.9%
	PE	8.6x	8.6x	9.4x	9.4x	9.4x	9.4x	11.2x

Appendix 2

Berkshire Hathaway Valuation

Two approaches:

1) Fig.C : Our consistent approach since 2012
2) Fig.D: Buffett's 'Five Groves' approach from the 2018 letter

Fig.C: Slowest growth in BRK valuation (+1% YoY, vs. 9-14% typical)

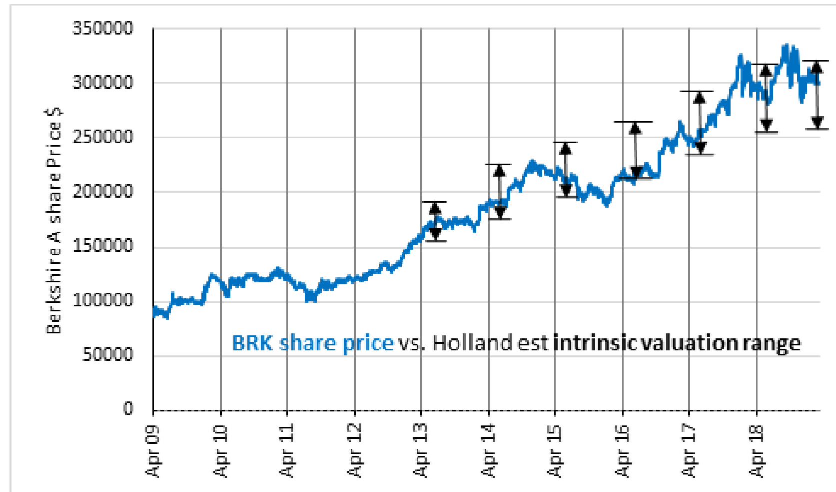
VALUATION SCENARIOS

today's share price = $299k

Range = $253.2k to $328.0k

		2011	2012	2013	2014	2015	2016	2017	2018	v's current Share Price $299k	intrinsic val cagr
A	pre-tax non-insurance earnings per-share ($k)	7.4	8.5	9.4	10.7	11.5	11.7	12.3	13.2		
A1	underwriting profits per-share ($k)					1.1	1.3		1.2		
B	pre-tax multiple	10x	10x	10x	10x	10x	10x	10x	10x		
C	Investments Per share ($k)	102.0	114.0	128.9	140.1	154.3	174.4	198.6	196.1		
D	Investments per share ex-float ($k)	59.3	69.5	82.1	88.8	100.9	118.7	129.3	121.3		
1	'Optimistic' Valuation: (A*B) + C	$176.0k	$199.2k	$222.9k	$246.7k	$268.8k	$291.6k	$321.4k	$328.0k	+10%	9%
3	Prudent Valuation: (A*B) + D	$133.2k	$154.7k	$176.1k	$195.3k	$215.5k	$235.9k	$252.1k	$253.2k	-15%	10%
4	1.2x book					$188.4k	$206.4k	$254.1k	$254.1k	-15%	
	average of Prudent-Optimistic range	$154.6k	$177.0k	$199.5k	$221.0k	$242.1k	$263.7k	$286.8k	$290.6k		9%
	YoY		14%	13%	11%	10%	9%	9%	1%		
	p/book						1.7x	1.4x	1.4x		

Source: Holland Advisors



		2013	2014	2015	2016	2017	2018	2019
"optimisitic"	top	$199k	$223k	$247k	$269k	$292k	$321k	$328k
"prudent"	bottom	$155k	$176k	$195k	$215k	$236k	$252k	$253k
share price						15/05/2019		$305k

Source: Holland Advisors

Fig.E: Buffett's 'Five Groves' Valuation Method

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.

		pre-tax	multiple		val
1	**non insurance**	21643	12x		259716
		mkt val	tax		val
2	**equities**	172757	-14500		158257
		after tax share	multiple		val
3	**shared owners**	1300	17x		22100
		cash buffer	fixed income	other cash	val
4	**cash**	20000	20000	92000	132000
		u/writing profit	multiple		val
5	**insurance**	2010	5		10050

optionality on 92bn

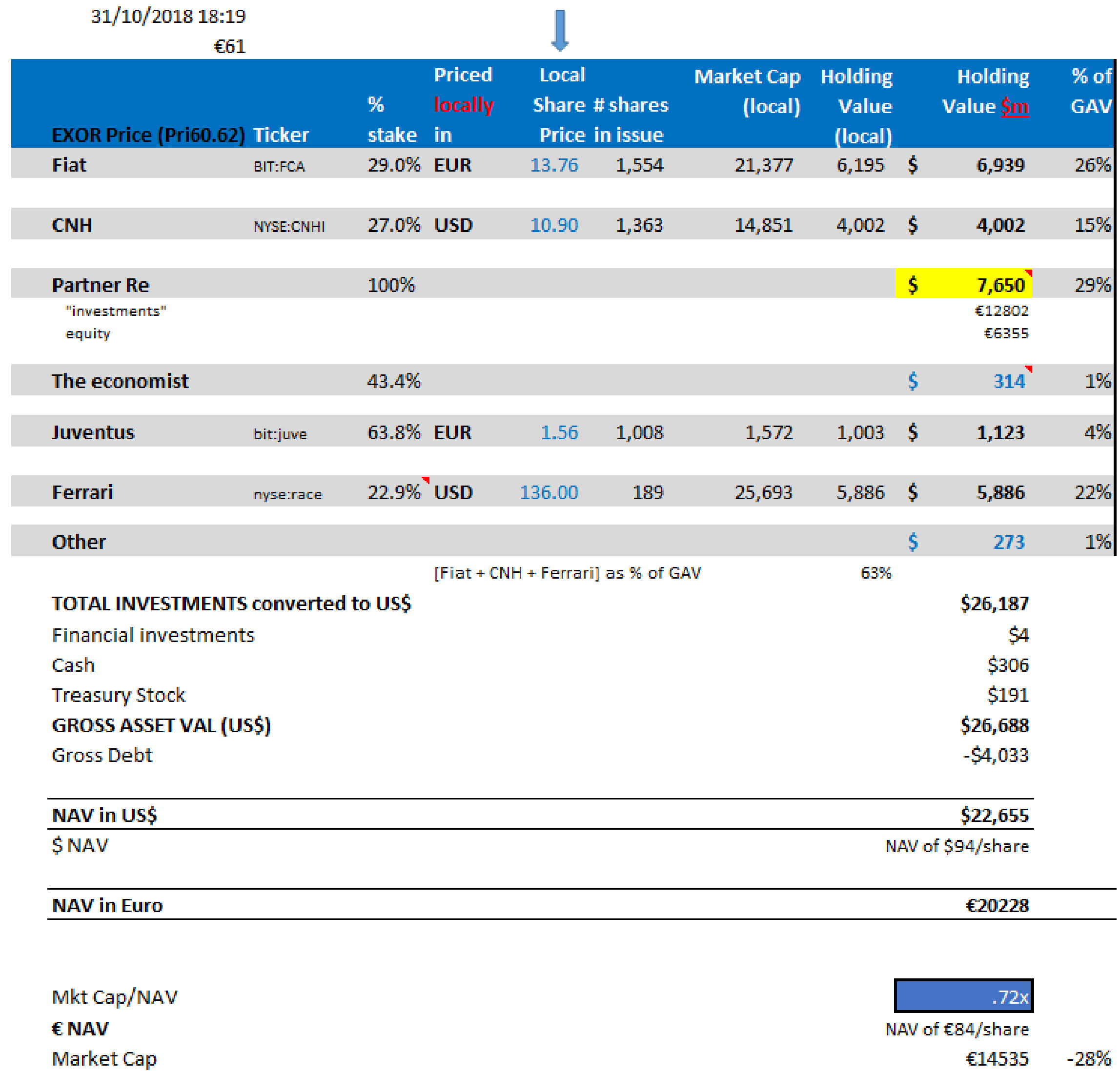
NB - not explicitly recommended by Buffett

Total	582123
# shares	1641
Intrinsic/share	355
share price	305
upside	16%

Source: Holland Advisors

Appendix 3

Fig.E: EXOR sum of the parts valuation



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EXOR Price (Pri60.62)	Ticker	% stake	Priced locally in	Local Share Price	# shares in issue	Market Cap (local)	Holding Value (local)		Holding Value $m	% of GAV
Fiat	BIT:FCA	29.0%	EUR	13.76	1,554	21,377	6,195	$	6,939	26%
CNH	NYSE:CNHI	27.0%	USD	10.90	1,363	14,851	4,002	$	4,002	15%
Partner Re		100%						$	7,650	29%
"investments"									€12802	
equity									€6355	
The economist		43.4%						$	314	1%
Juventus	bit:juve	63.8%	EUR	1.56	1,008	1,572	1,003	$	1,123	4%
Ferrari	nyse:race	22.9%	USD	136.00	189	25,693	5,886	$	5,886	22%
Other								$	273	1%

[Fiat + CNH + Ferrari] as % of GAV 63%

TOTAL INVESTMENTS converted to US$	**$26,187**	
Financial investments	$4	
Cash	$306	
Treasury Stock	$191	
GROSS ASSET VAL (US$)	**$26,688**	
Gross Debt	-$4,033	
NAV in US$	**$22,655**	
$ NAV	NAV of $94/share	
NAV in Euro	**€20228**	
Mkt Cap/NAV	.72x	
€ NAV	NAV of €84/share	
Market Cap	€14535	-28%

Source: Holland Advisors

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