One Huge Reason Why I'm Not Following Warren Buffett Into Restaurant Brands International Inc.

Description

It brings me great pain to say this because I respect the man so much, but sometimes I disagree with Warren Buffett.

I've found that as the Oracle of Omaha gets older, his definition of a value investment gets looser and looser. On the one hand, I can see his point. If I was 84 years old and had built the most successful conglomerate on the planet, I'd probably do things the same way he does. Remember, **Berkshire Hathaway** churns out billions in free cash flow each year. That money has to be invested somewhere.

Buffett is no longer blessed with being small enough to invest in anything but the largest stocks on the planet. The issue with investing in the giants is that they're so heavily covered that it's tough for anyone to get an edge, including Buffett himself.

So, what does he do? He finds huge stocks that are reasonably valued and invests in them, content in knowing that he's paying a fair price for a good business. When you're as limited as he is, truly great opportunities don't come along very often. Buffett is content to take his pick at the decent opportunities.

It works because Buffett has the advantage of insurance float, which are premiums he can invest that don't need to be paid back for years. This float essentially gives him a source of free leverage, assuming Berkshire's underlying insurance underwriting is profitable.

Because he can borrow for free, returns of 7-10% annually are magnified. That's pretty much Berkshire's secret sauce explained in the nutshell. When you've got that built-in leverage, there's little reason to take many risks. Just buy conservative businesses at decent prices and let the profits roll in.

This was probably Buffett's thinking when he participated in the 3G Capital transaction to acquire Tim Hortons, beefing up Burger King into a multinational behemoth now referred to as **Restaurant Brands International Inc.** (TSX:QSR)(NYSE:QSR). Buffett bought nearly $3 billion in preferred shares, along with a warrant that gave him the right to more than 8.4 million common shares. Berkshire exercisedthat warrant shortly after the deal became official.

On the one hand, there are plenty of reasons to like Buffett's investment. The preferred shares pay an annual dividend of 9%, a great yield in today's market. There's also the strength of Tim Hortons, which is as Canadian as lacrosse or the Maple Leafs. Buffett likes businesses with a sustainable competitive advantage, and Tim's presence in Canada is a pretty good one.

But there's also one huge thing to not like about the deal, and that's how expensive Restaurant Brands shares are. Analysts are forecasting the new company will earn just $1 per share in 2015, increasing that to $1.24 in 2016. That puts the company at 46.7 times 2015's expected earnings, and 37.6 times 2016's estimates.

That's a huge multiple, no matter how you slice it.

There's another issue with the stock, and that's the balance sheet. When 3G bought out Tim Hortons, it saddled the new company with debt. At the end of the year the total amount owing was more than $13.5 billion, including Buffett's preferred shares. Considering the company's market cap of $9.5 billion, that's a lot of debt.

The deal worked very much like most other private equity deals. The combined company should have the cash flow to slowly pay off the debt, but it'll likely take years for the amount owing to be whittled down a serious amount. There's likely not much risk in the cash flow from Tim Hortons, but the Burger King part of the business could be more suspect. There's are some strong competitors selling burgers.

I'd love to own a piece of Tim Hortons. But at this point, I can't even think about following Buffett into Restaurant Brands. The balance sheet is too ugly and shares are just too expensive.

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