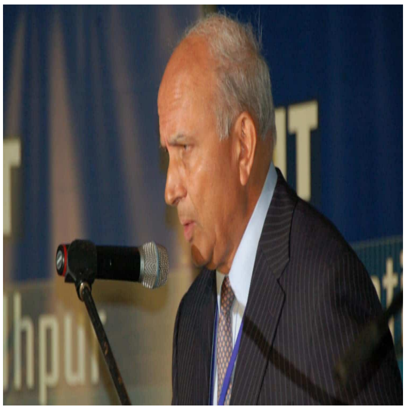

Why Fairfax Financial Holdings Ltd. Stock Has Nowhere to Go But up

Description

Fairfax Financial Holdings Ltd. (TSX:FFH) CEO Prem Watsa is ready to take the shackles off his holding company, and that's good news if you're a long-time shareholder. Here's why.

Right there in the opening paragraph of the company's annual shareholders letter, Prem Watsa highlights why Fairfax Financial is in great shape.

"We earned a record $1.7 billion in 2017, our book value per share increased 24.7% (adjusted for the $10 per share dividend paid) to $450 per share and we ended the year with a record $2.4 billion in cash and marketable securities in the holding company," Watsa wrote. "Since we began in 1985, our book value per share has compounded at 19.5% annually while our common stock price has compounded at 18.1% annually."

Warren Buffett, over the same period, has increased **Berkshire Hathaway Inc.'s** (NYSE:BRK.A)(NYSE:BRK.B) book value per share and market value per share by 17.2% and 18.7%, respectively.

Has Watsa lost his touch?

So, while Watsa has increased book value per share by 230 basis points greater than Buffett over the same 32-year period, Berkshire Hathaway has seen its market value per share increase by 60 basis points more than Watsa on an annual basis.

In the past five years, as Watsa hedged his equity portfolio against potential losses that never came, Fairfax's book value per share essentially went sideways, growing by just 3.6%, or one-fifth its historical average.

I can remember investors wondering in 2002, a year in which Berkshire Hathaway stock lost 3.8% of its value compared to 22.1% for the S&P 500, if the Oracle of Omaha had lost his touch. Since that fateful question in 2002, Berkshire Hathaway stock has delivered nine years of double-digit returns out of 15, seven of which were greater than 20%. More importantly, only three out of 15 years had negative returns.

Watsa hasn't lost his touch.

In fact, the company's April 26 annual meeting gave the veteran investor an opportunity to tell shareholders about his plan of attack to move the company's share price higher.

He now is aiming for 15% annual growth

On Fairfax's slide presentation at its annual meeting was the objective to grow its book value per share.

"We expect to compound our mark-to-market book value per share over the long term by 15% annually by running Fairfax and its subsidiaries for the long-term benefit of customers, employees, shareholders and the communities where we operate — at the expense of short term profits if necessary," Watsa proclaimed.

As Watsa likes to say, Fairfax's share price follows its book value per share. If the company meets the 15% goal over the next five years, book value per share would be very close to $1,000, which would act as a huge catalyst to the Fairfax share price.

Currently, Fairfax stock is trading around 1.3 times book value, less than the 1.4 multiple investors give Berkshire Hathaway, suggesting it could be very undervalued based on Watsa's future plans for growth.

Buybacks speeding up

I'm not a fan of share repurchases, but if anyone can do them without paying too much, Watsa's the person to do it.

Since 1985, the company has issued 29,5 million shares to make 50 acquisitions, which has increased net premiums written from $10 million in its first year to $10 billion in 2017, resulting in 1,000% growth.

During the same 32 years, it repurchased just 6.7 million shares, resulting in a net increase of 22.8 shares. Watsa now intends to use the company's free cash flow — $2.3 billion at the end of 2017 — to aggressively buy back its shares.

Fairfax's insurance expansion will move from being deal driven to organic growth with the funds saved going to shareholders.

Buffett won't pay more than 1.2 times book for his stock. It will be interesting to see how far Watsa will go to return capital to shareholders.

Nowhere to go but up

I’m being facetious when I say this, but some of the investments Watsa has made in 2017 could pay significant dividends for the company in three to five years, not the least of which is buying the Keg via **Cara Operations Ltd.** and rescuing the Canadian stores of Toys “R” Us.

This looks like a watershed moment where it moves from an insurance base to something more diversified.

In the end, Fairfax remains one of my top 10 stocks on the TSX.

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