1 Buy-and-Hold Stock That's Deeply Undervalued

Description

Valuing a stock is a complicated exercise. Traditional value investors need to estimate future growth, pick an appropriate discount rate, guess future cash flows, and run a basic equation. Don't even get me started on measuring the value of brands and intangibles.

But valuing a business is a lot easier when the CEO is a famously successful stock picker who regularly mentions his estimate for the company's intrinsic value. Prem Watsa, one of the most successful investors in the country, has built a fortune by picking undervalued stocks and holding them for the long term.

He's been called the Canadian Warren Buffett, because his company, **Fairfax Financial Holdings** (TSX:FFH), is essentially an insurance firm that invests in private and public companies. Buffett and Watsa both write letters to their shareholders once a year. The subject of "intrinsic value" often comes up.

There's no doubt that these legendary investors use sophisticated valuation methods for picking stocks. However, when they mention the value of their own company, they use a simple metric — book value (BV).

BV is defined as the net asset value of a company calculated as total assets minus intangibles and liabilities. For a holding company like Fairfax, this is an appropriate measure. BV measures the fair value of the company's many subsidiaries, including Northbridge, Zenith National, Brit, and OdysseyRe.

In his most recent letter, Watsa said he believes the intrinsic value of Fairfax was "far in excess" of this BV. When the letter was published, the BV per share was $595. Now, the stock trades at $622. That's a mere 4.5% more than BV.

For context, Buffett has often said he will buy back **Berkshire Hathaway** shares if the market price is 120% or below BV. Indeed, Fairfax management is aggressively putting its free cash flow ($2.3 billion) into repurchasing outstanding shares. So, it's a clear indication that Fairfax is undervalued.

If that's not convinced you, consider the fact that Watsa has managed to compound Fairfax's BV by 19.5% annually since 1985. Going forward, he expects BV to compound at a rate of 15%. Since the stock trades at a price-to-earnings ratio of 8.3 times, the price-to-earnings-growth ratio is 0.55.

Fairfax also offers a 2% dividend yield. That may not be impressive, but it's in line with the risk-free rate in Canada — 2.2% for 10-year government bonds. Considering the buyback program along with the dividend policy, shareholders can expect to receive a juicy piece of the company's free cash flows going forward.

No matter which way you look at it, there's little doubt that Fairfax Financial is a stable company with a long track record that's severely undervalued at the moment. The recent downturn in stocks makes it more likely Watsa will find an undervalued acquisition target to add to the portfolio soon.

With the company's diversified holdings of high-quality Canadian businesses, and growth powered by exposure to African and Indian stocks, I believe Fairfax is a great candidate for any value investor's portfolio. At the moment, the company is buying back its shares, which is the clearest indication of undervaluation shareholders will ever get.

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Date
2025/08/24
Date Created
2018/11/15
Author
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