Underestimated BMW

We try to find good investments not among things investors love but among those investors underestimate. One such company that is currently underestimated is BMW. We promised we would write about something we regard as a good investment. We chose BMW because it is a universally known company and also because it can be directly compared with Tesla, which we wrote about previously.

When one says BMW, people know what it is. Still, most people are surprised when they learn that it is comprised of two separate businesses: a financial one we can call BMW-Bank and another that designs, manufactures, and sells cars.

There are several ways of valuing a company. We choose a method termed sum of the parts. This involved dividing BMW into three units, each of which is valued separately. The sum of the three values will then tell us the value of the company as a whole. It is a very simple method, but it is entirely sufficient. The best investments are those the cheapness of which is immediately clear to the observer. Such is the case of BMW.

BMW-Bank is the division that provides financing to people and companies buying cars (BMW, Mini, Rolls-Royce) and BMW motorbikes, primarily through leasing and consumer loans. Approximately half of all BMW sales are financed in this manner. This business is exceptionally profitable and also bears low risk. Returns on equity regularly reach 18%. Normal banks would carry you to the moon and back to get that return. By comparison, the average return on equity for large US banks is currently 9.3%, for UK banks it is 5.3%, for European banks 7%, and for Japanese banks 6.6%. For these banks, the returns on equity achieved by BMW-bank is an unattainable dream.

But that's not all. The risk of bad loans at BMW-Bank is very low. Specifically, it's 0.3%. This means that only 1 in 300 loans goes unpaid. (Let's not forget that the borrowers from BMW-Bank are drivers of BMW cars, which is a sample of the population characterised by greatly above average income.) Credit risk for ordinary banks is frequently an order of magnitude higher, and sometimes it reaches up to several percentage points. If BMW-Bank were a stand-alone company, its shares should trade for at least 1.6–2.2 times book value per share. If we are conservative and stick with the 1.6 times, we come to a valuation for BMW-Bank of EUR 18.4 billion. That is the first part of the valuation of the company as a whole.

BMW's automotive business is itself interesting, not only because it has no debt but also because it has EUR 22 billion in cash. BMW management states that EUR 10 billion in cash is more than enough for the company easily to conduct its business without debt and with a reserve. In other words, BMW has at least EUR 12 billion of excess cash it could pay out to its shareholders at any time without having to put itself in debt and without in any way endangering its business in its current form and size. That is the second part of the valuation of the company in its entirety.

When we put the first and second parts together, we come to EUR 30.4 billion. BMW has 657 million of shares outstanding, which means that the value of BMW-bank and excess cash is EUR 46.2 per share. BMW preferred shares cost EUR 70 apiece which implicitly means that we are paying EUR 23.8 per share for the automotive buiness. That is 2.8 times its current annual profit and only approximately 40% of its book value. These numbers are completely absurd. No one really knows what is the value of BMW's automotive business, but we can be sure that it is not less than its book value. In a value ranking of global brands, by the way, BMW stands in the highest position among all European companies. The estimated value of its brand has been put at EUR 30 billion (EUR 45 per share).

If we would use a P/E of 8 for the automotive business, we would reach a value of EUR 44 billion. If we sum the accounting value and estimated brand value, this would come to EUR 67 billion. The value of the automotive business itself should be somewhere between that (55.5 billion). That is the third part of the valuation.

When we add all three parts we get to 85.9 billion and that is still a business without debt and with ten billion of net cash we are not including in the valuation. 85.9 billion means EUR 130 per share. Preferential shares cost 70. The market is offering the stock of a top-of-the-line, financially strong, family business for almost half of its value. How is this possible? Hard to say. Investors apparently concluded that either a hard recession is just around the corner and a recovery will never occur, or that Tesla will control the world and the other automotive companies are doomed. Neither will happen in fact. Quite contrary. There are three main trends in the automotive industry: the shift towards electric cars, the shift towards autonomous cars, and connectivity of cars to the outside world. Anyone who has been watching the top 10 automotive companies can see that BMW is very far in all three areas in comparison to the others. It is also one of the few automotive companies to remain profitable also during the Great Financial Crisis in 2008–2009.

To make sure our valuation of the entire company is not completely unreal we can compare it with two other methods – private transaction value and replacement value. Private transaction value tries to estimate what the price would be if the entire company were sold to a single buyer. This method is rather vague because there are not many comparable transaction, each company sold is a little different and in addition the sellers and buyers are mostly motivated also by other factors than just purely financial ones.

BMW is 50% owned by the Quandt family. We do not assume they would be ready to sell. It is more probable that the following generations will continue to own BMW. Nevertheless, if they were willing to sell, our analyses lead to the price being on the order of double to the current price.

The replacement value method tries to estimate how much it would cost to build an identical company from scratch. Using the analysis above we reached the conclusion that at current price per share we implicitly pay for BMW's automotive business EUR 23.8 per share, i.e. a total of approximately EUR 15.6 billion. If someone came to us and said: "Here's 15.6 billion euro, go and build a company comparable to BMW," we would refuse the money. For this amount you could not build even the factories to manufacture the cars in, let alone develop your own models, the sales network, the renown and brand value comparable to that of BMW, reaching margins and capital yields at top levels In the industry, and in addition to all of that to keep 10 billion in net cash as BMW now has. We believe even EUR 60 billion would not be enough and success would not be guaranteed even at higher amounts.

To summarize, it is impossible to buy or build the entire company for the current share price. The beauty of equity markets is, however, that we need not do it but instead can buy a share in an existing BMW for a price that in fact substantially underestimates the value of the entire company.

BMW is a conservative value investment with a large margin of safety supported by dividend yield of 5% which very probably will bring very satisfactory results to investors over the next 5–7 years. Over the last ten years, which is the recent economic cycle involving a deep recession, BMW's profitability increased 2.5 times which represents a growth of approximately 10% p. a. When we add a fat dividend we get to a level of 13–14% p. a. This was the rate of BMW share value growth over the last decade. If the situation were to be similar over the following decade, the company's growing value will over the long term tend to pull the share price strongly upwards.

Invest with care!

Daniel Gladiš, 23 August 2017

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