Stock Pick of the Week: W.R. Berkley Corporation (WRB)

In some industries profits can be hit or miss from year to year, but efficiently operating in the insurance industry can create a profit machine year in and year out. We have long been fans of this industry for just that reason. As long as the company does their due diligence and accurately appraises risk, they can continually bring in more premiums than claims paid out. This week we're highlighting a lesser-known player in the industry, but one with a strong history and impressive future upside. Our stock pick of the week is W.R. Berkley Corporation (WRB)

What Is W.R. Berkley?

W.R. Berkley, founded in 1967, operates in the property and casualty insurance industry — one of Warren Buffett's favorites. W.R. Berkley operates in three segments: domestic insurance, international insurance, and global reinsurance. The company underwrites business lines, commercial automobile, general liability, product liability, and professional liability insurance. It also provides services to small businesses and state and local government entities.

Why Look at W.R. Berkley?

W.R. Berkley is operating at levels of profitability not seen since 2007. In 2014, W.R. earned an after-tax operating profit (NOPAT) of almost $676 million, up over 29% from 2013 on the back of 11% revenue growth year over year. W.R. Berkley's profit growth over the long-term is just as impressive, as NOPAT has grown by 4% compounded annually over the last decade. This growth has accelerated and NOPAT has grown 18% compounded annually since 2008. Being smaller than some of the well-known insurers in this category has allowed W.R. to manage its underwriting business in a uniquely profitable manner.

On top of growing profits, W.R. Berkley is becoming increasingly more efficient with its capital allocation. The company's 2014 return on invested capital (ROIC) of 13% is its highest since 2007, and is up from 6% only six years ago. The company also generated $457 million in free cash flow in 2014.

These Adjustments Reveal W.R.'s Operating Profitability and Valuation

We make several key adjustments to the earnings and balance sheets of companies to uncover the recurring cash flows of each company's core business and the value left for shareholders. We made the following major adjustments to W.R. Berkley's earnings in 2014:

- Removed $10 million implied interest expense related to operating leases
- Added back $17 million in taxes due to non-operating expenses lowering operating earnings

When considering W.R.'s valuation, we also add $196 million in off-balance sheet debt (3% of market cap) due to operating leases to W.R.'s reported debt. This adjustment represents all of W.R.'s debt as the company has no other reported short-term or long-term debt.

W.R. Berkley is Vastly Undervalued

After removing the items highlighted above, we see that W.R.'s 2014 NOPAT is actually even higher than its GAAP net income, and that W.R. Berkley had an even better year than the market thinks. Because of this, W.R. Berkley is currently very undervalued. At its current price of ~$52/share, W.R. Berkley has a price to economic book value (PEBV) ratio of just 0.6. This ratio implies that the market expects the company's profits to permanently decline by 40%. This expectation is out of touch with reality considering that W.R. Berkley has grown NOPAT at a double-digit rate over the past six years. Such low expectations, coupled with the company's strong fundamentals lead us to give W.R. Berkley our Very Attractive rating.

If W.R. Berkley can grow NOPAT by just 7% compounded annually for the next 7 years, the company is worth $114/share — a 119% upside from current levels. With an economic book value of $80/share, it's easy to see just how undervalued WRB currently is.

Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, style, or theme.

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2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

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