Weekly Commentary | June 23, 2017
Ian Cooke, CFA & Darren Dansereau, CFA

QV Investors Inc.

What We Know Now vs. What We Knew Then

In our April 28th QV Update, we communicated our experience as investors in Home Capital. In the Update, we stated that although a case can be made for deep value in the stock, the business has failed to demonstrate the qualities and execution we expect. We were disappointed with leadership execution and candor. We actively encouraged the board to take steps to improve their chances of survival. When the company announced an abrupt and expensive secured source of funding, we had to make a choice. Do we preserve the capital we have remaining in this failed investment, or do we maintain an investment whose fate was largely in the hands of regulators, creditors and leadership which we had rapidly lost faith in? Although we recognized possible value in the shares, the company needed near flawless execution and luck on their side to continue as a going concern. Based on what we knew at the time, and our assessment of probable future outcomes, it made sense for us to sell.

A lot has transpired over the past seven weeks. In short order, new board members have come into Home Capital and have swiftly taken action. The company took an about face on its prior position to "vigorously defend" against regulatory allegations, announcing a settlement agreement with the securities commission. The company entered into an arrangement to sell funded mortgages to a third party and announced the sale of a portfolio of commercial assets to free up capital. Through the entire period, the company ratcheted up interest rates offered on CDIC guaranteed deposits to levels well above what competitors were offering.

Despite these important efforts, we believe equity owners were still in a precarious situation. According to the company's liquidity updates, term GIC funding had shrunk by a further $300 million from mid-May until mid-June. Second quarter results were going to provide very little reassurance, likely showing sharply negative earnings for the first time in more than two decades.

In our view, to restore confidence, the company needed to enter into a partnership that would provide deep access to funding and/or an immediate boost in credibility. Given the new board's pedigree and swift actions taken to date, we believed there was a chance of accomplishing that. However, we felt an agreement of that nature may or may not come at the expense of existing equity holders. Any new partner would likely require significant concessions.

Wednesday night, Home Capital announced Berkshire Hathaway had agreed to provide a secured loan and an injection of fresh equity. The new two billion dollar credit facility replaces the prior emergency loan of the same amount. It appears to offer very similar terms, with a modestly lower interest rate of 9-9.5% along with lower standby fees. With this secured loan in place, Berkshire is well positioned at the front of the creditor line if the company faces a relapse in future viability concerns.

Berkshire's equity injection provides a needed boost of confidence but comes at a significant cost. The proposed equity raise is highly dilutive, increasing the company's share count by over 60%. The proposal comes at more than a 30% discount to the trading price of the equity prior to the announcement. The offer price is well below the allowable discount to market prices under TSX rules. To get around this, the Company has applied to the TSX for an exemption under "financial hardship" provisions. In our view, Home Capital rightly justifies the discount and dilution, stating in the press release:

"…the Company has suffered an extraordinary and well-publicized loss of stakeholder confidence since April 2017, which led to a liquidity crisis that seriously threatened the Company's ability to continue to operate…the Company is in serious financial difficulty…"

Berkshire is one of very few companies that can help restore confidence in Home Capital. This is also an attractive deal for them. In a worst-case scenario, they are secured by a $2 billion high interest loan with plenty of collateral. In the best case, they restore confidence, lay favour with Canadian politicians and regulators while owning 40% of a large Canadian lender.

If approved, Home Capital today is much better equipped to navigate through the challenges that lie ahead. With the benefits of hindsight, staying the course in our investment would have been a better outcome. Recent events were not something we were willing to attach much probability to and the downside risks related to any missteps were grave. From an investing perspective, we own several attractively valued financial institutions that should benefit from a healthier Home Capital Group and increased confidence in the Canadian mortgage market. This includes our global strategy's investment in Berkshire Hathaway.