Home Capital Group Inc: Why Rejecting Buffett's Deal Is Good News for Shareholders

Description

What a roller-coaster ride it's been for shareholders of **Home Capital Group Inc.** (TSX:HCG) in 2017.

Fortunately for the shareholders who have made it this far — as well as those who have been sitting patiently on the sidelines and watching — it looks as though the fortunes of Canada's largest subprime lender are finally improving.

In April, Home Capital faced a crisis that nearly brought the company to its knees.

Staring the company in the face was an increasingly threatening housing bubble in its key markets of Ontario and British Columbia, not to mention the anticipation of rising interest rates on the part of Canada's central bank. Add to that a scandal alleging fraudulent practices and misleading disclosures.

It was the perfect storm for a "short sale," where speculators hope to make a profit by driving down the value of a security in hopes of buying it back at a lower price.

It wasn't long before Home Capital was confronted with a fleeing deposit base and a lack of access to capital via the brokerage networks that it had previously relied so heavily on. There were serious doubts that the company would survive to see the end of the year.

Shares of Home Capital went into free fall, losing 75% of their value in just five days, as the stock dropped from $20 to $5.

After a couple of days of desperate deal-making, Home Capital came to terms with HOOP (an Ontario healthcare workers' pension plan), who lent the struggling lender $2 billion on the terms of a 2.5% standby fee and 10% annual interest rate.

But the terms negotiated were crippling for Home Capital, which, at the time the deal was made, had a market capitalization of just $360 million.

While the deal with HOOP was enough to shore up the short-term liquidity problem, it left questions as to whether Home Capital would ever be able to emerge from its new debt load.

Then, along came Warren Buffett, who offered to invest $153.2 million in the company in exchange for a 19.99% ownership stake, with an option for a second tranche at $246.7 million for another 18.41% stake (subject to shareholders' approval), which would have brought the Oracle from Omaha's ownership share to 38.4% when all was said and done.

In addition to the equity deal, Buffett offered to help rescue Home Capital out from under its burgeoning debt load by offering to refinance the HOOP line of credit at a significantly lower rate.

After all, as a new owner of the company, Buffett wanted to secure financing that would help the company regain stability, not hurt it.

In the wake of the announcement, shares in Home Capital soared, up $4.06 or 27% to close at $19 on the Toronto Stock Exchange.

Yet almost inexplicably, Home Capital shares have given back much of those gains and closed yesterday's trading at $14.08 — a modest premium to the price Buffett paid to acquire his initial 19.99% stake.

Buffett's second tranche is rejected: Good news for shareholders

Yesterday, shareholders voted against the second tranche of Buffett's equity deal, limiting his stake to 19.99%.

The news may come as a bit of a shock to investors in light of the reaction when Buffett's interest was originally announced.

Yet today, shareholders are confident that three months later, the company is on firmer footing and is showing signs of securing a more stable future for itself; thus, there is no reason to further dilute current owners with an additional 19% investment from Buffett.

When asked about the prospects of the second tranche being approved in June, Buffett told the *Globe and Mail*, "We hope the shareholders vote yes, but if they vote no, you know, we'll be going ahead with everything we promised to do." He also said he had "no intention whatsoever of getting out in four months or eight months or 12 months."

Having the financial backing of **Berkshire Hathaway Inc.** is one thing, but now that shareholders have resisted the temptation to up Buffett's stake at the expense of diluting current shareholders, the current opportunity may be one that Foolish investors just can't afford to pass up on.

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