The Joker in Allied Capital's House of Cards, Part 2

By David Einhorn
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Editor's Note: This is the second installment of a two-part series by David Einhorn, founder of Greenlight Capital, on Allied Capital. To read the first part, which focused on underwriting performance, please click here. Greenlight Capital holds a short position in Allied Capital.

It's hard to imagine that **Business Loan Express**, a gain-on-sale originator of higher-risk loans, could have appreciated in value in the past 21 months. **Allied Capital** (ALD:NYSE - news - commentary - research - analysis) paid four times book value for the unit right before the economy headed south. Still, Allied now ascribes a "fair value" of $140 million to its original $105 million equity stake in the subsidiary.

Allied had never before disclosed any information about Business Loan Express' performance, but under pressure, it finally disclosed summary financial information. In the September quarter, earnings before interest, taxes and management fees, or EBITM, came to $12.9 million. Supported by growth in residuals of $10 million from June to September, it seems that more than three-fourths of Business Loan Express' EBITM stems from non-cash gain-on-sale.

Instead of breaking out useful information like the assumptions used to calculate the value of the securitization residuals and the historical static pool data to support the assumptions, Allied reports that if none of the loans default or prepay for the next 20 years, the $116 million of residuals would generate $469 million in cash. At the Bank of America conference in September, Allied's Chief Operating Officer Joan Sweeney noted, "I'd buy a $400 million stream of cash flows for $100 million." Does she really expect zero prepayments and defaults?

The summary financials show Business Loan Express has $3.6 million of annual pretax income. According to Allied, this is enough to support its $25 million preferred investment and aforementioned $140 million for Allied's 94% equity stake in Business Loan Express. The implied valuation of $175 million is 48 times Business Loan Express pretax earnings, or a 75 times price-to-earnings ratio, if one assumes a normal tax rate. Of course, this assumes the reasonability of Business Loan Express' gain-on-sale estimates.

As for the quality of those earnings, Business Loan Express is a cash user. It began life with around $117 million in total debt, so its Sept. 30 balance of $186 million suggests it has burned around $68 million in 21 months. Of course, a good chunk of those borrowings, some of which have been advanced by Allied and the rest partly guaranteed by Allied, has gone right back to Allied for management fees and interest charges.

The summary financials also show Business Loan Express with $61 million of stated equity. Subtract $6 million of goodwill and $25 million for the preferred equity, and you get tangible common equity of $30 million. This sliver of equity is supporting $116 million of "tangible" residuals. Allied carries its Business Loan Express holding at five times "tangible" common equity.

So how does Allied justify 75 times earnings and five times tangible book value? A simple magic trick with pro forma analysis:

- Step One: Exclude the management fees that Allied charges Business Loan Express. In response to criticism that these fees are artificial means of supporting Allied's reported earnings and dividend, Allied said, "Fact: As the majority owner of BLX, Allied Capital performs substantial consulting services on behalf of BLX, including loan systems integration, marketing, HR, Web site developments, and board recruitment to name a few, which more than justify the management fees it pays to us." What is the basis, then, for excluding fees for such valuable, necessary and justifiable services when calculating Business Loan Express' valuation? I asked Allied's management this question at the recent Piper Jaffray conference, and Allied's Chairman, CEO and President Bill Walton avoided the question by explaining that this issue would go away when it restructures Business Loan Express' corporate structure.

- Step Two: Pretend Business Loan Express could support much more senior debt than it does. It now has about $96 million of senior debt, and it was only able to obtain its senior line by having Allied co-sign for half the loan. Allied charges Business Loan Express $3.2 million per year just for co-signing. As discussed in Part 1, Business Loan Express doesn't have a strong enough balance sheet to obtain the letter of credit to support its securitizations from Bank of America. Despite this reality, for valuation purposes, Allied assumes that Business Loan Express somehow could obtain $155 million of senior debt. How? Do they think the debt would be secured by the residuals?

- Step Three: Now pretend this $155 million of senior debt would come at about a 3.25% interest rate. That is less than half the rate Allied pays for its own borrowings. Allied charges Business Loan Express more than 3.25% just to co-sign a smaller loan. In response to criticism that the 25% rate of interest Allied charges Business Loan Express is not a market rate and is not arm's length, Allied said, "Fact: Allied Capital has invested in both subordinated debt and preferred stock of BLX, in addition to owning a majority of the common equity. While the sub debt carries a 25% interest rate, which is at the high end of the range for a typical sub debt investment, our preferred stock investment has no current return at all. The combination of our sub debt and preferred stock investment generates an effective current return of 18%, which is a market rate for this type of financing." If Business Loan Express could borrow $155 million at 3.25%, why wouldn't it? Business Loan Express could take the extra $60 million and pay off most of the sub debt. So depending on the purpose of the analysis, Allied believes that Business Loan Express debt has a market rate of 18%-25% or 3.25%.

- Step Four: Apply a reasonable 8 times P/E to Business Loan Express' adjusted pro forma earnings that back out the management fees and pretend that it could borrow $155 million at 3.25%. On the other hand, if you apply the same eight times multiple to Business Loan Express' stated earnings assuming a normal tax rate, Allied's preferred equity investment would be slightly impaired, and its common equity investment carried today at $140 million would be worth zero.

- Step Five: Presto! Spin around three times and yell, "Unrealized Appreciation!"

Are you long Allied Capital and want to have your say? Email us with a quick synopsis of your argument, and you could be featured as an Opposing View writer on *RealMoney*.

David Einhorn founded Greenlight Capital in 1996 with $1.3 million, achieving a 29% return after fees and having grown to more than $1 billion under management. Before that, he worked as an analyst at Siegler Collery & Co. and an investment banking generalist at Donaldson Lufkin & Jenrette. At time of publication, Greenlight Capital was short Allied Capital, although holdings can change at any time. Under no circumstances does the information in this column represent a recommendation to buy or sell stocks.