The Joker in Allied Capital's House of Cards, Part 1

By David Einhorn
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Editor's Note: This is the first installment of a two-part series by David Einhorn, founder of Greenlight Capital, on Allied Capital. Greenlight Capital holds a short position in Allied Capital and a long position in New Century Financial.

There's trouble brewing at **Allied Capital** (ALD:NYSE - news - commentary - research - analysis), and its name is **Business Loan Express**.

Business Loan Express, the second-largest originator of loans in the Small Business Administration's popular 7a program, was formed in late 2000. Allied Capital paid about four times book value for its publicly traded predecessor, Business Loan Financial, and combined it with Allied's own SBA lender, Allied Capital Express.

Representing Allied's largest investment, Business Loan Express is 94% owned by Allied Capital. It represents 17% of Allied's net asset value and is expected to kick in 50 to 60 cents of Allied's per-share earnings this year, and also contributed $20 million to Allied's mark up of assets in the second quarter. Business Loan Express adds almost 10 cents per quarter in management fees and interest and added 20 cents in the second quarter when it marked up the value.

Business Loan Express is what is known as a gain-on-sale securitizer of its loans. Gain-on-sale securitizers book profits on loans at the time of securitization. A securitization is when loans are grouped into pools, and each pool is carved up among different investors according to their risk tolerances. Business Loan Express keeps the riskiest, most junior piece of the securitization, called the residual, and values it using a discounted cash-flow analysis based on its expectation of how the underlying loans will perform. If the expectation proves accurate, then the residual eventually pays off. If it doesn't, a write-off follows.

After several gain-on-sale securitizers such as **Cityscape** rose to high valuations based on rosy securitization assumptions and then blew up when the assumptions proved too optimistic, new audit rules were imposed a few years ago that required companies to disclose the underlying assumptions used in the gain-on-sale calculation in the footnotes to their audited financials. Despite many requests from investors, Allied has declined to disclose Business Loan Express' assumptions and escapes the required disclosure because it's an unconsolidated subsidiary.

In terms of consolidating Business Loan Express, Allied said in a June press release, "Fact: The consolidation issue is absolutely black and white. Since Allied Capital is a BDC [business development company] , the SEC rules for accounting for investment companies is quite clear." However, Business Loan Express' predecessor, Allied Capital Express, was consolidated. In addition, when I attended Allied's Aug. 1 analyst day, a senior Allied executive told me, "BLX should be consolidated. There is a way we could do that if we wanted to."

Allied discloses very little about how its SBA 7a loans perform. On the most recent conference call, it cited a delinquency rate of 7.9%, below industry averages and setting an average loan loss rate of about 1% over the past five years. Although that sounds like an enviable record, Business Loan Express' rapid growth appears to be masking poor loan performance. Its servicing portfolio has grown fivefold from June 1999 through March 2002.

Most of the few companies that persist in using gain-on-sale accounting, such as **Harley-Davidson** (HDI:NYSE - news - commentary - research - analysis), **Household International** (HI: - news - commentary - research - analysis), **AmeriCredit** (ACF:NYSE - news - commentary - research - analysis), **New Century Financial** (NCEN:Nasdaq - news - commentary - research - analysis) and **H&R Block** (HRB:NYSE - news - commentary - research - analysis), disclose static-pool analysis. What's that? Say you have a portfolio of $100 million of loans, and 10% are in default. If you add another $100 million of fresh loans that haven't had time to default, the reported default rate immediately falls to 5%. Loan additions have similar effects on delinquency rates. Static-pool analyses strip out the masking influence of subsequent new loan growth by evaluating loan performance based on the time of origination.

I obtained a static-pool analysis of Allied's SBA 7a loans originated between 1998 and 2001. The data comes from BancLab LLC's DataBanc, which includes loan performance data on more than 400,000 SBA 7a loans. At our request, DataBanc captured $662 million of Allied's SBA 7a loans and compared the performance to its national pool of about $33 billion of loans originated during the same time period. (For the full report, see greenlightcapital.com.) As the table shows, Allied's loans have more than twice the default rate of the national average. However, when I asked Chief Operating Officer Joan Sweeney recently how Business Loan Express compares in defaults and losses on a static-pool basis, she replied, "They perform in line with the national average." Additional discussion with Moody's has confirmed that gross defaults in Business Loan Express's static pools are twice the national average.

Default Rates
Allied tops the national average

	Default Rate	**Years from Origination**			
		1	**2**	**3**	**4**
Allied Pool	Annual	1.5%	5.0%	3.0%	2.4%
	Cumulative	1.5	6.6	9.6	11.9
National Pool	Annual	0.4	1.7	1.6	0.8
	Cumulative	0.4	2.1	3.7	4.5

Source: DataBanc

While default doesn't necessarily equal loss, DataBanc also captures recoveries on defaulted loans to calculate loss rates. Here, Allied performs even worse, with loss rates of more than three times the national average.

Loss Rates
Again, Allied gets a dubious distinction

	Loss Rate	**Years from Origination**			
		1	**2**	**3**	**4**
Allied Pool	Annual	0.9%	3.2%	2.0%	1.7%
	Cumulative	0.9	4.2	6.1	7.9
National Pool	Annual	0.3	0.9	0.9	0.3
	Cumulative	0.3	1.2	2.0	2.4

Source: DataBanc

This poor loan performance also appears to have impacted the structure of Business Loan Express' most recent securitizations. The Business Loan Express SBA Loan Trust 2002-1 contained a letter of credit provided by **Bank of America** equal to 7% of the beginning note balance. This is an unusual structure because, in most securitizations, the underlying assets and excess spread provide the collateral for the deal. Business Loan Express' own balance sheet doesn't seem strong enough to obtain the letter of credit, as Allied provided its own standby letters of credit to Bank of America. The 2002-1 transaction needed stronger enhancement, which suggests that the underlying collateral is weak.

In the current environment, things look even more difficult. As one industry insider who still does business with Business Loan Express put it after the last Fed cut, "I can't imagine these drops in prime are not having some significant impact on BLX's spreads. Although all short-term rates are falling, their debt agreements are probably based on LIBOR, and this has to be eating them up because they can not legally make SBA loans at rates greater than prime + 2.75%."

With the prime rate at 4.25%, it's hard to see how Business Loan Express makes much on loans backed by single-purpose real estate, such as gas stations, motels and car washes, at no more than 7% -- even if the taxpayers are picking up 75% of the eventual losses.

Stay tuned for Part 2 of this column tomorrow.

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 and long New Century Financial, although holdings can change at any time. Under no circumstances does the information in this column represent a recommendation to buy or sell stocks.