RHG Does Everything Right

It’s no secret that we’ve had our issues with the RHG board over the past few years. The lack of communication, lack of genuine independent representation on the board and an about face on strategy two years ago left us concerned for the welfare of minority shareholders.

Whether our criticism and pressure made a difference or not, I don’t know. But it must now be said that their actions, if not their words, have been exemplary.

Firstly, the company’s asset – a $15bn mortgage book in runoff – has been managed to perfection. The cash to shareholders, generated by charging customers an interest rate that keeps them on the books but still makes a profit, has been maximised. With some minor exceptions the funding has been kept in place through the most difficult environment possible. And the company has chosen to invest in its own book where required to keep funding in place. The net result is that the company has accrued a tangible asset balance substantially in excess of what I was expecting three years ago.

Secondly, RHG has bought back more than 16% of its own shares at substantially discounted prices. This has added a further 8-10% to the NTA per share, over and above what would otherwise have accrued to shareholders. I guess you could argue that, if they had communicated effectively with the investment community, shareholders wouldn’t have been selling at a discount to start with but, financially, it added substantially to shareholder value.

And now, finally, they have announced that they will give the money back in the most tax effective manner possible. True, the $0.88 on offer is less than the current NTA and the business will still generate more cash this financial year. Some have suggested that, by only paying $0.88, the board is somehow trying to short-change minority shareholders.

If they can sell the remaining business, including the runoff, for more than the ‘threshold price’ (included in the $0.88 per share), we’ll all get more than $0.88 and Chairman John Kinghorn will take his money with the rest of us. If they don’t achieve that price, the buyback will be optional. That is, if you want the $0.88 now, you can take it. If you think there’s more value in the rump, you can hang around with the existing board.

They currently have approximately $200m of cash and $100m of illiquid assets. If they can’t sell the illiquid assets and remaining business for a satisfactory price, they won’t have enough cash to pay everyone $0.88. So, Kinghorn has said that he won’t participate in the buyback if this situation arises. In short, we have the option to participate if we want. He doesn’t.

I can’t see how anyone can argue with their approach. All up, if you simply judged the board by their actions since late 2007, you couldn’t have asked for a better job.

For me, it’s been my most successful investment ever and there have been some important lessons along the way. The first one is an old one. Patience pays. Most of our frustration was probably related to the fact that we didn’t realise the value as soon as we wanted. But the business kept generating cash and, by keeping that cash, they were able to support

warehouses and keep bank funding that they otherwise might have lost. For those who were prepared to wait, it probably generated more value than it otherwise would have had they paid the cash out along the way.

The second lesson didn't apply directly to me but I know a lot of people that couldn't buy a stock that had already increased fourfold. When the RHG share price was $0.10, there were a lot of risks. In particular, it seemed highly likely that they would lose all their warehouse funding.

At $0.40, most of the risks had dissipated and it was obviously worth at least $0.80 (see RHG's atomic value). It was still a steal, but a trade very difficult to execute for most of us contrarians given we had already seen the price at less than 10 cents.

And the last lesson relates to management. We've had this conversation on Bristlemouth before but it's my personal view that the market for well-managed, wonderful businesses is a crowded space. Management is also an inherently difficult thing to assess. If you think you're buying in to wonderful management and pay a high price as a result, there's every chance you'll be disappointed.

Assume the worst, on the other hand, pay a price that compensates and you might just be pleasantly surprised.

Lastly, I'd like to thank all those that supported me in last year's RHG board tilt and, more importantly, continued to support *The Intelligent Investor* through what was a very difficult time in late 2007 and throughout 2008. With Timbercorp in all sorts of trouble and RHG trading as low as 5 cents, many people were (understandably) questioning whether I had any idea what I was talking about.

For those that managed to stay the course, I hope you have been justly rewarded.