After Plunging 33%, Is Home Capital Group Inc. a Huge Bargain?

Description

Home Capital Group Inc. (TSX:HCG) is one of Canada's most polarizing companies, and for good reason. It is Canada's leading subprime mortgage loan provider, and thus is the perfect target for anyone looking to short the Canadian housing market. But it's also a very profitable company with strong management, making it a favourite pick for many investors.

As one might expect, the stock has been on a wild ride over the past couple of years. It started in May 2013, when Steve Eisman (who gained fame for betting against U.S. subprime loans before the financial crisis) presented his bear case on Home Capital at the Ira Sohn Investment Conference. This prompted many American hedge funds to bet against the company.

But Home Capital continued to post impressive numbers, and the American short-sellers were forced to reverse their bets. As a result, Home Capital shares surged by 120% in 15 months.

More recently though, Home Capital has posted some troubling numbers, and its shares have nosedived. In just the last three weeks, the company's shares have fallen by about a third.

What's caused this drop? And more importantly, is this a golden opportunity?

Why the shares dropped

Home Capital's critics have mainly focused on credit quality, but this time the story is a little different. The company reported earlier this month that new mortgages were much lower than expected in the second quarter. This was a result of Home Capital ending its relationship with several of its broker partners.

The company's growth numbers will certainly take a hit. And it could get a lot worse. These brokers were cut off because they did not meet Home Capital's standards for quality—anonymous sources said there were even numerous examples of improper mortgage documentation from the brokers. So, we could see a meaningful rise in loan losses going forward

Until now, Home Capital's loan losses have remained very low. Annualized provisions totaled just 0.1%

of uninsured loans last year, and was even lower in the most recent quarter. But this latest news has prompted fresh worries about the company's mortgage portfolio.

Is Home Capital a bargain now?

On the surface, Home Capital appears to be extremely cheap. The company trades at just 6.5 times earnings, a ridiculously low number for a company with such a strong track record. But this is a very special case.

To determine if Home Capital is cheap, let's take a look at its results last year. The company reported loan losses of just 0.1% of uninsured loans, which led to adjusted net income of $4.09 per share. Even if losses were twice as high, adjusted net income still would have totaled $3.95 per share (assuming a constant income tax rate). Tripling losses would have still resulted in $3.81 per share in adjusted net income.

So, Home Capital shares are pricing in an extremely dire scenario for the company. Thus, this appears to be a major bargain. The company reports full results for the second quarter in just a couple of days—we'll find out more at that time.

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1. Editor's Choice

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