Why I’m Still Staying Far Away From Home Capital Group Inc.

Description

On Wednesday afternoon **Home Capital Group Inc.** (TSX:HCG), made two separate announcements.

In the first one, the company gave more details about its previous announcement about severing ties with many of its mortgage broker partners. In all, the company has now told 45 different brokers they’re not interested in doing business with them any longer after a third party informed Home Capital’s management that some of the loans these individuals brokered may have been given to borrowers with falsified income.

Additionally, Home Capital also released its second-quarter numbers. For the most part, results were in line with last year, with the company earning $1.03 per share on total revenue of just over $250 million. Last year the company earned $1.05 per share on revenue of $255 million.

But those numbers are less than what investors have come to expect. Throughout 2015 management has maintained that the expected growth rate of the bottom line would be between 8-13%. After these lackluster results, it seems pretty obvious that the company’s days of double-digit growth are behind it, at least for now.

While the results aren’t exactly encouraging, it’s the mortgage fraud allegations that really concern me about Home Capital.

A loss in confidence?

For those of you somewhat unfamiliar with Home Capital Group, the company’s model is simple. It mostly lends money to folks who are still decent borrowers, but have been rejected by more traditional lenders. Many of its borrowers are recent immigrants and people who are self-employed.

The biggest concern about lending to these people is always going to be default risk. After all, there’s a reason why Canada’s largest lenders aren’t terribly interested in these niche borrowers. Home Capital has always countered this criticism by reassuring investors that it has high underwriting standards. This confidence was a huge part of the business.

There’s another reason why Home Capital needs to make sure there’s confidence in its underwriting. The company borrows heavily in the bond market to be able to finance these loans, taking the interest spread as its profit. If investors no longer have faith in the company, the cost to borrow money will go higher.

At that point, the company has two options. It can either keep rates to borrowers the same and take less profits, or it can raise rates to borrowers, which might cause new loan originations to plunge. Neither of those situations are ideal.

Digging a little deeper into the fraud case shows it was a pretty big deal. Although the company only cut ties with 45 of its 3,000 mortgage broker partners, those brokers were responsible for a lot of business. In 2014 the group sent $960 million in mortgages to the company out of a total of $7.6 billion. Needless to say, one-eighth of the total loans originated during a whole year is a pretty big problem.

The bigger issue is the problem it creates with sentiment. Suddenly, it's very obvious Home Capital's underwriting standards aren't nearly as good as it thought. And the worst part? Somebody else had to tip the company off. It didn't even find out about this massive fraud on its own.

Even if these brokers were the only people abusing Home Capital's underwriting loopholes, the current situation still represents a massive problem for the company. When a leveraged financial loses the confidence of the market, there's no telling what the consequences might be. That's the big issue with Home Capital, and that's why it's still not a buy at under seven times earnings.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:HCG (Home Capital Group)

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