Why Home Capital Group Inc. Shares Will Likely Return to $50

Description

To say the least, **Home Capital Group Inc.** (TSX:HCG) has its fair share of naysayers. In fact, it is the most shorted stock on the TSX.

This isn't the first time sentiment has been negative on the company. Back during the economic crisis, its shares dropped by more than 50% in just five months. Then in May 2013, hedge fund manager Steve Eisman claimed that Home Capital was a perfect way to bet against an unsustainable Canadian housing market. Again, the shares dropped in response.

But through it all, Home Capital didn't miss a beat. The company kept growing its earnings, all while minimizing risk, and its stock price roared back each time. Investors who bet against Home Capital paid a dear price for doing so. As for the investors who bought at the bottom, they got handsomely rewarded.

Fast forward to today and Home Capital's shares are once again down on the year. And history may very well repeat itself.

Why Home Capital's shares have been crushed

Home Capital has been the target of short sellers for years, because as Canada's largest subprime mortgage lender, shorting the company is often seen as the easiest way to bet against Canadian housing.

In July, the shorts got what they were looking for. Home Capital announced that it had suspended its relationship with 45 mortgage brokers after discovering that they helped borrowers lie about their income on loan applications. These brokers had accounted for over 10% of the company's originations the previous year.

Suddenly, no one wanted a piece of Home Capital, and its stock price fell 19% in one day and another 20% over the following two weeks. The shares have only mildly recovered since then.

Solid results

Despite these issues, Home Capital continues to post solid results, which is nothing new. Earnings per share came in at $1.03, down less than 2% year over year (despite the headwind from cutting off the 45 brokers). Provisions for loan losses totaled only 0.06% of gross loans on an annualized basis, while net write-offs came in at just 0.04%. Only 0.30% of gross loans are non-performing, an improvement from last quarter.

Best of all, Home Capital has identified no major credit issues with the loans from those 45 brokers.

Compelling valuation

Home Capital currently trades for roughly 7.5 times earnings, a ridiculously low number for a company with such a strong track record. This means there is plenty of upside for the stock.

To illustrate, Home Capital has a medium-term objective to grow earnings by roughly 10% per year. If the company achieves this, then trades at 10 times earnings (which would still be cheaper than the Big Five banks), its share price will be at $50 by the end of 2017. That's a return of 50% plus dividends.

At the very least, even if Home Capital only partly achieves its objectives (or even if there are some bigger loan losses), then there's tremendous upside for the stock. Sooner or later, I would expect the share price to return to previous highs.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:HCG (Home Capital Group)

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bensinclair