



Aggressive Value Investors Ought to Consider Home Capital Group Inc.

Description

How low can **Home Capital Group Inc.** ([TSX:HCG](#)) stock go?

Fool.ca contributor Chris MacDonald [asked](#) readers this very question February 17. I've got an answer for Chris: I don't know, but what I do know is that Home Capital's underlying business isn't as bad as its stock price would suggest, providing aggressive value investors an opportunity that hasn't presented itself in almost five years.

I'm not talking about retirees who are living off their dividend income taking the plunge, but if you're in your 20s or 30s and have time to recover should Home Capital Group's troubles overwhelm it, or you're older and understand the risks associated with HCG stock at the moment, I think you'd be silly not to at least consider the idea.

Two things plague HCG stock.

Regulator troubles

The company faces disciplinary action from the Ontario Securities Commission (OSC) for failing to properly disclose to investors in 2014 and 2015 exactly what was happening regarding the \$1.9 billion in mortgages that were obtained through falsified documents and information.

National Bank of Canada analyst Jaeme Gloyn believes this isn't a big deal, suggesting the financial risk is entirely manageable and in the handful of millions. Given that Home Capital Group has always cooperated with regulators about this particular issue, it's hard to imagine the OSC throwing the book at it.

The bigger concern is the threat of a class-action lawsuit against the company, which could be a lot costlier than an OSC sanction. For example, if a potential class-action lawsuit did surface and Home Capital Group was required to pay claimants \$100 million, that would be 38% of its 2016 adjusted net income of \$263.4 million.

That's a big deal for a lot of reasons, but given its book value per share has increased in nine out of

the last 10 years, a break in that streak would have a negative effect on its stock price.

Tightening mortgage rules

Last October, the Federal Government [tightened](#) the mortgage insurance rules and that put a load of hurt on mortgage lenders such as Home Capital Group and **First National Corp.**, whose costs associated with funding mortgage loans went up as a result.

Long term, it shouldn't be an issue, but it certainly got investors thinking about Home Capital's bread-and-butter non-prime and near-prime customer base and what this would mean in terms of future growth in its mortgage business.

It's important to remember that while this whole issue with the fraudulent mortgage applications was unraveling, Home Capital Group continued to improve the quality of its mortgage clients, and while loan expenses are rising, a plan to cut \$15 million in annual operating costs should minimize the effect.

Proper underwriting, which the banks claim to do, is absolutely essential for Home Capital Group given that 80% of its residential mortgage portfolio is uninsured. The weighted average current loan-to-value ratio of its uninsured mortgages is 60.9%, which means the average mortgage client has 40% equity in their homes, making them far more stable than people with insured mortgages and 90% loan-to-value ratios.

Bottom line

Home Capital Group stock is currently trading at one times its 2016 book value per share of \$25.12 — the lowest multiple over the past 10 years. The last time it consistently traded below \$30 was five years ago when its profits were similar, but its book value was almost half what it is today.

Its business is in a better position than I thought. Last July, I wondered about [shorting](#) its stock because of its sub-prime legacy, but the fact is, most of its business is with hard-working self-employed customers who can't qualify for a traditional bank mortgage.

I believe that was a rush to judgment. Since that article, Home Capital Group stock is down 13.3%, which isn't a whole lot considering the level of short interest in its stock.

Aggressive value investors ought to be all over this one.

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