Aggressive Value Investors: Beware of Home Capital Group Inc.

Description

Fool Contributor Will Ashworth suggested in his most recent article on **Home Capital Group Inc.** (TSX:HCG) that the company's underlying business model seemed to be not as bad as the stock price suggested, providing a buying opportunity for aggressive value investors.

When reading through the company's financial statements, it is hard to find any concrete data on how Home Capital Group's business model has improved over time and why this proposed value exists.

I will take the time to expand on the financial results of Home Capital Group in its 2016 annual report to show why investors have lost faith in the Canadian lender, besides the recent Ontario Securities Commission's pending litigation and tightening mortgage rules (both of which may prove to be significant additional headwinds for the company).

Business fundamentals lagging

Top- and bottom-line metrics for Home Capital Group have all been hit in 2016. The company had declines in the following key fundamental metrics; these are year-over-year numbers, showing the percentage declines in each fundamental category:

- Net income (-13.9%)
- Adjusted net income (-8.8%)
- Total revenue (-2.8%)
- Diluted and adjusted earnings per share (-9.3% and -3.9%, respectively)
- Return on equity (-18.2%)
- Return on average assets (-14.3%)

We can see that the majority of the most fundamental metrics, from top-line to bottom-line numbers, have been on the decline for some time. It should be noted that all of the same categories declined in Q4 2016 compared with Q4 2015, and the majority of these quarterly numbers were far worse in the fourth quarter of 2016 compared with 2015, suggesting the slide has only just begun.

Downgraded guidance

In Home Capital Group's 2016 annual report, the company downgraded its own expectations for future growth. Anytime internal calculations confirm weaker expectations for future growth, analysts begin to sharpen their pencils and assign a higher risk profile and reduced growth expectations into the stock price.

Here's a quick summary of the downgraded guidance. Note the fact that the future expected payout ratio is left as unknown in the company's financial statements, meaning a dividend cut or the elimination of the current dividend may be an option management has considered or will consider in the future.

Measure	Previous	2016 Performance	New
Revenue growth	–	–	>5%
Diluted EPS growth	8% – 13%	-3.9% YOY	>7%
Return on shareholder's equity	>16%	16.3%	>15%
Dividend payout ratio	19% – 26%	25%	–

(Source: Home Capital Group 2016 Annual Report)

Conclusion

What value investors look for in analyzing if a stock is ripe for the picking and ready to make a rebound depends largely on the underlying fundamentals of the business. Such an investor would be wise to search for improving fundamentals before stating that Home Capital Group'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.

The stock market is comprised of millions of investors placing their bets as to the underlying value of equity positions in securities. It seems the market believes an aggressive buying opportunity for Home Capital Group doesn't exist, at least not yet.

I will be following up on Home Capital Group throughout the year, providing any updates to the contrary. For the time being, the prudent thing to do is to read the financial statements and make an educated investment decision based on the company's fundamentals.

Stay Foolish, my friends.

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