Home Capital Group Inc.: Most Recent Press Release Misleading

Description

In response to allegations from the Ontario Securities Commission formally accusing **Home Capital Group Inc.** (TSX:HCG) and three of the company's executives of failing to properly disclose the extent of a mortgage origination scandal in years past, the company issued a press release on Friday in response.

In this article, I will use the values released in the most recent press release from Home Capital to show that the company's quarterly net income decreased by 10% in the first quarter of last year, indicating further deterioration in Home Capital's fundamentals and more problems ahead for any investor thinking about taking a long-term position in this company.

What the press release said

The press release, aimed at re-asserting investor confidence, released earnings numbers early to the market. A very rare move, it is clear that the Home Capital board is concerned about a run on its operations and is doing everything in its power to calm investors.

The press release claimed an increase in adjusted diluted earnings per share (EPS) over the first quarter of last year. This press release also asserted that the strength of Home Capital's core residential mortgage business and improving mortgage discharges were two of the key drivers behind higher adjusted EPS numbers, and that the company was in a much stronger position than the news would indicate.

What the press release didn't say

First of all, a lot has changed over the past year, including the capital structure of Home Capital. As of Q1 2016, the company had 70 million (69,996,000, to be exact) shares outstanding; due to a number of large share buybacks over the past year, the current number of shares outstanding is estimated to be 64.2 million.

For lenders, typical categories of assets and liabilities are reversed; cash is a liability due to the fact that Home Capital needs to pay depositors a rate of interest (cash is essentially debt), and debt (mortgages) are the company's assets.

Reconciling this, we can see why Home Capital's use of its cash reserves (debt) to buy back shares, while increasing the share price and metrics such as EPS in the short term (since the denominator in these calculations simply gets smaller), is not a sustainable or effective strategy long term.

The real earnings story

I will be using diluted EPS as the primary metric to determine Home Capital's Q1 2017 IFRS earnings, as most of the legendary investors, such as Benjamin Graham and Warren Buffett, have done when analyzing earnings over a length of time.

Doing the math, we can easily back out the net income or earnings of Home Capital from the EPS numbers and the number of shares outstanding. Here is the real story:

	Q1 2017	Q1 2016
Diluted EPS	$0.90	$0.92
Shares Outstanding	64.2 million	70 million
Net Income	**$57.78 million**	**$64.25 million**

Thus, we can see that net income has substantially dropped year over year on the order of 10.1%, adjusting for share buybacks.

Interestingly, Home Capital decided to begin a significant share-buyback program in 2016, as the company's stock price began to sharply decline. As of Q1 2015, Home Capital had 70.2 million shares outstanding, meaning it only repurchased 200,000 shares in the fiscal year 2015 compared with 5.8 million shares in 2016 (or 8.3% of the outstanding float).

Bottom line

I found this press release to be very misleading for investors. While the stock increased by 12% as of noon Friday, I anticipate that investors will do their homework and see through this ploy.

Stay Foolish, my friends.

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