Home Capital Group Inc.: Next Stop, Zero?

Description

Wednesday might end up being remembered as the worst day in **Home Capital Group Inc.'s** (TSX:HCG) +20-year history.

Shares of the subprime mortgage provider plunged more than 60% in early Wednesday trading after the company revealed a shocking decline in its funding sources. On March 28, Home Capital had approximately $2 billion worth of deposits in high-interest savings accounts. By April 24, amid scores of bad news, that balance had declined to $1.4 billion.

In short, Home Capital is dealing with a proverbial run on the bank.

The company also said it expected these declines to continue, causing it to take drastic action. It announced it had agreed to take out a credit line worth up to $2 billion from an unnamed major institutional investor, but with some incredibly onerous terms.

The interest rate of this line of credit will start at 10% annually, and the company will have to pay a $100 million non-refundable commitment fee. In addition, Home Capital would also have to pay 2.5% interest on any standby funds not yet drawn, and the loan will mature in 364 days. The hope is, presumably, that the company will be able to pay off this loan with renewed deposit capital at that point.

Needless to say, healthy companies do not take out loans like this, especially in today's low interest rate environment. It reeks of desperation.

Can the stock survive?

Before this announcement, investors were debating the severity of Home Capital's problems. Some were convinced the company's problems were contained to the current Ontario Securities Commission investigation that questioned its disclosure practices from top management. In other words, the company would negotiate a settlement, pay the fine, and move on. No big deal.

Others were insistent there were far bigger problems below the surface. They're subscribers to the cockroach theory, which states there's never one piece of bad news. A scandal is evidence of further issues that have been covered up.

There are two huge issues with the current loan. The first involves nothing more than simple math. The company's mortgage rates range from a low of 2.14% for a two-year fixed loan to a high of 4.64%, which is the company's posted rate for a five-year fixed mortgage. It doesn't take a math genius to realize Home Capital is losing money with every mortgage it originates.

The bigger issue is sentiment. Ultimately, a bank is in the credibility business. If depositors don't feel the bank is sound, they will take their money out, even if that money is insured by the Federal Government.

Look at it this way: Oaken Financial, which is a subsidiary of Home Capital, currently pays its high-interest savings account depositors 1.75%. This is one of the best rates out there; most major competitors pay less than 1%. An extra 1% annually is nice, but not when it comes clouded with uncertainty.

A similar story is playing out with the company's GIC rates. Oaken Financial currently pays 2.5% to folks signing up for a five-year GIC. This is the highest rate in Canada. In comparison, Canada's big banks pay an average of 1.7%.

Home Capital's rates have been among the highest in Canada for years now, yet depositors are still leaving in droves. How does the company reverse the trend? I'm not sure it can.

The bottom line

At the end of the day, it comes down to this. Without ample low-cost liquidity, a bank cannot survive. By securing a credit line that reeks of desperation, Home Capital appears to have started falling down a slippery slope. If it cannot correct itself — and quickly, too — then its continued problems may ultimately lead to the stock being worthless.

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Date
2025/08/26
Date Created
2017/04/28
Author
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