Will Home Capital Group Inc. Survive the Latest Crisis?

Description

*Editor's Note: A previous version of this article stated that, "The greatest concern is that as guaranteed investment certificates (GICs) totaling almost **$113 billion** mature in coming weeks…" This has been updated to state that, "The greatest concern is that as guaranteed investment certificates (GICs) totaling almost **$13 billion** mature in coming weeks."*

The stunning meltdown of **Home Capital Group Inc.** (TSX:HCG) has caught many investors unaware. In just over two weeks, the company's fortunes have tanked; its stock is now worth roughly a third of where it was in mid-April 2017.

What is worse is that aside from an investigation by the Ontario Securities Commission and a class-action law suit, Home Capital has experienced a considerable run on its deposits.

This should be of considerable concern to investors.

Now what?

You see, Home Capital is in the business of lending money — more specifically, it offers mortgages — with a niche market position where it lends to non-prime borrowers. This can be a very lucrative business if the risks are appropriately managed.

Fears of the company's collapse have triggered a significant run on its on-demand deposits**,** which have tumbled by 70% over the last week to now be worth only $391 million. This means that it lacks the required level of liquidity to generate new mortgage business.

The bad news doesn't stop there.

The greatest concern is that as guaranteed investment certificates (GICs) totaling almost $13 billion mature in coming weeks, there will be full-blown run on these funds, leaving the cash-strapped mortgage lender incapable of funding new loans.

If Home Capital can't generate sufficient new business, then it will more than likely have to cease operations.

Nevertheless, the $2 billion loan from the Healthcare of Ontario Pension Plan will give it some breathing space, although it comes at a steep price. The loan has a 10% interest rate on drawn funds and 2.5% on undrawn balances. These high rates will impact Home Capital's margins, causing profitability to fall at a time when it desperately needs to generate more cash flow.

Home Capital's tapped-out liquidity means it will be forced to find more emergency loans to survive as a going concern. Given its precarious state, it is highly unlikely that it will be able to fund additional cost-effective funding, thereby leaving it incapable of writing desperately needed new business.

As a result, Home Capital has engaged two investment banks to weigh up other strategic options, including additional funding or even the sale of the company.

It is this last option that is shaping up as the most likely, with the likes of **Brookfield Asset Management Inc.** and **Fairfax Financial Holdings Ltd.**, among others, reportedly weighing potential bids for the wounded mortgage lender. Because of the securities commission investigation, class-action lawsuit and Home Capital's lack of liquidity, any buyer would be able to pick it up for a fire-sale price.

That means there could be very little on offer for existing shareholders, especially those who'd bought the company when it was trading at well over $20 per share.

So what?

It is extremely difficult to see how Home Capital can recover from the run on its deposits and survive without it being acquired by a company that has the required funding on hand. While the loan from the Healthcare of Ontario Pension Plan has given some hope, it appears insufficient to resolve the looming liquidity crisis.

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