



Is the Crisis at Home Capital Group Inc. Over?

Description

It has been a roller-coaster ride for investors in strife-prone alternate mortgage lender **Home Capital Group Inc.** ([TSX:HCG](#)). After plummeting to less than a third of its value during March 2017 because of fears that it would not survive a run on its deposits, the stock has surged by an impressive 43% since early April as management worked feverishly to stabilize the ship.

Since the run on its deposits, Home Capital has garnered considerable attention from contrarian investors who believe there is considerable value waiting to be unlocked. Even **Canadian Imperial Bank of Commerce** took a position as the stock price of Canada's largest alternate lender collapsed because it believed that credit quality remained solid and the company was undervalued.

Now what?

Key to determining if Home Capital can survive its current predicament and unlock value for investors is understanding what sparked the crisis. Contrary to the views expressed by some pundits, it wasn't issues relating to the quality of its lending portfolio, but rather a very public loss of confidence that was triggered by a confluence of events.

These events include fears surrounding credit quality created by a fraudulent mortgage scandal, a class-action lawsuit, and, most significantly, an investigation by the Ontario Securities Commission.

The events shattered confidence in the non-bank lender and triggered a run on its deposits, causing a liquidity crunch that almost caused it to collapse.

It is also important to recognize that the investigation does not relate to Home Capital's lending practices or credit quality. Rather, it is focused on allegations that the company breached its continuous disclosure requirements, misleading financial markets over the discovery of falsified income documentation for some mortgages.

Sources close to the investigation have indicated that a settlement with the securities regulator may be in sight.

There are also increasing signs that Home Capital has stabilized its liquidity position and may have found alternate funding. On-call deposits and GICs have not fallen significantly since the end of May.

Meanwhile, another rumour circulating is that Canada's second-largest private equity fund **Catalyst Capital Group Inc.** has offered to provide Home Capital with funding to stave off the liquidity crunch. This would certainly ensure the non-bank lender's survival, but it may not be a positive development for stockholders.

You see, Catalyst Capital is a predatory lender that specializes in profiting from distressed situations. This means that it would buy debt from Home Capital as part of the funding deal, placing it ahead of shareholders should the business fail or need to be restructured.

Typically, these types of firms only lend money with the objective of gaining ownership or control of the assets of the borrower at a significant discount to their market value.

Clearly, with a gross impaired loans ratio of 0.18%, Home Capital's credit quality remains high, meaning that the tangible book value of about \$26 per share, which is more than double its current share price, makes it significantly undervalued.

If Home Capital can successfully settle the securities commission investigation and secure sufficient, more cost-effective funding that doesn't endanger equity holders, I would expect its shares to rebound sharply.

So what?

Any investment in Home Capital is highly speculative; there is still plenty of way to go before the lender is out of the woods.

Nonetheless, what is increasingly clear is that the situation has stabilized, and Home Capital has plenty of levers at its disposal with which to resolve the liquidity issues, including selling a portion of its loan portfolio. While the situation does still appear dire, it is far better than it was a month ago. It is way too soon to write the non-bank lender off.

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