Is Home Capital Group Inc. Undervalued?

Description

After famed investor Warren Buffett's vote of confidence in **Home Capital Inc.** (TSX:HCG) it appears that the beleaguered alternative mortgage lender will survive. It has been a costly battle for the company; not only has it incurred significant costs in its fight to survive, but the reputational damage has been considerable, and that will take some time to repair.

Despite rallying significantly in recent days, Home Capital is still down by a massive 45% for the year to date, leaving some investors questioning if Home Capital is significantly undervalued.

Now what?

Buffett's decision to invest in Home Capital has been a life saver for the distressed mortgage lender. The investment has allowed Home Capital to throw off the shackles of the usurious $2 billion loan provided by Healthcare of Ontario Pension Plan and replace that with a far more reasonably priced credit facility.

That bodes well for Home Capital's ability to rebuild its business.

Nevertheless, its assets have shrunk.

To escape the liquidity crunch created by the massive run on deposits, Home Capital sold a portion of its mortgage portfolio. Earlier this month, it entered an agreement to sell $1.2 billion of mortgages to KingSett Capital and recently announced the sale of a further $250 million in residential mortgages to another third party. Those sales have decreased the size of its mortgage book by almost 8% to now be roughly $16 billion.

The proceeds of those sales are earmarked to meet repayments for outstanding credit facilities and bolster liquidity. These asset sales, however, mean that its book value has decreased and an 8% reduction in the size of its mortgage portfolio will also impact its ability to generate recurring revenue.

The ability to sell large tranches of its mortgages indicates there is considerable confidence in thecredit quality of Home Capital’s portfolio.

Home Capital is also in the process of settling the investigation by the Ontario Securities Commission over whether or not it misled investors and a class-action law suit launched by disgruntled investors over similar claims. The company has agreed to accept full responsibility for failing to meet its disclosure obligations and pay $30.5 million in a combination of penalties and restitution.

Fortunately, much of that settlement should be covered by its liability insurance.

While the settlement, asset sales, and Buffett’s vote of confidence have taken the company off life support and sparked a much-needed boost in the volume of deposits being received, there is still a long way to go before it is business as usual.

The reputational damage suffered by Home Capital will act as an impediment on receiving the necessary volume of deposits to generate profitable mortgages.

There is also the dilutive nature of Buffett’s deal and his proposed purchase of up to a 40% equity stake in the lender. The first tranche of that deal has been completed; Buffett acquired just over 16 million shares at $10 each, and the second tranche of almost 24 million shares needs to be approved by shareholders. This has become something of a sticking point for investors because Buffett is acquiring those shares at a 40% discount to the market price, and it will significantly dilute existing investors.

So what?

Much of the value that was present appears to have been priced in by the market. While the lender now appears to be on a sound footing, the reduction in the size of its loan book and dilutive sale of shares to Buffett means that, for at least the foreseeable future, there is little to no upside available to investors.

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