Is the Crisis at Home Capital Group Inc. Over?

Description

The past three months have been incredibly eventful for shareholders of **Home Capital Group Inc.** (TSX:HCG). What was a share price of approximately $25 sank to a low of $5.06, and many investors chose to jump ship along the way. The good news is that the company has turned the corner, and shareholders have seen a substantial increase from the 52-week low.

The company is currently trading at a price near $17 per share. The challenge that may be faced by investors going forward is the bad press that will follow the company for at least a few more months. Over the past three months, the Ontario Securities Commission (OSC) has investigated a number of senior executives and the company for knowingly providing mortgages based on false documentation. The fallout from this was a run on the company’s deposits which has since subsided.

Through the process, the company was forced to take a “lifeline,” which, had it not been replaced by Warren Buffett’s **Berkshire Hathaway**, eventually would have brought the company to an early end. With as much as it had going in the right direction, the same challenge has not gone away: the ability to finance long term mortgages.

Although the most significant part of the crisis has been dealt with, shareholders will need to keep their fingers on the pulse as the most recent financing provided at a cost of 9% is still a temporary solution. Within two years, the company will still need to address this long-term challenge. By then, investors looking for yield will hopefully have forgotten about the company’s woes and be willing to place their capital with either Home Capital Group (in a GIC or high-yield savings account) or with the new company that could bear another name.

If we look at past corporate scandals, the names of companies seem to change quite often after something this damaging comes to light. It is much more probable that in the case of Home Capital Group that the name will only be changed once the bad news is squarely behind it and a new direction is taken. Things may still be too fresh for this to happen.

Over the next one to two years, the two most important factors to weigh on the company will be its cost of capital and how much new lending is made by the company. The more lending that is done, the more the company stands to make from the interest charged on the mortgages. The caveat is that without a lower cost of funding these mortgages, the company will not be able to profitably deliver for shareholders.

Under the current circumstances, the company, which is carrying tangible book value of close to $26 per share, still trades at a significant discount. Clearly, many investors have not yet gotten over the bad press and are still pricing in bad news. There could still be more yet to come!

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