



## Is Home Capital Group Inc. an Attractive Investment?

### Description

The last few months have been a bumpy ride for investors in Canada's largest alternative mortgage lender, **Home Capital Group Inc.** ([TSX:HCG](#)). After nearly collapsing because a run on its deposits triggered by a very public loss of confidence in the company, it has recovered. Its shares are now more than double its early May 2017 lows. This can be attributed to famed billionaire investor Warren Buffett's \$400 million June bailout of the alternative lender.

While the crisis is over, and Home Capital will remain as a going concern, the question some investors are asking is, is Home Capital attractively valued?

### Now what?

A notable development that bodes well for Home Capital's future growth has been its ability to restore deposit-taking activities. By the start of August 2017, inflows had returned to historical averages, giving the company almost \$13 billion of deposits. That is a notable achievement because it means that the alternative lender is capable of underwriting new mortgages and growing its loans under management, which is key to boosting its earnings.

Another pleasing aspect of Home Capital's financial position is that it has been able to repay the outstanding balance of the credit facility provided by **Berkshire Hathaway Inc.**, giving it the ability to draw up to \$2 billion if required. That meant that at the start of August, it had aggregate liquidity, including available credit, of almost \$4 billion, which, along with growing deposit inflows, provides Home Capital with considerable financial flexibility.

The mortgage lender was also able to settle the Ontario Securities Commission investigation during the second quarter 2017 as well as the class-action lawsuit, removing the uncertainty around its financial outlook.

One favourable outcome of the crisis is that it demonstrated the quality of Home Capital's mortgage book. Despite coming close to failure, external parties were eagerly snapping up the portions of its loans that it tendered for sale to bolster its liquidity. By the end of the second quarter, Home Capital reported a non-performing loan ratio of a mere 0.23%, which was 10 basis points lower than a year

earlier and significantly less than any of the major banks.

Bank of Canada's decision to hike the benchmark overnight interest rate to 0.75% will boost the profitability of Home Capital's business. This is because higher rates increase the margins it is capable of generating from the mortgages it originates, thus leading to higher earnings.

Another impressive aspect of its financial condition is that Home Capital ended the second quarter well capitalized with a common equity tier one capital ratio (CET) of just over 17%. This was 68 basis points higher than the equivalent quarter in 2016 and well above the CET ratios of the big banks. Such a high ratio highlights the work the company has undertaken to strengthen its balance sheet and improve its resilience to any external financial shocks that could threaten the quality of its loan book or the sustainability of its business.

Each of these factors, in conjunction with it trading at roughly a 40% discount to its book value of \$21.63 per share at the end of the second quarter, has led some pundits to claim that Home Capital is heavily undervalued.

While there is certainly some truth to this claim, there are a number of issues that will impact its valuation.

Key among these is the dilutive nature of Buffett's investment in Home Capital.

The Oracle of Omaha secured an initial investment of 16 million shares at an average of \$9.55 each and is now looking for shareholder approval to buy another 24 million shares at an average price of \$10.30 each. He is acquiring the final tranche of shares at a substantial 21% discount to Home Capital's current market price, which, if approved, will dilute existing investors, leading some to question if the deal should go ahead.

### **So what?**

While there are question marks about Home Capital's true value, it is clear that it has pulled through the crisis and is well positioned to return to profitability. This leaves it attractively valued, especially now that deposit inflows are reaching pre-crisis levels and it has the backing of Buffett.

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