Is Home Capital Group Inc. a Value Investment or Should You Avoid it?

Description

Since the beginning of May, shares of **Home Capital Group Inc.** (TSX:HCG) have increased by over 100%, effectively doubling in value. Although this is incredible, between April 19 and April 26, shares of the company cratered, losing 73%. In the case of Home Capital Group, gaining over 100% is actually less in absolute dollars than losing 73%.

Nevertheless, the company is on the up and up, and it had an incredibly strong second quarter which included a multitude of great events.

The first is that Yousry Bissada was named president and CEO. This is important because he comes from a consumer background. He was CEO of Kanetix, which is one of Canada's largest online platforms for sourcing insurance quotes. Users go there, and then the insurance information is sold to providers. The experience Bissada has will help Home Capital Group find its customers again.

Second, it reached two separate legal agreements. The first is a global settlement with the Ontario Securities Commission (OSC). The second is a class-action lawsuit. Although this requires approval from the OSC and the Ontario Superior Court of Justice, I expect that'll get wrapped up.

Third, Home Capital Group brought on Warren Buffett as an investor, which tends to be a big win for any company. A subsidiary of Buffett's **Berkshire Hathaway Inc.** (TSX:BRK.A)(NYSE:BRK.B) invested $153.2 million to acquire a 19.99% equity stake in the company. The Berkshire subsidiary also provided a $2 billion line of credit to Home Capital Group at a 9% interest rate. During the second quarter, this line of credit was completely repaid.

Finally, the company's mortgage book is actually doing quite well. Its non-performing loan ratio is only 0.23%, which is 10 basis points lower than a year prior. These loans, which are 90 days late, account for such a small percentage of the book that I'm not particularly concerned in the short term.

So, the business is obviously on a much stronger footing than it was when Berkshire originally invested. With a book value of $21.63 at the end of the second quarter, investors are wondering if it's time to get in before the market figures out the value play.

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There are a couple of problems that need to be addressed first.

The first is the available liquidity. Home Capital currently has $3.94 billion as of August 1, with nearly half of that provided by deposits (a big win for the company). The problem with its liquidity is the 9% interest rate on the other $2 billion of its liquidity — the Berkshire portion.

If you were to get a mortgage today from a wide variety of lenders and have good credit, you're looking at a rate south of 5%. Therefore, the only way for Home Capital to make money on a 9% interest rate is to lend it at a rate higher than that. The only people that will pay that are subprime borrowers. That's a risky play for Home Capital Group.

The other problem, also tied to Berkshire, is the option for Berkshire to buy an additional $246.8 million in shares at an average price of $10.30. This would create an additional 24 million shares, which ultimately dilutes investors. I expect shareholders are going to fight back against this dilution, but if it goes through, there could be a short-term drop in the price.

I first wrote about Home Capital Group in July, and I was hesitant about investors putting money into the company. However, Bissada has joined the company, the deposit rates are increasing significantly, and it has some liquidity to make loans. I don't believe Home Capital Group is out of danger just yet, but it's on its way. A smart investment might not be a terrible idea.

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Page 2

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