

What Is Home Capital Group Inc. Worth?

Description

With the shareholder vote to approve Warren Buffett's purchase of an almost additional 24 million shares in **Home Capital Group Inc.** ([TSX:HCG](#)) looming, investors are asking themselves if the alternative mortgage lender is a worthwhile investment. This is especially the case when second-quarter 2017 results assign a book value of \$21.63 per share, which is a 55% premium to Home Capital's price at the time of writing.

This has led to some pundits claiming that Home Capital is significantly undervalued and is a very attractive investment. While there is certainly some truth to those claims, it is clear that Home Capital's tangible book value is nowhere near as high as the book value stated in its second-quarter results.

Let me explain.

Now what?

Tangible book value is one of the best tools available to investors for identifying whether or not a company is undervalued. Essentially, it takes the sum of the value of all assets less goodwill, intangible assets, and liabilities. After conducting this calculation using the numbers on Home Capital's second-quarter balance sheet, I have identified a tangible book value of \$20.23 per share, which is a 6.5% discount to the its book value of \$21.63 per share.

The elephant in the room is the upcoming shareholder vote to approve **Berkshire Hathaway Inc.'s** (NYSE:BRK.A)(NYSE:BRK.B) proposed \$267 million investment to acquire an additional 23,955,420 common shares at \$10.30 each. This will have a significant dilutive effect on existing shareholders; according to Institutional Shareholder Services Inc., the dilution could be as great as 30%, and if that is the case, it would mean that Home Capital's tangible book value is closer to \$14.16 per share.

After conducting my own calculations, I've identified that if the deal is approved, it would dilute Home Capital's value by about 23%. Such a significant dilution of value would cause its tangible book value to fall to \$15.56 per share. While that would be a big hit for many existing investors, it represents a 11% premium to Home Capital's price at the time of writing.

You see, the dilutive effect of Buffett's deal coupled with the market remaining jittery over the outlook for the business because of its near collapse leaves it trading at a significant discount to its fair value.

Nonetheless, there are clear indications that Home Capital's business has turned the corner and has stabilized.

One promising development from the crisis was that it highlighted that credit quality was not an issue for the alternative lender, and it battled to stay afloat by selling tranches of its mortgages. By the end of the second quarter, Home Capital had an impressive non-performing-loan ratio of a mere 0.23% — one of the lowest in its industry. That coupled with a loan-to-value ratio for its uninsured mortgages of

59% highlights just how prudently Home Capital has been managing its mortgage book.

Importantly, the lender has been able to boost its deposit-taking activities to pre-crisis levels; along with aggregate liquidity of \$3.94 billion and a notable capital ratio of 17.54%, this underscores the strength of its business.

So what?

The dilutive impact of Buffett's planned acquisition of a further 24 million shares at a considerable discount to its book value and market price is weighing heavily on its stock price. While there are both merits and disadvantages associated with this deal for stockholders, what is increasingly clear is that Home Capital is attractively valued, even if the deal proceeds.

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2. NYSE:BRKA (Berkshire Hathaway Inc.)
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Date

2025/07/02

Date Created

2017/09/12

Author

mattdsmith

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