Did Home Capital Group Inc. Need Buffett's Additional Investment?

Description

After **Home Capital Group Inc.'s** (TSX:HCG) recovery from near corporate failure and claims by a range of pundits that it is deeply undervalued, I recently explored just what the alternative mortgage lender was worth. In that article, I determined that the company's reported book value per share represented an optimistic valuation, and that its true value was somewhat lower, although still higher than its market price.

Unsurprisingly, shareholders resoundingly voted to reject Warren Buffett's planned purchase of a second tranche of almost 24 million shares for $10.30 each, leaving the Oracle of Omaha with a stake of just under 20% in the alternative lender.

The rational for that rejection was quite simple: had Buffett's purchase been approved, it would have diluted existing shareholders by somewhere between 20% and 30%. That would have seen those investors take a massive hit on an investment that, for many, is already underwater. The outcome of the vote, where over 88% of shareholders voted against the deal, has sparked considerable consternation among some pundits, who believed that the greater the legendary investor's investment in Home Capital, the more secure its future would be.

Now what?

The vulnerability of alternative lenders like Home Capital was underscored by its near collapse earlier this year, which led to Buffett electing to invest in the company through a subsidiary of **Berkshire Hathaway Inc.**

Now, the $64 million question for investors is, did Home Capital need additional assistance from Buffett?

As discussed in prior articles, the liquidity crisis and near collapse of Canada's largest alternative lender was triggered by a very public loss of confidence caused by a mortgage origination scandal rather than shortcomings in its loan portfolio.

In fact, Home Capital's mortgage portfolio is prudently managed, as evidenced by a 0.23% nonperforming loan ratio, which is lower than many of the big banks. It is the robust quality of its loan portfolio which made it easy for Home Capital to sell tranches of its mortgages to shore up its liquidity at the height of the crisis.

Furthermore, with its uninsured mortgages having an average loan-to-valuation ratio of just over 59%, there is plenty of wiggle room to manage the latest rate hikes and any others that may occur before the end of 2017.

More importantly, Home Capital has significantly bolstered its balance sheet top to head off the threat of another cash flow crisis.

At the end of the second quarter, it had total liquidity, including available credit facilities of over $3.9 billion after repaying the $2 billion line of credit from Berkshire Hathaway. That coupled with net average daily inflows from deposit-taking activities exceeding $15 million has left Home Capital in a strong position and more than capable of recommending originating mortgages without the need for any further injections of capital.

The latest rate hikes, which see the headline overnight rate at 1%, or double where it was six months ago, will lead to higher margins for Home Capital.

You see, it essentially increases the spread, or the difference between what it charges borrowers and pays for deposits, causing its net interest margin to widen, making its lending operations more profitable.

So what?

It is easy to understand why shareholders overwhelmingly rejected Buffett's additional investment. Home Capital's business has stabilized, and with almost $4 billion in liquidity, along with deposit volumes reaching pre-crisis levels in recent weeks, there was no need for that additional investment, particularly when it would significantly dilute existing shareholders.

What's more, without that dilution, my original calculations indicate that Home Capital has a net tangible asset value of about $20 per share, indicating that with it trading at just over $14 per share, it is undervalued.

For the reasons discussed, it means that the risk/reward equation is certainly in favour of risk-tolerant investors, making Home Capital an attractive investment.

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