Is Home Capital Group Inc. a Deep-Value Investment Opportunity?

Description

In mid-2017, alternative mortgage lender **Home Capital Group Inc.** (TSX:HCG) almost imploded, as it battled a severe liquidity crunch triggered by a massive run on deposits. By late 2017, the lender had emerged from the crisis intact with a little help from someone considered one of the greatest investors of all time, Warren Buffett.

Regardless of his vote of confidence in Home Capital, the company's stock has yet to recover to pre-crisis levels and is trading at a significant discount to its book value per share. Along with improving operations, this has sparked speculation that Home Capital is very attractively priced, making now the time to invest.

Now what?

Home Capital's 2017 net income plummeted to less than a 30th of what it had been a year earlier. That can be attributed to a steep decline in net interest income, which was almost 38% lower than 2016. Loans under management also declined sharply, falling by % year over year to just under $15 billion.

Non-interest expenses also spiked, primarily because of the costs associated with emergency financing to avert the liquidity crisis and the lender's collapse, rising by just over 15% compared to a year earlier.

Despite higher interest rates, Home Capital's margins declined with its net interest margin falling by 0.82%, as a higher cost of credit squeezed its profitability.

It is this sharp decline in profitability which saw the alternative lender report a return on equity for 2017 of 0.4% compared to 15% for 2016, which is weighing on its stock price.

There is also persistent anxiety about the health of Home Capital's loan portfolio, with fraudulent activity by former mortgage brokers aligned with the lender triggering the liquidity crisis.

Surprisingly, despite Home Capital's poor 2017 financial performance, mortgage fraud scandal, a securities commission investigation, and its near collapse, its credit quality remains solid. Nonperforming loans as a percentage of total loans came to 0.3%, or the same as a year earlier, while allowances for credit losses were 3% lower.

Importantly for a mortgage lender that has suffered for a near-catastrophic liquidity crisis, it finished 2017 with cash resources of $1.3 billion, which is 11% higher than 2016.

Clearly, the underlying fundamentals of Home Capital's business are improving, while credit quality remains high, meaning the risk attached to its loan book is not elevated.

So what?

Home Capital finished 2017 with a book value of $22.60 per share, which, while 11% lower than a year earlier, is still 36% higher than its share price at the time of writing. This indicates that the value of its assets is greater than the lender as a going concern. That disconnect can be attributed to a severe lack of confidence in Home Capital by the market and fears that there may be more surprises ahead.

It is here where the opportunity lies. As Home Capital's performance improves, and it consistently demonstrates that asset quality is high, market confidence in the lender will grow, which will give its stock a healthy lift. When that occurs, it is easy to see Home Capital appreciating substantially in value.

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