Why Is This Warren Buffett Stock Sinking?

Description

Home Capital Group Inc. (TSX:HCG), a Canadian mortgage lender rescued by Warren Buffett's **Berkshire Hathaway Inc.** (NYSE:BRK.A)(NYSE:BRK.B) last year, is on a slippery slope again, dashing hopes of recovery in its business anytime soon.

Since the beginning of this year, Home Capital stock has lost 21% of its value. This downfall came after the alternative mortgage lender surged about three-fold last spring after Warren Buffett's firm injected $400 million equity and provided a $2 billion line of credit to help stave off a liquidity crisis the lender faced.

In April 2017, Home Capital faced a run on its deposits after Ontario's securities regulator alleged that the lender and three top executives had misled shareholders about fraud the company had discovered in its mortgage broker channel. Investors rapidly lost confidence and pulled deposits, forcing the company to seek a bailout from Warren Buffett.

So, what's causing this latest drop in Home Capital's share price? Let's take a deeper look.

Canada's cooling housing market

Home Capital's recovery will be elusive until we see Canada's housing market stabilize after a number of government measures, which have started to cool the demand for housing units.

Those measures included tighter rules for uninsured mortgages and a 15% tax on foreigners buying properties in the nation's largest cities — Toronto and Vancouver.

The latest numbers show home sales in March plunged 22.7% from record a year earlier. The national average price for a home dropped 10.4% last month from March 2017. A cooling housing market and tighter mortgage regulations mean that Home Capital will find it tough to regain its market share, which it lost after last year's crisis.

There is no doubt that Home Capital's new management is working hard to turn around the business and develop its ties with mortgage brokers, but it's going to be a tough journey, especially when the demand for loans is shrinking.

In its latest earnings report, Home Capital reported $0.38 a share diluted earnings — one cent higher from the Street's consensus.

The total loan origination in the fourth quarter surged 126% to $872.1 million when compared to the third quarter, but it remains drastically low when compared to the fourth quarter of the last year when it was $2.43 billion.

The bottom line

HCG stock, trading at $13.61, is a highly speculative trade for contrarian investors who have the patience to wait. I don't see a quick recovery materializing that could help the company improve the profitability in a meaningful way at a time when mortgage lending is facing significant headwinds.

Home Capital will report first-quarter financial results on May 8, when it will be clear whether the new management has been able to sustain little profitability it showed during the last three months of 2017.

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