Why it's Not Too Late to Follow Warren Buffett Into Home Capital Group Inc.

Description

With the major debacle in shares of **Home Capital Group Inc.** (TSX:HCG) one year behind us, investors can now rest assured that the worst is over, as those with the right outlook and risk tolerance have stepped in and taken a position as opposed to those who were panicked sellers as the market crumbled.

As is most often the case, once a major shift occurs in any industry or security, there is a realignment of those who hold the shares of the company. More than one year ago, Home Capital Group paid a healthy dividend yield, which attracted many investors seeking a steady dividend payment. In many cases, these were retired investors seeking income from their portfolios and expecting not to draw down on their capital.

Once shares declined in value, however, the market witnessed a major mistake by many investors: shares changed hands from those who lost their capital to more aggressive investors, who acquired shares in the hopes of making substantial capital appreciation. Now one year later, shares are still trading at a reasonable price of $14 with a substantial amount of value remaining for investors who are prepared to accept the risk.

With two quarters of "normalized" earnings in the books, the overall market now has an idea of what can be expected from this alternative lender on a quarterly basis. As a reminder, there is no seasonality to the earnings of this name.

With quarterly earnings of $0.37 and $0.38 per share over the past few quarters, investors now have an idea what the bottom line is expected to be under normal conditions. In the hopes that company management will be able to improve day-to-day operations and efficiencies, the bottom line should increase for many more quarters to come.

In terms of valuation, the current price of $14 per share equates to approximately nine times earnings, if we assume that earnings are to increase by a small amount over the next year.

Is that reasonable?

If we look back more than one year, the quarterly earnings for Home Capital Group were typically in excess of $1 per share, leading to a much higher share price (at the same multiple). With a current footprint that is much smaller, investors seem to be more sour on the name instead of forgiving and moving forward. Due to the smaller footprint of the company, it is now much easier to make the necessary changes to forgo the thinner margin business and retain the most profitable parts.

How do investors capitalize?

There are a few options for investors. The most obvious is to purchase the stock and be ready to enjoy a long ride until shares return to more than $22 per share, which will be more in line with the amount of tangible book value per share. Barring this option, call options may be the best way to go for those seeking to swim in the very deep end of the pool. Time will tell!

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