



## Is Home Capital Group Inc. (TSX:HCG) a Deep-Value Investment Opportunity?

### Description

After last year's liquidity crunch and near corporate failure, alternative mortgage lender **Home Capital Group Inc.** ([TSX:HCG](#)) has been garnering considerable attention. Even more so, legendary investor Warren Buffett [agreed to bail out](#) the embattled company and acquired roughly a 20% stake in the lender. While Home Capital has recovered, it is unlike its closest peer **Equitable Group Inc.** ([TSX:EQB](#)), trading at a deep discount to its book value. This has caused some analysts to claim that Home Capital represents an [attractively valued](#) investment opportunity.

### Now what?

By the end of the first quarter 2018, Home Capital's book value was \$23.04 per share, or 2% higher than the previous quarter. This represents a 55% premium over the alternative lender's market price, which, on initial appearances, indicates that it is deeply undervalued and offers considerable upside to investors.

Nonetheless, the book value is still 12% lower than the \$26.18 per share reported for the equivalent period in 2017, which was before the liquidity crisis struck, which almost caused Home Capital to collapse.

Even Equitable Group, which also plummeted in value in response to Home Capital's crisis because of fears that the alternative mortgage industry would go into meltdown, is trading at a discount to its book value per share. For the first quarter, it reported a book value of \$67.14 per share, which is 16% higher than its current price. It is, nonetheless, significantly lower than the discount being applied by the market to Home Capital.

Typically, when a mortgage lender is trading at a deep discount to its book value, it indicates that there are deep concerns within the market about the quality of its loan book and the business's ability to grow earnings.

However, Home Capital's problems didn't emerge from issues over credit quality, but rather a very public loss of confidence in the company as it found itself embroiled in a range of scandals that triggered a run on deposits.

This becomes evident when examining the lender's balance sheet at the end of the first quarter. Home Capital reported that the value of net non-performing loans came to a healthy 0.29% of gross loans. That is an impressive figure, which is lower than any of the major banks, indicating that credit quality remains high. It is, however, more than double the 0.13% reported by Equitable Group for the same period.

Such a figure should reassure investors as to the quality of Home Capital's loan book. The only issue is that by the end of that quarter, the value of gross impaired loans had risen sharply to almost \$58 million, which is a worrying 15% greater than a year earlier, highlighting that there has been a deterioration in credit quality.

That is compared to Equitable Group, where gross impaired loans declined significantly in value to be 35% lower year over year. This indicates that Home Capital's issues relating to credit quality are more than likely company-specific issues rather than industry-wide trends or caused by a broad uptick in defaults by Canadian borrowers.

Another worrying trend is that Home Capital's level of liquidity had slipped by the end of the first quarter. Deposits totaled \$12.1 billion, which was almost 1% lower than the previous quarter and represented a 26% decrease compared to a year earlier. The good news was that the greatest decline was among deposits on demand, whereas time deposits, which form the core of Home Capital's loan funding, remained relatively stable.

### **So what?**

While Home Capital appears undervalued, and management has clearly righted the ship and therefore avoided collapse, the alternative lender it is still battling a range of internal problems that are impacting its financial performance. These issues — along with a cooling housing market — will weigh on its growth prospects and ultimately its share price, thereby explaining why it is trading at such a deep discount to its book value. There are signs, however, that Home Capital is undervalued, and once the market regains confidence in the lender, its stock will soar.

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