



Is Home Capital Group Inc. (TSX:HCG) an Attractive Deep-Value Investment?

Description

Despite [claims](#) by some analysts that alternative mortgage lender **Home Capital Group** ([TSX:HCG](#)) represents a deep-value investment opportunity, it has lost just over 7% since the start of 2018. The company faced near failure in 2017 when a run on deposits triggered by a mortgage underwriting scandal and regulatory investigation saw depositors and investors storm for the exits. It was only the [intervention](#) of Warren Buffett that essentially saved Home Capital from failure and allowed management to right the ship.

Nonetheless, since then lender has failed to perform, and it is trading at 58% less than its reported book value of \$23.40 per share. This has led to significant speculation that Home Capital remains a deep-value investment opportunity that is poised to soar.

Now what?

The mortgage lender's liquidity, while still lower than its pre-crisis levels, has improved significantly in recent months. At the end of the second quarter, 2018 total deposits came to \$12.5 billion, which was just over 3% greater than the previous quarter. A notable improvement was a solid decrease in dependence on deposits payable on demand. For the second quarter, they decreased in value by 14% quarter over quarter to represent 30% of total deposits against almost 40% at the end of the first quarter 2018. This is a significant development for Home Capital, because the marked increase in the proportion of time deposits provides it with a more reliable source of funding.

Despite this noteworthy progression, credit growth remains slow. Home Capital reported that the value of mortgages at the end of the second quarter was only 2% greater than the previous quarter and almost 13% lower than a year earlier. It is this which has been a major sticking point for investors and — along with a cooler housing market — has caused the market to treat Home Capital with caution.

The risk, however, is not as severe as believed. This is because not only has the mortgage lender been able to bolster funding, notably from time deposits, but credit quality remains high.

You see, one of the key triggers of the run on deposits in 2017 was a fear that credit quality was poor, and this would cause Home Capital to collapse, but this is far from reality. By the end of the second

quarter, the lender reported a gross impaired loans ratio of 0.45% compared to 0.38% for the quarter prior and 0.26% a year earlier. While there has been a sharp increase in gross impaired loans, the ratio is equivalent to or even less than many of Canada's major banks.

It is also far lower than the ratio required to indicate that the quality of Home Capital's credit portfolio is capable of threatening its survival. The alternative lender is also adequately capitalized, finishing the second quarter with a common equity tier one capital ratio of 23%, which is 6% greater than it had been a year earlier.

So what?

All of these factors indicate that Home Capital has stabilized its business and recommenced growth. It is steadily expanding its loan originations while boosting the quality of its deposit base, which is key to funding the company's lending business.

The key test, however, of whether Home Capital is a deep-value investment opportunity is to determine whether the book value reported by the company accurately reflects what its business is worth. After subtracting goodwill and intangibles, deferred tax assets, other assets, and liabilities from total assets, Home Capital has a book value of \$17.60 per share, which, while less than the \$23.40 reported, is still 21% greater than its current price.

While a cooler housing market and the negative sentiment associated with Home Capital's near collapse will continue to weigh on its market value for some time, there are clear signs that its business has improved substantially. This indicates that it is an attractively valued investment for contrarian, risk-tolerant investors.

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