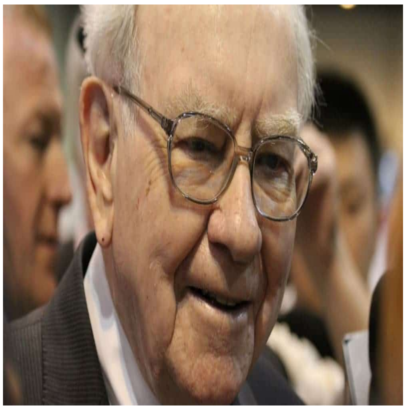

A Warren Buffett Turnaround Stock That's Stuck in the Mud

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 proving to be a tougher turnaround bet than many had believed.

Since the beginning of this year, Home Capital stock has lost 24% 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.

But after more than a year, it seems that the turnaround that many investors were betting on after the lender got the backing of the world's most successful value investor is still a distant dream.

In my view, HCG isn't trading on Warren Buffett premium as investors increasingly become skeptical on the quick recovery in its mortgage business. Here are two main factors that are impeding the company's growth.

Rising interest rates

When HCG is struggling to regain the lost share in the mortgage market, it's gotten a lot tougher. The Bank of Canada is becoming more aggressive in hiking interest rates, a move that's also raising costs for both borrowers and lenders.

Yesterday, the BoC raised its overnight benchmark rate by a quarter point to 1.75%, the third hike this year and the fifth since it began tightening in 2017. In a sign that more increases are in store, it dropped references to taking a gradual approach and added language about the need to bring rates to levels that are neutral, or no longer expansionary.

Rising rates is making it more expensive for the alternative mortgage lender to raise funding through term deposits, its main source of liquidity. To lure savers, HCG is raising the rate it offers on GICs, which in turn reduce the margin for the lender.

In the second-quarter earnings, the lender missed analysts' expectations as tighter margins hit the bottom line. Home Capital earned $29.6-million in the second quarter, which ended June 30.

Compared with the first quarter this year, profit fell by 14.4%.

Canada's cooling housing market

With cost pressure and intense competition in the mortgage market, Canada's home market is also cooling, and there is no sign that it will come back strongly when interest rates are rising. After a number of government measures aimed at demand management, many prospective buyers have moved to the sidelines.

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 bottom line

HCG stock, trading at $12.89, has no appeal for investors looking for a short-term gain. Its turnaround is tied to the cyclical factors that are not in the company's favour in the short-to-medium term. As such, I don't see a quick recovery materializing that could help the company improve the profitability in a meaningful way.

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