



Is Home Capital Group (TSX:HCG) a Poor Investment?

Description

In a surprise move in late 2018, billionaire investor Warren Buffett elected to [cut ties](#) with alternative mortgage lender **Home Capital Group** ([TSX:HCG](#)). When that was announced, the lender's shares sank, but since then they have rebounded strongly, gaining 30% since the start of 2019.

Buffett bought into the company, taking a 20% stake, when a series of events, including allegations of mortgage fraud and an Ontario Securities Commission investigation triggered a massive run on deposits, which almost saw Home Capital collapse. The Oracle of Omaha's investment was heralded as a defining moment for the company, but it was done on terms that didn't favour existing shareholders. Buffett's plans were rebuffed when shareholders [voted down](#) his planned acquisition of another 18% of Home Capital in September 2017.

Mixed results

The lender reported some mixed first-quarter 2019 results, which demonstrated that Home Capital still have a long way to go before it has fully recovered from its near-death experience. Mortgage originations totalling \$1.2 billion were 5% higher year over year, while loans under administration expanded by 2.5% to \$23 billion.

Importantly, deposits, which are critical for funding Home Capital's mortgages, grew by 12% to \$13.6 billion, indicating that it is having no problems with attracting funding to support its lending business. The value of deposits, however, are still 17% lower than pre-crisis levels, indicating that Home Capital's growth remains limited.

The alternative lender's net interest margin remained flat at 2.01% and provisions for credit losses edged up to \$6.1 million compared to \$6 million a year earlier. Non-performing loans also surged by a very worrying 84% year over year to \$106 million, which are more than double the pre-crisis first-quarter 2017 value.

Nonetheless, Home Capital's net non-performing loan ratio of 0.49% is quite low and indicative of a high-quality loan portfolio.

The fear is that a weaker-than-expected economy coupled with stagnant wage growth, heavily indebted households, and the fact that the lender's loans are of a lower quality than the major banks will cause lending losses to expand at an unhealthy clip. Home Capital's growth prospects could also be impacted by ever-tighter deposit and mortgage regulations being introduced by the Office of the Superintendent of Financial Institutions as it attempts to secure the stability of the financial system.

Putting it all together

At first glance, Home Capital appears heavily undervalued, trading at a 31% discount to its book value of \$27 per share.

However, after reviewing the lender's end of first quarter 2019 balance sheet and deducting good will and intangibles, restricted and other assets, as well as liabilities, Home Capital's net asset value comes to around \$14.33 per share. This is 30% less than Home Capital's current market value, indicating that the lender is fairly valued. With the headwinds being faced by the business, there isn't much upside ahead for investors.

While I am not bearish on the outlook for Canadian lenders like the U.S. hedge funds and traders that are short-selling Canada's banks, there are superior investment opportunities. After such a sharp run-up in value since the start of the year, there may not be much further value to be unlocked for investors, making it preferable for investors to look elsewhere.

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