Betting on This Risky Alternate Lender Could Spell Disaster

Description

Alternate mortgage lender **Home Capital Group** (TSX:HCG) continues to garner considerable attention with some pundits claiming that now is the time to invest because it is trading at a deep discount to its book value. The company almost collapsed in 2017 after claims of fraudulent mortgages and an investigation by Ontario's securities regulator triggered a massive run on deposits. If it hadn't been for the intervention of renowned billionaire investor Warren Buffett, Home Capital may have failed.

Is it an attractive investment?

Despite the investment being made on less than favourable terms for existing shareholders**,** this was heralded as positive development for investors and the lender. In a surprising move, Buffett slashed his investment in Home Capital seeing his holding fall from around 25% to less than 10%, causing the lender's stock to fall sharply. It has since recovered strongly, however, gaining 23% since the start of 2019.

This, combined with Home Capital reporting a book value of $27 per share of almost $10 per share greater than its current price, has led to considerable speculation that now is the time to buy. For manifold reasons, including Home Capital's mixed first-quarter 2019 results and industry headwinds, there are signs that after the significant gains made for the year to date that the lender is fairly valued.

Home Capital reported a 13% year over year decline in adjusted net income to $30 million despite higher net interest income and assets under administration, which can be blamed on a sharp increase in the provision for credit losses, which shot up from $3.9 million at the end of the previous quarter to $6.1 million.

The unhealthy increase in impaired loans was underscored by Home Capital's gross impaired loans ratio of 0.49% being 0.02% greater than the quarter prior and 0.2% higher year over year. While that ratio falls well within acceptable levels, it does indicate that there has been a marked decline in the quality of Home Capital's loan portfolio, which should be a cause for some alarm.

Despite Home Capital working feverishly to buttress its funding to see deposits rising by 11% year over year to $13.6 billion, it is significantly below the pre-crisis $16 billion reported at the end of the first quarter 2017. A lack of deposits will impact Home Capital's ability to generate mortgages because they are a key source of funding, curtailing its ability to grow.

The lender's ability to underwrite mortgages will also be impacted by steeper prudential regulation aimed at enhancing the stability of Canada's financial system.

A softer housing market and weaker prices are also weighing on the lenders outlook.

While it is claimed that Home Capital is trading at a discount to its book value per share, in actuality, it's not that simple. The book value reported by the lender includes non-tangible or non-marketable assets held on a company's balance sheet, which are typically not included when assessing the value of its assets. These include good will and intangibles, tax, derivative and other assets which are difficult to value.

After excluding non-material assets, subtracting liabilities and dividing the value by the number of common shares outstanding, Home Capital has a net tangible book value of $19.34 per share, a mere 5% greater than its market price. That value could fall to less than $15 per share, depending on which difficult to value assets are excluded.

Putting it together

This, along with Home Capital's diminished growth prospects because of lower economic growth and weaker housing market, means that the lender is approaching is its indicative fair value and there may not be much more upside ahead.

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