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Home Capital Group crisis deepens as Q1 earnings approach

By Liu Hanlei

On May 11, shareholders and the market will look with interest on Home Capital Group's (HCG) Q1 2017 earnings hoping to get an update of its current financial standing as its market capitalization plunged by 73% to CAD 450mn on May 8 from CAD 1.67bn at the start of April. The RMI-CRI 1-Year Probability of Default (PD) for HCG spiked and reached 1589 bps on May 8 from 50 bps at the start of April (see Figure 1). What happened in this period was a quick succession of events that dented investors' confidence in the lender.

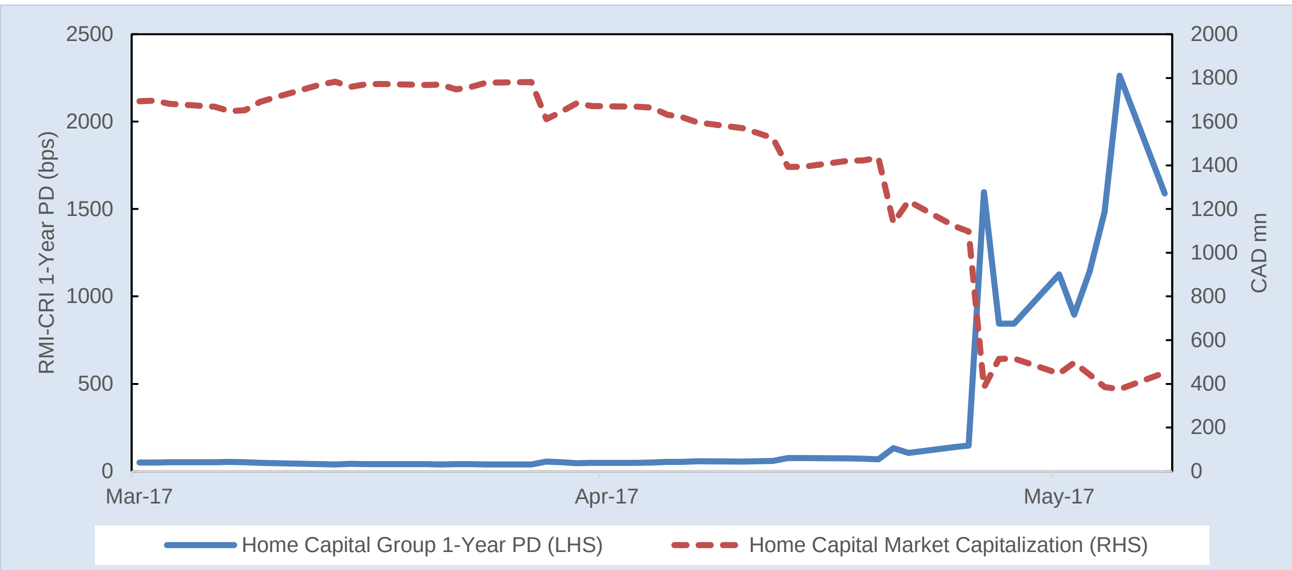

Figure 1: RMI-CRI 1-year PD for Home Capital Group (left axis) and market capitalization (right axis) *Source: RMI-CRI, Bloomberg*

HCG is Canada's leading non-prime mortgage lender with a mortgage loan size of CAD 18bn as of 31 December 2016, with a majority of its business from Ontario. On April 19, the Ontario Securities Commission (OSC) alleged that HCG failed to properly disclose its internal probe into fraudulent mortgage applications. HCG brokers who originated CAD 881mn in 2014, about 10% of its total 2014 originations, had falsified income information and HCG's underwriting department failed to detect the fraud. HCG did not disclose the fraud until five months after they are aware of the problem. Instead of disclosing information about the investigation, the company blamed the decline in originations on external factors such as the macro-economy and the competitive market during an earnings call with analysts. On April 24, the founder of the Company, Mr Gerald Soloway announced that he would step down.

However, what shook the market's confidence was the announcement that HCG had to establish a CAD 2bn credit line provided by the Healthcare of Ontario Pension Plan. The credit line was required to mitigate the impact of a decline in the Home Trust's High Interest Savings Account, a 90% decline from CAD 2bn in early April to CAD 192mn on May 8. HCG has since drawn down CAD 1.4bn as of May 8, with the first CAD 1bn at 10% interest rate plus other fees and charges effectively paying an interest of 22.5%. The firm is facing a funding crisis, as deposits are required to fund HCG's mortgage business. With a net income of CAD 247mn in FY2016, the CAD 225mn interest cost from the first CAD 1bn drawn credit line will take a toll on HCG's earnings in the coming quarters. Interestingly, its rival, Equitable Group which has about CAD 18bn in mortgage loans, also tapped a CAD 2bn credit line in the same period due to a slight drop in deposits. Equitable Group secured a credit line at lower rates and charges – the banks' cost of funds plus 1.25% interest rate on drawn funds. Rating agencies like S&P and DBRS have downgraded HCG's debt rating to junk citing a deterioration in funding, weak liquidity profile and the upcoming OSC's hearing against its senior management.

HCG is in urgent need of financing as nearly 51% of its CAD13.3bn of term deposits are maturing this year, which has since dipped to CAD 12.6bn as of May 8. As of 31 December 2016, CAD 3.6bn of its Guaranteed Investment Certificate (GIC) deposits are due within the coming 6 months and another CAD 3.2bn in the next 6 - 12 months. In addition, HCG has a CAD 325mn bond maturing on 24 May 2017, adding to its liquidity woes. In order to shore up its balance sheet, HCG has announced to suspend its dividend.

On the bright side, HCG's net non-performing loans (NPL) ratio stands at 0.3%. There is a 73% allowance set aside against gross non-performing loans and it is comparable to Equitable Group's NPL ratio at 0.21%. Additionally, rumors came up that buyout firms such as Apollo Global Management and Blackstone Group may be acquiring HCG. HCG has also hired RBC Capital Markets and BMO Capital Markets to provide advice on strategic financing options. However, a lack of interest from the 'Big 6' Canadian banks may raise some questions on the asset quality and profitability of HCG. Based on the last earnings results, HCG reported a lower than expected net income of CAD 50.7mn for Q4 2016, which was 27.8% lower than the net income reported in Q4 2015.

The next few months will be crucial for HCG given its weakened credit and liquidity profile. The firm postponed the release of its Q1 2017 to May 11, which may give a clearer picture of its financial status. With a high interest burden and a lack of investor confidence in HCG, the non-bank lender remains in a precarious state.

Credit News
World Bank warns of China debt risk from backdoor local borrowing **May 7.** Despite Beijing's efforts to impose fiscal discipline on localities and curb ballooning debt, the World Bank warned that the Chinese local governments remain addicted to off-budget borrowing. Growth of local government fiscal borrowing liabilities, seen as a huge risk for Chinese economy, accelerated from 22% in 2014 to 25% in 2015 and stayed high at 22% in the first half of 2016. According to a confidential March presentation obtained by the Financial Times, Beijing's effort to stop the use of local government fiscal financings as quasi-fiscal entities may have unintentionally encouraged them to increase borrowing. The World Bank China country director said they have been working productively with some provinces in China on developing the rules to maintain fiscal sustainability. (FT)
Oil's tumble tests hard-fought recovery at energy groups **May 6.** The oil industry, which was initially praised for its stellar performance in the first quarter despite lower prices, was met with an unpleasant surprise. The oil industry suffered a huge sell-off across the commodity market when the price of crude fell from USD 50 to USD 45 a barrel. The oil price is projected to decline in the long term due to beliefs of persistently high oil stockpiles and growing evidence of the industry's ability to keep pumping shale oil at relatively low prices. Crude contracts have also been affected as Brent delivery price slumped to just above USD 50 from USD 60 a barrel, making energy the worst performing sector on the S&P 500 in 2017. The underlying factor could be attributed to investors' anxiety over slowing demand in China where policymakers attempt to tighten credit conditions to curb financial risks in an effort to tackle a huge credit bubble. Further negotiations on the coming oil supply management might be threatened as decisions are increasingly being torn between members of OPEC in the aftermath of falling oil prices. (FT)
Puerto Rico files for record US debt restructuring **May 4.** A series of failures to negotiate with creditors over Puerto Rico's mounting debt worth USD 74bn prompted the country to file for Title III proceedings which is a process equivalent to bankruptcy in the US district court in San Juan. This would allow the country to cut 80% of its outstanding debt to just USD 787mn a year, as estimated by the federal oversight board. At the same time, Puerto Rico had to do more to return to financial stability amidst its shrinking population due to the exodus of its people over the fear of the ongoing crisis. The debt haircut was met with creditors' criticism, as it was believed to have not been "sufficiently negotiated in good faith". Unlike the traditional debt restructuring law afforded to US cities and public corporations like Detroit, this bankruptcy protection law is still new, and so remains unclear as to how it can affect assets such as bonds. (FT)

Marco Polo Maritime sailing into rough seas

May 3. On the backdrop of prolonged low oil price, Marco Polo Marine joined the ranks of Singapore-listed debt-troubled firms, including Swissco Holdings, Rickmers Maritime, Swiber Holdings, Ezra Holdings and its unit Emas Offshore. Although its creditors provided some room for the firm to put together a debt workout plan, Marco Polo Marine said on May 1 that it was now not confident of meeting the expectations of lenders and strategic investors; also it had suspended trading since May 2. As a matter of fact, Marco Polo Marine had gained approval last October from its noteholders to defer a SGD 50mn bond payment by three years to 2019. Nevertheless, since the working capital dried up due to dismal business, it could not pay up the interest due on the notes. (Business Times)

SIA may find itself in unusual net-debt spot as soon as 2018

May 3. Singapore Airlines Ltd (SIA) has 214 planes on order, including 39 long-range aircraft from Boeing. The USD 53bn of aircraft on order expanded a medium-term note program by two-thirds to USD 5 bn in April and said it intends to "proactively" take on more debt in the future. SIA has the smallest debt-to-equity ratio among 11 major airlines on the MSCI Asia Pacific Index at 10.3% and was blamed for 'lazy' balance sheet performances for its cash pile. SIA is currently expected to turn to a net-debt position as early as 2018 as the company borrows money and sells bonds to meet capital expenditure needs. According to equity research firms, SIA would benefit from raising cheaper borrowings, which will help improve return ratios and valuations. (Strait Times)

IMF says still need 'credible' debt relief for Greece (Business Times)

Italy's bad debt problem refuses to go away (FT)

Regulatory Updates

China's deleveraging bill tops USD 500bn

May 8. China's stock and bond markets have lost nearly USD 500bn since authorities started a clampdown on financial market leverage. Lenders and trust companies say sales of asset management products have dropped 30 percent, while metal prices have dropped together with real estate transactions. China's seven-day repo rate has increased to about 3% following efforts by Beijing to restrain excessive borrowing. Market observers welcome the tightening measures as China's USD 28tn debt pile is becoming a threat to its long-term economic stability. (Bloomberg)

Bank of England sets bailout debt levels for biggest lenders

May 5. As part of a transparency drive, the Bank of England published for the first time how much special debt, the minimum requirements for own funds and eligible liabilities (MREL), each big bank must issue as part of rules to prevent taxpayer bailouts of these lenders. The total requirements is made up of the banks' going concern capital that they currently hold and the special 'gone concern' debt that triggers once the bank is deemed to be failing. Lenders would have till 2022 to meet the full requirements. Once the full requirements come into force, Santander will have the highest overall MREL requirement of risk-weighted assets. (FT)

European central bank eyes blockchain regulation (Blockchain News)

Fitch: Basel III implementation in APAC to follow global pace (Reuters)

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