3 Stocks That Will Suffer From a Real Estate Decline

Description

Unlike the United States, Canada never really had a real estate crash during the financial crisis. Sure, prices did go down across the country during 2009, but they soon rebounded to new highs.

The average price of a home in Canada soared to $389,000 by the end of 2013, essentially double the average U.S. price of $198,000, even though each country has similar median household incomes and the U.S. offers borrowers both 30-year fixed mortgage rates and the ability to deduct mortgage interest from income taxes.

Additionally, for the past 17 years, the price of Canadian real estate has grown 5.4% per year, while income has only grown 2.7% annually. Sure, interest rates have come down in the meantime, but how confident can mortgage borrowers feel when they need record low interest rates just to be able to afford a mortgage?

If the housing market does see weakness over the long term, here are three stocks that will suffer right along with it.

1. **Rona** (TSX:RON) is Canada's largest home improvement retailer, with more than 800 franchised and corporate stores in all 10 Canadian provinces, and a concentration of stores in Quebec. Unfortunately for Rona, the real estate market in Quebec is already starting to roll over, and employment growth in the province is lagging the rest of Canada.

Rona released its third quarter sales numbers in November, and they weren't pretty. Same store sales were down 2.4%, total sales were down 4%, and those numbers represent a real estate market that's still healthy. If there is weakness in house prices, purchases from both homeowners and contractors will slow significantly.

2. **Brookfield Real Estate Services** (TSX:BRE) is the parent company of Royal LePage, Canada's third largest real estate company after Remax and Century 21, which both have large U.S. presences. If real estate prices start to decline, sales volumes will start to fall too, leading to some unhappy real

estate agents and some unhappy investors in Brookfield Real Estate Services.

At this point, the company appears to be on solid footing. The stock recently traded at a 52-week high, and the company bumped the monthly dividend to 10 cents per share — a dividend yield of 8.7%.

Still, a large percentage of its revenues are based on getting a fee on each transaction. As go sales volumes, so goes Brookfield Real Estate Services.

3. **Home Capital Group** (TSX:HGC) is Canada's largest alternative mortgage lender, lending money to people who just don't qualify at a traditional bank. This has been a great business since the 2008-09 financial crisis, since its competitors (who were mostly U.S. lenders) have pulled out of Canada, leaving the field wide open for Home Capital.

The company has been moving aggressively into mortgages that aren't insured by CMHC — Canada's federally owned lender default insurer — which is good for profits, but also increases default risk. Yes, the company generally requires a borrower to put 20% down, but remember that it typically costs 5% of the property's value to pay the real estate agent to sell it. This means that if the Canadian real estate market really starts to struggle, Home Capital's borrowers could be some of the first to default.

Foolish bottom line

If you're an investor who thinks the Canadian real estate market is set to go down, it's pretty easy to avoid stocks that are heavily exposed to house prices. Additionally, you'll want to avoid all the Canadian banks, since mortgage and home equity line of credit growth have been largely responsible for growth over the past few years.

You could even make the case that you'll want to avoid consumer discretionary stocks too, since consumer confidence will also decline. A prolonged real estate slump won't be good for Canada.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:BRE (Bridgemarq Real Estate Services Inc.)

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