The Stock Picker's Guide to Home Capital Group for 2014

Description

"I'm delighted to report that [the] shorts have all paid a very high price for the bad advice that they received and they have incurred very substantial losses."

Those words came from **Home Capital Group** (TSX:HCG) CEO Gerald Solloway during the Q3 2013 earnings call. He was referring primarily to Steve Eisman, who became famous after betting against the American housing market right before it crashed, and whose story was told in great detail by author Michael Lewis in the book *The Big Short*.

In May 2013, five years after the U.S. housing bust, Mr. Eisman was very pessimistic about Canada's housing market. At the Ira Sohn Conference he cited Home Capital, Canada's largest non-prime mortgage specialist, as the best way to bet against Canadian housing. His words clearly resonated, and other hedge fund managers began to short the stock as well. Within days, the stock sank 13% to below $50 per share.

Home Capital certainly seemed like a great way to profit from a Canadian housing correction. The company makes loans to people deemed too risky by banks, mainly entrepreneurs and immigrants. It operates entirely in Canada, unlike the large banks. Home Capital had also been on an incredible run over the previous decade, and thus could have been ill-prepared to deal with a serious correction.

By the end of the year, Home Capital traded at $80, costing Mr. Eisman and all those who followed him. So what did he miss?

First of all, Home Capital Group is very good at what it does. Despite lending to supposedly higher-risk borrowers, non-performing loans have averaged only 0.3% of total loans over the past three years. The company is also far more cost-effective than the big banks – its efficiency ratio, which measures expenses as a percentage of revenue, was only 30% in the most recent quarter. By comparison, the efficiency ratio for both **Royal Bank of Canada** (TSX:RY)(NYSE:RY) and **Toronto Dominion** (TSX:TD)(NYSE:TD) in Canada was most recently in the mid-40s.

As a result, Home Capital is much more profitable than the larger banks. For each of the past 10 years, the company's return on equity has been over 25%, remarkable for any company in any industry. By comparison, last year's return on equity for RBC and TD was 19% and 15% respectively. Home Capital's returns are not due to greater risk; its Tier 1 Capital ratio of 17% is well above the comparable figure at the big banks.

These high returns are especially meaningful because Home Capital has plenty of room to grow. The company's addressable market is about $240 billion of mortgages, and HCG has only a 3% market share.

Despite having such a strong track record and plenty of room for growth, the shares still aren't prohibitively expensive. At 11 times earnings, the shares of HCG trade in line with the big banks. This has been the only source of relief for Mr. Eisman and those who followed him.

Mr. Eisman has still paid a dear price, just like anyone else who bet against HCG over the past decade. The company's investors are hoping that will continue.

CATEGORY

1. Investing

TICKERS GLOBAL

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2. NYSE:TD (The Toronto-Dominion Bank)
3. TSX:HCG (Home Capital Group)
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Date
2025/07/27
Date Created
2014/02/04
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