A Better Way to Bet on Canada's Real Estate Market

Description

Canada's housing market is one of the country's most polarizing issues; everyone seems to have a strong opinion one way or the other. So far the bulls have been right, although one could easily argue that the price surge has made Canada's houses that much more overvalued.

If you think that our housing market will continue its upward trajectory, there are numerous ways to make that bet. The first one that comes to mind is simple — buy a house. But that is a big financial decision, and should be made based on your personal situation. Many people are not ready, willing, or able to make that step.

Another way is to invest in a Real Estate Investment Trust (REIT). But REITs have their own problems. First of all, they can have very levered balance sheets, making them quite risky. Secondly, they typically trade at full value, because dividend-focused investors covet REITs just for the payout.

There are some companies whose fortunes are tied to real estate, but make for much sounder investments. That's because they make their money not from owning real estate but rather from issuing mortgages, which tends to be much more profitable and safe. Three of these companies are listed below.

1. CIBC

All of the Canadian banks will continue to hit home runs if Canada's real estate market keeps surging. But it's also important to note that even if home prices slump, our banks will hold up a lot better than America's banks did during the financial crisis. Our regulations are stronger, our banks are more prudent, and our homeowners aren't as levered.

Of all the Canadian banks, the one with the biggest domestic exposure is **CIBC** (TSX: CM)(NYSE: CM). In 2013, the bank earned only 17% of its income outside of Canada, and other countries accounted for only 11% of average assets during the year. Within Canada, mortgages accounted for two-thirds of average loans in 2013.

It's no coincidence that CIBC is extremely profitable, with a return on equity of 20.9% in 2013. As a bonus, the stock is reasonably priced, at barely 10 times earnings.

2. Home Capital Group

Home Capital Group (TSX: HCG) makes its living by offering mortgages to people shunned by the big banks, typically immigrants and entrepreneurs. Yet credit losses totaled only 0.09% of gross loans in 2013.

As a result, Home Capital Group is extremely profitable, with a return on equity of 23.9% last year. The company also has better growth opportunities than the banks; management targets 13%-18% EPS growth per year. Yet it still trades at only 12 times earnings.

3. Equitable Group

Equitable Group (TSX: EQB), like Home Capital, is a mortgage originator that caters to those turned down by the big banks. Equitable does not do quite as good a job as Home Cap, but its return on equity is still in the high teens. And of course Equitable benefits from the same favourable mortgage characteristics enjoyed by CIBC and Home Cap.

Equitable also trades at just over 10 times earnings, about in line with CIBC and a slight discount to Home Cap.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:CM (Canadian Imperial Bank of Commerce)
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3. TSX:HCG (Home Capital Group)

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