Is Canadian Real Estate a Ticking Time Bomb?

Description

Last week, a report written by equity researcher Dan Werner of **Morningstar** warned that the Canadian real estate market is seriously overvalued. Because of a multitude of factors, Werner went as far as predicting that Canada could see a 30% nationwide decline in the price of houses.

Werner had several reasons for predicting such doom and gloom. Canadian law states that all mortgages (except in Alberta) are recourse loans. In theory, this would insulate lenders from large-scale defaults, since borrowers can be sued for any shortfall. But in reality, some of the hardest hit states in the U.S. housing meltdown were recourse states. When a borrower has most of their net worth tied up in housing, there's little reason to sue for the scraps that remain.

Canadian debt-to-equity ratios look awfully similar to U.S. numbers at the top of its market, as 23% of Canadian homeowners have a debt-to-value ratio of greater than 80%. The number in the U.S. at its peak was 22%. Sure, the average homeowner owns about 55% of their home, but that's weighed down considerably by the millions of Canadians who own their homes outright.

Werner also cites evidence that many Canadian borrowers can't handle higher interest rates. More than 2.5 million of us have used our RRSP to help out with funding the down payment. This loan must be repaid over time, or else the recipient has to pay tax on the proceeds. In recent years, a full 25% of Canadians couldn't afford to pay their RRSP loans back.

So if a crash happens, what does it mean for investors?

It's obviously bad news for a company like **Home Capital Group** (TSX: HGC), which lends money to folks who don't qualify at a traditional lender.

The company has been reporting some great results. Its most recent loan losses came in at less than 0.1% of its portfolio, and it continues to grow its business nicely. Management has done a terrific job leveraging mortgage brokers to help grow the business without the added cost of having to open up physical locations. The company has become Canada's leading alternative lender.

This is all fine and dandy when the housing market continues to hit new highs. But what happens if it starts to decline in a significant way? The answer is pretty clear.

The share price will go down.

It doesn’t matter if the company has rock solid fundamentals. Investors will see the real estate market start to decline and flee for the exits. Investor sentiment is important for most companies, but it’s doubly important for Home Capital.

Canada’s largest lenders will also suffer in the event of a housing correction. The vast majority of earnings growth from **Royal Bank** (TSX: RY)(NYSE: RY) and **TD Bank** (TSX: TD)(NYSE: TD) has been from increases in mortgage and secured line of credit business. Both these banks are such big lenders that it will be difficult for either of them to make up for any lack of growth in mortgages.

Even if Canada’s real estate market has the proverbial ‘soft landing’ it’s hard to paint a bullish picture on the banks. If mortgage growth dries up, chances are economic growth will also be tepid, since many Canadians are borrowing against their house to consume. It’s one of the reasons why bank stocks are trading at a pretty significant P/E discount compared to the overall market.

For investors who are looking to buy Canadian bank stocks, the question is simple — do you think the value of Canadian homes is about to fall? If you believe Morningstar and think a 30% correction is imminent, you’ll want to stay away from the banks, and definitely stay away from Home Capital.

If you think the market will keep chugging higher, the banks probably represent pretty good value at today’s prices. That’s up to you to decide, but personally I’m staying away.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:RY (Royal Bank of Canada)
2. NYSE:TD (The Toronto-Dominion Bank)
3. TSX:HCG (Home Capital Group)
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