



Why Home Capital Group Inc Could Be a Very Risky Investment

Description

On the surface, **Home Capital Group Inc** (TSX: HGC) looks like a screaming buy.

The company, which provides loans to borrowers rejected by traditional lenders, has delivered nothing short of terrific results. Recent loan losses were just 0.32%, which is better than a lot of traditional banks. The company's return on equity has been excellent as well, consistently over 20%. Since the end of 2010, earnings have increased 64%, yet the stock languishes at a trailing P/E ratio of just 14 times.

It trades at approximately the same valuation level as the banks, even though it has much better growth and superior interest spreads. Why doesn't the company get more love?

The answer is the Canadian housing market.

The market keeps defying the critics, heading ever higher in Toronto and Calgary, while shrugging off the weakness shown by Montreal and Ottawa to push the country's median home price higher. It seems like each time the Canadian Real Estate Association announces another average house price increase, the critics of the housing boom get a little louder.

There are plenty of reasons to doubt the market. Affordability in Toronto and Vancouver, the country's two largest markets, is terrible. Both cities are among the 10 most unaffordable in the world. Both markets have seen significant foreign investment, which is helping now but could dry up under a number of different scenarios.

Perhaps most importantly, Canadians are swimming in debt. We have record amounts of debt relative to disposable income, and we've borrowed north of a trillion dollars against our houses. Home ownership rates have peaked at 70%, right around the level where the U.S. saw its home ownership rate peak in 2006.

The elements are there for the market to decline. It just needs a catalyst.

There lies the issue. Pundits have been calling for a crash in the market since before The Great

Recession. These people have been consistently wrong, even though many of the same risks that are dangers now were also dangers back then. It's infinitely easier to figure out if a market is overvalued than when it's going to decline.

Coming back to Home Capital, there are a couple of choices the company has made that, while working out in the short term, have significantly increased its risk if the market does begin to fall.

First of all, the company has actively moved away from loans protected by mortgage insurance. It has more than \$21 billion worth of loans on the balance sheet, but has insured just \$7.6 billion worth. There's more than \$13 billion worth of loans that aren't insured, yet it has only a little over \$1.7 billion in liquid assets. That's fine in a rising or stable real estate market, but could turn out to be insufficient if things turn nasty.

A traditional lender has closer to a 50-50 split between insured and uninsured loans, which is much more conservative than Home Capital. Traditional lenders also have better access to capital, and generally lend to higher-quality borrowers. When times get bad, Home Capital will experience heavier losses, and has a far riskier portfolio.

The company has also really tied itself to the Ontario market. Of its \$15.1 billion residential mortgage portfolio, more than \$12.8 billion worth of loans are for houses that are located in Ontario, with a high concentration of those loans located in the Greater Toronto Area. In fact, compared to its last quarter, the company saw total loans fall in B.C., Alberta, and Quebec, but growth in Ontario more than made up for it.

Plus, if/when the market does fall, the company will have perception working against it. We all still remember U.S. banks failing during its housing crisis, so investors will stay very far away from what's perceived by many as Canada's weak link.

Home Capital is doing a good job executing now, but there's no way investors will want to hold it when the real estate market does decline. If you do decide to hold some of this stock in your portfolio, I'd recommend keeping it on a very short leash.

CATEGORY

1. Investing

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1. TSX:HCG (Home Capital Group)

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