



3 Reasons to Avoid Home Capital Group Inc.

Description

Last week, **Home Capital Group Inc.** ([TSX: HCG](#)) came out with quarterly earnings, which on the surface, didn't look so bad. Canada's largest alternative mortgage lender came in with earnings of \$1.01 per share, after adjustments. This came in a little light compared to analysts expectations, but still represented an increase of 11% compared to the same quarter last year.

The company also reported mortgage originations increasing 26% during the quarter, rising to \$2.6 billion. Most of the growth is attributed to Canada's major banks becoming a little more picky with their lending criteria, which means that many new homebuyers have little choice but to use Home Capital and its inflated interest rates. This looks to be good news, assuming Canada's housing market continues to stay hot.

Even though results looked good, Home Capital's stock still lost nearly 10% during the last two trading days. The reason? TD Securities came out and downgraded the stock, citing its elevated forward P/E ratio compared to the major banks, its already healthy return so far in 2014, and higher interest and origination costs going forward.

These aren't the only headwinds the company could experience in the future. Here are three reasons I'd avoid Home Capital Group's stock.

1. Risky loans

Home Capital is growing at a much faster pace than just about every other lender in Canada. But that begs the question — why don't the big banks want the business?

There's no doubt that many meetings in bank boardrooms have discussed Canada's housing market. Every indication I read is that execs are extremely wary of the market plunging. This is why the major banks have shied away from so-called fringe borrowers, focusing on deals that qualify for CMHC insurance, and with it, a government guarantee that will protect the lender in the result of a full scale housing meltdown.

Home Capital Group has gone in a different direction. The company actively seeks borrowers

who have been rejected by traditional banks, lending to these people in exchange for an interest rate of 2-3% higher than a comparable CMHC insured loan.

This works out well when the housing market is hot, but what about when the market cools? When that happens, the company could run into all sorts of problems, from increased interest expenses all the way to needing to raise capital if losses get too bad.

2. Concentration on one market

One of the nice things about holding one of Canada's "Big Five" banks is that you automatically get a company that has diverse operations across the country. With Home Capital, you get a company that's overly exposed to Southern Ontario, particularly the Greater Toronto Area.

As of September 30, the company has approximately \$15.6 billion worth of residential mortgages outstanding, and \$13.3 billion of those are located in Ontario, approximately 85% of the total. And since the vast majority of Ontario's population is located within a stone's throw of Toronto, it's feasible to assume so are the majority of Home Capital's loans. That lack of geographical diversification should cause investors to be concerned.

3. Housing bubble?

It's easy for bulls to say that Home Capital would increase lending if the Canadian housing market hit a prolonged slump. Traditional banks would get skittish, which would, in theory, increase the company's potential market.

But I'm doubtful reality will turn out that way. It's very possible that the company would be unable to raise capital from traditional sources in the event of a major housing correction, simply because investors will fear a repeat of what happened to dodgy U.S. lenders in 2009. That would leave it with little choice but to increase its deposit base, which is expensive and dependent on fickle consumers.

Bottom line? I'd avoid Home Capital for a better investment with less potential risk. We have a company that fits the bill that you're really going to like.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:HCG (Home Capital Group)

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