Why Did Home Capital Group Inc. Drop 15%?

Description

As I type this, shares of **Home Capital Group Inc.** (TSX:HCG) are getting hammered, down more than 15% compared with the closing price on Friday.

Let's take a closer look at what happened and whether or not the depressed price is now a buying opportunity.

The skinny

After the market closed on Friday, Home Capital gave investors a preview of upcoming second-quarter results, which are scheduled to come out at the end of the month. To put it mildly, they weren't pretty.

Traditional loan originations in the second quarter fell to $1.29 billion, a decline of more than 15% compared with the same quarter last year, when it issued more than $1.5 billion in new loans. Insured mortgage originations took an even harder hit, falling from $620 million to $280 million year over year.

For a company that's consistently impressed the market by beating growth expectations, these numbers were absolutely terrible. It's little surprise that shares have declined so aggressively on these results.

Analysts aren't giving the company any love either. In research notes issued Monday morning, analysts from **TD**, **Royal Bank**, Cormark Securities, and Macquarie all downgraded shares, although TD analyst Graham Ryding still has a $46 price target on the stock.

What's more interesting than Home Capital's results is the far-reaching implications for the Toronto real estate market.

The bigger picture

The Toronto real estate market has been the overwhelming factor in driving Home Capital's stratospheric growth over the past decade. The company has attempted to expand outside of its home market, but without much success. Currently, about 90% of the loan portfolio is concentrated in the

Greater Toronto Area.

Weakness in Home Capital's business points to either one of two things. Either the company is running out of borrowers, or the real estate market is starting to soften. Neither of those are things an investor wants to see.

This could be the beginning of a pretty nasty cycle. Home Capital bulls have always said the company had such tiny loan loss reserves because it was a skilled underwriter. Bears have countered by saying that increased real estate prices and a healthy economy just bailed out borrowers that got into trouble.

With Canada's economy starting to falter and loan originations down, it's easy to now envision a scenario where the bears could end up being right. Additionally, many feel Home Capital's loan loss provisions of just 0.07% are woefully inadequate, especially when you compare them with many of Canada's other major lenders.

There's also the argument to be made that Home Capital is a leading indicator for the Toronto real estate market. The first step of any downturn is a slowing of new mortgages followed by the more nasty stuff. With many pundits now calling Toronto's market a bubble, many investors are getting out now and asking questions later.

Personally, I think a major downturn in the Toronto market could be almost fatal for Home Capital. But even if the company manages to contain the damage to its balance sheet, it still has to deal with sentiment. It'll become a proxy on Toronto real estate, which isn't a good place to be when the market is declining. Investors will start to short it, and it'll be subject to huge price swings.

That's not the type of company I want in my portfolio. Combining that with my belief that the real estate market in Toronto is past due for a correction, I'm still staying far away from this company. Even after the 15% fall, I think there could still be more downside.

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