Why I Just Bought Shares of Home Capital Group Inc.

Description

For those of you unfamiliar with **Home Capital Group Inc.** (TSX:HCG), the company provides mortgages to people that the big banks turn down, typically entrepreneurs and new immigrants. HCG has done a fantastic job of this for many years, and investors have been handsomely rewarded. In fact, a $1,000 investment in HCG 15 years ago would today be worth more than $30,000.

Despite this impressive track record, the company has more than its share of critics. Chief among them are American investors—mainly hedge fund managers—looking to bet against the Canadian housing market.

Adding to the pressure, HCG has endured a significant hiccup recently. The company has just severed its relationship with 45 mortgage brokers for falsifying income information on mortgage applications. These brokers accounted for nearly $1 billion of total originations in 2014, about 11% of the total.

This couldn't have come at a worse time. Canada's economy may very well be in recession, which is raising fresh concerns about the housing market. Worse still, a cut in interest rates will likely squeeze the margins of all lenders.

Why is now the right time to buy Home Capital Group?

First of all, we shouldn't overreact to the news about these mortgage brokers. While they may have been dishonest about applicants' income, there was no evidence of false information about credit scores or property values. And for what it's worth, HCG doesn't expect these originations to lead to outsized credit losses.

Second, as mentioned, this company has an absolutely outstanding track record. If anyone can work through these issues and keep credit losses to a minimum, it's these guys.

Finally, the stock price has without a doubt fallen way too far. To illustrate, quarterly net income has declined by only 2% year over year, and credit losses are actually down. Yet in the past 12 months, the shares have fallen by more than a third, even after a nice rebound on Thursday.

In fact, no matter what way you look at it, HCG's stock is ridiculously cheap. The company has earned close to $4.50 per share over the last year, yet still trades in the low $30s. Put another way, HCG trades at about 1.5 times book value, despite earning a very impressive 19.1% return on equity (ROE). By comparison, **Toronto-Dominion Bank** trades at 1.7 times book value despite earning only 13% ROE.

Why are the shares so cheap?

At this point, there are a lot of people looking to bet against Canadian housing, and HCG is one of the most direct ways to do so. As a result, the company is the second-most shorted stock in Canada, with nearly 30% of its shares on loan for short selling.

These bets against HCG have intensified in recent weeks, which has led to heavy selling pressure. This is what has driven the company's share price down so far.

But if HCG is able to weather the storm, as it's done so many times before, then these shorts will eventually be forced to reverse their bets. That would be fantastic news for anyone holding the shares.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:HCG (Home Capital Group)

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