3 Reasons to Trade Your Royal Bank of Canada Shares for Home Capital Group Inc.

Description

There are a lot of reasons to shy away from **Home Capital Group Inc.** (TSX:HCG) these days.

To start with, there are growing concerns about the Canadian housing market, which seems overdue for a correction. Even worse, Canada is probably in the midst of a recession mainly due to low oil prices. Lower interest rates will likely compress margins. And household debt is at record levels.

There have also been some company-specific problems at Home Capital. Last month the company announced it was terminating its relationship with 45 independent brokers for falsifying mortgage application documents. These brokers collectively accounted for over 10% of originations last year.

But selling the stock, especially at this price, would be an overreaction. To illustrate, below we take a look at three reasons to prefer Home Capital to **Royal Bank of Canada** (TSX:RY)(NYSE:RY).

1. More growth prospects

Based on the latest numbers, Home Capital has not grown at all. But that is because of its terminated relationship with the 45 brokers.

Beneath the surface, the company has excellent growth prospects. Despite being the market leader for subprime mortgages, Home Capital still has less than 5% market share. Better yet, the company has an excellent track record of growing earnings.

Meanwhile, RBC's growth prospects are more limited. Its Canadian banking division is very mature, and growth prospects are limited in this environment. Large-scale growth in wealth management usually must come through acquisitions. And growth in Capital Markets can be very risky.

2. Less scope for losses

While Home Capital has greater scope for growth, there's also less chance of big losses. This is mainly because Canadian mortgage loans tend to be very safe.

To illustrate, Home Capital's annualized loan loss provisions totaled just 0.05% of total loans in the most recent quarter. Even when the world was mired in the 2008-09 recession, Home Capital's provisions didn't exceed 0.3% in any quarter.

By comparison, RBC's annualized loan losses totaled 0.25% of average loans last quarter. And this number reached 0.97% in 2009. The numbers are far higher than Home Capital's simply because corporate loans and credit card loans are far more risky than mortgages.

So, if Canada's economy does go from bad to worse, you should expect RBC to suffer more than Home Capital.

3. A far cheaper price

RBC has fewer prospects for growth than Home Capital, and more prospects for losses. In addition, Home Capital is better capitalized than RBC. Yet RBC is still far more expensive. In fact, it's not even close. RBC trades at close to 12 times earnings, while Home Capital trades for just seven times earnings.

There's a simple reason for this. American investors—hedge fund managers in particular—have been betting against Home Capital and driving its share price down. As should be clear by now, this is clearly overdone. That's created a great opportunity for the rest of us.

CATEGORY

1. Investing

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1. NYSE:RY (Royal Bank of Canada)
2. TSX:HCG (Home Capital Group)
3. TSX:RY (Royal Bank of Canada)

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