



Investors: 3 Reasons to Avoid Home Capital Group Inc.

Description

Over the long term, it's been very good to be a shareholder in **Home Capital Group Inc.** ([TSX:HCG](#)), Canada's largest alternative mortgage lender. Since 1999, shares of the company have surged more than 2,729%, not even including dividends.

Home Capital saw a market that was underserved by Canada's big banks, and used mortgage brokers as a way to access these borrowers. Years later, it has more than \$20 billion in loans on the balance sheet, and has an enviable record of both growing earnings and increasing its quarterly dividend.

But lately, the company has stumbled.

In July, it disclosed that some 45 mortgage brokers had been involved in sending almost \$1 billion in loans its way in 2014 from borrowers who may have fabricated their income. It also told the market that growth would be flat in 2015 as it deals with the aftermath of kicking those brokers out and a general slowdown in its main market, Toronto.

Shares of the company did not react well to those two pieces of news, slumping from \$42 per share to today's price of \$26.50, give or take a few cents. While this might look to be a good buying opportunity on the surface, I'm not so sure.

Here are three reasons why investors should avoid Home Capital.

Toronto housing bubble

As goes the Toronto real estate market, so will go Home Capital. It's that simple.

The company has been making an effort to expand throughout Canada, but more than 85% of its loan book is still located in the Toronto area. And the fact is, Toronto's real estate market is among the most overpriced in the world.

In a 2014 survey, Toronto ranked as the 13th least affordable metro in the world, with a median real estate price divided by medial household income ratio of 6.5, which put it marginally behind other cities

like Hong Kong or London. As much as I like the city of Toronto, I'd choose Hong Kong or London over it in a heartbeat.

Toronto condos often return so little that rental yields don't even cover the interest on the mortgage, even in today's sub-3% mortgage rate world. How anybody would consider a Toronto condo an attractive investment at this point is beyond me. Add all that up, and we have a risky lender who lends to risky borrowers in a risky market. I don't like those odds.

Confidence

Home Capital is dependent on the capital markets. It's attempting to grow its deposit base by offering attractive GIC yields to investors, but for the most part, it's borrowing the cash it lends from the bond market. A leveraged financial company needs market confidence in order to continue to lend. Debt is continually rolling over and must be refinanced.

What happens if the market suddenly turns against Home Capital and won't lend it any more cash? Even forcing the company to pay a greater interest rate could have a catastrophic effect on its margins.

Home Capital is the most popular way investors are betting on a decline in Canadian housing. The market is already well aware of the potential risks. What happens if these risks become a reality?

Tiny loan losses

One of the things I find most interesting is Home Capital's loan loss provisions. They're currently very low, at just 0.09%. Of course, times are good right now. The average Home Capital borrower has seen the value of their house go up, which means if they get into trouble, they can easily sell. This keeps loan losses small.

The last time Toronto's real estate crashed back in the 1990s, the whole market peaked at about a 1% loan loss. Since Home Capital lends to riskier borrowers, it's easy to assume more than 1% of its loans are at risk. Even at 1%, the end result is not good for the company. It has just \$1.5 billion in equity compared to \$20 billion worth of loans outstanding. A 1% write-off erases \$200 million from its equity, or a full \$3 per share.

Since Home Capital trades at about 1.5 times book value, investors are looking at a \$5 per share haircut at least, and that's not even factoring in a loss of confidence.

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1. TSX:HCG (Home Capital Group)

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