Investors: Be Wary of Home Capital Group Inc. and Genworth MI Canada Inc.

Description

It seems like every investor, at some point, has fallen for the proverbial value trap.

Here's how it goes. An investor analyzes a company that looks to be doing just fine on the surface. Revenue is solid and profits are strong. The valuation is tantalizingly cheap either on an earnings basis or a price-to-book value metric. Sure, there are well-known risks, but they're dismissed easily.

I believe such a situation may be occurring with **Home Capital Group Inc.** (TSX:HCG) and **Genworth MI Canada Inc**. (TSX:MIC). Here's why this value investor is staying far away from these two value stocks.

Home Capital

What Home Capital's management has accomplished over the last 20 years is nothing short of remarkable. The company has grown from being a tiny specialty lender to one that has become Canada's largest non-prime mortgage company with more than $20 billion in assets.

Bulls point out that the company's growth may be just beginning, since a large portion of its loan book is located in the Greater Toronto Area. If it can get that kind of traction in other areas, the future looks good.

The company has been experiencing some problems lately. Loan growth, which was fantastic up until 2015, has stagnated. The company has only grown its loan book by less than 1% over the past year. Management also admitted last year that some of the loans on the books may be fraudulent. To management's credit though, these loans are continuing to perform pretty well.

These problems are a couple of reasons why shares only trade hands at $32 each, despite earnings coming in at $3.98 per share over the last 12 months.

The other reason is Canada's housing bubble.

Investors are especially concerned about Toronto, Home Capital's main area. Real estate values there continue to skyrocket, something many pundits think has to come to a stop. Even with interest rates low, it seems as though the pool of first-time buyers is dwindling. Many people simply can't afford to buy houses.

It's obvious a prolonged slowdown in Toronto real estate will hit Home Capital, and hit it hard. This is the reason why shares are trading at eight times earnings. Not only will a slowdown affect new loan growth; it'll also bring down the value of existing properties in the mortgage portfolio, which is not a good thing for a lender with many uninsured loans.

Genworth

Genworth MI Canada is our nation's second-largest mortgage default insurer with over $300 billion of mortgages insured on its balance sheet.

Like Home Capital, Genworth looks very cheap on the surface. Shares trade approximately 10% under book value and the price-to-earnings ratio is just 8.3. Additionally, Genworth pays a pretty nice dividend of 5%.

Genworth is a play on Canada's real estate market as a whole. It has 42% of its portfolio located in Ontario and 20% exposure to Alberta. Both of those markets are viewed as risky for entirely different reasons. Ontario is carried by Toronto, and Alberta's market looks poised to dive as oil's slowdown hits the general economy.

A few things could save Genworth if a nationwide crash starts to happen. The company has been around long enough that the majority of its insurance covers houses that were bought years ago. Genworth's management also believes the company is well covered with nearly $6 billion in invested assets.

If the real estate market starts to decline in a big way, Genworth's share price will be affected. Sentiment matters, especially in stocks that are essentially a play on real estate. It won't matter how solid Genworth's balance sheet is. All that will matter is real estate heading down, which will bring down the share price.

I don't think Genworth or Home Capital will be brought down to bankruptcy once Canada's real estate finally starts to decline. I do think that the share price of each company will be affected, which is why I'm staying away from both of these value stocks. I just can't be bullish on real estate at this point of the cycle.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

1. TSX:HCG (Home Capital Group)

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Date
2025/08/25
Date Created
2016/05/11
Author
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