



Are Short Sellers Right About Home Capital Group Inc.?

Description

Tuesday was not a good day for **Home Capital Group Inc.** ([TSX:HCG](#)) shares.

An anonymous author identifying as “The Friendly Bear” wrote a scathing piece about the company on the investing website “Seeking Alpha.” The article investigated the company’s relationship with a mortgage brokerage called Re-Charge Corp.

Essentially, the dirt goes something like this.

Home Capital sold mortgages to Re-Charge in the autumn of 2015 on at least 14 different occasions. Many of these mortgages were on real estate in Brampton, Ontario, which insiders view as a place where mortgage fraud is common. Thus, the author of the article hinted that the reason why many of these loans were sold is because borrowers were either behind or in default.

Additionally, one of the principals of Re-Charge Corp is William J. Walker, a lawyer who was named to Home Capital’s board of directors in November 2015. This relationship between Walker and Re-Charge was never disclosed to shareholders. In fact, the relationship with Re-Charge was never disclosed.

Shares of Canada’s largest alternative mortgage lender slumped on the news, falling as much as 6% in intraday trading on Tuesday. Wednesday was a much different story with shares making up most of the losses from the day before.

Much of the reason for Wednesday’s gain was the company’s response to The Friendly Bear’s article. Through a statement, management said selling a small portion of their mortgages to third parties is commonplace, especially for deals that end up being overly complex. Any losses from these transactions have been accounted for. Some \$125 million worth of mortgages (out of a total portfolio of more than \$18 billion) were sold to third parties between 2013 and 2015.

The company also attempted to squash any rumours about the independence of Mr. Walker, saying it no longer dealt with Re-Charge as of September—a full two months before naming Walker to the board.

After all of this, investors might be left scratching their heads. Both sides make compelling cases. Which is right? Let's take a closer look at each.

The bear case

The bear case comes down to one word.

Credibility.

Remember, this latest allegation isn't the first time Home Capital has disappointed investors. In 2015 the company disclosed that some \$1.9 billion worth of loans on its balance sheet may have been obtained fraudulently. The company responded quickly and cut ties to the mortgage broker group responsible for originating the loans.

Then there's the company's loan losses. Home Capital specifically deals with people who are a higher credit risk than traditional banks, yet it consistently posts loan loss ratios that are much better than lenders who deal almost exclusively with borrowers that are lower risk.

Bulls say that's a result of good underwriting. But bears have a more sinister explanation. They say it's because the company either under reports non-performing loans or because it sells these bad loans to companies like Re-Charge.

Finally, there's the case of Toronto's real estate market. If the bubble pops, it could be very bad for Home Capital.

The bull case

There are two main reasons to be bullish on Home Capital.

The first is valuation. Shares currently trade hands at less than seven times trailing earnings. The company also pays a 3.5% dividend that has a payout ratio of less than 25%. Dividends don't get much more secure than that.

The second reason is growth potential. Home Capital is huge in Toronto and the surrounding communities. Some 90% of its portfolio is located in the region. The company should be able to continue growing in other markets, although that growth has been elusive.

The bottom line

An investment in Home Capital comes down to credibility. There are some very vocal bears that don't believe a word management says. There are also some vocal bulls who love the opportunity to load up on a company trading at less than seven time earnings.

Ultimately, investors have to weigh both sides and make a decision on their own. Personally, I stuck Home Capital on my own "too hard" pile months ago, choosing instead to watch the battle from the sidelines.

CATEGORY

1. Bank Stocks
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1. TSX:HCG (Home Capital Group)

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