3 Reasons Why This Value Investor Is Staying Far Away From Home Capital Group Inc.

Description

Home Capital Group Inc. (TSX:HCG) shocked the business world late on Monday by announcing it was parting ways with CEO Martin Reid, effective immediately. Remember, Reid had been at the job for only approximately a year after replacing long-time CEO Gerald Soloway, who had been in charge the previous 30 years.

Investors were shocked at the revelation. *Business News Network* reporter Jameson Berkow perhaps summarized it best when he said, "It cannot be overemphasized just how unusual a move like this is … We have decades of experience in this newsroom, tracking everything going on in the Canadian business world, and none of us can recall a time in recent history when there would be a regulated financial institution so abruptly parting ways with their chief executive officer."

Home Capital Group shares sank on the news, falling some 7% in Tuesday's morning trading.

I've been bearish on Home Capital for years now and will continue to be going forward. Here are the three main reasons I would encourage investors to avoid the stock.

The cockroach theory

The cockroach theory is as simple as it is powerful. There's never just one cockroach, and there's never just one issue with a company. In other words, the story that gets disclosed to investors is only the tip of the iceberg.

Home Capital is a classic example of the cockroach theory at work. Remember, the company previously disclosed upwards of $2 billion worth of possibly fraudulent mortgages in 2015 after a whistleblower revealed that a group of 45 mortgage brokers were submitting falsified documents. The fakes were so good that Home Capital could only tell investors some of the deals were based on lies. Nobody knew which ones for sure.

Then, more recently, the company was served with an enforcement notice from the Ontario Securities Commission (OSC), which stated the mortgage originator "failed to meet its continuous disclosure obligations” in 2014 and 2015.

If that kind of stuff has been made public, who knows what’s hiding behind the scenes?

Aggressive short-sellers

Home Capital has long been a favourite target for bearish investors looking to bet against Canadian real estate. These folks were only emboldened by the fraud allegations.

One thing I’ve learned about investing is to never bet against a whole army of short-sellers, especially ones as passionate as the investors currently betting against Home Capital.

Led by short-selling veteran Marc Cohodes, these folks are uncovering all sorts of dirt on the company. Operation Trillium is one example, which Cohodes claims was put in place to deal with those fraudulent mortgages. Home Capital has denied the existence of Operation Trillium.

The point is this. There are some very smart people trying to dig up dirt on the company. I’d much rather invest my money somewhere that isn’t subject to such scrutiny.

Toronto real estate

Despite efforts to diversify its lending base, the vast majority of Home Capital’s loans are against properties in the Toronto metro area. If Toronto’s real estate market ever declines, the company could be in a world of pain.

I’m no bank analyst; I can’t analyze a lender’s balance sheet and see if it can withstand a 20% drop in real estate prices. But I don’t need to be. All investors need to know is if Toronto real estate takes a dive, Home Capital shares will fall at the same time. There’s a clear link.

Nobody knows when Toronto’s real estate bubble will burst. All we do know is the city’s real estate is overvalued on virtually every traditional metric. That’s not the kind of market I want to bet on.

The bottom line

Home Capital profiles as a traditional value stock. Shares trade hands at just seven times trailing earnings and slightly under book value.

But there’s far more to this stock than those metrics. It’s for those reasons Home Capital Group won’t be entering my portfolio anytime soon, if ever.

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