Why I Wouldn’t Touch Equitable Group Inc.

Description

Equitable Group Inc. (TSX:EQB) operates through its subsidiary Equitable Bank, which offers a range of solutions including mortgage lending products. Marc Cohodes, a well-known short-seller who has called the downfall of many infamous Canadian stocks, believes that Equitable Group is a “poor man’s **Home Capital Group Inc.** (TSX:HCG),” which is another mortgage lender that Mr. Cohodes is short.

Unlike Home Capital Group, Equitable Group isn’t riding a huge amount of negative momentum, and the stock isn’t far off its all-time high. Home Capital Group, though, is down over 60% from its all-time high, and it looks like there’s no bottom in sight as the stock continues to fall farther into the abyss.

There’s no question that the Canadian housing market is overheated. Many pundits believe a correction could be in the cards sometime over the next few years. If there was a Canadian housing collapse, then both Equitable Group and Home Capital Group would get crushed, and their investors would lose their shirts.

Equitable Group owns a portfolio of mortgages that most Canadian banks would deem too risky. I see no reason why investors would want to add this amount of risk to their portfolios.

The company has exposure to the frothy Vancouver and Toronto markets housing markets, which are clearly in a bubble that’s on the verge of popping. I’d avoid lenders with exposure to these two cities like the plague because the risks are way too high given the potential rewards.

Equitable Group also has exposure to Alberta’s housing market, which is looking really scary when you consider how the Albertan economy is fairing after the rout in oil prices. Many foreign investors are turned off by Alberta’s oil patch, and this is certainly not going to help Alberta’s high unemployment rate.

There’s also the possibility that oil will fall back to levels seen in the early part of last year. If this happens, house prices will fall; Equitable Group is not in great shape to weather such a storm. Mr. Cohodes believes that Equitable Group has approximately $1.2 billion worth of uninsured loans in Alberta.

What about value?

The traditional valuation metrics for the stock of Equitable Group are very misleading. The stock trades at a 7.47 price-to-earnings multiple and a 1.3 price-to-book multiple. This stock appears dirt cheap, but I don't think it's cheap enough considering the amount of risk involved with an investment in this company.

One key metric Warren Buffett likes to look at is a company's ROE. Equitable Group's ROE is fantastic at 21%. What's going on? It sounds like Equitable Group runs a very profitable and efficient business, but you should know that a major reason why the ROE is so high is because the company is charging low-credit consumers more interest on their loans.

Sure, the stock looks cheap, but it's not. It's a value trap, and it's never a good idea to bet against Mr. Cohodes with his impressive track record of shorts.

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