



Home Capital Group Inc.: Boom or Bust?

Description

Contrarian investors have made a nice return since shares of one of Canada's most prominent alternative lenders, **Home Capital Group Inc.** ([TSX:HCG](#)), plummeted nearly 85% from the company's 52-week high in the second quarter on worries that a run on the bank would be enough to sink the alternative mortgage lender. As it turns out, Home Capital's stock price has rebounded nicely from its low, trading more than 175% higher from its low (as of writing) as iconic investor Warren Buffett placed his faith in the small Canadian lender, seizing an opportunity to take advantage of a potential long-term strengthening of the alternative mortgage market in Canada.

Early in July, however, headwinds for the Canadian alternative lending sector have materialized as the Office of the Superintendent of Financial Institutions (OSFI) released new regulations that are expected to significantly impact alternative lenders such as Home Capital and **Equitable Group Inc.** ([TSX:EQB](#)).

The new regulations will involve stress tests on lenders to be able to give out uninsured mortgages as well as a ban on "mortgage bundling" or "co-lending" — lending arrangements that allow lenders such as Home Capital and Equitable Group to partner with other lenders to lend at a higher loan-to-value (LTV) ratio. It's essentially a work around for LTV restrictions already in place for OSFI-regulated lenders.

These new restrictions are estimated to impact a very small percentage of the overall Canadian mortgage market (approximately 1%); however, alternative lenders are expected to feel the brunt of the changes. With co-lending restrictions reducing how much some borrowers can take on, it is expected that loan growth and supply/demand fundamentals may change in an unfavourable way for alternative lenders as regulators attempt to cool the overheated Canadian housing market and deter high-risk lending.

Bottom line

I have been bearish on Home Capital since last year in large part due to the fact that the alternative lender is far more exposed to a potential Canadian housing correction/recession than Canada's largest lenders. The recent introduction of increasingly strict regulations on Canadian lenders is not something

that will serve companies like Home Capital well in the long run.

While I follow Warren Buffett very closely and have great respect for his investment decisions, it appears to me that his recent Home Capital investment was more an investment of opportunity — one which will benefit Mr. Buffett alone, with Home Capital shareholders and management forced to find a way to pay back an exorbitant loan amount which is only marginally better than the previous loan from HOOPP.

Stay Foolish, my friends.

CATEGORY

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2. Investing

TICKERS GLOBAL

1. TSX:EQB (EQB)
2. TSX:HCG (Home Capital Group)

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