



## Avoid Equitable Group Inc. and its High ROE

### Description

**Equitable Group Inc.** ([TSX:EQB](#)) appears to be an earnings-growth king with astounding fundamentals and a dirt-cheap valuation; however, investors received a wake-up call, as shares nearly lost half of their value from peak to trough earlier in the year.

What exactly happened?

The crisis at **Home Capital Group Inc.** ([TSX:HCG](#)) sent shivers down the spines of Canadian investors who'd invested in alternative mortgage lenders. Although such mortgage lenders appear to have impressive metrics, like a high ROE (~17.6% TTM), and a clear long-term upward EPS trajectory, the company itself is not exactly a "steal," despite its ridiculously cheap valuation metrics.

Shares of EQB appear to be severely undervalued with a price-to-earnings multiple of 5.72, a price-to-book multiple of 0.9, a price-to-sales multiple of 2.6, and a price-to-cash flow multiple of 2.1, all of which are substantially lower than the company's five-year historical average multiples of eight, 1.3, 3.7, and 3.9, respectively. Shares of HCG also trade at such rock-bottom valuations with favourable ROE and EPS growth numbers.

As an investor who relies on traditional valuation metrics, you're probably thinking alternative lenders like EQB or HCG are a free ride to huge long-term gains. Warren Buffett likes stocks of businesses that consistently deliver EPS growth in addition to having high ROEs. Combine that with dirt-cheap valuation multiples, and you have a typical "Buffett" stock.

Coincidentally, Warren Buffett bought shares of HCG during its liquidity crisis; however, he got an even sweeter deal than what the general public could hope for. The rewards may be large with alternative lenders, but so are the risks, which aren't reflected in many key metrics.

Sure, the ROE is high, but it's high for a reason. Alternative lenders like EQB offer riskier loans to applicants that the big banks would deem "too risky" to consider. With riskier loans come higher potential rewards, but can you really afford to take such risks?

Many pundits are calling for a violent collapse in Canadian housing, and if that's the case, expect

alternative lenders to take massive hits.

To add even more salt in the wound, infamous short-seller Marc Cohodes is short both HCG and EQB. He'll probably be back with more dirt on both companies, and this could cause another nasty downturn for them.

### Bottom line

The potential rewards may be high, but so are the risks. Personally, I don't think the rewards justify the ridiculous amount of risk that you'll be taking with an investment in EQB. If the loans are too risky for the banks, then they're likely too risky for you as well.

Fellow Fool contributor Chris MacDonald has EQB as one of his [top three short plays](#) for the year, and I think he's right on the money.

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