Is Now the Time to Play the Canadian Alternative Mortgage Market?

Description

Alternative mortgages have long been considered a very good market to be in for Canadian investors. Largely escaping the 2008/2009 subprime crisis, which hampered the U.S. market, stronger government regulations and relatively more prudent lending policies from companies such as **Home Capital Group Inc.** (TSX:HCG) and **Equitable Group Inc.** (TSX:EQB) have allowed these lenders to flourish in recent years, with the exception of the market-wide dip alternative lenders felt earlier this spring after an investigation from the Ontario Securities Commission into mortgage origination at Canada's largest alternative lender.

Following a large investment from Warren Buffett's **Berkshire Hathaway Inc.** and a series of moves at the highest levels of Home Capital Group, much of the hoopla surrounding the short campaigns put on by various investors probing said companies has died down. The share price of Home Capital has rebounded approximately 175% since its 52-week low experienced earlier this spring, and shares of Equitable Group have similarly rebounded more than 60% over the same time frame, recovering from what appears to be market paranoia given the run on deposits Home Capital experienced during that time.

Many contrarian investors have certainly made a decent amount of money by timing the recent bottom in the Canadian alternative mortgage market, and a strong bull case can certainly be made for Canada's alternative lenders moving forward. Strong real estate markets, which are finally appearing to cool, combined with somewhat accommodative monetary policy (at least in the short term) should serve such companies well in the near term, providing additional support for a continued rebound in share prices across the sector.

That said, recently released mortgage regulations from the Office of the Superintendent of Financial Institutions (OSFI) may provide a very strong headwind for the alternative mortgage sector in Canada over the medium-term, as the OSFI has indicated its full rollout of rules designed to combat high-risk mortgage lending will be fully laid out by the end of October and implemented by the beginning of 2018.

The rules intend to slash the number of risky loans handed out in the Canadian mortgage market by private lenders or alternative lenders by requiring all borrowers qualify for loans at a rate which is 200 basis points (bps) higher than what the borrower would otherwise qualify for. With the vast majority of alternative mortgages already significantly higher than traditional mortgages (the current rate for alternative mortgages in Canada approximates is nearly 200 bps higher than “Big Six’s” rates right now), a significant percentage of borrowers may be cut out of the Canadian housing market altogether, leading to lower mortgage origination volumes, and therefore lower revenues over the medium term for alternative lenders sector wide.

The risk/reward relationship for this sector remains a difficult one to place a valuation on, and the sector-wide headwinds which have not yet hit alternative lenders remain a significant potential risk for investors looking for exposure in this sector. For these reasons, I remain on the sidelines.

Stay Foolish, my friends.

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