Home Capital Group Inc.: Will the Comeback Continue in 2018?

Description

Shares of **Home Capital Group Inc.** (TSX:HCG) rose 2.18% on January 24 and have climbed 2.7% in 2018 thus far. Home Capital finished 2017 strong along with other alternative lenders like **Equitable Group Inc.** Its third-quarter results saw the company return to profitability, although its mortgage originations dipped significantly — down $2 billion year over year.

The stock was off to a rough start in 2018, as investor skepticism emerged following new OSFI mortgage rules and an early rate hike from the Bank of Canada. More bad news hit on the day the rate hike was announced, as reports revealed short seller Marc Cohodes was suing Home Capital and its former executives for $4 million.

Cohodes has been a vocal critic of Home Capital since 2015, calling into question its underwriting and financial stability. He was vindicated in 2017 after Home Capital's president and CEO Mark Reid was fired after a number of officers were served enforcement notices from the Ontario Securities Commission (OSC). Home Capital stock went into a tailspin and brought a number of publicly listed lenders with it.

The Cohodes statement of claim alleges that Home Capital misrepresented financial and underwriting information either consciously or through negligence. Further, the suit contends that Home Capital "deliberately misled the public as to the impact of these issues." Home Capital responded to the lawsuit in stating that it had "valid defences" to the claims and was confident in defending its conduct.

However, Home Capital stock spiked on January 22 following a positive report from **Royal Bank of Canada** Capital Markets. The report projected that Home Capital was in a good position to repay its $475 million of deposit notes coming due in March. Currently, the company possesses $4.7 billion in liquidity due in part to a $2 billion bailout from **Berkshire Hathaway Inc.**

Cohodes pointed to this liquidity in calling into question the third-quarter results released by Home Capital. He argued that the steep decline in mortgage originations was proof that good brokers had drifted away from Home Capital, and that it would struggle going forward to attract quality credit. Home Capital is expected to release its fourth-quarter and full-year results for 2017 in early February.

Will Home Capital build on this momentum?

Canadian homeowners and prospective buyers will be tested by the tightening rate environment and new mortgage rules. Consumer debt continues to soar to record highs, even as Canadians list debt reduction as their top priority for the eighth consecutive year. Real estate industry experts are expecting a cool-down in the housing market in 2018, especially in comparison to the scorching-hot beginning we saw in 2017.

However, rising rates and tighter mortgage regulations could also drive more conventional buyers to move to alternative lenders. Retention rates are also expected to be aided by higher interest rates, as homeowners find it more difficult to go mortgage shopping.

For the time being, I still prefer Equitable Group for its dividend and its successive string of superior earnings. In any case, investors could be getting a bargain if they choose to dip into alternative lenders, as investor sentiment remains sour on all things housing to start the year.

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