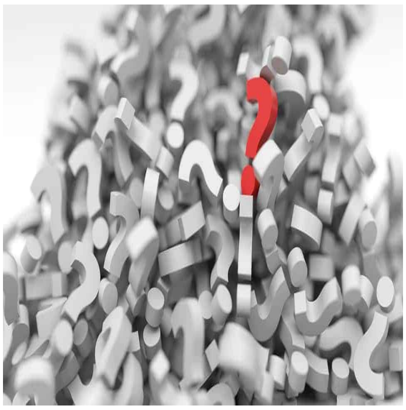

Are Alternative Lender Stocks Good Investments?

Description

Ever since **Home Capital Group Inc.** (TSX:HCG) imploded, alarm bells have rung in the ears of all investors that were drawn in by the industry's seemingly low valuation multiples and their above-average ROE numbers.

Warren Buffett loves inexpensive businesses with high ROEs, so naturally, many investors may have seen Canada's alternative lenders as some sort of must-own value stock. But are alternative lenders actually as cheap as they seem? Or is the underlying risk too much to handle for the average retail investor?

In case you haven't been keeping up with the macroeconomic picture, Canadians in aggregate are heavily indebted, which has ultimately led to the rise of alternative lenders looking to cash in (and probably exacerbate) the indebtedness of Canadians.

The Big Banks are subject to new rules that require more stringent loan practices, which cause a surge in rejected loan applications, whether it's for a mortgage or a line of credit to finance discretionary spending. That's where the alternative lenders have the opportunity to fill in the gap as they meet the demand for financing.

It's not just mortgage lenders like Home Capital, either. Alternative lenders like **goeasy Ltd.** (TSX:GSY) have soared, and are likely to profit from increasing demand for consumer debt. As the Canadian economy continues to heat up, consumers are going to need more debt to finance their lifestyles, and with easyhome's leasing of everyday items, we could be entering an economy where physical goods, like software, are based off monthly subscriptions.

Moving forward, there's no question that the alternative lenders are going to be focusing on the millennial generation — a generation that's been burdened with student loan debt and a lack of opportunities relative to past generations.

Although the much-covered unemployment in Canada is low, this metric doesn't paint an accurate picture of the unfortunate situation that millennials are facing.

The labour force participation rate is alarmingly low, and it hasn't bounced back since the Great Recession. The labour force participation rate accounts for discouraged workers and marginally attached workers, whereas the unemployment rate does not. Moreover, the unemployment rate doesn't factor part-time labour, nor does it consider the underemployed, two common sources of employment for many of today's millennials.

With a drought of opportunities and massive debts placed on their shoulders, there's no question as to why millennials may have no other choice than to rely on credit cards and alternative lenders to finance a lifestyle that wouldn't be possible without the use of leverage.

As bleak as this may sound, alternative lenders may be increasingly necessary as many young Canadians fall further into the debt spiral. Living with exorbitant amounts of debt has become the new normal, and I believe alternative lenders provide a means for younger generations (like millennials) to obtain a lifestyle that wouldn't be possible without alternative lenders. If alternative lenders didn't exist, many of today's younger folks would be living in impoverished conditions, and although leverage is never desired, most have acknowledged that loans may be the only way to go.

Thus, firms like goeasy and Home Capital may not be ticking timebombs like the bears including short-seller Marc Cohodes may believe. Predatory lending isn't ideal, but it can be profoundly profitable assuming that liquidity and solvency metrics are kept above a certain threshold to prevent crises.

While the business of subprime loans may make you cringe, I believe alternative lenders have staying power as the aggregate consumer deficit continues to soar. Unless a tremendous amount of wealth is passed on to younger generations to eliminate the generational wealth cap (don't count on it), I believe the demand for subprime consumer (and mortgage) loans will continue to be strong.

If you're going to invest in an alternative lender, make sure you only put down cash in a firm with ample liquidity, and expect stomach-churning amounts of volatility. The alternative lenders are here to stay, and they can be trusted as investments assuming financial health isn't a concern.

Stay hungry. Stay Foolish.

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