This Alternative Lending Company Offers Investors a Huge Margin of Safety

**Description**

The Canadian real estate market has been one of the hottest topics in the country the last few years. With housing prices growing rapidly and household debt at all-time highs, it's natural to wonder what's next for the real estate sector.



For mortgage companies, business has been difficult during this stretch, as higher regulations have been put in to protect the tax payers. One company that has really been affected by the negative consensus about the sector is **Home Capital Group** (TSX:HCG).

Home Capital is a specialty finance company that primarily deals in mortgages. The company typically deals with borrowers who don't meet normal bank requirements. It offers traditional mortgages and consumer lending as well as securitizing insured mortgages and offering home equity lines of credit.

## Past issues

Home Capital's problems all started when it had declining loan originations back in 2015. This was due to the company cutting ties with brokers that had been falsifying documents. Eventually, the Ontario Securities Commission stated it was investigating. The investigation, coupled with a high short interest in the stock, decimated the share price.

The problems only got worse, as both investors and depositors lost confidence, leading to a run on the bank, which ultimately forced the company into a liquidity crunch.

As the company began its turnaround and started attracting new depositors, management was careful to build its new deposits into products that aren't easily redeemable. In the past, much of the deposits the company had were demand deposits. This time around, the company has been issuing a lot more fixed-rate GICs.

The increase in fixed-term deposits should help Home Capital to better commit to its loan originations, as it has a better idea of the duration available on most of its deposits.

More recently, Home Capital has had trouble fully rebounding, as the regulations for Canadian mortgage lending have become stricter. This impacts Home Capital, because as an alternative finance company, it mainly deals with the higher risk, sub-prime borrowers.

Although the stock has recovered slightly over the last couple years, and the company has begun to turn itself around, the stock is still trading well below its all-time highs.

## Company operations

When looking at Home Capital's loan book, the first thing to notice is the high-quality nature of its portfolio. Non-performing loans have been rising slightly, lately, yet they are still less than half of 1% of total loans. Furthermore, net write-offs in Q1 were just 0.02% of loans on an annualized basis.

Although Home Capital's average customer is typically a sub-prime borrower, the loan-to-value (LTV) ratios in the portfolio look impressive. The weighted average LTV on residential mortgages was 59% as of Q1, meaning on average, Home Capital's borrowers own 41% of their homes.

This suggests that its mortgage book is more stable than the market gives it credit for, as borrowers with higher equity are much less likely to default on their mortgages.



## Bottom line

At just a $1.1 billion market cap, the company looks well undervalued, even for a company in an unloved sector such as real estate. Currently, the price-to-book ratio is sitting at just 0.68. Having the price-to-book ratio so low can be a great opportunity for investors, as it offers the chance to invest in the stock at a bargain.

Additionally, in the case of a real estate market meltdown in Canada, the discount offers investors a large margin of safety. The stock can't fall all that much further than it already has.

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danieldacosta