Home Capital: What a Run — and Can It Continue?

Description

Canadian alternative lender **Home Capital Group** (TSX:HCG) has more than recovered from a 2017 fiasco in which the lender flirted with a run on its deposits and a potential insolvency situation. The company's share price has increased approximately five-fold from its 2017 lows at the time of writing, demonstrating just how strong investor sentiment is in this sector.

Home Capital's edge over banks

One of the big drivers of this revival in Home Capital's share price has been additional government regulations around mortgage qualification criteria. Banks were disallowed from offering mortgages in excess of 25 years. Down payment minimums were raised to 20% across the country, which made qualifying for a bank loan nearly impossible for many.

Home Capital was thus able to pick up many of these otherwise high-quality borrowers who simply may not have saved $300,000 for a Vancouver or Toronto teardown.

Home Capital was therefore able to pick up the origination fees and a higher interest rate for those "risky" mortgages. This was a very good deal for all parties involved.

This sort of "high-risk" lending is very different from the types of loans Home Capital was giving out pre-rule changes, with sub-prime borrowers who had unsteady income a target market for Home Capital's products. The current loan portfolio of Home Capital has greatly improved. My outlook on the company has also shifted to be much more positive over time.

What's on the horizon for Home Capital?

That said, these loans are by definition more risky than 25-year loans with 20% down. Therefore, if we do find ourselves in a serious economic slowdown or rates rise quickly (which I don't see as a risk in the near-term), things could go south for a company like Home Capital.

Even though a significant portion of the high-risk loans Home Capital produces are bundled together and sold in tranches as mortgage backed securities (remind you of 2008?), new mortgage origination would grind to a halt in the case of a recession. Home Capital would be stuck with whatever is on their books that they couldn't bundle and sell off.

For right now, however, Home Capital investors look to be sitting pretty, and I don't anticipate this scenario will change markedly in the short term. That said, Home Capital still remains too risky of a bet for my blood. I think I will always be too risk adverse to own this name, and so it's a company for those braver than I am to trade.

Bottom line

I recommend that investors who are interested in investing in a company like Home Capital to check under the hood first to see if this is a company that meets your risk tolerance and your time horizon for investment.

Stay Foolish, my friends.

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chrismacdonald