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WATCHLIST THE GLOBE AND MAIL

Home Capital: The case for a misunderstood lender

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PUBLISHED AUGUST 7, 2012

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Many people fear the Canadian housing market is doomed to crash – and those fears are reflected in the stock price of Home Capital Group Inc., Canada's largest non-traditional mortgage lender.

The Toronto-based firm is trading at bargain levels of less than 7.5 times earnings. Several U.S. hedge funds are said to be shorting the stock.

I have a far more positive outlook. I own shares in Home Capital and I think there's a compelling case for this misunderstood lender.

It's not that I'm denying that Canadian real estate is pricey. My own research indicates Toronto, Vancouver and a few other markets may be overvalued. For instance, I calculate that the Toronto market is about 30 per cent overvalued relative to incomes and 40 per cent relative to rents. Other markets, however, seem much more reasonably priced.

What does this mean for Home Capital? Roughly one-half of the company's mortgage book consists of securitized mortgages that are fully insured by Canada Mortgage Housing Corp. or other mortgage insurers. Canadian taxpayers are on the hook for any losses, not Home Capital.

The other half of Home Capital's mortgage book is composed of uninsured mortgages on owner-occupied properties made to people that our Big Five banks won't touch. Borrowers include recent immigrants who have not been in Canada long enough to establish a credit history and business owners whose personal financial situations are intertwined with their businesses. These are situations that don't lend themselves to being underwritten by the big banks' automated scoring systems.

That's why Home Capital has its underwriting officers review every file to understand the credit risk and make sure that the property is one that they are prepared to lend

against. These are not "liar loans" like the ones made during the U.S. subprime fiasco, but well researched credits.

Another plus: These uninsured mortgages have a loan-to-value (LTV) at origination of less than 70 per cent. In other words, the borrowers have 30 per cent or more equity in their homes. They have every reason to avoid default.

Home Capital's habit of lending to people with substantial equity is one big reason it has historically achieved relatively low default rates. Add in Home Capital's dominance of its niche, Canada's lender-friendly laws and the company's pricing power and you can understand why it has been a profit machine.

If home prices did fall by half, the company's uninsured book would be hit, but not to a devastating extent. Using default rate and loss assumptions that are significantly higher than Home Capital's historical experience, I calculate that the company would lose two to three quarters worth of earnings. Home Capital's risk management team conducted its own internal stress test assuming a 45-per-cent drop in real estate prices and 10-per-cent unemployment. They concluded they would lose about one year's worth of earnings – a conclusion not dissimilar to my own.

Now I don't believe that a 50-per-cent correction is the most likely outcome. It is a possibility, but a gradual slowing of the market or a modest decline is more probable.

Home Capital's chief executive Gerry Soloway has been through several real estate corrections and knows how to position the company to weather storms. Case in point: During the recent Great Recession the company ramped up its originations of fully insured mortgages and curtailed their traditional uninsured mortgage book.

The company has generated an impressive return on equity that has been in excess of 20 per cent for 14 consecutive years. It has increased its dividend 14 times over the past eight years. Its proprietary lending procedures, when combined with the company's deposit-taking licence, provide the firm with a sustainable competitive advantage.

At less than 7.5 times current earnings I believe the stock is significantly undervalued. Home Capital should continue to grow its earnings in the future.

If we see a major Canadian real estate correction I suspect its management will see it coming before we do and manage the business defensively. The stock could trade lower but with a book value per share that should approach $30 by early next year I see limited downside risk. More importantly, the firm's strong capital position means that they will live to fight another day.

In the words of famed value investor Mohnish Pabrai: Heads I win, tails I don't lose too much. To my mind, that adds up to an attractive investment