Company News Alert

The big value in Canada's small lenders (RTGAM)
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When it comes to investing in the shares of Canadian financial institutions, could small be beautiful?

That's the contention of some institutional investors and analysts who have wandered off the beaten track and explored the merits of little-known companies that are in the financial business, but aren't among the familiar five Canadian big banks or the large life insurers.

There are more than a dozen of these companies, almost all overshadowed by the banks that dominate the financial sector.

Among them are such little-known names as leasing company Chesswood Group Ltd., alternative mortgage providers, such as Home Capital Group Inc., and purveyors of car loans to borrowers who are too risky for conventional financing, such as Carfinco Financial Group and Rifco Inc.

Chesswood and Rifco have been two of the best-performing financial stocks in Canada over the past year, rising 56 and 347 per cent respectively since the beginning of last year.

While the risks may be higher in smaller financial institutions, there is a big attraction. Some of these smaller companies are value plays, available at price-to-earnings multiples or multiples to book value well below those of the big banks, with the added kicker that their growth prospects may be better than those of larger financial institutions.

Among the most avid buyers of these stocks is Martin Ferguson, a well-regarded portfolio manager at Mawer Investment Management in Calgary, who is a major investor in the sector through the small-capitalization stock fund he manages. According to records compiled by Bloomberg, Mr. Ferguson's fund has assembled major positions in Home Capital Group, Equity Financial Holdings Inc., First National Financial Corp., Carfinco, Equitable Group and Element Financial Corp.

Mr. Ferguson says the sector is "overlooked or unloved," making it ripe for value-oriented stock pickers. Another believer is Toronto value fund manager Irwin Michael, who has a major stake in Equitable Group. He estimates the mortgage lender will earn $5.50 a share this year, giving it a price-to-earnings multiple of only seven. Most of the big banks trade at projected P/E multiples of 10 or more. "We like it a lot," Mr. Michael says of Equitable.

Many smaller financial firms can represent good value because most institutional investors want to play it safe with the big banks, so there is relatively little buying of the stocks. "You're never faulted if you buy a bank," Mr. Michael says of the thinking on the Street.

Earlier this year, Cormack Securities analyst Jeff Fenwick issued a report on the sector, saying valuations among small financial companies still seemed reasonable, with little credit given to their growth prospects. Mortgage lender Equitable Group is his "top pick," and he has a price target of $45 a share, compared to recent trading around $38.

He says the company trades at a "heavy discount to what its operating fundamentals would suggest given that we expect the firm to continue to produce [return on equity] in the high teens over the next two years."

Valuations among smaller financial institutions are depressed in part because their minute size makes them difficult for larger institutional investors to buy or sell in any quantity, without causing sharp price moves. Home Capital, the largest company in the sector, has a market capitalization of $2-billion, compared to nearly $90-billion for the Royal, Canada's largest bank.

To be sure, there are risks in the sector. Carfinco caters to car buyers with poor to non-existent credit ratings and had a loss rate of nearly 13 per cent last year.

But the company still managed to report a 52-per-cent return on equity because it was able to offset its high loan losses by charging high rates to borrowers.

Non-prime mortgage lenders also face higher risks of defaults, but companies have successfully avoided large loan losses by having borrowers make larger down payments on their homes.

An emerging mortgage lending play is Equity Financial Holdings. It recently sold its transfer agent and corporate trust services division to the TMX Group for $64-million and intends to use the proceeds to expand mortgage lending.

Mr. Ferguson characterized the sale price from TMX as "very good" and says Equity is "still a very promising story, but at higher risk than either Equitable or Home."

Another small-sized financial play in the mortgage business is First National Financial. Its main attraction is its portfolio of about $65-billion in mortgages for which it provides administration services, gaining fee revenue.

The company could be affected by the recent federal budget provision to clamp down on mortgage securitization.

However, the stock does have an attractive dividend yield of around 8 per cent and Mr. Ferguson said it has a "low-risk business model" with "huge free cash flow generation."

Low Profit Lenders

A selection of Canada's non-bank lenders:

Company	Ticker		Major Services	Recent Share Price $
Carfinco Financial Grp	CFN-T		car loans	10.27
Chesswood Group	CHW-T		leasing	10.05
Element Financial	EFN-T		lease financing	8.93
Equitable Group	ETC-T		mortgage lending	39.25
Equity Financial	EQI-T		mortgage lending	9.94
First National Financial	FN-T		mortgage lending	17.29
Home Capital	HCG-T		mortgage lending, trust company	58.07
Rifco	RFC-X		car loans	4.29
Source: Bloomberg				