

Below is a summary of HF Group FY'2023 performance:

Balance Sheet Items (Kshs bn)	FY'2022	FY'2023	y/y change
Net loans	36.3	38.8	6.9%
Government Securities	8.2	9.0	10.9%
Total Assets	57.0	61.6	8.0%
Customer Deposits	39.8	43.8	10.2%
Deposits Per Branch	1.8	1.7	(6.8%)
Total Liabilities	48.2	52.7	9.2%
Shareholder's Funds	8.8	8.9	1.1%

Balance Sheet Ratios	FY'2022	FY'2023	% y/y change
Loan to deposit ratio	91.2%	88.5%	(2.8%)
Government Securities to deposit ratio	20.5%	20.6%	0.1%
Return on Average Equity	3.1%	4.4%	1.3%
Return on Average Assets	0.5%	0.7%	0.2%
Dividend Yield	0.0%	0.0%	
Dividend Payout ratio	0.0%	0.0%	

Income Statement (Kshs bn)	FY'2022	FY'2023	y/y change
Net Interest Income	2.2	2.5	18.1%
Net non-Interest Income	0.9	1.2	41.3%
Total Operating income	3.0	3.8	24.8%
Loan Loss provision	(0.2)	(0.3)	59.3%
Total Operating expenses	(2.8)	(3.5)	22.8%
Profit before tax	0.2	0.3	75.7%
Profit after tax	0.3	0.4	46.2%
Core EPS	0.7	1.0	46.2%

Income Statement Ratios	FY'2022	FY'2023	y/y change
Yield from interest-earning assets	9.9%	11.0%	1.2%
Cost of funding	4.9%	5.8%	0.9%
Net Interest Spread	5.0%	5.3%	0.2%
Net Interest Margin	5.0%	5.4%	0.4%
Cost of Risk	6.4%	8.2%	1.8%
Net Interest Income as % of operating income	71.1%	67.2%	(3.8%)
Non-Funded Income as a % of operating income	28.9%	32.8%	3.8%
Cost to Income Ratio (with LLP)	93.5%	92.0%	(1.5%)
Cost to Income Ratio (without LLP)	87.1%	83.9%	(3.3%)

Capital Adequacy Ratios	FY'2022	FY'2023	% points change
Core Capital/Total Liabilities	8.0%	4.7%	(3.3%)
Minimum Statutory ratio	8.0%	8.0%	0.0%
Excess	0.0%	(3.3%)	(3.3%)
Core Capital/Total Risk Weighted Assets	8.3%	5.3%	(3.0%)
Minimum Statutory ratio	10.5%	10.5%	0.0%
Excess	(2.2%)	(5.2%)	(3.0%)
Total Capital/Total Risk Weighted Assets	12.2%	9.0%	(3.2%)
Minimum Statutory ratio	14.5%	14.5%	0.0%
Excess	(2.3%)	(5.5%)	(3.2%)
Liquidity Ratio	25.2%	24.5%	(0.7%)
Minimum Statutory ratio	20.0%	20.0%	0.0%
Excess	5.2%	4.5%	(0.7%)

Income Statement

- Core earnings per share increased by 46.2% to Kshs 1.0 from Kshs 0.7 in FY'2022, mainly driven by the 24.8% growth in total operating income to Kshs 3.8 bn, from Kshs 3.0 bn in FY'2022. However, the performance was weighed down by a 22.8% growth in total operating expenses to Kshs 3.5 bn, from Kshs 2.8 bn in FY'2022,
- The 24.8% growth in total operating income was mainly driven by a 18.1% growth in Net Interest Income to Kshs 2.5 bn, from Kshs 2.2 bn in FY'2022, coupled with a 41.3% growth in Non funded Income (NFI) to Kshs 1.2 bn, from Kshs 0.9 bn in FY'2022,
- Interest income grew by 21.9% to Kshs 5.2 bn from Kshs 4.3 bn in FY'2022, mainly driven by a 21.0% growth in interest income from loans and advances to Kshs 4.0 bn from Kshs 3.3 bn in FY'2022, coupled with 22.2% growth in interest from government securities to Kshs 1.1 bn, from Kshs 0.9 bn in FY'2022. As such, the Yield on Interest-Earning Assets (YIEA) increased to 11.0% from 9.9% recorded in FY'2022, mainly attributable to the faster 21.9% growth in interest income compared to a 8.9% increase in average interest earning assets to Kshs 47.2 bn, from Kshs 43.3 bn in FY'2022,
- Interest expense increased by 25.8% to Kshs 2.7 bn in FY'2023 from Kshs 2.1 bn in FY'2022, largely due to a 26.8% increase in interest expense on customer deposits to Kshs 2.0 bn from Kshs 1.6 bn in FY'2022, coupled with 71.8% increase in interest expenses on placements to Kshs 0.3 bn from Kshs 0.2 bn in FY'2022. Consequently, Cost of funds (COF) increased by 0.9% points to 5.8% from 4.9% recorded in FY'2022, owing to a faster 25.8% increase in Trailing interest expense to Kshs 2.7 bn, from Kshs 2.1 bn recorded in FY'2022, compared to a 5.7% increase in average interest bearing liabilities to Kshs 45.9 bn from Kshs 43.4 bn in FY'2022. Trailing interest expense refers to the performance of the interest expense for the past 12 consecutive months. On the other hand, Net Interest Margin (NIM) increased to 5.4% from 5.0% in FY'2022, attributable to the faster 18.1% increase in trailing Net Interest Income (NII) to Kshs 2.5 bn from Kshs 2.2 bn in FY'2022 relative to the 8.9% increase in average interest earning assets to Kshs 47.2 bn, from Kshs 43.3 bn in FY'2022,
- Non-Funded Income (NFI) increased by 41.3% to Kshs 1.2 bn from Kshs 0.9 bn in FY'2022, mainly driven by a 27.9% increase in the foreign exchange trading income to Kshs 0.17 bn from Kshs 0.14 bn in FY'2022, highlighting the bank's increased foreign exchange margins. Total fees and commissions increased by 37.1% to Kshs 0.4 bn, from Kshs 0.3 bn in FY'2022. The revenue mix shifted to 67:33, from 71:29 in FY'2022 for the Funded to Non-funded income owing to the faster increase in NFI by 41.3%, compared to the 18.1% increase in NII.
- Total operating expenses increased by 22.8% to Kshs 3.5 bn from Kshs 2.8 bn in FY'2022, driven by 59.3% increase in loan loss provisions to Kshs 0.3 bn from Kshs 0.2 bn recorded in FY'2022, coupled with a 22.2% increase in staff costs to Kshs 1.6 bn from Kshs 1.3 bn in FY'2022.
- Cost to Income Ratio (CIR) decreased to 92.0% from 93.5% in FY'2022, owing to the 24.8% increase in total operating income, which outpaced the 22.8% increase in total operating expenses. Notably, CIR without LLP decreased by 3.3% points to 83.9% from 87.1% recorded in FY'2022, and,
- Profit before tax increased by 75.7% to Kshs 0.3 bn from Kshs 0.2 bn in FY'2022. Similarly, profit after tax increased by 46.2% to Kshs 0.4 bn in FY'2023, from Kshs 0.3 bn in FY'2022.

Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 8.0% to Kshs 61.6 bn, from Kshs 57.0 bn in FY'2022, mainly attributable to the 6.9% growth in net loans and advances to Kshs 38.8 bn in FY'2023 from Kshs 36.3 bn in FY'2022, coupled with 10.9% increase in government securities to Kshs 9.0 bn, from Kshs 8.2 bn recorded in FY'2022

- Total liabilities grew by 9.2% to Kshs 52.7 bn, from Kshs 48.2 bn in FY'2022, largely attributable to a 10.2% growth in customer deposits to Kshs 43.8 bn in FY'2023, from Kshs 39.8 bn in FY'2022. Borrowings declined by 13.2% to Kshs 3.8 bn from Kshs 4.4 bn in FY'2022.
- The faster 10.2% growth in customer deposits as compared to the 6.9% growth in loans led to a decrease in the loan to deposits ratio to 88.5%, from 91.2% in FY'2022,
- Gross Non-Performing Loans (NPLs) increased by 27.5% to Kshs 10.8 bn in FY'2023 from Kshs 8.5 bn in FY'2022, while Gross Loans increased by 9.1% to Kshs 46.9 bn from Kshs 43.0 bn in FY'2022. Consequently, the asset quality deteriorated with the NPL ratio rising to 23.1% in FY'2023 from 19.7% in FY'2022,
- General Provisions (LLP) increased by 27.8% to Kshs 5.0 bn in FY'2023 from Kshs 3.9 bn in FY'2022. The NPL coverage decreased to 74.9% in FY'2023, from 78.8% in FY'2022, attributable to the 27.5% increase in gross non-performing loans which offset the 27.8% increase in provisions coupled with 11.6% increase in interest in suspense to Kshs 3.1 bn from 2.8 bn recorded in FY'2022.
- Shareholders' funds increased by 1.1% to Kshs 8.9 bn in FY'2023, from Kshs 8.8 bn in FY'2022, supported by a 31.3% increase in statutory loan loss reserves to Kshs 4.9 bn, from 3.7 bn in FY'2022. Notably, accumulated losses increased by 33.3% to Kshs 3.3 bn, from Kshs 2.4 bn in FY'2022,
- HF Group remained under-capitalized with a core capital to risk-weighted assets ratio of 5.3%, 5.2% points below the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio came in at 9.0%, 5.5% points below the statutory requirement of 14.5%, and,
- The bank currently has a Return on Average Assets (ROaA) of 0.7%, and a Return on Average Equity (ROaE) of 4.4%.

Key Take-Outs:

1. **Strong earnings growth** - Core earnings per share increased by 46.2% to Kshs 1.0 from Kshs 0.7 in FY'2022, mainly driven by the 24.8% growth in total operating income to Kshs 3.8 bn, from Kshs 3.0 bn in FY'2022.
2. **Asset quality deterioration** – The bank's gross NPL ratio increased to 23.1% in FY'2023 from 19.7% in FY'2022, attributable to the faster growth of 27.5% in Gross non-performing loans to Kshs 10.8 bn in FY'2023 from Kshs 8.5 bn in FY'2022, which outpaced the 9.1% increase in gross loans to Kshs 46.9 bn, from Kshs 43.0 bn recorded in FY'2022,
3. **Sustained Efficiency** – Cost to Income Ratio (CIR) improved by 1.5% points to 92.0%, from 93.5% in FY'2022, owing to the 24.8% increase in total operating income to Kshs 3.8 bn from Kshs 3.0 bn in FY'2022, which outpaced the 22.8% increase in total operating expenses to Kshs 3.5 bn, from Kshs 2.8 bn in FY'2022. The cost to income ratio without loan loss provisions declined by 3.3% points to 83.9%, from 87.1% in FY'2022.

We commend HF Group's turnaround performance, recording an increase in profit after tax of 46.2% to Kshs 0.4 bn in FY'2023, from Kshs 0.3 bn in FY'2022. Despite the four consecutive quarters of profitability witnessed by the Group so far, HF Group faces a major downside with its capital adequacy ratios remaining below the minimum statutory requirements set for banks. The group will have to review its business model or merge with a bank with stronger capital ratios so as to overcome its undercapitalization. Additionally, it can expand its client base to cover more financial interests of the economy like commercial banking, insurance as well as as get a good grounding in capitalizing on its strengths, that is, mortgage and real estate financing.

Valuation Summary

- We are of the view that HF Group is a "Sell" with a target price of Kshs 4.1 representing a downside of 2.1%, from the current price of Kshs 4.2 as of 28th March 2024.
- HF Group is currently trading at a P/TBV of 0.2x and a P/E of 4.2x vs an industry average of 0.8x and 4.0x respectively.