

Below is a summary of HF Group Q1'2024 performance:

Balance Sheet Items (Kshs bn)	Q1'2023	Q1'2024	y/y change
Net loans	37.0	38.1	3.1%
Government Securities	9.5	10.1	6.4%
<b>Total Assets</b>	<b>59.0</b>	<b>62.3</b>	<b>5.6%</b>
Customer Deposits	41.2	43.8	6.2%
Deposits Per Branch	1.9	2.0	6.2%
Total Liabilities	50.2	53.3	6.1%
<b>Shareholder's Funds</b>	<b>8.8</b>	<b>9.0</b>	<b>2.4%</b>

Balance Sheet Ratios	Q1'2023	Q1'2024	% y/y change
Loan to deposit ratio	89.7%	87.1%	(2.6%)
Government Securities to deposit ratio	23.0%	23.1%	0.1%
Return on Average Equity	3.8%	5.1%	1.3%
Return on Average Assets	0.6%	0.8%	0.2%

Income Statement (Kshs bn)	Q1'2023	Q1'2024	y/y change
Net Interest Income	0.6	0.7	7.6%
Net non-Interest Income	0.3	0.4	40.7%
<b>Total Operating income</b>	<b>0.9</b>	<b>1.1</b>	<b>17.7%</b>
Loan Loss provision	(0.1)	(0.1)	7.2%
Total Operating expenses	(0.8)	(0.9)	11.2%
Profit before tax	0.1	0.2	76.2%
<b>Profit after tax</b>	<b>0.1</b>	<b>0.2</b>	<b>80.4%</b>
<b>Core EPS</b>	<b>0.2</b>	<b>0.4</b>	<b>80.4%</b>

Income Statement Ratios	Q1'2023	Q1'2024	y/y change
Yield from interest-earning assets	9.8%	11.4%	1.6%
Cost of funding	4.8%	6.3%	1.5%
Net Interest Spread	5.0%	5.1%	0.2%
Net Interest Margin	5.0%	5.4%	0.3%
Cost of Risk	11.3%	10.3%	(1.0%)
Net Interest Income as % of operating income	69.6%	63.7%	(6.0%)
Non-Funded Income as a % of operating income	30.4%	36.3%	6.0%
Cost to Income Ratio (with LLP)	90.0%	85.1%	(5.0%)
Cost to Income Ratio (without LLP)	78.8%	74.8%	(4.0%)

Capital Adequacy Ratios	Q1'2023	Q1'2024	% points change
Core Capital/Total Liabilities	6.7%	4.5%	(2.2%)
Minimum Statutory ratio	8.0%	8.0%	0.0%
<b>Excess</b>	<b>(1.3%)</b>	<b>(3.5%)</b>	<b>(2.2%)</b>
Core Capital/Total Risk Weighted Assets	7.2%	5.2%	(2.0%)
Minimum Statutory ratio	10.5%	10.5%	0.0%
<b>Excess</b>	<b>(3.3%)</b>	<b>(5.3%)</b>	<b>(2.0%)</b>
Total Capital/Total Risk Weighted Assets	11.0%	8.8%	(2.2%)
Minimum Statutory ratio	14.5%	14.5%	0.0%
<b>Excess</b>	<b>(3.5%)</b>	<b>(5.7%)</b>	<b>(2.2%)</b>
Liquidity Ratio	24.7%	24.9%	0.2%
Minimum Statutory ratio	20.0%	20.0%	0.0%
<b>Excess</b>	<b>4.7%</b>	<b>4.9%</b>	<b>0.2%</b>

**Income Statement**

- Core earnings per share increased by 80.4% to Kshs 0.4 from Kshs 0.2 in Q1'2023, mainly driven by the 17.7% increase in total operating income to Kshs 1.1 bn, from Kshs 0.9 bn in Q1'2023 which outpaced the 11.2% increase in total operating expenses to Kshs 0.9 bn, from Kshs 0.8 bn in Q1'2023,
- The 17.7% growth in total operating income was mainly driven by a 7.6% growth in Net Interest Income to Kshs 0.7 bn, from Kshs 0.6 bn in Q1'2023, coupled with a 40.7% growth in Non funded Income (NFI) to Kshs 0.4 bn, from Kshs 0.3 bn in Q1'2023,
- Interest income grew by 28.5% to Kshs 1.5 bn from Kshs 1.2 bn in Q1'2023, mainly driven by a 28.9% growth in interest income from loans and advances to Kshs 1.2 bn from Kshs 0.9 bn in Q1'2023, coupled with 18.9% growth in interest from government securities to Kshs 0.3 bn, from Kshs 0.2 bn in Q1'2023. As such, the Yield on Interest-Earning Assets (YIEA) increased to 11.4% from 9.8% recorded in Q1'2023, mainly attributable to the faster 28.5% growth in interest income compared to a 7.2% increase in average interest earning assets to Kshs 48.4 bn, from Kshs 45.2 bn in Q1'2023,
- Interest expense increased by 52.4% to Kshs 0.8 bn in Q1'2024 from Kshs 0.5 bn in Q1'2023, largely due to a 58.8% increase in interest expense on customer deposits to Kshs 0.7 bn from Kshs 0.4 bn in Q1'2023, coupled with 177.8% increase in interest expenses on placements to Kshs 0.09 bn from Kshs 0.03 bn in Q1'2023. Consequently, Cost of funds (COF) increased by 1.5% points to 6.3% from 4.8% recorded in Q1'2023, owing to a faster 36.5% increase in Trailing interest expense to Kshs 2.9 bn, from Kshs 2.2 bn recorded in Q1'2023, compared to a 4.0% increase in average interest bearing liabilities to Kshs 46.8 bn from Kshs 45.0 bn in Q1'2023. 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 Q1'2023, attributable to the faster 14.5% increase in trailing Net Interest Income (NII) to Kshs 2.6 bn from Kshs 2.3 bn in Q1'2023 relative to the 7.2% increase in average interest earning assets to Kshs 48.4 bn, from Kshs 45.2 bn in Q1'2023,
- Non-Funded Income (NFI) increased by 40.7% to Kshs 0.4 bn from Kshs 0.3 bn in Q1'2023, mainly driven by a 14.4% increase in the foreign exchange trading income to Kshs 0.05 bn from Kshs 0.04 bn in Q1'2023, highlighting the bank's increased foreign exchange margins. Total fees and commissions increased by 56.0% to Kshs 0.12 bn, from Kshs 0.08 bn in Q1'2023. The revenue mix shifted to 64:36, from 70:30 in Q1'2023 for the Funded to Non-funded income owing to the faster increase in NFI by 40.7%, compared to the 7.6% increase in NII.
- Total operating expenses increased by 11.2% to Kshs 0.9 bn from Kshs 0.8 bn in Q1'2023, attributable to the 22.2% increase in staff costs to Kshs 0.44 bn, from Kshs 0.36 bn in Q1'2023, coupled with a 7.2% increase in loan loss provisions to Kshs 0.109 bn from Kshs 0.101 bn recorded in Q1'2023.
- Cost to Income Ratio (CIR) decreased to 85.1% from 90.0% in Q1'2023, owing to the 17.7% increase in total operating income, which outpaced the 11.2% increase in total operating expenses. Notably, CIR without LLP decreased by 4.0% points to 74.8% from 78.8% recorded in Q1'2023, and,
- Profit before tax increased by 76.2% to Kshs 0.2 bn from Kshs 0.1 bn in Q1'2023, with effective tax rate decreasing to 5.2% from 7.5% in Q1'2023. As such, profit after tax increased by 80.4% to Kshs 0.2 bn in Q1'2024, from Kshs 0.1 bn in Q1'2023.

**Balance Sheet**

- The balance sheet recorded an expansion as total assets increased by 5.6% to Kshs 62.3 bn, from Kshs 59.0 bn in Q1'2023, mainly attributable to the 3.1% growth in net loans and advances to Kshs 38.1 bn in Q1'2024 from Kshs 37.0 bn in Q1'2023, coupled with 6.4% increase in government securities to Kshs 10.1 bn, from Kshs 9.5 bn recorded in Q1'2023

- Total liabilities grew by 6.1% to Kshs 53.3 bn, from Kshs 50.2 bn in Q1'2023, largely attributable to a 6.2% growth in customer deposits to Kshs 43.8 bn in Q1'2024, from Kshs 41.2 bn in Q1'2023. Borrowings declined by 22.4% to Kshs 3.4 bn from Kshs 4.4 bn in Q1'2023.
- The faster 6.2% growth in customer deposits as compared to the 3.1% growth in loans led to a decrease in the loan to deposits ratio to 87.1%, from 89.7% in Q1'2023,
- Gross Non-Performing Loans (NPLs) increased by 27.6% to Kshs 11.2 bn in Q1'2024 from Kshs 8.8 bn in Q1'2023, while Gross Loans increased by 5.3% to Kshs 46.5 bn from Kshs 44.1 bn in Q1'2023. Consequently, the asset quality deteriorated with the NPL ratio rising to 24.1% in Q1'2024 from 19.9% in Q1'2023,
- General Provisions (LLP) increased by 16.2% to Kshs 4.9 bn in Q1'2024 from Kshs 4.2 bn in Q1'2023. The NPL coverage decreased to 74.4% in Q1'2024, from 81.4% in Q1'2023, attributable to the 27.6% increase in gross non-performing loans which offset the 16.2% increase in provisions,
- Shareholders' funds increased by 2.4% to Kshs 9.0 bn in Q1'2024, from Kshs 8.8 bn in Q1'2023, supported by a 22.3% increase in statutory loan loss reserves to Kshs 5.0 bn, from 4.1 bn in Q1'2023. Notably, accumulated losses increased by 16.3% to Kshs 3.2 bn, from Kshs 2.8 bn in Q1'2023,
- HF Group remained under-capitalized with a core capital to risk-weighted assets ratio of 5.2%, 5.3% points below the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio came in at 8.8%, 5.7% points below the statutory requirement of 14.5%, and,
- The bank currently has a Return on Average Assets (ROaA) of 0.8%, and a Return on Average Equity (ROaE) of 5.1%.

#### **Key Take-Outs:**

1. **Strong earnings growth** - Core earnings per share (EPS) increased by 80.4% to Kshs 0.4 from Kshs 0.2 in Q1'2023, mainly driven by the 17.7% increase in total operating income to Kshs 1.1 bn, from Kshs 0.9 bn in Q1'2023 which outpaced the 11.2% increase in total operating expenses to Kshs 0.9 bn, from Kshs 0.8 bn in Q1'2023.
2. **Asset quality deterioration** – The bank's gross NPL ratio increased to 24.1% in Q1'2024 from 19.9% in Q1'2023, attributable to the faster growth of 27.6% in Gross non-performing loans to Kshs 11.2 bn in Q1'2024 from Kshs 8.8 bn in Q1'2023, which outpaced the 5.3% increase in gross loans to Kshs 46.5 bn, from Kshs 44.1 bn recorded in Q1'2023,
3. **Sustained Efficiency** – Cost to Income Ratio (CIR) improved by 5.0% points to 85.1%, from 90.0% in Q1'2024, owing to the 17.7% increase in total operating income to Kshs 1.1 bn from Kshs 0.9 bn in Q1'2023, which outpaced the 11.2% increase in total operating expenses to Kshs 0.9 bn, from Kshs 0.8 bn in Q1'2023. The cost to income ratio without loan loss provisions declined by 4.0% points to 74.8%, from 78.8% in Q1'2023.

We commend HF Group's turnaround performance, recording an increase in profit after tax of 80.4% to Kshs 0.2 bn in Q1'2024, from Kshs 0.1 bn in Q1'2023. Despite the five 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 "Hold" with a target price of Kshs 4.6 representing a downside of 9.3%, from the current price of Kshs 4.2 as of 24<sup>th</sup> May 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 3.7x respectively.