HF Group limited – Q3’2018

30th November, 2018

Valuation Summary

- We are of the view that HF Group Ltd is a “***buy***” with a target price of Kshs 6.6, representing an upside of 37.4%, from the current price of Kshs 5.1 as of 30th November 2018, inclusive of a dividend yield of 6.9%,
- HF Group Ltd is currently trading at P/TBV of 0.2x vs an industry average of 1.4x.

Income Statement

- HF Group recorded a loss per share of Kshs 0.9 in Q3’2018, from a core earnings per share of Kshs 0.5 recorded in Q3’2017, in line with our expectations of a decline to a loss per share of Kshs 0.4. The performance was driven by a 15.4% decline in total operating income, coupled with a 4.6% rise in the total operating expenses,
- Total operating income declined by 15.4%, to Kshs 2.4 bn in Q3’2018, from Kshs 2.8 bn over the same period to Q3’2017. This was due to a 17.8% decline in Net Interest Income (NII) to Kshs 1.8 bn from Kshs 2.2 bn in Q3’2017, coupled with a 7.2% decline in Non-Funded Income (NFI) to Kshs 0.60 bn, from Kshs 0.64 bn in Q3’2017,
- Interest income declined by 14.1% to Kshs 4.7 bn, from Kshs 5.5 bn in Q3’2017. This was driven by a 13.6% decline in interest income on loans and advances to Kshs 4.4 bn from Kshs 5.1 bn recorded in Q3’2017, coupled with a 12.5% decline in interest from government securities to Kshs 237.9 mn, from Kshs 314.1 mn in Q3’2017. As a result of the decline in interest income, the yield on interest earning assets declined to 11.8% in Q3’2018, from 12.4% in Q3’2017,
- Interest expense declined by 11.7% to Kshs 2.9 bn, from Kshs 3.3 bn in Q3’2017, following a 6.8% decline in the interest expense on customer deposits to Kshs 1.7 bn, from Kshs 1.8 bn in Q3’2017. Furthermore, other interest expenses declined by 22.8% to Kshs 1.1 bn, from Kshs 1.4 bn in Q3’2017. Due to the decline in interest expenses, the cost of funds declined to 7.0%, from 7.4% in Q3’2017. The Net Interest Margin (NIM) declined to 4.6%, from 5.1% in Q3’2017,
- Non-Funded Income (NFI) declined by 7.2% to Kshs 598.0 mn, from Kshs 644.6 mn in Q3’2017. Fees and commissions on loans declined by 36.0% to Kshs 27.7 mn, from Kshs 43.2 mn in Q3’2017. Other fees and commission income declined by 29.5% to Kshs 112.6 mn, from Kshs 159.8 mn in Q3’2017. Forex trading income increased by 10.9% to Kshs 2.1 bn, from Kshs 1.9 bn in Q3’2017. However, other income rose by 7.2% to Kshs 426.8 mn, from Kshs 398.0 mn in Q3’2017. As a result of the above performance, the current revenue mix shifted to 75:25 funded to non-funded income as compared to 77:23 in Q3’2017. The proportion of NII to total revenue decreased owing to the slower decline in NFI at 7.2%, compared to the 17.8% decline in Net Interest Income (NII),
- Total operating expenses rose by 4.6% to Kshs 2.7 bn, from Kshs 2.6 bn, largely driven by a 15.7% rise in staff costs to Kshs 932.5 mn from Kshs 806.3 mn in Q3’2017, which the management attributed to a redundancy exercise taken, which increased the staff cost due to the one-off payout. Other operating expenses rose by 9.5% to Kshs 1.1 bn from Kshs 967.1 mn in Q3’2017. Loan Loss Provisions (LLP) however declined by 25.4% to Kshs 357.2 mn in Q3’2018, from Kshs 478.9 mn in Q3’2017.Consequently, the Cost to Income Ratio (CIR) deteriorated to 113.5%, from 91.8% in Q3’2017. Without LLP, the cost to income ratio also deteriorated to 98.6%, from 74.9% in Q3’2017,
- HF Group made a loss after tax of Kshs 332.1 mn from a profit after tax of Kshs 231.9 mn in Q3’2017.

Balance Sheet

- The balance sheet recorded a contraction as total assets declined by 10.5% to Kshs 63.4 bn from Kshs 70.8 bn in Q3’2017. This decline was largely driven by an 11.3% decline in loans and advances to Kshs 45.4 bn, from Kshs 51.2 bn in Q3’2017. Government securities rose by 429.5% to Kshs 3.9 bn from Kshs 730.6 mn in Q3’2017,

- Total liabilities declined by 11.6% to Kshs 52.6 bn from Kshs 59.5 bn in Q3’2017, mainly attributed to a 35.3% decline in borrowed funds to Kshs 15.4 bn from Kshs 23.7 bn in Q3’2017. Deposits however rose by 3.0% to Kshs 34.7 bn from Kshs 33.6 bn recorded in Q3’2017. Deposits per branch rose by 17.2% to Kshs 1.6 bn from Kshs 1.4 bn in Q3’2017 with the number of branches declining to 22 from 25 as at Q3’2017, on the closure of 3 branches in H1’2018,
- The decline in loans and advances coupled with the increase in deposits led to a decline in the loan to deposit ratio to 131.1%, from 152.3% in Q3’2017. Loans to loanable funds however rose to 92.0% from 88.8% recorded in Q3’2017 The proportion of government securities to deposits increased, to 11.2% from 2.2% in Q3’2017,
- Gross Non-Performing Loans (NPLs) increased by 10.4% to Kshs 8.9 bn in Q3’2018, from Kshs 8.1 bn in Q3’2017. The increase in NPL’s was attributed to the unfavorable trading environment during the quarter, leading to a slowdown in the real estate sector. Consequently, the NPL ratio deteriorated to 18.2% in Q3’2018, from 15.0% in Q3’2017. General Loan Loss Provisions (LLPs) increased by 45.2% to Kshs 2.3 bn from Kshs 1.6 bn in Q3’2017. Consequently, the NPL coverage improved to 42.4% in Q3’2018 from 36.8% in Q3’2017 supported by the 45.2% increase in in general provisions. The decline in the specific provisions despite a deterioration in asset quality, is due banks being allowed to charge provisions on equity, on the initial implementation of IFRS 9,
- Shareholders’ funds declined by 4.3% to Kshs 10.8 bn in Q3’2018 from Kshs 11.3 bn in Q3’2017, as retained earnings of Kshs 3.8 bn in Q3’2017 were depleted by 32.5% to Kshs 2.6 bn in Q3’2018,
- HF Group Limited remains sufficiently capitalized with a core capital to risk weighted assets ratio of 14.1%, 3.6% points above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 15.5%, exceeding the statutory requirement by 1.0% points. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 14.7%, while total capital to risk weighted assets came in at 16.2%, indicating that the bank’s total capital relative to its risk-weighted assets declined by 0.7% points due to implementation of IFRS 9,
- The bank currently has a Return on Average Assets (ROaA) of (0.5%) and a Return on Average Equity (ROaE) of (3.3%).

Key Take-Outs:

a) The bank experienced a deterioration in asset quality, with gross non-performing loans (NPLs) rising by 10.4%, to Kshs 8.9 bn in Q3’2018, from Kshs 8.1 bn in Q3’2017. This warranted increased provisioning by 45.2% to Kshs 2.3 bn from Kshs 1.6 bn in Q3’2017 and consequently an increase in the NPL coverage to to 42.4% in Q3’2018 from 36.8% in Q3’2017. The deteriorating asset quality, coupled with the tough operating environment occasioned by the interest rate cap, has continued to hamper the bank’s lending activities, leading to a decline in its interest income, as well as the associated fees and commission income.

b) The bank recorded declines in all of its revenue lines. This has resulted in the Bank issuing a profit warning for FY’2018 which the management has attributed to the downward revisions of the Central Bank Rate (CBR) that have led to reductions in lending rates during the year, hence negatively impacting the bank’s net interest income. The Business performance of the Bank has also been adversely affected by increased non-performing loans due to the unfavorable trading environment that has led to a slowdown in the real estate sector.

c) The bank deteriorated on its operational efficiency as the Cost to income ratio increased to 113.5%, from 91.8% in Q3’2017. Without LLP, the cost to income ratio also deteriorated to 98.6%, from 74.9% in Q3’2017. This was largely driven by a 15.7% rise in staff costs to Kshs 932.5 mn from Kshs 806.3 mn in Q3’2017 which the management attributed to a redundancy exercise taken which increased the staff cost due to a one-off payout. Going forward we expect the expenses to decline, with the continued implementation of the Bank’s digital banking strategy.

Given the poor performance, HF Group could improve in the future by:

a) NFI growth expansion: HF Group’s NFI is below the industry average, coming in at 30.0%. vs industry average of 34.5%. The growth in NFI could be driven by increased adoption of alternative channels. The bank is currently focusing on deepening its digital banking proposition having launched their digital banking platform in July, dubbed HF Whizz, which will enable customers to open an account, access loans, and deposit and transfer cash on mobile phones in a bid to grow non – funded income streams. This will improve operational efficiency as well as increase the bank’s transactional income,

b) Continued investment in digital channels to enhance accessibility as well as reduce operating expenses mainly through aligning staff costs to the bank’s operational needs: On this end, the Bank undertook a redundancy exercise during the year in a cost-cutting drive, which saw the merging of some staff positions. This is expected to improve efficiencies in subsequent periods by providing clarity on operational accountabilities and curb the high operational costs. The exercise saw an increase the staff cost due to the one-off payout. The move will, thereby improve operational efficiency,

c) Fundamentally, we still think HF Group as a conventional bank has a long stretch given inability to mobilize deposits. Ultimately, it seems that the end game will be coupling up with a strong bank with a sizeable asset base, and a strong deposit gathering capability, thereby complementing HF’s strength in mortgages and real estate development.

Below is a summary of the bank’s performance:

Balance Sheet Items	Q3'2017	Q3'2018	y/y change	Q3'2018e	Projected y/y change	Variance in Growth Actual vs. Expected
Government Securities	0.7	3.9	429.5%	2.4	233.1%	196.4%
Net loans	51.2	45.4	(11.3%)	46.2	(9.8%)	(1.5%)
Total Assets	**70.8**	**63.4**	**(10.5%)**	**63.3**	**(10.6%)**	**0.1%**
Customer Deposits	33.6	34.7	3.1%	34.8	3.4%	(0.3%)
Total Liabilities	59.5	52.6	(11.6%)	52.3	(12.0%)	0.4%
Shareholder's Funds	**11.3**	**10.8**	**(4.3%)**	**11.0**	**(2.8%)**	**(1.5%)**

Balance Sheet Ratios	Q3'2017	Q3'2018	y/y change
Loan to deposit ratio	152.3%	131.1%	(21.2%)
Return on Average Equity	2.0%	-3.3%	(5.3%)
Return on Average Assets	0.3%	-0.5%	(0.9%)

Income Statement	Q3'2017	Q3'2018	y/y change	Q3'2018e	Projected y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	2.2	1.8	(17.8%)	1.9	(13.5%)	(4.3%)
Net non-Interest Income	0.6	0.6	(7.2%)	0.6	(6.5%)	(0.7%)
Total Operating income	**2.8**	**2.4**	**(15.4%)**	**2.5**	**(11.9%)**	**(3.5%)**
Loan Loss provision	(0.5)	(0.4)	(25.4%)	(0.4)	(20.0%)	(5.5%)
Total Operating expenses	(2.6)	(2.7)	4.6%	(2.7)	4.5%	0.2%
Profit before tax	0.2	(0.3)		(0.2)		
Profit after tax	**0.2**	**(0.3)**		**(0.1)**		
Core EPS	**0.5**	**(0.9)**		**(0.4)**		

Income Statement Ratios	Q3'2017	Q3'2018	y/y change

Yield from interest-earning assets	12.4%	11.8%	(0.6%)
Cost of funding	7.4%	7.0%	(0.4%)
Net Interest Spread	5.1%	4.8%	(0.3%)
Net Interest Margin	5.1%	4.6%	(0.5%)
Cost of Risk	16.9%	14.9%	(2.0%)
Net Interest Income as % of operating income	77.2%	75.0%	(2.2%)
Non-Funded Income as a % of operating income	22.8%	25.0%	2.2%
Cost to Income Ratio	91.8%	113.5%	21.7%

Capital Adequacy Ratios	Q3'2017	Q3'2018
Core Capital/Total Liabilities	27.0%	21.4%
Minimum Statutory ratio	8.0%	8.0%
Excess	**19.0%**	**13.4%**
Core Capital/Total Risk Weighted Assets	15.5%	14.1%
Minimum Statutory ratio	10.5%	10.5%
Excess	**5.0%**	**3.6%**
Total Capital/Total Risk Weighted Assets	16.9%	15.5%
Minimum Statutory ratio	14.5%	14.5%
Excess	**2.4%**	**1.0%**
Liquidity Ratio	26.0%	22.9%
Minimum Statutory ratio	20.0%	20.0%
Excess	**6.0%**	**2.9%**
Adjusted core capital/ total deposit liabilities		22.4%
Adjusted core capital/ total risk weighted assets		14.7%
Adjusted total capital/ total risk weighted assets		16.2%

**Adjusted ratios in line with CBK's guidance note, with provisions added back for capital computation purposes*