HF Group Earnings Note – FY'2019
3rd April, 2020

Valuation Summary

- We are of the view that HF Group is a "***lighten***" with a target price of Kshs 4.2, representing an upside of 0.0%, from the current price of Kshs 4.2 as of 3rd April 2020,
- HF Group is currently trading at a P/TBV of 0.2x vs an industry average of 1.0x, with a P/E ratio of 2.6x compared to an industry average of 5.3x.

Key Highlights

- Housing Finance (HF) put on sale customer houses worth an estimated Kshs 2.0 bn, pointing to widespread distress in the real estate sector. The lender has signed up auctioneers to sell off the houses and commercial buildings, in a move aimed at trimming its non-performing loans portfolio, and,
- The Group also retired its Kshs 3.0 bn corporate bond in the fourth quarter of 2019 and highlighted their intentions of staying clear of the corporate bond market.

Income Statement

- HF Group released their FY'2019 financial results, recording a loss per share of Kshs 0.3 in FY'2019, an improvement from a loss per share of Kshs 1.6 recorded in FY'2018, not in-line with our expectations of a Kshs 0.3 earnings per share. This variance can be attributed to decline Net interest income where we expected a positive growth for the year. The performance of the group can be attributed to a faster 17.1% decline in total operating expenses, that out-paced the 6.0% decline in total operating income,
- Total Operating Income declined by 6.0% to Kshs 3.3 bn in FY'2019 from Kshs 3.6 bn, this can be attributed to the 13.2% decline in Net Interest Income (NII) to Kshs 2.0 bn from Kshs 2.3 bn recorded in FY'2018, coupled with the 6.4% increase in Non-funded Income (NFI) to Kshs 1.4 bn from Kshs 1.3 bn seen in 2018,
- Interest income declined by 15.4% to Kshs 5.1 bn, from Kshs 6.0 bn in FY'2018. This was driven by a 17.4% decline in interest income from loans and advances to Kshs 4.7 bn, from Kshs 5.7 bn in FY'2018. Interest income on government securities, however, recorded a 23.8% increase to Kshs 419.4 mn, from Kshs 338.8 mn in FY'2018. The yield on interest-earning assets declined to 11.0%, from 11.7% in FY'2018, due to the faster 15.4% decline in interest income compared to the 9.8% decline in the average interest-earning assets (IEA). Net Interest Margin (NIM) declined to 4.2%, from 4.4% in FY'2018, following the 13.2% decline in NII, that outpaced the 9.8% decline in IEA,
- Interest expense declined by 16.7% to Kshs 3.1 bn, from Kshs 3.8 bn in FY'2018, following a 17.7% decline in interest on Customer deposits to Kshs 1.8 bn, from Kshs 2.2 bn in FY'2018. Cost of funds declined to 6.8% from the 7.4% recorded in FY'2018, following the faster 16.7% decline in interest expense compared to the 8.9% decline in the average interest-bearing liabilities (IBL),
- Non-Funded Income rose by 6.4% to Kshs 1.4 bn, from Kshs 1.3 bn in FY'2018. The increase was mainly due to a 191.7% increase in Fees & Commissions to Kshs 183.6 mn, from Kshs 63.0 mn, coupled with a 49.5% increase in Other Fees to Kshs 226.9 mn from Kshs 151.8 mn, and a further 31.4% increase in Forex Trading Income from Kshs 38.2 mn in FY'2018 to Kshs 50.2 mn in FY'2019. The revenue mix shifted to 58:42 funded to non-funded income, from 63:37, owing to the decline in NII coupled with the growth in NFI,
- Total Operating Expenses declined by 17.1% to Kshs 3.5 bn from Kshs 4.2 bn seen in FY'2018. This is attributable to a 20.9% drop in Other Expenses to Kshs 2.0 bn from Kshs 2.6 bn in 2018, coupled with a 12.1% decline in Staff Costs from Kshs 1.2 bn to Kshs 1.1 bn in FY'2019, and a 6.8% decline in Loan Loss Provisions to Kshs 350.4 mn from Kshs 375.9 mn recorded in 2018,

- The Cost to Income Ratio (CIR) improved to 104.2%, from 118.2% in FY’2018. Without LLP, the cost to income ratio improved, to 93.8% from 107.7% in FY’2018, an indication of improved efficiency and,
- HF Group recorded a loss before tax of Kshs 137.8 mn a decline from a loss before tax of Kshs 642.7 mn in FY’2018. The Group’s Loss after Tax declined to Kshs 110.1 mn in FY’2019, from the Kshs 598.2 mn loss recorded in FY’2018,
- The board of directors do not recommended the payment of a dividend.

Balance Sheet

- The company’s balance sheet recorded a contraction as total assets declined by 6.8% from Kshs 60.5 bn to Kshs 56.5 bn in FY’2019.This is attributable to an 11.3% decline in the loan book to Kshs 38.6 bn from Kshs 43.4 bn recorded in FY’2018, coupled with a 54.0% decline in Placements to Kshs 0.9 bn from Kshs 2.0 bn recorded in FY’2018,
- Government securities increased by 43.3% to Kshs 4.6 bn from the Kshs 3.2 bn recorded in 2018,
- Total liabilities declined by 7.9% to Kshs 46.2 bn, from Kshs 50.2 bn in FY’2018, driven by a 56.9% decline in borrowings to Kshs 5.8 bn, from Kshs 13.5 bn in FY’2018. This drop can be attributed to the corporate bond that was retired during the last quarter of 2019. Customer deposits on the other hand increased by 7.7% to Kshs 37.4 bn from Kshs 34.7 bn in FY’2018. Deposits per branch increased marginally from Kshs 1.6 bn to Kshs 1.7 bn in FY’2019,
- The faster 11.3% decline in loans, which was higher than the 7.7% increase in deposits led to a decline in the loan to deposit ratio to 103.1% from 125.1% in FY’2018,
- The bank’s Non-performing Loans (NPLs) declined by 7.6% to Kshs 12.3 bn from Kshs 13.3 bn recorded in 2018. Consequently, the NPL ratio improved marginally to 27.7% from the 27.8% following the faster 7.6% decline in NPLs that outpaced the 7.5% decline in gross loans that came in at Kshs 44.4 bn in FY’2019 from Kshs 48.0 bn recorded in 2018,
- Shareholders’ funds declined by 1.5% to Kshs 10.2 bn in FY’2019, from Kshs 10.4 bn in FY’2018, this is attributable to a 77.0% decline in Retained earnings to Kshs 0.3 bn in FY’2019 from Kshs 1.3 bn. This effect was however mitigated by a 41.5% increase in statutory loan loss reserves to Kshs 2.7 bn from Kshs 1.9 bn recorded in FY’2018,
- HF Group remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 13.3%, 2.8% points above the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio came in at 14.6%, exceeding the statutory requirement by 0.1% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 13.2%, while total capital to risk-weighted assets came in at 14.5% indicating that the bank’s total capital relative to its risk-weighted assets decreased by 0.1% due to the impact of IFRS 9, and,
- The bank currently has a Return on Average Assets (ROaA) of (0.2%), and a Return on Average Equity (ROaE) of (1.1%).

Key Take-Outs:

1. The balance sheet contracted by 6.8% to Kshs 56.5 bn, from Kshs 60.5 bn in FY’2018. The contraction was mainly driven by an 11.3% decline in the loan book to Kshs 38.6 bn from Kshs 43.4 bn in FY’2018, coupled with a 54.0% decline in Placements to Kshs 0.9 bn from Kshs 2.0 bn recorded in FY’2018. The bank faces issues of asset-liability mismatch - with a high cost of funds and declining average interest-earning assets, and,

2. The bank experienced an improvement in asset quality as Non-performing Loans (NPLs) decreased by 7.6% to Kshs 12.3 bn from Kshs 13.3 bn recorded in 2018. Consequently, the NPL ratio improved marginally to 27.7% from the 27.8% following the faster 7.6% decline in NPLs that outpaced the 7.5% decline in gross loans that came in at Kshs 44.4 bn in FY'2019 from Kshs 48.0 bn recorded in 2018. Putting into consideration the current state of affairs regarding the COVID-19 pandemic, there is a lot more to be done to mitigate the effects experienced in the economy.

Going forward, the factors that would drive the bank's growth would be:

1. We maintain our view that HF Group as a conventional bank has a long way to go. They will ultimately have to adjust their business model, or couple up with a strong bank with a sizeable asset base, and a strong deposit gathering capability, in an effort to capitalize on HF's strength in mortgages and real estate development.

Below is a summary of the bank's performance:

Balance Sheet Items	FY'2018	FY'2019	y/y change	FY'2019f	Projected y/y change	Variance in Growth Actual vs. Expected
Net loans	43.4	38.6	(11.3%)	43.0	(0.9%)	(10.3%)
Total Assets	**60.5**	**56.5**	**(6.8%)**	**58.3**	**(3.7%)**	**(3.0%)**
Customer Deposits	34.7	37.4	7.7%	35.3	1.7%	6.0%
Total Liabilities	50.2	46.2	(7.9%)	47.7	(5.0%)	(2.9%)
Shareholder's Funds	**10.4**	**10.2**	**(1.5%)**	**10.5**	**1.6%**	**(3.1%)**

Balance Sheet Ratios	FY'2018	FY'2019	y/y change
Loan to deposit ratio	125.1%	103.1%	(22.0%)
Return on Average Equity	(5.5%)	(1.1%)	4.5%
Return on Average Assets	(0.9%)	(0.2%)	0.7%

Income Statement	FY'2018	FY'2019	y/y change	FY'2019f	Projected y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	2.3	2.0	(13.2%)	3.5	54.8%	(68.0%)
Net non-Interest Income	1.3	1.4	6.4%	1.4	9.9%	(3.5%)
Total Operating income	**3.6**	**3.4**	**(6.0%)**	**5.0**	**38.3%**	**(44.2%)**
Loan Loss provision	(0.4)	(0.4)	(6.8%)	(0.6)	61.0%	(67.8%)
Total Operating expenses	(4.2)	(3.5)	(17.1%)	(4.8)	13.7%	(30.9%)
Profit before tax	(0.6)	(0.1)	(78.6%)	0.1		
Profit after tax	**(0.6)**	**(0.1)**	**(81.6%)**	**0.1**		
Core EPS	**(1.6)**	**(0.3)**	**(81.6%)**	**0.3**		

Income Statement Ratios	FY'2018	FY'2019	y/y change
Yield from interest-earning assets	11.7%	11.0%	(0.7%)
Cost of funding	7.4%	6.8%	(0.6%)
Net Interest Spread	4.3%	4.2%	(0.1%)
Net Interest Margin	4.4%	4.2%	(0.2%)
Cost of Risk	10.5%	10.4%	(0.1%)
Net Interest Income as % of operating income	63.2%	58.4%	(4.8%)
Non-Funded Income as a % of operating income	36.8%	41.6%	4.8%
Cost to Income Ratio	118.2%	104.2%	(14.0%)

Capital Adequacy Ratios	FY'2018	FY'2019
Core Capital/Total Liabilities	20.9%	15.9%
Minimum Statutory ratio	8.0%	8.0%
Excess	**12.9%**	**7.9%**
Core Capital/Total Risk Weighted Assets	14.1%	13.3%
Minimum Statutory ratio	10.5%	10.5%
Excess	**3.6%**	**2.8%**
Total Capital/Total Risk Weighted Assets	15.4%	14.6%
Minimum Statutory ratio	14.5%	14.5%
Excess	**0.9%**	**0.1%**
Liquidity Ratio	20.9%	20.8%
Minimum Statutory ratio	20.0%	20.0%
Excess	**0.9%**	**0.8%**
Adjusted core capital/ total deposit liabilities	20.1%	15.5%
Adjusted core capital/ total risk weighted assets	14.5%	13.2%
Adjusted total capital/ total risk weighted assets	15.9%	14.5%