HF Group Earnings Note – FY’2020

1st April 2021,

Below is a summary of the bank’s performance:

Balance Sheet Items	FY’2019	FY’2020	y/y change
Net loans	38.6	37.0	(4.0%)
Total Assets	**56.5**	**55.4**	**(1.8%)**
Customer Deposits	37.4	39.9	6.8%
Total Liabilities	46.2	46.9	1.5%
Shareholder's Funds	**10.2**	**8.6**	**(16.2%)**

Balance Sheet Ratios	FY'2019	FY'2020	% point change
Loan to deposit ratio	103.1%	92.6%	(10.5%)
Return on Average Equity	(1.1%)	(23.3%)	(22.2%)
Return on Average Assets	(0.2%)	(3.9%)	(3.7%)

Income Statement	FY’2019	FY’2020	y/y change
Net Interest Income	2.0	1.9	(5.2%)
Net non-Interest Income	1.4	0.5	(63.0%)
Total Operating income	**3.4**	**2.4**	**(29.2%)**
Loan Loss provision	(0.4)	(0.4)	15.6%
Total Operating expenses	(3.5)	(4.1)	15.6%
Profit before tax	(0.1)	(1.8)	1183.6%
Profit after tax	**(0.1)**	**(1.7)**	**1443.7%**
Core EPS	**(0.3)**	**(4.4)**	**1443.7%**

Income Statement Ratios	FY’2019	FY’2020	% point change
Yield from interest-earning assets	11.2%	11.7%	(0.5%)
Cost of funding	6.8%	6.8%	0.0%
Net Interest Spread	4.4%	4.8%	(0.4%)
Net Interest Margin	4.3%	4.9%	(0.1%)
Cost of Risk	10.4%	17.0%	6.6%
Net Interest Income as % of operating income	58.4%	78.2%	19.8%
Non-Funded Income as a % of operating income	41.6%	21.8%	(19.8%)
Cost to Income Ratio	104.2%	170.1%	66.0%

Capital Adequacy Ratios	FY’2019	FY’2020
Core Capital/Total Liabilities	15.9%	7.2%
Minimum Statutory ratio	8.0%	8.0%
Excess	**7.9%**	**(0.8%)**
Core Capital/Total Risk Weighted Assets	13.3%	6.3%
Minimum Statutory ratio	10.5%	10.5%

Excess	**2.8%**	**(4.2%)**
Total Capital/Total Risk Weighted Assets	14.6%	7.5%
Minimum Statutory ratio	14.5%	14.5%
Excess	**0.1%**	**(7.0%)**
Liquidity Ratio	20.8%	20.9%
Minimum Statutory ratio	20.0%	20.0%
Excess	**0.8%**	**0.9%**
Adjusted core capital/ total deposit liabilities	15.5%	8.9%
Adjusted core capital/ total risk weighted assets	13.2%	7.9%
Adjusted total capital/ total risk weighted assets	14.5%	9.2%

Key Highlights

- The Kenya Mortgage Refinance Company (KMRC) – a government initiative to support long-term lending towards mortgages for affordable housing, got an approval to operate from the Central Bank of Kenya in September 2020. Housing Finance (HF) being a member of KMRC will benefit through its main line of business, which is mortgage lending.
- Britam Holdings the majority shareholder at 48.8%, recently revealed that they are in talks with a major bank for the purchase of some of the shares it owns. The reduction in shareholding comes at a time when Britam is undergoing massive restructuring especially at the top management level.

Income Statement

- HF Group recorded a loss per share of Kshs 4.4 in FY'2020, higher than the loss per share of Kshs 0.3 recorded in FY'2019, which was not in-line with our expectations of a Kshs 1.3 loss per share. This variance can be attributed to a higher 63.0% decline in Non-Funded Income to Kshs 0.5 bn from Kshs 1.4 bn in FY'2019. The performance of the group can be attributed to a 29.2% decline in total operating income to Kshs 2.4 bn from Kshs 3.4 bn in FY'2019, coupled with a 15.6% increase in total operating expenses to Kshs 4.1 bn from Kshs 3.5 bn in FY'2019,
- Total Operating Income declined by 29.2% to Kshs 2.4 bn in FY'2020, from Kshs 3.0 bn in FY'2019, attributable to the 63.0% decline in Non-Funded Income (NFI) to Kshs 0.5 bn, from Kshs 1.4 bn recorded in FY'2019, coupled with the 5.2% dip in Net Interest Income (NII) to Kshs 1.9 bn, from Kshs 2.0 bn recorded in FY'2019,
- Interest income declined by 17.4% to Kshs 4.3 bn, from Kshs 5.2 bn in FY'2019. This was driven by a 22.4% decline in interest income from loans and advances to Kshs 3.7 bn, from Kshs 4.7 bn in FY'2019. Interest income on government securities, however, recorded a 32.4% rise to Kshs 555.2 mn, from Kshs 419.4 mn in FY'2019. The Yield on Interest-Earning Assets increased to 11.7%, from 11.2% in FY'2019, due to a 1.5% increase in trailing interest income compared to the 2.0% decline in the average interest-earning assets (IEA). Trailing Interest Income refers to the performance of the interest income for the past 12 consecutive months,
- Interest expense declined by 23.8% to Kshs 2.4 bn, from Kshs 3.1 bn in FY'2019, driven by a 59.5% decline in other interest expenses to Kshs 0.4 bn, from Kshs 1.3 bn in FY'2019 coupled with a 55.5% increase in Deposits and placements from other banks to Kshs 154.2 mn, from Kshs 99.2 mn recorded in FY'2019. Notably, Interest expenses on customer deposits remained unchanged at Kshs 1.8 bn as was recorded in FY'2019. Cost of funds remained flat at 6.8% as recorded in FY'2019. Net Interest Margin (NIM) increased

to 4.2%, from 4.3% in FY’2019, due to a 10.0% increase in trailing Net Interest Income (NII), compared to a 2.0% decline in the average interest-earning assets,

- Non-Funded Income fell by 63.0% to Kshs 0.5 bn, from Kshs 1.4 bn in FY’2019. The decline was mainly due to an 81.7% decline in other income to Kshs 172.8 mn, from Kshs 942.6 mn, a 59.4% decline in Fees and commissions to Kshs 54.1 mn, from Kshs 133.0 mn and an 11.7% decline in other fees and commissions to Kshs 200.3 mn, from Kshs 226.9 mn in FY’2019. The decline in NFI was mitigated by the 93.3% increase in Forex trading income increased to Kshs 85.3 mn in FY’2020, from Kshs 50.1 mn in FY’2019. The total fees and commissions declined by 38.0% to Kshs 254.4 bn from Kshs 410.5 bn in FY’2019. Consequently, the revenue mix shifted to 78:22 funded to non-funded income, from 58:42, owing to the faster 63.0% decline in Non Funded Income compared to 5.2% decline in the Net Interest Income,
- Total Operating Expenses increased by 15.6% to Kshs 4.1 bn, from Kshs 3.5 bn seen in FY’2019. This is mainly attributable to a 15.6% increase in Loan Loss Provisions to Kshs 450.1 mn, from Kshs 350.4 mn recorded in FY’2019, coupled a 13.8% increase in staff costs to Kshs 1.2 bn, from Kshs 1.1 bn recorded in FY’2019. Notably the provisioning was sufficient as the Gross Non performing loans declined by 12.3% to Kshs 10.8 bn from Kshs 12.3 bn in FY’2020,
- The Cost to Income Ratio (CIR) deteriorated to 170.1%, from 104.2% in FY’2019 attributable to a 15.6% increase in the Total Expenses as compared to a 29.2% decline in the Total Operating Income. Without LLP, the cost to income ratio deteriorates as well to 153.1% from 93.8% in FY’2019, an indication of reduced efficiency, and,
- HF Group recorded a loss before tax of Kshs 1.8 bn, an increase from a loss before tax of Kshs 0.1 bn in FY’2019. The Group’s Loss after Tax increased to Kshs 1.7 mn in FY’2020, from the Kshs 0.1 bn loss recorded in FY’2019.

Balance Sheet

- The company’s balance sheet recorded a contraction as total assets declined by 1.8% to Kshs 55.4 bn, from Kshs 56.4 bn in FY’2019. This is attributable to a 4.0% decline in the loan book to Kshs 37.0 bn, from Kshs 38.6 bn recorded in FY’2019. This contraction in the loan book was however mitigated by a 54.4% rise in government securities to Kshs 7.1 bn, from the Kshs 4.6 bn recorded in FY’2019 and a 3.1% increase in placements to Kshs 968.7 mn, from Kshs 939.5 mn in FY’2019,
- Total liabilities increased by 1.5% to Kshs 46.8 bn in FY’2020, from Kshs 46.2 bn in FY’2019xx, driven by a 36.6% decline in borrowings to Kshs 3.9 bn, from Kshs 5.8 bn in FY’2019. This drop can be attributed to the Kshs 3.0 bn corporate bond that was retired during the last quarter of 2019. There was however a recorded 6.8% rise in Customer deposits to Kshs 39.9 bn, from Kshs 37.4 bn in FY’2019. Deposits per branch increased by 6.8% to Kshs 1.8 bn, from Kshs 1.7 bn in FY’2019, with the number of branches remaining unchanged at 22,
- The 4.0% decline in loans, coupled with the 6.8% increase in deposits led to a decline in the loan to deposit ratio to 92.6%, from 103.1% in FY’2019,
- Gross non-performing loans (NPLs) declined by 12.3% to Kshs 10.8 bn, from Kshs 12.3 bn recorded in FY’2019. Consequently, the NPL ratio improved to 25.2% from the 27.7% recorded in FY’2019, following the faster 12.3% decline in NPLs that outpaced the 1.3% decline in gross loans which came in at Kshs 43.9 bn in FY’2020, from Kshs 44.4 bn recorded in FY’2019. General loan loss provisions increased by 34.2% to Kshs 3.6 bn in FY’2020, from Kshs 2.7 bn in FY’2019. NPL coverage improved to 58.2% in FY’2020, from 47.8% owing to the faster 34.2% increase in general loan loss provisions which outpaced the 12.3% decline in gross NPLs,

- Shareholders' funds declined by 16.2% to Kshs 8.6 bn in FY'2020, from Kshs 10.2 bn in FY'2019, attributable to the accumulated loss of Kshs 1.2 bn seen in FY'2020, compared to the retained earnings of Kshs 0.3 bn, recorded in FY'2019,
- HF Group remains undercapitalized with a core capital to risk-weighted assets ratio of 6.3%, 4.2% points below the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio came in at 7.5%, below the statutory requirement by 7.0% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 7.9%, while total capital to risk-weighted assets came in at 9.2%, and,
- The bank currently has a Return on Average Assets (ROaA) of (3.9%), and a Return on Average Equity (ROaE) of (23.3%).

Key Take-Outs:

1. The bank experienced an improvement in asset quality as the NPL ratio improved by 3.1% points to 24.6% from the 27.7%, following the faster 12.3% decline in NPLs that outpaced the 1.3% decline in gross loans which came in at Kshs 43.9 bn in FY'2020, from Kshs 44.4 bn recorded in FY'2019. Key to Note, NPL coverage improved as well by 15.6% points to 63.4% from 47.8% recorded in 2019. Given that the NPL Ratio in H1'2020 was 26.7% the FY'2020 Ratio of 24.6% is a commendable improvement. However, putting into consideration the current state of affairs regarding the COVID-19 pandemic, there is a lot more the management can do to ensure that the NPLs are within or below the industry levels of 14.5% as at February 2021, and,
2. The bank recorded a contraction in its balance sheet as total assets declined by 1.8% to Kshs 55.4 bn, from Kshs 56.4 bn in FY'2019. This is attributable to a 4.0% decline in the loan book to Kshs 37.0 bn, from Kshs 38.6 bn recorded in FY'2019. This contraction in the loan book was however mitigated by a 54.4% rise in government securities to Kshs 7.1 bn, from the Kshs 4.6 bn recorded in FY'2019 and a 3.1% increase in placements to Kshs 968.7 mn, from Kshs 939.5 mn in FY'2019.

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

- We maintain our view that HF Group as a conventional bank has a long way to go, even with the injection of tier II capital of Kshs 1.0 bn, by the majority shareholder Britam Holdings in Q1'2021. 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, to capitalize on HF's strength in mortgages and real estate development.

Valuation Summary

- We are of the view that HF Group is a "***SELL***" with a target price of Kshs 1.8, representing a downside of 51.5%, from the current price of Kshs 3.8 as of 1st April 2021,
- HF Group is currently trading at a P/TBV of 0.2x vs an industry average of 0.2x, with a P/E ratio of 10.1x compared to an industry average of 7.1x.