

Below is a summary of the HF Group's FY'2021 performance:

| Balance Sheet Items | FY'2020 | FY'2021f | y/y change |
|----------------------------|-------------|-------------|---------------|
| Net loans | 37.0 | 34.7 | (6.2%) |
| Total Assets | 55.4 | 52.9 | (4.6%) |
| Customer Deposits | 39.9 | 37.7 | (5.6%) |
| Total Liabilities | 46.9 | 44.9 | (4.2%) |
| Shareholder's Funds | 8.6 | 8.0 | (6.9%) |

| Balance Sheet Ratios | FY'2020 | FY'2021f | y/y change |
|--------------------------|---------|----------|------------|
| Loan to deposit ratio | 92.6% | 92.0% | (0.6%) |
| Return on Average Equity | (18.1%) | (7.2%) | 10.9% |
| Return on Average Assets | (3.0%) | (1.1%) | 1.9% |

| Income Statement | FY'2020 | FY'2021f | y/y change |
|-------------------------------|--------------|--------------|----------------|
| Net Interest Income | 1.9 | 1.8 | (2.1%) |
| Net non-Interest Income | 0.5 | 0.5 | 3.6% |
| Total Operating income | 2.4 | 2.4 | (0.8%) |
| Loan Loss provision | (0.4) | (0.3) | (30.7%) |
| Total Operating expenses | (4.06) | (3.23) | (20.5%) |
| Profit before tax | (1.8) | (0.9) | (50.5%) |
| Profit after tax | (1.7) | (0.6) | (65.1%) |
| Core EPS | (4.4) | (1.5) | (65.1%) |

| Income Statement Ratios | FY'2020 | FY'2021f | y/y change |
|--|---------|----------|------------|
| Yield from interest-earning assets | 9.6% | 9.1% | (0.5%) |
| Cost of funding | 5.4% | 4.6% | (0.8%) |
| Net Interest Spread | 4.1% | 4.5% | 0.3% |
| Net Interest Margin | 4.2% | 4.2% | 0.0% |
| Cost of Risk | 17.0% | 11.9% | (5.1%) |
| Net Interest Income as % of operating income | 78.2% | 77.3% | (1.0%) |
| Non-Funded Income as a % of operating income | 21.8% | 22.7% | 1.0% |
| Cost to Income Ratio | 170.1% | 136.3% | (33.8%) |

| Capital Adequacy Ratios | FY'2020 | FY'2021 |
|--|---------------|---------------|
| Core Capital/Total Liabilities | 8.8% | 8.3% |
| Minimum Statutory ratio | 8.0% | 8.0% |
| Excess | 0.8% | 0.3% |
| Core Capital/Total Risk Weighted Assets | 7.8% | 8.3% |
| Minimum Statutory ratio | 10.5% | 10.5% |
| Excess | (2.7%) | (2.3%) |
| Total Capital/Total Risk Weighted Assets | 9.1% | 12.1% |
| Minimum Statutory ratio | 14.5% | 14.5% |
| Excess | (5.4%) | (2.4%) |
| Liquidity Ratio | 20.9% | 22.9% |
| Minimum Statutory ratio | 20.0% | 20.0% |
| Excess | 0.9% | 2.9% |
| Adjusted core capital/ total deposit liabilities | 8.9% | 8.4% |
| Adjusted core capital/ total risk weighted assets | 7.9% | 8.4% |
| Adjusted total capital/ total risk weighted assets | 9.2% | 12.3% |

Income Statement

- HF Group recorded a loss per share of Kshs 1.5 in FY'2021, lower than the loss per share of Kshs 4.4 recorded in FY'2020, not in-line with our expectations of a Kshs 2.0 loss per share. The performance of the group can be attributed to a 20.5% decline in total operating expenses to Kshs 3.2 bn, from Kshs 4.1 bn in FY'2020, coupled with a slight 0.8% decline in total operating income to Kshs 2.37 bn, from Kshs 2.38 bn in FY'2020,
- Total Operating Income slightly declined by 0.8% to Kshs 2.37 bn, from Kshs 2.38 bn in FY'2020, attributable to the 2.1% decrease in Net Interest Income (NII) to Kshs 1.8 bn, from Kshs 1.9 bn recorded in FY'2020. The decline was however mitigated by a 3.6% increase in Non-Funded Income (NFI) to Kshs 0.54 bn, from Kshs 0.52 bn recorded in FY'2020,
- Interest income declined by 8.0% to Kshs 3.9 bn, from Kshs 4.3 bn in FY'2020 driven by a 11.8% decline in interest income from loans and advances to Kshs 3.2 bn, from Kshs 3.7 bn in FY'2020, coupled with a 47.4% decline by interest income from placements with other banks to Kshs 21.8 mn from Kshs 41.4 mn in FY'2020. The decline was however mitigated by a 19.5% increase in interest income on government securities to Kshs 0.7 bn, from Kshs 0.6 bn in FY'2020. The Yield on Interest-Earning Assets decreased to 9.1%, from 9.6% in FY'2020, due to faster 8.0% decrease in trailing interest income compared to the 2.8% 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 12.7% to Kshs 2.1 bn, from Kshs 2.4 bn in FY'2020, attributable to the bank's ability to mobilise cheaper deposits with interest expense from customer deposits declining by 15.3% to Kshs 1.5 bn, from Kshs 1.8 bn in FY'2020 coupled with a 9.5% decline in other interest expenses to Kshs 0.40 bn, from Kshs 0.44 bn recorded in FY'2020. Cost of funds declined to 4.8%, from 5.4% as recorded in FY'2020 attributable to the faster 12.7% decline in interest expense, as compared to the 1.2% decline in average interest bearing liabilities. Net Interest Margin (NIM) remained unchanged at 4.2%, as was recorded in FY'2020,
- Non-Funded Income increased by 3.6% to Kshs 0.54 bn, from Kshs 0.52 bn in FY'2020 attributable to a 141.2% increase in fees and commissions from loans to Kshs 130.4 mn, from Kshs 54.1 mn, coupled with a 5.0% increase in other income to Kshs 181.4 mn, from Kshs 172.8 mn in FY'2020. This increase was weighed down by a 43.3% decline in Foreign exchange trading income to Kshs 48.4 mn in FY'2021, from Kshs 85.3 bn in FY'2020. Total fees and commissions increased by 21.2% to Kshs 308.3 mn, from Kshs 254.4 mn in FY'2020 attributable to expiry of the waiver on mobile banking fees. Consequently, the revenue mix shifted to 77:23 from 78:22 in FY'2020, funded to non-funded income, owing to the 3.6% increase in Non-Funded Income coupled with the 2.1% decline in the net Interest Income,
- Total Operating Expenses declined by 20.5% to Kshs 3.2 bn in FY'2021, from Kshs 4.1 bn in FY'2020, partly attributable to a 30.7% decline in Loans Loss Provisions (LLPs) to Kshs 0.3 bn in FY'2021, from Kshs 0.4 bn recorded in FY'2020, attributable to the reduced credit risk on the back of increased business activity in 2021 following the gradual economic recovery in Kenya. Other operating expenses declined by 27.3% to Kshs 1.8 bn in FY'2021, from Kshs 2.4 bn in FY'2020, while staff costs declined by 3.6% to Kshs 1.18 bn in FY'2021, from Kshs 1.22 bn in FY'2020,
- As a result, Cost to Income Ratio (CIR) improved to 136.3%, from 170.1% in FY'2020, attributable to the 20.5% decline in total operating expenses to Kshs 3.2 bn in FY'2021, from Kshs 4.1 bn recorded in FY'2020. Without LLP, the cost to income ratio also improved to 124.5%, from 153.1% in FY'2020, an indication of increased efficiency, and,

- HF Group recorded a loss before tax of Kshs 0.9 bn, a 50.5% decline from a loss before tax of Kshs 1.8 bn in FY'2020. Additionally, the Group's Loss after Tax declined by 65.1% to Kshs 0.6 bn in FY'2021, from the Kshs 1.7 bn loss recorded in FY'2020.

Balance Sheet

- The balance sheet recorded a contraction as Total Assets decreased by 4.6% to Kshs 52.9 bn in FY'2021, from Kshs 55.4 bn recorded in FY'2020. This is attributable to a 6.2% decline in the loan book to Kshs 34.7 bn, from Kshs 37.0 bn recorded in FY'2020, coupled with a 7.8% decline in Government securities to Kshs 6.6 bn in FY'2021, from Kshs 7.1 bn in FY'2020. This contraction in the loan book and Government securities were however mitigated by a 3.6% increase in other assets to Kshs 7.3 bn in FY'2021, from Kshs 7.1 bn in FY'2020,
- Total liabilities declined by 4.2% to Kshs 44.9 bn in FY'2021, from Kshs 46.9 bn in FY'2020, driven by a 5.6% decline in customer deposits to Kshs 37.7 bn in FY'2021, from Kshs 39.9 bn in FY'2020. Deposits per branch decreased by 5.6% to Kshs 1.7 bn, from Kshs 1.8 bn in FY'2020, with the number of branches remaining unchanged at 22,
- Loans declined at a faster rate, 6.2%, compared to the 5.6% decrease in deposits leading to a decline in the loan to deposit ratio to 92.0%, from 92.6% in FY'2020,
- Gross non-performing loans (NPLs) declined by 19.7% to Kshs 10.8 bn, from Kshs 8.7 bn recorded in FY'2020. Consequently, the NPL ratio improved to 21.1% from the 24.6% recorded in FY'2020, following the faster 19.7% decline in NPLs that outpaced the 6.3% decline in gross loans which came in at Kshs 41.1 bn in FY'2021, from Kshs 43.8 bn recorded in FY'2020. General loan loss provisions remained relatively unchanged at Kshs 3.6 bn in FY'2021, as was recorded in FY'2020. The NPL coverage thus improved to 73.6% in FY'2021, from 63.4% in FY'2020 owing to the 19.7% increase in gross NPLs coupled with the slight 0.1% increase in general loan loss provisions,
- Shareholders' funds declined by 6.9% to Kshs 8.0 bn in FY'2021 from Kshs 8.6 bn in FY'2020, attributable to the accumulated loss of Kshs 2.7 bn seen in FY'2021, compared to the accumulated loss of Kshs 2.4 bn, recorded in FY'2020, and,
- HF Group remains undercapitalized with a core capital to risk-weighted assets ratio of 8.3%, 2.2% points below the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio came in at 12.1%, below the statutory requirement by 2.4% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 8.4%, while total capital to risk-weighted assets came in at 12.3%.

Key Take-Outs:

1. The bank experienced an improvement in asset quality as the NPL ratio improved by 3.5% points to 21.1%, from the 24.6% recorded in FY'2020, following the faster 19.7% decline in NPLs that outpaced the 6.3% decline in gross loans which came in at Kshs 41.1 bn in FY'2021, from Kshs 43.8 bn recorded in FY'2020. Despite the improved asset quality during the period, HF Group's NPL ratio is still higher than the sectors average of 13.1% as at the end of December 2021, an indication that the group needs to improve its credit assessment in order to bring down this high NPL Ratio,
2. HF Group's total Operating Expenses declined by 20.5% to Kshs 3.2 bn in FY'2021, from Kshs 4.1 bn in FY'2020, mainly attributable to a 30.7% decline in Loans Loss Provisions (LLPs) to Kshs 0.3 bn in FY'2021, from Kshs 0.4 bn recorded in FY'2020, attributable to the reduced credit risk on the back of increased business activity in 2021 following gradual economic recovery, and,
3. Cost to Income Ratio (CIR) improved to 136.3%, from 170.1% in FY'2020, attributable to the 20.5% decline in total operating expenses to Kshs 3.2 bn in FY'2021, from Kshs 4.1 bn recorded in FY'2020.

Without LLP, the cost to income ratio also improved to 124.5%, from 153.1% in FY'2020, an indication of increased efficiency.

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 H1'2021. 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 2.6, representing a downside of 16.7%, from the current price of Kshs 3.2 as of 1st April 2022,
- 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 12.6x as compared to an industry average of 8.1x.