HF Group Earnings Note – H1'2019

30th August, 2019

Valuation Summary

- We are of the view that HF Group is a "***sell***" with a target price of Kshs 2.9, representing a downside of 26.8%, from the current price of Kshs 3.96 as of 30th August 2019,
- HF Group is currently trading at a P/TBV of 0.2x vs an industry average of 1.3x.

Key Highlights FY'2018

- March 2019, HF Group announced a 30.0% discount on 700 houses, giving investors two months to buy the properties located in 11 HF projects (eight completed projects and three nearing completion). All the houses on offer are located in Nairobi.
- Housing Finance (HF) also 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.

Income Statement

- HF Group released their H1'2019 financial results, recording a loss per share of Kshs 0.3 in H1'2019, from a core earnings per share of Kshs 0.02 recorded in H1'2018. The performance was driven by a 0.6% increase in total operating income, which was offset by a 6.2% increase in total operating expenses. The variance in core earnings per share growth was largely due to the 0.6% increase in total operating income and a 6.2% increase in total operating expenses which was not in line with our expectations of a 0.2% and 3.9% increases, respectively,
- Total operating income increased marginally by 0.6% to Kshs 1.94 bn, from Kshs 1.93 bn in H1'2018. This was driven by a 23.5% decline in Net Interest Income (NII) to Kshs 1.0 bn, from Kshs 1.3 bn in H1'2018, which was offset by a 55.8% increase in Non-Funded Income (NFI) to Kshs 914.2 mn from Kshs 586.8 mn in H1'2018,
- Interest income declined by 15.6% to Kshs 2.7 bn, from Kshs 3.2 bn in H1'2018. This was driven by a 17.6% decline in interest income from loans and advances to Kshs 2.5 bn, from Kshs 3.0 bn in H1'2018. Interest income on government securities however recorded a 34.3% rise to Kshs 195.7 mn, from Kshs 145.7 mn in H1'2018. The yield on interest-earning assets declined to 11.3%, from 11.8% in H1'2018, due to the faster 15.6% decline in interest income which more than offset the 12.9% decline in the average interest earning assets. Consequently, the Net Interest Margin (NIM) declined to 4.0%, from 4.9% in H1'2018,
- Interest expense declined by 9.8% to Kshs 1.7 bn, from Kshs 1.9 bn in H1'2018, following a 20.1% decline in interest on customer deposits to Kshs 886.4 mn, from Kshs 1.1 bn in H1'2018, which outweighed the 9.3% rise in other interest expenses to Kshs 740.3 mn, from Kshs 677.4 mn in H1'2018. Despite the decline, cost of funds rose to 7.4% from 7.0% in H1'2018, owing to the faster 13.0% decline in average interest bearing liabilities which outpaced the 9.8% decline in interest expense,
- Non-Funded Income increased by 55.8% to Kshs 914.2 mn, from Kshs 586.8 mn in H1'2018. The increase was mainly due to a 64.5% increase in other income to Kshs 712.2 mn, from Kshs 433.0 mn, coupled with a 49.7% increase in fees and commissions on loans however to Kshs 27.0 mn from Kshs 18.0 mn. The revenue mix shifted to 53:47 funded to non-funded income, from 70:30, owing to the decline in NII coupled with the growth in NFI,
- Total operating expenses increased by 6.2% to Kshs 2.0 bn from Kshs 1.9 bn in H1'2018, largely driven by a 17.1% decline in staff costs to Kshs 498.5 mn from Kshs 601.4 mn in H1'2018 that offset the 61.9% rise in Loan Loss Provisions (LLP) to Kshs 369.5 mn from Kshs 228.1 mn, in H1'2018,

- The Cost to Income Ratio (CIR) deteriorated to 104.9%, from 99.3% in H1’2018. Without LLP, the cost to income ratio however improved, to 85.8% from 87.5% in H1’2018, and,
- HF Group recorded a loss before tax of Kshs 94.3 mn from a profit before tax of Kshs 12.6 mn in H1’2018. HF Group also recorded a loss after tax of Kshs 158.3 mn from a profit after tax of Kshs 37.1 mn in H1’2018.

Balance Sheet

- The balance sheet recorded a contraction as total assets declined by 13.0% to Kshs 57.0 bn, from Kshs 65.5 bn in H1’2018. The contraction was mainly driven by a 14.8% decline in the loan book to Kshs 40.5 bn from Kshs 47.8 bn in H1’2018,
- Government securities however recorded a 5.4% increment to Kshs 4.2 bn, from Kshs 4.0 bn in H1’2018,
- Total liabilities declined by 14.3% to Kshs 46.6 bn, from Kshs 54.4 bn in H1’2018, driven by a 32.0% decline in borrowings to Kshs 10.6 bn, from Kshs 15.6 bn in H1’2018, coupled with a 6.6% decline in customer deposits to Kshs 33.8 bn, from Kshs 36.2 bn in H1’2018. Deposits per branch declined by 6.6% to Kshs 1.5 bn from Kshs 1.6 bn in H1’2018, as deposits declined yet the number of branches remained unchanged at 22,
- The faster decline in loans as compared to deposits led to a decline in the loan to deposit ratio to 119.8% from 131.4% in H1’2018. Loans to loanable funds as well declined to 90.8%, from 91.1% in H1’2018,
- Gross Non-Performing Loans (NPLs) increased by 14.3% to Kshs 10.1 bn in H1’2019 from Kshs 8.9 bn in H1’2018. The NPL ratio thus deteriorated to 22.1%, from 17.4% in H1’2018. General Loan Loss Provisions increased by 29.8% to Kshs 2.5 bn, from Kshs 2.0 bn in H1’2018. Consequently, NPL coverage increased to 53.2%, from 39.0% in H1’2018,
- Shareholders’ funds declined by 6.9% to Kshs 10.3 bn in H1’2019, from Kshs 11.1 bn in H1’2018, due a 76.4% decline in retained earnings to Kshs 769.5 mn, from Kshs 3.3 bn in H1’2018,
- HF Group remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 14.5%, 4.0% points above the statutory requirement. In addition, the total capital to risk-weighted assets ratio came in at 15.8%, exceeding the statutory requirement by 1.3% points. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 14.3%, while total capital to risk-weighted assets came in at 15.6% indicating that the bank’s total capital relative to its risk-weighted assets decreased by 0.2% due to the impact of IFRS 9, and,
- The bank currently has a Return on Average Assets (ROaA) of (1.1%), and a Return on Average Equity (ROaE) of (6.5%).

Key Take-Outs:

1. The bank experienced a deterioration in asset quality, with gross non-performing loans (NPLs) rising by 14.3% to Kshs 10.1 bn in H1’2019, from Kshs 8.9 bn in H1’2018. This warranted increased provisioning by 29.8% % to Kshs 2.5 bn, from Kshs 2.0 bn in H1’2018. 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,
2. Decline in balance sheet - The balance sheet assets declined by 13.0% to Kshs 57.0 bn from Kshs 65.5 bn in H1’2018. The contraction was driven by a 14.8% decline in the loan book to Kshs 40.5 bn from Kshs 47.6 bn in H1’2018. The bank faces issues of asset-liability mismatch - with high cost of funds and low earning long term assets.

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

1. NFI growth expansion: 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,
2. 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 in 2018 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, and,
3. Fundamentally, we maintain our view that HF Group as a conventional bank has a long way to go, given its inability to mobilize deposits. In addition, mortgage penetration in Kenya remains low, and with the capping of interest rates, its ability to issue long term mortgage loans and effectively price for risk has been greatly hampered. The bank will ultimately have to adjust its business model, 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	H1'2018	H1'2019	y/y change	H1'2019e	Projected y/y change	Variance in Growth Actual vs. Expected
Net loans	47.6	40.5	(14.8%)	42.6	(10.6%)	(4.2%)
Total Assets	**65.5**	**57.0**	**(13.0%)**	**58.8**	**(10.3%)**	**(2.7%)**
Customer Deposits	36.2	33.8	(6.6%)	33.7	(6.8%)	0.3%
Total Liabilities	54.4	46.6	(14.3%)	48.6	(10.7%)	(3.6%)
Shareholder's Funds	**11.1**	**10.4**	**(6.9%)**	**10.2**	**(8.2%)**	**1.3%**

Balance Sheet Ratios	H1'2018	H1'2019	y/y change
Loan to deposit ratio	131.4%	119.8%	(11.6%)
Return on Average Equity	(0.2%)	(6.5%)	(6.3%)
Return on Average Assets	(0.04%)	(1.15%)	(1.11%)

Income Statement	H1'2018	H1'2019	y/y change	H1'2019e	Projected y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	1.3	1.0	(23.5%)	1.3	(2.3%)	(21.2%)
Net non-Interest Income	0.6	0.9	55.8%	0.6	5.8%	50.0%
Total Operating income	**1.9**	**1.9**	**0.6%**	**1.9**	**0.2%**	**0.4%**
Loan Loss provision	(0.2)	(0.4)	61.9%	(0.2)	(17.0%)	79.0%
Total Operating expenses	(1.9)	(2.0)	6.2%	(2.0)	3.9%	2.3%
Profit before tax	0.0	(0.1)		(0.1)		
Profit after tax	**0.01**	**(0.10)**		**(0.04)**		
Core EPS	**0.02**	**(0.28)**		**(0.12)**		

Income Statement Ratios	H1'2018	H1'2019	y/y change
Yield from interest-earning assets	11.8%	11.3%	(0.5%)
Cost of funding	7.0%	7.4%	0.5%
Net Interest Spread	4.8%	3.8%	(0.9%)
Net Interest Margin	4.9%	4.0%	(0.9%)
Cost of Risk	11.8%	19.0%	7.2%
Net Interest Income as % of operating income	69.6%	52.9%	(16.7%)
Non-Funded Income as a % of operating income	30.4%	47.1%	16.7%
Cost to Income Ratio	99.3%	104.9%	5.5%

Capital Adequacy Ratios	H1'2018	H1'2019
Core Capital/Total Liabilities	23.7%	20.4%
Minimum Statutory ratio	8.0%	8.0%
Excess	**15.7%**	**12.4%**
Core Capital/Total Risk Weighted Assets	15.5%	14.5%
Minimum Statutory ratio	10.5%	10.5%
Excess	**5.0%**	**4.0%**
Total Capital/Total Risk Weighted Assets	16.9%	15.8%
Minimum Statutory ratio	14.5%	14.5%
Excess	**2.4%**	**1.3%**
Liquidity Ratio	20.9%	20.9%
Minimum Statutory ratio	20.0%	20.0%
Excess	**0.9%**	**0.9%**
Adjusted core capital/ total deposit liabilities	22.8%	19.1%
Adjusted core capital/ total risk weighted assets	16.5%	14.7%
Adjusted total capital/ total risk weighted assets	18.0%	16.2%