HF Group Earnings Note – H1’2020
28th August, 2020

Valuation Summary

- We are of the view that HF Group is a “***buy***” with a target price of Kshs 5.6, representing an upside of 40.8%, from the current price of Kshs 4.0 as of 28th August 2020,
- HF Group is currently trading at a P/TBV of 0.2x vs an industry average of 0.9x, with a P/E ratio of 1.0 x compared to an industry average of 5.5x.

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,

Income Statement

- HF Group recorded a loss per share of Kshs 0.8 in H1’2020, lower than the loss per share of Kshs 0.3 recorded in H1’2019, which was not in-line with our expectations of a Kshs 0.1 loss per share. This variance can be attributed to lower Non-Funded Income where we expected a 2.7% growth for first half of the year, compared to the 68.8% decline that was recorded. The performance of the group can be attributed to the decline in non-funded income, that resulted in a 34.4% decline in total operating income which weighed down on the effect of the 23.1% decline in total operating expenses,
- Total Operating Income declined by 34.4% to Kshs 1.3 bn in H1’2020 from Kshs 1.9 bn, this can be attributed to the 68.8% decline in Non-Funded Income (NFI) to Kshs 0.3 bn from Kshs 0.9 bn recorded in H1’2019, coupled with the 3.9% dip in Net Interest Income (NII) to Kshs 987.3 mn from Kshs 1.0 bn seen in H1’2019,
- Interest income declined by 12.7% to Kshs 2.4 bn, from Kshs 2.7 bn in H1’2019. This was driven by a 16.5% decline in interest income from loans and advances to Kshs 2.1 bn, from Kshs 2.5 bn in H1’2019. Interest income on government securities, however, recorded a 26.3% rise to Kshs 247.3 mn, from Kshs 195.7 mn in H1’2019. The yield on interest-earning assets declined to 10.6%, from 11.3% in H1’2019, due to the faster 12.7% decline in interest income compared to the 8.7% decline in the average interest-earning assets (IEA),
- Interest expense declined by 18.2% to Kshs 1.4 bn, from Kshs 1.7 bn in H1’2019, following a 55.2% decline in other interest expenses to Kshs 0.3 bn, from Kshs 0.7 bn in H1’2019. Interest expenses on customer deposits on the other hand increased by 9.1% to Kshs 1.0 bn in H1’2020, from Kshs 0.9 bn in H1’2019. Cost of funds declined to 6.4% from the 7.4% recorded in H1’2019, following the faster 18.2% decline in interest expense compared to the marginal 0.1% decline in the average interest-bearing liabilities (IBL). Net Interest Margin (NIM) increased to 4.3%, from 4.0% in H1’2019, due to the faster 8.7% decline in the average interest earning assets, compared to the 1.1% decline in trailing Net Interest Income (NII),
- Non-Funded Income fell by 68.8% to Kshs 0.3 bn, from Kshs 0.9 bn in H1’2019. The decline was mainly due to a 79.2% decline in other income to Kshs 0.1 bn, from Kshs 0.7 bn, coupled with a 61.9% decline in Other Fees and commissions to Kshs 61.0 mn from Kshs 160.0 mn. Forex trading income increased by 155.8% from Kshs 15.0 mn in H1’2019 to Kshs 38.4 mn in H1’2020, while income from fees and commissions increased by 42.1% from Kshs 27.0 mn, to Kshs 38.3 mn in H1’2020. Consequently, the revenue mix shifted to 78:22 funded to non-funded income, from 53:47, owing to the faster decline in NFI compared to NII,
- Total Operating Expenses declined by 23.1% to Kshs 1.6 bn from Kshs 2.0 bn seen in H1’2019. This is attributable to a 28.4% drop in Other Expenses to Kshs 0.8 bn from Kshs 1.2 bn in H’2019, coupled with a

276% decline in Loan Loss Provisions from Kshs 0.4 bn to Kshs 0.3 bn in H1’2019, and a 7.1% decline in Staff Costs to Kshs 462.9 mn from Kshs 498.5 mn recorded in H1’2019,
- The Cost to Income Ratio (CIR) deteriorated to 123.0%, from 104.9% in H1’2019. Without LLP, the cost to income ratio came in at 102.0% from 85.8% in H1’2019, and,
- HF Group recorded a loss before tax of Kshs 293.1 mn, a decline from a loss before tax of Kshs 94.3 mn in H1’2019. The Group’s Loss after Tax declined to Kshs 294.9 mn in H1’2020, from the Kshs 97.0 mn loss recorded in H1’2019

Balance Sheet

- The company’s balance sheet recorded a contraction as total assets declined by 0.9% from Kshs 57.0 bn to Kshs 56.5 bn in H1’2019. This is attributable to a 5.8% decline in the loan book to Kshs 38.2 bn from Kshs 40.5 bn recorded in H1’2019. This was however mitigated by a 171.7% increase in placements to Kshs 1.0 bn, from Kshs 0.5 bn in H1’2019, and a 13.5% rise in government securities increased to Kshs 4.8 bn from the Kshs 4.2 bn recorded in H1’2019,
- Total liabilities declined marginally by 0.1% to Kshs 46.56 mn in H1’2020, from Kshs 46.62 mn, driven by a 49.9% decline in borrowings to Kshs 5.3 bn, from Kshs 10.6 bn in H1’2019. This drop can be attributed to the corporate bond that was retired during the last quarter of 2019. The decline was mitigated by a 15.8% rise in Customer deposits to Kshs 39.2 bn from Kshs 33.8 bn in H1’2019. Deposits per branch increased by 15.8% from Kshs 1.5 bn to Kshs 1.8 bn in H1’2020, with the number of branches remaining unchanged at 22,
- The 5.8% decline in loans, coupled with the 15.8% increase in deposits led to a decline in the loan to deposit ratio to 97.4% from 119.8% in H1’2019,
- Gross non-performing loans (NPLs) declined by 8.2% to Kshs 11.9 bn from Kshs 13.0 bn recorded in H1’2019. Consequently, the NPL ratio improved to 26.7% from the 28.2% following the faster 8.2% decline in NPLs that outpaced the 2.8% decline in gross loans which came in at Kshs 44.6 bn in H1’2020, from Kshs 45.9 bn recorded in H1’2019. General loan loss provisions increased by 16.5% to Kshs 3.0 bn in H1’2020, from Kshs 2.5 bn in H1’2019. NPL coverage increased to 54.3% in H1’2020, from 41.5% owing to the faster 16.5% increase in general loan loss provisions which outpaced the 8.2% decline in gross NPLs,
- Shareholders’ funds declined by 4.3% to Kshs 9.9 bn in H1’2020, from Kshs 10.4 bn in H1’2019, attributable to the accumulated loss of Kshs 0.6 bn seen in H1’2020, compared to the retained earnings of Kshs 0.8 bn, recorded in H1’2019,
- HF Group remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 11.0%, 0.5% points above the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio came in at 12.3%, below the statutory requirement by 2.2% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 10.9%, while total capital to risk-weighted assets came in at 12.2%, and,
- The bank currently has a Return on Average Assets (ROaA) of (0.5%), and a Return on Average Equity (ROaE) of (3.0%).

Key Take-Outs:

1. The bank experienced an improvement in asset quality as Non-performing Loans (NPLs) by 8.2% to Kshs 11.9 bn from Kshs 13.0 bn recorded in H1’2019. Consequently, the NPL ratio improved to 26.7% from the 28.2% following the faster 8.2% decline in NPLs that outpaced the 2.8% decline in gross loans which came in at Kshs 44.6 bn in H1’2020, from Kshs 45.9 bn recorded in H1’2019. 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.

2. The bank recorded a contraction in its balance sheet as total assets declined by 0.9% from Kshs 57.0 bn to Kshs 56.5 bn in H1’2019. This is attributable to a 5.8% decline in the loan book to Kshs 38.2 bn from Kshs 40.5 bn recorded in H1’2019. This was mitigated by a 171.7% increase in placements to Kshs 1.0 bn, from Kshs 0.5 bn in H1’2019, and a 13.5% rise in government securities increased to Kshs 4.8 bn from the Kshs 4.2 bn recorded in H1’2019. Notably, the bank seems to rely more on placements and government securities despite the decline in yields of government securities,

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. 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	H1'2019	H1'2020	y/y change	H1'2020f	Projected y/y change	Variance in Growth Actual vs. Expected
Net loans	40.5	38.2	(5.8%)	37.6	(7.1%)	1.3%
Total Assets	**57.0**	**56.5**	**(0.9%)**	**50.6**	**(11.2%)**	**10.3%**
Customer Deposits	33.8	39.2	15.8%	33.7	(0.5%)	16.3%
Total Liabilities	46.6	46.6	(0.1%)	41.5	(11.0%)	10.9%
Shareholder's Funds	**10.4**	**9.9**	**(4.3%)**	**9.1**	**(12.2%)**	**7.9%**

Balance Sheet Ratios	H1'2019	H1'2020	y/y change
Loan to Deposit ratio	119.8%	97.4%	(22.4%)
Return on Average Equity	(6.5%)	(3.0%)	3.5%
Return on Average Assets	(1.1%)	(0.5%)	0.6%

Income Statement	H1'2019	H1'2020	y/y change	H1'2020f	Projected y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	1.0	1.0	(3.9%)	1.0	(0.4%)	(3.5%)
Net non-Interest Income	0.9	0.3	(68.8%)	0.9	2.7%	(71.4%)
Total Operating income	**1.9**	**1.3**	**(34.4%)**	**2.0**	**1.0%**	**(35.5%)**
Loan Loss provision	(0.4)	(0.3)	(27.6%)	(0.3)	(11.3%)	(16.3%)
Total Operating expenses	(2.0)	(1.6)	(23.1%)	(2.0)	(0.8%)	(22.2%)
Profit before tax	(0.1)	(0.3)	210.8%	(0.1)	(39.6%)	250.4%
Profit after tax	**(0.1)**	**(0.3)**	**203.9%**	**(0.0)**	**(56.0%)**	**259.8%**
Core EPS	**(0.3)**	**(0.8)**	**203.9%**	**(0.1)**	**(56.0%)**	**259.8%**

Income Statement Ratios	H1'2019	H1'2020	y/y change
Yield from interest-earning assets	11.3%	12.7%	1.4%

Cost of funding	7.4%	6.4%	(1.0%)
Net Interest Spread	3.8%	6.3%	2.5%
Net Interest Margin	4.0%	5.0%	1.0%
Cost of Risk	19.0%	21.0%	2.0%
Net Interest Income as % of operating income	52.9%	77.6%	24.6%
Non-Funded Income as a % of operating income	47.1%	22.4%	(24.6%)
Cost to Income Ratio	104.9%	123.0%	18.2%

Capital Adequacy Ratios	H1'2019	H1'2020
Core Capital/Total Liabilities	20.4%	12.7%
Minimum Statutory ratio	8.0%	8.0%
Excess	**12.4%**	**4.7%**
Core Capital/Total Risk Weighted Assets	14.5%	11.0%
Minimum Statutory ratio	10.5%	10.5%
Excess	**4.0%**	**0.5%**
Total Capital/Total Risk Weighted Assets	15.8%	12.3%
Minimum Statutory ratio	14.5%	14.5%
Excess	**1.3%**	**-2.2%**
Liquidity Ratio	20.9%	22.0%
Minimum Statutory ratio	20.0%	20.0%
Excess	**0.9%**	**2.0%**
Adjusted core capital/ total deposit liabilities	19.1%	12.5%
Adjusted core capital/ total risk weighted assets	14.3%	10.9%
Adjusted total capital/ total risk weighted assets	15.6%	12.2%