

Below is a summary of the HF Group's H1'2021 performance:

Balance Sheet Items	H1'2020	H1'2021	y/y change
Net loans	38.2	35.3	(7.5%)
Total Assets	56.5	53.0	(6.2%)
Customer Deposits	39.2	37.8	(3.5%)
Total Liabilities	46.7	44.8	(4.1%)
Shareholder's Funds	9.9	8.2	(17.3%)

Balance Sheet Ratios	H1'2020	H1'2021	y/y change
Loan to deposit ratio	97.4%	93.3%	(4.1%)
Return on Average Equity	(3.0%)	(21.2%)	(18.2%)
Return on Average Assets	(0.5%)	(3.3%)	(2.7%)

Income Statement	H1'2020	H1'2021	y/y change
Net Interest Income	1.0	0.9	(6.8%)
Net non-Interest Income	0.3	0.3	13.8%
Total Operating income	1.3	1.2	(2.2%)
Loan Loss provision	(0.3)	(0.1)	(78.2%)
Total Operating expenses	(1.57)	(1.56)	(0.2%)
Profit before tax	(0.3)	(0.3)	8.5%
Profit after tax	(0.3)	(0.3)	17.4%
Core EPS	(0.8)	(0.9)	17.4%

Income Statement Ratios	H1'2020	H1'2021	y/y change
Yield from interest-earning assets	10.6%	9.1%	(1.5%)
Cost of funding	6.4%	4.8%	(1.6%)
Net Interest Spread	4.2%	4.3%	0.1%
Net Interest Margin	4.3%	4.2%	(0.1%)
Cost of Risk	21.0%	4.7%	(16.3%)
Net Interest Income as % of operating income	77.6%	73.9%	(3.7%)
Non-Funded Income as a % of operating income	22.4%	26.1%	3.7%
Cost to Income Ratio	123.0%	125.5%	2.5%

Capital Adequacy Ratios	H1'2020	H1'2021
Core Capital/Total Liabilities	12.3%	10.1%
Minimum Statutory ratio	8.0%	8.0%
Excess	4.3%	2.1%
Core Capital/Total Risk Weighted Assets	10.8%	8.8%
Minimum Statutory ratio	10.5%	10.5%
Excess	0.3%	(1.7%)
Total Capital/Total Risk Weighted Assets	12.0%	12.3%
Minimum Statutory ratio	14.5%	14.5%
Excess	(2.5%)	(2.2%)
Liquidity Ratio	22.0%	22.2%
Minimum Statutory ratio	20.0%	20.0%
Excess	2.0%	2.2%
Adjusted core capital/ total deposit liabilities	12.5%	10.5%
Adjusted core capital/ total risk weighted assets	10.9%	9.1%
Adjusted total capital/ total risk weighted assets	12.2%	12.6%

Key Highlights

- 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 in HF Group. 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 0.9 in H1'2021, higher than the loss per share of Kshs 0.8 recorded in H1'2020, which was not in-line with our expectations of a Kshs 0.4 loss per share. The performance of the group can be attributed to a faster 2.2% decline in total operating income to Kshs 1.2 bn, from Kshs 1.3 bn in H1'2020, coupled with a 0.2% decrease in total operating expenses to Kshs 1.56 bn, from Kshs 1.57 bn seen in H1'2020,
- Total Operating Income declined by 2.2% to Kshs 1.2 bn, from Kshs 1.3 bn in H1'2020, attributable to the 6.8% dip in Net Interest Income (NII) to Kshs 0.9 bn, from Kshs 1.0 bn recorded in H1'2020. The decline was however mitigated by a 13.8% increase in Non-Funded Income (NFI) to Kshs 325.1 mn, from Kshs 285.6 mn recorded in H1'2020,
- Interest income declined by 15.8% to Kshs 2.0 bn, from Kshs 2.4 bn in H1'2020 driven by a 20.5% decline in interest income from loans and advances to Kshs 1.7 bn, from Kshs 2.1 bn in H1'2020. The decline was however mitigated by a 28.1% increase in interest income on government securities to Kshs 0.3 bn, from Kshs 0.2 bn in H1'2020. The Yield on Interest-Earning Assets decreased to 9.1%, from 10.6% in H1'2020, due to an 18.4% decrease in trailing interest income compared to the 4.1% 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 22.3% to Kshs 1.1 bn, from Kshs 1.4 bn in H1'2020, driven by a 42.3% decline in other interest expenses to Kshs 191.6 mn, and a 20.8% decline in interest expense from customer deposits to Kshs 766.6 mn, from Kshs 967.5 mn in H1'2020. Interest expense on Deposits and placements from other banks grew by 55.8% to Kshs 103.4 mn, from Kshs 66.4 mn recorded in H1'2020. Cost of funds declined to 4.8% in H1'2021, from 6.4% as recorded in H1'2020. Net Interest Margin (NIM) declined to 4.2% from the 4.3% recorded in H1'2020, due to a 6.7% decrease in trailing Net Interest Income (NII), compared to a 4.1% decline in the average interest-earning assets,
- Non-Funded Income increased by 13.8% to Kshs 325.1 mn, from Kshs 285.6 mn in H1'2020 following an 84.7% increase in fees and commissions from loans to Kshs 70.7 mn, from Kshs 38.3 mn, and a 27.4% increase in Forex trading income to Kshs 48.9 mn, from Kshs 38.4 mn in H1'2020. This increase was weighed down by a 3.6% decline in other income to Kshs 142.6 mn in H1'2021, from Kshs 148.0 mn in H1'2020. Total fees and commissions increased by 34.6% to Kshs 133.6 mn, from Kshs 99.3 mn in H1'2020. Consequently, the revenue mix shifted to 74:26 from 78:22 in H1'2020, funded to non-funded income, owing to the 13.8% increase in Non-Funded Income compared to the 6.8% decline in the net Interest Income,
- Total Operating Expenses decreased by 0.2% to Kshs 1.56 bn, from Kshs 1.57 bn seen in H1'2020. This is mainly attributable to a 78.2% decrease in Loan Loss Provisions to Kshs 58.2 mn, from Kshs 267.6 mn recorded in H1'2020. The decline in operating expenses was however weighed down by an 18.2% increase in staff costs to Kshs 547.2 mn, from Kshs 462.9 mn recorded in H1'2020,
- Cost to Income Ratio (CIR) deteriorated to 125.5%, from 123.0% in H1'2020, attributable to the 18.2% rise in staff costs to Kshs 547.2 mn, from Kshs 462.9 mn recorded in H1'2020. Without LLP, the cost to income ratio deteriorated as well to 120.9%, from 102.0% in H1'2020, an indication of reduced efficiency, and,

- HF Group recorded a loss before tax of Kshs 318.1 mn, an 8.5% increase from a loss before tax of Kshs 293.8 mn in H1'2020. The Group's Loss after Tax increased to Kshs 346.1 mn in H1'2021, from the Kshs 295.5 mn loss recorded in H1'2020.

Balance Sheet

- The company's balance sheet recorded a contraction as total assets declined by 6.2% to Kshs 53.0 bn, from Kshs 56.5 bn in H1'2020. This is attributable to a 7.5% decline in the loan book to Kshs 35.3 bn, from Kshs 38.2 bn recorded in H1'2020. This contraction in the loan book was however mitigated by a 1.9% rise in government securities to Kshs 4.9 bn, from the Kshs 4.8 bn recorded in H1'2020, and a 5.2% increase in placements to Kshs 1.42 bn in H1'2021, from Kshs 1.35 bn,
- Total liabilities decreased by 4.1% to Kshs 44.8 bn in H1'2021, from Kshs 46.7 bn in H1'2020, driven by a 12.3% decline in borrowings to Kshs 4.7 bn, from Kshs 5.3 bn in H1'2020, and a 3.5% decline in customer deposits to Kshs 37.8 bn in H1'2021, from Kshs 39.2 bn in H1'2020. There was however a 287.3% increase in placements to Kshs 0.5 bn in H1'2021, from Kshs 0.1 bn in H1'2020. Deposits per branch decreased by 3.5% to Kshs 1.7 bn, from Kshs 1.8 bn in H1'2020, with the number of branches remaining unchanged at 22,
- The 7.5% decline in loans, which declined faster than the 3.5% decrease in deposits led to a decline in the loan to deposit ratio to 93.3%, from 97.4% in H1'2020,
- Gross non-performing loans (NPLs) declined by 21.3% to Kshs 9.4 bn, from Kshs 11.9 bn recorded in H1'2020. Consequently, the NPL ratio improved to 22.6% from the 26.7% recorded in H1'2020, following the faster 21.3% decline in NPLs that outpaced the 7.3% decline in gross loans which came in at Kshs 41.4 bn in H1'2021, from Kshs 44.6 bn recorded in H1'2020. General loan loss provisions increased by 8.6% to Kshs 3.2 bn in H1'2021, from Kshs 3.0 bn in H1'2020. The NPL coverage thus improved to 65.1% in H1'2021, from 54.3% in H1'2020 owing to the 8.6% increase in general loan loss provisions coupled with the 21.3% decline in gross NPLs,
- Shareholders' funds declined by 17.3% to Kshs 8.2 bn in H1'2021, from Kshs 9.9 bn in H1'2020, attributable to the accumulated loss of Kshs 2.2 bn seen in H1'2021, compared to the accumulated loss of Kshs 0.6 bn, recorded in H1'2020,
- HF Group remains undercapitalized with a core capital to risk-weighted assets ratio of 8.8%, 1.7% points below 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 9.1%, while total capital to risk-weighted assets came in at 12.6%, and,
- The bank currently has a Return on Average Assets (ROaA) of (3.3%), and a Return on Average Equity (ROaE) of (21.2%).

Key Take-Outs:

1. The bank experienced an improvement in asset quality as the NPL ratio improved by 4.1% points to 22.6%, from the 26.7% recorded in H1'2020, following the faster 21.3% decline in NPLs that outpaced the 7.3% decline in gross loans which came in at Kshs 41.4 bn in H1'2021, from Kshs 44.6 bn recorded in H1'2020. Despite the improved asset quality during the period, HF Group's NPL ratio is still higher than the sectors average of 14.1% as at the end of June 2021, an indication that the group needs to improve its credit assessment in order to bring down this high NPL Ratio, and,
2. The bank recorded a contraction in its balance sheet as total assets declined by 6.2% to Kshs 53.0 bn, from Kshs 56.5 bn in H1'2020, attributable to a 7.5% decline in the loan book to Kshs 35.3 bn, from Kshs 38.2 bn recorded in H1'2020. Given the elevated credit risk in the COVID-19 operating

environment, HF group increased its allocation to government securities by 1.9% to Kshs 4.9 bn, from the Kshs 4.8 bn recorded in H1'2020.

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 3.9, representing a downside of 1.6%, from the current price of Kshs 4.0 as of 27th August 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 26.3x compared to an industry average of 16.0x.