Below is a summary of HF Group’s H1’2022 performance:

Balance Sheet Items (Kshs bns)	H1’2021	H1’2022	y/y change
Net loans	35.3	34.9	(1.1%)
Government Securities	4.9	9.2	87.8%
Total Assets	**53.0**	**55.7**	**5.2%**
Customer Deposits	37.8	39.1	3.4%
Deposits Per Branch	1.7	1.8	3.4%
Total Liabilities	44.8	46.8	4.6%
Shareholder's Funds	**8.2**	**8.0**	**(3.1%)**

Balance Sheet Ratios	H1’2021	H1’2022	y/y % pts change
Loan to deposit ratio	93.3%	89.2%	(4.1%)
Return on Average Equity	(21.2%)	(2.4%)	18.8%
Return on Average Assets	(3.3%)	(0.4%)	2.9%

Income Statement (Kshs bns)	H1’2021	H1’2022	y/y change
Net Interest Income	0.92	1.03	11.4%
Net non-Interest Income	0.3	0.5	53.2%
Total Operating income	**1.2**	**1.5**	**22.3%**
Loan Loss provision	(0.06)	0.10	76.0%
Total Operating expenses	(1.6)	(1.5)	(6.5%)
Profit before tax	(0.3)	0.1	(118.4%)
Profit after tax	**(0.3)**	**0.05**	**114.4%**
Core EPS	**(0.9)**	**0.1**	**114.4%**

Income Statement Ratios	H1’2021	H1’2022f	y/y % pts change
Yield from interest-earning assets	9.1%	9.3%	0.2%
Cost of funding	4.8%	4.8%	(0.0%)
Net Interest Spread	4.3%	4.5%	0.2%
Net Interest Margin	4.2%	4.5%	0.3%
Cost of Risk	4.7%	6.7%	2.0%
Net Interest Income as % of operating income	73.9%	67.3%	(6.6%)
Non-Funded Income as a % of operating income	26.1%	32.7%	6.6%
Cost to Income Ratio (with LLP)	125.5%	95.9%	(29.6%)

Capital Adequacy Ratios	H1’2021	H1’2022
Core Capital/Total Liabilities	10.1%	7.8%
Minimum Statutory ratio	8.0%	8.0%
Excess	**2.1%**	**(0.2%)**
Core Capital/Total Risk Weighted Assets	8.8%	8.1%
Minimum Statutory ratio	10.5%	10.5%
Excess	**(1.7%)**	**(2.4%)**
Total Capital/Total Risk Weighted Assets	12.3%	12.0%
Minimum Statutory ratio	14.5%	14.5%
Excess	**(2.2%)**	**(2.5%)**
Liquidity Ratio	22.2%	26.0%
Minimum Statutory ratio	20.0%	20.0%
Excess	**2.2%**	**6.0%**
Adjusted core capital/ total deposit liabilities	10.5%	7.9%

Adjusted core capital/ total risk weighted assets	9.1%	8.2%
Adjusted total capital/ total risk weighted assets	12.6%	12.1%

Income Statement

- HF Group recorded a core earnings per share of Kshs 0.1 in H1’2022, up from the loss per share of Kshs 0.9 recorded in H1’2021, against our expectations of a Kshs 0.1 loss per share. The performance of the group was attributed to a 22.3% increase in total operating income to Kshs 1.5 bn, from Kshs 1.2 bn in H1’2021, coupled with a 6.5% decline in total operating expenses to Kshs 1.5 bn, from Kshs 1.6 bn in H1’2021,
- Total Operating Income increased by 22.3% to Kshs 1.5 bn, from Kshs 1.2 bn in H1’2021, attributable to an 11.4% increase in Net Interest Income (NII), to Kshs 1.0 bn, from Kshs 0.9 bn recorded in H1’2021 coupled with a 53.2% increase in Non-Funded Income (NFI) to Kshs 0.5 bn, from Kshs 0.3 bn recorded in H1’2021,
- Interest income increased by 4.6% to Kshs 2.1 bn, from Kshs 2.0 bn in H1’2021, driven by a 37.5% increase in interest income from Government securities to Kshs 435.8 mn, from Kshs 316.8 mn in H1’2021. The growth was however weighed down by a 1.5% decline in interest income from loans and advances to Kshs 1,629.0 bn, from Kshs 1,654.1 bn in H1’2021, coupled with a 28.8% decline in interest income from placements with other banks to Kshs 7.5 mn from Kshs 10.5 mn in H1’2021. The Yield on Interest-Earning Assets rose by 0.2% points to 9.3%, from 9.1% in H1’2021, following the faster 3.1% increase in trailing interest income which outpaced the 0.5% increase 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 expenses on the other hand declined by 1.3% to Kshs 1,047.2 mn, from Kshs 1,061.5 mn in H1’2021, indicative of the bank’s ability to mobilise cheaper deposits with interest expense on customer deposits declining marginally by 0.2% to Kshs 764.7 mn, from Kshs 766.6 mn in H1’2021. Additionally, interest expenses on placements from banking institutions declined by 18.8% to Kshs 83.9 mn, from Kshs 103.4 mn recorded in H1’2021. Cost of funds remained unchanged at 4.8% as recorded in H1’2021 attributable to the marginal 0.7% decline in trailing interest expense coupled with performance of the average interest bearing liabilities which remained unchanged at Kshs 43.8 bn as recorded in H1’2021. Net Interest Margin (NIM) increased to 4.5%, from 4.2% recorded in H1’2021,
- Non-Funded Income increased by 53.2% to Kshs 498.0 bn, from Kshs 325.1 bn in H1’2021 attributable to a 48.9% increase in foreign exchange income to Kshs 72.9 mn, from Kshs 48.9 mn in H1’2021. Total fees and commissions increased by 13.2% to Kshs 151.2 mn, from Kshs 133.6 mn in H1’2021. Consequently, the revenue mix shifted to 67:33 from 74:26 in H1’2021, funded to non-funded income, owing to the 53.2% increase in Non-Funded Income that outpaced the 11.4% increase in the net Interest Income,
- Total Operating Expenses declined by 6.5% to Kshs 1.5 bn in H1’2022, from Kshs 1.6 bn in H1’2021, partly attributable to a 23.6% decline in other operating expenses to Kshs 731.6 mn in H1’2022, from Kshs 957.4 mn in H1’2021. The decline in expenses was weighed down by a 76.0% increase in Loans Loss Provisions (LLPs) to Kshs 102.6 mn in H1’2022, from Kshs 58.3 mn recorded in H1’2021, coupled with a 14.5% increase in staff costs to Kshs 626.6 mn in H1’2022, from Kshs 547.2 mn in H1’2021,
- As a result, the Cost to Income Ratio (CIR) improved to 95.9%, from 125.5% in H1’2021, attributable to the 6.5% decline in total operating expenses to Kshs 1.5 bn in H1’2022, from Kshs 1.6 bn recorded in H1’2021. Key to note, this is the second consecutive quarter since Q1’2020 that HF Group’s total operating expenses have been lower than its total operating income – a Cost to Income ratio of below 100.0%. However, the ratio is still high compared to the listed banking sector average, which stood at 59.0% as at H1’2022. Without LLP, the cost to income ratio also improved to 89.2%, from 120.9% in H1’2021, an indication of improved efficiency, and,

- HF Group recorded a profit before tax of Kshs 58.7 mn, a 118.4% increase from a loss before tax of Kshs 318.1 mn in H1’2021. Additionally, the Group posted a profit after tax of Kshs 49.9 mn, up from a loss of Kshs 346.1 mn in H1’2022. Notably, this is the second consecutive quarter that HF Group has registered a profit after tax.

Balance Sheet

- The balance sheet recorded an expansion as Total Assets increased by 5.2% to Kshs 55.7 bn in H1’2022, from Kshs 53.0 bn recorded in H1’2021 driven by an 87.8% increase in Government securities to Kshs 9.2 bn, from Kshs 4.9 bn in H1’2021. The increases were however weighed down by a 1.1% decline in the loan book to Kshs 34.9bn, from Kshs 35.3 bn recorded in H1’2021. The increased allocation to Government securities as compared to lending can be attributable to the deterioration of asset quality in the Real Estate sector, which the Group primarily lends to. Gross Non-Performing Loans (NPLs) in the Real Estate sector increased by 8.0% to Kshs 78.5 bn in Q1’2022, from Kshs 74.7 bn in FY’2021,
- Total liabilities increased by 4.6% to Kshs 47.8 bn in H1’2022, from Kshs 44.8 bn in H1’2021, driven by a 3.4% increase in customer deposits to Kshs 39.1 bn in H1’2022, from Kshs 37.8 bn in H1’2021. Deposits per branch increased by 3.4% to Kshs 1.8 bn, from Kshs 1.7 bn in H1’2021, with the number of branches remaining unchanged at 22,
- Deposits increased by 3.4%, compared to the 1.1% decrease in loans leading to a decline in the loan to deposit ratio to 89.2%, from 93.3% in H1’2021,
- Gross non-performing loans (NPLs) declined by 11.1% to Kshs 8.3 bn, from Kshs 9.4 bn recorded in H1’2021. Consequently, the NPL ratio improved to 20.1% from the 22.6% recorded in H1’2021, following the faster 11.1% decline in NPLs that outpaced the 0.1% decline in gross loans which came in at Kshs 41.3 bn in H1’2022, from Kshs 41.4 bn recorded in H1’2021. General loan loss provisions increased by 15.5% to Kshs 3.7 bn in H1’2022, from Kshs 3.2 bn recorded in H1’2021. The NPL coverage thus improved to 77.6% in H1’2022, from 65.1% in H1’2021 owing to the faster 15.5% increase in general loan loss provisions which outpaced the 11.1% increase in gross NPLs,
- Shareholders’ funds declined by 3.1% to Kshs 8.0 bn in H1’2022 from Kshs 8.2 bn in H1’2021, attributable to a 24.9% increase in the accumulated loss to Kshs 2.8 bn seen in H1’2022, compared to the accumulated loss of Kshs 2.2 bn, recorded in H1’2021, and,
- HF Group remains undercapitalized with a core capital to risk-weighted assets ratio of 8.1%, 2.4% points below the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio came in at 12.0%, below the statutory requirement of 14.5% by 2.5% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 8.2%, while total capital to risk-weighted assets came in at 12.1%.

Key Take-Outs:

1. **Improved Asset Quality** - The bank experienced an improvement in asset quality as the NPL ratio improved to 20.1% from the 22.6% recorded in H1’2021, following the faster 11.1% decline in NPLs that outpaced the 0.1% decline in gross loans which came in at Kshs 41.3 bn in H1’2022, from Kshs 41.4 bn recorded in H1’2021. Despite the improved asset quality during the period, HF Group’s NPL ratio is still higher than the sectors average of 13.0% as of H1’2022, an indication that the group needs to improve its credit assessment in order to bring down this high NPL Ratio,
2. **Improved Efficiency** - Cost to Income Ratio (CIR) improved to 95.9%, from 125.5% in H1’2021, attributable to the 6.5% decline in total operating expenses to Kshs 1.5 bn in H1’2022, from Kshs 1.6 bn recorded in H1’2021. Key to note, this is the second consecutive quarter that HF Group’s total operating expenses have been lower than its total operating income – a Cost to Income ratio of below

100.0%. However, the ratio is still high compared to the listed banking sector average, which stood at 53.1% as of Q1’2022. Without LLP, the cost to income ratio also improved to 89.2%, from 120.9% in H1’2021.

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 2.1, representing a downside of 30.5%, from the current price of Kshs 3.5 as of 2nd September 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 12.0x as compared to an industry average of 7.7x.