

Below is a summary of the HF Group's Q1'2021 performance:

Balance Sheet Items	Q1'2020	Q1'2021	y/y change
Net loans	38.4	35.8	(6.9%)
<b>Total Assets</b>	<b>56.6</b>	<b>53.9</b>	<b>(4.7%)</b>
Customer Deposits	38.0	37.2	(2.1%)
Total Liabilities	46.4	45.7	(1.6%)
<b>Shareholder's Funds</b>	<b>10.2</b>	<b>8.3</b>	<b>(18.9%)</b>

Balance Sheet Ratios	Q1'2020	Q1'2021	% point change
Loan to deposit ratio	101.1%	96.2%	(4.9%)
Return on Average Equity	0.5%	(20.4%)	(20.9%)
Return on Average Assets	0.1%	(3.4%)	(3.5%)

Income Statement	Q1'2020	Q1'2021	y/y change
Net Interest Income	0.6	0.5	(18.3%)
Net non-Interest Income	0.3	0.1	(46.7%)
<b>Total Operating income</b>	<b>0.8</b>	<b>0.6</b>	<b>(27.0%)</b>
Loan Loss provision	(0.1)	(0.1)	(45.8%)
Total Operating expenses	(0.8)	(0.8)	(4.8%)
Profit before tax	0.0	(0.2)	N/A
<b>Profit after tax</b>	<b>(0.0)</b>	<b>(0.2)</b>	<b>N/A</b>
<b>Core EPS</b>	<b>(0.0)</b>	<b>(0.5)</b>	<b>N/A</b>

Income Statement Ratios	Q1'2020	Q1'2021	% point change
Yield from interest-earning assets	11.2%	9.3%	(1.9%)
Cost of funding	6.5%	5.1%	(1.3%)
Net Interest Spread	4.7%	4.2%	(0.5%)
Net Interest Margin	4.5%	4.1%	(0.5%)
Cost of Risk	16.5%	12.2%	(4.3%)
Net Interest Income as % of operating income	70%	78%	8.2%
Non-Funded Income as a % of operating income	30%	22%	(8.2%)
Cost to Income Ratio	99.2%	129.3%	30.1%

Capital Adequacy Ratios	Q1'2020	Q1'2021
Core Capital/Total Liabilities	14.4%	7.4%
Minimum Statutory ratio	8.0%	8.0%
<b>Excess</b>	<b>6.4%</b>	<b>(0.7%)</b>
Core Capital/Total Risk Weighted Assets	12.4%	6.4%
Minimum Statutory ratio	10.5%	10.5%
<b>Excess</b>	<b>1.9%</b>	<b>(4.1%)</b>
Total Capital/Total Risk Weighted Assets	13.7%	9.9%
Minimum Statutory ratio	14.5%	14.5%
<b>Excess</b>	<b>(0.8%)</b>	<b>(4.7%)</b>
Liquidity Ratio	21.3%	20.6%
Minimum Statutory ratio	20.0%	20.0%
<b>Excess</b>	<b>1.3%</b>	<b>0.6%</b>

Adjusted core capital/ total deposit liabilities	13.9%	9.2%
Adjusted core capital/ total risk weighted assets	12.2%	8.1%
Adjusted total capital/ total risk weighted assets	13.4%	11.6%

### 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. 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 0.50 in Q1'2021, higher than the loss per share of Kshs 0.002 recorded in Q1'2020, which was not in-line with our expectations of a Kshs 0.42 loss per share. This variance can be attributed to a higher 46.7% decline in Non-Funded Income to Kshs 0.1 bn from Kshs 0.3 bn in Q1'2020. The performance of the group can be attributed to a 27.0% decline in total operating income to Kshs 0.6 bn, from Kshs 0.8 bn in Q1'2020, coupled with a slow 4.8% decrease in total operating expenses to Kshs 0.79 bn, from Kshs 0.83 bn seen in Q1'2020,
- Total Operating Income declined by 27.0% to Kshs 0.6 bn in Q1'2021, from Kshs 0.8 bn in Q1'2020, attributable to the 46.7% decline in Non-Funded Income (NFI) to Kshs 0.1 bn, from Kshs 0.3 bn recorded in Q1'2020, coupled with the 18.3% dip in Net Interest Income (NII) to Kshs 0.5 bn, from Kshs 0.6 bn recorded in Q1'2020,
- Interest income declined by 18.7% to Kshs 1.0 bn, from Kshs 1.2 bn in Q1'2020 driven by a 24.3% decline in interest income from loans and advances to Kshs 0.8 bn, from Kshs 1.1 bn in Q1'2020. Interest income on government securities, however, recorded a 41.9% rise to Kshs 0.2 bn, from Kshs 0.1 bn in Q1'2020. The Yield on Interest-Earning Assets decreased to 9.3%, from 11.2% in Q1'2020, due to a 19.5% decrease in trailing interest income compared to the 3.4% 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 19.0% to Kshs 0.5 bn, from Kshs 0.7 bn in Q1'2020, driven by a 38.7% decline in other interest expenses to Kshs 90.7 mn, and a 20.5% decline in interest expense from customer deposits to Kshs 0.4 bn, from Kshs 0.5 bn in Q1'2020. Interest expense on Deposits and placements from other banks grew by 112.1% to Kshs 59.7 mn, from Kshs 28.1 mn recorded in Q1'2020. Cost of funds declined to 5.1% in Q1'2021, from 6.5% as recorded in Q1'2020. Net Interest Margin (NIM) decreased to 4.1%, from 4.5% in Q1'2020, due to a 19.5% decrease in trailing Net Interest Income (NII), compared to a 3.4% decline in the average interest-earning assets,
- Non-Funded Income declined by 46.7% to Kshs 0.1 bn, from Kshs 0.3 bn in Q1'2020 following a 56.4% decrease in other fees and commissions to Kshs 41.9 mn, from Kshs 96.0 mn, and a 70.9% decrease in other income to Kshs 33.2 mn, from Kshs 114.3 mn in Q1'2020. This decline was mitigated by a 43.1% increase in Fees and commissions to Kshs 35.0 bn in Q1'2021, from Kshs 24.4 bn in Q1'2020, coupled with a 32.7% increase in Forex trading income to Kshs 25.0 mn in Q1'2021, from Kshs 18.8 mn in Q1'2020. Total fees and commissions declined by 36.2% to Kshs 76.8 mn, from Kshs 120.4 mn in Q1'2020. Consequently, the revenue mix shifted to 78:22 from 70:30 in Q1'2020, funded to non-funded income, owing to the faster 46.7% decline in Non Funded Income compared to the 18.3% decline in the net Interest Income,
- Total Operating Expenses decreased by 4.8% to Kshs 0.79 bn, from Kshs 0.83 bn seen in Q1'2020. This is mainly attributable to a 45.8% decrease in Loan Loss Provisions to Kshs 0.07 bn, from Kshs 0.14 bn

recorded in Q1'2020, coupled with a 3.8% increase in staff costs to Kshs 0.27 bn, from Kshs 0.26 bn recorded in Q1'2020,

- Cost to Income Ratio (CIR) deteriorated to 129.3%, from 99.2% in Q1'2020, attributable to the 45.8% rise in Loan Loss Provisions to Kshs 0.07 bn, from Kshs 0.14 bn in Q1'2020. Without LLP, the cost to income ratio deteriorated as well to 117.0%, from 82.7% in Q1'2020, an indication of reduced efficiency, and,
- HF Group recorded a loss before tax of Kshs 178.4 mn, a decrease from a profit before tax of Kshs 7.0 mn in Q1'2020. The Group's Loss after Tax increased to Kshs 191.8 mn in Q1'2021, from the Kshs 0.6 mn loss recorded in Q1'2020.

### **Balance Sheet**

- The company's balance sheet recorded a contraction as total assets declined by 4.7% to Kshs 53.9 bn, from Kshs 56.5 bn in Q1'2020. This is attributable to a 6.9% decline in the loan book to Kshs 35.8 bn, from Kshs 38.4 bn recorded in Q1'2020, and an 18.7% decline in placements to Kshs 0.8 bn in Q1'2021, from Kshs 0.9 bn. This contraction in the loan book was however mitigated by a 13.4% rise in government securities to Kshs 5.7 bn, from the Kshs 5.0 bn recorded in Q1'2020,
- Total liabilities also decreased by 1.6% to Kshs 45.7 bn in Q1'2021, from Kshs 46.4 bn in Q1'2020, driven by a 12.4% decline in borrowings to Kshs 5.1 bn, from Kshs 5.8 bn in Q1'2020, and a 2.1% decline in customer deposits to Kshs 37.2 bn in Q1'2021, from Kshs 38.0 bn in Q1'2020. There was however a 121.8% increase in placements to Kshs 1.5 bn in Q1'2021, from Kshs 0.7 bn in Q1'2020. Deposits per branch decreased by 2.1% to Kshs 1.69 bn, from Kshs 1.73 bn in Q1'2020, with the number of branches remaining unchanged at 22,
- The 6.9% decline in loans, coupled with the 2.1% decrease in deposits led to a decline in the loan to deposit ratio to 96.2%, from 101.1% in Q1'2020,
- Gross non-performing loans (NPLs) declined by 14.0% to Kshs 10.5 bn, from Kshs 12.2 bn recorded in Q1'2020. Consequently, the NPL ratio improved to 24.7% from the 27.3% recorded in Q1'2020, following the faster 14.0% decline in NPLs that outpaced the 4.9% decline in gross loans which came in at Kshs 42.6 bn in Q1'2021, from Kshs 44.8 bn recorded in Q1'2020. General loan loss provisions increased by 23.2% to Kshs 3.6 bn in Q1'2021, from Kshs 2.9 bn in Q1'2020. The NPL coverage thus improved to 64.7% in Q1'2021, from 52.2% owing to the faster 23.2% increase in general loan loss provisions which outpaced the 14.0% decline in gross NPLs,
- Shareholders' funds declined by 18.9% to Kshs 8.3 bn in Q1'2021, from Kshs 10.2 bn in Q1'2020, attributable to the accumulated loss of Kshs 2.5 bn seen in Q1'2021, compared to the accumulated loss of Kshs 0.1 bn, recorded in Q1'2020,
- HF Group remains undercapitalized with a core capital to risk-weighted assets ratio of 6.4%, 4.1% points below the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio came in at 9.9%, below the statutory requirement by 4.7% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 8.1%, while total capital to risk-weighted assets came in at 11.6%, and,
- The bank currently has a Return on Average Assets (ROaA) of (3.4%), and a Return on Average Equity (ROaE) of (20.4%).

### **Key Take-Outs:**

1. The bank experienced an improvement in asset quality as the NPL ratio improved by 2.3% points to 24.7%, from the 27.3% recorded in Q1'2020, following the faster 14.0% decline in NPLs that outpaced the 4.9% decline in gross loans which came in at Kshs 42.6 bn in Q1'2021, from Kshs 44.8 bn recorded in Q1'2020. Despite the improved asset quality during the period, HF Group's NPL ratio

is still higher than the sectors average of 14.6% as at the end of March 2021, an indication that 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 4.7% to Kshs 53.9 bn, from Kshs 56.5 bn in Q1'2020, attributable to a 6.9% decline in the loan book to Kshs 35.8 bn, from Kshs 38.4 bn recorded in Q1'2020. Given the elevated credit risk in the COVID-19 operating environment, HF group increased its allocation to government securities by 13.4% to Kshs 5.7 bn, from the Kshs 5.0 bn recorded in Q1'2020.

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 Q1'2021. 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 3.6, representing a downside of 6.3%, from the current price of Kshs 3.9 as of 28<sup>th</sup> May 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 25.2x compared to an industry average of 15.0x.