Below is a summary of the HF Group's Q1'2022 performance:

Balance Sheet Items (Kshs bns)	Q1'2021	Q1'2022	y/y change
Net loans	35.8	34.8	(2.7%)
Government Securities	5.7	7.2	26.5%
Total Assets	**53.9**	**54.3**	**0.7%**
Customer Deposits	37.2	38.4	3.1%
Total Liabilities	**45.7**	**46.4**	**1.7%**
Shareholder's Funds	**8.3**	**7.9**	**(5.0%)**

Balance Sheet Ratios	Q1'2021	Q1'2022	y/y % pts change
Loan to deposit ratio	96.2%	90.8%	(5.4%)
Return on Average Equity	(22.4%)	(4.5%)	17.9%
Return on Average Assets	(3.5%)	(0.7%)	2.8%

Income Statement (Kshs bns)	Q1'2021	Q1'2022	y/y change
Net Interest Income	0.47	0.52	9.7%
Net non-Interest Income	0.1	0.3	87.2%
Total Operating income	**0.6**	**0.8**	**26.8%**
Loan Loss provision	(0.07)	(0.06)	(24.3%)
Total Operating expenses	(0.8)	(0.7)	(6.8%)
Profit before tax	(0.2)	0.04	(121.9%)
Profit after tax	**(0.2)**	**0.03**	**117.8%**
Core EPS	**(0.5)**	**0.1**	**117.8%**

Income Statement Ratios	Q1'2021	Q1'2022f	y/y % pts change
Yield from interest-earning assets	9.3%	9.2%	(0.1%)
Cost of funding	5.1%	4.7%	(0.4%)
Net Interest Spread	4.2%	4.5%	0.3%
Net Interest Margin	4.1%	4.4%	0.3%
Cost of Risk	12.2%	7.3%	(4.9%)
Net Interest Income as % of operating income	77.8%	67.3%	(10.5%)
Non-Funded Income as a % of operating income	22.2%	32.7%	10.5%
Cost to Income Ratio (with LLP)	129.3%	94.9%	(34.4%)

Capital Adequacy Ratios	Q1'2021	Q1'2022
Core Capital/Total Liabilities	9.2%	8.0%
Minimum Statutory ratio	8.0%	8.0%
Excess	**1.2%**	**0.0%**
Core Capital/Total Risk Weighted Assets	8.1%	8.2%
Minimum Statutory ratio	10.5%	10.5%
Excess	**(2.5%)**	**(2.3%)**
Total Capital/Total Risk Weighted Assets	11.6%	12.1%
Minimum Statutory ratio	14.5%	14.5%
Excess	**(2.9%)**	**(2.4%)**
Liquidity Ratio	20.6%	24.6%
Minimum Statutory ratio	20.0%	20.0%
Excess	**0.6%**	**4.6%**
Adjusted core capital/ total deposit liabilities	9.2%	8.2%
Adjusted core capital/ total risk weighted assets	8.1%	8.4%

Adjusted total capital/ total risk weighted assets	11.6%	12.3%

Income Statement

- HF Group recorded a profit per share of Kshs 0.1 in Q1’2022, up from the loss per share of Kshs 0.5 recorded in Q1’2021, not in-line with our expectations of a Kshs 0.4 loss per share. The performance of the group can be attributed to a 26.8% increase in total operating income to Kshs 0.8 bn, from Kshs 0.6 bn in Q1’2021, coupled with a 6.8% decline in total operating expenses to Kshs 0.7 bn, from Kshs 0.8 bn in Q1’2021,
- Total Operating Income increased by 26.8% to Kshs 0.8 bn, from Kshs 0.6 bn in Q1’2021, attributable to the 87.2% increase in Non-Funded Income (NFI) to Kshs 0.3 bn, from Kshs 0.1 bn recorded in Q1’2021, coupled with a 9.7% increase in Net Interest Income (NII), to Kshs 0.52 bn, from Kshs 0.47 bn recorded in Q1’2021,
- Interest income increased marginally by 1.1% to Kshs 1.02 bn, from Kshs 1.01 bn in Q1’2021, driven by a 22.6% increase in interest income from Government securities to Kshs 197.7 mn, from Kshs 161.3 mn in Q1’2021, coupled with a 14.6% increase in interest income from placements with other banks to Kshs 4.9 mn from Kshs 4.3 mn in Q1’2021. The growth was however weighed down by a 3.1% decline in interest income on loans and advances to Kshs 820.7 mn, from Kshs 846.8 mn in Q1’2021. The Yield on Interest-Earning Assets declined marginally to 9.2%, from 9.3% in Q1’2021, due to faster 6.5% decline in trailing interest income compared to the 1.4% 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 6.5% to Kshs 503.2 mn, from Kshs 538.1 mn in Q1’2021, attributable to the bank’s ability to mobilise cheaper deposits with interest expense from customer deposits declining by 5.3% to Kshs 367.1 mn, from Kshs 387.7 mn in Q1’2021 coupled with a 38.3% decline in interest expenses from placements from banking institutions to Kshs 36.8 mn, from Kshs 59.7 mn recorded in Q1’2021. Cost of funds declined to 4.7%, from 5.1% as recorded in Q1’2021 attributable to the faster 9.4% decline in interest expense, as compared to the 0.6% decline in average interest bearing liabilities. Net Interest Margin (NIM) increased to 4.4%, from 4.1% recorded in Q1’2021,
- Non-Funded Income increased by 87.2% to Kshs 252.7 mn, from Kshs 135.0 mn in Q1’2021 attributable to a 248.7% increase in other income to Kshs 115.8 mn, from Kshs 33.2 mn, coupled with a 82.4% increase in other fees and commissions income to Kshs 76.4 mn, from Kshs 41.9 mn in Q1’2021. This increase was weighed down by a 1.9% decline in fees and commissions on loans and advances income to Kshs 34.3 mn, from Kshs 35.0 mn in Q1’2021. Total fees and commissions increased by 44.1% to Kshs 110.7 mn, from Kshs 76.8 mn in Q1’2021 attributable to expiry of the waiver on mobile banking fees. Consequently, the revenue mix shifted to 67:33 from 78:22 in Q1’2021, funded to non-funded income, owing to the 87.2% increase in Non-Funded Income that outpaced the 9.7% increase in the net Interest Income,
- Total Operating Expenses declined by 6.8% to Kshs 772.8 mn in Q1’2022, from Kshs 609.3 mn in Q1’2021, partly attributable to a 24.3% decline in Loans Loss Provisions (LLPs) to Kshs 56.4 mn in Q1’2022, from Kshs 74.6 mn recorded in Q1’2021, attributable to the reduced credit risk on the back of increased business activity in Q1’2022. Other operating expenses declined by 17.5% to Kshs 368.5 mn in Q1’2022, from Kshs 446.9 mn in Q1’2021. On the other hand, staff costs increased by 16.0% to Kshs 308.8 mn in Q1’2022, from Kshs 266.2 mn in Q1’2021,
- As a result, Cost to Income Ratio (CIR) improved to 94.9%, from 129.3% in Q1’2021, attributable to the 6.8% decline in total operating expenses to Kshs 733.8 mn in Q1’2022, from Kshs 787.7 mn recorded in Q1’2021. Key to note, this is the first time 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 56.4% as FY’2021. Without LLP,

the cost to income ratio also improved to 87.6%, from 117.0% in Q1’2021, an indication of increased efficiency, and,

- HF Group recorded a profit before tax of Kshs 39.1 mn, a 121.9% increase from a loss before tax of Kshs 178.4 mn in Q1’2021. Additionally, the Group posted a profit before tax of Kshs 34.2 mn, up from a loss of Kshs 191.8 mn in Q1’2022 Notably, this is the first period since Q2’2018 that HF Group has registered a profit after tax,

Balance Sheet

- The balance sheet recorded an expansion as Total Assets increased by 0.7% to Kshs 54.3 bn in Q1’2022, from Kshs 53.9 bn recorded in Q1’2021. This is attributable to a 26.5% increase in Government securities to Kshs 5.2 bn, from Kshs 7.7 bn in Q1’2021, coupled with a 47.6% increase in placements with other banking institutions to Kshs 1.2 bn, from Kshs 0.8 bn. The increases were however weighed down by a 2.7% decline in the loan book to Kshs 34.8 bn, from Kshs 35.8 bn recorded in Q1’2021. 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 74.7 bn in Q4’2021, from Kshs 69.2 bn in Q3’2021,
- Total liabilities increased by 1.7% to Kshs 46.4 bn in Q1’2022, from Kshs 45.7 bn in Q1’2021, driven by a 3.1% increase in customer deposits to Kshs 38.4 bn in Q1’2022, from Kshs 37.2 bn in Q1’2021. Deposits per branch increased by 1.7% to Kshs 1.74 bn, from Kshs 1.69 bn in Q1’2021, with the number of branches remaining unchanged at 22,
- Deposits increased by 3.1%, compared to the 2.7% decrease in loans leading to a decline in the loan to deposit ratio to 90.8%, from 96.2% in Q1’2021,
- Gross non-performing loans (NPLs) declined by 19.8% to Kshs 8.4 bn, from Kshs 10.5 bn recorded in Q1’2021. Consequently, the NPL ratio improved to 20.5% from the 24.7% recorded in Q1’2021, following the faster 19.8% decline in NPLs that outpaced the 3.2% decline in gross loans which came in at Kshs 41.2 bn in Q1’2022, from Kshs 42.6 bn recorded in Q1’2021. General loan loss provisions increased by 1.4% to Kshs 3.7 bn in Q1’2022, from Kshs 3.6 bn recorded in Q1’2021. The NPL coverage thus improved to 76.1% in Q1’2022, from 64.7% in Q1’2021 owing to the 19.7% increase in gross NPLs coupled with the slight 0.1% increase in general loan loss provisions,
- Shareholders’ funds declined by 5.0% to Kshs 7.9 bn in Q1’2022 from Kshs 8.3 bn in Q1’2021, attributable to a 11.4% increase in the accumulated loss to Kshs 2.7bn seen in Q1’2022, compared to the accumulated loss of Kshs 2.5 bn, recorded in Q1’2021, and,
- HF Group remains undercapitalized with a core capital to risk-weighted assets ratio of 8.2%, 2.3% points below the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio came in at 12.1%, below the statutory requirement of 14.5% by 2.4% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 8.4%, while total capital to risk-weighted assets came in at 12.3%.

Key Take-Outs:

1. The bank experienced an improvement in asset quality as the NPL ratio improved to 20.5% from the 24.7% recorded in Q1’2021, following the faster 19.8% decline in NPLs that outpaced the 3.2% decline in gross loans which came in at Kshs 41.2 bn in Q1’2022, from Kshs 42.6 bn recorded in Q1’2021. Despite the improved asset quality during the period, HF Group’s NPL ratio is still higher than the sectors average of 13.1% as at the end of December 2021, an indication that the group needs to improve its credit assessment in order to bring down this high NPL Ratio,

2. HF Total Operating Expenses declined by 6.8% to Kshs 772.8 mn in Q1’2022, from Kshs 609.3 mn in Q1’2021, partly attributable to a 24.3% decline in Loans Loss Provisions (LLPs) to Kshs 56.4 mn in Q1’2022, from Kshs 74.6 mn recorded in Q1’2021, attributable to the reduced credit risk on the back of increased business activity in Q1’2022 following gradual economic recovery, and,
3. Cost to Income Ratio (CIR) improved to 94.9%, from 129.3% in Q1’2021, attributable to the 6.8% decline in total operating expenses to Kshs 733.8 mn in Q1’2022, from Kshs 787.7 mn recorded in Q1’2021. Key to note, this is the first time 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 56.4% as FY’2021. Without LLP, the cost to income ratio also improved to 87.6%, from 117.0% in Q1’2021, an indication of increased efficiency.

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 3.0 as of 13th May 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 10.8x as compared to an industry average of 7.1x.