

Below is a summary of HF Group Plc Q1'2023 performance:

Balance Sheet Items	Q1'2022	Q1'2023	y/y change
Net loans	34.8	37.0	6.2%
Government Securities	7.2	9.5	31.4%
<b>Total Assets</b>	<b>54.3</b>	<b>59.0</b>	<b>8.6%</b>
Customer Deposits	38.4	41.2	7.4%
Deposits Per Branch	1.7	1.9	7.4%
Total Liabilities	46.4	50.2	8.1%
<b>Shareholder's Funds</b>	<b>7.9</b>	<b>8.8</b>	<b>11.7%</b>

Balance Sheet Ratios	Q1'2022	Q1'2023	y/y change
Loan to deposit ratio	90.8%	89.7%	(1.1%)
Return on Average Equity	(5.7%)	3.8%	9.5%
Return on Average Assets	(0.8%)	0.6%	1.4%

Income Statement	Q1'2022	Q1'2023	y/y change
Net Interest Income	0.5	0.6	21.0%
Net non-Interest Income	0.25	0.27	8.7%
<b>Total Operating income</b>	<b>0.8</b>	<b>0.9</b>	<b>17.0%</b>
Loan Loss provision	(0.1)	(0.1)	80.4%
Total Operating expenses	(0.7)	(0.8)	10.9%
Profit before tax	0.0	0.1	130.5%
<b>Profit after tax</b>	<b>0.03</b>	<b>0.1</b>	<b>143.5%</b>
<b>Core EPS</b>	<b>0.1</b>	<b>0.2</b>	<b>143.5%</b>

Income Statement Ratios	Q1'2022	Q1'2023	y/y change
Yield from interest-earning assets	9.2%	9.8%	0.6%
Cost of funding	4.7%	4.8%	0.1%
Net Interest Spread	4.5%	5.0%	0.5%
Net Interest Margin	4.4%	5.0%	0.6%
Cost of Risk	7.3%	11.3%	4.0%
Net Interest Income as % of operating income	67.3%	69.6%	2.3%
Non-Funded Income as a % of operating income	32.7%	30.4%	(2.3%)
Cost to Income Ratio	94.9%	90.0%	(4.9%)
Cost to Income Ratio without LLP	9.2%	9.8%	0.6%
Cost to Assets	4.7%	4.8%	0.1%

Capital Adequacy Ratios	Q1'2022	Q1'2023	% Change
Core Capital/Total Liabilities	8.0%	6.7%	(1.3%)
Minimum Statutory ratio	8.0%	8.0%	
<b>Excess</b>	<b>0.0%</b>	<b>(1.3%)</b>	<b>(1.3%)</b>
Core Capital/Total Risk Weighted Assets	8.2%	7.2%	(1.0%)
Minimum Statutory ratio	10.5%	10.5%	
<b>Excess</b>	<b>(2.3%)</b>	<b>(3.3%)</b>	<b>(1.0%)</b>
Total Capital/Total Risk Weighted Assets	12.1%	11.0%	(1.1%)
Minimum Statutory ratio	14.5%	14.5%	
<b>Excess</b>	<b>(2.4%)</b>	<b>(3.5%)</b>	<b>(1.1%)</b>
Liquidity Ratio	24.6%	24.7%	0.1%
Minimum Statutory ratio	20.0%	20.0%	
<b>Excess</b>	<b>4.6%</b>	<b>4.7%</b>	<b>0.1%</b>
Adjusted core capital/ total deposit liabilities	8.2%	6.9%	(1.3%)
Adjusted core capital/ total risk weighted assets	8.4%	7.3%	(1.1%)
Adjusted total capital/ total risk weighted assets	12.3%	11.2%	(1.1%)

**Income Statement**

- Core earnings per share rose by 143.5% to Kshs 0.2, from Kshs 0.1 registered in Q1'2022. This was mainly attributable to the 17.0% growth in total operating income to Kshs 0.9 bn, from Kshs 0.8 bn in Q1'2022. However, the growth was weighed down by 10.9% increase in total operating expenses to Kshs 0.8 bn from Kshs 0.7 bn in Q1'2022,
- Total operating income increased by 17.0% to Kshs 0.9 bn, from Kshs 0.8 bn in Q1'2022, driven by 21.0% increase in Net Interest Income (NII) to Kshs 0.6 bn, from Kshs 0.5 bn in Q1'2022, coupled with a 8.7% increase in Non-Funded Income (NFI) to Kshs 0.27 bn, from Kshs 0.25 bn in Q1'2022,
- Interest income grew by 15.1% to Kshs 1.2 bn, from Kshs 1.0 bn in Q1'2022, mainly driven by a 35.2% increase in interest income earned from government securities to Kshs 0.3 bn, from Kshs 0.2 bn in Q1'2022, coupled with a 9.8% increase in interest income from loans and advances to Kshs 0.9 bn, from 0.8 bn in Q1'2022. Additionally, the interest income from deposits and placement in other banking institutions increased by 104.1% to Kshs 10.1 mn, from Kshs 4.9 mn in Q1'2022. Consequently, the Yield on Interest-Earning Assets (YIEA) increased by 0.6% points to 9.8% from 9.2% in Q1'2022, attributable to the 12.5% growth in trailing interest income, which outpaced the 5.7% gain in Average Interest Earning Assets (AIEA). Trailing Interest Income refers to the performance of the interest income for the past 12 consecutive months,
- Interest expenses increased by 9.1% to Kshs 0.55 bn, from Kshs 0.50 bn in Q1'2022, following a 12.4% increase in interest expense on customer deposits to Kshs 0.41 bn, from Kshs 0.37 bn recorded in Q1'2022, coupled with 4.5% increase in other expenses to Kshs 103.7 mn, from Kshs 99.3 mn in Q1'2022. The growth in interest expense was mitigated by a 12.2% decline in interest expense from deposits and placements to Kshs 0.03 bn, from Kshs 0.04 bn recorded in Q1'2022. Consequently, the Cost of funds (COF) increased by 0.1% points to 4.8%, from 4.7% recorded in Q1'2022, attributable to a 4.6% increase in Trailing interest expense, which outpaced the 2.5% increase in average interest bearing liabilities. Trailing interest expense refers to the performance of the interest expense for the past 12 consecutive months. On the other hand, Net Interest Margin (NIM) increased by 0.6% points to 5.0%, from 4.6% in Q1'2022 due to faster 21.1% growth in trailing Net Interest Income, which outpaced the 5.7% increase in average interest-earning assets,
- Non-Funded Income (NFI) increased by 8.7% to Kshs 274.7 mn, from Kshs 252.7 mn in Q1'2022, driven by a significant 60.7% increase in the group's foreign exchange trading income to Kshs 42.1 mn, from Kshs 26.2 mn in Q1'2022, highlighting the group's increased foreign exchange margins, coupled with a 52.3% increase in Fees and Commissions income to Kshs 53.2 mn, from Kshs 34.2 mn in Q1'2022. Notably, total fees and commissions declined by 29.7% to Kshs 77.8 mn, from Kshs 110.7 mn recorded in Q1'2022, mainly on the back of a 66.6% decline in other fees and commissions to Kshs 25.5 mn, from Kshs 76.4 mn in Q1'2022. The revenue mix shifted to 70:30 from 67:33 funded to non-funded income, owing to the faster 21.0% growth of Net Interest income (NII), compared to the 8.7% growth in Non-Funded Income (NFI),
- Total operating expenses increased by 10.9% to Kshs 0.8 bn, from Kshs 0.7 bn in Q1'2022, driven by the 80.4% increase in Loan Loss Provision (LLP) to Kshs 101.7 mn, from Kshs 56.4 mn in Q1'2022, coupled with a 15.9% increase in staff cost to Kshs 0.4 bn, from Kshs 0.3 bn in Q1'2022. The increase in expenses was however mitigated by the 3.8% decline in other operationing expenses to Kshs 354.4 mn from Kshs 368.5 mn in Q1'2022,
- Cost to Income Ratio (CIR) improved by 4.9% points to 90.0%, from 94.9% in Q1'2022, owing to the 17.0% increase in total operating income, which outpaced the 10.9% increase in total operating expenses. Without LLP, Cost to Income ratio also improved by 8.8% points to 78.8%, from 87.6% in Q1'2022, an indication of improved efficiency,
- Profit before tax increased by 130.5% to Kshs 90.0 mn, from Kshs 39.1 mn in Q1'2022, with the effective tax rate, declining to 7.5%, from 12.4% in Q1'2022. Similarly, Profit after tax improved by 143.5% to Kshs 83.3 mn, from Kshs 34.2 mn in Q1'2022, and,

### **Balance Sheet**

- The balance sheet recorded an expansion as total assets grew by 8.6% to Kshs 59.0 bn, from Kshs 54.3 bn in Q1'2022, driven by a 31.4% increase in government securities to Kshs 9.5 bn, from Kshs 7.2 bn in Q1'2022, coupled with a 6.2% growth in the loan book to Kshs 37.0 bn, from Kshs 34.8 bn in Q1'2022,
- Total liabilities rose by 8.1% to Kshs 50.2 bn, from Kshs 46.4 bn in Q1'2022, driven by a 7.4% growth in customer deposits to Kshs 41.2 bn, from Kshs 38.4 bn. Deposits per branch increased by 7.4% to Kshs 1.9 bn, from Kshs 1.7 bn in Q1'2022, with the number of branches coming at 22 branches in Q1'2023, unchanged from Q1'2022,
- The 7.4% growth in customers' deposits outpaced the 6.2% growth in net loans, resulting in a decline in the loan to deposits ratio by 1.1% points to 89.7%, from 90.8% in Q1'2022,
- Gross Non-Performing Loans increased by 4.1% to Kshs 8.8 bn, from Kshs 8.4 bn in Q1'2022, while gross loans increased by 7.0% to Kshs 44.1 bn from Kshs 41.2 bn in Q1'2022. Consequently, the group's Asset Quality improved, with the NPL ratio declining by 0.6% points to 19.9% in Q1'2023, from 20.5% in Q1'2022,
- NPL coverage improved to 81.4% in Q1'2023, from 76.0% in Q1'2022 mainly due to the 6.2% increase in General Provisions (LLP) to Kshs 4.2 bn from Kshs 3.7 bn in Q1'2022, relative to the 4.1% gain in Gross Non-Performing Loans to Kshs 8.8 bn, from Kshs 8.4 bn in Q1'2022,
- Shareholders' funds increased by 11.7% to Kshs 8.8 bn in Q1'2023, from Kshs 7.9 bn in Q1'2022, supported by a 38.1% increase in revaluations reserves to Kshs 1.3 bn from Kshs 0.9 bn in Q1'2022 and an 16.4% increase in statutory loan loss reserve to Kshs 4.1 bn, from Kshs 3.5 bn in Q1'2022,
- HF Group remains undercapitalized with a core capital to risk-weighted assets ratio of 7.2%, 3.3% points below the statutory requirement of 10.5%. The total capital to risk-weighted assets ratio decreased to 11.0% in Q1'2023, from 12.1% in Q1'2022, and remained short of the statutory requirement of 14.5% by 3.5% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 7.3%, while total capital to risk-weighted assets came in at 11.2%, and,
- The bank currently has a Return on Average Assets (ROaA) of 3.8%, and a Return on Average Equity (ROaE) of 0.6%.

### **Key Take Outs**

1. **Earnings Growth**- Core earnings per share rose by 143.5% to Kshs 0.2, from Kshs 0.1 registered in Q1'2022. This was mainly attributable to the 17.0% growth in total operating income to Kshs 0.9 bn, from Kshs 0.8 bn in Q1'2022. However, the growth was weighed down by 10.9% increase in total operating expenses to Kshs 0.8 bn from Kshs 0.7 bn in Q1'2022,
2. **Improved Asset Quality** - The group's asset quality improved significantly, with the gross NPL ratio improving to 19.9% in Q1'2023, from 20.5% in Q1'2022, attributable to the 7.0% increase in gross loans to Kshs 44.1 bn, from Kshs 41.2 bn in Q1'2022 which outpaced the with 4.1% growth in Gross Non performing loans during the year to Kshs 8.8, from Kshs 8.4 bn in Q1'2022,
3. **Improved Efficiency** – Cost to Income Ratio (CIR) improved by 4.9% points to 90.0%, from 94.9% in Q1'2022, attributable to the 17.0% increase in total operating income to Kshs 0.9 bn in Q1'2023, from Kshs 0.8 bn in Q1'2022, which outpaced the 10.9% increase in total operating expenses to Kshs 0.8 bn, from Kshs 0.7 bn recorded in Q1'2022, and,
4. **Cautious Lending** – HF Group's Q1'2023 result was characterized by a faster 31.4% growth in government securities to Kshs 9.5 bn from Kshs 7.2 bn as compared to the 6.2% rise in net loans to Kshs 37.0 bn from Kshs 34.8 bn in Q1'2022, depicting the group's adoption of conservative lending strategy to take advantage of the higher interest rates in Fixed Income.

We commend HF Group's performance, recording an increase in profit after tax of Kshs 143.5% to Kshs 90.0 mn, from Kshs 39.1 mn in Q1'2022. Going forward, we maintain our view that HF Group as a conventional bank has a long way to go, despite five consecutive quarters of profitability, HF Group remains undercapitalized with a core capital ratios being below the statutory requirement. They will either have to diversify their client portfolio to include other sectors of the economy and 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 real estate and mortgage.

### **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 7.8%, from the current price of Kshs 4.2 as of 02<sup>nd</sup> June 2023,
- HF Group is currently trading at a P/TBV of 0.2x and a P/E of 6.2x vs an industry average of 0.2x and 4.0x, respectively.