HF Group Earnings Note – Q3’2020
4th December 2020,

Valuation Summary

- We are of the view that HF Group is a “***HOLD***” with a target price of Kshs 3.9, representing an upside of 15.8%, from the current price of Kshs 3.3 as of 4th December 2020,
- HF Group is currently trading at a P/TBV of 0.1x vs an industry average of 0.2x, with a P/E ratio of 8.9 x compared to an industry average of 6.0x.

Key Highlights

- The Kenya Mortgage Refinance Company (KMRC) – a government initiative to support long-term lending towards mortgages for affordable housing, got an approval to operate from the Central Bank of Kenya in September 2020. Housing Finance (HF) being a member of KMRC will benefit through its main line of business, which is mortgage lending.

Income Statement

- HF Group recorded a loss per share of Kshs 1.9 in Q3’2020, higher than the loss per share of Kshs 0.2 recorded in Q3’2019, and in-line with our expectation of a loss per share of Kshs 1.7. This variance can be attributed to lower Non-Funded Income where we expected a 10.1% decline for the third quarter of the year, compared to the 62.2% decline that was recorded. The performance of the group can be attributed to a 27.3% decline in total operating income, coupled with a 6.0% decline in total operating expenses,
- Total Operating Income declined by 27.3% to Kshs 2.0 bn in Q3’2020 from Kshs 2.8 bn in Q3’2019, this can be attributed to the 62.2% decline in Non-Funded Income (NFI) to Kshs 0.4 bn from Kshs 1.1 bn recorded in Q3’2019, coupled with the 5.6% dip in Net Interest Income (NII) to Kshs 1.6 bn from Kshs 1.7 bn recorded in Q3’2019,
- Interest income declined by 12.2% to Kshs 3.6 bn, from Kshs 4.4 bn in Q3’2019. This was driven by a 15.8% decline in interest income from loans and advances to Kshs 3.2 bn, from Kshs 3.8 bn in Q3’2019. Interest income on government securities, however, recorded a 25.2% rise to Kshs 391.6 mn, from Kshs 312.8 mn in Q3’2019. The yield on interest-earning assets declined to 10.3%, from 11.3% in Q3’2019, due to the faster 16.0% decline in trailing interest income compared to the 7.2% decline in the average interest-earning assets (IEA),
- Interest expense declined by 16.9% to Kshs 2.0 bn, from Kshs 2.4 bn in Q3’2019, this can be attributed to a 59.5% decline in other interest expenses to Kshs 0.4 bn, from Kshs 1.0 bn in Q3’2019. Interest expenses on customer deposits on the other hand increased by 6.3% to Kshs 1.4 bn in Q3’2020, from Kshs 1.3 bn in Q3’2019, coupled with a 192.4% increase in Deposits and placements from other banks to Kshs 179.6 mn from Kshs 61.4 mn recorded in Q3’2019. Cost of funds declined to 4.7% from the 7.0% recorded in Q3’2019, following the faster 16.9% decline in interest expense compared to a 6.9% decline in the average interest-bearing liabilities (IBL). Net Interest Margin (NIM) increased to 5.5%, from 4.4% in Q3’2019, due to the faster 7.2% decline in the average interest-earning assets, compared to the 5.6% decline in trailing Net Interest Income (NII),
- Non-Funded Income fell by 62.2% to Kshs 0.4 bn, from Kshs 1.1 bn in Q3’2019. The decline was mainly due to a 79.0% decline in other income to Kshs 0.1 bn, from Kshs 0.7 bn, coupled with a 47.0% decline in Other Fees and commissions to Kshs 145.6 mn from Kshs 274.9 mn. Forex trading income increased by 93.3% to Kshs 55.3 mn in Q3’2020, from Kshs 28.6 mn in Q3’2019, while income from fees and commissions increased by 11.8% to Kshs 52.1 mn in Q3’2020, from Kshs 46.6 mn. Consequently, the revenue mix shifted to 80:20 funded to non-funded income, from 62:38, owing to the faster decline in NFI compared to NII,

- Total Operating Expenses declined by 6.0% to Kshs 2.7 bn from Kshs 2.9 bn seen in Q3'2019. This is attributable to a 6.2% drop in Other Operating Expenses to Kshs 1.4 bn from Kshs 1.5 bn in Q3'2019, coupled with a 24.9% decline in Loan Loss Provisions to Kshs 0.4 bn from Kshs 0.6 bn in Q3'2019. Staff costs recorded an 8.8% increase to Kshs 839.5 mn from Kshs 771.9 mn recorded in Q3'2019,
- The Cost to Income Ratio (CIR) deteriorated to 133.2%, from 102.9% in Q3'2019. Without LLP, the cost to income ratio came in at 111.4% from 81.8% in Q3'2019, an indication of reduced efficiency and,
- HF Group recorded a loss before tax of Kshs 728.0 mn, an increase from a loss before tax of Kshs 81.4 mn in Q3'2019. The Group's Loss after Tax declined to Kshs 730.2 mn in Q3'2020, from the Kshs 84.6 mn loss recorded in Q3'2019

Balance Sheet

- The company's balance sheet recorded a contraction as total assets declined by 4.0% to Kshs 55.1 bn from Kshs 57.4 bn in Q3'2019. This is attributable to a 4.1% decline in the loan book to Kshs 37.6 bn from Kshs 39.2 bn recorded in Q3'2019 and, a 63.9% decline in placements to Kshs 0.9 bn, from Kshs 2.9 bn in Q3'2019. This was however mitigated by a 65.6% rise in government securities to Kshs 6.0 bn from the Kshs 3.6 bn recorded in Q3'2019,
- Total liabilities declined by 3.0% to Kshs 45.6 bn in Q3'2020, from Kshs 47.0 bn, driven by a 47.2% decline in borrowings to Kshs 5.2 bn, from Kshs 9.9 bn in Q3'2019. This drop can be attributed to the corporate bond that was retired during the last quarter of 2019. There was however a recorded 9.9% rise in Customer deposits to Kshs 38.0 bn from Kshs 33.8 bn in Q3'2019. Deposits per branch increased by 8.0% from Kshs 1.6 bn to Kshs 1.7 bn in Q3'2020, with the number of branches remaining unchanged at 22,
- The 4.1% decline in loans, coupled with the 9.9% increase in deposits led to a decline in the loan to deposit ratio to 98.8% from 113.3% in Q3'2019,
- Gross non-performing loans (NPLs) declined by 11.3% to Kshs 11.2 bn from Kshs 12.6 bn recorded in Q3'2019. Consequently, the NPL ratio improved to 25.4% from the 28.2% following the faster 11.3% decline in NPLs that outpaced the 1.6% decline in gross loans which came in at Kshs 44.1 bn in Q3'2020, from Kshs 44.8 bn recorded in Q3'2019. General loan loss provisions increased by 18.2% to Kshs 3.1 bn in Q3'2020, from Kshs 2.7 bn in Q3'2019. NPL coverage increased to 58.2% in Q3'2020, from 44.4% owing to the faster 18.2% increase in general loan loss provisions which outpaced the 11.3% decline in gross NPLs,
- Shareholders' funds declined by 8.5% to Kshs 9.6 bn in Q3'2020, from Kshs 10.4 bn in Q3'2019, attributable to the accumulated loss of Kshs 1.2 bn seen in Q3'2020, compared to the retained earnings of Kshs 0.7 bn, recorded in Q3'2019,
- HF Group remains undercapitalized with a core capital to risk-weighted assets ratio of 9.6%, 0.9% points below the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio came in at 10.9%, below the statutory requirement by 3.6% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 10.0%, while total capital to risk-weighted assets came in at 11.2%, and,
- The bank currently has a Return on Average Assets (ROaA) of (1.3%), and a Return on Average Equity (ROaE) of (7.6%).

Key Take-Outs:

1. The bank experienced an improvement in asset quality as Non-performing Loans (NPLs) improved by 11.3% to Kshs 11.2 bn from Kshs 12.6 bn recorded in Q3'2019. Consequently, the NPL ratio improved to 25.4% from the 28.2% following the faster 11.3% decline in NPLs that outpaced the 1.6% decline in gross loans which came in at Kshs 44.1 bn in Q3'2020, from Kshs 44.8 bn recorded in Q3'2019. Putting into

consideration the current state of affairs regarding the COVID-19 pandemic, there is a lot more to be done to mitigate the effects experienced in the economy.

2. The bank recorded a contraction in its balance sheet as total assets declined by 4.0% from Kshs 55.1 bn to Kshs 57.4 bn in Q3'2019. This is attributable to a 4.1% decline in the loan book to Kshs 37.6 bn from Kshs 39.2 bn recorded in Q3'2019 and, a 63.9% decline in placements to Kshs 0.9 bn, from Kshs 2.9 bn in Q3'2019. This was however mitigated by a 65.6% rise in government securities which increased to Kshs 6.0 bn from the Kshs 3.6 bn recorded in Q3'2019. Notably, the bank seems to rely more on government securities despite the decline in yields,

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. 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.

Below is a summary of the bank's performance:

Balance Sheet Items	Q3'2019	Q3'2020	y/y change	Q3'2020f	Projected y/y change	Variance in Growth Actual vs. Expected
Net loans	39.2	37.6	(4.1%)	38.6	(1.5%)	(2.7%)
Total Assets	**57.4**	**55.1**	**(4.0%)**	**57.1**	**(0.6%)**	**(3.4%)**
Customer Deposits	34.6	38.0	9.9%	40.7	17.7%	(7.9%)
Total Liabilities	47.0	45.6	(3.0%)	48.2	2.6%	(5.6%)
Shareholder's Funds	**10.4**	**9.6**	**(8.5%)**	**8.9**	**(14.9%)**	**6.4%**

Balance Sheet Ratios	Q3'2019	Q3'2020	y/y change
Loan to deposit ratio	113.3%	98.8%	(14.4%)
Return on Average Equity	(3.3%)	(7.6%)	(4.3%)
Return on Average Assets	(0.6%)	(1.3%)	(0.8%)

Income Statement	Q3'2019	Q3'2020	y/y change	Q3'2020f	Projected y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	1.7	1.6	(5.6%)	0.1	(91.7%)	86.1%
Net non-Interest Income	1.1	0.4	(62.2%)	1.0	(10.1%)	(52.1%)
Total Operating income	**2.8**	**2.0**	**(27.3%)**	**1.1**	**(60.4%)**	**33.1%**
Loan Loss provision	(0.6)	(0.4)	(24.9%)	(0.5)	(8.0%)	(16.9%)
Total Operating expenses	(2.9)	(2.7)	(6.0%)	(2.0)	(30.9%)	25.0%
Profit before tax	(0.1)	(0.7)	(794.2%)	(0.9)	(978.3%)	(184.1%)
Profit after tax	**(0.1)**	**(0.7)**	**(763.0%)**	**(0.7)**	**(678.2%)**	**84.8%**
Core EPS	**(0.2)**	**(1.9)**	**(763.0%)**	**(1.7)**	**(678.2%)**	**84.8%**

Income Statement Ratios	Q3'2019	Q3'2020	y/y change
Yield from interest-earning assets	11.3%	10.3%	(1.1%)
Cost of funding	7.0%	4.7%	(2.2%)
Net Interest Spread	4.4%	5.5%	1.2%
Net Interest Margin	4.5%	4.2%	(0.4%)
Cost of Risk	21.1%	21.8%	0.7%
Net Interest Income as % of operating income	61.6%	80.0%	18.4%
Non-Funded Income as a % of operating income	38.4%	20.0%	(18.4%)
Cost to Income Ratio	102.9%	133.2%	30.2%

Capital Adequacy Ratios	Q3'2019	Q3'2020
Core Capital/Total Liabilities	19.5%	11.3%
Minimum Statutory ratio	8.0%	8.0%
Excess	**11.5%**	**3.3%**
Core Capital/Total Risk-Weighted Assets	15.1%	9.6%
Minimum Statutory ratio	10.5%	10.5%
Excess	**4.6%**	**(0.9%)**
Total Capital/Total Risk-Weighted Assets	16.4%	10.9%
Minimum Statutory ratio	14.5%	14.5%
Excess	**1.9%**	**(3.6%)**
Liquidity Ratio	21.4%	20.3%
Minimum Statutory ratio	20.0%	20.0%
Excess	**1.4%**	**0.3%**
Adjusted core capital/ total deposit liabilities	-	11.7%
Adjusted core capital/ total risk weighted assets	-	10.0%
Adjusted total capital/ total risk weighted assets	-	11.2%