

Below is a summary of the HF Group's Q3'2021 performance:

Balance Sheet Items	Q3'2020	Q3'2021	y/y change
Net loans	37.6	34.6	(7.9%)
Total Assets	55.1	52.2	(5.3%)
Customer Deposits	38.0	37.5	(1.3%)
Total Liabilities	45.6	44.2	(3.0%)
Shareholder's Funds	9.6	8.0	(16.3%)

Balance Sheet Ratios	Q3'2020	Q3'2021	y/y change
Loan to deposit ratio	98.8%	92.2%	(6.6%)
Return on Average Equity	(7.6%)	(19.0%)	(11.4%)
Return on Average Assets	(1.3%)	(2.9%)	(1.6%)

Income Statement	Q3'2020	Q3'2021	y/y change
Net Interest Income	1.6	1.4	(14.8%)
Net non-Interest Income	0.4	0.5	12.2%
Total Operating income	2.0	1.8	(9.4%)
Loan Loss provision	(0.4)	(0.2)	(61.5%)
Total Operating expenses	(2.7)	(2.4)	(12.5%)
Profit before tax	(0.7)	(0.5)	(27.6%)
Profit after tax	(0.7)	(0.6)	(22.0%)
Core EPS	(1.9)	(1.5)	(22.0%)

Income Statement Ratios	Q3'2020	Q3'2021	y/y change
Yield from interest-earning assets	10.3%	8.6%	(1.7%)
Cost of funding	6.2%	4.6%	(1.4%)
Net Interest Spread	4.0%	4.1%	0.1%
Net Interest Margin	4.2%	3.9%	(0.3%)
Cost of Risk	21.8%	9.3%	(12.5%)
Net Interest Income as % of operating income	80.0%	75.3%	(4.7%)
Non-Funded Income as a % of operating income	20.0%	24.7%	4.7%
Cost to Income Ratio	133.2%	128.6%	(4.4%)

Capital Adequacy Ratios	Q3'2020	Q3'2021
Core Capital/Total Liabilities	11.3%	9.7%
Minimum Statutory ratio	8.0%	8.0%
Excess	3.3%	1.7%
Core Capital/Total Risk Weighted Assets	9.5%	9.5%
Minimum Statutory ratio	10.5%	10.5%
Excess	(1.0%)	(1.0%)
Total Capital/Total Risk Weighted Assets	10.7%	13.3%
Minimum Statutory ratio	14.5%	14.5%
Excess	(3.8%)	(1.2%)
Liquidity Ratio	20.3%	22.5%
Minimum Statutory ratio	20.0%	20.0%
Excess	0.3%	2.5%
Adjusted core capital/ total deposit liabilities	11.4%	9.9%
Adjusted core capital/ total risk weighted assets	9.6%	9.6%
Adjusted total capital/ total risk weighted assets	10.9%	13.4%

Income Statement

- HF Group recorded a loss per share of Kshs 1.5 in Q3'2021, lower than the loss per share of Kshs 1.9 recorded in Q3'2020, in-line with our expectations of a Kshs 1.5 loss per share. The performance of the group can be attributed to a 9.4% decline in total operating income to Kshs 1.8 bn, from Kshs 2.0 bn in Q3'2020, coupled with a 12.5% decline in total operating expenses to Kshs 2.4 bn, from Kshs 2.7 bn in Q3'2020,
- Total Operating Income declined by 9.4% to Kshs 1.8 bn, from Kshs 2.0 bn in Q3'2020, attributable to the 14.8% decrease in Net Interest Income (NII) to Kshs 1.4 bn, from Kshs 1.6 bn recorded in Q3'2020. The decline was however mitigated by a 12.2% increase in Non-Funded Income (NFI) to Kshs 0.5 bn, from Kshs 0.4 bn recorded in Q3'2020,
- Interest income declined by 18.4% to Kshs 3.0 bn, from Kshs 3.6 bn in Q3'2020 driven by a 23.1% decline in interest income from loans and advances to Kshs 2.5 bn, from Kshs 3.2 bn in Q3'2020. The decline was however mitigated by a 22.5% increase in interest income on government securities to Kshs 0.5 bn, from Kshs 0.4 bn in Q3'2020. The Yield on Interest-Earning Assets decreased to 8.6%, from 11.3% in Q3'2020, due to a 13.1% decrease in trailing interest income compared to the 7.4% 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 21.2% to Kshs 1.6 bn, from Kshs 2.0 bn in Q3'2020, driven by an 18.6% decline in interest expense from customer deposits to Kshs 1.1 bn, from Kshs 1.4 bn in Q3'2020 coupled with a 25.4% decline in interest expense from Deposits and placements with other banks to Kshs 0.1 bn, from Kshs 0.3 bn recorded in Q3'2020. Cost of funds declined to 4.6%, from 6.2% as recorded in Q3'2020 attributable to the faster 21.2% decline in interest expense, as compared to the 2.6% decline in average interest bearing liabilities. Net Interest Margin (NIM) declined to 3.9% from the 4.2% recorded in Q3'2020, due to a 14.8% decrease in trailing Net Interest Income (NII), compared to a 7.4% decline in the average interest-earning assets,
- Non-Funded Income increased by 12.2% to Kshs 0.5 bn, from Kshs 0.4 bn in Q3'2020 following a 88.5% increase in fees and commissions from loans to Kshs 98.2 mn, from Kshs 52.1 mn, and a 30.8% increase in Forex trading income to Kshs 72.3 mn, from Kshs 55.3 mn in Q3'2020. This increase was weighed down by a 14.7% decline in other income to Kshs 128.8 mn in Q3'2021, from Kshs 151.1 mn in Q3'2020. Total fees and commissions increased by 27.5% to Kshs 255.3 mn, from Kshs 197.8 mn in Q3'2020 attributable to expiry of the waiver on mobile banking fees. Consequently, the revenue mix shifted to 75:25 from 80:20 in Q3'2020, funded to non-funded income, owing to the 12.2% increase in Non-Funded Income coupled with the 14.8% decline in the net Interest Income,
- Total Operating Expenses declined by 12.5% to Kshs 2.4 bn in Q3'2021, from Kshs 2.7 bn in Q3'2020, mainly attributable to a 61.5% decline in Loans Loss Provisions (LLPs) to Kshs 0.2 bn in Q3'2021, from Kshs 0.4 bn recorded in Q3'2020, attributable to the reduced credit risk on the back of increased business activity in 2021 following gradual economic recovery. Staff costs on the other hand increased by 1.8% to Kshs 0.9 bn in Q3'2021, from Kshs 0.8 bn in Q3'2020,
- Cost to Income Ratio (CIR) improved to 128.6%, from 133.2% in Q3'2020, attributable to the 5.7% decline in other operating expenses to Kshs 1.3 bn in Q3'2021, from Kshs 1.4 bn recorded in Q3'2020. Without LLP, the cost to income ratio deteriorated to 119.4%, from 111.4% in Q3'2020, an indication of reduced efficiency, and,
- HF Group recorded a loss before tax of Kshs 527.2 mn, a 27.6% decline from a loss before tax of Kshs 728.0 mn in Q3'2020. The Group's Loss after Tax increased to Kshs 569.9 mn in Q3'2021, from the Kshs 730.2 mn loss recorded in Q3'2020.

Balance Sheet

- The balance sheet recorded a contraction as Total Assets decreased by 5.3% to Kshs 52.2 bn in Q3'2021, from Kshs 55.1 bn recorded in Q3'2020. This is attributable to a 7.9% decline in the loan book to Kshs 34.6 bn, from Kshs 37.6 bn recorded in Q3'2020, coupled with a 9.5% decline in Government securities to Kshs 5.4 bn in Q3'2021, from Kshs 6.0 bn in Q3'2020. This contraction in the loan book and Government securities were however mitigated by a 84.8% increase in placements to Kshs 1.7 bn in Q3'2021, from Kshs 0.9 bn in Q3'2020,
- Total liabilities decreased by 3.0% to Kshs 44.2 bn in Q3'2021, from Kshs 45.6 bn in Q3'2020, driven by a 12.1% decline in borrowings to Kshs 4.7 bn, from Kshs 5.3 bn in Q3'2020, and a 1.3% decline in customer deposits to Kshs 37.5 bn in Q3'2021, from Kshs 38.0 bn in Q3'2020. Deposits per branch decreased by 1.3% to Kshs 1.71 bn, from Kshs 1.73 bn in Q3'2020, with the number of branches remaining unchanged at 22,
- The 7.9% decline in loans, which declined faster than the 1.8% decrease in deposits led to a decline in the loan to deposit ratio to 92.2%, from 98.8% in Q3'2020,
- Gross non-performing loans (NPLs) declined by 20.0% to Kshs 9.0 bn, from Kshs 11.2 bn recorded in Q3'2020. Consequently, the NPL ratio improved to 22.0% from the 25.4% recorded in Q3'2020, following the faster 20.0% decline in NPLs that outpaced the 7.5% decline in gross loans which came in at Kshs 40.8 bn in Q3'2021, from Kshs 44.1 bn recorded in Q3'2020. General loan loss provisions increased by 6.2% to Kshs 3.4 bn in Q3'2021, from Kshs 3.2 bn in Q3'2020. The NPL coverage thus improved to 68.9% in Q3'2021, from 58.2% in Q3'2020 owing to the 6.2% increase in general loan loss provisions coupled with the 20.0% decline in gross NPLs,
- Shareholders' funds declined by 16.3% to Kshs 8.0 bn in Q3'2021 from Kshs 9.6 bn in Q3'2020, attributable to the accumulated loss of Kshs 2.6 bn seen in Q3'2021, compared to the accumulated loss of Kshs 1.2 bn, recorded in Q3'2020,
- HF Group remains undercapitalized with a core capital to risk-weighted assets ratio of 9.5%, 1.0% points below the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio came in at 13.3%, below the statutory requirement by 1.2% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 9.6%, while total capital to risk-weighted assets came in at 13.4%, and,
- The bank currently has a Return on Average Assets (ROaA) of (2.9%), and a Return on Average Equity (ROaE) of (19.0%).

Key Take-Outs:

1. The bank experienced an improvement in asset quality as the NPL ratio improved by 3.4% points to 22.0%, from the 25.4% recorded in Q3'2020, following the faster 20.0% decline in NPLs that outpaced the 7.5% decline in gross loans which came in at Kshs 40.8 bn in Q3'2021, from Kshs 44.1 bn recorded in Q3'2020. Despite the improved asset quality during the period, HF Group's NPL ratio is still higher than the sectors average of 13.6% as at the end of September 2021, an indication that the group needs to improve its credit assessment in order to bring down this high NPL Ratio,
2. HF Group's total Operating Expenses declined by 12.5% to Kshs 2.4 bn in Q3'2021, from Kshs 2.7 bn in Q3'2020, mainly attributable to a 61.5% decline in Loans Loss Provisions (LLPs) to Kshs 0.2 bn in Q3'2021, from Kshs 0.4 bn recorded in Q3'2020, attributable to the reduced credit risk on the back of increased business activity in 2021 following gradual economic recovery in the country,
3. Cost to Income Ratio (CIR) improved to 128.6%, from 133.2% in Q3'2020, attributable to the 5.7% decline in other operating expenses to Kshs 1.3 bn in Q3'2021, from Kshs 1.4 bn recorded in Q3'2020.

Without LLP, the cost to income ratio deteriorated to 119.4%, from 111.4% in Q3'2020, an indication of reduced efficiency, and,

4. The bank recorded a contraction in its balance sheet as total assets declined by 6.2% to Kshs 53.0 bn, from Kshs 56.5 bn in Q3'2020, attributable to a 7.5% decline in the loan book to Kshs 35.3 bn, from Kshs 38.2 bn recorded in Q3'2020.

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 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 3.0, representing a downside of 30.0%, from the current price of Kshs 4.3 as of 26th November 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 (56.1x) as compared to an industry average of (26.2x).