Housing Finance Earnings Update – Q3'2016
22nd November 2016

Valuation Summary

- We recommend a Buy for Housing Finance Group stock with a target price of Kshs 19.8 representing an upside of 44.4%, from the current price of Kshs 14.7, as at 22nd November 2016, inclusive of a dividend yield of 9.2%
- Housing Finance is currently trading at a P/B of 0.5x versus an industry average of 1.0x, and a P/E of 4.3x versus an industry average of 5.6x

Key highlights during the quarter

- HF Group, through its property and investments subsidiary, HF Development and Investment (HFDI), completed the construction of K-Mall and handed over space to key tenants including Tuskys Supermarkets, the Aga Khan University Hospital, among a host of other tenants. K-Mall is designed to provide for the retail needs of Eastlands residents
- HFDI also commenced the construction of Richland Pointe housing development in Kamiti, and is ground-breaking for the construction of 1,520 housing units at Clay City along Thika Super Highway

Income Statement

- Core earnings per share rose by 7.8% to Kshs 3.20 from Kshs 2.98 in Q3'2015 driven by a 21.0% growth in Operating revenue, despite being outpaced by Operating expenses which grew 25.7% y/y
- Total Operating revenue grew by 21.0% to Kshs 3.8 bn from Kshs 3.1 bn registered in Q3'2015, faster than our estimate of 8.3%. This was supported by a 14.2% growth in Net Interest Income (NII) and 67.1% growth in Non-Funded Income (NFI)
- Interest Income grew by 14.6% to Kshs 6.7 bn from Kshs 5.8 bn in Q3'2015, slower than Interest expense which grew by 15.0% to Kshs 3.6 bn from Kshs 3.1 bn in Q3'2015. This led to Net Interest Margin increasing to 6.4% from 6.1% in Q3'2015
- Non-Funded Income grew by 67.1% to Kshs 0.7 bn from Kshs 0.4 bn recorded in Q3'2015, against our expectation of a 3.5% growth. The growth in NFI was driven by an increase in other income, which recorded a 223.2% growth to Kshs 0.4 bn from Kshs 0.1 bn in Q3'2015, attributed to property sales which is an indication of increased uptake in the group's Real Estate projects. The revenue mix currently stands at 82:18, NII to NFI, from 87:13 in Q3'2015
- Total Operating expenses grew by 25.7% to Kshs 2.6 bn from Kshs 2.0 bn in Q3'2015. The growth in operating expenses was driven by a 16.7% rise in Loan Loss Provision (LLP) to Kshs 0.5 bn from Kshs 0.4 bn registered in Q3'2015 and other expenses, which rose 20.9% to Kshs 0.9 bn from Kshs 0.7 bn in Q3'2015. Without LLP, operating expenses grew by 28.1% to Kshs 2.1 bn from Kshs 1.6 bn in Q3'2015. Staff costs grew 8.0% to Kshs 843.7 mn from Kshs 781.5 mn in Q3'2015.
- The cost to income ratio increased to 68.1% from 65.6% registered in Q3'2015. Without LLP, cost to income ratio stood at 55.0% from 52.0% in the same period last year
- Profit after tax rose 7.8% y/y to Kshs 0.84 bn from Kshs 0.78 bn against our expectation of a 20.3% growth

Balance Sheet

- The balance sheet recorded an expansion in Q3'2016 with total assets rising by 10.5% to Kshs 73.5 bn from Kshs 66.5 bn in Q3'2015. The growth in total assets was driven by a 4.3% growth in the loan book and a 306.2% increase on investments in government securities. The bank's loan book stood at Kshs 53.9 bn from Kshs 51.7 bn in Q3'2015, while investment in government securities came in at Kshs 5.6 bn from Kshs 1.4 bn registered in Q3'2015 as the group looked to take advantage of the improved yields on government papers and build a sinking fund towards liquidation of the first tranche of its corporate bond expected in October 2017
- Total liabilities increased by 10.7% to Kshs 62.2 bn from Kshs 56.2 bn in Q3'2015 compared to our projection of a 11.3% growth, while shareholders' funds increased by 9.0% to Kshs 11.2 bn from Kshs 10.3 bn compared to our expectation of a 15.8% increase
- Customer deposits grew 10.8% to Kshs 41.6 bn from Kshs 37.6 bn registered in Q3'2015 attributed to growth in the number of retail outlets by the group's banking and mortgage lending subsidiary HFC, as part of the group's aggressive expansion strategy. This resulted in the loans to deposit ratio decreasing to 129.6% from 137.6% in Q3'2015, which is quite high compared to the industry average of 86.1%, and our preferred range of 80%-90%
- The yield on interest earning assets decreased to 10.5% from 14.0% in Q3'2015 with the cost of funds declining to 5.8% from 7.7% in Q3'2015
- Gross non-performing loans (NPLs) grew by 36.2% to Kshs 5.5 bn from Kshs 4.1 bn registered in Q3'2015, which led to an increase in the NPL to total loans ratio to 9.9% from 7.7% in Q3'2015

- Housing Finance Group is currently sufficiently capitalized with a core capital to risk weighted assets ratio at 14.9%, 4.4% above the statutory requirement with total capital to total risk weighted assets exceeding the statutory requirement by 2.5% to close the period at 17.0%. The Return on Average Equity (ROaE) decreased to 9.8% from 12.6% in Q3’2015 against our expectations of 10.4%, with the Return on Average Assets (ROaA) decreasing to 1.5% from 1.7% in Q3’2015 against our expectations of 1.6%

Going forward, Housing Finance Group’s growth will be propelled by:

i. The group’s property and investments subsidiary, HFDI, which is in line to launch Clay City, a Kshs 5 bn development that will put up 1,520 apartments along Thika Road in a joint venture strategy with Clay Works Limited
ii. The group is at an advanced stage of launching a number of new insurance products that will be housed by HFIA, the insurance subsidiary
iii. The group is planning to expand its banking channels and launch more innovative products as it seeks to make further inroads in the banking sector as evidenced by the growth in the number of retail outlets by the Group’s banking and mortgage lending subsidiary HFC

Below is a summary of the key line items in the balance sheet and income statement

Figures in Kshs millions unless otherwise stated

Balance Sheet	Q3'2015	Q3'2016	y/y change	Q3'2016e	Projected y/y change	Variance in growth vs projection
Net Loans	51.7	53.9	4.3%	55.1	6.6%	(2.3%)
Total Assets	**66.5**	**73.5**	**10.5%**	**74.5**	**12.0%**	**(1.5%)**
Deposits	37.6	41.6	10.8%	41.7	11.1%	(0.3%)
Borrowings	17.8	18.5	3.8%	18.1	1.4%	2.3%
Total liabilities	**56.2**	**62.2**	**10.7%**	**62.6**	**11.3%**	**(0.6%)**
Shareholders' Funds	**10.3**	**11.2**	**9.0%**	**11.9**	**15.8%**	**(6.8%)**

Income Statement	Q3'2015	Q3'2016	y/y change	Q3'2016e	Projected y/y change	Variance in growth vs projection
Net interest Income	2.7	3.1	14.2%	3.0	9.0%	5.3%
Net non-interest income	0.4	0.7	67.1%	0.4	3.5%	63.7%
Total Operating income	**3.1**	**3.8**	**21.0%**	**3.4**	**8.3%**	**12.8%**
Loan loss provision	(0.4)	(0.5)	16.7%	(0.3)	(36.0%)	52.7%
Total Operating expenses	**(2.0)**	**(2.6)**	**25.7%**	**(2.0)**	**(0.2%)**	**25.9%**
Profit before tax	**1.1**	**1.2**	**10.0%**	**1.3**	**21.2%**	**(11.2%)**
Profit after tax	**0.8**	**0.8**	**7.8%**	**0.9**	**20.3%**	**(12.6%)**

Key Ratios	Q3'2015	Q3'2016	y/y change
Loan to Deposit ratio	137.6%	129.6%	(8.1%)
Return on average equity	12.6%	9.8%	(2.8%)
Return on average assets	1.7%	1.5%	(0.2%)
Cost of funding	7.7%	5.8%	(2.0%)
Net Interest Margin	6.1%	6.4%	0.3%
Yield from interest-earning assets	14.0%	10.5%	(3.5%)
Cost to Income	65.6%	68.1%	2.5%

Capital Adequacy Ratios	Q3'2015	Q3'2016

Core Capital/Total Liabilities	20.7%	19.2%
Minimum Statutory ratio	8.0%	8.0%
Excess	**12.7%**	**11.2%**
Core Capital/Total Risk Weighted Assets	15.8%	14.9%
Minimum Statutory ratio	10.5%	10.5%
Excess	**5.3%**	**4.4%**
Total Capital/Total Risk Weighted Assets	18.6%	17.0%
Minimum Statutory ratio	14.5%	14.5%
Excess	**4.1%**	**2.5%**
Liquidity Ratio	24.2%	23.8%
Minimum Statutory ratio	20.0%	20.0%
Excess	**4.2%**	**3.8%**