Cytonn INVESTMENTS

HF Group PLC– H1’2023
31st August, 2023

Below is a summary of HF Group H1’2023 performance:

Balance Sheet	H1'2022	H1'2023	y/y change
Net Loans and Advances	34.9	38.1	9.1%
Government Securities	9.2	9.8	6.3%
Total Assets	55.7	60.7	8.9%
Customer Deposits	39.1	40.7	4.0%
Deposits Per Branch	1.8	1.8	4.0%
Total Liabilities	46.8	51.9	10.8%
Shareholders' Funds	8.0	8.9	11.4%

Key Ratios	H1'2022	H1'2023	% point change
Loan to Deposit ratio	89.2%	93.5%	4.3%
Government Securities to Deposit ratio	23.6%	24.1%	0.5%
Return on average equity	(3.5%)	4.7%	8.3%
Return on average assets	(0.5%)	0.7%	1.2%

Income Statement	H1'2022	H1'2023	y/y change
Net interest Income	1.0	1.3	24.2%
Net non-interest income	0.50	0.55	10.1%
Total Operating income	**1.5**	**1.8**	**19.6%**
Loan loss provision	(0.1)	(0.2)	55.0%
Total Operating expenses	(1.5)	(1.6)	11.0%
Profit before tax	0.1	0.2	240.4%
Profit after tax	**0.1**	**0.2**	**264.8%**
Core EPS	**0.1**	**0.5**	**264.8%**

Income Statement Ratios	H1'2022	H1'2023	% point change
Yield from interest-earning assets	9.3%	10.0%	0.7%
Cost of funding	4.8%	4.9%	0.1%
Net Interest Margin	4.5%	5.2%	0.7%
Net Interest Income as % of operating income	67.3%	69.9%	2.6%
Non-Funded Income as a % of operating income	32.7%	30.1%	(2.6%)
Cost to Income Ratio	95.9%	89.0%	(6.9%)
CIR without LLP	89.2%	80.3%	(8.9%)

Capital Adequacy Ratios	H1'2022	H1'2023	% points change
Core Capital/Total Liabilities	7.8%	6.0%	(1.8%)
Minimum Statutory ratio	8.0%	8.0%	
Excess	**(0.2%)**	**(2.0%)**	**(1.8%)**
Core Capital/Total Risk Weighted Assets	8.1%	6.4%	(1.7%)
Minimum Statutory ratio	10.5%	10.5%	
Excess	**(2.4%)**	**(4.1%)**	**(1.7%)**
Total Capital/Total Risk Weighted Assets	12.0%	10.2%	(1.8%)
Minimum Statutory ratio	14.5%	14.5%	
Excess	**(2.5%)**	**(4.3%)**	**(1.8%)**
Liquidity Ratio	26.0%	21.0%	(5.0%)
Minimum Statutory ratio	20.0%	20.0%	
Excess	**6.0%**	**1.0%**	(5.0%)

Income Statement

- Core earnings per share grew by 264.8% to Kshs 0.5, from Kshs 0.1 in H1’2022, driven by the 19.6% growth in total operating income to Kshs 1.8 bn, from Kshs 1.5 bn in H1’2022. However, the performance was weighed down by a 11.0% growth in total operating expenses to Kshs 1.6 bn from Kshs 1.5 bn in H1’2022,
- The 19.6% growth in total operating income was mainly driven by a 24.2% growth in Net Interest Income to Kshs 1.3 bn from Kshs 1.0 bn in H1’2022, coupled with a 10.1% growth in Non Interest Income (NFI) to Kshs 0.6 bn, from Kshs 0.5 bn in H1’2022,
- Interest income grew by 18.5% to Kshs 2.5 bn from Kshs 2.1 bn in H1’2022, mainly driven by a 15.7% growth in interest income from loans and advances to Kshs 1.9 bn from Kshs 1.6 bn in H1’2022. As such, the Yield on Interest-Earning Assets (YIEA) increased to 10.0% from 9.3% recorded in H1’2022, mainly attributable to the faster 18.5% growth in interest income compared to a 8.0% increase in average interest earning assets to Kshs 46.6 bn, from Kshs 43.2 bn in H1’2022,
- Interest expenses rose by 13.0% to Kshs 1.2 bn from Kshs 1.0 bn in H1’2022, driven by 77.6% increase in interest expense on other interest expenses to Kshs 352.7 mn from Kshs 198.6 mn in H1’2022, coupled with a 43.7% increase in interest expense from deposits and placements to Kshs 83.9 mn in H1’2023 from Kshs 120.6 mn recorded in H1’2022. The increase was however weighed down by a 7.2% decrease in interest expense from customer deposits to Kshs 709.7 mn , from 764.7 mn in H1’2022. Consequently, Cost of funds (COF) increased to 4.9% from 4.8% recorded in H1’2022, owing to a faster 7.9% increase in Trailing interest expense to Kshs 2.2 bn from Kshs 2.1 bn recorded in H1’2022, compared to a 4.4% increase in average interest bearing liabilities to Kshs 45.7 bn from Kshs 43.8 bn in H1’2022.Trailing interest expense refers to the performance of the interest expense for the past 12 consecutive months. Net Interest Margin (NIM) increased by 0.7% points to 5.2% from 4.5% in H1’2022, attributable to a 24.6% increase in trailing net interest income to Kshs 2.4 bn from Kshs 1.9bn recorded in H1’2022 which outpaced the 8.0% growth in average interest earning assets,
- Non-Funded Income (NFI) increased by 10.1% to Kshs 548.1 mn from Kshs 498.0 mn in H1’2022, mainly driven by a 51.1% increase in total fees and commissions income to Kshs 228.5 mn from Kshs 151.2 mn in H1’2022,coupled with a 13.5% increase in forex trading income to Kshs 82.7 mn, from 72.9 mn in H1’2022. The revenue mix shifted to 70:30 from 67:33 for the funded to Non-funded income owing to the 24.2% growth in Funded Income which outpaced 10.1% growth in the Non Funded Income,
- Total operating expenses increased by 11.0% to Kshs 1.6 bn from Kshs 1.5 bn in H1’2022, driven by 18.6% increase in staff costs to Kshs 743.0 mn from Kshs 626.6 mn recorded in H1’2022, and coupled with a 55.0% increase in loan loss provision to Kshs 159.0 mn from Kshs 102.6 mn in H1’2022. The increase in provisioning is partly attributable to rising credit risk as a result deteriorioted economic environment as evidenced by the average Purchasing Managers Index (PMI) of 48.7 in H1’2023, down from an average of 49.3 in H1’2022,
- Cost to Income Ratio (CIR) decreased to 89.0% from 95.9% in H1’2022, owing to the 19.6% increase in total operating income, which outpaced the 11.0% increase in total operating expense. Notably, CIR without LLP decreased by 8.9% points to 80.3% from 89.2% recorded in H1’2022, and,
- Profit before tax increased by 240.4% to Kshs 199.7 mn from Kshs 58.7 mn in H1’2022, with effective tax rate decreasing to 8.9% in H1’2023 from 15.0% in H1’2022, leading to a 264.8% increase in profit after tax to Kshs 182.0 mn in H1’2023, from Kshs 49.9 mn in H1’2022.

Balance Sheet

- The balance sheet recorded an expansion as total assets grew by 8.9% to Kshs 60.7 bn, from Kshs 55.7 bn in H1’2022, driven by a 9.1% loan book expansion to Kshs 38.1 bn, from Kshs 34.9 bn in H1’2022, coupled with a 6.3% increase investment in government securities to Kshs 9.8 bn from Kshs 9.2 bn in H1’2022,
- Total liabilities rose by 10.8% to Kshs 51.9 bn from Kshs 46.8 bn in H1’2022, driven by a 4.0% growth in customer deposits to Kshs 40.7 bn, from Kshs 39.1 bn in H1’2022, coupled with a 159.0% increase in placements by banking institutions to 2.0 bn from Kshs 0.8 bn recorded in H1’2022. This growth outpaced the 12.3% decrease in

borrowings to Kshs 4.2 bn, from Kshs 4.7 bn in H1’2022. With 22 branches countrywide over the period under review, deposits per branch remained relatively unchanged at Kshs 1.8 bn, for the two periods under review,

- The faster 9.1% growth in loans as compared to the 4.0% growth in deposit led to an increase in the loan to deposits ratio to 93.5%, from 89.2% in H1’2022,
- The bank’s Asset Quality deteriorated, with Gross NPL ratio increasing to 23.1% in H1’2023 from 20.1% in H1’2022, attributable to the faster growth of 26.6% in Gross non-performing loans to Kshs 10.5 bn, from Kshs 8.3 bn in H1’2022, which outpaced the 10.4% increase in gross loans to Kshs 45.6 bn, from Kshs 41.3 bn recorded in H1’2022,
- General Provisions (LLP) increased by 21.2% to Kshs 4.5 bn in H1’2023 from Kshs 3.7 bn in H1’2022. The NPL coverage decreased to 72.0% in H1’2023, from 77.6% in H1’2022, attributable to the 26.6% increase in gross non performing loans, which outpaced the collective 21.2% increase in provisions and the 12.4% increase in interest in suspense to Kshs 3.1 bn, from Kshs 2.7 bn in H1’2022
- Shareholders’ funds increased by 11.4% to Kshs 8.9 bn in H1’2023, from Kshs 8.0 bn in H1’2022, supported by a 27.2% increase in statutory loan loss reserves to Kshs 4.5 bn, from 3.5 bn. Accumulated losses increased to Kshs 3.0 bn, from Kshs 2.8 bn in H1’2022,
- HF Group remains under-capitalized with a core capital to risk-weighted assets ratio of 6.4%, 4.1% points below the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio came in at 10.2%, 4.3% points below the statutory requirement of 14.5%, and,
- The bank currently has a Return on Average Assets (ROaA) of 0.7%, and a Return on Average Equity (ROaE) of 4.7%.

Key Take-Outs:

1. **Strong earnings growth -** Core earnings per share (EPS) grew by 264.8% to Kshs 0.5, from Kshs 0.1 in H1’2022, driven by the 19.6% growth in total operating income to Kshs 1.8 bn, from Kshs 1.5 bn in H1’2022.
2. **Asset quality deterioration –** The bank’s gross NPL ratio increased to 23.1% in H1’2023 from 20.1% in H1’2022, attributable to the faster growth of 26.6% in Gross non-performing loans to Kshs 10.5 bn, from Kshs 8.3 bn in H1’2022, which outpaced the 10.4% increase in gross loans to Kshs 45.6 bn, from Kshs 41.3 bn recorded in H1’2022,

Going forward, the factors that would drive the bank’s growth would be:

- **Portfolio Diversification**. The lender remains undercapitalized with core capital ratios below the statutory requirements. As such, it can expand its client base to cover more financial interests of the economy like commercial banking, insurance as well as as get a good grounding in capitalizing on its strengths, that is, mortgage and real estate financing.

Valuation Summary

- We are of the view that HF Group is a “Accumulate” with a target price of Kshs 5.4 representing an upside of 19.9%, from the current price of 4.5 as of 1st September 2023,
- HF Group is currently trading at a P/TBV of 0.2x and a P/E of 6.6x vs an industry average of 0.8x and 3.5x respectively.