

Below is a summary of HF Group Q3'2023 performance:

Balance Sheet Items (Kshs bn)	Q3'2022	Q3'2023	y/y change
Net loans	35.2	38.5	9.3%
Government Securities	8.2	9.0	10.9%
<b>Total Assets</b>	<b>55.1</b>	<b>60.7</b>	<b>10.1%</b>
Customer Deposits	38.8	43.8	12.9%
Deposits Per Branch	1.8	1.7	(4.5%)
Total Liabilities	47.2	52.0	10.2%
<b>Shareholder's Funds</b>	<b>7.9</b>	<b>8.7</b>	<b>9.6%</b>

Balance Sheet Ratios	Q3'2022	Q3'2023	% y/y change
Loan to deposit ratio	90.7%	87.8%	(2.9%)
Government Securities to deposit ratio	21.0%	20.6%	(0.4%)
Return on Average Equity	(0.6%)	5.3%	5.9%
Return on Average Assets	(0.1%)	0.8%	0.9%

Income Statement (Kshs bn)	Q3'2022	Q3'2023	y/y change
Net Interest Income	1.6	1.9	21.4%
Net non-Interest Income	0.75	0.91	20.6%
<b>Total Operating income</b>	<b>2.3</b>	<b>2.8</b>	<b>21.1%</b>
Loan Loss provision	(0.1)	(0.2)	60.2%
Total Operating expenses	(2.2)	(2.6)	13.6%
Profit before tax	0.1	0.3	256.2%
<b>Profit after tax</b>	<b>0.06</b>	<b>0.24</b>	<b>283.9%</b>
<b>Core EPS</b>	<b>0.2</b>	<b>0.6</b>	<b>283.9%</b>

Income Statement Ratios	Q3'2022	Q3'2023	y/y change
Yield from interest-earning assets	9.7%	10.6%	0.9%
Cost of funding	4.9%	5.3%	0.4%
Net Interest Spread	4.8%	5.3%	0.6%
Net Interest Margin	4.7%	5.4%	0.7%
Cost of Risk	6.4%	8.4%	2.1%
Net Interest Income as % of operating income	67.6%	67.8%	0.1%
Non-Funded Income as a % of operating income	32.4%	32.2%	(0.1%)
Cost to Income Ratio	96.7%	90.7%	(6.0%)

Capital Adequacy Ratios	Q3'2022	Q3'2023	% points change
Core Capital/Total Liabilities	7.8%	5.1%	(2.7%)
Minimum Statutory ratio	8.0%	8.0%	0.0%
<b>Excess</b>	<b>(0.2%)</b>	<b>(2.9%)</b>	<b>(2.7%)</b>
Core Capital/Total Risk Weighted Assets	8.2%	5.8%	(2.4%)
Minimum Statutory ratio	10.5%	10.5%	0.0%
<b>Excess</b>	<b>(2.4%)</b>	<b>(4.7%)</b>	<b>(2.4%)</b>
Total Capital/Total Risk Weighted Assets	12.2%	9.6%	(2.6%)
Minimum Statutory ratio	14.5%	14.5%	0.0%
<b>Excess</b>	<b>(2.3%)</b>	<b>(4.9%)</b>	<b>(2.6%)</b>
Liquidity Ratio	23.5%	25.1%	1.6%
Minimum Statutory ratio	20.0%	20.0%	0.0%
<b>Excess</b>	<b>3.5%</b>	<b>5.1%</b>	<b>1.6%</b>

### Income Statement

- Core earnings per share increased by 283.9% to Kshs 0.6 bn from Kshs 0.2 in Q3'2022, mainly driven by the 21.1% growth in total operating income to Kshs 2.8 bn, from Kshs 2.3 bn in Q3'2022. However, the performance was weighed down by a 13.6% growth in total operating expenses to Kshs 2.6 bn, from Kshs 2.2 bn in Q3'2022,
- The 21.1% growth in total operating income was mainly driven by a 21.4% growth in Net Interest Income to Kshs 1.9 bn, from Kshs 1.6 bn in Q3'2022, coupled with a 20.6% growth in Non funded Income (NFI) to Kshs 0.9 bn, from Kshs 0.8 bn in Q3'2022,
- Interest income grew by 20.3% to Kshs 3.8 bn from Kshs 3.2 bn in Q3'2022, mainly driven by a 19.8% growth in interest income from loans and advances to Kshs 2.9 bn from Kshs 2.5 bn in Q3'2022. As such, the Yield on Interest-Earning Assets (YIEA) increased to 10.6% from 9.7% recorded in Q3'2022, mainly attributable to the faster 20.3% growth in interest income compared to a 8.6% increase in average interest earning assets to Kshs 46.3 bn, from Kshs 42.6 bn in Q3'2022,
- Interest expense increased by 19.1% to Kshs 1.9 bn in Q3'2023 from Kshs 1.6 bn in Q3'2022, largely due to a 21.7% increase in interest expense on customer deposits to Kshs 1.4 bn from Kshs 1.2 bn in Q3'2022, coupled with 47.8% increase in interest expenses on placements to Kshs 0.2 bn from Kshs 0.1 bn in Q3'2022. Consequently, Cost of funds (COF) increased by 0.4% points to 5.3% from 4.9% recorded in Q3'2022, owing to a faster 14.6% increase in Trailing interest expense to Kshs 2.4 bn, from Kshs 2.1 bn recorded in Q3'2022, compared to a 6.7% increase in average interest bearing liabilities to Kshs 45.9 bn from Kshs 43.0 bn in Q3'2022. 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 to 5.4% from 4.7% in Q3'2022, attributable to the faster 23.6% increase in trailing Net Interest Income (NII) to Kshs 2.5 bn from Kshs 2.0 bn in Q3'2022 relative to the 8.6% increase in average interest earning assets to Kshs 46.3 bn, from Kshs 42.6 bn in Q3'2022,
- Non-Funded Income (NFI) increased by 20.6% to Kshs 0.9 bn from Kshs 0.8 bn in Q3'2022, mainly driven by a 17.9% increase in the foreign exchange trading income to Kshs 0.12 bn from Kshs 0.10 bn in Q3'2022, highlighting the bank's increased foreign exchange margins. Total fees and commissions increased by 38.5% to Kshs 0.3 bn, from Kshs 0.2 bn in Q3'2022. The revenue mix remained unchanged at 68:32 for the Funded to Non-funded income owing to the fairly close increase margins of 21.4% and 20.6% For funded and Non Funded income respectively,
- Total operating expenses increased by 13.6% to Kshs 2.6 bn from Kshs 2.2 bn in Q3'2022, driven by 60.2% increase in loan loss provisions to Kshs 0.2 bn from Kshs 0.1 bn recorded in Q3'2022, coupled with a 21.7% increase in staff costs to Kshs 1.2 bn from Kshs 1.0 bn in Q3'2022. The increase in provisioning is partly attributable to rising credit risk as a result deteriorated economic environment as evidenced by the average Purchasing Managers Index (PMI) of 48.0 in Q3'2023 which was below the 50.0 points, despite the slight improvement from an average of 47.4 in Q3'2022,
- Cost to Income Ratio (CIR) decreased to 90.7% from 96.7% in Q3'2022, owing to the 21.1% increase in total operating income, which outpaced the 13.6% increase in total operating expenses. Notably, CIR without LLP decreased by 8.0% points to 82.3% from 90.3% recorded in Q3'2022, and,
- Profit before tax increased by 256.2% to Kshs 0.3 bn from Kshs 0.1 bn in Q3'2022, with effective tax rate declining to 10.1% in Q3'2023 from 16.6% in Q3'2022. As such, profit after tax increased by 283.9% to Kshs 0.2 bn in Q3'2023, from Kshs 0.1 bn in Q3'2022.

### Balance Sheet

- The balance sheet recorded an expansion as total assets increased by 10.1% to Kshs 60.7 bn, from Kshs 55.1 bn in Q3'2022, mainly attributable to the 9.3% growth in net loans and advances to Kshs 38.5 bn in Q3'2023 from

Kshs 35.2 bn in Q3'2022, coupled with 459.3% increase in placements to Kshs 1.5 bn, from Kshs 0.3 bn recorded in Q3'2022

- Total liabilities grew by 10.2% to Kshs 52.0 bn, from Kshs 47.2 bn in Q3'2022, largely attributable to a 12.9% growth in customer deposits to Kshs 43.8 bn in Q3'2023, from Kshs 38.8 bn in Q3'2022, coupled with a 6.3% growth in placements to Kshs 0.19 bn from Kshs 0.18 bn recorded in Q3'2022.
- The faster 12.9% growth in customer deposits as compared to the 9.3% growth in loans led to an increase in the loan to deposits ratio to 87.8%, from 90.7% in Q3'2022,
- Gross Non-Performing Loans (NPLs) increased by 24.9% to Kshs 10.6 bn in Q3'2023 from Kshs 8.5 bn in Q3'2022, while Gross Loans increased by 10.9% to Kshs 46.3 bn from Kshs 41.7 bn in Q3'2022. Consequently, the asset quality deteriorated with the NPL ratio rising to 22.8% in Q3'2023 from 20.3% in Q3'2022,
- General Provisions (LLP) increased by 23.9% to Kshs 4.7 bn in Q3'2023 from Kshs 3.8 bn in Q3'2022. The NPL coverage decreased to 74.0% in Q3'2023, from 77.2% in Q3'2022, attributable to the 23.9% increase in provisions coupled with 13.9% increase in interest in suspense to Kshs 3.2 bn from 2.8 bn recorded in Q3'2022, which offset the 24.9% increase in gross non-performing loans,
- Shareholders' funds increased by 9.6% to Kshs 8.7 bn in Q3'2023, from Kshs 7.9 bn in Q3'2022, supported by a 29.8% increase in statutory loan loss reserves to Kshs 4.6 bn, from 3.6 bn. Notably, accumulated losses increased to Kshs 3.1 bn, from Kshs 2.8 bn in Q1'2022,
- HF Group remained under-capitalized with a core capital to risk-weighted assets ratio of 5.8%, 4.7% points below the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio came in at 9.6%, 4.9% points below the statutory requirement of 14.5% by 4.7%. and,
- The bank currently has a Return on Average Assets (ROaA) of 0.8%, and a Return on Average Equity (ROaE) of 5.3%.

#### **Key Take-Outs:**

1. **Strong earnings growth** - Core earnings per share (EPS) grew by 283.9% to Kshs 0.6, from Kshs 0.2 in Q3'2022, mainly driven by the 21.1% growth in total operating income to Kshs 2.8 bn, from Kshs 2.3 bn in Q3'2022.
2. **Asset quality deterioration** – The bank's gross NPL ratio increased to 22.8% in Q3'2023 from 20.3% in Q3'2022, attributable to the faster growth of 24.9% in Gross non-performing loans to Kshs 10.6 bn, from Kshs 8.5 bn in Q3'2022, which outpaced the 10.9% increase in gross loans to Kshs 46.3 bn, from Kshs 41.7 bn recorded in Q3'2022,
3. **Sustained Efficiency** – Cost to Income Ratio (CIR) improved by 6.0% points to 90.7%, from 96.7% in Q3'2022, owing to the 21.1% increase in total operating income to Kshs 2.8 bn from Kshs 2.3 bn in Q3'2022, which outpaced the 13.6% increase in total operating expenses to Kshs 2.6 bn, from Kshs 2.2 bn in Q3'2022. Key to note, this is the third consecutive quarter in the current financial year that HF Group's total operating expenses have been lower than its total operating income, evidenced by a Cost to Income ratio of below 100.0%.

We commend HF Group's turnaround performance, recording an increase in profit after tax of 283.9% to Kshs 0.2 bn in Q3'2023, from Kshs 0.1 bn in Q3'2022. Despite the three consecutive quarters of profitability witnessed by the Group so far, HF Group faces a major downside with its capital adequacy ratios remaining below the minimum statutory requirements set for banks. The group will have to review its business model or merge with a bank with stronger capital ratios so as to overcome its undercapitalization. Additionally, 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 "Hold" with a target price of Kshs 4.2 representing an upside of 8.3%, from the current price of Kshs 3.9 as of 1<sup>st</sup> December 2023.
- HF Group is currently trading at a P/TBV of 0.2x and a P/E of 5.7x vs an industry average of 0.8x and 3.5x respectively.