Housing Finance Group Earnings Update – FY'2017

29th March, 2018

Valuation Summary

- We are of the view that Housing Finance Group stock is a "Lighten", with a target price of Kshs 11.7 representing an upside of 3.4%, from the current price of Kshs 11.7, as at 29th March, inclusive of a dividend yield of 3%,
- HF is currently trading at a P/TBV of 0.4x and a P/E of 32.5x, vs an industry average of 1.4x and 8.8x, respectively.

Key highlights during FY'2017

- During the year, HF Group secured a Kshs 1.5 Bn line of credit with the Arab Bank for Economic Development in Africa aimed for lending to the SME sector. The move is expected to complement their strategic initiative for lending to the SME and retail banking segments.

Income Statement

- Core earnings per share (EPS) declined by 86% to Kshs 0.4 from Kshs 2.6 in FY'2016, lower than our expectations for an EPS of Kshs 0.46. The decline in performance was driven by a 19% increase in operating expenses and a decline in operating income by 8%,
- Total operating income declined by 8% to Kshs 4.3 bn from Kshs 4.7 bn in FY'2016. The decline was driven by a 24.3% decline in Net Interest Income (NII) to Kshs 2.97 bn from Kshs 3.9 bn, despite a 78% growth in Non-Funded income to Kshs 1.3 bn from Kshs 0.8 bn in FY'2016,
- Total Interest Income declined by 17% to Kshs 7.1 bn from Kshs 8.6 bn in FY'2016, driven by a 37.6% decline in interest income on government securities to Kshs 0.3 bn from Kshs 0.5 bn. Interest income on loans and advances declined by 14.9% to Kshs 6.7 bn from Kshs 7.9 bn. As a result, the yield on interest-earning assets declined to 12.5% from 14.2% in FY'2016,
- Interest expense declined by 11% to Kshs 4.1 bn from Kshs 4.7 bn in FY'2016, following a 20.9% decline in interest expense on customer deposits to Kshs 2.3 bn from Kshs 2.9 bn in FY'2016. Cost of funds came in at 7.5%, a decline from 7.9% recorded in FY'2016. The Net Interest Margin declined to 5% from 7% in 2016,
- Non-Funded Income (NFI) recorded a growth of 78% to Kshs 1.3 bn from Kshs 0.8 bn in FY'2016. The growth in NFI was driven by an increase in other income that rose by 155.0% to Kshs 1.1 bn from Kshs 0.4 bn in FY'2016, despite a 13% decline in other fees and commissions to Kshs 0.1 bn from Kshs 0.2 bn in FY'2016. The revenue mix currently stands at 69:31 Funded to Non-Funded Income, compared to 84:16 in FY'16, owing to a decline in NII and an increase in NFI.
- Total operating expenses increased by 19.4% to Kshs 3.99 bn from Kshs 3.3 bn, driven by a 63.2% increase in other operating expenses to Kshs 1.9 bn from Kshs 1.1 bn in FY'2016. Staff costs rose 1.5% to Kshs 1.1 bn from Kshs 1.07 bn. Loan Loss Provisions (LLP) declined by 17.9% to Kshs 0.6 bn from Kshs 0.7 bn in FY'2016. Staff costs accounts for 27.28% of operating expenses while LLPs account for 14.5% of operating expenses,
- The Cost to Income ratio worsened to 92.3% from 71.3% in FY'2016, following the 19.4% increase in total operating expenses coupled with an 8% decline in total operating income. Without LLP, the Cost to Income ratio also deteriorated to 78.9% from 56.4% in FY'2016,
- Profit before tax declined by 77.2% to Kshs 0.3 bn from Kshs 1.4 bn, while profit after tax decreased by 86.1% to Kshs 0.1 bn from Kshs 0.9 bn in FY'2016. The effective tax rate increased to 59.5% from 33.7% in FY'2016,
- The Board recommended a final dividend of Kshs 0.35 per share, translating to a dividend yield of 3%.

Balance Sheet

- The balance sheet recorded a contraction in FY'2017, with total assets declining by 6.1% to Kshs 67.5 bn from Kshs 71.9 bn in FY'2016. This decline was driven by a 44% decline in investment in government securities to Kshs 2.3 bn from Kshs 4.1 bn in FY'2016, and an 8.9% decline in the loan book to Kshs 49.6 bn from Kshs 54.5 bn in FY'2016,
- Total liabilities declined by 7.5% to Kshs 56.1 bn from Kshs 60.6 bn in FY'2016, driven by a 3.7% decline in deposits to Kshs 36.7 bn from Kshs 38.1 bn in FY'2016. Deposits per branch declined by 4.6% to Kshs 1.5 bn from Kshs 1.6 bn in FY`2016,
- The faster decline in the loan book as compared to the deposits led to a decline in the loan to deposit ratio to 135.4% from 143% in FY'2016,
- HF's asset quality has been drastically deteriorating with the Gross non-performing loans increasing by 32.6% to Kshs 8.2 bn from Kshs 6.2 bn. The NPL ratio deteriorated to 15.6% in FY'2017 from 10.9% in FY'2016 as NPLs increased at a higher rate than the loan book,

- Shareholders' funds increased by 1.42% to Kshs 11.5bn from Kshs 11.3 bn in FY'2016. This is largely due to a 25.6% increase in revaluation reserves to Kshs 0.9 bn from 0.7 bn.
- HF is currently sufficiently capitalized with a core capital to risk weighted assets ratio at 15.8%, 5.3% above the statutory requirement, with total capital to total risk weighted assets exceeding statutory requirement by 2.68%.
- HF currently has a return on average assets of 0.2% and a return on average equity of 1.1%.

Key Take outs:

- The relatively challenging macroeconomic environment and the negative effects of the interest rate cap led to the decline in performance as the net interest income declined by 24.3%.
- HF Group is experiencing a drastic deterioration of its assets with the NPL ratio to 15.6% from 10.9% in 2016. Going forward, HF Group will have to be more prudent in its credit risk analysis, to avoid such high NPLs that will only lead to more provisioning and affect its bottom line profits negatively

Going forward, we expect HF's growth to be propelled by looking at the following areas;

(i) HF's NIM is way below industry average, with the bank's NIM standing at 5.2% below the market average of the listed banks of 8.4%.

(ii) Improvements in asset quality, with HF's NPL's rising drastically over the year, bringing the bank's NPL ratio to 15.6%, which is higher than the industry average at 7.9%,

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

Figures in Kshs billions unless otherwise stated

Balance Sheet	FY'2016	FY'2017	y/y change	FY'2017e	Expected y/y change	Variance in Actual Growth vs Expected
Government Securities	4.1	2.3	(44.0%)	1.0	(76.3%)	32.3%
Net Loans	54.5	49.6	(8.9%)	46.7	(14.2%)	5.3%
Total Assets	**71.9**	**67.5**	**(6.1%)**	**65**	**-10.0%**	**3.9%**
Deposits	38.1	36.7	(3.7%)	34.6	(9.1%)	(2.6%)
Borrowings	19.7	16.0	-18.7%	16.7	-15.4%	(3.4%)
Total liabilities	60.6	56.1	(7.5%)	0.0	6.5%	(14.0%)
Shareholders' Funds	**11.3**	**11.4**	**1.4%**	**11.4**	**0.8%**	**0.6%**

Balance Sheet Ratios	FY'2016	FY'2017	% y/y change
Loan to Deposit Ratio	143.0%	135.4%	(7.6%)
Return on average equity	8.3%	1.1%	(7.2%)
Return on average assets	1.3%	0.2%	(1.1%)

Income Statement	FY'2016	FY'2017	y/y change	FY'2017e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	3.9	3.0	(24.3%)	2.8	(30.0%)	5.6%
Net Non-Interest Income	0.8	1.3	78.2%	1	1.6%	76.6%
Total Operating Income	**4.7**	**4.3**	**(7.8%)**	**3.5**	(24.9%)	**17.1%**
Loan loss Provision	0.7	0.6	(17.6%)	0.8	8.6%	(26.1%)
Total Operating Expenses	3.3	4.0	19.3%	0.0	(33.7%)	53.0%
Profit before tax	1.4	0.3	(77.2%)	0.3	(75.5%)	(1.7%)
Profit after tax	**0.9**	**0.1**	**(86.1%)**	**0.2**	(82.0%)	**(4.1%)**

Income Statement Ratios	FY'2016	FY'2017	% y/y change
Yield from interest-earning assets	14.2%	12.5%	(1.8%)
Cost of funding	7.9%	7.5%	(0.4%)
Net Interest Spread	6.4%	5.0%	(1.4%)
Net Interest Margin	6.5%	5.2%	(1.3%)
Cost of Risk	14.9%	13.3%	(1.6%)
Net Interest Income as % of operating income	83.9%	68.9%	(15.0%)
Non-Funded Income as a % of operating income	16.1%	31.1%	15.0%
Cost to Income Ratio	71.3%	92.3%	21.0%

Capital Adequacy Ratios	FY'2016	FY'2017
Core Capital/Total Liabilities	26.2%	24.4%
Minimum Statutory ratio	8.0%	8.0%
Excess	**18.2%**	**16.4%**
Core Capital/Total Risk Weighted Assets	17.8%	15.8%
Minimum Statutory ratio	10.5%	10.5%
Excess	**7.3%**	**5.3%**
Total Capital/Total Risk Weighted Assets	19.6%	17.2%
Minimum Statutory ratio	14.5%	14.5%
Excess	**5.1%**	**2.7%**
Liquidity Ratio	21.1%	20.7%
Minimum Statutory ratio	20.0%	20.0%
Excess	**1.1%**	**0.7%**