Housing Finance Group Earnings Update – H1’2017
18th August, 2017

Valuation Summary

- We are of the view that Housing Finance Group stock is a “Buy” with a target price of Kshs 13.9, representing an upside of 24.9%, from the current price of Kshs 11.5, as at 18th August, inclusive of a dividend yield of 4.7%
- Housing Finance Group is currently trading at a P/TBv of 0.4x and a P/E of 4.5x, vs an industry average of 1.6x and 7.7x, respectively

Income Statement

- Core earnings per share (EPS) registered a 74.0% decline, coming in at Kshs 0.9 from Kshs 3.5 in H1’2016, driven by a 20.7% decline in operating revenue, coupled with an 8.6% increase in operating expenses,
- Total operating income declined by 20.7% to Kshs 2.0 bn from Kshs 2.5 bn in H1’2016, attributed to a 25.3% decline in Net Interest Income (NII) despite a 1.8% increase in Non-Funded Income (NFI),
- NII dropped by 25.3% to Kshs 1.6 bn from Kshs 2.1 bn in H1'2016, following an 18.2% decline in Interest Income to Kshs 3.7 bn from Kshs 4.5 bn, despite a 12.1% decline in Interest Expense to Kshs 2.1 bn from Kshs 2.4 bn in H1'2016. This resulted in the Net Interest Margin (NIM) declining to 5.7% from 6.7% in H1’2016,
- NFI increased marginally by 1.8% to Kshs 0.42 bn from Kshs 0.41 bn in H1'2016, driven by a 4.1% increase in other income to Kshs 0.27 bn from Kshs 0.25 bn in H1'2016. The current revenue mix shifted to 79:21 from 83:17 funded to non-funded income,
- Total operating expenses increased by 8.6% to Kshs 1.8 bn, from Kshs 1.6 bn in H1’2016, which was driven by a 24.9% increase in Loan Loss Provisions (LLP) to Kshs 0.4 bn from Kshs 0.3 bn in H1’2016, despite a 9.0% decline in staff costs to Kshs 0.5 bn from Kshs 0.6 bn in H1'2016,
- Cost to income ratio (CIR) deteriorated to 88.3% from 64.5% in H1'2016. Without LLP, the CIR worsened to 69.1% from 52.3% in H1'2016,
- Profit after tax declined by 74.0% to Kshs 0.2 bn from Kshs 0.9 bn in H1’2016

Balance Sheet

- The balance sheet recorded an expansion in H1’2017, with total assets increasing marginally by 0.4% to Kshs 71.6 bn from Kshs 71.3 bn in H1'2016, driven by a 41.4% increase in placements to Kshs 3.6 bn from Kshs 2.6 bn in H1'2016 despite a 1.3% decline in the loan book to Kshs 52.7 bn from Kshs 53.4 bn in H1'2016
- Total liabilities remained relatively flat at Kshs 60.3 bn, while shareholders’ funds increased by 2.9% to Kshs 11.3 bn, from Kshs 11.0 bn in H1’2016,
- Customer deposits declined by 6.0% to Kshs 37.4 bn from Kshs 39.8 bn in H1’2016. Consequently, the faster growth in loans compared to deposits resulted in the loan to deposit ratio increasing to 141.3% from 134.5% in H1’2016,
- Gross non-performing loans increased by 47.6% to Kshs 7.9 bn from Kshs 5.4 bn in H1’2016, leading to a rise in the Gross NPL ratio to 14.2%, from 9.7% in H1’2016,
- The yield on interest earning assets decreased to 13.0% from 15.0% in H1’2016, while the cost of funds came in at 7.5%, from 8.7% in H1’2016,
- Housing Finance Group is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 14.6%, 4.1% above the statutory requirement, with total capital to total risk weighted assets exceeding statutory requirement by 1.6% to close the period at 16.1%,
- The bank currently has a return on assets of 0.6%, while return on equity stands at 4.1%, a decline from 1.9% and 12.7% in H1’2016, respectively.

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Key Take outs:

a) Housing Finance Group registered an improved performance on NFI, which increased 1.8% y/y, as such improving its grip on revenue diversification with NFI to total income at 21.4% in H1'2017, up from 16.7% in H1'2016, driven by property sales by the group's property and investments subsidiary, HFDI.

b) Since the rate cap environment has reduced access to mortgages, leading to declining interest income and made it harder to attract deposits, these two factors will make it very hard for HF Group to grow. In the long term, we see only two viable options, either (i) HF Group will have to be acquired by a bank with strong deposit gathering capability, as we don't see space for another bank to successfully compete for deposits; or (ii) it will have to run a wholesale capital markets funding model, focused on sourcing more expensive capital from capital markets and deploying into real estate development and mortgage lending, that means rationalizing the cost base, which is currently set up like a commercial bank

Going forward, we expect Housing Finance Group growth to be propelled by;

i. The group's new insurance products that will be housed by Housing Finance Insurance Agency (HFIA), the insurance subsidiary. HFIA, through a partnership with Britam, has already launched a retail medical cover

ii. The group's property and investments subsidiary, HFDI, which is in line to launch Clay City, a Kshs 5.0 bn development that will put up 1,520 apartments along Thika Road in a joint venture strategy with Clay Works Limited,

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

Figures in Kshs bn unless otherwise stated

Balance Sheet	H1'2016	H1'2017	y/y change	H1'2017e	Expected y/y change	Variance in Actual Growth vs Expected
Government Securities	3.7	3.4	-7.5%	4.7	27.3%	(34.8%)
Net Loans	53.5	52.8	-1.3%	53.8	0.7%	(2.0%)
Total Assets	**71.3**	**71.6**	**0.4%**	**72.3**	**1.4%**	**(1.0%)**
Deposits	39.8	37.4	(6.0%)	38.4	(3.3%)	(2.7%)
Borrowings	18.3	21.6	18.1%	20.6	12.5%	5.6%
Total liabilities	60.3	60.3	0.0%	60.7	0.7%	(0.7%)
Shareholders' Funds	**11.0**	**11.3**	**2.9%**	**11.6**	**5.6%**	**(2.6%)**

Balance Sheet Ratios	H1'2016	H1'2017	% y/y change
Loan to Deposit Ratio	134.5%	141.3%	6.8%
Return on average equity	12.7%	4.1%	(8.6%)
Return on average assets	1.9%	0.6%	(1.3%)

Income Statement	H1'2016	H1'2017	y/y change	H1'2017e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	2.1	1.6	(25.3%)	1.5	(28.1%)	2.8%
Net Non-Interest Income	0.4	0.4	1.8%	0.5	13.5%	(11.7%)
Total Operating Income	**2.5**	**2.0**	**(20.8%)**	**2.0**	(21.1%)	**0.4%**
Loan loss Provision	0.3	0.4	24.9%	0.4	19.6%	5.3%
Total Operating Expenses	1.6	1.8	8.6%	1.5	(4.5%)	13.1%
Profit before tax	0.9	0.2	(74.0%)	0.4	(51.4%)	(22.7%)

Profit after tax	**0.6**	**0.2**	**(74.1%)**	**0.3**	(50.5%)	**(23.5%)**
Core EPS	**3.5**	**0.9**	**(74.1%)**	**0.9**	(75.5%)	**1.4%**

Income Statement Ratios	H1'2016	H1'2017	% y/y change
Yield from interest-earning assets	15.0%	13.0%	(2.0%)
Cost of funding	8.7%	7.5%	(1.2%)
Net Interest Spread	6.3%	5.5%	(0.8%)
Net Interest Margin	6.7%	5.7%	(1.0%)
Cost of Risk	12.2%	19.2%	7.0%
Net Interest Income as % of operating income	83.3%	78.6%	(4.7%)
Non-Funded Income as a % of operating income	16.7%	21.4%	4.7%
Cost to Income Ratio	64.4%	88.3%	23.9%

Capital Adequacy Ratios	H1'2016	H1'2017
Core Capital/Total Liabilities	19.6%	22.2%
Minimum Statutory ratio	8.0%	8.0%
Excess	**11.6%**	**14.2%**
Core Capital/Total Risk Weighted Assets	14.6%	14.6%
Minimum Statutory ratio	10.5%	10.5%
Excess	**4.1%**	**4.1%**
Total Capital/Total Risk Weighted Assets	17.1%	16.1%
Minimum Statutory ratio	14.5%	14.5%
Excess	**2.6%**	**1.6%**
Liquidity Ratio	21.8%	26.4%
Minimum Statutory ratio	20.0%	20.0%
Excess	**1.8%**	**6.4%**