Valuation Summary

- We are of the view that HF Group is a “***BUY***” with a target price of Kshs 6.6, representing an upside of 32.0%, from the current price of Kshs 5.0 as of 29th March 2019,
- HF Group is currently trading at a P/TBV of 0.2x vs an industry average of 1.5x.

Key Highlights FY’2018

- HF Group launched a digital financial services platform dubbed “HF Whizz” which is set to accelerate the growth of the bank’s digital banking strategy. The platform will enable customers to instantly open an account using their national identification card, transfer up to Kshs 200,000 daily, purchase goods and services, and make deposits through a pay bill.

Income Statement

- HF Group recorded a loss per share of Kshs 1.7 in FY’2018, from a core earnings per share of Kshs 0.4 recorded in FY’2017, against our expectations of a loss per share of Kshs 0.2. The performance was as a result of a 17.1% decline in total operating income, coupled with a 6.2% rise in the total operating expenses. The variance in core earnings per share growth against our expectations was largely due to the 17.1% decline in total operating income to Kshs 3.6 bn, from Kshs 4.3 bn in FY’2017, which outpaced our expectation of a 10.4% decline,
- Total operating income declined by 17.1% to Kshs 3.6 bn, from Kshs 4.3 bn in FY’2017. This was as a result of a 23.9% decline in Net Interest Income (NII) to Kshs 2.3 bn, from Kshs 3.0 bn in FY’2017, coupled with a 2.0% decline in Non-Funded Income (NFI) to Kshs 1.32 bn from Kshs 1.35 bn in FY’2017,
- Interest income declined by 15.2% to Kshs 6.0 bn, from Kshs 7.1 bn in FY’2017. This was driven by a 15.7% decline in interest income from loans and advances to Kshs 5.7 bn, from Kshs 6.7 bn in FY’2017. Interest income on government securities however recorded a 7.9% rise to Kshs 338.8 mn, from Kshs 314.1 mn in FY’2017. The yield on interest-earning assets declined to 11.7%, from 12.5% in FY’2017, attributed to a decline in yields on government securities as well as a decline in lending rates due to the two Central Bank Rate (CBR) cuts in 2018. Consequently, the Net Interest Margin (NIM) declined to 4.2%, from 5.2% in FY’2017, owing to lower yield on interest earning assets.
- Interest expense declined by 9.1% to Kshs 3.8 bn from Kshs 4.2 bn in FY’2017, following a 14.1% decline in other interest expenses to Kshs 1.5 bn from Kshs 1.7 bn in FY’2017, coupled with a 6.5% decline in interest on customer deposits to Kshs 2.2 bn, from Kshs 2.3 bn in FY’2017. Consequently, the cost of funds declined to 7.4%, from 7.5% in FY’2017, owing to a faster decline in interest expense that outpaced the decline in interest bearing liabilities,
- Non-Funded Income declined by 2.0% to Kshs 1.32 bn from Kshs 1.35 bn in FY’2017. The decline was mainly due to a 2.7% decline in other income to Kshs 1.07 bn from Kshs 1.1 bn, coupled with a 24.0% decline in FX trading income to Kshs 38.2 mn from Kshs 50.2 mn in FY’2017. Fees and commissions on loans however rose by 23.3% to Kshs 63.0 mn from Kshs 51.0 mn. The revenue mix shifted to 63:37 funded to non-funded income, from 69:31, owing to the high decline in NII that outpaced the decline in NFI,
- Total operating expenses rose by 6.2% to Kshs 4.2 bn from Kshs 4.0 bn in FY’2017, largely driven by a 12.8% increase in staff costs to Kshs 1.2 bn from Kshs 1.1 bn in FY’2017, with the rise being mitigated by a 34.8% decline in Loan Loss Provisions (LLP) to Kshs 375.9 mn from Kshs 576.2 mn in FY’2017,
- The Cost to Income Ratio (CIR) deteriorated to 118.0%, from 92.3% in FY’2017. Without LLP, the cost to income ratio also deteriorated to 107.7%, from 78.9% in FY’2017,

- HF Group recorded a loss before tax of Kshs 642.7 mn from a profit before tax of Kshs 311.6 mn in FY'2017. HF Group also recorded a loss after tax of Kshs 598.2 mn from a profit after tax of Kshs 126.2 mn in FY'2017,
- The bank does not recommend a dividend.

Balance Sheet

- The balance sheet recorded a contraction as total assets declined by 10.4% to Kshs 60.5 bn, from Kshs 67.5 bn in FY'2017. The contraction was driven by a 12.5% decline in the loan book to Kshs 43.4 bn from Kshs 49.6 bn in FY'2017, coupled with an 11.3% decline in placements to Kshs 2.0 bn from Kshs 2.3 bn in FY'2017,
- Government securities however recorded a 40.4% rise to Kshs 3.2 bn from Kshs 2.3 bn in FY'2017,
- Total liabilities declined by 10.5% to Kshs 50.2 bn from Kshs 56.1 bn in FY'2017, driven by a 16.0% decline in borrowings to Kshs 13.5 bn from Kshs 16.0 bn in FY'2017, coupled with a 5.3% decline in customer deposits to Kshs 34.7 bn, from Kshs 36.7 bn in FY'2017. Deposits per branch increased by 7.6% to Kshs 1.6 bn from Kshs 1.5 bn in FY'2017, as the number of branches declined to 22 from 25 as at FY'2017,
- The faster decline in deposits as compared to the decline in loans led to a decline in the loan to deposit ratio to 125.1% from 135.4% in FY'2017. Loans to loanable funds as well declined to 89.1%, from 94.0% in FY'2017
- Gross Non-Performing Loans (NPLs) increased by 62.4% to Kshs 13.3 bn in FY'2018 from Kshs 8.2 bn in FY'2017. The NPL ratio thus deteriorated to 27.8% in FY'2018 from 15.6% in FY'2017. General Loan Loss Provisions increased by 21.3% to Kshs 2.1 bn from Kshs 1.7 bn in FY'2017. Despite this, the NPL coverage declined to 34.5% in FY'2018 from 36.4% in FY'2017, due to the faster growth in gross non-performing loans that outpaced the rise in provisions.
- Shareholders' funds declined by 9.4% to Kshs 10.4 bn in FY'2018 from Kshs 11.4 bn in FY'2017, due a 64.0% decline in retained earnings to Kshs 1.3 bn from Kshs 3.7 bn,
- HF Group remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 14.1%, 3.6% points above the statutory requirement. In addition, the total capital to risk-weighted assets ratio came in at 15.4%, exceeding the statutory requirement by 0.9% points. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 14.5%, while total capital to risk-weighted assets came in at 15.9%.
- The bank currently has a Return on Average Assets (ROaA) of (0.9%), and a Return on Average Equity (ROaE) of (5.5%).

Key Take-Outs:

1. The bank experienced a deterioration in asset quality, with gross non-performing loans (NPLs) rising by 62.4%, to Kshs 13.3 bn in FY'2018, from Kshs 8.2 bn in FY'2017. This warranted increased provisioning by 21.3% to Kshs 2.1 bn from Kshs 1.7 bn in FY'2017. The deteriorating asset quality, coupled with the tough operating environment occasioned by the interest rate cap, has continued to hamper the bank's lending activities, leading to a decline in its interest income.
2. The bank deteriorated on its operational efficiency as the cost to income ratio increased to 118.2%, from 92.3% in FY'2017. Without LLP, the cost to income ratio also deteriorated to 107.7%, from 78.9% in FY'2017. This was largely driven by a 12.8% rise in staff costs to Kshs 1.2 bn from Kshs 1.1 bn in FY'2017 which the management attributed to a redundancy exercise taken, which increased the HF Group limited staff cost due to a one-off payout. Going forward we expect the expenses to decline, with the continued implementation of the Bank's digital banking strategy.
3. The balance sheet assets declined by 10.4% to Kshs 60.5 bn from Kshs 67.5 bn in FY'2017. The contraction was driven by a 12.5% decline in the loan book to Kshs 43.4 bn from Kshs 49.6 bn in FY'2017. Customer

deposits also recorded a 5.3% decline to Kshs 34.7 bn from Kshs 36.7 bn in FY'2017. The bank also faces issues of asset-liability mismatch- with high cost of funds and low earning long term assets

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

1. NFI growth expansion: The growth in NFI could be driven by increased adoption of alternative channels. The bank is currently focusing on deepening its digital banking proposition having launched their digital banking platform in July, dubbed HF Whizz, which will enable customers to open an account, access loans, and deposit and transfer cash on mobile phones in a bid to grow non – funded income streams. This will improve operational efficiency as well as increase the bank's transactional income,
2. Continued investment in digital channels to enhance accessibility as well as reduce operating expenses mainly through aligning staff costs to the bank's operational needs: On this end, the Bank undertook a redundancy exercise during the year in a cost-cutting drive, which saw the merging of some staff positions. This is expected to improve efficiencies in subsequent periods by providing clarity on operational accountabilities and curb the high operational costs. The exercise saw an increase the staff cost due to the one-off payout. The move will, thereby improve operational efficiency.

Fundamentally, we still think HF Group as a conventional bank has a long way to go, given its inability to mobilize deposits. In addition, mortgage penetration in Kenya remains low, and with the capping of interest rates, its ability to issue long term mortgage loans and effectively price for risk has been greatly hampered. The bank will ultimately have to adjust its business model, it seems that the end game will be coupling up with a strong bank with a sizeable asset base, and a strong deposit gathering capability, thereby complementing HF's strength in mortgages and real estate development.

Below is a summary of the bank's performance:

Balance Sheet Items	FY'2017	FY'2018	y/y change	FY'2018e	Projected y/y change	Variance in Growth Actual vs. Expected
Net loans	49.6	43.4	(12.5%)	46.4	(6.5%)	(6.0%)
Total Assets	**67.5**	**60.5**	**(10.4%)**	**63.9**	**(5.4%)**	**(4.9%)**
Customer Deposits	36.7	34.7	(5.3%)	35.0	(4.5%)	(0.8%)
Total Liabilities	56.1	50.2	(10.5%)	52.9	(5.7%)	(4.9%)
Shareholder's Funds	**11.4**	**10.4**	**(9.4%)**	**11.0**	**(4.3%)**	**(5.1%)**

Balance Sheet Ratios	FY'2017	FY'2018	y/y change
Loan to deposit ratio	135.4%	125.1%	(10.3%)
Return on Average Equity	1.1%	(5.5%)	(6.6%)
Return on Average Assets	0.2%	(0.9%)	(1.1%)

Income Statement	FY'2017	FY'2018	y/y change	FY'2018e	Projected y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	3.0	2.3	(23.9%)	2.4	(17.7%)	(6.2%)
Net non-Interest Income	1.3	1.3	(2.0%)	1.4	5.9%	(7.9%)
Total Operating income	**4.3**	**3.6**	**(17.1%)**	**3.9**	**(10.4%)**	**(6.7%)**
Loan Loss provision	(0.6)	(0.4)	(34.8%)	(0.5)	(16.7%)	(18.1%)
Total Operating expenses	(4.0)	(4.2)	6.2%	(4.0)	(0.6%)	6.8%
Profit before tax	0.3	(0.6)		(0.1)		
Profit after tax	**0.1**	**(0.6)**		**(0.1)**		

Core EPS	0.4	(1.7)		(0.2)		

Income Statement Ratios	FY'2017	FY'2018	y/y change
Yield from interest-earning assets	12.5%	11.7%	(0.7%)
Cost of funding	7.5%	7.4%	(0.0%)
Net Interest Spread	5.0%	4.3%	(0.7%)
Net Interest Margin	5.2%	4.2%	(1.0%)
Cost of Risk	13.3%	10.5%	(2.8%)
Net Interest Income as % of operating income	69%	63.2%	(5.6%)
Non-Funded Income as a % of operating income	31%	36.8%	5.6%
Cost to Income Ratio	92.3%	118.2%	25.9%

Capital Adequacy Ratios	FY'2017	FY'2018
Core Capital/Total Liabilities	24.4%	20.9%
Minimum Statutory ratio	8.0%	8.0%
Excess	**16.4%**	**12.9%**
Core Capital/Total Risk Weighted Assets	15.8%	14.1%
Minimum Statutory ratio	10.5%	10.5%
Excess	**5.3%**	**3.6%**
Total Capital/Total Risk Weighted Assets	17.2%	15.4%
Minimum Statutory ratio	14.5%	14.5%
Excess	**2.7%**	**0.9%**
Liquidity Ratio	20.7%	20.9%
Minimum Statutory ratio	20.0%	20.0%
Excess	**0.7%**	**0.9%**
Adjusted core capital/ total deposit liabilities		20.1%
Adjusted core capital/ total risk weighted		14.5%
Adjusted total capital/ total risk weighted		15.9%