HF Group limited – H1’2018

31st August, 2018

Valuation Summary

- We are of the view that HF group Bank is a “buy” with a target price of Kshs 10.2, representing an upside of 40.1%, from the current price of Kshs 7.8 as of 31st August, inclusive of a dividend yield of 4.1%,
- HF Group is currently trading at P/TBV of 0.3x vs an industry average of 1.6x.

Key Highlights H1’2018

- HF Group acquired the approvals from the Central Bank of Kenya (CBK) and the Capital Markets Authority (CMA) to venture into custodial services which will enables the bank to hold cash and other property on behalf of, pension schemes, stockbrokers fund managers, investment banks, and high-net worth individuals for a fee, a move that is set to increase their non-funded income.
- HF Group launched a mobile banking platform dubbed HF Whizz, which will enable customers to open an account, access loans, and deposit and transfer cash via their mobile phones.

Income Statement

HF Group released their H1’2018 financial results, with core earnings per share declining by 95.7% to Kshs 0.02 from Kshs 0.5 in H1’2017, in line with our expectations of a 95.0% decline. Performance was driven by a 9.4% increase in total operating expenses to Kshs 1.9 bn from Kshs 1.8 bn in H1’2017, coupled with a 1.5% decline in total operating income to Kshs 1.9 bn from Kshs 2.0 bn in H1’2017. The bank recorded a profit after tax of Kshs 6.8 mn. Highlights of the performance from H1’2017 to H1’2018 include:

- Total operating income declined by 2.7% to Kshs 1.9 bn in H1’2018 from Kshs 2.0 bn in H1’2017. Performance was driven by a 13.9% decline in Net Interest Income (NII) to Kshs 1.3 bn from Kshs 1.6 bn in H1’2017, despite a 38.2% increase in Non-Funded Income (NFI) to Kshs 586.8 mn from Kshs 424.5 mn in H1’2017,
- Interest income declined by 13.2% to Kshs 3.2 bn from Kshs 3.7 bn in H1’2017 bn, due to a decline in interest income on loans and advances by 12.4% to Kshs 3.0 bn from Kshs 3.4 bn in H1’2017, and a 34.2% decline in interest income on government securities to Kshs 145.7 mn from Kshs 221.5 mn in H1’2017. The yield on interest earning assets consequently declined to 11.7% in H1’2018 from 13.0% in H1’2017,
- Interest expense declined by 12.7% to Kshs 1.9 bn from Kshs 2.1 bn in H1’2017, following a 3.4% decline in the interest expense on customer deposits to Kshs 1.1 bn from Kshs 1.2 bn in H1’2017. Other interest expenses declined by 27.1% to Kshs 677.4 mn from Kshs 928.9 mn in H1’2017. Consequently, the cost of funds declined to 7.0% from 7.5% in H1’2017, while the Net Interest Margin declined to 4.9% from 5.7% in H1’2017,
- Non-Funded Income increased by 38.2% to Kshs 586.8 mn from Kshs 424.5 mn in H1’2017. The growth in NFI was driven by a 163.0% increase in other income to Kshs 433.0 mn from Kshs 265.6 mn in H1’2017. Fees and commissions on loans declined by 59.9% to Kshs 18.0 mn from Kshs 44.9 mn in H1’2017. Total fees and commissions however increased by 7.2% to Kshs 129.4 mn from Kshs 120.1 mn in H1’2017 due to a 47.0% increase in other fees to Kshs 111.4 mn in H1’2018 from Kshs 75.8 mn in H1’2017. The current revenue mix stands at 70:30 funded to non-funded income as compared to 79:21 in H1’2017. The proportion of non-funded income to total revenue increased owing to the faster growth in NFI, coupled with the decline in NII,
- Total operating expenses increased by 9.4% to Kshs 1.9 bn from Kshs 1.8 bn in H1’2017, largely driven by a 37.0% increase in other operating expenses to Kshs 845.4 mn from Kshs 616.9 mn in H1’2017, as

well as a 13.8% rise in staff costs to Kshs 601.4 mn from Kshs 528.4 mn in H1’2017. Loan loss provisions however declined by 40.1% to Kshs 228.1 mn in H1’2018 from Kshs 380.9 mn in H1’2017,

- The cost to income ratio deteriorated to 99.3% from 88.3% in H1’2017. Without LLP, the cost to income ratio also deteriorated to 87.5% from 69.1% in H1’2017,
- Profit before tax declined by 94.5% to Kshs 12.6 mn from Kshs 231.1 mn in H1’2017. Profit after tax declined by 95.7% to Kshs 6.8 mn in H1’2018 from Kshs 159.0 mn in H1’2017,

Balance Sheet

- The balance sheet recorded a contraction as total assets declined by 8.5% to Kshs 65.5 bn from Kshs 71.6 bn in H1’2017. This decline was driven by a 9.8% decline in the loan book to Kshs 47.6 bn from Kshs 52.8 bn in H1’2017. Government securities increased by 17.3% to Kshs 4.0 bn in H1’2018 from 3.4 bn in H1’2017,
- Total liabilities declined by 9.9% to Kshs 54.4 bn from Kshs 60.3 bn in H1’2017, driven by a 3.1% decline in customer deposits to Kshs 36.2 bn from Kshs 37.4 bn in H1’2017. Furthermore, borrowings declined by 27.7% to Kshs 15.6 bn in H1’2018 from Kshs 21.6 bn in H1’2017. However, deposits per branch increased by 10.2% to Kshs 1.6 bn from Kshs 1.5 bn in H1’2017 with the number of branches declining to 22 from 25 as at H1’2017,
- The loans to loanable funds ratio increased to 91.1% from 89.3% in H1’2017, due to the faster 11.6% decline in loanable funds to Kshs 52.2 bn from Kshs 59.1 bn in H1’2017,
- Gross non-performing loans increased by 12.0% to Kshs 8.9 bn in H1’2018 from Kshs 7.9 bn in H1’2017. As a consequence, the NPL ratio deteriorated to 17.4% in H1’2018 from 14.2% in H1’2017. General loan loss provisions increased by 15.4% to Kshs 2.0 bn from Kshs 1.7 bn in H1’2017. Thus, the NPL coverage improved to 39.0% in H1’2018 from 36.0% in H1’2017, due to the relatively faster increase in loan loss provisions,
- Shareholders’ funds declined by 9.9% to Kshs 54.4 bn in H1’2018 from Kshs 60.3 bn in H1’2017,
- HF Group Limited is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 15.5%, 5.0% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 16.9%, exceeding the statutory requirement by 2.4%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 16.5%, while total capital to risk weighted assets came in at 18.0%, indicating that the bank’s total capital relative to its risk-weighted assets declined by 1.1% due to implementation of IFRS 9,
- HF Group currently has a return on average assets of (0.04%) and a return on average equity of (0.2%).

Key Take-Outs:

1. The bank experienced a deterioration in asset quality, with gross non-performing loans (NPLs) rising by 12.0%, to Kshs 8.9 bn from Kshs 7.9 bn in H1’2017. This warranted increased provisioning by 15.4% to Kshs 2.0 bn from Kshs 1.7 bn in H1’2017 and consequently an increase in the NPL coverage to 39.0% in H1’2018 from 36.0% in H1’2017.
2. The Bank experienced a contraction of the balance sheet driven by an 8.5% decline in total assets to Kshs 65.5 bn from Kshs 71.6 bn in H1’2017. This decline was driven by a 9.8% decline in net loans and advances to customers to Kshs 47.6 bn from Kshs 52.8 bn in H1’2017.

Given the poor performance, HF Group could improve in the future by:

a. NFI growth expansion: HF Group’s NFI is below the industry average, coming in at 30.0%. vs industry average of 34.3%. The growth in NFI could to be driven by increased adoption of alternative channels with the Group shifting focus to 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,

b. Aligning the staff headcount to the bank's operational needs: The Bank is set to lay off 36 employees in a cost-cutting drive that will see it merge some staff positions. The move will provide clarity on operational accountabilities and curb the high operational costs, thereby improving operational efficiency,

c. Fundamentally, we think HF Group as a conventional bank is a long stretch given inability to gather deposits. Ultimately, 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	H1'2017	H1'2018	y/y change	H1'2018e	Projected y/y change	Variance in Growth Actual vs. Expected
Government Securities	3.4	4.0	17.3%	2.3	(31.7%)	49.1%
Net loans	52.8	47.6	(9.8%)	49.6	(6.0%)	(3.8%)
Total Assets	**71.6**	**65.5**	**(8.5%)**	**67.5**	**(5.7%)**	**(2.8%)**
Customer Deposits	37.4	36.2	(3.1%)	36.6	(1.9%)	(1.1%)
Total Liabilities	60.3	54.4	(9.9%)	56.3	(6.7%)	(3.1%)
Shareholder's Funds	**11.3**	**11.1**	**(1.5%)**	**11.3**	**(0.3%)**	**(1.2%)**

Balance Sheet Ratios	H1'2017	H1'2018	y/y change
Loan to deposit ratio	141.3%	131.4%	(9.8%)
Return on Average Equity	4.1%	(0.2%)	(4.3%)
Return on Average Assets	0.6%	(0.0%)	(0.7%)

Income Statement	H1'2017	H1'2018	y/y change	H1'2018e	Projected y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	1.6	1.3	(13.9%)	1.4	(12.4%)	(1.5%)
Net non-Interest Income	0.4	0.6	38.2%	0.5	8.1%	30.1%
Total Operating income	**2.0**	**1.9**	**(2.7%)**	**1.8**	**(8.0%)**	**5.3%**
Loan Loss provision	(0.4)	(0.2)	(40.1%)	(0.4)	(3.6%)	(36.5%)
Total Operating expenses	(1.8)	(1.9)	9.4%	(1.8)	3.5%	5.9%
Profit before tax	0.2	0.0	(94.5%)	0.0	(94.9%)	0.4%
Profit after tax	**0.2**	**0.0**	**(95.7%)**	**0.01**	**(95.0%)**	**(0.7%)**
Core EPS	**0.5**	**0.02**	**(95.7%)**	**0.02**	**(95.0%)**	**(0.7%)**

Income Statement Ratios	H1'2017	H1'2018	y/y change
Yield from interest-earning assets	13.0%	11.7%	(1.3%)
Cost of funding	7.5%	7.0%	(0.5%)
Net Interest Spread	5.5%	4.7%	(0.8%)
Net Interest Margin	5.7%	4.9%	(0.8%)
Cost of Risk	19.2%	11.8%	(7.4%)
Net Interest Income as % of operating income	78.6%	69.6%	(9.0%)

Non-Funded Income as a % of operating income	21.4%	30.4%	9.0%
Cost to Income Ratio	88.3%	99.3%	11.0%

Capital Adequacy Ratios	H1'2017	H1'2018
Core Capital/Total Liabilities	24.9%	23.7%
Minimum Statutory ratio	8.0%	8.0%
Excess	**16.9%**	**15.7%**
Core Capital/Total Risk Weighted Assets	15.9%	15.5%
Minimum Statutory ratio	10.5%	10.5%
Excess	**5.4%**	**5.0%**
Total Capital/Total Risk Weighted Assets	17.4%	16.9%
Minimum Statutory ratio	14.5%	14.5%
Excess	**2.9%**	**2.4%**
Liquidity Ratio	26.4%	20.9%
Minimum Statutory ratio	20.0%	20.0%
Excess	**6.4%**	**0.9%**
Adjusted core capital/ total deposit liabilities		22.8%
Adjusted core capital/ total risk weighted assets		16.5%
Adjusted total capital/ total risk weighted assets		18.0%