Cytonn INVESTMENTS

HF Group – Q3'2022
2nd December, 2022

Below is a summary of HF Group Q3'2022 performance:

Balance Sheet Items	Q3'2021	Q3'2022	y/y change
Net loans	34.6	35.2	1.7%
Government Securities	5.4	8.2	51.2%
Total Assets	**52.2**	**55.1**	**5.6%**
Customer Deposits	37.5	38.8	3.5%
Deposits Per Branch	1.7	1.8	3.5%
Total Liabilities	**44.2**	**47.2**	**6.8%**
Shareholder's Funds	**8.0**	**7.9**	**(0.7%)**

Balance Sheet Ratios	Q3'2021	Q3'2022	y/y change
Loan to deposit ratio	92.2%	90.7%	(1.5%)
Return on Average Equity	(19.0%)	0.5%	19.5%
Return on Average Assets	(2.9%)	0.1%	3.0%

Income Statement	Q3'2021	Q3'2022	y/y change
Net Interest Income	1.4	1.6	13.9%
Net non-Interest Income	0.5	0.8	66.1%
Total Operating income	**1.8**	**2.3**	**26.8%**
Loan Loss provision	(0.2)	(0.1)	(12.8%)
Total Operating expenses	(2.4)	(2.2)	(4.7%)
Profit before tax	(0.5)	0.1	114.0%
Profit after tax	**(0.6)**	**0.1**	**110.8%**
Core EPS	**(1.5)**	**0.2**	**110.8%**

Income Statement Ratios	Q3'2021	Q3'2022	y/y change
Yield from interest-earning assets	8.6%	9.7%	1.1%
Cost of funding	4.6%	4.9%	0.3%
Net Interest Spread	4.1%	4.8%	0.7%
Net Interest Margin	3.9%	4.7%	0.8%
Cost of Risk	9.3%	6.4%	(2.9%)
Net Interest Income as % of operating income	75.3%	67.6%	(7.7%)
Non-Funded Income as a % of operating income	24.7%	32.4%	7.7%
Cost to Income Ratio	128.6%	96.7%	(31.9%)
Cost to Income (Without LLPs)	119.4%	90.3%	(29.1%)

Capital Adequacy Ratios	Q3'2021	Q3'2022	y/y change
Core Capital/Total Liabilities	9.7%	7.8%	(1.9%)
Minimum Statutory ratio	8.0%	8.0%	
Excess	**1.7%**	**(0.2%)**	**(1.9%)**
Core Capital/Total Risk Weighted Assets	9.5%	8.2%	(1.3%)
Minimum Statutory ratio	10.5%	10.5%	
Excess	**(1.0%)**	**(2.3%)**	**(1.3%)**
Total Capital/Total Risk Weighted Assets	13.3%	12.2%	(1.1%)
Minimum Statutory ratio	14.5%	14.5%	
Excess	**(1.2%)**	**(2.3%)**	**(1.1%)**
Liquidity Ratio	22.5%	23.5%	1.0%
Minimum Statutory ratio	20.0%	20.0%	
Excess	**2.5%**	**3.5%**	**1.0%**
Adjusted core capital/ total deposit liabilities	9.9%	7.9%	(2.0%)
Adjusted core capital/ total risk weighted assets	9.6%	8.3%	(1.3%)
Adjusted total capital/ total risk weighted assets	13.4%	12.3%	(1.1%)

Income Statement

- Core earnings per share rose by 110.8% to Kshs 0.2, from a loss of Kshs 1.5 in Q3’2021, higher than our expectations of a 108.8% increase to Kshs 0.1, with the variance stemming from the 26.8% increase in total operating income, which was higher than our projection of a 17.0% increase. The performance was mainly driven by the 26.8% growth in total operating income to Kshs 2.3 bn, from Kshs 1.8 bn in Q3’2021, coupled with a 4.7% decline in total operating expenses to Kshs 2.2 bn, from Kshs 2.4 bn in Q3’2021,
- Total operating income increased by 26.8% to Kshs 2.3 bn, from Kshs 1.8 bn in Q3’2021, driven by a 66.1% increase in Non-Funded Income (NFI) to Kshs 0.8 bn, from Kshs 0.5 bn in Q3’2021, coupled with a 13.9% increase in Net Interest Income (NII) to Kshs 1.6 bn, from Kshs 1.4 bn in Q3’2021,
- Interest income grew by 6.8% to Kshs 3.2 bn, from Kshs 3.0 bn in Q3’2021, mainly driven by a 43.9% increase in interest income from government securities, to Kshs 0.7 bn, from Kshs 0.5 bn in Q3’2021. However, interest income from loans and advances remained unchanged at Kshs 2.5 bn, similar to what was recorded in Q3’2021, while interest income earned from deposits and placements with banking institutions declined by 49.0% to Kshs 9.3 mn, from Kshs 18.2 mn in Q3’2021. The Yield on Interest-Earning Assets (YIEA) increased to 9.7% from 8.6% in Q3’2021, attributable to the faster 14.6% growth in trailing interest income which outpaced the 2.4% growth in Average Interest Earning Assets (AIEA). Trailing Interest Income refers to the performance of the interest income for the past 12 consecutive months,
- Interest expenses increased marginally by 0.7% to Kshs 1.59 bn, from Kshs 1.58 bn in Q3’2021, following a 2.0% increase in interest expense on customer deposits to Kshs 1.2 bn, from Kshs 1.1 bn in Q3’2021, while interest expense from placements declined by 12.3% to Kshs 0.12 bn, from Kshs 0.13 bn recorded in Q3’2021. As a result, the Cost of funds (COF) rose by 0.3% points to 4.9%, from 4.6% recorded in Q3’2021, owing to the faster 6.6% increase in Trailing interest expense compared to the 0.8% growth in average interest bearing liabilities. Trailing interest expense refers to the performance of the interest expense for the past 12 consecutive months. Net Interest Margin (NIM) also increased by 0.8% points to 4.7%, from 3.9% in Q3’2021 due to the faster 24.2% growth in trailing Net Interest Income which outpaced the 2.4% increase in average interest-earning assets,
- Non-Funded Income (NFI) increased by 66.1% to Kshs 0.8 bn, from Kshs 0.5 bn in Q3’2021, driven by a significant 217.3% increase in other income to Kshs 0.4 bn, from Kshs 0.1 bn in Q3’2021, coupled with a 40.2% growth in the group’s foreign exchange trading income to Kshs 0.10 bn, from Kshs 0.07 bn in Q3’2021, highlighting the group’s increased foreign exchange margins. Notably, fees and commissions from loans and advances increased by 12.3% to Kshs 0.11 bn, from Kshs 0.10 bn recorded in Q3’2021 while other fees and commissions declined by 13.8% to Kshs 0.1 bn, from Kshs 0.2bn recorded in Q3’2021. Consequently, the total fees and commissions declined by 3.6% to Kshs 0.3 bn, from the Kshs 0.2 bn recorded in Q3’2021. The revenue mix shifted to 68:32 , funded to non-funded income, from 75:25 recorded in Q3’2021, owing to the faster 66.1% growth in NFI compared to the 13.9% growth of Net Interest Income (NII),
- Total operating expenses declined by 4.7% to Kshs 2.2 bn, from Kshs 2.4 bn in Q3’2021, largely driven by a 12.8% decrease in Loan Loss Provision (LLP) to Kshs 0.15 bn, from Kshs 0.17 bn in Q3’2021. The reduction in provisioning can be attributed to a reduction in Real Estate credit risk, evidenced by reduction in Gross Non-performing loans by 4.7% to Kshs 75.6 bn in September 2022, from Kshs 79.4 bn in June 2022. The decline in expenses was however weighed down by a 12.9% increase in staff costs to Kshs 1.0 bn, from Kshs 0.9 bn in Q3’2021,
- Cost to Income Ratio (CIR) significantly improved to 96.7%, from 128.6% in Q3’2021, owing to the 26.8% increase in total operating income, coupled with the 4.7% decline in total operating expenses. Key to note, this is the third consecutive quarter that HF Group’s total operating expenses have been lower than its total operating income – a Cost to Income ratio of below 100.0%. However, the ratio is still high compared to the listed banking sector average, which stood at 60.6% as of Q3’2022. Without LLP, Cost to Income ratio also improved significantly to 90.3% from 119.4% in Q3’2021, an indication of sustained efficiency, and,

- Profit before tax increased by 114.0% to Kshs 0.1 bn, from a loss before tax of Kshs 0.5 bn in Q3'2021. Notably, the Group posted a profit after tax of Kshs 61.5 mn in Q3'2022, up from a loss of Kshs 569.9 mn in Q3'2021, becoming the third consecutive quarter that HF Group has registered a profit after tax.

Balance Sheet

- The balance sheet recorded an expansion as total assets grew by 5.6% to Kshs 55.1 bn, from Kshs 52.2 bn in Q3'2021, driven by a 51.2% increase in government securities to Kshs 8.2 bn, from Kshs 5.4 bn in Q3'2021, coupled with a 1.7% growth of the loan book to Kshs 35.2 bn, from Kshs 34.6 bn in Q3'2021,
- Total liabilities rose by 6.8% to Kshs 47.2 bn, from Kshs 44.2 bn in Q3'2021, driven by a 3.5% growth in customer deposits to Kshs 38.8 bn, from Kshs 37.5 bn. Deposits per branch increased marginally by 3.5% to Kshs 1.8 bn, from Kshs 1.7 bn in Q3'2021, with the number of branches remaining unchanged at 22 branches recorded in Q3'2021,
- The slower 1.7% growth in loans as compared to the 3.5% growth in deposits led to a decline in the loan to deposits ratio to 90.7%, from 92.2% in Q3'2021,
- Gross non-performing loans(NPLs) declined by 5.9% to Kshs 8.5 bn, from Kshs 9.0 bn in Q3'2021, while the Gross loans increased by 2.3% to Kshs Kshs 41.7 bn, from Kshs 40.8 bn in Q3'2021. Consequently, the group's Asset Quality improved, with the NPL ratio declining to 20.3% in Q3'2022, from 22.0% in Q3'2021. On the other hand,, NPL coverage increased to 77.2% in Q3'2022, from 68.9% in Q3'2021, attributable to the 12.1% increase in General Provisions, coupled with the 5.9% decline in Gross Non-performing loans,
- Shareholders' funds declined slightly by 0.7% to Kshs 7.9 bn in Q3'2022, from Kshs 8.0 bn in Q3'2021, attributable to a 240.1% decline in other reserves to a loss of Kshs 0.07 bn in Q3'2022, from kshs 0.05 bn recorded in Q3'2021, coupled with a 9.4% increase in accumulated losses to Kshs 2.8 bn in Q3'2022, compared to the accumulated losses of Kshs 2.6 bn in Q3'2021,
- HF Group remains undercapitalized with a core capital to risk-weighted assets ratio of 8.2%, 2.4% points below the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio declined to 12.2% in Q3'2022, from 13.3% in Q3'2021, falling short of the statutory requirement of 14.5% by 2.3% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 8.3%, while total capital to risk-weighted assets came in at 12.3%, and,
- The bank currently has a Return on Average Assets (ROaA) of 0.1%, and a Return on Average Equity (ROaE) of 0.5%.

Key Take-Outs:

1. **Improved Asset Quality** - The group's asset quality improved significantly, with the NPL ratio improving to 20.3% in Q3'2022, from 22.0% in Q3'2021, attributable to the 5.9% decline in gross non-performing loans to Kshs 8.5 bn, from Kshs 9.0 bn in Q3'2021, coupled with 2.3% growth in Gross loans during the quarter. The asset quality improvement was driven by the easing credit risk in the Real Estate sector with gross Non-Performing Loans in Real Estate declining by 4.7% to Kshs 75.6 bn in Q3'2022, from Kshs 79.4 bn at the end Q2'2022. However, on a q/q basis, HF Group's Asset quality deteriorated by 0.2% points to 20.3%, from 20.1% recorded in Q2'2022, and,

2. **Sustained Efficiency** – Cost to Income Ratio (CIR) improved by 31.9% points to 96.7%, from 128.6% in Q3'2021, attributable to the 26.8% increase in total operating income to Kshs 2.3 bn in Q3'2022, from Kshs 1.8 bn in Q3'2021, coupled with the 4.7% decline in total operating expenses to Kshs 1.2 bn in Q3'2022, from Kshs 2.4 bn recorded in Q3'2021. Key to note, this is the third consecutive quarter 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%. However, the ratio is still high compared to the listed banking sector average, which stood at 60.6% as of Q3'2022.

Going forward, we maintain our view that HF Group as a conventional bank has a long way to go, despite the injection of tier II capital of Kshs 1.0 bn by the majority shareholder Britam Holdings in H1'2021 and three consecutive quarters of profitability. They will either have to adjust their business model, or couple up with a strong bank with a sizeable asset base, and a strong deposit gathering capability, to capitalize on HF’s strength in real estate and mortgage.

Valuation Summary

- We are of the view that HF Group is a “Lighten” with a target price of Kshs 3.2 representing a downside of 5.7%, from the current price of Kshs 3.4 as of 2nd December 2022,
- HF Group is currently trading at a P/TBV of 0.2x and a P/E of 1.4x vs an industry average of 0.2x and 7.6x, respectively.