Housing Finance Group limited – Q1’2018

31st May, 2018

Valuation Summary

- We are of the view that HF group Bank is a “buy” with a target price of Kshs 11.7, representing an upside of 51.2%, from the current price of Kshs 8.0 as of 31st May, inclusive of a dividend yield of 4.0%,
- HF Group is currently trading at P/TBV of 0.3x and a P/E of 24.6x vs an industry average of 1.7x and 9.2x, respectively.

Key Highlights Q1’2018

- HF 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.

Income Statement

- Housing Finance Group limited released the Q1’2018 financial results, with its core earnings per share declining by 58.4% to Kshs 0.4 from Kshs 1.0 in Q1’2017. Performance was driven by a 10.3% increase in total operating expenses to Kshs 928.0 mn from 841.1 mn in Q1’2017, that outpaced the 1.1% increase in total operating income to Kshs 980.1 mn from Kshs 970.4 mn in Q1’2017. The bank recorded a profit after tax of Kshs 37.1 mn, compared to our expectation of a loss of Kshs 15.4 mn in Q1’2017.The variance in performance compared to our expectation was largely due to a larger than expected decline in loan loss provisions, which declined by 43.9% to Kshs 112.7 mn from Kshs 200.7 mn in Q1’2017 despite the adoption of the IFRS 9 reporting standard,
- Total operating income increased by 1.1% to Kshs 981.0 mn in Q1’2018 from Kshs 970.5 mn in Q1’2017. Performance was driven by a 64.2% increase in Non-Funded Income (NFI) to Kshs 283.7 mn from Kshs 172.8 mn in Q1’2017, despite a 12.6% decline in Net Interest Income (NII) to Kshs 697.2 mn from Kshs 797.6 mn in Q1’2017,
- Total Interest income declined by 12.8% to Kshs 1.6 bn from Kshs 1.9 bn in Q1’2017 bn, due to a decline in both interest income on loans and advances by 10.4% to Kshs 1.5 bn from Kshs 1.7 bn in Q1’2017, and interest income on government securities by 41.2% to Kshs 50.2 mn in Q1’2018 from Kshs 118.9 mn in Q1’2017. The yield on interest earning assets consequently declined to 12.2% in Q1’2018 from 13.5% in Q1’2017,
- Interest expense declined by 13.0% to Kshs 915.5 mn from Kshs 1.1 bn in Q1’2017, following a 4.9% decline in the interest expense on customer deposits to Kshs 542.3 mn from Kshs 570.3mn in Q1’2017. Other interest expenses also declined by 24.3% to Kshs 342.2 mn in Q1’2018 from Kshs 452.2 mn in Q1’2017. Consequently, the cost of funds declined to 7.2% from 7.5% in Q1’2017, while the Net Interest Margin declined to 5.1% from 6.2% in Q1’2017,
- Non-Funded Income increased by 64.2% to Kshs 283.7 mn from Kshs 172.8 mn in Q1’2017. The growth in NFI was driven by a 104.3% increase in other income to Kshs 196.6 mn from Kshs 96.3 mn in Q1’2017. Fees and commissions on loans declined to Kshs 6.8 mn from Kshs 18.4 mn in Q1’2017. Total fees and commissions however increased by 32.6% to Kshs 69.6m from Kshs 52.5 mn in Q1’2017 due to an 84.0% increase in other fees to Kshs 62.7 mn in Q1’2018 from Kshs 34.1 mn in Q1’2017. Other operating expenses also increased by 26.1% to Kshs 1.2 bn from 1.0 bn in Q1’2017, largely attributed to the cost of houses sold during the quarter. The current revenue mix stands at 71:29 funded to non-funded income as compared to 82:18 in Q1’2017. 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 10.3% to Kshs 928.0 mn from Kshs 841.1 mn, largely driven by an 83.1% increase in other operating expenses to Kshs 475.1 mn in Q1’2018 from Kshs 258.4 mn in Q1’2017, with the rise mainly attributed to cost related to sale of houses during the quarter. Loan loss

provisions however declined by 43.9% to Kshs 112.7 mn in Q1’2018 from Kshs 200.7 mn in Q1’2017, as well as staff costs that declined by 18.0% to Kshs 218.7 mn from Kshs 266.9 mn in Q1’2017, due to the bank’s shifted focus to growth through leveraging digital channels, which has seen it reduce its staff costs,

- The cost to income ratio deteriorated to 94.6% from 86.7% in Q1’2017. Without LLP, the cost to income ratio also deteriorated to 83.1% from 66.0% in Q1’2017,
- Profit before tax declined by 59.1% to Kshs 52 mn, down from Kshs 129.4 mn in Q1’2017. Profit after tax declined by 58.1% to Kshs 37.1 mn in Q1’2018 from Kshs 88.3 mn in Q1’2017,

Balance Sheet

- The balance sheet recorded a contraction as total assets declined by 7.0% to Kshs 66.8 bn from Kshs 71.9 bn in Q1’2017. This decline was driven by a 12.9% decline in net loans and advances to customers to Kshs 48.8 bn from Kshs 54.6 bn in Q1’2017,
- Government securities also declined by 41.4% to Kshs 2.5 bn in Q21’2018 from 4.3 bn in Q’’2017,
- Total liabilities declined by 8.2% to Kshs 55.5 bn from Kshs 60.5 bn in Q1’2017, driven by a 6.1% decline in customer deposits to Kshs 35.9 bn from Kshs 38.3 bn in Q1’2017. Deposits per branch increased by 6.7% to Kshs 1.6 bn from Kshs 1.5 bn in Q1’2017 with the branches declining to 22 from 25 as at Q1’2017. The faster decline in loans as compared to deposits led to a decline in the loan to deposit ratio to 133.1% from 142.7% in Q1’2017,
- Gross non-performing loans increased by 8.9% to Kshs 8.5 bn in Q1’2018 from Kshs 7.8 bn in Q1’2017. As a consequence, the NPL ratio deteriorated to 16.6% in Q1’2018 from 13.6% in Q1’2017. Loan loss provisions increased by 34.9% to Kshs 1.9 bn from Kshs 1.4 bn in Q1’2017. The NPL coverage increased to 39.2% in Q1’2018 from 32.8% in Q1’2017, due to the relatively faster increase in loan loss provisions. The increase in the non-performing loans has been attributed to unfavorable macro-economic conditions that affected the property and financial sector,
- Shareholders’ funds declined by 0.7% to Kshs 11.3 bn in Q1’2018 from Kshs 11.4 bn in Q1’2017.
- HF Group Limited is currently sufficiently capitalized with a core capital to risk weighted assets ratio of 15.7%, 5.2% above the statutory requirement. In addition, the total capital to risk weighted assets ratio was 17.0%, exceeding the statutory requirement by 2.5%. Adjusting for IFRS 9, the core capital to risk weighted assets stood at 15.7%, while total capital to risk weighted assets came in at 17.0%, indicating that the bank’s total capital relative to its risk-weighted assets was not impacted by implementation of IFRS 9,
- HF Group currently has a return on average assets of 0.1% and a return on average equity of 0.7%.

Key Take-Outs:

1. The bank experienced a deterioration in asset quality, with gross non-performing loans (NPLs) rising by 8.9%, to Kshs 8.5 bn from Kshs 7.8 bn in Q1’2017. This was largely due to unfavorable macro-economic conditions that affected the property and financial sector. This warranted increased provisioning by 34.9% to Kshs 1.9 bn from Kshs 1.4 bn in Q1’2017 and consequently an increase in the NPL coverage to 39.2% in Q1’2018 from 32.8% in Q1’2017.
2. The bank’s total capital relative to its risk-weighted assets was not impacted by implementation of IFRS 9 as the total capital to risk weighted assets remained unchanged at 17.0% even after IFRS 9 adjustment.

We expect the bank’s growth to be further driven by:

a. HF Group Limited NFI is below the industry average, coming in at 31.8%. vs industry average of 33.6%. We expect the growth to be driven by increased adoption of alternative channels with the Group shifting focus to deepening its digital banking proposition with investment in online banking and mobile app channels to increase accessibility to customers and grow non – funded income streams. This will improve operational efficiency as well as increase the bank's transactional income.

b. The recent consolidation of the Group's real estate development business as a provider of affordable housing which is geared to tap into the National Government's big four agenda.

Below is a summary of the bank's performance:

Balance Sheet Items	Q1'2017 (mn)	Q1'2018 (mn)	y/y change	Q1'2018e (mn)	Projected y/y change	Variance in Growth Actual vs. Expected
Government Securities	4249.7	2491.1	(41.4%)	2177.6	(48.8%)	7.4%
Net loans	54598.3	47782.9	(12.5%)	48749.5	(10.7%)	(1.8%)
Total Assets	**71906.9**	**66839.9**	**(7.0%)**	**67161.6**	**(6.6%)**	**(0.4%)**
Customer Deposits	38257.1	35911.7	(6.1%)	36294.0	(5.1%)	(1.0%)
Total Liabilities	60526.9	55541.0	(8.2%)	55727.5	(7.9%)	(0.3%)
Shareholder's Funds	**11380.0**	**11298.9**	**(0.7%)**	**11434.1**	**0.5%**	**(1.2%)**

Balance Sheet Ratios	Q1'2017	Q1'2018	y/y change
Loan to deposit ratio	142.7%	133.1%	(9.7%)
Return on Average Equity	6.0%	0.7%	(5.3%)
Return on Average Assets	0.9%	0.1%	(0.8%)

Income Statement	Q1'2017 (mn)	Q1'2018 (mn)	y/y change	Q1'2018e (mn)	Projected y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	797.6	697.2	(12.6%)	606.0	(24.0%)	11.4%
Net non-Interest Income	172.8	283.7	64.2%	205.4	18.8%	45.3%
Total Operating income	**970.5**	**981.0**	**1.1%**	**811.4**	**(16.4%)**	**17.5%**
Loan Loss provision	(200.7)	(112.7)	(43.9%)	(196.8)	(2.0%)	(41.9%)
Total Operating expenses	(841.1)	(928.0)	10.3%	(834.1)	(0.8%)	11.2%
Profit before tax	129.4	52.9	(59.1%)	(22.7)	(117.5%)	58.4%
Profit after tax	**88.3**	**37.1**	**(58.1%)**	**(15.4)**	**(117.5%)**	**59.4%**
Core EPS	**6.0**	**5.2**	**(12.5%)**	**6.3**	**5.9%**	**(18.4%)**

Income Statement Ratios	Q1'2017	Q1'2018	y/y change
Yield from interest-earning assets	13.5%	12.2%	(1.3%)
Cost of funding	7.5%	7.2%	(0.3%)
Net Interest Spread	6.0%	5.0%	(1.0%)
Net Interest Margin	6.2%	5.1%	(1.2%)
Cost of Risk	20.7%	11.5%	(9.2%)
Net Interest Income as % of operating income	82.2%	71.1%	(11.1%)
Non-Funded Income as a % of operating income	17.8%	28.9%	11.1%

Cost to Income Ratio	86.7%	94.6%	7.9%

Capital Adequacy Ratios	Q1'2017	Q1'2018
Core Capital/Total Liabilities	24.2%	22.4%
Minimum Statutory ratio	8.0%	8.0%
Excess	**16.2%**	**14.4%**
Core Capital/Total Risk Weighted Assets	16.5%	15.7%
Minimum Statutory ratio	10.5%	10.5%
Excess	**6.0%**	**5.2%**
Total Capital/Total Risk Weighted Assets	18.1%	17.0%
Minimum Statutory ratio	14.5%	14.5%
Excess	**3.6%**	**2.5%**
Liquidity Ratio	21.4%	21.4%
Minimum Statutory ratio	20.0%	20.0%
Excess	**1.4%**	**1.4%**
Adjusted core capital/ total deposit liabilities		22.4%
Adjusted core capital/ total risk weighted assets		15.7%
Adjusted total capital/ total risk weighted assets		17.0%