HF Group Earnings Note – Q1’2019
31st May, 2019

Valuation Summary

- We are of the view that HF Group is a “***Sell***” with a target price of Kshs 2.9, representing a downside of 26.1%, from the current price of Kshs 4.4 as of 31st May 2019,
- HF Group is currently trading at a P/TBV of 0.2x vs an industry average of 1.2x.

Key Highlights FY’2018

- In March 2019, HF Group announced a 30.0% discount on 700 houses, giving investors two months to buy the properties located in 11 HF projects (eight completed projects and three nearing completion). All the houses on offer are located in Nairobi. ;

Income Statement

- HF Group release their Q1’2019 financial results, recording a loss per share of Kshs 0.4 in Q1’2019, from a core earnings per share of Kshs 0.1 recorded in Q1’2018. The performance was driven by a 21.6% decline in total operating income, coupled with only a marginal 0.1% decline in total operating expenses. Highlights of the performance from Q1’2018 to Q1’2019 include:
- Total operating income declined by 21.6% to Kshs 769.5 mn, from Kshs 1.0 bn in Q1’2018. This was driven by a 26.7% decline in Net Interest Income (NII) to Kshs 510.8 mn, from Kshs 697.2 mn in Q1’2018 coupled with an 8.8% decline in Non-Funded Income (NFI) to Kshs 258.7 mn from Kshs 283.8 mn in Q1’2018,
- Interest income declined by 16.2% to Kshs 1.4 bn, from Kshs 1.6 bn in Q1’2018. This was driven by a 19.1% decline in interest income from loans and advances to Kshs 1.3 bn, from Kshs 1.5 bn in Q1’2018. Interest income on government securities however recorded an 81.7% rise to Kshs 91.2 mn, from Kshs 50.2 mn in Q1’2018. The yield on interest-earning assets declined to 11.4%, from 12.1% in Q1’2018, due to the faster 16.2% decline in interest income which more than offset the 0.8% decline in interest earning assets, coupled with 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 4.1%, from 5.0% in Q1’2018,
- Interest expense declined by 8.3% to Kshs 839.9 mn, from Kshs 915.5 mn in Q1’2018, following a 15.0% decline in interest on customer deposits to Kshs 460.9 mn, from Kshs 542.3 mn in Q1’2018, which outweighed the 5.0% rise in other interest expenses to Kshs 359.3 mn, from Kshs 342.1 mn in Q1’2018. Despite the decline, cost of funds rose to 7.4% from 7.2% in Q1’2018, owing to only a Kshs 75.6 mn decline in interest expense despite the Kshs 658.3 mn decline in in interest bearing liabilities,
- Non-Funded Income declined by 8.8% to Kshs 258.7 mn, from Kshs 283.8 mn in Q1’2018. The decline was mainly due to a 35.2% decline in other income to Kshs 127.4 mn, from Kshs 196.6 mn, coupled with a 64.2% decline in FX trading income to Kshs 6.3 mn from Kshs 17.6 mn in Q1’2018. Fees and commissions on loans however rose by 140.2% to Kshs 16.4 mn from Kshs 6.8 mn. The revenue mix shifted to 66:34 funded to non-funded income, from 71:29, owing to the high decline in NII that outpaced the decline in NFI,
- Total operating expenses declined marginally by 0.1% to Kshs 927.1 mn from Kshs 928.0 mn in Q1’2018, largely driven by a 17.5% decline in other income to Kshs 492.4 mn from Kshs 596.6 mn in Q1’2018 that was offset by the 59.5% and 16.6% rise in Loan Loss Provisions (LLP) and staff costs to Kshs 179.7 mn and Kshs 255.0 mn, in Q1’2019, respectively,
- The Cost to Income Ratio (CIR) deteriorated to 120.5%, from 94.6% in Q1’2018. Without LLP, the cost to income ratio also deteriorated, to 97.1% from 83.1% in Q1’2018, and,
- HF Group recorded a loss before tax of Kshs 157.7 mn from a profit before tax of Kshs 52.9 mn in Q1’2018. HF Group also recorded a loss after tax of Kshs 158.3 mn from a profit after tax of Kshs 37.1 mn in Q1’2018.

Balance Sheet

- The balance sheet recorded a contraction as total assets declined by 11.6% to Kshs 59.1 bn, from Kshs 66.8 bn in Q1’2018. The contraction was mainly driven by a 13.9% decline in the loan book to Kshs 42.0 bn from Kshs 48.8 bn in Q1’2018, coupled with an 55.6% decline in placements to Kshs 1.3 bn, from Kshs 3.0 bn in Q1’2018,
- Government securities however recorded a 45.1% rise to Kshs 3.6 bn, from Kshs 2.5 bn in Q1’2018,
- Total liabilities declined by 12.1% to Kshs 50.2 bn, from Kshs 48.8 bn in Q1’2018, driven by a 22.9% decline in borrowings to Kshs 13.0 bn, from Kshs 16.9 bn in Q1’2018, coupled with a 5.3% decline in customer deposits to Kshs 34.0 bn, from Kshs 35.9 bn in Q1’2018. Deposits per branch declined by 5.3% to Kshs 1.5 bn from, Kshs 1.6 bn in Q1’2018, as deposits declined yet the number of branches remained unchanged at 22,
- The faster decline in loans as compared to deposits led to a decline in the loan to deposit ratio to 123.5% from 135.8% in Q1’2018. Loans to loanable funds as well declined to 90.6%, from 92.2% in Q1’2018,
- Gross Non-Performing Loans (NPLs) increased by 67.5% to Kshs 14.2 bn in Q1’2019, from Kshs 8.5 bn in Q1’2018. The NPL ratio thus deteriorated to 30.1%, from 16.3% in Q1’2018. General Loan Loss Provisions increased by 28.5% to Kshs 2.5 bn, from Kshs 1.9 bn in Q1’2018. Despite this, the NPL coverage declined to 36.4%, from 39.2% in Q1’2018, due to the faster growth in gross non-performing loans that outpaced the rise in provisions,
- Shareholders’ funds declined by 9.2% to Kshs 10.3 bn in Q1’2019, from Kshs 11.3 bn in Q1’2018, due a 76.5% decline in retained earnings to Kshs 825.9 mn, from Kshs 3.5 bn in Q1’2018,
- HF Group remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 13.7%, 3.2% points above the statutory requirement. In addition, the total capital to risk-weighted assets ratio came in at 14.9%, exceeding the statutory requirement by 0.4% 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%, and,
- The bank currently has a Return on Average Assets (ROaA) of (1.3%), and a Return on Average Equity (ROaE) of (7.4%).

Key Take-Outs:

1. The bank experienced a deterioration in asset quality, with gross non-performing loans (NPLs) rising by 67.5%, to Kshs 14.2 bn in Q1’2019, from Kshs 8.5 bn in Q1’2019. This warranted increased provisioning by 28.5% to Kshs 2.5 bn from Kshs 1.9 bn in Q1’2018. 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 120.5%, from 94.6% in Q1’2018. This was largely driven by a 16.6% rise in staff costs to Kshs 255.0 mn from Kshs 218.7 mn in Q1’2018, and,
3. Decline in balance sheet - The balance sheet assets declined by 11.6% to Kshs 59.1 bn from Kshs 66.8 bn in Q1’2018. The contraction was driven by a 13.9% decline in the loan book to Kshs 42.0 bn from Kshs 48.8 bn in Q1’2018. Customer deposits also recorded a 5.3% decline to Kshs 34.0 bn from Kshs 35.9 bn in Q1’2018. 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 in 2018 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, and,
3. Fundamentally, maintain our view that 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.

Balance Sheet Items	Q1'2018	Q1'2019	y/y change	Q1'2019e	Projected y/y change	Variance in Growth Actual vs. Expected
Net loans	48.8	42.0	(13.9%)	43.0	(11.8%)	(2.1%)
Total Assets	**66.8**	**59.1**	**(11.6%)**	**59.5**	**(10.9%)**	**(0.7%)**
Customer Deposits	35.9	34.0	(5.3%)	34.2	(4.8%)	(0.6%)
Total Liabilities	55.5	48.8	(12.1%)	49.2	(11.4%)	(0.7%)
Shareholder's Funds	**11.3**	**10.3**	**(9.2%)**	**10.3**	**(8.5%)**	**(0.7%)**

Balance Sheet Ratios	Q1'2018	Q1'2019	y/y change
Loan to deposit ratio	135.8%	123.5%	(12.3%)
Return on Average Equity	0.7%	(7.4%)	(8.0%)
Return on Average Assets	0.1%	(1.3%)	(1.4%)

Income Statement	Q1'2018	Q1'2019	y/y change	Q1'2019e	Projected y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	0.7	0.5	(26.7%)	0.6	(7.3%)	(19.5%)
Net non-Interest Income	0.28	0.26	(8.8%)	0.3	(7.6%)	(1.2%)
Total Operating income	**1.0**	**0.7695**	**(21.6%)**	**0.9**	**(7.4%)**	**(14.2%)**
Loan Loss provision	(0.1)	(0.2)	59.5%	(0.1)	15.1%	44.4%
Total Operating expenses	(0.9)	(0.9)	(0.1%)	(1.0)	2.8%	(2.9%)
Profit before tax	0.1	(0.2)		0.0		
Profit after tax	**0.0**	**(0.2)**		**(0.0)**		
Core EPS	**0.1**	**(0.4)**		**(0.1)**		

Income Statement Ratios	Q1'2018	Q1'2019	y/y change
Yield from interest-earning assets	12.1%	11.4%	(0.7%)
Cost of funding	7.2%	7.4%	0.2%
Net Interest Spread	4.9%	4.0%	(0.9%)
Net Interest Margin	5.0%	4.1%	(0.9%)
Cost of Risk	11.5%	23.4%	11.9%
Net Interest Income as % of operating income	71%	66%	(4.7%)
Non-Funded Income as a % of operating income	29%	34%	4.7%
Cost to Income Ratio	94.6%	120.5%	25.9%

Capital Adequacy Ratios	Q1'2018	Q1'2019
Core Capital/Total Liabilities	22.4%	20.2%
Minimum Statutory ratio	8.0%	8.0%
Excess	**14.4%**	**12.2%**
Core Capital/Total Risk Weighted Assets	15.7%	13.7%
Minimum Statutory ratio	10.5%	10.5%
Excess	**5.2%**	**3.2%**
Total Capital/Total Risk Weighted Assets	17.0%	14.9%
Minimum Statutory ratio	14.5%	14.5%
Excess	**2.5%**	**0.4%**
Liquidity Ratio	21.4%	20.8%
Minimum Statutory ratio	20.0%	20.0%
Excess	**1.4%**	**0.8%**
Adjusted core capital/ total deposit liabilities	22.3%	19.4%
Adjusted core capital/ total risk weighted assets	15.4%	14.5%
Adjusted total capital/ total risk weighted assets	16.9%	15.9%