HF Group Earnings Note – Q3’2019
29th November, 2019

Valuation Summary

- We are of the view that HF Group is a “***sell***” with a target price of Kshs 2.8, representing a downside of 53.3%, from the current price of Kshs 6.0 as of 28th November 2019,
- HF Group is currently trading at a P/TBV of 0.2x vs an industry average of 1.3x, with a P/E ratio of 3.7x compared to an industry average of 7.7x.

Key Highlights

- 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,
- Housing Finance (HF) also put on sale customer houses worth an estimated Kshs 2.0 bn, pointing to widespread distress in the real estate sector. The lender has signed up auctioneers to sell off the houses and commercial buildings, in a move aimed at trimming its non-performing loans portfolio.

Income Statement

- HF Group released their Q3’2019 financial results, recording a 74.5% decline in loss per share to Kshs 0.2 in Q3’2019, from a loss per share of Kshs 0.9 recorded in Q3’2018. The performance was driven by a 16.5% increase in total operating income, which was offset by a 5.6% increase in total operating expenses,
- Total operating income increased by 16.5% to Kshs 2.8 bn, from Kshs 2.4 bn in Q3’2018. This was mainly driven by a 78.9% increase in Non-Funded Income (NFI) to Kshs 1.1 bn, from Kshs 0.6 bn in Q3’2018. This was however weighed down by a 4.3% decline in Net Interest Income (NII) to Kshs 1.7 bn from Kshs 1.8 bn in Q3’2018,
- Interest income declined by 11.9% to Kshs 4.1 bn, from Kshs 4.7 bn in Q3’2018. This was driven by a 13.9% decline in interest income from loans and advances to Kshs 3.8 bn, from Kshs 4.4 bn in Q3’2018. Interest income on government securities, however, recorded a 31.5% rise to Kshs 0.3 bn, from Kshs 0.2 bn in Q3’2018. The yield on interest-earning assets declined to 11.3%, from 11.8% in Q3’2018, due to the faster 11.9% decline in interest income compared to the 11.5% decline in the average interest-earning assets. Consequently, the Net Interest Margin (NIM) declined to 4.5%, from 4.8% in Q3’2018,
- Interest expense declined by 16.6% to Kshs 2.4 bn, from Kshs 2.9 bn in Q3’2018, following a 42.3% decline in interest on other interest expenses to Kshs 0.7 bn, from Kshs 1.1 bn in Q3’2018. Despite the decline, the cost of funds remained flat at 7.0%,
- Non-Funded Income increased by 78.9% to Kshs 1.1 bn, from Kshs 0.6 bn in Q3’2018. The increase was mainly due to a 144.2% increase in other fees & commissions to Kshs 0.3 bn, from Kshs 0.1 bn, coupled with a 68.5% increase in fees and commissions on loans and advances to Kshs 46.6 mn from Kshs 27.7 mn, and a further 68.6% increase in other income from Kshs 0.4 bn in Q3’2018 to Kshs 0.7 bn in Q3’2019. The revenue mix shifted to 62:38 funded to non-funded income, from 75:25, owing to the decline in NII coupled with the growth in NFI,
- Total operating expenses increased by 5.6% to Kshs 2.9 bn from Kshs 2.7 bn in Q3’2018, largely driven by a 64.5% increase in loan loss provisions to Kshs 0.6 bn from Kshs 0.4 bn in Q3’2018. This was however offset by a 17.2% decline in Staff costs to Kshs 0.7 bn from Kshs 0.9 bn, in Q3’2018,
- The Cost to Income Ratio (CIR) improved to 102.9%, from 113.5% in Q3’2018. Without LLP, the cost to income ratio improved, to 81.8% from 98.6% in Q3’2018, and,

- HF Group recorded a 75.0% decline in loss before tax to Kshs 81.4 mn from a loss before tax of Kshs 325.6 mn in Q3’2018. The Group also recorded a 74.5% decline in loss after tax of Kshs 84.6 mn from a loss after tax of Kshs 332.0 mn in Q3’2018.

Balance Sheet

- The balance sheet recorded a contraction as total assets declined by 9.4% to Kshs 57.4 bn, from Kshs 63.4 bn in Q3’2018. The contraction was mainly driven by a 13.7% decline in the loan book to Kshs 39.2 bn from Kshs 45.4 bn in Q3’2018, coupled with a 41.6% decline in property & equipment to Kshs 1.2 bn from Kshs 2.1 bn recorded in Q3’2018,
- Government securities recorded a 7.0% decline to Kshs 3.6 bn, from Kshs 3.9 bn in Q3’2018,
- Total liabilities declined by 10.6% to Kshs 47.0 bn, from Kshs 52.6 bn in Q3’2018, driven by a 35.3% decline in borrowings to Kshs 9.9 bn, from Kshs 15.3 bn in Q3’2018. Customer deposits declined marginally by 0.1% to Kshs 34.6 bn from Kshs 34.7 bn in Q3’2018. Deposits per branch remained flat at Kshs 1.6 bn,
- The faster decline in loans as compared to deposits led to a decline in the loan to deposit ratio to 113.3% from 131.1% in Q3’2018,
- Gross Non-Performing Loans (NPLs) increased by 41.4% to Kshs 12.6 bn in Q3’2019 from Kshs 8.9 bn in Q3’2018. The NPL ratio thus deteriorated to 28.2%, from 18.2% in Q3’2018. General Loan Loss Provisions increased by 17.1% to Kshs 2.7 bn, from Kshs 2.3 bn in Q3’2018. Consequently, NPL coverage increased to 44.4%, from 42.4% in Q3’2018,
- Shareholders’ funds declined by 3.4% to Kshs 10.4 bn in Q3’2019, from Kshs 10.8 bn in Q3’2018,
- HF Group remains sufficiently capitalized with a core capital to risk-weighted assets ratio of 15.1%, 4.6% points above the statutory requirement of 10.5%. In addition, the total capital to risk-weighted assets ratio came in at 16.4%, exceeding the statutory requirement by 1.9% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 14.4%, while total capital to risk-weighted assets came in at 15.7% indicating that the bank’s total capital relative to its risk-weighted assets decreased by 0.7% due to the impact of IFRS 9, and,
- The bank currently has a Return on Average Assets (ROaA) of (0.6%), and a Return on Average Equity (ROaE) of (3.3%).

Key Take-Outs:

1. The balance sheet declined by 9.4% to Kshs 57.4 bn, from Kshs 63.4 bn in Q3’2018. The contraction was mainly driven by a 13.7% decline in the loan book to Kshs 39.2 bn from Kshs 45.4 bn in Q3’2018, coupled with a 41.6% decline in Property & equipment to Kshs 1.2 bn from Kshs 2.1 bn recorded in Q3’2018. The bank faces issues of asset-liability mismatch - with a high cost of funds and declining average interest-earning assets,
2. The bank experienced a deterioration in asset quality as gross non-performing loans (NPLs) increased by 41.4% to Kshs 12.6 bn in Q3’2019, from Kshs 8.9 bn in Q3’2018. This warranted increased provisioning by 17.1% to Kshs 2.7 bn, from Kshs 2.3 bn in Q3’2018. 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,

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

1. 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,
2. We maintain our view that HF Group as a conventional bank has a long way to go, given its inability to mobilize deposits evidenced by the slow deposit growth. Furthermore, the removal of the Interest rate cap will ultimately increase competition among banks in terms of credit offerings. The bank will ultimately have to adjust its business model, or couple up with a strong bank with a sizeable asset base, and a strong deposit gathering capability, in an effort to capitalize on HF's strength in mortgages and real estate development.

Below is a summary of the bank's performance:

Balance Sheet Items	Q3'2018	Q3'2019	y/y change	Q3'2019f	Projected y/y change	Variance in Growth Actual vs. Expected
Net loans	45.4	39.2	(13.7%)	38.3	(15.6%)	1.9%
Total Assets	**63.4**	**57.4**	**(9.4%)**	**54.5**	**(14.0%)**	**4.6%**
Customer Deposits	34.7	34.6	-0.1%	31.4	(9.4%)	9.2%
Total Liabilities	52.6	47.0	-10.6%	44.2	(15.9%)	5.3%
Shareholder's Funds	**10.8**	**10.4**	**(3.4%)**	**10.2**	**(5.9%)**	**2.5%**

Balance Sheet Ratios	Q3'18	Q3'19	y/y change
Loan to deposit ratio	131.1%	113.3%	(17.8%)
Return on Average Equity	(3.3%)	(3.3%)	0.0%
Return on Average Assets	(0.5%)	(0.6%)	(0.1%)

Income Statement	Q3'2018	Q3'2019	y/y change	Q3'2019f	Projected y/y change	Variance in Growth Actual vs. Expected
Net Interest Income	1.8	1.7	(4.3%)	1.8	(0.6%)	(3.8%)
Net non-Interest Income	0.6	1.1	78.9%	0.7	10.4%	68.5%
Total Operating income	**2.4**	**2.8**	**16.5%**	**2.4**	**2.2%**	**14.3%**
Loan Loss provision	(0.4)	(0.6)	64.5%	(0.3)	(26.0%)	90.4%
Total Operating expenses	(2.7)	(2.9)	5.6%	(2.7)	0.6%	5.0%
Profit before tax	(0.3)	(0.1)	(75.0%)	(0.3)		
Profit after tax	**(0.3)**	**(0.1)**	**(74.5%)**	**(0.2)**		
Core EPS	**(0.9)**	**(0.2)**	**(74.5%)**	**(0.6)**		

Income Statement Ratios	Q3'2018	Q3'2019	y/y change
Yield from interest-earning assets	11.8%	11.3%	(0.5%)
Cost of funding	7.0%	7.0%	(0.0%)
Net Interest Spread	4.8%	4.4%	(0.4%)
Net Interest Margin	4.8%	4.5%	(0.3%)
Cost of Risk	14.9%	21.1%	6.2%
Net Interest Income as % of operating income	75.0%	61.6%	(13.4%)
Non-Funded Income as a % of operating income	25.0%	38.4%	13.4%
Cost to Income Ratio	113.5%	102.9%	(10.6%)

Capital Adequacy Ratios	Q3'2018	Q3'2019
Core Capital/Total Liabilities	21.4%	19.5%
Minimum Statutory ratio	8.0%	8.0%
Excess	**13.4%**	**11.5%**
Core Capital/Total Risk-Weighted Assets	14.1%	15.1%
Minimum Statutory ratio	10.5%	10.5%
Excess	**3.6%**	**4.6%**
Total Capital/Total Risk-Weighted Assets	15.5%	16.4%
Minimum Statutory ratio	14.5%	14.5%
Excess	**1.0%**	**1.9%**
Liquidity Ratio	22.9%	21.2%
Minimum Statutory ratio	20.0%	20.0%
Excess	**2.9%**	**1.2%**
Adjusted core capital/ total deposit liabilities	22.8%	18.5%
Adjusted core capital/ total risk-weighted assets	16.2%	14.4%
Adjusted total capital/ total risk-weighted assets	17.6%	15.7%