Housing Finance Group – Q3’2017

1st December, 2017

Valuation Summary

- We are of the view that HF Group stock is an “buy”, with a target price of Kshs 14.2 representing an upside of 25.9%, from the current price of Kshs 11.5, as at 1st December, inclusive of a dividend yield of 1.9%,
- HF Group is currently trading at a P/TBV of 0.4x and a P/E of 17.7x, vs an industry average of 1.4x and 8.5x, respectively.

Key highlights during Q3’2017

- As part of the Bank’s strategy to enhance diversification, it completed Komarock Heights phase 1, a 480 apartment estate in Komarock, Nairobi developed by the Group’s subsidiary, Housing Finance Development and Investment. This is part of 1,272 housing units the company is developing in Komarock estate.

Income Statement

- Core earnings per share declined by 80.9%, in line with our projections of a 72.0% decline, to Kshs 0.2 from Kshs 0.8 in Q3’2016, attributable to a 25.1% decline in operating revenue coupled with a 0.9% increase in operating expenses,
- Total operating revenue declined by 25.1% y/y to Kshs 2.8 bn from Kshs 3.8 bn, driven by a 29.7% decline in Net Interest Income (NII) to Kshs 2.2 bn from Kshs 3.1 bn in Q3'2016, and a 4.0% decline in Non-Funded Income (NFI) to Kshs 0.64 bn from Kshs 0.67 bn,
- Interest Income declined by 18.5% to Kshs 5.5 bn from Kshs 6.7 bn in Q3’2016, attributable to a lower yield on interest-earning assets, which came in at 12.4% from 14.9% in Q3’2016. Interest income on government securities declined by 23.9% y/y to Kshs 0.3 bn from Kshs 0.4 bn, while interest income on loans and advances declined by 16.7% y/y to Kshs 5.1 bn from Kshs 6.1 bn,
- Interest expense decreased by 8.7% to Kshs 3.3 bn from Kshs 3.6 bn in Q3’2016, following a decline in cost of funding to 7.4% from 8.5% in Q3’2016. Interest expense on customer deposits declined by 22.5% to Kshs 1.8 bn from Kshs 2.3 bn in Q3’2016. Owing to the faster decline in interest income, the Net Interest Income declined by 29.7% to Kshs 2.2 bn from Kshs 3.1 bn in Q3’2016. The Net Interest Margin thus declined to 5.1% from 6.4% in Q3'2016,
- Non-Funded Income (NFI) recorded a drop of 4.0% to Kshs 0.64 bn from Kshs 0.67 bn in Q3'2016. The decline in NFI is attributable to a 21.3% drop in total fees and commissions to Kshs 0.2 bn from Kshs 0.3 bn in Q3’2016, and a 3.0% decrease in other income to Kshs 0.40 bn from Kshs 0.41 bn. Given the slower decline in NFI compared to decline in NII, the proportion of NFI to total revenue increased, with the current revenue mix at 77:23 funded to non-funded income from 82:18 in Q3’2016, (unlike the industry that has recorded an increased in NFI by 10.4%, we note that HF’s declined. HF’s peers in Tier 2 have also recorded an average NFI growth of 3.6%. Other Tier 2 banks include Stanbic, NIC, I&M and National Bank)
- Total operating expenses increased marginally by 0.9% to Kshs 2.59 bn from Kshs 2.57 bn, attributable to an 11.8% increase in other operating expenses to Kshs 1.0 bn from Kshs 0.9 bn in Q3’2016. However, staff costs declined by 4.4% to Kshs 0.8 bn from Kshs 0.84 bn in Q3’2016, while the Loan Loss Provision (LLP) also registered a 3.2% decline to Kshs 0.47 bn from Kshs 0.49 bn in Q3’2016,
- Following a 25.1% decline in operating revenue coupled with a 0.9% increase in operating expenses, the Cost to Income ratio worsened to 91.8% from 68.1% in Q3'2016. Without LLP, the Cost to Income ratio worsened to 74.9% from 55.0% in Q3'2016,
- Profit before tax declined by 80.7% to Kshs 0.2 bn from Kshs 1.2 bn. Profit after tax declined by 80.9% to Kshs 0.2 bn from Kshs 0.8 bn in Q3’2016.

Balance Sheet

- Total assets declined by 3.6% to Kshs 70.8 bn from Kshs 73.5 bn in Q3'2016. This decline is attributed to a 5.0% decline in the loan book to Kshs 51.2 bn from Kshs 53.9 bn in Q3’2016 coupled with an 86.9% decline in investment in government securities to Kshs 0.7 bn from Kshs 5.6 bn in Q3'2016, it is also notable that while most banking peers increased their investment in government securities by an average of 15.2%, HF’s has declined dramatically. Placements due from banks recorded an 80.1% increase to Kshs 4.5 bn from Kshs 2.5 bn in Q3’2016, following a 382.5% y/y increase in placements due from foreign banking institutions to Kshs 1.7 bn from Kshs 0.3 bn,
- Total liabilities declined by 4.4% to Kshs 59.4 bn from Kshs 62.2 bn in Q3'2016, attributed to a 19.2% decline in deposits to Kshs 33.6 bn from Kshs 41.6 bn in Q3'2016. Borrowings increased by 28.2% to Kshs 23.7 bn from Kshs

18.5 bn in Q3’2016, as HF Group mobilized cash to enable the bank pay back its Kshs 7.0 bn corporate bond that fell due in October 2017

- Shareholders’ funds increased marginally by 0.7% to Kshs 11.3 bn from Kshs 11.2 bn in Q3’2016, due to a 51.7% y/y increase in statutory loan loss reserves to Kshs 0.6 bn from Kshs 0.4 bn in Q3’2016 despite a 4.9% decline in retained earnings to Kshs 3.8 bn from Kshs 4.0 bn in Q3’2016,
- The faster decline in deposits compared to the loan book led to an increase in the loan to deposit ratio to 152.3% from 129.6% in Q3'2016. However, the banks’ loans to loanable funds ratio, which is a more suitable measure given HF Group’s primary business is mortgage provision, remained relatively stable at 88.8% from 88.5% in Q3’2016,
- Gross non-performing loans increased by 46.1% to Kshs 8.1 bn from Kshs 5.5 bn. The NPL ratio thus rose to 15.0% from 9.9% in Q3’2016, due to the slower growth of the loan book coupled with a faster growth in gross non-performing loans.
- The yield on interest earning assets declined to 12.4% from 14.9% in Q3’2016, while the cost of funds declined to 7.4% from 8.5% in Q3’2016,
- Housing Finance Group is currently sufficiently capitalized with a core capital to risk weighted assets ratio at 15.0%, 4.5% above the statutory requirement, with total capital to total risk weighted assets exceeding statutory requirement by 2.0%,
- Housing Finance Group currently has a return on average assets of 0.3% and a return on average equity of 2.0%.

Key Takeout:

HF's business model is not ideal in the interest rate cap environment as illustrated by:

- A contracting loan and a contracting deposit book; so far HF Group is the only bank that has reported contraction in both loans and deposits,
- Since the interest rate cap environment has reduced access to mortgages, leading to declining interest income and made it harder to attract deposits, these two factors will make it very hard for HF Group to record positive growth. Coupled with the decline in mortgage uptake, we expect HF Group’s FY’2017 to be at least 25.0% lower than the FY’2016 earnings.

Moving forward, HF Group’s growth will be driven by:

- Its property and investments subsidiary, HFDI, through partnerships to develop real estate products. This will be supported by normalization of property conveyance process at the Ministry of Lands Registries, which will ensure release of funds tied in incomplete transactions.

Below is a summary of the key line items in the balance sheet and income statement

Figures in Kshs billions unless otherwise stated

Balance Sheet	Q3'2016	Q3'2017	y/y change	Q3'2017e	Expected y/y change	Variance in Actual Growth vs Expected
Government Securities	5.6	0.7	(86.9%)	4.7	(15.1%)	(71.8%)
Net Loans	53.9	51.2	(5.0%)	51.9	(3.6%)	(1.4%)
Total Assets	**73.5**	**70.8**	**(3.6%)**	**76.0**	**3.4%**	**(7.0%)**
Deposits	41.6	33.6	(19.2%)	38.5	(7.5%)	(11.7%)
Borrowings	18.5	23.7	28.2%	24.4	31.9%	(3.7%)
Total liabilities	62.2	59.5	(4.4%)	64.6	3.8%	(8.2%)
Shareholders' Funds	**11.2**	**11.3**	**0.7%**	**11.4**	**1.4%**	**(0.7%)**

Balance Sheet Ratios	Q3'2016	Q3'2017	% y/y change
Loan to Deposit Ratio	129.6%	152.3%	22.7%
Return on average equity	11.7%	2.0%	(9.7%)
Return on average assets	1.8%	0.3%	(1.5%)

Income Statement	Q3'2016	Q3'2017	y/y change	Q3'2017e	Expected y/y change	Variance in Actual Growth vs Expected
Net Interest Income	3.1	2.2	(29.7%)	1.9	(37.6%)	7.9%
Net Non-Interest Income	0.7	0.6	(4.0%)	0.6	(8.7%)	4.6%
Total Operating Income	**3.8**	**2.8**	**(25.1%)**	**2.6**	(32.5%)	**7.3%**
Loan loss Provision	0.5	0.5	(3.2%)	0.6	17.7%	(20.9%)
Total Operating Expenses	2.6	2.6	0.9%	2.2	(13.9%)	14.8%
Profit before tax	**1.2**	**0.2**	**(80.7%)**	**0.3**	**(72.4%)**	**(8.5%)**
Profit after tax	**0.8**	**0.2**	**(80.9%)**	**0.2**	**(72.1%)**	**(8.9%)**
Core EPS	**2.4**	**0.5**	**(80.9%)**	**0.7**	(72.1%)	**(8.9%)**

Income Statement Ratios	Q3'2016	Q3'2017	% y/y change
Yield from interest-earning assets	14.9%	12.4%	(2.5%)
Cost of funding	8.5%	7.4%	(1.2%)
Net Interest Spread	6.4%	5.1%	(1.3%)
Net Interest Margin	6.4%	5.1%	(1.4%)
Cost of Risk	13.1%	16.9%	3.8%
Net Interest Income as % of operating income	82.2%	77.2%	(5.0%)
Non-Funded Income as a % of operating income	17.8%	22.8%	5.0%
Cost to Income Ratio	68.1%	91.8%	23.7%

Capital Adequacy Ratios	Q3'2016	Q3'2017
Core Capital/Total Liabilities	19.2%	24.3%
Minimum Statutory ratio	8.0%	8.0%
Excess	**11.2%**	**16.3%**
Core Capital/Total Risk Weighted Assets	14.9%	15.0%
Minimum Statutory ratio	10.5%	10.5%
Excess	**4.4%**	**4.5%**
Total Capital/Total Risk Weighted Assets	17.0%	16.5%
Minimum Statutory ratio	14.5%	14.5%
Excess	**2.5%**	**2.0%**
Liquidity Ratio	23.8%	26.0%
Minimum Statutory ratio	20.0%	20.0%
Excess	**3.8%**	**6.0%**