

**13th November 2020**

## **Equity Recommendations**

### **Overall Overview**

The adverse economic outlook as result of the COVID-19 pandemic has seen prices of most counters decline significantly, into bear market territory. The NASI, NSE20 and NSE25 are down 13.5%, 32.6%, 20.0% YTD to 143.00, 1,789 and 3,280 respectively.

In the short term, we expect significant pressure on companies' operating performance as a result of economic shocks. In our view, investors with a long-term view (ideally equity investors should have a long-term outlook anyway) and don't have short term liquidity constraints can take advantage of the attractive trading multiples for the capital gains potential.

High dividend yielding stocks are also good investing opportunities. However, with a need to conserve cash, this is a high-risk strategy due to the lower dividend safety (a number of companies have either reduced or deferred dividends or issued stock dividends instead of cash dividends).

A safer alternative for income investors is allocate funds to fixed income securities/money market fund.

Overall, the current market presents a buying opportunity for companies with strong fundamentals. We highlight some of these in the next section.

### **BANKING SECTOR:**

#### **HF Group**

We recommend a **SELL** on Housing Finance. The counter is trading at a P/B multiple of 0.12x (at a price of KES 3.45) against an industry average of 0.72x as at 13th November 2020. The counter has a high cost-to-income ratio of 93.8% (2019), higher than the listed banks' average of 53.6% (2019). Our recommendation is based on:

#### **Key Drivers**

- We expect continued growth of non-funded income in the long term as a result of the bank's digitization strategy supported by increase in fees and commissions on mobile and legacy loans and advances and fees and commissions on transactions.
  - In the short term, however, we note the reduction in non-funded income in 1H2020 predominantly due to a 79.2%

plunge in other income to KES 148.0 million (1H2019: KES 712.2 million) and the lower NFI contribution to total income at 22.4% (1H2019: 47.1%). We opine that the bank will continue to increase its holdings of government securities in lieu of lending in the short term and expect this to have a dampening effect on non-funded income.

- We are optimistic about the group's efforts to contain costs which have resulted in an improvement in the cost-to-income ratio (C/I) to 85.8% in 1H2020 from 102.0% in 1H2019. However we note that this is still above listed banks' average of 48.3% (excluding Stanbic) for the same period.
- We note that HF has been lending less and investing more in government securities. We opine that this is a prudent move given the uncertainty that has been brought on by the Covid-19 pandemic and the challenges the group has faced with non-performing loans.
- We see potential in affordable housing that the bank can tap into. Additionally, with the establishment and licensing (September 2020) of the Kenya Mortgage Refinance Company (KMRC), the bank can access cheaper long-term financing.

## Key Risks

- We expect that asset quality pressures are likely to increase from the real estate sector which has been experiencing a slowdown in growth even prior to the Covid-19 pandemic.
  - We note the real estate sector has been registering high non-performing loans. According to the CBK's September Monetary Policy Statement, the banking sector's asset quality had deteriorated to 13.6% in August 2020 from 13.1% registered in June 2020. The rise in the NPL ratio (gross non-performing loans/gross loans) was predominantly due to real estate sector as well as personal and transport and communication sectors.

- HF has made progress in improving asset quality with the NPL ratio (net NPL/net loan book) declining to 14.3% in 1H2020 (1H2019: 18.7%). However, we note that the decline in provisions could have been driven by the bank's move to lend less and invest more in government securities.
- According to management, the group has restructured loans worth KES 9.8 billion since the outbreak of the pandemic, which represents 25.0% of the loan book.
- We opine that real estate segment will still be a challenge even after the COVID-19 pandemic. We note that real estate has been the bank's main line of business and therefore revenue diversification (under the two-year strategy) is likely to be a challenge.
- Despite the continued improvement in operational efficiency (lower operating costs excl provisions), the group still has a very high cost to income ratio (82.7%), still above the listed bank's average of 48.3% (excl Stanbic).
- We note that customer deposit expenses have been on the rise with the cost of deposits remaining high (5.1%).

## 1H2020 Results Commentary

- HF's after tax loss grew by 210.8% y/y to KES 293.2 million from an after-tax loss of KES 94.3 million in 1H2019. The weaker performance was primarily due to a 68.8% y/y decline in non-funded income to KES 285.6 million.
- Total interest income fell by 12.7% y/y to KES 2.4 billion (1H2019: KES 2.7 billion). The decrease was mainly driven by a 16.5% y/y dip in income from loans and advances to KES 2.1 billion as the group's net loan book shrank by 5.8% y/y to KES 38.2 billion while the yield on loans fell to 10.8% from 11.9% in 1H2019.
- Income from government securities edged up by 26.3% y/y to KES 247.3 million as the group's holdings of government

securities surged by 13.5% y/y to KES 4.8 billion. Yield on government securities remained flat at 10.5%.

- Total interest expenses dipped by 18.2% y/y to KES 1.4 million mainly due to a 55.2% y/y decrease in other interest expenses to KES 331.9 million.
- Interest expenses from customer deposits grew by 9.1% y/y to KES 967.5 million as customer deposits edged up by 15.8% y/y to 39.2 billion. The cost of customer deposits declined marginally to 5.1% (1H2019: 5.2%).
- Consequently, net interest income declined by 3.9% y/y to KES 987.3 million. The net interest margin grew slightly to 4.5% (1H2019: 4.4%) due to a decline in interest earning assets (-2.1% y/y to KES 44.3 billion).
- Non-funded income fell by 68.8% y/y to KES 285.6 million predominantly due to a 79.2% plunge in other income to KES 148.0 million (1H2019: KES 712.2 million).
  - Other fees and commissions decreased by 61.9% y/y to KES 61.0 million.
  - Fees and commissions on loans and advances rose by 42.1% y/y to KES 38.3 million.
  - Consequently, the contribution of non-funded income to total income fell significantly to 22.4% (1H2019: 47.1%).
- Operating expenses (excluding provisions) declined by 22.1% y/y to KES 1.3 billion (1H2019: KES 1.7 billion) owing to a 39.6% y/y dip in other expenses to KES 539.6 million
  - The cost to income ratio (excluding provisions) improved to 85.8% (1H2019: 102.0%).
- Loan loss provisions fell by 27.6% y/y to KES 267.6 million as gross non-performing loans decreased by 8.2 y/y to KES 11.9 billion. The NPL ratio (net NPL/net loan book) improved to 14.3% (1H2019: 18.7%).

## Summary

Counter	Recommendation	YTD Change	Price as at 13th November 2020
HF	Sell	-46.59%	3.45

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**Recommendation Guide:**

**LONG-TERM BUY:** The company has strong fundamentals (strong financial performance, clear/reasonable strategy, competent management team etc.). However, there are certain investments or strategies that would require an investor to have a long-term view of the company to allow for capital appreciation. Also, the company may be facing headwinds which we view as short term.

**BUY:** Strong fundamentals. Minimal risks to the catalysts/growth drivers

**NEUTRAL:** This is where the positives and negatives in a company almost balance out. You can accumulate for the long term.

**SELL:** Deteriorating fundamentals. Risks outweigh the catalyst/growth drivers.

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