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Housing Finance (HF): 3Q2013 Results Note

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RECOMMENDATION:	NEUTRAL
Market Price (20.11.13)	29.00
Trailing BVPS: 2012	22.29
Trailing P/B (X)	1.30
Forecasted BVPS: 2013	25.40
Target Price	**33.04**
Upside Potential	**13.9%**

Share Statistics

Issued Shares (Mn)	231
Market Cap (KES Mn)	6,700
Market Cap (USD Mn)	77.49

Source: NSE

Summary

We maintain our **NEUTRAL recommendation** on the stock, with a revised **price target of KES 33.04**, based on a P/B multiple. This represents a 13.9% upside potential based on the prevailing market price of KES 29.00.

Key results highlights include:

- **Top-line growth challenges:** Although the base of total interest income has continued to grow, HF recorded the lowest growth in 3Q2013 in the last 7 quarters.
- **Relatively higher yields, coupled with marginal loan book growth:** The yield on loans and advances improved, albeit marginally from 10.7% (3Q2012) to 10.9% (3Q2013).
- **Lower cost of funds during the review period:** The total interest expense declined by 9.6% from KES 2.4 billion (3Q2012) to KES 2.1 billion (3Q2013). This was generally driven by the easing pressure on the cost of funds, mainly customer deposits.
- **Efficiency gains:** The cost/income (C/I) ratio dropped from 54.7% (3Q2012) to 49.6% (3Q2013).

Outlook

- **Deterioration in asset quality:** We note that the asset quality of the bank deteriorated in 3Q2013.
- **Interest rate environment:** As the company seeks to diversify sources of funds, performance will continue to be interest-rate sensitive. Contribution of non-funded income has continued to decline since FY2011

Year to 31 Dec	2010A	2011A	2012A	2013F
Net Income (Kshs '000)	379,481	622,279	743,335	860,771
EPS (Kshs)	1.65	2.70	3.23	3.73
BVPS (Kshs)	18.5	20.5	22.3	25.4
P/E x	16.06	4.59	4.79	7.78
P/B x	1.4	0.6	0.7	1.1
ROE	8.9%	13.2%	14.5%	14.7%
ROA	1.3%	2.0%	1.8%	1.7%
C/I Ratio	51.7%	47.0%	50.5%	51.0%

Source: Company reports, FIB estimates

Key Results Highlights

Housing Finance 3Q2013 Income statement (Kshs '000)	3Q2012	3Q2013	% change
Interest income	3,718,499	4,101,952	10.3%
Interest expenses	2,358,597	2,131,922	-9.6%
Net interest income	1,359,902	1,970,030	44.9%
Non-interest income	203,646	233,310	14.6%
Total operating income	**1,563,548**	**2,203,340**	**40.9%**
Operating expenses	855,361	1,093,179	27.8%
Loan loss provision	144,546	215,460	49.1%
Profit Before Tax	**563,641**	**894,701**	**58.7%**
Profit After Tax	**396,228**	**676,173**	**70.7%**
EPS	**2.29**	**3.90**	
Interest income yield	***10.7%***	***9.6%***	
Average cost of funds	***7.2%***	***5.2%***	
C/I Ratio	**54.7%**	**49.6%**	

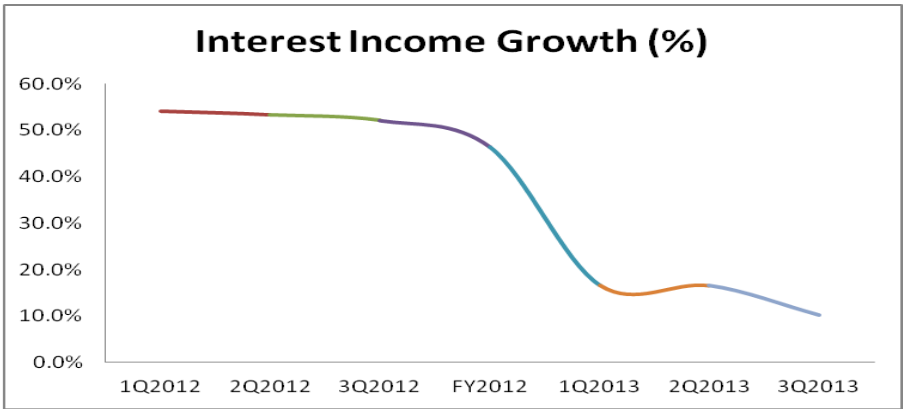
Source: Company Release

Housing Finance 1Q2013 Balance Sheet (Kshs '000)	FY2012	3Q2013	% change
Loan book	**30,293,711**	**33,477,045**	*10.5%*
Government securities	723,616	299,893	*-58.6%*
Investment in properties	442,055	792,986	*79.4%*
Total liabilities	35,819,332	41,555,276	*16.0%*
Customer deposits	***22,937,649***	***25,928,426***	*13.0%*
Shareholders' funds	**5,137,245**	**5,483,969**	*6.7%*
Capital adequacy ratio	***29.5%***	***22.1%***	
Core capital/total risk weighted assets	***19.1%***	***15.3%***	
Liquidity ratio	***36.80%***	***39.12%***	

Source: Company Release

The profit before tax (PBT) grew by 58.7% to KES 895 million while the profit after tax grew by KES 70.7% to KES 676 million. The additional growth in PAT that created the divergence compared to the growth in PBT emanated from a deferred tax recorded in 3Q2013.

Top-line growth challenges: Although the base of total interest income has continued to grow, HF recorded the lowest growth in 3Q2013 in the last 7 quarters. This depicts declining momentum in top-line growth as indicated in the chart below;



Source: Company reports, FIB data base

So far, we are yet to see a change in business model designed to break this trend.

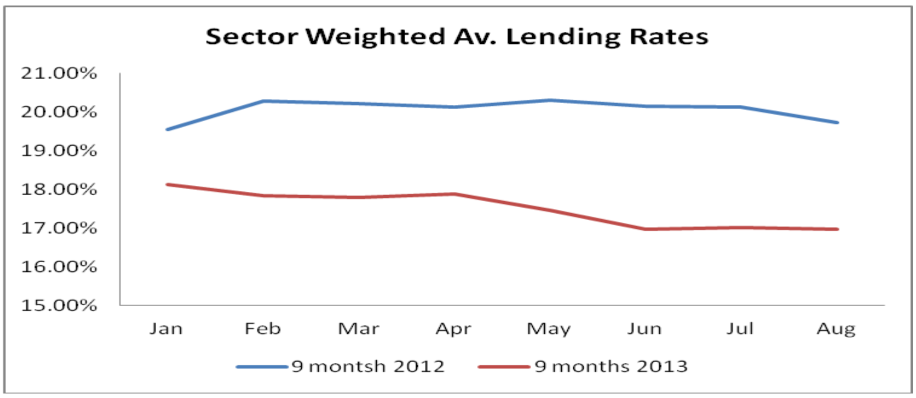
The business's funding base has continued to put pressure on the top-line growth momentum.

In our analysis of the 3Q2013 results, we note that in the context of decelerating growth, the following were the main boosters of the bottom-line;

Main Bottom-line Boosters

Relatively higher yields, coupled with marginal loan book growth: The yield on loans and advances improved, albeit marginally from 10.7% (3Q2012) to 10.9% (3Q2013). Interestingly, the industry weighted average lending rates throughout the 9 months to September 2013 were lower compared to a similar period in 2012.

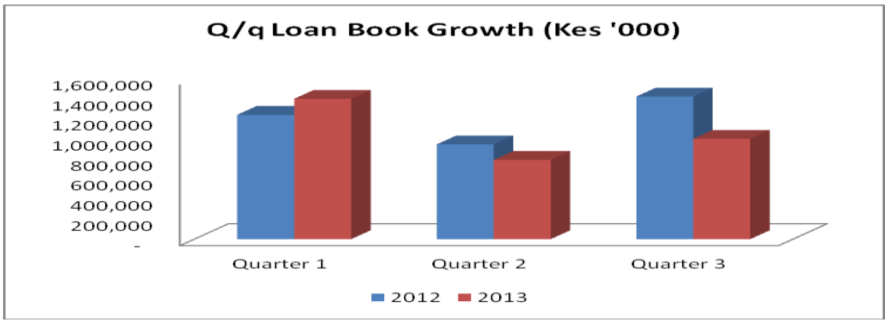
As depicted in the chart below, the sector weighted average lending rates opened the year at levels of 18.13% in January 2013, before slowly dropping to levels of 16.96% by August 2013.



Source: CBK

In terms of volumes, HF managed to push through an average of KES 1.1 billion quarter-on-quarter (q/q) in the first 3 quarters of 2013, lower than KES 1.2 billion recorded in a similar period in 2012.

Save for 1Q2013, the subsequent quarters underperformed compared to similar quarters in 2012.



HF seeks to accelerate growth in loan book. The growth in loan book and the level of lending rate will be a delicate balancing act in the medium term.

Lower cost of funds during the review period: The total interest expense declined by 9.6% from KES 2.4 billion (3Q2012) to KES 2.1 billion (3Q2013). This was generally driven by the easing pressure on the cost of funds, mainly on customer deposits.

The average cost of customer deposits dropped from 7.5% (3Q2012) to 4.7% (3Q2013). This resulted in the interest expense on customer deposits declining by 33.0% to KES 1.2 billion in 3Q2013. Growth in customer deposits was low in 3Q2013 (KES 81 million), compared to a growth of KES 1.6 billion and KES 1.3 billion in 1Q2013 and 2Q2013 respectively.

However, interest expense on borrowed funds increased by 66.2% from KES 557 million (3Q2012) to KES 926 million (3Q2013). More specifically, borrowed funds increased by KES 2.8 billion q/q.

In October 2012, HF announced a 76.0% oversubscription of its tranche 2 KES 3 billion bond. The targeted amount was KES 2.97 billion at a fixed rate of 13.0%.

We are yet to see diversification in sources of funds and we therefore do not expect to see a drop in this interest expense line in the medium term. Management has previously intimated of sourcing for funds from the international market, which come at relatively cheaper rates.

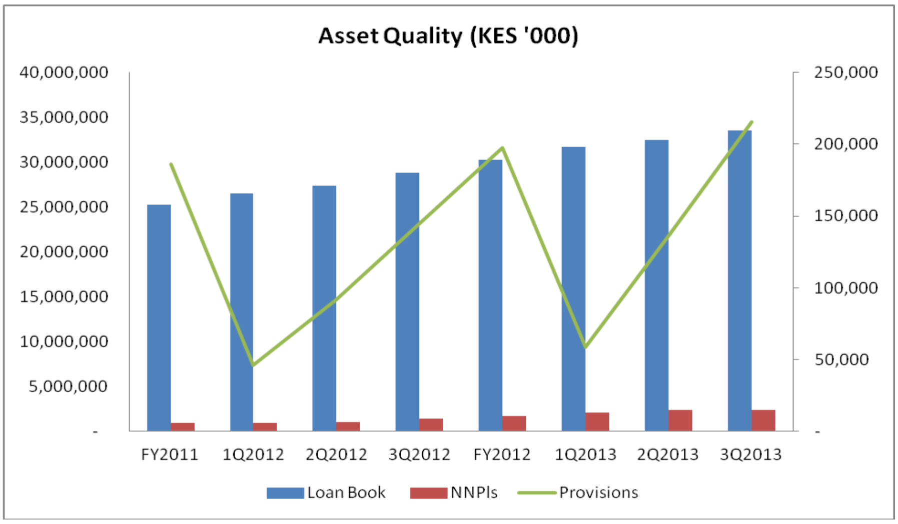
Efficiency gains: The cost/income (C/I) ratio dropped from 54.7% (3Q2012) to 49.6% (3Q2013). This was more to do with a boost in operating income (lower cost of funds hence higher net interest income) and a 49.2% growth in activity fees and commissions.

Business growth: HF intends to grow organically through increase in customer numbers, increase in product innovativeness (to 3 products/customer), efficiency improvement by rolling out a new core banking system and increased investments in property.

It recently introduced a new product in the market, EZESHA that entail 105% financing on the value of the property. However, we are yet to establish the market appetite for this product.

Outlook

Deterioration in asset quality: We note that the asset quality of the bank deteriorated in 3Q2013.

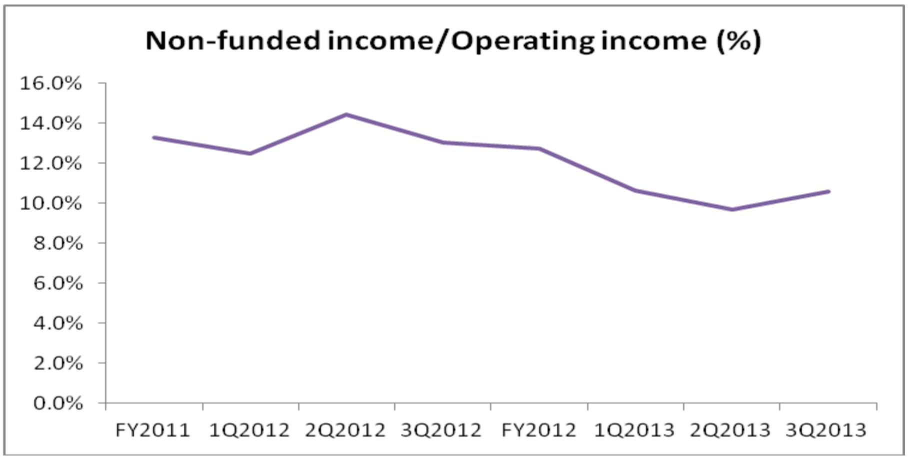


Source: Company reports, FIB data base

A closer look at the loan book reveals an interesting trend. Generally, the loan book quality has been improving during the first quarter and deteriorating in the subsequent quarters. This has resulted in a volatile trend in provisioning as depicted by the chart above. Going forward, we wait to see how asset quality will trend as the company seeks to increase mortgage uptake.

Interest rate environment: As the company seeks to diversify sources of funds, performance will continue to be interest-rate sensitive. Contribution of non-funded income has continued to be on the decline since FY2011. We have not seen strong indications geared towards growing non-funded income which would act as a cushion in times of increased interest rate volatility.

The table below depicts the trend in non-funded income (as a percentage of total operating income on a quarterly basis since FY2011).



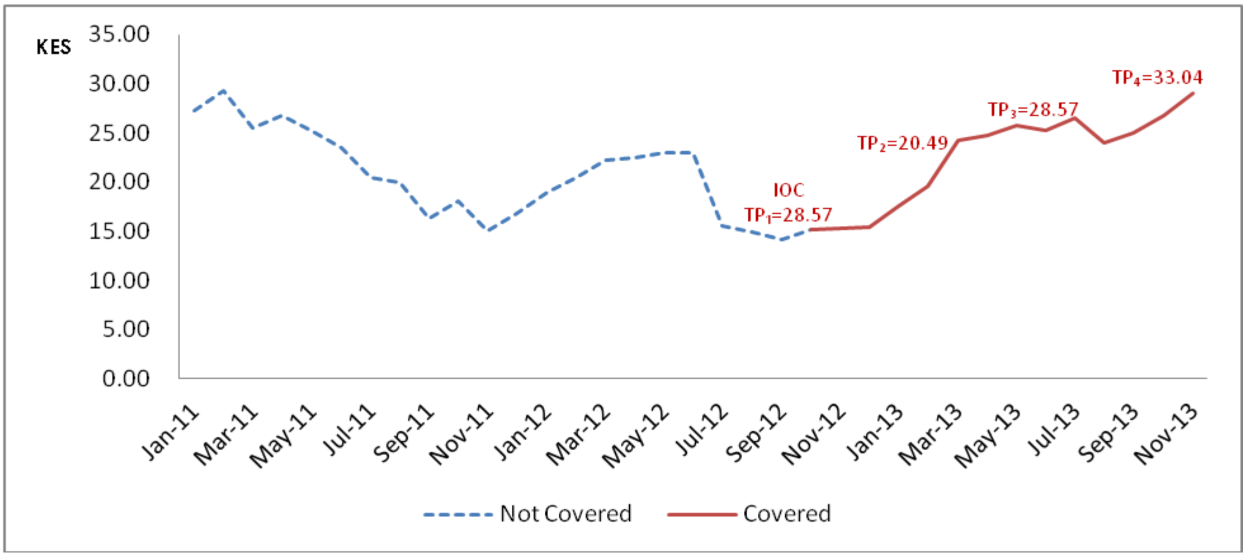
Source: Company reports, FIB data base

Recommendation

We maintain our **NEUTRAL recommendation** on the stock, with a revised **price target of KES 33.04**, based on a P/B multiple. This represents a 13.9% upside potential based on the prevailing market price of KES 29.00.

Target Price History

The chart below indicates the performance of the share price and the target prices at different times.



NB: IOC=Initiation of Coverage

Date	Recommendation	Target Price (TP)	Prevailing Market Price	Upside Potential
25-Oct-12	BUY	23.68	15.10	56.8%
25-Feb-13	NEUTRAL	20.49	17.80	15.1%
02-May-13	NEUTRAL	28.57	25.00	14.3%
21-Nov-13	NEUTRAL	33.04	29.00	13.9%

Sources: NSE, FIB analysis