Company Initiation Report

Banks

GCC Equities

SICO Research

May 24, 2016

بنك استثماري Investment Bank sico

Alinma Bank

Young and Dynamic

Price Data (SAR)	
Current Price	12.96
Target Price	15.00
52 wk High/Low	24.40/11.80

Ratings	
Short-term	Positive
Long-term	Buy
Risk Profile	Normal

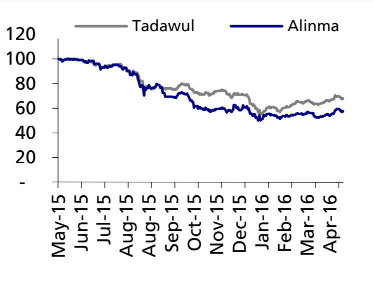
Market Data	
Sector	Banks
Market Cap	USD 5.18bn
Primary Exchange	Saudi Arabia
Other Exchange	
Reuters	1150.SE
Bloomberg	Alinma AB Equity
Free Float	74%

Valuation Ratios	2015A	2016E
P/E x	13.2	11.8
P/BV x	1.1	1.0
ROE %	8.1	8.8
Div Yld %	3.9	4.2

Trading Data	
Daily Vol (6M Avg)	57.7
Daily T/o (6M Avg USD)	209.3
Issued Shares	1,500.0

All in millions

Relative Price Performance



Restated to 100

Performance (%)	1m	3m	12m
Absolute	(3.7)	(2.3)	(46.5)
Relative	(1.2)	(8.9)	(12.2)

Source: SICO Research, Bloomberg

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- **A relatively new bank with a strong capital position, lack of legacy impaired loans and growing branch network; Alinma Bank to report robust lending growth**
- **Further cost rationalisation, fee income optimisation and asset yield expansion, led by consumer loan growth, to boost earnings**
- **We initiate with a target price of SAR 15/share and a 'Buy' recommendation**

Demanding valuations, justified by higher growth potential

Alinma is a Saudi-based Sharia-compliant bank, trading at 1x BVPS-2016, for an ROE expectation of 9%. It is a relatively new bank (commencing operations in 2008) on a growth trajectory with a large capital base, which is suppressing its ROE. As the bank leverages its balance sheet over the next few years, its ROE will increase. We expect the bank to report c.14% CAGR earnings growth over the next two years. We initiate with a **'Buy'** recommendation on the bank with a target price of **SAR 15/share**.

Why buy the stock?

Alinma Bank is a growth story, and we expect its earnings to increase at 15% CAGR 2015-19e, comfortably outpacing its peers growth at 10-12% over the same period. Near-term earnings will be driven by higher net interest income, balance sheet growth and lower impairment of its investment portfolio. We also expect the bank's opex to grow slower than its revenue growth.

Drivers of the bank's earnings growth

Higher concentration of short-term loans: Alinma Bank's financing assets are short-term in nature (66%), which can be easily re-priced in a likely rising interest rate environment. This will be positive for the bank's NIM.

Expect positive Jaws ratio: The bank's revenues are likely to grow faster than its operating expenses as the benefits of branch network expansions start to flow. The bank's opex-to-assets and cost-to-income ratios are the highest among its peers, and have potential for optimisation.

Fee income growth: Strong lending book growth will continue to support its fee income growth, and we also expect higher corporate finance related fees.

Reducing exposure to the construction sector: The bank is lowering its exposure to the vulnerable construction sector, which reduces its balance sheet risk. We expect only a modest pick-up in the provisioning as it does not have legacy impaired loans, and has a high NPL coverage ratio of 175%.

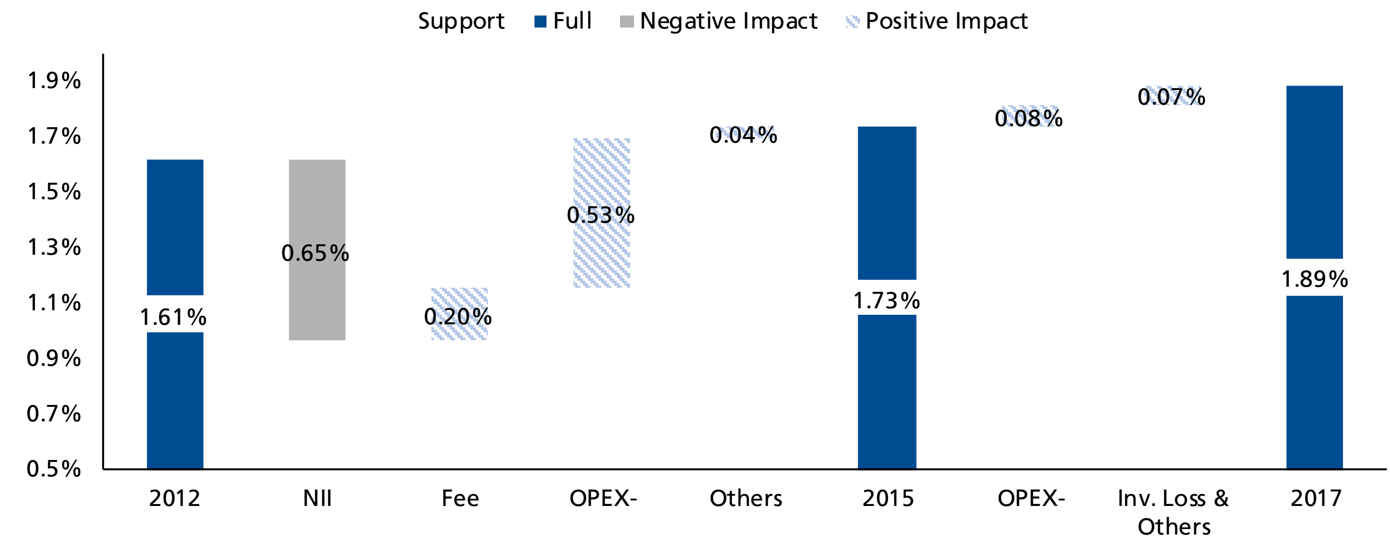
Summary Financials

SAR mn	2014A	2015A	2016E	2017E	2018E	CAGR (%)
Net Interest Income	2,075	2,279	2,478	2,914	3,065	10.2
Net Profit	1,264	1,470	1,651	2,052	2,104	13.6
ROAE	7.27	8.10	8.80	10.41	10.14	
Net Interest Margin (%)	3.00	2.79	2.77	3.06	3.05	
Loans to Deposit (%)	90	86	86	84	81	
NPL Ratio (%)	0.6	0.7	1.0	1.2	1.3	
P/E (x)	15.4	13.2	11.8	9.5	9.2	
P/BV (x)	1.1	1.1	1.0	1.0	0.9	

Source: Company, SICO Research, Bloomberg

Alinma Bank would be able to further boost its ROA, with operating expense optimisation and unlikely reoccurrence of high investment related loss witnessed in 2015. The bank's NIM would improve from 2017, with steady pick-up in interest rate.

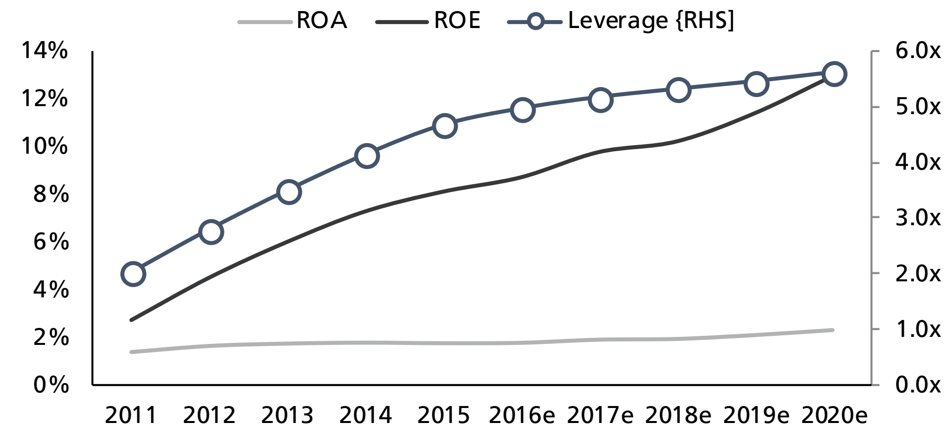
Exhibit 1: Driver of ROA. The bank's ROA will be supported by lower investment losses and operating expense, while higher balance sheet leverage will boost the bank's ROE.



Source: SICO Research, Company Data

Alinma Bank would be able to improve its ROA from 1.73% in 2015 to 2.08% in 2017, and in addition increase in leverage will boost its ROE from 8.1% 2015 to 11.4%.

Exhibit 2: In addition to improvement in ROA, increasing leverage would boost the bank's ROE. The Saudi bank leverage is 7.0x in 2015, compared to 4.6x for Alinma Bank.



Source: SICO Research, Company Data

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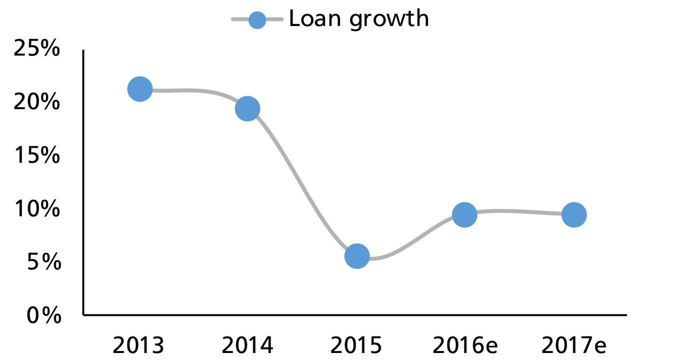
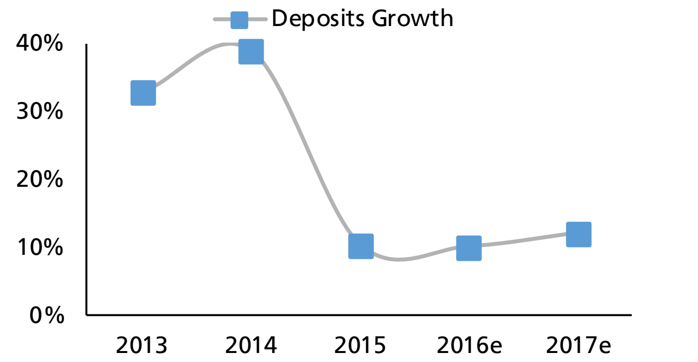
Alinma Bank at a Glance

Exhibit 3: Alinma's lending to pick up after a moderate lending growth in 2015, due to strong capital base



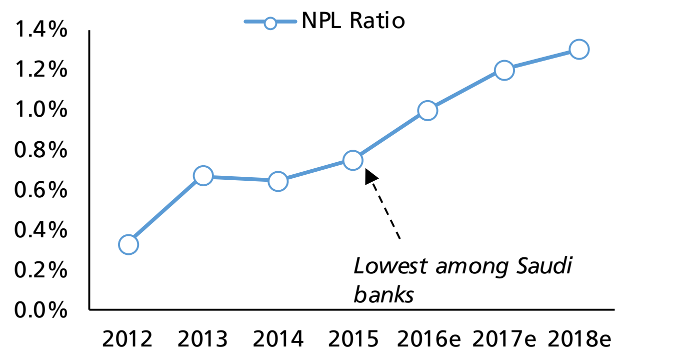
Source: SICO Research, Company Data

Exhibit 4: Deposits growth to continue in line with its lending book growth



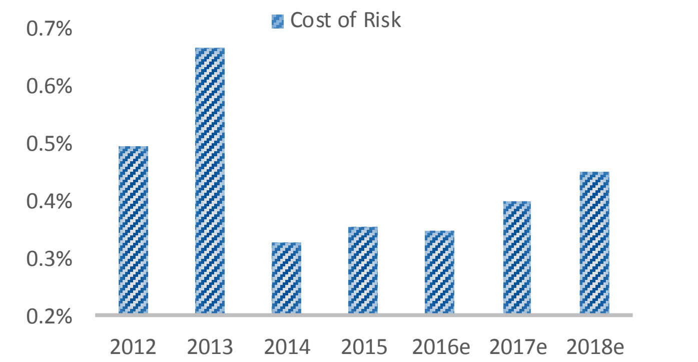
Source: SICO Research, Company Data

Exhibit 5: Alinma to witness moderate asset quality deterioration in weak economic backdrop…



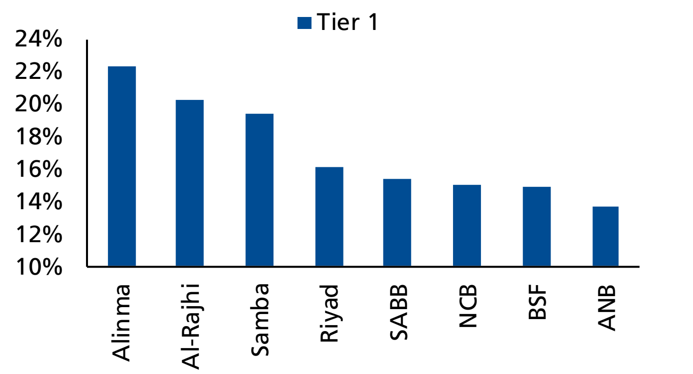
Source: SICO Research, Company Data

Exhibit 6: …however, provisioning to increase marginally due to strong NPL coverage



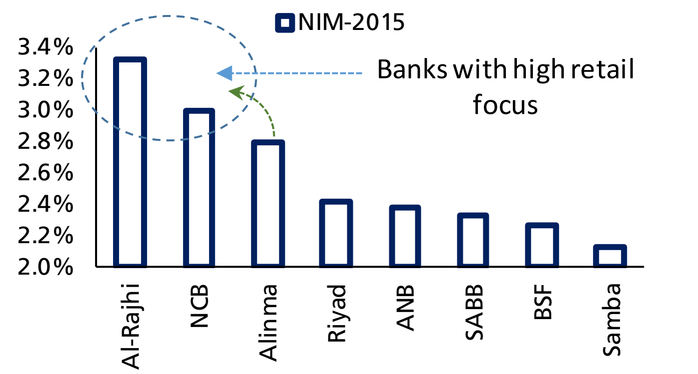
Note: Cost of Risk = Provisions/ average loans Source: SICO Research

Exhibit 7: Strongest capital position among Saudi Arabian banks



Source: SICO Research, Company Data

Exhibit 8: Healthy NIM but may improve further as the bank expands into consumer business



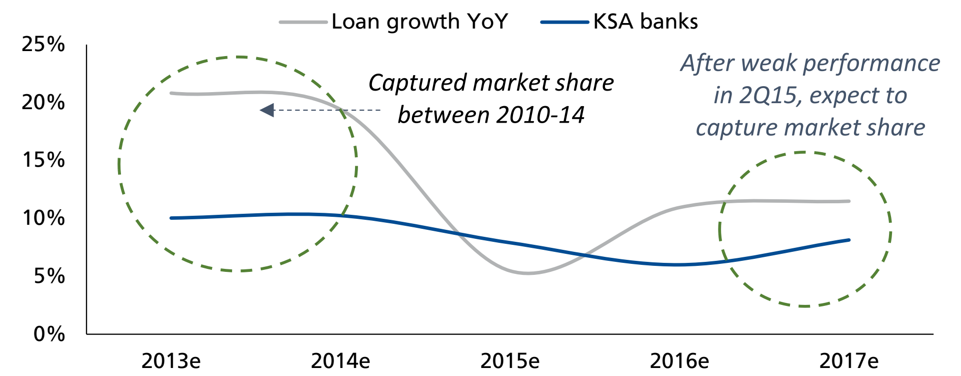
Source: SICO Research, Company Data

Investment Case:

Strong growth will continue

Growth has been strong: Alinma Bank continues to grow its lending book at above average pace versus peers since it commenced operations in 2009, which we expect will continue in 2016 and 2017. However, the bank witnessed weak lending book growth in 2Q15 and 3Q15, which we believe was driven by a decline in its public and construction sectors' exposure.

Exhibit 9: Alinma Bank to revive its growth trajectory in 2016 and 2017

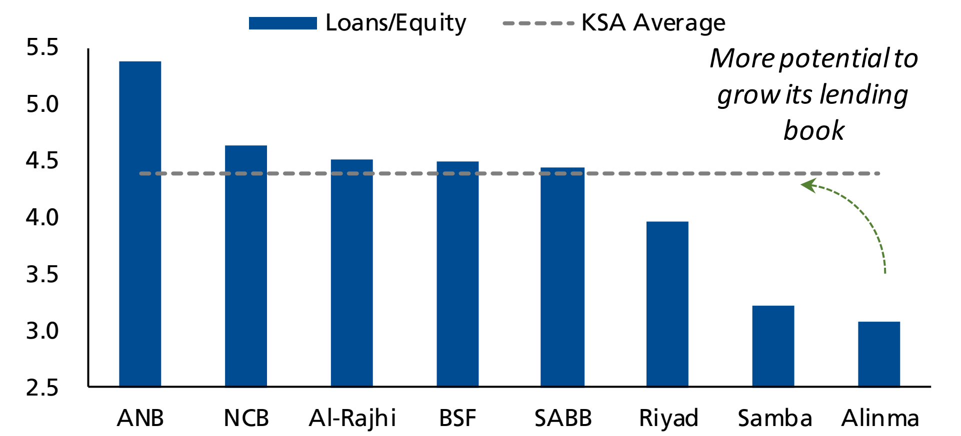


Source: SICO Research, Company Data

Strong growth to continue: We see considerable potential for Alinma Bank to leverage its balance sheet by further growing its lending portfolio. The bank's loans-to-equity ratio is the lowest among Saudi Banks at 3.1x, compared with 4.4x of our Saudi bank's coverage.

Alinma is a relatively new bank with a strong tier 1 ratio of 22.3% (Saudi banks' average 16.43%), and the bank can easily continue to outpace the lending book growth of its peers. We expect the bank to continue to grow its lending book at 10% CAGR 2015-20, which will lower its tier 1 ratio to 19.4% by the 2020s.

Exhibit 10: Alinma Bank has more potential to leverage its balance sheet



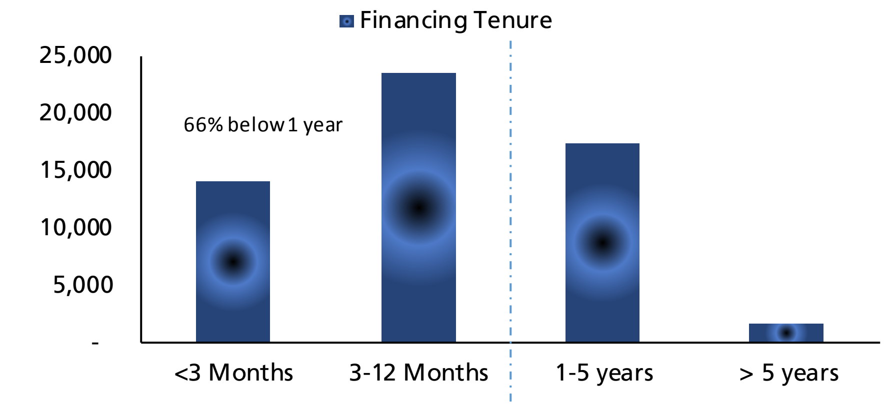
Note: KSA average is the average of KSA banks under our coverage
Source: SICO Research, Company Data

Favourable lending mix to support NIMs

Positives from high concentration of short-term loans: Alinma Bank's lending book is skewed towards short-term loans (< 1 year), comprising ~2/3 of its lending book. This makes the bank better suited to counter any pick-up in interest rates. With Saudi interbank rates higher by c.50bps in the last 6 months, the maturing loans can be disbursed at higher yields.

The bank also has the option to increase the duration of its lending book and boost its NIM.

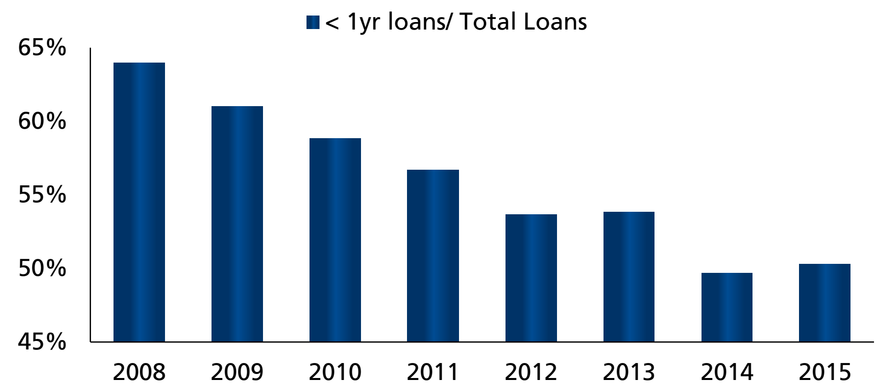
Exhibit 11: Two-thirds of Alinma Bank's financing book is short-duration loans and can be re-priced at higher yields, with increase in interest rates



Source: SICO Research, Company Data

Saudi banks' loan book duration: Saudi banks have been consistently raising the duration of their lending books, with long-term loans now comprising 50% of total loans, up from 35% in 2008. We believe most banks are already close to their target level of long-duration loans (such as Al Rajhi) and cannot further increase the duration of their books.

Exhibit 12: Saudi banks continue to increase their lending book duration; they will struggle to boost their NIM any further by increasing loan duration



Source: SICO Research, Company Data

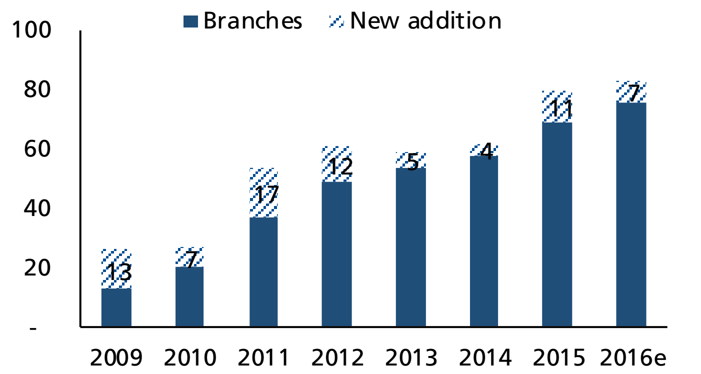
Operating expenses to stabilise

Strong expansion plans to continue

Branch network: Alinma Bank is in its growth phase, with its branch network growing from 13 in 2009 to 69 in 2015, adding on an average 9 branches every year. We expect the bank to add 7 more branches in 2016, followed by 5 more in subsequent years.

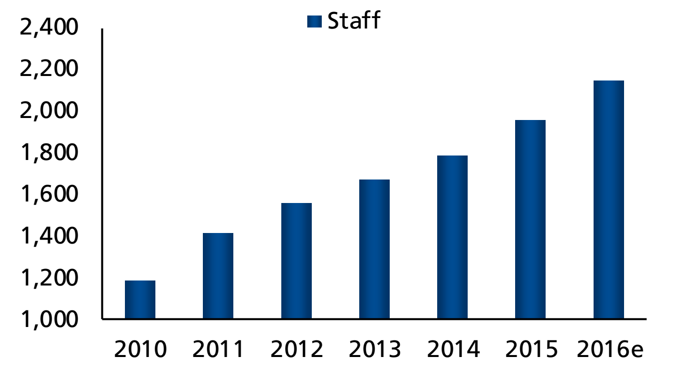
Alinma Bank has added c.760 staff over the past 5 years, raising its total staff strength to 1,950 in 2016, at an average of c.28 staff per branch, a ratio the bank will likely maintain.

Exhibit 13: Bank to continues adding average 5-7 branch networks over the next 3 years



Source: SICO Research, Company Data

Exhibit 14: The bank is likely to maintain its staff per branch average at 28

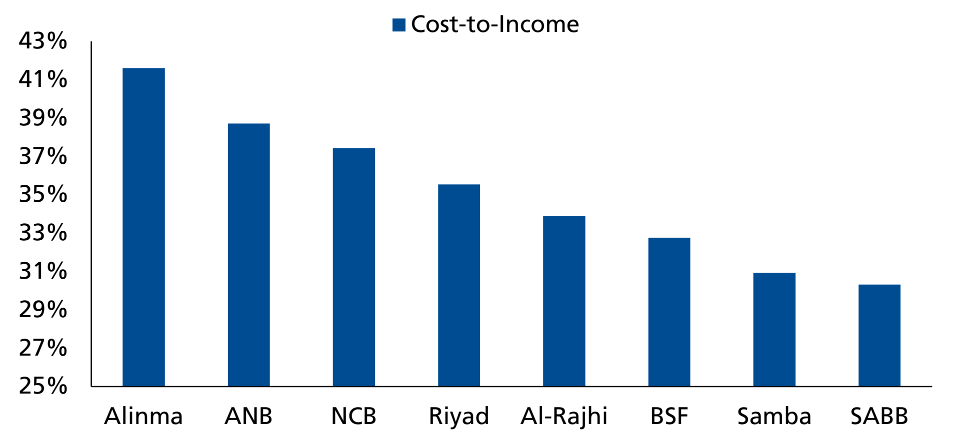


Source: SICO Research, Company Data

More opportunity for cost-rationalisation

Despite the strong branch network expansion, we estimate that the bank's operating expenses will grow at 7% CAGR 15-20e, slower than its revenue growth of 13% CAGR 15-20e. The bank lowered its cost-to-income ratio to 42% in 2015, down from 60% in 2009. We see more opportunity for the bank to lower the ratio to 38% in 2018, considering it is much higher than the Saudi banks' average of 34% in 2015.

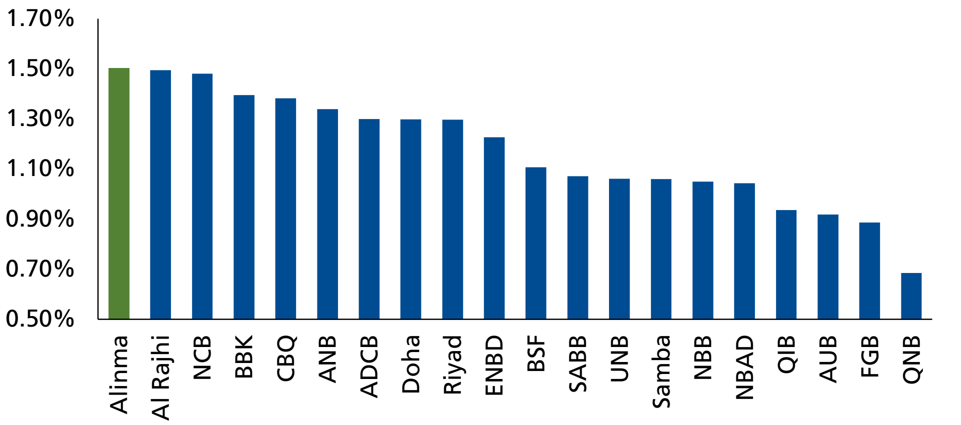
Exhibit 15: Alinma has more potential to lower its operating expenses, which are relatively higher than its peers



Source: SICO Research, Company Data

Alinma Bank's operating expenses-to-assets ratio is the highest among our GCC banks' coverage. The bank's operating expenses are high as Alinma is on an expansionary path; however, we believe that over time the bank will be able to consolidate its expenses, which should result in slower expense growth compared to its assets growth.

Exhibit 16: Alinma's operating expenses-to-assets ratio 2015 is highest among major banks of the GCC

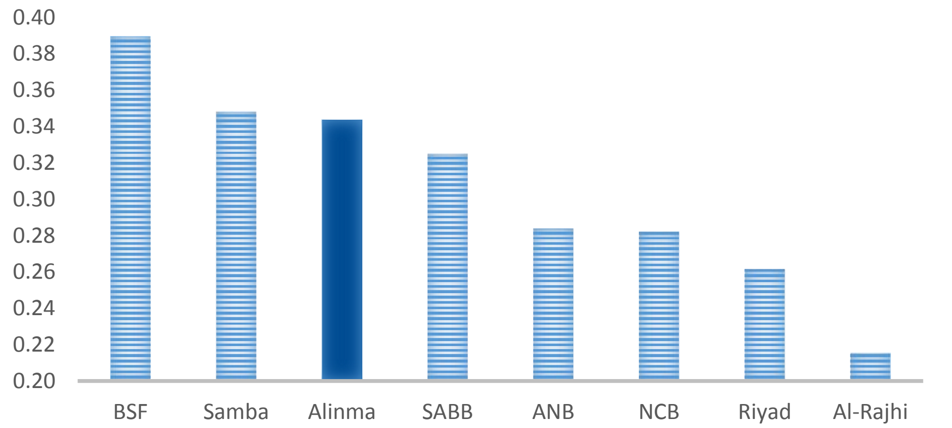


Source: SICO Research, Company Data

Alinma Bank's staff expenses-to-employee ratio high

Alinma has the potential to further lower its staff-expenses-to-employee ratio, which is only lower than BSF and Samba among its peers. Unlike other banks, BSF paid 2 months' bonus to all its employees, which pushed up its operating expenses by 12% in 2015; while Samba's staff cost has been historically high, due to its focus towards corporate banking and Investment banking.

Exhibit 17: Staff expenses-to-employee ratio 2015. Staff expenses growth to be slower than asset growth.

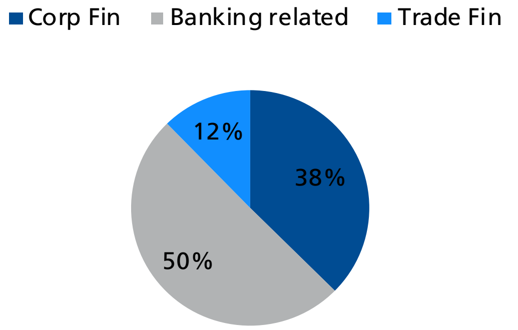


Source: SICO Research, Company Data

Earnings growth to be boosted by fee income growth

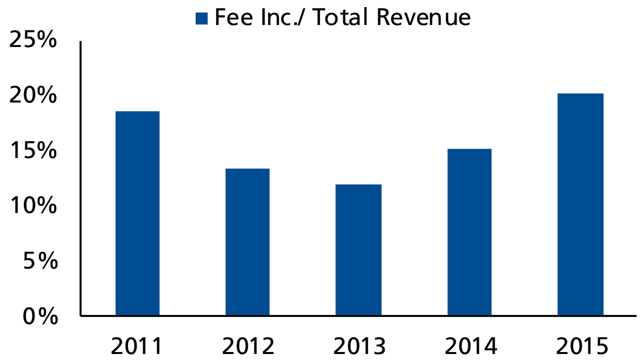
Alinma Bank is likely to report a 9% CAGR 2015-20e fee income growth, supported by balance sheet growth and efficiency improvement. More than half of the bank's fee income is related to its banking activities, which should continue to grow with expected strong lending book expansion.

Exhibit 18: Fee income distribution-2015. Diversified but skewed towards balance sheet growth.



Source: SICO Research, Company Data

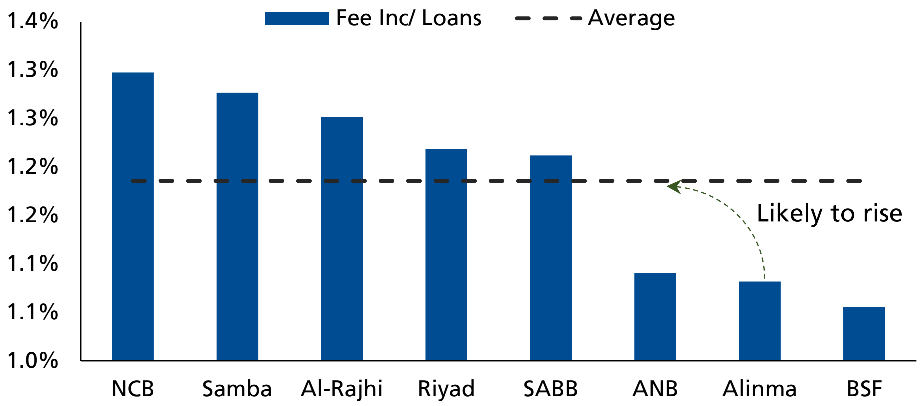
Exhibit 19: Alinma Bank's fee income contribution to total revenue has remained strong



Source: SICO Research, Company Data

Alinma Bank's fee income-to-loan ratio is less than its peers, and we see further potential for the bank to improve the ratio and bring it in line with its peers. As discussed previously, the bank should benefit from balance sheet growth, and we believe that being a Sharia-complaint institution, it can target mid-size corporate related financial deals.

Exhibit 20: Fee income to loan ratio-2015; more potential to grow and come in line with peers



Source: SICO Research, Company Data

Lending mix- shift to lower asset quality deterioration

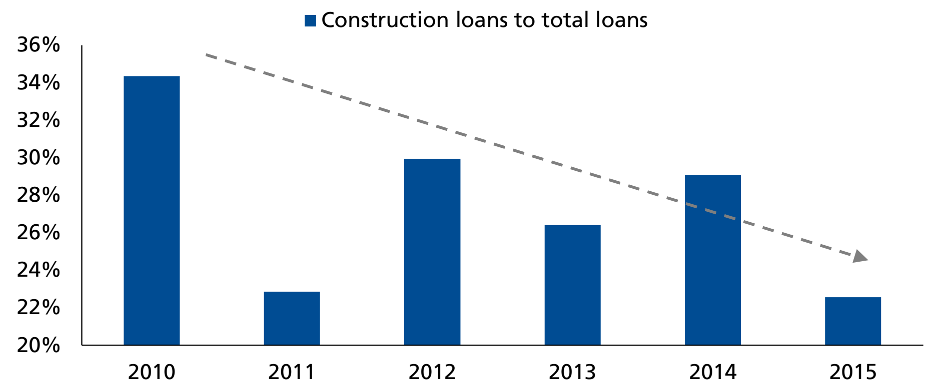
Lowering exposure to real estate and construction sector

Alinma Bank is shifting its exposure from a higher concentration in the building and construction sector to the consumer, services and commerce sectors. The bank also mildly increased its exposure to the agriculture and services sectors.

Alinma Bank's exposure to the building and construction sector declined from 34% in 2010 to 23% in 2015. As a Sharia-complaint bank, we do not expect the exposure to fall below 20% of its lending book.

Although we do not expect to see a significant slowdown in the construction sector, payment delays are likely and corporations with high leverage are at greater risk of default.

Exhibit 21: Declining construction loans to total loans ratio

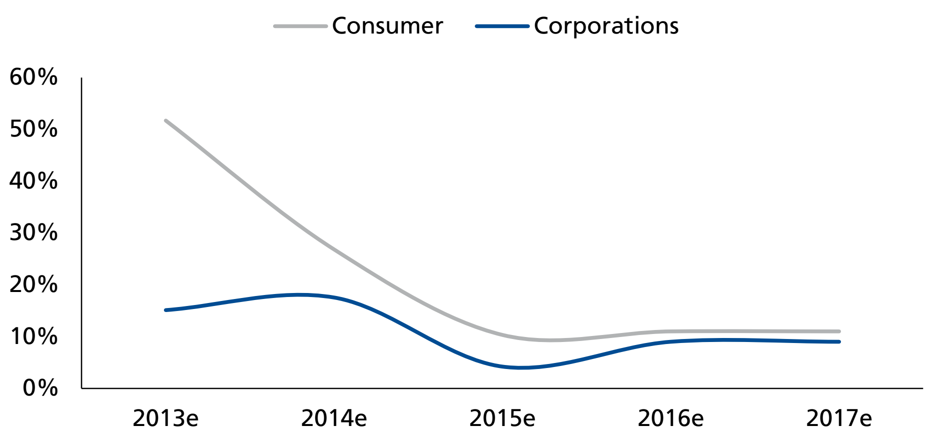


Source: SICO Research, Company Data

Increasing exposure to consumer sector

Alinma Bank continues to grow its consumer lending book more rapidly than its corporate portfolio. We believe the trend will continue as the bank increases its branch footprint in the Kingdom. Increasing exposure to the consumer sector will also further boost the bank's net interest margins.

Exhibit 22: Increasing exposure to consumer lending



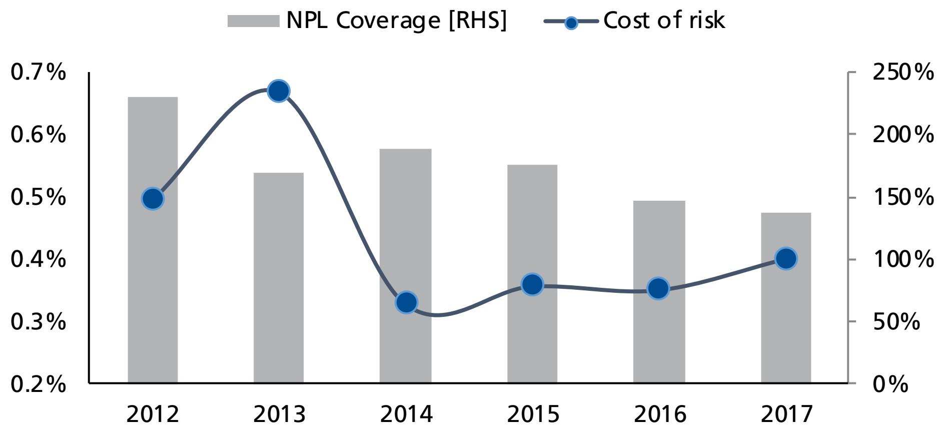
Source: SICO Research, Company Data

Cost of risk to remain capped

Alinma Bank's cost of risk (provisions-to-average loans) should marginally increase by 5 bps in 2016.

- Alinma Bank's lending book started growing from 2010 onwards, hence it does not have legacy bad loans that it may be servicing. We believe the bank has a relatively clean lending book, and as it is lowering its construction sector exposure, the asset quality deterioration should also be slow.
- The bank has a NPL ratio of 0.7% with a strong NPL coverage of 175%. We forecast the bank's NPL ratio to increase to 1.2% in 2017, and its NPL coverage to taper down to 140%.

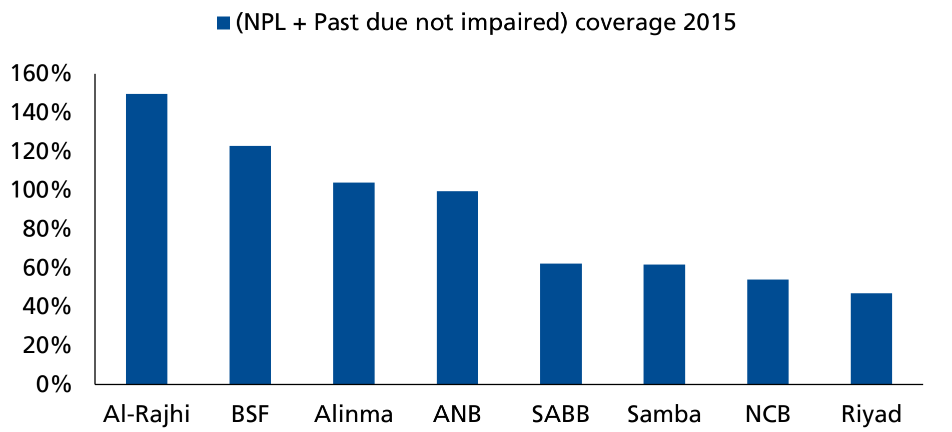
Exhibit 23: Strong NPL coverage will cap the bank's cost of risk



Source: SICO Research, Company Data

- The bank's past due loans marginally increased to SAR 292mn in 2015 from SAR 272mn in 2014. Even if assuming all past-due loans will turn delinquent in 2016, we estimate that the bank's NPL coverage will be 104%.

Exhibit 24: Alinma has a strong (past due + impaired loan) coverage; if all past due loans turn impaired, it still will have more than 100% coverage

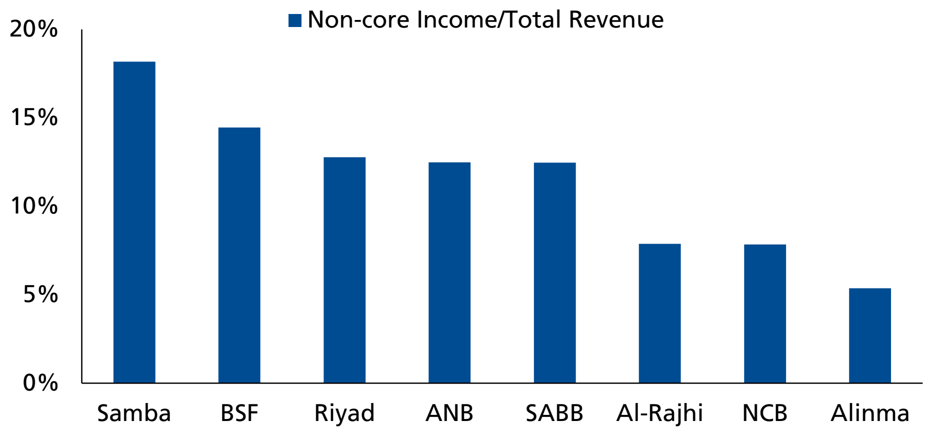


Source: SICO Research, Company Data

High reliance on core income suggests sustainability

Banks with low reliance on non-core income are likely to better sustain their earnings. Alinma Bank has been able to maintain its non-core income below 6% of total revenues, which we believe to be sustainable.

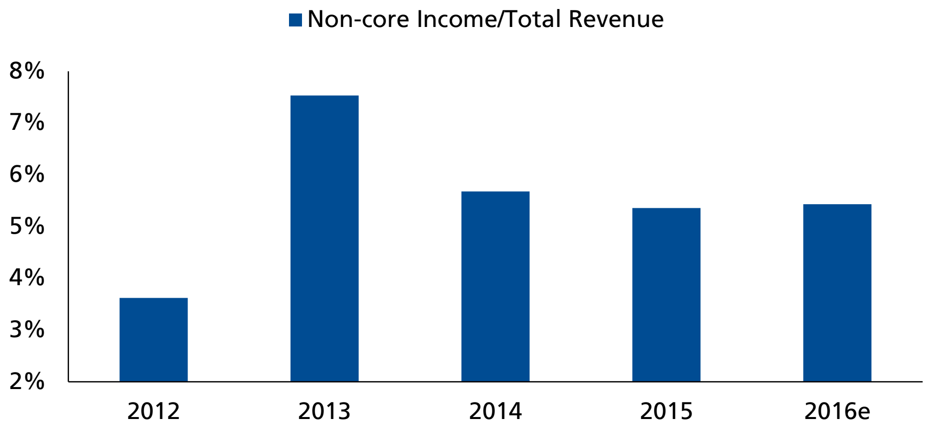
Exhibit 25: Non-core Income-total revenue-2015. Alinma Bank has low reliance on non-core Income compared to its peers



Source: SICO Research, Company Data

For our analysis, we have removed investment-related income, FX gains and other income from our core income category, as they are usually more volatile.

Exhibit 26: Stable non-core income to total revenue



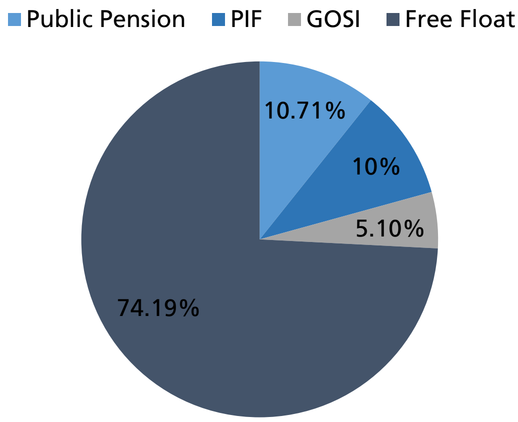
Source: SICO Research, Company Data

Alinma Bank Profile

Alinma Bank commenced business operations in 2008, and provides Shariah-compliant banking services focused primarily on the Kingdom of Saudi Arabia. As at 2015 end, the bank operates out of 69 branches and 1,166 ATMs.

The bank's subsidiaries provide diversification to its core business. They include (1) Alinma Investment Company, providing asset management, advisory and brokerage services; (2) Al-Tanweer Real Estate Company for facilities mortgage financing for the bank; and (3) Alinma Cooperative Insurance Agency, the insurance agent for Alinma Tokia Marine.

Exhibit 27: Shareholders' profile. Healthy free-float

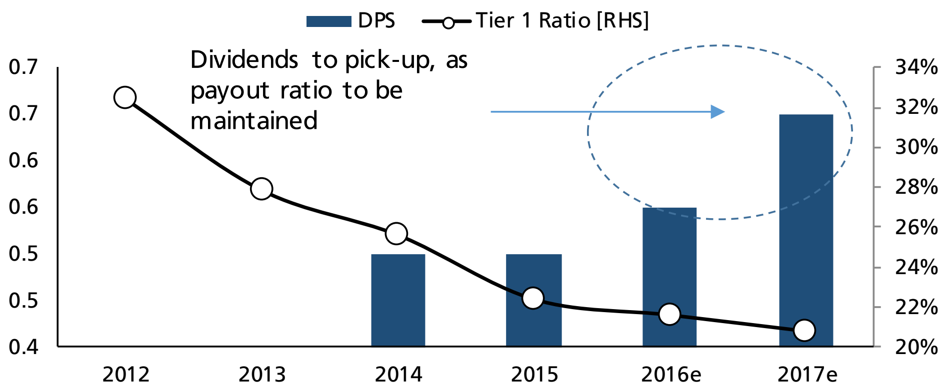


Source: Company Data

Dividends likely to pick up

Alinma Bank will likely continue to increase its dividends per share, while maintaining its payout ratio at ~50%. The bank has a strong tier 1 ratio of 22.3%, the highest among Saudi banks, and we do not see much risk to its dividends payment.

Exhibit 28: Dividends should increase going forward into 2016, supported by strong tier 1 ratio



Source: SICO Research, Company Data

Valuation Methodology

We have used the residual income method to value the bank. In the residual income valuation approach, we calculate the fair value of a company as the sum of its current net asset value and the present value of its future residual income. The residual income is measured as an excess return over the cost of equity.

To measure the residual income valuation, we have split the future period into three stages: **explicit (2016e-20e), steady growth (2021e-30e) and maturity (2031e-45e)**. In the explicit stage, residual income is calculated on our earnings estimate. In the steady growth phase, we assume a constant growth rate of our net profit and adjust it with our sustainable dividend pay-out ratio assumption, to arrive at the excess return to equity. In the maturity phase, we assume that the return on equity would converge to the cost of equity.

Risk-free rate:

To arrive at **Saudi risk free rate** we add Saudi country risk premium to the long-term US risk free rate. We arrive at the **long-term US risk free rate**, we have adopted a weighted average (80%) of 15yr average of US 10yr bond and 20% weight being given to the preceding year's average 10-yr bond rate.

In order to calculate the **Saudi country risk premium**, we adjust risk premium, the default spread (1.33%) based on the Saudi Arabia's rating (Moody's – A1) is adjusted by the global average of equity to bond market volatility of 1.5x, leading to a risk premium of 2.00%.

Equity risk premium: We have assumed an equity risk premium of 6.04% (adjusted for the Saudi market) of long-term equity market returns for global markets. This takes into account the returns generated by the S&P 500 (which has the longest history, and represents the most developed equity market in the world) for the period 1928-2015. Accordingly, during this period, the S&P 500 generated an excess return of 4.54% over the risk free asset (US 10- year treasury). We have added a 1.5% illiquidity and disclosure premium.

Exhibit 29: Cost of Equity Methodology

Components	Methodology
Risk free rate	(0.8)* (Average of US 15 Year bond)+(0.2)*(Average of preceeding year US 10 yr bond)
Country Premium	1.5 X Default spread
Equity Premium	US equity premium based on S&P 500 and US 10 Yr (1928 to 2015 period) + 1.5% premium for GCC markets
Default Spread	Takes lower of Moody/S&P's rating and avg. CDS spread between rating classes and USD bond.

Source: SICO Research

Alinma Financials

Income Statement (SAR mn)	2014A	2015A	2016E	2017E	2018E
Interest Income	2,286	2,547	3,023	3,398	3,596
Interest Expense	(211)	(268)	(545)	(484)	(531)
Net Interest Income	**2,075**	**2,279**	**2,478**	**2,914**	**3,065**
Fees Income	396	620	668	721	777
Non-Interest Income	**545**	**784**	**848**	**912**	**974**
Total Revenue	**2,620**	**3,063**	**3,326**	**3,826**	**4,039**
Operating_expenses	(1,185)	(1,274)	(1,351)	(1,446)	(1,548)
Pre-Provision Profit	**1,435**	**1,789**	**1,976**	**2,380**	**2,491**
Loan loss charges	(145)	(196)	(266)	(291)	(352)
Profit Before Tax	**1,264**	**1,470**	**1,651**	**2,052**	**2,104**
Zakat	0	0	0	0	0
Profit After Tax	**1,264**	**1,470**	**1,651**	**2,052**	**2,104**
Minority Interest	0	0	0	0	0
Net Income	**1,264**	**1,470**	**1,651**	**2,052**	**2,104**
Core Income	**1,125**	**1,317**	**1,479**	**1,859**	**1,902**

Balance Sheet (SAR mn)	2014A	2015A	2016E	2017E	2018E
Cash & cash equivalent	6,066	5,133	7,584	8,239	8,952
Interbank	10,318	17,015	17,865	18,759	19,697
Investments	8,011	6,357	6,637	6,949	7,296
Net Loans	53,637	56,570	61,755	67,445	73,486
Investment in associates	25	111	103	105	110
Intangible assets	0	0	0	0	0
Fixed Assets	1,544	1,629	1,710	1,796	1,886
Other Assets	1,261	1,910	2,005	2,106	2,211
Total Assets	**80,862**	**88,725**	**97,660**	**105,398**	**113,637**
Total deposits	59,428	65,542	72,096	80,747	90,437
Due to Interbank	33	2,264	3,741	1,646	(922)
Debt Securities	0	0	0	0	0
Other liabilities	3,462	2,567	2,644	2,750	2,887
Total liabilities	62,923	70,372	78,481	85,143	92,403
Minority Interest	0	0	0	0	0
Total Equity	**17,939**	**18,352**	**19,179**	**20,255**	**21,234**
Total Equity & Liabilities	**80,862**	**88,725**	**97,660**	**105,398**	**113,637**
Valuation (Per Share)					
EPS	0.8	1.0	1.1	1.4	1.4
DPS	0.5	0.5	0.6	0.7	0.8
BPS	12.0	12.2	12.8	13.5	14.2

Alinma Ratios

Key Ratios (%)	2014A	2015A	2016E	2017E	2018E
Asset Quality					
NPL Ratio	0.6	0.7	1.0	1.2	1.3
NPL Coverage	188	175	158	151	159
Provisions/ Avg. Loans	(0.29)	(0.36)	(0.45)	(0.45)	(0.50)
Margins					
Asset Yields	3.3	3.1	3.4	3.6	3.6
Funding Cost	0.4	0.4	0.8	0.6	0.6
NIM	3.0	2.8	2.8	3.1	3.0
Capital Adequacy (%)					
Core Tier 1 Ratio	0.0	0.0	0.9	2.0	2.9
Tier 1 Ratio	25.6	22.3	21.9	21.5	21.0
CAR	26.1	22.9	22.6	22.2	21.7
Total RWA (LCY mn)	70,140	82,128	87,664	94,145	100,951
Liquidity Ratios (%)					
Liquid Assets/ Total Assets	30	32	33	32	32
Wholesale funding/ Total Assets	0	0	0	0	0
Loans and Advances to Deposit	90	86	86	84	81
Loans/Assets	66	64	63	64	65
Income statement ratio %					
Fees Income/ Total Revenue	15.1	20.2	20.1	18.8	19.2
Cost to Income Ratio	45.2	41.6	40.6	37.8	38.3

Du Pont Analysis	2014A	2015A	2016E	2017E	2018E
Net Interest Income	2.9	2.7	2.7	2.9	2.8
Fee Income	0.6	0.7	0.7	0.7	0.7
Other non-Int Income	0.2	0.2	0.2	0.2	0.2
Total Revenue	**3.6**	**3.6**	**3.6**	**3.8**	**3.7**
Staff Expense	(0.9)	(0.8)	(0.8)	(0.8)	(0.8)
Other Overhead Expenses	(0.8)	(0.7)	(0.7)	(0.7)	(0.7)
Operating Expense	**(1.6)**	**(1.5)**	**(1.4)**	**(1.4)**	**(1.4)**
Pre-provisioning Profit	**2.0**	**2.1**	**2.1**	**2.3**	**2.3**
Loan loss provisioning	(0.2)	(0.2)	(0.3)	(0.3)	(0.3)
Others	0.0	(0.1)	(0.1)	0.0	0.0
Zakat & Minority Interest	0.0	0.0	0.0	0.0	0.0
ROA	**1.8**	**1.7**	**1.8**	**2.0**	**1.9**
Equity/Assets	24.2	21.4	20.1	19.4	18.9
ROE	**7.3**	**8.1**	**8.8**	**10.4**	**10.1**

Source: Company, SICO Research, Bloomberg

Price, Target Price and Rating Change History Chart of (Alinma AB)

Date	Closing Price	Target Price	Rating	Initiation
23-May-16	13.0	15.0	B	X

B=Buy, A=Add, N=Neutral, R=Reduce, S=Sell, U/R = Under Review

Securities & Investment Company BSC

Analyst Stock Rating Definitions

Time horizon	
Short term	SICO Research issues a Short term outlook if the analyst feels that there are factors which might affect the short-term performance of the stock during the immediate six months after issuing a rating. This might be due to both quantitative and qualitative factors which the analyst think can affect the price Performance in the short- term. Short term outlook can be different from the long term rating and the estimated up side or down side from the current price based on the Target Price estimate for the company
Long term	SICO Research's Long-term rating is based on the Target Price target price (given below) calculated by the The Target Price is arrived at using both fundamental and comparative valuation methods based on the detailed Financial models developed by analysts incorporating current expectations and analyst's assumptions.
	Target price for a stock is calculated one year forward from the valuation date
Recommendation (Short term)	
Positive	Analyst expect positive triggers in the short term which might affect current price positively (> 10%)
Neutral	Analyst does not expect any short term triggers/events (+/- 10%)
Negative	Analyst expect negative triggers in the short term which might affect current price adversely (< 10%)
Recommendation (Long term)	
Buy	If Risk profile is "**High**" Target price estimate offers **20%+** return from the current share price.
	If Risk profile is "**Normal**" Target price estimate offers **15%+** return from the current share price.
Neutral	If Risk profile is "**High**" Target Price estimate offers **0% to 20%** return from the current share price.
	If Risk profile is "**Normal**" Target Price estimate offers **5% to 15%** return from the current share price
Sell	If Risk profile is "**High**" Target price estimate offers less than **0%** return from the current share price.
	If Risk profile is "**Normal**" Target price estimate offers less than **5%** return from the current share price.
Risk	
High	Stock volatility (360 days standard deviation) exceeds 2x of S&P GCC market volatility
Normal	Stock volatility (360 days standard deviation) lower than 2x of S&P GCC market volatility

NOTES

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