



## Marhaba to Rising Rates

2016 is likely to be a watershed year for the Saudi banking sector, as it faces new opportunities in the shape of higher benchmark rates and the government re-entering the bond market. On the flip side, the sector must also confront challenges in the shape of a bottoming-out in cost of risk in 2015 and tighter liquidity. In the wake of the difficulties faced as the global financial crisis unfolded in 2008, the sector (led by a prudent and capable regulator) is prepared to capitalize on the new operating environment. Initiating coverage of 7 conventional banks and assuming coverage of 4 shariah-compliant banks with SABB, ARNB and Samba as our top picks.

**US Fed on the brink of raising rates for the first time in 8 years:** The KSA banking sector is positively geared to higher rates, with a high proportion of zero cost deposits. This gearing has only increased since the US Federal Reserve initiated zero interest rate policy. In 2008, demand deposits made up 41% of sector deposits, while as per SAMA's numbers this proportion stood at 66% as of July 2015. During this period, sector NIM has contracted from 3.7% (2007A) to 2.5% (2015E). We expect NIM to expand 66bps in 2015E-2018F.

**Government bond issuance will ease competitive pressures and allow liquid banks to re-price asset portfolios faster:** Recent declines in oil prices is projected to push KSA into a budget deficit in 2015. In order to finance this deficit the government has already issued bonds of SAR55 bln (the first issuance in 8 years), and is expected to issue SAR20 bln on a monthly basis for the remainder of the year. This issuance is expected to reduce competitive pressure in the market, allow banks to deploy into these higher yielding bonds and tighten local market liquidity (6m SAIBOR has risen 11 bps since end-Aug). As of July 2015, the sector had approximately SAR310 bln (14% of total assets) in liquid domestic assets (excluding statutory deposits), of which SAR208 bln were SAMA Bills. According to market reports, the bonds were issued at 1.92% for 5YR and 2.65% for 10YR. In our opinion, SAMBA, SABB, SHB and ARNB are likely to benefit most from the yield pick-up. Conversely, the issuance could put upward pressure on cost of funds, impacting banks with low demand deposit bases.

**KSA banking sector remains a strong long-term play on demographics and growing financial inclusion.** KSA banking sector benefits from structural drivers such as large, young and growing population (c.50% of the population is less than 25 years old), growing household income (c.8.5% CAGR in 2005-12) and government focus on expanding financial inclusion and documenting transactions.

**Low oil prices present growth and credit risk challenges; require strategy adjustment:** Should low oil prices persist and result in a curtailment in government spending, the sector could see depressed deposit and credit growth, and an uptick in NPLs. Assigned account retail lending, regulatory caps on lending to retail borrowers (i.e. higher LTV for mortgages) and stronger risk management should contain credit risk. Furthermore, the government in the near term appears to be committed to maintaining current expenditure levels, with some cuts foreseen in infrastructure spending. Finally, the sector maintains a high NPL coverage provisioning at 183% (2014A), with high collective provisions taken over the recent past. Banks will also need to re-evaluate their stated growth goals in SME lending, as it would not be conducive in a tougher economic environment.

**Rate hike delay holding back sector performance:** KSA banking sector has outperformed EM banks by 11% on a YTD basis and has moderately underperformed DM banks by c.2%. Relative to TASI, KSA banks performed in line YTD and +3% Y/Y, where ALBI and BJAZ are notable underperformers. However, over the last month the sector has underperformed by c.5% (to TASI) as expectations built of the US Fed delaying its first rate hike.

Bank	Rating	CMP	Target Price	Exp. Return
ALBI	HOLD	24.90	26.00	6.9%
Alinma	HOLD	17.50	16.50	-2.8%
BJAZ	SELL	21.10	18.00	-12.5%
RJHI	HOLD	56.00	60.00	10.3%
ARNB	BUY	28.40	38.00	38%
NCB	HOLD	55.00	55.00	1.9%
Riyad	SELL	13.80	13.00	0%
SABB	BUY	28.10	35.00	28%
SAMBA	BUY	23.70	31.00	36%
SHB	HOLD	33.30	34.00	6.1%
SIBC	SELL	20.40	16.00	-17%

Source: Bloomberg, SFC

Bank	P/B 2015e	P/E 2015e	RoAA 2015e	ROAE 2015e
ALBI	2.0	15.6	2.1%	16%
Alinma	1.5	18.4	1.7%	8%
BJAZ	1.2	6.9	1.8%	19%
RJHI	2.0	12.9	2.2%	16%
ARNB	1.3	8.5	2.0%	16%
NCB	2.1	11.0	2.2%	21%
Riyad	1.1	9.7	1.9%	12%
SABB	1.5	10.0	2.2%	15%
SAMBA	1.2	9.1	2.3%	13%
SHB	1.6	8.7	2.1%	19%
SIBC	1.0	8.8	1.6%	12%

Source: SFC

### Bank Index movement vs. TASI



Source: Bloomberg

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**Summary - KSA Banks**

Key Parameters		AIBilad	Alinma	AlJazira	Al Rajhi	ARNB	NCB	Riyad	SABB	SAMBA	SHB	SIBC	Median
Growth (CAGR 2014-18e)													
	Earnings	11.1%	13.4%	8.2%	10.7%	7.8%	11.3%	3.1%	7.6%	7.6%	8.5%	-3.2%	8.2%
	Net Loans	7.3%	5.1%	5.5%	4.9%	5.7%	6.7%	3.6%	6.6%	5.4%	8.3%	3.8%	5.5%
	Custom Deposits	7.0%	5.7%	5.2%	6.2%	6.0%	7.0%	7.0%	7.2%	6.0%	8.4%	4.5%	6.2%
Profitability & Efficiency ^													
	Net Interest Margin (Total Assets)	2.4%	2.9%	2.3%	3.3%	2.4%	2.7%	2.4%	2.2%	2.2%	2.2%	1.7%	2.4%
	Cost / Income (ex-Impairment)	59.2%	45.2%	57.2%	33.1%	38.3%	37.9%	35.0%	29.2%	30.2%	31.8%	37%	37%
Liquidity ^													
	Liquid Assets / Total Assets	29.3%	20.3%	17.2%	16.3%	14.1%	11.2%	13.6%	11.6%	10.2%	10.4%	10.7%	13.6%
	Net Loans / Customer Deposits	77.2%	90.3%	75.6%	80.4%	80.0%	66.3%	81.4%	79.0%	75.8%	84.8%	81.3%	80.0%
Asset Quality ^													
	Provisions / Gross Financing	2.8%	1.2%	1.6%	2.5%	2.2%	2.3%	1.5%	2.0%	2.1%	2.0%	1.4%	2.0%
	Non Performing Financing / Gross Financing (NPFs)	1.5%	0.6%	0.9%	1.3%	1.0%	1.3%	0.8%	1.3%	1.3%	1.3%	0.7%	1.3%
	Provisions / Non Performing Financing	192%	188%	181%	196%	218%	180%	189%	161%	161%	161%	188%	188%
Balance Sheet Strength ^													
	Equity / Total Assets	13.0%	22.2%	9.3%	13.6%	12.5%	10.4%	16.6%	13.9%	18%	11.1%	13%	13%
	Tier I Capital	15.6%	25.6%	11.4%	17.0%	14.1%	14.5%	16.9%	15.6%	20%	11.9%	14%	16%
Return Parameters (2015e)													
	RoAA	2.1%	1.7%	1.8%	2.2%	2.0%	2.2%	1.9%	2.2%	2.3%	2.1%	1.6%	2.1%
	RoAE	15.7%	8.0%	18.5%	16.0%	15.6%	20.7%	11.7%	15.4%	13.1%	19.0%	12.2%	16%
	Dividend Yield	2.6%	2.7%	2.2%	3.1%	4.1%	1.9%	5.7%	3.5%	5.0%	4.0%	4.5%	3.5%
Valuation													
	P/Earnings (x)												
	2014A	14.4	20.7	14.9	13.3	9.9	12.7	9.5	9.9	9.5	10.5	9.2	10.5
	2015E	15.6	18.4	6.9	12.9	8.5	11.0	9.7	10.0	9.1	8.7	8.8	9.7
	2016E	15.1	15.2	14.7	12.8	8.1	10.1	9.6	9.3	8.6	8.2	10.5	10.1
	P/PPP (x)*												
	2014A	14.5	18.3	8.9	9.9	8.4	11.1	7.9	9.1	9.2	8.8	8.3	9.1
	2015E	14.0	15.1	5.7	10.4	7.7	9.9	8.3	9.1	8.8	7.4	8.8	8.8
	2016E	11.6	12.7	7.5	9.6	6.9	9.0	8.2	8.1	8.1	6.7	9.3	8.2
	P/BV (x)												
	2014A	2.1	1.5	1.4	2.2	1.4	2.4	1.2	1.6	1.2	1.8	1.1	1.5
	2015E	2.0	1.5	1.2	2.0	1.3	2.1	1.1	1.5	1.2	1.6	1.0	1.5
	2016E	1.8	1.4	1.1	1.9	1.2	1.8	1.1	1.3	1.1	1.4	1.0	1.3
<b>Recommendation</b>		<b>HOLD</b>	<b>HOLD</b>	<b>SELL</b>	<b>HOLD</b>	<b>BUY</b>	<b>HOLD</b>	<b>SELL</b>	<b>BUY</b>	<b>BUY</b>	<b>HOLD</b>	<b>SELL</b>	
<b>Target Price (SAR)</b>		<b>26.00</b>	<b>16.50</b>	<b>18.00</b>	<b>60.00</b>	<b>38.00</b>	<b>55.00</b>	<b>13.00</b>	<b>35.00</b>	<b>31.00</b>	<b>34.00</b>	<b>16.00</b>	
Upside potential (%)		4%	-5%	-15%	7%	34%	0%	-6%	25%	31%	2%	-21%	
Current Market Price (SAR)		24.92	17.46	21.09	55.98	28.40	54.99	13.79	28.07	23.75	33.30	20.35	

^ Based on FY2014 results; \* Pre-provision profit

Source: Company Reports, Tadawul



### Summary - Loans and Deposits

Key Parameters	AlBilad	Alinma	AlJazira	Al Rajhi	NCB	ARNB	Riyad	SABB	SAMBA	SHB	SIBC
Net Loans (SAR bln)	28	54	41	206	221	104	133	115	124	65	57
Provisions / Gross Financing	2.8%	1.2%	1.6%	2.5%	2.3%	2.2%	1.5%	2.0%	2.1%	2.0%	1.4%
Non Performing Financing / Gross Financing (NPFs)	1.5%	0.6%	0.9%	1.3%	1.3%	1.0%	0.8%	1.3%	1.3%	1.3%	0.7%
Provisions / Non Performing Financing	192%	188%	181%	196%	180%	218%	189%	161%	161%	161%	188%
Customer Deposits (SAR bln)	37	59	55	256	333	130	164	146	164	77	71
Deposits Mix (%)											
Demand	73%	54%	48%	89%	76%	53%	44%	59%	66%	39%	28%
Time	16%	45%	50%	9%	20%	42%	50%	34%	25%	59%	70%
Others	11%	1%	2%	2%	4%	4%	6%	6%	9%	2%	2%
Net Loans/Deposits	77.2%	90.3%	75.6%	80.4%	66.3%	80.0%	81.4%	79.0%	75.8%	84.8%	81.3%

^ Based on FY2014 results

Source: Company Reports, Tadawul

### Summary - Key Branch Metrics

Key Parameters	AlBilad	Alinma	AlJazira	Al Rajhi	NCB	ARNB	Riyad	SABB	SAMBA	SHB	SIBC
Branches	116	58	70	501	342	156	318	81	72	55	48
Deposit per branch (SAR mln)	317	1,025	780	511	974	831	516	1,801	2,275	1,397	1,474
Net Loans per branch (SAR mln)	244	925	589	411	645	665	420	1,422	1,723	1,185	1,197
ATMs	953	1,022	511	3,997	2,643	1,110	2,551	854	543	382	442
Point of Sale	2,690	3,119	5,255	32,792	26,514	10,368	20,008	10,644	6,786	9,150	2,819
Employees	3,443	1,778	2,015	11,761	12,356	4,554	5,789	3,314	3,404	2,395	1,418
Cost per employee (SAR 000)	216	358	358	214	264	271	254	348	370	240	375

^ Based on FY2014 results

Source: Company Reports, Bloomberg, Tadawul

### Summary - KSA Banks

	Cost / Income (ex-Impairment)			Yield on Earning Assets			Cost of Funds			Net Interest Margin*		
	2014	2015E	2016F	2014	2015E	2016F	2014	2015E	2016F	2014	2015E	2016F
Al Rajhi	33.1%	36.4%	36.0%	3.6%	3.3%	3.5%	0.16%	0.11%	0.20%	3.4%	3.2%	3.3%
AlBilad	59.2%	61.1%	57.6%	2.7%	2.5%	2.7%	0.16%	0.12%	0.17%	2.5%	2.4%	2.6%
Alinma	45.2%	42.7%	38.3%	3.3%	3.3%	3.5%	0.41%	0.39%	0.51%	2.9%	2.9%	3.0%
AlJazira	57.2%	50.2%	58.6%	2.9%	2.9%	3.2%	0.60%	0.47%	0.61%	2.3%	2.4%	2.5%
NCB	39.0%	38.5%	37.2%	3.4%	3.3%	3.5%	0.66%	0.62%	0.75%	2.8%	2.7%	2.8%
Riyad	35.0%	37.6%	38.7%	2.9%	2.7%	2.9%	0.48%	0.32%	0.56%	2.4%	2.4%	2.3%
SABB	29.2%	30.6%	29.4%	2.6%	2.5%	2.7%	0.37%	0.33%	0.46%	2.2%	2.2%	2.3%
SHB	31.8%	31.1%	29.9%	2.9%	2.8%	3.0%	0.68%	0.60%	0.86%	2.2%	2.2%	2.1%
ARNB	38.3%	39.3%	38.8%	2.8%	2.6%	3.0%	0.37%	0.32%	0.51%	2.4%	2.3%	2.5%
SAMBA	30.2%	31.7%	30.8%	2.5%	2.7%	3.1%	0.26%	0.23%	0.32%	2.2%	2.2%	2.4%
SIBC	37.3%	41.1%	43.9%	2.6%	2.6%	2.8%	0.84%	0.84%	1.18%	1.7%	1.7%	1.6%
<b>Median</b>	<b>37.3%</b>	<b>38.5%</b>	<b>38.3%</b>	<b>2.9%</b>	<b>2.7%</b>	<b>3.0%</b>	<b>0.41%</b>	<b>0.33%</b>	<b>0.51%</b>	<b>2.4%</b>	<b>2.4%</b>	<b>2.5%</b>
	Operating Income (SAR mln)			NSCI (SAR mln)			NSCI / Operating Income			Operating Income / Net Income		
	2014	2015E	2016F	2014	2015E	2016F	2014	2015E	2016F	2014	2015E	2016F
Al Rajhi	13,667	13,775	14,840	9,817	9,953	11,001	72%	72%	74%	144%	142%	155%
AlBilad	2,097	2,291	2,533	1,019	1,129	1,292	49%	49%	51%	118%	141%	157%
Alinma	2,620	3,167	3,349	2,075	2,378	2,588	79%	75%	77%	164%	158%	150%
AlJazira	2,226	2,993	2,703	1,445	1,597	1,791	65%	53%	66%	256%	130%	312%
NCB	16,228	17,686	19,473	11,279	12,342	13,957	70%	70%	72%	130%	126%	129%
Riyad	8,012	8,015	8,211	5,130	5,280	5,597	64%	66%	68%	118%	123%	130%
SABB	6,502	6,651	7,345	4,063	4,247	4,822	62%	64%	66%	95%	100%	107%
SHB	3,182	3,637	3,958	1,966	2,244	2,459	62%	62%	62%	108%	107%	111%
ARNB	5,507	6,027	6,740	3,623	3,918	4,472	66%	65%	66%	126%	119%	126%
SAMBA	7,385	7,834	8,478	4,593	4,667	5,313	62%	60%	63%	92%	89%	97%
SIBC	2,531	2,564	2,539	1,540	1,714	1,745	61%	67%	69%	107%	114%	139%
<b>Median</b>	<b>5,507</b>	<b>6,027</b>	<b>6,740</b>	<b>3,623</b>	<b>3,918</b>	<b>4,472</b>	<b>64%</b>	<b>65%</b>	<b>66%</b>	<b>118%</b>	<b>123%</b>	<b>130%</b>

\* Based on Total Assets

Source: Company Reports, Tadawul

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**Summary - Valuation**

Key Parameters	AlBilad	Alinma	AlJazira	Al Rajhi	ARNB	NCB	Riyad	SABB	SAMBA	SHB	SIBC	Median
Earnings CAGR 2014-18E	11.1%	13.4%	8.2%	10.7%	7.8%	11.3%	3.1%	7.6%	7.6%	8.5%	-3.2%	8.2%
Market Capitalization (SAR mln)	12,460	26,190	8,436	90,968	28,400	109,980	41,370	42,105	47,500	19,032	13,228	28,400
Market Capitalization to Deposits (x)	0.34	0.44	0.15	0.36	0.22	0.33	0.25	0.29	0.29	0.25	0.19	0.29
Market Capitalization to Loans (x)	0.44	0.49	0.20	0.44	0.27	0.50	0.31	0.37	0.38	0.29	0.23	0.37
ROAA*	2.1%	1.7%	1.8%	2.2%	2.0%	2.2%	1.9%	2.2%	2.3%	2.1%	1.6%	2.1%
ROAE*	15.7%	8.0%	18.5%	16.0%	15.6%	20.7%	11.7%	15.4%	13%	19.0%	12%	16%
Valuation												
P/Earnings (x)												
2014A	14.4	20.7	14.9	13.3	9.9	12.7	9.5	9.9	9.5	10.5	9.2	10.5
2015E	15.6	18.4	6.9	12.9	8.5	11.0	9.7	10.0	9.1	8.7	8.8	9.7
2016E	15.1	15.2	14.7	12.8	8.1	10.1	9.6	9.3	8.6	8.2	10.5	10.1
P/PPP (x)*												
2014A	14.5	18.3	8.9	9.9	8.4	11.1	7.9	9.1	9.2	8.8	8.3	9.1
2015E	14.0	15.1	5.7	10.4	7.7	9.9	8.3	9.1	8.8	7.4	8.8	8.8
2016E	11.6	12.7	7.5	9.6	6.9	9.0	8.2	8.1	8.1	6.7	9.3	8.2
P/BV (x)												
2014A	2.1	1.5	1.4	1.4	1.4	2.4	1.2	1.6	1.2	1.8	1.1	1.4
2015E	2.0	1.5	1.2	1.3	1.3	2.1	1.1	1.5	1.2	1.6	1.0	1.3
2016E	1.8	1.4	1.1	1.2	1.2	1.8	1.1	1.3	1.1	1.4	1.0	1.2

\*2015e

Source: Company Reports, Tadawul

**KSA Banks - Results Summary 3Q 2015**

In SAR bln	Loan					Deposit					Total Assets				
Bank	3Q 15	2Q 15	3Q 14	QoQ	YoY	3Q 15	2Q 15	3Q 14	QoQ	YoY	3Q 15	2Q 15	3Q 14	QoQ	YoY
RIBL	138	137	141	1%	-2%	160	166	162	-4%	-1%	217	222	217	-2%	0%
SAMBA	127	131	120	-3%	6%	175	171	164	2%	7%	234	226	216	3%	8%
RJHI	210	211	204	0%	3%	265	267	250	0%	6%	325	327	299	-1%	9%
ALBI	32	32	28	2%	17%	41	38	37	6%	11%	49	49	44	1%	12%
BJAZ	42	42	40	-1%	4%	56	56	54	0%	4%	68	68	66	1%	4%
SIBC	58	57	58	1%	0%	67	70	70	-5%	-4%	90	93	91	-2%	0%
ALINMA	53	53	50	0%	5%	60	60	53	0%	13%	82	82	75	1%	9%
BSFR	124	125	118	-1%	5%	144	143	132	1%	9%	185	186	183	-1%	1%
SABB	129	127	117	2%	10%	156	151	144	3%	8%	197	192	183	3%	8%
NCB	237	233	214	2%	11%	364	360	344	1%	6%	477	461	438	3%	9%
SHB	73	71	63	3%	15%	83	83	73	-1%	14%	104	102	92	2%	14%
ARNB	113	111	96	2%	17%	133	132	115	0%	16%	165	166	150	-1%	10%
<b>Aggregate Sector</b>	<b>1,336</b>	<b>1,328</b>	<b>1,248</b>	<b>0.6%</b>	<b>7.1%</b>	<b>1,702</b>	<b>1,698</b>	<b>1,596</b>	<b>0.3%</b>	<b>6.7%</b>	<b>2,195</b>	<b>2,175</b>	<b>2,053</b>	<b>0.9%</b>	<b>6.9%</b>

In SAR mln	NSCI					Operating Income					Net Profit				
Bank	3Q 15	2Q 15	3Q 14	QoQ	YoY	3Q 15	2Q 15*	3Q 14	QoQ	YoY	3Q 15	2Q 15	3Q 14	QoQ	YoY
RIBL	1,262	1,294	1,316	-2%	-4%	1,863	2,169	1,990	-14%	-6%	899	1,128	1,076	-20%	-16%
SAMBA	1,184	1,163	1,175	2%	1%	1,990	1,949	1,850	2%	8%	1,371	1,333	1,281	3%	7%
RJHI	2,495	2,514	2,378	-1%	5%	3,195	3,535	3,439	-10%	-7%	1,721	1,941	1,662	-11%	4%
ALBI	294	287	264	2%	11%	566	585	551	-3%	3%	203	207	237	-2%	-14%
BJAZ	411	403	378	2%	9%	532	611	583	-13%	-9%	166	736	47	-77%	253%
SIBC	442	431	389	2%	13%	603	641	576	-6%	5%	351	383	371	-8%	-5%
ALINMA	548	610	529	-10%	4%	708	845	687	-16%	3%	375	365	331	3%	13%
BSFR	1,044	1,016	980	3%	7%	1,588	1,579	1,487	1%	7%	1,020	1,016	926	0%	10%
SABB	1,079	1,067	1,029	1%	5%	1,689	1,675	1,655	1%	2%	1,140	1,137	1,059	0%	8%
NCB	3,210	3,136	2,791	2%	15%	4,313	4,283	4,114	1%	5%	1,994	2,363	1,869	-16%	7%
SHB	606	564	564	7%	7%	880	923	809	-5%	9%	493	539	462	-9%	7%
ARNB	995	970	919	3%	8%	1,470	1,502	1,366	-2%	8%	764	835	748	-9%	2%
<b>Aggregate Sector</b>	<b>13,569</b>	<b>13,454</b>	<b>12,713</b>	<b>0.8%</b>	<b>6.7%</b>	<b>19,398</b>	<b>20,297</b>	<b>19,106</b>	<b>-4.4%</b>	<b>1.5%</b>	<b>10,498</b>	<b>11,983</b>	<b>10,069</b>	<b>-12.4%</b>	<b>4.3%</b>

Source: Company Reports, Tadawul



## Executive Summary

### Positively geared to higher interest rates

*High proportion of demand deposits in deposit mix drives sector gearing to higher interest rates*

The KSA banking sector is positively geared to higher rates, with a high proportion of zero interest cost deposits (66% of total deposits in July 2015). Since 2008, ZIRP and 3 rounds of QE, have depressed the sector's NIM by 116 bps to 2015E (96 bps to 2014A). We expect NIM to expand by 21 bps in 2016F and by 66 bps between 2015E and 2018F.

*Lift-off in US interest rates is imminent*

*US Fed 'nearly' ready to abandon zero rate policy*

Comments from US Federal Reserve officials indicate that they are 'nearly' ready to take the next step in the policy normalization process initiated in early 2014 with the tapering of purchases under QE3. The Fed is expected to start raising benchmark Fed Fund Rate ("FFR") later this year. Current Fed governor median expectations are for the FFR to rise to 25 bps by end-2015, 1.6% in 2016, 2.6% in 2017 and to peak at 3.5% in 2018.

*Higher core demand deposits will underpin NIM expansion*

The sector's deposit maturity has declined significantly since 2008. In that period, demand deposits have grown from 41% of overall deposits to 64% in 2014A, and 68% in 2015E. This was part of the enlargement of the maturity mis-match that supported margins in the exceptionally low interest rate environment, and hence overall sector profitability.

*Banks with low core demand deposits could see cost of funds rise before yields*

In this context, as the opportunity cost of holding liquid demand deposits for depositors rises, banks with lower core demand deposits could start to face higher funding costs. We expect this to have a marginal impact for cost of funds of these banks in 2016E (government bond issuance could have a greater impact as discussed later in this report), but could become relatively significant in 2017 and 2018. SAIB seems particularly vulnerable in this context (80% LDR in 2014A), its average demand deposits share 2010-1H2015 stands at 23% (1H2015: 30%). BJAZ is the only shariah-compliant bank with average (2010-1H2015: 39%) below 50%, while of the conventional banks SHB (41%: 1H2015) and, surprisingly given its extensive branch network, RIBL (45%) are also below 50% amongst the conventional banks.

*To support profitability in low rate environment, banks have lengthened loan book maturity*

*Banks have lengthened A-L mismatch to support profitability in the low rate environment*

According to SAMA data, the maturity of the loan book has lengthened significantly with >1 YR maturity loans, which tend to be floating rate, forming a larger proportion of the loan book. This proportion has increased from 41% in 2010 to an average of 49% for the first 6 months of 2015. This A-L mismatch is expected to benefit from higher rates seeping into the balance sheet. The investment risks of this mismatch are well covered by the strength of the sovereign backing and the general health of individual banks' credit profiles. The intense competition seen in the past few years can limit the full pass-through of the benefits of higher rates, mitigated partially by higher government bond issuance. We expect the pass-through to be relatively fuller for banks with a corporate concentration as typically corporate lending re-prices every 3 months, whilst only approximately 20% of the retail portfolio matures in a given year.

### Government bond issuance could raise yields on investment portfolios

*Gov't bonds a welcome avenue for bank excess liquidity*

Brent Crude prices are down 12.2% YTD (US\$50.31/b), averaging US\$59.89/b YTD2015. According to the IMF at the conclusion of its Article IV consultations, the central government fiscal balance is expected to post a deficit of 19.5% of GDP in 2015. Oil revenue is projected to decline from 32.6% of GDP in 2014 to 24.2% of GDP in 2015, while expenditure is expected to expand to 49.5% of GDP. The government has thus far funded SAR75 bln of the 2015 deficit through bond issues, and is expected to issue a further

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SAR60 bln through to the end of the year. In 2016, we project that the government will issue approximately SAR10 bln per month.

*ARNB, SABB, Samba and SHB yield on investments are significantly below sector*

The conventional banks, with the exception of NCB, have seen yields on investments decline over the past few years. This yield stands at below 2% for all the conventional banks with the exception of NCB and SAIB, versus reported yields for government bonds of 1.92% (5YR) and 2.65% (10 YR). ARNB, SHB, SABB and Samba whose yield on investment is significantly below the 1.8% (2014) sector average, would clearly gain by switching part of their liquid assets to the government bonds. ARNB, SABB and Samba also hold liquid assets in excess of 30% of total assets.

#### **Demographic profile and growing financial inclusion: long-term positives**

*Demographic trend support long term sector growth.*

KSA banking sector benefits from structural drivers such as large and growing population, high proportion of young people (c.50% of the population less than 25 years old), growing household income (c.8.5% CAGR in 2005-12) and government focus on expanding financial inclusion and documenting transactions.

*Significant strides in financial inclusion made, but KSA still lags GEM peers*

Despite the significant strides in development of the financial sector, compared to banking systems in GEM, KSA commands low banking penetration. With private sector credit and deposits to GDP at 45% and 56% respectively, KSA lags the GCC by c.30ppt and c.10ppt below average comparable Asian economies such as Indonesia, India and Thailand. As 1) the recent gains on expanding banking services to a larger proportion of the population mature, 2) the demographic trend continues to add to the working age population, and 3) number of households continue to increase as household sizes fall, this under-penetration relative to peer countries should narrow. This catch-up potential presents a significant growth opportunity in the long-term.

#### **'Lower-for-longer' oil prices likely to depress loan and deposit growth, raise credit risk**

*'Lower-for-longer' oil prices could impact volume growth in deposits and loans, as well as raise credit risk*

Recent weakness in oil prices that has morphed into a 'lower-for-longer' view could dampen volume growth for the sector, as well as posing risk of higher credit losses. Private sector credit growth and credit losses both share a historical correlation to oil prices.

Recent non-Oil GDP growth has been bolstered by an expansionary fiscal policy. In the context of lower oil prices and indications by the government that it is looking to curtail some investment expenditure in 2015, and into 2016, should result in loan growth slowing significantly from the 5yr CAGR (2009-2014) of 12%. For the sector, we are expecting loan growth to slow to a 4yr CAGR (2014A-18F) of 6%.

*NPLs have been creeping higher this year.*

Over the last two quarters, the sector has started to see NPLs creep higher. NPLs for the sector stood at SAR14.95 bln in June 2015, versus SAR14.86 bln in 1Q2015 and SAR14.42 bln end-2014, up 3.6% versus end-2014. The smaller banks, BJAZ (16%), Bilad (16%), SAIB (14%) and Alinma (10%) have all seen a substantial percentage up-tick in the first half of 2015, along with Riyadh (11%).

The sector is well-positioned to limit NPL accretion, led by a pro-active and conservative regulator. Recent pro-active steps to curtail future NPL accretion risk include linking retail loans to maintaining salary/pay account with the same bank and regulatory caps on retail lending (i.e. higher LTV requirement for mortgages). Furthermore, since the fall-out suffered as a consequence of the financial crisis over 2008 to 2010, SAMA has pushed banks to bolster collective provisioning and maintain strong capital adequacy.



#### ALBI

TASI	1140
Rating	Hold
12M Target Price	26.00
Last Price	24.92
Upside to Target	4.3%
Dividend Yield	2.6%
Expected Total Return	6.9%

#### Bank AlBilad

AlBilad has combined strong deposit mobilization franchise and capital base to deliver appreciable asset growth in the past few years. We expect growth to slow in the current economic environment. HOLD with a lower target price of SAR 26, the bank remains our preferred exposure amongst shariah-compliant banks. Bank AlBilad's low cost funding base (demand deposits 78% of total deposits vs. system: 66% as at end 2Q15) and adequately capitalized balance sheet (Tier I ratio of 15.4% as of 2Q15) has supported its aggressive lending strategy. This is well reflected in its recent volume growth numbers. In a tougher economic environment growth is likely to slow, and the tighter spreads on aggressive loan book expansion are a risk.

#### Alinma

TASI	1150
Rating	Hold
12M Target Price	16.50
Last Price	17.46
Upside to Target	-5.5%
Dividend Yield	2.7%
Expected Total Return	-2.8%

#### Alinma Bank

Macro headwinds will limit sustained RoE improvement. In our view, balance sheet inefficiencies (excess capital) will remain a near term drag on the stock. HOLD with a reduced target price of SAR16.5. Alinma Bank's near-term equity story remains less attractive. The bank benefits from a strong capital base (Tier 1 as of 2Q15: c.24%) which in turn should likely lead to potentially robust growth going forward (2014-19F EPS CAGR 11%). The bank operates at a relatively higher cost-structure (cost to income 2Q15: 48% vs. 35% for the sector; and 41% for the shariah-compliant banks), which has room for improvement. Furthermore, the financing portfolio is well diversified (c.18% exposure to low-risk government/quasi government segment). Despite, Alinma's positives we fail to see a favorable trade-off between risks and growth prospects at Alinma.

#### BJAZ

TASI	1020
Rating	Sell
12M Target Price	18.00
Last Price	21.09
Upside to Target	-14.7%
Dividend Yield	2.2%
Expected Total Return	-12.5%

#### Bank Al Jazira

Despite the recent sell off in BJAZ we fail to see a buying opportunity. Market opening presents scope for broking growth but exposure to share margin financing is a near-term concern. Maintain our Hold rating with a reduced target price of SAR 18. BJAZ has one of the lowest NIM (2.8% in 2Q15) amongst the peer group of shariah-compliant banks (Alinma: 3.3%, AlBilad: 2.8%; and AlRajhi: 3.8%), though recent results have indicated a slight improvement in margins sequentially. Bank's low capitalization level (Tier I capital 2Q15: c.14%) along with high-cost funding base as demand deposits comprise only 48% of total customer deposits in 2Q15 (vs. 66% for the system) are key concerns. Streamlining of its cost structure (cost to income 2014: 57% vs. 36% for the sector) holds the key to long term equity story for BJAZ. We fail to see an attractive risk-return trade off in BJAZ positives.

#### RJHI

TASI	1120
Rating	Hold
12M Target Price	60.00
Last Price	55.98
Upside to Target	7.2%
Dividend Yield	3.1%
Expected Total Return	10.3%

#### AlRajhi Bank

Declines in NIM and RoAE over recent years should be arrested as higher interest rates feed-in up to 2018, however we see competitive challenges to market share. The impact of new management holds the key to a more constructive view. HOLD with an upward revision in target price to SAR 60 per share. Al Rajhi Bank is the largest shariah-compliant financial institution in KSA and key strengths include wide scale of operations (c.27% market share in terms of number of branches in KSA), low cost funding base (demand deposits c.95% of customer deposits vs. c.66% for the system) and efficient cost structure (cost to income of 32% vs. 36% for the sector). However, despite its strong market position, rising competition has eroded NIM and RoE.

#### ARNB

TASI	1080
Rating	Buy
12M Target Price	38.00
Last Price	28.4
Upside to Target	33.8%
Dividend Yield	4.1%
Expected Total Return	37.9%

#### Arab National Bank

Building on its strong performance in 1H2015 in loan growth and fee income generation, ARNB is also a beneficiary of higher interest rates and government bond issuance; initiate with BUY and SAR38 target price. ARNB is likely to accrue benefits from higher interest rates and government bond issuance at a faster pace than most of its peers. Its retail loan footprint, 24% of lending versus 31% for sector should allow for faster re-pricing of loan book as the US Fed initiates rate tightening cycle in late 2015. It should also benefit from the government bond issuance, as it replaces part of its low yielding investment portfolio into the higher yielding bonds. It outpaced the sector in loan growth up 21% Y/Y and delivered 12.6% Y/Y

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growth in fee income in 1H2015. The bank continues to outperform peers in payment fees whilst growing remittance, loan and insurance fees.

#### National Commercial Bank

Despite the highest core demand deposit base of peer banks, we see limited upside from higher interest rates in medium term. Valuation premium adequately captures forward outlook. Clarity needed on conversion to full shariah-compliance. Initiate with a HOLD and target price of SAR55. 24%, 18% and 18% share in demand deposits, branches and loans respectively, only surpassed by AlRajhi in the number of branches, makes NCB is a strong player in the corporate, retail and treasury segments. Three-quarters of NCB's deposit base comprise zero-cost demand deposits. It has the sector's largest investment book and an extensive branch network. Evidence of improvement in efficiency ratios, customer acquisition and cross-selling would lead us to a more constructive view on the stock.

#### Riyad Bank

Weak deposit mobilization, limited near-term upside from higher interest rates, uptick in NPLs in 1H2015 and potential weakening in fee income. A more constructive outlook dependent on more effective utilization of old and new brick network. Initiate with SELL, target price SAR13. RIBL maintained its NIM over 2010-2014A, in the face of sharp fall in sector NIM from 3.7% to 3.1%, as it avoided chasing volume in a competitive environment. This however has come at the cost of market share, where its share has fallen from 14% in 2010 to 10% in 1H2015. Similarly, its share of deposits has fallen from 12% in 2010 to 10% in 1H2015.

#### Saudi British Bank

Industry-leading cost efficiency, corporate focus and liquid B/S deliver gearing to higher interest rates. Strong brand and relationship with HSBC allow it to punch above its weight in deposit mobilization, retail banking and trade finance. Initiate with BUY and SAR35/share target price. One of the best positioned banks to benefit from higher interest rates with 59% of its loan book and 70% of its investment portfolio maturing within a year. This is bolstered further by a strong market share push in 1H2015, where it delivered above sector average 12.3% and 9.2% loan and deposit growth respectively.

#### Samba Financial Group

Quality of its capital strength, staff and branch productivity, corporate franchise and credit risk management places it above peers. Initiate with BUY and SAR30 target price. We believe that the historic low interest rate environment did not provide adequate risk-adjusted returns to motivate expansion in the balance sheet, but as interest rates tick up Samba might come into its own. Samba's balance sheet liquidity (its adjusted HQLA stood at 29% of total assets in 1H2015) is the strongest in the industry and best positioned to tap into higher yielding assets such as government bonds. In addition to this, its historical strength in managing credit risk should appeal to investors as economic conditions get relatively tighter. It clearly punches below its weight in the lending market, where it's share was only 10% in 1H2015, however the bank remains the first port-of-call for large borrowers, indicating that it can expand market share.

#### Saudi Hollandi Bank

SHB has delivered above average loan growth versus peers over the past few years, and the trend continued into 1H2015 and likely to continue to 2018F. The bank has made significant in-roads into retail and mid-market commercial. This should support margins as cost of funds pressures appear. Initiating with a HOLD and SAR34 target price. SHB's demand deposits comprise only 40% of total deposits (5-year average: 41%; only bank whose 1H2015 ratio is below 5-year average) and its LDR stands at 85.4% (only Alinma higher) suggesting that cost of funds should begin to rise from 3Q2015, preceding gains from higher interest rates on assets. Earning assets are very liquid as 83% and 88% of loan and

<b>NCB</b>	
TASI	1180
Rating	Hold
12M Target Price	55.00
Last Price	54.99
Upside to Target	0.0%
Dividend Yield	1.9%
Expected Total Return	1.9%

<b>RIBL</b>	
TASI	1010
Rating	Sell
12M Target Price	13.00
Last Price	13.79
Upside to Target	-5.7%
Dividend Yield	5.7%
Expected Total Return	0.0%

<b>SABB</b>	
TASI	1060
Rating	Buy
12M Target Price	35.00
Last Price	28.07
Upside to Target	24.7%
Dividend Yield	3.5%
Expected Total Return	28.2%

<b>Samba</b>	
TASI	1090
Rating	Buy
12M Target Price	31.00
Last Price	23.65
Upside to Target	31.1%
Dividend Yield	5.0%
Expected Total Return	36.1%

<b>SHB</b>	
TASI	1040
Rating	Hold
12M Target Price	34.00
Last Price	33.30
Upside to Target	2.1%
Dividend Yield	4.0%
Expected Total Return	6.1%

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investment books mature within 1 year respectively. Higher rates should feed into asset yields materially in 1H2016, bolstered by expansion of A-L mismatch. Mid-market exposure paid-off in the past but could show early signs of stress in a downturn.

#### **Saudi Investment Bank**

##### **SAIB**

TASI	1030
Rating	Sell
12M Target Price	16.00
Last Price	20.35
Upside to Target	-21.4%
Dividend Yield	4.5%
Expected Total Return	-16.9%

With a greater corporate focus than most peers, SAIB has been looking to diversify into retail and SME, a strategy that may be risky given competition levels in the sector and a tougher economic environment. Initiate with a SELL Rating, target price SAR16. Combined with a low NIB base (5YR avg. demand deposits to total: 23%), which has improved of late (1H2015: 30%) in line with sector, SAIB is unlikely to see significant accretion in NIM as interest rates rise. Cost of funds likely to tick up from 4Q2015. Yield on average investments stood at 2.1% in 2014, thus government bonds do not add significant value. NPL accretion of 14.3% in 1H2015 versus 2014 is also a concern.

## Table of Contents

<b>Executive Summary</b>	5
<b>Investment Risks</b>	11
<b>Sector to Welcome End of US Zero Rate Policy</b>	12
<i>US Fed likely to tighten starting late 2015</i>	12
<i>Zero cost deposits now make up a majority of overall sector deposits</i>	13
<i>Growing A-L mismatch has supported margins and profitability, and supports gearing</i>	15
<i>Evaluating sensitivity of our forecasts to above or below projected interest rate</i>	17
<b>KSA Gov Bonds After 8 Year Hiatus</b>	18
<i>Lower oil prices will push 2015 fiscal balance into a deficit</i>	18
<i>Banks will look to switch part of low yielding liquid assets into bonds</i>	19
<b>Long term Structural Story Remains Intact</b>	21
<i>Play on demographics and growing financial inclusion</i>	21
<i>'Lower-for-longer' oil likely to depress 2-3 years' loan and deposit growth, and raise credit risk</i>	22
<b>Bank AlBilad: Growth Premium Adequately Priced-in; HOLD</b>	26
<b>Alinma Bank: Value Unlocking Prospects in Better Macro Picture; HOLD</b>	31
<b>Bank AlJazira: Unfavorable risk-return trade off; SELL</b>	36
<b>AlRajhi Bank: Valuation Premium Harder to Justify; HOLD</b>	42
<b>Arab National Bank: Outperformance to be bolstered by rate hikes; BUY</b>	48
<b>National Commercial Bank: Improvement Needed to Justify Further Premium; HOLD</b>	54
<b>Riyad Bank: Punching Below its Weight; SELL</b>	60
<b>Saudi British Bank: Strongly Positioned to Push on From 2016; BUY</b>	67
<b>Samba Financial Group: Tops on Capital and Efficiency Metrics; BUY</b>	73
<b>Saudi Hollandi Bank: Cost of Funds Uptick Imminent; HOLD</b>	79
<b>Saudi Investment Bank: Poor ROAE Outlook; SELL</b>	85

## Investment Risks

### *Fed delays or reverses course; behind the curve*

The US economy appears to be the only bright spark in an environment of poor growth in other developed economies, and slowing growth in developing economies (most notably China). Our base case is for the Fed to hike this year, focusing on its domestic economy, the risks of asset mis-pricing from Zero Rate Interest Policy ("ZIRP") and falling behind the curve. However, institutions such as the IMF have warned that the US Fed may be moving too early, whilst there is also concern that the US Fed may have to backtrack and ease policy. In an environment of tepid loan growth, this could result in further NIM contraction for the sector.

On the flip side, if the US Fed is behind the curve, causing growth and inflation in the US to accelerate more sharply than expected, this would lend more support to oil prices and result in faster hikes by the US Fed to a higher peak Fed Fund Rate ("FFR"). Thus, loan growth could beat our estimates, as well as NIM expansion.

The KSA government has reiterated its commitment to the US\$ peg, however in a scenario of: 1) the US Fed hiking interest rates (feeding into SAIBOR via the peg) and 2) 'lower-for-longer' oil prices, an argument could be made for KSA monetary policy to diverge from that of the US. Should that happen, domestic interest rates would remain depressed, and the corresponding shift in the peg could impact US\$ lending by KSA banks. Interestingly, the Qatar central bank recently stated its intention of maintaining low interest rates even with Fed tightening policy. That would require it to deploy its foreign reserves to defend the currency as the interest rate differential moves against it, instituting capital controls or modifying/abandoning the peg with the US dollar.

### *Average oil price above or below our expectations*

Our forecast assumptions are built on oil prices averaging approximately the same as YTD2015. As with the FFR, the market is split on the future direction of prices. Pessimistic forecasts highlighting substantial current inventory and the oversupply building in the coming year (Iran raises production, China slowdown, etc.) point to the possibility of WTI declining to US\$30 or lower. Recent IEA study however sees a sharp contraction in US shale oil supply, and higher prices next year. Given the relationship between oil prices and KSA growth, fiscal balance, loan growth and NPL accretion, both scenarios could have a significant bearing on sector earnings.

### *NCB stated intention of becoming fully shariah-compliant*

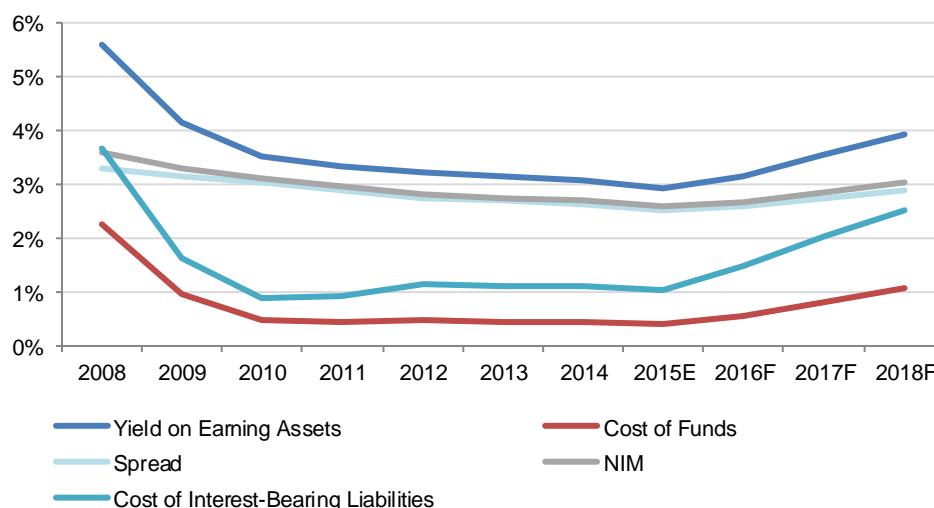
NCB has stated that it intends to become fully shariah-compliant by 2019. Whilst there are instances in markets such as Pakistan of conventional banks converting to shariah-compliant, they have typically been smaller players. NCB, however, is a significant part of the KSA banking system, comprising 22% of all sector assets and 29% of interbank lending (1H2015A). Whilst SAMA has shown its ability as a prudent and proactive regulator, such a conversion poses a risk of unforeseen consequences, such as complicating the government's debt management strategy.

Furthermore, NCB conversion would subject the fully shariah-compliant banks to more competitive pressure. AlRajhi could see some deterioration in its competitive advantage, whilst the smaller shariah-compliant lenders would likely struggle.

## Sector to Welcome End of US Zero Rate Policy

The KSA banking sector is positively geared to higher rates, with a high proportion of zero interest cost deposits (66% of total deposits in July 2015). From 2008, ZIRP and 3 rounds of QE, have depressed the sector's NIM by 116 bps to 2015E (96 bps to 2014A). We expect NIM to expand by 21 bps in 2016F and by 66 bps between 2015E and 2018F.

**Fig 1: Historic and projected yields for the sector**



Source: Company Accounts, SFC

### US Fed likely to tighten starting late 2015

Comments from US Federal Reserve officials indicate that they are 'nearly' ready to take the next step in the policy normalization process initiated in early 2014 with the tapering of purchases under QE3. The Fed is expected to start raising its benchmark Fed Fund Rate ("FFR") later this year. In its September 2015 meeting, the US Fed opted to delay the hike. However, 13 out of 17 Governors reiterated their view that the FFR would be hiked in 2015, though both remaining meetings (October and December have potential hurdles).

Figure 1 below shows the dot plot following the most recent meeting of the Federal Open Markets Committee in September 2015. The median projection of where policy makers think the federal funds rate will end the year 2015 has slipped downwards over the course of the year through September.

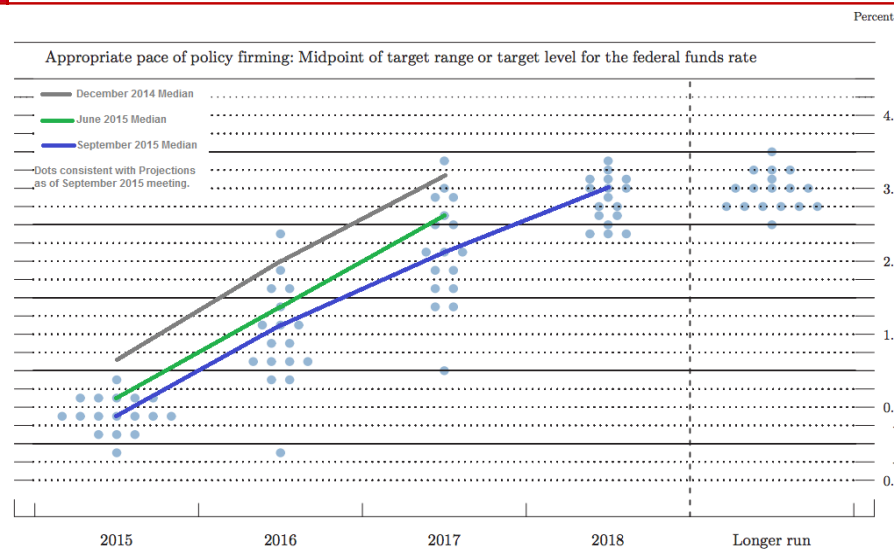
Through 2015, the Governors' expectations regarding velocity of hikes up to 2017 has also been lowered substantially.

Current Fed governor median expectations are for the FFR to rise to 25 bps by end-2015, 1.6% in 2016, 2.6% in 2017 and to peak at 3.5% in 2018. Given the tepid growth recovery in developed economies and growing concerns regarding the fallout from a slowdown in emerging markets, we expect that the rate hike velocity may be revised down further.

US Fed 'nearly' ready to start hiking the Fed Fund Rate

Dampening of expectations of the velocity of rate hikes, including start date, has weighed on sector performance

**Fig 2: FOMC median FFR expectations**



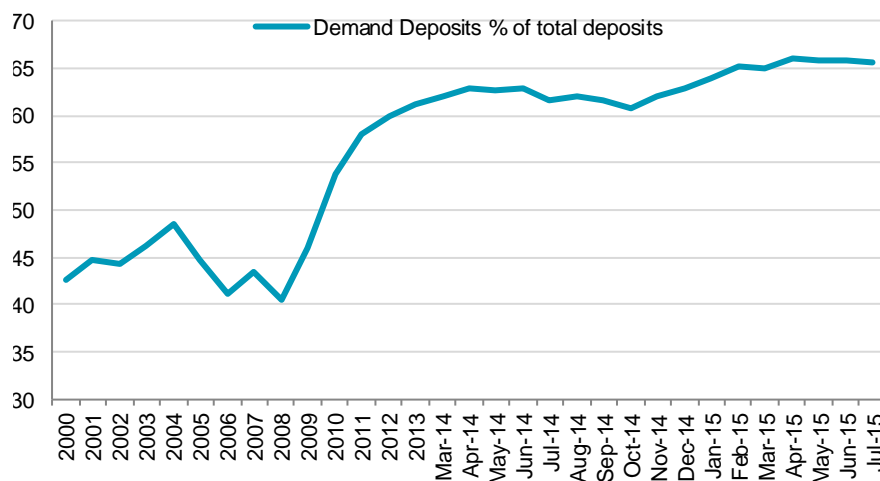
Source: US Federal Reserve - September 2015, SFC

### Zero cost deposits now make up a majority of overall sector deposits

*Sector's gearing to higher interest rates is built upon the high proportion of demand deposits*

The sector's deposit maturity has declined significantly since 2008. In that period, demand deposits have grown from 41% of overall deposits to 64% in 2014A, and 68% in 2015E. This was part of the enlargement of the maturity mis-match that supported margins in the exceptionally low interest rate environment, and hence overall sector profitability.

**Fig 3: Low-cost demand deposits have risen sharply from 2008**



Source: SAMA, SFC

*Growth in demand deposits driven by:*

1. Growth in awareness / availability of shariah compliant deposit products
2. Lower opportunity cost of holding demand deposits
3. Growth in bank deposit mobilization infrastructure

The rapid expansion in the share of demand deposits stems from 3 key drivers in our view. The first is the rapid growth in shariah-compliance in the Kingdom's banking sector, wherein shariah-compliant provided 28% of this growth (2008-2014), an out-sized impact given their 25% (2014) share in deposits. Secondly, the opportunity cost of liquidity collapsed following 2008, thus reducing the incentive for both retail and corporate depositors to lock-in interest-paying time deposits. Finally, falling yields in interest-earning assets incentivized conventional banks to invest in expanding liability-gathering infrastructure. Since 2010, the number of branches have grown by 20% to 1,154 in 2014, while deposits per branch have grown by

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44% to SAR1.14 bn. In this respect, Samba (2014: SAR2.28bn / branch) and SABB (2014: SAR1.80 bn / branch) stand out as the strongest deposit franchises.

The acceleration in demand deposit share growth in YTD2015 suggests that depositors, particularly large corporates are factoring in expectations of higher rates going forward, and improving their liquidity profiles to execute capital expenditure as government payments may become more choppy going forward. Thus we expect demand deposits share to peak in 2015E, and fall to 62% in 2018F.

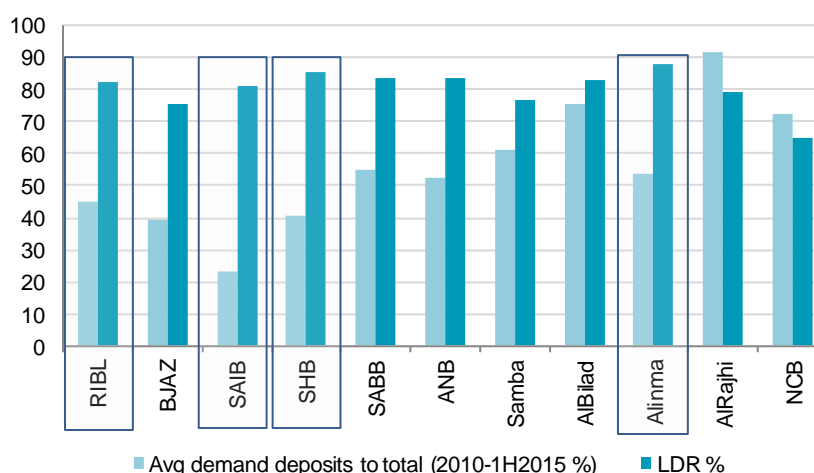
In this context, as the opportunity cost of holding liquid demand deposits for depositors rises, banks with lower core demand deposits could start to face higher funding costs. We expect this to have a marginal impact for cost of funds of these banks in 2016E (government bond issuance could have a greater impact as discussed later in this report), but could become relatively significant in 2017 and 2018. SAIB seems particularly vulnerable in this context (80% LDR in 2014A), its average demand deposits share 2010-1H2015 stands at 23% (1H2015: 30%). BJAZ is the only shariah-compliant bank with average (2010-1H2015: 39%) below 50%, while of the conventional banks SHB (41%: 1H2015:) and, surprisingly given its extensive branch network, RIBL (45%) are also below 50% amongst the conventional banks. RIBL's substantial branch network expansion in 2014 of 66 branches, as the new branches mature, could dampen increases in cost of funds.

Alinma's high L/D Ratio (1H2015: 88%) and smaller branch network should result in time deposits continuing to play a significant role in its funding strategy, and thus its cost of funds could also see above-sector increments.

*As rates rise, increasing opportunity cost, we expect share of demand deposits to fall*

*Banks with low core demand deposit bases look vulnerable to increases in cost of funds*

**Fig 4: Some banks may face near term cost of funds pressure**



Source: Company Accounts, SFC

The government bond issuance also poses a risk for cost of funds. According to the market, 5YR and 10YR bonds have been privately placed at 1.92% and 2.65% respectively in the issue last month. Over the last few months, the government has issued SAR55bn bonds, which compete directly with banks looking to raise time deposits.

According to media sources, the government plans to issue SAR20bn per month for the remainder of the year, and this could potentially stretch into next year. 4Q results will present a clearer picture of how bonds impact on banks' cost of funds as the impact of 3Q-end time deposit pricing flows into the P&L.

It is also important to be aware of the major role that government/quasi-government deposits play in the overall deposit composition of the sector. If the government finances become strained, this could result in withdrawal of these deposits, potentially tightening sector liquidity negatively and impacting ability to

*Gov't bonds will also provide competition for bank deposits*

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expand loan assets. In the table below, we evaluated the impact of 10% to 50% withdrawal of these deposits on 2010-2014 to evaluate impact on LDR for the sector.

**Fig 5: Sensitivity of sector LDR to withdrawal of gov't entities deposits**

	2010	2011	2012	2013	2014
Deposits of gov't entities (SAR mln)	196,546	201,306	251,578	282,985	334,710
Deposits of gov't entities as % of total	21	19	21	21	22
Sector LDR	72	72	74	76	76
<b>LDR if gov't entities deposits fell by:</b>					
10%	73	74	76	77	77
20%	75	75	77	79	79
30%	76	77	79	81	81
40%	78	79	81	82	83
50%	80	80	83	84	85

Source: SAMA, SFC

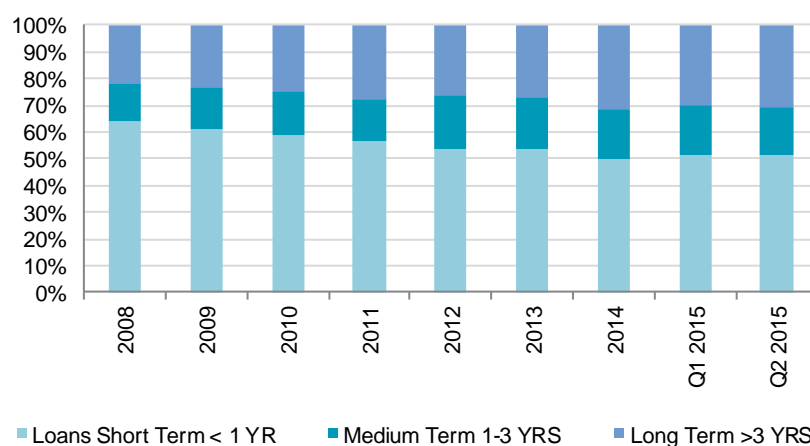
*Growing A-L mismatch has supported margins and profitability, and supports gearing*

*Banks expanded A-L mismatch to support margins and profitability*

According to SAMA data, the maturity of the loan book has lengthened significantly with >1 YR maturity loans, which tend to be floating rate, forming a larger proportion of the loan book. This proportion has increased from 41% in 2010 to an average of 49% for the first 6 months of 2015.

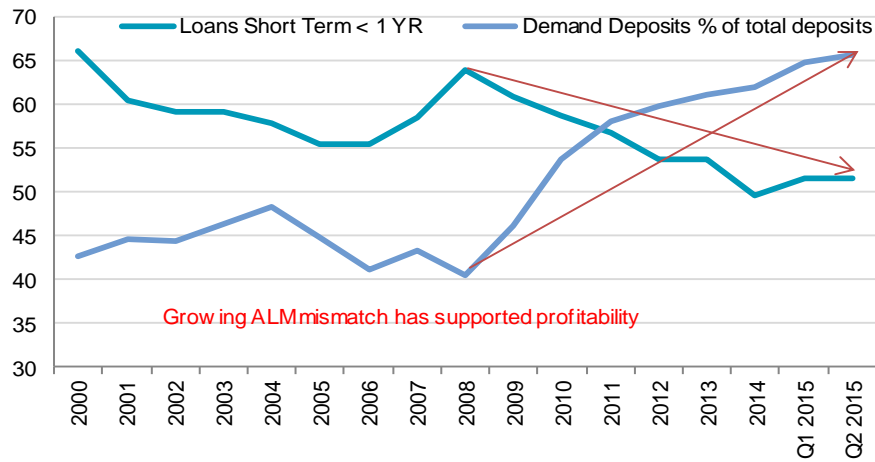
This A-L mismatch is expected to benefit from higher rates seeping into the balance sheet. The investment risks of this mis-match are well covered by the strength of the sovereign backing and the general health of individual banks' credit profiles.

**Fig 6: Sector has extended maturity of loan book**



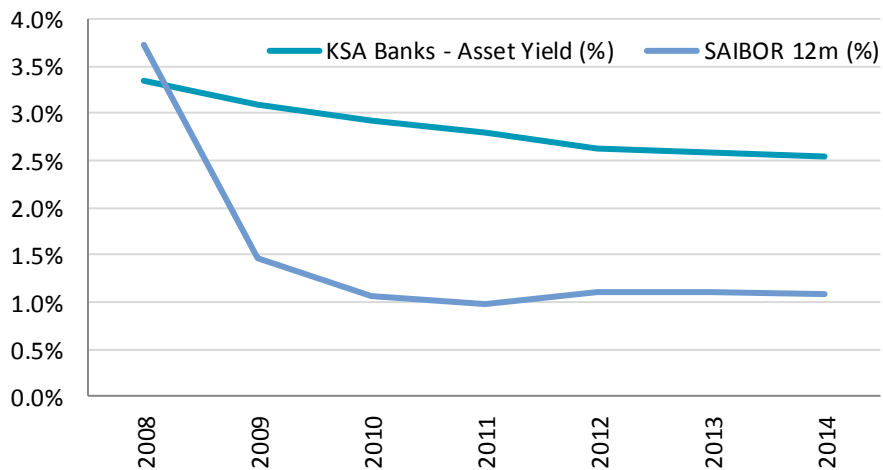
Source: SAMA, SFC

**Fig 7: Expansion in A-L maturity mismatch has supported profitability**



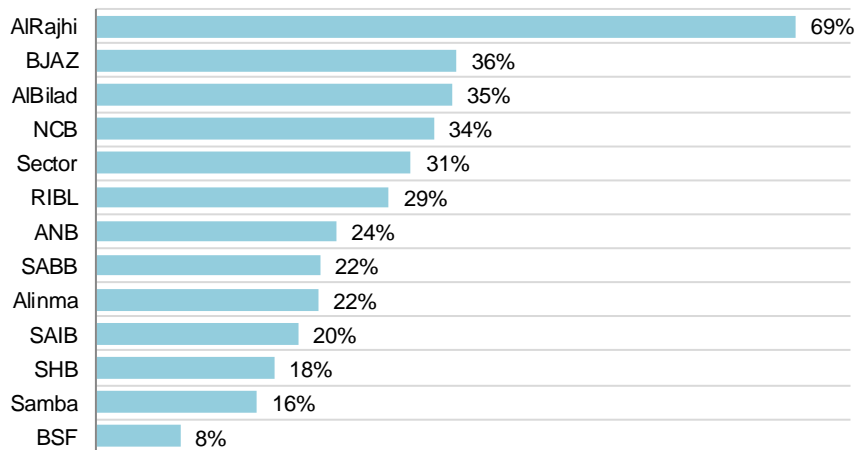
Source: SAMA, SFC

**Fig 8: Asset yield has held up**



Source: Company Accounts, Bloomberg, SAMA, SFC

**Fig 9: Share of retail lending of total loan book**



Source: Company Accounts, SFC

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*Banks with corporate lending focus will see faster loan book repricing*

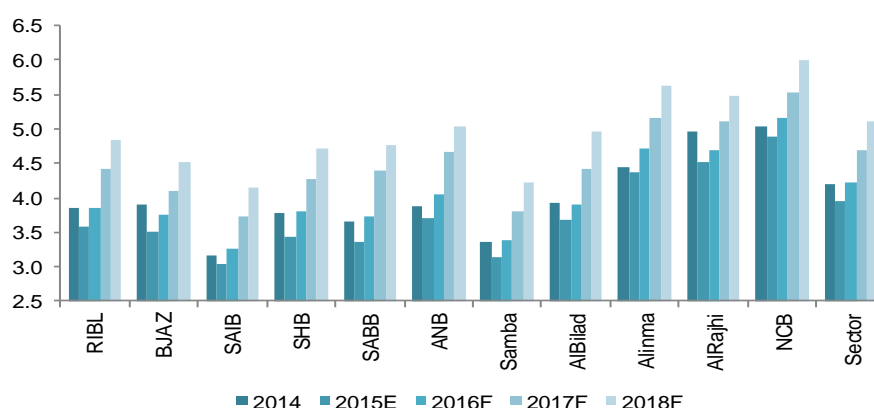
*Samba has lowest retail exposure, while AlRajhi has the highest*

The intense competition seen in the past few years can limit the full pass-through of the benefits of higher rates, mitigated partially by higher government bond issuance.

We expect the pass-through to be relatively fuller for banks with a corporate concentration as typically corporate lending re-prices every 3 months, whilst only approximately 20% of the retail portfolio matures in a given year.

Of the banks under coverage, Samba has the lowest proportion of retail loans at 16% in 2014. Followed by SHB, SAIB, Alinma and SABB. AlRajhi is a clear outlier with 69% of its loan book comprising retail loans.

**Fig 10: Share of retail will determine speed of loan book repricing**



Source: Company Accounts, SFC

### Evaluating sensitivity of our forecasts to above or below projected interest rate

The table below presents a sensitivity analysis of our forecasts to above or below projected interest rates to the sector's cost of funds, NIM and net income (please note it 1) assumes full immediate pass through of rates to yield on earning assets and cost of interest-bearing liabilities and 2) holds all other assumptions unchanged for simplicity).

The sensitivity shows that net margin and net income are highly sensitive to changes in interest rates, driven by the low sensitivity of cost of funds (driven by high proportion of demand deposits). In the 2008-2014 period, banks have been able to mitigate impact of lower rates via expanding A-L mismatch, helped by vibrant economic activity which drove lending and fee income higher.

**Fig 11: Sensitivity of Forecasts to Interest Rates**

<b>SAIBOR +50 bps</b>				
Impact on Cost of Funds (bps)	2016F	2017F	2018F	
	19	20	21	
Impact on NIM (bps)	34	33	32	
Impact on Net Income (%)	17	15	14	
<b>SAIBOR +25 bps</b>				
Impact on Cost of Funds (bps)	9	10	10	
Impact on NIM (bps)	17	16	16	
Impact on Net Income (%)	8	8	7	
<b>SAIBOR -25 bps</b>				
Impact on Cost of Funds (bps)	-9	-10	-10	
Impact on NIM (bps)	-17	-16	-16	
Impact on Net Income (%)	-8	-8	-7	
<b>SAIBOR -50 bps</b>				
Impact on Cost of Funds (bps)	-19	-20	-21	
Impact on NIM (bps)	-34	-33	-32	
Impact on Net Income (%)	-17	-15	-14	

Source: SFC

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*Sector profitability is highly sensitive to changes in interest rates*

## KSA Gov Bonds After 8 Year Hiatus

*Lower oil prices will push 2015 fiscal balance into a deficit*

IMF is projecting a fiscal deficit for KSA in 2015, driven by lower oil revenues

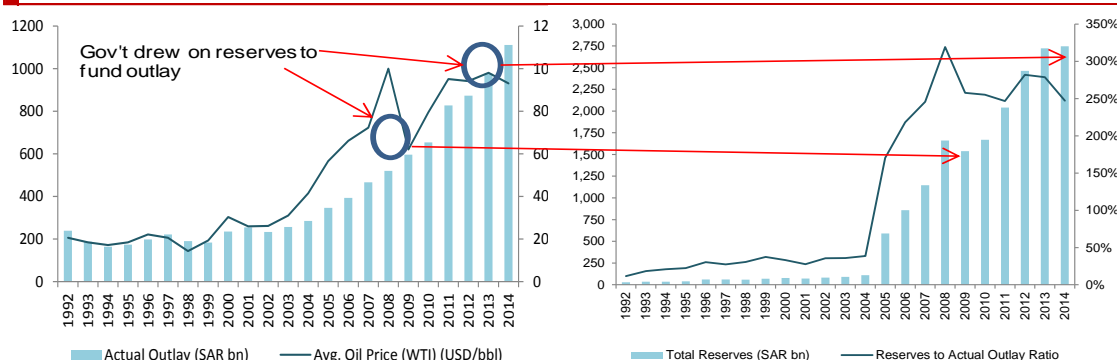
Brent Crude prices are down 12.2% YTD (US\$50.31/b), averaging US\$59.89/b YTD2015. According to the IMF at the conclusion of its Article IV consultations, the central government fiscal balance is expected to post a deficit of 19.5% of GDP in 2015. Nominal GDP is projected to decline to US\$644 bln, against real GDP growth of 2.8%. Oil revenue is projected to decline from 32.6% of GDP in 2014 to 24.2% of GDP in 2015, while expenditure is expected to expand to 49.5% of GDP.

**Fig 12: IMF Economic Projections for KSA**

	2010	2011	2012	2013	2014	Proj. 2015
<i>Annual percentage change unless otherwise specified</i>						
Real GDP	4.8	10	5.4	2.7	3.5	2.8
Real Oil GDP	-0.1	12.2	5.1	-1.6	1.5	2.4
Real Non-Oil GDP	9	8.1	5.5	6.4	5	3.1
Nominal GDP (US\$ bln)	527	670	734	744	746	644
<i>Percent of GDP</i>						
Central Gov't Revenue	37.5	44.5	45.3	41.4	37.3	29.9
of which: Oil Revenue	33.9	41.2	41.6	37.1	32.6	24.2
Central Gov't Expenditure	34	33.4	33.3	35.6	40.8	49.5
Fiscal Balance (deficit -)	3.6	11.2	12	5.8	-3.4	-19.5
<i>US\$ bln; unless otherwise specified</i>						
Exports	251.1	364.7	388.4	376	343.3	236.2
of which: Oil and Refined Products	215.2	317.6	337.5	322	285.2	183.7
Imports	-97.4	-120	-141.8	-153.4	-155.5	-152.7
Current Account	66.8	158.6	164.8	135.5	81.2	-5.8
Current Account (% of GDP)	12.7	23.7	22.4	18.2	10.9	-0.9
SAMA Net Foreign Assets	440.4	535.2	647.6	716.7	724.3	659.8
in months of imports of goods and services	26.7	29.8	33.8	34.1	36.3	32.4

Source: IMF; Article 4 Consultations Press Release; August 17, 2015

**Fig 13: Budget outlay tracks oil prices, the budget has been funded from foreign assets lately**



Source: CDSI, SAMA, Bloomberg, SFC

The government has tapped two sources to fund the projected deficit of SAR471 bln (US\$125.6bln), running down foreign reserves and issuing bonds. As per available data, the government has reduced foreign reserves by SAR226 bln (US\$60.2 bln) up to June 2015, furthermore it has issued bonds of SAR35 bln.

The remaining SAR210 bln is likely to be financed through a combination of running down foreign reserves and bond issuance. Market reports indicate that the government is aiming to issue bonds of SAR20 bln per month for the last 4 months of the year.

The gov't has funded this deficit via drawing on foreign reserves and bond issuance



**Fig 14: Possible permutations of funding 2016 budget**

Fiscal Deficit % of GDP	Fiscal Deficit US\$ bln	Fiscal Deficit SAR bln	Bond Issuance (SR bln)		Foreign Reserves (SR bln)	
			25%	50%	25%	50%
5%	32	121	30	60	2,299	2,330
10%	64	242	60	121	2,209	2,269
15%	97	362	91	181	2,118	2,209
20%	129	483	121	242	2,028	2,149

Source: SFC

*We estimate that the gov't will fund 25% of the deficit via bonds*

In Fig. 11 above, we have estimated how issuance could evolve in 2016. If we take our current estimates for 2015 issuance, the government is aiming to finance 24.4% of the IMF projected 2014 fiscal deficit with bond issuance, and the remaining 75.4% through its foreign reserves.

Taking varying levels of the fiscal deficit on 2014E (IMF) nominal GDP of US\$644 bln, we have evaluated the bond issuance assuming the government finances 25% and 50% of the deficit through bond issues.

Even with the government running a 20% of GDP deficit again, and only funding 25% of the deficit through bond issuance, the foreign reserves remain at very comfortable levels. The IMF projects net foreign assets at US\$659.8 bln at end-2015, equivalent to 32.4 months of imports. In 2010, net foreign assets stood at US\$440.4 bln and covered 26.7 months of imports.

However, funding 50% of the deficit through bond sales to banks could begin to crowd-out private sector lending. The above analysis suggests that at least for the coming year, fiscal retrenchment can be limited, even if oil prices average the same in 2016 as YTD 2015. The latest comments from government officials suggest that they will be looking to curtail capital spending by SAR30-50 bln.

*There is sufficient liquidity in the sector to absorb projected issuance in 2015 and 2016*

In the above scenario, bond issuance would approximately be similar to the estimated 2015 sales. An average of SAR10 bln every month. As per our understanding, shariah-compliant banks will not be permitted to invest in these bonds, however are expected to push for government sukuk issues. NCB's participation may also be doubtful as it has announced that it intends to become shariah-compliant.

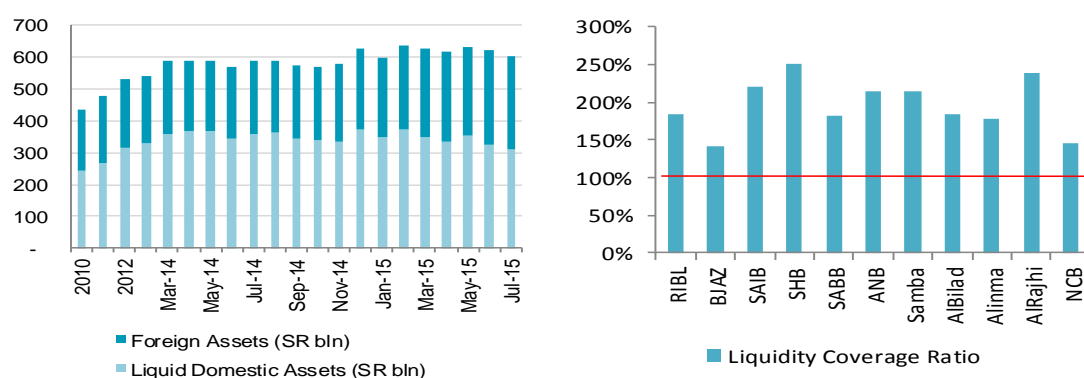
#### **Banks will look to switch part of low yielding liquid assets into bonds**

SAMA data on the banking sector assets shows that banks in KSA are quite liquid. As of July 2015, the sector held SAR310 bn in liquid domestic assets and SAR294 bn in foreign assets (primarily comprising foreign government bonds and foreign quasi government bonds).

*Opportunity for some banks to increase the yield on investments*

The conventional banks (see Fig. 13 below), with the exception of NCB, have seen yields on investments decline over the past few years. This yield stands at below 2% for all the conventional banks with the exception of NCB and SAIB, versus reported yields for government bonds of 1.92% (5YR) and 2.65% (10 YR). ARNB, SHB, SABB and Samba whose yield on investment is significantly below the 1.8% (2014) sector average, would clearly gain by switching part of their liquid assets to the government bonds. ARNB, SABB and Samba are also highly liquid with liquid assets in excess of 30% of total assets.

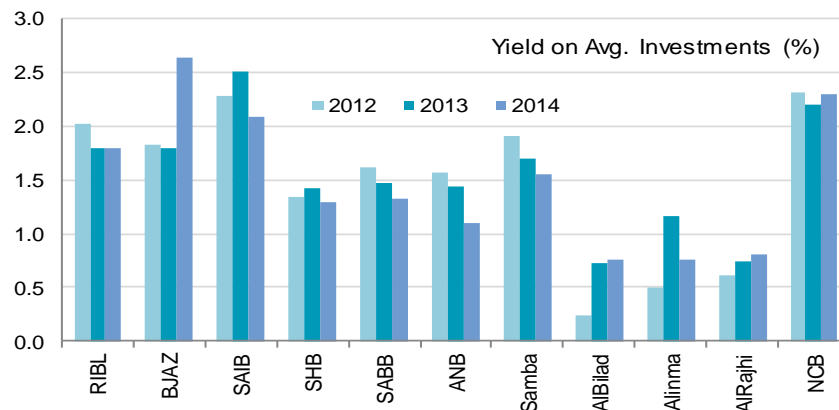
**Fig 15: Sector is Liquid**



Source: SAMA, SFC

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**Fig 16: Yields on investments for individual banks**



Source: Company Accounts, SFC

*Banks may limit participation in the near term until rate outlook is clearer*

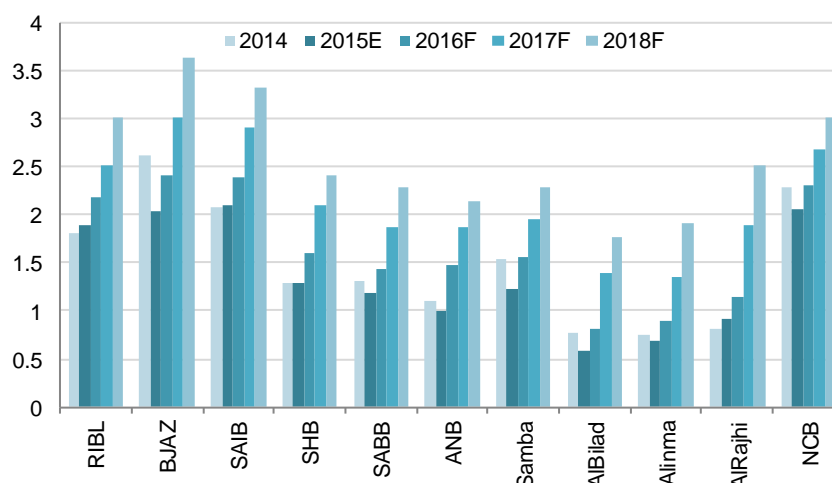
Caution must however be exercised in estimating the yield gains over the next couple of years. In a rising interest rate environment, we expect most bank treasuries a) limit participation in the next 12-18 months to lock-in to higher yields once the US Fed rate hike cycle is firmly established and b) to skew their bids towards to the 5YR maturity bonds. In the case of NCB, it may limit participation on account of its already (relative to bond yields) high yielding investments and also on account of its announced intention to become fully shariah-complaint.

*Gov't will need to issue sukuks to tap the big shariah-complaint pool of funds*

In the case of the other shariah-compliant banks, they are not able to participate in these issues, however we do believe that as the government's debt management strategy crystalizes, it will look to issue sukuks to tap this liquidity.

Furthermore, the government could tilt its borrowing towards short-term SAMA bills as yields on longer-term bonds rise to contain debt-servicing costs.

**Fig 17: Projected yields on investments**



Source: Company Accounts, SFC

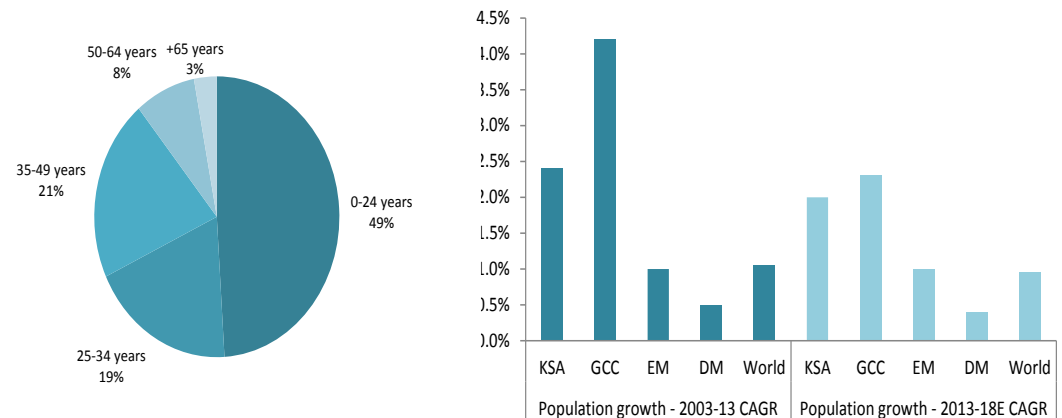
## Long term Structural Story Remains Intact

*Play on demographics and growing financial inclusion*

*Demographic trends support long-term growth*

KSA banking sector benefits from structural drivers such as large and growing population, high proportion of young people (c.50% of the population is less than 25 years old), growing household income (c.8.5% CAGR in 2005-12) and government focus on expanding financial inclusion and documenting transactions.

**Fig 18: Demographic trends are positive for sector**

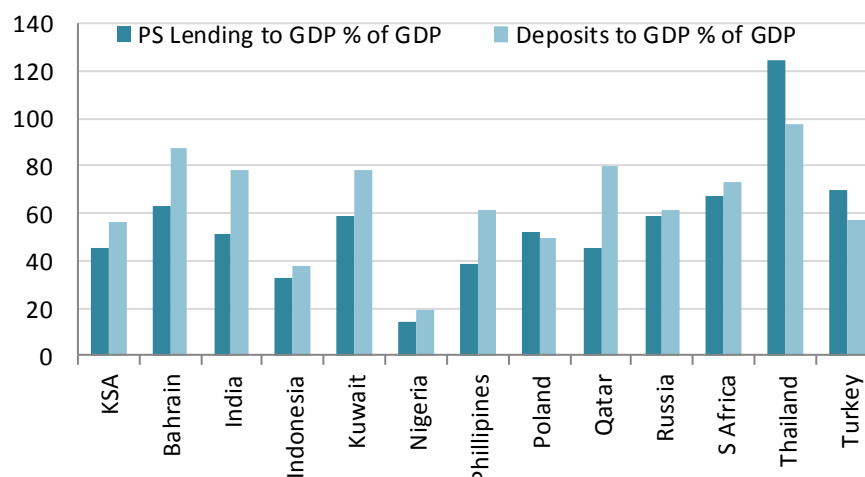


Source: World Bank

*Impressive strides made in improving financial inclusion in the country*

Over the past few years, significant strides have been made in KSA to expand the reach of financial sector to a greater proportion of the population. For example, in 2011, only 46% of KSA's population aged 15 and over had a bank account. Over a short four year period, this proportion has increased to 69% (2014). Impressively, this has been driven by an expansion in rural areas, where in 2014 72% of population aged 15 or more has an account versus 47% in 2011. Even more impressive is the growth in accounts amongst women where in 2014 61% of the female population (15+) have an account against just 15% in 2011. This growth compares favorably against non-OECD high income countries where account holders as a percentage of the population (15+) grew from 58% (2011) to 73% (2015).

**Fig 19: KSA banking sector penetration lags peers**



Source: IMF, SAMA, Country Central Banks, SFC

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However, KSA still lags GEM

Despite the significant strides in development of the financial sector, compared to banking systems in GEM, KSA commands low banking penetration. With private sector credit and deposits to GDP at 45% and 56% respectively, KSA lags the GCC by c.30ppt and c.10ppt below average comparable Asian economies such as Indonesia, India and Thailand.

As 1) the recent gains on expanding banking services to a larger proportion of the population mature, 2) the demographic trend continues to add to the working age population, and 3) number of households continue to increase as household sizes fall, this under-penetration relative to peer countries should narrow. The catch-up potential presents a significant growth opportunity in the long-term.

**However, 'Lower-for-longer' oil likely to depress 2-3 years' loan and deposit growth, and raise credit risk**

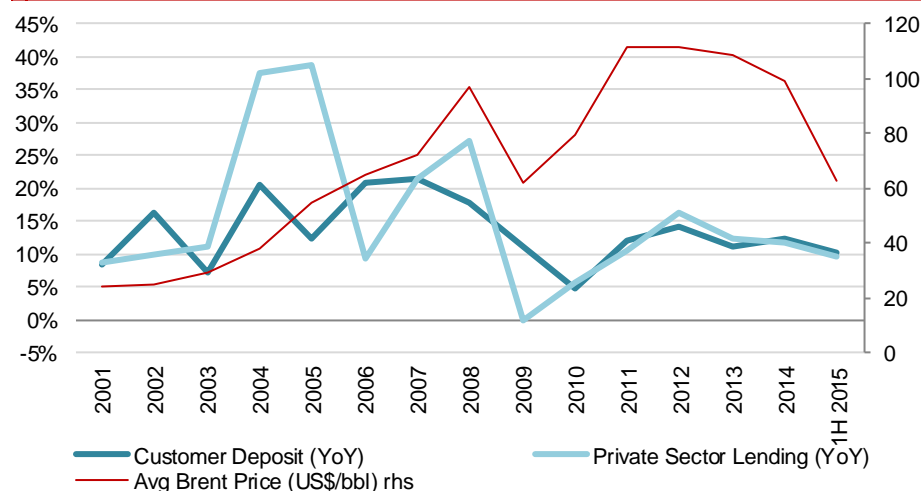
'Lower-for-longer' oil prices could depress loan and deposit volumes, as well as raise credit risk

On the flip side, recent weakness in oil prices has morphed into a 'lower-for-longer' view that could dampen volume growth for the sector, as well as posing the risk of higher credit losses. Private sector credit growth and credit losses both share a historical correlation to oil prices. With oil prices impacting both with a lag.

We are forecasting loan growth to halve from the 12% CAGR 2009-14

Recent non-Oil GDP growth has been bolstered by an expansionary fiscal policy which in the context of lower oil prices and indications by the government that it is looking to curtail some investment expenditure in 2015, and into 2016, should result in loan growth slowing significantly from the 5yr CAGR (2009-2014) of 12%. For the sector, we are expecting loan growth to slow to a 4yr CAGR (2014A-18F) of 5.6%.

**Fig 20: Lagged relationship between oil prices with loan & deposit growth**



Source: EIA, SAMA, SFC

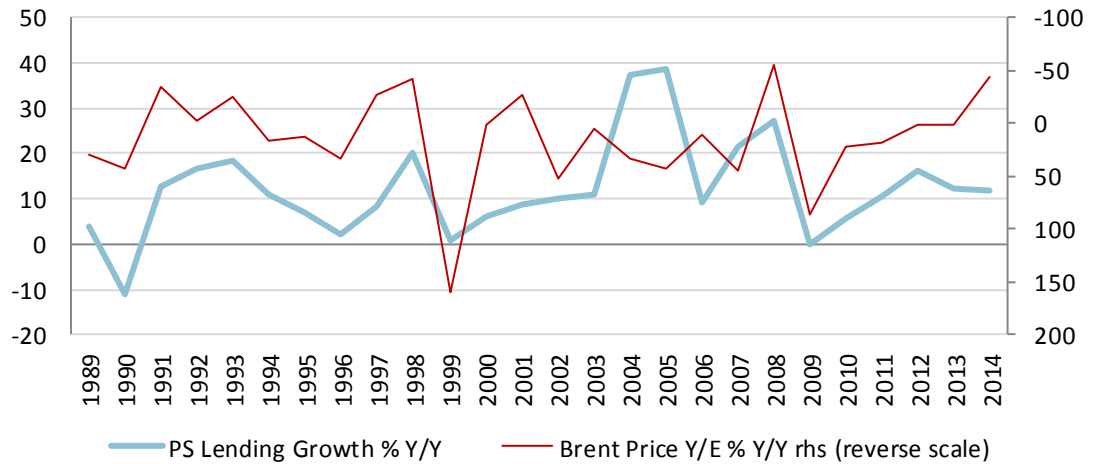
Lending growth is already slowing

Lending to the private sector is already slowing, as per SAMA data, it grew c.6% in 1H2015 versus c.8% in the corresponding period last year. On a Y/Y (Aug 2015) basis it has slowed to 8.3% versus 11.8% and 12.5% in 2014 and 2013 respectively.

Lower oil prices lead to an initial uptick in borrowing

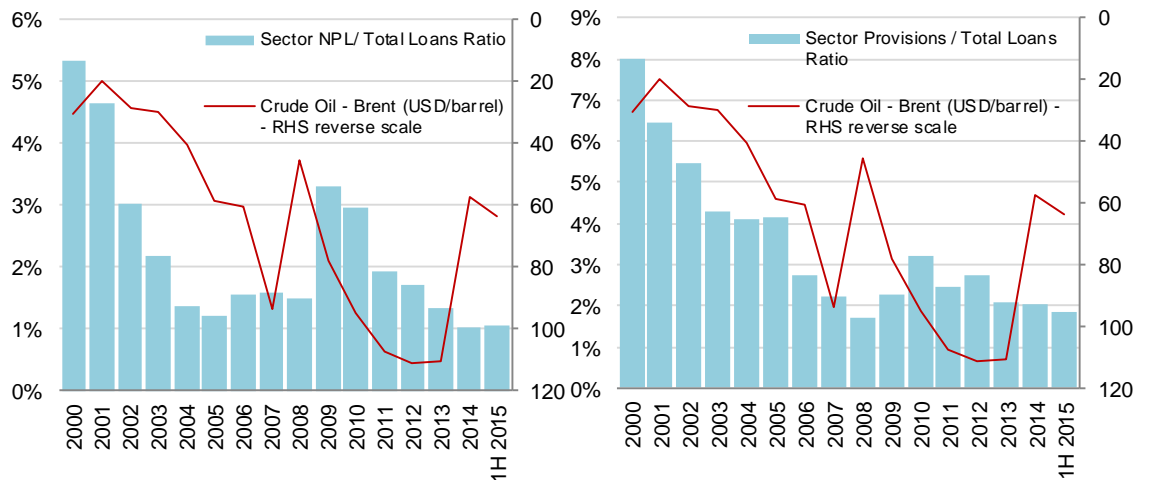
That said, another interesting aspect of the relationship between loan growth and oil prices can be seen in Fig. 21 below. The chart below displays how loan growth reacts to end of year oil price change Y/Y, where the 2 have an inverse relationship. Thus periods of where oil prices have dipped on a Y/Y basis, see **an increase** in lending, and vice versa. This relation has played out in the first 2 quarters of 2015 as well. This is most likely the result of government sub-contractor financing requirements as government payments vary with changes in oil prices.

**Fig 21: Immediate term inverse relationship between oil prices and loans**



Source: EIA, SAMA, SFC

**Fig 22: NPL and cost of risk react with a lag of c.12 months to oil prices**



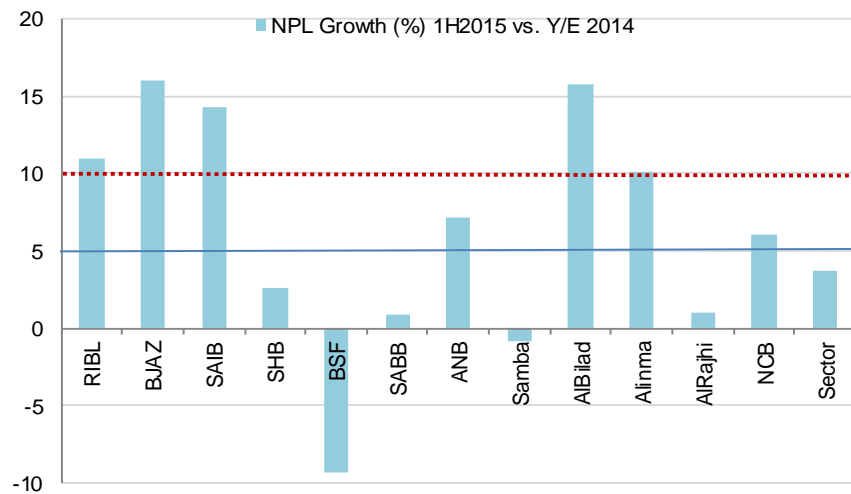
Source: EIA, SAMA, SFC, Company Accounts

*NPLs have crept higher in 1H2015, and going by summary numbers for 3Q2015, they could have trended higher still*

Over the last two quarters, the sector has started to see NPLs creep higher. NPLs for the sector stood at SAR14.95 bln in June 2015, versus SAR14.86 bln in 1Q2015 and SAR14.42 bln end-2014, up 3.6% versus end-2014. The smaller banks, BJAZ (16%), Bilad (16%), SAIB (14%) and Alinma (10%) have all seen a substantial percentage up-tick in the first half of 2015, along with Riyad (11%).



**Fig 23: RIBL, BJAZ, SAIB, AIBilad and Alinma saw NPLs rise 10%+ from Y/E2014**



Source: Company Reports, SFC

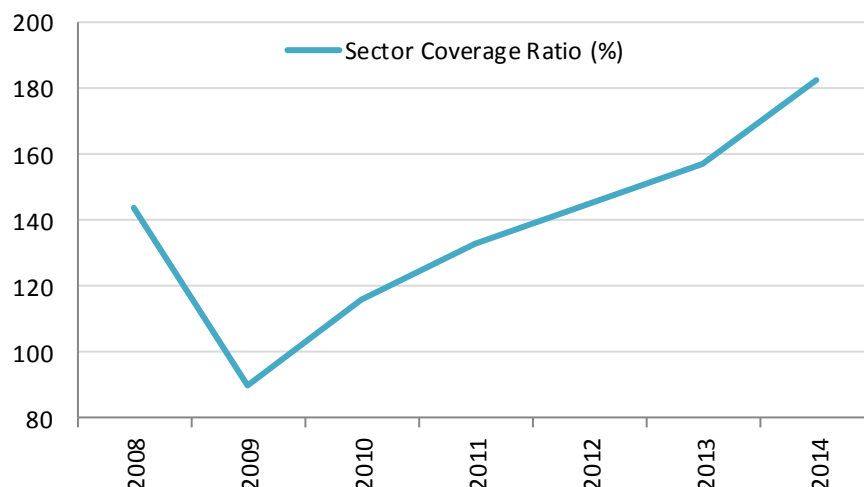
AIBilad, BJAZ and Alinma have all been underperforming the banking index since end-June, while SAIB and RIBL have performed in line. AIBilad and BJAZ are significant underperformers by 14.9% and 14.4% respectively.

However, after a 46% fall in NPLs over the 2010-2014 period, an up-trend is to be expected, where the bulk of the impact of lower oil prices and lower government spending should become more apparent from 2H2016. Consequently, we believe that the sector's cost of risk will bottom-out in 2015, and trend higher over the next few years.

The sector is well-positioned to limit NPL accretion, led by a pro-active and conservative regulator. Recent pro-active steps to curtail future NPL accretion risk include assigned account retail lending and regulatory caps on retail lending (i.e. higher LTV requirement for mortgages).

Furthermore, since the fall-out suffered as a consequence of the financial crisis over 2008 to 2010, SAMA has pushed banks to bolster collective provisioning and strengthen capital adequacy.

**Fig 24: NPL coverage is high 180%+, bolstered by collective provisioning**



Source: Company Reports, SFC

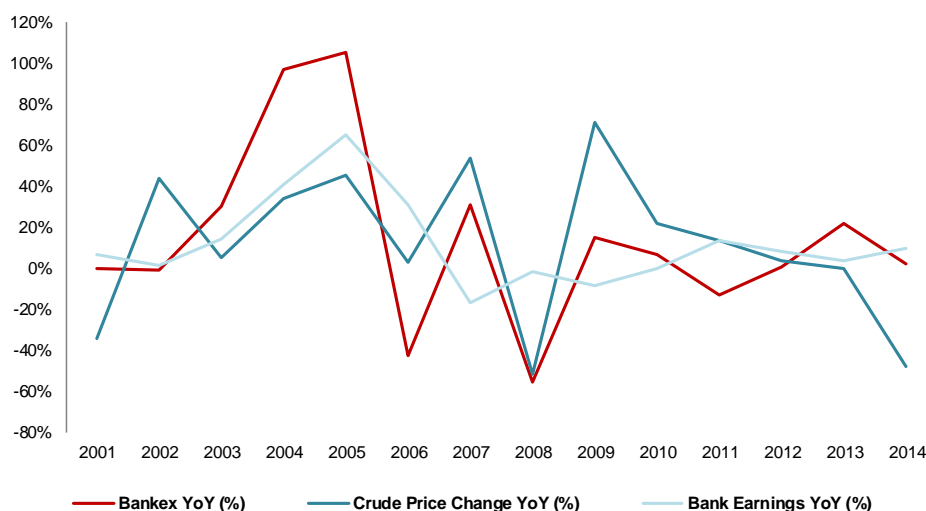
After a 46% fall in NPLs over 2010-14, an uptick was expected

The regulator and sector have taken steps to limit NPL accretion and protect bank balance sheets

*Historically, banking sector earnings and share price have moved in a close relationship with oil prices*

Historically, bank share price performance and earnings have followed oil as seen in the chart below. The sector index has a particularly close relationship with oil price performance, however in the recent past this relationship has loosened. This is likely the result of 1) market participants' view that the government can use its huge financial reserves to engineer a soft landing for the economy, and 2) because this round of weakness in oil prices will likely be accompanied by higher interest rates.

**Fig 25: KSA Bank Index vs. Earnings and Crude Oil Price change**



Source: Bloomberg, Tadawul, SFC; Bankex = Sector Index excluding RJHI

**Fig 26: Fee & Commission Income growth vs. Crude Oil Price change**



Source: Bloomberg, Tadawul, SFC

*Similar relationship evident between oil and non-interest income, perhaps partially explain ing 3Q2015 trend*

The same (lagged) relationship appears to exist between oil prices and bank non-interest income, perhaps partly explaining the weakness seen in non-interest income in the 3Q2015 results. However, given other factors potentially impacting non-interest income in 3Q2015, like 2 long holidays for Eid festivals and regulatory limits on fees for retail products, more information available in 4Q2015 and annual account disclosures would be needed to confirm such.



## Growth Premium Adequately Priced-in

AlBilad has combined a strong deposit mobilization franchise and capital base to deliver appreciable asset growth in the past few years. We expect growth to slow in the current economic environment. HOLD with a lower target price of SAR 26 per share, the bank remains our preferred exposure amongst shariah-compliant banks. Bank AlBilad's (1140/ALBI AB) low cost funding base (demand deposits 78% of total deposits vs. system: 66% as at end 2Q15) and adequately capitalized balance sheet (Tier I ratio of 15.4% as at end 2Q15) has supported aggressive lending strategy. This is well reflected in recent volume growth numbers. In a tougher economic environment growth is likely to slow, and the tighter spreads on aggressive loan book expansion are a risk.

**Low cost deposit base a positive, room for improvement on the cost front:** With low cost demand deposits accounting for 78% of total deposits (vs. system: 66%), the cost of funds remains low (16 bps in 2014). However, ALBI operates on a higher cost base (cost to income 2Q15: 60%, vs. 36% for the sector) and has an opportunity to improve this metric considerably.

**Adequate capitalization to support growth, LDR near limit:** ALBI has a strong capital base with a Tier-1 capital of 15.4% in 2Q 2015. The bank's LDR remained low at 77% at end-2014 but has increased to 83% by the end of 2Q15. We expect the bank's deposit base and loan book to register a high single growth in the next five years (CAGR: 7% 2014-19E).

**Earnings volatility the key risk:** While total income growth (2015E: +9% & 2016E: +11.5%) is expected to continue with an expanding branch presence, the corresponding earnings growth is forecast to remain depressed in light of high operating expenses and the absence of any loan recoveries (SAR 141mn in bad loan recoveries in 2014). Overall, we expect the RoE to average c.14% during the forecast period.

**Near-term risks remain elevated due to high exposure to building & construction sector:** Asset quality has improved over past few years with a NPL ratio of 1.5% in 2014 (c.5.5% in 2009) and has adequate provisioned for losses (192% in 2014). However, the bank's exposure to the building & construction sector (SAR 5.6bn, c.15% of performing financing in 2014) and the 14.7% rise in NPL in 1H2015, highest in sector after BIAZ, suggests caution is warranted, given anticipated project delays due to the fallout from declining oil prices. The NPL ratio is likely to deteriorate to 2.1% levels during the forecast period with basic coverage levels projected to remain above 150%.

**AlBilad trades at 2.0x 2016F BV, at a premium to the sector PBV of 1.4x:** The bank's exposure to the building and construction sector remains the key risk to the equity story. Given its diversified earnings mix and growth (NI 11% CAGR 2014-2018F), we believe AlBilad will continue to trade at a premium to the sector. At our target price, ALBI would trade at 1.9x 2016F BV. We have valued the bank on Warranted Equity using 15% sustainable ROE, 7.0% growth rate and 11% cost of equity.

### Rating Summary

<b>Recommendation</b>	<b>Hold</b>
<b>12-Month Target price (SAR)</b>	<b>26.0</b>
<b>Upside/(Downside)</b>	<b>4.3%</b>

### Stock Details

Last Close Price	SAR	24.9
Market Capitalization	SAR mln	12,460
Shares Outstanding	mln	500
52-Week High	SAR	48.4
52-Week Low	SAR	23.7
Price Change (YTD)	%	-29.4
12-Mth ADTV	mln	1.1
EPS 2015E	SAR	1.6
Reuters / Bloomberg	1140.SE	ALBI AB

Source: Tadawul

### Key Shareholders (%)

Mohamed Ibrahim Al Sebaee	18%
Abdullah Al-Subaiei Investment	11%
Khalid Al Rajhi	9%
Others	62%

Source: Tadawul

### Price Multiples

	2015E	2016E
P / E	15.6x	15.1x
P / B	2.1x	2.0x
Dividend Yield (%)	2.6%	2.7%

Source: SFC

### 1-Year Share Performance



Source: Bloomberg



## Summary Financials

All figures are in SAR mn

Summary Financials	2013	2014	2015E	2016E	2017E	2018E
<b>INCOME STATEMENT</b>						
Income from investing and financing assets	975	1,073	1,178	1,364	1,691	2,016
Return on deposits and financial liabilities	(28)	(54)	(49)	(72)	(103)	(131)
<b>Net income from investments and financing activities</b>	<b>947</b>	<b>1,019</b>	<b>1,129</b>	<b>1,292</b>	<b>1,588</b>	<b>1,884</b>
y-o-y growth %	12.8%	7.7%	10.8%	14.4%	22.9%	18.7%
Other Income	971	1,078	1,162	1,242	1,328	1,436
<b>Total operating income</b>	<b>1,917</b>	<b>2,097</b>	<b>2,291</b>	<b>2,533</b>	<b>2,915</b>	<b>3,320</b>
y-o-y growth %	10.4%	9.4%	9.2%	10.6%	15.1%	13.9%
Expenses	(1,018)	(1,241)	(1,399)	(1,460)	(1,583)	(1,710)
<b>Pre-provision Profit</b>	<b>899</b>	<b>857</b>	<b>892</b>	<b>1,073</b>	<b>1,333</b>	<b>1,611</b>
Charge for impairment on financing	(175)	8	(92)	(249)	(279)	(296)
<b>Total operating expenses</b>	<b>1,188</b>	<b>1,233</b>	<b>1,490</b>	<b>1,709</b>	<b>1,862</b>	<b>2,005</b>
Cost-to-income ratio % (Excl. provisions)	53.1%	59.2%	61.1%	57.6%	54.3%	51.5%
<b>Net Income</b>	<b>729</b>	<b>864</b>	<b>800</b>	<b>824</b>	<b>1,054</b>	<b>1,315</b>
<b>BALANCE SHEET</b>						
<b>Assets</b>						
Cash and balances with SAMA	4,187	4,468	4,955	5,872	6,889	8,084
Due from banks and other financial institutions	6,155	8,785	8,960	9,139	9,322	9,509
Investments	1,667	2,635	2,859	3,088	3,335	3,602
Financing, net	23,415	28,355	31,791	33,565	35,511	37,574
Property and equipment, net	762	798	803	812	826	848
Other assets, net	136	189	204	220	238	257
<b>Total Assets</b>	<b>36,323</b>	<b>45,230</b>	<b>49,573</b>	<b>52,697</b>	<b>56,121</b>	<b>59,874</b>
<b>Liabilities</b>						
Due to banks and other financial institutions	976	1,191	1,310	1,441	1,585	1,744
Customers' deposits	29,108	36,724	40,396	42,820	45,389	48,112
Other liabilities	1,139	1,424	1,495	1,570	1,648	1,731
<b>Total Liabilities</b>	<b>31,222</b>	<b>39,339</b>	<b>43,201</b>	<b>45,831</b>	<b>48,623</b>	<b>51,587</b>
<b>Total Equity</b>	<b>5,101</b>	<b>5,891</b>	<b>6,372</b>	<b>6,866</b>	<b>7,498</b>	<b>8,287</b>
<b>Total Liabilities and Equity</b>	<b>36,323</b>	<b>45,230</b>	<b>49,573</b>	<b>52,697</b>	<b>56,121</b>	<b>59,874</b>
<b>Key Ratio</b>						
P/E	17.1	14.4	15.6	15.1	11.8	9.5
P/BV	2.4	2.1	2.0	1.8	1.7	1.5
P/PPP	13.9	14.5	14.0	11.6	9.3	7.7
ROAE	15.4%	15.7%	13.1%	12.4%	14.7%	16.7%
ROAA	2.2%	2.1%	1.7%	1.6%	1.9%	2.3%
Dividend Yield	0.0%	2.0%	2.6%	2.6%	3.4%	4.2%
Net Income growth	-23%	18%	-7%	3%	28%	25%
Total Income growth	10%	9%	9%	11%	15%	14%
NPL/Gross Financing	1.90%	1.48%	1.55%	1.80%	2.00%	2.00%
Equity/Total Assets	14.0%	13.0%	12.9%	13.0%	13.4%	13.8%
Tier-1 Capital	16.0%	15.7%	14.0%	14.3%	14.7%	15.2%

Source: Company Reports, Bloomberg

## Investment Thesis

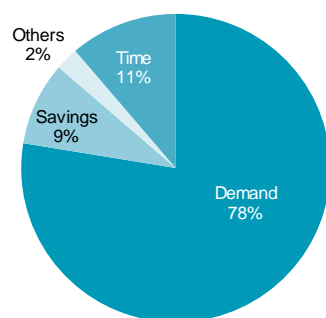
**Solid interest-free deposit franchise, potential for greater cost efficiency:** Demand deposits accounted for 78% of total deposits in 1H 2015 (vs. system: 66%), which have driven the cost of funds to historic low of 16bps in 2014A. Like the majority of the sector, the growth of demand deposits has outstripped growth in overall deposits, over 2010-2014A the proportion of demand deposits to total deposits has risen by more than 10ppt. We believe that despite the high demand deposit base, the bank could start facing pressure to raise relatively high cost time deposits, as LDR at 83% in 1H2015 (vs. c.81% for the sector according to SAMA data) is near the regulatory maximum.

In terms of maturity of assets/liabilities, short term deposits (<3 months) accounted for c.91% of total deposits, while financing portfolio is skewed towards the short-term with 67% of loans maturing within a year. As short-term loans mature, the bank has scope to re-price as rates rise, and some scope to expand A-L mismatch to capture rising term premium as yield curve steepens.

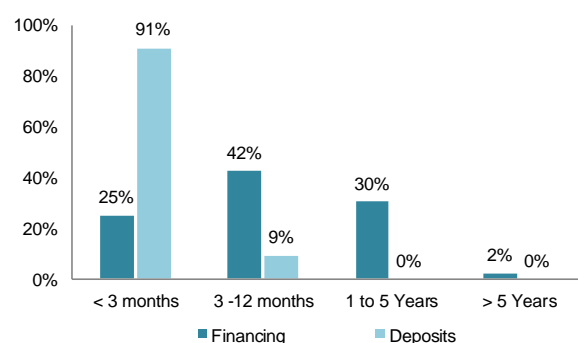
However, ALBI operates on a higher cost base (cost to income 2Q15: 60%, vs. 36% for the sector), whilst this will fall as interest income is bolstered by higher rates, the bank has relatively poor operating gearing limiting flow of higher interest earnings to the bottom line. The bank has been successful in reducing cost to income from a high of 87% in 2009 to 53% in 2013, but these gains were somewhat reversed in 2014 (59%) and likely to post 62% in 2015E.

Given that cost-to-income is almost twice that for the sector, we see an opportunity to contain this cost going forward, though await concrete numbers before taking a more constructive view on the bank. Much of this improvement can arise from branch and employee productivity. Financing and deposit per branch stood at a sector low of SAR 244mn and SAR 317mn, respectively in 2014. This compares to sector average of SAR 666mn/branch for loans and an average SAR 862mn of deposits per branch. Similarly, employee productivity lags the sector, at SAR 11mn of deposits per employee as against the estimated sector average of SAR 30mn per employee; and loans per employee stood at SAR 8mn vs. sector average of SAR 23 mn in 2014.

**Deposit Mix (2H 2015)**



**Maturity Profile (% of Total)**



Source: Company Reports, SFC

**Adequate capitalization and liquidity position to support growth:** ALBI has a strong capital base with a Tier-1 capital of 15.4% in 2Q 2015. The bank's LDR remained low at 77% at end of 2014 but has increased to 83% by the end of 2Q. We expect deposits and loans to register a 7% CAGR in the next five years (2014-19E) as system-wide deposit and loan growth slow in response to the tougher economic environment.

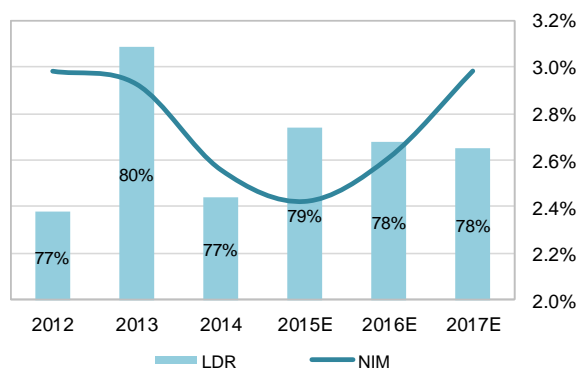
Given the tough economic headwinds and increasing competition from conventional banks expanding their shariah-compliant product offering, our view is that the bank will not be able to sustain its high growth rates





and we foresee a significant slowdown in lending, a risk to the valuation. All in all, we expect NIM to expand by 77 bps to 3.3% by 2018F, we expect limited expansion (5bps) in 2016F. Our peak forecast rate stands below the 3.7% NIM before the global financial crisis.

#### Net Financing to Customer Deposits and NIM

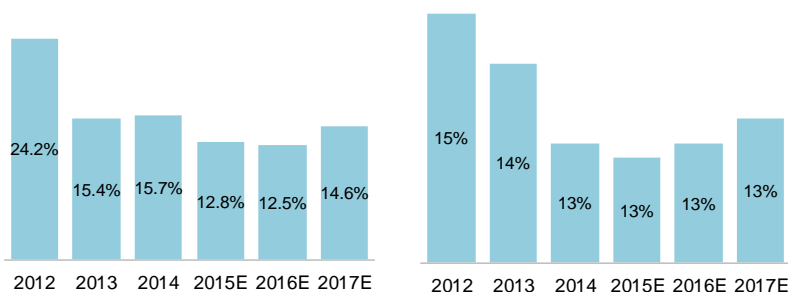


Source: Company Reports, SFC

**Earnings volatility the key risk:** While total income growth (2015E: +9% & 2016E: +11.5%) is expected to continue with an expanding branch presence (from 75 branches in 2010 to 116 branches as of 1H 2015 or nearly 10 new branches per year), the corresponding earnings growth is forecast to remain depressed in light of higher operating expenses and the absence of any loan recoveries (SAR 141mn in bad loan recoveries in 2014). This tends to keep the earnings volatile, a dampener to the equity story of ALBI. Overall, we expect the RoE to average c.14% during the forecast period, rising to 16.7% in 2018F.

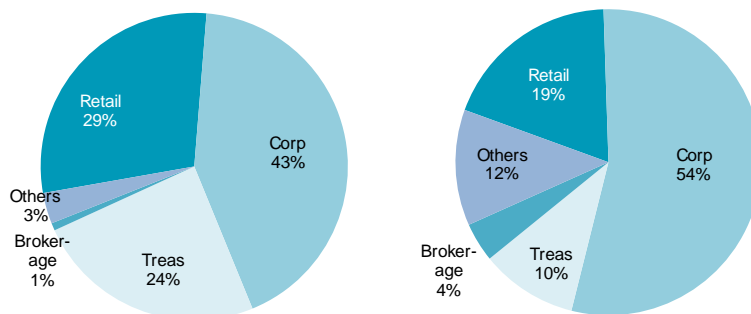
#### Return on Equity Forecast

#### Equity / Total Assets



#### Business by Segment 2014

#### Earnings Mix by Segment 2014

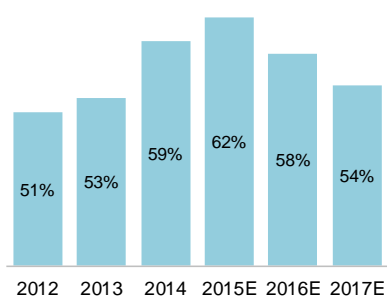


Source: Company Reports, SFC

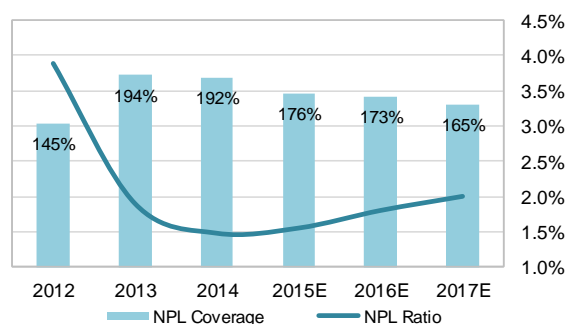
**Near-term risks remain elevated due to its high exposure to building & construction sector:** Asset quality has improved with a NPL ratio of 1.5% in 2014 (c.5.5% in 2009) and has adequate provisioning for

losses (192% in 2014). However, the bank's exposure to the building & construction sector (SAR 5.6bn, c.15% of performing financing in 2014) warrants caution, given anticipated project delays as the government looks to curtail the fiscal deficit. NPLs rose 14.7% in 1H2015, highest in sector after BIAZ. The NPL ratio is likely to deteriorate to 2.1% levels during the forecast period with basic coverage levels forecast to remain above 150%. High dependence on remittance business (c.57% of total fee income) for the fee income adds to the business risks, especially during challenging macroeconomic conditions. Overall, on YTD basis, the shares of ALBI (down 29%) have underperformed the TASI (down 7%) and KSA Bank Index (down 7%) indicates that the bank's high exposure to building and construction sector, and slower growth outlook is a perceived risk among investors.

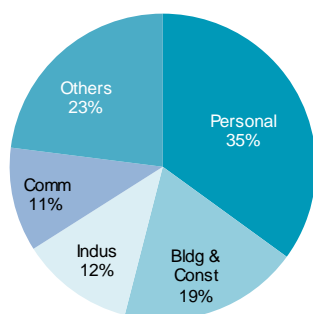
#### Cost-Income (ex-impairment) Trend



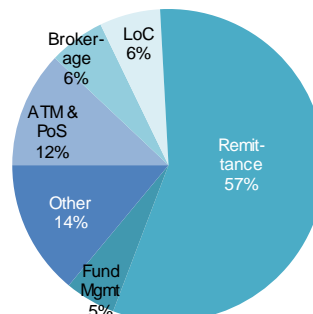
#### Non-Performing Financing Coverage and Ratio



#### Credit by Segment 2014



#### Fee Income Mix 2014



Source: Company Reports, SFC

#### Valuation Sensitivity

We have valued the bank on Warranted Equity using 15% sustainable ROE, 7.0% growth rate and 11% cost of equity. At our target price, ALBI would trade at 1.9x 2016F BV.

#### Target Price sensitivity to sustainable ROE and growth rate assumptions

Sustainable ROE		Growth Rate				
		5.0%	6.0%	7.0%	8.0%	9.0%
	13.0%	17.6	18.5	19.8	22.0	26.6
	14.0%	19.7	20.9	22.9	26.2	32.9
	15.0%	21.7	23.4	26.0	30.4	39.3
	16.0%	23.8	25.9	29.1	34.5	45.6
	17.0%	25.8	28.4	32.2	38.7	52.0

Source: Company Reports, Tadawul, SFC



## Value Unlocking Prospects in Better Macro Picture

Current macroeconomic environment in KSA challenging for the bank to sustain ROE improvements. In our view, balance sheet inefficiencies (excess capital) will remain a near term drag on the stock. HOLD with a reduced target price of SAR16.5. Alinma Bank's (1150/ALINMA AB) near-term equity story remains less attractive. The bank benefits from a strong capital base (Tier 1 as of 2Q15: c.24%) which in turn should likely lead to potentially robust growth going forward (2014-19F EPS CAGR 11%). The bank operates at a relatively higher cost-structure (cost to income 2Q15: 48% vs. 35% for the sector; and c.41% for the shariah-compliant banks), which has room for improvement. Furthermore, the financing portfolio is well diversified (18% exposure to low-risk government/quasi government segment). Despite Alinma's positives, we fail to see a favorable trade-off between risks and growth prospects at Alinma.

**High double digit earnings growth prospects; ROE expansion could be delayed:** Recent reports suggest that the government is looking to curtail investment spend to manage the fiscal balance, thus we expect corporate debt demand to be relatively muted. Net financing portfolio will witness a CAGR of c.6%, while the earnings growth will be supported mostly by improvements containing costs. ROE is forecast to range 8% to 11% in the forecast period.

**Attractive financing margin and room for improving its cost structure; corporate finance advisory fees may not be sustainable:** Alinma has an attractive margin (2014: 3.3%) despite focus on the corporate segment (relatively low margin compared to retail/consumer). This is largely driven by the "long-term" nature of financing, which offers higher profit rates, and likely to be on a floating structure, thus allowing faster re-pricing as interest rates rise. Corporate finance and advisory is a key fee income driver (33% of total fee Income in 2014), which is estimated to record a c.7% CAGR during 2014-19F. Moreover, being the most recent entrant into the domestic banking sector, Alinma operates on a relatively higher cost structure (cost to income 2014: 48% vs. c.41% for the shariah-compliant banks) indicating room for improvement.

**Strong capital position support lending, high LDR a challenge:** Alinma's LDR ratio of c.90% in 2014 was the highest among peer group and above SAMA's upper limit of 85%. This presents a challenge for the bank in the immediate term, as a relatively low demand deposit base combined with a high LDR puts the bank in a weak competitive position while negotiating for time deposits. We expect cost of funds to start ticking higher from 4Q15.

**Exposure to the building & construction sectors is a key risk for Alinma:** Alinma's financing portfolio is well diversified and has exposure to the Government/Quasi government segment (18% of financing in 2014) and consumer financing (22%). However, exposure to the building & construction sector remains relatively high (c.29% in 2014). Given the challenges of an economic slowdown in KSA, the NPL ratio is expected to increase from the current 0.7% levels to in excess of 1.2%. In 1H2015, we have already seen NPL rise by 26% YoY.

**Alinma trades at 1.5x 2016F BV, a moderate premium to the sector PBV:** ROE expansion will remain challenging in the current economic environment, thus further premium not justified. We have valued the bank on Warranted Equity using 12% sustainable ROE, 8.0% growth rate and 11% cost of equity.

### Rating Summary

Recommendation	HOLD
12-Month Target price (SAR)	16.5
Upside/(Downside)	(5.5%)

### Stock Details

Last Close Price	SAR	17.5
Market Capitalization	SAR mln	26,190
Shares Outstanding	mln	1,500
52-Week High	SAR	25.2
52-Week Low	SAR	15.5
Price Change (YTD)	%	(12.5%)
12-Mth ADTV	mln	31.2
EPS 2015E	SAR	1.01
Reuters / Bloomberg	1150.SE	ALINMA AB

Source: Tadawul

### Key Shareholders (%)

General Retirement Fund	11%
Public Investment Fund	10%
GOSI	5%
Free Float	74%

Source: Tadawul

### Price Multiples

	2015E	2016E
P / E	18.4x	15.2x
P / B	1.5x	1.5x
Dividend Yield (%)	2.7%	4.0%

Source: SFC

### 1-Year Share Performance



Source: Bloomberg

## Summary Financials

All figures are in SAR mn

Summary Financials	2013	2014	2015E	2016E	2017E	2018E
<b>INCOME STATEMENT</b>						
Income from investments and financing	2,021	2,286	2,532	2,911	3,395	3,986
Return on time investments	(186)	(211)	(237)	(323)	(426)	(627)
<b>Net income from investments and financing activities</b>	<b>1,835</b>	<b>2,075</b>	<b>2,295</b>	<b>2,588</b>	<b>2,969</b>	<b>3,360</b>
y-o-y growth %	21%	13%	11%	13%	15%	13%
Other Income	444	545	789	761	837	863
<b>Total Income</b>	<b>2,279</b>	<b>2,620</b>	<b>3,085</b>	<b>3,349</b>	<b>3,806</b>	<b>4,223</b>
y-o-y growth %	25%	15%	18%	9%	14%	11%
Expenses	(990)	(1,185)	(1,353)	(1,281)	(1,409)	(1,528)
<b>Pre-provision Profit</b>	<b>1,289</b>	<b>1,435</b>	<b>1,732</b>	<b>2,068</b>	<b>2,397</b>	<b>2,695</b>
Charge for impairment on financing	(274)	(162)	(301)	(344)	(496)	(602)
Total operating expenses	(1,264)	(1,347)	(1,654)	(1,625)	(1,904)	(2,130)
Cost-to-income ratio % (Excl. Impairments)	43.4%	45.2%	43.9%	38.2%	37.0%	36.2%
<b>Net Operating Income</b>	<b>1,015</b>	<b>1,273</b>	<b>1,431</b>	<b>1,724</b>	<b>1,902</b>	<b>2,093</b>
Share of loss from associate/ Others	(10)	(9)	(4)	0	1	1
<b>Net Profit</b>	<b>1,005</b>	<b>1,264</b>	<b>1,427</b>	<b>1,724</b>	<b>1,902</b>	<b>2,094</b>
<b>BALANCE SHEET</b>						
<b>Assets</b>						
Cash and balances with SAMA	4,972	6,066	6,313	6,386	6,509	6,752
Due from banks and other financial institutions	4,972	10,318	10,834	11,375	11,944	12,541
Investments	5,399	8,036	8,840	9,547	10,024	10,526
Financing, net	44,924	53,637	54,415	56,821	60,945	65,332
Property and equipment, net	1,475	1,544	1,658	1,741	1,787	1,800
Other assets, net	1,259	1,261	1,419	1,589	1,764	1,941
<b>Total assets</b>	<b>63,001</b>	<b>80,862</b>	<b>83,479</b>	<b>87,460</b>	<b>92,974</b>	<b>98,891</b>
<b>Liabilities</b>						
Due to banks and other financial institutions	201	33	196	216	235	254
Customers' deposits	42,763	59,428	61,805	64,895	69,438	74,298
Other liabilities	3,206	3,462	3,635	3,817	4,008	4,208
<b>Total liabilities</b>	<b>46,169</b>	<b>62,923</b>	<b>65,636</b>	<b>68,928</b>	<b>73,681</b>	<b>78,760</b>
<b>Total equity</b>	<b>16,832</b>	<b>17,939</b>	<b>17,843</b>	<b>18,532</b>	<b>19,293</b>	<b>20,131</b>
<b>Total liabilities and equity</b>	<b>63,001</b>	<b>80,862</b>	<b>83,479</b>	<b>87,460</b>	<b>92,974</b>	<b>98,891</b>
<b>Key Ratio</b>						
P/E	26.1	20.7	18.4	15.2	13.8	12.5
P/BV	1.6	1.5	1.5	1.4	1.4	1.3
P/PPP	20.3	18.3	15.1	12.7	10.9	9.7
ROAE	6.0%	7.3%	8.0%	9.5%	10.1%	10.6%
ROAA	1.7%	1.8%	1.7%	2.0%	2.1%	2.2%
Dividend Yield	0.0%	2.9%	2.7%	4.0%	4.4%	4.8%
Net Income growth	37%	20%	13%	21%	10%	10%
Total Income growth	25%	15%	18%	9%	14%	11%
NPL/Gross Financing	0.67%	0.65%	0.70%	0.85%	1.05%	1.20%
Equity/Total Assets	26.7%	22.2%	21.4%	21.2%	20.8%	20.4%
Tier-1 Capital	27.7%	25.6%	27.6%	26.5%	25.9%	25.4%

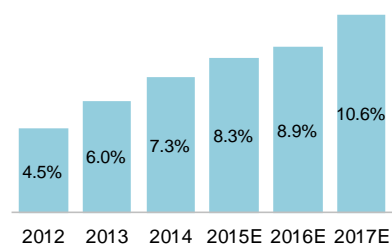
Source: Company Reports, Bloomberg

## Investment Thesis

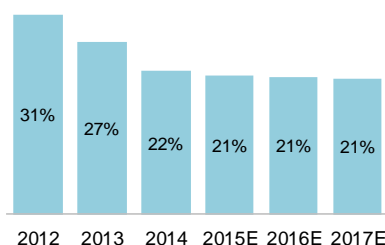
**High double digit earnings growth prospects; ROE expansion could be delayed:** Recent reports suggest that the government is looking to curtail investment spend to manage the fiscal balance, thus we expect corporate debt demand to be relatively muted. Net financing portfolio will witness a CAGR of 6%, while the earnings growth (CAGR of 11% during 2014–19F) will be supported mostly by improvements in containing costs. ROE is projected to range c.8% to 11% in the forecast period.

In light of the anticipated slowdown, we see a case for further delay in ROE expansion at Alinma, meaning the current environment will act as a near term drag to the equity story. In our view, the recent under performance of the bank (vs. peers) is thus justified in this context. On YTD basis, the shares of Alinma (down 13%) have underperformed the TASI (down 7%) and KSA Bank Index (down 7%). In this emergent environment, consolidating expenses and expanding core demand deposit base will be the key to earnings stability, whilst the ability to outperform sector in deposit mobilization will drive positive earnings surprises.

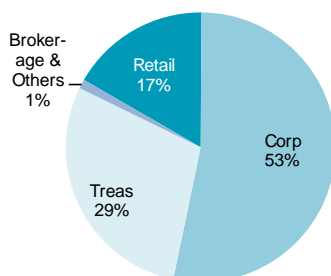
### Return on Equity Forecast



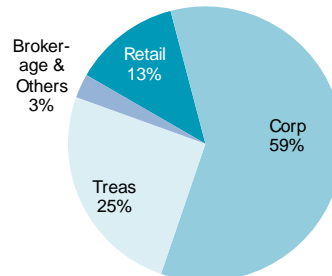
### Equity / Total Assets



### Business by Segment 2014



### Earnings Mix by Segment 2014

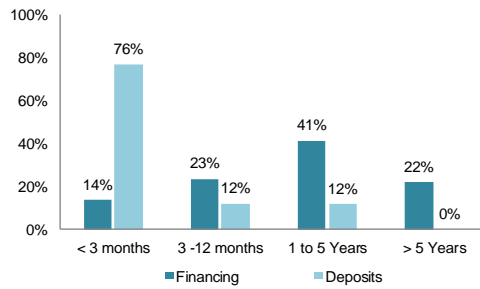


Source: Company Reports, SFC

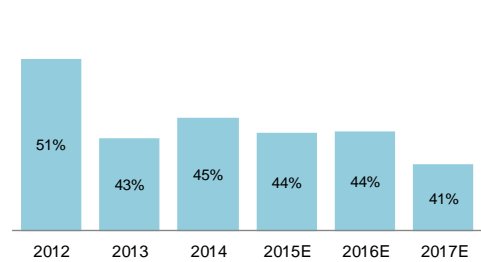
**Attractive financing margin:** Alinma has an attractive margin (2014: 3.3%) despite its focus on the corporate segment (relatively low margin compared to retail/consumer). This is largely driven by the “long-term” nature of financing, which offers higher floating profit rates, thus allowing faster re-pricing as interest rates rise.

In terms of maturity of assets/liabilities, short term deposits (<3 months) accounted for 76% of total deposits at Alinma while maturity on financing side was well spread across maturity brackets with 41% financing due in the 1 to 5 years period. In the immediate term, its high LDR (1H2015: 90%) may necessitate growing time deposits, thus applying upward pressure on cost of funds, however in the medium term higher base interest rates should drive gains in NIM.

**Maturity Profile - Financing & Customer Deposits (% to Total)**



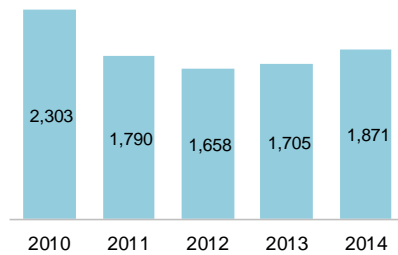
**Cost-Income (ex-impairment) Trend**



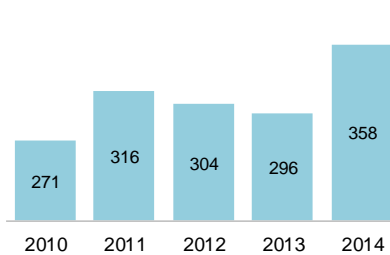
Source: Company Reports, SFC

**Room for improving cost structure:** As the most recent entrant into the domestic banking sector, Alinma operates at a relatively higher cost structure (cost to income 2014: 45% vs. average c.41% for shariah-compliant banks) indicating room for improvement. In fact, Alinma has seen mixed trends on the expenses side. The bank has successfully brought down the rental expenses per branch over the years to SAR 1.9mn per branch/year (down 5.1% CAGR 2010-14 compared to rental expenses of average SAR 1.3mn per branch/year; an increase of +6.6% CAGR for the shariah-compliant peers). However, the salary cost per employee increased 7.1% CAGR during 2010-14 period as against c.4.1% CAGR increase for the shariah-compliant peers.

**Branch Rental Expense (SAR 000s)**



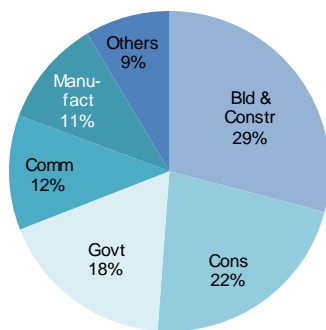
**Employee Salary Expense (SAR 000)**



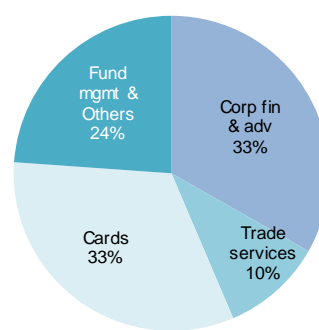
Source: Company Reports, SFC

**Corporate finance advisory fees may not be sustainable:** Corporate finance advisory income has been a key fee income driver (33% of total fee income in 2014), going forward however we are forecasting lower corporate finance advisory income as Alinma has not been able to capture significant deals in the recent past, and we predict that sector corporate finance income will come under pressure as the government cuts investment spending to contain the fiscal deficit. We expect fee income for the bank to grow at an estimated 7% CAGR during 2014–19F versus the 33% CAGR over 2010-14.

**Credit by Sector 2014**



**Fee Income Mix 2014**

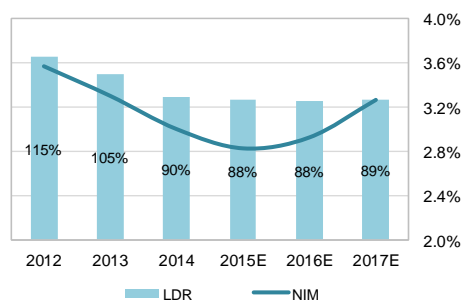


Source: Company Reports, SFC

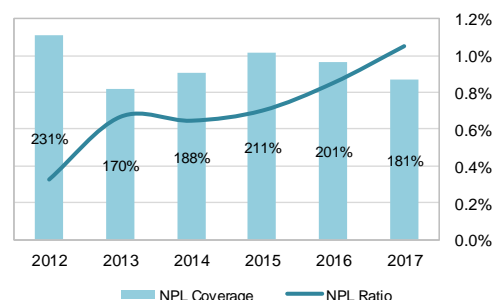


**High LDR a near-term challenge:** Alinma's LDR ratio of 90% in 2014 was the highest among peer group and above SAMA's upper limit of 85%. This presents a challenge for the bank in the immediate term, as a relatively low demand deposit base combined with a high LDR puts bank in a weak competitive position while negotiating for time deposits. We expect cost of funds to start ticking higher from 4Q15. Alinma is expected to grow deposit base (CAGR: 6%, 2014-19F), which will help maintain the LDR ratio near c.90% levels in the forecast period. Given the high LDR levels, deposit mobilization holds key for Alinma to support growth in lending.

#### Net Financing / Customer Deposits and NIM



#### Non-Performing Financing Coverage and Ratio



Source: Company Reports, SFC

**Exposure to the building and construction sectors is a key risk for Alinma:** Alinma's financing portfolio is well diversified and has exposure to the government/quasi government segment (18% of financing in 2014) and consumer financing (22%). This considerable dependence on the government financing is structurally a positive for the bank, but growth could be limited by a slowdown in government investment spending. Credit risk from the high exposure to building & construction (29%) is a concern. Overall, we are conservative on our estimates and forecast the financing portfolio to register a CAGR of c.6% in the forecast period 2014-19F (2009-14A: CAGR: +28%).

Given the challenges of an economic slowdown in KSA, the NPL ratio is expected to increase from the current 0.7% levels to in excess of 1.2%. In 1H2015, we have already seen NPL rise by 26% YoY. The basic NPL coverage levels are forecast to remain near 200% levels.

#### Valuation Sensitivity

We have valued the bank on Warranted Equity using 12% sustainable ROE, 8.0% growth rate and 11% cost of equity.

#### Target Price sensitivity to sustainable ROE and growth rate assumptions

Sustainable ROE		Growth Rate				
		6.0%	7.0%	8.0%	9.0%	10.0%
	10.0%	10.1	9.6	8.8	7.0	1.1
	11.0%	12.4	12.5	12.6	13.0	14.1
	12.0%	14.7	15.3	16.5	18.9	27.2
	13.0%	16.9	18.2	20.3	24.9	40.2
	14.0%	19.2	21.0	24.2	30.8	53.2

Source: Company Reports, Tadawul, SFC

## Unfavorable risk-return trade off

Despite the recent sell off in the shares of Bank Al Jazira (1020/BJAZ AB) we fail to see a buying opportunity. Market opening represents opportunity to expand broking, but exposure to share margin financing is a near-term concern. Modifying rating to SELL with a reduced target price of SAR 18/share. BJAZ has one of the lowest NIM (2.8% in 2Q15) amongst the peer group of shariah-compliant banks (2Q15: Alinma: 3.3%, Al Bilad: 2.8%; and Al Rajhi: 3.8%), and recent results have indicated a slight improvement in margins sequentially. Bank's low capitalization level (Tier I capital 2Q15: c.14%) along with high-cost funding base as demand deposits only 48% of total customer deposits in 2Q15 (vs. 66% for the system) are key concerns. Streamlining of cost structure (cost to income 2014: 57% vs. 36% for the sector) holds the key to long term equity story for BJAZ.

**Loan growth has been impressive, but likely to slow:** BJAZ has made considerable in-roads into retail and mid-market commercial lending over the recent past, more than doubling its overall loans (retail and commerce loans rose by 35% and 39% CAGR 2010-2014). However, in a tougher economic environment, loan portfolio is forecast to grow at low-single digits (CAGR 2014 to 19E: c.+5%). Financing portfolio expansion will be driven by a balanced approach between the retail (4 new branches YTD as of 2Q15) and corporate segments. Earnings growth is estimated to remain volatile while the RoAE to average c.10% during the forecast period.

**Higher cost deposits and room for improvement on the cost front:** With demand deposits accounting for 48% of total deposits (vs. System: 66%), the cost of funds remains high at BJAZ. It also operates on a higher cost base (cost to income 2014: 57%, 36% for the sector) versus shariah-compliant peer group (c.49% in 2014). Reduced dependency on broking income will be key to reducing cost-to-income.

**Sound liquidity position to support lending, low capitalization a challenge:** BJAZ has a relatively low capital base with Tier 1 capital of 13.6% in 2Q15. The banking group's LDR ratio is expected to remain around 76% levels, with the deposit base generating a CAGR of +5% over the forecast horizon, which leaves room for further growth on the assets side.

**Rising NPLs are a concern.** The bank has considerably strengthened the quality of its loans over the recent past, where its NPL ratio has fallen from 7.5% in 2009 to 0.9% in 2014. However, in 1H2015 BJAZ has seen the fastest accretion in NPLs in the sector, rising 16% against Y/E2014. In 2H, given the bank's significant exposure to share-margin financing (8% of net financing in 2014A) and the TASI's decline, we believe further increases may be on the horizon.

**BJAZ trades at 1.1x 2016F BV, at a discount to the sector PBV of 1.4x:** Given its exposure to broking/share trading activities and weak ROE outlook, we believe BJAZ will continue to trade at a discount to the sector. At our target price, BJAZ would trade at 1.0x 2016F BV. We have valued the bank on Warranted Equity using 11.5% sustainable ROE, 6.0% growth rate and 11.4% cost of equity.

### Rating Summary

<b>Recommendation</b>	<b>Sell</b>
<b>12-Month Target price (SAR)</b>	<b>18.0</b>
<b>Upside/(Downside)</b>	<b>(14.7%)</b>

### Stock Details

Last Close Price	SAR	21.1
Market Capitalization	SAR mln	8,436
Shares Outstanding	mln	400
52-Week High	SAR	34.6
52-Week Low	SAR	19.8
Price Change (YTD)	%	(24.1%)
12-Mth ADTV	mln	2.3
EPS 2015E	SAR	3.07
Reuters / Bloomberg	1020.SE	BJAZ AB

Source: Tadawul

### Key Shareholders (%)

United Brothers Development Co.	7%
El-Ahly Pakistan Bank	6%
Kamil Salih Abdullah	5%
Others	83%

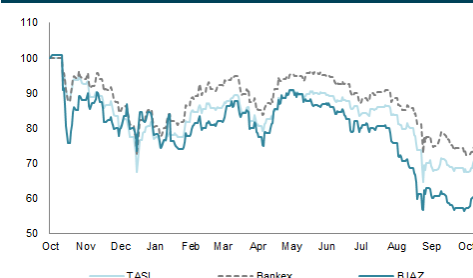
Source: Tadawul

### Price Multiples

	2015E	2016E
P / E	6.9x	14.7x
P / B	1.2x	1.1x
Dividend Yield (%)	2.2%	2.0%

Source: SFC

### 1-Year Share Performance



Source: Bloomberg



## Summary Financials

All figures are in SAR 'mn

Summary Financials	2013	2014	2015E	2016E	2017E	2018E
<b>INCOME STATEMENT</b>						
Special commission income	1,645	1,783	1,881	2,178	2,519	2,975
Special commission expense	(422)	(338)	(285)	(387)	(593)	(803)
<b>Net Special Commission Income</b>	<b>1,223</b>	<b>1,445</b>	<b>1,597</b>	<b>1,791</b>	<b>1,926</b>	<b>2,172</b>
y-o-y growth %	28.6%	18.2%	10.5%	12.2%	7.5%	12.8%
Other Income (Fee/Trading and Others)	616	781	1,397	912	975	1,043
<b>Total Operating Income</b>	<b>1,839</b>	<b>2,226</b>	<b>2,993</b>	<b>2,703</b>	<b>2,901</b>	<b>3,215</b>
y-o-y growth %	15.1%	21.0%	34.5%	-9.7%	7.3%	10.8%
Expenses	(1,051)	(1,275)	(1,502)	(1,583)	(1,702)	(1,831)
<b>Pre-provision Profit</b>	<b>788</b>	<b>952</b>	<b>1,492</b>	<b>1,120</b>	<b>1,199</b>	<b>1,385</b>
Charge for impairment on financing	136	383	259	542	573	606
<b>Total Operating Expenses</b>	<b>1,188</b>	<b>1,658</b>	<b>1,761</b>	<b>2,125</b>	<b>2,275</b>	<b>2,436</b>
Cost-to-income ratio % (Excl. provisions)	69.9%	64.2%	69.1%	55.2%	54.5%	57.6%
<b>Net Operating Income</b>	<b>652</b>	<b>569</b>	<b>1,233</b>	<b>578</b>	<b>626</b>	<b>779</b>
Share of loss from associate/ Others	(1)	(4)	(4)	(4)	(4)	(4)
<b>Net Profit</b>	<b>651</b>	<b>565</b>	<b>1,229</b>	<b>574</b>	<b>622</b>	<b>775</b>
<b>BALANCE SHEET</b>						
<b>Assets</b>						
Cash and balances with SAMA	7,306	6,552	7,101	6,646	6,655	6,607
Due from banks and other financial institutio	3,074	4,909	5,154	5,412	5,683	5,967
Investments	12,597	11,335	11,902	13,092	14,139	15,270
Loans and advances, net	34,995	41,245	43,185	45,519	48,182	51,115
Other real estate, net	672	126	128	131	133	136
Investment in associate	121	660	656	652	648	644
Property and equipment, net	508	599	749	861	975	1,098
Other assets	703	1,129	1,151	1,174	1,198	1,222
<b>Total Assets</b>	<b>59,976</b>	<b>66,554</b>	<b>70,027</b>	<b>73,487</b>	<b>77,613</b>	<b>82,059</b>
<b>Liabilities</b>						
Due to banks and other financial institutions	4,359	3,736	3,961	4,159	4,283	4,412
Customers' deposits	48,083	54,569	56,752	59,590	63,165	66,955
Other liabilities	807	1,090	1,112	1,134	1,157	1,180
Debt securities in issue	1,000	1,000	1,000	1,000	1,000	1,000
<b>Total Liabilities</b>	<b>54,248</b>	<b>60,396</b>	<b>62,825</b>	<b>65,883</b>	<b>69,605</b>	<b>73,547</b>
<b>Total Equity</b>	<b>5,729</b>	<b>6,158</b>	<b>7,202</b>	<b>7,604</b>	<b>8,008</b>	<b>8,512</b>
Minority Interest	-	-	-	-	-	-
<b>Total Liabilities and Equity</b>	<b>59,976</b>	<b>66,554</b>	<b>70,027</b>	<b>73,487</b>	<b>77,613</b>	<b>82,059</b>
<b>Key Ratio</b>						
P/E	13.0	14.9	6.9	14.7	13.6	10.9
P/BV	1.5	1.4	1.2	1.1	1.1	1.0
P/PPP	10.7	8.9	5.7	7.5	7.0	6.1
ROAE	12.1%	9.6%	18.5%	7.8%	8.0%	9.4%
ROAA	1.2%	0.9%	1.8%	0.8%	0.8%	1.0%
Dividend Yield	0.0%	0.0%	2.2%	2.0%	2.6%	3.2%
Net Income growth	30%	-13%	117%	-53%	8%	24%
Total Income growth	15%	21%	34%	-10%	7%	11%
NPL/Gross Financing	1.20%	0.88%	1.00%	1.30%	1.50%	1.70%
Equity/Total Assets	9.6%	9.3%	10.3%	10.3%	10.3%	10.4%
Tier-1 Capital	12.2%	11.4%	12.4%	12.2%	11.8%	11.9%

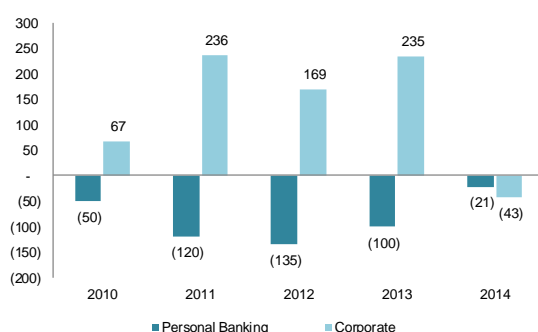
Source: Company Reports, Bloomberg

## Investment Thesis

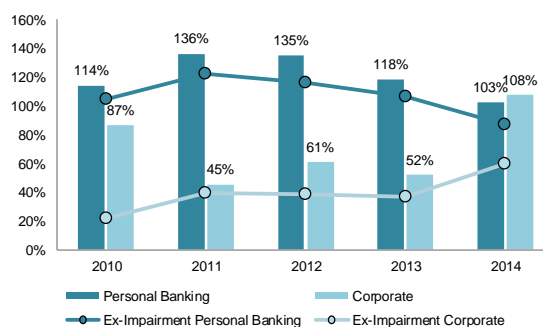
**Slowdown in earnings growth:** BJAZ has made considerable in-roads into retail and mid-market commercial lending over the recent past, more than doubling its overall loans (retail and commerce loans rose by 35% and 39% CAGR 2010-2014). However, in a tougher economic environment, BJAZ's loan portfolio is forecast to slow to low-single digits (CAGR 2014 to 19E: c.+5%). Financing portfolio expansion will be driven by a balanced approach between the retail (4 new branches YTD as of 2Q 2015) and corporate segments. Earnings growth is estimated to remain volatile while the RoAE to average c.10% during the forecast period.

Considering that the personal banking and corporate segments are currently loss making, BJAZ remains very much reliant on its share broking business (47% of total fee Income and 8% of total financing). This exposes BJAZ to much greater earnings volatility than peers, especially in the current unfavorable trading environment. In fact BJAZ has struggled to turn its personal banking operation earnings positive (2014: SAR 23 mln net loss); largely on account of higher operating expenses and impairment costs. The corporate segment too had slipped into the red in 2014 (net loss: of SAR 43mn), largely on higher impairment costs. Thus the bank's earnings performance is dependent solely on treasury and brokerage/trading income. Any improvement in the personal and corporate segment should support an earnings upside.

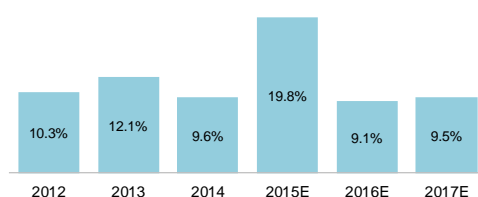
Earnings Trend - Personal and Corporate Segment (in SARmn)



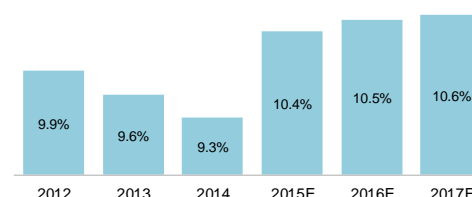
Trend in Operating expenses as a % to Total Segment Income



Return on Equity Forecast

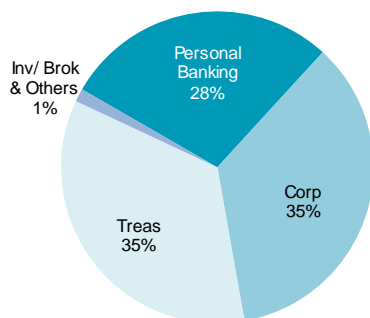


Equity / Total Assets

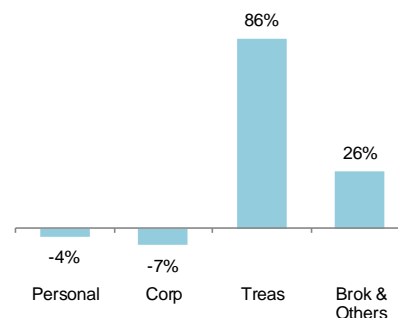


Source: Company Reports, SFC

#### Business by Segment 2014



#### Earnings Mix by Segment 2014

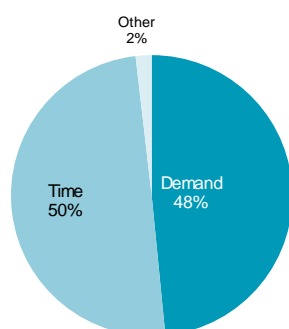


Source: Company Reports, SFC

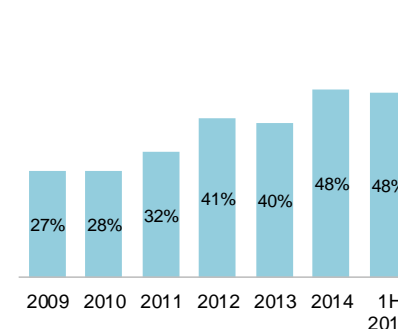
In our view, the recent under performance of the bank (vs. sector and peers) is thus justified. On YTD basis, the shares of BJAZ (down 24%) have underperformed the TASI (down 7%) and KSA Bank Index (down 7%).

**Higher cost deposits and room for improvement on the cost front:** With demand deposits accounting for only 48% of total deposits (vs. System: 66%), the cost of funds remains high at BJAZ. The deposit profile at BJAZ has however increased favourably towards demand deposits in the past 5-years (share of demand deposits stood at 27% in 2009 as against 48% in 1H 2015) and has significant room to align more towards the sector average.

#### Deposit Mix 2014



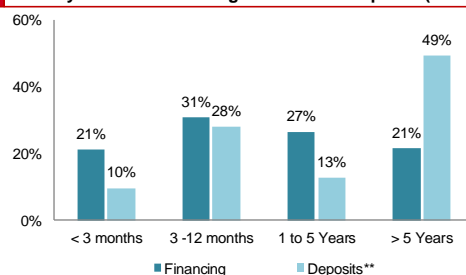
#### Demand to Total Deposits (2009-1H2015)



Source: Company Reports, SFC

In terms of maturity of assets/liabilities, 21% of total financing matures >5YRS period while 27% is in the 1 to 5 year bracket, indicating the long term nature of its lending policy. On the funding side, nearly 49% of total deposits are classified as no fixed maturity indicating that low cost short term funds are partly funding the long term loans. BJAZ has on financing side 48% of total financing with maturity brackets of 1 Year and above. It also operates on a higher cost base (cost to income 2014: 57%, 36% for the sector) versus shariah-compliant peer group (c.49% in 2014).

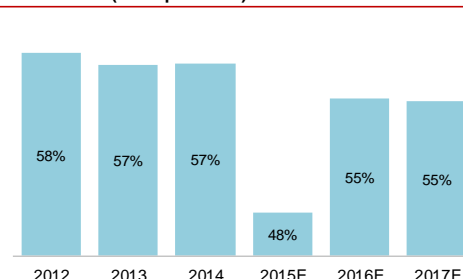
#### Maturity Profile - Financing & Customer Deposits (% to Total)



\*\* Deposits for > 5 Years are classified as 'No Fixed Maturity'

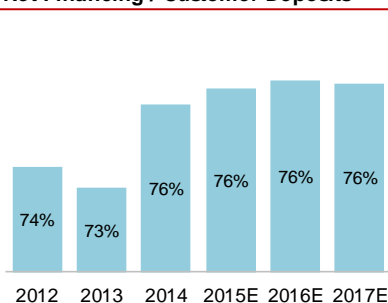
Source: Company Reports, SFC

#### Cost-Income (ex-impairment) Trend

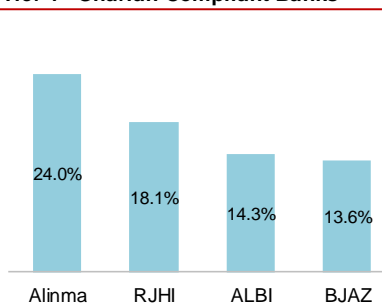


**Sound liquidity position to support lending, low capitalization levels among Shariah compliant banks:** BJAZ has had relatively low capital base with a Tier-1 capital at 11.8% at the end of 2014 which has now improved to 13.6% in 2Q 2015. However, amongst the Shariah compliant banks, BJAZ still has the lowest Tier 1 capital as of 1H 2015. In terms of liquidity, the banking group's LDR ratio is expected to remain around 76% levels, with the deposit base generating a CAGR of +5% over the forecast horizon, which leaves room for further growth in assets. We see a moderate 20-30 bps improvement in NIM in the forecast period (from 2.4% in 2014A to 2.7% in 2018F levels).

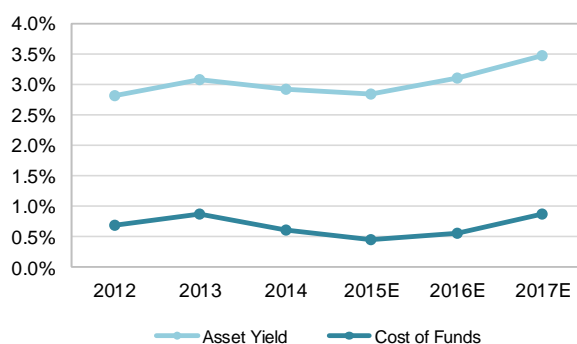
#### Net Financing / Customer Deposits



#### Tier 1 - Shariah Compliant Banks



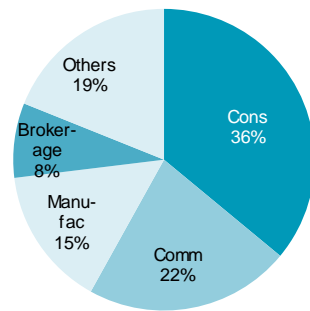
#### Asset Yield and Cost of Funds



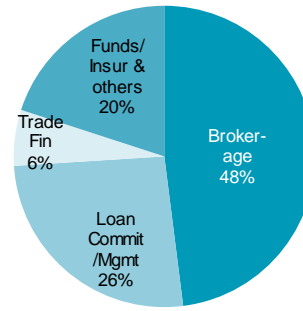
Source: Company Reports, SFC

**Considerable improvement in asset quality over the years; exposure to share trading finance warrants caution:** BJAZ's asset quality has improved significantly in recent years, with the NPL ratio at 0.9% in 2014 (vs. 7.5% in 2009). Basic provision coverage levels (i.e. excluding collateral values) remain adequate (2014: 181%). The group's exposure to financing for share trading (SAR 3.4bn, c.8% of performing portfolio in 2014 and c.48% contribution to fee income) warrants caution, especially in uncertain market conditions. We expect the NPL ratio to deteriorate to 2.5% by 2017F, with basic coverage levels expected to remain elevated above 180% levels.

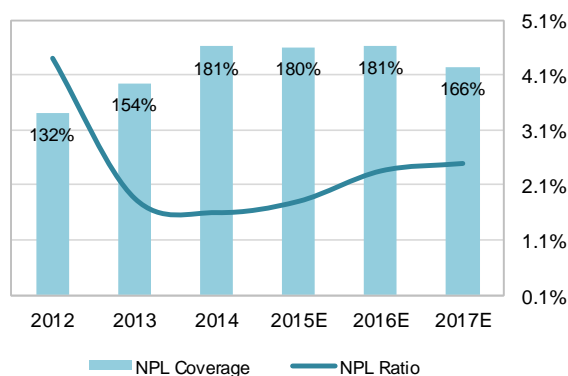
#### Credit by Sector 2014



#### Fee Income Mix 2014



#### Non-Performing Financing Coverage and Ratio



Source: Company Reports, SFC

#### Valuation Sensitivity

We have valued the bank on Warranted Equity using 11.5% sustainable ROE, 6.0% growth rate and 11.4% cost of equity. At our target price, BJAZ would trade at 1.0x 2016F BV.

#### Target Price sensitivity to sustainable ROE and growth rate assumptions

		Growth Rate				
		4.0%	5.0%	6.0%	7.0%	8.0%
Sustainable ROE	9.5%	13.4	12.7	11.8	10.5	8.3
	10.5%	15.6	15.3	14.9	14.3	13.3
	11.5%	17.9	17.9	18.0	18.1	18.2
	12.5%	20.2	20.6	21.1	21.9	23.2
	13.5%	22.4	23.2	24.2	25.7	28.2

Source: Company Reports, Tadawul, SFC





## Valuation Premium Harder to Justify

Declines seen in NIM and RoAE over recent years should be arrested as higher interest rates feed-in up to 2018, however we see challenges to market share as competitors roll-out shariah-compliant products. The impact of new management holds the key to a more constructive view. HOLD with an upward revision in target price to SAR 60 per share. Al Rajhi Bank (1120/RJHI AB) is one of the premier shariah-compliant financial institutions in KSA and key strengths include wide scale of operations (c.27% market share in terms of number of branches in KSA as of 2Q15), low cost funding base (demand deposits c.95% of customer deposits vs. c.66% for the system as of 2Q15) and efficient cost structure (cost to income of 32% vs. 36% for the sector). However, despite its strong market position, in a competitive environment, AlRajhi's equity story has not panned out as expected and the bank witnessed NIM and RoE contraction in the recent past.

**Scale and market reach are key competitive advantages, but competitive pressures are rising:** Given its scale (market share of branches, 2Q 2015: c.27%) and established franchise (c.16% of system financing, 2Q 2015), AlRajhi will remain a dominant player in the retail space, however the aggressive roll-out of shariah-compliant products by competitors threatens market share. Relaxation in LTV limits for mortgage financing in the near-term would be a real boost for the bank.

**Re-pricing likely to be relatively slow as rates rise, but AlRajhi's cost leadership is a positive:** While the NIM has compressed over the past five years (down to 3.3% in 2014 vs. near 6% in 2008), primarily due to increased competition, we see a potential bottoming out in margin contraction as higher interest rates impact feed into loan book. The high proportion of retail lending (69% of financing portfolio and c.76% earnings in 2014), mean that re-pricing impact from higher interest rates is likely to be slow as c.20% of the retail loans mature each year. With demand deposits accounting for a significant share of the deposit base (c.95% of total deposits), the cost of funds is estimated to remain low. On the operational front, the group has an industry-leading cost structure, which is witnessed by a cost-to-income ratio of 32% compared with an average 36% for the sector and average: c.43% for the shariah-compliant banking peers.

**Asset quality managed well, consumer financing will continue to be the key focus:** Asset quality has improved with the NPL ratio at 1.3% in 2014 (3.3% in 2009) and has adequate basic provision coverage (196% in 2014). However, AlRajhi has historically had a higher net NPL ratio and cost of risk, and as the economic environment becomes tougher, we forecast the NPL ratio to increase and range between 1.3% and 1.9% during the forecast period while coverage levels are expected to remain elevated.

**AlRajhi trades at 1.9x 2016F BV, at premium to the sector PBV of 1.4x:** Given its steady RoAE outlook (averaging 18% over forecast period), we believe AlRajhi will continue to trade at a sector premium. At our target price, RJHI would trade at 2.0x 2016F BV. We have valued the bank on Warranted Equity using 18% sustainable ROE, 3.5% growth rate and 10.4% cost of equity.

### Rating Summary

Recommendation	Hold
12-Month Target price (SAR)	60.0
Upside/(Downside)	7.2%

### Stock Details

Last Close Price	SAR	56.0
Market Capitalization	SAR mln	90,968
Shares Outstanding	mln	1,625
52-Week High	SAR	69.3
52-Week Low	SAR	48.4
Price Change (YTD)	%	11.0%
12-Mth ADTV	mln	3.6
EPS 2015E	SAR	4.33
Reuters / Bloomberg	1120.SE	RJHI AB

Source: Tadawul

### Key Shareholders (%)

Sulaiman AlRajhi Endowment	15%
GOSI	10%
Others	75%

Source: Tadawul

### Price Multiples

	2015E	2016E
P / E	12.9x	12.8x
P / B	2.0x	1.9x
Dividend Yield (%)	3.1%	5.1%

Source: SFC

### 1-Year Share Performance



Source: Bloomberg

## Summary Financials

All figures are in SAR mn

Summary Financials	2013	2014	2015E	2016E	2017E	2018E
<b>INCOME STATEMENT</b>						
Gross financing and investment income	10,115	10,213	10,254	11,563	14,058	16,799
Income paid to customers on time investments	(466)	(395)	(301)	(563)	(997)	(1,195)
<b>Net financing and investment income</b>	<b>9,649</b>	<b>9,817</b>	<b>9,953</b>	<b>11,001</b>	<b>13,061</b>	<b>15,604</b>
y-o-y growth %	3.3%	1.7%	1.4%	10.5%	18.7%	19.5%
Other Income	4,196	3,850	3,822	3,840	4,085	4,348
<b>Total Income</b>	<b>13,845</b>	<b>13,667</b>	<b>13,775</b>	<b>14,840</b>	<b>17,146</b>	<b>19,952</b>
y-o-y growth %	-1.0%	-1.3%	0.8%	7.7%	15.5%	16.4%
Expenses	(4,057)	(4,519)	(5,010)	(5,345)	(5,758)	(6,192)
<b>Pre-provision Profit</b>	<b>9,788</b>	<b>9,148</b>	<b>8,764</b>	<b>9,496</b>	<b>11,387</b>	<b>13,760</b>
Charge for impairment on financing	(2,350)	(2,312)	(1,734)	(2,386)	(3,027)	(3,477)
Total operating expenses	(6,407)	(6,831)	(6,745)	(7,731)	(8,786)	(9,669)
Cost-to-income ratio % (Excl. provisions)	29.3%	33.1%	36.4%	36.0%	33.6%	31.0%
<b>Net Operating Income</b>	<b>7,438</b>	<b>6,836</b>	<b>7,030</b>	<b>7,110</b>	<b>8,360</b>	<b>10,283</b>
<b>Net Profit</b>	<b>7,438</b>	<b>6,836</b>	<b>7,030</b>	<b>7,110</b>	<b>8,360</b>	<b>10,283</b>
<b>BALANCE SHEET</b>						
<b>Assets</b>						
Cash and balances with SAMA	29,970	33,585	16,347	19,438	18,023	16,660
Due from banks and other financial institutions	15,463	16,516	17,342	18,209	19,120	20,076
Investments	39,573	42,550	70,207	77,228	84,950	93,445
Financing, net	186,813	205,940	215,869	223,809	236,401	249,653
Customer debit current accounts, net	275	-	-	-	-	-
Property and equipment, net	4,320	4,814	5,215	5,630	6,135	6,754
Other assets, net	3,456	4,306	5,383	5,491	5,601	5,713
<b>Total assets</b>	<b>279,871</b>	<b>307,712</b>	<b>330,363</b>	<b>349,804</b>	<b>370,229</b>	<b>392,300</b>
<b>Liabilities</b>						
Due to banks and other financial institutions	3,640	2,135	2,263	2,377	2,448	2,521
Customers' deposits	231,589	256,077	274,002	290,443	307,869	326,341
Other liabilities	6,237	7,603	7,983	8,382	8,802	9,242
<b>Total liabilities</b>	<b>241,466</b>	<b>265,815</b>	<b>284,249</b>	<b>301,201</b>	<b>319,118</b>	<b>338,104</b>
<b>Total equity</b>	<b>38,405</b>	<b>41,896</b>	<b>46,114</b>	<b>48,603</b>	<b>51,111</b>	<b>54,196</b>
<b>Total liabilities and equity</b>	<b>279,871</b>	<b>307,712</b>	<b>330,363</b>	<b>349,804</b>	<b>370,229</b>	<b>392,300</b>
<b>Key Ratio</b>						
P/E	12.2	13.3	12.9	12.8	10.9	8.8
P/BV	2.4	2.2	2.0	1.9	1.8	1.7
P/PPP	9.3	9.9	10.4	9.6	8.0	6.6
ROAE	19.9%	17.0%	16.0%	15.0%	16.8%	19.5%
ROAA	2.7%	2.3%	2.2%	2.1%	2.3%	2.7%
Dividend Yield	4.5%	3.1%	3.1%	5.1%	6.4%	7.9%
Net Income growth	-6%	-8%	3%	1%	18%	23%
Total Income growth	-1%	-1%	1%	8%	16%	16%
NPL/Gross Financing	1.57%	1.26%	1.26%	1.55%	1.76%	1.90%
Equity/Total Assets	13.7%	13.6%	14.0%	13.9%	13.8%	13.8%
Tier-1 Capital	18.5%	17.0%	17.0%	16.1%	15.6%	15.3%

Source: Company Reports, Bloomberg

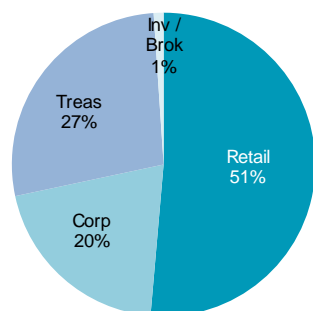
## Investment Thesis

**Scale and market reach are key competitive advantages, but competitive pressures are rising:** Given its scale (market share of branches, 2Q 2015: c.27%) and established franchise (c.16% of system financing, 2Q 2015), AlRajhi will remain a dominant player in the retail space, however the aggressive roll-out of shariah-compliant products by competitors threatens market share. Bank's ROE has declined over the past (from mid-20s to mid-teens) and we forecast ROE's to range 15-20% in the forecast period.

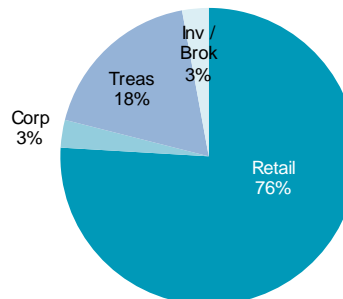
Given its large scale of operations, Al Rajhi growth is expected to remain in mid-single digits (loan CAGR 2014-19E: +5.1%; deposit CAGR: 2014-19E: +6.2%). This compares to the high growth seen in the past 5 years (loan CAGR 2009-14: +12.9%; deposit CAGR: 2009-14: +15.8). The bank however, has been successful in growing fee income in the recent past which accounted for 30% of the total income in 2014 (2009: fee income represented only 17% of bank's total income). Much of the fee income growth has been driven by growth in credit cards (fee income CAGR: 2009-14: +15%) and share broking services (CAGR: 2009-14: +11%). Fee income from share trading and credit card services together contributed 23% of total fee income in 2014 compared to 16% in 2009.

*Regulatory changes from SAMA will be an overhang given the banks' retail exposure:* SAMA has introduced tighter regulations for retail products in KSA. During 2014, SAMA set a cap of 1% of financing amount or SAR 5,000 (whichever is lower) on all fees, costs and administrative services charged by banks. Furthermore, SAMA kept at its discretion the right to impose a restriction on the consumer financing portfolio not to exceed a specified percentage of a bank's total financing portfolio. AlRajhi, being the biggest player in the consumer segment remains the most exposed to further tightening of retail lending regulations.

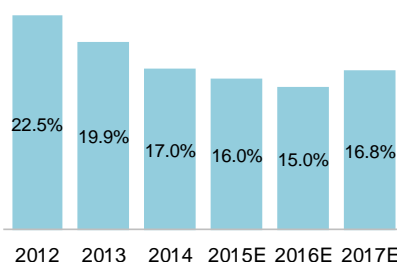
Business by Segment 2014



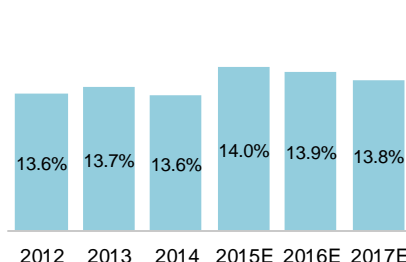
Earnings Mix by Segment 2014



Return on Equity Forecast



Equity /Total Assets

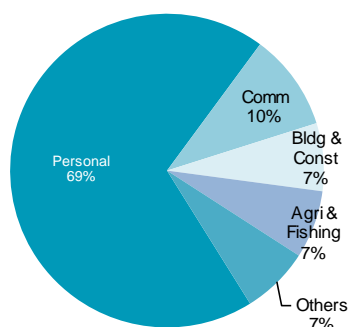


Source: Company Reports, SFC

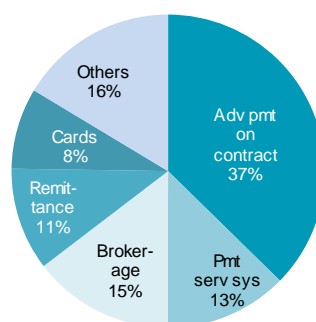
**Re-pricing likely to be slow as rates rise, but AlRajhi's cost efficiency is a positive:** While the NIM has contracted over the past five years (down to 3.3% in 2014 vs. near 6% in 2008), we see a potential

bottoming out in margin contraction as higher interest rates impact feed into loan book. The high proportion of retail lending (69% of financing portfolio and 76% earnings in 2014), mean that re-pricing impact from higher interest rates is likely to be slow as 20% of the retail loans mature each year. AlRajhi's major retail lending push came in 2011 and 2012, and assuming that average maturity of these loans is 5 years, then approximately SAR53 bln of retail loans will mature in 2016-2017. That's almost a quarter of their overall loans and 1/3rd of their retail loans (as of 2014A). The re-deployment of these loans presents a risk in a low loan growth environment, particularly with retail lending restrictions in place. Alternatively, if RJHI is able to successful re-deploy these maturing loans, it would warrant upside revisions to our estimates.

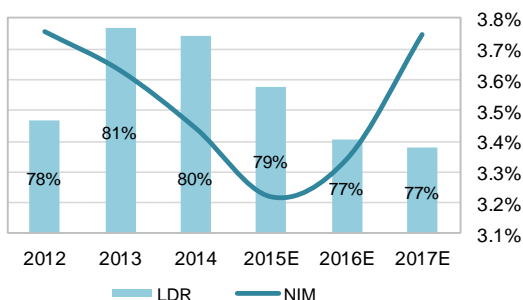
#### Credit by Sector 2014



#### Fee Income Mix 2014



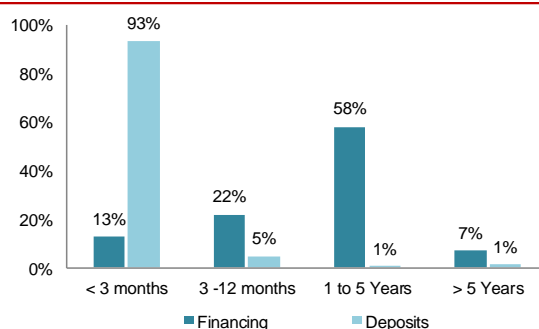
#### Net Financing / Customer Deposits and NIM



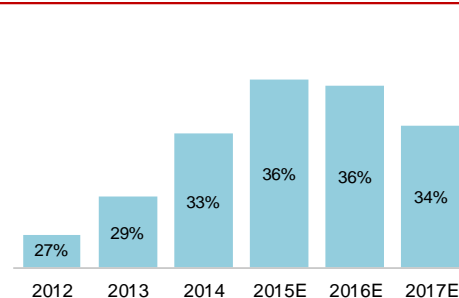
Source: Company Reports, SFC

With demand deposits accounting for a significant share of the deposit base (95% of total deposits and 93% maturing within 3 months), the cost of funds is estimated to remain low. On the operational front, the group has an efficient cost structure, which is witnessed by a cost-to-income ratio of 33% compared with an average 36% for the sector and average: c.49% for the shariah-compliant banking peers.

#### Maturity Profile - Financing & Customer Deposits (% to Total)



#### Cost-Income (ex-impairment) Trend

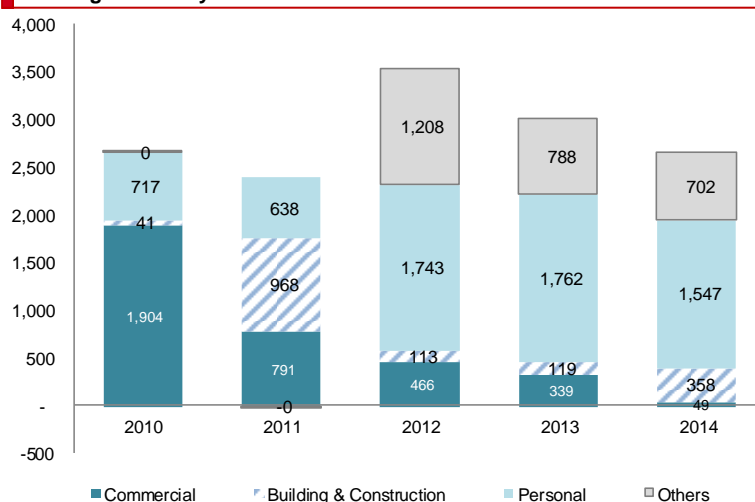


Source: Company Reports, SFC

**Asset quality managed well, consumer financing will continue to be the key focus:** Asset quality has improved with the NPL ratio at 1.3% in 2014 (3.3% in 2009) and has adequate basic provision coverage (196% in 2014). However, AlRajhi has historically had a relatively higher net NPL ratio and cost of risk, and as the economic environment becomes tougher, we forecast the NPL ratio to increase and range between 1.3% and 1.9% during the forecast period while coverage levels are expected to remain elevated around c.180%.

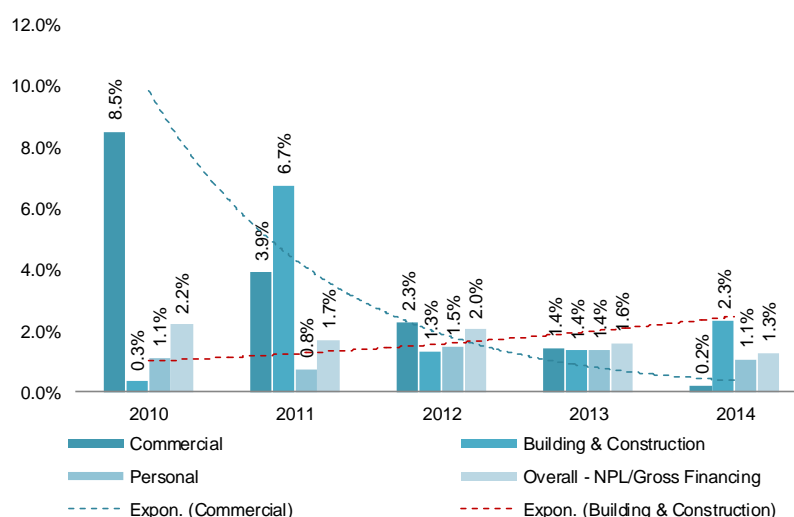
Historically for AlRajhi, NPLs have mostly originated in its financing towards the commercial and building & construction segment. In the retail segment, AlRajhi has a commendable track record on asset quality management, the key competitive advantage in our view. For instance the NPL to gross financing ratio was contained at average 1.1% within its retail/consumer lending portfolio as compared to c.1.4% for the shariah-compliant peers.

#### NPL Origination by Sector in SARmn - Period 2010 to 2014



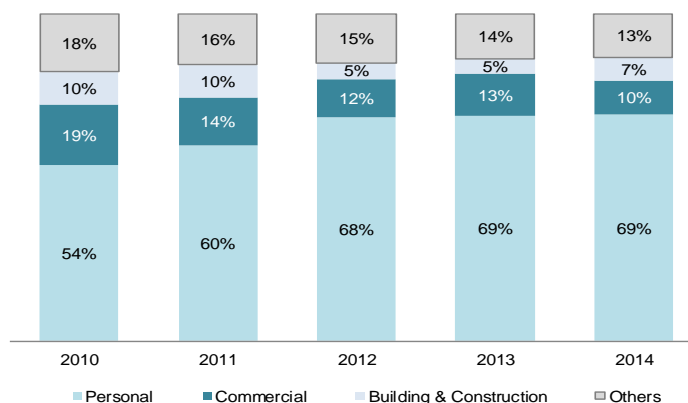
Source: Company Reports, Tadawul, SFC

#### NPL to Gross Financing (%) by Sectors 2010 to 2014



Source: Company Reports, SFC

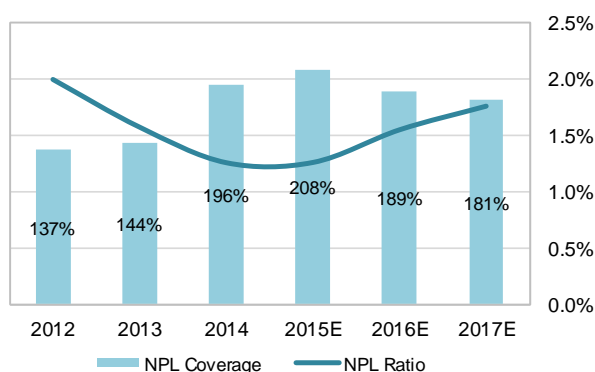
#### Credit by Sector (% of Total Performing Financing) - 2010 to 2014



Source: Company Reports, SFC

Since AlRajhi has increasingly turned more towards retail side of the business, we do not expect the NPLs to deteriorate down to 2009 levels.

#### Non-Performing Financing Coverage and Ratio



Source: Company Reports, SFC

In the context of tapering growth in the sector, AlRajhi's key competitive advantage of low cost operations alongside the track record of managing asset quality on the retail side, should allow it to compete effectively. On YTD basis, the shares of AlRajhi (+11%) have outperformed the TASI (down 7%) and KSA Bank Index (down 7%).

#### Valuation Sensitivity

We have valued the bank on Warranted Equity using 18% sustainable ROE, 3.5% growth rate and 10.4% cost of equity. At our target price, RJHI would trade at 2.0x 2016F BV.

#### Target Price sensitivity to sustainable ROE and growth rate assumptions

		Growth Rate				
		1.5%	2.5%	3.5%	4.5%	5.5%
Sustainable ROE	16.0%	47.5	49.6	52.3	56.0	61.1
	17.0%	50.4	52.9	56.2	60.5	66.5
	18.0%	53.4	56.3	60.0	65.0	71.9
	19.0%	56.4	59.7	63.8	69.5	77.4
	20.0%	59.4	63.0	67.7	74.0	82.8

Source: Company Reports, Tadawul, SFC



## Outperformance to be bolstered by rate hikes; BUY

Building on its strong performance in 1H2015 in loan growth and fee income generation, ARNB is also a beneficiary of higher interest rates and gov't bond issuance; initiate with BUY and SAR38/share target price. ARNB is likely to accrue benefits from higher interest rates and government bond issuance at a faster pace than most of its peers. Retail loan footprint, (24% of lending versus 31% for sector) should allow for faster re-pricing of loanbook as the US Fed initiates its rate tightening cycle in late 2015. It should also benefit from the government bond issuance, as it replaces part of low yielding investment portfolio into the higher yielding bonds. It outpaced the sector in loan growth up 21% Y/Y and delivered 13% Y/Y growth in fee income in 1H2015. The bank continues to outperform peers in payment fees; whilst growing remittance, loan and insurance fees.

**Below sector average retail loan footprint and faster commercial lending in 1H2015 augurs well as rates rise:** ARNB's business model is built around its corporate banking and treasury business, which constituted 44% and 32% of asset base in 2014 respectively. This heavy tilt towards commercial lending, with almost 50% of loans maturing within 1 year (2014), will allow ARNB to re-price loan book relatively quickly as rate hikes by the US Fed feed into SAIBOR. Its investment portfolio is similarly short-dated with 56% (2014) of investments maturing within 1 year (39% within 3 months). The industry leading expansion in lending in 1H2015 augurs well for pick-up in loan book yields, particularly as SAIBOR edges higher.

**Comparatively low yield on investments should get significant boost from cycling maturing instruments into government bonds:** In 2014A, the bank's yield on average investments stood at 1.2%, compared with 1.8% for the sector. In 2015E, we expect this to dip further to 1.1%. The gov't bond issuance presents the bank with an opportunity to start locking in higher yields. Assuming the average maturity of investments from 2014 carried into 2015, up 56% of investments can be potentially deployed depending on treasury strategy and liquidity preferences. We are forecasting investment yield to rise to 1.5% in 2016F, with risk to the upside.

**Bank's outperformance on payment fees, and continuing growth in remittance, loan and insurance fees reflect strong cross-selling performance:** In 1H2015, ARNB posted 13%Y/Y growth in fee income versus the sector which saw fee-income fall 1% Y/Y. Over the 2009-2014 period, fee income has grown by a CAGR of 19% versus 11% for the sector, showing consistent long-term performance.

**Relatively higher cost structure and uptick in NPLs in 1H2015 weaken franchise value:** ARNB cost-to-income ratio stood at 38% in 2014, 2ppt above the sector. There has been discernible improvement (1.5 ppt) from its peak in 2012, and stronger top-line growth should help improve the ratio. Secondly, we note with caution the up-tick in the bank's NPLs in 1H2015 (up 7.2% over 2014, versus 3.7% for the sector).

**Trading at 1.2x 2016F BV slight discount to the sector:** At our target price, ARNB would trade at 1.6x BV with a RoAE of 15%. The bank has relatively outperformed the sector by 3% on YTD basis. We have valued the bank on Warranted Equity with 15% sustainable ROE, 5% growth rate and 11% cost of equity.

### Rating Summary

Recommendation	Buyd
12-Month Target price (SAR)	38.0
Upside/(Downside)	33.8%

### Stock Details

Last Close Price	SAR	28.4
Market Capitalization	SAR mln	28,400
Shares Outstanding	mln	1,000
52-Week High	SAR	36.2
52-Week Low	SAR	26.1
Price Change (YTD)	%	(4.1%)
12-Mth ADTV	mln	0.4
EPS 2015E	SAR	3.55
Reuters / Bloomberg	1080.SE	ARNB AB

Source: Tadawul

### Key Shareholders (%)

Arab Bank	40%
GOSI	11%
Rashed Al Rashed & Sons Co.	10%
Others	39%

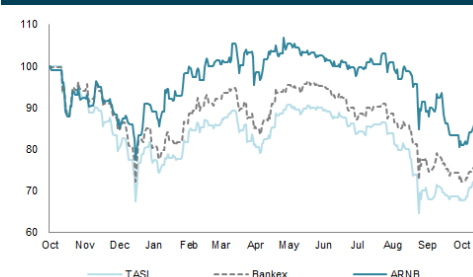
Source: Tadawul

### Price Multiples

	2015E	2016E
P / E	8.5x	8.1x
P / B	1.3x	1.2x
Dividend Yield (%)	4.1%	6.2%

Source: SFC

### 1-Year Share Performance



Source: Bloomberg



## Summary Financials

All figures are in SAR mn

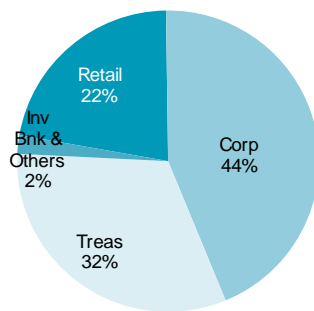
Summary Financials	2013	2014	2015E	2016E	2017E	2018E
<b>INCOME STATEMENT</b>						
Special commission income	3,945	4,091	4,457	5,255	6,421	7,310
Special commission expense	(570)	(469)	(493)	(817)	(1,270)	(2,050)
<b>Net special commission income</b>	<b>3,375</b>	<b>3,623</b>	<b>3,964</b>	<b>4,438</b>	<b>5,151</b>	<b>5,260</b>
y-o-y growth %	3.5%	7.3%	9.4%	12.0%	16.1%	2.1%
Other Income	1,735	1,885	2,108	2,268	2,413	2,542
<b>Total operating income</b>	<b>5,110</b>	<b>5,507</b>	<b>6,073</b>	<b>6,706</b>	<b>7,564</b>	<b>7,802</b>
y-o-y growth %	7.3%	7.8%	10.3%	10.4%	12.8%	3.1%
Expenses	(1,994)	(2,107)	(2,368)	(2,618)	(2,859)	(3,088)
<b>Pre-provision Profit</b>	<b>3,116</b>	<b>3,400</b>	<b>3,704</b>	<b>4,088</b>	<b>4,705</b>	<b>4,714</b>
Charge for impairment on financing	(627)	(551)	(405)	(607)	(765)	(870)
<b>Total operating expenses</b>	<b>2,621</b>	<b>2,658</b>	<b>2,773</b>	<b>3,225</b>	<b>3,625</b>	<b>3,958</b>
Cost-to-income ratio % (Excl. provisions)	39.0%	38.3%	39.0%	39.0%	37.8%	39.6%
Associate Income/Others	36	28	30	33	37	40
<b>Net Income</b>	<b>2,525</b>	<b>2,877</b>	<b>3,330</b>	<b>3,514</b>	<b>3,976</b>	<b>3,884</b>
<b>BALANCE SHEET</b>						
<b>Assets</b>						
Cash and balances with SAMA	14,972	21,252	21,080	24,734	28,928	34,543
Due from banks and other financial institutions	2,767	1,936	2,032	2,134	2,241	2,353
Investments	28,248	33,876	35,570	37,349	39,216	41,177
Loans and advances, net	88,456	103,724	113,051	118,373	123,858	129,565
Investment in associates	467	494	494	494	494	494
Property and equipment, net	1,647	1,746	1,905	2,077	2,277	2,466
Other assets, net	1,242	1,503	1,579	1,658	1,740	1,828
<b>Total Assets</b>	<b>137,935</b>	<b>164,668</b>	<b>175,851</b>	<b>186,960</b>	<b>198,900</b>	<b>212,573</b>
<b>Liabilities</b>						
Due to banks and other financial institutions	7,641	9,016	9,917	10,909	12,000	13,200
Customers' deposits	106,373	129,631	136,113	144,280	152,936	163,642
Debt securities in Issue and borrowing	1,688	1,688	3,688	3,688	3,688	3,688
Other liabilities	3,046	3,694	3,879	4,073	4,277	4,490
<b>Total Liabilities</b>	<b>118,747</b>	<b>144,029</b>	<b>153,596</b>	<b>162,949</b>	<b>172,900</b>	<b>185,020</b>
<b>Total Equity</b>	<b>19,080</b>	<b>20,601</b>	<b>22,216</b>	<b>23,973</b>	<b>25,961</b>	<b>27,515</b>
Non-controlling interest	108	38	38	38	38	38
<b>Total Liabilities and Equity</b>	<b>137,935</b>	<b>164,668</b>	<b>175,851</b>	<b>186,960</b>	<b>198,900</b>	<b>212,573</b>
<b>Key Ratio</b>						
P/E	11.3	9.9	8.5	8.1	7.1	7.3
P/BV	1.5	1.4	1.3	1.2	1.1	1.0
P/PPP	9.1	8.4	7.7	6.9	6.0	6.0
ROAE	13.7%	14.5%	15.6%	15.2%	15.9%	14.5%
ROAA	1.8%	1.9%	2.0%	1.9%	2.1%	1.9%
Dividend Yield	3.0%	3.1%	4.1%	6.2%	7.0%	8.2%
Net Income growth	6%	14%	16%	6%	13%	-2%
Total Income growth	7%	8%	10%	10%	13%	3%
NPL/Gross Financing	1.11%	1.03%	1.05%	1.20%	1.40%	1.50%
Equity/Total Assets	13.8%	12.5%	12.6%	12.8%	13.1%	12.9%
Tier-1 Capital	15.1%	14.1%	13.9%	13.8%	14.0%	13.8%

Source: Company Reports, Bloomberg

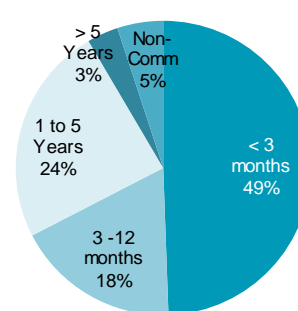
## Investment Thesis

**Below sector average retail loan footprint and faster commercial lending in 1H2015 augur well as rates rise:** ARNB's business model is built around its corporate banking and treasury business, which constituted 44% and 32% of asset base in 2014 respectively. This heavy tilt towards commercial lending, with almost 50% of loans maturing within 1 year (2014), will allow ARNB to re-price its loan book relatively quickly as rate hikes by the US Fed feed into SAIBOR. Its investment portfolio is similarly short-dated with 56% (2014) of investments maturing within 1 year (49% within 3 months). The industry leading expansion in lending in 1H2015 augurs well for pick-up in loan book yields, particularly as SAIBOR edges higher.

**Assets by Segment 2014**



**Investment Maturity 2014**



Source: Company Reports, SFC

Longer tenor financing arrangements are typically floating, thus should re-price with SAIBOR. However recent competitive trends imply that the risk premium on these facilities has been depressed by competitive pressures. Our conversations with various managements have borne out our view, where they report some long-term facilities with historically low risk premiums on SAIBOR. Going forward, as market liquidity conditions get tighter, risk premiums are likely to expand allowing the likes of ARNB to accrue higher yield as they expand their A-L mismatch.

**Comparatively low yield on investments should get significant boost from cycling maturing instruments into government bonds:** ARNB's yield on investment portfolio suffers in comparison to peers and the sector. In 2014A, yield on average investments stood at 1.2%, compared with 1.8% for the sector. In 2015E, we expect this to dip further to 1.1%. The government bond issuance presents the bank with an opportunity to start locking in higher yields. Assuming the average maturity of investments from 2014 carried into 2015, up to 56% of investments can be potentially deployed into the higher yielding bonds depending on treasury strategy and liquidity preferences.

Given the bank's conservative stance in the past, we expect the bank to expand the A-L mismatch in its investment portfolio slowly. Fresh investments in government bonds are likely to be clustered around the 5YR maturity until the rate cycle matures and the yield curve steepens delivering more term premium. Thus the yield pick-up in the next 12-18 months is likely to be relatively muted, where we forecast investment yield to rise to 1.5% in 2016F, versus 1.2% in 2014A, with risk to the upside.

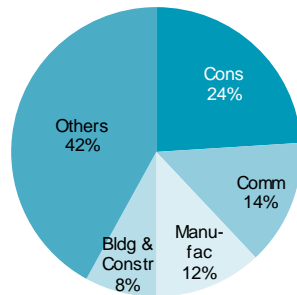
**Bank's outperformance on payment fees, and continuing growth in remittance, loan and insurance fees reflect strong cross-selling performance:** In 1H2015, ARNB posted 13%Y/Y growth in fee income

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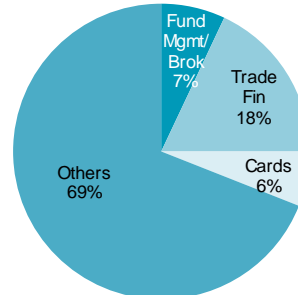
versus the sector which saw fee-income fall 1% Y/Y. Over the period 2009-2014, fee income has grown by a CAGR of 19% versus 11% for the sector, showing consistent long-term performance.

Going forward, we expect overall fee growth to slow to a 5YR CAGR of 6% reflecting slower economic growth and lower trade volumes. Fees from trade finance are in particular vulnerable to the economic slowdown.

#### Credit by Sector 2014



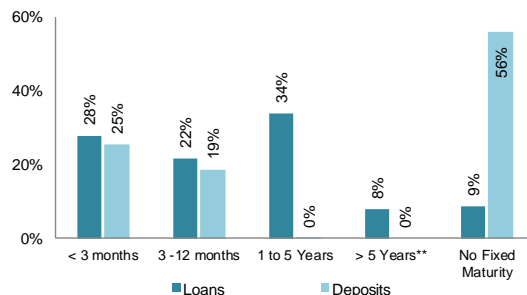
#### Fee Income 2014



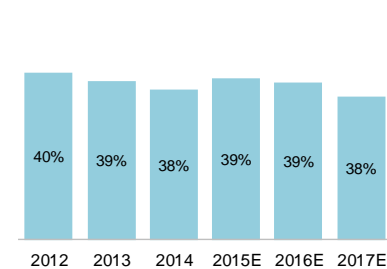
Source: Company Reports, SFC

**Relatively higher cost structure and uptick in NPLs in 1H2015 weaken franchise value:** ARNB cost-to-income ratio stood at 38% in 2014, 2ppt above the sector. There has been discernible improvement (1.5 ppt) from its peak in 2012, and stronger top-line growth should help improve the ratio.

#### Maturity Profile - Loan & Customer Deposits (% to Total)



#### Cost-Income (ex-impairment) Trend



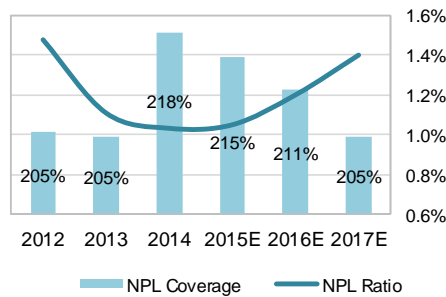
Source: Company Reports, SFC

Secondly, we note with caution the up-tick in the bank's NPLs in 1H2015 (up 7.2% over 2014, versus 3.7% for the sector). Given the relatively tougher economic environment, an uptick is to be expected. The bank over the past few years reduced exposure to the commerce sector (from 30% of net financing in 2008 to 14% in 2014A), which in the 2008-2010 period was a large contributor of NPLs. Its exposure to the building & construction (7% of net financing) and mining & quarrying (1% of net financing) are limited. Data regarding origin of incremental NPLs is not available. Overall, we are expecting the NPL ratio to increase from 1% in 2014 to 1.4% in 2017F.

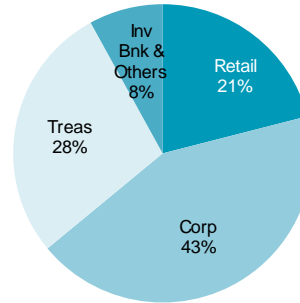
The bank maintains a sector high NPL coverage ratio in excess of 200%. This is consistent with a conservative policy of building provisioning in periods of low credit stress. The bank pursued the same policy before the global financial crisis, where overall provision coverage exceeded 300%. We are forecasting that the bank continues conservative provisioning policy maintaining coverage above 200% of NPLs. If the bank shifts to a less conservative policy or builds up provisioning to pre-2009 levels, this would pose a risk to our forecasts. We do not believe that ARNB will bolster coverage level significantly higher than forecasted levels.

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#### NPL Loans Coverage and Ratio



#### Earnings Mix by Segment 2014



Source: Company Reports, SFC

#### Valuation Sensitivity

We have valued the bank on Warranted Equity with 15% sustainable ROE, 5% growth rate and 11% cost of Equity. At our target price, ARNB would trade at 1.6x BV with a RoAE of 15%. The bank has relatively outperformed the sector by 3% on YTD basis.

#### Target Price sensitivity to sustainable ROE and growth rate assumptions

		Growth Rate				
		3.0%	4.0%	5.0%	6.0%	7.0%
Sustainable ROE	13.0%	29.1	29.9	30.9	32.4	34.6
	14.0%	31.8	32.9	34.5	36.6	39.9
	15.0%	34.4	36.0	38.0	40.9	45.2
	16.0%	37.1	39.0	41.5	45.1	50.5
	17.0%	39.7	42.0	45.1	49.4	55.8

Source: Company Reports, Tadawul, SFC

#### Company Overview

The Arab National Bank was established in 1979 with its head office in Riyadh. ARNB is currently the seventh largest bank in the Kingdom by assets totaling SAR 166bn as of 2Q15 (c.7.7% market share). At end-2014, the bank operated 156 branches, 1,110 ATMs, 94 remittance service centers and 10,368 PoS terminals across the country. As of September 20, 2015, ARNB had a market capitalization of c.SAR 30bn (c.USD 7.9bn). Jordan-based Arab Bank PSC holds a 40% stake in the bank while the rest of the shares are held by two main Saudi Arabian entities: Jab Trading Co. (5.7%) and the General Organization for Social Insurance (GOSI, 11.3%).

ARNB offers personal and commercial banking services through four segments: Retail, Corporate Banking, Treasury and Investment Banking Services. The bank also holds a 30% stake in the insurance venture with global insurance majors - MetLife and AIG. ARNB established a home loans company (c.40% stake; issued capital SAR 800mn) to take advantage of opportunities in the housing segment in KSA.

- **Geographic focus:** ARNB's operations are primarily focused in KSA (c.93% of total assets).
- **Income composition:** Net Special Commission Income (NSCI, +7% YoY in 2014) accounted for c.66% of total bank Income while Fee Income (+25% YoY) constituted c.24% of total income. Dividend, Exchange, Trading Income and others accounted for the rest of bank's total income in 2014.
- **Balance sheet decomposition:** Liquid Assets (14%), investments (21%), and net financing (63%) constituted the primary share of ARNB's balance sheet on the Assets side, according to its most recent annual financial disclosure. In contrast, total liabilities (79% of total assets) comprise primarily of customer deposits (c.SAR 130bn or 90% of total liabilities). Demand deposits account for 53% of

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total customer deposits (vs. 63% for the system) while time deposits constituted c.42% in 2014 (vs. 25% for the system).

- **Concentration and asset quality:** The performing financing portfolio, primarily concentrated in four sectors (Consumer, Commerce, Manufacturing and Building & Construction collectively constitute 58% of the financing portfolio). Total loan book grew c.17% YoY in 2014. Non-performing financing (NPFs) facilities to gross financing stood at 1.03% (2013: 1.11%), with basic provision coverage at 218% (2013: 205%).
- **Segmental information:** Corporate Banking and Treasury account for the majority of the bank's asset base, with 44% and 32% share, respectively. In 2014, the Corporate Banking division accounted for 43% of the group's profits and generated a return on assets of 1.7%. On the other hand, Treasury accounted for 28% of the group's profits and generated RoA of 1.5%.



## Improvement Needed to Justify Further Premium

Despite the highest core demand deposit base of peer banks, we see limited upside from higher interest rates in medium term. Valuation premium adequately captures forward outlook. Clarity needed on conversion to full shariah-compliance. Initiate with a HOLD and target price of SAR55. 24%, 18% and 18% share in demand deposits (21% of overall), branches and loans respectively, only surpassed by AlRajhi in the number of branches, makes NCB a strong player in the corporate, retail and treasury segments of the industry. Three-quarters of NCB's deposit base comprise zero-cost demand deposits, it has the sector's largest investment book and an extensive branch network. Evidence of improvement in efficiency ratios, customer acquisition and cross-selling would lead us to a more constructive view on the stock.

**Improved in retail, but cost efficiency and productivity suffers in comparison to scale:** It has made significant in-roads into the retail market, utilizing an extensive distribution network, but cost to income ratio at 39% is significantly higher than the sector, and other productivity indicators also indicate that brand strength is not being fully utilized. NCB saw a substantial rise in the cost-to-income in retail operations in 2014, rising from 66% in 2013 to 77% in 2014. While retail assets rose 20% in this period, income only rose 6.5%, reflecting high competition and also relative underperformance in cross-selling. Net income from retail operations fell from SAR1.9 bln in 2013 to SAR1.2 bln 2014.

**Amongst the banks not fully shariah-compliant, NCB has the highest proportion of demand deposits:** In 1H2015, the share of demand deposits was 77% (vs. 5-year average of 72%) 9ppt higher than Samba. AlRajhi at 95% has the largest proportion of demand to total deposits, which suggests an opportunity for NCB if it becomes shariah-compliant (not our base case).

**The bank is boosting Tier-1 capital with perpetual sukuks, aiming to raise SAR7 bln by end-2015:** NCB's CET-1 ratio has dropped from 16.2% in 2013 to 14.2% in 1H2015, significantly below the sector average and systemically important banks. As of July 2015, the bank had successfully raised SAR3 bln, with another SAR2 bln in the pipeline. We view these issues as a positive as high CET-1 ratios depress ROAE for KSA banks.

**NCB has a relatively high yield on average investments at 2.3% in 2014, versus 1.8% for sector:** NCB has a relatively higher yield on its investments than the sector (2014A: 1.8%). This is driven by the longer maturity of investment portfolio, with only 24% of investments maturing within a year. We, thus, see relatively little benefit accruing to NCB in the near future from government bond issuance.

**Conversion to full shariah-compliance is difficult at the bank and sector level:** There are few examples of successful transitions from conventional to fully shariah-compliant banking, and literally none involving banks of NCB's size or systemic importance. Until a clear plan is formulated with SAMA's approval, we remain skeptical that the transition will happen.

**NCB trades at a substantial premium to the sector at 1.8x 2016F BV versus 1.4x for the sector:** The bank is up 2% YTD versus -7% and -7% for the sector and index respectively. It trades at par with our target price. We have valued the bank on Warranted Equity with 18% sustainable ROE, 4.5% growth rate and 11.4% cost of equity.

### Rating Summary

Recommendation	Hold
12-Month Target price (SAR)	55.0
Upside/(Downside)	0.0%

### Stock Details

Last Close Price	SAR	55.0
Market Capitalization	SAR mln	1,09,980
Shares Outstanding	mln	2,000
52-Week High	SAR	72.8
52-Week Low	SAR	48.8
Price Change (YTD)	%	2.4%
12-Mth ADTV	mln	2.2
EPS 2015E	SAR	4.88
Reuters / Bloomberg	1180.SE	NCB AB

Source: Tadawul

### Key Shareholders (%)

Public Investment Fund	44%
Public Pension Agency	10%
GOSI	10%
Others	36%

Source: Tadawul

### Price Multiples

	2015E	2016E
P / E	11.x	10.1x
P / B	2.1x	1.8x
Dividend Yield (%)	1.9%	3.0%

Source: SFC

### 1-Year Share Performance



Source: Bloomberg



## Summary Financials

All figures are in SAR mn

Summary Financials	2013	2014	2015E	2016E	2017E	2018E
<b>INCOME STATEMENT</b>						
Special commission income	11,810	13,589	14,917	17,226	20,015	23,563
Special commission expense	(1,713)	(2,311)	(2,292)	(3,217)	(4,434)	(5,921)
<b>Net special commission income</b>	<b>10,096</b>	<b>11,279</b>	<b>12,624</b>	<b>14,009</b>	<b>15,581</b>	<b>17,642</b>
y-o-y growth %	12.3%	11.7%	11.9%	11.0%	11.2%	13.2%
Other Income	4,761	4,950	5,344	5,516	5,762	6,049
<b>Total operating income</b>	<b>14,858</b>	<b>16,228</b>	<b>17,968</b>	<b>19,525</b>	<b>21,343</b>	<b>23,691</b>
y-o-y growth %	10.5%	9.2%	10.7%	8.7%	9.3%	11.0%
Expenses	(5,796)	(6,334)	(6,811)	(7,241)	(7,789)	(8,386)
<b>Pre-provision Profit</b>	<b>9,061</b>	<b>9,894</b>	<b>11,157</b>	<b>12,284</b>	<b>13,554</b>	<b>15,306</b>
Charge for impairment on financing	(836)	(1,145)	(978)	(1,245)	(1,447)	(1,816)
<b>Total operating expenses</b>	<b>6,632</b>	<b>7,480</b>	<b>7,788</b>	<b>8,487</b>	<b>9,235</b>	<b>10,202</b>
Cost-to-income ratio % (Excl. provisions)	37.7%	37.9%	37.1%	36.5%	36.0%	35.1%
Associate Income/Others	(237)	45	-	-	-	-
<b>Net Income</b>	<b>7,989</b>	<b>8,793</b>	<b>10,180</b>	<b>11,039</b>	<b>12,107</b>	<b>13,489</b>
<b>BALANCE SHEET</b>						
<b>Assets</b>						
Cash and balances with SAMA	39,090	28,819	36,447	40,420	39,691	37,501
Due from banks and other financial institutions	14,835	19,863	20,856	21,899	22,994	24,144
Investments	125,294	152,903	168,248	185,073	203,580	223,938
Loans and advances, net	187,687	220,722	244,889	256,510	271,236	286,595
Investment in associates	829	408	412	416	420	424
Property and equipment, net	2,762	3,427	3,922	4,424	4,941	5,494
Other assets, net	5,701	7,184	7,759	8,379	9,050	9,774
<b>Total Assets</b>	<b>377,287</b>	<b>434,878</b>	<b>483,952</b>	<b>518,435</b>	<b>553,147</b>	<b>589,046</b>
<b>Liabilities</b>						
Due to banks and other financial institutions	24,732	35,449	37,576	39,831	42,221	44,754
Customers' deposits	300,601	333,095	366,405	388,389	411,693	436,394
Other liabilities	7,906	9,862	10,355	10,873	11,416	11,987
<b>Total Liabilities</b>	<b>334,751</b>	<b>387,957</b>	<b>428,887</b>	<b>455,643</b>	<b>481,880</b>	<b>509,686</b>
<b>Total Equity</b>	<b>40,934</b>	<b>45,214</b>	<b>53,357</b>	<b>61,084</b>	<b>69,559</b>	<b>77,653</b>
Minority Interest	1,602	1,707	1,707	1,707	1,707	1,707
<b>Total Liabilities and Equity</b>	<b>377,287</b>	<b>434,878</b>	<b>483,952</b>	<b>518,435</b>	<b>553,147</b>	<b>589,046</b>
<b>Key Ratio</b>						
P/E	14.0	12.7	11.0	10.1	9.2	8.2
P/BV	2.7	2.4	2.1	1.8	1.6	1.4
P/PPP	12.1	11.1	9.9	9.0	8.1	7.2
ROAE	20.3%	20.4%	20.7%	19.3%	18.5%	18.3%
ROAA	2.2%	2.2%	2.2%	2.2%	2.3%	2.4%
Dividend Yield	1.1%	1.5%	1.9%	3.0%	3.3%	4.9%
Net Income growth	24%	10%	16%	8%	10%	11%
Total Income growth	11%	9%	11%	9%	9%	11%
NPL/Gross Financing	1.52%	1.26%	1.20%	1.35%	1.45%	1.55%
Equity/Total Assets	10.8%	10.4%	11.0%	11.8%	12.6%	13.2%
Tier-1 Capital	15.9%	14.5%	15.3%	16.4%	17.5%	18.3%

Source: Company Reports, Bloomberg



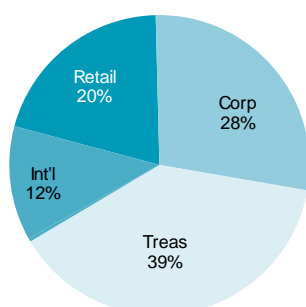


## Investment Thesis

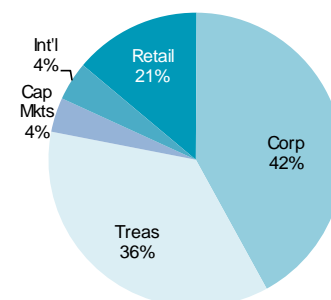
**Improved in retail, but cost efficiency and productivity suffers in comparison to scale:** It has made significant in-roads into the retail market, utilizing an extensive distribution network, but cost to income ratio at 39% is significantly higher than the sector, and other productivity indicators also suggest that brand strength is not being fully utilized. As yields pick up on earning assets, we expect NCB's cost-to-income to improve to 36% in 2018F versus 35% for the sector, however still suffering in comparison to banks such as AlRajhi, Samba and SABB.

Overall, the bank's poor cost-to-income appears to be more a top line issue than in efficient operations. NCB has the sector's lowest LDR ratio, which if expanded to in line with the sector would drive the cost-to-income significantly lower. In this context, NCB has aggressively pursued market share in the retail market. However, this has come at the cost of a substantial rise in cost-to-income ratio of its retail operations in 2014, rising from 66% in 2013 to 77% in 2014. While retail assets rose 20% in this period, income only rose 6.5%, reflecting high competition and also relative underperformance in cross-selling. Net income from retail operations fell from SAR1.85 bln in 2013 to SAR1.2 bln 2014. Delivering continued growth in retail assets, whilst containing costs would drive a more constructive view on the bank.

**Assets by Segment 2014**

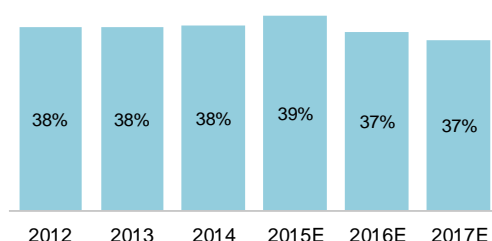


**Earnings Mix by Segment 2014**



Source: Company Reports, SFC

**Cost-Income (ex-impairment) Trend**

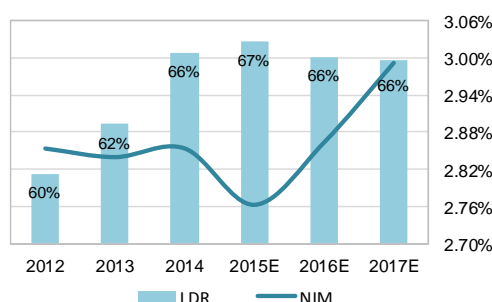


Source: Company Reports, SFC

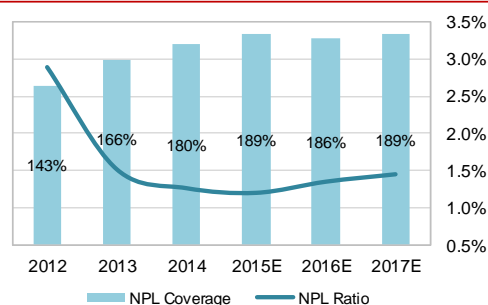


**Amongst the banks not fully shariah-compliant, NCB's has the highest proportion of demand deposits:** In 1H2015, the share of demand deposits was 77% (vs. 5-year average of 72%) 9ppt higher than Samba. AlRajhi at 95% has the largest proportion of demand to total deposits, which suggests an opportunity for NCB if it becomes shariah-compliant (not our base case). This core demand deposit base results in significant gearing to higher interest rates. Furthermore, with the sector's lowest LDR ratio (65% in 1H2015), NCB has the ability to contain increases in time deposit rates.

#### Net Loans / Customer Deposits and NIM



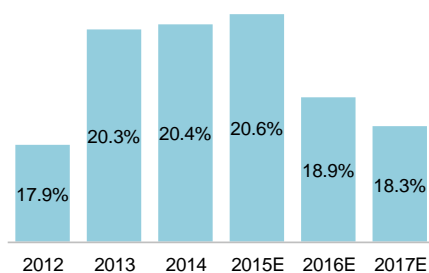
#### Non-Performing Loans Coverage and Ratio



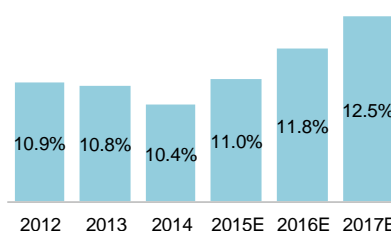
Source: Company Reports, SFC

**The bank is boosting Tier-1 capital with perpetual sukuks, aiming to raise SAR7 bln by end-2015:** NCB's CET-1 ratio has dropped from 16.2% in 2013 to 14.2% in 1H2015, significantly below the sector average and systemically important banks. As of July 2015, the bank had successfully raised SAR3 bln in Tier 1 qualifying perpetual sukuks, with another SAR2 bln in the pipeline. We view these issues as a positive as high CET-1 ratios depress ROAE for KSA banks. This could pave the way for more attractive dividend payout by the bank in the future, thus adding upside risk to our dividend forecasts and valuation.

#### Return on Equity Forecast



#### Equity /Total Assets

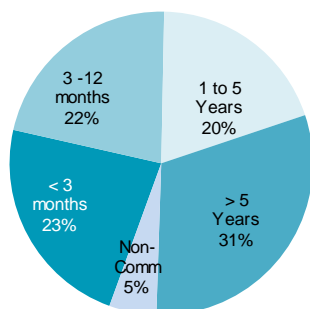


Source: Company Reports, SFC

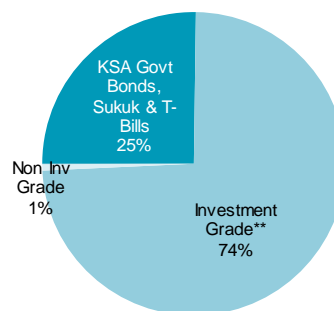
**NCB has a relatively high yield on average investments at 2.3% in 2014, versus 1.8% for sector:** NCB has a relatively higher yield on its investments than the sector (2014A: 1.8%). This is driven by the longer maturity of investment portfolio, with only 24% of investments maturing within a year. We, thus, see relatively little benefit accruing to NCB in the near future from government bond issuance. Even as rates rise and impact returns on the government issuance, NCB's commitment to full shariah-compliance may temper its participation. On the flip side, the investment portfolio is tilted towards Government-backed debt issues. Should the bank tilt the portfolio towards a riskier profile, the bank could see yields pick up. As liquidity conditions tighten in the sector over the next 24 months, we could see NCB accrue benefits from wider term and credit risk premiums.



### Investment Maturity 2014 (Market Risk)

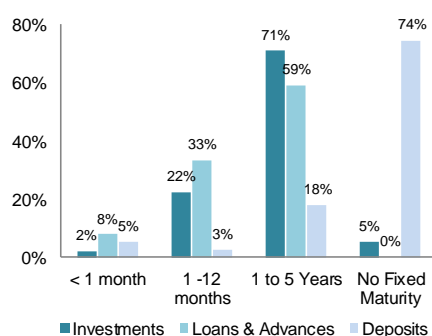


### Credit Quality of Investments 2014

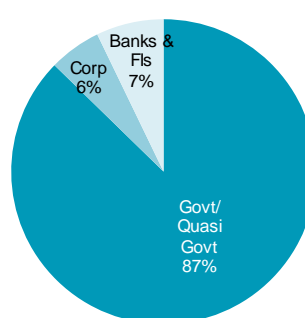


\*\* Aaa to Baa3 ratings under various ratings methods

### Maturity Profile



### Investments by Counterparty 2014



Source: Company Reports, SFC

**Conversion to full shariah-compliance is difficult at the bank and sector level:** A clear business case could be made for the NCB to make this conversion. AlRajhi, a bank of comparable size enjoys a 50 bps and 59 bps advantage over NCB in cost of funds and net interest margin (applying a similar cost of funds (0.2%) to our model in 2015 estimates yields a 13% net income impact).

However, there are few examples of successful transitions from conventional to fully shariah-compliant banking, and literally none involving banks of NCB's size or systemic importance. Until a clear plan is formulated with SAMA's approval, we remain skeptical that the transition will happen.

### Valuation Sensitivity

We have valued the bank on Warranted Equity with 18% sustainable ROE, 4.5% growth rate and 11.4% cost of equity. It trades at par with our target price.

### Target Price sensitivity to sustainable ROE and growth rate assumptions

		Growth Rate				
		2.5%	3.5%	4.5%	5.5%	6.5%
Sustainable ROE	16.0%	43.1	44.9	47.2	50.3	54.7
	17.0%	46.1	48.3	51.1	54.9	60.2
	18.0%	49.2	51.7	55.0	59.4	65.7
	19.0%	52.2	55.1	58.9	64.0	71.2
	20.0%	55.2	58.5	62.8	68.5	76.7

Source: Company Reports, Tadawul, SFC



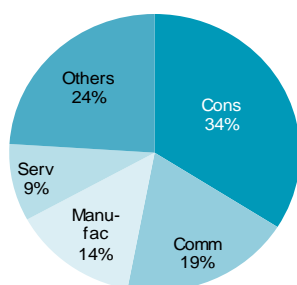
## Company Overview

National Commercial Bank (NCB) was formed in 1955 and commenced business as a partnership registered in Jeddah Trade Register. The bank was converted into a Saudi Joint Venture Company in 1997 and was listed in 2014 on the Saudi Stock Exchange in one of the country's biggest IPOs. Currently, NCB is the largest bank in the Kingdom by assets (as of 2Q15 total assets of SAR 461bn; c.21.2% market share). Headed by CEO Saeed AlGhamdi, NCB operated 342 branches, 2,643 ATMs, 97 remittance service centers and 26,514 PoS terminals at end-2014. Total headcount stands at 7,839. As of September 20, 2015, the banking group had a market capitalization of SAR 110bn (c.USD 30bn). Public Investment Fund (PIF) holds 44% stake in NCB followed by GOSI and PPA at 10% each.

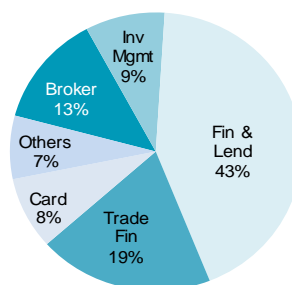
The bank offers various shariah-compliant and conventional banking products through five principal operating segments: Retail Banking, Corporate Banking, Treasury, Capital Markets and International Banking. NCB has an Insurance venture in KSA through a 30% stake in ALAHLI Takaful Co. In addition to its strong presence in Saudi Arabia, NCB also has branches in Lebanon, Bahrain and representation offices in Singapore, Seoul and Shanghai. NCB owns 67% stake in a Turkey-based bank - Turkiye Finans Katilim Bankasi (TFKB).

- **Geographic focus:** NCB's operations are mainly focused in KSA (c.62% of total assets), Turkey (13%) and GCC/Middle East (10%).
- **Income composition:** Net special commission income (NSCI, +12% YoY in 2014) accounted for 70% of total bank income while fee income (+9.7% YoY) constituted 20%. Exchange, Trading, Dividend Income among others accounted for the rest of bank's total income in 2014.
- **Balance sheet decomposition:** Liquid Assets (11%), investments (35%), and net financing (51%) constituted the primary share of NCB's balance sheet on the assets side, according to its most recent annual financial disclosure (2014). In contrast, total liabilities (89% of total assets) comprise primarily of customer deposits (c.SAR 333bn or 86% of total liabilities). Current account/demand deposits account for 76% of total customer deposits at NCB (vs. 63% for the system) while time deposits constituted 20% in 2014 (less than that for the system at 25%).
- **Concentration and asset quality:** The performing financing portfolio for NCB is concentrated in four major sectors (Consumer, Commerce, Manufacturing and Services) and collectively constitutes 75% of the loan portfolio. Total financing grew 18% YoY in 2014 to SAR 221bn. Non-performing financing facilities to gross financing stood at 1.26% (2013: 1.52%), with basic provision coverage at 180% (2013: 165%).
- **Segmental information:** Treasury and Corporate account for the majority of the bank's asset base, with 39% and 28% share, respectively while Retail accounts for 20% share in total assets. In 2014, the Corporate division accounted for 42% of the group's profits and generated RoA of 3.0%.

**Credit by Sector 2014**



**Fee Income 2014**



Source: Company Reports, SFC



## Punching Below its Weight

Weak deposit mobilization, limited near-term upside from higher interest rates, uptick in NPLs in 1H2015 and potential weakening in fee income. A more constructive outlook dependent on more effective utilization of old and new brick network. Initiate with SELL, target price SAR13. RIBL maintained NIM over 2010-14A, in the face of sharp fall in sector NIM from 3.7% to 3.1%, as it avoided chasing volume in a competitive environment. This however has come at the cost of market share, which has fallen from 13.8% in 2010 to 10.3% in 1H2015 while deposit share has fallen from 12% in 2010.

**Branch network expansion accruing advantages? Not enough evidence.** Share of demand deposits has risen sharply in 1H2015 to 56% (2014A: 44%; 5-year avg: 45%). This is a faster pace than sector, perhaps as a result of substantial increase in branch network in 2014, but more evidence needed to determine whether this is sustainable. In 2014, RIBL recorded the weakest deposit per branch mobilization of SAR225 mln in the sector, driven by relatively poor performance historically (SAR268 mln) and a substantial number of new branches. 10% deposit share is sub-par against share in branches and ATMs.

**In the low interest environment since 2008, RIBL has adopted a conservative policy of defending yield. Fee income could be pressured.** It has however increased A-L mismatch to bolster yields, in 2010 loans of >1 YR maturity stood at 49% of total loans versus 57% in 2014. As interest rates rise, RIBL may look to expand share in lending, however having given up share in the last few years and the sector remaining competitive, it is likely to find growth hard to achieve unless it is willing to give up yield or chase riskier lending avenues. Given a relatively tougher economic environment, we believe the bank is unlikely to change strategy in lending, but will instead look to unlock value from branch expansion. Furthermore, corporate finance advisory and trade finance (19% of revenue) could come under pressure in slower economic environment.

**RIBL maintains a relatively longer maturity investment portfolio versus peers:** Investments maturing in a year or less were 49% of investment portfolio, while yield on average investments stood at 1.8%, in line with the sector. Any significant advantage to RIBL from cycling investments into government bonds at current yields seems remote.

**Whilst asset quality metrics have improved, exposure to building & construction and the mining & quarrying sectors may make it susceptible to above average NPL accretion:** NPL ratio has been maintained at below 1% for past several years and coverage at 189%, however at the cost of high write-offs. Composition of loan book makes it relatively susceptible to NPL accretion, particularly the recent build of mining & quarrying sector exposure to 5% of loan book (from 2%). Exposure to the mining & quarrying sector could be problematic due to recent fall in commodity prices. Furthermore, a cut in government spending may impact exposure to the building & construction sector (10% of loans in 2014). In 1H2015, NPLs grew 11% over end-2014, significantly above the sector average of 3.7%.

**RIBL trades at 1.1x 2016F BV versus 1.4x for the sector:** The bank is down 28% and 15% on Y/Y and YTD basis, underperforming the sector by 3% and 9% respectively. At our target price of SAR13, it would trade at 1.0x, which is warranted given 11.5% 2016F RoAE and relatively poor earnings growth prospects. We have valued the bank using Warranted Equity with the following inputs: 12% sustainable ROE, 4.5% growth rate and 12% cost of equity.

### Rating Summary

Recommendation	Sell
12-Month Target price (SAR)	13.0
Upside/(Downside)	(5.7%)

### Stock Details

Last Close Price	SAR	13.8
Market Capitalization	SAR mln	41,370
Shares Outstanding	mln	3,000
52-Week High	SAR	20.6
52-Week Low	SAR	13.8
Price Change (YTD)	%	(15.3%)
12-Mth ADTV	mln	2.6
EPS 2015E	SAR	1.43
Reuters / Bloomberg	1010.SE	RIBL AB

Source: Tadawul

### Key Shareholders (%)

Public Investment Fund	22%
GOSI	17%
Sharbatli Abdul Rahman	10%
Others	52%

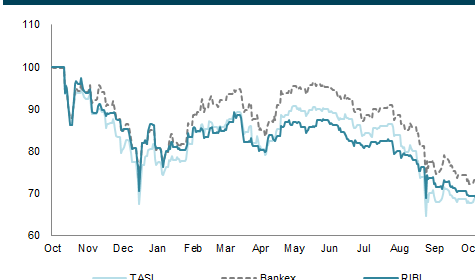
Source: Tadawul

### Price Multiples

	2015E	2016E
P / E	9.7x	9.6x
P / B	1.1x	1.1x
Dividend Yield (%)	5.7%	6.2%

Source: SFC

### 1-Year Share Performance



Source: Bloomberg



## Summary Financials

All figures are in SAR mn

Summary Financials	2013	2014	2015E	2016E	2017E	2018E
<b>INCOME STATEMENT</b>						
Special commission income	5,517	5,945	5,837	6,643	7,979	9,297
Special commission expense	(820)	(815)	(557)	(1,047)	(1,757)	(2,831)
<b>Net special commission income</b>	<b>4,697</b>	<b>5,130</b>	<b>5,280</b>	<b>5,597</b>	<b>6,221</b>	<b>6,466</b>
y-o-y growth %	7.2%	9.2%	2.9%	6.0%	11.2%	3.9%
Other Income	2,377	2,882	2,735	2,614	2,741	3,003
<b>Total operating income</b>	<b>7,074</b>	<b>8,012</b>	<b>8,015</b>	<b>8,211</b>	<b>8,963</b>	<b>9,469</b>
y-o-y growth %	3.0%	13.3%	0.0%	2.4%	9.2%	5.6%
Expenses	(2,578)	(2,806)	(3,018)	(3,180)	(3,372)	(3,575)
<b>Pre-provision Profit</b>	<b>4,496</b>	<b>5,206</b>	<b>4,997</b>	<b>5,030</b>	<b>5,591</b>	<b>5,894</b>
Charge for impairment on financing	(605)	(900)	(782)	(806)	(827)	(1,084)
<b>Total operating expenses</b>	<b>3,184</b>	<b>3,706</b>	<b>3,799</b>	<b>3,986</b>	<b>4,198</b>	<b>4,659</b>
Cost-to-income ratio % (Excl. provisions)	36.4%	35.0%	37.6%	38.7%	37.6%	37.8%
Associate Income/Others	57	47	70	81	93	107
<b>Net Income</b>	<b>3,947</b>	<b>4,352</b>	<b>4,286</b>	<b>4,305</b>	<b>4,857</b>	<b>4,916</b>
<b>BALANCE SHEET</b>						
<b>Assets</b>						
Cash and balances with SAMA	20,929	25,316	27,099	33,438	40,501	50,357
Due from banks and other financial institutions	4,439	3,915	4,110	4,316	4,532	4,758
Investments	43,538	46,963	51,660	55,534	59,699	64,177
Loans and advances, net	131,191	133,490	137,867	143,017	148,440	153,915
Investment in associates	442	469	539	620	713	819
Property and equipment, net	1,663	1,707	1,827	1,827	1,837	1,845
Other assets, net	2,608	2,339	2,527	2,729	2,947	3,183
<b>Total Assets</b>	<b>205,246</b>	<b>214,589</b>	<b>226,027</b>	<b>241,887</b>	<b>259,083</b>	<b>279,478</b>
<b>Liabilities</b>						
Due to banks and other financial institutions	7,578	3,790	4,017	4,258	4,514	4,785
Customers' deposits	153,200	164,079	169,002	182,522	197,124	214,865
Other liabilities	6,598	7,183	7,542	7,919	8,315	8,731
<b>Total Liabilities</b>	<b>171,376</b>	<b>179,052</b>	<b>188,561</b>	<b>202,699</b>	<b>217,953</b>	<b>236,380</b>
<b>Total Equity</b>	<b>33,870</b>	<b>35,537</b>	<b>37,466</b>	<b>39,188</b>	<b>41,131</b>	<b>43,097</b>
<b>Total Liabilities and Equity</b>	<b>205,246</b>	<b>214,589</b>	<b>226,027</b>	<b>241,887</b>	<b>259,083</b>	<b>279,478</b>
<b>Key Ratio</b>						
P/E	10.5	9.5	9.7	9.6	8.5	8.4
P/BV	1.2	1.2	1.1	1.1	1.0	1.0
P/PPP	9.2	7.9	8.3	8.2	7.4	7.0
ROAE	12.0%	12.5%	11.7%	11.2%	12.1%	11.7%
ROAA	2.0%	2.1%	1.9%	1.8%	1.9%	1.8%
Dividend Yield	4.9%	5.9%	5.7%	6.2%	7.0%	7.1%
Net Income growth	14%	10%	-2%	0%	13%	1%
Total Income growth	3%	13%	0%	2%	9%	6%
NPL/Gross Financing	0.95%	0.77%	0.85%	0.95%	1.10%	1.25%
Equity/Total Assets	16.5%	16.6%	16.6%	16.2%	15.9%	15.4%
Tier-1 Capital	16.6%	16.9%	16.9%	16.5%	16.2%	15.7%

Source: Company Reports, Bloomberg



## Investment Thesis

**Branch network expansion accruing advantages? Not enough evidence.** Share of demand deposits has risen sharply in 1H2015 to 56% (2014A: 44%; 5-year avg: 45%). This is a faster pace than sector, perhaps as a result of substantial increase in branch network in 2014, but more evidence needed to determine whether this is sustainable. In 2014, RIBL recorded the weakest deposit per branch mobilization of SAR225 mln in the sector, driven by relatively poor performance historically (SAR268 mln) and a substantial number of new branches. In 1H2015, the measure has improved to SAR293 mln, but remains very low compared to the sector (SAR555 mln) and NCB (SAR777mln) which has a similar sized network. Its share of sector and demand deposits at 9.8% and 8% respectively is disappointing against share in branches (16.7%) and ATMs (16.5%).

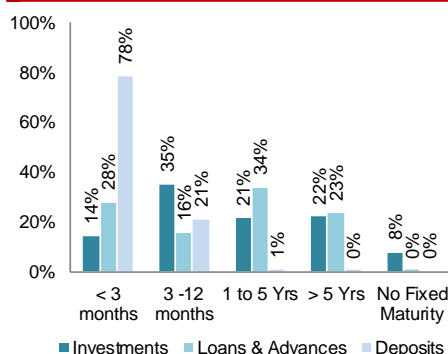
Retaining and growing demand deposit base will be key to RIBL's future outlook, and is a clearly identifiable area of below par performance. As interest rates rise, and opportunity cost of holding demand deposits, we expect the proportion of demand to total deposits for the industry to fall, and this trend will provide a test of resilience of RIBL's recent outperformance in growing demand deposits. As of now, we are forecasting demand deposits to make up 50% of overall deposits for RIBL by 2018F, higher than its previous 5YR average of 44%, but below 2015E level of 58%.

**In the low interest environment since 2008, RIBL has adopted a conservative policy of defending yield.** It has however increased A-L mismatch to bolster yields, in 2010 loans maturing >1YR stood at 49% of total loans versus 57% in 2014. As interest rates rise, RIBL may look to expand share in lending, however having given up share in the last few years and the sector remaining competitive (though less than in recent past), it is likely to find growth hard to come by unless it is willing to give up yield or chase riskier lending avenues. Given a relatively tougher economic environment, we believe they are unlikely to change strategy in lending, but will instead look to unlock value from branch expansion.

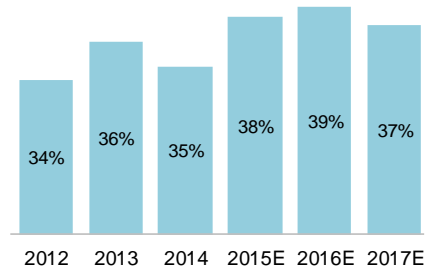
**Trade finance & corporate finance advisory income could come under pressure.** RIBL generates a significant 19% of total income (60% of total fee income) from corporate finance advisory and trade finance. If the economy slows as a result of lower oil prices and government expenditure, we see both these income streams coming under pressure. This is already evident in the bank's 2<sup>nd</sup> quarter results, where fee income has dipped 12% Q/Q, whereas historically the 2<sup>nd</sup> quarter is the strongest for fee income for the bank. In 2013 and 2014, 2<sup>nd</sup> quarter fee income comprised 52% of first half fee income (27% and 28% of annual fee income in 2013 and 2014 respectively), while in 1H2015 its contribution fell to 47%.



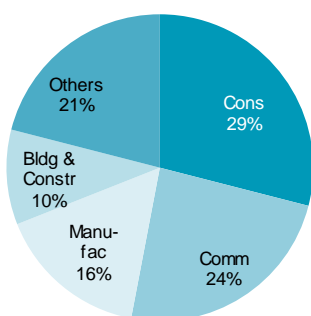
### Maturity Profile



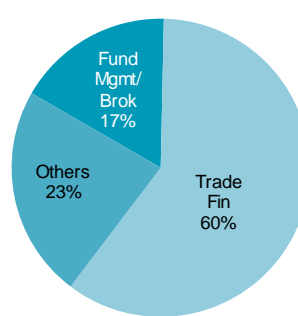
### Cost-Income (ex-impairment) Trend



### Credit by Sector 2014



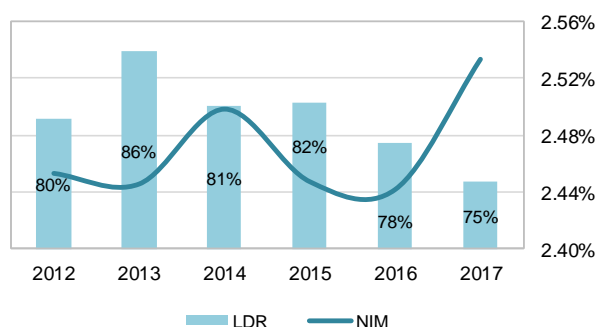
### Fee Income 2014



Source: Company Reports, SFC

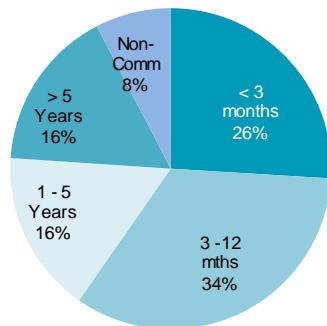
**RIBL maintains a relatively longer maturity investment portfolio versus peers:** Investments maturing in a year or less were 49% of investment portfolio, while yield on average investments stood at 1.8%, in line with the sector. We don't see any significant advantage to RIBL from cycling investments into government bonds at current yields. Versus peers, it maintains a relatively riskier profile in its investment portfolio which in our forecasts results in a higher yield pick-up over the forecast period from higher base rates, expanding term and credit risk premium in 2017 and 2018.

### Net Loans / Customer Deposits and NIM

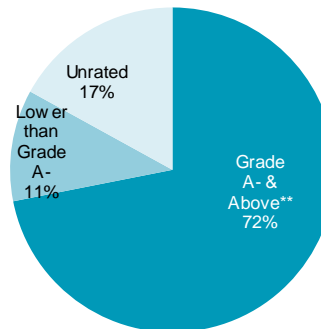


Source: Company Reports, SFC

#### Investment Maturity 2014 (Market Risk)

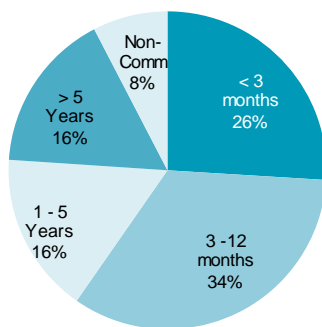


#### Credit Quality of Investments 2014

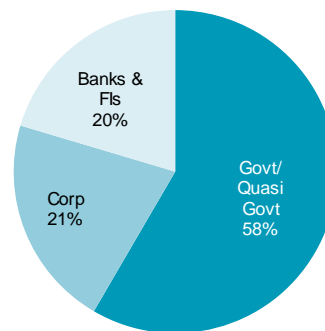


\*\* As per S&P ratings methodology.

#### Investment Maturity 2014 (Liquidity)



#### Investments by counter-party 2014



Source: Company Reports, SFC

**Whilst asset quality metrics have improved, exposure to mining & quarrying sector may make it susceptible to above average NPL accretion:** NPL ratio has been maintained at below 1% for past several years and coverage at 189%, however at the cost of high write-offs. Composition of loan book makes it relatively susceptible to NPL accretion, particularly the recent build of mining & quarrying sector exposure to 5% of loan book (from 2%). Exposure to the mining/quarrying sector could be problematic due to recent fall in commodity prices. The bank also has 10% exposure to the building and construction sector, which may come under pressure if government investment expenditure is cut. In 1H2015, NPLs grew 11% over end-2014, significantly above the sector average of 3.7%. In our current forecasts, we expect NPLs to rise to 1.3% of gross loans in 2018F, but with continued pressure on oil prices and government expenditure, risks are skewed towards higher NPL accretion. We expect the bank to maintain a relatively conservative coverage ratio averaging c.195% over the forecast period.

#### Valuation Sensitivity

We have valued the bank using Warranted Equity with the following inputs: 12% sustainable ROE, 4.5% growth rate and 12% cost of equity. At our target price of SAR13, it would trade at 1.0x, which is warranted given 11.5% 2016F RoAE and relatively poor earnings growth prospects.



### Target Price sensitivity to sustainable ROE and growth rate assumptions

Sustainable ROE		Growth Rate				
		2.5%	3.5%	4.5%	5.5%	6.5%
	10.0%	10.6	10.3	9.9	9.5	8.9
	11.0%	11.8	11.6	11.5	11.2	11.0
	12.0%	13.0	13.0	13.0	13.0	13.0
	13.0%	14.2	14.3	14.5	14.8	15.1
	14.0%	15.4	15.7	16.1	16.6	17.2

Source: Company Reports, Tadawul, SFC

## Company Overview

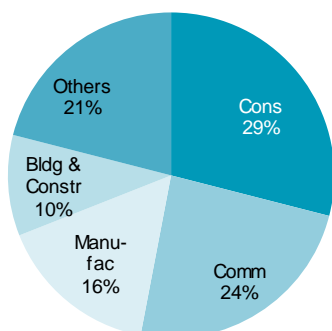
Riyad Bank was established in 1957 with its head office in Riyadh. RIBL is the fourth largest bank in the Kingdom by assets (as of 2Q15 total assets of SAR 222bn; 10.2% market share). At end-2014, the bank operated 318 branches, 2,551 ATMs, 97 remittance service centers and 20,008 PoS terminals across the country. Headed by CEO Talal Al-Qudaibi, Riyad Bank provides conventional and shariah-compliant banking through four segments: Retail, Corporate, Investment Banking/Brokerage Services (Riyad Capital) and Treasury. The Bank also holds a c.20% stake in the insurance venture through Al Alamiya Cooperative Insurance Co.

As of September 20, 2015, the banking group had a market capitalization of SAR 43.3bn (c.USD 11.6bn). Besides, General Organization for Social Insurance (GOSI, 17%) and Public Pension Agency (PPA, 9% stake), the shares are held by two Saudi Arabian entities: Al Nahla Trading Co. (9%) and Masik Holding Co. (8%).

- **Geographic focus:** Riyad Bank's operations are primarily focused in KSA (89% of total assets).
- **Income composition:** Net special commission income (NSCI, +9% YoY in 2014) accounted for 64% of total bank income while fee income (+11% YoY) constituted 25% of total income. Dividend, exchange, trading income and others accounted for the rest of bank's total income in 2014.
- **Balance sheet decomposition:** Liquid Assets (14%), investments (22%), and net financing (62%) constituted the primary share of RIBL's balance sheet on the assets side, according to its most recent annual financial disclosure. In contrast, total liabilities (83% of total assets) comprise primarily of customer deposits (SAR 164bn or 92% of total liabilities). Demand deposits account for 44% of total customer deposits at RIBL (vs. 63% for the system) while time deposits constituted 50% in 2014 (vs. 25% for the system).
- **Concentration and asset quality:** The performing financing portfolio is primarily concentrated in four sectors (Consumer, Commerce, Manufacturing and Building & Construction collectively constitute 79% of the financing portfolio). Total loan book grew a moderate 2% YoY in 2014. Non-performing financing (NPFs) facilities to gross financing stood at 0.77% (2013: 0.95%), with basic provision coverage at 189% (2013: 153%).
- **Segmental information:** Corporate Banking and Treasury account for the majority of the bank's asset base, with 43% and 35% share, respectively. In 2014, the Corporate Banking division accounted for 64% of the group's profits and generated RoA of 3.0%. On the other hand, Treasury accounted for 26% of the group's Profits and generated a RoA of 1.5%.

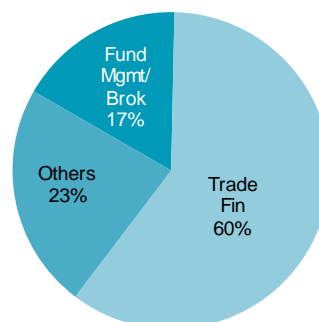


#### Credit by Sector 2014



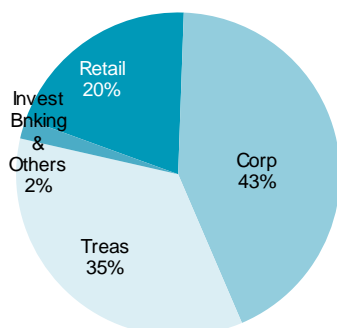
Source: Company Reports, Tadawul, SFC

#### Fee Income 2014



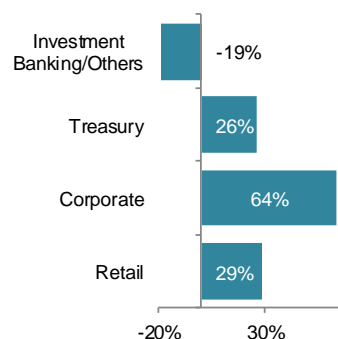
Source: Company Reports, Tadawul, SFC

#### Assets by Segment 2014



Source: Company Reports, Tadawul, SFC

#### Earnings Mix by Segment 2014



Source: Company Reports, Tadawul, SFC



## Strongly Positioned to Push on From 2016

Industry-leading cost efficiency, corporate focus and liquid B/S deliver gearing to higher interest rates. Strong brand and relationship with HSBC allow it to punch above its weight in deposit mobilization, retail banking and trade finance. Initiate with BUY and SAR35/share target price. One of the best positioned banks to benefit from higher interest rates with 59% of its loan book and 70% of its investment portfolio maturing within a year. This is bolstered further by a strong market share push in 1H2015, where it delivered above sector average 12.3% and 9.2% loan and deposit growth respectively.

**Low retail loan footprint and short-tenor commercial lending in 1H2015 augurs well as rates rise:** A heavy tilt towards short-tenor commercial lending (78% of loan book in 2014A; 59% of loans maturing within 1 year), will allow SABB to re-price its loan book relatively quickly as rate hikes by the US Fed feed into SAIBOR and yields on average loans.

**Comparatively low yield on investments should get boost from cycling maturing instruments into government bonds:** 19% of SABB's investments mature within 3 months and 70% within 12 months (2014A), explaining its sub-par yield on investment portfolio of 1.3% vs. the sector at 1.8%. This maturity profile should allow it to cycle maturing investments into higher yielding bonds, and also lock into higher interest rates as the US Fed tightens.

**Bank brand strength and HSBC relationship is evident in its performance in retail banking and trade finance:** As of 1H2015, SABB accounted for 9.7% of sector deposits despite accounting for only 4% of the branches. Deposits per branch have improved from SAR 1.2bln in 2010 to SAR1.8bln and SAR1.9bln in 2014 and 1H2015 respectively. In 2014, each branch on average generated over SAR1 bln in demand deposits, versus an industry average of SAR555 mln and SAR501 mln for banks with similar-sized branch networks. The brand strength also reflects in its ability to generate fee income, which contributes 25% of total income vs. 23% for sector. However we note the apparent decline in trade finance income in 2Q2015. Trade finance and corporate finance advisory fees (c.17% of total income) could face pressure from low oil prices and cuts in government expenditure.

**Superior translation of RoAA to RoAE. Change in dividend payout policy could drive more interest.** SABB's CET-1 stands at 15.2%, slightly above average for peer conventional banks, yet its strong RoAA delivers the 3rd highest RoAE. Reinitiating interim dividends (SAR0.40 per share in 2015) for the first time since 2007, should drive further interest in the stock.

**SABB trades at a discount to the sector PBV of 1.4x at 1.3x 2016F BV:** The bank has underperformed the sector by 5ppt and 19ppt on a Y/Y and YTD basis, and is down 26% this year. At our target price of SAR35, the bank would trade at 1.7x 2016F BV with an RoAE of 15%. We have valued the bank using Warranted Equity Valuation with 17% sustainable ROE, 5% growth rate and 11.7% cost of equity.

### Rating Summary

Recommendation	Buy
12-Month Target price (SAR)	35.0
Upside/(Downside)	24.7%

### Stock Details

Last Close Price	SAR	28.1
Market Capitalization	SAR mln	42,105
Shares Outstanding	mln	1,500
52-Week High	SAR	41.3
52-Week Low	SAR	26.9
Price Change (YTD)	%	(25.7%)
12-Mth ADTV	mln	0.4
EPS 2015E	SAR	2.82
Reuters / Bloomberg	1060.SE	SABB AB

Source: Tadawul

### Key Shareholders (%)

HSBC	40%
Olayan Saudi Invest Co.	17%
GOSI	10%
Others	35%

Source: Tadawul

### Price Multiples

	2015E	2016E
P / E	10.0x	9.3x
P / B	1.5x	1.3x
Dividend Yield (%)	3.5%	4.3%

Source: SFC

### 1-Year Share Performance



Source: Bloomberg



## Summary Financials

All figures are in SAR mn

Summary Financials	2013	2014	2015E	2016E	2017E	2018E
<b>INCOME STATEMENT</b>						
Special commission income	4,386	4,626	4,780	5,617	7,155	8,377
Special commission expense	(667)	(563)	(534)	(795)	(1,592)	(2,097)
<b>Net special commission income</b>	<b>3,719</b>	<b>4,063</b>	<b>4,247</b>	<b>4,822</b>	<b>5,563</b>	<b>6,280</b>
y-o-y growth %	13.9%	9.2%	4.5%	13.6%	15.4%	12.9%
Other Income	2,096	2,440	2,405	2,523	2,777	2,920
<b>Total operating income</b>	<b>5,815</b>	<b>6,502</b>	<b>6,651</b>	<b>7,345</b>	<b>8,340</b>	<b>9,200</b>
y-o-y growth %	12.6%	11.8%	2.3%	10.4%	13.5%	10.3%
Expenses	(1,723)	(1,896)	(2,037)	(2,158)	(2,316)	(2,484)
<b>Pre-provision Profit</b>	<b>4,093</b>	<b>4,606</b>	<b>4,615</b>	<b>5,187</b>	<b>6,024</b>	<b>6,716</b>
Charge for impairment on financing	(442)	(450)	(507)	(809)	(1,145)	(1,137)
<b>Total operating expenses</b>	<b>2,165</b>	<b>2,346</b>	<b>2,544</b>	<b>2,967</b>	<b>3,461</b>	<b>3,620</b>
Cost-to-income ratio % (Excl. provisions)	29.6%	29.2%	30.6%	29.4%	27.8%	27.0%
Associate Income/Others	123	109	124	128	131	135
<b>Net Income</b>	<b>3,774</b>	<b>4,266</b>	<b>4,231</b>	<b>4,506</b>	<b>5,011</b>	<b>5,715</b>
<b>BALANCE SHEET</b>						
<b>Assets</b>						
Cash and balances with SAMA	26,124	19,314	19,267	20,725	20,484	22,311
Due from banks and other financial institutions	3,286	2,469	2,592	2,722	2,858	3,001
Investments	37,400	45,281	49,809	54,790	60,269	63,885
Loans and advances, net	106,115	115,221	125,684	133,018	140,567	148,685
Investment in associates	647	652	671	691	712	733
Property and equipment, net	604	663	900	1,153	1,433	1,734
Other assets, net	3,127	4,010	4,331	4,677	5,051	5,455
<b>Total Assets</b>	<b>177,302</b>	<b>187,609</b>	<b>203,254</b>	<b>217,777</b>	<b>231,375</b>	<b>245,805</b>
<b>Liabilities</b>						
Due to banks and other financial institutions	3,770	4,086	4,331	4,591	4,866	5,158
Customers' deposits	138,961	145,870	160,458	171,690	181,991	192,910
Debt securities in Issue and borrowing	5,392	5,343	3,093	3,093	3,015	3,015
Other liabilities	6,346	6,239	6,551	6,878	7,222	7,583
<b>Total Liabilities</b>	<b>154,469</b>	<b>161,538</b>	<b>174,432</b>	<b>186,252</b>	<b>197,094</b>	<b>208,667</b>
<b>Total Equity</b>	<b>22,833</b>	<b>26,071</b>	<b>28,821</b>	<b>31,525</b>	<b>34,281</b>	<b>37,138</b>
<b>Total Liabilities and Equity</b>	<b>177,302</b>	<b>187,609</b>	<b>203,254</b>	<b>217,777</b>	<b>231,375</b>	<b>245,805</b>
<b>Key Ratio</b>						
P/E	11.2	9.9	10.0	9.3	8.4	7.4
P/BV	1.8	1.6	1.5	1.3	1.2	1.1
P/PPP	10.3	9.1	9.1	8.1	7.0	6.3
ROAE	17.6%	17.4%	15.4%	14.9%	15.2%	16.0%
ROAA	2.3%	2.3%	2.2%	2.1%	2.2%	2.4%
Dividend Yield	2.4%	2.5%	3.5%	4.3%	5.4%	6.8%
Net Income growth	16%	13%	-1%	6%	11%	14%
Total Income growth	13%	12%	2%	10%	14%	10%
NPL/Gross Financing	1.41%	1.27%	1.20%	1.33%	1.50%	1.60%
Equity/Total Assets	12.9%	13.9%	14.2%	14.5%	14.8%	15.1%
Tier-1 Capital	15.1%	15.6%	15.9%	16.3%	16.6%	17.0%

Source: Company Reports, Bloomberg

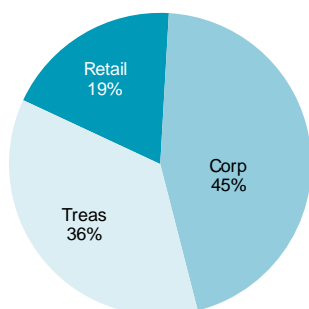


## Investment Thesis

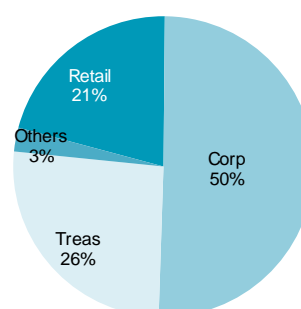
**Low retail loan footprint and short-tenor commercial lending augur well as rates rise:** A heavy tilt towards short-tenor commercial lending (78% of loan book in 2014A; 59% of loans maturing within 1 year), will allow SABB to re-price its loan book relatively quickly as rate hikes by the US Fed feed into SAIBOR.

Whilst longer tenor loans are typically priced at a floating rate, market reports suggest that the term and risk premiums have been very tightly priced due to competitive pressures in the recent past. As monetary policy normalizes from its current emergency setting, thus tightening liquidity conditions, we expect competitive pressures to ease. This should lead to a steeper yield curve, higher term premiums as well as higher credit risk premiums. Banks like SABB will benefit as they expand their A-L mismatch. Given the bank's preference for short-term commercial facilities, we expect it to move relatively slowly until the rate cycle matures.

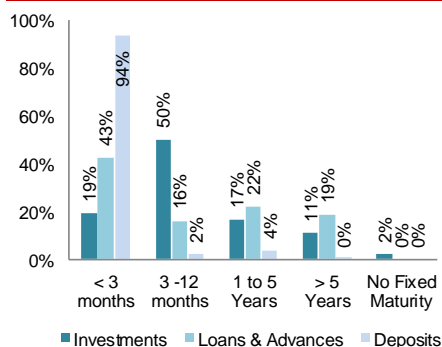
**Assets by Segment 2014**



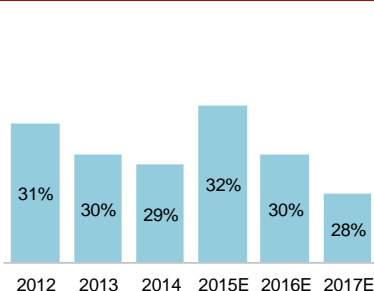
**Earnings Mix by Segment 2014**



**Maturity Profile**



**Cost-Income (ex-impairment) Trend**



Source: Company Reports, Tadawul, SFC

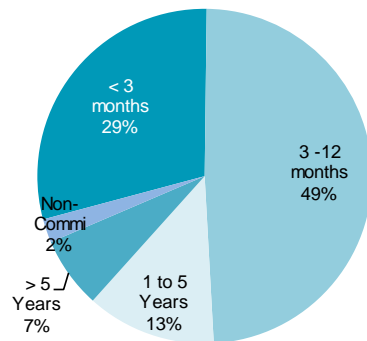
Source: Company Reports, Tadawul, SFC

**Comparatively low yield on investments should get boost from cycling maturing instruments into government bonds:** 19% of SABB's investments mature within 3 months and 70% within 12 months (2014A), explaining the sub-par yield on investment portfolio of 1.3% vs. the sector at 1.8%. This maturity profile should allow it to cycle maturing investments into higher yielding bonds, and also lock into higher interest rates as the US Fed tightens. Again, the bank can raise its yield via expanding its A-L mismatch, though we expect the bank to limit investment in the near term as the yield curve is quite flat, and the term premium limited. The bank's risk profile in the investments is very risk-averse, where 67% of portfolio comprises sovereign debt. SABB has scope to expand the risk of investment portfolio as the risk-reward profile improves.

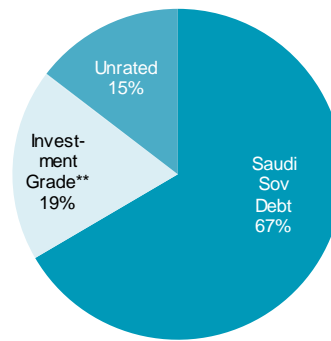




#### Investment Maturity 2014 (Market Risk)

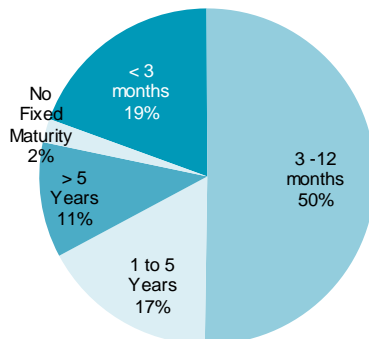


#### Credit Quality of Investments 2014

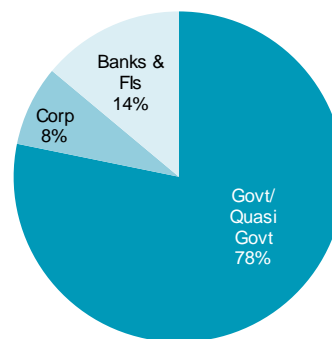


\*\* AAA to BBB ratings under S&P Ratings methodology

#### Investment Maturity 2014 (Liquidity)



#### Investments by Counterparty 2014

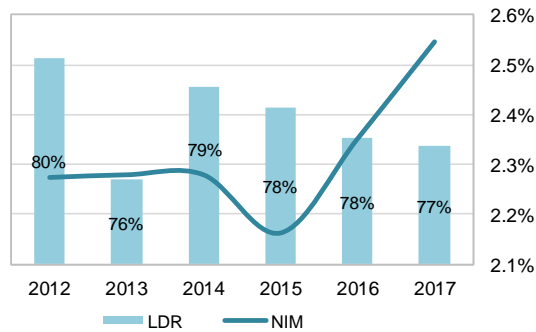


Source: Company Reports, SFC

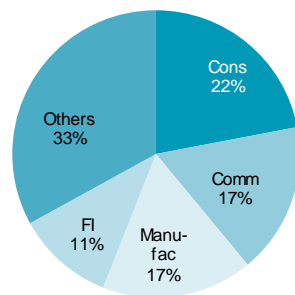
**Bank brand strength and HSBC relationship is evident in performance in retail banking and trade finance:** As of 1H2015, SABB accounted for 9.7% of sector deposits despite accounting for only 4% of the branches. Deposits per branch have improved from SAR 1.2bln in 2010 to SAR1.8bln and SAR1.9bln in 2014 and 1H2015 respectively. In 2014, each branch on average generated over SAR1 bln in demand deposits, versus an industry average of SAR555 mln and SAR501 mln for banks with similar-sized branch networks. The brand strength also reflects its ability to generate fee income, which contributes 25% of total income vs. 23% for sector.

SABB fee income however may come under pressure over the forecast period if low oil prices persist and government investment expenditure is curtailed to limit the fiscal deficit. Trade finance and corporate finance advisory income make up c.17% of the bank's total income. In the 2<sup>nd</sup> quarter, the bank's fee income declined by c.3% Q/Q. Whilst the decline is relatively small in percentage terms, historically fee income for the bank is strongest in the 2<sup>nd</sup> quarter. We think the current weakness is largely driven by a decline in trade finance income (13.5% of total income).

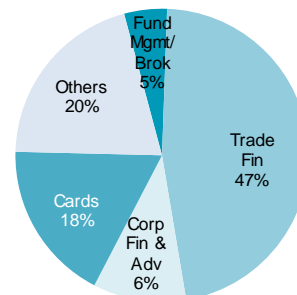
### Net Loans / Customer Deposits and NIM



### Credit by Sector 2014



### Fee Income 2014

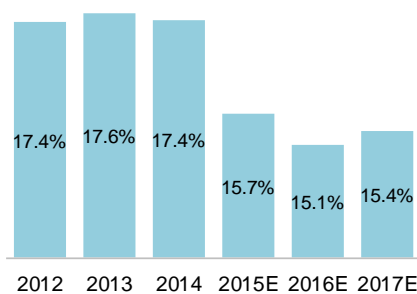


Source: Company Reports, SFC

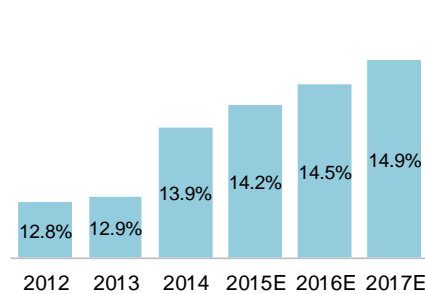
**Superior translation of RoAA to RoAE. Change in dividend payout policy could drive more interest.** SABB's CET-1 capital stands at 15.2%, slightly above average for peer conventional banks, yet its strong RoAA delivers the 3rd highest RoAE. The change in dividend policy, where it has paid an interim dividend (SAR0.40 per share) in 1H2015, is a positive step.

Modulating dividend payout further could drive RoAE higher, as current CET-1 ratio is sufficiently conservative. For our forecasts, we have adopted a more aggressive dividend payout, rising to 50% in 2018. Under our assumptions, CET-1 ratio rises to 17% in 2018, which indicates that there is upside risk to our dividend forecasts.

### Return on Equity Forecast



### Equity /Total Assets



Source: Company Reports, SFC



## Valuation Sensitivity

have valued the bank using Warranted Equity Valuation with 17% sustainable ROE, 5% growth rate and 11.7% cost of equity. At our target price of SAR35, the bank would trade at 1.7x 2016F BV with an RoAE of 15%. We

### Target Price sensitivity to sustainable ROE and growth rate assumptions

		Growth Rate				
		3.0%	4.0%	5.0%	6.0%	7.0%
Sustainable ROE	15.0%	27.4	28.3	29.5	31.1	33.4
	16.0%	29.5	30.7	32.3	34.3	37.3
	17.0%	31.6	33.1	35.0	37.6	41.2
	18.0%	33.8	35.5	37.7	40.8	45.1
	19.0%	35.9	37.9	40.5	44.0	49.1

Source: Company Reports, Tadawul, SFC

## Company Overview

The Saudi British Bank (SABB) was established in 1978 by taking over the activities and services of the British Bank of the Middle East in the KSA. SABB is the fifth largest bank in the country by assets (as of 2Q15 total assets of SAR 192bn; 8.4% market share). Headed by Davd Dew and Board Chairman Khalid Olayan, the bank operates 81 branches, 854 ATMs and 10,644 PoS terminals across the Kingdom at end 2014. As of September 20, 2015, the banking group had a market capitalization of SAR 45.6bn (c.USD 12.2bn). HSBC Group holds 40% stake in SABB while Olayan Saudi Investment Co. (17%) is one of the major shareholders.

SABB offers various banking services primarily through three segments: Retail, Corporate and Treasury. Brokerage, asset management, and investment banking services are provided through a wholly owned subsidiary – SABB Securities (100% owned). The Bank also owns 51% stake in HSBC Saudi Arabia and in addition to 32.5% stake in the insurance venture – SABB Takaful.

- **Geographic focus:** SABB's operations are primarily focused in KSA (94% of total assets).
- **Income composition:** Net special commission income (NSCI, +9.2% YoY in 2014) accounted for 62% of total bank income while fee income (+15% YoY) constituted 25% of total income. Exchange, trading, dividend income and others accounted for the rest of bank's total income in 2014.
- **Balance sheet decomposition:** Liquid Assets (12%), investments (21%), and loans & advances (61%) constituted the primary share of SABB's balance sheet on the assets side, according to its most recent annual financial disclosure (December 2014). In contrast, total liabilities (86% of total assets) comprise primarily of customer deposits (SAR 146bn or 90% of total liabilities). Demand deposits account for 59% of total customer deposits at SABB (vs. 63% for the system) while time deposits constituted 34% in 2014 (in line with that for the system at 25%).
- **Concentration and asset quality:** SABB's loan portfolio is concentrated into four notable sectors (Consumer, Commerce, Manufacturing, and credit for Financial Institutions) collectively constitutes 68% of the loan portfolio. Total loan book grew a 8.6% YoY in 2014 to SAR 115bn. Non-performing loan (NPLs) facilities to gross loans & advances stood at 1.27% (2013: 1.41%), with basic provision coverage at 161% (2013: 148%).
- **Segmental information:** Corporate and Treasury segment account for the majority of the bank's asset base, with 45% and 36% share in total assets, respectively. In 2014, the Corporate division accounted for 50% of the group's Profits and generated RoA of 2.5%. On the other hand, Treasury accounted for 26% of the group's profits and generated RoA of 1.7%.



## Tops on Capital and Efficiency Metrics

Quality of its capital strength, staff and branch productivity, corporate franchise and credit risk management places it above peers. Initiate with BUY, target price of SAR31. We believe the historic low interest rate environment did not provide adequate risk-adjusted returns to motivate expansion in the balance sheet, but as interest rates tick up Samba might come into its own. Samba's balance sheet liquidity (adjusted HQLA stood at 29% of total assets in 1H2015) is the strongest in the industry and best positioned to tap into higher yielding assets such as government bonds. In addition, historical strength in managing credit risk should appeal to investors as economic conditions get relatively tighter. It clearly punches below its weight in the lending market, where share was only 9.8% in 1H2015, however the bank remains the first port-of-call for large borrowers, indicating that it can expand market share.

**CET1 at 19%, 68% interest-free deposits, LDR of 77% and no wholesale funding enable aggressive RWA growth:** Following the global financial crisis, Samba has underperformed the sector in loan and asset growth. The bank's share of total system loans and assets has fallen rapidly since the onset of the financial crisis and the implementation of ZIRP, which sent SAIBOR to historic lows. We argue that as interest rates rise, Samba will begin to compete again indeed the jump in LDR from 72% in 2013 to 77% in 1H2015 indicates a growing willingness.

**Comparatively low yield on investments should get significant boost from cycling maturing instruments into government bonds:** 43% of Samba's investments mature within 3 months and 54% within 12 months as of 2014, explaining sub-par yield on investment portfolio of 1.5% vs. the sector at 1.8%. This maturity profile should allow it to cycle maturing investments into higher yielding bonds, and also lock into higher interest rates as the US Fed tightens monetary policy.

**Branch / staff productivity are impressive; credit risk management strong:** Samba mobilizes an industry best SAR2.4 bln and SAR50 mln deposits per branch and employee respectively, of which SAR1.6 bln per branch are demand deposits. The bank boasts 30% cost-to-income ratio (2014A), bettered only by SABB. Strength in credit risk management was apparent as the global financial crisis unfolded. Sector cost of risk rose significantly to 1.4% and 1.2% in 2009 and 2010 respectively, while Samba's peaked at 0.7% in 2009. In the following 4 years, the sector's cost of risk averaged 0.64% versus 0.25% for Samba.

**The decline in retail market share and low ROAE detract from value:** The bank has lost out in retail market share in recent years, and heightened competition in this segment poses a challenge. With immediate opportunities in corporate and treasury, we do not expect this to be a priority for the bank. Furthermore, there is a poor translation of an industry high ROAA (2014A: 2.4%) into ROAE (2014A: 13.6%), due to high capitalization (CET1 2014A: 19%). This compares to SABB (ROAA: 2.3%; ROAE: 17.4%) and AlRajhi (ROAA: 2.3%; ROAE: 17%). Exploring M&A or modulating dividend policy could boost ROAE.

**Samba trades at 1.1x 2016F BV, at a deep discount to the sector (1.4x).** The bank has outperformed the sector by 10ppt and 12ppt on a Y/Y and YTD basis, reflecting its strong defensive characteristics and prospects for higher interest rates. At our target price, the bank would trade at 1.4x 2016F BV. We have valued the bank using Warranted Equity using the following inputs: sustainable ROE of 13%, growth rate of 5% and 10.5% cost of equity.

### Rating Summary

Recommendation	Hold
12-Month Target price (SAR)	31.0
Upside/(Downside)	30%

### Stock Details

Last Close Price	SAR	23.7
Market Capitalization	SAR mln	47,300
Shares Outstanding	mln	2,000
52-Week High	SAR	31.0
52-Week Low	SAR	20.9
Price Change (YTD)	%	5.4%
12-Mth ADTV	mln	1.5
EPS 2015E	SAR	2.60
Reuters / Bloomberg	1090.SE	SAMBA AB

Source: Tadawul

### Key Shareholders (%)

Public Investment Fund	23%
General Retirement Org.	15%
GOSI	12%
Others	50%

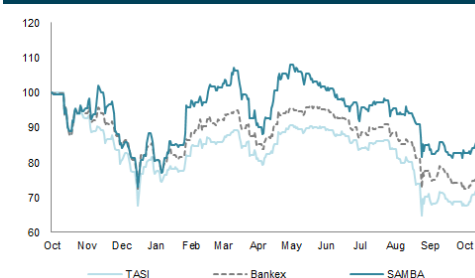
Source: Tadawul

### Price Multiples

	2015E	2016E
P / E	9.1x	8.6x
P / B	1.2x	1.1x
Dividend Yield (%)	5.0%	5.8%

Source: SFC

### 1-Year Share Performance



Source: Bloomberg



## Summary Financials

All figures are in SAR mn

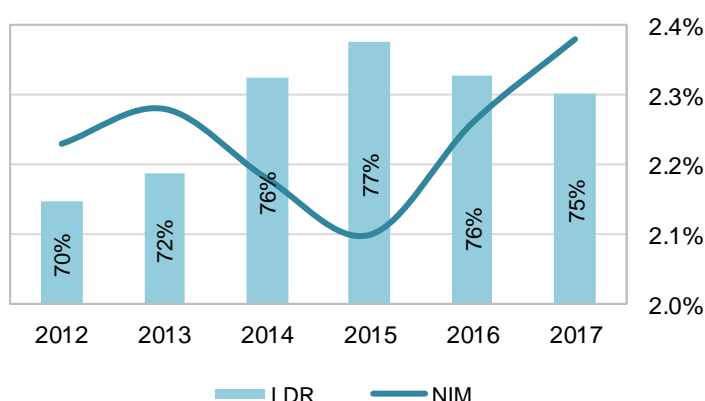
Summary Financials	2013	2014	2015E	2016E	2017E	2018E
<b>INCOME STATEMENT</b>						
Special commission income	4,997	5,041	5,171	5,971	7,345	8,518
Special commission expense	(469)	(448)	(504)	(658)	(1,425)	(2,074)
<b>Net special commission income</b>	<b>4,528</b>	<b>4,593</b>	<b>4,667</b>	<b>5,313</b>	<b>5,921</b>	<b>6,443</b>
y-o-y growth %	6.0%	1.4%	1.6%	13.8%	11.4%	8.8%
Other Income	2,472	2,791	3,166	3,164	3,311	3,464
<b>Total operating income</b>	<b>7,001</b>	<b>7,385</b>	<b>7,834</b>	<b>8,478</b>	<b>9,232</b>	<b>9,908</b>
y-o-y growth %	4.6%	5.5%	6.1%	8.2%	8.9%	7.3%
Expenses	(2,137)	(2,233)	(2,486)	(2,612)	(2,788)	(2,976)
<b>Pre-provision Profit</b>	<b>4,864</b>	<b>5,152</b>	<b>5,347</b>	<b>5,865</b>	<b>6,444</b>	<b>6,932</b>
Charge for impairment on financing	(353)	(141)	(136)	(387)	(776)	(810)
<b>Total operating expenses</b>	<b>2,490</b>	<b>2,374</b>	<b>2,622</b>	<b>2,999</b>	<b>3,563</b>	<b>3,786</b>
Cost-to-income ratio % (Excl. provisions)	30.5%	30.2%	31.7%	30.8%	30.2%	30.0%
Associate Income/Others	(0)	(5)	(6)	(7)	(7)	(7)
<b>Net Income</b>	<b>4,510</b>	<b>5,005</b>	<b>5,205</b>	<b>5,472</b>	<b>5,661</b>	<b>6,115</b>
<b>BALANCE SHEET</b>						
<b>Assets</b>						
Cash and balances with SAMA	20,383	14,679	12,688	12,420	9,721	12,561
Due from banks and other financial institutions	4,858	7,406	7,554	7,705	7,859	8,016
Investments	60,341	64,516	67,741	75,870	84,975	89,224
Loans and advances, net	113,455	124,079	134,219	139,550	146,484	153,575
Property and equipment, net	1,824	2,067	2,235	2,248	2,266	2,289
Other assets, net	4,176	4,652	5,024	5,426	5,860	6,329
<b>Total Assets</b>	<b>205,037</b>	<b>217,399</b>	<b>229,462</b>	<b>243,219</b>	<b>257,166</b>	<b>271,995</b>
<b>Liabilities</b>						
Due to banks and other financial institutions	7,473	9,385	9,948	10,545	11,178	11,848
Customers' deposits	158,337	163,795	173,623	184,040	195,082	206,787
Other liabilities	4,296	5,307	5,307	5,307	5,307	5,307
<b>Total Liabilities</b>	<b>170,106</b>	<b>178,487</b>	<b>188,878</b>	<b>199,892</b>	<b>211,567</b>	<b>223,943</b>
<b>Total Equity</b>	<b>34,803</b>	<b>38,784</b>	<b>40,450</b>	<b>43,186</b>	<b>45,451</b>	<b>47,896</b>
Minority Interest	128	128	134	141	148	155
<b>Total Liabilities and Equity</b>	<b>205,037</b>	<b>217,399</b>	<b>229,462</b>	<b>243,219</b>	<b>257,166</b>	<b>271,995</b>
<b>Key Ratio</b>						
P/E	10.5	9.5	9.1	8.6	8.4	7.7
P/BV	1.4	1.2	1.2	1.1	1.0	1.0
P/PPP	9.7	9.2	8.8	8.1	7.3	6.8
ROAE	13.6%	13.6%	13.1%	13.1%	12.8%	13.1%
ROAA	2.2%	2.4%	2.3%	2.3%	2.3%	2.3%
Dividend Yield	3.9%	4.3%	5.0%	5.8%	7.2%	7.8%
Net Income growth	4%	11%	4%	5%	3%	8%
Total Income growth	5%	5%	6%	8%	9%	7%
NPL/Gross Financing	1.73%	1.31%	1.25%	1.35%	1.45%	1.60%
Equity/Total Assets	17.0%	17.8%	17.6%	17.8%	17.7%	17.6%
Tier-1 Capital	19.0%	19.6%	21.0%	21.1%	21.0%	20.9%

Source: Company Reports, Bloomberg

## Investment Thesis

**CET1 at 19%, 68% interest-free deposits, LDR of 77% and no wholesale funding enable aggressive RWA growth:** Following the global financial crisis, Samba has under-performed the sector in loan and asset growth. The bank's share of total system loans and assets has fallen rapidly since the onset of the financial crisis and the implementation of ZIRP, which sent SAIBOR to historic lows. We argue that as interest rates rise, Samba will begin to compete again; indeed the jump in LDR from 72% in 2013 to 77% in 1H2015 indicates a growing willingness.

### Net Loans / Customer Deposits and NIM

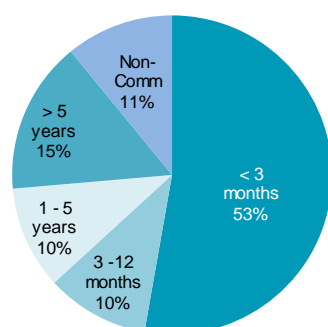


Source: Company Reports, SFC

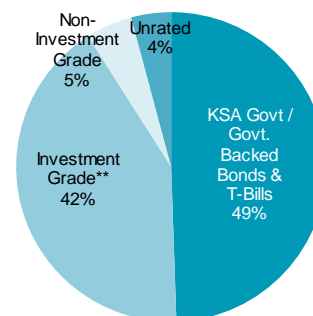
With the onset of the global financial crisis, ZIRP and an uptick in sector NPLs, Samba rapidly reduced its loan exposure, where its LDR fell from 73% in 2008 to a low of 57% in 2009. Contrary to its very conservative image, the bank has raised exposure since, with LDR rising to 77% in 1H2015. We expect the bank to increase the risk profile of its asset portfolio, including expanding A-L mismatch as rates rise. As competition eases, we expect the bank to start increasing retail exposure in the latter half of the forecast period.

**Comparatively low yield on investments should get significant boost from cycling maturing instruments into government bonds:** c.53% of Samba's investments mature within 3 months and 63% within 12 months as of 2014, explaining the sub-par yield on investment portfolio of 1.5% vs. the sector at 1.8%. This maturity profile should allow it to cycle maturing investments into higher yielding bonds, and also lock into higher interest rates as the US Fed tightens monetary policy.

### Investment by Maturity 2014 (Market Risk)



### Credit Quality of Investments 2014

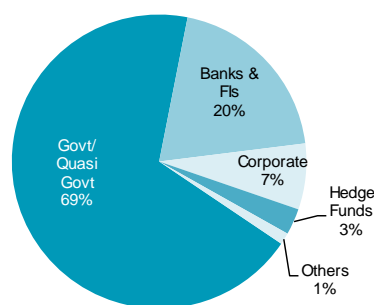


\*\* Aaa to Baa3 ratings under Moody's ratings methodology.

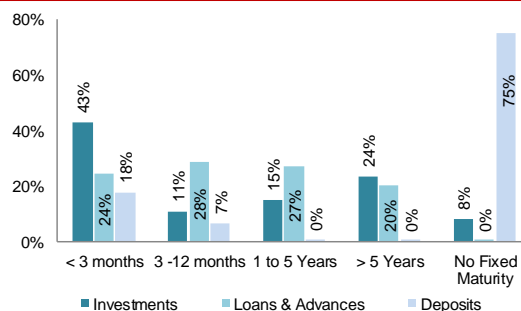
Source: Company Reports, SFC



#### Investments by counter-party 2014



#### Maturity Profile - Loan, Customer Deposits & Investments



Source: Company Reports, SFC

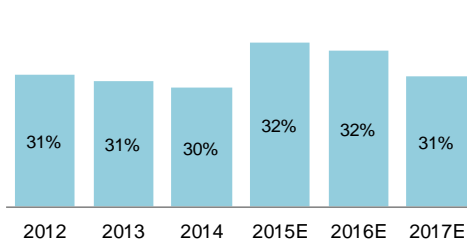
The bank is a beneficiary of the government bond issues, utilizing the issues to bolster yield. However, we expect it to limit participation to the shorter-tenor 5YR instrument until the interest rate cycle matures. Thus, incremental gains in the portfolio yields will be relatively limited in near term, unless risk premiums adjust faster than current forecasts.

Given that c.91% of total investments are in high credit grade securities, the bank has the option to raise risk profile as the artificially depressed risk premium expands on tighter local and global liquidity.

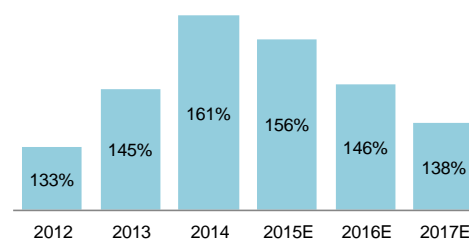
**Branch / staff productivity are impressive; credit risk management strong:** Samba mobilizes an industry best SAR2.4 bln and SAR50 mln deposits per branch and employee respectively, of which SAR1.6 bln per branch are demand deposits. The bank boasts a cost-to-income 30% (2014A), bettered only by SABB. We see scope for improvements in its cost efficiency on account of higher total income as its NIM expands, however current forecast is only for a marginal decline in the forecast period. As the rate cycle matures in late 2018 and 2019, cost to income is likely to decline towards the 2007 level of 27.3%.

The bank's strength in credit risk management was apparent as the global financial crisis unfolded. Sector cost of risk rose significantly to 1.4% and 1.2% in 2009 and 2010, while Samba's peaked at 0.7% in 2009. In the following 4 years, the sector's cost of risk averaged 0.64% versus 0.25% for Samba. Over the forecast period, we expect the NPL ratio to expand by 30bps to 1.6% in 2018.

#### Cost-Income (ex-impairment) Trend



#### Loan Provision / Non Performing Loans



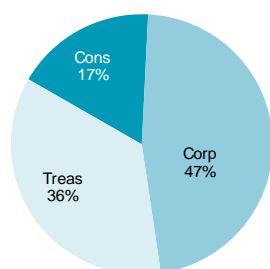
Source: Company Reports, SFC

**The decline in retail market share and low RoAE detract from value:** The bank has lost out in retail market share in recent years, and heightened competition in this segment poses a challenge. With immediate opportunities in corporate and treasury, we do not expect this to be an immediate priority for the bank. Furthermore, there is a poor translation of an industry high ROAA (2014A: 2.4%) into ROAE (2014A: 13.6%), due to high capitalization (CET1 2014A: 19%). This compares to SABB (ROAA: 2.3%; ROAE: 17.4%) and AlRajhi (ROAA: 2.3%; ROAE: 17%). Exploring M&A or modulating dividend policy could boost ROAE.

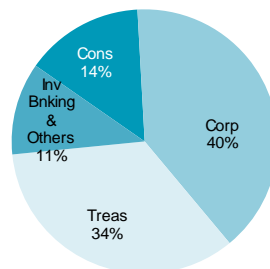




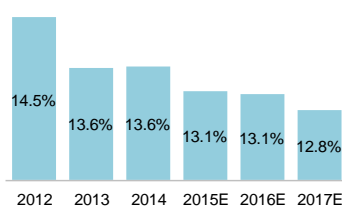
#### Assets by Segment 2014



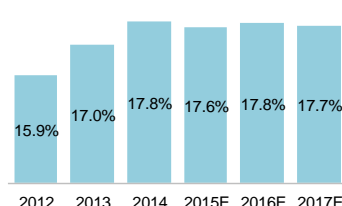
#### Earnings Mix by Segment 2014



#### Return on Equity Forecast



#### Equity /Total Assets



Source: Company Reports, SFC

### Valuation Sensitivity

We have valued the bank using Warranted Equity using the following inputs: sustainable ROE of 13%, growth rate of 5% and 10.5% cost of equity. At our target price, the bank would trade at 1.5x 2016F BV at a slight premium to the sector.

#### Target Price sensitivity to sustainable ROE and growth rate assumptions

		Growth Rate				
		3.0%	4.0%	5.0%	6.0%	7.0%
Sustainable ROE	11.0%	23.2	23.5	23.8	24.4	25.2
	12.0%	25.8	26.5	27.4	28.8	31.0
	13.0%	28.4	29.5	31.0	33.2	36.7
	14.0%	31.0	32.5	34.6	37.6	42.4
	15.0%	33.6	35.5	38.2	42.0	48.1

Source: Company Reports, Tadawul, SFC

### Company Overview

SAMBA Financial Group (SAMBA) was formed in 1980 by taking over the existing branches of Citibank N.A. in Jeddah and Riyadh. Citibank had retained a 40% stake initially which was later sold in three tranches during 1991 (10% stake sale), in 2002 (another 10% stake sale) and in 2004 (Citibank sold the remaining 20% stake in SAMBA). Currently, SAMBA is the third largest bank in the Kingdom by assets (as of 2Q15 total assets of SAR 226bn; 10.4% market share). The bank operates 72 branches, 543 ATMs, 31 remittance service centers and 6,786 PoS terminals across the country (as of end 2014). As of September 20, 2015, the group had a market capitalization of SAR 46.5bn (c.USD 12.4bn). The General Organization for Social Insurance (GOSI, 12%), General Retirement Org. (9% stake) and Public Investment Fund (23%) are the major shareholders in SAMBA.

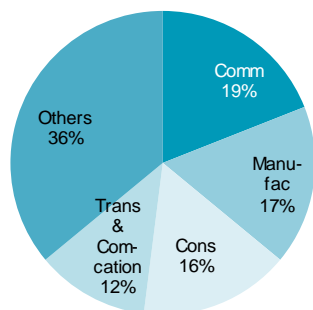
The bank offers various Shariah-compliant products along with conventional banking products through four segments: Consumer, Corporate, Investment Banking and Treasury. Apart from Saudi Arabia, SAMBA has



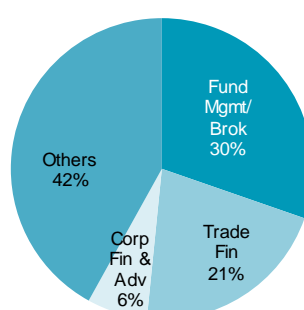
branches in London, Dubai and Qatar and has a subsidiary, Samba Bank Limited, in Pakistan (85% stake).

- **Geographic focus:** SAMBA's operations are primarily focused in KSA (79% of total assets).
- **Income composition:** Net special commission income (NSCI, +1.4% YoY in 2014) accounted for 63% of total bank income while fee income (+11% YoY) constituted 24% of total income. Dividend, exchange, trading income and others accounted for the rest of bank's total income in 2014.
- **Balance sheet decomposition:** Liquid assets (10%), investments (30%), and net financing (57%) constituted the primary share of SAMBA's balance sheet on the assets side, according to its most recent annual financial disclosure. In contrast, total liabilities (82% of total assets) comprise primarily of customer deposits (SAR 164bn or 92% of total liabilities). Demand deposits account for 66% of total customer deposits at SAMBA (vs. 63% for the system) while Time deposits constituted 25% in 2014 (in line with that for the system at 25%).
- **Concentration and asset quality:** The performing financing portfolio is well diversified for SAMBA. Four sectors (Commerce, Manufacturing, Consumer and Transport & Communication) collectively constitute only 63% of the loan portfolio. Total loan book grew a 9.4% YoY in 2014 to SAR 124bn. Non-performing financing (NPFs) facilities to gross financing stood at 1.31% (2013: 1.73%), with basic provision coverage at 161% (2013: 146%).
- **Segmental information:** Corporate and Treasury account for the majority of the bank's asset base, with 47% and 36% share, respectively. In 2014, the corporate division accounted for 40% of the group's profits and generated RoA of 2.0%.

**Credit by Sector 2014**



**Fee Income 2014**



Source: Company Reports, SFC

## Cost of Funds Uptick Imminent

SHB has delivered above average loan growth versus peers over the past few years, and the trend continued into 1H2015 and likely to continue to 2018F. The bank has made significant in-roads into retail and mid-market commercial. This should support margins as cost of funds pressures appear. Initiating with a HOLD, target price of SAR34. SHB's demand deposits comprise only 40% of total deposits (5-year average: 41%; only bank with 1H2015 ratio below 5-year average) and its LDR stands at 85% (only Alinma higher) suggesting that cost of funds should begin to rise from 4Q2015, preceding gains from higher interest rates on assets. Earning assets are very liquid, 83% and 88% (2014 accounts) of its loan and investment books mature within 1 year respectively. Higher rates should feed into asset yields materially in 1H2016, bolstered by expansion of its A-L mismatch.

**Low retail loan footprint and faster commercial lending in 1H2015 augurs well as rates rise:** Retail comprises only 18% of SHB's loan book. This combined with a very liquid investment portfolio should allow SHB to re-price earning assets at a pace above peers as rate hikes by the US Fed feed into SAIBOR. Maintaining its high LDR ratio whilst expanding A-L mismatch will be key to boosting yields and profitability. The operational gearing is bolstered by an efficient cost structure (Cost-to-income 2014A: 32% versus 36% for the sector) that is only bettered by SABB and Samba.

**Low core demand deposits and high LDR should result in cost of funds picking up before yields as rates rise:** SHB has a relatively weak demand deposit base, which combined with a high LDR ratio, leads to a weak competitive position as it competes for time deposits at the end of the quarter to meet regulatory requirements. We believe its cost of funds has bottomed-out in 1H2015, and should trend higher from here.

**Significant improvement seen in mobilizing liabilities and generating fee income:** As of 1H2015, SHB accounted for 4% of sector deposits despite accounting for only 3% of the branches. The bank has seen significant improvement in its liability mobilizing where deposits per branch have improved from SAR946 mln in 2010 to SAR1.4bln and SAR1.5bln in 2014 and 1H2015 respectively. Its demand deposits per branch are in line with the sector (2014A: SAR545 mln), but significantly lag SABB and Samba. The challenge going forward will be to translate its growing retail franchise into higher sustainable demand deposits. The bank leads the market in corporate finance and advisory fees, where fee income constitutes 38% of revenue in 2014 versus 34% in 2010. However, there is significant scope for improvement in payment, remittance, loan and insurance fees.

**Managing credit risk will be challenging, and uncertainty regarding divestment by RFS (RBS, Fortis, Santander) consortium will weigh on valuation:** The strong growth in lending over the past few years, particularly expanding share of SME and retail, in a 'lower-for-longer' oil price environment could lead to an uptick in NPLs and cost of risk. Thus far, NPL accretion is muted where 1H2015 NPLs have ticked up 2.6% in the last 6 months, versus 3.7% for sector and the strong accretion seen in banks such as RIBL and BJAZ.

**SHB at a PBV of 1.4x (2016F) in line with the sector:** The bank has outperformed the sector by 8ppt Y/Y, while trading in line on YTD. It trades at par with our Warranted Equity Valuation of SAR34, using 17% sustainable ROE, 5% growth rate and 12.8% cost of equity.

### Rating Summary

Recommendation	Hold
12-Month Target price (SAR)	34.0
Upside/(Downside)	2.1%

### Stock Details

Last Close Price	SAR	33.3
Market Capitalization	SAR mln	19,032
Shares Outstanding	mln	571.5
52-Week High	SAR	49.1
52-Week Low	SAR	31.8
Price Change (YTD)	%	(8.7%)
12-Mth ADTV	mln	0.2
EPS 2015E	SAR	3.69
Reuters / Bloomberg	1040.SE	SHB AB

Source: Tadawul

### Key Shareholders (%)

ABN Amro	40%
Olayan Saudi Invest Co.	22%
GOSI	11%
Others	28%

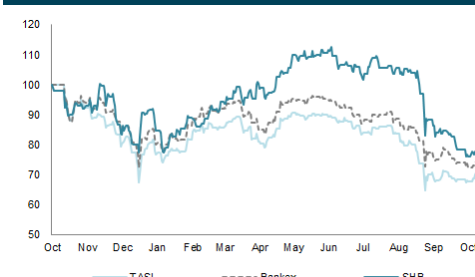
Source: Tadawul

### Price Multiples

	2015E	2016E
P / E	8.7x	8.2x
P / B	1.6x	1.4x
Dividend Yield (%)	4.0%	4.9%

Source: SFC

### 1-Year Share Performance



Source: Bloomberg



## Summary Financials

All figures are in SAR mn

Summary Financials	2013	2014	2015E	2016E	2017E	2018E
<b>INCOME STATEMENT</b>						
Special commission income	2,096	2,486	2,853	3,391	4,116	4,776
Special commission expense	(472)	(520)	(535)	(851)	(1,372)	(1,815)
<b>Net special commission income</b>	<b>1,624</b>	<b>1,966</b>	<b>2,317</b>	<b>2,539</b>	<b>2,744</b>	<b>2,962</b>
y-o-y growth %	18.3%	21.1%	17.9%	9.6%	8.1%	7.9%
Other Income	992	1,216	1,393	1,499	1,599	1,716
<b>Total operating income</b>	<b>2,616</b>	<b>3,182</b>	<b>3,710</b>	<b>4,038</b>	<b>4,343</b>	<b>4,678</b>
y-o-y growth %	17.9%	21.6%	16.6%	8.8%	7.5%	7.7%
Expenses	(895)	(1,011)	(1,133)	(1,185)	(1,278)	(1,382)
<b>Pre-provision Profit</b>	<b>1,721</b>	<b>2,171</b>	<b>2,577</b>	<b>2,853</b>	<b>3,065</b>	<b>3,296</b>
Charge for impairment on financing	(218)	(346)	(402)	(542)	(730)	(767)
<b>Total operating expenses</b>	<b>1,114</b>	<b>1,357</b>	<b>1,534</b>	<b>1,727</b>	<b>2,008</b>	<b>2,149</b>
Cost-to-income ratio % (Excl. provisions)	34.2%	31.8%	30.5%	29.3%	29.4%	29.5%
Associate Income/Others	(1)	(4)	5	7	9	13
<b>Net Income</b>	<b>1,502</b>	<b>1,821</b>	<b>2,181</b>	<b>2,318</b>	<b>2,344</b>	<b>2,542</b>
<b>BALANCE SHEET</b>						
<b>Assets</b>						
Cash and balances with SAMA	6,663	9,523	10,800	10,494	10,561	9,655
Due from banks and other financial institutions	1,751	539	566	594	624	655
Investments	16,849	18,784	21,414	23,983	26,382	29,020
Loans and advances, net	53,652	65,148	74,238	79,602	84,030	89,624
Investment in associates	17	13	18	24	34	46
Property and equipment, net	505	526	560	596	635	677
Other assets, net	1,031	2,086	2,253	2,433	2,628	2,838
<b>Total Assets</b>	<b>80,468</b>	<b>96,619</b>	<b>109,847</b>	<b>117,727</b>	<b>124,892</b>	<b>132,515</b>
<b>Liabilities</b>						
Due to banks and other financial institutions	2,494	3,055	3,238	3,432	3,638	3,856
Customers' deposits	61,875	76,814	88,336	94,519	100,191	106,202
Other liabilities	2,072	2,109	2,214	2,325	2,441	2,563
<b>Total Liabilities</b>	<b>71,067</b>	<b>85,877</b>	<b>97,688</b>	<b>104,177</b>	<b>110,170</b>	<b>116,522</b>
<b>Total Equity</b>	<b>9,401</b>	<b>10,742</b>	<b>12,159</b>	<b>13,550</b>	<b>14,722</b>	<b>15,993</b>
<b>Total Liabilities and Equity</b>	<b>80,468</b>	<b>96,619</b>	<b>109,847</b>	<b>117,727</b>	<b>124,892</b>	<b>132,515</b>
<b>Key Ratio</b>						
P/E	12.7	10.5	8.7	8.2	8.1	7.5
P/BV	2.0	1.8	1.6	1.4	1.3	1.2
P/PPP	11.1	8.8	7.4	6.7	6.2	5.8
ROAE	17.0%	18.1%	19.0%	18.0%	16.6%	16.6%
ROAA	2.0%	2.1%	2.1%	2.0%	1.9%	2.0%
Dividend Yield	1.8%	1.5%	4.0%	4.9%	6.2%	6.7%
Net Income growth	20%	21%	20%	6%	1%	8%
Total Income growth	18%	22%	17%	9%	8%	8%
NPL/Gross Financing	1.36%	1.27%	1.20%	1.35%	1.55%	1.70%
Equity/Total Assets	11.7%	11.1%	11.1%	11.5%	11.8%	12.1%
Tier-1 Capital	12.4%	11.9%	11.8%	12.2%	12.5%	12.8%

Source: Company Reports, Bloomberg

## Investment Thesis

**Low retail loan footprint and faster commercial lending in 1H2015 augurs well as rates rise:** Retail comprises only 18% of SHB's loan book. This combined with a very liquid investment portfolio should allow SHB to re-price earning assets at a pace above peers as rate hikes by the US Fed feed into SAIBOR. Maintaining its high LDR ratio whilst expanding A-L mismatch, will be key to boosting yields and profitability. The operational gearing is bolstered by an efficient cost structure where cost-to-income (2014A) stands at 32% versus 36% for the sector, and only bettered by SABB and Samba amongst peer banks.

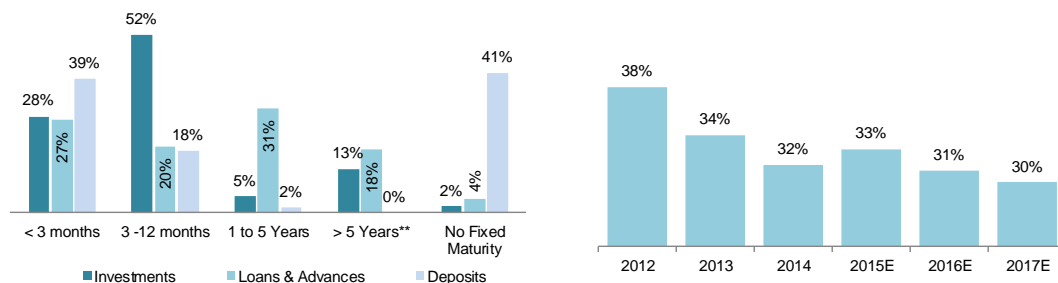
SHB's loan portfolio maturity is slightly longer than its peer group with 47% of loans maturing within a year. However, the portfolio is heavily skewed towards commercial lending, where the longer tenor lending should be at floating rate. We however remain concerned about the tight pricing in the market in term and credit risk premiums over the recent past. We expect SHB to get limited traction from SAIBOR rises, and wider premiums for term and credit risk.

In its investment portfolio, SHB maintains a very short-dated book, with 80% of investments maturing within a year. We believe that SHB over the next few years can improve yields substantially from expanding the A-L mismatch on its investment portfolio.

SHB also maintains a lean cost structure, where cost-to-income stood at 32% in 2014A. This efficient structure increases its operational gearing, thus more of its gains in NIM should flow to the bottom line. We expect the cost-to-income ratio to improve to 30% by 2017F.

### Maturity Profile - Loan, Customer Deposits & Investments

### Cost-Income (ex-impairment) Trend



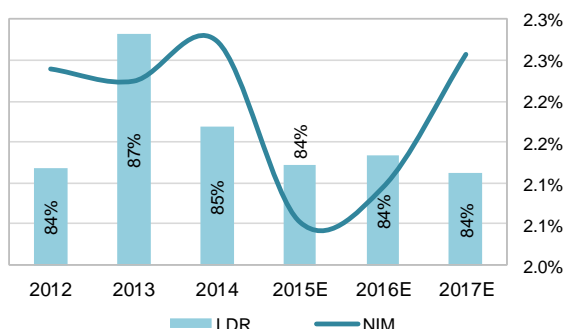
Source: Company Reports, SFC

**Low core demand deposits and high LDR should result in cost of funds picking up before yields as rates rise:** SHB has a relatively weak core demand deposit base, which combined with a high LDR ratio, leads to a weak competitive position as it competes for time deposits at the end of the quarter to meet regulatory requirements. We believe that its cost of funds have bottomed-out in 1H2015, should trend higher from here.

SHB is the only bank with demand deposits as a percentage of total below the 5YR average in 1H2015. The sector in general has seen a sharp increase in this ratio over the recent past, and most banks have been able to take advantage. As the opportunity cost of holding demand deposits rises with higher rates, this may present a challenge for SHB. It will also see competition from government bonds.

Combined with a high LDR ratio, close to the regulatory cap of 85%, SHB will need to seek out more expensive deposits. This was evident in Q2 numbers, and could become more pronounced in the last 2 quarters of 2015. SHB is likely to be amongst the first banks to see accretion in their cost of funds, whilst meaningful yield pick-up in earnings assets only likely to come through from 2016 onwards.

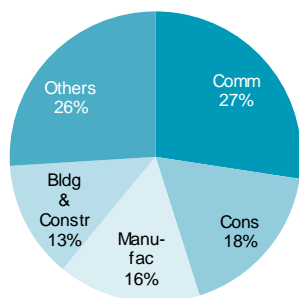
### Net Loans / Customer Deposits and NIM



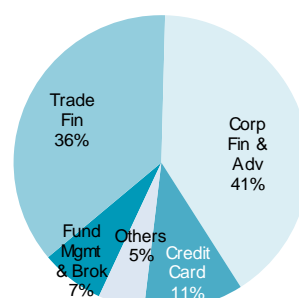
Source: Company Reports, SFC

**Significant improvement seen in mobilizing liabilities and generating fee income:** As of 1H2015, SHB accounted for 4% of sector deposits despite accounting for only 3% of the branches. The bank has seen significant improvement in its liability mobilizing where deposits per branch have improved from SAR946 mln in 2010 to SAR1.4bln and SAR1.5bln in 2014 and 1H2015 respectively. Demand deposits per branch are in line with the sector (2014A: SAR545 mln), but significantly lag SABB and Samba. The challenge going forward will be to translate the growing retail franchise into higher sustainable demand deposits. The bank leads the market in corporate finance and advisory fees, where fee income constitutes 41% of revenue in 2014 versus 34% in 2010. However, there is significant scope for improvement in payment, remittance, loan and insurance fees.

### Credit by Sector 2014



### Fee Income 2014



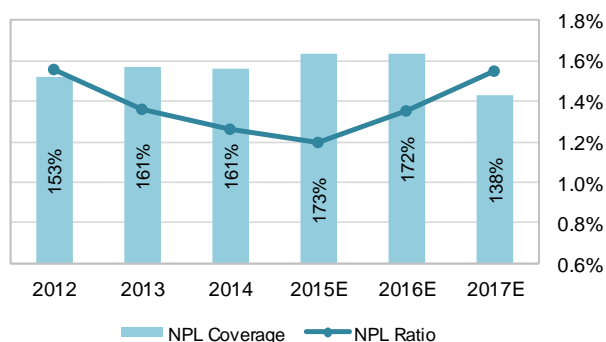
Source: Company Reports, SFC

**Managing credit risk may be challenging, and uncertainty regarding divestment by RFS (RBS, Fortis, and Santander) consortium will weigh on valuations:** The strong growth in lending over the past few years, particularly expanding share of SME and retail, in a 'lower-for-longer' oil price environment could lead to an uptick in NPLs and cost of risk. Thus far, NPL accretion is muted where 1H2015 NPLs have ticked up 2.6% in the last 6 months, versus 3.7% for sector and the strong accretion seen in banks such as RIBL and BJAZ.

We are projecting a relatively muted accretion in NPLs over our forecast period, however it would be prudent to note that SHB recorded significantly higher NPL ratio prior to the relatively benign NPL environment seen in the economy in the last few years. Following the global financial crisis, SHB's NPL ratio ticked up to c.6%. Building and construction comprise 13% of the bank's net financing portfolio, which could be impacted by lower government expenditure. The bank has significantly reduced exposure to manufacturing, which was a major NPL contributor in 2009.

Our forecast is predicated on a stronger regulation, credit risk management and the ability of the government to use significant foreign assets to smooth the impact of low oil prices on the economy.

### Non-performing Loans Coverage and Ratio



Source: Company Reports, SFC

### Valuation Sensitivity

It trades at par with our Warranted Equity Valuation of SAR34, using 17% sustainable ROE, 5% growth rate and 12.8% cost of equity.

### Target Price sensitivity to sustainable ROE and growth rate assumptions

		Growth Rate				
		3.0%	4.0%	5.0%	6.0%	7.0%
Sustainable ROE	15.0%	27.6	28.1	28.8	29.6	30.8
	16.0%	29.7	30.4	31.4	32.6	34.3
	17.0%	31.7	32.7	34.0	35.6	37.8
	18.0%	33.8	35.1	36.6	38.6	41.4
	19.0%	35.9	37.4	39.2	41.6	44.9

Source: Company Reports, Tadawul, SFC

### Company Overview

Founded in 1926, Saudi Hollandi Bank (SHB) is the first bank to be established in the Kingdom. With headquarters in Riyadh, SHB is the eighth largest bank in the country by assets (as of 2Q15 total assets of SAR 103bn; 4.7% market share). The bank operates 55 branches, 382 ATMs and 9,150 POS terminals across KSA. SHB employees 1,737 staff headed by Dr. Bernd van Linder. Approximately 32% of the shares are held by two Saudi Arabian entities: Olayan Saudi Investing Co. (22%) and the General Organization for Social Insurance (GOSI, 11%). ABN Amro (recently acquired by a consortium of European banks) owns 40% stake in SHB.

In 2007, a consortium of banks consisting of the Royal Bank of Scotland (RBS), Banco Santander and Fortis acquired its majority shareholder ABN AMRO Bank. As a result, 40% shareholding in SHB was transferred to the consortium of banks. Key business segments include: Corporate banking, Personal banking, Treasury and Investment Banking Services. Brokerage, asset management, and investment banking services are provided through a wholly owned subsidiary - Saudi Hollandi Capital.

- **Geographic focus:** SHB's operations are primarily focused in KSA (98% of total assets).
- **Income composition:** Net special commission income (NSCI, +21% YoY in 2014) accounted for 62% of total bank income while fee income (+18% YoY) constituted 27% of total income. Dividend, exchange, trading income and others accounted for the rest of bank's total income in 2014.
- **Balance sheet decomposition:** Liquid assets (10%), investments (19%), and net financing (67%) constituted the primary share of SHB's balance sheet on the assets side, according to its most recent annual financial disclosure. In contrast, total liabilities (73% of total assets) comprise primarily of customer deposits (SAR 77bn or 80% of total liabilities). Demand deposits account for 39% of total

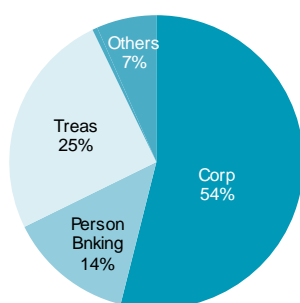




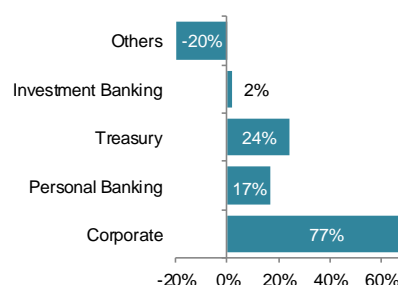
customer deposits at SHB (vs. 63% for the system) while time deposits constituted 59% in 2014 (vs. 25% for the system).

- **Concentration and asset quality:** The performing financing portfolio, primarily concentrated in four sectors (Commerce, Consumer, Manufacturing and Building & Construction collectively constitute 74% of the financing portfolio). Total loan book grew 22% YoY in 2014. Non-performing financing (NPFs) facilities to gross financing stood at 1.3% (2013: 1.4%), with basic provision coverage at 161% (2013: 162%).
- **Segmental information:** Corporate Banking and Treasury account for the majority of the bank's asset base, with 54% and 25% share, respectively. In 2014, the Corporate Banking division accounted for 77% of the group's profits and generated RoA of 2.7%. On the other hand, Treasury accounted for 24% of the group's profits and generated RoA of 1.8%.

**Assets by Segment 2014**



**Earnings Mix by Segment 2014**



Source: Company Reports, SFC



## Poor ROAE Outlook

With greater corporate focus than most peers, SAIB has been diversifying into retail and SME segments but may face competitive challenges in a tougher economic environment. Initiate with a SELL Rating, target price SAR16. Combined with a low core deposit base (5YR avg. demand deposits to total: 23%), which has improved of late (1H2015: 30%) in line with sector, SAIB is unlikely to see significant accretion in NIM as interest rates rise. Cost of funds likely to tick up from 3Q2015. Yield on average investments stood at 2.1% in 2014, thus government bonds do not add significant value. NPL accretion of 14.3% in 1H2015 versus 2014 is also a concern.

**Cost of funds could move higher in 4Q2015:** SAIB is one of the banks we have identified at risk of significant increment in cost of funds from 4Q2015. Low demand deposit base combined with a LDR of 81% puts it in a weak position as the bank seeks quarter closing deposits, particularly as it will now also compete with government bond issuance. That said, the bank is efficient in generating deposits from its branch network (1H2015: SAR1.5 bn per branch) and has been successful in raising demand deposits per branch from SAR106 mln in 2010 to SAR409 mln in 2014. It has a 4.1% share in deposits versus a 2.5% share in branches. If the bank is able to expand its retail franchise, it could push demand mobilization higher.

**Relatively long-dated investment portfolio, yielding 2.1%:** SAIB runs a relatively long-dated investment portfolio, which yielded 2.1% in 2014. Whilst we see no appreciable advantage to yields from cycling of investments into government bonds, SAIB would benefit from a higher risk-adjusted return. Further, as SAIB is relatively more dependent than peers to treasury income, the government bonds will be a welcome destination for liquidity. As the rate cycle matures in 2017 and 2018, we could see NIM ticking higher.

**Need for expansion in Retail and SME to support higher NIM:** The bank has been shifting in this direction, leading to an estimated 26 bps increment in simple yield on earning assets in 1H2015, however this needs to be much stronger in our opinion to compensate for higher risk. Expansion in the retail and SME market, with relatively weaker infrastructure and the tougher economic environment could be a risky strategy, without bolstering demand deposit mobilization franchise.

**Some concern at high percentage accretion in NPLs:** SAIB has seen NPLs rise by 14.3% in the first half of this year, much higher than the sector (3.7%) and in line with small / medium lenders. Whilst, an uptick in NPLs is expected after a sustained period of decline, but with expected drop in government spending, we are concerned that this may significantly impact cost of risk for SAIB going forward.

**SAIB trades at 1.0x 2016F BV, at a steep discount to the sector PBV of 1.4x:** Given its poor RoAE outlook (averaging 10% over forecast period), we believe a steeper discount is warranted. At our target price, SAIB would trade at 0.8x 2016F BV. The stock has traded in line with the sector Y/Y and underperformed by 6ppt YTD. We have valued the bank on Warranted Equity Valuation using 10% sustainable ROE, 5% growth rate and 11.3% cost of equity.

### Rating Summary

<b>Recommendation</b>	<b>Sell</b>
<b>12-Month Target price (SAR)</b>	<b>16.0</b>
<b>Upside/(Downside)</b>	<b>(21.4%)</b>

### Stock Details

Last Close Price	SAR	20.4
Market Capitalization	SAR mln	13,228
Shares Outstanding	mln	650
52-Week High	SAR	28.9
52-Week Low	SAR	19.2
Price Change (YTD)	%	(12.5%)
12-Mth ADTV	mln	0.6
EPS 2015E	SAR	2.31
Reuters / Bloomberg	1030.SE	SIBC AB

Source: Tadawul

### Key Shareholders (%)

Public Pension Agency	17%
GOSI	17%
Saudi Oger Ltd.	9%
Others	57%

Source: Tadawul

### Price Multiples

	2015E	2016E
P / E	8.8x	10.5x
P / B	1.0x	1.0x
Dividend Yield (%)	4.5%	4.3%

Source: SFC

### 1-Year Share Performance



Source: Bloomberg



## Summary Financials

All figures are in SAR mn

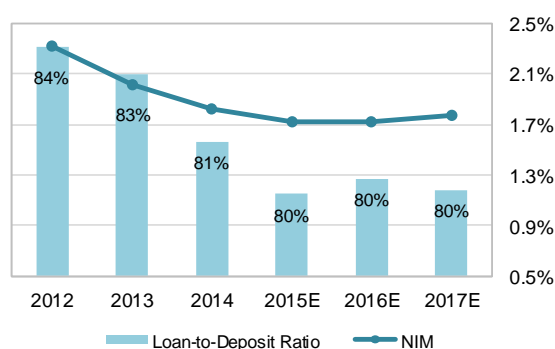
Summary Financials	2013	2014	2015E	2016E	2017E	2018E
<b>INCOME STATEMENT</b>						
Special commission income	1,884	2,166	2,384	2,720	3,326	3,822
Special commission expense	(519)	(626)	(670)	(975)	(1,325)	(1,704)
<b>Net special commission income</b>	<b>1,365</b>	<b>1,540</b>	<b>1,714</b>	<b>1,745</b>	<b>2,001</b>	<b>2,118</b>
y-o-y growth %	9.9%	12.8%	11.3%	1.8%	14.7%	5.9%
Other Income	652	992	851	794	834	751
<b>Total operating income</b>	<b>2,017</b>	<b>2,531</b>	<b>2,564</b>	<b>2,539</b>	<b>2,835</b>	<b>2,869</b>
y-o-y growth %	17.1%	25.5%	1.3%	-1.0%	11.7%	1.2%
Expenses	(762)	(943)	(1,054)	(1,115)	(1,181)	(1,250)
<b>Pre-provision Profit</b>	<b>1,255</b>	<b>1,588</b>	<b>1,511</b>	<b>1,423</b>	<b>1,654</b>	<b>1,619</b>
Charge for impairment on financing	(129)	(231)	(155)	(326)	(411)	(574)
<b>Total operating expenses</b>	<b>891</b>	<b>1,174</b>	<b>1,209</b>	<b>1,441</b>	<b>1,592</b>	<b>1,824</b>
Cost-to-income ratio % (Excl. provisions)	37.8%	37.3%	41.1%	43.9%	41.7%	43.6%
Associate Income/Others	161	80	148	159	185	214
<b>Net Income</b>	<b>1,287</b>	<b>1,436</b>	<b>1,504</b>	<b>1,257</b>	<b>1,427</b>	<b>1,259</b>
<b>BALANCE SHEET</b>						
<b>Assets</b>						
Cash and balances with SAMA	6,307	9,128	8,679	7,223	6,726	6,125
Due from banks and other financial institutions	5,574	879	1,231	1,330	1,436	1,551
Investments	17,696	22,397	25,085	27,593	29,800	32,185
Loans and advances, net	47,567	57,473	57,984	61,252	64,038	66,835
Investment in associates	1,071	846	994	1,154	1,338	1,552
Property and equipment, net	873	910	926	935	951	961
Other assets, net	1,408	1,994	2,153	2,326	2,512	2,713
<b>Total Assets</b>	<b>80,495</b>	<b>93,626</b>	<b>97,053</b>	<b>101,812</b>	<b>106,800</b>	<b>111,922</b>
<b>Liabilities</b>						
Due to banks and other financial institutions	9,828	5,002	5,302	5,620	5,958	6,315
Customers' deposits	57,044	70,733	72,855	76,498	80,323	84,339
Other liabilities	1,371	2,039	2,141	2,248	2,360	2,478
<b>Total Liabilities</b>	<b>70,243</b>	<b>81,774</b>	<b>84,298</b>	<b>88,366</b>	<b>92,641</b>	<b>97,132</b>
<b>Total Equity</b>	<b>10,253</b>	<b>11,852</b>	<b>12,755</b>	<b>13,446</b>	<b>14,159</b>	<b>14,789</b>
<b>Total Liabilities and Equity</b>	<b>80,495</b>	<b>93,626</b>	<b>97,053</b>	<b>101,812</b>	<b>106,800</b>	<b>111,922</b>
<b>Key Ratio</b>						
P/E	10.3	9.2	8.8	10.5	9.3	10.5
P/BV	1.3	1.1	1.0	1.0	0.9	0.9
P/PPP	10.5	8.3	8.8	9.3	8.0	8.2
ROAE	13.1%	13.0%	12.2%	9.6%	10.3%	8.7%
ROAA	1.8%	1.6%	1.6%	1.3%	1.4%	1.2%
Dividend Yield	3.1%	3.6%	4.5%	4.3%	5.4%	4.8%
Net Income growth	41%	12%	5%	-16%	14%	-12%
Total Income growth	17%	26%	1%	-1%	12%	1%
NPL/Gross Financing	0.82%	0.75%	0.75%	1.05%	1.25%	1.45%
Equity/Total Assets	12.7%	12.7%	13.1%	13.2%	13.3%	13.2%
Tier-1 Capital	14.5%	14.1%	14.6%	14.7%	15.1%	15.0%

Source: Company Reports, Bloomberg

## Investment Thesis

**Cost of funds could move higher in 4Q2015:** SAIB is one of the banks we have identified at risk of significant increment in cost of funds from 4Q2015. Its low demand deposit base combined with a LDR of 81% puts it in a weak position as the bank seeks quarter closing deposits, particularly as it will now also compete with government bond issuance. That said, the bank is efficient in generating deposits from its branch network (1H2015: SAR1.5 bn per branch) and has been successful in raising its demand deposits per branch from SAR106 mln in 2010 to SAR409 mln in 2014. It has a 4.1% share in deposits versus a 2.5% share in branches. If the bank is able to expand its retail franchise, it could push demand deposit mobilization higher.

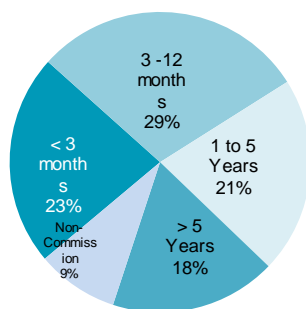
### LDR and Net Interest Margin



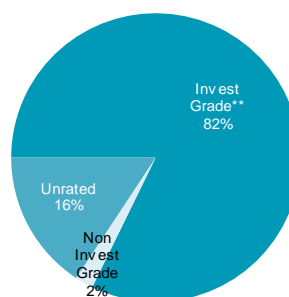
Source: Company Reports, SFC

**Relatively long-dated investment portfolio, yielding 2.1%:** SAIB runs a relatively long-dated investment portfolio, which yielded 2.1% in 2014. Whilst we see no appreciable advantage to yields from cycling of investments into government bonds, SAIB would benefit from a higher risk-adjusted return. Furthermore, as SAIB is relatively more dependent than peers to treasury income, the government bonds will be a welcome destination for liquidity. As the rate cycle matures in 2017 and 2018, we could see NIM ticking higher.

### Investment by Maturity (Market Risk)



### Credit Quality of Investments

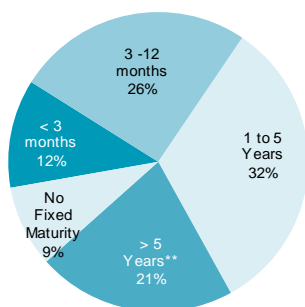


\*\* External ratings agency methodology

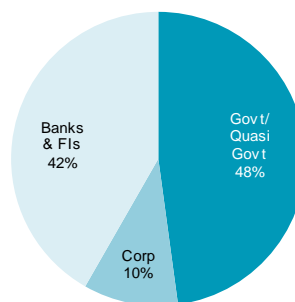
Source: Company Reports, SFC



#### Investment by Maturity (Liquidity)



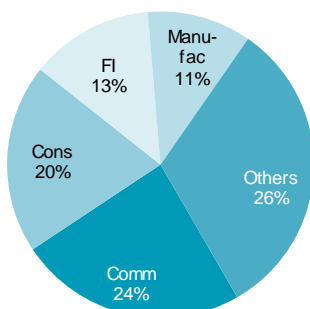
#### Investments by counter-party



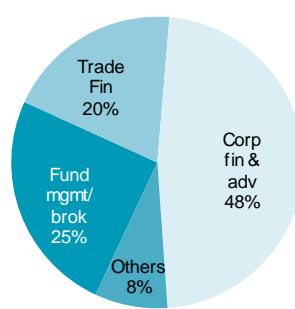
Source: Company Reports, SFC

**Need to further expand in Retail and SME to support higher NIM:** The bank has been shifting in this direction, leading to an estimated 26 bps increment in simple yield on earning assets in 1H2015, however this needs to be much stronger in our opinion to compensate for higher risk. As competition in the sector eases due to tighter liquidity, leading to an expansion in term and credit risk premiums, the bank should see the benefits from higher yields. That said, expansion in the retail and SME market with relatively weaker infrastructure and the tougher economic environment could be a risky strategy. As noted above, the expansion into retail and SME must also yield advantages in mobilization of liabilities, particularly in capturing higher stable demand deposits.

#### Credit by Sector 2014



#### Fee Income 2014

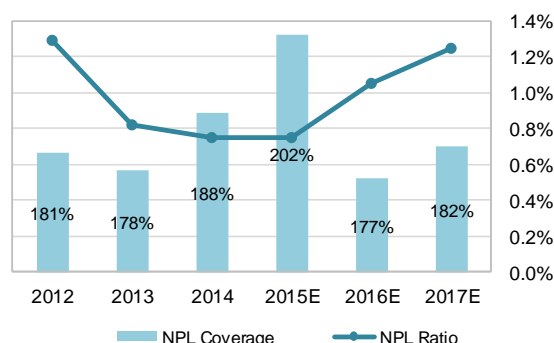


Source: Company Reports, Tadawul, SFC

**Some concern at high percentage accretion in NPLs:** SAIB has seen NPLs rise by 14.3% in the first half of this year, much higher than the sector (3.7%) and in line with small / medium players. Whilst, an uptick in NPLs is expected after a sustained period of decline, but with oil prices at 8-year lows we are somewhat concerned that this may impact cost of risk for banks such as SAIB significantly going forward. We are forecasting the bank's NPL ratio to increase to 1.3% by 2017F, up 60 bps from 2014. Should oil prices continue to remain under pressure, and correspondingly a sharp contraction is seen in government spending, we could see NPLs tick up higher than current forecasts.

Following the global financial crisis in 2008, SAIB saw NPLs tick up to c.6% of loans, whilst pre-2008 SAIB's average NPL ratio was c.1%. Our forecasts are predicated on a stronger regulatory environment, stronger risk management, and the ability of the government to utilize foreign assets to smooth reduction in government expenditure in a 'lower-for-longer' oil price environment.

### NPL Coverage and Ratio



Source: Company Reports, Tadawul, SFC

### Valuation Sensitivity

We have valued the bank on Warranted Equity Valuation using 10% sustainable ROE, 5% growth rate and 11.3% cost of equity. At our target price, SAIB would trade at 0.8x 2016F BV. The stock has traded in line with the sector Y/Y and underperformed by 6ppt YTD.

### Target Price sensitivity to sustainable ROE and growth rate assumptions

	Sustainable ROE	Growth Rate				
		3.0%	4.0%	5.0%	6.0%	7.0%
	8.0%	12.6	11.6	10.3	8.5	5.9
	9.0%	14.7	14.0	13.1	11.9	10.1
	10.0%	16.9	16.5	16.0	15.3	14.3
	11.0%	19.1	19.0	18.9	18.7	18.4
	12.0%	21.3	21.5	21.7	22.1	22.6

Source: Company Reports, Tadawul, SFC

### Company Overview

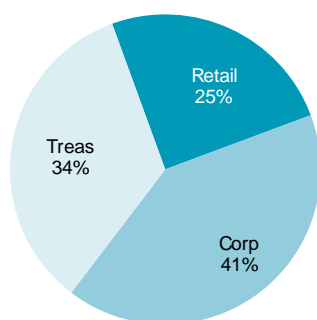
Saudi Investment Bank (SAIB) was established in 1976 with head office in Riyadh. SAIB is currently the ninth largest bank in the Kingdom by assets (as of 2Q15 total assets of SAR 93bn; 4.3% market share). The bank operated 48 branches, 442 ATMs and 2,819 PoS terminals across the country at end-2014. SAIB is headed by CEO Musa'ed Al Mineefi and Chairman of BoD Abdullah Jum'ah. As of September 20, 2015, the bank had a market capitalization of SAR 13.1bn (c.USD 3.5bn). Besides, General Organization for Social Insurance (GOSI, 17%) and Public Pension Agency (17% stake), the shares are held by The National Commercial Bank (7%), Saudi Oger (9%) and JP Morgan International (7.5%).

Main business segments include: Retail, Corporate, Investment Banking/Brokerage Services and Treasury. SAIB has three JV associate companies – 1) AMEX (Saudi Arabia) Ltd. (credit cards/ other American Express products), 2) Saudi Orix Leasing Co. (lease-financing services) and 3) Amlak International for Finance and Real Estate Development Co (real estate finance products and services). The Bank holds 19% stake in the insurance venture Mediterranean Gulf Insurance and Reinsurance Co. (MEDGULF), classified as "Available for Sale" investments.

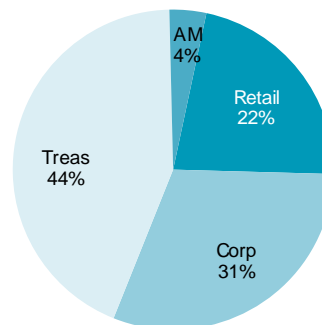
- **Geographic focus:** Saudi Investment Bank's operations are primarily focused in KSA (89% of total assets).
- **Income composition:** Net special commission income (NSCI, +13% YoY in 2014) accounted for 61% of total bank income while fee income (+23% YoY) constituted 19% of total income. Trading, exchange income and others accounted for the rest of bank's total income in 2014.

- **Balance sheet decomposition:** Liquid assets (11%), investments (24%), and net financing (61%) constituted the primary share of SAIB's balance sheet on the assets side, according to its most recent annual financial disclosure. In contrast, total liabilities (87% of total assets) comprise primarily of customer deposits (SAR 71bn or 86% of total liabilities). Demand deposits account for 28% of total customer deposits at SAIB (vs. 63% for the system) while time deposits constituted 70% in 2014 (vs. 25% for the system).
- **Concentration and asset quality:** The performing financing portfolio is primarily concentrated in four sectors (Commerce, Consumer, Financial Institutions and Manufacturing collectively constitute 68% of the loan portfolio). Total loan book grew a solid 21% YoY in 2014. Non-performing financing (NPFs) facilities to gross financing stood at 0.75% (2013: 0.82%), with basic provision coverage at 189% (2013: 178%).
- **Segmental information:** Corporate Banking and Treasury account for the majority of the bank's asset base, with 41% and 34% share, respectively. In 2014, Treasury accounted for 44% of the group's profits and generated RoA of 2.0%. On the other hand, Corporate Banking division accounted for 31% of the group's profits and generated RoA of 1.1%.

**Assets by Segment 2014**



**Earnings Mix by Segment 2014**



Source: Company Reports, SFC





## Research and Advisory Department

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### Rating Framework

#### **BUY**

Shares of company under coverage in this report are expected to outperform relative to the sector or the broader market.

#### **HOLD**

Shares of company under coverage in this report are expected to perform inline with the sector or the broader market.

#### **SELL**

Shares of company under coverage in this report are expected to underperform relative to the sector or the broader market.

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