Middle East Saudi Arabia
Banking

Deutsche Bank

21 January 2009

Saudi Banks

Resilience in adversity

Rahul Shah
Research Analyst
(971) 4 4283 261
rahul.shah@db.com

Initiating on Saudi banks - a good value sector facing negative trends
We are initiating coverage of the Saudi Banking sector. We rate three stocks a Buy (Arab National Bank, TP SAR42.60, Riyad Bank, TP SAR25.60, and Saudi Investment Bank, TP SAR20.40), four stocks a Hold (Banque Saudi Fransi, SABB, Samba Financial Group, and Saudi Hollandi Bank) and three stocks a Sell (Al Rajhi Bank, TP SAR49.50, Bank Albilad, TP SAR9.10, and Bank Aljazira, TP SAR10.90).

Cautious outlook
We believe sector volume growth is likely to slow sharply in 2009 and remain muted in 2010. Net special commission income margins are likely to decline, while credit impairment charges should rise sharply. We see earnings growth averaging 3-4% pa. Our 2010 forecasts are 24% below consensus.

Resilient profitability
Despite a deteriorating operating environment, the Saudi banks' high revenue generation capacity and low operating gearing suggests the sector will continue to add value for shareholders. We forecast a median sector ROE of 18.5% in 2010.

Measured risk profile
Saudi banks typically have limited exposure to loan categories (such as mortgages, construction, and credit cards) that have caused problems in developed markets. Their investment portfolios appear conservative, consisting largely of bonds issued by government entities and highly-rated corporates. Wholesale funding needs are also limited.

Attractively valued based on a target book multiple approach
We see selective good value in the sector. We compare the return on equity generated by the Saudi banks to our estimate of their cost of capital (in the 10.5%-12.5% range) to determine a fair price-to-book ratio for each stock. Our cost of capital is based on a risk free rate of 5% and equity risk premium of 7%. We also make adjustments to account for risk and capital strength differentials. Upside risks to our forecasts include the possibility that sector volume growth or interest rates are above our expectations. Downside risks include the possibility that loan quality or investment portfolio impairment is worse than forecast.

Investment strategy
Our view of deteriorating operating fundamentals leads us to favour stocks offering good value with limited risk. We believe banks attempting to significantly increase market share or re-position themselves are more likely to miscalculate risk or encounter competitive headwinds.

Top picks
We believe Arab National Bank will benefit from limited capital markets exposure and improved cross-selling to its large retail customer base. Riyad Bank's already extensive distribution network should allow the business to grow without significantly affecting costs. Saudi Investment Bank should benefit from any normalisation of returns from its investment portfolio and improvements in retail banking.

Coverage Change

Top picks	
Arab National Bank (1080.SE),SAR30.50	**Buy**
Saudi Investment Bank (1030.SE),SAR16.10	**Buy**
Riyad Bank (1010.SE),SAR19.90	**Buy**

Companies featured			
Arab National Bank (1080.SE),SAR30.50			**Buy**
	2007A	2008E	2009E
EPS Adjusted (SAR)	3.78	4.07	4.22
P/E Adjusted (x)	22.4	7.5	7.2
Saudi Investment Bank (1030.SE),SAR16.10			**Buy**
	2007A	2008E	2009E
EPS Adjusted (SAR)	1.83	1.75	1.77
P/E Adjusted (x)	–	9.2	9.1
Riyad Bank (1010.SE),SAR19.90			**Buy**
	2007A	2008E	2009E
EPS Adjusted (SAR)	2.52	2.02	2.17
P/E Adjusted (x)	19.6	9.9	9.2
Bank Albilad (1140.SE),SAR26.10			**Sell**
	2007A	2008E	2009E
EPS Adjusted (SAR)	0.24	0.55	0.65
P/E Adjusted (x)	166.6	47.7	39.9
BANK ALJAZIRA (1020.SE),SAR14.70			**Sell**
	2007A	2008E	2009E
EPS Adjusted (SAR)	2.69	1.27	1.01
P/E Adjusted (x)	18.3	11.6	14.6
Al Rajhi Bank (1120.SE),SAR54.75			**Sell**
	2007A	2008E	2009E
EPS Adjusted (SAR)	4.31	4.47	4.41
P/E Adjusted (x)	27.2	12.2	12.4
Samba Financial Group (1090.SE),SAR39.30			**Hold**
	2007A	2008E	2009E
EPS Adjusted (SAR)	5.36	5.14	5.05
P/E Adjusted (x)	22.4	7.6	7.8
Banque Saudi Fransi (1050.SE),SAR49.50			**Hold**
	2007A	2008E	2009E
EPS Adjusted (SAR)	4.82	5.04	5.27
P/E Adjusted (x)	24.0	9.8	9.4
Saudi Hollandi Bank (1040.SE),SAR41.90			**Hold**
	2007A	2008E	2009E
EPS Adjusted (SAR)	1.66	3.97	4.16
P/E Adjusted (x)	37.7	10.6	10.1
Saudi British Bank (1060.SE),SAR59.75			**Hold**
	2007A	2008E	2009E
EPS Adjusted (SAR)	4.34	4.98	5.39
P/E Adjusted (x)	20.6	12.0	11.1

Table of Contents

Executive summary

With this report we initiate research coverage on ten listed Saudi banking stocks.

Sector outlook

The Saudi banking sector enjoyed healthy volume growth in recent years as corporate lending expanded amid strong global growth and rising oil prices. These two drivers have reversed direction, and we now predict system volume growth will slow significantly in the coming months. This should have a negative impact on net special commission income, which generates two-thirds of sector revenues. We expect net special commission income to be further affected by the low interest rate environment, which should squeeze margins. Despite efforts by banks to improve cross-selling rates, we believe subdued customer demand will moderate fee income growth. Although a small contributor to total sector income, investment portfolio income could introduce some volatility to individual Saudi banks.

A healthy volume growth environment has encouraged the Saudi banks to relax cost discipline in recent years. Branch and ATM networks have expanded and headcount has risen. We believe cost growth will decline, but not as rapidly as revenues, resulting in a continued upward drift in sector cost-income ratios.

Good economic growth has improved banks' asset quality over the last few years. We expect this trend to reverse sharply, however, with the non-performing loans/loans ratio rising from the current 1.8% to 5% by end-2010. We expect loan loss provision charges to rise rapidly and provisions coverage to decline to 60-70%.

We expect earnings growth of just 3% in both 2009E and 2010E and return on equity to decline from 20% in 2008E to 16% in 2010E.

Investment summary

We believe the Saudi banking sector offers good value at current levels, although investor risk aversion remains high. In this context, we prefer companies that trade on attractive multiples and have a lower financial risk and strategic risk profile. Our investment recommendations are summarized below.

Arab National Bank (Buy, TP SAR42.60). We believe the company is likely to post above-average revenue growth, reflecting limited exposure to the equity brokerage business and scope for improved cross-selling. We value the stock based on a target book multiple approach using a cost of capital of 11.2%. Key investment risks include the bank's sizeable retail banking exposure, a sector we expect to see sluggish growth and inferior asset quality.

Riyad Bank (Buy, TP SAR25.60). We believe the company is likely to experience earnings per share growth averaging 6% over the next two years, above the sector average, as the income statement drag from the investment portfolio diminishes. We view the bank's large distribution network and strong capital base positively. We value the stock based on a target book multiple approach using a cost of capital of 10.9%. Key investment risks include the bank's sizeable investment portfolio, which is skewed towards equities, and its large unfunded commitments book, which could affect liquidity.

Saudi Investment Bank (Buy, TP SAR20.40). We believe the bank is likely to experience earnings growth of 20% pa through 2010, one of the highest in the sector, as returns from the bank's investment portfolio improve. We note that the bank is better capitalized than other corporate and investment banking-oriented entities, while derivatives and unfunded commitments are small. We value the shares based on a target book multiple approach using a cost of capital of 11.4%. Key risks include the bank's sizeable investment portfolio and the high proportion of loans (18%) to the real estate and construction sector.

Banque Saudi Fransi (Hold, TP SAR52.30). BSF volume growth should be above the sector average, reflecting its limited retail banking exposure, and its net special commission income margin should prove less susceptible to low interest rates. We also view the bank's high operating efficiency favourably. The bank's revenues are dependent on returns from its investment portfolio, which could introduce an element of volatility, while the bank also has large derivatives and unfunded commitments portfolios. Our target price is calculated using a target book multiple approach and a cost of capital of 10.7%.

SABB (Hold, TP SAR60.90). We believe SABB's relationship with its main shareholder HSBC confers many benefits in risk management and product and infrastructure development. We expect the bank to have stronger fee income growth than its peers, reflecting good cross-selling performance. However, we are concerned by the sharp decline in the bank's net special commission income margin in recent quarters and its lean capital structure. We use a target book multiple approach to value the shares based on a cost of capital of 10.7%.

Samba (Hold, TP SAR52.30). We believe the bank has the strongest corporate and investment banking franchise in the country, reflected by the company's high per capita revenues and low cost-income ratio. The bank also appears to have a high risk appetite, however, notably in relation to market risks (the bank has large financial investments and derivatives portfolios) and credit risk (high exposure to the construction and real estate sector and asset quality inferior to the sector). We value the shares on a target book multiple approach using a cost of capital of 10.5%.

Saudi Hollandi Bank (Hold, TP SAR39.30). We believe the bank's net special commission income will prove more resilient to the low interest rate environment than its peers', while fee income should benefit from less exposure to the declining equity brokerage industry. However, we believe SHB will continue to experience inferior asset quality toother banks in the sector, which may also draw attention to its relatively weak capital base. We value the shares using a target book multiple approach and a cost of capital of 11.6%.

Al Rajhi Bank (Sell, TP SAR49.50). We believe the bank's revenues are among the most sensitive to declining interest rates. We also believe retail banking (to which the bank is most exposed) will continue to experience sluggish growth, which could result in a shift to corporate customers, where Al Rajhi's competitive position is weaker. We believe the bank's asset quality has already started to decline, reflecting negative trends in the retail banking segment. Our target price is calculated using a target book multiple approach and a cost of capital of 12.7%. Risks to our view include the bank's funding and operating cost advantages, which could leave the franchise well-placed if system-wide price competition increases.

Bank Albilad (Sell, TP SAR9.10). We believe the bank's cost base is too high in relation to the current business volumes and that the likely slowdown in sector activity will hamper efforts to actively expand the franchise. On this basis, we see profitability remaining below the cost of capital, even after assuming good levels of market share accretion. We employ a target book multiple approach to value the shares based on a cost of capital of 12.1%. Risks to our view include the possibility that the bank could return excess capital to shareholders, actively shrink the cost base or consider a business combination with another domestic bank.

Bank Aljazira (Sell, TP SAR10.90). The bank is extremely sensitive to two negative revenue drivers: falling interest rates and a declining equity brokerage fee pool. Accordingly, we believe the bank will post the lowest revenue growth in the sector over the next two years, while profitability is also likely to be sub-par. Our valuation employs a target book multiple approach with a cost of capital of 12.4%. Risks to our investment view include the possibility of the bank announcing an aggressive cost-cutting programme or that management develops a successful growth niche for the business.

Valuation

For each of the banks in our research coverage universe, we compare our forecast return on equity against the estimated cost of equity to identify a target price book ratio for the shares. Our valuation model takes into account future dividend payments and also makes adjustments for capital strength and risk that are not directly captured in our earnings model.

We derive cost of equity using our estimate of the risk free rate (5%), equity risk premium (7%) and beta factor (which we base on historical observations). We conservatively assume no long-term growth in our valuation model. Our calculations are summarized in Figure 1:

Figure 1: Valuation summary

	Share Price SAR	Market Cap SARbn	2010 ROE	Cost of equity	Fair P/book ratio	2010 NAV	Capital Adjustment SAR	Qualitative Adjustment	12-month Target Price	Upside/ (Downside)	Investment Rating	P/E 2008E	Price/ Book Value 2008E	Dividend Yield 2008E	ROE 2008E
Al Rajhi Bank	55.75	88.1	20.1%	12.7%	159%	23.7	2.7	10%	49.5	-11%	Sell	12.5	3.03	3.2%	26.2%
Arab National Bank	31.10	21.3	17.7%	11.2%	158%	24.9	0.0		42.6	37%	Buy	8.2	1.62	4.0%	23.0%
Bank Albilad	25.00	7.8	7.0%	12.1%	57%	12.4	1.0	10%	9.1	-64%	Sell	45.7	1.34	0.2%	5.1%
Bank Aljazira	14.60	4.6	5.4%	12.4%	43%	18.5	1.6	10%	10.9	-25%	Sell	11.5	1.49	0.9%	7.8%
Banque Saudi Fransi	50.00	27.8	19.3%	10.7%	180%	29.3	0.0	-10%	52.3	5%	Hold	9.9	2.17	4.2%	23.4%
Riyad Bank	20.45	21.1	11.6%	10.9%	107%	20.0	1.1		25.6	25%	Buy	10.1	1.13	5.9%	13.9%
SABB	62.00	37.5	23.3%	10.7%	217%	25.4	-0.9		60.9	-2%	Hold	12.5	3.12	4.3%	26.7%
Samba	45.90	41.9	19.6%	10.5%	186%	27.7	0.0	-10%	52.3	14%	Hold	8.9	2.04	5.4%	24.3%
Saudi Hollandi Bank	39.10	10.4	19.4%	11.6%	167%	24.6	-1.5	-10%	39.3	1%	Hold	9.9	1.99	4.5%	21.6%
Saudi Investment Bank	15.350	7.6	11.4%	11.4%	100%	19.9	0.0		20.4	33%	Buy	10.2	0.93	1.3%	9.6%
Sector Average			15.5%	11.4%	135%			0.0%		-2.1%		1.92	1.89	3.4%	18.2%
Sector Median			18.5%	11.3%	164%			0.0%		2.8%		2.02	1.80	4.1%	22.3%

Source: Deutsche Bank, Zawya. Share prices as of market close, 17 January 2009

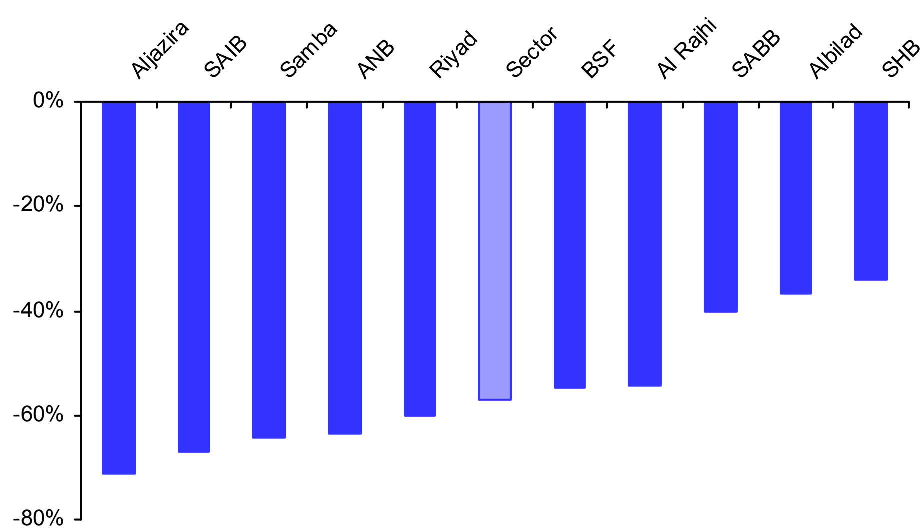
Note: to aid comparison between conventional and purely Shariah-compliant banks, we have used the term loans to incorporate customer investments in this report.

Investment strategy

We present investment views on individual stocks within our research universe in subsequent sections of this report. However, a number of overriding themes have emerged from our work:

Price declines have opened up attractive opportunities
The Saudi banks sector has declined by 55% over the past 12 months. We believe such aggressive price declines have opened up significant discrepancies between current share prices and their intrinsic value

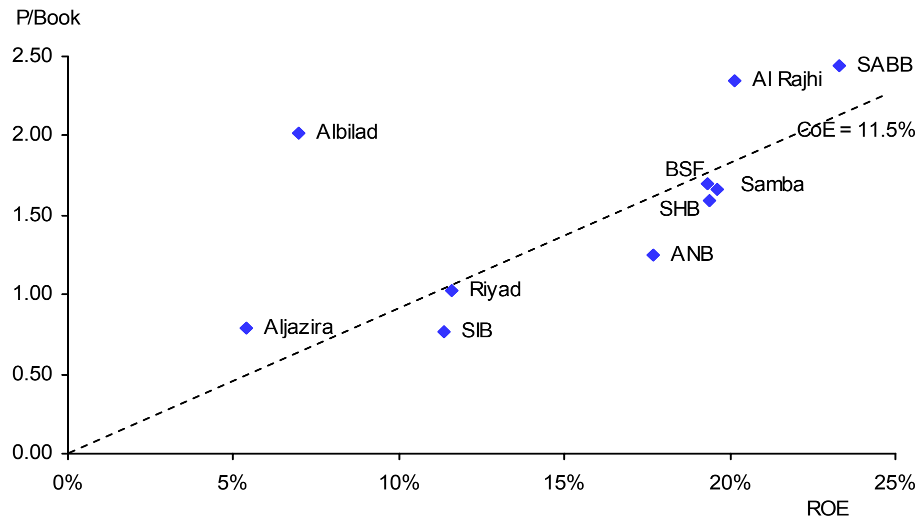
Figure 2: Saudi Bank share price performance, last 12 months



Source: Deutsche Bank, Bloomberg. Data recorded to market close, 17 January 2009

A cautious sector scenario already appears to be priced in
Our fundamental outlook for the sector calls for declining earnings growth momentum as the economic environment deteriorates. Nevertheless, we see most banks continuing to generate returns well in excess of the cost of capital, reflecting good revenue generating capacity, low operating gearing and moderate risk exposures.

Figure 3: Current Saudi bank valuations based on our 2010 NAV and ROE forecasts



Source: Deutsche Bank

Note that our target price calculations incorporate an adjustment for potential risks arising from real estate, financial investments, derivatives and off balance sheet commitments.

Transformational stories generate unnecessary risk in the current environment
Given our view that the sector is transitioning from rapid to sluggish volume growth, we believe that certain companies will be inappropriately positioned for the new environment, either because their business models may come under undue strain, or because prior actions may have elevated the corporate risk profile. We highlight by company below some of our key concerns in this respect.

Figure 4: Saudi banks: strategic risk assessment summary

Company	Strategic Issue	Risk Assessment	Rationale
Al Rajhi Bank	High share of sluggish retail banking market. Low interest rates reduce funding advantages	High	Aggressive push into corporate banking could impair business risk/return profile
Arab National Bank	Lower dynamism than many competitors	Low	Sector slowdown, and new product introductions will lead to performance convergence
Bank Albilad	Distribution infrastructure and capital base significantly exceed needs of current business	High	Current cost structure makes business uncompetitive; rapid growth may not be possible in a slowing sector
Bank Aljazira	Rapidly shrinking revenue base due to declining interest rates and lower equity brokerage revenue	High	Search for new revenue streams may be raising business risk profile and adding to costs
Banque Saudi Fransi	Small retail banking presence limits deposit collection ability	Low	Sector leading cost efficiency. Low interest rates reduce funding cost disadvantages
Riyad Bank	High excess capital following Q2 08 capital increase. Underutilised distribution infrastructure	Medium	Sector slowdown limits risk of sub-optimal investment in growth. Good cost efficiency and profitability despite excess capacity
SABB	Weak capital strength relative to peers	Low	Good risk management and strong core shareholder support should limit downside
Samba	Large investment portfolio, with greater exposure to potentially more risky international/ equity securities	Medium	Samba appears to have a stronger risk appetite than its peers, particularly for market risk
Saudi Hollandi Bank	Poor recent asset quality track record; sub-scale retail franchise; thinly capitalised	High	Limited ability of core shareholder to boost capital to fund growth or absorb unexpected losses.
Saudi Investment Bank	Underperforming retail banking business; high real estate exposure	Medium	Strong capital base sufficient to absorb significant write-downs

Source: Deutsche Bank

Summary

Figure 5: Investment Strategy Scorecard

	Fundamental Value	Financial Risk	Strategic Positioning	Investment Rating
Al Rajhi Bank	x	✔		Sell
Arab National Bank	✔		✔	Buy
BankAlbilad	x	✔	x	Sell
Bank Aljazira	x	✔	x	Sell
Banque Saudi Fransi		x	✔	Hold
Riyad Bank	✔			Buy
SABB			✔	Hold
Samba	✔	x		Hold
Saudi Hollandi Bank		x	x	Hold
Saudi Investment Bank	✔			Buy

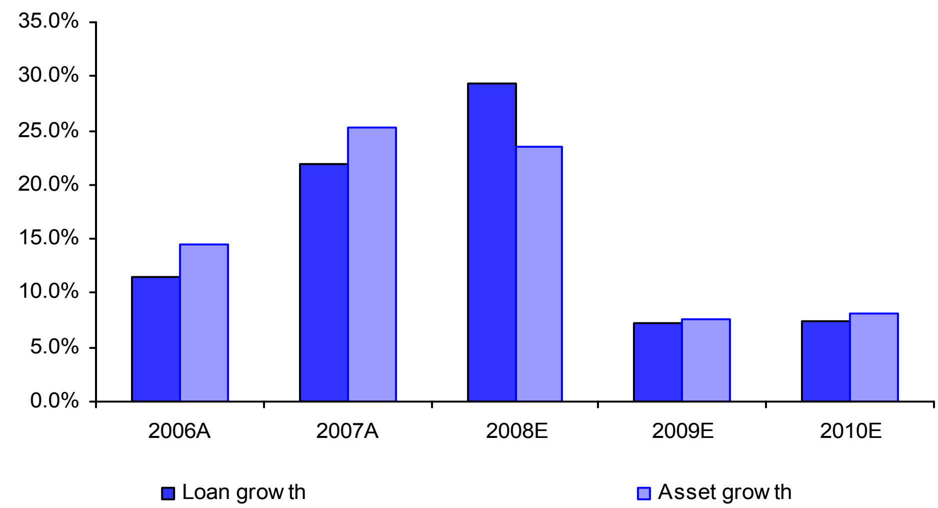
Source: Deutsche Bank

Key fundamental trends

We believe the following key themes will emerge in coming years:

Business momentum to slow significantly
After expanding by 13% in 2006 and 25% in 2007 and an estimated 24% in 2008, we expect the sector balance sheet to slow considerably: towards 8% in 2009 and 2010. We expect revenue growth over the next two years to average 4-5%.

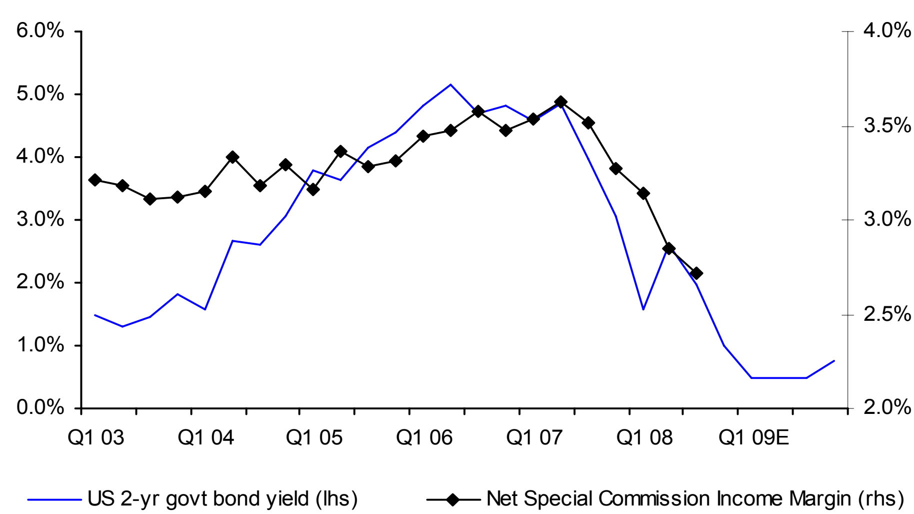
Figure 6: We expect business volume growth to slow sharply



Source: Deutsche Bank, Company data

Margin compression likely
With the Federal Reserve driving down global interest rates, we believe Saudi banking net special commission income margins are likely to face downward pressure until at least mid-2010 even if banking system liquidity conditions improve.

Figure 7: Net special commission income margins likely to be squeezed further



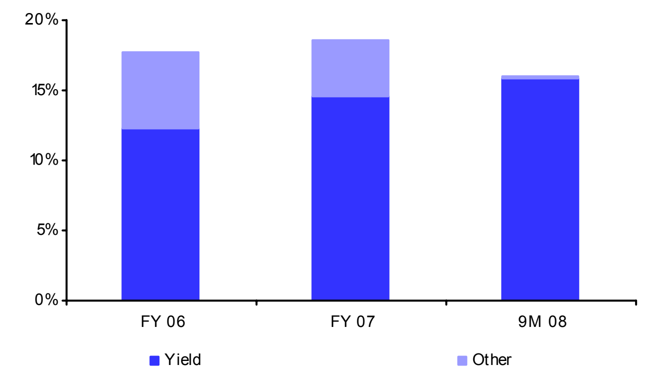
Source: Deutsche Bank, Bloomberg, Company data

Investment returns likely to be muted

The bulk of the income generated by the Saudi banks' financial investment portfolios is incorporated within net special commission income as yield. We view this component as relatively stable. However, changes in value, gains or losses on disposal also have a meaningful impact, although the sensitivity to key drivers such as equity index levels and interest rates has historically been surprisingly weak.

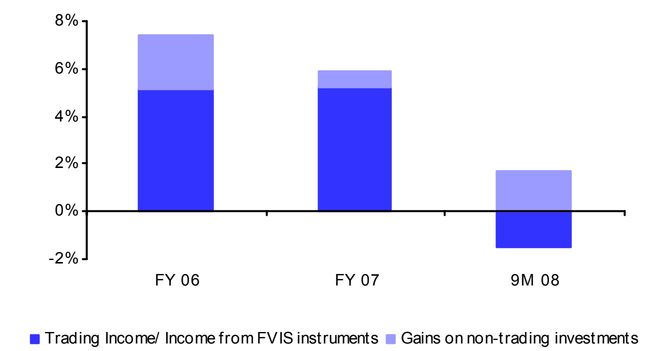
Going forward, we have assumed the non-yield contribution from the investment portfolios is small. We have also not factored in any significant impairment charges.

Figure 8: Contribution of investment portfolios to Saudi bank revenues (pre funding costs)



Source: Deutsche Bank, Company data

Figure 9: Trading and non-trading income as % Saudi bank revenues

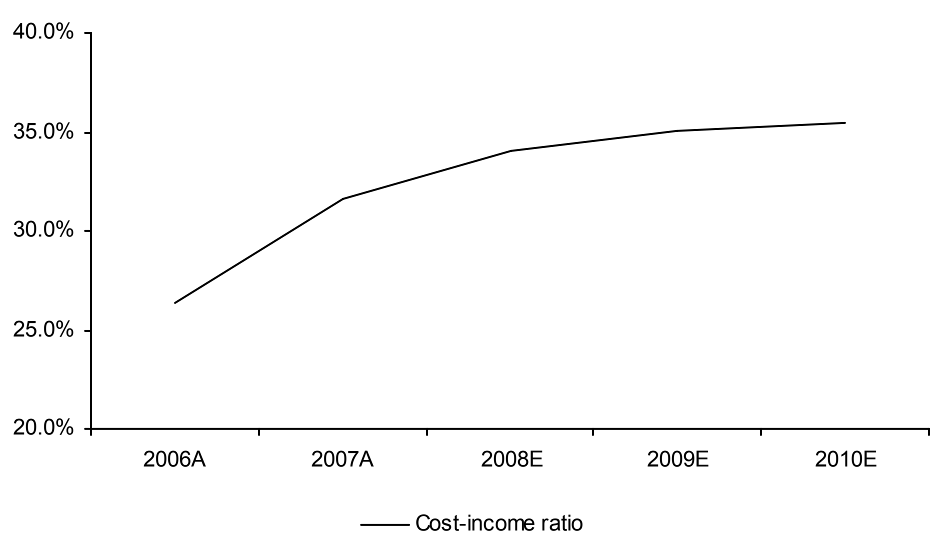


Source: Deutsche Bank, Company data

Operating efficiency set to decline

We believe operating margins are also likely to contract. With management's confidence boosted by recent strong volume growth, Saudi banks have been investing heavily in new distribution capacity. With business growth now set to slow significantly, we see cost growth continuing to moderately outstrip revenue development over the coming years.

Figure 10: Sector cost-income ratios likely to keep rising

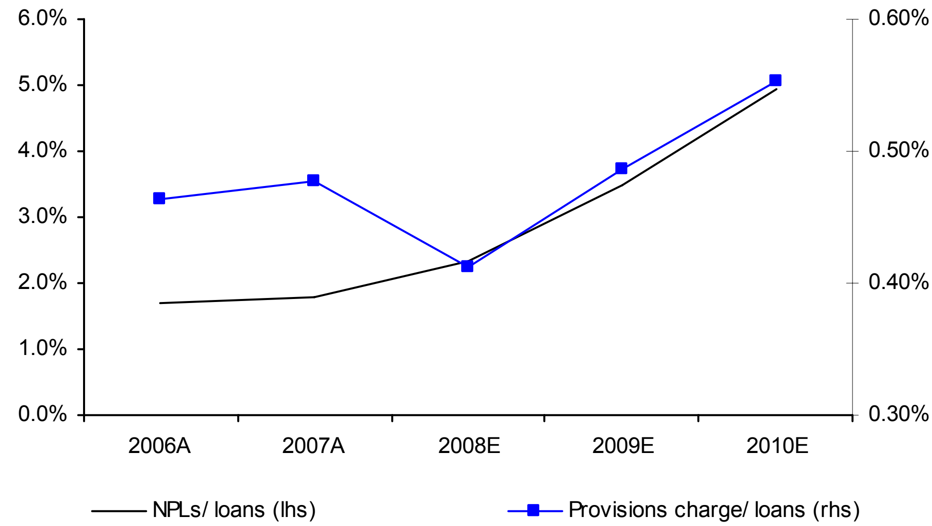


Source: Deutsche Bank, Company data

Asset quality expected to deteriorate

A combination of rapid recent credit growth and deteriorating economic fundamentals is likely to drive loan delinquencies higher. However, we believe a conservative regulatory environment, limited direct exposure to real estate assets and the Saudi government's significant fiscal flexibility should limit the uptick in non-performing loans.

Figure 11: We believe asset quality is likely to worsen

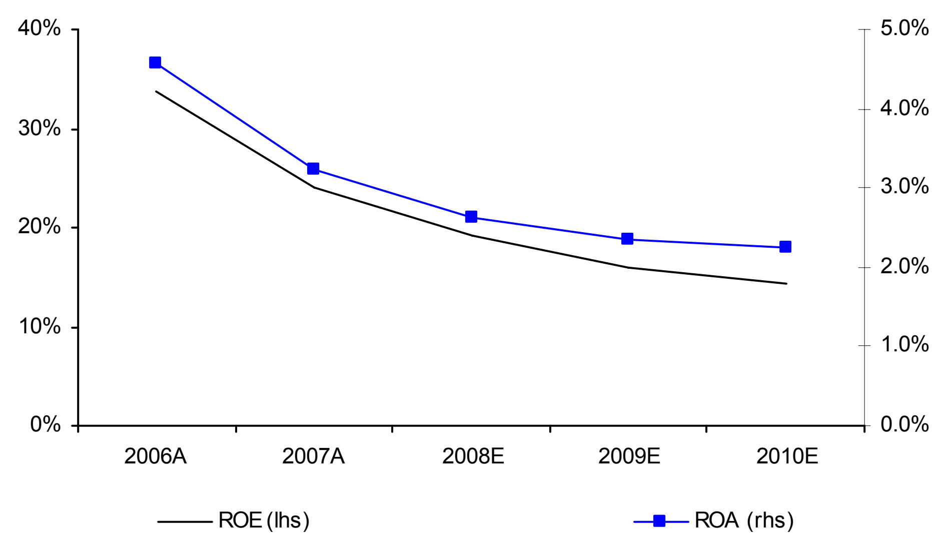


Source: Deutsche Bank, Company data

Profitability squeezed, but still healthy

Slower business development, higher risk charges and a decline in operating efficiency ratios will all serve to depress banking sector profitability in the coming years. However, our current projections still point to sector profitability comfortably exceeding the banks' cost of capital.

Figure 12: ROE and ROA set to decline

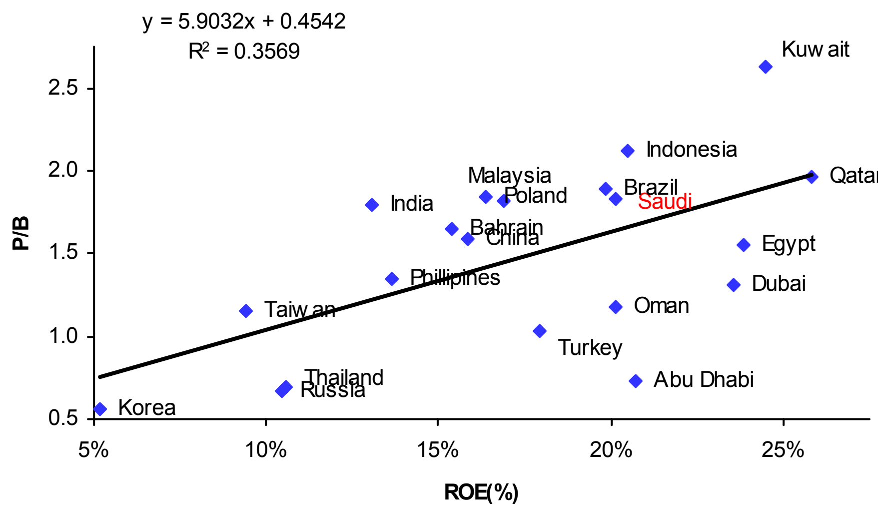


Source: Deutsche Bank, Company data

Long-term growth story intact

While we are cautious on the near-term outlook for the retail banking business, we believe the Saudi banking sector is likely to be a key beneficiary of product innovation, a further opening of the Saudi capital markets and broader economy, and increased domestic utilization of the Kingdom's vast accumulation of oil wealth. We believe these characteristics,combined with conservatively positioned balance sheets, more than justify the modest premium to their emerging market peers at which the Saudi banks sector trades.

Figure 13: Global bank P/B vs. ROE data (2009E)



Source: Deutsche Bank, Bloomberg consensus

Sector highlights

Figure 14 highlights some key sector features and identifies outliers for selected key metrics.

Figure 14: Selected sector highlights and outliers

9M08 unless otherwise specified	High		Sector Average	Low	
	Company	Value	Value	Company	Value
Profile					
Market capitalisation (SAR bn)	Al Rajjhi Bank	83.6	21.2	Bank Aljazira	4.4
Total assets (SAR bn)	Samba Financial Group	187.1	101.9	Bank Albilad	I5.3
Total equity (SAR bn)	Al Rajhi Bank	25.6	12.7	Bank Albilad	3.2
Government ownership level	Samba Financial Group	44.5%	21.2	Aljazira, Albilad	0%
Free float	Bank Aljazira	60.5%	42.0%	Riyad Bank	29.8%
Revenues					
Net special commission income/total revenues	Riyad Bank	80.1%	69.2%	Bank Aljazira	52.6%
Net special commission income margin (as % assets)	Al Rajhi Bank	5.8%	2.9%	Saudi Investment Bank	2.18%
Fee income/total revenues	Bank Aljazira	46.5%	25.2%	Al Rajhi Bank	14.9%
Revenue/employee (SARm) (FY07)	Samba Financial Group	2.301	1.456	Bank Albilad	0.394
Revenue/branch (SARm) (FY07)	Samba Financial Group	110.712	42.289	Bank Albilad	12.976
Revenues/ avg. assets (H108)	Al Rajhi Bank	7.57%	4.86%	Saudi Investment Bank	3.22%
Cost Efficiency					
Cost/income ratio (FY07)	Bank Albilad	82.3%	34.3%	Banque Saudi Fransi	24.3%
Cost/assets ratio (FY07)	Bank Albilad	4.6%	1.4%	Saudi Investment Bank	0.84%
Cost/employee (SARm) (FY07)	Samba Financial Group	0.629	0.475	Al Rajhi Bank	0.302
Cost/branch (SARm) (FY07)	Samba Financial Group	30.243	12.811	Al Rajhi Bank	6.025
Balance Sheet					
Equity/assets	Bank Albilad	21.1%	12.47%	Saudi British Bank	8.26%
Tier 1 ratio	Bank Albilad	21.6%	11.10%	Saudi Hollandi Bank	7.12%
BIS ratio	Bank Albilad	22.6%	13.00%	Saudi Hollandi Bank	9.77%
Loans/deposits	Bank Albilad	111.9%	87.3%	Saudi Investment Bank	69.4%
Loans/assets	Al Rajhi Bank	83.8%	63.0%	National Commercial Bank	49.0%
Deposits/assets	Saudi Investment Bank	79.0%	72.2%	Riyad Bank	60.4%
Investments/assets	Samba Financial Group	35.1%	24.8%	Al Rajhi Bank	0.80%

Figure 14: Selected sector highlights and outliers (Cont'd)

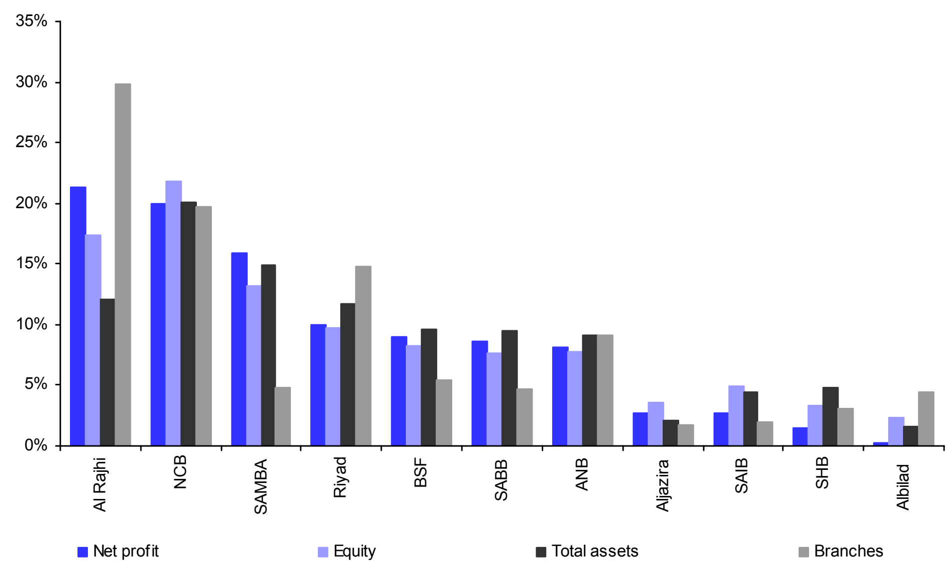
	Company	Value	Value	Company	Value
Asset Quality					
NPLs/net loans (FY07)	Saudi Hollandi Bank	3.9%	1.7%	Saudi British Bank	0.31%
Provisions/NPLs (FY07)	Arab National Bank	354.0%	145.3%	Bank Albilad	69.9%
Bad debt charge/net customer loans	Al Rajhi Bank	0.6%	0.2%	Arab National Bank	0.08%
Profitability					
Revenues/assets	Al Rajhi Bank	7.3%	4.2%	Saudi Investment Bank	2.90%
Gross operating profit/assets	Al Rajhi Bank	5.3%	2.7%	Bank Albilad	1.37%
Net profit/assets	Al Rajhi Bank	4.2%	2.3%	Bank Albilad	1.33%
ROE	Saudi British Bank	27.6%	20.6%	Bank Albilad	6.31%
Growth (2006 - 9M08, CAGR)					
Revenues	Bank Albilad	14.9%	5.4%	Bank Aljazira	-34.6%
Operating Costs	Bank Aljazira	24.6%	13.4%	Saudi Investment Bank	0.44%
Net income	Saudi Hollandi Bank	15.2%	-2.3%	Bank Aljazira	-58.8%
Loans	Bank Aljazira	58.8%	26.0%	Bank Albilad	15.9%
Deposits	Saudi British Bank	31.5%	19.9%	Riyad Bank	14.5%
Total Assets	Saudi British Bank	36.2%	25.2%	Saudi Hollandi Bank	16.9%
Business Mix					
Retail banking exposure (as % assets) (H108)	Al Rajhi Bank	42.2%	21%	Saudi Hollandi Bank	9.69%
Retail banking exposure (as % revenues) (H108)	Al Rajhi Bank	59.5%	44%	Bank Albilad	22.3%
Retail banking exposure (as % net income) (H108)	Al Rajhi Bank	51.3%	33%	Bank Aljazira	11.9%
Consumer & credit card loans (as % loans) (FY07)	Al Rajhi Bank	50.6%	26%	Bank Albilad	5.30%
Building & construction industry loans (as % loans) (FY07)	Saudi Investment Bank	18.5%	8%	Bank Albilad	3.16%
Valuation					
2008E P/E Multiple	Bank Albilad	27.8	10.8	Arab National Bank	8.0
2008E P/Book Multiple	Al Rajhi Bank	3.19	1.85	Saudi Investment Bank	1.03
2008E Dividend Yield	Bank Albilad	0.2%	3.3%	Riyad Bank	5.7%

Source: Deutsche Bank, Zawya

The Saudi banking system

The Saudi banking market consists of 11 key domestic participants (ten of which are listed) plus a number of foreign entities (a mixture of GCC and Western banks). The market shares of the domestic banks across a range of metrics are presented in Figure 15:

Figure 15: Saudi bank market shares (FY07)



Source: Deutsche Bank, SAMA, Company data

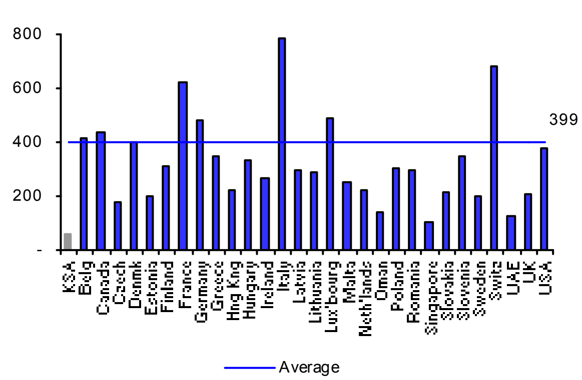
Our research coverage universe consists of all the banks in Figure 15 with the exception of National Commercial Bank (NCB), which is unlisted (and owned by a number of state entities).

Key features

Low banking penetration

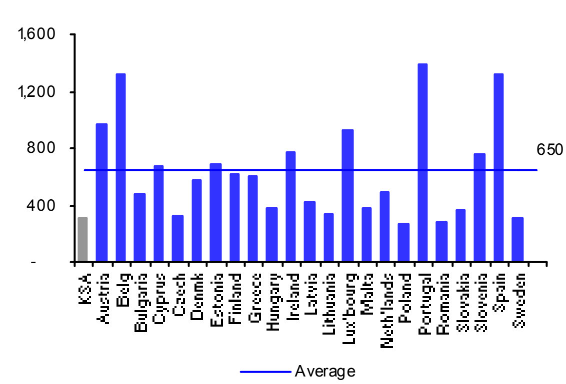
The penetration of Saudi Arabia's banking system is lower than that of most developed economies, with lower per capita numbers of bank branches and ATMs.

Figure 16: Branches per m population (2007)



Source: Deutsche Bank, ECB, Central Banks

Figure 17: ATMs per m population (2007)

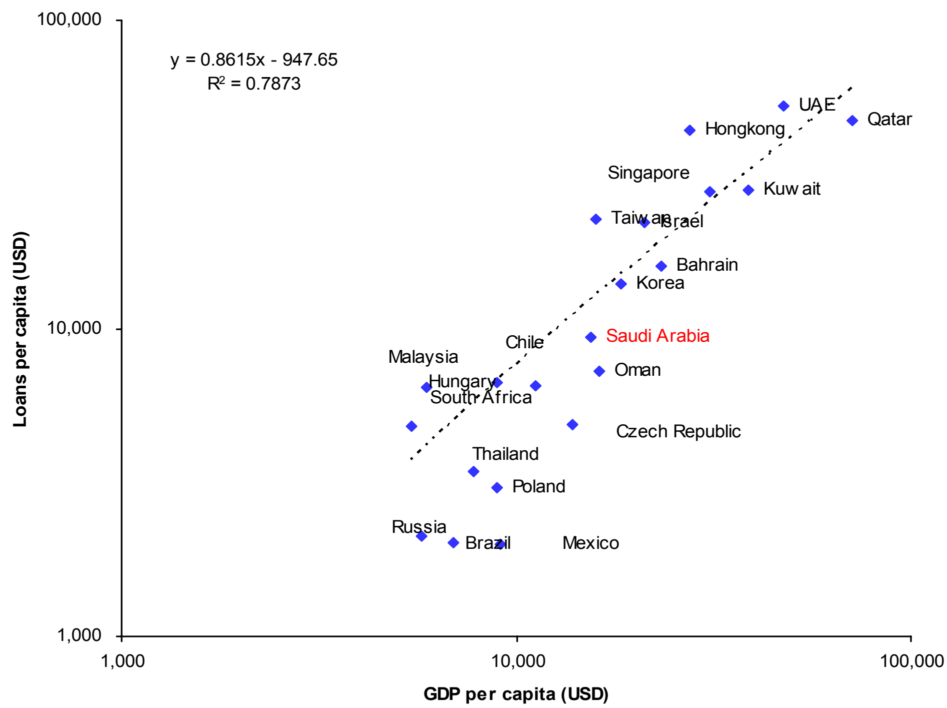


Source: Deutsche Ban, ECB, Central Banks

The Saudi authorities have recognized the positive role the banking system can play in the development of the local economy, for example in improving the provision of financial resources to the private sector. As the government's long-term growth plan calls for expansion of the private sector, we believe sector development (within a prudent regulatory framework) is likely to be encouraged.

We note that both the Saudi economy and its banking system have significant catch-up potential relative to neighbouring economies such as Bahrain, Kuwait, the UAE and Qatar, and a selection of other emerging markets.

Figure 18: Saudi economy and banking system have significant scope to converge to levels achieved by other GCC and East Asian markets

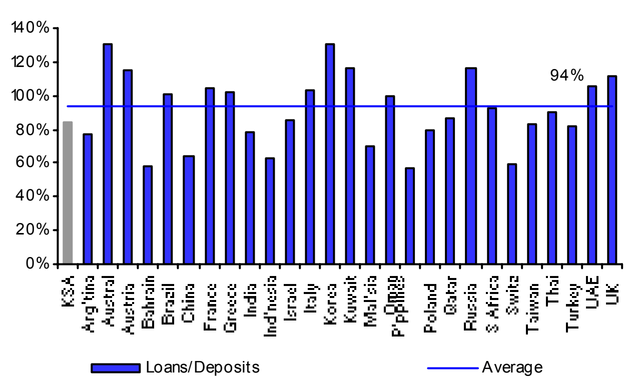


Source: Deutsche Bank

Conservative balance sheet structure

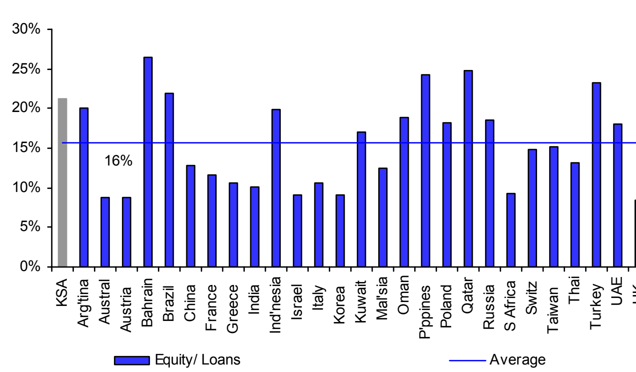
The Saudi banking system appears relatively conservatively positioned with customer deposits exceeding loans and a high equity/loans ratio.

Figure 19: Loans/deposits ratios (2007)



Source: Deutsche Bank, Central Banks

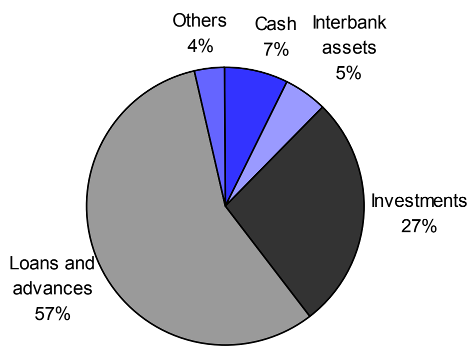
Figure 20: Equity/loans ratio (2007)



Source: Deutsche Bank, Central Banks

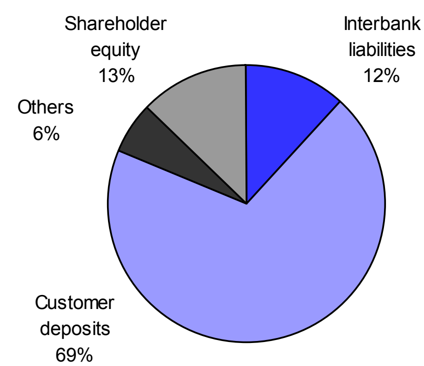
Loans account for around 60% of bank balance sheet assets. Investments are the next largest asset class, equivalent to around a quarter of the balance sheet. On the liabilities side, deposits are by far the largest category (over 70%), with interbank positions and equity accounting for the bulk of the remaining funding needs.

Figure 21: Asset mix (H108)



Source: Deutsche Bank, Company data

Figure 22: Liabilities mix (H108)

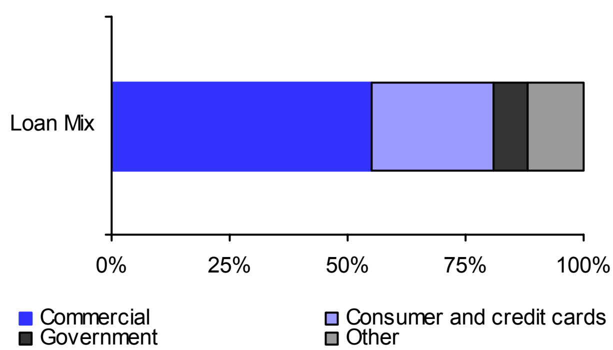


Source: Deutsche Bank, Company data

Short-maturity loan profile

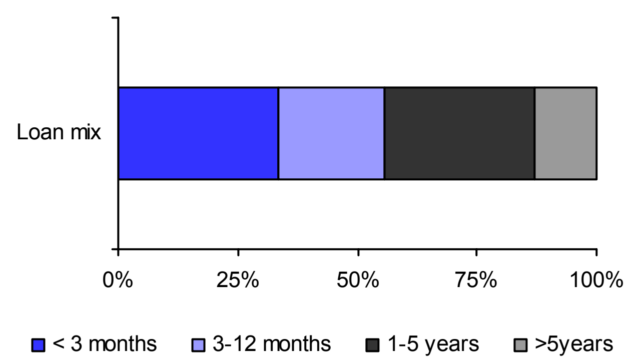
The structure of the loan book is presented in Figures 23 and 24. We believe around one-quarter of loans is allotted to individuals and more than twice this amount is allotted to corporates. The bulk of lending is less than one-year maturity. There is very little long-term lending, reflecting an underdeveloped mortgage market.

Figure 23: Loan mix by borrower (FY07)



Source: Deutsche Bank, Company data

Figure 24: Loan mix by maturity (FY07)

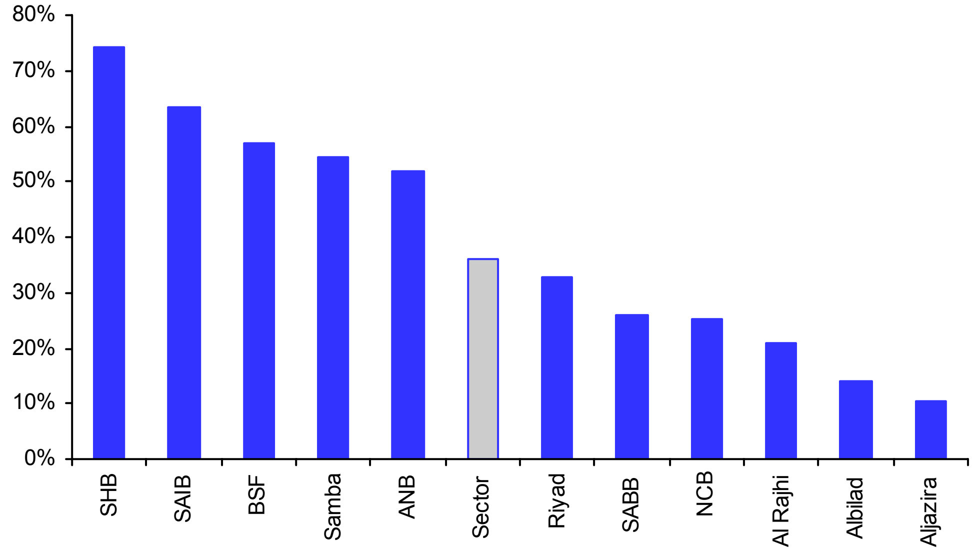


Source: Deutsche Bank, Company data

Limited real estate exposure

Investors may be concerned that Saudi banks could also be affected by the widespread decline in global real estate values. In this regard, we believe the limited extent of direct real estate financing extended by the banks should provide some comfort. Loans to construction and real estate companies account for around 8% of system credit, an exposure that is lower than the total equity capital in the banking system. Exposure to consumer mortgage lending is extremely limited at just 2% of system credit, reflecting the lack of a clear legal framework concerning issues such as foreclosure of secured property. Finally, we cite evidence of significant unmet demand for home ownership, suggesting residential property prices should be well-supported.

Figure 25: Construction sector loans/ sharehodlers' equity



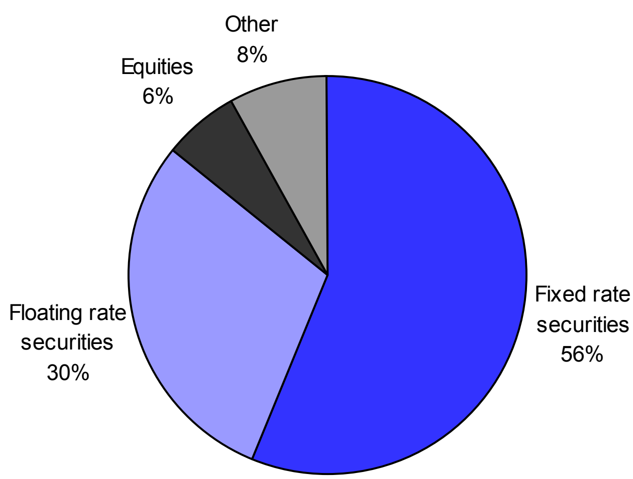
Source: Deutsche Bank, Company data

Moderate market risks

The Saudi banks' investment portfolios are largely invested in government bonds and other corporate and bank-issued fixed and floating rate securities. Equities comprise less than 6% of the typical bank's investment portfolio, and we estimate 40% of the investment portfolios are invested internationally.

The key risk area of the investment portfolios, we believe, is equity investments. Here, the maximum exposure is equivalent to 25% of the equity base, while the sector average is around 12%. We view this exposure as broadly manageable, although much depends on the quality of equity risk management.

Figure 26: Saudi banking sector investment portfolio: breakdown by asset class (FY07)

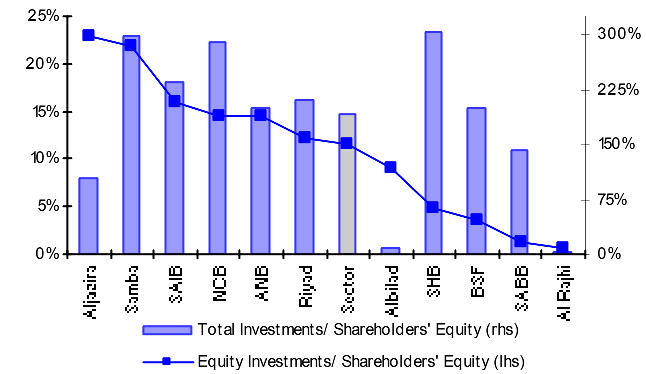


Source: Deutsche Bank, Company data

High equity/assets ratio

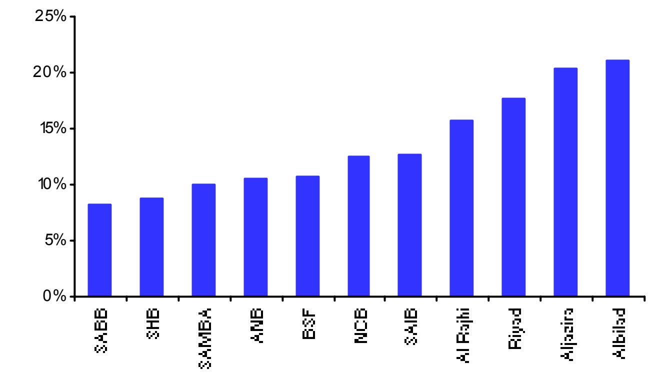
Relative to developed market banking systems, the Saudi banks are extremely well-capitalised. As of 9M08, the average equity/assets ratio stood at 12.5%.

Figure 27: Investment assets as a % shareholder equity (FY07)



Source: Deutsche Bank, Company data. Note: Riyad Bank data adjusted for Q2 08 capital increase

Figure 28: Equity/assets ratio (9M08)

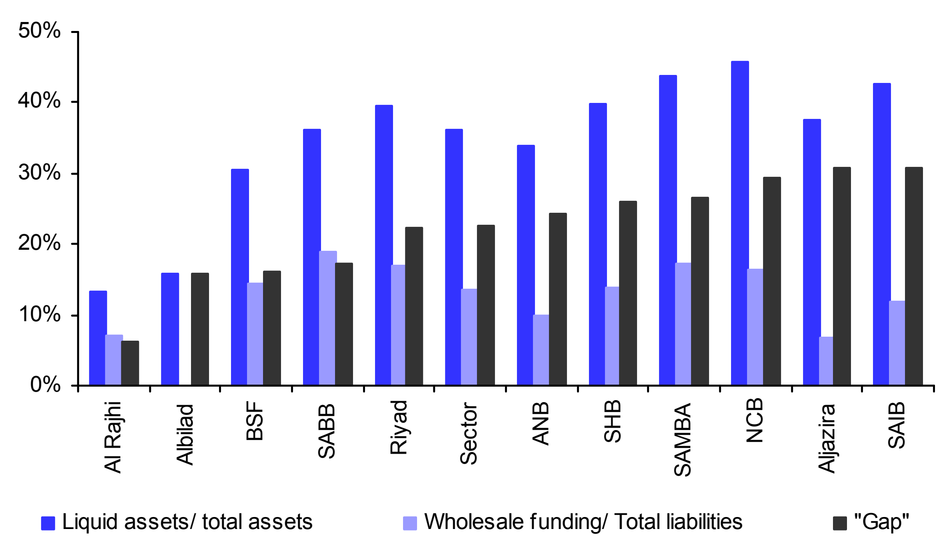


Source: Deutsche Bank, Company data

High proportion of liquid balance sheet assets
On average, over one-third of the Saudi banks' assets can be considered liquid (in the form of cash, typically short-term interbank loans or investments).

Limited wholesale funding needs
Reflecting the limited stage of development of the Saudi financial system, Saudi banks' wholesale funding needs (defined here as debt securities, term loans and interbank funding) are relatively limited, typically accounting for just 14% of overall liabilities.

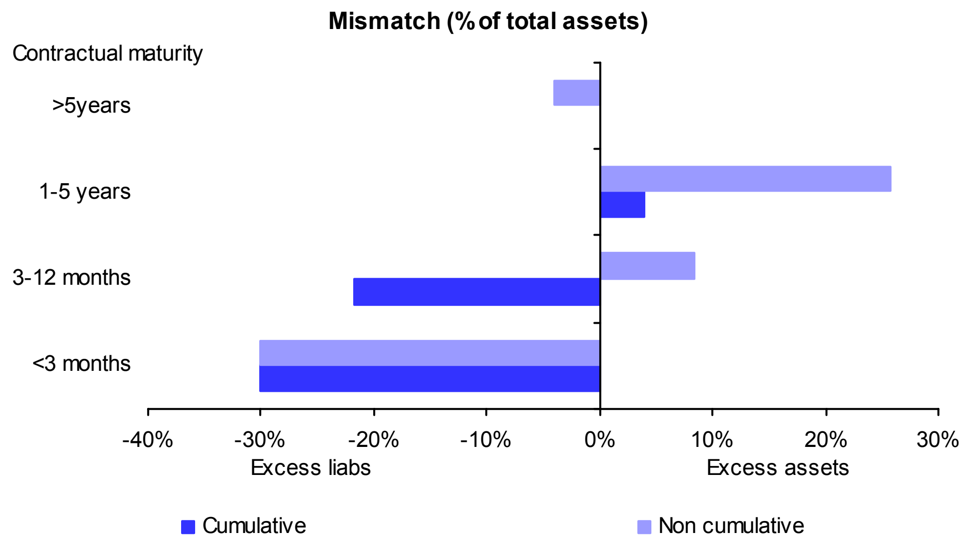
Figure 29: All Saudi banks have surplus liquid assets relative to wholesale funding needs



Source: Deutsche Bank, company data

Maturity mismatch
In common with most global peers, Saudi banks have a structural maturity mismatch; their assets tend to be of a longer maturity than their liabilities. We show the extent of this mismatch at the sector level in Figure 30.

Figure 30: Saudi banks typically have a surplus of short-dated obligations relative to liquid assets (as determined by contractual maturities)



Source: Deutsche Bank, Company data

Around one half of banking system assets has a maturity in excess of one year, while around two-thirds of liabilities could be redeemed by counterparties within three months. In practice, however, liabilities such as time deposits are much stickier than their legal maturities indicate. We believe the mismatch will only be a problem if confidence in bank solvency were to be negatively affected. Given high levels of equity capital and in our view a low risk asset portfolios, we view such a scenario as unlikely.

Ownership

The government (via GOSI, the Public Investment Fund and the Public Pension Agency) is a key investor in the Saudi banking sector, with an average ownership level of 21%. Other key investors include the Al Rajhi family, whose aggregate ownership of the sector stands at almost 13%, and major foreign investors such as HSBC, Calyon and Arab Bank.

Figure 31: Key shareholders in the Saudi banking sector

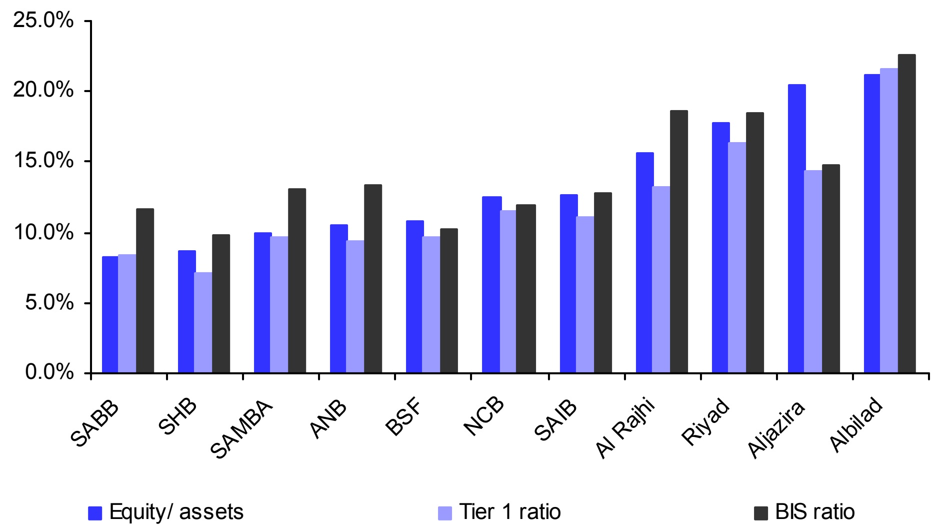
Entity	% ownership of sector (weighted by mkt capitalization)	Key stakes
Al Rajhi family	12.5%	Al Rajhi (44.1%), Albilad (13.4%)
GOSI	11.6%	Riyad (21.6%), SAIB (21.5%), BSF (12.8%), Samba (11.4%), ANB (10.8%), NCB (10.0%), Alinma (10.0%), Al Rajhi (9.9%), SHB (9.6%), SABB (9.5%),
Public Investment Fund	6.8%	NCB (69.3%), Samba (22.9%), Riyad (21.7%), Alinma (10.0%)
HSBC	4.4%	SABB (39.9%)
Calyon	3.4%	BSF (31.1%)
Arab Bank (PJSC)	2.8%	ANB (40.0%)
Public Pension Agency	2.8%	NCB (20.7%), SAIB (17.3%), Samba (10.2%)
Olayan Saudi Inv Co	2.6%	SHB (20.7%), SABB (17.0%)
RBS Group (formerly ABN Amro)	1.4%	SHB (39.9%)

Source: Deutsche Bank, Company data, Tadawul, Zawya

Capital adequacy

The Saudi banking system appears well-capitalised by international standards, with tier 1 ratios close to 12% and BIS capital ratios above 13%. The average equity/asset ratio of 12.5% also appears strong.

Figure 32: Capital ratios (9M08)



Source: Deutsche Bank, Company data

Credit ratings

Other than Bank Albilad, which is unrated, the Saudi banks covered in this report all have investment grade credit ratings, typically a few notches below the AA- rating of the Saudi government.

Figure 33: Saudi bank credit ratings

	S&P			Moody's			Fitch		
	L-Term	Outlook	S-Term	L-Term	Outlook	S-Term	L-Term	Outlook	S-Term
Al Rajhi	A	Stable	A-1	A1	Stable	P1	A+	Stable	F1
ANB	A	Stable	A-1	A1	Stable	P1	A	F1	Stable
Aljazira				A3	Stable	P2	A-	F2	Stable
Albilad									
BSF	A	Stable	A-1	A1	Stable	P1	A	F1	Stable
NCB	A+	Stable	A-1	A1	Stable	P1	A+	F1	Stable
Riyad	A+	Stable	A-1	A1	Stable	P1	A+	F1	Stable
SABB	A	Stable	A-1	A1	Stable	P1	A	F1	Stable
SAMBA	A	Stable	A-1	A1	Stable	P1	A+	F1	Stable
SHB				A1	Stable	P1	A-	F2	Stable
SAIB	A-	Stable	A-2	A2	Stable	P1	A-	F2	Stable
Kingdom of Saudi Arabia	AA-	Stable	A-1+	AA3	Stable	P1	AA-	F1+	Stable

Source: Deutsche Bank, S&P, Moody's, Fitsch

Business mix

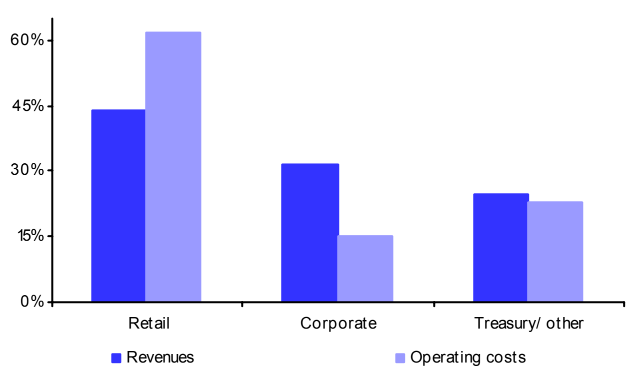
All of the large Saudi banking groups provide divisionalised financial information. Segmental disclosures are regulated by SAMA, suggesting comparability should be high.

Retail banking is a key source of funding and has typically generated just over half of the sector's revenues.

Corporate banking has a relatively balanced funding and credit position and in the past has generated around one quarter of system revenues.

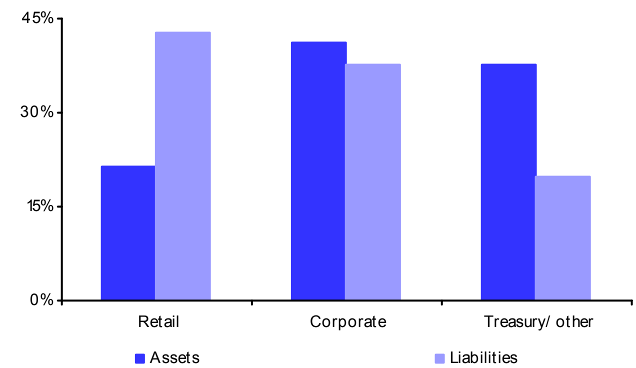
Banks use their treasury operations to invest surplus retail banking funds to generate around 20% of sector revenues.

Figure 34: Contribution to sector revenues and operating costs by business division (H108)



Source: Deutsche Bank, Company data

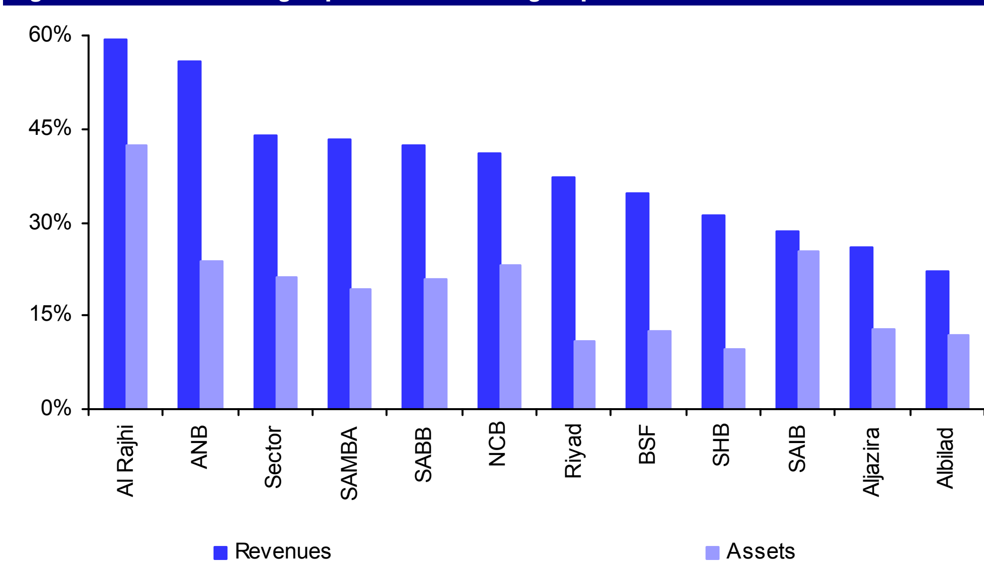
Figure 35: Contribution to sector assets and liabilities by business division (H108)



Source: Deutsche Bank, Company data

Al Rajhi Bank and ANB are the most exposed to the retail banking business, while SAIB, Aljazira, and Albilad are the least exposed.

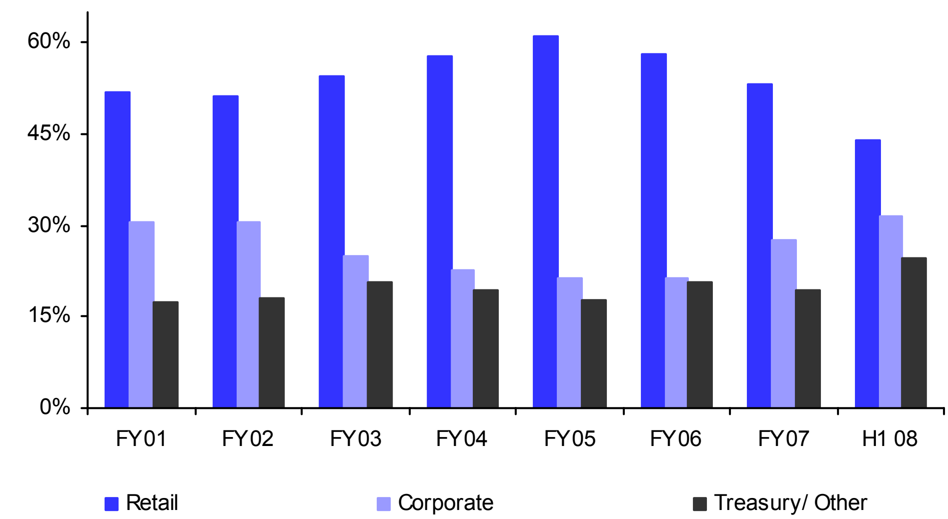
Figure 36: Retail banking exposure (as a % of group revenues and assets H108)



Source: Deutsche Bank, Company data

In recent years, the retail banking share of sector income and profitability has declined substantially. We believe this primarily reflects declining equity brokerage revenue. Retail loan growth has also been extremely sluggish since 2005.

Figure 37: Revenue contribution from retail banking has declined in recent years

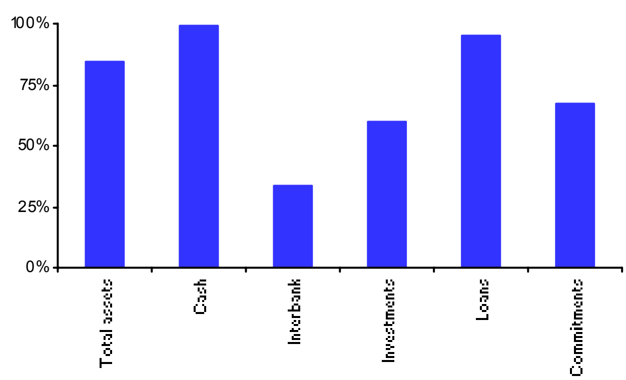


Source: Deutsche Bank, Company data

Geographic mix

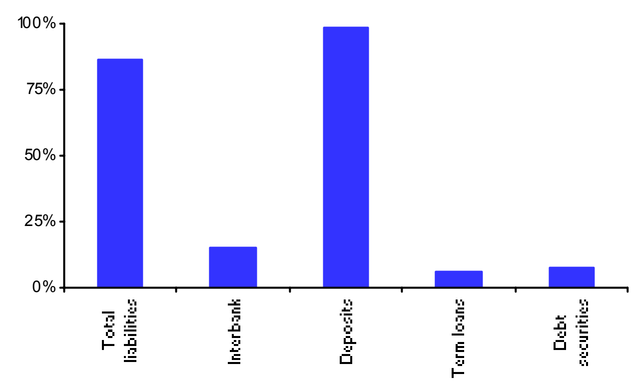
Saudi banks overwhelmingly maintain a domestic focus, with 85-90% of total assets and liabilities located in the Kingdom. However, the geographic mix of the banking system presents an interesting dichotomy. Direct customer business is largely domestically focused (typically close to 100% of customer loans and deposits are with domestic counterparties). In contrast, wholesale assets and liabilities (such as interbank positions, investments assets and debt funding) have a much higher non-domestic component, perhaps reflecting the lack of development of the local capital markets and banking system.

Figure 38: Geographic mix: assets (domestic proportion)



Source: Deutsche Bank, Company data

Figure 39: Geographic mix: liabilities (domestic proportion)



Source: Deutsche Bank, Company data

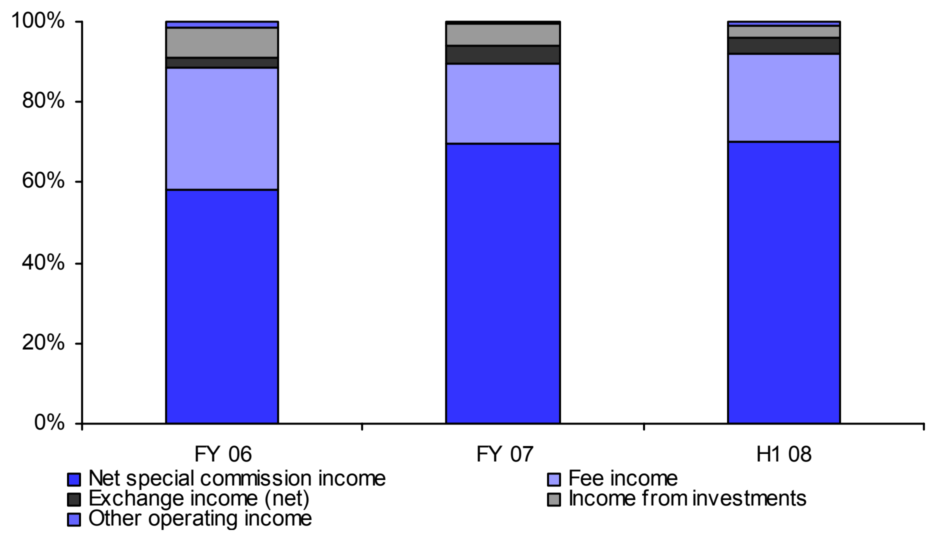
While a number of banks have made modest investments abroad in recent years, we believe solid long-term domestic growth prospects, regulatory conservatism and unfavourable capital market conditions should result in international exposures remaining small.

Sector outlook

Revenues

Around two-thirds of Saudi banks' revenues are generated from their intermediation activities. Fee-based income has declined in importance in recent years, reflecting lower equity market activity levels. Income from investments (such as trading gains) is a typically small but volatile element of the revenue mix.

Figure 40: Revenue mix



Source: Deutsche Bank, Company data

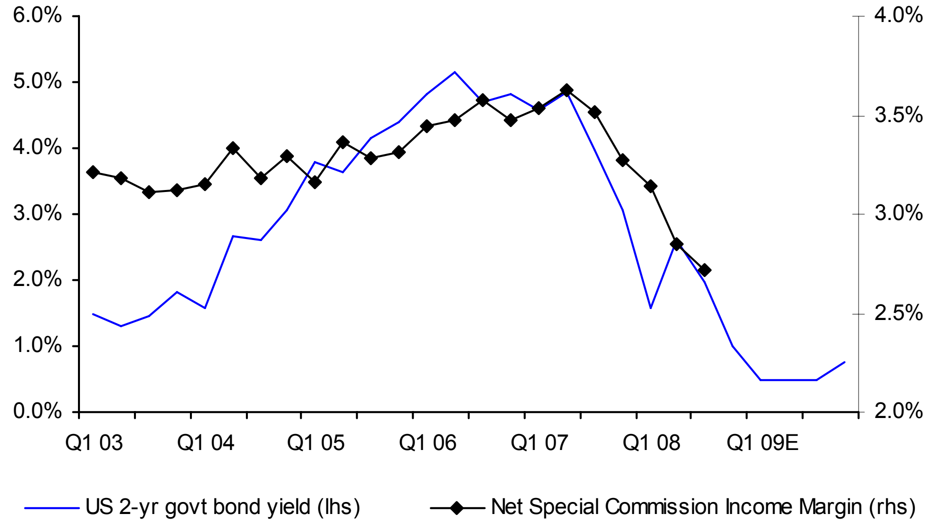
Net special commission income

Net special commission income is driven by two factors: the excess spread on capital extended to the banks' counterparties relative to the funding cost of such capital and the volume of such business undertaken.

- Margins

In relation to the level of spread the banks can generate, a key determinant appears to be the prevailing cost of capital. With a significant proportion of bank funding effectively interest-free (either in the form of equity or current account deposits), banks can generate higher spreads when prevailing interests rates are high. This relationship is illustrated in Figure 41:

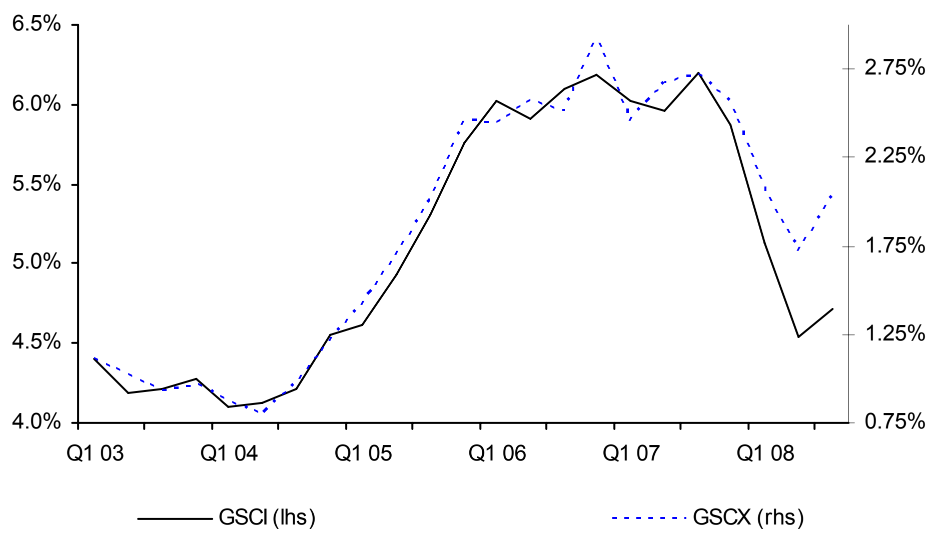
Figure 41: Net special commission income margin (as % assets) versus interest rates



Source: Deutsche Bank, Company data, Bloomberg

We believe the key reason for this recent margin deterioration can be traced to funding costs that have not tracked interest rates down to the same extent as asset yields (particularly on loans). We doubt this situation will improve while credit crunch and liquidity constraints abound.

Figure 42: Saudi bank funding costs have not fallen as quickly as asset yields in recent quarters

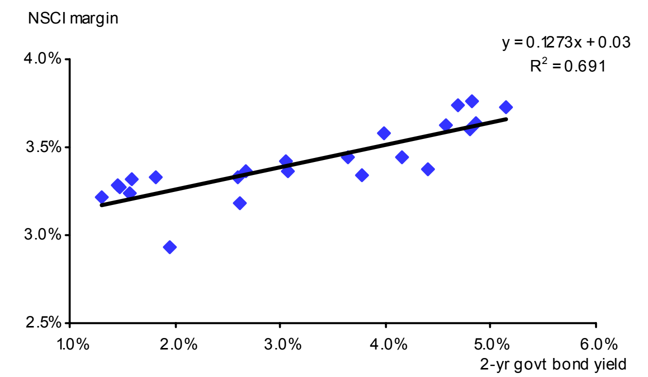


Source: Deutsche Bank, Company data

Historically, the net special commission income margin has been relatively insensitive to interest rates, with a 1% point increase in interest rates tending to increase net special commission income by around 4% due to margin expansion of 13bps. However, the data also suggest this relationship may have become more sensitive in recent quarters.

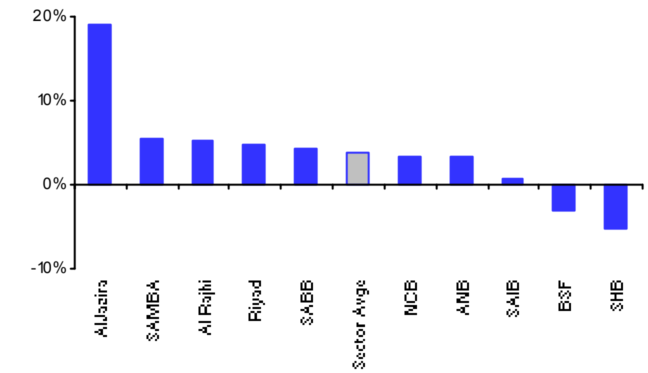
Looking at individual banks, the most exposed to margin compression appears to be Bank Aljazira (although we suspect the relationship between margins and interest rates may have been contaminated by the bank's exposure to high margin stock lending, a business that was growing as interest rates rose in the mid part of the decade, but more recently has significantly declined in volume). Most of the Saudi banks' net special commission income margins tend to benefit modestly from rising interest rates, although Banque Saudi Fransi and Saudi Hollandi Bank are interesting exceptions, perhaps as a result of their low levels of free funding (low equity/assets ratio and high proportion of time deposit customer funds).

Figure 43: Net special commission income margin regression analysis



Source: Deutsche Bank, Company data, Bloomberg

Figure 44: Net special commission income – historical impact of 1% point increase in interest rates



Source: Deutsche Bank, Company data, Bloomberg. Note: Albilad excluded due to lack of sufficient historical data

We present margin forecasts for the Saudi banks in our universe in Figure 45 below. We expect margin pressure to be maintained, but moderated from the levels of recent quarters as monetary easing slows and wholesale funding market conditions gradually normalize.

Figure 45: Net special commission income margin forecasts (as % assets)

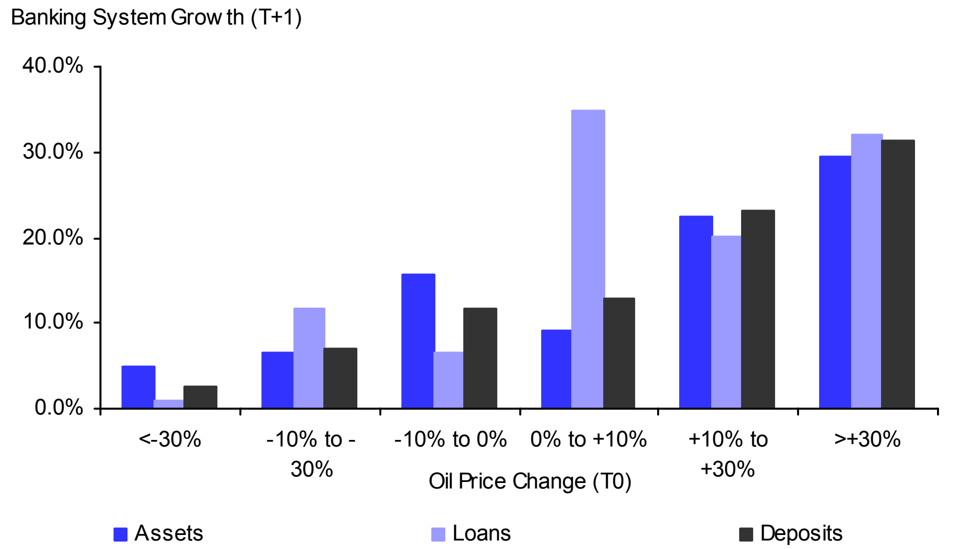
	FY 06A	FY 07A	FY 08E	FY 09E	FY 10E
Al Rajhi	6.82%	6.71%	5.88%	5.12%	4.88%
ANB	3.47%	3.37%	3.18%	2.87%	2.75%
Aljazira	3.19%	3.19%	2.73%	2.51%	2.439%
Albilad	3.93%	3.83%	3.54%	3.44%	3.29%
BSF	2.74%	2.56%	2.36%	2.17%	2.10%
NCB	3.77%	3.57%	3.45%	3.15%	2.99%
Riyad	3.36%	3.03%	2.88%	2.63%	2.53%
SABB	3.79%	3.57%	2.75%	2.32%	2.20%
SAMBA	3.70%	3.55%	2.90%	2.55%	2.41%
SHB	2.75%	2.52%	2.61%	2.42%	2.39%
SAIB	2.56%	2.42%	2.05%	1.85%	1.75%
Sector	3.47%	3.37%	2.85%	2.55%	2.41%

Source: Deutsche Bank, Company data

- Balance sheet volumes

We believe the change in oil price is a key driver in banking sector balance sheet volume trends. Rising oil prices appear to drive higher banking sector growth (after a one-year lag). Indeed the banking system appears to be more sensitive to oil price developments than the overall economy, perhaps reflecting the important impact oil prices can have on consumer and corporate confidence.

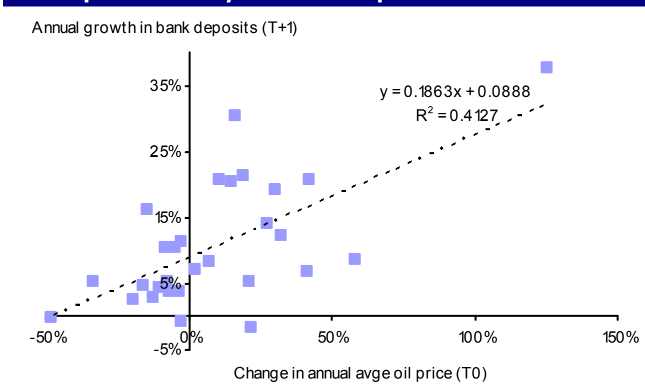
Figure 46: Banking system growth historically positively affected by higher oil prices (after a 12-month lag)



Source: Deutsche Bank, SAMA, BP

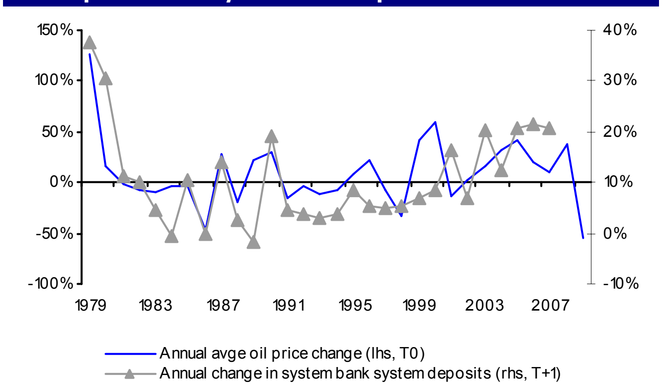
While 2008 data is likely to be benign (largely reflecting a strong first half to the year), our USD45 average oil price forecast for 2009 (a 55% decline on the 2008 level) suggests banking sector volume growth could slow sharply in the coming years.

Figure 47: Declining oil prices historically negative for subsequent bank system development



Source: Deutsche Bank, BP, SAMA

Figure 48: Declining oil prices historically negative for subsequent bank system development

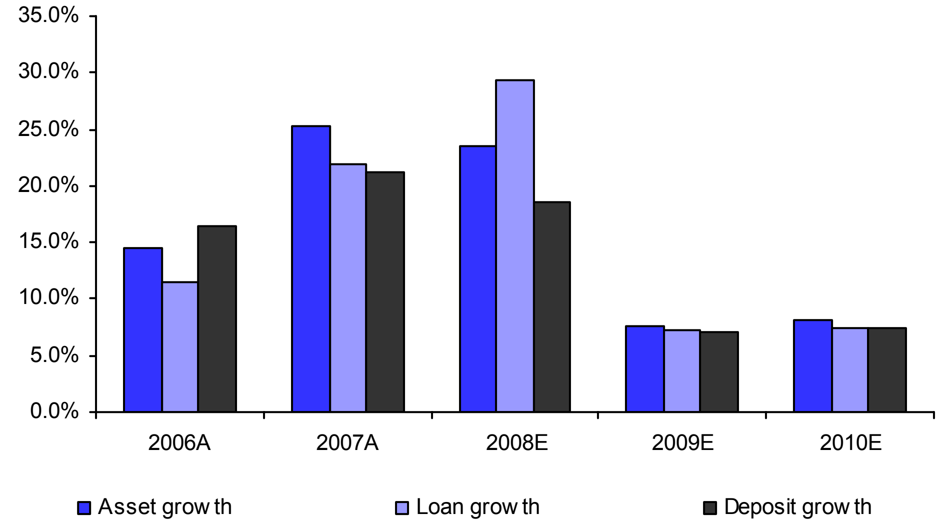


Source: Deutsche Bank, BP, SAMA

Indeed, there are good reasons to believe banking system growth could come in below the rate suggested by the longer-term oil price relationship given the sector-specific impact of the global credit crunch.

We present our bank system volume growth forecasts in Figure 49:

Figure 49: Bank sector balance sheet volume projections



Source: Deutsche Bank, Company data

On the basis of our margin and business volume forecasts, we expect net special commission income to register average growth of just 3.0-3.5% in 2009 and 2010. We believe any moves by global central banks towards tighter monetary policy (perhaps in 2010) would be positive for the top line revenue performance of the Saudi banks. Such a move would likely reflect more robust global macroeconomic fundamentals, thereby accelerating business volume growth and supporting higher margins in the sector.

- Net special commission income outlook

We present our net special commission income forecasts by bank in Figure 50:

Figure 50: Net special commission income growth forecasts

	FY 06A	FY 07A	FY 08E	FY 09E	FY 10E
Al Rajhi	20.2%	13.1%	8.5%	0.9%	1.8%
ANB	15.3%	15.0%	16.2%	3.0%	2.9%
Aljazira	72.4%	24.9%	9.2%	4.6%	3.7%
Albilad	228.6%	48.9%	11.3%	3.4%	5.7%
BSF	18.2%	13.8%	15.4%	7.5%	6.1%
NCB	8.1%	14.2%	17.8%	0.3%	1.6%
Riyad	9.5%	11.6%	20.9%	5.7%	3.6%
SABB	32.5%	15.7%	4.5%	3.1%	2.2%
SAMBA	22.6%	15.0%	1.1%	0.6%	1.9%
SHB	17.7%	2.6%	20.6%	6.4%	6.7%
SAIB	31.1%	2.5%	-0.6%	2.4%	3.3%
Sector	20.2%	14.2%	11.3%	3.1%	3.3%

Source: Deutsche Bank, Company data

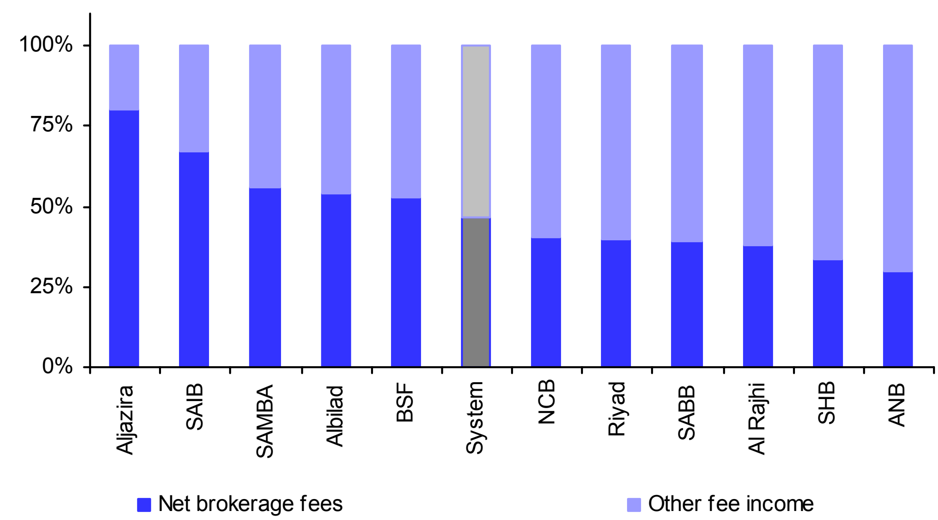
Fee income

At close to a quarter of banking system revenues, fee income is the second largest contributor of income for the Saudi banks.

- Equity brokerage fees

Despite the significant decline in the Saudi stock exchange level and trading volumes, share trading remains a key component of the overall fee pool, generating an estimated one-third of the current system fee income (down from a peak proportion of around three-quarters during the middle part of the decade and around half in 2007).

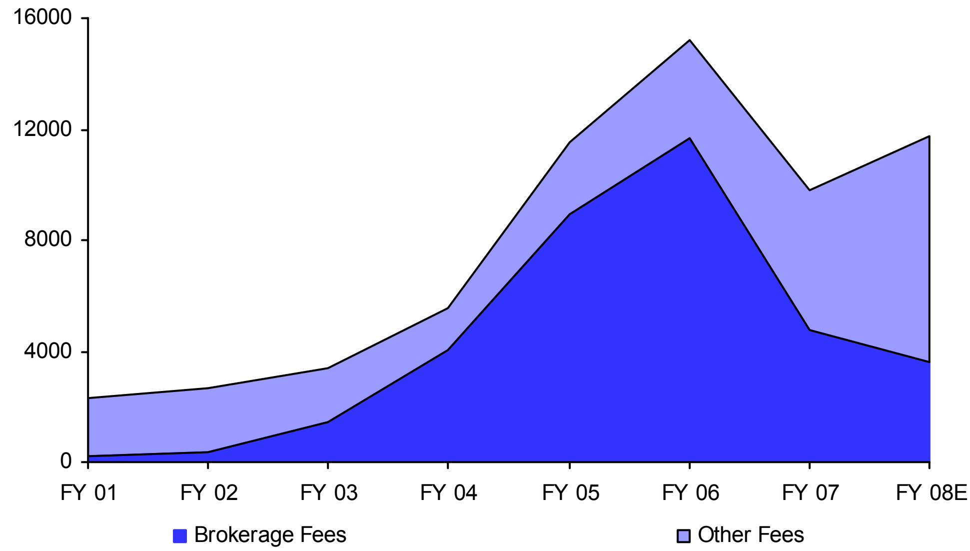
Figure 51: Brokerage fees as a proportion of overall fee income



Source: Deutsche Bank, Company data

Indeed, until very recently, overall fee pool trends were driven almost exclusively by brokerage fee developments. This dependence has weakened considerably in recent quarters as brokerage fees have continued to decline and growth in other fee income has accelerated (in part through the banks' efforts to improve cross-selling rates).

Figure 52: Historical brokerage and non-brokerage fee income trends at sector level (SARm)

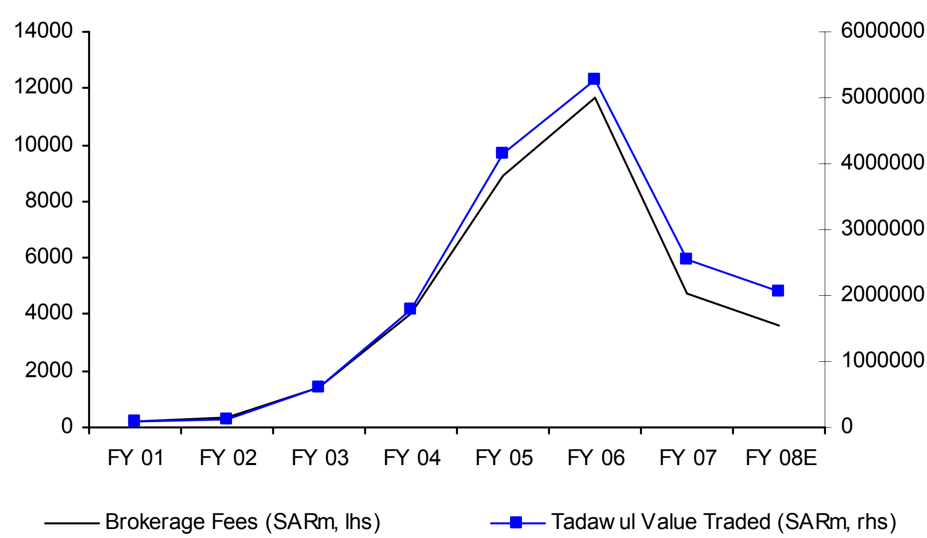


Source: Deutsche Bank, company data

- Equity brokerage fee outlook

Brokerage income is highly dependent on activity levels of the Saudi stock market.

Figure 53: Estimated historical brokerage fee trends



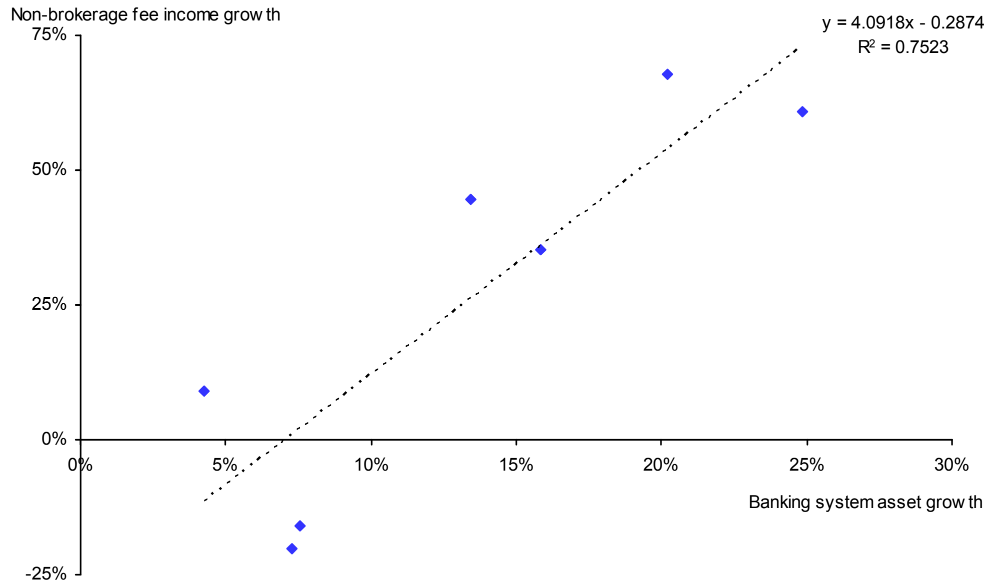
Source: Deutsche Bank, Tadawul, Company data

We believe brokerage income has declined by around 20% this year (a little more than the decline in Tadawul activity, reflecting some price competition). We cautiously assume a further decline of this magnitude in 2009 (reflecting ongoing pricing pressure and our view that retail investors are likely to remain cautious even if the Tadawul index recovers some lost ground), followed by stabilization in 2010.

- Other fees

For the increasingly important non-brokerage fees, we note that historically development has been closely linked to levels of overall banking activity.

Figure 54: Non-brokerage fee income has historically been associated with balance sheet volume growth



Source: Deutsche Bank, Company data, SAMA

We have previously indicated that we believe system balance sheet growth will be relatively muted (averaging around 8% in 2009 and 2010). However, recent data suggest banks are improving their fee generation from cross-selling. We believe non-brokerage fee income growth at the sector level could average 20% in 2009 and 2010.

Our fee income growth forecasts are shown in Figure 55:

Figure 55: Fee income forecasts

	FY 06A	FY 07A	FY 08E	FY 09E	FY 10E
Al Rajhi	4.6%	-36.7%	40.2%	11.2%	9.1%
ANB	42.2%	-21.3%	9.5%	8.8%	9.2%
Aljazira	104.1%	-62.8%	-21.3%	-9.1%	3.0%
Albilad	575.6%	-41.6%	47.0%	9.6%	8.8%
BSF	41.6%	-42.9%	-5.3%	1.2%	6.4%
NCB	27.4%	-6.5%	23.0%	8.2%	9.4%
Riyad	20.0%	-23.3%	21.2%	8.2%	9.4%
SABB	7.8%	-47.8%	49.7%	12.4%	8.6%
SAMBA	27.0%	-33.1%	14.3%	4.1%	7.8%
SHB	7.3%	-38.3%	28.2%	12.0%	9.8%
SAIB	19.6%	-49.2%	13.0%	1.1%	4.4%
Sector	27.0%	-38.3%	21.2%	8.2%	8.8%

Source: Deutsche Bank, Company data

Exchange income

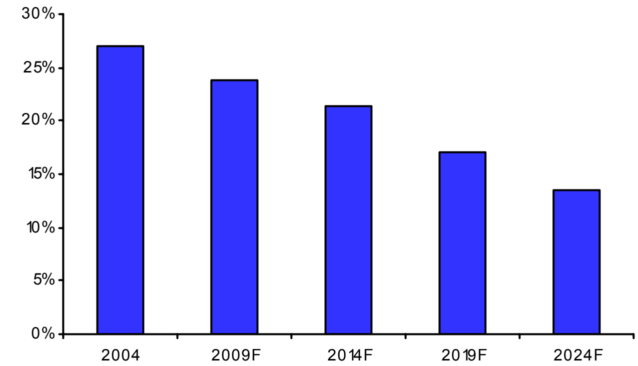
Exchange income typically accounts for around 4% of Saudi bank income, although the proportion has risen in recent years as brokerage fee income (in particular) has declined.

We believe exchange income will remain a relatively stable part of banking sector income. Its weighting could decline modestly, however, if the Saudi government realizes its long-term plan to reduce the economy's dependence on foreign labour, reducing remittance flows.

Figure 56: Exchange income (as % total revenue)

Source: Deutsche Bank, Company data

Figure 57: Proportion of non-Saudis living in KSA is projected to decline



Source: Deutsche Bank, Eighth Development Plan (Ministry of Economy and Planning)

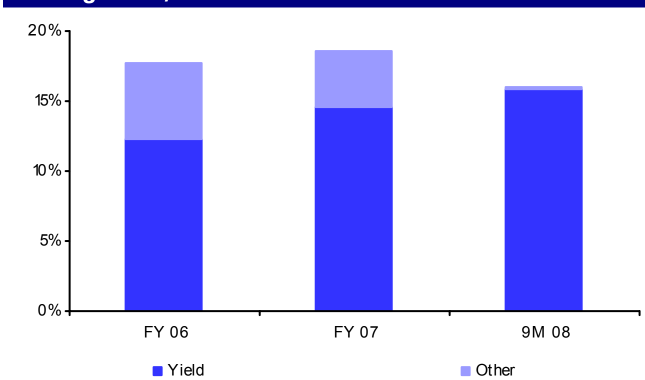
Investment income

The Saudi banks' investment portfolios (which on average account for 27% of balance sheet assets) generate revenues in three principal ways: 1) through yield generation (recorded as gross special commission income, or in the case of equities, as dividend income); 2) via realised and unrealised changes in the value of trading securities; and 3) as realised gains and losses for other securities categories.

The regular yield component has averaged 4.4% of the investment portfolio in recent years and is typically the largest and most stable contribution. Even as other elements of the investment portfolio have declined, the overall contribution to total bank revenues (pre funding costs) has also been quite stable.

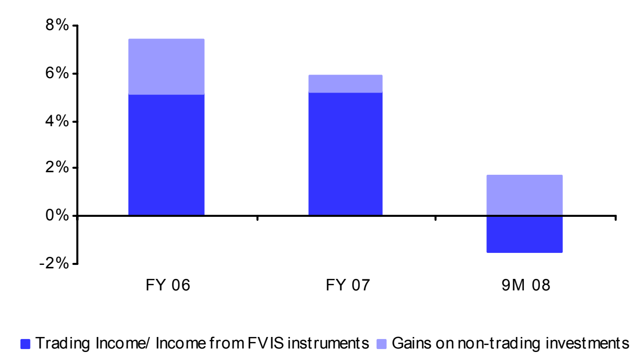
We accounted for the yield component in our discussion of net special commission income above and focus here on other income streams from the banks' investment portfolios.

Figure 58: Income from the Saudi banks' investment portfolios contributes around 18% of total revenues (pre funding costs)



Source: Deutsche Bank, Company data

Figure 59: Trading income has declined sharply in recent years (% total revenues, net of funding costs)

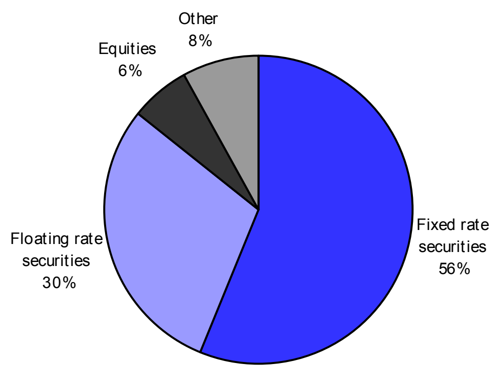


Source: Deutsche Bank, Company data

As Figures 60 and 61 show, trading income has been very volatile in recent years. On average, the Saudi banks' trading portfolio has an 85% equity component, suggesting continued equity market weakness would continue to depress these revenues. However, examination of the historical data suggests there is very little correlation between trading income and equity market performance.

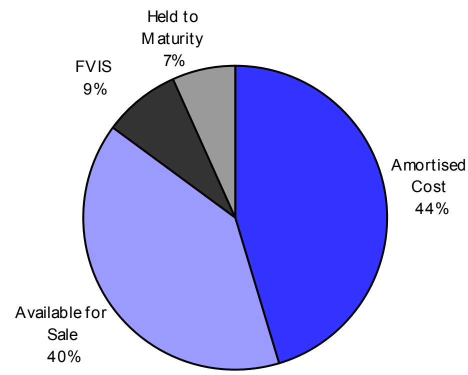
In contrast, gains on non-trading investments have proved less volatile, perhaps reflecting the greater weighting of floating and fixed rate investments that would have contributed to this revenue stream.

Figure 60: Investment portfolio composition (by asset class)



Source: Deutsche Bank, Company data

Figure 61: Investment portfolio composition (by accounting treatment)



Source: Deutsche Bank, Company data

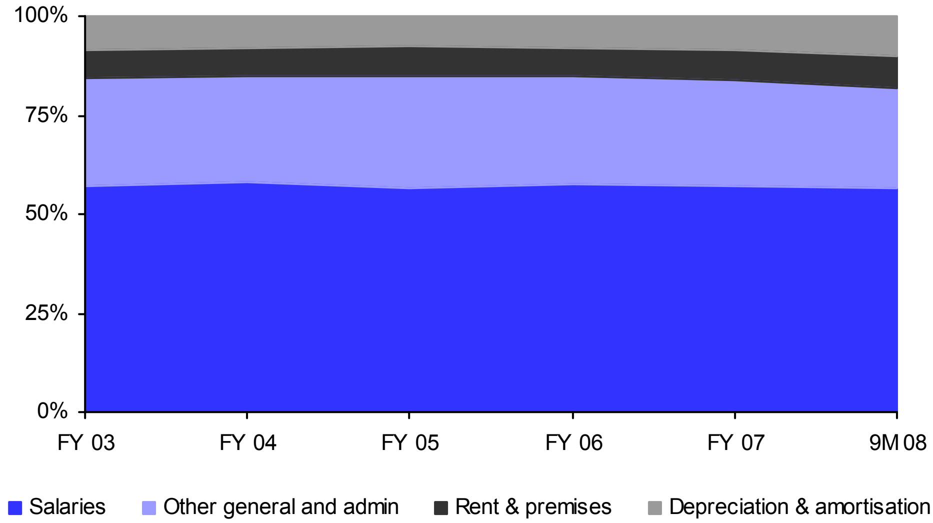
In our forecasts we assume banks' investment portfolios will continue to generate income yields of c. 4.5%. We cautiously assume that trading income and gains on non-trading assets are minimal, suggesting that at the industry level the total contribution from investment portfolios will be broadly in line with that experienced in 9M08.

In the Risk section of this report, we consider in more detail the possibility and potential impact of significant valuation declines on the Saudi banks' investment portfolios.

Operating costs

Wages and salaries are the largest source of costs for the Saudi banks. The operating cost mix has remained broadly stable over the past few years.

Figure 62: Salaries are the largest component of Saudi bank operating costs

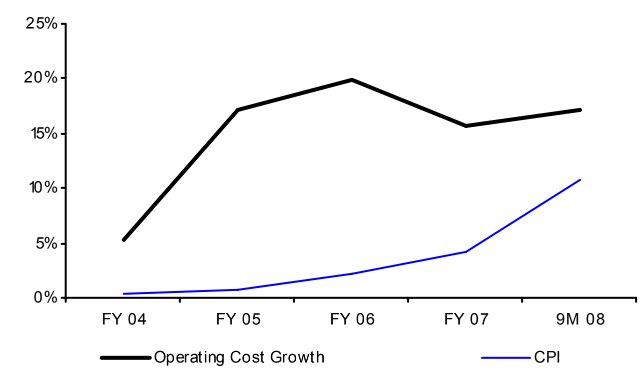


Source: Deutsche Bank, Company data

Until 2008, official Saudi inflation statistics indicated that cost pressures in the Kingdom were limited. The situation has changed significantly in recent quarters, with housing and food costs rising sharply. However, as in other economies, inflation already seems to be trending down as global growth declines and commodity prices fall.

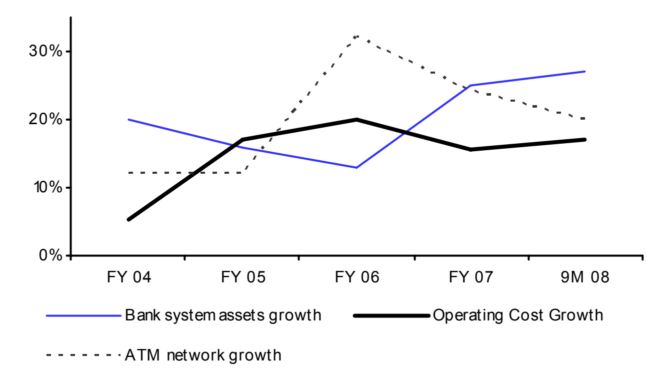
In contrast, cost growth in the Saudi banking system has been robust for a number of years. We believe this largely reflects investment in new capacity rather than underlying inflation.

Figure 63: Bank system operating cost growth and inflation



Source: Deutsche Bank, Company data, SAMA

Figure 64: Bank system operating cost growth and business volume growth



Source: Deutsche Bank, Company data, SAMA

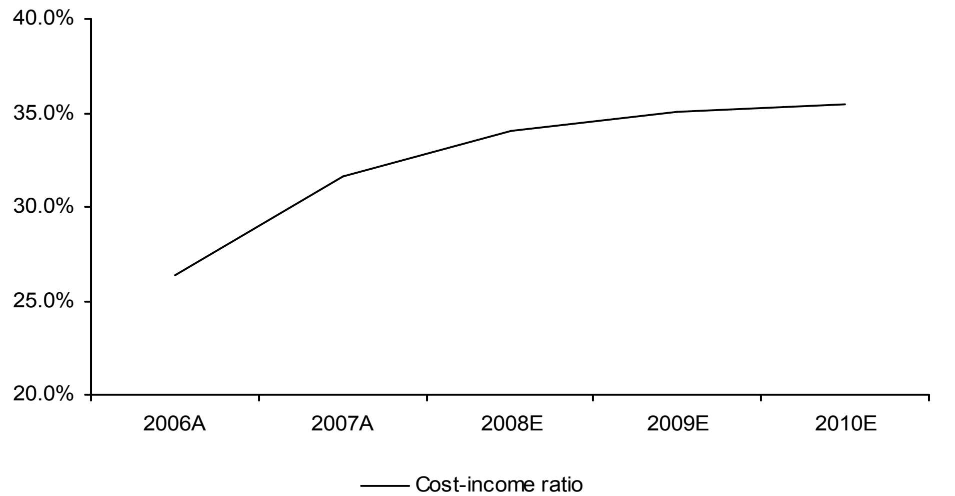
Indeed, we believe these robust cost growth trends are likely to be sustained, at least in the near-term. Most banks are looking to expand their distribution capacity, reflecting a combination of factors, in our view:

- The buoyant business volume experience of the past few years has likely recalibrated management expectations upwards
- A desire to capture low cost retail deposits via branch network extension (particularly given illiquid wholesale funding markets)

- Management's desire to position their businesses to benefit from the likely development of the retail banking sector (most notably, from the potential enactment of a mortgage law)

Given our cautious revenue outlook, we see cost growth continuing to outstrip income, resulting in a continued upward drift in the cost-income ratio.

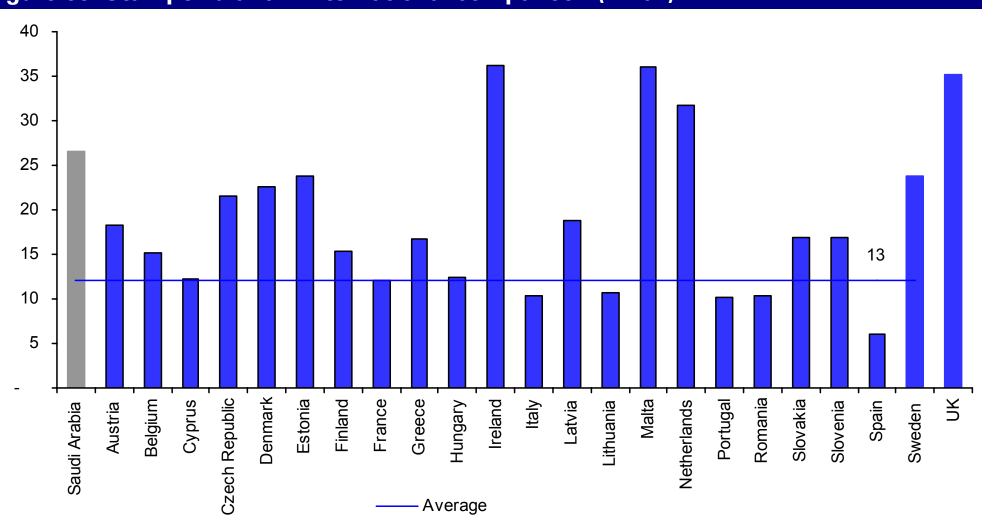
Figure 65: Saudi bank cost-income ratios are likely to rise, reflecting robust cost growth and sluggish revenue development



Source: Deutsche Bank, Company data

However, we also see scope for fundamental efficiency improvements. On average, Saudi banks employ the equivalent of 27 staff per branch, compared to the European bank average of 13. Through redeployment of staff from administrative to sales-oriented roles, it appears possible for the Saudi banks to expand their distribution capabilities without significantly increasing headcount. Indeed, a number of Saudi banks are trying to shift the profile of their headcount in line with this approach. Moreover, the data suggests there is a cost cushion which could be accessed by more aggressive management teams in the event that the revenue outlook deteriorates significantly.

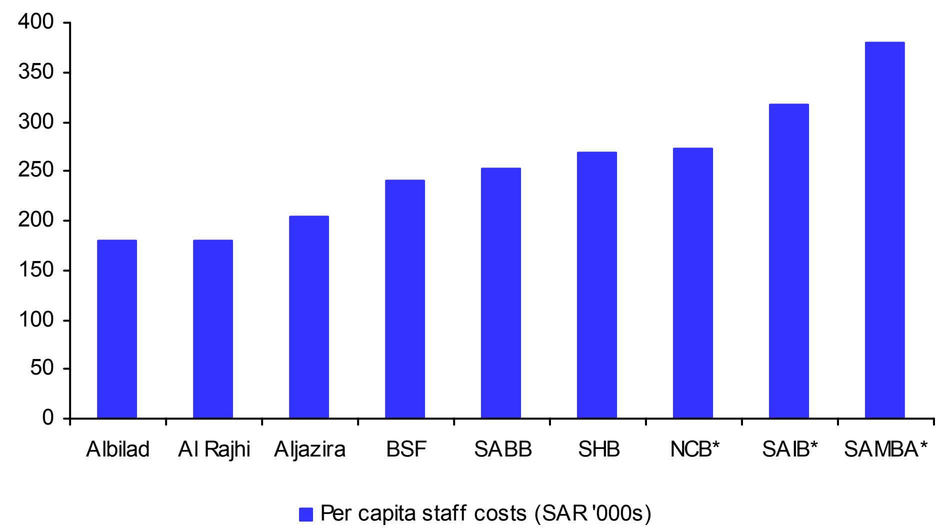
Figure 66: Staff per branch: international comparison (FY 07)



Source: Deutsche Bank, ECB

One interesting feature of the Islamic banks Al Rajhi, Albilad and Aljazira is that their cost structures appear to benefit from lower staff costs. We believe this is not reflective of the business mix (while Al Rajhi is skewed towards retail banking, where per capita staff costs tend to be lower, Aljazira and Albilad have more corporate banking exposure). Rather, it may reflect the wish of certain individuals to work at companies that share their beliefs and values.

Figure 67: Per capita staff costs (2007)

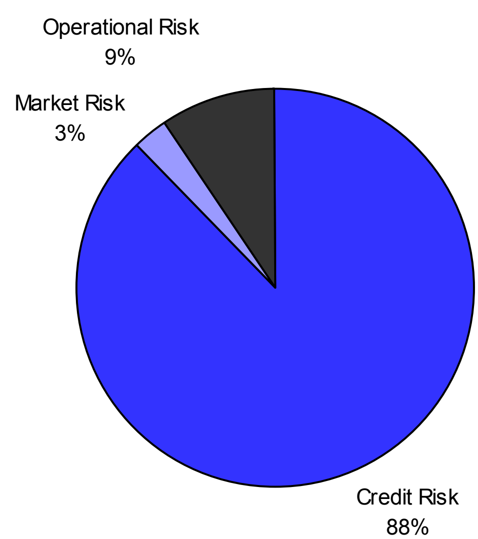


*Source: Deutsche Bank, Company data. * denotes 2006 data, otherwise data is 2007*

Risk costs

As highlighted above, we believe the Saudi banking system is relatively conservatively positioned. Basel II disclosures by the banks indicate they are mainly subject to credit risks.

Figure 68: Basel II risk exposure by type (H108)

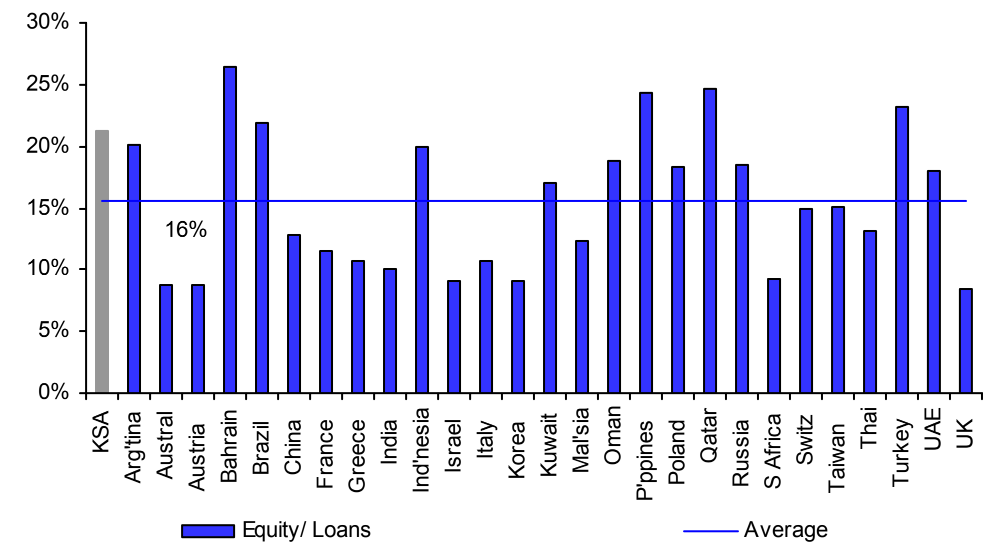


Source: Deutsche Bank, Company data

Credit risk

The equity/loans ratio of the Saudi banking system compares favourably with those of other markets, indicating that the banks have a greater cushion to absorb losses from any deterioration in loan portfolio quality. We also view the likelihood of losses from loan exposures as more limited than other banking systems, reflecting lower real estate exposure and the significant financial resources available to the Saudi government to cushion the economy from a sharp contraction.

Figure 69: Saudi bank system equity/loan ratio (2007)

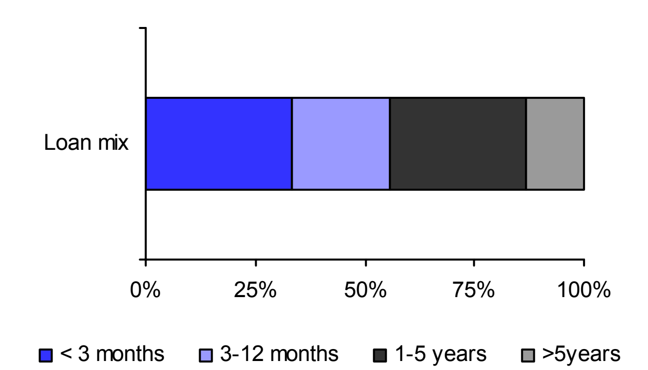


Source: Deutsche Bank, Central Banks

The bulk of loans are short-term (less than one year), while only a quarter are long-term (over three years maturity), partly reflecting the underdeveloped nature of the domestic retail and corporate mortgage market.

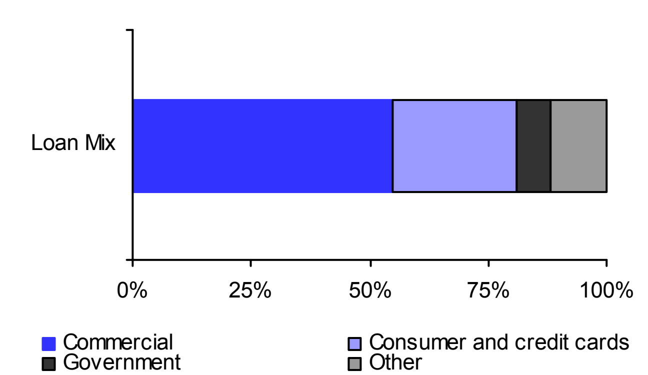
Commercial loans form the largest category of credit, followed by consumer lending. We present more details by borrower type in Figure 71:

Figure 70: Loan mix by loan maturity



Source: Deutsche Bank, Company data

Figure 71: Loan mix by borrower category



Source: Deutsche Bank

Around 80% of overall credit exposure and over 90% of the banks' customer loan portfolios are domestic. Around half of international exposures are to European borrowers (principally banks and other financial institutions).

Asset quality statistics appear broadly sound, with the volume of non-performing or at risk loans typically low and non-performing loans more than covered by existing provisions.

Figure 72: Key credit risk information by bank

	Domestic component		Asset quality		Loan Mix		
	Loans	Credit Risk	NPLs/ Loans	Provisions/ NPLs	Corporate	Consumer	Government
Al Rajhi	92%	95%	3.0%	109%	38%	51%	11%
ANB	97%	88%	0.5%	354%	70%	30%	0%
Aljazira	99%	92%	2.0%	161%	93%	7%	0%
Albilad	73%	89%	0.8%	70%	95%	5%	0%
BSF	92%	87%	0.7%	190%	91%	7%	2%
NCB	97%	73%	2.2%	141%	39%	35%	26%
Riyad	94%	86%	1.6%	139%	77%	23%	1%
SABB	100%	81%	0.3%	290%	76%	20%	3%
SAMBA	95%	82%	2.3%	160%	81%	18%	1%
SHB	100%	92%	3.9%	110%	85%	13%	2%
SAIB	100%	88%	1.3%	243%	90%	7%	3%
Sector	95%	87%	1.8%	145%	67%	26%	7%

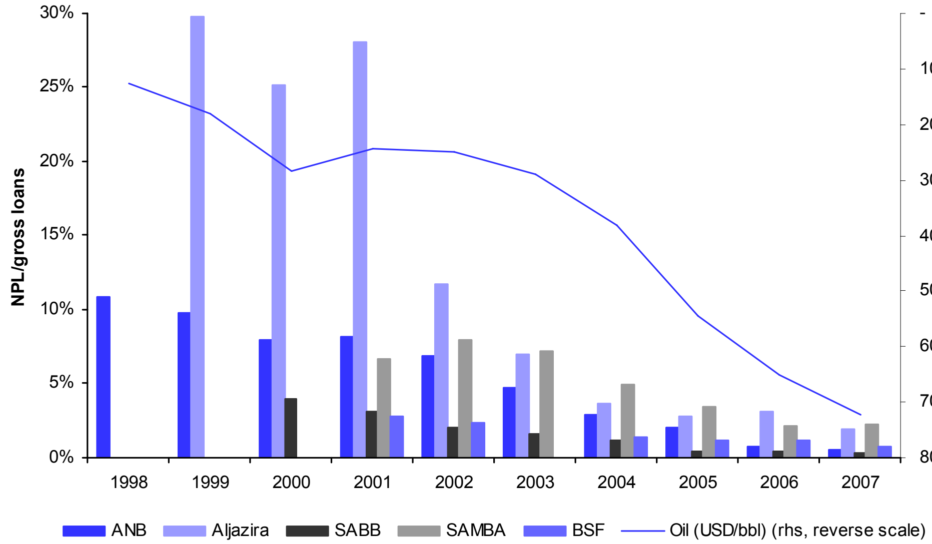
Source: Deutsche Bank

Credit risk outlook

We believe future asset quality trends will be negative. We are already seeing anecdotal signs of stress among retail exposures (sluggish credit growth, increased SAMA oversight, reports of rising auto loan delinquencies and forced liquidation of equity market collateral). We believe problems will also extend to corporate exposures as economic growth slows and corporates find it increasingly difficult to roll-over maturing debts.

How bad could things get? Unfortunately, asset quality statistics are not disclosed at the system level and entity level asset quality information provides only a limited story. For those banks on which we have been able to collect a reasonable dataset, we see that asset quality has improved consistently in recent years. We believe it is not just a coincidence that this period has seen steadily increasing oil prices. With oil prices falling (and projected to remain low by our commodities analyst) and global economic growth stalling, we believe non-performing loans are set to rise substantially.

Figure 73: Asset quality improvements over the past few years have coincided with steadily appreciating oil prices



Source: Deutsche Bank, Company data, BP.

Our baseline forecasts for the Saudi banking sector assume that the NPLs/loans ratio will rise to an average level of 5% by 2010, while provisions coverage will decline to around 60%. This is broadly in line with the experience of the sector in 2003 and implies a reduction in sector earnings power of around 20%.

At the individual entity level our asset quality model has three principal drivers:

- Historical asset quality experience

The risk appetite and risk management capabilities of different banks can vary considerably. We view historical trends as a key indicator of such differences:

Figure 74: Recent asset quality trends

	NPLs/Loans			Provisions/NPLs		
	2005	**2006**	**2007**	**2005**	**2006**	**2007**
Al Rajhi	2.0%	2.3%	3.0%	168%	136%	109%
ANB	2.2%	0.7%	0.5%	201%	321%	354%
Aljazira	2.9%	3.3%	2.0%	177%	173%	161%
Albilad	0.0%	0.2%	0.8%	-	33%	70%
BSF	1.2%	1.2%	0.7%	182%	148%	190%
NCB	1.5%	2.1%	2.2%	218%	176%	141%
Riyad	1.1%	1.6%	1.6%	270%	177%	139%
SABB	0.5%	0.4%	0.3%	194%	301%	290%
SAMBA	3.5%	2.3%	2.3%	124%	182%	160%
SHB	1.3%	2.6%	3.9%	158%	114%	110%
SAIB	1.0%	1.1%	1.3%	364%	358%	243%
Sector	1.8%	1.7%	1.8%	179%	174%	145%

Source: Deutsche Bank, Company data

- Recent loan credit growth

Given the likely downturn in the Saudi economy in the coming 12-24 months, we view the most recently extended credits as being the highest risk; we believe recent borrowers are more likely to be highly geared and surprised by any downturn in their own income levels.

- Loan mix

We believe retail credits are more likely to see impairment than corporate credits. We are already seeing more retail banking-oriented entities record a higher bad debt charge than their peers. Regarding corporate exposures, we believe lending to the construction sector is a particular risk area given difficult financing conditions and slowing economic growth.

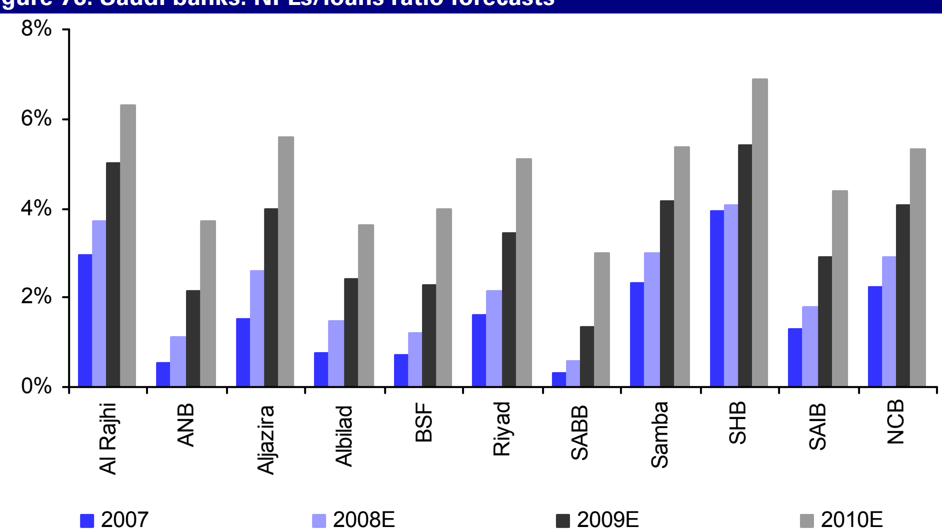
Figure 75: Asset quality risk factors: recent credit growth and loan mix

	Annual Loan Growth		Loan Mix			
	FY 07	9M 08	Consumer	Corporate	(Construction Sector)	Government
Al Rajhi	17%	26%	51%	38%	5%	11%
ANB	23%	29%	30%	70%	9%	0%
Aljazira	111%	71%	7%	93%	5%	0%
Albilad	38%	-9%	5%	95%	3%	0%
BSF	17%	39%	7%	91%	11%	2%
NCB	14%	29%	35%	39%	8%	26%
Riyad	29%	39%	23%	77%	7%	1%
SABB	46%	54%	20%	76%	4%	3%
SAMBA	20%	24%	18%	81%	12%	1%
SHB	4%	42%	13%	85%	11%	2%
SAIB	12%	37%	7%	90%	18%	3%
Sector	22%	29%	26%	67%	8%	7%

Source: Deutsche Bank, Company data

Based on these factors, our model generates the following loan quality outlook for the Saudi banks. We expect Saudi Hollandi Bank and Al Rajhi Bank to have the highest NPLs/loans ratios in 2010 and SABB to have the lowest.

Figure 76: Saudi banks: NPLs/loans ratio forecasts



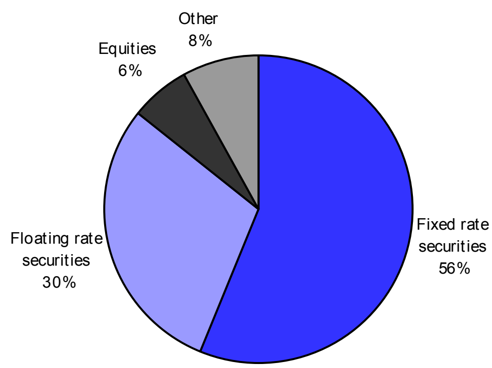
Source: Deutsche Bank, Company data

In our sensitivity analysis, we examine the impact of asset quality states that differ from our baseline scenario.

Market risk

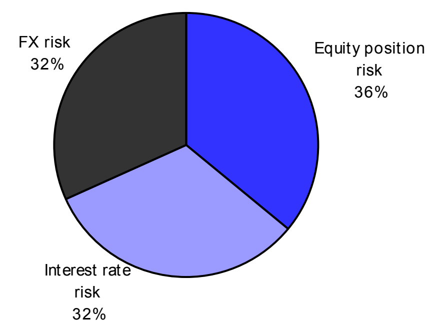
According to the Saudi banks' Basel II disclosures, market risk comprises just 3% of their overall risk profiles. Although equities comprise just 6% of sector investment portfolios, their weighting of risk is considerably higher, reflecting the higher volatility of this asset class. Fixed income and currency risks are the other key drivers of market risk for the Saudi banks.

Figure 77: Investment portfolio mix (by asset class FY07)



Source: Deutsche Bank, Company data

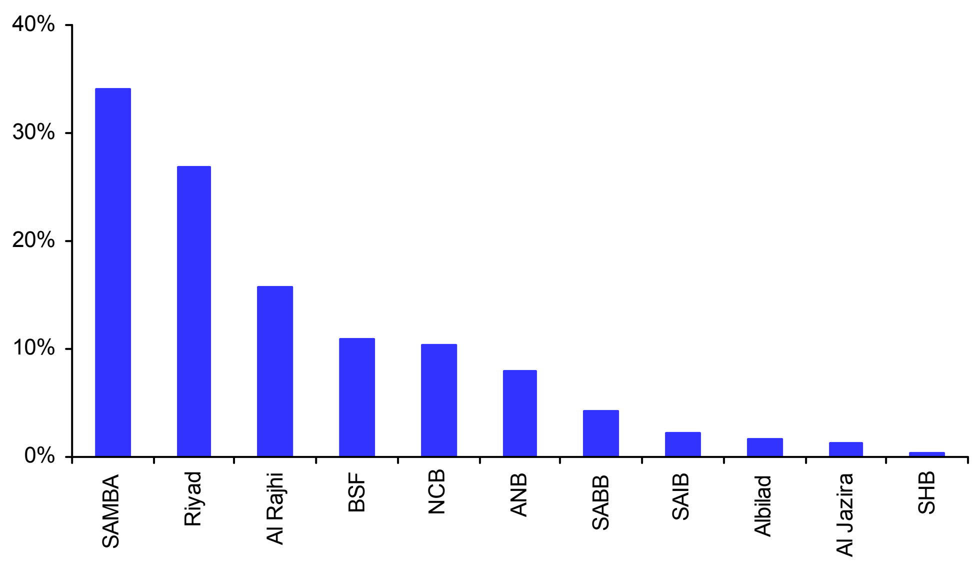
Figure 78: Market risk mix (H108)



Source: Deutsche Bank, Company data

The appetite for market risk appears to vary significantly from institution to institution, with Samba, Riyad and Aljazira appearing most comfortable in their ability to generate shareholder value from market-based activities.

Figure 79: Share of overall sector market risk (H108)



Source: Deutsche Bank, Company data

In our forecasts to 2010 we assume that the investment portfolios will generate a yield of around 4.5%, broadly in line with the overall experience in 9M08. We assume neither significant trading gains nor losses.

Operational risk

Data prepared by the banks for Basel II purposes suggest operational risks account for 9% of the Saudi banks' overall risk profile. Most of the banks have elected to use the standardized approach, calibrating operational risk to revenue generation.

Liquidity risk

In the current environment, a key concern for bank sector investors clearly relates to liquidity. Relative to their global peers, we believe Saudi banks are conservatively positioned with respect to liquidity risk. However, as geared businesses with structural mismatches, the banks are not immune from issues affecting banks globally.

Sensitivity analysis

Our earnings forecasts are based on a number of key assumptions (as outlined in more detail in the "Sector outlook" section).

- Slowing business volume growth
- Declining net special commission income margins
- Declining equity brokerage fees, but growth in other fee categories
- Stable income from the banks' investment portfolios (primarily recorded within net special commission income)
- Rising loan provision charges
- Limited investment impairment charges

The current environment presents investors with a high degree of uncertainty regarding potential future outcomes. We present below a sensitivity analysis in a number of areas which may help investors flex our forecasts to be more in line with their own views.

Figure 80 summarises the results of our core sensitivities at the sector level:

Figure 80: Sensitivity analysis

Risk Factor	B/sheet volume growth	Interest rates	Equity brokerage fees	Operating cost growth	Loan loss provisions		Equity investments	
Potential Shift	1% point reduction	25bps increase	10% increase	1% point decrease	Additional 1% of loan book		25% reduction in value	
Impact on:	Net income	Net income	Net income	Net income	Net income	Equity	Net income	Equity
Al Rajhi Bank	-1.3%	2.2%	0.6%	0.5%	-23%	-4.3%	-2%	-0.4%
Arab National Bank	-1.3%	1.4%	0.7%	0.6%	-31%	-5.3%	-8%	-2.0%
BankAlbilad	-2.6%	4.2%	4.2%	2.9%	-62%	-4.2%	0%	-4.0%
Bank Aljazira	-2.4%	11.0%	9.0%	2.8%	-62%	-3.2%	-24%	-3.3%
Banque Saudi Fransi	-1.0%	-0.9%	1.0%	0.4%	-32%	-5.8%	0%	-0.6%
Riyad Bank	-1.3%	1.9%	1.1%	0.6%	-32%	-3.6%	-19%	-2.5%
SABB	-1.0%	1.7%	1.2%	0.5%	-30%	-6.6%	0%	-0.9%
Samba	-1.1%	2.1%	1.6%	0.5%	-24%	-4.4%	-34%	-7.0%
Saudi Hollandi Bank	-1.4%	-1.9%	1.1%	0.9%	-38%	-7.1%	0%	-1.0%
Saudi Investment Bank	-1.1%	0.5%	2.1%	0.5%	-36%	-3.9%	0%	-4.1%
Sector median	-1.3%	1.8%	1.1%	0.6%	-32%	-4.4%	-1.0%	-2.2%

Source: Deutsche Bank

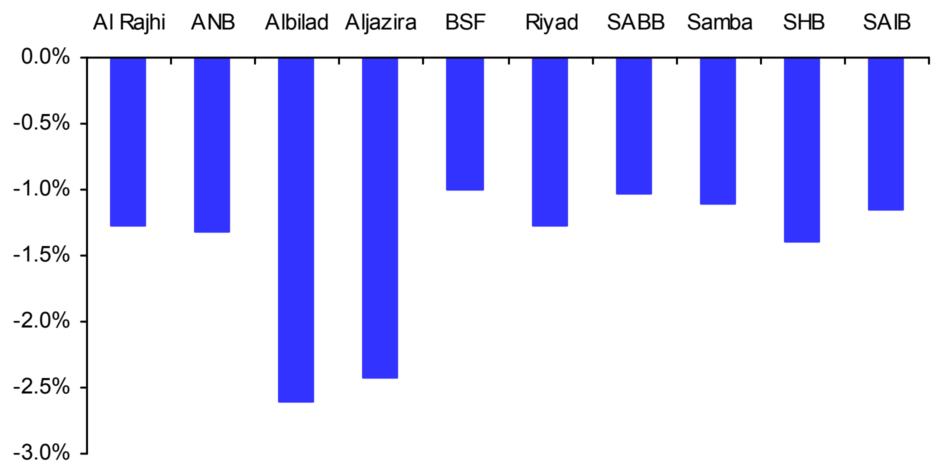
Revenues

We present below a number of scenarios that could affect our revenue projections. In calculating these sensitivities we have not factored in any implications for the banks' costs, but rather have assumed that the revenue change flows straight through to the bottom line.

Impact of lower volume growth

We have assumed balance sheet growth of 8% pa. Solely considering the impact on net special commission income, each 1% point decline in balance sheet growth would reduce sector earnings by around 1.3%, with Bank Albilad and Bank Aljazira most affected:

Figure 81: Impact of 1% point decline in balance sheet growth on Saudi bank earnings (2010E)

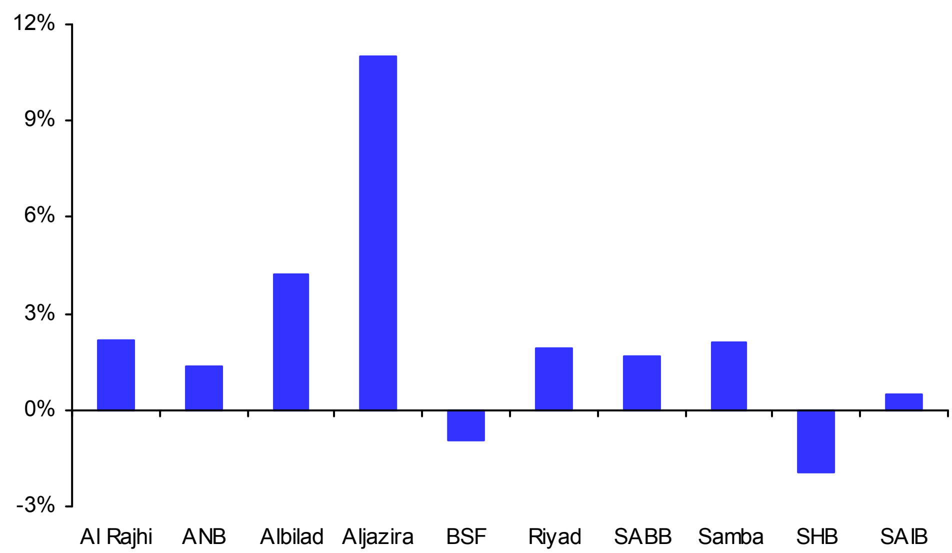


Source: Deutsche Bank. Note: our calculations are based solely on the impact of lower volumes on net spcial commission income and do not account for any impact on other revenue stream, or operating and risk costs.

Impact of higher interest rates

While interest rates appear to have limited potential to decline, an unexpectedly sharp global economic recovery could see interest rates rise to more normal levels. Figure 82 highlights the potential impact on net special income of such a scenario, based on the Saudi banks' historical net special commission income margin experience. On average, such an interest rate shift might be expected to generate an uplift of 1.8% to sector earnings (other things being equal), although Bank Aljazira in particular might be expected to be a much bigger beneficiary.

Figure 82: Potential impact on Saudi bank earnings of a 25bps increase in interest rates (2010E)

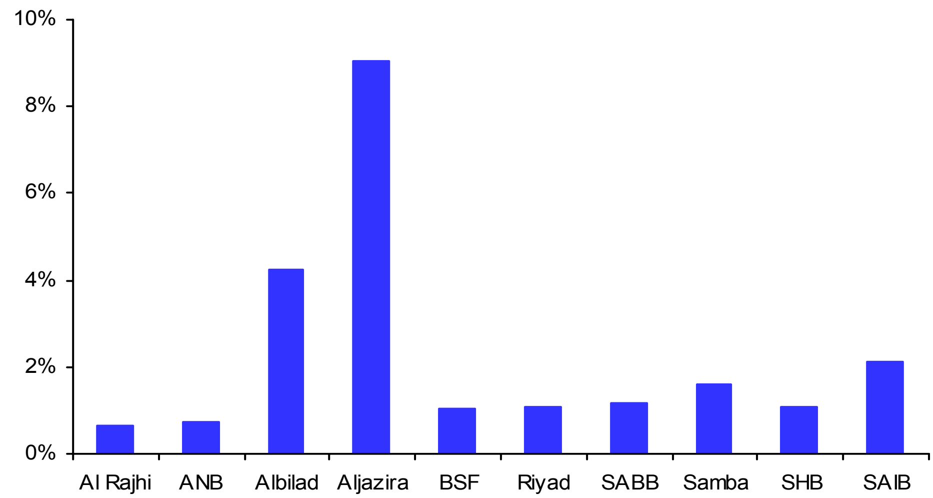


Source: Deutsche Bank. Note: our calculation is based on the historical correlation between each bank's net special commission income margin and interest rates, and does not take into account any potential impact on other revenue or cost streams

Recovery in equity brokerage fees

Our baseline forecasts are for continued declines in this income stream, thereby extending the trend of the past few years. Figure 83 highlights the sensitivity of the banks' earnings to a reversal of this trend. A 10% increase in brokerage fees could lift sector earnings by 1.1%, although again there would be a wide variation across the sector, with Bank Aljazira appearing to be the most sensitive to changes in this revenue stream.

Figure 83: Impact on earnings of a 10% increase in brokerage fees (2010E)

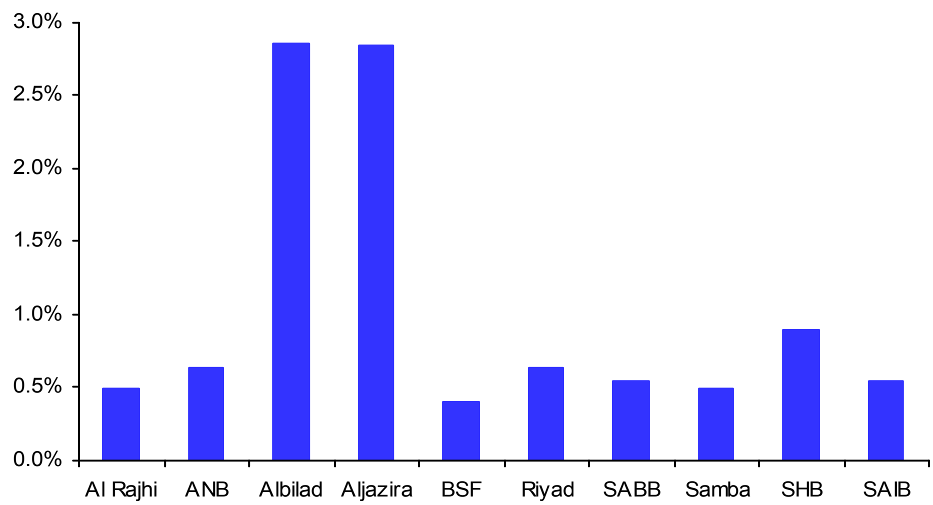


Source: Deutsche Bank. Note: our calculation assumes the full impact of any revenue increase is transferred to net income i.e. there are no costs associated with the incremental revenue.

Impact of slower cost growth

Sector cost growth has averaged 17% pa over the past three years (well in excess of inflation), as banks have invested in additional distribution infrastructure in an environment of strong business volume growth. We expect cost growth to average 7% pa. We highlight below the potential impact of more aggressive cost control from bank management teams. Not surprisingly, earnings of the most operationally geared companies in the sector, Bank Albilad and Bank Aljazira, would benefit most from lower cost growth.

Figure 84: Impact of a 1% point reduction in cost growth on Saudi bank earnings (2010E)



Source: Deutsche Bank

Risks

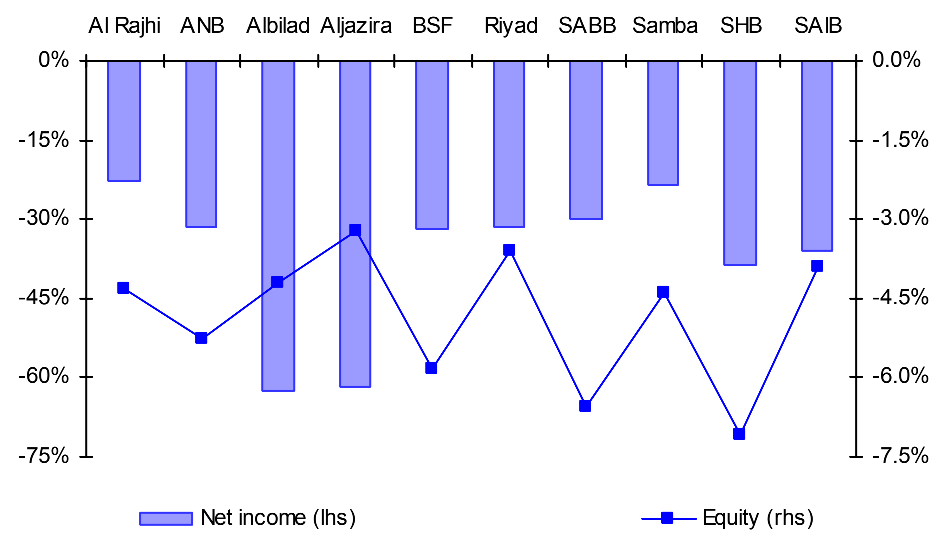
We consider certain scenarios of the risk of the banks' credit and investment portfolios.

Credit risk

Our baseline assumption is for the system's non-performing loans/loans ratio to rise from 1.8% in 2007 (the last reported data point) to 5.0% in 2010E. Over this period we expect the provisions coverage ratio to decline from 146% to 61%.

In Figure 85 we examine the impact of an additional 1% of loans becoming non-performing and being 100% provided for by each of the Saudi banks in our coverage universe.

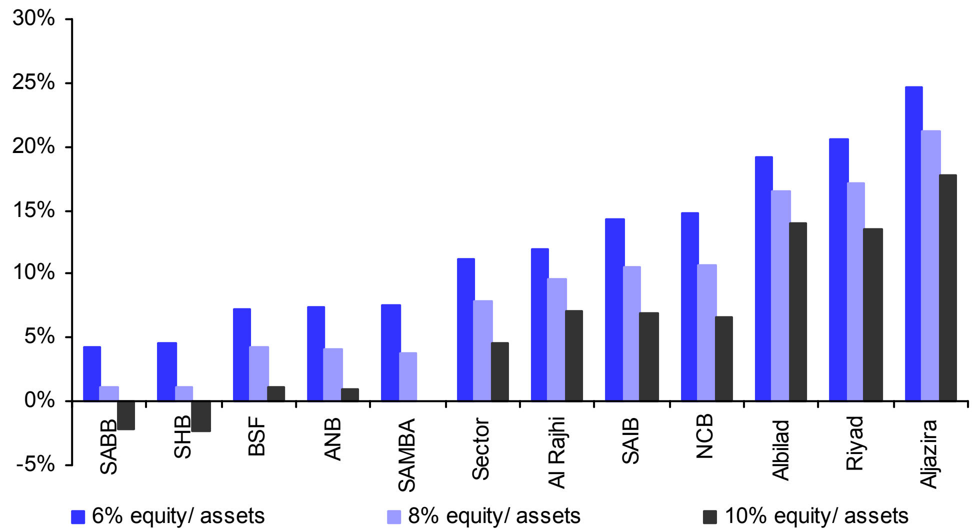
Figure 85: Impact of providing for 1% of loans on Saudi bank profitability and equity (2010E)



Source: Deutsche Bank

Our analysis, as shown in Figure 86, indicates that there is a wide variation within the sector of loan provisioning that could take place before certain equity/asset ratio triggers are breached. On average, 10% of the loan book could be fully written down before a bank's equity/assets ratio falls below 6%. However, there is wide variation between entities. For example, Bank Aljazira would be able to raise provisions equivalent to 18% of its loan book before its equity/assets ratio declines below 10%. In contrast, provisions against less than 5% of SABB's loan book would bring the bank's equity/assets ratio down to 6%.

Figure 86: Saudi bank provisioning capacity (as % loans) before reaching selected equity/asset ratio trigger points (H108)



Source: Deutsche Bank, Company data

Investment portfolio risk

Investments account for around 27% of Saudi banks' balance sheets (compared to 57% for customer loans). In addition, around 85% of these portfolios consist of floating and fixed rate instruments from government and highly-rated corporate issuers.

Some Saudi banks had a limited amount of exposure to US subprime assets, but according to the ratings agencies, these have now been largely written down or provided for. We believe the volume of other exotic investments (structured products and so on) is also limited. In our view, the key risk to investors lies with the equities portion of the Saudi banks' portfolios.

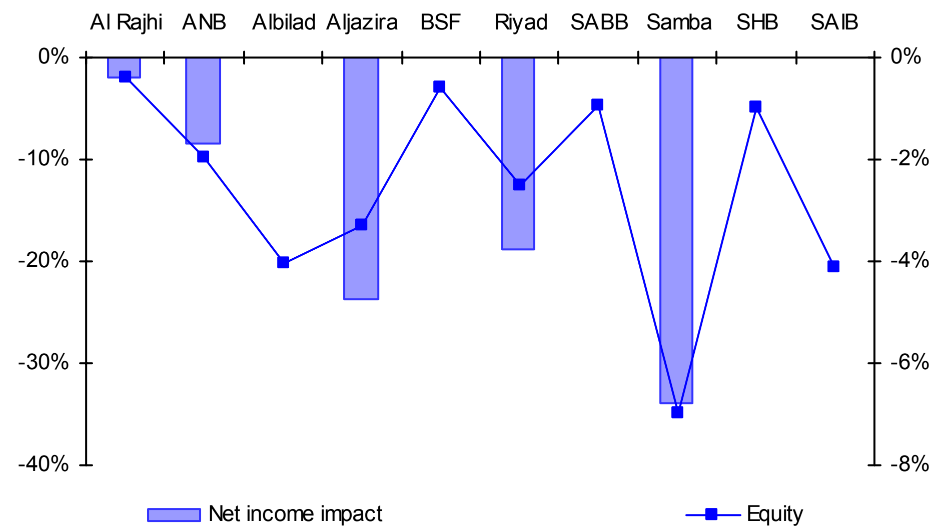
Potential impact of lower equity values

We present below the potential impact on bank earnings and equity of a 35% decline in the Saudi stock market (from the 9M08 level). The index declined by this amount in Q408.

In order to obtain this data, we assume that any change in the equity trading portfolio is taken directly to earnings, while shareholders' equity is also affected by the change in the value of the equity available for sale portfolio, and by half of the change in the remainder of the equity portfolio (i.e., assuming 50% of the value change is deemed a permanent diminution).

With a number of the banks accouting for their equity investments solely on an available for sale basis, their income statements could be shielded from recording any loss of value until the security is sold. We therefore view the potential impact on equity as a more representative guide to relative sensitivity across the sector to equity value fluctuations.

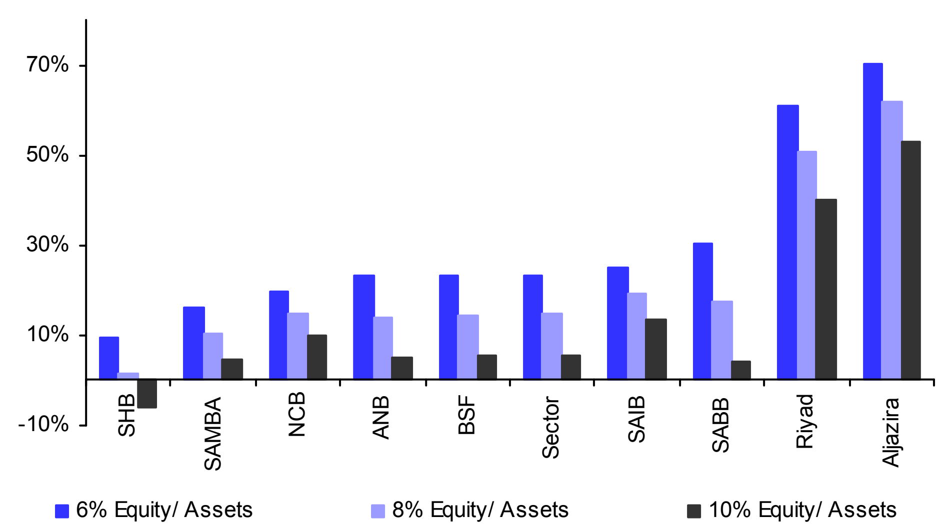
Figure 87: Impact of 25% decline in equity investments on Saudi bank earnings and equity (2010E)



Source: Deutsche Bank

The analysis conducted above relates solely to the equity portfolios of the Saudi banks, where we believe valuation risks are concentrated. It is nevertheless possible that the banks' fixed and floating rate portfolios will also deteriorate in value (e.g., if the economic downturn affects the debt servicing ability of the issuer). Figure 88 examines some sensitivities to write-downs of the investment portfolio. Most of the banks would be able to absorb investment portfolio write-downs of more than 20% before their equity/assets ratio falls below 6%.

Figure 88: Level of investment portfolio write-downs that could be absorbed before reaching selected equity/asset ratio trigger points (FY07)

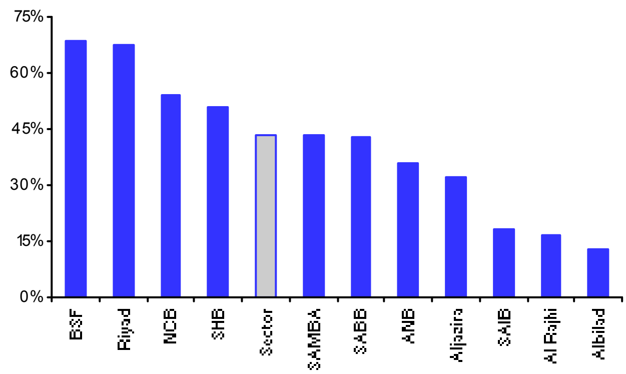


Source: Deutsche Bank, Company data. Note that Bank Albilad and Al Rajhi Bank would both be able to absorb full write-downs of their financial investment portfolios without reaching any of these equity/ asset ratio trigger points. Note also that for Riyad Bank we have used H1 08 equity base to reflect the company's Q2 08 capital increase.

Liquidity risk

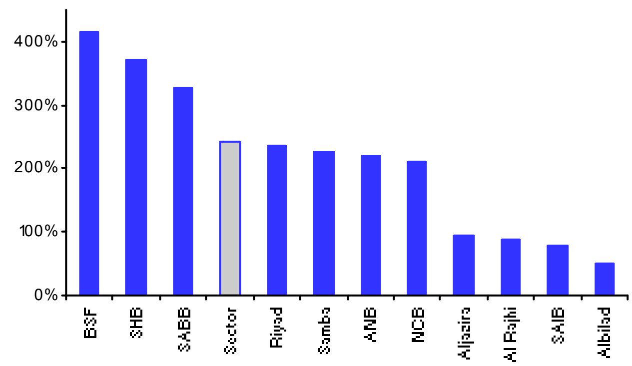
Although we do not seek to quantify any potential impact, we do note that the Saudi banks, like most of their international peers, have a surplus of long-dated assets relative to their liabilities. If confidence in an institution or the sector were to be negatively affected, this could result in short-term funding being withdrawn. Unexpected drawdowns of committed funds could exacerbate the situation. We present below a ranking of Saudi banks with the largest exposure to off balance sheet commitments, although we acknowledge that the risk associated with such off balance sheet commitments is typically extremely low.

Figure 89: Commitments/loans ratio (9M08)



Source: Deutsche Bank, Company data

Figure 90: Commitments/equity ratio (9M08)



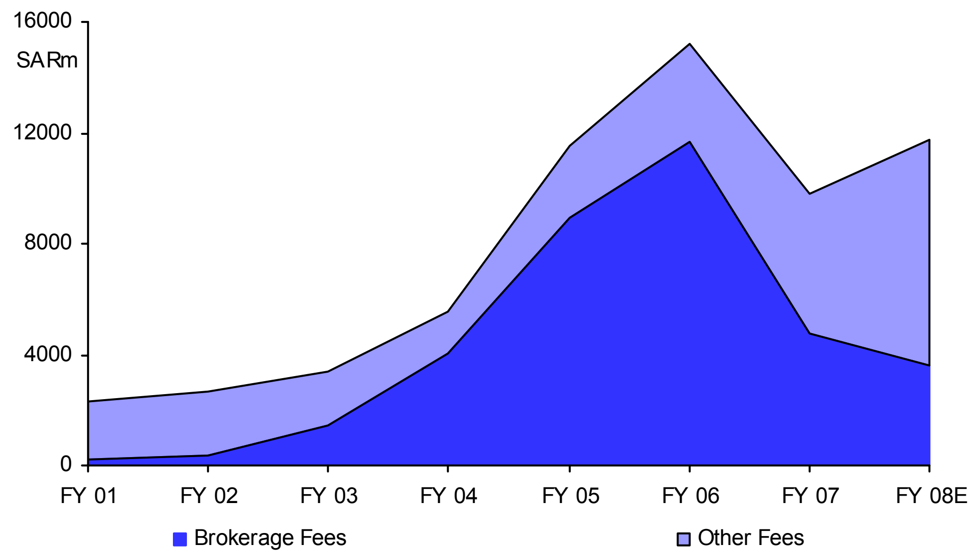
Source: Deutsche Bank, Company data

Key strategies

While each bank will be charting its own course, a number of key themes have emerged from our discussions with the companies:

Improved cross-selling
The decline in brokerage income over the past few years has served to remind Saudi banking management teams that it is not wise to rely too heavily on any single source of revenues. Accordingly, many banks are investing heavily in information technology and staff training to improve the number of products sold to both retail and corporate customers. The fruits of such efforts have been apparent in recent fee income trends. However, the true test is likely to be in the coming quarters as credit growth slows.

Figure 91: Sector fee income trends (SARm)

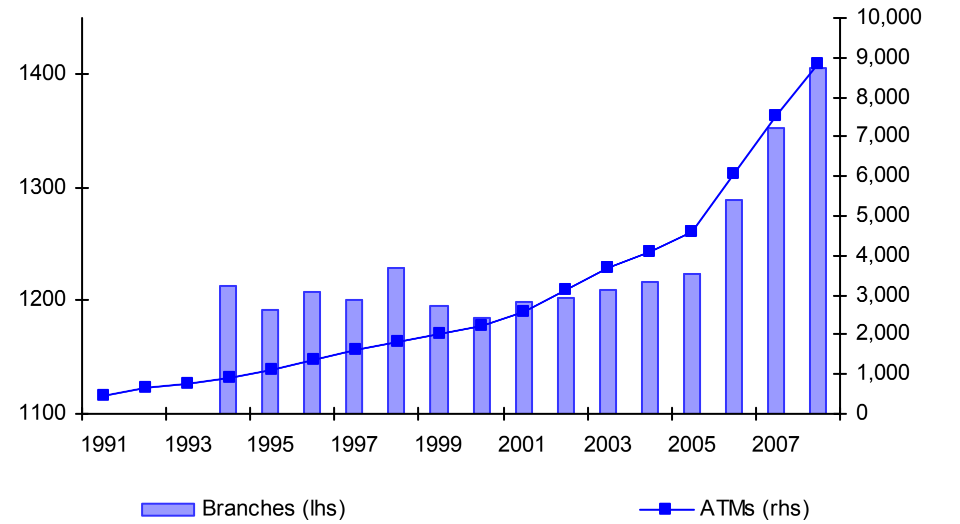


Source: Deutsche Bank, Company data

Funding diversification
As elsewhere, the Saudi banking system has experienced a shortage of liquidity in recent months. This has manifested in higher interbank rates, difficulties in obtaining longer-term wholesale market funding, and in the steady rise in deposit costs. Many of the banks that previously focused on corporate customers are now attempting to woo more stable (and cheaper) retail deposits.

Enhanced distribution
Despite significant recent growth, the Saudi banking system is underdeveloped relative to developed and local markets. Given structural growth potential and the possibility that a wider range of retail banking products (most notably mortgages) might be made available, many banks have in place plans to significantly expand their branch networks. Despite slowing volume growth, we believe the acceleration in the growth of the distribution network witnessed in recent years will be sustained.

Figure 92: Branch and ATM network expansion has accelerated in recent years

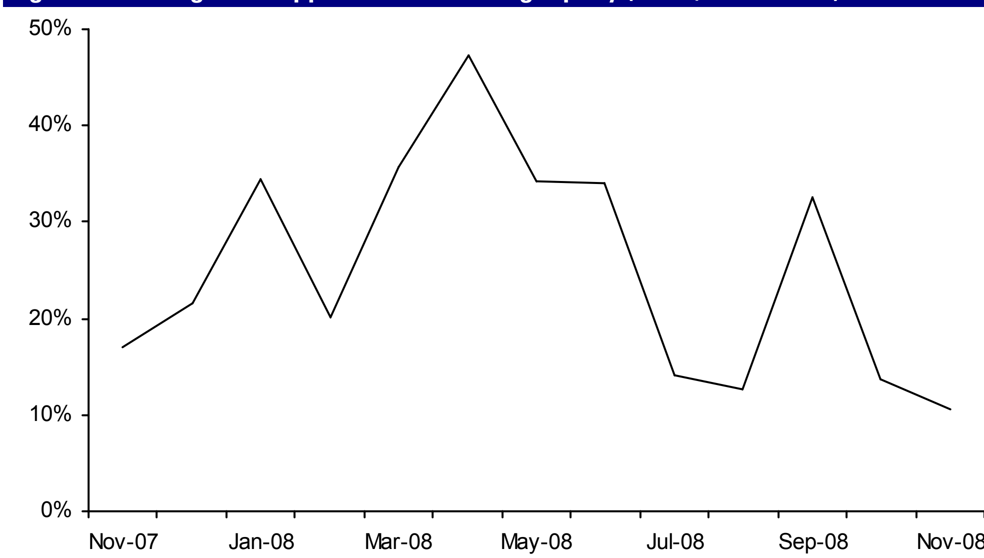


Source: Deutsche Bank, SAMA

Rising risk aversion

The sharp decline in the Saudi equity market has already negatively impacted Saudi bank earnings in recent quarters. We believe expectations of a sharp slowdown in the global economy will manifest in a preference for government entities and public sector employees as credit clients. We believe this conservative approach will contribute to already slowing business volume growth (which appeared to peak in the first half of 2008).

Figure 93: Loan growth appears to be slowing rapidly (MoM, annualised)

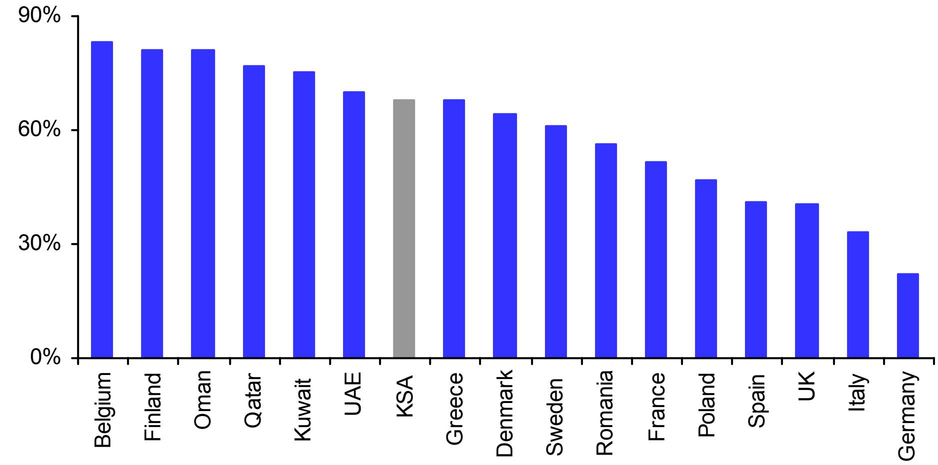


Source: Deutsche Bank, SAMA

Consolidation is a longer-term possibility

With economic conditions deteriorating, performance differentials between stronger and weaker Saudi banks could act as a catalyst for consolidation. As the regulator and an investor, the government would be the key player in determining whether sector consolidation should proceed. However, concentration within the sector is already quite high, suggesting competition could be negatively affected by consolidation. Saudi banks are also quite large within a GCC context, suggesting that there is limited pressure to create "national champions" ahead of further economic harmonisation of the region. We therefore view consolidation as possible rather than likely.

Figure 94: Top five bank market share – international comparison



Source: Deutsche Bank, ECB

Valuation

To determine the intrinsic values of the Saudi banking stocks, we discount our projected earnings by an appropriate discount rate and incorporate any structural characteristics that may impact financial performance outside the narrow window of our earnings model.

Our target price calculations are summarized in Figure 95. We see significant potential upside for Arab National Bank, Riyad Bank and Saudi Investment Bank. In contrast, we believe the shares of Bank Albilad, Bank Aljazira and Al Rajhi Bank are overvalued.

Figure 95: Summary target price calculations

	Share Price	2010 ROE	Cost of equity	Fair P/book ratio	2010 NAV	PV Dividends			Capital Adjustment	Qualitative adjustment	12-month Target Price	Upside/ (Downside)	Investment Rating
						2008	2009	2010	SAR				
Al Rajhi Bank	55.75	20.1%	12.7%	159%	23.7	1.51	1.34	1.19	2.7	10%	49.5	-11%	Sell
Arab National Bank	31.10	17.7%	11.2%	158%	24.9	0.86	0.96	1.04	0.0		42.6	37%	Buy
Bank Albilad	25.00	7.0%	12.1%	57%	12.4	-	0.04	0.07	1.0	10%	9.1	-64%	Sell
Bank Aljazira	14.60	5.4%	12.4%	43%	18.5	0.11	0.09	0.08	1.6	10%	10.9	-25%	Sell
Banque Saudi Fransi	50.00	19.3%	10.7%	180%	29.3	1.72	1.64	1.55	0.0	-10%	52.3	5%	Hold
Riyad Bank	20.45	11.6%	10.9%	107%	20.0	0.86	0.93	0.98	1.1		25.6	25%	Buy
SABB	62.00	23.3%	10.7%	217%	25.4	2.16	2.06	1.97	-0.9		60.9	-2%	Hold
Samba	45.90	19.6%	10.5%	186%	27.7	2.16	1.95	1.77	0.0	-10%	52.3	14%	Hold
Saudi Hollandi Bank	39.10	19.4%	11.6%	167%	24.6	1.28	1.34	1.37	-1.5	-10%	39.3	1%	Hold
Saudi Investment Bank	15.35	11.4%	11.4%	100%	19.9	0.09	0.15	0.21	0.0		20.4	33%	Buy
Average		15.5%	11.4%	135%								1.2%	
Median		18.5%	11.3%	164%						0%		2.7%	

Source: Deutsche Bank. Shares priced as of market close, 17 January 2009

Earnings and financial performance

We present detailed earnings forecasts for the Saudi banks in our research universe in subsequent sections of this report; we summarise below our EPS and ROE expectations for these companies. We believe earnings growth will slow considerably and profitability will decline but remain comfortably above the cost of capital.

Figure 96: EPS and ROE forecast for our Saudi bank research universe

	EPS							ROE			
	FY07A	08/07E	FY08E	09/08E	FY09E	10/09E	FY10E	FY07A	FY08E	FY09E	FY10E
Al Rajhi	4.30	4%	4.47	-1%	4.41	2%	4.51	29.5%	26.2%	22.4%	20.1%
ANB	3.78	7%	4.07	4%	4.22	-1%	4.16	26.6%	23.0%	20.4%	17.7%
Aljazira	0.24	126%	0.55	20%	0.65	28%	0.83	2.4%	5.1%	5.8%	7.0%
Albilad	2.68	-53%	1.27	-20%	1.01	-4%	0.97	18.1%	7.8%	5.8%	5.4%
BSF	4.82	5%	5.04	5%	5.27	2%	5.36	26.3%	23.4%	21.4%	19.3%
Riyad	2.51	-20%	2.02	7%	2.17	5%	2.27	23.9%	13.9%	11.6%	11.6%
SABB	4.34	15%	4.98	8%	5.39	4%	5.58	26.3%	26.7%	25.4%	23.3%
SAMBA	5.36	-4%	5.14	-2%	5.05	2%	5.18	29.1%	24.3%	21.3%	19.6%
SHB	1.66	139%	3.97	5%	4.16	9%	4.52	10.0%	21.6%	19.9%	19.4%
SAIB	1.83	-17%	1.51	17%	1.77	22%	2.16	12.9%	9.6%	10.2%	11.4%
Sector average		20%		4%		7%		20.5%	18.2%	16.4%	15.5%
Sector median		4%		5%		3%		25.1%	22.3%	20.2%	18.5%

Source: Deutsche Bank, Company data

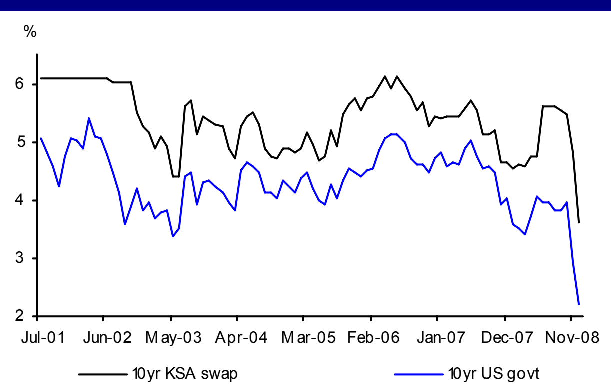
Cost of capital

Risk free rate

We believe Saudi swap rates have historically been a good proxy for the risk-free rate in that country. Over the past few years these swap rates have been around 100bps above those of US treasuries of a similar tenor.

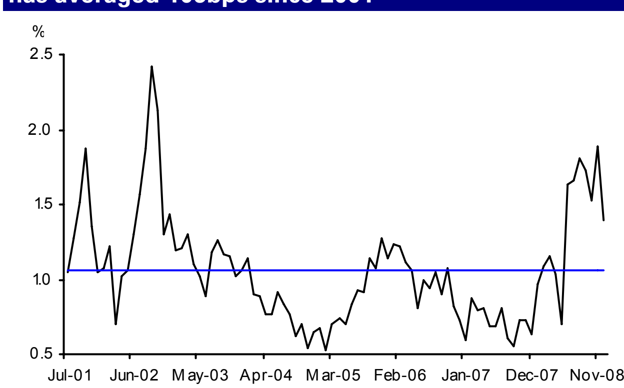
In recent weeks, however, the sharp slowdown in the US economy and aggressive monetary easing by the US Federal Reserve (and other central banks) have resulted in a sharp flight to quality by fixed income investors. As a result, government bond yields have declined sharply and no longer represent an appropriate measure of the risk-free rate, in our view.

Figure 97: US and Saudi risk free rates



Source: Deutsche Bank, Bloomberg

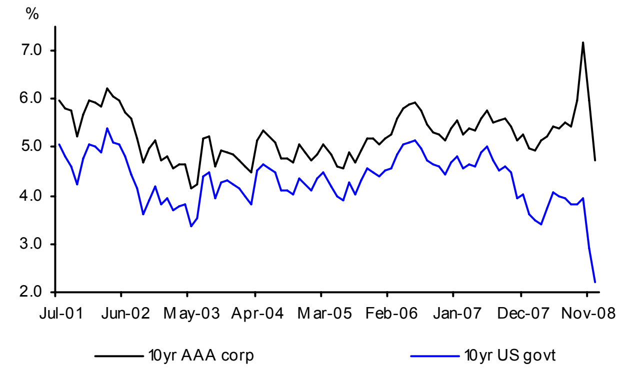
Figure 98: Spread between Saudi and US risk-free rates has averaged 106bps since 2001



Source: Deutsche Bank, Bloomberg

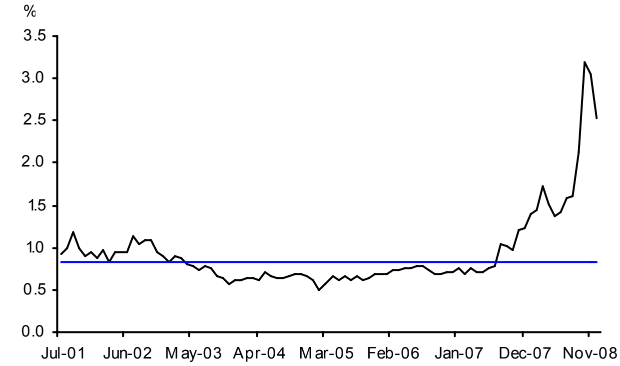
We believe high quality corporate bonds, which have not experienced as sharp a reduction in yields, may represent a better measure of the current risk-free rate. For example, 10-year AAA corporate debt is currently yielding 4.75%, broadly in line with its yield over the past few years. Historically, 10-year AAA-rated corporate debt has traded at a yield roughly 75bps higher than 10-year US government debt.

Figure 99: AAA corporate and US government bond yields



Source: Deutsche Bank, Company data

Figure 100: Spread between AAA corporate and US risk free rates has average 82bps since 2001



Source: Deutsche Bank, Company data

Our calculation of the current risk free rate for Saudi banks is close to 5% (see Figure 101).

Figure 101: Risk-free rate calculation –

	%
Current US AAA corporate 10 year bond yield	
Less: traditional spread AAA corporate 10-year bond yield vs. US 10-year government bond yield	4.75
Plus: traditional spread of Saudi risk-free rate over US 10-year government bond yield	-0.82
Implied risk-free rate	1.06

Source: Deutsche Bank, Bloomberg

Equity risk premium

We have taken our base equity risk premium as 7%, broadly consistent with the calculations published by the DB Investment Advisory Group.

The average beta factor we apply is 0.9, with a range from 0.8 to 1.1 based on the historic behaviour of each bank's shares.

Other adjustments

Capital Strength

An additional element of our target price calculation relates to each bank's capital strength, which varies widely throughout the sector. For banks with capital in excess of that needed for an equity/assets ratio of 12%, we add 50% of the value of this surplus to our target price. The rationale for this adjustment is that we are applying a full equity cost of capital to this low-yielding (but also low risk) excess capital, which is unjustifiably harsh. As illustrated in Figure 102, capitalizing the income stream generated by this excess capital at an appropriate discount rate (the risk-free rate) generates a value 58% higher than if the cost of equity were to be used as a discount rate.

Our 50% adjustment also includes a small discount to account for the risk that management may not deploy the excess capital wisely.

Figure 102: Rationale for target price capital adjustment calculation

	Discount rate used		
	Risk-free	Cost of equity	Difference
Excess Capital	100	100	
Income generated (assume invested in risk-free securities)	5	5	
Discount rate applied	5.0%	12.0%	
Capitalised value of this income stream	100	42	-58%

Source: Deutsche Bank

This adjustment is most relevant to Bank Albilad and Bank Aljazira, where it accounts for over 15% of our target price.

In a similar vein, for banks with an equity/assets ratio below 10%, we make an adjustment to account for the risk that the bank may need to raise additional capital to strengthen its balance sheet. Since most banks in the sector are well-capitalised, this reverse adjustment has only a minimal impact on our target price calculations.

Financial Risk

One issue that could create the illusion of value would be if asset (and hence book) values were to decline from their current stated values, perhaps as a result of a sharper-than-expected deterioration in macroeconomic fundamentals. Where possible we have tried to incorporate such risks directly in our earnings model (for example, by forecasting higher non-performing loans volumes). However, we acknowledge that more negative scenarios that could lead to difficulties for the Saudi banks are possible.

For the purposes of this analysis, we have selected four broad areas of exposure where we believe exteme negative scenarios are possible (but unlikely): real estate; equity investments; unfunded commitments; and derivatives. In this context, we believe entities with more limited exposure to perceived areas of risk and high levels of equity capital should be better-placed to preserve the identified fundamental value.

Figure 103: Saudi bank exposure to certain risk criteria

As % equity	As % shareholders' equity				Risk ranking (1=low, 10=high risk)				
	Construction sector loans (FY07)	Equity Investments (FY07)	Off b/sheet commitments (9M08)	Nominal value derivatives (9M08)	Construction sector/equity	Total investments/ shareholders' equity (rhs)	Commitment/ equity ratio	Nominal value derivatives/ equity	Total
Al Rajhi Bank	21%	1%	89%	0%	4	1	3	1	9
Arab National Bank	52%	14%	221%	378%	6	7	5	6	24
Bank Albilad	14%	9%	51%	0%	2	5	1	1	9
Bank Aljazira	11%	23%	96%	0%	1	10	4	1	16
Banque Saudi Fransi	57%	4%	417%	1853%	8	3	10	10	31
Riyad Bank	18%	12%	236%	299%	3	6	7	5	21
SABB	26%	1%	328%	690%	5	2	8	7	22
Samba	54%	22%	226%	1159%	7	9	6	9	31
Saudi Hollandi Bank	74%	5%	372%	1124%	10	4	9	8	33
Saudi Investment Bank	64%	16%	79%	28%	9	8	2	4	23
Sector	36%	12%	242%	526%					22

Source: Deutsche Bank, Company data. Note: Riyad Bank data has been adjusted to take account of the SAR13bn capital increase that took place in Q2 08.. We have assumed Albilad's financial investment portfolioconsists largely of equities.

In our target price calculations, we have given a 10% credit to Al Rajhi Bank, Bank Albilad and Bank Aljazira to reflect their limited exposure to areas of potential risk. However, their current share prices appear to incorporate quality premia of least 30%, which we view as excessive.

Similarly, we reduce our target prices for Saudi Hollandi Bank, Banque Saudi Fransi and Samba Financial Group by 10% to account for their high exposure to areas of potential risk.

Sensitivity Analysis

We present below the potential impact on our calculated target prices of changes to key inputs to our valuation model

Figure 104: Target price calculation – key sensitivities

	Risk free rate	Equity Risk Premium	Beta	ROE
	1% point increase	1% point increase	0.1 increase	1% point increase
Al Rajhi Bank	-6%	-7%	-4%	4%
Arab National Bank	-8%	-7%	-6%	5%
BankAlbilad	-6%	-7%	-5%	12%
Bank Aljazira	-6%	-6%	-4%	15%
Banque Saudi Fransi	-8%	-7%	-6%	5%
Riyad Bank	-7%	-6%	-5%	7%
SABB	-8%	-7%	-6%	4%
Samba	-8%	-6%	-6%	5%
Saudi Hollandi Bank	-8%	-7%	-5%	5%
Saudi Investment Bank	-8%	-7%	-6%	9%
Sector Average	-7%	-7%	-5%	7%
Sector Median	-8%	-7%	-6%	5%

Source: Deutsche Bank

Valuation – international peer group comparison

Traditional metrics

Based on commonly used market multiples, Saudi banks appear expensive relative to other banking stocks.

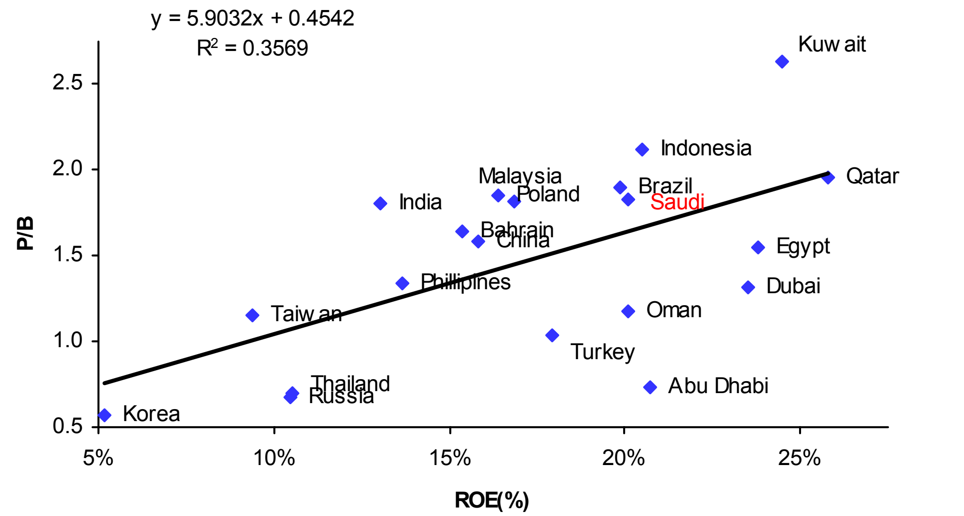
Figure 105: Saudi and international bank valuation multiples comparison

	P/E			P/B			D/Y(%)		
	2007	2008e	2009e	2007	2008e	2009e	2007	2008e	2009e
KSA	9.46	10.16	9.46	2.30	2.02	1.80	2.90	4.11	4.46
GCC median	9.61	8.52	8.05	2.01	1.68	1.65	5.18	5.26	7.62
EM median	10.98	9.59	9.24	2.69	1.59	1.47	4.22	4.17	4.32
KSA premium (vs. GCC banks)	0%	28%	24%	18%	23%	11%	91%	56%	93%
KSA premium (vs. EM banks)	-12%	13%	8%	-12%	30%	24%	55%	24%	9%

Source: Deutsche Bank, Bloomberg

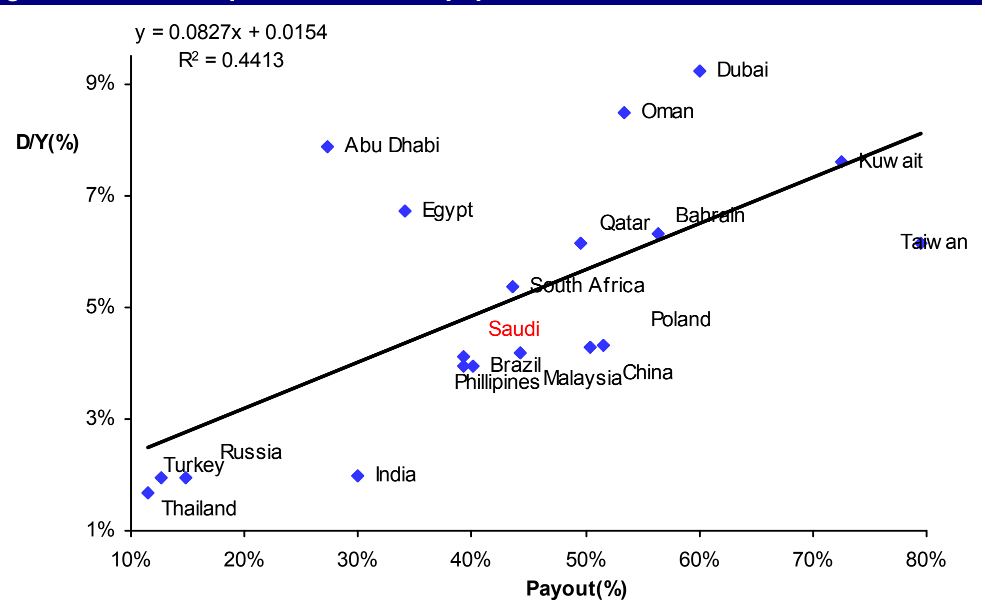
However, adjusting for the Saudi banks' better-than-average profitability and low payout ratio reduces the perceived premium. Note also that our earnings estimates are more conservative than consensus expectations.

Figure 106: P/B and ROE ratios for selected emerging markets (2009E)



Source: Deutsche Bank, Bloomberg

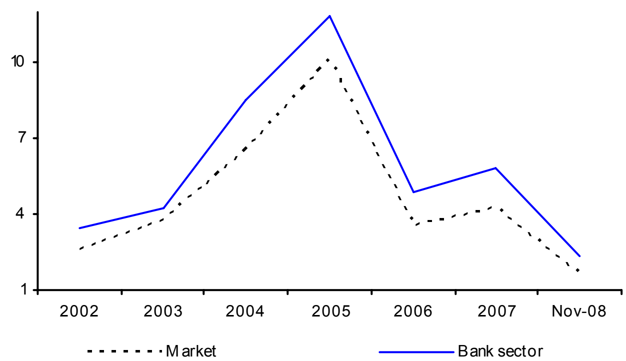
Figure 107: Dividend yield and dividend payout ratios (2009E)



Source: Deutsche Bank, Bloomberg

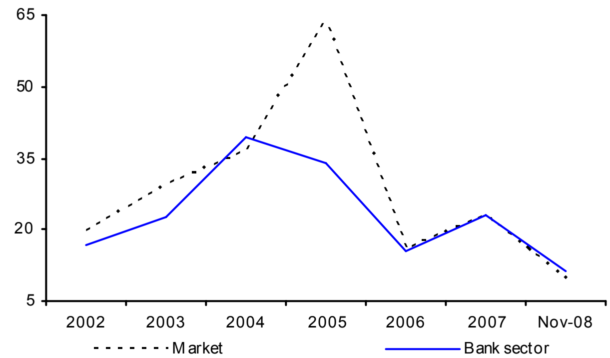
In part, we believe this reflects the huge multiples at which the Saudi banking sector (and overall market) have traded in the past.

Figure 108: Historical trailing PB multiples for the Saudi stock market and banks sector



Source: Deutsche Bank, Tadawul

Figure 109: Historical PE multiples for the Saudi stock market and banks sector



Source: Deutsche Bank, Tadawul

However, we believe the premium of Saudi banks relative to their peers can also be justified on fundamental grounds because they operate in an environment with a number of structural features that could mitigate risk and drive superior structural growth:

- Underdeveloped banking system

Relative to other regional and emerging banking markets, the Saudi banking system appears underdeveloped. As the system matures, we expect its growth to exceed that of the overall economy, suggesting Saudi banks have good structural growth characteristics and should trade at a premium to the broader Saudi market.

- Conservative regulatory framework

We believe the Saudi Arabian Monetary Authority (SAMA) and other key regulatory and government bodies have taken a relatively conservative approach to managing the Saudi banking system. Capital and liquidity levels are high in an international context, and key risk areas (such as consumer lending) are actively monitored. We also note that loan exposure to the real estate sector is currently limited.

- Accumulated reserves could cushion the economy

Saudi Arabia recently unveiled its fiscal budget for 2009. Government spending is projected to be SAR475bn, up 16% on the budgeted level for 2008, and SAR65bn higher than expected government revenues of SAR410bn. The government should be able to bridge the projected 2009 fiscal deficit by dipping into accumulated reserves built up in previous years (for example, the government generated a surplus of SAR590bn in 2008 alone). The Saudi government has also limited debt outstanding (equivalent to 13.5% of GDP). The government's strong finances suggest that it is well-placed to soften any economic slowdown to which the economy might be subjected.

Figure 110: Saudi Arabian bank multiples: international comparison

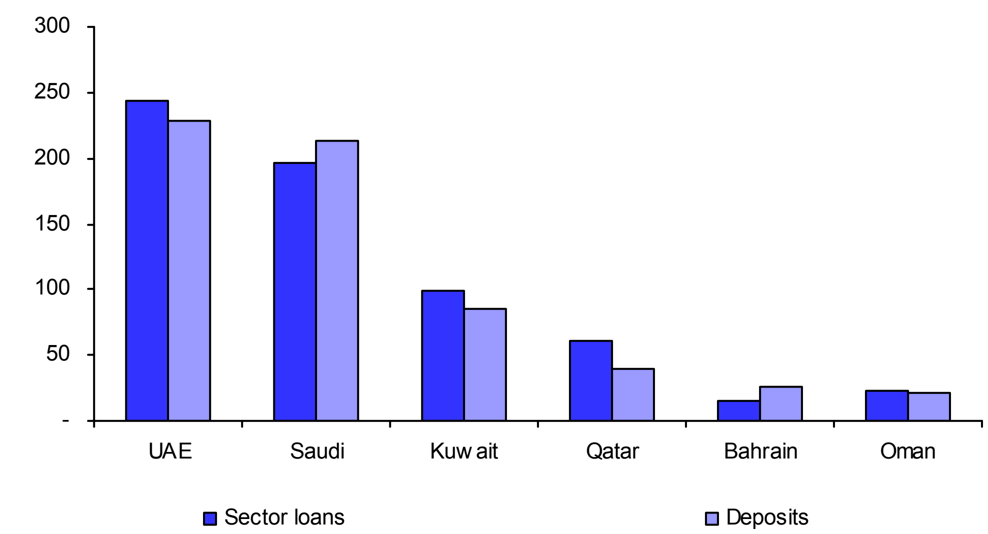
	P/E			P/B		
	2007	**2008E**	**2009E**	**2007**	**2008E**	**2009E**
Al Rajhi	13.0	12.5	12.6	3.54	3.03	2.65
ANB	8.2	7.7	7.4	1.92	1.62	1.40
Albilad	103.5	45.7	38.3	2.42	2.29	2.17
AlJazira	5.4	11.5	14.5	0.93	0.87	0.83
BSF	10.4	9.9	9.5	2.50	2.17	1.91
Riyad	8.2	10.1	9.4	1.86	1.13	1.07
SABB	14.3	12.5	11.5	3.57	3.12	2.74
SAMBA	8.6	8.9	9.1	2.31	2.04	1.83
SHB	23.6	9.9	9.4	2.28	1.99	1.77
SAIB	8.4	10.2	8.7	1.02	0.93	0.85
Saudi Arabia	**9.5**	**10.2**	**9.5**	**2.30**	**2.02**	**1.80**
Abu Dhabi	5.7	4.7	5.9	1.19	0.91	0.81
Bahrain	3.2	8.9	8.1	0.48	1.41	1.32
Brazil	17.5	7.6	8.2	4.23	1.82	1.60
China	12.2	8.7	10.5	3.67	1.44	1.32
Chile	13.4	10.1	9.8	2.93	2.20	2.07
Dubai	11.9	10.8	9.4	2.25	2.19	1.95
Egypt	8.2	6.5	4.8	2.17	1.87	1.59
India	17.4	13.9	13.9	3.31	2.82	1.72
Kuwait	9.0	8.1	7.5	2.09	1.91	1.80
Malaysia	6.3	9.9	10.8	3.06	2.14	1.88
Oman	9.2	6.7	5.6	1.23	1.18	1.08
Phillipines	11.3	15.1	11.3	2.65	1.93	1.81
Poland	11.9	4.4	6.4	2.13	0.79	0.73
Qatar	9.9	7.8	7.3	2.71	1.87	1.63
Russia	19.8	4.9	6.8	3.00	0.61	0.60
South Africa	10.6	8.2	8.0	2.68	1.50	1.37
Taiwan	9.7	51.5	11.6	1.88	1.18	1.04
Thailand	5.4	6.9	7.2	1.94	0.93	0.86
Turkey	14.9	6.3	5.9	2.69	1.08	0.94
Average	10.9	10.6	8.4	2.44	1.57	1.37
Median	10.6	8.1	8.0	2.65	1.50	1.37

Source: Deutsche Bank. Priced as at market close, 17 January 2009.. Based on DB estimates except for Bahrain, Dubai, Eqypt, Kuwait, Oman, Qatar (Bloomberg consensus).

Saudi banks in a GCC context

Regionally, the Saudi banking system ranks a close second to the UAE's by loans and deposits.

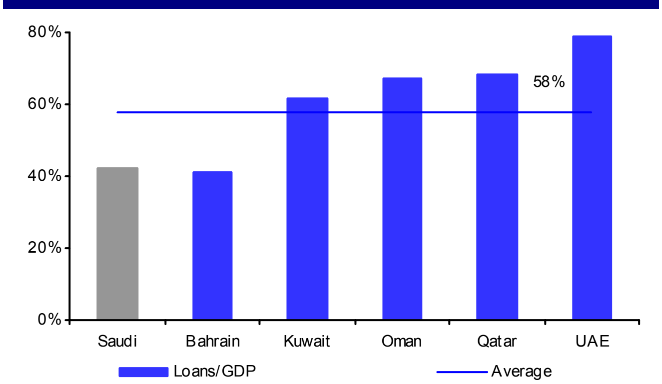
Figure 111: GCC banking system loan and deposit volumes (9M08, USDbn)



Source: Deutsche Bank, Central Banks

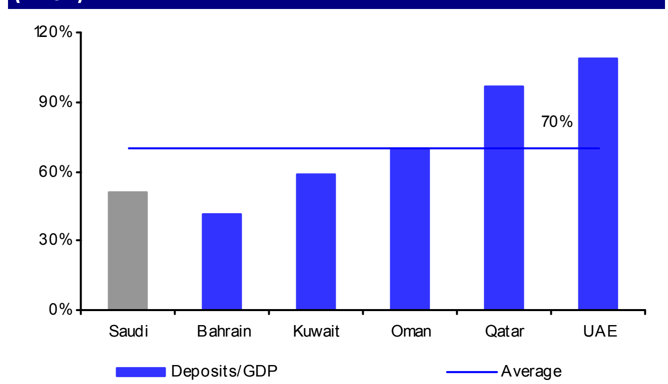
Relative to the size of the Saudi economy, the banking system is relatively underdeveloped, which we believe supports a positive long-term view for the sector.

Figure 112: GCC banking system loan/GDP ratios (FY07)



Source: Deutsche Bank, Central Banks

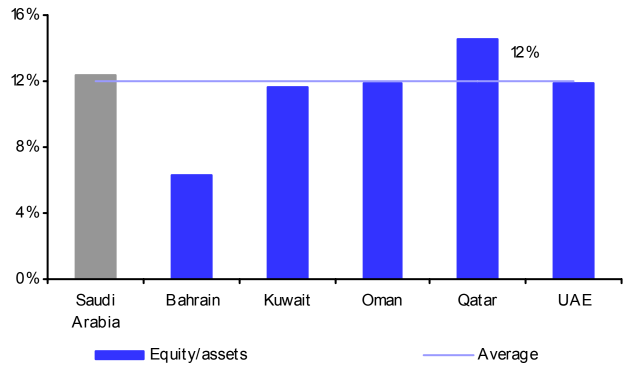
Figure 113: GCC banking system deposit/GDP ratios (FY07)



Source: Deutsche Bank, Central Banks

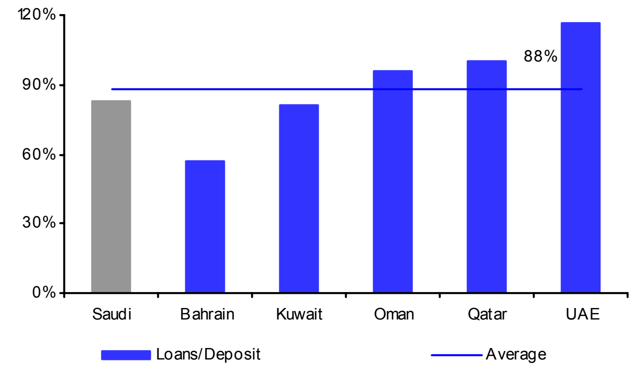
In our view the Saudi banking system has attractive relative risk features, including strong capital ratios and limited wholesale funding needs. Exposure to real estate is also limited, largely due to the lack of an established mortgage market in the country.

Figure 114: GCC banking system equity/asset ratios (FY07)



Source: Deutsche Bank, Central Banks

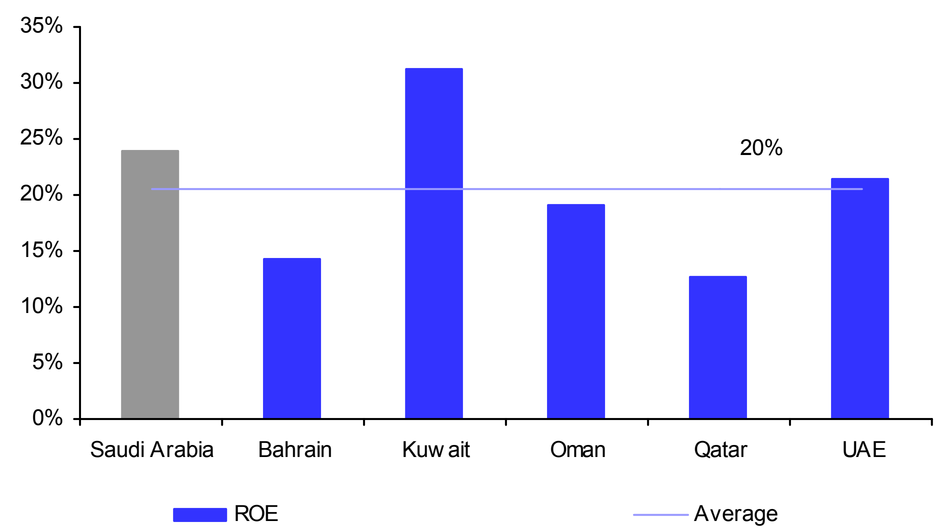
Figure 115: GCC banking system loan/ deposit ratios (FY 07)



Source: Deutsche Bank, Central Banks

Profitability levels also compare favourably with other regional banking systems.

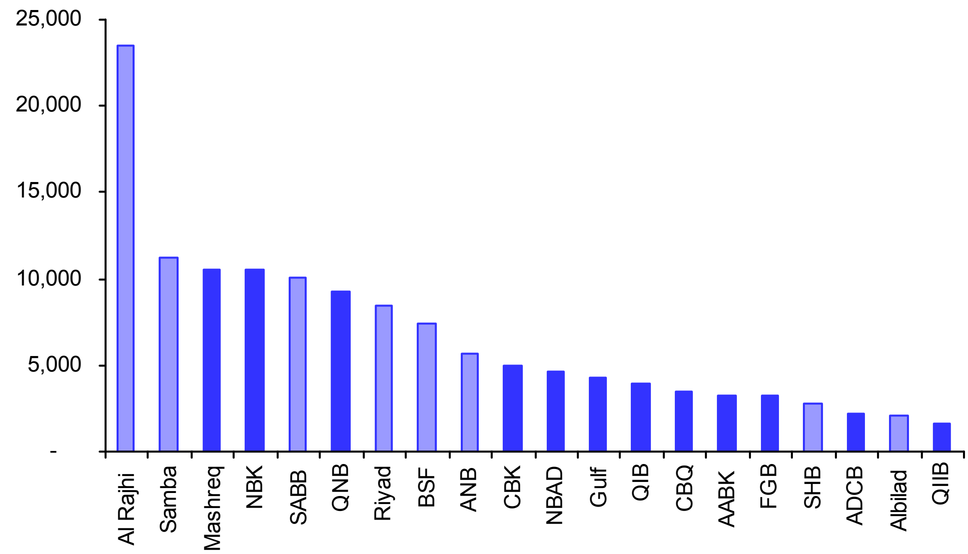
Figure 116: GCC bank profitability (ROE, 2007)



Source: Deutsche Bank, Bloomberg

Considering individual entities, Saudi banks are well represented within the largest regional banking stocks.

Figure 117: GCC banks sector by market capitalization (USDm)



Source: Deutsche Bank, Bloomberg

Key performance and valuation metrics for selected GCC banks are presented below:

Figure 118: Selected performance metrics for largest GCC listed banks (FY07)

	ROE	ROA	C/I	NIM
Al Rajhi	29.5%	5.61%	26.1%	6.7%
NBK	19.9%	2.81%	30.7%	3.5%
Samba	29.1%	3.45%	27.3%	3.6%
QNB	22.5%	2.70%	35.2%	2.3%
Mashreq	22.4%	2.63%	61.5%	2.8%
SABB	36.0%	2.97%	32.7%	3.6%
Riyad	25.3%	2.80%	35.3%	3.0%
BSF	36.3%	3.02%	25.6%	2.6%
ANB	35.0%	2.85%	36.4%	3.4%
CBK	23.8%	3.34%	24.4%	2.9%
NBAD	24.8%	2.08%	31.7%	2.6%
QIB	28.3%	6.93%	19.4%	9.6%
Gulf	29.3%	2.85%	35.5%	2.8%
FGB	21.0%	3.32%	22.2%	2.4%
CBQ	22.3%	3.10%	31.1%	3.0%
SHB	24.0%	0.90%	47.4%	2.5%
AABK	26.1%	2.82%	33.4%	NA
ADCB	18.1%	2.12%	32.1%	2.8%
QIIB	25.4%	5.23%	65.7%	4.5%
Albilad	2.4%	0.52%	82.3%	3.8%
Regional average	25.1%	3.1%	36.8%	3.6%
Regional median	25.1%	2.9%	32.4%	3.0%

Source: Deutsche Bank, Bloomberg, Company data

Figure 119: Saudi Bank multiples: GCC comparison

	P/E			P/B		
	2007	2008	2009	2007	2008	2009
Al Rajhi	13.0	12.5	12.6	3.54	3.03	2.65
ANB	8.2	7.7	7.4	1.92	1.62	2.65
Albilad	103.5	45.7	38.3	2.42	2.29	2.17
AlJazira	5.4	11.5	14.5	0.93	0.87	0.83
AlJazira	9.3	19.7	24.8	1.60	1.49	2.65
Albilad	60.4	26.7	22.3	1.41	1.34	2.65
BSF	10.4	9.9	9.5	2.50	2.17	2.65
Riyad	8.2	10.1	9.4	1.86	1.13	2.65
SABB	14.3	12.5	11.5	3.57	3.12	2.65
SAMBA	8.6	8.9	9.1	2.31	2.04	2.65
SHB	23.6	9.9	9.4	2.28	1.99	2.65
SAIB	8.4	10.2	8.7	1.02	0.93	2.65
Saudi Arabia	**9.5**	**10.2**	**9.5**	**2.30**	**2.02**	**1.80**
Kuwait Fin'c House	8.4	6.2	5.1	1.78	1.86	1.65
Nat'l Bk of Kuwait	8.9	8.9	8.5	1.89	1.70	1.70
Comm' Bk o' Kuwait	11.4	10.4	10.0	3.21	2.69	2.48
Burgan Bank	5.8	6.3	5.6	1.53	1.11	1.05
Kuwait	**9.0**	**8.1**	**7.5**	**2.09**	**1.91**	**1.80**
Commerc'l Int'll Bk	8.7	6.9	6.1	2.66	2.13	1.76
Nat'l SociétéGén Bk	8.0	5.0	4.9	1.49	1.20	1.07
Crédit Agricol Egypt	5.7	5.3	4.6	1.50	1.45	1.32
Alwatany Bk of Egypt	9.1	9.0		2.24	2.55	2.16
Egypt	**8.2**	**6.5**	**4.8**	**2.17**	**1.87**	**1.59**
Emirates NBD	5.1	3.6	3.2	0.77	0.65	0.57
Dubai Islamic Bank	2.6	3.2	3.5	0.73	0.60	0.54
Mashreqbank	17.7	16.6	14.3	3.38	3.43	3.04
Comm' Bk of Dubai	5.8	4.6	4.1	1.34	0.83	0.73
Dubai	**11.9**	**10.8**	**9.4**	**2.25**	**2.19**	**1.95**
Abu Dhabi Comm Bk	4.0	4.3	5.5	0.74	0.70	0.64
First Gulf Bank	5.9	4.1	5.7	1.16	0.73	0.66
Nat. Bank of Abu Dhabi	6.4	5.5	6.3	1.43	1.16	1.00
Abu Dhabi	**5.7**	**4.7**	**5.9**	**1.19**	**0.91**	**0.81**
Qatar Nat'l Bk	10.7	9.2	8.2	3.06	1.90	1.73
Commercial Bank	8.0	6.1	5.7	2.01	1.14	0.98
Qatar Islamic Bank	11.1	6.8	6.6	3.02	2.76	2.21
Doha Bank	6.0	5.7	7.2	1.52	1.17	1.13
Qatar	**9.9**	**7.8**	**7.3**	**2.71**	**1.87**	**1.63**
Ahli United Bank		7.6	7.6	0.00	1.25	1.13
Nat'l Bank Bahrain	12.4	12.0	11.4	2.11	2.00	1.89
BBK	13.3	14.1	7.6	1.68	1.70	1.82
Bahrain	**3.2**	**8.9**	**8.1**	**0.48**	**1.41**	**1.32**
BankMuscat	8.8	6.2	4.7	1.11	1.09	1.00
Nat'l Bank of Oman	8.9	7.7	6.5	1.89	1.44	1.27
Bank Dhofar	10.3	8.2	6.7	2.11	1.35	1.21
Oman Int'l Bank		5.7	5.9	0.14	0.99	0.93
Oman Int'l Develop.		5.7	5.9	0.14	0.99	0.93
Oman	**9.2**	**6.7**	**5.6**	**1.23**	**1.18**	**1.08**

Source: Deutsche Bank, Bloomberg Consensus

Model updated:21 January 2009

Running the numbers

Middle East

Saudi Arabia

Banking

Al Rajhi Bank

Reuters: 1120.SE Bloomberg: RJHI AB

Sell

Price (20 Jan 09)	SAR 54.75
Target price	SAR 49.50
52-week Range	SAR 47.80 - 103.06
Market Cap (m)	SARm 82,125 USDm 21,897

Company Profile

Founded in 1957, Al Rajhi Bank ranks third in Saudi Arabia by assets, but has the largest branch and ATM networks in the country reflecting a focus on retail banking. The bank is the largest provider of Islamic banking products in the Arab world. Al Rajhi Bank is largely focused on the Saudi market, although there is a small operation in Malaysia. The Al Rajhi family owns just under half of the shares. The Sharia Board plays a significant role in the direction of the business.

Rahul Shah
+971 4 4283-261 rahul.shah@db.com

Fiscal year end 31-Dec	2005	2006	2007	2008E	2009E	2010E
Data Per Share						
EPS (stated)(SAR)	3.76	4.87	4.30	4.47	4.41	4.51
EPS (DB) (SAR)	3.77	4.96	4.31	4.47	4.41	4.51
Growth Rate - EPS (DB) (%)	nm	31.7	-13.2	3.8	-1.3	2.2
DPS (SAR)	0.39	0.45	1.80	1.80	1.80	1.80
BVPS (stated) (SAR)	8.98	13.45	15.74	18.41	21.02	23.72
Tang. NAV p. sh. (SAR)	8.98	13.45	15.74	18.41	21.02	23.72
Market Capitalisation	243,474	130,288	175,855	82,125	82,125	82,125
Shares in issue	1,500	1,500	1,500	1,500	1,500	1,500
Valuation Ratios & Profitability Measures						
P/E (stated)	43.2	17.8	27.3	12.2	12.4	12.1
P/E (DB)	43.1	17.5	27.2	12.2	12.4	12.1
P/B (stated)	18.1	6.5	7.4	3.0	2.6	2.3
P/Tangible equity (DB)	18.1	6.5	7.4	3.0	2.6	2.3
ROE(stated)(%)	47.6	43.4	29.5	26.2	22.4	20.1
ROTE (tangible equity) (%)	41.9	44.2	29.5	26.2	22.4	20.1
ROIC (invested capital) (%)	47.8	44.2	29.5	26.2	22.4	20.1
Dividend yield(%)	0.4	0.3	2.2	3.3	3.3	3.3
Dividend cover(x)	9.6	10.8	2.4	2.5	2.5	2.5
Profit & Loss (SARm)						
Net interest revenue	5,677	6,826	7,722	8,375	8,450	8,600
Non interest income	2,057	2,542	1,590	2,035	2,225	2,415
Commissions	1,950	2,052	1,523	1,975	2,170	2,365
Trading Revenue	0	0	0	0	0	0
Other revenue	107	490	68	60	55	50
Total revenue	7,734	9,368	9,312	10,410	10,675	11,015
Total Operating Costs	1,582	1,955	2,428	2,855	3,170	3,320
Employee Costs	793	1,121	1,454	1,675	1,800	1,875
Other costs	789	834	974	1,180	1,370	1,445
Pre-Provision profit/(loss)	6,152	7,413	6,884	7,555	7,505	7,695
Bad debt expense	536	253	443	850	890	935
Operating Profit	5,616	7,160	6,441	6,705	6,615	6,760
Pre-tax associates	0	0	0	0	0	0
Pre-tax profit	5,616	7,160	6,441	6,705	6,615	6,760
Tax	0	0	0	0	0	0
Other post tax items	17	142	9	0	0	0
Stated net profit	5,633	7,302	6,450	6,705	6,615	6,760
Goodwill	0	0	0	0	0	0
Extraordinary & Other items	17	142	9	0	0	0
Bad Debt Provisioning	0	0	0	0	0	0
Investment reval, cap gains / losses	0	0	0	0	0	0
DB adj. core earnings	5,650	7,444	6,459	6,705	6,615	6,760
Key Balance Sheet Items (SARm) & Capital Ratios						
Risk-weighted assets	73,909	79,715	100,269	170,106	180,737	194,027
Interest-earning assets	82,787	91,735	106,576	137,650	146,950	157,250
Customer Loans	80,135	89,852	105,213	135,000	144,000	154,000
Total Deposits	70,112	75,882	92,756	120,000	127,500	137,500
Stated Shareholder Equity	13,469	20,179	23,606	27,611	31,526	35,586
Equals: Tangible Equity	13,469	20,179	23,606	27,611	31,526	35,586
Tier 1 capital	13,469	20,179	23,606	27,624	31,539	35,599
Tier 1 ratio (%)	18	25	24	16	17	18
o/w core tier 1 capital ratio (%)	18.2	25.3	23.5	16.2	17.5	18.3
Credit Quality						
Gross NPLs/Total Loans(%)	2.02	2.23	2.94	3.70	5.03	6.33
Risk Provisions/NPLs(%)	170	138	110	85	70	62
Bad debt / Avg loans (%)	na	0.30	0.45	0.71	0.64	0.63
Bad debt/Pre-Provision Profit(%)	8.7	3.4	6.4	11.3	11.9	12.2
Growth Rates & Key Ratios						
Growth in revenues (%)	nm	21	-1	12	3	3
Growth in costs (%)	na	24	24	18	11	5
Growth in bad debts (%)	nm	-53	75	92	5	5
Growth in RWA (%)	nm	8	26	70	6	7
Net int. margin (%)	7.69	7.82	7.79	6.86	5.94	5.65
Cap.-market rev. / Total revs (%)	nm	nm	nm	nm	nm	nm
Total loans / Total deposits (%)	114	118	113	113	113	112
ROTE Decomposition						
Revenue % ARWAs	20.93	12.20	10.35	7.70	6.09	5.88
Net interest revenue % ARWA	15.36	8.89	8.58	6.20	4.82	4.59
Non interest revenue % ARWA	5.57	3.31	1.77	1.51	1.27	1.29
Costs/income ratio (%)	20.5	20.9	26.1	27.4	29.7	30.1
Bad debts % ARWAs	1.45	0.33	0.49	0.63	0.51	0.50
Tax rate (%)	0.0	0.0	0.0	0.0	0.0	0.0
Adj. Attr. earnings % ARWA	15.29	9.69	7.18	4.96	3.77	3.61
Capital leverage (ARWA/Equity)	2.7	4.6	4.1	5.3	5.9	5.6
ROTE (Adj. earnings/Ave. equity)	41.9	44.2	29.5	26.2	22.4	20.1

Source: Company data, Deutsche Bank estimates

Al Rajhi Bank

Quality premium looks overdone

Outlook

In line with other sector participants, we see Al Rajhi Bank's business volume growth slowing sharply in 2009 and 2010. Combined with margin compression from low interest rates and changes to the business mix (a further shift towards corporate customers), this leads us to project future revenue growth averaging 3% pa. With the bank continuing to invest in distribution network expansion and risk costs staying high, we believe the company will generate a flat to lower earnings profile over the next two years. Although declining, the bank's profitability should remain above the sector average, reflecting high asset yields and good operating efficiency.

We believe Al Rajhi Bank's net special commission income will be more negatively impacted by low interest rates than most of its peers due to the mismatch between the bank's variable rate lending and nil cost funding. We note that net special commission income is the key driver of the bank's revenues.

We see Al Rajhi Bank's high exposure to the retail business as being a negative from an asset quality perspective and highlight that, in contrast to the overall sector, asset quality trends had already started deteriorating in 2007. We also believe retail banking activity will continue to lag that of the corporate sector over the coming months.

We note that the bank is rapidly growing its corporate loan book, reflecting sluggish retail credit development, but also management's intention to bulk up this business. We believe that at this stage in the economic cycle such a transition could open the way for excessive risks being brought onto the balance sheet. Investment in the corporate business, combined with continued expansion of the distribution network, is also likely to result in cost growth continuing to outstrip revenue development.

While Al Rajhi has a number of key strengths (dominant retail franchise, funding and operating cost advantages and limited capital markets risk) we believe the current premium at which the bank trades to the sector is excessive. We have a Sell rating on the shares.

Valuation

We value the shares on a target price book multiple basis, using 2010 as our benchmark year and discounting back by the cost of equity. We assume a risk-free rate of 5.0%, an equity risk premium of 7.0% and a beta to the market of 1.10 (based on historical price performance). In common with our approach to other banks in the sector, we do not apply a long-term growth adjustment to our cost of capital calculation.

Our target price calculation also gives credit to Al Rajhi Bank for its strong capital base and its relatively low exposure to market and credit risks.

Figure 120: Al Rajhi Bank target price calculation

17 January 2009	Share Price	2010 ROE	Cost of equity	Fair P/book ratio	2010 NAV	PV Dividends			Capital Adjustment	Qualitative Adjustment	12-month	Upside/ (Down side)	Investment Rating
	SAR					2008E	2009E	2010E	SAR		Target Price		
Al Rajhi Bank	55.75	20.1%	12.7%	159%	23.7	1.51	1.34	1.19	2.7	10%	49.5	-11%	Sell
Sector Median		18.5%	11.3%	164%						0%		2.7%	

Source: Deutsche Bank

Al Rajhi Bank shares are trading at a sizeable premium to the sector, whether measured by PE multiples, PB ratio or dividend yield. While we believe some premium can be justified on the basis of the bank's superior asset yield and operating cost advantages, we view the current level as excessive. We believe that the benefit of the bank's low cost deposit funding will be less pronounced in a low interest rate environment.

Figure 121: Al Rajhi Bank valuation multiples

17 January 2009	Share Price	P/E				P/book				DY			
		2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
Al Rajhi Bank	55.75	13.0	12.5	12.6	12.4	3.54	3.03	2.65	2.35	3.2%	3.2%	3.2%	3.2%
Sector Median		9.5	10.2	9.5	9.2	2.30	2.02	1.80	1.62	2.9%	4.1%	4.1%	4.5%

Source: Deutsche Bank, Company data

Risks to our view

Al Rajhi Bank has significant funding cost advantages relative to its peers due to its large volume of non-interest bearing retail deposits. This would prove to be particularly beneficial if market funding costs were to increase, either due to rising interest rates or an exacerbation of liquidity difficulties.

The bank also has operating cost advantages relative to its peers (reflecting good cost management, scale benefits and an ability to attract talent due to the bank's Shariah-compliant status). This could be advantageous if an expected volume growth slowdown were to lead to enhanced price competition in the banking market.

Al Rajhi Bank also benefits from having less exposure to equity brokerage income than many of its peers, leaving it less exposed to the continued decline in this fee pool which we expect. Al Rajhi Bank's investment portfolio is also small.

Key themes

Continued expansion of the distribution network could reduce operating efficiency

Despite having the largest branch distribution network in the country, management is embarking on an investment programme to extend the network. Although Al Rajhi's cost structures are lower than most of its competitors, this expansion is contributing to cost growth at a time when revenue development is expected to slow considerably. Pressure to utilize the new distribution capacity could contribute to a deterioration in risk discipline, in our view.

Move into corporate banking could also lead to enhanced adverse selection risk issues
As one of the most retail-banking oriented institutions in Saudi Arabia, Al Rajhi bank's business growth might have been expected to reflect the sluggish trends experienced by this sector. Instead, Al Rajhi's credit growth has been robust (+26% at 9M08). We believe this reflects rapid growth in the bank's corporate banking business, an area where Al Rajhi's market position is considerably weaker. While a strategy to develop a more rounded business profile makes sense in the long run, in the near term we believe the bank pushing into areas where it has lower levels of expertise could result in the possibility of bad risks being brought onto the balance sheet.

Quality of retail loan exposures likely to deteriorate
With economic growth slowing, we believe retail loan quality is likely to deteriorate as employment levels and collateral values decline. Anecdotal evidence already points to isolated problems in the stock lending and auto finance industries. As the largest retail franchise, we believe Al Rajhi bank would be more affected by these trends than its peers.

Retail business activity likely to remain sluggish
In tandem with a decline in the quality of retail banking exposures, we believe this business segment is likely to remain the slowest-growing part of the industry. Again, this would tend to impact Al Rajhi Bank more than its peers.

Aggressive valuation
Al Rajhi Bank is trading at a significant premium to the sector. While we believe some premium is warranted to reflect the bank's superior profitability (driven by high revenue margins and low operating costs) and limited market risk (arising from the bank's small investment portfolio, and limited exposure to equity brokerage income), the current level is difficult to justify, in our view. This is particularly the case given the lack earnings momentum we expect in the coming years.

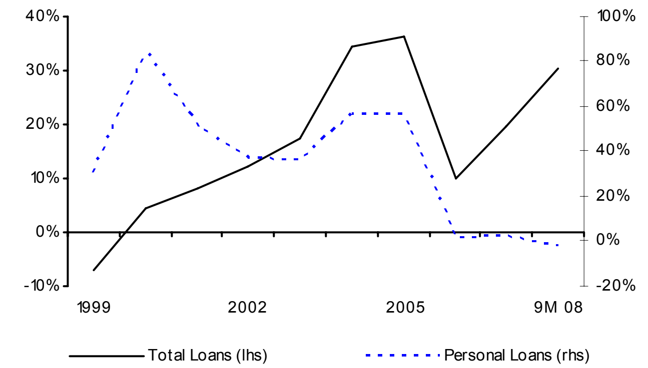
Significant funding cost advantage
One of the key benefits of Al Rajhi's strong retail distribution franchise and well-established position as the leading purely Islamic banking institution in the country is that the business is able to attract significant quantities of non-interest bearing deposits. However, we believe the benefits of this cheap funding will be less important in a world of low interest rates.

Strong distribution network and operating cost advantages
Over time Al Rajhi Bank has been able to use its scale and retail banking expertise to generate significant operating cost advantages relative to its peers and is able to run its branches in a very lean manner. This cost advantage is allowing the bank to invest in expanding the network further and to fund increased penetration of the corporates sector. We believe low operating costs could also allow the bank to compete more aggressively for business from a pricing perspective.

Diversification strategy carries some risk

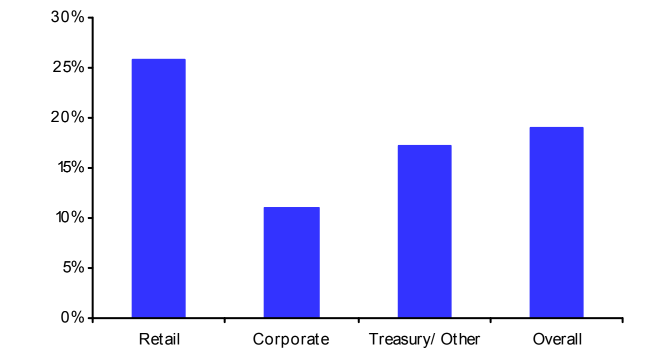
Management is attempting to broaden the bank's business profile by expanding the corporate banking business. Given the relatively sluggish performance of the personal lending business in Saudi Arabia, Al Rajhi bank has been forced to drive its recent balance sheet growth by targeting corporate customers. Corporate banking is an area where Al Rajhi has tended to lag, suggesting the possibility of market share accretion exists.

Figure 122: Saudi banking system: Total credit and personal loan growth trends



Source: Deutsche Bank, SAMA

Figure 123: Al Rajhi Bank: market share by business unit (FY07)



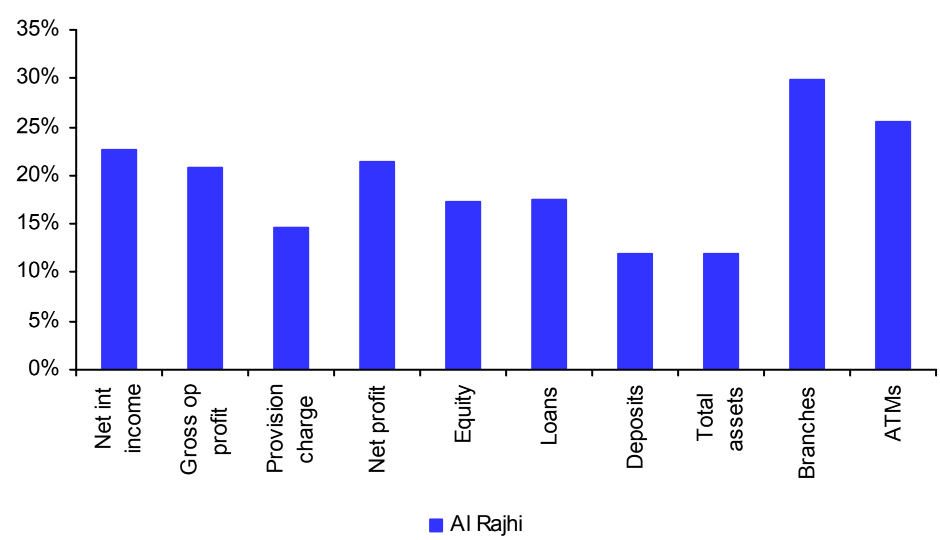
Source: Deutsche Bank

While we would agree with this strategy from a long-term perspective, in the current environment we believe an aggressive push into new business areas could leave the business exposed to unwanted risks. Investments to develop new capabilities and acquire customers could also depress near-term returns.

Business profile

With a business heavily oriented towards retail banking, Al Rajhi Bank benefits from its huge distribution network, which is the largest in the country. High margins generated from the bank's retail customers, combined with good operating efficiency, allow the bank to experience sector-leading levels of profitability.

Figure 124: Market share data (FY07)

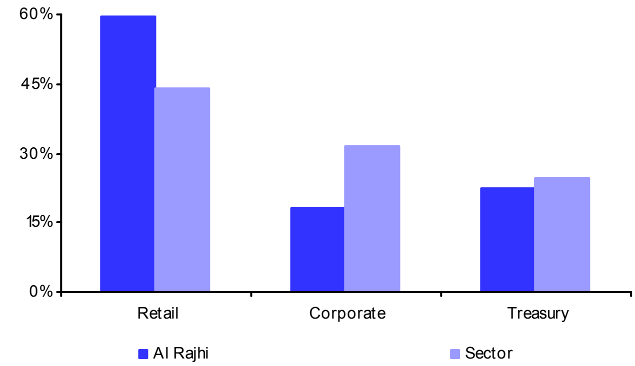


Source: Deutsche Bank, Company data, SAMA

Business mix

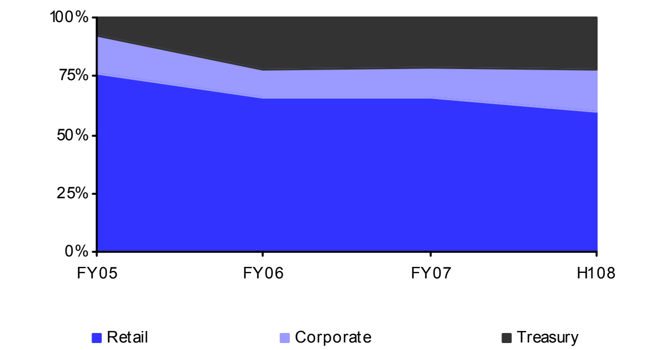
Al Rajhi is the most retail banking-oriented of the Saudi banks, with around 60% of revenues and half of group net income coming from this area (versus sector averages of 44% and 33% respectively). However, reflecting broader sector trends, the contribution of the retail business has declined over the past few years, largely reflecting lower brokerage revenues and more sluggish volume growth.

Figure 125: Al Rajhi's revenues are more heavily skewed towards retail banking…



Source: Deutsche Bank, company data

Figure 126: …however, retail banking revenue growth is declining in importance

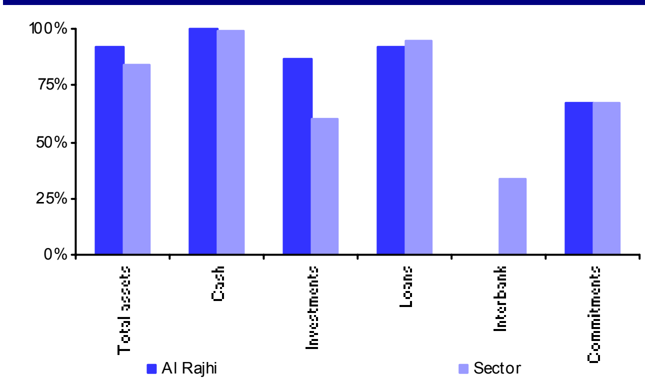


Source: Deutsche Bank, Company data

Geographic mix

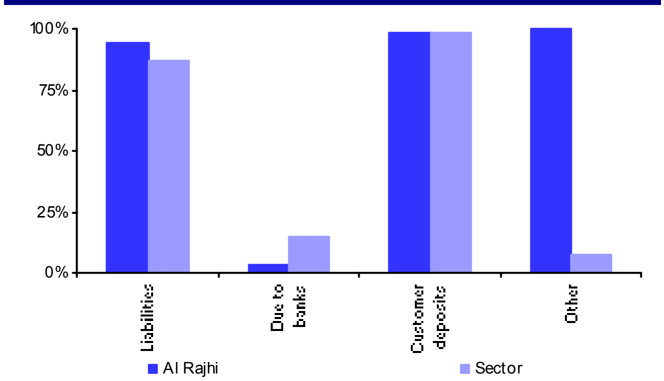
Al Rajhi Bank's balance sheet is one of the most domestically oriented in the sector, which we believe largely reflects the high weighting of customer loans (87% of all assets) and customer deposits (equivalent to 76% of total assets). Like other banks in the sector, this direct customer business is overwhelmingly domestic in nature. In contrast, almost all interbank assets and funding are with international counterparties; the overall size of these balances is small, however (at around 5% of total assets).

Figure 127: Geographic mix – assets and off-balance sheet commitments



Source: Deutsche Bank, company data

Figure 128: Geographic mix – liabilities

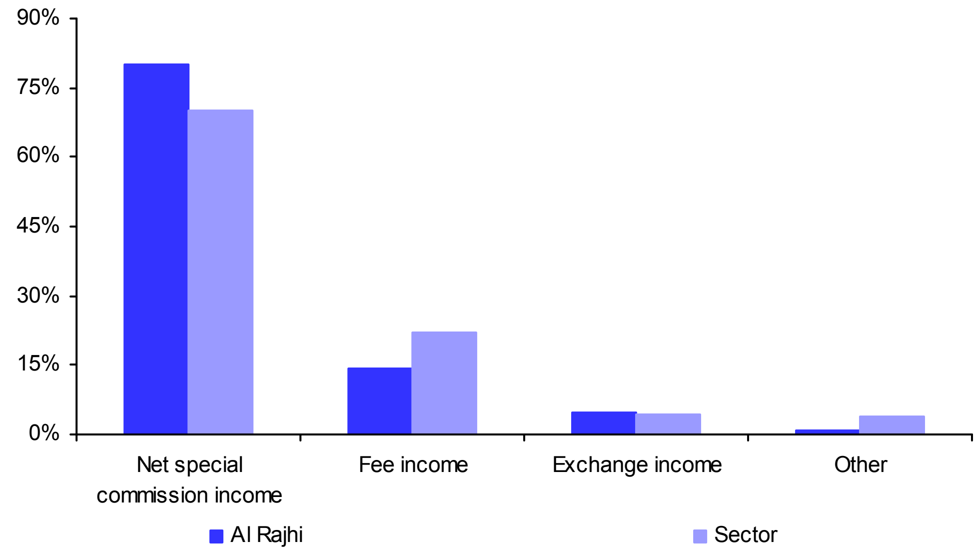


Source: Deutsche Bank, company data

Revenues

Around 80% of Al Rajhi Bank's revenues are derived from net special commission income, reflecting the high spreads that the bank is able to generate on its banking intermediation activities (skewed towards retail customers that generate high proportion of non-interest bearing deposits).

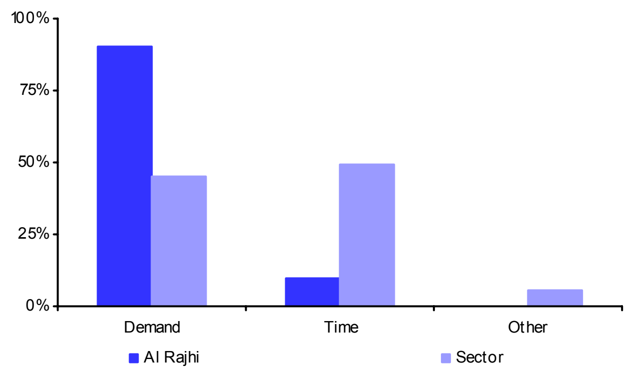
Figure 129: Revenue mix (H108)



Source: Deutsche Bank, company data

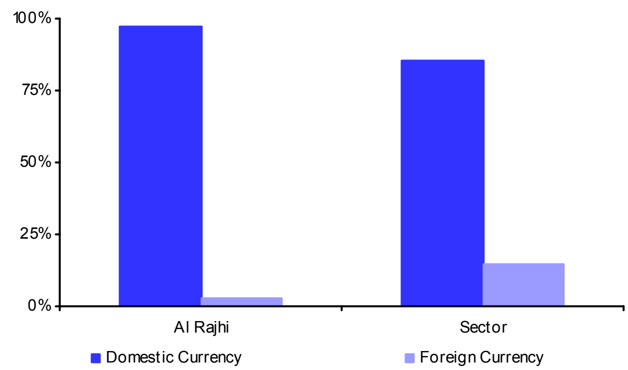
We note that the bank appears able to raise sufficient deposits from the domestic market, avoiding the need for foreign currency deposits.

Figure 130: Al Rajhi customer funding is predominantly in the form of demand deposits



Source: Deutsche Bank, company data

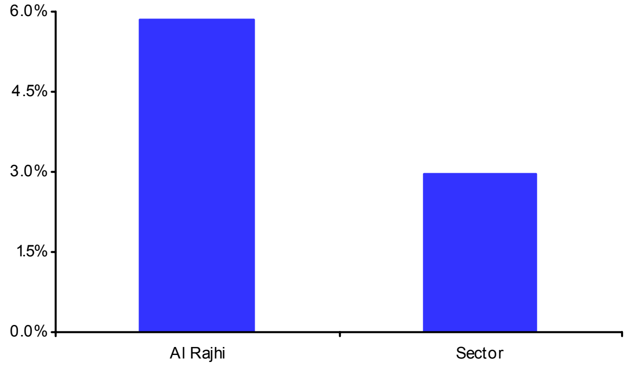
Figure 131: Al Rajhi's deposits are largely derived from domestic clients



Source: Deutsche Bank, company data

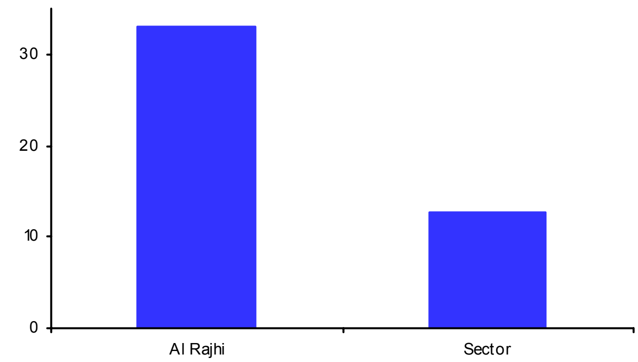
Largely as a result of its retail lending skew and an ability to attract interest-free deposits, Al Rajhi Bank has the highest net special commission margin in the sector. However, the large level of free funding also results in the bank being among the most sensitive to declining interest rates.

Figure 132: Al Rajhi's net special commission income margin is almost twice the sector average (9M08)



Source: Deutsche Bank, Company data

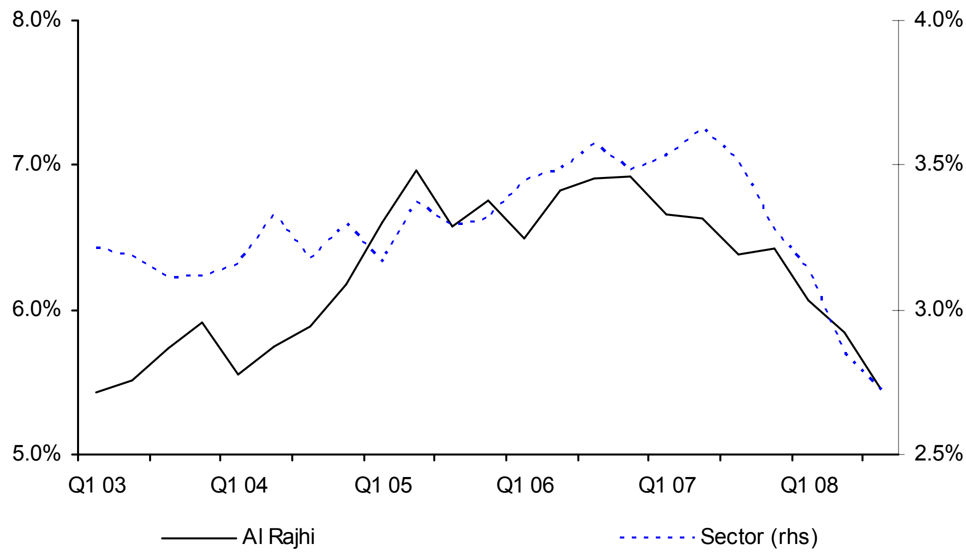
Figure 133: Al Rajhi bank's NSCI margin is almost three times more sensitive to interest rate changes than the sector average (bps change in NSCI margin for 100bps change in interest rates)



Source: Deutsche Bank, company data. Chart indicates the historical sensitivity of the net special commission income margin to a 100bps change in interest rates

In common with other sector participants, the bank has been unable to benefit from the run-up in market rates in recent months. We believe margin trends are likely to remain negative.

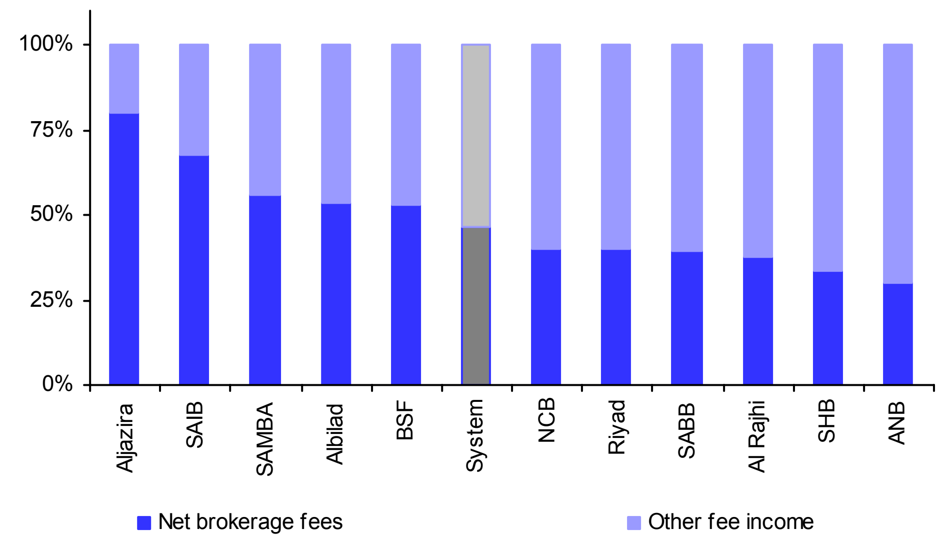
Figure 134: Net special commission income margins are trending down



Source: Deutsche Bank, company data

Al Rajhi Bank's high intermediation margin has had the favourable impact of shielding Al Rajhi from the sharp downturn in brokerage revenues that has been experienced across the sector. This is particularly the case given that Al Rajhi Bank's fee income is more diversified than most other sector participants.

Figure 135: Al Rajhi is less dependent on brokerage fee income than its peers



Source: Deutsche Bank, Company data

However, a key concern over the coming quarters is the potential impact of lower interest rates on the bank's net special income, given that the bank's funding costs are relatively insensitive to interest rates. However, the yield on the bank's assets also appears to be relatively insensitive to interest rates, reflecting the retail banking skew of the business (loans to retail customers tend to be fixed rate, while those to corporates tend to be variable rate). However, the effect is not matched; we would expect net interest margins to decline to reflect the reduction in interest rates as US policy aims to counteract the impact of the financial crisis on the real economy.

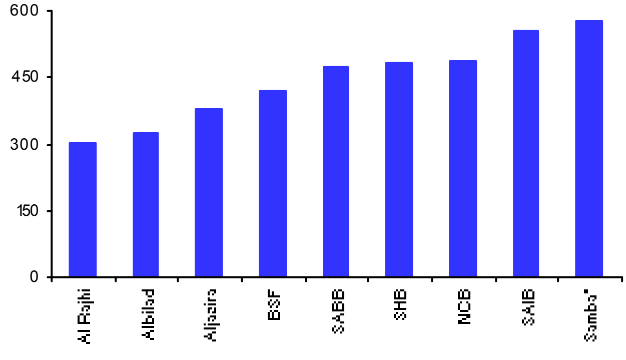
Like many other Saudi banks, Al Rajhi has been able to grow its fee income this year. While we expect brokerage revenues to continue to decline, we believe that other activities (trade finance, remittances and credit cards) will experience positive trends during the year.

Operating costs

Despite having the largest distribution network in the country, Al Rajhi's cost base does not appear excessive (indeed, the bank's 9M08 cost-income ratio of 27% was among the lowest in the sector). We believe this reflects a strong culture of cost control throughout the organization. Indeed, Al Rajhi's per capita staff costs are the lowest in the sector, while the bank's per branch costs are also sector-leading. While one would expect retail banking to have lower cost structures than corporate and investment banks, Al Rajhi outperforms similarly positioned peers such as NCB and Riyad Bank.

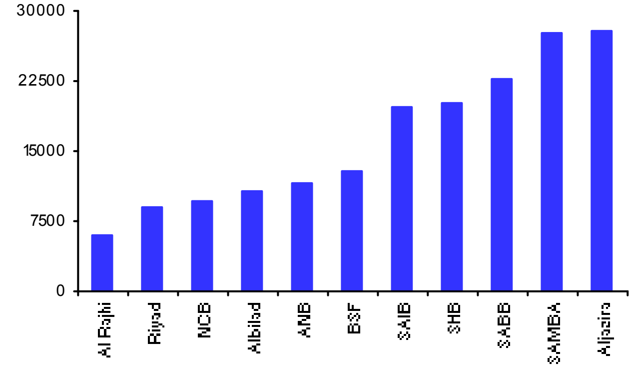
Al Rajhi bank's investments in new distribution infrastructure are contributing to steady cost growth, which has averaged over 20% over the pat few years. This has been in excess of core revenue growth (i.e., even after excluding the effect of weaker share brokerage commission), which suggests to us that the current level of investment is not sustainable.

Figure 136: Per capita operating costs (SAR'000s, FY07)



*Source: Deutsche Bank * = estimated from FY 06 data, Company data*

Figure 137: Operating costs per branch (SAR'000s)



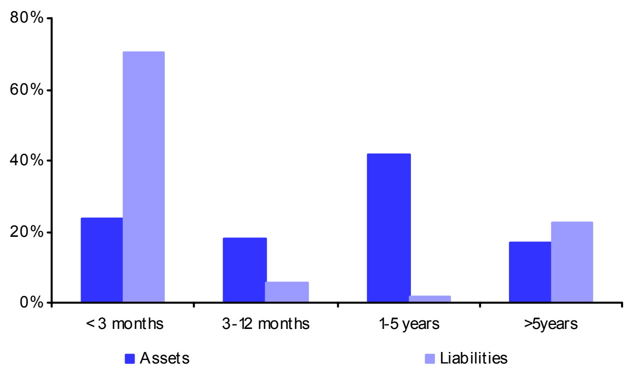
Source: Deutsche Bank, Company data

Risks

Liquidity risk

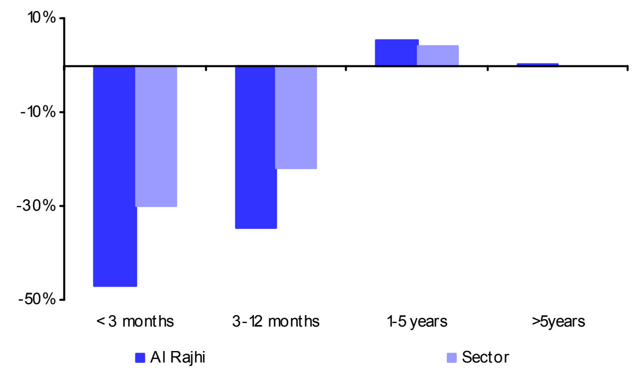
In common with its pure Islamic banking peer, Bank Albilad, the asset side of Al Rajhi's balance sheet is relatively illiquid. Customer loans account for over 80% of the asset base, with only 13% of the assets in liquid form, largely as cash. In contrast, over two-thirds of the bank's liabilities have a maturity of less than three months. This maturity mismatch is one of the largest in the Saudi banking sector.

Figure 138: Al Rajhi: contractual maturity dates for assets and liabilities (FY07)



Source: Deutsche Bank, Company data

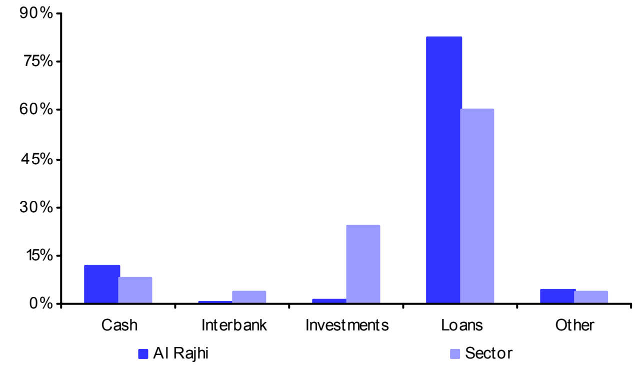
Figure 139: Cumulative asset-liability maturity mismatch: Al Rajhi and sector average (FY07)



Source: Deutsche Bank, Company data

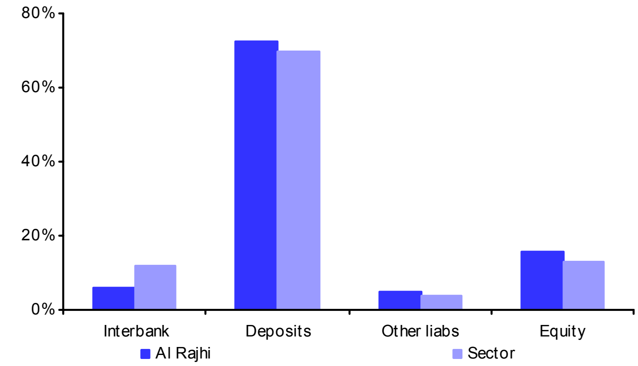
This balance sheet structure may be one reason why the bank has elected to have a relatively conservative funding structure. The equity/assets ratio stands at 16% (although this has been trending down in recent quarters as the bank has grown), and there is limited wholesale debt market funding.

Figure 140: Asset mix (H108)



Source: Deutsche Bank, company data

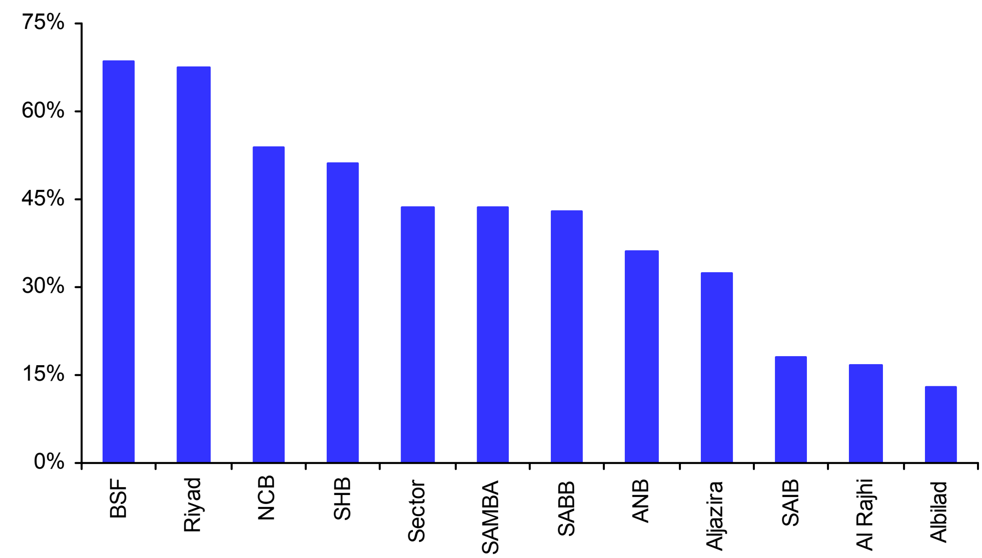
Figure 141: Liability mix (H108)



Source: Deutsche Bank, company data

The bank's portfolio of unfunded commitments is also small relative to the overall size of the loan book and asset base, equivalent to 17% of balance sheet loans (relative to a sector average of 44%).

Figure 142: Al Rajhi has a small portfolio of unfunded commitments (as % of loans, 9M08)



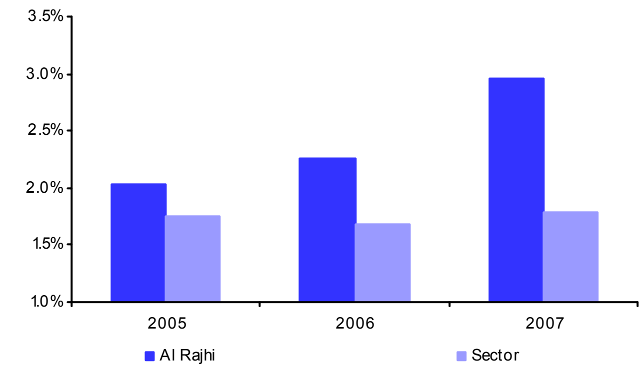
Source: Deutsche Bank, company data

We note that the bank does not use derivatives instruments to hedge risk or take active positions.

Credit risk

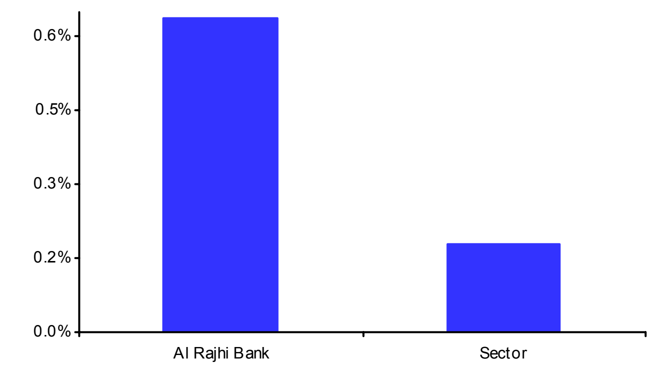
Relative to its peers, Al Rajhi bank has a higher proportion of non-performing loans. Moreover, this proportion actually increased during 2007. We suspect this increase may have been driven by the bank's retail loan portfolio and note that those banks with higher retail lending exposure are currently experiencing higher provisioning charges.

Figure 143: NPLs/loans ratio: Al Rajhi vs. sector



Source: Deutsche Bank, company data

Figure 144: Loan loss provisions charge (as % of loans, 9M08)

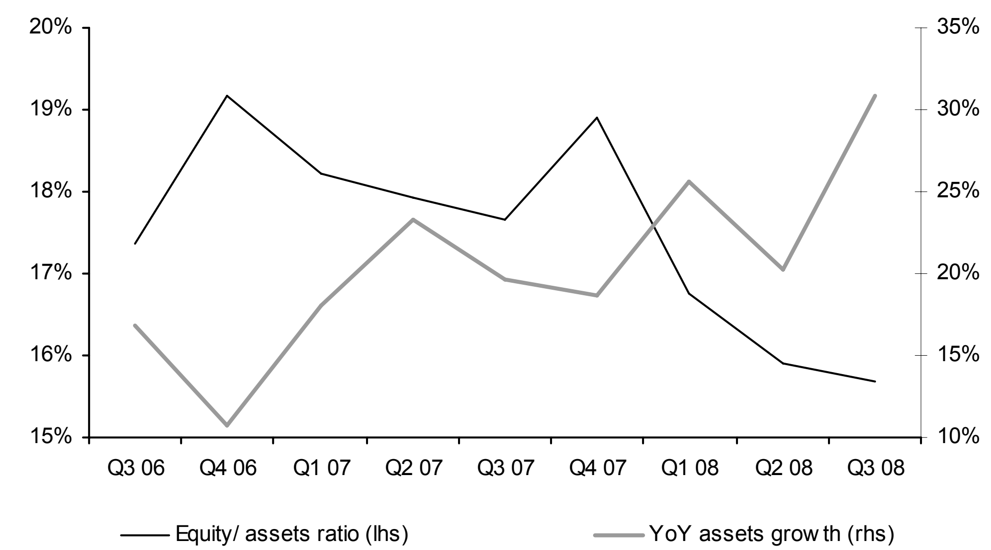


Source: Deutsche Bank, company data

Capital adequacy

Al Rajhi Bank is one of the better capitalized banks in the sector. As of Sep 08, the bank's tier 1 ratio was close to 13.2%, and the BIS ratio 18.6%. However, as the bank has pushed more aggressively into the corporate banking arena, its capital strength has declined. An expected slowdown in business volume growth should help capital ratios recover in the future.

Figure 145: Equity/assets ratio has declined in recent quarters as asset growth has accelerated



Source: Deutsche Bank, Company data

Ownership and background

Members of the Al Rajhi family are the largest shareholders of the bank, collectively owning 44% of the shares. GOSI owns an additional 10%.

The Al Rajhi family also has significant interests (via a 13% stake) in another Saudi Islamic bank, Bank Albilad. Bank Albilad is a relatively new entrant into the Saudi banking scene, and while its strategy is evolving, it has to date avoided competing head-on against Al Rajhi Bank in the retail banking segment, preferring instead to focus on mid- to large-sized corporate clients.

Al Rajhi is the largest purely Islamic banking institution in the world, and is also the largest retail bank in Saudi Arabia (it ranks second overall). Although the bank has the largest branch and ATM network in the country, it is continuing to invest in network expansion. One of the main benefits of the bank's extensive distribution capacity is the ability to collect large quantities of low cost deposits. Because many of its customers prefer to adhere to Shariah principles, most of its deposits are in fact interest-free. Indeed, we believe over 90% of the bank's asset base is funded from nil interest rate sources. It is therefore unsurprising that the bank has the highest net special commission income margin in the system. Al Rajhi Bank's strong positioning within the retail Islamic banking space is a strong source of competitive advantage, in our view.

However, all the main Saudi banking players have in recent years launched Shariah-compliant banking products. As these products gain more visibility in the market, they may serve to chip away at Al Rajhi's market share or even, where applicable, pricing advantages. However, we believe customer inertia is likely to result in limited near-term effects.

Figure 146: Shareholder structure

Shareholder	Stake
Sulaiman Abdulazi Saleh Al Rajhi	24.6%
Saleh Abdulaziz saleh Al Rajhi	13.6%
GOSI	9.9%
Abdullah Abdulazziz Saleh Al Rajhi	5.9%
Free Float	46.0%

Source: Deutsche Bank, Tadawul, zawya

This page has been intentionally left blank.

Model updated:18 January 2009

Running the numbers

Middle East

Saudi Arabia

Banking

Arab National Bank

Reuters: 1080.SE Bloomberg: ARNB AB

Buy

Price (20 Jan 09)	SAR 30.50
Target price	SAR 42.60
52-week Range	SAR 29.50 - 98.25
Market Cap (m)	SARm 19,845 USDm 5,291

Company Profile

Founded in 1979, Arab National Bank is mid-sized player in the Saudi Arabian banking system, with market share of close to 10%. The bank offers a mixture of conventional and Islamic banking products to its domestic customers, and also has a branch in London. Jordan's Arab Bank PLC is the largest shareholder, with a 40% stake, while other Board members own a further 17% of the shares.

Rahul Shah
+971 4 4283-261 rahul.shah@db.com

Fiscal year end 31-Dec	2005	2006	2007	2008E	2009E	2010E
Data Per Share						
EPS (stated)(SAR)	2.81	3.85	3.78	4.07	4.22	4.16
EPS (DB) (SAR)	2.81	3.90	3.78	4.07	4.22	4.16
Growth Rate - EPS (DB) (%)	nm	38.7	-3.0	7.4	3.9	-1.4
DPS (SAR)	0.84	0.60	0.11	1.00	1.25	1.50
BVPS (stated) (SAR)	6.59	12.26	16.18	19.24	22.21	24.87
Tang. NAV p. sh. (SAR)	6.59	12.26	16.18	19.24	22.21	24.87
Market Capitalisation	49,449	35,542	55,110	19,845	19,845	19,845
Shares in issue	651	651	651	651	651	651
Valuation Ratios & Profitability Measures						
P/E (stated)	27.1	14.2	22.4	7.5	7.2	7.3
P/E (DB)	27.0	14.0	22.4	7.5	7.2	7.3
P/B (stated)	11.5	4.5	5.2	1.6	1.4	1.2
P/Tangible equity (DB)	11.5	4.5	5.2	1.6	1.4	1.2
ROE(stated)(%)	32.3	35.0	26.6	23.0	20.4	17.7
ROTE (tangible equity) (%)	42.7	41.4	26.6	23.0	20.4	17.7
ROIC (invested capital) (%)	32.4	35.5	26.6	23.0	20.4	17.7
Dividend yield(%)	1.3	1.0	0.2	3.3	4.1	4.9
Dividend cover(x)	3.3	6.4	34.4	4.1	3.4	2.8
Profit & Loss (SARm)						
Net interest revenue	2,189	2,525	2,904	3,375	3,475	3,575
Non interest income	922	1,275	1,022	975	1,242	1,353
Commissions	808	1,121	977	1,125	1,225	1,335
Trading Revenue	18	32	55	0	17	18
Other revenue	96	121	-10	-150	0	0
Total revenue	3,111	3,800	3,926	4,350	4,717	4,928
Total Operating Costs	1,065	1,268	1,428	1,580	1,670	1,720
Employee Costs	658	770	843	925	975	1,000
Other costs	408	497	585	655	695	720
Pre-Provision profit/(loss)	2,064	2,532	2,498	2,770	3,047	3,208
Bad debt expense	221	60	37	125	300	500
Operating Profit	1,825	2,472	2,461	2,645	2,747	2,708
Pre-tax associates	0	0	0	0	0	0
Pre-tax profit	1,825	2,472	2,461	2,645	2,747	2,708
Tax	0	0	0	0	0	0
Other post tax items	3	33	0	0	0	0
Stated net profit	1,828	2,505	2,461	2,645	2,747	2,708
Goodwill	0	0	0	0	0	0
Extraordinary & Other items	3	33	0	0	0	0
Bad Debt Provisioning	0	0	0	0	0	0
Investment reval, cap gains / losses	0	0	0	0	0	0
DB adj. core earnings	1,830	2,538	2,462	2,645	2,747	2,708
Key Balance Sheet Items (SARm) & Capital Ratios						
Risk-weighted assets	45,237	61,110	72,523	108,139	115,041	124,245
Interest-earning assets	63,172	72,672	83,441	103,000	110,000	117,750
Customer Loans	38,815	49,747	61,122	75,000	79,500	85,000
Total Deposits	48,832	61,773	73,692	90,000	95,000	102,500
Stated Shareholder Equity	4,289	7,980	10,525	12,519	14,453	16,185
Equals: Tangible Equity	4,289	7,980	10,525	12,519	14,453	16,185
Tier 1 capital	6,337	7,980	10,525	10,965	12,899	14,631
Tier 1 ratio (%)	14	13	15	10	11	12
o/w core tier 1 capital ratio (%)	14.0	13.1	14.5	10.1	11.2	11.8
Credit Quality						
Gross NPLs/Total Loans(%)	2.18	0.74	0.52	1.13	2.14	3.82
Risk Provisions/NPLs(%)	201	321	354	144	88	60
Bad debt / Avg loans (%)	na	0.14	0.07	0.18	0.39	0.61
Bad debt/Pre-Provision Profit(%)	10.7	2.4	1.5	4.5	9.8	15.6
Growth Rates & Key Ratios						
Growth in revenues (%)	nm	22	3	11	8	4
Growth in costs (%)	na	19	13	11	6	3
Growth in bad debts (%)	nm	-73	-39	237	140	67
Growth in RWA (%)	nm	35	19	49	6	8
Net int. margin (%)	3.72	3.72	3.72	3.62	3.26	3.14
Cap.-market rev. / Total revs (%)	nm	nm	nm	nm	nm	nm
Total loans / Total deposits (%)	79	81	83	83	84	83
ROTE Decomposition						
Revenue % ARWAs	7.86	7.15	5.88	4.82	4.23	4.12
Net interest revenue % ARWA	5.53	4.75	4.35	3.74	3.11	2.99
Non interest revenue % ARWA	2.33	2.40	1.53	1.08	1.11	1.13
Costs/income ratio (%)	33.6	33.4	36.4	36.3	35.4	34.9
Bad debts % ARWAs	0.56	0.11	0.06	0.14	0.27	0.42
Tax rate (%)	0.0	0.0	0.0	0.0	0.0	0.0
Adj. Attr. earnings % ARWA	4.63	4.77	3.68	2.93	2.46	2.26
Capital leverage (ARWA/Equity)	9.2	8.7	7.2	7.8	8.3	7.8
ROTE (Adj. earnings/Ave. equity)	42.7	41.4	26.6	23.0	20.4	17.7

Source: Company data, Deutsche Bank estimates

Arab National Bank

A sleeping giant

Outlook

With limited exposure to equity brokerage fees, we see ANB delivering high single-digit revenue growth in 2009 (around twice the sector average) before declining to mid single-digit growth in 2010. The bank is currently benefiting from sector-leading asset quality. However, we expect loan loss provision charges to rise sharply in the future, which in turn is likely to result in a flat earnings profile to 2010.

We regard ANB as something of a sleeping giant. Limited investment relative to peers has caused the bank to lose its distribution infrastructure market share, while it also proved less able to benefit from the boom in equity brokerage fees earlier this decade. Nevertheless, the bank retains a strong deposit franchise and large retail customer base, while its risk profile (in terms of loan asset quality and investment portfolio composition) appears sound. We believe investments to revamp the bank's branch network and IT infrastructure and efforts to improve cross-selling rates could allow the bank to generate superior revenue growth relative to its peers.

With the shares trading at a discount to the sector, we believe investors have the opportunity to invest in a lower risk entity with modest turnaround potential at an attractive relative valuation. We have a Buy rating on the stock.

Valuation

We value the shares on a target price book multiple basis, using 2010 as our benchmark year and discounting back by the cost of equity. We assume a risk-free rate of 5.0%, an equity risk premium of 7.0% and a beta to the market of 0.88 (based on historical price performance). In common with our approach to other banks in the sector, we do not apply a long-term growth adjustment to our cost of capital calculation.

Figure 147: Arab National Bank target price calculation

17 January 2009	Share Price	2010 ROE	Cost of equity	Fair P/book ratio	2010 NAV	PV Dividends			Capital Adjustment	Qualitative Adjustment	12-month	Upside/ (Down side)	Investment Rating
	SAR					2008E	2009E	2010E	SAR		Target Price		
Arab National Bank	31.10	17.7%	11.2%	158%	24.9	0.86	0.96	1.04	0.0		42.6	37%	Buy
Sector Median		18.5%	11.3%	164%						0%		2.7%	

Source: Deutsche Bank, Zawya

ANB trades at a slight discount to the sector in terms of PE and PB. Its dividend yield is broadly in line. We believe this represents an attractive investment opportunity.

Figure 148: Arab National Bank valuation multiples

	Share Price	PE				PB				DY			
		2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
Arab National Bank	31.10	8.2	7.7	7.4	7.5	1.92	1.62	1.40	1.25	0.4%	4.0%	4.0%	4.8%
Sector Median		9.5	10.2	9.5	9.2	2.30	2.02	1.80	1.62	2.9%	4.1%	4.1%	4.5%

Source: Deutsche Bank, Zawya. Share prices as of market close, 17 January 2009

Risks to our view

Capital base: Arab National Bank's capital base is smaller than many of its peers. In an environment of rapid growth, this could have created the risk that the bank would need to raise additional capital or turn away business and lose market share. However, in our view, business volume growth across the sector is set to slow sharply. ANB's sector leading asset quality and low-risk investment portfolio, however, suggest to us that existing levels of capital are adequate.

Retail banking exposure: We believe the development of the retail banking sector will continue to lag the overall sector as a weakening economy lowers consumer confidence and job security. As one of the Saudi banks with the greatest exposure to this sector, we believe ANB may be more affected by such a scenario.

Key themes

Strong asset quality

ANB has among the best loan quality statistics in the sector (NPLs/loans ratio of 0.5% and provisions coverage of 350%), though these measures were boosted by significant write-offs in 2006. While we believe asset quality is likely to decline in the future, ANB will likely retain its asset quality advantage over other banks in the sector.

Good funding base

Almost 80% of ANB's funding is generated through customer deposits, one of the highest ratios in the sector. This demonstrates the strength of the bank's commercial franchise and limits the bank's wholesale funding needs.

Limited exposure to brokerage income

ANB is the Saudi bank with the least exposure to equity brokerage fee income. Given our view that this revenue stream is likely to decline in 2009, this lack of exposure should be viewed positively.

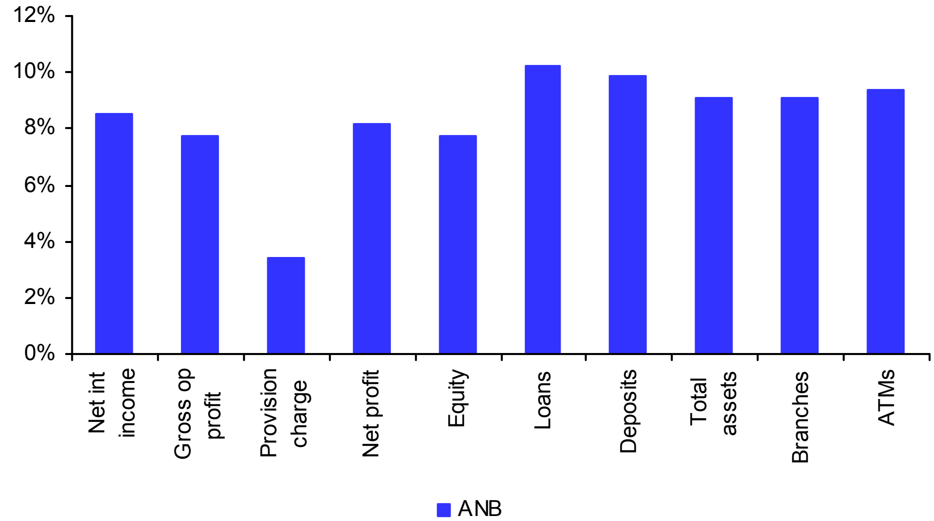
Retail banking exposure

Retail banking activities currently generate over half of the bank's revenues. We see revenue growth from this industry segment remaining sluggish as slower economic growth impacts consumer confidence. Asset quality is also likely to deteriorate. However, we believe ANB could partly offset this negative scenario through improved cross-selling.

Business profile

Arab National Bank has a market share in the region of 9%. The bank is less well-capitalised than the sector average, but it benefits from superior asset quality. Around half of the bank's revenues are generated from retail banking activities.

Figure 149: Market share data (FY07)



Source: Deutsche Bank, Company data, SAMA

Business mix

ANB's business mix is skewed towards retail customers, who generate over 50% of group revenues and almost 40% of group net income, higher proportions than the sector average.

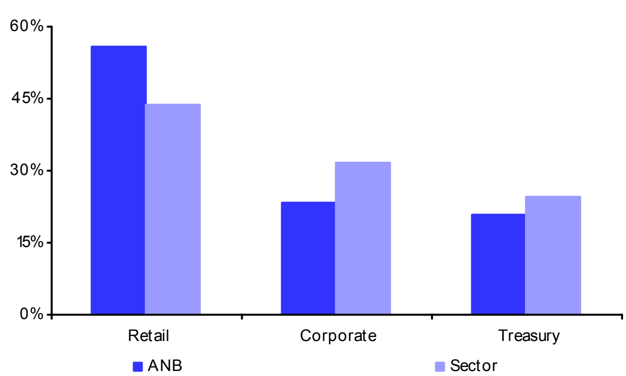
Distribution infrastructure

ANB's branch market share has experienced a modest decline over the past decade, with the bank's branch opening activity failing to keep pace with the overall sector. This effect has been more pronounced in terms of ATMs, however, where market share has almost halved over the period. We also believe the bank is not maintaining its share of internet banking.

Part of the reason for these trends relates to the bank's customer mix, which is skewed towards older, more mass-market individuals. This segment of the population is less likely to use alternative channels such as ATMs and internet banking.

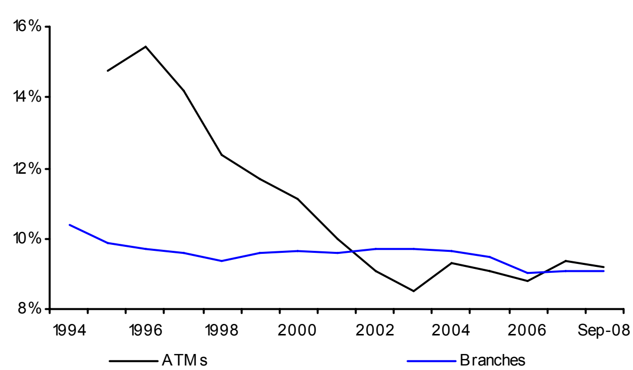
However, management is seeking to broaden its customer profile, and in this vein, we would expect the bank's long-term decline in relative distribution capacity to be staunched.

Figure 150: Revenue business mix (H108)



Source: Deutsche Bank, Company data

Figure 151: Branch and ATM market shares

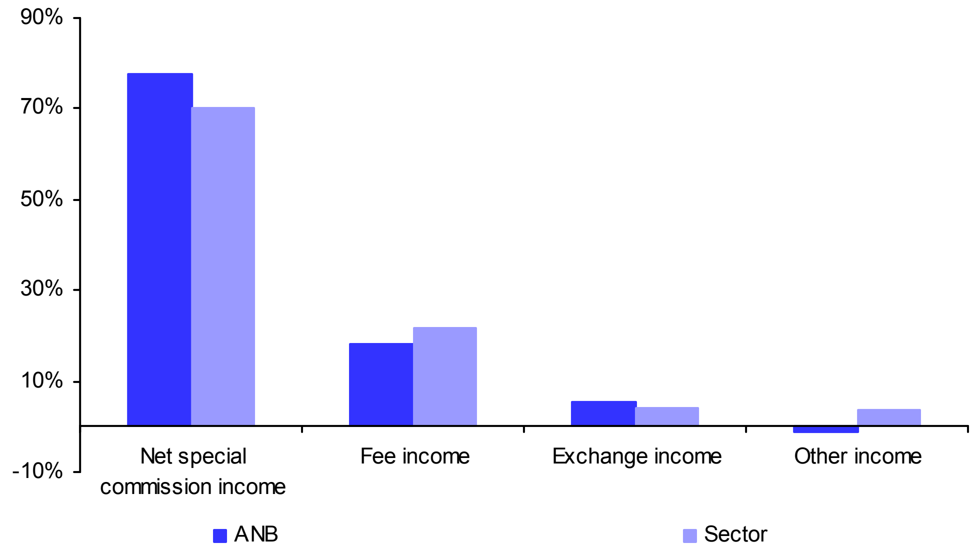


Source: Deutsche Bank, SAMA

Revenues

ANB appears to generate lower revenues relative to balance sheet exposures than its peers, which appears to confirm management's view that cross-selling can be improved. Indeed, the bank is more reliant on spread-based income than most other banks in the sector.

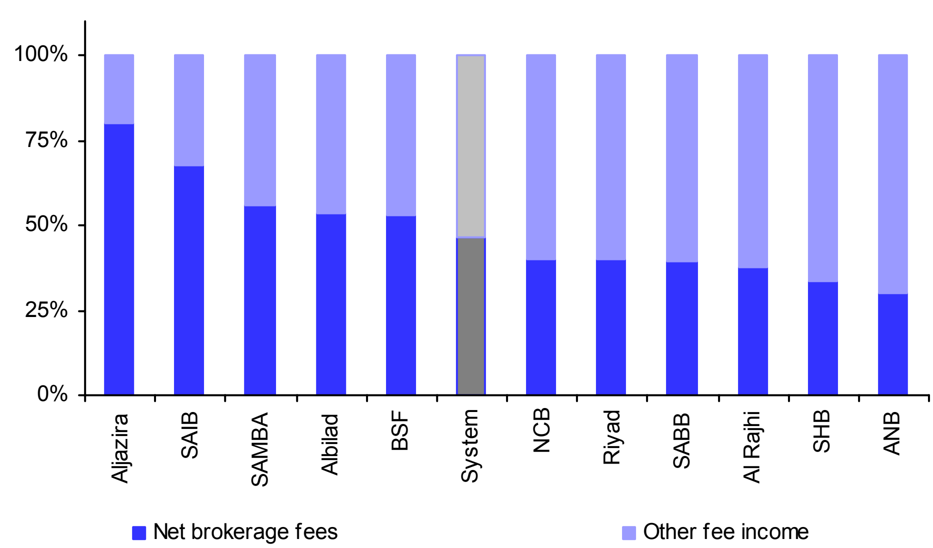
Figure 152: Revenue mix: ANB is more dependent on spread-based income than its peers



Source: Deutsche Bank, Company data

Weakness in prior cross-selling ability is apparent in the bank's lower exposure to brokerage and mutual fund fees than its peers. While this has helped cushion the bank as revenues from these sources have declined in recent years, management has recognized that the bank's performance in this area needs to improve in the future. The bank is looking to increase the number of CMA-approved mutual funds, while the share brokerage product and associated marketing efforts are also being improved.

Figure 153: Fee income mix (FY07)



Source: Deutsche Bank, Company data

Operating costs

Despite investments in IT infrastructure, branch refurbishment and additional branches, cost growth has proved relatively steadily (at 12% 9M08/9M07). Together with the recovery in revenue growth this year, this has allowed the cost-income ratio to trend downwards in recent quarters.

While at the group level the bank's cost base appears in line with peers, within the retail business there appears to be scope for additional cost-cutting. Continued growth in the bank's use of alternative distribution channels may improve efficiency ratios in this business area over the coming years.

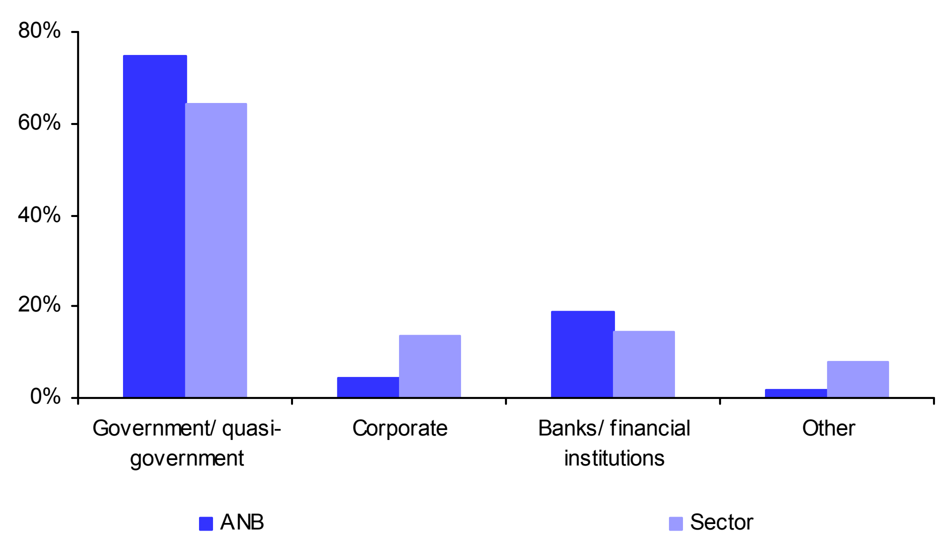
One area where ANB's cost structure differs from its peers is its heavy reliance on operating leases to finance parts of its branch network. Given that the bank is looking to reposition some branches and remodel others, this financing arrangement may provide some flexibility advantages relative to outright ownership of the branch infrastructure.

Risks

Market risk
The bulk of ANB's investment portfolio is invested in Saudi government-issued development bonds.

However, the bank also has a relatively high proportion of securities issued by financial institutions in its portfolio. While these investments were likely made for conservative reasons, the length and depth of the credit crunch could have elevated the risk profile of this part of the portfolio.

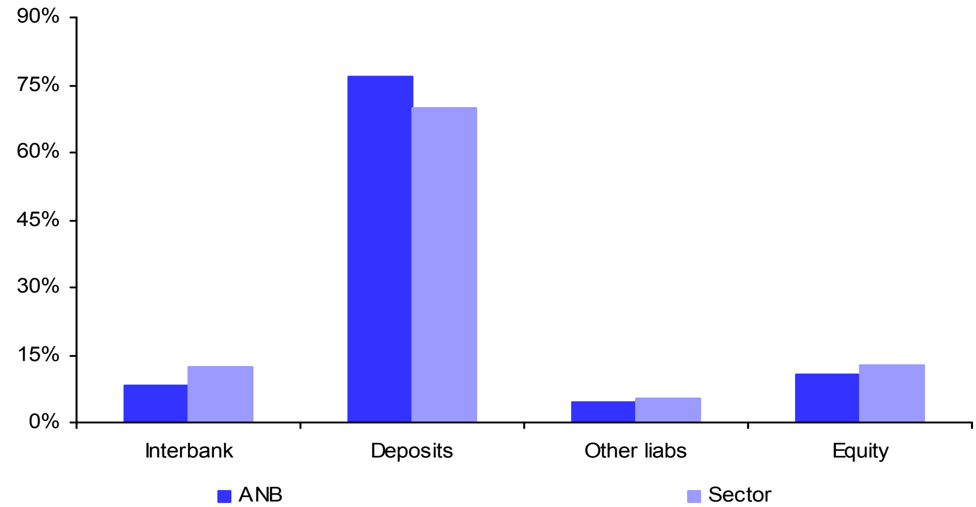
Figure 154: Investment portfolio by issuer type



Source: Deutsche Bank, Company data

Liquidity risk
Thanks to its strong retail banking presence, ANB has the highest proportion of deposit funding within the sector, at just under 80%. In the current environment of tight liquidity, this is a valuable resource.

Figure 155: ANB has the highest proportion of deposit funding in the sector (H108)



Source: Deutsche Bank, Company data

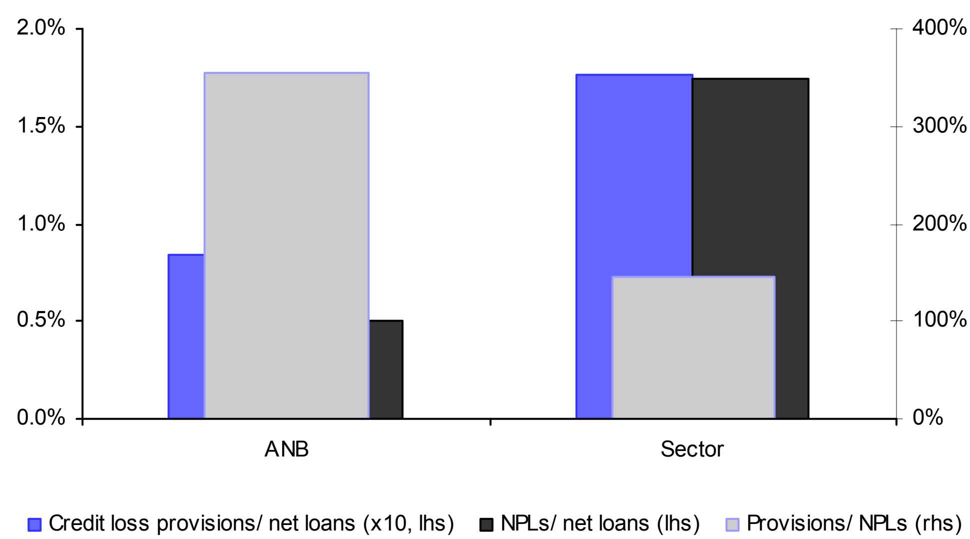
Credit risk

ANB's loan book is more skewed towards retail customers than any other banks apart from Al Rajhi Bank and NCB. However, the proportion of corporate loans is rising, reflecting the sluggishness of retail credit demand as Saudi stock market weakness negatively affects sentiment.

In terms of the corporate loan book, ANB has limited exposure to the government. Its market share of loans to companies in the commercial sector is also low. In contrast, ANB has a higher-than-average exposure to the manufacturing sector.

Following significant write-offs in 2006, ANB's asset quality ratios now compare extremely favourably to other banks in the sector. Perhaps as a result, the bank has felt comfortable making the fewest additions to its loan loss provisions year-to-date. However, we do see asset quality deteriorating in the coming years, with credit loss provisions rising sharply and NPL coverage declining below 100%.

Figure 156: ANB has superior asset quality metrics to its peers (9M08)



Source: Deutsche Bank, company data

Capital adequacy

Although sound by international standards, ANB's tier 1 ratio of 9.4% (9M08) appears low relative to the sector average of 11%. The equity/assets ratio of 10.5% is also towards the lower end of the domestic range. However, with sector volume growth likely to slow, we do not believe capital constraints are a risk to the development of the business.

Ownership and background

A relatively large proportion of ANB's retail customers are pensioners, as the bank won a government contract to provide these individuals with regular payments. Partly for this reason ANB is more skewed towards retail banking than some of its peers.

Management is now seeking to transform the image of the retail branches in order to improve cross-selling rates: it is remodelling existing branches, investing heavily in IT infrastructure (a new IT system roll-out is planned for next year) and opening new branches.

The company has entered into several joint ventures it hopes to sell through its distribution network, including: a JV with AIG in life and non-life insurance; a JV with DarAl Arkan, known as the Saudi Home Loan Company, to provide Shariah-compliant housing finance; and a JV with Consolidated Contractors Company, known as Ejar Crane and Equipment Company, to provide heavy equipment leasing finance.

Although management has indicated that it will look at international acquisition opportunities, given the significant scope to improve the productivity of the existing business footprint and the current uncertain growth environment, we believe a large transaction is unlikely. Moreover, through its core shareholder, Arab Bank, ANB is linked to a number of financial institutions in the MENA region.

Figure 157: Shareholder structure

Shareholder	Stake
Arab Bank PJSC	40.0%
GOSI	10.8%
Rashid Abdul Rahman Al Rashid & Sons	9.9%
Al Jaber Trading Co	5.6%
Free Float	33.7%

Source: Deutsche Bank, Tadawul, Zawya

Model updated:21 January 2009

Running the numbers

Middle East

Saudi Arabia

Banking

Bank Albilad

Reuters: 1140.SE Bloomberg: ALBI AB

Sell

Price (20 Jan 09)	SAR 26.10
Target price	SAR 9.10
52-week Range	SAR 23.50 - 43.00
Market Cap (m)	SARm 7,830 USDm 2,088

Company Profile

Established in 2004, Bank Albilad has established itself as a supplier of Islamic banking products to Saudi nationals and corporates, whom it serves via a network of over 60 branches and 400 ATMs. Reflecting its roots in the money exchange business, remittances continue to generate a sizeable proportion of Albilad's earnings. Following a 2005 IPO, around 60% of the bank's shares are owned by the general public.

Rahul Shah

+971 4 4283-261 rahul.shah@db.com

Fiscal year end 31-Dec	2005	2006	2007	2008E	2009E	2010E
Data Per Share						
EPS (stated)(SAR)	-0.33	0.59	0.24	0.55	0.65	0.83
EPS (DB) (SAR)	-0.59	0.59	0.24	0.55	0.65	0.83
Growth Rate - EPS (DB) (%)	nm	200.1	-59.3	126.3	19.5	27.6
DPS (SAR)	0.00	0.00	0.00	0.00	0.05	0.10
BVPS (stated) (SAR)	9.66	10.08	10.35	10.89	11.55	12.38
Tang. NAV p. sh. (SAR)	9.66	10.08	10.35	10.89	11.55	12.38
Market Capitalisation	51,480	11,925	12,075	7,830	7,830	7,830
Shares in issue	300	300	300	300	300	300
Valuation Ratios & Profitability Measures						
P/E (stated)	-524.8	66.9	166.6	47.7	39.9	31.3
P/E (DB)	-289.3	66.9	166.6	47.7	39.9	31.3
P/B (stated)	17.8	3.9	3.9	2.4	2.3	2.1
P/Tangible equity (DB)	17.8	3.9	3.9	2.4	2.3	2.1
ROE(stated)(%)	-3.4	6.0	2.4	5.1	5.8	7.0
ROTE (tangible equity) (%)	-6.1	6.0	2.4	5.1	5.8	7.0
ROIC (invested capital) (%)	-6.1	6.0	2.4	5.1	5.8	7.0
Dividend yield(%)	0.0	0.0	0.0	0.0	0.2	0.4
Dividend cover(x)	nm	nm	nm	nm	13.1	8.3
Profit & Loss (SARm)						
Net interest revenue	109	359	534	595	615	650
Non interest income	54	296	244	331	360	390
Commissions	54	296	244	331	360	390
Trading Revenue	0	0	0	0	0	0
Other revenue	0	0	0	0	0	0
Total revenue	163	655	779	926	975	1,040
Total Operating Costs	182	470	641	687	704	715
Employee Costs	105	246	357	375	380	385
Other costs	77	224	284	312	324	330
Pre-Provision profit/(loss)	-18	185	138	239	271	325
Bad debt expense	0	7	65	75	75	75
Operating Profit	-18	178	72	164	196	250
Pre-tax associates	0	0	0	0	0	0
Pre-tax profit	-18	178	72	164	196	250
Tax	0	0	0	0	0	0
Other post tax items	-80	0	0	0	0	0
Stated net profit	-98	178	72	164	196	250
Goodwill	0	0	0	0	0	0
Extraordinary & Other items	-80	0	0	0	0	0
Bad Debt Provisioning	0	0	0	0	0	0
Investment reval, cap gains / losses	0	0	0	0	0	0
DB adj. core earnings	-178	178	72	164	196	250
Key Balance Sheet Items (SARm) & Capital Ratios						
Risk-weighted assets	3,009	5,569	9,549	15,856	17,488	19,354
Interest-earning assets	5,321	9,960	13,613	13,650	14,975	16,400
Customer Loans	5,212	9,669	13,321	13,000	14,250	15,600
Total Deposits	3,915	7,858	12,689	13,000	13,500	14,250
Stated Shareholder Equity	2,899	3,024	3,104	3,268	3,464	3,714
Equals: Tangible Equity	2,899	3,024	3,104	3,268	3,464	3,714
Tier 1 capital	2,899	3,024	3,104	3,160	3,356	3,606
Tier 1 ratio (%)	96	54	33	20	19	19
o/w core tier 1 capital ratio (%)	96.4	54.3	32.5	19.9	19.2	18.6
Credit Quality						
Gross NPLs/Total Loans(%)	0.00	0.22	0.78	1.46	2.28	3.30
Risk Provisions/NPLs(%)	nm	33	70	76	69	60
Bad debt / Avg loans (%)	0.00	0.09	0.57	0.57	0.55	0.50
Bad debt/Pre-Provision Profit(%)	0.0	3.8	47.4	31.4	27.7	23.1
Growth Rates & Key Ratios						
Growth in revenues (%)	nm	301	19	19	5	7
Growth in costs (%)	na	159	36	7	2	2
Growth in bad debts (%)	nm	nm	829	15	0	0
Growth in RWA (%)	nm	85	71	66	10	11
Net int. margin (%)	2.05	4.70	4.53	4.36	4.30	4.14
Cap.-market rev. / Total revs (%)	nm	nm	nm	nm	nm	nm
Total loans / Total deposits (%)	133	123	105	100	106	109
ROTE Decomposition						
Revenue % ARWAs	10.87	15.27	10.30	7.29	5.85	5.65
Net interest revenue % ARWA	7.26	8.37	7.07	4.68	3.69	3.53
Non interest revenue % ARWA	3.61	6.90	3.23	2.61	2.16	2.12
Costs/income ratio (%)	111.1	71.7	82.3	74.2	72.2	68.8
Bad debts % ARWAs	0.00	0.16	0.86	0.59	0.45	0.41
Tax rate (%)	0.0	0.0	0.0	0.0	0.0	0.0
Adj. Attr. earnings % ARWA	-11.83	4.15	0.96	1.29	1.18	1.36
Capital leverage (ARWA/Equity)	0.5	1.4	2.5	4.0	5.0	5.1
ROTE (Adj. earnings/Ave. equity)	-6.1	6.0	2.4	5.1	5.8	7.0

Source: Company data, Deutsche Bank estimates

Bank Albilad

Born in a different world

Outlook

With significant equity funding, Bank Albilad was created to capitalize on the rapid growth environment that has characterized the Saudi banking sector. Significant investment in distribution infrastructure was made, and the business grew strongly in both 2006 and 2007, although business activity has slowed considerably during 2008.

In contrast to its recent performance and despite an expected slowdown in sector growth trends, we have factored in low double-digit business volume growth at Bank Albilad, implying market share accretion. Accordingly, and despite pressure on net special commission income margins from the low interest rate environment, we see revenue growth averaging 6% in 2009 and 2010, above the sector average. With much of the bank's cost infrastructure already in place, we also assume that the growth of the business opens up the potential for operating efficiency improvements to be made, allowing the cost-income ratio to decline from 76% in 9M 08 to 69% by 2010. We see gross operating profit growth averaging 16% over the next two years, and sector leading annual net income growth of 24% over this period.

With industry growth set to slow sharply, we believe the risks to our forecasts are skewed to the downside. Firstly, potentially lower volume growth would have a direct impact on the bank's revenues. Secondly, with the activity levels still lower than we believe can be supported by the bank's infrastructure, cost efficiency is likely to be extremely sensitive to volume trends.

However, even assuming our more optimistic base case scenario, we see significant downside risk to the shares. We believe investors would need to see business volume growth of 20% pa over the next five years for sector PE and PB multiples to converge to the current sector average. In an uncertain economic environment, we view such an outcome as extremely unlikely. We initiate research coverage of the shares with a Sell recommendation.

Valuation

Based on our forecasts, Bank Albilad shares are trading at a significant premium to the sector. In an environment where sector volume growth is likely to decline, making significant market share accretion more difficult to achieve, we believe the current premium attached to the shares is unjustified.

We value the shares on a target price book multiple basis, using 2010 as our benchmark year and discounting back by the cost of equity. We assume a risk-free rate of 5.0%, an equity risk premium of 7.0% and a beta to the market of 1.02 (based on historical price performance). In common with our approach to other banks in the sector, we do not apply a long-term growth adjustment to our cost of capital calculation.

Our target price calculation also gives credit to Bank Albilad for its strong capital base and its relatively low exposure to market and credit risks.

Figure 158: Bank Albilad target price calculation

	Share Price	2010 ROE	Cost of equity	Fair P/book ratio	2010 NAV	PV Dividends			Capital Adjustment	Qualitative Adjustment	12-month	Upside/ (Down side)	Investment Rating
	SAR					2008E	2009E	2010E	SAR		Target Price		
Bank Albilad	25.00	7.0%	12.1%	57%	12.4		0.04	0.07	1.0	10%	9.1	-64%	Sell
Sector Median		18.5%	11.3%	164%						0%		2.7%	

Source: Deutsche Bank, Zawya. Priced as of close, 17 January 2009

Relative to its peers, Bank Albilad trades at a significant premium.

Figure 159: Bank Albilad valuation multiples

	Share price	PE multiple				PB multiple				Dividend Yield			
		2007A	2008E	2009E	2010E	2007A	2008E	2009E	2010E	2007A	2008E	2009E	2010E
Bank Albilad	25.00	103.5	45.7	38.3	30.0	2.42	2.29	2.17	2.02	0.0%	0.2%	0.2%	0.4%
Sector Median		9.5	10.2	9.5	9.2	2.30	2.02	1.80	1.62	2.9%	4.1%	4.1%	4.5%

Source: Deutsche Bank, Company data, Zawya. Priced as of close, 17 January 2009

Risks to our view

In our view, Bank Albilad is a geared play on the sector. A sharp economic recovery would put in place conditions conducive to rapid growth of the business. This would afford the bank more opportunities to grow market share, and to experience scale economies and an improving cost-income ratio. Growth of the business would also help to reduce the bank's significant excess capital position, which is currently depressing equity-based return measures.

While we believe either measure would not address the core problems of Albilad's positioning in the sector, we believe the announcement of significant operating costs or capital efficiency measures could also be well-received by investors.

Alternatively, management could seek a business combination as a means to bulk up the business without trying to win market share organically in a sluggish (and likely competitive) environment. While the bank's excess capital would be attractive in the current market, we believe local and foreign players would be hard-pressed to justify the current market valuation on economic grounds.

Key themes

Distribution infrastructure not fully utilized

Bank Albilad currently operates a network of 61 branches and over 400 ATMs. Given that the bank's business is skewed towards corporate customers, one would expect business activity levels to be at least in line with the 4-5% market share implied by the size of Albilad's business network. In reality, Albilad's market share by business volume is around 2%. This volume shortfall is putting significant pressure on operating efficiency levels

Strong capital base demands significant business growth

With an equity/assets ratio of 21%, Albilad could almost double its volume of business before reaching sector average levels of balance sheet gearing. In the meantime, this excess capital is depressing the bank's return on equity.

Retail banking environment is proving competitive

As a bank run purely along Shariah principles, Albilad might be expected to have a marketing advantage relative to the Islamic banking arms of the larger commercial banks. However, the bank appears to be more successful at attracting business from corporate customers than from individuals. We believe this is partly reflective of the bank's limited distribution network, but also due to the presence of the large and efficient competitor Al Rajhi Bank.

Priced for growth and profitability

Despite its significant strategic challenges, Bank Albilad is one of the highest rated stocks in the sector. We believe the current valuation is consistent with the bank more than doubling its business volume, tripling its return on equity and a five-fold increase in its earnings on a five-year view. We view such a scenario as unrealistic in the current macroeconomic environment.

Capital and cost restructuring measures could deliver a temporary profit boost

Bank Albilad has the highest capital ratios in the Saudi banking sector, reflecting in our view a capital-raising exercise designed to fuel the long-term expansion of the business. With industry growth likely to slow significantly, Albilad may struggle to deploy its excess capital effectively. If the outlook remains unfavourable, management could decide that shareholders would be able to generate better returns by investing this capital elsewhere. However, such a course of action would not address the bank's inferior cost efficiency.

We therefore believe that any capital release announcement would likely also be accompanied by news of aggressive cost restructuring, which could involve branch closures and headcount reduction in order to more closely match bank infrastructure and business volume. However, unless the bank was to find a profitable niche, we are concerned that downsizing the business could leave it too thinly resourced to effectively compete with much larger competitors.

Consolidation is possible, but potentially difficult for an acquirer to justify

With return of capital and cost-cutting unlikely to boost the bank's long-term franchise value, we see two possible routes for the business. If the economic environment were to improve, then we believe the bank could return to its core strategy of growing at above market rates to fill out its existing distribution footprint. Alternatively, we see consolidation as the key route to adding value for shareholders. Consolidation would allow Albilad to pursue cost-cutting without shrinking the business below a viable size, and could potentially be linked with distribution of excess capital. However, we have no reason to believe that management is in merger discussions at this time and note that such a move could result in an exodus of customers.

What expectations is the market pricing in for Bank Albilad?

Bank Albilad's physical and financial infrastructure appears to be capable of supporting activity levels which are a multiple of the current level. Priced on a historic PE multiple of 108 and P/B multiple of 2.5, investors also appear to be factoring in a clear improvement in profitability.

We present a simple model for the business, which on a five-year view could bring the bank's trading multiples in line with the current 2010 multiples for the sector.

Our model makes a number of assumptions, each of which we view as optimistic:

- Annual business volume growth of 20%, equivalent to the bank nearly doubling its market share over the modelling period (assuming system volume growth of 8% pa).

- Revenue margins (as percentage of assets) to decline by 4% per annum – the annual sector average decline over the past two years has been around 15%.
- Cost growth of 4% per year, implying an improvement that the cost-income ratio almost halves from 2007 to 2014.
- Provisioning charges to grow at 15% per annum, slower than overall loan growth. We view this as optimistic, as we believe the asset quality cycle has turned and expect non-performing loans to rise sharply from current levels.

For these reasons, we view the model as unrealistic, suggesting the shares are currently overvalued.

Figure 160: Bank Albilad: hypothetical projection to bring market valuation multiples in line with current 2010e sector multiples

	2007		2008E		2009P		2010P		2011P		2012P		2014P
Revenues	779	19%	926	15%	1056	14%	1203	14%	1372	14%	1564	14%	1783
Operating costs	641	7%	687	6%	714	4%	743	4%	773	4%	804	4%	836
Gross operating profit	138	74%	239	43%	341	35%	460	30%	599	27%	760	25%	947
Loan loss provisions	65	15%	75	15%	86	15%	99	15%	113	14%	130	14%	148
Net income	72	126%	164	56%	255	42%	362	34%	486	30%	631	27%	799
Total assets	16636	2%	17000	11%	20400	20%	24480	20%	29376	20%	35251	20%	42301
Customer investments/ loans	13321	-2%	13000	18%	15336	18%	18086	18%	21324	18%	25132	18%	29611
Equity	3104	5%	3268	7%	3498	8%	3787	9%	4127	9%	4506	9%	4905
Revenues/ assets	5.6%		5.5%		5.6%		5.4%		5.1%		4.8%		4.6%
Cost-income ratio	82%		74%		68%		62%		56%		51%		47%
Loan provisions charge/ loans	0.49%		0.58%		0.56%		0.55%		0.53%		0.52%		0.50%
ROA	0.52%		0.98%		1.36%		1.61%		1.80%		1.95%		2.06%
ROE	2.4%		5.1%		7.5%		9.9%		12.3%		14.6%		17.0%
Equity/ assets ratio	19%		19%		17%		15%		14%		13%		12%
Customer loans/ assets	80%		76%		75%		74%		73%		71%		70%
Dividend Payout ratio	0.00%		0.0%		10.0%		20.0%		30.0%		40.0%		50.0%
PE multiple	103.5		45.7		29.4		20.7		15.4		11.9		9.4
PB multiple	2.4		2.3		2.1		2.0		1.8		1.7		1.5

Source: Deutsche Bank. Note: 2008E is in line with our current 2008E forecast. Subsequent projections are based on the assumptions highlighted in the preceding text and are not consistent with our earnigs model.

Could potential consolidation add value for shareholders?

If Bank Albilad were unable to fulfil its growth objectives as a result of an unfavourable macroeconomic and banking sector environment, we believe the bank would have three course of action:

- Management could decide to return excess capital to shareholders. While this would provide a temporary boost to profitability, structural issues (such as the large cost base relative to business volume) would not be solved.
- Reducing costs to more closely match the bank's business volumes would provide a near-term boost to earnings. However, we are concerned that such a course of action would leave the business too thinly resourced to compete effectively against large Saudi banks, particularly if management proved unable to identify and then exploit a particular product niche or customer segment.

- Consolidation could potentially offer a more sustainable solution, as it would allow the business to simultaneously grow and cut costs. However, we believe some customer business could be lost as a result of disruption to the relationship or lack of affinity with the new business.

Figure 161 illustrates the level of cost cutting required (depending on different revenue loss assumptions) to bring Bank Albilad's current 2010 PE multiple into line with the sector. Based on our calculations, it appears that a minimum cost reduction of 75% (with no lost revenue) would be required.

Figure 161: PE 2010e multiples under potential revenue attrition and cost reduction scenarios

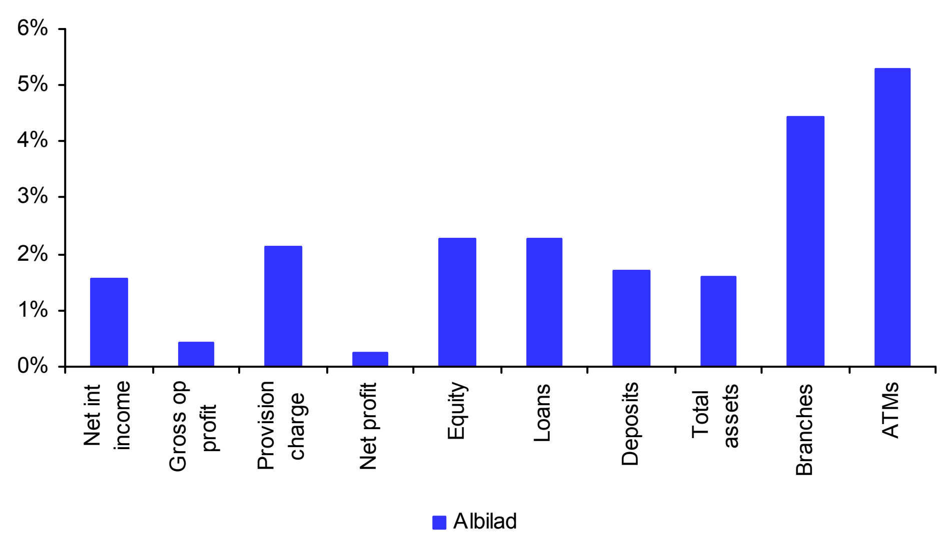
		Revenue attrition				
		0%	**5%**	**10%**	**15%**	**20%**
Cost reduction	**0%**	30.0	37.9	51.4	79.8	178.6
	15%	21.0	24.6	29.6	37.3	50.3
	30%	16.1	18.2	20.8	24.3	29.2
	45%	13.1	14.4	16.0	18.0	20.6
	60%	11.0	12.0	13.0	14.3	15.9
	75%	**9.5**	10.2	11.0	11.9	13.0
	100%	7.8	8.2	8.7	9.3	9.9

Source: Deutsche Bank

Business profile

In terms of business activity, Bank Albilad's market share currently stands at around 2% pa. However, the bank has a much higher share of distribution infrastructure; its cost base (relative to income generation) is consequently somewhat high and this is depressing its profitability relative to peers.

Figure 162: Bank Albilad's business market share lags behind that of its distribution infrastructure (FY07)

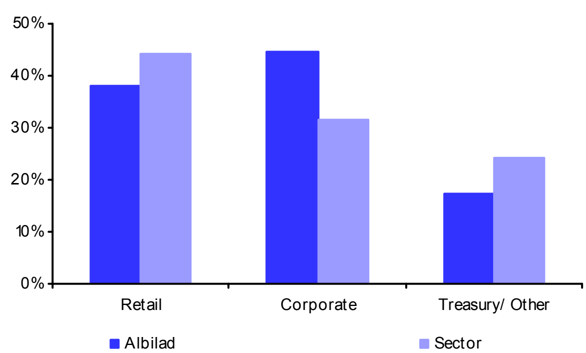


Source: Deutsche Bank, Company data, SAMA

Business mix

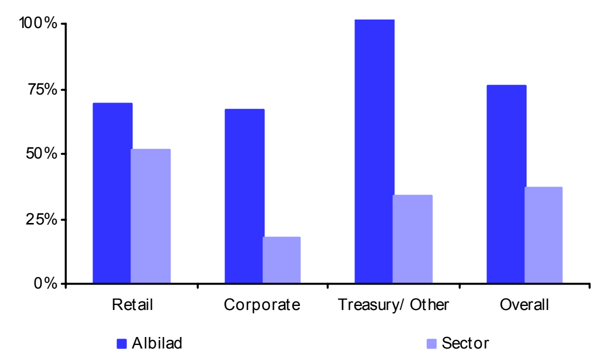
Albilad's business mix is skewed towards corporate banking, reflecting its limited branch distribution network and strong competition from Al Rajhi Bank, which both hamper its prospects in the retail banking business. In addition, with the business not yet mature, and physical infrastructure still underutilised, the bank's cost structures are much higher than those of peers.

Figure 163: Business mix (revenues, H1 08)



Source: Deutsche Bank, Company data

Figure 164: Cost-income ratios (H1 08)



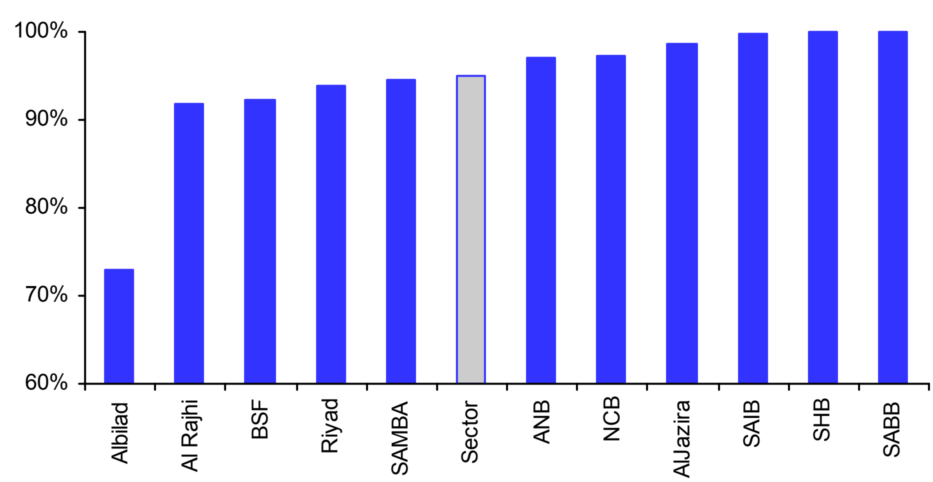
Source: Deutsche Bank, Company data

We believe the bank will need to significantly expand its business volumes (which could result in a deterioration in risk discipline) or restructure its cost base (which could impact staff morale and customer confidence) in order to lift profitability to sector average levels.

Geographic mix

Although investments and deposits are purely domestic in nature, Albilad's loan book is the most internationally exposed of the Saudi banks; a large segment of its customer lending is to non-Saudi GCC customers. Given the bank's limited international resources, these non-domestic exposures could potentially be subject to higher risk.

Figure 165: percentage of loans to domestic borrowers (FY07)



Source: Deutsche Bank, Company data

Competition

The key competitor for Albilad in the retail banking arena is Al Rajhi, as it is well-established as the key provider of Islamic banking products and has a much stronger brand and distribution network.

Accordingly, Bank Albilad tries to target large and mid-sized corporates rather then the retail market.

Key competitors of the Enjaz remittance business, which generates around one-sixth of the bank's revenues and profits, include SpeedCash (operated by Samba) and Tawil (operated by Al Rajhi Bank).

Distribution infrastructure

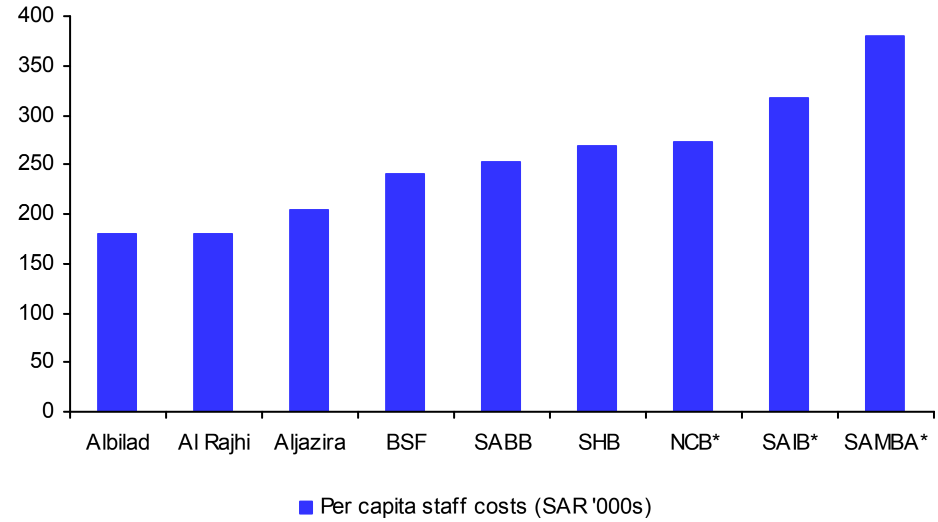
The bank has 60 branches and 84 Enjaz centres (for remittances) and 406 ATMs. Real estate infrastructure accounts for a relatively large proportion of the bank's balance sheet (close to 4%, four times larger than the sector average) and the bank's business market share is around half the level one might expect given the size of the bank's branch and ATM networks.

This excess of infrastructure is one reason why Albilad has one of the highest cost-income ratios in the sector. Premises and depreciation costs account for 30% of the bank's cost base, roughly double the sector average. We believe that as the franchise matures and business volume market shares rise to that of the bank's infrastructure, cost-income ratios will converge towards those of other sector participants. However, an expected slowdown in customer demand growth has likely delayed the timeframe in which this would occur, suggesting only steady rather than spectacular progress is possible over the next few years.

Another quirk of Albilad's cost structure relates to the bank's heavy dependence on operating leases as a means of financing its branch network. While this reliance on operating leases may offer cashflow advantages, from an income statement perspective we do not believe there is a significant effect (it effectively shifts costs from depreciation to premises costs).

One area where the bank does appear to have a cost advantage over peers relates to per capita staff costs, which are the lowest in the sector.

Figure 166: Per capita staff costs



*Source: Deutsche Bank, Company data. Data is FY 07 except *(FY 06)*

Risk profile

Credit risk

Looking at the sectoral breakdown of the customer investment portfolio indicates that Albilad has more exposure to corporate borrowers than the system average and that there is a significant skew towards the commerce sector.

Although the loan book has not had time to age, we do not believe the bank is taking excessive credit risks relative to other market participants. Nevertheless, we believe the bank may seek to record a relatively high loan provisioning charge in the income statement in order to build up its stock of provisions and to reflect an expected sector-wide deterioration in asset quality.

Operating risk

The formula used by the bank under Basel II equates to 15% of the last three years' revenues.

Market risk

The bank's treasury function invests largely in commodity Murabaha instruments (where other GCC banks are the counterparty) and also takes spot FX positions.

From a market risk perspective, the bank primarily takes currency positions in the spot market. The key driver of movements in the value of this portfolio is interest rate movements, which are largely influenced by developments of the US economy.

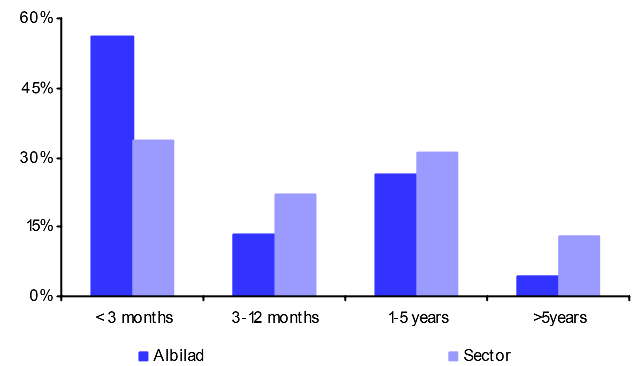
As an Islamic bank, Albilad has access to a much more limited suite of securities than conventional banks. For example, Albilad cannot conduct repo operations with other banks (including the central bank). In addition, the sukuk market is not well established and lacks liquidity. Within the bank's investment portfolio, the proportion of liquid assets is typically very low and largely confined to equities, which are of uncertain value.

Liquidity risk

As an institution that tries to adhere to Shariah concepts, Bank Albilad has access to a more limited suite of liquidity and risk management products than its conventional banking peers. On the asset side of the balance sheet, this manifests itself in the limited size of the bank's financial investment portfolio (3% of total assets at 9M08) and the skew of these assets towards real estate and commodities, rather than the fixed income instruments more commonly found on commercial banking balance sheets. As a relatively new entrant to the Saudi banking scene, the bank may also be more vulnerable to a loss of depositor confidence than more established (and larger) competitors.

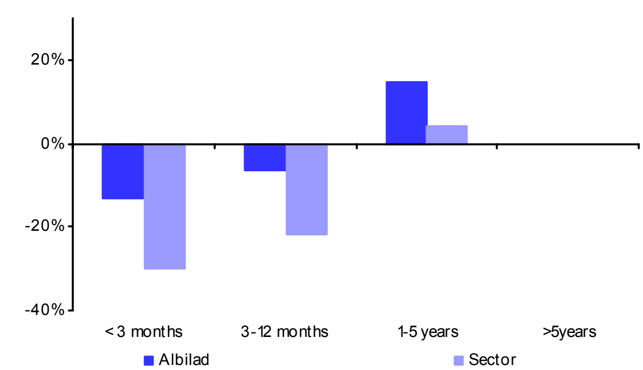
To offset these factors, Albilad holds a relatively high amount of cash (14% of total assets). The bank's customer loan portfolio is also heavily skewed towards shorter maturities. As a result, Albilad has a much less pronounced maturity mismatch profile than many of its peers:

Figure 167: Albilad's loans are skewed towards shorter maturities (FY07)…



Source: Deutsche Bank, company data. Chart depicts % loans with differing contractual maturity dates

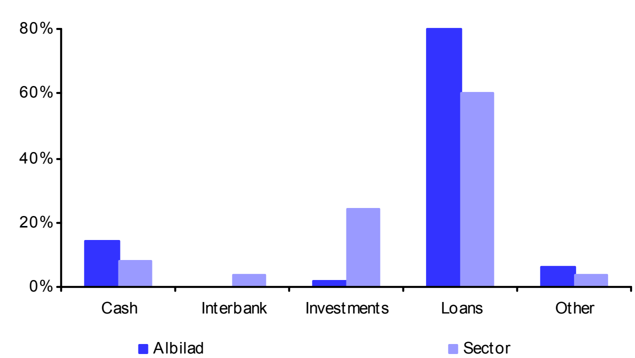
Figure 168: …meaning that Alibilad's asset-liability maturity mismatch is less pronounced than other Saudi banks (FY07, cumulative)



Source: Deutsche Bank, company data. Chart depicts cumulative asset-liability mismatch (as % assets)

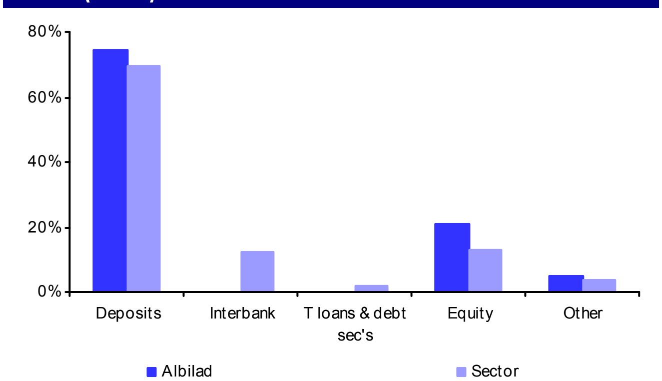
The bank is also extremely well-capitalised (equity/assets ratio of 21%) and has no wholesale debt funding commitments such as term loans or debt securities issuance.

Figure 169: Albilad's assets are skewed towards cash and customer investments (loans) (H108)



Source: Deutsche Bank, Company data

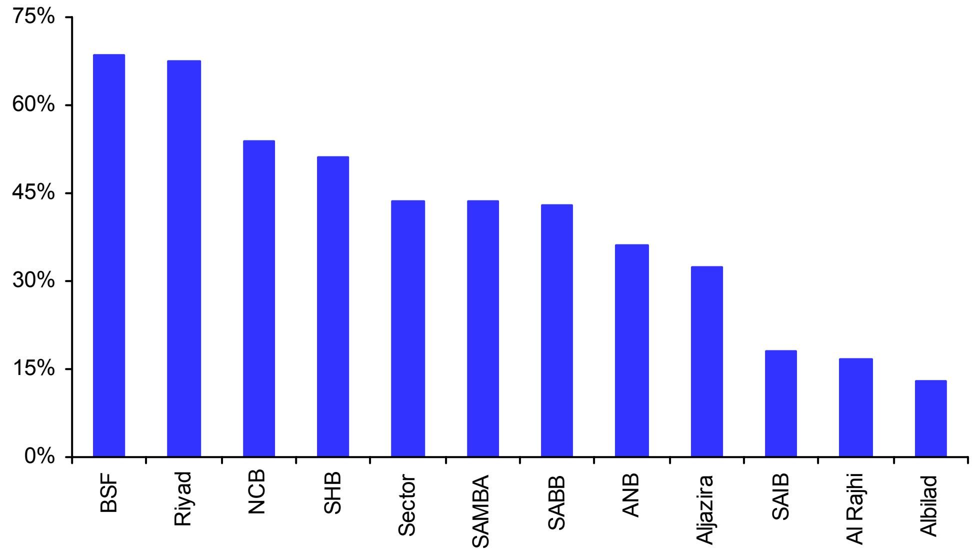
Figure 170: Albilad has negligible wholesale funding needs (H108)



Source: Deutsche Bank, Company data

The bank's prudent approach may also explain the its relatively low exposure to unfunded commitments relative to other banks in the sector. Albilad's commitments of SAR1639m (at 9M08) were equivalent to just 13% of its loan exposure versus the Saudi banking average of 44%.

Figure 171: Albilad has only a small portfolio of unfunded loan commitments

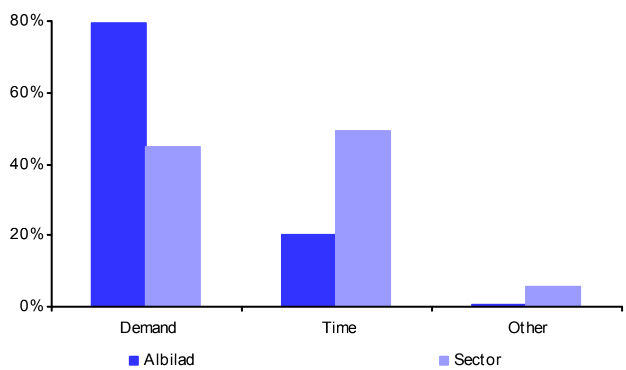


Source: Deutsche Bank, company data

Funding costs

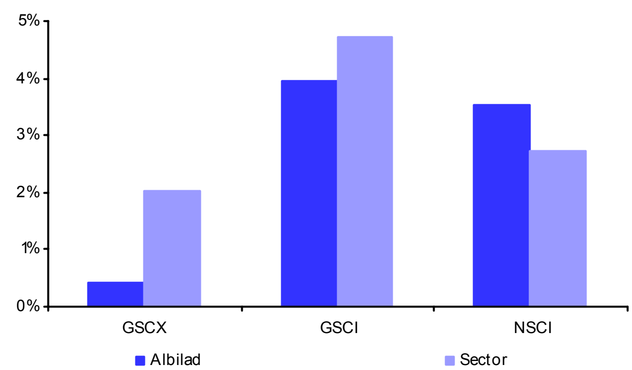
Albilad has extremely low funding costs, which reflect the high proportion of non-interest bearing demand deposits and the substantial free funding provided by the bank's strong equity base.

Figure 172: Albilad's deposit base consists mainly of interest-free funding



Source: Deutsche Bank, Company data

Figure 173: Albilad's lower funding costs allow the bank to record a high net special commission income margin (Q308 data)



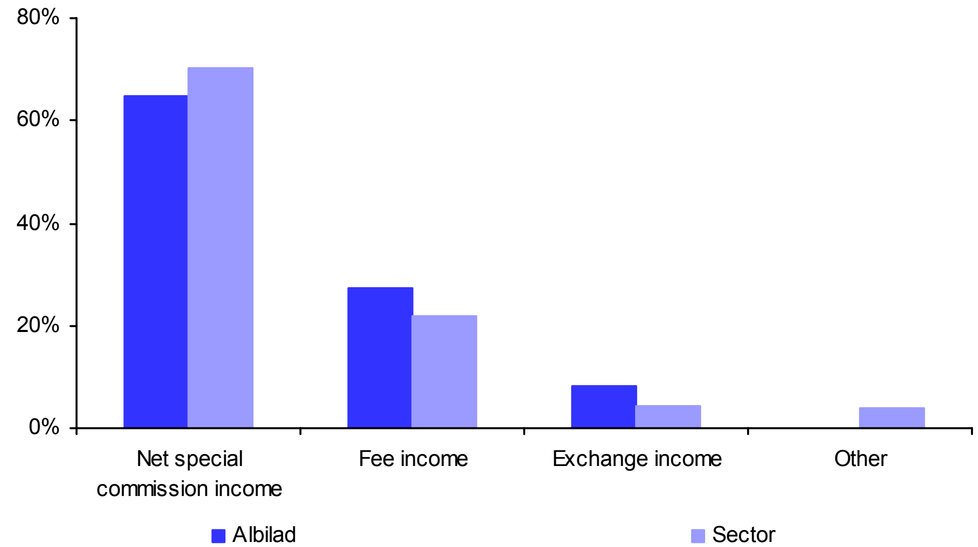
Source: Deutsche Bank, Company data

Revenue mix

Albilad's ability to generate net special commission income benefits from the bank's ability to attract low-cost funding (indeed, the cost of funds is currently even lower than for Al Rajhi Bank). This more than offsets the bank's relatively low yielding asset base (skewed towards corporate borrowers) to allow the bank to generate a superior net special commission income margin than most of its peers.

Reflecting Albilad's roots in the remittance business, exchange income is a much more important component of revenues than for other Saudi banks

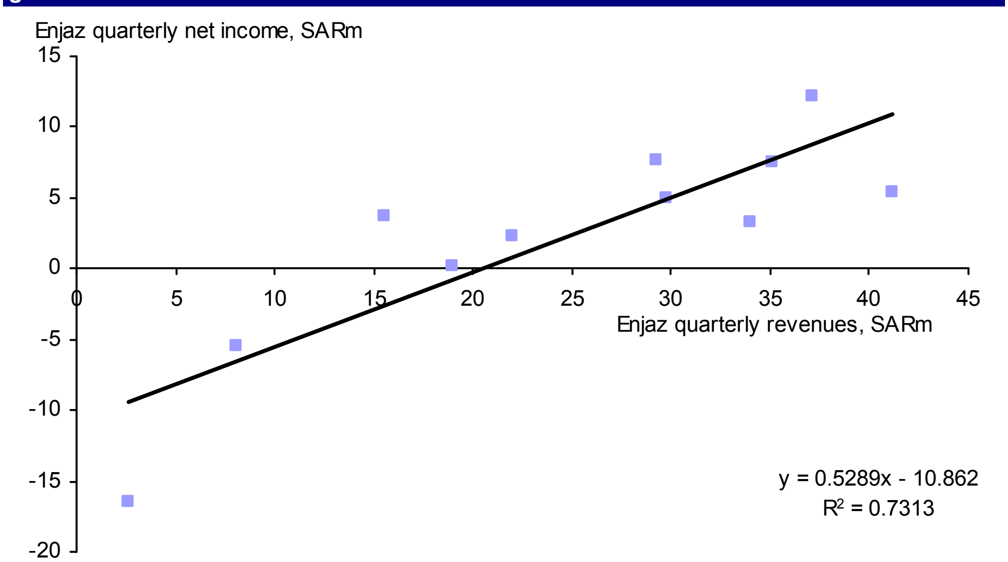
Figure 174: Albilad's revenue mix (H108) is more skewed towards fee and exchange income



Source: Deutsche Bank, Company data

Albilad's Enjaz remittance business generated around one-sixth of the bank's revenues and profits in 9M08. The business is performing well (growing revenues 45% 9M/9M), while improving economies of scale are leading to a sharp improvement in profitability:

Figure 175: Enjaz remittance business is experiencing improving profitability as it grows



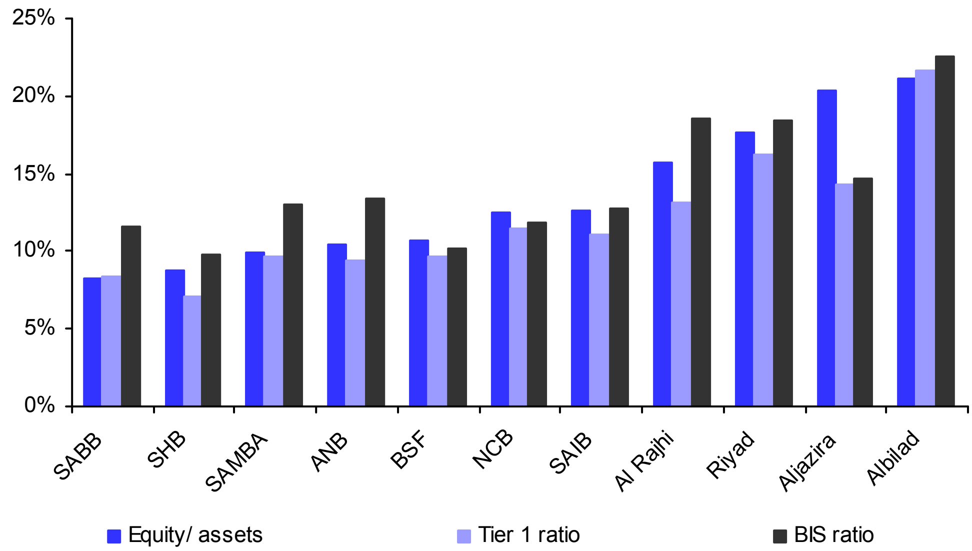
Source: Deutsche Bank, Company data

We believe Albilad's other areas of business would also benefit from scale economies.

Capital adequacy

At 21.1%, Bank Albilad has the highest tier 1 ratio in the sector (9M08 data). This high level of capitalization will be used by management to fund significant future growth of the business. However, the bank's equity cushion could also serve to offset liquidity risk issues that may arise from the bank's Shariah banking approach.

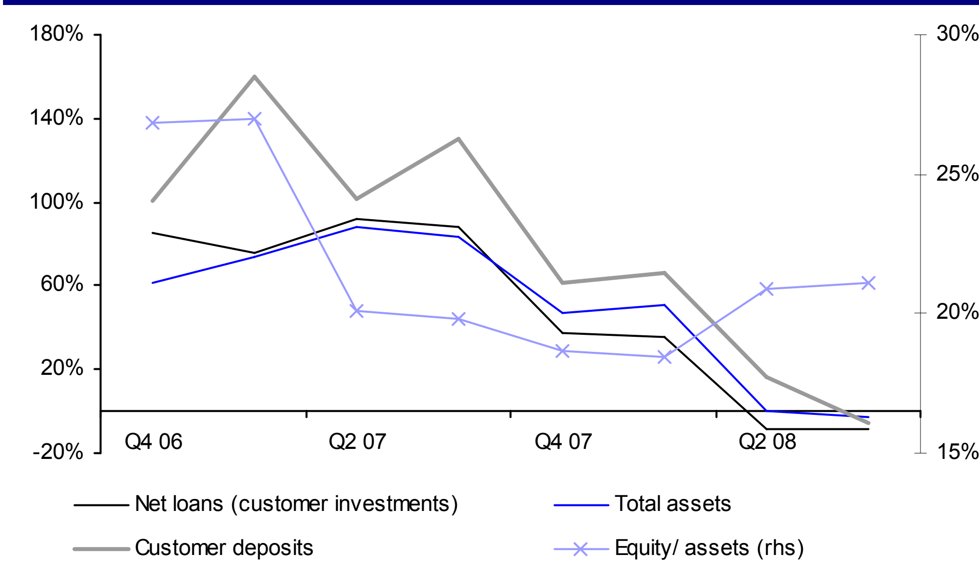
Figure 176: Bank Albilad is the best capitalised bank in the Saudi banking system



Source: Deutsche Bank, Company data

In the near term, however, investment in growth is likely to depress profitability. We also note that volume growth has slowed in recent quarters as the risk environment deteriorates. While the scale of the business remains small, we expect operating profitability to continue to lag the sector and for the bank's high capitalization level to further depress its return on equity.

Figure 177: Slower business volume growth means excess capital is no longer being consumed

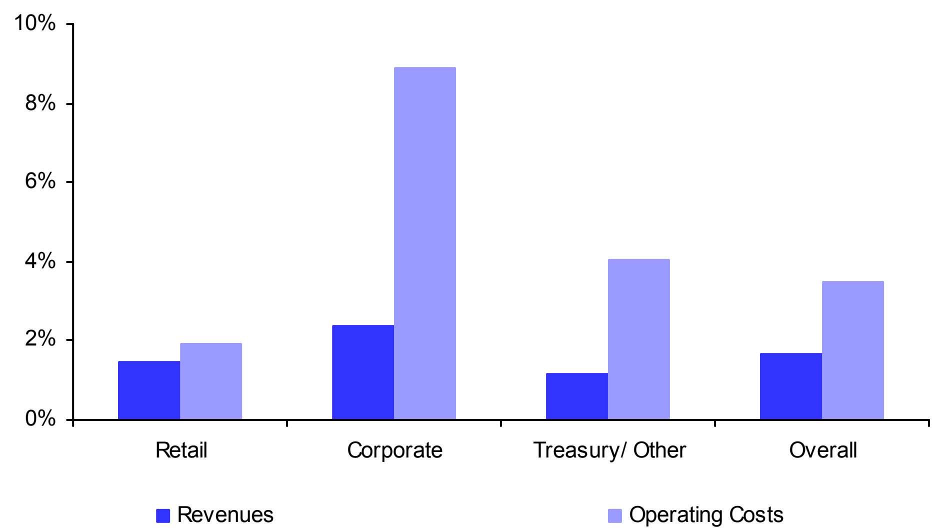


Source: Deutsche Bank, Company data

Cost efficiency

Bank Albilad's cost-income ratio at 9M 08 was 62%, an improvement on the 82% recorded in FY07, but still the highest in the sector by some margin. We have previously highlighted the mismatch between business volume and distribution infrastructure as one driver of these low margins. One could argue that as the business grows and matures, the efficiency of the business would improve. However, another key issue relates to Albilad's business mix. The bank is proving more successful at winning business in corporate banking and treasury than in retail banking; we believe scale is an important driver of value in both these business areas.

Figure 178: Albilad has a higher market share in businesses where it suffers from significant cost disadvantages (H108)



Source: Deutsche Bank, Company data

Ownership structure

Key shareholders include members of the Al Rajhi and Subeaei families. We believe the free float is close to 60%

Figure 179: Shareholder structure

Shareholder	Stake
Mohammed Ibrahim Mohammed Al Subeaei	11.9%
Abdullah Ibrahim Mohammed Al Subeaei	11.1%
Abdulrahman Saleh Abdulazziz Al Rajhi	6.9%
Abdulaziz Abdulrahman Saleh Al Rajhi	6.5%
Free float	57%

Source: Deutsche Bank, Tadawul, Zawya

Model updated:18 January 2009

Running the numbers

Middle East

Saudi Arabia

Banking

BANK ALJAZIRA

Reuters: 1020.SE Bloomberg: BJAZ AB

Sell

Price (20 Jan 09)	SAR 14.70
Target price	SAR 10.90
52-week Range	SAR 13.55 - 53.50
Market Cap (m)	SARm 4,410 USDm 1,176

Company Profile

Established in 1975, Bank Aljazira offers Sharia -compliant banking products to its largely domestic client base. The bank operates 24 branches in Saudi Arabia, and has recently expanded its ATM network to over 300. Historically, the bank has generated a significant proportion of its revenues from equity brokerage, but the revenue base is now more diversified. Aljazira is 40%-owned by core shareholders.

Rahul Shah
+971 4 4283-261 rahul.shah@db.com

Fiscal year end 31-Dec	2005	2006	2007	2008E	2009E	2010E
Data Per Share						
EPS (stated)(SAR)	2.91	6.58	2.68	1.27	1.01	0.97
EPS (DB) (SAR)	2.91	6.26	2.69	1.27	1.01	0.97
Growth Rate - EPS (DB) (%)	nm	114.9	-57.1	-52.9	-20.4	-3.8
DPS (SAR)	0.22	0.75	0.38	0.13	0.13	0.13
BVPS (stated) (SAR)	3.11	13.98	15.66	16.80	17.68	18.53
Tang. NAV p. sh. (SAR)	3.11	13.98	15.66	16.80	17.68	18.53
Market Capitalisation	23,851	14,738	14,738	4,410	4,410	4,410
Shares in issue	300	300	300	300	300	300
Valuation Ratios & Profitability Measures						
P/E (stated)	27.3	7.5	18.3	11.6	14.6	15.2
P/E (DB)	27.3	7.8	18.3	11.6	14.6	15.2
P/B (stated)	25.6	3.5	3.1	0.9	0.8	0.8
P/Tangible equity (DB)	25.6	3.5	3.1	0.9	0.8	0.8
ROE(stated)(%)	41.6	57.5	18.1	7.8	5.8	5.4
ROTE (tangible equity) (%)	93.8	73.3	18.1	7.8	5.8	5.4
ROIC (invested capital) (%)	41.6	54.7	18.1	7.8	5.8	5.4
Dividend yield(%)	0.5	0.8	0.9	0.9	0.9	0.9
Dividend cover(x)	13.2	8.8	7.2	10.1	8.1	7.8
Profit & Loss (SARm)						
Net interest revenue	276	477	595	650	680	705
Non interest income	1,042	2,134	851	560	504	520
Commissions	925	1,885	716	565	518	535
Trading Revenue	96	31	15	-25	-28	-30
Other revenue	22	219	120	20	14	15
Total revenue	1,319	2,610	1,446	1,210	1,184	1,225
Total Operating Costs	322	527	671	785	806	829
Employee Costs	169	297	365	430	445	455
Other costs	154	231	306	355	361	374
Pre-Provision profit/(loss)	996	2,083	775	437	378	396
Bad debt expense	119	16	-26	45	75	105
Operating Profit	878	2,067	801	380	303	291
Pre-tax associates	0	0	0	0	0	0
Pre-tax profit	878	2,067	801	380	303	291
Tax	0	0	0	0	0	0
Other post tax items	-3	-93	4	0	0	0
Stated net profit	874	1,974	805	380	303	291
Goodwill	0	0	0	0	0	0
Extraordinary & Other items	0	-95	1	0	0	0
Bad Debt Provisioning	0	0	0	0	0	0
Investment reval, cap gains / losses	0	0	0	0	0	0
DB adj. core earnings	874	1,879	806	380	303	291
Key Balance Sheet Items (SARm) & Capital Ratios						
Risk-weighted assets	10,497	10,225	14,411	33,487	36,385	39,605
Interest-earning assets	12,538	13,482	21,856	23,250	24,850	26,600
Customer Loans	6,911	6,271	13,229	15,000	16,500	18,000
Total Deposits	10,816	10,917	15,647	17,250	18,500	20,000
Stated Shareholder Equity	933	4,194	4,698	5,040	5,305	5,559
Equals: Tangible Equity	933	4,194	4,698	5,040	5,305	5,559
Tier 1 capital	2,670	4,099	4,691	5,040	5,305	5,559
Tier 1 ratio (%)	25	40	33	15	15	14
o/w core tier 1 capital ratio (%)	25.4	40.1	32.6	15.1	14.6	14.0
Credit Quality						
Gross NPLs/Total Loans(%)	2.90	3.29	1.51	2.50	3.79	5.28
Risk Provisions/NPLs(%)	177	173	161	95	66	53
Bad debt / Avg loans (%)	na	0.24	-0.27	0.32	0.48	0.61
Bad debt/Pre-Provision Profit(%)	11.9	0.8	-3.3	10.3	19.9	26.5
Growth Rates & Key Ratios						
Growth in revenues (%)	nm	98	-45	-16	-2	4
Growth in costs (%)	na	63	27	17	3	3
Growth in bad debts (%)	nm	-86	-261	-274	67	40
Growth in RWA (%)	nm	-3	41	132	9	9
Net int. margin (%)	2.47	3.66	3.37	2.88	2.83	2.74
Cap.-market rev. / Total revs (%)	nm	nm	nm	nm	nm	nm
Total loans / Total deposits (%)	64	57	85	87	89	90
ROTE Decomposition						
Revenue % ARWAs	14.94	25.19	11.74	5.05	3.39	3.22
Net interest revenue % ARWA	3.13	4.60	4.83	2.71	1.95	1.86
Non interest revenue % ARWA	11.81	20.59	6.91	2.34	1.44	1.37
Costs/income ratio (%)	24.4	20.2	46.4	63.9	68.1	67.7
Bad debts % ARWAs	1.35	0.16	-0.21	0.19	0.21	0.28
Tax rate (%)	0.0	0.0	0.0	0.0	0.0	0.0
Adj. Attr. earnings % ARWA	9.91	18.14	6.54	1.59	0.87	0.77
Capital leverage (ARWA/Equity)	9.5	4.0	2.8	4.9	6.8	7.0
ROTE (Adj. earnings/Ave. equity)	93.8	73.3	18.1	7.8	5.8	5.4

Source: Company data, Deutsche Bank estimates

Bank Aljazira

Looking for the next big thing

Outlook

Bank Aljazira's revenue development is likely to be negatively impacted by sustained low interest rates, which should squeeze the net special commission income margin, and further expected declines in equity brokerage revenues. We believe Aljazira is the most exposed of the Saudi banks to these negative trends. Accordingly, we see the bank posting broadly flat revenues until 2010. Although costs are likely to be better controlled than in the past, much higher credit risk costs should drive sharp earnings declines in the coming years. We believe the return on equity is likely to remain in the single digits.

We believe Bank Aljazira is unfavourably positioned for the current environment. From a business mix perspective, the bank remains heavily exposed to equity brokerage – a revenue stream that we see continuing to decline. The bank's net special commission income is also among the most sensitive to declining interest rates. While management has been trying to offset these negatives by rapidly growing the balance sheet, we believe some of this business is being attracted on price, further lowering margins. Larger business volumes also potentially increase the risk profile of the business. We believe the bank's high cost base is a legacy of earlier good times (Aljazira was extremely profitable during the equity market boom in the middle part of the decade), but that aggressive downsizing is not a viable long-term strategy as it would result in the business being too small to be viable.

From a book value perspective, Bank Aljazira currently trades below par and at a significant discount to the sector. However, we believe this discount should be larger, reflecting negative earnings momentum and the low earnings power of the franchise. We have a Sell rating on the shares.

Valuation

We value the shares on a target price book multiple basis, using 2010 as our benchmark year and discounting back by the cost of equity. We assume a risk free rate of 5.0%, an equity risk premium of 7.0% and a beta to the market of 1.06 (based on historical price performance). As with other banks in the sector, we do not apply a long-term growth adjustment to our cost of capital calculation.

Our target price calculation also gives credit to Bank Aljazira for its strong capital base and its relatively low exposure to market and credit risks.

Figure 180: Bank Aljazira target price calculation

	Share Price	2010 ROE	Cost of equity	Fair P/book ratio	2010 NAV	PV Dividends			Capital Adjustment	Qualitative Adjustment	12-month	Upside/ (Down side)	Investment Rating
	SAR					2008E	2009E	2010E	SAR		Target Price		
Bank Aljazira	14.60	5.4%	12.4%	43%	18.5	0.11	0.09	0.08	1.6	10%	10.9	-25%	Sell
Sector Median		18.5%	11.3%	164%						0%		2.7%	

Source: Deutsche Bank, Zawya. Share prices as of market close, 17 January 2009

The bank's shares trade at a discount to the sector on a PB basis, but at a premium in terms of PE multiple and dividend yield.

Figure 181: Bank Aljazira target price calculation

	Share Price	P/E				P/book				DY			
		2007A	2008E	2009E	2010E	2007A	2008E	2009E	2010E	2007A	2008E	2009E	2010E
Bank Aljazira	14.60	5.4	11.5	14.5	15.1	0.93	0.87	0.83	0.79	2.6%	0.9%	0.9%	0.9%
Sector Median		9.5	10.2	9.5	9.2	2.30	2.02	1.80	1.62	2.9%	4.1%	4.1%	4.5%

Source: Deutsche Bank. Zawya. Table prices as of market close, 15 January 2009

Risks to our view

Bank Aljazira is one of the most geared plays to the equity market in the Saudi banking sector, both in terms of revenue generation and risk (equities form a large segment of the bank's investment portfolio). The bank would therefore be a key beneficiary of any sustained upturn in stock market values and trading activity. However, we believe a sustained rise in stock market levels would be required to encourage significant numbers of retail investors to resume equity trading.

The bank would also benefit from a rise in interest rates, which would boost net special commission income. Such a scenario would likely be associated with an improvement in the global economy, and stronger banking volume growth trends.

The bank appears to have significant scope to reduce costs or to re-allocate resources more effectively. However, we believe the former course of action could leave the business in a sub-scale state, while the latter would require current rapid rates of growth to be sustained, which could result in margin compression (due to price competition) and risk accumulation (from adverse selection risks). Rapid growth is likely to become increasingly difficult as industry volume trends deteriorate over the coming quarters.

Successful repositioning of the business. Historically, Bank Aljazira has had a strong (and very profitable) retail equity brokerage franchise. With this business continuing to decline, we believe management will need to find another niche for the bank. We note that a branch refurbishment programme is currently underway and believe other initiatives are also likely to be announced periodically.

Liquidity position is strong. Partly as a result of its strong equity capital base, Bank Aljazira has one of the most favourably structured balance sheets from a liquidity perspective. If an environment of heightened liquidity concerns were to arise, we believe this could support investor sentiment towards the Aljazira shares.

Key themes

NSCI sensitive to low interest rates

Historically, Bank Aljazira's net special commission income margin has been extremely sensitive to prevailing interest rates. With the impact of recent interest rates cuts still to be fully reflected, we believe Aljazira is likely to suffer most from margin compression in the coming quarters.

Fee income skewed towards declining brokerage income

Bank Aljazira's revenue stream is the most exposed in the sector to equity brokerage revenue. While this positioning proved extremely lucrative in the middle years of this decade, we see significant further revenue declines taking place in this revenue generator in 2009.

Cost base high relative to distribution infrastructure

Bank Aljazira has the highest cost-per-branch ratio in the sector. We believe this is partly a legacy of the extremely high profits generated by the company in prior years, which may have resulted in a relaxation of cost discipline. However, the small size of the business is also a contributory factor, in our view.

Business is at a strategic cross-road: revenues

An obvious way to improve shareholder returns, at least in the short term, would be for the bank to aggressively downsize its cost-base. The problem with this approach, in our view, is that without repositioning the business, it would simply be too small and would therefore prove unable to compete with larger and better resourced competitors.

Business is at a strategic crossroad: efficiency

Recent high levels of activity suggest that the business is trying to grow its way to better efficiency (spreading the costs across a broader business). While this is probably a more viable long-term strategy, we believe the deteriorating macroeconomic environment will make such a strategy hard to sustain, even for a relatively small operator like Aljazira.

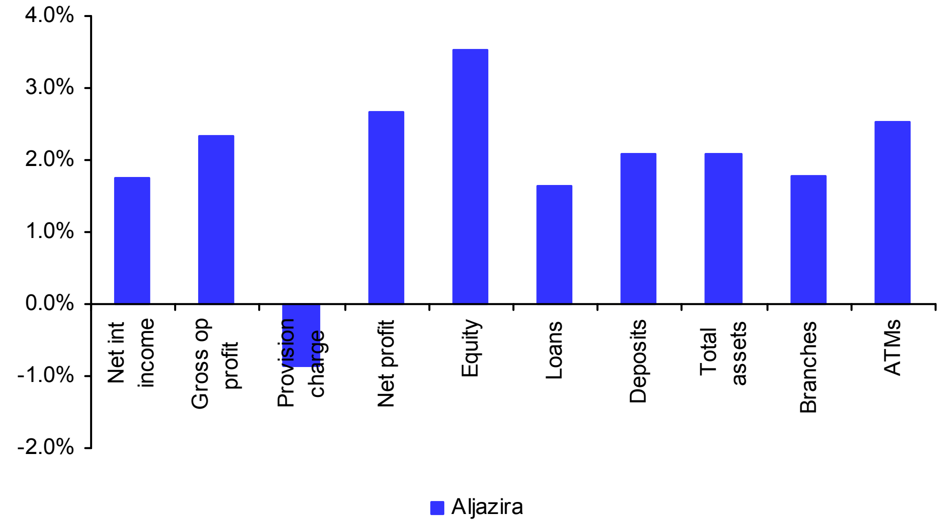
Business is at a strategic crossroad: niche business

We believe the key to the bank's success will be the ability of management to find a new niche for the business to exploit. While we hold the management team in high regard, we believe the success of any repositioning is extremely uncertain and is not something we have reflected in our valuation of the business at this stage

Business profile

Bank Aljazira has a market share of around 2%. It is considerably better capitalised than most of its peers with an equity/assets ratio of 20.4%, compared with a sector average of 12.5%.

Figure 182: Bank Aljazira market share



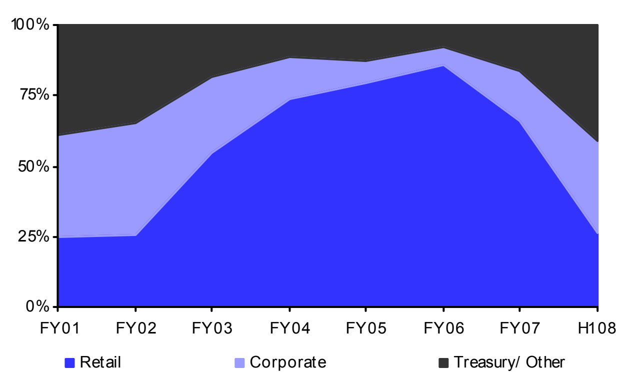
Source: Deutsche Bank, Company data, SAMA

Business mix

The collapse in brokerage revenues has had a profound impact on the profitability mix of the business. Retail banking, which generated over 80% of revenue and net income for the business in 2006, is now the smallest contributor to the business.

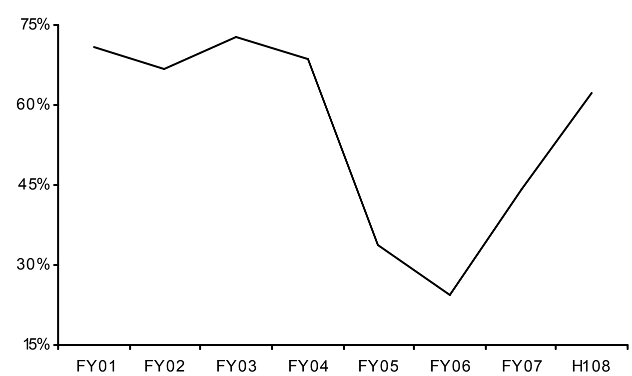
The weakness in retail banking revenues has lifted the group's cost-income ratio back to levels experienced in the first half of the decade.

Figure 183: Revenue breakdown by business unit



Source: Deutsche Bank, Company data

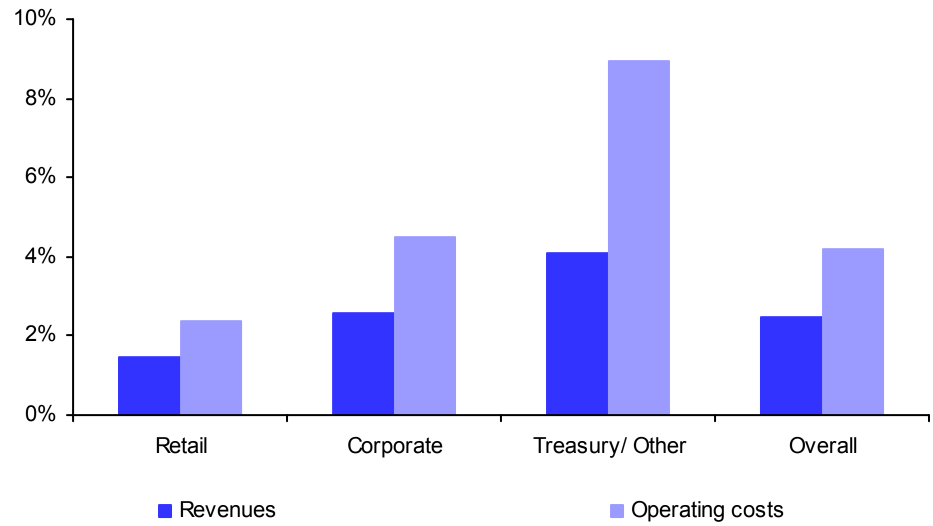
Figure 184: Aljazira cost-income ratio



Source: Deutsche Bank, Company data

With treasury operations now generating a significant proportion of group earnings (40%, versus a sector average of 25%), one could also argue that the quality of earnings has deteriorated relative to peers. This is particularly the case since Aljazira's cost efficiency in this area lags that of its competitors. We believe the treasury business is subject to scale economies and that Bank Aljazira is too small to be fully competitive in this area.

Figure 185: Revenue and operating cost market shares by division: Aljazira's market share is highest in treasury, where its cost disadvantage is greatest (H108)

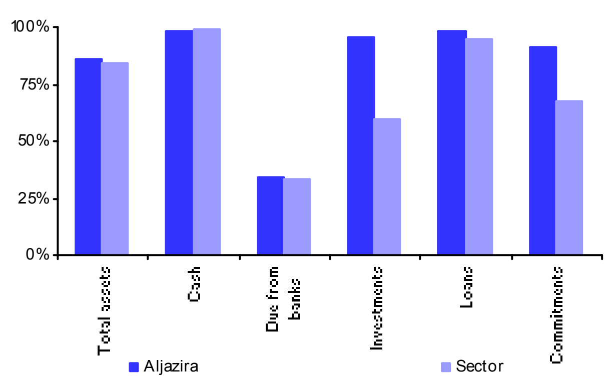


Source: Deutsche Bank, Company data

Geographic mix

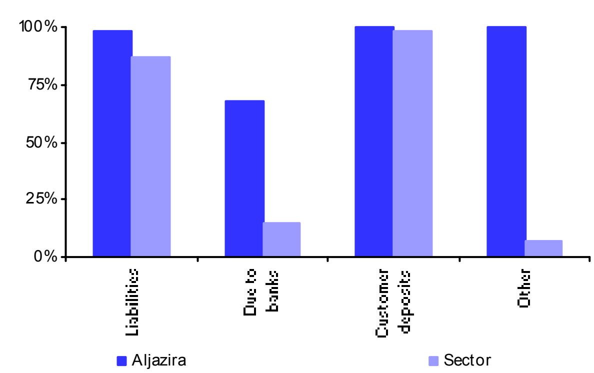
Like the other Saudi banks, Bank Aljazira is overwhelmingly focused on the domestic market. This is particularly apparent in the case of its investment portfolio and its interbank funding. (Other banks have a more internationally diversified portfolio for both of these balance sheet categories.) Aljazira's off-balance sheet commitments are also much more geared to the domestic market than the sector average.

Figure 186: Geographic mix – assets



Source: Deutsche Bank, Company data

Figure 187: Geographic mix – liabilities



Source: Deutsche Bank, Company data

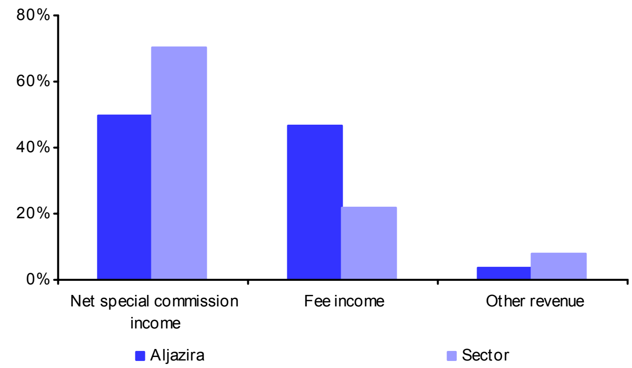
Revenues

Although Aljazira's strong equity brokerage franchise has suffered in line with market trends in recent years, the bank remains more heavily exposed to fee income than its peers.

Figure 188: Bank Aljazira: fees as % of total revenues

Source: Deutsche Bank, Company data

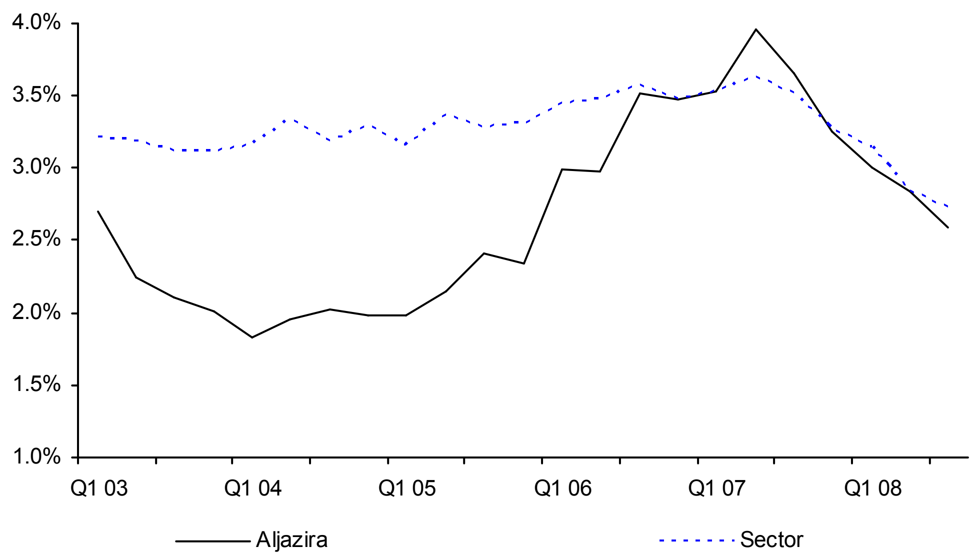
Figure 189: Revenue mix (H108)



Source: Deutsche Bank

While Aljazira is experiencing rapid credit (+70%) and deposit (+50%) growth, we are concerned that these volumes are not translating into sharper revenue growth; 9M08 net special commission income was just 11% higher than in 9M07, indicating a substantial compression in margins over the past year (since Q207 Aljazira's margin has declined by 140bps, versus a 90bps decline for the sector).

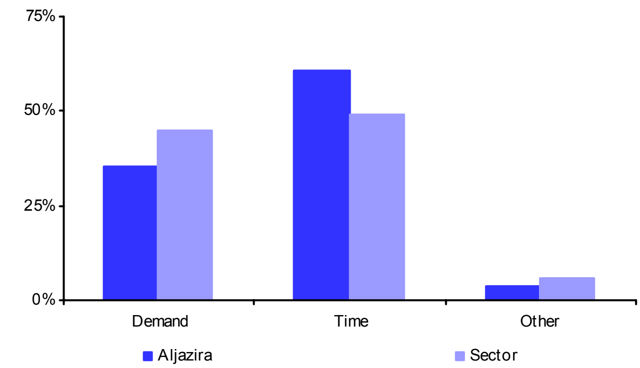
Figure 190: Net special commission income margin – Aljazira and Saudi banks sector



Source: Deutsche Bank, Company data

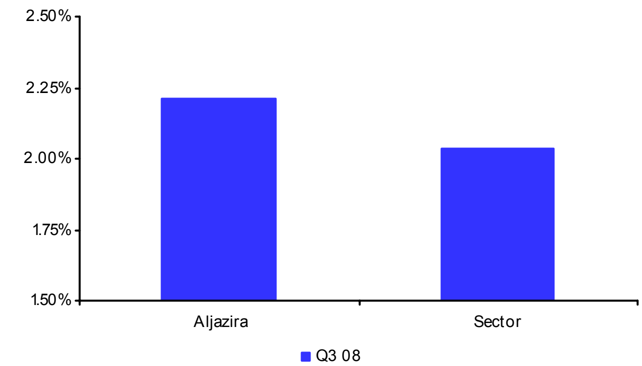
Although mix and lag effects may explain some of this discrepancy, it appears to us that the bank is competing on price in order to attract new business. For example, on the funding side, the proportion of non-interest bearing deposits has declined sharply in recent years. Unlike Al Rajhi Bank and Bank Albilad, it appears that Aljazira has not been able to leverage its Shariah-compliant status to attract low-cost deposits. The bank's funding costs are actually above the sector average.

Figure 191: Deposit mix (FY07)



Source: Deutsche Bank, Company data

Figure 192: Gross special commission expense comparison (Q308)

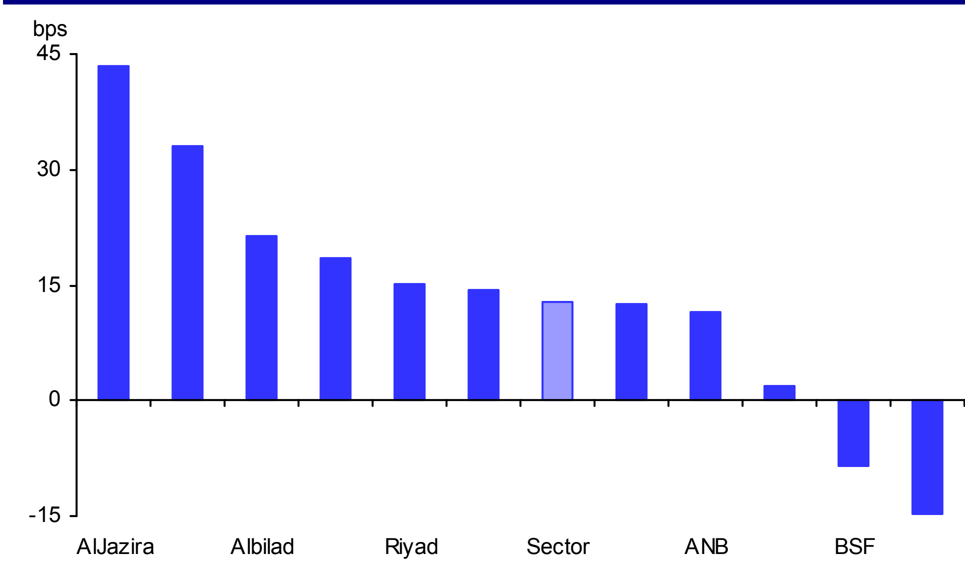


Source: Deutsche Bank, Company data

A more serious risk would arise if the bank were also relaxing credit standards to fuel loan book expansion. We have no evidence to suggest that this is occurring.

An additional negative factor concerning the net special income outlook concerns the likely interest rate environment. Historically, Aljazira's margin has been one of the most positively correlated to interest rates, suggesting sustained low interest rates will be a negative driver in the future.

Figure 193: Change in net special commission income margin for each 100bps change in interest rates (historical experience)



Source: Deutsche Bank, Company data

Within Saudi Arabia, Aljazira is the bank that depends most on fees as a source of revenue. The bank's fees are also the most exposed to equity brokerage, a revenue pool which we believe will continue to decline in 2009. We believe Aljazira's fee income will experience a sizeable decline in 2009.

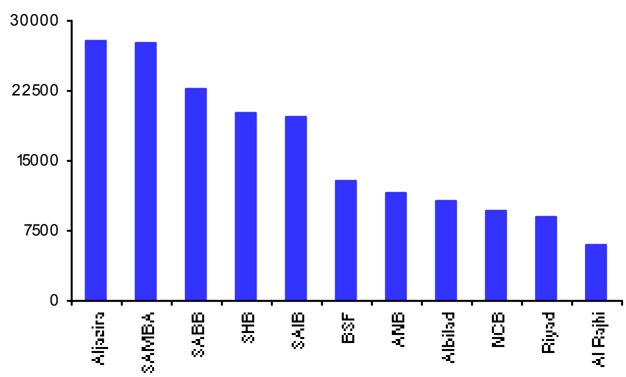
Operating costs

The sharp decline in brokerage fees has driven a much more rapid deterioration in Aljazira's cost-income ratio relative to that of other Saudi banks. We believe management is currently targeting a ceiling of 50% for this ratio, compared with the 9M08 figure of 63%.

The bank may not be able to match its peers for cost-efficiency as a result of its smaller size. We believe a sizeable part of the cost base is fixed (for example, the level of IT expenditure). We note that the bank needs to maintain investment in its IT infrastructure in order to support its leadership of the equity brokerage business and also to effectively manage the risk of its own equity exposures.

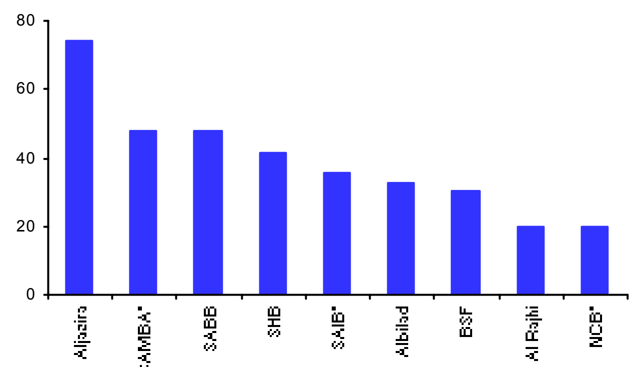
We believe the bank's cost structures are excessive relative to its distribution capacity. For example, Aljazira has the highest staff-per-branch ratio in the sector. Similarly, it has the highest operating cost-per-branch ratio in the sector – even higher than corporate and investment banking-focused entities. We believe the bank will need to spread its fixed costs across a much larger business if it is to compete effectively against the competition. This may explain the growth spurt that the company has embarked upon in recent quarters. Unfortunately, given the likelihood of an economic slowdown, rapid expansion of the business may have resulted in excessive risk being taken on, resulting in increased future impairment charges. Moreover, we believe high growth in business activity is unlikely to be sustained.

Figure 194: Operating costs per branch (SAR '000s)



Source: Deutsche Bank, Company data

Figure 195: Staff per branch (FY07)



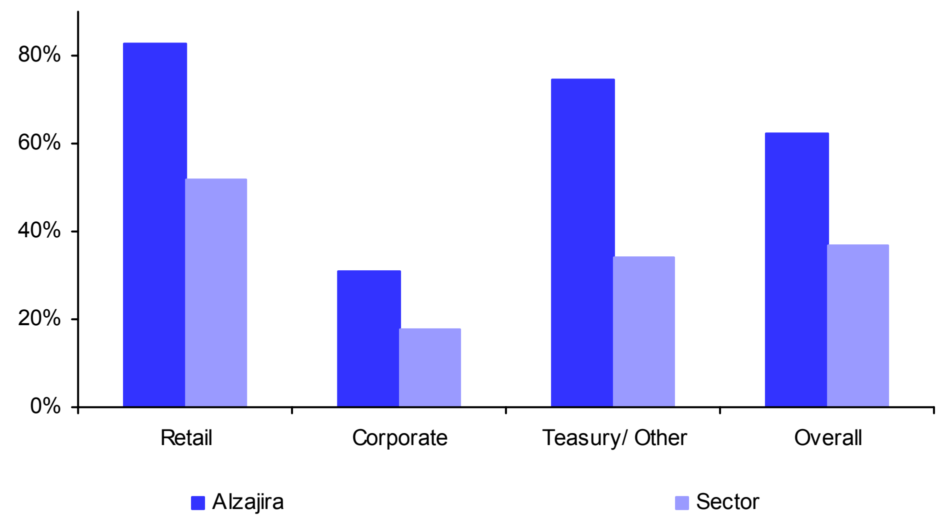
*Source: Deutsche Bank, Company data *=2006 data*

One positive driver to the bank's efficiency ratios could come from improved performance of the branches. We believe a number of branches are still not profitable. A branch refurbishment and rebranding process is currently underway and this repositioning could serve to benefit underperforming branches.

In addition, we note that the bank has expanded its ATM network by around 50% over the past year, an investment which explains much of the current 21% run-rate for cost growth.

The bank's cost efficiency problem is most apparent in the retail banking division, where the cost-income ratio exceeds 80%. However, relative to the competition one could argue that the other parts of the business have even greater efficiency issues; the cost-income ratio in the corporate banking and treasury businesses is around twice the sector average.

Figure 196: Cost-income ratio by division (H108)



Source: Deutsche Bank, Company data

Risk

Credit risk

As part of its revenue diversification strategy, the bank has been rapidly increasing the size of its loan book, particularly in the corporate loan segment. Around one-quarter of all loans are to manufacturing companies.

We believe a significant part of the retail loan book is being used to finance shares. This element of the loan portfolio is monitored very actively by the bank's own internal risk managers and by SAMA. The bank ensures that the value of the underlying collateral (shares) remains above its own exposure to the customer; where trigger levels are breached, forced liquidation of the shares takes place. Positions are monitored on a daily basis.

A key potential risk, in our view, relates to recent press comments indicating that SAMA has asked banks not to undertake forced liquidation of equity collateral, as this was viewed to be having a negative impact on stock market index levels. If such reports were confirmed, this would in our view significantly increase the risk profile of such loans.

We further note that the bank's provisions coverage ratios appear less conservative than other Saudi banks. This is particularly concerning given the rapid recent growth in the loan book, which could result in higher non-performing loans developing in the future.

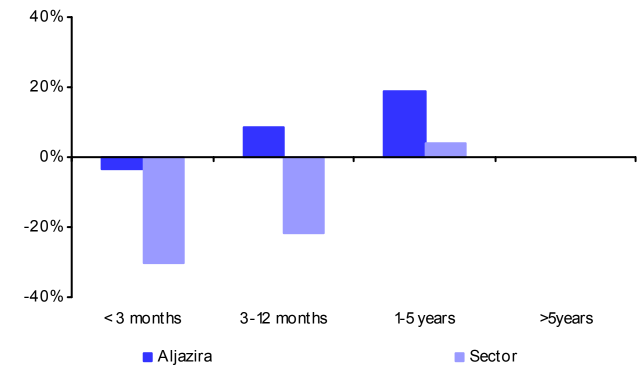
Bank Aljazira's loan quality statistics do not appear too different from those of other sector participants. However, there is a difference in trend; most other banks saw an improvement in asset quality during 2007. In contrast, Bank Aljazira experienced an increase in the volume of past due but not impaired loans.

Liquidity risk

Bank Aljazira has a relatively conservative balance sheet profile from a liquidity perspective. Indeed, the position has likely improved, as the customer loan portfolio is increasingly being funded by longer maturity time deposits.

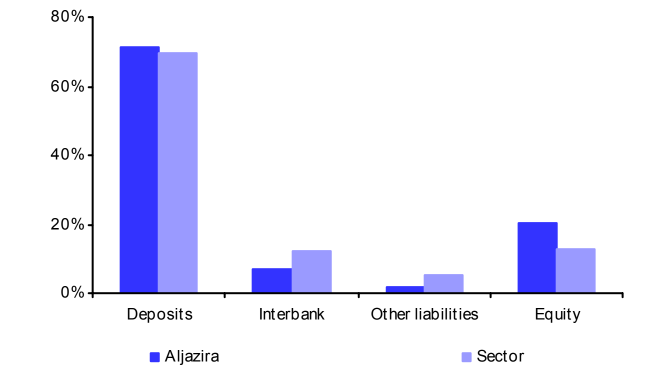
In addition, the bank has a relatively conservative funding profile, consisting of deposits (accounting for around 70% of total assets) and shareholders' equity (20% of total assets), suggesting limited direct implications from the credit crunch.

Figure 197: Asset-liability mismatch by contractual maturity (FY07)



Source: Deutsche Bank, Company data

Figure 198: Liability mix (H108)



Source: Deutsche Bank, Company data

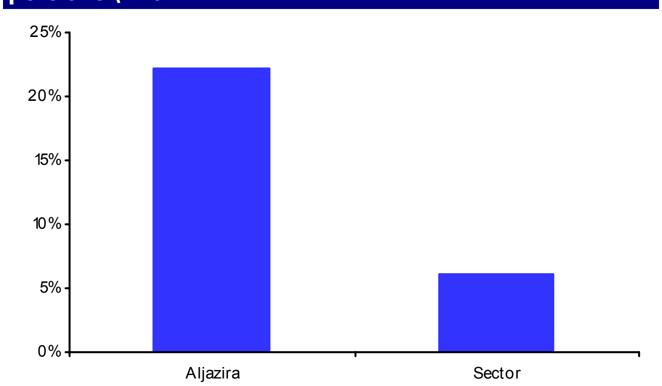
In conjunction with the bank's rapid expansion in loans, off-balance sheet commitments have also risen (up 90% during 9M08). Although the absolute level of commitments appears modest, we are concerned that any attempt by the bank to tighten its credit criteria could result in these unfunded commitments being drawn.

Bank Aljazira does not currently have any exposure to derivatives products. However, we understand the issue is being reviewed by the Shariah Board in order to determine whether certain instruments could be permissible.

Market risk

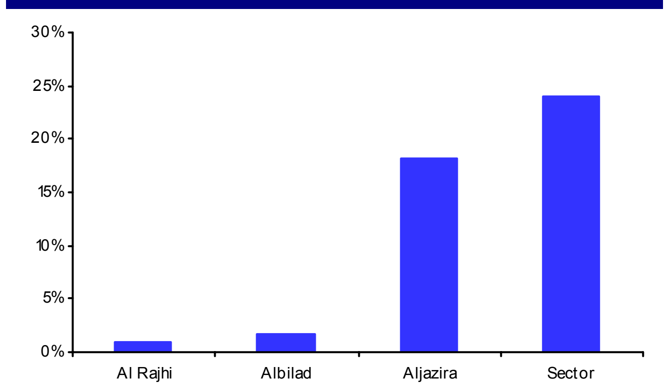
With the bank's Shariah principles limiting the type of instruments the bank can invest in, Aljazira's investment portfolio is much more skewed towards equities than any of its peers. Moreover, unlike its Islamic banking peers Al Rajhi Bank and Bank Albilad, Aljazira's investment portfolio is quite large in relation to its balance sheet. Together with the bank's still high level of brokerage fee income, we believe this investment profile further increases the exposure of the business to equity market performance.

Figure 199: Proportion of equities within investment portfolio (FY07



Source: Deutsche Bank

Figure 200: Investment portfolio/assets ratio (H108)

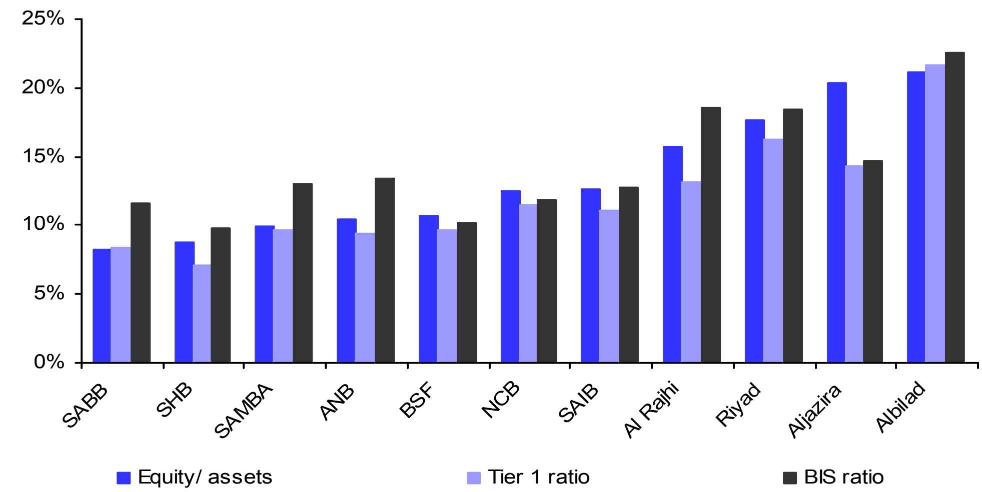


Source: Deutsche Bank, Company data

Capital base

Aljazira appears to be well-capitalised currently. As at 9M08, the bank's equity/assets ratio stands at 20.4% and the tier 1 ratio at 14.3%. Although management has significant growth plans for the business, it has indicated that no additional capital increase is planned. We expect the dividend payout ratio to remain low, however, as the bank seeks to prioritise business growth over income distribution.

Figure 201: Saudi bank capital ratios



Source: Deutsche Bank, Company data

Ownership and background

The National Bank of Pakistan has been a shareholder in the bank since 1975, at which time it had a 35% stake and took management control. Since then its stake has been steadily reduced as Aljazira has raised additional capital.

The bank remains one of the smaller banks within the sector. In the past it had identified share brokerage as an area where the bank could differentiate itself from its peers. Revenues from this activity increased markedly during the first half of the decade, such that at one stage 65% of the bank's profits were coming from this activity. Since 2006, revenues from this activity have declined markedly.

Aljazira became a fully-fledged Islamic banking entity in mid-2006. However, it has yet to attract significant volumes of interest-free deposits, perhaps reflecting the highly competitive nature of this business and the difficulty of changing customer perceptions towards the bank.

The main shareholder currently is Rashid Abdul Rahman Al Rashid & Sons, the diversified Saudi conglomerate which also owns stakes in Arab National Bank and Banque Saudi Fransi. We believe the free float is close to 60%.

Figure 202: Shareholder structure

Shareholder	Stake
Rashid Abdul Rahman Al Rashid & Sons	22.2%
Union Brothers for Development	6.5%
National Bank of Pakistan	5.8%
Mohammed Saleh Abddullah Kamel	5.0%
Free float	60.5%

Source: Deutsche Bank, Tadawul, Zawya

Model updated:18 January 2009

Running the numbers

Middle East

Saudi Arabia

Banking

Banque Saudi Fransi

Reuters: 1050.SE Bloomberg: BSFR AB

Hold

Price (20 Jan 09)	SAR 49.50
Target price	SAR 52.30
52-week Range	SAR 40.10 - 97.50
Market Cap (m)	SARm 27,844 USDm 7,424

Company Profile

Established in 1977, Banque Saudi Fransi is a full-service commercial bank. Reflecting its skew towards corporate and institutional customers, the bank has a higher business market share (around 10%) than suggested by its network of around 75 branches and 270 ATMs. Key shareholders include Credit Agricole, which has a 31% stake and management control, the government (13% holding) and other core shareholders (15%).

Fiscal year end 31-Dec	2005	2006	2007	2008E	2009E	2010E
Data Per Share						
EPS (stated)(SAR)	3.94	5.35	4.82	5.04	5.27	5.36
EPS (DB) (SAR)	3.94	5.35	4.82	5.04	5.27	5.36
Growth Rate - EPS (DB) (%)	nm	35.7	-9.8	4.5	4.6	1.7
DPS (SAR)	0.40	1.33	1.75	2.00	2.10	2.20
BVPS (stated) (SAR)	9.67	16.72	19.98	23.02	26.19	29.35
Tang. NAV p. sh. (SAR)	9.67	16.72	19.98	23.02	26.19	29.35
Market Capitalisation	65,239	46,575	65,109	27,844	27,844	27,844
Shares in issue	563	563	563	563	563	563
Valuation Ratios & Profitability Measures						
P/E (stated)	29.4	15.5	24.0	9.8	9.4	9.2
P/E (DB)	29.4	15.5	24.0	9.8	9.4	9.2
P/B (stated)	12.0	5.0	5.8	2.2	1.9	1.7
P/Tangible equity (DB)	12.0	5.0	5.8	2.2	1.9	1.7
ROE(stated)(%)	33.4	36.3	26.3	23.4	21.4	19.3
ROTE (tangible equity) (%)	40.7	40.5	26.3	23.4	21.4	19.3
ROIC (invested capital) (%)	33.4	36.2	26.3	23.4	21.4	19.3
Dividend yield(%)	0.4	1.4	2.4	4.0	4.2	4.4
Dividend cover(x)	9.8	4.0	2.8	2.5	2.5	2.4
Profit & Loss (SARm)						
Net interest revenue	1,706	2,017	2,296	2,650	2,850	3,025
Non interest income	1,388	1,922	1,405	1,562	1,662	1,742
Commissions	1,254	1,716	1,085	1,100	1,135	1,215
Trading Revenue	110	189	311	525	525	525
Other revenue	24	16	9	-63	2	2
Total revenue	3,094	3,939	3,701	4,212	4,512	4,767
Total Operating Costs	743	841	948	1,130	1,150	1,205
Employee Costs	395	463	543	625	670	700
Other costs	348	378	405	505	480	505
Pre-Provision profit/(loss)	2,351	3,098	2,753	3,142	3,362	3,562
Bad debt expense	135	90	42	250	400	550
Operating Profit	2,216	3,007	2,711	2,832	2,962	3,012
Pre-tax associates	0	0	0	2	2	2
Pre-tax profit	2,216	3,007	2,711	2,834	2,964	3,014
Tax	0	0	0	0	0	0
Other post tax items	0	0	0	0	0	0
Stated net profit	2,216	3,007	2,711	2,834	2,964	3,014
Goodwill	0	0	0	0	0	0
Extraordinary & Other items	0	0	0	0	0	0
Bad Debt Provisioning	0	0	0	0	0	0
Investment reval, cap gains / losses	0	0	0	0	0	0
DB adj. core earnings	2,216	3,007	2,711	2,834	2,964	3,014
Key Balance Sheet Items (SARm) & Capital Ratios						
Risk-weighted assets	51,716	65,394	92,033	136,509	150,159	163,810
Interest-earning assets	63,384	73,366	85,575	112,500	125,300	136,150
Customer Loans	42,979	51,130	59,850	80,000	89,000	96,000
Total Deposits	50,793	61,998	74,007	86,000	91,000	97,500
Stated Shareholder Equity	5,437	9,405	11,241	12,949	14,732	16,508
Equals: Tangible Equity	5,437	9,405	11,241	12,949	14,732	16,508
Tier 1 capital	6,929	9,405	11,241	12,585	14,368	16,144
Tier 1 ratio (%)	13	14	12	9	10	10
o/w core tier 1 capital ratio (%)	13.4	14.4	12.2	9.2	9.6	9.9
Credit Quality						
Gross NPLs/Total Loans(%)	1.23	1.18	0.73	1.22	2.25	3.91
Risk Provisions/NPLs(%)	182	148	190	110	74	54
Bad debt / Avg loans (%)	na	0.19	0.08	0.36	0.47	0.59
Bad debt/Pre-Provision Profit(%)	5.7	2.9	1.5	8.0	11.9	15.4
Growth Rates & Key Ratios						
Growth in revenues (%)	nm	27	-6	14	7	6
Growth in costs (%)	na	13	13	19	2	5
Growth in bad debts (%)	nm	-33	-54	495	60	38
Growth in RWA (%)	nm	26	41	48	10	9
Net int. margin (%)	2.86	2.95	2.89	2.68	2.40	2.31
Cap.-market rev. / Total revs (%)	nm	nm	nm	nm	nm	nm
Total loans / Total deposits (%)	85	82	81	93	98	98
ROTE Decomposition						
Revenue % ARWAs	6.47	6.73	4.70	3.69	3.15	3.04
Net interest revenue % ARWA	3.57	3.44	2.92	2.32	1.99	1.93
Non interest revenue % ARWA	2.90	3.28	1.78	1.37	1.16	1.11
Costs/income ratio (%)	24.0	21.4	25.6	25.4	25.5	25.3
Bad debts % ARWAs	0.28	0.15	0.05	0.22	0.28	0.35
Tax rate (%)	0.0	0.0	0.0	0.0	0.0	0.0
Adj. Attr. earnings % ARWA	4.63	5.13	3.44	2.48	2.07	1.92
Capital leverage (ARWA/Equity)	8.8	7.9	7.6	9.4	10.4	10.1
ROTE (Adj. earnings/Ave. equity)	40.7	40.5	26.3	23.4	21.4	19.3

Source: Company data, Deutsche Bank estimates

Rahul Shah
+971 4 4283-261 rahul.shah@db.com

Banque Saudi Fransi

Profitable corporate banking franchise

Outlook

Banque Saudi Fransi should experience less of a slowdown in volume growth than more retail-banking oriented peers, while its net special commission income margin should prove less susceptible to lower interest rates. We see the bank delivering mid-single-digit revenue growth, although income from the bank's investment portfolio could be subject to volatility. Cost growth should broadly match revenue trends, although we do expect loan loss provisioning charges to rise as asset quality deteriorates. We see EPS growth of 5% in 2009 and 2% in 2010.

We note that the bank's net special commission income margin has in the past proved relatively insensitive to interest rate developments, with variations in the bank's funding costs broadly matching asset yield fluctuations. Unlike other Saudi banks, therefore, BSF's margins may not suffer in the low interest rate environment we expect over the coming one to two years. BSF is one of the most efficient banks in the sector, and the experience of working with major shareholder Calyon (the investment banking division of France's Credit Agricole) appears beneficial. We believe the bank's limited retail banking exposure will cushion it from the sluggish volume and deteriorating asset quality trends likely to be experienced by that market segment.

However, we are uncomfortable with Banque Saudi Fransi's high exposure to a number of areas of perceived risk. Loans to the real estate and construction sectors account for 11% of the loan book, above the 8% sector average. BSF also manages a large derivatives portfolio, and its revenues are more exposed than the sector average to developments at its investment portfolio. The bank's capital ratios are also near the lower end of the sector range.

With the shares currently valued broadly in line with the sector, we rate the shares as Hold.

Valuation

We value the shares on a target price book multiple basis, using 2010 as our benchmark year and discounting back by the cost of equity. We assume a risk-free rate of 5.0%, an equity risk premium of 7.0% and a beta to the market of 0.88 (based on historical price performance). As with other banks in the sector, we do not apply a long-term growth adjustment to our cost of capital calculation.

Our target price calculation takes into account our view that, relative to its equity base, BSF has high exposure to credit, market and liquidity risks.

Figure 203: Banque Saudi Fransi target price calculation

17 January 2009	Share Price	2010 ROE	Cost of equity	Fair P/book ratio	2010 NAV	PV Dividends			Capital Adjustment	Qualitative Adjustment	12-month	Upside/ (Down side)	Investment Rating
	SAR					2008E	2009E	2010E	SAR		Target Price		
Banque Saudi Fransi	50.00	19.3%	10.7%	180%	29.3	1.72	1.63	1.55	0.0	-10%	52.3	5%	Hold
Sector Median		18.5%	11.3%	164%						0%		2.7%	

Source: Deutsche Bank, Zawya

Banque Saudi Fransi trades broadly in line with its peers on the basis of PE, PB and dividend yield.

Figure 204: Banque Saudi Fransi valuation multiples

	Share price	P/E				P/B				DY			
		2007A	2008E	2009E	2010E	2007A	2008E	2009E	2010E	2007A	2008E	2009E	2010E
Banque Saudi Fransi	50.00	10.4	9.9	9.5	9.3	2.50	2.17	1.91	1.70	3.5%	4.2%	4.2%	4.4%
Sector median		9.5	10.2	9.5	9.2	2.30	2.02	1.80	1.62	2.9%	4.1%	4.1%	4.5%

Source: Deutsche Bank, Company data, Zawya. Shares priced as of market close, 17 January 2009

Risks to our view

A key risk to our positive investment view relates to the relatively high proportion of revenue generated by BSF's investment portfolio (11% of revenues in 9M08). This could introduce some volatility into reported results, while the possibility of losses or sizeable impairment charges cannot be ignored. However, two-thirds of the portfolio consists of government-issued paper; only 2% consists of equities.

An additional risk relates to the high proportion of unfunded commitments the bank has extended to its customers, equivalent to two-thirds of the bank's loan book as of 9M08. A large, unexpected withdrawal of these commitments could generate funding and liquidity issues for the bank.

An additional risk relates to the low capital strength of the bank relative to its domestic peers. While the current position seems adequate, the capital base could appear stretched if the bank were to incur losses due to an unexpected deterioration in the value of some of its assets.

Key themes

Corporate banking skew should benefit the business

We believe the Saudi retail banking industry is likely to see continued sluggish development as slower economic growth, weaker employment and falling collateral values hit consumer confidence. We also see corporate banking volumes decreasing, but remaining positive. BSF should be less affected by these trends than some of its peers.

High operating efficiency

Banque Saudi Fransi has the lowest cost-income ratio in the sector (24.3% at 9M08), and its cost/assets ratio also compares extremely favourably with its peers. This in part reflects the bank's business mix (less exposure to retail banking, which tends to have a higher cost-income ratio), but we believe the bank has also been able to leverage its relationship with major shareholder Calyon to generate fundamental competitive advantages.

Limited sensitivity to falling interest rates

BSF has limited access to interest-free funding (whether in the form of customer deposits or shareholders' equity). Relative to its peers, its funding costs tend to be higher and more sensitive to interest rate fluctuations. We believe an environment of declining interest rates puts BSF in a better position than many of its peers; we see less NSCI margin erosion at BSF than at other banks.

Modest expansion plan

Like other Saudi banks, BSF plans to extend its branch network to improve its ability to attract retail deposits. However, the plan appears fairly limited (involving potentially ten new branches), and we do not believe management is looking to significantly reposition the business. Given these modest aims, we believe the cost and risk of this investment should be limited.

High exposure to derivatives and investment income

Relative to its peers, BSF generates a relatively high proportion of revenues from its investment portfolio. Fluctuations in this revenue could generate near-term earnings volatility, while the portfolio could be subject to impairments if an issuer were unable to service its debts. We note that around two-thirds of the portfolio relates to government securities, while equities account for just 2% of the portfolio.

High exposure to off-balance sheet commitments

BSF has a sizeable portfolio of unfunded commitments (equivalent to 69% of the bank's loan book). The unexpected withdrawal of these commitments could potentially lead to liquidity issues.

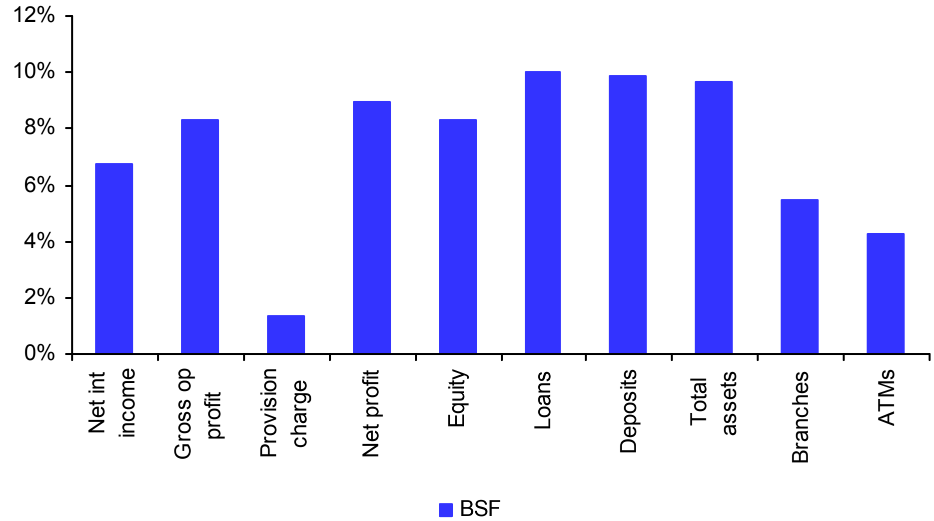
Relatively tight capital base, but risk of equity issue appears limited

BSF's 9M08 equity/assets ratio of 10% is lower than the average Saudi bank but appears adequate in an international context; an expected slowdown in bank system growth suggests capital is unlikely to constrain the development of the business. Although the bank's major shareholder is also potentially capital-constrained, we believe the prospect of an equity issue is slight. However, our view could change if the bank's asset base were significantly impaired, or its valuation negatively adjusted

Business profile

Banque Saudi Fransi has a balance sheet market share of around 10%. As a predominantly corporate banking-oriented business, BSF has less need for an extensive branch and ATM network. To date, corporate credit asset quality has remained benign, allowing the bank to experience a low loan loss provisioning charge.

Figure 205: Market share data (FY07)



Source: Deutsche Bank, SAMA, Company data

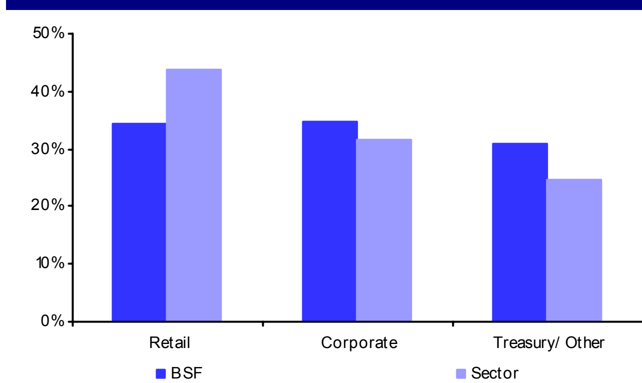
Business mix

BSF has limited exposure to retail banking, which generates around a fifth of group income. The corporate business is much more significant, generating around half of group earnings, not least due to its high operating efficiency (single-digit cost-income ratio).

Figure 206: Cost-income ratios at group and divisional level

Source: Deutsche Bank, Company data

Figure 207: Revenue mix by division



Source: Deutsche Bank, Company data

Indeed, BSF is the most efficient Saudi bank from a cost-efficiency perspective. This partly reflects the skew of the bank's business away from retail banking (which tends to have an intrinsically higher cost-income ratio), but as illustrated above, the bank appears to have fundamental cost efficiency advantages in the corporate and treasury businesses, as well. We believe this reflects a skew towards more balance sheet intensive (but lower operating cost) products. Management has indicated an interest in growing the bank's investment banking capabilities. However, we believe expansion efforts in this area will be modest given the current operating environment.

Distribution strategy

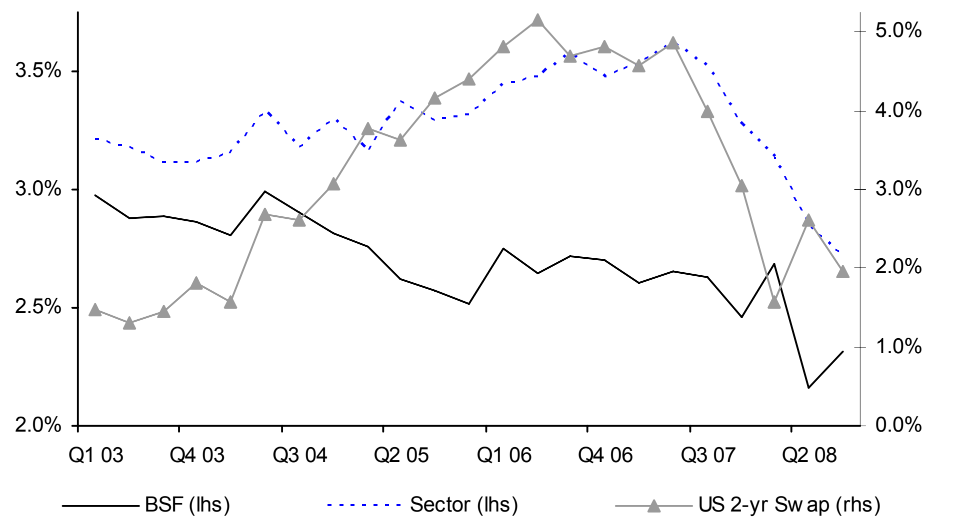
BSF has increased the size of its branch network from 68 at the end of 2006 to 75 currently. We expect additional openings in the coming months. This expansion drive reflects a decision by management to more actively target the retail banking market.

Management has been learning from the extensive retail banking experience of core shareholder Credit Agricole. The internet banking platform is based on the Credit Agricole platform, while branches are also being re-designed on the French model to split the operational and service sides of the business in order to facilitate additional cross-selling.

Revenues

Banque Saudi Fransi generates around 60% of its income from net special commission income (based on 9M08 data), broadly in line with the sector average. Unusually, however, BSF's margins for this revenue stream appear to be relatively insensitive to interest rates.

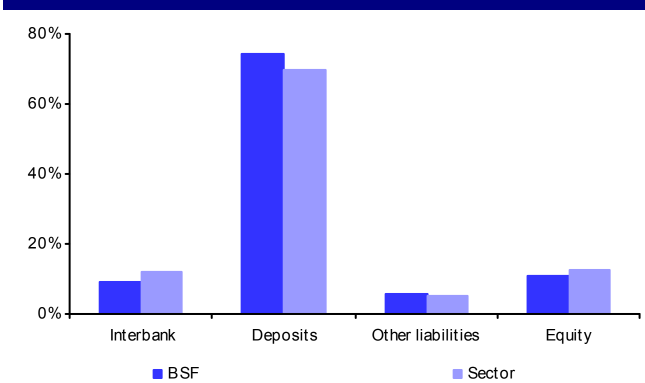
Figure 208: BSF's net special commission income margin is relatively insensitive to interest rate changes



Source: Deutsche Bank, Company data

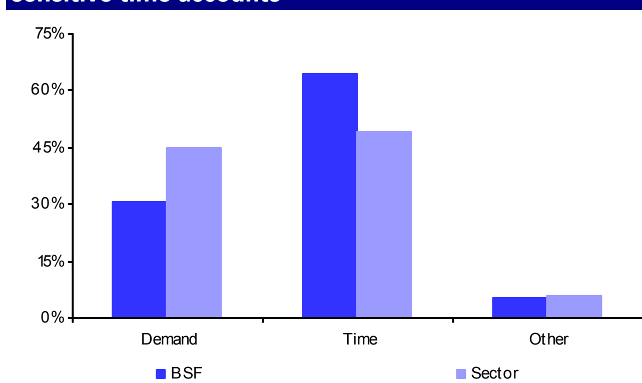
We believe this largely reflects the bank's variable cost funding base, which has relatively limited interest-free deposits and a smaller-than-average equity base.

Figure 209: BSF's funding is skewed towards deposits



Source: Deutsche Bank, Company data

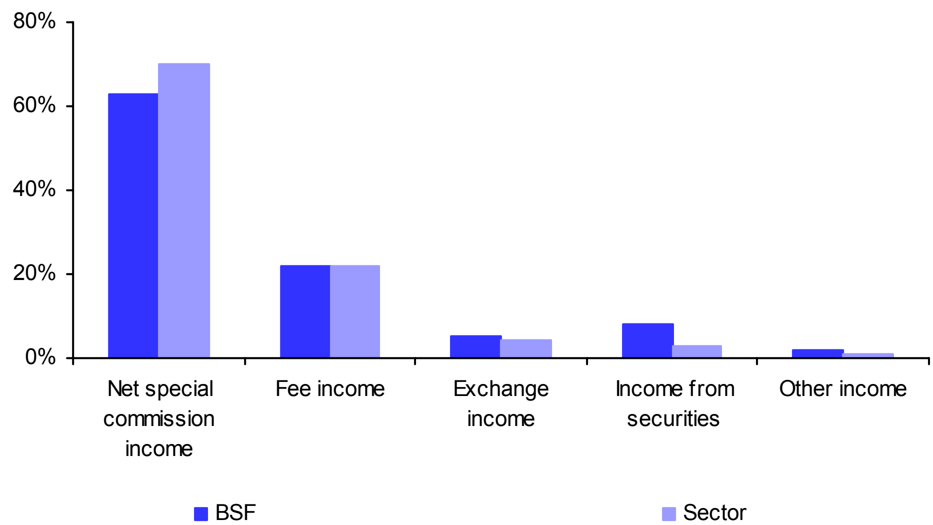
Figure 210: BSF's deposits are typically interest rate-sensitive time accounts



Source: Deutsche Bank, Company data

Even relative to other Saudi banks with active investment banking businesses, Banque Saudi Fransi is much more reliant on trading income, which has historically contributed 8-10% of revenues. Somewhat surprisingly, given difficult capital market conditions, net trading income has actually been a positive driver of revenue development in 2008; we believe this positive trend is unlikely to be sustained.

Figure 211: Revenue mix (H108): BSF is less exposed to spread-based income, but more dependent on the performance of its investment portfolio

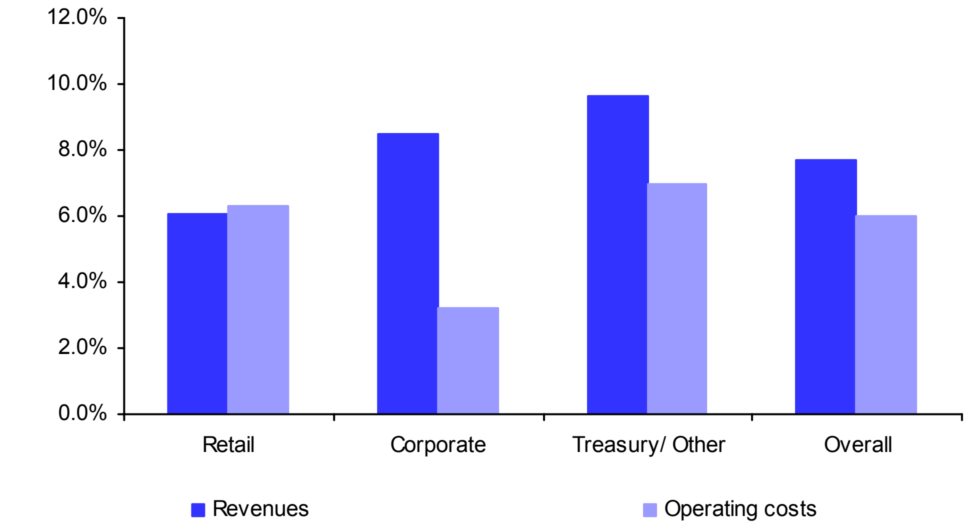


Source: Deutsche Bank, company data

Operating costs

BSF's efficiency metrics appear attractive relative to other Saudi banks. We believe part of this advantage relates to the bank's skew towards corporate banking and treasury activities, which tend to have lower cost-income ratio characteristics. But we also note that BSF's efficiency in both these areas is superior to its competitors, possibly reflecting a combination of knowledge transfer from Calyon and its particular business mix (divisional data suggests a skew towards more balance sheet-intensive products).

Figure 212: BSF has higher market shares in those businesses where it has cost advantages



Source: Deutsche Bank, Company data

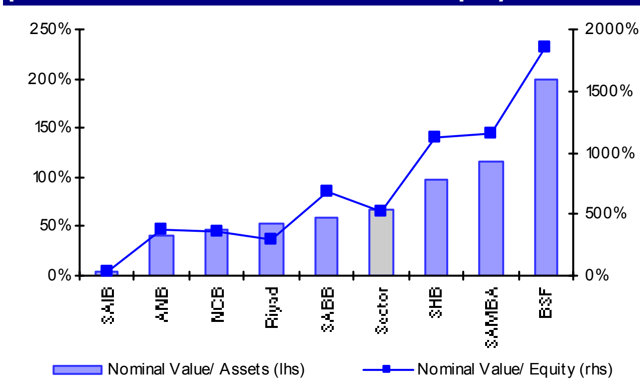
Risks

Market risk

BSF appears to be more reliant on income from its investment portfolio than many other Saudi banks, generating 11% of its revenues in 9M08 from this source, three times the sector average.

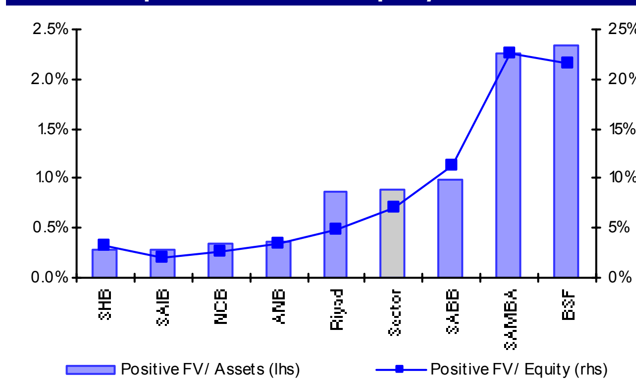
Management has indicated that the bulk of this income is generated from plain vanilla derivatives used to hedge risk. We note that BSF's derivatives portfolio is one of the largest in the sector (both in terms of nominal value and counterparty credit risk).

Figure 213: Nominal value of Saudi banks' derivatives portfolios relative to their assets and equity



Source: Deutsche Bank, company data

Figure 214: Positive intrinsic value of Saudi banks' derivatives portfolios (a counterparty risk measure)



Source: Deutsche Bank, company data

At the same time, the bank has also been raising impairment provisions against its investment portfolio, suggesting recent trading gains may not be sustained.

Credit risk

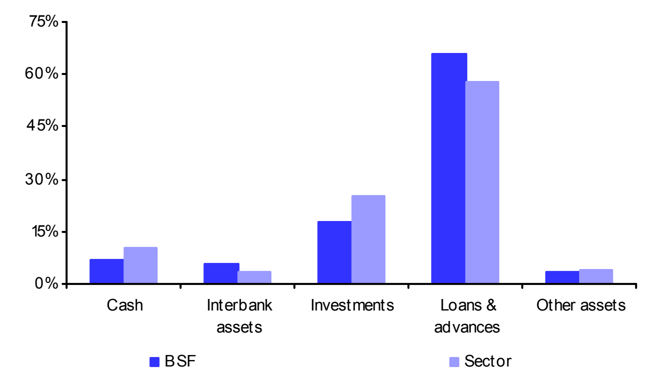
BSF's loan book is weighted towards corporate loans, and as one might expect given the relative safety of such borrowers, key loan quality ratios compare favourably with the rest of the sector. The provisioning charge increased significantly in Q308, however, which may indicate that the favourable asset quality trend of the past has altered course.

In terms of relative sectoral exposure, BSF's loan portfolio is more heavily weighted to the manufacturing and services sectors, which together account for around 40% of total credit. Exposure to the construction sector, at 11% of total loans, is also large.

Liquidity risk

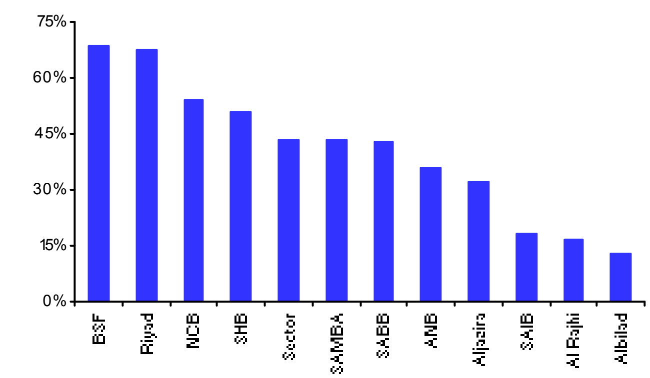
Two-thirds of BSF's assets consist of loans, a larger proportion than other Saudi banks (except for fully Shariah-compliant Al Rajhi and Albilad), leaving relatively limited room for liquid assets such as investments. While the funding structure of the bank is broadly in line with its peers, we note that BSF does have a relatively large portfolio of unfunded commitments, equivalent to 69% of balance sheet loans. The unexpected withdrawal of these commitments could put pressure on the bank's liquidity position.

Figure 215: BSF's assets are more heavily skewed towards loans



Source: Deutsche Bank, Company data

Figure 216: BSF has a large unfunded commitments position (commitments/loans ratio 9M08)



Source: Deutsche Bank, company data

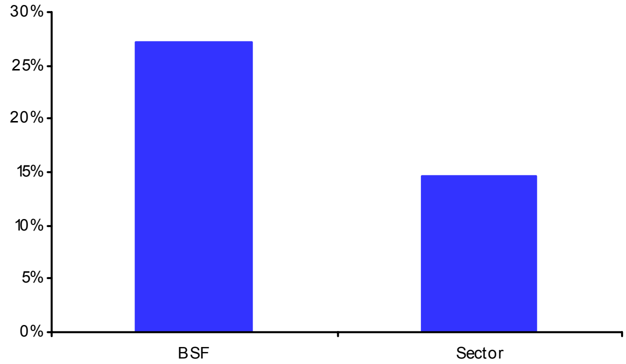
Combined with the bank's lower capital base, these findings suggest the bank's liquidity risk may be higher than other banks in the sector.

Funding

In common with the rest of the sector, three-quarters of BSF's liabilities consist of customer deposits. However, two-thirds of these deposits are in the form of time deposits, reflecting the bank's skew towards sophisticated corporate customers. We also note that a high proportion of the bank's deposits are denominated in foreign currencies, suggesting the bank may be competing with a wide international pool of banks for such funds.

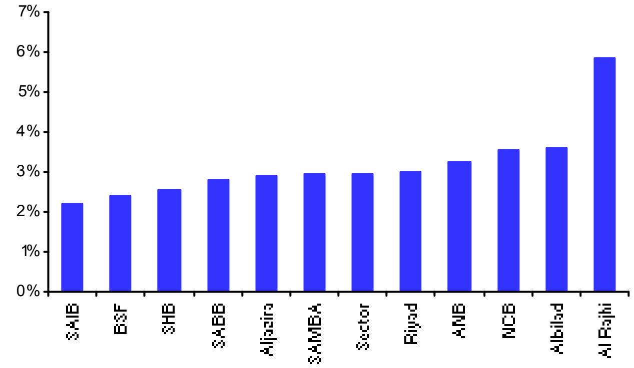
This, along with the bank's sizeable lower yielding corporate loan book, is key to the bank's lower net special commission margin relative to peers (2.4% at 9M08 versus a sector average of 2.9%).

Figure 217: Foreign currency deposits as % of total deposits (FY07)



Source: Deutsche Bank, company data

Figure 218: Net special commission income margin (9M08)

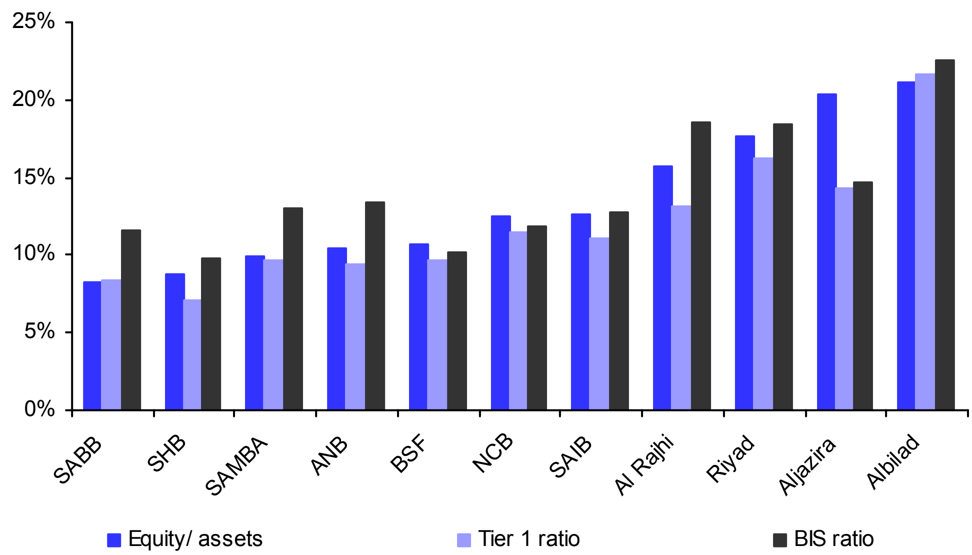


Source: Deutsche Bank, company data

Capital base

Banque Saudi Fransi's capital ratios are among the lowest in the sector, although they compare favourably with those of other corporate and investment banking-oriented entities.

Figure 219: Saudi bank capital ratios



Source: Deutsche Bank, Company data

A key consideration in relation to any capital-raising relates to the wishes of the main shareholders, who have all been long-term holders. Given its own financial difficulties (in common with many western banking groups), we believe Credit Agricole would not wish to inject significant new capital into BSF anytime soon.

Indeed, given our expectation of rapidly slowing business volume growth, we see little need for the bank to raise new capital at this time. However, our view could change if the bank were to experience significant asset impairment or negative valuation adjustments.

Ownership and background

Credit Agricole (via its takeover of Credit Lyonnais) has had an interest in Banque Saudi Fransi since the post-war period. Today, Credit Agricole's investment banking subsidiary Calyon owns 31% of the shares and has effective management control of the business. Currently there are seven Calyon officers employed in senior positions in BSF. However, the divisional management consists of local employees.

The bank has key strengths in corporate banking, in particular project finance, where it has around 14% market share (versus an average market share of just under 10%).

Until around 2000, retail banking was viewed largely as a tool to fund the core businesses. However, around 2000 the bank started to offer retail credit products. The bank has a good positioning in the HNWI segment of the retail market. Many of these clients are long-standing and very loyal to the bank. The bank's strength in this segment is indicated by its share of the brokerage business, which is believed to be in line with the overall business profile despite the bank's limited overall retail presence. We believe management is seeking to modestly increase BSF's retail banking market share (which we estimate to be around 6% currently).

Management is now trying to instil a more sales-oriented culture at the bank. However, risk aversion is not being relaxed. The bank is specifically targeting government employees.

Figure 220: Shareholder structure

Calyon (Credit Agricole)	31.1%
GOSI	12.8%
Rashid Abdul Rahman Al Rashid & Sons	9.8%
Mohammed Ibrahim Mohammed Al Issa	5.3%
Free Float	41.0%

Source: Deutsche Bank, Tadawul, Zawya

This page has been intentionally left blank.

Model updated:21 January 2009

Running the numbers

Middle East

Saudi Arabia

Banking

Riyad Bank

Reuters: 1010.SE Bloomberg: RIBL AB

Buy

Price (20 Jan 09)	SAR 19.90
Target price	SAR 25.60
52-week Range	SAR 19.90 - 46.82
Market Cap (m)	SARm 29,850 USDm 7,959

Company Profile

Riyad Bank operates a network of 200 branches and close to 2000 ATMs, and has a market share by assets of around 12%. The business is largely domestically focused, although there is a branch in London. The bank offers a range of conventional and Islamic banking products and investment services to its retail, corporate and institutional customers. Core shareholders own 70% of Riyad stock.

Rahul Shah
+971 4 4283-261 rahul.shah@db.com

Fiscal year end 31-Dec	2005	2006	2007	2008E	2009E	2010E
Data Per Share						
EPS (stated)(SAR)	2.36	2.42	2.51	2.02	2.17	2.27
EPS (DB) (SAR)	2.61	2.42	2.52	2.02	2.17	2.27
Growth Rate - EPS (DB) (%)	55.8	-7.1	4.0	-19.9	7.4	4.8
DPS (SAR)	1.33	1.66	0.83	1.00	1.20	1.40
BVPS (stated) (SAR)	9.12	9.98	10.98	18.16	19.13	20.00
Tang. NAV p. sh. (SAR)	9.12	9.98	10.98	18.16	19.13	20.00
Market Capitalisation	84,425	40,312	59,375	29,850	29,850	29,850
Shares in issue	1,201	1,201	1,201	1,388	1,500	1,500
Valuation Ratios & Profitability Measures						
P/E (stated)	29.8	13.9	19.7	9.9	9.2	8.8
P/E (DB)	27.0	13.9	19.6	9.9	9.2	8.8
P/B (stated)	7.7	3.4	4.5	1.1	1.0	1.0
P/Tangible equity (DB)	7.7	3.4	4.5	1.1	1.0	1.0
ROE(stated)(%)	27.3	25.3	23.9	13.9	11.6	11.6
ROTE (tangible equity) (%)	30.1	25.3	24.0	13.9	11.6	11.6
ROIC (invested capital) (%)	30.1	25.3	24.0	13.9	11.6	11.6
Dividend yield(%)	2.3	3.2	2.6	5.0	6.0	7.0
Dividend cover(x)	1.8	1.5	3.0	2.0	1.8	1.6
Profit & Loss (SARm)						
Net interest revenue	2,672	2,926	3,266	3,950	4,175	4,325
Non interest income	1,509	1,960	1,902	1,060	1,580	1,830
Commissions	1,189	1,459	1,282	1,520	1,640	1,790
Trading Revenue	246	358	480	-550	-100	0
Other revenue	74	143	140	90	40	40
Total revenue	4,180	4,886	5,168	5,010	5,755	6,155
Total Operating Costs	1,424	1,605	1,824	1,935	2,055	2,150
Employee Costs	793	875	960	1,020	1,075	1,120
Other costs	631	729	864	915	980	1,030
Pre-Provision profit/(loss)	2,757	3,281	3,344	3,075	3,700	4,005
Bad debt expense	212	372	346	275	450	600
Operating Profit	2,545	2,909	2,998	2,800	3,250	3,405
Pre-tax associates	0	0	0	0	0	0
Pre-tax profit	2,545	2,909	2,998	2,800	3,250	3,405
Tax	0	0	0	0	0	0
Other post tax items	293	0	13	0	0	0
Stated net profit	2,837	2,909	3,011	2,800	3,250	3,405
Goodwill	0	0	0	0	0	0
Extraordinary & Other items	293	0	13	0	0	0
Bad Debt Provisioning	0	0	0	0	0	0
Investment reval, cap gains / losses	0	0	0	0	0	0
DB adj. core earnings	3,130	2,908	3,024	2,800	3,250	3,405
Key Balance Sheet Items (SARm) & Capital Ratios						
Risk-weighted assets	63,604	73,536	90,893	145,763	157,710	169,658
Interest-earning assets	74,581	85,398	99,250	132,000	142,250	152,500
Customer Loans	45,606	52,183	67,340	92,500	100,000	107,500
Total Deposits	52,730	69,192	84,331	90,000	95,000	101,000
Stated Shareholder Equity	10,960	11,992	13,187	27,244	28,694	29,999
Equals: Tangible Equity	10,960	11,992	13,187	27,244	28,694	29,999
Tier 1 capital	10,960	11,992	13,187	25,647	27,097	28,402
Tier 1 ratio (%)	17	16	15	18	17	17
o/w core tier 1 capital ratio (%)	17.2	16.3	14.5	17.6	17.2	16.7
Credit Quality						
Gross NPLs/Total Loans(%)	1.11	1.60	1.63	2.16	3.45	5.12
Risk Provisions/NPLs(%)	270	177	139	89	64	50
Bad debt / Avg loans (%)	0.53	0.76	0.58	0.34	0.47	0.58
Bad debt/Pre-Provision Profit(%)	7.7	11.4	10.3	8.9	12.2	15.0
Growth Rates & Key Ratios						
Growth in revenues (%)	21	17	6	-3	15	7
Growth in costs (%)	5	13	14	6	6	5
Growth in bad debts (%)	119	76	-7	-20	64	33
Growth in RWA (%)	34	16	24	60	8	8
Net int. margin (%)	3.72	3.66	3.54	3.42	3.04	2.93
Cap.-market rev. / Total revs (%)	nm	nm	nm	nm	nm	nm
Total loans / Total deposits (%)	86	75	80	103	105	106
ROTE Decomposition						
Revenue % ARWAs	7.52	7.13	6.29	4.23	3.79	3.76
Net interest revenue % ARWA	4.81	4.27	3.97	3.34	2.75	2.64
Non interest revenue % ARWA	2.71	2.86	2.31	0.90	1.04	1.12
Costs/income ratio (%)	34.1	32.8	35.3	38.6	35.7	34.9
Bad debts % ARWAs	0.38	0.54	0.42	0.23	0.30	0.37
Tax rate (%)	0.0	0.0	0.0	0.0	0.0	0.0
Adj. Attr. earnings % ARWA	5.63	4.24	3.68	2.37	2.14	2.08
Capital leverage (ARWA/Equity)	5.3	6.0	6.5	5.9	5.4	5.6
ROTE (Adj. earnings/Ave. equity)	30.1	25.3	24.0	13.9	11.6	11.6

Source: Company data, Deutsche Bank estimates

Riyad Bank

Well-capitalised with a strong distribution network

Outlook

Following aggressive credit expansion in 2008, we see Riyad's loan growth slowing to the high single-digit level. Lower volume growth and margin compression are likely to hit net special commission income growth, although trends will be distorted by the impact of the recent equity increase. We believe fee income growth is likely to be robust (high single-digits) despite further contraction of the equity brokerage business. In addition, we expect the bank's investment portfolio losses to subside, allowing total revenues to record high single digit growth, above the sector average. With a number of investment projects coming to an end, we see Riyad Bank's cost growth moderating. Despite our expectations of sharply higher loan loss provisioning charges, we see single-digit net income growth. After adjusting for new share issuance, we see EPS growth averaging 6% in the coming years, above our average expectations for the sector.

Management issued a significant amount (SAR13bn) of new equity capital in Q208, which, combined with a significant branch and ATM network, appears to have positioned Riyad Bank to increase its market share from 11% to 15%. However, the bank appears competitive even in its current framework, reflecting the breadth and scale of the business franchise and good cost management. We believe this is important, as a sharp slowdown in the banking sector is likely to preclude the bank from making significant progress towards its long-term market share goals. In this context, we believe the equity raised could be an effective buffer in an uncertain economic environment. We also note that the bank appears to be making progress in growing its non-brokerage fee income, although it remains to be seen whether this performance can be sustained as volume growth slows. We also see scope to reduce costs in the bank's treasury operations.

We see good value in the shares, which we rate as Buy.

Valuation

We value the shares on a target price book multiple basis, using 2010 as our benchmark year and discounting back by the cost of equity. We assume a risk-free rate of 5.0%, an equity risk premium of 7.0% and a beta to the market of 0.84 (based on historical price performance). In common with our approach to other banks in the sector, we do not apply a long-term growth adjustment to our cost of capital calculation.

Our target price calculation takes into account our view that, following its SAR13bn capital increase in May 2008, Riyad Bank has an extremely strong capital base.

Figure 221: Riyad Bank Target Price calculation summary

17 January 2009	Share Price	2010 ROE	Cost of equity	Fair P/book ratio	2010 NAV	PV Dividends			Capital Adjustment	Qualitative Adjustment	12-month	Upside/ (Down side)	Investment Rating
	SAR					2008E	2009E	2010E	SAR		Target Price		
Riyad Bank	20.45	11.6%	10.9%	107%	20.0	0.86	0.93	.98	1.1	0%	25.6	25%	Buy
Sector Median		18.5%	11.3%	164%						0%		2.7%	

Source: Deutsche Bank, Zawya.

Given the sizeable capital increase undertaken in Q208, it is not surprising that the bank trades at a significant discount to the sector from a PB multiple perspective. However, the bank also has a lower PE and DY.

Figure 222: Riyad Bank valuation multiples

	Share Price	P/E				P/book				DY			
		2007A	2008E	2009E	2010E	2007A	2008E	2009E	2010E	2007A	2008E	2009E	2010E
Riyad Bank	20.45	8.2	10.1	9.4	9.0	1.86	1.13	1.07	1.02	4.1%	5.9%	5.9%	6.8%
Sector Median		9.5	10.2	9.5	9.2	2.30	2.02	1.80	1.62	2.9%	4.1%	4.1%	4.5%

Source: Deutsche Bank, Company data, Zawya. Shares priced as at market close, 17 January 2009

Risks to our view

A key negative revenue driver in 2008 was returns from Riyad Bank's investment portfolio. Around 11% of this portfolio consists of equities, a higher proportion than the sector average, and we believe this component has been a key driver of the reported downturn. In our view,the bank's investment income will contribute to earnings volatility in the coming quarters, although the overall drag on earnings is likely to diminish.

A further risk relates to the liquidity position of the company, principally arising from the bank's large unfunded commitments portfolio (equivalent to two-thirds of the loan book). The unexpected utilisation of a sizeable portion of these commitments could negatively affect the liquidity position of the organization.

Key themes

Strong distribution franchise

Riyad Bank has the second-largest branch network (after Al Rajhi Bank) and the largest ATM system in Saudi Arabia. Although the bank's distribution network appears larger than needed to support current business volumes, good cost control and the scale of the business mean that operating efficiency metrics are in line with sector norms.

Well-capitalised following rights issue

Following a SAR13bn equity capital increase in May 08, Riyad bank is one of the best capitalized institutions in the sector. While management raised this capital to fuel growth, it should ease investor concerns of solvency as the macroeconomic environment becomes more difficult. With volume growth now slowing sharply, we believe management will not aggressively chase market share through a relaxation of price or risk discipline.

Treasury division room for improvement

Rapid growth of the bank's loan book has reduced the amount of funding available to fuel the Treasury business. Investment returns have also suffered as capital markets have deteriorated. Management has failed to respond to this deteriorating revenue position by adjusting costs – we believe there is scope for efficiency improvements.

Liquidity risks

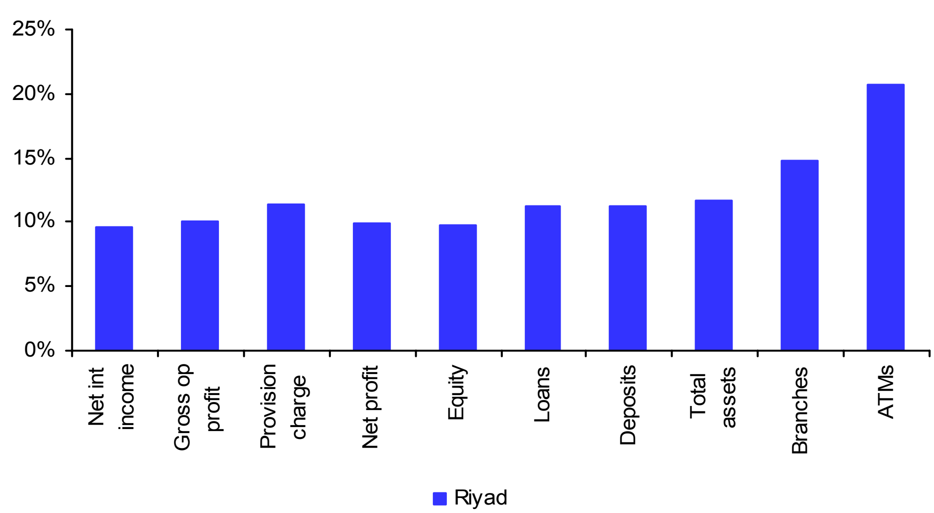
Riyad Bank has a more pronounced asset-liability mismatch than many of its peers, largely reflecting the short-dated nature of much of its deposit funding. Also of potential concern is the large size of the bank's unfunded commitments, equivalent to around two-thirds of the balance sheet loan book. The unexpected withdrawal of a significant portion of these commitments could put pressure on the bank's liquidity position.

Investment income more sensitive to equity market trends
Riyad Bank's investment portfolio appears to be more skewed towards equity investments than other Saudi banks. This may be one reason why income related to the investment portfolio turned sharply negative in 2008. As such, we believe the scope for additional negative surprises may be less pronounced than for other Saudi banks.

Business profile

Riyad Bank's market share of loans and deposits stands at around 11%. This compares with its branch market share of 15%. Following a rights issue in Q208, we estimate the bank's market share of equity to be around this level. Management appears, therefore, to have the capacity to significantly expand business activity levels.

Figure 223: Market share data (FY07)



Source: Deutsche Bank, Company data, SAMA

Distribution strategy
Riyad Bank has 201 branches, the third-largest branch network in the country after Al Rajhi Bank and National Commercial Bank. The bank also has almost 2000 ATMs; its market share of this distribution channel has doubled over the past decade as management has sought to lower transaction costs and improve customer convenience.

Business mix

Riyad Bank's retail banking franchise benefits from a contract to pay the vast majority of government employees' salaries. This generates healthy fees for the bank (Al Rajhi Bank is also a key beneficiary of this trend), but also gives the bank access to an attractive segment of the retail banking population.

Management has identified two principal structural drivers of the retail banking business.

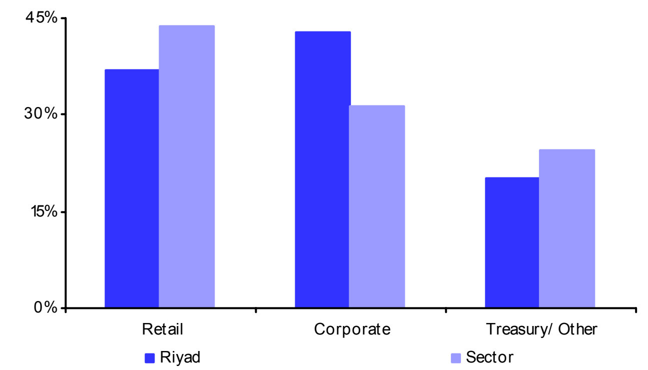
On the retail banking side, management believes there is strong growth potential in the credit card market. Cash use remains relatively high in Saudi Arabia, but card use appears set to grow quite rapidly. With other banks also looking to expand in this area, we believe an element of margin pressure is likely.

Longer term, the potential enactment of a mortgage law would enable banks to help meet the population's huge demand for housing.

Currently, however, the corporate banking business is the key driver of group performance, generating 70% of group earnings from 45% of group revenues.

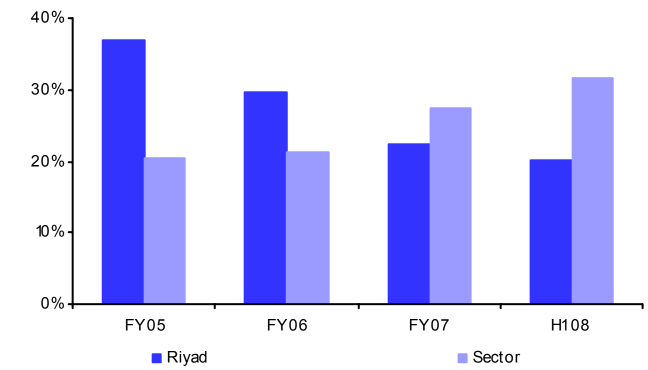
In contrast, the recent performance of the Treasury division has been poor. While other banks have seen revenue growth in this area, Riyad's divisional top line has shrunk considerably. We believe this reflects a decline in excess deposit funding from the retail banking business as loan growth has accelerated, although weak results from the bank's investment portfolio may also have contributed to this negative trend. The Treasury division's costs have not adjusted to this negative revenue trend, resulting in nil net income contribution from this activity. We see scope for efficiency improvements in this area, which accounts for around half of group costs.

Figure 224: Riyad Bank: revenues by business unit (H108)



Source: Deutsche Bank, Company data

Figure 225: Riyad Bank's Treasury recent decline of division revenues

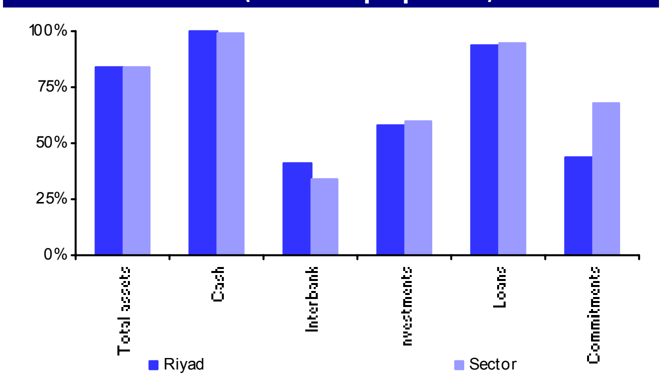


Source: Deutsche Bank, Company data

Geographic mix

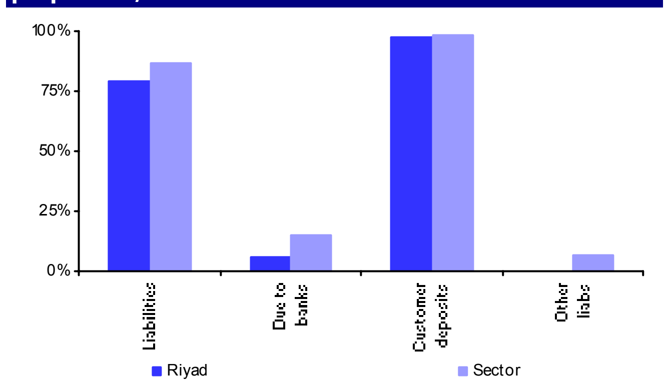
Riyad Bank's geographic mix broadly reflects the key features of the sector, namely an overwhelmingly domestic focus for direct customer business and more international counterparties for other balances. A key divergence with peers relates to off-balance sheet commitments, which are large (equivalent to two-thirds of existing loan book) and over half of which are to international counterparties. Given the lack of Riyad's international resources, a concern is that these commitments could carry higher-than-expected levels of risk

Figure 226: Geographic mix of assets and off-balance sheet commitments (domestic proportion)



Source: Deutsche Bank, company data

Figure 227: Geographic mix of liabilities (domestic proportion)

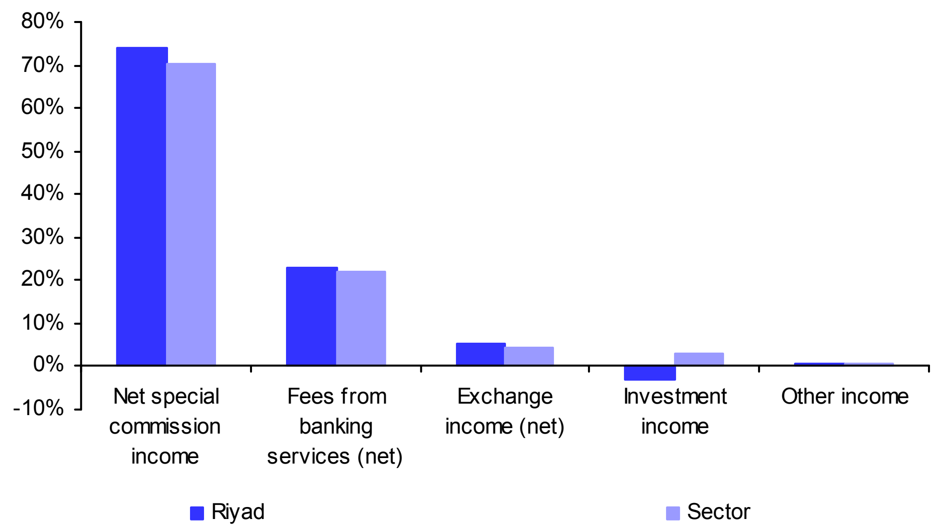


Source: Deutsche Bank, company data

Revenues

In common with other Saudi banks, Riyad Bank's revenues are predominantly generated from spread-based income.

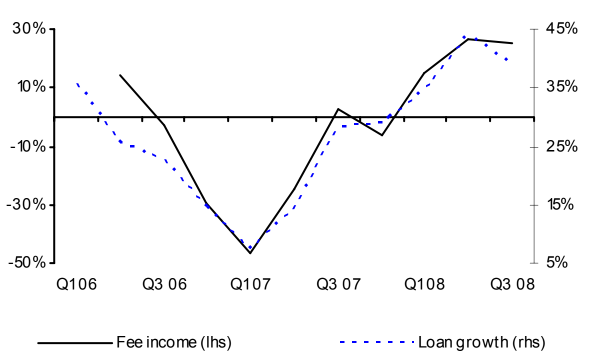
Figure 228: Riyad Bank revenue mix



Source: Deutsche Bank, Company data

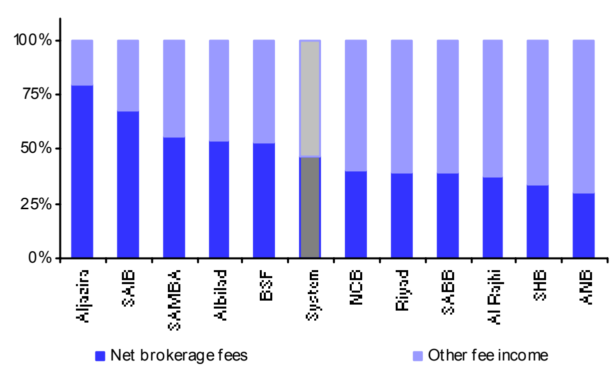
Riyad Bank experienced a recovery in fee income in 2008. A key driver appears to have been the acceleration in loan growth (which has boosted related fee income), while we believe trade and corporate finance fees have also maintained a positive trajectory. We believe share trading fee income has remained sluggish, reflecting broader market trends.

Figure 229: Riyad Bank: Annual loan and fee income growth



Source: Deutsche Bank, Company data

Figure 230: Fee income split (FY07)

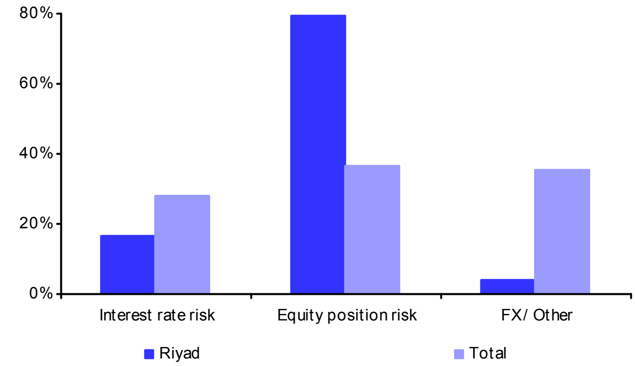


Source: Deutsche Bank, Company data

Riyad Bank's trading gains have largely been driven by equity positions in the past. This skew may explain the significant decline in trading income in 2008: as of 9M08 the bank lost SAR523m on its trading book versus a gain of SAR389m in the corresponding period in the previous year. We believe the scale of this negative performance is unlikely to be repeated in the coming year.

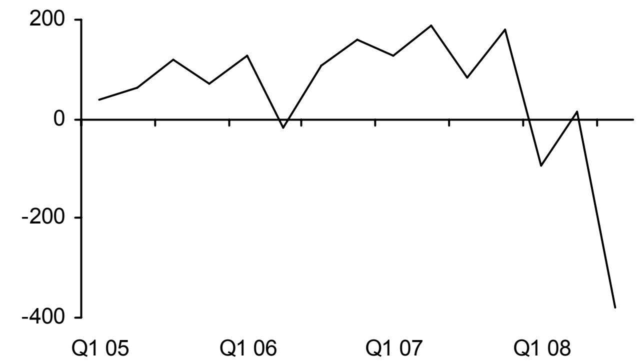
The sensitivity to equities may also explain the higher volatility of Riyad's trading income relative to its peers'.

Figure 231: Market risk sources (H108)



Source: Deutsche Bank, Company data

Figure 232: Riyad Bank: Income from investment portfolio has recently turned negative (SARm)



Source: Deutsche Bank, Company data

In contrast, other income recovered strongly in 2008. However, this line is made up of a wide variety of transactions, many of which are one-off in nature. Accordingly, we do not believe this positive trend is likely to be sustained.

Operating costs

A near 25% increase in the ATM network resulted in sharply higher 2008 premises costs. However, other costs were well-controlled, and the 9M08 cost growth of 6% appears attractive. Unfortunately, the bank's trading losses in recent quarters have resulted in a continuation of the cost-income ratio's upward trend.

One of the reasons of the heavy investment in the ATM network is to ease the transactional burden on branches. Management intends branches to become much more sales-driven locations, with an array of services tailored to appeal to high net worth individuals in particular. A recent IT investment programme to support this shift is also winding down.

For reasons of reduced investment and improved resource allocation, we believe future cost growth is likely to moderate.

Risks

Credit risk

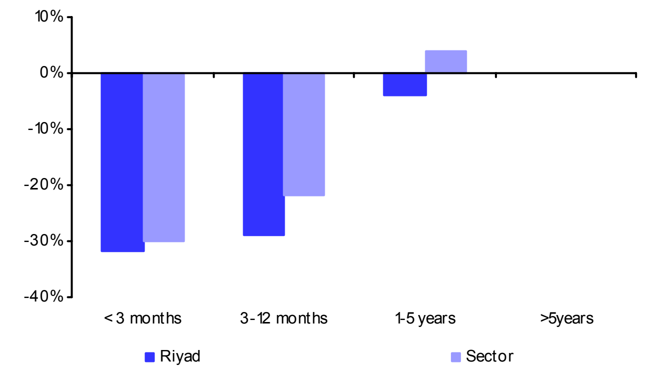
From a relative sector weighting perspective, Riyad Bank is most exposed to Commerce (one-third of the loan book) and Manufacturing, while its exposure to Government Loans is modest. Construction sector exposure is 7% of total loans and Retail exposure is 23%, both in line with the sector average. The non-performing loans/loans ratio of 1.6% is also in line with sector norms.

Liquidity risk

Riyad's asset mix is broadly in line with the sector average. Although the bank had a slightly larger asset-liability maturity mismatch than its peers at end-07, we suspect the Q208 capital issue improved the bank's position (as the bank could invest the new long-term funding in shorter dated assets).

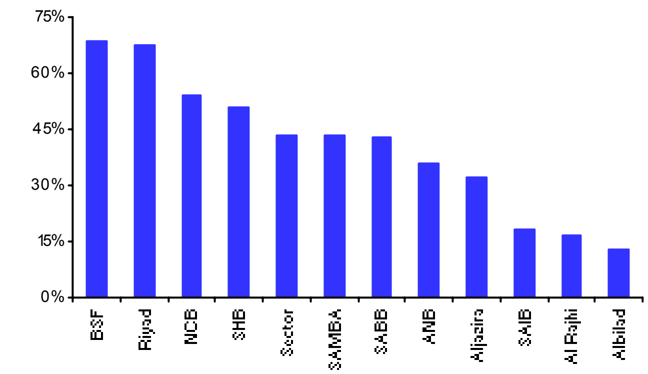
More concerning, perhaps, is Riyad Bank's proportion of unfunded commitments (equivalent to two-thirds of the on-balance sheet loan book). The unexpected withdrawal of a significant proportion of these commitments could generate funding difficulties for the bank

Figure 233: Riyad Bank has a more pronounced asset-liability maturity mismatch than its peers (FY07)



Source: Deutsche Bank, Company data. Chart compares contractual maturities of asset and liabilities (on a cumulative basis), relative to total assets

Figure 234: Off-balance sheet commitments/loans ratio



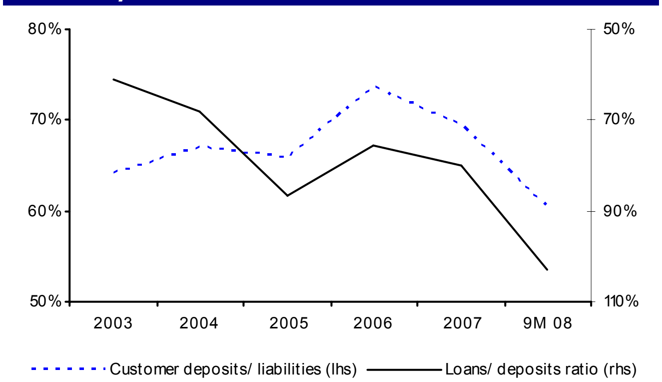
Source: Deutsche Bank, Company data

Funding costs

Riyad's funding from customer deposits is just 61% of total assets, less dependent than other Saudi banks. This proportion has declined significantly in recent years as the bank has targeted rapid expansion of its loan book.

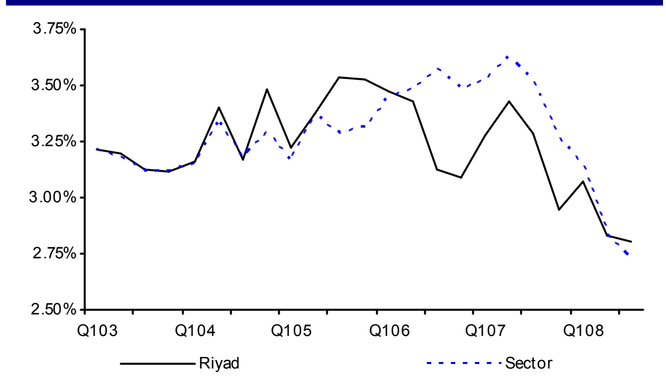
With more of the funding mix weighted towards interbank deposits, this shift in funding structure resulted in Riyad's net special commission income margin declining well before interest rate cuts eroded the margins of other sector participants. More recently, however, Riyad Bank's margin has proved more resilient. We believe the bank's sizeable capital increase completed in Q208 will help maintain this more resilient recent trend.

Figure 235: Importance of deposit funding has declined in recent years



Source: Deutsche Bank, Company data

Figure 236: Riyad Bank net special commission margin relative to sector



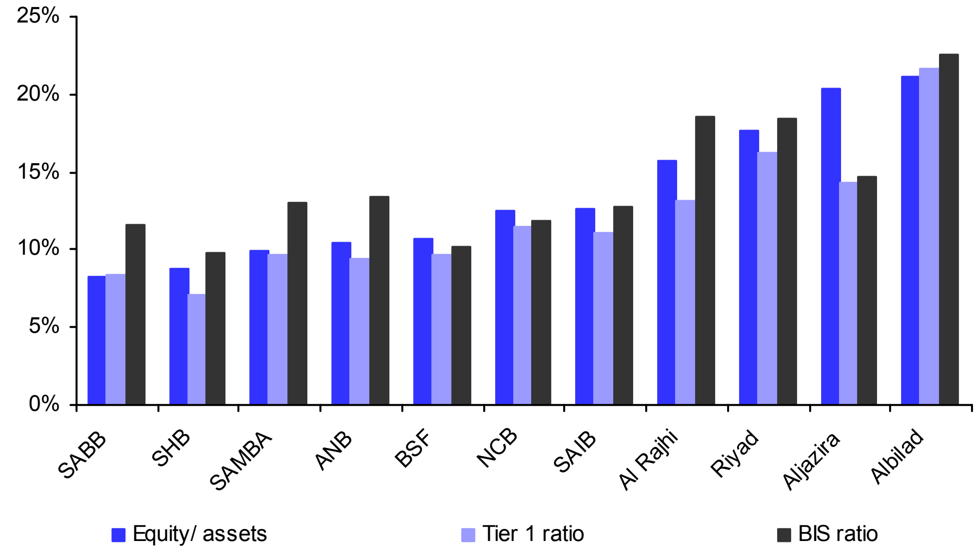
Source: Deutsche Bank, Company data

Capital base

Following the Q208 rights issue, Riyad Bank has become one of the better-capitalized banks in Saudi Arabia, with a 9M08 equity/assets ratio of 17.7% and a tier 1 ratio of 16.3%. Management has indicated that this capital will be used to fund future business growth.

However, in the near term the capital should also provide a useful cushion to help the bank withstand any fallout from the global credit crunch.

Figure 237: Riyad Bank is one of the better capitalised banks in the sector



Source: Deutsche Bank, Company data

Ownership

Riyad Bank has a number of core shareholders. As well as public sector institutions, the shareholder register includes Mohammed Al Issa (who also owns a stake in Banque Saudi Fransi) and the Al Nahla Group (a diversified Saudi conglomerate). The free float is relatively limited at around 30%.

Figure 238: Shareholder structure

Shareholder	Stake
Public Investment Fund	21.7%
GOSI	21.6%
Mohammed Ibrahim Mohammed Al Issa	10.6%
Al Nahla Group	9.9%
Al Nakd Saudi Establishment	6.5%
Free Float	29.7%

Source: Deutsche Bank, Tadawul, Zawya

This page has been intentionally left blank.

Model updated:18 January 2009

Running the numbers

Middle East

Saudi Arabia

Banking

Saudi British Bank

Reuters: 1060.SE Bloomberg: SABB AB

Hold

Price (20 Jan 09)	SAR 59.75
Target price	SAR 60.90
52-week Range	SAR 46.00 - 114.00
Market Cap (m)	SARm 35,850 USDm 9,559

Company Profile

Established in 1978, SABB operates a network of around 70 branches and 430 ATMs. The company is a mid-sized player in the Saudi banking system, with a market share approaching 10%. The bank offers a wide range of conventional and Islamic banking products to its retail, corporate and institutional customers. HSBC is the largest shareholder, with a 40% stake in the business.

Rahul Shah
+971 4 4283-261 rahul.shah@db.com

Fiscal year end 31-Dec	2005	2006	2007	2008E	2009E	2010E
Data Per Share						
EPS (stated)(SAR)	4.17	5.07	4.34	4.98	5.39	5.58
EPS (DB) (SAR)	4.17	5.07	4.34	4.98	5.39	5.58
Growth Rate - EPS (DB) (%)	nm	21.4	-14.3	14.5	8.3	3.6
DPS (SAR)	1.35	2.50	2.35	2.50	2.65	2.80
BVPS (stated) (SAR)	8.58	15.67	17.37	19.85	22.59	25.37
Tang. NAV p. sh. (SAR)	8.58	15.67	17.37	19.85	22.59	25.37
Market Capitalisation	79,500	44,156	53,625	35,850	35,850	35,850
Shares in issue	600	600	600	600	600	600
Valuation Ratios & Profitability Measures						
P/E (stated)	31.7	14.5	20.6	12.0	11.1	10.7
P/E (DB)	31.7	14.5	20.6	12.0	11.1	10.7
P/B (stated)	15.4	4.7	5.1	3.0	2.6	2.4
P/Tangible equity (DB)	15.4	4.7	5.1	3.0	2.6	2.4
ROE(stated)(%)	37.3	36.0	26.3	26.7	25.4	23.3
ROTE (tangible equity) (%)	45.3	41.8	26.3	26.7	25.4	23.3
ROIC (invested capital) (%)	37.3	36.0	26.3	26.7	25.4	23.3
Dividend yield(%)	1.3	2.3	3.5	4.2	4.4	4.7
Dividend cover(x)	3.1	2.0	1.8	2.0	2.0	2.0
Profit & Loss (SARm)						
Net interest revenue	2,045	2,709	3,134	3,275	3,375	3,450
Non interest income	1,775	1,907	1,240	1,716	1,964	2,144
Commissions	1,710	1,742	969	1,425	1,600	1,740
Trading Revenue	23	93	178	290	360	400
Other revenue	43	72	92	1	4	4
Total revenue	3,820	4,617	4,374	4,991	5,339	5,594
Total Operating Costs	1,208	1,404	1,429	1,698	1,740	1,839
Employee Costs	716	779	760	940	1,025	1,100
Other costs	492	625	669	758	715	739
Pre-Provision profit/(loss)	2,612	3,213	2,945	3,354	3,599	3,755
Bad debt expense	108	225	396	400	450	500
Operating Profit	2,504	2,988	2,549	2,893	3,149	3,255
Pre-tax associates	0	52	58	75	85	95
Pre-tax profit	2,504	3,040	2,607	2,968	3,234	3,350
Tax	0	0	0	0	0	0
Other post tax items	0	0	0	18	0	0
Stated net profit	2,504	3,040	2,607	2,986	3,234	3,350
Goodwill	0	0	0	0	0	0
Extraordinary & Other items	0	0	0	0	0	0
Bad Debt Provisioning	0	0	0	0	0	0
Investment reval, cap gains / losses	0	0	0	0	0	0
DB adj. core earnings	2,504	3,040	2,607	2,986	3,234	3,350
Key Balance Sheet Items (SARm) & Capital Ratios						
Risk-weighted assets	48,954	52,399	77,369	100,145	108,013	116,239
Interest-earning assets	61,453	67,290	78,583	127,000	136,250	145,500
Customer Loans	40,847	42,450	62,001	87,500	94,000	100,000
Total Deposits	48,534	59,258	71,848	100,000	107,500	117,500
Stated Shareholder Equity	5,149	9,405	10,425	11,911	13,554	15,224
Equals: Tangible Equity	5,149	9,405	10,425	11,911	13,554	15,224
Tier 1 capital	7,493	9,405	10,425	10,266	11,909	13,579
Tier 1 ratio (%)	15	18	13	10	11	12
o/w core tier 1 capital ratio (%)	15.3	17.9	13.5	10.3	11.0	11.7
Credit Quality						
Gross NPLs/Total Loans(%)	0.49	0.39	0.32	0.57	1.33	3.00
Risk Provisions/NPLs(%)	194	301	290	190	110	62
Bad debt / Avg loans (%)	0.30	0.54	0.76	0.54	0.50	0.52
Bad debt/Pre-Provision Profit(%)	4.1	7.0	13.5	11.9	12.5	13.3
Growth Rates & Key Ratios						
Growth in revenues (%)	53	21	-5	14	7	5
Growth in costs (%)	41	16	2	19	2	6
Growth in bad debts (%)	78	108	76	1	13	11
Growth in RWA (%)	27	7	48	29	8	8
Net int. margin (%)	3.53	4.21	4.30	3.19	2.56	2.45
Cap.-market rev. / Total revs (%)	nm	nm	nm	nm	nm	nm
Total loans / Total deposits (%)	84	72	86	88	87	85
ROTE Decomposition						
Revenue % ARWAs	8.73	9.11	6.74	5.62	5.13	4.99
Net interest revenue % ARWA	4.67	5.35	4.83	3.69	3.24	3.08
Non interest revenue % ARWA	4.06	3.76	1.91	1.93	1.89	1.91
Costs/income ratio (%)	31.6	30.4	32.7	32.8	32.6	32.9
Bad debts % ARWAs	0.25	0.44	0.61	0.45	0.43	0.45
Tax rate (%)	0.0	0.0	0.0	0.0	0.0	0.0
Adj. Attr. earnings % ARWA	5.72	5.90	3.93	3.28	3.03	2.90
Capital leverage (ARWA/Equity)	7.9	7.0	6.5	7.9	8.2	7.8
ROTE (Adj. earnings/Ave. equity)	45.3	41.1	25.7	26.1	24.7	22.6

Source: Company data, Deutsche Bank estimates

Saudi British Bank (SABB)

Conservatively managed but thinly capitalised HSBC affiliate

Outlook

After experiencing strong growth in 2008, we believe SABB's business activity is set to slow sharply in 2009 and 2010. We see the bank posting mid-single-digit revenue growth with a relatively flat net special commission income profile acting as a drag on more robust fee and exchange income development. We also expect the cost-income ratio to remain relatively stable, while the loan loss charges are likely to remain high. We expect to see mid-single-digit net income growth in 2009-2010.

We have been impressed by SABB's progress in relation to its fee income and note that management has focused on improving cross-selling rates across the business.

Management has put in place a limited expansion plan (which should increase the number of branches to 78 by end-09). We believe this will have a limited impact on the bank's cost growth and could help improve the volume of retail deposits the franchise is able to attract.

We view SABB's relationship with its main shareholder, HSBC, in a positive light. In particular, we believe the Saudi bank can benefit from input in the areas of risk management (credit, market, liquidity and operational) and can also realise scale economies by sharing certain aspects of HSBC's infrastructure (such as IT systems). We believe the relationship with HSBC should also prove beneficial to SABB in areas such as funding.

We rate SABB as a Hold to reflect the premium to the sector at which the shares trade and the lack of clear positive drivers, in our view.

Valuation

We value the shares on a target price book multiple basis, using 2010 as our benchmark year and discounting back by the cost of equity. We assume a risk-free rate of 5.0%, an equity risk premium of 7.0% and a beta to the market of 0.82 (based on historical price performance). In common with our approach to other banks in the sector, we do not apply a long-term growth adjustment to our cost of capital calculation.

Our target price calculation takes into account our view that SABB's capital base is weaker than that of its peers.

Figure 239: SABB target price calculation summary

	Share Price	2010 ROE	Cost of equity	Fair P/book ratio	2010 NAV	PV Dividends			Capital Adjustment	Qualitative Adjustment	12-month	Upside/ (Down side)	Investment Rating
	SAR					2008E	2009E	2010E	SAR		Target Price		
SABB	62.00	23.3%	10.7%	217%	25.4	2.15	2.06	1.97	-0.9	0%	60.9	-2%	Hold
Sector Median		18.5%	11.3%	164%						0%		2.7%	

Source: Deutsche Bank. Share prices based on market close, 15 January 2009

SABB trades at a premium to the sector from a PE and PB perspective, but at a slight discount in terms of dividend yield.

Figure 240: SABB valuation multiples

	Share Price	P/E				PB				DY			
		2007A	2008E	2009E	2010E	2007A	2008E	2009E	2010E	2007A	2008E	2009E	2010E
SABB	62.00	14.3	12.5	11.5	11.1	3.57	3.12	2.74	2.44	3.8%	4.3%	4.3%	4.5%
Sector Median		9.5	10.2	9.5	9.2	2.30	2.02	1.80	1.62	2.9%	4.1%	4.1%	4.5%

Source: Deutsche Bank, Company data

Risks to our view

With net special commission income generating two-thirds of the bank's income, we are somewhat concerned that in recent quarters margins have started to decline more rapidly than past experience would suggest. It appears that the bank's funding costs are not declining as fast as asset yields. With interest rates set to remain low, we believe margin pressure is likely to persist.

Further, we note that SABB's investment portfolio is much more heavily skewed towards corporate issuers than other Saudi banks. With the economic environment deteriorating, we believe corporate bonds represent a higher risk than bonds issued by governments and related entities. We nevertheless view the overall default risk as low.

Although adequate by international standards, SABB's capital ratios appear low in a domestic context (9M08 equity assets ratio of 8.3% is significantly lower than the sector average of 12.5%). While we view the need for additional capital as remote, the lean capital structure leaves the bank more vulnerable to unexpected asset quality deterioration than its peers.

Key themes

Ownership structure viewed positively

With 40% ownership and management control, we believe HSBC can benefit SABB by sharing its significant emerging market expertise in areas such as risk management, marketing and product development. SABB can also benefit from HSBC's scale in relation to IT infrastructure and funding costs and utilise HSBC's global network of products and services to differentiate its offering from more domestically oriented competitors.

Non-brokerage fee income growing strongly

After seeing a significant decline in fee income in 2007, SABB has experienced more positive trends in 2008. We believe this improvement is driven primarily by non-brokerage products. Management has indicated that improved cross-selling has been a key focus of the organization. However, it remains to be seen whether this positive momentum can be maintained as loan and deposit volume growth slows.

Limited branch expansion plan

Management has indicated that it expects the bank's branch network to grow from 68 currently to 75 by end-09. We believe this growth can be justified given that the bank's business volume market share significantly exceeds that of its distribution network. We believe the new branches should modestly enhance the bank's ability to attract retail deposits.

Net special commission income margin pressure to persist

Recent quarters have seen a sharp decline in SABB's net special commission income margin (from 3.57% in FY07 to 2.81% in 9M08) as funding costs have resisted the decline in interest rates. With interest rates likely to remain low for a significant period of time, we believe margins will continue to trend lower in the coming quarters.

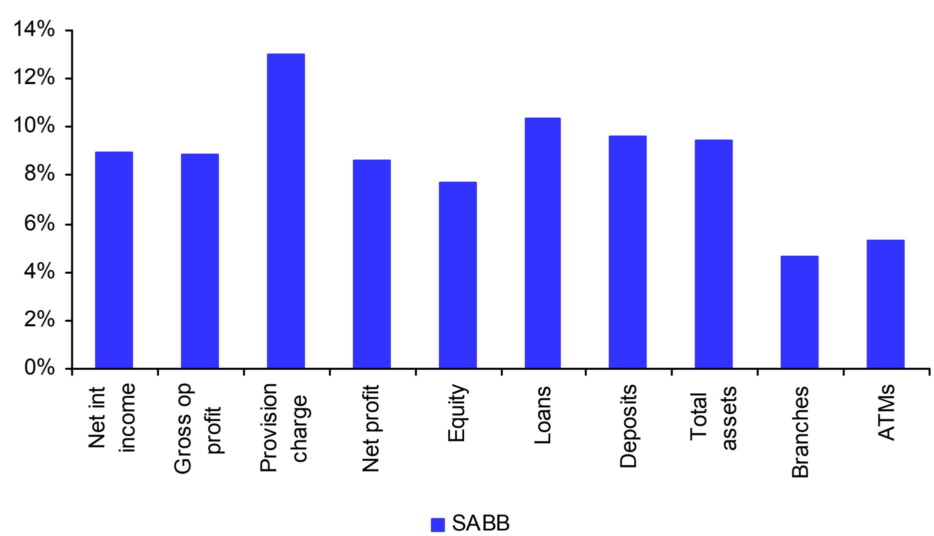
Investment portfolio skewed towards corporate issuers
With around half of SABB's investment portfolio skewed towards corporate issuers, and with the Saudi economy likely to slow, we believe the bank's investment portfolio is more exposed to default risk than its peers. We currently view the risk as low, however, and note that the vast majority of these corporate issues have an investment grade credit rating.

SABB is less well-capitalized than its peers
SABB's equity/assets ratio of 8.3% is significantly lower than the sector average (12.5%). While the bank enjoys the implicit support of HSBC, and we view the need for an equity issue as remote (not least as the bank's ratios appear adequate in an international context), the relatively lean capital structure does mean the bank is less well-placed than local peers to absorb the impact of unexpected asset impairment.

Business profile

SABB has a roughly 9-10% share of the Saudi banking market. The bank supports this level of activity with a relatively small network of 68 branches, partly reflecting a corporate banking skew to the business.

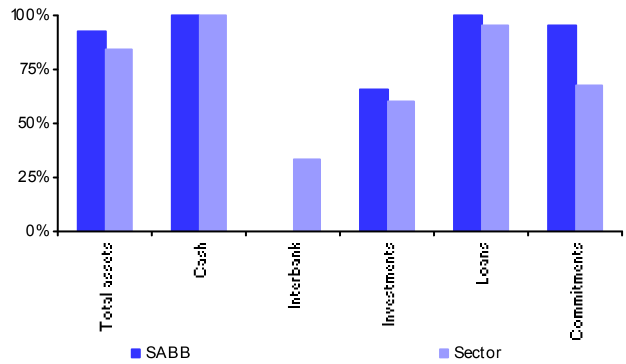
Figure 241: FY07 market shares



Source: Deutsche Bank, Company data

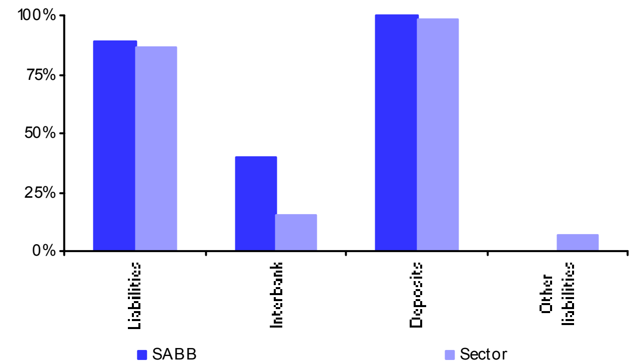
Geographic mix
SABB's business is overwhelmingly domestic, which is somewhat surprising given the bank's focus on corporate customers. We believe the bank's position within the HSBC group allows it to refer international business opportunities to its international partners, allowing management to focus on the domestic business. This approach could have positive risk management implications. The contrast with peers is most apparent in the case of off-balance sheet commitments, where SABB has limited exposure.

Figure 242: Geographic mix: assets



Source: Deutsche Bank, Company data

Figure 243: Geographic mix: liabilities



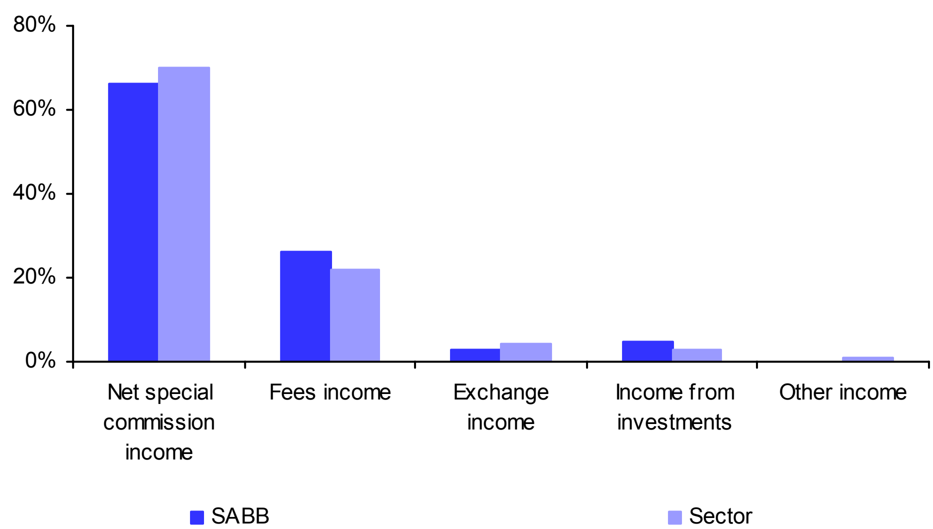
Source: Deutsche Bank, Company data

Revenues

Management has indicated that it is focusing its effort on growing non-capital markets-related revenue streams such as net special commission income and non-brokerage fee income.

In common with other Saudi banks, net special commission income is the key driver of revenues, accounting for around two-thirds of the total, broadly in line with the sector average.

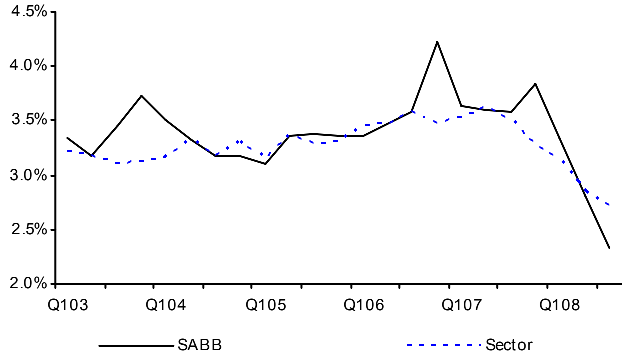
Figure 244: SABB revenue mix is slightly more skewed towards fee and investment-related income



Source: Deutsche Bank, company data

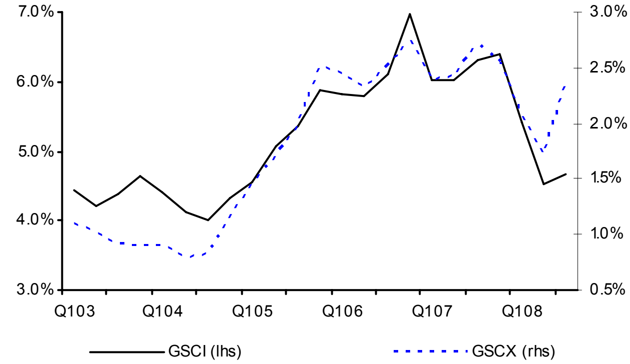
While the bank has previously been relatively immune to interest rate movements, in recent quarters the bank's net special commission income margin has fallen sharply, reflecting a limited decline in funding costs, despite sharply lower interest rates. In contrast, asset yields (particularly for loans) have experienced larger declines. As a result, SABB currently has one of the narrowest net special commission income margins in the sector.

Figure 245: SABB: net special commission income margin has declined rapidly in recent quarters



Source: Deutsche Bank, Company data

Figure 246: SABB: comparison of gross special commission income and expense yields



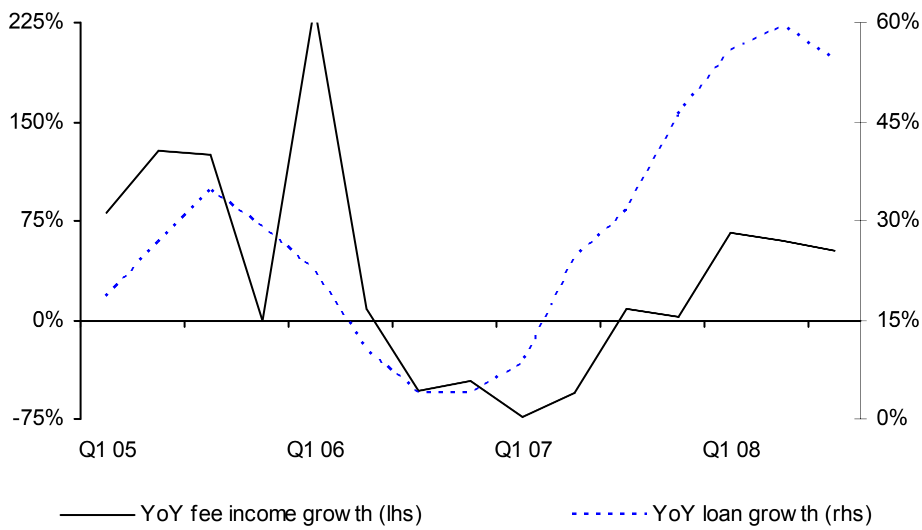
Source: Deutsche Bank, Company data

The bank is looking to expand the proportion of fees within its core revenue stream. In 2006, non-brokerage fees were equivalent to just 20% of core revenues; as of 9M08 the proportion had increased to 30% (trade finance has been a key growth driver). Management hopes that this figure will continue to rise to around 40%.

We note that brokerage income accounts for around 40% of SABB's fee income, slightly less than the 47% average for the sector (based on 2007 data). This could result in less volatility in the fee income line relative to peers.

This increase in fee income is being driven by increased efforts to cross-sell products. For example, new loan customers will also be offered insurance, trade finance products and so on.

Figure 247: Loan growth has been a key driver of the recent recovery in fee income



Source: Deutsche Bank, Company data

One of the key drivers of this cross-selling effort has been the decline in interest rates, which is putting downward pressure on the spread-based business. SABB notes that many banks in the sector have been enjoying a high level of free funding; the economics of their businesses are likely to be more challenging than for banks accustomed to a high cost of funds in the past.

A key driver of deteriorating fee growth trends over the past few years has been equity brokerage. In 2006, this revenue stream generated around 65%of group profits. Today we estimate that figure has declined to around 10%.

Operating costs

The company is currently investing in two key areas:

- Opening new branches – currently SABB has 68 branches; this should rise to 78 by the end of 2009. One of the key drivers of this investment is management's desire to attract more stable retail deposit funding. SABB's share of branch and ATM infrastructure is roughly half its share of business volumes, and we believe that this modest expansion of the business can be readily supported.
- IT infrastructure – the bank is shifting the business onto the latest HSBC systems

The other key driver of recent cost growth (18% in 9M08) has been the strong organic growth experienced by the bank.

Currently, the bank's cost-income ratio is 32%, which compares extremely favourably with the broader HSBC group. We believe the cost-income ratio is likely to stabilize around the current level.

Risks

Credit risk

The bank experienced acceleration in loan growth in 2008. We believe draw-downs on infrastructure project finance commitments have contributed to this trend.

For the corporate loan book (which accounts for around three-quarters of all loans), SABB uses the HSBC suite of risk metrics. This entails classifying each exposure into 7 risk buckets (with 7 being the poorest, 1 the best). HSBC group policy demands that 95% of the loan book falls into categories 1-3, a target which SABB comfortably exceeds. In common with other banks, SABB has not suffered any provisions on its corporate loan book over the past few years. The provisioning charges taken through the income statement are based on actuarial computations.

For retail loans, management indicated that customers have suffered over the past three years. They have lost money in the stock market and their borrowing capacity and financial condition has deteriorated as a result. Accordingly, growth trends for this segment of the credit market have been extremely sluggish.

In order to access growth in the retail segment, SABB is focusing its attention on the credit card segment. Here delinquency levels have been low since Q406 due to a tightening of credit standards at this time.

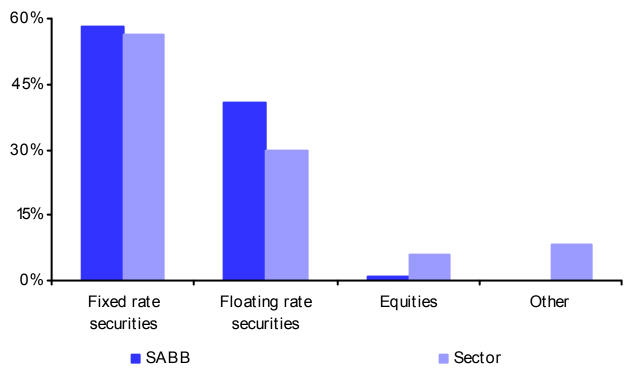
The bank's NPLs/loans ratio of 0.3% compares extremely favourably with the sector average of 1.8%, suggesting SABB's credit risk profile is favourable.

Market risk

SABB management has indicated that the company does not take significant proprietary trading positions . The main purpose of its trading book is to facilitate customer transactions. This assertion is confirmed by the bank's Basel II filings (as of H108).

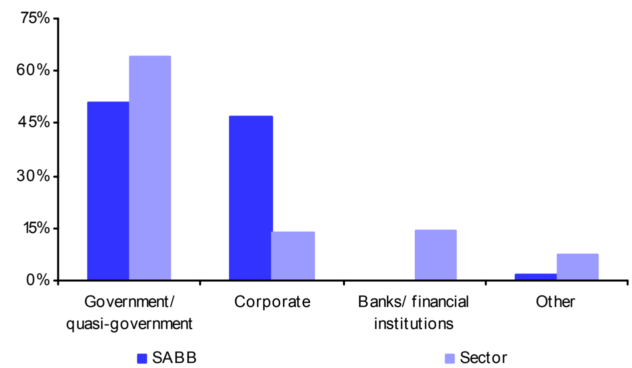
SABB did have some US sub-prime assets on its books, but these were substantially written down during H108. The bank also has a sizeable corporate bond portfolio. With economic conditions deteriorating globally and in the region, such exposures could prove more vulnerable than government-issued paper. However, we note that the vast majority of this paper has an investment grade rating, while the experience in other parts of the business suggests the organisation's risk appetite is fairly limited.

Figure 248: SABB: Investment mix by asset class (FY07)



Source: Deutsche Bank, Company data

Figure 249: SABB: Investment mix by issuer (FY07)



Source: Deutsche Bank, Company data

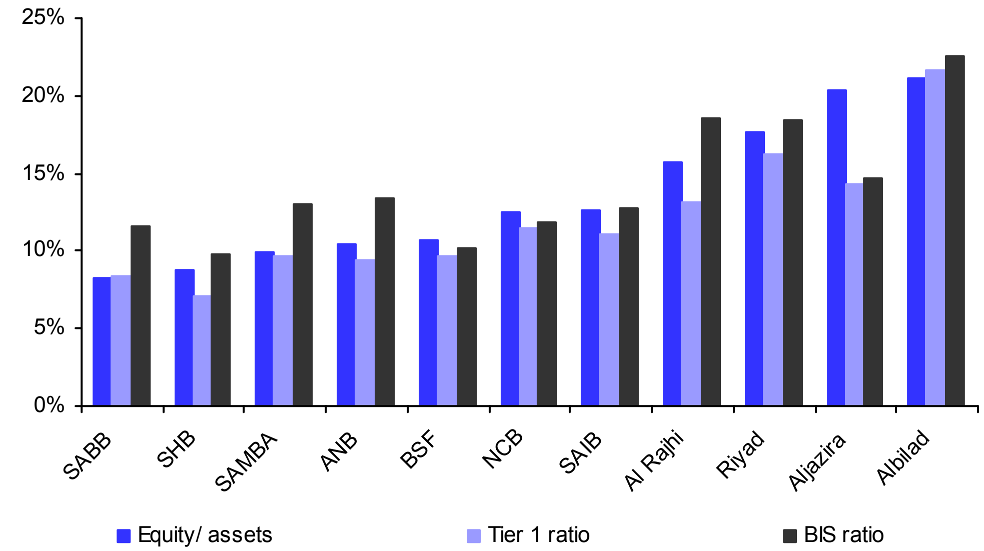
Liquidity risk

SABB complies with HSBC group liquidity criteria, which management believes is more conservative than policies employed by other Saudi banks. Comparing SABB's asset-liability maturity mismatch with its peers appears to support this claim; SABB's position is more balanced. The size of the bank's unfunded commitments portfolio is also smaller than the sector average.

Capital adequacy

Although adequate in an international context, SABB's capital ratios are lower than other Saudi banks. Although we believe the company has a low risk profile, this lean capital structure does leave less room for error than for better-capitalised entities. We note the bank does have scope to issue hybrid tier 1 and tier 2 securities, however.

Figure 250: SABB's capital strength ratios compare poorly with other banks in the sector (9M08)



Source: Deutsche Bank, Company data

Ownership

HSBC is the key owner of the business (40% of the shares) and has effective management control. The second-largest shareholder is the Olyan Saudi Investment Company, with a 17% stake. This investor also has a sizeable stake in Saudi Hollandi Bank. While a merger of these two entities could be facilitated by this common investor, we question whether such a transaction would make sense for shareholders. Cost synergies could be difficult to realize given labour market rigidities, and revenue attrition could occur due to the largely overlapping corporate client portfolios of the businesses.

Figure 251: Shareholder structure

Shareholder	Stake
HSBC	39.9%
Olayan Saudi Investment Co	17.0%
GOSI	9.5%
Free Float	33.6%

Source: Deutsche Bank

This page has been intentionally left blank.

Model updated:18 January 2009

Running the numbers

Middle East

Saudi Arabia

Banking

Samba Financial Group

Reuters: 1090.SE Bloomberg: SAMBA AB

Hold

Price (20 Jan 09)	SAR 39.30
Target price	SAR 52.30
52-week Range	SAR 39.30 - 149.00
Market Cap (m)	SARm 35,370 USDm 9,431

Company Profile

Established in 1980, and formerly known as Saudi American Bank, Samba Financial Group ranks as the second largest Saudi bank by assets. Market shares for many products are in the region of 15%, although the bank operates a relatively small network of around 65 branches and 470 ATMs. The bank offers a range of conventional and Islamic banking and investment services, with a high penetration of corporate and institutional customers. Government entities own around 40% of the shares

Rahul Shah

+971 4 4283-261 rahul.shah@db.com

Fiscal year end 31-Dec	2005	2006	2007	2008E	2009E	2010E
Data Per Share						
EPS (stated)(SAR)	4.46	5.79	5.36	5.14	5.05	5.18
EPS (DB) (SAR)	4.47	5.79	5.36	5.14	5.05	5.18
Growth Rate - EPS (DB) (%)	nm	29.6	-7.3	-4.2	-1.7	2.5
DPS (SAR)	1.87	2.27	2.93	2.50	2.50	2.50
BVPS (stated) (SAR)	10.64	17.00	19.83	22.47	25.02	27.70
Tang. NAV p. sh. (SAR)	10.64	17.00	19.78	22.47	25.02	27.70
Market Capitalisation	116,700	83,850	108,000	35,370	35,370	35,370
Shares in issue	900	900	900	900	900	900
Valuation Ratios & Profitability Measures						
P/E (stated)	29.0	16.1	22.4	7.6	7.8	7.6
P/E (DB)	29.0	16.1	22.4	7.6	7.8	7.6
P/B (stated)	12.2	5.5	6.1	1.7	1.6	1.4
P/Tangible equity (DB)	12.2	5.5	6.1	1.7	1.6	1.4
ROE(stated)(%)	34.9	36.9	29.1	24.3	21.3	19.6
ROTE (tangible equity) (%)	40.8	41.9	29.2	24.3	21.3	19.6
ROIC (invested capital) (%)	34.9	36.9	29.1	24.3	21.3	19.6
Dividend yield(%)	1.8	2.0	3.2	6.4	6.4	6.4
Dividend cover(x)	2.4	2.6	1.8	2.1	2.0	2.1
Profit & Loss (SARm)						
Net interest revenue	3,508	4,301	4,944	5,000	5,030	5,125
Non interest income	2,316	2,972	2,252	2,202	2,383	2,640
Commissions	2,122	2,696	2,050	2,250	2,350	2,525
Trading Revenue	143	262	199	-253	-2	75
Other revenue	51	14	3	205	35	40
Total revenue	5,824	7,273	7,196	7,202	7,413	7,765
Total Operating Costs	1,511	1,799	2,077	2,277	2,440	2,505
Employee Costs	910	1,186	1,289	1,350	1,400	1,450
Other costs	602	613	788	927	1,040	1,055
Pre-Provision profit/(loss)	4,313	5,474	5,230	5,125	5,223	5,460
Bad debt expense	298	264	312	300	425	600
Operating Profit	4,015	5,210	4,808	4,625	4,548	4,660
Pre-tax associates	0	0	0	0	0	0
Pre-tax profit	4,015	5,210	4,808	4,625	4,548	4,660
Tax	0	0	0	0	0	0
Other post tax items	3	0	20	0	0	0
Stated net profit	4,018	5,210	4,828	4,625	4,548	4,660
Goodwill	0	0	0	0	0	0
Extraordinary & Other items	3	0	0	0	0	0
Bad Debt Provisioning	0	0	0	0	0	0
Investment reval, cap gains / losses	0	0	0	0	0	0
DB adj. core earnings	4,021	5,211	4,828	4,625	4,548	4,660
Key Balance Sheet Items (SARm) & Capital Ratios						
Risk-weighted assets	80,544	93,211	117,749	163,861	176,797	189,734
Interest-earning assets	101,534	109,855	136,440	168,000	180,750	196,000
Customer Loans	62,386	67,028	80,553	97,500	102,500	110,000
Total Deposits	85,240	94,856	115,811	127,500	135,000	142,500
Stated Shareholder Equity	9,576	15,300	17,845	20,220	22,518	24,927
Equals: Tangible Equity	9,576	15,300	17,806	20,220	22,518	24,927
Tier 1 capital	12,906	15,300	17,936	18,145	20,443	22,853
Tier 1 ratio (%)	16	16	15	11	12	12
o/w core tier 1 capital ratio (%)	16.0	16.4	15.2	11.1	11.6	12.0
Credit Quality						
Gross NPLs/Total Loans(%)	3.55	2.28	2.33	2.97	4.15	5.36
Risk Provisions/NPLs(%)	124	182	160	113	86	72
Bad debt / Avg loans (%)	0.54	0.41	0.42	0.34	0.43	0.56
Bad debt/Pre-Provision Profit(%)	6.9	4.8	6.0	5.9	8.1	11.0
Growth Rates & Key Ratios						
Growth in revenues (%)	47	25	-1	0	3	5
Growth in costs (%)	16	19	15	10	7	3
Growth in bad debts (%)	63	-12	18	-4	42	41
Growth in RWA (%)	25	16	26	39	8	7
Net int. margin (%)	3.68	4.07	4.02	3.28	2.88	2.72
Cap.-market rev. / Total revs (%)	nm	nm	nm	nm	nm	nm
Total loans / Total deposits (%)	73	71	70	76	76	77
ROTE Decomposition						
Revenue % ARWAs	8.04	8.37	6.82	5.11	4.35	4.24
Net interest revenue % ARWA	4.84	4.95	4.69	3.55	2.95	2.80
Non interest revenue % ARWA	3.20	3.42	2.13	1.56	1.40	1.44
Costs/income ratio (%)	25.9	24.7	27.3	28.8	29.5	29.7
Bad debts % ARWAs	0.41	0.30	0.30	0.21	0.25	0.33
Tax rate (%)	0.0	0.0	0.0	0.0	0.0	0.0
Adj. Attr. earnings % ARWA	5.55	6.00	4.58	3.28	2.67	2.54
Capital leverage (ARWA/Equity)	7.4	7.0	6.4	7.4	8.0	7.7
ROTE (Adj. earnings/Ave. equity)	40.8	41.9	29.2	24.3	21.3	19.6

Source: Company data, Deutsche Bank estimates

Samba Financial Group

Profitable risk-taker

Outlook

We see Samba Financial Group's business volume growth declining sharply in 2009 and 2010, reflecting our top-down view that the Saudi economy is set to slow significantly.. In addition, we believe low interest rates are likely to put downward pressure on net special commission income margins. Overall we see revenues growing by around 4% annually, although Samba's high exposure to market risks could generate volatility around this figure. We see loan loss provisioning costs rising significantly, resulting in a flat earnings profile over the next two years, while return on equity is likely to dip below 20% by 2010.

We have a Hold recommendation on the shares. We believe the bank has a very strong corporate and investment banking franchise, while the retail arm of the business is also extremely profitable. The bank generates the highest revenues per branch and per employee in the sector, and cost efficiency is good. However, we do not view the valuation as compelling at current levels, as we believe the business is more exposed to credit and market risks than its peers.

Valuation

Figure 252: Samba Financial Group target price calculation summary

	Share Price	2010 ROE	Cost of equity	Fair P/book ratio	2010 NAV	PV Dividends			Capital Adjustment	Qualitative Adjustment	12-month	Upside/ (Down side)	Investment Rating
	SAR					2008E	2009E	2010E	SAR		Target Price		
Samba	45.90	19.6%	10.5%	186%	27.7	2.16	1.95	1.77	0.0	-10%	52.3	14%	Hold
Sector Median		18.5%	11.3%	164%						0%		2.7%	

Source: Deutsche Bank, Zawya,. Share price as of market close, 17 January 2009

Samba Financial Group trades broadly in line with the sector, with a slight PB premium and a modest dividend yield discount.

Figure 253: Samba Financial Group valuation multiples

	Share Price	P/E				P/book				DY			
		2007A	2008E	2009E	2010E	2007A	2008E	2009E	2010E	2007A	2008E	2009E	2010E
Samba	45.90	8.6	8.9	9.1	8.9	2.31	2.04	1.83	1.66	6.4%	5.4%	5.4%	5.4%
Sector median		9.5	10.2	9.5	9.2	2.30	2.02	1.80	1.62	2.9%	4.1%	4.1%	4.5%

Source: Deutsche Bank, Company data. Share price as of market close, 17 January 2009.

Risks to our view

We see a number of areas of risk at Samba Financial Group. From a revenue perspective, we note that the bank's net special commission income margin has declined substantially in the past few quarters. We believe this may partly reflect the bank's growing dependence on interbank funding, but we see this downward trend persisting in a sustained low interest rate environment.

From a credit risk perspective, we note that Samba's asset quality already lags peers (FY07 NPLs/loans ratio of 2.2% versus 1.7% sector average) and that the bank is one of the most exposed to the real estate and construction sectors (which consume 12% of the bank's loans, relative to 8% sector average). We believe loans to these sectors could deteriorate more sharply than other exposures, and see Samba's loan loss provisioning charges rising sharply in the coming years.

Samba is also the Saudi bank most exposed to market risks (the bank accounts for almost one-third of sector market risk, according to H108 Basel II disclosures). Investments account for one-third of Samba's balance sheet, which is the highest proportion in the sector. These investments are more likely to be international, and could prove to be more sensitive to the slowing global economy than domestic exposures. The bank also has a large derivatives portfolio. Samba's exposure to capital markets is likely to result in high earnings volatility, in our view.

We believe the bank also has elevated liquidity risk relative to its peers due to a significant mismatch between the contractual maturities of the bank's assets and liabilities and a recently increased dependence on wholesale funding.

Key themes

Strong and profitable corporate and investment banking franchise
We believe Samba is the leading corporate and investment banking franchise in the country. The bank generates high revenues from its employees and branches, and operating efficiency is also high. The bank's retail business is also highly profitable.

Elevated market risk
Samba accounts for almost one-third of the Saudi banking sector's market risk, according to H108 Basel II disclosures. The bank's investment portfolio accounts for around 35% of total assets, the highest proportion in the sector; a significant percentage (53%) of these securities are from foreign issuers that may be more affected by the ongoing global economic slowdown.

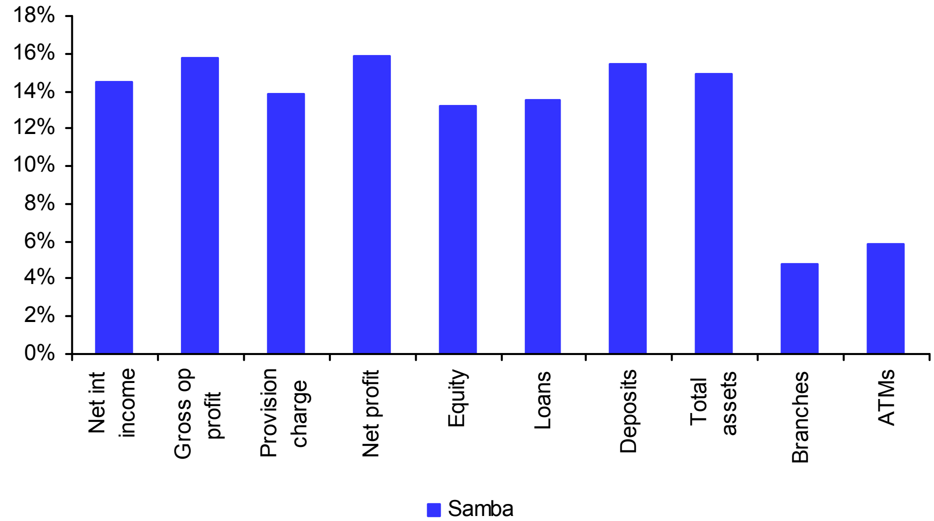
Credit quality currently lags peers and is likely to deteriorate further
Samba's NPLs/loans ratio at end-07 was 2.2%, above the sector average of 1.7%. We note that the bank has sizeable exposure to the real estate and construction industries (12% of loans, versus 8% for the sector). We believe the loan loss provisioning charge is likely to rise substantially from current levels.

Large derivatives portfolio
Samba has the largest derivatives portfolio in the country with a nominal value in excess of SAR250bn and a counterparty credit risk of SAR4.5bn (as at 9M08). Even small fluctuations in the value of this portfolio could have a material impact on the bank's profitability.

Business profile

Samba has a market share of around 14% of the Saudi banking system. Its market share of business volumes significantly exceeds that of its distribution network, reflecting the bank's focus on corporate and investment banking.

Figure 254: Market share data (FY07)

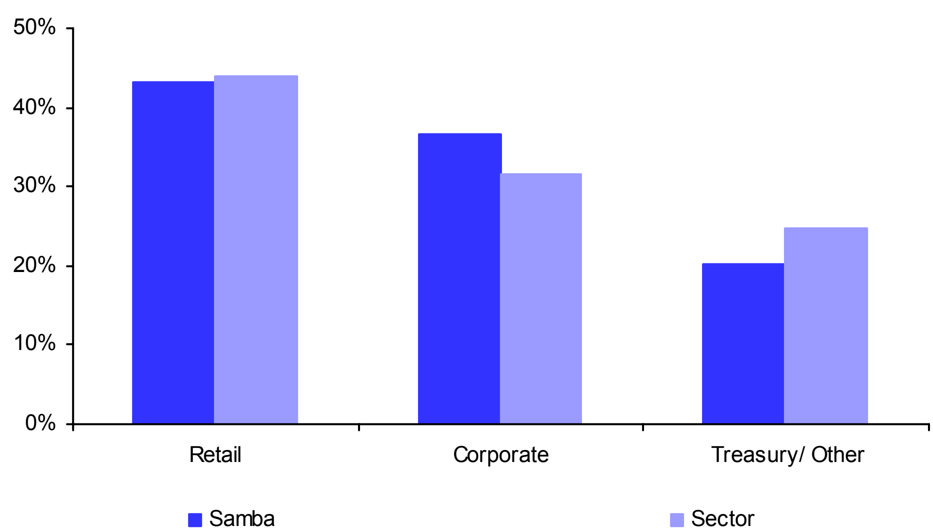


Source: Deutsche Bank, SAMA, Company data

Business mix

Somewhat surprisingly given Samba's large investment portfolio and seemingly high market risk appetite, the bank's treasury operations do not contribute a significant proportion of the bank's earnings. Indeed, based on the bank's divisional disclosures, the overall business mix profile appears broadly in line with the sector average.

Figure 255: Revenue mix by business division

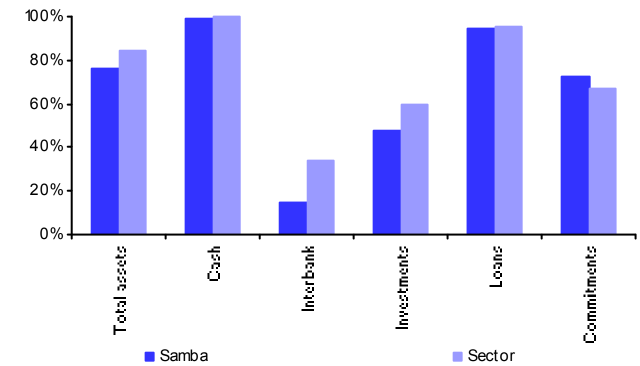


Source: Deutsche Bank, Company data

Geographic mix

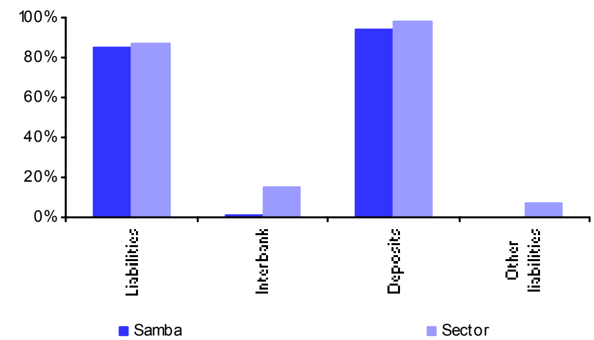
Samba's balance sheet appears less exposed to the domestic market than its peers. This partly reflects the lower weighting of customer loans in the asset base. However, the bank's sizeable investment portfolio is also more international than many of its peers.

Figure 256: Geographic mix: assets (% of domestic, FY07)



Source: Deutsche Bank, Company data

Figure 257: Geographic mix: liabilities (% of domestic, FY07)

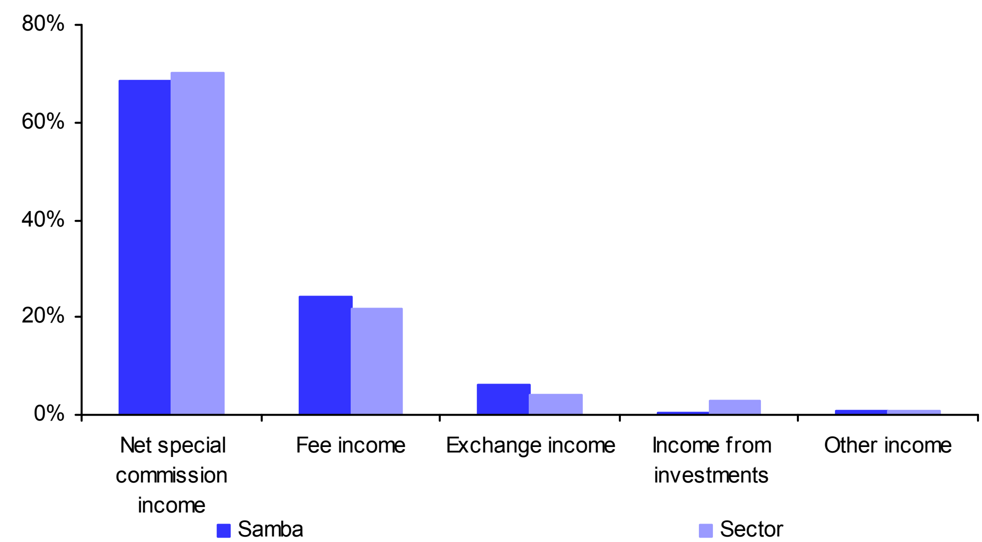


Source: Deutsche Bank, Company data

Revenues

Samba's revenue mix is broadly in line with the sector average. However, key differences include the relative importance of exchange income and the weak mark-to-market losses taken in parts of the investment portfolio. Samba has one of the larger investment portfolios and market risk profiles in the sector.

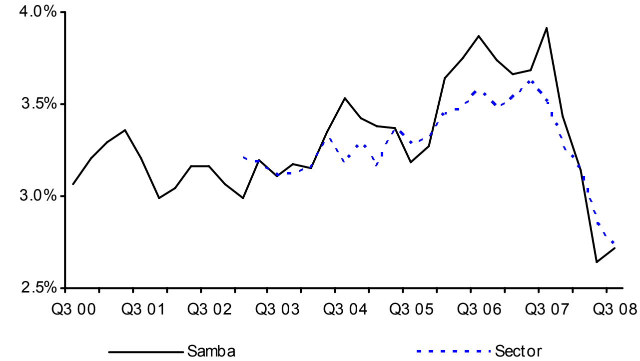
Figure 258: Revenue profile (H108)



Source: Deutsche Bank, Company data

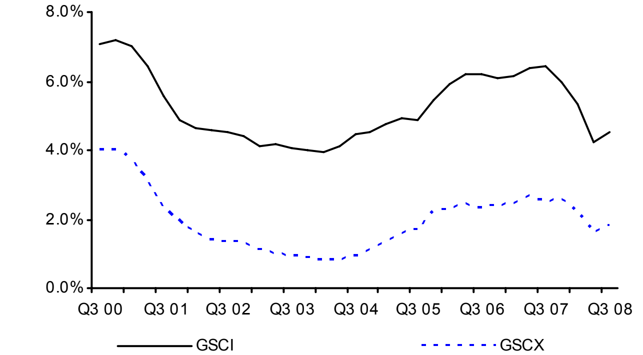
While the bank has previously been relatively immune to interest rate movements, in recent quarters the bank's net special commission income margin has declined sharply, reflecting a greater recent sensitivity of asset yield (in particular, corporate loans) to interest rate declines. We note that this margin decline has coincided with a sharp increase in the bank's dependence on interbank funding.

Figure 259: Net special commission income margin (as % of assets)



Source: Deutsche Bank, Company data

Figure 260: Gross special commission income and expense (as % of assets)



Source: Deutsche Bank, Company data

This margin decline has resulted in relatively sluggish net special commission income even as loan and deposit growth has remained robust.

In contrast, fee income has experienced a more favourable trend in recent quarters; while brokerage remains the biggest fee generator and is likely negatively affected by the downward trend in the Saudi stock market, corporate and trade finance fees appear to be faring well.

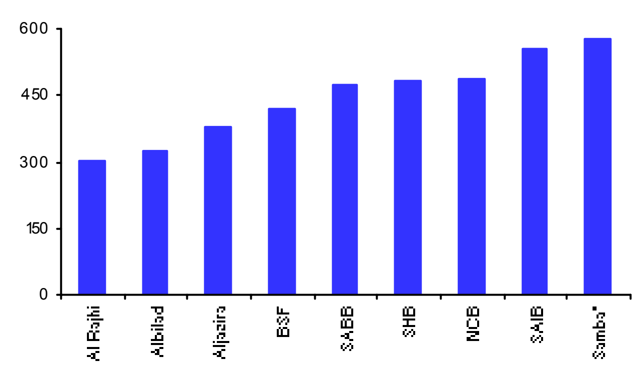
Owing to the weakening equity valuations, Samba has recorded significant mark-to-market losses of its investment portfolio over the past year. However, the bank was able to mitigate the impact of these losses through profitable disposals of certain non-trading assets. We question the sustainability of such positive disposal gains, however.

Operating costs

Samba's skew towards corporate and investment banking allows the bank to generate high volumes of business from relatively low levels of infrastructure. It is for this reason, we believe, that non-staff costs form a much smaller proportion of the cost base than at other Saudi banks (34% vs. 43% for the sector). A contributing factor is that Samba's staff is, on average, well-remunerated, which again reflects Samba's business mix skew towards corporate and investment banking.

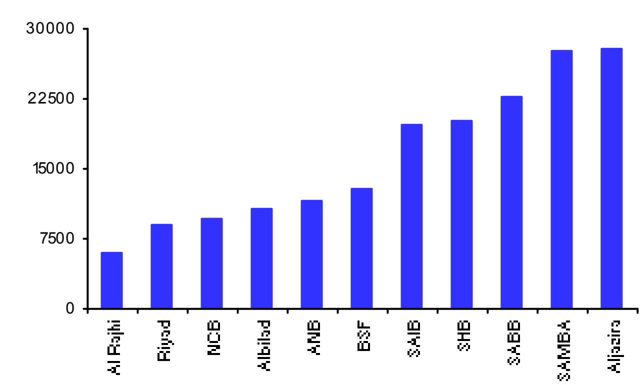
Indeed, Samba's cost base appears high relative to its peers across a broad range of metrics.

Figure 261: Operating costs per employee (FY07, SAR)



Source: Deutsche Bank, company data

Figure 262: Operating costs per branch (FY07, SAR)

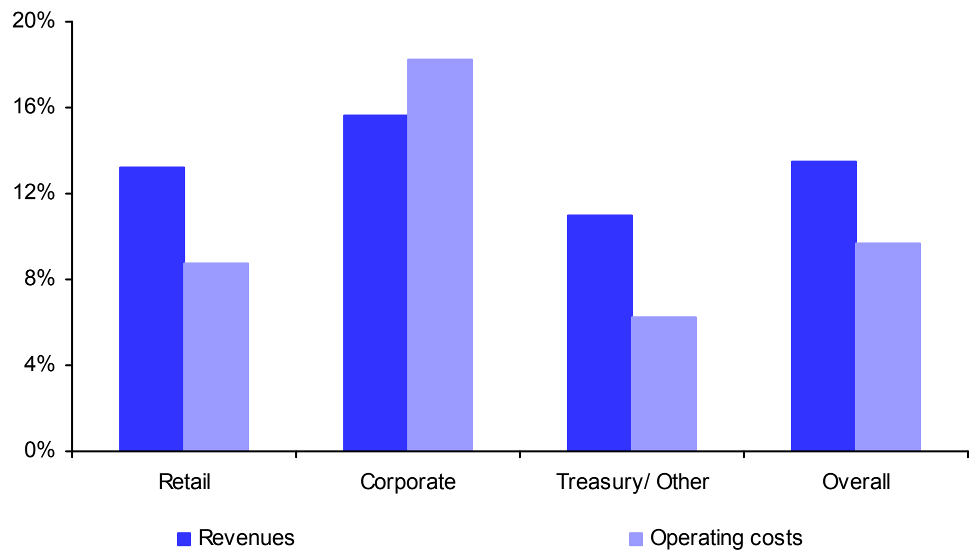


Source: Deutsche Bank, company data

Nevertheless, Samba's cost-income ratio is one of the lowest in the sector, as the bank is able to effectively deploy these high-cost resources to its advantage. The bank generates the highest revenues per branch and per employee in the sector.

While part of the reason for Samba's low cost-income ratio relates to its strong corporate banking franchise, we also believe that the bank has strong cross-selling capabilities, particularly in the retail segment.

Figure 263: Samba's retail and treasury operations enjoy cost advantages relative to peers (market share by division, H108)



Source: Deutsche Bank, Company data

Risks

Credit risk

Samba's credit quality appears to lag other Saudi banks, with non-performing loans of 2.3% above the 1.8% sector average. We also note that non-performing loans, past due but not impaired, and special mention loans together account for almost 10% of the loan book. In this context, the current bad debt charge appears a little low, not least given continued expansion of the loan portfolio.

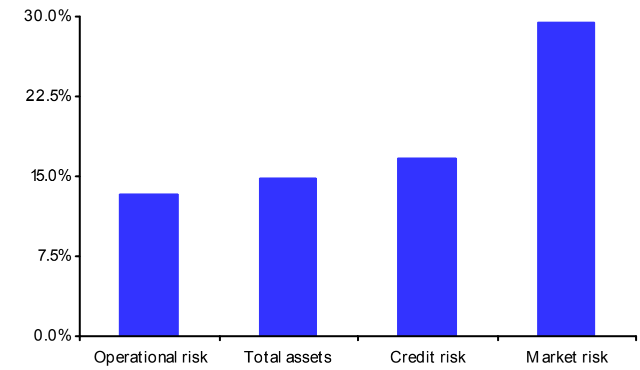
We note also that the bank's loan portfolio is more exposed to the real estate and construction sectors than average (12% of loans versus 8% for the sector). We believe this sector could be vulnerable to the current environment of tighter credit conditions and slowing economic growth.

Market risk

According to the Basel II disclosures presented by the Saudi banks as at June 2008, Samba has by far the greatest exposure to market risk of any of the banks. Almost one-third of the bank' assets comprise investments, the highest proportion in the Saudi banking sector. Samba also has an extensive derivatives portfolio.

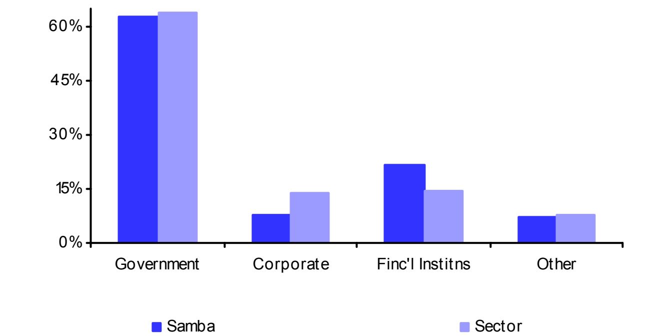
Relative to other Saudi banks, Samba's investment portfolio is more exposed to banks and financial institutions. While such investments may in the past have been viewed as low risk, the global financial crisis has significantly altered the investment landscape.

Figure 264: Samba's share of market risk is higher than for other risk categories (H108)



Source: Deutsche Bank, Company data. Note: Total assets data is end-07

Figure 265: Investment portfolio mix by issuer type (FY07)



Source: Deutsche Bank, Company data

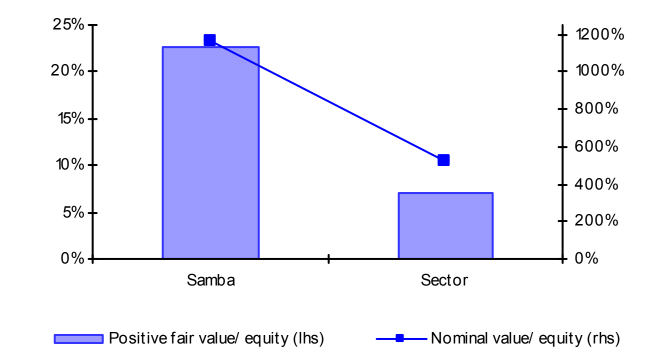
In this context, it is perhaps not surprising that Samba has recorded significant impairment provisions and mark-to-market losses against its investment portfolio in recent quarters.

We further note that Samba has the largest derivatives portfolios in the sector, in terms of both nominal value (SAR250bn) and counterparty credit risk (SAR4.5bn). The experience of Kuwait's Gulf Bank vividly demonstrates the need to actively manage counterparty credit risk in the current environment.

Figure 266: Samba's income from investments has turned negative in recent quarters (12m trailing data)

Source: Deutsche Bank, Company data

Figure 267: Samba's exposure to derivatives is significantly higher than the sector average



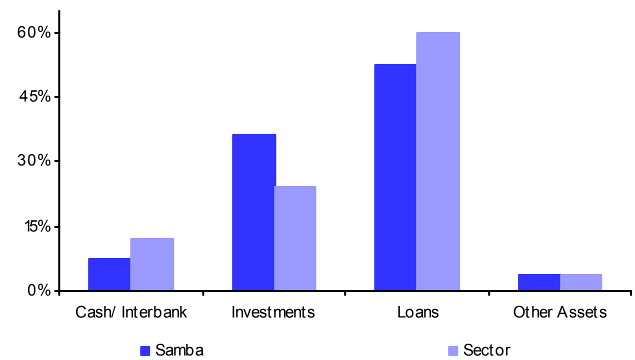
Source: Deutsche Bank, Company data

Liquidity risk

Like its corporate banking-focused peers, Samba has a large financial investments portfolio, which accounts for around one-third of total assets. Loans account for around half of total assets, a smaller proportion than the Saudi average. Accordingly, we believe Samba's asset base is relatively liquid.

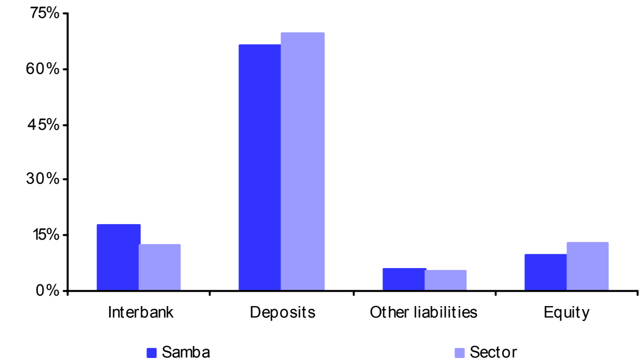
However, a key area of concern relates to the rapid acceleration in balance sheet growth in recent quarters. We note that deposits have not been able to keep pace with this shift, resulting in a much higher dependence on interbank funding (which has increased from 7% to 18% of total liabilities during the course of 2008). With interbank funding markets remaining tight, we doubt whether such facilities can be considered a stable source of long-term funding for the business.

Figure 268: Asset mix (H108)



Source: Deutsche Bank, Company data

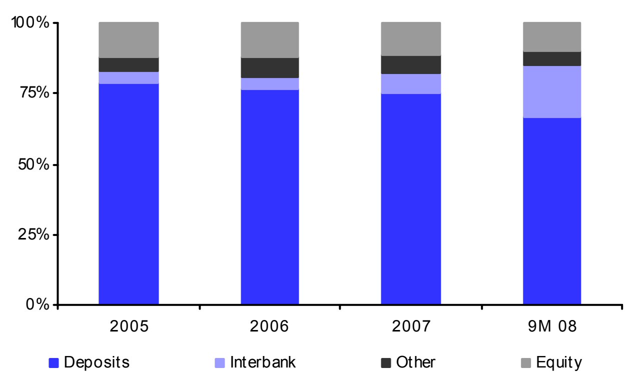
Figure 269: Liability mix (H108)



Source: Deutsche Bank, Company data

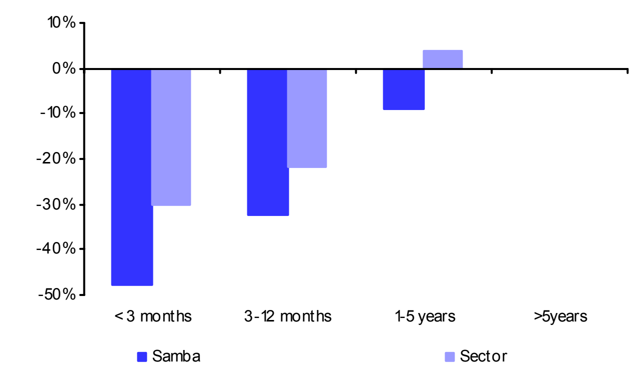
In addition, we note that, based on contractual maturities, Samba's balance sheet has a significant asset-liability mismatch, suggesting there would be some liquidity risk if, for example, shorter-term funding facilities were not renewed and Samba was unable to liquidate parts of its investment portfolio. The bulk of this mismatch arises from the long-dated nature of the bank's investment portfolio. If we assume these assets could be sold, then the mismatch would be significantly reduced; however, liquidity for many fixed income instruments is currently poor.

Figure 270: Samba's dependence on interbank funding has increased significantly in recent quarters



Source: Deutsche Bank, company data

Figure 271: Samba has a more significant asset-liability maturity mismatch than its peers



Source: Deutsche Bank, company data

Deposits

As of end-07, 36% of Samba's deposits were demand deposits, slightly lower than the sector average of 45%. Samba has traditionally experienced an overall cost of funds in line with the sector average, although this situation could change if the shift from customer deposits to interbank funds continues.

Ownership

Government entities own around 45% of Samba's shares. This is the highest level of government ownership in the listed Saudi banks sector.

Figure 272: Shareholder structure

Shareholder	Stake
Public Investment Fund	22.9%
GOSI	11.4%
Public Pension Agency	10.2%
Moen Abdulwahed Abdulmajid Al Aneh	7.7%
Kingdom Holding Co	5.0%
Free Float	42.8%

Source: Deutsche Bank, Company data

Model updated:21 January 2009

Running the numbers

Middle East

Saudi Arabia

Banking

Saudi Hollandi Bank

Reuters: 1040.SE Bloomberg: SHB AB

Hold

Price (20 Jan 09)	SAR 41.90
Target price	SAR 39.30
52-week Range	SAR 33.40 - 64.00
Market Cap (m)	SARm 11,087 USDm 2,956

Company Profile

Founded in 1926 as the first bank in Saudi Arabia, Saudi Hollandi Bank today has close to a 5% share of the domestic banking market. Saudi Hollandi operates a network of around 45 branches and 190 ATMs, and provides a wide range of financial services to a client base skewed towards corporates and institutions. The bank is 40%-owned by the UK's RBS, following its takeover of ABN Amro.

Rahul Shah
+971 4 4283-261 rahul.shah@db.com

Fiscal year end 31-Dec	2005	2006	2007	2008E	2009E	2010E
Data Per Share						
EPS (stated)(SAR)	3.98	3.60	1.66	3.97	4.16	4.52
EPS (DB) (SAR)	3.98	3.59	1.66	3.97	4.16	4.52
Growth Rate - EPS (DB) (%)	nm	-9.6	-53.9	139.7	4.7	8.7
DPS (SAR)	1.43	0.71	0.71	1.50	1.75	2.00
BVPS (stated) (SAR)	13.88	16.09	17.18	19.65	22.06	24.58
Tang. NAV p. sh. (SAR)	13.88	16.09	17.18	19.65	22.06	24.58
Market Capitalisation	26,964	16,703	16,538	11,087	11,087	11,087
Shares in issue	265	265	265	265	265	265
Valuation Ratios & Profitability Measures						
P/E (stated)	25.6	17.5	37.7	10.6	10.1	9.3
P/E (DB)	25.6	17.6	37.7	10.6	10.1	9.3
P/B (stated)	7.3	3.9	3.6	2.1	1.9	1.7
P/Tangible equity (DB)	7.3	3.9	3.6	2.1	1.9	1.7
ROE(stated)(%)	31.0	24.0	10.0	21.6	19.9	19.4
ROTE (tangible equity) (%)	28.6	24.0	10.0	21.6	19.9	19.4
ROIC (invested capital) (%)	31.0	24.0	10.0	21.6	19.9	19.4
Dividend yield(%)	1.8	0.8	1.4	3.6	4.2	4.8
Dividend cover(x)	2.8	5.1	2.3	2.6	2.4	2.3
Profit & Loss (SARm)						
Net interest revenue	1,014	1,193	1,223	1,475	1,570	1,675
Non interest income	704	753	553	725	794	869
Commissions	653	683	475	605	680	750
Trading Revenue	48	70	74	115	109	114
Other revenue	3	1	4	5	5	5
Total revenue	1,718	1,946	1,776	2,200	2,364	2,544
Total Operating Costs	567	643	842	925	1,014	1,073
Employee Costs	327	369	465	540	610	650
Other costs	240	274	376	385	404	423
Pre-Provision profit/(loss)	1,151	1,303	935	1,275	1,350	1,471
Bad debt expense	99	349	496	225	250	275
Operating Profit	1,052	955	439	1,050	1,100	1,196
Pre-tax associates	0	0	0	0	0	0
Pre-tax profit	1,052	955	439	1,050	1,100	1,196
Tax	0	0	0	0	0	0
Other post tax items	0	-2	0	0	0	0
Stated net profit	1,052	953	439	1,050	1,100	1,196
Goodwill	0	0	0	0	0	0
Extraordinary & Other items	0	-2	0	0	0	0
Bad Debt Provisioning	0	0	0	0	0	0
Investment reval, cap gains / losses	0	0	0	0	0	0
DB adj. core earnings	1,052	951	438	1,050	1,100	1,196
Key Balance Sheet Items (SARm) & Capital Ratios						
Risk-weighted assets	31,213	34,488	37,304	63,037	67,827	73,627
Interest-earning assets	37,595	42,963	45,781	57,500	61,500	66,500
Customer Loans	23,777	26,480	27,555	39,500	42,500	46,000
Total Deposits	28,565	32,414	34,605	46,000	50,000	55,000
Stated Shareholder Equity	3,672	4,258	4,547	5,200	5,837	6,504
Equals: Tangible Equity	3,672	4,258	4,547	5,200	5,837	6,504
Tier 1 capital	3,672	4,258	4,547	4,591	5,228	5,895
Tier 1 ratio (%)	12	12	12	7	8	8
o/w core tier 1 capital ratio (%)	11.8	12.3	12.2	7.3	7.7	8.0
Credit Quality						
Gross NPLs/Total Loans(%)	1.26	2.59	3.91	4.05	5.41	6.90
Risk Provisions/NPLs(%)	158	114	110	88	71	58
Bad debt / Avg loans (%)	na	1.39	1.83	0.67	0.61	0.62
Bad debt/Pre-Provision Profit(%)	8.6	26.8	53.0	17.6	18.5	18.7
Growth Rates & Key Ratios						
Growth in revenues (%)	nm	13	-9	24	7	8
Growth in costs (%)	na	13	31	10	10	6
Growth in bad debts (%)	nm	251	42	-55	11	10
Growth in RWA (%)	nm	10	8	69	8	9
Net int. margin (%)	2.95	2.96	2.76	2.86	2.64	2.62
Cap.-market rev. / Total revs (%)	nm	nm	nm	nm	nm	nm
Total loans / Total deposits (%)	83	82	80	86	85	84
ROTE Decomposition						
Revenue % ARWAs	11.01	5.92	4.95	4.39	3.61	3.60
Net interest revenue % ARWA	6.49	3.63	3.41	2.94	2.40	2.37
Non interest revenue % ARWA	4.51	2.29	1.54	1.45	1.21	1.23
Costs/income ratio (%)	33.0	33.0	47.4	42.0	42.9	42.2
Bad debts % ARWAs	0.64	1.06	1.38	0.45	0.38	0.39
Tax rate (%)	0.0	0.0	0.0	0.0	0.0	0.0
Adj. Attr. earnings % ARWA	6.74	2.90	1.22	2.09	1.68	1.69
Capital leverage (ARWA/Equity)	4.3	8.3	8.2	10.3	11.9	11.5
ROTE (Adj. earnings/Ave. equity)	28.6	24.0	10.0	21.6	19.9	19.4

Source: Company data, Deutsche Bank estimates

Saudi Hollandi Bank

Favourable revenue positioning offset by capital concerns

Outlook

We see business volume growth slowing sharply at Saudi Hollandi Bank, in line with expected sector trends, as sluggish global economic growth and lower oil prices negatively impact the domestic operating environment. We believe SHB will experience superior net special commission income growth compared to other Saudi banks, as the bank's margins are less sensitive to falling interest rates. Fee income should also benefit from the bank's limited exposure to equity brokerage revenue. We believe revenue and gross operating profit development at the bank should be in the high single-digits and better than the sector average. However, the bank will continue to experience asset quality deterioration, resulting in moderately higher loan loss provisioning charges. We see earnings growth in the high single-digits over the next two years.

While income statement trends should be broadly positive, we do see a number of areas of concern. The bank is relatively thinly capitalised, while its credit quality experience has also been inferior to its peers.

We have a Hold rating on the shares, which we see as reasonably valued on a standalone basis.

Valuation

We value the shares on a target price book multiple basis, using 2010 as our benchmark year and discounting back by the cost of equity. We assume a risk-free rate of 5.0%, an equity risk premium of 7.0% and a beta to the market of 0.79 (based on historical price performance). In common with our approach to other banks in the sector, we do not apply a long-term growth adjustment to our cost of capital calculation.

Our target price calculation takes into account our view that Saudi Hollandi Bank has higher exposure to credit and market risks than its peers. We also make a valuation adjustment to account for the bank's inferior capital strength compared to the sector average.

Figure 273: Saudi Hollandi Bank target price calculation summary

	Share Price	2010 ROE	Cost of equity	Fair P/book ratio	2010 NAV	PV Dividends			Capital Adjustment	Qualitative Adjustment	12-month	Upside/ (Down side)	Investment Rating
	SAR					2008E	2009E	2010E	SAR		Target Price		
Saudi Hollandi Bank	39.10	19.4%	11.6%	167%	24.6	1.28	1.34	1.37	-1.5	-10%	39.3	1%	Hold
Sector Median		18.5%	11.3%	164%						0%		2.7%	

Source: Deutsche Bank, Zawya. Prices as of market close, 17 January 2009

The shares are trading broadly in line with the sector on PE, PB and dividend yield measures.

Figure 274: Saudi Hollandi Bank valuation multiples

	Share Price	P/E				P/B				DY			
		2007A	2008E	2009E	2010E	2007A	2008E	2009E	2010E	2007A	2008E	2009E	2010E
Saudi Hollandi Bank	39.10	23.6	9.9	9.4	8.7	2.28	1.99	1.77	1.59	1.8%	4.5%	4.5%	5.1%
Sector median		9.5	10.2	9.5	9.2	2.30	2.02	1.80	1.62	2.9%	4.1%	4.1%	4.5%

Source: Deutsche Bank, Company data, Zawya. Prices as of market close, 17 January 2009

Risks to our view

A key concern relates to the bank's poor asset quality track record. Despite limited retail banking exposure, the bank's NPLs/loans ratio has been significantly above the sector average, and loan loss provisioning charges in both 2006 and 2007 were high. With the economic environment deteriorating, we believe SHB will experience further declines in asset quality and project an NPLs/loans ratio of 6.9% in 2010. In this context, the bank's relatively high exposure to the real estate and construction sectors (11% of loans, compared to the sector average of 8%) is a concern.

With asset quality deteriorating, investors may increasingly focus on the capital base of the company. The bank has an equity/assets ratio of 8.7%, significantly below the sector average of 12.5%, suggesting that the bank has less scope to absorb unexpected losses.

Moreover, we believe that the bank's core shareholder, the UK's RBS group, could be unwilling to inject additional capital into the bank if the need arose. RBS has encountered difficulties of its own; the UK government has become a key shareholder of the business and imposed some restrictions on how the bank may utilize its capital. A scenario of deteriorating asset values could therefore result in enhanced strategic uncertainty.

Key themes

Limited sensitivity of net special commission income to falling interest rates
As a result of its limited retail banking franchise (hence limited access to low cost deposits) and small equity funding base, SHB's funding costs are broadly as sensitive to interest rate moves as its assets. Accordingly, the bank's net special commission income stream should prove relatively immune to the low interest rate environment we believe will persist over the coming one to two years.

Low exposure to equity brokerage fee income
Again as a result of its limited retail banking franchise, equity brokerage contributed to just one-third of the bank's 2007 fee income (compared to a sector average of around half). We see this revenue stream continuing to decline, and therefore view SHB's more limited exposure positively.

Poor asset quality track record
SHB experienced deterioration in its NPLs/loans ratio from 2.6% to 3.9% during 2007 (which is the last available data point). In contrast, sector NPLs/loans averaged around 1.7% over this period, when the macroeconomic environment was benign. We see economic conditions deteriorating in the coming years and believe sector loan quality will deteriorate. We see SHB's NPLs/loans ratio rising to close to 7% in 2010, compared to a sector average at this time of 5%.

Above-average exposure to the real estate sector
11% of SHB's loan portfolio consists of credit extended to the real estate and construction sectors. While low in an international context, this exposure is above the sector average of 8%. We believe the real estate sector could be at risk given the environment of tight credit and deteriorating economic fundamentals.

Low capital strength
SHB's equity/assets ratio is currently 8.7%, well below the sector average of 12.5%. We believe deteriorating asset quality or any unexpected impairment to the bank's investment portfolio could focus investor attention on this particular metric and raise concerns regarding the need for additional capital to be raised. We note that the bank is in the process of raising additional tier 2 capital.

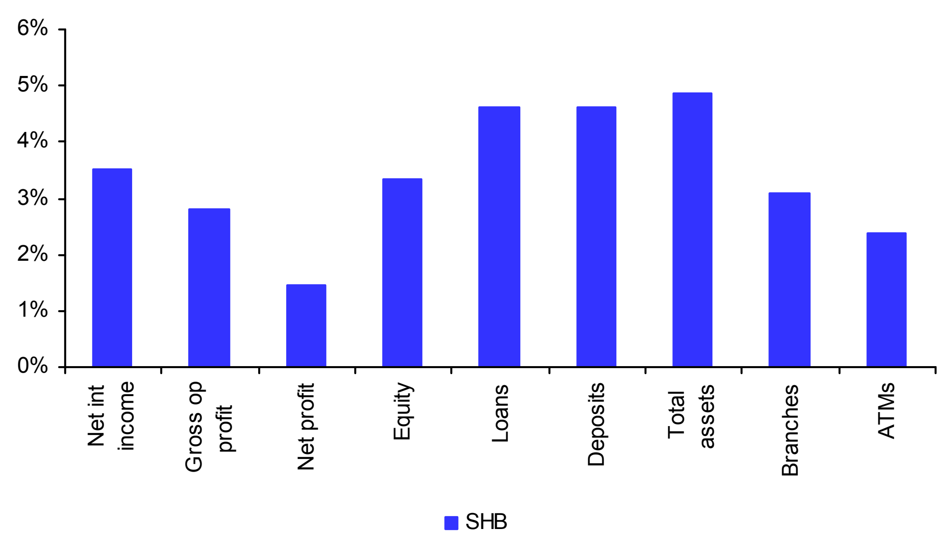
Ownership uncertainty
Following its acquisition of parts of the ABN Amro business, the UK's RBS Group has a 40% ownership stake in SHB. Having been recapitalised by the UK government, we believe investors may have concerns regarding this entity's commitment to the SHB business.

Business profile

Saudi Hollandi Bank has a market share of around 5%. Like other corporate banking-oriented entities, its share of business is higher than suggested by its branch network.

Unlike many of its peers, Saudi Hollandi Bank does not appear to be making a concerted push to expand its retail banking presence. The business mix remains skewed towards the corporate sector, which accounts for around 85% of the loan book. We believe this shift in mix accounts for a number of key differences in SHB's performance metrics relative to its peers. For example, the bank has a lower net interest margin and higher employee and branch productivity (as measured by business volume and revenue generation).

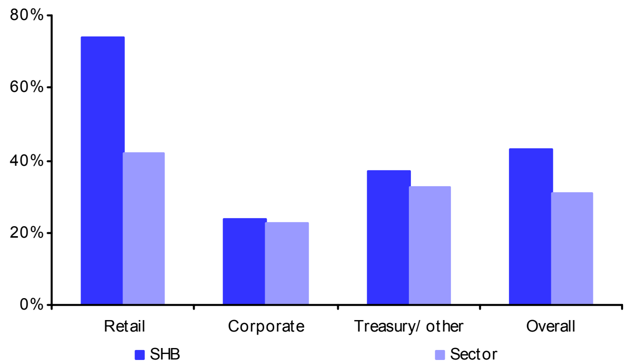
Figure 275: Market share data (FY07)



Source: Deutsche Bank, Company data, SAMA

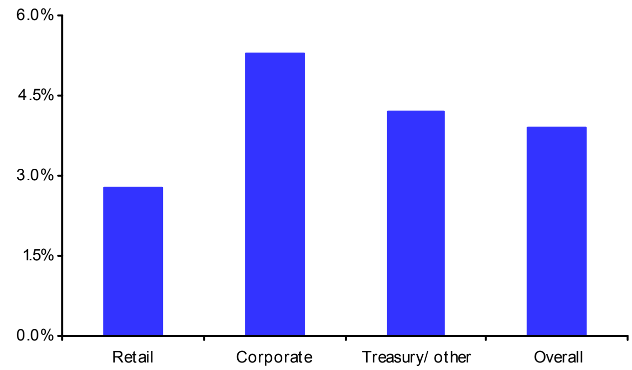
Business mix
SHB's business is highly targeted at the corporate sector, which together with treasury activities generates around 90% of net income. Indeed, the bank's retail banking operations may suffer from being sub-scale, with divisional cost-income ratio above 70%.

Figure 276: Divisional cost-income ratios (H108)



Source: Deutsche Bank, Company data

Figure 277: Divisional revenue market shares (H108)

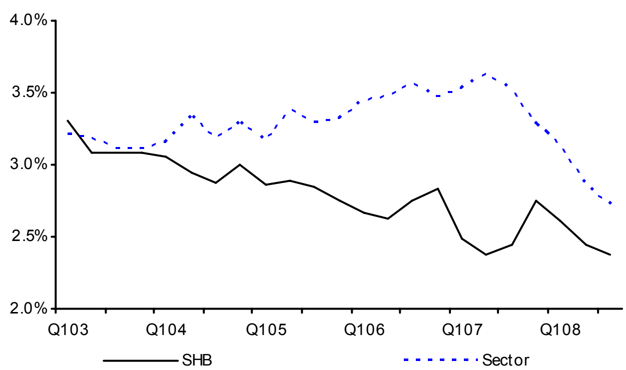


Source: Deutsche Bank, company data

Revenues

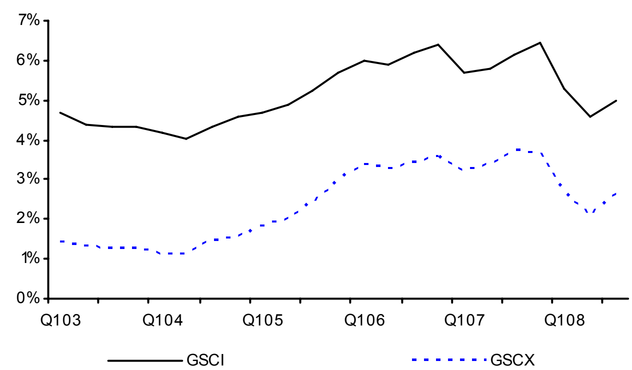
The bank has a lower net interest margin than most of its peers, reflecting its reliance on higher cost time deposits and its limited exposure to higher margin retail borrowers and savers. These features also account for the relative insensitivity of the bank's net special commission income margin to interest rates.

Figure 278: Net special commission income margin (as % of assets)



Source: Deutsche Bank, Company data

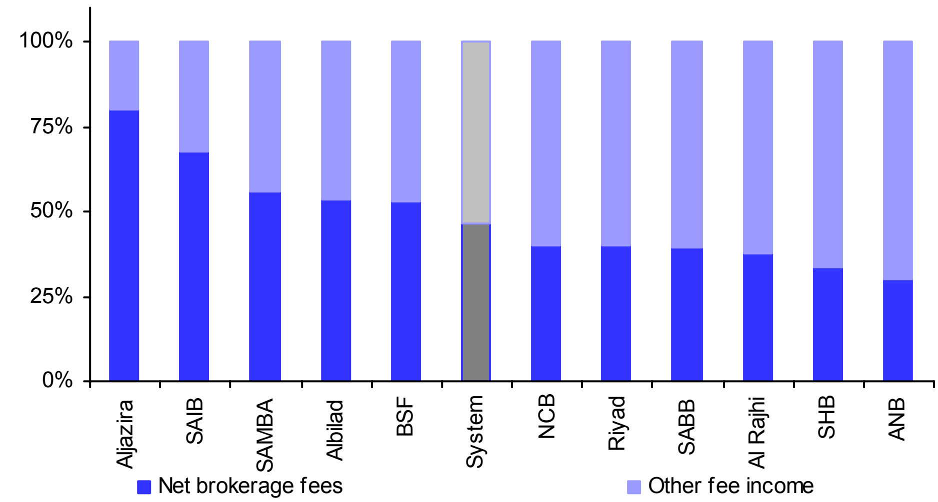
Figure 279: Saudi Hollandi Bank: Gross special commission income and expense (as % of assets)



Source: Deutsche Bank, Company data

Partly as a result of its limited retail banking franchise, the bank's fee income has not been as badly affected as others by the decline in share brokerage income. The bank's fee mix is more exposed to trade finance and corporate finance. We believe both of these areas could be hit if economic growth in Saudi Arabia slows significantly.

Figure 280: Fee income mix (FY07)



Source: Deutsche Bank, Company data

Income from the investment portfolio accounted for 6% of 9M08 revenues, roughly twice the sector average. The bulk of this income was from trading related to the bank's FX activities, reflecting the bank's strengths in trade finance and other cross-border business.

Risks

Credit risk

SHB's loan book is significantly skewed towards corporate customers, who account for almost 90% of outstanding credit. Relative to peers, the bank is the most exposed to the Manufacturing, Utilities, Construction and Commerce sectors.

During 2007, the most significant increase in non-performing loans took place in the corporate loans segment, particularly to clients in the Commerce sector. Corporate loans also saw the highest increase in past due but not impaired balances.

Given the bank's limited consumer credit exposure, we are somewhat concerned by the poor asset quality of the bank. The NPLs/loans ratio rose from 2.6% to 3.9% during 2007, while the sector average during this period was around 1.7%. In 2007 Saudi Hollandi Bank charged loan loss provisions equivalent to a whopping 180bps of its loan book (following a high 132bps in 2006).

Trends during the course of 2008 appear more benign. While no asset quality disclosures have been made, the provisioning charge against loans has declined significantly, while credit growth has also accelerated sharply.

We do believe that loan quality is likely to deteriorate in the coming years as economic growth slows. Given the bank's relatively poor track record in this area, we believe the SHB could be more greatly affected by this deterioration than its peers and see the NPLs/loans ratio approaching 7% in 2010 (versus an expected sector average at this time of 5%).

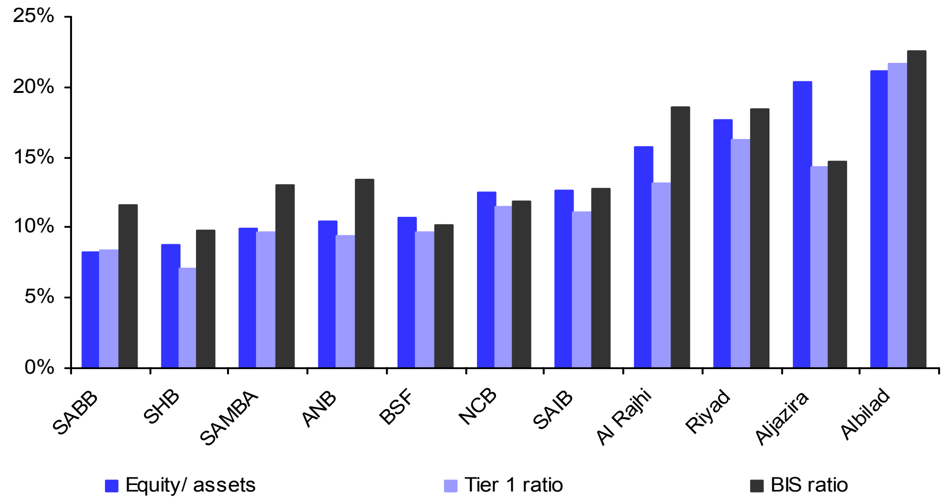
Funding mix

Time deposits comprise over two-thirds of SHB's deposit base, the highest proportion in the sector. This is the key reason why the bank's cost of deposit funds is among the highest in the sector. We believe this is a function of the bank's relatively weak distribution network (its 44 branches are just 2% of the national total) and customer skew towards corporates.

Capital adequacy

Saudi Hollandi bank has the lowest prudential ratios in the sector, a characteristic that has been enhanced by the recent acceleration in credit growth. The bank also has the lowest equity/assets ratio in the sector.

Figure 281: Capital strength ratios



Source: Deutsche Bank

Given a relatively lean capital structure, the bank could come under pressure to raise additional equity if it (or other sector participants) were to experience unexpected losses or suffer valuation impairments. However, we believe that the bank's main shareholder, RBS, would be unwilling to underwrite a rights issue given its own weakened state, suggesting that other than a change in control, the bank will need to boost its capital ratios via internal resources.

Ownership

In our view, the ownership structure of the bank generates uncertainty over the future direction of the business. RBS is a key shareholder, with a 40% stake in the business. However, the bank has recently encountered difficulties and is now majority-owned by the UK government. We believe RBS's management could be under pressure to dispose non-core assets in order to strengthen its balance sheet; the SHB stake could be open to review under such a scenario. The second key shareholder of the business is the Olayan Group (21% stake), which is also a key owner of SABB (17% stake). However, we do not think a merger of these two entities is likely as potential cost synergies might be neutralized by lost revenues (both banks have large (and overlapping) corporate client franchises).

Figure 282: Ownership structure

Shareholder	Stake
RBS Group	39.9%
Olayan Saudi Investment Co	20.8%
GOSI	9.6%
Free Float	29.7%

Source: Deutsche Bank, Tadawul, Zawya

This page has been intentionally left blank.

Model updated:21 January 2009

Running the numbers

Middle East

Saudi Arabia

Banking

Saudi Investment Bank

Reuters: 1030.SE Bloomberg: SIBC AB

Buy

Price (20 Jan 09)	SAR 16.00
Target price	SAR 20.40
52-week Range	SAR 15.25 - 38.00
Market Cap (m)	SARm 7,200 USDm 1,920

Company Profile

Saudi Investment Bank was established in 1976. The bank offers a range of financial services to its predominantly corporate and institutional customers, and has a market share of around 4%. Reflecting its customer base, the bank has less access than its peers to cheap demand deposit funding, and has a higher exposure to fee income in its revenue base. SAIB operates a network of around 30 branches and 250 ATMs. Shareholders include the Saudi government and JP Morgan.

Rahul Shah
+971 4 4283-261 rahul.shah@db.com

Fiscal year end 31-Dec	2005	2006	2007	2008E	2009E	2010E
Data Per Share						
EPS (stated)(SAR)	2.36	4.46	1.83	1.51	1.77	2.16
EPS (DB) (SAR)	2.36	4.46	1.83	1.75	1.77	2.16
Growth Rate - EPS (DB) (%)	nm	88.5	-59.0	-4.0	0.8	22.0
DPS (SAR)	0.29	0.00	0.00	0.10	0.20	0.30
BVPS (stated) (SAR)	6.38	13.34	15.04	16.45	18.02	19.87
Tang. NAV p. sh. (SAR)	6.38	13.34	15.04	16.45	18.02	19.87
Market Capitalisation	0	0	0	7,200	7,200	7,200
Shares in issue	450	450	450	450	450	450
Valuation Ratios & Profitability Measures						
P/E (stated)	na	na	na	10.6	9.1	7.4
P/E (DB)	na	na	na	9.1	9.1	7.4
P/B (stated)	na	na	na	1.0	0.9	0.8
P/Tangible equity (DB)	na	na	na	1.0	0.9	0.8
ROE(stated)(%)	23.9	35.5	12.9	9.6	10.2	11.4
ROTE (tangible equity) (%)	37.1	45.2	12.9	11.1	10.2	11.4
ROIC (invested capital) (%)	23.9	35.5	12.9	11.1	10.2	11.4
Dividend yield(%)	na	na	na	0.6	1.3	1.9
Dividend cover(x)	8.2	nm	nm	15.1	8.8	7.2
Profit & Loss (SARm)						
Net interest revenue	786	1,030	1,056	1,050	1,075	1,110
Non interest income	730	1,526	579	359	497	575
Commissions	683	819	443	490	500	525
Trading Revenue	0	0	0	0	0	0
Other revenue	47	707	137	-131	-3	50
Total revenue	1,516	2,556	1,635	1,409	1,572	1,685
Total Operating Costs	352	454	716	735	657	580
Employee Costs	224	259	287	295	305	315
Other costs	128	194	430	440	352	265
Pre-Provision profit/(loss)	1,164	2,103	1,151	924	1,065	1,155
Bad debt expense	100	97	97	105	120	135
Operating Profit	1,064	2,006	822	569	795	970
Pre-tax associates	0	0	0	0	0	0
Pre-tax profit	1,064	2,006	822	569	795	970
Tax	0	0	0	0	0	0
Other post tax items	0	0	0	110	0	0
Stated net profit	1,064	2,006	822	679	795	970
Goodwill	0	0	0	0	0	0
Extraordinary & Other items	0	0	0	110	0	0
Bad Debt Provisioning	0	0	0	0	0	0
Investment reval, cap gains / losses	0	0	0	0	0	0
DB adj. core earnings	1,064	2,006	822	789	795	970
Key Balance Sheet Items (SARm) & Capital Ratios						
Risk-weighted assets	24,902	25,586	32,224	56,894	61,742	67,354
Interest-earning assets	37,868	38,767	43,814	52,500	55,750	59,750
Customer Loans	19,794	20,691	23,129	30,500	32,500	35,000
Total Deposits	27,858	27,931	32,768	43,000	47,000	51,000
Stated Shareholder Equity	2,871	6,001	6,770	7,404	8,109	8,944
Equals: Tangible Equity	2,871	6,001	6,770	7,404	8,109	8,944
Tier 1 capital	5,307	6,001	6,770	6,538	7,243	8,078
Tier 1 ratio (%)	21	23	21	11	12	12
o/w core tier 1 capital ratio (%)	21.3	23.5	21.0	11.5	11.7	12.0
Credit Quality						
Gross NPLs/Total Loans(%)	0.96	1.05	1.28	1.80	2.92	4.40
Risk Provisions/NPLs(%)	364	358	243	145	95	67
Bad debt / Avg loans (%)	na	0.48	0.44	0.39	0.38	0.40
Bad debt/Pre-Provision Profit(%)	8.6	4.6	8.4	11.4	11.3	11.7
Growth Rates & Key Ratios						
Growth in revenues (%)	nm	69	-36	-14	12	7
Growth in costs (%)	na	29	58	3	-11	-12
Growth in bad debts (%)	nm	-3	0	9	14	13
Growth in RWA (%)	nm	3	26	77	9	9
Net int. margin (%)	2.40	2.69	2.56	2.18	1.99	1.92
Cap.-market rev. / Total revs (%)	nm	nm	nm	nm	nm	nm
Total loans / Total deposits (%)	71	74	71	71	69	69
ROTE Decomposition						
Revenue % ARWAs	7.28	10.13	5.66	3.16	2.65	2.61
Net interest revenue % ARWA	3.77	4.08	3.65	2.36	1.81	1.72
Non interest revenue % ARWA	3.51	6.04	2.00	0.81	0.84	0.89
Costs/income ratio (%)	23.2	17.7	29.6	34.4	32.3	31.5
Bad debts % ARWAs	0.48	0.38	0.33	0.24	0.20	0.21
Tax rate (%)	0.0	0.0	0.0	0.0	0.0	0.0
Adj. Attr. earnings % ARWA	5.11	7.95	2.84	1.77	1.34	1.50
Capital leverage (ARWA/Equity)	7.3	5.7	4.5	6.3	7.6	7.6
ROTE (Adj. earnings/Ave. equity)	37.1	45.2	12.9	11.1	10.2	11.4

Source: Company data, Deutsche Bank estimates

Saudi Investment Bank

A well-capitalised corporate and investment banking business with potentially improving retail trends

Outlook

We see core banking revenues growing in the lower single-digits, reflecting an expected slowdown in business volume growth, net special commission income margin pressure and only modest fee income growth. Reported revenues should receive a boost as we see a reduction in negative valuation adjustments to the investment portfolio. Investment portfolio impairment charges are also expected to decline, more than compensating for modest increases in loan provision charges. Accordingly, we see the business averaging 20% earnings growth in 2009-10, one of the highest in the sector

We rate the shares a Buy. They are trading at a considerable discount to the sector, and we believe much of the potential negative newsflows that could be expected in the coming quarters is already reflected in the share price. The bank has already experienced a squeeze in its net special commission income margin, fee income has been sluggish and returns from the investment portfolio have shifted into negative territory. Indeed, we expect that a moderation in negative valuation adjustments/impairments related to the investment portfolio could allow the bank to post good earnings growth to 2010. We also note that the bank has limited exposure to derivatives and unfunded commitments, two areas with the potential to surprise on the downside. In addition, the bank is much more strongly capitalised than other corporate and investment banking-oriented Saudi banks.

Valuation

We value the shares on a target price book multiple basis, using 2010 as our benchmark year and discounting back by the cost of equity. We assume a risk-free rate of 5.0%, an equity risk premium of 7.0% and a beta to the market of 0.91 (based on historical price performance). In common with our approach to other banks in the sector, we do not apply a long-term growth adjustment to our cost of capital calculation.

Figure 283: Saudi Investment Bank target price calculation summary

	Share Price	2010 ROE	Cost of equity	Fair P/book ratio	2010 NAV	PV Dividends			Capital Adjustment	Qualitative Adjustment	12-month	Upside/ (Down side)	Investment Rating
	SAR					2008E	2009E	2010E	SAR		Target Price		
Saudi Investment Bank	15.35	11.4%	11.4%	100%	19.9	0.09	0.15	0.21	0.0	0%	20.4	33%	Buy
Sector Median		18.5%	11.3%	164%						0%		2.7%	

Source: Deutsche Bank, Zawya. Shares priced as at market close, 17 January 2009

Saudi Investment Bank trades at a discount to the sector in terms of PE and PB multiples. It trades at a premium from a dividend yield perspective.

Figure 284: Saudi Investment Bank valuation multiples

17 January 2009	Share Price	P/E				P/B				DY			
		2007A	2008E	2009E	2010E	2007A	2008E	2009E	2010E	2007A	2008E	2009E	2010E
Saudi Investment Bank	15.35	8.4	10.2	8.7	7.1	1.02	0.93	0.85	0.77	0.0%	1.3%	1.3%	2.0%
Sector median		9.5	10.2	9.5	9.2	2.30	2.02	1.80	1.62	2.9%	4.1%	4.1%	4.5%

Source: Deutsche Bank, Zawya, Company data.

Risks to our view

We believe Saudi Investment Bank's revenues are vulnerable in a number of areas. In relation to net special commission income, we note that the bank's funding costs have recently failed to respond to lower interest rates, resulting in a significant squeeze in margins. We believe this squeeze is likely to persist given our expectations of sustained low interest rates. In relation to fee income, we note that SAIB is relatively highly exposed to equity brokerage and mutual fund fees, revenue streams where we sees risks of further downside. Finally we note that the bank's investment portfolio has in the past been a significant contributor to income. While the current contribution of this portfolio is low, suggesting limited further downside (indeed, our forecasts point towards a reversal of some recent negative trends), these income streams are susceptible to significant volatility.

From a risk profile, we believe the business is reasonably well-positioned. However, the bank is much more exposed to the real estate and construction industries than its peers (these industries accounted for 18% of 2007 loans, compared to a sector average of 8%). With economic growth slowing and financing for real estate projects increasingly hard to obtain, we believe loan quality could deteriorate significantly in the coming years.

From a strategic positioning perspective, we note that the bank is looking to improve its performance in the retail banking arena. This is an area where SAIB's performance has significantly lagged its peers in recent years, in our view largely reflecting the bank's heavy exposure to equity brokerage. We see further downward pressure on equity brokerage revenues, but believe improved performance from other retail banking revenue drivers will allow SAIB market share in this area to stabilize or even improve.

Key themes

Capital base appears strong

SAIB is one of the better-capitalized corporate banking-focused entities. Our stress testing suggests the bank is well-placed to absorb reasonable expectations of asset impairment.

Exposure to derivatives and unfunded commitments is low

Somewhat surprisingly, given the importance of the bank's investment portfolio, SAIB's derivatives portfolio is small. The bank also has a relatively small portfolio of unfunded commitments, suggesting less liquidity risks from unexpected drawdowns would be less than for other institutions.

Retail banking franchise underperformance likely to be reversed

In recent years, SAIB has seen a more marked decline in the contribution of its retail banking business than those of peers. We believe this may reflect the importance of equity brokerage income within the retail banking franchise. With this revenue stream rapidly declining in importance and moderate branch expansion taking place, we believe some stabilization in the performance of this business is likely.

Net special commission income margins have deteriorated rapidly in recent quarters
SAIB's net special commission income margin has in the past proved relatively insensitive to interest rates, a reflection of the limited amount of interest-free funding that the bank has been able to attract, resulting in funding costs and asset yields moving broadly in tandem. This relationship has broken down in recent quarters, however, as funding costs have failed to fully respond to the impact of interest rate cuts. With interest rates likely to remain low for some time, we believe downward pressure on asset yields is likely to persist, suggesting margins will remain squeezed.

Fee income remains exposed to equity brokerage trends
In 2007, equity brokerage and mutual fund fees accounted for two-thirds of SAIB's fee income. As such, the bank remains exposed to a revenue stream that we believe is likely to continue to decline. While efforts to cross-sell other products are having a positive effect, this sectoral trend is likely to have a negative impact on the bank's relative fee income performance, in our view.

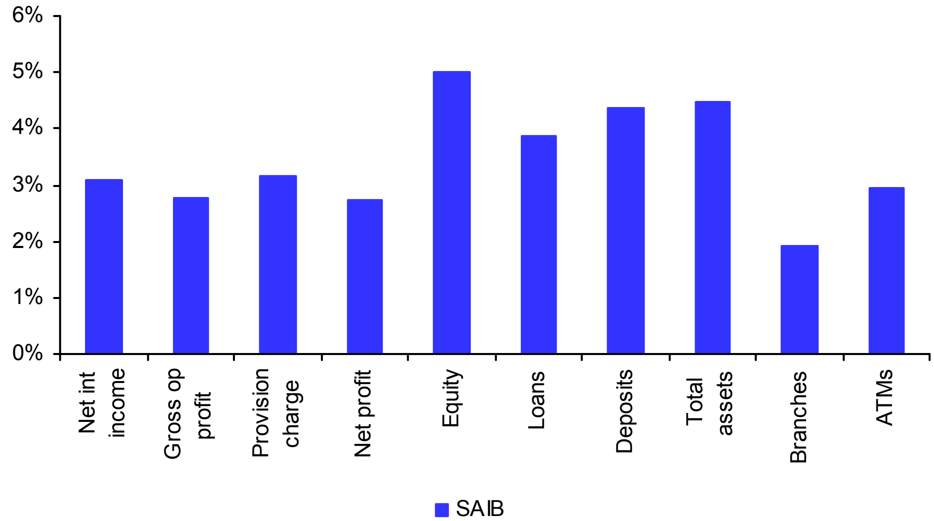
Income from the investment portfolio could generate earnings volatility
Income generated from the bank's investment portfolio has in the past been a significant contributor to the bank's revenues. Currently the contribution reflects negative valuation adjustments and impairments, suggesting an improved outlook is not unreasonable. However, we believe the bank's dependence on revenues from this source could result in high quarterly earnings volatility.

SAIB has significant exposure to the construction sector
Relative to other Saudi banks, SAIB's loan portfolio is the most exposed to the construction sector. 18% of SAIB's loans are to companies in the construction and real estate sectors, significantly above the 8% sector average. We believe this sector is particularly vulnerable to the current environment of tight lending conditions and slower economic growth. However, we note that the bank's recent asset quality track record has been good. The current NPLs/loans ratio of 1.3% is better than the sector average.

Business profile

Saudi Investment Bank has roughly 4% of the Saudi market. Focused on corporate and investment banking activities, the bank has less need of an extensive branch network than more retail-oriented entities.

Figure 285: Market share data (FY07)

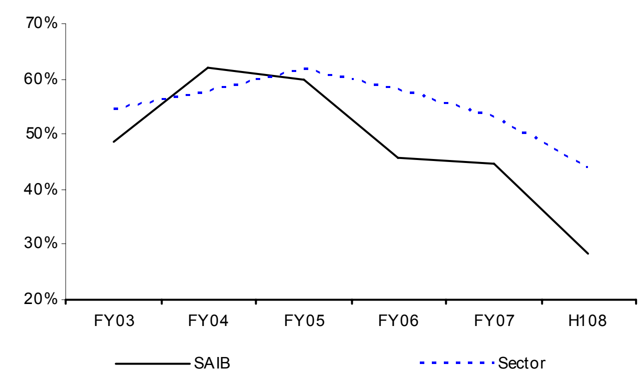


Source: Deutsche Bank, Company data, SAMA

Management and strategy

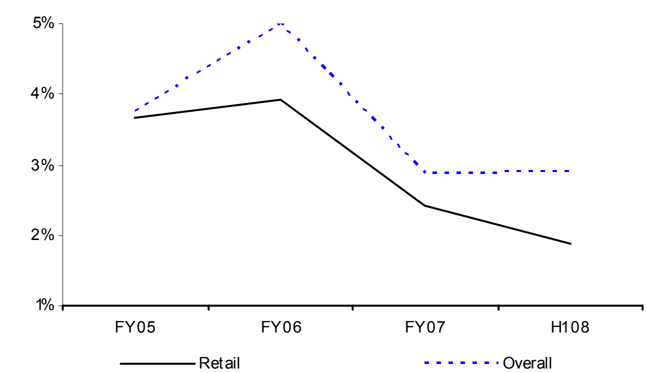
All Saudi banks have been experiencing deterioration in the contribution of retail banking earnings to their businesses in recent years, reflecting declining equity brokerage fees and more sluggish credit volumes than the corporate sector. However, SAIB's performance appears to have significantly lagged the sector.

Figure 286: Retail banking revenues: total revenues



Source: Deutsche Bank, Company data

Figure 287: SAIB: Retail and overall revenue market share trends



Source: Deutsche Bank, Company data

We believe bank management is trying to address the underperformance of the retail business. A modest branch opening programme is underway, while staff training and branch refurbishment programmes are also in place.

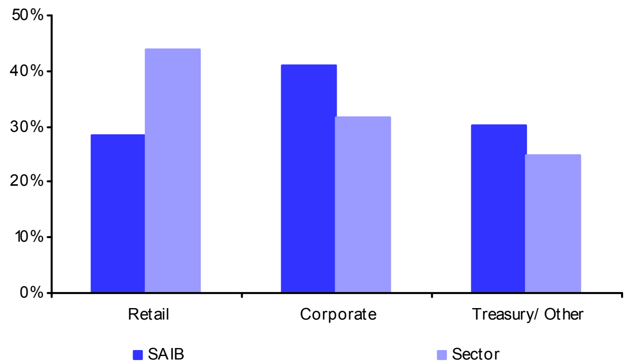
Business mix

Reflecting underperformance in this business area, SAIB is less exposed to retail banking than its peers. This activity generates less than a third of revenues and a quarter of income. In contrast, the bank's corporate banking division generates almost half of group earnings.

Geographic mix

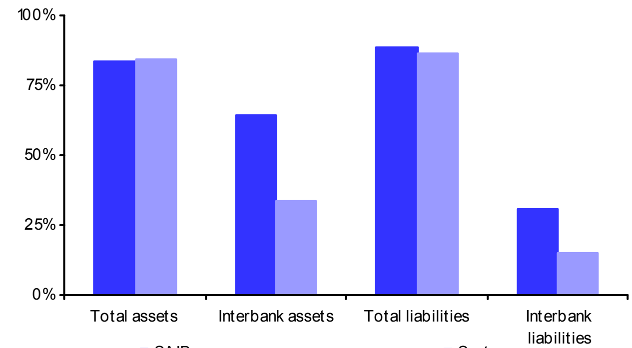
The geographic mix of SAIB's balance sheet is broadly in line with that of its peers. One interesting divergence relates to interbank assets. SAIB is the only bank whose interbank asset counterparties are predominantly domestic entities – other banks are much more reliant on international counterparties. We view SAIB's positioning in this area as less risky.

Figure 288: Revenue mix by business division (H108)



Source: Deutsche Bank, Company data

Figure 289: Geographic mix of assets and liabilities (FY07)

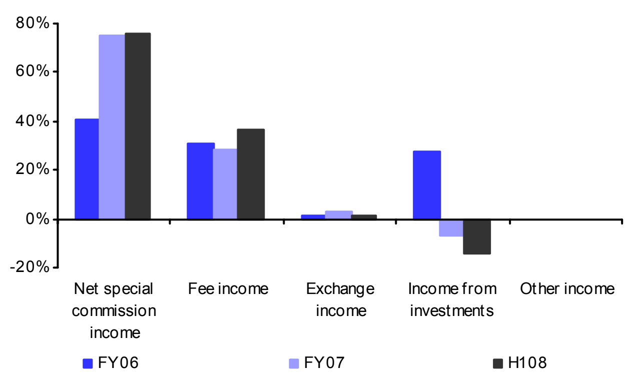


Source: Deutsche Bank, Company data

Revenues

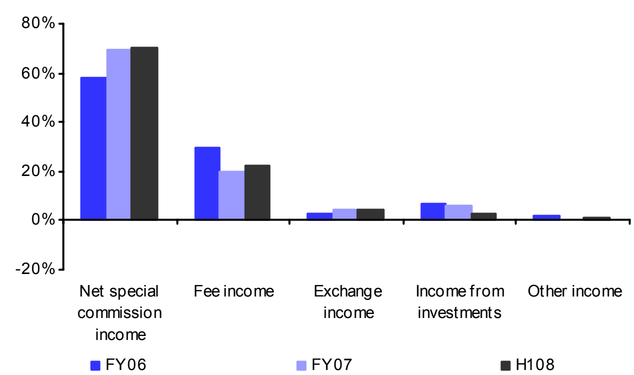
Somewhat surprisingly given SAIB's corporate and investment banking focus, net special commission income is a key driver of overall revenues. The key reason for this is the current weak performance of the bank's investment portfolio, while fee income generation is well short of the peak levels reached in prior years. Under more normal capital market conditions, we would expect SAIB's revenue profile to be much more diversified than the sector average.

Figure 290: Revenue mix: SAIB



Source: Deutsche Bank, Company data

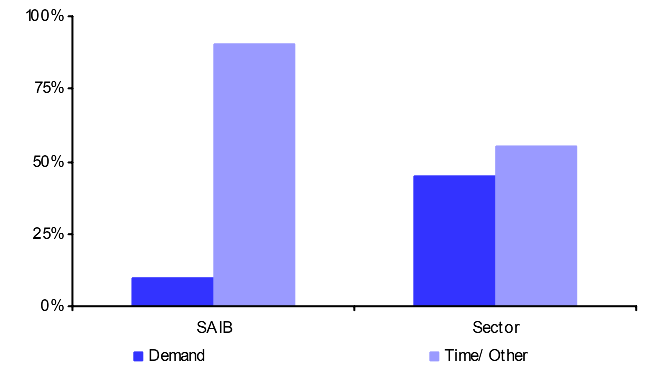
Figure 291: Revenue mix: sector



Source: Deutsche Bank, Company data

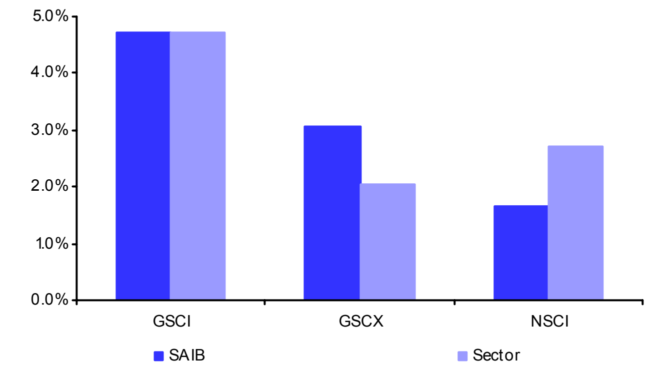
Only around 10% of SAIB's deposits are non-interest bearing, a much smaller proportion than is the case for other Saudi banks. This goes some way towards explaining the relatively high funding costs (and low net interest margins) experienced by the bank.

Figure 292: Deposit mix (FY07)



Source: Deutsche Bank, Company data

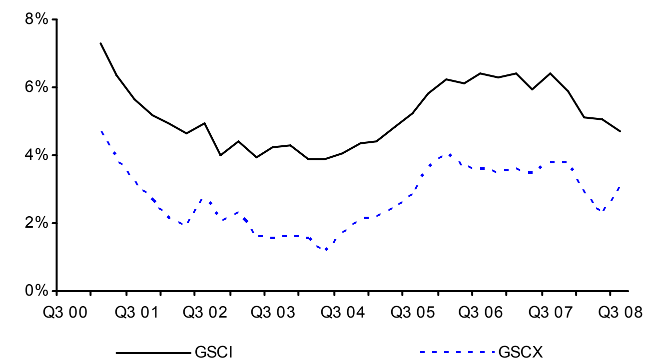
Figure 293: Special commission income gross and net margins (as % of assets Q308)



Source: Deutsche Bank, Company data

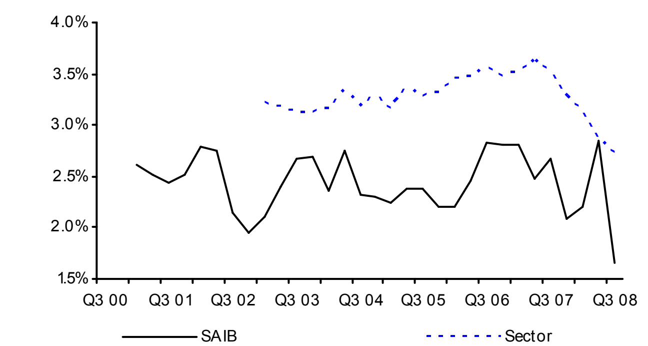
Although SAIB's asset yield and funding costs are highly sensitive to interest rate moves, the effect tends to cancel, resulting in a relatively stable net special commission income margin. As with other Saudi banks, the recent net interest margin trend has been unfavourable, however, with funding costs higher than might otherwise be expected, perhaps reflecting liquidity and funding strains in the Saudi banking system.

Figure 294: SAIB: gross special commission income and expense margins (as % of assets)



Source: Deutsche Bank, Company data

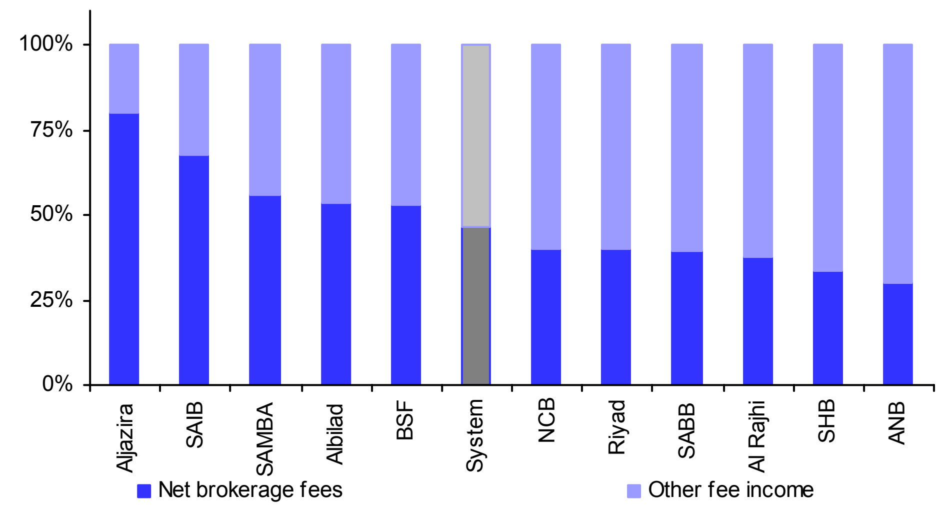
Figure 295: Net special commission income margin trends



Source: Deutsche Bank, Company data

We note that the bank's fee income line is more exposed to brokerage and mutual fund fees than its peers. We have a negative outlook for revenue from these activities, suggesting SAIB's fee income outlook could be worse than the sector average.

Figure 296: Fee income split (FY07)

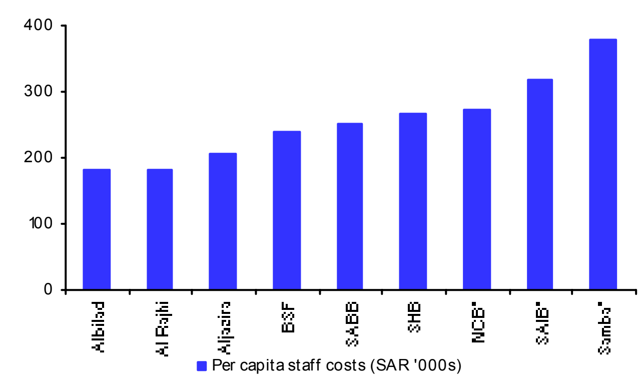


Source: Deutsche Bank, Company data

Operating costs

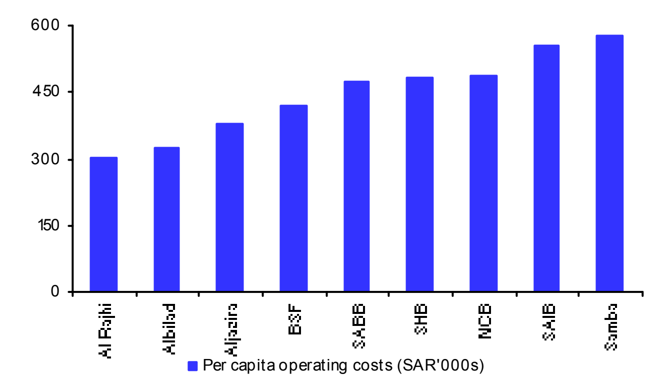
Relative to its peers, SAIB has higher per capita salary costs, reflecting in our view a business mix skewed towards corporate and capital market activities where average salary levels are above those typically found in retail banking. However, revenues per capita are also high, as reflected in the bank's respectable 9M08 cost-income ratio of 31%.

Figure 297: Per capita staff costs (FY07)



*Source: Deutsche Bank, Company data. * = 2006 estimated based on 2006 staff numbers*

Figure 298: Per capita operating costs (FY07)



*Source: Deutsche Bank, Company data. * = estimated based on 2006 staff numbers*

Risks

Credit risk costs

Uniquely in the sector, SAIB's interim results often present risk costs as a round number (e.g., exactly SAR5m in Q308). Our conversations with management suggest that 70% of credits are ranked according to an internal ratings system designed to assess the risk of loan non-payment. The remainder of the loan book (consisting of larger balances) is assessed on a case-by-case basis. In the absence of specific provisioning needs, provisioning charges are determined according to the overall risk profile of the loan book. The experience of prior years suggests a more detailed analysis of the loan book is carried out towards year-end

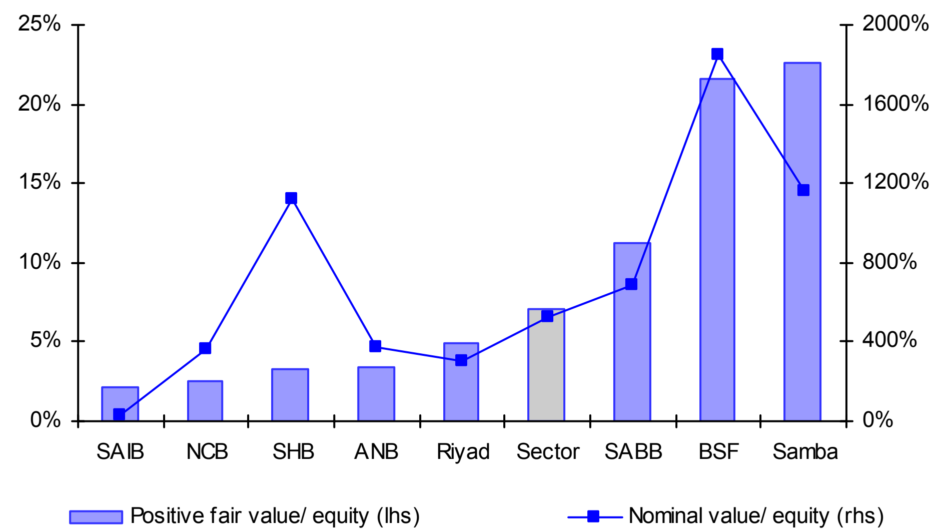
Market risk

Non-trading investments have generated significant volatility to the income statement in recent years at SAIB. The bulk of this impact is generated by the equity component of the investment portfolio, reflecting realized gains from disposals and by permanent impairment assessments (where the market value change is significant, management encourages this to be recognized in the profit and loss account as an impairment charge).

In addition, we note that SAIB's investment portfolio is less oriented towards government-issued paper than other domestic banks (47% of the overall portfolio, compared with a 64% sector average), which may further increase the risk profile of the business.

However, SAIB has a surprisingly small derivatives portfolio, suggesting risks to shareholders should be limited.

Figure 299: SAIB's derivatives portfolio is smaller than other corporate and investment banking-oriented peers



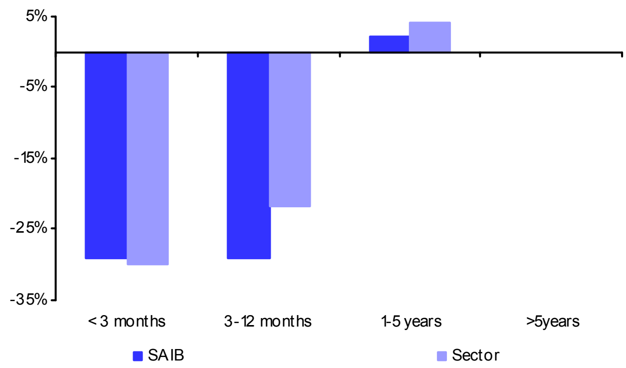
Source: Deutsche Bank, Company data

Liquidity risk

Like other corporate banking-oriented Saudi banks, SAIB has a relatively large investment portfolio, which accounts for almost one-third of all assets. Customer loans account for around half of all assets, a smaller proportion than the sector average. Considering contractual maturities of its assets and liabilities, SAIB appears to be broadly in line with its peers.

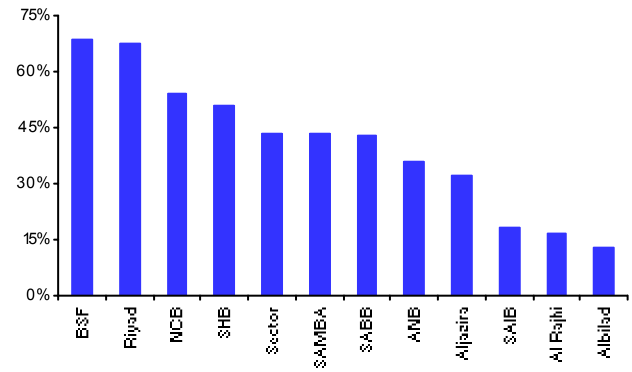
In addition, we note that the size of the bank's unfunded commitments portfolio is small, which should limit the possibility of unexpected drawdowns.

Figure 300: SAIB asset-liability maturity mismatch



Source: Deutsche Bank, Company data

Figure 301: SAIB's exposure to unfunded commitments is low (unfunded commitments/loans ratio, 9M08)



Source: Deutsche Bank, Company data

Branch opening strategy

The main purpose of opening new branches is to help the bank attract new retail deposits. Longer-term, the bank also hopes to expand its retail credit portfolio. Fee income has also benefited from these investments; fees from Murabaha loans and stock market trading have increased. The new branches are concentrated in new areas for the bank, such as Mekkah and Medina Taif.

Capital strength

With a 9M08 equity/assets ratio of 12.5%, SAIB is one of the better-capitalised corporate and investment banking-oriented entities in the Saudi banking system. Over the long term we believe management may seek to utilize this capital to expand the bank's retail banking presence. Indeed, a modest branch opening programme is being pursued with this aim. However, with the outlook for retail banking remaining sluggish, we see little possibility of this capital being deployed. In the current environment, we believe investors will view SAIB's capital strength as a welcome cushion against the emergence of any unexpected risks.

Ownership

SAIB has a broad base of core shareholders, which includes the US bank JP Morgan and unlisted market leader NCB. The free float of the shares is estimated to be close to 40%.

Figure 302: Shareholder structure

Shareholder	Stake
GOSI	21.5%
Public Pension Agency	17.3%
Saudi Oger	8.5%
JP Morgan	7.4%
NCB	7.3%
Free Float	38.0%

Source: Deutsche Bank, Tadawul, Zawya

Appendix 1

Important Disclosures

Additional information available upon request

For disclosures pertaining to recommendations or estimates made on a security mentioned in this report, please see the most recently published company report or visit our global disclosure look-up page on our website at http://gm.db.com/ger/disclosure/DisclosureDirectory.eqsr.

Analyst Certification

The views expressed in this report accurately reflect the personal views of the undersigned lead analyst about the subject issuers and the securities of those issuers. In addition, the undersigned lead analyst has not and will not receive any compensation for providing a specific recommendation or view in this report. Rahul Shah

Equity rating key

Buy: Based on a current 12- month view of total share-holder return (TSR = percentage change in share price from current price to projected target price plus pro-jected dividend yield) , we recommend that investors buy the stock.

Sell: Based on a current 12-month view of total share-holder return, we recommend that investors sell the stock

Hold: We take a neutral view on the stock 12-months out and, based on this time horizon, do not recommend either a Buy or Sell.

Notes:

1. Newly issued research recommendations and target prices always supersede previously published research.

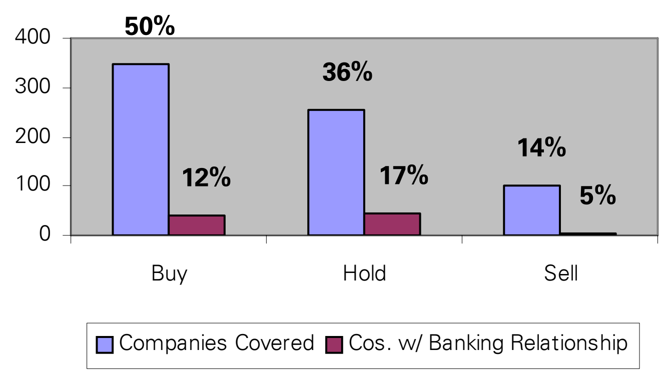
2. Ratings definitions prior to 27 January, 2007 were:

Buy: Expected total return (including dividends) of 10% or more over a 12-month period

Hold: Expected total return (including dividends) between -10% and 10% over a 12-month period

Sell: Expected total return (including dividends) of -10% or worse over a 12-month period

Equity rating dispersion and banking relationships



Global Universe

Regulatory Disclosures

1. Important Additional Conflict Disclosures

Aside from within this report, important conflict disclosures can also be found at https://gm.db.com/equities under the "Disclosures Lookup" and "Legal" tabs. Investors are strongly encouraged to review this information before investing.

2. Short-Term Trade Ideas

Deutsche Bank equity research analysts sometimes have shorter-term trade ideas (known as SOLAR ideas) that are consistent or inconsistent with Deutsche Bank's existing longer term ratings. These trade ideas can be found at the SOLAR link at http://gm.db.com.

3. Country-Specific Disclosures

Australia: This research, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act.
EU countries: Disclosures relating to our obligations under MiFiD can be found at http://globalmarkets.db.com/riskdisclosures.
Japan: Disclosures under the Financial Instruments and Exchange Law: Company name - Deutsche Securities Inc. Registration number - Registered as a financial instruments dealer by the Head of the Kanto Local Finance Bureau (Kinsho) No. 117. Member of associations: JSDA, The Financial Futures Association of Japan. Commissions and risks involved in stock transactions - for stock transactions, we charge stock commissions and consumption tax by multiplying the transaction amount by the commission rate agreed with each customer. Stock transactions can lead to losses as a result of share price fluctuations and other factors. Transactions in foreign stocks can lead to additional losses stemming from foreign exchange fluctuations.
New Zealand: This research is not intended for, and should not be given to, "members of the public" within the meaning of the New Zealand Securities Market Act 1988.
Russia: This information, interpretation and opinions submitted herein are not in the context of, and do not constitute, any appraisal or evaluation activity requiring a license in the Russian Federation.

Middle East locations

Deutsche Bank Dubai
Dubai International Financial Centre
The Gate, West Wing, Level 3
P.O. Box 504 902
Dubai City
Tel: (971) 4 3611 700

Deutsche Bank Saudi Arabia
Al Faisaliah Tower
17th & 28th Floor
Olaya, Riyadh
Saudi Arabia
Tel: (+966) 1 273 9700

Deutsche Bank Israel
46 Rothschild Boulevard
21st Floor
66883 Tel Aviv
Tel: (+972) 3 710-2000

Deutsche Bank Turkey
Eski Buyukdere Cad. Tekfen Tower
No:209 Kat:17-18
TR-34394 Istanbul
Tel: (+90) 212 317 01 00

International locations

Deutsche Bank Securities Inc.
60 Wall Street
New York, NY 10005
United States of America
Tel: (1) 212 250 2500

Deutsche Bank AG London
1 Great Winchester Street
London EC2N 2EQ
United Kingdom
Tel: (44) 20 7545 8000

Deutsche Bank AG
Große Gallusstraße 10-14
60272 Frankfurt am Main
Germany
Tel: (49) 69 910 00

Deutsche Bank AG
Deutsche Bank Place
Level 16
Corner of Hunter & Phillip Streets
Sydney, NSW 2000
Australia
Tel: (61) 2 8258 1234

Deutsche Bank AG
Level 55
Cheung Kong Center
2 Queen's Road Central
Hong Kong
Tel: (852) 2203 8888

Deutsche Securities Inc.
2-11-1 Nagatacho
Sanno Park Tower
Chiyoda-ku, Tokyo 100-6171
Japan
Tel: (81) 3 5156 6701

Global Disclaimer