A LOOK BACK AT YEAR 2009: "TOUGH YET PROFITABLE"

- Serving one of the largest players in the global oil industry did not shield the Saudi banking sector from the repercussions of the global financial crisis. This crisis has taken its toll on the Saudi economy hitting oil prices and eroding major portion of the wealth of Saudi individuals invested in the region and globally.

- Frozen capital markets, tight credit conditions, panic and lack of visibility over asset quality governed most of the first half of 2009. Things got more complicated with the default of two major family conglomerates with an estimated exposure of USD 30 billion. In return, Saudi banks have selected the conservative approach by refraining from lending to putting stricter criteria for lending which was reflected in the moderate contraction of 0.6% in the loan portfolio during FY 09 as compared to FY 08.

- On the other hand, deposits, being the main source of funds for the Saudi banking sector have demonstrated to be very stable and resilient, backed by a supportive intervention by the regulatory authorities who insured domestic deposits and injected around SAR 15 billion when they felt it was needed. In fact, the banking sector's deposits expanded by 6.1% in FY 09, reflecting the robust liquidity in the market and translating into loans to deposits ratio of 78.3% for the aggregate sector, down from 80.7% a year earlier.

- NPLs were the hot-spot in 2009, rising to an all-time high of 3.26% of gross loans and obliging banks to increase their provisioning level to record high of SAR 10.19 billion that was closely inline with our forecast of SAR 10.26 billion. On the other hand, NPL coverage for the sector dropped to 92% in FY 09, down from 157% in FY 08.

- Despite the high level of provisions, this sector has managed to report a total profit of SAR 25.7 billion, down by a slight 1.1% Y-o-Y, with only one bank reporting a loss. This profit is backed by higher operating income and lower investment provisions and confirms our view that net income acting as the first line of defense, should be enough to face the rising tides of credit defaults.

- A positive net income coupled with a conservative dividend payout policy and a decreasing loan portfolio have helped improve the capital adequacy of Saudi banks.

- *Our View:* As the Saudi economy returns back to growth and as the outlook for oil remains supportive in the medium term, we believe that Saudi banks are better prepared to cope with any further repercussions of the global financial crisis and are ready to ride the new wave of growth.
  In this context, we expect the loan growth for the sector to return to double digit growth in 2010 supported by abundant liquidity in the system and accommodative fiscal and monetary policies. Also, net income growth is expected to accelerate to a rate of 22% in FY 2010. In doing so, we do not exclude the possibility of further credit problems especially during the first half of 2010, with provisions for credit losses expected to be around SAR 7 billion in FY 2010 and the NPL ratio to hover around the 2% level.

- Going forward, we see that the Saudi banking sector has managed to absorb the first wave of credit defaults and has gained additional immunity to face further waves should they come. Staying profitable during a tough year confirms our bullish outlook for the Saudi banking sector that we have outlined earlier in our report about the Saudi banking sector "Defying the downturn - Ready for the recovery" dated 26 September 2009.
  Based on the recent financial performance, we have revised the target price downward for SABB and altered our recommendation to reflect the recent price performance. Consequently, our top picks within the sector are Samba Financial Group and Arab National Bank.

COVERED BANKS

	Current Price (SAR)	Target Price (SAR)	Upside Potential	Recommendation	PB	NI Growth (09-10)	PE 2010 E
Samba Financial Group	58.00	69.75	20.30%	Accumulate	2.34	13.60%	10.07
Al Rajhi Bank	76.00	80.72	6.20%	Hold	3.97	11.60%	15.09
Riyad Bank	28.00	31.54	12.60%	Accumulate	1.49	20.60%	11.49
Saudi British Bank	47.50	55.34	16.50%	Accumulate	2.73	34.20%	13.07
Banque Saudi Fransi	46.90	51.48	9.80%	Hold	2.16	17.30%	11.70
Arab National Bank	44.00	53.87	22.40%	Accumulate	1.99	16.40%	10.37
Saudi Hollandi Bank	32.50	35.61	9.80%	Hold	1.91	1005%	11.32

SECTOR COVERAGE

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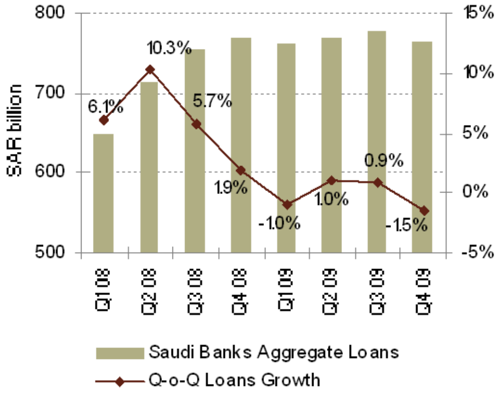
YEAR 2009 IN REVIEW

Loan Growth Remained Muted

Chart 1: Saudi Banks Loan Growth



Source: Saudi Banks Financial Statements

Table 1: Loan Growth across Banks

Loans Growth	FY 09-o-FY 08	Q4-o-Q3 09	FY 09 (SAR mil)	FY 08 (SAR mil)
Bilad	33.1%	4.3%	11,014	8,275
Riyad	10.5%	0.4%	106,515	96,430
Rajhi	5.7%	3.2%	148,707	140,677
NCB	3.9%	-3.7%	112,158	107,909
Jazira	2.5%	-0.6%	15,504	15,133
SIB	0.8%	-2.4%	29,785	29,556
BSF	-3.2%	-3.7%	78,315	80,866
SABB	-4.8%	-3.1%	76,382	80,237
SHB	-5.2%	-7.5%	36,023	38,017
ANB	-10.5%	-2.9%	66,811	74,662
Samba	-14.3%	-1.8%	84,147	98,147
Total	-0.6%	-1.5%	765,359	769,908

Source: Saudi Banks Financial Statements

Following the increase of 0.9% in Q3 09 Saudi banks loan book contracted by 1.5% Q-o-Q in the fourth quarter of 2009 to reach SAR 765.4 billion at the end of December 2009. This has led to a 0.6% decline in the loan book during FY 09, compared to our estimate of an increase of 1.1%. This decline in the banking sector's loan book follows a growth of 31% recorded in the previous fiscal year and is particularly attributed to the cautious lending policies adopted by local banks amid the global financial crisis and following the defaults by Al Saad and Al Gosaibi Groups.

Among the eleven banks we cover in our analysis, Bank Al Bilad led the way by rising 33.1% followed by Riyad Bank and Al Rajhi Bank that displayed a growth of 10.5% and 5.7% respectively. On the negative front, Samba Financial Group reported the highest drop in its loan book, down by 14.3% Y-o-Y followed by Arab National Bank that reported a drop of 10.5%.

By Business Segment

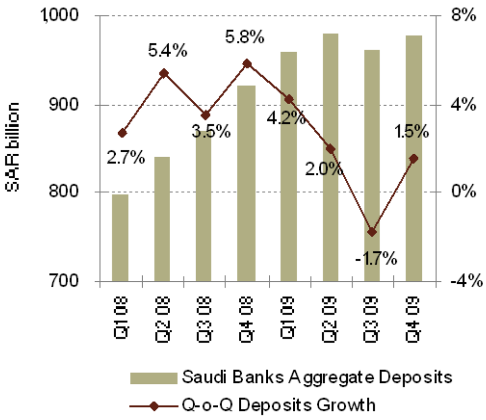
The relative decline in the banking sector's loan book is also attributed to the drop in the corporate loans which had been a driving force of growth for many banks in recent years. In fact, commercial loans growth dropped to -3.4% in FY 09 from 37% and 39% in FY 07 and FY 08 respectively. On the other hand, consumer loans growth improved to 6.4% in FY 09 from 4.6% in FY 08. Consequently, the retail loans represented 22.3% of the total loan book at the end of 2009, up from 20.7% in FY 08, while corporate loans accounted for 70.7% at the end of FY 09 down from 72.4% in FY 08. We believe this trend is likely to continue going forward as mortgage financing is expected to expand starting this year. We also believe that banks advocate this trend as retail loans usually offer higher margins than corporate loans, and are more diversified and less concentrated.

Our View

As the Saudi economy returns to growth at a relatively faster pace, and with the sharp pick up in project financing currently underway, we believe that the overall loan growth will eventually return to double digit growth in 2010 supported by the abundant liquidity in the system and the accommodative fiscal and monetary policies.

Deposit Growth Revived in Q4 09

Chart 2: Saudi Banks Deposit Growth



Source: Saudi Banks Financial Statements

Table 2: Deposit Growth across Banks

Deposits Growth	FY 09-o-FY 08	Q4-o-Q3 09	FY 09 (SAR mil)	FY 08 (SAR mil)
Bilad	25.1%	13.1%	13,721	10,971
Riyad	19.2%	4.9%	125,278	105,056
NCB	17.9%	2.1%	202,583	171,822
Samba	9.6%	3.8%	147,129	134,228
Jazira	5.9%	-0.2%	22,142	20,900
SHB	4.2%	-5.3%	44,827	43,012
Rajhi	3.4%	-2.2%	120,533	116,611
BSF	-1.7%	1.1%	91,237	92,791
SABB	-3.8%	-0.1%	89,187	92,678
SIB	-6.0%	-0.4%	38,247	40,702
ANB	-10.9%	2.7%	82,680	92,743
Total	6.1%	1.5%	977,564	921,515

Source: Saudi Banks Financial Statements

After contracting by 1.7% in Q3 09, the Saudi banking sector deposit growth recovered, expanding by 1.5% Q-o-Q in the fourth quarter of 2009 to reach SAR 977.6 billion at the end of FY 09. This has translated into a Y-o-Y growth of 6.1% in the sector's deposits during FY 09, broadly inline with our expectations of 8% growth and reflecting the robust liquidity in the market. Looking at the banks individually, we observe that the best performers in this regard were Bank Al Bilad and Riyad Bank that reported an increase of 25.1% and 19.2% respectively while Arab National Bank and Saudi Investment Bank delivered a notable decline of 10.9% and 6.01% respectively.

Deposit Decomposition

Table 3: Deposit Decomposition across Banks

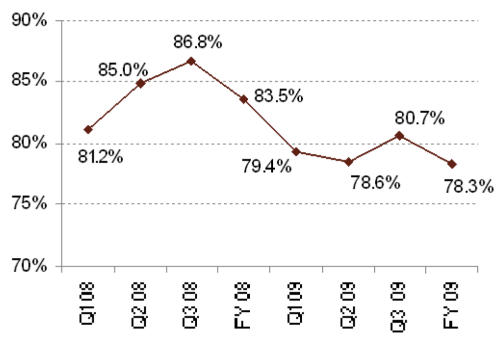
Saudi Banks	2008		2009	
	SAR million	%	SAR million	%
Demand Deposits	365,764	39.7%	461,845	47.2%
Time Investments	505,950	54.9%	463,287	47.4%
Saving	12,249	1.3%	12,740	1.3%
Other	37,553	4.1%	39,692	4.1%
Total	921,515	100%	977,564	100%

Source: Saudi Banks Financial Statements

Taking a closer look at the combined deposit decomposition of Saudi banks, we notice that demand deposits, that are typically non-remunerated, represented 47.2% of customer deposits at the end of 2009, up from 39.7% at the end of 2008. This reflects the low-interest rate environment in KSA and would represent a very positive and important indicator for the Saudi banks going forward as their deposit base ensures a relatively stable and cheap source of funding.

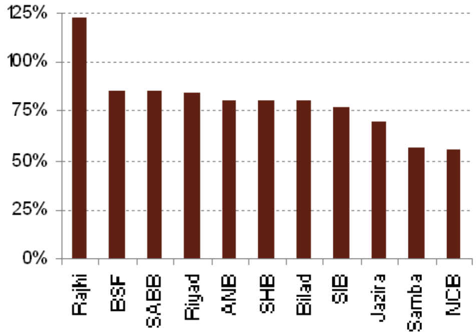
Relaxed Liquidity

Chart 3: Saudi Banks Loans to Deposits Ratio



Source: Saudi Banks Financial Statements

Chart 4: Loans to Deposits Ratio across Banks (FY 09)



Source: Saudi Banks Financial Statements

Examining the liquidity position of the banks, we notice that the 6% deposit growth as opposed to a slight contraction in loans resulted in a lower loans-to-deposits ratio of 78.3% in Q4 09, down from 80.7% in Q3 09 and from 83.5% in Q4 08. This indicates that the overall system liquidity is comfortable both on an aggregate and on an individual level. As illustrated in chart 4, most of the Saudi banks present low leverage with loans to deposits ratio below 86%, with the exception of Al Rajhi Bank. Notably, NCB and Samba are the best positioned to benefit from an upturn in the credit cycle as these banks present loans to deposits ratios at the 55% range.

It is worth noting that unlike their global and regional peers, the Saudi funding market did not experience massive disruptions as they do not depend on wholesale funding and they did not face any loss of confidence in the banking sector during this crisis.

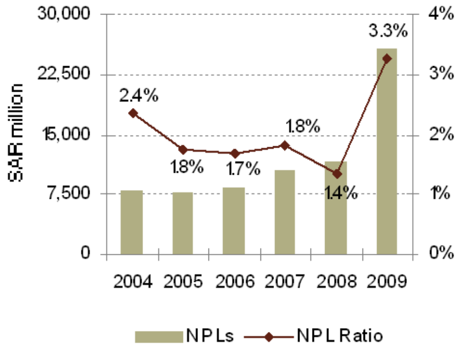
Weaker Credit Quality

Table 4: NPL Ratio across Banks

NPL Ratio	2008	2009
Jazira	1.50%	7.47%
SHB	2.73%	5.86%
SIB	0.97%	5.75%
Bilad	1.21%	5.52%
NCB	2.39%	4.64%
SABB	0.24%	4.51%
Samba	1.82%	3.32%
ANB	0.39%	2.81%
Rajhi	1.91%	2.53%
BSF	0.94%	1.27%
Riyad	1.29%	1.16%
Saudi Banks Average	1.36%	3.26%

Source: Saudi Banks Financial Statements

Chart 5: Evolution of Saudi Banks NPLs



Source: Saudi Banks Financial Statements

The impact of the economic downturn and the accompanying defaults of large Saudi Groups resulted into a strong growth in non-performing loans (NPLs) during year 2009. At the end of 2009, total NPLs surged to SAR 25.77 billion, up from SAR 11.47 billion in FY 08. Also, NPLs accounted for 3.26% of gross loans in FY 09 surpassing our estimates of 2.27% and versus 1.36% at the end of 2008.

The major source of deviation was SABB which reported NPLs of SAR 3.5 billion up from SAR 194 million, translating into an NPL ratio of 4.5% compared to our estimate of 1%.

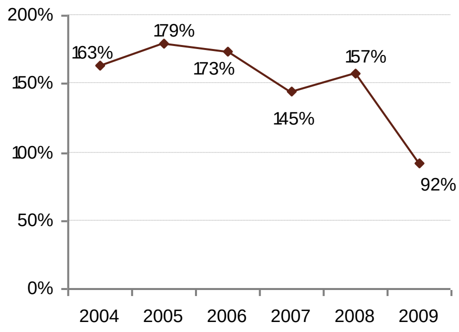
Reduced Coverage

Table 5: NPL Coverage across Banks

NPL Coverage	2008	2009
SABB	325.04%	50.35%
Bilad	90.56%	62.11%
Jazira	163.85%	65.19%
SIB	251.94%	70.11%
ANB	348.98%	75.86%
NCB	110.94%	85.37%
SHB	107.80%	100.22%
Rajhi	142.79%	108.43%
Samba	167.01%	116.14%
BSF	110.99%	126.60%
Riyad	131.93%	140.88%
Saudi Banks Average	157.20%	91.90%

Source: Saudi Banks Financial Statements

Chart 6: Evolution of NPL Coverage for Saudi Banks



Source: Saudi Banks Financial Statements

As shown in table 5 and Chart 6 above, NPL coverage for the Saudi banking sector dropped to 92% in FY 09 from 157% in FY 08. More alerting is the major drop in coverage witnessed in some banks, like Saudi British Bank that reported NPL coverage of 50% in FY 09, down from 325% in FY 08. Also, Al Bilad Bank, Bank Al Jazira, Saudi Investment Bank and Arab national bank, they all reported NPL coverage between 60% and 75%, which may raise questions regarding the needs for further high provisioning in the coming two quarters.

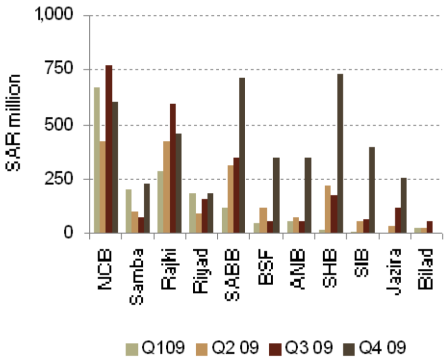
Credit Provisioning Matching our Forecasts

Table 6: Saudi Banks Provisions for Credit Losses

SAR million	FY 09	FY 08	FY 09-o-FY 08
NCB	2,474	729	3.4 times
Rajhi	1,761	1,227	1.4 times
SABB	1,496	371	4 times
SHB	1,148	25	45 times
Riyad	619	349	1.8 times
Samba	605	267	2.3 times
BSF	575	94	6.1 times
ANB	527	60	8.7 times
SIB	515	30	17 times
Jazira	412	61	6.7 times
Bilad	61	20	3.1 times
Total	10,191	3,235	3.15 times

Source: Saudi Banks Financial Statements

Chart 7: Provisions for Credit Losses across Banks (FY 09)

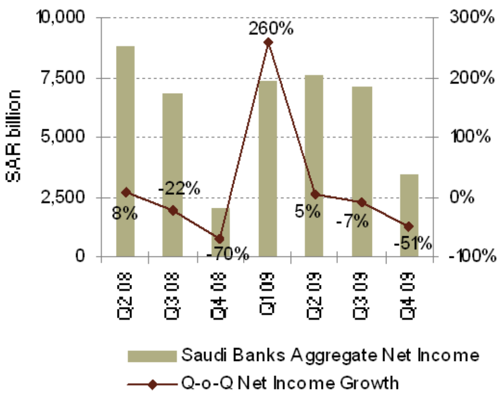


Source: Saudi Banks Financial Statements

On the income statement side, Saudi Banks' aggregate provisions for credit losses skyrocketed in Q4 09, escalating by 73% Q-o-Q following the 30% increase in Q3 09. This high level of provisioning during the fourth quarter of the year led to a total provisioning of SAR 10.19 billion in FY 09, matching our forecasts of SAR 10.25 billion, and up from SAR 3.24 billion recorded in FY 08.
Going forward into 2010, we believe that credit provisioning will remain the single largest risk factor and we expect loan-loss provisions to total around SAR 7 billion in FY 2010 most of which will be booked in the first half of the year.

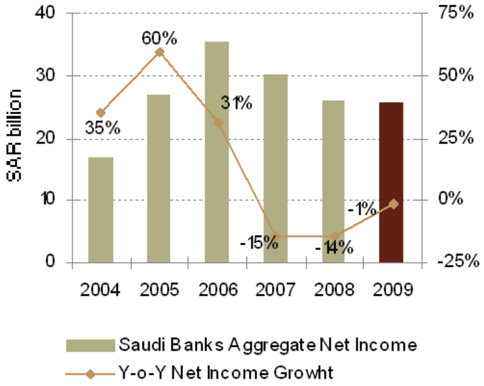
Satisfactory Profitability Levels

Chart 8: Saudi Banks Net Income (Quarterly Growth)



Source: Saudi Banks Financial Statements

Chart 9: Saudi Banks Net Income (Yearly Growth)



Source: Saudi Banks Financial Statements

After two years of notable plunge in earnings, profitability of the Saudi banking sector declined by a mere 1% Y-o-Y during FY 09. This decrease in earnings is primarily due to increased loan loss provisions that were largely offset by the decline in impairment for financial investments coupled with a growth in operating income.

Mixed Profitability across Sector Players

Table 7: Net Income across Banks

Net Income Growth	FY 09-o-FY 08	Q4-o-Q3 09	Q4 09-o-Q4 08	FY 09 (SAR mil)	FY 08 (SAR mil)
NCB	98.9%	-25.7%	NM	4,040	2,031
Riyad	14.8%	20.1%	-17.3%	3,030	2,639
Rajhi	3.9%	-18.1%	1.3%	6,767	6,514
Samba	2.4%	-31.0%	-2.6%	4,560	4,454
SIB	1.6%	NM	NM	522	513
ANB	-4.7%	-53.4%	-15.1%	2,370	2,486
BSF	-11.9%	-54.6%	3.3%	2,471	2,806
SABB	-30.4%	-95.5%	-15.6%	2,032	2,920
Jazira	-87.6%	NM	NM	28	222
SHB	-93.0%	NM	NM	86	1,224
Bilad	NM	NM	NM	(248)	125
Total	-1.1%	-50.8%	72.6%	25,658	25,934

Source: Saudi Banks Financial Statements

Looking at the banks individually, the figures show a high level of disparity with NCB, Riyad Bank and Al Rajhi Bank delivering a growth of 99%, 15% and 4% respectively while Saudi Hollandi Bank, Bank Al Jazira and Saudi British Bank reporting a severe drop of 93%, 88% and 30% respectively.

Improving Capital Adequacy

Table 8: Saudi Banks Tier 1 Ratio

Tier 1 Ratio	2008	2009
Bilad	23.25%	19.85%
Jazira	19.34%	17.15%
Rajhi	14.60%	13.82%
NCB	16.10%	18.60%
Riyad	13.90%	15.80%
SIB	13.33%	14.14%
Samba	13.10%	16.00%
ANB	11.93%	14.32%
BSF	10.97%	13.13%
SABB	8.29%	10.15%
SHB	9.95%	11.20%

Source: Saudi Banks Financial Statements

As of the end of 2009, the capital position of Saudi Banks improved significantly with most of the banks displaying a growth in their Tier 1 ratio. The fact that the simple average Tier 1 ratio for Saudi Banks increased during FY 09 to 14.9% from 14.1% a year earlier suggests that the Saudi banking system has shown resilience during the global financial crisis.

The positive net income of banks combined with a conservative dividend payout ratio, and a drop in loans has helped improve the capital adequacy of the Saudi banking sector.

Disclaimer