Banking

HOLD: 12M TP @ 92

Valuation Summary (TTM)	
Price (SAR)	86.5
PER TTM (x)	21.3
P/Book (x)	4.0
Dividend Yield (%)	2.7
Free Float (%)	94%
Shares O/S (mn)	4,000
YTD Return (%)	15%
Beta	1.1

(mn)	SAR	USD
Market Cap	346,000	92,259
Total Assets	801,483	213,712

Price performance (%)	1M	3M	12M
Al Rajhi Bank	14%	26%	15%
Tadawul All Share Index	7%	7%	15%

Trading liquidity (,000)	1M	3M	6M
Avg daily turnover (SAR ,000)	382,792	313,542	311,230
Avg Daily Volume (,000)	4,533	4,321	4,307

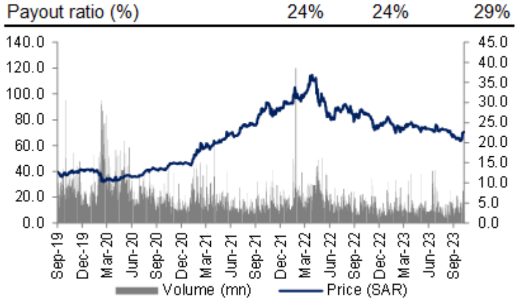
52 week	High	Low	CTL*
Price (SAR)	88.00	63.10	37.1

* CTL is % change in CMP to 52wk low

Major shareholders	
Al Rajhi Abdullah	2.2%
Vanguard Group Inc/T	2.0%
BlackRock Inc	1.4%
Others	94.5%

Other details	
Exchange	Saudi Arabia
Sector	Banks
Index weight (%)	15.2%

Key ratios	2020	2021	2022
EPS (SAR)	2.65	3.69	4.24
BVPS (SAR)	14.53	16.82	20.93
DPS (SAR)	0.63	0.88	1.25
Payout ratio (%)	24%	24%	29%



Al Rajhi Bank – Steadfast growth

Al Rajhi Bank (ARB) is the largest Islamic bank in the world, with a leadership position in the Middle East region in retail banking, in terms of deposits. It is also the largest bank in the Kingdom in terms of the number of customers serviced and distribution network. Retail loan book constitutes >70% of the total loan book, with a leadership position in personal loans (c.42% market share in 3Q23), mortgage loans (c.42% market share), and auto loans (c.45% market share). It also has a growing presence in corporate banking, wherein it is the 3rd largest player in KSA with a market share of c.13%. ARB has shown a robust performance in the past four years, with its loan book growing by 25% (CAGR 2018-22) driven by strong performance in both its retail and corporate book. We continue to remain positive on the macro-outlook of the Kingdom, which has an estimated USD1.25tn+ projects underway towards various Mega and Giga projects to transform the Kingdom as per its Vision 2030. Further, Saudi's successful bid for Expo 2030 and the upcoming 2034 FIFA World Cup are likely to showcase the potential of the country as a travel destination. These projects will require substantial investments to support the burgeoning tourist inflow, given the already high occupancy rates of hotels in Riyadh, which are amongst the highest globally. We also see strong potential for growth in the country post these one-off events, given the government's focus on transforming Saudi into a regional hub for business and tourism. This in turn is likely to avoid the creation of asset bubbles witnessed in other countries in the region post such events. However, in 2023 the growth of its loan book (+4% YTD in 3Q23) has slowed down owing to lower growth in mortgage (+3% YTD in 3Q23) and personal loans (-6% YTD in 3Q23). Increasing interest rate (average 3M-SIBOR at 5.9% in 2023 vs 3.1% in 2022, and 2.5% in 2018) was the main reason for this. However, we feel that the interest rates have peaked at the current levels, and the same is likely to start trending down. Based on the FOMC Dots median, an expected cumulative rate cut of 250bps is likely in the next three years and is likely to soften the SIBOR. However, we expect the recovery in the loan book to be gradual, as the impact of the softening interest rate will be at a lag. Overall, we expect the retail loan book to grow at a CAGR of c.5% between 2022-27e. The corporate loan book of the company has continued to grow in 2023 (+20% YTD in 3Q23), aided by the strong performance of its SME division and a relatively lower base. We expect this trend to continue, as we forecast corporate loans to grow at a CAGR of 10% (2022-27e).

The deposits profile of ARB has weakened over the period as the share of CASA to total deposits has been trending lower (91% in 2018 to 65% in 3Q23) as a result of increasing interest rates, which have made time deposits more attractive. This along with the structure of the company's asset book, with mortgage loans, which are originated at fixed rates, accounting for c.40% of total loans has put pressure on the net income margins from loans and investment (NIM) (4.9% in 2018 to 3% in 2023e). However, with the softening of interest rates, we expect the scenario to improve, though gradually. The asset quality of ARB (NPL of 0.6% and coverage of 240% in 3Q23) is one of the best in the industry and is supported by strong capital ratios (core tier 1 of 16.5% and tier 1 of 19.6%), which too was among the best in the industry. Overall, we remain positive on the operating performance of the company, though the loan book growth is likely to be slower and NIM levels are expected to lag its historical performance. ARB is currently trading at 3.4x its 2024e book value, with a dividend yield of 1.5% (2024e). We feel that at the current levels, the stock has limited upside and we initiate coverage on the company with a target price of *SAR92/share* and a *Hold* rating.

Valuations: Strong business franchise, as the largest Islamic bank globally, superior asset quality, more than adequate capitalization, and the continued potential for growth, all aid in the attractiveness of ARB. However, retail loan book growth is expected to lag its historical performance, while NIM recovery is likely to be slow, which will limit the improvement in profitability. We are initiating coverage in ARB with a ***Hold*** rating with a target price of ***SAR92/share.***

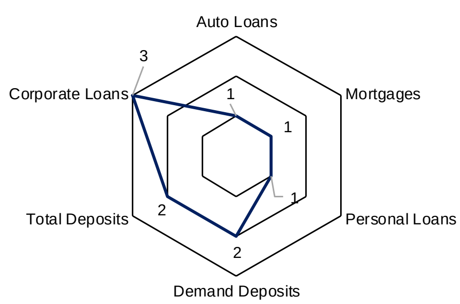
Strong distribution network across KSA

Strong business franchisee as the largest Islamic bank globally, with a leading position in retail banking in Saudi Arabia

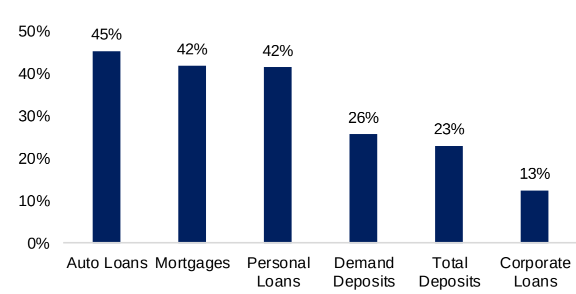
Al Rajhi Bank (ARB) has a network of 536 branches covering four countries (Saudi, Jordan, Malaysia, and Kuwait), serving more than 15mn customers, and is the largest Islamic bank in the world. The company has a leading presence in the retail banking segment in Saudi, operating 4,604 ATMs, 581,700 POS, and 163 remittance centers, across the country. The company is the largest retail bank in the Middle East, based on retail deposits, and is the largest bank in KSA, based on the number of customers, distribution network, and banking transactions (average transactions of 817mn/month).

The strong business franchisee of ARB and its strong network has aided the bank to have a robust and commanding presence in its retail operations. It has a 45% market share in the auto loan segment and a 42% market share each in personal and mortgage loans, making it a market leader across all three businesses. Though ARB's exposure to corporate banking is relatively small, it was still the third largest player in corporate loans with a market share of 12.5%. Its strong brand has also helped it to garner access to low-cost funding, with a market share of 23% in customer deposits and 26% market share in demand deposits, making it the second largest player in both parameters.

Top player in most product class



Strong market share in retail products



Source: Company filings and US Research

The strong market position of ARB and its extensive presence in the industry makes it an entity of high systematic importance to the Saudi economy. This makes the bank a strong candidate for financial support in case of need.

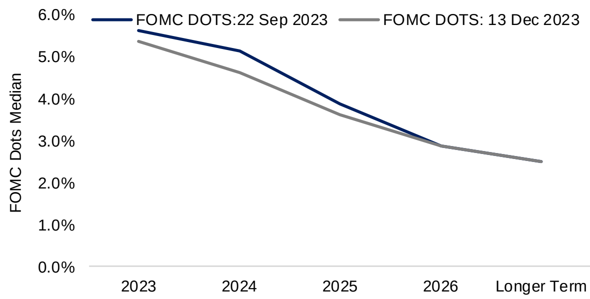
ARB is an institution with high systematic importance to the Saudi economy

In the past, the Saudi Central Bank has been proactive in providing financial help to banks in the country to ease liquidity and boost lending. For instance, in 2022 SAMA placed SAR50bn as time deposits with the commercial banks at a discount to the 3-month SIBOR rates to support the liquidity of the banks. Similarly, in 2020, the central bank infused USD13.3bn in the banking system to ease Covid-related pressure on the banking system and to provide loans to the SME segments, to help them maintain jobs. We expect continued systematic support from the government, given some of the high-stake investments being undertaken by the country. This will be further supported by favorable oil prices, which is expected to remain strong (Brent prices are expected to average USD85/bbl for 2024 and USD83/bbl for 2025 as per Bloomberg median estimates).

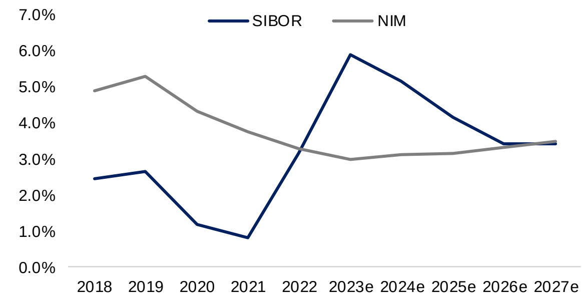
Change in the funding mix puts pressure on NIM, though the outlook is better

The net income margins from loans and investment (NIM) of ARB has come under pressure in the past few years, though its profitability growth has been robust, driven by a phenomenal growth in its loan book. However, with the growth slowing down in 2023, the impact of lower yields is more obvious. Growing inflation and the resultant increase in key policy rates in the US has pushed up the cost of funding in the Kingdom. The average 3M-SIBOR has increased from 2.5% in 2018 to 5.9% in 2023, which in turn has made the time deposit a much more lucrative form of deposit. Mortgage loans account for c.40% of the total loans and are predominantly originated as fixed-rate loans, while the proportion of time deposits to total deposits have increased (6% in 2018 to 33% in 3Q23). Increasing cost of funding on the one hand, and an inflexibility in pricing a part of the asset book on the other has resulted in the NIM of ARB coming under pressure (4.9% in 2018 to c.3% for 9M23).

Rate cuts will be sharper than previously expected



NIMs to gradually improve as interest rates fall



Source: Bloomberg, Company filings and US Research

NIMs to improve as interest rates soften

However, due to slowing inflation and stagnation of growth in the US, we feel that the interest rates have peaked and expect the pressure on the same to come down over the next 3 to 4 years. Post the recent FOMC meeting the FED Dots median rate shows a downward trend in the interest rates, with it falling to 2.9% in 2026, from 2023 levels of 5.4%. This is likely to result in a corresponding easing of SIBOR rates. We forecast the 3M-SIBOR rates to average 5.2% for 2024e, 4.2% for 2025e, and 3.4% for 2026e. As a result, we also expect the deposit profile to improve, with the proportion of time deposits declining to 24% by 2027e, compared to 33% in 3Q23e.

Overall, we expect NIMs to improve gradually from the current levels of c.3% to 3.5% in 2027e. However, ARB's NIM is unlikely to reach the levels of 2018 and 2019 (c.5%), wherein the 3M-SIBOR average was c.2.5%, during our forecast period as we do not expect interest rates to reach these levels anytime soon.

Macro factors to power loan growth

As per a report by Knight Frank, since 2016 real estate and infrastructure projects launched in the Kingdom have been estimated at +USD1.25tn, with the value of the current projects underway pegged at USD250bn. Of the total outlay, 18% of the ongoing projects or USD229bn has been planned in Riyadh. These projects include building +241k residential homes by 2030 and new office spaces of 3.6mn sqm. Further, KSA has also recently won the bid to conduct the Expo 2030 in Riyadh. Towards this, the Kingdom has earmarked SAR29bn as investments, which is likely to boost the investments in real estate in the region. It has been reported that Riyadh has one of the highest hotel occupancy rates globally. As per Knight Frank, Riyadh currently has 22,000 rooms available, compared to 132,000+ rooms available in Dubai during its 2020 expo. An addition of 290,000 rooms has been planned in KSA for the next ten years, though it has been estimated that Riyadh alone will require c.60-70k additional hotel rooms to accommodate the increase in demand.

Projects	Project Value USD bn	Value Commissioned USD bn	Progress	Expected Completion
NEOM	500.0	237.0	45%	2030
Red Sea Global	23.6	21.0	35%	2030-35
Jabal Omar	5.6	4.0	78%	2026
Masar Makkah	9.8	8.3	52%	2030
Thaker	7.0	1.3	100%	2030
Al Ula	15.0	6.5	51%	2027
Jeddah Economic City	30.0	1.7		TBD
King Abdullah Economic City	27.0	13.0	74%	2028
Jeddah Central	20.0	4.5	16%	2030
Shams Al Arous	2.0	0.5	49%	2025
Rua Almadinah	37.0	8.8	32%	2030
Knowledge Economic City	8.0	3.4	69%	2025
Roshn	1.9	1.8	23%	2026
Seven	1.4	0.4	8%	2026
Marafy	1.4	0.4	8%	TBD
Sub Total	**689.7**	**312.6**		
Riyadh Projects				
New Murabba	50.0	3.6		2030
King Salman Park	9.8	8.8		2027
Qiddiya	9.8	8.8	24%	2030
King Abdullah Financial District	10.5	10.0	98%	2027
Sports Boulevard	6.5	1.4	24%	2030
Diriyah Gate	63.0	2.3	42%	2027
Riyadh Expo 2030	7.8			2030
Dahiyat Al Fursan	20.0	6.3	22%	2027
North Pole	20.0			2030
Roshn-Riyadh	30.3	12.4	40%	2027
Seven	1.5	1.4	31%	2027
Sub Total	**229.2**	**55.0**		
Total	**918.9**	**367.6**		

Source: Knight Frank, MEED Projects, and US Research

These projects will require additional investments into the real estate market in the coming years, which in turn is expected to keep the loan offtake of banks strong. Taking into account the 2034 FIFA World Cup scheduled in the country and the potential for an increase in tourism, we feel that the investments will continue its momentum.

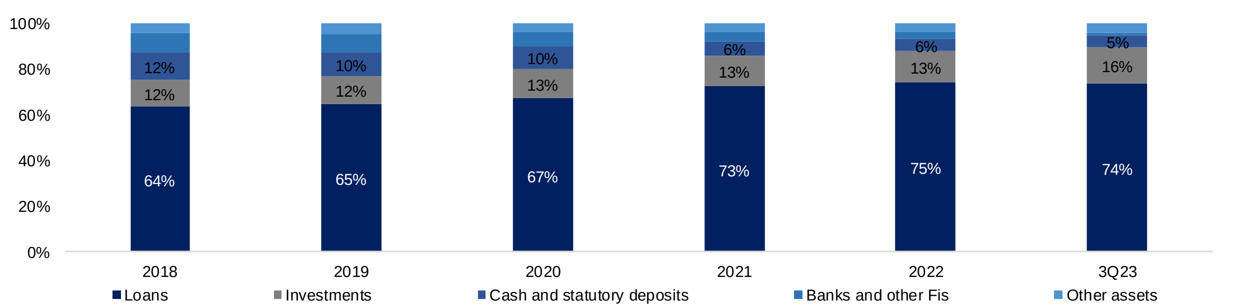
For 1H23, the inbound tourism in Saudi recorded its best historical half-yearly performance with the number of tourists increasing by a solid 142% YoY to 14.6mn tourists. Tourism spending on the other hand increased by a robust 132% YoY to SAR87bn. Religion continued to dominate the purpose of the visit, accounting for 45%. This was followed by visiting friends and relatives (23%), leisure (20%), business (6%), and others (6%). Visits for leisure purposes reported a massive 347% YoY growth in 1H23 and we see strong potential for growth in this area, given the government investments in the country to improve the infrastructure of the country. Currently, tourism accounts for 8% of the country's GDP, which is expected to increase to 10% of GDP by 2030. This will be driven by a phenomenal 15% CAGR improvement in non-Saudi tourists from 26mn in the current year to 70mn in 2030e.

Saudi offers opportunities that can sustain return on investments even post one-off events

We view this growth potential in tourism and its investment in infrastructure as a key differentiator vis-à-vis the other countries in the region. The growth potential within the country will result in continued utilization of the new assets, which reduces the chances of potential asset bubbles, thereby ensuring consistent asset quality for Saudi Banks.

Asset mix dominated by lending, powered by retail loans, with asset quality remaining better than the industry average

Contribution from loans and investments have increased



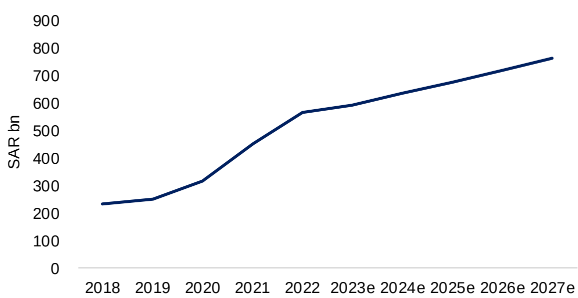
Source: Company filings and US Research

The asset mix of ARB is strong and has been improving, with the proportion of financing assets to total assets increasing to 74% in 3Q23 from 64% in 2018. Investments on the other hand have increased from 12% of total assets in 2018 to 16% in 3Q23.

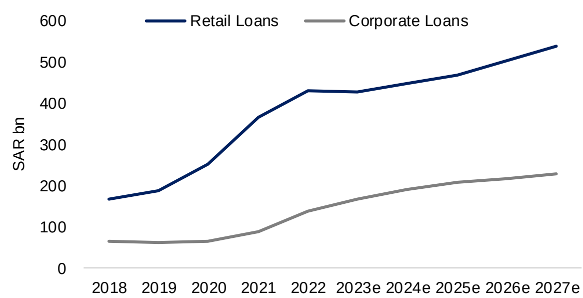
Strong mortgage and personal loans offtake have driven retail loan growth

Loan book has grown by a CAGR of 22% between 2018-3Q23, outperforming the industry growth of 12.7% for the same period. ARB growth in financing has been driven by a 20%+ growth in both retail and corporate loans. However, the loan book has been dominated by retail loans, which accounted for 72% of total loans in 3Q23. Mortgage loans accounted for 53% of total retail loans in 3Q23, and in the past 5 years it has registered a robust growth of 45%+ (CAGR). The growth has been mainly driven by higher residential mortgage, as a result of government initiatives to improve housing in the Kingdom.

Loan growth has been strong



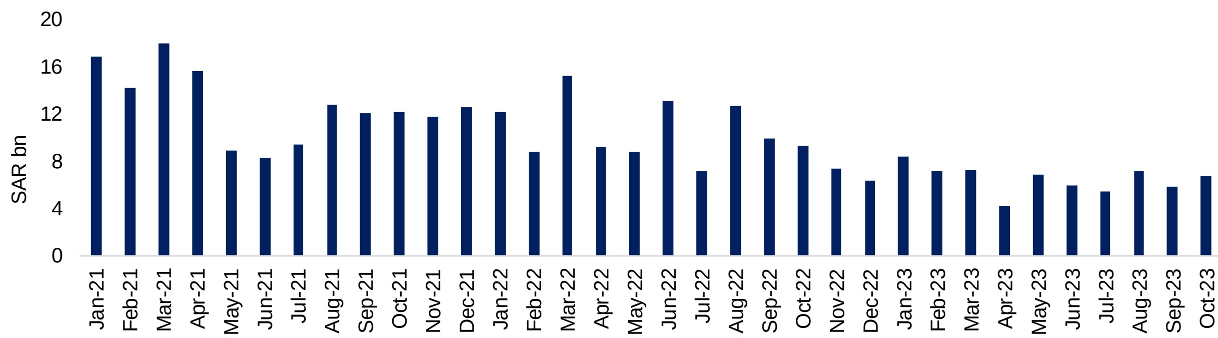
Loan growth driven by both retail and corporate



Source: Company filings and US Research

New residential mortgages in the Kingdom have grown by a robust CAGR of 75%+ from the levels of SAR28bn in 2018 to SAR153bn in 2021. However, since then there have been signs of these loans slowing down due to the firming up of interest rate, as new residential loans fell to SAR120bn in 2022. This situation was accentuated in 2023, as the average monthly new mortgages declined from SAR10bn in 2022 to SAR6.5bn in 2023 (Jan-Oct). This in turn has resulted in a relatively weak growth in the mortgage loans of ARB by 7% YoY and 3% YTD to SAR229bn as of Sep-23.

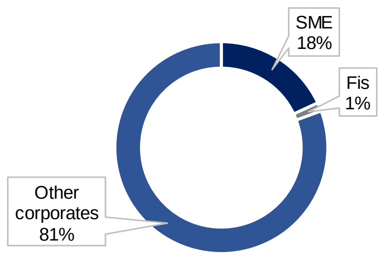
Monthly new residential mortgage trends lower in 2023



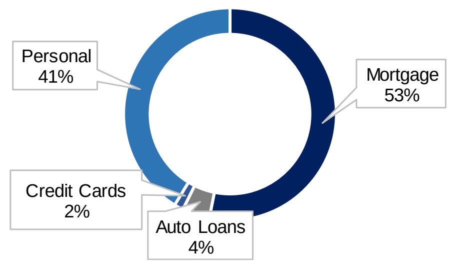
Source: SAMA, Company filings and US Research

Personal loans were the second largest contributor to total loans and accounted for >40% of the retail loans in 3Q23. The growth in loans from this vertical was robust at 13% (CAGR during 2019-22), though 2023 witnessed pressure on its performance. During this period, the loan value fell by 8% YoY and 6% YTD to SAR178bn (as of Sep-23). Auto loans (4% of retail loans) and credit card loans (1%) were the other verticals in ARB's retail operations. Auto loan performance was weak as of Sep-23 (flat YoY and -5% YTD), though credit operations remained strong (+20% YoY and YTD). Overall, the performance of the retail division was impacted by increasing interest rates. However, we feel that the interest rates have peaked and expect it to start trending lower from 2024 onwards. Added to this, we remain confident in the Kingdom's ongoing investment programs and the potential for growth in the real estate segment. However, we expect the recovery to be slightly slower, with the major impetus coming post-2025. Overall, we expect retail loans to grow at a CAGR of 5% between 2022-27e, driven mainly by a recovery in mortgage operations (+5% CAGR between 2022-27e).

SMEs form an important part of corporate loan book



Mortgages and personal loans dominate retail loans



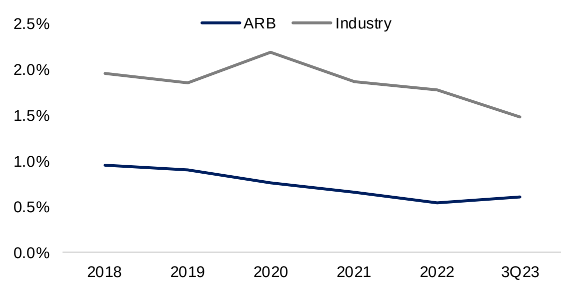
Source: Company filings and US Research

Corporate loans on the other hand accounted for 28% of the company's loan portfolio and have grown by a robust 21.6% CAGR between 2018-3Q23. The largest growth in this vertical has come from loans to SMEs, which have grown by +100% CAGR during the period, and accounted for 18% of total corporate loans in 3Q23. The overall growth in this vertical has continued to remain strong as of Sep-23 (26% YoY and 20% YTD), with loans to SMEs continuing to drive growth (+30% YoY and +15% YTD).

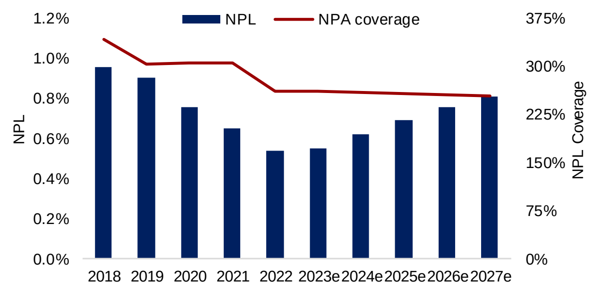
Corporate loans to continue to grow

ARB's market share in corporate loans has nearly doubled from 6.7% in 2019 to 12.5% for 3Q23 and is currently the 3rd largest player in the segment. Going forward, we expect the loan offtake from corporate will continue to remain strong. Corporate financing will be favorably aided by the investments expected in the economy in the next five years in infrastructure, real estate, hotels, etc. Saudi has set a target of SMEs accounting for 35% of the country's GDP by 2030. As a result, we expect growth in SME loan book to remain strong in the medium term. We have forecasted the corporate loans to grow at a CAGR of 10% between 2022-27e, driven by strong performance from the SME segment. Overall, we expect the financing of ARB to grow at a CAGR of 6% between (2022-27e) and will be driven by corporate loans. We expect retail loan growth to lag in the medium term, and pickup post 2025.

NPA levels substantially lower than industry average



Asset quality to remain comfortable

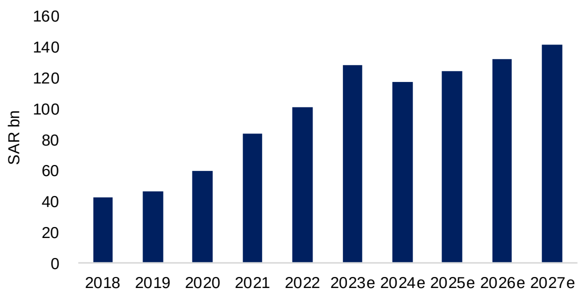


Source: Company filings and US Research

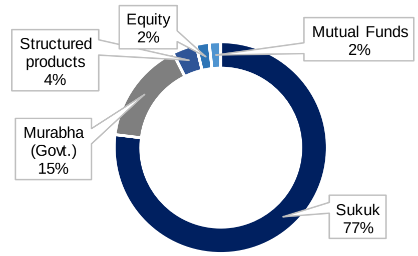
Low NPLs and strong coverage to aids asset quality

Asset quality of ARB has been consistently strong and better than the industry average, with its NPL to gross loans falling from 1% in 2018 to 0.6% in 3Q23 (industry average of c.1.5% for 3Q23). The asset quality of the company's retail book is strong with NPLs remaining stable at c.0.4% (2018 and 3Q23), while the corporate loan quality has improved from 2.4% in 2018 to 1.2% in 3Q23. We feel that the strong asset quality of the company has been at the back of a high proportion of its financing coming from retail operations, especially mortgage. Mortgage loan book growth has been quite strong since 2018 and we feel that the profile of these loans is relatively new. This is evidenced by the fact that c.40% of its loans outstanding had a maturity of greater than 5 years. Normally it takes time for mortgage loans to mature, resulting in defaults taking place after 5 years. As a result, the true test of the company's asset quality will be reflected in the coming years, though we remain comfortable with the overall credit quality. Given that most of the mortgage loans have been under government schemes, the default risk is likely to be limited. We also take into account the untapped growth opportunities through higher participation of private sectors, including the growing role of SMEs, and the potential for tourism. These in turn provide us with a comfort over any systematic risk that could affect the credit profile of the loan book, including the occurrence of an asset bubble, as was the case in some of the other countries in the region. NPL coverage was comfortable at 240% for 3Q23 and we expect this to continue to remain more than adequate going forward.

Strong growth in investment book; likely to moderate



Investments dominated by debt instruments



Source: Company filings and US Research

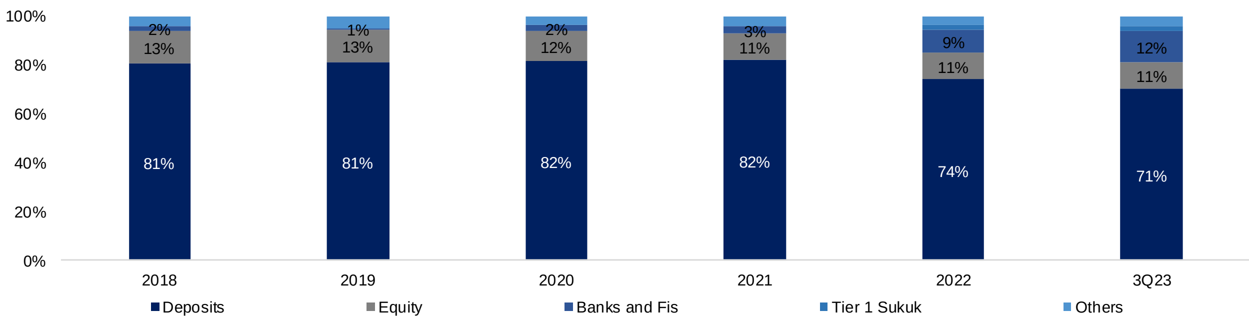
Investments dominated by Sukuk and government entities

The proportion of investments to total assets have increased from 12% in 2018 to 16% in 3Q23, as the investment book has grown by a robust 26% CAGR. The investment book appears to be fairly conservative with 93% of it being accounted for by investments in Sukuks and government securities. Investments in equity and structured products accounted for 6% of the total investment portfolio, with the balance being made up by mutual funds. The quality of the investment book appears to be fairly strong, with non-investment grade and unrated investments accounting for a mere 7% of the debt instruments (including structured products). We see the growth in the investment book was on account of the increase in interest rate. In the next five years, we expect the interest rates to fall gradually, which is likely to result in the proportion of investments to total assets falling to historical levels by 2027e.

The funding mix is strong, though skewed towards time deposit due to high-interest rates; likely to normalize gradually

The funding profile of ARB has come under pressure, with the proportion of deposits to total liabilities falling from 81% in 2018 to 71% in 3Q23, while the share of banks and financial institutions have increased from 2% in 2018 to 12% in 3Q23. Increases in interest rates have resulted in higher demand for high-cost time deposits, which is likely to have resulted in the increasing dependence on short-term bank borrowings of ARB. However, despite the fall, ARB’s funding profile continues to be better than the industry average of 67.5% deposits to total liabilities in 3Q23. Going forward we expect the company’s funding profile to improve, as we feel that the interest rates have peaked and are likely to trend downwards during the medium term. However, the improvement is likely to be gradual, given that the rates will continue to be lucrative, vis-à-vis historical levels.

Deposit's proportion to total liabilities falls



Source: Company filings and US Research

Proportion of time deposits to total deposits have increased; return to normal levels will be gradual

The deposit mix too has undergone a substantial change in its character, as the proportion of time deposits to total deposits has increased from 6% in 2018 to 33% in 3Q23. This has resulted in the proportion of CASA to total deposits falling from 91% in 2018 to 65% in 3Q23. However, this continues to be substantially higher than the peer average of 58.4%, as ARB continued to have one of the highest CASA ratios among its peers. Going forward, we expect the proportion of CASA to improve to 74% by 2027e, as we expect the interest rates in Saudi Arabia to moderate.

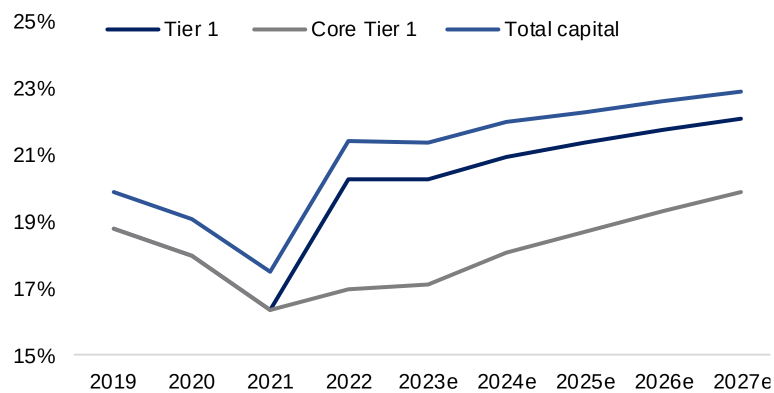
Overall, we feel that the funding profile of ARB continues to be strong, despite an increase in the dependence on market funding (2% in 2018 to 16% in 3Q23). We take into account the strong credit rating of the company (A1/Moody's, A-/S&P & Fitch) and the solid business franchisee it has in the country, which makes access to funds within and outside the country easier and cheaper.

Capitalization strong with one of the highest statutory ratios among its peers

ARB's capital quality has been consistently strong and comfortable, with a tier 1 ratio of a robust 19.6% in 3Q23. The quality of the capital too was strong with 84% of the tier 1 capital being made up of equity. During 2022, the company issued SAR16.5bn tier 1 Sukuk in two tranches, SAR6.5bn junior subordinated perpetual instrument in Jan-2022, and a SAR10bn junior subordinated perpetual instrument in Nov-22. Excluding the Sukuk issue, the core tier 1 at 16.5% in 3Q23 was also strong. Both these ratios were better than the industry average of 18% (tier 1) and 16% (core tier 1) and were one of the highest among its peers.

Going forward we expect this trend to continue, as we expect the bank to maintain its strong capital adequacy ratios, that would be better than its peers. ARB's strong capital position, seen in tandem with its superior asset quality makes it one of the safest in the industry.

Core capital ratios expected to remain strong



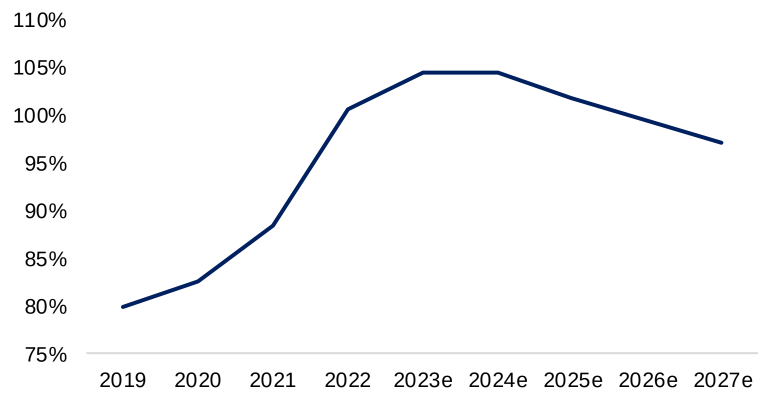
Source: Company filings and US Research

Liquidity remains adequate, despite loans to deposit ratio being higher than historical average

Liquidity remains comfortable

Loan-to-deposit ratio of ARB has been under pressure since 2018, as it increased from 78.9% in 2018 to 104.4% in 3Q23. It was also higher than the industry average of 98.4%. However, the company has continued to maintain its statutory liquidity ratios well above the minimum requirement (liquidity coverage ratio of 145% vs the requirement of 100% and net stable funding ratio of 110% vs the requirement of 100% in 3Q23). Added to this, the company's strong credit rating and low dependence on market funding largely mitigates any liquidity risks.

L/D has deteriorated, though expected to improve

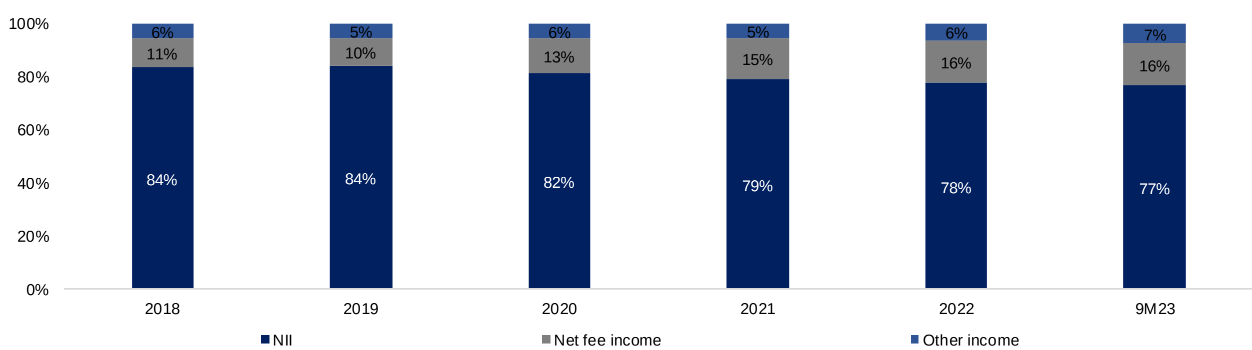


Source: Company filings and US Research

Strong growth in profitability powered by an increase in loan book

The total income of ARB has increased by a CAGR of 13% between 2018-22, and was aided by a strong growth of 25% CAGR in net fee income, 16% CAGR in other income, and an 11% CAGR in net income from loans and investments (NII). Growth in NII was aided by strong growth in loan (25% CAGR 2018-22) and investment books (24% CAGR 2018-22), even as the fall in NIMs restricted the growth to a certain extent. Net fee income on the other hand has witnessed consistent growth since 2018, with its proportion to total income increasing from 11% in 2018 to 16% in 2022. We view this improvement positively, as it diversifies the income profile of the bank. Despite the strong growth in other income, its proportion to total income has broadly remained stable at c.5-6% in the last four years.

Total income well diversified, aided by a strong increase in fee income



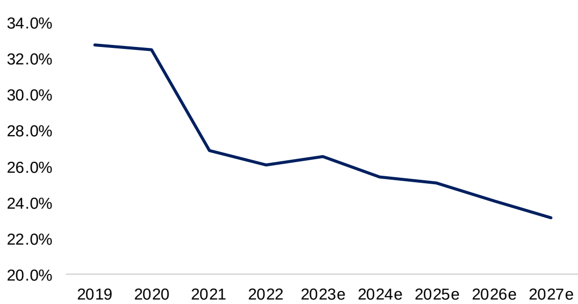
Source: Company filings and US Research

However, ARB's performance in 2023 has come under pressure, as total income for 9M23 fell by 4% YoY, at the back of lower NII (-5% YoY) and net fee income (-6% YoY). Growth in other income (20% YoY) restricted the fall to a certain extent. NII was impacted by pressure on NIMs, which fell to 3% in 9M23, compared to 3.3% in 9M22, at the back of higher cost of funds.

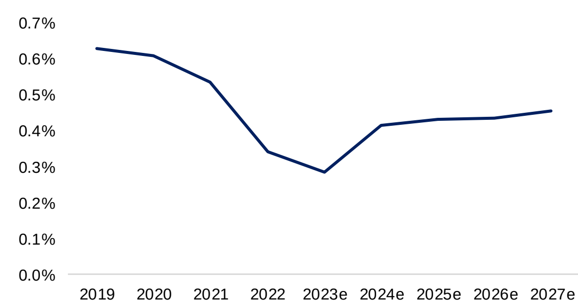
Recovery in NIM and steady loan book growth to drive total income

Going forward, we expect total income growth to recover from 2024 and will be aided by a steady growth in the loan book and a softening in interest rates, making the cost of funds cheaper. However, the recovery will be gradual and will pick up pace post 2026e. Overall we expect total income to grow at a CAGR of 10% between 2023e-27e.

Cost to income ratio improves



Cost of risk to remain under control



Source: Company filings and US Research

Operating expenses on the other hand increased by a much lower (vis-à-vis total income growth) 7% CAGR between 2018 and 2022, with cost to income ratio improving to 26.1% in 2022 compared to 32.6% in 2018. Though the cost-to-income ratio increased marginally to 26.9% in 9M23, it was broadly under control.

Operating costs and impairments to remain under control

ARB has the lowest cost-to-income ratio amongst its peers, which averaged c.32%, despite having one of the widest distribution networks in the Kingdom. We view this ability of the bank to scale up its operations, while managing its cost structure positively. We expect this trend to continue, as the company is likely to outperform its peers in terms of managing its costs.

Impairments grew at a CAGR of 7% between 2018-22, at the back of increasing size of its loans and investment book. Cost of risk however has fallen from 0.6% in 2018 to 0.3% in 2022. Impairments were lower in 2023, as it fell by 33% YoY in 9M23, with cost of risk remaining at 2022 levels.

Overall net income of ARB grew by a robust 46% CAGR between 2018-22, powered by an improvement in total income and control over its operating expenses and asset quality. However, in 9M23 it witnessed a decline of 2% YoY, at the back of lower total income, which was to a certain extent made up by lower impairments. Going forward, we expect the net income to grow by a CAGR of 10% between 2022-27e, aided by a steady improvement in the yield and growth in its asset size.

Valuation:

Blended target price at SAR92/share

Investment in ARB is supported by its strong business franchisee, as a leading provider of Islamic financing globally, superior asset quality, and better than peer capital quality. We also remain positive on the growth of its loan book, though the same is likely to be gradual. We also expect improvement in the NIM of ARB, though it will be lower than the levels achieved in 2018 and 2019. Overall, we feel that the current market price fully reflects the medium-term performance of the company and initiate coverage with a ***Hold*** rating at a target price of ***SAR92/share***.

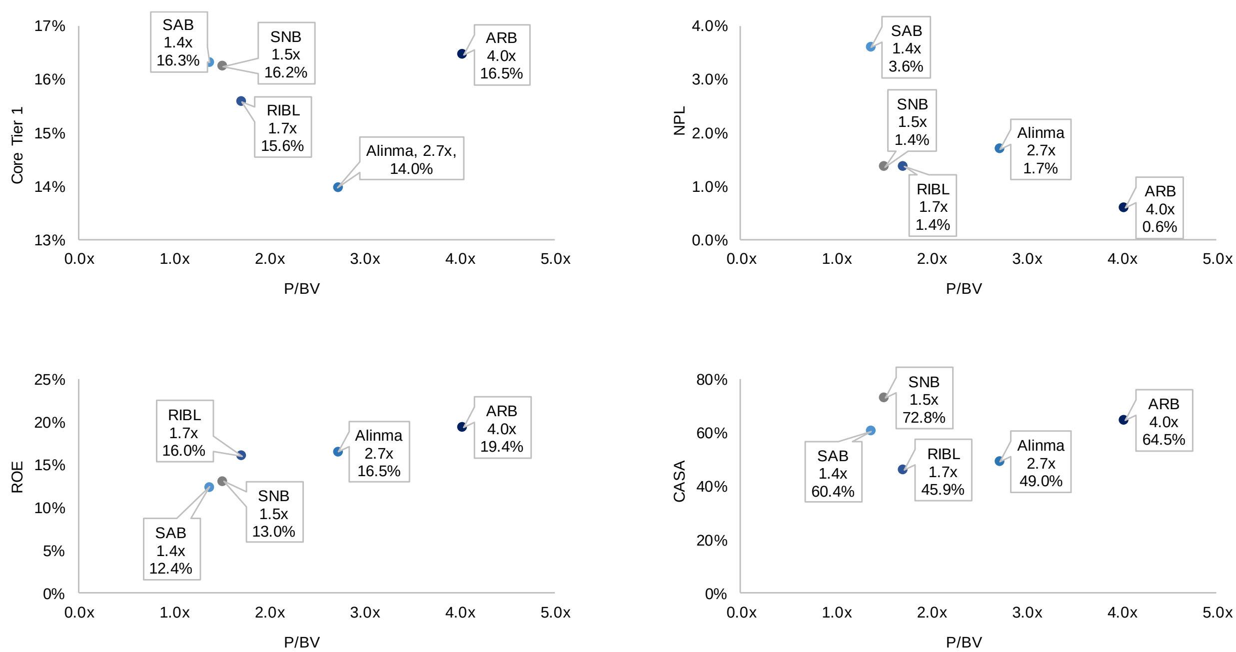
We arrive at the target price using an equal-weighted combination of residual valuation and relative valuation (P/BV). The residual valuation is based on a risk-free rate of 4.1%, a market risk premium of 4.7%, and a beta of 1.1x, giving us a cost of equity of 9.0%. We have also used a two stage terminal growth rate, as we expect the strong impetus on growth will occur as we near 2030, with growth rate of stage 1 at 15% and stage 2 at 2%. Based on these inputs we get a fair value price of SAR94/share, using the residual valuation methodology.

Residual Valuation (SAR mn)	2022	2023E	2024E	2025E	2026E	2027E
Equity	83,725	90,542	103,051	116,628	131,979	149,330
Net income		16,881	17,870	19,397	21,929	24,787
Less Cost of equity		(7,570)	(8,186)	(9,317)	(10,544)	(11,932)
Residual value		9,312	9,684	10,080	11,384	12,855
Discounted residual value		**9,305**	**8,874**	**8,472**	**8,775**	**9,087**
Current equity value						**83,725**
Terminal value						**246,367**
Equity value						**374,605**
Fair value per share (SAR)						***94***

Cost of Capital	
Risk free rate	4.1%
Adjusted beta	1.1x
Equity risk premium	4.7%
Cost of equity	9.0%
Terminal growth	
Stage 1	15.0%
Stage 2	2.0%

For relative valuations we have used P/BV; ARB has quoted at a median P/BV of 3.5x in the past five years, consistently higher than the valuation of its peers, which are currently averaging at c.2x. For our valuation purposes we take into account the bank's superior operating quality under most parameters. Given this, we feel that the bank will continue to demand premium valuations vis-à-vis its peers in the country. Therefore, we use the five-year median P/BV multiple of 3.5x and arrive at a fair value of SAR90/share from the relative valuation. Using an equally weighted average, we arrive at a target price of ***SAR92/share*** and a ***Hold*** rating on ARB.

Valuations richer than peers, but key operating ratios outperform most of its peers



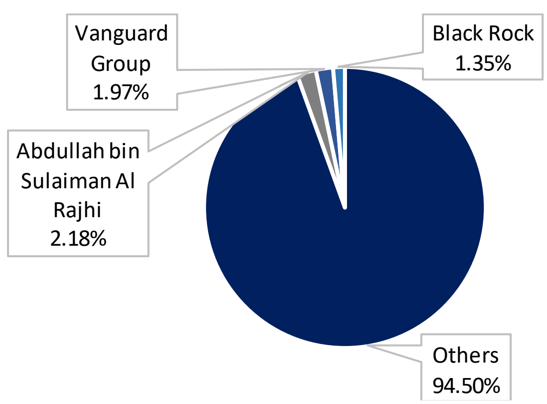
Relative valuation	
BV (2024e)	26
5 year median P/BV	3.5x
Fair Value	***90***

Methodology	Tp/Sh SAR	Wt	Avg./Sh SAR
Residual valuation	94	50%	47
Relative valuation	90	50%	45
Value per share			**92**

About the Company

Established in 1957, ARB is the largest Islamic Bank in the world, with total assets of c.SAR800bn, and a paid-up capital of SAR40bn. It has 60+ years of experience in banking and related activities. Various companies under the Al Rajhi brand were merged into Al Rajhi Trading and Exchange Corporation in 1978. In 1988 the bank was set up as a joint stock company under the name of Al Rajhi Banking and Investment Corporation and later converted into Al Rajhi Bank in 2006. The company has operations in 4 countries and services 15.2mn customers. It has a strong digital presence, with 12.5mn active digital customers and a digital-to-manual ratio of 94:6. The bank has a strong distribution network across the Kingdom with over 500 branches, +4.6k ATMs, +581k POS, and +160 remittance centers. ARB was also rated the number one bank in terms of Brand Power Score. It also had a leadership position in the country in terms of the number of transactions, which averaged more than 800mn per month. ARB has been rated A1 by Moody’s, and A- by both S&P & Fitch.

Share Holding Pattern



Board of Directors		
S.no	Name	Position
1	Abdullah bin Sulaiman Al Rajhi	Chairman
2	Ibrahim bin Mohammed Al Rumaih	Deputy Chairman
3	Abdulaziz bin Khalid Al Ghufaily	Director
4	Badr bin Mohammed Al Rajhi	Director
5	Khalid bin Abdulrahman Al Gwaiz	Director
6	Alaa bin Shakib Al Jabri	Director
7	Ibrahim bin Fahad Al Ghofaily	Director
8	Hamza bin Othman Khoshaim	Director
9	Raeed bin Abdullah Al-Tamimi	Director
10	Abdulatif bin Ali Al Seif	Director
11	Waleed bin Abdullah Al Mogbel	Director

Source: Bloomberg, Company Filings and US Research

Income Statement (SAR mn)	2019	2020	2021	2022	2023e	2024e	2025e	2026e	2027e
Net income from loans and investment	16,428	16,913	20,392	22,173	21,617	23,582	25,505	28,476	31,937
Net fee income	1,987	2,660	3,933	4,624	4,101	4,777	5,320	5,886	6,526
Other income	1,069	1,149	1,391	1,778	2,034	2,059	2,100	2,142	2,185
Total income	**19,484**	**20,721**	**25,716**	**28,575**	**27,751**	**30,418**	**32,925**	**36,504**	**40,648**
Operating expenses	(6,386)	(6,742)	(6,927)	(7,451)	(7,367)	(7,743)	(8,262)	(8,806)	(9,404)
Profit before impairments	**13,099**	**13,979**	**18,790**	**21,124**	**20,385**	**22,675**	**24,663**	**27,698**	**31,244**
Impairments	(1,772)	(2,166)	(2,345)	(2,001)	(1,563)	(2,751)	(3,037)	(3,248)	(3,608)
Profit before tax	**11,326**	**11,814**	**16,445**	**19,123**	**18,822**	**19,924**	**21,627**	**24,450**	**27,637**
Tax	(1,168)	(1,218)	(1,699)	(1,972)	(1,941)	(2,054)	(2,230)	(2,521)	(2,850)
Profit after tax	**10,159**	**10,596**	**14,746**	**17,151**	**16,881**	**17,870**	**19,397**	**21,929**	**24,787**

Balance Sheet (SAR mn)	2019	2020	2021	2022	2023e	2024e	2025e	2026e	2027e
Cash and statutory deposits	39,294	47,363	40,363	42,052	47,282	59,135	70,137	83,334	99,535
Due to financial institutions	32,058	28,655	26,065	25,656	8,178	8,783	9,341	9,943	10,599
Investments - Net	46,646	60,046	84,138	101,325	128,564	117,152	124,588	132,625	141,365
Financing - Net	249,683	315,712	452,831	568,338	594,458	637,376	676,651	719,249	765,570
PP&E and right to use assets	10,407	10,235	10,148	11,339	12,336	13,277	14,167	15,012	15,818
Other assets	5,998	6,814	10,099	13,655	18,540	18,247	17,803	17,990	19,244
Total Assets	**384,087**	**468,825**	**623,645**	**762,366**	**809,358**	**853,971**	**912,687**	**978,153**	**1,052,131**
Liabilities and Equity									
Liabilities									
Due to banks and other FI	2,220	10,764	17,952	70,839	104,632	95,887	87,653	78,013	66,805
Customer deposits	312,406	382,631	512,072	564,925	568,878	610,118	664,211	723,415	788,525
Other liabilities	18,269	17,311	26,339	26,377	28,806	28,416	27,694	28,246	30,972
Total liabilities	**332,895**	**410,706**	**556,363**	**662,141**	**702,316**	**734,420**	**779,558**	**829,674**	**886,302**
Equity									
Share capital	25,000	25,000	25,000	40,000	40,000	40,000	40,000	40,000	40,000
Reserves	26,192	33,119	42,282	43,725	50,542	63,051	76,628	91,979	109,330
Total shareholders' equity	**51,192**	**58,119**	**67,282**	**83,725**	**90,542**	**103,051**	**116,628**	**131,979**	**149,330**
Tier 1 Sukuk	0	0	0	16,500	16,500	16,500	16,500	16,500	16,500
Total Equity	**51,192**	**58,119**	**67,282**	**100,225**	**107,042**	**119,551**	**133,128**	**148,479**	**165,830**
Total liabilities and equity	**384,087**	**468,825**	**623,645**	**762,366**	**809,358**	**853,971**	**912,687**	**978,153**	**1,052,131**

Cash Flows (SAR mn)	2019	2020	2021	2022	2023e	2024e	2025e	2026e	2027e
Cash from operations	4,187	24,420	23,855	8,603	16,419	16,888	16,761	19,561	23,235
Cash from investments	(5,186)	(8,912)	(28,204)	(21,686)	(2,768)	(2,416)	(2,464)	(2,513)	(2,564)
Cash from financing	(7,676)	(3,792)	(6,239)	16,036	(10,064)	(5,361)	(5,819)	(6,579)	(7,436)
Net changes in cash	(8,675)	11,716	(10,587)	2,953	3,587	9,111	8,477	10,469	13,235
Cash balance	**21,111**	**32,827**	**22,240**	**25,193**	**28,780**	**37,891**	**46,368**	**56,837**	**70,072**

Ratios	2019	2020	2021	2022	2023e	2024e	2025e	2026e	2027e
Per Share (SAR)									
EPS	2.5	2.6	3.7	4.3	4.2	4.5	4.8	5.5	6.2
BVPS	12.8	14.5	16.8	20.9	22.6	25.8	29.2	33.0	37.3
DPS	1.9	0.6	0.9	1.3	1.3	1.3	1.5	1.6	1.9
Total income/share	4.9	5.2	6.4	7.1	6.9	7.6	8.2	9.1	10.2
Valuations									
M.Cap (SAR mn)	165,108	157,170	276,318	361,231	346,000	346,000	346,000	346,000	346,000
P/E	16.3	14.8	18.7	21.1	20.5	19.4	17.8	15.8	14.0
P/BV	3.2	2.7	4.1	4.3	3.8	3.4	3.0	2.6	2.3
Div. yield	4.6%	1.6%	1.3%	1.4%	1.5%	1.5%	1.7%	1.9%	2.1%
Capital Quality									
Equity to total assets	13.3%	12.4%	10.8%	11.0%	11.2%	12.1%	12.8%	13.5%	14.2%
Tier 1	18.8%	18.0%	16.4%	20.3%	20.2%	21.0%	21.4%	21.7%	22.1%
Core Tier 1	18.8%	18.0%	16.4%	17.0%	17.1%	18.1%	18.7%	19.3%	19.9%
Total capital	19.9%	19.1%	17.5%	21.4%	21.4%	22.0%	22.3%	22.6%	22.9%
Earning Quality									
NIM	5.3%	4.3%	3.8%	3.3%	3.0%	3.1%	3.2%	3.3%	3.5%
NII to total income	84.3%	81.6%	79.3%	77.6%	77.9%	77.5%	77.5%	78.0%	78.6%
Fee income to total income	10.2%	12.8%	15.3%	16.2%	14.8%	15.7%	16.2%	16.1%	16.1%
Other income to total income	5.5%	5.5%	5.4%	6.2%	7.3%	6.8%	6.4%	5.9%	5.4%
Cost to income ratio	32.8%	32.5%	26.9%	26.1%	26.5%	25.5%	25.1%	24.1%	23.1%
Impairment coverage	7.4	6.5	8.0	10.6	13.0	8.2	8.1	8.5	8.7
ROA	2.6%	2.3%	2.4%	2.2%	2.1%	2.1%	2.1%	2.2%	2.4%
ROE	19.8%	18.2%	21.9%	20.5%	18.6%	17.3%	16.6%	16.6%	16.6%
Return on RWA	3.7%	3.3%	3.5%	3.4%	3.2%	3.1%	3.1%	3.2%	3.3%
Asset Quality									
Cost of risk	0.6%	0.6%	0.5%	0.3%	0.3%	0.4%	0.4%	0.4%	0.5%
NPL	0.9%	0.8%	0.7%	0.5%	0.6%	0.6%	0.7%	0.8%	0.8%
NPL coverage	303.0%	305.6%	305.6%	260.2%	261.1%	259.1%	257.3%	255.6%	254.2%
Stage 1 ratio		96.3%	97.0%	97.5%	97.4%	96.8%	96.1%	95.5%	95.0%
Stage 2 ratio		2.6%	2.1%	1.7%	1.7%	2.3%	2.9%	3.4%	3.9%
Stage 3 ratio		1.1%	0.9%	0.8%	0.8%	0.9%	1.0%	1.1%	1.1%
Stage 1 coverage		0.9%	0.8%	0.6%	0.6%	0.6%	0.6%	0.6%	0.6%
Stage 2 coverage		24.0%	24.3%	17.9%	18.0%	18.4%	18.6%	18.7%	18.8%
Stage 3 coverage		72.4%	75.6%	64.1%	64.5%	65.2%	65.7%	66.1%	66.3%
Provisions to gross loans	2.7%	2.3%	2.0%	1.4%	1.4%	1.6%	1.8%	1.9%	2.1%
Funding									
Deposits to total funding	85.4%	84.7%	85.7%	76.8%	72.9%	73.9%	75.1%	76.2%	77.2%
Market funds to total funding	0.6%	2.4%	3.0%	11.9%	15.5%	13.6%	11.8%	9.9%	8.2%
Liquidity									
Loans to deposits	79.9%	82.5%	88.4%	100.6%	104.5%	104.5%	101.9%	99.4%	97.1%
Investments and cash to total assets	22.4%	22.9%	20.0%	18.8%	21.7%	20.6%	21.3%	22.1%	22.9%

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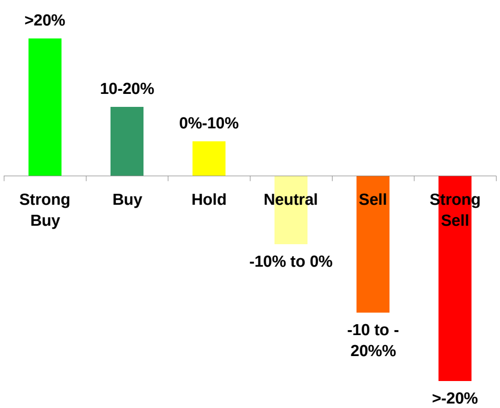
Rating Criteria and Definitions

Rating



Rating Definitions	
Strong Buy	This recommendation is used for stocks whose current market price offers a deep discount to our 12-Month target price and has an upside potential in excess of 20%
Buy	This recommendation is used for stocks whose current market price offers a discount to our 12-Month target price and has an upside potential between 10% to 20%
Hold	This recommendation is used for stocks whose current market price offers a discount to our 12-Month target price and has an upside potential between 0% to 10%
Neutral	This recommendation is used for stocks whose current market price offers a premium to our 12-Month target price and has a downside side potential between 0% to -10%
Sell	This recommendation is used for stocks whose current market price offers a premium to our 12-Month target price and has a downside side potential between -10% to -20%
Strong Sell	This recommendation is used for stocks whose current market price offers a premium to our 12-Month target price and has a downside side potential in excess of 20%
Not rated	This recommendation used for stocks which does not form part of Coverage Universe

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