



Initiation Coverage

March 07, 2018

Recommendation	Neutral
Current Price (SAR)	73.1
Target Price (SAR)	72.4
Upside/Downside (%)	(0.9%)

As of February 28, 2018

Key Data (Source: Bloomberg)

Market Cap (SAR bn)	118.8
52 Wk High (SAR)	76.2
52 Wk Low (SAR)	61.0
Total Outstanding shares (in mn)	1,625
Free Float (%)	86.8%

RJHI Vs TASI (Rebased)

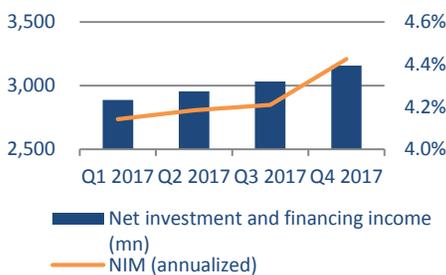


Price Performance (%)	Absolute	Relative
1m	3.4%	3.7%
6m	21.3%	16.4%
12m	18.3%	11.7%

Major Shareholders (%)

General Organization for Social Insurance	10.19
Abdullah Sulaiman Abdulaziz Al Rajhi	2.17
Mohammed Abdulaziz Al Rajhi & Sons Co.	2.05

Net investment and financing income (SAR mn) and NIM (annualized)



Source: Bloomberg, Company Financials, FALCOM Research; Data as of 28th February 2018

Al Rajhi Bank concluded FY 2017 on a strong note and an increase of 3.7% YoY in operating income, driven by a 7.2% increase in net financing and investment income. Al Rajhi's net profit for the period came in at SAR 9.1bn (up 12.2% YoY), supported by a decline in provisions (down 27.8% YoY) and salary expenses (down 2.1% YoY). Total profits for the year surged despite a decline of 8.6% YoY and 9.0% YoY in fees from banking services and exchange income, respectively.

Al Rajhi reported record profits in FY 2017, driven by sustained growth in its operating income as the bank managed to curb costs by leveraging economies of scale. Al Rajhi announced a dividend payout of SAR 6.5bn in FY 2017, thereby increasing its RoE and dividend yield to 16.9% and 5.5%, respectively (2016: RoE: 16.5%, Div. yield: 2.7%). The dividend payout is expected to remain stable, driven by the bank's strong earnings growth and hefty capital buffers (Al Rajhi's CAR at 21.9% was the highest in the market as of Q3 2017). However, considering the effect of oil price volatility, apart from the challenges posed by IFRS 9 standards and an additional zakat levy, we assign a 'neutral' rating to Al Rajhi Bank. The stock has also run up by 13% over the past three months, which indicates that its price has essentially captured most of the positive news.

Leading Shari'ah-compliant bank with strong liquidity and asset quality:

Al Rajhi leads in retail customer base in Saudi Arabia (9 mn as of Q3 2017) with a network of 584 branches. During 2014-16, when other banks in Saudi Arabia struggled with liquidity concerns, Al Rajhi's deposit base remained strong, seeing a negligible increase in the cost of funds. This is partially attributable to the bank's low-cost deposits; Al Rajhi's deposit base constitutes majorly of zero-cost deposits (92% as of FY 2017) which provide a hedge against cost volatilities. In addition to its robust liquidity position, bank's asset quality remained strong with an NPL ratio of 0.7% (down from 1.2% in 2016); the asset quality is expected to remain strong going forward. Given the strong fundamentals; we do not foresee any major near-term obstacles to bank's growth.

Management focus on SME lending to drive loan growth:

Al Rajhi's credit growth moderated to 3.8% YoY (2016: 7.0% YoY), or SAR 233.5bn, in FY 2017 amid economic headwinds; however, the management believes that loan growth would pick up pace in 2018 due to increased government spending. The bank is closely aligned with Saudi Arabia's NTP 2030 and believes that the plan, and a more forward-looking budget, would help it diversify into other sectors like corporate and SME lending apart from retail lending, in which Al Rajhi already has a strong hold.

P&L volatility to rise following IFRS 9 implementation and additional zakat levy:

The IFRS 9 standard mandates banks to adopt a proactive approach to provisioning, based on expected losses; thus, Al Rajhi, which has an exposure of 21.1% to risky sectors such as commercial, industrial, and real estate, may suffer from net income volatility in future. Additionally, the General Authority of Zakat and Tax (GAZT) issued 'assessment orders' on a zakat levy of SAR 723mn to be paid by the bank for the period 2002-09. Al Rajhi has appealed against the assessment; however, if enforced, the additional zakat levy would hit the bank's bottom line.

Effect of VAT on cost-to-income ratio to be offset by strong earnings growth:

The implementation of VAT would increase the bank's costs; however, Al Rajhi, with its strong brand value and customer base, would be able to transfer the additional costs to retail customers in the form of fees. Further, we believe that the effect of VAT implementation on the cost-to-income ratio (average 32.1% over the forecast period) would be neutralized by the bank's net income growth. We expect an 8% growth in net earnings in 2018 driven by an increase in interest and, fees and commission income.

Valuation: We valued Al Rajhi using the weighted average approach (Residual Income and P/B) to arrive at a fair value of SAR 72.4 per share. We considered COE at 10.7%, with a terminal growth rate of 2.0%.

	2017	2018E	2019E	2020E
Net financing and investment income (SAR bn)	12.0	13.0	14.5	16.5
Operating income (SAR bn)	15.9	17.1	19.0	21.6
EPS (SAR)	5.6	6.1	6.9	7.9
Net Interest Margin (%)	4.2%	4.5%	4.7%	5.1%
Cost to income (%)	32.9%	32.6%	32.3%	31.9%
RoE (%)	16.9%	17.2%	18.1%	19.2%
P/B (x)	2.1	2.0	1.9	1.7
NPL (%)	0.7%	0.7%	0.7%	0.7%
Provision coverage (%)	313.8%	318.8%	318.8%	318.8%

Source: Company Financials, FALCOM Research



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Valuation Summary

Explanation of valuation methodology and assumptions

We valued Al Rajhi using the weighted average method, with equal weightage given to RI and P/B approach to arrive at a fair value of SAR 72.4 per share. We considered cost of equity at 10.7% with a terminal growth rate of 2.0%. In relative terms, Al Rajhi is trading at 1yr forward P/B of 2.0x, at a premium of 35.4% to its sector peers and premium of 29.2% to the Tadawul All Share Index.

Residual Income valuation

SAR Mn	FY 2017	FY 2018E	FY 2019E	FY 2020E	FY 2021E
Net income for the year	9,121	9,886	11,155	12,845	14,940
Beginning book value	51,947	55,751	59,136	63,792	70,137
Cost of equity		10.68%	10.68%	10.68%	10.68%
Equity charge		-5,953	-6,314	-6,811	-7,488
Excess equity return		3,933	4,841	6,034	7,451
Ending book value		59,136	63,792	70,137	78,576
Discount Factor		0.9	0.8	0.7	0.7
Discounted returns (including terminal value)		3,613	4,018	4,525	54,024
PV of cash flows (A)					66,181
Beginning book value (B)					55,751
Assumed Terminal Growth Rate					2.0%
Equity Value (A+B)	121,931	Cost of Equity Assumptions			
Number of shares in mn	1,625	Risk free rate	2.6%		
Target Price in SAR per share	75.03	Beta	0.900		
CMP in SAR as on February 21st, 2018	73.10	Country risk premium (US)	2.0%		
Upside/(Downside) to current market price	2.65%	Saudi spread	6.9%		
		Cost of equity	10.7%		

P/B Valuation		Weighted average Valuation	Weighted average price
Exit Year	2018	RI Valuation	75.03
Normalized ROE	18.7%	P/B valuation	69.86
Cost of Equity	10.68%	Weighted average fair price	72.45
Terminal growth rate	2.00%	Upside/(Downside) %	-0.89%
Justified P/B	1.92		
BVPS	36.39		
Target Price	69.86		
Upside/downside	-4.43%		

Risks

Upside Risks:

- Expansion of economy at a greater than expected rate will lead to sharp uptick in credit demand.
- Al Rajhi will attract huge foreign inflows if Saudi Arabia is included in MSCI emerging markets index, due to its strong brand value.
- An increase in interest rates following Fed decision of rate hike will boost top line.

Downside Risks

- Emerging Shari'ah compliant banks like Alinma and Al Bilad might weaken Al Rajhi's customer base.
- Decline in oil prices might affect credit demand in the region due to austerity measures undertaken by the government.
- IFRS 9 standards might lead to considerable net income volatility if the economic situation deteriorates.

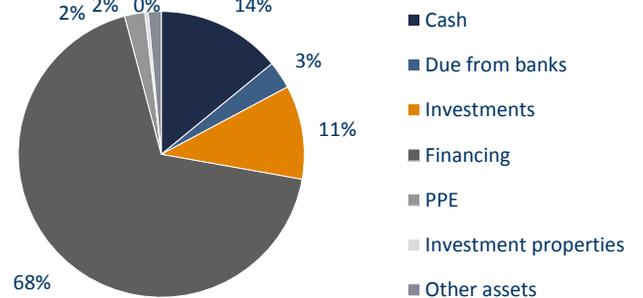


Key Charts

Net Financing and Investment Income (SAR bn) and NIM



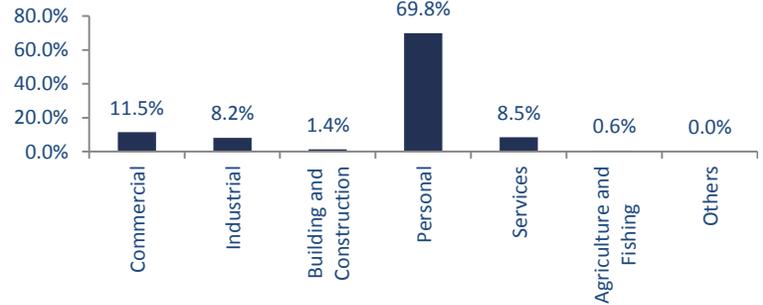
Asset break-up (2017)



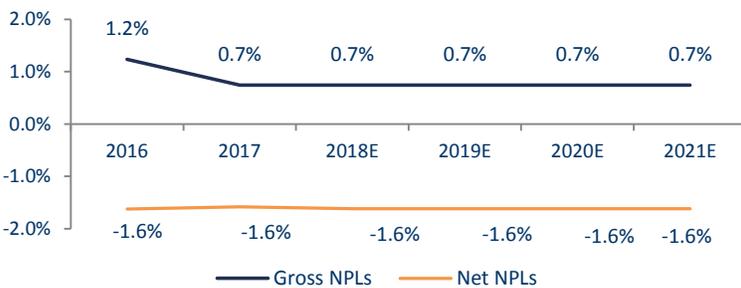
Investment Yield (%)



Asset concentration by sectors (2017)



Gross and Net NPLs



EPS and ROE



P/B



Dividend Yield (%)



Source: FALCOM Research Estimates



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Summary Financials

P&L (SAR mn)	2017	2018E	2019E	2020E
Net financing and investment income	12,029	12,984	14,491	16,506
Fee income	2,697	2,810	3,037	3,273
Total operating income	15,905	17,118	19,048	21,564
Total operating expenses	(5,237)	(5,586)	(6,157)	(6,884)
Pre-provision profit	10,668	11,532	12,891	14,681
Impairment charge for financing, net	(1,548)	(1,647)	(1,736)	(1,836)
Net Income	9,121	9,886	11,155	12,845
EPS	5.6	6.1	6.9	7.9
DPS	4.0	4.0	4.0	4.0

BS (SAR mn)	2017	2018E	2019E	2020E
Cash	48,282	50,894	54,334	59,452
Due from banks	10,710	10,924	11,142	11,365
Investments	36,401	38,934	41,643	44,541
Financing, net	233,536	248,387	261,873	276,889
Total assets	343,117	365,149	386,983	412,440
Due to banks	5,523	5,799	6,089	6,393
Customer deposits	273,056	290,421	306,189	323,747
Total liabilities	287,366	306,013	323,192	342,304
Shareholder equity	55,751	59,136	63,792	70,137
Total liabilities and equity	343,117	365,149	386,983	412,440

Solvency	2017	2018E	2019E	2020E
Credit risk weighted assets	219,688	233,795	247,775	264,074
Operational risk weighted assets	26,832	28,555	30,263	32,254
Market risk weighted assets	4,595	4,890	5,182	5,523
Total risk weighted assets	251,115	267,240	283,220	301,851
Tier I capital	55,751	59,136	63,792	70,137
Tier II capital	2,746	2,922	3,097	3,301
Total tier I and tier II	58,497	62,059	66,889	73,437

Valuation	2017	2018E	2019E	2020E
PE	13.0	12.0	10.6	9.2
PB	2.1	2.0	1.9	1.7
Dividend Yield	5.5%	5.5%	5.5%	5.5%

Source: Bloomberg, Company Financials, FALCOM Research

Growth	2017	2018E	2019E	2020E
Operating income	3.7%	7.6%	11.3%	13.2%
Pre-provision profit	3.2%	8.1%	11.8%	13.9%
Net income	12.2%	8.4%	12.8%	15.2%
Loan growth	3.8%	6.4%	5.4%	5.7%
Deposit growth	0.2%	6.4%	5.4%	5.7%

Ratios (%)	2017	2018E	2019E	2020E
Yield on earning assets	4.4%	4.6%	4.9%	5.2%
Cost of funds	0.2%	0.1%	0.1%	0.1%
Spread (Yield-Costs)	4.2%	4.5%	4.7%	5.1%
Net Interest Margin	4.2%	4.5%	4.7%	5.1%
Cost/Income (%)	32.9%	32.6%	32.3%	31.9%
ROE	16.9%	17.2%	18.1%	19.2%
ROA	2.7%	2.8%	3.0%	3.2%
Loans/ Customer Deposits	85.5%	85.5%	85.5%	85.5%
Loans/Total Assets	68.1%	68.0%	67.7%	67.1%
Customer Deposits/Total Funding	95.0%	94.9%	94.7%	94.6%
RWA/Total Assets	73.2%	73.2%	73.2%	73.2%
Tier I ratio	22.2%	22.1%	22.5%	23.2%
Capital adequacy ratio	23.3%	23.2%	23.6%	24.3%
Gross NPLs	0.7%	0.7%	0.7%	0.7%
Net NPLs	-1.6%	-1.6%	-1.6%	-1.6%
Provision coverage	313.8%	318.8%	318.8%	318.8%

Peer Valuations	12M Fwd PB	12m Fwd PE
Alinma Bank	1.46x	13.75x
Bank Al-Jazira	NA	8.39x
Bank Albilad	NA	11.22x
Sharjah Islamic Bank	0.58x	8.93x
Abu Dhabi Islamic Bank	1.18x	11.39x
Dubai Islamic Bank	1.59x	7.90x
Qatar Islamic Bank	1.54x	11.19x
Kuwait Finance House	1.69x	14.39x
Al Rajhi Bank	1.99x	12.26x
Sector Median	1.47x	10.76x
TASI	1.54x	13.57x



FALCOM Rating Methodology

FALCOM Financial Services uses its own evaluation structure, and its recommendations are based on quantitative and qualitative data collected by the analysts. Moreover, the evaluation system places covered shares under one of the next recommendation areas based on the closing price of the market, the fair value that we set and the possibility of ascent/descent.

Overweight: The Target share price exceeds the current share price by $\geq 10\%$.

Neutral: The Target share price is either more or less than the current share price by 10%.

Underweight: The Target share price is less than the current share price by $\geq 10\%$.

To be Revised: No target price had been set for one or more of the following reasons: (1) waiting for more analysis, (2) waiting for detailed financials, (3) waiting for more data to be updated, (4) major change in company's performance, (5) change in market conditions or (6) any other reason from FALCOM Financial Services.

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