Key themes

History suggests time deposits rise in a rising rate environment

Government deposits has a strong correlation with budget surplus

Outlook for loan growth remains strong, the worst of liquidity tightness behind us

The banks' high multiple (P/B of 2.2x) versus its history is justified by the sharp improvement expected in ROE

Saudi Banks

Is the worst behind us? We believe yes

The consensus thesis that Saudi banks, that have access to low cost deposits, would be at the forefront of benefitting from the US Fed rate hikes has not played out as expected so far. The bank index took a beating (refer figure 7), particularly post Q1 2022 results, after most of the key Saudi banks (except SNB) decided not to upgrade their NIM guidance for 2022. The possible reason for the same has been tight liquidity situation in the system, as loans have outgrown deposits consistently in the recent past, and the hostile competition, especially in the corporate segment, that has hurt the expectations for better NIMs. The recent news of SAMA infusing SAR50bn (c.2% of Total Deposit and c.10% of Time Deposit as on May'22) in the form of time deposits should improve the liquidity situation, albeit temporarily. However, in this report, we have analysed what could be the possible remedies on a sustainable level. We have looked at similar phases in the last decades where liquidity situation had become abnormally tight, and in our view, the phase between 2003-2007 is a more comparable period (explained in detail in the following sections). We believe there are three major drivers which would improve the liquidity situation going forward.

1. The rising rates attracting more time deposits, which has happened in the past (2005-2007)

2. Government deposits eventually going up as seen in past when oil prices have been high and there is budget surplus

3. Banks' focus on promoting time & savings products as SAMA allows higher weight for time deposits in LDR calculation

View on liquidity: We believe the worst is behind us in terms of liquidity tightness as the SAMA infusion sends a message that the central bank would be willing to infuse further funds into the system time and again, until the deposit growth picks up. Post the SAMA intervention, SAIBOR3m spread over LIBOR has corrected to around 67 bps (as of 29th June) from the highs of over 150 bps seen in May.

Outlook: In terms of loan growth, we remain positive (explained in detail in the Outlook section) and expect total loan book (for ten banks aggregate) to grow by c.13% y-o-y in 2022 and over 9% in 2023. Based on our analysis, the total net income (for ten banks aggregate) should increase by 23% and 29% in 2022 and 2023, respectively.

Valuations: After the recent correction, the banks are trading at a 1 year blended forward (average book value of 2022e and 2023e) price to book of 2.2x compared to its 3-year historical average of 1.5x. The banks have continuously rerated in the last 3-5 years, from 1.1x in 2017 to 1.7x in 2021 on bright growth prospects. In our view, although the current multiple is higher than the historical average, the strong growth prospects and sharp improvement in ROE (almost 16% in 2023 from 11% in 2021) justifies the current multiple.

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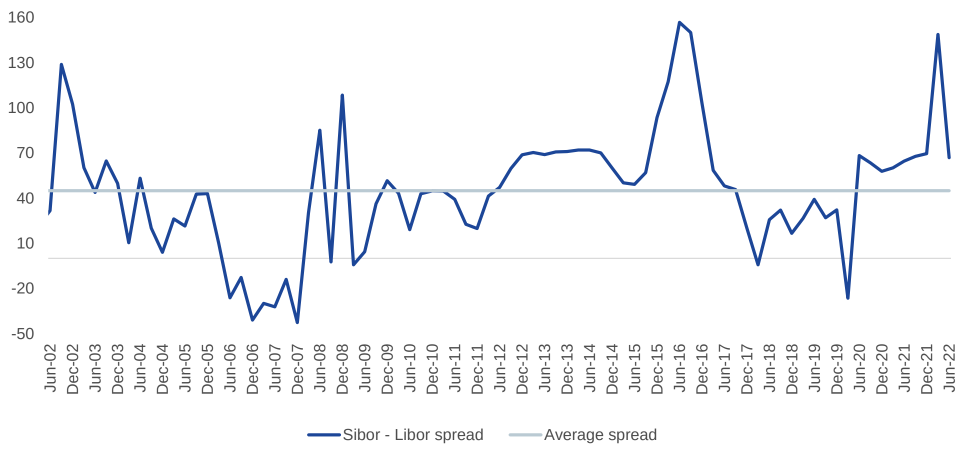
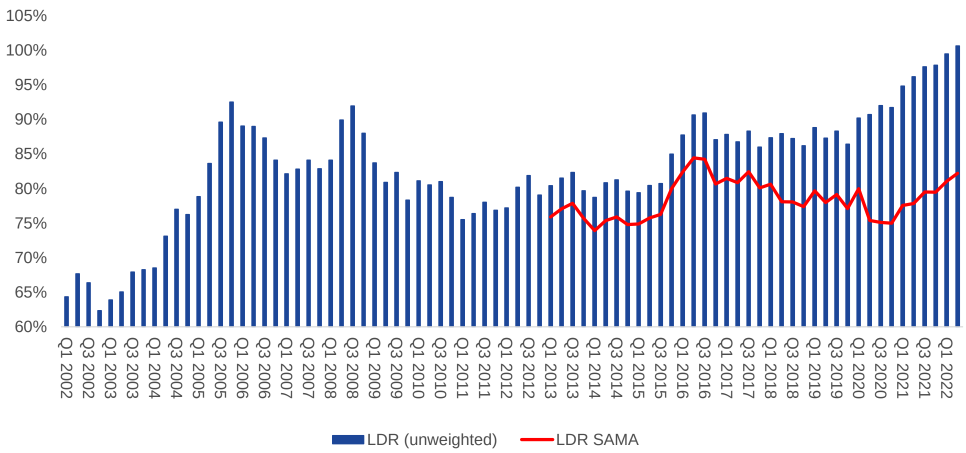
Figure 1 SIBOR-LIBOR trend



Source: Bloomberg, Al Rajhi Capital. Note: last data point is as of 29 June 2022.

Figure 2 Unweighted LDR vs SAMA LDR



Source: SAMA, Al Rajhi Capital. Note: last data point is as of May 2022. Unweighted LDR is calculated by dividing total loans by total deposits as per SAMA filings

Fed hikes, but Saudi banks need to wait for the benefits

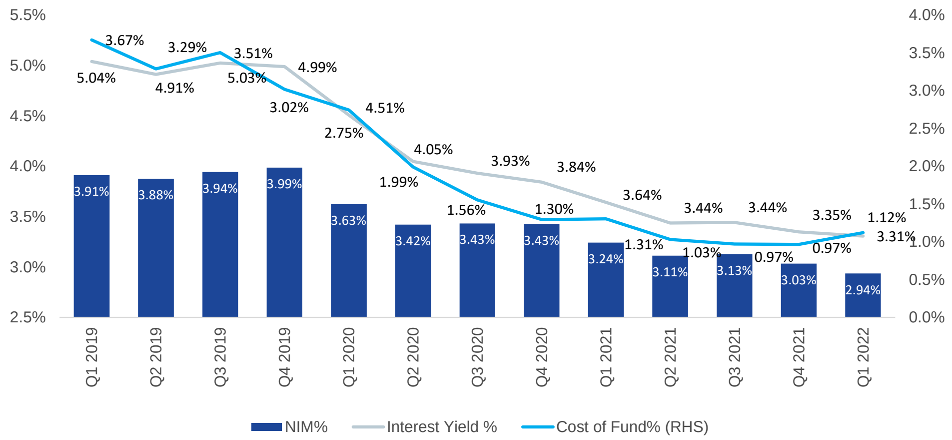
There has been a significant shift in the US Fed rate expectations in just over a span of 6 months (refer figure 5). At the December 2021 meeting, the Fed Dot plot indicated Fed rate to touch 0.875% by the end of 2022. Now, after the recent Fed meeting (June), when the US central bank became more vocal about taming inflation and raised rates aggressively by 75 bp, the implied Fed rate as per the dot plot is expected to touch 3.375% by the end of 2022. In theory, higher rates should be beneficial to Saudi banks given its strong exposure to low cost deposits (interest earning time deposits account for just 24% of total deposits, refer figure 9). Additionally, the Saudi banks should be favoured as the sector is witnessing strong growth both on the retail mortgage front as well corporate credit.

However, the elevated loan to deposit ratio has become an obstacle for banks to benefit from the rising rate environment, atleast in the short term. In the last two years, the lending growth has been strong, the total loan book grew by about 15% y-o-y in both 2020 and 2021, outgrowing the growth in the deposit base of about 8%. As on May'22, the total loans have grown another 14% y-o-y, while deposit base is up just 9% y-o-y. It has pushed the LDR (unweighted) to almost 101% (May 2022), a level not seen in the recent memory. This, at one point of time in May, had pushed the interbank rate, SAIBOR 3m spread over LIBOR to 150 bps (refer figure 1), just shy of the two decades high of 157 bps seen in 2016. Further a situation has been witnessed where competition for incremental time deposits (which have tenor-based weights, refer figure 12) has intensified to an extent where some banks are claiming that marginal time deposits are being attracted at a mark-up over SAIBOR. Moreover, the spread charged over SAIBOR on incremental loans has come under pressure as large banks are focusing not only on protecting their market share on retail loans, but also grow their corporate loan portfolio.

This reflects in our NIM analysis (refer figure 3), which shows that in Q1 2022, the aggregate cost of funding went up to 1.12% from 0.97% in Q4 2021, while interest yield declined to 3.31% in Q1 2022 from 3.35% in Q4 2021. Moreover, after the Q1 2022 results, none of the major banks (except SNB) upgraded its FY 2022 guidance for NIMs despite change in expectations for rate hikes. In March 2022, Fed dot plot indicated additional 100 bps hike compared to December 2021 when the banks had formed their original guidance for 2022.

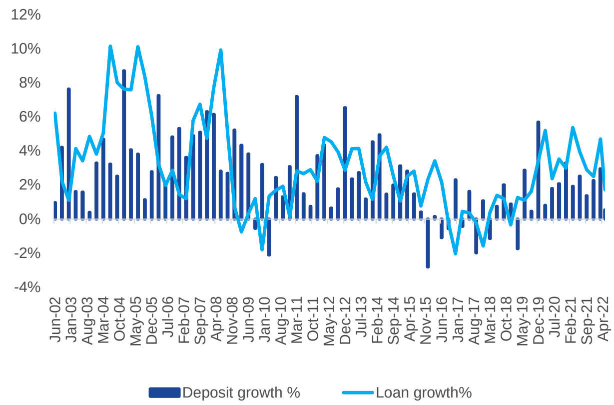
Thus, the Saudi bank index, which was a strong outperformer during Jan-April 2022 (+32% versus TASI: +22%), saw a heavy sell off after the Q1 2022 results. As such the bank index is down 18% from the start of May to till date versus -15% for TASI (refer figure 7). In our view, although competition could continue to weigh on the NIMs in 2022, the liquidity situation should improve sooner than later as deposits' growth follow credit growth, albeit with a lag. In the following section, we have explained the reasons why deposit growth, that has lagged so far, the credit growth, should improve going forward.

Figure 3 Sector level NIM, COF and Yield



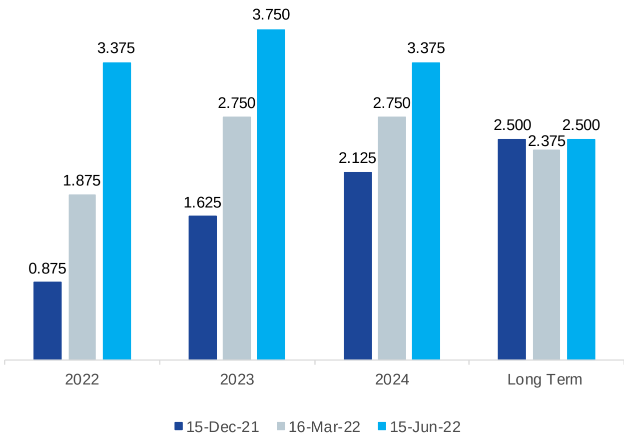
Source: Company data, Al Rajhi Capital. Sector data represents Al Rajhi, SNB, Riyad Bank, BSF, Arab National Bank, Saudi Fransi, Alinma, Aljazira, SABB and Albilad. NIM% = NII divided by IEA, Interest Yield % = Interest income divided by IEA, COF% = Interest Cost divided by IBL Net Interest Income (NII) = Interest Income – Interest Cost. Interest Earning Assets (IEA) include loans, investments, due from banks. Interest bearing Liabilities (IBL) include time deposits, borrowings and due to Banks.

Figure 4 Loans vs. Deposits' growth



Source: SAMA, Al Rajhi Capital. Note. Note the last data point is as of May 2022

Figure 5 FOMC Median Dot Plot as per meeting dates



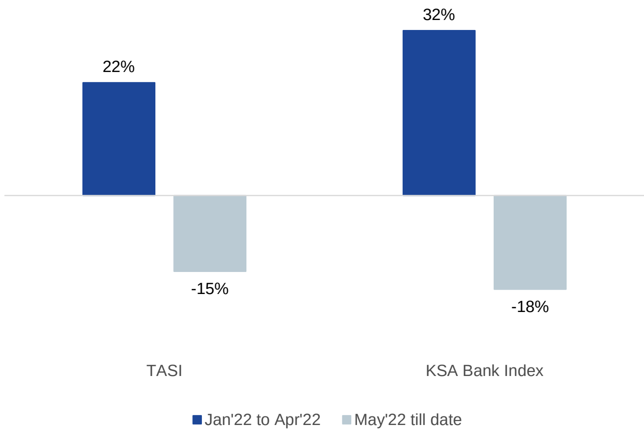
Source: Bloomberg, Al Rajhi Capital

Figure 6 FY 2022 NIM Guidance

	NIM	
	Guidance after Q1 2022	**Guidance after Q4 2021**
Saudi National Bank	3.15% to 3.30% (FY 21: 2.90%)	3.0% to 3.1%
Riyad Bank	0bps to +10bps	0bps to +10bps
Alinma Bank	+10 to 15 bps	+10 to 15 bps
Banque Saudi Fransi	2.90% to 2.95%	2.90% to 2.95%

Source: Company data, Al Rajhi Capital

Figure 7 TASI vs Bank Index Performance



Source: Bloomberg, Al Rajhi Capital, Note: May till 29th June, 2022

Possible remedies

Over a shorter period of time, we continue to expect intervention from SAMA in the form of open market operations or infuse funds directly through time deposits as it did recently (SAR50bn) to improve the liquidity situation. The recent decision from the central bank to not match the Fed rate hike of 75 bps rise (June meeting), where SAMA raised repo by only 50 bps, indicates the central bank is already taking steps to ease the liquidity situation. Further, recently SAMA also extended the tenor on its repo facility to a maximum of 13 weeks from four.

However, our focus in this report is to analyse possible remedies that are self-sustainable over the medium to long term. As per our analysis, the factors such as rising rates, government achieving budget surplus are favorable for higher deposits. There has been strong positive correlation between interest rates and time deposits, and government budget surplus with government deposits (explained in detail in the following sections). We believe the funding mix of the banking system shifting towards interest-bearing time deposits is a fundamental change that is likely to persit for a considerable period. The latest data also indicates that this is already happening as the mix of time & savings deposits in total deposits have grown to almost 24% as of May 2022 compared to almost 22% in May 2021 (Source: SAMA). Historically, time deposits as a % of total deposits peaked in 2008 at 43%

In the recent years, the banking system's exposure to long term loans (over 3 years) has changed drastically, attributable mostly to the growth in mortgage. From just 31% mix at the end of 2017, the share of long term loans has increased to slightly over 50% as of May 2022 (source: SAMA). Thus from an asset liability mismatch standpoint, higher dependency on time deposits should be seen as positive development given the higher weights for time deposits in the LDR calculation. Moreover the longer commitments would add to the funding cost visibility and thus facilitate efficient pricing, especially for the longer tenor products. Although this would result in a notable increase in the aggregate funding cost we see the impact on NIMs to be shortlived as the incremental cost would eventually be passed on to the borrower, given the likleyhood of a more rational pricing in coming quarters.

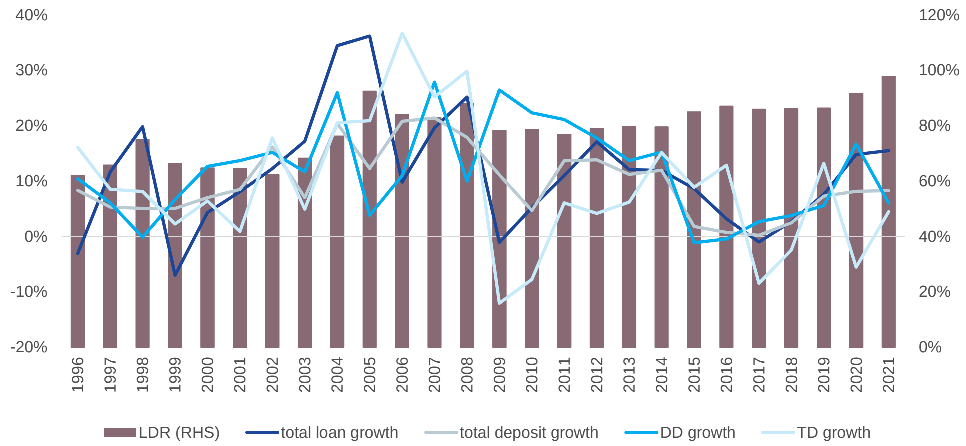
History says time deposits grow in a rising rate environment:

The current scenario of high LDR is very similar to the development witnessed during 2003 and 2005. During this phase, total loan book grew by 29% on an average for three years, while deposit base's growth averaged just over 13%, resulting in an LDR of almost 93% in 2005. However, the situation improved in the following two years, in 2006 loan base grew by another 10% y-o-y, while deposits were up 21%, and in 2007 loan base grew by 20% and deposits again managed to outgrow loans by posting growth of over 21%. Thus, by the end of 2007, the LDR had improved to 83% from 93% in 2005.

The key aspect of the strong deposit growth was the time deposits (TD), that managed to grow at a CAGR of 26% for four years during 2004 and 2007, with 2006 witnessing a growth of 37% y-o-y followed by 25% jump in 2007. The mix of time deposits in total deposits grew to almost 40% by the end of 2007, from 31% at the start of 2004 (figure 9). The driver for TD was the sharp rise in interest rates during 2004-2007. Interest rates (repo) which had bottomed in Q2 2004 at 1.5% increased to 5.5% by the end of 2007.

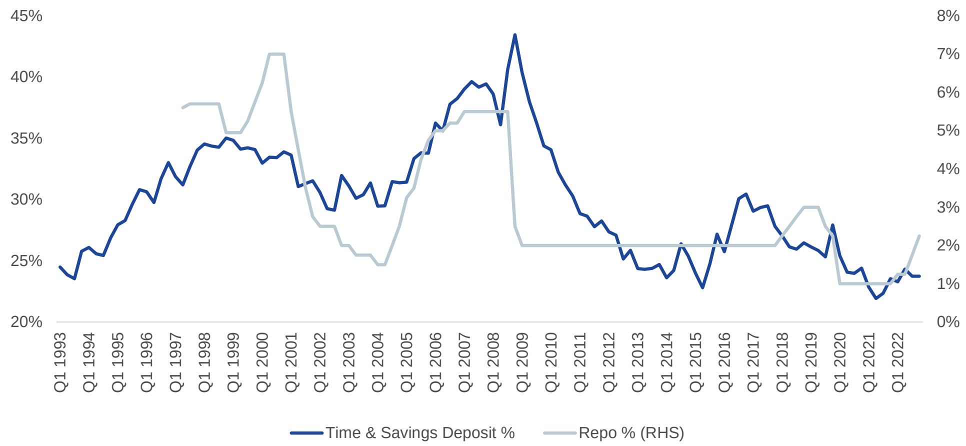
Thus, it implies a strong correlation between interest rates and the growth of TD. Over the last six months, Saudi repo has increased from 1.0% at the end of Q4 2021 to 2.25% currently. Moreover, with Fed's plans to raise rates aggressively, the repo rate of Saudi will also follow suit. In our view, this phase exactly matches with the 2004-2007 phase, thus we believe going forward strong growth in time deposits could be witnessed, easing the liquidity situation in the system.

Figure 8 Time deposits drove total deposit growth during 2004-2007 phase



Source: SAMA, Al Rajhi Capital

Figure 9 Time Deposit mix increases as repo rises



Source: SAMA, Al Rajhi Capital, Note: Time and Saving deposit % is as of May'22

Higher oil and budget surplus to boost government deposits

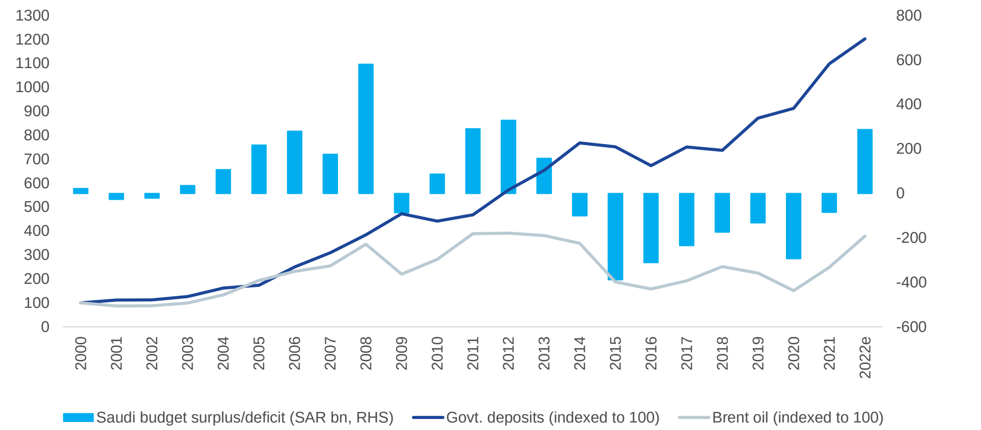
Before the crash of oil prices in the second half of 2014, the government deposits had a very strong correlation with oil prices. Between 2000 to end of 2013, when oil prices grew at a CAGR of 11%, government deposits grew at a CAGR of over 16%, outperforming the 14% CAGR growth seen in the total deposit growth. However, in the recent years, particularly from the end of 2014 to now (May 2022), government deposits have grown by just 6% CAGR, as oil prices, despite the recent rise, are largely flat compared to the average prices of 2014. In our view, the major reason for weak growth in deposits have been the budget deficit that the government has been facing from 2014-2021.

The year 2022, is the first year in about 9 years when the government is expected to have a budget surplus. During 2004-2008, when the budget surplus was very strong and growing, governments deposits grew at a CAGR of 25%. Although, the government deposits have been on the weaker side so far, given the tight liquidity situation we believe the government would be willing to support the banking system sooner than later.

The deposits from the government would be helpful, however the mix of government deposits are more of time than demand and the long-term trend shows the government is increasingly focused on increasing its time deposits. As of May 2022, 46% of the government deposits were time deposits compared to 17% at the end of 2009 and 28% at the end of 2000 (figure

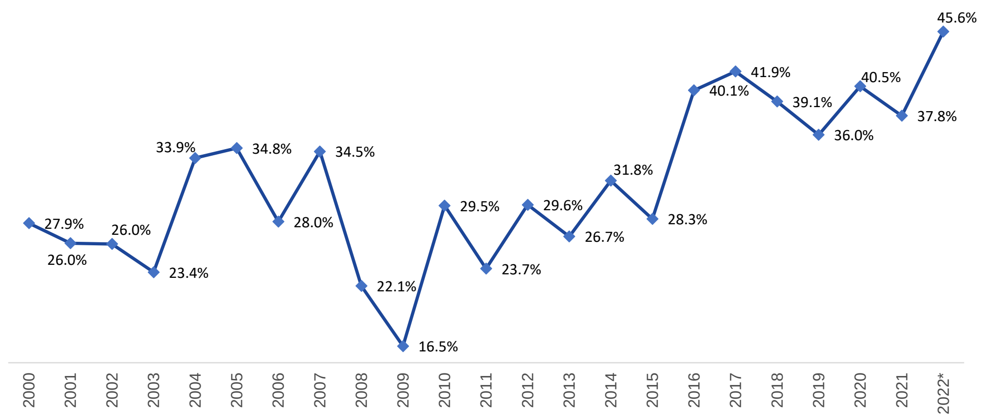
11). This implies that if the government deposits rise, it would also mean that the interest-bearing time deposits for the banks would increase going forward.

Figure 10 Budget surplus should drive government deposits



Source: SAMA, Bloombegr, Al Rajhi Capital. Note: For 2022, budget surplus is our estimate of SAR288bn, government deposits are as of May 2022 and Brent oil price is the forward price for 2022 as per Bloomberg

Figure 11 Govt. time deposits as a % of total govt. deposits



Source: SAMA, Al Rajhi Capital. Note: For 2022, the data is as of May 2022

Support from SAMA for long dated time deposits

In early 2018, the Saudi Central Bank issued new guidelines on the methodology of calculating LDR. Effective from April 2018, the LDR calculation was modified through placing higher weights for long-term deposits thus encouraging banks to introduce savings products. For example, demand deposits were assigned a weight of 100%, while time deposits of over 5 years was calculated at a weight of 190%. The weight increases as the tenure for time deposit increases (refer figure 12). Post this change in 2018, the weighted LDR declined from the highs of 84% in 2016 to around 75% in 2020.

The latest weighted LDR is around 82.2% (May 2022), higher than the levels seen in 2020, but below the 90% cap mandated by SAMA. Since, the weight for longer duration time deposits is incrementally higher, the incentive for banks to attract longer dated time deposits is also high. We have witnessed a strong focus from the banks to attract time & savings deposits. The caveat with the long-dated time deposits is that they are priced at a higher interest compared to the shorter dated. Nevertheless, this is an additional driver for interest-bearing time deposits to go up in the system.

Figure 12 SAMA formula for calculating LDR

	Demand	Within 1 month	1-3 Months	3-4 Months	4-6 Months	6-8 Months	8-12 Months	1-2 Years	2-5 Years	More than 5 Years	Total
Deposit Weights	100%	105%	110%	115%	120%	130%	140%	150%	170%	190%	
Actual Deposit	998	200	237	64	64	32	0	40	37	1	**1673**
Weighted Deposit	998	210	261	74	77	42	0	60	63	2	**1786**
Long term loan, bonds, sukuk											**40**
Total Loan											**1340**
Unweighted LDR %											78%
Regulatory LDR %											73%

Source: SAMA Al Rajhi Capital, Note: Numbers are for illustration purpose only

Outlook on loans and impact on banks net income:

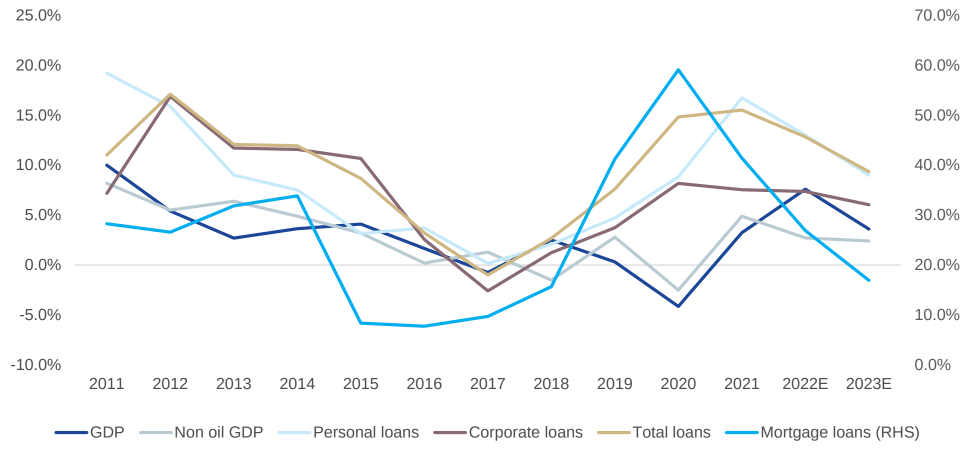
Mortgage origination still strong, corporate credit also robust:

The total credit growth in the system continues to be robust. So far in 2022 (as of May 2022), total loan book has grown by 14% y-o-y. As of Q1 2022, the growth was 15%, mainly driven by 33%% growth in the mortgage loans (retail). Despite the robust growth in the last three years (2019-2021) of average around 47%, the mortgage growth story has remained intact. Although, the monthly new mortgage originations (retail) in the year so far (Jan-May 2022) have tapered to almost SAR11bn (compared to around SAR13bn each in 2021 and 2020) respectively, it still remains significantly above about SAR7bn seen in 2019. We believe the mortgage story has more legs and the monthly originations would average SAR10bn in 2022 and SAR8bn in 2023. Based on these assumptions, we estimate 27% growth in mortgage loans in 2022 and 17% in 2023.

On the personal loans (includes consumer credit and credit card loans), the growth in 2021 was very strong at almost 17% y-o-y as the economic activity had picked up after some of the Covid related restrictions were eased off. We assume some tapering of growth to happen in 2022 and 2023 as interest rates go up and inflation hits the spending power. Nevertheless, with full reopening of the economy in 2022, we believe personal loans to grow by 13% y-o-y (our calculations show in Q1 2022 it grew by around 14%) in 2022 followed by a 9% growth in 2023.

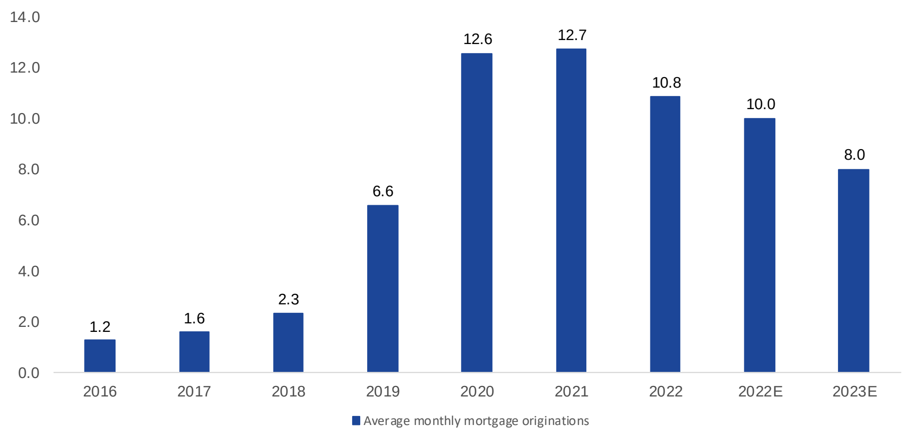
The market believes the next driver of loan growth for banks in the near term would be corporate as higher oil prices would boost government spending that has a direct effect on corporate loans. The corporate loans (calculated as total loans minus mortgage and personal loans) accounts for major chunk of the total loan book at around 57% (as of 2021), thus any improvement in the growth outlook would have notable impact on the total loans in the system. In the last three years, the corporate loan growth has averaged around 6.5%. As per our analysis, the corporate loans grow at a multiple of around 2.1x (last 10 years average adjusted for years of negative growth and abnormal multiple) of the non-oil GDP growth (real) with a peak of 3.3x seen in 2015 when non-oil GDP grew by 3.2% while corporate loan book increased by 10.7%. We are assuming 2.7x multiple in 2022 (in Q1 2022 it has been around 2.7x) and 2.5x in 2023, slightly lower than the peak as we believe the government is following a conservative approach on channelizing the oil windfall into the system. Our non-oil GDP growth estimates are 2.7% in 2022 and 2.4% in 2023. We have considered Bloomberg estimates for total GDP growth of 7.6% in 2022 and 3.6% in 2023 and used our internal estimates for calculating oil GDP growth (assumed 15% and 5% growth in 2022 and 2023, respectively). Based on these assumptions, we believe the corporate loan book would grow by over 7% in 2022 and 6% in 2023.

Figure 13 Total loans to grow by 13% and 9% in 2022 and 2023, resp.



Source: SAMA, Bloomberg, Al Rajhi Capital

Figure 14 Average Monthly Mortgage Origination to remain strong (numbers in SARbn)



Source: SAMA, Al Rajhi Capital

ROE to hit multi year high in 2023:

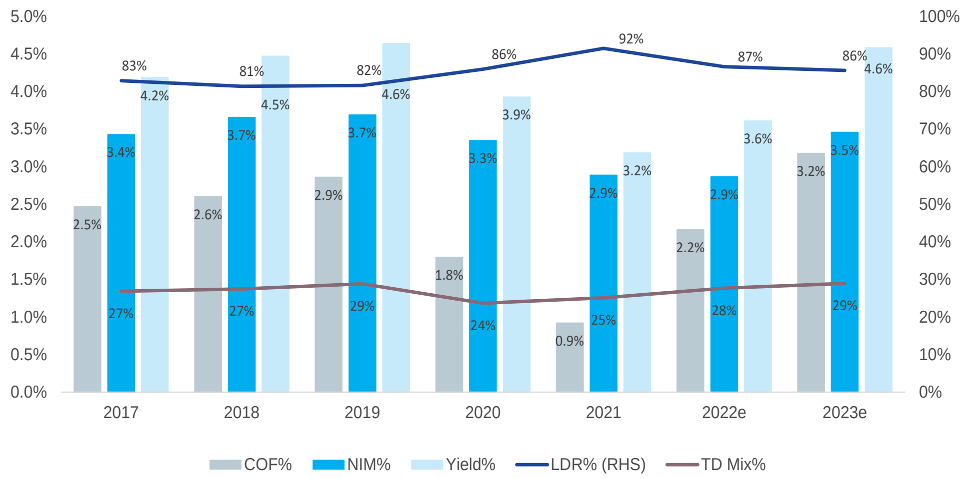
Based on our positive outlook for loan growth, we have assumed total loan book for the ten banks (Al Rajhi, SNB, Riyad Bank, BSF, Arab National Bank, Saudi Fransi, Alinma, Aljazira, SABB and Albilad), to grow by 13% in 2022 and 9% in 2023, led by banks that have exposure to both mortgages and corporate book. In terms of LDR, we assume Q2 2022 to have seen the worst and the situation should improve from here on, we believe LDR would end at 87% by 2022 and 86% by 2023 from 92% in 2021. In terms of deposit mix, we believe time deposits would increase (28% in 2022 and 29% in 2023 from 25% in 2021) and it would be the key driver of the growth in total deposits going forward.

We also assume that the large banks would be more aggressive in terms of defending their market share in retail loans and growing their corporate exposure. For SAIBOR, we have assumed it to revert to its historical relation with the Saudi repo rate. Currently, SAIBOR is at around 70 bps higher than the Saudi repo rate, while historically it has been at a discount of 10 bps to Saudi repo. We believe the SAIBOR's spread over LIBOR has peaked and following the deposit infusion by SAMA, SAIBOR would move closer to Saudi Repo rate. By the end of 2022, we believe the discount to Saudi repo rate to reach 5 bps and by 2023 we expect it to revert to historical pattern of discount of 10 bp. Our estimate for Saudi repo rate is based on the Fed dot plot, we are assuming SAMA to match the incremental rate hikes by the Fed.

Our analysis shows that NIMs would be largely flat in 2022 on higher cost of funding (2.2% from 0.9% in 2021), while improve notably by 60 bp in 2023, as the impact of repricing of both retail and corporate would reflect more prominently. We estimate the aggregate net income for the ten banks to increase by 23% in 2022 and 29% in 2023, further improving the ROE to almost 13% and 16% in 2022 and 2023, respectively from about 11% in 2021.

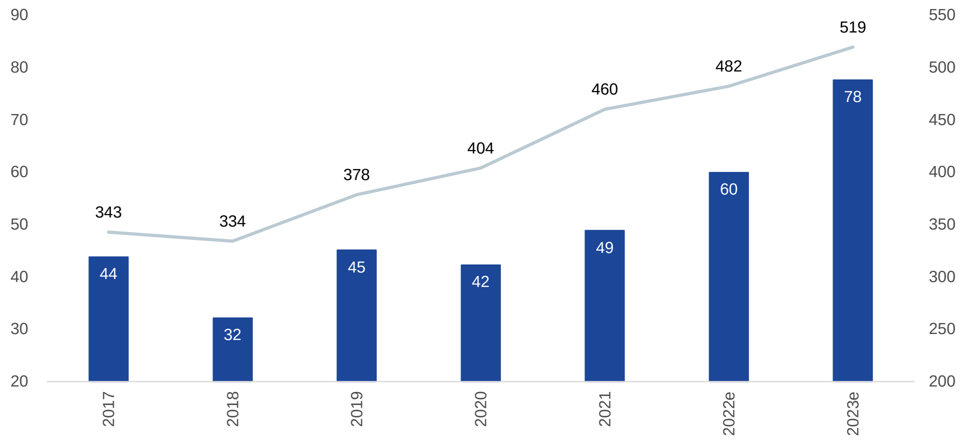
After the recent correction, the banks are trading at a 1 year blended forward (average of 2022e and 2023e) price to book of 2.2x compared to its 3-year historical average of 1.5x. The banks have continuously rerated in the last 3-5 years, from 1.1x in 2017 to 1.7x in 2021 on bright growth prospects. In our view, although the current multiple is higher than the historical average, the better growth prospects and sharp improvement in ROE (16% in 2023 from 11% in 2021) justifies current multiple.

Figure 15 NIM should improve in 2023 after remaining flat in 2022



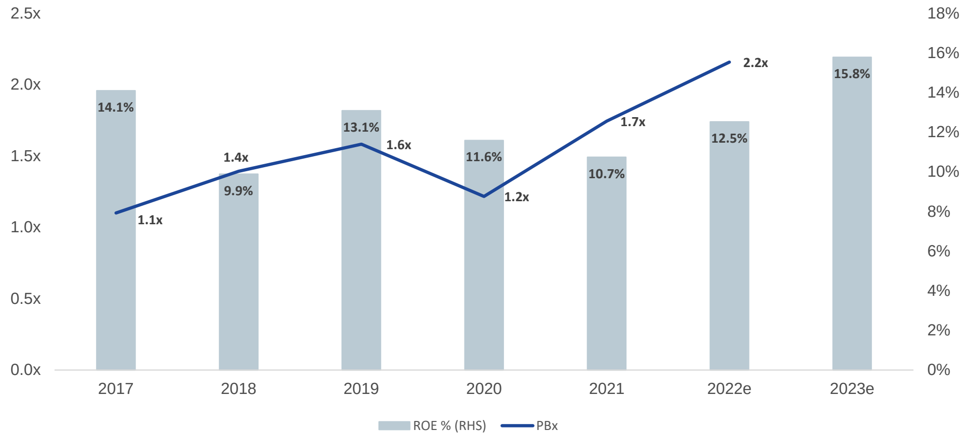
Source: Company data, Al Rajhi Capital

Figure 16 Net Income to grow by 23% in 2022 and 29% in 2023 (numbers in SARbn)



Source: Company data, Al Rajhi Capital

Figure 17 ROE expansion should justify higher PB Multiple



Source: Company data, Bloomberg, Al Rajhi Capital. Note: P/B is a one year blended forward multiple. P/B for 2022 is current market cap divided by average book value of 2022e and 2023e. Market cap. is as of 28th June 2022.

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"Overweight": Our target price is more than 10% above the current share price, and we expect the share price to reach the target on a 12 month time horizon.

"Neutral": We expect the share price to settle at a level between 10% below the current share price and 10% above the current share price on a 12 month time horizon.

"Underweight": Our target price is more than 10% below the current share price, and we expect the share price to reach the target on a 12 month time horizon.

"Target price": We estimate target value per share for every stock we cover. This is normally based on widely accepted methods appropriate to the stock or sector under consideration, e.g. DCF (discounted cash flow) or SoTP (sum of the parts) analysis.

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