

Sharia banks fared better than conventional banks

The Saudi banking sector recorded earning growth for Q1-2018 of 7.4%YoY, driven by 12.3%YoY earning growth for Sharia compliant banks, as all of four Sharia compliant banks exhibited strong performance. Al-Inma led with 38.1% YoY growth, followed by Al-Jazira at 13.6%, Al-Rajhi and Al-Bilad maintained an impressive run with 7.3% YoY and 11.7% YoY growth in earnings, respectively. Sharia banks increased their share in earnings from 26.5% in Q1-2017 to 27.7% in Q2-2018.

Loans in 1Q-2018 stood at SAR 1.37bn as compared to SAR 1.40bn in 1Q-2017, a decline of 2% YoY. However, Sharia compliant banks registered a 2.5% YoY growth in loans. Bank Al-Bilad and Al-Inma led with 17.9%YoY and 7.2%YoY growth in loans respectively, while Al-Rajhi remained flat at SAR 229.0bn. The flat sector performance in lending came on the back of weak economic fundamentals.

On the other hand, deposit base for the Sharia Compliant banks grew by 6.4% YoY, in contrast conventional banks who's deposits base dropped by 3.5%YoY. The three banks under our coverage; namely Bank Al-Bilad, Al-Inma and Al-Rajhi, showed deposit growth of 16.6%, 9.7% and 4.7% respectively.

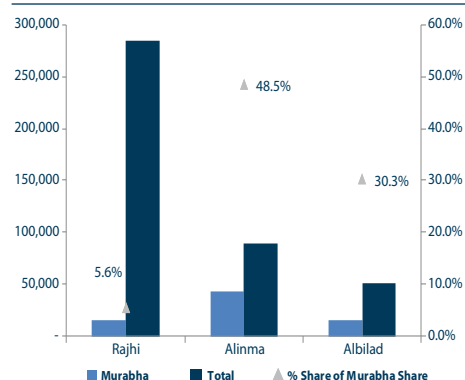
Higher Lending rates supports the topline, while higher Murabaha deposits dilute earnings

Higher lending rates along with lower Murabaha deposits has had a positive impact on the bottom line. Low concentration of Murabaha deposits in Shariah complaint banks, has historically led to bottom line expansion, with rising lending rates. **Al-Rajhi**, with merely 6.0% Murabaha deposits, stand to benefit the most. Murabaha deposits at Al-Bilad increased to SAR 14.4bn (28.3% of total deposits) from SAR 8.0bn (18.4% of total deposits) mounting to 80%YoY increase (Al-Bilad's total deposits grew by 16.5% to SAR 50.8bn). Al-Inma has always maintained high share of Murabaha deposits, which further jumped to 48.7% in Q1-2018 from 42.3% in Q1-2017, a significant rise specially in a rising lending rate environment. We believe Al-Rajhi stands to benefit the most out of the three banks, whereas increasing dependence on Murabaha deposit by Al-Bilad and Al-Inma, will result in higher cost of financing. For 2018, we expect higher financing and investment expenses for Al-Bilad and Al-Inma on murabaha investment by 26.4%YoY and 14.1%YoY respectively, whereas we expect marginal increase for Al-Rajhi by 6.6%YoY.

Lending Activity still slow

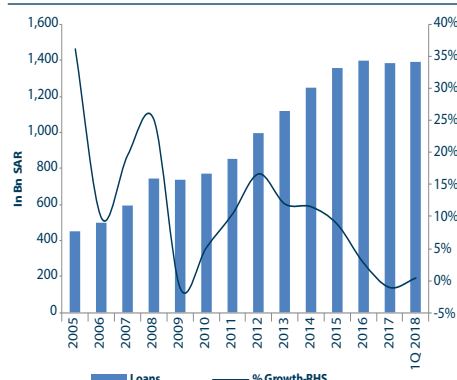
Recession, along with government prudence towards awarding new contracts, has kept the loan growth under check. As mentioned above, Shariah compliant banks achieved higher growth in loans. Al-Bilad and Al-Inma led in loan growth whereas Al-Rajhi remained flat. Going forward, with a reversal in trend expected on the back of improving crude oil prices (WTI prices improved 14.2% YTD), higher production on the back of revised OPEC-Russia deal, lowering of subsidies, value added tax, and other taxes are expected to support the government in balancing its budget.

Murabaha Deposits



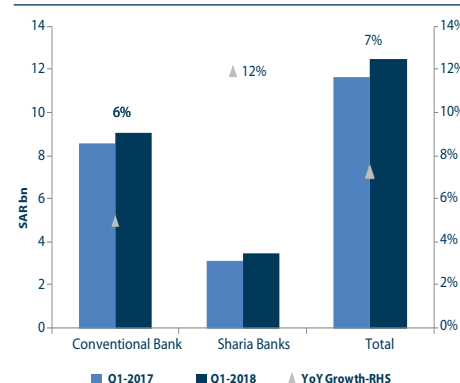
Source:Argaam

Lending Activity-Saudi banking Sector



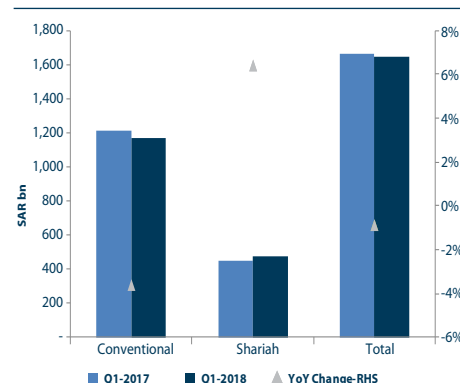
Source:SAMA

Net Income-Q1-2018



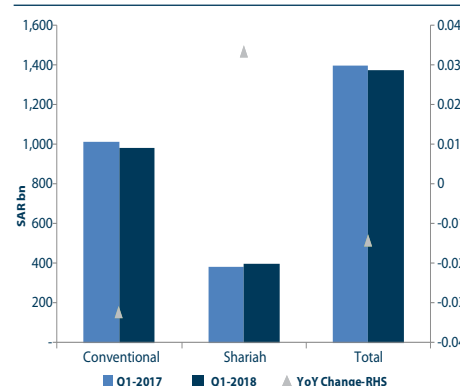
Source:Argaam

Shariah banks Deposit Growth



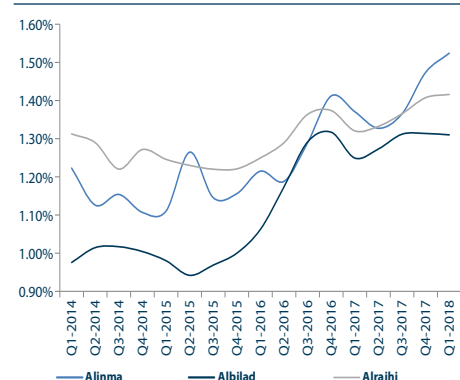
Source:Argaam

Shariah Banks Financing, net



Source:Argaam

Lending rates



Source:Argaam

IFRS 9 adoption-Equity Adjustment after IFRS 9 adoption

Under IFRS 9 accounting standard, Saudi banks are required to set aside provisions for credit impairment in anticipation of default rather than the previous practice of retrospective provisioning.

The banks have taken these provision directly by adjusting equity, this directly impacted banks solvency. The following table shows the impact on banks under our coverage.

Banks	Retained Earnings			Opening Balance-2018
	Closing Balance 2017	Expected Credit Losses	Reclassification in accordance with IFRS 9	
Bank Al-Rajhi	13,906	(2,883)	129	11,154
Bank Al Al-Bilad	531	(71)	45	505
Bank Al-Inma	1,896	(723)	114	1,288

Source: argaam

Going forward, we expect additional provisions with new loans, hence marginal additions are expected. For Al-Rajhi, given the high concentration of retail loans (70%-72% of retail loans), we believe the credit worthiness assumptions to remain the same given the fragmented nature of the retail loans, hence additions to credit provision will remain the same. However for Al-Bilad and Al-Inma, with higher concentration of corporate loans, we can expect random large increase in provision.

Valuation & Outlook

The banking sector looks set to benefit from the recovery in the oil prices and the potential emergence of the Saudi economy from recession. The sector in the last couple years has faced multiple issues like higher provision from credit losses, provisions on financial assets, slowdown in deposit growth, stagnant loan growth. However, Shariah compliant banks have maintained their performance despite of the hurdles. The major challenge that remain for the sector is the muted loans growth, which potentially can recover once the economy steps out of recession. Most of the international bodies are expecting recovery in the Saudi economy which can potentially result in higher spending by the government, hence providing the required impetus to support loan growth. We remain positive on the Shariah banking sector, despite of increasing share of Murabaha deposits for Al-Bilad and Al-Inma.

We have revised our target for the 3 banks under coverage. Our top pick is **Banks Al-Rajhi** with a revised price target of SAR 96.4/share. Major play for Al-Rajhi is the low share of Murabaha deposits, which in the rising lending rate environment will result in net financing income expansion, along with lower provisions and rising share in deposits bodes well for the company. We expect Al-Rajhi to post earnings of SAR 9.5bn for 2018, depicting a forwards PE of 14.8x as compared to current PE of 15.2x. We update our recommendation to “**Overweight**”.

Bank Al-Inma has seen a significant growth in its deposit base from SAR 81.4bn to SAR 89.3bn depicting a jump of 9.7% YoY, primarily higher contribution from murabaha deposits, which will result in higher Murabaha deposit financing cost. Despite that company has maintained a high ADR of around 88%-90%. For 2018, we expect Al-Inma to post earnings of SAR 2.3bn depicting a jump of 15.9%. The company is currently trading at a PE of 14.7 against our forward PE estimate of 13.74x. We update our price target to SAR 23.7, with an “**Overweight**” Recommendation.

Bank Al-Bilad has also shown strong growth in its deposit base to SAR 50.8bn in Q1-2018, a 16.6 YoY rise, however as discussed earlier Murabaha deposit have led the way in driving the total deposits growth. Higher share of Murabaha deposit means a higher cost on deposit, resulting in diluted bottom line and margins, however the high ADR ratio of around 90% will provide support for strong performance.

We expect Al-Inma to post earnings of SAR 1.04bn, depicting a jump of 10.4%. The company is currently trading a PE of 14.6x, against our forward PE expectation of 13.7x. We update to an “**Overweight**” recommendation with a price target of SAR26.4/share.

Banks	Target Price	Upside	Recommendation
Bank Al-Rajhi	96.4	11%	Overweight
Bank Al-Inma	23.7	10%	Overweight
Bank Al-Bilad	26.4	12%	Overweight

Source: Al-Jazira, Prices as of 27th of June, 2018

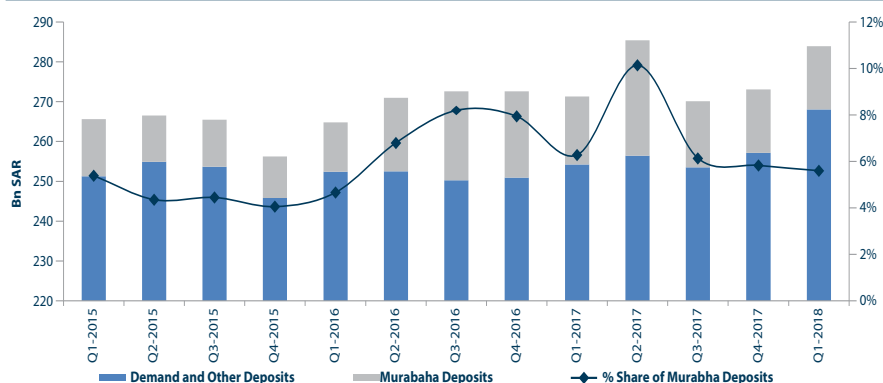
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Bank Al-Rajhi

Company Snapshot	2016	2017	2018
Gross financing and investments income	11,751	12,581	13,271
% Growth	14.6%	7.1%	5.5%
Return on customers' time investments	(528)	(552)	(619)
Net financing and investments income	11,223	12,029	12,652
Total operating expenses	7,215	6,784	7,374
Net income for the year	8,126	9,121	9,547
% Growth	14.0%	12.2%	4.7%
Customers' deposits	272,593	273,056	287,932
% Growth	6.4%	0.2%	5.4%
Financing, net	224,994	233,536	226,750
% Growth	7.0%	3.8%	-2.9%
Investments, net	34,033	36,276	38,253
% Growth	-14.7%	6.6%	5.4%
ADR	86%	88%	82%
NIMs	2.3%	1.4%	1.5%
NPL ratio	1.2%	1.2%	1.2%
NPL Coverage	231%	314%	224%
ROE	15.6%	16.4%	17.0%
ROA	2.4%	2.7%	2.7%
EPS (diluted)	5.00	5.61	5.87
PB	2.81	3.15	3.37
PE	12.62	13.27	14.79
Dividend Yield	5.2%	4.0%	3.4%

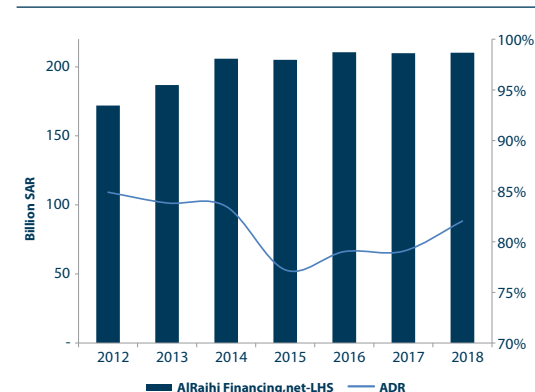
Source: AlJazira Capital Research

Al-Rajhi Deposits



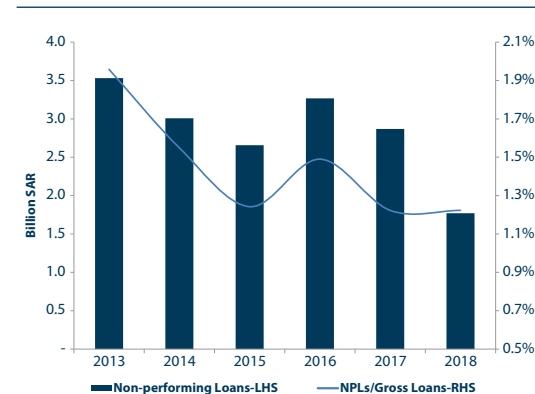
Source: Company Financials, Al-Jazira Research

Al-Rajhi Lending



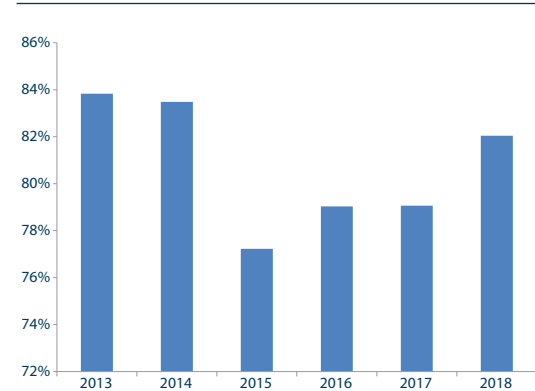
Source: Company Financials, Al-Jazira Research

Al-Rajhi NPLs



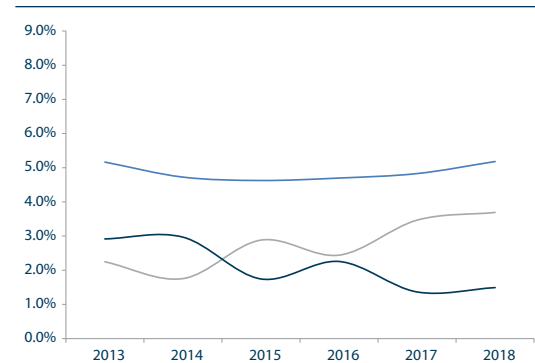
Source: Company Financials, Al-Jazira Research

Al-Rajhi ADR



Source: Company Financials, Al-Jazira Research

Al-Rajhi NIMs



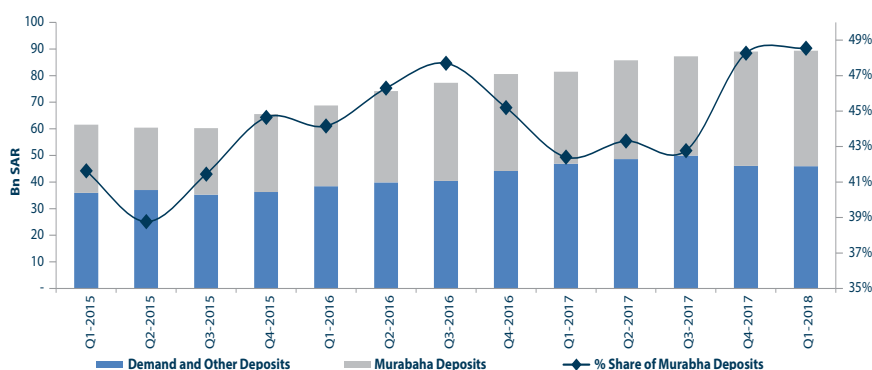
Source: Company Financials, Al-Jazira Research

Bank Al-Inma

Company Snapshot	2016	2017	2018
Income from investments and financing	3,486	4,255	4,472
% Growth	36.9%	22.1%	5.1%
Return on time investments	(834)	(762)	(974)
Income from investment and financing activities, net	2,652	3,493	3,499
Total operating expenses	1,813	2,356	2,047
Net income for the year	1,502	2,011	2,331
% Growth	2.2%	33.9%	15.9%
Customers' deposits	80,612	89,065	95,363
% Growth	23.0%	10.5%	7.1%
Financing, net	70,312	79,060	84,086
% Growth	23.3%	12.4%	6.4%
Investments	6,157	15,320	7,284
% Growth	-4.9%	148.8%	-52.5%
ADR	88%	90%	89%
NIMs	2.2%	3.2%	3.0%
NPL ratio	0.8%	1.0%	1.0%
NPL Coverage	105%	109%	101%
ROE	6.0%	7.0%	8.0%
EPS (diluted)	1.00	1.34	1.55
PB	1.26	1.56	1.68
PE	15.0	14.3	13.8
Dividend Yield	3.5%	4.2%	4.3%

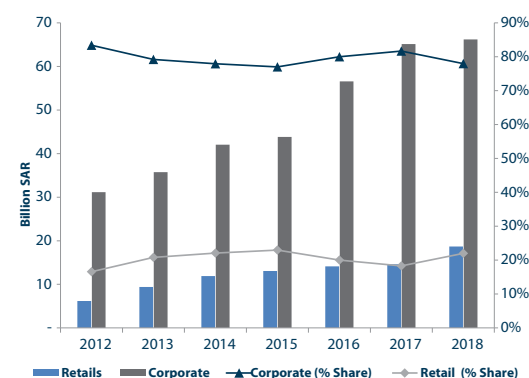
Source: AlJazira Capital Research

Al-Inma Deposits



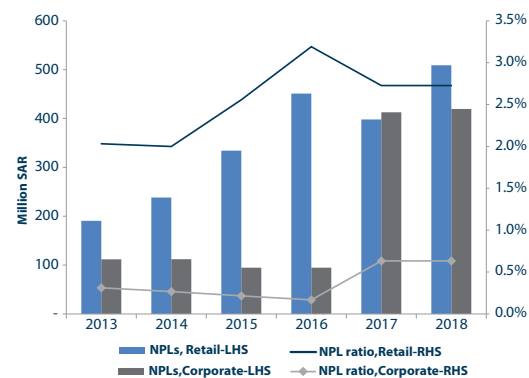
Source: Company Financials, Al-Jazira Research

Al-Inma Loans



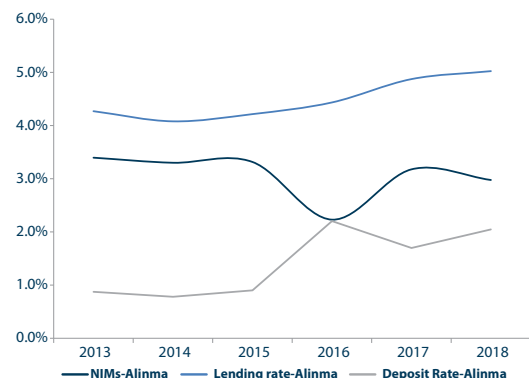
Source: Company Financials, Al-Jazira Research

Al-Inma: NPLs



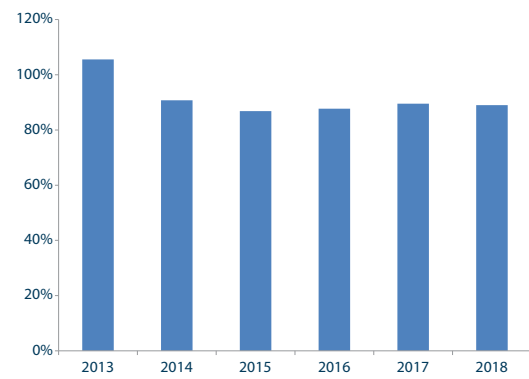
Source: Company Financials, Al-Jazira Research

Al-Inma NIMs



Source: Company Financials, Al-Jazira Research

Al-Inma ADR



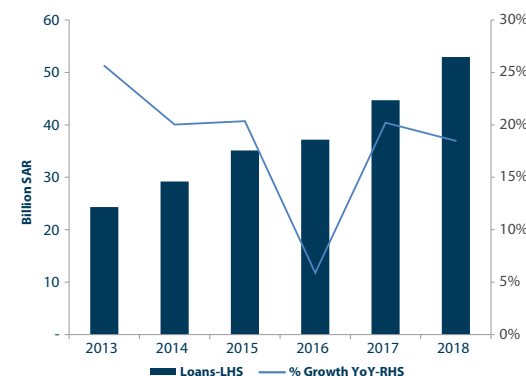
Source: Company Financials, Al-Jazira Research

Bank Al Bilad

Company Snapshot	2016	2017	2018
Income from investing and financing assets	1,644	2,045	2,537
YoY Growth (%)	27.2%	24.4%	24.0%
Return on deposits and financial liabilities	(95)	(132)	(183)
Net income from investing and financing assets	1,549	1,913	2,354
Total operating expenses	1,830	1,947	2,138
Net income for the year	1,130	1,556	2,023
YoY Growth (%)	2.6%	15.7%	10.0%
Customers' deposits	50,812	58,185	66,135
YoY Growth (%)	-4.6%	18.8%	20.5%
Financing, net	38,494	44,077	50,765
YoY Growth (%)	5.6%	20.1%	18.1%
Investments, net	5,081	5,528	5,952
YoY Growth (%)	4.5%	66.8%	20.5%
ADR	90%	91%	89%
NIMs	2.4%	2.6%	3.0%
NPL ratio	1.4%	1.2%	1.5%
NPL Coverage	-198%	-235%	-203%
ROE	11.4%	12.3%	12.6%
ROA	1.5%	1.5%	1.4%
EPS (diluted)	1.35	1.56	1.72
PB	1.74	1.62	1.73
PE	15.27	13.13	13.69
Dividend Yield	2.4%	2.0%	1.5%

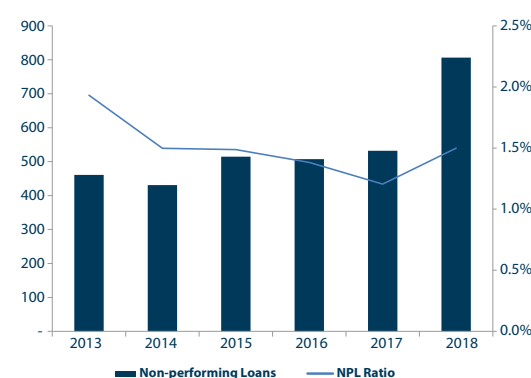
Source: AlJazira Capital Research

Al-Bilad Loans



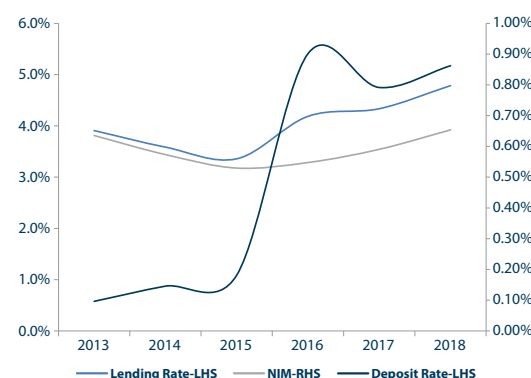
Source: Company Financials, Al-Jazira Research

Al-Bilad NPLs



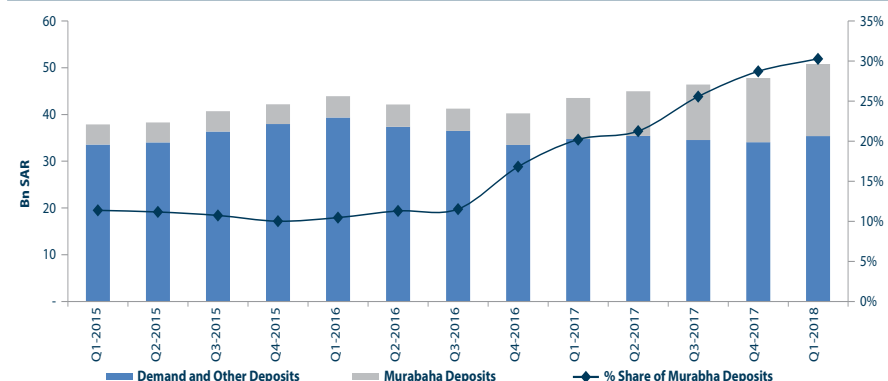
Source: Company Financials, Al-Jazira Research

Al-Bilad NIMs



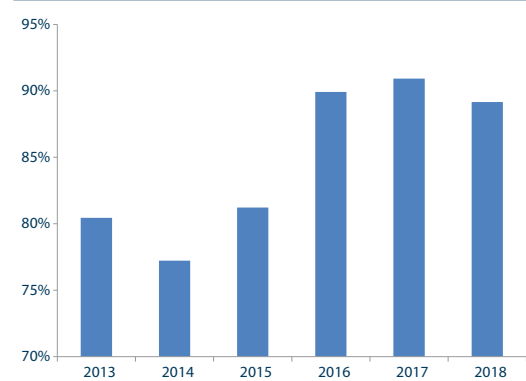
Source: Company Financials, Al-Jazira Research

Al-Bilad Deposits



Source: Company Financials, Al-Jazira Research

Al-Bilad ADR



Source: Company Financials, Al-Jazira Research

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1. **Overweight:** This rating implies that the stock is currently trading at a discount to its 12 months price target. Stocks rated "Overweight" will typically provide an upside potential of over 10% from the current price levels over next twelve months.
2. **Underweight:** This rating implies that the stock is currently trading at a premium to its 12 months price target. Stocks rated "Underweight" would typically decline by over 10% from the current price levels over next twelve months.
3. **Neutral:** The rating implies that the stock is trading in the proximate range of its 12 months price target. Stocks rated "Neutral" is expected to stagnate within +/- 10% range from the current price levels over next twelve months.
4. **Suspension of rating or rating on hold (SR/RH):** This basically implies suspension of a rating pending further analysis of a material change in the fundamentals of the company.

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