Saudi Banks – Rally on shaky legs

Rate cuts benefit mostly to be seen in 2025 if cuts are staggered

3rd March 2024

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Contents

Executive summary

Rally on shaky legs?

- **What led the rally since Nov?** The sharp drop in the US treasury yields in Q4 2023 and the Fed's dovish message in the December meeting led to a strong rally in the banking sector. The banking index is up 33% from the lows of 9,601 made on 23rd Oct. 2023. Despite Q4 results being mixed/slightly below consensus and the rate cut expectations normalizing to 3-4 cuts from 6-7 cuts at the start of the year, the banking index has held on to its post-rally levels. The resilience, in our view, is getting support from the guidance on NIMs from the corporate banks, that was better than expected, improvement in the liquidity situation in the recent weeks (SAIBOR declining to 6.23% now from the highs of 6.38% in December), and the positive sentiment in the global equity markets. However, as the rate cut assumptions have now changed drastically in the recent weeks and most of the positives already being priced in the stock prices, the question arises on the sustainability of the rally.

- **Q4 2023 results and 2024 guidance:** Overall, most of the banks in Q4 2023 reported slightly weaker earnings than expected hurt by higher cost of funding (SAIBOR rose to 6.38% in Dec., average 6.31% in Q4 2023), spike in provisions and the ongoing shift in the deposit mix (time deposits continued to go up). Moreover, some of the banks raised their exposure to fixed-rate investments and acquired more long-dated repricing loans in H2 2023 (6/12 months SAIBOR linked loans have lower yields than 3M-SAIBOR linked loans), thus the positive impact on the asset yield was limited during the quarter. As SAIBOR has come off its highs, there is a possibility that Q1 might not see similar rise in the cost of funding as seen in Q4 2023. Overall, the 2024 guidance on loans appear reasonable to us given the strong prospects for the corporate loans, while on NIMs there is a possibility that the guidance could be a bit optimistic. Currently, we are considering mid-point of the guidance range for most of the banks, and we have shared our analysis on NIMs to derive the implied cost of funding from the guidance on slide 7. The NIM guidance indicates that the banks have assumed the cuts to be consecutive and start in May.

- **Our view on US Fed rate and SAIBOR**: As mentioned in our 2024 outlook report, we believe the number of rate cuts to be 3 and skewed towards H2 2024 (in line with the FOMC Dot Plot). The recent message from the Fed minutes as well as two consecutive CPI readings above the expectations reinforce our view that number of rate cuts will be more modest than implied by the Fed fund futures. Post the last Fed meeting, even the fed fund futures now expects just 3-4 rate cuts starting June 2024. Our SAIBOR estimate is based on the Dot Plot and another year of tight liquidity. We estimate SAIBOR to end at 5.48% by the end of 2024 and 4.43% by 2025-year end.

- **Where can the guidance go wrong?** The NIM guidance is heavily dependent on the impact of rate cuts to be fully seen in 2024 (75bps cut in funding costs) and not pricing in the risks of staggered cuts in H2 2024 (which is highly possible). With signs of US economy being strong, wage growth being resilient and shelter inflation still high, there is a possibility that the rate cuts would be staggered and start in June. Even the Fed fund futures are giving the higher probability of cuts starting in June instead of May. Moreover, in light of anticipated rate cuts, there is a risk of corporate deposit holders to shift towards long dated time deposits from short dated ones. Thus, in such a scenario, where most of the banks have positioned themselves for rate cuts by increasing fixed rate investment exposure, they could be at risk of NIM compression much more than their guidance. Further, the negative surprise can also come from higher provisions than guided by the banks. Despite elevated interest rates and rise in corporate loans mix in the system, most of the banks have guided for cost of risk in line with 2023. Moreover, coverage ratio, though comfortable, have fallen compared to historical levels.

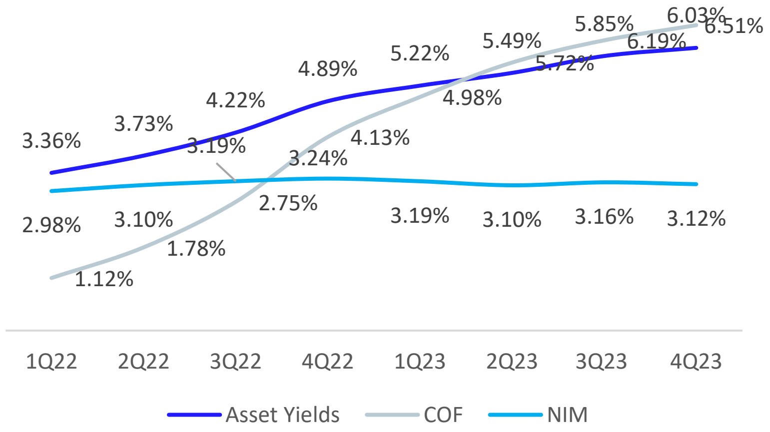
- **View on the sector's valuations:** Our 2024 estimates are broadly based on the guidance provided by the banks and we would wait for more data points such as inflation trend in the US , wage data in the US and Q1 earnings from the banks to incorporate the above-mentioned risks. Based on our current assumptions, there is modest upside left from the current levels with decent upside in the selective corporate names, especially the ones that did not fully participate in the recent rally. However, if there are any signs of another reading of hot inflation data in the US or liquidity conditions tightening, we believe profit booking at current valuation levels should be considered.

Banks – Q4 numbers and 2024 Guidance

Loan guidance reasonable, NIMs appear to be optimistic

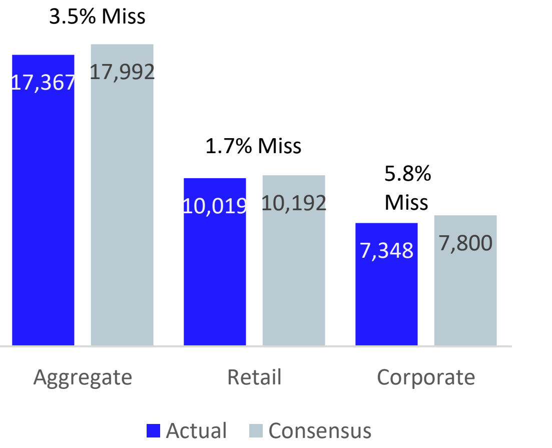
- Most of the banks in Q4 2024 reported slightly weaker earnings than expected hurt by higher cost of funding, spike in provisions and the ongoing shift in the deposit mix. Corporate banks earnings were hurt by relatively weaker improvement in the asset yield as well as higher provisions, while retail banks were hurt by higher SAIBOR.
- Overall, the 2024 guidance on loans appear reasonable to us given the strong prospects for the corporate loans, while on NIMs there is a possibility that the guidance could be a bit optimistic. It appears the banks have based their NIM guidance on assumption that asset yield will be hardly impacted this year, while cost of funding will see full benefits of 3 rate cuts. Further, on cost of risk as well, the guidance appear optimistic given the elevated interest rates and the rise in the mis of corporate loans in the system. However, so far we have not any signs of major NPAs in the system.

NIM Trend



Source: Company Data, Al Rajhi Capital. Note: COF is only based on interest bearing liabilities, does not include demand deposits

4Q23 (SAR mn) Net Income vs Consensus



Source: Company Data, Al Rajhi Capital. Consensus used here is considered from Argaam. Retail Banks considered are Al Rajhi, SNB, BJAZ and Albilad and rest are corporate

2024 guidance by Banks

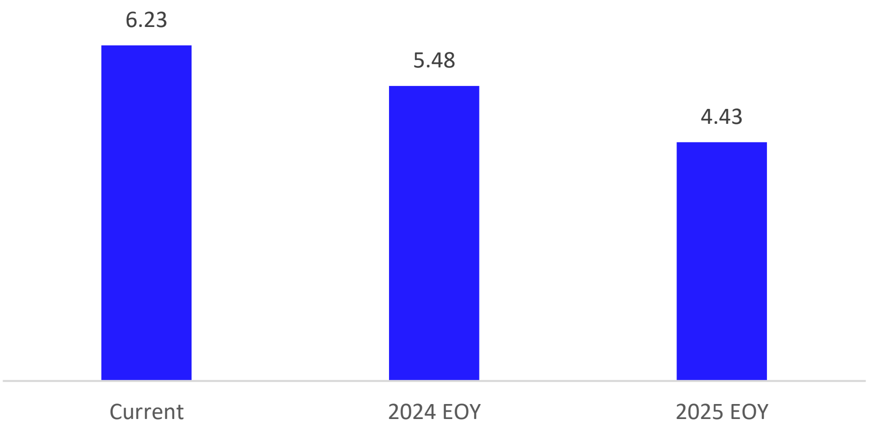
	NIM		Loan Growth		Cost of Risk		Cost to Income		ROE/ROTE		CET-1	
	Guidance	Change	FY23	Guidance	FY23	Guidance	FY23	Guidance	FY23	Guidance	FY23	Guidance
Rajhi	3.04% - 3.14%	5bps to 15bps	4.6%	Mid Single-digit	25	25 - 35	27.2%	<27%	19.4%	>19%	20.4%	>20%
SNB	3.00% - 3.20%	-6bps to 14bps	10.0%	High Single-digit	16	30 - 50	27.6%	<27%	16.8%	16% - 17%	19.4%	18% - 19%
Riyad	3.46% - 3.51%	-10bps to -15bps	13.0%	High Single to Low Double-digit	70	65 - 75	31.3%	<32%	15.6%	>15%	15.7%	>15%
Alinma	3.76% - 3.86%	-5bps to +5bps	18.5%	Mid-teens	77	65 - 75	31.3%	~30%	17.2%	>17%	17.5%*	19% - 20%*
ANB	3.61% - 3.71%	-5bps to +5bps	6.0%	Mid-teens	48	50 - 60	33.2%	<32%	12.1%	>13%	18.8%	>19%
BSF	3.10% - 3.30%	-23bps to -43bps	12.8%	Low Double-digit	96	60 - 70	32.4%	<32%	10.6%	11% - 13%	16.7%	17% - 18%
BJAZ	2.10% - 2.15%	5bps to 10bps	14.0%	Mid-teens	30	30 - 35	58.2%	<56%	7.9%	>8%	17.3%	16.5% - 17.0%
SIB	~2.75%	-23bps	17.0%	>15%	47	45 - 50	41.8%	41.5% - 42.5%	11.7%	>12%	19.4%	>18.75%
SABB	2.85% - 2.95%	-10bps to -20bps	18.0%	Above Sector	27	30 - 45	32.4%	<32%	15.3%	15% - 16%		

*Source: Company Data, Al Rajhi Capital, * CAR Pillar Note: Albilad has not been included as guidance is not available*

View on Fed rate and SAIBOR

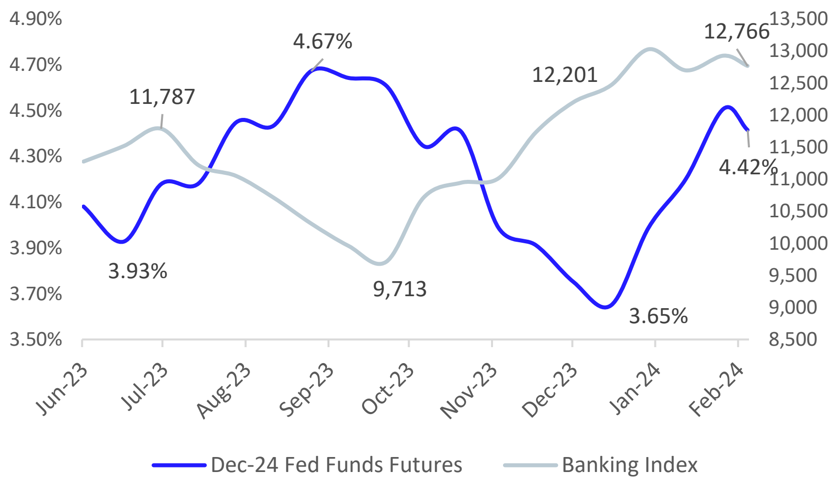
- Fed fund futures have been extremely volatile in the past six months as the Fed continues to be data dependent, that has given mixed signals in the recent months. The two consecutive CPI readings (above expectations) have raised worries over inflation being sticky that might force Fed to keep real interest rates elevated. Further, the inflation in shelter continues to be high and the recent monthly growth of 0.6% implies annualized shelter inflation of 7.2%. As the wage growth (4.5% y-o-y in Jan. 2024) continues to be solid, another year of sticky inflation is possible. In this backdrop, the Fed in its recent meetings has poured water on expectations of rate cuts starting in March.
- The US Fed fund futures and the treasury yields have now gone back to Oct 2023 levels, whereas the Saudi banking index is still 33% higher than the October level. We continue to stick to our view of 3 rate cuts and believe there is a possibility of the cuts being staggered instead of 3 straight cuts, unless the US economy deteriorates notably. Our SAIBOR estimate is 5.48% by the end of 2024 and 4.43% by 2025. In our view, the tight liquidity situation will keep the spread over LIBOR elevated (assumed 60 bps in 2024 and 55 bps in 2025)

SAIBOR estimates (End of year)



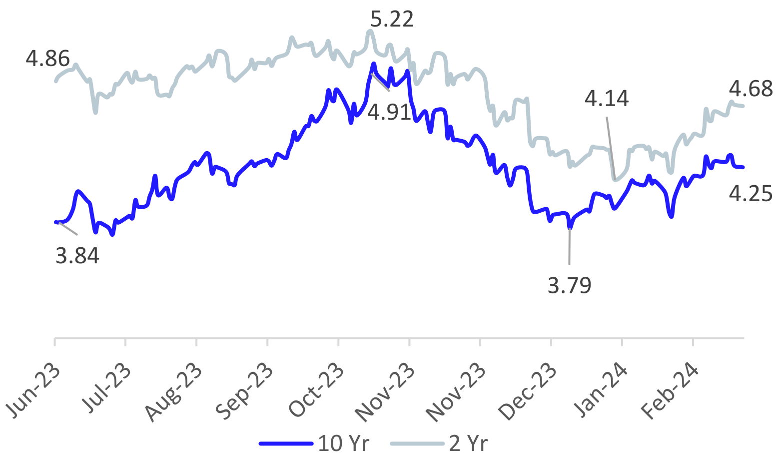
Source: Bloomberg, Al Rajhi Capital. EOY: End of year

Fed fund futures rate for Dec- 24 & KSA Banking Index



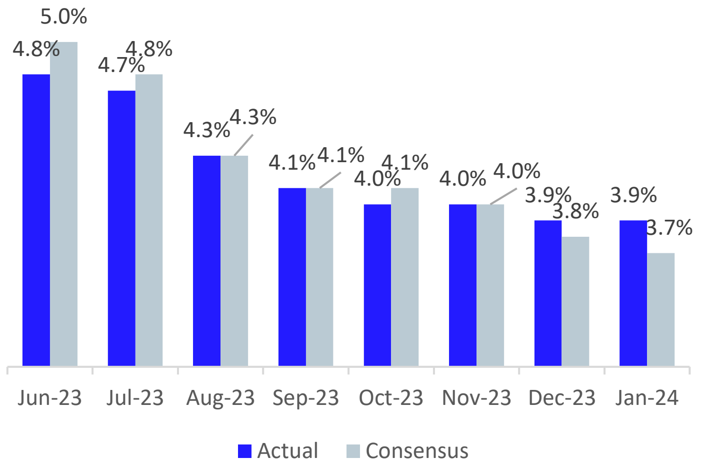
Source: Bloomberg, Al Rajhi Capital

US Bond yield curve (%) since start of 2023



Source: Bloomberg, Al Rajhi Capital

US Core inflation Actual vs Consensus (y-o-y change)



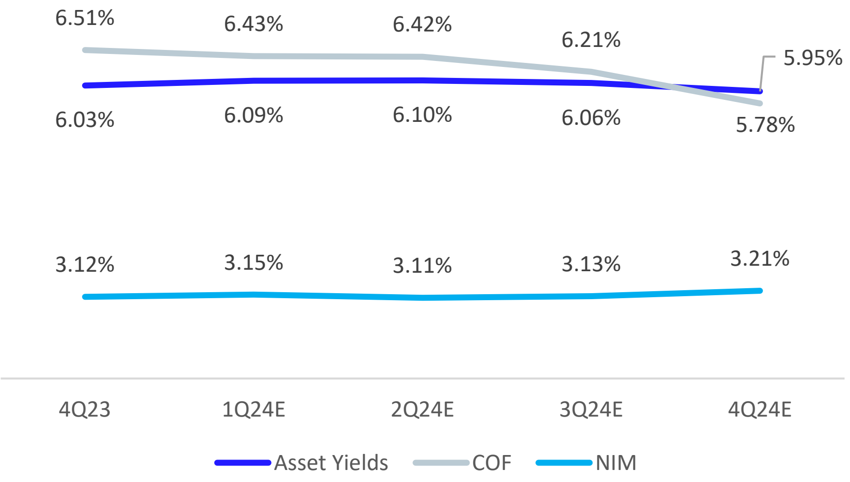
Source: Bloomberg, Al Rajhi Capital

Banks - NIMs

Staggered cuts could mean no benefits in 2024

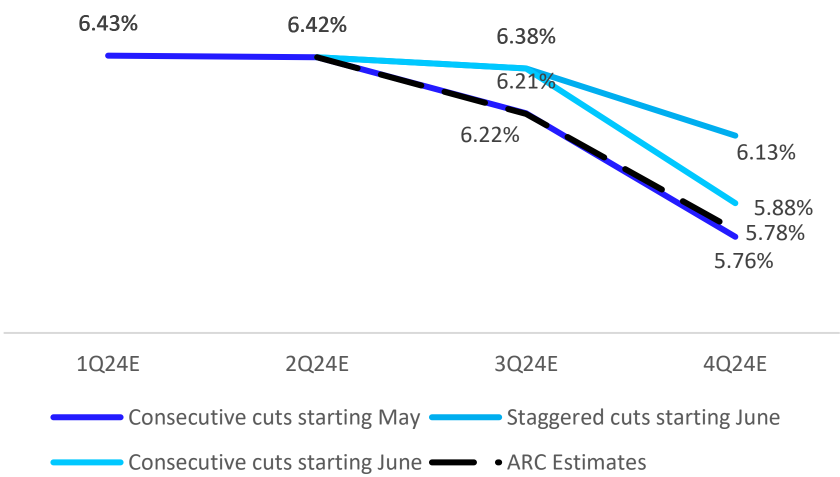
- The NIM guidance from the banks imply that they expect the rate cuts to be consecutive for 3 months starting May, thus posing a risk in case the cuts are staggered. Further, the NIM guidance also does not consider the possibility of clients shifting to long dated time deposits (6/9 months instead of 3 months) ahead of the cuts. Although, we are not considering the possibility of the same to happen in our NIM projections and at the moment also do not consider the possibility of staggered cuts yet. We believe unless the US economy deteriorates substantially the Fed will follow a wait and watch approach after every cut.
- We have shown the analysis on cost of funding if the cuts are staggered versus consecutive cuts and the implied cost of funding (derived) from the guidance. If the cuts are staggered starting June, then the cost of funding will decline only 29 bps in Q4 2023 from the peak of 6.42% in Q2 2023, whereas the implied COF from the guidance assumes 60-70 bps decline. Thus, in such a situation, the NIMs would be under pressure in 2024 and the benefits of rate cuts will only appear in 2025.
- Based on our assumption of 90% of incremental deposits to be funded by time deposits (in 2023 all the incremental deposits were funded by TD) and 3 rate cuts, NIMs for the sector would change be flattish in 2024 versus our earlier expectations of 4 bps decline. However, in case of staggered cuts scenario, the NIMs could decline 7bps on assumption that cost of funding will not reduce much, while asset yield will remain largely stable.

Implied asset yield and COF as per NIM guidance



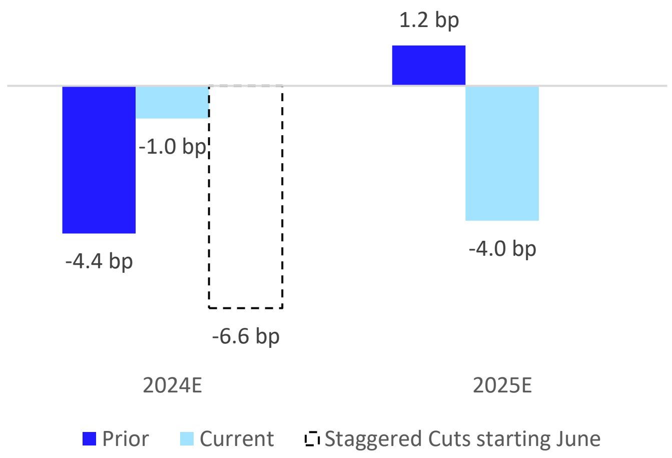
Source: Al Rajhi Capital estimates, Note:COF is only based on interest bearing liabilities, does not include demand deposits

COF (only interest bearing liab.) trends in diff. scenarios



Source: Al Rajhi Capital estimates, Note: COF is only based on interest bearing liabilities, does not include demand deposits. Assumed liablities reprice within 3 months and floating assets in 6 months

NIM Expansion/Contraction changes to our estimates

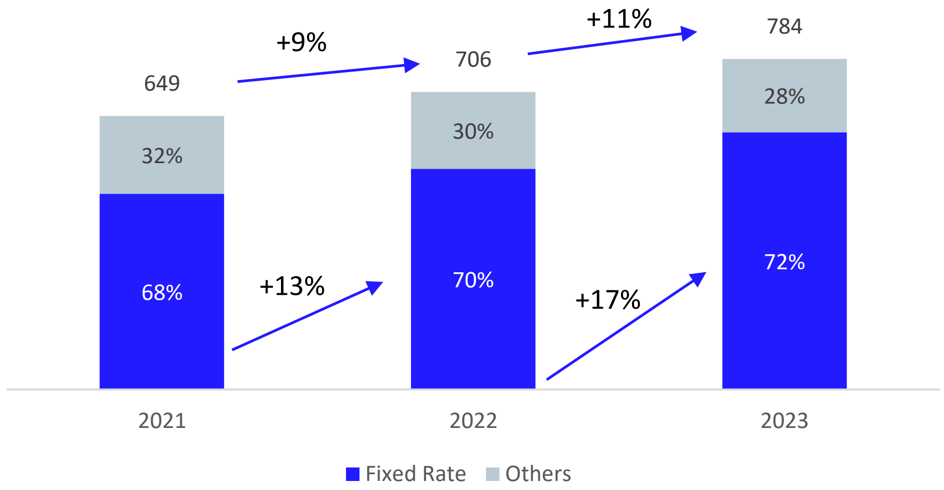


Source: Al Rajhi Capital estimates. NIM expectations in staggered cuts is based on assumption that assets will not reprice notably, while cost of funding will

Banks position themselves in a rate cut scenario

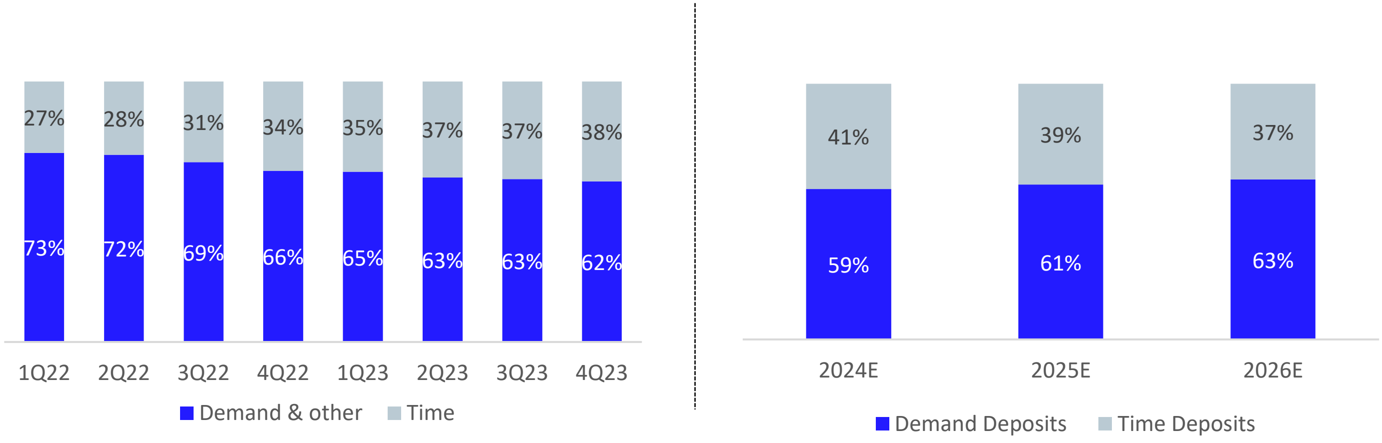
- In the anticipation of rate cuts, most of the Saudi banks in 2023, particularly in H2 increased their investments in the fixed rate securities to position themselves favorably in a rate cut scenario. The overall growth in the investments was 11% in 2023, even slightly higher than the lending growth. Moreover, fixed rate investments grew by 17% in 2023 outpacing the growth in total investments and pushing its mix to increase by 200 bps y-o-y and 400 bps versus 2021.
- Despite time deposits mix expected to go up, the shift towards fixed rate investments should ease the pressure on NIMs in a rate cut situation given that the liabilities reprice faster compared to assets. However, in a stable or staggered rate cut scenario, this move might pressure the NIMs as fixed rate investments in government sukuks typically yield lower than retail as well as corporate financing.

Fixed rate investments' (SAR bn) growth outpaced growth in total investments



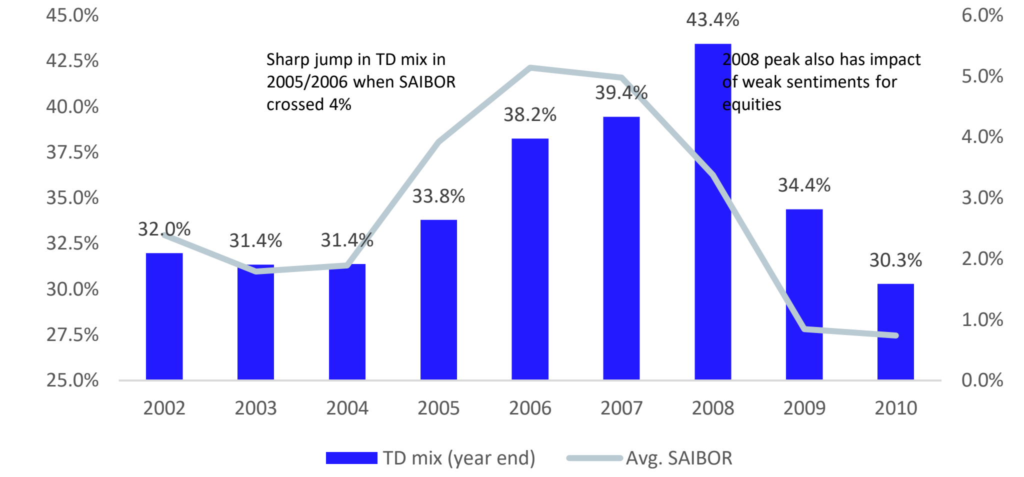
Source: Company Data, Al Rajhi Capital. Note: Others includes Floating rate, equities, mutual funds, etc.

Time deposits could continue to go up as long as SAIBOR is around 4%-4.5%



Source: Company Data, Al Rajhi Capital Note: The mix is based on deposits from the ten banks, it could differ from SAMA numbers

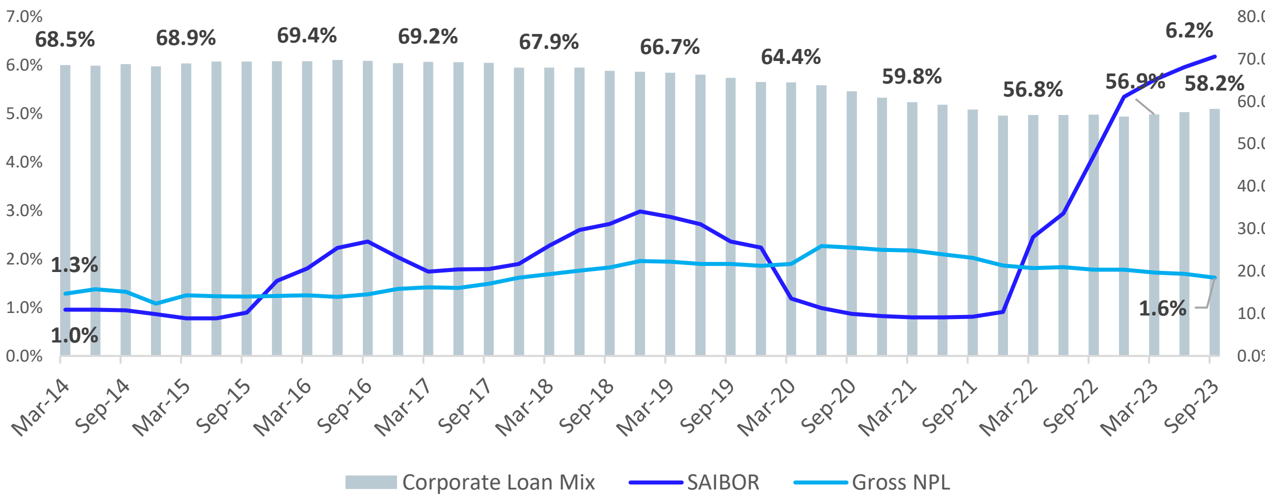
2002-2010 cycle indicates SAIBOR above/below 4% critical for shift in TD mix



Source: SAMA, Al Rajhi Capital. Note: TD mix here is from SAMA, could differ from the chart in the left

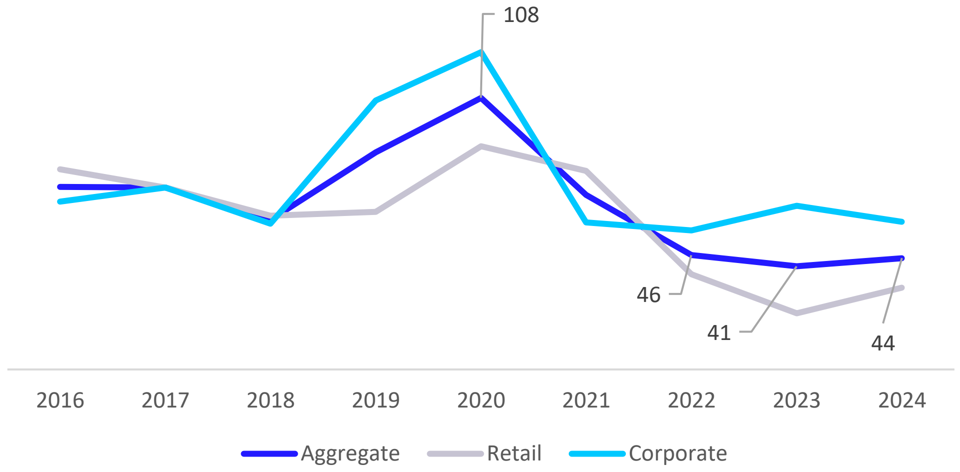
Banks – CoR assumes healthy lending environment

NPLs and Corporate loan mix at the system



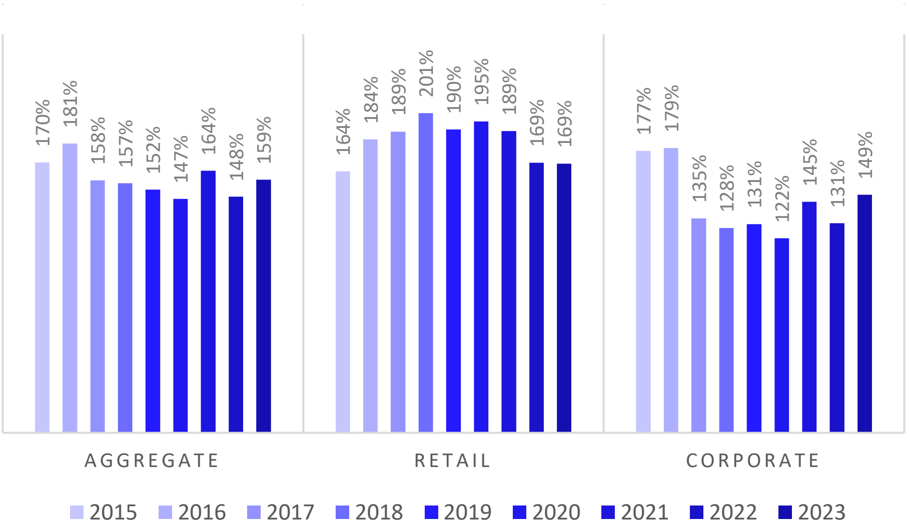
Source: SAMA, Al Rajhi Capital.

Cost of Risk (bps) is guided to be flattish



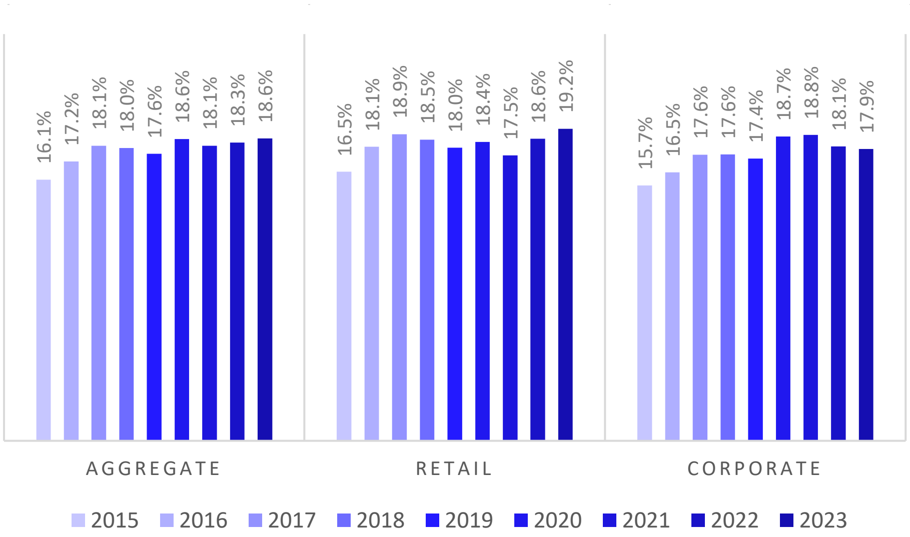
Source: Company Data, Al Rajhi Capital. 2024 ARC estimates is based on the guidance from the banks

Coverage Ratio



Source: Company Data, Al Rajhi Capital

CET-1/Tier-1 Ratio



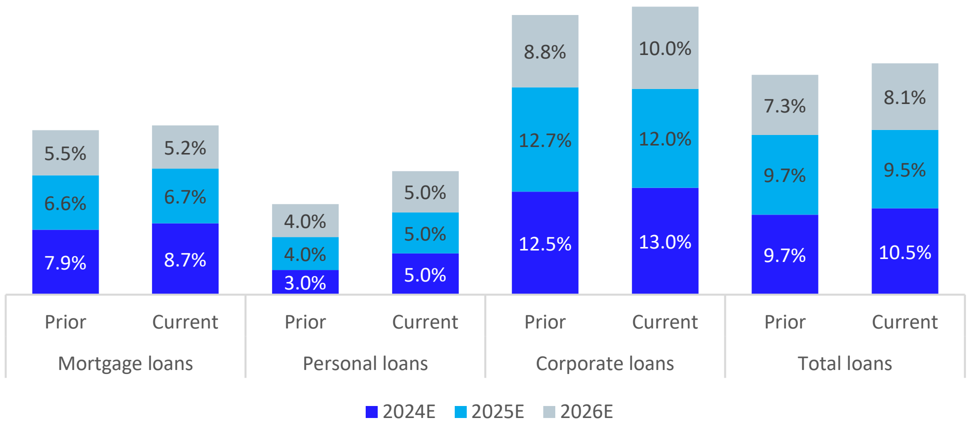
Source: Company Data, Al Rajhi Capital.

Banks – Loan estimates

Corporate loan growth continues to be the driver

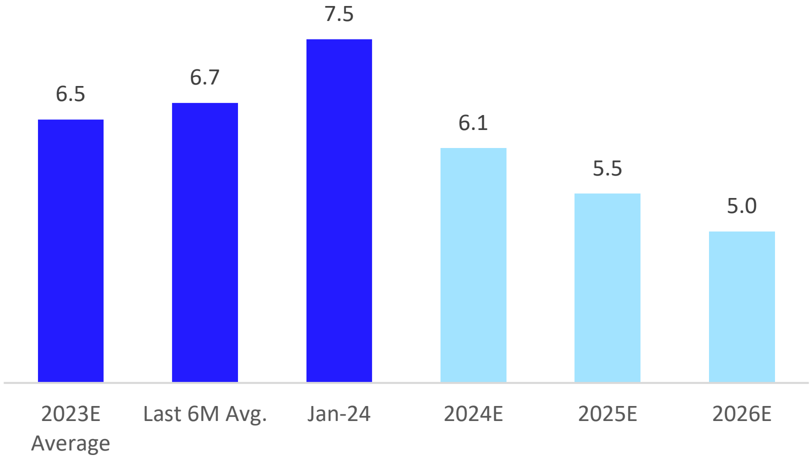
- Even in the face of elevated interest rates and repayments of personal loans disbursed in 2020/2021, the overall loan growth has remained robust. The key driver has been the corporate loan which is growing by low to mid teens. As per January 2024 SAMA numbers, corporate loans grew over 14% y-o-y (estimated). Mortgage monthly loan originations that were subdued last year also have shown signs of improvement, the latest reading for January showed monthly origination of SAR 7.5 bn versus average origination of SAR 6.7 mn in the last six months and 2023 average of SAR 6.5 bn. We raise our estimates on mortgage origination for 2024 to SAR 6.1 bn from SAR 5.7 bn before. At the same time, we also believe personal loans would grow at a higher rate now supported by higher disposable income and promotional activities form the banks.
- Corporate loan growth should remain low double digits in the near future led by SMEs and project finance demand related to giga-projects as the execution gathers steam. Our inhouse research view is that oil prices will remain stable led by Saudi Arabia's active role in managing in the output. Thus, sentimentally it should bode well for the companies exposed to the giga projects and investments should continue to flow towards the ramp up of the giga projects. We anticipate sectors such as construction, utilities, leisure & entertainment to be the key growth drivers.
- Based on our revised estimates for each segment, our new loan growth expectations for 2024 is 10.5% y-o-y and 9.5% y-o-y in 2025.

Loan growth estimates



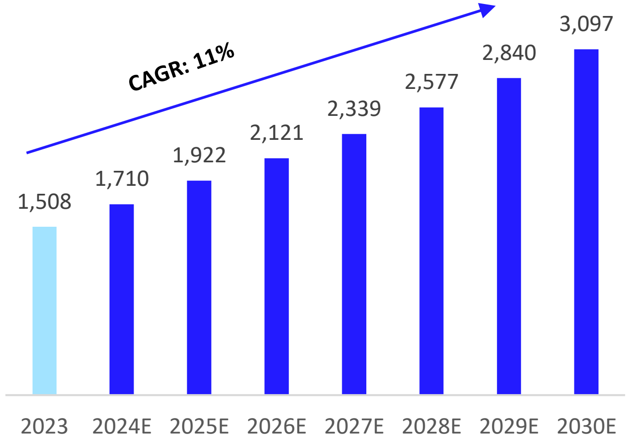
Source:Al Rajhi Capital estimates

New Mortgage Origination (SAR bn)



Source: SAMA, Al Rajhi Capital estimates

Corporate loans (SAR bn) maintain strong growth



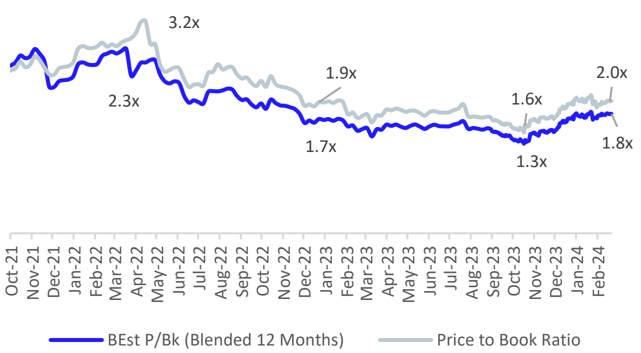
Source: SAMA, Al Rajhi Capital

Banks – Growth estimates and Valuations

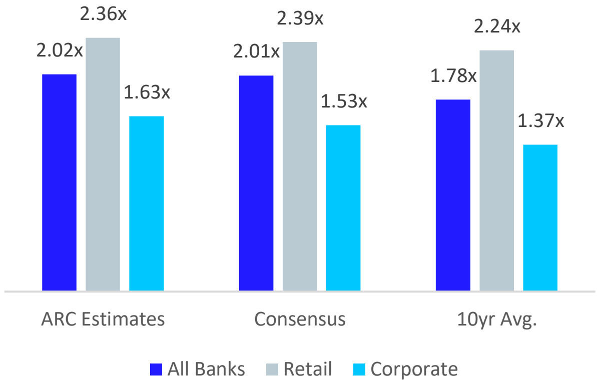
Valuations pricing in all the positives

- Our 2024 estimates are broadly in line with the guidance provided by the banks and we would await for more clarity on cost of risk and funding pressure before we incorporate the risks mentioned on NIMs and COR. We expect net income to grow by 7% y-o-y in 2024 supported by loan growth and stable NIMs. The ROEs are expected to have already peaked in 2023 but remain healthy at >15% in 2024 and 2025.
- Post the rally, Saudi banks are now trading at a blended forward P/B (2024/2025) of 2.0x (on tangible equity), above historical average of 1.8x. Both the corporate as well as retail banks are trading at a slight premium to the historical average multiples. On the back of strong loan growth prospects, the premium valuations are justified to some extent, however, in case the NIMs and COR see signs of possible downward revision, then profit taking should be considered.

Trailing and fwd. 12 months*



Valuations - Price to Book (Blended 2024/2025)



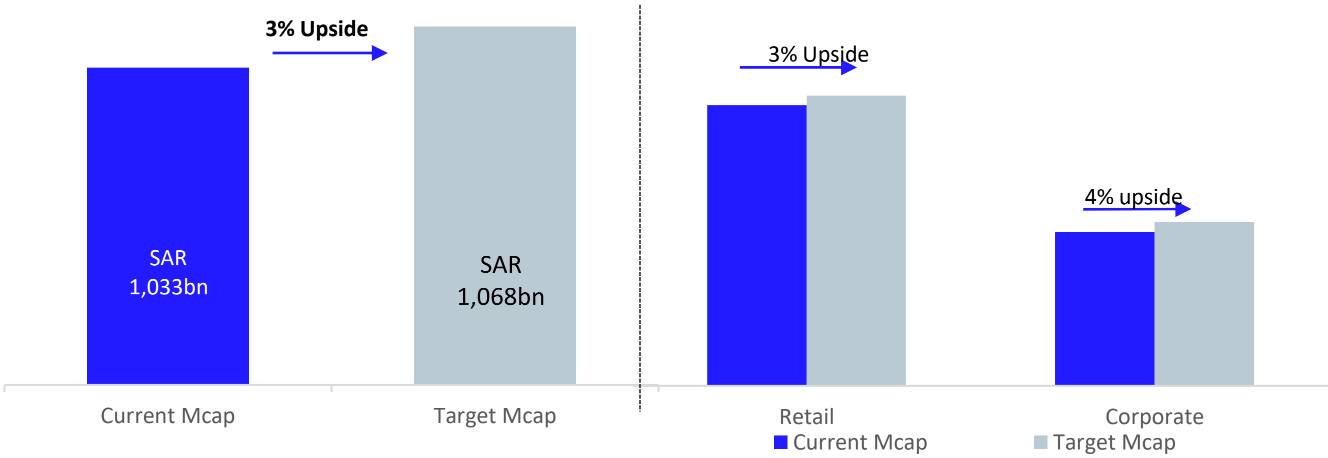
*Source: Company filings, Bloomberg, Al Rajhi Capital estimates, Note: * Left side chart, the P/B is not adjusted for tangible equity. Retail Banks considered are Al Rajhi, SNB, BJAZ and Albilad and rest are corporate. Consensus P/B considers only tangible book value (excluding Goodwill and Sukuk).*

Summary of our key parameters

Aggregate (SAR mn)	2023	2024E	2025E	2026E
Net interest income growth	10.9%	8.0%	6.8%	8.7%
Total operating income growth	9.5%	7.6%	6.6%	7.9%
Net income growth	11.9%	7.2%	5.0%	8.8%
Loan Growth	10.6%	10.3%	10.3%	8.9%
Deposit Growth	7.8%	8.2%	10.3%	8.9%
Asset yield	5.6%	6.0%	5.6%	5.4%
Cost of funds (deposits)	5.7%	6.2%	5.3%	5.1%
COR	41	44	51	53
NIM Change	-2.2 bp	-1.0 bp	-4.0 bp	1.7 bp
ROE (%)	16.1%	15.8%	15.2%	15.5%

Source: Company Data, Al Rajhi Capital. The loan growth mentioned above is net loans and thus would differ from our estimates for the system due to provisions. Cost of funds is cost for interest bearing liabilities, does not include demand deposits

Target upside appear modest after recent rally

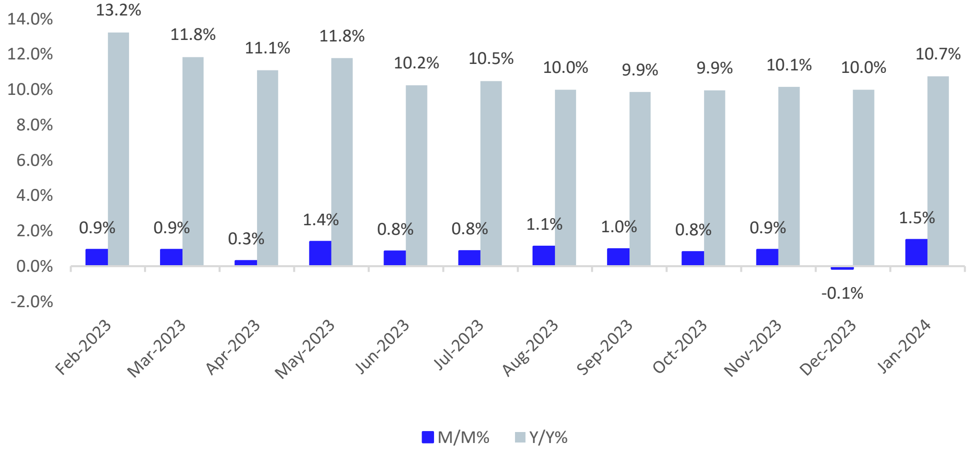


Source: Company Data, Al Rajhi Capital Note: Gordon Growth valuation methodology used. ROEs are average of 2023/2024/2025 to capture NIM changes in Base. Retail Banks considered are Al Rajhi, SNB, BJAZ and Albilad and rest are corporate

Appendix

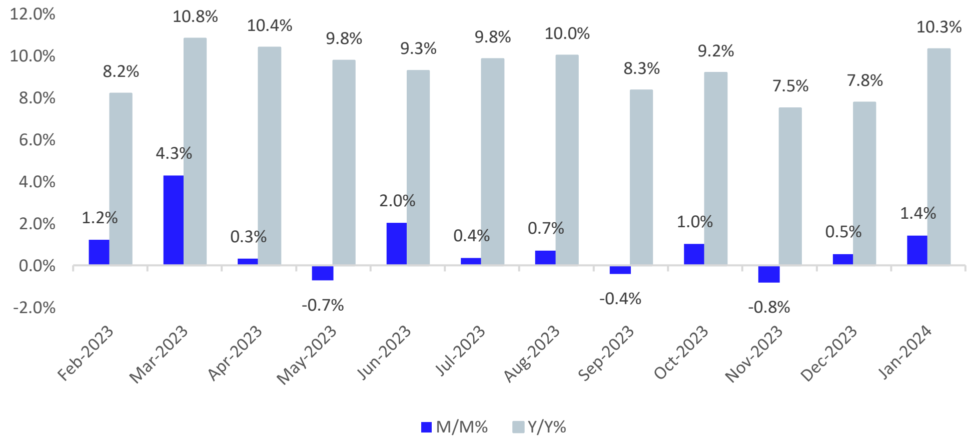
SAMA Data

Credit Growth (Last 12 Months)



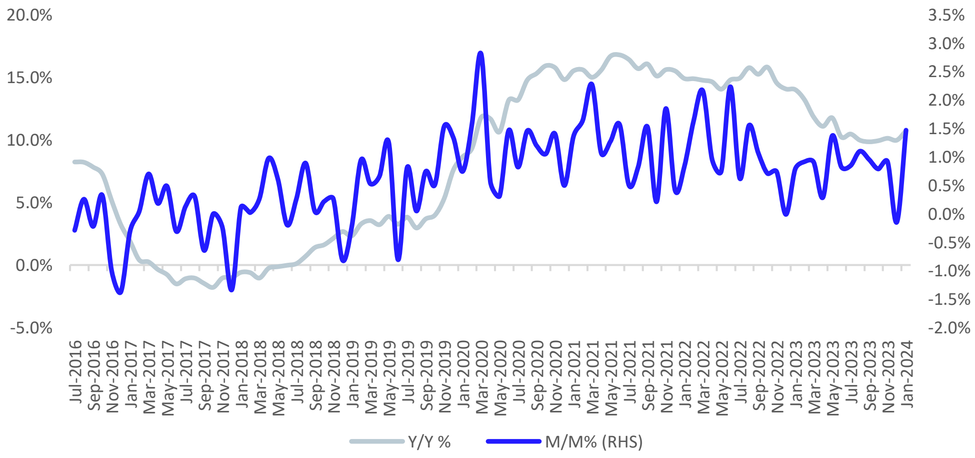
Source: Saudi Central Bank, Al Rajhi Capital

Deposit Growth (Last 12 Months)



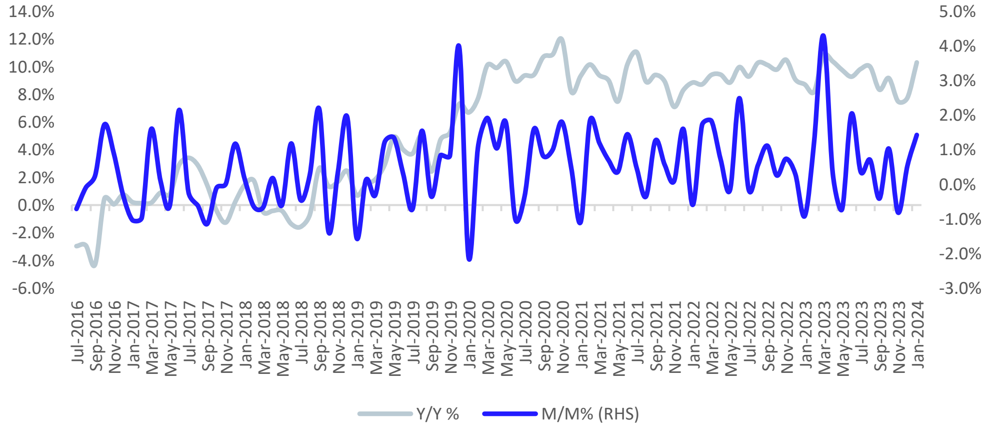
Source: Saudi Central Bank, Al Rajhi Capital

Credit Growth Long Term



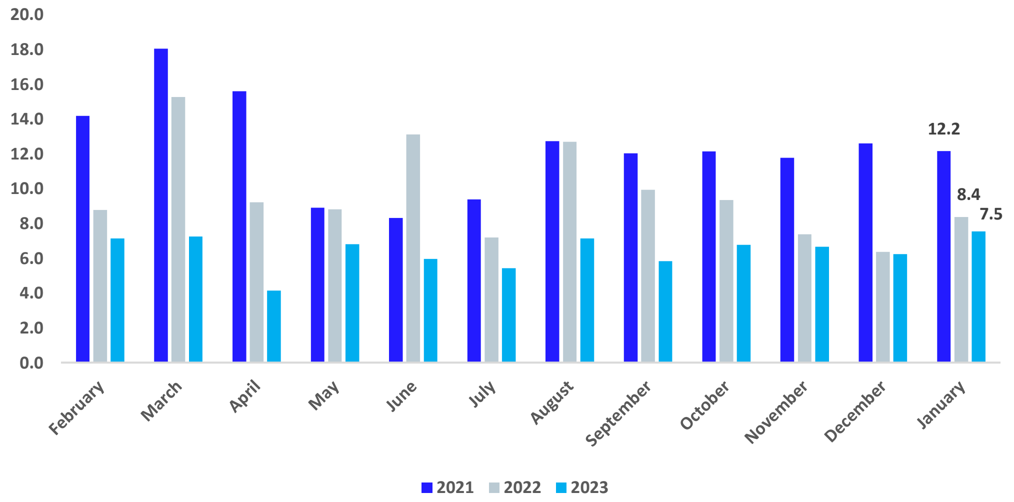
Source: Saudi Central Bank, Al Rajhi Capital

Deposit Growth Long Term



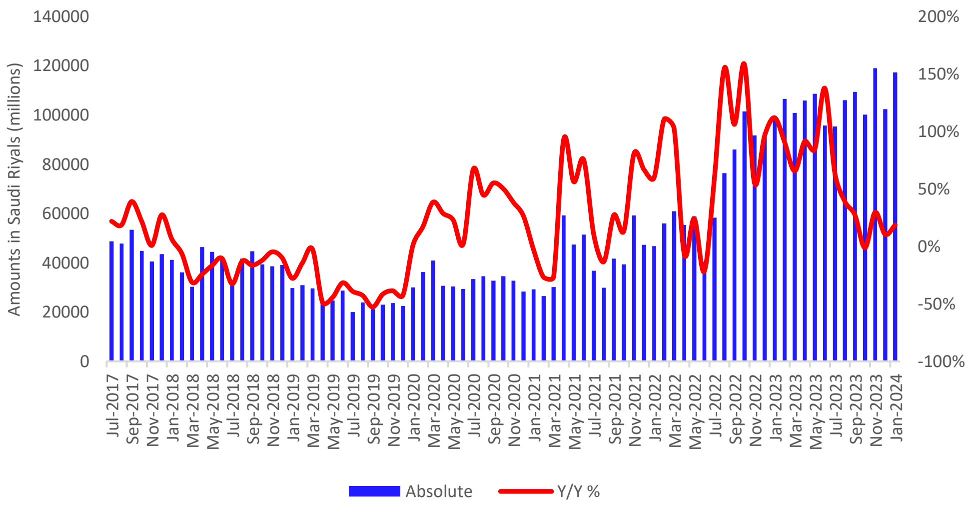
Source: Saudi Central Bank, Al Rajhi Capital

New Mortgage Origination (Last 12 Months '000)



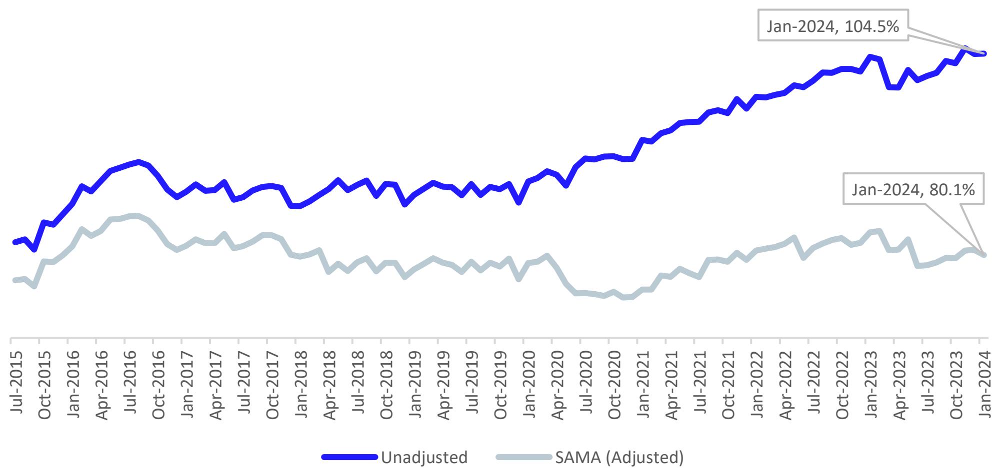
Source: Saudi Central Bank, Al Rajhi Capita Bars before January indicates 2020, 2021, 2022 respectivelyl

Interbank Liabilities (Long-Term)



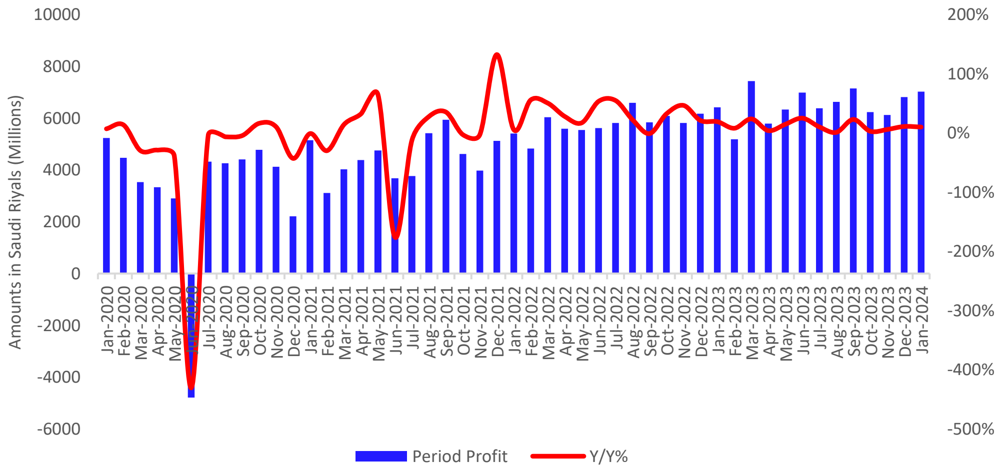
Source: Saudi Central Bank, Al Rajhi Capital

LDR (Long-term)



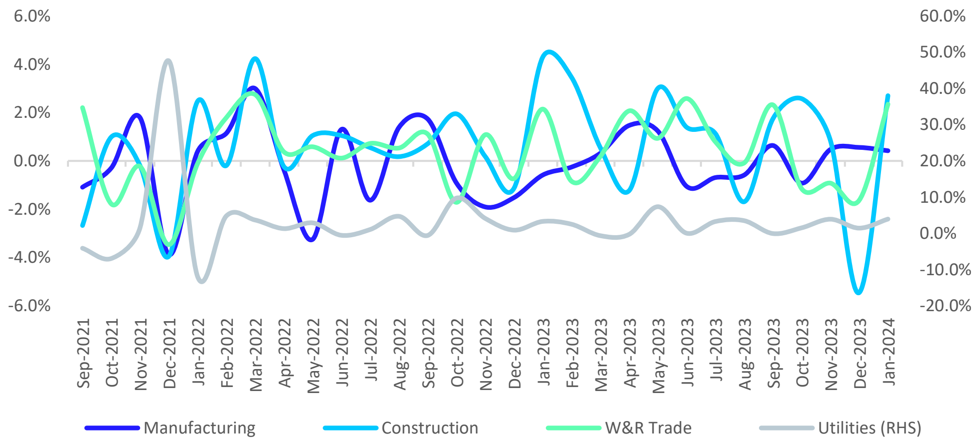
Source: Saudi Central Bank, Al Rajhi Capital

Bank profit before zakat



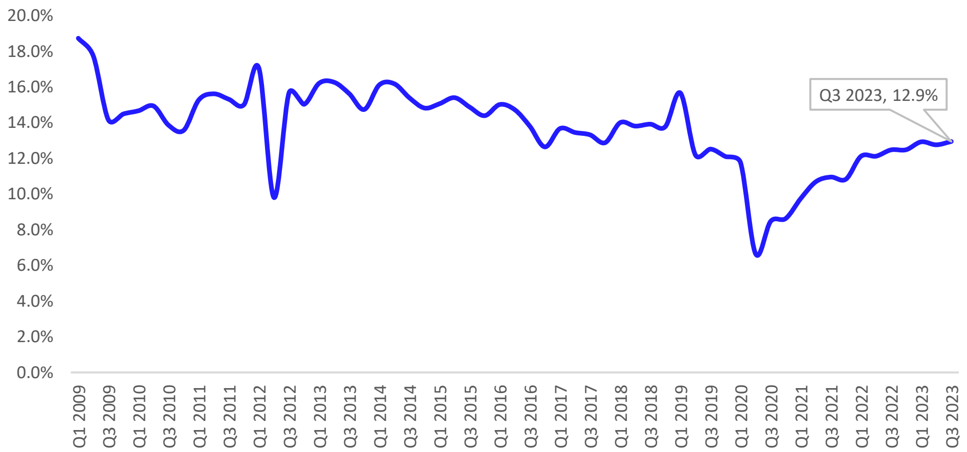
Source: Saudi Central Bank, Al Rajhi Capital

Bank-Credit Classified by Economic Activity



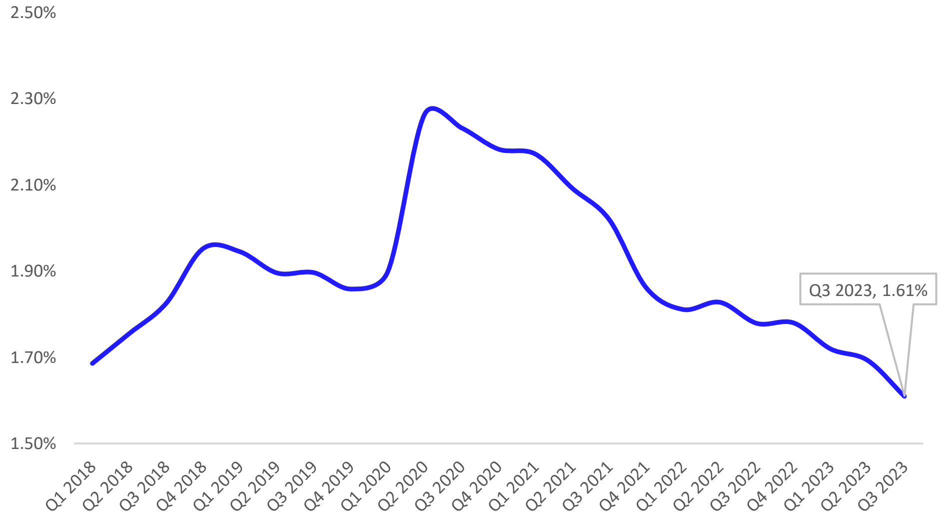
Source: Saudi Central Bank, Al Rajhi Capital

Return on Equity



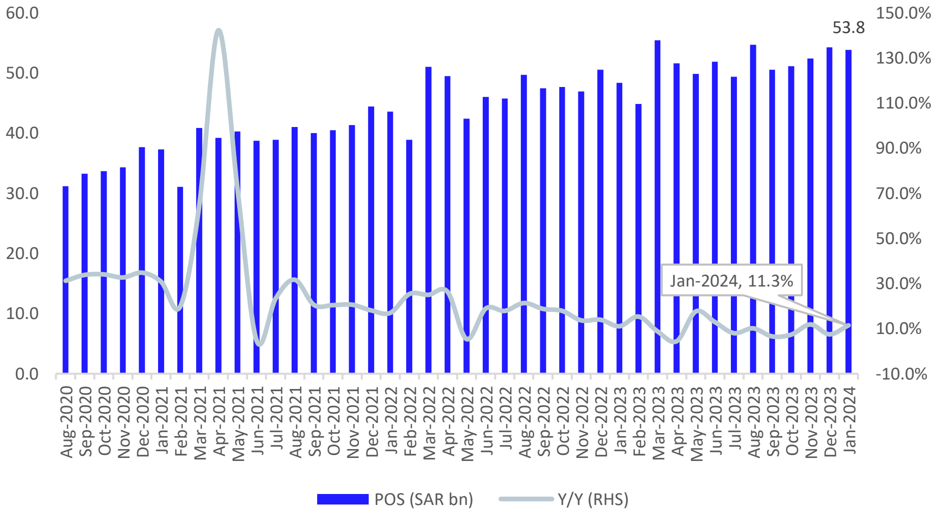
Source: Saudi Central Bank, Al Rajhi Capital

Non-performing loans to Gross loans



Source: Saudi Central Bank, Al Rajhi Capital

Point-of-sale transactions (POS) trend



Source: Saudi Central Bank, Al Rajhi Capital

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"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.

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Please note that the achievement of any price target may be impeded by general market and economic trends and other external factors, or if a company's profits or operating performance exceed or fall short of our expectations.

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