Saudi Banks Sector
Banks –Finance
Saudi Arabia
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الراجحي المالية
Al Rajhi Capital

Implications

- Q3 2017 earnings growth was subdued by higher provisioning charges.
- Liquidity tightened modestly along with rise in SAIBOR.
- The financial health of the smallest 60 companies listed on Tadawul used in our study has improved in 2017, with lower leverage and higher operating profit.
- We don't expect to see a surge in provisions in Q4 2017 (as was seen in Q4 2016), as the improving financial health of the smaller companies suggests that asset quality is unlikely to deteriorate materially from here.
- There is upside potential for the Banking sector in the near to medium term on possibility of increased government spending on capex due to higher oil prices and expansionary 2018 budget.The downside risks are related to lower banking activity post the recent purge.

See page 5-6 for our study on the smallest 60 listed companies

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Saudi Banking sector:

Q3 net income growth restricted by higher provisioning

The consolidated net income of banks was only marginally higher in Q3 2017, +0.4% q-o-q (+14.3% y-o-y) (Figures 1 & 2), as the earnings were under pressure from stagnant credit and the increase in provisioning. The liquidity situation slightly tightened over the past few months as indicated by higher loan to deposit ratio and rising SAIBOR. Credit quality also deteriorated in Q3 2017, as indicated by the rising NPLs to gross loans ratio (Figure 8). We studied the financial performance of 60 listed small caps on the Tadawul to get a sense of the financial health of the smaller companies in the Kingdom (Figure17). Our study showed that the financial health of these companies has started to improve. Thus, going forward, we are unlikely to see a material decline in asset quality from the current levels, and therefore the spike in provisioning seen in Q4 2016, is unlikely to return this year. Further, there is a potential upside for the Banking sector with the possibility of recovery in capital expenditure from the government and some troubled companies repaying their dues.

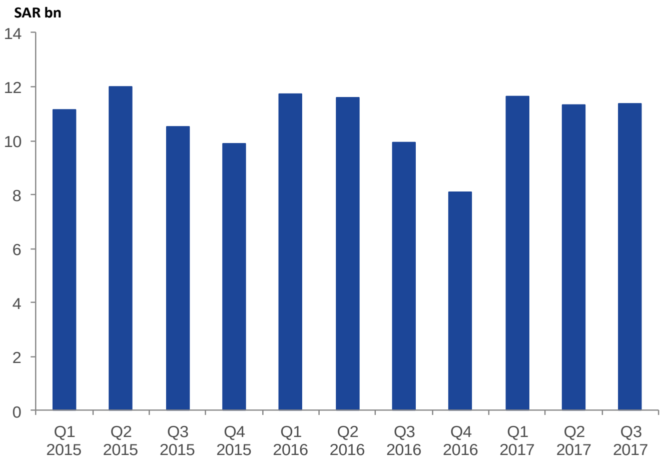
Asset yields firm as effective SAIBOR level remains elevated: SAIBOR has been trending higher after touching a low in May (Figure 6), resulting in a marginal increase in effective SAIBOR rate for the banking sector (as per our calculations) in Q3 (Figure 3). As a result, asset yields also remained firm, marginally higher at 4.9% (~2bps q-o-q) in Q3 2017. With overall credit remaining stagnant, gross interest income still improved in Q3 2017 (+1.8% q-o-q; +0.8% y-o-y), in line with our expectation (Figure 19). Following the trend in SAIBOR, bank deposit costs also increased marginally, while total deposits declined 2.4% q-o-q (-0.5% y-o-y) by the end of Q3 (Figure 24). This resulted in NIMs remaining largely flat for the quarter (on a sequential basis) and net interest income growth slowing down to 1.7% q-o-q in Q3 2017, compared to 4.3% growth witnessed in the previous quarter (Figure 20).

Figure 1 Net Income (SAR mn)

Bank	Q3 2016	Q2 2017	Q3 2017	y-o-y	q-o-q
Al Rajhi	2,009	2,182	2,265	12.7%	3.8%
Samba	1,341	1,271	1,308	-2.5%	2.9%
Riyad	729	848	1,077	47.6%	27.0%
BSF	1,010	1,005	1,001	-1.0%	-0.4%
SABB	995	1,129	1,083	8.9%	-4.1%
ANB	722	849	775	7.5%	-8.7%
Al Awwal	263	322	363	38.1%	12.7%
SIB	219	356	358	63.3%	0.8%
Alinma	312	488	542	73.9%	11.0%
AlJazira	161	220	228	41.7%	3.4%
Albilad	228	239	244	7.1%	2.2%
NCB	1,962	2,417	2,126	8.4%	-12.1%
Total	**9,951**	**11,325**	**11,370**	**14.3%**	**0.4%**

Source: Company data, Al Rajhi Capital

Figure 2 Consolidated Net Income of banks

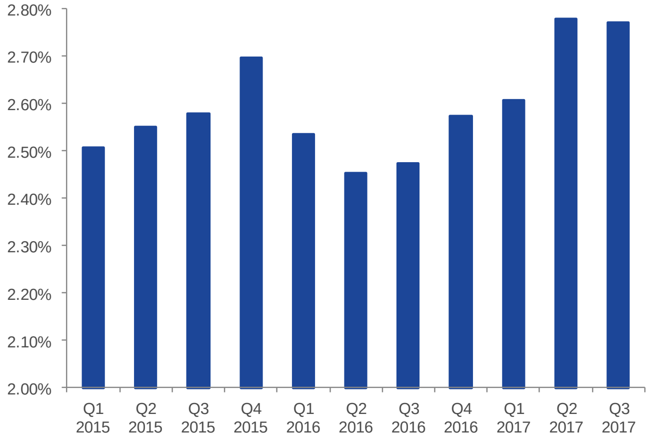


Source: Company data, Al Rajhi Capital

Figure 3 Gross interest income vs. the effective SAIBOR

Source: Bloomberg, Tadawul, Company data, Al Rajhi Capital

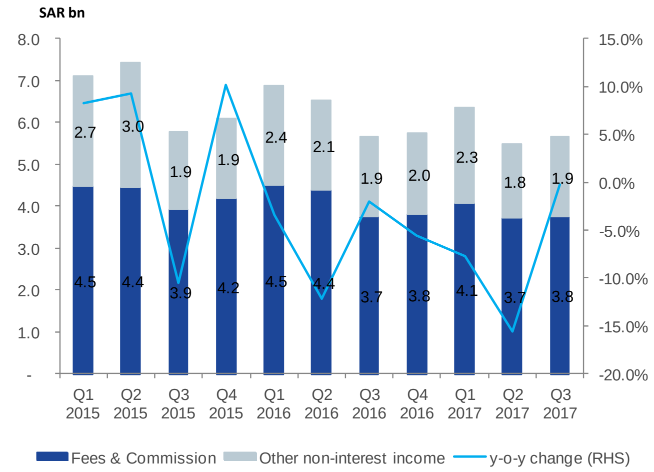
Figure 4 Spread between yield on net loans and effective SAIBOR



Source: Bloomberg, Tadawul, Company data, Al Rajhi Capital (yield earned calculated as: Gross interest income earned/ (net loans + investment))

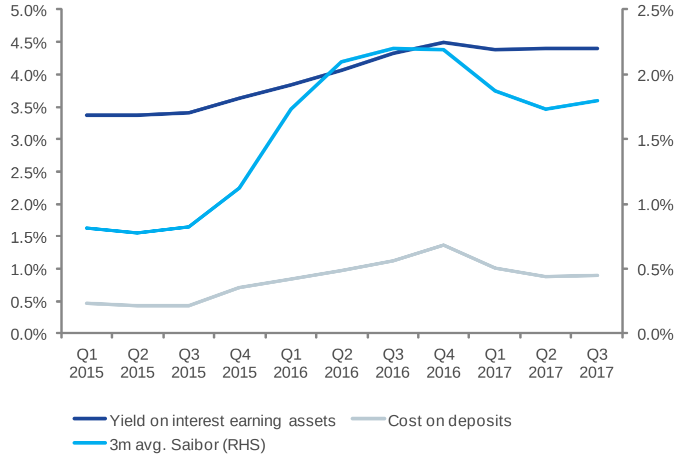
Non-interest income modestly picked up: Commission & Fees income, which forms about two-thirds of the total non-interest income recovered in Q3 (+1.1% q-o-q; +0.4% y-o-y), supported partially by increased trading on the Tadawul (compared to the seasonally weak Q2). In addition, gains on non-trading investments, especially for Arab National Bank and Saudi Investment Bank, led to a 2.8% q-o-q (-0.2% y-o-y) increase in non-interest income for the sector (Figure 5).

Figure 5 Non-interest income



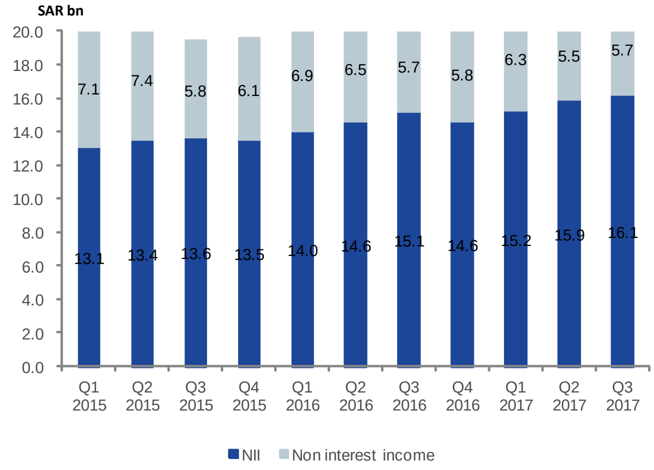
Source: Company data, Al Rajhi Capital

Figure 6 Spread between yield on loan and cost of deposits stable



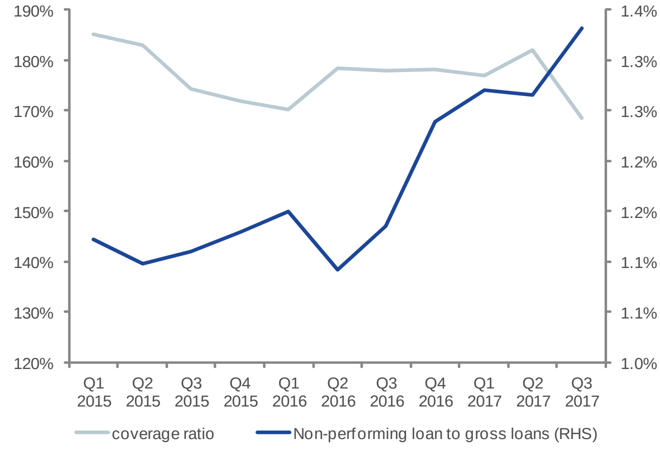
Source: Company data, Bloomberg, Al Rajhi Capital

Figure 7 Total operating income breakdown



Source: Tadawul, Company data, Al Rajhi Capital

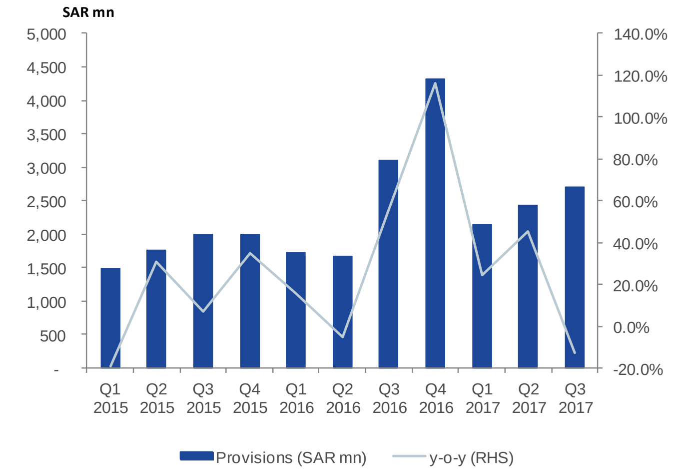
Figure 8 Asset quality has deteriorated in Q3 2017



Source: Company data, Al Rajhi Capital

Provisions rise q-o-q as asset quality dips: Provisioning for the quarter was higher than expected in Q3 (Figure 10). While we had expected total provisions to be in the range witnessed during the previous couple of quarters (SAR2.1-2.5bn), Q3 2017 saw a 11.4% q-o-q (-12.6% y-o-y) increase in total provisions to SAR2.7bn. The increase in provisioning was mainly due to higher provisioning at NCB, ANB and Aljazira. Figure 8 shows that asset quality did deteriorate in Q3 2017, as NPLs rose as a percentage of gross loans, primarily due to higher NPLs at Banque Saudi Fransi and NCB. As a result, even though the total operating income for the sector grew 2% q-o-q (net interest income: 1.7% q-o-q, non-interest income, 2.8% q-o-q), the higher provisioning limited the bottom line growth to a negligible 0.4% q-o-q. On a y-o-y basis though, the provisioning reduced by 12.6%, aided by a 27.3% lower provisions by NCB (Figure 9).

Figure 9 Provisions increased sequentially in Q3



Source: Company data, Al Rajhi Capital

Figure 10 Provisions (SAR mn)

						Percentage share	
Banks	**Q3 2016**	**Q2 2017**	**Q3 2017**	**y-o-y**	**q-o-q**	**Q3 2016**	**Q3 2017**
Al Rajhi	571	405	410	-28.2%	1.1%	18.4%	15.1%
Samba	62	60	74	19.0%	23.1%	2.0%	2.7%
Riyad	385	371	288	-25.2%	-22.4%	12.4%	10.6%
BSF	54	62	56	2.4%	-10.3%	1.8%	2.1%
SABB	190	165	168	-11.3%	1.9%	6.1%	6.2%
ANB	225	267	334	48.5%	25.1%	7.2%	12.3%
Al Awwal	340	285	255	-24.8%	-10.5%	11.0%	9.4%
SIB	195	78	122	-37.4%	56.4%	6.3%	4.5%
Alinma	41	124	105	152.6%	-15.6%	1.3%	3.9%
AlJazira	29	62	85	198.4%	37.9%	0.9%	3.2%
Albilad	51	77	116	128.9%	51.3%	1.6%	4.3%
NCB	956	475	695	-27.3%	46.5%	30.9%	25.7%
Total	**3,099**	**2,431**	**2,708**	**-12.6%**	**11.4%**	**100.0%**	**100.0%**

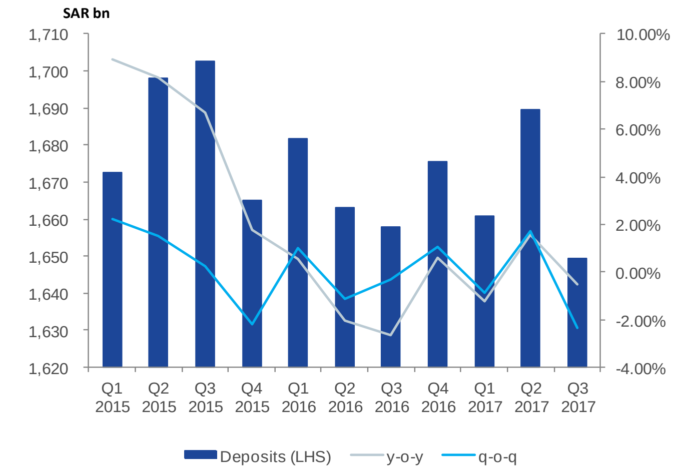
Source: Company data, Al Rajhi Capital

Credit unchanged over the previous quarter, while deposits declined slightly: Overall credit for the sector remained stagnant in Q3 2017 on a sequential basis ((Figure 11 and 22), indicating weak economic activity. The proportion of long term loans has started to decline after rising in the early part of the year, while proportion of short and medium term loans has increased. SAMA data showed that the banking sector's exposure to the "manufacturing and processing" continued to decline in Q3, while exposure to the "building & construction sector" was marginally up (Figure 13). Total deposits slipped 2.4% q-o-q (-0.5% y-o-y) to ~SAR1,650bn (Figures 12 & 24). Share of demand deposits slipped from 64.5% in Q2 2017 to 64.1% in Q3 2017. As a result of the lower deposits and unchanged credit level, overall loan to deposit ratio increased to 82.5% (as per SAMA) by the end of Q3 2017 (Figure 14). The loan to deposit ratio for banks (as per our calculation) show more uniformity compared to the same quarter last year (Figure 26).

Figure 11 Loans were stagnant sequentially

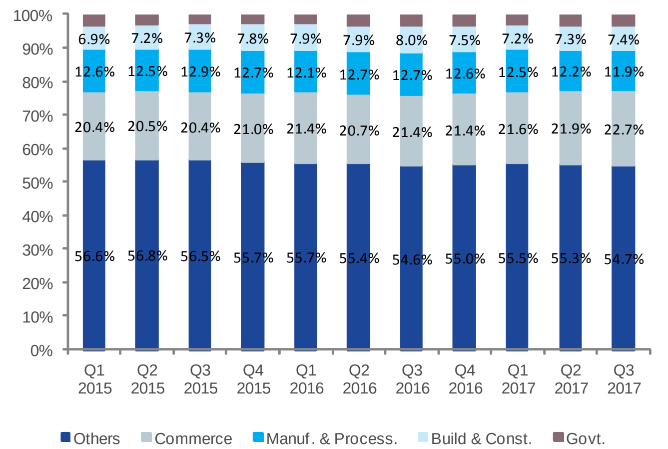
Source: Tadawul, Company data, Al Rajhi Capital

Figure 12 Deposits slipped in Q3



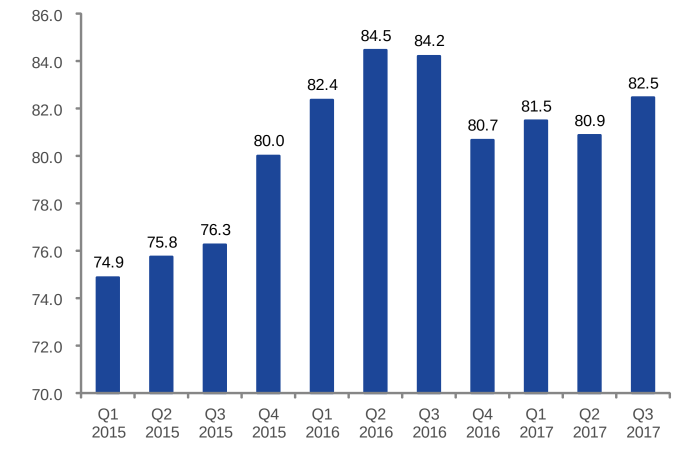
Source: Tadawul, Company data, Al Rajhi Capital

Figure 13 Sector-wise credit exposure



Source: SAMA, Al Rajhi Capital

Figure 14 Loan to Deposit ratio (%)



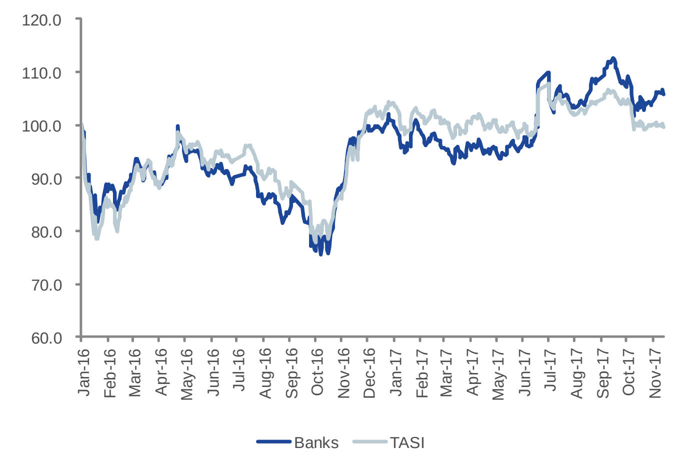
Source: SAMA, Al Rajhi Capital

Slight tightening of liquidity: The increase in LDR ratio (to the highest level in last four quarters, along with uptick in SAIBOR rates over the last few months, indicate some tightening in liquidity compared to the first half of the year. SAMA data shows that the banking sector's "Other Deposits" with SAMA has slipped to 2.4% of total assets by the end of Q3 2017, lowest in last four quarters. The Saudi government has raised ~SAR39bn from the domestic debt market so far this year, which saw strong response from domestic institutions (Source: Bloomberg). Al Rajhi Bank reported a ~ SAR4bn increase in its sukuk holding in Q3 from Q2, while Alinma has invested ~SAR7bn in government's sukuk issuance.

Unlike last year, we may not see sharp further deterioration in asset quality in Q4: To get a sense on the asset quality, we studied the financials of the 60 small cap companies listed on Tadawul (Figure 17) which we believe could provide a good proxy for underlying economy. We looked at the financial performance of these companies and the trends over the last few quarters. We studied trends of key ratios such as– 1) Net debt/EBITDA, which gives an understanding of the leverage of the company, 2) Interest Coverage ratio, which helps to gauge if the company is in a position to service its interest expense, 3) Operating income – to see how profitability is moving, 4) debt-to-equity – to check overall leverage. We annualized the data for 2017 to make it comparable to last few years data, and removed any outliers (upto 4 companies among the 60) which were distorting the overall data set. Based on this study we found that the financial performance of companies has improved in 2017 from a low of 2016 for most of the companies. **While overall operating income of group of companies improved in 2017 after falling sharply in the previous year, the market-cap weighted debt-to-equity ratio of the group also declined during the period. In addition, the companies with net debt/EBITDA of more than 5x has reduced in 2017, while companies that are cash positive (more cash than debt) has increased**.

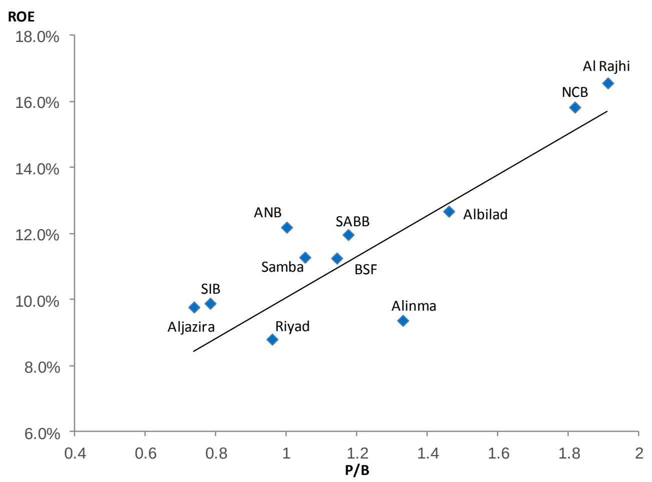
This shows that the financial health of the smaller companies in the Kingdom is starting to improve, and the asset quality of the banking sector may not materially decline from here. Thus, we don't expect see a similar surge in provisions in Q4 2017, as was seen in the same quarter last year.

Figure 15 Performance of Bank sector vs. TASI (Rebased at 100)



Source: Bloomberg, Al Rajhi Capital

Figure 16 ROE (avg. last 4 quarters) vs. P/B (12m forward)



Source: Bloomberg, Company data, Al Rajhi Capital

Figure 17 Financial Health Analysis of 60 small-cap companies (by market-cap)

	2013	2014	2015	2016	2017*	Trend
Cap-weighted debt to equity ratio	19.7%	19.7%	19.1%	23.6%	16.3%	Positive
Cap-weighted Operating income (aggregate) SAR mn	66.2	61.8	47.7	26.9	27.8	Positive
Interest coverage ratio						
Market-cap of companies having no interest burden	27.8%	29.5%	25.7%	22.2%	21.0%	Flat
Market cap weighted interest coverage ratio for interest paying companies	9.7x	9.9x	6.5x	4.7x	1.5x	Negative
No. of companies with no interest burden	26	22	19	17	16	Flat
No. of companies with interest coverage ratio above 2.5x	25	24	27	22	25	Positive
No. of companies with interest coverage ratio below 2.5x	9	14	14	21	19	Positive
Net Debt to EBITDA						
Market-cap weighted companies having negative net debt	29.3%	23.5%	19.3%	18.0%	26.6%	Positive
Market-cap weighted net debt to EBITDA	2.1x	7.2x	3.3x	2.6x	2.1x	Positive
No. of companies with net debt to EBITDA below 5x	44	48	41	38	45	Positive
No. of companies with net debt to EBITDA above 5x	11	8	14	16	12	Positive
No. of companies with negative EBITDA	5	4	5	6	3	Positive

Source: Company data, Al Rajhi Capital. * Annualized from 9M or 6M data if data was unavailable

Figure 8 Sector Comparison: Leverage and Borrowing Expenses

	Net debt (% of total assets)	Gross debt (% of total assets)	Cons. EBIT (SAR bn)	Cons Net Debt (SAR bn)	Net Debt/EBIT
Agricultural & Food	29.4%	34.6%	4.0	19.8	4.9
Building & Construction	27.7%	32.2%	0.9	7.6	8.7
Cement	9.6%	16.3%	2.2	3.8	1.8
Healthcare	15.8%	19.6%	1.2	1.7	1.4
Industrial Investment	43.9%	49.5%	3.5	53.5	15.4
Petrochemical	17.4%	31.6%	41.2	98.1	2.4
Real Estate Dev.	16.9%	32.1%	2.0	15.8	7.8
Retail	24.3%	30.4%	2.3	6.1	2.6
Telecom	6.0%	18.3%	11.6	10.4	0.9
Transport	27.3%	35.8%	2.0	8.0	4.0

Source: Bloomberg, Al Rajhi Capital

A likely uptick in government expenditure provides potential upside for the sector: The government has reduced expenditure in order to reign in its deficit. The cut has been mostly in capital expenditure, while the temporary cut in salary and allowance expenditure, announced in the latter half of 2016, was restored earlier this year. The government has been conservative, spending only 40% of the budgeted expenditure for the year by the end of H1. In our view, this has been seen mainly in the building & construction sector and indirectly other sectors as well, resulting in a cut in capital expenditure by the private sector and slowdown in credit growth. With the recent increase in crude oil prices, and news announcement mentioning that the next year budget is likely to be expansionary, there is a possibility that spending on capital expenditure may recover. That will encourage investment by the private sector, which could result in revival in credit growth. This will also have a positive impact on the sector's credit quality. In addition, news articles suggest that some troubled companies have started to repay their dues (Saudi Binladen group paid SAR1.85bn recently). These provide a potential upside for the Banking sector in the near to medium term. On the other hand, the recent events leading to bank account closures may weaken bank activities in the near term.

Figure 19 Total special commission income (SAR mn)

	Q3 2016	Q2 2017	Q3 2017	y-o-y change	q-o-q change
Al Rajhi	3,075	3,097	3,178	3.4%	2.6%
Samba	1,782	1,670	1,727	-3.0%	3.5%
Riyad	1,889	1,821	1,913	1.3%	5.0%
BSF	1,571	1,675	1,715	9.1%	2.4%
SABB	1,595	1,507	1,491	-6.5%	-1.1%
ANB	1,489	1,531	1,489	0.0%	-2.7%
Al Awwal	1,090	974	978	-10.3%	0.4%
SIB	861	846	868	0.9%	2.7%
Alinma	916	1,021	1,062	15.9%	4.0%
AlJazira	623	612	633	1.6%	3.4%
Albilad	467	517	548	17.3%	5.9%
NCB	4,377	4,268	4,282	-2.2%	0.3%
Total:	**19,734**	**19,538**	**19,884**	**0.8%**	**1.8%**

Source: Company data, Al Rajhi Capital

Figure 20 Net profit (loss) special commission income/ Investments (SAR mn)

	Q3 2016	Q2 2017	Q3 2017	y-o-y change	q-o-q change
Al Rajhi	2,914	2,954	3,032	4.0%	2.6%
Samba	1,466	1,386	1,447	-1.3%	4.4%
Riyad	1,321	1,473	1,539	16.5%	4.4%
BSF	1,108	1,167	1,207	9.0%	3.4%
SABB	1,222	1,284	1,258	2.9%	-2.0%
ANB	1,067	1,215	1,184	11.0%	-2.6%
Al Awwal	664	701	713	7.3%	1.7%
SIB	461	486	509	10.5%	4.6%
Alinma	688	834	877	27.6%	5.1%
AlJazira	407	453	470	15.4%	3.7%
Albilad	362	431	449	24.1%	4.2%
NCB	3,442	3,473	3,449	0.2%	-0.7%
Total	**15,121**	**15,860**	**16,134**	**6.7%**	**1.7%**

Source: Company data, Al Rajhi Capital

Figure 21 Total Operating Income (SAR mn)

	Q3 2016	Q2 2017	Q3 2017	y-o-y change	q-o-q change
Al Rajhi	3,878	3,877	3,976	2.5%	2.6%
Samba	2,036	1,988	2,021	-0.7%	1.7%
Riyad	1,855	1,984	2,076	11.9%	4.6%
BSF	1,588	1,630	1,630	2.6%	-0.1%
SABB	1,687	1,801	1,764	4.5%	-2.0%
ANB	1,494	1,636	1,677	12.2%	2.5%
Al Awwal	911	927	940	3.2%	1.4%
SIB	633	656	702	10.8%	7.0%
Alinma	829	1,007	1,063	28.2%	5.6%
AlJazira	575	659	685	19.1%	4.0%
Albilad	639	718	763	19.5%	6.3%
NCB	4,663	4,478	4,492	-3.7%	0.3%
Total:	**20,788**	**21,360**	**21,788**	**4.8%**	**2.0%**

Source: Company data, Al Rajhi Capital

Figure 22 Loans and advances (SAR mn)

Bank	Q3 2016	Q2 2017	Q3 2017	y-o-y change	q-o-q change
Al Rajhi	225,863	232,797	233,181	3.2%	0.2%
Samba	129,803	120,522	120,678	-7.0%	0.1%
Riyad	152,631	141,181	142,068	-6.9%	0.6%
BSF	133,937	129,383	128,948	-3.7%	-0.3%
SABB	125,875	117,883	116,686	-7.3%	-1.0%
ANB	115,625	114,884	115,932	0.3%	0.9%
Al Awwal	77,264	70,739	68,736	-11.0%	-2.8%
SIB	61,288	61,626	61,069	-0.4%	-0.9%
Alinma	69,275	76,961	77,812	12.3%	1.1%
AlJazira	43,195	40,971	40,926	-5.3%	-0.1%
Albilad	36,247	40,665	41,815	15.4%	2.8%
NCB	259,915	256,901	256,852	-1.2%	0.0%
Total	**1,430,918**	**1,404,512**	**1,404,702**	**-1.8%**	**0.0%**

Source: Company data, Al Rajhi Capital

Figure 23 Investments (SAR mn)

Bank	Q3 2016	Q2 2017	Q3 2017	y-o-y change	q-o-q change
Al Rajhi	33,753	31,578	35,692	5.7%	13.0%
Samba	53,721	56,545	63,411	18.0%	12.1%
Riyad	44,009	43,082	46,884	6.5%	8.8%
BSF	24,936	25,441	26,115	4.7%	2.6%
SABB	29,034	21,317	25,252	-13.0%	18.5%
ANB	25,666	24,880	25,759	0.4%	3.5%
Al Awwal	20,858	14,993	16,390	-21.4%	9.3%
SIB	20,550	21,623	21,840	6.3%	1.0%
Alinma	6,326	7,265	13,293	110.1%	83.0%
AlJazira	16,474	17,337	20,401	23.8%	17.7%
Albilad	3,042	4,492	5,872	93.0%	30.7%
NCB	111,487	114,634	116,900	4.9%	2.0%
Total	**389,856**	**383,186**	**417,809**	**7.2%**	**9.0%**

Source: Company data, Al Rajhi Capital

Figure 24 Customer Deposits (SAR mn)

Bank	Q3 2016	Q2 2017	Q3 2017	y-o-y change	q-o-q change
Al Rajhi	272,600	285,390	270,102	-0.9%	-5.4%
Samba	173,964	171,273	166,736	-4.2%	-2.6%
Riyad	160,821	156,980	156,051	-3.0%	-0.6%
BSF	147,277	163,904	155,472	5.6%	-5.1%
SABB	144,084	138,314	134,565	-6.6%	-2.7%
ANB	128,236	130,747	128,547	0.2%	-1.7%
Al Awwal	84,204	81,770	81,101	-3.7%	-0.8%
SIB	66,447	66,557	71,065	6.9%	6.8%
Alinma	77,319	85,783	87,229	12.8%	1.7%
AlJazira	50,335	49,170	49,676	-1.3%	1.0%
Albilad	41,244	44,971	46,402	12.5%	3.2%
NCB	311,225	314,690	302,593	-2.8%	-3.8%
Total	**1,657,757**	**1,689,547**	**1,649,539**	**-0.5%**	**-2.4%**

Source: Company data, Al Rajhi Capital

Figure 25 Total Assets (SAR mn)

Bank	Q3 2016	Q2 2017	Q3 2017	y-o-y change	q-o-q change
Al Rajhi	330,516	345,597	338,030	2.3%	-2.2%
Samba	238,314	231,080	228,873	-4.0%	-1.0%
Riyad	223,472	218,990	218,224	-2.3%	-0.3%
BSF	195,737	205,344	201,704	3.0%	-1.8%
SABB	185,904	182,519	179,481	-3.5%	-1.7%
ANB	167,263	171,032	163,643	-2.2%	-4.3%
Al Awwal	106,847	101,635	101,454	-5.0%	-0.2%
SIB	96,182	96,827	98,284	2.2%	1.5%
Alinma	102,937	111,376	111,373	8.2%	0.0%
AlJazira	65,952	67,004	67,528	2.4%	0.8%
Albilad	55,646	59,732	62,533	12.4%	4.7%
NCB	438,765	449,776	444,679	1.3%	-1.1%
Total	**2,207,535**	**2,240,912**	**2,215,806**	**0.4%**	**-1.1%**

Source: Company data, Al Rajhi Capital

Figure 26 Loan to deposit ratio (net loans by customer deposits)

Bank	Q3 2016	Q4 2016	Q1 2017	Q2 2017	Q3 2017	y-o-y bps	q-o-q bps
Al Rajhi	82.9%	82.5%	84.6%	81.6%	86.3%	348	476
Samba	74.6%	72.8%	72.9%	70.4%	72.4%	(224)	201
Riyad	94.9%	91.2%	91.4%	89.9%	91.0%	(387)	110
BSF	90.9%	81.7%	81.5%	78.9%	82.9%	(800)	400
SABB	87.4%	86.0%	84.4%	85.2%	86.7%	(65)	148
ANB	90.2%	85.0%	88.0%	87.9%	90.2%	2	232
SHB	91.8%	85.2%	87.8%	86.5%	84.8%	(700)	(176)
SIB	92.2%	91.8%	93.6%	92.6%	85.9%	(630)	(666)
Alinma	89.6%	87.2%	90.3%	89.7%	89.2%	(39)	(51)
AlJazira	85.8%	81.6%	83.0%	83.3%	82.4%	(343)	(94)
Albilad	87.9%	89.9%	88.9%	90.4%	90.1%	223	(31)
NCB	83.5%	80.3%	81.0%	81.6%	84.9%	137	325
Total:	**87.6%**	**84.6%**	**85.6%**	**84.8%**	**85.6%**	**(207)**	**73**

Source: Company data, Al Rajhi Capital (* the definition of deposits may vary compared to SAMA, resulting in different LDR ratio)

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