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SAUDI BANKING SECTOR

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NCB Capital

BANKS WITH STRONG FUNDING BASE TO OUTPERFORM

We initiate coverage on Saudi Banks with a positive view as we believe the sector's turnaround is well underway. The sector is likely to benefit from macro-economic recovery and increasing NIMs. Supply side remains strong with high capitalisation and stable low-cost deposits. The sector is also a play on 1) Saudi's Vision 2030 transformation and 2) Tadawul's inclusion in emerging market indices. We prefer banks that will structurally benefit from higher interest rates and relatively healthy asset quality. We initiate coverage on four Saudi banks including Al Rajhi (AlRajhi), Samba Financial Group (Samba), Banque Saudi Fransi (BSFR) and Alinma (Alinma). We are Overweight on AlRajhi, Samba and BSFR with PTs of SAR111.3, SAR40.6 and SAR39.8 respectively, while we rate Alinma as Neutral with PT of SAR23.8.

Margins to remain the key driver for earnings growth: We believe the sector's near-term profitability will be a function of better margins. The Saudi central bank (SAMA) had raised interest rates by 100bps in 2018 following US Fed. SAMA is expected to continue mirroring the Fed's rate direction, with at least one more rate hike of 25bps anticipated in 2019. This would be positive for Saudi banks' NIMs given the higher contribution of NIB deposits (c65% of total deposits). Sector loan exposure and ability to keep the cost of funds down would remain key differentiating factors for individual banks. We expect NIMs to expand in the range of 18-36bp in 2019, led by AlRajhi and Samba.

Higher government spending and Vision 2030 to spur volumes: The corporate capex cycle remains indirectly linked to oil prices, which influence government capex. In our view, increased government capex in 2019 would create credit demand from sectors such as manufacturing, construction and transport. The government's housing initiatives would boost mortgage loans. We believe Saudisation initiatives, women driving and the Citizen Account program are expected to revitalise demand for personal and auto loans. Loan growth is forecast around 6.6% in 2019 vs -1.0%/4.8% in 2017/2018f. The forecast is still conservative as it is considerably below the long-term median value of 11.0%.

Managing cost of funds would be key: We prefer banks that will structurally benefit from a higher interest rate environment. AlRajhi remains the major winner in the long-run due to ample availability of NIBs, while Samba and BSFR may see faster book repricing, due to their larger exposure to the corporate sector. We also believe all three will manage to keep their cost of funds low due to lower LDRs.

AlRajhi, Samba and BSFR are our preferred play: The sector trades at 1.4x PB 2019f, a premium to the EM banking space. However, we believe the premium is justified by higher ROEs that come from the better margin outlook, superior asset quality, robust capitalization and SAR/US$ peg. The sector is currently offering a dividend yield of 4.9%. AlRajhi, Samba and BSFR are our preferred picks.

Key Risks: Slower than expected macro-economic recovery and credit growth.

Valuation Summary

	Rtg	Mkt Price (SAR)	Target Price (SAR)	Upside/ Down side
AlRajhi	OW	96.6	111.3	15.2%
Samba	OW	34.8	40.6	16.7%
BSFR	OW	34.5	39.8	15.5%
Alinma	N	24.0	23.8	(0.7)%

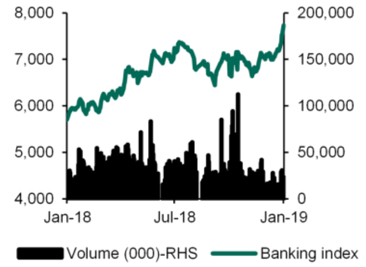
Source: Tadawul, NCBC Research
Note: N- Neutral, OW – Overweight, NR – Not Rated; Prices as of 10 January 2019

Valuation Metrics

2019f	PE (x)	PB (x)	ROE (%)	Div yield (%)
AlRajhi	12.6	2.5	20.7	5.2
Samba	10.8	1.5	13.9	5.4
BSFR	9.6	1.2	12.5	5.2
Alinma	11.6	1.6	14.0	5.5

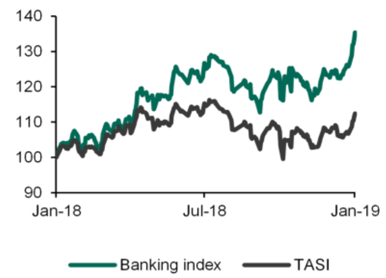
Source: Tadawul, NCBC Research
Note: Prices as of 10 January 2019

Banking sector performance



Source: Tadawul, NCBC Research

Relative performance



Source: Tadawul, NCBC Research

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Overview of coverage

Exhibit 1: Key positives and negatives

	Rating	Target price	Current price	Upside/ Downside	Positives	Negatives
Al Rajhi	OW	SAR111.3	SAR96.6	15.2%	• Largest Islamic bank with a strong retail franchise • Leader in retail market • Strong structural profitability • Benign asset quality • Highest capitalisation	• Limited room to lower cost of funds • Relatively higher impact of Zakat case • Limited presence in the corporate segment
Samba	OW	SAR40.6	SAR34.8	16.7%	• Strong capitalisation and liquidity • Conservative risk policies culminating into sound asset quality • Stronger NIM outlook given higher corporate exposure and available room to lower cost of funds	• Muted volume outlook and declining market share • AFS investments could be hit by interest rate hike
BSFR	OW	SAR39.8	SAR34.5	15.5%	• Higher potential benefit from rate hike compared to peers • Superior cost efficiency • Adequate capitalisation • Robust liquidity position	• Shift in funding mix towards expensive time deposits • One of the lowest NIMs among Saudi banks • High NPL ratio and low provision coverage ratio
Alinma	N	SAR23.8	SAR24.0	(0.7)%	• Solid capitalisation levels • Strong track record of growth • Highest exposure to government and GRE loans • Improving cost efficiency	• Highest exposure to building and construction sector • Likely to face asset quality issues due to aggressive lending growth • Funding cost could be pushed upwards due to tight liquidity

Source: NCBC Research. Prices as of 10 January 2019

N: Neutral, UW: Underweight, OW: Overweight, NC: Not Covered

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NEUTRAL: Target price represents a change in the share price between -10% and +15% in the next 12 months

UNDERWEIGHT: Target price represents a fall in share price exceeding 10% in the next 12 months

PRICE TARGET: Analysts set share price targets for individual companies based on a 12 month horizon. These share price targets are subject to a range of company specific and market risks. Target prices are based on a methodology chosen by the analyst as the best predictor of the share price over the 12 month horizon

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