ميفك كابيتال
MEFIC Capital

BANKING SECTOR QUARTERLY REVIEW

December 2018

Quarterly Review of Banking Sector in Saudi Arabia

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Executive Summary

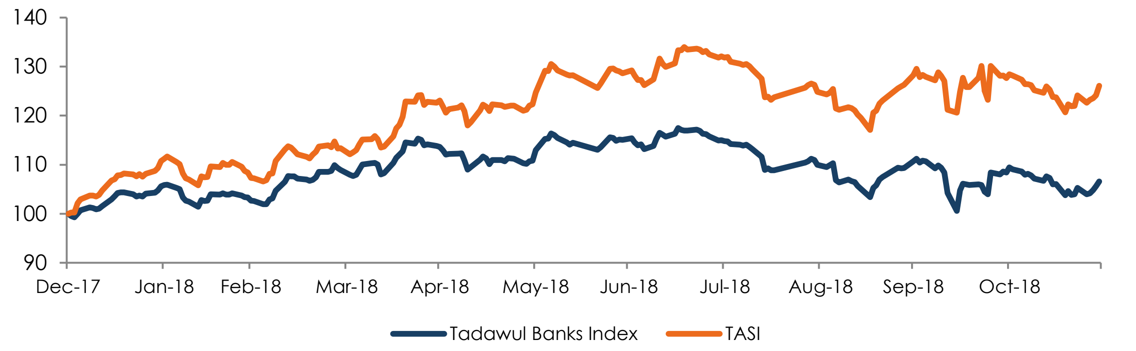
The key highlights of Saudi Banking Sector are:

- Total bank credit recorded its highest rate of growth (+1.5% YoY) this year so far in Q3 2018, reaching SAR 1.43tn by the end of September 2018.
- In terms of sectoral breakup of credit, banks increased their exposure to Manufacturing and processing sector by 2.9% QoQ in Q3 2018, while Building and Construction sector witnessed a growth of 3.3% QoQ.
- In Q3 2018, total bank deposits have rose 2.1% YoY and 1.4% QoQ to SAR 1.636tn. Loans-to-deposits ratio has increased to 87.4% from 85.6% at the end of 2017.
- Interest rates in Saudi Arabia have risen steadily in the recent past, with 3-month Saudi Interbank rate (SAIBOR) rising to 2.84% at the end of November 2018, from 1.33% in December 2015. The rising interest rate environment is especially beneficial for Saudi banks, expanding their Net Interest Margins (NIMs).
- As loan growth has been limited due to subdued economy, much of the investments have moved into government bonds. In Q3 2018, Saudi banks' investment in government securities has increased 26% YoY. Overall, the banks' investment in government securities has risen to SAR 296.6 bn by the end of Q3 2018, compared to SAR 86.2 bn by the end of 2015.
- Q3 2018 was another robust quarter for Saudi banking sector, as the aggregate net profit of Saudi banks increased 10.7% YoY in Q3 2018, after clocking 7.4% YoY and 11.8% YoY growth during Q1 2018 and Q2 2018 respectively. The earnings growth was mainly supported by higher operating revenue and higher fees for banking services.
- Alinma Bank, Bank AlBilad and NCB were the top performers in the sector in Q3 earnings, with earnings growth of 20.5% YoY, 15.7% YoY and 15.4% YoY respectively.
- Slowly but gradually deteriorating quality of its assets could be a cause of concern for Saudi banks, with the non-performing loans (NPL) to total loans ratio increasing to 1.8% by the end of Q2 2018 from 1.2% at the end of 2015. However, banks are well capitalized.
- Saudi Banking sector is on track to witness its first merger in nearly two decades, as on October 4 2018, Saudi British Bank and Alawwal Bank have approved the binding agreement to merge the two institutions, creating Saudi's third largest bank in the process.
- We believe the sector appears strong currently, given the level of capitalization, strong liquidity position, consistent profitability, and robust quarterly earnings growth for the last three quarters.

Saudi Banking Review: Sector-wide trends

Among top 10 sectors by market capitalization, banking has been the best performing sector in Saudi stock market so far this year. Tadawul Banks Index has surged 26.1% year-to-date in 2018 (as of November 29), compared to Tadawul All Share Index (TASI), which is up 6.6% during the same period. Robust quarterly earnings, Saudi Arabia's inclusion in MSCI Emerging Market index and lower provisioning costs have all contributed to rally in Saudi banks' share prices; while rising interest rate environment has proven to be especially conducive for the performance of banks.

Figure 1: TASI vs Tadawul Banks Index (YTD 2018 – Rebased to 100)

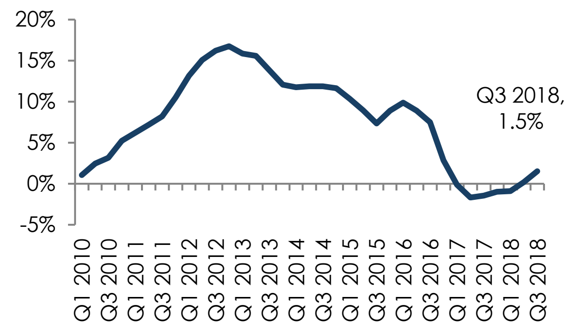


Source: Tadawul

Bank credit grows 1.5% YoY in Q3 2018

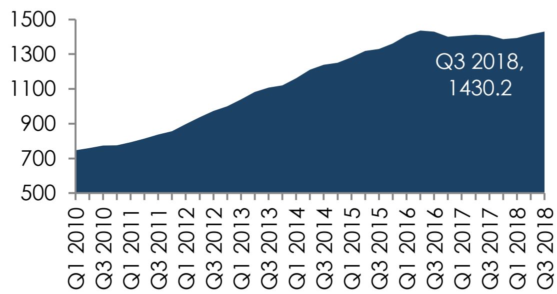
Total bank credit recorded its highest rate of growth (+1.5% YoY) this year so far in Q3 2018, reaching SAR 1.43tn by the end of September, having risen by mere 0.2% YoY in the previous quarter. Credit growth had slowed down after Q1 2015, before which it enjoyed double digit growth in every quarter for three years (See Figure 2). In and after 2015, the growth was negatively impacted by overall economic slowdown and subsequent tightening of government spending. The credit growth was in the negative territory in every quarter of 2017 and Q1 2018.

Figure 2: Total Credit Growth (% YoY)



Source: SAMA

Figure 3: Total Bank Credit (SAR bn)

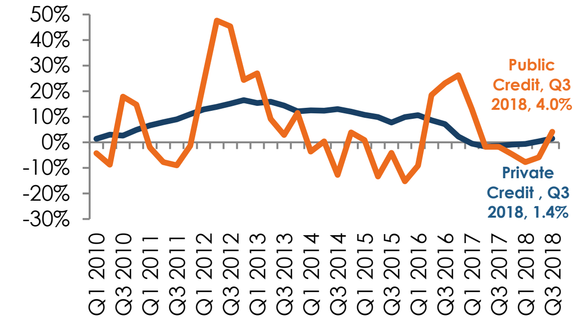


Source: SAMA

The growth in Q3 2018 was contributed by both private sector credit (1.4% YoY) and public sector loans (4% YoY). While private sector credit achieved the highest rate of growth so far this year, public sector credit turned positive for the first time since Q1 2017, mainly due to higher government spending during the quarter. In terms of maturity, the credit growth was strongly contributed by the growth in long term credit (more than 3 years), which increased 15.6% YoY. On the other hand, short term lending (less than 1 year) fell 2.6% YoY; while the medium term credit (1 to 3 years) fell 10.4% YoY.

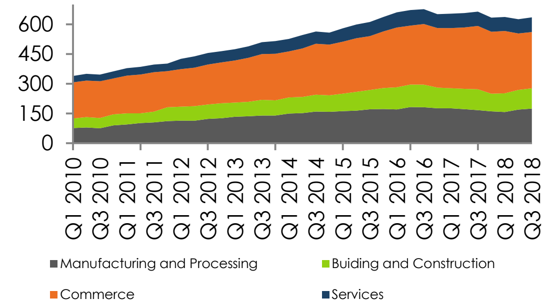
On a QoQ basis, total credit has grown incrementally in every quarter of 2018, growing by 1.1% in Q3, after posting 0.5% and 1.5% growth during Q1 and Q2 2018 respectively.

Figure 4: Credit Growth: Private vs Public Sector (% YoY)



Source: SAMA

Figure 5: Bank credit across major sectors (SAR bn)



Source: SAMA

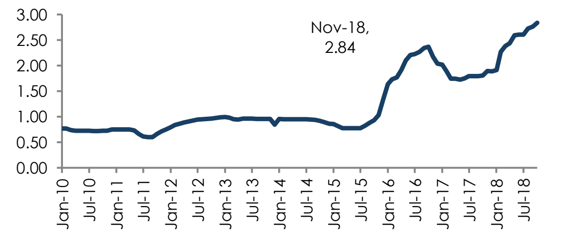
In terms of sectoral breakup of corporate credit; Commerce, Manufacturing & Processing and Building & Construction remain the top three sectors in credit exposure, accounting for 20%, 12% and 7% of overall credit respectively in Q3 2018. Banks increased their exposure to Manufacturing and Processing sector by 2.9% QoQ in Q3 2018, while Building and Construction sector witnessed a growth of 3.3% QoQ. Credit to Commerce sector declined by 0.3% QoQ.

On a YoY basis, credit to Manufacturing and Processing sector grew 4.6% in Q3 2018, being in the positive territory for the first time since Q1 2017; following stable growth in the manufacturing sector GDP over the last two quarters (3.3% YoY and 3.2% YoY growth at constant prices in Q1 and Q2 2018 respectively). Credit to Building and Construction sector continued to fall (down 2.7% YoY) in Q3 2018, after being in the negative territory for the last eight quarters. This reflected a prolonged slump in the sector, which has continued in 2018 as well, with the Construction sector GDP falling 1.7% YoY and 3.2% YoY in Q1 and Q2 2018 respectively. Credit to Commerce sector declined 11.1% YoY in Q3 2018, after falling 8.1% YoY during the previous quarter. This was mostly due to high base effect owing to increased exposure during 2017.

As interest rates rise, so do banks' investments in government bonds

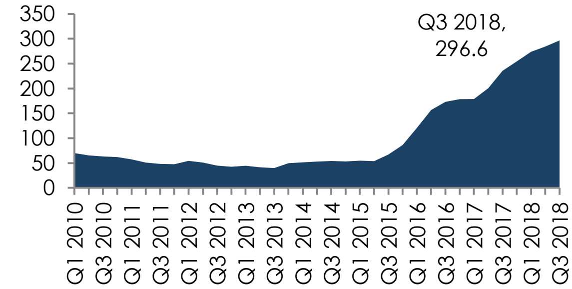
Interest rates in Saudi Arabia have risen steadily since 2015, with 3-month Saudi Interbank rate (SAIBOR) rising to 2.84% at the end of November 2018, from 1.33% in December 2015. As the Saudi Riyal is pegged to the US Dollar, Saudi Arabian Monetary Authority (SAMA) follows US Fed rate policy, regarding changes in the key interest rates. The US Fed has raised its target rate thrice so far this year; and SAMA has followed suit, raising the repo rate thrice by 25bps each, from 2% at the start of the year, to 2.75% in September 2018.

Figure 6: SAIBOR 3M (%)



Source: SAMA

Figure 7: Bank investments in govt. securities (SAR bn)



Source: SAMA

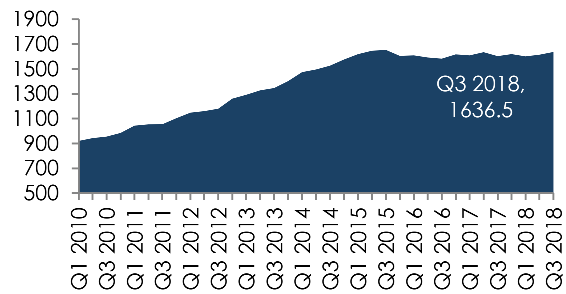
The rising interest rates environment is especially beneficial for Saudi banks, expanding their Net Interest Margins (NIMs). Saudi banks have a high concentration of low-cost deposits, with demand deposits making up about 62% of total deposits in the overall banking system by the end of Q3 2018 (See Figure 8). Since demand deposits generate little or no interest, they cap funding cost in rising interest rate environment thereby expanding their net interest margins (NIMs).

In Q3 2018, total bank deposits rose 2.1% YoY and 1.4% QoQ to SAR 1.636tn. Deposits growth has slowed down in recent years, after witnessing double-digit growth in almost every quarter from Q1 2011 to Q2 2015. This was mainly due to the fact that the government has withdrawn much of the emergency deposits injected to improve liquidity, at the time when oil prices slumped. Private sector deposits, however, have witnessed stable growth; as a result of which total deposits have only declined by 1% up to Q3 2018 from the all-time peak of SAR 1.653tn achieved at the end of Q3 2015. With loan growth also subdued, the liquidity position is fairly comfortable for Saudi banks. Loans-to-deposits ratio has increased to 87.4% in Q3 2018 from 85.6% at the end of 2017.

As loan growth is limited, much of the deposits have moved into government bonds. In Q3 2018, Saudi banks' investment in government securities increased 26% YoY. Overall, the banks' investment in government securities has risen to SAR 296.6 bn by the end of Q3 2018, compared to SAR 86.2 bn by the end of 2015. The increase is also due to Saudi government raising debt to finance the fiscal deficit caused due to lower oil revenue. Nevertheless, in a high interest rate environment, this remains an NIM-expanding trend.

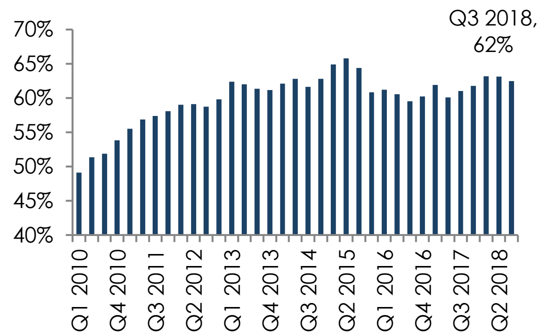
Asset quality of Saudi banks have been slowly deteriorating in recent years, with non-performing loans (NPL) to total loans ratio increasing to 1.8% by the end of Q2 2018 from 1.2% at the end of 2015. However, with a healthy Tier 1 Capital Adequacy Ratio of 18.9% at the end of Q2 2018 (compared to Global Emerging Markets average of 13.7%), this remains a short-term concern rather than a long-term one.

Figure 8: Total Bank Deposits (SAR bn)



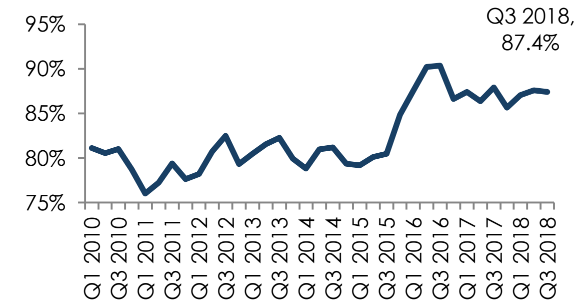
Source: SAMA

Figure 9: Demand Deposits as a % of total deposits



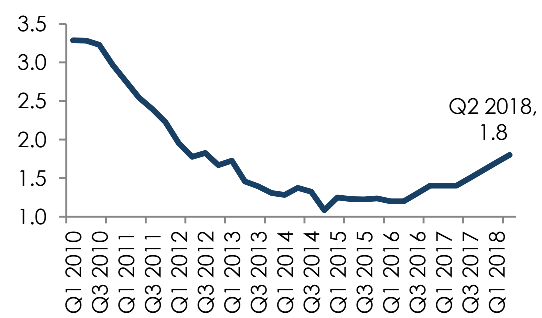
Source: SAMA

Figure 10: Loans to Deposit Ratio (%)



Source: SAMA

Figure 11: NPL-to-Total Loans (%)



Source: SAMA

Comparative Performance and Valuations of Saudi Banks

Q3 2018 Earnings Performance: Another robust quarter

Q3 2018 was another robust quarter for Saudi banking sector, as the aggregate net profit of Saudi banks increased 10.7% YoY in Q3 2018, after clocking 7.4% YoY and 11.8% YoY growth during Q1 2018 and Q2 2018 respectively. The earnings growth was mainly supported by higher operating revenue and higher fees for banking services. The earnings growth was fairly spread across the sector, with all the 12 listed banks except Alawwal Bank recording YoY growth in net profits. Rising interest rate environment triggered by Fed rate hikes generally continued to help banks to expand their NIMs, as all but two of the 12 banks were able to increase their NIMs compared to the previous quarter. Alinma Bank, Bank AlBilad and NCB were the top performers in the sector, with earnings growth of 20.5% YoY, 15.7% YoY and 15.4% YoY respectively. Alawwal Bank was the only listed bank with YoY fall in earnings (-22.6% YoY) in Q3 2018, due to decreased operating income and commission income. Total deposits of Alawwal Bank declined 16.6% YoY; and with demand deposits making up only 42% of the total deposits, the bank couldn't benefit much from the NIM-expanding trend.

Alinma Bank beat the consensus earnings estimate by 8.1%, and expanded its NIM by 28 basis points (bps) QoQ. National Commercial Bank recorded the highest positive change in NIM (30 bps) on QoQ basis. Bank Aljazira beat the consensus estimate by 7.9%, while achieving 12.1% YoY earnings growth.

Table 1: Saudi Listed Banks – Quarterly Earnings performance (sorted by YoY Growth)

Company	Q3 18 PAT (SAR mn)	Q3 18 PAT Consensus Est. (SAR mn)	% Variation (Est. vs Actual)	YoY%	QoQ%	NIM Q3 18 (%)	NIM Q2 18 (%)	Change in NIM (bps)
Alinma Bank	653.0	604.2	8.1%	20.5%	5.2%	3.54%	3.25%	28
AlBilad Bank	287.0	300.5	-4.5%	15.7%	4.0%	3.33%	3.14%	18
National Commercial Bank	2,454.0	2,459.5	-0.2%	15.4%	-4.8%	3.48%	3.18%	30
Saudi British Bank	1,247.0	1,241.6	0.4%	15.1%	-12.9%	3.22%	3.00%	22
Arab National Bank	890.1	904.3	-1.6%	14.8%	-3.2%	2.97%	3.00%	-3
Al Rajhi Bank	2,573.0	2,604.4	-1.2%	13.6%	0.2%	3.75%	3.74%	1
Bank Aljazira	255.1	236.5	7.9%	12.1%	0.7%	3.02%	2.83%	19
Samba Financial Group	1,417.0	1,420.4	-0.2%	8.3%	1.2%	2.80%	2.68%	11
Riyad bank	1,165.0	1,150.8	1.2%	8.2%	9.7%	3.06%	3.02%	4
Saudi Investment Bank	362.0	380.0	-4.7%	1.1%	0.0%	2.38%	2.23%	15
Banque Saudi Fransi	1,005.0	1,027.1	-2.1%	0.4%	9.1%	2.52%	2.62%	-11
Alawwal Bank	281.0	291.5	-3.6%	-22.6%	10.8%	2.90%	2.89%	1
Sector	**12,589**	**12,620.8**	**-0.2%**	**10.7%**	**-0.5%**	**3.08%**	**2.97%**	**11**

Source: Tadawul, Reuters Eikon, MEFIC Capital, Sector NIMs average of all listed banks

Table 2: Saudi Listed Banks – Price and Valuations (sorted by Price performance 2018 YTD)

Company	Mcap (SAR mn)	P/E (TTM)	Div. Yield (%) (TTM)	P/B (TTM)	ROE (%) (TTM)	Price performance % (2018 YTD)
Riyad Bank	52,500	12.10	4.4%	1.38	11.7%	40.0%
Al Rajhi Bank	139,100	13.94	5.3%	2.64	18.9%	32.5%
Samba Financial	61,900	11.62	5.2%	1.38	12.3%	31.7%
Alawwal Bank	16,689	14.55	0.0%	1.22	8.5%	23.3%
Bank Albilad	14,940	14.22	2.8%	1.87	13.5%	21.6%
Arab National Bank	29,800	9.14	4.2%	1.24	13.4%	20.6%
Saudi British Bank	48,750	11.01	5.2%	1.48	13.5%	20.4%
Banque Saudi Fransi	40,259	11.62	3.7%	1.26	10.9%	16.8%
Saudi Investment Bank	12,555	8.74	3.6%	0.87	10.2%	11.0%
Bank Aljazira	11,513	10.04	2.3%	0.98	9.4%	10.9%
Alinma Bank	31,260	12.85	3.9%	1.54	12.1%	8.9%
National Commercial Bank	135,000	12.73	3.2%	2.35	17.1%	-18.3%
Sector	**594,266**	**11.88***	**3.7%***	**1.52***	**12.6%***	**26.6%**

Source: Tadawul, Reuters Eikon, MEFIC Capital
*Note: Mcap & Valuation data as of November 29, 2018, *- Average of all listed cement companies*

Outlook

Banking has been one of the best performing sectors in Saudi stock market so far this year. We believe the sector appears strong currently, given strong liquidity position, level of capitalization, consistent profitability, and robust quarterly earnings growth for the last three quarters. Rising interest rate environment is especially beneficial for Saudi banks, helping them to their Net Interest Margins (NIMs). Amid efforts to expand credit growth into targeted sectors, the Saudi Banking sector is on track to witness its first merger in nearly two decades, as on October 4 2018, Saudi British Bank and Alawwal Bank have approved the binding agreement to merge the two institutions, creating Saudi Arabia's third largest bank in the process. However, deteriorating asset quality could be a short term concern, although the banks are adequately capitalized.

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