SHUAA

Saudi Banks

MMG exposure not a major concern

Reiterate Samba as our top pick

Equity Research **Event Update**

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Sector Coverage

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MMG'S DIFFICULTIES IN ACTION… SABB AND RIYAD ARE THE MOST EXPOSED

Mohammad Al Mojil Group (MMG) has been witnessing financial difficulties since mid-2011, with high provisions on ongoing projects, cost over-runs and delays in collection of receivables. With accumulated losses reaching more than 120% of share capital by H1 12-end, shares were suspended, BOD convened to discuss continuity plans and an AGM is expected to meet early November to discuss further plans for the company. MMG's total exposure to Saudi banks stood at c. SAR 1.16bn as of FY 11-end in terms of short term loans, the largest exposure of which is SABB (SAR 310mn) and Riyad (SAR 250mn). ANB follows closely with a total exposure of SAR 189mn, Samba at SAR 155mn and NCB at SAR 109mn. Al Rajhi has the lowest exposure to MMG at SAR 20mn while banks like SHB and Alinma have no such exposure.

SAUDI BANKS WELL COVERED… PROVISIONING PRESSURE AT HIGHLY-EXPOSED BANKS

Our analysis indicates that surplus reserves for exposed Saudi banks, which we calculate as loan loss reserves over and above the 100% NPL coverage, stands at SAR 6.5bn. This surplus covers total MMG exposure by 5.5 times, indicating Saudi banks' strong coverage levels and ample room to manage any problematic exposures like MMG. Total exposure to MMG makes up 5% of total loan loss reserves of Saudi banks, further strengthening our view that banks are well equipped to weather this corporate difficulty. On an individual basis, Riyad Bank stands as the bank with lowest surplus reserves relative to its exposure at 1.3x followed by SABB at 1.6x. On the other hand, Samba and BSF both exhibit relatively solid loan loss reserves relative to MMG's loans at 4.6x and 3.5x respectively. Rajhi's low exposure to MMG coupled with strong existing coverage levels translate into the highest surplus coverage at 64x. While the exposure relative to loans, equity and assets is negligible, the impact looks more significant when compared to pre-provision income and net income. In our view, this would pose pressure on provisioning in H2 12 and 2013, namely in the highly-exposed banks like SABB, ANB and Riyad.

RECENT UNDERPERFROMANCE UNJUSTIFIED… REITERATE SAMBA AS TOP PICK

The Saudi banking index has been a clear underperformer since the start of this year with Saudi banking index up 3.7% compared to a 6.9% gain for Tadawul. More recently, banking stocks have come under strong selling pressure following increasing speculation of MMG's impact on banks, weakening of trading values on Tadawul and increasing global economic uncertainty. Yet, this underperformance relative to Tadawul on one hand and other regional banking peers on other hand has been overdone in our view. As Saudi banks continue to underperform TASI and the wider EM peers, valuation is becoming increasingly attractive with the Tadawul Banking Index trading at a weighted P/B ratio of 1.6x, back to lows of early 2011 (Arab spring) and close to 30% below the highs of early 2010. We view this sharp discount as unwarranted as the operating environment of the banking system has improved significantly since early 2010. We reiterate Samba as our top pick among Saudi banks with a target price of SAR 63.80/share (upside potential of 43%) based on a sustainable ROE of 17%. Our positive stance is based on: 1) a top tier status (CAR at 18%), 2) potential to aggressively expand lending (loan book up 8% YTD and 11% YoY) with low LTD at 68%, 3) strong asset quality metrics (NPL coverage at 130%) and 4) discounted valuations at 7.8x and 1.2x 2013 P/E and P/B respectively.

Saudi Banks vs. MMG

MMG's financial position deteriorating since 2011

Mohammad Al Mojil Group (MMG) is a Saudi-based contractor that is primarily engaged in oil & gas construction works, along with an exposure to industrial construction and general civil works. The company has been witnessing financial difficulties since mid-2011, with high provisions on ongoing projects, cost over-runs and delays in collection of receivables. This has led the contractor to disclose an FY 11 net loss of SAR 1.1bn. Year-to-date, the picture has not changed significantly as more losses have been booked on completed and ongoing projects in addition to a growing allocation to cost-overruns and provisions on receivables. Quarterly results have been delayed by management, which has led Tadawul to suspend trading on the shares. However, results for Q2 12 came out towards mid-September revealing an H1 12 net loss of SAR 643mn, implying accumulated losses of SAR 1.5bn, more than 120% of share capital. Shares were suspended (Saudi law stipulates a maximum accumulated loss of 75% of share capital), BOD convened to discuss continuity plans and an AGM is expected to meet early November to discuss future plans for MMG.

MMG financial highlights (SAR mn)

	FY 11	H1 12
Total debt	1,369	1,551
Short term debt	1,205	1,452
% of total debt	88%	94%
Total equity	363	(280)
Debt/equity (x)	3.8	N/A
Accumulated losses	(887)	(1,530)
Share capital	1,250	1,250
% of share capital	71%	122%
Net losses	(1,108)	(643)
Current assets	1,848	1,452
Current liabilities	2,508	2,788

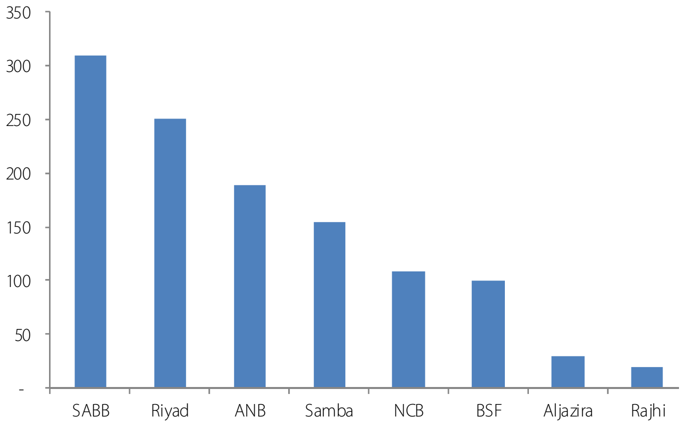
Source: MMG, SHUAA Capital

Significantly, MMG has been banned from accessing its cash liquidity (bank facilities) in August-end yet creditors (mainly Saudi banks) re-granted access for the company to tap into its SAR 170mn of available financing. The company, in its Q2 12 results' report highlighted several restructuring solutions which include: 1) asset sales, 2) increasing efforts to collect cost-overruns from existing clients, 3) cost-cutting measures and 4) speeding up the process of receivables' collection. In our opinion, MMG represents a one-off case among Saudi corporates and not a part of a wide sector trend. The company has taken on excessive leverage against delays in project completions and has faced significant cost overruns.

SABB and Riyad are the most exposed

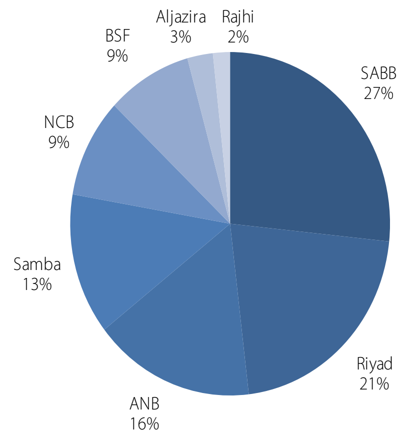
MMG's total exposure to Saudi banks stood at c. SAR 1.16bn as of FY 11-end in terms of short-term loans, the largest exposure with SABB (SAR 310mn) and Riyad (SAR 250mn). ANB follows closely with a total exposure of SAR 189mn, Samba at SAR 155mn and NCB at SAR 109mn. This total exposure makes up around 0.2% of system loans. Numbers put MMG's total debt at SAR 1.55bn as of Q2 12-end, of which SAR 1.45bn are of short-term nature (94% of total). However, detailed breakdown of exposure is not provided on quarterly basis, yet we do not expect that much has changed since 2011 year-end and hence we use FY 11 exposure to assess the impact on Saudi banks.

Banks' exposure to MMG - FY 11 (SAR mn)



Source: MMG, SHUAA Capital

SABB and Riyad make up 48% of total exposure



Source: MMG, SHUAA Capital

Saudi banks well covered against any shocks from MMG

Our analysis indicates that surplus reserves for Saudi banks, which we calculate as loan loss reserves over and above the 100% NPL coverage stands at SAR 6.5bn. This surplus covers total MMG exposure by 5.5 times, indicating Saudi banks strong coverage levels and ample room to manage any problematic exposures like MMG. Total exposure to MMG make up 5% of total loan loss reserves of exposed Saudi banks, further strengthening our view that banks are well equipped to weather this corporate difficulty.

Banks' exposure analysis (SAR mn)

Bank	NPL ratio	NPL coverage	NPLs	Loan loss reserve	Reserves @ 100% coverage	Surplus reserves	Exposure to MMG	Surplus reserve coverage	% of total reserves
Riyad	1.62%	117%	1,896	2,221	1,896	325	250	1.3x	11%
Samba	2.39%	130%	2,355	3,062	2,355	706	155	4.6x	5%
SABB	1.74%	130%	1,678	2,178	1,678	500	310	1.6x	14%
ANB	1.86%	176%	1,533	2,700	1,533	1,167	189	6.2x	7%
Rajhi	1.74%	145%	2,803	4,077	2,803	1,274	20	63.7x	0%
BSF	1.05%	132%	1,068	1,413	1,068	346	100	3.5x	7%
Jazira	3.69%	126%	1,042	1,310	1,042	268	30	8.9x	2%
NCB	3.14%	139%	4,778	6,644	4,778	1,866	109	17.1x	2%
Total	**2.04%**	**138%**	**17,153**	**23,606**	**17,153**	**6,452**	**1,163**	**5.5x**	**5%**

Source: Banks' financials, SHUAA Capital

On an individual basis, Riyad Bank stands as the bank with the lowest surplus reserves relative to its MMG exposure at 1.3x followed by SABB at 1.6x. In addition to having the largest exposure to MMG among the peer group, the coverage ratio for these two banks is also below the peer group average of 138%, especially Riyad Bank. This explains the low surplus reserve coverage compared to their MMG loans. On the other hand, Samba and BSF both exhibit relatively solid loan loss reserves relative to MMG loans at 4.6x and 3.5x respectively. ANB's strong coverage levels (176% as at Q2 12) enable a surplus coverage ratio at comfortable 6.2x its MMG exposure. Rajhi's low exposure to MMG coupled with strong existing coverage levels translate into the highest surplus coverage of 64x among Saudi banks. It is worth mentioning that banks like Saudi Hollandi Bank (SHB) and Alinma have no exposure to the construction group.

MMG's exposure in context

Bank	Exposure (SAR mn)	% Loans	% Equity	% Assets	% Pre-provision income*	% Net income*
Riyad	250	0.2%	0.8%	0.1%	5.5%	6.9%
Samba	155	0.2%	0.5%	0.1%	3.1%	3.4%
SABB	310	0.3%	1.7%	0.2%	8.4%	8.8%
ANB	189	0.2%	1.1%	0.2%	6.2%	6.9%
Rajhi	20	0.0%	0.1%	0.0%	0.2%	0.2%
BSF	100	0.1%	0.5%	0.1%	2.9%	3.2%
Jazira	30	0.1%	0.6%	0.1%	4.0%	5.5%
NCB	109	0.1%	0.3%	0.0%	1.2%	1.5%
Total	**1,163**	**0.1%**	**0.6%**	**0.1%**	**2.9%**	**3.5%**

Source: Banks' financials, SHUAA Capital
**based on H1 12 annualized numbers*

As evident from the table above, banks' exposure is fairly negligible relative to loans, assets and equity. As a % of loans, the exposure varies from low of 0.01% for Rajhi to a high of 0.3% at SABB. In general, the impact on equity remains limited with exposure making up 1.7% of SABB's equity, 1.1% for ANB, 0.8% for Riyad and 0.5% for Samba and BSF. On the other hand, the impact looks more significant when looking at the exposure relative to income statement, namely pre-provision income (PPP) and net income. These ratios peak at ANB, Riyad and SABB at 6.2%, 5.5% and 8.4%, respectively, relative to pre-provision income. On a net income basis, MMG's exposure would make up 3% of net income at Samba, 7% at Riyad and ANB while reaching highs of 9% at SABB.

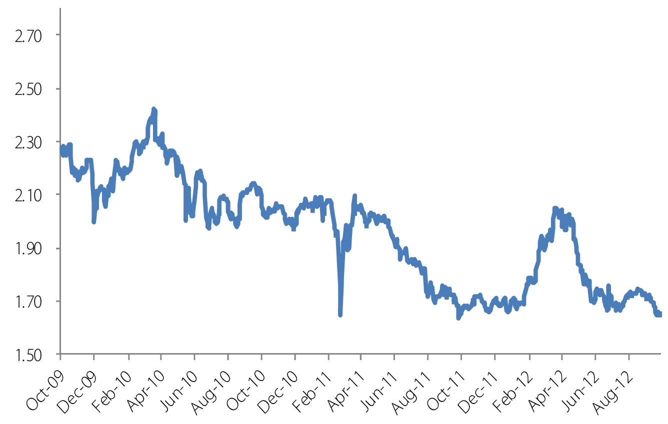
Pressure on provisions expected at highly-exposed banks, yet nothing major

In our view, some of these exposures are material and would pose pressure on provisioning in H2 12 and 2013, namely in SABB, ANB and Riyad. However, we point out to the fact that MMG's financial situation has been deteriorating since 2011 which could imply that Saudi banks have already taken some measures on loan loss provisions. It is worth noting that the Saudi banking sector has been beefing up coverage levels over the past two years and controlling further NPL formation. MMG's case is an example where Saudi banks are likely to weather without any major difficulties, keeping in view the healthy operating environment for the sector. Loan growth remains strong (up 11% YTD), liquidity remains abundant (Loans-to-deposits at 83%), fee income generations benefiting from accelerated credit growth and asset quality metrics remain healthy.

Recent price underperformance unjustified

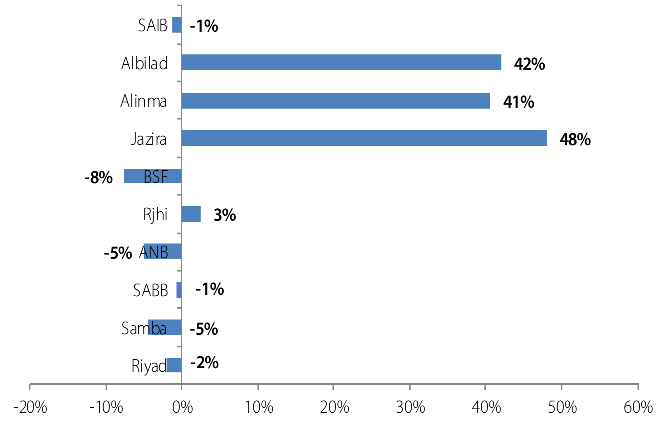
The Saudi banking index has been a clear underperformer since the start of this year with Saudi banking index up 3.7% compared to a 6.9% gain for Tadawul. More recently, banking stocks have come under strong selling pressure following increasing speculation of MMG's impact on banks, weakening of trading values on Tadawul and increasing global economic uncertainty. Yet, this underperformance relative to Tadawul on one hand and other regional banking peers on other hand has been overdone in our view.

TASI Banking index P/B at its 2011 lows



Source: Bloomberg, SHUAA Capital

Saudi banks YTD performance



Source: Bloomberg, SHUAA Capital

On a valuation basis, Saudi banks are currently trading at average 2012 P/E and P/B multiples of 12.4x and 1.5x respectively. These valuations are down c. 7%-9% since our sector report published on August 12, 2012. As Saudi banks continue to underperform TASI and the wider EM peers, valuation is becoming increasingly attractive with the Tadawul Banking Index trading at a weighted trailing P/B ratio of 1.6x, back to lows of early 2011 (Arab spring) and close to 30% below the highs of early 2010. We view this sharp discount as unwarranted as the operating environment of the banking system has improved significantly since early 2010. We note that: 1) System's credit has expanded 28% since Q1 10-end, 2) loans/assets up from 53% to a current 59% as re-leveraging efforts continue, 3) asset quality improving significantly with coverage ratio up from 90% to 135% and NPL down to 2.0% from highs of 3.3% in Q1 10 and 4) profitability rising with system ROE of 17% vs. 15% in 2010. Major banks like Samba and BSF are currently trading at their three-year lows and considerably below their historical averages, with Samba and BSF serving as key examples.

Comparative valuation of Saudi banks

Company	Market Cap (USD mn)	YTD performance	P/E		P/B		ROE		Div. yld (%)
			2012	2013	Current	2012	Current	2012	2012
Al Rajhi	28,498	3%	13.4	11.6	3.1	3.0	23.4	23.6	5.02
Samba	10,679	-5%	8.8	7.8	1.4	1.3	16.1	15.6	4.14
SABB	8,079	-1%	9.7	8.3	1.6	1.5	17.9	17.3	3.58
ANB	5,926	-5%	9.3	8.1	1.3	1.2	13.6	14.0	4.49
BSF	7,497	-8%	9.2	8.1	1.3	1.3	15.5	14.8	3.85
SHB	2,805	7%	9.3	8.3	1.4	1.3	15.0	14.7	3.30
Riyad	9,140	-2%	10.2	9.2	1.1	1.1	10.6	11.1	6.12
Albilad	2,256	42%	12.8	11.8	2.1	2.0	10.1	24.2	-
Alinma	5,260	41%	28.4	19.0	1.2	1.2	2.7	3.9	-
Aljazira	2,008	48%	15.2	11.7	1.6	1.5	6.5	10.0	2.27
SAIB	2,339	-1%	10.4	9.2	1.0	1.0	8.5	9.8	3.62
Average			**12.4**	**10.3**	**1.5**	**1.5**	**12.7**	**14.4**	**3.3**
Median			**10.2**	**9.2**	**1.4**	**1.3**	**13.6**	**14.7**	**3.6**

Source: Bloomberg, SHUAA Capital, Company reports

We await Q3 12 numbers…reiterate SAMBA as top pick

With the above being said, we await Q3 12 numbers to assess any provisioning pressures on banks' profitability and hence any implications from the MMG exposure. However, we are of the view that the overall picture for the Saudi banking sector remains intact and the recent price underperformance represent attractive entry points at discounted valuations. We reiterate Samba as our top pick among Saudi banks with a target price of SAR 63.80/share (upside potential of 43%) based on a sustainable ROE of 17%. Our positive stance is based on: 1) a top tier status (CAR at 18%), 2) potential to aggressively expand lending (loan book up 8% YTD and 11% YoY) with low LTD at 68%, 3) strong asset quality metrics (NPLcoverage at 130%) and 4) discounted valuations at 7.8x and 1.2x 2013 P/E and P/B respectively. Within our other buy-rated names [BSF (TP: SAR 40.7/share, 31% upside) and SABB (TP: SAR 40.90/share, 35% upside)], we keep an eye on SABB's provisioning levels in Q3 12 as the bank remains one of the most exposed to MMG.