

Al Rajhi Bank

Strong Recovery in Q4 2020, yet Unattractive at Current Market Price

16 Feb 2021

Al Rajhi reported Y-o-Y net income growth during Q4 2020 (+45.0%) for the first time in FY2020 supported by the strong continued growth in financing and lower provisions during the quarter compared to Q4 2019. Strong growth in mortgages portfolio and non-yield income offset lower Net Interest Margin (NIM) during FY2020, allowing Al Rajhi to report 4.3% Y-o-Y net income growth during FY2020 despite lower SAIBOR. Going forward, we expect further NIM contraction during FY2021e which might pressure Al Rajhi's net income if improved Cost to Income Ratio and financing growth don't offset the drop in NIM. We raise our target price for Al Rajhi due to higher-than-expected financing growth and updated management guidance. However, the stock is trading at a 33% premium to peers, making it unattractive in our view. We maintain our **Neutral** recommendation for Al Rajhi with a target price of **SAR83.5/share**.

Al Rajhi's net financing and investment income grew by 8.9% Y-o-Y and 10.5% Q-o-Q during Q4 2020 supported by the strong growth in mortgages during the year, especially given the revoking of 15% VAT on real estate passed last October. Net interest margin, however, tightened by 50bps to 4.7% in FY2020, mainly due to lower SAIBOR during the year.

Fees and commissions income jumped by 89.3% Y-o-Y and 33.1% Q-o-Q during Q4 2020 as the impact of fees waiver ended in Q3 2020, allowing for a strong Q-o-Q recovery, in addition to higher income from brokerage fees, digital fees, and payments fees. Such growth was achieved despite fee waiver of all digital & financing processing fees during the first 9 months of 2020. Operating income grew by 30.2% Y-o-Y and 17.6% Q-o-Q on account of higher total income and significantly lower depreciation expense during Q4 2020 vs Q4 2019. Impairment charges fell by 17.3% Y-o-Y but increased by 18.3% Q-o-Q on account of strong credit growth during Q4 2020. Consequent to lower provisions, non-financing expenses, and rise in total income, Al Rajhi's net income increased by 45.0% Y-o-Y and 17.4% Q-o-Q during Q4 2020.

Al Rajhi reported record growth in net financing at 26.4% Y-o-Y in FY2020 supported by the continued rise in demand for mortgage lending. Al Rajhi's Mortgage financing growth accelerated to 90% Y-o-Y during FY2020 amid lower interest rates and government support. The bank expects c.30% CAGR in mortgage financing over the coming 3 years.

Customers deposits increased by 22.5% Y-o-Y in FY2020, reflected in the drop in Loan to Deposits (LDR) ratio to 75.0% in FY2020 vs 77.1% in FY2019. It is worth mentioning that time deposits doubled during Q4 2020 vs Q3 2020 accounting for more than 11% of total deposits in FY2020 yet the deposit is a short-term addition to deposits and is not indicative of a long-term shift to higher reliance on time deposits, according to management's disclosure.

Al Rajhi didn't announce any dividend distributions to date and is expected to reach a decision by the end of this month. Given the absence of SAMA's restriction on dividends distributions and Al Rajhi's strong financial position and profitability during 2020, we believe the bank is likely to distribute dividends for FY2020.

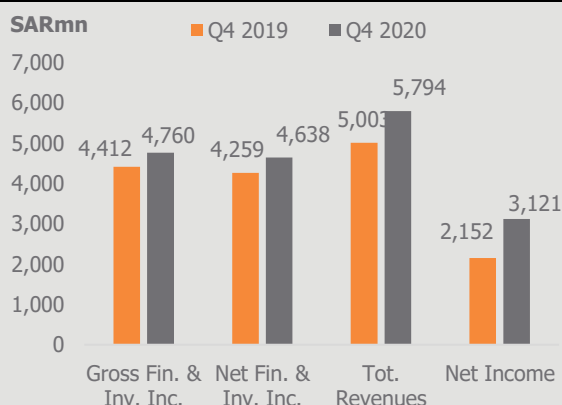
Al Rajhi Bank stock is currently trading at 3.6x its book value vs 1.4x in the banking sector, and a record P/E of 20x FY 2020 earnings vs 16x in FY2019 and 15x for the banking sector. While it may be justified that Al Rajhi would be trading at a premium to its peers given its high earnings quality and strong financial position, we believe it is unattractive at current market price.

Recommendation	Neutral
Previous Recommendation	Neutral
Current Price (15-02-2021)	SAR85.0
Target Price (52 weeks)	SAR83.5
Upside/ (Downside)	-1.8%
Shariah Compliance	Pass

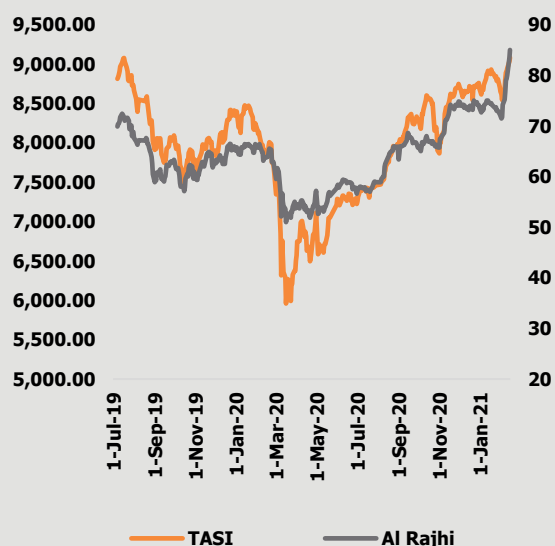
Key Financial Ratios

Ratio	Q4 2020	Q3 2020	Q4 2019
Gross Fin. & Inv.	11.2%	4.9%	3.0%
Net Fin. Margin	97.4%	98.0%	96.6%
Net Inc. Margin	65.6%	62.1%	48.8%

Key Financial Results (Q4 2020)



Share Price Performance



Financial Overview

2020A Overview & Outlook

Lower rates tightened Al Rajhi's NIM during FY2020. Al Rajhi's NIM was more impacted by lower rates than smaller banks given that 90% of its deposits are non-profit bearing, meaning they don't benefit from lower rates. On the other hand, Al Rajhi's focus on fixed rate loans and low exposure to SMEs loan deferral program (SMEs account for only 2% of net financing) likely eased the impact of the drop in SAIBOR. Al Rajhi's NIM contracted to 4.7% in FY2020 vs 5.2% in FY2019 amid lower SAIBOR rates and loan deferral programs initiated by SAMA. Average SAIBOR rate during the year dropped by 140bps in FY2020, accounting for more than 90% of the drop in NIM.

Extraordinary financing growth coupled with the rise in non-yield income offset the impact of lower NIM and supported Al Rajhi's bottom-line during FY2020. Despite lower NIM, Al Rajhi's net income grew by 4.3% during FY2020. Growth was supported by (i) record growth in portfolio financing (+26.4% Y-o-Y) backed by mortgage financing (+90.0% Y-o-Y), and (ii) rise in non-yield income (+25.0% Y-o-Y) supported by fees & commissions (+33.8% Y-o-Y) due to higher POS/e-commerce sales and higher brokerage fees from Al Rajhi Capital.

Impairment charges and Cost of Risk rise, yet asset quality remains high. Al Rajhi's impairment charges increased by 22.2% during FY2020 due to COVID-19 impact and the record growth in financing. Cost of Risk increased to a four-year high of 0.75% vs 0.71% in FY2019. However, asset quality remains high as NPL ratio dropped to 0.76% vs 0.90%. Stage 2 and stage 3 loans dropped to 2.9% and 0.74% of total loans, respectively, vs 3.5% and 0.90% in FY2019.

Al Rajhi's strong financial position was maintained in FY2020 despite COVID impact. Despite the pressure imposed by COVID-19 on the banking sector during FY2020, Al Rajhi maintained its strong financial position during the year with Capital Adequacy Ratio (CAR) at 19.1% vs 19.9% in FY2019, and adequate Liquidity Coverage Ratio above 100% at 155%. The bank is well-provisioned with NPL coverage at 306% and stage 3 coverage at 82.8% in Q4 2020 vs 76.9% in Q4 2019.

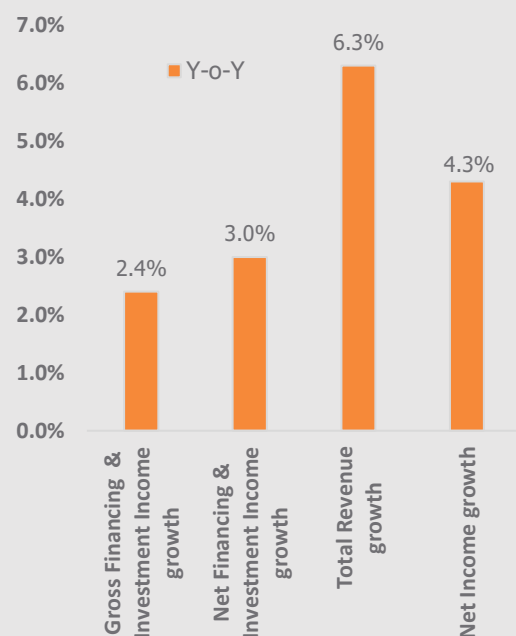
We see lower Net Interest Margin (NIM) as the key downside risk for Al Rajhi in FY2021e due to (i) lower expected average SAIBOR during the year, (ii) higher competition amid increased credit demand, (iii) ample liquidity in the banking sector due to SAMA's liquidity injection in the sector through deposits with a maturity of up to 3 years which will pressure lending rates.

Mortgages remain the key growth driver, but at slower growth rates from this point. Mortgages will continue to drive financing growth for the banking sector, in general, and Al Rajhi in particular, but at more normalized growth rates than FY2020. If Cost to Income Ratio doesn't improve further during FY2021e to offset the tightening of NIM, Al Rajhi's net income will be pressured during FY2021e, especially given lower expected financing growth rate during FY2021e. Accordingly, while strong growth in financing and non-yield income offset NIM contraction during FY2020, we believe this may not be the case during FY2021e.

Key Financial Ratios

Ratio	FY 2020	FY 2019
Gross Fin. & Inv. growth	2.4%	13.1%
Net Financing Margin	97.3%	96.8%
Net Income Margin	61.0%	59.9%
Net Interest Margin	4.7%	5.2%
Return on Equity	19.9%	20.5%
Cost to Income	32.5%	32.8%
NPL Ratio	0.76%	0.90%
Cost of Risk	0.75%	0.71%
NPL Coverage	305.6%	303.0%
LDR Ratio	75.0%	77.1%
Liquidity Coverage Ratio	155.0%	175.0%
Net Stable Funding Ratio	123.0%	132.0%
Capital Adequacy Ratio	19.1%	19.9%

Key Financial Results (2020A)



Financial Projection

Residual Income Valuation

	2021 F	2022 F	2023 F	2024 F	2025 F	2026 F
Net Income	10,413	12,092	13,519	15,258	17,022	18,720
Excess Return for Excess Capital	269	257	269	306	352	427
Adjusted Net Income	10,144	11,835	13,250	14,952	16,670	18,293
Equity Charge	4,243	4,615	4,909	5,151	5,405	5,589
Economic Value Added (EVA)	5,901	7,220	8,341	9,802	11,265	12,705
Discount Factor	0.91	0.83	0.76	0.69	0.63	0.57
NPV of EVA	5,378	5,998	6,316	6,764	7,086	7,284
EVA Forecast period	38,825					
Perpetual Growth Rate	3.0%	We have valued Al Rajhi using Residual Income approach, considering a Cost of Equity equal to 9.7% (based on a risk-free rate of 2.7%, market risk premium 7.0%, Beta of 1.0).				
Terminal Value	194,854					
Terminal Value Discounted	111,711					
Required Equity	38,761	Based on the Residual Income valuation, the fair price of Al Rajhi share is SAR83.5, which is lower than the traded value by 1.8%.				
Surplus Capital	13,107					
Dividends	6,250					
Total Fair Value	208,655					
Number of shares	2,500					
Target price per share (52 Weeks)	83.5					
Current share price (14-02-2021)	85.0					
Upside/(downside)	-1.8%					

Financial Ratios

	2020 A	2021 F	2022 F	2023 F	2024 F	2025 F	2026 F
Net Income Margin	61.0%	59.1%	60.0%	60.6%	61.4%	62.0%	62.5%
Net Spread	3.9%	3.7%	3.8%	3.9%	4.1%	4.3%	4.5%
Total Finances / Total Deposits	84.5%	84.0%	83.8%	83.6%	83.4%	83.2%	83.0%
Investments / Total Deposits	15.8%	14.7%	14.3%	14.3%	14.5%	14.7%	15.3%
Return on Average Equity	19.4%	17.3%	18.7%	19.5%	20.5%	21.3%	21.8%
CASA Ratio	88.8%	93.0%	93.0%	93.0%	93.0%	93.0%	93.0%

Income Statement

	2020 A	2021 F	2022 F	2023 F	2024 F	2025 F	2026 F
Gross financing and investment income	17,378	17,624	20,137	22,323	24,858	27,442	29,969
Net financing and investment income	16,913	17,168	19,602	21,717	24,159	26,649	29,083
Non-financing related income	3,808	3,998	4,198	4,407	4,628	4,860	5,103
Total Revenues	20,721	21,166	23,800	26,124	28,787	31,509	34,186
Operating income	13,979	14,042	16,214	18,035	20,151	22,275	24,299
Net Income	10,595	10,413	12,092	13,519	15,258	17,022	18,720

Balance Sheet

	2020 A	2021 F	2022 F	2023 F	2024 F	2025 F	2026 F
Total Investments	60,285	65,243	69,810	74,697	79,926	85,521	91,507
Total Financing	315,712	364,731	402,436	431,591	454,000	477,528	492,544
Total assets	468,825	529,554	581,116	622,765	656,933	693,135	719,612
Customers Deposits	382,631	442,646	488,073	523,488	550,981	579,922	598,759
Total Liabilities	410,706	467,272	514,242	551,122	580,032	610,461	630,719
Total equity	58,119	62,281	66,874	71,643	76,901	82,673	88,893
Total liabilities and equity	468,825	529,554	581,116	622,765	656,933	693,135	719,612

Guide to Ratings and Disclaimer

Guide to Ratings

Buy	An upside potential of more than 20% in 52-week period
Overweight	An upside Potential of more than 10% in 52-week period
Neutral	Will stay in the range of its value (up/down 10%) in a 52-week period
Underweight	A downside potential of more than 10% in 52-week period
Sell	A downside potential of more than 20% in 52-week period

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