

■ Huge Goodwill Impairment Dents 2Q Income Statement

At the end of 2Q 2020, SABB completed its first full financial year after the merger with Alawwal Bank, which closed on 16th June 2019 and resulted in SABB becoming the third largest bank in the Kingdom. The first half of 2020 has been challenging from an economic standpoint as precautionary measures for COVID-19 resulted in temporary shutdown of many economic activities for weeks while international oil prices also plummeted. At the same time, lower interest rates have hurt the income for banks.

The merger with Alawwal Bank in an all-share deal closed in June 2019 in the middle of the inclusion of the Tadawul in the MSCI EM Index, which resulted in higher share prices for most of the stocks in the market, including SABB. Thus, the merger in June 2019 resulted in SABB booking a Goodwill of SAR 16.2 billion, which was beyond what management was comfortable with. This matter has been put to rest now with an impairment charge.

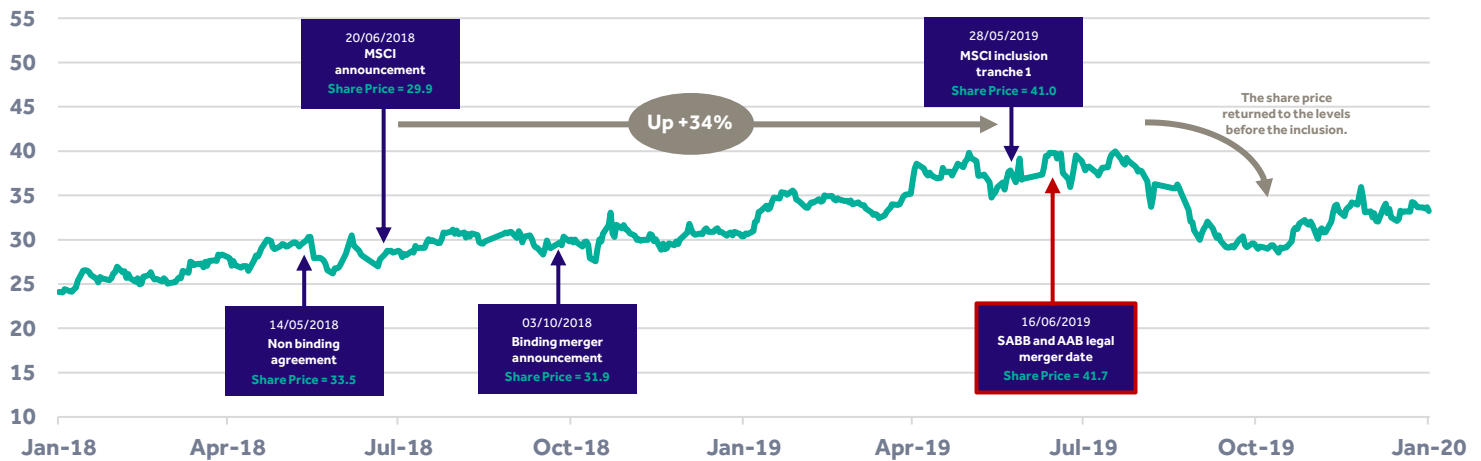
While the Goodwill impairment charge is a one-off accounting charge on the income statement and does not have any business implications, it is likely to result in SABB posing a net loss for the full year 2020. **We have a Neutral rating on SABB with a SAR 24.00 target price.**

Goodwill inflated by higher share price

During the merger period, the inclusion of Saudi Arabia into the MSCI Emerging Markets index was ongoing, with SABB one of the stocks to be included in the MSCI EM Index. SABB's share price went up +34% as investors generally preposition during the index inclusion period, as has been the case with other markets as well.

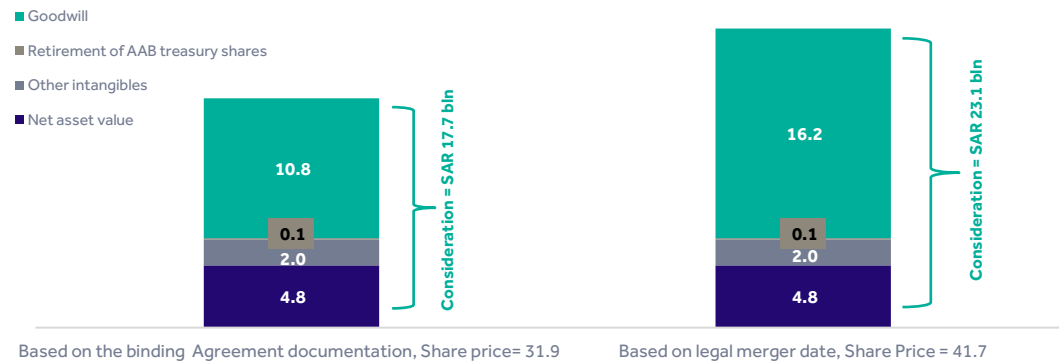
SABB's management has quantified the impact of the increase in share price, which caused an increase in Goodwill by SAR 5.4 bln, reaching SAR 16.2 bln. This is depicted in Exhibits 1 and 2 below:

Exhibit 1: SABB share price movements during 2018-2019



Source : Riyad Capital, SABB

Exhibit 2: Goodwill at different share prices (SAR bln)



Source : Riyad Capital, SABB

Goodwill Impairment

Locking in an inflated Goodwill at a stock price of SAR 41.7 per share is not beneficial and likely not representative. Given the stressed economic conditions with COVID-19 and the fact that SABB had 12 months from the merger date to agree the final valuation as per accounting standards, the Bank decided to book an impairment charge now.

While quantifying an appropriate charge is difficult given the inputs are quite sensitive, nevertheless SABB has concluded a Goodwill impairment charge of SAR 7.4 bln on a best effort basis. This is a non-cash item and one-off accounting charge to the income statement. This charge includes both the overstatement due to inflated stock price as well as additional perceived stress due to the prevailing situation from COVID-19.

While this is clearly disappointing, yet it has no effect on the Capital, liquidity, funding or the ability of the bank to compete in the market. On the income statement side, this charge will likely cause the full year to be in a loss and has also caused the retained earnings to turn negative as of June 2020.

Goodwill Impairment of SAR 7.4 bln is comprised of two components:

- 1- **SAR 5.4 bln:** Difference due to the temporary rise of SABB's share price caused by Saudi Arabia's inclusion into the MSCI EM Index. (Difference between stock price of SAR 41.70 and SAR 31.90 multiplied by number of shares i.e. 554 million).
- 2- **SAR 2.0 bln:** The emergence of COVID-19 and its impact on the economy resulting in impairment assessment's expectation of future returns.

Financial summary

Table 1: Income Statement (SAR million)

	1H 2020	1H 2019	Change
NSCI	3,718	3,097	20%
Operating Income	4,687	3,981	18%
Net Income	(5,896)	910	-
Average Shares	2,055	1,917	-
EPS (SAR)	(2.86)	0.59	-

Source : Riyad Capital, Tadawul, Argaam

Table 2: Balance Sheet (SAR million)

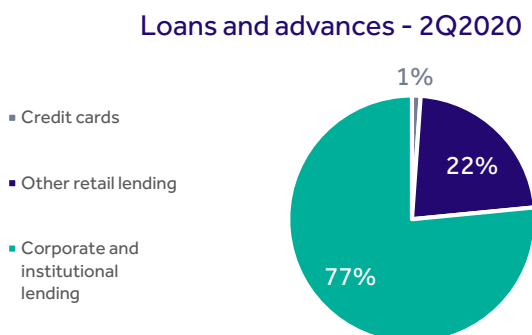
	1H 2020	1H 2019	Change
Assets	266.99	270.82	(1%)
Investments	64.02	56.18	14%
Deposits	188.36	196.16	(4%)
Loan	152.95	154.96	(1%)

Source : Riyad Capital, Tadawul

Loans and advances at SAR 153 bln

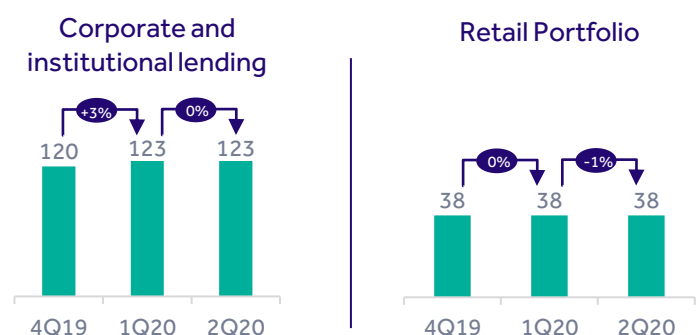
Net loans declined after two quarters of recovery, yet we believe that there is some room for growth as SABB has more appetite and a renewed focus. We may see some improvement in the retail segment due to a possible increase in mortgages as the corporate side is expected to remain subdued.

Exhibit 3: Loans and advances Breakdown



Source : Riyad Capital, SABB

Exhibit 4: Segment Growth

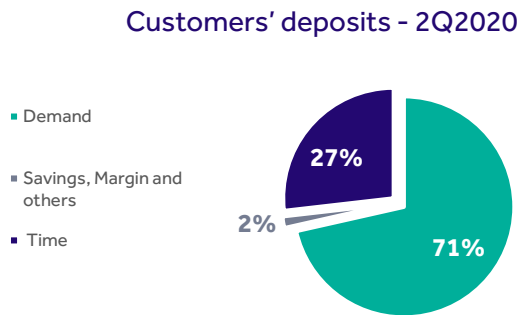


Source : Riyad Capital, SABB

Customer Deposits at SAR 188 bln

Overall, deposits remained flat on a quarterly basis in 2Q. However, SABB's demand deposit (non-interest bearing deposits) ratio rose to 71% in 2Q2020 (2Q2019: 64%, 1Q2020: 68%). Demand deposits in nominal terms, have increased from SAR 128 billion in 1Q2020 to SAR 135 billion in 2Q2020, while time deposits fell from SAR 57 billion to SAR 51 billion on a quarterly basis. NIB deposits from SAMA are expected to have played a part in this.

Exhibit 5: Customer Deposits Breakdown



Source : Riyad Capital, SABB

Exhibit 6: Segment Growth



Source : Riyad Capital, SABB

Neutral stance

While the Goodwill impairment is more of a one-off accounting charge on the income statement resulting in a net loss in 1H2020 and does not impact the Bank's capital or its business prospects, it is likely that the full year 2020 will also be a net loss due to this huge charge. The merger is expected to yield synergies to the bank going forward but it is likely to take some time to realize as the Banks' physically merge infrastructure first and integrate systems.

We maintain our SAR 24.00 target price on SABB as well as the Neutral rating.

Stock Rating

Buy	Neutral	Sell	Not Rated
Expected Total Return Greater than +15%	Expected Total Return between -15% and +15%	Expected Total Return less than -15%	Under Review/ Restricted

* The expected percentage returns are indicative, stock recommendations also incorporate relevant qualitative factors
For any feedback on our reports, please contact research@riyadcapital.com

Disclaimer

Riyad Capital is a Saudi Closed Joint Stock Company with Paid up capital of SR 200 million, licensed by the Saudi Arabian Capital Market Authority NO.07070-37. Commercial Registration No: 1010239234. Head Office: Granada Business Park 2414 Al-Shohda Dist. – Unit No 69, Riyadh 13241 - 7279 Saudi Arabia. Ph: 920012299.

The information in this report was compiled in good faith from various public sources believed to be reliable. Whilst all reasonable care has been taken to ensure that the facts stated in this report are accurate and that the forecasts, opinions and expectations contained herein are fair and reasonable. Riyad Capital makes no representations or warranties whatsoever as to the accuracy of the data and information provided and, in particular, Riyad Capital does not represent that the information in this report is complete or free from any error. This report is not, and is not to be construed as, an offer to sell or solicitation of an offer to buy any financial securities. Accordingly, no reliance should be placed on the accuracy, fairness or completeness of the information contained in this report. Riyad Capital accepts no liability whatsoever for any loss arising from any use of this report or its contents, and neither Riyad Capital nor any of its respective directors, officers or employees, shall be in any way responsible for the contents hereof. Riyad Capital or its employees or any of its affiliates or clients may have a financial interest in securities or other assets referred to in this report. Opinions, forecasts or projections contained in this report represent Riyad Capital's current opinions or judgment as at the date of this report only and are therefore subject to change without notice. There can be no assurance that future results or events will be consistent with any such opinions, forecasts or projections which represent only one possible outcome. Further, such opinions, forecasts or projections are subject to certain risks, uncertainties and assumptions that have not been verified and future actual results or events could differ materially. The value of, or income from, any investments referred to in this report may fluctuate and/or be affected by changes. Past performance is not necessarily an indicative of future performance. Accordingly, investors may receive back less than originally invested amount. This report provides information of a general nature and does not address the circumstances, objectives, and risk tolerance of any particular investor. Therefore, it is not intended to provide personal investment advice and does not take into account the reader's financial situation or any specific investment objectives or particular needs which the reader may have. Before making an investment decision the reader should seek advice from an independent financial, legal, tax and/or other required advisers due to the investment in such kind of securities may not be suitable for all recipients. This research report might not be reproduced, nor distributed in whole or in part, and all information, opinions, forecasts and projections contained in it are protected by the copyright rules and regulations.