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Presentation

Operator: Ladies and gentlemen, welcome to Al Rajhi Bank's Third Quarter 2019 earnings call. I'll now hand over to your host Mr. Amr Sager, Head IR. Sir, please go ahead.

Amr Sager, Head IR

Hello, everyone. It gives us pleasure to welcome you to Al Rajhi Bank's earnings call and webcast, with the management to present the third quarter 2019 results. You can download a copy of the presentation from the webcast link or our website along with other financial material.

With us today are

- **CEO, Steve Bertamini**
- **CFO, Abdullah Alkhalifa**

We'll start with Steve, who will give an update on business performance and strategy update, and then we will pass to Abdullah to give us an update on the financial results. We will then open the floor for questions and answers.

Steve Bertamini, CEO

Thanks, Amr. A warm welcome back to everyone. Before I begin the presentation for the third quarter results, I wanted to both introduce and congratulate Walid Al-Moqbel, who joins us today. As you may have come to hear, he's going to be the CEO effective January of 2020. He has 13 years experience with the bank, and was previously the CFO, the COO and Deputy CEO; therefore he knows the bank inside and out. He's also been leading our digital efforts that have been very successful. I'm sure you'll get a chance to speak to him more in the future, but he is here today as well if there are some questions down the track.

So, without further adieu, let's go ahead and start. As I think you've seen from our results, our ABCDE strategy implementation remains on track. We saw a very strong growth in mortgages and net profit margins again. We continue to improve our customer service digitization. And we've done, recently, a strategy update for 2025, which was approved by the board, and we'll share more details of that in due course.

In terms of performance of the first nine months, we are up 18.2% in net income before zakat, which is up compared to the market, 3%. So a substantial out-performance in terms of net income before zakat. We continue to improve all our ratios. Our cost-of-risk remains very stable, we are 60 bps for the first nine months of this year. NPL is at 0.94% versus the industry at 1.9%, and good profit growth across all our businesses.

In terms of balance sheet, we continue to do very well in non-profit bearing deposits, all time high balances, and we've grown 5% year-on-year, the market is up 2.2% Also, we managed to somehow slightly further increase our non-profit bearing accounts from 95% to 97%.

If I then turn your attention to the next page. In terms of strategic overview, I think most of you have been through this before, but I'll touch on it very lightly in case we have some new joiners. We've been running a five-part strategy we call it ABCDE, since late 2015, early 2016. It consists of (A) accelerating growth, (B) becoming the employer of choice, (C) focusing on customers, (D) leading in digital, and (E) executing with excellence. And you can see in the body of the page, all the key areas that we've been focusing on, really since 2015, just to highlight a few; growing mortgage was really the very first priority we had. And as you can see from our results, we continue to do very well. We've also continued to materially enhance our yields. We've done a great job with our staff, both in terms of training and engagement. We've done a lot of work on updating our value propositions, over 13 new products launched. And as I mentioned during the last call, we now move from number seven in the country to number one in terms of our Net Promoter Score. A lot of work has been done in digital, I'll highlight a few comments in a moment. Very good progress migrating to online channels. And of course, continue to focus on compliance and centralizing and automating operations.

If we then go to the strategy update, which is page four on your presentation, this is really where we show you how the strategy is actually delivering in both terms of financial and non-financial metrics. I'll highlight just a few of these. As you can see, we continue to do very well in mortgage. We grew 52% year-on-year and our book net stands at 47 billion, which is roughly 26% of our retail portfolio and 19.2% of the total book. Also very strong improvement in margins of 51 bps to 5.21. We've talked about the progress we've made with our staff in terms of driving the engagement score. We also continue improving our mix of females in the bank. We're up 70% since 2015, while the headcount has remained relatively flat. And as you know, we also launched the school of banking and we have a very strong graduate program in place.

Customer focus, I touched already on the Net Promoter Score, you can see the improvement that we've done. Also obviously, this is something that we'll continue to monitor very closely to ensure that we maintain our leadership position. On the digital side, it's been a particularly successful year. This is, as I mentioned, an area that Walid has been leading. We've increased our share of point-of-sale machines in the country to 26%, which is up 240 basis points from last year, and also increased our share of spend. Number of active digital customers also continues to do exceedingly well. We've added over a million customers year-to-date this year. We're now getting over 50% of all new account openings on digital channels. The good thing is that the actual overall number of customers, year-on-year, has also increased over 30%. So this isn't just replacing, it's also generating more customers for us.

On the execution excellence, we continue to focus on automation and robotics. We are now beginning the process of moving into our new Tier 4 data center, which should occur sometime during the late first quarter, early second quarter next year. And you can see that the kind of volumes that we're processing continues to increase. Just to give you a sense, 2018, for example, was 172 million, so 50 million more transactions per month than we did in the past. Overall, very solid progress in terms of executing on our strategy. As I mentioned, in due course, we'll give an update of the 2025 strategy which was recently approved by the board, which rest assured, is continuing very much on the ABCDE path that we've done and really encouraging further investment in growth in some key areas such as digital.

So with that, I'll turn it over to Abdullah.

Abdullah Alkhalifah, CFO

Hello, everyone. Thank you again for taking the time to dial in to our Q3 earnings call. As you heard from Steve earlier, our net income before zakat has actually grown 18.2%, driven mainly by growth in the top line. Our total revenue increased by 13% compared to the same period last year. The main driver for this top line growth has been the yield income. Yield has increased by 14%. This is a result of the NIMs expansion. We picked up 46 basis points compared to the full year last year. And if you compare to the same period, we picked up 51 basis points in NIMs expansion in the first nine months this year compared to the same period last year.

We also had a good performance on fee income. We had 7.2% growth in fee income. The net income after zakat grew 9.7%. One of the reasons for this, which I mentioned in Q2 earnings call last time, is that Zakat methodology changed in Q4 2018. So if you look at the difference on the bottom right chart, you find the net income after zakat for the first nine months last year. You can see that distribution of yield and fee, and obviously have been some growth in expenses; and one of the reasons has been the one-offs. But you see zakat's difference between the same period this year versus last year, 662m. There will be a catch up in Q4, when we publish our full year results. You'll find zakat charges pretty much closer to same period this year, with the exception of the growth on the bottom line. One of the main driver for the NIM's expansion is the strong growth in mortgage as we had 52% growth YoY.

It's not only strong growth in mortgage but also accelerating as we had 13.4% growth in Q3 compared to Q2. We also had strong growth in current accounts. We continue to increase our market share and increase the overall non-interest-bearing deposits, which is similar to what we had in Q2, 97% for customer deposits are non-interest-bearing deposits.

If you look at the bottom left chart, cost of risk for this quarter has been lower by 10 basis points compared to the previous quarter. This has to do mainly with the fact that we had the positive migration from stage two to stage one during the quarter. If you look at the operating efficiency, we continue to gain more growth on the top line versus expenses. In this case, over 350 basis points of positive jaws .That helped to improve our cost to income ratio by 100 basis points, as you see in the top right chart.

On page seven, you can see the quarterly trends of our revenue, 13.6% compared to the same quarter last year. As far as net income before zakat, again, it's continuously positive improvement on the trend. On page eight, in terms of return on equity has improved from the previous report of 19.8 to now 21.6. And as we did the last quarter, we also disclosed what it would look like when we published the full year results, after adjusting from this one-off zakat settlement and also the zakat charge for 2018. Because that has to be recycled through income statement in 2018, and that will drop the return on equity to 7.56%. Return on assets, again, improved if you recall, the zakat charge, because the zakat charge for 2018 after the first nine months, has been lowered by 662m than the same period this year, which we'll also correct in Q4 once we publish the full year financials.

On page nine, as I mentioned before, we had a strong growth in current accounts. The overall customer deposits increased by 3.5%. But what really mattered for us is the growth on the current accounts, which is 5.3%. As I mentioned before, that reaches 97% non-interest-bearing deposits compared to, for example, to 95% in the same period last year. We had good growth in financing, 5.4%. One of the drivers, as I mentioned before, is the strong growth in mortgage business. But we also had a 3.8% growth coming from corporate side as well which also helped. This is in line with our guidance which we're going to touch on later.

Capital adequacy is very healthy at 19.54%. Getting better efficiency with capital adequacy, and we've reapetdly been told by investors that we have so much capital. However, you can see that with growth of risk weighted assets, capital efficiency will continue to improve. Page 10, on the expense trends, we had year-on-year growth on operating expenses of 9.5%. But as we mentioned in Q2, we had one-offs in Q2 and if we neutralize that, the actual overall without one-offs will be only 5.3%, compared to the same period last year. As we mentioned before our business plan always try to target positive jaws of 300 basis points or more. This period compared to the previous has actually been 350 basis points, that's what helped on the top right chart to reduce our cost to income by 100 basis points.

If you look at the bottom right chart, we show the one-offs of 166 million. This has mainly to do with VAT, the penalty that we had because of the changes in the interpretation of the VAT regulation regarding home loans. On page 11, on the asset quality a slight increase on the NPL ratio, compared to Q2, moving from 0.85% to 0.94%. This NPL increase come from the corporate side as corporate has increased from 1.77% to 2.16%. May seem like a large increase, but as far as the dollar amount, it's less than of SAR 300 million of migrations to NPLs. But we still have very healthy NPL coverage of 306% our provision is over 300 basis points as a percentage of gross loans, higher than the market average.

On page 12, on the capitalization, obviously we increased our capital due to the income growth in the bottom line, from 51 last year, to 52. Risk weighted assets increased by 4.7%. As a result, you see capital adequacy as we mentioned before, for tier one, 18.5%, for tier one and two is 19.5. And lastly, on the guidance, we've actually upgraded the guidance in two categories. One is the net profit margin. As I mentioned before, we had additional growth in mortgage in Q3 versus Q2, of more than 13%. So we upgraded our NIM's guidance to be 35 to 45 basis points, for the full year. We expect some little bit of contraction maybe in Q4 due to the repricing of some of the assets.

The other one we slightly changed as far as the guidance is the cost to income. If you recall previously, we were saying below 31. But because of these one-offs and because of Q4, which tends to be higher usually in terms of operating expenses, we said about 31%. We maintained the rest of the guidance. So loan growth is mid-single digits, and you see we had 5.4% so far. Cost of risk we said 60 to 70 bps, we closed the first nine months at 60, the lower end of that guidance. And we mentioned that one of the reasons for Q3 has been the positive migration from stage two to stage one. Capital and ROE, we'll maintain the same guidance that we had before. And with that, we're ready to take your questions.

Operator: We shall now take our first question from Naresh Bilandani from JP Morgan. Your line is open, please go ahead.

Naresh: Hi, thank you very much. It's Naresh Bilandani from JP Morgan. Just two quick questions, please. One, on your new upcoming strategy, and I know you share more details going forward, I just wanted to kindly just take a reassurance from you that we are not likely to see any surprises in terms of a shift from the key areas like retail, or digitization. Or alternatively, if you can just share some early thoughts on, are there any new areas where the bank would like to focus going forward? Like, say for example, increasing the mix of corporate within the loan book or any sort of inorganic growth, whether it's intra-country or cross-border. Any elements that could offer a scope for surprise, that would be very much appreciated.

Second, I know it may be a bit too early to provide guidance, but just wanted to gauge some thoughts from you on how should we think of the emerging trends going into the next year. I'm inclined to think that a flattish trend is still possible, but you alluded to some pressure popping up into the margins in the fourth quarter. But now I think, is flattish trend still a realistic thing to expect a given that the Fed is now likely to be on hold and you still don't feel the need to change any pricing on the mortgage book at this stage, given the growth. Thanks.

Steve: Thanks, Naresh. I'll take the first one and let Abdullah take the second one. Look, in terms of the strategy, it's really reinforcing what we're doing. We really want to lead in payments. We want to keep capturing as much growth as we can for mortgage, accelerate digital transformation. We do think there are some opportunities in low mass, we can do a better job in private banking, keep growing corporate, and obviously, you know, embrace new ways of working, keep upgrading the talent of the bank. It's pretty much consistent but obviously, we'll be upgrading, or revising our financial and non-financial KPIs. This is really where the team is doing a lot of the work. Again, the other area, which is heavy on the IT side, as I mentioned, in our core banking systems, etc. So it's all about continuing to invest in the areas that we've done very well so that we can maintain very strong momentum into 2020 and beyond.

Abdullah: Yes, as far as the NPMS, the guidance for 2020, we'll be providing that guidance when we publish our Q4 results. Having said that, though, you would need to consider a few factors. One, the continuous expansion on mortgage is actually support NIM's; and we should be reasonably expecting faster growth of wholesale side compared to 2019, which we're shifting some of the assets from being invested in liquid assets into SIBOR plus spread growth, that would also supports NIM's. Any further growth on current accounts will be supported. On the other handmarket rates is expected to be lowered next year and some repricing will take place next year. This would add downward pressure on NIM's.

So you have two opposing factors. We're in the process of finalizing our 2020 business plan. And following Q4, we'll be giving the guidance for 2020.

Naresh: Okay. Well, thank you very much for your replies. Thanks.

Operator: Thank you. We shall not take our next question from Abdulaziz Abanami from NCB Capital. Your line is open, please go ahead.

Abdulaziz: Yes, hi. This is Abdulaziz Abanami from NCB Capital. Just a couple of questions. The first one is, currently, how much of your mortgage book constitutes of the total retail book? And number two, any update from the SAMA's outlook concerning the new, possibly new provisioning policy? Thank you.

Steve: So, in terms of a mortgage, it's 26% of the retail book and 19% of the overall book. There has been no new update on the SAMA guidance. As you know, our understanding is, even if it comes in, it really applies on the equity side. And my view is that it will probably be deferred. I mean, there's a lot of consultation, information back and forth, but we don't see it having any material impact on us at this stage.

Abdulaziz: Any expected timeline?

Steve: We don't know yet. Again, my personal view is they might defer it, but we will just have to wait and see what happens.

Abdulaziz: All right. Thanks.

Operator: We shall now take our next question from Muhammad Potrik from Riyad Capital. Your line is open, please go ahead.

Muhammad: Good afternoon, gentlemen. Thank you very much for the call. This is Muhammad Potrik from Riyad Capital. I just had two quick questions. First on the mortgage. Again, I mean, we've seen pretty high exponential growth on this side. I mean, what are the expectations going forward, especially into next year from you guys? And secondly, regarding the Aramco IPO, I mean, what kind of impact do you expect on Q4 for the bank and maybe also for the sector. Thank you.

Steve: So in terms of mortgage growth, as I think we've said consistently, we're expecting double digit growth to continue. Abdullah made a comment before, we've seen that accelerate throughout the year. So I'm fairly bullish on mortgage growth remaining strong into, certainly 2020, and I think potentially beyond. And in terms of Aramco, obviously, no one's given any guidance because we're not quite sure what the price is yet, but there will be some fee income but again, I don't think it's going to be substantial.

Muhammad: All right. Thank you.

Operator: We should take our next question from Mohammed Mussa from Hassana Investment. Please go ahead.

Mohammed: Hi, Steve, Abdullah and Amr. I just had a few questions. So the first question is, when you look at your corporate product offering relative to a conventional bank's product offering, do you see any meaningful holes? If so, could you give us an idea of what those products would be and how much of an opportunity could it be for a large fees corporate franchise? And my other question is, are there any upfront or one-off operating costs incurred as a result of underwriting mortgages, so, insurance or marketing expenses.

Steve: In terms of our corporate products, we think the historical gaps that we had, have largely been closed over the last 12, 18 months. For example, we now have securitization, we can do FX forwards, we can do profit rate swaps. So I would say there are no material gaps in our corporate product suite that prevent us from competing effectively. We also, for example, as the first bank, offer end-to-end supply chain finance, so we're actually doing some things that other banks don't offer today. So I beleive that from that perspective, I'm comfortable where we are.We now also have virtual accounts, we've completed the product suite, so I'm not concerned there's any major gap there.

Abdullah: There is no one-offs on the sale of mortgage. There is obviously upfront fees that the customer pays and that fee is paying off, obviously, the valuation cost of the property and covering some potential operational costs that we run. So no specific one-offs on the sale of mortgage.

Mohammed: All right. Thank you, guys.

Operator: We will now take our next question from Edmond Christou from Bloomberg Intelligence. Your line is open, please go ahead.

Edmond: Thanks for taking my question. I have a few, please. Indeed, we're seeing strong growth on the mortgages in Q3. But when I look at the margin and try to calculate retail margin, the retail margin in Q3, they were weaker than expected compared to Q2. I don't know if there's anything to read from this data there. You can correct me on this. The other question is when I try to calculate the gross cost of risk in Q3, it has picked up from Q2. Anything behind this and that we should read from it? And the dip in the current accounts in Q3, do you think the level of current account you have, is it sustainable going forward? Now we have IPO that is modeling for liquidity in the market. I would like to hear your thoughts on this. Thank you.

Abdullah: Thanks, Edmond. Yield on retail products actually increased in Q3. Obviously, what you see, Edmond, is at the beginning of the quarter, end of the quarter. We actually look at this on daily basis. So, we have the right average balances. We've actually improved cost of risk, I mentioned, actually dropped. It used to be 63bps in Q2, dropped to 53bps. And I mentioned the reason why, was the positive migration from stage two to stage one. On the current counts, obviously, link it to the IPO from Aramco. IPO generally presents opportunities and risks. On opportunity side, there could be some margin lending, it could be obviously once the shares is listed, there'll be more volumes trading and of course, we do have a fully owned subsidiary which is one of the largest broker in the market. So, we benefit from brokerage income.

But on the other hand, on the risk side, naturally, some of these current accounts will be used to finance the subscription, so that can potentially present some reduction in current accounts. As far as the percentage of current accounts of total customer deposits, we never said, 97% is going to be sustainable. Obviously, once we see faster growth on loans, this might drop down, but it's not going to drop from 97 to 70. Most likely 97 becomes like 95, 94, or 92. So still very high compared to any bank on the globe actually, not just in Saudi.

Edmond: Okay, thank you. Just follow up on that cost of risk, I meant the gross cost of risk, the one...I excluded the recoveries. It seems there is a few basis points pick up between Q3 to Q2... So I want to understand if there's anything to read from this.

Abdullah: No, I mean, as I mentioned, there have been in one hand, a pick up on the NPLs, on the corporate side, increased, as I mentioned in my presentation. But on the other hand, we have also positive migration from stage two to stage one. So, as far as the total bank, yes, there have been a small pick-up in NPL ratio from 0.85 to 0.94. So there hasn't been really major movement there as far as the cost of risk.

Edmond: Thank you.

Operator: As there are no further questions at this time, I would like to turn the call back to Steve for any additional or closing remarks.

Steve: Okay. So, thank you very much for everyone dialing in. We're aware that some of you or your teams may have been to London and that there's also analyst meetings happening also this week, so obviously makes our job a bit easier today. So from my side, just want to thank all of you for your continued support. Obviously, we're very proud of the results of the bank, not only in the last three quarters, but also back since 2015, both financial and non-financial terms. We remain very confident of our ability to continue to deliver in 2020 and beyond. The team in place is very strong, Walid will do a great job.