



Dubai Crisis: No contagion this time around

Diversification related development in recent years has resulted in new risks and vulnerabilities emerging alongside the traditional oil-driven volatility in the Gulf Cooperation Council (GCC) region. The dramatic expansion of the Dubai real estate sector in particular created bubble-like conditions which were punctured by the oil-linked fall in sentiment and the sudden tightness in credit conditions. Dubai World's (DW) announcement on November 25th for a standstill on all its debt repayments, including those of its real estate development company, created a shudder through the global and regional financial markets. The company's plan for restructuring the USD26bn debt and the government washing its hands of any guarantee made investors in the region nervous; they were calmed by Abu Dhabi's USD10bn help to Dubai. However, questions surrounding the impact on Saudi Arabia, the largest economy in the region, and its banking sector abound.

- The Saudi Arabia's economy seems to be on a strong footing as its growth in recent years has been broad based. Robust public finance and government support to infrastructure and capacity expansion projects reduce the economy's vulnerability. A quick recovery of the financial markets and negligible impact on liquidity and risk perception further bolster our view that the impact of the Dubai crisis is unlikely to have any significant bearing on Saudi Arabia's financial markets and its economic growth.
- Although Abu Dhabi's support has soothed nerves in the short term, Dubai still has to manage about USD16bn-17bn over the year to honour the debt commitments. DW has started the restructuring process for debt maturing over the next 12 months. The outcome of these talks is likely to affect the regional bourses only. However, it is unlikely to create a crisis-like situation.
- With the Saudi banking system still reeling under the fear of loan defaults from two large Saudi business conglomerates, the Dubai crisis added to the woes of Saudi banks. However, SAMA head Mohammad Al-Jasser indicated that Saudi banks' exposure to the Dubai-based troubled company is less than 0.2% of their balances, which is entirely manageable given the strength of Saudi banks' balance sheets.
- Although Saudi banks' exposure to DW is minimal, the fear of deteriorating asset quality remains their top concern. Banks in the country are cautious on lending activity in the current economic environment to avoid any further loan book deterioration.
- The Dubai crisis has hurt investment sentiment regarding the region and raising money from international markets through sukuk or other instruments will be difficult and expensive. However, the Saudi banking sector is expected to remain largely unruffled by this change to sentiment as it hardly depends on wholesale funding.
- With the Dubai crisis further muting the confidence of an already battered corporate community, the banks are likely to shift their focus to the retail sector. The proposed mortgage law is likely to propel the demand for mortgage loans.

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Saudi Economy likely to come out unscathed from Dubai crisis

The Dubai debt crisis is unlikely to have a significant impact on the global and regional financial markets in general and the Saudi Arabian market in particular. When DW asked creditors for a six-month reprieve, the Tadawul Stock Exchange declined marginally, but recovered within a week. The Sovereign Credit Default Swaps also widened 18bps, albeit temporarily. Thus, the threat of possible contagion withered away in a week. Moreover, Saudi Arabia's liquidity was hardly affected and the inter-bank interest rates remained largely unchanged.

Saudi Arabia's economic strength lies in the fact that being the largest economy in the Gulf Cooperation Council, it is fairly diversified, unlike Dubai, which primarily thrives on real estate and construction. The former's real GDP grew 4.5% in 2008, with the hydrocarbon sector growing 5.3% and the non-hydrocarbon sector growing 4.3%. Among the non-hydrocarbon sectors, the wholesale and retail sectors grew 5.7%, construction 3.6%, and financial services 3.5%. Strong government finances and high spend on infrastructure and capacity expansion further bolstered the economy.

Moreover, the Saudi Arabian Monetary Agency's (SAMA) risk management policy and its measures during the peak of the global financial crisis place Saudi Arabia on strong footing that is unlikely to be tempered by the Dubai crisis.

The quick recovery of Saudi markets dispels the fear of high correlations

The possible contagion effect of the Dubai debt crisis on global and regional stock prices was muted. Although the UAE's two stock indices declined in the range of 15-25%, most of the global financial markets declined in the range of just 3-5%. Even other regional stock indices fell in the range of 2-6%. The high long-term correlation coefficients among GCC stock indices (e.g., the correlation coefficient between Tadawul and DFM over the last two years is 0.96) had made investors jittery. However, the recovery in UAE stock prices soothed investor nerves as Dubai received a USD10bn "bailout package" from Abu Dhabi.

Moreover from a medium term perspective, the UAE's fiscal position remains sound backed by its oil revenue strength. Its total government foreign assets stand at USD460bn, according to the Institute of International Finance. With total estimated debt at USD160bn at the end of 2008, the country is a net creditor to the rest of the world.

Notably, DW has already started the restructuring process for the debt maturing within a year, which should affect the regional bourses only. Even in the event of a negative outcome of the restructuring talks, the relatively small participation of institutional investors in the

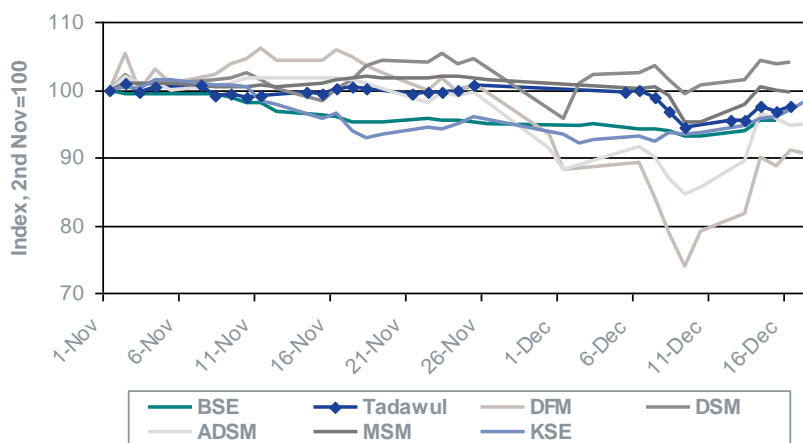
Stock market recovery was quick, aided by Abu Dhabi bailout and strong economic fundamentals of the UAE

However, debt restructuring is unlikely to create crisis like situation in Saudi Arabia



Saudi Arabia stock market mitigates any major sell off risks arising due to the losses incurred by these players. In fact, three companies — Herfy Food Services Company, Al Sorayai Trading & Industrial Group and Al Tassar Travel Group — have received approvals from the market regulator, Capital Market Authority, for IPOs early next year, reflecting improved market sentiment.

Chart 1: Muted reaction from stock markets in the GCC region



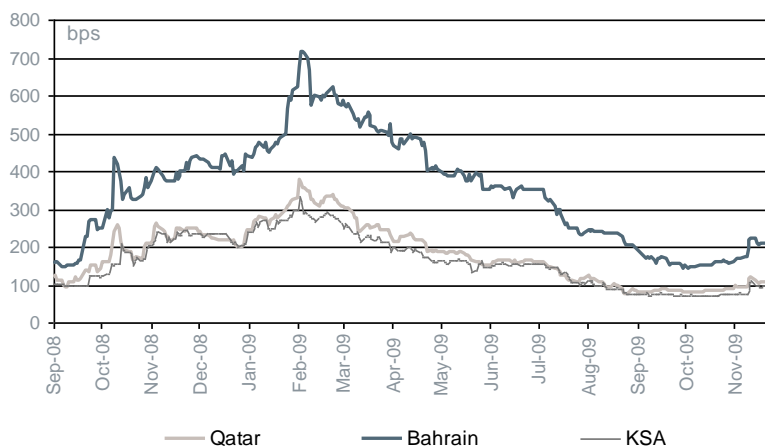
Source: Bloomberg

Saudi Arabia's country risk profile unlikely to suffer

After the DW announcement, the Credit Default Swap spreads for sovereign bonds of the Kingdom jumped 18bps, but returned to the pre-announcement levels within a week; TASI also recovered most of its losses since the announcement. Reading this in conjugation with the reaction of TASI, suggests that investors' confidence in the Saudi economy is intact. Lower CDS spreads typically help companies to raise funds at smaller mark-ups.

There is no threat to country's risk rating as CDS spread improves quickly

Chart 2: CDS spread retreats sooner than expected



Source: Reuters



Not a single corporate from the Kingdom has been put under rating review

There has been marginal uptick in corporate CDS, reflecting no significant increase in risk premium on corporate debt

Liquidity in inter-bank money market was comfortable as 3-month SAIBOR remained unchanged at around 0.77%

Change in risk perception on corporates debt also muted

Unlike large rating downgrades of many corporates in Dubai, none of the corporate entities from the Kingdom has been put under review by any global rating agency. However, corporate fund raising will be under tighter scrutiny as markets will seek more clarity on the relationship between the state and state-controlled corporations. Following Dubai's clarification that DW does not enjoy government guarantees, alongside similar developments this year in Kazakhstan, Russia and Ukraine, banks and investors are likely to be relatively concerned about the assumption of implicit state support.

Although it is early to comment on the problems that corporates may face in raising funds in the aftermath of the DW announcement, normalization in the CDS spreads offers some clues. Sovereign CDS has not only normalized for the country, but there also has not been any significant move in corporate CDS. For instance, CDS spread for SABIC's 5-year debt increased marginally from about 150bps in the pre-announcement period to 170bps later. For many financial companies and banks, the spread has widened by a smaller 10bps. We expect this spread spike to correct itself once the dust settles. However, our view is contingent on the outcome of the DW's debt restructuring talks.

However, the need for greater transparency in the balance sheets of major corporate entities, especially those in close ties with the government, has become urgent, not only in the UAE but throughout the region. Access to further credit, especially to quasi-government entities, is likely to depend on the ability of these corporations to provide the market with improved disclosure and higher financial reporting quality and frequency.

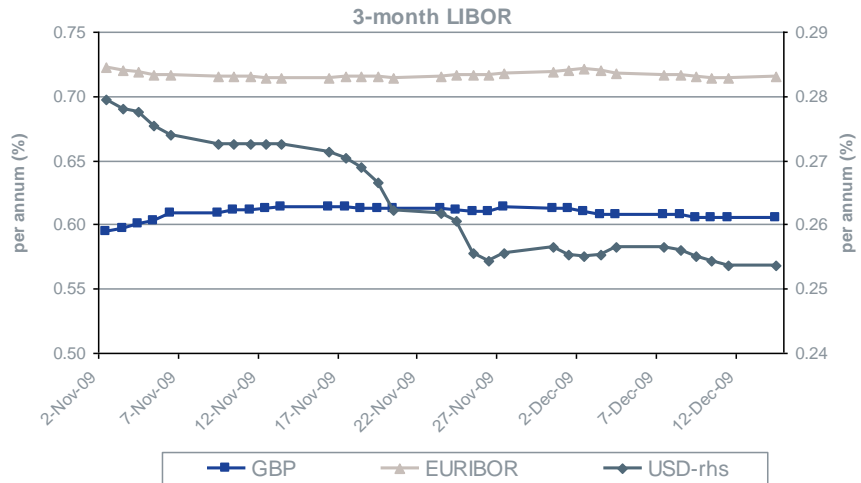
Negligible impact on liquidity

The impact of the DW announcement on global or regional liquidity, especially in money markets, has been negligible. There has hardly been any movement in LIBORs in any of the major currencies. In the UAE too, there has not been any hardening in the 3-month inter-bank rates. Although the UAE inter-bank interest rate spiked marginally, the additional liquidity facility announced by the UAE central bank allayed fears, normalizing the rate. Saudi Arabia three-month inter-bank offer rate remained unchanged at 0.77%.

Consistent decline in inflation from close to double digit last year to 4.2% in 3Q-09 provides room for the central bank to keep liquidity at comfortable levels. Major central banks such as the Federal Reserve, the Bank of England and the European Central Bank have pledged to keep policy rates low for some time. Therefore, it is unlikely that SAMA will tighten its monetary stance in the near future, allowing banks to access money markets at low interest rates.



Chart 3: No impact on global inter-bank rates



Source: Bloomberg

Chart 4: Negligible impact on regional inter-bank rates



Source: Bloomberg

Public spending unfurled by the crisis

Robust government finance reflected by strong fiscal surpluses and the sharp decline in public debt over the last few years provides support to the view that the Dubai crisis is unlikely to impact public spending on infrastructure and capacity expansion in the economy.

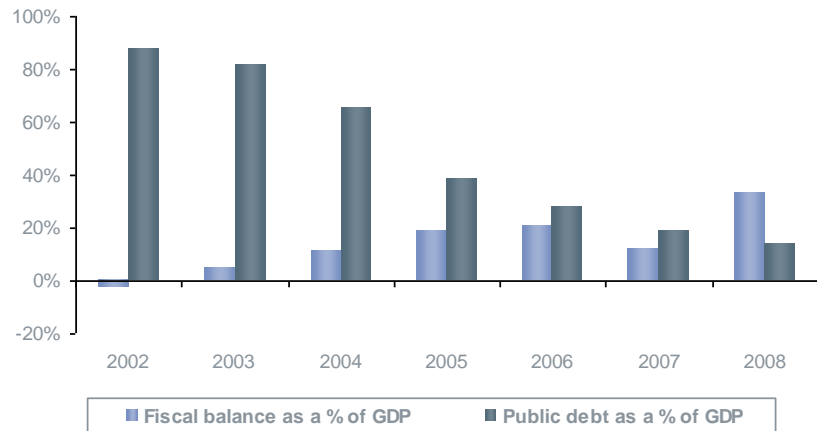
Strong government balance sheet likely to support public spending more than expected

Our view is based on the government’s management of the economy using both fiscal and monetary tools during the global crisis last year and earlier this year. It announced the budget for 2010 with a 13.7% increase in its expenditure over the previous year even when the oil price was hovering around USD40 per barrel. Budget funds were allocated for new projects and there were higher appropriations for existing projects. The Kingdom has



committed a total new capital spending of SAR225bn (\$60.0bn) in 2009, up 36.3% over the 2008 budget. The capital budget for 2009 at 47.3% of the total budgeted expenditure was proportionally higher than 40.2% in 2008.

Chart 5: Fiscal surplus surpassed public debt



Source: SAMA

Government has been spending more than it proposes in budget

Moreover, the government has ended up spending, on average, 22% more than the budgeted amount in the last nine years. Actual budget expenditure was 18.6% higher than budgeted in 2001 when oil prices had declined. Now, since oil prices have recovered more than 70% since the 2009 budget was presented, it is safe to assume that government expenditure may be higher than the originally proposed SAR475bn (USD126.7bn).

Investments likely on track

Government commitment to infrastructure investment and capacity expansion is unlikely to be affected by the crisis

Tighter credit conditions in global financial markets have affected private investments in the Kingdom in the first half of this year. However, the oil price recovery, along with the improvement in global credit markets, has brought investments back on track. Moreover, the long-term commitment from the government to invest in expanding capacity in the hydrocarbon sector is intact. The government plans to increase crude oil production capacity to 15mbd over the medium term and invest USD60bn during 2009-2012 to expand crude oil and gas production and refining capacity.

Projects in the Kingdom's six economic cities are likely to continue attracting capital. According to SAGIA, the government's investment agency, King Abdullah Economic City has so far attracted investments worth USD27bn. Riyadh expects the completion of the King Abdullah Financial District in 2013 with the aim of becoming a hub for international banking. With Dubai struggling with the payment crisis, the likelihood of Riyadh's financial district emerging as a financial center is boosted. The location of the proposed GCC central bank will be an added advantage for the city.



Dubai World unlikely to deepen global crisis wound for Saudi banks

With the Saudi banking system still reeling under the fear of loan defaults from two large Saudi business conglomerates, the recent Dubai credit crisis further fueled the scare. However, these fears were gradually alleviated, with both SAMA and markets downplaying the issue. Though none of the Saudi banks have detailed their exposure to the troubled state-owned company DW, it seems that the Dubai crisis will have little impact on the performance of Saudi banks. Saudi banks mostly focus on domestic markets and have limited exposure to the GCC and Middle East markets. Moreover, Saudi banks have strong balance sheets, owing to their low leverage (loans-to-deposits ratios below 100%), and a strong capital position, evidenced by the 16% capital adequacy ratio at end-2008. We believe the Saudi banking sector should withstand the current crisis without any major deterioration in asset quality after the DW announcement.

SAMA: Dubai crisis to have little impact on asset quality

When the Dubai government announced plans to ask the creditors of the state-owned DW and Nakheel (its real estate subsidiary) for a standstill on its debt repayments of USD26bn, there was a growing fear among Saudi investors about its impact on the Saudi banking system. Mohammad Al-Jasser, head of SAMA (Saudi Arabia Monetary Agency), appealed to the investors to stay calm as the exposure of Saudi banks to DW was less than 0.2% of their balances. For cross-border exposure, Saudi banks need to get an approval from SAMA on a case-by-case basis. Hence, the statement from the head was rather comforting, and we believe that such exposure is entirely manageable given the strength of the Saudi banks' balance sheets.

SAMA head confirms Saudi banks' limited exposure to DW and its subsidiaries

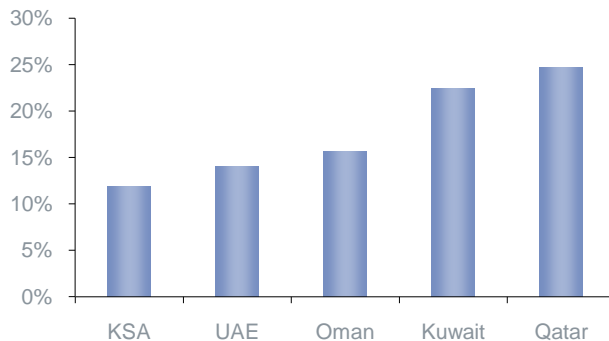
Limited exposure to external markets corroborates SAMA's statement

Saudi banks' operations are largely confined to the domestic market, which have remained relatively safe. An analysis of the geographic mix of loans to examine future loan impairments illustrates that the Kingdom accounts for almost 88.2% of Saudi banks' total assets and 89.4% of their loans. The exposure to GCC and Middle East loans is 6.5%, while Europe and other regions make up the rest. Thus, the limited foreign exposure of loan assets limits Saudi banks' vulnerability to any regional or international shock. Similarly, the recent Dubai credit woes hardly pose any threat for Saudi banks which have less than 0.2% exposure to the troubled state-owned company DW and its subsidiaries.

Exposure outside KSA is limited to less than 12%

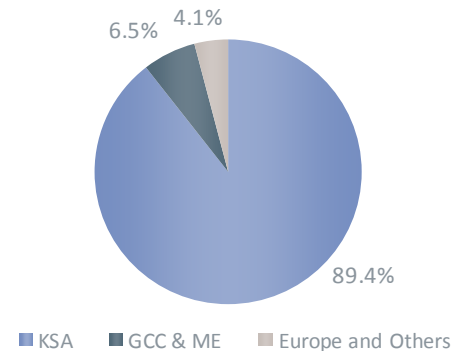


Chart 6: Foreign assets as %age of total assets (2008)



Source: SAMA

Chart 7: Geographic mix of loans (2008)



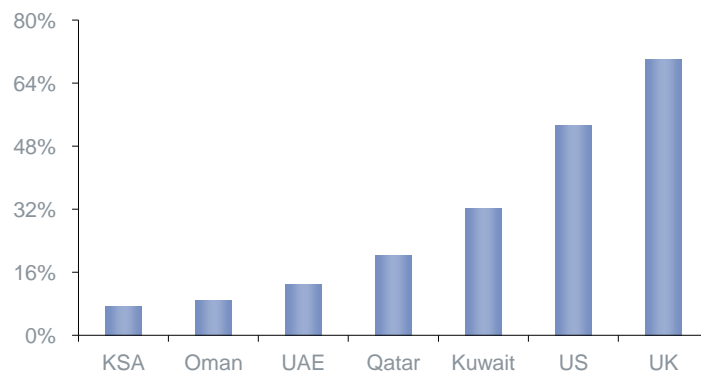
Source: Saudi Banks Financial Statements

Exposure to real estate sector remains acceptable

Saudi banks' exposure to real estate sector is 7.3%

The high real estate exposure was the main cause of the Dubai crisis and the earlier global economic meltdown. Consequently, related fears over the real estate and construction outlook caused large impairments and high provisioning to banks. However, Saudi banks escaped unscathed as there was no bubble in the Saudi property market unlike some of its regional counterparts. In fact, Saudi banks have one of the lowest exposures to the real estate and construction sectors in the region. Of the banks' total loan portfolio, lending to real estate was only 7.3% of total loans at end-2008, compared to 12.9% in the UAE, 20.3% in Qatar and 32.3% in Kuwait. We believe that the current exposure to the sector should not be a cause for worry and the fundamentals of the sector are intact as there are no major cancellations of real estate projects. Furthermore, there is no major price correction in real estate in the country which is a positive for the banking sector.

Chart 8: Exposure to real estate loans (2008)



Source: Central Banks' data



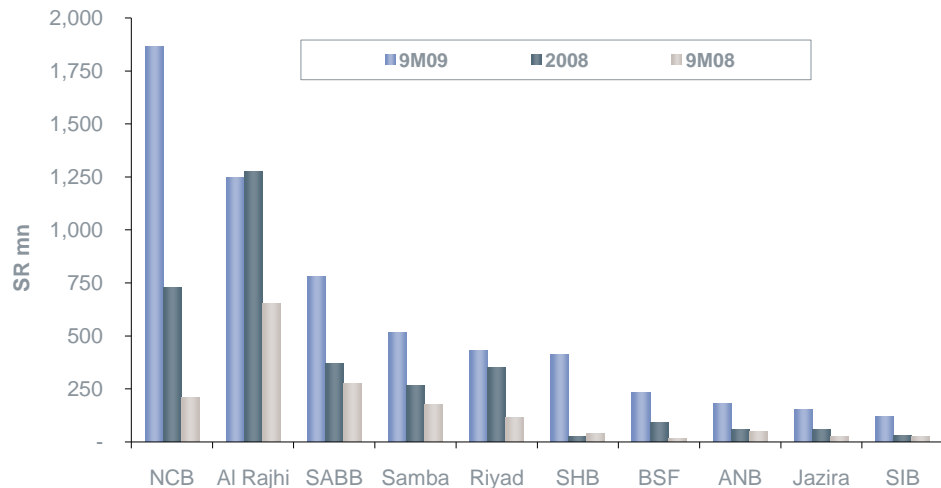
Higher provisioning in 9M2009 indicates the fear of greater NPLs in Saudi banking system

Asset quality still under the scanner

Although Saudi banks' exposure to DW is minimal, the fear of a weakening asset quality remains the top concern for Saudi banks presently. The recent loan defaults by two large Saudi conglomerates Al Gosaibi Group and Al Saad Group have further aggravated the concerns as most Saudi banks are exposed to these two groups.

Notably, Saudi banks had exhibited strong asset quality indicators as of December 2008, when the NPL ratio (non-performing loans to gross loans) and coverage ratio (provisions to NPL) were healthy at 1.36% and ~160% respectively. Unfortunately, NPLs and accumulated provisions are not disclosed in the quarterly financial statements. However, the provisioning charges for Saudi banks in 2009 give an indication of the direction of the loan quality.

Chart 9: Provisioning expenses



Source: Saudi Banks Financial Statements

Individually, net provisioning charges increased for all major banks in 9M2009 over 2008, which clearly indicates a weakening in asset quality. We expect the NPL ratios of most Saudi banks to increase sharply in 2009 as a consequence of the preceding rapid growth in their loan portfolios, whose quality has deteriorated sharply in the current cyclical downturn. Consequently, we see a general increase in provisioning for all banks to keep NPL coverage ratios at satisfactory levels throughout our forecasting horizon.

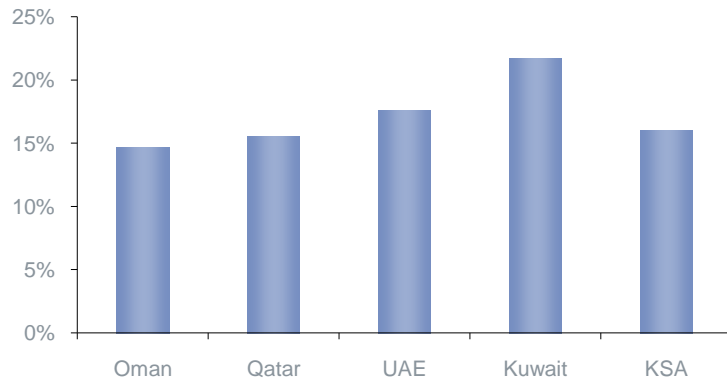
Capitalization remains healthy, should help withstand any similar crisis

Apart from strong fundamentals, the Saudi banking system is adequately capitalized (at par with the regional average) to help it withstand the current crisis and absorb any further deterioration in asset quality. The average capital adequacy ratio for the sector at end-2008 was 16%, well above the minimum 8% requirement set by SAMA. This abundance of capital is also illustrated by the sector's high average total equity to total assets (TE/TA) ratio of 12.4%.

Saudi banking system has adequate capitalization to absorb deterioration in asset quality



Chart 10: Capital adequacy ratio (2008)



Source: Central banks' data

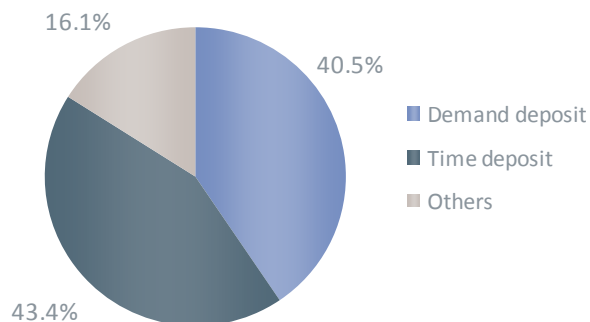
Low reliance on wholesale funding to hold the sector in good stead

Strong deposit franchise enables Saudi banks to remain self-reliant for their funding requirements

The Dubai crisis is likely to hurt investment sentiment in the region and raising money from international markets through sukuk or other instruments will be difficult and expensive. However, the Saudi banking sector should again be unruffled by this change as it hardly depends on wholesale funding. As Saudi banks have a strong domestic deposit franchise, the share of wholesale funding in total funding sources is less than 12.5%. In fact, most banks have room for further loan growth without resorting to the more costly wholesale funding to close any funding gap.

Another source of strength in the Saudi banks' funding structure is the ratio of government and government-related entities' deposits to total deposits, which stood at 21% at end-2008. We believe this is an additional comfort, preserving bank deposits and protecting them from any major withdrawals during a crisis. Further, non-interest bearing demand deposits make up 40% of the total deposits, enabling banks to earn higher margins.

Chart 11: Deposit break-up (2008)



Source: SAMA



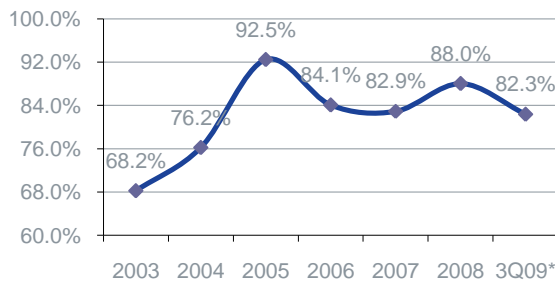
We believe the deposit base will continue to grow at a modest pace, as in the past, and the need for external financing will be minimal. However, the ratio of time deposits to total deposits should increase as clients start seeking higher returns on their deposits. We believe that the deposit growth in retail-focused banks will outperform their peers in the coming five years as retail deposits are considered less volatile than corporate ones.

Low loan-to-deposit ratio further comforts funding

Conservative loan-to-deposit ratio does not require external financing

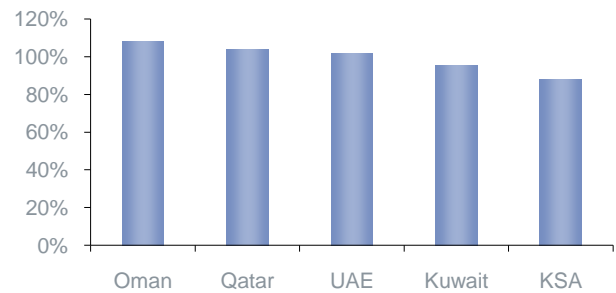
Saudi banks' loan-to-deposit ratio was comfortable at 82.3% at end-3Q2009. In terms of liquidity, we believe Saudi banks are better placed than their regional counterparts. Kuwait has an average loan-to-deposit ratio of 96%, while the UAE's average is 101% and Qatar's is 104%. We believe that Saudi banks' conservative lending attitude, unlike its neighbors, acted as a shield against the financial crisis. The current leverage does not require banks to increase their deposit base aggressively; rather it provides strength for future growth.

Chart 12: Loan-to-deposit ratio (2008)



Source SAMA

Chart 13: Comparison with GCC countries (2008)



Source: Central banks' data

Dubai crisis unlikely to aggravate an already sluggish loan growth

Lending remained flat in the last four quarters

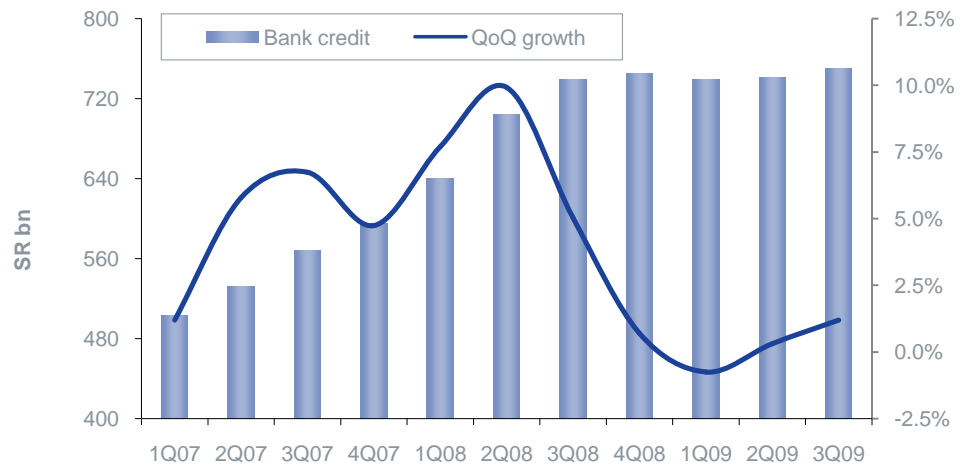
We believe that the Dubai crisis will have limited impact on the credit disbursement of Saudi banks as they mostly focus on domestic markets. We see the current lull in lending growth – the loan book has remained mostly stable in the last four quarters – as a natural pause after a prolonged period of rapid growth. We attribute the current sluggishness in Saudi private sector credit to the growing risk aversion of banks.

Recovery is expected in the 2nd half of 2009

However, the Saudi banks' loan books should grow again with the continued government support to the banking sector and the sustained government spending on infrastructure projects. We believe that Saudi banks are actually taking time off from the rapid growth in lending books of the past few years, reviewing their risk management systems, cleaning up their balance sheets and preparing themselves for the next growth phase. As a result, we may see a high single-digit loan book growth in 2010, after only a marginal increase in 2009.



Chart 14: Loan performance – QoQ growth



Source: SAMA

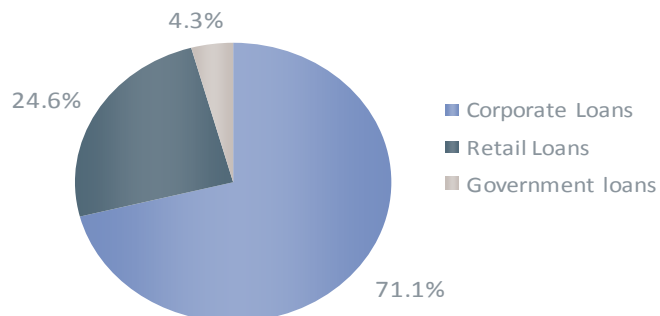
Crisis may bring retail lending in focus; more support likely for new mortgage law...

With the Dubai crisis further muting the confidence of an already battered corporate community, the banks are likely to shift their focus to the retail sector, which currently contributes less than 25% to the total loan book. The shift towards the higher-margin retail sector can further support the proposed mortgage law, which in turn can catapult retail lending in the Kingdom.

Retail lending remained underdeveloped due to tight personal lending norms by SAMA

Corporate loans, which grew at an average 29.5% p.a. over the past five years due to the previous expansion of the economy, are expected to slow down in the near term as several projects have been cancelled or put on hold. The petrochemical industry is the most affected, where almost one-third of projects worth more than USD20bn have been put on hold. Asset quality has been hit the hardest in the corporate sector, which will entail Saudi banks tightening their lending terms while disbursing corporate loans in the short-term.

Chart 15: Segment mix of loans (2008)



Source: SAMA

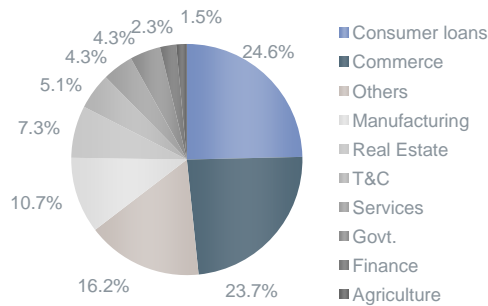


Mortgage lending should grow after mortgage law is passed; real estate exposure would not be a concern in KSA

Exposure to real estate loans to increase

The proposed mortgage law is expected to fuel residential and mortgage loan demand, which will increase the domestic banks' exposure to the real estate sector. Historically, Saudi banks have had very low exposure to mortgage loans (2% as of 2008, compared with 7.5% in the UAE). We are not particularly concerned about the growing exposure to the construction and real estate sectors in the Kingdom given the genuine high demand for residential properties, as reflected by fewer delays and cancellations of ongoing real estate projects. However, Saudi banks should not indulge excessively in the real estate sector and be wary of the Dubai example.

Chart 16: Loan distribution by sector (2008)



Source: SAMA

The crisis is unlikely to cause any visible effect on the already falling profitability

Although the Dubai crisis is unlikely to have any visible impact on their earnings, Saudi banks' profitability is already suffering from the global crisis and defaults from two local conglomerates. The main challenges that Saudi banks face include maintaining business volumes and adequate asset quality while improving profitability. Given the steep loan loss provision charges in 2009, we expect a marginal drop in Saudi banks' net income. We anticipate the worst stage of the earnings cycle for Saudi banks to be between 4Q2009 and 1H2010, as revenues are impaired by stagnant loan growth, and bottom lines are hurt by NPL losses and a reduction in fee and commission income. The total net income of all Saudi banks in 9M2009 was SR22.4mn, compared with SR26.4mn for the full-year 2008. We believe 4Q2009 should see higher provisioning on account of defaults by Saudi corporates. Overall, the earnings visibility will remain low until the macro-economic picture improves, which is not expected before the second half of 2010.



Conclusion

The Saudi economy has been a leading beneficiary of the recent diversification effort in the region as the contribution of the non-oil sector to the country's GDP growth has risen to an unprecedented level in recent years. More importantly, the diversification effort has been balanced to avoid any bubble build-up in the any one sector. The oil price boom during 2003-08 has resulted in a robust budget surplus over successive years and consequently declining public debt from a high of 88% to 14% of GDP over the period. The country's external balance remains strong with SAMA holding foreign exchange reserves in excess of USD400bn.

Structural reforms since the early part of the current decade have moved Saudi Arabia up to the highest rank in the region and to 16th place globally in the World Bank's 2009 Doing Business Survey. The Saudi Arabian General Investment Authority (SAGIA) continues to improve the business environment by constantly reviewing laws, regulations and procedures and comparing them with other countries to identify administrative barriers as well as other bottlenecks to investment.

In the wake of the global financial crisis last year, the Saudi Arabia Monetary Agency (SAMA) provided deposit guarantees, slashed commercial bank reserve requirements on demand deposits, trimmed yields on treasury bills, placed long-term deposits with banks and cut policy rates. SAMA also lowered the reverse repo rates gradually from 2% in July 2008 to 0.5% in June 2009. Such measures helped the banking system to overcome the crisis unscathed and obviated the need for any support to the banking system after the recent DW announcement.

Besides supporting the banking sector, authorities have regulated the sector in a pragmatic manner by curbing foreign exposure and encouraging an increased risk exposure to certain types of loan (such as personal and real estate loans). Moreover, authorities have consistently provided guidelines for risk assessment and loan approvals.



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