Arab National Bank

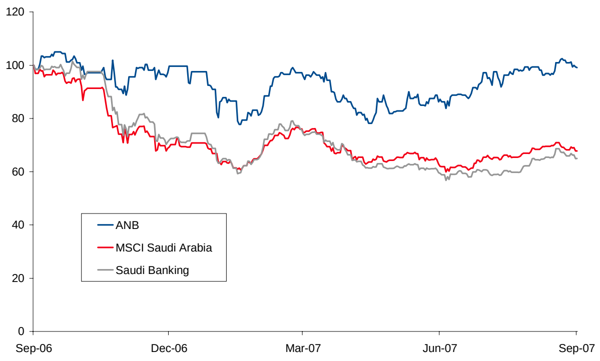
September 13, 2007

Key Data

Current Price*	Avg. Value Traded per Day
SAR 79.25	SAR 6 million
52-Week High	**Market Cap**
SAR 84	SAR 36.1 billion
52-Week Low	**Number of Shares Oustanding**
SAR 62.25	455 million
Reuters	**Bloomberg**
1080.SE	ARNB AB
Ownership Structure	
Closely Held: 67%	Public: 33%

Sources: Reuters, Tadawul, and MENA Equity Research
**As of September 12, 2007*

Rebased Performance



Sources: Reuters and MENA Equity Research

Key Ratios

	2007 f	2008 f	2009 f	2010 f	2011 f
P/B	3.4	2.8	2.3	2.0	1.8
P/E	14.0	12.6	11.2	9.9	8.6
EPS Growth	2.8%	10.9%	12.4%	14.0%	14.7%
RoAE	27.8%	24.3%	22.7%	22.0%	21.9%
RoAA	3.1%	3.0%	2.9%	2.9%	3.0%
Net Interest Margin	4.0%	4.1%	3.9%	3.9%	3.9%
Net Interest Spread	2.3%	2.4%	2.2%	2.2%	2.2%
Dividend Payout	19.0%	27.0%	36.3%	41.3%	46.3%

1Q2007 IBP a	2Q2007 IBP a
SAR 661.4 millions	SAR 756.0 millions
3Q2007 IBP f	**4Q2007 IBP f**
SAR 639.9 millions	SAR 597 millions

Sources: Reuters and MENA Equity Research
IBP = Income before Provisions, a = actual, f = forecast

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Highlights

12-Month Fair Value per Share: SAR 104.4

Recommendation: Buy – Risk Level: 2**

Reason for Report: Initiation of Coverage

- Arab National Bank (ANB) is a major player in the Saudi banking sector, accounting for 9% of total banking assets and enjoying high brand recognition.
- ANB has outperformed the overall Saudi banking sector in terms of lending growth and deposit accumulation in the past few years. The bank has also outperformed in terms of net profit growth and enjoys an asset quality that is better than the average of its peers.
- Going forward, we expect ANB to grow faster than the overall sector, but not at the rates witnessed in previous years. We forecast net loans, deposits, and net profit to grow by a compounded annual growth rate (CAGR) of 15%, 14%, and 13%, respectively, in the five years ending in 2012.
- ANB is in a process of transforming its consumer banking business, as branches are converted from transactional centers into sales centers. ANB is focusing on diversifying its income stream by developing various joint ventures. The bank is aggressively expanding its branch network and is also emphasizing the provision of other delivery channels, with the aim of boosting efficiency.
- Our estimate of ANB's 12-month fair value per share stands at SAR 104.4. This value is a weighted average of three estimates, reached by using three separate valuation models: Discounted Equity Cash Flow (DECF), the Dividend Discount Model (DDM), and a peer-based multiples valuation model known as Warranted Equity Valuation (WEV).
- We have assigned ANB a risk rating of 2 on a scale of 1 to 5. We believe the major risk facing ANB relates to it being an almost wholly domestic Saudi bank, and hence overexposed to the vagaries of the Saudi economy.

***Please refer to page 2 for recommendations and risk ratings.*

Risk and Recommendation Guide

Recommendation	Upside (Downside) Potential	Risk Level*				
		1	2	3	4	5
Buy	more than 20%					
Accumulate	between 10% and 20%					
Hold	between -5% and 10%					
Reduce	between -10% and -5%					
Sell	less than -10%					

**1 being least risky*

EXECUTIVE SUMMARY

Arab National Bank (ANB) is a major player in the Saudi banking sector, accounting for 9% of the country's total bank assets as of June 2007. ANB enjoys high brand recognition in Saudi Arabia, and while it is a universal bank offering all kinds of services, it has an especially strong retail banking franchise, in addition to a rapidly growing corporate banking business.

ANB has outperformed the overall Saudi banking sector in terms of lending growth and deposit accumulation in the past few years, benefiting from a large branch network, which stood at 123 branches as of June 2007. ANB's net loans and deposits grew by a CAGR of 33% and 22%, respectively, in the four years ending in 2006, compared to growth rates of 24% and 15% for the overall sector. At the same time, ANB grew its net profit more rapidly than its peers did, logging a 48% CAGR in the three years ending in 2006, compared with 41% for its peers. Moreover, the bank's annualized return on average equity (RoAE) reached 32% in the first half of this year, while RoAE stood at 28% for its peers. Going forward, we expect ANB to grow faster than the overall sector, but not at the rates witnessed in previous years. We forecast ANB's net loans to grow by a CAGR of 15% in the five years ending in 2012, with a growth of 14% in deposits. Net profits are forecast to reach SAR 4.8 billion by 2012, growing by a 13% CAGR in the coming five years.

ANB's management has instilled a customer-focused strategy in the bank's operations. The bank is in a process of transforming its consumer banking business, as branches are converted from transactional centers into sales centers. ANB is also focusing on diversifying its income stream by developing various joint ventures. ANB has embarked on an optimistic plan to open as many as 50 new branches roughly between the first quarter of 2007 and the first quarter of 2008. At the same time, the bank is emphasizing the provision of other delivery channels, with the aim of bringing down the cost of each transaction.

Our estimate of ANB's 12-month fair value per share stands at SAR 104.4, 32% above the share's official closing price as of September 12, hence our "Buy" recommendation. This value is a weighted average of three estimates, reached by using three separate valuation models: Discounted Equity Cash Flow (DECF), the Dividend Discount Model (DDM), and a peer-based multiples valuation model known as Warranted Equity Valuation (WEV).

We have assigned ANB a risk rating of 2 on a scale of 1 to 5. This follows our subjective criteria for risk such as franchise strength, stock price volatility, and the overall operating environment. We believe the major risks facing ANB are as follows:

- As the bank is predominantly a domestic Saudi player, it is overexposed to the vagaries of the Saudi economy, which is very much tied to one factor: price of oil

- ANB will be entering into several joint ventures. It remains to be seen whether the bank will succeed in reaping the intended benefits, the most important of which is the diversification of its income stream

- Regulatory: The imposition of overly cautious policies that could possibly hamper growth is a risk that is always present

VALUATION

The purpose of this valuation exercise is to estimate ANB's fair value per share 12 months from now. Although the estimate reached is our best guess of the share's value one year from now, this does not mean that we believe this value will necessarily prevail at that time. Valuation, although implemented according to well-established, sound, and quasi-scientific methods, remains a highly subjective exercise. The subjectivity does not lie in the implementation of the procedures and methods that are used to reach an estimate of fair value, but in the assumptions that must be made regarding various variables, without which a fair value cannot be reached. Hence, the estimate of fair value is, to a high degree, an outcome of those assumptions. Accordingly, parties with different assumptions will, undoubtedly, reach very different estimates of the share's fair value. This is one primary reason why our 12-month fair value estimate will not necessarily be the one to prevail at that time. Nevertheless, even when a consensus exists among analysts as to the fair value of a company's share, that is still no guarantee that the share price will migrate toward that fair value. At the end of the day, it is primarily investors' behavior that determines the price of any share. This behavior is a function of a wide array of factors, including sentiment, risk tolerance, objectives, and technical analysis, as well as analysts' recommendations.

Our estimate of ANB's 12-month fair value per share stands at SAR 104.4, 32% above the share's official closing price as of September 12. This value is a weighted average of three estimates (Figure 1), reached by using three separate valuation models: Discounted Equity Cash Flow (DECF), the Dividend Discount Model (DDM), and a peer-based multiples valuation model known as Warranted Equity Valuation (WEV). DECF carries the highest weight, as it is the more firm-specific cash-flow-based valuation method, which entails a comprehensive and detailed breakdown of the bank's future cash flows.

Our estimate of the 12-month fair value is SAR 104.4 per share

Figure 1 Weighted Average Fair Value per Share

Valuation Method	Value (SAR)	Weight (%)
Discounted Equity Cash Flow (DECF)	111.0	60%
Dividend Discount Model (DDM)	95.4	30%
Warranted Equity Valuation (WEV)	91.7	10%
Weighted Average Fair Value	**104.4**	**100%**

Source: MENA Equity Research

Discounted Equity Cash Flow

DECF is a function of the following variables, which we forecast over the next six years:

- Forecasts of *Net Attributable Income* (NAI), which is an earnings measure and, hence, primarily a function of total income, the cost structure, and provisioning levels.

- Forecasts of *Changes in Risk-Weighted Assets and Contra Accounts*. Globally accepted standards and local Saudi banking regulations mandate that minimum levels of capital adequacy be maintained as growth takes place. Hence, a percentage of income must be reinvested and so is not available for distribution. While the current regulatory minimum ratio is 8%, ANB's management does not wish to see the ratio fall below 12%, hence 12% was chosen for ANB.

- Forecasts of *New Gross Investments in Fixed Assets*. Although fixed assets constitute a much smaller share of the total balance sheet of banks than is the case for other companies, we still account for them for the sake of completeness.

- Forecasts of *Depreciation*, which are primarily a function of the bank's gross fixed assets level.

In addition, estimates of the following two variables are required:

- The *long-term expected growth rate* in equity cash flows beyond the forecast horizon, that is, beyond the next six years. This is supposed to be a sustainable growth rate that extends in perpetuity and is necessary to arrive at an estimate of ANB's share at the end of the forecast horizon, widely known as the *Terminal Value.*

- The *Cost of Equity* for ANB, which is investors' minimum required return for investing in ANB's shares, and hence is used to discount future equity cash flows.

In the DECF valuation (Figure 2), full financial statements are forecasted until 2012. Equity cash flows (ECFs), defined as NAI plus depreciation, minus new gross investments in fixed assets, and minus 12% of the increase in risk-weighted assets and contra accounts, are then extracted from those financial statements. In addition, ECFs are assumed to grow at the perpetual growth rate of 6% in 2013 and beyond. ECFs beyond 2007 are then discounted to a point in time that is 12 months from now, yielding a total value to shareholders of SAR 50.5 billion. Using ANB's current number of outstanding shares (455 million), we arrive at a fair value of SAR 111 per share.

The DECF valuation resulted in a fair value of SAR 111 per share

Figure 2 DECF Valuation

Figures in SAR Thousands			Forecast		
Fiscal Year Ends December	2008	2009	2010	2011	2012
Net Attributable Income	**2,854,474**	**3,209,203**	**3,657,702**	**4,194,969**	**4,780,025**
Add: Depreciation	125,547	143,036	161,631	182,643	206,387
Deduct: Investment in Fixed Assets	(238,146)	(213,386)	(239,928)	(269,860)	(303,621)
Deduct: 12% of Change in Risk-Weighted Assets and Contra Accounts	(1,562,935)	(1,683,447)	(1,648,242)	(1,750,167)	(1,867,003)
Equity Cash Flows	**1,178,940**	**1,455,406**	**1,931,163**	**2,357,585**	**2,815,788**
Terminal Value					**66,327,444**

Total Value of Equity in 12 Months	**50,492,996**
Current Number of Shares Outstanding	**455,000**
Fair Value per Share in 12 Months (SAR)	**111.0**

Source: MENA Equity Research

The chosen cost of equity (10.5%) is mainly a function of interest rate levels, risks in the operating environment, a subjective assessment of the equity risk premium, and the volatility of ANB's share price returns as compared with those of the stock market.

One major drawback of discounted cash flow valuations is that they are highly sensitive to the inputs used. This issue is more acute in the case of banks, as they are much more leveraged than most other companies. To get a feel for the impact of input changes on the valuation output, we performed a sensitivity analysis on two primary inputs of the DECF model, the cost of equity and the perpetual growth rate (Figure 3).

The estimate of fair value is highly sensitive to two major inputs used

Figure 3 DECF Sensitivity

		Perpetual Growth Rate				
		5.00%	5.50%	6.00%	6.50%	7.00%
Cost of Equity	9.5%	114.2	126.9	143.3	165.0	195.5
	10.0%	102.6	112.6	125.1	141.2	162.6
	10.5%	93.0	101.1	111.0	123.3	139.1
	11.0%	85.1	91.7	99.7	109.4	121.5
	11.5%	78.4	83.9	90.4	98.3	107.8

Source: MENA Equity Research

DIVIDEND DISCOUNT MODEL

The DDM can be used when the dividend stream can be reasonably forecasted, a situation that generally holds for banks. DDM is a function of the following variables.

- *Dividends* that will be declared and paid during the forecast horizon
- An assumption regarding the *perpetual growth rate* in dividends beyond the forecast horizon (similar to the case for the DECF model)
- ANB's *cost of equity*

The DDM yields a total value for shareholders of SAR 43.4 billion 12 months from now. Using ANB's current number of outstanding shares, we arrive at a fair value of SAR 95.4 per share (Figure 4).

The DDM resulted in a fair value of SAR 95.4 per share

Figure 4 Dividend Discount Model

Figures in SAR Thousands			Forecast		
Fiscal Year Ends December	2008	2009	2010	2011	2012
Dividends Declared	770,708	1,165,069	1,510,778	1,942,439	2,452,345
Terminal Value					57,766,338

Total Value of Equity in 12 Months	43,423,282
Current Number of Shares Outstanding	455,000
Fair Value per Share in 12 Months (SAR)	95.4

Source: MENA Equity Research

WARRANTED EQUITY VALUATION

WEV is a form of peer-based multiples valuation model. It is employed by comparing the adjusted price-to-book (P/B) multiples of a number of similarly rated commercial banks that operate in countries comparable to Saudi Arabia on a gross domestic product (GDP) per capita basis. In fact, the majority of the countries that we chose have a higher GDP per capita than does Saudi Arabia. One reason for this is our inability to identify a comparable sample of banks if we specify a respective GDP per capita that is very close to that of Saudi Arabia. Nevertheless, we believe that Saudi banks should, in fact, be compared to banks that operate in countries that have a higher GDP per capita than that of Saudi Arabia owing to the enormous amount of oil, and hence potential wealth, that Saudi Arabia enjoys. Additionally, we believe other GCC banks can also be included in the sample, because their operating environments are similar to that of Saudi Arabia, even if the respective countries' GDP per capita levels are not similar to that of Saudi Arabia. However, only three banks from the UAE were included, due to the unavailability of consensus estimates on other GCC-based banks.

Using the WEV valuation model, ANB appeared slightly undervalued compared with its peers

Figure 5 Warranted Equity Valuation

Country	Bank	P/B* (2007 f)	ROE **	EPS Growth ***	WEV	FSR Moody's
South Korea	Daegu Bank	1.5	17.7%	3.5%	242.4	C-
South Korea	Kookmin Bank	1.6	17.2%	5.3%	170.3	C
South Korea	Korea Exchange Bank	1.4	14.7%	2.7%	353.2	C-
South Korea	Pusan Bank	1.6	17.8%	7.5%	120.6	C-
Greece	Alpha Bank AE	3.0	25.0%	12.9%	93.6	C
Greece	EFG Eurobank Ergasias SA	3.2	24.4%	18.7%	69.3	C+
Greece	National Bank of Greece	2.8	25.5%	19.4%	57.0	C+
Greece	Piraeus Bank SA	2.6	22.6%	22.8%	50.8	C
Greece	ATEbank	2.3	19.5%	14.5%	81.9	D
Greece	Emporiki Bank of Greece	2.7	20.3%	20.3%	65.2	C-
Portugal	Banco BPI	3.0	19.7%	17.1%	88.5	C
Portugal	Banco Comercial Portugues	2.3	19.5%	15.4%	77.1	C+
Portugal	Banco Espirito Santo	1.8	16.8%	16.2%	66.6	C+
Czech Republic	Komercni Banka	3.0	19.2%	6.6%	236.1	C
Hungary	OTP Bank	2.6	23.0%	18.1%	63.3	C+
UAE	Abu Dhabi Commercial Bank	2.2	20.7%	14.5%	72.8	C
UAE	National Bank of Abu Dhabi	2.9	25.2%	6.5%	173.1	C
UAE	National Bank of Dubai	2.4	20.8%	13.0%	89.2	C-
Cyprus	Bank of Cyprus	3.6	27.7%	22.9%	56.4	C-
Cyprus	Hellenic Bank Public Co.	2.8	18.2%	18.0%	85.3	D+
Cyprus	Marfin Popular Bank	2.3	19.7%	25.7%	46.0	C-
	Average				**103.1**	
Saudi Arabia	**Arab National Bank**	**3.2**	**25.2%**	**12.4%**	**103.1**	**C**
	12-Month Fair Value (SAR)	**91.7**				

Sources: Reuters Knowledge, Moody's, and MENA Equity Research
** Prices as of September 10, 2007*
*** ROE is the average of the forecasted ROEs for the next two or three years, based on consensus estimates*
**** EPS growth is the CAGR in forecasted EPS for the next two or three years, based on consensus estimates*

In the WEV, we adjust the P/B ratio by correcting for two variables that affect the P/B level significantly, namely, expectations of future earnings growth and future return on equity levels. Specifically, the adjusted P/B is obtained by dividing the raw leading P/B by both the CAGR in earnings per share (EPS) for the coming two or three years and the average return on equity (ROE) in the same period of time (all based on consensus estimates). The rationale behind this adjustment is that differing P/B multiples among banks do not necessarily reflect differences in “valuations”, but rather can be a reflection of different growth expectations and potential. After adjusting the P/B ratios for the sample of ANB’s peers, we eliminate the highest and lowest values, and we average. We then assume that ANB’s adjusted P/B should be equal to that average. Afterward, we plug in our forecast of ANB’s 2008–2010 CAGR in EPS and average ROE for the same period to extract a raw leading P/B ratio for ANB. Finally, using our forecast of ANB’s book value per share, we arrive at a value of SAR 91.7 per share for ANB.

RISKS

- The major risk facing ANB arises from the fact that the bank is predominantly a domestic Saudi player with almost no presence abroad. This means that ANB is overexposed to the vagaries of the Saudi economy, which is very much tied to one single factor: the price of oil. A deteriorating Saudi economy will hamper earnings and balance sheet growth; in addition, it will worsen asset quality.

- Some risk lies in the launching of ANB’s various joint ventures. It remains to be seen whether the bank will reap the intended benefits, the most important of which is the diversification of its income stream.

- The performance of the Saudi stock market was at the heart of Saudi banks’ performance in the past few years. ANB, as well as other banks in Saudi Arabia, will be exposed, especially through brokerage, to another equity boom and bust if that indeed materializes again.

- Another risk arises from the fact that banks are heavily regulated. The imposition of overly cautious policies that could possibly hamper growth is a risk that is always present and can not be dealt with.

- Finally, there is some risk with regard to geopolitics and internal security threats. It could be argued that Saudi Arabia, at least until now, has been more prone to security incidents than the other GCC countries. Nevertheless, the occurrence of such incidents has declined significantly lately.

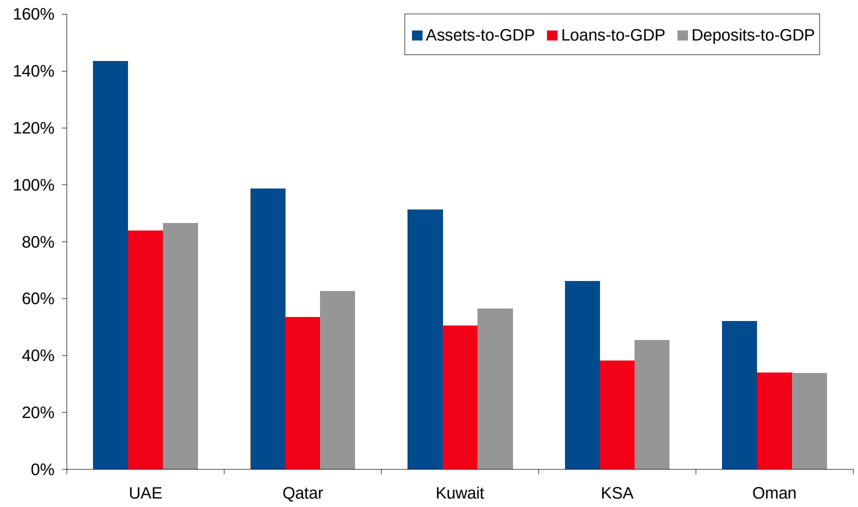
SAUDI BANKING SECTOR HIGHLIGHTS

SECTOR SIZE AND ISLAMIC BANKING

The Saudi and UAE banking sectors are the two largest in the GCC, coming very close to each other in terms of total assets. Total banking assets in Saudi Arabia reached SAR 936.1 billion as of June 2007. When compared to the size of the underlying economy, however, the Saudi sector is one of the smallest, with lower banking penetration rates than the other GCC countries, with the exception of Oman (Figure 6). This relatively underbanked status of the economy naturally translates into growth potential for the banking sector.

Low commercial banking penetration rates indicate ample room for Saudi banking sector growth

Figure 6 Banking Penetration Rates — 2006



Sources: GCC central banks and MENA Equity Research

The sector comprises 17 commercial banks, six of which are branches of foreign banks operating in the country. Four Saudi banks—Arab National Bank (ANB), Banque Saudi Fransi (BSF), The Saudi British Bank (SABB), and Saudi Hollandi Bank (SHB)—are each associated with a major foreign bank through significant ownership stakes reaching 40%. The Saudi Arabian Monetary Agency (SAMA)—the central bank of Saudi Arabia—is gradually opening up the sector to foreign banks. In addition to the banks currently operating, it has licensed a few others that have not yet opened for business. Furthermore, the USD 2.8 billion initial public offering (IPO) of Inmaa Bank, a new Saudi bank, is expected in the fourth quarter of 2007, making it one of the largest in Saudi Arabia in terms of paid-up capital.

Saudi Arabia is witnessing an insatiable demand for Islamic banking. All Saudi banks offer Shari'a-compliant products, and, increasingly, the majority of retail banking is conducted according to Islamic Shari'a. A large proportion of the total bank branches have been converted to be Shari'a compliant, and a new Islamic bank, Bank Al Bilad, started operations in 2005. The reason for this thrust into Islamic banking is, simply, customer demand, which is more and more in favor of Shari'a-compliant products as opposed to conventional ones.

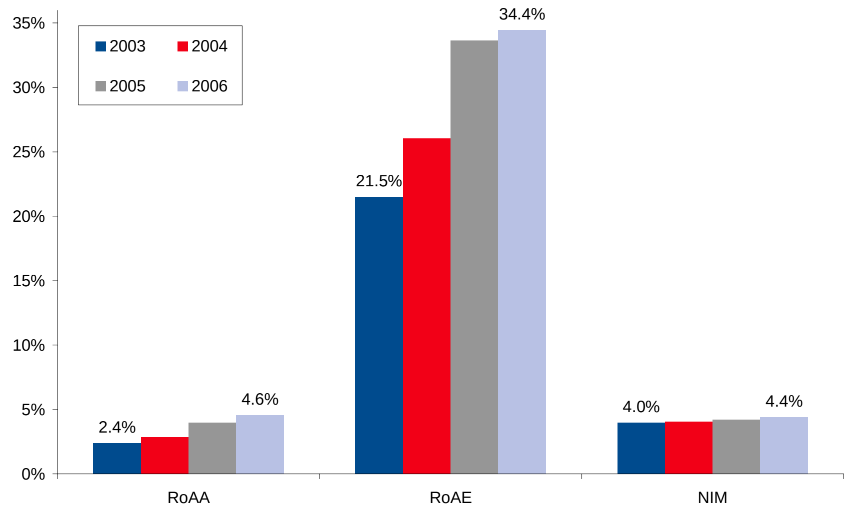
BANK PROFITABILITY AND BROKERAGE COMMISSIONS

Saudi banks have witnessed robust growth in their core banking operations in the past few years. In addition, they benefited immensely from the outburst of trading activity witnessed on the Saudi stock market, as income from fees and commissions, primarily brokerage commissions, skyrocketed in the past few years, reaching 30% of total operating income in 2006. The collapse of the Saudi stock market in 2006 and the simultaneous dip in its liquidity slowed the growth of income from fees and commissions during that year, and the ongoing sluggish trading activity during the first half of 2007 resulted in a significant dip in the banks' earnings during that period.

All profitability indicators steadily increased in the three years ending in 2006, as shown in Figure 7.

Margins and returns improved during the three years ending in 2006, with the increase in the net interest margin being less pronounced than the increase in returns

Figure 7 Net Interest Margin and Returns in the Saudi Sector



Sources: Banks' financial statements and MENA Equity Research

The return on average assets (RoAA) rose to 4.6% in 2006, nearly double its level three years earlier, while the return on average equity (RoAE) climbed to 34.4%. The surge in RoAA and RoAE was on the back of an increase in the net interest margin (NIM), which rose from 4% in 2003 to 4.4% in 2006, but, more importantly, was due to skyrocketing brokerage commissions, as brokerage is a very high-margin business.

Nevertheless, the combined net profits of Saudi banks dropped by 15% in the first half of 2007 on the back of lower brokerage commissions reflecting the dip in trading activity during that half, as mentioned above. Most banks saw their profits fall as value traded on the Saudi Stock Exchange (Tadawul) stood at SAR 1,488 billion, 53% below the SAR 3,138 billion traded in the first half of 2006. ANB bucked the trend with nearly flat earnings, despite sustaining a 30% drop in its income from fees and commissions. Going forward, trading activity on Tadawul will be a key driver of banks' income from fees and commissions.

END OF BROKERAGE MONOPOLY AND CAPITAL MARKET ACTIVITIES SPIN-OFF

Until recently, Saudi banks enjoyed a monopoly in stock brokerage services on Tadawul. However, in its efforts to develop the country's capital market environment in general and Tadawul in particular, the Saudi Capital Market Authority (CMA) has granted licenses to a number of financial institutions to conduct brokerage business, among other securities market activities. The number of financial institutions licensed to conduct various securities market activities has risen rapidly, to reach 78 by the end of August 2007. Hence, local banks' market share of total brokerage is expected to shrink, which will weigh on their earnings from that activity. Nevertheless, local banks enjoy an advantage over the incoming institutions in terms of their geographic reach and their ability to extend margin lending, and therefore local banks' brokerage market share is not expected to fall significantly.

It is important to note that as per CMA regulations, local banks were required to have spun off their capital market activities into separate licensed entities by July 2007, though that might not have a significant effect on the banks' bottom lines. However, the segregation of capital market activities from core commercial banking activities will drive the management of each business activity to focus wholly on its core operations, which should be beneficial in the long term. ANB's subsidiary has received the CMA license to conduct various capital market activities but is not operational yet. ANB and some other Saudi banks have been granted a six-month extension to complete all the necessary procedures to segregate their capital market activities from their commercial banking activities, thereby actually launching their subsidiaries.

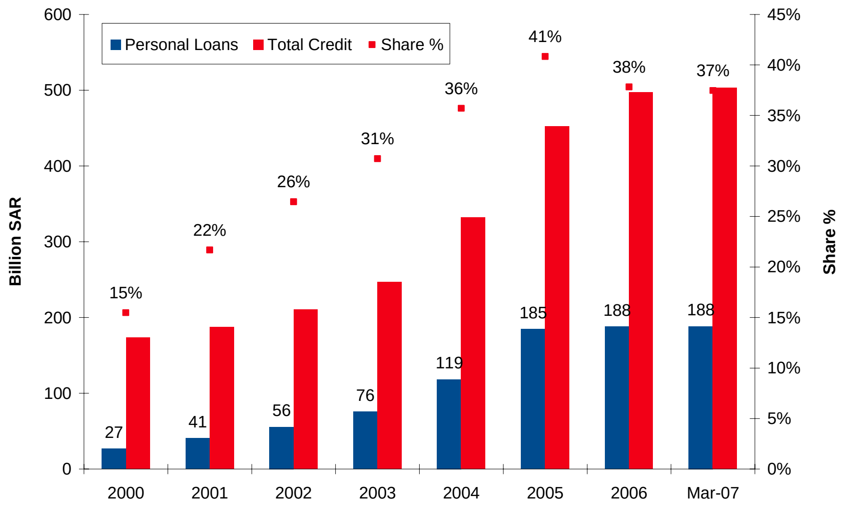
Capital market activities have potential for very strong growth in the years to come. Investment banking, for example, despite strong growth recently, is still in its infancy in Saudi Arabia. The small number of listed companies on Tadawul (103 at the end of August 2007) in relation to the size of the Saudi economy (GDP of USD 347 billion in 2006) and the very low debt levels that Saudi companies generally have are only two simple indicators of the potential for investment banking growth in Saudi Arabia. As for asset management, there is significant wealth to be invested, especially with the price of oil forecast to stay high, at least in the medium term. Moreover, the value of domestic shares held by the investment funds of Saudi banks make up a miniscule share (less than 3%) of the total market capitalization of Tadawul. Even when compared with the free float of Tadawul, this share remains tiny, reflecting significant potential for the expansion of assets under management of commercial banks, and hence fees to be earned.

PERSONAL LENDING

Private sector lending has witnessed vigorous growth in recent years, driven by a rapid increase in personal lending, which grew by a strong 47% CAGR during the five years ending in 2005, driving up its share of total lending to 41%, compared with a mere 15% in 2000. The favorable economic environment was one reason behind the exponential growth in personal lending, as Saudis found it more convenient to borrow funds from local banks on the back of double-digit growth in nominal GDP during the past four years. It is worth mentioning that most personal lending is tied to electronic salary assignment, which boosts asset quality and, in effect, makes personal lending a low-risk undertaking. This, accompanied by the higher margins compared with corporate lending, makes personal lending a highly lucrative business. Undoubtedly, a considerable share of personal loans found their way into the booming Saudi equity market, with the Tadawul index surging by a CAGR of 88% in the three years ending in 2005. Toward the end of 2005 SAMA, concerned with the rapid increase in personal lending, issued guidelines aiming to curb the excessive growth in personal lending. The new regulations cut the maximum consumer loan maturity to five years and capped the debt service payments at one-third of a borrower's salary. These new regulations had an immediate effect, and the growth in personal lending nearly came to a halt, with its share of total credit dropping to 37% by the end of March of this year (Figure 8). Going forward, due to these ongoing restrictions, growth in personal lending is expected to remain subdued.

Growth in personal lending reached a standstill in 2006 after rising rapidly in previous years

Figure 8 Personal Lending versus Total Credit



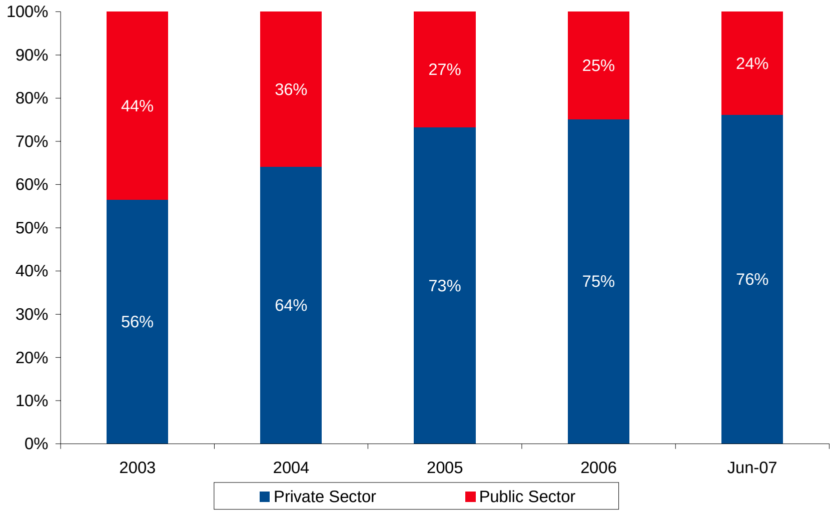
Sources: SAMA and MENA Equity Research

DECLINING EXPOSURE TO THE GOVERNMENT

The surge in private sector lending and the record budget surpluses witnessed in Saudi Arabia are leading to a decrease in the banking sector's exposure to the government, with claims on the public sector dropping to 24% of total claims as of June 2007, down from 44% at the end of 2003 (Figure 9). Government securities, primarily bonds, account for the bulk (78%) of the banking sector's total claims on the public sector. Outstanding government securities held by commercial banks have even dropped in absolute terms, from SAR 151 billion in 2003 to SAR 125 billion at the end of June 2007. The budget surplus in 2006 was a colossal SAR 265 billion, enabling Saudi authorities to reduce the level of national debt, which is estimated to have represented 28% of GDP at the end of 2006, compared with 40% a year earlier. Going forward, we expect claims on the private sector to continue to gradually replace claims on the public sector as the government continues its policy of reducing its debt.

The banking sector's claims on the private sector are replacing claims on the public sector

Figure 9 Banking Sector's Claims on the Private and Public Sectors as a Share of Total Claims



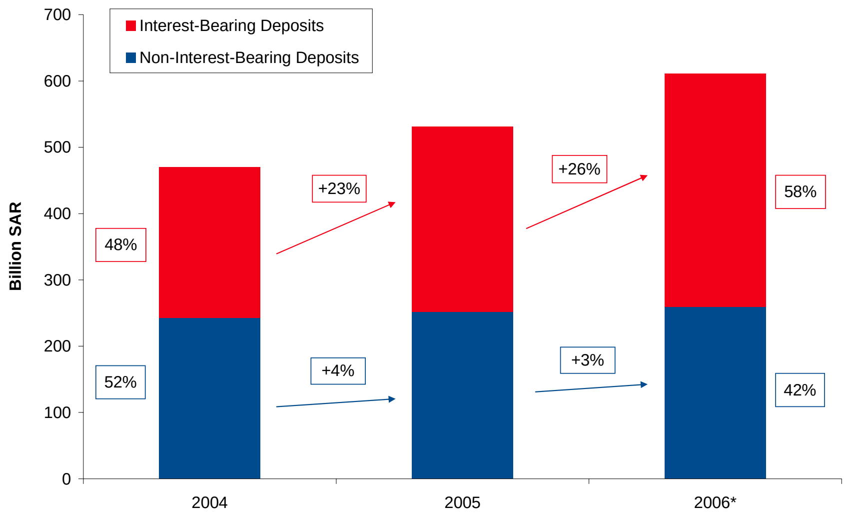
Sources: SAMA and MENA Equity Research

Cost of Funding

Since 2005, there has been rapid growth in the cost of funds, driven primarily by rising interest rates. With the Saudi riyal pegged to the U.S. dollar, domestic interest rates track rates in the United States. Accordingly, domestic rates started rising in 2004, following the interest rate increases witnessed in the United States. Factors other than rising interest rates also lie behind this surge in funding costs, including an increase in the share of interest-bearing deposits out of total deposits (Figure 10).

Interest-bearing deposits grew faster than non-interest-bearing ones in 2005 and 2006

Figure 10 Interest-Bearing versus Non-Interest-Bearing Deposits



Sources: Moody's, Fitch, banks' financial statements, and MENA Equity Research ** Estimate*

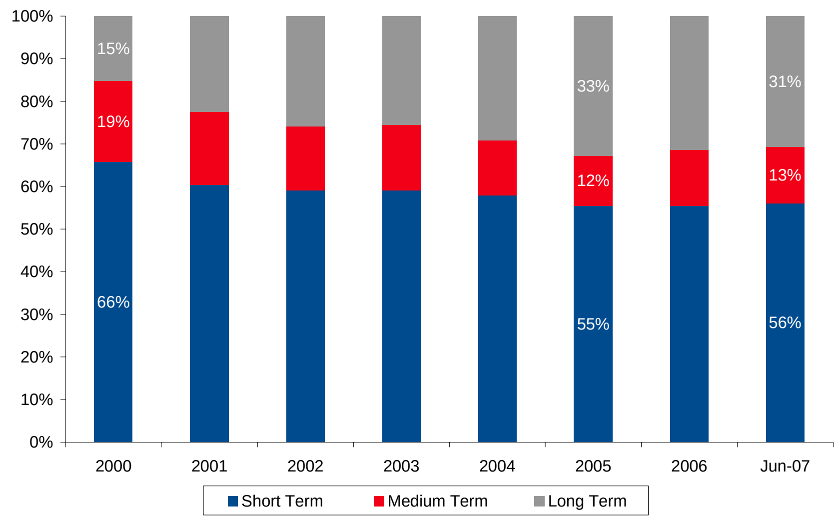
Historically, the Saudi banking sector has benefited from a high proportion of non-interest-bearing (NIB) deposits out of total customer deposits. Nevertheless, a gradual shift toward interest-bearing deposits has recently been seen, as they grew by an estimated 55% in the two years ending in 2006, compared with a much slower 7% growth in NIB deposits. Going forward, we expect the growth in interest-bearing deposits to continue to outstrip that of NIB deposits, even as banks prefer otherwise. Nevertheless, bank policies as well as a probable drop in interest rates will have a slowing effect on the growth of interest-bearing deposits.

Banking Credit Maturities

The average maturity of banking credit has been steadily lengthening, driven by an outburst in personal lending and growth in project financing, both of which are characterized by generally longer maturities. While long-term credit, defined as having more than three years' maturity, represented 15% of total credit in 2000, that share rose to 33% at the end of 2005, to later drop to 31% following the implementation of SAMA's consumer lending regulations, which included a five-year cap on the maturity of consumer loans (Figure 11).

The share of long-term credit in total credit steadily increased in the years before 2006, but has since dropped

Figure 11 Banking Credit Maturities



Sources: SAMA and MENA Equity Research

The lengthening maturity of banking credit was one reason Saudi banks have increasingly resorted to wholesale funding with the majority of those banks having now issued some kind of bonds after debt was basically non-existent on their balance sheets before the year 2004. Going forward, we expect Saudi banks to rely more and more on wholesale funding, though it will continue to constitute a tiny share of their overall balance sheets.

COMPANY OVERVIEW

COMPANY BACKGROUND

Arab National Bank is a major player in the Saudi banking sector, with a 9% share of the country's total banking assets as of June 2007. ANB is 40% owned by the Arab Bank, while the Saudi General Organization for Social Insurance (GOSI) holds an 11% stake. ANB took its present form in 1980, when it took over the operations of Arab Bank Limited, which had been present in Saudi Arabia since 1949. ANB is a universal bank, offering both conventional and Shari'a-compliant products and services. The bank's business operations can be broken down into three major segments: retail banking, corporate banking, and treasury, representing 29%, 41%, and 30% of the bank's total assets, respectively, as of June 2007. Nevertheless, the retail segment accounted for 63% of total net income in 2006, but that share decreased to 50% in the first half of 2007. The bank's geographic reach and operations lie almost entirely in Saudi Arabia, with 123 branches and 629 ATMs as of June 2007. Additionally, ANB has one branch in London. The bank, which employed 3,416 staff at the end of 2006, has been steadily increasing its Saudization ratio, from 81% in 2002 to 91% in 2006. ANB is rated by the main international rating agencies, Standard and Poor's, Moody's, and Fitch, as A, A1, and A, respectively.

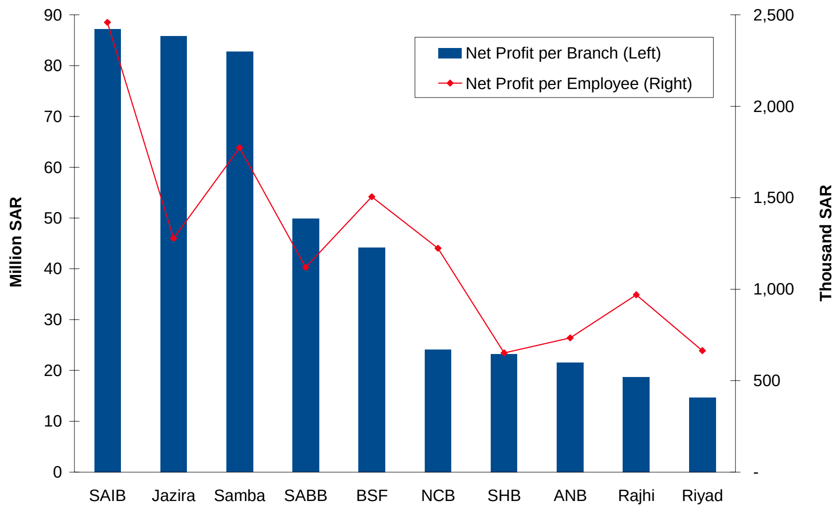
STRATEGY

ANB's management has instilled a customer-focused strategy in the bank's operations, reinforcing the already high brand recognition that ANB enjoys. In addition to expanding its core retail and corporate banking businesses, ANB is focusing on diversifying its income stream by developing joint ventures in the housing finance, heavy equipment leasing, bancassurance, and car leasing domains. This is in addition to the regulatory-imposed spin-off of capital market activities into a separate licensed subsidiary. In capital market activities, the focus has been on brokerage, asset management, investment banking, and advisory services. ANB might consider regional expansion but in a cautious way and on a very selective basis and in coordination with the Arab Bank.

ANB is in a process of transforming its consumer banking business; with the help of McKinsey, a renowned consultancy, ANB is converting its branches from transactional centers into sales centers. The bank's management has focused on improving cross-selling, which will become increasingly important with the launching of the various joint ventures. The bank continues to invest in information technology and in upgrading its systems. ANB is currently replacing its core banking system, a process that will be completed in 2008. The bank is also emphasizing the provision of various delivery channels other than branches, with the aim of bringing down the cost of each transaction. ANB was the first bank in Saudi Arabia to launch Internet banking, branded "Alarabi-eBank," back in 2000 and has a high-quality phone banking service through "Hatif Alarabi." To support the consumer banking business in particular, ANB has also embarked on an optimistic plan to open as many as 50 new branches roughly between the first quarter of 2007 and the first quarter of 2008. This is a rather bold endeavor, considering that ANB's branch network expanded by a single branch in the period from year-end 2001 to year-end 2006. Moreover, we believe ANB has room to enhance the profitability of its current branches, as ANB's net profit per branch and net profit per employee measures are generally lower than those of its Saudi peers (Figure 12).

ANB's lower net profit per branch and net profit per employee as compared with its peers indicate that there is room for efficiency gains

Figure 12 Net Profit per Branch and Net Profit per Employee — 2006



Sources: Banks' financial statements, SAMA, and MENA Equity Research

Personal Banking and Housing Finance

ANB has a strong retail franchise, with personal loans representing close to 35% of its total net loans at the end of 2006—one of the highest shares among the conventional Saudi banks. Still, that share is below the bank's record 40% at the end of 2005. The decrease in the share of personal loans was primarily due to the tightened consumer-lending regulations imposed by SAMA. ANB outgrew the overall sector in terms of personal lending in the past few years, thereby increasing the bank's market share from 7.5% in 2003 to 9.5% by the end of 2006.

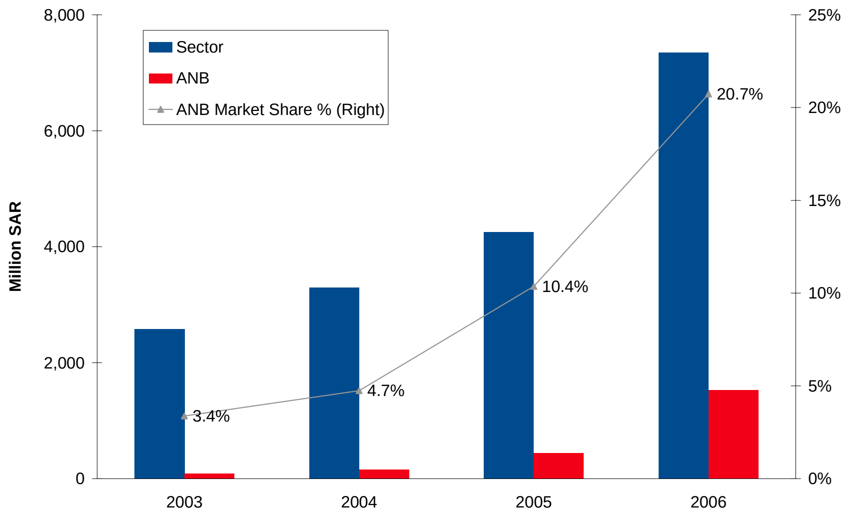
ANB is now a leader in credit cards, after significantly outperforming the growth rate of the sector as a whole. ANB's credit card lending grew by a CAGR of 160% in the three years ending in 2006, compared with 42% for the overall sector, driving ANB's market share from a mere 3.4% in 2003 to 20.7% in 2006 (Figure 13). This robust growth in credit card lending was due to many factors, including an expanded sales force, a focus on cross-selling, aggressive marketing, effective deployment of technology, and the success of the Islamic credit cards that were launched a few years ago.

ANB practices market segmentation and benefits from its exclusive relationship with government pensioners. It is also worthwhile to note that the majority of ANB's new retail business is Shari'a compliant.

In a major move, ANB will be tapping the housing finance market through a 40% stake in a SAR 2 billion joint venture with Dar Al Arkan, Kingdom Installment Co., and the International Finance Corporation. Preliminary approval has already been received from SAMA, and ANB expects the new company to become operational in 2007. Housing finance is a key growth area in Saudi Arabia, and ANB will capitalize on being one of the first banks to tap this severely underserved market. With a population of around 24 million, of which close to 50% are under the age of 18, housing finance is forecast to witness robust growth if the regulatory environment is supportive. In this regard, a mortgage law is expected to go into effect before the end of 2007.

ANB's credit card lending growth was much faster than that of the overall sector

Figure 13 Credit Card Lending: ANB versus Sector



Sources: ANB's financial statements, SAMA, and MENA Equity Research

Another important growth area for banks is bancassurance, given the low level of insurance penetration in Saudi Arabia. ANB is well positioned to benefit from that, given the bancassurance joint venture it is planning to launch with one of the largest insurance companies worldwide.

Corporate and Commercial Banking

Corporate banking is playing an increasingly important role for ANB, with its share of net profit rising from 6.6% in 2005 to 23% in the first half of 2007. ANB's corporate portfolio outgrew the sector's, especially in the past year and a half. In 2006 alone, ANB's commercial portfolio, excluding overdrafts, grew by a healthy 40%. A new separate unit, the Merchant Banking Group, within the Corporate Banking Division, was created in 2006 to perform various functions, including overseeing the operations of the various joint ventures. In addition, ANB was one of the first banks to provide credit facilities to small business entities, under the "Kafala" scheme. Unlike in personal banking, where the majority of the business is Shari'a compliant, the bulk of the corporate banking business is still conventional. Corporate banking is expected to continue to play an increasingly important role for ANB, especially with the ongoing regulatory restrictions on consumer lending. Several hundred billion dollars worth of projects are planned in Saudi Arabia in the next few years, which bodes well for the growth in corporate banking. Nevertheless, ANB is not especially enthusiastic about participating in large-scale project financing, given the long-term nature and low margins that characterize such kind of financing.

Wholesale Funding, Risk Management, and Asset Quality

ANB is resorting to wholesale funding to lessen the asset/liability maturity mismatch and to support the bank's capital. In 2005, ANB entered into a USD 350 million three-year syndicate term loan facility. More importantly, ANB's treasury launched a USD 850 million Euro Medium Term Note program (EMTN) in the fourth quarter of 2006, and issued a USD 500 million 10-year floating-rate note under that program. The notes were priced at Libor plus 83 basis points (bps) and are nonconvertible, unsecured, and listed on the London Stock Exchange. These notes are callable in 5 years and, more importantly, are subordinated; hence, they count toward Tier II capital, thus boosting the bank's capital adequacy ratio. It is possible that ANB will resort more to wholesale funding going forward; still, that funding will always represent a tiny share of the overall balance sheet. As of June 2007, the loan facility and the issued note represented a mere 4% of the overall balance sheet. As for Basel II, ANB is working toward implementing the standardized approaches for credit risk and operational risk, while a more advanced approach will be implemented for managing market risk. The unit responsible for credit risk, the Credit Group, was separated from the all-encompassing Risk Management Group to enable it to focus more on its primary responsibility. In fact, ANB enjoys a formidable asset quality, with its nonperforming loans representing a very low 0.7% of its total gross loans at the end of 2006 while its nonperforming loan coverage stood at a sky-high 321%. This should be compared with sector averages of 1.7% and 177%, respectively, and places ANB in second place among Saudi banks in terms of those two indicators.

FINANCIAL OVERVIEW AND FORECASTS

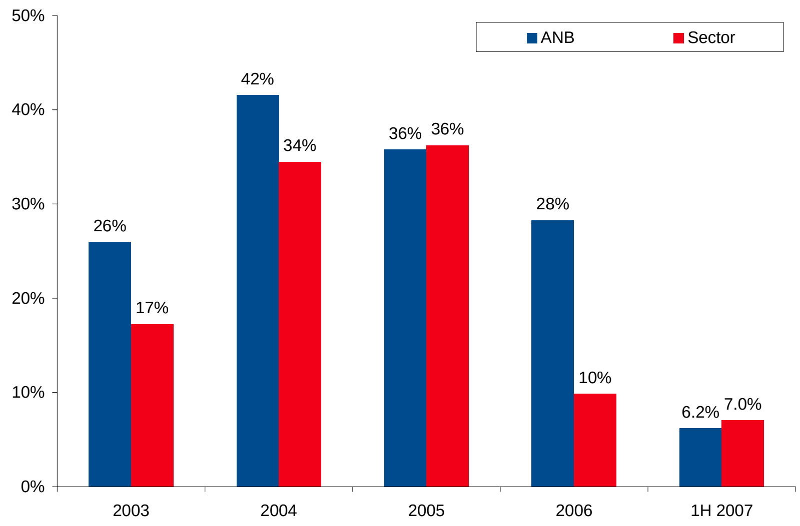
ANB has outperformed the Saudi sector in terms of balance sheet growth as well as earnings growth in the past few years. Going forward, we expect a continuation of this trend, though at narrowing differential growth rates, as ANB benefits from a proactive management with a strategy focused on long-term sustainable growth.

LENDING

ANB's net loans rose more rapidly than the sector's in the four years ending in 2006, logging a CAGR of 33% compared to a growth rate of 24% for the overall sector (Figure 14). Lending to all sectors witnessed vigorous growth, but none as much as personal lending, which nearly tripled in the two years ending in 2005, accounting for close to 54% of the total growth in net loans during that period. In 2006, with the restrictions imposed on personal lending, corporate lending (excluding overdrafts) witnessed a robust 40% growth.

Loans grew more rapidly at ANB than they did in the overall sector

Figure 14 Loan Growth: ANB versus Sector

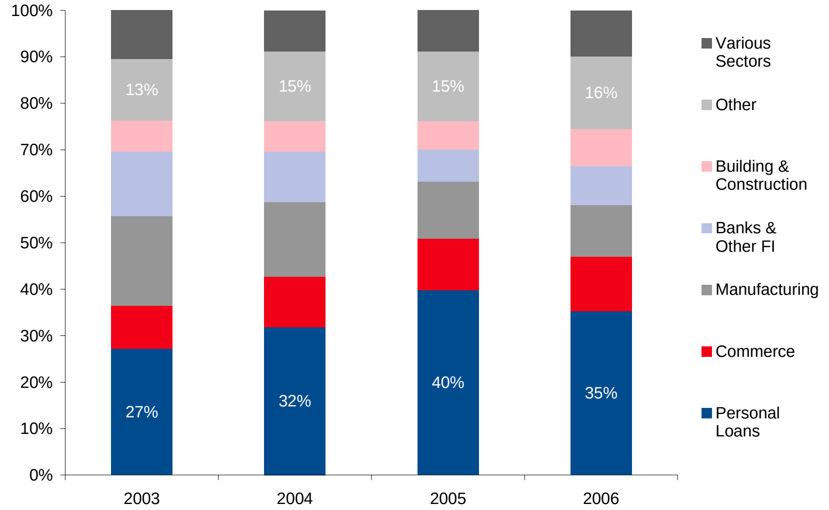


Sources: ANB's financial statements, SAMA, and MENA Equity Research

Figure 15 shows the breakdown of ANB's lending portfolio during the past four years. In line with the overall sector, ANB's portfolio was characterized by an increasing share of personal loans out of total loans in the years leading up to 2005, only to drop following SAMA's consumer-lending tightening regulations. Nevertheless, ANB managed to record a decent 13% growth in its personal loans in 2006 at a time when personal lending growth in the overall sector was almost nil. Soaring growth in the bank's credit card lending (+246% in 2006) partly explains this relatively strong growth in personal lending. It is worthwhile to note that margin lending is included in the "Other" category, which also includes loans to holding companies and conglomerates.

Personal loans represented 35% of the lending portfolio at the end of 2006, down from a record 40% one year earlier

Figure 15 Breakdown of ANB's Lending Portfolio

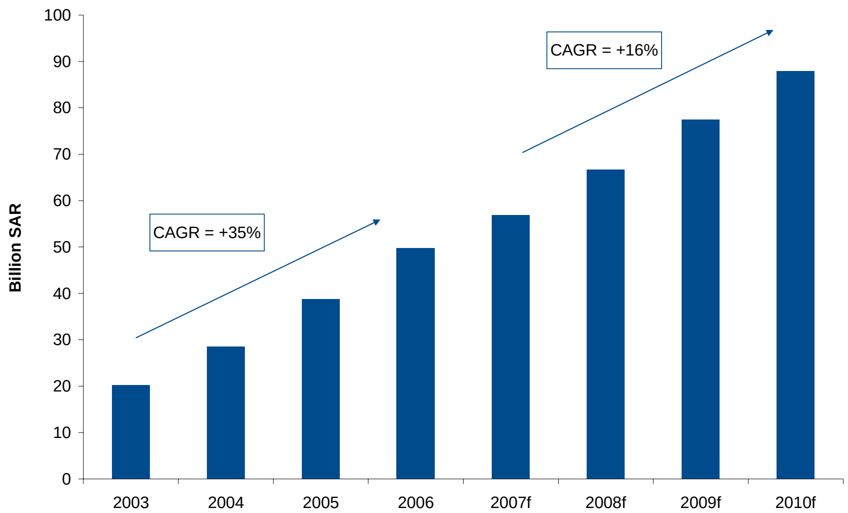


Sources: ANB's financial statements and MENA Equity Research

Going forward, we expect ANB to further outperform the sector in terms of personal lending, driven by its successful credit card business, the aggressive opening of new branches, and the bank's focus on transforming its branches into sales centers as opposed to transactional centers. In terms of corporate banking, ANB has outgrown its peers by a wide margin during the past year and a half, a discrepancy we believe is unsustainable in the long term. However, ANB will soon start reaping the rewards of its 40% stake in the new housing finance joint venture. We forecast ANB's total net loans to reach SAR 56.8 billion by the end of 2007 and to grow by a 16% CAGR in the three years ending in 2010 (Figure 16).

We forecast ANB's net loans to grow by a 16% CAGR in the three years ending in 2010

Figure 16 ANB's Net Loans



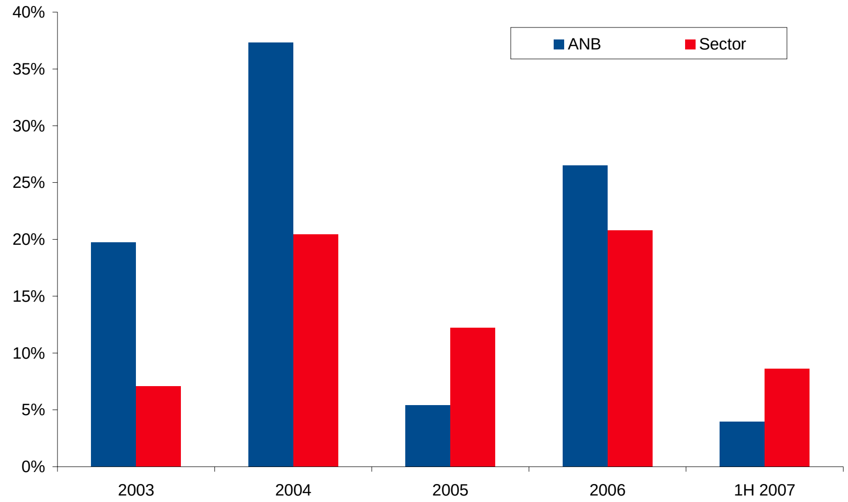
Sources: ANB's financial statements and MENA Equity Research

DEPOSIT ACCUMULATION

ANB succeeded in accumulating deposits faster than the overall growth rate of sector deposits in the past few years. While the CAGR of total sector deposits stood at 15% in the four years ending in 2006, ANB managed to log a CAGR of 22% during the same period (Figure 17).

ANB has underperformed the sector in deposit accumulation in the first half of this year after generally outperforming it in the years before

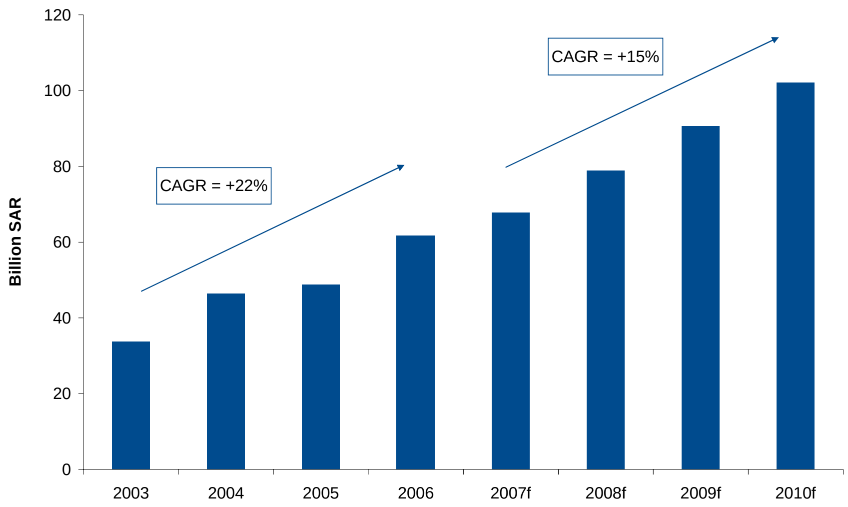
Figure 17 Deposit Growth: ANB versus Sector



Sources: ANB's financial statements, SAMA, and MENA Equity Research

Deposit growth at ANB lagged behind net loan growth in each of the past five years, driving up the loans-to-deposits ratio to 80.5% at the end of 2006, up from 53% five years earlier. Going forward, we expect a further slight increase in that ratio, as overall lending will grow slightly faster than deposit accumulation. In line with the trend in the Saudi sector, ANB's demand deposits (which are generally NIB, but not in their entirety) grew much slower than did other forms of deposits in the past few years. Demand deposits grew by a CAGR of 15% in the four years ending in 2006, versus a CAGR of 26% in time, saving, and other deposits. Nevertheless, to lessen the increase in funding costs, ANB is promoting NIB deposits at the expense of interest-bearing ones. This was felt in the first half of this year, when the growth in NIB deposits was faster than the growth in interest-bearing ones. The Saudi banking sector still has a high share of NIB deposits in overall deposits as compared with the other GCC banking sectors. We expect this differential to diminish in the long term, as Saudis are increasingly unwilling to earn a zero return on their funds (especially in this relatively high-interest-rate environment), even as banks prefer otherwise. We forecast ANB's total deposits to reach SAR 67.8 billion by the end of 2007 and to grow by a 15% CAGR in the three years ending in 2010 (Figure 18).

Figure 18 ANB's Deposits



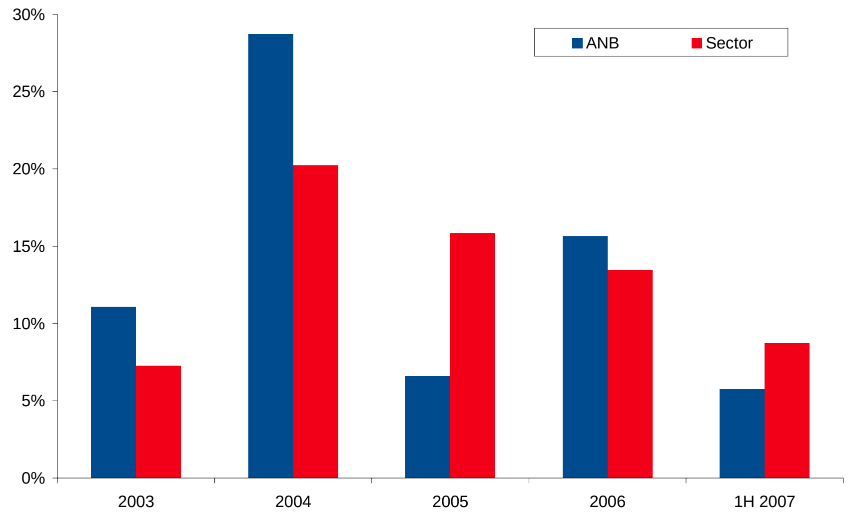
Sources: ANB's financial statements and MENA Equity Research

We forecast ANB's deposits to grow by a 15% CAGR in the three years ending in 2010

Total Balance Sheet Growth and Uses of Funds

In terms of total balance sheet growth, ANB slightly outgrew the overall sector, logging a 15.2% CAGR in the four years ending in 2006, compared to 14% for the sector as a whole (Figure 19).

Figure 19 Asset Growth: ANB versus Sector



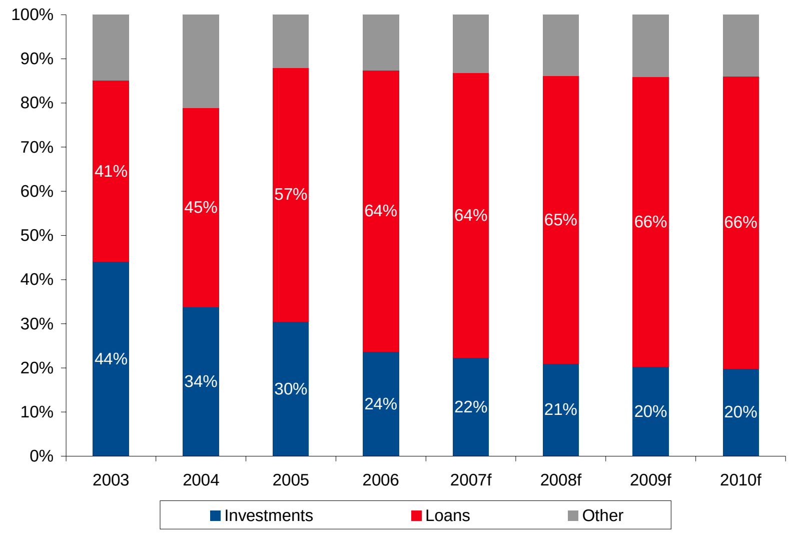
Sources: ANB's financial statements, SAMA, and MENA Equity Research

ANB slightly outgrew the sector in terms of total balance sheet growth

Investments are representing an increasingly smaller share of total assets for ANB as well as for most other banks in Saudi Arabia. Investments accounted for 44% of ANB's total assets in 2003, a share that steadily dropped to 24% by the end of 2006 (Figure 20). Robust growth in the lending portfolio was one reason for this.

Lending as a share of total assets increased, while investments' share decreased. Going forward, we expect the share of loans to further increase slightly before stabilizing

Figure 20 ANB's Asset Breakdown

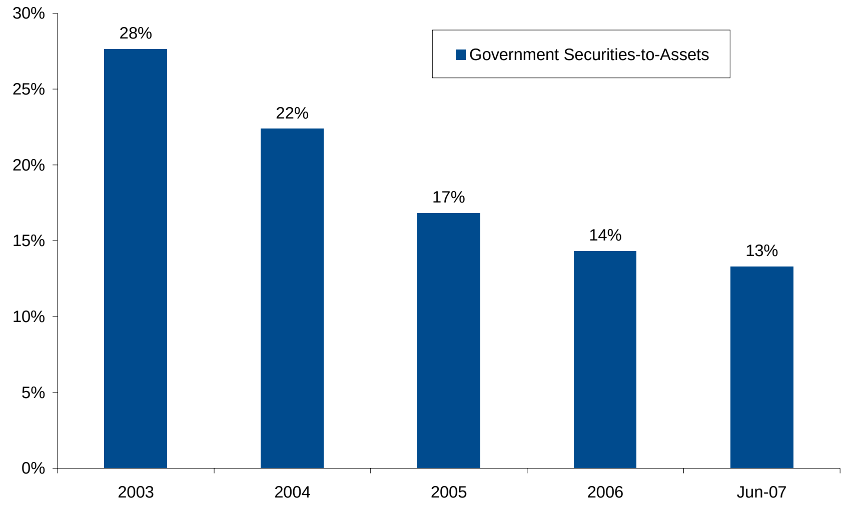


Sources: ANB's financial statements and MENA Equity Research

Another primary reason was the drop in Saudi government securities held by banks, due to fewer outstanding issues as the Saudi authorities reduce the size of the national debt. Total government securities held by commercial banks as a share of total bank assets has dropped rapidly, from 28% in 2003 to 13% by June 2007 (Figure 21).

The steady decrease in government securities as a share of total bank assets is expected to persist but at a slower pace than in previous years

Figure 21 Government Securities as a Share of Total Bank Assets



Sources: SAMA and MENA Equity Research

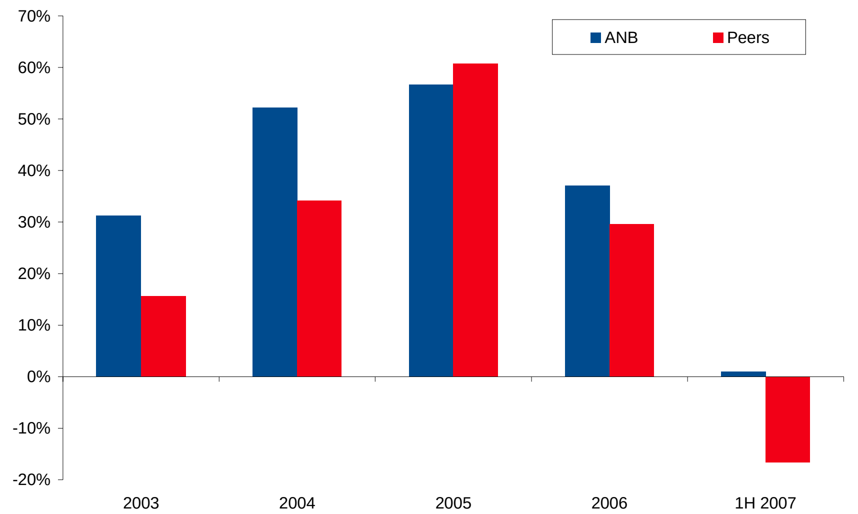
Going forward, we expect the quick drop in the investments' share of ANB's total assets to moderate and eventually stabilize, as Saudi government securities will increasingly be replaced by a diversified portfolio of international investment-grade fixed-income securities, structured products, equities, and hedge funds. We forecast ANB's lending portfolio to further increase as a share of total assets but not to exceed the 68% mark, given the degree of conservatism exhibited by ANB's management.

PROFITABILITY

In terms of net profit growth, ANB also outgrew its peers, achieving a strong 48% CAGR in the three years ending in 2006, compared to 41% for a sample comprised of the nine remaining Saudi banks, that is, all other Saudi banks with the exception of the relatively newcomer, Bank Al Bilad (Figure 22).

ANB outperformed its peers in terms of net profit growth and was one of only three Saudi banks that did not witness a decrease in net profit in the first half of this year

Figure 22 Net Profit Growth: ANB versus Peers

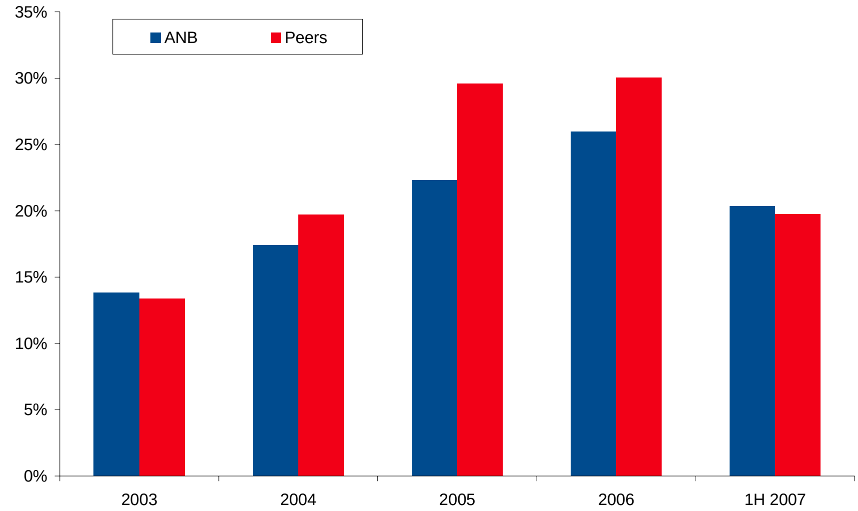


Sources: Banks' financial statements and MENA Equity Research

A closer look at ANB's earnings shows that the bank's total operating income grew at a CAGR of 26%, on par with the sample's growth, in the three years ending in 2006. This was on the back of a CAGR of 18.4% in net interest income, which was slightly ahead of the sample's 17.9%, and a CAGR of 56% in income from fees and commissions, which lagged behind the sample's 67%. In general, fees and commissions were less important sources of income for ANB than for other Saudi banks. Although ANB's income from fees and commissions represented a larger share of its total operating income in the years before 2007, rising from 14% in 2003 to 26% in 2006, that share rose from 13% to 30% for the overall sample during that time period (Figure 23). This was primarily due to ANB's lower level of brokerage commissions as a share of total fees as compared with its Saudi peers, which can be clearly seen in the results of the first half of this year, as the share of fees in total operating income dropped much less for ANB than it did for its peers. In addition, 38% of the increase in ANB's operating income between 2003 and 2006 was attributed to fees and commissions, while that share stood at 46% for ANB's peers.

Figure 23 Fees and Commissions as a Share of Total Operating Income

Fees and commissions as a share of total operating income were less volatile for ANB than they were for its peers, due to lower exposure to brokerage

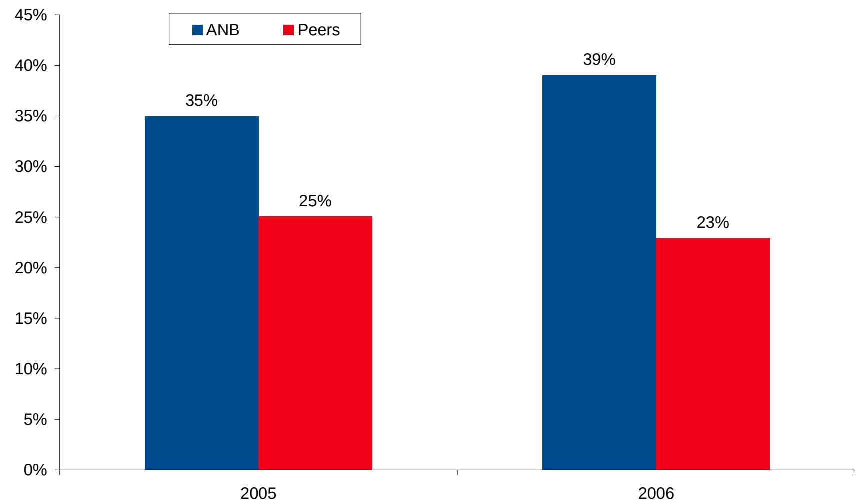


Sources: Banks' financial statements and MENA Equity Research

Fees and commissions can be broken down into two general categories: those derived from core banking operations and others related to the stock market, especially through brokerage. Brokerage commissions were a major income booster for Saudi banks in 2005 and 2006, as trading activity on Tadawul reached very high levels; however, these levels were unsustainable, as the earnings in the first half of this year clearly show. In contrast, fees from core banking services are potentially sustainable and can be recurring going forward. ANB enjoyed a larger share of core banking fees and commissions in its total fees and commissions, which stood at close to 35% and 39% in 2005 and 2006, respectively, as compared with the sample's 25% and 23% (Figure 24).

Figure 24 Fees from Core Banking Operations as a Share of Total Fees

ANB enjoyed a larger share of fees from core banking operations in total fees as compared with its peers



Sources: Banks' financial statements and MENA Equity Research

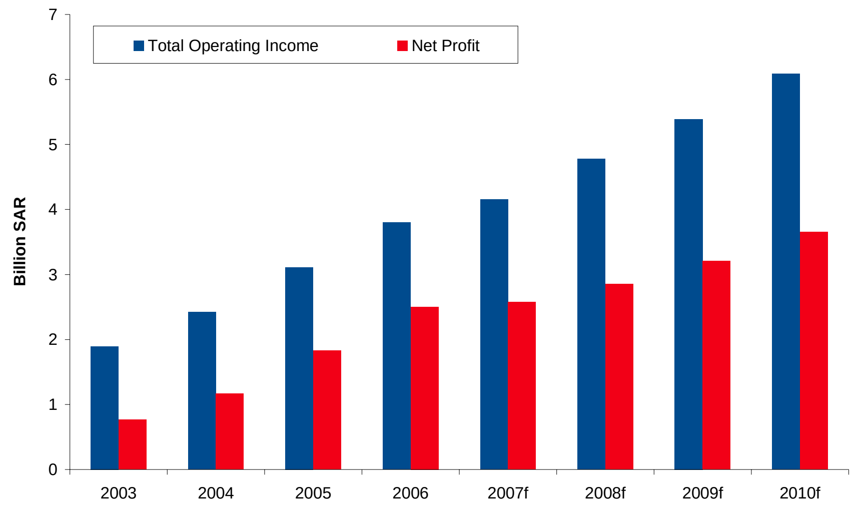
This was an outcome of a conscious policy by ANB's management to limit exposure to the stock market. That certainly dampened net profit growth when trading on Tadawul skyrocketed, but it also resulted in generally more sustainable earnings when this trading activity subsided after the first quarter of 2006. Earnings in the first half of this year are testimony to that, as ANB was one of only three Saudi banks that did not witness a decline in its earnings compared with the same period in 2006. The combined net profit of ANB's peers dropped by 17% during the first half of this year.

As for ANB's cost dynamics, the bank witnessed a CAGR of 16% in its costs in the three years ending in 2006, ahead of the sample's 13%. For our purposes here, costs were defined to include salaries and employee-related expenses, rent and premises-related expenses, depreciation, and other general and administrative expenses. Going forward, we expect costs to continue growing at high rates, especially driven by the opening of many new branches in the short to medium term. If ANB grew its operating income in line with that of its peers and suffered a slightly higher expansion in its costs, then how was the bank able to outperform its peers in terms of net profit growth? The answer lies in provisioning. ANB's credit loss charges, net of recoveries, stood at SAR 313 million in 2003 but dropped to SAR 60 million in 2006, while those of the sample increased slightly, from SAR 2,103 million to SAR 2,220 million. Assuming ANB's credit loss charges had increased by the same rate as that of the sample, the bank would have logged a 42.8% CAGR in its net profit, which is very much in line with that of its peers.

Going forward, we expect core banking operations to be the main driver of earnings. We do not forecast major jumps or falls in ANB's NIM, which has been rather stable in the past few years. Accordingly, we expect net interest income to grow by a 12% CAGR in the five years ending in 2012, to account for around 68% of total operating income during that year. In addition, we expect a healthy growth rate in income from fees and commissions derived from core banking operations. We forecast ANB's total operating income to grow by a CAGR of 14% in the three years ending in 2010, to reach SAR 6.1 billion, and its net profit to grow by 12%, reaching SAR 3.7 billion in 2010 (Figure 25).

We forecast ANB's total operating income and net profit to grow by a CAGR of 14% and 12%, respectively, in the three years ending in 2010

Figure 25 ANB's Total Operating Income and Net Profit

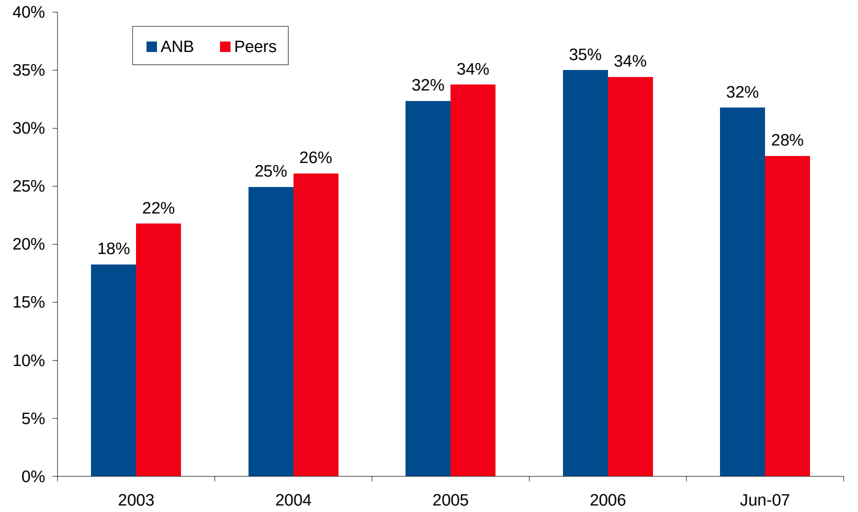


Sources: ANB's financial statements and MENA Equity Research

Although RoAE in the Saudi sector rose sharply in the past three years, ANB was able to log an even more rapid increase in its RoAE, nearly doubling it in the three years ending in 2006, which brought it more in line with the sector's average, and then further surpassing that average in the first half of 2007 (Figure 26). In a way, this was an outcome of management's policy of focusing on sustainable and risk-adjusted returns.

Coming from lower levels, ANB's RoAE steadily increased to surpass the weighted average RoAE of its peers starting in 2006

Figure 26 RoAE: ANB versus Peers

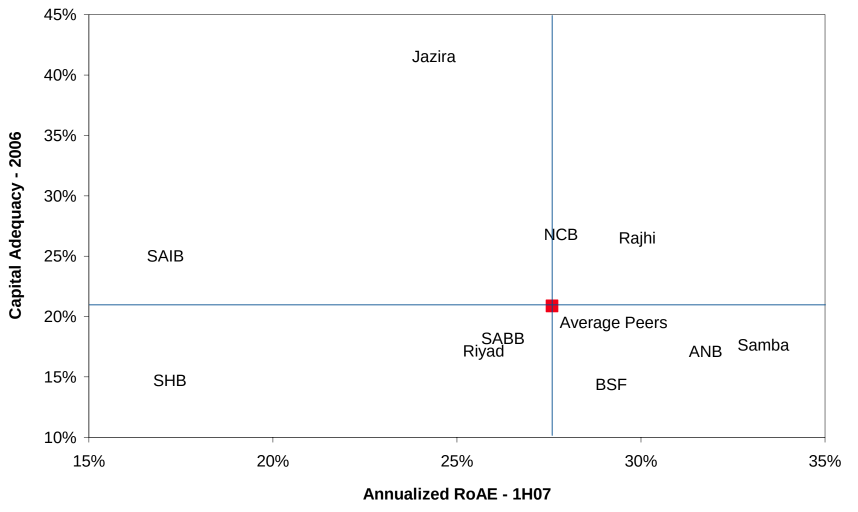


Sources: Banks' financial statements and MENA Equity Research

To incorporate risk, we plot the capital adequacy ratio for the sample of banks at the end of 2006, versus the RoAE in the first half of 2007. ANB's RoAE exceeded those of its peers, owing to its better earnings in addition to a more efficient use of capital, though at a higher risk level, if the capital adequacy ratio is used as an indication of that.

The higher RoAE for ANB is not on the back of excessive risk taken, although the bank's capital adequacy ratio is at the lower end of the spectrum

Figure 27 Capital Adequacy versus RoAE: ANB versus Peers



Sources: Banks' financial statements and MENA Equity Research

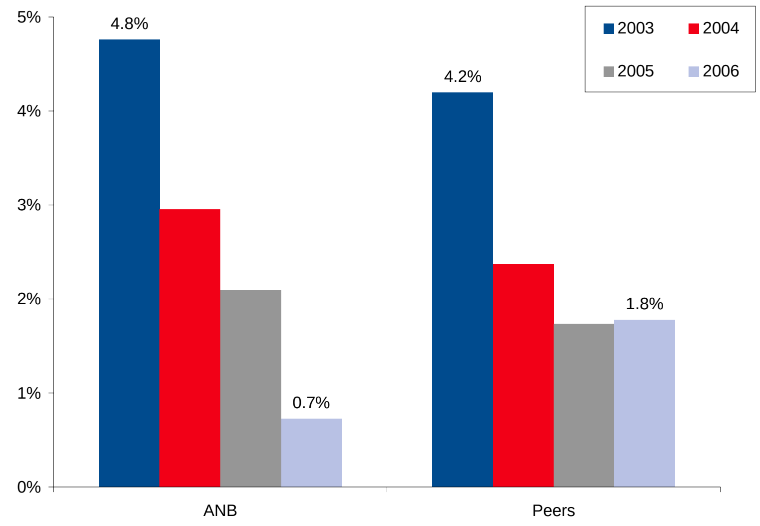
ANB has generally maintained a lower capital adequacy ratio as well as a lower shareholders' equity-to-assets ratio as compared with its peers in the past few years; albeit ratios that are well above alarming levels.

ASSET QUALITY

ANB's robust earnings growth was not at the expense of a worsening asset quality. While asset quality in the overall sector generally improved in the past few years (especially in 2004 and 2005), ANB's asset quality indicators improved vis-à-vis other Saudi banks. The sample's ratio of nonperforming loans (NPLs) to gross loans dropped from 4.2% in 2003 to 1.8% in 2006, but ANB's ratio dropped from 4.8% to 0.7% during the same period (Figure 28).

The NPLs-to-gross loans ratio dropped across the board, but more so for ANB

Figure 28 NPLs-to-Gross Loans Ratio: ANB versus Peers

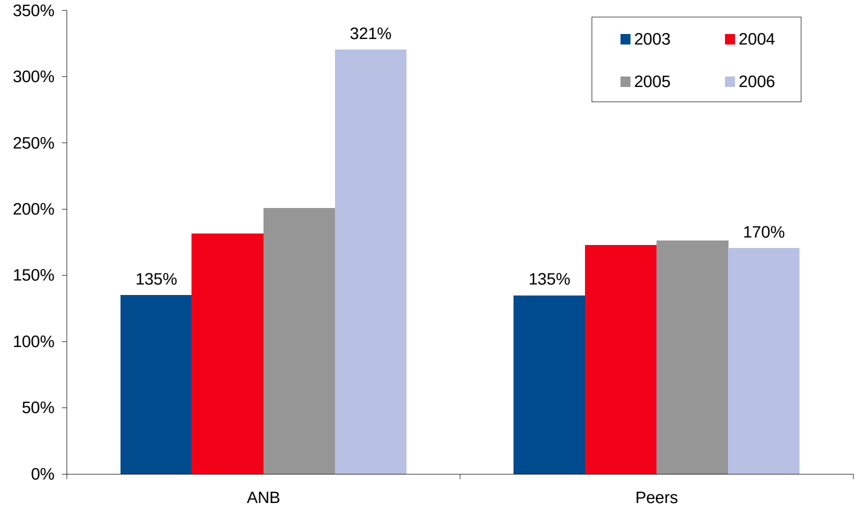


Sources: Banks' financial statements and MENA Equity Research

Similarly, the sample's NPL coverage ratio increased from 135% in 2003 to 170% in 2006, while ANB's ratio jumped from 135% to 321% (Figure 29). Nevertheless, one primary reason for ANB's rapidly improving asset quality indicators, and hence the bank's "outperformance" when it comes to asset quality, was significant write-offs, amounting to SAR 597 million, undertaken during 2006. Excluding those sizable write-offs, ANB's NPLs would have represented 1.9% of its gross loans in 2006, while the bank's coverage ratio would have stood at 184.4%. Going forward, we expect ANB to maintain a very favorable asset quality; however, we believe the NPL coverage ratio will drop from its current highs, as it is likely that slightly lower provisioning will be employed to enhance earnings. In all cases, excess provisions do reflect hidden value, as that excess renders the taking of lower provisions in the future a viable option.

ANB's NPL coverage ratio reached 321% at the end of 2006, nearly double the ratio for the bank's peers

Figure 29 NPL Coverage Ratio: ANB versus Peers



Sources: Banks' financial statements and MENA Equity Research

FINANCIAL STATEMENTS AND KEY RATIOS

Balance Sheet (SAR Thousands)		Historical				Forecast			
Fiscal Year Ends December	2004	2005	2006	2007	2008	2009	2010	2011	2012
ASSETS									
Cash and balances with SAMA	7,061,456	2,495,186	3,216,007	4,053,967	5,557,353	6,758,768	7,613,797	8,806,300	10,321,587
Due from Banks	4,731,873	3,933,675	4,633,337	5,113,954	5,998,096	6,943,544	7,859,938	8,874,922	9,997,911
Net Investments	21,379,365	20,581,515	18,446,685	19,611,930	21,504,415	23,839,079	26,365,163	28,778,917	31,064,643
Net Loans and Advances	28,557,967	38,778,556	49,747,224	56,798,759	66,709,878	77,405,023	87,914,340	99,604,240	112,590,461
Net Fixed Assets	382,415	418,108	586,251	798,669	911,268	981,617	1,059,914	1,147,131	1,244,366
Other Assets	1,211,967	1,285,039	1,405,879	1,732,182	1,966,341	2,235,438	2,505,997	2,813,484	3,157,461
TOTAL ASSETS	**63,325,043**	**67,492,079**	**78,035,383**	**88,109,462**	**102,647,351**	**118,163,469**	**133,319,149**	**150,024,994**	**168,376,429**
LIABILITIES & EQUITY									
Due to Banks	9,820,827	8,376,934	3,098,603	4,343,642	5,139,370	5,990,273	6,815,028	7,728,513	8,739,203
Customer Deposits	46,315,710	48,832,464	61,773,494	67,781,210	78,832,986	90,651,085	102,106,005	114,793,300	128,830,667
Other Purchased Funds	-	1,312,500	3,187,500	3,187,500	3,187,500	3,187,500	3,187,500	3,187,500	3,187,500
Other Liabilities	2,218,886	2,633,502	1,995,648	2,242,344	2,567,434	2,976,056	3,359,429	3,780,302	4,246,093
Total Liabilities	**58,355,423**	**61,155,400**	**70,055,245**	**77,554,696**	**89,727,291**	**102,804,914**	**115,467,962**	**129,489,615**	**145,003,463**
Total Shareholders' Equity	**4,969,620**	**6,336,679**	**7,980,138**	**10,554,766**	**12,920,060**	**15,358,555**	**17,851,188**	**20,535,379**	**23,372,966**
TOTAL LIABILITIES AND EQUITY	**63,325,043**	**67,492,079**	**78,035,383**	**88,109,462**	**102,647,351**	**118,163,469**	**133,319,149**	**150,024,994**	**168,376,429**

Income Statement (SAR Thousands)		Historical				Forecast			
Fiscal Year Ends December	2004	2005	2006	2007	2008	2009	2010	2011	2012
Special Commission Income	2,456,310	3,445,180	4,659,311	5,275,345	5,929,142	6,740,351	7,576,986	8,549,680	9,645,637
Special Commission Expense	(570,032)	(1,256,051)	(2,134,354)	(2,297,038)	(2,530,717)	(2,992,581)	(3,396,142)	(3,830,101)	(4,310,699)
Net Special Commission Income *	**1,886,278**	**2,189,129**	**2,524,957**	**2,978,307**	**3,398,424**	**3,747,769**	**4,180,844**	**4,719,579**	**5,334,938**
Income from Fees and Commissions	422,207	693,915	986,501	759,557	939,138	1,098,782	1,260,062	1,463,052	1,685,074
Other Operating Income	115,674	229,376	290,194	417,523	439,271	545,894	647,750	730,590	788,282
Total Operating Income	**2,424,159**	**3,112,420**	**3,801,652**	**4,155,387**	**4,776,833**	**5,392,445**	**6,088,656**	**6,913,221**	**7,808,293**
Provisions for Credit Losses	(317,587)	(220,539)	(60,354)	(79,710)	(206,166)	(222,475)	(218,609)	(243,167)	(270,132)
Salaries and Employee Related Expenses	(568,857)	(657,689)	(770,468)	(862,686)	(926,258)	(1,033,633)	(1,168,702)	(1,323,378)	(1,497,969)
General and Administrative Expenses	(304,242)	(313,485)	(412,443)	(532,178)	(670,653)	(790,679)	(892,651)	(987,440)	(1,081,916)
Depreciation	(60,065)	(75,544)	(84,107)	(105,109)	(125,547)	(143,036)	(161,631)	(182,643)	(206,387)
Other Operating Expenses	(6,545)	(18,750)	-	(18,456)	(13,707)	(15,963)	(14,818)	(10,531)	(4,517)
Total Operating Expenses	**(1,257,296)**	**(1,286,007)**	**(1,327,372)**	**(1,598,139)**	**(1,942,331)**	**(2,205,787)**	**(2,456,410)**	**(2,747,159)**	**(3,060,922)**
Net Operating Profit	**1,166,863**	**1,826,413**	**2,474,280**	**2,557,248**	**2,834,503**	**3,186,659**	**3,632,245**	**4,166,061**	**4,747,372**
Other Income / (Expenses)	(62)	1,219	30,445	17,380	19,971	22,544	25,457	28,908	32,654
Income Taxes	-	-	-	-	-	-	-	-	-
Net Profit	**1,166,801**	**1,827,632**	**2,504,725**	**2,574,628**	**2,854,474**	**3,209,203**	**3,657,702**	**4,194,969**	**4,780,025**

Key Ratios		Historical				Forecast			
Fiscal Year Ends December	2004	2005	2006	2007	2008	2009	2010	2011	2012
Growth in Loans	41.6%	35.8%	28.3%	14.2%	17.4%	16.0%	13.6%	13.3%	13.0%
Growth in Deposits	37.3%	5.4%	26.5%	9.7%	16.3%	15.0%	12.6%	12.4%	12.2%
Growth in Net Profit	52.2%	56.6%	37.0%	2.8%	10.9%	12.4%	14.0%	14.7%	13.9%
Growth in Operating Income	27.8%	28.4%	22.1%	9.3%	15.0%	12.9%	12.9%	13.5%	12.9%
Loans-to-Assets	45.1%	57.5%	63.7%	64.5%	65.0%	65.5%	65.9%	66.4%	66.9%
Loans-to-Deposits	61.7%	79.4%	80.5%	83.8%	84.6%	85.4%	86.1%	86.8%	87.4%
NPLs-to-Gross Loans	3.0%	2.1%	0.7%	0.8%	0.9%	1.0%	1.1%	1.2%	1.3%
NPL Coverage	181.7%	200.6%	320.5%	263.7%	233.0%	208.7%	189.1%	172.8%	159.0%
Capital Adequacy	15.9%	15.8%	17.1%	18.3%	18.4%	18.3%	18.4%	18.5%	18.5%
Growth in Non Interest Expense	11.2%	2.3%	3.2%	20.4%	21.5%	13.6%	11.4%	11.8%	11.4%
Non Interest Expense-to-Average Assets	2.2%	2.0%	1.8%	1.9%	2.0%	2.0%	2.0%	1.9%	1.9%
Cost-to-Income	38.5%	33.6%	33.3%	36.1%	36.1%	36.5%	36.5%	36.1%	35.7%
Non Interest Income-to-Operating Income	22.2%	29.7%	33.6%	28.3%	28.9%	30.5%	31.3%	31.7%	31.7%
Dividend Payout	33.4%	30.0%	15.5%	19.0%	27.0%	36.3%	41.3%	46.3%	51.3%
Net Interest Margin	3.6%	3.6%	3.8%	4.0%	4.1%	3.9%	3.9%	3.9%	3.9%
Net Interest Spread	3.0%	2.5%	2.1%	2.3%	2.4%	2.2%	2.2%	2.2%	2.2%
RoAE	24.9%	32.3%	35.0%	27.8%	24.3%	22.7%	22.0%	21.9%	21.8%
RoAA	2.1%	2.8%	3.4%	3.1%	3.0%	2.9%	2.9%	3.0%	3.0%

*Sources: ANB's financial statements and MENA Equity Research * Equiv. to Net Interest Income*

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