AK Securities

Highlights on Turkish Banking Sector

Including Comments on Isbank, Garanti and TEB

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1. **Strong m&a activity carried the multiples to a higher stage.** With the tightening of margins and diminished local growth prospects, European Banks started looking for growth opportunities in emerging countries. Turkey is one of the primary target markets in that respect. Rising interest towards Turkish Banks fetched a re-rating and the average P/B multiple of the banks in our coverage exceeded 2.0x levels from below 1.0x of last year.
2. **Switch to TL denominated retail loans keep the margins stable.** The real interest rate on benchmark g-bond slipped down from 19% at the end of 1H04 to 11% at the end of 1H05. However, almost all of the banks in our coverage increased their margins or kept them stable. The margin contractions in a few players are insignificant to mention. Banks displayed this better-than-anticipated operational performance by growing through high margin consumer loans (including credit cards). Share of consumer loans in total lending is 34% that climbed from 28% a year ago. House loans that expand through a monthly CAGR of a huge 15% YtD is the main driver of the growth. As the consumer loans are fixed rate and long term with maturities up to 25 years, spreads will further widen in the following years as deposits (with average maturity of 3 months) are constantly repriced through lower rates.
3. **Credit Card Loans Would Cause Asset Quality Problems.** NPL ratio of core consumer loans is outstanding at 0.65% (0.68% at 04-end). However, the NPL ratio of credit card loans, that constitute 14% of the lending, is 7% that rose from 4% at the end of 2004. The ratio would hike up to 16% at the end of 2006, if the worsening keeps its current trend. Around 70% of credit card receivables earn an average of a tremendous 80% real return per annum. The leading players in credit card business such as YKB and Garanti, which we praised the line of attack in a growing economy, may face significant asset quality problems if the worsening in NPLs keeps its current trend.
4. **Deposit Growth is Still Meager**. As the high withholding tax burden of 18% from the interest earned on TL denominated loans and 24% withholding tax on interest earned on FX deposits still persist (whereas higher interests on g-bonds are tax free for individuals), the banks incline towards foreign borrowings on the funding side. YtD loan growth of the sector is 22% as of July 22, 2005 whereas deposits expanded by just 8% during the same period. However, as the withholding tax burden across the board on returns of all kinds of instruments including bonds and deposits will be 15% starting from 2006, the share of deposits would definitely rise leading to less currency mismatch problems and stronger balance sheet growth.
5. **Lower Loan Growth, Higher Deposit Growth Projected for 2006**. We expect the loans to expand by 44% and 32% respectively for 2005 and 2006 in nominal TL terms, whereas our growth forecast for deposits for the same two years are 22% and 30%, respectively.

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ISBANK - Market Outperformer / Target Value US$13.27bn / 18% Upside Potential

Our top pick throughout the large-cap banks is Isbank. The Bank eagerly divests its non core assets one after another. Isbank sold a total of US$122mn of non-core assets and booked a total of US$58mn profit out of those transactions YtD. The Bank's free capital rose from a US$140mn deficit at 1H04-end to a surplus of US$1bn at 1H05-end. Isbank has a gross property and equipment book of US$3.6bn. We estimate the non core real estate book as US$2.5bn. The real estate craze that caused a more than 50% rise in prices creates the space Isbank needs to divest those non-core assets. That would supply the required TL funds in the form of cost-free cash capital to finance the booming long term TL consumer loan demand. Through maintaining this strategy, the Bank managed to keep its net interest margin at 9% which is the highest figure throughout the Banks that announced 1H05 financials. The cost of TL deposits at 12% which is the lowest level in the sector also supports the operating profitability.

GARANTI BANK - Market Performer / Target Value US$5.44bn / 2% Downside Potential

M&A story caused a 50% YtD rise in Mcap and the Bank outperformed the ISE-100 index by 21%. Reportedly, ABN Amro Societe Generale, Deutsche Bank, General Electric and Temasek Holding are interested in stake sale of Garanti Bank. We hear from the media that Dogus Group prefers to sell a minority stake in the Bank and keep the administrative rights. Besides this issue, the Group also committed to remove the Bank's 24% Tansas stake until the end of October 2005. ABN Amro has the mandate to sell this stake that has a US$110mn market value. Reportedly, interested parties include Migros, French Casino (which had talks with Dogus Group regarding the acquisition of Tansas in 2001), and British Tesco. The two most noteworthy competitive advantages of Garanti are its strength in alternative distribution channels that account for 71% of the transactions and its strength in credit cards. 23% of its loans are to credit cards whereas its market share in credit card spending volume is 20.5%, the highest following YKB's 23.1% market share in 2Q05.

TEB - Market Outperformer / Target Value US$728mn / 15% Upside Potential

In late 2004, Colakoglu family sold half of TEB Financial Services that owns 84.25% of TEB to BNP Paribas through a 2.05x P/B. BNP Paribas started converting TEB into a retail Bank from a corporate one that has a core market of low margin export financing. Retail loans made up a mere 6% of total loans at the end of 1Q05. By March-end, TEB pulled down the interest rates on all types of consumer loans to the lowest range in the market and increased the share of retail lending in loans to 8.2% at the end of 1H05. TEB targets to increase their share to 33% in the next 3-5 years. The Bank plans to bring BNP Paribas' mortgage expert affiliate UCB to Turkey following the enactment of the mortgage act possibly in late 2005. Being an overly conservative Bank with 45% of assets in cash items with no positive return was holding the Bank's margins at a low level a year ago. The Bank pulled down the core liquidity ratio to 27.5% at the end of 1H05 and also increased the share of loans in assets to 52% (56% in TL) from 41% a year ago (48.5% in TL). We expect the Bank to increase its ROE from 17% (monetary loss adjusted) in 2004 to 20% in 2005.