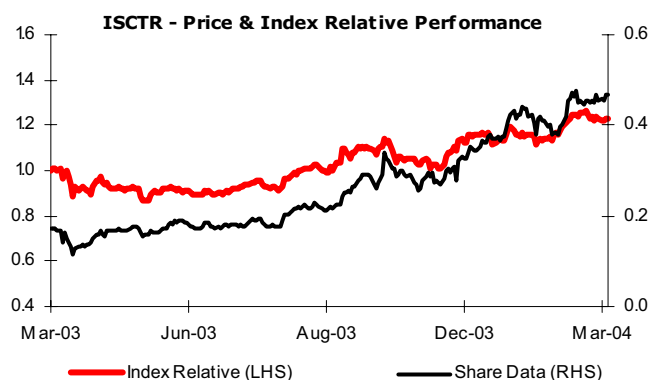


## ISBANK Banking Sector

## Market Outperformer

- The most appealing issue concerning Isbank is its determination to return to core banking activities through non-core asset divestures. The free capital to assets ratio that had stood at -10% in 2001, gradually improved to a positive 1% at the end of 2003.
- The Bank has more than 1,000 separate pieces of real estate that could be sold for an estimated US\$150mn. We expect the bulk of these divestures to take place in 2004. Two participations in the pipeline for sale in 2004 are the long steel producer Izmir Demir Celik and patterned flat glass producer Cayirova Cam.
- The long-awaited merger of Isbank Group's Aria and Turk Telekom's Aycell is complete. Isbank Group has a 20% stake in the new company (TTT). The market share of the merged company is 14% with the entire country under coverage. TTT targets surpassing Telsim, which has a 25% market share.
- Another major issue is the rise in asset quality, which had also pulled down the bottom-line in the last two quarters of 2003. Isbank increased the provision coverage from 44% to 72% in the third quarter, setting aside 100% NPL provisions in the final quarter.
- The Bank is in negotiations to restructure about half of the US\$825mn fully provisioned problematic receivables. We expect a strong rise in the Bank's 2004 net profit due to hefty provision reversals.
- Isbank Group's restructuring aimed at boosting efficiency and creating shareholder value is likely to be concluded in the following one year. The plan will be finalized following the enactment of the new Banks Act.
- Taking into consideration the Bank's dedication to divesting non-core assets, its increased asset quality, potential provision reversal, upcoming 'restructuring of the Group' backed efficiency rise and the 15% upside to our fair value target of US\$7,647mn, we reiterate our 'Market Outperformer' rating for Isbank.

<b>Price (TL / US¢)</b>	6,150 / 0.47
<b>Price Range (1 Year, TL/US¢)</b>	2,017 / 0.12 - 6,200 / 0.48
<b>Number of Shares (mn)</b>	1,426,694
<b>Market Cap. (US\$mn)</b>	6,668
<b>Free Float</b>	28%
<b>Daily Vol. (3 Month, US\$mn)</b>	42.8
<b>Ticker (Reuters, Bloomberg)</b>	ISCTR.IS, ISCTR.TI



PERFORMANCE	1 Week	1 Month	3 Month	1 Year
<b>US\$</b>	%3.1	%11.4	%32.3	%175.3
<b>Index Relative</b>	%1.4	%2.1	%6.5	%22.9

### SUMMARY FORECASTS (Inf. Adj. Unconsolidated BRSA, US\$mn) & VALUATION

	2002A	2003A	2004F	2005F
<b>Assets</b>	19,641	22,254	26,103	29,575
<b>Sh. Equity</b>	3,515	4,016	4,697	5,366
<b>Net Profit</b>	257	303	480	576
<b>ROE</b>	7.3%	8.1%	11.0%	11.4%
<b>P/B</b>	1.9	1.7	1.4	1.2
<b>P/E</b>	25.9	22.0	13.9	11.6

### SHAREHOLDING STRUCTURE

Isbank Pension Fund	43.49%
CHP	28.09%
Float	28.42%

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## I. INVESTMENT THEME

**The most appealing issue concerning Isbank is its determination to return to core banking activities through non-core asset divestures.** The key indicator of this metamorphosis is free capital, which shifted into positive territory following long years in the red. The free capital to assets ratio that had stood at -10% in 2001, gradually improved to a positive 1% at the end of 2003. We estimate the Bank's current US\$186mn free capital, to climb to US\$300mn (1.15% of assets) by the end of this year.

**The Bank has more than 1,000 separate pieces of real estate that could be sold for an estimated US\$150mn.** We expect the bulk of these divestures to take place in 2004. Two participations in the pipeline for sale in 2004 are the long steel producer Izmir Demir Celik and patterned flat glass producer Cayirova Cam. Isbank has received 4 bids for IDC. We expect Isbank to liquidate its 57% stake in IDC for US\$45mn in the first half of 2004.

**The long-awaited merger of Isbank Group's Aria and Turk Telekom-owned Aycell is complete.** Isbank group has a 20% stake in the new company (TTT). Aria has 2.2 million and Aycell 2 million subscribers. Therefore, the market share of the merged company is 14% with the entire country under coverage. TTT targets surpassing Telsim, which has a 25% market share, and becoming the second largest domestic operator within the upcoming six months. Both Aria and Aycell brands will be preserved, while Aria will focus on retail and Aycell on corporate clients. We estimate the new establishment's value to Isbank Group at US\$100mn rather than the US\$752mn stated in the Bank's books.

**Another major issue concerning the Bank is the rise in asset quality, which had also pulled down the bottom-line in the last two quarters of 2003.** Isbank increased the provision coverage from 44% to 72% in the third quarter, setting aside 100% NPL provisions in the final quarter. The NPL ratio also healed gradually throughout 2003 from 15% to 11%. The Bank is in negotiations to restructure about half of the US\$825mn fully provisioned problematic receivables. We expect a strong rise in the Bank's 2004 net profit due to hefty provision reversals.

**Isbank Group's restructuring aimed at boosting efficiency and creating shareholder value is likely to be concluded this year.** The plan will be finalized following the enactment of the new Banks Act probably in the second half of this year. After the completion of the restructuring, the Group will be divided into two parts; the financial and industrial divisions. The non-financial affiliates will be transferred to the industrial holding, whereas the financial ones will either remain under Isbank or else be sold to the financial holding company.

**Taking into consideration the Bank's dedication to divesting non-core assets, its increased asset quality, potential provision reversal, upcoming restructuring of the Group-backed efficiency rise and the 15% upside to our fair value target of US\$7,647mn, we reiterate our 'Market Outperformer' rating for Isbank.**

## II. PAST PERFORMANCE & FUTURE PLANS

### Benefiting from Economic Recovery

*The most appealing issue surrounding the Bank is its determination to return to core banking activities*

The most appealing issue surrounding the Bank is its determination to return to core banking activities through non-core asset divestitures. The key indicator of this metamorphosis is free capital, which shifted into positive territory after long years in the red. The free capital to assets ratio that had stood at -10% in 2001, gradually improved to a positive 1% at the end of 2003. We estimate the Bank's current US\$186mn free capital climbing to US\$300mn by the end of this year.

The primary outcome of having positive free capital is increased interest margins, which is extremely important in a declining real interest rate environment. A negative free capital basically means that a Bank is allocating interest bearing funds such as deposits into frozen assets such as real estate, net NPLs or subsidiaries. A supplementary positive outcome of having positive free capital is lower SDIF deposit insurance premiums. The Banks with positive cash capital pay (1/10,000)\*Savings Deposits less premium to the Fund per quarter.

Date	Divested Asset	Cash (US\$mn)	Profit&Sh.Equity (US\$mn)
15-Jan-03	Real Estate	0.57	0.04
24-Jan-03	Real Estate	0.29	0.07
31-Jan-03	Participation	3.38	1.54
7-Feb-03	Real Estate	0.57	0.37
25-Feb-03	Real Estate	0.07	0.02
27-Feb-03	Participation	3.33	1.59
13-Mar-03	Real Estate	0.20	0.13
May-03	Real Estate	28.00	8.00
23-Jun-03	Participation	15.83	4.16
27-Jun-03	Participation	2.00	1.19
27-Jun-03	Participation	48.93	33.27
18-Aug-03	Participation	1.32	1.25
20-Aug-03	Participation	47.23	24.17
24-Oct-03	Participation	0.03	0.00
2-Dec-03	Participation	23.86	0.00
4Q03	Real Estate	22.00	7.00
<b>Total 2003</b>		<b>198</b>	<b>83</b>

*Isbank raised about US\$200mn from real estate and participation sales and booked US\$83mn profit*

Last year, Isbank raised about US\$200mn from real estate and participation sales and booked US\$83mn profit, which ultimately supported the capital equity. Isbank sold the remaining glass-related participations, such as Soda Sanayi and Camis Packaging, to Sisecam. Only one very small glass producer named Cayirova Cam remains to be liquidated in return for an estimated US\$5mn. The Bank also divested 200 staff lodgings for US\$22mn and booked a US\$7mn profit from the operation in 4Q03.

Isbank has more than 1,000 separate items of real estate that could be sold for an estimated US\$150mn. We expect the bulk of those divestitures to take place in 2004. Two participations in the pipeline for sale in 2004 are the long steel producer Izmir Demir Celik (IDC) and the above-mentioned patterned flat glass producer Cayirova Cam. Isbank has received 4 bids for IDC. We expect Isbank to liquidate its 57% stake in IDC for US\$45mn in the first half of 2004.

As the economy continues its recovery, Isbank will succeed in locating interested parties for the remaining industrial participations such as the 26% stake in Pirelli tires and the 49% stake in Celikkord. This said, we do not expect to witness these liquidations in 2004. It is worth noting that there is also foreign direct investment interest in glass manufacturers, although no serious developments have registered thus far.

*Isbank group has a 20% stake in the Aria-Aycell merged company*

#### The Aria-Aycell Merger

Isbank Group's 51% affiliate Aria (İş-Tim) and Turk Telekom-owned Aycell's long awaited merger is concluded. Isbank group has a 20% stake in the Aria-Aycell merged company called TT&TIM (Turk Telekom and Telecom Italy or TTT). The remaining shares are separated equally between Turk Telekom and TIM. Aria and Aycell have 2.2 million and 2 million subscribers at the end of 2003, respectively. Therefore the market share of the merged company is 14% with the entire country under coverage. TTT targets surpassing Telsim, which has a 25% market share, and becoming the second largest domestic operator within the coming six months. Both Aria and Aycell brands are preserved, while Aria focuses on retail and Aycell on corporate clients.

We value Isbank's stake in TTT at a much lower level than the total capital contribution of the Bank. On top of the Bank's initial capital injection of US\$400mn, an additional contribution of US\$380mn is made through converting the receivable from Aria to capital (only US\$50mn Isbank loan left in TTT). Taking into account Turkcell's EV, the number of subscribers and after applying a 25% haircut due to lower usage fees, we believe that TTT deserves a US\$1.3bn EV. Aria has a net debt position of roughly US\$800mn and Aycell's debt will be entirely wiped by Turk Telekom before the merger. Therefore, we calculate the fair value of TTT at US\$500mn. This brings the value to Isbank Group to US\$100mn, rather than the US\$780mn stated in the Bank's books.

*We have given TTT a US\$680mn haircut*

Therefore, we have given TTT a US\$680mn haircut. The direct haircut on bank-only Isbank, which holds 15% of TTT, corresponds to US\$510mn. We would reconsider the valuation of TTT after thoroughly analyzing the strategies and the increase in subscriber base in the following months. Unfortunately, we cannot for now obtain any solid financial data either on Aria or on Aycell with which to deepen our analysis.

#### Shareholder Structure of TTT

	Stake TLtrln	Stake %
Isbank	986	14.87%
Trakya Yatirim Holding	230	3.46%
Efes Holding	57	0.87%
Sise Cam	46	0.69%
Anadolu Sigorta	5	0.07%
Anadolu Hayat	2	0.04%
<b>Isbank Group</b>	<b>1,326</b>	<b>20.00%</b>
Turk Telekom	2,651	40.00%
TIM	2,651	40.00%
<b>TTT Total</b>	<b>6,628</b>	<b>100.00%</b>

*Source: The Company*

Although the US\$380mn loan to Aria that was converted to capital appears to be a negative for Isbank, the situation is not as bad as it seems. Instead of collecting the whole interest income from Aria every six months, Isbank used to make a partial collection and add the remainder of the interest on top of the principle. However, it is obvious that the Bank will no longer be booking the estimated US\$18mn interest income accruals from that particular loan. Isbank announced that it is not planning to join any TTT capital increases, since it has already lost the majority stake in the Company.

*Another major issue concerning the Bank is the expected rise in asset quality that also pulled down the bottom-line in the last two quarters of 2003*

**Asset Quality Enhancement to Boost Future Returns**

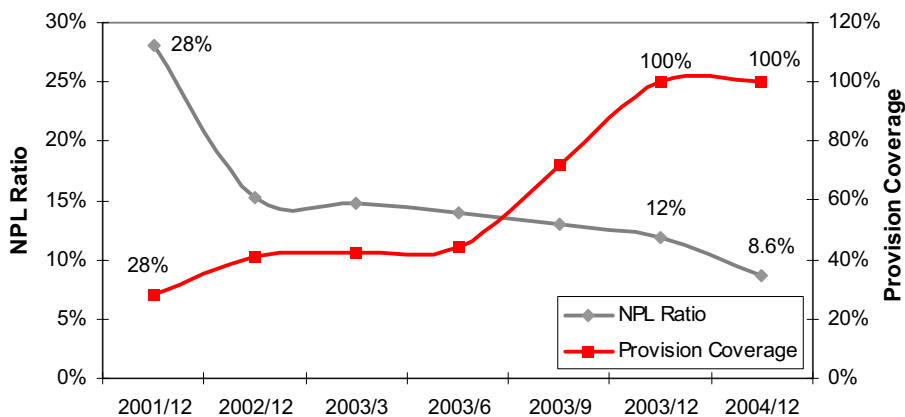
Another major issue concerning the Bank is the expected rise in asset quality that also pulled down the bottom-line in the last two quarters of 2003. Isbank increased the provision coverage from 44% to 72% in the third quarter, setting aside 100% NPL provisions in the final quarter. The NPL ratio also healed gradually throughout 2003 from 15% to 11%.

The provision expenses had a US\$177mn negative effect on the P/L. The discretionary reserve reversals also limited the negative effects of provisioning. The Bank used US\$50mn of the US\$86mn discretionary reserves as NPL provisions, booking the remainder as 'other provisions'. A further enhancement to the NPL ratio is likely, as the Bank is in negotiations to restructure about half of its US\$825mn fully provisioned problematic receivables. We expect 35% of the loans-under-follow-up to be restructured within this year. We expect a strong rise in the Bank's 2004 net profit due to hefty provision reversals.

*Banks are obliged to follow the restructured problematic loans in the NPL accounts for 6 months before reversing the provisions*

Banks are obliged to follow the restructured problematic loans in the NPL accounts for 6 months before reversing the provisions. Therefore, we would probably see the major effects of provision reversals on the P/L in the second half of this year. However, as we have observed in YKB's restructuring case; those provisions could even be reversed right after the restructuring agreements are signed, when certain legal procedures are fulfilled at the beginning of negotiations. Aside from the restructuring-backed reversals, the problematic loan collections-backed reversals would also contribute to the profitability to a lesser extent. We expect the provision reversals to add momentum to the stock and increase investor interest in Isbank shares throughout the following quarters.

**Improving Asset Quality of Isbank**



Source: Bank Financials

### **The Long-Awaited Restructuring is on its Way**

We have been talking about Isbank group's restructuring aimed at boosting efficiency and creating shareholder value for quite some time now. The non-core asset divestures we have seen over the past few years were a part of that strategy. Following a brainstorming period, the Bank's number of possible alternative restructuring plans has been reduced from 12 to 5.

*The Group will most likely be divided into two parts; the financial and the industrial divisions*

Upon completion of the restructuring, the Group will most likely be divided into two parts; the financial and the industrial divisions. The non-financial affiliates will be transferred to the industrial holding, whereas the financial ones will either remain under Isbank or else be sold to the financial holding company.

The plan is projected to be finalized following the enactment of the new Banks Act prepared by the BRSA and currently under preview by the Banks Association of Turkey (BAT). Major players in the sector expect the proposal to pass through Parliament in the second half of this year. The upcoming changes in the Banks Act were arranged under the leadership of Engin Akcakoca, the former head of the BRSA. The changes provide the guidelines to the formation of financial holdings and the limitations of bank ownership by media groups, political parties and pension funds. Owned by a political party (CHP) and by its own pension fund, Isbank, which is planning to establish a financial holding, will be one of the most sensitive banks to these changes.

*In the proposed Banks Act, the political parties, media groups and pension funds can neither directly nor indirectly hold bank shares*

In the proposed Banks Act, the political parties, media groups and pension funds can neither directly nor indirectly hold bank shares. This scheme is very harsh, placing many bank owners in the extremely delicate situation of liquidating their stock holdings, possibly within a very limited timeframe. We do not believe this change can take effect the way it stands. The State Minister also announced that the changes would not affect the existing shareholding status of the banks.

Another major change proposed in the draft Banks Act is that the financial holding companies and the banks be unable to hold the shares of non-financial companies that are not related to the core business. Accordingly, banks may only hold stakes in companies providing support services (i.e.: IT), or else less than 5% of its capital base worth of non financial company stakes for trading purposes. The maximum holding period of those trading securities is limited to 6 months. Through transferring its non-financial affiliates to the industrial holding to be established, Isbank is able to overcome this problem. The Group also plans the IPOs of the potential holding companies as well as the SPOs of certain participations following its restructuring.

Consequently, we expect the Bank to finalize its reorganization within a short period of time after the enactment of the new bank legislation. The law may be enacted around fall 2004, and the restructuring of the Group may take place in 2005, latest.

### III. VALUATION

*Our major tool in bank valuation is the warranted equity method*

Our major tool in bank valuation is the warranted equity method. Rather than simply adding up the hidden value of the affiliates on top of the consolidated book value projections, we have preferred to eliminate the book values of the participations from the bank-only shareholders' equity, and subtract their fair values from the Bank's current market capitalization so as to end up with a core business P/B multiple. Here we consider it advantageous to work through the unconsolidated financials for the sake of the analysis.

Rather than putting the Bank's multiple side by side with the peer group average, we have chosen to weigh it against  $[(ROE-g)/(k-g)]$  as a benchmark. We have derived the core business ROE through dividend-deducted projected net income and average book value adjusted for affiliates. We have also eliminated certain non-core real estates in the pipeline for liquidation.

For the cost-of-capital calculations we have used CAPM, in which we took adjusted Beta as an estimation of the individual stock's risk. Adjusted beta is derived from daily changes for the past one-year period, but modified by the assumption that a security's beta moves toward the market average of 1.0 over time. (Adjusted beta =  $0.67 * \text{Raw beta} + 0.33 * 1.0$ ).

For the country risk premiums we have subtracted the long-term US Government security's current yield from the yield on the long-term Turkish Government Eurobond that has the highest yield. This spread is valid for bonds. And since the stock market is empirically 1.5 times more volatile (standard deviation) than the bond market, we have multiplied the risk premium by this coefficient and then added the total to the US long-term risk-free rate to derive a cost of equity ( $k=RfUS+B*(RfTR-RfUS)*1.5$ ).

Subsequent to reaching a benchmark P/B multiple via the warranted equity approach, it is quite a straightforward process to reach a fair value for the core banking operations via one-year forward looking bank-only shareholders' equity. To attain a value for the Bank as a whole, we add up the fair value of the subsidiaries and the non core real estates waiting to be liquidated.

*We consider the fair values of the subsidiaries that are calculated by our glass, telecom and petrochemical analysts*

We consider the fair values of the subsidiaries that are calculated by our glass, telecom and petrochemical analysts for major listed participations. For other subsidiaries, we have used the market values for the traded ones and taken into consideration the rest at restated cost to arrive at a fair value for the Bank as a whole.

**VALUATION**

<b>BRSA Unconsolidated US\$mn</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
Simple P/BV :	1.7	1.4	1.2
Market Cap	6,668	6,668	6,668
BRSA Unconsolidated Sh. Equity	4,016	4,697	5,366
Current Market Value of Affiliates	2,254	2,254	2,254
Market Cap. (Adjusted for Affiliates)	4,414	4,414	4,414
Book Value (Adj. For Book Value of Affiliates and Potential Non-Core Asset Liquidations)	1,624	2,306	2,975
P/BV (Adj.)	2.7	1.9	1.5
ROE (Sustainable)	19%		
g	3.0%		
R <sub>f</sub> Turkey (Highest Yield Eurobond)	8.0%		
R <sub>f</sub> US (30yr Eurobond)	5.0%		
B	1.2		
R <sub>f</sub> Turkey - R <sub>f</sub> US	3%		
k	10%		
Benchmark P/B [(ROE-g)/(k-g)]	2.3		
Target Value of the Bank (Via 2004 BV)	5,243		
Current Market Value of Affiliates + Potential Non-Core Asset Liquidations	2,404		
Target Value of the Bank	7,647		
Upside	15%		

Source: Ak Securities

*Although the Bank is trading with a simple 2004 P/B multiple of 1.4x, the ratio rises to 1.9x after the adjustments*

Although the Bank is trading with a simple 2004 P/B multiple of 1.4x, the ratio rises to 1.9x after the adjustments. The first adjustment took place in the value of affiliates, mainly TTT. By simply comparing the number of subscribers with Turkcell and applying a 25% haircut due to lower usage fees we have reached a US\$1.3bn EV for TTT. Aria roughly has a US\$800mn net debt, whereas we have assumed no net debt contribution from Aycell. This approach takes us to a fair value of US\$500mn for TTT (1.3-0.8).

*The value to Isbank Group, which has a 20% stake in TTT, turns into US\$100mn rather than the US\$780mn in the books*

Therefore, the value to Isbank Group, which has a 20% stake in TTT, turns into US\$100mn rather than the US\$780mn in the books. The direct haircut to unconsolidated Isbank, which holds 15% of TTT, is US\$510mn. We have also made a US\$150mn curtailment from shareholder equity for the real estates in order to prevent their value from positively affecting the Bank's fair value by being multiplied by the benchmark P/B multiple attained from the warranted equity model. It is worth noting that we add up this value subsequent to arriving at a fair value for the core banking business. Besides the haircuts, we have also incorporated the incremental values of Anadolu Cam, Sisecam and Petrol Ofisi between our fair value targets and the year-end balance sheet values that amount to US\$523mn. The largest proportion of the hidden value stems from Sise Cam, which had a US\$513mn market cap at the end of 2003, whereas our current valuation stands at US\$1.2bn. Isbank has a 66% stake in the Company.

*With the contribution of the fair value of affiliates and potential non-core asset divestures, the fair value of Isbank adds up to US\$7,647mn.*

Using the adjusted shareholders' figures and the 2.3x benchmark P/B multiple derived from our warranted equity model, we arrive at a US\$5.2bn value for the core banking operations of Isbank. With the contribution of the fair value of affiliates and potential non-core asset divestures, the fair value of Isbank adds up to US\$7,647mn.

Taking into consideration the Bank's dedication to divest non-core assets, its increased asset quality, potential provision reversal, upcoming restructuring of the Group-backed efficiency rise, and the 15% upside to our fair value target, we reiterate our **'Market Outperformer'** rating for Isbank.

IV. KEY NOTES ON THE BANKING SECTOR

**Windfall Gains Lifted the Bottom-lines Last Year...**

*Benchmark bond yields slipped down to 25% from 56% gradually in 2003, causing huge windfall gains*

Last year was one of the brightest the Turkish Banking sector has ever experienced. Benchmark bond yields slipped down to 25% from 56% gradually in 2003, causing huge windfall gains, especially for those banks carrying substantial amounts of Government securities. It is obvious that neither the trading gains nor the interest accruals from bonds will be as good as they were last year. We definitely expect the yields to come down, but it will be a far cry from 2003's mouth watering returns. Our year-end projection for the nominal yield on the benchmark bond is 15%. Although this year's estimated 1000bp slide is incomparably lower than the 3100bp of last year, it is worth mentioning that due to convexity, a one percentage point slide roughly corresponded to a TL500 appreciation in bond prices last year compared with TL700 of 2004.

**...But What about the Future**

*We expect the real rate to decline to 5% in 2005*

We expect the contribution of bonds to continue comprising a significant proportion of interest income in the coming periods as well. However, beyond 2005, the banks must be prepared for a low interest rate environment. Currently the real interest rates using the benchmark bond yield and one year forward WPI, is around 11%. We expect the real rate to decline to 5% in 2005. Hence, the banks can no longer be able to make money from allocating deposits to bonds, but must instead build a solid lending book. This is exactly what the banks are trying to do; finding a sustainable loan client base.

In order to build a healthy client base, the key targets of the banks are the SMEs and the retail clients. The large corporations definitely preserve their importance, especially due to their cross selling capacities. And yet the interest rates on loans granted to blue chip companies can barely cover the funding costs, frequently leaving virtually nothing to the banks.

*Therefore, the banks are striving to lend to SMEs and to retail clients, and offer loans in TL-terms*

Therefore, the banks are striving to lend to SMEs and to retail clients, and offer loans in TL-terms. The real interest rate on TL-denominated consumer loans is roughly 15%. The real interest rate on the benchmark Eurobond, on the other hand, remains strong at 12%. Although banks cannot generate meaningful returns either via financing their TL earning assets with TL deposits or financing their FX earning assets with FX deposits, directing the FX deposits to TL assets creates significant spreads.

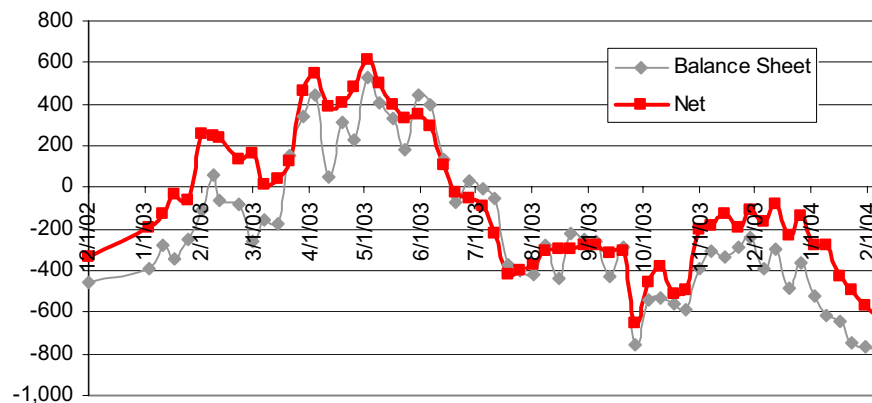
<b>SPREADS</b>			
	<b>TL Bonds/ FX Deposits</b>	<b>LT Eurobond/ FX Deposits</b>	<b>TL Bonds/ TL Deposits</b>
<b>31-Dec-02</b>	32.9%	8.3%	0.1%
<b>31-Mar-03</b>	48.3%	9.2%	6.1%
<b>30-Jun-03</b>	31.7%	7.5%	2.9%
<b>30-Sep-03</b>	14.8%	6.9%	0.0%
<b>31-Dec-03</b>	7.1%	5.9%	-0.1%
<b>4-Mar-04</b>	9.2%	5.8%	0.1%

*Source: The CB, Ak Securities*

We have used annually-compounded real interest rates for the figures in the chart above. It is quite clear that operating with a short FX position always yields

the highest spreads. Although financing the TL bonds with TL deposits seems to have a zero spread, the windfall gains on bond yields in 2003 earned the Banks record substantial gains. And since those windfall gains will come to an end especially beyond 2004, this particular line of attack will have become wholly out of the question. This is precisely why the Banks have been widening their short FX positions for the past couple of months. The net short FX position of the Banks is limited to 20% of their capital bases. No bank as yet is even at one third of this limit.

**Long/(Short) FX Position of Private Comm. Banks (US\$mn)**



Source: The BRSA, Ak Securities

*The US\$783mn balance sheet short FX position as of February 6, 2004 points to the widest currency mismatch since mid-2002*

The US\$783mn balance sheet short FX position as of February 6, 2004 points to the widest currency mismatch since mid-2002. The banks have the opportunity to reduce their BS short positions with long forward FX contracts and record less FX short positions in absolute-terms. As seen in the chart below Isbank has the lowest net FX position in absolute-terms amongst the big-4. It is also worth mentioning that Akbank has the only long net FX position in the peer group.

**Long/(Short) FX Positions 2003**

US\$mn	AKBANK	GARANTI	ISBANK	YKB
BS FX Position	-20	-150	-44	-118
Off BS Position	138	83	6	18
<b>Net FX Position</b>	<b>118</b>	<b>-67</b>	<b>-38</b>	<b>-100</b>

Source: Company Data

*From April until the end of 2003, the monthly CAGR of aggregate consumer loans and credit cards was a hefty 8%*

**Increased Emphasis on Retail Banking**

Together with rising confidence, the demand for consumer loans started to climb in April 2003, right after the fall of Baghdad. From April until the end of 2003, the monthly CAGR of aggregate consumer loans and credit cards was a hefty 8%, and car loans were the main driver, with a strong 16% CAGR in real TL-terms. We expect the strong demand for consumer loans to continue with a slowing pace in 2004, as the slide in interest rates will not be as significant as in 2003.

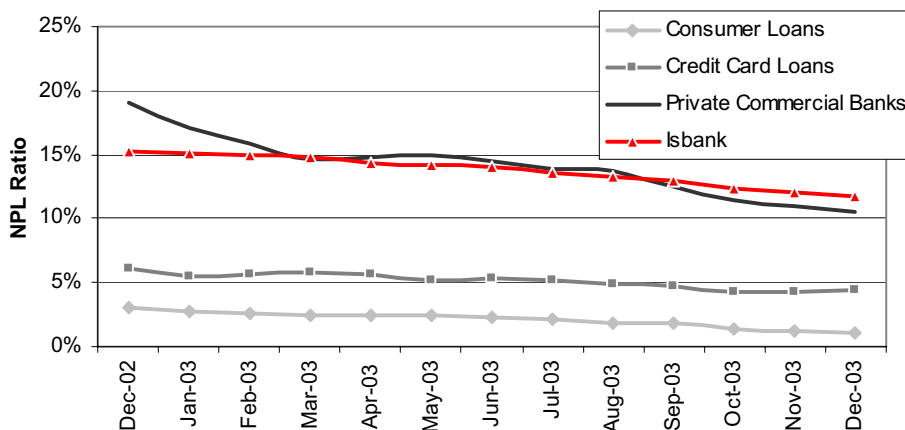
Since the interest rates on consumer loans are fixed and those loans have a maturity of around 1.5 years, consumer lending will definitely support the profitability of the banks in a declining interest rate environment, where average maturity of deposits is only 2 months. Thus, on top of earning relatively higher interest rates, the maturity mismatch also moves in favor of consumer loans. It is

The NPL ratio of core consumer loans is a mere 1%

worth recalling that should there be an unexpected economic downturn, precisely these fixed rate consumer loans would hurt the banks the most.

The spreads are higher in the retail segment, but what about asset quality? The NPL ratio of core consumer loans is a mere 1%, and has been declining gradually from 3% levels over the past year. This NPL ratio level is significantly lower than the aggregate private commercial banks' total NPL ratio of 10%.

**NPL Ratios Improving**



Source: Bank Financials, The CB

Coupled with the higher spreads, fine asset quality combined with solid collateral provides the reasons why banks are fiercely competing in the consumer loan segment

Coupled with the higher spreads, fine asset quality combined with solid collateral provides the reasons why banks are fiercely competing in the consumer loan segment. The question at this point is; can this strategy create a sustainable client base? We think not. Cross-selling and long term relationship in consumer loans are not experienced frequently. Hence, creation of customer loyalty is much too questionable. Customers obtain consumer loans from the bank offering the lowest rate, and it is nearly impossible to issue a credit card, or to make the customer use it. The longer maturity, which locks the book to higher yields, is the one of the key advantages of consumer lending.

**Market Shares in Consumer Loans & Credit Card Loans**

		Akbank	Garanti	Isbank	YKB
<b>1Q02</b>	Consumer Loans	5.3%	11.1%	15.0%	5.0%
	Credit Card Loans	8.8%	17.4%	12.4%	23.5%
<b>2Q02</b>	Consumer Loans	6.7%	8.8%	19.5%	6.0%
	Credit Card Loans	9.2%	18.8%	11.9%	25.9%
<b>3Q02</b>	Consumer Loans	8.3%	7.7%	20.4%	7.1%
	Credit Card Loans	9.0%	20.1%	12.3%	27.9%
<b>4Q02</b>	Consumer Loans	13.1%	6.6%	24.7%	10.6%
	Credit Card Loans	8.1%	20.6%	11.5%	27.8%
<b>1Q03</b>	Consumer Loans	12.6%	6.0%	22.6%	10.5%
	Credit Card Loans	8.4%	21.0%	12.0%	25.7%
<b>2Q03</b>	Consumer Loans	11.7%	6.0%	25.0%	10.0%
	Credit Card Loans	8.9%	22.1%	12.3%	26.4%
<b>3Q03</b>	Consumer Loans	13.9%	5.3%	26.7%	8.4%
	Credit Card Loans	9.5%	21.7%	11.6%	26.0%
<b>4Q03</b>	Consumer Loans	21.5%	5.0%	22.5%	6.9%
	Credit Card Loans	11.4%	22.8%	11.9%	26.2%

Source: Bank Financials, The CB

*Credit card spending volume is the main source of commission and fee income*

Gaining strength in the credit card market, on the other hand, is a totally different issue. Building a credit card customer base continues to create value for the bank going forward. Together with generating a real interest return of up to 100% levels on credit card loans, credit card spending volume is the main source of commission and fee income. Therefore, we believe investment in credit card loans to be a shrewder line of attack relative to building a core consumer loan client base.

*Isbank remains the market leader in core consumer loans, with a 23% market share*

Isbank remains the market leader in core consumer loans, with a 23% market share, but gradually loses market share to Akbank. Isbank's market share in credit card loans, on the other hand, has been stable at 12% for the past two years. Via its thriving Bonus Card scheme, Garanti is grabbing market share in the credit card segment not essentially from the large players, but from the medium-sized ones.

*A huge 32% of Isbank's net loans are composed of TL-denominated consumer and credit card loans*

A huge 32% of Isbank's net loans are composed of TL-denominated consumer and credit card loans, which is the highest ratio among the peers followed by Akbank. Since Isbank did set aside full provision for NPLs that are almost wholly to corporations (pulled down the amount of net loans, in other words), the share of CL&CCL in total loans rose by 6pp to 32% in the final quarter of 2003. The coverage rise also pulled down the share of performing loans in Isbank's total assets to 27.6%. The Bank's loans slipped below those of Akbank both in absolute-terms and as a percentage of assets for the first time ever as of the end of 2003 (29.6% of Akbank's assets are made up of loans).

**Share of Consumer and Credit Card Loans in Total Loans**

		<b>Akbank</b>	<b>Garanti</b>	<b>Isbank</b>	<b>YKB</b>
<b>2002/12</b>	Consumer Loans	6%	3%	10%	4%
	Credit Card Loans	5%	15%	7%	16%
	<b>CL&amp;CCL</b>	<b>11%</b>	<b>18%</b>	<b>16%</b>	<b>20%</b>
<b>2003/03</b>	Consumer Loans	7%	3%	10%	5%
	Credit Card Loans	6%	15%	7%	15%
	<b>CL&amp;CCL</b>	<b>13%</b>	<b>18%</b>	<b>17%</b>	<b>20%</b>
<b>2003/06</b>	Consumer Loans	7%	4%	13%	6%
	Credit Card Loans	7%	20%	8%	19%
	<b>CL&amp;CCL</b>	<b>15%</b>	<b>24%</b>	<b>21%</b>	<b>25%</b>
<b>2003/09</b>	Consumer Loans	11%	5%	17%	6%
	Credit Card Loans	8%	21%	8%	21%
	<b>CL&amp;CCL</b>	<b>19%</b>	<b>26%</b>	<b>26%</b>	<b>27%</b>
<b>2003/12</b>	Consumer Loans	21%	6%	23%	7%
	Credit Card Loans	9%	22%	9%	22%
	<b>CL&amp;CCL</b>	<b>30%</b>	<b>28%</b>	<b>32%</b>	<b>29%</b>

*Source: Bank Financials, The CB*

Consequently, we believe that those Banks that manage to create a solid customer base mainly in TL-denominated loans will be the relative winners of the upcoming low interest rate environment.

**High Tax on Deposits Limits Asset Growth**

Despite all the favorable figures on the consumer loans side and sliding bond yields, the balance sheet growth of the banking sector in real-terms was only 4%. The major reason behind this low expansion rate is the increase in the value of

*Another factor limiting balance sheet growth is the real persons' preference for allocating excess funds into bonds rather than deposits*

the TL mainly against the US\$, which pulls down the TL-denominated values of FX assets that roughly make up half of the balance sheet. Another factor limiting balance sheet growth is the real persons' preference for allocating excess funds into bonds rather than deposits. The interest income on bonds does not create a tax burden, whereas the interest income on deposits of up to three months maturity (majority of deposits have less than 3 months maturity), bears an 18% withholding tax burden. Taking into consideration that the interest rates earned on bonds are even higher than the deposits, it would not be a rational move to keep the savings as deposits.

In 2003 deposits including repos slipped by 1.2% (US\$1.4bn<sup>1</sup>), whereas the bonds of individuals hiked 31% (US\$5.8bn<sup>1</sup>). We expect the banking sector asset size to climb from US\$160bn to US\$178bn, and a deposit growth of around 10% for 2004.

*We do not project a major positive impact of deposits' flight to safety subsequent to the removal of the blanket guarantee in July 2004*

We do not project a major positive impact of deposits' flight to safety on reputable banks, at least in the following one year subsequent to the removal of the blanket guarantee in July 2004. To limit the weakening of their deposit bases, we expect the small banks to lift interest rates by around 100bp over that of the large ones. This line of attack would limit inter-sector deposit transfers, at a cost of squeezed margins for the small ones. The relatively higher deposit costs would cause a lack of profitability that would eventually push the small banks to consolidation, probably in late 2005, unless they are able to restructure themselves as a niche bank dealing with export financing, corporate banking, etc...

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<sup>1</sup> In real TL terms converted to US\$ via the current exchange rate.

## **V. FINANCIAL STATEMENTS & FORECASTS**

**FINANCIAL STATEMENTS – BALANCE SHEET****Unconsolidated Inflation Adjusted BRSA US\$mn**

<b>Assets</b>	<b>2002A</b>	<b>2003A</b>	<b>2004F</b>	<b>2005F</b>
I. Cash And Balances With The Cb	280	500	704	821
Ii. Trading Securities (Net)	915	1,612	1,718	1,804
Iii. Banks And Other Financial Institutions	740	921	1,288	1,657
Iv. Money Market Securities	525	251	513	752
V. Investment Sec. Available For Sale (Net)	4,114	6,182	6,586	6,915
Vi. Loans	5,988	6,146	7,475	8,900
Vii. Factoring Receivables	-	-	-	-
Viii. Investment Sec. Held To Maturity (Net)	1,239	686	731	767
Ix. Investments And Associates (Net)	697	518	573	606
X. Subsidiaries (Net)	1,605	1,724	1,846	1,906
Xi. Other Investments (Net)	-	-	-	-
Xii. Finance Lease Receivables (Net)	-	-	-	-
Xiii. Reserve Deposits	894	849	1,067	1,245
Xiv. Miscellaneous Receivables	42	45	56	66
Xv. Accrued Interest And Income Receivable	884	1,062	1,335	1,557
Xvi. Property And Equipment (Net)	1,655	1,580	1,988	2,318
Xvii. Intangible Assets [Net]	0	0	0	0
Xviii. Other Assets	64	177	223	260
<b>Total Assets</b>	<b>19,641</b>	<b>22,254</b>	<b>26,103</b>	<b>29,575</b>

<b>Liabilities &amp; Shareholders' Equity</b>	<b>2002A</b>	<b>2003A</b>	<b>2004F</b>	<b>2005F</b>
I. Deposits	13,838	14,014	16,160	18,367
Ii. Interbank Money Market	251	1,367	1,910	2,206
Iii. Funds Borrowed	1,188	1,953	2,081	2,185
Iv. Marketable Securities Issued (Net)	-	-	-	-
V. Funds	-	-	-	-
Vi. Miscellaneous Payables	107	89	124	144
Vii. Other External Resources	239	309	432	499
Viii. Taxes And Other Duties Payable	43	46	64	74
Ix. Factoring Payables	-	-	-	-
X. Finance Leasing Payables (Net)	4	5	-	-
Xi. Accrued Interest And Expenses Payable	184	175	245	283
Xii. Provisions	272	280	390	451
Xiii. Subordinated Loans	-	-	-	-
Xiv. Minority Interest	-	-	-	-
<b>Xv. Shareholders' Equity</b>	<b>3,515</b>	<b>4,016</b>	<b>4,697</b>	<b>5,366</b>
<b>Total Liabilities</b>	<b>19,641</b>	<b>22,254</b>	<b>26,103</b>	<b>29,575</b>

Source: Company Data, Ak Securities Estimates

**FINANCIAL STATEMENTS – INCOME STATEMENT****Unconsolidated Inflation Adjusted BRSA US\$m**

<b>Income Statement</b>	<b>2002A</b>	<b>2003A</b>	<b>2004F</b>	<b>2005F</b>
<b>I. INTEREST INCOME</b>	<b>2,760</b>	<b>2,625</b>	<b>2,469</b>	<b>2,084</b>
1.1. Interest on loans	1,167	1,147	1,447	1,239
1.2. Interest received from reserve deposits	59	73	72	83
1.3. Interest received from banks	22	17	30	39
1.4. Interest received from money m. transactions	103	35	11	17
1.5. Interest received from marketable sec. portfolio	1,379	1,324	877	678
1.6. Other interest income	30	30	33	28
<b>II. INTEREST EXPENSE</b>	<b>1,823</b>	<b>1,841</b>	<b>1,736</b>	<b>1,325</b>
2.1. Interest on deposits	1,596	1,601	1,375	1,037
2.2. Interest on money market transactions	1	168	281	208
2.3. Interest on funds borrowed	67	64	73	75
2.4. Interest on securities issued	-	-	-	-
2.5. Other interest expense	159	8	8	6
<b>III. NET INTEREST INCOME (I - II)</b>	<b>936</b>	<b>785</b>	<b>733</b>	<b>759</b>
<b>IV. NET FEES AND COMMISSIONS INCOME</b>	<b>216</b>	<b>347</b>	<b>530</b>	<b>628</b>
<b>V. DIVIDEND INCOME</b>	<b>-</b>	<b>0</b>	<b>-</b>	<b>-</b>
<b>VI. NET TRADING INCOME</b>	<b>(71)</b>	<b>645</b>	<b>263</b>	<b>244</b>
6.1. Profit/losses on trading account securities (Net)	292	480	430	297
6.2. Foreign exchange gains/losses (Net)	(363)	164	(167)	(53)
<b>VII. PROFIT/LOSS FROM HELD TO MATURITY M. S.</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>VIII. OTHER OPERATING INCOME</b>	<b>400</b>	<b>234</b>	<b>366</b>	<b>491</b>
<b>IX. TOTAL OPERATING INCOME (III+IV+V+VI+VII+VIII)</b>	<b>1,482</b>	<b>2,010</b>	<b>1,892</b>	<b>2,121</b>
<b>X. PROVISION FOR LOAN LOSSES OR OTHER REC. (-)</b>	<b>477</b>	<b>579</b>	<b>159</b>	<b>188</b>
<b>XI. OTHER OPERATING EXPENSES (-)</b>	<b>879</b>	<b>1,046</b>	<b>980</b>	<b>1,116</b>
<b>XII. NET OPERATING INCOME (IX-X-XI)</b>	<b>126</b>	<b>385</b>	<b>754</b>	<b>817</b>
<b>XIII. PROFIT/LOSSES FROM ASSOCIATES AND SUBS.</b>	<b>92</b>	<b>48</b>	<b>41</b>	<b>43</b>
<b>XIX. NET MONETARY PROFIT/LOSS</b>	<b>39</b>	<b>(77)</b>	<b>(109)</b>	<b>(37)</b>
<b>XIV. INCOME BEFORE TAXES (XII+XIII)</b>	<b>257</b>	<b>356</b>	<b>685</b>	<b>822</b>
<b>XV. PROVISION FOR TAXES ON INCOME (-)</b>	<b>-</b>	<b>52</b>	<b>206</b>	<b>247</b>
<b>XVI. NET OPERATING INC./EXP. AFTER TAXES (XIV-XV)</b>	<b>257</b>	<b>303</b>	<b>480</b>	<b>576</b>
<b>XVII. EXTRAORDINARY INCOME/EXP. AFTER TAXES</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>XIX. PROFIT/LOSSES ON UNCONSOLIDATED INVESTMENTS (-)</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>XX. NET PROFIT/LOSS</b>	<b>257</b>	<b>303</b>	<b>480</b>	<b>576</b>
<b>Ratios</b>	<b>2002A</b>	<b>2003A</b>	<b>2004F</b>	<b>2005F</b>
Free Capital/Assets	-5.3%	0.8%	1.1%	1.8%
IEA/IBL	94.7%	97.2%	97.6%	98.3%
NPL Ratio	15.3%	11.8%	8.6%	8.6%
NPL Coverage	41.3%	100.0%	100.0%	100.0%
Loans/Deposits	43.3%	43.9%	46.3%	48.5%
Cost/Income	59.3%	40.1%	51.8%	52.6%
NI Spread	6.6%	8.5%	4.5%	4.4%
NI Margin	6.5%	9.1%	4.7%	4.5%
ROE	7.5%	8.5%	10.9%	11.4%
Net Fee Inc./IEA	1.5%	2.6%	2.9%	2.9%
Income from Securities/Gross Interest Income	54.8%	57.7%	43.5%	38.7%
Income from Loans/Gross Interest Income	38.2%	38.4%	50.5%	53.7%
<b>BS Breakdown</b>				
Core Liquidity Ratio	12.4%	11.3%	13.7%	15.1%
Securities	31.9%	38.1%	34.6%	32.1%
Loans	30.5%	27.6%	28.6%	30.1%
Deposits	70.5%	63.0%	61.9%	62.1%

Source: Company Data, Ak Securities Estimates

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# AK SECURITIES

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