

UBS Investment Research

Turkish Participation Banks

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Growth in the fast lane

■ Profitable niche with a strong growth performance

Participation banking is a fast-growing niche, with a significance outperformance over conventional banks in the last five years. Underpenetrated nature of SMEs, inflow of oil money, growing foreign trade ties with the MENA region, greater presence of Islamic finance houses in Turkey and potential interest-averse customers in eastern Turkey still waiting to be tapped by participation banks should all drive further expansion in interest-free banking in Turkey going forward.

■ Bank Asya: Profit-driven business approach pays off

Bank Asya leads the segment, recording by far the strongest growth performances since 2003, when branch size was doubled and interest margins climbed to one of the highest in the overall banking system. The bank enjoys one of the strongest fee income records in the sector, thanks to its exposure to off-balance sheet activities.

■ Albaraka Turk: Earnings quality to improve notably

Albaraka is known for its conservative business approach, which boasts one of the highest asset qualities in the sector. Despite its cautious lending strategies, the bank has managed to grow its loan book at a CAGR of 42% over the past three years, mainly via the SME segment, enabling it to record above-average returns.

■ Valuation: Deserve to trade at a premium

We forecast Bank Asya and Albaraka's earnings to grow at CAGR of 40% and 34% over 2007-09. With sustainable ROE of 27%, our target price for Bank Asya corresponds to 26% upside potential. Besides, the bank is an M&A proxy. We initiate coverage of Asya with a Buy. With sustainable ROE of 22%, our 12-month upside potential for Albaraka is 13%, and we initiate coverage with Neutral rating.

Table 1: Turkish Banks- Valuation summary

	Rating	PE			P/BV			ROE			ROA		
		2007E	2008E	2009E	2007E	2008E	2009E	2007E	2008E	2009E	2007E	2008E	2009E
Akbank	Neutral	12.36	8.65	8.19	2.36	2.14	2.01	24.2	25.9	25.3	3.5	4.0	3.8
Isbank	Buy	13.90	9.96	8.10	1.94	1.83	1.67	15.6	18.9	21.6	2.0	2.4	2.7
Garanti	Neutral	9.66	10.80	9.03	3.02	2.69	2.29	39.4	26.4	27.4	4.2	3.1	3.3
YKB	Neutral	18.46	13.16	10.52	3.35	2.87	2.38	21.1	23.5	24.8	1.6	2.0	2.2
Vakifbank	Buy	10.25	8.35	6.87	2.02	1.88	1.70	22.2	23.3	25.9	2.6	2.7	2.8
Bank Asya	Buy	15.59	12.50	9.58	3.53	3.12	2.41	27.6	27.9	28.4	3.9	3.8	4.0
Albaraka Turk	Neutral	17.11	14.88	11.93	2.61	2.78	2.49	21.9	19.7	22.1	2.8	2.8	3.0

Source: UBS estimates

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Contents	page
Executive summary	3
Interest-free vs conventional	5
— Advantages and drawbacks	5
Bank Asya and Albaraka Turk	7
Valuation: Deserve a premium	9
— An impressive performance so far	9
Global Islamic banking	14
— Historical background	14
— What is Islamic banking? The fundamental features	15
— The growth and expansion of Islamic finance	18
Interest-free banking in Turkey	21
— History and regulatory framework	21
— The characteristics of interest-free banking practice	25
Profile of participation banking	31
— Overview of participation banks	31
Participation vs conventional	45
— Key strengths over conventional banks	45
— Potential risk factors: The challenges ahead	48
The growth potential	50
— A look at sector fundamentals	50
— Potential performance drivers	51
Bank section	54
Asya Katilim Bankasi	55
— Investment thesis	56
— Valuation	57
— Earnings outlook	57
Albaraka Katilim Bankasi	60
— Investment thesis	61
— Valuation	62
— Earnings outlook	62
Appendix	65
Appendix	66

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Executive summary

Interest-free banking – or so-called participation banking – has a short history in the Turkish banking system, and captures less than a 4% share in the sector overall. Nevertheless, this share has risen from as little as 1% in the early part of this decade, recording a CAGR of 36% over the past five years, compared with 20% for the overall banking sector. This growth has been driven by issues such as (a) a tougher regulatory environment; (b) growing customer awareness; (c) long-established relations with the small and medium-sized enterprises (SMEs); (d) an expansion in product mix involving more customer-focused strategies, and (e) a wider branch network.

Despite the impressive growth since 2001, the market share of participation banking (named as participation as the system is constructed on revenue sharing philosophy between the bank and the depositor) in the system still stands at quite low levels. The underpenetrated nature of SMEs, potential interest-averse customers mainly in eastern Turkey still waiting to be tapped by participation banks, and the penetration levels in other Muslim countries highlight the significant growth potential for the interest-free banking sub-segment.

We think that the SME segment, growing foreign trade ties between Turkey and the Middle East and North Africa (MENA) region, the inflow of oil money, the growing presence of Islamic finance houses in Turkey, and the organic expansion plans of the underlying players should all drive further expansion in participation banking in Turkey. Our forecasts imply that participation banks will grow at a CAGR of 26% between 2007 and 2012, against a CAGR of 17% for conventional banks in the same time frame, such that the market share of interest-free banking in the system will exceed 5% by 2011. We need to highlight, however, that the interest-free banking sub-segment is among the most vulnerable in the event of a slowdown in the Turkish economy, owing to participation banks' large exposure to SMEs, which are the engine room of the Turkish economy.

Bank Asya and Albaraka Turk are the two listed banks of the four participation banks. They have similar business models dedicated to SMEs, and their attitude to risk is the main differentiating factor. Although Bank Asya was the last entrant to the interest-free sub-segment, it leads participation banks in almost all business areas thanks to the aggressive organic growth strategies implemented since 2003. Bank Asya recorded by far the strongest growth performance of the four, doubling its number of branches and achieving one of the highest interest margins in the overall banking system. Equally important is the fact that the bank enjoys one of the strongest fee income generation records in the sector, thanks to its very significant exposure to off-balance sheet activities.

Albaraka Turk, by contrast, is the smallest of the four participation banks, and is known for its conservative business approach, which places great importance on risk management issues. Indeed, the bank boasts one of the highest levels of asset quality among Turkish banks; almost all problem loans are provisioned regardless of the collaterals held. Albaraka Turk is behind Bank Asya in terms of fee revenues, as the risk-averse approach has so far prevented Albaraka from extending its non-cash loan exposure aggressively. That said, the business model – dedicated to the underpenetrated/less price elastic/high-yielding SMEs, and the

Participations banks should continue to grow faster vs. conventional banks

Bank Asya leads the participation banking sub-segment

Albaraka has the most conservative business approach among its rivals

interest-free banking practice itself – makes Albaraka Turk one of the most profitable banks in Turkish banking sector.

We expect Bank Asya's EPS to grow at a CAGR of 40% over 2007-09, on the back of strong credit growth focused on SMEs, and forecast an ROE of 28% by end-2009. We think that the erosion of the bank's interest margins will be gradual, thanks to the effective business mix and the nature of participation banking, where the bank is prohibited from betting on interest-earning assets. Fee revenue generation power is also expected to strengthen further, given the bank's dominance in non-cash loans and increased focus on credit card lending. We think that rising operating costs, caused mainly by investment in the branch network, will be more than offset by strong revenue growth. We believe that the relatively weaker asset quality vs. its peers and the level of the CAR would be the main challenges to the future aggressive growth performance of the bank.

Similarly, we forecast that Albaraka Turk will post annual bottom line earnings growth of 34% on average until end-2009, driven by accelerated credit growth centred mainly on SMEs. Coming from a low base, fee revenue should improve considerably, on the back of a greater emphasis on off-balance sheet activities, in parallel with growing business volume with the MENA region, and higher exposure to the credit card segment. We estimate that the ROE of Albaraka Turk will reach 22% by 2009, from the current 20%.

Based on 2008 prospective earnings, Bank Asya trades at a P/BV of 3.1x and PE of 12.5x, against banking sector averages of 2.5x and 11.5x, respectively. Albaraka Turk trades at a P/BV of 2.8x and PE of 14.9x, also based on 2008E earnings. These multiples may appear expensive, but the defensive nature of participation banks – in the sense that they have only limited exposure to the systemic risks that conventional banks are subject to, yet enjoy highly profitable prospects – justifies a premium for participation banks over conventional banks, in our view.

Our valuation model, which assumes a sustainable ROE of 27% and COE of 12% for Bank Asya, justifies multiples above current levels. Our target price of YTL13.30 per share for the bank corresponds to 26 % upside potential in US dollar terms on a 12-month perspective, which puts the bank into our Buy recommendation range. Furthermore, Bank Asya is currently the only participation bank left with local shareholders, which makes the bank one of the main M&A proxies in the Turkish banking sector. We therefore initiate our coverage of Bank Asya with a Buy rating.

With a sustainable ROE of 22% and a COE of 12%, our valuation model for Albaraka Turk implies a 12-month target price of YTL6.80 per share, which implies 13% upside potential in US dollar terms. Our 12-month upside potential, however, is not enough to justify a Buy rating. We initiate coverage of Albaraka Turk with a Neutral rating.

We expect Bank Asya and Albaraka to post earnings growths of 40% and 34%, respectively, between 2007-09

We initiate coverage of Bank Asya with a Buy rating and Albaraka with a Neutral rating

Interest-free vs conventional

Advantages and drawbacks

The practice of interest-free banking by its nature means there is limited vulnerability to the systemic risks that conventional banks are subject to. At the same time, participation banks enjoy higher returns thanks to their high exposure to SMEs. Participation banks are mainly trade financing entities, and the focus on lending, both cash and non-cash, allows stronger fee generation relative to conventional banks. The asset quality standards of participation banks are on average lower than those of conventional banks, which are to be expected given that SMEs are their main focus, and have weaker cost efficiency, which is largely attributable to investments in their branch networks. Their limited exposure to retail lending and their under-leveraged nature in terms of wholesale funding should also be counted among the opportunities, as well as the potential weaknesses, of participation banks.

We think the key strengths of participation banks relative to conventional banks are as follows.

Key strengths of participation banks relative to conventional banks

- The focus on lending, particularly to SMEs – one of the most underbanked segments, and relatively less price sensitive than the retail segment.
- Higher returns on the loan book, with a strong commitment to the second-highest yielding lending segment in Turkey – SMEs.
- Lower funding costs versus conventional banks, given that part of their customer base is interest averse for Islamic reasons.
- Stronger fee income generation power, thanks to the strong presence in lending – both cash and non-cash.
- Limited exposure to the systemic risks of the Turkish banking system, such as interest rate and open FX position risks.

Chart 1: SWOT analysis

<p>Strengths</p> <ul style="list-style-type: none"> ◆ Higher return on the loan book ◆ Lower funding costs ◆ Stronger fee income ◆ SMEs are the main area of focus ◆ Lower exposure to systemic risks 	<p>Weaknesses</p> <ul style="list-style-type: none"> ◆ Weaker asset quality ◆ Higher than industry opex standards ◆ Requirement to provide Interest-free banking-compliant products ◆ Limited usage of external financing ◆ Size of participation banks
<p>Opportunities</p> <ul style="list-style-type: none"> ◆ Underbanked/high-yielding nature of SMEs ◆ Oil money flowing into Turkey ◆ Growing presence of Islamic finance houses ◆ Increase in customer awareness and satisfaction ◆ Growth potential of the banking sector 	<p>Threats</p> <ul style="list-style-type: none"> ◆ More vulnerable to economic downturns ◆ Intensifying competition among participation banks ◆ Limited exposure to retail banking ◆ Higher off-balance sheet activities ◆ Need to expand the branch network

Source: UBS

We see the following as the main weaknesses and challenges for participation banks.

Key weaknesses of participation banks relative to conventional banks

- Higher non-performing loan (NPL) rates than conventional banks, due to high SME exposures, and lower provisioning rates, due to the loss-sharing nature of the system.
- Operating costs are higher than the industry average, which can be attributed to branch investments and economies of scale disadvantages.
- The requirement to comply with interest-free banking practice. The need to provide interest-free banking compliant products/services limits the room for manoeuvre.
- Limited exposure to the retail segment could be a disadvantage for participation banks in a falling interest rate environment,
- Participation banks are extremely under-leveraged, with only minor exposure to external funding.

The potential growth drivers

Despite the impressive growth since 2001, the share of participation banking in the system still stands at quite low levels. The underbanked nature of SMEs and customer potential mainly in the eastern side of the country, however, highlight significant growth potential for the interest-free sub-segment. Indeed, penetration levels in other Muslim countries indicate the potential in Turkey. Of equal importance, the growing trade interactions between Turkey and the MENA region, and increasing presence of Islamic finance houses in Turkey, should further boost the expansion of participation banking. We need to emphasise also that the participation banking sub-segment is one of the most vulnerable to economic downturns, with its large exposure to SMEs.

We think the main drivers of growth in participation banking are as follows:

Main growth drivers for participation banking

- Exposure to the under-penetrated SME segment, which offers stronger growth and higher yields to participation banks.
- Growing foreign trade interactions between Turkey and the MENA region should contribute to the expansion of participation banking in Turkey.
- Potential customers that have been excluded from the system for Islamic reasons and are waiting to be tapped by participation banks.
- The growing presence of Islamic finance houses in Turkey should generate further expansion in participation banking.
- The overall Turkish banking sector remains an underbanked market, with the consumer and SME segments the main potential drivers.

Bank Asya and Albaraka Turk

The major differentiating factors

Bank Asya and Albaraka Turk are the two listed participation banks, and have quite similar business models. Both banks are heavily exposed to SMEs (more than 70% of the loan book) and have only limited exposure to retail lending, allowing them to exceed CAGR of 40% in loans over the past three years. We think that the main differences between Albaraka and Bank Asya come from their attitudes to risk. Although Bank Asya was the last entrant into the participation banking sub-segment, it is now the leader in interest-free banking, taking market share from all of its rivals since 2003. The bank has posted by far the strongest growth performance among its rivals over the past three years, on the back of aggressive organic growth strategies and doubling its number of branches. Having achieved one of the highest interest margins in the system, the bank also enjoys the strongest fee income generation in the Turkish banking universe, with non-cash loans as high as 124% (as of 9M07) of total assets.

We think that the non-cash loan exposures of the two banks are a good indicator of their risk attitudes, as Albaraka Turk's ratio of non-cash loans to total assets was only 32% in the same time frame. Their asset quality levels, on the other hand, reflect the growth policies pursued so far. Due to its conservative approach, Albaraka Turk enjoys the strongest asset quality among participation banks, while Bank Asya has the poorest record. Provisioning policies are another indicator of the risk attitudes of the two banks. Despite the loss-sharing nature of provisions, Albaraka Turk almost fully provisions its problem loans regardless of the collateral held, whereas Bank Asya reserves for only 68% (as of 9M07) of its problem loans.

We think the main differences between Bank Asya and Albaraka arise in the following areas.

Main areas of differentiation

Interest margins: Although both banks have similar returns on their loan books and have close interest spreads, Bank Asya enjoys higher interest margins. We think that this should be attributed mainly to the banks' funding structures. A greater proportion of Bank Asya's loan book is financed via costless funding in the form of demand deposits and equity, which allow higher interest margins.

Off-balance sheet activities and fee revenues: Bank Asya has one of the strongest fee revenue generation track records in the system, on the back of a strong focus on non-cash lending. Although its exposure has increased significantly in recent years, Albaraka is much less focused on non-cash loans. This causes the bank to post lower fee revenues than Bank Asya.

Asset quality: Bank Asya recorded an impressive CAGR of 62% in its loan book over the past three years, and its SME focus caused the bank to report above-average NPL rates. Albaraka posted a CAGR of 42% in loans over the same time frame, lagging behind its rivals in terms of growth. That said, the bank enjoys the strongest asset quality among participation banks, and even compares favourably with conventional banks. The risk-averse approach of Albaraka also ensures that the bank almost fully provisions its problem loans

regardless of the collateral held, whereas Bank Asya provisions 68% of its problem loans.

Capital adequacy: Bank Asya has the lowest capital adequacy ratio (CAR) (14% as of 9M07) among the participation banks. We think this is attributable to the aggressive strategies pursued over recent years and to the change in regulation, which increases the weight of non-cash loans in risk-weighted assets (RWAs). Albaraka, by contrast, has the highest CAR (22% as of 9M07) among the banks we cover, following the capital increase in 2Q07.

Ownership structure: Albaraka Turk boasts a strong ownership structure, buttressed by its shareholders – Albaraka Banking Group (ABG) and the Islamic Development Bank (IDB). Bank Asya, on the other hand, has a much more fragmented ownership structure, with none of the shareholders holding more than 5% of the bank. That said, Bank Asya is the only locally-owned bank of the current four participation banks, which makes the bank one of the main M&A proxies in the Turkish banking sector.

Table 2: Ratios and performance analysis: Bank Asya and Albaraka (9M07)

9M07	Bank Asya	Albaraka Turk
Income statement		
NIM analysis		
Return on TL loans	25.7%	27.0%
Loan/deposit spread (blended)	4.5%	4.3%
NIM	7.2%	5.1%
Fee income generation		
Fee income to assets	3.1%	1.4%
Fee income to total income	33.9%	23.0%
Fee coverage	84.8%	51.4%
Cost efficiency		
Opex to income	40.0%	44.8%
Opex to assets	4.9%	3.6%
Profitability		
ROE	26.7%	20.3%
ROA	3.8%	2.6%
Balance sheet		
Funding		
Deposits to total assets	75.5%	81.5%
Funds borrowed to total assets	5.6%	0.0%
Cash equity to total assets	15.1%	17.3%
Loan to deposit ratio	111.5%	92.2%
Asset quality		
NPL rate	4.9%	1.4%
NPL provision rate	67.9%	92.3%
Capital adequacy		
CAR	14.4%	22.3%
Shareholders' equity to assets	13.6%	15.3%

Source: UBS estimates

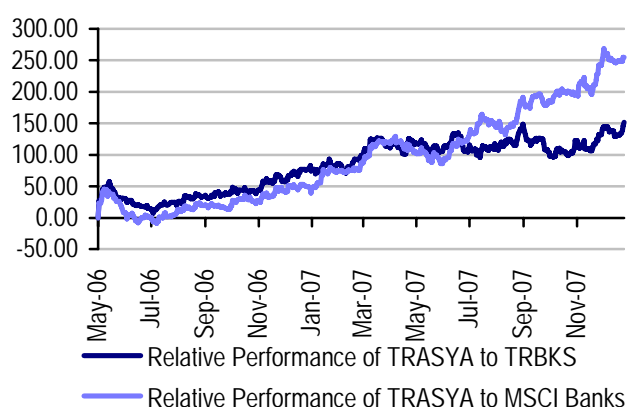
Valuation: Deserve a premium

An impressive performance so far

Participation banks have consistently beaten the MSCI Bank index over the past year, thanks to their defensive business model, which allows above-sector ROEs and limits their exposure to the systemic risks that conventional banks are subject to. Indeed, Bank Asya, the leading interest-free bank in Turkey, was the second best performer after Garanti, consistently beating both the MSCI Bank and the EMEA banks indexes. We highlight that Bank Asya has outperformed MSCI banks by an impressive 137% in 2007, driven by its aggressive organic growth policies, which have been paying off handsomely via positive earnings surprises. On the other hand, Albaraka Turk, which was publicly listed only in June 2007, had also beaten the MSCI banks index by 46%, since it started trading, but this was driven rather by the strong sentiment towards Turkish banks generally. Given its relatively cautious banking approach, with a more conservative business model, Albaraka Turk has lagged the overall Turkish banks index in the underlying time frame.

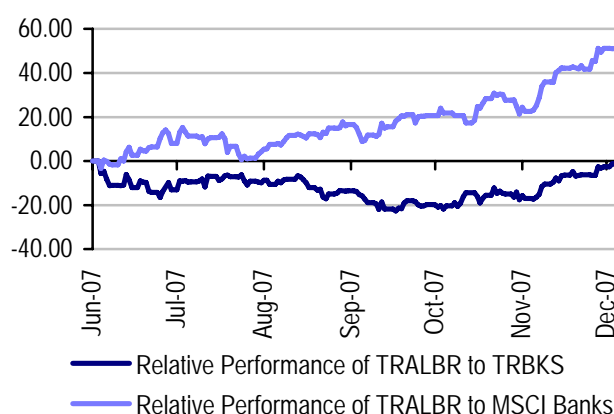
Bank Asya was one of the best performers in 2007, on the back of aggressive growth strategies that have been paying off handsomely

Chart 2: Bank Asya rel. to MSCI Banks and Turkish Banks



Source: UBS

Chart 3: Albaraka Turk rel. to MSCI Banks and Turkish Banks



Source: UBS

Our base-case scenario is for a soft landing of the US economy. We believe that further monetary easing by the Fed will follow in the coming period, which would be to the Central Bank of Turkey's (CBT) advantage (the Turkey-specific risk factors remaining equal). Our economics team believes the CBT will continue with its cautious rate cuts throughout 2008. Consequently, we expect policy rates to decline to around 13.5% by year-end 2008. Although we are concerned that our expectations for 2008 may be slightly optimistic – and are worried about the fact that the recent rally pushed valuations to record highs (with lower discount rates and expectations of stronger earnings fundamentals) – we remain positive on Turkish banks as we head into early 2008.

We expect the CBT's cautious monetary ease to continue throughout 2008

Following the earlier-than-expected reduction in policy rates by the CBT in September, it was first the conventional banks' shares which moved higher. Balance sheet structures that have relatively higher Turkish lira exposure, more exposure to interest rate/FX open position risks, and a greater reliance on consumer lending can be counted among the drivers of conventional bank shares at the time. With their defensive banking nature – being less subject to interest

Participation banks are less risky but on average more profitable than conventional banks

rate risk, lower exposure to Turkish lira funding and limited presence in the retail segment – participation banks underperformed conventional banks at the time. Once investor fears that the US economy could face a harder landing intensified, however, participation banks once again became the favoured sub-segment for investors, who are looking for a safe play among Turkish banks.

Table 3: Turkish banks: Forecasts and valuations

	Rating	PE			P/BV			ROE			ROA		
		2007E	2008E	2009E	2007E	2008E	2009E	2007E	2008E	2009E	2007E	2008E	2009E
Akbank	Neutral	12.36	8.65	8.19	2.36	2.14	2.01	24.25	25.95	25.32	3.45	4.03	3.85
Isbank	Buy	13.90	9.96	8.10	1.94	1.83	1.67	15.59	18.88	21.56	2.00	2.43	2.68
Garanti	Neutral	9.66	10.80	9.03	3.02	2.69	2.29	39.45	26.38	27.43	4.24	3.13	3.30
YKB	Neutral	18.46	13.16	10.52	3.35	2.87	2.38	21.09	23.49	24.76	1.63	2.02	2.24
Vakifbank	Buy	10.25	8.35	6.87	2.02	1.88	1.70	22.20	23.27	25.92	2.64	2.65	2.83
Bank Asya	Buy	15.59	12.50	9.58	3.53	3.12	2.41	27.55	27.88	28.39	3.92	3.81	4.03
Albaraka Turk	Neutral	17.11	14.86	11.93	2.61	2.78	2.49	21.90	19.72	22.07	2.82	2.80	2.98

Ticker	Paid-in cap. YTL	Free float %	3m. avg. vol. US\$m	Core ROE			Core PE			Core P/BV			
				2007E	2008E	2009E	2007E	2008E	2009E	2007E	2008E	2009E	
Akbank	AKBNK.IS	3,000,000	36.00	68	22.6%	25.9%	24.9%	11.15	8.08	7.24	2.52	2.09	1.81
Isbank	ISCTR.IS	2,756,555	33.00	202	29.2%	30.2%	30.7%	13.22	9.76	7.67	3.86	2.94	2.35
Garanti	GARAN.IS	2,100,000	52.00	142	34.6%	24.3%	24.5%	8.86	10.25	8.24	3.06	2.49	2.02
YKB	YKBNK.IS	3,427,051	24.00	88	37.7%	33.4%	30.6%	17.50	12.79	9.74	6.60	4.28	2.98
Vakifbank	VAKBN.IS	2,500,000	25.00	40	20.5%	20.9%	23.0%	9.80	8.18	6.42	2.01	1.71	1.48
Bank Asya	ASYAB.IS	300,000	41.00	5	28.7%	27.4%	25.9%	17.72	13.39	9.83	5.08	3.67	2.55
Albaraka Turk	ALBRK.IS	269,500	21.00	4	16.8%	18.4%	20.1%	18.04	13.73	10.44	3.03	2.53	2.10

Source: UBS estimates

Participation banks trade at higher multiples than conventional banks, on the back of better earnings prospects. Note that the two listed interest-free banks, Bank Asya and Albaraka, posted ROEs of 32% at the end of 2006, against the banking sector average of 20% at the time. We forecast healthy EPS growth of 38% in US dollar terms in 2008 for Bank Asya, which will allow an ROE of 28%, when average banking sector ROE is estimated at 24%. We think that the expected earnings growth justifies further upside for Bank Asya. On the other hand, we estimate the EPS growth of Albaraka at as high as 37% for 2008, against Turkish banks and EMEA banks averages of 30% and 22%, respectively. However, the capital increase in 2Q07 diluted the ROE of the bank. We estimate that the ROE of Albaraka will be 20% by end-2008, and expect it to be sustained at c22% going forward. On this basis, while the strong growth cycle in Turkish banks is not without risk, we have a positive view on participation banks.

Looking at the international peers of the Turkish participation banks, it can be seen that Bank Asya and Albaraka Turk are trading at higher valuation multiples. When profitability is also considered along with the valuation multiples, however, one can witness that participation banks, mainly Bank Asya, are still attractive. International interest-free banks trade at PE 12.0x on average, based on 9M07 historical earnings, with their ROE averaged at 22%.

Due to their effective business model and expected EPS growth, participation banks are trading at a premium against the banking sector

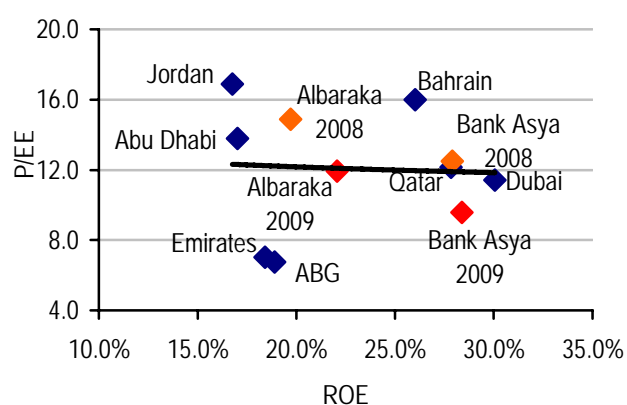
Bank Asya is attractive even from the international peer comparison perspective

Table 4: International interest-free banks: Valuation multiples

Bank	Ticker	Country	Currency	Market cap. (millions)	PE 9M07	P/BV 9M07	ROE 9M07	ROA 9M07
Albaraka Banking Grp. (ABG)	BARKA BI	Bahrain	US Dollar	1,549	6.74	1.41	18.9%	2.3%
Jordan Islamic Bank	JOIB JR	Jordan	US Dollar	507	16.89	2.27	16.8%	1.1%
Emirates Islamic Bank	EIB UH	UAE	US Dollar	NA	7.03	0.85	18.4%	1.7%
Qatar Islamic Bank	QIBK OD	Qatar	US Dollar	5,186	12.16	3.49	27.8%	7.1%
Dubai Islamic Bank	DIB UH	UAE	US Dollar	8,974	11.43	3.00	30.1%	3.8%
Bahrain Islamic Bank	BISB BI	Bahrain	US Dollar	833	15.99	3.06	26.0%	3.5%
Abu Dhabi Islamic Bank	ADIB UH	UAE	US Dollar	2,607	13.80	1.56	17.0%	1.8%

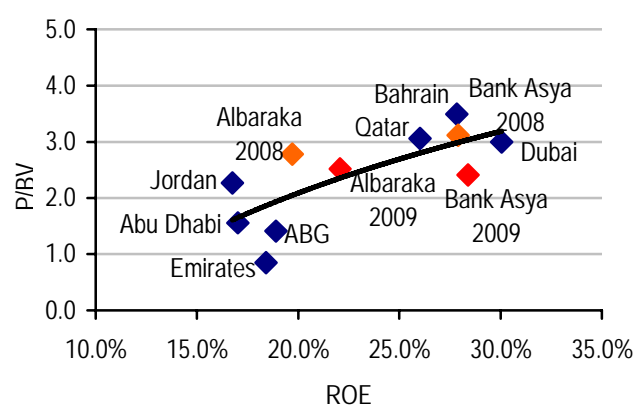
Source: Bloomberg

Chart 4: Global Islamic Banks PE vs ROE



Source: Bloomberg, UBS

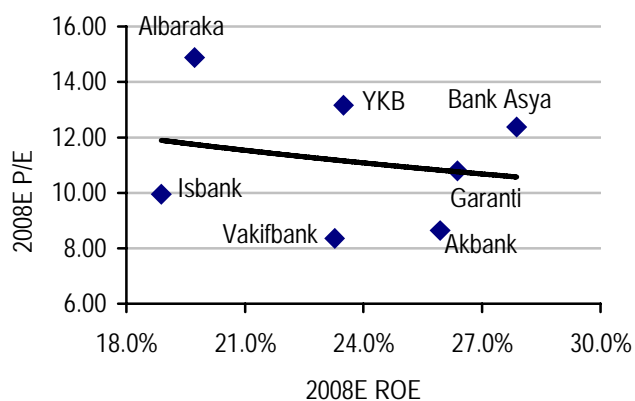
Chart 5: Global Islamic Banks PBV vs ROE



Source: Bloomberg, UBS

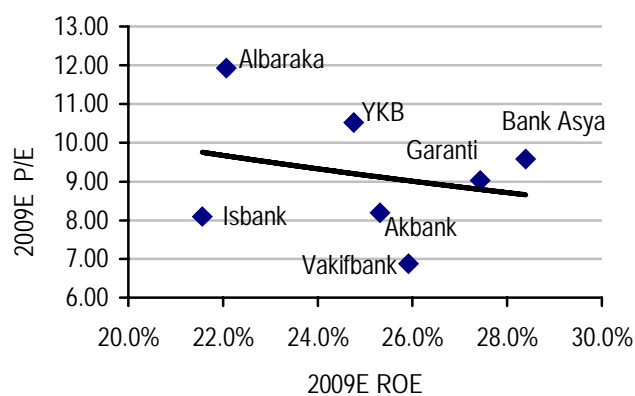
Based on 2008 prospective earnings, Bank Asya trades at a P/BV of 3.1x and PE of 12.5x, against banking sector averages of 2.5x and 11.5x, respectively. These multiple levels may appear expensive, but when ROEs are included into picture, it can be monitored that participation banks still offer growth and value combination within the EMEA/GEM universe. Looking at 2009 forecast valuations/earnings mix (2009e PE of 9.6x and ROE of 28%), Bank Asya becomes more attractive.

Chart 6: Turkish banks PE vs. ROE, 2008E



Source: UBS

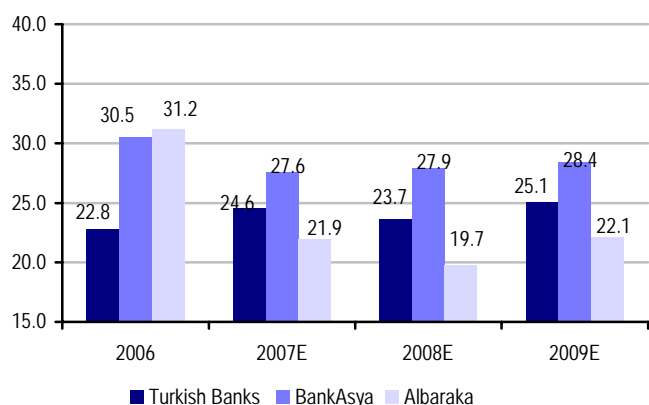
Chart 7: Turkish banks PE vs. ROE, 2009E



Source: UBS

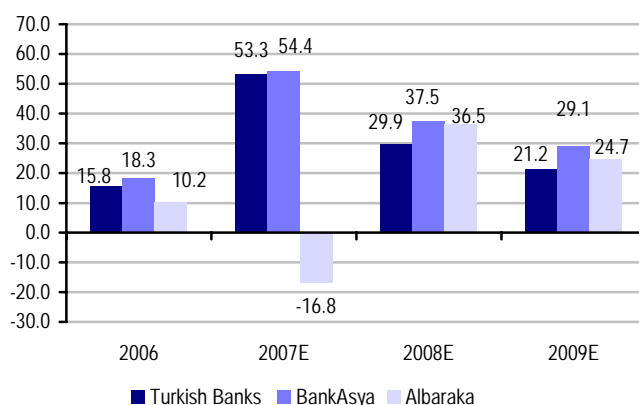
On the other hand, Albaraka trades at a P/BV of 2.8x and PE of 14.9x, also based on 2008 prospective earnings. Given the defensive nature, in the sense that they have only limited exposure to the systemic risks that conventional banks are subject to, yet have highly profitable prospects, we believe that participation banks deserve to trade at a premium over conventional banks.

Chart 8: Sector ROE vs. Participation banks ROE



Source: UBS estimates

Chart 9: Trend earnings – EPS Growth



Source: UBS estimates

Recall that National Commercial Bank (NCB) acquired 60% of Turkiye Finans (number two bank among the four participation banks in Turkey) in July 2007 for US\$1.1bn. The deal implies that the value set for Turkiye Finans corresponds to US\$1.8bn, implying a P/BV multiple of about 5.0x. Although the value determined for the bank also implies a certain control premium, we think that the NCB deal could thrust interest-free banks into a new era.

The NCB acquisition of Turkiye could thrust participation banks into new era

Table 5: Valuation summary: Gordon growth model (USD m)

USD million	Bank Asya	Albaraka Turk
Parent-only Net Profit - 2008e	217	93
Parent-only BV	773	491
Core ROE	27%	22%
Growth Rate	6%	6%
COE	12%	12%
Implied target P/BV (x)	4.3	3.2
Parent-only Target Value	3,324	1,553
MV of Participations	88	4
Target MCap.	3,413	1,557
Current MCap.	2,710	1,378
Upside / (downside)	26%	13%

Source: UBS

Based on our model, we assume that Bank Asya should be able to achieve sustainable ROE of 27%. The level of return, together with solid growth and a cost of equity (COE) of 12%, justifies multiples above current levels (based on a traditional Gordon growth model), in our view. Our target price of YTL13.30 per share for Bank Asya, corresponds to 26% upside potential in US dollar terms on a 12-month perspective, which puts the bank into our Buy recommendation range. Furthermore, the bank is currently the only participation bank left with local shareholders, and it would not be surprising to see Bank Asya approached by an international interest-free investor soon, given the bank's profitable nature and growth prospects. We think that the valuations implicit in the NCB-Turkiye Finans deal would be considered at the time of partnership negotiations. We initiate coverage of Bank Asya with a Buy rating.

We initiate coverage of Bank Asya with a Buy rating and Albaraka with a Neutral rating

With a sustainable ROE of 22% and a COE of 12% for Albaraka Turk, our Gordon growth valuation model implies a 12-month target price of YTL6.80 per share, which indicates 13% upside potential in US dollar terms. Our 12-month upside potential, however, is not enough to justify a Buy rating; we therefore initiate coverage of Albaraka Turk with a Neutral rating.

Table 6: LATAM and EMEA valuation summary

	Rel MSCI Banks (%) US \$				Adj PE			Adj P/BV			Adj (ROE %)			Adj EPS Growth (%)		
	1 mnth	3 mnth	12 mnth	YTD	2007E	2008E	2009E	2007E	2008E	2009E	2007E	2008E	2009E	2007E	2008E	2009E
Czech Republic	13.9	23.6	82.6	1.3	15.8	14.1	12.5	3.0	2.7	2.4	19.5	19.9	20.4	11.8	11.8	13.1
Hungary	3.6	5.7	22.8	-3.4	11.1	10.3	8.7	2.4	2.0	1.7	24.0	21.7	21.5	8.1	8.4	18.0
Israel	10.6	18.4	23.6	1.9	8.3	8.4	7.7	1.3	1.1	1.1	16.1	14.3	14.4	82.5	-1.0	8.9
Poland	1.0	12.7	43.1	-1.5	15.2	12.6	10.3	3.5	3.0	2.6	24.8	26.0	27.0	32.9	22.4	22.4
Russia	6.9	22.3	39.7	1.6	21.5	15.7	12.0	3.1	2.6	2.2	19.7	18.7	20.1	27.9	36.9	30.4
South Africa	-4.5	1.1	14.6	-1.2	9.3	7.9	6.7	2.2	1.8	1.5	27.4	25.8	25.2	17.9	18.2	17.5
Argentina	-3.0	-13.3	-16.0	-4.0	11.2	8.8	7.1	1.9	1.7	1.4	17.8	19.6	20.8	4.3	26.8	24.4
Brazil	-5.0	11.0	57.7	-4.5	13.2	11.6	10.1	3.2	2.8	2.4	25.9	25.6	24.7	6.3	13.9	13.7
Mexico	-3.8	4.0	18.0	-2.6	12.6	11.1	9.6	2.6	2.2	1.8	23.2	21.6	20.7	14.2	13.5	15.0
Akbank	0.3	0.9	61.2	-6.1	12.4	8.6	8.2	2.4	2.1	2.0	24.2	25.9	25.3	36.5	43.0	5.5
Garanti	-2.8	18.5	176.4	-7.7	9.7	10.8	9.0	3.0	2.7	2.3	39.4	26.4	27.4	138.4	-10.6	19.6
Is Bank	-2.5	11.3	49.5	-3.4	13.9	10.0	8.1	1.9	1.8	1.7	15.6	18.9	21.6	52.8	39.6	23.0
Vakifbank	8.1	8.4	55.9	-4.9	10.3	8.4	6.9	2.0	1.9	1.7	22.2	23.3	25.9	50.1	22.7	21.6
YKB	-6.6	16.7	118.2	-4.5	18.5	13.2	10.5	3.4	2.9	2.4	21.1	23.5	24.8	57.4	40.3	25.1
Bank Asya	8.1	27.4	136.7	1.8	15.6	12.5	9.6	3.5	3.1	2.4	27.6	27.9	28.4	54.4	37.5	29.1
Albaraka Turk	15.2	32.8	NA	-2.7	17.1	14.9	11.9	2.6	2.8	2.5	21.9	19.7	22.1	-16.8	36.5	24.7
Turkey	-1.3	11.4	102.1	-5.8	13.8	11.5	9.4	2.7	2.5	2.2	24.6	23.7	25.1	53.3	29.9	21.2
EMEA	2.2	12.5	41.0	-1.0	12.5	10.6	8.8	2.5	2.1	1.8	23.6	22.2	22.8	36.5	22.0	21.6
LATAM	-4.1	11.2	55.8	-4.0	13.3	11.6	10.2	3.2	2.7	2.3	25.5	25.2	24.3	9.0	14.4	13.8
GEM	0.9	12.4	50.4	-0.9	14.8	12.6	10.9	2.4	2.2	1.9	20.2	20.0	20.3	30.1	22.9	18.0

Source: UBS estimates

Global Islamic banking

Historical background

Islamic tenets define any transaction which culminates in “interest” as illicit. This principle kept conservative Muslims out of the financial system until as late as the mid-1960s, when studies on introducing Islam-compliant banking practices first began. It was not until 1971 that non-interest banking was implemented in practice. The first Islamic bank, the Egyptian Nasir Social Bank, was incorporated in that year – a bank which functioned like the savings and loan associations in the United States.

Thanks to the sudden spike in oil prices in the late 1970s, which furnished capital accumulation in oil-producing Gulf nations, the establishment of new finance houses and expansion of financial services provided by these institutions became inevitable. The need to allocate excess capital according to Islamic principles gave birth to banks such as the Dubai Islamic Bank, the Sudan Faisal Islamic Bank, Egypt Faisal Islamic Bank and the Bahrain Islamic Bank. The so-called Islamic financial system is founded on the absolute prohibition of the payment or receipt of any predetermined guaranteed rate of return, effectively closing the door to the concept of “interest” and precluding the use of debt-centred instruments.

Coming to the early 1980s, the application of Islamic banking practices expanded to other Muslim countries in the Middle East. Islamic revivalism, spurred on by the 1979 Iranian Islamic Revolution, which was initially supported by many in the Arab and Islamic world, at least on the popular level, was one of the factors at the time that gave an impetus to Islamic banking. In the period, banks and financial institutions in Iran, Pakistan and Sudan adopted the interest-free banking principles into their financial systems. On the other hand, as is currently the case in Turkey, some other Muslim nations have introduced Islamic banking to their citizens as a complementary arm to their financial systems. Countries like Malaysia, Indonesia, Bangladesh, Jordan and Egypt incorporate Islamic banking into their financial systems, with interest-free banking practised alongside conventional banking (“conventional” being defined as an interest-based banking system).

Growth potential of Islamic finance and trend towards tapping interest-averse people living outside the Gulf region have expanded the scope of the business. Interest-free banking is now expanding beyond its traditional borders of Muslim economies into western countries where conventional banking is implemented. As a result, more than 300 financial institutions in over 75 countries around the globe practise some form of interest-free banking/finance today, and the underlying industry has been growing at an annual rate of more than 15% for the past five years (acc. to the International Islamic Finance Forum).

Overall, the turnover of the Islamic banking/finance sub-segment is now estimated at US\$70bn, having grown from just US\$5bn back in the mid-1980s. Total assets in the global interest-free banking system are estimated to exceed US\$250bn. This suggests that the system’s assets could exceed US\$500bn, if the assets of the interest-free banking divisions of global conventional banks such as HSBC and BNP Paribas are included.

First Islamic banks were established as late as the 1970s

In Turkey, interest-free banking is practised alongside conventional banking

Islamic banking has expanded beyond its traditional borders

Global conventional banks noticed the potential, and are now tapping interest-averse community through their specialised divisions

What is Islamic banking? The fundamental features

The term “interest-free (or Islamic) banking” is relatively a new one in the global banking lexicon, appearing in the 1970s. The basic principles of Islamic banking are referred to in the Sharia rules and law that govern economic, social, political and cultural aspects of Islamic societies. Islamic Law originates from the rules dictated by the Koran. As highlighted earlier, prohibiting the receipt and payment of interest is at the heart of interest-free banking practice. Among the other crucial pillars are refraining from supporting sectors which do not comply with Islamic Law, and justice in the distribution of revenues. The system of interest-free banking also advocates risk-sharing, individuals’ rights and responsibilities, property rights, enterprise and the sanctity of contracts, while discouraging speculative behaviour.

Prohibition of receipt and payment of interest is at the core of the system

Table 7: Two banking frameworks: Comparison of conventional and Islamic banking

Characteristics	Conventional banking	Islamic banking
Nominal value guarantee of:		
Demand deposits	Yes	Yes
Investment (profit/loss sharing) deposits	Yes	No
Equity-based system, where capital is at risk	No	Yes
Rate of return on deposits	Certain and guaranteed	Uncertain, not guaranteed
Mechanism to regulate final returns on deposits	Irrespective of banks' performance / profits from investment	Depending on banks' performance / profits from investments
Profit/Loss share (PLS) principle is applied	No	Yes
Use of direction by banks with regard to collateral	Yes	Possible for reducing moral hazard in PLS modes - Yes, in non-PLS modes
Banks pooling of depositors' funds to provide depositors with professional investment management	No	Yes

Source: IMF, UBS

Main principles of Islamic banking

(1) Prohibition of interest: Prohibition of “riba”, a term literally meaning “an excess” and interpreted as “any unjustifiable increase of capital whether in loans or sales” is the central tenet of the system. More precisely, any positive, fixed, predetermined rate tied to the maturity and the amount of principal is considered as “riba”, and is prohibited based on the arguments of justice, equality and property rights.

Islam encourages earning profits... but any fixed / pre-determined rate tied to maturity is against the Islamic way of banking

Islam encourages the earning of profits, but forbids the charging of interest because profits, determined ex-post, symbolize successful enterprise and the creation of additional wealth. On the contrary, interest, determined ex-ante, is a cost accrued irrespective of the outcome of business operations and may not create wealth if there are business losses. Social justice demands, as part of the system, that borrowers and lenders share the rewards (as well as the losses) in an equitable manner, and that the process of wealth accumulation and distribution in the economy is fair and representative of true productivity.

- (2) **Money as “potential” capital:** Money is treated as “potential” capital – that is, money becomes actual capital only when it joins hands with other resources to undertake a productive activity. Islam recognizes time value of money, but only when it acts as capital, not when it is “potential” capital.
- (3) **Sanctity of contracts:** Islam upholds contractual obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard.
- (4) **Interest-free banking-approved activities:** Only the business activities that do not violate the rules of Shariah qualify for investment. For example, any investment in a business dealing with alcohol, gambling or casinos would be prohibited.

The system is constructed on a profit- and loss-sharing philosophy

Table 8: Principled transactions

Interest-free banking principles prohibit...	...and allow or encourage	Implication
Riba: An increase; any return of money on money	Risk sharing, co-investments	Interest is not allowed
Gharar: Uncertainty; any sale that involves risk, hazard where outcome is unknown	Profit margin on transactions	An underlying transaction, exchange of commodity is required
Maysir: Gambling, investment in forbidden areas (eg. alcohol)	Transparent transactions	Many derivatives, speculative instruments cannot be used

Source: The McKinsey Quarterly, UBS

Banking is the most developed part of the Islamic financial system, and interest-free banking is currently practised through two channels: (a) “specialized” Islamic bank and (b) “Islamic windows”. Specialized Islamic banks are commercial and investment banks, structured wholly on Islamic principles, and deal only with Islamic instruments. The state constitutions of Iran and Pakistan, for example, require their banking systems to be fully compatible with Islamic Law. On the other hand, Islamic windows are special facilities offered by conventional banks to provide services to those customers who wish to engage in interest-free banking. Both Western banks and banks based in Muslim countries provide Islamic windows. As indicated earlier, Islamic banking exists alongside conventional banking in Turkey, Egypt, Indonesia, Malaysia, Sudan and countries belonging to the Gulf Cooperation Council (GCC).

Islamic windows allow conventional banks to exploit opportunities in interest-free banking

Traditionally, specialized interest-free banks have been well positioned to attract deposits from their clients, but these institutions have generally lacked the technical ability to invest efficiently. This gap has been bridged somewhat by the services of Western banks which swiftly and efficiently deploy funds into investment channels acceptable under Islamic regulations. The downside is that this has often meant lower returns for investors in the interest-free financial system, owing to the requirement for a second layer of intermediation. However, this trend is now changing, and interest-free banks are becoming more resourceful and going global, in part owing to their increased integration with international financial markets. At the same time, aware of the potential of Muslim-populated markets, Western banks are also reaching out to interest-

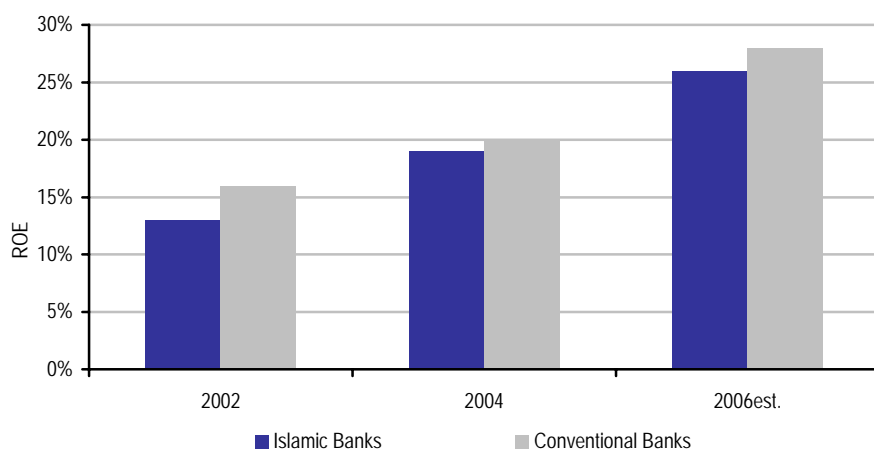
Islamic banks are now integrated with global financial markets

averse investors directly and eliminating the middleman – the Islamic banks or Islamic windows of banks in Muslim countries.

Most Muslim countries have a burgeoning current account surplus, which has built impressively over the past 10 years. In the Middle East, this is largely due to the oil boom. In South-east Asia, this may have more to do with structural changes associated with the 1997 currency crisis. The generous return on equity we have seen in the interest-free banking sector has been supporting innovation. This represents the fuel feeding talent and research, which ultimately leads to fresh product design and marketing ideas. The ROE levels of interest-free banks have been catching up with those in the conventional banking business, as illustrated in the chart below. Accordingly, there is every reason to believe that these financial institutions can produce product innovations of the sort that have long characterized conventional investment markets.

ROEs of Islamic banking approached to conventional banks' levels

Chart 10: Earnings performance: ROEs of global Islamic and conventional banks



Source: Global Investment House

Instruments used by the Islamic banks/finance houses

Some of the most popular instruments used by the Islamic banks/finance houses are as follows.

- **Trade with mark-up or cost-plus sale (murabaha):** This is one of the most widely used instruments for short-term financing, and is based on the traditional notion of purchase finance. The investor undertakes to supply specific goods or commodities, incorporating a mutually agreed contract for resale to the client and a mutually negotiated margin.
- **Leasing (ijara):** Leasing is designed for financing vehicles, machinery, equipment and aircraft. Different forms of leasing are permissible, including leases where a portion of the instalment payment goes toward the final purchase (with the transfer of ownership to the lessee).
- **Profit-sharing agreement (mudaraba):** This is identical to an investment fund in which managers handle a pool of funds. The agent-manager has relatively limited liability while having sufficient incentives to perform. The

Murabaha (short-term trade financing) is the most popular instrument for financing

capital is invested in broadly defined activities, and the terms of profit and risk-sharing are customized for each investment.

- **Equity participation (musharaka):** This is analogous to a joint venture. Both entrepreneur and investor contribute to the capital (assets, technical and managerial expertise, working capital, etc.) of the operation in varying degrees and agree to share the returns (as well as the risks) in proportions agreed to in advance.
- **Sales contracts:** Deferred-payment sale (bay' mu'ajjal) and deferred-delivery sale (bay' salam) contracts, in addition to spot sales, are used for conducting credit sales. In a deferred-payment sale, delivery of the product is taken on the spot, but delivery of the payment is delayed for an agreed period. Payment can be made in a lump sum or in instalments, provided there is no extra charge for the delay.

The growth and expansion of Islamic finance

The growth in Islamic finance initially coincided with the current account surpluses of oil-exporting Muslim countries. However, the trend continued even in the face of eroding oil revenues, reflecting the influence of other factors, such as the call for socio-political and economic systems based on Islamic principles and a stronger Islamic identity. In addition, the introduction of broad macroeconomic and structural reforms has paved the way for the expansion of Islamic finance. There are a number of key factors behind the recent growth in Islamic finance. One is the strong demand from a large number of immigrant and non-immigrant Muslims for interest-free banking compliant financial services and transactions. A second is growing oil wealth, with demand for suitable investments soaring in the Gulf region. Another key factor is the competitiveness of many of the products offered by Islamic finance houses, attracting both Muslim and non-Muslim investors.

Yet despite the rapid growth during the period, the scope of interest-free banking remains rather limited in most Muslim countries, and tiny in the context of the global financial system. For interest-free banking to take off and play a bigger role, especially in the Middle East, policymakers must tackle enormous hurdles — notably on the regulatory front. Interest-free banking has so far been spared any serious financial crisis, with the exception of a few small cases (such as the case in the Dubai Islamic Bank in 1998 and Ihlas Finans in Turkey in 2001). Nevertheless, building confidence in a new industry is crucial for the development of Islamic finance.

The strong growth potential of participation banking has attracted the attention of global Western financial institutions. Leading global banks such as Citigroup, Goldman Sachs, HSBC, Morgan Stanley, Standard Chartered, ABN Amro, Bank of America, Societe Generale, BNP Paribas and Commerzbank have all extended their product mix by introducing Islamic financial instruments, in order to serve 1.2 billion Muslims around the world. Even governments are joining in: Japan is planning to become the first non-Muslim country to issue interest-free banking compliant bonds (according to *The American*), the UK is revising its laws to make London the “gateway” for Islamic finance in Europe,

Oil wealth and expansion of the product mix are among the main factors that are stimulating growth in Islamic finance

Regulatory structures have to be strengthened further, if Islamic banks are to play a bigger role in the system

Global western financial institutions are all getting in the game

and Malaysia has proposed substantial tax incentives in its budget for its Islamic financial sector.

Along with the growing attractiveness of Islamic banking, a need has emerged for prudential supervision in order to reduce the risks to the soundness of the banking system and enhance banks' role as active players in the development of the economy. The regulatory framework for Islamic banking practice then revolves around issues such as reinforcing banks' operating environment, internal governance and market discipline.

As one of the fastest growing sub-sectors of the global financial system, the consensus is that the sustainable development of interest-free banking also depends on the following factors:

- Breaking the prejudice against interest-free banking
- Overcoming the difficulties in the implementation of interest-free banking
- Improving the supervisory standards of interest-free banking practice
- Increasing the effectiveness of Islamic finance instruments
- Strengthening the role and functioning of the Islamic Development Bank
- Cooperating with the global banking community with the aim of integrating the interest-free banking sub-sector into global banking system
- Improving customer awareness of alternative financial products

Improving supervisory standards and increasing customer awareness are challenges ahead

Structural disadvantages

We think that the two main structural disadvantages of Islamic banks, due to the industry's very nature, are as follows:

- (a) **The lack of scale:** Scale is vital to drive down cost-income ratios, and – by international standards – Islamic banks are well below the optimal scale.
- (b) **Liquidity:** A liquid secondary market for Islamic fixed income instruments does not exist. Hence, Islamic banks are forced to focus on shorter-term tools to ensure sufficient liquidity. This puts them at a disadvantage to conventional banks, both in exposure to market risk and in long-term returns on a bank's investment portfolio, although some governments have tried to create liquidity by issuing interest-free banking compliant bonds.

Economies of scale and the lack of a liquid secondary market for fixed income securities are two main disadvantages

Many Islamic financial institutions, particularly those in Bahrain, Malaysia and Sudan, have been gearing up for further expansion by continuing to develop, refine and market innovative Islamic financial instruments, on both the asset and liability sides of the business. In recent years, many new Islamic financial products have been developed and gained increasing popularity in financial market activities, including equity and bond trading and investment, Islamic insurance and reinsurance (Takaful/re-Takaful), Islamic syndicated lending, and investment in Islamic collective investment schemes and other wealth and asset management products.

Islamic financial products are diversifying

In recent years, Islamic investment funds have prospered in the Gulf countries and Malaysia. Among the different categories are equity funds, real estate and property funds, murabaha funds, commodity funds and leasing funds. Islamic equity funds are the most common, and total assets worldwide grew more than 25% a year between 1997-03. In Malaysia, the number of Islamic investment funds reached 71 in 2004, up from 7 in 1995, with their net asset value as a percentage of total funds more than doubling over this 10-year period.

Table 9: Interest-free banking compliant funds

1990	1995	2000	2006
Equity	Equity	Equity	Equity
Murabaha	Murabaha	Murabaha	Murabaha
	Leasing	Leasing	Leasing
		Balanced and Secured	Balanced and Secured
		Sukuk	Sukuk
		Lifestyle Funds	Lifestyle Funds
			Private Equity
			Real Estate
			Funds of Funds
			Hedge Funds

Source: Failaka, Calyx Financial

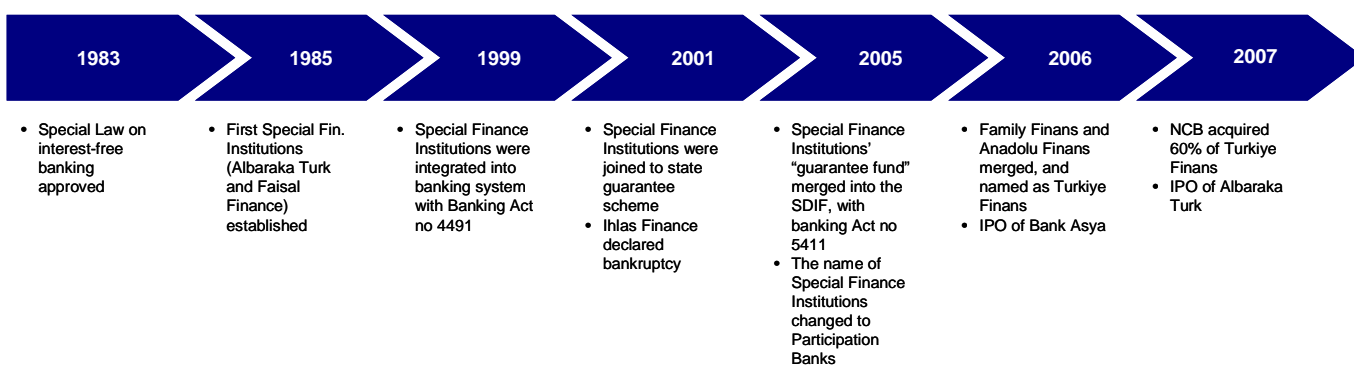
Interest-free banking in Turkey

History and regulatory framework

Efforts to set up a banking niche in Turkey, which would be the complementary part of the overall functioning of the banking sector and would aim to pull in the so-called conservative population into the financial system, have been intensified with liberalisation movements in the Turkish economy in the first half of 1980s. On this ground, the Turkish government was approved the decree of ‘Special Legislation on Interest-free Banking’ in 1983, which opened the way for Islamic banks to function in Turkey. With the establishment of legal framework for interest-free banking practices, the so-called ‘under-the-pillow’ funds in Turkey - that had been out of the system for one of many reasons – were started to be utilized in financing economic activities.

The decree on interest-free banking was approved in 1983

Chart 11: Chronology of interest-free banking in Turkey



Source: Participation Banks Association and UBS

As with their counterparts in other predominantly Muslim countries, Special Finance Institutions (or interest-free banks that were later named as participation banks) were defined as non-interest banks, operating in an environment where the receipt and payment of interest is prohibited. As implied above, the interest-free banking practices exist alongside conventional banking as an integral part of the Turkish financial system, which is quite similar to countries like Egypt, Indonesia, Malaysia and Sudan. However, it took two years for the first finance houses to be established in Turkey after the approval of the decree on interest-free banking in 1983.

In 1985 the first Special Finance Institutions, Albaraka Turk and Faisal Finance (later named as Family Finans) were established, both of which were Saudi-Turkish partnerships. These banks were followed by Kuveyt Turk in 1989, a partnership between the Kuwait Finance House and the Turkish General Directorate of Foundations. In the 1990s, three more players joined the race to tap the interest-averse population. In 1991, Anadolu Finans was established, which was followed by Ihlas Finance in 1995 and Bank Asya in 1996 – all of which were fully owned by local investors at the time.

Albaraka Turk was the first and Bank Asya was the last Special Finance Institution to be established

Although interest-free banking was introduced as integral part of the Turkish financial system, it was only in 1999, and after the Banking Act no. 4491, that Special Finance Institutions were officially integrated into the Banking Law. Under the Banking Law, the regulatory framework that deals with Special

It was only in 1999 that interest-free banks were integrated into the Banking Law

Finance Institutions was strengthened and these institutions were brought under the same umbrella of regulations covering conventional banks. The law also allowed the establishment of the Special Finance Institutions Association, an association whose mission is to ensure that Special Finance Institutions undertake their intermediation function in accordance with the Banking Act.

When two financial crises happened in 2000 and 2001, the picture was no different for the interest-free banking system. In the period, Ihlas Finance (the Special Finance Institution established by Ihlas Group in 1995), which was once the leader, became insolvent and shook the non-interest banking segment of the business. The bankruptcy of Ihlas Finance put other banks in danger at the time, because interest-free banking relied intensely on customer confidence. As a result, the Banking Act 4491 had taken Special Finance Institutions under the state guarantee scheme with the so-called guarantee fund, alongside conventional banks, where ‘current’ and ‘profit/loss sharing’ participation accounts (local and foreign currency denominated) of up to YTL50,000 and held by individual customers were brought under state guarantee.

Following the financial crisis in 2001, interest-banks were also taken under state guarantee scheme

Table 10: Chronology of interest-free banking in Turkey

Date	Event
1983	Special Law on interest-free banking approved
1985	First Special Fin. Institutions (Albaraka Turk and Faisal Finance) established
1989	Kuveyt Turk Finance established
1991	Anadolu Finance established
1996	Bank Asya established
1999	Special Finance Institutions were integrated into banking system with Banking Act no. 4491
2001	Special Finance Institutions Association was established
2001	Ihlas Finance declared bankruptcy
2001	Special Finance Institutions were joined to the state guarantee scheme
2005	Special Finance Institutions’ ‘assurance fund’ merged into the SDIF, with Banking Act no. 5411
2005	The name of Special Finance Institutions changed to Participation Banks
2006	Family Finans and Anadolu Finans merged, and named as Turkiye Finans
2006	IPO of Bank Asya
2007	Acquisition of Adabank by TII (The International Investor) rejected by the regulator
2007	NCB acquired 60% of Turkiye Finans
2007	IPO of Albaraka Turk

Source: Participation Banks Association, UBS

The regulatory framework for Special Finance Institutions was strengthened in the following years. When the new Banking Law (no. 5411) came into effect in November 2005, the Special Finance Institutions’ guarantee fund, (established in 2001) was merged into the Savings Deposits Insurance Fund (SDIF). Of equal importance, ‘Special Finance Institutions’ were renamed ‘Participation Banks’, with a more concrete definition of their interest-free characteristics with the introduction of new Banking Law.

The regulatory framework was further strengthened by the new Banking Law in 2005

In 2006, the two Special Finance Institutions – Anadolu Finans and Faisal Finance (later renamed Family Finans when acquired by the Ulker Group) – were merged and renamed Turkiye Finans, giving birth to one of the largest players in the interest-free segment of the business. There are currently four participation banks in Turkey, namely Turkiye Finans, Bank Asya, Albaraka Turk and Kuveyt Turk. The number of players, however, may reach five, because Adabank (seized by the regulator in July 2003 during the Imar Bank investigation) is expected to be re-tendered soon by the SDIF. We need to highlight that the regulator has not provided new licenses for any of the banking segments since 2002, and one should therefore expect significant interest in the underlying tender from the gulf region.

Four interest-free banks are currently active in the fastest growing sub-segment

Table 11: Participation banks in the Turkish banking system

	2003	2004	2005	2006	1H07
Participation banks' share in the banking sector					
Assets	2.0%	2.4%	2.0%	2.7%	3.4%
Loans (inc. leasing)	4.5%	5.1%	5.0%	4.8%	6.1%
Deposits	2.6%	3.1%	3.5%	3.7%	4.1%
Market shares - assets					
Bank Asya	0.5%	0.6%	0.7%	0.8%	1.1%
Turkiye Finans	0.6%	0.8%	0.8%	0.8%	1.0%
Kuveyt Turk	0.5%	0.5%	0.6%	0.6%	0.7%
Albaraka Turk	0.4%	0.5%	0.5%	0.5%	0.6%
Market shares - deposits					
Bank Asya	0.6%	0.8%	0.9%	1.0%	1.2%
Turkiye Finans	0.7%	1.0%	1.1%	1.1%	1.2%
Kuveyt Turk	0.6%	0.7%	0.8%	0.8%	0.8%
Albaraka Turk	0.6%	0.7%	0.7%	0.7%	0.8%
Market shares - loans					
Bank Asya	0.9%	1.3%	1.4%	1.4%	1.9%
Turkiye Finans	1.3%	1.6%	1.5%	1.5%	1.8%
Kuveyt Turk	1.1%	1.1%	1.1%	1.1%	1.3%
Albaraka Turk	1.2%	1.0%	1.0%	0.9%	1.0%

Source: Company data and UBS

A boom in oil-related wealth and the change to the political architecture following the terror attacks in the United States on 11 September 2001 have increased capital flows to Turkey from the Gulf region. It should be recalled that in April 2007, MNG Bank (a small conventional bank) was acquired by Arab Bank Plc and BankMed consortium, and renamed Turkland. More importantly, National Commercial Bank (NCB) agreed with the shareholders of Turkiye Finans (number two participation bank in Turkey) in July 2007 regarding the acquisition of a 60% stake in the bank at an acquisition P/BV of 5.0x (Q1 07). The value set for Turkiye Finans was one of the highest in the Turkish banking sector, and we believe that this would constitute a benchmark for future deals in the interest-free banking segment of the business. In the same month, National

Oil money is now flowing into Turkey

Bank of Kuwait (NBK) agreed with Ozyol Holding, regarding the acquisition of a 40% stake in Turkish Bank (a small conventional bank, with a mere 0.13% share in the overall banking system).

Table 12: Recent financial acquisitions by Middle Eastern investors in Turkey

Bank	Date	Acquirer	Acquired (%)	Amount paid	PBV (x)	Comment
Turkland (MNG Bank)	April -- 2007	Arab Bank & Bank Med	91.0%	US\$160m	3.40	Activated
Turkiye Finans	July -- 2007	NCB	60.0%	US\$1.1bn	5.00	Approval Process
Turkish Bank	July -- 2007	NBK	40.0%	US\$160m	5.20	Approval Process

Source: UBS

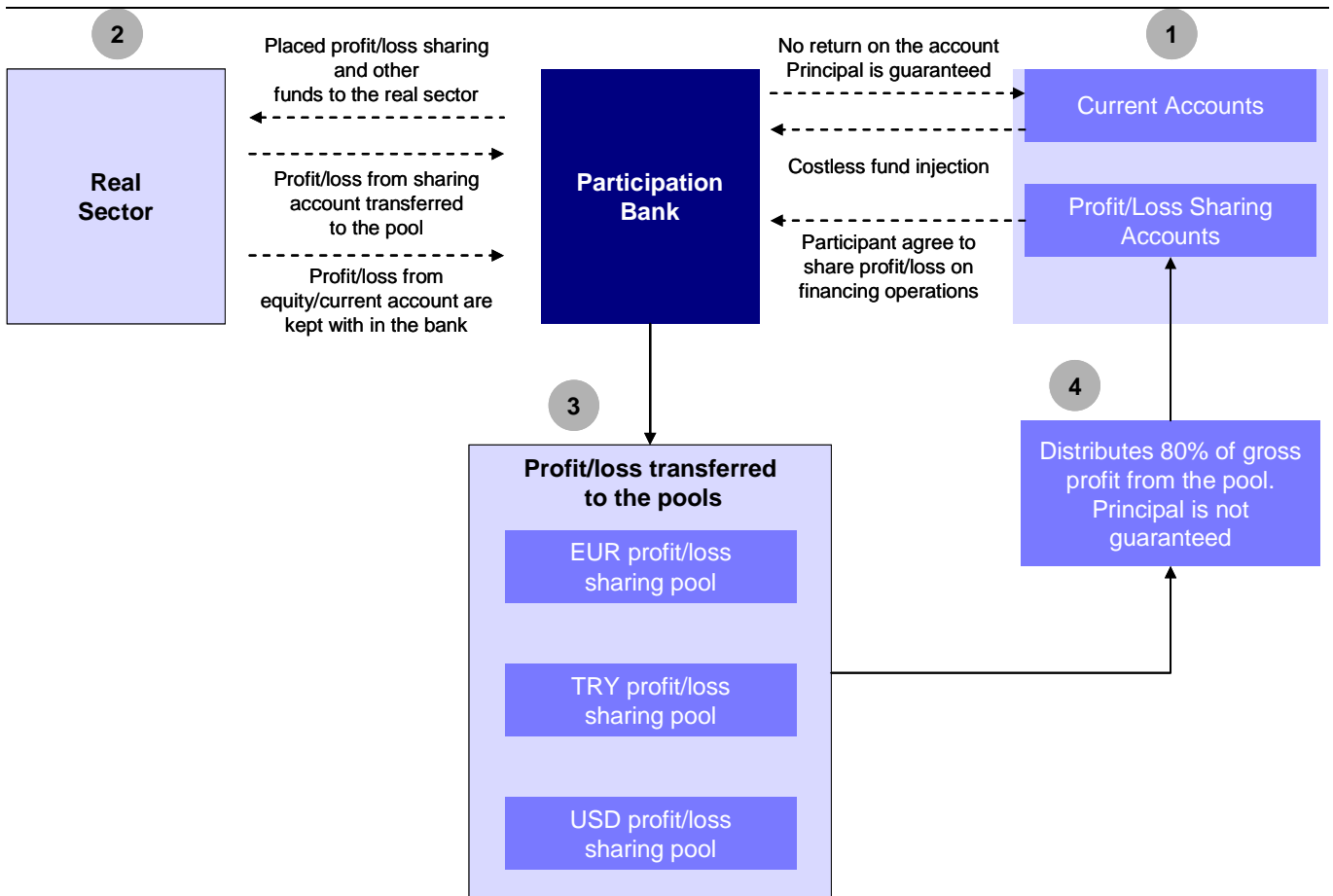
The characteristics of interest-free banking practice

As is the case in other Muslim counterparts that operate under the name ‘Islamic banking’, the functioning of participation banks in Turkey is centred on the concept of interest-free banking, where receipt and payment of any predetermined, guaranteed rate of return is prohibited. Participation banking is centred on the philosophy of ‘profit/loss sharing’, while at the same time placing equal emphasis on ethical, moral, social and religious dimensions to enhance equality and fairness for the good of the whole society.

Participation banks are fully authorised to perform all banking activities with the exception of collecting deposits, and are subject to all regulations governing the Turkish banking sector, as highlighted earlier. Instead of deposits, funds are collected in two ways: special current accounts and ‘profit/loss-sharing participation accounts’ (participation banks also have opportunities to raise funds from international capital markets), each of which described in greater detail below. Participation banks are also subject to the SDIF’s oversight and the deposit insurance protection scheme.

Funds are mainly collected through participation accounts, where no fixed/pre-determined return is offered and the principal is not guaranteed

Chart 12: Operation of a participation bank



Source: UBS

Unlike conventional banks, participation banks do not pay or receive interest as part of their banking activities – the principle difference between the two banking segments. More specifically, participation banks are prohibited from placing funds in interest-earning assets (IEA). On this context, revenues are

derived primarily from the income generated through utilising customer funds for trade finance and from service charges plus premiums. The main principles of the participation banking system, more specifically the fund generation and financing practices, can be summarised as follows:

(a) Fund collection policies

Participation banks usually categorise their funds into three different pools: (1) profit/loss-sharing account pools (time deposits); (2) special current account pools (demand deposits) and (3) banks' own sources (mainly equity), and funds are directed to lending, as participation banks are prohibited from investing in interest-earning assets. Placements are extended to customers according to the type of the pool, and underlying placements cannot be directed to another pool once the fund related to a particular pool is utilised for lending.

The characteristics of the participation banks' main funding sources are:

- (1) **Profit/loss-sharing (participation) account pools:** This account is the main source of funding for participation banks, and corresponds to an agreement between the participant, and the bank in advance on a fixed maturity to share the profit and loss generated from lending and leasing operations. Profit/loss sharing participation accounts are within themselves collected in currency pools, with maturities ranging from 1 month to 12 months. In turn, an interest-free bank lends in similar maturities and in the same currency, when compared with the participation account pools, so as to limit both maturity mismatch and FX position risks. In the event that profit evolves, the bank allocates on average 80% of its total gross profit/loss to the participant and 20% is kept by the bank itself (although some longer maturity, larger size accounts have ratios of 90-10%).

Participation accounts are established based on a revenue-sharing philosophy

In the profit/loss-sharing accounts, the profits/losses generated from the placements are transferred to the pool of profit/loss-sharing accounts, and the value of the pool is calculated on a daily basis. This application protects the participant from being exposed to the risk from one single company. In this system, where the principal is not guaranteed, the participant's profit or loss is calculated on the basis of the latest pool value and then linked to the principal amount. Even so, the participant has the right to withdraw part of the capital before the profit account expires, but no return is paid to the customer on the account.

Profits obtained from lending operations financed through participation accounts are calculated on an accrual basis, but distributed to the account holders (depositors) only if the instalments are actually cashed in. Participation banks index the profits added to the pool on a daily basis, with the intention of allowing account holders to monitor the daily performance of their accounts. The account holder, however, can only realise those profits if the underlying participation account is held to maturity. As implied above, however, there is no guarantee of return for customers of participation banks on their profit-sharing accounts, and there is no guaranteed return of the principal with respect to profit-sharing accounts. We believe that these aspects of the accounts help reduce participation banks' sensitivity to interest rate risks during periods of

The fund collection mechanism reduces the sensitivity to interest rate risks

market fluctuations and provide participation banks with a competitive advantage over conventional banks.

It should be noted that losses on the loan book are also reflected in participation accounts. Nevertheless, participation banks only have unrestricted pools in the sense that the funds are used in a wide range of placements with no limitation, and such losses do not significantly affect the rate of return. Moreover, the provisioning amendment allows banks to reserve up to 0.5% of the profits that will be distributed to participation accounts as provisions. Should a loss emerge on a credit funded by a participation account, these reserves are used in order not to reflect losses in the participation accounts.

Losses on the loan book are also reflected in participation accounts, as part of the profit/loss sharing mechanism

(2) **Special current account pools (Amana):** The nature of current accounts is identical to ‘demand deposits’ received by commercial banks except for the fact that they are not allowed to distribute profits (in the case of conventional banking, the banks are allowed to pay interest on demand deposits). The partial or full withdrawal of current accounts is possible at any time. This is a favourable means of funding for banks due to its cost-free nature. As part of the interest-free banking principles, the principle payment is always guaranteed in special current accounts.

Current accounts are similar to demand deposits, and the principal payment is always guaranteed

(3) **Shareholders’ equity:** As is the case in special current accounts, all profits generated through utilising the shareholders’ equity is channelled directly to the participation bank.

Table 13: Participation banks – a sample balance sheet structure

Assets	Liabilities
Trade Finance / Asset-backed Transactions	Current Account / Demand Deposits
Murabaha	Amana
Bay mua’jal	
Bay salam	
Collateral-based Products	General Investment Accounts*
Ijara (leasing)	Mudaraba
Istisna	Musharaka
Syndication	Specialized Investment Accounts*
Mudaraba (special purpose)	Mudaraba
Musharaka (venture capital / private equity)	Musharaka
Fee-based Services (letters of credit, safety deposit boxes, etc.)	Equity
Ju’ala	
Qard Hassana	

Source: Grais and Iqbal (2003)

Note: * A general investment account would be like an investment or time deposit, whereby customers share in the profits (or losses) of the bank, but do not have any management control. Specialised investment accounts involve a specific investment opportunity the bank offers to its clients (e.g. private equity, joint ventures or a fund)

(b) Fund utilisation policies

By their nature, participation banks are pure lenders, offering a full range of products to their customers, from corporate/commercial banking to retail banking (including credit cards). Furthermore, unlike conventional banks, which are required by law to establish a separate entity for their leasing operations, participation banks have the right to carry out leasing activities directly. As detailed before, the principles of participation banking largely dictate the purposes for a bank that lends and the procedure by which loan proceeds are extended to the customers. Of equal importance, participation banks have independent advisory boards, which relate solely to the development, approval and implementation of the bank's particular products/services, although it does not participate in the corporate governance or credit decisions.

Under interest-free banking principles, loan proceeds cannot be used for purposes or products that are deemed to be unethical, including, for example, expenditures for or related to alcohol, tobacco and gambling. Loan proceeds can only be used to support production (which generally means products used in the customer's business operations) and to pay certain service providers, so long as such services (such as installation services) were rendered in connection with the acquisition of such tangible products.

Due to the short-term nature of the funds collected in Turkey, participation banks have generally opted for short-term lending instruments such as Murabaha. As profit-sharing accounts have maturities of less than two months (on average, the same as in conventional banks), participation banks concentrate on short-term assets. In that context, most of the participation banks have ceilings for financial leasing assets and retail loans, both of which, by their nature, have longer-term maturities. On average, c70-80% of all financing in participation banks is Murabaha.

With respect to participation banks' lending practices, funds are essentially disbursed to the provider of products/services. Typically, a borrower will provide the bank with a pro-forma invoice of goods/services for which the funds will be borrowed. When the loan is extended, the money is transferred to the borrower's account, but then automatically debited and transferred to the vendor.

The profit to be paid to the participation accounts is calculated according to the pools' yields on loans, which are adjusted for NPL provisions. Participation banks allocate maximum provisioning (100% of the loan minus collateral value) for NPLs arising from the 'special current account' and 'shareholders' equity' pools. As far as the 'participation account' pools are concerned, however, most of the participation banks provision only at the minimum required level for NPLs with the intention of limiting the erosion in deposit yields (as profit to be paid to participation accounts are adjusted for NPL provisions).

On the other hand, as part of the liquidity management policies, participation banks place some of their idle funds in Murabaha investments in commodity markets for the short term, through correspondent banks with which they have established business lines. In compliance with their strategies, participation banks do not work with a speculative line in treasury transactions, preferring to keep a square position in foreign currencies.

Participation banks are pure lenders

Banking practice has to be performed according to Islamic ethics

About 70-80% of all financing is via short-term Murabaha loans

There is no cash transaction between the bank and borrower

Banks try to keep provisions on participation accounts at a minimum, in order not to hurt the deposit yields

Fund utilization alternatives are summarized below:

(4) **Corporate/commercial Finance (Murabaha):** The lending process can be classified under various names such as trade finance, cost-plus financing, purchase-sale contract, mark-up, production support programs and short-term financing. In this method, the customer applies to the bank with the pro-forma invoice of the goods he wants to buy. The bank then pays for the goods on the understanding that the transactions are essentially a purchase and sell transaction with the bank acting as an intermediary. The bank requires the final invoice from the customer as proof of purchase, and then the customer starts paying the debt to the bank in certain instalments. The difference between the purchase and sale prices constitutes the mark-up. The mark-up may be a percentage of the selling price or a lump sum.

Long-established relations with SMEs

The transaction may be concluded either without a prior promise to buy, in which case it is called an ordinary Murabaha, or with a prior promise to buy submitted by a ‘banking Murabaha’, i.e., Murabaha to the purchase order. The transaction is one of the trust-based contracts that depend on transparency with regard to the actual purchasing price or the cost price plus common expenses.

Table 14: Products offered by interest-free banks

(a) Fund Collection	(c) Other Banking Activities
Special Current Accounts	Cheque Book Services
Profit and Loss Sharing Participation Accounts	Money Remittances
	Letters of Guarantee, Performance Bonds
(b) Fund Utilisation	Credit Cards, POS Terminals
Corporate Finance	FX Transactions inc. Foreign Trade Banking
Financial Leasing	Alternative Distribution Channels
Retail Finance (Housing, Vehicles and Consumer Finance)	
Participation in Business Projects	

Source: Participation Banks Association and UBS

(5) **Retail Finance:** As is the case in corporate finance, a participation bank pays the seller for personal needs such as auto or mortgage loans on behalf of the customer (borrower), by debiting the customer later. Retail loans are primarily for the finance of home and vehicle purchases and are secured by such property. On the other hand, participation banks’ credit cards can only be used for the purchase of goods/services, and not for cash advances.

Retail loans are for the finance of home and vehicle purchases and are secured by such property

As in commercial banking practice, retail loans must be extended for products and services used in connection with the acquisition of such products. Funds are transferred directly to the vendor or service provider’s account. The repayment process of a retail loan, on the other hand, resembles the system applied in conventional banking, where a larger portion of the early payments are applied to the mark-up portion and a greater portion applied to the principal near the end of the term. In contrast with commercial loans, Turkish law requires that participation banks permit retail customers to prepay their loans without a discouragement fee.

In line with the principles of interest-free banking, the application of credit card activities differs from the application in conventional banks. Participation bank's credit card loans do not provide any cash withdrawal opportunities, and again, in line with participation banking practice, there is no compounding of interest of the type implemented by conventional banks.

Credit cards can only be used for the purchase of goods/services, and not for cash advances

For the aforementioned reasons, however, the revolving debt rate at participation banks is lower than at conventional banks. That said, the characteristic of the credit card business is more like providing credit cards as a service to increase cross-selling and generate commissions on credit card transactions. Of equal importance, credit card customers of participation banks avoid carrying large balances on their credit cards for many of the same reasons. In parallel with this behaviour, the level of problem loans in the credit card segment remains negligible.

- (6) **Financial Leasing (Ijara):** Leasing is designed for the financing of vehicles, machinery, equipment and aircraft. Various forms of leasing are permissible, including leases where a portion of the instalment payment goes toward the final purchase (with transfer of ownership to the lessee).
- (7) **Profit-sharing Agreement (Mudaraba):** This is identical to an investment fund in which managers handle a pool of funds. The agent-manager has relatively limited leeway while still having sufficient incentive to perform. The capital is invested in broadly defined activities, and the terms of profit and risk sharing are customised for each investment. The maturity structure ranges from short to medium term, and is more suitable for trade activities.
- (8) **Equity Participation (Musharaka):** This instrument resembles the classic 'joint venture'. Both the bank and the entrepreneur contribute to the capital (assets, technical and managerial expertise, working capital, etc) of the operation to varying degrees and agree to share the returns/risks in proportions, which are agreed to in advance. Traditionally, this form of transaction has been used to finance fixed assets and working capital of medium to long-term duration.

Unlike at conventional banks, participation banks are allowed by law to carry out leasing transactions directly

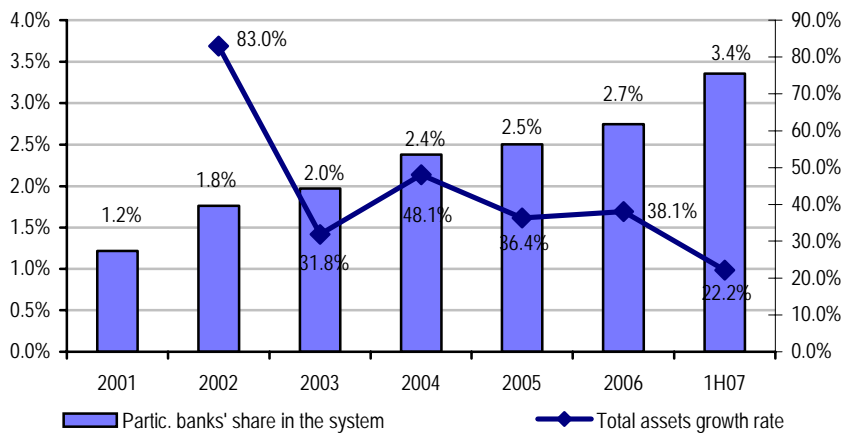
Profile of participation banking

Overview of participation banks

Participation banking has a short history in the Turkish banking system, and captures a mere 3.4% share in the overall banking sector. That said, this has come up from as low as 1% in the early 2000s, recording a CAGR of 36% over the past five years versus 20% for the overall banking sector in the same period. Similar trends were witnessed on the funding and lending sides, where participation banks grew at significantly higher rates, when compared with the conventional banks. Total deposits held by participation banks grew at a CAGR of 34% in 2003-07, compared to an average 20% growth rate per year for the overall banking system. A similar picture is seen in lending performances; Participation banks recorded a CAGR of 47% (including lease receivables), compared with 37% in the banking sector for 2003-07.

Participation banks have significantly higher growth rates than conventional banks

Chart 13: Participation banks – the growth performance (2001-07)



Source: Turkish Participation Banks Association and UBS

Factors stimulating the growth in participation banking include:

- **Improved regulatory environment:** Introduction of state guarantees on participation accounts and a stronger regulatory framework improved public's confidence, which had been eroded by financial crisis in early 2000s.
- **The reform and disinflation process:** The restructuring/disinflation process that has taken place in the economy since 2001 has reshaped the overall financing system and put the participation banks into a stable growth phase.
- **Aggressive growth strategies:** The wider branch network and emphasis on marketing operations boosted earnings and allowed market share gains.
- **Experience in lending:** Close relationships established with SMEs allowed banks to exploit the credit demand that has emerged in the past few years.
- **Growing customer/participant awareness of the system:** Increased marketing activities helped interest-averse people to join the system.

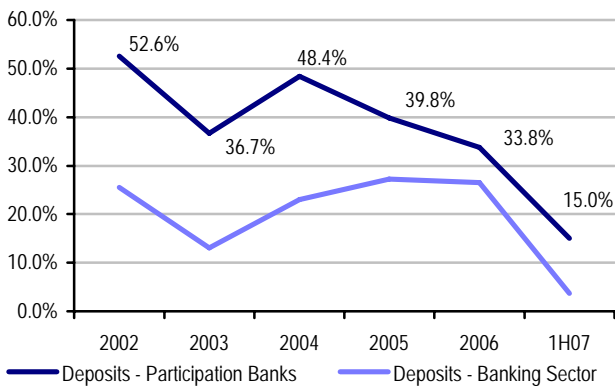
Long-established relations with SMEs are paying off

- **Expansion of product mix with more customer-focused strategies:**
Conventional banks' focus on SMEs encouraged participation banks to expand their product mix, with the intention of maintaining customer base.

Banks were hit by the financial crisis in early 2000s. But, interest-free banks also suffered from the erosion of confidence in the system, which relied on a revenue-sharing philosophy. In 2001, Ihlas Finans filed for insolvency, triggering a run on participation banks. It was in the immediate wake of this turbulence that deposits were brought under a state guarantee scheme. With the state guarantee covering current/profit sharing accounts, and backed by the factors listed above, participation banking has entered into a growth phase.

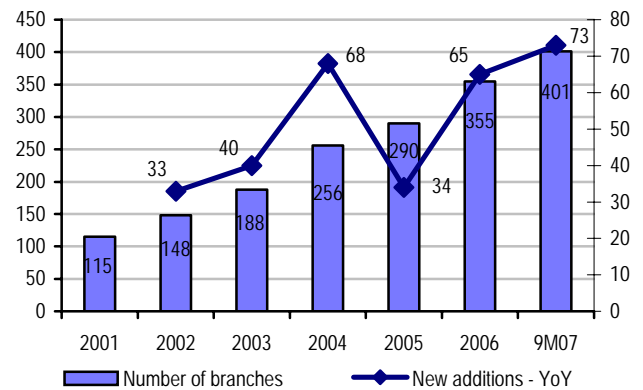
The bankruptcy of Ihlas was the turning point for participation banks

Chart 14: Deposit growth (2002-07)



Source: Turkish Participation Banks Association and UBS

Chart 15: New branch additions (2002-07)

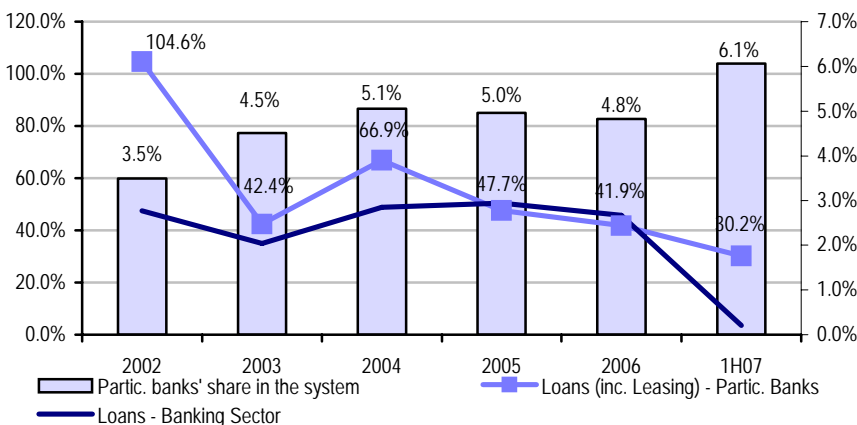


Source: Turkish Participation Banks Association and UBS

It should be noted that participation banking assets grew at a CAGR of 36% in 2003-07 – almost twice as fast as the CAGR of 20% in the overall banking system. Accordingly, the market share of participation banks in the banking system has reached 3.4%, and more than doubled from 1.2% in 2001 to 2.7% in 2006. Similar trends were witnessed on the funding and lending sides, where participation banks grew twice as fast as conventional banks.

The share of participation banking in the banking system has tripled since 2001

Chart 16: Loan growth (2002-07)



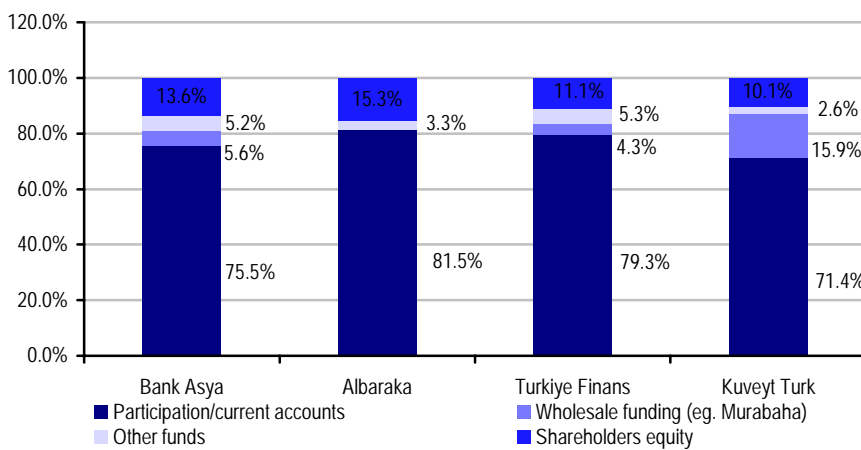
Source: Turkish Participation Banks Association and UBS

The funding structure of participation banks

As is the case at conventional banks, deposits are the main source of funding for participation banks, capturing a 77% share in the balance sheet (versus 62% for conventional banks). Participation banks are extremely under-leveraged, with only limited exposure to external funding, and we think the low leverage nature of the balance sheet raises the potential for future growth. That said, interest-free banking is still very much in its youth, and international interest-free markets lack the depth and experience to handle international deals. An interest-free bank that enters external-financing deals usually has limited financial backing, raising the cost of interest-free funds compared with other types of funds.

Participation and current accounts constitute the main source of funding

Chart 17: Breakdown of the funding base – 9M07 *

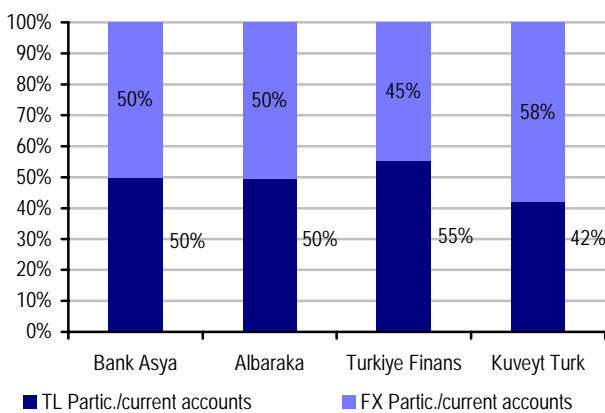


Source: Company data and UBS; Note: * Kuveyt Turk financials refer to 1H 07

Kuveyt Turk and Bank Asya have the highest exposures to wholesale funding (or more specifically to the so-called Murabaha syndications) with 16% and 6% share in balance sheets, respectively. On the other hand, Albaraka Turk has no exposure to external funding, and at least in the short term, has no plans to raise funds via murabaha (or any other long-term interest-free instruments).

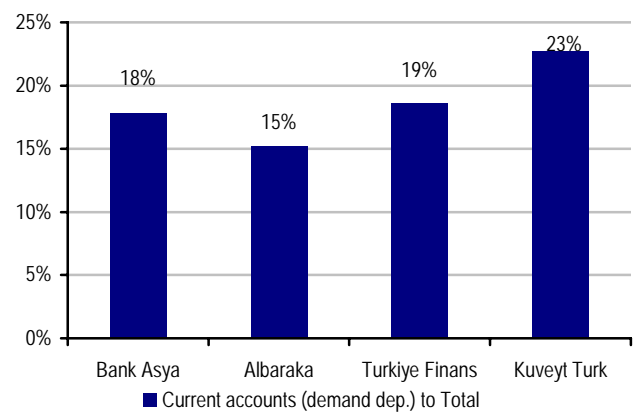
Only 6% of Bank Asya’s funding is dedicated to wholesale funding, whereas Albaraka has no exposure to wholesale/external funding

Chart 18: Currency breakdown of deposits – 9M07 *



Source: Company data and UBS; Note: * Kuveyt Turk financials refer to 1H 07

Chart 19: Demand deposits as % of total – 9M07 *



Source: Company data and UBS; Note: * Kuveyt Turk financials refer to 1H 07

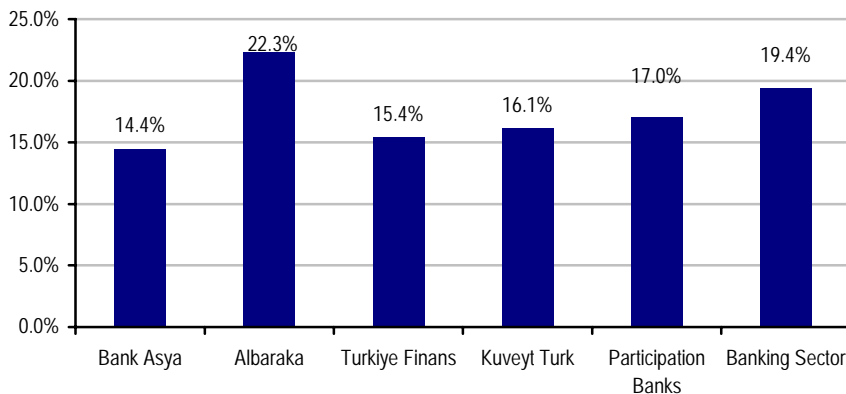
Headed by Albaraka, however, most of the participation banks are indirectly involved in long-term financing by acting as guarantors for their customers, by channelling Murabaha finance from foreign banks. Since these funds are not listed as a liability on the balance sheet, the underlying commitment is recorded off-balance sheet. Just as importantly, participation banks also generate fee revenues from the underlying transactions by providing non-cash loans (letter of guarantees, credits etc.) to customers.

On the other hand, participation banks are stronger in terms of attracting demand deposits, the cost-free way of funding their assets. Demand deposits on average accounted for 19% of the total assets in participation banks as of 9M07, higher than the 16% share in the overall banking sector. Among the two listed banks, the greater portion of the loan book of Bank Asya is funded via demand deposits and shareholders equity and is one of the key reasons why Bank Asya posts higher NIMs, as detailed in later sections.

Capital adequacy

Participation banks' capital adequacy ratio (CAR) averaged 17% as of 9M07, which is below the overall banking sector ratio of 19% in the same time frame. That said, CAR levels are well above the minimum required level of 8% highlighted above, and comfortably satisfies the so-called 'target level' set by the banking watchdog. The target level was introduced by the regulator in 2006, which aims to prepare the banks for the Basel-II environment and to force banks to strengthen their capital structures. It should be noted that a bank is banned from opening new branches and is required to pay higher SDIF premiums if the target CAR level is below 12%.

Chart 20: The CAR comparison – 9M07 *



Source: Company data and UBS; Note: * Kuveyt Turk financials refer to 1H 07

The first set of criteria regarding Basel-II application has been the inclusion of operational risk to the capital adequacy ratio calculations in 1H07, which swept away on average 250bp from the CARs of the five conventional banks in our coverage universe. The second stage of the Basel-II process is to incorporate new risk weightings to banking assets, and was planned to be in effect by 2008. In July 2007, however, the regulator deferred the implementation of the second

Albaraka Turk is involved in long-term financing indirectly by acting as a guarantor for its customers

Demand deposit in total is higher in Bank Asya versus Albaraka

Participation banks in general have lower CARs, when compared with conventional banks

Introduction of Basel-II will sweep away some 250bp from the CARs of the conventional banks in our coverage universe

stage to 2009, which we think allowed the banks room to improve their capital adequacies further.

As with the rest of the banking sector, the introduction of Basel-II applications to the Turkish banking system will erode participation banks' CAR levels as well. By their nature, however, participation banking practices bear zero exposure to government securities, and the decline in the CAR will therefore be much lower for participation banks than for conventional banks.

Due the nature of their business, erosion in participation banks is relatively limited

Table 15: Expected Basel-II impact on Turkish banks

	CAR		Impact of operational risk	Impact of new weightings		Full impact of Basel-II application
	2006	9M07*		Stage I	Stage II	
Akbank	20.7%	20.4%	280bp	200bp	480bp	
Isbank	23.9%	20.8%	260bp	300bp	560bp	
Garanti	14.1%	15.1%	160bp	100bp	260bp	
YKB	12.3%	12.9%	140bp	200bp	340bp	
Vakifbank	19.7%	16.6%	290bp	200bp	490bp	
Bank Asya	18.1%	14.4%	140bp	150bp	290bp	
Albaraka	15.3%	22.3%	250bp	200bp	450bp	

Source: Company data and UBS; Note: * This reflects the impact of operational risk

Bank Asya has the lowest CAR (14% as of 9M07) among the participation banks, which should be attributed to the aggressive growth strategies pursued by the bank over the years (which have been paying off), and to the change in the regulation which increases the weight of non-cash loans in risk-weighted assets (RWA). It should be noted that Bank Asya's overall loan book posted a CAGR of 62% over the past three years, enabling the bank to post above-average returns on its loan book, when placing the bank on top of the participation banking segment. We do not see particular capital pressure on Bank Asya despite fast growth, due to the high ROE, and that full retention of profits for the next five years. We also expect the bank's management to improve its capital base through alternative funding instruments like subordinated debt, and hence, the robust credit growth rates to remain intact.

Bank Asya has the lowest CAR, due to the aggressive growth strategies implemented over the years

On the other hand, Albaraka Turk has the highest CAR (22%) among the banks we cover, which gives the bank more than enough room to finance the expected aggressive credit growth going forward. It should be recalled that Albaraka Turk distributed YTL10m from its 2006 profit (a payout ratio of 11%), and in line with the aim of financing the growth process (and suggested by the management), we expect Albaraka Turk's dividends to remain limited in the coming years. In our projections we have assumed that the Albaraka Turk will continue to distribute cash dividends to its ordinary shareholders going forward, but with a payout ratio of 15%.

Albaraka Turk has a CAR as high as 22%, which is more than high enough to exploit the expected credit growth going forward

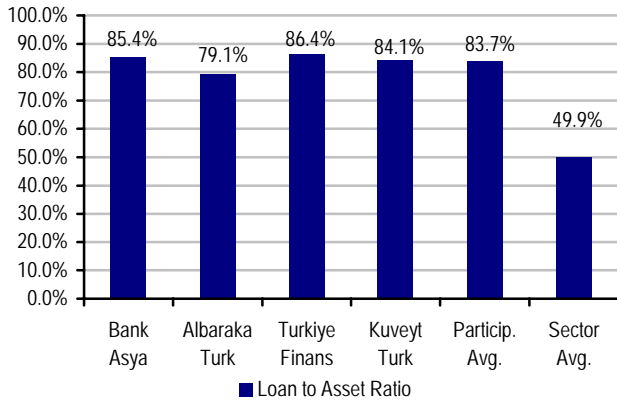
The lending performance

Participation banks have a developed lending culture because they have been carrying out the so-called 'real banking' since their establishment. These banks have higher loan exposures in the Turkish banking system with a loan (including lease receivables) to asset ratio averaging 84%, in contrast to the banking

Participations banks posted CAGR of 47% in loans over the past four years, with strong dedication to SMEs

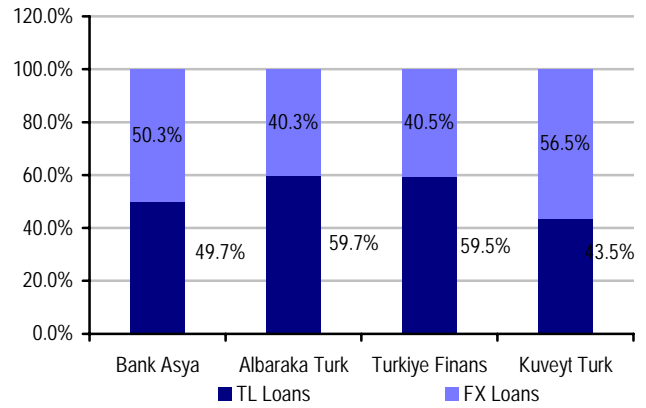
sector's average of 50% as of 9M07. Of equal importance, the focus on SMEs has been paying handsomely, with participation banks' overall loan book posting a CAGR of 47% over the past four years (in the 2004-06 period). Note that retail loans (including credit cards) constituted only 14% of the overall loan books, and presence in the second-highest yielding segment (SME banking) enables participation banks to record above-average returns on their loan books.

Chart 21: Loan-to-asset ratio – 9M07 *



Source: Company data and UBS; Note: * Kuveyt Turk financials refer to 1H 07

Chart 22: Currency breakdown of the loan book – 9M07 *

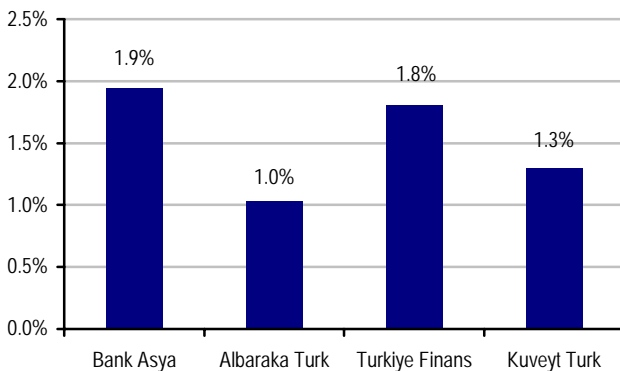


Source: Company data and UBS; Note: * Kuveyt Turk financials refer to 1H 07

Bank Asya leads the participation banks, with a 2% market share in the overall banking system. Bank Asya's loan book is dedicated to the SME/commercial segment of the business. We need to highlight that this has risen from 0.9% in 2003, thanks to aggressive organic growth strategies implemented in the period. In fact, Bank Asya recorded a CAGR of 78% between 2003 and 2007, significantly beating the participation bank average and the sector as a whole.

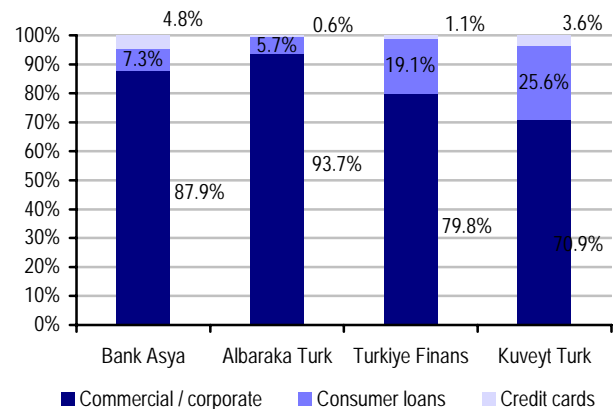
Bank Asya leads the participation banks, with a strong presence in the so-called *murabaha* loans segment

Chart 23: Loan market shares – 9M07



Source: Company data and UBS

Chart 24: Loan breakdown by business segment *



Source: Company data and UBS; Note: * Kuveyt Turk financials refer to 1H 07

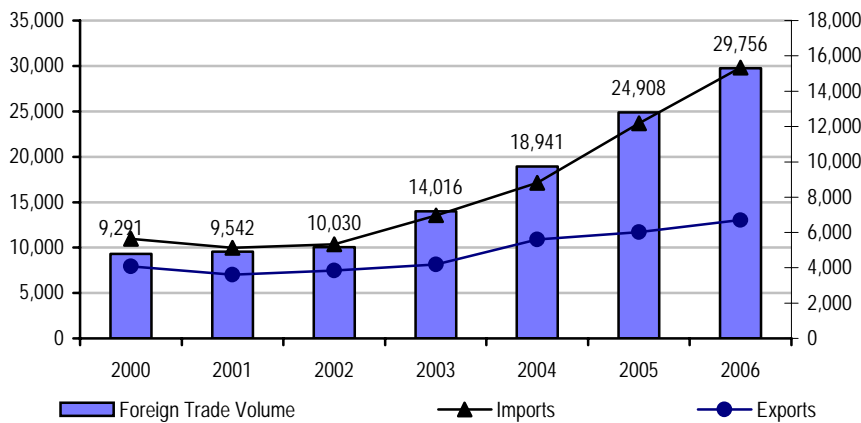
Albaraka Turk, on the other hand, has the lowest market share among participation banks, failing to extend its market share over the past four years. This could be attributed to the bank's profit-driven approach, which puts the bank closer to the conservative side of the business in terms of growth policies. Turkiye Finans was second to Bank Asya among participation banks, capturing 50bp in the loan market since 2004.

Albaraka has the lowest share among the four, which can be attributed to conservative lending policies

Turkey’s exports have reached record-breaking levels in recent years. More importantly, the scope of Turkey’s cross-border economic relations have also widened from being mainly focused on the EU to include the Middle East and North Africa (MENA) region as well, where the Turkish presence has become more prominent in recent years. Turkey has increased its presence in these areas and has hence increased its trading volumes in the MENA in recent years, with North Africa rising as a major export and direct investment market for Turkish businesses and entrepreneurs, and the Arab Gulf countries closely eyeing business and investment opportunities in Turkey.

Growing trade interactions with the MENA region are expanding non-cash loans and adding on fee revenues

Chart 25: Turkey's foreign trade volume with the MENA region (US\$m)



Source: Turkish Statistical Institute

Turkey is benefiting from increased wealth from oil money, as well as the change in global political architecture after the terror attacks in the United States on 11 September 2001. Investments by Muslims are now flowing into Turkey via privatizations and acquisitions. We expect the presence of gulf money to increase further with further investments in Turkey’s real estate sector, as well as the upcoming privatizations. In this context, and backed by a business model which focuses primarily on trade financing, participation banks boast several key strengths against conventional banks, which have contributed to their growth, profitability and efficiency.

In terms of exploiting the opportunities arising from the inflow of oil money, participation banks boast key strengths when compared with conventional banks

The practice of interest-free banking is in theory supportive of asset quality, and the lending system limits the deterioration in loan books. With the fund utilisation practice applied in the system, which requires participation banks to transfer funds to the vendor/service provider’s account, the borrower has less opportunity to deceive the bank in terms of the purpose of the use of the loan. We need to stress that the bulk of bad loans were related to the 2001 crisis, as most participation banks had not written these loans off over time. That said, due to heavy exposure to the SME segment of the business, new NPL additions were higher than at conventional banks.

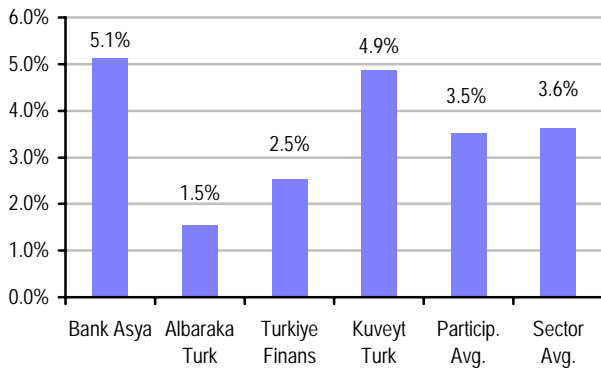
Participation banks have higher NPLs because they have strong SME exposure

Bank Asya has the highest NPL ratio among its peers, with 5.1% by 9M07, which should be attributable to faster growth and higher dedication to the SME segment of the business, where average NPLs are hovering around 7-8% levels. On the contrary, due to the strict credit risk management policies and strong

Bank Asya has the worst asset quality records; Albaraka has the strongest

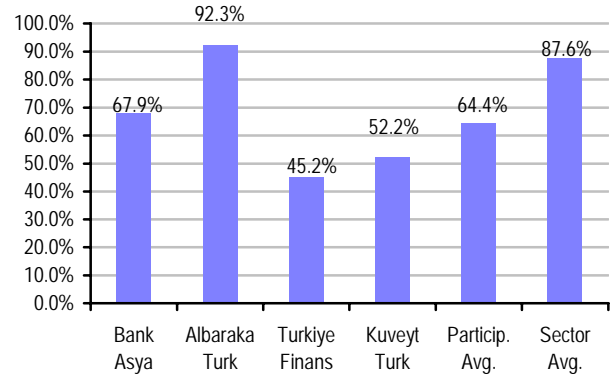
emphasis placed on asset quality at the group level, Albaraka Turk boasts the strongest asset quality among participation banks, and indeed compares favourably with conventional banks. As of 9M07, Albaraka Turk’s NPL rate stood at just 1.5%, well below the 2.5% NPL for Turkiye Finans, the second lowest among participation banks. In the same time frame, the average NPL rate for participation banks and the sector stood at 3.5% and 3.6%, respectively.

Chart 26: NPL rates (gross) – 9M07 *



Source: Company data and UBS; Note: * Kuveyt Turk financials refer to 1H 07

Chart 27: NPL provision rates – 9M07 *



Source: Company data and UBS; Note: * Kuveyt Turk financials refer to 1H 07

As far as provisioning policies are concerned, however, participation banks are less conservative than conventional banks. In 2006, the NPL coverage ratio of participation banks stood at 64%, behind the 88% average for the entire banking system. Participation banks’ lower propensity to provision should be attributed to the ‘loss sharing’ nature of provisions recorded for the loans financed by profit/loss sharing accounts. Participation banks reserve 100% provisions for loans financed through the equity or current accounts.

Participation banks have a lower propensity to provision, because of the loss-sharing nature of interest-free banking

However, since provisions related to the loans that are financed by profit and loss-sharing participation accounts have to be shared with the participation account holders as a loss, interest-free banks usually reserve at the minimum required level. Looking at provisioning policies on an individual bank basis, the risk-averse approach ensures that Albaraka Turk almost fully provisions its problem loans regardless of the collateral held. As of 9M07, 92% of bad loans were provisioned, followed by Bank Asya among participation banks with 68%.

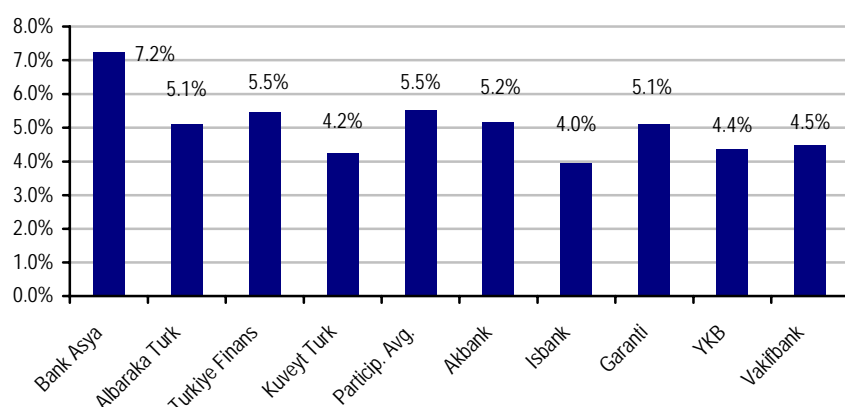
Due to its conservative stance, Albaraka provisions almost fully for problem loans

Interest income generation and the NIM

By their nature, participation banks do not participate in the deposit collection race, and the limitations of participation banking ensure that these banks are relatively resilient to volatility in financial markets. On average, almost half of the deposits (according to management guidance) are tied to participation banks due to interest concerns. In other words, such deposits are relatively sticky (less price sensitive), and hence, less subject to competition. As a result, the business model enables below-sector average funding costs for participation banks. On the other hand, the interest-free banking model prevents these banks from placing funds in interest-earning assets; hence, loan-to-asset ratio is averaged at as high as 84% (inc. lease receivables), the highest in our coverage universe.

Participation banks have the benefit of below-sector average funding costs

Chart 28: NIM comparison – 9M07 *



Source: Company data and UBS; Note: * Kuveyt Turk financials refer to 1H 07

Deposits, which constitute the primary source of funding (about 80% of the total as of 9M07) do not offer any fixed/pre-determined return to the depositor; instead, the return on the placements is shared with the depositor. This system therefore limits the extent of interest rate risk (one of the main systemic risks of the banking system) that participation banks are subject to, while enabling funding costs to navigate to below sector levels. On the other hand, implementing the ‘currency pooling method’ enables participation banks to refrain from another financial market-related issue, the FX open position risk.

The process of intermediation limits the interest rate and FX open position risks

Table 16: NIM and spread performance – 9M07

(%)	Bank Asya	Albaraka Turk	Turkiye Finans	Kuveyt Turk
NIM (unadj.)	7.2	5.1	5.5	4.2
Interest yield (blended)	15.0	11.9	13.1	10.7
Interest cost (blended)	9.1	8.8	8.3	7.3
Balance sheet spread	5.9	3.1	4.8	3.4
Loan/deposit spread	4.5	4.3	3.2	3.6

Source: UBS

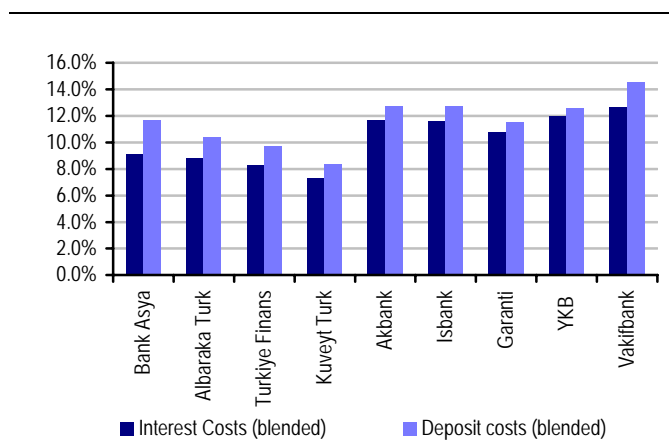
The nature of the funding system is not the only issue to highlight for participation banks. These banks boast a developed lending culture because they have been carrying out the real intermediation process since their establishment, which SME lending – their primary focus – has been paying off with total loans posting CAGR of 47% over the past four years. Note that retail loans constituted only 14% of total loans, and as players in the second-highest yielding segment, SME banking (a segment where the customer is less price sensitive and relations, services, and consultancy are crucial), participation banks are able to record above-average returns on their loan books.

SME exposure means the return of the loan book is higher than at conventional banks

Of equal importance, participation banks collect payments from the loan portfolio on a monthly basis, which allow these banks to receive 10-15% of their loan book on hand as liquidity each month. While pushing yields higher, the lending system also limits the interest rate risk as the extent of the duration gap is much more limited when compared to conventional banks. In addition, it is important to highlight that participation banks are less sensitive than conventional banks to a decline in interest rates. It should be noted that participation banks' NIMs has declined by 120bp on average over the past three years, while the conventional banks in our coverage universe have seen NIM levels plummet by 200bp in the same period.

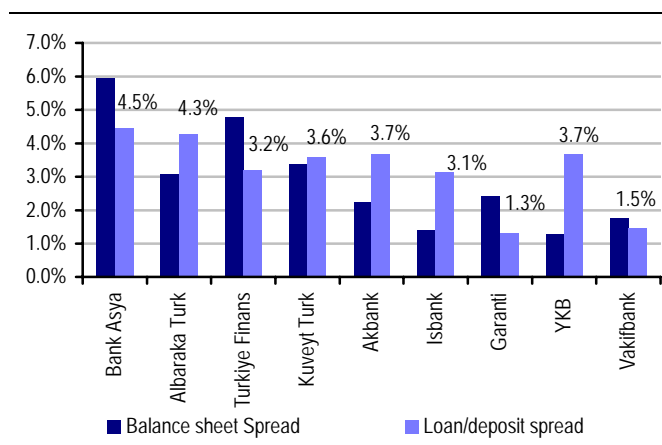
The decline in NIMs was smoother, with no exposure to securities and only limited exposure to consumer lending

Chart 29: Funding costs – 9M07 *



Source: UBS; Note: * Kuveyt Turk financials refer to 1H 07

Chart 30: Spread analysis – 9M07 *



Source: UBS; Note: *Kuveyt Turk financials refer to 1H 07

Bank Asya enjoys the highest NIMs among participation banks, and obviously one of the highest in the overall banking system. Bank Asya's NIM stood at 7.2% as of 9M07, and the strong margin records can be attributed to:

Bank Asya has the highest NIM among peers and one of the highest NIMs in the overall banking system

- (a) **Strong return on the loan book:** Bank Asya has no exposure to government securities and its loan to asset ratio was as high as 85%. More importantly, bulk of the funds is dedicated to the under-penetrated SME segment, where the bank enjoys almost 25% TL yields and high customer loyalty. Accordingly, Bank Asya posts the highest yields among its peers, when the business model enables funding costs of the bank to remain below sector average levels.
- (b) **Greater portion of the loan book is financed through costless funding:** Bank Asya has the highest free equity among the peer group, and has the largest demand deposit base (or current accounts), which has enabled the

bank to finance greater portion of its loan book through costless funding – allowing higher interest margins.

On the contrary, Albaraka Turk’s NIM stood at 5.1% (9M07), and is expected to increase further in the coming quarters, as we believe that positives of the capital increase that was undertaken in Q2 would become more evident in 2008. Overall, we expect participation banks to witness relatively mild declines in their NIMs, when compared with conventional banks, in a falling interest rate environment. Our view of smoother margin contractions can be attributed to:

- (1) **Zero exposure to low-yielding government securities.** About 30% of banking sector assets is still tied to government securities, which raise the sector’s vulnerability to interest rate fluctuations.
- (2) **Only limited exposure to low margin retail lending.** The share of retail loans in the overall loan book stood at just 14% as of 9M07 for participation banks, compared to an average of about 35% in the overall banking sector (including credit card loans).
- (3) The bulk of funds are dedicated to the underpenetrated SME segment, where participation banks enjoy c25% local currency yield and relatively high customer loyalty.

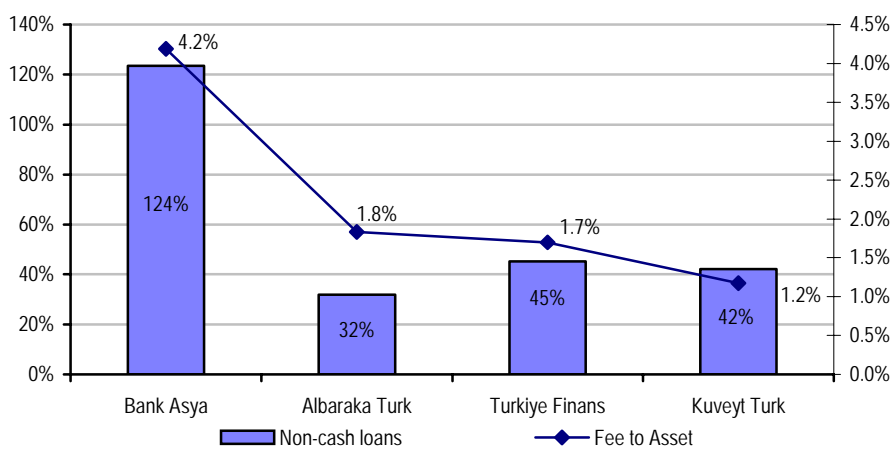
Albaraka has one of the lowest NIMs among its rivals because a higher portion of the loan book is financed via participation accounts

Fee income generation

Participation banks’ non-interest income generation power is on average beyond conventional banks, thanks to their strong presence in non-cash lending and trade finance. Looking at the fee revenue presence in overall income; participation bank earnings are more reliant on fee income, with fee to total income ratio stood at 28% by 9M07 versus on average 20% for the overall sector. Of equal importance, fee revenues of participation banks covered on average 66% of operating costs, when coverage ratio was 50% for the banking sector as a whole. Bank Asya has the best fee income generation records in the Turkish banking system, with a fee-to-asset ratio more than twice as high as the sector average, and 93% of all operating costs are covered by fee revenues.

Higher cash and non-cash loan exposures allow stronger fee income records than at conventional banks

Chart 31: Non-cash loan exposure – 9M07 *

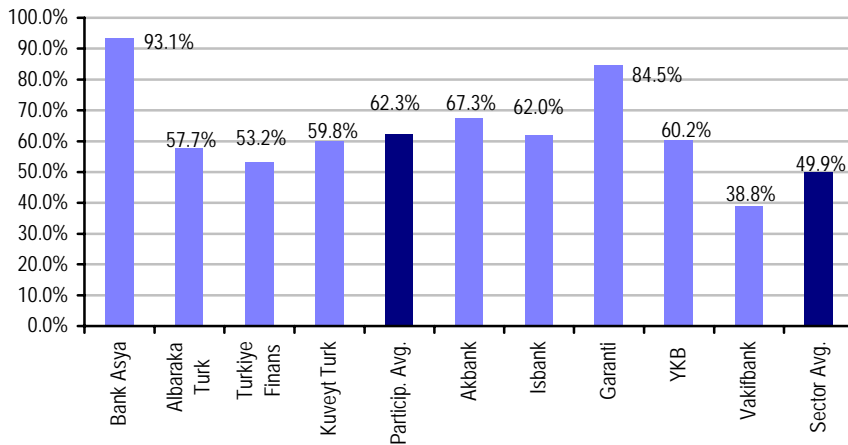


Source: Company data and UBS; Note: *Kuveyt Turk financials refer to 1H 07

As highlighted above, one key feature of participation banks is their exposure to off-balance sheet activities, where letters of guarantee, letters of credit and commitments stand out as the main instruments. Bank Asya is ranked fourth in the non-cash loan market in the banking sector and has highest non-cash loan exposure relative to its balance sheet size (among the listed banks). It should be noted that the bank’s non-cash loan-to-asset ratio was as high as 124% as of 9M07, which in turn allows strong commission inflows.

Bank Asya’s fee-to-asset ratio is twice as high as the banking sector average, and almost all operating costs are covered

Chart 32: Fee – opex coverage ratios – 9M07 *

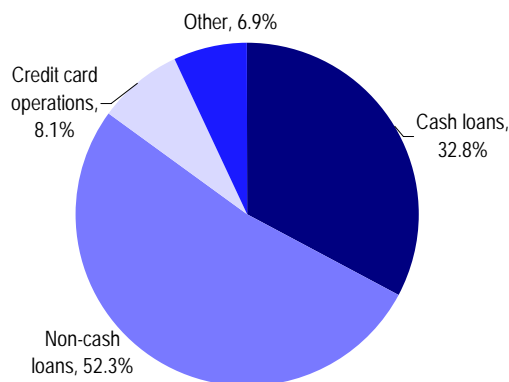


Source: Company data and UBS; Note: *Kuveyt Turk financials refer to 1H 07

Albaraka Turk lags behind the other three participation banks in terms of fee income generation, mainly due to its risk-averse stance, leading the bank to adopt a cautious approach to non-cash lending. It should be noted that the bank’s non-cash loans are now five times higher than in 2005 (YTL1.06bn as of 9M07). Nevertheless, the ratio of non-cash loans remained at 32%, versus 124% for Bank Asya. Accordingly, Albaraka Turk’s fee-to-asset ratio stood at 1.8% in 9M 07, and 53% of operating costs are covered by fee revenues, versus the participation bank averages of 2.2% and 66%, respectively.

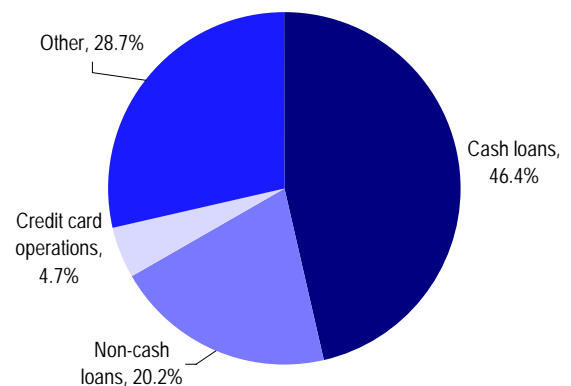
Albaraka has a relatively weaker record, which is attributable to its limited exposure to non-cash loans

Chart 33: Net fee breakdown – Bank Asya



Source: Company data and UBS

Chart 34: Net fee breakdown – Albaraka Turk



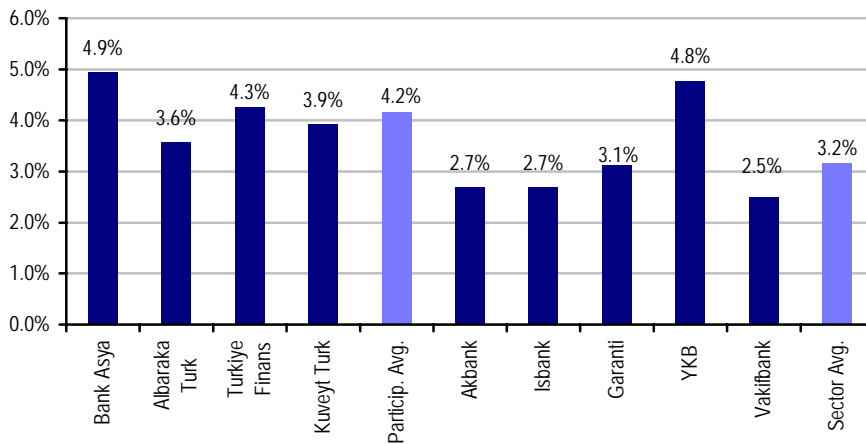
Source: Company data and UBS

Cost efficiency records

Participation banks in general have weaker cost efficiency records, when compared with conventional banks, which can largely be attributed to investments in the branch network and to the economies of scale disadvantages. As shown in the next section of the report, however, participation banks have more than compensated for owning a higher cost base via stronger operating profit performances.

Weaker cost efficiencies because of economies of scale and investments in the branch network

Chart 35: Cost-to-asset ratios – 9M07 *

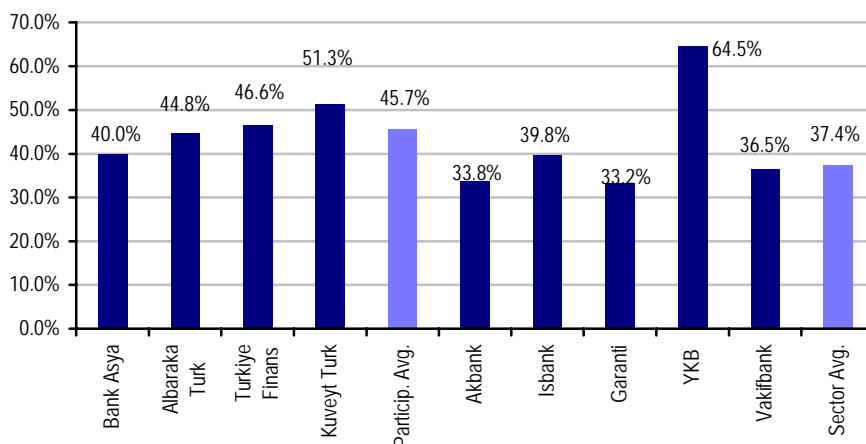


Source: Company data and UBS; Note: * Kuveyt Turk financials refer to 1H 07

Bank Asya has the highest cost-to-asset ratio among its peers, which can be attributed to the organic expansionary policies. The bank has been in a growth phase, and the branch network has more than doubled in the past three years. Going forward, we think that Bank Asya should benefit more from the economies of scale in line with the planned branch expansion. When cost to income ratio is considered, Bank Asya has the lowest record at industry standards, thanks to its strong interest income and fee generation powers that boosts the denominator (total income).

Bank Asya has the worst opex record; a natural consequence of aggressive growth policies, almost all of which are covered by fee revenues

Chart 36: Cost-to-income ratios – 9M07 *



Source: Company data and UBS; Note: * Kuveyt Turk financials refer to 1H 07

The operating cost record at Albaraka Turk is better than the industry standards, but weaker when compared with conventional banks. Albaraka Turk’s cost-to-asset ratio was 3.6% in 9M07. However, the bank has one of the poorest ‘fee coverage ratios’ (the ratio of net fee revenues to operating expense) in the banking sector, which we think is an issue of economies of scale. With the upcoming balance sheet growth, we also forecast further improvement in cost efficiency ratios, even though branch openings are a central feature of the bank’s organic expansion strategy.

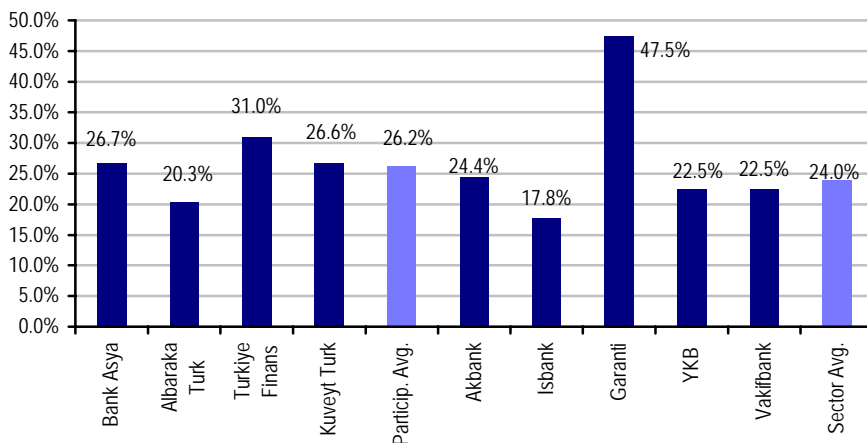
Albaraka has better cost efficiency records than the industry standards

Profitability

Participation banks in general enjoy stronger profitability ratios, thanks to their effective business model, which allows higher net interest income and fee revenue generation than conventional banks. As of 9M07, the average ROE of participation banks was 26%, which could have been higher if Albaraka Turk had not hold its capital increase in Q2. It should be recalled that by end-2006, the ROE of participation banks averaged 30% versus 20% for the overall banking sector. We think the strong profitability of participation banks is attributed to (1) high NIM and (2) the growing contribution of fee revenues.

Participation banks have higher ROEs than conventional banks

Chart 37: ROE Comparison – 9M07 *



Source: Company data and UBS; Note: *Kuveyt Turk financials refer to 1H 07

Bank Asya’s ROE was as high as 27% in 9M07 (and the ROA was as high as 3.8% versus the banking sector’s 3.0% in the same time frame), and is obviously one of the most profitable banks in the Turkish banking system. Albaraka Turk’s ROE came down to 20% in Q3 (and ROA was at 2.6% by 9M07), not because of the deterioration in bottom line earnings but because of the capital increase undertaken in the second quarter of the year. It should be recalled that Albaraka Turk’s ROE was as high as 32% at the end of 2006, whereas the banking sector and participation banks averaged 20% and 30%, respectively.

With an ROE of 27%, Bank Asya is one of the most profitable banks in the system; Albaraka’s ROE dropped to 20%, following the capital increase in Q2 07

Participation vs conventional

Key strengths over conventional banks

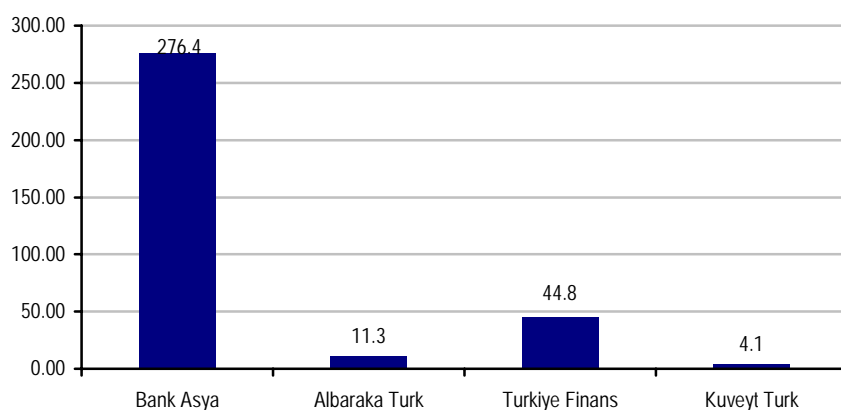
Participation banks are exposed to much more limited risks than conventional banks, due to the nature of interest-free banking. More specifically, participation banks have little vulnerability to the systemic risks faced by conventional banks. In other words, their business model can be defined as defensive relative to conventional banking. That said, the defensive characteristics of participation banking should be evaluated not merely from a risk perspective but also from the point of view of profitability. The developed lending culture, and the process of intermediation itself, allows participation banks to record strong bottom-line earnings. The key strengths of participation banking are summarised below.

- (1) **Limited exposure to systemic risks, such as interest rate and open FX position risks:** The “currency pooling method” implemented as part of the financial intermediation process helps protect participation banks against foreign currency fluctuations. Participation banks establish profit/loss sharing participation accounts according to the type of currency, and loans are extended to customers from each pool of the same currency. It should be noted that the FX on-balance-sheet position of participation banks stood at a surplus by 9M07, while for conventional banks this figure was a negative US\$7.2bn (FX open position).

A defensive business model

Currency pooling method provides cushion against FX risk

Chart 38: FX on-balance-sheet position (US\$m) – 9M07 *



Source: Company data. *Kuveyt Turk financials refer to 1H07

- (2) **Fund utilisation practice allows higher returns on the loan book, while limiting the interest rate risk (the main systemic risk of the Turkish banking system):** The main systemic risk of the Turkish banking system is interest rate risk, due to maturity imbalances between assets and liabilities. The average deposit maturity is less than two months, and banks in turn extend loans on average for six months. Participation banks have similar maturity structures. However, the “fund utilisation practice” limits participation banks’ interest rate risk. As emphasised earlier, profit and loss participation accounts do not offer any fixed/predetermined return to the depositor; instead, the return on the placements is shared with the account holder. This system therefore limits the interest rate risk.

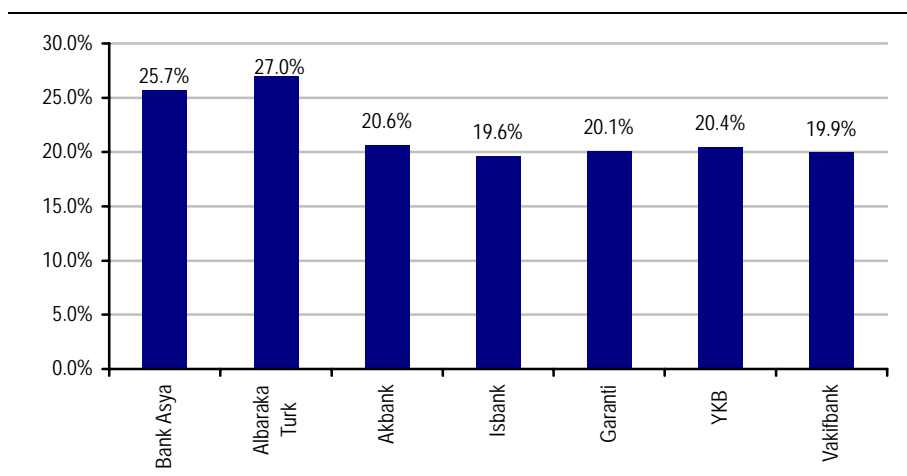
The process of financial intermediation limits the extent of interest rate risk

Of equal importance, the lending process requires the bank to pay the vendor for goods/services on behalf of the customer, and the customer in turn pays the bank in monthly instalments. This system allows banks to receive on average 10-15% of the loan book on hand as liquidity each month. While pushing yields higher, the lending system, therefore, limits interest rate risk.

- (3) **Long-established relations with SMEs are paying off:** Participation banks have a developed lending culture, as they have been engaged in so-called “real banking” since they were established. Their primary area of focus, SMEs, has paid off handsomely with total loans by participation banks posting a CAGR of 47% over the last three years. Note that retail loans, in which competition is intense and returns are relatively low, constitute only a limited proportion of loan portfolios, and being a player in the second-highest yielding segment – SME banking – enables a participation bank to record above-average returns.

Focus on SMEs allows above-average returns on the loan book

Chart 39: YTL loan yields (return on loans, annualised) – 9M07



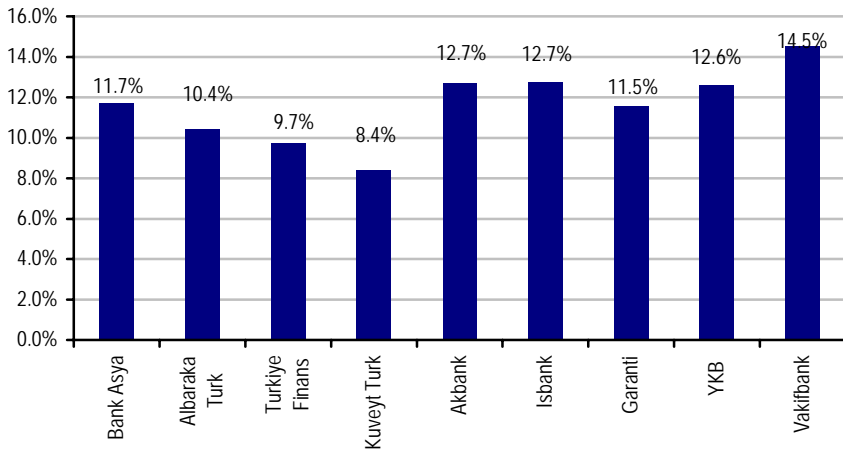
Source: Company data, UBS

- (4) **Less subject to competition vs. conventional banks, due to the nature of interest-free banking practice:** As many participation bank customers use them for Islamic reasons, competition with commercial banks is less intense. Of equal importance, the competition threat from overseas is also limited. The banking regulator does not provide new commercial licenses for any banking segment, and licenses are separate for each banking segment. In other words, Turkish banking regulations do not allow for Islamic windows, and a desire on the part of a conventional bank to become involved in participation banking would require a sacrifice with respect to its existing license terms. As far as M&A opportunities are concerned, Turkey has few opportunities left for newcomers in the banking sector. Looking at the participation banking segment itself, three of the four participation banks already have foreign shareholders; only Bank Asya offers a real opportunity due to its locally-owned shareholding structure.
- (5) **Business model enables funding costs to remain below sector average levels:** Constituting the primary source of funding and representing on average about an 80% share of the total, deposits (current and participation

Competition threats from overseas and conventional banks are limited

accounts) do not offer any fixed return to the depositor, as the system is established on a profit/loss sharing philosophy. Moreover, almost half of all deposits are tied to participation banks because of interest aversion. In other words, such deposits are relatively sticky (less price sensitive), and hence less subject to competition risk. As a result, the business model means participation banks have below-sector-average funding costs.

Chart 40: Deposit costs (blended) – 9M07 *

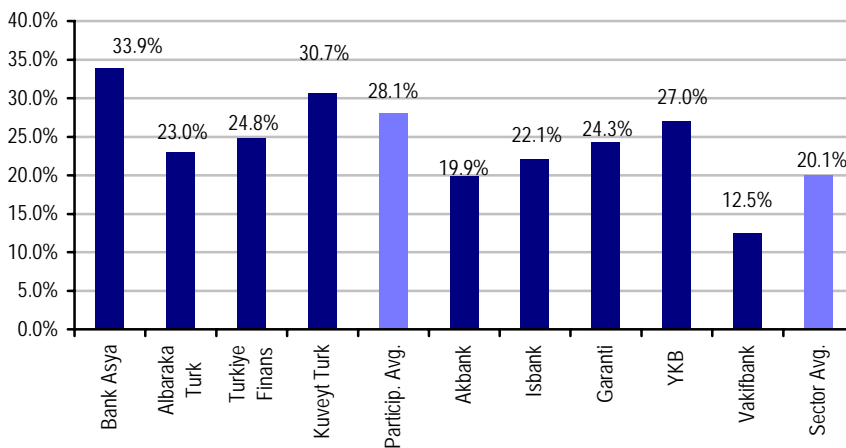


Source: Company data and UBS; Note: * Kuveyt Turk financials refer to 1H07

(6) **Strong non-interest revenue generation power:** Participation banks’ non-interest income generation power is on average greater than that of conventional banks, thanks to the former group’s strong presence in non-cash lending and trade finance. Participation bank earnings are more reliant on fee income; their fee/total income ratio stood at 28% by 9M07 vs. an average of 20% for the total banking sector. Of equal importance, participation banks’ fee revenues covered on average 66% of operating costs, while coverage ratio was 50% for the sector as a whole.

Greater dedication to lending – both cash and non-cash – allows greater fee generation

Chart 41: Fee/total income ratio – 9M07 *



Source: Company data and UBS; Note: * Kuveyt Turk financials refer to 1H07

Potential risk factors: The challenges ahead

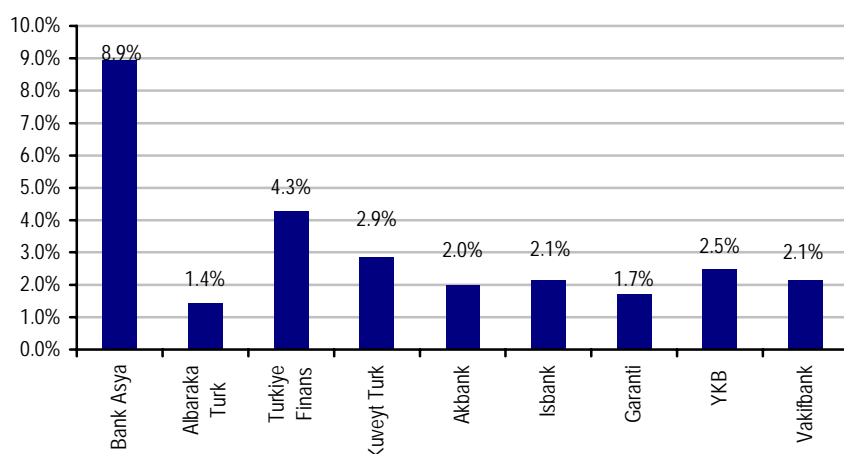
Participation banks also have certain disadvantages relative to conventional banks, due to their interest-free banking nature. One is the requirement for interest-free banking compliant products, which limits participation banks' 'flexibility'. Also, their asset quality tends to be worse than conventional banks', due to their significant exposure to SMEs, and they have weaker cost efficiency records, which is largely attributable to investment in their branch networks as well as to weaker economies of scale. Issues such as limited exposure to retail lending and wholesale funding also number among the opportunities as well as current weaknesses of participation banks.

Weaker asset quality and cost performance are the main challenges

- (1) **Weaker asset quality:** Although the practice of interest-free banking is in principle supportive of asset quality, and the lending system limits the deterioration in loan books within itself, participation banks' exposure to the SME segment usually results in higher NPL additions than those of conventional banks. Of equal importance, participation banks' NPL provision rates are lower than the banking sector average, something that is attributed to the "loss-sharing" nature of provisions recorded for the loans financed by profit/loss sharing accounts.

Exposure to SME segment causes higher NPL additions vs. conventional banks

Chart 42: New NPL additions (2006): NPL additions to loan ratios



Source: Company data and UBS

- (2) **Limited exposure to retail lending could be a disadvantage in a falling interest rate environment:** Participation banks are mainly trade-financing banks, with only limited exposure to consumer lending. They have been more involved in commercial banking, mainly focusing on shorter-maturity *murabaha* (trade financing) loans. That said, while SMEs remain their key focus area, we expect both credit card lending and other means of consumer lending to increase gradually over time for participation banks.
- (3) **Requirement to provide interest-free banking-compliant products/services limits the flexibility:** As with their counterparts in other Muslim countries, Turkish participation banks are legally defined as non-interest banks, operating in an environment where the receipt and payment of interest is prohibited. In our view, the need for participation banks' products to comply with Islamic rules limits flexibility when it comes to

Consumer loans capture small share of the overall loan book

Response to conventional banks' products with interest-free banking compliant products may not be timely

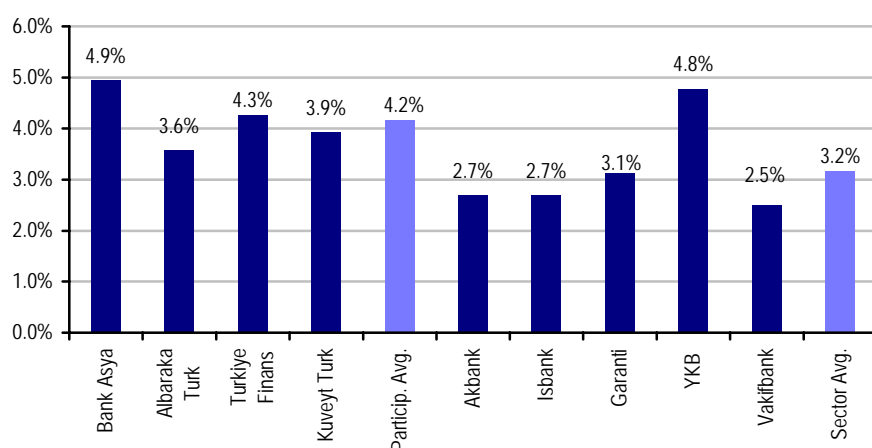
introducing new products, which is likely to impair their competitiveness going forward.

- (4) **Participation banks are extremely under-leveraged, with only minor exposure to external funding:** Interest-free banking is still very much in its youth, and international markets lack the depth and experience to handle international deals. An interest-free bank that enters an external-financing deal usually has limited financial backing, raising the cost of interest-free funds compared to other types of fund. However, international debt markets are expected to develop rapidly, with all the global players now also having some kind of presence in Islamic finance.
- (5) **Higher-than-average operating costs:** Participation banks in general have weaker cost efficiency records than conventional banks, which can largely be attributed to investment in the branch network as well as to economies of scale disadvantages. With the upcoming balance sheet expansions, however, we expect to see cost-efficiency improvements, even though branch openings remain a central feature of participation banks' organic expansion strategies.

Limited wholesale funding, as capital markets lack depth and experience

Participation Banks are now in the growth phase, with branch investments a soaring component of operating costs

Chart 43: Cost-to-asset ratios – 9M07 *



Source: Company data and UBS; Note: * Kuveyt Turk financials refer to 1H07

- (6) **Competition between participation banks is intensifying:** In 2006, two participation banks – Anadolu Finans and Family Finans – merged to form a new group, Turkiye Finans, which is now the second-largest of the country's four participation banks. Albaraka Turk recently increased its capital in pursuit of aggressive growth targets. In addition, Kuveyt Turk is also expected to raise new capital in early 2008 to create fresh funds for the upcoming credit demand. For its part, Bank Asya intends to sustain its strong growth performance of the past three years.

Rising competition between participation banks may result in higher-than-anticipated margin compression

The growth potential

A look at sector fundamentals

The Turkish banking system's overall balance sheet has expanded at a CAGR of 24% over the last five years, hitting 90% of GDP in 2006, up from 73% in 2002. In the same time frame, lending growth was almost twice as fast, with total loans rising to 39% of GDP from just 17% in 2002. Nevertheless, the sector remains underbanked by global standards, and the low levels of penetration – and hence immense growth potential – in almost all banking areas has attracted the interest of global players, as indicated by some recent M&A deals in the sector. The banking sector's 90% of GDP lags far behind the EU average of 304% (as of 2005, latest available data). Likewise, the volume of consumer loans – at 12% of GDP – and, more specifically, mortgage loans – at 4% of GDP (EU average 43%) – also stand as testament to the underpenetrated nature of the sector.

Turkish banking sector remains an underbanked market

Table 17: Banking penetration rates: Turkey and the EU

(% Share of GDP)	Assets	Deposits	Loans	Consumer loans	Mortgage loans
Emerging EU countries (2005)					
Czech Republic	111	70	42	13	10
Slovakia	99	72	38	10	8
Hungary	94	54	67	16	10
Poland	87	46	36	11	5
Median	98	61	46	12	8
EU candidates (2005)					
Croatia	119	70	70	-	-
Bulgaria	72	56	39	-	-
Romania	43	27	20	-	-
Median	78	51	43	-	-
EU-25 average	304	104	126	8	43
Turkey (2006)	89	55	39	12	4

Source: ECB

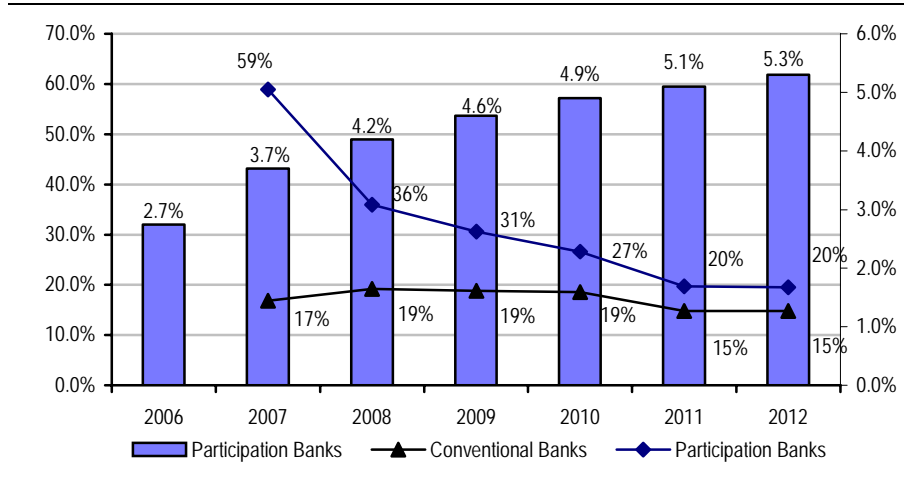
We expect 31% CAGR in the overall loan book of the banking system during 2007-09, on the back of lower interest rates that should boost consumer and SME lending and improve consumer confidence. We think the main driver of retail loan growth in this period should be residential loans, which we project to climb to 9% of GDP by 2009, from 4% in 2006. We estimate that net earnings in the Turkish banking sector will see CAGR of 32% during 2007-09, driven by interest revenues on the loan book and fee income. We expect sector NIMs to start trending down by 2009, with net interest income itself increasing at a CAGR of 20% in the same time frame. We also expect fee income generation power to strengthen over the period, on the back of higher cash loan growth and a greater emphasis on retail-centred lending strategies.

Consumer and SME segments should drive lending growth going forward

Looking at the performance of the banking system by segment, we believe that participation banks will continue to post higher growth rates than their conventional counterparts. Our forecasts imply that participation banks will see CAGR of 26% in 2007-12 in total assets, against a CAGR of 17% for conventional banks over the same period. Accordingly, we anticipate that participation banks' share of the overall Turkish banking market will have grown to 5.3% by 2012 from 2.7% at end-2006.

The share of participation banking in total is expected to reach 5% by 2010

Chart 44: Growth assumptions and the share of participation banks in the system



Source: UBS estimates

Potential performance drivers

Participation banks' share of the total banking system stood at 3.4% as of H107, and a comparison with counterparts in other Muslim countries with similar banking models illustrates the growth potential in Turkey. As management guidance suggests, the interest-averse market is located mainly in the eastern part of the country, a significant proportion of which is still underbanked and waiting to be tapped by participation banks. Recent moves by these banks to extend their presence into the eastern part of Turkey indicate that their customer base could grow significantly in the near future. In fact, the business area that participation banks are most exposed to – SMEs – is itself one of the most underbanked segments and produces the second-highest yields after credit cards. We think the key determinants of growth in participation banking are:

Underbanked nature of SMEs and customer potential in eastern part of Turkey highlight significant growth potential

- (1) **Growing interaction between Turkey and the MENA region, with the inflow of oil money likely adding to the expansion of interest-free banking in Turkey:** Muslim countries in the Gulf region have been enjoying current account surpluses that have been building impressively over the last 10 years thanks to the boom in crude oil prices. Accordingly, Turkey is benefiting from a boost in oil wealth as well as a change in the conjecture since 9/11, and so-called oil money is now flowing into Turkey through privatisations and acquisitions to sectors like finance, real estate and telecoms.

Participation banks benefiting from oil money flowing into Turkey

We think that investment in Turkey from the Gulf will continue, with upcoming privatisations such as the block sale of Halkbank and Vakifbank, and in the real estate sector. Moreover, increasing economic interaction

with the MENA region, whose potential remains very much untapped, would be another catalyst for growth in participation banking.

- (2) **Exposure to the under-penetrated SME segment should back growth in participation banking:** Participation banks are pure lenders, as the nature of the business prohibits such banks from betting on interest-earning assets. They have long-standing relations with SMEs, which are the engine room of the Turkish economy, accounting for 99.8% of the economy by volume and employing 75% of the Turkish workforce. However, of the total loans extended to the economy, only 30% is channelled to the SME segment (which can be attributed to high real interest rates and the difficulty of meeting collateral requirements), highlighting the immense potential available to the banking sector.

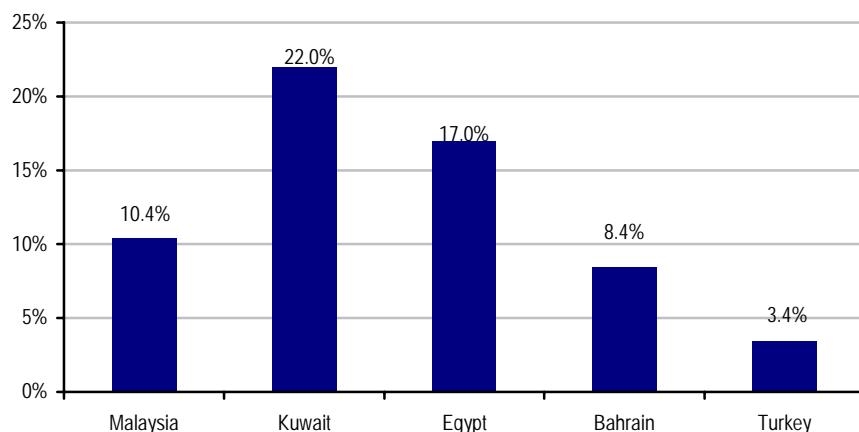
SMEs offer potential for higher yields and stronger growth

Access to finance for SMEs has improved in recent years, as the banking sector has become aware of the potential in this immature lending segment. The growth potential of the SME segment is among the main reasons for foreign interest in the Turkish banking sector. It should be noted that SME lending offers the second-best yield after credit cards among all lending segments. Accordingly, SMEs are now the primary focus of the banking sector, with Turkish banks offering new products/services to capture market share.

- (3) **Penetration levels in other Muslim nations illustrate the growth potential of interest-free banking in Turkey:** Comparing the share of interest-free banking in the overall banking system in Muslim nations that practise Islamic banking alongside conventional banking demonstrates the under-banked nature of participation banking in Turkey. For example, Islamic banking constitutes 22% of total banking assets in Kuwait (based on 2005 financials). Even in the least penetrated market, Bahrain, interest-free banking's share of the overall banking system stands at 8.4%. The share of participation banking in the Turkish system, in contrast, was only 3.4% by H107, highlighting the immense growth potential in Turkey. We should emphasise, however, that this rose from as low as 1.2% in 2001, having grown at a CAGR of 43% between 2001 and 2006.

Low penetration levels relative to other Muslim countries

Chart 45: Share of interest-free banking – an international comparison



Source: Turkish Participation Banks' Association

There is no specific study in Turkey showing the growth potential of participation banking. According to a survey undertaken in December 2007 by the public survey company Konda, which covered 41 Turkish provinces and involved 5,300 responses, about 53% of people are against “interest” as they consider it against their Islamic faith. On the other hand, a greater proportion of interest-averse people are located in eastern Turkey, many parts of which are under-banked and waiting to be tapped by participation banks. It was only a few years ago that participation banks started to extend their operations to eastern Turkey.

- (4) **Growing presence of Islamic finance houses should gear up further expansion in participation banking:** The boom in oil wealth and the change to the global conjecture since 9/11 have increased capital flows into Turkey from the Gulf region. In April 2007, MNG Bank was acquired by Arab Bank Plc and the BankMed consortium. More importantly, NCB reached an agreement with the shareholders of Turkiye Finans in July 2007 regarding the acquisition of a 60% stake of the bank at an acquisition P/BV of 5.0x (Q107). In the same month, NBK reached agreement with Ozyol Holding regarding the acquisition of 40% stake of Turkish Bank. We believe the growing presence of Islamic finance houses in the system should gear up further expansion in participation banking by the development and marketing of innovative Islamic financial instruments on both the asset and liability sides of the business.

Growing presence of Islamic finance houses in Turkey should gear up further expansion in participation banking

Bank section

UBS Investment Research

Asya Katilim Bankasi

Global Equity Research

Turkey

Banks, Ex-S&L

12-month rating **Buy**
Prior: Not Rated

12m price target 1,137.70c

Price 904.86c

RIC: ASYAB.IS BBG: ASYAB TI

Trading data (c)

52-wk range	1,160.00c-510.00
Market cap.	US\$2.71bn
Shares o/s	300m
Avg. daily value (cm)	-

Balance sheet data 12/08E

Shareholders' equity	US\$0.86bn
P/BVPS x	3.2
Tier one capital ratio	15.3%

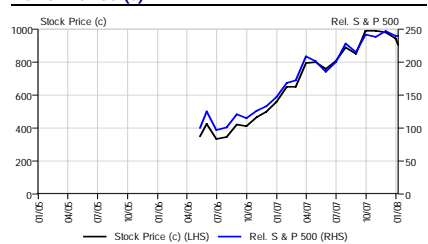
Forecast returns

Forecast price appreciation	+25.7%
Forecast dividend yield	0.0%
Forecast stock return	+25.7%
Market return assumption	9.9%
Forecast excess return	+15.8%

EPS (UBS, US\$)

	12/08E		Cons.	12/07 Actual
	From	To		
12/08E	-	0.72	-	-
12/09E	-	0.93	-	-

Performance (c)



Source: UBS

www.ubs.com/investmentresearch

Where value and growth meet

■ Fast-growing, profitable niche player

Bank Asya is the market leader in the fastest-growing and most profitable sub-segment in Turkey, participation banking. Underpinned by an effective business model based on interest-free banking, the bank's aggressive growth strategies of recent years have been paying off handsomely, with the overall loan book posting a CAGR of 62% over the last three years, during which time the branch network has more than doubled in size, enabling the bank to post ROEs close to 30%.

■ SMEs act as catalysts of growth, allowing for above-average returns

The easing interest rate cycle and the group's SME lending exposure should act as catalysts in stimulating loan growth at Bank Asya. Compared with its peers, bank has wider branch network, is better positioned in the SME segment and owns more commercialised business structure. We expect the loan book to post a CAGR of 51% between 2007 and 2009, mainly on the back of short-term murabaha loans.

■ Lower risk of margin compression

We forecast a smoother decline in NIM levels going forward, relative to the conventional banks, thanks to Bank Asya's strong commitment to SMEs, expected volume growth due to the currently under-banked nature of SMEs, and the relatively limited levels of competition on the funding side of the business.

■ Valuation: Initiate coverage with a Buy rating

Bank Asya has been one of the strongest-performing Turkish banks, beating the MSCI banks index by an impressive 137% in 2007. At a 2008E P/E of 12.5x and P/BV of 3.1x, the bank is trading at a premium to the sector, which we consider justified by its defensive yet profitable business nature. Besides, it is also an M&A proxy. Our 12-month price target of YTL13.30 (US\$11.4) per share offers 26% upside potential; we therefore initiate coverage of Bank Asya with a Buy rating.

Highlights (US\$m)	12/06	12/07	12/08E	12/09E	12/10E
Revenues	335	488	665	822	986
Pre-tax profits	137	197	271	350	418
Net income	102	158	217	280	334
EPS (UBS, US\$)	0.34	0.53	0.72	0.93	1.11
Net DPS (UBS, US\$)	0.00	0.00	0.00	0.00	0.00

Profitability & Valuation	5-yr hist av.	12/07	12/08E	12/09E	12/10E
ROE %	-	27.6	27.9	28.4	28.0
P/Op x	-	5.0	4.1	3.3	2.8
P/BVPS x	-	3.5	3.2	2.4	2.1
PE (UBS) x	-	15.6	12.5	9.7	8.1
Net dividend yield %	-	0.0	0.0	0.0	0.0

Source: Company accounts, Thomson Financial, UBS estimates. (UBS) valuations are stated before goodwill, exceptionals and other special items. Valuations: based on an average share price that year, (E): based on a share price of 904.86c on 07 Jan 2008 21:37 GMT

Kazim Andac

Analyst

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Investment thesis

Bank Asya is one of the most profitable banks in the Turkish banking system with an ROE of 27% at 9M07, underpinned by an effective business model that has evolved under the framework of interest-free banking. Bank Asya boasts a developed lending culture as it has operated as a financial intermediary ever since its establishment, having one of the highest loan exposures in the system which is concentrated mainly in the SME segment, an area that is quite underbanked yet represents one of the highest-yielding segments. The aggressive growth strategies pursued by the bank over the years have been bearing fruit, with the overall loan book posting a CAGR of 62% over the last three years and the branch number almost doubling, enabling the bank to post above-average returns on its loan book. Bank Asya is now the leading participation bank in Turkey.

Bank Asya has low exposure to the systemic risks – such as interest rate and open FX position risk – faced by conventional banks. As a result, while the bank's business model is highly profitable, it should also be regarded as less risky than the conventional banks'. That said, we should highlight that the interest-free sub-segment is among the most vulnerable in the event of a slowdown in the Turkish economy, owing to participation banks' large exposure to SMEs, which are the engine room of the Turkish economy.

Due to the aggressive lending strategies implemented over the years and focused mainly on the SME segment of the business, the bank's bad loan portfolio is on the rise. In fact, Bank Asya's NPL rate is the highest among the peer group, at 5% by 9M07. That said, we believe the bank's asset quality is in good shape, considering that SME loans comprise almost 70% of the overall loan book. We highlight that the NPL rates of the SME segment are hovering around 8% levels, and banks that have similar loan exposures to this business area suffer from higher NPL rates.

Thanks to its business model, which makes for lower funding costs and an effective loan mix, Bank Asya enjoys one of the highest NIM levels in the Turkish banking system. Constituting the primary source of funding and capturing a 76% share of total deposits (current and participation accounts), participation accounts do not offer any fixed return to the depositor. Moreover, almost half the deposits are, on average, tied to the bank because of interest aversion. In other words, such deposits are less price elastic and hence less subject to competition. With its business model enabling below-sector-average funding costs and strong interest yields, Bank Asya generated a NIM of 7.2% at 9M07, which was significantly higher than both the participation bank and banking sector averages.

Bank Asya has one of the strongest fee income generating operations in the Turkish banking system, on the back of strong dedication to non-cash lending (ranks 4th in the Turkish banking system) and trade finance (holds about 2.5% of the foreign trade financing activity in Turkey). It should be noted that the bank's "fee-to-asset" ratio is a record 4.2% (against the sector rate of 1.6%), while its "fee coverage" ratio stands as high as 85%, against the sector's 50%.

Loan book expanded at CAGR of 62% over the last three years, branch network doubled

NIM level one of the highest in the Turkish banking system

An impressive fee revenue records

Valuation

Bank Asya trades at a 2008E P/BV of 3.1x and P/E of 12.5x, against Turkish banking sector averages of 2.5x and 11.5x, respectively. The valuation multiples may appear expensive when compared with conventional banks, but given its highly profitable and less risky nature Bank Asya deserves to trade at a premium to commercial banks.

We assume that the bank can produce a sustainable ROE of 27%. Together with the anticipated strong growth and a COE of 12%, we think that Bank Asya shares offer further upside potential. Our target price of YTL13.30 per share for corresponds to 26% upside potential on a 12-month perspective, which puts the bank into our Buy rating range. Furthermore, Bank Asya is currently the only participation bank left with only Turkish shareholders, and we would not be surprised if it were approached by an international interest-free investor due to its profitable nature and growth prospects. We think the valuations set for the Turkiye Finans deal would be considered at the time any partnership negotiations. We therefore initiate coverage of Bank Asya with a Buy rating.

Level of sustainable returns, together with strong growth prospects, should allow further upside potential

Earnings outlook

We expect Bank Asya's EPS to grow at CAGR of 40% between 2007 and 2009, on the back of strong lending growth centred mainly on SMEs, corresponding to ROE of 28% by the end of 2009. We think the erosion of interest margins will be smooth thanks to the bank's effective business mix and the nature of interest-free banking, where the bank is prohibited to invest in interest-earning assets. Its fee revenue-generating power, which is already one of the strongest in the Turkish financial system, is also expected to strengthen further, thanks to the group's dominance in non-cash lending and its increased focus on credit card lending. We think the rise in operating costs, caused mainly by investment in the branch network, will be more than compensated for through strong revenue growth going forward, via higher interest income and stronger fee revenues in absolute terms.

The interest rate easing cycle and the exposure to SME lending should all act as catalysts in stimulating Bank Asya's loan growth. The bank now has a wider branch network, is better positioned in the SME segment and owns more commercialised business structure than its peers. We expect the bank's overall loan book to post a CAGR of 51% between 2007 and 2009, mainly on the back of short-term murabaha loans. The share of lease receivables in the total is expected to continue to decline over time, due to their longer-maturity nature and the fact that these loans are no more attractive in terms of tax incentives. On the other hand, we expect the bank's NPL rate to stabilise at around the 5% level in the medium term, which would be higher than the banking sector average, so as to more genuinely reflect the NPL levels of the SME business and the bank's heavy exposure to non-cash loans.

We expect strong credit growth rates to continue going forward

On the back of rapid loan growth and change in the amendment of capital adequacy calculation, which raises the weight of non-cash loans in risk-weighted assets (RWA), Bank Asya's capital adequacy ratio (CAR) could come under pressure. It should be noted that the CAR stood at 14.4% as of 9M07, and

Capital adequacy would be kept at comfortable levels by raising Tier-II capital and possibly through a rights issue

we forecast RWA will post a CAGR of 42% between 2007 and 2009. In September 2007 the bank authorised management to raise US\$200m of subordinated debt, which we think will allow Bank Asya to keep its CAR at 14-15% in 2008. Due to the aggressive lending growth expected for the bank, the possibility of a rights issue in 2009 should not be ruled out.

Going forward, we forecast a smoother decline in the bank's NIM levels compared with conventional banks, thanks to its strong commitment to the second-highest yielding loan segment (SMEs), the expected volume growth due to the currently under-banked nature of SMEs and the relatively limited competition on the funding side of the business. We forecast average annual growth of 33% in Bank Asya's NII until 2009, which should help limit the decline in the NIM to 80bp over 2007-09. We estimate the NIM will fall from 7.9% in 2007 to 7.1% by the end of 2009.

One important feature of Bank Asya is its intensive off-balance sheet activities, which in turn lead to strong commission flows. Although management guidance suggests that non-cash loan exposure will ease gradually over time, we think that non-cash loans will remain the main determinant of fee revenues going forward. We also highlight that Bank Asya's credit card loans have increased by 59% on average per annum over the last three years, thanks to the launch of several simultaneous credit card products with easy payment facilities. We expect the credit card segment's contribution to fee revenues to increase gradually over time. Overall, we forecast net fee income to post a CAGR of 46% between 2007 and 2009, allowing the fee-to-asset ratio to be maintained at 4% by 2009 and resulting in a fee coverage ratio of as high as 100%.

Bank Asya plans to open 25 branches each year in the next five years. Accordingly, we forecast that staff expenses (salaries etc.) will see a CAGR of 30% during 2007-09, although this will be more than offset by stronger interest income and fee revenue generation during the same period. We forecast that Bank Asya's cost/asset and cost/income ratios will be 4.4% and 39%, respectively, by 2009. Overall, we estimate net profit will post CAGR of 40% between 2007 and 2009, which corresponds to an ROE of 28% by the end of 2009.

Decline in the NIM should be smoother vs. conventional banks

Non-cash loans to remain as the main driving force behind fee revenues

Surge in opex to be more than compensated for through interest income and fee revenue increases

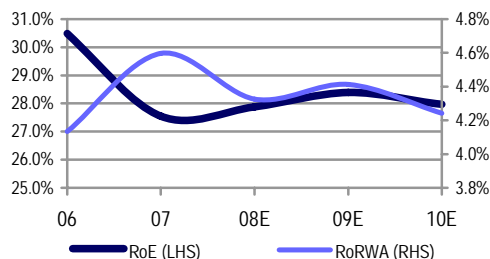
Asya Katilim Bankasi

Per share (c)	12/06	12/07	12/08E	12/09E	12/10E
EPS (stated)	34.08	52.64	72.39	93.45	111.50
EPS (UBS adjusted)	34.08	52.64	72.39	93.45	111.50
GOPS	1.12	1.63	2.22	2.74	3.29
DPS	0.00	0.00	0.00	0.00	0.00
BVPS (stated)	150.00	232.10	287.20	371.14	426.11
BVPS (adjusted)	150.00	232.10	287.20	371.14	426.11
Profit & Loss (US\$m)					
Net interest income	180	274	377	457	547
Other income	155	213	289	365	439
Total revenues	335	488	665	822	986
Expenses	(145)	(192)	(260)	(310)	(369)
Operating profit	190	295	406	512	618
Provisions and other items	(53)	(98)	(134)	(162)	(200)
Profit before tax	137	197	271	350	418
Pre-exceptional net income	102	158	217	280	334
Capital dynamics (US\$m)					
Risk-weighted assets	2,473	4,397	5,643	7,064	8,707
Tier one capital	439	696	862	1,113	1,278
Total capital	452	700	866	1,119	1,285
Tier one ratio	17.7%	15.8%	15.3%	15.8%	14.7%
Total capital ratio	18.3%	15.9%	15.3%	15.8%	14.8%
Net profit after tax	102	158	217	280	334
Tier 1 requirement	0.0%	0.0%	0.0%	0.0%	0.0%
Less: Working capital requirement	0	0	0	0	0
Less: Dividends	0	0	0	0	0
Surplus capital generated	102	158	217	280	334
Surplus capital generation ratio		36.0%	31.2%	32.5%	
Balance sheet (US\$m)					
Assets	2,973	5,091	6,313	7,587	9,010
Customer loans	1,968	4,239	5,427	6,630	8,144
Customer deposits	2,277	3,839	4,647	5,589	6,741
Funds under management	0	0	0	0	0
Loans : assets	66.2%	83.3%	86.0%	87.4%	90.4%
Deposits : assets	76.6%	75.4%	73.6%	73.7%	74.8%
Loans : deposits	86.4%	110.4%	116.8%	118.6%	120.8%
Shareholders funds : assets	15.13%	13.68%	13.65%	14.67%	14.19%
Asset quality (US\$m)					
Non-performing assets	91	221	294	365	456
Total risk reserves	83	179	240	297	372
NPLs : loans	4.65%	5.21%	5.41%	5.51%	5.60%
NPL coverage	91%	81%	82%	81%	81%
Provision charge : average loans	2.99%	2.66%	2.51%	2.52%	2.59%
Net NPLs : shareholders' funds	1.9%	6.0%	6.2%	6.1%	6.6%
Profitability					
Net interest margin (avg assets)	7.32%	6.81%	6.60%	6.58%	6.59%
Provisions : operating profit	27.8%	33.2%	33.1%	31.6%	32.3%
RoE	30.5%	27.6%	27.9%	28.4%	28.0%
RoAdjE	30.5%	27.6%	27.9%	28.4%	28.0%
RoRWA	4.13%	4.60%	4.33%	4.41%	4.24%
RoA	4.16%	3.92%	3.81%	4.03%	4.03%
Productivity					
Cost : income ratio	43.2%	39.4%	39.0%	37.7%	37.4%
Costs : average assets	5.9%	4.8%	4.6%	4.5%	4.4%
Compensation expense ratio	22.6%	23.8%	22.1%	19.9%	18.8%
Momentum					
Revenue growth	+67.8%	+45.7%	+36.5%	+23.5%	+20.0%
Operating profit growth	+78.7%	+55.4%	+37.4%	+26.2%	+20.6%
Net profit growth	+42.9%	+54.4%	+37.5%	+29.1%	+19.3%
Dividend growth	NM	NM	NM	NM	NM
Value*					
UBS bank valuation					
Leveraged P/E					
Risk tendency P/E					
Merger P/E					
Market capitalisation (US\$m)	847	1,922	2,715	2,715	2,715
Conventional valuation					
Market cap./Revenues	8.1x	5.6x	4.1x	3.3x	2.8x
Market cap./Operating profit	14.3x	9.2x	6.7x	5.3x	4.4x
P/E (stated)	26.6x	17.2x	12.5x	9.7x	8.1x
P/E (UBS adjusted)	26.6x	17.2x	12.5x	9.7x	8.1x
Dividend yield (net)	0.00%	0.00%	0.00%	0.00%	0.00%
P/BV (stated)	6.0x	3.9x	3.2x	2.4x	2.1x
P/BV (adjusted)	6.0x	3.9x	3.2x	2.4x	2.1x

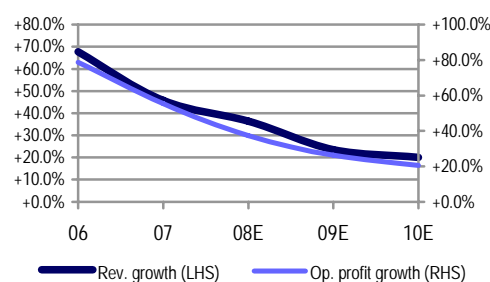
Source: UBS estimates, * Historical, current, & future valuations are based on a share price of YTL10.60 as at close on 07 Jan 2008

Bank Asya is the leader in the participation banking sub-segment in Turkey, capturing 1.1% of total assets and 1.9% of total loans in the overall banking system. The bank has a widespread ownership structure, with none of its shareholders owning more than a 5% stake. The main focus is SMEs, where the bank mainly extends trade financing loans. Bank Asya ranks fourth in terms of size of its non-cash loan book and holds about 2.5% of the foreign trade financing activity in Turkey.

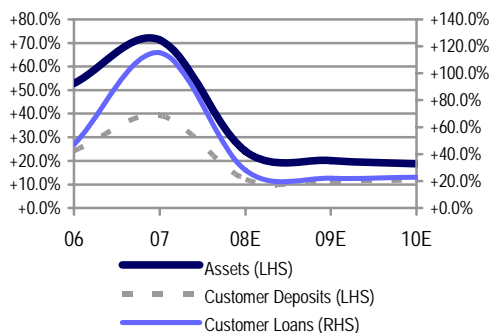
Profitability (RoE & RoRWA)



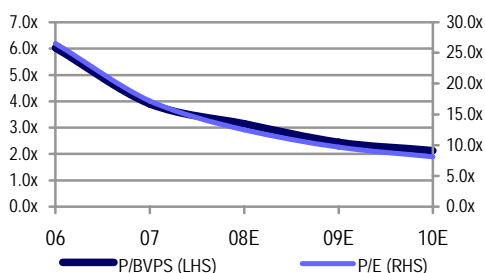
Momentum (Revenue & Operating profit growth)



Balance Sheet Growth



Value (P/Adj. BVPS & P/Adj. EPS)



UBS Investment Research

Albaraka Katilim Bankasi

Defensive profile, with sustainable growth

■ Strong volume-led revenue growth

Albaraka Turk is known for its conservative banking approach, which puts its asset quality among the strongest in the system. Despite its relatively cautious lending strategies, however, Albaraka Turk has managed to grow its loan book at a CAGR of 42% over the past three years, mainly via the underpenetrated SME segment, enabling it to record above-average returns on its loan book.

■ Earnings quality to improve significantly

Liquidity in hand, further monetary easing by the CBT and exposure to SME lending should all act as catalysts in stimulating loan growth, mainly on the back of short-term murabaha loans, which should carry the bank's loan-to-asset ratio to as high as 88% by the end of 2009. On this basis, we estimate the bank's total loans will grow at CAGR of 39% between 2007 and 2009.

■ Prime to benefit from growing interactions with the MENA region

Margin erosion should be smooth, thanks to an effective business mix and the nature of interest-free banking, which prohibits the bank from investing in IEAs. Coming from a low base, we also expect fee income to improve significantly amid greater emphasis on non-cash lending, in parallel with the increase in business done with the MENA region and the increased focus on credit card lending.

■ Valuation: Positives largely reflected in the share price

Albaraka Turk has outperformed the MSCI banks index by 46% since its IPO. On 2008E P/E of 14.9x and P/BV of 2.8x, the bank is trading at a premium to the sector, which we consider justified by its defensive yet profitable business nature. That said, our 12-month fair value of YTL6.80 (US\$5.8) per share offers only 13% upside potential, which is not enough to put the bank into our Buy range. We therefore initiate coverage of Albaraka Turk with a Neutral rating.

Highlights (US\$m)	12/06	12/07	12/08E	12/09E	12/10E
Revenues	140	192	255	303	363
Pre-tax profits	50	85	116	145	177
Net income	48	68	93	116	141
EPS (UBS, US\$)	0.30	0.25	0.34	0.43	0.52
Net DPS (UBS, US\$)	0.04	0.04	0.05	0.06	0.07
Profitability & Valuation	5-yr hist av.	12/07	12/08E	12/09E	12/10E
ROE %	-	21.9	19.7	22.1	23.7
P/Op x	-	6.0	5.4	4.5	3.8
P/BVPS x	-	2.6	2.8	2.5	2.1
PE (UBS) x	-	17.1	14.9	11.9	9.7
Net dividend yield %	-	1.0	1.0	1.2	1.4

Source: Company accounts, Thomson Financial, UBS estimates. (UBS) valuations are stated before goodwill, exceptionals and other special items. Valuations: based on an average share price that year, (E): based on a share price of 511.36c on 04 Jan 2008 21:35 EST

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Global Equity Research

Turkey	
Banks, Ex-S&L	
12-month rating	Neutral
	<i>Prior: Not Rated</i>
12m price target	577.70c
	-
Price	511.36c
RIC: ALBRK.IS BBG: ALBRK TI	

Trading data (c)

52-wk range	534.01c-330.85
Market cap.	US\$1.38bn
Shares o/s	270m
Avg. daily value (cm)	-

Balance sheet data 12/08E

Shareholders' equity	US\$0.50bn
P/BVPS x	2.8
Tier one capital ratio	22.0%

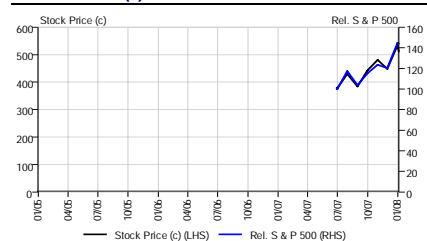
Forecast returns

Forecast price appreciation	+13.0%
Forecast dividend yield	1.2%
Forecast stock return	+14.2%
Market return assumption	9.8%
Forecast excess return	+4.4%

EPS (UBS, US\$)

	12/08E		12/07
	From	To	Cons. Actual
12/08E	-	0.34	-
12/09E	-	0.43	-

Performance (c)



Source: UBS
www.ubs.com/investmentresearch

Investment thesis

Albaraka Turk was established in 1985 as Turkey's first participation bank. Its major shareholder is one of the world's leading Islamic banks, ABG. As is the case in the overall segment itself, Albaraka is dedicated to the SME segment, which is heavily under-penetrated and less price elastic, and provides yields of up to 25%. The bank has the highest exposure to lending in the overall banking system with a loan-to-asset ratio of 86%. Of equal importance, the focus on SMEs has been the catalyst of growth, extending Albaraka Turk's loan book by CAGR of 42% over the last three years and enabling it to record above-average returns on its loan book. Liquidity on hand, further monetary easing expected by the CBT in 2008 and the exposure to SME lending should all act as catalysts in stimulating loan growth going forward.

Thanks to its conservative banking approach, which is profit-driven rather than growth-oriented, Albaraka has one of the strongest asset qualities in the Turkish banking system, although it has lagged its rivals in terms of growth. Due to its strict credit risk management policies and the strong emphasis it places on asset quality at group level, Albaraka Turk enjoys the strongest asset quality among participation banks, and indeed compares favourably with conventional banks. Albaraka Turk's NPL rate (gross) stood at just 1.4% as of 9M07, despite the fact that the SME segment is its key area of focus, when the average NPL rate for participation banks stood at 3.3%, broadly mirroring the 3.6% in the overall banking sector. Its risk-averse approach also ensures that the bank almost fully provisions its problem loans regardless of the collateral held.

Albaraka Banking Group (ABG) and Islamic Development Bank (IDB) are the major shareholders. The ABG has interests in 10 geographically diverse subsidiaries incorporated in Algeria, Bahrain, Egypt, Jordan, Lebanon, Pakistan, South Africa, Sudan, Tunisia and Turkey. The bank offers foreign trade intermediary services through its network of 236 correspondent banks based in more than 60 countries worldwide, from Singapore to the UK, from South Africa to Morocco and from Australia to Kazakhstan.

Due to its parent's presence in the region, we think Albaraka Turk should be the prime beneficiary of growing foreign trade ties with the MENA region. Economic interaction between Turkey and the MENA region is strengthening, and Turkey is benefiting accordingly from the increasing foreign trade volume as a destination for increased oil money wealth. Turkey is now one of the main recipients of Gulf investment, and capital is now flowing into Turkey via privatisations and acquisitions.

Albaraka Turk has limited exposure to non-core assets. Consequently, the bank has one of the highest free equity-to-asset ratios in the Turkish banking sector. On the other hand, the bank was running a CAR as high as 22% as of 9M07, which is the highest among the Turkish banks in our coverage universe. Furthermore, the dent in Albaraka Turk's CAR which will follow the introduction of Basel-II criteria will be much softer than for conventional banks, thanks to its zero exposure to securities and lower operational and credit risks.

Has one of the strongest asset qualities in the banking system

Albaraka is primed to benefit from growing trade interactions between Turkey and the MENA region

Albaraka has the highest CAR among the banks we cover

Valuation

Looking at valuation multiples, the bank trades at a 2008E P/E of 14.9x against EMEA and Turkish banking averages of 10.6x and 11.5x, respectively. With a sustainable ROE of 22% and a COE of 12%, our Gordon growth valuation model implies a 12-month target price of YTL6.80 per share, which offers 13% upside potential in US dollar terms. However, current 12-month upside potential is not sufficient to put Albaraka Turk's shares into our Buy rating range. We therefore initiate coverage with a Neutral rating, and will closely eye the shares for better entry points throughout the year.

Most of the positives are reflected in the share price

Earnings outlook

We forecast Albaraka Turk will post a CAGR of 34% in its net profit between 2007 and 2009, on the back of accelerated credit growth centred mainly on SMEs. We believe the contraction in interest margins will be relatively resilient going forward when compared with conventional banks. The effective business model of participation banks, and the characteristic of the system itself, which prohibits banks investing in IEAs, should allow for a smoother contraction in NIMs. On the other hand, coming from a low base, fee revenues should also improve considerably on the back of a greater emphasis on off-balance sheet activities, in parallel with an increase in business volume with the MENA region and an increased focus on credit card operations. We think the rise in operating expenditure stemming from ongoing investment in the branch network will be more than offset by strong revenue growth, with a significant improvement in earnings quality.

Profit/loss sharing participation accounts will remain the main source of funding for Albaraka, hence the bank should remain extremely under-leveraged, with no exposure to wholesale funding. As international Islam-compatible capital markets are very much in their youth, Albaraka Turk believes it is less costly to finance organic growth via deposits and equity, although the low-leverage nature of the balance sheet increases the potential for future growth. Albaraka Turk has hitherto opted to avoid direct involvement in long-term financing, instead acting as a guarantor/agent between customers and foreign banks, and by providing non-cash loans, thereby generating fee income. We forecast that the bank's overall deposit base will post a CAGR of 32% between 2007 and 2009, with the share of deposits in the overall balance sheet estimated at 84% by 2009.

Continuing to stay away from wholesale funding in the short run

A downward trend in interest rates, an expected increase in credit demand and the bank's exposure to SME lending should all act as catalysts in stimulating loan growth. We forecast Albaraka's loan book will see CAGR of 39% between 2007 and 2009, mainly driven by short-term murabaha loans, which should carry the loan/asset ratio to as high as 88% at the end of 2009. We expect the share of lease receivables in the total to continue declining over time, due to their longer-maturity nature and the fact that these loans are no more attractive in terms of tax incentives. On the other hand, as part of Albaraka Turk's medium-term growth plans, credit card loans (and overall retail loans) should also increase gradually over time. Coming from a low base, we estimate the bank's retail loans (including credit card loans) will rise an average 25% YoY in the 2007-09 period.

We forecast CAGR of 39% for the loan book in 2007-09

With the greater portion of the loan book financed via current accounts and shareholder equity going forward, thanks to the capital increase undertaken in Q207, the effective business model that focuses on the underbanked SME segment and the expected volume growth in the less price-sensitive SME segment, Albaraka should witness relatively smoother margin contractions going forward. We forecast a CAGR of 35% in NII until 2009, which should help the bank limit the decline in the NIM to 50bps in 2007-09.

NII to increase on average 35% each year until end-2009, when decline in NIM could be limited to 50bps

As highlighted earlier, Albaraka Turk's fee income generation record is the weakest among the peer group, going hand in hand with the bank's relatively conservative stance in the past. That said, Albaraka Turk's non-cash loan exposure is on the rise, thanks to a growing volume of intra-group business interactions. In parallel with the increase in off-balance sheet activities of the bank, fee revenue generation is also strengthening.

Coming from a low base, and backed by growing off-balance sheet activities, fee revenues should increase considerably

In addition, the charging of commissions on services provided via alternative distribution channels (currently these services are new and free of charge) and an increase in credit card exposure should accelerate fee income growth. We also expect new product introductions on both commercial and retail banking, which are in compliance with interest-free banking, will increase the cross-sell rate and contribute to non-interest revenues. We forecast net fee income to post a CAGR of 45% between 2007 and 2009, pushing the fee-to-asset ratio to 1.9% by 2009 and resulting in a fee coverage ratio of 69%.

Albaraka Turk opened 18 new branches in 2007, and as part of its organic growth strategy plans to open 20 more in 2008, targeting a network of 130 branches by 2012. We foresee hefty investments, mainly in 2008 and 2009, and easing towards 2010. We expect staff expenditure (salaries etc.) will see a CAGR of 33% during 2007-09 period, although this will be more than offset by stronger interest income and fee revenue generation. We forecast that Albaraka Turk's cost-to-asset ratio will be 3.2% by 2009. Overall, we estimate net profit will post CAGR of 34% between 2007 and 2009, which corresponds to an ROE of 22% by the end of 2009.

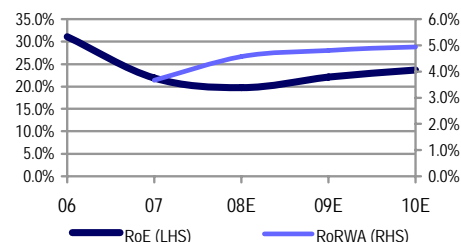
Albaraka Katilim Bankasi ADR

Per ADR (US\$)	12/06	12/07	12/08E	12/09E	12/10E
EPS (stated)	0.30	0.25	0.34	0.43	0.52
EPS (UBS adjusted)	0.30	0.25	0.34	0.43	0.52
GOPS	0.87	0.71	0.95	1.13	1.35
DPS	0.04	0.04	0.05	0.06	0.07
BVPS (stated)	1.09	1.65	1.84	2.05	2.38
BVPS (adjusted)	1.09	1.65	1.84	2.05	2.38
Profit & Loss (US\$m)					
Net interest income	73	122	162	190	229
Other income	67	70	93	113	135
Total revenues	140	192	255	303	363
Expenses	(83)	(84)	(109)	(124)	(146)
Operating profit	56	109	146	179	217
Provisions and other items	(6)	(24)	(30)	(34)	(41)
Profit before tax	50	85	116	145	177
Pre-exceptional net income	48	68	93	116	141
Capital dynamics (US\$m)					
Risk-weighted assets	0	1,852	2,208	2,600	3,117
Tier one capital	0	436	485	542	630
Total capital	0	445	495	552	642
Tier one ratio		23.6%	22.0%	20.8%	20.2%
Total capital ratio		24.0%	22.4%	21.2%	20.6%
Net profit after tax	48	68	93	116	141
Tier 1 requirement	0.0%	0.0%	0.0%	0.0%	0.0%
Less: Working capital requirement	0	0	0	0	0
Less: Dividends	8	14	19	23	28
Surplus capital generated	41	54	74	93	116
Surplus capital generation ratio			17.0%	19.1%	
Balance sheet (US\$m)					
Assets	1,773	3,045	3,583	4,167	4,932
Customer loans	1,304	2,308	2,874	3,455	4,136
Customer deposits	1,532	2,500	2,980	3,501	4,167
Funds under management	0	0	0	0	0
Loans : assets	73.6%	75.8%	80.2%	82.9%	83.9%
Deposits : assets	86.4%	82.1%	83.2%	84.0%	84.5%
Loans : deposits	85.1%	92.3%	96.4%	98.7%	99.3%
Shareholders funds : assets	9.87%	14.62%	13.82%	13.27%	13.03%
Asset quality (US\$m)					
Non-performing assets	25	36	44	52	62
Total risk reserves	33	46	56	66	80
NPLs : loans	1.89%	1.55%	1.53%	1.50%	1.50%
NPL coverage	136%	130%	127%	128%	130%
Provision charge : average loans	0.43%	1.18%	1.08%	1.02%	1.02%
Net NPLs : shareholders' funds	-5.0%	-2.4%	-2.4%	-2.6%	-2.9%
Profitability					
Net interest margin (avg assets)	4.49%	5.07%	4.87%	4.90%	5.03%
Provisions : operating profit	11.0%	22.0%	20.7%	19.2%	18.7%
RoE	31.2%	21.9%	19.7%	22.1%	23.7%
RoAdjE	31.2%	21.9%	19.7%	22.1%	23.7%
RoRWA		3.67%	4.57%	4.81%	4.95%
RoA	2.99%	2.82%	2.80%	2.98%	3.11%
Productivity					
Cost : income ratio	59.8%	43.4%	42.6%	41.0%	40.2%
Costs : average assets	5.2%	3.5%	3.3%	3.2%	3.2%
Compensation expense ratio	34.0%	31.3%	30.9%	28.4%	25.1%
Momentum					
Revenue growth	+14.3%	+37.7%	+32.5%	+19.0%	+19.8%
Operating profit growth	+69.7%	+93.6%	+34.3%	+22.4%	+21.5%
Net profit growth	+41.1%	+40.1%	+36.5%	+24.7%	+22.3%
Dividend growth	NM	-7.3%	+22.3%	+21.8%	+19.6%
Value*					
UBS bank valuation					
Leveraged P/E					
Risk tendency P/E					
Merger P/E					
Market capitalisation (US\$m)		1,163	1,379	1,379	1,379
Conventional valuation					
Market cap./Revenues	9.9x	7.2x	5.4x	4.5x	3.8x
Market cap./Operating profit	24.5x	12.7x	9.4x	7.7x	6.3x
P/E (stated)	16.9x	20.3x	14.9x	11.9x	9.7x
P/E (UBS adjusted)	16.9x	20.3x	14.9x	11.9x	9.7x
Dividend yield (net)	0.87%	0.81%	0.99%	1.20%	1.44%
P/BV (stated)	4.7x	3.1x	2.8x	2.5x	2.1x
P/BV (adjusted)	4.7x	3.1x	2.8x	2.5x	2.1x

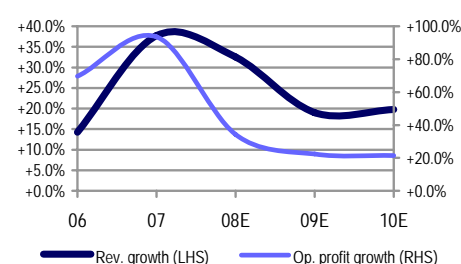
Source: UBS estimates, * Historical, current, & future valuations are based on a share price of c\$11.36 as at close on 04 Jan 2008

Albaraka Turk was incorporated in 1985 as Turkey's first special finance house. The bank has two main shareholders: Albaraka Banking Group (ABG) owns 54.1% of Albaraka Turk's outstanding shares, while Islamic Development Bank (IDB) holds a 7.8% stake. Albaraka Turk is the smallest of the current four participation banks in Turkey, and has 0.6% and 1% shares in assets and loans in the overall banking sector, respectively.

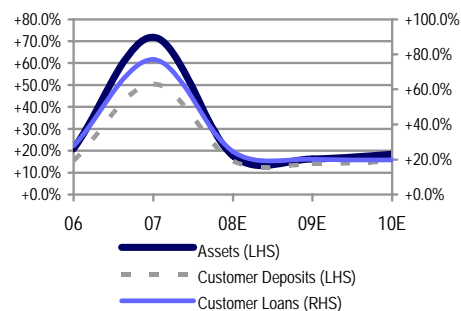
Profitability (RoE & RoRWA)



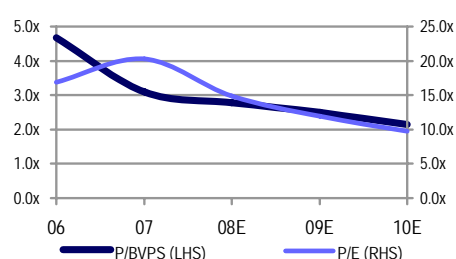
Momentum (Revenue & Operating profit growth)



Balance Sheet Growth



Value (P/Adj. BVPS & P/Adj. EPS)



Appendix

Table of Charts

Chart 1: SWOT analysis	5
Chart 2: Bank Asya rel. to MSCI Banks and Turkish Banks	9
Chart 3: Albaraka Turk rel. to MSCI Banks and Turkish Banks	9
Chart 4: Global Islamic Banks PE vs ROE	11
Chart 5: Global Islamic Banks PBV vs ROE	11
Chart 6: Turkish banks PE vs. ROE, 2008E	11
Chart 7: Turkish banks PE vs. ROE, 2009E	11
Chart 8: Sector ROE vs. Participation banks ROE	12
Chart 9: Trend earnings – EPS Growth	12
Chart 10: Earnings performance: ROEs of global Islamic and conventional banks	17
Chart 11: Chronology of interest-free banking in Turkey	21
Chart 12: Operation of a participation bank	25
Chart 13: Participation banks – the growth performance (2001-07)	31
Chart 14: Deposit growth (2002-07)	32
Chart 15: New branch additions (2002-07)	32
Chart 16: Loan growth (2002-07)	32
Chart 17: Breakdown of the funding base – 9M07	33
Chart 18: Currency breakdown of deposits – 9M07	33
Chart 19: Demand deposits as % of total – 9M07	33
Chart 20: The CAR comparison – 9M07	34
Chart 21: Loan-to-asset ratio – 9M07	36
Chart 22: Currency breakdown of the loan book – 9M07	36
Chart 23: Loan market shares – 9M07	36
Chart 24: Loan breakdown by business segment	36
Chart 25: Turkey’s foreign trade volume with the MENA region (US\$m)	37
Chart 26: NPL rates (gross) – 9M07	38
Chart 27: NPL provision rates – 9M07	38
Chart 28: NIM comparison – 9M07	39
Chart 29: Funding costs – 9M07	40
Chart 30: Spread analysis – 9M07	40
Chart 31: Non-cash loan exposure – 9M07	41
Chart 32: Fee – opex coverage ratios – 9M07	42
Chart 33: Net fee breakdown – Bank Asya	42
Chart 34: Net fee breakdown – Albaraka Turk	42
Chart 35: Cost-to-asset ratios – 9M07	43
Chart 36: Cost-to-income ratios – 9M07	43
Chart 37: ROE Comparison – 9M07	44
Chart 38: FX on-balance-sheet position (US\$m) – 9M07	45
Chart 39: YTL loan yields (return on loans, annualised) – 9M07	46
Chart 40: Deposit costs (blended) – 9M07	47
Chart 41: Fee/total income ratio – 9M07	47
Chart 42: New NPL additions (2006): NPL additions to loan ratios	48
Chart 43: Cost-to-asset ratios – 9M07	49
Chart 44: Growth assumptions and the share of participation banks in the system	51
Chart 45: Share of interest-free banking – an international comparison	52

Appendix

Table of Figures

Table 1: Turkish Banks- Valuation summary	1
Table 2: Ratios and performance analysis: Bank Asya and Albaraka (9M07)	8
Table 3: Turkish banks: Forecasts and valuations	10
Table 4: International interest-free banks: Valuation multiples	11
Table 5: Valuation summary: Gordon growth model (USD m).....	12
Table 6: LATAM and EMEA valuation summary.....	13
Table 7: Two banking frameworks: Comparison of conventional and Islamic banking.....	15
Table 8: Principled transactions	16
Table 9: Interest-free banking compliant funds	20
Table 10: Chronology of interest-free banking in Turkey	22
Table 11: Participation banks in the Turkish banking system	23
Table 12: Recent financial acquisitions by Middle Eastern investors in Turkey	24
Table 13: Participation banks – a sample balance sheet structure	27
Table 14: Products offered by interest-free banks	29
Table 15: Expected Basel-II impact on Turkish banks	35
Table 16: NIM and spread performance – 9M07.....	39
Table 17: Banking penetration rates: Turkey and the EU	50

■ Statement of Risk

The Turkish economy is improving, but not stable. The government has been implementing an IMF-controlled restructuring and reform programme since 1999. Success in following the reform schedule remains critical for the government and economy. A widening current account deficit as a result of a deteriorating trade balance is also a key macro risk, as are ongoing negotiations with the EU for accession. Talks commenced as of 3 October 2005, and any potentially negative news flow would affect the Turkish markets negatively.

For risks specific to participation banks Asya and Albaraka, please see pp48-49.

■ Analyst Certification

Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.

Required Disclosures

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UBS Investment Research: Global Equity Rating Allocations

UBS 12-Month Rating	Rating Category	Coverage ¹	IB Services ²
Buy	Buy	55%	39%
Neutral	Hold/Neutral	36%	36%
Sell	Sell	8%	20%
UBS Short-Term Rating	Rating Category	Coverage ³	IB Services ⁴
Buy	Buy	less than 1%	25%
Sell	Sell	less than 1%	50%

1:Percentage of companies under coverage globally within the 12-month rating category.

2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.

3:Percentage of companies under coverage globally within the Short-Term rating category.

4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS. Rating allocations are as of 31 December 2007.

UBS Investment Research: Global Equity Rating Definitions

UBS 12-Month Rating	Definition
Buy	FSR is > 6% above the MRA.
Neutral	FSR is between -6% and 6% of the MRA.
Sell	FSR is > 6% below the MRA.
UBS Short-Term Rating	Definition
Buy	Buy: Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.
Sell	Sell: Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.

KEY DEFINITIONS

Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.

Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium).

Under Review (UR) Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.

Short-Term Ratings reflect the expected near-term (up to three months) performance of the stock and do not reflect any change in the fundamental view or investment case.

EXCEPTIONS AND SPECIAL CASES

UK and European Investment Fund ratings and definitions are :

Buy: Positive on factors such as structure, management, performance record, discount; Neutral: Neutral on factors such as structure, management, performance record, discount; Sell: Negative on factors such as structure, management, performance record, discount.

Core Banding Exceptions (CBE) : Exceptions to the standard +/-6% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified in the Company Disclosures table in the relevant research piece.

Company Disclosures

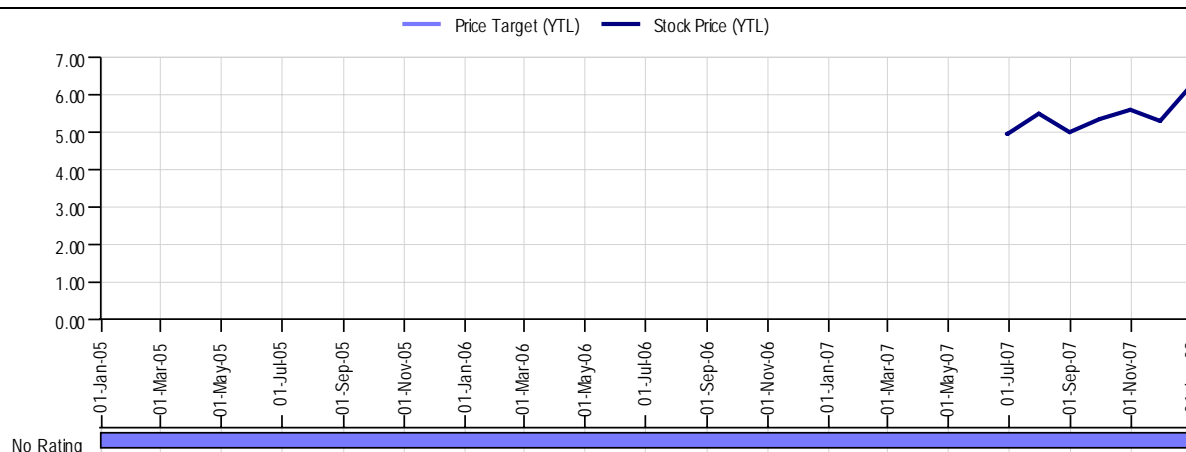
Company Name	Reuters	12-mo rating	Short-term rating	Price	Price date
Albaraka Katilim Bankasi	ALBRK.IS	Not Rated	N/A	516.45c	07 Jan 2008
Asya Katilim Bankasi	ASYAB.IS	Not Rated	N/A	904.86c	07 Jan 2008

Source: UBS. All prices as of local market close.

Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

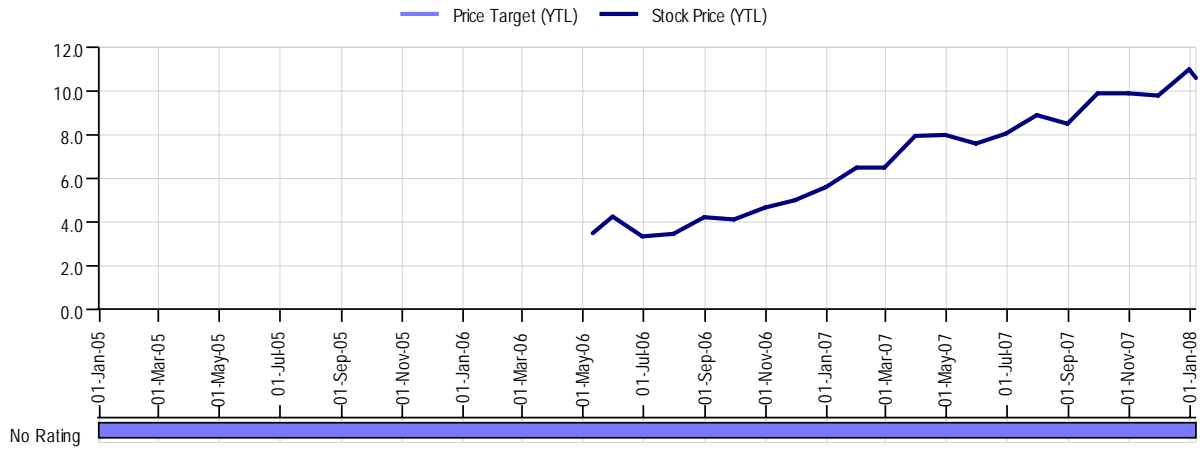
Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

Albaraka Katilim Bankasi (YTL)



Source: UBS; as of 07 Jan 2008

Asya Katilim Bankasi (YTL)



Source: UBS; as of 07 Jan 2008

Additional Prices: Akbank, 691.45c (07 Jan 2008); Garanti, 828.03c (07 Jan 2008); Is Bank, 606.09c (07 Jan 2008); Vakifbank, 334.63c (07 Jan 2008); YKB, 331.21c (07 Jan 2008); Source: UBS. All prices as of local market close.

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