Industry Flash

16 January 2008 | 12 pages

Turkish Banks

Company Visit Notes

- **Feedback on 4Q07 and Expectations for 2008** — We visited 6 Turkish Banks earlier this week with a group of investors, getting some feedback on 4Q07 trends and expectations for 2008.
- **Outlook Remains Positive** — Turkish Banks managements share a cautiously optimistic view for the sector despite the ongoing turmoil in global markets. They expect rates to be cut by 175-200bps in 2008, 5%+ GDP growth, and around 30%+ loan growth.
- **Temporary Aggression in Deposit Market in 4Q** — It looks like the sector has had stiff competition in deposits in the latter part of 4Q, which must have taken away some of the positive impact of falling rates on funding costs. Isbank seems to have grabbed some market share from others. All of the banks said the competition was only in 4Q and has stopped sharply in 2008.
- **Margin Improvement in 4Q:** — Despite competition on the deposit side, the cost of funding was generally falling for Turkish banks due to CB rate cuts and as a result margins improved slightly for most of the banks in 4Q.
- **Not Worried About Foreign Funding** — Despite the turmoil in global financial markets, Turkish banks told us the cost of foreign funding has not increased substantially and the swap market is still healthy in terms of liquidity and costs.
- **We Remain Positive on Turkish Banks** — The ongoing turmoil in global markets have had its toll on Turkish Banks with share prices 25% off their peaks. We believe the positive macro and sector backdrop are still intact and there is room for healthy earnings growth. With our target prices implying 37% average upside for banks, we see the current weakness in share prices as a good long-term buying opportunity.

Akin Tuzun[1]
+44-20-7986-4248
akin.tuzun@citi.com

Emre Izgi, CFA[1]
+44-20-7986-3903
emre.izgi@citi.com

See Appendix A-1 for Analyst Certification and important disclosures.

~1Citigroup Global Markets Ltd

Turkish Banks Trip Notes

General Highlights:

- **Deposit war:** Our discussions with Turkish banks revealed that there was a strong competition for deposits in the latter part of 4Q07. This was mainly led by Isbank, while other banks like Garanti and Finansbank joined, too. We sense that Isbank grabbed visible market share from some of the banks with very marginal increase in cost of deposits. The other banks have seen fall in their deposit costs in 4Q07 but had there not been a deposit fight, the costs would have probably fallen further.

- **Margin trends:** The margins were generally up in 4Q07 according to the banks. This was partially driven by the duration mismatch impact but also due to slight increase in interest earning assets to interest bearing liabilities ratio.

- **NPL sales:** Some of the banks indicated that they are planning to sell some part of their NPL portfolios in the first quarter of the year. The most visible one is Yapi Kredi, which is considering selling TL530m (30% of the NPL book) in 1Q08. If sold at a good price (25%-30% face value), such transactions could create value for shareholders and improve earnings growth.

- **2008 Expectations:** we saw the banks cautiously optimistic about 2008. They expect 5%+ GDP growth, inflation coming down to below 6% levels, interest rates easing by 175-200 bps at CB level. So in all aspects, better than 2007. But this was not fully reflected in their loan growth assumptions in our view. They generally expect 25%-30% loan growth for the sector. In fact, the sector has grown 30% in TL loans and 43% in FX loans already in 2007, which was a weak macro year. We believe with those macro parameters, sector growth could be much stronger. At the bank-specific level, each bank expects 5%-10% higher growth for their own bank on top of sector growth.

- **Doing Good in FX Loans:** Larger banks seem to do well at the corporate lending level as foreign intermediaries have become reluctant to lend to Turkish corporates due to problems in their home markets. As a result, banks like Isbank and Garanti have signed big ticket loan transactions in 2007. This is likely to continue in 2008 given the heavy M&A and investments program of Turkish corporates particularly in energy and construction.

- **Branch Expansions:** Almost all the banks have aggressive branch opening strategies for 2008. This could bring additional cost increases at the operating levels (although not much as these are mostly smaller branches)

- **Foreign Funding Not a Major Issue:** the general feedback from Turkish banks was that the swap market was still very healthy in terms of cost and liquidity provided. The banks also do not expect a major increase in foreign wholesale funding costs.

Bank Specific Highlights

Yapi Kredi (YKBNK.IS - YTL3.64; 1M)

- **Restructuring Almost Fully Completed:** In 4Q07, Yapi Kredi has almost completed its restructuring with transferring leasing, factoring and international operations under Yapi Kredi, creating some value for YKB shareholders and improving the CAR to 14% from 12.9%. The brokerage and asset management will be transferred in 1Q08.

- **Targets Met:** By the end of 2007, Yapi Kredi met most of the targets that were set at the beginning of the restructuring phase. These were mainly 20% ROE, CAR of 12%+, and cost of risk of 0.9%. The only target yet to be met is the cost/income ratio of less than 50%. Due to aggressive branch openings, this has not been achieved yet but by 2008-end, it could be reachable.

- **One-off costs increase cost/income slightly in 4Q:** there were some one-off costs in 4Q 8typically for all the banks) which increased cost/income ratio. As of 9M07, Yapi Kredi's cost/income was 65.5%, well above the industry average of 44%.

- **Branch Expansion Strategy:** YKB plans to open 160 branches in 2008 (it was 676 as of 2007). The target for 2009 year-end is 1000. These are mostly small-scale retail branches with 6/7 people initially to grow up to 10/11 if needed. The average break-even time for branches is 9 to 12 months.

- **NPL Sale:** Yapi Kredi plans to sell some of its NPL portfolio in 1Q08. the figure in consideration is TL530m, 30% of the NPL book as of 9M07. There was no indication from management with regards to the potential price but they expect a better price than the recent similar transaction of Sekerbank, which sold its NPL book at 20% face value. Given that Yapi Kredi's coverage level is 82% (and probably more for the portfolio being sold), this transaction could create value.

- **NPL Write-downs in 4Q07:** Yapi Kredi did some write-downs in 4Q07 in its credit card NPL portfolio, pulling down the ratio from 7.0% to 5.9%. Based on the level of existing coverage on these NPLs, this could create some costs in 4Q07. We believe this is why cost/income was slightly higher in 4Q.

- **Interested in Halkbank but only at a reasonable price:** The bank management have interest in the Halkbank privatisation but think the price may be too high for their interest. They think the organic branch expansion strategy is much better and cost efficient for the time being.

Isbank (ISCTR.IS - YTL6.50; 1M)

- **Grabbed Back Some Deposit Market Share in 4Q:** Isbank has seen improvement in its deposit market share in 4Q on the back slightly more aggressive pricing versus the market (20-25bps in our view). We do not anticipate Isbank to grab back all market share it lost (from 15.4% in 1Q07 to 13.0% in 3Q07) but the market share gains could be around 1% levels. (the management has not given any indication)

- **Cost of Deposits:** When asked about the impact of aggressive pricing on deposits, the management said that the market share gains were on the back of marginal increases in deposit rates. We do not expect to see a visible increase in cost of funding but the rest of the sector was experiencing some drop in cost of funding and therefore Isbank's margin trends in 4Q07 may be less handsome versus the sector.

- **Deposit War Ended sharply in 1Q08:** The fight for deposits was mainly in December 2007 and ended abruptly in January. Given that the average maturity in deposits is around 1 month, we do not see the impact of this to continue in 1Q08 so we are not worried about rising costs.

- **Growth Strategy To Revive in 2008:** Isbank has been following a conservative strategy in 2007, lagging the peers in overall asset growth (both in deposits and loans). The management indicates that this will change in 2008. Assuming there is not major disruption in global and the local market, Isbank aims to be aggressive in loan growth, but not that aggressive in funding as they have excess funding for a potentially strong loan growth in 2008.

- **Corporate Loan Performance Was Strong:** Isbank has signed big ticket deals on the corporate front in 4Q07 (the big one was together with Garanti). The reluctance of foreign banks in lending Turkish companies in 4Q07 due to problems in their home markets, has helped big banks like Isbank and Garanti on FX corporate loans.

- **Sale of Participation Portfolio:** One crucial topic was the potential timeline for Isbank to reduce its stakes in some of the subsidiaries to 51% as had been indicated by the CEO in 4Q07. There is no definite timeframe for this but the bank is willing to drop to 51% in all subsidiaries, raising some cash to utilise in banking assets .We believe that the most probable timeline for this is 2H08, given the current equity market conditions.

- **More Visible Sale Potentials in 2009:** There are two potentially big equity participations in Isbank's portfolio which could be IPO'd in 2009. One of them is Avea, the mobile operator and the other one is the re-insurance company. The banks management said there is not definite time frame on both but could be considered as an option in the future.

- **Branch openings:** Isbank plans to open 75/100 branches in 2008. The cost of opening a new branch for Isbank is around TL200-300K and usually reaches break-even in less than a year.

- **Transformation Project:** This is one of the key points for Isbank according to the management. The aim is to convert Isbank to a more customer- and sales-oriented structure from a product-oriented one. The completion date is end of 2009 but the management expects to start seeing positive effects from 2H08 onwards. Also, the costs associated with the project is less than originally planned (US$300m versus US$500m).

- **Operating Costs To Increase in 4Q but cost/income at reasonable levels:** The bank has had some pick up in operating costs in 4Q (partly due to the transformation project) but the cost income ratio hovers around 40% levels. (41% as of 9M07). This signals that the income growth will compensate for opex increase.

- **High Provisioning Saga Not Fully Over:** The extremely prudent manner at Isbank management level seems to have continued in 4Q07. Although there was no guidance, it seems that the NPL provisioning and free provisioning have continued in 4Q, which may depress the bottom line compared with the benign operational performance.

Garanti (GARAN.IS - YTL8.75; 2M)

- **Deposit growth surpassed loan growth in 4Q:** Garanti management indicates that after an above-industry average loan growth delivered in the first 9 months of the year, the bank lagged the sector in loan growth in 4Q07, while their deposits grew faster than loans, lowering the loans-to-deposit ratio. When asked, the bank said that this was not due to problems faced in the swap market or worries on potential foreign funding problems in 2008.

- **The swap market is still healthy:** They have not experienced substantial increases or liquidity problems in the swap market, which they normally use extensively for the financing of mortgage type of loans. But the bank is now using shorter-term swap funding (less than a year) rather than longer-term deals. This is probably increasing the duration mismatch, which could be beneficial if cost of TL deposits fall throughout 2008 along with CB rate cuts.

- **Deposit rates are not coming down yet:** Despite the 150bps rate cuts by Central Bank in the last three months of 2007, this was not fully reflected on deposit pricing of Turkish banks. This is not only for Garanti but also true for the most of the sector. The reasons behind this is (i) the market interest rate has not come down parallel with CB rate cuts and (ii) there was a deposit market share war in the latter part of 4Q07.

- **GE stake sale:** When asked about the recent sale of GE's 5% Garanti stake back to Dogus Group, the management said that this was not an indication of a change in GE's commitment to Garanti and their partnership with Dogus Group. Both groups continue co-operation in many areas from media to finance both in Turkey and abroad and there was no change in the strategic partnership in Garanti management. We believe that GE wanted to raise some cash prior to year-end financials for its own accounts given the problems in the US mortgage market.

- **Halkbank privatisation:** Garanti remains interested in Halkbank and GE is still committed to such transaction if at the right price. They also don't see another group buying Halkbank as a serious threat as they think it will take some time for the new owner to restructure the bank.

Halkbank

- **Strong Loan Growth in 2007:** Halkbank indicated that the bank's outperformance of the sector in loan growth continued in 4Q07.
- **Credit Card Partnership with HSBC:** The management has high hopes on their partnership with HSBC on credit cards. They expect fees and credit card loans to grow in 2008 on the back of that.
- **Deposit War in 4Q07:** Halkbank confirmed the deposit war in the last quarter of the year. They saw Isbank as one of the more aggressive players but as of 1st of January, competition has eased substantially.
- **Halkbank less sensitive to interest rates:** When asked about the sensitivity of Halkbank to rate-cut cycle, the bank management said that due to lower duration mismatch and floating nature of the securities portfolio, Halkbank is less sensitive to interest rates so they feel comfortable if rates do not come down as anticipated.
- **NPL recovery decelerating:** After a strong NPL recovery in 2006 with recoveries making up 13% of total banking income, this has fallen in 2007. As of 9M07, the NPL recovery made up only 5.4% of total income and this is expected to fall further by the end of 2007.
- **Halkbank is Immune To State Deposits Liberalisation:** With only 4% of total deposits in state deposits, Halkbank feels comfortable about the long-anticipated liberalisation in state deposits. Management see Ziraat and Vakifbank as more subject to risk and in fact see themselves as a beneficiary of this change.

Finansbank (FINBN.IS - YTL5.25; Not Rated)

- **Grabbing market share in credit cards and consumer loans:** Finansbank management indicated that they saw market share increases in these areas in 4Q07.
- **Main Focus is Mortgage Loans in 2008:** Along with credit cards, their main focus will be mortgage loans in 2008.
- **Joined the deposit war in 4Q:** Given their focus on TL consumer loans, Finansbank also joined the fight for deposits in 4Q, with short-lived campaigns attracting deposits from other banks.
- **Aggressive Branch Opening Strategy:** The bank opened 102 branches in 2007, reaching 411 branches by the end of the year. This trend continues in 2008 with a new branch being opened every two days. These branches generate net profits after 7/8 months. After 12/13 months, they pay off the initial investments.
- **Expects 35% Loan growth for the sector:** While the other banks are more conservative (30% loan growth), Finansbank has a slightly higher assumption for the sector loan growth. The bank itself envisages 45% growth. For business enterprises, the growth expectation is 43% while for households, it is 56%.

- **Wholesale funding costs still reasonable:** Finansbank has not seen a major pick-up in foreign borrowing costs. Management indicated that while they were raising funds at Libor+35-40bps, this is now around 57-60bps. The swap market is also still healthy with reasonable costs and liquidity being offered to Turkish banks. The bank told us that the cost of swap funding for financing a typical mortgage loan is around 15.4%.

Turkiye Is Bankasi

Valuation

Our valuations point to a fair value of TL28.4 billion for Isbank, or TL10.15 per share. Based on this target value, the implied P/E and P/BV for 2008E are 10.3x and 2.34x. Our valuation methodology for Turkish banks is to value the core banking business separately. For this we have three methods: (1) EVA method arrives at fair value by adding discounted EVA flows (adjusted profits minus required capital charges) to adjusted starting book value; (2) Tobin's Q P/BV; and (3) Gordon's growth model. For participations, we have an NAV-based approach where we value those participations individually. In Isbank's case, 20% of the target value is associated with participations.

Risks

We rate Isbank Medium Risk due to a number of risks that could cause the share price to deviate from our target price. The major industry-specific risks are: (i) interest rate risk; (ii) local currency risk; and (iii) NPL risk due to rapid loan growth. The company-specific risks are: (i) continuation of over-provisioning despite assumption otherwise; (ii) high maturity mismatch; and (iii) potential market share losses or high funding cost pressure due to increasing competition particularly after exposure of foreign banks in the sector.

If the impact on the company from any of these factors proves to be more negative than we anticipate, the stock will likely have difficulty achieving our financial and price targets. Likewise, if any of these factors proves to have less of an effect than we anticipate, the stock could materially outperform our target.

Turkiye Garanti Bankasi AS

Valuation

Our valuations point to a fair value of TL 22.6 billion for Garanti, or TL10.85 per share. Based on this target value, the implied P/E and P/BV for 2008E are 10.5x and 2.82x. Our valuation methodology for Turkish banks is to value the core banking business separately. For this we have three methods: (1) EVA method arrives at fair value by adding discounted EVA flows (adjusted profits minus required capital charges) to adjusted starting book value; (2) Tobin's Q P/BV; and (3) Gordon's growth model. For participations, we have an NAV-based approach where we value those participations individually.

Risks

We rate Garanti Medium Risk due to a number of risks that could cause the share price to deviate from our target price. The major industry-specific risks are (i) interest rate risk; (ii) local currency risk; and (iii) NPL risk. The company-specific risks are: (i) dependence on credit cards; (ii) lower than industry average NPL coverage; and (iii) overcrowded foreign investor base which could create stronger selling pressure in a top-down market sell-off.

If the impact on the company from any of these factors proves to be more negative than we anticipate, the stock will likely have difficulty achieving our financial and price targets. Likewise, if any of these factors proves to have less of an effect than we anticipate, the stock could materially outperform our target.

Yapi Ve Kredi Bankasi AS

Valuation

Our valuations point to a fair value of TL17.3 billion for Yapi Kredi, or TL5.51 per share. Based on this target value, the implied P/E and P/BV for 2008E are 10.1x and 2.59x, respectively. Our valuation methodology for Turkish banks is to value the core banking business separately. For this we have three methods: (1) EVA method arrives at fair value by adding discounted EVA flows (adjusted profits minus required capital charges) to adjusted starting book value; (2) Tobin's Q P/BV; and (3) Gordon's growth model. For participations, we have an NAV based approach where we value those participations individually.

Risks

We rate Yapi Kredi Medium Risk due to a number of risks that could cause the share price to deviate from our target price. The major industry-specific risks are: (i) interest rate risk; (ii) local currency risk; and (iii) NPL risk. The company-specific risks are: (i) high maturity mismatch; (ii) below-average capital adequacy ratio; (iii) low NPL coverage; and (iv) failure to recover in terms of market share growth.

If the impact on the company from any of these factors proves to be more negative than we anticipate, the stock will likely have difficulty achieving our financial and price targets. Likewise, if any of these factors proves to have less of an effect than we anticipate, the stock could materially outperform our target.

Appendix A-1

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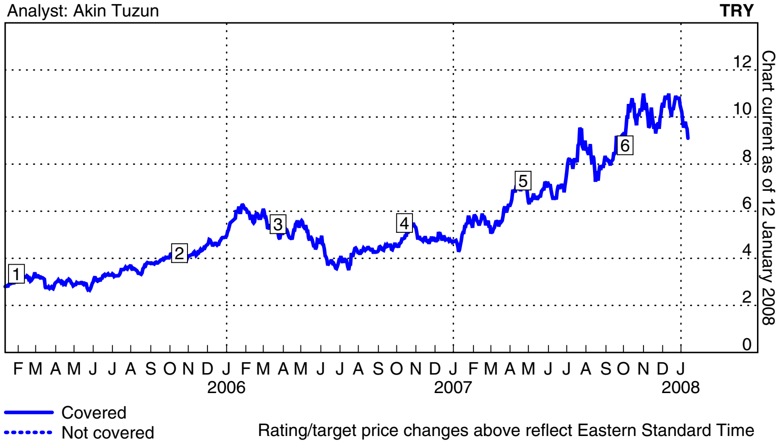
IMPORTANT DISCLOSURES

Garanti Bankasi (GARAN.IS)

Ratings and Target Price History - Fundamental Research

Analyst: Akin Tuzun



#	Date	Rating	Target Price	Closing Price
1:	28 Jan 05	*1H	*1.93	2.94
2:	18 Oct 05	*1M	*4.56	4.00
3:	24 Mar 06	*3M	*4.43	5.05
4:	13 Oct 06	*1M	*5.08	4.86
5:	23 Apr 07	*3M	*6.25	NA
6:	3 Oct 07	*2M	*10.85	9.15

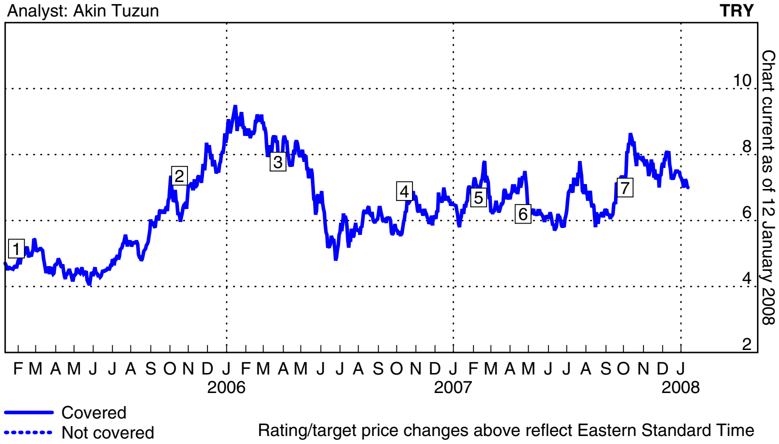
*Indicates change.

Rating/target price changes above reflect Eastern Standard Time

Isbank (ISCTR.IS)

Ratings and Target Price History - Fundamental Research

Analyst: Akin Tuzun



#	Date	Rating	Target Price	Closing Price
1:	28 Jan 05	1H	*3.77	4.55
2:	18 Oct 05	*1M	*8.28	6.14
3:	24 Mar 06	1M	*9.05	8.00
4:	13 Oct 06	1M	*6.26	6.07
5:	9 Feb 07	1M	*6.59	7.00
6:	23 Apr 07	*3M	6.59	NA
7:	3 Oct 07	*1M	*10.15	7.15

*Indicates change.

Rating/target price changes above reflect Eastern Standard Time

Yapi ve Kredi Bankasi A.S. (YKBNK.IS)

Ratings and Target Price History - Fundamental Research

Analyst: Akin Tuzun

#	Date	Rating	Target Price	Closing Price
1:	28 Jan 05	*3S	*1.99	2.22
2:	18 Oct 05	*2H	*2.21	1.89
3:	24 Mar 06	*3H	*2.61	2.67
4:	13 Oct 06	*2M	*2.40	2.71
5:	23 Apr 07	*3M	*2.83	NA
6:	3 Oct 07	*1M	*5.51	3.88

*Indicates change.

Covered
Not covered

Rating/target price changes above reflect Eastern Standard Time

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