

# HALKBANK

January 08, 2008

## EQUITY RESEARCH **STRONG BUY** (Initiation of coverage)

### Turkey's "hot" bank

We are initiating coverage on Halkbank with a STRONG BUY recommendation. Halkbank is an outstanding investment case 1- as a restructuring story, offering the strongest growth and profitability prospects among large banks, 2- as an M&A play, being on the privatization agenda in 2008, and 3- as the only true dividend play among banks with a 7.2% dividend yield. Our 12M target value of US\$14,952 bn implies an upside potential of 30% for the stock.

- Halkbank has an exceptional balance sheet dominated with securities and a low loan/deposit ratio, implying strong growth potential for the bank. We expect the bank to grow loans at CAGR of 35% in the next two years, out beating peers, by shifting redeeming securities to higher yielding loans and leveraging on its under-utilized deposit base and post a solid 29% return on equity in 2009.
- As a well capitalized state bank, Halkbank distributes all distributable income as dividends. Dividend payout was 87% in 2006 and we expect a similar ratio for 2007, implying a dividend yield of 7.2%.
- Halkbank will be privatized in 3Q2008 through the block sale of state's remaining 75%. We support this strategy as we believe private ownership will eliminate the risk of being used for populist activities in the future for the bank. Besides, we think that an aggressive and committed owner would accelerate the convergence of efficiency ratios to peer group averages.
- We expect a generous premium to Halkbank's market multiple during the strategic sale. However, we doubt that the minorities will benefit as we think the Privatization Administration will provide call exemption to the buyer as it did in previous privatizations.
- Halkbank's P/BV multiples look stretched on a '07 and '08 basis due to high dividend payments. '09 multiples look more compelling at 10.1x earnings and 2.7x BV but are still higher than the peer group averages. However, we believe the premium is well-deserved thanks to the banks strong growth and profitability prospects.

Current Price (07/01/08)	YTL10.70
Current Mcap (mn)	US\$11,480
12-mth Target Price	YTL14.95
Target Mcap (mn)	US\$14,952

12-mth Forecast Returns (US\$)	
Dividend Yield	7%
Capital Appreciation	23%
12-mth Total Return	30%

Stock Data		
Ticker	HALKB.IS	HALKB TI
Sector		Banking
# of Shares (mn)		1,250
3M Avg. Trd. Vol. (mn)		US\$27.0
52-week Range	YTL6.80 -	YTL12.20

Market Data	
ISE 100	52,570
YTL/US\$	1.1651

Shareholder Structure	
Privatization Administration	74.98%
Others	0.04%
Foreign Holding as % of Free Float	94%

Financials (YTL mn)	2006	2007E	2008E	2009E
Net Int. Income	1,370	1,691	1,971	2,271
% ch yoy		23%	17%	15%
Net Income	863	1,131	1,286	1,451
% ch yoy		31%	14%	13%
BV	3,780	4,150	4,474	5,539
% ch yoy		10%	8%	24%

Operating Margins	2006	2007E	2008E	2009E
NIM	4.6%	4.7%	4.7%	4.6%
Cost/Income	38%	37%	36%	37%
ROAE	24%	29%	30%	29%
ROAA	2.8%	3.1%	3.0%	2.9%
Dividend Yield	5.6%	7.2%	2.9%	3.3%

Financial Ratios	2006	2007E	2008E	2009E
P/E (US\$, x)	19.0	13.2	11.0	10.1
P/BV (x)	4.3	3.2	3.2	2.7

Price Performance	1M	3M	YTD	YoY*
US\$ Absolute	4%	-1%	-13%	37%
ISE-100 Relative	10%	7%	-7%	3%

\* since the IPO on May 10, 2007



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## INVESTMENT POSITIVES

### **Balance sheet restructuring promises strong growth and profitability**

Halkbank has an exceptional balance sheet dominated with securities (46% of total assets) and a low loan/deposit ratio (54%), implying strong growth potential for the bank. We expect the bank to grow loans at CAGR of 35% in the next two years, while defending margins, by shifting redeeming securities to higher yielding loans and leveraging on its under-utilized deposit base. Increasing retail exposure will help improve fee income's contribution to the bottomline, and coupled with low cost base structure, we project Halkbank will post a CAGR of 13% in net earnings over the next two years, implying a solid 29% return on equity in 2009.

### **Well-equipped to grow in the under-banked SME and consumer lending**

Halkbank is strategically focused on SME lending and has started expanding into consumer lending after its merger with retail-focused Pamukbank in 2004. We believe, the bank, with its extensive distribution network, YTL denominated deposit funding (74% of total deposits is in YTL), long-lasting SME relationships and government support in lending to SMEs is well-positioned to grow in under-penetrated SME and consumer lending. We are assuming a CAGR of 35% in Halkbank's loan book in the two years between 2007 and 2009, enhancing its market share by 80 bps to 7.2%. We expect consumer loans to more than double in the next two years and account for 27% of the total loan book by 2009, mainly driven by housing loans and general purpose loans.

### **Established but under-utilized franchise**

Halkbank has 586 branches, ranking it fifth in the Turkish banking system. The bank does not have an aggressive branch expansion strategy unlike most peers as it already enjoys presence in each and every city in Turkey. Besides, 62% of total branches are located in the Anatolia region where most peers are trying to penetrate, versus 48% for the peer group average. Rather, the bank is running after improving its efficiency ratios by utilizing its already established franchise.

### **The real dividend bet among banking stocks**

As a well capitalized state bank, Halkbank distributes all distributable income as dividends. Dividend payout was 87% in 2006 and we expect a similar ratio for 2007 earnings, implying a dividend yield of 7.2%. In 2008, however, after the block sale of the bank is finalized, we believe the bank will be distributing only 30% of dividends as it will need financing to restructure and grow further.

### **The "block sale" strategy is the best for minority shareholders**

Halkbank is on the government's privatization agenda for 2008. The privatization strategy is the sale of the remaining 75% as a block to a strategic partner in the third quarter of 2008. We support this strategy as we believe private ownership will eliminate the risk of being used for populist activities in the future. Besides, we think that an aggressive and committed owner would

accelerate the convergence to peer group averages in terms of efficiency ratios.

#### **A precious M&A target**

We expect strong interest in Halkbank's block sale both from domestic and international players, given its strong deposit base and established presence in the Anatolia region, where all others are trying to penetrate. Besides, the bank will maintain its privilege to provide Treasury-subsidized loans to the SMEs during the five year period after the privatization, which is an important competitive advantage in gaining & maintaining market share in the high growth potential SME business. Given the high transaction multiples in the Turkish banking sector in 2007 and the strategic importance of Halkbank, we do expect a generous premium to Halkbank's market multiple during the strategic sale. However, we doubt that the minorities will benefit as we think the Privatization Administration will provide call exemption to the buyer as it did in previous privatizations such as Eregli, Tupras and Petkim.

#### **RISKS**

##### **Increasing competition in the Turkish banking system**

The long-term prospects of the under-penetrated Turkish banking system attracted a lot of foreign players to the market. Most of the players are now equipped with financial support and international experience and are after market share growth and expansion. Banks should expect lower net interest margins and an upward pressure on costs going forward.

##### **Lack of interest for the block sale due to global liquidity issues**

Huge sub-prime losses of global financial players and global liquidity issues might hurt the risk appetite for emerging markets in general and decrease the interest for the block sale of Halkbank. Even some domestic players might have to pull back if the global partner is not in the situation to support such a big acquisition. The 75% of the bank is worth almost US\$9 bn, even without a control premium.

##### **Liberalization of state deposits**

State deposits that are held at three state banks, including Halkbank, will be liberalized at the beginning of 2008, allowing all private banks to bid for these deposits and thus, adding to the competition in the market. Three state banks have around YTL21 bn in state deposits, referring to 7% of total sector deposits. Among the three we think that the negative impact on Halkbank will be the least as it has the lowest exposure to state deposits. The bank has 4% of total deposits (around YTL1 bn) in state deposits and management expects only 20% of this to flee.

##### **A possible provisioning for the pension fund deficit**

The downside risk to our bottomline estimates for Halkbank could come from the provisioning for the pension deficit it inherited during the Pamukbank

merger. The deficit is calculated as YTL9 mn under the BRSA regulations and is provisioned for. Under IAS, however, the deficit is calculated as YTL270 mn. The IAS based deficit is expected to come down as the bank replaces retirees with low cost new employees. However, if the BRSA asked for a provisioning according to IAS as of today, the impact on the bottomline would be 4% in 2008 and 2009, assuming that it will be provisioned for in the next five years in equal amounts.

**High foreign ownership ratio**

Halkbank's foreign ownership in total free float is quite high at 94%, implying that the story has already been widely appreciated by institutional investors. This, however, could be a disadvantage if global conditions were to deteriorate, as there might be outflows from emerging market stocks regardless of the quality of the investments.

## HALKBANK – A SNAPSHOT

Halkbank is Turkey's seventh largest bank in terms of assets with a 7.2% market share. The bank has one of the widest distribution networks in the system with 586 branches, boasting presence in each and every city of Turkey and serving 6.2 million customers. Leveraging on its strong presence in the rural areas of Turkey where competition is less, the bank ranks fourth in terms of YTL deposits with a 10% market share.

### Market shares of Turkey's top 10 banks

	Total Assets (YTL mn)	Market Share (%)	Total Loans (YTL mn)	Market Share (%)	Total Deposits (YTL mn)	Market Share (%)	No. of branches	Market Share (%)
1 Ziraat Bank	77,089	15%	19,860	8%	65,628	20%	1,248	17%
2 Isbank	76,461	15%	32,126	13%	43,499	13%	929	13%
3 Akbank	64,363	12%	33,302	13%	39,089	12%	698	9%
4 Garanti Bank	59,505	11%	34,715	14%	34,602	10%	545	7%
5 YKB	47,917	9%	25,204	10%	31,517	9%	660	9%
6 Vakifbank	40,081	8%	20,833	8%	26,936	8%	331	4%
<b>7 Halkbank</b>	<b>38,004</b>	<b>7%</b>	<b>15,980</b>	<b>6%</b>	<b>29,707</b>	<b>9%</b>	<b>586</b>	<b>8%</b>
8 Finansbank	18,838	4%	13,096	5%	11,529	3%	378	5%
9 Denizbank	12,856	2%	8,498	3%	7,943	2%	299	4%
10 Oyakbank	12,114	2%	8,035	3%	8,406	3%	365	5%

Source: The Banks Association of Turkey

Halkbank was established by the state in 1938 in order to support Turkey's tradesmen & artisans and small businesses. It is the only bank that can provide Treasury-subsidized loans to these small businesses and thus enjoys a significant price advantage compared to peers. Besides, it is used as the intermediary for the distribution of "fund loans" by some government institutions like Ministry of Finance and mass housing administration. The bank does not bear the risk of these "fund" loans but generates fee income from the intermediary act.

In the 1990s and early 2000s, the bank took over some problematic banks (Tobank in 1992, Sumerbank in 1993, Etibank in 1998 and 96 branches of Emlakbank in 2001), which helped build-up its large distribution network. In 2000, the Parliament passed a law to restructure the bank and injected some non-tradable government bonds to cover its duty losses mainly stemming from the bank's receivables from the Treasury. Later in 2004, the bank was merged with Pamukbank, a leading retail bank that failed due to high group company NPLs. The merger proved to be a positive step for Halkbank as it enabled the renewal of the IT infrastructure and introduced the bank with consumer banking, while added to the bank's duty losses. More non-tradable securities were injected to the bank in order to cover these new duty losses.

**VALUATION**

We used the Gordon growth model to value Halkbank and looked at the domestic peer valuations for a reality check.

Our Gordon growth model yields a 12-month target valuation of US\$14,952 bn for Halkbank. In this method, we find the fair P/BV and multiply it with the forecast adjusted book value for 2009. We then discount the value to 2008 year-end to calculate the 12-month target and add the dividend payment expected for 2007.

We do not incorporate any upside related to the block sale as we believe the acquirer will be given exemption from making a call to minority shareholders as in the previous privatizations such as Erdemir, Tupras and Petkim.

We have used a risk free rate of 7% and 55% equity risk premium, translating into a cost of equity of 10.9%. We used a sustainable return on equity (RoE) of 27%, considering the bank is expected to generate 29% RoAE in the next two years in USD terms.

<b>Gordon Growth Model (US\$ mn)</b>	
Sustainable ROE	27%
Risk free	7.0%
Equity Risk Premium	55%
Cost of Equity	10.9%
Growth	4.8%
Implied P/BV	3.67
Adjusted Bank-only BV09E	4,294
Fair value for the bank business	15,755
<b>12M target valuation</b>	<b>14,213</b>
Dividend 2007E	740
<b>12M total valuation</b>	<b>14,952</b>
<b>12M target price per share (YTL)</b>	<b>15.0</b>

Source: Raymond James estimates

We have also used two sensitivity analyses to see the effect of change in growth, ROE and cost of equity assumptions. A 1pp change in ROE translates into roughly US\$640 mn change in the valuation of the bank (or 4% change), while 0.5pp change in the growth from 4.8% to 5.3% at 10.9% cost of equity assumption leads to a US\$931 mn increase (+6% change). Similarly, if we increase the cost of equity by 0.5pp from 10.9% to 11.4%, the change would be US\$1,114 mn (-8% change).

<b>Sensitivity Analysis (US\$ mn)</b>											
<b>Cost of Equity</b>	<b>Growth</b>					<b>Cost of Equity</b>	<b>ROE</b>				
	3.8%	4.3%	4.8%	5.3%	5.8%		25%	26%	27%	28%	29%
11.9%	11,802	12,281	12,827	13,457	14,191	11.9%	11,738	12,283	12,827	13,372	13,916
11.4%	12,588	13,155	13,808	14,570	15,468	11.4%	12,631	13,220	13,808	14,397	14,986
10.9%	13,486	14,163	14,952	15,884	17,000	10.9%	13,672	14,312	14,952	15,592	16,233
10.4%	14,521	15,338	16,303	17,459	18,868	10.4%	14,901	15,602	16,303	17,004	17,705
9.9%	15,728	16,726	17,922	19,380	21,199	9.9%	16,374	17,148	17,922	18,696	19,470

Source: Raymond James estimates

Next, we compared Halkbank with the large cap banks listed on the ISE. But for comparison purposes, we illustrated all banks in the table below. Halkbank's P/BV multiples look stretched on a 2007 and 2008 basis due to high dividend payments from 2006 and 2007E earnings. Being a well-capitalized state bank Halkbank distributes all distributable income and we expect it to continue to do so until 2008, when it will be fully privatized. After 2008, we assumed that the bank will be distributing 30% of distributable income, similar to peers, versus 87% in 2006 and 85% in 2007E. 2009 multiples look more compelling at 10.1x earnings, 2.7x BV but are still higher than the peer group averages of 9.4x and 2.1x, respectively. However, we believe the premium is well-deserved thanks to the banks strong growth and profitability prospects.

### Summary Valuation Table for Turkish Banks

07/01/2008	PRICE YTL	P. Target YTL	% chg	MCap US\$ mn	Target MCap US\$ mn	% chg	P/E*				P/BV				ROAE (%)				Recomm.
							2006	2007E	2008E	2009E	2006	2007E	2008E	2009E	2006	2007E	2008E	2009E	
<b>Large-Caps</b>																			
Akbank	8.10	11.3	39%	20,857	27,017	30%	18.7	14.5	11.4	9.8	4.1	2.3	2.1	1.9	23%	20%	19%	21%	HOLD
Garanti	9.70	14.4	48%	17,483	24,170	38%	23.5	13.8	10.6	9.4	5.3	3.0	2.5	2.1	24%	27%	26%	25%	STRONG BUY
Halkbank	10.70	15.0	40%	11,480	14,952	30%	19.0	13.2	11.0	10.1	4.3	3.2	3.2	2.7	23%	28%	29%	29%	STRONG BUY
Isbank**	7.10	10.4	46%	16,798	22,866	36%	18.4	11.0	8.8	7.9	3.8	2.4	2.2	1.9	21%	27%	26%	25%	STRONG BUY
Vakif	3.92	5.2	33%	8,411	10,402	24%	15.6	12.4	10.2	9.1	2.6	1.9	1.9	1.7	17%	18%	18%	19%	HOLD
YKB	3.88	5.4	38%	11,413	14,690	29%	31.9	16.1	12.8	10.4	4.8	3.1	2.6	2.2	15%	23%	22%	23%	BUY
<b>Average</b>							<b>21.2</b>	<b>13.5</b>	<b>10.8</b>	<b>9.4</b>	<b>4.2</b>	<b>2.7</b>	<b>2.4</b>	<b>2.1</b>	<b>20%</b>	<b>24%</b>	<b>24%</b>	<b>24%</b>	
<b>Mid-Caps</b>																			
Bank Asya	10.60	14.6	38%	2,729	3,503	28%	26.7	17.1	11.6	9.4	6.1	3.8	3.0	2.3	30%	27%	29%	28%	STRONG BUY
TEB	2.78	3.8	36%	1,801	2,285	27%	24.3	16.0	11.8	10.4	4.6	2.7	2.3	1.9	20%	21%	21%	20%	BUY
TSKB	1.87	3.2	70%	642	1,019	59%	8.6	7.6	6.1	5.5	1.5	1.1	1.0	0.9	18%	17%	17.7%	17.7%	BUY
<b>Average</b>							<b>19.9</b>	<b>13.6</b>	<b>9.8</b>	<b>8.4</b>	<b>4.1</b>	<b>2.5</b>	<b>2.1</b>	<b>1.7</b>	<b>23%</b>	<b>22%</b>	<b>23%</b>	<b>22%</b>	

\* excluding one-off gains

\*\* bank-only

Source: Euroline, RJ estimates

## Shareholder Structure

Halkbank is a state-owned bank on the government's privatization agenda. As a first step to Halkbank's privatization, 25% of the bank was listed on the Istanbul Stock Exchange in May 2007. The government announced willingness to continue with the privatization in 2008 through the block sale of the state's remaining 75% stake in the bank.

## Shareholder Structure

Shareholder	Paid-in-capital in 1,000 YTL	% stake
Privatization Administration	937,276	74.98%
Free Float	312,250	24.98%
Others	474	0.04%
TOTAL	1,250,000	100.00%

Source: Halkbank financial statements

## Privatization plans

### ***A block sale with call tender exemption is the most likely sale strategy***

Privatization of Turkey's three state banks, including Halkbank, is a pledge in the IMF stand-by agreement. Halkbank's privatization process started with a 25% listing on the Istanbul Stock Exchange in May 2007. The government passed a law to enable Halkbank's full privatization by 2010 but seems eager to complete it in 2008. The privatization strategy is the sale of the remaining 75% as a block to a strategic partner in the third quarter of 2008.

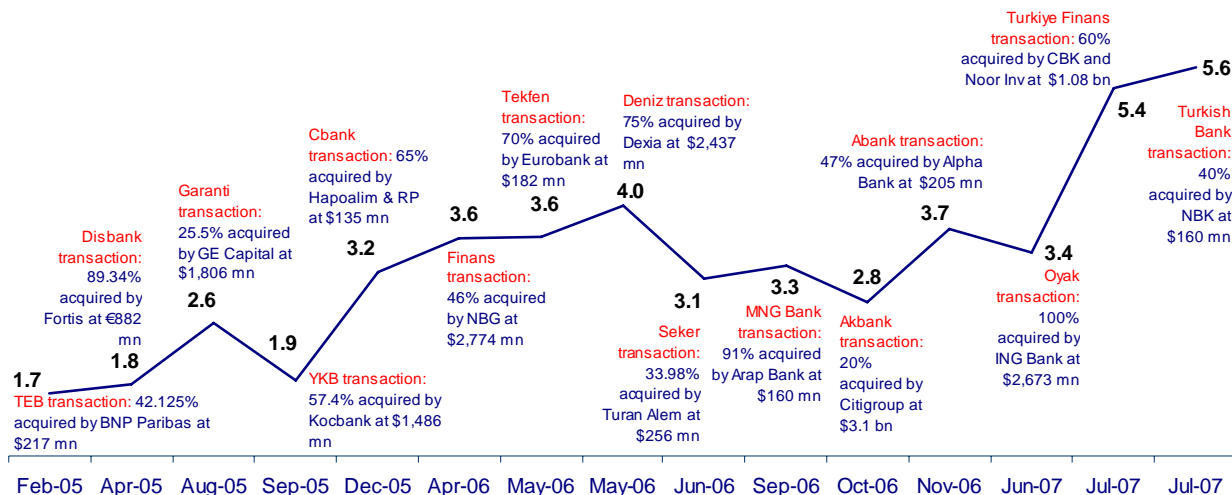
We expect strong interest in Halkbank's block sale given its strong deposit base and established presence in the Anatolia region, where all others are trying to penetrate. Besides, the bank will maintain its privilege to provide Treasury-subsidized loans to the SMEs during the five year period after the privatization, which is an important competitive advantage in gaining & maintaining market share in the high growth potential SME business.

Among existing players Akbank, Garanti Bank, YKB and Fortis publicly shared interest in the possible block sale of Halkbank. However, we believe interest for the bank will not be limited to existing players but there will also be interest from those banks which want to enter the market as Halkbank would provide an easy penetration to the system. Spanish Banco Bilbao Vizcaya Argentaria was among the rumored names of interest from outsiders for Halkbank. Furthermore, we think Kuwait Investment Authority, which acquired 5% of the bank during the IPO, might also be bidding for the majority.

Acquirers paid generous premiums to market multiples for long-term prospects during the bank acquisitions in Turkey. The transaction multiples increased with almost every new transaction (as depicted on the next page) and raised expectations for the forthcoming deals. Decreasing supply, competitive pressure to enter the market and long term strategic value are solid supporting arguments for these expectations.

Given the data and the strategic importance of Halkbank, we do expect a generous premium to Halkbank’s multiple during the strategic sale. However, we doubt that the minorities will benefit as we think the Privatization Administration will provide call exemption to the buyer as it did in previous privatizations such as Ereğli, Tupras and Petkim.

**Turkish Banks’ M&A transaction multiples**



Source: RJ calculations

**FINANCIALS & EARNINGS OUTLOOK**

We project Halkbank to report YTL1,131 mn net earnings in full year 2007 and to post a CAGR of 13% in net earnings over the next two years. We expect the bank to grow its loan book at a higher pace than peers, while defending margins, relying on its under-utilized franchise, low loan/deposit ratio and maturing HtM securities portfolio that it shifts to higher yielding loans. Increasing retail exposure will help improve fee income’s contribution to the bottomline, and coupled with low cost base structure, we think the bank will be reporting 30% return on equity in 2008 and 29% in 2009.

**Summary Bank-only Projections**

YTL mn	2007E	2008E	2009E	CAGR (07E-08E)
Loans	17,505	24,505	31,805	35%
YoY % change	50%	40%	30%	
Deposits	30,477	37,000	43,000	19%
YoY % change	12%	21%	16%	
Assets	39,178	46,462	54,008	17%
YoY % change	14%	19%	16%	
Equity	4,150	4,474	5,539	16%
YoY % change	10%	8%	24%	
Net Interest Income	1,691	1,971	2,271	16%
YoY % change	23%	17%	15%	
Net Income	1,131	1,286	1,451	13%
YoY % change	31%	14%	13%	

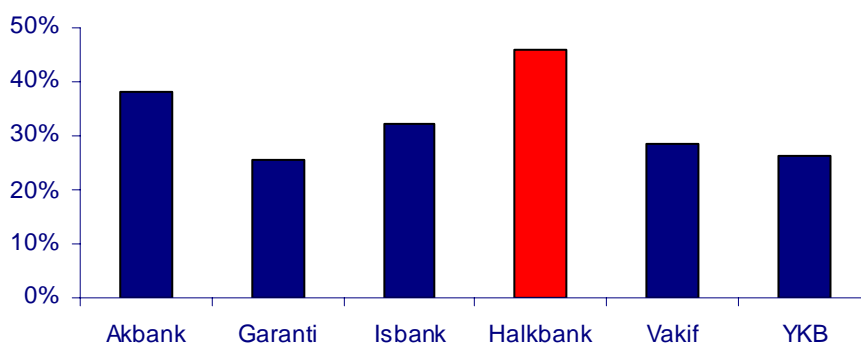
Source: Company financial statements, RJ estimates

**Balance sheet restructuring drives growth**

Halkbank has an exceptional balance sheet dominated with securities and a low loan/deposit ratio, implying strong growth potential for the bank. We expect the bank to grow loans at CAGR of 35% in the next two years by shifting redeeming securities and leveraging on its under-utilized deposit base.

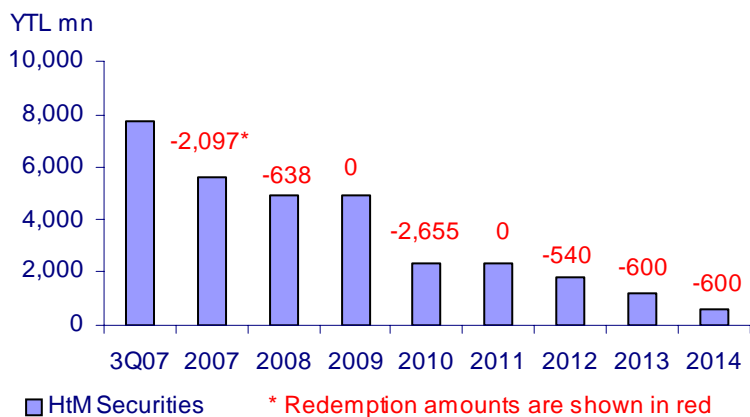
Securities accounted for 46% of the bank's total assets as of 3Q07, versus 30% for the peer group average. More than half are held-to-maturity securities the bank was given due to duty losses in 2001 and after the merger with Pamukbank in 2004 and are expected to redeem gradually until 2014. However, the biggest redemptions are due in the next three years. We think securities' stake in total assets will decline to 29% by 2009 as the bank shifts the redeeming securities into loans.

**Securities/Assets Comparison as of 3Q07**



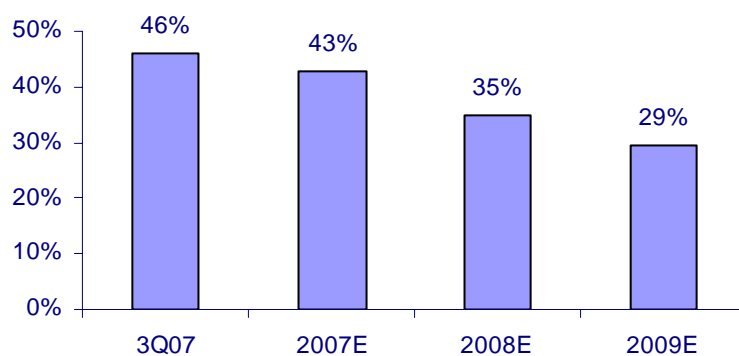
Source: Company financial statements

**HtM Redemptions**



Source: Company management

**Halkbank Securities/Assets**



Source: Company financial statements, RJ estimates

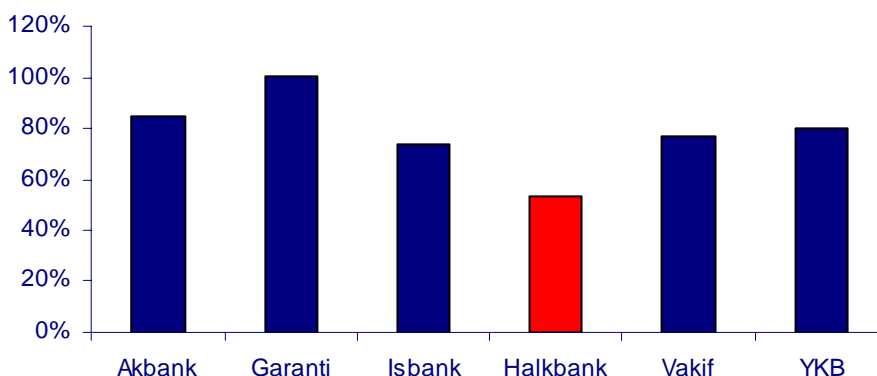
Deposit collection is the major source of funding, accounting for 78% of the total liabilities. Halkbank, leveraging on its wide distribution network in the under-banked Anatolia region, enjoys a 9% market share in total deposits and even a stronger market share (10%) in YTL deposits, which is in scarcity in the sector. The bank has 74% of total deposits in YTL, compared to 61% for the peer group average.

State deposits that are held at three state banks, including Halkbank, will be liberalized at the beginning of 2008, allowing all private banks to bid for these deposits and thus, adding to the competition in the market. Three state banks have around YTL21 bn in state deposits, referring to 7% of total sector deposits. Among the three we think the negative impact on Halkbank will be the least as it has the lowest exposure to state deposits; the bank has 4% of total deposits (around YTL1 bn) in state deposits and expects only 20% of this to flee.

Despite the above sector average loan growth since 2005, Halkbank has the lowest loan/deposit ratio of 54% among peers. The low loan/deposit ratio will enable the bank to grow its loan book without feeling too much of a pressure on the funding cost. We expect the bank’s loan/deposit to increase to 74% by the end of 2009, which is still lower than peer average of 83%.

The bank, however, is somehow not efficient in raising cost-free demand deposits. Demand deposit’s stake in total deposits is only 9% for Halkbank, compared to the peer average of 16%. We expect the bank to increase demand deposits stake by 200 bps to 11% in the next two years.

**Loan/deposit, as of 9M07**

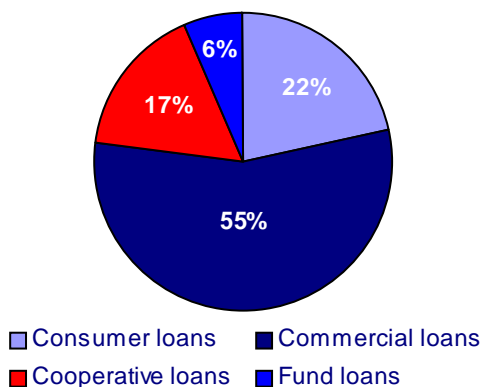


Source: Company financial statements

**SME and consumer banking will be the main growth areas**

Halkbank is strategically focused on SME lending and has started expanding into consumer lending after its merger with retail-focused Pamukbank in 2004. SME loans accounted for 55% of total loan book in 3Q07, including 6% in fund loans and 17% in government subsidized loans.

## Breakdown of loan book, as of 3Q07



Source: Company management

Halkbank is the only bank in Turkey that can provide Treasury-subsidized loans to artisans and craftsmen collected under an association named cooperatives and thus enjoys a significant price advantage compared to peers. The amount of the subsidy is determined at the beginning of each year by the Treasury and was announced as 35% (of the interest payment) for 2008. Halkbank will continue to have this privilege within the five years after its full privatization. However, the bank has already started reducing its dependence on these loans by allocating less of its incremental resources and brought down cooperative loans' share in total loans to 16% from 26% in 2005. We expect this gradual decline to continue in the next couple of years until the bank loses the privilege.

Besides, Halkbank acts as the intermediary for the distribution of "fund loans" allocated by some government institutions like Ministry of Finance. The bank does not bear the risk of these "fund" loans but generates fee income from the intermediary act. However, we think this intermediary act will be shifted to other state-banks (most probably to Ziraat Bank) after Halkbank's block sale.

Consumer banking in Halkbank, on the other hand, is relatively new and small. Halkbank was introduced to consumer banking after its merger with Pamukbank in 2004. Since 2005, the bank has grown its consumer loan book (including credit cards) at a CAGR of 129% (albeit from a low base) and consumer loans' share in total loan book increased to 22% up from 16% in 2005. However, it is still low, implying strong growth potential, compared to 38% for YKB, 34% for Akbank & Garanti, 28% for Vakifbank and 26% for Isbank.

We believe, Halkbank, with its extensive distribution network, YTL based deposit funding (74% of total deposits is in YTL), long-lasting SME relationships and government support in lending to SMEs is well-positioned to grow in under-penetrated SME and consumer lending.

We are assuming a CAGR of 35% in Halkbank's loan book in the two years between 2007 and 2009, enhancing its market share by 80 bps to 7.2%. We expect consumer loans to more than double in the next two years and account for 27% of the total loan book by 2009, mainly driven by housing loans and

general purpose loans. Credit card business is one area the bank has focused on improving in 2007 and thus entered into cooperation with HSBC to distribute the latter's well-known installment card Advantage. We have seen similar cooperation in the past delivering success, one of the earliest being TEB's cooperation with Garanti for the latter's Bonus Card in mid-2006. In a year TEB grew its number of credit cards by more than fourfold and credit card loan book by 6 folds. We believe Halkbank will more than triple its credit card loan book in the next two years, however, impact will be limited as credit card loans will remain only a limited portion of the total loan book (2%). We see credit card business as a complementary business line rather than a competition area for the bank.

### Breakdown of loan portfolio

YTL mn	2007E	% chng	2008E	% chng	2009E	% chng
Consumer Loans	3,757	95%	5,994	60%	8,575	43%
Housing loans	1,717	101%	2,800	63%	4,177	49%
Auto loans	57	-5%	66	15%	86	30%
General purpose	1,982	96%	3,128	58%	4,312	38%
Credit Card loans	259	23%	441	70%	795	80%
SME & commercial loans	13,489	42%	18,070	34%	22,435	24%
<b>TOTAL LOANS</b>	<b>17,505</b>	<b>41%</b>	<b>24,505</b>	<b>40%</b>	<b>31,805</b>	<b>30%</b>
Consumer loans/Total	21%		24%		27%	
Cons loans incl credit cards/Total	23%		26%		29%	

Source: Company data, RJ estimates

### Asset quality is improving

While Halkbank's non performing loan (NPL) ratio has come down significantly from 49% in 2002 and 16% in 2005, it is much higher than peers' due to NPLs dating back to the 2001 crises. Otherwise, NPL ratio on new loans is less than 1% according to company management. Halkbank's NPL ratio stood at 6.2% in 3Q2007 compared to the large cap banks' average of 4.1%. The bank provisions for 100% of the loans NPLs, however, including the fund loans, in which the bank does not bear the risk but acts as the intermediary and thus does not provision for, the NPL coverage ratio stands at 99%. The bank has been recovering some of these NPLs and expects to generate approximately 10% of net income on collection of NPLs per annum. We expect the NPL ratio to improve to 4.2% in 2009, thanks to collections and new loan additions and assume the NPL coverage will be 100% after 2008 as there will not be any fund loans after the full privatization of the bank.

### Net Interest Margin

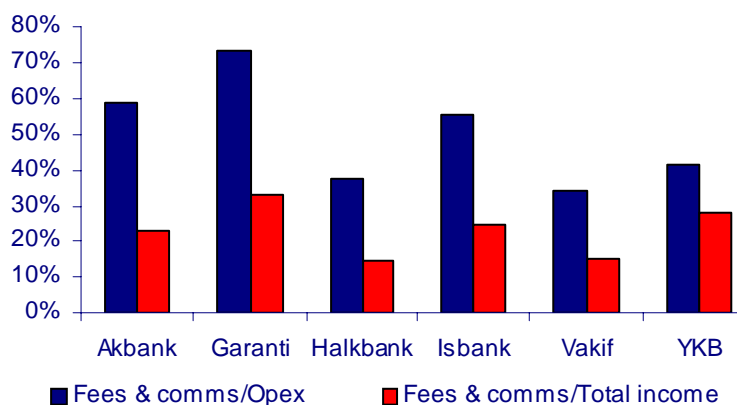
Net interest margin decline is inevitable for all players in the Turkish banking system given the increasing competition and expected decline in interest rates in the long-term. Halkbank, having a low maturity mismatch on its balance sheet (which stems from its high floating rate SME loan and HtM exposure), is not a beneficiary of the declining interest rate environment even in the short-term. However, we still think that Halkbank is well positioned to defend NIM in

the next two years, benefiting from its balance sheet restructuring (the bank is shifting redeeming securities to higher yielding loans) and wide YTL based deposit base. We expect the bank's NIM to remain flat at 4.7% in 2008 and stabilize at 4.6% in 2009.

**Increasing exposure to consumer lending should improve fee income**

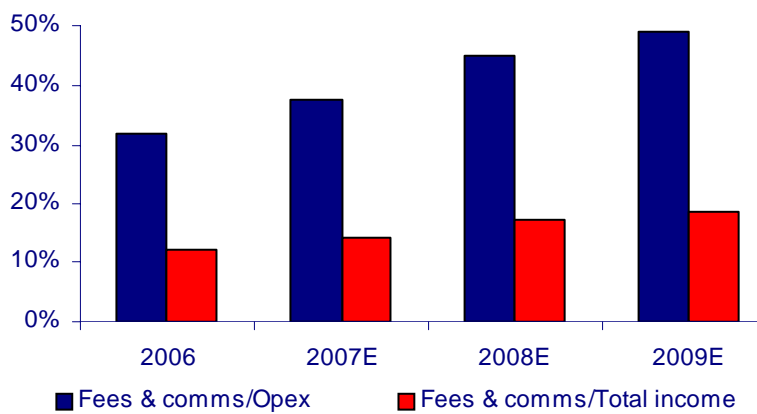
Fee income is one specific area the bank has lagged peers significantly due to lack of a significant consumer exposure until now. The bank generates only 14% of total revenues with the fee income it generates, compared to the large cap banks' average of 25%. We believe the bank's increasing exposure to consumer banking and credit card business (which is one of the major contributors to fee income for Turkish banks) will help improve fee income generation capability going forward. We project the bank to cover 48% of operating expenses with fee income and commissions in the next two years, up from 38% currently.

**Comparison of fees & commission generation**



Source: Company data, RJ estimates

**Halkbank's fees & commission generation**



Source: Company data, RJ estimates

**Efficiency improvement and cost measures**

Halkbank closed down 313 branches during the restructuring period starting in 2001. The bank currently has 586 branches, ranking it fifth in the Turkish banking system. The bank does not have an aggressive branch expansion strategy unlike most peers as it already enjoys presence in each and every city in Turkey. Besides, 62% of total branches are located in the Anatolia region where most peers are trying to penetrate, versus 48% for the peer group average.

**Number of branches**

	2001	2005	2006	20073Q	% chng 2001/3Q2007
Ziraat Bank	1,504	1,146	1,247	1,248	-256
Isbank	841	875	891	929	88
Akbank	613	660	683	698	85
YKB	524	579	598	660	136
Halkbank	899	584	588	586	-313
Garanti Bank	295	432	483	545	250
Vakifbank	55	305	314	331	276
Finansbank	108	208	309	378	270
Oyakbank	14	307	349	365	351
Denizbank	55	236	262	299	244

Source: Banks' Association of Turkey

**% of branches located in cities excluding three largest (Ankara, Ist, Izmir)**

	2001	2005	2006
Halkbank	72%	62%	62%
Isbank	56%	56%	55%
Vakifbank	59%	56%	55%
Akbank	52%	51%	51%
Garanti Bank	29%	39%	40%
YKB	38%	38%	38%

Source: Banks' Association of Turkey

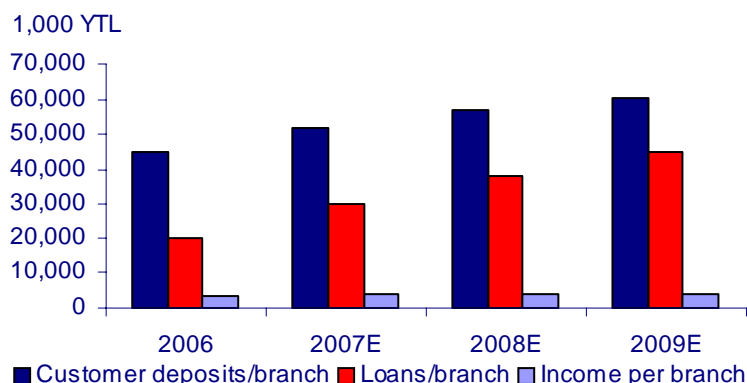
Rather, the bank is in plans to improve its efficiency ratios to peer group averages. As depicted in the table below, Halkbank is currently under-utilizing its franchise. We expect the bank to improve efficiency ratios gradually going forward, approaching peer group averages.

**Comparison of efficiency ratios**

1,000 YTL	Akbank	Garanti	Isbank	Vakif	YKB	Average	Halkbank
Customer deposits/branch	54,137	62,097	45,556	83,679	47,278	58,549	50,214
Loans/branch	47,710	63,696	34,580	65,718	38,188	49,978	27,269
No. of employees per branch	19	25	21	27	21	23	20
Income per branch	4,576	5,196	3,784	5,230	5,198	4,797	3,895
Income per employee	242	205	183	194	250	215	197

Source: Company financial statements

**Halkbank's efficiency ratios**



Source: Company financial statements, RJ estimates

Enjoying an established branch network throughout the country, Halkbank boasts a low cost base with a cost/income ratio at 38% compared to the peer average of 48%. We expect the cost base to remain low in the next two years for two reasons: First, the bank owns 65% of its branches, so the increasing rent prices will not have major a negative impact on costs going forward. Second, 3,000 high-cost employees will retire and be replaced with lower-cost staff (the salary of retiring employees to newly hired ones is up to 3x higher).

**Capital and dividends**

As a state bank, Halkbank distributes all distributable income as dividends. Dividend payout was 87% in 2006 and we expect a similar ratio for 2007, considering the bank is well-capitalized operating at a comfortable capital adequacy ratio of 20.6%. Including the BASEL II impacts, management calculates the CAR around 19%. (The official minimum requirement for the CAR is 8%. However, banks are required to keep it above 12% in order to be able to open branches according to BRSA regulations). In 2008, however, after the block sale of the bank is finalized, we believe the bank will be distributing only 30% of dividends as it will need financing to restructure and grow further.

**Pension fund deficit could be the downside risk to bottomline estimates**

The downside risk to our bottomline estimates for Halkbank could come from the provisioning for the pension deficit it inherited during the Pamukbank merger. The deficit is calculated as YTL9 mn under the BRSA regulations and is provisioned for. Under IAS, however, the deficit is calculated as YTL270 mn. The IAS based deficit is expected to come down as the bank replaces retirees with low cost new employees. However, if the BRSA asked for a provisioning according to IAS as of today, the impact on the bottomline would be 4% in 2008 and 2009, assuming that it will be provisioned for in the next five years in equal amounts.

## BRSA BANK-ONLY FINANCIAL STATEMENTS in YTL mn

BALANCE SHEET					
YTL mn	2005	2006	2007E	2008E	2009E
Cash & CB	1,286	2,551	2,993	3,604	3,848
Securities	17,573	18,139	16,797	16,195	15,902
Loans, net	6,330	11,646	17,505	24,505	31,805
Loans	6,310	11,630	17,490	24,488	31,805
NPLS	1,202	1,085	1,091	1,245	1,406
Loan loss provisions (-)	-1,182	-1,070	-1,076	-1,228	-1,406
Other interest earnings assets	752	1,079	724	868	998
Subsidiaries and Associates	33	135	146	156	164
Property & Equipment	702	661	631	675	762
Other Assets	178	215	383	460	529
<b>TOTAL ASSETS</b>	<b>26,854</b>	<b>34,425</b>	<b>39,178</b>	<b>46,462</b>	<b>54,008</b>
Deposits	21,113	27,188	30,477	37,000	43,000
Interbank	40	672	1,483	1,483	1,483
Funds borrowed	468	873	945	1,132	1,298
General Provisions	33	72	124	174	226
Other liabilities	1,900	1,840	1,999	2,199	2,463
SHs Equity	3,299	3,780	4,150	4,474	5,539
<b>TOTAL LIABILITIES &amp; EQUITY</b>	<b>26,854</b>	<b>34,425</b>	<b>39,178</b>	<b>46,462</b>	<b>54,008</b>
INCOME STATEMENT					
YTL mn	2005	2006	2007E	2008E	2009E
<b>Net Interest Income</b>	<b>925</b>	<b>1,370</b>	<b>1,691</b>	<b>1,971</b>	<b>2,271</b>
Net Monetary Profit/Loss	0	0	0	0	0
Net trading income	224	-214	0	0	0
<b>Adjusted Net Interest Income</b>	<b>1,149</b>	<b>1,156</b>	<b>1,691</b>	<b>1,971</b>	<b>2,271</b>
Net Fees & Commissions	155	232	331	450	553
Dividend Income	12	14	19	24	27
Other Operating Income	270	641	434	407	427
<b>Total Operating Income</b>	<b>1,585</b>	<b>2,042</b>	<b>2,476</b>	<b>2,851</b>	<b>3,278</b>
Net provisions	112	202	184	260	325
Other operating expenses	672	723	878	985	1,140
<b>Net Operating Income</b>	<b>801</b>	<b>1,117</b>	<b>1,414</b>	<b>1,607</b>	<b>1,813</b>
Income/losses from participations	0	0	0	0	0
<b>Pre-tax Income</b>	<b>801</b>	<b>1,117</b>	<b>1,414</b>	<b>1,607</b>	<b>1,813</b>
Taxation	247	254	283	321	363
Extraordinary Profit/Loss	0	0	0	0	0
<b>Net Income</b>	<b>554</b>	<b>863</b>	<b>1,131</b>	<b>1,286</b>	<b>1,451</b>

## BRSA BANK-ONLY FINANCIAL STATEMENTS in US\$ mn

BALANCE SHEET					
US\$ mn	2005	2006	2007E	2008E	2009E
Cash & CB	959	1,815	2,552	2,883	2,983
Securities	13,097	12,905	14,324	12,956	12,328
Loans, net	4,717	8,285	14,927	19,604	24,655
Loans	4,703	8,274	14,914	19,590	24,655
NPLS	896	772	930	996	1,090
Loan loss provisions (-)	-881	-761	-918	-982	-1,090
Other interest earnings assets	560	768	617	695	774
Subsidiaries and Associates	25	96	124	125	127
Property & Equipment	523	470	538	540	590
Other Assets	132	153	327	368	410
<b>TOTAL ASSETS</b>	<b>20,013</b>	<b>24,491</b>	<b>33,409</b>	<b>37,170</b>	<b>41,867</b>
Deposits	15,735	19,343	25,989	29,600	33,334
Interbank	30	478	1,264	1,186	1,149
Funds borrowed	349	621	806	906	1,006
General Provisions	25	51	106	139	175
Other liabilities	1,416	1,309	1,705	1,759	1,909
SHs Equity	2,459	2,689	3,539	3,579	4,294
<b>TOTAL LIABILITIES &amp; EQUITY</b>	<b>20,013</b>	<b>24,491</b>	<b>33,409</b>	<b>37,170</b>	<b>41,867</b>

INCOME STATEMENT					
US\$ mn	2005	2006	2007E	2008E	2009E
<b>Net Interest Income</b>	<b>690</b>	<b>957</b>	<b>1,301</b>	<b>1,603</b>	<b>1,788</b>
Net Monetary Profit/Loss	0	0	0	0	0
Net trading income	167	-149	0	0	0
<b>Adjusted Net Interest Income</b>	<b>857</b>	<b>807</b>	<b>1,301</b>	<b>1,603</b>	<b>1,788</b>
Net Fees & Commissions	116	162	255	366	435
Dividend Income	9	10	15	19	22
Other Operating Income	201	448	334	331	336
<b>Total Operating Income</b>	<b>1,182</b>	<b>1,426</b>	<b>1,904</b>	<b>2,318</b>	<b>2,581</b>
Net provisions	84	141	141	211	256
Other operating expenses	502	505	675	801	898
<b>Net Operating Income</b>	<b>597</b>	<b>780</b>	<b>1,088</b>	<b>1,306</b>	<b>1,428</b>
Income/losses from participations	0	0	0	0	0
<b>Pre-tax Income</b>	<b>597</b>	<b>780</b>	<b>1,088</b>	<b>1,306</b>	<b>1,428</b>
Taxation	184	177	218	261	286
Extraordinary Profit/Loss	0	0	0	0	0
<b>Net Income</b>	<b>413</b>	<b>603</b>	<b>870</b>	<b>1,045</b>	<b>1,142</b>

KEY RATIOS in YTL

KEY RATIOS (YTL)							
	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Dec-08	Dec-09
<b>Volume Growth YtD (%)</b>							
Loan	84%	11%	27%	37%	50%	40%	30%
Consumer	207%	21%	43%	66%	95%	60%	43%
Mortgage	329%	14%	35%	64%	101%	63%	49%
Auto	3%	-4%	-5%	-6%	-5%	15%	30%
GPL	174%	29%	52%	72%	96%	58%	38%
Credit Cards	-1%	6%	12%	12%	23%	70%	80%
Consumer inc CC	154%	20%	40%	61%	88%	60%	46%
Commercial	73%	10%	24%	32%	42%	34%	24%
Deposit	29%	5%	6%	9%	12%	21%	16%
Customer Deposit	25%	6%	10%	12%	15%	21%	16%
YTL	15%	4%	10%	14%	17%	21%	19%
FX	65%	12%	9%	5%	8%	21%	7%
<b>Volume Growth QoQ (%)</b>							
Loan	15%	11%	14%	8.4%	10%		
Consumer		21%	18%	16%	17%		
Mortgage		14%	19%	22%	22%		
Auto		-4%	-1%	-1%	1%		
GPL		29%	18%	13%	14%		
Credit Cards		6%	5%	0%	10%		
Consumer inc CC		20%	17%	15%	17%		
Commercial	-6%	10%	13%	7%	8%		
Deposit	2%	5%	1%	3%	3%		
Customer Deposit	1%	6%	4%	2%	3%		
YTL	-1%	4%	6%	4%	3%		
FX	8%	12%	-3%	-3%	3%		
<b>Asset Structure</b>							
Net loans/Total Assets	34%	36%	40%	42%	45%	53%	59%
Securities/Total Assets	53%	52%	49%	46%	43%	35%	29%
Equity/Total Assets	11%	11%	10%	10%	11%	10%	10%
IEAs/Assets	97%	97%	97%	97%	97%	97%	97%
Loans/Deposits	43%	46%	51%	54%	57%	66%	74%
<b>Funding Structure</b>							
Deposits/Total Assets	79%	80%	78%	78%	78%	80%	80%
TL Deposits/Total Deposits	73%	71%	73%	74%	74%	74%	76%
Demand Deposits/Total Deposits	9%	8%	9%	9%	9%	10%	11%
<b>Profitability YtD</b>							
Net Interest Margin	4.6%	4.7%	4.7%	4.7%	4.7%	4.7%	4.6%
Net Income (YTL 1,000)	863,498	237,584	535,416	813,807	1,131,441	1,285,576	1,450,560
YoY growth (%)	56%	21%	75%	27%	376%	14%	13%
RoAE	24.4%	24.4%	29.2%	29%	28.5%	29.8%	29.0%
RoAA	2.8%	2.7%	3.0%	3.0%	3.1%	3.0%	2.9%
<b>Profitability Quarterly</b>							
Net Interest Margin	5.3%	4.7%	4.7%	4.7%	4.8%		
Net Income (YTL 1,000)	222,124	237,584	297,832	278,391	317,634		
QoQ growth (%)	-34%	7%	25%	-7%	14%		
RoAE	24.8%	24.4%	31.5%	30.1%	31.8%		
RoAA	2.6%	2.7%	3.3%	3.0%	3.3%		
<b>Asset Quality</b>							
NPL/Gross Loans	8.5%	7.8%	6.8%	6.2%	5.9%	4.8%	4.2%
NPL Coverage	99%	99%	99%	99%	99%	99%	100%
<b>Operating Efficiency YtD</b>							
Fees & comms/Avg. Assets	0.8%	0.9%	0.9%	0.9%	0.9%	1.1%	1.1%
Fees & comms/Opex	32%	37%	35%	38%	38%	46%	48%
Fees & comms/Total income	12.1%	14.2%	13.6%	14.2%	14.1%	16.7%	18.1%
Opex/Avg. Assets	2.4%	2.3%	2.5%	2.4%	2.4%	2.3%	2.3%
Cost/Income	38%	38%	38%	38%	37%	36%	37%
<b>Operating Efficiency Quarterly</b>							
Fees & comms/Avg. Assets	0.7%	0.9%	0.9%	0.9%	0.9%		
Fees & comms/Opex	30%	37%	34%	43%	38%		
Fees & comms/Total income	13%	14%	13%	15%	14%		
Opex/Avg. Assets	2.4%	2.3%	2.7%	2.1%	2.4%		
Cost/Income	42%	38%	39%	36%	37%		
<b>Market shares</b>							
Loans	5.4%	5.8%	6.2%	6.4%	6.6%	7.0%	7.3%
Consumer loans	4.2%	4.8%	5.1%	5.4%	5.8%	6.4%	6.6%
Housing loans	3.9%	4.2%	4.5%	5.0%	5.6%	6.3%	6.5%
Auto loans	0.9%	1.0%	1.0%	1.0%	1.0%	1.0%	1.1%
General purpose	6.4%	7.4%	7.7%	7.7%	7.0%	7.4%	7.3%
Credit card	1.0%	1.0%	1.0%	1.0%	1.0%	1.4%	2.2%
Customer deposits	8.9%	9.0%	9.0%	9.1%			
Total deposits	8.8%	8.9%	8.7%	8.9%	9.0%	9.1%	9.2%
<b>Efficiency ratios YtD</b>							
Customer deposits/branch	44,760	47,563	49,412	50,214	51,516	56,733	60,329
Loans/branch	19,806	22,120	25,205	27,269	29,871	37,933	45,049
No. of employees per branch	18	18	18	20	20	19	19
Income per branch	3,252	3,637	3,958	3,895	4,000	4,179	4,321
Income per employee	176	199	220	197	203	219	233

Source: Company financial statements, RJ estimates

**Raymond James Securities – Turkey**

***Rating definitions:***

- 1-Strong Buy** : The analyst has high conviction that the stock will appreciate and produce a total return of at least 25% in US\$ terms over the next 12 months.
- 2-Buy** : The analyst believes that the stock will appreciate and produce a total return of at least 15% in US\$ terms over the next 12 months.
- 3-Hold** : The analyst believes that the stock will produce a total return of less than 15% in US\$ terms over the next 12 months.
- 4-Sell** : The analyst believes that the stock will generate a negative return in US\$ terms over the next 12 months.
-

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