

February 08, 2008

**Turkey
EMEA Banks**

Halkbank (HALKB.IS - TRL 8.20) 1-Overweight

Initiation of Coverage

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A Turkish decoupling story

Investment Conclusion

- We initiate coverage with a target price of TRL 12.00 (46% upside potential) and 1-Overweight rating. The two short-term catalysts that could have considerable impact on the stock are: 1) better-than-expected YE07 results and 2) government's clarification of its privatisation strategy.

Summary

- Independent of its likely privatisation, Halkbank differentiates itself from its peers with its strong growth rates and profitability thanks to unique opportunities on its balance sheet and strong market positioning. Its strengths in SME lending TL deposits and Anatolian coverage are major attraction points. We expect Halkbank's ROE to average 29.2% over the next three years, with strong market share gains. Halkbank offers best dividend yield and ROE combination among peers.

Stock Rating

 New: 1-Overweight
Old: 0-Not Rated

Target Price

 New: TRL 12.00
Old: N/A

Sector View: 1-Positive

FY Dec Currency TRL	2006A	2007E		2008E		2009E	
	Actual	Old	New	Old	New	Old	New
Net Income (m)	863	N/A	1104	N/A	1296	N/A	1414
EPS (stated)	0.69	N/A	0.88	N/A	1.04	N/A	1.13
EPS (adj.)	0.69	N/A	0.88	N/A	1.04	N/A	1.13
PE (adj.)	12.9	N/A	10.1	N/A	8.6	N/A	7.9
ROE (stated %)	24.4	N/A	27.9	N/A	29.9	N/A	29.3
ROE (adj. %)	24.4	N/A	27.9	N/A	29.9	N/A	29.3
Price/NAV	2.9	N/A	2.7	N/A	2.5	N/A	2.2
Price/NAV (adj.)	2.9	N/A	2.7	N/A	2.5	N/A	2.2

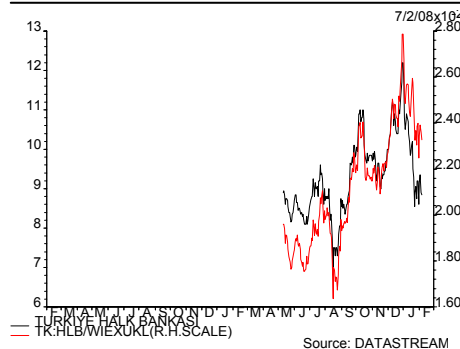
Market Data

Market Cap (m)	10250
Shares Outstanding (m)	1250.0
Float (%)	25
Net Div Yield (%)	4.49
Convertible	No
Shares per ADR	N/A

Financial Summary

NAV/Share FY06	3.0
NAV(adj.)/Share FY06	3.0
Tier 1 BIS Ratio FY07 (%)	21.2
Total BIS Ratio FY06 (%)	N/A

Stock Overview


 Reuters HALKB.IS
Bloomberg HALKB TI
ADR

Performance	1M	3M	12M
Absolute %	-16	-11	0
Rel. Market %	2	17	0
Rel. Sector %	2	20	0

52 Week Range 12.20 - 6.80

Prospects

- Still a unique story independent of privatisation prospects:** Halkbank is differentiated from its peers by its impressive profitability growth thanks to unique opportunities offered by its balance sheet and strong market positioning. We expect Halkbank's ROE and dividend payout ratio to average 29% and 65%, respectively, over the next three years.
- Minimum exposure to domestic and global fluctuations:** We believe Halkbank stands out as the best decoupling story among peers, with 84% of its balance sheet denominated in Turkish lira. On the funding side, foreign borrowings are negligible, with deposits comprising 90% of its interest-bearing liability base. The bank maintains the highest Tier-1 ratio and one of the lowest maturity-mismatch figures among peers, which serve as a cushion against domestic fluctuations.

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- **Among the best exposed to Turkey's growing SME business:** Halkbank is the leading SME bank of Turkey, with 55% of its lending book allocated to this under-penetrating banking segment. We think the bank is very well placed to take advantage of the growth in Turkey's SME business owing to its already high market share, know-how and strong customer relations built up over the years, and its focus and exclusivity in some types of SME lending.
- **Good franchise well placed for internal convergence:** Despite being the seventh-largest bank in terms of assets, the bank ranks third in terms of network coverage of less developed parts of the country. Our analysis indicates that this is a promising market position as banking penetration differences between Turkey's big cities and the rest of the country are not really justified by GDP per capita differences. The bank also ranks second among peers in terms of most-wanted TL deposits.
- **Impressive rise in lending market share:** In 2007, we expect Halkbank's lending growth to be around 52% compared with the sector's 29%. We expect the bank to beat the market significantly over next three years as well, leveraging off its underutilised branch network, hefty redemptions from the security portfolio and strength of its capital adequacy.
- **Proximity to under-banked population to support retail banking growth:** We expect consumer lending, where the bank has a relatively low base, to be the fastest growing sub-segment. Thanks to its focused branch network, high market share in pension payrolls and long relationship with co-operatives and SMEs, the bank has close proximity to the lower-income groups of Turkey in particular. When mortgage the business expands from high-middle class to lower-income groups, Halkbank should gain additional market share.
- **Inexpensive growth to boost the bottom line:** The bank has the lowest cost/income ratio among peers, despite having the lowest branch utilisation. We expect the cost/income ratio to improve in 2008 as the bank continues to restructure its personnel. Further, Halkbank has a high level of branch ownership (65%), which reduces rent expenses. Although we expect the cost/income ratio to rise beyond 2009, with increasing promotional expenses, the bank's cost structure should remain more favourable than that of its peers. As the bank benefits from Pamukbank's advanced banking platform, it does not really need to invest heavily in technology along with rising business volumes.
- **Substantial collections from bad loans:** Since 2004, the bank has made total collections of around TL 1bn from NPLs in principal and interest. Management expects to recover around 30% of current gross NPLs in the next four years, which, according to our estimates, will account for 6% of pre-tax profits.
- **Offers the best dividend yield among banks for 2008:** We expect the bank to distribute around 80% of its 2007 earnings as cash dividends in 1H 2008. This corresponds to a dividend yield of 8.6% at current price, which we expect to be the highest among peers.
- **Attractive upside potential:** We initiate coverage with a target price of TL 12.00 (46% upside potential) and 1-Overweight rating. Our 2008 implied P/E is 11.6x, higher than current Turkish banks' average, but lower than emerging market peers. We believe this is justified by the high ROE and dividend payout nature of the stock.

Risks

- **Management longevity:** No government intervention has been observed in Halkbank since the beginning of rationalisation of state banks in 2001. However, as a state entity, the bank is exposed to possible destabilisation in domestic politics. The expected privatisation could also result in a loss of experienced personnel and managers.
- **A faster-than-expected drop in interest rates:** The best-case scenario for Halkbank is a gradual decline in interest rates. A fast drop would cause the bank lose valuable reinvestment opportunities. We assume Halkbank will also have a slower deposit re-pricing compared with asset re-pricing, similar to its peers.
- **Asset quality:** Halkbank is the major SME bank in the country. SMEs tend to be the most heavily hit companies in periods of economic downturn. With 55% of lending book assigned to SMEs, the bank's asset quality would be highly vulnerable in such periods.
- **A secondary offering:** Although the bank is in the government's privatization program, our forecasts and valuation do not incorporate the sale of the bank. We would not be surprised if the government were to postpone bank's strategic sale because of market conditions. However, if it were to decide on an SPO before the strategic sale, this would not only put some short-term pressure on the stock price, but also decrease potential buyers' appetites.

Valuation

We are initiating coverage of Halkbank with a 1-Overweight recommendation. Our 12-month target price of TL 12.00 suggest upside potential of 46%. We have applied a 10-year residual income valuation model to Halkbank to be consistent with our convergence-based banking sector forecasts. Our modelling period resembles a two-stage model. In the first five-year phase, growth, ROE and dividend payout ratio is higher than the second phase on average. In the second five years, we tried to achieve a steady stage whereby the bank could sustain a certain level of profitability, growth and dividend payout ratio.

Figure 1: Halkbank residual income valuation

TL m (unless otherwise stated)	2005A	2006A	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
Net profit	554	863	1,111	1,278	1,418	1,563	1,775	2,004	2,289	2,661	3,120	3,661
EPS (TL)	0.44	0.69	0.89	1.02	1.13	1.25	1.42	1.60	1.83	2.13	2.50	2.93
Adjusted EPS (TL)	0.44	0.69	0.89	1.02	1.13	1.25	1.42	1.60	1.83	2.13	2.50	2.93
EPS Growth (%-adjusted)	4.9	55.9	28.7	15.0	11.0	10.2	13.6	12.9	14.2	16.3	17.3	17.3
ROE (%)	17.6	24.4	28.1	29.6	29.5	28.3	27.3	26.1	25.4	25.2	25.2	25.2
Adjusted ROE (%)	17.6	24.4	28.1	29.6	29.5	28.3	27.3	26.1	25.4	25.2	25.2	25.2
Dividends paid within year	408	460	751	889	831	709	672	763	862	984	1,144	1,342
Dividend Payout Ratio (%)	83.1	87.0	80.0	65.0	50.0	43.0	43.0	43.0	43.0	43.0	43.0	43.0
CAR (%)	49.6	32.0	21.2	17.2	15.3	14.4	13.8	13.3	12.8	12.5	12.2	12.0
Equity (Beginning of Period)			3,780	4,122	4,535	5,106	5,961	7,019	8,191	9,573	11,178	13,072
Cost of Equity (%)			16.5	16.5	16.5	16.5	16.5	16.5	16.5	16.5	16.5	16.5
Cost of Equity (TL m)			624	680	748	843	984	1,158	1,351	1,580	1,844	2,157
Residual Income			480	616	665	719	792	831	946	1,082	1,274	1,475
Discount factor (x)			1.0000	0.8584	0.7368	0.6324	0.5429	0.4660	0.4000	0.3433	0.2947	0.2530
Present Value			480	529	490	455	430	387	378	371	375	373
Growth (%)												8.0
Long term risk free rate (%)												11.5
Equity Risk premium (%)												5.0
Beta (x)												1.00
PV of residual income												3,789
Terminal Value (discounted)												4,740
Total Value												8,529
Equity invested												4,122
Fair value of equity (end-2007)												12,651
Number of shares (m)												1,250
Fair value per share (TL -current)												10.28
Value of participations (per share)												0.00
Fair price of the Company (TL - current)												10.28
12 month target price (TL)												12.00
Current Price (TL)												8.20
Upside Potential(%)												46.0
Implied 2008 P/E (x)												11.5
Implied 2008 P/BV (x)												3.3

Source: Company data, Lehman Brothers estimates

Figure 2: Halkbank sensitivity analysis

Long-term Rf (%)	9	10	11.5	13	14	15
Growth (%)						
5	14.43	12.70	10.71	9.22	8.42	7.73
6	15.24	13.27	11.05	9.43	8.57	7.84
7	16.29	13.98	11.47	9.67	8.75	7.97
8	17.68	14.89	12.00	9.97	8.95	8.12
9	19.62	16.10	12.62	10.33	9.21	8.29
10	22.54	17.80	13.46	10.79	9.51	8.50

Source: Lehman Brothers estimates

The risk-free rate we have applied to the cost of equity for Halkbank is a function of our long-term forecasts for real interest rates and inflation in Turkey. To be on the conservative side, we used an 8% nominal growth rate, which is significantly below our long-term nominal growth assumption for Turkey's GNP and Halkbank's average performance over the forecast period. Our sensitivity analysis is shown in Figure 2. In view of its rather short trading history, we kept the beta at 1.0. In line with industry norms, we assumed an equity risk premium of 5%.

We assumed that participation values were fair the bank's balance sheet, considering their negligible size (0.4% of assets). Therefore, we did not carry out sum-of-the-parts analysis.

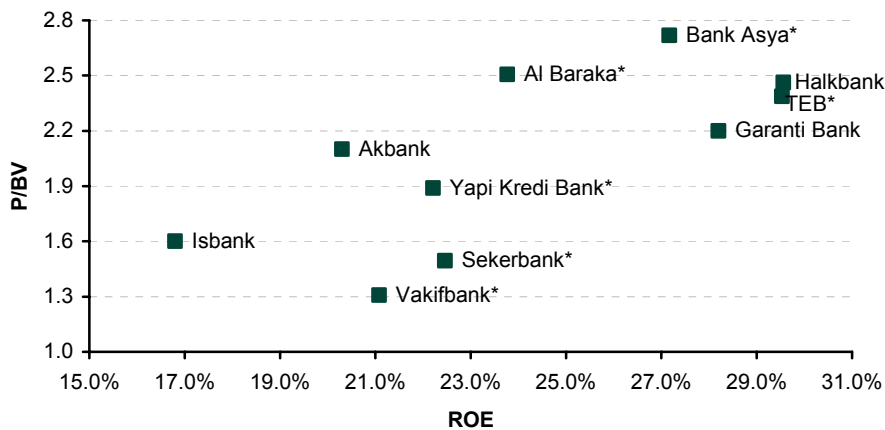
We did not treat the collections from bank's large NPL portfolio as one-off gains because these have been a steady source of income for the bank over the past four years and should remain so in the near future, as explained in the earnings outlook section of this report.

Figure 3: Comparable multiples (5 February 2008)

	Adj. ROE (%)		Adj. P/E (x)		Adj. P/BV (x)	
	2008E	2009E	2008E	2009E	2008E	2009E
Akbank	20.3	21.9	10.9	7.0	2.1	1.4
Isbank	16.8	19.2	9.9	6.2	1.6	1.1
Garanti Bank	28.2	26.3	8.8	6.0	2.2	1.4
Halkbank	29.6	29.5	8.7	7.8	2.4	2.2
Yapi Kredi Bank*	22.2	21.0	9.1	7.6	1.8	1.4
Halkbank	29.6	29.5	6.5	5.5	1.3	1.2
Vakifbank*	21.1	22.5	8.5	6.5	2.3	1.8
TEB*	29.5	31.2	11.2	9.1	2.7	1.7
Bank Asya*	27.2	22.6	7.2	6.3	1.5	1.3
Sekerbank*	22.5	21.3	12.5	10.0	2.5	2.2
Al Baraka*	23.8	23.3	5.1	4.7	0.9	0.8
TSKB*	19.1	18.0	9.4	6.8	2.0	1.5
Turkey Weighted Average	23.0	23.3	9.4	6.0	2.0	1.3
Turkey Large cap (W.A.)	22.7	20.9	16.4	14.3	3.9	3.6
Bank Pekao	25.4	26.3	10.7	9.4	3.1	2.4
Halyk Bank	35.0	32.8	8.2	7.8	1.5	1.3
Kazkommertsbank	19.8	17.6	13.7	12.5	2.8	2.5
Komercni Banka	22.0	21.0	10.1	9.0	2.2	1.9
OTP Bank	24.3	22.9	17.5	15.0	4.1	3.5
PKO BP	24.9	25.2	14.4	11.6	2.6	2.2
Sberbank	19.5	20.3	22.3	16.2	1.9	1.7
VTB Bank	8.7	11.2	14.0	13.0	2.7	2.4
BZ WBK	20.9	19.7	14.0	10.7	2.6	2.1
BRE Bank	21.2	21.8	13.3	10.9	2.4	2.1
Millennium	19.2	20.4	14.2	12.0	2.8	2.4
EEMEA Banks Average	22.5	22.2	7.7	7.2	1.1	1.0
Bank Hapoalim	15.9	15.7	7.2	6.7	1.2	1.1
Bank Leumi	15.6	15.6	8.5	6.8	1.0	0.8
Israel Discount Bank	11.5	10.6	8.2	7.6	1.1	1.1
Mizrahi Tefachot	13.8	14.9	7.9	7.1	1.1	1.0
Israel Average	14.2	14.2	8.6	7.4	2.0	1.7
Continental Europe Average	17.0	18.7	8.7	7.6	2.1	1.8
Pan Europe Average	19.1	20.3	10.9	7.0	2.1	1.4

Source: Lehman Brothers estimates, Bloomberg consensus (marked with *)

Figure 4: ROE vs. PBV (2008E)



Source: Lehman Brothers estimates, Bloomberg consensus (marked with *)

In Figure 3 we provide a comparable multiples table. Halkbank's current 2008E P/E ratio indicates a discount to the average of its domestic peers, while 2008E P/BV is at a premium. We believe this discrepancy is a function of the high dividends we expect in 2008 as the bank should distribute the highest dividends relative to its equity in the next two years. When we adjust the 2008E P/BV to account for our dividend expectation of TL 883m, P/BV declines to 1.9, which is the market average. Therefore, we do not believe the stock is expensive compared with the averages of its domestic or emerging market peers, despite its superior ROE performance.

When we look at other high-ROE banking stocks in Turkey (averaging around 27%), we observe that these have much lower capital adequacy ratios and hence small or no dividend payouts, yet their average P/BV is around 2.4x. Therefore, we believe Halkbank deserves a better multiple, with a sustained profitability in 2008 and 2009 and high dividends. Our target price implied multiples reflect this. Our 2008 implied P/BV declines from 3.3x to 2.8x when adjusted for the dividend payment.

Privatisation is the government's problem

Our valuation and forecasts for Halkbank do not incorporate any likely sale of the government's controlling stake to a third party. However, it is an asset already in the PA's portfolio, in line with government's pledge to the IMF that all public banks will be privatised by 2010. However, the government has not announced that Halkbank is in the privatisation schedule for 2008. The most recent statement was made by the finance minister, who said that technical preparations for the block sale of 75% would begin shortly, without indicating any time period.

The 2008 privatisation agenda is already loaded with the IPO of TurkTelekom, the privatisation of electricity and natural gas distribution companies, sale of operating licences for highways and bridges, privatisation of Tekel and the National Lottery. Therefore, we would not be surprised to see a postponement in the strategic sale of Halkbank, PA's biggest expected revenue source, with an excuse of poor market conditions. Many foreign and domestic financial institutions have expressed an interest in this sale, and global liquidity problems could decrease their appetite if we do not see an improvement in global conditions. A secondary offering, which would aim to raise more cash for the state before giving up on the controlling stake, is also a possibility. Nonetheless, this would not only put pressure on the stock price with additional liquidity, but also decrease the interest of likely strategic buyers, in our view.

In a possible strategic sale, we would expect minorities to benefit from possible synergies in the longer term because a tender call (if sold at a premium to market price) is less likely in a privatisation. These synergies could increase if the buyer would be an entity already present in Turkey depending on how complementary Halkbank would be to a buyer's existing operations, e.g. Halkbank's network would be more valuable to Garanti and YKB compared with Isbank or Akbank, as we have shown in the full report.

Please see full report for further details.

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Company Description:

As of 3Q07, Halkbank was the seventh largest bank of Turkey with total assets of TL38.0bn (US\$31.5bn). The bank ranks fifth with 586 branches when the network size is considered. Halkbank was established in 1933, with a mission to support Turkey's small and medium-sized enterprises (SME), artisans, tradesmen and craftsmen.

Important Disclosures:

Halkbank (HALKB.IS)

TRL 8.20 (07-Feb-2008)

1-Overweight / 1-Positive

Rating and Price Target Chart:

CHART IS NOT APPLICABLE

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Valuation Methodology: We used residual earnings method to value the whole company and arrived at a price per share. We applied a long-term risk free rate of 11.5%, equity risk premium of 5% and long term growth rate of 8%. The beta we used for Halkbank is 1. To reach a fair price, we have discounted the net income that the company is expected to create over its cost of equity each year. The target price for the company represents the fair price carried forward for 12 months with the cost of equity applied.

Risks Which May Impede the Achievement of the Price Target: Halkbank almost fully generates its revenues within Turkey and hence, is exposed to volatility in domestic politics and general economy. Management longevity could be under threat with changing governments.

Important Disclosures Continued:

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Company Name	Ticker	Price (07-Feb-2008)	Stock / Sector Rating
Halkbank	HALKB.IS	TRL 8.20	1-Overweight / 1-Positive

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Garanti Bank (GARAN.IS)	Halkbank (HALKB.IS)
Isbank (ISCTR.IS)	Komercni Banka (BKOMsp.PR)
OTP Bank (OTPB.BU)	

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