Company note

Initiation of coverage

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Emerging Market Banks: Turkey

Türk Ekonomi Bankası

(TEBNK TI, TRY22.8, Underperform, Target TRY19.0

Right here, right now!

TEB is beating its budgets hands down but has only promised a 20% ROE this year. Extra profitability is therefore likely to be absorbed into faster branch openings, bringing forward its ambitious expansion plan. This looks entirely the correct strategy for TEB, but means near-term risks of (a) likely earnings downgrades for 2007 and (b) a capital increase. This presents a risk of underperformance, especially since it is rated at a premium to the sector. We initiate coverage with an Underperform rating and TRY19 target price, believing these near-term risks will create a better buying opportunity.

Seizing the day. TEB has an ambitious target to reach 4.85% market share by 2011. It had the prescience to realise that the hike in interest rates last year was its chance, while the rest of the sector espoused caution and new foreign entrants got to grips with their 'new toys'. Along the way it promises shareholders to make 20% ROE.

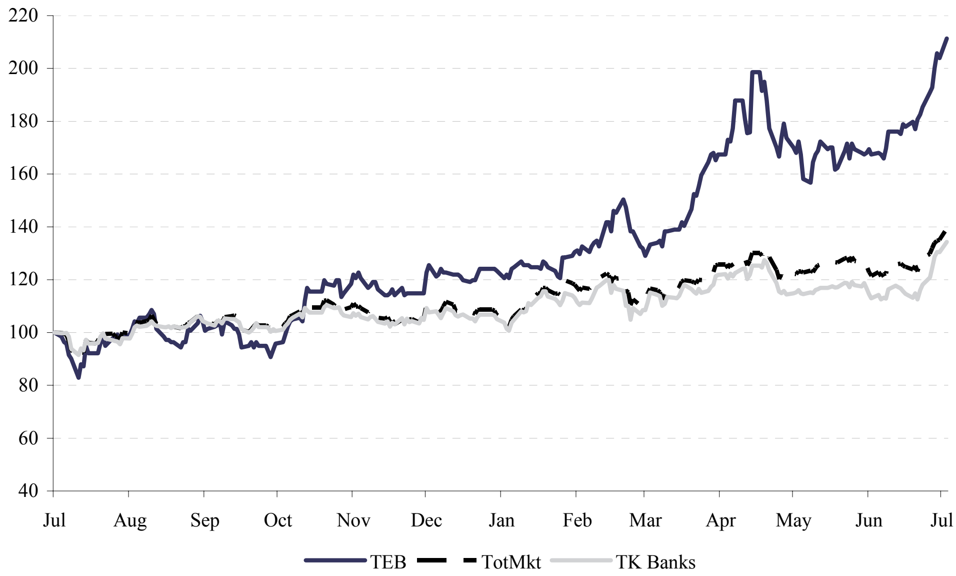
Daha hızlı ,daha yüksek, daha güçlü (faster, higher, stronger!). So far this year it seems TEB is beating its budgets hands down, with loan volumes likely to be up 50% and firmer margins. Extra profitability likely means TEB will run faster, accelerating its investment programme. More pain now to get stronger market share and higher profits ahead of plan.

Are you ready for the burn? Iterating the 20% ROE target implies little more than 20% profit growth – good, but 12% below consensus. Faster growth means TEB is capital hungry, launching Turkey's first Tier1 debt issue, but it intends to raise equity each year through to 2009 in order to keep up the pace and stay ahead of Basel II. As this ambition gets absorbed, we think there is significant near-term risk of underperformance.

Limitations of free float. Laudably, BNP wants to see TEB stay listed for visibility and market discipline, and there seems some idea to increase the free float. This cannot be too soon, in our view. Average trading volumes of under $2mn per day mean this is off many investors' lists and is a low volume for a top-regarded Turkish bank. This also means the price may be more volatile, reflecting these risks and opportunities. Stay in for the ride, or wait for a likely buying opportunity? While the longer-term story is strongly intact, current valuations are ahead of its peer group, and near-term downside risk is rising. Accordingly, we initiate coverage with an Underperform rating and target price of TRY19 -17%.

Year-end Dec	2006	2007E	2008E		2006	2007E	2008E
KBW op EPS new	1.40	1.30	1.67	Net profit (mn)	106	130	167
KBW op EPS old	n/a	n/a	n/a	NAVPS	7.2	6.8	8.5
IBES EPS (USD)		1.44	1.76	P/NAV	3.16	3.34	2.69
KBW EPS % ch YoY	25%	-7%	28%	DPS	0	0	0
KBW op P/E	16.2	17.5	13.7	Yield (%)	1.1%	0.0%	0.0%
IBES P/E	16.2	15.9	13.0	ROE (%)	21%	21%	22%
Shares (mn)	100.0	100.0	100.0	Market cap EUR (bn)	1.30		

Figure 1: Share price performance (rebased)



Source: Datastream

The shares have performed strongly since the end of last year, outperforming the sector and the market, perhaps raising the risk of profit taking.

Valuation

After such strong price performance, justified by the aggressive strategy and successful growth, the shares are now rated at a premium to the Turkish bank sector, and at the average of consensus valuations for EMEA, and such performance in the near term may be difficult, unless there is:

- A sustained sector rally as investors become wildly enthusiastic about Turkish risk, and in which case the whole sector flies; and
- This growth translates into earnings upgrades to add to the share price momentum. As we describe, in the near term we think this highly unlikely.

Figure 2: Relative ratings

Company		PE		EPS ch	PBV		ROE	
	Price	2007E	2008E	2008	2007E	2008E	2007E	2008E
Akbank	8.6	13.4	11.0	22.5	2.8	2.8	22.3	27.3
Asya	8.3	11.2	7.7	45.9	2.9	2.1	29.7	31.7
Garanti	8.2	11.7	10.3	26.8	2.4	1.9	39.7	25.7
Halk*	9.3	10.9	10.4	30.6	2.7	2.4	28.7	30.4
Isbank*	7.1	12.7	10.3	23.2	1.7	1.5	15.1	15.9
YKB*	3.3	13.3	10.7	24.0	2.4	1.9	20.6	21.6
TEB	**22.8**	**17.5**	**13.7**	**28.2**	**3.3**	**2.7**	**21.1**	**21.8**
Turkey		**13.0**	**10.6**	**28.7**	**2.6**	**2.2**	**25.3**	**24.9**
EMEA		**18.8**	**15.4**	**18.8**	**3.4**	**2.6**	**20.9**	**20.2**
KBW European Banks		**10.6**	**10.1**	**11.1**	**1.9**	**1.7**	**19.0**	

Source: KBW estimates; Note * IBES estimates. EMEA averages from KBW and IBES estimates

In our view, TEB is likely to have very strong 2Q07 results, and in anticipation the shares may continue to do well ahead of this. But this very success enables TEB to accelerate its strategy, likely to mean more costs in the short term to bring forward expected profits from a market share grab. This also means a clear need for raising more capital. In effect, we think the 2Q07 results will be accompanied by a realisation that 2007 profits are likely to be a respectable 20% growth, but this is well below market expectations and we wait for the capital issue to feed into the market.

While the strategy appears laudable to us, there is a risk of near-term profit taking and underperformance. In effect, a better entry point to this strategy looks possible to us.

Valuation

In looking at the valuation, we ignore a need for capital, given that at this point the size of any capital increase (indeed if any) or potential dilution is not visible. We have then used an earnings discount model, warranted equity valuation and relative valuation to ascertain a valuation range, and the results are shown in the table below.

The main assumptions we use in these models are:

- Cost of equity – 19.6%; and
- Medium-term growth rate – 10.5%.

Figure 3: Summary of valuation methodology results and suggested target price

	Price	Upside/downside
Earnings discount model	20.9	-8.5%
Warranted equity valuation	14.8	-35.3%
Relative (PE) valuation	17.2	-24.5%
Target price	**19.0**	**-16.7%**

Source: KBW estimates

The longer range growth more or less is valued correctly, in our view, as seen from the earnings discount model, but there is more short-term downside risk after the considerable outperformance and high relative valuation. Accordingly, recognising this we suggest a target price of TRY19, some 17% lower, and suggest taking profits to look for a better entry point for the longer-term story.

Strategy

'Daha hızlı ,daha yüksek, daha güçlü' – 'faster, higher, stronger'. In short, TEB saw, and sees, an opportunity to grow fast and change market position. Just before and during the banking crisis of 2000, TEB started to hire available experienced SME bankers, bought branches from Kent Bank and so has been investing heavily in this segment since 2003.

This started to signal a change from the highly cautious over capitalised, over liquid strategy of the bank, which only targeted to most upscale retail customers. With BNP on board as a strategic investor, TEB started to target faster growth to grow its market share from 1.8% to 4.85% by 2011, targeting SME and retail banking as a primary focus. It merged with BNP's operations and sees this as a help in developing, in particular, the retail segment, and not just the upper net-worth customers that TEB used to target.

It has also had great success targeting Turkish companies through BNP's network in Algeria, Morocco, Qatar, Ukraine, and is about to start this in Russia. As well as TEB getting off-balance-sheet trade finance business, it also helps to ensure better customer relations with the company in Turkey.

With the financial turmoil of last year, TEB saw its chance to run faster, while, in the main, the major private banks started to withdraw capacity from the lending market. It also sees that there are new foreign banks, which have bought into the Tier 2 banks, and it will take some time for them to study the market and then become increasingly proactive.

So the time is NOW! TEB targets 400 branches and thinks the faster it does this the more likely it is to have the pick of locations and access to cheaper staff before competition drives these costs up. With 100 branches already in Istanbul (out of 233), it is now targeting deeper penetration of Anatolia.

Branches were budgeted to become profitable in 18-24 months, but the experience to date is this happens just after a year. This expansion also leads to the fast loan growth targeted by the company. Banks, on average, seem to think c.20-25% loan growth this year is possible, whereas it appears TEB may produce 50% this year. Rating agencies point this out as a risk, but as yet, in common with the sector, there has been no real deterioration in credit quality in its chosen segments.

2Q07 excitement – a preview

We think TEB will present strong results, expected on 1 August, and consequently the shares may perform well in the run-up to these. Strong results for us mean expecting loan volumes of 50% YoY and 23% YTD. This should also drive fee income. In addition, deposit collection without pressure on pricing is also likely, implying too that the net interest margin firms. Asset quality problems are not expected to be evident. Cost growth is expected to be high too since TEB has already opened all the 60 branches it had originally targeted this year. We expect this to result in net operating income to be up 45% YoY (2Q last year suffered a reversal in FX income) but expect it to be flat QoQ, and ROE to be high at 30%.

Figure 4: Summary 2Q07 expectations (TRYmn)

	1H06	1H07E	2Q06	1Q07	2Q07E
Loans	4,019	6,070	4,019	5,482	6,070
Deposits	4,750	6,488	4,750	5,933	6,488
Total assets	7,145	9,957	7,145	9,081	9,957
Shareholders' funds	494	610	494	595	610
Net interest	131	235	66	114	121
Total revenue	212	320	92	158	162
Costs	-124	-191	-70	-94	-98
Provisions	-8	-23	-5	-12	-11
Net income	63	89	15	44	45
NIM	4.3%	5.8%	4.3%	5.5%	5.1%
Cost/income	58.4%	59.8%	76.7%	59.1%	60.5%
Provision/av loans	-0.4%	-0.3%	-0.3%	-0.3%	-0.2%
ROE	26.5%	32.4%	12.2%	30.6%	30.1%

Source: KBW estimates

This performance would be in line with or possibly better than the implied consensus forecasts for the year.

2H07 – don't get carried away

Since TEB management never promised its major shareholders better than 20% ROE and has consistently said it expects not much more than 20% net profit growth, this better performance than budget gives an opportunity to jump higher and grab a stronger market share position. We think this is exactly what TEB will do and makes good sense in terms of its longer-term strategy.

So in the 2Q07 results, we expect to hear that the branch opening programme will be brought forward. Since many banks are trying to open branches, by opening them faster TEB thinks it will get a better pick of locations and staff. However, the short-term result is that TEB is most likely to invest this extra profitability and end the year as budgeted with 20% ROE and 20% profit growth.

But get more excited about the longer term

This investment approach is likely to mean stronger volumes for next year, and similarly faster branch opening, perhaps more than the 60 it is currently targeting. While this means a lot of new costs constraining the pace of net profit growth, the quantum of income should continue to grow quickly, resulting in greater profits from 2009, when TEB is likely to start concentrating more on cost containment.

Medium-term estimates

Our main assumptions are set out in the table that follows. In this we have ignored the future capital increases, which may mean faster top-line and net profit growth, but at the same time may dilute the EPS growth to similar as suggested.

Figure 5: Summary model assumptions

	2005	2006	2007E	2008E	2009E
Growth					
Growth in loans, net	86%	67%	40%	41%	35%
Growth in customer deposits	43%	67%	39%	30%	22%
Growth in total assets	52%	53%	31%	26%	24%
Profitability and margins					
ROE (total)	20%	21%	21%	22%	23%
ROE (core banking)	28%	26%	25%	26%	27%
Net interest margin	5.1%	4.6%	5.1%	5.0%	5.2%
Cost/income					
Cost/income	59%	64%	67%	66%	60%
Cost/assets	4%	4%	4%	4%	4%
Balance sheet ratios					
Loans/deposit	91%	91%	92%	100%	110%
Loan/asset	55%	60%	64%	72%	78%
Liquid assets/asset	16%	17%	19%	15%	11%
Asset quality					
NPL ratio	1.1%	0.9%	1.5%	2.0%	2.0%
Loan loss provisions/gross NPLs	50%	68%	70%	80%	90%
Capital adequacy					
Tier 1 ratio	9.0%	8.9%	8.8%	8.4%	7.9%
Tier 2 ratio	3.3%	5.4%	3.8%	3.0%	2.3%
Capital adequacy ratio	12.3%	14.3%	8.8%	8.4%	7.9%

Source: KBW estimates

Figure 6: Key data

	2006A	2007E	2008E	2009E	2010E	2011E
PROFIT & LOSS (TRYmn)						
Net interest income	305	471	600	773	882	1,057
Net commission income	77	123	185	222	255	286
Trading gains	-14	14	18	21	23	25
Other revenues	100	46	49	53	56	59
Total revenues	**468**	**654**	**852**	**1,069**	**1,216**	**1,426**
Costs	-297	-440	-560	-642	-681	-714
Operating profit	**171**	**214**	**292**	**427**	**535**	**712**
Loan loss charge	-17	-36	-67	-137	-189	-253
Associate income	0	0	0	0	0	0
Pre-tax profit	**135**	**162**	**208**	**272**	**327**	**440**
Tax	-29	-32	-42	-54	-65	-88
Minorities	0	0	0	0	0	0
Net profit	**106**	**130**	**167**	**218**	**262**	**352**
ASSETS						
Interbank	438	481	506	531	557	585
Gross customer loans	4,996	7,000	9,928	13,387	17,482	22,207
Securities holdings	1,634	1,553	1,475	1,401	1,471	1,545
Total assets	**8,282**	**10,830**	**13,608**	**16,820**	**20,518**	**24,837**
Net interest-earning assets	8,019	10,568	13,382	16,623	20,396	24,774
LIABILITIES						
Interbank	771	810	850	893	937	984
Deposits	5,426	7,528	9,765	11,950	14,195	16,395
Subordinated debt	300	300	300	300	300	300
Shareholders' equity	**552**	**682**	**849**	**1,033**	**1,251**	**1,551**
GROWTH RATES (%)						
Total revenues	38.5%	39.9%	30.1%	25.6%	13.7%	17.3%
Costs	49.6%	48.2%	27.1%	14.7%	6.0%	4.9%
Operating profit	22.7%	25.5%	36.3%	46.4%	25.3%	33.1%
Net profit	24.2%	23.0%	28.2%	30.7%	20.4%	34.3%
Gross customer loans	66.4%	40.1%	41.8%	34.8%	30.6%	27.0%
Deposits	66.8%	38.7%	29.7%	22.4%	18.8%	15.5%
Total assets	52.7%	30.8%	25.7%	23.6%	22.0%	21.1%
RATIOS - PROFITABILITY (%)						
Return on ave. assets	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Return on ave. equity	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Cost/income (less trading gains)	-61.7%	-68.8%	-67.1%	-61.3%	-57.1%	-51.0%
Cost/income	-63.5%	-67.3%	-65.7%	-60.1%	-56.0%	-50.1%
Tax rate	21.5%	20.0%	20.0%	20.0%	20.0%	20.0%
Payout	-	-	-	-	-	-
NII/average NIEA	4.6%	5.1%	5.0%	5.2%	4.8%	4.7%
NII/total revenues	65%	72%	70%	72%	73%	74%
RATIOS - BALANCE SHEET (%)						
Tier 1 ratio	8.90%	8.76%	8.36%	7.94%	7.60%	7.51%
Equity/total assets	6.7%	6.3%	6.2%	6.1%	6.1%	6.2%
NIEA/total assets	96.8%	97.6%	98.3%	98.8%	99.4%	99.7%
Gross loans/total assets	60.3%	64.6%	73.0%	79.6%	85.2%	89.4%
Deposits/gross loans	108.6%	107.5%	98.4%	89.3%	81.2%	73.8%
RATIOS - ASSET QUALITY (%)						
Loan loss charge/ave. net loans	0.43%	0.60%	0.80%	1.20%	1.25%	1.30%
Gross NPLs/gross loans	0.90%	1.50%	2.00%	2.00%	2.00%	2.00%
Loan loss reserves/gross NPLs	67.5%	70.0%	80.0%	90.0%	100.0%	100.0%
PER SHARE DATA (TRY)						
EPS reported	1.40	1.30	1.67	2.18	2.62	3.52
Book value	7.22	6.82	8.49	10.33	12.51	15.51
NAV	7.22	6.82	8.49	10.33	12.51	15.51

NII = net interest income; NIEA = net interest earning assets. Source: Company, KBW estimates

Reg AC

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