TERA Brokers

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BANKING SECTOR

2h14 prospects better;yet valuations not so attractive!

Banks	AKBANK	GARANTI	HALKBANK	IS BANK	VAKIFBANK	YAPI KREDI
Ticker	*AKBNK*	*GARAN*	*HALKB*	*ISCTR*	*VAKBN*	*YKBNK*
Recommendation	*NEUTRAL*	*NEUTRAL*	*BUY*	*NEUTRAL*	*NEUTRAL*	*NEUTRAL*
Share Price TL	*7.67*	*7.99*	*14.60*	*5.29*	*4.59*	*4.52*
New Target Price	8.29	8.07	18.69	6.00	5.07	4.31
Old Target Price	7.70	7.72	18.20	5.79	4.81	4.04
Change	8%	5%	3%	4%	5%	7%
P/E'14e	10.2	10.5	7.1	7.8	7.7	10.8
P/E'15e	9.0	8.8	6.7	7.4	6.8	8.6
Upside Potential	8%	1%	28%	13%	10%	-5%

Net earnings were down 10% y/y but 5% above the consensus estimates...

Yearly contraction in bottom-lines was mostly driven by depletion of bulky trading gains booked in 2q13 whereas lower margins are compensated by volume growth. Relatively strong other income figures and lower provisions (thanks to benign specific cost of risk in tandem with only slight deterioration on asset quality and declining general provisions on lower loan initiations and contracting credit card balances) partly supported the profitability. In addition, shareholder equities were supported through m-t-m gains on securities & subsidiaries. The below is the 2q14 results of the large caps:

Net Income (mn TL)	2q14	2q13	Δ y/y	1q14	Δ q/q	1h14	1h13	Δ y/y
AKBNK	893	914	*-2%*	651	*37%*	1,544	1,782	*-13%*
GARAN	810	887	*-9%*	760	*7%*	1,571	1,891	*-17%*
HALKB	632	715	*-12%*	530	*19%*	1,163	1,428	*-19%*
ISCTR	829	877	*-5%*	815	*2%*	1,645	1,901	*-13%*
VAKBN	349	382	*-9%*	374	*-7%*	723	905	*-20%*
YKBNK	428	621	*-31%*	487	*-12%*	915	1,162	*-21%*
Total	3,942	4,396	*-10%*	3,618	*9%*	7,561	9,069	*-17%*

YKBNK better on margins HALKB solid on asset quality...

AKBNK's 2q14 net income was ***significantly above estimates***, thanks to trading gains of TL63mn and better than expected fee income. However the earnings quality is lower q/q due to declining provisioning coverage and reversal of TL70mn free provisions. Therefore, in the absence of these "one-off" like items, bottom-line would fall behind the estimates.

HALKB's net income was ***in line with estimates***; however, earning quality for HALKB in 2q14 was rather weak vs. our estimates given higher than expected dividends and trading gains at the expense of lower NII.

GARAN's bottom-line was ***in line***, yet adjusted net interest income (for losses on derivatives) and net fees were slightly above our estimates whereas provisions were above our forecasts. However, the bank set

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aside TL50mn free provisions this quarter in the absence of which bottom-line would surpass expectations by around 9%.

I**SCTR**'s results were on the ***downside in terms of earnings quality*** given the higher than expected dividends received and lower tax rate.

YKBNK's net income was in line thanks to surge sub-segment of other income item (other than NPL collections) which could be mostly of non-recurring natures. However, improving loan-deposit spreads despite hefty deposit growth (7% for total and 18% for TL deposits) should be ***deemed quite positive*** on the margins.

VAKBN's results were mostly in line and ***profitability was supported by quite strong NPL collections*** which are expected to mostly be carried over to upcoming quarters).

AKBNK and YKBNK posted relatively stronger volumes in 2q14...

During the quarter, volume growth was mostly balanced with consumer loan growth gaining pace vs. 1q14. AKBNK's and YKBNK's growth figures were quite strong in both loans and deposits whereas HALKB's deposit base contracted rather sharply on switching to repos to finance growth. Credit card lending volumes continued to retreat for the private banks given the regulatory pressures.

QoQ Growth	AKBNK	GARAN	HALKB	ISCTR	VAKBN	YKBNK
Loans	6.6%	1.6%	3.7%	2.6%	2.5%	5.7%
TL Loans	7.5%	2.6%	4.2%	4.2%	2.6%	6.6%
Consumer Loans	6.2%	4.3%	-0.1%	2.4%	2.7%	5.4%
Credit Cards	-4.4%	-0.8%	1.6%	-3.1%	0.7%	-2.5%
Comm. Inst. Loans	-1.2%	4.2%	3.8%	3.4%	7.7%	6.5%
IEAs	3.7%	0.9%	-1.4%	2.9%	-0.6%	1.5%
Deposits	4.9%	0.7%	-6.3%	-0.8%	1.3%	7.3%
TL Deposits	16.0%	4.1%	-8.3%	8.6%	7.3%	18.1%
IBLs	2.8%	-0.3%	-3.2%	2.1%	-1.4%	0.2%
SHE	8.7%	3.8%	5.1%	11.1%	5.4%	3.0%

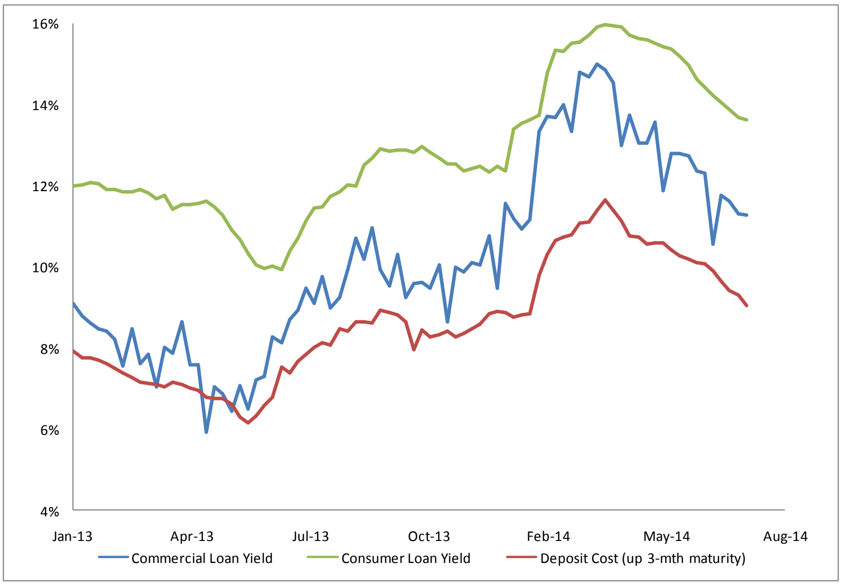
Most of the banks revised their expectations upwards...

Following the results, most of the banks revised their 2014 expectations upwards. Upside to the expected profitability does stem from better than initially expected margin outlook on CBT's ongoing rate cut cycle (we believe that the bank will go for two 25bps policy rate cuts for the remainder of the year) whereas better than expected asset quality evolution and trading gains on securities trading supports the positive sentiment as well. In light of recent downtrend on deposit costs, strong collections performance, better trading income and lower NPL originations, ***we revised our 2014 bottom-line estimates for the large six caps on average by 9%.*** On the other hand, ***we cut our 2015 bottom line expectations by about 3%*** mainly due to lower volumes and lower fee income. Thus we look for 1% drop in earnings followed by 14% net income growth in 2015.

	AKBNK	GARAN	HALKB	ISCTR	VAKBN	YKBNK
Net Earnings (14E)	3,066	3,215	2,601	3,047	1,518	1,828
Net Earnings (14E)-Old	2,691	2,816	2,499	2,840	1,416	1,788
Change	14%	14%	4%	7%	7%	2%
Net Earnings (15E)	3,508	3,827	2,782	3,218	1,710	2,311
Net Earnings (15E)-Old	3,526	3,768	3,005	3,222	1,959	2,434
Change	-1%	2%	-7%	0%	-13%	-5%

Margin improvement is to prevail in 2h14...

We think that better than expected margins for 2014 would translate into lower margins/trading gains for 2015. As seen from the weekly loan yield/deposit cost data of CBT, improvement in core spreads (TL loan-deposit spreads) will prevail in the coming two quarters (TL deposit costs down on around 270bps since end of Mar'14) leading to improvement in margins (despite lower contribution from CBT linkers in 3q14). Below is the graph depicting average lending yields and deposit costs for the new placement as per CBT's weekly data:



We raise our TPs by 4.5% on average; HALKB is only BUY rated bank and top pick...

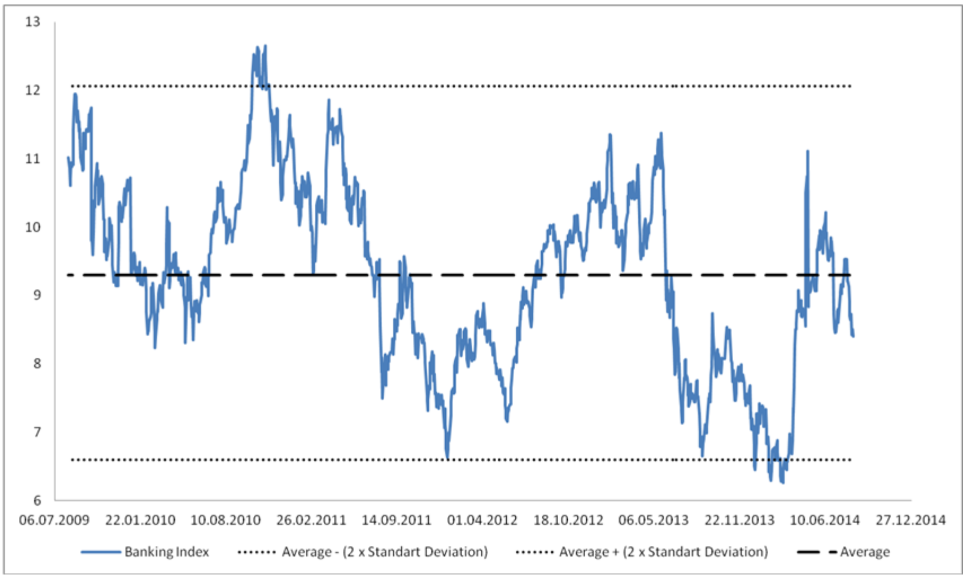
Along with adjustments to net income estimates; we updated the peer multiples, rolled our target prices one-quarter further and slightly modified the sustainable ROE assumptions. As a result, our TPs edged up by 4.5% on average. ***HALKB still top pick and*** our only BUY rated large bank thanks to more attractive valuation (%28 upside potential), solid asset quality and expectations of sale of insurance subsidiaries before year-end. On the other hand, we like AKBNK and GARAN on Balance Sheet flexibility and earning generation capacities. Meanwhile, YKBNK seems to be less attractive due to dependence on non-recurring revenue lines, lower tier-1 ratio, and less room to switch from securities to loans going forward.

Valuations are highly sensitive to risk free rate assumptions...

We reckon that the Turkish Banks' valuations are quite sensitive to cost of equity assumptions and here we use TL risk free rate of 9% and each 100bps change in Rf would change the valuations by around 5%. Going forward, if the inflation does not subside and/or global risk appetite wanes, bond yields could edge up and this poses a downside risk to valuations.

From the relative valuation perspective, Turkish Banks are neither cheap nor expensive...

According to Bloomberg data, Banking Index trades at around 8.4x P/E vs. 5-year average of 9.3x following the c. 11% decline from the levels observed on July 25th. The current levels suggests than Turkish Banks trades at about 18% discount to MSCI EM Banks vs. 5-year average of 17%. Thus, from the relative valuation perspective, Turkish Banks are neither cheap nor expensive.



Upside potentials are not attractive; risks seem balanced...

We think that following recent sell-off (TR banks underperformed EM banks by around 14% since July 25th) valuation metrics are at fair levels. Our average upside potential for the 1-year horizon being 9% supports this argument as well. On the downside, deterioration in inflation outlook and possibility of elevating funding costs in tandem with squeeze in global liquidity would hurt the sector whereas the new fee regulation (expected to be effective starting on Nov'13) may dent the profitability especially for the private banks. However, prospects of much better 2h14 vs. 1h14 (we expect sector 2h14 net income to surge 25% y/y mainly on improving margins), earning generation capacity of the sector thanks to relatively stronger balance sheets (safe capitalizations and high provisioning coverage), expectations of further (albeit at much smaller scale; we look for 2 cuts of 25bps) cuts by CBT should provide buffer for the sector.

TERA BROKERS RATING

BUY	**More than 20% return**
NEUTRAL	**Between +20% and -10% return**
SELL	**Downside potential is more than 10%**

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