EARNINGS REVIEW 1Q18

Turkey | Banks | 14 May 2018

Isbank

Income under equity* boosts ROAE

Expected impact: Positive

Isbank posted an impressive TRY1,807mn net income (+50.0% QoQ, +10.0% YoY) in its Q1 bank only financials. The results came significantly above both our TRY1,437mn call and the consensus estimates of TRY1,426mn by 25.7% and 26.7%, respectively. The main reasons behind the deviation from consensus were; i) TRY510mn income under equity related to *accounting methodology change and ii) TRY709mn other income related to IFRS-9 transition driven reversals. In Q1, Isbank managed to remarkably expand its net earnings on the back of; i) progressed NII (+5.5% QoQ, +16.2% YoY), ii) newly introduced income under equity account (TRY510mn), iii) inflated other income related to IFRS-9 reporting (TRY790mn, +212.7% QoQ) and iv) slightly reduced OPEX (-2.0% QoQ). However, further growth in the bottom-line was constrained by; i) inflated provisions expense related to IFRS-9 reporting (TRY1,130mn, +90.9% QoQ), ii) slightly weaker fee generation (-1.5% QoQ) and iii) elevated trading loss at TRY678mn (4Q17: -TRY650mn). Unlike peers, reported NIM and Swap adj. NIM improved by 9bps and 11bps QoQ to 4.47% and 3.85%, respectively, while CPI-excluded NIM also improved by 11bps QoQ 3.80% in Q1. The Bank has shown confident stance for achieving FY2018 swap adjusted NIM guidance of 3.7-3.9%. On the asset quality front, mixture of hiked net NPL inflows (1Q18: TRY346mn) and moderate denominator effect (Loans: +3.0% QoQ) led to slight deterioration in NPL ratio (+9bps QoQ to 2.30% vs. FY2018 NPL ratio guidance at <3.0%). Following IFRS-9 related adjustments and specific provisions of Q1, the post IFRS-9 specific coverage ratio materialized at 71.7%. The bank booked TRY532mn (+59.6% QoQ) specific provisions which resulted in increased specific CoR readings (+31bps QoQ) of 88bps. The bank hinted that certain big ticket accounts and some energy sector loans have been transferred to Stage II as of 1Q18. Following IFRS-9 related methodology changes, re-classifications and loan expansion of the quarter, the bank booked TRY596mn general provisions, putting some burden on the bottom-line. As for solvency metrics, CAR and CET1 eased by 15bps and 25bps to 16.51% and 13.78%, respectively, mostly due to TRY depreciation and dividend payment. ROAE managed to improve by 552bps QoQ to 17.49%, substantially supported by the new accounting methodology. Despite impressive NI and improved NIM in Q1, due to weak TRY and uncertain macro conditions, we reduce our FV estimate to TRY7.20/share from TRY8.00/share with HOLD rating unchanged, offering 22% upside potential at the current valuation.

Core business loses momentum - In Q1, Isbank remained as the leading lender with an additional 3.0% QoQ (+12.3 YoY) advance in the lending business on top of the previous quarter's 4.7% QoQ growth; but, it lagged the sector average growth pace of 4.9% QoQ in the quarter. While the bank departed from its faster growth tempo in TRY lending (+0.9% QoQ vs. Sector: 3.9% QoQ), the loan growth was mainly led by FC business (+6.2% QoQ vs. Sector: +6.9% QoQ) most of which was however driven by TRY depreciation (+1.3% QoQ in USD terms). At 12.3% YoY growth, the overall lending activity was slightly below the bank's guidance of a growth of 13-14%. Regarding the segmental distribution, the bank showed a greater focus on commercial & corporate loans (+5.1% QoQ) and retail segment (+1.3% QoQ), while remaining muted on SMEs (-0.3% QoQ). Deposits showed slower growth figures with 1.5% QoQ in Q1. Isbank refrained from competing on FC deposits (+1.6% QoQ vs. Sector + 5.0% QoQ) and also displayed limited emphasis on TRY deposits (+1.5% QoQ vs. Sector 3.7% QoQ). Hence, the LDR rose by 163bps QoQ to 130.9% in Q1, still one of the highest among Tier1 banks. Also note that at 8.1% YoY, deposit growth remains visibly short of the FY2018 guidance of 13-14%.

Core spread expansion continued in Q1 – The bank has successfully adopted asset pricing and maintained its leading position in terms of core-spreads among Tier 1 banks in our coverage. With asset re-pricings still reflecting to the books, TRY loan yields improved by 35bps QoQ; however, FC loan yields

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GLOBAL SECURITIES

HOLD 22% upside

Fair Value	TRY7.20
Prev. (HOLD)	Prev. (TRY8.00)
Bloomberg ticker	**ISCTR TI**
Share Price	TRY5.90
Market Cap	USD6.22bn/TRY26.6bn
Free Float	31%

TRYmn [1Q18]	Actual	Consensus	Deviation	Global Est
Net income	1,807	1,426	27%	1,437

TRY mn	1Q18	1Q17	YoY	4Q17	QoQ
NII	3,749	3,228	16.2%	3,554	5.5%
Net fees	921	801	15.0%	935	-1.5%
LLP	1,130	870	29.9%	592	90.9%
OPEX	1,963	1,642	19.6%	2,002	-2.0%
Net income	1,807	1,642	10.0%	1,205	50.0%

Performance	1M	3M	6M	12M
Absolute	-8%	-16%	-8%	-11%
Relative	-1%	-6%	-2%	-17%
Relative $	-12%	-25%	-17%	-25%

Estimates	2016	2017	2018E	2019E
Securities	53,269	59,429	62,866	66,085
Loans	203,142	239,407	273,420	310,862
Deposits	177,359	203,751	233,336	263,991
Book value	35,961	43,093	49,988	57,986
Net income	4,701	5,308	6,899	7,481
P/E (x)	5.65	5.00	3.94	3.63
P/BV (x)	0.74	0.62	0.54	0.47
P/Deposits	0.15	0.13	0.11	0.10

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fell as much as 34bps QoQ in Q1. These readings translated into flattish in blended loan yields at 10.87%, while blended deposits costs showed a moderate decline of 26bps QoQ in Q1 thanks to sticky deposit base and limited growth. Hence, the bank achieved an additional 26bps QoQ expansion in blended core-spread to many quarters high of 5.90% in Q1.

NIM improves with widened core spread - While CPI linkers continued to generate steady interest income as much as TRY551mn up by 29.3% YoY in Q1, its sequential contribution to NII eased to 0.4% QoQ from 17.0% QoQ in 4Q17. Nevertheless, unchanged CPI linker contribution enabled ISCTR to reflect the 26bps QoQ expansion in core spreads to the NIM. Hence, the reported NIM improved by 9bps QoQ to 4.47% in Q1, slightly above the budgeted target range of 4.2–4.4% for FY18. In tandem, CPI linkers-excluded NIM improved 11bps QoQ to 3.80%. With the short term swap utilisation remaining flattish at around USD6bn, cost of swap book showed a close-to-flat rise of 1.0% QoQ to TRY512mn in Q1. Hence, the swap adjusted NIM ratio expanded by 11bps to 3.85%, in line with the FY18 guidance of 3.7-3.9%. The bank saw further trading loss which amounted to TRY678mn in the quarter with an additional 4.2% QoQ rise; however, trade adjusted NIM still increased by 9bps QoQ to 3.65%.

The NPL ratio slightly increased with normalized net inflows - NPLs grew at an accelerated pace of 7.3% QoQ to c.TRY5.8bn vs. the moderate loan book growth of 3.0% QoQ. The unpleasant combination of reduced collections (TRY432mn, -26.3% QoQ) and increased new additions (TRY779mn, +23.2% QoQ) ultimately resulted in normalized net inflows at TRY346mn (+662.5% QoQ vs. –70.7% QoQ in 4Q17). With increased net inflows and adequate provisioning, the bank booked TRY532mn specific provisions (+59.6% QoQ) resulting in increased quarterly specific CoR at 88bps (+31bps QoQ). Against this backdrop, the NPL ratio slightly worsened by 9bps QoQ to 2.30% mainly due to ramped up net inflows, as mentioned, and limited denominator effect (Loans: +3.0%) in the quarter. This is however one of the best asset quality indicators among Tier1 banks. Also note that the Bank sees no change in the FY2018 NPL guidance of <3%. With the introduction of IFRS-9 reporting as of 1Q18, certain abnormalities might be observed on banking sector financials; on Isbank case, we observe i) decreased specific provisions (c.-TRY756mn) and increased general provisions (c.+TRY890mn) at the time of transition according to our calculations and ii) inflated provisions expense account (TRY1,130mn, +90.9% QoQ) which should be evaluated in this way considering also elevated other income account (TRY790mn: +212.7% QoQ; 1Q18 collections: TRY200mn; and IFRS-9 related reversals: TRY504mn). These accounts should normalize going forward as it contains one-off items related to IFRS-9 transition. With that being said, post IFRS-9 specific coverage and gross coverage has finalized at 71.7% and 130.9% as of 1Q18, respectively.

Some transfers to Stage II – The bank hinted that certain big ticket accounts and some energy sector loans have been transferred to Stage II as of 1Q18. Following these reclassifications (some related to IFRS-9 reporting), Stage II share under total loans increased by 347bps to 8.5%. To remind, the bank holds USD500mn OTAS exposure. The collateral base for this account should theoretically be at around 60%. Also worth noting that the bank continues to operate with TRY1,550mn of free provisions as a buffer.

Operating efficiency remained under pressure - OPEX was down by 2.0% QoQ after having shown c.10% QoQ expansion in 4Q17 when amortization of digitalization investments and pension fund provisions expense hit the bottom-line. Despite some improvement with base effects, the annual pace of OPEX came in at 19.6% YoY both above the current CPI @ 10.85% YoY and the FY18 guidance of 13-14% range, which was actually re-stated as CPI + 3-4%. On the other hand, C/I ratio eased 796bps to four quarters low of 41.0% in Q1. Fee income somewhat softened from its elevated level in 4Q17, declining by 1.5% QoQ, which however showed 15.0% YoY increase owing to the solid lending activity. The Q1 fee income remains on track with FY2018 guidance of 15%.

Isbank maintains solid solvency metrics - Solvency metrics faced slight decline due to negative impact of dividend distribution (-41bps) and RWA expansion (-78bps QoQ) in the wake of TRY depreciation in Q1. Even though the bank found strong support from organic capital generation (+56bps QoQ) and IFRS-9 related factors (+37bps QoQ), CAR and CET1 eased by 15bps and 25bps QoQ to 16.51% and 13.78%, respectively in the quarter, fairly meeting the >14% target for FY2018. Note that 10% depreciation on TRY would result in 55bps reduction on the bank's CAR.

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Switched to income under equity model – As of 1Q18, the bank decided to adopt a common industry practice of income under equity methodology in place of dividend income for the accounting of subsidiary contribution. This decision should enable the bank to effectively leverage its group company's value additions. Needless to say, this could have some substantial impact on NI evolution going forward. The management believes the current figures of income under equity can be an approximation for the whole year, which leaves us with c.TRY2bn contribution from this account in place of the previously guided TRY800mn dividend income for FY2018. All told, the adoption of this model should raise the bank's ROAE figures closer to the ROATE performance.

Bottom-line: FV reduced to TRY7.20 from TRY8.00 with HOLD rating unchanged - In Q1, net earnings encountered 50.0% QoQ surge to TRY 1,807mn (+10.0% YoY) yet with the substantial support of accounting methodology change. This translated into a 552bps QoQ increase in ROAE to 17.59%, albeit with a decline of 166bps in annual terms in Q1. Despite the QoQ improvement in ROAE and NIM expansion, due to weak TRY and challenging macro environment, we reduce our FV estimate to TRY7.20 from TRY8.00 with HOLD rating unchanged, offering 22% upside potential at the current valuation. Note that ISCTR trades at 2018E P/BV of 0.54x against the peer average of 0.62x going into publication.

Exhibit 1: Balance sheet ratios

Balance sheet ratios	3M17	6M17	9M17	12M17	3M18
Securities/Assets	17.1%	17.2%	17.0%	16.4%	16.3%
Trading/Total securities	4.4%	3.7%	4.4%	4.1%	0.6%
AFS/Total securities	83.1%	82.6%	81.8%	83.1%	59.7%
HTM/Total securities	12.5%	13.7%	13.8%	12.8%	39.7%
Liquid assets/Total assets	27.6%	27.3%	27.5%	27.0%	26.7%
Loans/Assets	65.8%	65.7%	66.0%	66.1%	66.5%
LDR	114.6%	116.9%	117.9%	117.5%	119.1%
Deposit/Total assets	57.4%	56.2%	56.0%	56.2%	55.8%
Funds borrowed/Total assets	9.8%	9.4%	9.4%	10.6%	10.9%
MM/Total assets	6.3%	7.3%	7.2%	5.5%	5.5%
Securities issued/Total assets	6.9%	7.2%	7.1%	7.2%	7.3%
Equity/Total assets	11.2%	11.7%	11.8%	11.9%	12.1%
Leverage	8.9	8.5	8.5	8.4	8.3
Free equity to assets	6.5%	6.8%	6.8%	6.7%	7.0%
IEA/IBL	113.9%	113.5%	113.9%	113.9%	113.9%
IEA/Total Assets	93.4%	93.0%	93.5%	93.1%	93.1%
CAR	14.94%	16.53%	16.98%	16.66%	16.51%
CET1	13.05%	14.05%	14.10%	14.03%	13.78%
T1	13.01%	14.01%	14.06%	13.99%	13.78%

Source: Bank financials, Global Securities

Exhibit 2: Profitability ratios

Profitablity ratios	3M17	6M17	9M17	12M17	3M18
ROAA	2.05%	1.49%	1.42%	1.37%	1.99%
ROAE	19.15%	13.51%	12.58%	11.97%	17.49%
NIM	4.36%	4.15%	4.08%	4.37%	4.47%
Adjusted NIM	4.0%	3.5%	3.5%	3.6%	3.6%
IEA yield (quarterly)	8.57%	8.82%	9.18%	9.50%	9.49%
IBL cost (quarterly)	4.65%	5.17%	5.64%	5.67%	5.55%
IEA-IBL Spread (quarterly)	3.92%	3.65%	3.54%	3.83%	3.94%
Securities yield (Blended)	8.48%	8.47%	8.82%	9.52%	9.39%
Loans yield (Blended)	9.88%	10.18%	10.57%	10.87%	10.87%
Deposits cost (Blended)	4.31%	4.74%	5.25%	5.23%	4.97%
Loans-deposits spread (Blended)	5.57%	5.44%	5.32%	5.64%	5.90%
Securities issued cost (Blended)	7.54%	7.52%	8.40%	9.57%	9.19%
Interest on loans / Total interest income	80.5%	81.0%	80.9%	80.6%	81.2%
Interest on securities / Total interest income	18.1%	17.7%	17.6%	17.9%	17.4%
Net interest income / Total operating income	71.3%	80.3%	81.2%	86.9%	78.3%
Net fee income / Total operating income	17.7%	20.5%	20.7%	22.8%	19.2%
Net fee income / Opex	48.8%	42.5%	44.9%	46.7%	46.9%
Net fee income / Assets	0.96%	0.96%	0.95%	1.03%	0.99%
Non-banking income / Total operating income	11.0%	-0.7%	-1.9%	-9.7%	2.5%
LLPs / Total operating income	19.2%	14.0%	15.4%	14.5%	23.6%
Cost/Income ratio	36.3%	48.2%	46.1%	48.9%	41.0%

Source: Bank financials, Global Securities

Exhibit 3: Publication schedule

Date	Publication
09.08.2018	2Q18 Earnings release
09.11.2018	3Q18 Earnings release

Source: Public disclosure platform

Exhibit 4: Recommendation history

15.10.1993 (Initiation date)	Rating	Target Price	Prev. Day's close	Upside
05.02.2018	Hold	8.00	7.54	6.1%
31.10.2017	Hold	7.65	6.71	14.0%
14.06.2017	Hold	7.40	6.81	8.6%
03.02.2017	Hold	6.85	5.49	24.8%
27.12.2016	Hold	5.80	4.72	23.0%

Source: Global Securities

Exhibit 5: Coverage universe recommendation overview

	Buy	Hold	Reduce	Sell	U/R
Universe	20	19	1	0	1
Universe %	49%	46%	2%	0%	2%

Source: Global Securities

Date of completion of this report: 14.05.2018 08:50 UTC+3

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