# 2018 Turkey Strategy Report

**January 8, 2018**

## Strategies to beat the market

*Note that all data are per **January 3, 2018** closing*


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# Impressive rally in 2017 despite so many uncertainties

## Turkish equities: A strongly performing asset class in 2017

As may be remembered, we published our 2017 Strategy Report titled 'A year of two-halves' which assumed a relatively cautious positioning in 1Q17 followed by an outright risk-on atmosphere starting from 2Q17 onwards. We are glad our 2017 market strategy was very well paid off. Despite so many crosswinds blowing on (geo)politics, Turkish stocks staged an impressive rally, up by 47.6% YoY. This was one of the longest uninterrupted risk-on positioning in Borsa Istanbul.

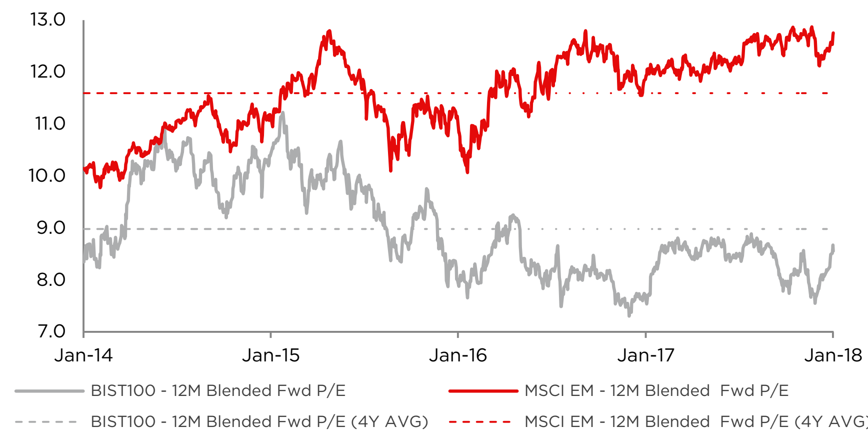
Investors have done much better than they hoped in most of 2017 on the back of a number of global and domestic factors. From global perspective, Turkish stocks delivered more than expectations on the account of an extended risk/reward carry and roll-down trades elsewhere in EMs, powered by the pull of 'ETF-led flows into high-yielding assets' and a 'compression of risk premia' throughout the year. Particularly, the latter boosted EM valuations, adding to investors' search for yield bias and prompting leveraged inflows into local markets. This has been a broad-based phenomenon in Turkey. From domestic perspective, investors found significant value to play with bullish trades amid the generous incentive packages.

While the benchmark index (BIST100) outperformed MSCI EM Index by c.10%, Turkish stocks traded at 34% relative discount in terms of 12M fwd P/E as of the end of 2017. Also, Turkish banks traded at a 31% discount to EM banks on 12M trailing P/BV of 0.76x by the end of 2017. Hence, the combination of promising earnings growth and the weak lira has set the bar rather high for valuations to reach 'stretched levels' anytime soon. Also, TRY assets' underperformance was basically because of Turkey's (geo)political wrestling with the West. In fact, the tension with the Western block has been on the rise since the July 2016 failed coup attempt, and has just escalated to unprecedented levels with the arrest of the U.S. Consulate staff member in Istanbul over terror charges and alleged ties to the Fethullahist Terrorist Organization (FETO). Turkey-U.S. relations are now witnessing hefty pressure as the court case in New York against a state-run Halkbank former executive, M. Hakan Attila, on charges of violating the U.S. sanctions on Iran could put Turkey on a collision course in the international arena.

## MSCI TR Index vs MSCI EM Index


*Source: Bloomberg*

## 12M Blended fwd Looking P/Es 4Y Averages




*Source: Bloomberg*

# Goldilocks picture so far

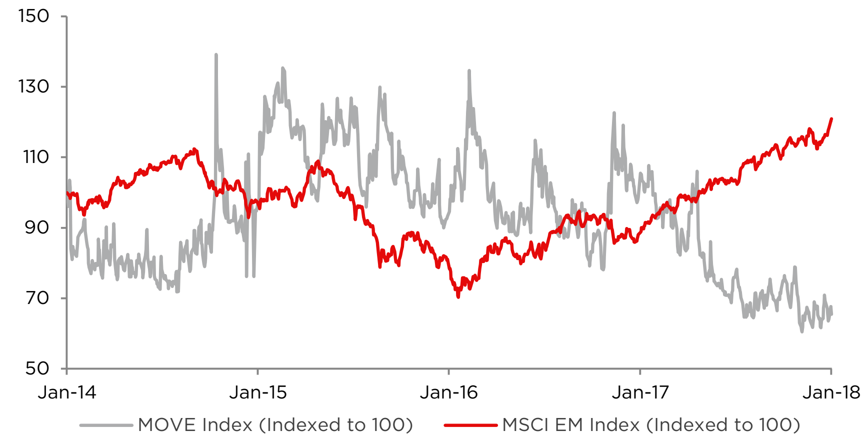
## Risk-on sentiment to remain a core play with some caution

The increased tension with the U.S. has blurred the line between politics and economics. This has been followed by some type of setbacks on foreign policy and financial relations such as delaying talks on EU-accession bid, refraining from upgrading customs union with Turkey, and exploring cuts in EU pre-accession financial aid to Turkey (EUR4.4bn for the period 2014-2020). The good news is that EU has vowed to allocate of EUR3bn to Syrian refugees in Turkey early 2018 and shown some efforts to maintain their dialogue on economy, trade and energy, whereas the visa row between Turkey and the U.S. has ended on Dec 28.

While this atmosphere have left investors with a little bitter taste of funds flow given the USD200bn plus external financing problem, market conditions still offer attractive hedging opportunities amid supportive macro performance. First and foremost, global conditions should continue to remain supportive owing to synchronised growth in advanced countries, slow global inflation, timid rate hikes and stealth reduction in dollar liquidity by Fed, and stable oil/commodity prices. There is little to expect a reversion to mean which generally occurs in case of massive debt imbalances and/or increasing excess supply over demand as a result of overinvestment where neither of these situations appear imminent. Rather, global economic momentum helps boosting earnings globally.

Against this backdrop, risk-on sentiment seems to remain a core play for some more time to come. To the extent that global growth is sustained and interest rates (and credit spreads) remain well-contained with slow inflation and subdued wages, we may see many accounts re-engaging at better levels after few legs of bearish carry unwinds. Yet, equity-implied volatility has remained at record-low average levels. However, low volatility is no longer a safer bet as investors have now realised that it won't last forever. Rather, this raises the question of what will drive up volatility. In fact, volatility should at some point return to its long term average. We can't predict what the catalyst would be, it could be (geo)politics; it might be a shift in inflation outlook; it could be bad news about global economy; it could be faster than expected tightening by Fed; or it might be an event risk.

### MOVE Index vs MSCI EM Index




*Source: Bloomberg*

## Favouring selective equity exposure to Turkey for 2018…

- True, 2017's pattern of low and stable volatility is unlikely to be repeated in 2018. But, on the other hand, macro policy makers around the globe continue to pledge to prevent potential volatility and thereby truncate systemic risks, either. Particularly, central banks seem to avoid disproportionate actions.
- As a result, we continue to favour equity exposure to Turkey for 2018, as we think profit margins can continue to improve along with valuations offering juicy opportunities in terms of MSCI multiples despite the risk of modestly high volatility. Hence, there could be opportunities to profit selectively from long volatility positioning through the year. All the investors need is to find a 'good timing' to act as the current environment is surrounded by the 'fog of war'.

GLOBAL SECURITIES

# Some headwinds fade as others re-emerge, but…

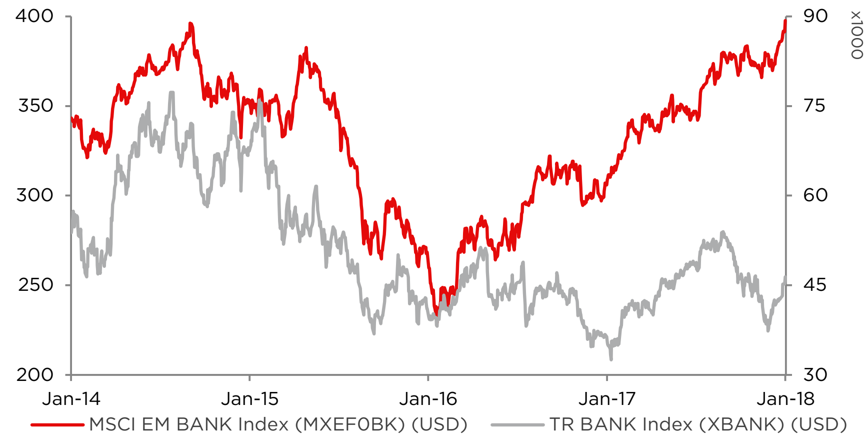
## …there are many tailwinds too…

Despite so many crosswinds on (geo)politics blowing currently, domestic macro conditions provide valuable catalyst for those who have bullish exposures in Turkish stocks. First and foremost, fiscal stimulus that has provided an upward drift for demand side so far seems to stay with us for a while longer albeit with a modestly lesser degree. In fact, ending this support will be difficult since the factors weighing on consumption and investment, such as higher inflation and interest rates and lower productivity, are structural rather than cyclical. We expect expansionary budget policies to remain pivotal until 2019 elections, fiscal deficit to widen, and yields to remain elevated with adverse implications for debt metrics.

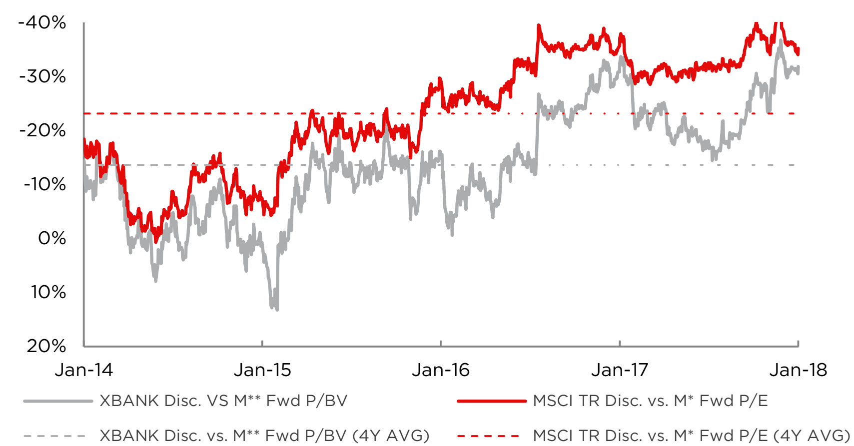
The Credit Guarantee Fund (CGF) will be made permanent to counteract liquidity shortages and sustain the recovery by revolving TRY90bn CGF loans due in 2018 and deploying fresh TRY50bn to boost investments. Turkish banks' capital buffers make them well placed to absorb further moderate shocks whereas the level of NPLs would remain moderate. Putting geopolitical risks and the US court cases aside, inflation pressures may act as wild card as the CBRT may 'bite the bullet', if 'expectations-driven inflation spiral' were to become undeniable at the double digit territory. This is not unlikely given the headline CPI hovering at decade highs.

Against this macro backdrop, we calculate our new target for BIST100 at 126k offering c.9% upside at the Jan. 3, 2018 close over the 12M investment horizon. After having achieved c.19% alpha over BIST100 with a solid c.73% absolute return in TRY terms last year, we will continue to stay in the market and utilize risk on trades in 2018. Nevertheless, 'no-brainer bull trades' should be risky to build new exposures in early 2018. Rather, 'selective' portfolio allocation is warranted given the uncertain financing environment. The situation may remain patchy until Q2 with some areas of stand-out weakness such as growth:inflation trade-off, external imbalances and credit risk before taking 'secular long-positions' thereafter. Hence, TRY markets may fluctuate in a wide range move during early 2018. Such price action in equities may thus discourage investors to enter a 'naked directional trade' before seeing more 'concrete evidence' to act.

## MSCI EM Banks vs. XBANK in USD terms




## MSCI TR Banks P/E and XBANK P/BV discount




**MSCI EM ** MSCI EM Banks*

*Source: Bloomberg, Global Securities estimates*

# Keep your powder dry in case of catching up with EM peers

## Directional risk-on positioning remains core play….

We do share some investors' scepticism to enter a 'naked directional trade' on TRY assets due to the lack of clarity on foreign politics and international relations. Moreover, such sceptical sentiment may end up with a wave of ro-ro (risk-on/risk-off) trades in times of distress. Even in such atmosphare, we expect these swings to turn into 'high conviction on directional buy trades' at cheaper valuations in the following period, which could thereby extend institutional investors' 'risk-on' positioning in longer horizon. Herein, bear in mind that we don't rule out that the current market dynamics might swing the pendulum of gains and losses, and such price action may last well into Q2. That said, Turkish stocks could at some point pull another secular risk rally out of the hat regardless of event risks this year.

We think, geopolitical risks and the US court cases apart, investors are still NOT enough packed with risk. In fact, the market is inclined to buy on discounted prices in terms of MSCI EM peer multiples. Hence, outright risk aversion is NOT a close call, in our opinion. Rather, some accounts may keep their powder dry in case of Turkish stocks' attempt to catch up with EM peers after the impact of idiosyncratic shocks on (geo)politics begins to fade into the rear view mirror.

We maintain the view from our 2H17 Strategy Report (June 14, 2017), which suggested investors to rotate into 'quality improvers' from all other 'conventional high risk/return plays'. We define 'quality improvers' as decent yield deliverers with 'sustained operational growth, well-diversified business strategy and solid investment theme as well as better liquidity, shorter maturity and currency hedge' characteristics. As for banks, we expect ROAE (14.6%) to stay 300bps below CoE (17.6%) in 2018 and see modest return potential over the next 12M due to the elevated cost of financing. That said, risks remain skewed to upwards rather than downwards as banks have already priced in most of potential headwinds at P/BV trading 32% discount vs. MSCI EM peers going into publication. In fact, banks may offer decent return opportunity depending on cost of financing. We believe, our top pick portfolio should help investors to beat the benchmark this year.

## Investment Ideas

| TOP PICKS | | | |
|---|---|---|---|
| AEFES | FV TRY 29.10 | BUY | UPSIDE 17% |
| EREGL | FV TRY 11.91 | BUY | UPSIDE 17% |
| GARAN | FV TRY 12.20 | BUY | UPSIDE 14% |
| MGROS | FV TRY 35.20 | BUY | UPSIDE 29% |
| PETKM | FV TRY 9.10 | BUY | UPSIDE 14% |
| TRKCM | FV TRY 5.50 | BUY | UPSIDE 24% |
| TUPRS | FV TRY 150.20 | BUY | UPSIDE 23% |
| VAKBN | FV TRY 8.00 | BUY | UPSIDE 18% |
| YATAS | FV TRY 35.54 | BUY | UPSIDE 27% |
| ZOREN | FV TRY 2.00 | BUY | UPSIDE 27% |

*Source: Global Securities estimates*

## Valuation Multiples (2018E)*

| | EPS growth | P/E | EV/EBITDA | P/BV |
|---|---|---|---|---|
| Banks | 11% | 5.1 | n.m. | 0.73 |
| Non-financials | 11% | 10.4 | 6.8 | 1.72 |
| **Coverage** | **11%** | **8.0** | **n.m.** | **1.24** |
| MSCI EM | 25% | 13.1 | 8.7 | 1.66 |

**Coverage universe only*

*Source: Bloomberg, Global Securities estimates*

GLOBAL SECURITIES

# Top Pick Stocks

**The equally weighted 2H17 top picks portfolio has outperformed the XU100 index by 9.0% (Absolute performance: +24.7%) since the inception date of June 14th, 2017. The FY17 top pick portfolio has outperformed the XU100 index by c.19.0% (Absolute performance: +73.6%) since the inception date of December 27th, 2016.**

**We revised our portfolio for 1H18 as we believe the following names will outperform the index based on their company-specific stories:**

| Stock | FV (TRY) | % upside potential | P/E 2018E | EV/EBITDA 2018E (P/BV for financials) | Investment themes |
|---|---|---|---|---|---|
| **AEFES** | 29.10 | 17% | 30.0x | 7.7x | • Signs of improvement in domestic market<br>• AEFES – AB InBev merger in Russia and Ukraine likely to create synergies<br>• World Cup in Russia will support growth in the country |
| **EREGL** | 11.91 | 17% | 11.1x | 6.3x | • Increasing product spreads and steady volumes supporting operational profitability<br>• The depreciation of TRY against USD should favour the operational performance going forward<br>• Favourable hard-currency cash position of the company |
| **GARAN** | 12.20 | 14% | 5.9x | 0.95x | • Sector leading NIM and capitalization figures<br>• Bulky CPI linker portfolio enables generous securities income<br>• High-yielding asset management and accompanying high profitability with solid asset quality |
| **MGROS** | 35.20 | 29% | 72.0x | 7.2x | • High CPI fuels growth and supports margins<br>• Increasing its footprint in Turkish organized FMCG thanks to its unique position in the supermarket segment<br>• The divesture of real estate portfolio of recently acquired KIPA may help deleveraging |
| **PETKM** | 9.10 | 14% | 8.1x | 6.8x | • We expect positive contribution from favourable product spreads especially aromatics<br>• The depreciation of TRY against USD should favour the operational performance going forward<br>• Future catalysts might come from the benefits from Petlim and Star Refinery investments |
| **TRKCM** | 5.50 | 24% | 7.6x | 6.2x | • Price increases in both domestic and international markets<br>• High capacity utilization with steady sales performance supporting the volume growth<br>• Decline in soda ash prices lowering the costs and improving the margins |
| **TUPRS** | 150.20 | 23% | 7.6x | 6.1x | • Increasing product cracks and stable volume with high CUR supporting the operational performance<br>• Continuing stable trends in med refining margins<br>• Exceptionally high FCF and dividend yields |
| **VAKBN** | 8.00 | 18% | 4.1x | 0.64x | • Potential premium on share transfer appraisal value<br>• Highest YtD ROAE performance among Tier1 class<br>• High operating efficiency and robust fee growth |
| **YATAS** | 35.54 | 27% | 11.9x | 7.2x | • Promising growth prospects well supported by the wider domestic and international store network<br>• Along with the accreditation to the Turquality incentive program, international sales are expected to accelerate rapidly<br>• Further margin improvement with the positive impact of new investment and robust balance sheet structure |
| **ZOREN** | 2.00 | 27% | 17.5x | 9.4x | • Renewable exposure drives profitability<br>• Being fully-integrated energy player helps to increase stability for the upcoming periods' financials<br>• USD based revenue generation supports net debt to EBITDA ratio |

*Source: Global Securities estimates*

# FV & Rating changes

**We revised our fair value and recommendations for the following companies in our coverage universe:**

| Stock | FV (TRY) | % upside potential | P/E 2018E | EV/EBITDA 2018E (P/BV for financials) | Investment themes |
|---|---|---|---|---|---|
| **AKBNK** | 10.90 | 10% | 5.9x | 0.88x | • Sector leading asset quality and NPL coverage<br>• Sector leading operating efficiency<br>• High profitability and capitalization |
| **CCOLA** | 43.00 | 21% | 15.5x | 7.4x | • Increasing share of immediate consumption packs helping margins in Turkey<br>• The impact of excise tax on soft drinks should be limited<br>• Recovery in international markets continue |
| **TCELL** | 17.54 | 16% | 13.9x | 5.6x | • Well grasping the robust data growth in Turkey with dedicated service offerings<br>• Cross- and up-sell opportunities may help further ARPU growth<br>• Share overhang is behind us and dividend distribution is likely to continue |
| **THYAO** | 15.80 | -2% | 7.5x | 8.2x | • Strong passenger growth likely to continue in 2018E<br>• Strict cost control pushing margins higher<br>• Positives are already priced in, thus downgrading to HOLD, despite FV increase |
| **TKFEN** | 17.17 | 6% | 10.3x | 3.8x | • Potential cash generations from contracting business with the late additions of new projects<br>• Agriculture segment continue to contribute positively in terms of operational performance<br>• USD based revenue generation supports the hard currency net cash position |

*Source: Global Securities estimates*

# Sensitivity Analysis

**Our base-case scenario** for Turkish equities assumes a **11.0%** risk free rate and **5.5%** equity risk premium considering geopolitical uncertainties. Hence, our 12M bottom-up index target of **c.126,000** suggests **c.9%** upside potential from the **January 3, 2018 closing.** All else being equal on global front:

Our worst-case scenario for Turkish equities is a 14.0% risk free rate and 8.5% equity risk premium, which implies a bottom-up index target of **c.101,000**.

Our best-case scenario for Turkish equities is a 8.0% risk free rate and 4.5% equity risk premium, which implies a bottom-up index target of **c.145,000**.

| ERP \ RF | 8.0% | 9.0% | 10.0% | 11.0% | 12.0% | 13.0% | 14.0% |
|---|---|---|---|---|---|---|---|
| 2.5% | 156,265 | 150,762 | 145,453 | 140,331 | 135,209 | 130,274 | 125,519 |
| 3.5% | 150,762 | 145,453 | 140,331 | 135,390 | 130,448 | 125,686 | 121,099 |
| 4.5% | 145,453 | 140,331 | 135,390 | 130,622 | 125,854 | 121,260 | 116,834 |
| 5.5% | 140,331 | 135,390 | 130,622 | 126,022 | 121,422 | 116,990 | 112,720 |
| 6.5% | 135,209 | 130,448 | 125,854 | 121,422 | 116,990 | 112,720 | 108,606 |
| 7.5% | 130,274 | 125,686 | 121,260 | 116,990 | 112,720 | 108,606 | 104,642 |
| 8.5% | 125,519 | 121,099 | 116,834 | 112,720 | 108,606 | 104,642 | 100,822 |

*Source: Global Securities estimates*

# Stock sensitivity to risk metrics

| MOST SENSITIVE STOCKS TO | | | | | | | |
|---|---|---|---|---|---|---|---|
| Strong € | Strong US$ | Low oil price | Low natural gas price | Exports | Prospective M&A | Domestic consumption | |
| **POSITIVE IMPACT ON** | | | | | | | |
| CLEBI | AKSEN | AKSA | AKENR | ARCLK | AKSEN | AKSEN | MGROS |
| ARCLK | ASELS | PETKM | AKSEN | ANACM | ARCLK | ANACM | SISE |
| DOCO | ENKAI | PGSUS | ANACM | FROTO | CCOLA | ARCLK | TOASO |
| ENKAI | EREGL | THYAO | EGSER | KCHOL | KCHOL | BIMAS | TRKCM |
| FROTO | PETKM | KORDS | ODAS | SISE | SAHOL | BIZIM | TTRAK |
| PGSUS | KORDS | SASA | SAHOL | TOASO | SISE | CCOLA | TUPRS |
| TAVHL | SISE | | SISE | TRKCM | TAVHL | DOAS | ULKER |
| TOASO | SODA | | SODA | TTRAK | TCELL | EKGYO | TATGD |
| TRKCM | THYAO | | TRKCM | ULKER | TRKCM | EREGL | TRGYO |
| | TKFEN | | KUTPO | VESBE | ULKER | FROTO | AKSGY |
| | TRKCM | | USAK | VESTL | VESTL | KCHOL | AKCNS |
| | TUPRS | | | CIMSA | | | |
| | CIMSA | | | | | | |
| **NEGATIVE IMPACT ON** | | | | | | | |
| AEFES | AEFES | TUPRS | | | | | |
| BAGFS | AKENR | | | | | | |
| CCOLA | TCELL | | | | | | |
| DOAS | TRGYO | | | | | | |
| DOHOL | TTKOM | | | | | | |
| MGROS | ARCLK | | | | | | |
| TCELL | CCOLA | | | | | | |
| TRGYO | ULKER | | | | | | |
| TTKOM | YAZIC | | | | | | |
| ULKER | ZOREN | | | | | | |
| YAZIC | | | | | | | |

*Source: Global Securities estimates*

# Technical view for XU100 and MSCI EM index in USD terms

**The 3.200 level is a critical resistance for the XU100$ for the medium term, because this level represent both the highest level of the downward trend (red line) and the 38.2% Fibonacci level (pink line). Meanwhile the RSI indicator is approaching to the excessive buying area.**

## XU100 index (USD)

- There is an upward momentum tendency which started early 2017 (blue line). Also 50, 100 and 200 moving averages are being sub-merged. These moving averages can be the support levels for the index in the upcoming months.
- It's worth noting that, in case of risk aversion, the blue trend line (current: 2.800 level) should be a critical support level for the index. However, if the XU100$ index breaks above 3.200 level (current resistance level), the upward momentum could accelerate for the mid-term.

## MSCI TR index (USD)

- MSCI Emerging Markets Index continues to navigate in an upward trend. The upward trend channel (blue trend channel) should be monitored going forward. The lower boundary of the blue trend channel (current: 1,100 ) acts as the main support level for the aforementioned trend channel.
- If the index stays above 1,100 level, upward trend should continue in the mid-term. To remind, the index has gained momentum after its progression above (Mid-2017) the long-term resistance level (red trend line).

## XU100 index (USD) technical analysis chart

*Source: Matriks*

## MSCI EM index (USD) technical analysis chart

*Source: Matriks*

# Domestic Politics : A heavier agenda

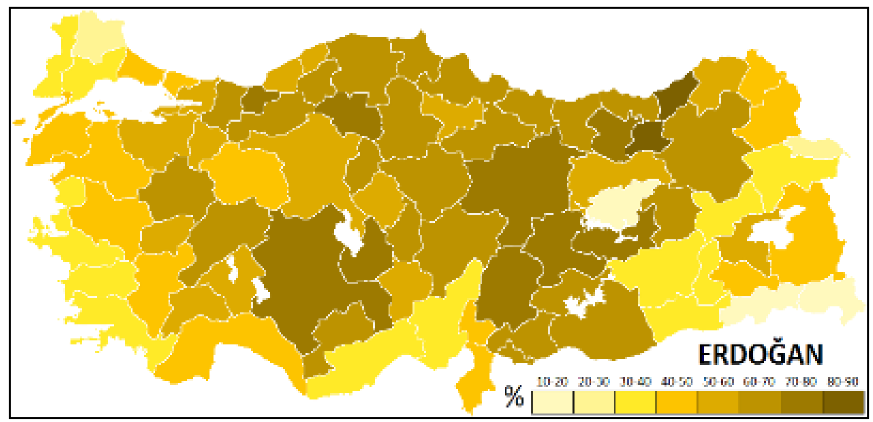
## Key questions on domestic politics

- Political agenda is currently dominated by the following uncertainties:
  - Electoral support for the ruling Justice and Development (AK) Party
  - Likelihood of early elections
  - The AK Party's capacity to control the political agenda
  - Pre-election alliance(s) and efforts to passivize the opposition
  - Chances of compromising with the West
- True, Ankara can reverse the course both in diplomacy and at home to constitute some relief against potential bearish pressures on the economy. However, baseline scenario sees political risks to remain on the table in the near term. In either case, early elections should not be ruled out, although the ruling AKP executives have repeatedly cited they have no such agenda.
- Turkey is due to hold three elections in 2019 – local elections in March, and simultaneous parliamentary and presidential elections in November 2019 – following recent constitutional amendments shifting Turkey from a parliamentary system to an executive presidential system. Yet, the bar remains relatively high for calling for a snap or early ballot given the underlying re-shuffling process within the ruling AK Party. President Erdogan wants to renew all provincial organizations ahead of the 2019 elections to avert metal fatigue risk. Also, parliament has been in an intense period to harmonize the existing legislation with the new constitution. However, the likelihood of early elections in 2018 are now on the rise, as Erdogan may be willing to capitalise on merits of the 2017's robust growth.
- The new constitution requires achieving the 50% plus 1 vote to get re-elected in Nov. 2019 elections, which seems to be challenging. Hence, Erdogan has now pushed the AK Party members to concentrate on both parliamentary and presidential elections in 2019 with a heavier workload.

## Political composition in the Apr 2017 referendum


*Source: Anadolu Agency*

## Public support for President Erdogan



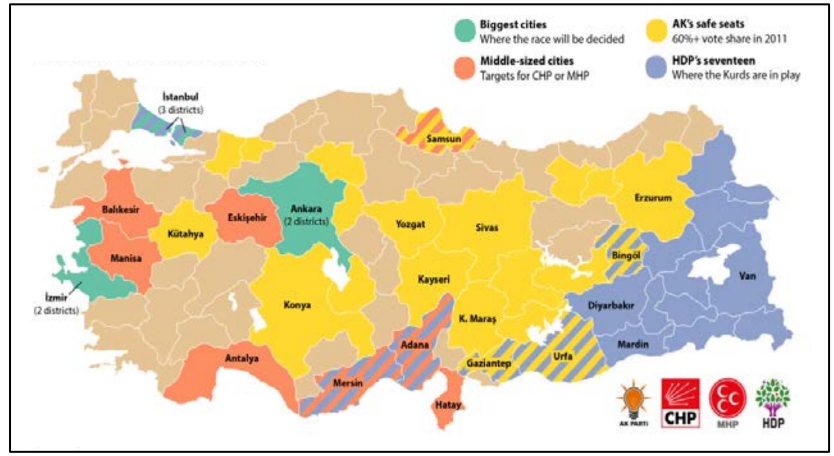

*Source: (Web)wikipedia.com*

# Election threshold and pre-election alliances

## What is the game plan?

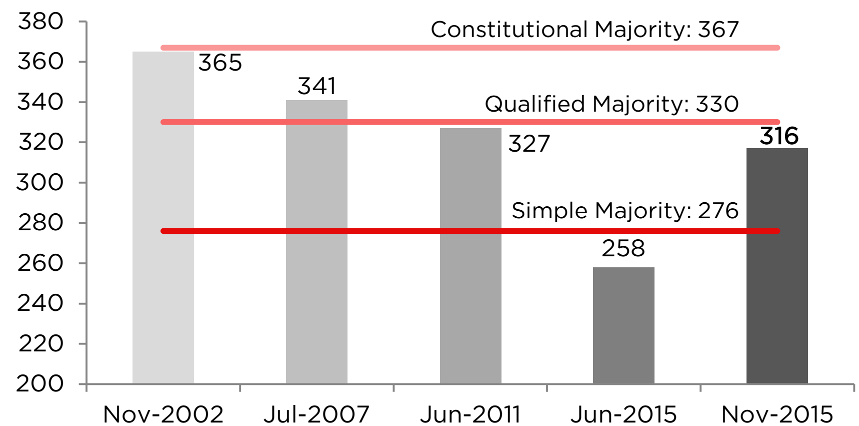
- Both the main opposition Republican People's Party (CHP) and Good (İYİ) Party's (new party on nationalist centre) are expected to hold their general conventions in 1Q2018 to be ready for snap/early elections. Also, the legal requirement of passing the enabling laws of the presidential system will soon begin. Meanwhile, the ruling Justice and Development (AK) Party and its main ally, the Nationalist Movement Party (MHP), appear to be accelerating efforts to draft new laws, including the Election Law and Political Parties Law. The key questions are: i) Will the 10% election threshold be lowered? ii) Will parties be allowed to form pre-election alliances?
- The AK Party is unlikely to reduce the 10% popular election threshold in order to dominate the Grand Assembly, despite earlier calls from MHP leader Bahceli. Instead, the AKP and MHP could form a pre-election alliance and enter parliament together, while the pro-Kurdish Peoples' Democratic Party (HDP) and the newcomer Good Party may struggle to exceed the threshold. The outcome remains at odds, though. First, there is suspicion of many Kurdish citizens refraining to reveal their preference in opinion polls. Hence, risks for HDP remain skewed to the upside rather than downside. Second, latest opinion polls show that the Good Party scores around the election threshold of 10% currently, and some pollsters claim it could tap up to 20%. The AK Party may consider this situation as a motive to call for snap elections to leave the Good Party and HDP out of the parliament.
- If this plan holds, we may see a three party parliament consisting solely of AKP, CHP and MHP, with a clear majority granted to potential AKP-MHP cooperation. What currently remains crystal clear is that the current developments could induce new rounds of an AKP-MHP alliance, which may push for early elections in 2018. To sum up, all these factors have sparked rumours of a snap ballot, although the political agenda should be very busy in 2018 with relevant legal adjustments to prepare the current institutional infrastructure in full compliance with the executive presidential system.

## Political standing in Turkey




Source: (Web)jamesinturkey.com

## # of the AK Party seats in Turkish parliament




Source: Supreme Board of Election

# Electoral support for the ruling AK Party

## An AKP-MHP cooperation : A holly alliance?

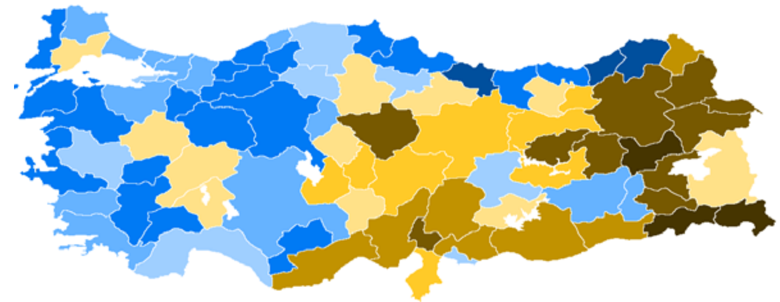
- After having conducted a closed door meeting with the AK Party deputies on Nov 30, President Erdogan met PM Yildirim on Dec 1, allegedly to develop a road map for drafting adjustment laws in a tighter agenda (probably less than 6M). As always the case, President Erdogan will have the last word; but, opinion polls should be pivotal.

- Based on latest polls, the electoral support for the AK Party has been slipping towards mid 40%s given liberal democratic wing (i.e. educated young urban voters) loosening their sympathy into the Party. Main reasons could be i) long-lasting TRY weakness, ii) the reshuffling of the AK Party (i.e. replacing the ageing senior class with new inexperienced names), iii) disappointment due to polarisation with the West, iv) some loss of popularity amid the continuation of the state of emergency, and iv) increased pressure on municipalities.

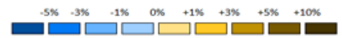
- Both geopolitical issues (Syria, Iraq, Jerusalem etc) and the US court cases currently dominate the political agenda. Herein, there is a heated debate about the impact of Reza Zarrab/Hakan Atilla trial process on voter attitudes, while its reflection on opinion polls remain uncertain yet.

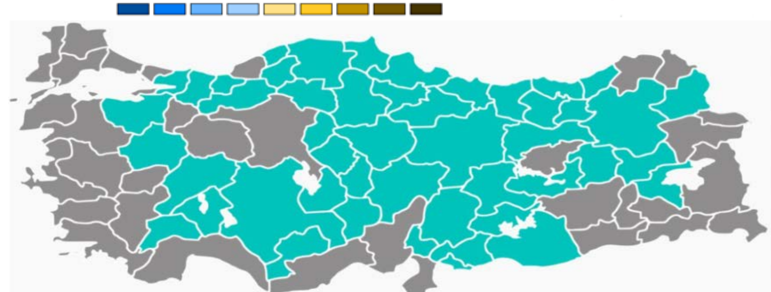
- Despite the impressive GDP growth in 2017, on-going tension in domestic politics and Turkey's geopolitical wrestling with the West resulted in more undecided voters than usual for an election race (c.20%). In such atmosphere, even an AKP-MHP alliance may not secure the 50% plus 1 vote to win the presidency.

## Political standing in Turkey

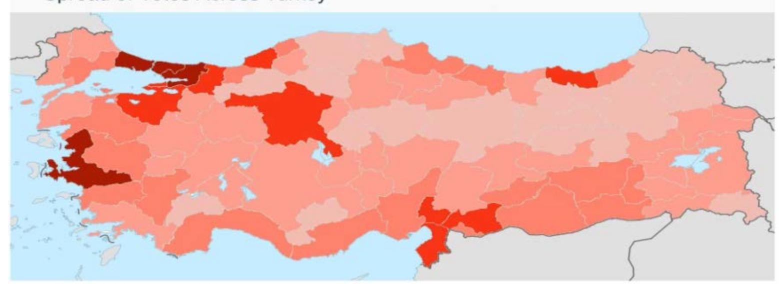


Turkish Constitutional Referendum 2017
Swing (relative to presidential election 2014)



Spread of Votes Across Turkey



Population density

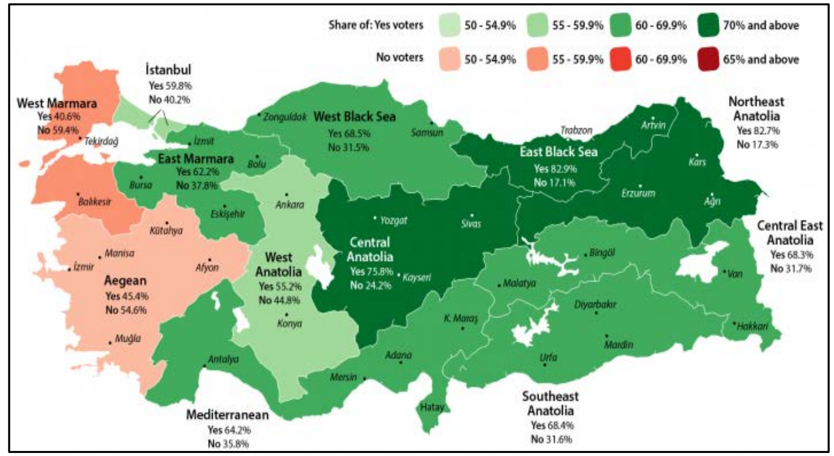
*Source: (Web)jamesinturkey.com*

# Election system: A key area in focus

## Election system: Will it be changed?

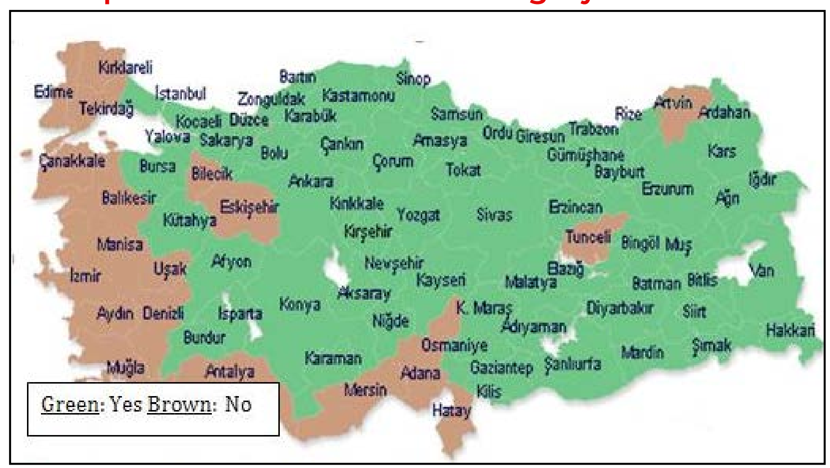
- Since the constitutional amendment included a provision obligating the parliament to complete legislative harmonization within six months, the government is expected to issue an empowering act to conduct the legislative changes by the help of governmental decrees in effect of law.
- One of the first legislative changes is expected to be in the election system. This is critical because the recently adopted partisan presidential system is exposed to certain risks. The new charter assumes that the leader of the ruling party and president-elect would be the same name. Hence, the leader is assumed to have full influence over the governing party, which would make the legislative work in the parliament more quicker and efficient. In such a case, the partisan presidential system should accelerate the executive as the president will directly select MPs but leave less space for the checks-and-balances role of parliament.
- In the event that the president and government (also the parliamentary majority) are not from the same party, the system could turn the other way around. In this case, if the president is the leader or a member of the opposition party, it could ultimately lock the system. The charter draft assumes that electorate would never want to separate the presidency from the parliamentary majority.
- In order to overcome this issue, the ruling AK Party is currently working on new electoral system which is called a 'reduced constituency' model. In a reduced constituency, the two big parties (and their pre-election alliances) are likely to predominate although there is a strong independent candidate. If approved, such system could hit the pro-Kurdish HDP most as it would lower the chances of joining parliamentary elections with independent candidates in a bid to by-pass the 10% election threshold.

## The April 2017 referendum voting by region




Source: (Web)jamesinturkey.com

## The April 2017 referendum voting by cities



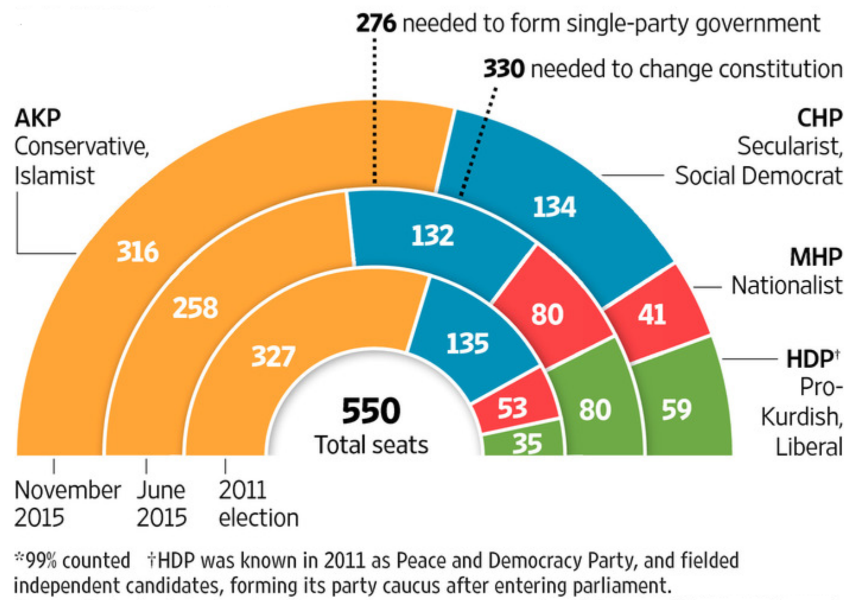

Source: Supreme Board of Election

# A new party in Turkish political spectrum

## The Good Party…

- While the reduced constituency model may be considered as a pre-emptive move to deter pro-Kurdish HDP's attempt to by-pass the election threshold, the newcomer 'İyi Parti' (Good Party) seems to be a new challenge for the ruling AK Party. Ms Meral Aksener, a former Nationalist Movement Party (MHP) deputy, introduced the new party on Oct 25, 2017 with the motto 'Turkey Will Be Good'.
- Meral Aksener, who had been expelled from the MHP after she had put in her candidacy for leadership in 2015, seems to play very critical role in Turkish politics in the run-up to the Nov 2019 elections, as the new nationalist centre under her leadership is believed to score up to 20% from at least 10-12% of the electorate. Aksener's role in the Nov 2019 elections is a double-edged sword, though.
- On one hand, as some of pollsters currently show, Aksener's Good Party could ultimately divide the nationalist block and result in big erosion in the MHP's vote base (11.9% in Nov. 1, 2015 elections) and drag it below the 10% threshold. Such outcome could, on the other hand, pave the way for a two-party legislature, granting the AK Party a great favour. On the other hand, the Good Party may also pose a threat to the AK Party's absolute power in parliament if Ms Aksener were to tap up to 20% of the national vote as few pollsters currently claim. Should this be the case, the AK Party's long-standing one-party government might see a challenge and may face a coalition scenario.
- All told, from the AK Party and MHP perspective, the risk is twofold: the MHP may to fail to achieve the 10% popular threshold and remain out of the parliament in the next elections while the risk of losing absolute majority is not low for the ruling AK Party. Hence, the Good Party effect may be one of the major reasons to push the AK Party to set a pre-election alliance with the nationalist MHP and/or call for early elections.

## Seats per party




*Source: Supreme Board of Election*

## Local elections: A negative motive for parliamentary elections ?

- The motive and the atmosphere in local elections are rather different from those in general elections. In local elections, electoral vote for mayors rather than political parties and their leaders. That's why the results in local elections may seemingly differ from parliamentary elections. In local elections, the AK Party generally scored less than in parliamentary elections since 2005. At this juncture, the AK Party may consider local elections in Mar 2019 as a risk factor in the run-up to the Nov 2019 elections, and thereby may be inclined to bring it forward.

# Relations between Turkey and US

## The Atilla court case

- The New York Federal Court jury has convicted Hakan Atilla, a former deputy CEO of state-run Halkbank, charged of participating in a multi-year scheme to violate U.S. sanctions against Iran. Specifically, Hakan Atilla was found guilty of five counts of conspiracy and bank fraud but acquitted of money laundering. The U.S. District Judge Richard Berman is expected to sentence Atilla on April 11.
- Halkbank has already said its foreign trade transactions and money transfers are transparent and underlined that it has always committed strictly to national and international regulations in all its business. Also, Halkbank emphasized the bank has not been a part to any uncertain and illegal transaction linked to any country, and it has not carried out any uncertain and unlawful transfer transaction.
- The government unanimously criticized the U.S. Jurors' verdict and described it as 'unjust and unfortunate' saying that the trial was based on 'evidence that was fake and open to political exploitation'.

## An ultimate compromise seems most likley outcome…

- Mutual start of proceeding visa applications is indeed good step in a way to cool-off the heightened tension between the two countries. This has actually supported our core view that Turkey will ultimately 'compromise' with the United States at some point, because otherwise would result in an economic hardship for which Turkey has no room to tolerate potential headwinds given the USD200bn plus external financing problem. While the chances of taking further constructive steps have increased after the resolution of visa row, we continue to think more time and effort are needed to bridge the gap between Turkey and the United States. In fact, restoring relations could be in the interests of both sides in the future.
- It seems too early to say that Turkey and U.S. relations have completely normalized, as the visa spat was not only the issue. Still, there are a number of disputes remaining unresolved: i) the U.S.'s tactical partnership with the Syrian Kurdish Militia (YPG - an offshoot of the outlawed PKK); ii) Ankara's demand for the U.S. to extradite outlawed FETO leader Gulen; iii) the Attila case; iv) the arrest warrant against the security guards of President Erdogan; v) the U.S.'s demand for the release of an American pastor and local employees of the U.S. mission in Turkey accused of having links to the outlawed FETO and vi) recently finalized purchase of S-400 missiles system from Russia.
- The U.S. - Turkey relations seems to continue on a bumpy road for a while longer. However, the recent past provides some evidence of quick U-turns. If true, we may see a political settlement, either with the U.S. or EU, switching to a more moderate regime at home. A moderation of the current political tension would relax the opposition and might win the heart of undecided voters, @ 20% of total electoral in latest opinion polls. If the government cools off the tension, it could hold local and presidential elections as scheduled in 2019. Another victory seems highly likely if the AK Party sets a friendly atmosphere and builds up hopes high again.

# Potential openings in foreign policy

## Seeking for an alliance in Europe…

- If Ankara were to fail to come up with a coherent plan to deal with the guilty verdict for Hakan Atilla, we could probably see increasing contacts with EU authorities to unfreeze the membership negotiations and launch talks on new Customs Union. Herein, EU needs to be convinced that the new constitution amendments are in full compliance with the Copenhagen criteria; not to mention the EU pre-requisites that have been asking Turkey to ease Anti-Terror Law and lift the emergency rule. If satisfied, Turkey could be granted some sweeteners such as approving visa liberalisation and updating Customs Union agreement.
- Above mentioned steps are not easy tasks for the ruling AK Party, as it is difficult to see the party sacrificing it for the limited gains on the EU front. Herein, in order to make progress in relations with EU, Turkey should, first and foremost, compromise with Germany on political issues.
- Turkey's exports to Germany compose of 10% of total exports bill with the competitive advantage clearly in Germany's favour. Turkey's share in Germany's USD2.1trillion direct investments abroad stands at only USD13bn, or 0.6%. For Germany, this share is obviously insignificant, but for Turkey, where FDI stock is worth USD125bn, it represents 10% of the total, which is rather significant. Germany is also an important lender for Turkey. Loans provided by German financial institutions account for 10% of the Turkish private sector's USD211bn long-term borrowing currently. In tourism sector, German visitors long topped the list of foreign tourists until overtaken by Russians in more recent years.
- In sum, Germany's role in Turkish economy is hard to ignore. Any measure taken by Germany should have visible implications on the Turkish economy immediately. Given the latest bilateral constructive statements, we believe Germany is willing to cooperate with Turkey; not to compete.

## Signs of recovery in relations with EU…

- Recall, the Parliamentary Assembly of the Council of Europe (PACE) degraded Turkey's status and reopened a monitoring process in April 2017. The latest verdict addressed Ankara's scaling back from the Copenhagen Criteria, indicated that Turkey has lost its thirteen years of achievements in the EU process. While this could provide legal ground to open a debate on the full-membership talks with Turkey, EU leaders have no intention to end the accession talks with Turkey.
- Turkey-EU relations have stopped straining. Indeed, EU did not choose to break off political relations with Turkey; nor did suspend the membership process. EU has provided a road-map to restore relations which contains i) accelerating visa liberalization, ii) resuming refugee readmission deal, iii) upgrading the Customs Union agreement by expanding to agriculture, services and public procurements, iv) opening of new negotiation chapters if not a close call, and v) fighting against terrorism in full coordination .
- While no concrete progress has been provided yet, the chances are not low as Turkey is now looking for a new opening with EU, following the strained relations with the U.S despite some easing of late. At this stage, we don't rule out a symbolic start to new Customs Union negotiations and/or approval of visa liberalisation.
- Herein, we see Turkey and France are now in new era as the two countries have pledged better ties with key deals such as Turkey's second nuclear plant, Turkish Airlines' purchase of 25 jets from Airbus, and Turkey's participation to a Franco-Italian missile system project. Nevertheless, France avoids making encouraging statements on Turkey's full membership to the EU, rather suggesting 'a new formulation' to re-define Ankara-Brussels ties. Also, some circles in Europe offers a 'Brexit-type model' in relations with Turkey, basically focusing on trade and economic relations rather than political issues.

# Turkey - Russia relations : In a new era….

## Now 'beyond normalization' and entering 'a new phase'…

- Turkey and Russia relations are now completely restored after the downing of a Russian jet in Nov. 2015. The two countries put emphasize on further cooperation on defense, energy, trade and geopolitics.
- Putin has used Turkey's broken ties with the West as platform to capitalise on his long-lasting regional targets. He has been successful in reaching his ultimate goal, as Ankara is still disappointed with the West for what it considers a weak response to the 15 July 2016 failed coup attempt. Also, the United States' close cooperation with the YPG against ISIS threat has been another reason that has motivated Turkey to set close contacts with Russia in recent months. Hence, Turkey's reconciliation with Russia can be described as an 'alliance of misfits' as two countries have been feeling 'rejected and mistreated' by the West.
- This may however leave the Western block with a bitter taste of future relations on both the EU and NATO fronts. The Western countries have put a very close eye on Russia – Turkey relations. Conventional wisdom is that the warmer the relations between Ankara and Moscow are, the colder they become between Turkey and the Western Block. In this regard, we all know what happened when foreign politics was reshaped in an anti-Western route, such as creating further tension in relations with international community, complicating trade and financing channels.
- Also note that while the deals between the two countries can be explained in terms of economic and, therefore political pragmatism, it seems too early to bet on sustainable and trustworthy co-operations. This is basically because Putin has usually engaged in 'frenemity' politics which generally results in 'paradoxical' and 'unreliable' agreements rather than long-lasting peaceful resolutions.

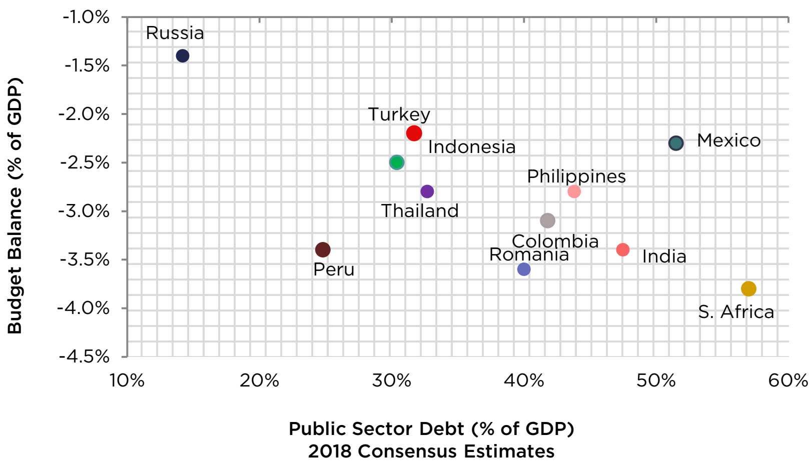
## Turkey – Russia cooperation

Source: (Web)news.gtp.gr

- We think, the relationship is apparently one-sided. Turkey buys anti-missile systems (USD2.5bn), natural gas (USD5bn p.a.) and nuclear reactors (USD22bn) from Russia but sells cheap tomatoes, discounted holiday packages and various consumer durables. So far, there is no sign that Kremlin will support Turkey in Caucasus or Middle-east.

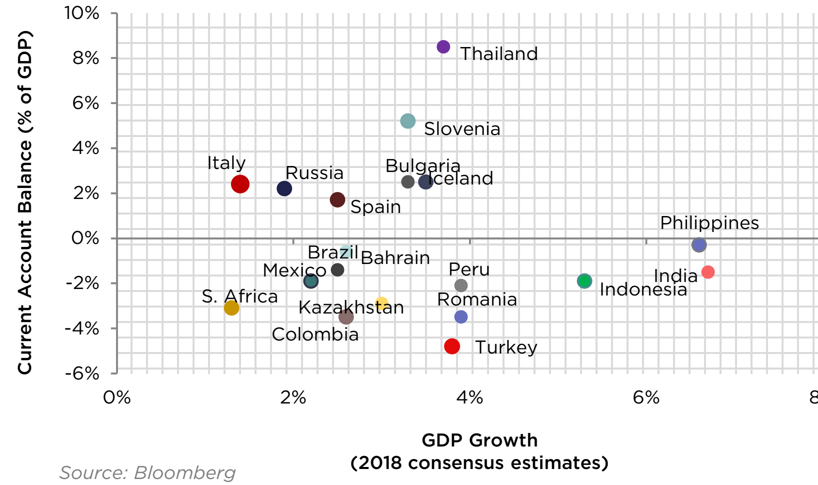
# Turkey – Peer Comparison…

## Budget & Public Debt



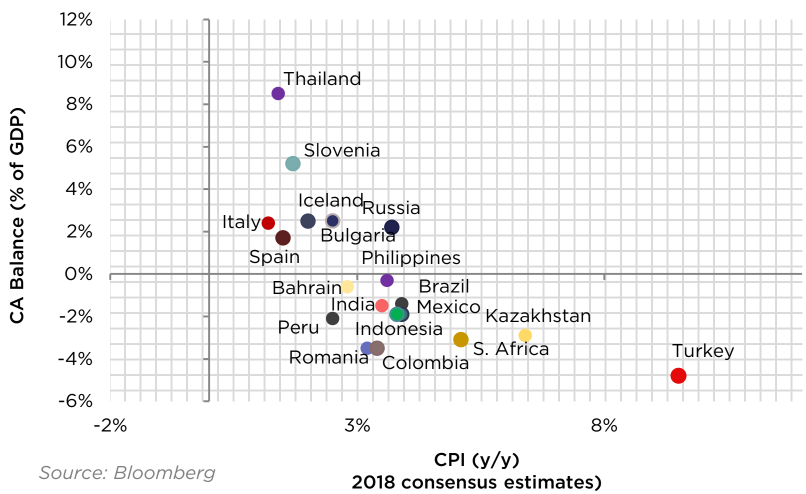

*Source: Bloomberg*

## Growth & CA Balance



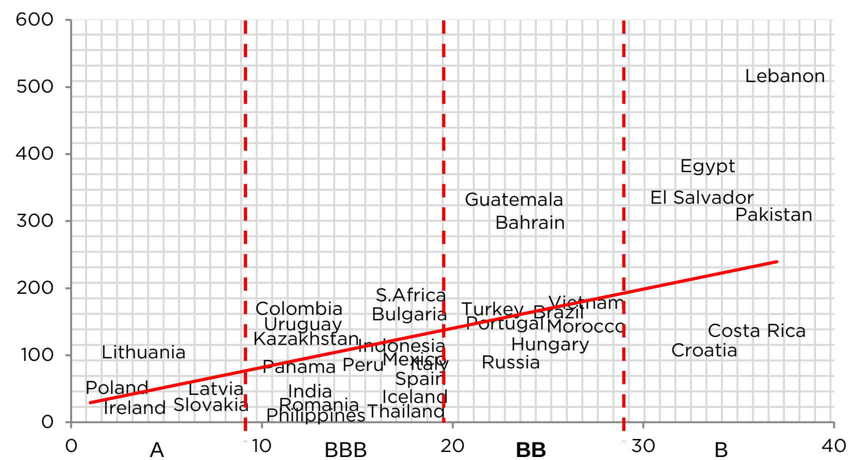

*Source: Bloomberg*

## CPI & CA Balance




*Source: Bloomberg*

## CDS vs Sovereign Ratings (bps)




*Source: Bloomberg, 29 Dec 2017*

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# Ratings…

## Rating agencies have sceptical view on Turkey …

- Moody's sees the 2018 outlook for Turkish companies as negative due to limited clarity on policy direction, reform fatigue, and high volatility.
- Fitch Ratings highlighted that the investigations by U.S. authorities into a group of Turkish figures accused of violating sanctions on Iran could put Turkish banks' ratings under pressure if the situation were to escalate. Fitch warns that if there was a case of reputational damage resulting in diminished access to capital markets or a large fine that wasn't offset by the state support; it could result in negative rating pressure on banks.
- With the glass half-full, rating agencies underline;
  - *most of the Turkish corporates have 'good track record of operating in a challenging environment*
  - *export-oriented manufacturing companies will see growth opportunities as demand in Europe increases and TRY remains competitive*
  - *Turkish banks will continue to have good funding market access in 2018 and be able to largely roll over their foreign debt service*
  - *Also, Turkish banks' capital buffers make them well placed to absorb further moderate shocks.*

## Turkey Sovereign Ratings

| Fitch | Moody's | S&P | Rating Status |
|---|---|---|---|
| A- | A3 | A- | Investment Grade |
| BBB+ | Baa1 | BBB+ | |
| BBB | Baa2 | BBB | |
| BBB- | Baa3 | BBB- | |
| **BB+ (Stab)** | **Ba1 (Stab)** | BB+ | Junk Status |
| BB | Ba2 | **BB (Neg)** | |
| BB- | Ba3 | BB- | |
| B+ | B1 | B+ | |

*Source : Rating Agencies*

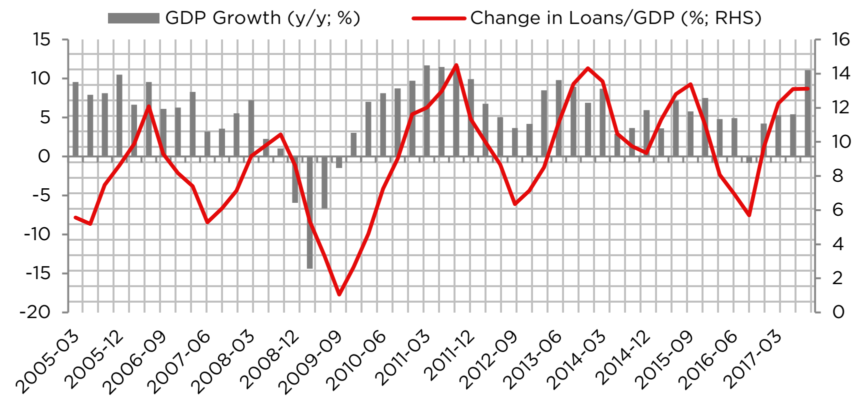
GLOBAL SECURITIES

# GDP Growth : A stellar performance in Q3

## Growing faster than China and India…

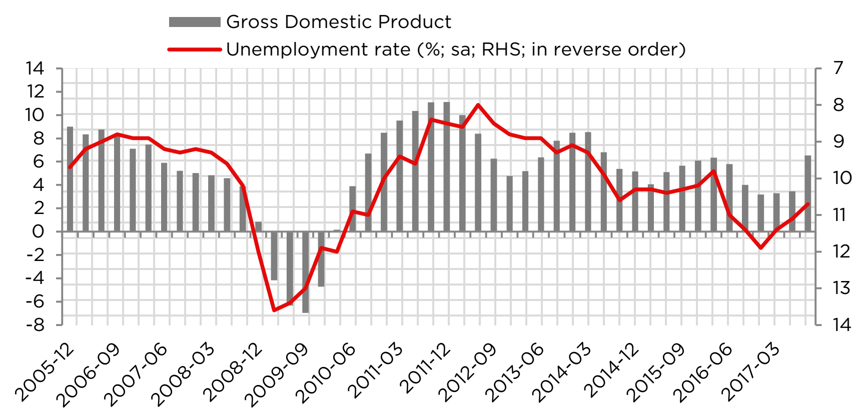
- GDP growth surprised on the upside in Q3, coming in at a whopping 11.1% YoY and 7.4% YtD. This impressive result has made the country's growth the fastest among G20 whereas China came in second with 6.8% and India was third with 6.3%. Sub-items were strong across the board. The main contribution came from exports which rose by 17.2% YoY in Q3. Also, the rebound in machinery and equipment investment, which grew by 15.3% YoY was good news in terms of demand composition of growth, though having come from a suppressed base.
- One should not rule out that stimulus measures and base effects were the key drivers of this stellar performance. To remind, the government decided to deploy a comprehensive stimulus pledge to accelerate the GDP growth through injecting some steroids such as the TRY250bn credit guarantee fund (CGF), wage subsidies, cuts in bank provisions and VAT on durables, and flexible due dates for tax and social security payments.
- Following the consumption driven growth in 2017, the government expects investments to take the driver seat at some point, and lead the growth going-forward. True, the robust growth in 2017 may require manufacturing sector to begin inventory restocking which could pose a catalyst for private investments next year. Inventory restocking can only materialize if consumer confidence picks up and the rebound in investment extends – all of which do not look that much easy given the current (geo)political risks and heightened tension with the U.S. led Western Block.
- We expect GDP growth at 4.3% in 2018 and 4.0% 2019, after ending 2017 at 7.0%.

## GDP Growth vs loans




Source: TurkStat

## Growth vs Unemployment



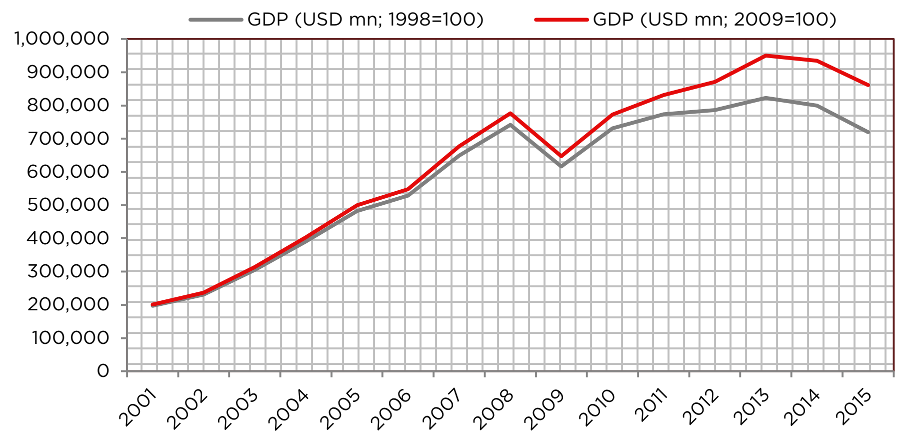

Source: TurkStat, CBRT, BRSA

# GDP : Higher in new methodology

## Will it last for longer?

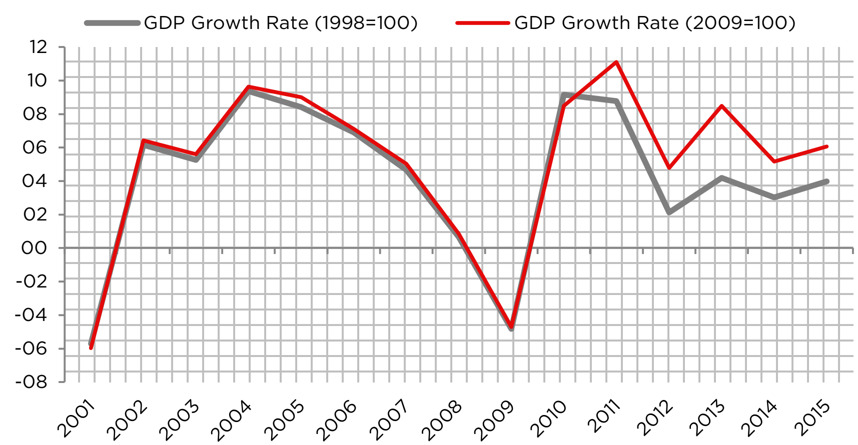
- The key question now is whether or not above-trend growth momentum will last in the medium term. The answer still remains unknown as the Turkish economy has followed a roller-coaster ride in the past several decades. Following an anaemic performance with severe imbalances in the 1990s and financial crisis in 2001, Turkey enjoyed five years of rapid economic growth, with GDP per capita increasing at almost 8%pa accompanied by structural changes, productivity growth and a broadening base of economic activity. From 2007 onwards, however, growth slowed significantly and productivity stagnated in all metrics. Then, Turkey entered into a well-known 'stop-and-go' cycles so typical of emerging economies.
- Constrained household incomes, an ageing work force and over-dependence on external financing sluggish investment will likely suppress the potential growth given the entrenched structural constraints, i.e. low savings rates, declining productivity and labour market inefficiencies. Also, the growth-inflation paradigm has been doing badly due to heightened inflation risks while Turkey's CAGR GDP of 7% during 2013-2017 apparently contradicts with the seasonally adjusted increase in unemployment rate to 10.6% from 8.8% over the same period. Against this backdrop, tight money/loose fiscal policy mix would be ultimately growth negative should the sugar-rush stage of the CGF facility fade into the rear view mirror.
- Delaying structural reforms (i.e. labour market, tax and pension systems) remain as main hurdle for growth prospects. Hence, the economic rebound would unlikely last without key structural reforms. In fact, reform fatigue and unpredictable currency dynamics have undermined Turkey's productive capacity and increased its reliance to external financing which damages private sector income statements. We therefore expect the fiscal accommodation to remain operational till at least the 2019 elections.

## GDP Revision




*Source: TurkStat*

## New series looks more volatile




*Source: TurkStat*

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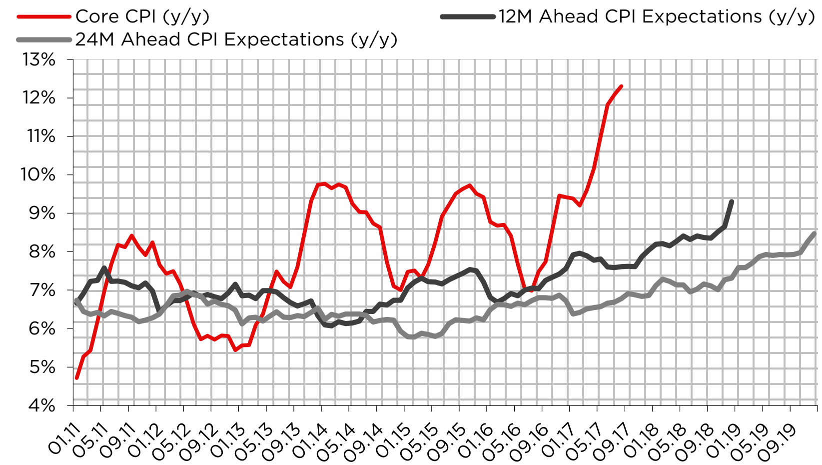
# Inflation genie out of the bottle ?

## Inflation risks continue to flash on investors' radar

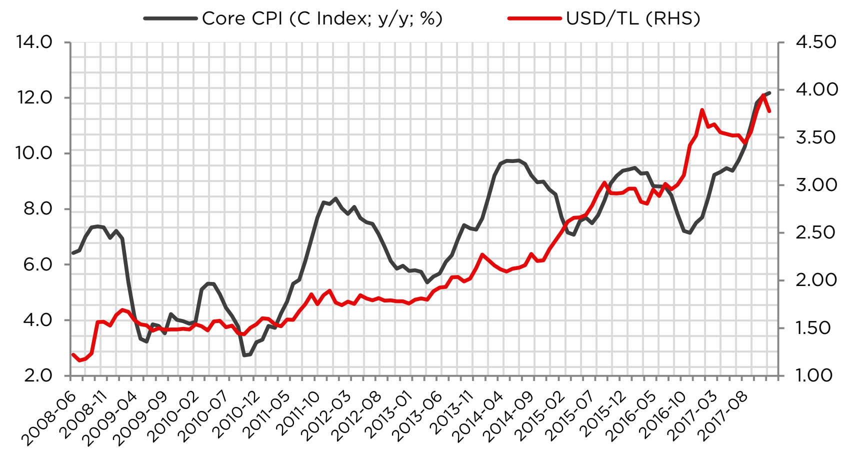
- CPI ended 2017 at 11.92% YoY after having climbed to all-time high of 12.98% YoY in November in series' 14yr history, exceeding the CBRT's revised year-end estimate of 9.8%. On the cost-inflation side, domestic PPI (excl. agriculture) came in at 15.47% YoY, indicating 355bps spread between PPI and CPI and thus posing further cost-push inflation pressures to final prices.
- True, CPI peaked at the 13% in November. Also, supportive base-effects could further soften the headline CPI; but this is not to say that the outlook would become comfortable any time soon. Rather, markets should remain in the period of questioning the CBRT's forecast of 7.0% for end-2018, judging by increasing inflation expectations across the forecast horizon 2017-2019. We believe that inflation will not only rise above the CBRT's target centre at 7.0% this year (already a reality now), but will also threaten the 9.0% target ceiling. We expect the headline CPI to come in at 9.4% by end of 2018, before slowing to 8.5% in the end-2019.
- The CBRT has done the right move by adopting a tighter stance. However, the elevated inflation supported our view that price pressures are likely to stay with us for a while longer. Indeed, there are five fundamental reasons to be on alert in inflation: a) 'core measures' are still exposed to upside risks; b) despite the recent easing, currency pressures could continue to pass-through to CPI in the forthcoming period; c) on-going 'credibility gap' in inflation targeting may be further embedded in expectations against the risk of inflation overshooting, d) this should add to 'price stickiness', and e) the risk of an 'expectations-driven inflation spiral' is now on the table.

## Core Inflation vs. Expectations




*Source: CBRT, Global Securities*

## Core CPI vs. USDTRY




*Source: CBRT, Bloomberg*

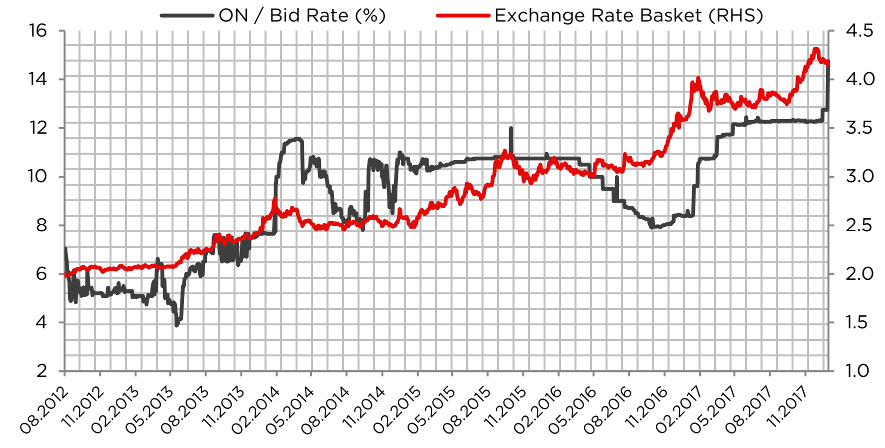
GLOBAL SECURITIES

# The CBRT delivered 444bps unorthodox rate hike in 2017

## Liquidity tightening: A panacea for inflation problem ?

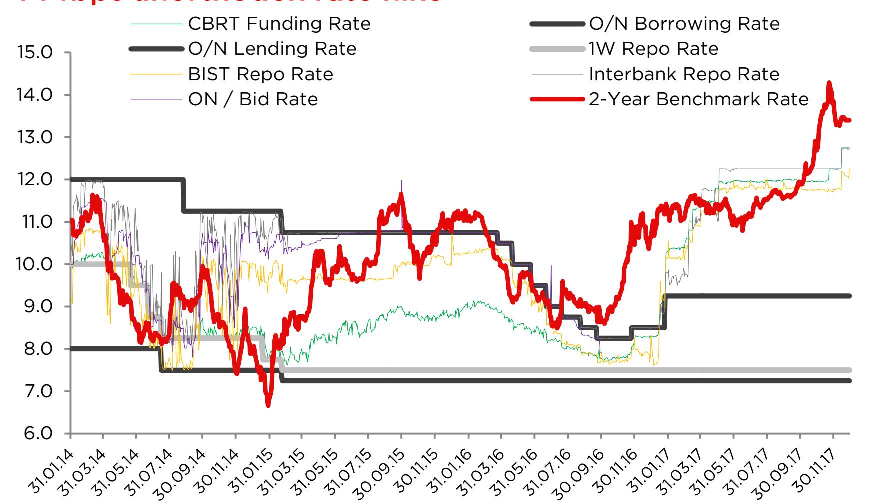
- The CBRT delivered a total of 444bps hike in the effective funding rate in 2017 particularly through Late Liquidity Window (LLW).
- Looked at with a glass half full, the CBRT's efforts of intervening inflation pressures via FC swaps/forward deals and LLW facility could be interpreted as a signal that the tolerance for weaker exchange rates has already run out given the heightened FX pass-through effects to inflation. With the glass half empty, however, it can also be interpreted that the CBRT categorically resists adopting orthodox tightening, but rather is inclined to go along with temporary tight liquidity measures against reflationary forces.
- In fact, the CBRT is rather chasing two rabbits: supporting activity on one hand and fighting currency/inflation pressures on the other hand; but, things get more complicated with inflation risks rising further and growth showing signs of entering the overheated territory.
- We feel monetary and fiscal policies are forced to walk the tightrope. This is however a very difficult task to carry out for too long because the government induced growth resulted in challenging macro imbalances such as double digit inflation, deteriorating CPI expectations and pricing behaviour, flattening(-to-slightly inverting) yield curve, and widening CAD.
- The CBRT is contented itself with derivative deals in FC market, liquidity management, and verbal intervention channels. Nevertheless, if selling pressures on the TRY were to intensify further, these steps would remain insufficient to provide meaningful protection for the TRY against potential bearish unwinds.

## Interest rate vs. exchange rate




*Source: CBRT*

## 444bps unorthodox rate hike




*Source: CBRT, Global Securities*

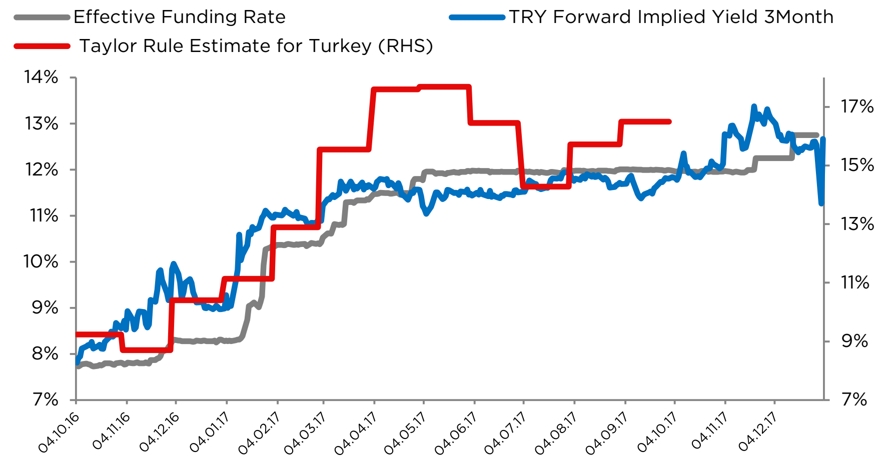
GLOBAL SECURITIES

# … coast is not yet clear…

**Yet, the bar has been set high for firing heavy bullets…**

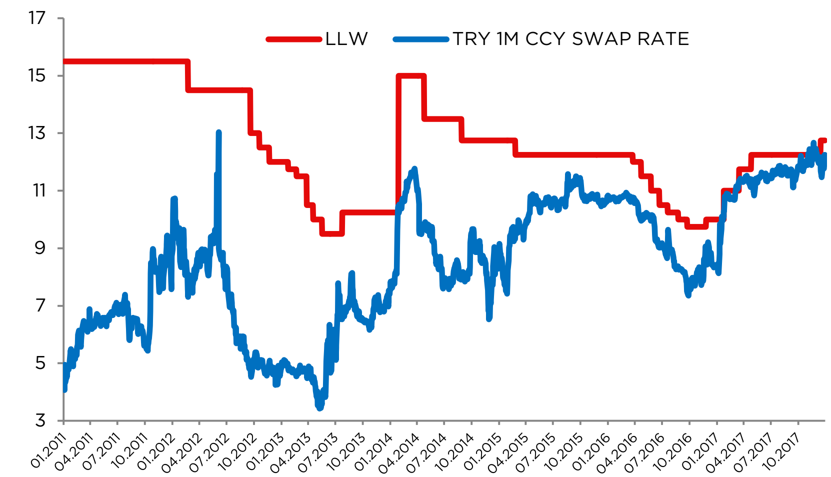
- The CBRT's decision to deliver additional monetary tightening was a welcome move for many after a string of increased currency volatility late 2017. Nevertheless, it is not a game changer and is unlikely to bring any more than a 'temporary relief' on the currency front.
- We maintain our key take-outs from moves by the CBRT:
  - Market conditions are likely to drive the next move
  - The Bank will modify its unconventional policy mix against uncertain financial market conditions and unleash 'light bullets' from its conventional arsenal (i.e. adjustments in i/rate corridor)
  - However, the bar has been set rather high for firing 'heavy bullets' in the baseline scenario (i.e. orthodox rate hikes)
  - The CBRT will switch to 'crowd control' mode and deliver further rate hikes on in the LLW if risk-off sentiment was to dominate markets
  - The door for further rate hikes will be opened NOT by 'the CBRT itself' but by potential 'market sell-offs' - as is the case currently.
- We stick to our core view that Turkey needs 'more conventional dose' and 'orthodox stance' to tackle the currently growing imbalances given GDP growing above the long-run trend and indicating signs of overheating, CAD widening by stealth, external debt accumulating, and risks to inflation expectations remaining skewed to upside.
- While the CBRT categorically resists adopting orthodox policy stance, the heightened currency and inflation pressures may keep the door open for further rate hikes in the forthcoming MPC meetings if CPI decisively navigates at the double digit territory. Simply put, the CBRT may 'bite the bullet', if 'expectations-driven inflation spiral' were to become undeniable.

## TRY Expected Depreciation Path (bps)




*Source: CBRT, Bloomberg*

## Swap rate vs CBRT LLW rate (%)




*Source: CBRT, Global Securities*

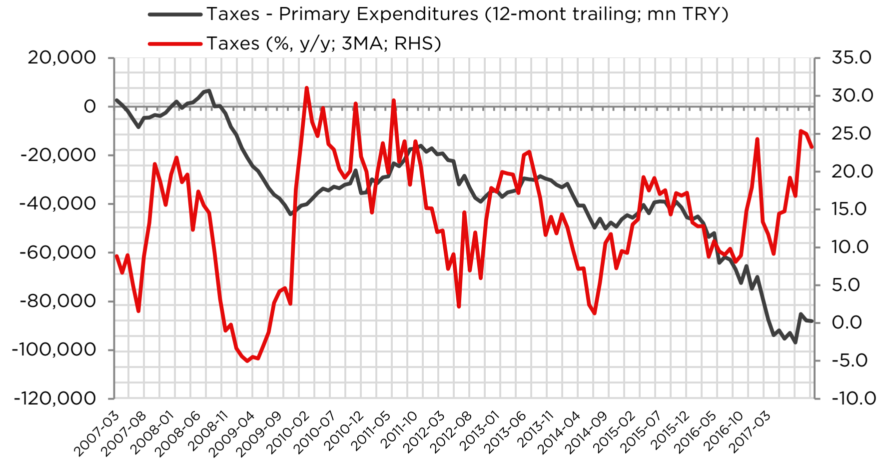
GLOBAL SECURITIES

# Fiscal Policy : No longer a strong anchor

## Budget remains under spending pressure despite one-off measures

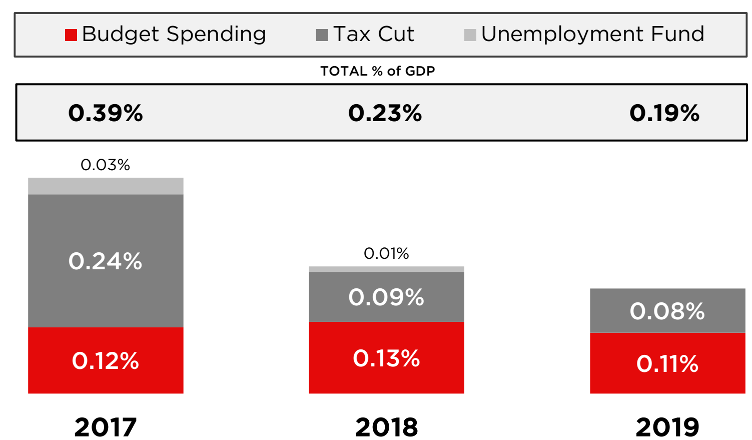
- We expect budget deficits to reach 2.3% of GDP in 2017 from 1.1% of GDP in 2016 alongside with the stimulus measures becoming visible on the fiscal front. Recall, the government introduced a long list of stimulus measures early 2017, which should provide an upward drift to the Turkish economy as much as 0.8% of GDP during 2017 – 2019, 0.4ppt of which is calculated to have materialized in 2017. The rest is expected to be effective during 2018 – 2019, with 0.2ppt for each year. While claiming that half of the stimulus package is one-off, it should bring a total of TRY26.3bn burden on the central government budget over the next three years.
- Turkey’s public debt-to-GDP ratio should however remain at around 30% of GDP amid the 20% upward revision in GDP series. That said, fiscal outlook does not offer safe haven as long as Treasury provides generous guarantees for mega projects undertaken by private sector. Together with planned Sukuk issuance of TRY9.3bn for Vakifbank’s stake transfer to Treasury at current prices, the total amount of guarantee is said to reach TRY460bn which, if included in public accounts could push public debt-to-GDP to 45%.
- The government has introduced a restructuring scheme for tax arrears and other public receivables amounting to an enormous TRY120bn, and raised a cumulative TRY23bn over the last two years. This is a familiar theme for Turkey. Indeed, Turkey experienced a similar story several times in the last decade. Each time, the government had a good start for the collection of public arrears, but the process did not operate as efficient as was hoped for because it lent weight to expectations that Turkish policy-makers would launch new restructuring schemes. Past episodes of the restructuring of public receivables backfired as they left tax-payers more reluctant to fulfil their regular tax obligations on time. The latest restructuring scheme is one of the many! Rather, it may lead to a tendency to pay dues at a later stage.

## Fiscal loosening




*Source: Ministry of Finance*

## Stimulation measures (% of GDP)




*Source: Ministry of Finance*

# Sovereign wealth fund : A saviour or wrong prophet ?

**Turkey has transferred stakes worth billions of dollars in major state-owned companies to wealth fund**

- The estimated value of the transferred assets to be as much as TRY50bn at market value, according to our rough calculations and local media. The government aims to manage USD200bn in assets in the future.
- The fund will be able to use the stakes as 'collateral' to secure funding for giant 'infrastructure investments'. That means that the companies transferred to the sovereign wealth fund won't be able to independently decide on their own investment and dividend policies but rather will be automatically required to finance public infrastructure investments.
- Sovereign Wealth Fund could build up a 'securitization mechanism' and issue 'asset-backed securities' to support mega infrastructure investments.
- The fund is more akin to a national development bank, with its design suggesting an effort to create a funding vehicle by leveraging up assets.
- Sovereign wealth funds are generally used by commodity-exporting countries to enable them to save a portion of their large external surpluses to hedge against commodity price falls. Turkey doesn't fit into this category, as she is not a country generating external surpluses nor is a commodity exporter. Hence, "the design of Turkey's sovereign wealth fund suggests an effort to create a funding vehicle by leveraging up public/private assets".
- Investor community could become seriously concerned over public finance, long-term productivity and growth potential, if this policy were to hit institutional independence, transparency and accountability in the public sector as a whole.

| Company name | State % |
|---|---|
| Ziraat Bank | 100.0% |
| Halkbank | 51.1% |
| Borsa Istanbul | 73.6% |
| Petroleum Pipeline Corporation (BOTAS) | 100.0% |
| Turk Telekom | 6.9% |
| National Lottery | 100.0% |
| TURKSAT | 100.0% |
| Turkish Airlines | 49.1% |
| Turkish Post and Telegraph Organization (PTT) | 100.0% |
| National petroleum producer Turkish Petroleum -TPAO | 100.0% |
| Izmir Port, Sugar & Tea Factories, Mining Facilities | 100.0% |
| State-run broadcast TRT | 100.0% |

*Source : Local media*

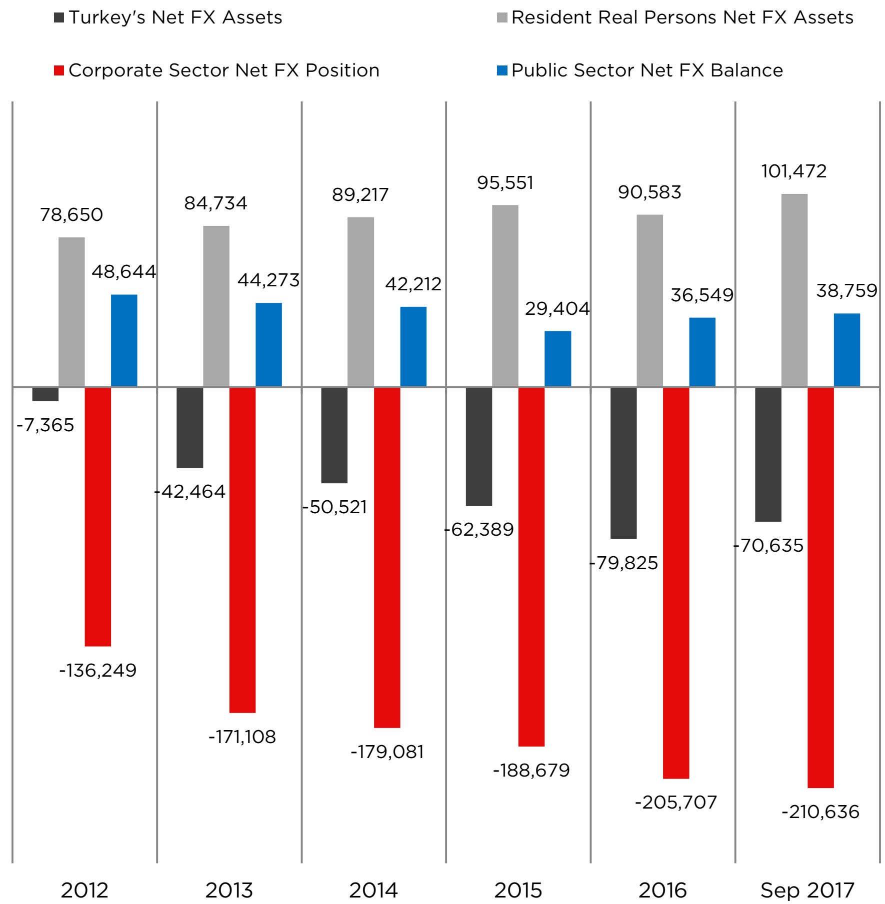
- Along with audit-free structure and a complicated financing structure, the Fund may pave a way for the destruction at the country's fiscal discipline even if this is not a close call.
- S&P was watching the extent to which the wealth fund would get access to a share of social security system revenues.

# Currency Outlook: Struggling with a big currency mismatch yet

## External financing: A sword of Damocles

- The strained relations with the U.S. and EU-block may be slowly boiling over to the Turkish economy and TRY markets if the current political pressure on global lenders were to reduce funds flow to Turkey. While the resolution of the visa spat is indeed good step in a way to cool-off the heightened tension between Turkey and the United States, and thereby removed some of the pressure on TRY crosses, the coast may soon be clear to become comfortable about outlook for the currency market.
- To remind, the German government's call for cutting funding to Turkey from the country's state-owned KfW bank, EIB and EBRD has put external fund-addicted Turkish economy at odds given its USD200bn plus financing problem, corporate sector FX mismatch of USD211bn and weak FX reserve adequacy (i.e., External Liabilities falling due over next 12M to Gross CB FX Reserves stands at 148% currently, comparing with Moody's Ba1 median of 66%).
- Given such financing picture, the longer currency pressures stay high, the higher banks' non-lira financing costs that will end up with heightening credit and capital risks. Hence, any reduction in capital flows could stalemate the supply of credit, given external debt makes up almost 55% of GDP.
- While most of European banks have remained committed to their on-going financing deals in Turkey, investors have taken some discomfort from the latest discussions on Turkey's stellar banking relations with their global counterparts. Given the increased reliance on external financing, potential cut in international banks' exposure could result in a 'chilling effect' on balance of payments. We think this is a less likely outcome as the Western block has already greater integration with the Turkish corporate and banking sector.

## Turkey's Net FX Balance posts USD70bn deficit




*Source: CBRT, BRSA, TurkStat, Global Securities Estimates*

GLOBAL SECURITIES

# Turkey’s external financing burden falling due over the next 12-month

| (USD mn) | 2012 | 2013 | 2014 | 2015 | 2016 | 10M17 |
|---|---|---|---|---|---|---|
| **External Financing Needs (Next 12M)** | **192,153** | **231,315** | **210,398** | **191,954** | **192,855** | **215,347** |
| Current Account Deficit (12M trailing) | 47,961 | 63,621 | 43,597 | 32,118 | 33,010 | 41,904 |
| **Outstanding External Debt Due Over Next 12M** | **144,192** | **167,694** | **166,801** | **159,836** | **159,845** | **173,443** |
| CBRT | 3,777 | 2,639 | 1,376 | 487 | 826 | 671 |
| General government (incl. Eurobonds) | 4,589 | 4,877 | 4,929 | 4,320 | 6,113 | 6,934 |
| Banks | 75,298 | 99,522 | 107,454 | 95,560 | 91,937 | 96,531 |
| OW: Public | 11,196 | 17,605 | 18,287 | 16,933 | 19,373 | 18,666 |
| OW: Private | 64,102 | 81,917 | 89,167 | 78,627 | 72,564 | 77,865 |
| Funds Borrowed | 36,294 | 51,570 | 60,861 | 53,741 | 49,290 | 51,695 |
| FX Deposit Account | 8,768 | 11,507 | 13,120 | 14,821 | 13,231 | 15,130 |
| Bank Deposits (Off-shore) | 18,588 | 25,390 | 20,068 | 17,387 | 17,251 | 18,086 |
| TRY Deposits (Off-shore) | 11,648 | 11,055 | 13,405 | 9,611 | 12,165 | 11,620 |
| Non-bank Corporates | 60,528 | 60,656 | 53,042 | 59,469 | 60,969 | 69,307 |
| Trade Credits | 26,390 | 32,325 | 31,855 | 33,145 | 36,440 | 43,169 |
| Short-term debt due to imports | 22,084 | 27,828 | 27,744 | 29,459 | 32,773 | 39,193 |
| Pre-export financing | 4,306 | 4,497 | 4,111 | 3,686 | 3,667 | 3,976 |
| Other Credits | 34,138 | 28,331 | 21,187 | 26,324 | 24,529 | 26,138 |
| | | | | | | |
| Private sector | 124,454 | 142,341 | 142,018 | 137,957 | 133,185 | 146,884 |
| Banks | 64,102 | 81,917 | 89,167 | 78,627 | 72,564 | 77,865 |
| Factoring & Leasing | 7,393 | 7,900 | 6,914 | 7,741 | 7,644 | 6,987 |
| Non-financial Corporates | 52,959 | 52,524 | 45,937 | 51,589 | 52,977 | 62,032 |
| Public sector | 15,961 | 22,714 | 23,407 | 21,392 | 25,834 | 25,888 |
| OW: Banks | 11,196 | 17,605 | 18,287 | 16,933 | 19,373 | 18,666 |
| CBRT | 3,777 | 2,639 | 1,376 | 487 | 826 | 671 |
| | | | | | | |
| Loans & Deposits | 135,826 | 160,178 | 160,496 | 155,029 | 152,906 | 165,838 |
| Foreign Loans | 96,822 | 112,226 | 113,903 | 113,210 | 110,259 | 121,002 |
| Funds Borrowed | 36,294 | 51,570 | 60,861 | 53,741 | 49,290 | 51,695 |
| Trade Credits | 26,390 | 32,325 | 31,855 | 33,145 | 36,440 | 43,169 |
| Other Credits | 34,138 | 28,331 | 21,187 | 26,324 | 24,529 | 26,138 |
| Deposits | 39,004 | 47,952 | 46,593 | 41,819 | 42,647 | 44,836 |
| FX Deposit Accounts | 8,768 | 11,507 | 13,120 | 14,821 | 13,231 | 15,130 |
| Off-shore Accounts | 30,236 | 36,445 | 33,473 | 26,998 | 29,416 | 29,706 |
| OW: TRY Denominated | 11,648 | 11,055 | 13,405 | 9,611 | 12,165 | 11,620 |
| | | | | | | |
| CBRT Net Foreign Assets | 43,743 | 39,255 | 39,361 | 28,252 | 34,100 | 37,187 |
| CBRT Reserves (Excl Gold) | 100,320 | 112,002 | 106,314 | 92,922 | 92,050 | 95,480 |

*Source : CBRT, Global Securities*

# FX Balance : Improved but struggling with a big currency mismatch

- The USD200bn plus external financing requirement has been the '*weak link*' with the overall currency mismatch, though it eased to USD70bn in 3Q 2017 from USD80bn at the end of 2016, according to our estimates (excluding medium-long term external debt of the state sector). Note that corporate sector's currency mismatch remained steady at around USD210bn +/- after having peaked at USD215bn in September 2016.

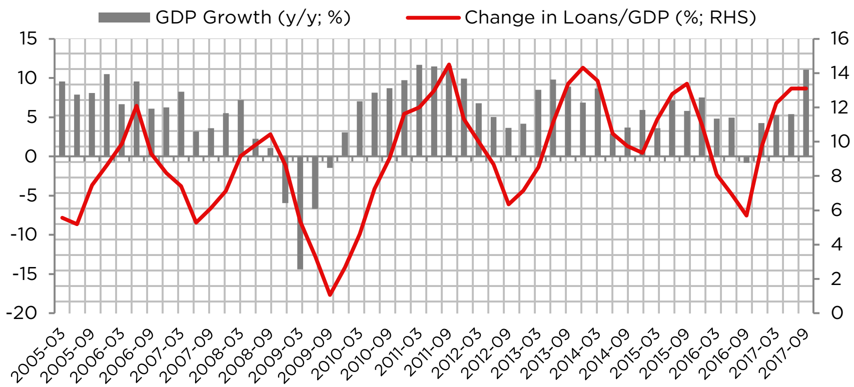
| (USD mn) | 2012 | 2013 | 2014 | 2015 | 2016 | 31Q17 |
|---|---|---|---|---|---|---|
| Turkey's Net FX Assets* | -7,365 | -42,464 | -50,521 | -62,389 | -79,825 | -70,635 |
| *Including Non Resident Real Persons* | *41,279* | *1,809* | *-8,308* | *-32,985* | *-43,276* | *-31,876* |
| Resident Real Persons Net FX Assets** | 78,650 | 84,734 | 89,217 | 95,551 | 90,583 | 101,472 |
| Resident Real Persons FX Assets*** | 79,198 | 85,057 | 89,413 | 95,671 | 90,658 | 101,544 |
| FX Deposits | 68,138 | 73,928 | 81,458 | 91,025 | 84,917 | 95,005 |
| Precious Stones Deposit Accounts**** | 9,655 | 9,574 | 6,580 | 3,463 | 4,506 | 5,391 |
| Eurobonds | 1,405 | 1,555 | 1,375 | 1,184 | 1,235 | 1,148 |
| FX Indexed Government Securities | 0 | 0 | 0 | 0 | 0 | 0 |
| Resident Real Persons FX Liabilities | 548 | 323 | 196 | 120 | 75 | 72 |
| Consumer Loans Indexed to FX | 510 | 278 | 160 | 92 | 47 | 33 |
| Credit Cards FX | 38 | 44 | 36 | 28 | 28 | 39 |
| Corporate Sector Net FX Position | -136,249 | -171,108 | -179,081 | -188,679 | -205,707 | -210,636 |
| Banking Sector Net FX Position | 1,590 | -363 | -2,869 | 1,335 | -1,250 | -230 |
| Central Bank Net Foreign Assets | 43,743 | 39,255 | 39,361 | 28,252 | 34,100 | 36,479 |
| Public Sector FX Deposits | 5,077 | 5,250 | 3,043 | 1,291 | 2,797 | 2,570 |
| Public Sector External Debt due over next 12M | 176 | 232 | 191 | 139 | 348 | 290 |

** Excl Non Resident Real Persons and Medium-Long Term Public Debt ** Incl Participation Banks and Gold Accounts *** Incl Participation Banks **** USD, incl Participations*

*Source : CBRT, BRSA, TurkStat, Global Securities Estimates*

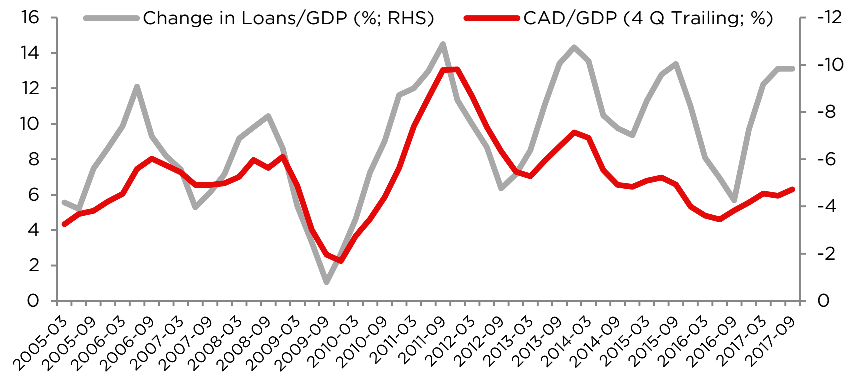
# Current account deficit widens in accordance with growth…

## Loan growth drives economic activity



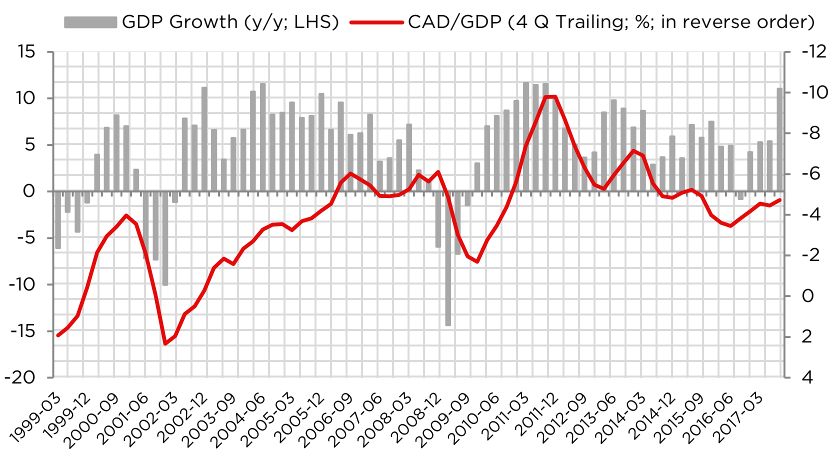

*Source : CBRT, TurkStat*

## …and current account deficit



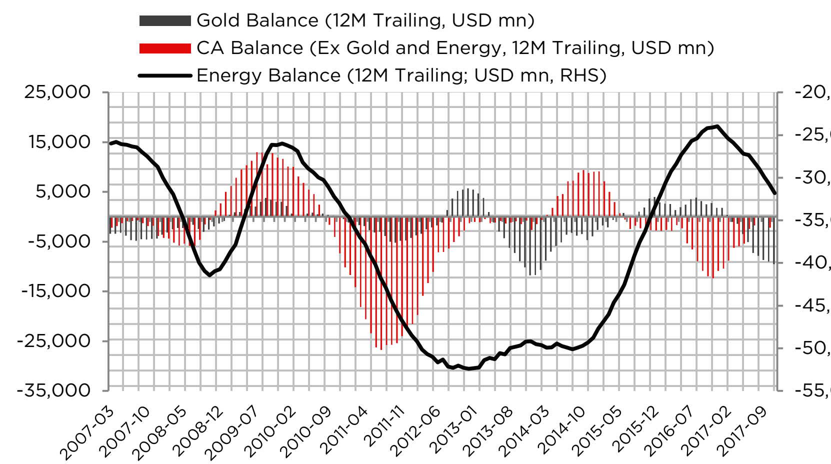

*Source : TurkStat, CBRT*

## CA Deficit vs. GDP Growth




*Source: CBRT, TurkStat*

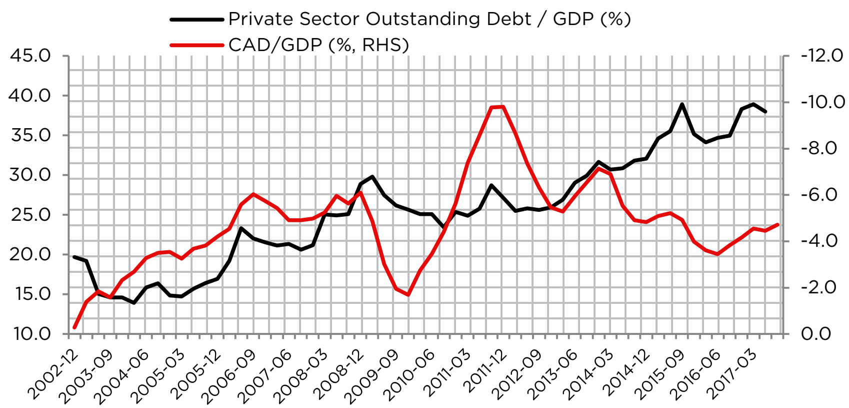
## Energy imports weigh on CA, core deficit widens




*Source: CBRT, TurkStat*

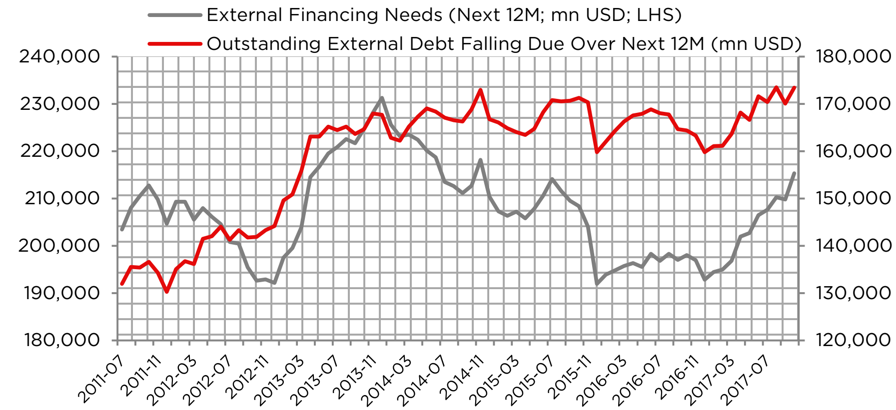
# External financing : Imbalances become visible

## Private sector debt accumulates



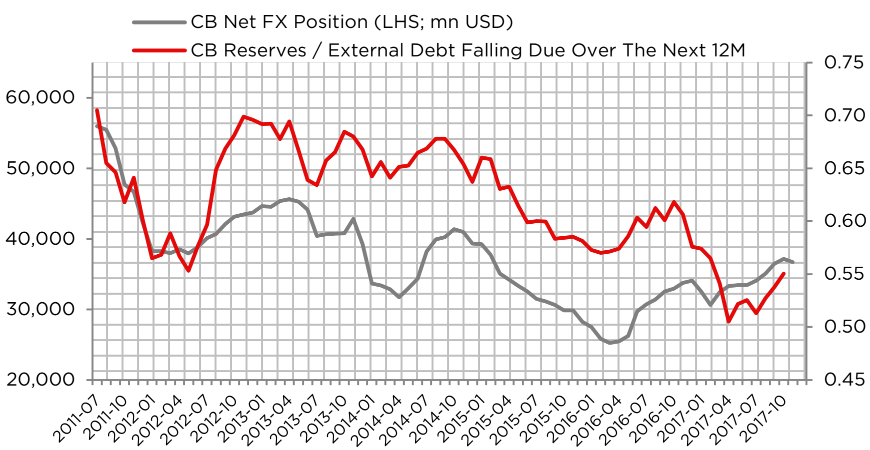

*Source : CBRT, TurkStat*

## External financing needs reach USD215bn



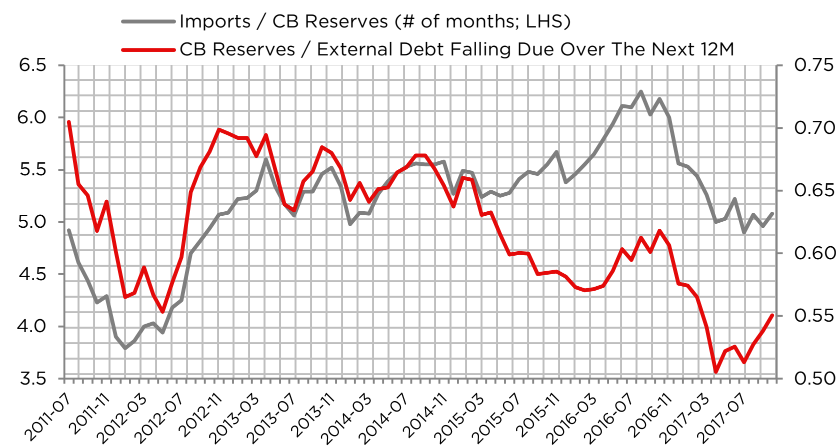

*Source : TurkStat, CBRT*

## CB Reserves vs External Debt Service




*Source: CBRT, BRSA*

## Reserve evolution remains weak vs external debt

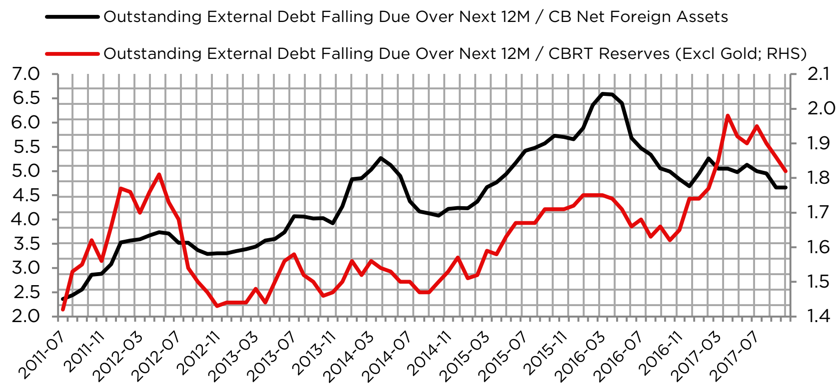



*Source: CBRT, BRSA*

GLOBAL SECURITIES

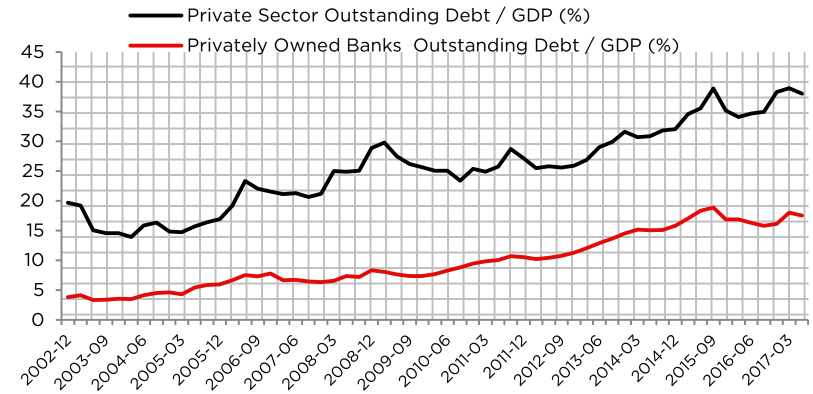
# External debt accumulates continuously…

## External debt vs. CB net foreign assets



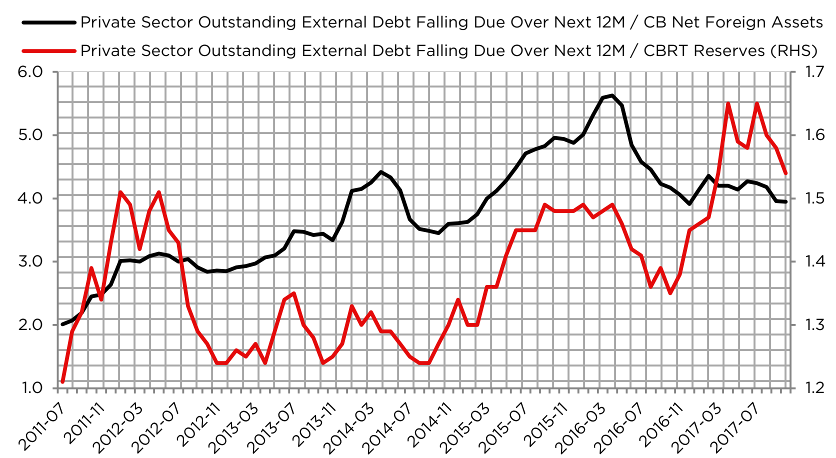

*Source : CBRT, TurkStat*

## Banks' outstanding external debt



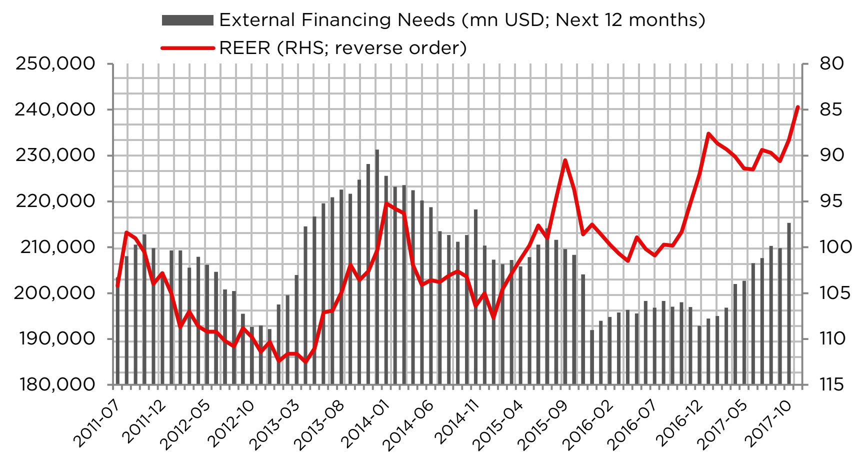

*Source : TurkStat, CBRT*

## Private sector is not willing to borrow more




*Source: CBRT, BRSA*

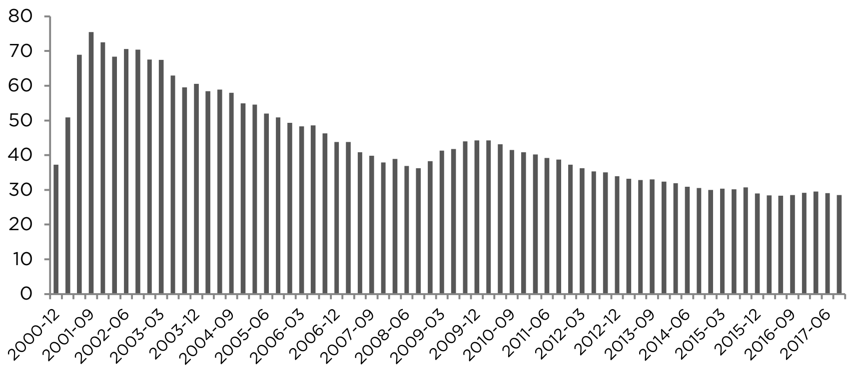
## External debt service drives REER




*Source: CBRT, BRSA*

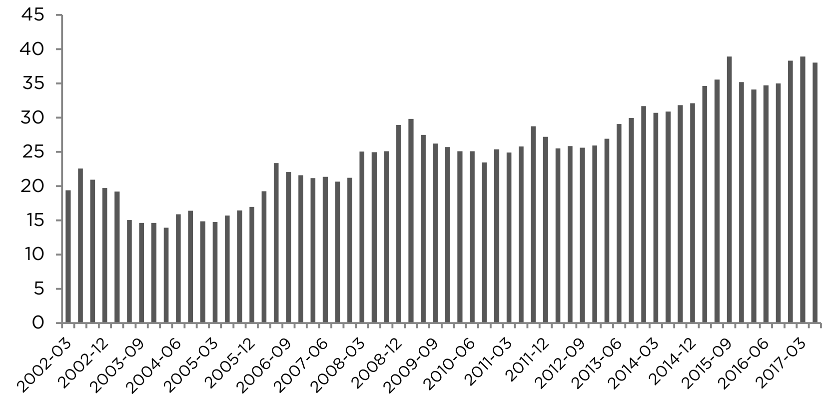
# Turkey's outstanding debt : Accumulating

## Central Government Outstanding Debt/GDP (%)



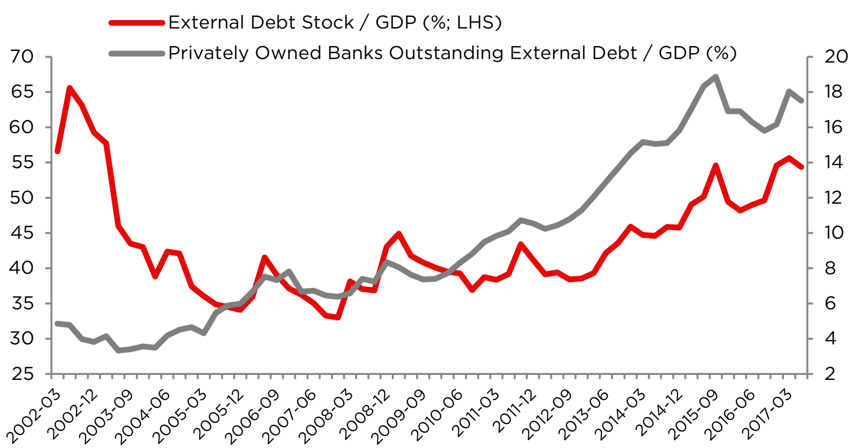

*Source : CBRT, TurkStat, Turkish Treasury*

## Private Sectort External Debt/GDP (%)



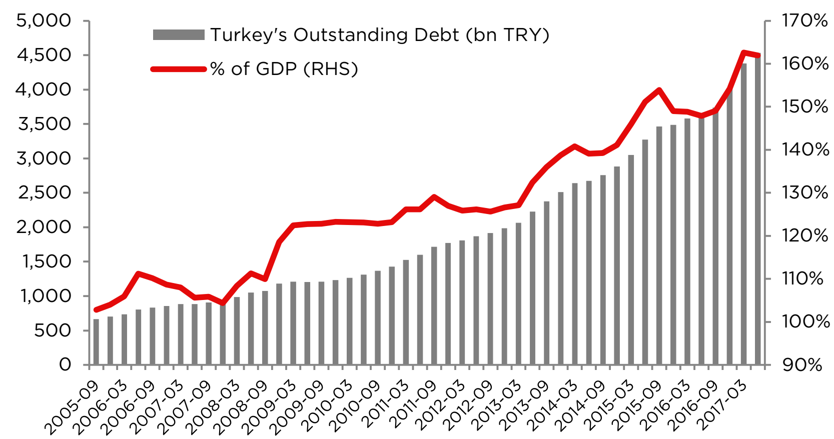

*Source : CBRT, TurkStat, Turkish Treasury*

## External Debt / GDP




*Source: CBRT, TurkStat, Turkish Treasury*

## Turkey's Outstanding Debt




*Source: CBRT, TurkStat, Turkish Treasury, Global Securities*

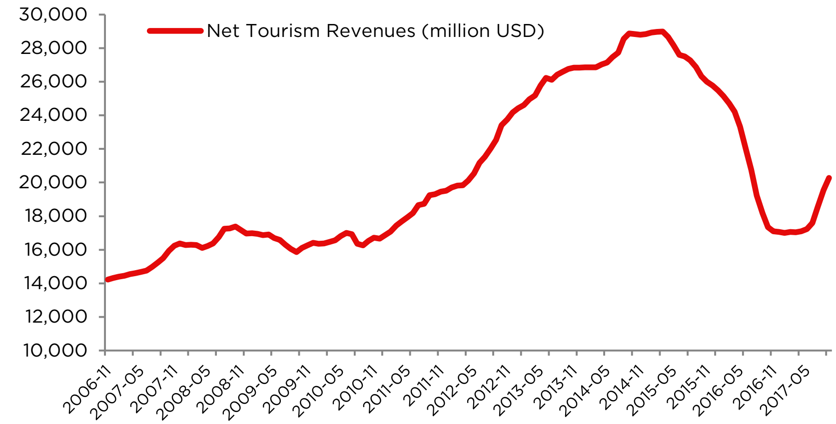
GLOBAL SECURITIES

# Tourism : A saviour?

## Growing demand signals bright tourism season in 2018…

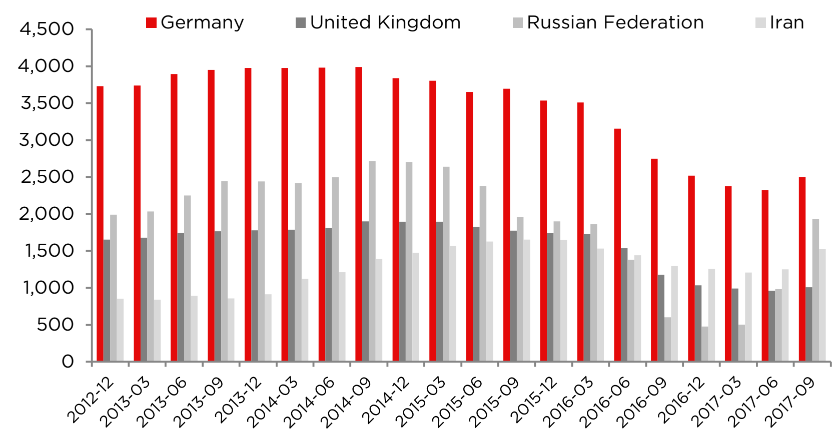
- Recall, the number of foreign tourists visiting Turkey plummeted to 25.3 million in 2016, down from 36.2 million in 2015 amid a series of terror attacks, a failed coup attempt and a diplomatic crisis with Russia. These negativities slashed Turkey's tourism revenues in 2016 to USD22.1bn, down from USD31.5bn in 2015.
- In 2017, with 4.5 million arrivals, Russians were the number one nationality visiting Turkey, followed by Germans and Iranians. In 2016, 24.7 million foreign nationals visited Turkey, and in the first 11 months of 2017. This figure rose by more than 5 million. Also, Turkey sees visible increases in tourists from regional markets like Iran, Iraq, Georgia, and Bulgaria.
- Turkey expects 31.4 million tourists to visit by the end of 2017 with revenue of USD26bn. The ministry of tourism said that more than 35 million tourist arrivals are expected in 2018, nearly 41% of which is expected to come from European countries.
- One of the world's largest tourism agencies, TUI Group, announced that the demand for Turkey in 2018 has seen a 70% increase. The Agency expects a significant increase in 2018 - with Germans, Greeks, Dutch and Italians who have already begun early reservations for 2018. Also, the number of Russian visitors is expected to exceed 4.5 million in 2018.
- Note that tourism is composing of 3-3.5% of GDP and 10% of current account revenues.

## Tourism revenues




*Source: CBRT*

## Tourism revenues by countries




*Source: CBRT, Global Securities*

GLOBAL SECURITIES

# Oil prices : Not a significant risk factor for Turkey…

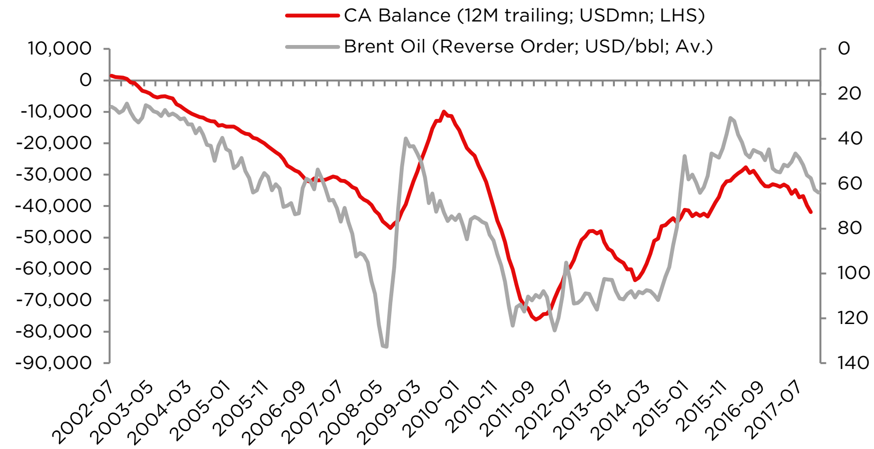
## Global inventory build up likely to help starting from mid 2018…

- Commodity prices have been generally firming, with Brent oil price in particular having surged by c.50% to USD66 per barrel, from last summer's low of USD44 per barrel. As a commodity/energy importer, the spike in oil prices clearly poses a challenge for Turkey's macroeconomic balances as higher import bill results in wider current account deficit, faster inflation and slower GDP growth.

- We assume that oil prices will average around USD58.5 per barrel in 2018 with the assumption of strong year-on-year growth in US shale oil supply, relatively slower global demand growth, particularly in China, and accompanying inventory build up.

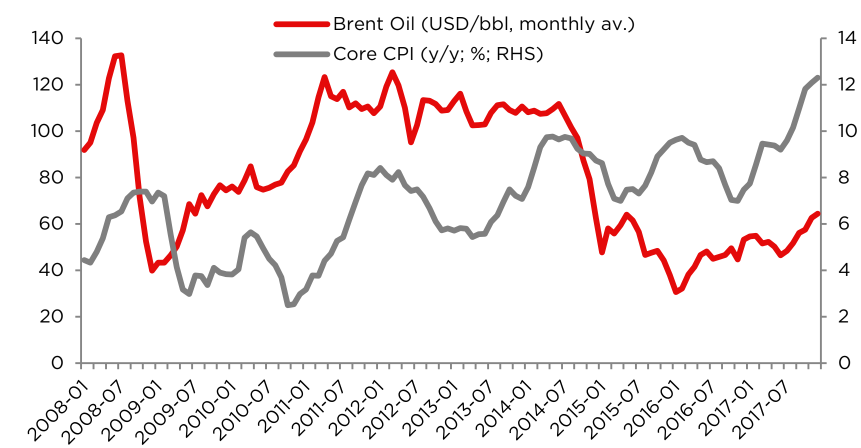
- Herein, it may be useful to recall our rules of thumb as regards the oil price impact on the Turkish economy: every USD10 change in the oil price moves up the energy imports bill by about USD4.5bn (or 0.5ppt of GDP), while every 10% increase in the local currency price of oil adds about 0.2 pp to the headline CPI.

## Oil prices vs. Current Account




*Source: CBRT*

## Oil prices vs. Core CPI




*Source: CBRT, TurkStat*

GLOBAL SECURITIES

# Credit market : All guns fired

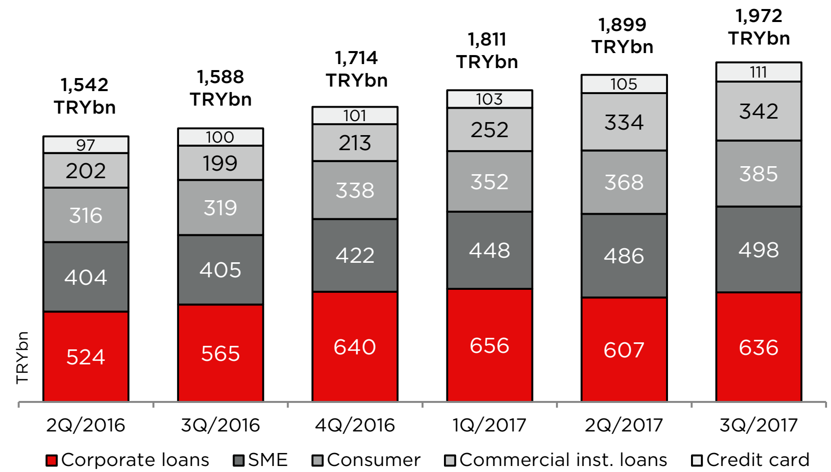
**Turkish banks have maintained a steady foot on the gas pedal and pressed on with the process of expanding core business…**

- In total lending, banks put more emphasis on corporate (+4.2% QoQ) and consumer loans (+4.7% QoQ) in Q3, while also expanding in SME (+3.3% QoQ), commercial instalments (+2.5% QoQ) and credit card (+5.5% QoQ) segments. Turkish lenders also advanced in FC lending, posting a c.1.8% QoQ growth in USD terms mainly driven by business loans in Q3.
- With the beginning of 3Q17, sector loan growth gradually slowed down and shifted to corporate, consumer and credit card segments. As the credit guarantee fund (CGF) provided much needed liquidity to the economy, the transfiguration to consumer and credit card lending seems natural for the system.

**TRY business lending activity mainly driven by the effective utilization of the credit guarantee fund (CGF)…**

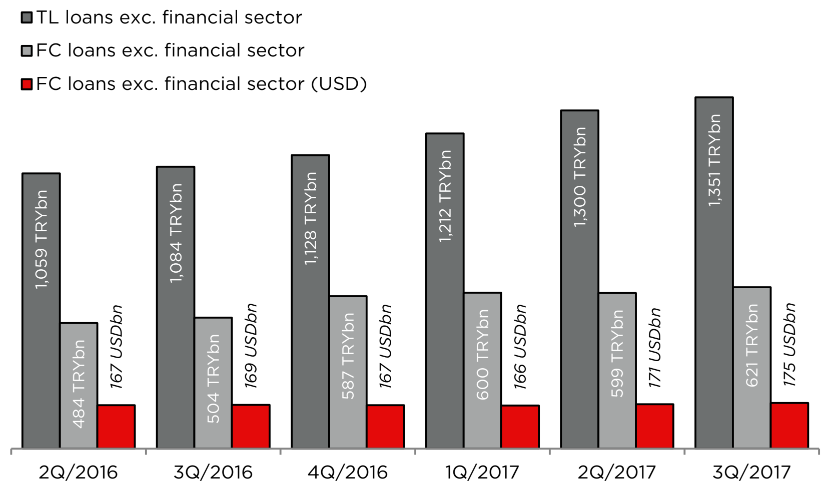
- Treasury-backed collateral facility aiming to give financing access to SMEs with insufficient collateral base went into force on Mar 10, 2017 with fresh TRY250bn (c.USD70bn) in credit line. While the credit guarantee fund (CGF) facility was particularly aimed at SMEs to ease their TRY40bn cash flow problem, the new fund should help the banking system accelerating the overall credit growth. This is however cyclical, not structural.
- Treasury's risk will be capped at 7% of the total credit facility, amounting to TRY17.5bn during 2017-2019. Treasury guarantee will likely help banks partially off-load NPLs from SMEs onto the public budget whereas lowering risk weights of SME loans. Banks have currently seen strong contribution of the CGF loans to asset quality i.e. CAR, CoR, and coverage ratios.

## Banking sector loans segment distribution




*Source: BRSA Weekly Figures*

## Banking sector loans currency distribution



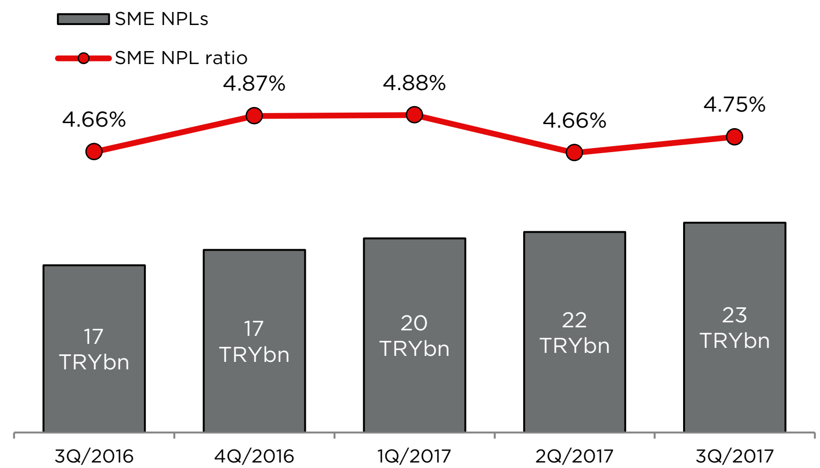

*Source: BRSA Weekly Figures*

# Credit guarantee fund has changed the game

## Enthusiasm for credit guarantee fund (CGF)...

- Some 347K clients have utilized TRY196bn of the overall CGF limit of TRY250bn and obtained TRY219bn cash loans as of mid-Oct 2017. The c.TRY157bn (c.87% of CGF) of the funds were granted as TRY loans while FC front remained below 15% of the funding scheme with TRY14.5bn EUR and TRY9.0bn USD loans in circulation as of mid-October. The FC portion of the CGF was mainly utilized as export loans. In details, some 50% of the credits were provided to trade (38%) and construction (13%), while 30% went to manufacturing. The SME share under this facility reached TRY164bn (74.6% of CGF). The majority of the remaining portion (25.4%) has been granted to non-SME entities. On the other hand, c.92.4% of the loans were used for 'working capital' needs while only 2.5% were for investments.
- The limit utilization for the guarantees has reached 78.6%. This has made up nearly c.12ppt of the c.18% YtD loan growth whereas the rest of the loan growth (non-CGF led portion) has been mainly driven by consumer (+14.7% YtD) and corporate loans (+5.62% YtD) as of mid 10M17. Herein, additional c.TRY50bn of guarantees remain untapped translating into c.TRY55bn of potential lending in the forthcoming period. Also, note that loan growth was at c.6% YtD as of mid 10M17, when excluding the CGF support.
- Tier1 banks' CGF lending book reached c.TRY100bn as of 3Q17. ISCTR, GARAN and AKBNK were the first banks to start granting CGF loans. In fact, these names led the CGF growth in 1Q17. With the beginning of Q2, the rest of the Tier I names effectively joined the scheme. Coupled with ISCTR, the state-run lenders VAKBN and HALKB led the CGF expansion in 3Q17. Sector loan expansion weighed dominantly on the CGF facility, and for most of the Tier I, names CGF growth surpassed total loan growth in Q2.

## Banking sector SME NPLs

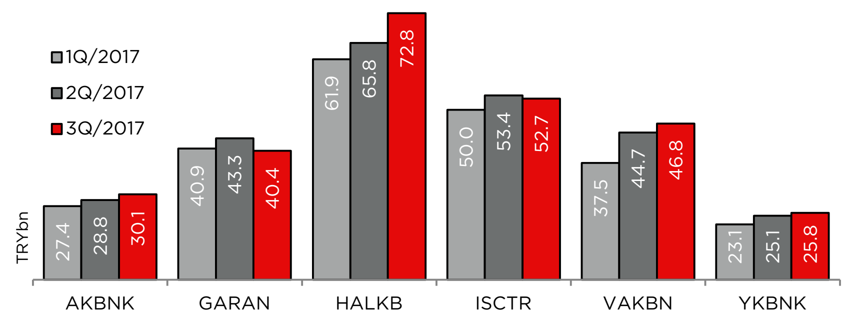



*Source: BRSA Weekly Figures*

## Teir 1 banks SME loan portfolio

**% of SME loans in total loans as of 3Q/2017**

| AKBNK | GARAN | HALKB | ISCTR | VAKBN | YKBNK |
|---|---|---|---|---|---|
| 16.9% | 20.1% | 37.8% | 23.0% | 26.9% | 14.0% |




*Source: Bank Presentations, Bank IR Departments*

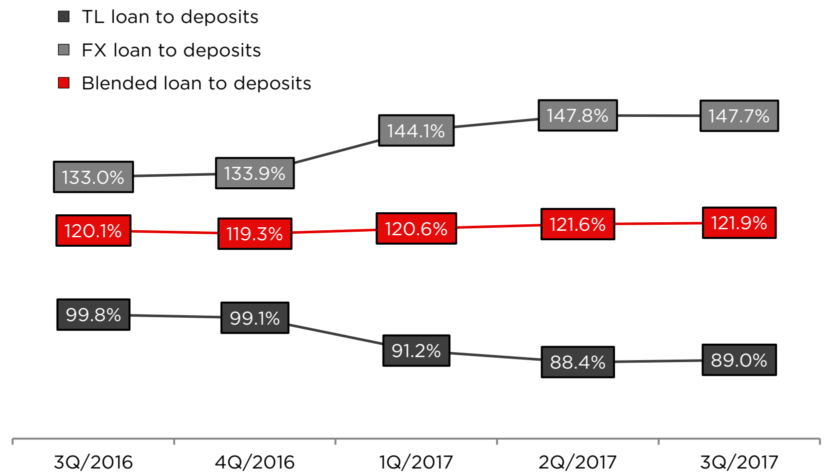
GLOBAL SECURITIES

# Credit guarantee fund puts weigh on financing side, though…

## The flip side of CGF lending is the cold-reality of financing costs…

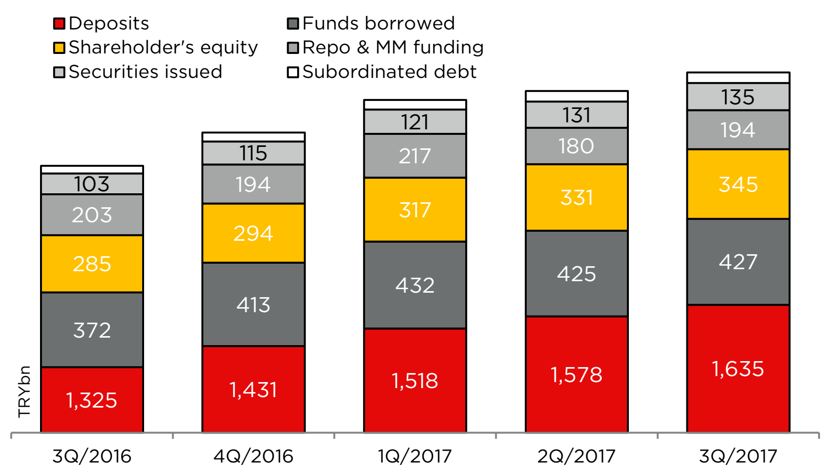
- Treasury-backed credit guarantee scheme has provided great potential to boost the loan book and maintained NIM evolution through an optimized RWA density and sustainable asset quality with manageable NPLs. Hence, the fund has added to banks' CAR and NPL ratios as well as profitability metrics while transferring the ultimate default/credit risk to the government.
- However, the CGF driven acceleration in TRY loan growth has put pressure on local currency liquidity and thereby resulted in increased cross-currency swap utilization to fund some part of loan book expansion. Hence, the funding side of the loan generation under the CGF facility have resulted in some negative implications on 2017 NI figures through heavy swap costs.
- Despite TRY funding squeeze, banks pressed on with the process of expanding core business alongside with the CGF scheme. Hence, TRY loan growth significantly outpaced TRY deposit growth, bringing TRY loan-to-deposit (LDR) ratio to historic high of 148% in 2017. Given the scarcity of TRY deposits, banks needed to convert excess FX deposits into TRY or access into foreign wholesale markets to fund their TRY loans.
- The sharp TRY loan growth was mainly funded by FX sources. This should have some adverse implications on the credit policy as: i) either banks should reduce their appetite to pursue further aggressive loan growth due to the funding constraints, or they will see further deterioration in TRY LDR ratios; (ii) while  banks have managed not to fully reflect the increased funding costs to loan pricing, deposit costs should remain higher due to TRY liquidity squeeze, resulting in NIM compression; and (iii) banks should continue to utilise CCY swaps as long as LDR remains far above 100%.

## Banking sector TL and FX loan to deposit




*Source: BRSA Monthly Figures*

## Banking sector funding distribution




*Source: BRSA Monthly Figures*

GLOBAL SECURITIES

# CGF lending continues, bad debt formation moderates…

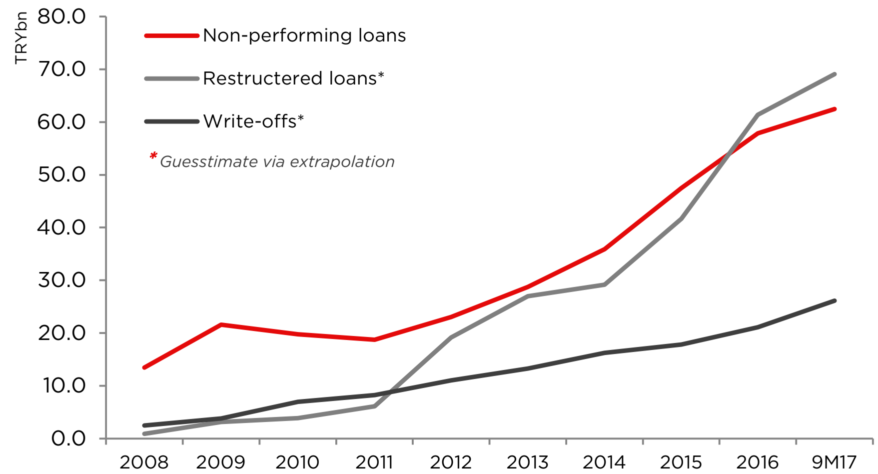
## An additional TRY100bn CGF loans likely to be provided in 1Q18

- While TRY liquidity squeeze and elevated LDR should at some point damage the credit growth in the near future, the CGF will be made permanent to counteract liquidity shortages and sustain recovery by revolvingTRY90bn CGF loans due in 2018 and deploying fresh TRY50bn to boost investments mostly in 1Q18. With this scheme, the government is planning to provide an additional TRY100bn (c.3% of GDP) to the economy as of end of 1Q18.

## NPL flows may bring the spotlight to business lending; but not now

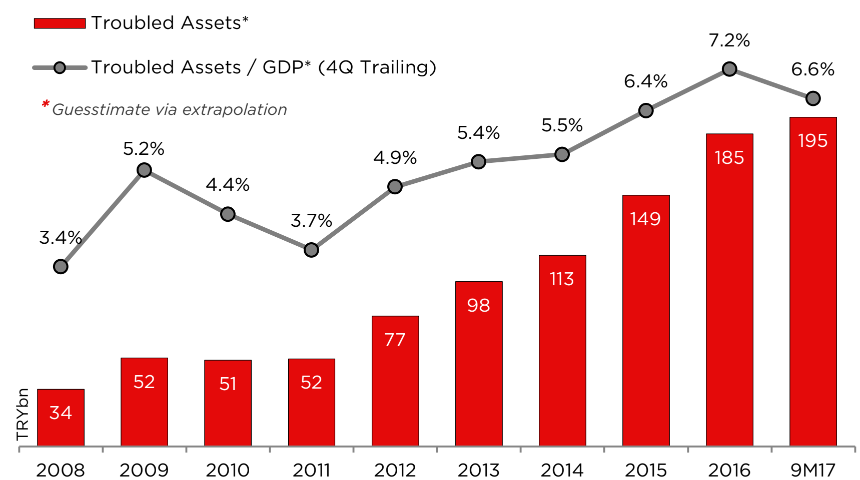
- Bank loans continues to show solid performance, growing by around 15% currently in 13-month FX and seasonally adjusted (moving average) terms after having surged by C.40% YoY during mid-2017. Banks' 'solid capital buffers' can absorb a rise in loan losses; but investors should not underestimate 'NPL problem' with TRY62.5bn bad loan book.
- Note that consumers and SMEs bear the big portion of the risk. Adding the over-due loans of TRY5.2bn in non-bank financial sector (such as factoring and leasing companies), the overall NPL problem in the Turkish financial sector reaches TRY67.7bn as of 3Q17. Coupled with 'bounced cheques' (TRY19.4bn) and 'protested bills' (TRY13.0bn), we see the 'troubled receivables in financial and non-financial corporate sector' have just amounted to TRY100.1bn, reaching 3.4% of the 4Q trailing GDP in 3Q2017.
- When considering 'deferred payables/restructured loans' and 'NPL write-offs (incl NPL sales to Asset Management Companies), this number amounts to TRY195.3bn or 6.6% of the 4Q trailing GDP in Q3. The jury has yet to decide on whether this is the indication of a big risk or whether this is affordable for the Turkish economy under a moderate growth pace. Asset quality worries deferred to 2018 and beyond thanks to the effective utilization of the CGF.

## Banking sector troubled loans




Source: BRSA Weekly Figures, Global Securities Calculations

## Banking sector troubled assets




Source: BRSA Weekly Figures, CBRT

GLOBAL SECURITIES

# Core spreads under pressure

## Banks provide constructive guidance; but...

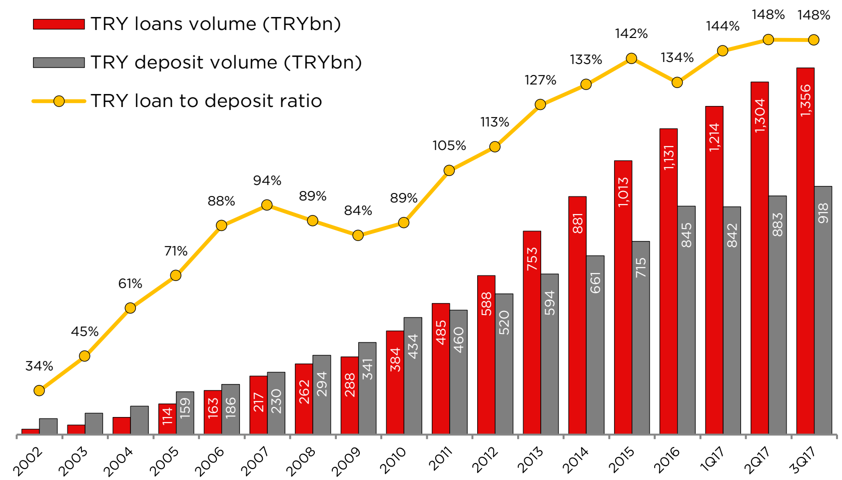
- The CGF driven acceleration in TRY loan growth and TRY funding squeeze offered an unpleasant cocktail for local currency costs. Hence, Turkish lenders saw higher financing costs while the sector failed to fully reflect the increased CBRT funding costs to loan pricing until mid Q3. However, this was not unexpected given the maturity mismatch between deposits and loans.

- The overall burden of TRY deposits on core spreads was more than halved owing to a more moderate 14bps QoQ rise in FC deposit costs in Q3. Hence, the sector faced an affordable 63bps rise in blended deposit costs in the quarter. More importantly, the widening of blended loan yield (+40bps QoQ) partially offset deposit cost increase of 63bps QoQ, resulting in a 23bps QoQ contraction in the loan-to-deposit spread in Q3.

- Banks are hopeful for core spreads given the effects of progressive repricing reflecting to the books and deposit cost expansion softening to some extent. While expecting no significant change in 1Q18 spread outlook, Tier1 banks see 2Q18 would be the better quarter given the anticipation of single digit inflation and thus relatively easier cost of funding starting from Q2 onwards.

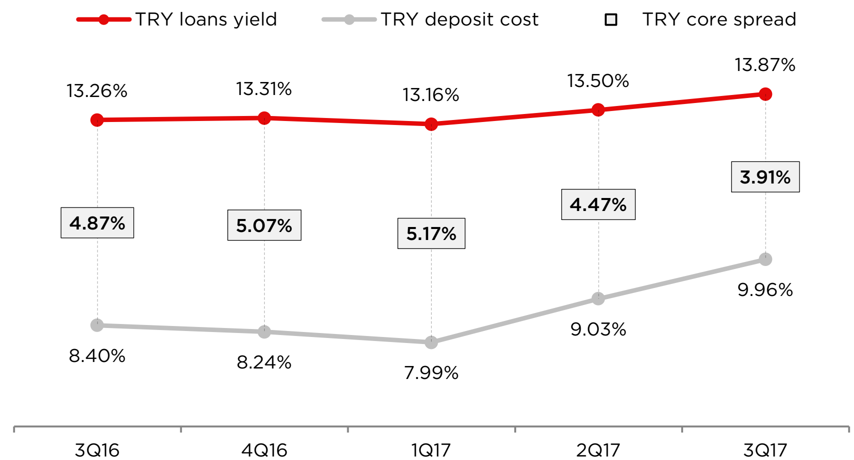
- Nevertheless, this year's spread evolution should be conditional on the cost of funding, which will be mainly driven by CPI path.

## TRY volume and TRY Loan to Deposit Ratio




*Source: BRSA Monthly Figures*

## TRY loan yield and deposit cost




*Source: BRSA Monthly Figures*

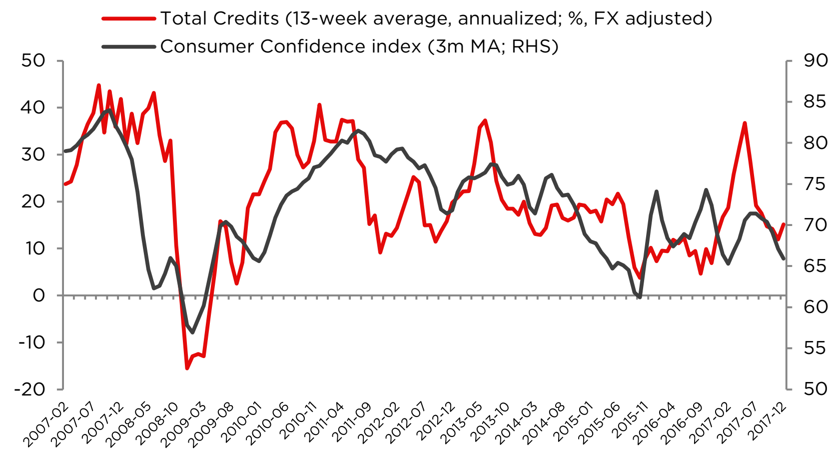
GLOBAL SECURITIES

# Asset quality : Not a major concern until end of 2018

## Asset quality worries deferred to late 2018 and beyond

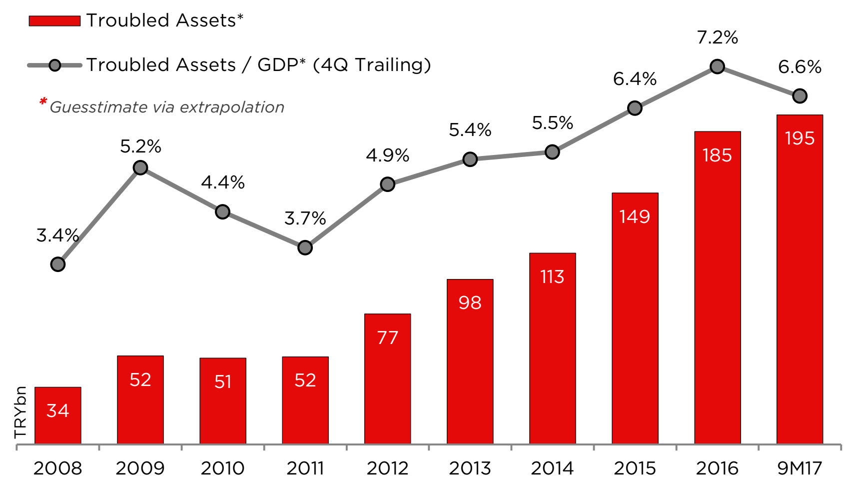
- Faster economic activity, strong loan growth and heavy restructurings have gradually improved the NPL ratio to 3.05% (lowest figures since 3Q15) as of 3Q17 despite currency pressures. In TRY terms, SME loans which composed of c.25% of loan book remained in the spotlight as the NPL ratio (4.75%) in the segment remained way above the ratio for the overall NPL book (3.05%) in Q3 albeit with some easing from 4.87% in YE16.
- Also, FC asset quality has been key focus given corporate balance sheets still remaining 'under fire' amid USD211bn currency mismatch, equivalent to c.25% of GDP as of 3Q17. With the glass half full, despite on-going currency pressures, FC asset quality has so far been resilient owing to i) relatively longer maturity structure of FC loans, ii) concentration of FC loans in large corporates due to strict credit policy rules and directives, (iii) fully hedged FX positions, and (iv) Treasury guarantees to mega construction projects mostly financed through longer term foreign currency loans.
- However, this is not to say that the coast is clear to become comfortable about balance sheet risks. The continuation of the TRY weakness coinciding with a bulk of maturities could hit those sectors with less hedging capacity. A wave of corporate defaults could turn into a systemic problem given that most of the FC financing is raised via the domestic lenders.
- Potentially problematic loans (Group 2) was at 3.54% (+12bps QoQ) of the total loan book for Tier 1 banks as of Q3, which continued to leave investors with a bad taste about NPL formation in the coming quarters. Given c.85% of fresh CGF loans booked at 0% risk weight, Turkish banks may sustain solvency ratios by rebalancing fresh loans and loan restructurings. Specifically, Turkish banks should have a great chance to transfer some of overdue SME loans in Group 2 category to the CGF scheme, which should support CoR and keep asset quality intact in potentially distress periods.

## Bank Loans vs Consumer Confidence




*Source: CBRT, BRSA, TurkStat*

## Troubled receivables in financials and non-financials



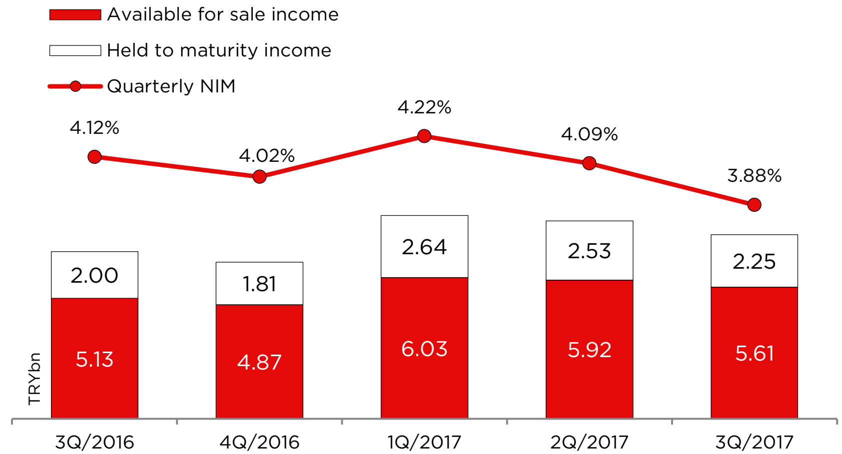

*Source: BRSA, CBRT*

# NIM performance for Tier1 class

## NIM evolution well defended owing to decent CPI linker income

- The first quarter's loan yield compression, which was perfectly counter-balanced by the deposit cost contraction, turned into expansion in Q2 (+34bps QoQ) and Q3 (+40bps QoQ) as the duration effect faded. Nevertheless, tight liquidity conditions, together with the elevated Treasury roll-over rates, continued to push up deposit costs and squeeze margins.
- Not only did loan-to-deposit spreads weigh on margins, but CPI linkers also had a pivotal impact. In Q1, decent CPI linker income of TRY2.58bn (+75.7% QoQ) allowed NIM evolution to continue in Tier 1 banks, widening by 21bps to 4.16% despite slight contraction on core spreads (-10bp to 5.13% in Q1). In Q2 and Q3, NIM faced double whammy of relatively softer CPI-linkers contribution and the increased pressures on core spread mainly driven by TRY funding squeeze. Hence, NIM showed two consequent quarters of contraction, narrowing by 21bps to 3.95% in Q2 and 27bps to six quarters low of 3.68% in Q3. For Tier1 banks under our coverage, CPI linkers' share in NIM diminished to 53bps in Q3 from 67bps in Q2 from 69bps in Q1.
- Given the TRY86.4bn inflation linked portfolio in Tier1 banks under our coverage as of end-Q3, these banks should continue to enjoy CPI-linker valuations in the forthcoming quarters as long as inflation hovers around double digits or high single digits at least. While Tier1 banks have already guided strong CPI-linker gains in 4Q17 based on their projections for year-end CPI and supportive effects of progressive loan repricing on the books, core spreads may not show the long-awaited decent expansion given TRY deposit rates remaining unexpectedly high in the wake of increased market pressures. Hence, the current upward drift in deposit rates could weigh on the NIM metrics. We therefore expect no material upward revisions to flattish guidance for FY2017 NIM.

## Banking sector securities income & NIM

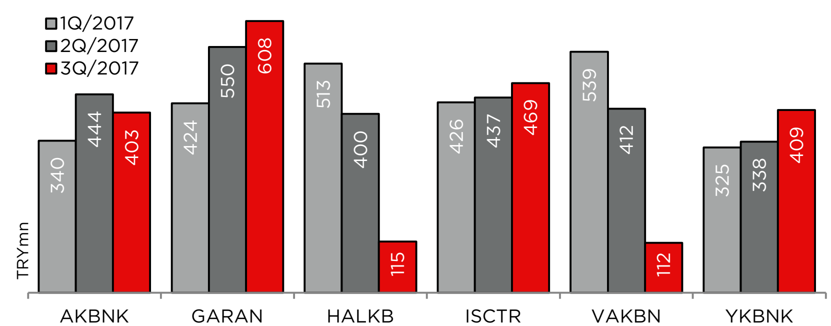



*Source: BRSA Monthly Figures*

## Tier 1 banks CPI income and CPI Exc. NIM

**Quarterly CPI Excluded NIM for 2017/09** — **TIER I AVG: 3.15%**

| AKBNK | GARAN | HALKB | ISCTR | VAKBN | YKBNK |
|---|---|---|---|---|---|
| 3.00% | 4.17% | 2.21% | 3.48% | 2.96% | 2.89% |




*Source: Bank Financials, Bank Presentations, Global Securities Calculations*

# NIM evolution : What to expect?

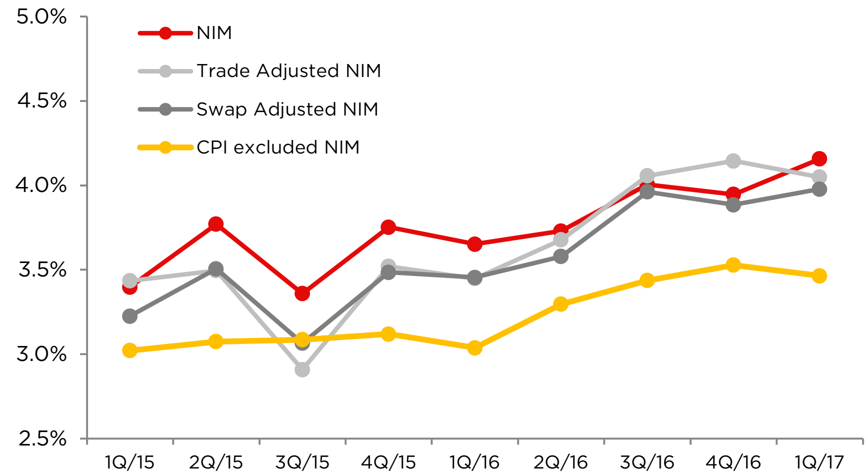
## CPI linkers appear to be relatively less supportive in 2018

- We expect October 2017 - October 2018 CPI print, which is the most widely used benchmark by banks for calculating CPI linker yields, to be at 11.9% and 10.9%, respectively. This indicates an average c.9% YoY drop in CPI-linker income for banks in our coverage in 2018, assuming a flat CPI linker volume. ISCTR and VAKBN should be impacted slightly more negatively than peers as their 2018E NI are set to retreat c.3% for both of these names, while AKBNK looks more defensive. We calculate each 1ppt decline in CPI-linker income will take-off 2.7% from the bottom line, when assuming all else being equal.

## 2018E NIM likely to remain steady for Tier1 banks

- In our Tier1 coverage universe, the 21bps widening in NIM (+9bps QoQ in swap adjusted) in Q1, was followed with a 21bps QoQ (-43bps QoQ swap adjusted) and a 27bps contraction (-27bps QoQ swap adjusted) in Q2 and Q3, respectively, as the increased pressures on core spread heavily took a toll on margins during the aforementioned period. While swap costs continued to weigh on NIM, CPI linker yields partly compensated for lower core spreads in Tier1 class. After sliding 27bps QoQ (-27bps swap-adj.) in Q3, we expect Tier1 banks' NIM under our coverage should end 2017 with an average widening of 23bps YoY.
- The major risk to our forecasts is higher-than-expected increase in TRY deposit costs in 4Q17 and its subsiding impact extending to 1H18. As for 2018, we project a close-to-flat NIM evolution for Tier1 class due to lower CPI-linker yields and slight elevation in LDR, while remaining flat if adjusted for swap costs against the backdrop of macro environment we assumed.

## Tier 1 banks quarterly NIM average evolution

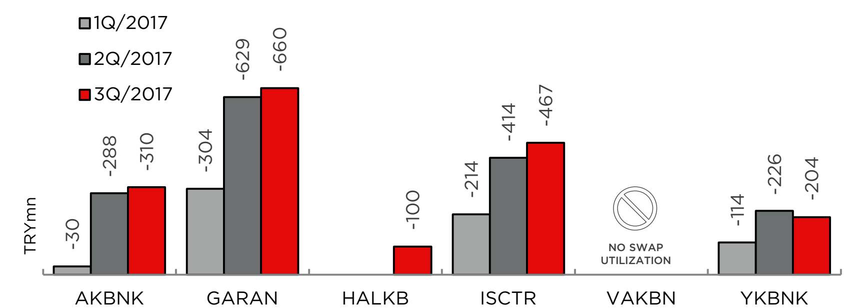



*Source: Bank Financials, Bank Presentations, Global Securities Calculations*

## Tier 1 banks Swap income/loss and Swap Adj. NIM

**Quarterly Swap Adjusted NIM for 2017/09** — **TIER I AVG: 3.27%**

| AKBNK | GARAN | HALKB | ISCTR | VAKBN | YKBNK |
|---|---|---|---|---|---|
| 3.13% | 4.10% | 2.24% | 3.48% | 3.16% | 3.22% |



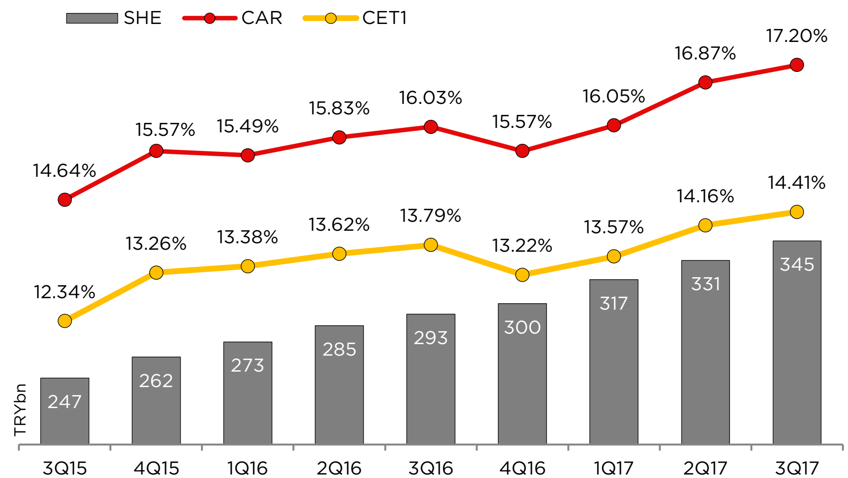

*Source: Bank Financials, Bank Presentations, Global Securities Calculations*

# Solvency metrics improved significantly

## Capital ratios saw a technical boost

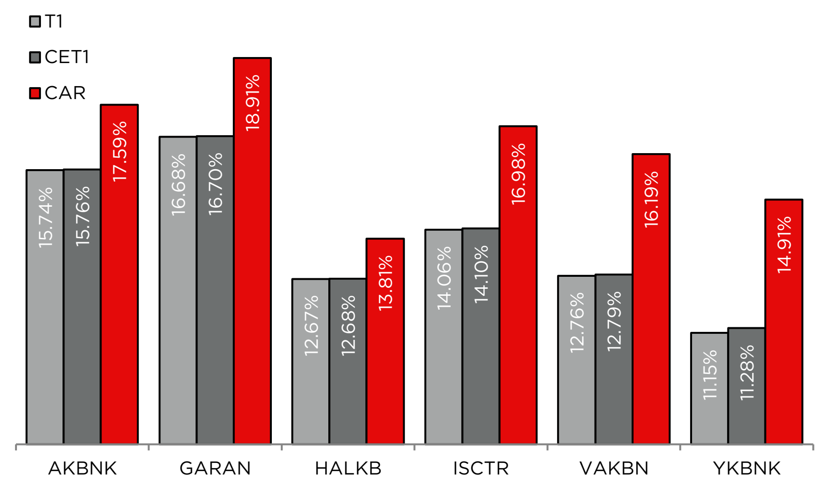
- Tier1 banks have recorded a 148bps increase in their average CET1 ratio and 224bps increase in their average total CAR during the first nine months of 2017. From a CET1 ratio perspective, GARAN and AKBNK are the two banks that stand out, followed by ISCTR, while YKBNK CET1 ratio remains below peers. GARAN has the highest CAR (3Q17: 18.91%) in our coverage universe, following its USD750mn subordinated debt issuance which has also provided strong buffer against potential currency depreciation. At Halkbank, CAR remains at the lowest end of our coverage universe (3Q17: 13.81%) as the bank failed to finalize its planned Basel-III compliant Tier2 bond issuance due to the US court case against its former deputy CEO last year.
- IFRS-9 has become effective as of Jan 1, 2018. 36 of 49 banks are ready to restate their financials on basis of expected loss approach. IFRS-9 should require additional general provisioning to be set aside by those who have lower coverage ratio; but, those with above-average provision coverage should benefit the new accounting standards as they will no longer need to run higher provisioning rates. In fact, it would be enough to operate with 75-80% NPL coverage ratio. Based on projections by a group of banks, new financial standards should result in c4% decline in provisions and 30-35bps improvement in CET1. AKBNK would benefit the most from the IFRS-9 transition followed by VAKBN, ISCTR and GARAN; but, these banks appear to be in no rush to reverse the excess portion of provisioning into cash.
- The USD4.75bn Oger Telecom loan remains as key risk which could trigger potential market distress if it were to fall into default. We expect a market friendly outcome from the OTAS debt impasse. Recall, Qatari phone carrier Ooredoo (QSC) offered a plan to Saudi Telecom Co to bid for Oger Telekomunikasyon AS and therefore indirectly to acquire shares in TTKOM late 2017. Nevertheless, the story ended without progressing. To remind, the loan is currently classified under performing loans.

## Banking sector capital & capital solvency




Source: BRSA Monthly Figures

## Tier 1 banks capital solvency




Source: Bank Financials

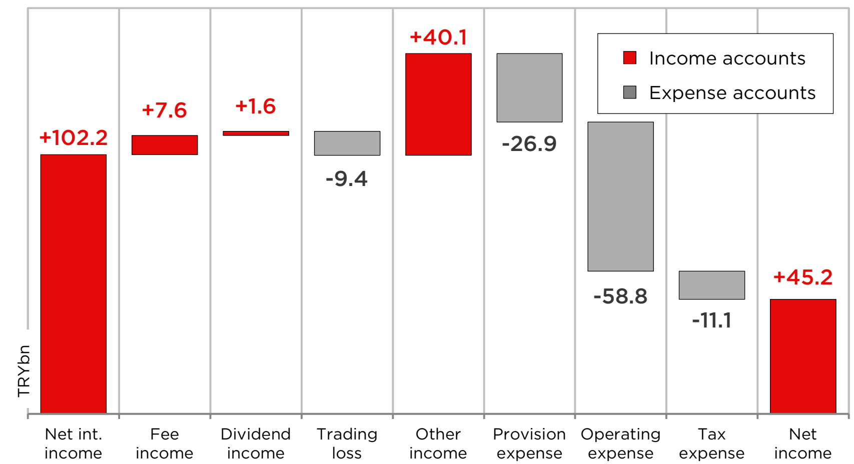
GLOBAL SECURITIES

# ROAE performance

## Mid-to-high teens in ROAE looks sustainable

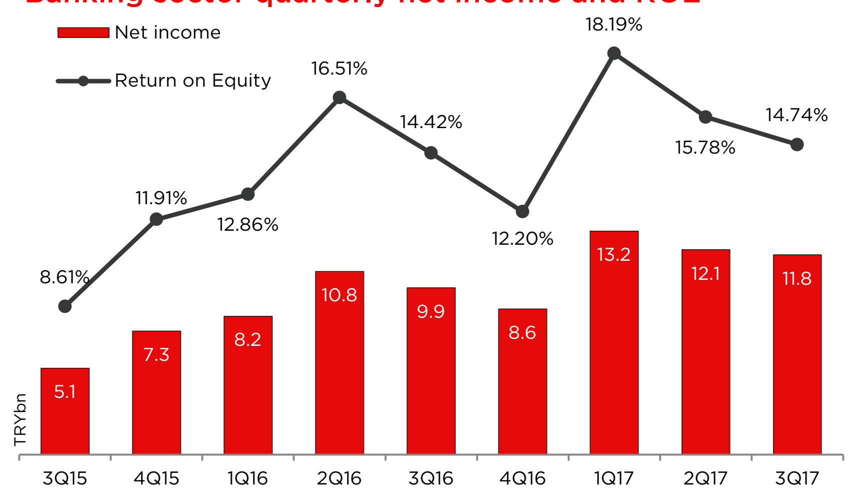
- Despite the increased pressures on NIM, strong lending activity and bulky CPI linker portfolio were the positives of the last year, all helped by on-going operating efficiency and solid fee generation. Particularly, enthusiastic utilization of the CGF scheme with zero risk weighting has remained a catalyst.
- On the operating side, fee and commission income kept an elevated trajectory increasing as much as +17.5% YoY (+0.9% QoQ) owing to strong loan growth YtD as of 3Q17 and increased efforts of cross-sell activities on the side-lines of GPL extensions. OPEX softened by 1.2% QoQ (+11.3% Cumulative YoY) in 3Q17 which basically benefited from seasonal factors.
- For the foreseeable future, we expect OPEX to go hand-in-hand with inflation in 2018; but, risks should remain skewed to the downside owing to disciplined cost control, optimization of branch network and digital banking.
- Against this backdrop, despite rising provisioning burden and negative implications of inflation on NIM and OPEX, ROAE has shown further improvement of 225bps YtD to 15.57% as of 3Q17 for the sector as a whole. We think 4Q17 was not much different than earlier 2017 with some downside risks.
- Despite generous support from CPI linker portfolio, ROAE looks navigating a tad below 15% given new additions to provisioning book and on-going core spread compression alongside with increasing deposit costs.
- Looking forward, we see mid-to-high teens in ROAE rather sustainable with inflation pressures relatively contained and cost of financing normalized.

## Banking sector 11M17 income statement




*Source: BRSA Monthly Figures*

## Banking sector quarterly net income and ROE




*Source: BRSA Monthly Figures*

# Banking Sector : Attractive valuations are not the only catalyst

**Attractive valuations are not the only catalyst, but re-rating of 2018 macro backdrop in context of moderate growth, relatively tamed inflation and eased regulations looks promising for core banking revenue expansion despite the strained international relations slowly boiling over to the economy.**

We work with FY2018 earnings growth forecast of c.15% for the banking sector mainly against the backdrop of core banking revenue expansion. Despite relatively limited NIM contraction, we delivered upward revision to our NI estimates on the account of a pick up in fee growth and slight deceleration in trading losses. With an anticipated TRY100bn (3% of GDP) CGF utilisation in 1Q18, the lending business should prove to be chief catalyst, while inflation driven OPEX and hefty LLP burden continue to pose headwind to NI generation. Also, funding costs should remain the weak link given the TRY liquidity squeeze continuing, LDR edging up to historic highs, and inflation remaining the black sheep in the macro pack.

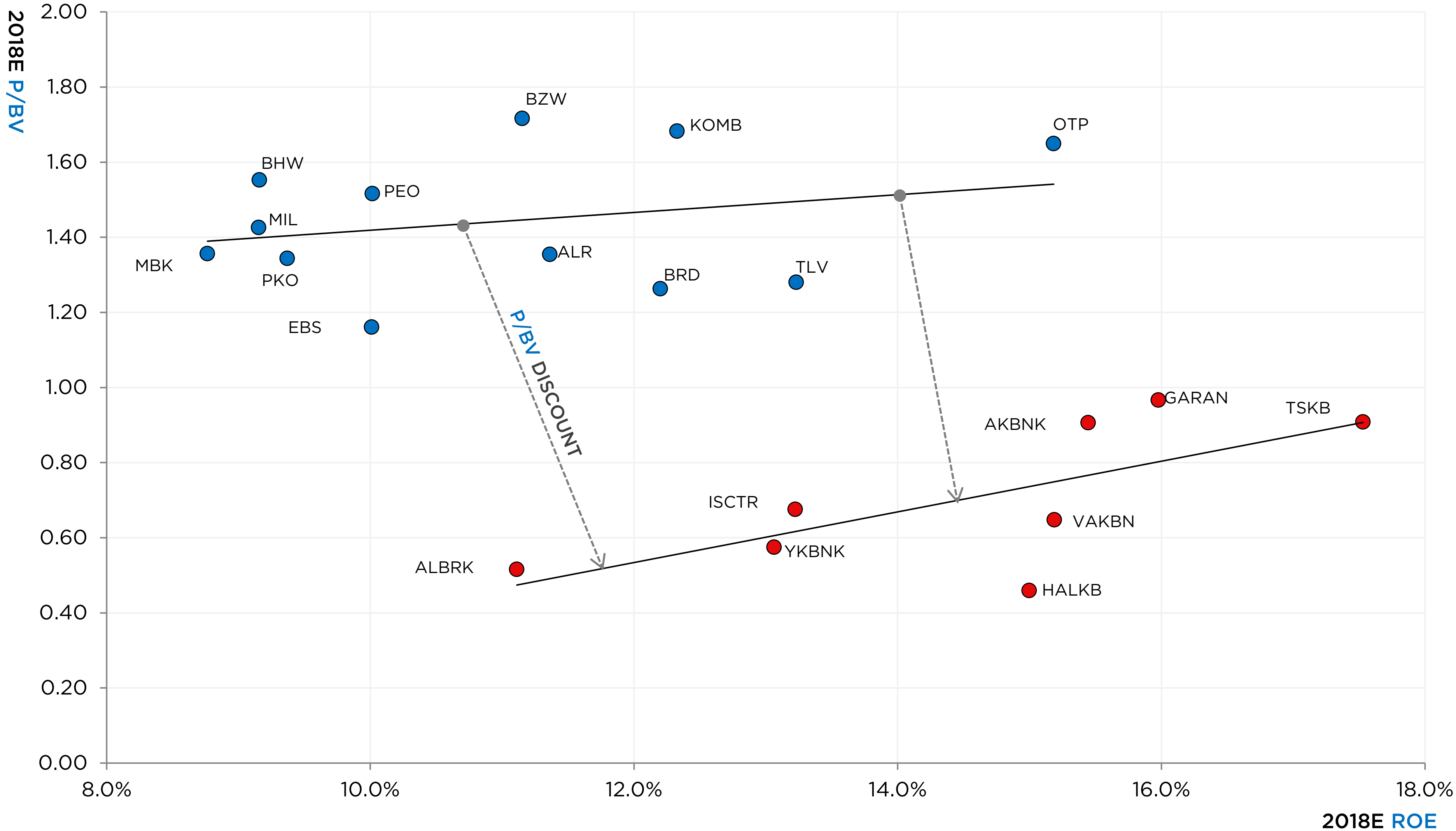
We model a 13bps YoY decline in annualised ROAE to 14.63% for 2018E, assuming 15.7% YoY book value expansion through organic capital generation. We project CoE at 17.6%, 300bps above ROAE in 2018. That said, risks remain skewed to upwards rather than downwards as banks have already priced in most of potential headwinds at the P/BV trading 32% discount vs. MSCI EM banks going into publication which leaves the door wide open for decent return opportunities in tranquil times. While this is not a done deal due to possible continuation of defensive trades amid the (geo)political risks and hefty financing costs, Turkish banks should compare well to EM peers, especially profitability metrics, owing to well-defended NIM evolution, solid lending business, and steady operating efficiency. As for capitalisation, the subordinated debt issuances and exchange transactions to Basel-III compliant Tier2 bonds built some buffer for solvency metrics against currency volatility; not to mention strongly accumulated provision buffer to meet IFRS-9 directives. Thus, we project CAR at 16.1% on average for Tier1 in 2018E with a close-to-flat YoY progression.

Against this backdrop, we made upward revisions to our FV estimates to below mentioned names by c.8% on average; offering c.12% upside for Tier 1 banks on average at the valuations on January 03, 2018 close. Specifically, we delivered decent upward revisions for AKBNK, GARAN and VAKBN. We now favour GARAN and VAKBN as top pick banking stocks for 1H18.

| TRYmn | 2015A | 2016A | 2017E | 2018E |
|---|---|---|---|---|
| Net interest income | 77,316 | 91,343 | 113,276 | 127,442 |
| Net fee income | 6,471 | 7,229 | 8,313 | 9,336 |
| Dividend income | 1,263 | 1,464 | 1,571 | 1,665 |
| Trading income | -6,256 | -1,502 | -9,012 | -7,011 |
| Other operating income | 34,405 | 37,844 | 42,953 | 44,671 |
| Total operating income | 113,199 | 136,379 | 157,102 | 176,104 |
| Loan loss provisions | 24,643 | 30,634 | 31,860 | 34,663 |
| Operating expenses | 55,485 | 58,463 | 65,479 | 71,044 |
| Net operating income | 33,070 | 47,281 | 59,764 | 70,396 |
| Taxes | 7,008 | 9,750 | 11,953 | 15,487 |
| Net income | 26,062 | 37,532 | 47,811 | 54,909 |
| | | | | |
| Net int. income/op.income | 68.30% | 66.98% | 72.10% | 72.37% |
| Net fee income/op.income | 5.72% | 5.30% | 5.29% | 5.30% |
| Non-int. income/op.income | 31.70% | 33.02% | 27.90% | 27.63% |
| Trading loss/op.income | 5.53% | 1.10% | 5.74% | 3.98% |
| Cost of risk | 1.81% | 1.90% | 1.65% | 1.52% |
| Specific cost of risk | 1.16% | 1.33% | 1.08% | 1.00% |
| Cost/income | 49.02% | 42.87% | 41.68% | 40.34% |
| NIM | 3.83% | 3.89% | 4.11% | 3.95% |
| ROAE | 10.55% | 13.35% | 14.75% | 14.63% |
| ROAA | 1.20% | 1.48% | 1.59% | 1.56% |

*Source: Global Securities estimates, BRSA Monthly Figures*

# Turkish Banks vs. Members of peer group




GLOBAL SECURITIES

# Macro Forecasts

| | | | | | | | | | | | ESTIMATE | INDICATIVE | PROJECTION |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Growth** | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017E | 2018I | 2019P |
| GDP (TRY mn)-nominal prices | 880,461 | 994,783 | 999,192 | 1,160,014 | 1,394,477 | 1,569,672 | 1,809,713 | 2,044,466 | 2,338,647 | 2,608,526 | 3,100,937 | 3,564,174 | 4,032,934 |
| GDP (USD mn) | 677,439 | 776,640 | 646,895 | 772,367 | 831,691 | 871,123 | 950,351 | 934,855 | 861,467 | 856,767 | 848,921 | 900,044 | 971,791 |
| GDP per capita (USD; at market rate) | 9,656 | 10,931 | 8,980 | 10,560 | 11,205 | 11,588 | 12,480 | 12,112 | 11,014 | 10,807 | 10,638 | 11,181 | 11,953 |
| GDP growth rate(%; y/y) | 5.0 | 0.9 | -4.7 | 8.5 | 11.1 | 4.8 | 8.5 | 5.2 | 6.1 | 3.2 | 7.0 | 4.3 | 4.0 |
| Unemployment Rate (%) | 9.2 | 10.0 | 13.1 | 11.1 | 9.1 | 8.4 | 9.0 | 9.9 | 10.3 | 10.9 | 10.5 | 10.8 | 11.0 |
| **Inflation & Rates** | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018I | 2019P |
| CPI (y/y; end of period-%) | 8.39 | 10.06 | 6.53 | 6.40 | 10.45 | 6.16 | 7.40 | 8.17 | 8.81 | 8.53 | 11.92 | 9.40 | 8.50 |
| CPI (y/y; annual average-%) | 8.76 | 10.44 | 6.25 | 8.57 | 6.47 | 8.89 | 7.49 | 8.85 | 7.67 | 7.78 | 11.14 | 10.50 | 8.90 |
| The CBRT f/cast for CPI (eop; %, last Revision) | 4.00 | 4.00 | 7.50 | 6.50 | 8.30 | 7.40 | 6.80 | 8.90 | 7.90 | 7.50 | 9.80 | 7.00 | 5.00 |
| Benchmark Rate (2yr; oya-%) | 18.26 | 19.28 | 11.65 | 8.46 | 8.82 | 8.37 | 7.36 | 9.33 | 9.71 | 9.81 | 11.82 | 12.50 | 11.75 |
| Benchmark Rate (2yr; end of period-%) | 16.62 | 16.45 | 9.06 | 7.08 | 11.04 | 6.16 | 10.03 | 7.97 | 10.78 | 10.65 | 13.40 | 12.00 | 11.50 |
| O/N Borrowing rate (end of period-%) | 15.75 | 15.00 | 6.50 | 1.50 | 5.00 | 5.00 | 3.50 | 7.50 | 7.25 | 7.25 | 7.25 | 7.25 | 7.25 |
| 1-Week Repo Rate (end of period-%) | | | | 6.50 | 5.75 | 5.50 | 4.50 | 7.50 | 7.50 | 8.00 | 8.00 | 8.00 | 8.00 |
| O/N Lending rate (end of period-%) | 20.00 | 17.50 | 9.00 | 9.00 | 12.50 | 9.00 | 7.75 | 10.75 | 10.75 | 8.50 | 9.25 | 9.25 | 9.25 |
| BIST Interbank Repo Rate (end of period-%) | | | | | 11.46 | 6.34 | 7.75 | 11.23 | 10.75 | 8.50 | 12.75 | 12.00 | 11.25 |
| **Foreign Currency** | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018I | 2019P |
| Depreciation (USD - oya; %; nominal) | -9.1 | -0.1 | 19.0 | -3.1 | 11.5 | 7.5 | 6.0 | 15.0 | 24.4 | 11.1 | 20.7 | 8.4 | 4.8 |
| Depreciation (USD - eop; %; nominal) | -18.0 | 31.3 | -2.3 | 3.4 | 22.8 | -5.7 | 19.7 | 9.2 | 25.4 | 20.6 | 7.2 | 7.8 | 4.7 |
| USDTRY (average; market Bid Rate) | 1.3003 | 1.2994 | 1.5467 | 1.4987 | 1.6714 | 1.7964 | 1.9041 | 2.1899 | 2.7233 | 3.0266 | 3.6528 | 3.9600 | 4.1500 |
| USDTRY (end of period; market Bid Rate) | 1.1593 | 1.5218 | 1.4873 | 1.5376 | 1.8889 | 1.7819 | 2.1324 | 2.3290 | 2.9207 | 3.5224 | 3.7753 | 4.0700 | 4.2600 |
| EURTRY (average; market Bid Rate) | 1.7782 | 1.9008 | 2.1502 | 1.9887 | 2.3239 | 2.3090 | 2.5288 | 2.9086 | 3.0208 | 3.3453 | 4.1232 | 4.7200 | 5.2000 |
| EURTRY (end of period; market Bid Rate) | 1.7102 | 2.1332 | 2.1427 | 2.0551 | 2.4438 | 2.3509 | 2.9371 | 2.8298 | 3.1867 | 3.7133 | 4.5196 | 4.9850 | 5.5000 |
| **Balance of Payments (USDmn)** | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017E | 2018I | 2019P |
| Trade Balance | -62,791 | -69,937 | -38,785 | -71,661 | -105,935 | -84,083 | -99,858 | -84,567 | -63,395 | -56,073 | -77,050 | -73,500 | -73,000 |
| Current Account Balance | -36,949 | -39,425 | -11,358 | -44,616 | -74,402 | -47,961 | -63,608 | -43,597 | -32,118 | -32,615 | -45,000 | -41,000 | -42,000 |
| Current Account Balance/GDP (%) | -5.5 | -5.1 | -1.8 | -5.8 | -8.9 | -5.5 | -6.7 | -4.7 | -3.7 | -3.8 | -5.3 | -4.6 | -4.3 |
| Brent Oil (USD/bbl; Annual Average) | 72.4 | 96.9 | 61.7 | 79.6 | 111.2 | 111.6 | 108.6 | 98.9 | 52.4 | 44.0 | 54.2 | 58.5 | 60.0 |
| **Fiscal Balance (TRYmn)** | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017E | 2018I | 2019P |
| Budget Balance/GDP (%) | -1.6 | -1.8 | -5.3 | -3.5 | -1.3 | -1.9 | -1.0 | -1.1 | -1.0 | -1.1 | -2.3 | -2.1 | -2.2 |
| Primary Balance/GDP (%) | 3.96 | 3.34 | 0.04 | 0.71 | 1.68 | 1.21 | 1.74 | 1.30 | 1.26 | 0.80 | -0.1 | -0.1 | -0.2 |
| Gross Central Government Debt/GDP (%) | 38.2 | 38.2 | 43.9 | 40.1 | 36.4 | 32.6 | 31.3 | 28.7 | 27.5 | 28.5 | 30.0 | 30.5 | 31.0 |

*Source : TurkStat, CBRT, MoF, Global Securities*

GLOBAL SECURITIES

# Defense Industry

## How promising is Turkish Defense Industry?

- Rising global and regional tensions have led to increasing demand for defense and military products in the Middle East, Central Asia, Far East, and Eastern Europe. These regions are the most attractive markets.
- The AK Party has been taking giant steps in national defense in order to diminish dependence on foreign sources and eventually becoming an exporter of defense products. In this regards, Turkey has signed agreements for defense industry cooperation with the countries of Benin, Chad, Congo, Mali, Senegal, Gabon, Romania, Gambia, Somali and Indonesia, and memorandums of understanding with Great Britain, Kuwait, United Arab Emirates, Chile and Ukraine. Also, Turkey has signed more-concrete military cooperation agreements with Nigeria, Djibouti, Ivory Coasts, Montenegro, Qatar and Sweden. More importantly, Ankara has agreed on a framework accord with British defense giant BAE Systems for Turkish national warplane whereas Turkey has been recently awarded as Pakistan's submarine modernization project. Recently the defense industry authority has been tied to the Turkish presidency with a new state of emergency
- Turkey's military expenditures were USD15.3bn in 2002 and USD14.9bn in 2016. Also, during the past 15 years, annual research and development expenditures climbed from USD1.8bn to USD20bn. Turkey stands at 18th place with USD14.9bn, corresponding to 2% of GDP. The central government reserved TRY64.3bn for the spending on defense and military in general for 2017 where this figure stood around TRY58bn in 2016. The government has promised to allocate an additional TRY8bn to Turkish Defense Industry Fund to support the sector investments and R&D developments. This could increase the already planned TRY64bn spending target to TRY72bn for 2017 (+12.4% YoY) which could mean possible tenders for listed companies in defense sector, such as. ASELS, OTKAR, and KATMR.

### Main Battle Tank - Altay

Source Undersecrateriat for Defense Industry

### Amored Tactical Vehicle – Cobra II

Source Undersecrateriat for Defense Industry

# Defense Industry

### How promising is Turkish Defense Industry?

- Within the context of these agreements, defense companies displayed ATAK helicopter, Altay tank, Hurkus and Anka drones, reconnaissance and attacking drones, missiles (i.e. Kaan, TRG-122, TRG 300 Kaplan, Gokdogan and Bozdogan, all made Roketsan – an affiliate of Aselsan: ASELS), air defense systems (i.e. Korkut and Hisar), and armoured vehicles (i.e. HIZIR by Katmerciler: KATMR, Yavuz- Ural by Otokar: OTKAR, and unlisted producers' Ejder Yalcin by Nurol, and Kirpi by BMC). In addition, there were two major transactions such as submarine sales to Indonesia and an agreement with Pakistan for the sale of four Turkish-made (Mil-Gem) warships by ASELS. Another landmark agreement came in Feb 2017 between Turkish military vehicle manufacturer OTKAR and the United Arab Emirates' Tawazun. In a USD661mn agreement, the pair formed a joint venture, Al Jasoor, to make 8x8-wheeled amphibious armoured vehicles.
- The AK Party Vision Document for 2023 envisages a bullish outlook for the Turkish defense industry with annual export target of USD25bn. Nevertheless, there is a long way to go to place the 2023 targets within reach given the figures from Turkey's Exporters Assembly, highlighting USD1.7bn exports from the Turkish defense sector in 2016. Note that one-third of those sales in 2016 were to the United States, followed by sales to Germany, Malaysia, Azerbaijan, Britain, UAE, Qatar, Saudi Arabia and Tunisia.
- There are several factors favouring Turkish defense industry. First, Turkey is aware of Iran's advances in developing its own defense systems and doesn't want to lag behind. Second, Turkey believes that it can't be a regional leader simply by depending on NATO. Moreover, Turkey's disputes with the West encourage it to become more independent in defense. Third, Turkey's involvement in the regional issues provides a motive for defense industry.

### National Combat Aircraft : TF-X


*Source: Undersecrateriat for Defense Industry*

### National Ship - Milgem


*Source: Undersecrateriat for Defense Industry*

# Retail: Another year of inflation

## Growth fuelled by inflation

- Retailers enjoyed robust revenue growth and margin expansion during 2017, on the back of elevated inflation levels, which reached the highest level since late 2003. Major retailers BIMAS and MGROS revised their guidance for the year several times, and looking at the run rates they will finish the year at the high end of their current revised guidance.
- While expecting a relatively benign inflationary environment for 2018E compared to 2017, our average CPI inflation target is still as high as 10.1%, giving the retailers a cushion to reflect cost and opex pressures to the consumers. The major headwinds on opex side could be the lift of minimum wage incentive, which came into affect in 2016 and ends at the end of 2017 and increasing oil prices.

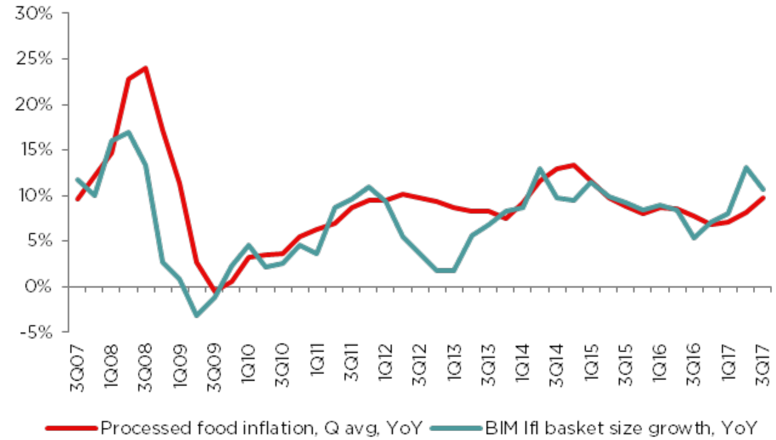
## Top five players now dominate the market

- Until 2013, retailers of all sizes were growing at somewhat the same rate. In terms of sqm, top five retailers and others chains shared the organized market 50-50. Since then, top five players dominated the market by registering a CAGR of 22%, while others stagnated, merged with each other, went bankrupt or were acquired by the top five. We expect this trend to continue in 2018E and major players to post above market and inflation topline growth with better profitability. Our top pick, **MGROS** is the cheapest option to enjoy this growth.

## Sluggish TRY is the best friend of local fashion retails

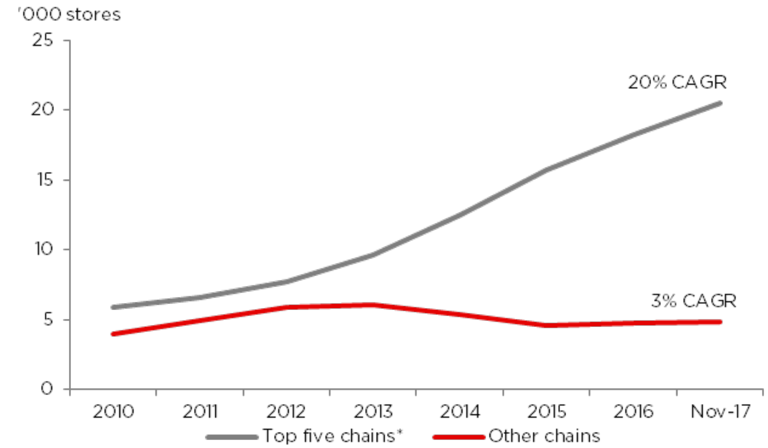
- The depreciation of TRY gave the local fashion retailers a pricing advantage against international players in the last couple years, which may continue into 2018E. Similar to FMCG retailers, they can also reflect prices to consumers due to high inflation level.

## Process food inflation push prices higher




*Source: CBT, BIMAS*

## Only the major players are growing




*Source: ortakalan.com.tr, * Top five: A101, BIM, Sok, Migros, CarrefourSa.*

GLOBAL SECURITIES

# Food and beverages: Better domestic environment and a World Cup

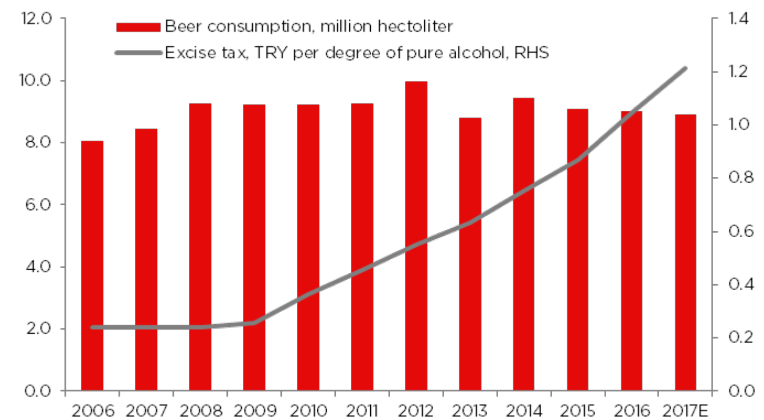
## Growth at home, growth in the international markets

- Like other consumer plays, food & beverages sector had a better year especially in 3Q17, in the domestic market. All sector related macro data, from tourist arrivals to consumer confidence were stronger vis-à-vis 2016. CCOLA posted the highest domestic sparkling volume in 3Q, while domestic beer market was almost flat, even though there was sharp increase in excise taxes. During 9M17, total confectionary market also grew by 6% in Turkey, and ULKER managed to keep its market position.
- The international markets also performed well in 2017, as the impact of the macroeconomic turmoil in CIS Countries and Pakistan fades away. AEFES and CCOLA not only posted better volumes and profitability in local currencies, but also enjoyed sluggish TRY. ULKER also posted strong international revenues, despite a small volume increase with downsizing in non-branded products.
- We expect the domestic momentum to continue in beer market, with higher tourist arrivals from Western Europe, as Turkey has become cheaper than its competitors owing to sluggish TRY, yet the high excise tax rate is still hurting the affordability. However, the major volume boost should come from Russia, the host country of World Cup 2018. AB InBev is the beer sponsor of the Cup, and regardless of the upcoming merger, **AEFES** may benefit from this event. Thus, we add the stock to our top picks. CCOLA, on the other hand, will continue to focus on immediate consumption packs (IC-SKUs with <=1lt), amid the new excise tax on non-alcoholic beverages, to increase margins, major international markets may continue to lead the growth.
- For ULKER, we may continue to witness the increasing margins with the addition of new MENA subsidiaries, UI MENA and IBC. The main story for the year is the integration of these assets, and growing domestic market share.

## Input costs remains as a hurdle

- The main risk for food and beverage companies is still the elevated input costs, although major input costs are expected to be relatively flat (in hard currency terms), we may see some headwinds from packaging materials and sluggish TRY.

## Excise tax curbing affordability



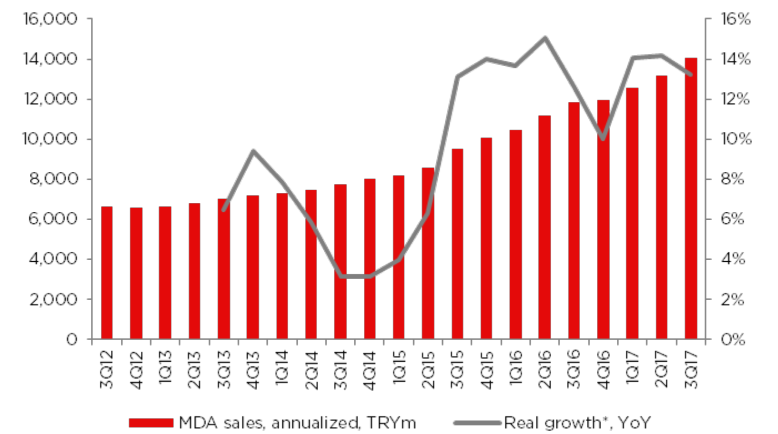

*Source: TAPDK, Revenue Administration, Global Securities*

# Consumer durables/Furniture: Cycling a year of incentives

## Will the base effect rule?

- To stimulate domestic demand, the Government reduced the special consumption tax (SCT) on small and major home appliances to 0% from 6.7% and the VAT for furniture to 8% from 18% in February 2017 for two months, which were later extended until the end of September 2017. These cuts helped the sectors to enjoy high demand during this period, however the real growth stood slightly below the trend between 2015-16.
- Although the growth in white goods were robust during 9M17, with 23% volume expansion, ARCLK, the biggest player in the market kept its market growth expectation at c.10%, close to long-term averages of the market. The market shrank by 5% and 16%, respectively, in October and November, proving ARCLK's expectations. We believe the domestic market will be shaky for appliance producers in 1H18, due to base effects. Exports, on the other hand, may gain momentum with currency advantage (strong EUR against USD and TRY) and upcoming World Cup, which may boost TV sales.
- Furniture and bedding sector is expected to soar as much as 30% according to sector representatives' forecast in 2017. However, we believe the growth of sector should lose some of its momentum in 2018 due to pulled forward demand in 2017, coupled with the troubles of sector leader which is expected to suffer more in 2018.
- **YATAS** is one of our top picks, despite the demand related headwinds, owing to its growth prospects along with the positive impact of new investment, strong balance sheet, and ongoing expansion in store network,.

## SCT cut supported the sector for 2017




*Source: Turkstat, GfK Temax * Total revenue growth adjusted for MDA price inflation*

## Yatas vs. Top 10 & Sector, TRYmn

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017E |
|---|---|---|---|---|---|---|
| **Home Furnishing Sector** | 15,737 | 17,392 | 21,045 | 19,783 | 24,278 | 31,561 |
| **Top 10 revenues** | 2,701 | 2,777 | 3,278 | 3,594 | 3,653 | |
| **Yatas revenues** | 191 | 217 | 275 | 325 | 500 | 817 |
| **Yatas' share in Sector %** | **1.2%** | **1.2%** | **1.3%** | **1.6%** | **2.1%** | **2.6%** |
| **Yatas' share in Top 10 %** | **7.1%** | **7.8%** | **8.4%** | **9.1%** | **13.7%** | |
| *Sector growth* | | *11%* | *21%* | *-6%* | *23%* | *30%* |
| *Top 10 growth* | | *3%* | *18%* | *10%* | *2%* | |
| *Yatas' growth* | | *14%* | *26%* | *18%* | *54%* | *63%* |
| *Top 10 growth ex. Yatas* | | *2%* | *17%* | *9%* | *-4%* | |

*Source: Source: Turkstat, Company data, Global Securities Estimates*

# Aviation: Final approach for the new airport / Auto: Exporters over distributors

## Waiting for the first landing

- 2017 was a year of two stories for Turkish aviation. In 1Q17, the sluggish performance in passenger numbers prevailed, following the dire events in 2016. Whereas, starting from April, we witnessed a sharp increase in traffic, which led to upside revisions for 2017E expectations. Coupled with strict cost control, airliners posted robust operational profitability. The early signs for 2018 suggest that passenger growth will be in line with the long term trends.
- Main stories of 2018 for aviation will be the sustainability of the cost control measures of the airlines, the tender of Sabiha Gokcen and the construction progress of the 3rd airport of Istanbul. More than 70% of the construction is completed, and we may see the inaugural flight in early 2018. The opening date of the phase 1 is due on October 2018, yet we expect a slight delay. The sector will have to bear some kind of capex related to the new airport. In addition due to its high cost the new airport may negatively affect the competitive power of THYAO in transfer passenger beyond 2018.

## Waiting for the first landing

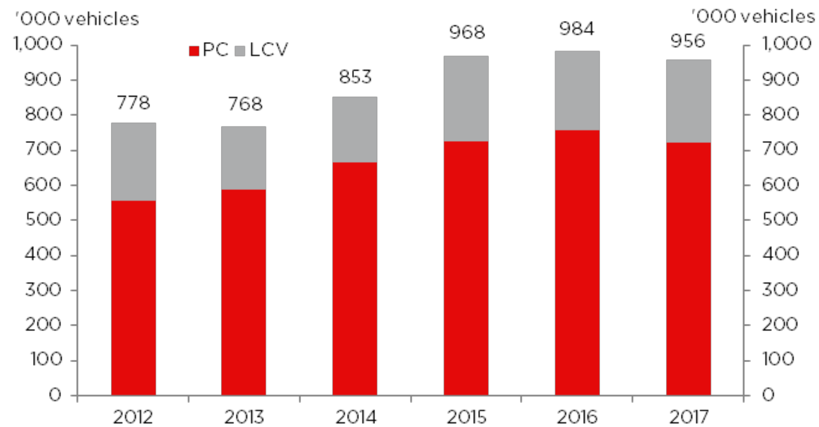
- Similar to air pax traffic, auto sales also fluctuated during 2017, and end the year with a small contraction YoY vs. a flat market in 2016. Following the increase in motor vehicle tax for new cars, we may see another year of stagnation for 2018. On the export side, we expect FROTO to continue enjoying high demand for Ford products in the UK, while TOASO's exports should outpace the disappointing year of 2017.

## Airports in Istanbul

| | New Airport | Ataturk | Sabiha Gokcen |
|---|---|---|---|
| Capacity (pax per annum) | 90m in 2018<br>120mn planned | c. 60mn | c. 30mn<br>c. 40mn after 2nd runway |
| Proximity to city center* | 45 kms | 23 kms | 40 kms |
| No. of runways | 1 in 2018<br>6 in 2025 | 3<br>(only 2 can be used simultaneously) | 1 in 2017<br>2 in 2019 |
| Public transportation | Buses only<br>Metro in 2021<br>High speed train in 202? | Buses and light rail transport | Buses only<br>Metro in 2018<br>High speed train in 202? |
| Concession payment per annum | EUR1bn | USD150mn | EUR76mn |

*Source: Company/consortium data,, press * From Taksim Square*

## Auto sales like to hover around 1m threshold




*Source: Automotive Distributors'*

# Telecoms: Digitalization continues

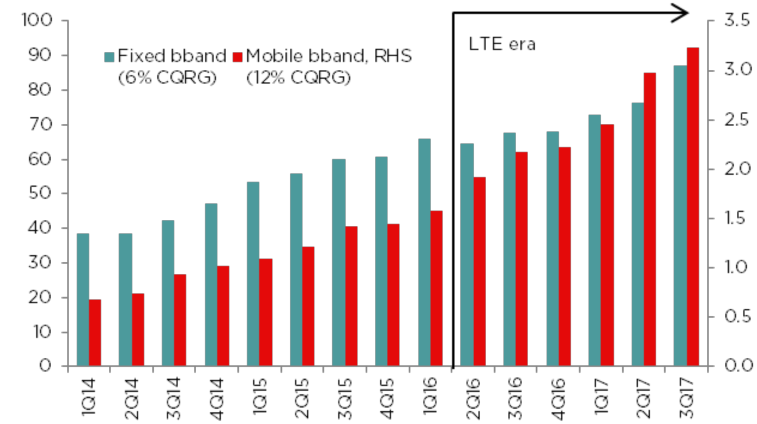
## In the middle of the transformation cycle

- Telecom market has been passing through a major transformation for the last couple of years, with declining voice and higher demand for data and digital services. Both TCELL and TTKOM posted double digit growth for 9M17. This trend accelerated, especially on the mobile side, with the launch of LTE services in 2Q16, and since than data consumption per month per user more than doubled. This growth trend is likely to continue going forward, as operators continue to offer and advertise new services. The operators also target to sell other services, like TV and broadband, or evaluate upselling options to meet the ever increasing demand.
- On the mobile side, the subscriber transition to post-paid from pre-paid continues. This trend not only helps the companies to earn higher ARPU, but also decreases the churn rates. As we still fall behind the European average, we may see further improvement in this breakdown in favour of post-paid, which currently has 53% share in total subscribers, carrying blended ARPU to TRY30 with 6% CAGR in the last 9 years.

## TCELL is likely to better grasp the growth

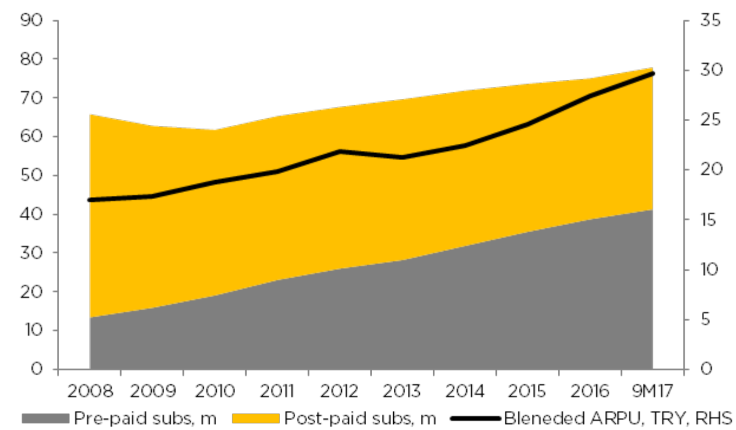
- We believe both operators will continue to enjoy robust growth in 2018, yet our preferred stock for the sector is still TCELL. The company is better positioned to benefit from the strong trends, in our view. We also like TTKOM, yet the share overhang due to OTAS' debt impasse may continue to weigh on the share price.

## Data consumption soared in the last couple of years




*Source: Information and Communication Technologies Authority*

## Post-paid subscribers growing rapidly




*Source: Information and Communication Technologies Authority, Global Securities*

GLOBAL SECURITIES

# Real Estate: Not promising in the current circumstances

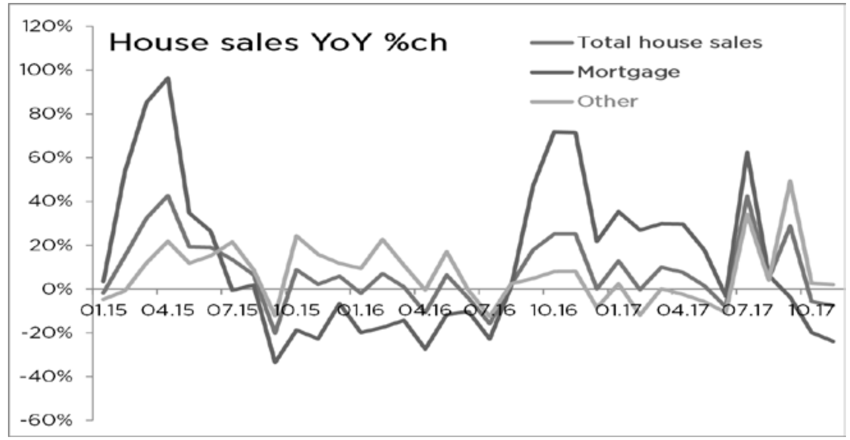
- Turkey total home sales in general fell 7% YoY in Nov'17 with mortgage-backed sales (31% of total sales) dropping 24% YoY where the declining trend continued with acceleration. Other housing sales showed a limited increase of 2% after the last big hike. Additionally, first home sales declined 6.5% to 59,354 and second-hand sales fell 8.4% to 63,378 in Nov'17. It is evident that the housing market has lost its steam due to weak consumption appetite, regional supply/demand imbalances, and hefty financing costs for construction firms.

- Housing price index rose 11.7% YoY in Oct'17 where the price increases in Istanbul and capital Ankara decelerated with the Aegean province of Izmir remaining flattish. While the house price increase has been losing its momentum, increasing construction costs have been putting pressure on the firms in terms of financing needs.

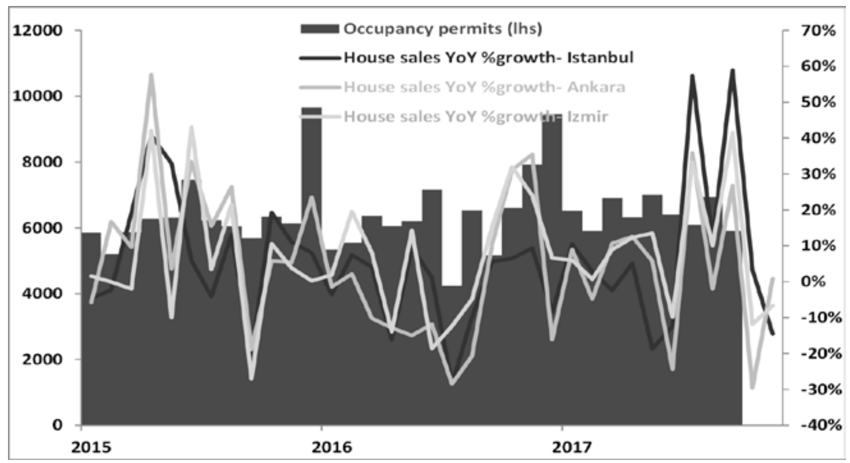
- It is observed the prices of especially branded/luxury projects have been above market average due to high building plot costs in big cities like Istanbul, Ankara, and Izmir. The lagging demand in the housing market seems to affect future price expectations for the market negatively which results in an obvious delay concerning the demand for new housing.

- Increasing construction costs and sluggish demand conditions continue to put pressure on prices which takes a toll on the profit margins of construction companies.

## TURKSTAT House sales data




*Source: TURKSTAT*



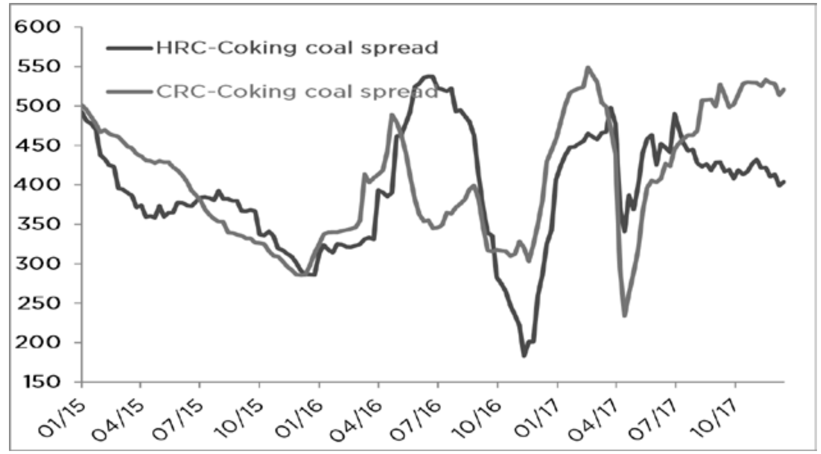

*Source: TURKSTAT.*

GLOBAL SECURITIES

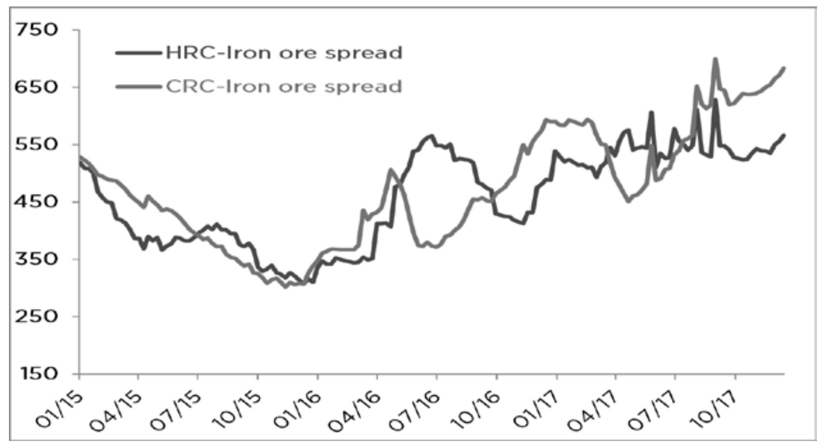
# Iron & Steel: China effect

- In November, China decided to decrease steel production in order to fight the exacerbating air pollution problem. It has been estimated that the supply cut would continue during Nov'17-Mar'18 which could put downward pressure on iron ore prices. For coking coal prices, it should be remembered that it has reclaimed its glory towards the end of 2016.
- Supply-side concerns in Australia and China's restriction on mining days resulted in a steep rally in coking coal prices. As supply problems have been solved and China softened its control on mining days, coking coal prices withdrew from their peak. Recently, premium hard coking coal has been consolidating near the $200/tons. In contrast to last year when coal prices rose too fast and too soon, this year's price rise has been more gradual and fundamental.
- During 2017, it is observed that steel companies have been able to pass higher feedstock costs to buyers where the steel producers experienced a robust margin expansion. Both cold-rolled and hot-rolled prices showed improvement in 4Q17 when compared with 4Q16. Hot-rolled prices averaged $619/tons in 4Q17 with a 17% YoY increase while 2017 average increased to $620/tons (2016 average: $520/tons, +19% YoY). Furthermore, cold-rolled prices increased to $731/tons on average in 4Q17 with a 17% YoY rise where 2017 prices averaged $658/tons (2016 average: $513/tons, +28% YoY). In addition, the product/feedstock spreads have soured in 4Q17 as well where hot-rolled/coal spreads have averaged at $413/tons in 4Q17 with a 55% YoY increase and cold-rolled/coal spreads have averaged at $523/tons with a 47% YoY increase.

## Product price/Feedstock spreads




*Source: Bloomberg*



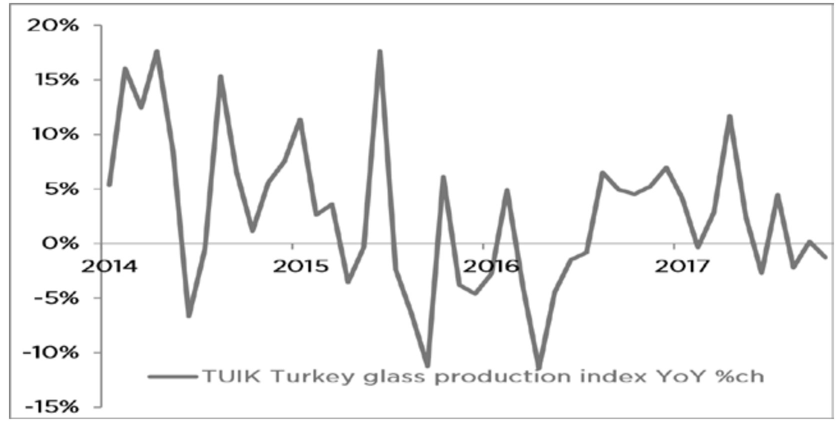

*Source: Source: Bloomberg*

# Glass

## A safe bet

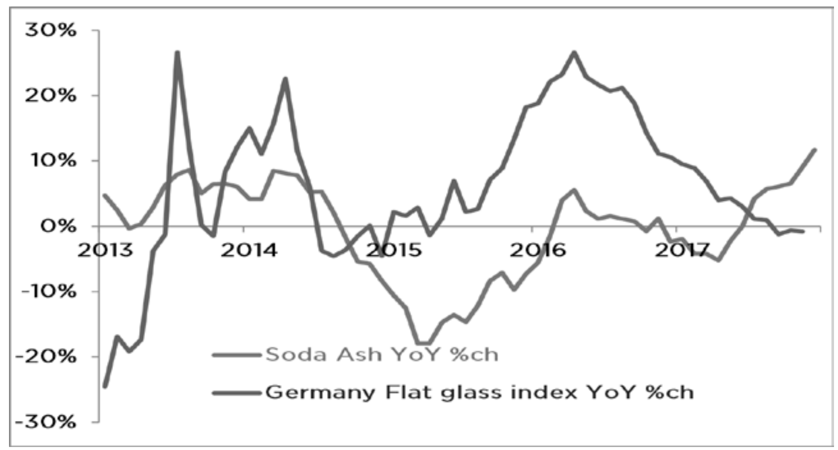
- Average global glass production capacity is estimated to be 180mn tons with $130-140bn value. Total glass market grows at an annual rate of 2-4% where 53% is glass packaging, 29% float glass, 5% glassware, and 13% other glass products. Float glass is the fastest growing market since it provides an important feedstock for automotive, construction, furniture, and whitegoods sectors. Global float glass demand grows at an annual pace of 4-5% where 76% of global float glass demand comes from Europe, Northern America, and China. Eastern Europe, Russia, and Turkey are among the most dynamic float glass markets in terms of high demand and high growth potential.
- Turkey glass production capacity is around 3.5mn tons with Sisecam covering 90% of total production. Total production capacity of Sisecam (both domestic and abroad) amounts to 4.7mn tons with 3mn tons for domestic production. 50% of domestic production is for float glass while glass packaging comprising 32%, and glassware 16%. Most important raw materials as feedstock for glass production are sand, soda ash, dolomite, and quartz where 98% of raw materials in domestic glass production are supplied locally since Turkey has rich resources of these key materials. Raw materials make up 33% of total feedstocks as energy costs are around 20% (most of which is natural gas) whereas labour costs are around 24%.
- Soda ash prices have been in a declining trend during most part of 2017 due to the manifestation of Ciner in the market surely putting some pressure on prices since Ciner is a natural soda ash producer and they can produce with lower costs. Additionally, natural gas discount made in October 2016 helped local glass producers in terms of further margin improvement. Float glass demand has been sustainable during 2017 as there has been an increase, especially in architectural glass and auto glass demand with the pick-up in construction and automotive sectors.

## TURKSTAT Glass production




Source: TURKSTAT

## Soda ash vs. Germany Flat glass index




Source: Bloomberg

# TOP PICKS

## Anadolu Efes (AEFES, Buy, FV TL29.10, upside 17%)

Analyst(s): Evren Gezer

| Market data | TL | Free float | 32% |
|---|---|---|---|
| MCap (mn) | 14,779 | Foreign stake in free float | 80% |
| T/over (3m avg, mn) | 7.0 | Weight in BIST-100 | 1.88% |
| 12-m range | TL17.98 - 25.12 | Dividend yield (2018E) | 1.00% |

| Stock Performance | 1M | 3M | 6M | 12M |
|---|---|---|---|---|
| Absolute (%) | 7% | 19% | 14% | 35% |
| Rel. to BIST-100 (%) | -5% | 7% | -2% | -11% |
| Rel. to US$ (%) | 12% | 13% | 7% | 29% |

### Investment theme

After years of stagnation, we see signs of improvement in Turkish domestic market and the contraction in AEFES' market share seems to be stabilizing at around 70%. A successful relaunch of the brand in mid-2017 helped the company to post a slight expansion in 3Q in Turkey, which we expect to accelerate to some extent. For 2018, higher number of visitors with a better mix, shift of Ramadan out of the high season and a relatively lower excise tax increase for 1H may positively affect the domestic volumes. Nevertheless, affordability is still a concern. On the international side, the company is expected to complete the merger with AB InBev in Russia and Ukraine in 1H18, prior to the World Cup. This merger will not only make the new company a strong second player in the market, but also create some synergies on opex front, in our view. Furthermore, AB InBev is the sponsor of the Fifa World Cup, which will be held in Russia in June and July 2018. According to the company's expectations, the beer consumption in the country, which has been contracting for many years as a result of regulatory actions, is expected to expand by 0.5% to 1% in 2018. Since AB InBev is the sponsor of the event, we believe its branded beers, which will be sold by AEFES' fully consolidated JV by then, will grab the lion's share from this expansion. All in all, we increased our target price to TRY29.10/shr., and our rating to BUY. The main risk for the company remains as the possible regulatory actions that can be taken by Turkish or Russian authorities.


| Financials (TLmn) | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| Sales | 10,420 | 12,565 | 14,509 | 16,200 |
| EBITDA | 1,662 | 1,961 | 2,320 | 2,571 |
| Net debt | 3,427 | 3,623 | 3,114 | 2,575 |
| Net earnings | -71 | 397 | 492 | 527 |

| Ratios | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| P / E | n.m | 37.3 | 30.0 | 28.0 |
| EV / EBITDA | 14.3 | 9.4 | 7.7 | 6.7 |
| EV / Sales | 2.3 | 1.5 | 1.2 | 1.1 |
| ROE | -0.8% | 4.4% | 5.5% | 5.5% |

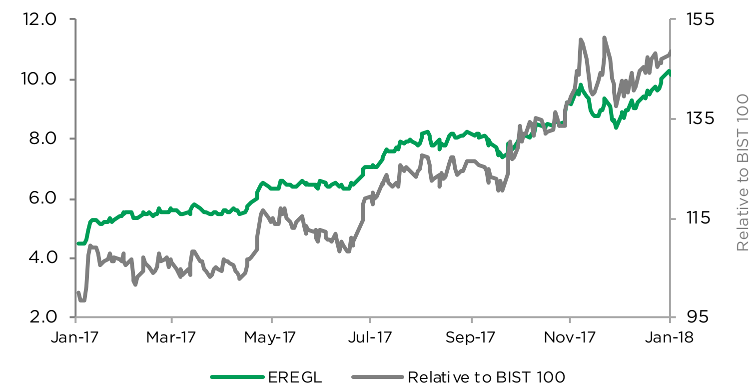
## Eregli (EREGL, Buy, FV TL11.91, upside 17%) — Analyst(s): Utku Uygur

| Market data | TL | Free float | 48% |
|---|---|---|---|
| MCap (mn) | 35,630 | Foreign stake in free float | 75% |
| T/over (3m avg, mn) | 115.5 | Weight in BIST-100 | 6.81% |
| 12-m range | TL4.33 - 10.58 | Dividend yield (2018E) | 7.70% |

| Stock Performance | 1M | 3M | 6M | 12M |
|---|---|---|---|---|
| Absolute (%) | 21% | 24% | 44% | 119% |
| Rel. to BIST-100 (%) | 8% | 11% | 25% | 45% |
| Rel. to US$ (%) | 27% | 18% | 35% | 108% |

### Investment theme

So far, both cold-rolled and hot-rolled prices showed improvement in 4Q17 when compared with 4Q16. Hot-rolled prices averaged $619/tons in 4Q17 with a 17% YoY increase while 2017 average increased to $620/tons (2016 average: $520/tons, +19% YoY). Furthermore, cold-rolled prices increased to $731/tons on average in 4Q17 with a 17% YoY rise where 2017 prices averaged $658/tons (2016 average: $513/tons, +28% YoY). In November, China decided to decrease steel production in order to fight the deteriorating air pollution problem. It has been estimated that the supply cut would continue during Nov'17-Mar'18 which could put downward pressure on iron ore prices. For coking coal prices, it should be remembered that it has reclaimed its glory towards the end of 2016. Supply-side concerns in Australia and China's restriction on mining days resulted in a steep rally in coking coal prices. As supply problems have been solved and China softened its control on mining days, coking coal prices withdrew from their peak. Recently, premium hard coking coal has been consolidating near the $200/tons. In contrast to last year when coal prices rose too fast and too soon, this year's price rise has been more gradual and fundamental. During 2017, it is observed that steel companies have been able to pass higher feedstock costs to buyers where the steel producers experienced a robust margin expansion. Moreover, the product/feedstock spreads have soured in 4Q17 as well where hot-rolled/coal spreads have averaged at $413/tons in 4Q17 with a 55% YoY increase and cold-rolled/coal spreads have averaged at $523/tons with a 47% YoY increase. Rest assured that the strong operational performance of EREGL would most likely continue for the following quarters. The net cash position of the company showed a noteworthy improvement in 3Q17 to TRY1,448mn of net cash whereas it had been TRY225mn at the end of 2Q17. Strong hard-currency denominated cash position usually provides support for the stock price during times of market turmoil which is one of the main reasons EREGL is picked as a defensive play. Considering the recent depreciation of TRY against hard-currencies, EREGL could be one of the outperformers with its sustainable USD based revenue generation. As the increasing trend in product prices is still supporting strong USD denominated revenue generation and increasing product spreads is still backing the strong operational profitability of the company, we maintain our positive stance for EREGL with its undemanding valuation and high FCF & Dividend yields.




| Financials (TLmn) | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| Sales | 11,637 | 17,269 | 19,039 | 20,436 |
| EBITDA | 2,729 | 5,086 | 5,398 | 5,795 |
| Net debt | -667 | -1,448 | -1,548 | -1,648 |
| Net earnings | 1,516 | 3,047 | 3,214 | 3,447 |

| Ratios | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| P / E | 23.5 | 11.7 | 11.1 | 10.3 |
| EV / EBITDA | 13.0 | 6.7 | 6.3 | 5.9 |
| EV / Sales | 3.0 | 2.0 | 1.8 | 1.7 |
| ROE | 10.0% | 19.0% | 18.7% | 19.3% |

## Garanti Bank (GARAN, Buy, FV TL12.20, upside 14%)

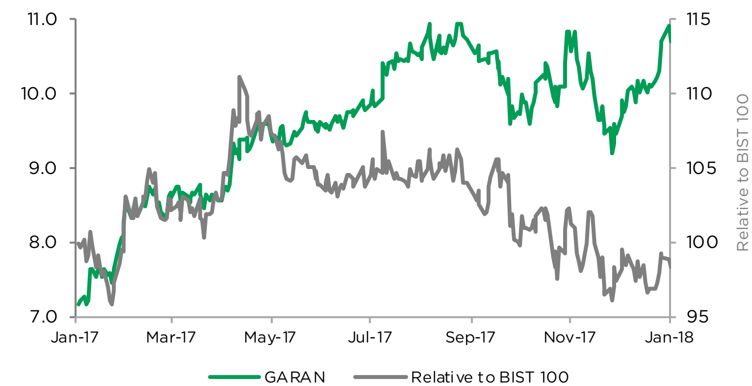
Analyst(s): Sertan Kargin & Kerem Mimaroglu

| Market data | TL | Free float | 48% |
|---|---|---|---|
| MCap (mn) | 45,024 | Foreign stake in free float | 73% |
| T/over (3m avg, mn) | 406.7 | Weight in BIST-100 | 8.60% |
| 12-m range | TL7.11 - 11.10 | Dividend yield (2018E) | 2.80% |

| Stock Performance | 1M | 3M | 6M | 12M |
|---|---|---|---|---|
| Absolute (%) | 13% | 10% | 9% | 47% |
| Rel. to BIST-100 (%) | 1% | -1% | -6% | -3% |
| Rel. to US$ (%) | 18% | 5% | 2% | 40% |

### Investment theme

Garanti has continued to compare well to its peers, especially its profitability metrics, owing to the optimised cost of financing, stricter cost control and continued high-yielding asset management. Well defended NIM evolution, bulky CPI linker portfolio, and early utilisation of CGF with 0% risk weighting, are the other positives. Also, we think Garanti is among one of the best-positioned names in terms of solvency. The Basel-III compliant Tier2 bond issuance added 112bps QoQ to capital adequacy, boosting CAR to 18.9% and Tier 1 ratio to 16.7% as of 3Q17, whereas Garanti has found further support from organic capital generation and RWA optimisation via the CGF facility. While GARAN remains stuck with its yield sensitive asset management policy, the increased cost of lira deposits poses key headwind as has been the case for its competitors. We believe, NIM should manage to hold promising (2018E: 5.16%, +5bps YoY) thanks to on-going NII progress and bulky CPI linker portfolio – an important hedge for NIM. As has been the case for its competitors, Garanti's ability to sustain robust TRY loan growth of c.20% may prove more difficult in the coming quarters as the TRY liquidity squeeze and elevated loan-to-deposit ratio remain conundrum. As long as reliance on non-lira deposits rises, utilization of swap instruments will likely weigh on trading line given the lender's net swap funding volume reaching TRY26bn from TRY8bn in Q4 2016 which took-off 9bps from NIM in 3Q17. True, heavy financing costs remain major headwind to the stock; but there are some tailwinds becoming more pronounced. These are i) proactive upward loan pricings counterbalancing some of the heightened swap costs, ii) the bank has possessed high quality portion of the CGF loans thanks to its first mover advantage; iii) strong fee-income generation remains a differentiating factor amongst its peers, iv) optimised and opportunistic funding strategy helps sustain NIM evolution, iv) the transformation of the bank following the controlling ownership change (from a joint control of BBVA and Dogus Group to full BBVA control) provides more clarity for the management. Against this backdrop, we expect GARAN's earnings to grow by c.13% YoY in 2018E and c.12% YoY in 2019E with a 2018E tangible ROE of 17.2% which compares with Tier I banks average of 15.2% based on our estimates. Garanti shares have outperformed the XBANK index by c.10% in FY17. The bank currently trades 2018E P/BV of 0.95x, against the peer average of 0.73x going into publication. Garanti deserves to trade at higher premiums than its current 2017E P/BV premiums versus peers given its healthy NIM evolution, solid solvency metrics, operating efficiency, and well balanced funding strategy.




| Financials (TLmn) | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| Securities | 47,059 | 48,458 | 50,880 | 53,096 |
| Loans | 185,043 | 205,053 | 230,655 | 260,325 |
| Deposits | 161,232 | 179,707 | 201,286 | 225,103 |
| Net earnings | 5,071 | 6,717 | 7,605 | 8,517 |

| Ratios | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| P / E | 8.9 | 6.7 | 5.9 | 5.3 |
| P / BV | 1.27 | 1.10 | 0.95 | 0.83 |
| ROA | 1.9% | 2.2% | 2.3% | 2.3% |
| ROE | 14.3% | 17.6% | 17.2% | 16.8% |

## Migros Ticaret (MGROS, Buy, FV TL35.20, upside 29%)

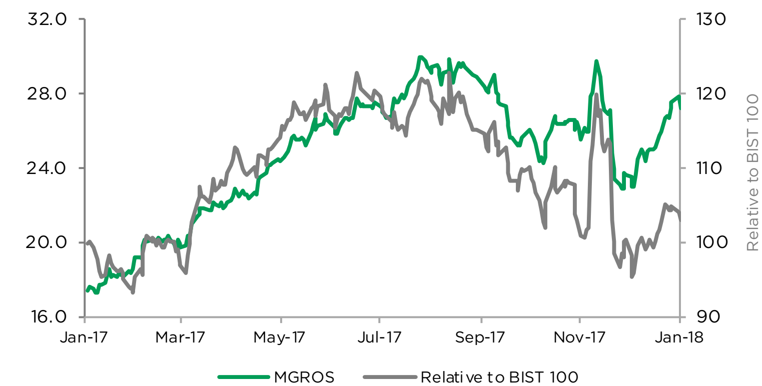
Analyst(s): Evren Gezer

| Market data | TL | Free float | 35% |
|---|---|---|---|
| MCap (mn) | 4,850 | Foreign stake in free float | 43% |
| T/over (3m avg, mn) | 19.8 | Weight in BIST-100 | 0.68% |
| 12-m range | TL17.08 - 30.50 | Dividend yield (2018E) | 0.00% |

| Stock Performance | 1M | 3M | 6M | 12M |
|---|---|---|---|---|
| Absolute (%) | 15% | 4% | -1% | 55% |
| Rel. to BIST-100 (%) | 3% | -7% | -14% | 2% |
| Rel. to US$ (%) | 20% | -1% | -7% | 47% |

### Investment theme

We reiterate our BUY rating for MGROS, while raising our target price to TRY35.20/shr., on the back of strong financial performance and well positioning of the company in the supermarket segment of Turkish FMCG sector. The company is one of the true winners of the increasing footprint of the organized retail in Turkey, with robust growth in the last couple of years, which accelerated in 2017 with the acquisition of KIPA, the third biggest super/hypermarket retailer in Turkey at the time of the acquisition. During this rapid growth era, MGROS managed to increase margins, attract new traffic and reduced shrinkage levels, owing to price investments, introduction of private label products, improved supply chain and also reached higher penetration with proximity stores. Given more than 1,800 outlets around Turkey, the company is 3x larger than its closest competitor, CarrefourSa. As we mentioned in our previous report, we still believe that further acquisitions in the segment are imminent; it is harder for MGROS to a find candidate like Kipa, yet region focused acquisitions are possible. Despite its robust performance and strong prospects, MGROS was one of the laggards in the BIST last year, due to the share overhang related to the stake that are held by the private equity fund for the last 10 years. The fund has been divesting for the last couple years, reducing its stake to 15.4% from as high as 98%. We believe this overhang will end sooner or later and we expect to see the true reflection of the operational performance of the company. The main risks for the stock remain as the strong competition coming from discount segment and lira's weakness against EUR, as well as the above mentioned share overhang risk, in our view.




| Financials (TLmn) | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| Sales | 11,059 | 15,427 | 18,163 | 20,488 |
| EBITDA | 669 | 801 | 1,013 | 1,193 |
| Net debt | 1,807 | 2,562 | 2,446 | 2,181 |
| Net earnings* | -293 | 732 | 67 | 204 |

** MGROS' 2017E net income includes TRY1.09bn one-off, non-cash income related to KIPA acquisition, which distorts multiples for the year.*

| Ratios | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| P / E* | n.m | 6.6 | 72.0 | 23.8 |
| EV / EBITDA | 9.9 | 9.3 | 7.2 | 5.9 |
| EV / Sales | 0.6 | 0.5 | 0.4 | 0.3 |
| ROE* | -152.8% | 125.7% | 6.7% | 17.9% |

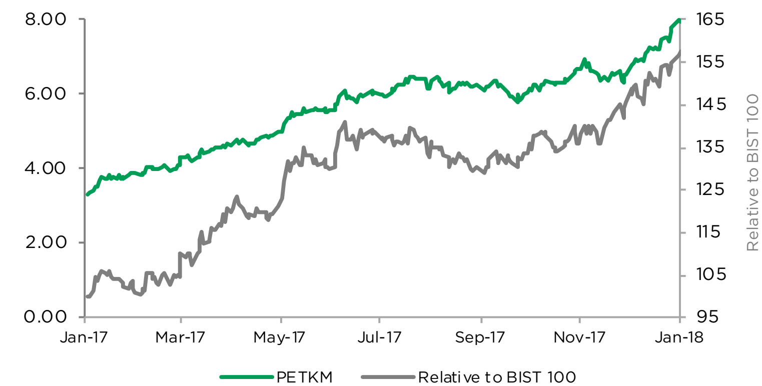
## Petkim (PETKM, Buy, FV TL9.10, upside 14%) Analyst(s): Utku Uygur

| Market data | TL | Free float | 44% |
|---|---|---|---|
| MCap (mn) | 11,940 | Foreign stake in free float | 54% |
| T/over (3m avg, mn) | 140.7 | Weight in BIST-100 | 2.09% |
| 12-m range | TL3.26 - 8.09 | Dividend yield (2018E) | 9.30% |

| Stock Performance | 1M | 3M | 6M | 12M |
|---|---|---|---|---|
| Absolute (%) | 22% | 29% | 33% | 138% |
| Rel. to BIST-100 (%) | 8% | 16% | 15% | 57% |
| Rel. to US$ (%) | 27% | 23% | 25% | 126% |

### Investment theme

Middle East LDPE prices remained flat in 4Q17 at $1,232/ton when compared to last year whereas European Ethylene prices climbed 11% YoY and 5% QoQ to reach an average of $1,450/ton. Yet, the increase in TRY terms is 11% YoY in Middle East prices and 26% YoY in European prices. These positive developments would be reflected on the company's top-line figures as a substantial increase on a yearly basis whereas the TRY depreciation since 2Q16 also underpinned the sales performance. Surely, the recent rise in the oil prices pushes the Naphtha prices up, increasing the main cost item of naphtha-based producers like PETKM. The drop in the Ethylene-Naphtha spread is well compensated with the price hikes in aromatics with benzene prices increasing 15% YoY and 10% QoQ. Moreover, TRY depreciation compared to last year also helps the company in terms of margins. Potential further depreciation of TRY against USD might solidify the market position of PETKM against its importer competitors since PETKM's revenue is totally USD-based where its COGS are 15% TRY-denominated. If crude oil prices were not to pass the 60-65$ range in 2018, naphtha-based producers like PETKM would continue to enjoy favourable spreads compared to ethane-based producers. We believe that Brent and WTI prices would possibly swing between $40 and $65 a barrel in 2018 due to rising U.S. shale production, dropping but still exuberant global supplies, and mingling compliance with OPEC's output cuts. We are still bullish for PETKM with the contribution of favourable overall product spreads, the weakness of TRY supporting operational performance, the completion and commencement of operations in Petlim's 1.5 million TEU capacity container terminal's Phase 1, and the future benefits the company can have with the completion of Star Refinery.




| Financials (TLmn) | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| Sales | 4,533 | 7,343 | 7,563 | 7,790 |
| EBITDA | 887 | 1,773 | 1,826 | 1,840 |
| Net debt | 1,125 | 452 | 483 | 516 |
| Net earnings | 726 | 1,397 | 1,472 | 1,479 |

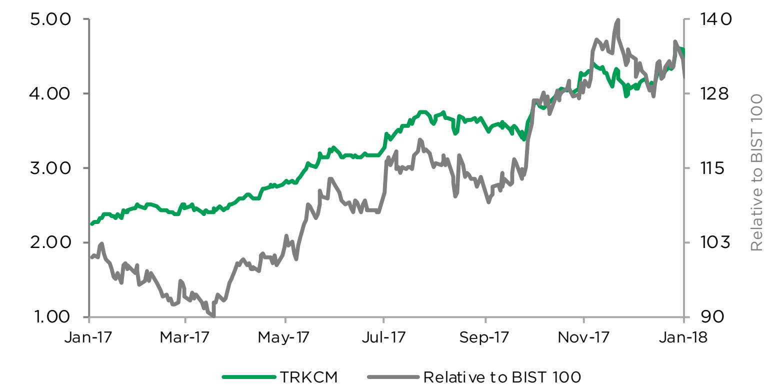
| Ratios | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| P / E | 16.5 | 8.5 | 8.1 | 8.1 |
| EV / EBITDA | 14.8 | 7.0 | 6.8 | 6.8 |
| EV / Sales | 2.9 | 1.7 | 1.6 | 1.6 |
| ROE | 24.2% | 41.1% | 37.2% | 34.7% |

## Trakya Cam (TRKCM, Buy, FV TL5.50, upside 24%)

Analyst(s): Utku Uygur

| Market data | TL | Free float | 28% |
|---|---|---|---|
| MCap (mn) | 5,029 | Foreign stake in free float | 55% |
| T/over (3m avg, mn) | 9.1 | Weight in BIST-100 | 0.56% |
| 12-m range | TL2.22 - 4.65 | Dividend yield (2018E) | 3.00% |

| Stock Performance | 1M | 3M | 6M | 12M |
|---|---|---|---|---|
| Absolute (%) | 9% | 15% | 36% | 97% |
| Rel. to BIST-100 (%) | -3% | 3% | 17% | 30% |
| Rel. to US$ (%) | 14% | 10% | 27% | 88% |




### Investment theme

Excluding Italy, like-for-like increase in TRKCM's consolidated revenue has seen an increase of 33% YoY in 3Q17, thanks to growth in total volumes (12% YoY), price hikes (6% YoY), positive currency effect (14% YoY) and favourable product mix (1% YoY). In terms of top-line growth, both Turkey and European operations pitched in with 39% and 56% YoY increases, respectively. The sturdy top-line growth in Turkey originated from sales volume growth in architectural glass and price hikes whereas the European operations revenue contribution was generated from price hikes only. Additionally, hard-currency denominated auto-glass sales contributed positively again with a 41% YoY increase while float glass sales also increased 50% on a yearly basis in 3Q17. Profitability of both Turkey and European operations soared in 3Q17 with their EBITDA increasing 83% and 53% YoY, respectively (+4% and +1% QoQ). In terms of operating margin contribution, Turkey operations stood out in terms of EBITDA margin with a 7ppts YoY and 4ppts QoQ increase in 3Q17 due to the lower marginal cost after the price hikes, the natural gas discount, and the decline in soda ash prices. Looking at the products, auto glass segment achieved a better profitability with a 21% YoY increase whereas the biggest contribution was attributable to the float glass segment with its EBITDA rising 78% YoY and 12% QoQ in 3Q17. Soda ash prices have been in a declining trend during most part of 2017 due to the manifestation of Ciner in the market surely putting some pressure on prices since Ciner is a natural soda ash producer and they can produce with lower costs. Additionally, natural gas discount made in October 2016 helped local glass producers in terms of further margin improvement; although, the recent price increase in natural gas from BOTAS could have a slightly negative impact on the profitability of TRKCM. Float glass demand has been sustainable during 2017 as there has been an increase especially in architectural glass and auto glass demand with the pick-up in construction and automotive sectors where we expect a similar scenario also for 2018. We maintain our BUY recommendation for TRKCM and raise our FV estimate of TRY4.83/share to TRY5.48/share due to price increases in both domestic and European markets, expectations for a decline in soda ash prices, and steady volumes both in domestic and international markets. We expect that weakening in TRY against hard currencies might result in better top-line figures and margins going forward which drives the operational profitability.

| Financials (TLmn) | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| Sales | 3,016 | 3,981 | 4,730 | 5,466 |
| EBITDA | 489 | 892 | 1,037 | 1,087 |
| Net debt | 1,153 | 1,247 | 1,428 | 1,614 |
| Net earnings | 547 | 581 | 663 | 690 |

| Ratios | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| P / E | 9.2 | 8.7 | 7.6 | 7.3 |
| EV / EBITDA | 13.2 | 7.0 | 6.2 | 6.1 |
| EV / Sales | 2.1 | 1.6 | 1.4 | 1.2 |
| ROE | 16.6% | 16.6% | 16.9% | 15.8% |

## Tupras (TUPRS, Buy, FV TL150.20, upside 23%)

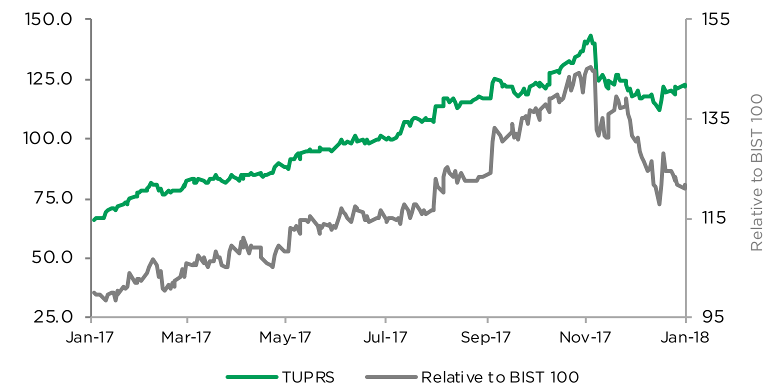
Analyst(s): Utku Uygur

| Market data | TL | Free float | 49% |
|---|---|---|---|
| MCap (mn) | 30,626 | Foreign stake in free float | 79% |
| T/over (3m avg, mn) | 166.5 | Weight in BIST-100 | 5.97% |
| 12-m range | TL64.05 - 145.00 | Dividend yield (2018E) | 10.70% |

| Stock Performance | 1M | 3M | 6M | 12M |
|---|---|---|---|---|
| Absolute (%) | 4% | -1% | 23% | 91% |
| Rel. to BIST-100 (%) | -8% | -11% | 6% | 26% |
| Rel. to US$ (%) | 8% | -6% | 15% | 81% |

### Investment theme

The increasing trend in product prices continues to support the steady top-line growth coupled with rising sales volume (3Q17: +10% YoY) where the contribution to strong sales performance comes mostly from domestic diesel, bitumen, and gasoline. Gasoline prices averaged US$595/tons in 4Q17 with 16% YoY and 8% QoQ increase. Similarly, diesel prices averaged US$560/tons in 4Q17 with a 21% YoY and 13% QoQ increase. Backed by strong product prices, we expect the strong cash and revenue generation performance of TUPRS to continue. In 3Q17, refining margins were positively affected by the supply outages in many European refineries. Additionally, strong demand has also led to a rise in average diesel crack margins in July and August. During 4Q17, med refining margins have been on a normalization trend where in 4Q17 margins declined to $4.1/bbl (3Q17: $6.5/bbl) mostly due to finalization of refinery maintenances and the impact of one-off production disruptions realized in Europe with higher oil prices and lower demand for European distilled gasoline from the U.S. Net margin of TUPRS had climbed to US$8.9/bbl (US$2.4/bbl higher than benchmark) in 3Q17 thanks to increasing product margins, positive domestic market environment, high complexity, and favourable crude purchases. We expect that the company guidance already takes these developments into account with Med complex margin guidance of $5.25/bbl-$5.75/bbl. Please note that the company revised up its 2017YE guidance for med complex and TUPRS net margins from US$4.25-4.75 to US$5.25-5.75 and from US$7.0-7.5 to US$7.5-8.0, respectively. The guidance also incorporates the Izmir refinery crude unit shutdown in 4Q17 (planned to be completed in Jan' 2018). Even though there are short-term challenges, we maintain our bullish stance on TUPRS due to favourable valuation and high FCF & dividend yields.




| Financials (TLmn) | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| Sales | 34,855 | 52,796 | 55,260 | 57,588 |
| EBITDA | 3,214 | 5,994 | 5,721 | 5,904 |
| Net debt | 6,084 | 4,457 | 4,170 | 3,987 |
| Net earnings | 1,793 | 4,362 | 4,044 | 4,160 |

| Ratios | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| P / E | 17.1 | 7.0 | 7.6 | 7.4 |
| EV / EBITDA | 11.4 | 5.9 | 6.1 | 5.9 |
| EV / Sales | 1.1 | 0.7 | 0.6 | 0.6 |
| ROE | 22.2% | 44.8% | 33.5% | 30.5% |

## Vakıf Bank (VAKBN, Buy, FV TL8.00, upside 18%)

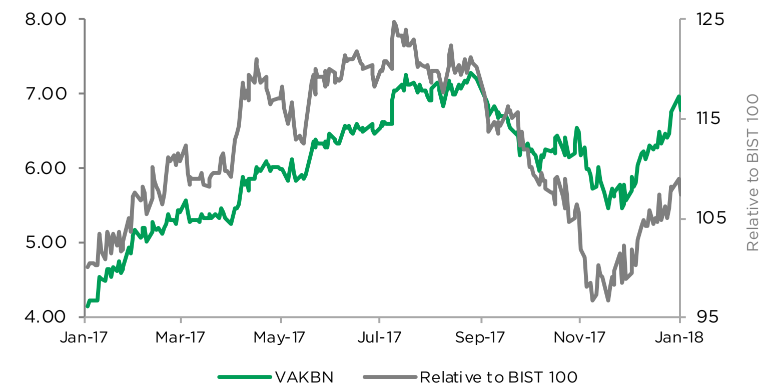
Analyst(s): Sertan Kargin & Kerem Mimaroglu

| Market data | TL | Free float | 25% |
|---|---|---|---|
| MCap (mn) | 16,975 | Foreign stake in free float | 88% |
| T/over (3m avg, mn) | 81.8 | Weight in BIST-100 | 1.69% |
| 12-m range | TL4.13 - 7.31 | Dividend yield (2018E) | 0.70% |

| Stock Performance | 1M | 3M | 6M | 12M |
|---|---|---|---|---|
| Absolute (%) | 22% | 9% | 4% | 61% |
| Rel. to BIST-100 (%) | 9% | -2% | -10% | 6% |
| Rel. to US$ (%) | 27% | 4% | -3% | 53% |

### Investment theme

Vakifbank is among the largest lenders of CGF loans despite ongoing TRY funding squeeze, ranked second player after another state-run Halkbank with c.TRY21bn utilization from the fund facility as of the end of 3Q17. On deposit side, Vakifbank significantly benefited from public sector deposits which reached 32% of total deposits in Q3 thanks to changing regulation. This should continue to mitigate the negative impact of rising funding costs on NIM to some extent. Given the current TRY deposit rates hovering at the 13-14% range, Vakifbank seems to face some pressure on core spreads which could take a toll on margins. That said, we believe steady NIM evolution should continue along with further contribution from CPI linkers and state deposits. We expect fee income to maintain the solid growth trajectory owing to the strong loan growth and increased efforts of cross-sell activities on the side-lines of GPL extensions, while expecting OPEX to go hand-in-hand with inflation in the forthcoming period. Given the double-digit inflation and promotion payments to pensioners, OPEX rose by 16.3% YoY in Q3 whereas C/I ratio surged by 594bps QoQ to 43.9% in the quarter sparking a debate over the continuation of operating efficiency though YtD C/I remained at 37.2% as of 9M17. These entire readings still hint that the 2017 OPEX growth target of CPI plus 1-2ppts (low teens) might have been missed to some extent. As for asset quality, while the elevated CoR could remain as hurdle, eased regulations and reduced RWA density by the CGF should help to some extent. Needless to say, the subordinated debt conversion has provided some buffer for CAR against potential currency pressures. Vakifbank is ready to implement the IFRS9 in terms of general provisioning, which accumulated to TRY2.3bn. Any excess amount will be reversed and then converted into Tier1 capital. Against this backdrop, we expect VAKBN earnings to grow by c.12% YoY in 2018E and c.10% YoY in 2019E with a 2018E tangible ROE of 17.0% which compares with Tier I banks average of 15.2% based on our estimates. Transfer of the General Directorate of Foundations' 58.45% stake in VAKBN should have some implications on the share price. The most indicative factors for VAKBN share performance at this point would be the obtained appraisal value which remains uncertain yet. We do not expect the share transfer to trigger a tender call for the VAKBN minorities as this can be taken as a transaction between two state bodies. Hence, the transfer seems to be finalized at some premium price. We upgrade VAKBN to BUY and raise our FV to TRY8.00 from TRY6.95 offering c.18% upside potential. VAKBN shares have significantly outperformed the XBANK index by c.19% in FY17. The bank currently trades 2018E P/BV of 0.64x, against the peer average of 0.73x going into publication.




| Financials (TLmn) | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| Securities | 27,611 | 30,990 | 32,448 | 33,522 |
| Loans | 146,619 | 184,129 | 212,424 | 241,443 |
| Deposits | 123,838 | 154,255 | 178,027 | 201,776 |
| Net earnings | 2,703 | 3,753 | 4,186 | 4,590 |

| Ratios | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| P / E | 6.3 | 4.5 | 4.1 | 3.7 |
| P / BV | 0.88 | 0.74 | 0.64 | 0.57 |
| ROA | 1.4% | 1.6% | 1.5% | 1.5% |
| ROE | 14.1% | 17.8% | 17.0% | 16.3% |

GLOBAL SECURITIES

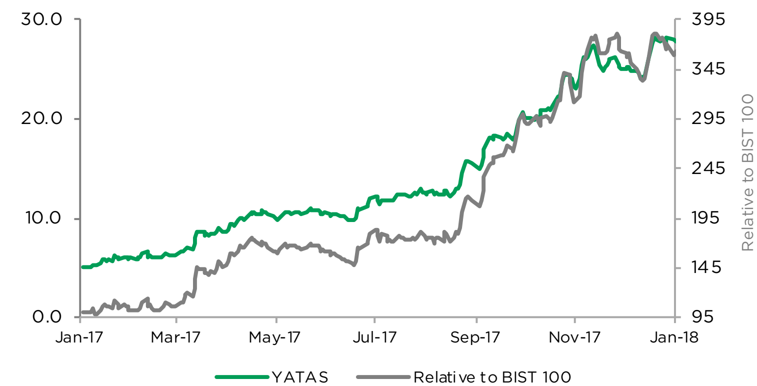
## Yatas (YATAS, Buy, FV TL35.53, upside 27%) — Analyst(s): Cem Unal

| Market data | TL | Free float | 54% |
|---|---|---|---|
| MCap (mn) | 1,193 | Foreign stake in free float | 47% |
| T/over (3m avg, mn) | 7.5 | Weight in BIST-100 | 0.26% |
| 12-m range | TL5.00 - 28.50 | Dividend yield (2018E) | 0.00% |

| Stock Performance | 1M | 3M | 6M | 12M |
|---|---|---|---|---|
| Absolute (%) | 12% | 38% | 128% | 458% |
| Rel. to BIST-100 (%) | 0% | 24% | 97% | 268% |
| Rel. to US$ (%) | 17% | 31% | 114% | 430% |

### Investment theme

We have a Buy rating for YATAS with TRY35.53 target price offering 27% upside. The company achieved an impressive growth which was increased considerably with the effect of new business model to a CAGR of 32.4% during 2013-2016. Yatas recorded robust operational figures with 159% of YoY growth as of 9M17, which increased its EBITDA margin by 500bps to 15.1%. On a going-forward basis, we assume significant opportunities to grab market share from other players to continue, especially considering the seizure of leading names in the sector by the Saving Deposit Insurance Fund and deterioration of small-scale retailers, which constitute around 60% of the sector. These are also well supported by bright outlook of the sector with favorable demographic factors. Furthermore, the company targets to double the store openings in abroad over the next couple of years with the contribution of recent accreditation to Turquality incentive program. We believe the company to remain intact in 2018 despite the high base of 2017 and continue to hold growth momentum going forward. Therefore, we assume top line to grow by 41% reaching at TRY1.15bn of revenues with 14.7% of EBITDA margin, which is slightly below the guidance of the company for 2018 as we intend to see the effects of disappearing VAT cut. All in all, we like Yatas on the back of promising growth prospects well supported by the wider domestic and international store network, sustainable margin evolution along with the positive impact of new investment, robust balance sheet structure along with the strong cash generation and decent dividend potential, vivid brand awareness and recent accreditation of Turquality incentive program. Putting all pieces together, we believe the Yatas should offer attractive return opportunities in the forthcoming period. The main risks are the removal of fiscal incentives to the furniture sector, the acceleration of operations of the seized market players, including the market leader, the continuation of fragmented structure of the sector and the lack of economies of scale, new challenges in the macro environment and accompanying deterioration in residential sector.




| Financials (TLmn) | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| Sales | 502 | 817 | 1,152 | 1,460 |
| EBITDA | 55 | 119 | 169 | 219 |
| Net debt | 64 | 43 | 30 | 40 |
| Net earnings | 17 | 66 | 100 | 135 |

| Ratios | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| P / E | 68.3 | 18.0 | 11.9 | 8.8 |
| EV / EBITDA | 22.7 | 10.4 | 7.2 | 5.6 |
| EV / Sales | 2.5 | 1.5 | 1.1 | 0.8 |
| ROE | 16.3% | 47.4% | 44.9% | 42.7% |

## Zorlu Enerji (ZOREN, Buy, FV TL2.00, upside 27%)

Analyst(s): Cem Unal

| Market data | TL | Free float | 15% |
|---|---|---|---|
| MCap (mn) | 3,160 | Foreign stake in free float | 7% |
| T/over (3m avg, mn) | 52.5 | Weight in BIST-100 | 0.19% |
| 12-m range | TL1.10 - 1.81 | Dividend yield (2018E) | 0.00% |

| Stock Performance | 1M | 3M | 6M | 12M |
|---|---|---|---|---|
| Absolute (%) | 16% | 1% | 16% | 37% |
| Rel. to BIST-100 (%) | 4% | -9% | 1% | -10% |
| Rel. to US$ (%) | 21% | -4% | 9% | 30% |


### Investment theme

We upgrade our target price for ZOREN from TRY1.91 to TRY2.00 which offers 27% upside on the back of the increase in the real rate of return from 11.91% to 13.61% by EMRA which should increase the revenue requirement for distribution arm. Zorlu Enerji has 21 operational power plants and 1,090MW of total installed capacity in Turkey, Pakistan and Israel. As of today, 624 MW of this capacity, which corresponds to 57% of total, is based on renewables resources. The company is targeting 1,161 MW of renewable capacity by 2020 (71% of total targeted installed capacity of 1,626 and 1.9x more than the current capacity of 624MW). Further capacity upside comes from renewable energy projects in Pakistan and new geothermal exploration permits in Turkey. The company especially focuses on geothermal energy in Turkey, which has a higher capacity factor and feed-in tariff than hydro and wind. As of 9M17, 90% of the EBITDA from energy generation comes from the operations supported by the state's renewable energy support scheme, which is a partial hedge for the company's hard currency liabilities. The renewable energy investments drive the sustainable EBITDA performance with USD denominated revenue generation since the renewable market became more profitable and attractive with the depreciation of TRY against hard currencies and the weakness of spot prices. The company has a total installed power of 240MW in geothermal energy. The geothermal power capacity will reach 440 MW when Kızıldere III-2nd unit (in 1H18) and Alaşehir II (in 2019) become operational. We expect a yearly EBITDA contribution of USD150mn yearly from Kizildere II and Kızıldere III in 2018E and USD180mn in 2019E after the second unit of Kızıldere III is put into use. An annual contribution of USD30mn EBITDA is expected from Alasehir I in 2018E and USD15mn EBITDA is expected from Alasehir II investment which is expected to be operational in 2019. In addition, Bahawulpur I solar power plant in Pakistan with an installed capacity of 100 MW is planned to come on stream by 1H18, which is expected to create USD10-11mn EBITDA per annum. Additionally, along with acquisition of the operating rights for Osmangazi Electricity Distribution region in February 2017 also makes positive contribution to financials. Thus, we pencil in USD45mn EBITDA for 2017, which reaches USD231mn in 2035, the last full year of concession. All in all, we expect total EBITDA of USD136mn in 2016 to reach c. USD200mn in 2017E and USD325mn in 2018E, including the effect of the distribution arm.

| Financials (TLmn) | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| Sales | 1,195 | 3,040 | 3,982 | 4,672 |
| EBITDA | 413 | 760 | 1,311 | 1,726 |
| Net debt | 5,258 | 6,062 | 9,163 | 10,333 |
| Net earnings | -4 | 77 | 180 | 305 |

| Ratios | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| P / E | n.m | 41.2 | 17.5 | 10.4 |
| EV / EBITDA | 20.4 | 12.1 | 9.4 | 7.8 |
| EV / Sales | 7.0 | 3.0 | 3.1 | 2.9 |
| ROE | -0.9% | 6.7% | 12.2% | 19.7% |

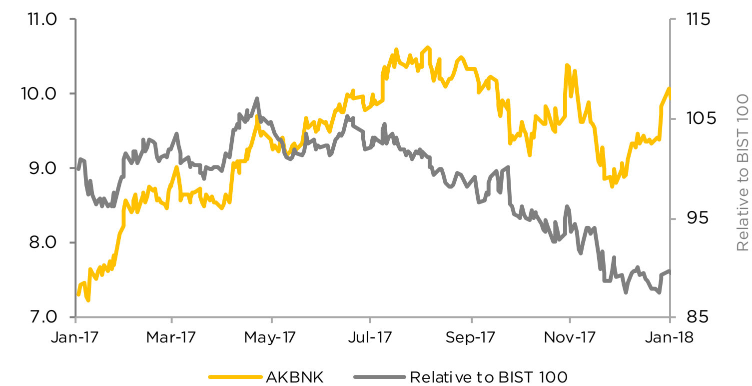
# FV & RATING CHANGES

| Market data | TL | Free float | 52% |
|---|---|---|---|
| MCap (mn) | 39,760 | Foreign stake in free float | 65% |
| T/over (3m avg, mn) | 183.4 | Weight in BIST-100 | 8.23% |
| 12-m range | TL7.18 - 10.72 | Dividend yield (2018E) | 2.30% |

| Stock Performance | 1M | 3M | 6M | 12M |
|---|---|---|---|---|
| Absolute (%) | 13% | 5% | 1% | 34% |
| Rel. to BIST-100 (%) | 1% | -6% | -12% | -11% |
| Rel. to US$ (%) | 18% | 0% | -5% | 27% |

## Investment theme

We believe AKBNK should remain one of the key players in the Turkish banking sector in an environment of cost of financing remaining elevated, currency pressures continuing, volatility picking up, and growth momentum softening. We think, Akbank can offer decent performance owing to its relatively resilient financials to potential volatility. Akbank comes top of the list in terms of liquidity management given c.36% liquid asset to total asset ratio while remaining the least exposed bank to external wholesale funds among privately owned Tier1 banks. With external wholesale funding reaching 15.2% of total funding, Akbank is less vulnerable to external financing conditions when compared to Tier1 average (c.16.5%) under our coverage. Akbank has one of the best Tierl ratios among peers which could help the bank decoupling in times to adjustments for Basel III and IFRS9. We expect no risk from IFRS-9 as it's been operating at nearly 100% coverage ratio with bulky provisioning book. In fact, IFRS-9 could be positive for profitability as IFRS-9 directives require less provisioning ratio such as 75-80%, indicating that potential reversals could materialize after the new financial standard becomes effective in 1Q18. The USD1.5bn OTAS loan still remains a source of concern, though. The loan is currently classified under performing loans and no provision has been set aside yet. The Bank's solvency metrics were well supported by the USD500mn sub-debt issue in Mar 2017. From the operating perspective, Akbank is by far the most efficient Turkish bank in our coverage. C/I ratio has been almost pegged to around 35% which is the main evidence of Akbank's solid efficiency. As for earnings, the bank management has concentrated its efforts in core banking business in order to deliver high earnings quality, particularly through optimisation of the branch network and digital banking. Akbank's earnings sensitivity to interest rate fluctuations is relatively low thanks to interest rate swap deals whereas its bulky CPI linker exposure supports NIM. Against this backdrop, we expect Akbank's earnings to grow by c.10% YoY in 2018E and c.11% YoY in 2019E with a 2018E tangible ROE of 15.8%, comparing with Tier I banks average of 15.2% based on our estimates. The bank currently trades 2018E P/BV of 0.88x, against the peer average of 0.73x going into publication. Worth noting that there may be potential overhang over the stock due to Sabanci Families' latest trade registrations. This is the major culprit of the stock's 2.3% underperformance versus XBANK over the FY17, in our opinion. With the glass half-full, this can also be considered as an indication that the stock may offer decent return potential in case of normalization of trade dynamics.




| Financials (TLmn) | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| Securities | 58,226 | 64,594 | 68,425 | 72,301 |
| Loans | 161,673 | 190,756 | 218,054 | 248,172 |
| Deposits | 158,878 | 182,171 | 205,993 | 231,601 |
| Net earnings | 4,529 | 6,121 | 6,739 | 7,456 |

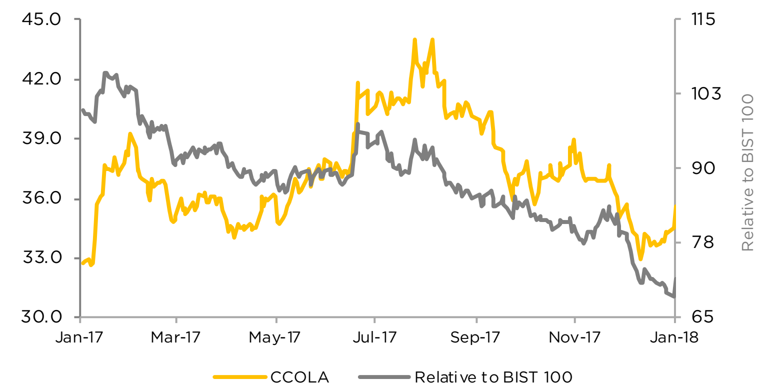
| Ratios | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| P / E | 8.8 | 6.5 | 5.9 | 5.3 |
| P / BV | 1.23 | 1.00 | 0.88 | 0.79 |
| ROA | 1.8% | 2.1% | 2.1% | 2.1% |
| ROE | 14.0% | 16.9% | 15.8% | 15.6% |

| Market data | TL | Free float | 25% |
|---|---|---|---|
| MCap (mn) | 9,056 | Foreign stake in free float | 87% |
| T/over (3m avg, mn) | 10.2 | Weight in BIST-100 | 0.90% |
| 12-m range | TL31.97 - 44.30 | Dividend yield (2018E) | 0.60% |

| Stock Performance | 1M | 3M | 6M | 12M |
|---|---|---|---|---|
| Absolute (%) | 1% | -5% | -12% | 9% |
| Rel. to BIST-100 (%) | -10% | -15% | -24% | -28% |
| Rel. to US$ (%) | 6% | -10% | -18% | 4% |

## Investment theme

We made a slight adjustment to our estimates in CCOLA, revising our target price to TRY43/shr. while keeping our BUY rating. In domestic market, the transition to immediate consumption packs continues. The share of these packs with 1 lt or less content, reached almost 23% as of 2017, from around 14% in 2013. Although these packs have lower volume, they traditionally have a higher unit case price, which positively affects the margins. As of 3Q17, we see the highest sparkling volume increase in Turkey in years, with strong contribution from small packs and promotions. For 2018, the overlap of Ramadan and the high season will be further supporting volume, and share of IC packs should continue to grow; however, the introduction of excise tax for non-alcoholic beverages may mitigate the margin improvement to some extent. As a reminder, cola drinks, which constitute a larger part of the volume in Turkey, already have 25% excise tax for many years, thus the impact should remain limited. On the international front, we expect the strong growth in Pakistan and Central Asia to continue. We may also see a better environment in Iraq. Elevated feedstock prices may continue to weigh on the margins throughout 2018, with sluggish TRY, yet the company will continue to hedge its costs for possible fluctuations.

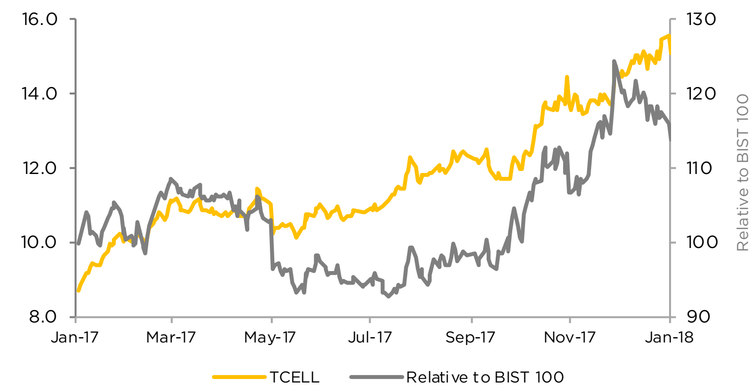



| Financials (TLmn) | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| Sales | 7,050 | 8,652 | 9,594 | 10,594 |
| EBITDA | 1,060 | 1,289 | 1,432 | 1,580 |
| Net debt | 2,293 | 1,872 | 1,600 | 1,178 |
| Net earnings | -28 | 407 | 584 | 722 |

| Ratios | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| P / E | n.m | 22.2 | 15.5 | 12.6 |
| EV / EBITDA | 11.4 | 8.5 | 7.4 | 6.5 |
| EV / Sales | 1.7 | 1.3 | 1.1 | 1.0 |
| ROE | -0.7% | 12.6% | 24.6% | 25.0% |

| Market data | TL | Free float | 49% |
|---|---|---|---|
| MCap (mn) | 33,220 | Foreign stake in free float | 91% |
| T/over (3m avg, mn) | 116.7 | Weight in BIST-100 | 6.48% |
| 12-m range | TL8.43 - 15.68 | Dividend yield (2018E) | 8.80% |

| Stock Performance | 1M | 3M | 6M | 12M |
|---|---|---|---|---|
| Absolute (%) | 3% | 26% | 38% | 79% |
| Rel. to BIST-100 (%) | -8% | 13% | 20% | 18% |
| Rel. to US$ (%) | 8% | 20% | 30% | 70% |




## Investment theme

We raised our TP to TRY17.54/shr. for TCELL while keeping our BUY rating, owing to the operator's ongoing splendid performance in transforming to a digital operator from a traditional telecom operator. In the last couple of quarters, the company managed to expand its subscriber base in more profitable post-paid side and hence increased its blended mobile ARPU with a 9% CAGR in the last four years. We expect the mobile ARPU to grow by another 8% in 2018, with cross- and up-sell opportunities, as well as continued trend in switch to post-paid from pre-paid. The ever increasing demand for data supports this transition trend. New digital services and tariffs, which support higher data consumption will also continue to support ARPU growth and eliminate the mitigating impact of the declining voice revenues. Although the company increases prices in line with the inflation for the last couple of quarters, TCELL continued to increase its subscriber base in the last couple of quarters. This basically came from its service quality, which will prevail in the future, as the company acquired the best spectrum available during the tender for LTE held in 2015. Following Telia's total 14% stake sale in May and September 2017, we now believe that the share overhang is over, and the company will continue to distribute 50% of its distributable income, without any major conflicts. TCELL's net debt/EBITDA of 1.2x and a very small short fx position, which is well below the company's threshold at USD500mn, does not pose major risk for the share price. The main risks for the company are a slowdown in the data demand and a regulatory change in the telecom sector, in our view.

| Financials (TLmn) | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| Sales | 14,286 | 17,327 | 19,626 | 21,931 |
| EBITDA | 4,599 | 5,684 | 6,466 | 7,208 |
| Net debt | 3,729 | 3,769 | 3,253 | 2,704 |
| Net earnings | 1,512 | 2,184 | 2,386 | 2,726 |

| Ratios | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| P / E | 22.0 | 15.2 | 13.9 | 12.2 |
| EV / EBITDA | 8.0 | 6.5 | 5.6 | 5.0 |
| EV / Sales | 2.6 | 2.1 | 1.9 | 1.6 |
| ROE | 9.4% | 12.4% | 11.8% | 12.4% |

## Turkish Airlines (THYAO, Hold, FV TL15.80, downside 2%)

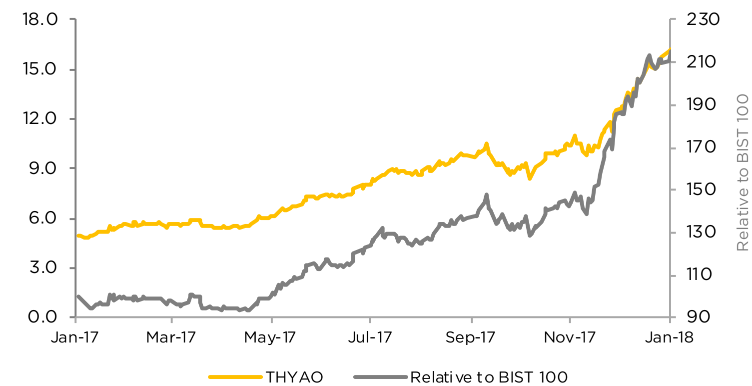
Analyst(s): Evren Gezer

| Market data | TL | Free float | 50% |
|---|---|---|---|
| MCap (mn) | 22,356 | Foreign stake in free float | 67% |
| T/over (3m avg, mn) | 1,122.6 | Weight in BIST-100 | 4.45% |
| 12-m range | TL4.76 - 16.23 | Dividend yield (2018E) | 0.00% |

| Stock Performance | 1M | 3M | 6M | 12M |
|---|---|---|---|---|
| Absolute (%) | 30% | 81% | 101% | 232% |
| Rel. to BIST-100 (%) | 16% | 62% | 74% | 119% |
| Rel. to US$ (%) | 35% | 72% | 89% | 215% |

### Investment theme

Following the dire events in 2016, Turkish aviation sector made its comeback in the second half of 2017, with total passenger number grew by more than 10% YoY, following a 4% contraction a year ago. The airliners, especially THYAO, also positively affected from this growth, posting strong pax figures starting from 2Q17. In addition, the sluggish pax and hence revenue growth, forced the company to strictly control costs, which resulted in robust EBITDAR growth, carrying the margin above 20% in 2017E from 16.6% in 2016. We believe the passenger growth and strict cost control in Turkish Airlines will continue in 2018E, which will keep the margins above 20% level. The main theme for the year is the relocation of the operations to the new airport, which is expected to open in late 2018. We still believe in the growth potential of the company, yet we think these prospects have already priced in, thus although we increase our target price for THYAO to TRY15.80/shr., we cut our recommendation to HOLD. The main risk for the company should be the increasing airport expenses with the relocation that may be reflected to the ticket prices and hence have a negative impact on THYAO's competitive power in transfer pax beyond 2018.




| Financials (TLmn) | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| Sales | 29,468 | 37,847 | 46,225 | 54,722 |
| EBITDA | 2,521 | 6,303 | 7,476 | 9,254 |
| Net debt | 29,661 | 34,282 | 39,315 | 43,214 |
| Net earnings | -47 | 1,555 | 2,974 | 3,869 |

| Ratios | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| P / E | n.m | 14.4 | 7.5 | 5.8 |
| EV / EBITDA | 20.6 | 9.0 | 8.2 | 7.1 |
| EV / Sales | 1.8 | 1.5 | 1.3 | 1.2 |
| ROE | -0.3% | 8.3% | 13.7% | 14.7% |

## Tekfen Holding (TKFEN, Buy, FV TL17.17, upside 6%)

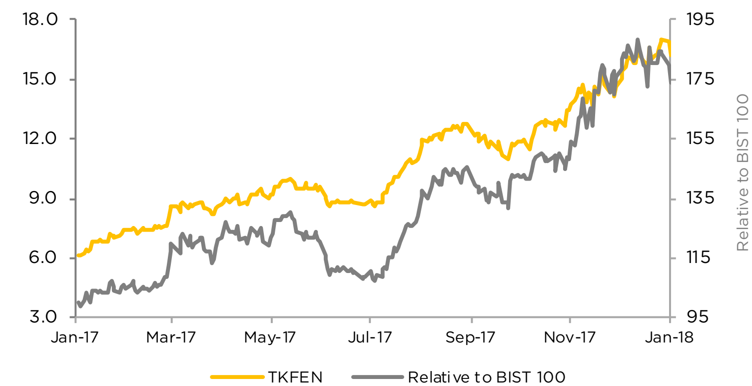
Analyst(s): Utku Uygur

| Market data | TL | Free float | 48% |
|---|---|---|---|
| MCap (mn) | 5,994 | Foreign stake in free float | 74% |
| T/over (3m avg, mn) | 22.4 | Weight in BIST-100 | 1.15% |
| 12-m range | TL6.06 - 17.35 | Dividend yield (2018E) | 2.40% |

| Stock Performance | 1M | 3M | 6M | 12M |
|---|---|---|---|---|
| Absolute (%) | 11% | 36% | 82% | 161% |
| Rel. to BIST-100 (%) | -1% | 22% | 57% | 72% |
| Rel. to US$ (%) | 16% | 30% | 71% | 148% |

### Investment theme

TKFEN has achieved an EBITDA of TRY108mn for contracting operations in 3Q17 which carries the 9M cumulative EBITDA to TRY341mn with a 179% YoY increase for the corresponding period. Trailing 12M EBITDA margin at 11.8% sets a new record, up from 9.2% at 2016YE and 10.4% for the previous quarter. As of 3Q17, contracting backlog has been $3.57bn, broadly unchanged compared to previous quarter. It should be noted that TKFEN has also signed a new contract in Oct'17, worth approximately USD155mn regarding the electromagnetic works for the ongoing construction of Star Refinery's Coker Unit in Aliaga, Izmir. The company has also signed a contract with UAE-based Petrofac International UAE, LLC for the construction of a gas terminal to be built near Kiyikoy within the framework of Turkish Stream project. We expect recent projects, especially Al Khor Expressway in Qatar, could contribute positively to revenue generation in 2018. To remind, the management has revised up its 2017YE expected contracting EBITDA margin realization from 6.6% to 9.7% and net profit margin up from 3.9% to 6.3% with the new business additions and positive outlook regarding the cash generation performance. Agriculture segment also continues to achieve higher profitability where the segment achieved 65% YoY and 4% QoQ top-line growth in 3Q17 with a 19% YoY increase for 9M17. Even though the sales volume declined by 6% YoY in 9M17 due to the sales boost with the VAT reduction in 1Q16, the company reported a 32% YoY increase in 3Q17 with 9M17 volumes reaching 1,497 ktons. Thanks to the increase in average domestic sales prices and higher volumes, the company continued its steady revenue generation in the third quarter as well. Terminal segment's revenue and operational profitability also improved significantly owing to the high fill rate ratio in petroleum products along with higher handling volume in dry/liquid bulk-general cargo. As a result, the strong operational performance continued in 3Q17 where agriculture segment's EBITDA rose 120% YoY and 16% QoQ in 3Q17 with nine month EBITDA growing 65% on a yearly basis. 12m EBITDA margin increased to 19.4% which was 18.5% in 2Q17 and 14% in 3Q16. Please note that the company has already made major updates regarding its 2017YE expectations by revising up their EBITDA and net income estimates: EBITDA margin up to 17% from 13%; Net profit margin up to 14% from 10% where they have already achieved their targets in the first nine months.




| Financials (TLmn) | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| Sales | 4,737 | 7,456 | 9,538 | 9,104 |
| EBITDA | 506 | 998 | 1,228 | 1,172 |
| Net debt | -331 | -816 | -1,316 | -1,028 |
| Net earnings | 324 | 455 | 582 | 555 |

| Ratios | 2016 | 2017E | 2018E | 2019E |
|---|---|---|---|---|
| P / E | 18.5 | 13.2 | 10.3 | 10.8 |
| EV / EBITDA | n/a | 5.2 | 3.8 | 4.2 |
| EV / Sales | 1.2 | 0.7 | 0.5 | 0.5 |
| ROE | 13.8% | 17.9% | 19.5% | 16.1% |

# Important Disclosures

**BASIS FOR RECOMMENDATIONS**
**12-MONTH RATING DEFINITION**

**BUY: Buy stocks are expected to have a total return of at least 15% and are the most attractive stocks in our coverage universe on a 12-month horizon.**

**HOLD: Hold stocks are expected to deliver a positive total return of up to 15% within a 12-month period.**

**REDUCE: Reduce stocks are expected to achieve a negative total return up to -10% within a 12-month period.**

**SELL: Sell stocks are expected to post a negative total return of more than -10% within a 12-month period.**

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