

Mid Cap  
 Commercial Banks  
 Equity – Turkey

## Overweight (V)

Target price (TRY)	3.28
Share price (TRY)	1.48
Potential total return (%)	121.6

Performance	1M	3M	12M
Absolute (%)	-30.5	-43.1	-57.5
Relative <sup>^</sup> (%)	-16.9	-30.5	-39.5

Index<sup>^</sup> ISTANBUL COMP

RIC VAKBN.IS  
 Bloomberg VAKBN TI

Market cap (USDm) 2,987  
 Market cap (TRYm) 3,700

Free float (%) 25

Note: (V) = volatile (please see disclosure appendix)

# Vakifbank

Lowering target price from TRY3.54 to TRY3.28, maintain Overweight (V)

- ▶ **Not the most profitable Turkish bank with a 2008e ROAE of 15%, but we believe it has room for operational improvement**
- ▶ **Strong TRY deposit base is an important source of funding given the current liquidity conditions in the markets**
- ▶ **One of the cheapest banks in the GEM universe, with 2008e P/E of 4.5x and P/BV of 0.6x. We lower our target price from TRY3.54 to TRY3.28 to account for higher interest rates and new volume data; maintain Overweight (V)**

## Comparatively cheap

Vakifbank has been one of the worst-performing banks in Turkey so far this year, underperforming the ISE-100 index by c35% and the ISE-Banks index by c20% since the beginning of the year. It now trades at 4.5x its 2008e P/E and 0.6x 2008e P/BV. We believe the market has not only priced in delays to the strategic sale processes of Halkbank and Vakifbank, punishing the share prices of both banks, but also priced in a more crisis-like scenario for the Turkish banking sector.

We believe that the sell-off in Vakifbank this year results from exaggerated concerns about Turkey and Vakifbank itself. We estimate the current price level for Vakifbank suggests either the provisioning expenses of Vakifbank will more than double compared with 2007, or 30% lower NIM compared with our current forecasts, or almost 800bps higher risk-free rate compared with our current long-term risk-free assumption of 13%.

We assign a very low probability to any one of these conditions or a mix of them occurring. However, markets seem to continue to price in a mix of them for the time being, given the volatility in global markets and uncertainties regarding Turkish politics. According to our base-case scenario, we believe the current price for Vakifbank offers a highly attractive return potential. In our view, the main potential catalysts for price recovery would be strong results for the company in Q2 2008 and in the following quarters, improved inflation expectations after the peak, which we expect in 3Q 2008, and a decline in political uncertainties by the end of this summer.

We have made revisions to our model for Vakifbank after the completion of 2Q 2008 (incorporating the rise in the interest rates and new sector volume data). Due to sharp rise in the market interest rates, we cut our bottom-line forecasts for Vakifbank to TRY823 from previous TRY857. Our DCF driven valuation model suggests a 12-month target price of TRY3.28, reduced from TRY3.54 previously, indicating a potential return of c120%. We maintain our Overweight (V) rating.

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## Financials & valuation

### Financial statements

Year to	12/2007a	12/2008e	12/2009e	12/2010e
<b>P&amp;L summary (TRYm)</b>				
Net interest income	1,676	1,798	2,147	2,425
Net fees/commissions	360	458	605	817
Trading profits	193	20	55	30
Other income	266	304	326	418
Total income	2,496	2,581	3,132	3,690
Operating expense	-995	-1,169	-1,376	-1,555
Bad debt charge	-221	-236	-306	-398
Other	-148	-146	-154	-161
HSBC PBT	1,133	1,029	1,296	1,575
Exceptionals	125	0	0	0
PBT	1,258	1,029	1,296	1,575
Taxation	-227	-206	-259	-315
Minorities + preferences	0	0	0	0
Attributable profit	1,031	823	1,037	1,260
HSBC attributable profit	906	823	1,037	1,260

### Balance sheet summary (TRYm)

Ordinary equity	5,226	5,843	6,674	7,675
HSBC ordinary equity	5,226	5,843	6,674	7,675
Customer loans	23,470	29,009	35,452	44,054
Debt securities holdings	10,987	12,049	11,568	10,756
Customer deposits	28,863	33,642	38,150	44,436
Interest earning assets	37,128	43,100	49,726	57,314
Total assets	42,408	49,163	56,040	64,974

### Capital (%)

RWA (TRYm)	31,383	37,829	45,329	55,433
Total tier 1	15.8	14.6	13.9	13.1
Total capital	15.3	14.2	13.5	12.7

### Ratio, growth & per share analysis

Year to	12/2007a	12/2008e	12/2009e	12/2010e
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#### Year-on-year % change

Total income	9.4	3.4	21.4	17.8
Operating expense	6.3	17.6	17.7	13.0
Pre-provision profit	11.5	-6.0	24.4	21.5
HSBC EPS	17.6	-9.1	26.0	21.5
DPS	-3.5	4.3	-48.7	26.0
NAV (including goodwill)	17.5	11.8	14.2	15.0

#### Ratios (%)

Cost/income ratio	39.8	45.3	43.9	42.2
Bad debt charge	1.1	0.9	0.9	1.0
Customer loans/deposits	81.3	86.2	92.9	99.1
NPL/loan	4.6	5.0	4.8	4.8
NPL/RWA	3.6	4.0	3.9	4.0
Provision to risk assets/RWA	3.6	4.0	3.9	4.0
Coverage	100.0	100.0	100.0	100.0
ROE (including goodwill)	18.7	14.9	16.6	17.6

#### Per share data (USc)

EPS reported (fully diluted)	0.41	0.33	0.41	0.50
HSBC EPS (fully diluted)	0.36	0.33	0.41	0.50
DPS	0.15	0.16	0.08	0.10
NAV	2.09	2.34	2.67	3.07
NAV (including goodwill)	2.09	2.34	2.67	3.07

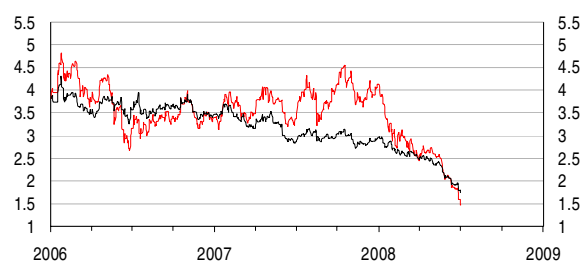
### Core profitability (% RWAs) and leverage

Year to	12/2007a	12/2008e	12/2009e	12/2010e
Net interest income	6.3	5.2	5.2	4.8
Net fees/commissions	1.4	1.3	1.5	1.6
Trading profits	0.7	0.1	0.1	0.1
Total income	9.4	7.5	7.5	7.3
Other income	1.0	0.9	0.8	0.8
Operating expense	-3.7	-3.4	-3.3	-3.1
Pre-provision profit	5.6	4.1	4.2	4.2
Bad debt charge	-0.8	-0.7	-0.7	-0.8
HSBC attributable profit	3.4	2.4	2.5	2.5
Leverage (x)	5.5	6.3	6.6	7.0
Return on average equity	18.7	14.9	16.6	17.6

### Valuation data

Year to	12/2007a	12/2008e	12/2009e	12/2010e
PE*	4.1	4.5	3.6	2.9
Pre-provision multiple	2.5	2.6	2.1	1.7
P/NAV	0.7	0.6	0.6	0.5
REP multiple	0.6	0.7	0.5	0.4
Equity cash flow yield (%)	6.7	10.0	13.8	14.9
Dividend yield (%)	10.4	10.8	5.6	7.0

### Price relative



Source: HSBC

Notes: price at close of 02 Jul 2008

\* = Based on HSBC EPS (fully diluted)

## Well-positioned against global-liquidity conditions

Wholesale funding is just 16% of Vakifbank's total assets, among the lowest rates for the banks we cover. It also has one of the lowest ratios of fee and commission income to average assets. We expect Vakifbank to improve its fee and commission income, increase its cross-selling ratio and harness the high TRY mix in its IEA with the new projects in the pipeline, such as the credit card brand partnership with Worldcard of YKB and the Istanbul Municipality pay-pass card projects. Currently the bank has 7.5m retail customers, out of which 2.1m are salary customers and around 1m inactive credit card customers. We expect the credit card and pay-pass projects will not only help the bank to activate its existing customer base but also will attract new clients expanding the bank's client base.

Another positive for Vakifbank is that the bank has some of the highest branch efficiencies in terms of loans per branch and deposits per branch, and it plans to expand its network by 100 branches per year in 2008 and 2009. That will increase the total number of branches to more than 550 by the end of 2009. We expect the branch roll-out, especially in Istanbul, will help the bank to reach its retail customer base much easily going forward.

## Weaknesses and risks

On the negative front, Vakifbank has the longest maturity-mismatch period of the Turkish banks in our coverage, and we expect it to be the most negatively affected by interest rate hikes. As a result, we now have one of the lowest net income forecasts for Vakifbank in 2008 in the market, after the recent revisions to our model.

Another important issue is the capital adequacy for Vakifbank. According to our analysis, the bank has one of the lowest capital adequacy ratios (CAR) (at 13.4% as of 1Q 2008) versus the average for the banks in our coverage at 16.1% (when adjusted for the recent rights issues). More importantly, the bank's NPL ratio of 4.5% (as of 1Q 2008) poses another threat. If the bank's NPL ratio increases to 6.4%, meaning if the bank books bad loans totalling TRY515mn, the bank's CAR reaches 12%, ceteris paribus. Therefore, we believe that a potential rights issue is a risk for the Vakifbank if the asset quality deteriorates at a pace much faster than we forecast. For the time being we do not have such a rights issue in our models, yet we believe that this is one of the reasons why the market has punished the stock so much since the beginning of the year.

## Changes in forecasts

We have made revisions to our model for Vakifbank after the completion of 2Q 2008 (incorporating the rise in the interest rates and new sector volume data). Due to sharp rise in the market interest rates, we cut our bottom-line forecasts for Vakifbank to TRY823 from previous TRY857.

Please find below the main changes in our forecasts.

#### Changes in forecasts

	2007a	Old		2007a	New		Change		Reason for change
		2008e	2009e		2008e	2009e	2008e	2009e	
Net interest income	1,676	1,889	2,186	1,676	1,798	2,147	-4.8%	-1.8%	Due to rising interest rates
Net fees / commissions	360	459	609	360	458	605	-0.2%	-0.7%	Due to rising interest rates
Operating expense	995	1,169	1,376	995	1,169	1,376	0.0%	0.0%	
HSBC net income	906	857	1,065	906	823	1,037	-4.0%	-2.6%	
ROAE	18.7%	15.4%	16.9%	18.7%	14.9%	16.6%	0.5pps	0.3pps	
Loans	23,470	28,382	34,721	23,470	29,009	35,452	2.2%	2.1%	After June 20, sector data
Deposits	28,863	33,896	38,488	28,863	33,642	38,150	-0.7%	-0.9%	After June 20, sector data
Book value	5,226	5,877	6,728	5,226	5,843	6,674	-0.6%	-0.8%	Fall in net income
Total Assets	42,408	49,462	56,448	42,408	49,163	56,040	-0.6%	-0.7%	Slower deposit growth

Source: HSBC estimates, Vakifbank

## Target price, rating and risks

We value the Turkish banks using a residual income valuation methodology, in which their intrinsic value is the sum of their current NAV and the present value of their future residual income – the returns achieved over the CoE. Our model consists of three stages: the first includes residual income based on the explicit forecast period; the second (maturity stage) assumes a constant growth rate in net profit; and the final (declining stage) assumes a convergence of returns towards the CoE.

Our assumptions are: a 13.0% risk-free rate (on financial forecasts based on TRY terms) in 2008, gradually declining to 10.0% in 2012 and beyond, together with a 5.5% equity risk premium. We use a beta of 1.10.

The stock looks highly attractive at a 2008e PE of 4.5x and P/BV of 0.6x. Moreover, according to our valuation model, Vakifbank's target price of TRY3.28 per share down from TRY3.54 per share previously indicates a c125% potential return, which is well above the 8.5%-28.5% Neutral band for volatile Turkish stocks. We therefore maintain our Overweight (V) rating.

As well as the common risks to all the Turkish banks in our coverage, such as lower-than-expected volume growth, a sharp and sustained correction in the currency, a further rise in the cost of equity and deterioration in the loan quality, the main risks to our view on Vakifbank seem to be (1) problems during transformation and restructuring within the bank and with the branch expansion and (2) the aforementioned risk of a rights issue.

Vakifbank: three-stage residual income valuation (TRYm, expect for per share data)

	2008e	2009e	2010e	2011e
Net profit	823	1,037	1,260	1,442
NAV	5,843	6,674	7,675	8,803
ROE	15.7%	17.7%	18.9%	18.8%
CoE	19.1%	18.3%	17.6%	16.8%
PV of residual income	-145	-23	54	79
	<b>Value</b>	<b>Growth</b>	<b>Payout</b>	
Maturity phase (12e-26e)	1,334	12%	47%	
Decline phase (27e-37e)	362		47%	
Total residual income	1,661			
NAV YE2007	5,226			
<b>Intrinsic value</b>	<b>6,887</b>			
No of shares	2,500			
Value per share	2.75			
<b>Current share price</b>	<b>1.48</b>			
<b>12m target price</b>	<b>3.28</b>			
<b>Upside/Downside</b>	<b>122%</b>			

Source: HSBC estimates, Vakifbank

# Disclosure appendix

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Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.

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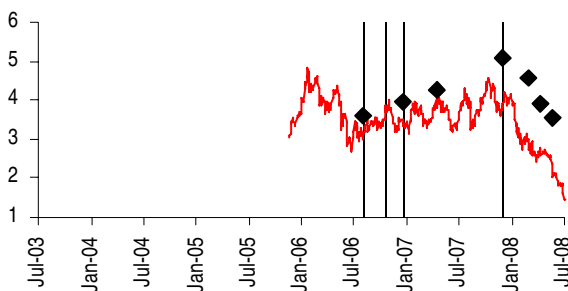
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<b>Neutral (Hold)</b>	32%	(17% of these provided with Investment Banking Services)
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## Share price and rating changes for long-term investment opportunities

Vakifbank (VAKBN.IS) Share Price performance TRY Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
N/A	Underweight	04 August 2006
Underweight	Neutral	18 October 2006
Neutral	Neutral (V)	18 December 2006
Neutral (V)	Overweight (V)	30 November 2007
Target Price	Value	Date
Price 1	3.60	07 August 2006
Price 2	3.96	18 December 2006
Price 3	4.24	18 April 2007
Price 4	5.10	30 November 2007
Price 5	4.56	03 March 2008
Price 6	3.90	14 April 2008
Price 7	3.54	20 May 2008

Source: HSBC

## HSBC & Analyst disclosures

### Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
VAKIFBANK	VAKBN.IS	1.48	02-Jul-2008	6, 7

Source: HSBC

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