MORI VIEWS

UNTAPPED DYNAMISM, JUNE 22, 2017

Turkey is delivering China & India type growth

“Experts” have underestimated GDP and earnings growth

Consensus inflation forecasts may be too high

Banks’ 1st Q net profits up 65% YOY

Banks’ NPL ratios are half of EE average

We are not selling yet…

***Turkstat, BRSA, Central Bank reports**

Exceeding even the most bullish projections, TURKSTAT announced that the Turkish GDP grew by 5% in the first quarter of 2017 after growing by 3.5% in the last quarter of 2016. This places Turkey third behind only China and India in regard to GDP growth.

Both private domestic consumption and public sector’s consumption expenditures contributed strongly to the first quarter growth. It is worth noting that exports grew by 10.6%, whereas imports grew by only 0.8% in 1Q17 contributing positively to overall GDP*.

In our stock valuation models, Mori uses 4% and 4.5% GDP growth projections for 2017 and 2018, respectively, which is higher than IMF, World Bank, OECD and street consensus projections. We believe a significant majority of both domestic and international economic institutions and market economists have significantly underestimated the dynamism in the Turkish economy. We anticipate a number of upward revisions to 2017 price targets.

Another key area where we differ from the crowd is in expected interest rates and cost of equity. We think the market is too pessimistic about future inflation which is reflected in high short-term interest rates. We anticipate inflation to trend down in the summer months and surprise on the downside compared to the current market expectations by the end of 2017.

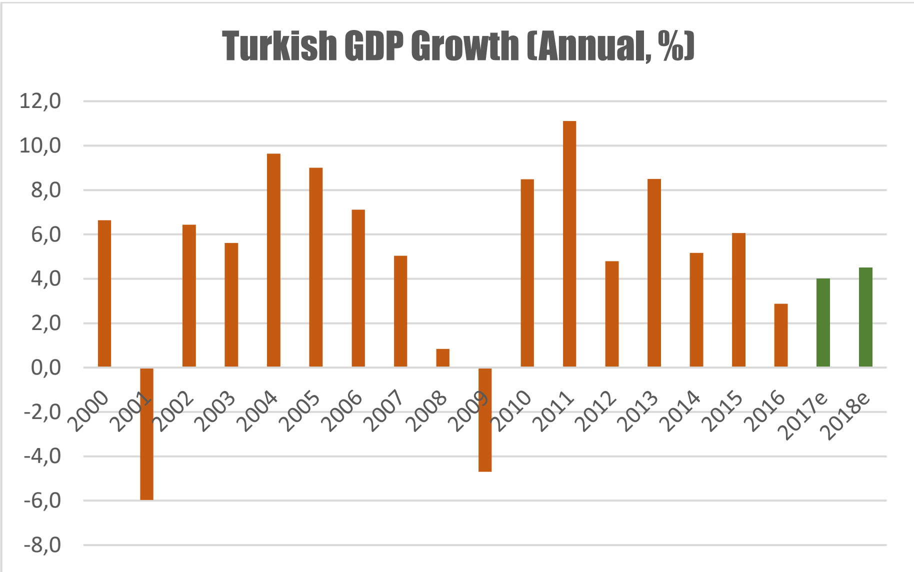
We increased our Turkish exposure at the beginning of 2017 primarily via selective banking stocks based on attractive valuations and high-quality balance sheets and earnings potential. The sector’s aggregate net profit increased by 65% year-on-year in the first quarter of 2017, which significantly beat projections. The earnings momentum in 2017 remains strong despite the fact that the sector posted strong profits in 2016 (aggregate 44% increase in Turkish lira terms and 30% in Euro terms).

Balance sheets are also strong with an average non-performing loans (NPL) ratio of 3.2%* at the end of 2016. Turkish bank’s NPLs are about half of other major Emerging European countries (excluding Greece where the official NPL ratio stood at over 36%)*.

Short-term investors may be tempted to take profits as the Turkish banks we follow have gained between 26% and 50% so far in 2017. However, we are still bullish on a selective basis (namely Vakifbank and Halkbank), as our 12-24 month valuation for these stocks are too hard to ignore - both banks trade at a price-to-book value of 0.7 times according to our in-house projections.

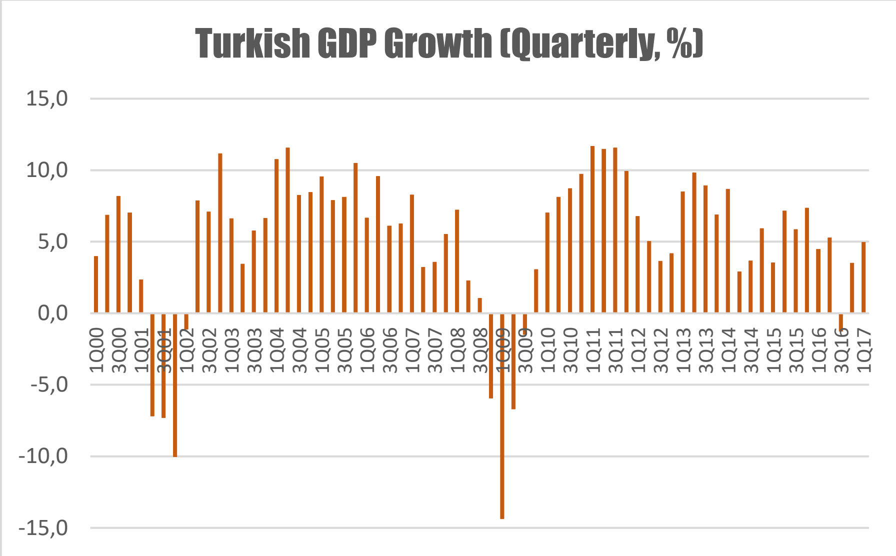
In summary, we now expect the market to revise growth and earnings projections accordingly in light of the strong GDP figure. And if we are right, the market will have to revise down the cost-of-equity (i.e. discount rates) later in the year, which would give another boost to valuations.

We believe that foreign economists do not fully understand and appreciate the dynamism of the Turkish economy. Domestic economists are perhaps the most sceptical about their own countries. It is, therefore, not surprising that the Turkish GDP growth of 5% in the first quarter of 2017 significantly surpassed both international and local projections.



Sources: Turkstat, Mori estimates

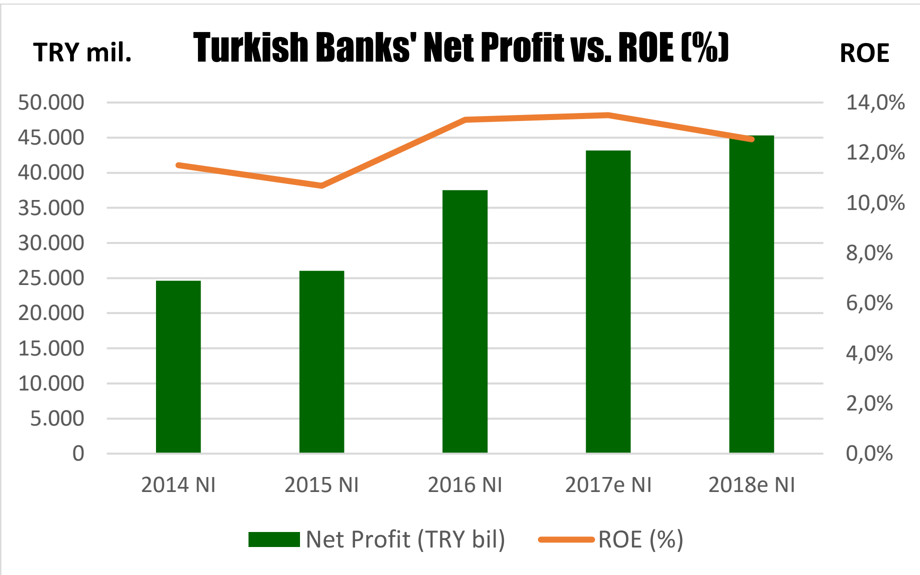
Accounting for a relatively low share of the economy (approximately 20% according to Turkstat), the Turkish government's main economic influence is to provide political and legislative stability. Mori's thesis is that Turkey will continue to grow above the average global growth rate going forward, strengthened by the "Yes" vote in April 16th referendum that has eliminated the risk of struggling coalition governments for the future. To remind investors, a majority of the Turkish public voted "Yes" to a presidential system which is planned to be fully implemented at the next elections to be held in 2019. Thus, voters in the future will vote for electing the president and the MPs in the parliament. Executive power is to be consolidated under the president, who will form his/her cabinet from outside and not within the parliament. The president will be allowed to be elected for a maximum of two terms going forward, as well. Historically, Turkey's GDP growth has benefited from strong, unified governments. Despite the unfortunate domestic and geopolitical events that took place in 2016, the economy still managed to grow 2.9% in 2016 and the growth momentum increased further in 2017.



Sources: Turkstat, Mori estimates

Mori has expressed its view on Turkey by increasing its exposure to Turkish stocks, primarily banking names. We believe Turkish banks are among the best managed banks in Emerging Europe, leveraging the sector's use of state-of-the-art technology giving them superior efficiency and cost control benefits.

Despite a challenging economic environment in 2016, Turkish banks still managed to increase aggregate net profits by 30% in Euro terms. During the same period, banking stocks were sold-off with BIST Banking Index declining 7% in Euro terms on the back of several terror attacks, the attempted military coup, increased noise regarding the referendum and increased geopolitical risks of Turkey's neighbours. We, however, saw this as an opportunity to buy the banking stocks we liked significantly below their book values.



Sources: BRSA, Mori estimates

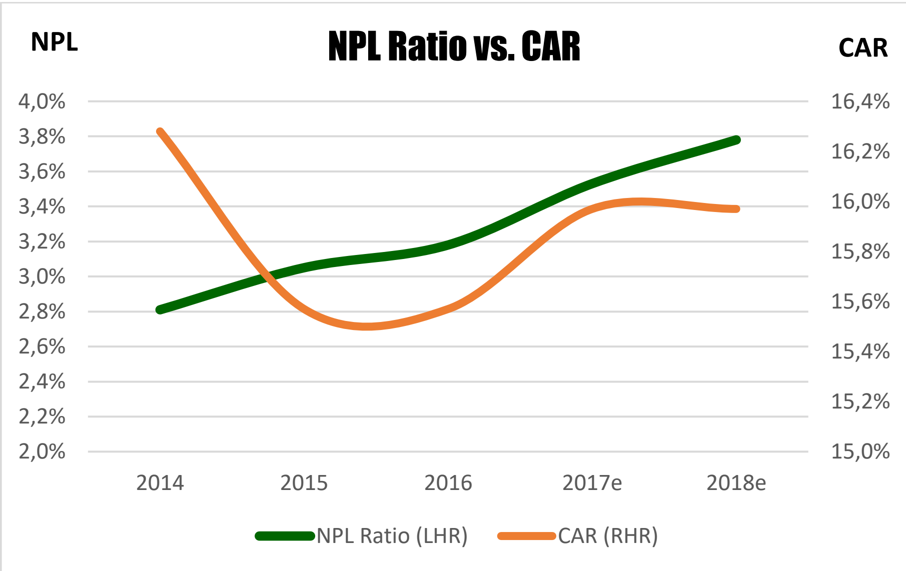
Turkish banks' balance sheets are also strong with non-performing loans accounting for 3.2% of the total. As shown in the table below the NPL ratio is the lowest compared to other major Emerging European countries.

Banking Sector in Emerging Europe

End-2016	Turkey	Russia	Cz. Republic	Poland	Hungary	Greece
Total Banking Assets/GDP	105.4%	93.2%	127.6%	92.8%	102.8%	200.1%
Total Loans/Total Deposits	119.3%	83.0%	78.3%	98.4%	74.6%	131.6%
Total Assets/Total Equity	909.5%	929.7%	880.7%	931.0%	949.1%	946.9%
NPL (overdue) Ratio	**3.2%**	**6.7%**	**4.8%**	**5.1%**	**7.1%**	**36.2%**

Sources: Central Banks, BRSA, VTB Capital

The sector is well-capitalized with capital adequacy ratio standing at roughly 16%. While total loans-to-deposits ratio have risen above 100% in the last couple of years, currently hovering around 120%, we do not foresee a need for the banks to raise equity capital for the next 12-18 months to fund further growth.



Sources: BRSA, Mori estimates

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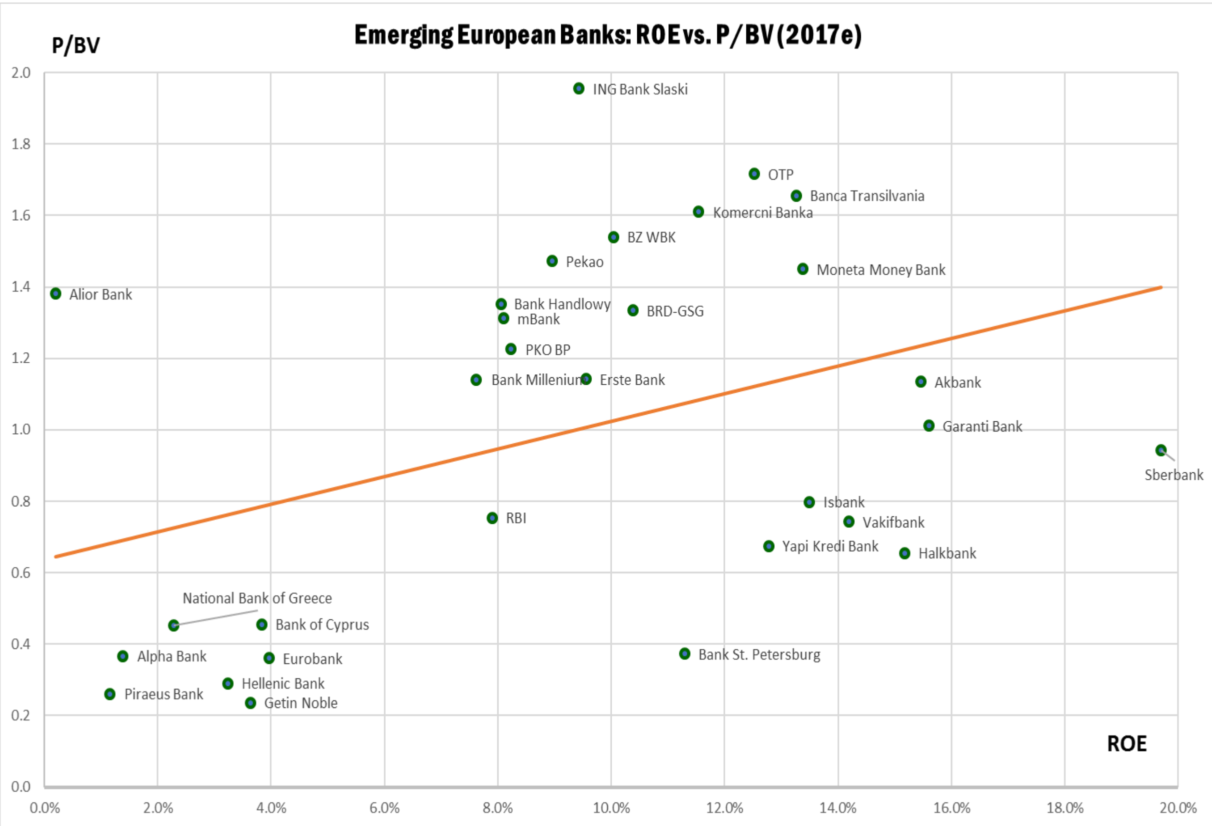
Mori believes the current high risk-free interest rates and corresponding cost of equity (e.g. yield on 2-year benchmark Turkish government bond was 11% at the time of publication) are the primary reason for relatively low multiples of the banking stocks. However, we think that the market is behind the curve (as it has been with growth projections) with its inflation forecasts. We expect inflation to start trending down later in the summer months and mostly likely finish the year below 9%. If correct, we would expect multiples to revert to their historic averages, which would imply a potential 50% upside for some of our bank holdings. Therefore, despite year-to-date price returns of 26-50% depending on the banking stock, we believe the upside potential in some of the banking stocks that we hold far exceeds the risk of a short-term correction.



Sources: Various analyst reports, Mori estimates, based on share prices from Bloomberg as of June 14, 2017

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