Classical Insights -- Emerging Markets

Global Investment Analysis Based on the Classical Economic Model

Classical Insights Emerging Markets Bullet Points March 27, 2009

Turkish stocks are extremely cheap and most have bulletproof balance sheets as well. If a Turkish company has made it to 2009, it has survived crises much worse than this one. For example: Back in 2003, non-performing loans in the Turkish banking system were 12%. Today they are 3.8% (and nearly 100% provisioned). Turkey's corporate tax rate is low at 20% and the recent drop in the lira has given a boost to industry.

This week, I did conference calls with five Turkish firms. They're all attractive. The challenge is that so many EM stocks are appealing now that it's not possible to say these five are the best options out there. Regardless, each of these should work. Here are the names:

Five Turkish companies

		M cap (TRL mln)	Share price (TRL)	Price target	Upside to target	EPS 2009e	EPS 2010e	P/E 2009e	P/E 2010e	P/book
Turk Hava Yollari	THYAO	1,111	6.35	16.30	157%	1.04	2.51	6.1	2.5	
Vestel White Goods	VESBE	203	1.12	2.44	118%	0.12	0.29	9.3	3.9	
Turcas Petrol	TRCAS	347	2.54	5.98	135%	0.56	0.75	4.5	3.4	
TSKB Bank	TSKB	375	0.75	2.03	171%	0.25	0.29	3.0	2.6	0.50
Isbank	ISCTR	10,197	3.70	6.12	65%	0.60	0.68	6.2	5.4	0.93

The Classical Insights EM portfolio already holds Turcas, TSKB and Vestel White Goods. We'll be adding Turk Hava Yollari. *Turning first to THYAO …*

THYAO TI -- 6.35

all data in Turkish lira

Sales and earnings

	2007	2008e	2009e	2010e
Sales	**4522**	**5939**	**6278**	**8040**
Sales growth		31%	6%	28%
EPS	**1.67**	**4.44**	**1.04**	**2.51**
Cash flow	3.67	6.52	3.33	4.97
Cons. EPS		5.52	2.94	2.72

Target price & valuation data

Our 12-mo. target	16.30	(based on 6.5x 2010 EPS)	
Upside to target	157%		
Mkt cap	1,111	Enterprise value	3,171
P/sales (2009e)	0.18	EV/sales (2009e)	0.51
P/E (2008e)	1.4	EV/EBITDA (2008e)	2.9
P/E (2009e)	6.1	EV/EBITDA (2009e)	4.2
P/E (2010e)	2.5	EV/EBITDA (2010e)	2.8

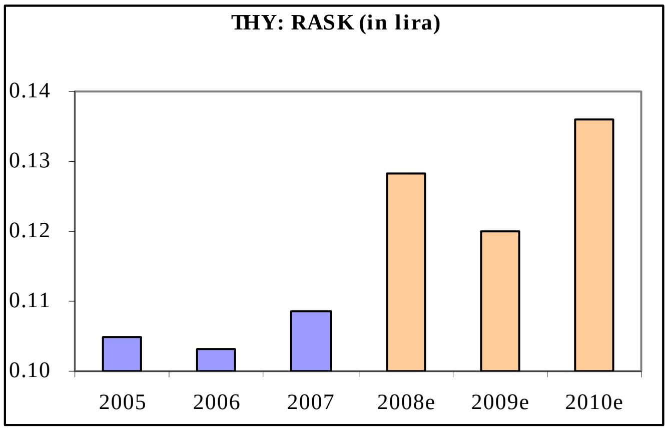
cash flow defined simply as EPS + depreciation. FCF defined as cash flow – capex.

If you like emerging market airlines, Turk Hava Yollari (aka Turkish Airlines) has much to recommend it. For one thing, it makes money: THY has been in the black every year since 2004. Also, it's quite cheap on a price/sales basis (0.17x). The firm has no debt beyond operating leases – and those are guaranteed by European multilateral agencies (so THY pays just a tad over LIBOR). THY has a natural cost advantage versus peers because 60% of its non-fuel costs are in Turkish lira. It also has a great geographic location: Istanbul is 3 hours or less from 50 countries. That means THY can fly narrow-body planes to all kinds of Asian and Middle Eastern where its European competitors must use more expensive widebodies.

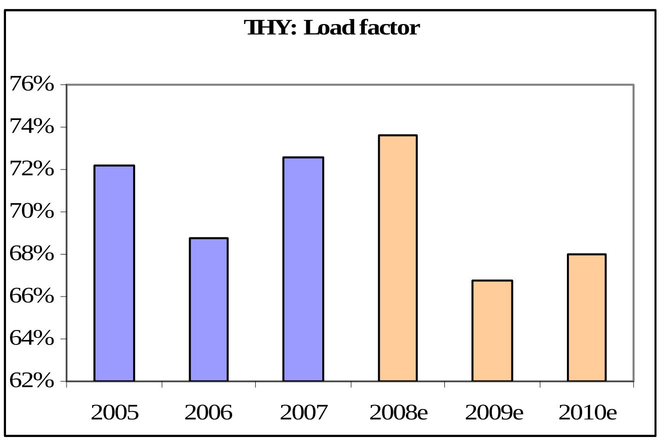
So far, 2009 is going much better than one might expect, according to management: Load factor for January and February was down 170 bps YoY (66.2% vs. 67.9%) and March is looking similar to February. That's not bad in this environment.

Management continues to model for a capacity increase of 13% (ASK) this year and just a slightly smaller growth in revenues per seat kilometer (RASK). So far, ASK growth is *exceeding* the 13% target. That's rather amazing given the macro situation. We're modeling for 13% ASK growth in both 2009 and 2010.

The key data point for THY is RASK. Management still expects RASK to be up slightly this year, but we're modeling for it to drop about 7% (from 0.128 lira/kilometer to 0.120). Conceptually, weakness in the lira relative to other currencies should offset a good bit of ticket price weakness. However, with the European economy looking *so* bad, we find it hard to see RASK remaining stable. In 2010, we expect RASK to bounce back to .136 lira/kilometer:

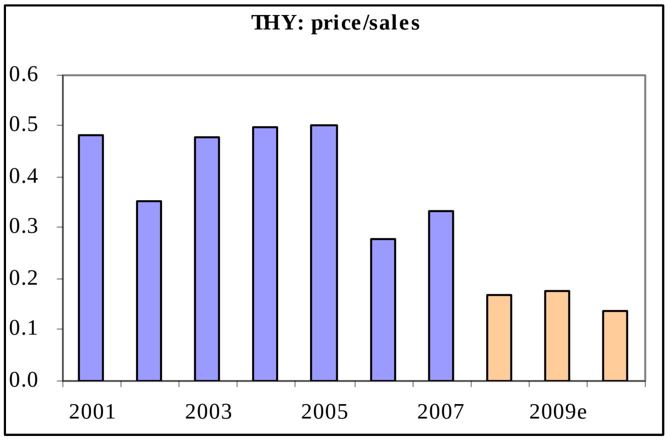


We're modeling for load factor to fall hard this year, to 68% from 73.7%. That may prove too extreme given that it's only down 150 bps so far this year. We are modeling for load factor to remain flat in 2010. That, too, may be too conservative.



Lower fuel costs should offset much of the weakness in the load factor. THY historically has never hedged its fuel costs (though it's starting to now). That means it will get the full benefit of lower fuel costs this year.

THY has huge operating leverage by virtue of its 0.17x price/sales ratio. It's interesting to note that the price/sales ratio has fallen sharply in recent years. If things start to go well, THY could make a *lot* of money quickly.



Our forecasts are well below consensus for 2009, chiefly because we're pessimistic about RASK. For 2010 we expect an earnings rebound. When confidence in the European economic outlook returns, there's no reason THY shares couldn't rise to 6.5x our 2010 EPS estimate, or 16.30/share.

There are plenty of risks here: Fuel costs could rise (and are doing so right now), while pricing and load factors could weaken more than we expect. Plus, the airline recently had an accident. Bookings haven't been affected so far, but if THYAO had *another* accident, it would definitely have an impact.

Turning to Vestel White Goods …

VESBE TI -- 1.12

all data in Turkish lira

Sales and earnings

	2008	2009e	2010e	2011e
Sales	**1259**	**1196**	**1376**	**1513**
Sales growth		-5%	15%	10%
EPS	**0.16**	**0.12**	**0.29**	**0.41**
Cash flow	0.42	0.37	0.55	0.69
FCF	0.24	0.23	0.35	0.45
Cons. EPS		0.19	0.27	

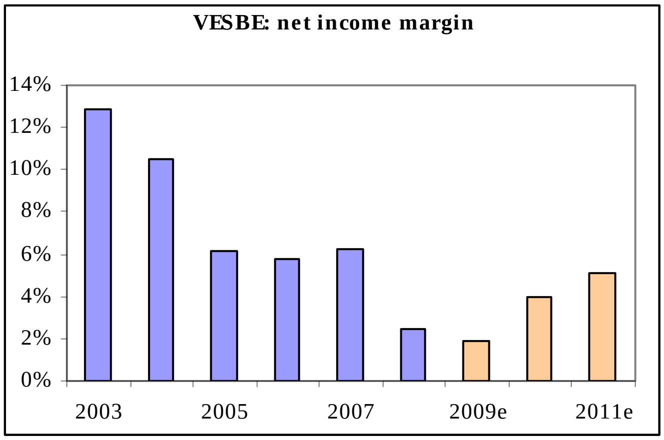
Target price & valuation data

Our 12-mo. target	2.44	(based on 8x 2010 EPS	
Upside to target	118%	+ 0.16/sh for net cash.	
Mkt cap	213	Enterprise value	175
P/sales (2009e)	0.18	EV/sales (2009e)	0.15
P/E (2009e)	9.6	EV/EBITDA (2009e)	3.6
P/E (2010e)	3.9	EV/EBITDA (2010e)	3.4
P/E (2011e)	2.7	EV/EBITDA (2011e)	3.3

cash flow defined simply as EPS + depreciation. FCF defined as cash flow - capex.

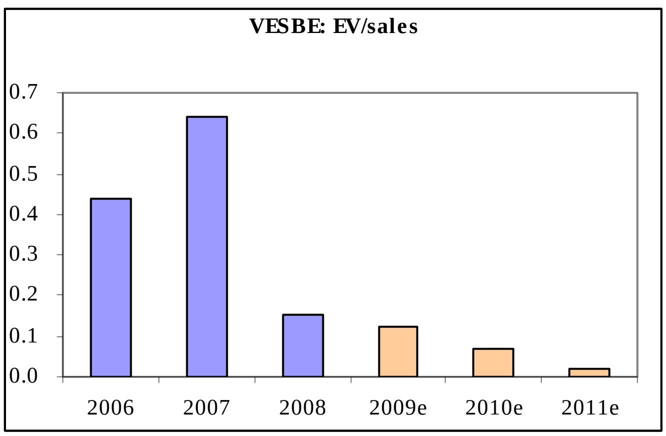
Vestel White Goods will have huge earnings power when the European economy recovers. Vestel makes refrigerators, ovens, washing machines and dishwashers. It has a cash-positive balance sheet and has been consistently profitable since 2003. VESBE shares are down 75% in the past six months, but business really isn't that bad. Unit sales fell just 5% in Q4 2008, vs. a 10% contraction for the industry as a whole. For the first two months of 2009, unit sales are down 6%. We're modeling for a 5% sales decline in 2009, with lira weakness offsetting volume declines. VESBE's margins should be helped by lira weakness and lower steel costs (materials are 80% of COGS). VESBE also stands to benefit from consumers switching to lower-cost brands.

VESBE has a lot of earnings power. For example, if the firm were to earn 0.41/share in 2011, that would still only represent a 5.1% net-income margin. From 2003-2007, VESBE's net-income margin ranged between 5.7% and 12.9%.

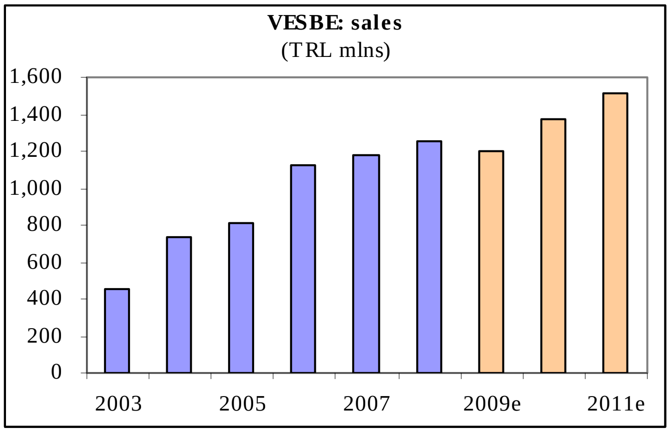


If VESBE were to get back to a 6% net-income margin in 2010 (not impossible), it would earn about 0.44/share. In that scenario, VESBE shares easily could rise to 3 lira each (if not higher).

VESBE may have a tiny market cap, but it sells more than $700 million per year of white goods. The firm's EV/sales ratio is down to an extremely low 0.15x. In our model, EV/sales falls to zero by mid 2012. In other words, if you buy VESBE today, you should get all your money back in three years (from free cash flow). Then you'd own the shares for nothing.



VESBE has grown steadily over the past six years and it has plenty of opportunities to keep expanding. For instance, in recent quarters VESBE held discussions with Whirlpool about becoming an OEM manufacturer, but these discussions have been tabled for the time being due to the recession. In general, Turkey is a great manufacturing base for appliances. They are bulky items so it's not economical to ship them too far (i.e. from Asia to Europe). Thus, Turkey is the natural appliance manufacturing base for Europe.



The top risk with VESBE is that the European economy remains weaker than we expect for longer than we expect. That's a real concern. Another risk is that more competitors enter the market, either from Eastern Europe or China.

We're valuing VESBE at 8x expected 2010 earnings plus 0.16 lira/share (i.e. 80% of net balance sheet cash at year-end 2008).

Turning to Turcas Petrol …

Turcas Petrol (TRCAS TI)

Share price (TRL)	2.54		EPS 2008e	0.59
Shares out (mln)	137		EPS 2009e	0.56
Market cap (TRL mln)	347		EPS 2010e	0.75
EV *	267		P/E (2009e)	4.5
Annual sales **	2100		Target	**5.98**
EV/sales	0.13		Upside	135%

** EV excludes debt carried in Petkim and other JVs*
*** This is TRCAS's share of the JV w/Shell*

Turcas Petrol owns a 30% stake in Shell & Turcas Petrol, which is the market leader in Turkish gas stations (by sales). Shell & Turcas owns and operates 1,300 stations all over the country and has a 30% share of the national market. Last year it was Turkey's 5th largest company by sales.

TRCAS is doing fine and is very cheap. This was a $1 billion company a year ago, but now its market cap is $210 million. It has net cash of $48 million (though that excludes debt held in its Petkim JV). We expect Turcas to earn 0.56 lira/share this year from the gas stations, which would put it at 4.6x current-year earnings. Earnings should rise next year on higher volumes and (potentially) inventory gains.

However, Turcas owns 12.5% of Petkim, which is the largest (and only) petrochemicals plant in Turkey, with a 25% share of the market. This was a source of losses for Turcas in 2008, because Petkim is a high-cost producer relative to Middle-Eastern competitors (though low-cost relative to European producers). That said, business at Petkim actually has been improving a bit in recent months. The plant is now running at 95% of capacity. Several factors have helped: the weaker lira, a big headcount reduction (1,000 employees were let go, bringing the headcount down to 2,200) and a desire by domestic Turkish buyers to buy from Petkim rather than buy foreign product. (Companies are nervous about making commitments to foreign petrochemical firms because exchange rates are so volatile and they don't want to get stuck with a big foreign exchange hit.)

Bottom line: We are continuing to value Petkim at zero, and valuing Turcas at a straight 8x multiple to expected 2010 earnings. That implies 132% upside. If the global economy picks up, Petkim will have some value too.

Turning to TSKB …

TSKB (TSKB TI)

Share price (TRL)	0.75		2008 EPS	0.24
Shares out (mln)	500		2009e EPS	0.25
Market cap (TRL mln)	375		2010e EPS	0.29
Book value/share	1.50		NPL ratio	0.7%
Price/book	0.50		Target	2.03
Capital ratio	21.0%		Upside	171%

TSKB is one of the world's cheapest banks. I've met or talked with management four times over the past three years and the story is always very stable. TSKB does development finance and this is considered an unsexy business when times are good. But when times are bad it's a great business: NPLs don't rise much and funding is no problem (because the vast bulk of it comes from multilaterals).

TSKB is not only cheap but very strong too:

a) Price/book is 0.5x;
b) P/E is 3.1x on 2008 earnings, and earnings should be up fractionally in 2009;
c) Capital adequacy ratio is 21% (the highest in the Turkish banking sector);
d) NPLs are 0.7% of total loans, and they're reserved at more than 100%. (Management expects NPLs to trend up to 1% as 2009 goes along, or perhaps 1.5% in a particularly-bad scenario);
e) There are no currency mismatches in the loans;
f) The bank's portfolio of Turkish government bonds (30% of assets) has been rising in value.

Why is TSKB so cheap? Three reasons:

a) General paranoia;
b) Flat loan growth;
c) Concern that TSKB's customers almost all borrow in dollars and euros and thus may have trouble with a mismatch between their revenue streams and interest costs. In theory, clients' revenue streams should also be in foreign currency, which reduces currency risk.

We expect earnings to rise to 0.25 lira/share this year (from 0.24 lira/share in 2008). A big contributing factor will be the recent strength in the dollar and euro, which has increased the size of the firm's loan book in lira terms. Also helping is the recent rally in Turkish government bond prices. On the negative side, the share count is expected to rise by 20% in May (to 600 million shares). That will offset the vast bulk of earnings gains from lira weakness and higher bond prices.

TSKB lends to a broad array of sectors. Most recently, it has been lending heavily for power and energy projects (20% of total loans), in the wake of the liberalization of the Turkish power and energy sectors.

Our target for TSKB is based on a 7.5x multiple to expected 2010 earnings of 0.29 lira/share.

Turning to Isbank …

Isbank (ISCTR TI)

Share price (TRL)	3.70		EPS 2008	0.55
Shares out (mln)	2756		EPS 2009e	0.60
Market cap (TRL mln)	10197		EPS 2010e	0.68
Book value/share	3.97		NPL ratio	4.4%
Price/book	0.93		Target	6.12
Capital ratio	15.5%		Upside	65%

Turkish banks as a group are very strong, and Isbank is no exception. The firm's capital-adequacy ratio was 15.5% at year-end, and all its NPLs were fully provisioned. There are no bad assets in the securities portfolio, either: Isbank's securities are 100% Turkish government bonds (and these have been rallying).

NPLs were 4.4% at the end of 2008, and management expects that figure to rise to 5.5% by year-end 2009. Currently, NPLs are about 4.7%, so they haven't risen much in Q1.

Another interesting development is that *interest-rate spreads have been rising*. Isbank is one of Turkey's top banks, and it has been benefiting from flight to quality by depositors. Net-interest margin was 5.8% at year-end and now it's running at 6.3%. That's a good spread. Management expects net-interest income to rise by 10-12% for the year, and fees & commissions to rise by 8-10%.

Isbank is currently trading at about 6.1x expected 2009 earnings. Our price target is based on a 9x multiple to expected year-end 2010 earnings. The resulting price target is 6.12 lira/share.
The risks here are:

- Isbank's loan portfolio grew 40% last year. (This year loan growth will be 5-10%.) Thus, Isbank has a fairly young loan portfolio. It may worsen more abruptly than we're modeling for;
- The equity portfolio may not perform well;
- Turkish Treasury bonds may decline.

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