

## Company Update

# Koc Holding

## Poised to benefit from recovery

■ **Rating upgrade to Outperform:** We are upgrading our rating for Koc Holding from Neutral to Outperform, while adding the stock to our Top Picks list. We also raise our 12-month target price estimate from TRY4.54/share to TRY5.00/share mostly because of the net positive impact of the recent target price revisions in major Koc Holding subsidiaries. In addition, the better outlook expectation for core operations is effective in our rating upgrade.

■ **Lagging behind its major subsidiaries:** Koc Holding underperformed most of its major listed subsidiaries since we downgraded the stock on September 2, while also lagging behind the ISE-100 index by 5% over the same period. The company's NAV discount had narrowed to as little as 14% in early September, but retreated to 24% NAV discount as of latest close.

■ **A better outlook for the subsidiaries:** Koc Holding subsidiaries have weathered the economic slump well thanks to their sound positioning in the market, the implementation of efficiency measures and agile management. The subsidiaries are now waiting for a recovery to get underway to utilise their full capacities, so any indications of an upturn would serve as a catalyst for these stocks. Economic growth in an environment of low interest rates would offer particular support to cyclicals such as Tofas, Ford Otosan and Arcelik, while demand pick up and rise in refining margins could provide catalyst to Tupras shares.

■ **Key risk factors:** On the contrary to our view for Koc Holding, there a number of risk factors that could put pressure on the share price performance such as 1) a loss of appetite towards Turkish banks, 2) early rate hikes, 3) longer-than-expected weakness in the refining sector, and 4) any overhang risk on the shares.

■ **Could trade at tighter discounts:** Our 12-month target price is based on a sum-of-the-parts valuation with a 15% conglomerate discount to our target NAV estimate. Koc Holding currently trades at a 24% discount to its estimated NAV, comparing with its 22% average discount over the last two years. Although the current NAV discount does not seem to offer a particular trading opportunity, we think that the company could trade at tighter NAV discount levels considering that Koc Holding has largely reduced its leverage via asset sales in the past two years and carries a growth potential with its hefty cash-in-hand. It is also worth reminding that the NAV discount narrowed to as little as 7% in the last one year. We also believe that, given the company specific prospects, the probable positive sentiment in Koc Holding's major subsidiaries may also be among the positive catalysts for Koc Holding.

Key Financials (US\$m)	2007	2008	2009F	2010F
Revenues	36,014	42,842	27,387	31,276
EBITDA	3,356	3,508	3,174	3,082
Net Earnings	1,766	1,558	905	789
P/E	4.1	3.7	7.3	8.4
P/Book	0.6	0.5	0.6	0.5

Source: Company, FinansinvestForecasts

## Outperform (previously Neutral)

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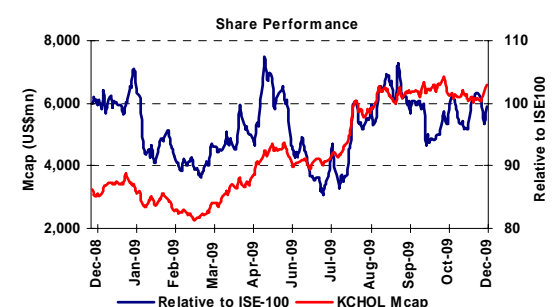
### Stock Data

Bloomberg / Reuters	KCHOL TI / KCHOL.IS
Price (TRY)	4.06
12m Price Target (TRY)	5.00
52 week Price Range (TRY)	1.68-4.14
Shares Outstanding	2,415,141,000
Market Cap (TRYmn):	9,805
Market Cap (USDmn):	6,589
Enterprise Value (USDmn)	n.m.

### Trading Data

#### Relative Performance

3mth:	-0.3%
12mth:	-1.0%
3 mo. Avrg. Daily Trading Vol.	US\$ 35.22 mn
Weight in ISE-100	1.96%
Beta (5 year, on weekly returns)	1.05
Foreign Ownership	
Current	59.0% of free float
12 month ago	53.7% of free float



## Reasons behind the upgrade

We are upgrading our rating for Koc Holding from Neutral to Outperform, while raising our target price from TRY4.54/share to TRY5.00/share due to the changes in our target price estimates for Koc Holding subsidiaries. The main reasons behind our rating upgrade are as follows:

### Net positive impact of latest revisions

Our refining, durables and automotive analysts revised their valuations for Tupras, Arcelik and Tofas upwards, while our banking analyst revised our valuation down for Yapi Kredi Bankasi. In addition, we have adjusted the target price estimate for Ford Otosan incorporating the latest dividend payment. All in all, target price changes in both directions at the subsidiaries' level have resulted in a net positive impact for Koc Holding – and accordingly we have revised up our 12-month target market cap estimate for the company from US\$7,500mn to US\$8,250mn.

**Figure 1: Koc Holding – Changes in target market cap estimates**

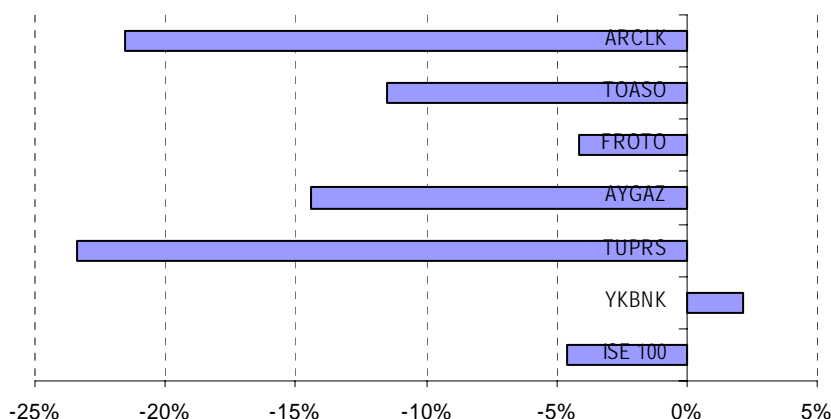
Company	Ticker	New Target (Us\$m)	Old Target (Us\$m)	New Rating	Old Rating
Yapi Kredi Bankasi	YKBNK TI	10,750	11,400	Outperform	Outperform
Tupras	TUPRS TI	5,900	4,300	Outperform	Neutral
Arcelik	ARCLK TI	2,625	2,175	Outperform	Neutral
Ford Otosan	FROTO TI	2,150	2,350	Neutral	Neutral
Tofas	TOASO TI	1,525	1,475	Neutral	Neutral
Koc Holding	KCHOL TI	8,250	7,500	Outperform	Neutral

Source: Finansinvest Forecasts

### Lagged behind its listed subsidiaries

Koc Holding has underperformed most of its major listed subsidiaries since we downgraded the stock on September 2. The company has also underperformed the ISE-100 index by 5% over the same period. The company's NAV discount narrowed to as little as 14% in early September but retreated to 24% NAV discount as of latest close.

**Figure 2: Koc Holding – Relative Share Performance**



Source: ISE, Finansinvest

## A better outlook in core segments

The outlook for Koc Holding's major subsidiaries is beginning to look brighter, due to both industry-specific and company-specific developments.

### Yapi Kredi Bank: Focusing on operational efficiency

Yapi Kredi Bank (YKB) is focusing on improving its operational efficiency, effecting a fall in operating expenses – through optimizing the branch network size and efficiency gains in its branch network. Increasing productivity in the commercial segment, increased use of alternative delivery channels and an improving cross-sell ratio are all expected to be the major areas of the operational efficiency gains. This, in return, is expected to result in a contraction in Non-HR expenses, while improving the revenue generation.

Moreover, the bank boasts lower exposure to securities – just 21% of the total assets are composed of securities (31% in our coverage). Lira denominated fixed rate securities amount for 23% of the bank's total equity against a ratio of over 80% for the banks in our coverage. A rise in interest rates, which now looms as we approach the end of the monetary easing cycle, would help keep YKB safe.

### Arcelik: Improved operating margins and market share gains in Europe

Arcelik is enjoying a significant improvement in operating margins thanks to the more rational pricing environment among European durable manufacturers, continued restructuring in the electronics segment and the implementation of efficiency measures. Although the current margin levels do not appear sustainable, some of the gains will be maintained going forward. The company has also managed to capture market share in Europe on the back of increased consumer tendency towards more economic products together with the entry to new marketing channels. While our consumer durables analyst expects Arcelik's European market share to come under pressure once competitors ramp up their marketing activities, a portion of the market share gains will be long lasting. At home, the company will benefit from the favourable interest rate environment through the recovery in the housing market, although a sharp rebound is not expected until consumer confidence increases.

### Tupras: Managing well under tough market conditions

The global refining outlook appears weak in the short-term with middle distillate inventories at high levels and plenty of spare refining capacity globally. With poor demand conditions and lower capacity utilisation in global refineries, refining margins have dipped in 9M09 while Tupras succeeded in keeping its gross margin at a premium to global refineries thanks to a combination of changing product yields, the premium of domestic sales prices to CIF prices, and the ability to procure crude from a range of sources at reasonable prices. Hence, our refining analyst believes that the downside risks are limited for Tupras. Once the fundamentals start to improve globally, Tupras could continue to benefit. Additionally, Tupras has started work on the Residue Upgrade Project (RUP), finally ending the ambiguity over the project, which could serve as a catalyst. The project will raise production of white products through conversion from black products. Tupras' white product yield is set to increase once work on the investment is completed, supporting the company's premium over the Med-complex margin. Tupras management aims to complete the US\$1.8-2.0bn investment by 2014. Our refining analyst forecasts that the Tupras will generate around US\$400m in additional EBITDA per year from 2015 onwards from the RUP.

**Operational efficiency improvements to help better revenue generation**

**Arcelik is now more stronger considering the improvement in operating margins and better WC management**

**Tupras had better operating performance versus its refining peers under tough market conditions**

### **Prospects of recovery in LCV demand could be supportive for Tofas and Ford Otosan**

#### **Tofas & Ford Otosan: Poised to benefit from recovery in LCV demand**

Despite somewhat uncertain picture for the automotive sector in 2010 in the absence of government incentives, our automotive analyst thinks Tofas and Ford Otosan could benefit from a gradual improvement in demand for light commercial vehicles (LCV), a segment which saw precious little benefit from the incentive programs, due to its relatively low sensitivity to incentives but higher dependence on economic activity. Tofas has clinched the market leadership position in the domestic market in 2009 thanks to its portfolio of small and new vehicles, and some of the gains will be permanent. The company enjoyed relatively strong exports thanks to the increasing popularity of the Minicargo in Europe, while the launch of the new Doblo in early 2010 may serve to reinforce the export performance. On the other hand, Ford Otosan partially mitigated the export volume losses with the start of the Transit Connect exports to U.S., something that will continue in 2010. Ford Otosan is expected to start work on the new Transit investment in 2010 and new Connect investment in 2011. A possible announcement on these issues, which would clear the uncertainty, may help support the shares. On top of this, we still think there are prospects that Ford will grant Ford Otosan the production of a new model after the completion of the restructuring studies by Ford Europe, which could provide a catalyst to the stock.

#### **Well-positioned to benefit during the recovery**

Koc Holding shares provide investors an easy means of attaining exposure to a number of cyclical sectors and the finance sector. Managed to position itself as the leader or in the top-three in each core sector, Koc Holding promises benefits to investors in the recovery period.

#### **Easing concerns over subsidiaries' cash needs**

Due largely to the global financial crisis, Koc Holding's subsidiaries, especially Arcelik, experienced some pressure late in 2008 and early 2009 when it came to rolling over their short-term debts. Meanwhile, Koc Holding supported both of its subsidiaries through cash injections (i.e. rights issue in Energy Investments and Arcelik, purchasing KFS shares from Arcelik). However, now considering our cash dividend projections from Tupras (2010-2015 forecasted average: US\$215mn), Energy Investments would not face major problems in its annual debt service of around US\$200mn by 2015. On the other hand, Arcelik's net debt had nearly halved from US\$2.0bn at the end of 2008 to US\$1.0bn at the end of September this year, thanks to declining working capital and additional support from the sale of non-core asset KFS and the cash injection. On the other hand; in the event of a worsening in economic conditions, the levered financials of these subsidiaries may still put pressure on Koc Holding shares although leverage concerns have largely diminished in the past two years.

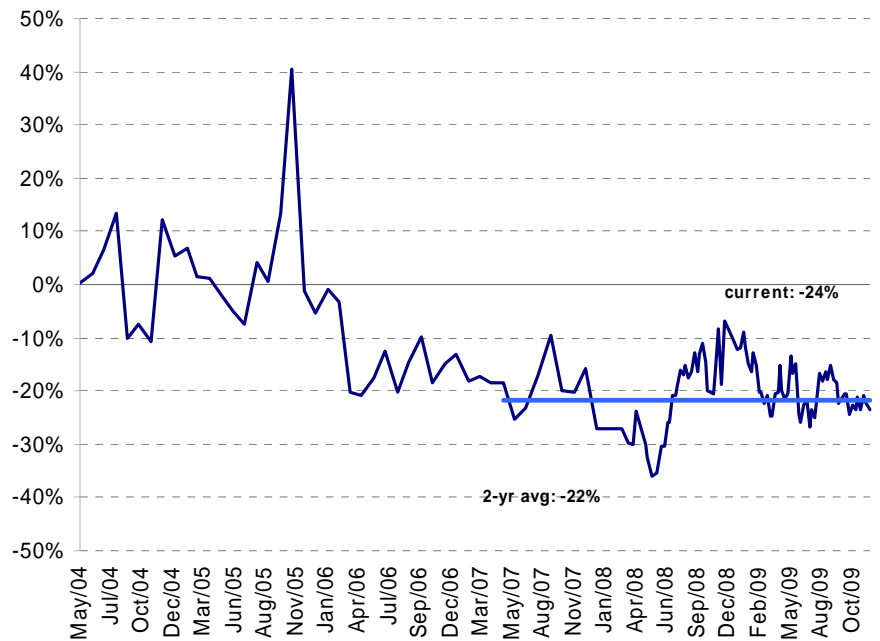
#### **Comfortable cash position**

Koc Holding commands a hefty cash position of US\$725mn at the solo holding level. Koc Holding may consider utilising this cash if an opportunity arises. The privatization of electricity generation assets and/or new green field investments in the Turkish energy sector, acquisition of an international white goods brand and further accumulation of KFS (Koc Financial Services) shares (in case of acquisition of an international white goods brand) as well as other currently unforeseen opportunities could be areas of cash utilisation by the company. The cash-in-hand also provides an element of defensiveness to the portfolio, an important asset if the market turns negative.

### Further contraction in NAV discount would not come as a surprise

Koc Holding currently trades at a 24% discount to its estimated NAV, comparing with its 22% average discount over the last two years. Although the current NAV discount does not seem to offer a particular trading opportunity, we think that the company could trade at tighter NAV discount levels considering that Koc Holding has largely reduced its leverage via asset sales in the past two years and carries a growth potential with its hefty cash-in-hand. It is also worth reminding that the NAV discount narrowed to as little as 7% in the last one year. We also believe that, given the company specific prospects, the probable positive sentiment in Koc Holding's major subsidiaries may also be among the positive catalysts for Koc Holding.

**Figure 3: Koc Holding – Historical NAV discount**



Source: ISE, Finansinvest

**Having larger exposure to credit card lending may put pressure on YKB's operating margins**

## Key risk factors

### Pressure on the banking segment

YKB has high exposure to credit card lending, which may place some pressure on margins while the Central Bank (CBRT) continues to lower the cap rate on interest rates in the credit card business. Credit card lending constitutes 19% of the bank's total loan volume, with this business providing a 24% contribution to total operating revenues.

Another risk is the relatively high exposure to non-cash lending when compared to its peers, which is likely to pile upward pressure on the bank's NPL ratio. Non-cash lending comprises 26% of the bank's total cash and non-cash exposure.

A higher loans-to-deposits ratio, especially on the Lira side (110% in YKB vs. 90% in the sector at the end of September), when compared to its peers, may result in margin pressure as a deposit pricing race gets underway once economic activity begins to recover.

### Earlier than expected rate hikes

Koc Holding holds stakes in cyclical subsidiaries, which are sensitive to interest rates. Our economist expects the Central Bank to raise policy rates by 2 percentage points in 2H09. Earlier-than-expected or steeper-than-expected rate hikes could undermine investor sentiment towards cyclicals, casting risk over our rating for Koc Holding.

### Short-term refining outlook looks weak

Global refining margins have been weak in the past year, mainly due to oversupply concerns amid pressure on demand. Considering the middle distillate inventories and spare refining capacity, our refining analyst believes that the margin outlook looks set to remain under pressure in the short/medium term. A further fall in global refining margins or a prolonged weakness in the sector could be risks for our forecasts on Koc Holding's refining subsidiary, Tupras.

### Overhang risk on shares

Yildirim Ali Koc has registered 24,150,000 Koc Holding shares in the Central Registry Agency for potential sale at the ISE within the next 99 years. This corresponds to 1% of the total shares in Koc Holding. It met with barely any reaction in the market due to the relatively small extent of the sale amount. Recall that Omer Koc had also sold 24.4 million Koc Holding shares on the ISE through a block sale in early November, which had also no implications on the share price. Ali Koc holds a further 2.2% direct stake (excluding the shares put up for sale) and Omer Koc holds a further 1.8% direct stake in Koc Holding. If these stakes are also registered for a potential sale, this could create some overhang on the stock.

## Appendix: SOTP valuation

**Figure 4: Sum-of-the-parts (SOTP) Valuation for Koc Holding**

Segment/ Company	Business Line	Holding's Stake	Valuation Basis	Share Price/ Valuation Multiple	Mcap US\$m	Holding's Stake US\$m	% of NAV	12M Target MCap US\$m	Holding's Stake US\$m	% of NAV
<b>Automotive</b>										
Tofas Fabrika	Manufacturing	37.6%	Market Cap.	4.28	1,438	541	6%	1,525	573	6%
Ford Otosan	Manufacturing	38.5%	Market Cap.	9.00	2,122	816	9%	2,150	827	8%
Otokar	Manufacturing	44.7%	Market Cap.	14.70	237	106	1%	268	120	1%
Turk Traktor	Tractor Manufacturing	37.7%	Market Cap.	8.95	321	121	1%	364	137	1%
Otokoc	Trade	96.3%	EV/EBITDA	9.6	493	475	6%	559	538	6%
<b>Total</b>						<b>2,059</b>	<b>24%</b>		<b>2,195</b>	<b>23%</b>
<b>Consumer Durables</b>										
Arcelik	White Goods	40.5%	Market Cap.	5.60	2,543	1,030	12%	2,625	1,063	11%
Arcelik LG Klima	AC	5.0%	Book Value	1.0	83	4	0%	94	5	0%
<b>Total</b>						<b>1,034</b>	<b>12%</b>		<b>1,068</b>	<b>11%</b>
<b>Food &amp; Retail</b>										
Tat Konserve	Food	43.7%	Market Cap.	2.92	267	116	1%	300	131	1%
Koctas	Retail	37.1%	EV/EBITDA	15.8	747	277	3%	846	314	3%
Duzey	Distribution	31.2%	Book Value	1.0	22	7	0%	25	8	0%
<b>Total</b>						<b>401</b>	<b>5%</b>		<b>453</b>	<b>5%</b>
<b>Finance</b>										
KFS	Financial Services	37.6%	Owns 82% of YKBNK		7,550	2,835	33%	8,792	3,302	34%
Koc Finans	Consumer finance	44.5%	Book Value	1.0	81	36	0%	92	41	0%
<b>Total</b>						<b>2,871</b>	<b>33%</b>		<b>3,342</b>	<b>34%</b>
<b>Energy</b>										
EYAS	Owns 51% of Tupras	75.0%	TUPRS MCap.-Net Debt of SPV		1,332	999	12%	1,809	1,357	14%
Aygaz	LPG Distribution	40.7%	Market Cap.	5.45	1,099	447	5%	1,244	506	5%
<b>Total</b>						<b>1,446</b>	<b>17%</b>		<b>1,863</b>	<b>19%</b>
<b>Others</b>										
Altinyunus Cesme	Tourism	30.0%	Market Cap.	5.55	62	19	0%	71	21	0%
Mares Altinyunus	Tourism	38.4%	Market Cap.	8.20	30	12	0%	34	13	0%
Others			Book Value			51	1%		58	1%
<b>Total Subsidiaries</b>						<b>7,892</b>	<b>92%</b>		<b>9,014</b>	<b>93%</b>
						Listed	7,042	82%	8,050	83%
						Unlisted	851	10%	964	10%
Net Cash - Holding only						726	8%		726	7%
<b>NAV</b>						<b>8,619</b>		<b>12M Target NAV</b>	<b>9,740</b>	
<b>Discount to NAV</b>						<b>-24%</b>		<b>Target Discount to NAV</b>	<b>-15%</b>	
<b>KCHOL Current MCap</b>						<b>6,589</b>		<b>12M Target MCap</b>	<b>8,279</b>	
								<b>12M US\$ Upside Potential</b>	<b>26%</b>	

Source: ISE & Finans Invest estimates

\*calculated by inflating current value estimates forward by 12M

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