

TURKISH AIRLINES

HOLD

(PREV. BUY)

Downgrade to Hold due to limited upside

■ **Revising up our 12M TP to TRY 4.50/share, but downgrading to Hold.** Following the latest air traffic data and change in our macro estimates and valuation methodology, we have increased our 12M TP by 10% to TRY 4.50/sh (prev. TRY 4.10/sh). We still believe in Turkish Airlines' good long term prospects, since the carrier is a true growth story. However, following 40% outperformance year to date, we downgrade Turkish Airlines to Hold based on our revised TP representing limited 10% upside potential.

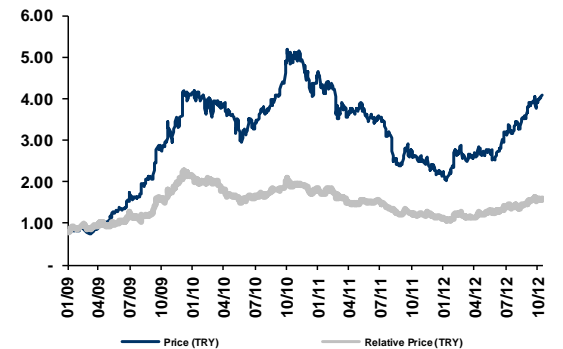
■ **Historical high load factors to support margins.** Turkish Airlines continues its rapid expansion as it introduced 18% more capacity (i.e. Available Seat Km) and carried 20% more passengers during Jan-Sep'12. With 46% yoy increase in transfer pax, the carrier also enjoys more of its widening network, which has reached more than 200 destinations. Short haul routes are feeding more into long haul, which has been supportive for the carrier to post historical high load factors (e.g. 77.9% in Jan-Sep'12, which is 3pp higher than previous high 74.9% in Jan-Sep'08). Historical high load factors, higher utilization of fleet and staff should be supportive for the carrier to improve its operating margins.

■ **Negative news flow likely to weigh on the shares.** Escalation of on-going political tension between Turkey and Syria is concerning, since it could have negative impact on demand, especially on transfer pax as well as origin to destination traffic. Although we do not expect it to take place in the short term, news flow regarding potential SPO is another concern.

■ **Yield outlook is more important than nominal oil price.** We fail to find empirical evidence in favor of significant positive/negative relationship between oil price changes and Turkish Airlines. Yet, during sharp volatility in oil prices in either direction, the correlation between stock performance and oil price increases. We think that investors attach more importance on yield outlook rather than nominal oil price.

Stock Data	16 October 2012
Current price	4.08
Target price	4.50
Return	10%
Current Mcap	4,896
Bloomberg Ticker	THYAO TI
Cost of Equity	14.7%
Number of outstanding shares (mn)	1,200
High / Low Price Range (12M)	4.09/2.01
3-m Average Daily Turnover (\$ mn)	36.2

Price Performance (%)	1M	3M	6M	YtD
Return	6.8	29.4	49.8	92.5
Relative to ISE100	4.4	15.9	29.1	40.4



IFRS	2009	2010	2011	2012E	2013E
Sales (TRY mn)	7,036	8,423	11,815	14,778	17,109
EBITDAR (TRY mn)	1,593	1,379	1,615	2,304	2,466
EBIT (TRY mn)	763	463	339	862	787
Net income (TRY mn)	559	286	19	573	471
EPS reported (TRY)	0.6	0.3	0.0	0.5	0.4
DPS (TRY)	0.0	0.0	0.0	0.0	0.0
ROE (%)	17.4	8.0	0.4	12.2	9.2
P/E (x)	4.1	16.7	n.m.	8.6	10.4
P/BV (x)	0.7	1.3	0.9	1.0	0.9
EV/EBITDAR (x)	3.5	7.0	7.3	5.2	4.9
Net Debt / Equity (%)	50	89	140	129	154
Div. yield (%)	0.0	0.0	0.0	0.0	0.0

Source: Turkish Airlines, Yapi Kredi Yatırım Research estimates

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INCOME STATEMENT

TRY mn	2009	2010	2011	2012E	2013E
Total revenues	7,036	8,423	11,815	14,778	17,109
COGS	5,200	6,652	9,788	11,907	13,980
Gross profit	1,836	1,771	2,028	2,870	3,129
Opex	1,073	1,308	1,689	2,009	2,342
EBITDA	1,255	970	1,194	1,902	1,977
Depreciation	492	507	856	1,041	1,190
Operating income	763	463	339	862	787
Financial expense/income	0	-80	35	-239	-288
Net other expense/income	-26	-17	-227	77	76
Pre-tax income	737	366	146	699	575
Tax	-178	-79	-127	-126	-103
Profit from discontinued operations	0	0	0	0	0
Minority interest/other	0	0	0	0	0
Net income	559	286	19	573	471

BALANCE SHEET

TRY mn	2009	2010	2011	2012E	2013E
Cash and liquid assets	1,313	898	1,763	2,368	1,841
Inventories	149	172	252	305	360
Accounts receivable	444	578	760	948	1,101
Other current assets	893	1,844	1,296	1,251	1,216
Total current assets	2,798	3,492	4,071	4,873	4,519
Tangible assets	4,811	6,443	11,093	12,215	14,614
Other non-current assets	961	714	1,239	1,143	1,158
Total non-current assets	5,772	7,157	12,331	13,358	15,772
Total assets	8,570	10,649	16,403	18,231	20,291
Short-term debt	458	557	949	1,014	1,159
Accounts payable	559	736	999	1,212	1,427
Other current liabilities	930	1,248	2,001	2,435	2,287
Total current liabilities	1,948	2,541	3,949	4,661	4,873
Long-term debt	2,585	3,695	7,134	7,710	8,978
Other non-current liabilities	593	666	820	948	1,058
Total non-current liabilities	3,178	4,361	7,955	8,658	10,036
Minority interest	0	0	0	0	0
Total shareholders' equity	3,445	3,747	4,499	4,911	5,382
Total liabilities and equity	8,570	10,649	16,403	18,231	20,291

CASH FLOW STATEMENT

TRY mn	2009	2010	2011	2012E	2013E
Profit before tax	737	366	146	699	575
Depreciation	492	507	856	1,041	1,190
Changes in working capital	-21	20	1	-29	8
Other	12	-31	550	613	-222
Operating cash flow	1,221	861	1,552	2,325	1,550
Capex	-454	-629	-1,089	-1,604	-1,765
Asset sales & other	319	-124	914	-998	-1,276
Investing cash flow	-135	-753	-174	-2,602	-3,042
Change in debt	-404	-385	-644	240	923
Dividends	-99	0	0	0	0
Other	4	0	2	0	0
Financing cash flow	-500	-384	-642	240	923
Total cash flow	586	-277	736	-37	-569

KEY RATIOS

(%)	2009	2010	2011	2012E	2013E
Sales growth	14.1	19.7	40.3	25.1	15.8
EBITDAR growth	26.9	-13.4	17.0	42.7	7.0
Net profit growth	-52.5	-48.8	-93.5	n.m.	-17.8
Gross profit margin	26.1	21.0	17.2	19.4	18.3
EBITDAR margin	22.6	16.4	13.7	15.6	14.4
Net profit margin	7.9	3.4	0.2	3.9	2.8

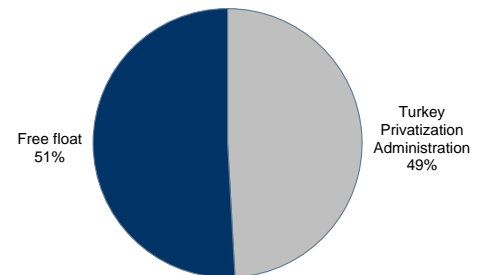
Investment Case

Turkish Airlines is the fastest growing airlines in Europe utilizing its main hub Istanbul's strategically advantageous location, which is positioned perfectly to benefit from the transfer passenger traffic, especially between Europe-Asia markets. The carrier has also unit cost advantage to its European peers, which translates into higher margins. Following strong outperformance year to date we expect a consolidation before we see another positive trend.

Stock Triggers & Risks

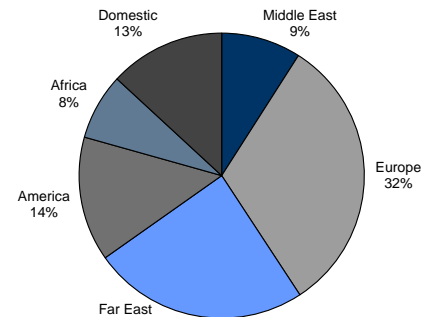
Strong traffic data announcements, especially improving load factors, should be supportive for the stock as it signals positive demand outlook and Turkish Airlines' ability to reflect its cost increase to passengers through higher fuel surcharges. Escalation of the political tension with Syria is an important risk.

Graph 1: Shareholder Structure



Source: Turkish Airlines

Graph 2: RPK Breakdown (9M12)



Source: Turkish Airlines

DOWNGRADE TO HOLD

We revised up our 12M TP to TRY4.50/sh (prev. TRY4.10/sh) but downgrade it to Hold due to limited upside

In line with the change in our macro estimates and latest air traffic results, we updated our Turkish Airlines model. Due to continuous strong trend in air traffic figures, we are now more bullish in terms of growth (i.e. higher ASK) and load factor estimates. We revised down our oil price estimate for 2012 from USD120/bbl to USD113/bbl, but kept the remaining years same at USD115/bbl. Mainly due to lower oil price estimate (resulting in lower fuel surcharge), we also reduced our yield estimates. More importantly, we switch to multiple only valuation methodology, where we value Turkish Airlines based on a 6.0x 2012E and 2013E EV/EBITDAR multiple. Accordingly, we increased our 12M TP to TRY4.50/sh (prev. TRY4.10/sh). Although we revised upward our TP, we downgrade the stock to Hold due to limited 10% upside potential.

Please note that, if we use our previous methodology (50% DCF and 50% multiple valuation), our 12M target price would be 11% higher.

Market appreciated growth story with solid traffic results, since it would be reflected in yields

The carrier had suffered the short term setback of its rapid expansion strategy (e.g. lower load factors) and exogenous factors like high oil prices in 2011, when it was the most oversold stock (USD463mn decline in foreign ownership) by the foreign institutional investors, significantly underperforming the market. However, as the carrier started to post stronger air traffic data and improved its yields, investors appreciated its growth story more, especially at times when the movement in oil price was also supportive of the sentiment. In fact foreign investors were USD260mn net buyers since the beginning of the year and the stock had outperformed ISE-100 by 42% ytd. We expect a consolidation around these price levels before we see another positive trend in the stock price with strong air traffic data.

Chart 1: Turkish Airlines: Net Foreign Inflow & Foreign Ownership

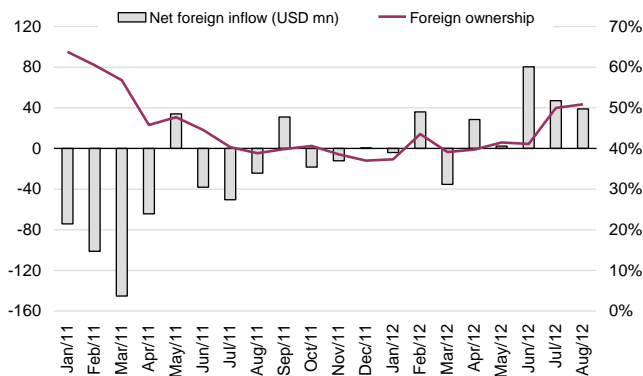
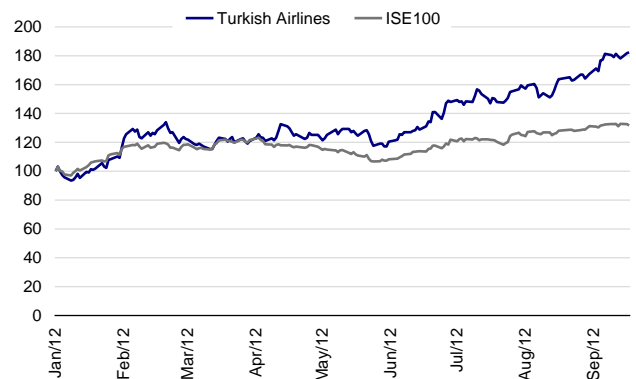


Chart 2: Relative Performance*



Source: ISE, Yapi Kredi Yatirim Research

* prices are based on 01 Jan 2011

Tension with Syria

Turkish Airlines started to bypass Syrian airspace on some routes since Syria closed its air space for Turkish carriers. Note that Turkish Airlines already stopped its direct flights to Syria (i.e. Damascus and Aleppo). Based on our rough estimate, this change should affect flights to some Middle Eastern countries, such as Iraq, Kuwait, Qatar, Oman, and Dubai. As of Jan-Sep'12 traffic, Middle East routes in total generate only 9% of Available Seat Km (which is the basis for cost generation). Taking into account the fact that fuel cost accounts 37% of total cost in 1H12, the increase in flight distance in only limited routes should not have a material impact on total fuel consumption, especially taking into account the fact that aircraft consumes significant part of the fuel for short - mid haul flights during take-off and landing.

Turkish Airlines is facing problems in terms of its receivables. Accordingly the carrier has problems in collecting its EUR 50mn receivables in Iran, according to dailies. The news states Turkish Airlines had to face huge FX losses due to devaluation of Iranian riyal. As of 30 June 2012, Turkish Airlines had total TRY1,001mn (EUR440mn) trade receivables in its balance sheet, which should also have taken into account some provisions as well. Looking at Euro/Riyal parity on Bloomberg data, the devaluation seems 10% ytd, but we know that the actual rate on the street is different than what the Central Bank announces. It is likely that Turkish Airlines had to book some losses (if not for provision definitely for FX moves), due to its business in Iran. However, it is hard to estimate its impact with limited knowledge at this point. Assuming that Turkish Airlines had to book half of this receivable as loss in 2012, our 2012E net income estimate (i.e. TRY 573mn) would be 10% lower.

There was also news in the media claiming a block sale of 30% share in Turkish Airlines in 2013, but it was immediately denied by Privatization Administration, which stated that no strategy and timing is clear for Turkish Airlines for the time being. Market has reacted negatively to this news due to potential SPO discounts and excess supply concerns. However, we are not concerned about an SPO in near future, since there are many legal issues to be solved at first, such as international air traffic rights.

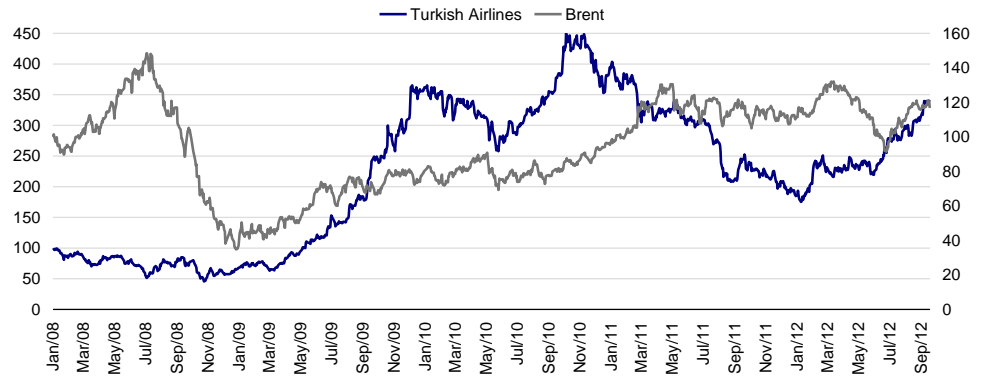
Our major concern for Turkish Airlines is an escalation of ongoing political tension between Turkey and Syria. This would negatively affect not only transfer passenger (which accounts around 40-45% of total international pax) but also origin to destination traffic, due to lower tourist arrivals to Turkey.

There is no direct correlation of oil price and Turkish Airlines' stock performance

There is a common perception at the market that Turkish Airlines should underperform the ISE, if the oil price is increasing. However, our study shows that there is no direct correlation between the oil price and Turkish Airlines stock performance.

Please refer to analysis done by Eren Ocakverdi from our Macroeconomic Research team at page 6 for further information about the impact of oil prices on Turkish Airlines stock price.

Chart 3: Turkish Airlines & Brent Price Performance*

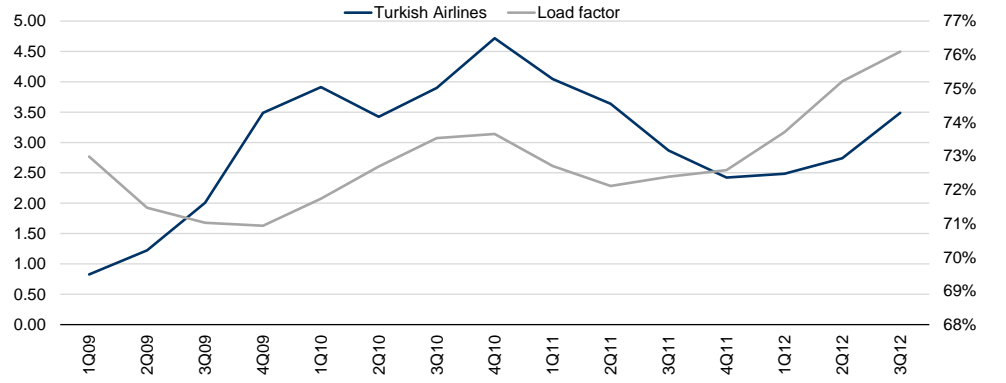


* Based 100 for 1 Jan 2008 data
Source: Bloomberg, Turkish Airlines, Yapı Kredi Yatırım Research

Yield outlook is more important than nominal oil price

The correlation between oil price and Turkish Airlines only increases at times when there is a sudden jump in oil prices. Thus, rather than the nominal price, the volatility is a more important factor for the general sentiment on the stock. Moreover, we believe that market players attach more importance on indicators about yield performance (e.g. load factor) since they would like to know whether Turkish Airlines could manage to reflect this cost increase to passengers.

Chart 4: Turkish Airlines Stock Price & Load Factor Performance*



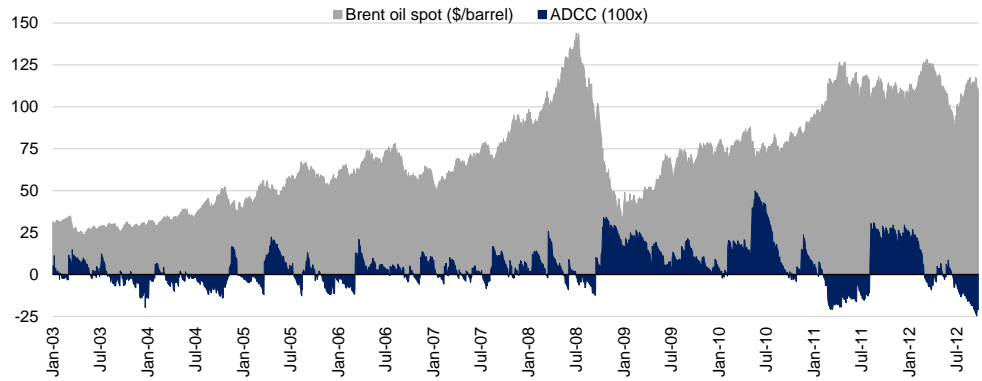
* average stock price and annualized load factor for each quarter
Source: Rasyonet, Turkish Airlines, Yapi Kredi Yatirim Research

Measuring the Impact of Oil Prices on Turkish Airlines

The purpose of this analysis is to propose a formal statistical framework that can be used to identify the relationship between oil prices and Turkish Airlines (THY). Traditional correlation coefficient calculated by fixing the sample may not provide sufficient information if the relation is dynamic in nature. Technical analysis tools, on the other hand, may fail to measure the causality appropriately.

Chart 5 demonstrates the time-varying correlation (which also takes into account the GARCH behavior) between daily return series of these variables ¹ along with the movement of oil prices during January 1, 2003 and September 4, 2012.

Chart 5: Time-Varying Correlation (With Garch Effects)



Source: Rasyonet, www.eia.gov, Yapi Kredi Yatirim Research

Conditional correlation takes values between -0.20 and 0.49 during the sample period and suggests a relatively weak relationship. Rising oil prices do not necessarily weaken/strengthen this relationship as there are periods when both THY and oil prices have moved in the same direction. Of course, THY is not solely governed by oil price movements and there are a number of potential explanatory variables, XU100 being an important candidate among them. A structural and flexible model is built to identify this nexus:

$$\log(xu100_t) = common_t + \varepsilon_t$$

$$\log(thyao_t) = \beta * common_t + specific_t + \epsilon_t$$

$$common_t = common_{t-1} + \gamma_{1,t-1} * d\log(brent_t) + \xi_t$$

$$specific_t = specific_{t-1} + \gamma_{2,t-1} * d\log(brent_t) + \zeta_t$$

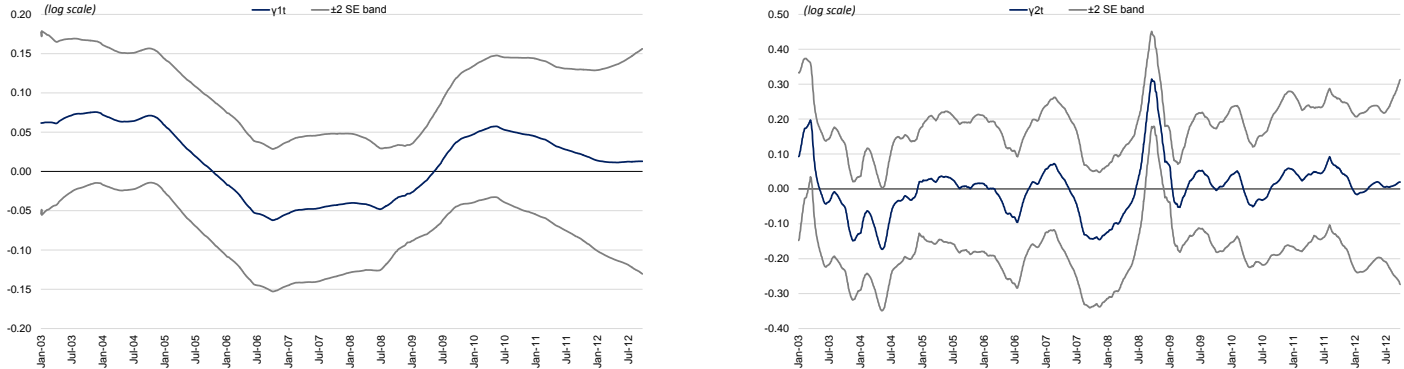
$$\gamma_{it} = \gamma_{it-1} + \eta_{it} \quad i = 1,2$$

The model assumes that market movements are dominated by random walk and therefore a common component, which is designed as a latent variable, is defined to capture that behavior. Besides the common factor, a specific variable (also random) is defined to account for other forces that drive price changes in THY (e.g. omitted variables, firm-specific factors). The model also allows for the estimation of beta for THY, while controlling the impact of changes in oil prices. These impacts are assumed to be effective through two transmission channels and to follow random walk.

¹ Asymmetric Dynamic Conditional Correlation (ADCC)-GARCH model of Cappiello, Engle & Sheppard (2006) is estimated to obtain the time-varying correlation coefficient.

Estimation results show that the change in oil prices may have effects in both directions and that the uncertainty around these parameters is quite large to make conclusive inferences (see Chart 6). **In other words, we fail to find empirical evidence in favor of significant positive/negative relationship between oil price changes and THY.**

Chart 6: Impact of the Change in Oil Prices

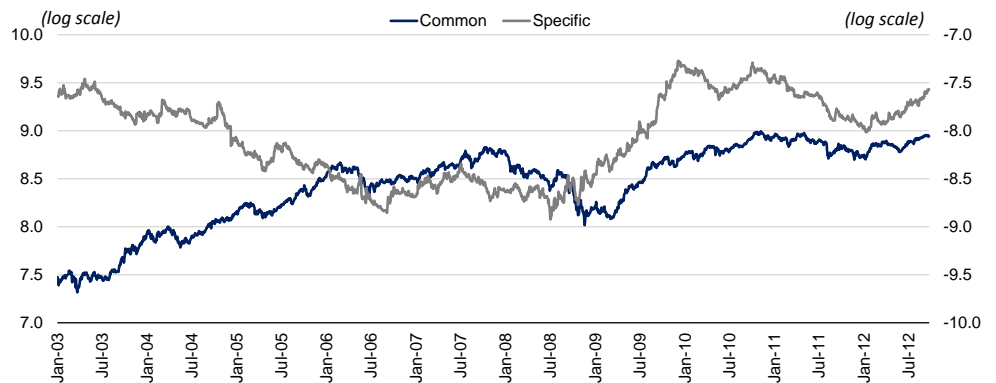


Source: Rasyonet, www.eia.gov, Yapi Kredi Yatirim Research

Beta of THY is estimated to be 0.8 and means that 1% change in the market will lead to 0.8% change in THY, ceteris paribus. However, market-driven movements governed by common component cannot explain the whole behavior observed in THY. The results show that there are other factors in play (e.g. balance sheet fundamentals) that influence the price dynamics (see Chart 7).

Turkish Airlines was practically a state owned company with government holding 98% of total shares. With the IPO of 20% of the shares in 2004, government's share decreased to 75%. And as of mid-2006, more than 50% of shares of Turkish Airlines became publicly traded. Until then, THY had been mostly irresponsive to market developments. This phenomenon reflects itself by a downward slope in the specific component, during which the common component displays an upward trend. THY still decouples from the market occasionally. For instance, the pace of recovery during 2009 or the rate of deceleration during 2011 was faster than that of XU100.

Chart 7: Market-Driven (Common) and Other (Specific) Factors That Influence THY



Source: Rasyonet, www.eia.gov, Yapi Kredi Yatirim Research

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