THE DRIVE YOU DEMAND

UBAM - TURKISH EQUITY

Quarterly Comment | Q3 2018

For Qualified Investors in Switzerland or Professional Investors or Eligible Counterparties as defined by the relevant laws.

Market Comment

- BIST100 index gained 3.9% in 3Q18. The Lira was weak against the EUR/USD, as the basket increased to 6.57. Two year yields moved up to 25.82%, while 5 year CDS spreads moved up to 377bps by the end of 3Q18.
- The new economy program was announced in Sep’18. The program sees a slowdown in GDP growth to 2.3% in 2019 down from an expected 3.5% in 2018. In the following two years, GDP growth is expected to increase gradually to 5.0%. The government also increased its projections on CPI inflation to 20.8% for 2018, 15.9% for 2019, 9.8% for 2020 and 6.0% for 2021. Economy management plans to maintain fiscal discipline with total of TRY59.9bn cut in expenditures and an additional TRY16bn income through revenue-raising measures in 2019. Projects that have not been tendered yet, or tendered but have not started yet will be suspended. Meanwhile, the government plans a financial structure assessment program in regard to banking sector loans. According to its outcome, it was stated that necessary measures would be taken to strengthen the financial structure of the banking sector.
- The Central Bank of the Republic of Turkey (CBRT) hold its rates constant in its Jul’18 meeting, which was considered a dovish move and disappointed the market, thus leading to depreciation in the currency. Following the sharp depreciation in Turkish Lira, CBRT had to increase its policy rate (i.e. one week repo auction rate) by 625 bps to 24.00% from 17.75% in its Sep’18 meeting, which is a hawkish move, considering the fact that Bloomberg market consensus median expectation was a 325bps increase. There was some wording change in the press release, where CBRT stresses the importance of price stability even though there is a weakening in domestic demand. CBRT states that recently released data indicate a more significant rebalancing trend in the economic activity, where external demand maintains its strength, while the slowdown in domestic demand accelerates. CBRT states that recent developments regarding the inflation outlook point to significant risks to price stability and price increases have shown a generalized pattern across subsectors, reflecting the movements in exchange rates. CBRT thinks that deterioration in the pricing behaviour continues to pose upside risks on the inflation outlook, despite weaker domestic demand conditions and the Committee has decided to implement a strong monetary tightening to support price stability.
- Turkish economy grew by 5.2% in 2Q18 on annual basis, which is in line with the market consensus of 5.3%. Private consumption once again stood as the main driver of economic activity in 2Q18 albeit it is losing momentum compared to 1Q18 with 6.3% annual growth and 3.8ppt contribution. There was a weakening in total investment growth, which added 1.2ppt to headline. The contraction in machinery-equipment played the key role in the slowdown of investments. Due to the reflection of weakening in the Turkish Lira, export growth increased to 4.5% whereas import growth fell back to 0.4% due to the

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weakening in domestic demand. As a result, the contribution of net exports turned back to positive territory to 1.0ppt, for the first time since 3Q17.

- On company specific news, privately-owned commercial bank Akbank renewed its matured syndicated debt (c. USD940mn) with a roll-over rate of 104%. The cost stands at Libor + 275bps for USD portion (USD285mn) and Euribor + 265bps for EUR portion (EUR591mn). Separately, defense company Aselsan signed two agreements with TAI worth USD255mn, and it announced an amendment to the FIRAT-M60T Project agreement to get an additional order at an amount of EUR96.8mn and TRY25mn. Finally, construction company Tekfen signed an agreement with Saudi Aramco Oil Company for construction works of Haradh Gas program and Satellite Gas Compression Stations Pipelines. Total value of the project is USD590mn and it is expected to be completed within 33 months.

Performance Review

- In line with the general negative trend in the Turkish market, the fund was down by 21.8% in 3Q18 and outperformed the MSCI Turkey Index by 0.3%. All sectors performed poorly during the quarter. Information technology, healthcare, and financials were the main laggards, while Industrials and energy sectors performed well relative to other sectors.
- We benefited from our overweight in apparel and denim retailer Mavi Jeans, which started to grab investor attention following its significant underperformance year to date. We also benefited from our overweight position in ceramic tile producer Ege Seramik, which likely to enjoy higher exports due to sharp devaluation in Turkish Lira. On the other hand, we were hurt by our overweight in brewery company Tuborg with no specific reason. We continue to like Tuborg, and we think that its strong balance sheet should be a valuable asset during turbulent times. We were also hurt by our underweight position in contracting company Tekfen Holding. The company announced better than expected 2Q18 results during the quarter and was relatively resilient to the devaluation in Turkish Lira due to its international operations.

Portfolio Activity

- We opened a position in Mavi, apparel and denim retailer in Turkey, due to its attractive valuation. The company has a strong brand value in the country and likely to grab market share as the foreign players likely to suffer from the weak TRY in the near future.

  We switch to the underweight position in the banking sector in general since we think that ongoing turbulence in Turkish economy (i.e. increasing rates and depreciation in Turkish Lira), likely to put pressure on banks' bottom lines in the near future. We also took some profit in our overweight position in brewery company Tuborg, following its rapid strong outperformance. We also trim some of our overweight position in the brewery company Tuborg, in order to take some profit. We still like Tuborg since the company continues to enjoy increasing market share in a relatively defensive sector, while its strong balance sheet with ample cash is a valuable asset especially during volatile times like nowadays.

Outlook

- Central Bank of Republic of Turkey (CBRT) decision to increase the rates well above the average and median expectations in its Sep'18 meeting was a positive step in terms of gaining confidence on CBRT's independence. In fact, CBRT's latest action was the main reason why Turkish Lira gained back some of its losses during the month, in our view. Meanwhile, the pressure on Turkish Lira is also stemming from the concerns about the short-term international financing need of Turkish banks and corporates. Recently, one of Turkey's leading private bank (i.e. Akbank) successfully renewed its syndication loan with a 104% rollover ratio. We think that news flow about

Turkish banks successfully rolling over their syndication loans likely to support the Turkish Lira in the near future.

- The New Economy Program (NEP) for the period 2018-2021 announced during the quarter. The new program is named "Balance-Discipline-Transformation" as it seeks to balance the economy with moderate growth, declining inflation and reduction in current account deficit while sticking to the budget discipline. The program's main target is to transform Turkey into a country with a higher value-added production and exports. The targets set in the new economic program are generally realistic, especially in terms of GDP growth for 2019 and 2020, while there are doubts on budget deficit figures, in our view. There might be also concerns about properly and timely implementation of the NEP. While we think that NEP restore some confidence, investors would like to see concrete action before turning more positive on Turkish assets.
- On the international front, civil war in Syria continues to be the main topic. Recently, Turkey and Russia agreed to create a demilitarized zone between Syrian rebels and government forces in the northern city of Idlib, which should prevent a potential humanitarian crisis in the country. We think that the situation in Syria will continue to be chaotic in the near future and it could have a short-term impact on the markets if the political tensions increased rapidly. Separately, although the tensions eased lately, there are still major disagreements between Turkey and the USA. The major disagreement is the continued detention of American pastor Andrew Brunson, whose next regular court hearing is scheduled on 12 Oct'18. Any positive step on Pastor Brunson case, such as the announcement of his release, should reduce the tension between Turkey and the USA and it would be perceived positively by the market.
- While local news flow regarding domestic and international politics may result in Turkish markets' short-term performance to deviate relative to EMEA peers, we still think that global risk appetite will be the main factor for the long-term performance. The normalization of monetary policies of advanced economies should inevitably increase the cost of foreign funding for emerging markets, but there is still ample global liquidity considering the major central bank's balance sheet. We are positive on emerging countries since they are expected to outperform their developed peers in terms of economic growth due to their inherent dynamics. On the other hand, increasing concerns about global trade wars could hurt the sentiment of the global economic outlook, which in turn could have a negative impact on emerging markets.

- On 2019E multiples, BIST100 is trading at around 6.2x earnings, which is at a huge discount to developed markets' PE of 15.0x and MSCI emerging markets' PE of 10.7x. Moreover, BIST100's current multiple (i.e. 7.3x) is much lower than the last 10 years median PE of 10.7x. We admit that Turkish corporates should face earnings downgrade in the coming quarters because of the slowing economy and expected FX losses of those corporates with high FX debt. Nevertheless, BIST100 multiple is even below the 7.5x of 2008, which was the year when the Turkish economy had a serious recession with 6.0% GDP contraction. It seems that the latest negatives for the economy mostly priced in by the markets and there is a limited downside, in our view. Yet, we think that the volatility in the FX and interest markets is limiting the investor's interest in BIST100. We think that investors would like to see more visibility on Turkey's economic growth for 2019 before turning more positive on the Turkish stock market.

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