الوكالة الإسلامية الدولية للتصنيف

Islamic International Rating Agency

FIDUCIARY RATING REPORT

Albaraka Turk Katilim Bankasi

February 25, 2015

Analysts:
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	Credit Ratings (February 25, 2015)
International Scale - FCY	BB+/A3
International Scale - LCY	BBB-/A3
National Scale - (LT/ST)	AA-(tr)/A1(tr)
Rating Outlook	Stable

Fiduciary Score **76-80**

Fiduciary Score 76-80 indicates strong fiduciary standards and a well developed governance structure, wherein rights of stakeholders are well-defined and protected.

Company Information

- Incorporated in **1984**
- **Public Listed Company**
- Sector: **Participation Banking**
- External auditors for 2014: **Ernst & Young**
- Key Shareholders:
  - **Albaraka Banking Group - 54%**
  - **Topbas Family - 11%**
  - **Islamic Development Bank - 8%**
- General Manager: **Dr. Fahrettin Yahşi**
- No. of Branches: **202**

CORPORATE BACKGROUND

Established in 1984, Albaraka Turk Katilim Bankasi ('ATKB' or 'Albaraka Turk' or 'the bank') is the pioneer of participation finance in the Republic of Turkey ('Turkey' or 'the country'). Before the promulgation of participation banking laws in the country, ATKB operated as a 'Special Finance House', extending interest free loans mainly to a corporate clientele until 2005, when it was converted into a full-fledged participation bank. The bank presently ranks the third in size among the four participation banks operating in the country, and commands a market share of 1.4% in the total banking sector deposits and of 23.7% in the participation banking sector deposits as of end-Sep'14.

Branch presence is a critical factor in improving customer outreach for Turkish banks, in part, accounted for by the country's geographical spread. ATKB had 202 branches in Turkey, mostly concentrated in Istanbul and other key urban areas, which renders the network comparable in scale to other participation banks. The bank employs a steadily increasing workforce of 3,510 staff members, which has demonstrated stability, despite Turkey's competitive landscape in the banking sector.

ECONOMIC AND SECTOR CONTEXT

Turkey is the 18th largest economy in the world with GDP (nominal) at over $ 820b. Economic growth has been robust and well diversified over the years, although GDP growth rate dipped in 2014 to 3% vis-à-vis 4.1% in the preceding year. Lower growth in 2014 was attributable in large part to weaker domestic demand in the backdrop of high inflation and policy rates. The effects were compensated for, to some extent, by growth in net exports, with the current account deficit narrowing to 5.2% of GDP.

A narrowing current account deficit bodes well for the country, though external financing requirements remain significant. A sharp decline in crude oil prices is also likely to have a positive impact on trade balance in terms of reducing oil import bill. However, core drivers of the country's balance of payments position continue to pose challenges, particularly in the context of changes in global liquidity levels and slowdown in the Euro region. Managing external financing requirements and addressing structural issues vis-à-vis growth and current account deficit, remain key policy priorities. In this respect, regulators have been pursuing measures to incentivize savings, though meaningful results have yet to emerge.

The Turkish banking sector is characterized by quality capital, low default rates and vigilant regulatory framework. Loan growth has historically been high and above the target rate on average. Policy changes and benchmark rate adjustments by the Central Bank of the Republic of Turkey (CBRT) have been frequent and often significant, in attempts to manage the external account and inflation. By regional standards, the sector's growth trends and future outlook remain positive.

Quality of the sector's loan portfolio has remained intact with gross impairment ratio reported at 2.84% at end-2014. The banking sector remains well capitalized with a 16% capital adequacy ratio. Improvement in capital over the years has been supported by robust profitability of the sector.

Share of participation banks in total assets is moderate at 5.2% as of end-2014. Growth in the sector has historically exceeded that of the total banking industry and the sector is likely to continue growing further. This will however be in the backdrop of increased competition given that some large conventional banks are to initiate their participation banking operations in the near future. Given their significant financial resources and wide branch networks, and these conventional banks already having presence in regions where existing participation banks are yet to penetrate, the competitive landscape is set to become more challenging.

KEY RATING DRIVERS

Recognized sponsor and franchise: Albaraka Turk benefits from the presence of ABG as its main sponsor in terms of a multijurisdictional presence, strong franchise and potential for business synergies. ABG is a recognized name in participation banking and as a group has played a critical role in product innovation and setting standards in Islamic banking.

Continued growth in a competitive market: Rapid organic business expansion over the past five years, has allowed the bank to keep pace with growth within the participation banking segment. A positive banking sector outlook, given continuity of sustained and diversified growth, as expected in Turkey's economy, bodes well for the bank in the medium-term. Entry of large network conventional banks in the participation banking domain could spur the market further; however, these may also pose strong competition to existing participation banks, which have so far commanded limited market space.

Strong asset quality indicators: Ratings derive support from Albaraka Turk's robust risk profile, with sound asset quality indicators and conservative reserving requirements prescribed by the local regulators. With a net impairment ratio at 0.2% as of end-Sept'14 and general provisions in excess of net non-performing loans, the bank's ability to weather stress on credit quality may be deemed strong. Banking regulations in Turkey are closely aligned with European Union (EU) Acquis Communautaire and international standards (International Accounting Standards, Basel I and Basel II), and support well-developed risk management capabilities and sound governance structures.

Room for further diversification: Portfolio concentration is moderate vis-à-vis client-wise and sector-wise exposures. The bank's business targets plan on optimizing the portfolio mix, benefitting from new opportunities in diverse sectors of a growing economy.

Sound liquidity: Liquid reserves of the bank reflect a sound position, having improved on a timeline basis, with liquid assets to total funding ratio improving to 35% by end-Sep'14 vis-à-vis 32% as of Dec'13 (Dec'10: 26%). A broad based deposit mix depicts the bank's market access, exemplified by its gradually strengthening access to Islamic capital markets, both locally and internationally, supporting IIRA's assessment of the bank's liquidity risk profile.

Sustained earnings performance: Albaraka Turk has consistently posted strong earnings with return on average assets and average equity being healthy at 1.7% and 18.1% in 2013, and despite having dipped slightly in 9M2014. Absolute net profit of the institution has nonetheless continued to depict an increasing trend.

Capital levels may need reinforcement: While capital generated internally is likely to continue to support moderate levels of growth in coming years, the bank may require external capital injection to tap growth opportunities and to reinforce its position in the Turkish banking sector. This may be particularly relevant with increasing foreign investment in the banking sector, emerging competition from large network banks and increased capital requirements as envisaged under Basel III. Capital adequacy ratio, which is supported by a $200m Tier II Murabaha financing, was calculated at 13.79% as of end-Sep'14, above the minimum regulatory requirement of 12%.

Effective governance practices: The bank's overall corporate governance structure is effective, with transparency and management profile and stability being key areas of strength. The governance framework also benefits from comprehensive regulatory guidelines and supervision. Key areas of improvement include election of greater number of independent directors on the Board, implementation of state of the art information systems as planned and further reinforcement in risk management capabilities.

IIRA Rating Scales & Definitions

Ratings on International Scale

Foreign Currency Ratings

The foreign currency ratings by IIRA measure the ability of the rated entities to service their foreign currency obligations. These ratings incorporate all the sovereign risks of a country, including the risk of converting local currency to foreign currency.

Local Currency Ratings

The local currency ratings by IIRA measure the ability of the rated entities to service their local currency obligations. These ratings incorporate all the sovereign risks of a country, except the risk of converting local currency to foreign currency.

Ratings on National Scale

The national scale local currency ratings assigned by IIRA are tiered against an assumed local government rating of 'AAA' and, therefore, do not incorporate all the sovereign risks of a country.

Issue/Issuer Rating Scale & Definitions

Medium to Long Term

IIRA uses a scale of AAA to C to rate credit worthiness of the issuer and long term issues, with AAA being the highest possible rating and C being the lowest possible rating.

AAA: Highest credit quality. Represent the least credit risk.

AA : High credit quality. Protection factors are strong. Risk is modest but may vary slightly from time to time because of economic conditions.

A : Good credit quality. Protection factors are adequate. Risk factors may vary with possible changes in the economy.

BBB : Adequate credit quality. Protection factors are reasonable and sufficient. Risk factors are considered variable if changes occur in the economy.

BB : Obligations deemed likely to be met. Protection factors are capable of weakening if changes occur in the economy. Overall quality may move up or down frequently within this category.

B : Obligations deemed likely to be met. Protection factors are capable of fluctuating widely if changes occur in the economy. Overall quality may move up or down frequently within this category or into higher or lower rating grade.

CCC : Considerable uncertainty exists towards meeting the obligations. Protection factors are scarce and risk may be substantial.

CC : A high default risk

C : A very high default risk

D: Defaulted obligations

Note: IIRA appends modifiers + or - to each generic rating classification from AA through B. The modifier + indicates that the obligation ranks in the higher end of its generic rating category; no modifier indicates a mid-range ranking; and the modifier - indicates a ranking in the lower end of that generic rating category.

Rating Outlook : The three outlooks 'Positive', 'Stable' and 'Negative' qualify the potential direction of the assigned rating(s). An outlook is not necessarily a precursor of rating change.

Rating Watch-list : IIRA places entities and issues on 'Watch-list' when it deems that there are conditions present that necessitate re-evaluation of the assigned rating(s). A 'Watch-list' announcement means that the status of the assigned rating(s) is uncertain and an event or deviation from an expected trend has occurred or is expected and additional information is necessary to take a rating action.

Short Term

IIRA uses a scale of A1+ to C to rate credit worthiness of the issuer and its short term obligations, with A1+ being the highest possible rating and C being the lowest possible rating.

A1+ : Highest certainty of timely payment. Short-term liquidity, including internal operating factors and / or access to alternative source of funds, is outstanding and safety is just below risk free short-term obligations.

A1 : High certainty of timely payment. Liquidity factors are excellent and supported by good fundamental protection factors. Risk factors are minor.

A2 : Good certainty of timely payment. Liquidity factors and company fundamentals are sound. Access to capital markets is good. Risk factors are small.

A3 : Satisfactory liquidity and other protection factors qualify entities / issues as to investment grade. Risk factors are larger and subject to more variation. Nevertheless, timely payment is expected.

B : Speculative investment characteristics. Liquidity may not be sufficient to ensure timely payment of obligations.

C : Capacity for timely payment of obligations is doubtful.

Fiduciary Rating Score

(91-100) – Very Strong Fiduciary Standards
(91-93), (94-97), (98-100)*
Rights of various stakeholders are well protected and the overall governance framework is strong.

(76-90) – Strong Fiduciary Standards
(76-80), (81-85), (86-90)*
Rights of various stakeholders are protected. Minor weaknesses have been identified in the overall governance framework.

(61-75) – Adequate Fiduciary Standards
(61-65), (66-70), (71-75)*
Rights of various stakeholders are adequately protected. Certain weaknesses have been identified in a few governance related areas.

(40-60) – Basic Fiduciary Standards
(40-46), (47-56), (54-60)*
Rights of various stakeholders are relatively vulnerable. Significant weaknesses have been identified in the overall governance framework.

(Less than 40) – Low Fiduciary standards
Rights of various stakeholders are at high risk and the overall governance framework is weak.

**Apart from the lowest score range, all score ranges have been split into three sub-divisions for further clarity*

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