DenizInvest

Turkey / equity / automotive

Karsan

Turnaround story begins in 2015

May 21, 2014

MARKET OUTPERFORMER (initiated)

KARSN.IS	KARSN TI

Stock Data	
Current Price (TL)	1.16
12M Target Price (TL)	1.60
Upside potential	38%
Current Mcap (TLmn)	534
Free Float (FF)	34.35%
FF. Mcap (TLmn)	183
Foreign Share in FF	3.26%

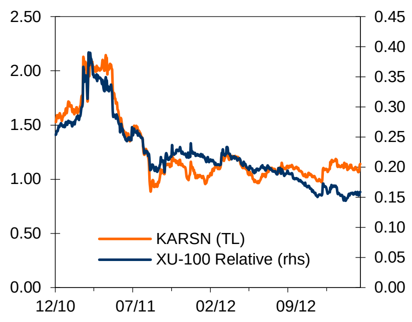
Report priced as of May 20, 2014

Relative Performance to BIST-100

1m	3m	6m	12m
10%	5%	8%	31%

Avg. Daily Trading Volume (TLmn)

1m	3m	6m	12m
10.5	6.7	9.0	12.2



Kurthan Atmaca

kurthan.atmaca@denizinvest.com

+90 212 336 5164

Turning into an OEM producer from contract auto manufacturer. Karsan has been producing commercial vehicles for the world's leading brands such as Peugeot, Renault and Hyundai through its flexible manufacturing facilities. However, it has been suffering from being a contract manufacturer as the profitability is very low for contract manufacturers. Eventually, Karsan has decided to become an OEM producer, producing its own products rather than being a contract manufacturer, and taken some steps (such as; Hyundai deal, expiry of PSA and Renault agreements, enrichment of product mix with own brands and establishing a JV with Chinese producer) to improve its profitability and balance sheet, which will start paying off in 2015.

Hyundai deal to ignite turnaround. Karsan signed an agreement with Hyundai Motor Company (HMC) for the production of more than 200k light commercial vehicles between 2014-2021. According to our calculation, Karsan will generate more than TL1bn revenue from (protected by take-or pay clause) Hyundai vehicle sales in 2015 (2014E top-line: TL537mn), totaling c.TL15.7bn between 2014-2021.

Strong growth in P&L is on the way. Deriving strength from Hyundai project, profitable BredaMenarinibus sales and upcoming new product launches, we expect the company to post substantial growth in P&L as we expect revenues, EBITDA and net profit to surge at a 3-year CAGR of 32%, 40% and 76%, respectively.

Initiating coverage with MARKET OUTPERFORMER rating and target price of TL1.60/share, which offers 38% upside potential. Karsan shares have been underperforming both benchmark index and local peers for many years due to losses at the bottom-line level and successive rights issues. However, starting next year, there will be significant improvement in the company's operational and bottom-line performance, carrying multiples (9.0x and 6.2x on 2015E and 2016E P/E) at attractive levels. Although the negative effects of transition (i.e. low capacity utilization rate and high financial expenses) will inevitably keep earnings under pressure throughout 2014, we believe that investors may tend to overlook the weakness to be seen in figures during this period and focus on the growth potential in 2015.

Risks to our valuation includes; i) potential increase in interest rates and possible contraction in commercial vehicle demand, ii) any jump in raw material costs, iii) lower than expected bus sales, and iv) any delay in Hyundai project.

Summary Financials	2013A	2014E	2015E	2016E
Revenues (TLmn)	913	537	1,702	2,101
EBITDA (TLmn)	64	14	144	175
Net Income (TLmn)	16	-28	59	87
EBITDA Margin	7.0%	2.7%	8.5%	8.3%
Net Margin	1.7%	-5.3%	3.5%	4.1%
Revenue growth	57%	-41%	217%	23%
EBITDA growth	n.m.	-77%	898%	21%
Net Income growth	n.m.	n.m.	n.m.	46%
P/E	25.3	n.m.	9.0	6.2
EV/EBITDA	13.5	76.8	7.5	5.2
EV/Sales	0.9	2.1	0.6	0.4

Sales Contact:

Emir Tayman (+90 212 370 6806)
Emir.Tayman@denizinvest.com

Ayca Gurdal (+90 212 370 6808)
Ayca.Gurdal@denizinvest.com

Deniz Yatirim Menkul Degerler A.S. Buyukdere Cad. No: 106 Kat: 15 34394 Esentepe, Istanbul TURKEY

Investment Case

We initiate our coverage for Karsan (KARSN TI) with a MARKET OUTPERFORMER rating and a target price of TL1.60/share, offering 38% upside potential. Karsan used to be producing vehicles for Renault and PSA during the last five years and, accordingly, has been suffering from being a contract manufacturer as the profitability is very low for contract manufacturers. Consequently, the company recorded significant losses at bottom-line due to low profitability and high financial expenses given the sizeable leverage. Eventually, Karsan has decided to become an OEM producer, producing its own products, rather than being a contract manufacturer. On top of this, an agreement with Hyundai has been signed for the production of new commercial vehicles, which would provide TL15bn revenue - protected by take or pay clause - between 2014-2021. Karsan shares have been underperforming the benchmark index and its local peers (Tofas, Ford Otosan) by 41% and 66%, respectively, throughout the last three years due to loss at bottom-line and successive rights issues. Starting from 2015, the company will post substantial growth in P&L as we expect revenues, EBITDA and net profit to advance at a 3-year CAGR of 32%, 40% and 76%, respectively, pulling multiples (9.0x and 6.2x on 2015E and 2016E P/E) at attractive levels. Although the negative effects of transition (i.e. low capacity utilization rate and high financial expenses) will inevitably keep earnings under pressure throughout 2014, we believe that investors may tend to overlook the weakness to be seen in figures during this period and focus on the growth in 2015. Major risks to our valuation are: i) potential increase in interest rates and decline in consumer confidence, possible contraction in commercial vehicle demand, ii) any jump in raw material costs, iii) lower than expected bus sales, and iv) any delay in Hyundai project.

Turning into an OEM producer from contract auto manufacturer. Karsan was established as a commercial vehicle producer in 1966 in Bursa as the only contract auto manufacturer in Turkey. The company has been producing commercial vehicles for the world's leading brands such as Peugeot, Renault and Hyundai, including its own, through its flexible manufacturing facilities, providing marketing, sales and after-sales services through its widespread network. However, it has been suffering from being a contract manufacturer as the profitability is very low for such type of manufacturers. Eventually, Karsan has decided to become an OEM producer, producing its own products rather than being a contract manufacturer. As a first step, Renault and Peugeot contracts was not renewed as all of them expired by the end of 2013. On top of this, an agreement with Hyundai has been signed, which includes take-or-pay clause, for the production of new commercial vehicles. Moreover, the company has kicked off the sale of its own products (such as; Jest, Karsan Atak, Karsan Star, Concept V1), which have higher profitability compared to Renault and Peugeot production.

Turnaround story begins with Hyundai deal in 2015. Hyundai Motor Company (HMC) has aspirations to become the second biggest automotive producer - ranked currently in fourth place - in the world. In order to reach this goal, the company has decided to enrich its product portfolio via new investments. HMC has no presence in 4-6 tons vehicle market in Europe and wants to step in to this market. Accordingly, on November 27th 2012, Karsan signed an agreement with HMC for the production of more than 200k light commercial vehicles (so called Semibonnet project) between 2014-2021. The production is planned to start at the end of 2014. According to our calculation, Karsan will generate more than TL1bn revenue from (protected by take-or pay clause) Hyundai vehicle sales in 2015 (2014E top-line: TL537mn), totaling c.TL15.7bn between 2014-2021. Note that the profitability of HMC vehicle sales will be higher compared to Renault and Peugeot sales.

BredaMenarinibus sales have significant impact on both top-line and profitability. In 2010, Karsan and Italian bus brand BredaMenarinibus signed an agreement for a cooperation, which has a scope of manufacturing and selling buses ranging from 6.5 meters up to 18 meters. The serial production and sales have started in October 2010. The company sold 573 buses, mostly to municipalities driven by the demand thanks to local elections in March 2014, and generated c.TL350mn revenue in 2013 (40% of 2013 top-line). The price and profitability of bus sales are more than two times higher than other commercial vehicle sales as the company's EBITDA margin reached highest level since 2005. Growing bus market and demand from municipalities would pave way for higher bus sales in the coming years, having positive impact on top-line and operating margins, in our view.

Strong growth in P&L is on the way. Deriving strength from Hyundai project, profitable BredaMenarinibus sales and upcoming new product launches, we expect the company to post substantial growth in P&L as we expect revenues, EBITDA and net profit to surge at a 3-year CAGR of 32%, 40% and 76%, respectively.

Risks to our valuation: Main risks to our valuation are ; i) potential increase in interest rates and decline in consumer confidence, possible contraction in commercial vehicle demand, ii) any jump in raw material costs, iii) lower than expected bus sales, and iv) any delay in Hyundai project.

Model Assumptions and Valuation

Valuation

We have employed a blended valuation method using DCF and peer comparison methods for Karsan. We attached higher weight to DCF methodology as it captures Hyundai project, which covers 2014-2021 period, better compared to peer comparison.

FIGURE 1 –Valuation summary (TLmn)

Method	Mcap	Upside	Weight
DCF	693	30%	75%
Peer Comparison Equity Value	492	-8%	25%
Target Value	**643**		
12M Target Price (TL/shr)	**1.60**		
KARSN current price (TL/shr)	1.16		
Upside potential	**38%**		

Source: Deniz Invest Research

DCF approach

Assumptions: We use 10.0% risk-free rate, 5.0% equity risk premium and a 0.9 beta and accordingly, we reached a 14.5% cost of equity. With a 14.0% cost of debt and zero tax assumption as we expect the company to record loss at bottom-line in 2014, our WACC is 14.0% for 2014. We put in a terminal growth rate of 5% and assume the 20% tax rate to remain constant throughout our forecast period of 2015-2023. Note that we also incorporated the company's TL165.8mn receivable from IETT bus sales to our cash flow via discounting it as we assumed receivables to be obtained in three years.

FIGURE 2 – DCF analysis of Karsan

TLmn	2014E	2015E	2016E	2017E	2018E	2019E	2020E	2021E	2022E	2023E
Sales	**537**	**1,702**	**2,101**	**2,348**	**2,640**	**3,143**	**3,887**	**5,114**	**2,642**	**2,753**
Sales Growth	*-41%*	*217%*	*23%*	*12%*	*12%*	*19%*	*24%*	*32%*	*-48%*	*4%*
Gross Profit	73	241	273	308	348	414	511	671	350	366
Gross margin	*13.6%*	*14.1%*	*13.0%*	*13.1%*	*13.2%*	*13.2%*	*13.2%*	*13.1%*	*13.3%*	*13.3%*
EBIT	-14	115	145	168	193	239	304	412	155	159
EBIT margin	*-2.6%*	*6.7%*	*6.9%*	*7.2%*	*7.3%*	*7.6%*	*7.8%*	*8.1%*	*5.9%*	*5.8%*
EBITDA	**14**	**144**	**175**	**198**	**224**	**270**	**336**	**445**	**189**	**195**
EBITDA margin	*2.7%*	*8.5%*	*8.3%*	*8.4%*	*8.5%*	*8.6%*	*8.7%*	*8.7%*	*7.2%*	*7.1%*
Tax	0	-23	-29	-34	-39	-48	-61	-82	-31	-32
Capex	-103	-43	-29	-31	-32	-33	-34	-36	-37	-39
Change in Working Capital	102	-93	8	-32	-37	-64	-95	-156	314	-14
Free Cash Flow	**14**	**-15**	**124**	**103**	**116**	**126**	**147**	**171**	**435**	**110**
WACC	14.0%	12.5%	12.6%	12.7%	12.8%	12.8%	12.8%	12.8%	12.8%	12.8%
Discount Factor	1.08	1.22	1.37	1.54	1.74	1.96	2.22	2.50	2.82	3.18
PV of Free Cash Flow	**13**	**-12**	**91**	**66**	**67**	**64**	**66**	**69**	**154**	**35**
NPV	**612**									
Terminal Growth	5%									
Terminal Value	462									
Net Cash (a/o 1Q14)	-518									
Receiv. from IETT bus sales	137									
Fair Value (TLmn)	**693**									
Current Mcap	534									
Upside Potential	**30%**									

Source: Deniz Invest Research

Peer comparison approach

Trades at significant discount to its domestic peers. We do not take into account 2014 multiples as we expect the company to record loss at bottom-line and hardly generate EBITDA. Therefore, we calculate peer comparison equity value using only 2015 multiples. While local peers such as Tofas and Ford Otosan trade on 2015E average multiples of 10.8x P/E and 8.3x EV/EBITDA, Karsan shares trade at respective 43% and 10% discount.

FIGURE 3 – Peer multiples comparison

		EV/EBITDA		P/E	
Company	**Country**	**2014E**	**2015E**	**2014E**	**2015E**
Faw Car Company	China	6.3	5.0	9.7	8.6
Jiangling Motors Corp.	China	8.3	5.1	9.7	7.1
Tata Motors Ltd.	India	4.5	4.0	9.5	8.3
Magna International	Canada	6.7	6.2	12.1	10.3
International Peers' Median		**6.5**	**5.0**	**9.7**	**8.4**
Tofas	Turkey	8.5	7.5	12.7	10.9
Ford Otosan	Turkey	13.0	9.1	13.7	10.7
Domestic Peers' Median		**10.8**	**8.3**	**13.2**	**10.8**
Karsan	Turkey	76.8	7.5	9.0	6.2
Premium/(Discount) to domestic peers		n.m.	-10%	-32%	-43%
Premium/(Discount) to international peers		n.m.	49%	-7%	-27%

Source: Bloomberg and Deniz Invest Research

Sensitivity analysis

Valuation is sensitive to the changes in WACC and terminal growth rate. We tested the sensitivity of Karsan's target price to terminal growth rate value and WACC, which are at 5% and 12.5%-14.0%, respectively, in our base case scenario. Please find the analysis at the table below.

FIGURE 4 – Sensitivity analysis

	Terminal growth rate		
WACC (%)	**-1%**	**0**	**+1%**
+2%	1.15	1.21	1.29
+1%	1.30	1.38	1.49
0	1.49	**1.60**	1.76
-1%	1.72	1.88	2.12
-2%	2.02	2.27	2.65

Source: Deniz Invest Research

Scenario analysis

Bus sales will be crucial for the company's valuation. According to our base case scenario, we estimate 300 bus sales per year after 2015 throughout our forecast period. Our best case scenario assumes 400 bus sales, while worst case scenario assumes 200 bus sales after 2015. Note that we presume all the other variables to remain constant. Please see the analysis at the table below.

FIGURE 5 – Scenario analysis

Bus unit sales	-100 Worst case	0 Base case	+100 Best case
Karsan target price (TL/sh)	1.39	1.60	1.81
Upside	20%	38%	56%

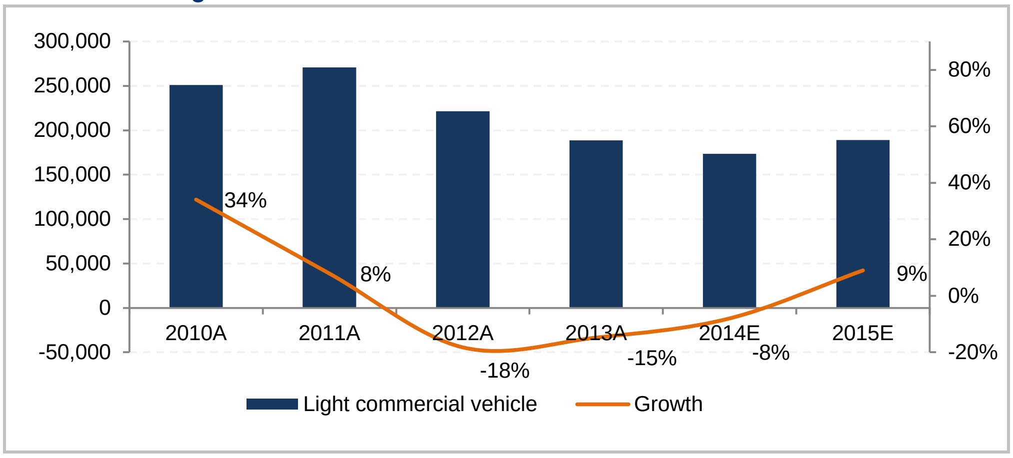
Source: Deniz Invest Research

Sector Outlook

Turkish Commercial Vehicle Market

Light commercial vehicle (LCV) market has been on declining trend since 2011. During 2010-2013, domestic light commercial market contracted at a CAGR of 9% due to special consumption tax increase in 2011, extra costs for obtaining LCV license to operate and shift from LCVs to passenger cars. In the first four months of 2014, LCV demand tumbled by 33% YoY due to souring consumer sentiment and jump in auto loan rates. As we anticipate some relief in interest rates and consumer sentiment until 2014YE, our LCV market contraction forecast is 8% YoY in 2014, but we foresee some improvement (+9%) in 2015 due to pent-up demand and low base effect. Karsan produces LCVs for PSA but most of it is exported (90%) rather than sold in the domestic market, but Karsan stopped producing LCV for PSA in 2013.

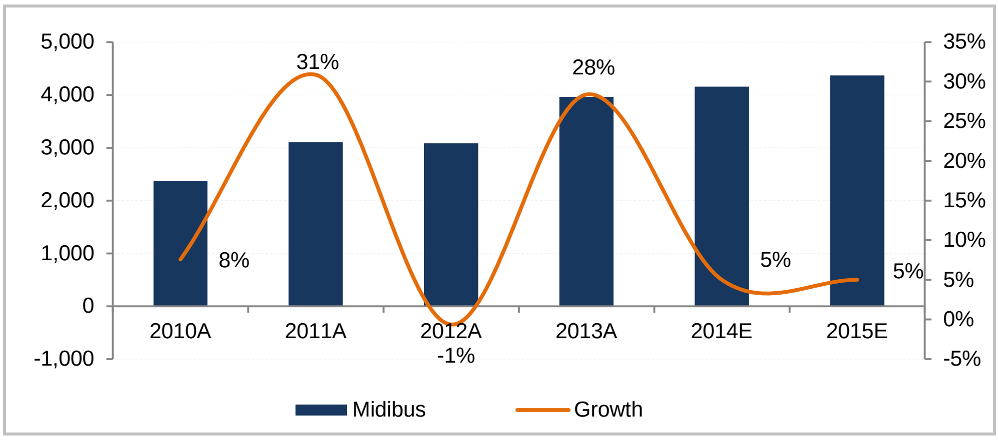
FIGURE 6 – Light commercial vehicle market



Source: Automotive Manufacturers' Association

Unlike LCV, midibus segment is growing. A midibus is a classification of single-decker minibuses, which are generally larger than a traditional minibus but smaller than a full-size single decker, can be anywhere between 7m-9m long and has capacity of carrying 25-35 passengers. In contrast to the contraction in LCV segment, the midibus market grew at a CAGR of 19% between 2010-2013. We expect 5% YoY growth in 2014 and 2015 in midibus demand. Karsan recently made its new midibuses debut at the Busworld Turkey Fair on April 24th 2014. The new midibuses have been named as Karsan Atak and Karsan Star and their delivery to customers is planned to start in mid-2014. With the launch of new midibuses, the company will be raising its market share as it has no presence in midibus market.

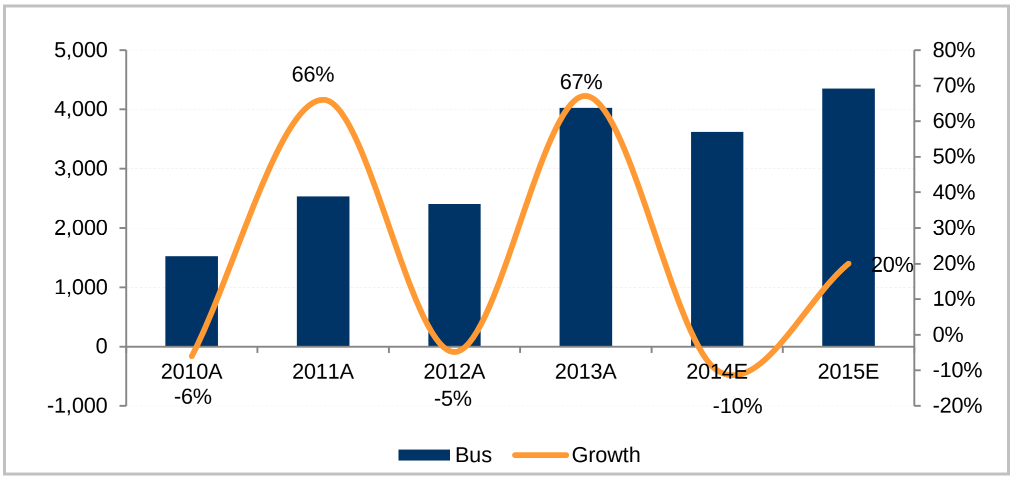
FIGURE 7 – Midibus market



Source: Automotive Manufacturers' Association

Bus is the most profitable commercial vehicle segment. During 2010-2013, bus market grew at a CAGR of 38% thanks to municipalities' bulk bus purchases, mostly in 2013 (+67% YoY), before the municipality elections. We expect some 10% YoY contraction in demand after the completion of municipality elections in 2014, but foresee recovery in next year thanks to general elections in 2H15. Karsan has started sales of buses in October 2010 and sold 573 buses (corresponding to 14% market share) in 2013, mostly to municipalities. We think that mid to long term growth potential of bus demand, especially in Istanbul, is high given the new investments such as third airport, third bridge and building of two new cities (each having 1mn population), which would increase Istanbul's population and accordingly need for transportation vehicles. Also, other big city municipalities need bus as the need for new transportation vehicle rises- note Istanbul Municipality Otobus A.S.' expected tender of 500 buses and upcoming tenders of other big city municipalities. Note also that the profitability of bus sales is more than two times higher than light commercial vehicle sales. Otokar is the biggest player in terms of market share, while Mercedes, Temsa, Man, BMC are other important players.

FIGURE 8 – Bus market

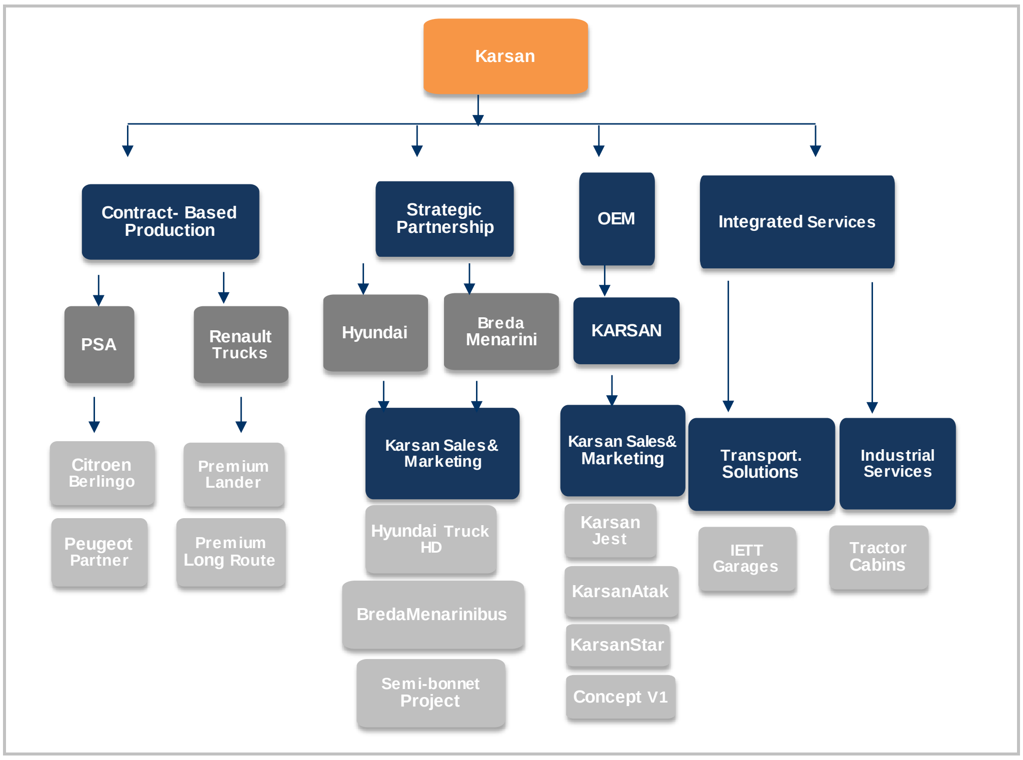


Source: Automotive Manufacturers' Association

Company in Brief

One of the oldest automotive production companies in Turkey. Karsan was established as a commercial vehicle producer in 1966 in Bursa as the only contract auto manufacturer in Turkey. The company has been producing commercial vehicles for the world's leading brands such as Peugeot, Renault and Hyundai, including its own, through its flexible manufacturing facilities, providing marketing, sales and after-sales services through its widespread network. Farm tractor cabin manufacturing, military truck cabin manufacturing, cataphoressis, paint application, body conversion and CNG filling station and maintenance service for buses are the other services that the company provides. Karsan's 25% subsidiary (but fully consolidated as Karsan has management rights) Karsan Pazarlama handles the marketing, sales and after-sales services of Karsan, Hyundai Truck and BredaMenarinibus brands. Karsan Pazarlama is also responsible for the export and public sector sales of all these brands. Note that Karsan has 58 dealers spread over Turkey, while the number of Hyundai Truck dealers is 27. Karsan outsources research & development and creation of new product studies (such as creation of Karsan's products; Jest, Karsan Atak, Karsan Star, Concept V1) as it has agreement with Hexagon Studio, which provides design and engineering services covering all steps of the product development cycle. Hexagon Studio is a joint venture company of Kiraca and Hexagon Group of companies.

FIGURE 9 – Business model



Source: Company

Shareholder structure: Kiraca Holding is the main shareholder, with its 63.46% stake, and Inan Kirac is the BOD head of the Holding. Free-float share of Karsan is currently 36.54%.

FIGURE 10 – Shareholders structure

Shareholders	mn shares	Stake
Kiraca Holding	292	63.46%
Free Float	168	36.54%
Total	**460**	**100%**

Source: Company

Karsan has two production facilities located in Bursa. Karsan's annual production capacity was at 27,980 in 2013. However, the company's capacity will decline to 18,200 (one shift) in 2014 due to ongoing Hyundai new vehicle production investment and will stay at that level throughout our forecast period.

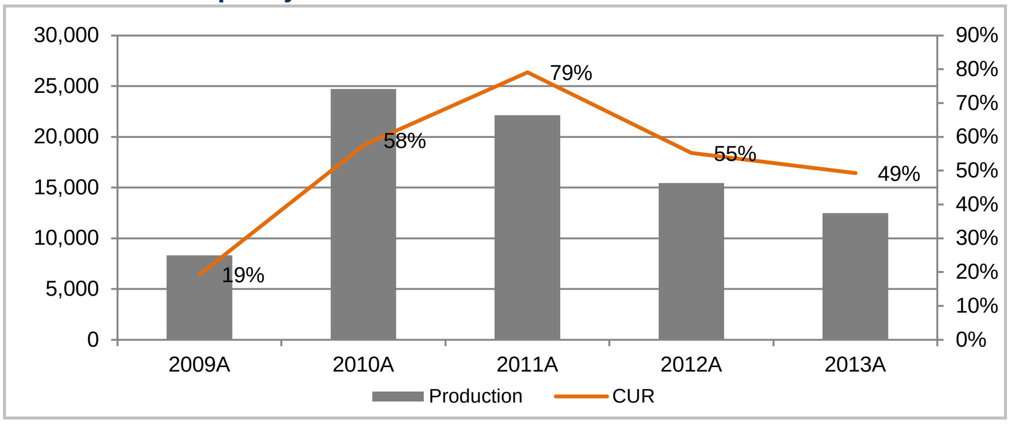
FIGURE 11 – Production capacity

Facility	Location	Capacity (unit/year)	Operations	Total area (sqm)	Closed area (sqm)
Hasanaga	Bursa	18,200	Commercial vehicle and bus production, paint, assembly, welding	200,000	90,000
OSB	Bursa	-	Tractor cabin and bus production, cataphoresis and paint, spare part	30,000	25,000

Source: Company

Operates with low capacity utilization rate. Since Karsan has been operating mainly as a contract manufacturer, both the domestic and export market conditions have been posing noticeable influence on the company's capacity utilization rates. The production orders from Renault, PSA Group (Peugeot-Citroen) and Hyundai are important determinants for CUR as there is no take-or-pay clause on production volume. Consequently, the company has been suffering significantly from low CUR, which causes loss at operational level. Note that CURs have been in a declining trend since 2011 due to contraction in domestic commercial vehicle market and weak demand in export markets after Eurozone crisis. The CUR was 79% at its highest in 2011 with the production of 22,146 units, while this figure was at 49% in 2013. Due to low capacity utilization rate - accordingly weak operational performance - and high financial leverage, the management had announced five rights issues collecting total of TL395mn from shareholders over the last eight years. The latest one was in July 2013 as the shareholders injected TL200mn cash into the company.

FIGURE 12 – Capacity utilization rates



Source: Company

The company has a wide product mix with different features. Karsan was amongst the two leader brands in the market of Minibus segment by J10. However, the company no longer produces J series since the end of 2013. Recently developed "Jest" is also Karsan's product, which is designed to grab further market share from minibus segment. The company has also the manufacturing and distribution license for HD35 and HD75 series Hyundai Trucks and manufactures, markets and sells those vehicles in the domestic market. Additionally, Karsan manufactures buses under brand name of BredaMenarinibus. Note that the company had been producing Partner and Berlingo LCV's for PSA Group (Peugeot-Citroen), Renault Premium and Kerax HCV's for Renault Trucks. LCV's were sold by PSA Group companies in the domestic market (10%) and in export markets (90%). Similarly, trucks were sold by Renault in the domestic market (50%) and in export markets (50%). However, the production agreements with aforementioned brands Renault and PSA) expired in 2013 and the company is not producing these products in 2014.

FIGURE 13 – Product portfolio

Type of Transport	Brand	Model	Type of Vehicle	Passenger Capacity	Length	Fuel Type	MLW
Passenger Transport	Karsan	Jest	Minibus	11+10+1	-	Diesel	-
	Karsan	Jest	Minibus	11+4+6+1	-	Diesel	
	Karsan	Jest	Minibus	11+1+1	-	Diesel	
	Karsan	Jest	Minibus	15+1	-	Diesel	-
	BredaMenarinibus	Vivacity C	Bus	-	8m	Diesel	-
	BredaMenarinibus	Vivacity M	Bus	-	9m	Diesel	-
	BredaMenarinibus	Avancity N	Bus	-	11m	Diesel	-
	BredaMenarinibus	Avancity L	Bus	-	12m	Diesel	-
	BredaMenarinibus	Avancity S	Bus	-	18m	CNG	-
	BredaMenarinibus	Vivacity C	Bus	-	8m	CNG	-
	BredaMenarinibus	Avancity N	Bus	-	11m	CNG	-
	BredaMenarinibus	Avancity L	Bus	-	12m	CNG	-
	BredaMenarinibus	Avancity S	Bus	-	18m	CNG	-
Cargo Transport	Hyundai Truck	HD35 Short	Pickup	-	-	Diesel	3.5t
	Hyundai Truck	HD75 Medium 140 HP	Light Truck	-	-	Diesel	7.5t
	Hyundai Truck	HD75 Long 140 HP	Light Truck	-	-	Diesel	7.5t
	Hyundai Truck	HD75 Long 150 HP	Light Truck	-	-	Diesel	7.5t

Source: Company

Light commercial vehicle sales compose majority of the sales volume. PSA Group LCVs Partner and Berlingo sales (mostly exported) make up 80% of total sales volume, while J series and Jest sales come in the second place with total of 7% share. BredaMenarinibus and Renault Truck sales have minor share in unit sales but higher share in total revenues. The PSA Group LCV sales and Renault Truck were on the declining trend in the last three years due to weak demand both in domestic and export markets. From 2013 onward, Karsan's newly developed minibus "Jest" has started to replace J-series. Also, Jest is expected to grab significant market share in minibus market given its disabled friendly design, which will be compulsory in passenger transport in the coming years.

FIGURE 14 – Sales volume

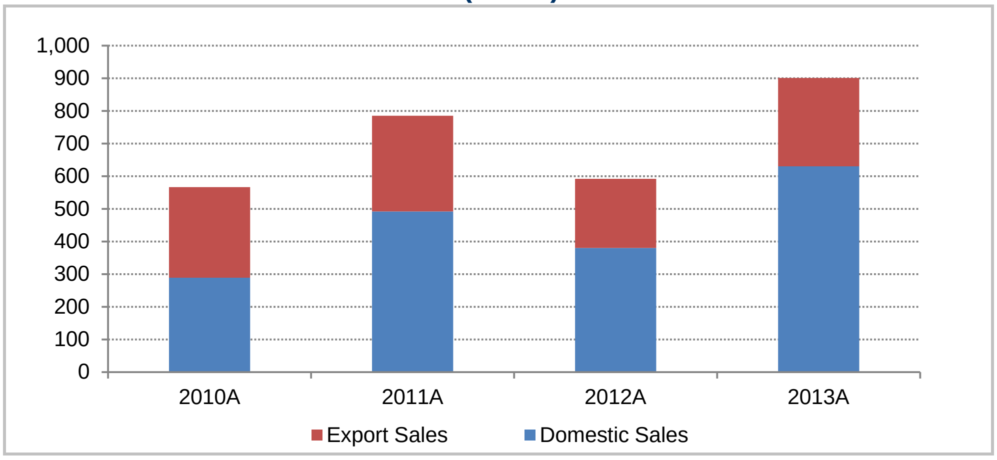
Products	2010A	2011A	2012A	2013A
J9-J10	2,375	2,864	3,116	268
Jest	0	0	0	668
Partner/Berlingo	21,349	16,869	11,180	10,085
Hyundai Truck	827	523	164	106
Renault Trucks	764	1,824	1,004	900
BredaMenarinibus	0	76	0	573
Total	**25,315**	**22,156**	**15,464**	**12,600**

Source: Company

Bus sales are the major contributor of top-line. During 2010-2013, Karsan's domestic revenues grew at a CAGR of 30% despite 7% contraction in local commercial vehicle (CV) market in the same period. The bus sales were the driver of top-line growth, although all of the product type revenues eroded due to contraction in CV demand. On the other hand, the company's export revenues, which compose 30% of top-line as of 2013, were almost flat in the last three years. The main export destinations are Algeria (13%), Tunisia (5%), Italy (2%) and France (2%). Note that Karsan exports 27 different countries.

Industrial services and spare parts revenues have noticeable share in total revenues. Karsan provides local industrial services besides contract manufacturing and works with brands such as Ford, Turk Traktor, Renault Mais etc.. On top of spare parts sales, the company specifically provides industrial services; such as stamping body parts, painting truck cabins, production of farm tractor cabins, cataphoresis coating and painting. Also, the company provides CNG filling and maintenance services for municipality buses. In 2013, Karsan generated total of TL161mn revenues (CAGR of 33% in 2010-2013), which makes up 18% of top-line, from these two segments (61% spare parts and 39% industrial services). Note that these segments are more profitable than commercial vehicle sales as its gross margin is higher than 25%.

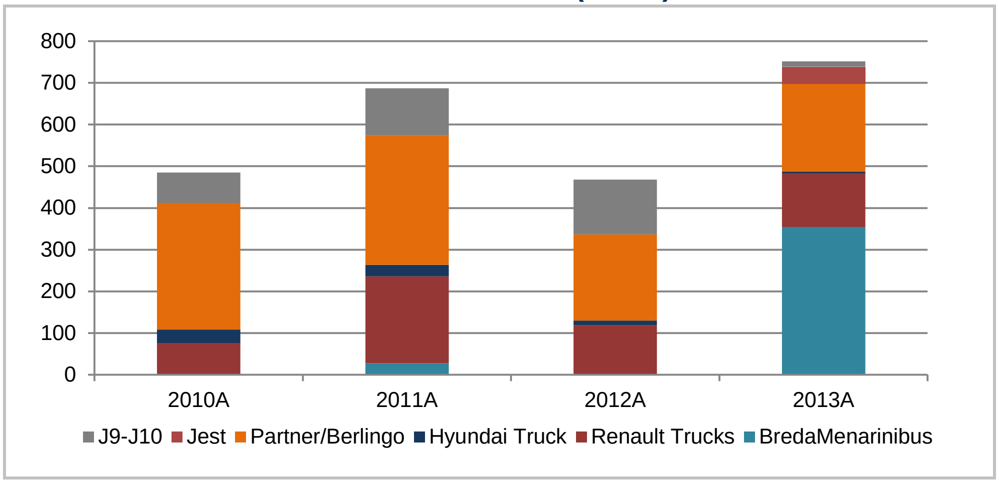
FIGURE 15 - Revenue breakdown (TLmn)



Source: Company

Contract manufactory products are being replaced by more profitable own-brand and BredaMenarinibus products. The share of contract manufactory products (such as; Peugeot Partner & Berlingo and Renault Trucks) drastically fell to 45% in 2013 thanks to higher share of BredaMenarinibus (47%) and the company's own brand Jest (5%) sales. With the expiry of Peugeot and Renault agreements in 2013 and start of Hyundai semi bonnet project in 2015, the share of profitable products in total mix will surge and have positive impact on the company's operational margins.

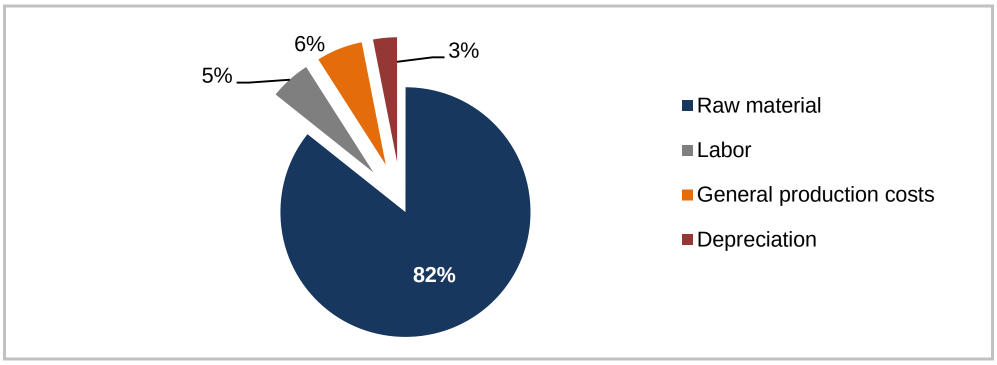
FIGURE 16 – Product revenue breakdown (TLmn)



Source: Company

Raw materials compose more than 80% of the total COGS. Most of the COGS formed by raw materials, while direct labor constitutes 5%, general production costs 6% and depreciation 3% as of 2013-end. Around 30% of raw material costs are EUR based as the engines and axles are imported.

FIGURE 17 – Cost structure



Source: Company

Turning into an OEM producer from contract auto manufacturer. Karsan used to be producing vehicles for Renault and PSA during the last five years and, accordingly, has been suffering from being a contract manufacturer as the profitability is very low for contract manufacturers. Additionally, the company's operational margins have been hit by lack of take-or-pay agreements considering that Renault and Peugeot had the right to change the production amount without any clause, which cause low capacity utilization rates. Consequently, the company recorded significant losses at bottom-line due to low profitability for being contract manufacturer, low capacity utilization rates and high financial expenses given the high leverage. Eventually, Karsan has decided to become an OEM producer, producing its own products rather than being a contract manufacturer. As a first step, Renault and Peugeot contracts have not been renewed and all of them expired by the end of 2013. Additionally, an agreement with Hyundai has been signed, which includes take-or-pay agreement, for the production of new commercial vehicles. Moreover, the company has kicked off the sale of its own products (such as; Jest, Karsan Atak, Karsan Star, Concept V1), which have higher profitability compared to Renault and Peugeot sales.

FIGURE 18 – Production contract details

Projects	Initiation date	Duration	Status
Peugeot J Series	May-07	-	Valid - Name and license rights granted
Peugeot Partner & Citroen Berlingo	Feb-08	5 years	Expired in December 2013
Renault Trucks	Sep-08	5 years	Expired in November 2013
Hyundai Truck	Aug-07	5 years	Extended in 2009
Hyundai - Semibonnet	Nov-12	Minimum 7 years	Production will start in Dec-14
BredaMenarinibus	Sep-10	-	Valid

Source: Company

Turnaround story begins with Hyundai deal. HMC has aspirations to become the second biggest automotive producer - ranked currently in fourth place - in the world. In order to reach this goal, the company has decided to enrich its product portfolio via new investments. HMC has no presence in 4-6 tons (gross vehicle weight) vehicle market in Europe and wants to step in to this market. Accordingly, on November 27th 2012, Karsan signed an agreement with HMC for the production of more than 200k light commercial vehicles (so called Semibonnet project) between 2014-2021. The new vehicle will weigh 3-6 tons and will have some versions including vans, light trucks and minibuses. The production is planned to start at the end of 2014. Also, Karsan will become the exclusive producer of this vehicle as it will not be manufactured in any of HMC plants except the one in Korea and the produced vehicles will be sold in domestic market (10%) and export markets (90%) such as; Europe, North Africa, Middle East and CIS. In 2013-2014, Karsan will invest US$60mn for the production, while HMC will invest US$200mn for development of the vehicle. The company will finance machinery investment via financial lease of EUR25mn and long term financial loan of EUR10mn. According to our calculation, Karsan will generate more than TL1bn revenue from (protected by take-or pay clause) Hyundai vehicle sales in 2015 (2014E top-line: TL537mn), totaling c.TL15.7bn between 2014-2021. Note that the profitability of HMC vehicle sales will be higher compared to Renault and Peugeot sales.

BredaMenarinibus sales have significant impact on both top-line and profitability. In 2010, Karsan and Italian bus brand BredaMenarinibus signed an agreement for a cooperation, which has a scope of manufacturing and selling buses ranging from 6.5 meters up to 18 meters. The serial production and sales have started in October 2010. The company sold 573 buses, mostly to municipalities thanks to local elections in March 2014, and generated c.TL350mn revenue in 2013 (40% of 2013 top-line). Note that the profitability of bus sales is more than two times higher than other commercial vehicle sales. Karsan provided five years of service guarantee for IETT's buses. The company pursuits for new bus tenders both in domestic and export markets such as Istanbul Municipality Otobus A.S.' expected tender of 500 buses and upcoming tenders of other big city municipalities.

FIGURE 19 – Bus tenders

Tenders	# of bus	Tender value	Delivery date	Additional note
Istanbul Municipality 1	240	EUR58.6mn	1H13	Including 5 years maintenance service
Istanbul Municipality 2	300	EUR83.6mn	2H13	Spare parts sale
Konya Municipality	40	EUR12.7mn	1Q14	Including 2 years maintenance service
Bologna Municipality	14	EUR3.9mn	4Q13	-
Total	**594**	**EUR159mn**		

Source: Company

Karsan's new midibuses are on the way. The newest members of the Karsan brand new generation of public transportation vehicles made their debut at the Busworld Turkey Fair on April 24th 2014. The new midibuses have been named as Karsan Atak and Karsan Star and their delivery to customers is planned to start in mid-2014. With the launch of new midibuses, the company will be enriching its product mix as it has no presence in midibus segment, which is a profitable and growing (CAGR of 19% between 2010-2013) market.

Concept V1 project (Taxi). Karsan has set forth its vision to be a provider of "Limitless Transportation Solutions." Within that context, in addition to the ongoing activities with its current business partners, the company has embarked on designing and commissioning original vehicles under its own brand, aimed at creating transportation solutions for unmet demands. As a result, Karsan has initiated Concept V1 project, which is designed for the use of all taxi commuters, operators and drivers, with the help of its sister company, Hexagon Design, and participated New York taxi tender in 2011, where it made the shortlist of three along with the Nissan NV200 and Ford's Transit Connect, but could not win the tender. The Concept V1 has been developed since then and now may also be used as passenger car with alternative engine options (benzene, diesel and CNG). Starting from 2015, London will be replacing cab engines (mainly diesel engine) with electric ones as the transformation is planned to be completed by 2018. Therefore, it is expected that there will be 5-6k replacement in London taxi market each year whose size is around 22k. This project could be a good opportunity for Karsan as it had already presented its Concept V1 in London. Note also that the management is in talks with 14 metropoles for possible taxi tenders.

Karsan is among the candidates of TUBITAK's electric car project. The government has been working on various schemes to incentivize the production of electric car in Turkey. As a part of this scheme, Turkish Science Institution (TUBITAK) has invited interested companies to participate the electric car development project as the government will provide EUR30mn incentive (according to the newspapers) to the winner for the design of the car. The finalists in this project are; Karsan, Hema Endustri (Magna), Anadolu Isuzu, Derindere, Hisarlar and Malkoclar. Note that Karsan presents the electric version of its taxi designed for New York in this project.

Exploring new markets via having partnership with a Chinese company. Karsan has been in talks for selling its J10 production line to Chinese Hubei Suizhou at a price of EUR18mn. Following the acquisition of Hubei Suizhou by another Chinese company Wuhan Zhong Yuan Ban Tai, Karsan signed a letter of intent with Wuhan Zhong Yuan Ban Tai for a feasibility study to launch a JV in China in order to manufacture 30k units of J10 minibuses and other Karsan products. According to the agreement, Karsan will have a 35% stake in the new JV to be formed with a paid-in-capital of EUR62mn. Karsan will be giving its production line and know how in return for capital to be put for its share, which corresponds to EUR18mn. If the feasibility studies come out as positive, it may be a positive development for Karsan as it enters a new market.

Forecasts

Unit sales

2015 unit sales will be strong after weak 2014. Karsan had not renewed production contracts with PSA and Renault, which will cause CUR and unit sales to decline in 2014. However, 2015 unit sales will surge by more than 700% YoY thanks to initiation of Hyundai project sales as it brings 14.5k sales volume, protected via take-or-pay agreement. With the beginning of Hyundai project production, we forecast that CUR will increase significantly in 2015 and the company will move to two shifts in 2016. As a note, we assume that Karsan will sell 20k units of Hyundai vehicles per year after take-or-pay agreement expires in 2021-end.

FIGURE 20 – Unit sales

Unit sales	2012A	2013A	2014E	2015E	2016E	2021E	2023E+
J9 - J10	3,116	268	0	0	0	0	0
Jest	0	668	1,250	1,500	1,575	2,010	2,216
Karsan Atak & Star	0	0	500	850	850	1,100	1,200
Peugeot Partner/Citroen Berlingo	11,180	10,085	0	0	0	0	0
Hyundai mini-truck	164	106	30	0	0	0	0
HMC new vehicle	0	0	0	14,500	20,500	50,000	20,000
Renault Truck	1,004	900	0	0	0	0	0
BredaMenarinibus	0	573	250	350	300	300	300
Total	**15,464**	**12,600**	**2,030**	**17,200**	**23,225**	**53,410**	**23,716**
Growth	*-30%*	*-19%*	*-84%*	*747%*	*35%*	*-*	*-*
CUR	**55%**	**45%**	**11%**	**95%**	**64%**	**117%**	**52%**

Source: Company, Deniz Invest Research estimates

Revenues

Rising bus sales and initiation of Hyundai project to boost top-line in 2015. This year will be a transition year as the company ended production contracts with PSA and Renault, which make up 55% of 2012 and 37% of 2013 top-line, and undertakes investment for production of new HMC vehicle, which causes some production loss. Also, we expect 56% YoY decline in bus sales after completion of municipality elections in 2014 but foresee recovery next year thanks to general elections in 2H15. Consequently, we anticipate 41% YoY contraction in the company's 2014 top-line. However, we estimate significant YoY jump in 2015 revenues driven by HMC new vehicle sales (adds c.1bn revenue), lucrative bus sales ahead of general elections and positive contribution from newly launched midibuses. For 2013-2016, we expect the company's top-line to grow at a CAGR of 32%.

FIGURE 21 – Revenue forecasts

TLmn	2012A	2013A	2014E	2015E	2016E	2021E	2023E+
J9 - J10	131	13	0	0	0	0	0
Jest	-	41	85	102	108	137	151
Karsan Atak & Star	-	0	100	170	170	220	240
Peugeot Partner/Citroen Berlingo	206	210	0	0	0	0	0
Hyundai mini-truck	11	6	2	0	0	0	0
HMC new vehicle	0	0	0	1,006	1,445	4,288	1,855
Renault Truck	119	127	0	0	0	0	0
BredaMenarinibus	0	354	156	221	165	196	206
Industrial services & spare part	115	161	193	203	213	272	300
Total	**583**	**913**	**537**	**1,702**	**2,101**	**5,114**	**2,753**
Growth	*-27%*	*57%*	*-41%*	*217%*	*23%*	*-*	*-*

Source: Company, Deniz Invest Research estimates

Margins

Operational margins to stabilize after years of volatile trend. The gross margin of the company has been following unstable trend due to volatility in domestic vehicle market, low CURs, lack of take-or-pay agreement and value added product mix. However, we expect Karsan's gross margin to stabilize starting from 2015 deriving strength from rising CUR and increase in value added products to mix (such as; bus and midibus). Note that the share of value added products will reach to 23% in 2015's top-line from nil in 2012.

FIGURE 22 – Gross margin forecasts

Margin breakdown	2012A	2013A	2014E	2015E	2016E	2021E	2023E+
J9 - J10	10%	8%	-	-	-	-	-
Jest	-	11%	11%	11%	11%	11%	11%
Karsan Atak & Star	-	-	17.5%	17.5%	17.5%	17.5%	17.5%
PSA Partner-Berlingo	10%	5%	-	-	-	-	-
Hyundai minitruck	9%	9%	10%	-	-	-	-
HMC new vehicle	-	-	-	13%	13%	13%	13%
Renault Truck sales	9%	8%	-	-	-	-	-
BredaMenarinibus	0%	30%	30%	30%	30%	30%	30%
Industrial serv. & spare part	25%	25%	25%	25%	25%	25%	25%
Gross margin	**4.4%**	**17.6%**	**13.7%**	**14.1%**	**13.2%**	**13.2%**	**13.3%**

Source: Deniz Invest Research estimates

Net profit

Strong operational performance will lead to higher profitability. The company suffers from weak operational performance as well as high financial expenses (2013 net financial loss: TL57mn) due to significant leverage, which cause loss at the bottom-line. With the pickup in operational performance, Karsan will begin to post positive bottom-line results starting from next year, until then we expect the company to record losses throughout 2014.

FIGURE 23 – Net profit forecasts

TLmn	2012A	2013A	2014E	2015E	2016E
Net profit	-59	16	-28	59	87
Net margin	*-10.1%*	*1.7%*	*-5.3%*	*3.5%*	*4.1%*

Source: Company, Deniz Invest Research estimates

Capex

Most of the capex need will be completed in 2014. Karsan has been investing in the production line of new HMC vehicle since 2013. The total budget for the investment is US$60mn as some portion of it has already been completed in 2013, while HMC will invest US$200mn for development of the vehicle. We expect the company to spend EUR35mn for this investment including maintenance capex and some minor investments for midibuses in 2014. After the completion of this investment, the company will not have any significant capex need as it has enough capacity for further production.

FIGURE 24 – Capex estimates

TLmn	2012A	2013A	2014E	2015E	2016E
Capex	79	91	103	43	29
Ratio to sales	*13.6%*	*10.0%*	*19.1%*	*2.5%*	*1.4%*

Source: Company, Deniz Invest Research estimates

Indebtedness

Debt stock to ease along with rising operational performance. Due to low capacity utilization rate - accordingly weak operational performance - and high financial leverage, the management had announced five rights issues collecting total of TL395mn from shareholders over the last eight years. The latest one was in July 2013 as the shareholders injected TL200mn cash into the company. Still, net debt/EBITDA level will be high due to poor operational performance in 2014. However, we expect this ratio to decrease starting from 2015 with the kickoff of HMC project. The management will issue TL-bond up to TL100mn with two years maturity for financing of ongoing investments and debt rollover as the company has short-term financial debt of TL278mn. Note also that company has insignificant short FX position (US$6.9mn and EUR3.3mn) as of 1Q14-end.

FIGURE 25 – Indebtedness and financial ratios

TLmn	2012A	2013A	2014E	2015E	2016E
Net debt	229	464	577	546	372
Financial debt	244	504	613	608	553
Equity	260	342	312	371	458
Asset	729	1,031	1,065	1,293	1,391
P/BV	1.2	1.2	1.7	1.4	1.2
Debt/Equity	0.9	1.5	2.0	1.6	1.2
Net debt/Equity	0.9	1.4	1.8	1.5	0.8
Net debt/EBITDA	n.m.	7.3	39.9	3.8	2.1
ROE	n.m.	5%	n.m.	16%	19%
ROA	n.m.	2%	n.m.	5%	6%

Source: Company, Deniz Invest Research estimates

FIGURE 26 – IFRS summary income statement and forecasts

TLmn	2013A	2014E	2015E	2016E
Revenues	**913**	**537**	**1,702**	**2,101**
COGS	-790	-464	-1,461	-1,828
Gross Profit	**161**	**73**	**241**	**273**
Operating Expenses	-123	-87	-126	-127
Operating Profit/(Loss)	**38**	**-14**	**115**	**145**
Other income (expense) - net	28	26	17	17
Financial expenses	-67	-57	-65	-61
Profit Before Tax and Minorities	**-2**	**-46**	**67**	**101**
Tax	6	12	-13	-20
Minority interests	-11	-6	-6	-6
Net Income/Loss	**16**	**-28**	**59**	**87**
EBITDA	**64**	**14**	**144**	**175**

Source: Company and Deniz Invest Research estimates

FIGURE 27 – IFRS summary balance sheets and forecasts

TLmn	2013A	2014E	2015E	2016E
Current Assets	**446**	**464**	**753**	**927**
Cash and Banks	39	36	62	181
Trade Receivables	143	199	330	336
Due from related parties (net)	2	2	2	2
Inventories (net)	96	58	190	239
Other Current Assets	136	139	139	139
Fixed asset to be sold	29	29	29	29
Fixed Assets	**586**	**602**	**540**	**464**
Equity Participations	0	1	1	1
Long term Receivables	173	115	58	0
Net Tangible Assets	296	355	351	333
Intangible fixed assets	93	100	100	100
Other Long-Term Assets	24	31	31	31
TOTAL ASSETS	**1,031**	**1,065**	**1,293**	**1,391**
Short Term Liabilities	**221**	**398**	**566**	**602**
Short term borrowings	82	302	300	273
Trade Payables	127	74	244	307
Due to Related Parties	9	6	6	6
Other Payables	4	16	16	16
Long Term Liabilities	**477**	**364**	**365**	**341**
Long term borrowings	422	311	308	281
Severance payments	10	12	16	19
Other Long-Term Payables	45	41	41	41
Minority Interests	**-8**	**-9**	**-9**	**-9**
Shareholders' Equity	**342**	**312**	**371**	**458**
TOTAL LIAB. AND SH EQUITY	**1,031**	**1,065**	**1,293**	**1,391**

Source: Company and Deniz Invest Research estimates

Buyukdere Cad. No: 106 Kat: 16 34394 Esentepe, Istanbul TURKEY

ANALYST CERTIFICATION

I, Kurthan Atmaca, hereby certify that the views expressed in this research report accurately reflect my personal opinion about the companies and the securities discussed herein. This report has been submitted to the issuer of the financial instrument it relates to before its publication. Like all employees of Deniz Yatırım, the remuneration can be based in part on the results of Deniz Yatırım as a whole. No part of my compensation was or is related to any recommendation or opinion expressed in this report.

COMPANY SPECIFIC REGULATORY DISCLOSURES

Deniz Yatırım or any entity of Denizbank can perform commercial banking, brokerage and advisory services for or on behalf of any of the companies or organisations referred to in this report. Furthermore, Deniz Yatırım or any entity of Denizbank may hold a position either independently or for the benefit of third parties, or trade in the securities of any company or organisation referred to this report, as a broker, market maker, or in any other role. The following disclosures relate to relationships between Denizbank or its subsidiaries and companies covered by the equity research division of Deniz Yatırım and referred to in this research. Denizbank may have from time to time non-securities related banking relationships with the companies covered by its research department.

RECOMMENDATIONS

We use three stock recommendations which reflect the share's expected relative performance versus BIST-100 index over the next twelve months.

Market Outperformer: we expect this stock’s return to be +10pps relative to our index target.

Market Performer: we expect this stock’s return to be between +10pps and -10pps relative to our index target.

Market Underperformer: we expect this stock’s return to be -10pps relative to our index target.

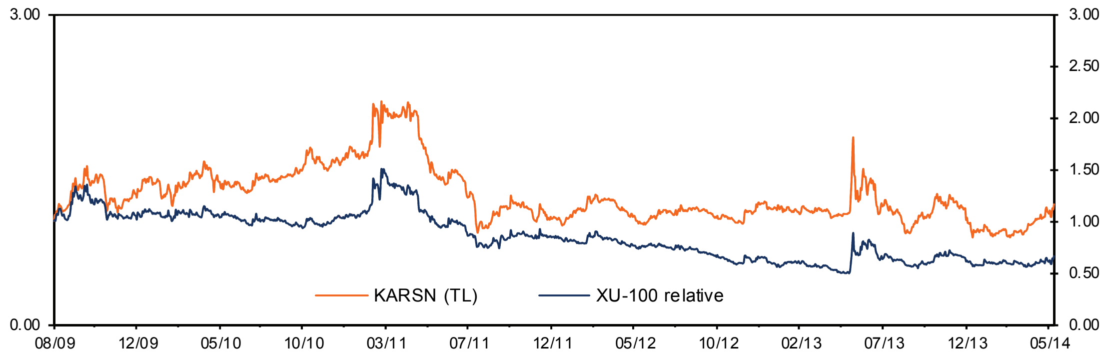
DISTRIBUTION OF RATINGS (AS OF 20/05/2014)

	RATING DISTRIBUTION	
Rating Category	**Count**	**% breakdown**
Market Outperformer (M.O.)	32	42%
Market Performer (M.P.)	29	38%
Market Underperformer (M.U.)	3	4%
Under Review (U.R.)	13	17%
Total	**77**	**100%**

MEASURES PREVENTING CONFLICTS OF INTEREST

To the extent permitted by law, Deniz Yatırım, or its officers, employees or agents, may have bought or sold the securities mentioned in this report, or may do so in the future. Analysts' remuneration can be based in part on the results of Deniz Yatırım which may include investment banking revenues. Analysts are required to respect the information sharing policy that restricts disclosure of recommendations to third parties or to any other department of Deniz Yatırım prior to the distribution or the public disclosure thereof. Similar information barriers apply to the staff involved in the corporate banking, corporate finance and structured finance activity in order to prevent conflicts of interest. They are not allowed to enter into transactions involving securities of a listed company for their own account or for the account any third party, when involved in the customer relationship with such company nor communicate on the relationship with such company outside the corporate department without the prior authorization of the Compliance Officer.

Buyukdere Cad. No: 106 Kat: 15 34394 Esentepe, Istanbul TURKEY



Local Regulatory Authority for Deniz Invest: Capital Markets Board of Turkey

DenizInvest

Buyukdere Cad. No: 106 Kat: 15 34394 Esentepe, Istanbul TURKEY

Equity Research

Sinan Goksen	**Head of Research**	Sinan.Goksen@denizinvest.com +90 212 336 5190

Sales

Emir Tayman	**Head of Sales & Trading**	Emir.Tayman@denizinvest.com +90 212 370 6806