Investing in Turkey

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‘Great chief’ steers into uncharted waters

Since the Gezi protests, prime minister Erdogan still has a way of angering the middle and professional classes, writes *Daniel Dombey*

Mind the gap: Recep Tayyip Erdogan, third from right, waiting to cross the Bosphorus by train AP

Few countries have goals as grand as Turkey’s; few cities have ambitions that compare with Istanbul’s. The dynamism of the Turkish commercial capital is inescapable, as is that of prime minister Recep Tayyip Erdogan, its member of parliament and most ardent champion.

That said, Turkey is going through a challenging time of transition. Both the economic model that has brought it success and Mr Erdogan’s style of government could be tested and, indeed, overturned, by events.

The prospect of tighter US monetary policy has made the international economic environment less forgiving for a country with Turkey’s structural imbalances. Meanwhile, Mr Erdogan’s ambition to become head of state – and his confrontational style – seem set to make next year a political turning point. His own role could markedly change.

In October Mr Erdogan inaugurated the world’s first transcontinental undersea rail tunnel, linking the Asian and European sides of Istanbul. A sign at the entrance to the Marmaray tunnel thanked the “great chief” – the prime minister himself – for pursuing the project, just one of many transforming the city and serving as calling cards for the new Turkey.

The Zorlu centre, a towering new mall, arts, housing and office complex near the financial district proclaims Turkey’s ability to attract international brands and to charge rents of €150 a square metre and more. The country’s young consumers are the great draw.

This is the Turkey that Mr Erdogan is building. In most of the 81 provinces, you can see his ambition taking concrete form. To many eyes, foreign and domestic, it is a world of opportunity, an $800bn economy of 76m people enviably placed between Europe, Asia, Africa and the Middle East.

“If you invest here”, says Selcuk Yorgancioglu, head of Turkey and Central Asia for Abraaj, the Dubai-based private equity group, “you need to be hands on, but when you do that you make money.” Abraaj’s recent high-profile deals include the sale of a 50 per cent stake in Turkey’s largest hospital chain as part of a larger $2bn transaction.

> ‘Institutional investors are still betting on growth, particularly that driven by Turkish consumers’

Other recent noteworthy deals include big secondary public offerings of Ulker, a leading biscuits and chocolate producer, and Emlak Konut, a government-controlled property developer. Allianz bought Yapi Kredi Sigorta, the insurer (see page 2).

“Institutional investors are still betting on growth,” says Cem Karakas, head of finance at Yildiz Holding, Ulker’s parent, particularly that “driven by Turkish consumers”.

At the same time, neither the rates of growth that Turkey has enjoyed during Mr Erdogan’s decade in office, nor the leadership he has provided can be taken for granted in the years ahead. Turkey, like other emerging markets, will still probably outgrow most developed economies and converge towards their standards of living. Yet, if the US Federal Reserve reins in its monetary stimulus, which has helped boost emerging markets, growth is likely to slow.

To an important extent, the change has already occurred. Turkish officials themselves engineered a slowdown from an unsustainable level of about 9 per cent in 2010-11 to just 2.2 per cent last year. Gross domestic product is expected to rise 3-4 per cent this year.

Mr Erdogan’s goal to make Turkey one of the world’s 10 biggest economies by 2023 – which would require growth of some 15 per cent a year –

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To progress, the country must get back to ‘normal’

Commentary
ANDREW FINKEL

At a political retreat outside Ankara this month, Recep Tayyip Erdogan, the Turkish prime minister, reassured his Justice and Development (AK) party faithful that his government remained on a reformist track.

He dismissed suggestions that allowing women MPs to wear religious headscarves in parliament – a keystone of his “democratisation package” unveiled on September 30 – was an attempt to polarise the electorate or to value the beliefs of his own religiously conservative supporters at the expense of the rest of society.

“Turkey is going through a period of normalisation,” Mr Erdogan insisted.

Less than a week after making those remarks, the prime minister appeared deliberately to court controversy by insisting that the authorities had an obligation to stop men and women university students from sharing the same private accommodation. Such prohibitions have no basis in Turkish law and a senior cabinet spokesman tried to explain away the remarks as a moral preference rather than a government directive. Mr Erdogan intervened a second time to say that he had not been misunderstood at all and still insisted that young adults could be prevented from cohabiting.

“This is a police state spying on its citizens’ houses, hunting for immoral behaviour behind closed doors,” wrote Ihsan Dagi, a columnist for the Zaman newspaper group, which, until recently, has been a close supporter of the AK Party.

The irony, Mr Dagi noted, is that the AK Party came to power in 2002 with a civil libertarian agenda and a determination to set aside Islamist rhetoric.

A look at those early days in power reveals how successful the AK party was in overcoming the scepticism of the international community. It was buoyed by what at the time were referred to as the “twin anchors” – an IMF standby programme designed to repair public finances and membership negotiations with the EU that necessitated deep institutional reform.

In retrospect, it can be seen that Turkey benefited from a third, less publicised lifeline – an abundance of global liquidity that meant much-needed finance and investment came its way.

It was win-win. Strict fiscal discipline brought down inflation and real interest rates, giving the treasury wiggle room.

“The public reaped the reward through public expenditure on infrastructure, health and education and the government reaped the political benefit with victory at the polls,” explains Seyfettin Gursel, economics professor at Istanbul’s Bahcesehir university.

No longer the sick economy of Europe, Turkey bounced back post-Lehman Brothers with an eye-catching 9.2 per cent growth in gross domestic product in 2010. AK won a third term in office in 2011 with nearly half the popular vote.

The government used its mandate to dismantle the old, and in many cases undemocratic, institutions of the old Republican guard. The wings of the Turkish military were clipped. However, the prime minister began to face mounting criticism that he was filling the vacuum with unaccountable institutions under his control.

Toki, the state housing authority, was given virtually unlimited powers to appropriate and rezone swaths of urban land. Blueprints for multibillion-dollar infrastructure projects began to appear from Ankara back rooms without environmental impact studies. The ability of the court of accounts to audit public expenditure has been constantly undermined. The central bank, though independent, has come under intense pressure to keep interest rates low and growth in motion at the expense of currency stability and the inflation rate.

The latest EU progress report criticised changes in the public procurement law that reduced penalties for bid rigging. It also voiced its opposition to the lack of independence in the Turkish press.

There was an outpouring of popular frustration at the end of spring in what started as a campaign to save a clump of trees in Istanbul’s Gezi Park. Police heavy handedness led to a month of demonstrations. The pro-government press has come down hard on individuals and corporations that it suspected of supporting the protests. One paper even blamed the glitches in the newly opened metro system linking the European and Asian sides of Istanbul on the work of Gezi activists.

Voicing concerns: protesters gathered in Taksim square Getty

This in turn has led to investors taking a harder look at Turkey. Some foreign investors have been holding back to see how the dust settles after an election cycle that includes municipal and presidential elections next year and a general election the year after that.

According to Prof Gursel, perceptions of Turkey have changed, but he believes this is less the result of a deliberate shift in policy than because the government has exhausted the benefits of its initial reforms and has still to engage in those that would make the economy far more competitive.

“The windfall of macroeconomic stability has been used up,” says Prof Gursel. He dates the government’s growing insecurity and the rallying cries to its conservative political base to 2011, when it realised it would have to adjust to a low-growth regime.

The Turkish story was of a country making good progress in dealing with its problems – even the hard ones like the Kurdish question, according to Christian Keller, head of emerging market research at Barclays Capital in London. “Gezi made people step back and be less prepared to give Turkey the benefit of the doubt.”

This does not have to be permanent. “The record over the past 10 years has been strong and perceptions can turn more optimistic again,” says Mr Keller.

For that to happen, however, and to paraphrase the prime minister, Turkey must go back to being normal.

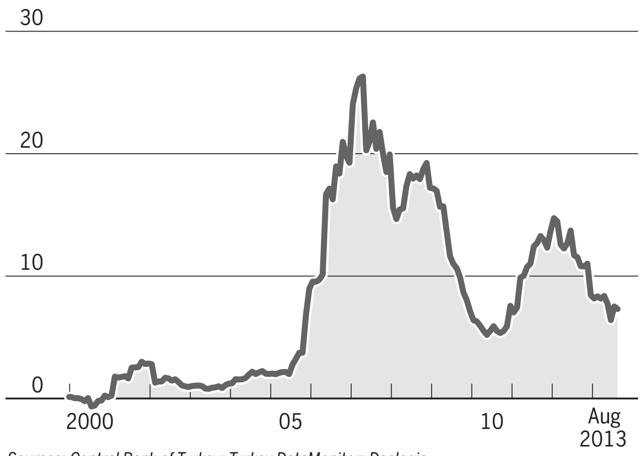
Investing in Turkey

Panoramic overview: with a large and youthful population, increasing purchasing power and a well-trained labour force, the country, which has a customs union with the EU, is well located to serve Europe and the Middle East Dreamstime

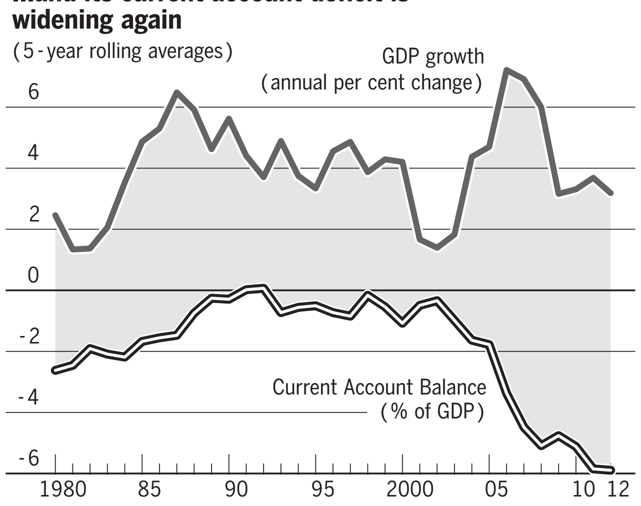
Turkey's challenge in numbers

By Valentina Romei and David Edgerly

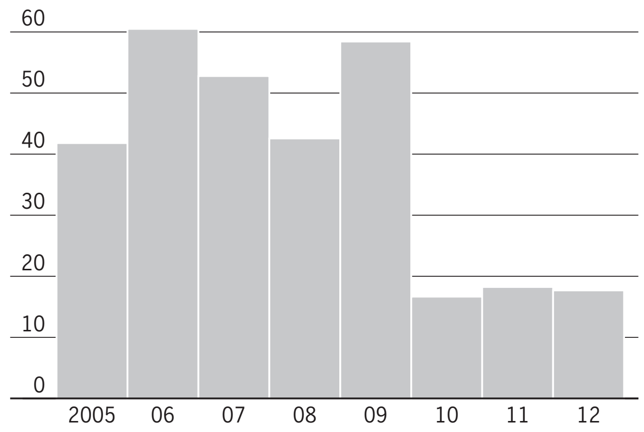
Net direct investment in Turkey has been declining....
Rolling 12-month sum ($bn)



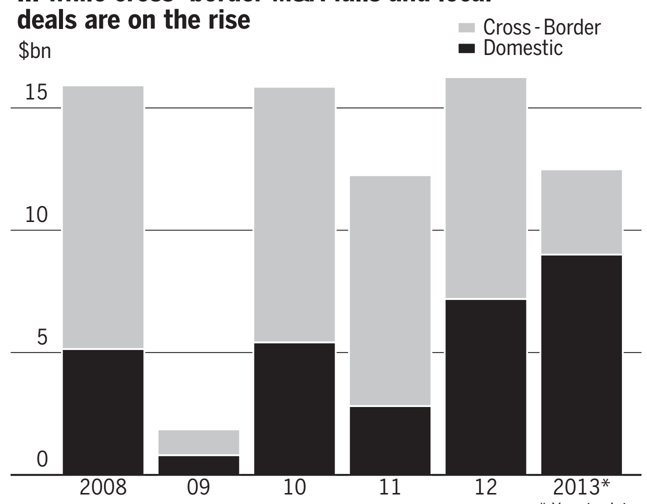
...and its current account deficit is widening again
(5-year rolling averages)



FDI covers a shrinking proportion of the current account deficit...
FDI as % of current account deficit



... while cross-border M&A falls and local deals are on the rise
$bn



* Year to date

Sources: Central Bank of Turkey; Turkey DataMonitor; Dealogic

FT graphic

Current account deficit is economy's Achilles heel

Growth Reliance on imports and short-term fund flows increase risk, reports *David Edgerly*

Deputy Prime Minister Ali Babacan recently presented Turkey's ambitious medium-term economic programme to a group of investors in London. The programme envisions increased gross domestic product growth and a declining current account deficit as a percentage of GDP. The problem is that those two goals seem mutually exclusive.

Given the structure of the Turkish economy, any growth in GDP results in a higher, not lower, current account deficit. "Each percentage point of GDP growth requires more current account deficit than historic averages," says Murat Ucer, economist at the consultancy GlobalSource Partners.

Annual energy imports of approximately $60bn are often blamed for the high current account deficit. They are undoubtedly a factor, but South Korea also imports almost all its energy and somehow manages a strong current account surplus.

The government recognises the problem and has introduced a number of prudent measures such as providing equity investment incentives, introducing measures to increase private increasing private savings, encouraging renewable energy, and establishing two nuclear energy plants in an effort to correct the external imbalances.

But a working paper prepared by the Turkish central bank in 2010 points to a deeper reason for Turkey's heavy dependence on imports.

The report demonstrates that, as the Turkish economy developed beyond the traditional labour-intensive industries like textiles, manufacturing required more raw materials and sophisticated machinery and equipment, most of which continued to be imported.

The paper surveyed 145 leading manufacturing companies in Turkey and found that in key sectors, such as electronics and metals, imports accounted for more than 80 per cent of the total expense of raw material and equipment.

In petrochemicals, imports account for 87 per cent of total inputs. In the automotive sector, imports amount to almost 60 per cent of total inputs.

The paper lists several reasons, including the relatively strong Turkish lira from 2002-10 and the customs union with the European Union, for the predominance of imported raw material and equipment.

But the main reason given by the companies is the lack of an adequate domestic supply chain. The required material, from coking coal to sophisticated chip sets, either does not exist at all or not in sufficient amounts in the domestic market to offset the imported goods.

One result of the reliance on imported raw material and equipment is to reduce the value-added domestic content of Turkish exports.

The bank's paper cites the example of the television industry. Turkish-made TV sets account for about 50 per cent of the EU market, but important components of those televisions are imported into Turkey.

In theory, the 15 per cent decline of the Turkish lira so far in 2013 should narrow the current account deficit by encouraging exports. When those same exports, however, contain so many imported components the positive impact may be limited.

Given the economy's structure, it is difficult to see how any growth, driven by domestic demand or exports, can avoid increasing the current account deficit.

However, as one London-based institutional investor noted, the actual amount of the current account deficit is less important than the government's means of funding it.

"Here the Turkish government has been extremely lucky with the global liquidity situation," the investor says.

"In one sense, the best Turkish natural resource was the US Federal Reserve's balance sheet. There was plenty of money available to fund any deficit as long as the Fed kept rates low. Once that situation changes the Turkish narrative also changes. All those short-term funds that flowed into Turkey could easily go elsewhere."

Another investor dismisses the government's attempts to downplay the size of the deficit when it says that energy imports account for a large part of it.

"The Turkish government keeps presenting charts showing the non-energy current account deficit, as if they do not need to finance the energy part," he says.

"For portfolio investors, who are asked to finance it, the actual dollar amount and the future ability to pay us back are important. It does not matter whether the current account deficit is from oil or champagne – both are consumed."

This situation presents policy makers with some difficult choices.

They can slow down the economy. But with three elections – municipal, presidential, and parliamentary – in the next 18 months this does not seem likely.

Given the government's strong aversion to interest rate adjustments, that tool has been removed from the policy toolbox. Yet most of the government's measures will take time to become effective. The critical question is whether the global economic situation will continue to give Turkey the time it needs.

> 'The government has been extremely lucky with the global liquidity situation'

Flat out: Turkish-made TVs account for about 50 per cent of the EU market Alamy

Uncertainty gives pause for thought

Foreign direct investment

Politics, red tape and an unpredictable legal system are causes for concern, writes *David Edgerly*

Viewed from afar, Turkey is an obvious target for long-term foreign investment. The country has a large, young population, increasing purchasing power, a well trained work force, and low penetration rates for many consumer and industrial products. On top of this, it has a customs union with the EU and is well located to serve the Middle East as well as Europe.

Yet the actual amount of net foreign direct investment (FDI) does not reflect these oft-repeated attractions. In 2008, for example, net FDI in Turkey was $17.2bn. By 2012 that amount had dropped to $8.4bn. To the end of August 2013, the number was ever lower, at $5.7bn against $6.9bn in the same period the previous year.

The government's ambitious targets for FDI received a blow in August when TAQA, the Abu Dhabi National Energy Company, withdrew from a planned $12bn investment to develop Turkey's abundant lignite reserves.

Neither party gave a clear reason for the withdrawal. The Gulf press, however, blames the abrupt withdrawal on deteriorating political relations with the UAE following Turkey's continued strong support for the Muslim Brotherhood after it was overthrown in Egypt last summer.

Turkish officials had high hopes that this project would help reduce the annual imported energy bill of about $55bn. Two planned nuclear power plants – one Japanese and one Russian – should help cut that cost, but it could be 2023 before the first is operating.

In addition to the decline in FDI, Turkey has had difficulty attracting high-value-added technology investment. The World Economic Forum's Global Competitiveness Report gives a hint as to why high-tech companies may prefer Asia to Turkey.

In the higher education and training category, for example, South Korea ranks 22nd, while Turkey languishes in 65th place. In the innovation and sophistication category South Korea is 20th and Turkey 47th.

A western banker who had just left a meeting with large European companies said their big issue with Turkey was: "Lack of respect for the rule of law. The legal playing field is not perceived as level and there are too many arbitrary decisions. The slowdown in FDI for Turkey is not just an emerging market phenomenon caused by [US Federal Reserve] tapering. The year was already slow, long before the concerns about the Fed's actions."

One Istanbul energy expert cites the problems of inefficient bureaucracy common in emerging markets. "Even as a Turk, I don't see any consistency, predictability from the state. Badly drafted laws and opaque regulations leave the door open to negative judicial decisions. Constantly changing regulations cost time and money," he says.

Western bankers say the changed global financial landscape has made financing many projects problematic. "Basel III has forced many banks to pay much closer attention to their capital, and they are not so interested in financing mega-infrastructure projects such as Istanbul's third airport," says one.

A consultant recently returned from Europe and the US adds that the changed political perception of Turkey has made some potential investors cautious.

"After the Gezi protests and the strong government reaction against anyone associated with the protests, there is some renewed concern about stability in Turkey. Many companies wonder which way Turkey is going and have decided to delay a final investment decision," he says.

Ata Koseoglu, president of strategy and business development at Sabanci, a leading Turkish conglomerate, concedes the slowdown in FDI, but notes that, in addition to the continued strong pace of domestic M&A, there have been a number of large deals with foreign partners.

He mentions in particular the $3bn sale of two electricity distribution companies to Enerjisa (Sabanci's joint venture with the German energy company Eon) and the $1bn sale of Yapi Kredi Sigorta to Allianz. FDI will also be strengthened by the planned $5.3bn Star Refinery on the Aegean coast, a joint venture involving Socar, Azerbaijan's state oil company.

These projects indicate Turkey can still attract significant foreign investment in the long term.

'Great chief' steers his country into uncharted waters

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seems well out of reach. In the months since the Fed first broached its policy of reducing, or "tapering", its monetary stimulus, the Turkish lira has become more vulnerable. This is largely because of fears that the country's economy is out of balance.

It was bad enough that Turkey ran a current account deficit of about 10 per cent of gross domestic product when the economy was firing on all cylinders.

It is, if anything, of greater concern that the deficit may amount to 7 per cent this year, even with the economy growing more slowly. Particularly worrying is the financing of the deficit – only some 15 per cent is underwritten by foreign direct investment, which remains well below its 2007 peak of $22bn.

In part, this is because of fewer privatisation opportunities and the travails of the EU, traditionally the main investment source.

The rest of the deficit is financed by short-term funds, of the kind that, with Fed tapering, may be much less available.

Turkish ministers argue that tapering will lead to a repricing phenomenon, namely that a weaker lira, among other factors, will still draw in sufficient foreign funds. "We have a large current account deficit but that is the only rough spot in a relatively solid macro picture," says Mehmet Simsek, finance minister.

He adds that the government is working on structural reforms to attract foreign direct investment: "We need to attract more FDI: that is key to everything, to making this country, more productive, more innovative, but also to avoid hiccups down the road associated with large current account deficits."

Others argue that Turkey needs a sizeable shift away from consumption and towards exports, perhaps facilitated by further lira devaluation.

The International Monetary Fund warns that, without structural reforms, growth will either remain slower or suffer from "bouts of instability" because of a dependence on "highly volatile external inflows".

A recent report by Goldman Sachs labelled Turkey's current account deficit "unsustainable" and foresaw a "potentially very costly" adjustment.

Events this year have displayed Turkey's political unpredictability. Tempers may have calmed since the Gezi Park demonstrations at the end of spring, when the prime minister accused an "interest rate lobby" of plotting against the country and promised to "throttle" speculators. Memories of that confrontation linger, however.

Koc Holding, Turkey's biggest company, is still having its tax affairs investigated after it was criticised by Mr Erdogan during Gezi, and the prime minister has a way of angering the middle and professional classes. They recoiled, for example, at his recent suggestion that he would make it illegal for men and women to share private student accommodation.

Some leading Turkish executives privately talk of a climate of fear, adding that the personalisation of power under Mr Erdogan undermines Turkey's attractiveness for foreign investors. Government ministers retort that the prime minister has carried out unparalleled political and economic reforms.

Next year, Mr Erdogan, who has promised to serve no more terms as premier, is expected to compete in the first direct presidential elections. Victory might allow him to beef up what has been a largely ceremonial post. "Erdogan certainly has a huge fan base, which sees him almost as a faultless 'master'," wrote Mustafa Akyol, a leading columnist and once a government supporter. But he went on to add that rifts were growing between centre-right conservatives and Islamists in the ruling AK party because of the prime minister's "reckless one-man show".

Posters of Mr Erdogan are almost everywhere but the country may be heading for destinations he has not planned. Amid new economic and political currents, Turkey could find itself in troubled waters.

> Rifts are growing within the ruling AK party because of the PM's 'reckless, one-man show'

Investing in Turkey

Money may be tight, but development will go on

Forecast Leaders in the worlds of finance and business talk to *Daniel Dombey* and *Leyla Boulton* about what lies ahead for Turkey

Mehmet Simsek
Finance minister

The former Merrill Lynch analyst has his work cut out for him.

Markets are increasingly nervous about the country's current account deficit – the lira's more than 10 per cent fall against the dollar between late May and mid-November has not helped – and the short-term funds that have poured into Turkey may be in shorter supply if the US Federal Reserve tapers its stimulus.

But in an interview with the Financial Times, Mr Simsek dismisses the idea that QE tapering would hit Turkey particularly hard. "This is not another Lehman episode," he says. "This is more about repricing of assets.

"So you had quite a bit of a tailwind for Turkey, but there have also been significant headwinds: our biggest trading partners has been in recession; Europe has been a big drag for Turkey."

Looking ahead, Turkey "may not have the type of interest rates we had a few months ago . . . [or] as strong a currency, which is a mixed blessing". But he insists funds will continue to flow: "There is a general understanding that as long as Turkey continues to implement structural reforms and has political stability, a current account deficit of about [currently between 6 and 7 per cent of GDP] would be manageable [and] overlooked for the sake of more medium-term prospects." He adds: "We have a strong fiscal position . . . Turkey's debt dynamics are as favourable as they can be relative to any country in this region, except those that are oil and gas rich."

Throughout this summer's Gezi Park protests Mr Simsek used Twitter to hit back at criticism of his boss, Recep Tayyip Erdogan. Yet he says the central bank's reluctance to increase interest rates should not be linked to the prime minister's denunciations of an "interest rate lobby", but to the bank's duty to maintain financial stability.

"If the Turkish central bank comes up with creative ways of managing lots of pressures at the same time, I don't think we should be dismissive of that," he says.

Of the plunge in the saving rate, which has increased Turkey's reliance on foreign capital, he says: "Private sector savings have collapsed, because of the discovery of credit.

"It is only recently that Turks have seen single-digit inflation and close to single-digit interest rates and . . . they have begun a spending spree . . . [We] import almost $25bn worth of cars; 80 per cent of all cars sold in this county are imports. Why? Because people think they can afford it."

'If the central bank finds ways to manage many pressures at the same time, we should not be dismissive'

Ibrahim Turhan
Borsa Istanbul chairman and CEO

The former central banker and academic has headed the Istanbul Stock Exchange, rebranded Borsa Istanbul, since January 2012.

He is outspoken about what he sees as the exchange's below par performance in recent years and his desire for family-owned groups to be more willing to give up control to outside shareholders.

He also criticises traditional ways of saving, such as buying gold and property, that do not free funds for productive purposes: "Ladies buying gold bracelets think they are saving but these are not investment tools."

Recalling that a decade ago, he predicted the rapid growth of the banking sector, he says: "I think the same is about to happen for capital markets." He believes the number of listed companies is "too low, in terms of market capitalisation, compared with GDP, in view of the liquidity available . . . We are doing everything necessary to trigger growth".

Indeed, as part of Mr Turhan's drive to improve the capacity, the exchange has recently begun a partnership with Nasdaq, which is likely soon to buy an equity stake in Borsa Istanbul.

But he says Turkey should not be too disappointed by the relative paucity of new issuers.

"Under normal conditions, this year might have been better in terms of the IPO performance. But in view of the hot summer [of protests], the Fed discussions [of easing back on asset purchases], of course, some companies delayed their decisions," says Mr Turhan

However, he adds: "There are a couple of very large companies planning their IPOs for 2015 and 2016. I know that 2014 will be much better than this year and 2015 and 2016 will really take off."

His argument is that Turkish companies will increasingly have to look beyond banks for capital. "If you take the Turkish banking system balance sheet, assets to gross domestic product are 100 per cent, the loans to deposit ratio is more than 100 per cent," he says.

"That means that it will be more difficult to have bank lending, especially for 2014, 2015, 2016, when there will be huge [infrastructure] projects." As a result, although bank finance will remain the "main channel" for financing Turkey's planned big projects, including a vast new airport for Istanbul and a canal to bypass the Bosphorus, "it will not suffice for the needs of Turkish corporates".

He adds that infrastructure projects are also "100 per cent fitted to the sukuk model" of non-interest bearing Islamic finance.

'Ladies buying gold bracelets think they are saving, but these purchases are not investment tools'

Ali Sabanci
Chairman, Pegasus

Ali Sabanci left the employ of his family's tyres-to-supermarkets conglomerate in 2005 to run Pegasus, a low-cost airline that nips at the heels of Turkish Airlines wherever it can.

"Our model is not as harsh as Ryanair, but not as friendly as easyJet," says the US-educated scion of one of Turkey's oldest and once most powerful of business dynasties.

"Low prices stimulate demand," he adds, calling for further liberalisation that would eat away at Turkish Airlines' privileges in terms of routes and airport access. Claiming his costs are just 60 per cent of Turkish Airlines', Mr Sabanci says Pegasus could charge a third of the flag carrier's fares to Ankara if it, too, were allowed to fly to the capital from Istanbul's main Ataturk airport.

Since he floated a 34.5 per cent stake in Pegasus in April, the Istanbul stock exchange wants to use his example to encourage other Turkish company owners to come to market.

"As the middle class grows, it becomes clear what virgin territory we are in," says the 44-year-old, of the exponential growth of aviation and other services such as cineplexes over the past decade. Putting his money where his mouth is, he is developing plans for Esas – a company through which members of the Sabanci family including his father hold a controlling stake in Pegasus – to build shopping malls in the cities of Anatolia, most of which happen to have airports served by the airline.

"When I came out of business school, I thought my family's business was working very well because we were well provided for. When I returned to Turkey, the first thing I realised was that it was not a meritocracy. When I was made head of strategy, I did not know whether I deserved it or not," he said.

The rival Koc conglomerate had the good fortune, he says, of being "forced" to look for talent outside the family, as it had far fewer children to pass the business on to.

Yet, in tacit acknowledgement that he still owes much to his privileged background, Mr Sabanci says lesser known entrepreneurs are more worthy of recognition. "Look at the lady who set up Koton [a clothing retailer] and went to London this summer to learn English."

With almost filial respect, he says Turkish Airlines is "three years older than my dad and flies to more destinations than any other airline, so I am not going to criticise it".

Yet, he notes the carrier owes much to government support. "The question is: with full liberalisation, would the cards fall the same way?"

'As the middle class grows, it becomes clear what virgin territory we are in'

Tougher regime for banks amid moves to temper credit boom

Finance

Tight regulation has kept sector out of trouble, reports *Piotr Zalewski*

By 2023, the centenary of the founding of the Republic of Turkey, the government of Recep Tayyip Erdogan wants to establish Istanbul as one of the world's top 10 financial centres, with a $2.6bn complex housing the country's regulatory bodies as well as national and foreign banks.

But, while the Istanbul International Financial Centre's promotional materials glitter with computer-generated images of golden skyscrapers, the Turkish banking sector has lost some of its lustre.

After the US Federal Reserve announced in mid-May it would start winding down its $85bn monthly bond buying, prompting an outflow of funds from emerging markets, Turkish bank stocks took a beating.

According to data compiled by Muge Dagistan, an analyst at FinansInvest, Turkish banks' share prices fell 26 per cent in absolute terms between May 17 and mid-September, or 9 percentage points more than the whole stock market.

As the lira slipped to record lows against the dollar, concerns also mounted that, with an election next year, the central bank had become too wedded to the country's growth targets to tighten monetary policy. Market participants' anxiety increased further after the bank, having raised overnight lending rates in July and August, pledged not to do so again until 2014.

Meanwhile, Mr Erdogan's reaction to protests that engulfed several Turkish cities in June – when he attacked a cryptic "interest rate lobby" and the authorities launched investigations into brokerages and foreign exchange transactions – saw investors and bankers scratching their heads in disbelief.

But, more recently, the banks, many of which enjoy investment-grade status from credit-ratings agencies, have been able to heave a sigh of relief.

After the Fed announced in September that it would continue bond purchases for the time being, bank stocks recovered some of their losses.

Data released in November by Turkey's bank watchdog, the Banking Regulation and Supervisory Agency (BDDK), revealed that their total assets had increased by 20.3 per cent in the first nine months of 2013, reaching 1,649bn lira ($808bn). Profits rose to 19.9bn lira ($9.8bn), a 16.2 per cent leap from the same period last year.

Although deposit costs, which have been rising since May, ate into banks' margins, and profits fell significantly in the third quarter, analysts expected a rebound by the end of the year.

That the banks were able to ride out the summertime turbulence in the markets did not come as a surprise.

Ever since a calamitous February 2001 crisis forced Turkey to spend a third of GDP refinancing its banking sector, the BDDK has run a tight ship, imposing strict accounting standards, reserve requirements, and capital adequacy ratios.

Until 2011, when it allowed the Lebanese bank Audi to set up shop, the watchdog had not granted a single licence in more than a decade. It has since issued three more, to the Bank of Tokyo-Mitsubishi UFJ, Italy's Intesa Sanpaolo and Rabobank, a Dutch bank.

Turkey has also become a hot destination for Islamic finance. "Participation banks", the religiously neutral name that the government has coined for Islamic banks, reached a combined 90.8bn lira ($44bn) in assets in September, an increase of 29 per cent from 2012, growing 10 percentage points more than conventional banks.

A field that has hitherto included just four players – Turkiye Finans, Bank Asya, Kuveyt Turk, and Albaraka Turk – is about to get bigger. State-run Ziraat and Halkbank plan their own sharia-compliant units.

However, averse to fresh interest rate rises, the government has attempted to temper a credit boom by way of more regulations on banks. With rates low, loans have risen by roughly 30 per cent over the past year, to more than 1tn lira, double the central bank's 15 per cent target.

Asset quality shows visible signs of deterioration. Non-performing loan (NPL) ratios are still some of the lowest in Europe, but the volume of NPLs is rising fast – up 53 per cent since the end of 2011 to 28.6bn lira.

The savings rate, meanwhile, has dipped to a new low of 12.6 per cent of GDP.

This year, Mr Erdogan, seemingly out of the blue, warned Turks of the risks of credit card loans – up by some 86 per cent since 2010, according to Moody's Investors Service.

"Those credit cards; don't have them," he said. "If everybody spends as much as [banks] want them to, they won't even be able to earn that income."

Yet, any illusion that the prime minister's remarks had been a mere flight of fancy was put to rest in October, when the BDDK introduced new caps on credit card borrowing and spending limits, and increased the minimum threshold for monthly payments.

The new rules are expected to cut into banks' profits by several percentage points.

With a nod to Turkey's gaping current account deficit, Ali Babacan, deputy prime minister, recently made clear that more regulation was in the pipeline.

"If loans are issued to increase exports, production and investment, and to support small and medium-size enterprises, we will say 'yes'," he said.

"However, we will say 'no' to loans that are issued for the sole purpose of increasing consumption, as the exhaustion of such a measure will only harm our economy."

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Businesses set out to build global reputations

Expansion Buying well-known names is a shortcut to growth, writes *Leyla Boulton*

Chocolate havens: Godiva has opened 50 retail outlets in China under Turkish ownership Dreamstime

Selling everything from chocolates in China to fridges in Africa or fashion in Europe, Turks have set up shop somewhere near you.

The past decade has seen Turkish companies transform themselves from exporters to international retailers and manufacturers, since a devastating financial crisis in 2001.

To diversify risk, "companies have been trying not to put all their eggs in one basket," says Mehmet Sami, a partner at Deloitte in Istanbul. To illustrate their success in doing so, he cites World Bank statistics showing that Turkish companies now account for 1 per cent of world trade as opposed to 0.6 per cent in 2001.

As companies seek to move out of their comfort zone of Europe and the Middle East, they are expanding in Africa and exploring the Asia-Pacific region.

In the past, Turkish groups had no incentive to go abroad because "it was so easy to make money" in their protected domestic market, explains Mehmet Ali Babaoglu. After quitting the textile business, the businesssman is helping his son develop a luxury line of non-alcoholic sparkling wine and halal prosciutto aimed at the Gulf market.

"Whereas in the US, companies would go abroad, in Turkey you started another business, which is how we ended up with all these conglomerates," he says. "Now, however, knowhow is becoming more important than know who."

The domestic influence of the old Istanbul-based conglomerates has declined as political power has shifted to the Justice and Development party with roots in Islam and provincial Anatolia. But all companies, including Koc, Turkey's biggest group by any measure, stand to benefit from more focused support provided by the country's first single-party government in decades.

Perhaps the most conspicuous example of a business development policy has been the rapid growth of Turkish Airlines, the national carrier, which now flies to more destinations than any other – in the process making it possibly the closest thing Turkey has to a homegrown global brand. Another initiative, Turquality, to help companies develop international brands, refunds 40 per cent of spending on promotional activity abroad.

There are many routes to building a global business. But the most striking has been the acquisition of famous brands by Turkish companies. When Yildiz bought Godiva, the luxury Belgian chocolatier, from Campbell Soup in 2008, it acquired more than just an understanding of the luxury business. "You say Yildiz, Ulker, and nobody knows what you are talking about, but you say Godiva and the attention changes," says Jim Zaza, Yildiz's vice-chairman who previously worked for PepsiCo.

After Godiva opened 50 retail outlets in China under Turkish ownership, Yildiz's Ulker chocolate and biscuit producer is assessing how to develop products "relevant to Chinese consumers" with a local manufacturer of noodle-based snacks.

Fresh from raising $431m through a secondary offering on the Istanbul stock exchange, Yildiz, which expects a 23 per cent increase in earnings and sales of $8.5bn this year, says it is close to another acquisition in North America. Buying a well-known brand can help build an existing business relatively quickly, says Bulent Eczacibasi, chairman of the eponymous family conglomerate, which in 2007 bought Villeroy & Boch's tile division while working to develop its own Vitra brand of bathroom ceramics.

But brands worth acquiring are not often for sale at prices that would make an acquisition profitable. That is why Eczacibasi (meaning 'chief pharmacist', the honorific taken as a surname by the founder of a business that started in pharmaceuticals) is building a second factory in Russia – to produce bathroom fittings. "We did not find companies we could acquire in Russia and we cannot export there because of high import barriers," explains Mr Eczacibasi, who this year forecasts group sales of $2.8bn, with $1.1bn of that generated abroad.

Still browsing is Boyner, a clothing producer and retailer. "We would be interested in buying private label ready to wear," says Umit Boyner, a board member. "There are increasing opportunities to buy companies in Europe. We are looking and the Chinese are looking, too. I hope the European brands remain European," she says, clearly counting Turkey, an aspiring EU member, as European.

A stroll around Nisantasi, a wealthy Istanbul neighbourhood, illustrates the challenge of turning Turkish brands into global names.

Take Yargici, a womenswear chain that sold a stake to a Gulf investor two years ago and whose name ("Yargajee") is barely pronounceable by non-Turkish speakers. Its elegant offering is streets ahead of nearby Marks and Spencer, which like most global brands has shops in Istanbul.

Yet Yargici has so far opened just one outlet abroad, in the chic 16th arrondissement in Paris – before its Gulf deal – and that has since closed.

Germany Customers enjoy brands without borders

The Munich area's first Mavi jeans shop was doing swift business on a recent Saturday afternoon. But it was not the "Made in Turkey" labels that had attracted these shoppers of all ages at a modern shopping arcade.

In fact, neither the 48-year-old housewife who bought a shirt there, nor her friends looking for coats, nor the trio of students who stopped in to try on trousers, even knew Mavi was a Turkish brand. Nor were any of the customers Turkish.

"People who know the brand from Turkey, shop in Turkey," explained one of the shop assistants. That puts Mavi in an unusual position in Germany, where Turkish companies have tended to focus on the 3m consumers of Turkish origin.

"The classic examples are food brands offering ingredients or finished products you would not be able to find in a German supermarket," says Elif Aksit, senior research manager at market research group GIM.

For sellers of perishable goods, that makes sense, though the fact that they now cater to fourth- and fifth-generation immigrants, whose tastes might be as much German as Turkish, suggests growth lies in a wider market. For purveyors of non-perishables, winning over non-Turks is vital. Mavi does not hide its origins; nor does it make much of them: it gives different cuts of jeans Ikea-style names that sound more English than Turkish: Emma, Serena, Martin.

Meanwhile, Beko, a white-goods brand owned by Istanbul-based Arcelik, appeals to German consumers and distributors by offering cheaper products than its better-known German competitors such as Bosch.

Price might trump reputation in some areas, but Arcelik, which says its products are also innovative, is not putting all its money on winning over German customers to previously unfamiliar brand names.

Instead, it has bought top brands such as Germany's Grundig, the electronics maker, and this year began selling white goods under that name in addition to TV sets and radios.

Metres-high renditions of the Grundig logo grace Munich's main train station, as conspicuous an example of the increasingly global nature of business as, say, Emirates stadium in north London – if only anyone knew Grundig is now Turkish. But in cosmopolitan Germany, the revelation draws mostly shrugs.

As one of the German students said of Mavi's Turkish roots: "I didn't know it, but I'm all for it."

Rose Jacobs


Made in Turkey: Mavi jeans on display online in Germany

Istanbul Modern It may not make a profit but draws crowds and money

One of Turkey's most successful young brands, Istanbul Modern, is about to celebrate its 10th birthday.

The country's main modern art museum has received 5m people since it opened in 2004 and held shows around the world.

Harvard University wants to do a case study of a not-for-profit organisation whose name recognition and crowd-pulling power should make it the envy of Turkish groups building brands abroad.

Visitors to this leading tourist attraction are mostly young people (half the Turkish visitors are under 25 years old), women (more than half) and foreigners (41 per cent).

A champion is Recep Tayyip Erdogan, who recently intervened to ensure the museum was untouched by a plan to redevelop the Bosphorus waterfront it sits on. The prime minister also helped launch the museum.

"He became a big defender after we fought for 14 years and contacted many different [Turkish coalition] governments and nobody was interested in supporting us," says museum chairwoman Oya Eczacibasi, whose husband's family conglomerate is a founder and donor, alongside other corporate sponsors.

Leyla Boulton


Oya Eczacibasi

One man who divides a nation

Opinion
LEYLA BOULTON

Turks are in the grip of admiration or dismay at one man: Recep Tayyip Erdogan, the prime minister, who appears to have morphed from courageous reformer to irritable authoritarian.

"We have a one-man show and he is all over the place," says one veteran western observer of Turkey. The only question is "how big the bill will be", agrees a Turkish entrepreneur.

Both were referring to Mr Erdogan's heavy-handed response to protests in Turkish cities this year, followed by attacks on everything from an "interest rate lobby" to co-educational student housing.

The demonstrations, sparked by the prime minister's project to bulldoze Istanbul's small Gezi park and reconstruct an Ottoman-era barracks, showed just how much Turkey has changed in the decade since I left in 2003.

The confrontation's two protagonists – a more prosperous, somewhat more protest-prone, middle-class and the country's first democratically elected single-party government in decades – are partly his achievement. Other elements of his legacy, including housing, roads and free healthcare for all, ensure this still popular politician is likely to win elections next year.

Yet, I was struck on a recent visit by how Mr Erdogan has alienated even Turks who, a decade ago, welcomed him with open arms, rather than those who wished the former Islamist firebrand could somehow be stopped from taking office. "We thought he would be a democrat but he has become a despot," says one liberal.

At the Hamsi restaurant in Kadikoy fish market one recent Saturday lunchtime, previous supporters of the prime minister celebrated as a small triumph for democracy the blocking of one of his allies from becoming chairman of Fenerbahce football club.

Turkey was and still is a tribal place, prone to conspiracy theories. Ask finance minister Mehmet Simsek, whom I first met when he was a thoughtful analyst at Merrill Lynch, 15 years before he spearheaded a campaign against a foreign media "conspiracy" behind the protests. Declaring that conspiracy theories are not always "ridiculous", he refers to recent revelations that the US and UK spied on their allies. "Edward Snowden [who leaked material suggesting the UK government bugged the telephones of allied governments, including Mr Simsek's] was spot on."

As the minister points out, the absence of an effective opposition is not the fault of the ruling Justice and Development party (AKP). Democratic culture is under developed after a succession of weak coalition governments left real power to the military and business people such as Aydin Dogan, a media magnate whose other business interests were advanced by politicians' fear of his newspapers.

But Mr Erdogan's undemocratic reflexes have raised objections even within his own AKP, including two of the party's co-founders, President Abdullah Gul and Bulent Arinc, deputy prime minister.

In negotiating with Kurds, of which Mr Simsek is one, Mr Erdogan has shown potential for greatness. Yet he is no Nelson Mandela and his increasingly erratic behaviour – whether in building a mosque intended to be visible from all over Istanbul, or in talking about himself in the third person – resembles that of a man in a hurry.

Turkish media have speculated that Mr Erdogan, who not only faces elections next year, has cancer. When the press found out about a first operation in 2011, a statement was issued about a "digestive tract" operation involving the removal of polyps. In the absence of western-style bulletins on the prime minister's health, reliable information is scarce, although Mr Erdogan did deny in a media interview that he had cancer.

The EU bears a big share of the blame for the current state of affairs in Turkey. Although acceptance of Ankara as a full candidate for membership in 1999 probably spared Turkey a coup when the AKP came to power in 2002, the EU smashed the fragile compass that would have kept Turkey on a steadier course. Declarations by then French president Nicolas Sarkozy that Muslim Turkey could never join the union undermined the soft power of EU accession talks.

"Supporters of the EU process felt and feel very alone," says Umit Boyner, a businesswoman who was ironically awarded the Légion d'honneur by France this month. "Integration into Europe was not an economic issue for Turkey. We needed this for political reasons, to improve the rule of law and human rights."

Less democratic Turks, who warned at the outset that the AKP was not to be trusted, feel vindicated. For others, events in Egypt are a reminder that things could be worse.

"Democracy is very young in our country," says Ali Sabanci, the chairman of Pegasus Airlines who is also the son-in-law of Mr Dogan. "But it's also relative. Look at the neighbours, they help us out."

Mr Sabanci takes a dim view of the "soft coup" that ousted Turkey's first elected Islamist government in 1997.

"This was called fine-tuning of democracy, but it bothers me that I had to live through this. Democracy is not somebody's monopoly."

The writer was FT Turkey correspondent 1998-2003