

## Disintermediation takes root in Turkey

by Duncan Kerr

*The country's rapidly growing SMEs urgently need funding avenues other than those provided by the country's banks. Some new options are beginning to emerge to solve that conundrum.*

Sevket Basev is 38-years old and chief executive and a founding partner of Istanbul-based 3 Seas Capital Partners, an independent corporate finance boutique that specializes in mergers and acquisitions.

Back in 2003 the then 28-year old and three other partners founded the firm to capitalize on what they saw as a golden opportunity to provide independent, specialist M&A advice to mid to large-cap companies in Turkey.

At that time the Turkish M&A market was noticeable only by the absence of deals, but Basev and his partners were convinced their business idea was a good one and that sooner or later deal-making activity would blossom.

After a few barren years when they made little – their first client was Basev's father and first deal was the disposal of the family business, which made folding doors – their bet has since paid off.

Today, the Turkish M&A market is noticeable by the proliferation of deal-making activity and 3 Seas Capital is the leading adviser in the country by number of deals, a ranking the firm has sustained since 2008.

Indeed, last year alone Ernst & Young estimates that a record 315 M&A deals worth a combined \$30 billion were completed in Turkey, making the country one of the few to buck the downward trend.

Furthermore, the four partners today advise everyone from powerful Turkish families such as the Sabancı, which through Sabancı Holding control one of Turkey's largest industrial conglomerates, to young entrepreneurs.

Sitting in the landscaped garden of 3 Sea Capital's villa-cum-head-office in Bebek, a wealthy coastal area of Istanbul that has a strong whiff of Saint-Tropez about it, Basev says its been quite a journey since the firm was founded.

"A year after establishing the firm, I gave our first interview – to Euromoney," he says. "Back then we were young, small but ambitious. At the time we were discussing if there was real opportunity to do pure M&A advisory. Fortunately, it has proved so."

Basev has earned a few more grey hairs from the cut-and-thrust of deal-making since Euromoney first interviewed him, but for all that he has gained he has not lost any of the enthusiasm he espoused in 2003.

Back then he was an entrepreneur with ambitions to build an investment banking business. A decade later he is an investment banker and entrepreneur who wants to help Turkish companies, large and small, realize their potential through M&A and growth capital investment.



**Sevket Basev, chief executive and a founding partner of Istanbul-based 3 Seas Capital Partners**

For Turkey's small and medium-sized companies, and especially the small companies with annual turnovers of around \$10 million and less, this is as acute a challenge as it is elsewhere in the world. Funding to this sector of the economy is simply constrained.

Basev is quick to highlight the problem this creates: "Turkish mid-cap companies are growing so fast that the gap between them and small-cap sector is going to increase; that will be a major problem for our economy in the future if we don't address it now."

He adds: "The real challenge with growing and developing the economic ecosystem in Turkey lies in creating the intermediation system that will target these small enterprises. That is the major issue Turkey faces in evolving into a more powerful market."

Turkey has changed considerably in the past 10 years and can rightfully claim to be a beacon of stability in a region riven with problems, whether it's the eurozone crisis on one of its borders or civil war and terrorism on another.

The landmark Kurdish settlement earlier this year has certainly helped foster a new sense of confidence and stability in the country, but the bombing last month in Reyhanli, killing over 50, has raised concerns the Syrian conflict may spillover.

While Turkey stands defiant to all of these threats, its resilience is being tested.

After a couple of breakneck years, economic growth slowed to 2.2% in 2012 – a quarter of the rate the previous year. In large part this slowdown has been engineered by the mercurial central bank governor Erdem Basci amid fears in 2011 that the economy was overheating.

Since September last year, however, Basci has been cutting interest rates to try and ward against lira appreciation and boost economic growth towards the government's target of a robust 4% at year-end.

On May 16, Basci cut rates again by 50 basis points, pushing the benchmark one-week repo policy rate down to an all-time low of 4.5%, the borrowing rate to 3.5% and the lending rate to 6.5% from 10% last September.

This loosening of monetary policy has been made easier by falling inflation, which the central bank forecasts could come in at 5.3% at year-end. It was about 6% in April.

However, with benchmark interest rates at all-time lows and inflation hovering above, this has created a negative real interest rate environment. In turn, this is beginning to have a profound effect on Turkey's financial sector and how the real economy is funded.

Where before millions of Turks reaped the lucrative rewards of sticking most, if not all of their savings on deposit with a bank, negative real rates have forced them to look elsewhere for inflation-beating returns.

"For the locals negative real interest rates has almost had the same impact as dropping tropical fish in the Arctic Ocean – they seize up," says Istanbul-based Mustafa Bagriacik, head of investment banking, Turkey, for Deutsche Bank. "Everybody is now asking: 'What shall I do with my money?' So it's a big paradigm shift for the local retail investors, which, on one level, is making equities and some corporate bonds look attractive because they offer yields above inflation."

Erdal Aral, general manager of Is Investment, the investment banking arm of Isbank  
From meagre beginnings in 2010 with TL2 billion (\$1.1 billion) of issuance, the Turkish lira bond market has grown impressively year-on-year since; this year it is on course to break the TL50 billion barrier, says Erdal Aral, general manager of Is Investment, the investment banking arm of Isbank.

"This is disintermediation of the banking system," he says. "Of course bankers will not be particularly happy with this situation, but we are expecting this market to continue to grow so long as the economy supports disintermediation."

So far financial institutions or banks generate about 90% of domestic lira bond issuance, but Aral is bullish that in time Turkish corporates will increase their share of the market to about 20% from 10% currently.

Koç Finansman, a consumer finance unit of industrial conglomerate Koç Holding, drug-maker Deva Holding and Aygaz, a liquefied petroleum gas distributor, have said they plan to tap the market this year. For investors, there's already good sector diversity there too.

Although still young, the growth of Turkey's domestic capital markets is a necessary and healthy evolution and one that has been expected to accelerate for some time. One of the main problems has been the shallowness of the institutional investment asset base.

The value of institutional assets under management in Turkey is equivalent to around 5% of GDP, "so almost nothing," says Aral. "If you compare this to other European countries, it is around 40% plus, so there is a long way to go for Turkey."

However, at long last, there are now real efforts to change this.

Earlier this year prime minister Erdogan's government made what is seen to be a smart move to increase pension savings in the country by offering to top up savers' pension contribution by 25%. So for every TL1,000 saved, the state adds TL250.

It has already had a dramatic impact.

Private pension industry assets have increased by over 7% to about TL22 billion since the introduction of the incentive in January, and assets are expected to grow about 30% this year, according the Istanbul-based Pension Monitoring Center.

"The government is placing the right amount of emphasis today on developing institutional investment and capital markets than it did previously," says Ömer Yenidogan, general manager of TEB Asset Management, a joint venture with BNP Paribas.

"Why? Because any country with a current account deficit always needs to try and harness domestic consumption, but this time around the Turkish government is also emphasizing savings. The government used to give incentives through salaries. Now they are incentivizing saving. It's a huge incentive and it's working. Pension funds are natural buyers of capital market securities too."

This growing pool of savings will naturally support the growth and development of Turkey's capital markets over the long-term, but there are other reasons why they have remained underdeveloped for so long.

One of the main constraints was the government. Historically it has dominated the Turkish lira debt market, in-effect crowding-out the corporate sector almost entirely, says Yenidogan. But change is afoot there too.

"Today, the size of outstanding government debt is falling significantly, the real rate is now in negative territory, and there is pressure on the banks on the lending side, so credit markets are improving strongly," he says.

It will inevitably take time for Turkey to have a full-blown domestic credit market, but the confluence of powerful factors now driving this development, not least government support, are bringing that potential ever closer to realization.

The issue in Turkey, as it appears to be in every other country, whether classed as developed or developing, is that domestic credit markets are unlikely to help the sector of the economy that most needs support – SMEs.

"It is different economics," says Aral. "The visibility of these SMEs is unfortunately not very high, so the cost of capital markets borrowing would be particularly high for them."

Ali Fuat Erbil, executive vice-president for financial institutions and corporate lending at Garanti, says the SME sector also faces funding challenges in the banking sector, where "before the major barrier to borrowing has been the absence of collateral.

"By and large these companies are not financed in the banking system. This sector needs financing, and that is one of the major challenges for the Turkish economy," he says.

Turkey is far from alone in facing this challenge. And Turkish banks similarly have plenty of company elsewhere in their reluctance to lend. The UK's banks continue to be pilloried by politicians and the public for not lending enough to the SME sector.

But Turkish banks are in a different position.

While stable, deposit-rich, well-capitalized and profitable – the Turkish banking sector's net profits increased 16.3% year-on-year to TL6.96 billion in the first quarter, helping to deliver a sector return on equity of 14.6%, according to the Banking Regulation and Supervision Agency – funding for the banks is an issue and may become a concern. Interestingly, it's a symptom of the banking sector's successful growth.

"Funding is not really an issue at this time, but is becoming more of one because the banking sector's loan-to-deposit ratio is very close or even above 100%," says Erbil.

"In the past, we have been deposit rich. Now, we're all growing much faster than the deposit growth; the reason for that is because real interest rates are negative and the savings in the country is still limited. Therefore we, as banks, are not amassing enough deposits to fund our assets. We need to be creative here."

Creativity appears to be a euphemism for wholesale market funding, whether domestic, international, or a quirky mix of both.

In January this year Akbank, Turkey's second biggest bank by market capitalization, sold TL1 billion of five-year Eurobonds predominantly to international investors – the first such bond issue of its kind.

Akbank's chief executive, Hakan Binbasgil, was naturally chuffed with the result, saying at the time: "With this transaction, we have paved the way to raise long-term debt in our own currency abroad."

Binbasgil expects the country's banks to start selling lira-denominated Eurobonds in an "extensive manner."

Isbank and Garanti, the country's biggest bank by market capitalization, are sure to follow, fuelling expectations of \$3 billion equivalent in so-called eurolira issuance from the banks this year, and in addition to \$18 billion of dollar-denominated bonds.

Such a healthy issuance pipeline continues the trend of the past couple of years, when Turkish banks stormed the Eurobond market, raising record amounts of dollar-denominated funding, some of which has been in subordinated form for the first time.

Corporates are also feeding foreign investors' appetite – heightened by Fitch Ratings' upgrading of Turkey to investment-grade status last November – for Turkish risk too, and led by Eurobonds from brewer Anadolu Efes, oil refiner Tupras, whitegoods maker Arcelik and airport operator Sabiha Gokcen Havalimanlar.

"We are finding many ways to fund ourselves – Eurobonds, securitizations, syndicated-loans, Turkish lira bonds," says Erbil at Garanti. "These are all increasing as a proportion of our liabilities, but the main funding source remains deposits."

That may be so, but for those bearish on the Turkish banking sector, increased market funding denominated in foreign currencies could prove problematic.

"Banks' external debt has risen from 8% of GDP on the eve of the global financial crisis to around 14% at present. In fact, this is a larger external debt burden than at any point since at least 1992," says William Jackson, emerging markets economist at Capital Economics in London. "The fact that this debt is held by foreigners rather than local residents makes the banking sector more vulnerable to swings in global risk appetite. In the event of an external shock – whether it has anything to do with Turkey or not – foreigners are less likely to be willing to roll these debts over. As a result, banks will have to raise FX by selling lira assets. This typically leads to a credit crunch. Note that each time banks haven't been able to roll over their external debt, Turkey has fallen into a recession."

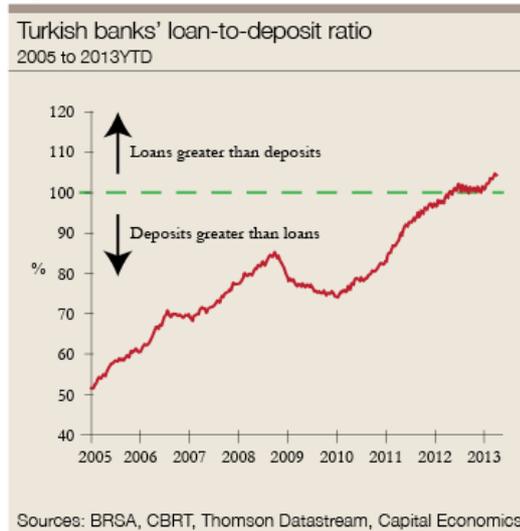
That the central bank cut rates again in May suggests it is concerned economic growth is not rebounding fast enough, but the fact remains that Turkey is still growing at a decent rate and especially compared to anaemic growth in the west.

The banks are in pretty good shape too, absent any major shocks to the world financial system, and the sector continues to lend apace – up 4.9% in the first quarter versus a year earlier, with housing loans and personal loans up about 20% each, according to the BRSA.

There is also room for new entrants. "It not about how old a bank is, it's about how effectively your bank can price people's needs directly," says Hüseyin Özkaya, chief executive of Odeabank,

the Turkish subsidiary of Lebanon's Bank Audi that has been growing rapidly since it was granted a banking licence last October.

The travesty is that no matter how much the banking sector continues to grow, its balance sheet will continue to ignore SMEs and particularly small companies and start-up entrepreneurs. The growth of Turkey's capital markets will not help there either. But some new options are beginning to emerge.



Private bank TEB Özel, Turkey's first, this year launched an angel investment platform in exclusive partnership with Etohum, a network of entrepreneurs, professionals and investors in the new economy.

Gökhan Mendi, assistant general manager of consumer banking and private banking at TEB, says: "What we have created is a platform for entrepreneurs with good business ideas, as well as investors who want to invest in them, which is something that did not exist in Turkey before."

The government has helped there too. In the past year angel investment has become regulated and tax breaks or incentives for business angels have been introduced. This is helping to generate interest.

Basev of 3 Seas has also seen the opportunity and together with Duygu Anil and two others founded advisory firm Peri Capital, which principally focuses on small-cap transactions under \$10 million.

But it's a tough fight to do deals, he says. "Frankly, we are struggling more here than we thought we would. There really aren't enough sophisticated investors right now who are willing to invest in this area."

Nevertheless, Basev remains undeterred and characteristically enthusiastic.

"The biggest challenge we have in Turkey over the next five years is creating the right structures to be able to fund these small enterprises," he says.

"For investors, there is a huge investment opportunity there if someone is willing to tap into this area – the growth there is going to be huge. If they get the right funding, these companies will grow and continue to grow for the next 20 years to come."