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Emerging Markets Private Equity Association

Insight Turkey

An Overview of Trends in Select Sectors and Markets March 2012

Turkey's unique geographic location has long been one of its defining characteristics: a country positioned at the nexus of civilizations and trade routes. While its recent history has been one of macroeconomic volatility, today, Turkey is widely perceived as an island of stability standing between two regions facing immense challenges. To its northwest, the European sovereign debt crisis threatens recession and systemic financial risks; while to its south and southwest, the Arab Spring and subsequent political upheavals risk regional instability and a slowdown in economic activity.

Private equity investors increasingly hold a favorable perception of Turkey. Seeking to capitalize on the country's growth, macroeconomic stability and compelling demographics, investors have driven deal activity from nine transactions in 2009 to 31 in 2011, with over US$1 billion invested over the three-year period. Nevertheless, as a nascent private equity market, Turkey can present challenges to GPs and LPs. This report explores the dynamics at play within Turkey's private equity market, and highlights some risks and opportunities for investors.

Drivers of Growth: Macroeconomic Stability and Demographics

Turkey's GDP more than tripled in size over the last decade—from US$196 billion in 2001 to US$734 billion in 2010—shedding the effects of the 2000–2001 Turkish financial crisis. Two overarching trends have served as the foundation of Turkey's impressive economic growth: macroeconomic stability and demographics.

Turkish policymakers learned valuable lessons from the country's financial crisis and pursued a variety of reforms to support macroeconomic stability. These included a rationalization of fiscal spending, the creation of an independent central bank, strengthening the domestic banking system and a reduction in the country's susceptibility to foreign capital flight.

Today, fiscal spending is restrained—the government reduced its gross debt levels from 67.7% of GDP in 2003 to 39.1% in 2011—leaving room for maneuver in a downturn. Moreover, the country's banks stand in stark contrast to those in a number of neighboring European markets, with capital adequacy ratios upwards of 17% against regulatory requirements of 12%. The IMF projects annual GDP growth of around 4% between 2012 and 2016, although risks remain with the current account deficit and a potential near-term slowdown in economic activity.

Demographics have been the second pillar supporting Turkey's economic performance. With a population of 74 million—42% of whom are under the age of 25—Turkey has a growing middle class with increasing purchasing power; household consumption accounts for more than 70% of Turkish GDP. The steady improvements in living standards, coupled with a 250% increase in consumer credit over the last three years, have driven demand for a variety of consumer goods and services, thereby fueling private sector growth and drawing investors' attention to the country.

Fundraising – Primarily a Foreign LP Game

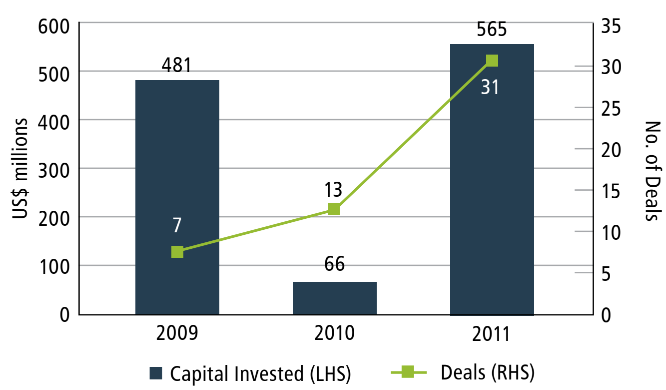
Turkey-dedicated private equity funds raised just US$342 million in 2011. However, this figure understates the amount of capital available for investments in Turkey, as regional funds (i.e., Central and Eastern Europe or Middle East and North Africa) and global funds opportunistically invest a substantial amount of capital in the country.

Historically, development finance institutions (DFIs) have been the primary LPs committing to Turkish private equity funds. For example, the first independent local fund manager, Turkven, received commitments from a number of DFIs, including IFC, DEG, EIB and FMO for its first fund in 2002.

Today, foreign pension funds and commercial LPs are playing a greater role in GPs' fundraising efforts. Actera Partners, for example, raised capital from Canada Pension Plan Investment Board and Ontario Teachers' Pension Plan for its first fund. Additionally, industry sources note that Turkven—which has raised US$1.4 billion for its third fund, but will cap it below US$900 million to remain in the middle market—and Actera—which is targeting US$1.07 billion for its second fund—are receiving commitments from commercial LPs.

Despite Turkey's status as an upper middle income country, most market participants believe the DFIs, including

Exhibit 1: Turkey Private Equity Investment, 2009–2011 (US$m)



Source: EMPEA.

EBRD, will continue to play an important role in the country by seeding first-time fund managers. Mediterra Capital Partners, for example, recently received commitments from DFIs for its maiden 2011 vintage fund, which is targeting EUR250 million in commitments.

However, Memet Yazici, Managing Partner of TRPE Capital (recent spin out of Rhea Asset Management), believes the role of DFIs may be about to change. Yazici says, "2012 and 2013 vintage funds may be the last vintages that a majority of DFIs will support in Turkey."

One potential pool of capital that remains conspicuously absent amidst this fundraising activity is the local institutional investor base. Barış Öney, Managing Partner of Globalturk Capital, notes, "This is the biggest challenge when you try to raise capital for Turkey. Foreign LPs ask if local investors are committing to the fund, but Turkish pension funds aren't even investing into the stock market in real terms—let-alone private equity." Öney believes the government needs to develop an incentive structure for local institutional investors to invest in private equity. If local institutional LPs begin to allocate to private equity, they could catalyze the growth of fund managers targeting companies in smaller segments of the market.

As things stand, Isabelle Boujnah, Principal at fund of funds Quilvest, notes that family offices are among the limited local sources of capital present in Turkey. "If you speak to some local fund managers," adds Boujnah, "they have so far preferred to refuse local money because if the large families were to invest in a fund, the local business community would see the fund as an affiliate of the family, and many might see that as a potential conflict of interest. This perception may actually change in the near future." Until local institutional LPs enter the picture, foreign capital is likely to remain the primary option for GPs.

A Broad Array of Market Participants

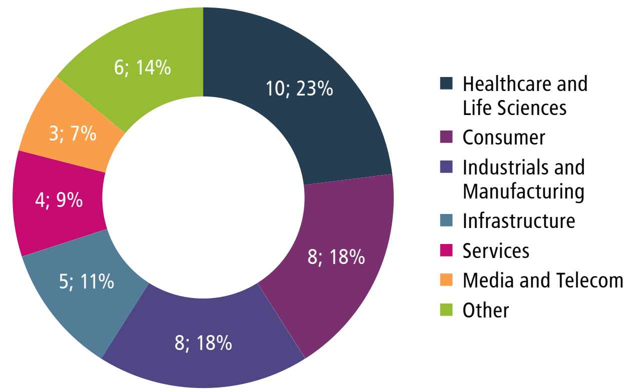
Over the last three years, approximately US$1.1 billion has been invested across 51 deals in Turkey (see Exhibit 1).[1] By and large, the bulk of investments have been focused on the healthcare and consumer sectors (see Exhibits 2 and 3). Even investments in the industrials and manufacturing sector are tied to the consumer story, as the companies tend to produce cars, white goods or furniture.

Broadly speaking, there are three types of GPs operating in the country: local, regional and global (see Exhibit 4). The local fund managers, such as Turkven and Actera, are present across all market segments—from growth capital to buyout—and typically write equity tickets ranging from US$10 million to US$100 million.

The regional fund managers access Turkey through a CEE fund (e.g., Advent International, Bridgepoint Capital and Mid Europa) or a MENA fund (e.g., Abraaj Capital, Swicorp and The Carlyle Group). Based on disclosed transaction values, these managers tend to target deals averaging in the US$100 million range.

The global fund managers tend to be large buyout firms

Exhibit 2: Turkey Private Equity Investments by Sector, 2010–2011 (No. of Investments, % of Total)



(e.g., BC Partners and TPG). They seek out the largest deals, which tend to require US$400–US$500 million of equity. According to one local fund manager, there are only one or two deals of this scale each year, which is in part due to a limited availability of debt for buyouts. However, notable exceptions include Kohlberg Kravis Roberts & Co.'s US$1.24 billion investment in transportation company UN Ro-Ro in 2007, and BC Partners and Turkven's US$1.7 billion acquisition of retailer Migros Turk in 2008.

According to Demet Ozdemir, Partner with Ernst & Young in Turkey, there is some nuance to this breakdown. "Global buyout firms do have an appetite for big-ticket transactions," notes Ozdemir, "but among them, if they have an office in Turkey, they start to act like a local player, which means their appetite for investments becomes smaller and they target mid-size deals."

Seymur Tari, Managing Director at Turkven, believes that global and local fund managers each offer distinct value propositions to their LPs. "In general, the locals do not overlap with the global buyout firms. There are some regional players who are smaller, but you need to be one of two things: you are either local and have a very strong local network that gives you an edge; or you are global and that gives you the edge. Between those two, however, it is difficult to operate."

Too Much Capital? It Depends on the Segment…

This broad array of investors raises questions about deal flow and whether too many investors are chasing too few deals. Patrick O'Brien, Partner at ADM Capital, relays that

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The Emerging Markets Private Equity Association (EMPEA) is an independent, global membership association whose mission is to catalyze private equity and venture capital investment in emerging markets. EMPEA's 300 members include the leading institutional investors and private equity and venture capital fund managers across developing and developed markets. For more information, visit us at empea.net.

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[1] Based on publicly disclosed sources.

"there have been an increasing number of fund managers running around and not many tickets written. In part, that's because—certainly in terms of buyout activity—there aren't that many people that want to sell their businesses." E&Y's Ozdemir suspects there may be a capital overhang, particularly for deals with US$100 million ticket sizes: "If you look at the investments made over the last five years and compare them with the funds raised, there is a significant mismatch."

That said, Quilvest's Boujnah believes that "competition will still remain fairly limited on the middle market segment. Even if Actera and Turkven, for example, compete head-to-head in some cases, it's still mainly proprietary deal flow and there are plenty of deals to go around." Globalturk Capital's Öney argues that this segment of the market is not only where the greatest deal flow lies—some 60% of Turkish companies have fewer than 250 employees—but also where expertise and capital are most needed. GPs may face challenges, however, as many Turkish companies in this segment are family-owned businesses that are averse to surrendering control or diluting their equity stakes.

The European debt crisis has not greatly reduced bank lending to Turkish companies; however, there is a hangover from the global financial crisis that leaves many companies facing a finance gap. ADM Capital's O'Brien finds that "the bank market is a little bit fragile, it lacks sophistication, and frankly a lot of companies are under-equitized." This gap presents private equity fund managers an opportunity to create value by rationalizing a firm's capital structure and improving cash flow management. Aygen Yayikoglu, Founder and Managing Partner of Crescent Capital, believes the European debt crisis will "affect the extent to which banks will be demanding a higher level of equity financing at the project level. So in a sense, it will create more opportunities for private equity."

Exits – Building a Track Record

The investment thesis driving private equity activity in Turkey also attracts multinationals to the country. Strategic sales have thus been the preferred exit strategy for GPs. ADM Capital's O'Brien believes private equity investors can play a critical role in professionalizing Turkish companies and bringing them to scale, thereby creating attractive investment opportunities for multinationals. "Major strategics don't want to buy shrapnel, they want to buy the finished article. Once you can get to scale, cross-border strategic buyers will look to Turkish companies for access to the domestic market or to acquire a low-cost manufacturing platform for their whole network," observes O'Brien.

The European debt crisis is unlikely to soften European strategic buyers' demand for acquisitions of attractive Turkish companies, as corporations have ample cash on their balance sheets for acquisitions. In the largest exit to date, for example, Actera Partners and TPG Capital sold their stakes in the Turkish spirits company Mey Içki to U.K. premium drinks company Diageo for US$2.11 billion in August 2011.

Strategic sales are not the only exit option. According to Globalturk Capital's Öney, the Istanbul Stock Exchange is deepening and can present "a viable exit route if the IPO size is around US$200 million or more. If it's smaller, you might be able to list the company on the London AIM or NASDAQ, but you need to structure the investment from the beginning with this option in mind." Should the government allow local pension funds and institutional investors to expand their investment mandates to include public equities, exits via IPO may become a more feasible option for private equity funds in lower market segments.

Looking Ahead: Risks and Opportunities

While most market participants believe Turkey is well-positioned for continued growth and private equity investment, there are two overarching risks: the current account balance and moves to centralize regulatory authority.

Turkey's economy has structural characteristics that leave it prone to current account deficits, including a customs union

Exhibit 3: Sampling of Recent Investments in Turkey

Fund Manager, Co-investors	Company	Sector	Trans. Value (US$m)	Trans. Date
ADM Capital	Universal Hospitals Group	Hospitals and Clinics	140	May-11
Bridgepoint Private Equity	Tuvturk	Automotive	N/A	Sep-09
Eurasia Capital Partners Ltd.	Wenice Group	Industrials & Manufacturing	N/A	Oct-10
Global Capital Management Ltd. (100% subsidiary of Global Investment House KSCC)	Bıçakcılar	Industrials & Manufacturing	111.3	Feb-11
Globalturk Capital	Hittite Solar Energy	Energy & Natural Resources	N/A	Jan-12
Mediterra Capital	Mikro Ödeme	Banking & Financial Services	N/A	Jan-12
Mid Europa Partners	Kent Hospital Group	Hospitals and Clinics	100	Oct-11
One Equity Partners, Rhea Asset Management	Nortel Netas	Infrastructure	N/A	Oct-10
PineBridge Investments	Ulusal Faktoring	Banking & Financial Services	30	Mar-11
Rhea Asset Management*	Dentistanbul	Hospitals and Clinics	N/A	Nov-10
Swicorp	Step Halıcılık ve Mağazacılık Sanayi ve Ticaret A.Ş.	Consumer	7	Jul-08
The Carlyle Group	Bahçeşehir Koleji	Services	N/A	Dec-11
Turkven Private Equity	Doğa Koleji	Services	N/A	Mar-11

* Note that the private equity team of Rhea Asset Management spun out to form TRPE Capital in February 2012.
Source: EMPEA.

with Europe that constrains its ability to limit imports, and a dependence on imported natural resources (e.g., oil and metals). In recent years, investments in capacity expansion have compounded these trends, driving up the current account deficit to 10.2% of GDP. A ballooning current account deficit could lead the Turkish central bank to increase interest rates within its policy corridor, thereby dampening domestic demand and potentially the performance of portfolio companies.

Last August, the Turkish government issued a decree placing 10 formerly independent regulatory bodies—including the banking and capital markets regulators—under the direct control of their ministries, raising concerns about equal treatment for foreign private equity firms. However, analysts at intelligence and advisory firm Ergo believe that this change will not adversely impact foreign GPs. "The centralization is—at least in principle—meant to simplify the regulatory framework for foreign investors," notes Marina Grushin, an Associate with the firm, "But our sources in country do feel that restoring the independence of regulatory bodies will be important in the longer term."

In terms of opportunities, GPs will likely find success in the lower market segments and by venturing outside of Istanbul to find manufacturers in the Anatolian, Black Sea and Aegean regions. One market participant notes that newcomers should consider entering into smaller segments, making US$10–US$20 million investments in small- to mid-size companies.

Umut Korkmaz, Director of M&A at Egeli & Co. Investment Holding Inc., believes that the next trend "is for private equity funds to differentiate themselves by focusing on secure and sustainable cash flows in small- to mid-cap companies that are located mostly in Anatolia. The asset prices are expected to be much more reasonable toward the end of 2012 and a considerable number of companies are also assumed to sell their shares to finance growth capital expenditures." Quilvest's Boujnah sees these "Anatolian Tigers" as an exciting opportunity, as "most PE activity to date has been executed in Istanbul within an elite group of people."

So far, Turkey is standing up to its reputation as an island of stability amidst regional economic and political volatility. Whether today's successes will lay the groundwork for future challenges is anyone's guess, but market participants are optimistic about the opportunities Turkey currently presents to private equity investors.

Exhibit 4: Sampling of Exits in Turkey

Fund Manager	Company Name	Sector	Year of Initial Investment	Capital Invested	Exit Date	Exit Type
Abraaj Capital	Acıbadem Healthcare	Hospitals and Clinics	2008	US$585m	Jan-12	Strategic Sale
ADM Capital	Işıklar Holding	N/A	2006	US$72.5m	Oct-11	MBO
Global Environment Fund (GEF)	DentIstanbul	Healthcare and Life Sciences	2007	US$17m	Nov-10	Secondary Sale
TPG Capital; Actera Partners	Mey Içki	Food and Beverage	2006	US$810m	Aug-11	Strategic Sale
Turkven Private Equity; Advent International	Roma Plastik	Industrials and Manufacturing	2006	N/A	Jul-10	Strategic Sale

Source: EMPEA.

Exhibit 5: Sampling of Firms Investing in Turkey

Fund Manager	Fund Name (Vintage Year, Fund Size to Date/Target)	Geographic Focus
7L Capital Advisors	7L Capital Partners Emerging Europe (2005, US$61m)	CEE
Abraaj Capital	Abraaj Buyout Fund IV (2008, US$2.6B)	MENA
Actera Partners	Actera Partners II LP (Raising, US$1.07B)	Turkey
ADM Capital	ADM Capital CEECAT Recovery Fund (2010, EUR265m)	CEE
Advent International	Advent Central & Eastern Europe IV (2008, US$1.6B)	CEE
BC Partners	BC European Capital IX (2011, EUR6.5B)	Global
Bosphera Advisory	Bosphera Fund (Raising, US$350m)	Turkey
Bridgepoint	Bridgepoint Capital IV (2009, US$4.85B)	Europe / CEE
The Carlyle Group	Carlyle MENA Partners (2007, US$500m)	MENA
Citi Venture Capital International	Citigroup Venture International Growth Partnership II (2007, US$4.3B)	Global
Crescent Capital	Crescent Clean Energy Transition Fund (2010, US$89.3m)	Turkey
Darby Overseas Investments Ltd.	Darby Converging Europe III (2011, EUR140m)	CEE
Eurasia Capital Partners	Eurasia Capital Partners Fund (2010, EUR60m)	Turkey
Mediterra Capital Partners	Mediterra Capital Partners I (2011, EUR100m)	Turkey
Mid Europa Partners	Mid Europa Fund III (2007, US$2.1B)	CEE
Mubadala Infrastructure Partners	Mubadala Infrastructure Partners (2008, US$425m)	MENA
PineBridge Investments*	PineBridge Gateway Partners (2010, US$500m)	Global
Swicorp	Intaj Capital (2007, US$250m)	MENA
TRPE Capital	Turkish Innovation and Growth Fund (Raising, US$200m)	Turkey
Turkven Private Equity	Turkven Private Equity Fund III (Raising, capped below US$900m)	Turkey

* Fund of funds.
Source: EMPEA.