Private equity and venture capital in Turkey

by Levent Bosut, PDF Corporate Finance

As a promising emerging market, Turkey provides unique investment opportunities for private equity investments primarily because of its investor friendly liberalisation, deregulation, and privatisation policies, fast growing business environment, and scarcity of capital. However, figures show that the industry has not grown to expectations. In this article, you may find the reasons and misconceptions leading to a sluggish private equity market in Turkey as well as attempts to improve the industry and the recent legislation for setting up local funds.

Turkey offers promising private equity opportunities

The fast growing domestic market, entrepreneurial spirit, competitive workforce, and unique location of Turkey, coupled with liberalisation, deregulation and privatisation policies create a significant demand for private capital. Due to insufficient capital formation, the crowding out effect of high government debt and high interest rates, resulting inadequate banking system, companies find it extremely hard to finance expansion, let alone buy-outs, startups or seed capital. Credit markets are available only to the largest companies and to a few who can provide collateral, rather than future cash flows.

In addition, political and economical instability have resulted in economic crisis every four to five years, eroding already weak financial structure of private companies, along with the financial system. The public equity markets are not sufficient to fill the gap either. The window of opportunity in the IPO market remains open only for limited periods of time. The companies usually issue a symbolic percentage of shares to the public and most companies are not large, attractive and institutional enough to float shares in the domestic and international stock markets.

High growth in global PE activity

Global PE fundraising has grown from a mere US$18bn in 1990 to US$250bn by the end of the decade. In the US, this fast growth was one of the major driving forces behind the fast growth in the technology sectors. The surge in the US was followed by Europe and, to a great extent, by the emerging markets in Latin America, Asia and Eastern Europe.

In 2001, after its peak in 2000, PE investment was 0.25% of GDP in Europe and 0.60% in the US. For example, this ratio was 0.13% in Ireland, 0.18% in Spain, 0.25% in Hungary, 0.44% in Netherlands, 0.65% in UK and 0.87% in Sweden.

If Turkey had the same PE investment to GDP ratio of Europe, PE investments in 2001 alone would have been close to US$500m. However, the numbers are not even close to this, as illustrated below.

Insignificant PE activity in Turkey

One would expect the PE activity in Turkey to follow this surge due to substantial capital formation in the world; saturation of PE deals in the developed markets relative to the ones in Turkey; mismatch of abundant deal flow and capital scarcity in Turkey implying low valuations and high expected returns; and significant increase in PE activity in similar emerging markets.

However, institutional PE activity in Turkey has been limited, excluding corporate venturing. Until 1995, there was no significant PE activity. Total invested capital reached approximately US$100m at the end of 1999. In 2000 alone, close to US$100m was invested following the trends in the world and as a response to the positive developments in Turkey. Even this record performance is small as compared to the country's potential.

After the 2001 crisis, the PE activity almost ceased to exist and many newly founded PE funds pulled out. In the following years, the activity has continued at a rate less than US$40m a year. As of the beginning of 2003, we predict that slightly less than US$250m PE capital has been cumulatively invested and there is about US$250m of committed capital seeking PE deals in Turkey.

Difficulties in PE market in Turkey

Considering the availability of funds for PE globally and scarcity of capital in Turkey along with expected abundant deal flow, one would wonder why PE is not so developed in Turkey. In this section, the difficulties in the Turkish PE market are presented covering the issues of:

- fund raising;
- interest of existing funds;

- quantity and quality of deal flow;
- legal issues;
- macroeconomic and political issues; and
- exit opportunities.

Fund raising

Domestic capital formation is insignificant and a substantial capital of Turkish nationals is kept outside of the country due to past gains from unregistered economic activity and somewhat distrust to the system. The local institutional investors do not play a significant role due to immature private pension fund and insurance markets. The funds that would be employed in the PE market are predominantly raised from international investors. Despite its huge potential and fundamental promises, Turkey has not enjoyed the FDI flows that it deserves.

While the total FDI flows in the world have increased from US$57bn in 1982 and US$200bn in 1990 to US$1,300bn in 2000 (the record year), during this period FDI inflows to Turkey were consistently less than US$1bn or less than 0.4% of GDP. The FDI flows in similar markets have been 10 times this ratio.

Some institutional investors require a track record of PE activity before investing into the country. Many investors shy away from Turkey due to persistent high inflation, high government deficit, macroeconomic and political instability and slow progress in the long expected reforms and privatisation. However, many other emerging markets with similar flaws enjoyed substantial FDI growth in the same period.

Interest of existing funds

The funds which cover Turkey from abroad, without allocating substantial local resources, find it hard to close deals due to long lasting evaluation, negotiation, due diligence, deal structuring stages as a result of complications with availability and accuracy of information, legal difficulties and cultural dissimilarity of local companies. As a result, international PE funds often lose interest after facing difficult local conditions.

Quantity and quality of deal flow

This section is partly based on presentations by market participants like Commercial Capital, Turkven and PDF in TurkVCa events. In Turkey there are more than 30,000 companies with sales of more than US$2m, 2,500 companies with sales of more than US$10m, and close to 1,000 with sales of more than US$25m.

As explained earlier, one would expect abundant deal flow due to local opportunities and scarcity of capital. In reality there are difficulties in the quantity and the quality of deal flow:

- Many owner managers are not aware of the PE process and are not ready for the idea of sharing control and full transparency.
- Most family-owned companies are too small for a meaningful exit in terms of trade sale or IPO. Many industries are fragmented with over capacity consisting of a large number of players with insignificant market shares competing fiercely with each other. Though the lack of large players with significant market share presents a problem, it also presents an opportunity to do roll-up deals in Turkey.
- Many companies are unfocused, diversified businesses with no clear core competencies that make it difficult to envisage an exit in the form of a targeted trade sale.
- Many companies do not have aggressive growth plans, as they have been tired of ups and downs and leverage and fixed costs could be deadly in crisis.
- Many lack effective corporate governance, management information systems and management accounting standards. Ownership and management are mostly intermingled.
- It is hard to evaluate past performance of companies due to high inflation, volatility, poor bookkeeping, and inter company transactions.
- Many companies keep different sets of accounting books, for tax, banking and management purposes. In certain industries a portion of sales are unregistered.
- Large conglomerates create tough competition in many areas due to their ability to transfer huge resources eliminating the significance of players likely to be PE targets.
- Up until recently, valuation expectations have been quite high in spite of scarcity of capital.

Despite these problems, we believe there is significant deal flow in Turkey that is more than enough to feed the existing funds.

Language skills, quality of senior and middle management, availability of chief financial officers, third party providers like corporate finance, legal and accounting advice is quite strong in Turkey that improves the quality of deal flow as well as the ease of closing, monitoring and exiting.

There are positive developments to improve the corporate governance standards. A new code of standards was prepared with the cooperation of business associations and universities.

Fierce competition forces holding companies to reconsider their focus on core competencies, creating spin-off opportunities. While limiting the numbers of sizeable attractive targets, the fragmented nature of many sectors also present deal flow in the form of roll-up opportunities, though no PE financed roll-up has taken place yet.

The funds have to be patient, flexible and need to learn and adapt to local practices, rather than applying generic approaches.

Legal issues

Making minority investments in Turkey could be a difficult task due to insufficient minority rights and enforcement of contracts. Long and complicated shareholder agreements increase the closing time and transaction costs.

Macroeconomic and political issues

Ups and downs in the growth rate and recent crises may force companies to recapitalise with lower valuations, presenting lucrative PE opportunities. However, at the same time, this instability shies away investors with the fear of devaluation that would erode the capital gains in real currency, as well as lack of growth, profitability and timely exit in the weak markets.

Exit opportunities

Fundamentally, there should be sufficient exit opportunities in Turkey, considering the relatively effective stock market and attractive positioning of Turkish companies for multinationals.

There are 262 listed companies at the Istanbul Stock Exchange (ISE) with a market capitalisation of US$35bn as of April 2003 and an average daily trading volume of US$281m during 2002. However, most of the trading takes place in the very large issues.

In most of the emerging markets, an IPO has hardly been the exit route. For example, in 1998 and 1999, only 3% of all private equity exits in Eastern Europe were IPO exits.

In Turkey, PE funds experienced only two successful exits in the form of IPO – exit of Sparx from Unal Tarim and Arat Tekstil. The other exit mechanism – trade sales – require the attention of multinationals into Turkey. As stated earlier, the FDI flows into the country has been insignificant as compared to the potential of the country. The only track record of a successful exit of PE funds is the sale of Termoteknik, an aluminum radiator manufacturer to UK based Caradon after the investment of Merrill Lynch.

Role of advisors

Corporate finance advisors contribute to a great extent to the establishment of the PE market by convincing international players to include Turkey in their investment focus; generating abundant deal flow to novice regional or local funds helping them to convince investors during fund raising; educating the market participants about PE; identifying, screening and preparing attractive deal flow.

Advisors support the deals by closing the information and expectation gap between the PE fund and the target company. Financial advisors also play a major role during the exit stage. Corporate finance advisors know that they are in a multi-period game and they have to be fair to the investors while protecting the rights of their clients.

M&A International Inc., which is the world's leading network for mergers and acquisitions in mid market, has been involved with PE industry by assisting companies during PE financing stage and during the exit stage. During 2002, out of 161 deals with a total deal size of US$9.2bn that M&A International Inc. were involved in, in 33 deals a PE element was present, whether fundraising or exit of PE funds.

M&A International Inc., along with Acquisitions Monthly organised M&A Mid-Market Forums in Rome (2001), Prague (2002), and will organise the upcoming forum in Dublin (2003), all of which aim to bring practitioners from around the world in one-to-one meetings and workshops to discuss current issues, trends and business opportunities. Private equity has been one of the key topics in these events in which major PE funds were present discussing the trends on fund raising, investing and exiting stages, as well as meeting M&A specialists.

Cooperation attempts: Venture Capital Association

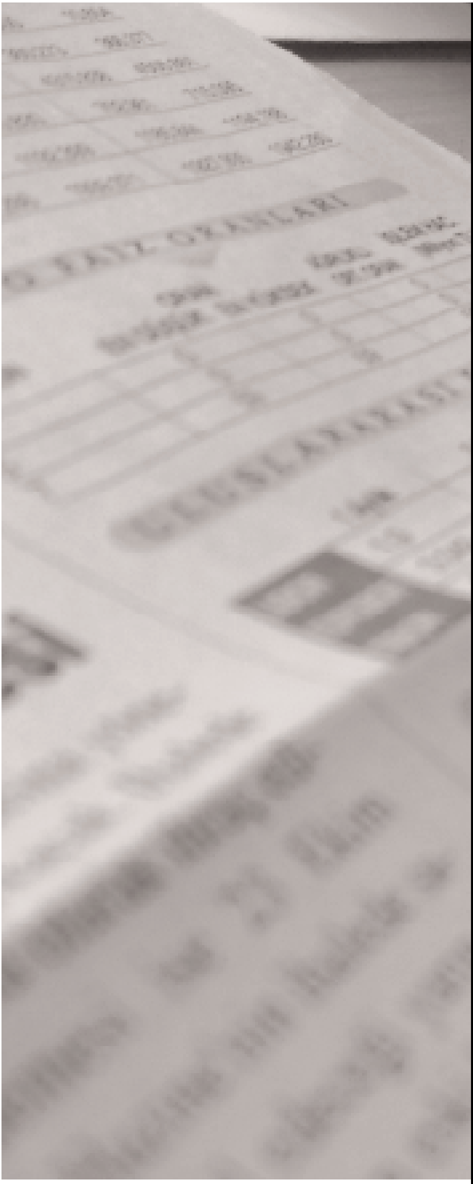
The cooperation of market participants is important to promote PE activity and protect the rights of the participants. Turkish Venture Capital and Private Equity Association, TurkVCa (www.turkvca.org), aims to enhance the development of venture capital in Turkey by increasing the interaction among the market participants, organising events and encouraging and commencing research and lobbying activities. TurkVCa has contributed in the areas of the minority shareholder rights, deal flow generation and legal framework issues.

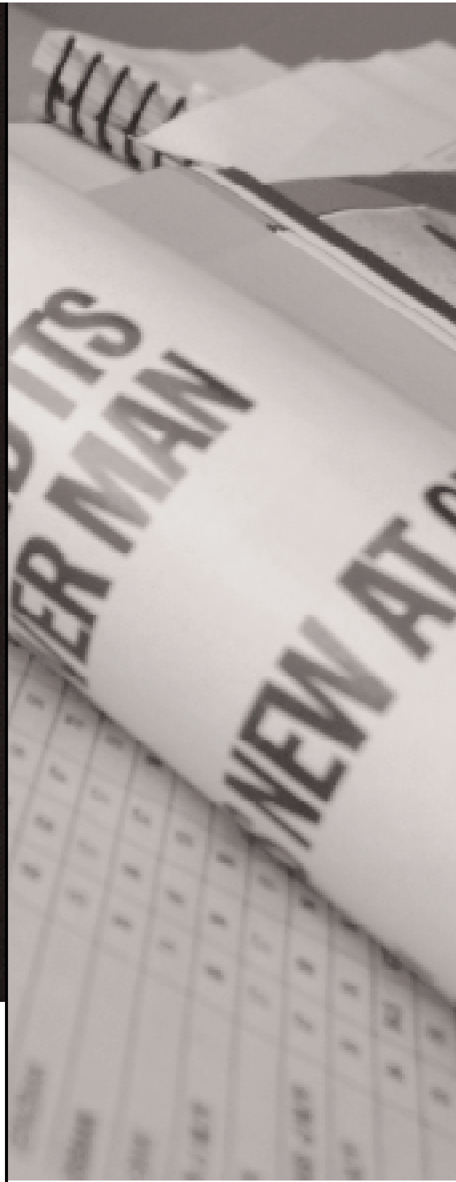
TurkVCa played an important role at the initiation of a new Venture Capital Investment Trusts ("VCIT") legislation. As a result of fruitful discussions during the TurkVCa events, Capital Markets Board ("CMB") first allowed options and futures contracts in PE investments. Then the discussions led to a report on deficiencies of the former VCIT legislation. In early 2003, incorporating the suggestions by TurkVCa along with a number of players, CMB passed a new VCIT legislation, which is highlighted in the next section.

PE fund legal structures

The following are types of PE investors in Turkey categorised by structure:

- Independent, dedicated country funds with





M&A International Inc.

M&A International Inc. is the longest established and most successful network of independent corporate finance advisers around the world specializing in mid market mergers and acquisitions.

We locate buyers, sellers and joint venture partners. We evaluate businesses, find capital, assist in negotiations.

M&A International Inc. works with owner-managed and private equity backed businesses as well as public companies and their subsidiaries.

We minimize risk and maximize value as we have a detailed knowledge of local markets and an entrepreneurial understanding of transactions.

M&A International Inc offers the combined resources and institutional strength of a multinational organization of more than 350 professionals in over 30 independently owned merger and acquisition specialists and investment banking firms, extending to every major commercial and financial market around the world.

Our proven track record of over 400 transactions worth over USD 14 billion in the last two years puts us at number 1 in the midsize M&A market.

"The world's leading international M&A network"

PDF Corporate Finance

Member of M&A International Inc.

Harmanci Giz Plaza 10A,
Levent 80640
Istanbul, Turkey
Tel: +90 212 280 9313
Fax: +90 212 280 7701
e mail: pdf@pdf.com.tr
www.pdf.com.tr

M&A International Inc.

For more information regarding M&A International Inc. or any individual member firm, visit us at www.mergers.net

Limited Partnership (LP) structures and local management teams, such as Turkven Private Equity. Turkven manages a fund with institutional investors and is an affiliate of Advent International. Fund size of US$88m including the co-investment intention of Advent.

- Dedicated country funds with LP structures that are subsidiaries of MNCs, such as the AIG fund of US$85m dedicated to Turkey. The AIG Blue Voyage Fund has a local advisory team in Turkey. An early example of this type was the Sparx fund sponsored by Nomura, investing both in public and private equity.
- Regional funds that are subsidiaries of multinational/regional commercial/investment banks or asset management companies, such as Citibank, Merrill Lynch, and Commercial Capital managed from their headquarters, Com Cap having a liaison office. These funds invest from regional funds and do not have specific dedicated capital for the Turkish market. The Soros Southeastern European fund sponsored by OPIC is an exception with a team in Turkey.
- Independent regional funds with LP structures managed from London or another financial centre, like Safron sponsored by Middle Eastern and US investors and Investment companies like EMEA sponsored by EFG Hermes of Egypt, investing Middle Eastern capital with local representatives.
- Development banks and multilaterals such as the IFC, FMO, DEG covering Turkey from their respective headquarters, providing equity, mezzanine and debt instruments.
- Venture Capital Investment Trusts (VCITs) operating in Turkish jurisdiction under the legislation from Capital Markets Board (CMB), like Vakif and Is Risk.
- Last but not the least, holding companies mostly acquiring the majority of target companies with no explicit exit strategy. Corporate venturing has played a significant role and substituted institutional PE investments in Turkey. Holding groups in Turkey have enjoyed possession of substantial capital, human resources, technical skills, good relations with government, economies of scope in management functions and synergies to offer with other group companies.

Local legislation to promote PE

In 1993, Venture Capital Investment Trusts legislation was passed by the Capital Markets Board to promote PE in Turkey by giving tax breaks to these types of special companies.

The tax incentive provided to VCITs allows them to operate totally free of corporate tax from all activities including dividends from portfolio companies and capital gains from investments in portfolio companies.

In 2003, CMB passed a new VCIT legislation allowing VCITs to be established with less strict conditions.

Prior to the new legislation of 2003, in order to qualify for these incentives, VCITs were required to fulfil certain obligations including listing minimum 49% of shares in the stock exchange in five years, starting with a minimum 10% in the end of the first year. The floatation could take place only after making first portfolio investments. There were also strict disclosure requirements about the portfolio companies. The minimum life of a VCIT was restricted to be 10 years. Since the issuance of this legislation first in 1993, only two local VCITs were founded.

Based on the types of investors that can invest in the fund, the new legislation of 2003 defined two different types of VCITs: one that can sell shares to the public and one that can issue shares only to accredited investors such as local and international institutional investors. The restrictions related to the latter were significantly reduced. This type of VCITs are no longer required to list shares in the stock market, disclose detailed information on the portfolio companies, and make investments in portfolio companies prior to issuing shares to accredited investors. The minimum capital requirement for this type of VCITs is also currently one fifth of the capital requirement of VCITs that can sell shares to the public. The restriction about the minimum life of a VCIT was also removed with the new legislation.

Author:
Levent Bosut (Managing Partner)
PDF Corporate Finance,
member of M&A International Inc.
Harmanci Giz Plaza 10A
Levent 80640
Istanbul
Turkey
Tel: +90 212 280 9313
Fax: +90 212 280 7701
Email: pdf@pdf.com.tr
Web: www.pdf.com.tr
www.mergers.net