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Turkish distressed debt market review

The landscape is about to change

PwC Portfolio
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Foreword

The Turkish distressed asset market is set to open up with increasing investor interest from both regional and international names.

Expecting a surge in distressed volumes in 2017, banks are looking for alternative resolution strategies to dispose of their non-performing stock, both in the retail and corporate space.

Further, local asset management companies (AMCs) are in the need of outside funding and signal great willingness to team up with international players to realise mutually beneficial deals.

We hope you will enjoy discovering the opportunities of the Turkish distressed asset market through this report and wish you pleasant reading.

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In a nutshell ...

Turkish economy on its way to overcoming recent challenges

The dynamic and diverse Turkish economy, the world's 17th largest, **proved its resilience in spite of recent events**, delivering continued growth. It is expected to stay the course in the upcoming years backed by **solid macroeconomic fundamentals**.

Expansive financial sector in search of a new profitability model

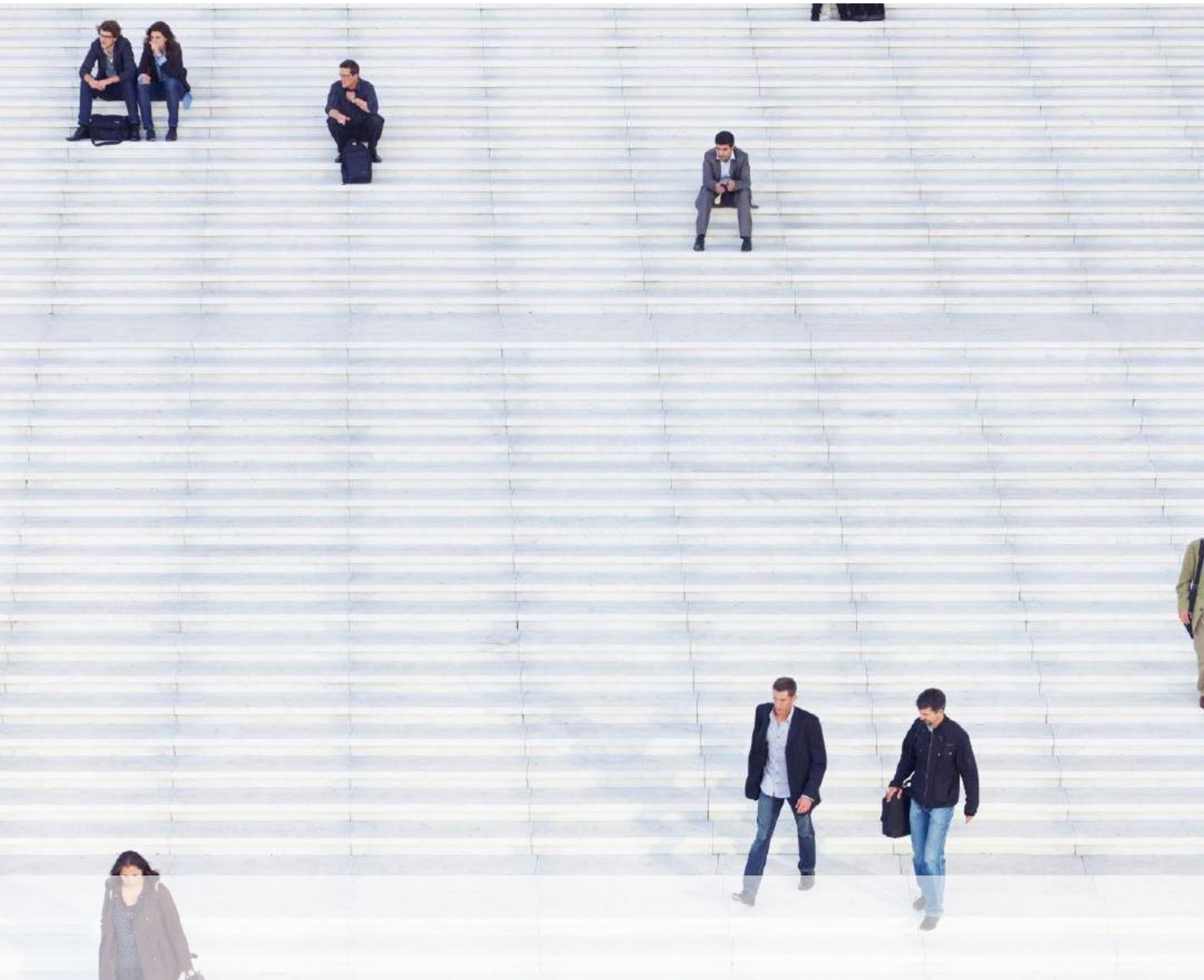
Well capitalized Turkish banks have delivered solid returns during challenging years. Yet, an **expected deterioration in asset quality** is foreseen to put pressure on their profitability, with most banks reconsidering their strategies to maintain prior years' earnings.

NPL stock anticipated to rise

The country's low NPL ratio to date was driven by **repeated restructuring practices** coupled with (mostly retail unsecured) regular debt sales. However, **NPL volume growth is expected to accelerate** in the upcoming year(s) driven by macro dynamics. On the upside, **state banks are foreseen to be allowed to perform NPL sales**, contributing to the easing of system pressure.

Distressed debt opportunities for early movers

A relatively young distressed asset management industry with significant upside opportunities. Local **AMCs willing to team up with foreign investors** to put themselves in a competitive position for the upcoming **expected surge in NPL deal activity**.



01

- ***Growing economy*** *with favorable demographics*
- ***Supportive monetary policy*** *with built-in resilience to severe shocks*
- ***Political stability expected*** *in the second half of 2017 and thereafter*

Macroeconomic environment

✓Strong macroeconomic fundamentals
✓Young and growing population
✓Political focus back on economic agenda

Growing economy Turkey is the world's 17th largest economy and projected to be ranked 12th by 2050, next to UK, Russia and France. Despite security concerns and political turmoil, **GDP growth for 2017 is expected to be ca. 3.0%**, still higher than the EU's forecasted growth of ca. 1.7%. This upward trend is expected to accelerate by 2018 with an average annual growth of ca. 3.5% for the following few years.

Favorable demographics Turkey, an OECD and G20 member, is **one of the largest middle income countries with a young and growing population**. Ca. 56% of the 79m population is under the age of 35. Further, the country's population is forecasted to grow considerably (close to 90m) by 2030.

Diverse economy with robust labor supply The **large and dynamic economy** is relatively diverse across industries. Services, manufacturing and agriculture constitute more than 50% of the total GDP. **Turkey has a robust and educated labor supply** to support the economy (unemployment rate of ca. 10% in October 2016).

Strong fiscal discipline The **government's balance sheet is still resilient** despite the challenging events in recent years. The public debt to GDP ratio was reduced from 72% in 2002 to a mere 27% in 2016, which is substantially lower than in many European countries.

Supportive monetary policy Notwithstanding ca. 8% inflation in 2016 (above target), monetary policy loosened during the year and **expansionary measures were taken for household credits such as extensions of term limits on credit cards and consumer loans**. Lower global oil prices helped to weaken price inflation. Yet, recent depreciation of the Lira is likely to continue to put pressure on inflation (ca. 8.2% in 2017E).

Resilient to severe shocks The failed coup attempt in July, geopolitical uncertainty, and the following downgrades in ratings have challenged Turkey throughout 2016. Yet, the country's **economy proved its resilience** by delivering moderate growth and maintaining its solid macroeconomic fundamentals.

Turkish Sovereign Wealth Fund The newly established **SWF is likely to be supportive for Turkey's macro economy**. It aims to contribute 1.5% to the annual GDP growth, particularly by funding large-scale projects.

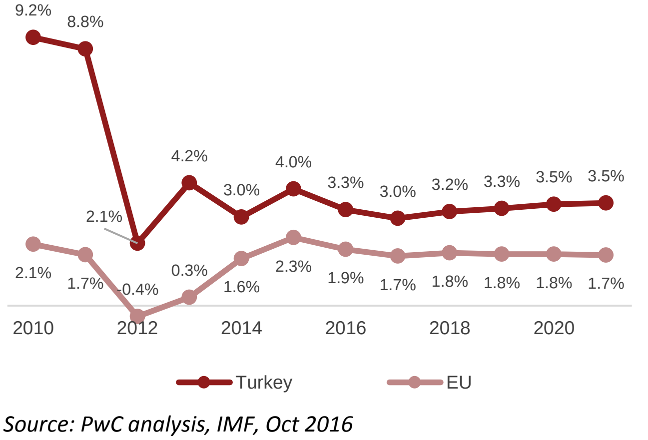
Political agenda and economy A public referendum in April 2017 regarding constitutional amendments is likely to lead to **political stability in the second half of 2017 and thereafter**. Hence, political focus will be put onto Turkey's economic agenda.

Country highlights (YE 2016)

- **Population:** 78.9 million
- **Democracy:** Secular democratic state
- **Currency:** Turkish Lira (TL)
- **GDP**: USD 820-830 billion (7th in Europe)
- **GDP per capita:** USD 11,000
- **Key economic sectors**: Services, manufacturing, agriculture and financial services
- **Ratings:** Moody's (Ba1; stable), S&P's (BB; negative), Fitch (BB+; stable)

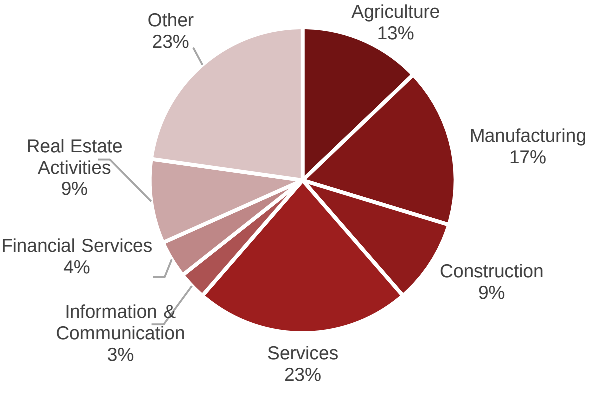
Source: PwC analysis, IMF, Turkstat, Rating Agencies

GDP growth at constant prices (in %)



Source: PwC analysis, IMF, Oct 2016

GDP by sector of activity (YE 2016)



Source: PwC analysis, Turkstat, Sep 2016

02

- ***Second largest banking system in emerging Europe*** *with remarkable loan growth over the past years*
- ***Top 10 banks dominate the market***
- ***Regulatory supportive measures*** *to help withstand macro turbulence*

Financial sector overview

✓ Substantial loan volume growth in the past 10 years
✓ Top 10 banks account for 85% of the market
✓ Financial sector profitability challenged by provisioning costs

Second largest banking system (after Russia) in emerging Europe, even though still underpenetrated (loans to GDP ratio of ca. 58%; EU: ca. 101%). **The Turkish banking industry dominates the financial sector with total assets of ca. EUR 736bn**. It is comprised by 32 deposit banks, 5 Islamic (participation) banks, 13 development and investment banks.

Remarkable loan growth The total volume of loans reached ca. EUR 467bn in 2016, with a **CAGR of ca. 25% since 2008**. Recent developments have slightly slowed down growth to ca. 17% in 2016 (forecasted growth of ca. 10-15% in 2017).

Highly liquid with solid deposit base Deposits, being the largest source of funding, account for ca. 53% of total liabilities in the banking sector. Still, **Turkish banks are particularly reliant on short-term external funding**.

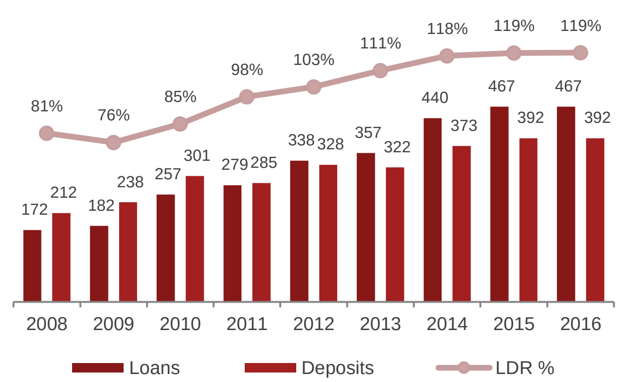
Well capitalized with strong profitability The banking industry is generally well capitalised with an **average CAR of ca. 15.6%** which offers a good buffer to absorb unexpected losses. Turkish banks' profitability is still higher than in Western Europe with an **average RoE of ca. 14%**. This will, however, be challenged by an expected deterioration in asset quality and a moderate growth forecast.

Dominance of top banks The sector is highly concentrated with the **top five and top ten banks owning ca. 58% and ca. 85% of the total banking sector's assets, respectively**. Among the top five banks, the biggest lender is a state-owned bank, namely Ziraat, while the other four banks are private. Halkbank and Vakifbank are the main successors of the top five followed by a group of players such as Finansbank, Denizbank and TEB, with market shares between 3% and 4%.

Regulatory support To support banks in withstanding macro challenges, **BRSA lowered the provisioning on unsecured retail loans** and simultaneously **increased the term limits for consumer loans and credit cards,** encouraging banks to support household lending. A new Credit Guarantee Fund has been established to stimulate lending to SMEs.

Challenges ahead Higher funding costs and rising **expenses for provisions due to a rise in NPLs will likely squeeze margins in the banking sector** and drive banks to consider their current business models and strategies.

Loans and deposits in banking (EUR bn)



Source: PwC analysis, BRSA

Key banking system indicators YE 2016 (%)

	Turkey	EU
Capital Adequacy Ratio	15.6%	17.2%
NPL Ratio	3.2%	6.5%
Cost-to-Income Ratio	44.0%	64.2%
Return on Equity	14.0%	5.4%

Source: PwC analysis, Turkish Banking Association, ECB

Top five banks by loan volume (YE 2016)

	Bank	Total loans	NPL ratio
1	T.C. ZİRAAT BANKASI A.Ş.	EUR 64bn	1.8%
2	TÜRKİYE İŞ BANKASI	EUR 56bn	2.4%
3	Garanti	EUR 51bn	2.8%
4	YapıKredi	EUR 48bn	4.9%
5	AKBANK	EUR 45bn	2.6%

Source: PwC analysis, Turkish Banking Association

03

- ***Substantial distressed debt stock already present*** *with further NPL stock increase expected*
- ***Regular sales of non-performing portfolios ongoing*** *while secured portfolios to be brought back to market*
- ***High seller appetite for new buyer market entrants*** *with state banks expected to be allowed to sell NPLs soon*

Supply-side view on NPLs

✓NPL stock increase expected
✓Regular sales of retail unsecured to continue, with corporate to start and accelerate
✓State-owned banks expected to be allowed to sell soon

Substantial distressed debt stock already present In banking alone, the total **NPL stock sums up to ca. EUR 15.7bn** (YE 2016), split between:

- Private banks – ca. EUR 11.6bn (74%)
- State banks – ca. EUR 3.2bn (21%)
- Participation banks – ca. EUR 0.9bn (5%)

The **distribution across corporate (30%), SME (37%) and retail (33%) segments is fairly equal**, with each making up roughly a third of the total stock.

Further stock increase expected NPL volume has **increased by ca. 22% YoY 2016, to ca. EUR 15.7bn**, mainly driven by growth in the **SME and corporate segments.** The rising trend in NPL volumes is expected to continue with a **forecasted NPL ratio of ca. 4% by eoy 2017** due to 1) easing regulatory curbs on retail lending, 2) recent TL depreciation by ca. 20% in 2016 hurting companies with FX loans and 3) moderate economic growth mostly impacting SMEs.

NPL ratio remains relatively low, with **system ratios between 2.7% and 3.2% from 2011 to 2016**. This is essentially caused by three factors: 1) private banks regularly selling their (mostly retail unsecured) NPLs, 2) a cultural aversion towards being indebted, and 3) a distinctive restructuring practice in Turkey.

Eased regulation to restructure corporate loans in selected industries. Accordingly, banks had the **flexibility to restructure corporate loans in shipping, tourism and energy twice** until YE 2016.

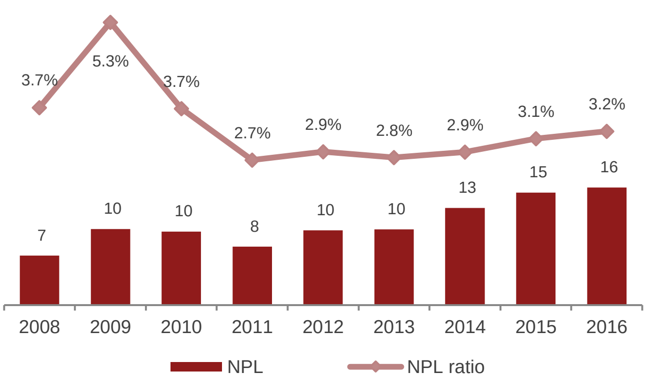
Regular sales of non-performing portfolios ongoing Banks have **sold ca. EUR 8bn NPLs since 2008**, with the peak reached in 2014. Historically, most NPL sales were largely corporate secured portfolios. Nowadays, the market **mostly observes unsecured retail deals**, which are frequently disposed of by private banks on an ongoing basis.

Secured portfolios to be brought back to market A number of secured (corporate and retail) portfolios are expected to be brought to market in 2017 and after, driven by **banks looking for alternative resolution solutions** to their internal processes.

High seller appetite for new buyer market entrants Seller banks are interested in expanding the range of potential buyers, given the high concentration in the market.

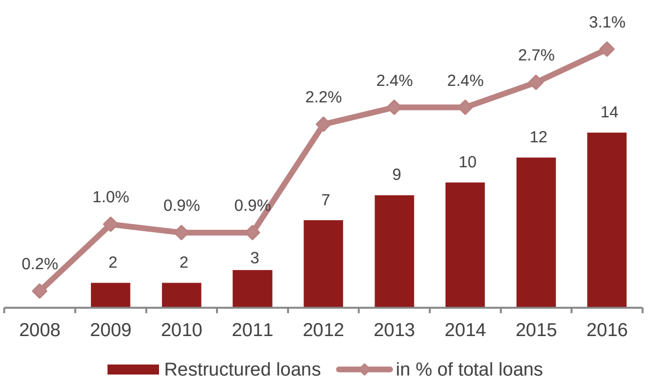
State banks expected to be allowed to sell NPLs soon A new legislation has been published in January 2017 authorising the BRSA to resolve the principles of state banks' receivable sales to AMCs. While state banks are currently awaiting BRSA guidance, it is expected that their **portfolios will be traded in the market soon**.

NPL stock and ratio in banking (EUR bn)



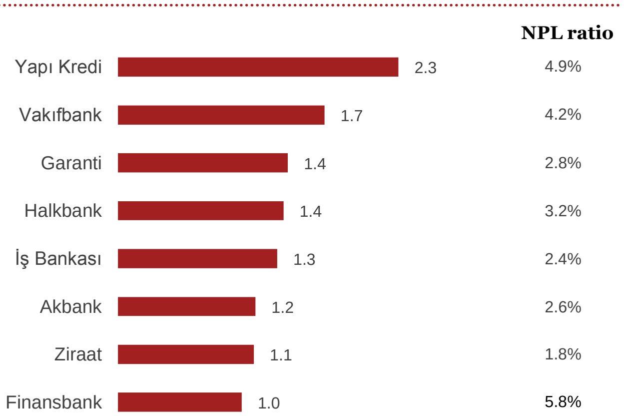
Source: PwC analysis, Banking Regulation and Supervision Authority

Restructured loans in banking (EUR bn)



Source: PwC analysis, Turkish Banking Association

NPLs in banking by main players YE 2016 (EUR bn)



Source: PwC analysis, Banking Regulation and Supervision Authority

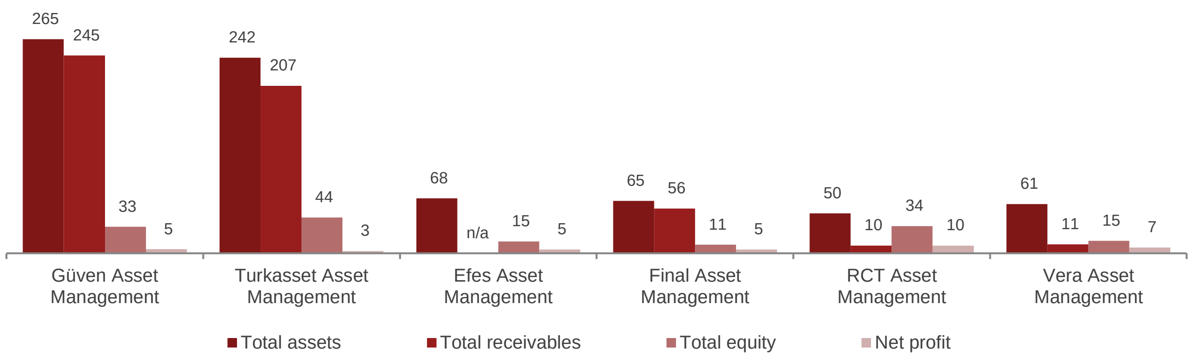
04

- *13 licensed AMCs, with* ***top two covering ca. 60% of the market***
- ***Buyer appetite*** *driven by existing stock, expected volume increase and* ***state banks coming to market***
- ***New AMCs encouraged by local regulator***

Demand-side view on NPLs

✓Rising international investor appetite
✓Buyer market dominated by two largest AMCs

Financial information of key AMCs YE 2015 (in EUR m)



Source: Audited financial reports 2015, PwC analysis

13 active local AMCs licensed by BRSA with a total portfolio of ca. EUR 7.2bn of claims. The two largest AMCs, Güven and Turkasset, dominate the market with ca. 60% market share. **Three new local players entered the market in 2016.**

License from BRSA required for buying and owning NPLs The first regulation regarding AMCs was established in 2005 while banks started to sell NPLs regularly to AMCs in 2008. BRSA regulates all AMCs and currently allows them only to **buy NPLs from private banks and financial institutions located in Turkey**.

AMCs only for NPLs AMCs in Turkey are not allowed to purchase doubtful receivables of the non-financial sector. Total doubtful receivables in telecom, utilities and media alone are estimated to be ca. EUR 10bn. In mid- to long-term, however, **AMCs are expected to penetrate those sectors** driven by amendments in the corresponding regulation.

Upcoming opportunities The large existing NPL stock from private banks with expected rising volumes and anticipated pipeline from state banks encourage AMCs to be **interested in international funding, equity partnerships and portfolio-based investments**.

New entrants encouraged and expected The regulator created **no barriers for market entrants**. New acquirers and green field investments are encouraged depending on the financial strength and credibility of the investor.

Focus on top AMCs in the market

GÜVEN VARLIK YÖNETİM

- Established in 2005
- Owned by Fiba Holding, which is a well known, diversified conglomerate
- Merged with Girişim Varlık in 2015
- Güven has acquired a total loan portfolio of ca. EUR 3.5bn by paying a total price of ca. EUR 530m since 2007

TURKASSET

- Established in 2008
- Main shareholder is a local reputable PE firm
- EBRD became the minority shareholder investing TL100m in 2011
- Turkasset became the legal successor after the merger with LBT in 2014
- Turkasset acquired +100 portfolios with total amount of ca. EUR 2.5bn from 35 different institutions

FİNAL VARLIK YÖNETİM

- Established in 2011
- Owned by Altinbas Group
- Purchased portfolios from several banks and financial institutions, including factoring and leasing companies
- Final acquired ca. EUR 520m for a total of ca. EUR 50m from different financial institutions in 2014 and 2015

Appendix

Abbreviations

Abbreviations	Description
AMC	Asset Management Company
bn	Billion
BRSA	Banking Regulation and Supervision Agency
CAGR	Compound Annual Growth Rate
CAR	Capital Adequacy Ratio
CIR	Cost-to-Income Ratio
ECB	European Central Bank
EU	European Union
EUR	Euro
FX	Foreign Exchange
G20	Group of Twenty
GDP	Gross Domestic Product
m	Million
n/a	Not applicable
NPL	Non-Performing Loan
OECD	Organisation for Economic Co-operation and Development
RoE	Return on Equity
TL	Turkish Lira
SME	Small and Medium-sized Enterprise
SWFI	Sovereign Wealth Fund Institute
YE	Year End
YoY	Year-on-Year

PwC Portfolio Advisory Group

Our specialists are fully conversant with the Turkish distressed debt market

Profound technical know-how, as well as regional understanding coupled with strong transactional experience enable us to accompany our clients, advising and providing them with active support acrosss the full value chain of distressed assets value extraction.

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