THE FUTURE OF TURKEY’S CAPITAL MARKETS

A PERSPECTIVE ON CHALLENGES AND OPPORTUNITIES
EXECUTIVE SUMMARY

After a decade of high growth, Turkey’s economy has reached a certain maturity with output per capita exceeding US$10,000, supported by globally competitive industries. On the other hand, the Country’s capital markets development has lagged behind overall economic development. Peer group comparisons to similar emerging market economies show that both equity and debt capital markets are underpenetrated in Turkey. The current situation presents an untapped opportunity for many players, as well as an opportunity for Turkey to finance the next chapter of its economic growth.

There are many reasons why a deepening of Turkey’s capital markets is now required. The government’s heavy financing needs funded by banks with ever growing branch networks have crowded out other borrowers for a number of decades. The post-crisis response at the turn of the millennium has led to the replacement of government securities on high-growth bank balance sheets by commercial and consumer lending using largely the existing liability structures. This transformation is almost complete: loan-to-deposit ratios tripled between 2003 and 2013 from 43% to 111%, while capital adequacy halved from 31% to 15%.

At this point, banks are increasingly more selective on how they use their balance sheets, and will likely not be able to finance Turkey’s growing economy at the same rate alone. Capital markets will need to fill in some of the gaps. The development of capital markets requires simultaneous support from a wide range of market constituents. While policymakers in Turkey need to continue with the actions to encourage the growth of domestic savings, intermediaries and market infrastructure players need to educate investors and borrowers on emerging asset classes such as corporate bonds, derivatives or asset management products.

The growth of capital markets will bring about a set of challenges to the industry. There are three major areas where players will encounter challenges, and resulting opportunities:

- Opening up of the current government and bank-dominated debt capital markets to private businesses
- In equity markets, increasing the number and depth of smaller cap listings to allow investors the access to a wider range of portfolio selection options
- Creating a sizeable buy side for the newly created assets, including asset managers, pension funds and insurers

Various players will seek to seize these opportunities. A different set of success factors will be relevant and the players who recognize this shift early will thrive. Just like the boom of commercial banking over the last 15 years, we expect to see a different set of leaders inside the capital markets ecosystem who will flourish and gain prominence.

1 Source: Banking Regulation and Supervisory Agency data – OW analysis
CATCHING UP WITH TURKEY’S ECONOMIC DEVELOPMENT

There is a mismatch between the complexity and size of the Turkish economy and the size of its capital markets. In this paper we try to understand the size of the gap as well as the opportunities it presents to various players for both equity and debt capital markets.

In terms of market capitalization, Turkey’s equity markets are significantly smaller than peers – benchmarking Turkey to the average peer shows that equity markets could easily double in size.

Exhibit 1: Peer group comparison of market cap

LISTED COMPANIES/GDP IN %

Source: World Bank and Economist Intelligence Unit
*1 Peer average includes South Africa, Chile, Thailand, Brazil, Russia, India, China, Indonesia and Argentina

In terms of trade volumes, Turkish equity markets have reasonable flow relative to GDP (see Exhibit 2). Turkey’s stock market trade volume is higher as a percentage of GDP than all BRIC\(^2\) countries with the exception of China. However, stock market flows are highly concentrated around the largest cap stocks such as major banks, airlines and telecom companies. As of June 2014, 70% of trading volume took place on the top ten stocks.

Exhibit 2: Peer group comparison of equity trade volumes

STOCK MARKET TRADE VOLUME/GDP – 2012, IN %

Source: World Bank and Economist Intelligence Unit and Oliver Wyman analysis

2 Brazil, Russia, India and China
Similar to equities, Turkey’s debt capital markets are also much less developed than the size of the economy should require. Government and bank debt have dominated these markets since the 1980’s, leaving little room in the marketplace for private businesses (see Exhibit 3). A comparison to peer benchmarks indicates that debt markets could double or triple in size.

Exhibit 3: Peer comparison of debt issue volumes

<table>
<thead>
<tr>
<th>ISSUER TYPE, IN %</th>
<th>% OF GDP – 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private – Businesses</td>
<td>15</td>
</tr>
<tr>
<td>Private – Financial Institutions</td>
<td>10</td>
</tr>
<tr>
<td>Central government and local authority</td>
<td>5</td>
</tr>
<tr>
<td>Public sector and supranationals</td>
<td>0</td>
</tr>
<tr>
<td>ISSUER TYPE, IN %</td>
<td>35%</td>
</tr>
<tr>
<td>US</td>
<td>Ger.</td>
</tr>
<tr>
<td>Source: Dealogic, Economist Intelligence Unit and Oliver Wyman analysis</td>
<td></td>
</tr>
</tbody>
</table>

Many would argue that there are several reasons for a developing economy to foster capital markets development, since a properly functioning capital markets ecosystem brings economic and commercial benefits. Alongside the banking system, such an ecosystem enables economic growth through meeting the needs of a diverse group of investors, furthering the risk management of companies and institutions and creating an environment of better governance, thereby improving corporate responsibility in different industries. Moreover, it facilitates price discovery across a range of assets.

Exhibit 4: Capital Markets Ecosystem

Principals: capital users
- Businesses (e.g., companies of all sizes, private and public sector)
- Governments/agencies
- Individuals

Financial intermediaries
- Brokers, banks, insurers
- Asset/wealth managers

Financial instruments
- Debt, equities, loans
- Real estate, commodities

Principals: capital providers
- Institutions (e.g., pension funds, insurers)
- Governments/agencies
- Individual investors
- Financial institutions

Market Enablers
- Market infrastructure providers: exchange, depositories, custodians, ratings agencies, credit bureaus, market data vendors
- Regulatory and legal environment: regulations (for securities, investments, banking, insurance); legal (intellectual property protection; dispute resolution mechanisms)
- Supporting capabilities: e.g., participant educational programs, ICT for reliable data availability
WHAT HAS CHANGED?

Several different drivers facilitate capital markets development alongside economic development. Turkey has a number of these in place:

- Banks’ balance sheets, while still comfortable, are no longer flush with liquidity and capital. Given new balance sheet constraints, coupled with declining return on equity, banks will be more selective on where they place their capital. Corporate lending, for many banks, has become an unprofitable activity for the first time.
- Demand for long-term financing is growing, with several major infrastructure investments in the pipeline. These include strategic projects such as the widening of major roads, the building of high-speed rail tracks and the construction of a third airport in Istanbul.

Exhibit 5: Banks’ balance sheets have transformed rapidly, but loan demand continues to outpace deposit growth

<table>
<thead>
<tr>
<th>Interest Rates Have Stabilized Around 10%*</th>
<th>Loan-to-deposit Ratios Are Above 100%</th>
</tr>
</thead>
<tbody>
<tr>
<td><img src="chart1.png" alt="Interest Rates Chart" /></td>
<td><img src="chart2.png" alt="Loan-to-deposit Chart" /></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Capital Adequacy Ratios Approaching the 12% BRSA Minimum</th>
<th>Continued Demand for Financing Outpacing Deposit Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td><img src="chart3.png" alt="Capital Adequacy Chart" /></td>
<td><img src="chart4.png" alt="Annual Growth Chart" /></td>
</tr>
</tbody>
</table>

Source: BRSA monthly bulletin, Oliver Wyman analysis

*1 One Year and similar maturity government security annual compound yields from the year ends

- Thanks to several institutional reforms, infrastructure and regulatory enablers are in place to better support capital markets activity.
- Capital markets legislation was recently aligned with international best practices around retail mis-selling risk and funds management infrastructure. Several exchanges have been merged under Borsa Istanbul, which also entered a strategic partnership with NASDAQ OMX.
A CHALLENGING, BUT POTENTIALLY FRUITFUL TRANSITION

There are still a number of important challenges across the value chain for Turkey’s capital markets. Each of these challenges can be turned into an opportunity by pioneers and innovators, it has been the case in other markets. The opportunities we see in this environment of transition are:

1. Opening up of the current government and bank-dominated debt capital markets to private businesses
2. In equity markets, increasing the number and depth of smaller cap listings to allow investors to access a wider range of portfolio selection options
3. Creating a sizeable buy side for the newly created assets, including asset managers, pension funds and insurers

OPPORTUNITY 1: OPENING UP OF DEBT CAPITAL MARKETS TO PRIVATE BUSINESSES

While large Turkish banks currently pay around 150 basis points over government yields for 1-year funding, top-tier corporates in Turkey can borrow at low rates, limiting the added value offered by bank intermediation for wholesale funding to businesses. Tight margins on corporate lending have become less attractive for banks looking to improve profitability.

In this context, relative cost of funding among public sector companies, banks and private businesses will determine the slice of the pie each takes from the debt markets. The access of large corporates to debt capital markets will require efforts from the corporates themselves as well as policy makers, regulators and market infrastructure players:

- **Transparency:** The banking sector provides a great example to non-financial corporations with respect to the benefits of transparency. The Banking Regulation and Supervisory Agency of Turkey has extensive corporate governance and reporting requirements to enhance transparency and accountability – more than many peer markets. Other industries in Turkey can improve their own access to investors by voluntarily increasing transparency and adopting better corporate governance and risk management

- **Liquidity in secondary markets:** There are numerous levers to improve liquidity of individual securities, including structural actions to attract a diverse group of investors to the markets by serving their specific needs, as well as more technical steps around the market making mechanisms supported by the incentive structures
OPPORTUNITY 2: INCREASING SMALLER CAP EQUITY LISTINGS AND ENHANCING LIQUIDITY

Turkey’s economic engine is skewed towards middle market and SMEs. Similar to debt markets, increased involvement of smaller caps on the stock exchange can be achieved in three main ways: building liquidity, improving oversight and regulation, and providing more comprehensive information to investors.

Turkey can learn valuable lessons in all three areas from trading platforms for small and medium-sized enterprises in other markets:

- **Increased liquidity**: AltX – the South African stock exchange for small and medium-sized companies – is popular among a high number of small investors with small shares, creating liquidity. The exchange’s settlement authority borrows securities during any liquidity crunch.

- **Oversight and regulation**: Neuer Markt, the stock exchange for technology shares in Germany, was hit hard when the dotcom bubble burst. The trading platform had listed many companies without sufficient oversight, causing widespread defaults. Frequent cases of insider trading were not adequately investigated by German authorities, which later brought about many court cases and fines. Listing requirements were relatively loose, mainly due to pressure to bring more companies to the market in a short time. Such a lack of oversight due to high ambition undermines credibility in the first period of business downturn.

- **Information to investors**:
  - The AIM (the Alternative Investment Market of the London Stock Exchange) appoints firms as Nominated Advisors (NOMADS) to manage the admission of new issues and monitors the listed companies for a solid flow of information to investors.
  - AltX of South Africa, recognizing the higher risk of smaller companies, actively seeks out experienced investors.
  - One of the reasons behind the fall of Neuer Markt in Germany is the attraction of many small investors who were misled by irresponsible investment consultants and brokers. Conflicts of interest in banks also hinder timely and comprehensive information sharing with investors.
CASE STUDY: THAI BOND MARKETS

Thailand has one of the most developed debt capital markets in emerging countries, with an annual issue volume reaching 6% of GDP, 40% of which is issued by private businesses.

The Thai government has built an extensive benchmark yield curve, in a conscious effort to grow the market. It decreased its bond issue frequency and increased the issue sizes in order to stimulate the secondary markets. It also issued benchmark bonds up to a maturity of fifty years, thereby providing reference rates for all private issues.

A diverse set of assets meets the full spectrum of demand, with different investors seeking different balances of risk and return. These assets include:

- Seven benchmark government bonds, ranging from a 3-year to a 50-year maturity
- Savings bonds targeted at retail investors issued by the government. They can be purchased as multiples of THB10,000 (approximately US$300). Targeted e-bonds can be purchased using ATMs
- Other products in the market include Islamic bonds, foreign issuer bonds and inflation-indexed bonds

OPPORTUNITY 3: GROWING THE DOMESTIC BUY-SIDE

Traditionally, bank deposits, gold and real estate account for a significant proportion of Turkish savings. Financial investments managed by the broader asset management industry are therefore very limited in comparison. Banks have started to tap into savings in the form of gold – estimated to be of similar size to the banking sector’s deposit base - using gold-denominated savings accounts, while the property price boom has continued to make real estate an attractive savings vehicle for retail investors.

Exhibit 6: Who Turkish savers trust for their financial investments

<table>
<thead>
<tr>
<th>IN TRY BN</th>
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<tbody>
<tr>
<td>2,000</td>
</tr>
<tr>
<td>1,500</td>
</tr>
<tr>
<td>1,000</td>
</tr>
<tr>
<td>500</td>
</tr>
<tr>
<td>0</td>
</tr>
</tbody>
</table>

2008 2013 2018 estimate

Source: Capital Markets Board of Turkey, BRSA, Insurance Association, Oliver Wyman analysis

Note: While there is partial double counting from the insurance sector, a substantial portion of insurance and pension savings are invested in government securities, rather than a broader set of asset classes
Around half of bank deposits in Turkey are currently lodged in deposit accounts holding more than TRY1 MM (around US$500,000), most with less than one-year maturity. These large accounts will be the prime targets of retail brokers and asset managers as they seek to expand their businesses. The segment has been growing by approximately 20% per annum, and we are likely to see a larger portion of these savings moving to asset managers as investment options diversify.

Our estimates show that an amount roughly equal to the total volume of bank deposits is invested in buy-to-let residential real estate in Turkey\(^3\). A potential shift of this capital into securities will make home ownership easier for mortgage seekers, increase transparency in the housing market and develop capital markets through the introduction of new products.

Turkish private pension funds came into existence in the early 2000s and are still only 3% of the deposit market. The growth observed in pensions was precipitated by the recent pension reform, effectively implemented in order to increase the structurally low savings rate in the Country. The full impact will take years to materialize – sustaining the recent growth rates over the coming decade. Given that the impact of this subsidy has not yet been fully realized, we believe high growth will be maintained over the next five years. In light of these drivers, we expect the pensions industry to grow to around a quarter of the size of bank deposits by 2018. As pensions and insurance markets are both underpenetrated, we would expect the essential levers for players in these markets to be distribution, marketing and management of customer value.

Certain factors, however, could potentially inhibit a major structural change in the makeup of the Turkish savings base. A higher interest rate environment would encourage investors to maintain their assets in deposits; political instability and economic uncertainty would prompt investors to keep their money in foreign exchange deposits and gold\(^4\) and sustained increases in real estate price (between 2009 and 2014, prices have increased by approximately 50% on US$ basis\(^5\)) would continue to attract savings to this particular investment type.

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3 Based on housing ownership statistics from Turkstat and Oliver Wyman benchmarks
4 Gold holdings not shown in the chart due to lack of relevant data
5 Source: Reedin median real estate sale prices
CONCLUSION

Capital markets ecosystems are complex with a diverse set of players; their development depends on collective actions by many stakeholders (See Exhibit 7).

Exhibit 7: Development actions needed from various market constituents

<table>
<thead>
<tr>
<th>PLAYER</th>
<th>EXAMPLES OF DEVELOPMENT ACTIONS</th>
<th>IMPACT ON CAPITAL MARKETS</th>
</tr>
</thead>
</table>
| Government                  | • Continue to take policy action to encourage the growth of domestic savings and the development of a strong asset management industry  
                              • Encourage savers to bring their wealth stored in gold and real estate into the financial markets | • Establish a material buy-side                                
                              • More efficient use of wealth through financial intermediaries                                      |
| Regulators                  | • Require better corporate governance and transparency from all issuers. Examples might include enforcement of rules around insider trading, balance sheet audits and minority rights | • Increased the demand for mid-cap corporate listings            |
| Brokers, traders            | • Educate investors, both institutional and retail, around emerging asset classes e.g. corporate bonds, asset-backed securities and equity derivatives  
                              • Segment and better understand customers to identify potential sell-side and buy-side clients for emerging asset classes and provide liquidity through market making | • Increased demand for currently low profile asset classes  
                              • Simultaneous development of buy and sell sides                                                    |
| Bank holding companies      | • At a BHC group level, recognise that lending and capital markets activities are potential substitutes  
                              • Define a strategy and operational model that enables the value-based guidance to clients between balance sheet lending and capital markets | • Efficient allocation of business volumes between business lines  
                              • Capital markets create value for both group shareholders and the clients                          |
| Exchanges                   | • Revise listing requirements to be  
                              − flexible enough to allow smaller corporations to list  
                              − comprehensive enough to ensure all listed companies have trustworthy financials and good corporate governance | • Provide confidence to existing and potential investors               |
| Asset and wealth managers, private bankers | • Build expertise around a growing set of asset classes. For instance, build capabilities to make portfolio allocation decisions on asset-backed securities, infrastructure project bonds, corporate bonds and mid-cap equities  
                              • Revise the compensation and incentive schemes to attract required talent                    | • Increase returns on growing assets under management  
                              • Build required capabilities to participate in increasingly sophisticated capital markets                                                        |
In an environment of transition, players recognizing this shift early will reap the benefits. Turkey presents opportunities to several players, particularly to those in nascent markets such as corporate finance, securities, insurance, pension funds, and asset and wealth management.

- Corporates that can diversify their funding sources will reduce their dependency and may be able to access longer-term funding for their investments at advantageous rates. Transparency of corporate financials and enhanced governance will be essential to reduce funding costs.
- Investment banks, exchanges and brokers serving as arbitrators between the investors and private businesses will create value for their clients as well as their shareholders. Intermediaries who push the development of secondary markets will be leading market makers in the newly established markets.
- Pension funds and insurers will find themselves in a high-growth market. Strong marketing activity will allow some players to penetrate new segments. They will expand their investment portfolio by building expertise in a wider set of asset classes ranging from relatively traditional assets such as corporate bonds to less conventional ones such as private equity and real estate funds.
- Agile banks will reallocate their capital based on economic value, both across business units and within corporate and investment banking. A number of factors will make the economics of corporate lending more transparent in Turkey. For example, the availability of reliable benchmark curves enables better assessment of funding costs. Recent regulation is also encouraging banks to estimate their cost of risk for all lending.
- The nascent alternative investments industry, including hedge funds, private equity funds and venture capital funds, will also demand and support the need for better functioning capital markets. Many will demand transparency and better governance as they invest or see their portfolio companies mature towards an IPO exit.

In the high inflation and high risk environment of the 1990s, Turkish commercial banks collected deposits to finance Turkish government borrowings. Over the last decade, banks diversified their assets to profitably serve a range of customers from mass market to large corporates. Another wave of change is nearing as the growing Turkish economy and its key constituents will demand better access to capital markets.
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