INVESTING IN Turkey

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Chance to assert economic independence

But without the IMF 'walking stick', the recovery will be more sluggish, says **Delphine Strauss**

When financial leaders converged on Istanbul for theOctober meetings of the International Monetary Fund and World Bank, Turkey took pride in becoming the first country to host the gathering twice. An even greater source of pride was the fact that it had finally broken free from the IMF's tutelage, after a half century as a serial recipient of funds and advice, lurching from one bail-out to the next.

While the global recession drove many countries into the IMF's embrace, for Turkey it became a chance to assert new independence in economic management. Ankara might yet agree a new loan on its own terms but, as Recep Tayyip Erdogan, the prime minister, put it, there was no need to lean on an IMF "walking stick".

Thanks to previous reforms, Turkey entered the downturn with a solid banking system and strong public finances, helping it avoid a familiar pattern of capital flight, currency collapse, rampant inflation and spiralling interest rates.

Instead, with a stable currency, falling inflation, and bond yields near record lows, the central bank was able to cut interest rates by more than 10 percentage points in a year to mitigate a brutal contraction in the real economy. Banking sector profits for the year may reach TL20bn ($13.5bn), 50 per cent higher than in 2008.

Ratings agencies have signalled they may upgrade Turkey's sovereign rating – a move long priced into markets. Fitch cited its "relative resilience to the severe stress test of the global financial crisis" and Moody's said it was "better prepared … than would have seemed possible, given its dependence on external financing."

Yet Mr Erdogan's ruling Justice & Development (AK) party must still convince outsiders it can maintain stability without external anchors. Inflows of foreign capital fuelled rapid gains in prosperity in the years up to 2007, largely because investors were reassured by IMF oversight, and by Turkey's application for membership of the European Union.

Now, Mr Erdogan is determined not to let the IMF dictate fiscal policy, and the prospect of EU accession is so distant that it has ceased to interest investors. Instead, the AKP is pressing on with reforms to extend rights for Kurds and other minorities that, while much-needed, have stirred political tensions. Paradoxically, some risks may be increasing just as the worst of the crisis passes.

Ali Babacan claimed credit at the IMF meetings for becoming one of the first economy ministers to commit himself to an exit from fiscal stimulus, with a medium-term plan to stabilise debt in 2010 and cut the budget deficit from 6.6 per cent at the end of this year to 4 per cent by the end of 2011. But economists say reliance on higher tax revenues and a lack of detail on how fiscal rules will be formulated or spending controlled reduce the plan's credibility.

The Treasury expects to roll over almost all domestic debt payments next year, a ratio that would increase if there were any fiscal slippage, external shock or mishap with privatisations.

Tevfik Aksoy, analyst at Morgan Stanley, says the record lows in real interest rates have sapped enthusiasm in the bond market, with inflows of only $1.3bn from non-residents between March and September.

If government debt issuance proves higher than planned, domestic banks will be the main buyers, reducing their ability to lend to the private sector and fuel recovery.

"The absence of an IMF deal would not imply a funding crisis but would likely imply a slower recovery in private sector credit growth," says Christian Keller, economist at Barclays Capital.

Banks are in any case unlikely to return to aggressive lending at a time when bad loans are still rising and low central bank interest rates will reduce their margins.

Economists expect gross domestic product to contract by some 5.5 per cent over 2009 as a whole, and grow by 3.5 per cent in 2010 if there is no IMF support – a sluggish recovery by Turkish standards, and not enough to bring relief from double-digit unemployment.

Fiscal pressure is also delaying some reforms the government thinks desirable. Mr Babacan has said plans to promote Istanbul as a financial centre cannot yet include tax cuts. Draft legislation on renewable energy is also delayed because of doubts over the cost of price guarantees for solar energy.

> 'The modernisation process is likely to be highly volatile and prone to intense power struggles'

Yet the continued strains on public finances and corporate cash flow may mean new activity for M&A bankers and private equity investors in 2010.

The need to raise revenues is prompting the government to re-launch long-delayed privatisations of energy distribution grids and lay plans to privatise profitable power stations.

Istanbul municipality wants to sell the fleet of ferries plying the Bosphorus; there will be a second attempt to auction off the national lottery, and Mr Babacan has signalled plans to start the privatisation of state-owned Ziraat bank.

Suzan Sabanci Dincer, chairwoman of the lender Akbank, predicts there will also be a wave of restructuring, as groups weakened by the downturn seek scale to compete.

Ferruh Tunc, senior partner at KPMG's Istanbul office, thinks private equity buyers are close to finding a new price level for deals, after a year in which sellers' expectations far exceeded what they were willing to offer.

In the last month, the UK firm Bridgepoint has acquired a stake in the vehicle inspection company Tuvturk, while a private equity arm of HSBC is among investors in the ground-handling company Havas after a stake sale by TAV, an airport operator that needed to cut debt to pursue rapid expansion.

As always, the biggest risks to all this activity are political. At present, companies are benefiting from the AKP's hyperactive foreign policy, as it promotes closer trade ties with neighbours as a means of bolstering regional stability.

Domestic politics, however, remain fraught. The AKP's big clashes with the military and judiciary in 2007 and 2008 had subsided into lower-level rumblings. But tensions have risen sharply in recent days after a string of anonymous letters alleging military schemes to discredit the AK Party, and a row about government-authorised wiretapping of secularist-minded judges and prosecutors.

A record tax fine against the billionaire media owner Aydin Dogan is a sign that political tensions are spilling over into the corporate arena.

"Turkey's modernisation process is likely to be highly volatile and prone to intense power struggles between competing interest groups," writes Ahmet Akarli at Goldman Sachs.

Without a "benevolent" power such as the EU to smooth the process, he adds, "it may prove difficult to avoid frequent political setbacks and, in the extreme, acute social conflict, leading to extended periods of uncertainty."

Sculptures of a bull and a bear outside the Istanbul Stock Exchange: foreign capital inflows were encouraged by IMF oversight Bloomberg

State vigilance is a rising investor concern

CORPORATE TAX

Delphine Strauss asks whether recent demands mark a new strategy

When Turkey's finance ministry sent the Dogan media group a bill for TL4.8bn ($3.2bn) in unpaid taxes and penalties this autumn, foreign investors were dismayed – but not overly nervous.

Ministers maintained that the fine, along with a TL900m penalty imposed earlier in the year, was the result of routine inspections, with no political interference. But most viewed it as personal – the culmination of a long and public feud between prime minister Recep Tayyip Erdogan and Aydin Dogan, the billionaire whose newspapers and TV channels had become increasingly critical of his government.

However, evidence is now mounting of a much broader enforcement drive by corporate tax inspectors – which economists and accountants say is long-overdue, but must be carried out consistently to keep investor confidence.

This month, Google's Turkish operation became the latest target, receiving a fine of around TL70m. In October, Turkcell, the mobile phone operator, was asked to provide collateral to meet a TL258.3m tax demand. Earlier in the year, the oil company BP received a TL474m fine relating to duty-free fuel sales. All three companies say they have complied with tax rules and will seek legal redress if necessary.

"Punitive taxation continues, becoming a major uncertainty for foreign direct investment and domestic fixed investment," analysts for the consultancy Global Source wrote after news of the Google fine emerged.

The fines are the result of changes inside the tax administration designed to step up scrutiny of big companies – and raise cash for the treasury.

"There have been more tax inspections in the last three months and, as with any government, it's because it needs the money," says Alan Greenhalgh at the accountancy firm Kapital Karden.

Better enforcement is needed. "Unfortunately, paying taxes is not very common in Turkey," Ali Babacan, economy minister, said in defence of the Dogan fine. Statistics from the Organisation for Economic Co-operation and Development bear this out: taxes on income, profits and capital gains equalled 5.3 per cent of gross domestic product in 2006, against an OECD average of 13 per cent.

Because of its narrow tax base, Turkey has relied disproportionately on indirect taxation, especially on a plethora of consumption taxes that are not always economically rational.

Reforms are being introduced to broaden the tax base, lower rates on some taxes and improve collection. But with the budget deficit set to rise to 6.6 per cent of GDP, tax cuts are on hold and the temptation will be to resort to blunter instruments.

> 'Unfortunately, paying taxes is not very common in Turkey'
>
> **Ali Babacan, Economy Minister**

"I think the government is very keen to improve its revenues from those companies that are profitable. The banking sector fears the same . . . unjustified tax attempts by the authorities [as with Dogan]," says a senior banking executive in Istanbul.

Accountants complain tax inspectors' zeal is not always matched by competence, or clear and predictable legislation. "I'm not happy with the way they conduct investigations. For years, the best people have not been choosing to work for the government," says a partner at a big accountancy firm in Istanbul.

Ambiguities in the tax procedural code mean too many points are open to interpretation, while seeking redress in the Turkish courts could take years.

Despite the vagaries of the system, foreign investors have in general received pragmatic treatment from the current government, often more favourable than of locals.

One important inducement for foreign capital – a zero rate of withholding tax on bonds – is now at risk after a court ruled it was inequitable given the 10 per cent rate charged to Turkish investors.

Mr Babacan has promised foreign investors an overhaul of corporate tax rules to leave "no room for grey areas" and ensure "foreseeable, predictable, fair implementation."

He is clearly keen to steer the debate beyond the controversy over the Dogan case. But like it or not, that row may now be the yardstick by which foreign investors judge the system.

New terminal lands on time and budget

SABIHA GÖKÇEN

Istanbul's second airport aims for growth, writes Delphine Strauss

Two weeks before opening, workmen were knee-deep in wet concrete outside the main entrance, tenants were assembling shops, and lines of red suitcases were passing through tests of baggage handling systems.

But when the new international terminal at Istanbul's Sabiha Gökçen airport opened its doors this month, its operators could celebrate completing it a year ahead of schedule – with a 20m passenger capacity bigger than required by contract.

While airlines around the world suffer mounting losses and falling passenger numbers, Turkish aviation is thriving. Turkish Airlines claims it will this year be the only European flag carrier to grow, largely due to its success in turning Istanbul's Ataturk airport into a hub between Europe and the Middle East.

The bold expansion at Sabiha Gökçen reflects changes closer to home: the rapid development of Istanbul's Asian shore, the rising aspirations of Turkey's middle classes, and the appeal of the city itself to both tourists and businessmen.

The wavy silhouette of its roof – meant to suggest the seven hills on which the city was founded – is the mark of an architect chosen by the Turkish military, which owns the airport. But the consortium that built the terminal, after bidding €1.92bn for 20-year operating rights, is a collaboration between a Turkish conglomerate, Limak, and India's GMR Infrastructure. Their joint venture holds an 80 per cent stake in the operation, with 20 per cent owned by the Malaysian airport operator MAHB.

Limak has local knowledge and expertise in construction, but GMR added experience in equipment purchases, says Cenk Alpsoy, GMR International's regional head. It also flew in IT experts from Hyderabad and Delhi to help switch operations from the old to the new terminal.

GMR comes fresh from building Hyderabad's new airport but Sabiha Gökçen is its first foray overseas. Mr Alpsoy says the group chose Turkey for its first venture because of the potential for other projects in its core areas of energy and road-building.

Other Turkish groups are eyeing the opportunities for airport expansion in Turkey and beyond. Celebi, a ground handling company, has just won contracts at Delhi's international airport and in Brussels. TAV, which runs Istanbul's main Ataturk airport, has just formed a joint venture with Saudi Arabia's Al-Rajhi Holding to bid for projects.

Profits under the BOT (build, operate and transfer) contracts that predominate are highly sensitive to trends in passenger numbers. At Sabiha Gökçen, the contract unusually includes ground handling, cargo and refuelling, as well as revenues from passenger taxes, duty free sales, car parking and an airport hotel.

But the consortium must recover its €450m investment as well as meeting payments to the government. It is counting on passenger numbers rising from some 6m this year to 10m by 2010 and double that by 2020.

> Turkish Airlines' presence will be crucial to attract other flag carriers

"Our target is that everyone in Turkey will fly," says Gökhan Bugday, the airport's chief executive – echoing prime minister Recep Tayyip Erdogan, who sees air travel as a symbol of progress and prosperity.

He argues airlines can be lured from the bigger Ataturk airport not just by low prices, but with shorter taxi times and a faster turnround at peak times.

But Sabiha Gökçen has had problems at peak hours in the old terminal trying to meet airlines' demands for flight connections with a shorter gap than it can physically manage, leading to chaotic scenes at departure. Shedding a low-cost image looks challenging. Pegasus, which uses Sabiha Gökçen as its main base, is a fast-expanding no-frills carrier. Most airlines listed on the airport's website also fit that category.

Sabiha Gökçen's management says Turkish Airlines' presence will be crucial to attract other flag carriers: they delayed the terminal's opening to coincide with the launch of new THY routes. But Temel Kotil, THY's chief executive, is less enthusiastic about the terminal, saying: "We don't have great plans for it."

Ebru Özdemir, a board member of Limak, sees the airport's fortunes rising with those of the city – and in particular its less developed Asian side.

She rattles off the names of companies due to move to the more residential shore of the Bosphorus – including state-owned banks set to relocate from Ankara – and of multinationals such as Unilever and Procter & Gamble already installed.

Istanbul's attractions go beyond its romantic skyline, she suggests, saying the consortium had declined an offer from a private hospital to set up a diagnostic centre in the old terminal building – ready to receive medical tourists from Russia or former Soviet Union countries.

In a more glamorous anecdote, she says the director of the new Abu Dhabi Guggenheim museum chose to hold meetings in Turkey so both US and Middle Eastern visitors could get visas. "Istanbul is becoming more of a magnet," she says.

Low interest rates call for new strategy

BANKING

Delphine Strauss says that this year's windfall profits are unlikely to be matched over the next few years

"We were caught by the crisis with our seatbelts fastened," says Suzan Sabanci Dincer, Akbank's chairwoman, in a fair summary of the ease with which Turkey's banking sector has withstood the shocks of the past two years.

Due to reforms enacted after a previous banking crisis, Turkish banks – Akbank among them – entered the downturn with enviable capital cushions, no exposure to toxic derivatives and with the bulk of their funding coming from a stable deposit base.

In the year to September, net profit for the sector as a whole was 41 per cent higher than in the same period of 2008, according to figures from the banking regulator. Banks continued opening branches, although at a slower pace than planned, keeping staff numbers broadly flat despite stringent cost-cutting.

But much of that was thanks to the central bank's decision to counter the recession by cutting interest rates by more than 1000 basis points in a year.

Because Turkish banks can generally adjust their own rates on deposits faster than on loans, a year of monetary easing has boosted their margins and produced windfall profits.

"The net interest margin is the most important determinant of profitability for Turkish banks and so far it has been moving in their favour," analysts at Fitch Ratings wrote recently.

Now, with the overnight borrowing rate at a historic low of 6.5 per cent, the central bank appears to be nearing the end of its easing cycle. As their margins narrow, banks are likely to be even more wary in lending to companies and consumers struggling through one of the deepest recessions in the region.

Tefvik Bilgin, head of the banking regulator, has warned banks are unlikely to match 2009's profits for some years after. "The damage to the real economy makes us very cautious," Ms Sabanci Dincer says.

Loans by Turkish banks grew 30 per cent in 2008, but were roughly flat this year, and she expects muted growth of just 12 per cent in 2009, as well as tougher lending criteria.

The prospect of interest rates remaining low for an extended period, however, may demand a more fundamental shift in behaviour from both lenders and savers, who for decades have been accustomed to double-digit rates of return.

"This is something we've never lived through," says Namik Aksel, chief executive of HSBC Asset Management in Istanbul.

Turkey's habitual crises always involved the lira crashing, high inflation and interest rates, "so investors are risk-averse," he notes.

Now, Ms Sabanci Dincer says: "The banking model in Turkey is changing."

For high street banks, fee income will become more important, while their clients may be tempted by more adventurous options for their investments than short-term cash deposits.

That will mean training bank branch staff in asset management, she says.

"We have to educate our clients – they have to know where they're investing. Until now, they go to see the bank manager . . . they have coffee, bargain over the interest rate, and it's done. Now, if you don't explain different asset classes, it'll backfire, he won't be happy."

If that shift does occur, the implications are big – one peculiarity of Turkish capital markets is the near-absence of retail investors, especially in equities.

Although Turks can invest in shares simply by walking up to a cashpoint and picking from a choice of funds, most view the stock market as the preserve of speculators. One result is that pension funds remain puny next to emerging market peers.

Mr Aksel says 75 per cent of household savings go to cash deposits at present, with just 4 per cent invested in equities – and rich families buying stock in their own companies account for most of that.

The total equity exposure of domestic institutional investors was TL1.7bn ($1.14bn) at the end of

> Until now, [clients] go to see the bank manager . . . they have coffee, bargain over the interest rate, and it's done.'
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> **Suzan Sabanci Dincer, Akbank chairwoman**

August 2009 – just 2 per cent of the Istanbul Stock Exchange's free float.

Yet there have been inflows in recent weeks to HSBC Turkey's equity funds – even if these are still a very small proportion of the total under management, Mr Aksel says.

He has also seen shifts from cash deposits into fixed-income funds, and says HSBC is exploring new commodity-based funds after trebling its gold fund in three months.

"The structural case for equities remains strong as long as real rates stay in mid single-digit levels over the next few years," Ali Riza Incekara, analyst at BGC Partners wrote in a recent strategy note.

"Mutual funds and pension funds are likely to be the primary vehicles for domestic retail investors in shifting their portfolio," he adds.

"Before the 2001 crisis, interest rates were 'low' at 30 per cent and people were going into equities – retail investors were the last in. People got hurt very badly and never wanted to go back," Mr Aksel says.

"This time, we feel it's going to be different."

Change in drug prices prompts heartache

PHARMACEUTICALS

Pelin Turgut examines the effects of electorally popular healthcare changes

Amidst the debate over Islamism, a key driver behind the landslide re-election won by Turkey's government in 2007 went unnoticed: healthcare reform.

Starting in 2005, the Justice and Development Party (AKP) enacted a series of IMF-sought changes to rein in a sprawling social security system, broaden access to quality healthcare and improve the regulatory environment for manufacturers.

"Newspapers no longer run those tragic pictures of people waiting in line in front of public hospitals because those queues no longer exist," says Serkan Tarmur, a partner in PwC Turkey and co-author of a recent sectoral survey. "Anybody can now get treatment, even in private hospitals and the state will reimburse the hospital for it. This has been a radical, successful reform and it was an important factor in the government's re-election."

It was almost too successful. By October, the Health Ministry had already spent the TL12.5bn ($8.3bn) allocated for pharmaceutical expenditures in 2009, jeopardising budgetary targets in a tight fiscal year. The prescription drug market grew nearly 10 per cent last year to $9.4bn and is expected to maintain that growth rate to become one of the world's top 10 largest markets in the next decade. "Even in a year of financial crisis such as this, healthcare costs have increased because access has become easier and state insurance coverage is wider," says Mr Tarmur.

To stem rising costs, the government issued an overnight decree in September that would change pricing and has multinational manufacturers up in arms.

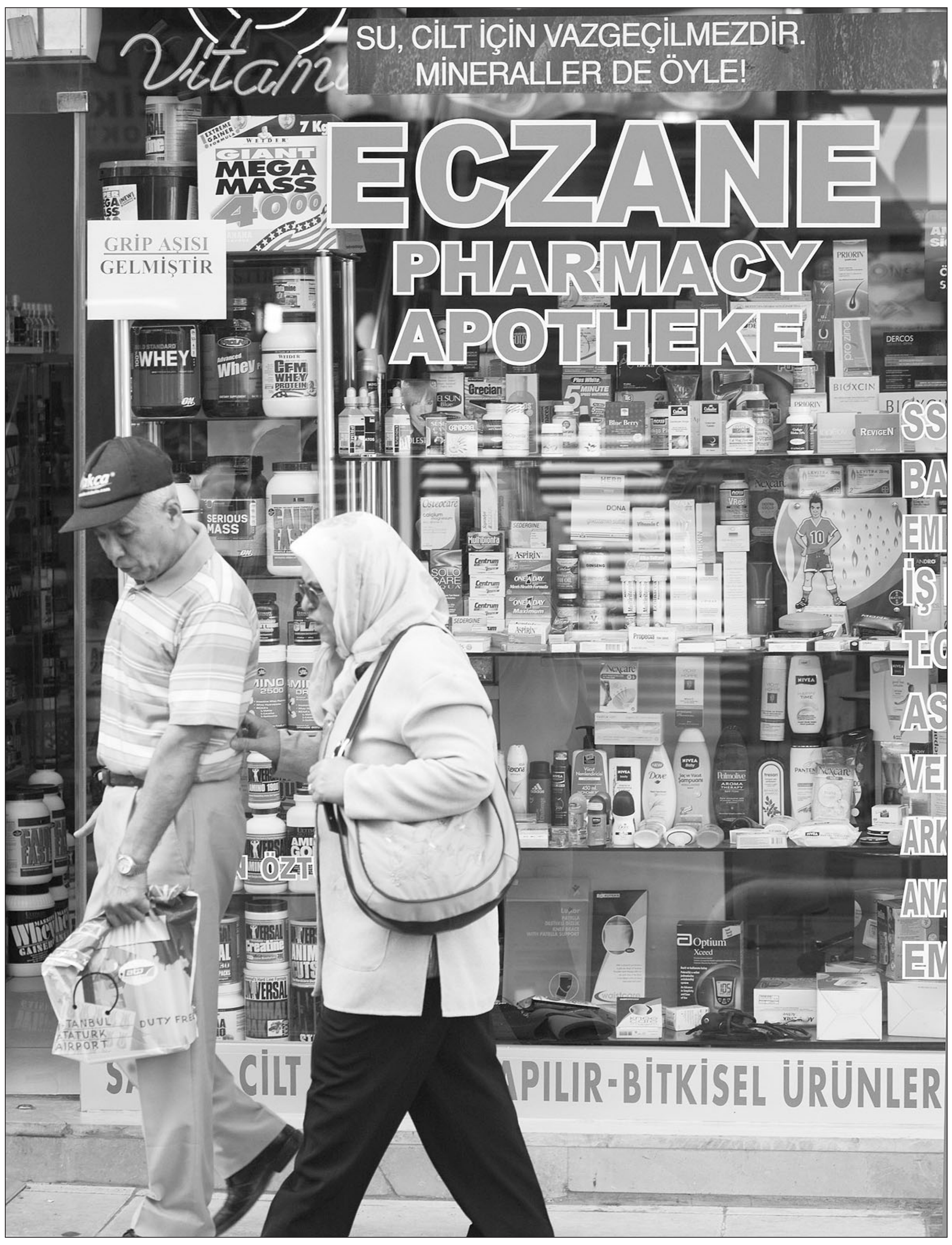
Under the present system, the Ministry of Health sets the retail price of medicine as well as the rates by which pharmaceutical companies can increase their prices. Since 2004, the price for an original pharmaceutical has been based on the lowest ex-factory price found in five reference countries – France, Greece, Italy, Portugal and Spain. The prices of original and generic products were then capped at 100 per cent and 80 per cent of the reference price, respectively.

The September decree changed that dramatically. Prices on both original and generic drugs can now be no higher than 60 per cent of the reference price. "All of a sudden, the rules have changed," says Engin Guner, deputy head of the Association for Research-based Pharmaceutical Companies (AIFD).

"Business and investment plans for 2009 and 2010 were made before this new price decree. If this regulation takes effect as is, it will be very hard for the sector to fulfill its investment potential." Drug expenditure in Turkey at $136 per person is already low compared with the OECD average, he said, estimating that 75 per cent of proposed cost-cutting would be from original pharmaceutical manufacturers. In a recent survey, 84 per cent of AIFD members said the proposed change would stop new capital or production investments, while more than half said at least 20 per cent of jobs would be cut.

The state is a key force in more than one respect. More than 80 per cent of all drug purchases are reimbursed by the social security institution, with the remaining nearly 20 per cent of public sector employees similarly state-reimbursed through the Finance Ministry. Private health insurance is negligible, accounting for 1.2m people out of a 75m population last year.

The pressure to keep healthcare costs down is likely to boost the



Local support: small pharmacists have run a campaign to encourage people to buy generic drugs Alamy

generic drugs market. "There is a move towards generics on the part of the government as an important cost-saving measure," says Mr Tarmur. Turkey has a strong generics manufacturing tradition, accounting for 53 per cent of unit sales last year. There are several large, well-established companies and they are being courted by foreign investors. In July, Pfizer was rumoured to be interested in the takeover of generics market leader Abdi Ibrahim.

> Multinational generics manufacturers have not yet come to Turkey mainly because of the financial crisis

Local industry also has support in the form of the vocal Turkish Pharmacists Union, who recently ran a successful campaign to buy generic that resulted in several multinational companies increasing discounts on their brands. (All pharmacies in Turkey are individually owned, there are no chains.)

Opportunities for new investment are also helped by the fragmented structure of the local market – the top 10 companies together account for less than half of sales. "The large multinational generics manufacturers haven't yet come to Turkey mainly because of the financial crisis, with the exception of Zentiva [which bought 75 per cent of Eczacibasi's generic pharmaceuticals business in 2007]. But talks with various companies are ongoing. They will wait for the market to settle after this price change and then act," says Mr Tarmur. In a recent PwC survey of pharmaceutical manufacturers and private equity investors, more than 40 per cent cited regulatory uncertainty as the main barrier to investment.

For its part, the government delayed enactment of the price change to December, suggesting there may be revisions. But it is unlikely to be annulled altogether, signalling that a period of restructuring for pharmaceutical manufacturers is yet to come.

Success of oil pipeline depends on whims of Moscow

ENERGY

Government wants to ease traffic on the Bosphorus, says David O'Byrne

At 30km long but just 700m wide at its narrowest, Istanbul's Bosphorus strait is one of world's most crowded and potentially hazardous waterways, where even with state-of-the-art radar monitoring, transiting ships are still obliged to take on a pilot.

Fringed with forests and villages on its upper reaches, and the palaces and mosques of Istanbul at its lower end, it is also one of the most beautiful.

It is no surprise then that with oil tanker traffic through the straits having more than doubled since 1995 and expected to double again in the next decade on the back of fast-rising oil production in Russia and the Caspian basin, Turkey is keen to provide an alternative export route.

"Traffic through the strait already presents an unacceptable risk to the population of Istanbul, and any oil pipeline that can relieve the pressure will be welcome," says Burak Ozugergin, spokesman for Turkey's foreign ministry which has long warned of the dangers posed by too much tanker traffic.

Turkey's own proposed solution is the Samsun-Ceyhan, or Trans Anatolian pipeline, planned to carry oil from Turkey's Black Sea coast, 550km across the country to the Mediterranean coast, bypassing the crowded Bosphorus.

Sponsored by a consortium of Turkey's Calik Enerji and ENI of Italy it is designed to carry up to 1.5m barrels per day.

It is also expected to help kickstart a new petroleum refining, petrochemicals and manufacturing sector at the Mediterranean port of Ceyhan, which Turkey has long harboured ambitions of turning into a major regional energy hub.

However despite presiding over a ground-breaking ceremony at Ceyhan in 2007, Calik and Eni have struggled to secure sufficient commitments of oil to ensure the line will be commercially viable.

Eni can supply oil from the giant Kashagan field in Kazakhstan which it is developing in partnership with Kazakh state oil company KazMunaiGaz, but the line also needs oil from Russian or Kazakh producers.

Support has been slow in coming, however, with Russia having long backed a rival project to build a pipeline through Bulgaria and Greece – a far shorter route, and Kazakhstan having

> 'Shipping oil by tanker through the strait will always be cheaper than any pipeline'

long declined to commit to any of the competing schemes.

That situation has now changed with a recent agreement between Turkey, Italy and Russia committing the three countries to work together on this and other regional energy projects.

Russian prime minister Vladimir Putin also announced that he had secured Kazakh support for the project – a claim yet to be confirmed by Almaty.

It is an important step, but there is still no definite commitment of oil to the Samsun-Ceyhan line.

"Negotiations are still continuing with both Russia and Kazakhstan," a spokesman for the Calik-Eni consortium told the FT.

It is also a step that confirms that Moscow can make or break the project.

"Shipping oil by tanker through the strait is always going to be cheaper than any pipeline," says John Roberts, Caspian analyst at Platts.

"Ultimately Russia controls the oil routes from the Caspian to the Black Sea, and only Russia can ensure the line has enough oil to make it viable."

Such a move by Russia would come at a price, he cautions, pointing out that the recently signed agreements make only one definite commitment – for Turkey to allow ENI and Russia's Gazprom to conduct a feasibility study for a bypass line of their own.

They plan to construct that line, the South Stream gas pipeline, across the Black Sea to export Russian gas to Europe, by-passing Ukraine which has previously attempted to leverage its location on Russia's gas export route to obtain cheap gas.

Russia is also hoping to co-operate with Turkey on other pipelines, including a second gas line across the Black Sea and an extension of an existing gas line south across Turkey to Ceyhan and on to Israel that would also allow for the development of gas-based industries at Ceyhan.

Links growing beyond aid and smuggling

IRAQ

Alex Barker says the country's long-term relationship with its war-torn neighbour is an opportunity

The Taq Taq oil field in Iraq's self-ruled Kurdish region: Turkish companies have been forced to halt production following a dispute between the Kurds and Baghdad AFP

Pass a big construction site in Erbil, Suleimaniya or Dohuk – the booming cities of Iraqi Kurdistan – and it is most likely that the workers will be toiling away for a Turkish company.

In good times and bad, merchants from Turkey have beaten a path over the long, mountainous and disputed border with Iraq, looking to sell their wares or tap the region's great and largely unrealised commercial potential.

From oil to construction, Turkish entrepreneurs have amassed some of the political clout and business hardiness necessary to cope with the Kurdish region's rocky regulatory terrain – turning them into valued partners for others.

When European or US companies are contemplating a move into Iraqi Kurdistan, their first port of call is often Istanbul. "It is simple logic for everybody to turn to Turkey for support," says Ercüment Aksoy, head of the Turkish-Iraqi business council. "We are the pioneers."

It marks the maturing of a cross-border business relationship that has long survived in spite of politics, from the oppression of Saddam Hussein to the peaks of Kurdish separatist violence in Turkey.

For many years, the flow across the border mainly amounted to food (often aid), Turkish troops, units of the rebel Kurdish Workers Party insurgents and hidden loads of "mazout" – illegal smuggled fuel.

Now Turkey is preparing to open two more border gates and a consulate in Erbil – an unthinkable political step five or 10 years ago. International oil companies are working in tandem with Turkish groups to legitimately pump oil across the border. There is even talk of reviving the great Ottoman dream of a railway linking Baghdad and Berlin via Istanbul.

Ahmet Davutoglu sealed this diplomatic progress in October by making the first ever visit by a Turkish foreign minister to the Kurdish region, flanked by dozens of businessmen. Mr Aksoy says the visit was "important for business".

"To have a consulate and the presence of the government will make it easier in all our areas of work," he says. "Diplomatically, rather than standing back to back, we're now hand in hand. This is a great opportunity."

To date construction has been the dominant business area. Big public infrastructure contracts – from airports and universities to roads and new housing developments – have invariably gone to Turkish groups able to draw on a skilled, often ethnically Kurdish workforce that are willing to tolerate a tough and sometimes dangerous working environment. A further $180m road-building contract was awarded to Yüksel Insaat last month, a group with experience in construction projects from Kabul to Qatar.

But those seeking their fortune in Northern Iraq tend to be firmly focused on the region's abundance of oil. Development is still severely hampered by the lack of export routes, legal uncertainty and wrangling between Erbil and Baghdad over sharing oil revenue.

Two Turkish companies – Genel Enerji and Petoil – were again among the first to attempt to overcome these obstacles, taking poll positions in key concessions. Both are also now examples of Turkish groups acting as a bridgehead for international investors – a rough model of co-operation that could apply to many other sectors as the region's economy develops.

Genel Enerji, owned by the powerful Cukurova group, is in partnership with Heritage Oil of the UK and has plans to merge, should the deal be given a green light by regulators and the Kurdish authorities. Meanwhile Petoil, which secured licence agreements in Northern Iraq a few months before the US invasion, is now working with Prime Natural Resources of the US and Oil Search of Australia to develop fields.

Yet the problems faced by these energy groups underline how difficult and unpredictable business can be in northern Iraq. Genel in recent months has been forced to halt production from its Taq Taq field following a dispute between the Kurds and Baghdad over payment mechanisms, dealing a serious blow to its cashflow.

There is evidence of similar problems in areas such as construction. Ilnur Çevik, a former newspaper proprietor and businessmen who worked in northern Iraq, says the risks of working in such a fledgling economy are often unbearable.

"There was no proper planning, no proper supervision, everything was arbitrary, and you have to deal with corruption," he said. "On paper it looks very nice. But the reality is sometimes very different."

But Joost Hilterman of the International Crisis Group argues such cases are the expected commercial casualties of a tricky working environment. "Business and Turkish investment is booming. There are of course cases where the relationship has soured on an individual basis," he says "The Kurdish region does not have a banking system or a regulatory system. Investors are not the majors [international companies], they are smaller companies that are the big risk-takers. Considering that, the situation is not bad at all."

Meanwhile Kurdish authorities are looking to court more established companies, meeting with dozens of big hitters in Turkey's business community.

Safeen Dizayee, spokesman for the Kurdish Democratic Party, says the relationship must move beyond "flooding our markets with Turkish goods" and building infrastructure to more inward investment and outward exports. "We had lots of cowboys coming in, not finishing projects, disappearing with advance payments. Now we're looking more at serious companies," he says.

BC deal tests water for private equity

MIGROS

Martin Arnold says debt-funded acquisitions are becoming attractive

As a Greek dealmaker who oversaw Turkey's biggest private equity acquisition, Nikos Stathopoulos is used to breaking new ground.

Now the managing partner at BC Partners hopes to set more precedents at Migros, Turkey's biggest supermarket group, which was bought by a BC-led consortium in a $3.15bn deal last year.

Mr Stathopoulos says the 1,300-store chain is growing strongly and bucking the trend of falling sales and profits that has hit many private equity-owned companies since last year's collapse of Lehman Brothers.

Mr Stathopoulos, who led the Migros acquisition, says it has proved resilient to a fierce recession in Turkey's economy, which is expected to contract by about 6-7 per cent this year. "That is mostly due to the defensive characteristics of food retail, as people still have to eat," he says.

The BC executive says that since Migros was bought by a consortium of BC, Turkven, and Italy's DeA Capital, it has been taking market share from its rivals, thanks to its full range of store formats, such as 5M hypermarkets, Migros supermarkets, and Sok discount stores.

As customers have shifted away from the more upmarket supermarkets, such as Macrocenter, they have spent more in discount stores, such as Sok, says Mr Stathopoulos.

"As we have five brands in different formats, we have experienced growth in all formats and can address consumer needs from different directions," he says. "Sok is performing particularly strongly as people are trading down in times of recession."

In addition, organised retailers, such as Migros and its smaller rivals Carrefour and Tesco, have increased their share of Turkey's food retail market from traditional Bakkal "mom and pop" stores.

Supermarkets and other organised retailers still control only 40 per cent of Turkey's food market, compared with about 80-90 per cent in most western European countries, so there is more room to grow, argues Mr Stathopoulos.

Another driver of growth at Migros is Turkey's healthy demographic growth, which contributed to a 1.3 per cent rise in its population last year to 71.5m people, more than half aged under 30.

In the six months to June, Migros revenues rose by 13 per cent to TL2.68bn ($1.8bn), while its earnings before interest, tax, depreciation and amortisation increased 8 per cent to TL192.4m.

Mr Stathopoulos says Migros has opened 250 stores in the first nine months of this year and aims to reach 3,000 outlets by the end of BC's five-year plan.

The second way that BC hopes Migros will be a pioneering deal is by becoming Turkey's first private equity-owned company to benefit from the tax-deductibility of its interest payments, although it is unclear if this can be achieved.

This benefit, which generates tax-savings for private equity-owned companies, is a common feature of leveraged buy-outs in the US and Europe, but has not been tested in Turkey before.

> The credit crisis could throw up more opportunities, as Turkey's rich families are forced to sell assets to raise capital

In preparation for the possible move, the $1.5bn of debt used to finance the initial buy-out of Migros has been transferred from the acquisition vehicle to the operating company.

The final way that the BC boss hopes the Migros deal will break new ground in Turkey is to become one of the first companies to benefit from a proposed law to allow squeeze-outs of minority shareholders.

BC owns 98 per cent of Migros shares, but has been prevented from taking it private by the lack of a squeeze-out law, forcing it to keep publishing full quarterly results.

"Turkey is modernising and coming in line with the rest of Europe," says Mr Stathopoulos. "This should boost mergers and acquisitions by private equity and inward investment in Turkey."

Other big private equity groups that have invested in Turkey recently will be watching closely to see how BC fares in its push to improve the rules for private equity in the country.

Big private equity deals in Turkey have included TPG's acquisition of a controlling stake in Mey Icki, Turkey's biggest producer of spirits including Raki, the country's most famous tipple, in a deal worth about $810m in February 2006.

Kohlberg Kravis Roberts announced its first private equity deal in Turkey in October 2007 with the acquisition of UN Ro-Ro, a cargo shipper that ferries trucks between Istanbul and Italy, in a transaction put at €910m.

In the media sector, Providence Equity bought almost 50 per cent of Digiturk, the country's largest digital television broadcaster, three years ago.

The credit crisis has slowed buy-out activity in Turkey – like much of the world – with only two private equity deals so far this year, compared with six last year, according to Dealogic.

But there are signs that private equity is regaining its appetite for Turkish deals as Bridgepoint last month offered to acquire a 33 per cent stake in Tüvturk, a vehicle inspection company.

The credit crisis could throw up opportunities, as rich families, such as the Koç family (which sold Migros) and the Dogan family (which faces a $3.3bn tax fine), are forced to sell assets to raise capital.

"Some of these families or corporates are overleveraged, may have debt maturing soon that needs repaying, or may want to improve their capital structure, so I expect there will be some potential disposals coming out of them," says Mr Stathopoulos.

Contributors

Delphine Strauss
Turkey Correspondent

Martin Arnold
Private Equity Correspondent

Alex Barker
Political Correspondent

David O'Byrne
Pelin Turgut
FT Contributors

Tom Griggs
Commissioning Editor

Steven Bird
Designer

Andy Mears
Picture Editor

For advertising details, contact:
Regina Gill
Phone +49 69 156 85 16
Email : regina.gill@ft.com

Government wary of temptations of Bacchus

WINE

Political attitudes make for a challenging investment climate, says **Pelin Turgut**

Although home to one of the world's earliest wine-producing regions – dating back 4,000 years – Turkey's wine offerings were low on variety and uninspiring until just a few years ago.

A state-run alcohol monopoly and two companies – Kavaklidere and Doluca, founded at the same time as the republic in the 1920s – dominated a lacklustre market. Then there were a handful of lesser brands, known colloquially as "dog-killers". Vintage year or grape variety were little-known details and hardly mattered.

Those days are receding. A combination of industry liberalisation, a slew of wealthy executives investing in boutique vineyards and innovation by the US-educated scions of established wine-makers is helping to revitalise an ancient tradition.

Turks can now count a number of homegrown grape varieties, such as the dark, tannic Bogazkere, fruity red Kalecik Karasi or delicate Narince, technology has improved and international buyers are taking note. "What I saw in vineyards and cellars suggests it will not be long before Turkey produces something truly exceptional," said well-known wine critic Jancis Robinson, who writes for the FT, after a recent visit.

After all, the Turkish wine industry would appear to have huge potential: the country is the world's fourth-largest grape grower, it has favourable climate and soil conditions, nearly 1,000 indigenous grape varieties and a large, youthful population – more than half of 70m are under the age of 35 – with rapidly urbanising palates. Alcohol sales rose by 19.5 per cent to more than 1.1bn litres last year.

Yet businesses are faltering. Wine producers accuse the government of failing to support the nascent industry, chiefly through a tax levied since 2002, which is among the steepest in the world when measured against per capita income.

Wine taxes now amount to €0.80 per litre, compared with a European average of €0.48 per litre. "The tax has made wine very expensive, which has reduced consumption and brought the 12-15 per cent annual sectoral growth we saw in the early 2000s to a standstill," says Sibel Kutman, a member of the board at Doluca.

More recently, an advertising ban took effect in July making it illegal to promote alcohol in association with food, Turkish cultural or historic values, or – in vague wording – in a way that might appeal to youth.

"The government has adopted an attitude of passive resistance," says Resit Soley, a prominent architect-turned-vintner who owns the up-market Corvus label. "It doesn't kill you, but it saps your strength. It is an exhausting constant struggle."

> 'It is a great market, both in terms of its vineyards and a large, youthful consumer population'

Due to Muslim prohibition, under Ottoman rule, wine-making was traditionally the province of the empire's Christian Greek and Armenian subjects. When the Empire collapsed in the 1920s, most of its non-Muslim minorities left, taking their expertise with them.

It was the plight of abandoned vineyards on the Aegean island of Bozcaada that prompted Mr Soley to turn to wine-making. "I've had a house on the island for 20 years," he says. "I could see a tradition dying out and I wanted to save it." His Corvus label produces about 300,000 bottles a year, several of which have won international awards. He began exporting last year to counter a slowdown in domestic sales he attributes to high taxes. "My goal now is to sell nine out of 10 bottles abroad," he says. "That's the only way to circumvent the tax dilemma here."

The republic's westernising founder Mustafa Kemal Ataturk famously enjoyed a tipple and kept a wine cellar. But some 80 years later, his successor, Prime Minister Recep Tayyip Erdogan, a devout Muslim, abstains, as do most members of his cabinet. AKP mayors in various municipalities have tried periodically to ban alcohol sales.

"The official attitude is less than friendly," says Mr Kutman. "For a country on the road to EU membership, there is no desire to officially promote Turkish wine or to see wine as a national product."

The market was liberalised in 2001 when a state monopoly on alcoholic beverages was lifted and private sector wine imports freed up. A market watchdog, TAPDK, was established in 2002 to regulate the industry. A private consumption tax was introduced the same year, at a rate of 48.7 per cent on fresh grape wine. Over the next three years, it was raised to 63.3 per cent. Imports are taxed further – 50 per cent on European products, 70 per cent for other countries.

About half the sector's revenues are paid out in tax – more than TL3bn ($1.9bn) last year.

"All I'm asking for is fairness," says Mr Soley. "As it stands, I have to pay tax on my product two weeks after I've invoiced it. But I get paid by supermarkets and suppliers weeks, even months after they receive an order."

As Turkish wines make their mark abroad, foreign investors such as Piero Antinori and Frescobaldi have visited to look into vineyards. "On one level it is a great market," says Mr Kutman. "Both in terms of its vineyard opportunities and a large, youthful consumer population.

"But there is a big question mark over the political attitude. That makes investors wary."

Rising quality: men carrying grapes to market in Murefte Getty

Volumes rise, spending falls

TOURISM

Delphine Strauss asks if all-inclusive hotels are good for the health of the industry

Eight and a half tons of fireworks; enough caviar to fill a private jet; and a guest list ranging from Sharon Stone and Tom Jones to the prime minister of Uzbekistan: last May's launch party opening the Mardan Palace hotel in Antalya was nothing if not lavish.

The hotel, complete with gold-plated bathrooms and a five acre swimming pool, is the creation of the Azerbaijani billionaire Telman Ismailov, the latest oligarch drawn to the Mediterranean province already popular with high-spending Russians.

Its vast premises are typical of a trend in Turkey's coastal resorts towards hotel complexes that can accommodate tourists on all-inclusive packages.

Less typical is its extravagance: local businesses have long complained that package deals drive down prices and quality, attracting only the most impecunious holidaymakers.

"Small shopkeepers are dying because of the all-inclusive hotels. People don't eat outside, they don't buy outside. Shops are closing in Side," says Tuncay Tuksal, who once owned seven shops selling vivid carpets in the beach resort.

> 'The all-inclusives have helped Turkey overcome the economic crisis but we have to look to the long term'

He now owns only two, both inside five star hotels, and earns money through exports.

Yet Turkey's image as a low-cost, short-haul destination has served it well this year, as crisis-conscious Europeans seek to cut holiday spending.

Foreign visitor numbers from January to September were 1.5 per cent higher than in the same period of 2008, which is striking, given sharp falls elsewhere around the Mediterranean.

The latest data suggest Turkey has benefited in particular from British tourists opting to holiday outside the eurozone because of the weak pound, a trend confirmed by bookings at tour companies such as Thomas Cook and TUI Travel.

But the flow of visitors is little consolation to businesses losing money as tourists shorten their stay and scrimp on extras such as tours or seafront dining.

Revenues from foreign visitors, $16bn in 2008, fell 8.4 per cent year-on-year in the first nine months of 2009. Measured in Turkish lira, the drop is milder, but industry associations expect the trend to continue to the end of 2009.

Tour companies say Turkey is popular not just because it is cheap, but because of the price-quality ratio, modern accommodation and range of activities.

Official data show that, although aggregate tourism revenues rose steadily up to 2008, foreigners' average expenditure has been falling for years, peaking at $706 in 2003 and declining to $635 by 2008. It has averaged $573 so far this year.

The decline could be partly due to shorter stays, as Istanbul becomes a popular weekend destination.

But Faruk Boyaci, a board member at the industry association Turob, says: "Tourism on the coast is losing... This year the all-inclusive system has helped Turkey overcome the economic crisis, but we have to look to the long term."

"It's a big problem for us," says Cumhur Guven Tasbasi, a senior official at the ministry of culture and tourism. He says the ministry is working on new regulations that will impose tough supervision even on big, top-end hotels offering all-in deals. "We may even ban them for smaller hotels," he adds.

But he gave no details of how such a ban could be implemented, and said well-run packages protected tourists from grubby eateries and shopkeepers' sharp practices. Rather than abolishing the system, the government may focus on incentives to drive coastal tourism upmarket and develop niches such as sports or spa holidays.

Ertugrul Gunay, culture minister, is considering cuts in sales and consumption taxes on tourism, Turkish media reported last week.

In August, Recep Tayyip Erdogan, the prime minister, promised tax breaks for yacht owners flying the Turkish flag, as he opened a marina at the Aegean port of Didim.

Investors, though, may be turning their attention away from Turkey's coast. The Limak group, which owns popular beach resort hotels, is building a complex in northern Cyprus, whose casinos attract Turkish, Israeli and Greek Cypriot tourists. In Turkey, it is now focusing on four-star city hotels, a market it thinks under-served.

Even the Mardan Palace is not immune to the tough economic climate. Soon after the launch party, a vast market owned by Mr Ismailov in Moscow was shut down by police citing health regulations.

Russian commentators speculated that the ill-timed display of wealth in Antalya had angered the authorities.

The hotel is now offering cut-price rooms for the next public holiday, and Turkish media report its staff have sought help from unions over unpaid salaries.