A maturing market

Noyan Turunç and Kerem Turunç of TURUNÇ provide an overview of recent developments in the Turkish private equity market

The authors wrote in *IFLR's 2012 Guide to Turkey* that the private equity market in Turkey is maturing and Turkey is on track to become a key investment market for private equity funds. Despite some recent media coverage of the market indicating an environment of increased difficulty in closing deals, the authors believe that this phenomenon is not endemic to the market and that the Turkish private equity market is likely to expand even further in the long run.

A tale of numbers

Private equity investors have gradually become more eager to make investments in Turkey over the last several years. Among other factors, this is due to an increased awareness of the potential in the country and the perception that Turkey has been representing an opportunity for high growth. Having said that, the development of a robust private equity market in Turkey will, of course, take some time.

Just a decade ago, there were barely any private equity deals in Turkey, with an estimated investment per annum of around $30 million between 1995 and 2005. Although there has not been a consistent increase in deal volumes since, as can be noted from the following chart, the general trend over the last few years is encouraging.

Year	Private equity deal volume
2006	$2.2 billion
2007	$2.3 billion (~0.5% increase)
2008	$4.9 billion (~113% increase)
2009	$0.7 billion (~86% decrease)
2010	$0.9 billion (~29% increase)
2011	$1.2 billion (~33% increase)
2012	$1.6 billion (~33% increase)

Sustained economic growth is likely to help to maintain and increase this deal flow, and enhanced laws are likely to contribute positively, too.

A (virtually) level playing field

Turkish law essentially imposes no investment restrictions specific to private equity investments. The same is true for club deals, which are normally governed by general legal principles. Further, subject to certain limited restrictions and disclosure requirements on foreign ownership – such as in the media, financial and real-estate sectors – foreign investors can freely invest in Turkish companies and are accorded the same rights as Turkish persons. Because a large component of investor confidence, private equity and otherwise, is the legal framework available in the market, this level playing field is one that should not be underestimated when comparing the Turkish market to others in the region and other emerging markets.

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A new law

Turkey's new commercial code (Commercial Code) entered into force in July 2012. The Commercial Code is the primary law that governs the operation of companies and brought significant changes, many of which are likely to aid private equity transactions.

Better corporate governance practices and enhanced transparency are two of the major pillars of the Commercial Code. Accordingly, the Commercial Code introduces extensive corporate governance and transparency requirements. In the same vein, the responsibility of the board for company records and operations, as well as directors' accountability over them, have been significantly expanded and effectively brought in line with international standards.

For private equity funds looking to invest in Turkish companies, in particular small to mid-size ones, one of the most worrisome considerations has historically been corporate governance practices, which lag behind European standards. Some of those practices are inadequate bookkeeping standards, the lack of consistent and easy-to-understand financial statements, tax non-compliance, unrecorded transactions, and high levels of transactions with shareholders and other related parties. Accordingly, many private equity funds have found that conducting due diligence on, and valuing, certain Turkish companies are often difficult and expensive tasks. Also, they have often found that post-closing risks are sometimes unpredictable or intolerably high. Many deals in Turkey never see past their preliminary stages due to these complications – a fact which partially explains the relatively small number of closed deals compared to the number of private equity players active in the market. Starting in 2013, however, essentially all Turkish companies operating in the financial sector, as well as other companies of a certain size, will be required to prepare financial statements using Turkish accounting standards based on international standards, and these statements will be required to be audited by independent auditors. With the exception of certain types of entities (for example, national newspapers) which are subject to lower thresholds, the basic rule is that a company must meet or exceed any two of the following three thresholds for two consecutive years (starting with 2011) to be subject to this requirement: a net asset value of TRY 150 million ($83.9 million); net annual revenues of TRY 200 million; and a workforce of 500. This change is expected to help private equity investors as they will find it much easier to read their potential targets' financials. The government's goal is to lower these thresholds over time so that eventually virtually all Turkish companies, except perhaps the smallest ones, are subject to the same general accounting and audit standards. This would make the financial statements of Turkish companies easier to understand for private equity investors and also increase the appetite for minority investments.

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There are certain other welcome changes in the Commercial Code. For example, a parent company, provided that it holds at least 90% of the shares and voting rights in a subsidiary, is now permitted to squeeze out a minority shareholder of such subsidiary if the minority shareholder 'prevents the operation of the company, acts against the principle of good faith, creates discernible hardship or acts recklessly'. The purchase price for the squeeze-out will be the prevailing trading price, if the company's shares are listed on a stock exchange, or the true value or a price calculated under a generally accepted method, if the shares are not traded on an exchange or if the trading price is not fair. The Commercial Code contains another squeeze-out method pursuant to which the merging entities in a merger transaction may decide in the merger agreement to either:

- pay a cash consideration to the shareholders of the non-surviving entity *pro rata* to their shareholding interests, or
- offer to those shareholders the choice between: (a) such cash consideration, or (b) shares in the surviving entity *pro rata* to their shareholding interests.

In order for such a clause to be valid, the merger agreement needs to be approved by shareholders holding at least 90% of the voting rights in the non-surviving company. Both of these provisions are likely to help private equity investors, in particular when uncooperative small shareholders are in the picture. However, time will show how practical it will be to employ these provisions, which will depend to a certain extent on how courts will interpret them.

The Commercial Code brought into effect many other changes likely to be welcomed by private equity players. For example, single shareholder companies and single member boards are now possible, and legal entities will be permitted to hold

About the author

Noyan Turunç is a partner based in the Istanbul and Izmir offices of TURUNÇ, a full-service corporate law firm, established in 1990, with offices in Istanbul, Izmir and Ankara, and is the firm's founding partner.

Turunç is an expert in M&A transactions with decades of experience representing sellers and buyers, including private equity funds, in domestic and cross-border deals in a multitude of industries. His diverse practice covers many other areas, including banking and finance, restructuring and insolvency, project finance, competition law, labour and employment law, and tax. He has also litigated hundreds of cases in many areas, including with respect to corporate matters, competition law, labour and employment law, tax, and customs. He has represented domestic and international corporations and financial institutions in a wide variety of jurisdictions including Turkey, the EU, the US, Asia and Latin America.

Turunç is the author of many publications including the English-language books *The Law and Practice of Mergers and Acquisitions* in Turkey and *Turkish Labor Law*.

Before founding TURUNÇ, he was general counsel at Boeing Services (Turkey) and The Coca-Cola Export Corporation (Turkey).

Turunç received his LLB degree and his LLM degree (in competition law) from the Ankara University School of Law.

Contact information

Noyan Turunç
TURUNÇ

Maçka Caddesi 24/2
Tesvikiye 34367 Istanbul
Turkey

T: +90 212 259 4536
F: +90 212 259 4538
E: nturunc@turunc.av.tr
W: www.turunc.av.tr

board memberships (through a real person representative). Also important to note is that there are no restrictions on the citizenship or residence of directors or officers of companies. Further, it is possible to conduct online board and general assembly meetings, which is likely to decrease the cost and administrative burdens of being a foreign investor.

Another positive change is that privately-owned joint stock companies are now permitted to adopt a registered capital system. Previously, only public companies could do so. Further, the Commercial Code introduces the concept of 'conditional capital increases', pursuant to which the general assembly of the company will be permitted to conditionally increase the capital of the company to accommodate the exercise of convertible and similar debt instruments, and stock options of employees. One other welcome change is that share buybacks of up to 10% of the company's capital is now permitted (up to 20% in limited companies under certain limited circumstances).

A blow to acquisition finance

One change brought by the Commercial Code that is likely to be detrimental to private equity transactions is the prohibition on financial assistance. This prohibition was borrowed from Council Directive 77/91/EEC regarding the formation of public limited liability companies and the maintenance and alteration of their capital. Although that Directive was amended in 2006 by the today's Directive 2006/68/EC, the Commercial Code follows the original EC Directive by setting forth that a joint stock company may not advance funds, make loans or provide security, with a view to the acquisition of its shares by a third-party. The exceptions contained in the relevant article also follow the original EC Directive and are limited to transactions by banks and other financial institutions in their ordinary course of business, and transactions undertaken for the acquisition of shares by the employees of the company or the employees of one of its subsidiaries. These exceptions may not be used if they have the effect of reducing the reserves of the company below mandatory statutory thresholds or limits set by the company's articles of association. They also cannot be used if they prevent the creation of statutorily mandated reserves or the use of such reserves. Read broadly, which is generally agreed by practitioners to be the legislative intent of the article, this provision would essentially rule out the use of acquisition financing by a target operating company. One unclear issue is whether the prohibition also applies to limited companies (we believe it does), which for various reasons have not traditionally been the primary vehicle of choice in M&A transactions. It is also not yet known whether regulators will interpret the provision also to preclude alternative structures, for example the merger of the operating company with the holding company in a financed transaction.

In addition to the obvious practical problems the prohibition is likely to cause, what is troubling about it is that it is modelled after an outdated Directive. In any case, even under the original EC Directive, many EU members never extended the prohibition to privately-owned companies. Further, today's EC Directive was adopted because of the general view that European leveraged buyout (LBO) markets were being hampered by some of the heavy-handed provisions of the original EC Directive. Today's EC Directive permits companies (whether publicly or privately-owned) to provide financial assistance for the acquisition of their shares as long as certain conditions, such as arm's-length terms, the approval of shareholders, and the maintenance of prescribed net asset and reserve thresholds, among others, are met. The drafting of the Commercial Code began before today's EC Directive was adopted and its prohibition on financial assistance was never updated to be aligned with the new EC Directive. It would be recommendable to amend the form of the prohibition so that it applies only to public companies and so that financial assistance by such companies is subject to the safeguards contained in the current EC Directive.

A more appetite-whetting landscape

Turkey is a maturing market. The proliferation of private equity investments in Turkey is part of a larger macroeconomic story unfolding over the past few years. This is evidenced by high GDP growth, a relatively low inflation rate which has settled in after historical rates of near triple digits, a sizeable consumption-driven young middle class that stimulates growth and demand, and financing being abundantly available to private equity funds from local banks. The existence of a plethora of family-owned businesses of varying sizes across a multitude of industries that are worried about succession is further driving growth in private equity investments in Turkey. In addition, Turkey is increasingly being seen by outside investors as more attractive in light of the recent heightened economic instabilities experienced by the eurozone and the political quandaries of the Middle East.

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High-profile deals as well as successful exits over the last few years have diminished much of the historical scepticism on the part of targets and investors alike, and increased everyone's appetite. Today, there are well over 50 private equity firms exploring deal opportunities in the country, many of them with offices in Turkey. On balance, the Commercial Code is likely to encourage these private equity firms to do deals with Turkish companies. Enhanced transparency and new audit requirements will enable investors to consider a wider range of potential targets and evaluate them quickly and more economically. Access to information and improved corporate governance practices are also likely to make companies more attractive for minority investments, which are relatively uncommon in Turkey. As discussed above, if necessary amendments are made to some of its provisions and effective enforcement mechanisms are implemented, the Commercial Code will play a significant role in the country's flourishing private equity market. This is particularly true if awareness of Turkey's potential and the perception that Turkey represents an opportunity for high growth remain.

About the author

Kerem Turunç is a partner based in the Istanbul office of TURUNÇ.

Turunç is an expert in M&A transactions, including domestic and cross-border private equity investments. Among his many deals in numerous jurisdictions, including Turkey, the US and the EU, is the groundbreaking acquisition of Mey Içki by TPG Capital. He also regularly advises companies on corporate governance matters, and has extensive experience in capital markets transactions (under, among others, New York, English and Turkish laws) in many jurisdictions.

Before joining TURUNÇ, he worked in the New York and London offices of Cleary Gottlieb Steen & Hamilton.

Turunç received his JD from the University of Virginia School of Law where he was a Dean's Scholar, and his BA, with distinction, from Yale University. He has lectured at Harvard Law School, Kadir Has University Faculty of Law and New York University.

Contact information

Kerem Turunç
TURUNÇ

Maçka Caddesi 24/2
Tesvikiye 34367 Istanbul
Turkey

T: +90 212 259 4536
F: +90 212 259 4538
E: kturunc@turunc.av.tr
W: www.turunc.av.tr