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PANORAMA TURKEY

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INSOLVENCIES IN TURKEY

Disclosure of the exit strategy by FED Chairman Ben Bernanke in May 2013 triggered a new period marked by a change in the risk perception towards developing economies in financial markets. Turkey entered this period with a high current accounts deficit, a production sector substantially dependent on imports and three successive elections. The high level of forex debt burden and the import dependence make the corporate sector vulnerable to volatility in exchange rates and slowdown in domestic demand. In 2014, companies were able to resist to the sharp depreciation of the lira at the beginning of the year by sacrificing partly their profits. The sharp rises in exchange rates, which

started in December 2013, stabilized only after the Central Bank sharply reduced interest rates at the end of January. However, these rises in exchange rates continue negatively affecting company balance sheets. On the other hand, the credit restriction measures introduced by Banking Regulation and Supervision Agency (BRSA) at the beginning of the year to contain the current accounts deficit have slowed down domestic demand, which was among the factors that made it difficult for companies to collect their receivables. In line with these developments, impairments were started to be observed in the payment capacities of sectors with production and sales concentrated predominantly on the domestic market. The rises in both protested bills and bad checks confirm this impairment. Bad checks amounted to 15.9 billion TL in the first 10 months of 2014, up

by 5.4%. The amount of protested bills also rose by 9.1% y-o-y in the first ten months of 2014, due to rising interests and slowing domestic demand. Given that the level of exchange rates and domestic demand are two key factors affecting the profitability of companies in Turkey, a moderate recovery in domestic demand in the first quarter of 2015 may positively affect profitability of companies. However, developments in the global economy, geopolitical risks, the expected process of interest rate hike by FED and the upcoming general elections in Turkey signal the persistence of exchange rate risk. This suggests that we are entering a period when companies must manage their cash flows and borrowing much more consciously. Coface highlights the risks in construction and non-iron and metal sectors in particular.

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RISE IN EXCHANGE RATES AND SLOWDOWN IN DOMESTIC DEMAND AFFECTED COMPANIES' PAYMENT PERFORMANCE



QUOTES BY ECONOMISTS

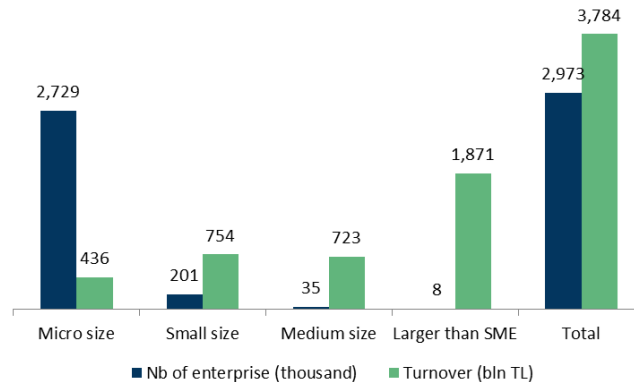
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LIRA DEPRECIATION RESULTED ON EXCHANGE LOSSES

According to Entrepreneur Information System (EIS) data announced by Ministry of Industry, total number of enterprises in Turkey reached 2 million 973 thousand in 2013, up by 11.4% relative to 2012. Given that the number of enterprises in Turkey was 1 million 806 thousand in 2006, when records were started to be regularly integrated, it is evident that stable growth and lower inflation and interest rates relative to past years have contributed to improvement of investment climate in Turkey. The average number of enterprises entering Turkish economy annually is around 160-170 thousand. According to EIS data, 91.8% of these 2 million 973 thousand enterprises consists of enterprises with 0 to 9 employees and less than 1 million TL turnover. Although such enterprises have a large share in terms of number, they account for only 11.5% of total turnover. 7.9% of enterprises consist of small and medium enterprises with 10 to 249 employees and 1 million TL to 40 million TL turnover. These companies have a share of 39% in total turnover. The enterprises larger than SMEs account for 7.7% of total enterprises and have a share of 49.5% in total turnover.

Chart 1: Number of enterprises and level of turnovers in 2013



Source: Ministry of Industry, Entrepreneur Information System

It is noteworthy that the exchange rate losses of companies have surged significantly due to the rises in exchange rates at the end of 2013. Due to the political uncertainties and global risk aversion against the emerging countries, the lira weakened 15% against the dollar in December 2013-January 2014 period. Accordingly, exchange rate losses jumped 163% in 2013 compared with 2012.

In the manufacturing industry exchange rate losses grew by 122.7% during the same period while in the wholesale and retail trade sector these losses rose around 187%. The construction sector, one of the leading sectors of Turkish economic growth, exchange losses jumped 130% between 2012-2013. This is an important indicator of the vulnerability of companies to volatility in exchange rates.

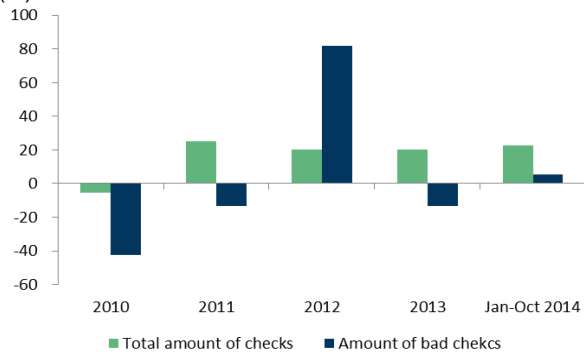
In the light of these data, net average profit margins of the construction, manufacturing and wholesale & retail trade sectors during the last five years have been calculated as 4.3%, 2.9% and 1.6%, respectively. The rising exchange rate losses weigh on profitability of the companies. As mentioned above, Turkish corporate sector is dominated by the micro and SME size enterprises. The general characteristic of these companies is the lack of equity capital making them vulnerable to fluctuations in the economy and the exchange rates. Therefore, the sharp depreciation of the lira at the beginning of 2014 coupled with the slowdown in the pace of economic growth caused a deterioration in cash flow management of these companies and resulted in delays in payments.

2 IMPAIRED PROFITS MADE PAYMENTS DIFFICULT

In Turkey, the most important determinants of company profitability and payment capacities are exchange rates and domestic demand. According to the Ministry of Industry data, small and medium enterprises account for 78% of total employment, 55% of total value added, 50% of total investments and 60% of total exports. However, equity insufficiency and the problems encountered by such companies in access to credit, bring along a series of financial weaknesses particularly during times of volatility in exchange rates.

The main indicators to follow up the payment performance of the companies in Turkey are the amount of the bounced checks, protested bills and number of companies that have been shut down. During the periods of solid economic growth and strong lira, usually companies are able to pay their invoices in a short time. However when the growth slows and the lira depreciates, then the time of payment for the companies gets longer and the number of unpaid checks increases. The recently sluggish domestic demand and the sharp rises in exchange rates and interests at the beginning of 2014 seem to have negatively affected the financial performance of companies. As a matter of fact, while the ratio of bad checks to total checks follows a horizontal trend, impairment is observed in bad checks on an annual basis. According to TBB Risk Center data, the amount of bad checks grew by 5.4% y-o-y in the first 10 months of 2014, reaching 15.9 billion TL. This rise is attributable in part to the 22.9% growth in the total amount of checks submitted to banks during the same period, reaching 483.5 billion TL. However, it is worth noting that although the total amount of checks submitted to banks grew by 20.2%, the amount of bad checks declined by 13.6% in 2013, when domestic demand was buoyant and growth was closer to its potential level. It should, therefore, be noted that the rise in bad checks is due not only to the growth in the use of checks but also to the slowdown in the economy.

Chart 2: Annual change in amounts of total and bad checks (%)



Source: TBB Risk Center, Coface calculations
*Annual increase during January – October

Manufacturing, construction and wholesale sectors account for some 45% of GDP. Therefore, the impairment in the profitability of companies in line with the contraction in these sectors adversely affects the payment capacity of domestic market. According to data published by TOBB, of the 12.178 companies shut down in the first ten months of the year, 33.8% were in the

wholesale and retail sector, 20.5% were in the construction sector and 14.5% in the manufacturing industry. However, since these sectors represent sectors where the highest numbers of start-ups are registered, it may not be surprising that they experience the highest number of shut-downs.

Chart 3: Number of start-ups and shut-downs (12-month rolling)



Source: TOBB, Coface calculations

The negative reflections of economic slowdown on the payment performance of companies manifest themselves in protested bills as well. According to Risk Center data, the amount of protested bills grew by 9.1% in the first 10 months of 2014 y-o-y, due to rising interest rates and sluggish domestic demand. The amount of protested bills had reached 6.9 billion TL, up by 41.8% relative to the year before, in 2012 when the economic management had taken measures to curb consumption and contain credit expansion with a view to cooling down the economy. The amount of both the protested bills and bad checks has increased particularly in the third quarter of the year.

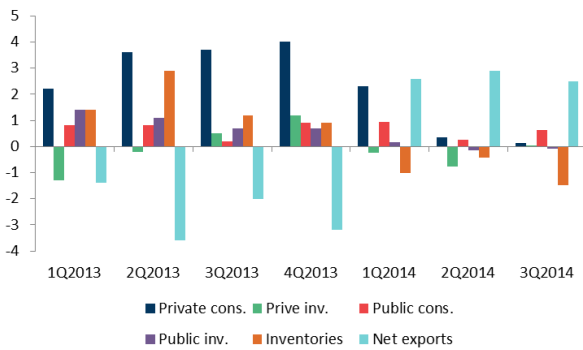
The main reason of the deterioration of the companies' payment performance is the depreciation of the Turkish lira. Due to the political uncertainties and global risk aversion against the emerging countries, the lira weakened 15% against the dollar in December 2013-January 2014 period. This sharp depreciation reduced the profit margin of companies mainly because of their dependence on imports which became more expensive and their forex indebtedness. In the third quarter of 2014, the level short-term foreign debt stock of Turkish real sector stood at 112.5 billion USD, around 14% of GDP.

The second reason is the slowdown in economy. Turkish economy grew by 1.7% in the third quarter of 2014, relative to the same quarter of the year before. Thus, growth in the first three quarters of the year amounted to 2.8%. During this period, private consumption spending slowed down remarkably due particularly to both the sharp interest rate hikes by the Central Bank early in the year and the measures taken by BRSA to contain the rise in consumer loans, and total domestic demand led to a 0.8% age point contraction in growth. Coface forecasts Turkish economy to grow by 3.1% in 2014 and by 3.5% in 2015. In November 2014, Coface downgraded Turkey's country risk assessments which measures corporate risks, from A4 to B, due to lower growth perspective, higher private sector indebtedness and volatility in exchange rates.

According to seasonally and calendar-adjusted data, the econ-

omy grew by 0.4% in the third quarter of 2014, relative to the previous quarter. During the subject period, while manufacturing industry did not grow, wholesale and retail trade sector contracted by 0.5%. The construction sector grew by only 0.2% relative to the previous quarter, according to seasonally and calendar-adjusted data.

Chart 4: Contributions of sub-items to growth (% points)



Source: TurkStat, Coface calculations

On the other hand, as the oil prices declined around 40% since mid-2014, the production cost of manufacturing sector is expected to increase. Dependence stood at 43% in 2011, according to a research conducted by the Ministry of Economy. This dependence is especially high in iron and steel sector (69%), chemicals (56%), motor vehicles (51%), plastics (45%), textile (43%) and white goods and consumer electronics (40%). Although the production costs would ease in these sectors, companies having trade ties with Russia may face difficulties while collecting their bills as Coface estimates Russian energy-dependent economy to contract by 3% in 2015. Corporate and banking external debt has ballooned in Russia. Corporate external debt stock went from 294 bn USD in 2009 to 444 in 2014. Russia's corporates and banks owe 130 bn until end of 2015. Corporates face falling oil prices and are unable to refinance themselves since they are banned from capital markets due to western sanctions.

Sectors	Risk level	Sectors	Risk level
Metals*	Very high risk	Pharmaceuticals	Moderate risk
Food	Medium risk	Electric, electronics, IT	High risk
Chemicals	High risk	Paper	Medium risk
Construction	Very high risk	Automotive	Medium risk
Textile and clothing	Medium risk	Retail	Medium risk

*Except iron and steel

● Moderate risk ● Medium risk ● High risk ● Very high risk

3 SECTOR RISKS

Trends like slowdown or acceleration in domestic demand have different reflections on collections and payment performances across sectors. The 15% depreciation, on average, of Turkish Lira until November in 2014, the recovery in European countries which are the major export markets of Turkey, even if vulnerable, and strengthening of growth dynamics in the US economy, among others, have helped the export-oriented sectors in Turkey to perform better in terms of both growth and payment capacity in 2014.

According to the barometer prepared by Coface by taking as a basis indicators like sector payment performances, macroeco-

omic balances, sector supply and demand developments and risks in export markets, sector risks are assessed as follows:

Metal sector (excluding iron and steel): Risk level: very high. Import-dependence in raw material supply declines in raw material prices and the negative impacts of changes in exchange rates on borrowing costs are the main risks facing companies. Impairment is observed in the cash flows of particularly companies whose borrowing costs have risen and which face difficulties in proper inventory management. The declines in raw material prices, on the other hand, lead to a decline in the sales prices of end products, and thus reduce company profitability. In aluminum supply, the move of international suppliers to come together and form a monopoly can represent a threat to raw material supply. The high cost of energy in Turkey poses a risk for metal sector which is highly dependent on energy for production, and leads to the weakening of competitiveness. However, the expected acceleration of economic growth in 2015, fall in energy prices, the reduced volatility in exchange rates, and the ongoing recovery in the European countries, which are the key export markets for the sector, can be listed as factors to support the sector. Furthermore, the population and income growth in Turkey as well as rapid urbanization may also support the medium-term outlook of the sector.

Automotive sector: Risk level: medium. The automotive market contracted by 14% during the period January-November 2014, due to tax rates increased at the beginning of the year, rises in interest rates, the macro prudential measures taken by BRSA to contain consumer loans and the rises in exchange rates. However, the strong balance sheet of the companies operating in the sector is substantially reducing risks concerning payment capacity. Distributors are likely to be the group that may be affected most severely from declining sales. However, this does not pose a sector-wide risk. On the other hand, despite the contraction in the domestic market, the 5% annual rise in total exports and the 20% rise in automobile exports during the period January-November create a positive outlook for the sector.

Food sector: Risk level: medium. The greatest risk for food producers is the rise of production costs due to drought experienced during 2014. Small and medium size producers, in particular, are negatively affected by the increases in costs. On the hypermarkets side, problems are observed in the management of cash flows due to extended payment terms. The still vulnerable recovery in the European countries, the main export market of the sector, appears to be another risk factor. The growing debt of the intermediary food wholesalers due to payment difficulties of small enterprises creates a financial pressure and makes companies more vulnerable. However, in the light of recent developments, there seems to be no risk that threatens the operations of companies across the sector. Food exports grew by 5% during the period January-October, relative to the same period of the year before. According to the data of Business Monitor International, per capita food consumption in Turkey was around 658 USD in 2013. Considering that this figure is 3,564 USD in Denmark, 2,325 SD in Germany, 1,182 USD in Greece and 1,535 in Poland, there clearly is a significant growth potential for the sector. Factors like rapid urbanization, high rate of young population and growing employment, help maintain a buoyant food wholesale and retail market.

Chemical sector: Risk level: high. Almost 70% dependence on imports in raw material supply, the vulnerability to volatility in exchange rates due to borrowing cost and the impacts of slowdown in the construction sector are assessed as high risk factors.

Construction sector: Risk level: very high. This sector represents 6% of GDP and accounts for 7.5% of total employment in Turkey. Construction sector is characterized as faster growth during times of economic growth and faster slowdown during times of economic slowdown. The sharp interest hike by the Central Bank at the beginning of 2014, the slowdown in economic activity and the rising inflation rate have led to a decline in demand in the housing segment. As a matter of fact, the indicator showing the probability of buying a house in the next 12 months, under the consumer confidence index has been weakening since May 2014. Low borrowing costs and stability in the labor market, which were among the most important factors fueling the rise in the probability of buying a house in the past, are not supporting the housing segment as much as they did the earlier, following the rise in interest rates and the slowdown in the economy. The slowdown in demand growth rate is adversely affecting the financial performance of smaller construction companies in particular. Although the Central Bank reduced interest rate, and thus borrowing costs, during the period April-August, 2014, the weighted average interest rates of housing loans is approximately 1 point higher as of the beginning of December 2014 than that as of end-2013. Housing loan interest are approximately 3 points higher than those in June 2013, when interest rates hit the bottom. On the other hand, first-hand house amounted to 383,000 in the first nine months of the year. On the supply side, the number of apartments with occupancy permits issued during the same period amounted to 569,000, up by 12.1% relative to the same period of 2013, and the number of buildings for which construction license has been issued reached 810,000, up by 33.3%, which signal a risk of supply surplus going forward. On the infrastructure side, both public and private sector investments are expected to continue. The Treasury guarantee offered for build-operate-transfer model projects with investment value of more than 1 billion TL has eliminated the financing issue, which is one of the major risks concerning such projects, and has supported growth in the sector. However, the high public influence in the infrastructure segment brings along the probability of extended payment terms and raises the risk of levels of sub-contractors.

Retail sector: Risk level: medium. Household spending accounts for some two thirds of GDP in Turkey. Average monthly consumption spending per household reached 2,572 TL in 2013, up from 2,120 TL in 2011 and 2,366 TL in 2012. Non-alcoholic drinks accounted for 19.9% of household spending in 2013, followed by household appliances with 6.6%, apparel and shoes with 5.3% and alcoholic drinks with 4.2%. Young population and rising income levels are keeping the demand for retail products buoyant. On the other hand, the high rental fees of shops in malls, rental fees denominated in foreign currencies and high energy costs pose a risk on profit margins. However, the sector does not seem to have a high risk level overall. As a matter of fact, retail sale volumes have been cruising above last year's levels since the turn of the year. According to the most

recently announced data, the seasonally-adjusted retail sales volume index increased by 4.2% on average during the period January-October 2014, relative to the same period of past year. Seasonally-adjusted retail turnover index increased by 11.6% on average, during the same period.

Textile-apparel sector: Risk level: medium. The volatility in cotton prices, the primary raw material for this sector, rises in exchange rates and the fact that companies produce predominantly for certain large foreign buyers are among the key risks. However, factors such as the recovery in the EU, the largest export market, the advanced machinery stock of the sector, advantages of geographical position, and the high flexibility of producers in terms of market and product diversity support the rise in the sector's sales. As a matter of fact, textile exports and apparel exports grew by 7.3% and 11.4%, respectively, during the period January-October 2014 relative to the same period of the year before.

Pharmaceuticals: Risk level: low. Turkey is among the major markets for the pharmaceutical sector, on account of its growing population and per capita income as well as easier access to pharmaceutical products. In Turkey, per capita healthcare spending amounted to 1,110 TL in 2013, up from 987 TL in 2012. The ratio of healthcare expenditures to national income rose to 5.4% in 2013, from 5.2% in 2012. In the sector, where the biggest client is the government and which is very strictly regulated, reference pricing system has been under implementation since 2004. However, despite the rises in exchange rates, the Euro exchange rate fixed at 1.96 TL in 2009 has not been updated since then, which causes a pressure on the profitability of companies. On the other hand, the high level of competition in the generic drug segment is also causing a price pressure and negatively affecting profitability. This may bring along an equity problem for local firms in particular.

Conclusion

In Turkey's industrial landscape, small and medium size enterprises account for 80% of all companies. The equity constraints, managerial weaknesses, technological insufficiencies, planning and marketing issues observed among these companies, by nature, lead these companies to operate with very low margins. Therefore, any potential contraction in domestic demand and/or currency depreciation leads to an impairment in the financial performance of these companies and weaken their payment capacities.

The destruction caused by volatilities experienced in 2014 both in domestic demand and in money markets on payments and collections still continues. This is confirmed by the rises in both protested bills and bad checks. Export-oriented sectors seem to have outperformed domestic-oriented sectors in 2014. An improvement may be observed in the latter as well, together with the acceleration expected in growth in 2015. However, it should be noted that developments in the global economy, geopolitical tensions and general elections in the country may cause sudden volatilities on the exchange rate side in 2015, as a key risk factor.

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