The Alchemy

Volume II

MERGEN

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The Bowl of the Alchemist

I would like to start the Vol.II of The Alchemy with great thanks to our friends and colleagues all over the world. As we have stated in the foreword of The Alchemy Vol.I., *"Having a name such strong for strategy paper is a huge risk that we are aware of"*, yet receiving encouraging mails from most of our recipients was definitely the most beautiful reward in exchange of the risk we have taken so far. Most of our colleagues and friends congratulated for the philosophy we have undertaken issuing The Alchemy, and that will definitely be a huge support for us to continue on this path. We have stated multiple times in The Alchemy Vol. I. that our intention is to provide "value added comment", not raw data as we are not a research house, but to bring "views & thoughts" which aims to enlighten the path of investors in this very difficult market. In this regard, I welcome you into the pages of The Alchemy Vol.II.

Vol.I. was underlining that our main intention is to create our own model of "Alchemy", by analysing the data we already have by adding different ingredients from political, economic, legal and of course from the market bowls. Followers of the Turkish market will agree that during the second quarter, these bowls had seen quite important changes, which will force us to question the main theme of "soft landing" we have stated in the Vol.I.

Starting from this issue, we will be having a section called "Philosopher's Stone" at the end. Obviously we are not in arrogance to name ourselves as a Philosopher, yet this is a metaphor used by the alchemists for the very last process of turning common metal into gold. As understood, this section will be a summary and wrap up of the whole comments we have stated during the report.

Please join us for the pride and joy we feel due to the launch of our website, www.mergenconsulting.com , from where our friends and colleagues can download the history of The Alchemy, as well as different relevant studies and useful links.

Dr. Kıvanç ERMAN
Founder
Mergen Consulting

Politics

“2013 seems to be a year where the politics will definitely be very important in Turkey’s future. We are sure that after a decade, we will be talking about this period a lot, and the sociologists , politologues and other social scientists will be very much occupied with the phenomena that we are witnessing today.”

These were the exact words used in the opening of this chapter in Vol. I., almost 3 months ago. It was definitely not a prophecy but just an educated guess, due to what we were living during those days of brotherhood, peace and a hope of a new era.

Yet this paragraph is still quite true, as what we have witnessed during the last month is probably will be debated a lot by the social scientists in the future. As followers of Turkey and the market already know, the “Gezi Park Movement” and what has been lived there will definitely change the course of the Turkish democracy. Starting from a single, decent and naive request of protecting the last remaining green area in the middle of the city, and of protesting the to-be-erected concrete building by the municipality, became something totally different, a kind of a silent resurge of the public, despite the use of excessive force by the police. The protestors, aged between 17 and 40 mostly but supported from all demographic classes, used the deadly weapon of “humour” against the water cannons and pepper sprays, utilized very generously by the police. Obviously government and the Prime Minister Mr. Erdoğan were the main targets of this deadly weapon and the protestors taught Turkey lots of lessons during that 20 days including respect to each other’s thoughts, lifestyle, beliefs and ways to protest without violence and vandalism. This was actually the re-birth of Turkish democracy like a phoenix, from its ashes.

Although lots of figures are stated by authorities about the financial loss created by these protests, we believe that the biggest profit is to see that there is a generation coming, with lots of sense of humour, less politicised, caring & respecting about others’ beliefs and lifestyles, getting unified for a decent cause to make them heard. For non-Turkish readers, this is a generation that we were accusing of being ignorant and selfish. Paradoxal, isn’t it?

On the other side, the statements and accusations coming from the government side were not as embracing as expected and the edge of blade politics executed may create internal problems within the public if continued. Government and the PM accused the international powers, provocateurs, even the interest lobbies that the protesting generation did not understand the meaning of. During these declarations, we have faced lots of questions of friends from generation Y, asking us what the "interest lobby" is. Mr. Prime Minister and the government members accused the protestors with drinking alcohol in a mosque, attacking a woman with head-scarf and else, none of them proven so far and remain a little bit provocative and diversion oriented.

Lots of things happened and we are not in a position to judge either party, as this is something that the history will do in the future. Yet we believe that the only winner will be the Turkish democracy.

These incidents also blocked temporarily the opening of a new chapter in Turkey-EU full membership negotiations, yet the problem has been solved after a diplomatic tour of the Minister of Foreign Affairs. The government believes that the incidents are used as a "cause" as the recent 5-year government program of Germany states the refusal of Turkey's full membership as the size and economy of the country will be "too heavy" for the EU.

On the other hand, the oil & natural gas negotiations with the Northern Iraq side is still continuing whereas the Minister of Energy declared that as of 2016, Turkey will be buying 100,000 barrels of petroleum on daily basis from Iraq. However, Turkey will also be drilling for petroleum in consortium with Northern Iraq Autonome Region, within the borders of this region.

Another small but noteworthy event, is that Turkey has paid back the remaining share of its debt to IMF. As of June, Turkey is not only a country indebted to IMF but also providing funds for those who are in need of it.

Economics

Our main theme in the 1Q 2013 was the “soft landing” possibility and we have debated in our first issue that Turkey is in process of such soft landing, despite the noise from the market players.

The recent data supports our thesis as the 1Q GDP growth figure was better than expected and this is also approved by Moody’s, upgrading Turkey on May 16th. Moody's declared that the country's credit rating was raised to investment grade the first time in two decades as the government reduced its debt and current account deficits. This was the main theses of The Alchemy Vol.I we have shared with our friends as of 1Q. As we have always stated, the current account deficit is not a "reason" but a "consequence" given the structure of the Turkish economy. Hence, delays so far about the upgrade were not justifiable in scientific terms, given the Country's debt structure and other main economic aggregates.

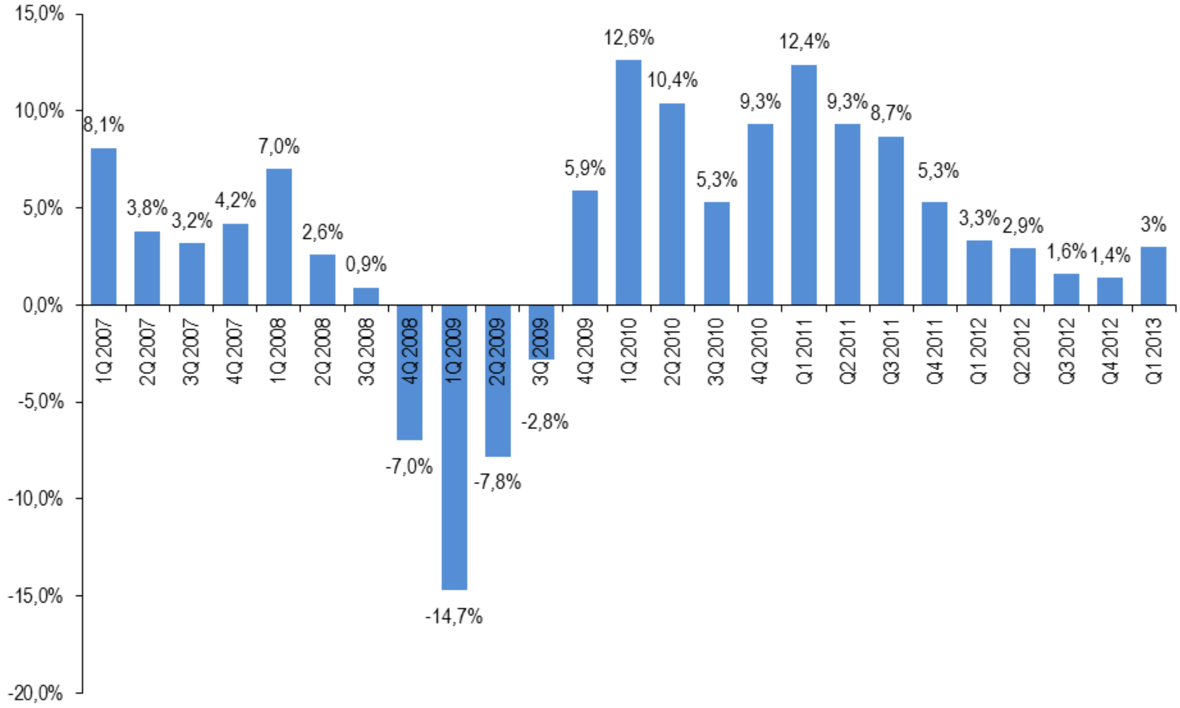
Moody’s said in the upgrade statement that it lifted Turkey’s government bond ratings by one step to Baa3, the lowest investment grade, from Ba1. The move puts Turkey’s credit rating at the same level as Spain, Colombia and India. The outlook was set at stable.

The ratings boost reflects “recent and expected future improvements in key economic and public finance metrics,” Moody’s analysts wrote in the statement. Turkey’s “progress on structural and institutional reforms that Moody’s expects will reduce existing vulnerabilities to shocks to international capital flows over time” was also cited.

As stated by various investors and analysts so far, the move was “long overdue as the market has long traded Turkey as investment grade", and that this should bring a whole new investor base to Turkey.

Supporting our thesis, the data gathered during 2Q 2013 suggest that the economy is soft landing despite the noises around. The GDP growth in 1Q 2013 has been declared as 3%, better than market expectations.

Quarterly Growth Figures 2007-2013



Source: Treasury, Middle Term Programme

IMF, World Bank, OECD and UN expect the GDP growth of Turkey between 3.1%-3.6% for 2013, yet the government's Middle Term Plan suggests a growth of 4%. Although the 1Q growth gives hope to reach this figure, weaker than expected activity in the 2Q and Ramadan-hosting 3Q will make this success almost impossible. However, we believe that the growth will not be less than expected by the stated institutions, unless something extraordinary happens. As stated in The Alchemy Vol.I., the below chart suggests that the Turkish economy landed quite well indeed, and we see no reason for the pattern to change.

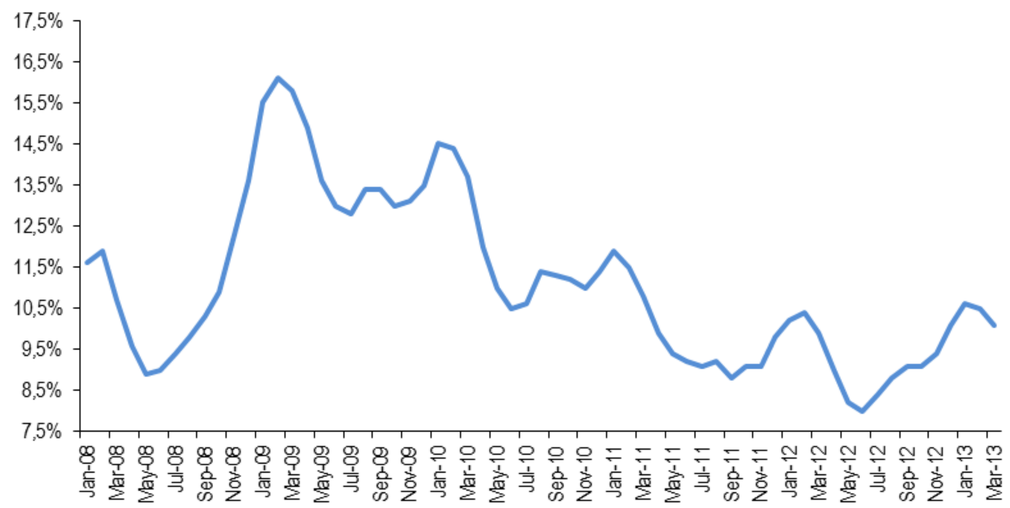
Annual GDP Growth 2000-2014

Source: Treasury, Middle Term Programme

In The Alchemy Vol.I., our biggest argument supporting the soft landing scenario was the lack of increase in the unemployment figures. During 2012, we have even experienced some decrease in the unemployment figures despite the contraction of the GDP growth. We believe that this is still the case although we see some correction in the 1Q of 2013. Traditionally 2Q and 3Q are better situated periods for unemployment, therefore it will not be self-convincing to say that the correction will be limited.

The below monthly chart supports our thesis above, as one can see that 2Q and 3Q figures are advantageously situated as a pattern in Turkish economy, due to the harvesting season in agriculture. 1Q is always the peak level, as is the year end, therefore we see the small increase in 1Q 2013 as a seasonal correction and believe that the unemployment will remain at manageable levels during 2013, as a sign of soft landing.

Unemployment, Monthly Figures, 2008 - 2013



Source: TurkStat, Middle Term Programme

We also believe that talking about the type of landing is not a theme anymore as the Middle Term Programme suggests a GDP growth of 4% for 2013 and 5% for 2014 & 2015. Therefore, we believe that the economy has already soft landed and now is getting prepared for a new period of take-off. The new economic debate will be the height of this take off and the new international environment that will support or prevent this action.

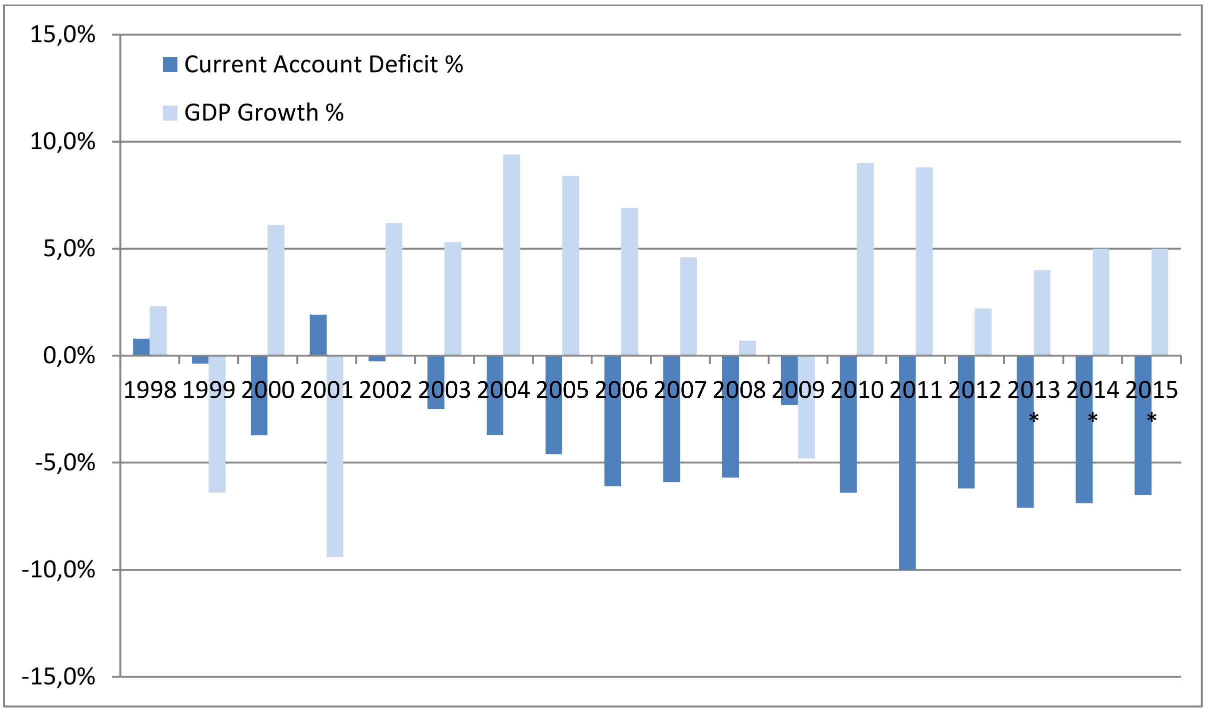
Every reader is aware of the fact that FED has decided to finish the asset buy-back programme, creating relief to the world markets for quite some time. This is surely the end of the “easy money” policy and means that the interest rates will go up due to the scarcity of the money, yet we do not think that this will create a huge cash squeeze as this will mean shooting himself by the leg for FED and the US markets.

It is a common metaphor used by economists that it is the central banks’ duty to remain sober during the party and collect the glasses to prevent others becoming further drunk. Therefore, they are always the bad guys as they do not join the party and pull the plug while everybody else dances like a ritual.

The decision of FED does not only mean higher interest rates and less money available, but also it will mean that there will be a shift of capital flows from emerging markets to developed markets again. This, by definition, brings us to the question of how Turkey will be affected from such shift of capital flows. The logic and the quick response suggest that as a CAD bearing country, Turkey will be affected negatively and it would be the end of the golden era, or the illusion, that we are experiencing for the last 5 years.

However, the readers of The Alchemy also know that we always state in our conversations and previous personal presentations, although current account deficit is one of the major problems in Turkish economy, it is a consequence rather than a cause. In the Vol I, we have used below chart as a proof of this thesis, and suggested that the CAD always increases during the periods of GDP growth.

Current Account Deficit vs. GDP Growth

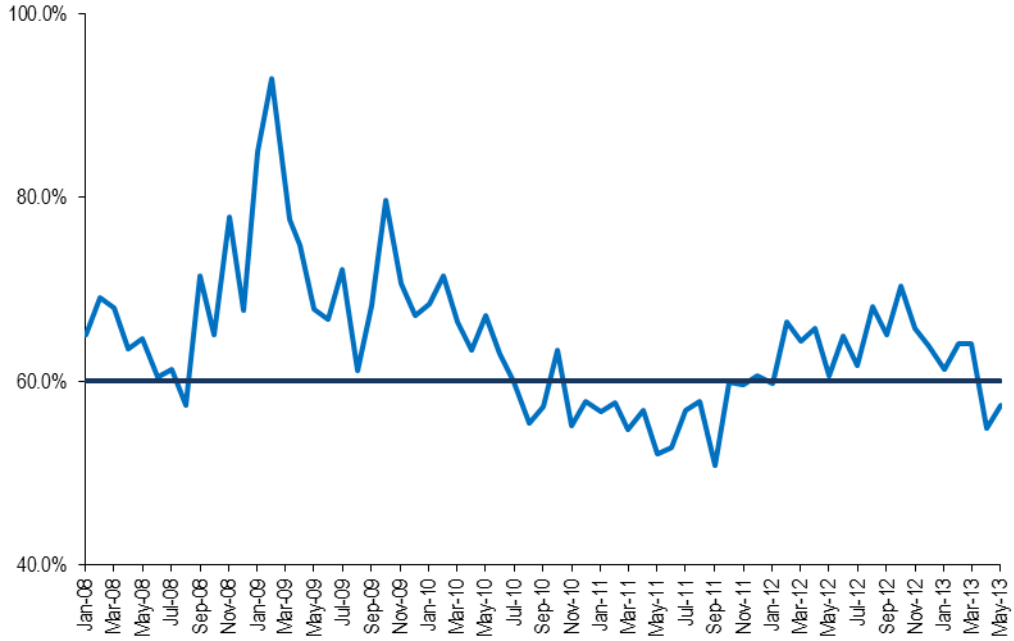


Source: TurkStat, Middle Term Programme

The negative correlation in the above chart suggests that Turkish economy must have a CAD in order to have a GDP Growth, as this defect is structural and cannot be offset easily. Yet, one can also observe that a GDP growth around 5% on average usually keeps the economy with a sustainable CAD, hence the aim of the government.

As always stated, the growth of the CAD is one thing, but it is important why it is created and how you finance the gap. We have stated previously that Turkey is a net importer of energy, therefore we always have to purchase oil, natural gas and energy, forcing us to live with a certain level of CAD, due to the export – import coverage ratio of the country, usually between 60-65% levels when healthy and sustainable.

Export – Import Coverage Ratio, Monthly Figures



Source: TurkStat, Middle Term Programme

We do accept that the latest crash in the ratio as of April 2013 is a little bit worrying, yet we see it up ticking as of May 2013, therefore it does not include the recent volatility of the exchange rates and depreciation of TRL vs. USD and EUR, supporting the recovery of the above chart during the coming months. For us, one of the most important aggregates is the breakdown of the external trade; therefore quality of the Ex - Im process as well as the quantity of it. The below tables suggest a perfect balance and a hedging situation for Turkish trade markets.

Distribution & Top 5 Markets of External Trade

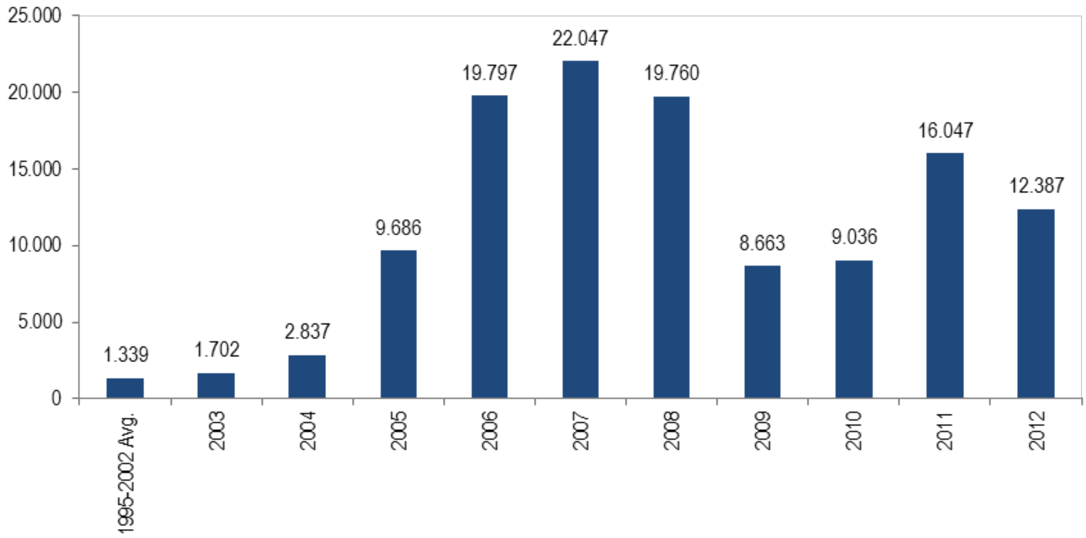
2012 Export Distribution		2012 Import Distribution	
EU 27	38,83%	EU 27	35,76%
Non-EU Europe	9,42%	Non-EU Europe	16,81%
Africa	8,76%	Africa	2,32%
America	6,31%	America	8,33%
Middle East	27,84%	Middle East	9,78%
Others	8,83%	Others	27,01%

2012 Top 5 Export Markets		2012 Top 5 Import Markets	
Germany	8,8%	Russia	10,0%
Iraq	7,2%	China	9,6%
England	5,3%	Germany	9,5%
Italy	4,7%	USA	5,9%
Russia	4,5%	Italy	4,7%

Source: TurkStat

The above table suggest an economy with a well-balanced external trade dynamics as the exports are diversified all around the world and the imports are more specialized as 40% of the imports are made by the top 5 import markets where as this figure remains at 30% for the top 5 export markets. These statistics are the result of the government's active international politics and business-oriented approach for the last decade and are not subject to change easily.

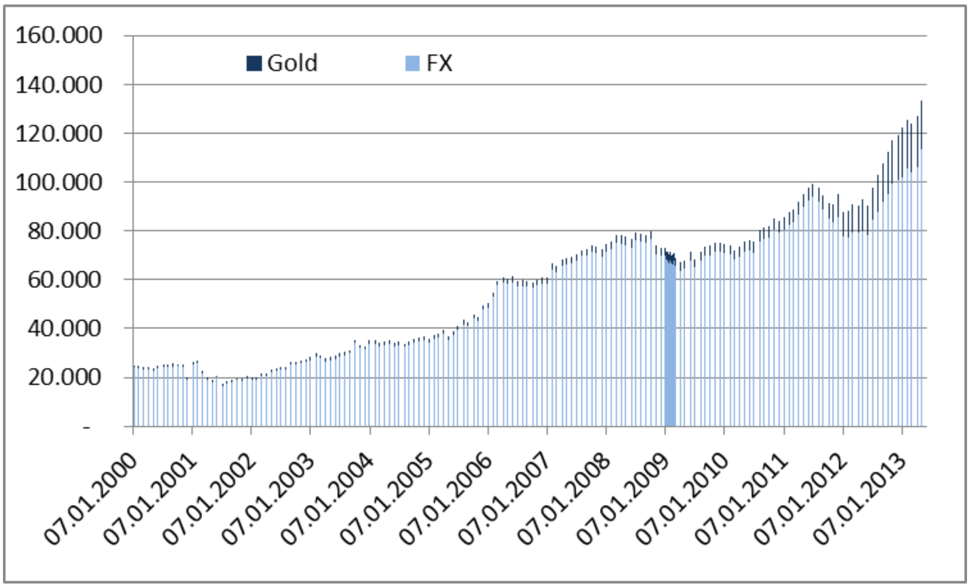
Foreign Direct Investments, Annual Figures



Source: TurkStat

The main factor financing the current account deficit is the direct investments as well as the portfolio investments into the economy. As stated above, for the last decade, government has been in a business friendly active international politics approach, therefore they managed to attract more international investments than ever. Obviously it is not easy to reach the prosperous days of 2006-2008 but the level of the FDIs is still at comforting levels. One of the main issues to be alerted is the level of portfolio investments, or simply the hot money, which can shift easily especially due to the FED decision. Yet, the major point of focus is the CB reserves to prevent an external attack in such case, which are comforting as well with a level of almost USD 130 billion as of end-June, including the gold reserves of the country. This level suggest that the CB has accumulated an important amount of reserves, unlike the historical experience, corresponding to a level of 18 months of net external trade deficit, comforting for the market players and the rating agencies.

CBTR Gross Reserve Figures

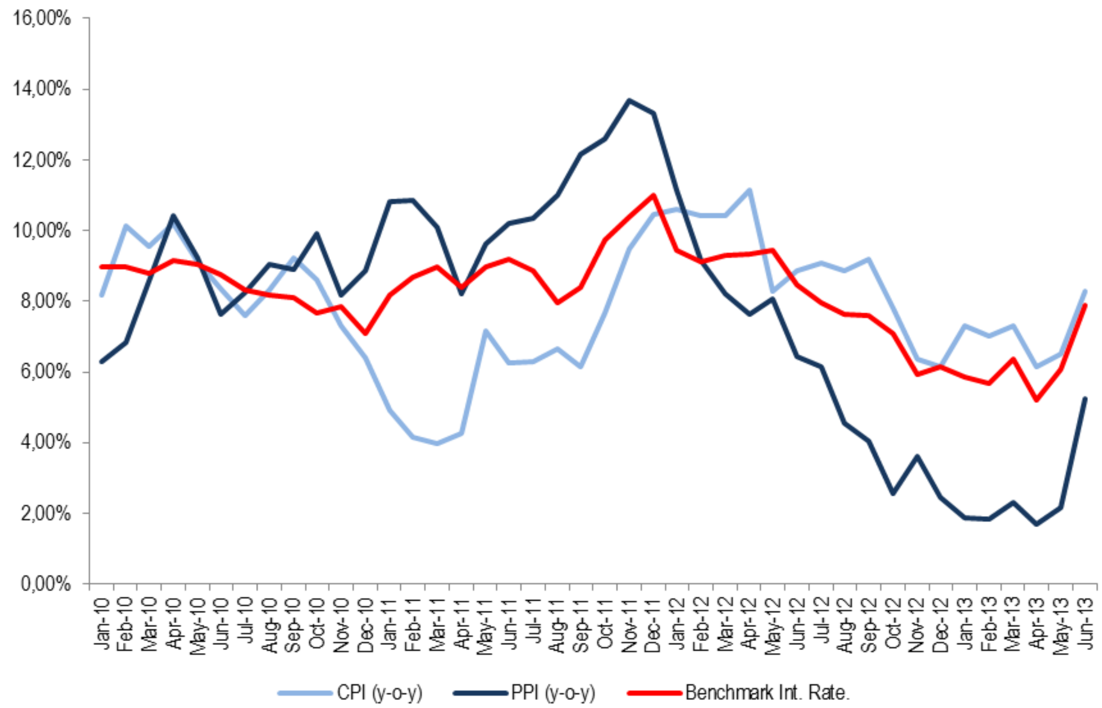


Source: Central Bank of Republic of Turkey

In light of these statistics, we believe that the FED statement creates no extra threat for Turkish economy on the CAD basis, other than the gradual increase in interest rate levels and the cash becoming slightly squeezed.

Coming back to the economic aggregates, we see that there is a slight development on the inflation side, where we started to see some up-ticks after experiencing all-time-low figures, especially on the PPI side. Although we have experienced lower CPI figures in the past, namely in 1Q 2013, one may see the shift between CPI & PPI, thanks to the recovering of the domestic demand. However, the major difference between 1Q 2011 and 1Q 2013 is the real interest rates. During the 1Q 2011 we have experienced a sharply falling CPI vs. and increasing benchmark rate, creating a real interest of almost 5% where during the last 6-9 months we have been living in an environment of negative real interest rate due to the extreme bullish expectations.

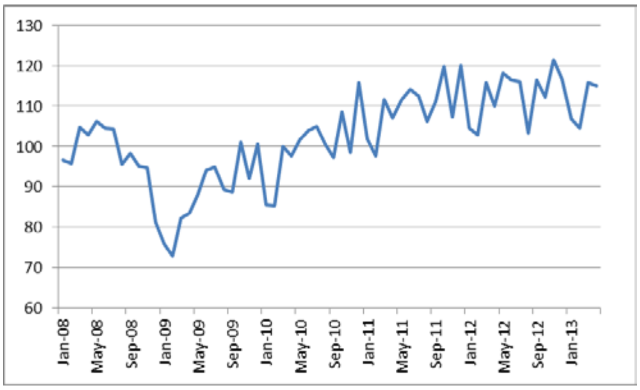
Inflation & Benchmark Rates



Source: TurkStat, CBRT

As seen from the graph above, the period of negative real interest rate is about to end with sharply increasing benchmark rate due to the Gezi Park riots and the FED decision. It is obvious that such period was not much sustainable at these nominal levels of the inflation & interest rates and these events were only the triggering factor for these indicators reverting to the equilibrium levels. Although it is another sign of soft landing, the surge in CPI & PPI is a little bit worrying as due to base effect we expect the uptick to continue in July as well. The extra increase in PPI means that the producers are now able to reflect their costs to the prices and unless prevented by some demand cut, this may create further inflation. Hence, volatility on the interest rates may be experienced for the near future.

Industrial Production Index

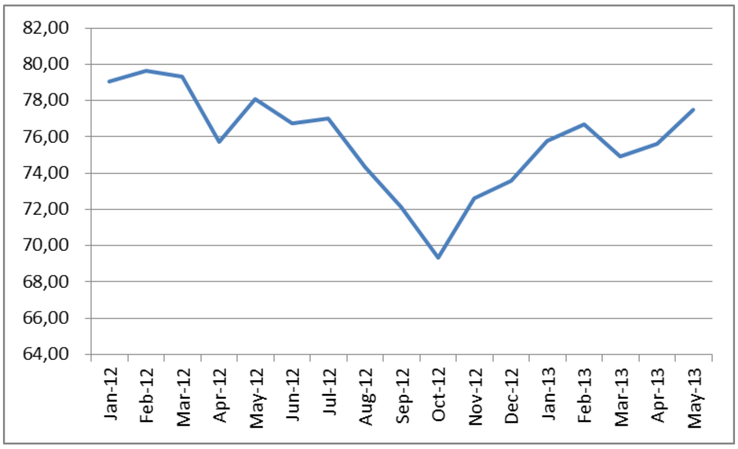


Source: TurkStat, CBRT

Capacity Utilization Rate

Other aggregates are also supportive of our bullish stance about the economy. Industrial production and the consumer confidence indices provide volatile but upwards improvement where the capacity utilization rate is stable in a wide range

Consumer Confidence Index



Source: TurkStat, CBRT

After analysing these main economic aggregates, we can summarize our thoughts and implications on our real estate strategy as follows, also self-criticising our findings in Vol.I.:

1. Turkish economy had a soft landing and this is a theme already over for further debate. We are in the period of a possible take – off where all the expectations for GDP growth are over 3%. We still stick to the finding that 2013 will be a better growth year, as stated by the government officials and authorities.
2. This landing has been positive for the real estate market so far, yet GDP growth will also bring CAD, to be followed closely. We believe that we need more exports for the CAD comfort, hence growth possibility.
3. Despite the FED decision, we do not expect a shake-off in the markets. We see the recent developments in the markets as corrections and reverting to the equilibrium, as negative interest rate and continuously increasing stock market are not sustainable.
4. Both the exporters and the CB seem to be happy with the new equilibrium level of TRL vs. USD & EUR. Increasing CAD may create some more volatility as stated in Vol.I, yet we still believe that the TRL vs. FX volatility will be much less than the EUR/USD volatility as is the fact for the last 3 years.
5. The low level of leverage in the economy (36%) will likely to continue and will create an immunity in a world where debt is the most scarce item and will be scarcer.
6. The immunity in this sense, coupled with low level of leverage in the real estate sector, with the help of huge cash in banking sector will provide a better environment for 2013.
7. The recent upgrade from Moody's came before the expectations of the market. In this sense, out of 4 big credit rating agencies only S&P did not place Turkey in investment grade status. We do not expect an upgrade from S&P in the near future but the current status will provide cushion for negative effects coming from the outer world. This also fuels the expectations of more foreign investment in Turkey, easing the anxiety of concerns for current account deficit financing.
8. The only risk we see in the real estate side is the residential sub-sector. This is the area where the interest rate is subject to change quite easily, hence the investment appetite and given the stock in the market, we suggest to keep an eye here as it directly affects the banking sector and other players in the market.

In this regard, we keep our long-term bullish stance on the economy and the real estate markets, if nothing extraordinary happens on the political side of the coin. The new theme is the expectation of a sustainable GDP growth performance and we believe that we have already passed the soft landing scenario. We expect the positive and supporting investment conditions to continue during the remaining half of 2013.

Commercial Real Estate Markets

Before we start, we would like to state that careful readers would realize that the numbers in this issue and the previous one will not overlap as from this issue forward, we switch to Turkish Council of Shopping Centres (AYD) figures from Jones Lang LaSalle figures as we believe it would be fair to use a supra-corporation source such as a sectorial union to preserve our independence. As natural in the world of statistics, both dataset have their pros and cons, but for the sake of independence and consistency, we remain to stick with AYD figures, provided and updated publicly on monthly basis. This is not unfortunately the case when speaking about the office market, and we have to rely on private datasets, as there is no sectorial union or council to provide such data in detail, unfortunately.

For the sake of avoiding a possible mistake, we have to state that the AYD figures take into account each and every publicly announced shopping center project as “pipeline”, regardless of the realization possibility or opening time, contrary to the Jones Lang LaSalle figures considering the pipeline mostly as “under construction”. Therefore when compared to the JLL figures, AYD data has an enormous and scary amount of pipeline but shows a longer-term future as a possibility picture. A simple filtering on these data suggests a pipeline of approximately 2.5 to 3 million sqm until the end of 2015. We suggest our readers to keep this difference in mind while making their analysis based on these datasets.

The retail market continued to draw attentions in the 2Q of the year as well. AYD stated that we have seen 9 new projects opening their doors to public during the 2Q, with a total GLA of 268,000 sqm. The Council also states that the 1Q had opening of 7 centres as well, totalling a figure of 221,000 sqm, therefore the total addition to the stock for 1H 2013 is almost 500,000 sqm with 16 new projects.

When we look at the distribution of 2Q 2013 openings, we see that 171,800 sqm (64%) of this is in Istanbul whereas the rest of Turkey remained at 96,800 sqm. The main reason disturbing the long-held 40/60 ratio is the opening of Vialand in Eyüp district of Istanbul, reaching a GLA of 110,000 sqm, supported by a theme park attached.

2Q 13 Openings	City	GLA (sqm)
Fatsa City	Ordu	7.800
Güneşli Park AVM	Istanbul	25.000
Pakt Plus	Çanakkale	7.000
Avenue Bodrum	Muğla	20.000
Axis Kağıthane	Istanbul	29.300
Pekdemir Turgutlu AVM	Manisa	11.500
Piazza Maraş	Kahramanmaraş	50.500
Semerkand Line	Istanbul	7.500
Vialand	Istanbul	110.000

Source: Turkish Council of Shopping Centres

With the addition of these openings, the number of active shopping centres in Istanbul reached a total of 95 with 3,3 million sqm where the rest of Turkey holds 216 centres reaching a total of 5,3 million sqm. The total size of the market reached 8.7 million sqm with 311 centres according to the AYD figures and the weight of Istanbul remained as 38,5% in GLA.

As of 2Q 13		Active	Under Const / Planned	Total
Istanbul	Unit	95	39	134
	GLA (sqm)	3.356.742	1.978.277	5.335.019
Diğer	Unit	216	64	280
	GLA (sqm)	5.323.668	6.934.145	12.257.813
Toplam	Unit	311	103	414
	GLA (sqm)	8.680.410	8.912.422	17.592.832

Source: Turkish Council of Shopping Centres

Zorlu Centre, one of the most awaited shopping centres, is expected to open during late 3Q or very early 4Q in case of a delay. The project is the centre of attention for public and media since the purchase of the land at USD 1 billion by Zorlu Group at the time and is expected to be the only competitor to İstinyePark in terms of concept and performance, until Emaar

Square will be completed on the Asian side of Istanbul. As known, Zorlu Centre will be hosting a performance centre, residential units, a Ruffles Hotel and a limited size of offices. The shopping centre is expected to be the focus point where lots of new brands as well as some existing luxury brands will be taking place. Perfect location of the centre fuels the expectations of performance and we believe that the project will enter into the "investment lists" of many fund managers even before this expectation is realized.

The strong pipeline suggests that we will be reaching the 9,5 million sqm thresholds until the end of 2013 with almost 350 shopping centres. However, delays are always a possibility even for the top notch assets, therefore one must be cautious for such projections. Yet, these delays do not change the fact of a strong pipeline in the future.

City	Unit	GLA	GLA / 000 Capital
İstanbul	95	3.356.742	242,28
Ankara	31	1.192.525	240,16
Karabük	3	48.248	214,30
Bolu	2	45.100	160,45
Eskişehir	4	123.000	155,75
Muğla	7	120.935	142,09
Bursa	9	366.825	136,46
Kocaeli	9	221.443	135,46
Samsun	6	162.848	130,10
Antalya	14	269.227	128,66

Source: Turkish Council of Shopping Centres

Our recent dataset suggests that Istanbul is still the market leader with a slight difference over Ankara, with 242 to 240 sqm respectively. Karabük and Bolu are in the list due to their small population, where statistically the average size of the centre in these cities is extremely small.

AYD dataset suggest that the GLA/000 capita is 115 for the whole country. However, a point to debate is a miscalculation done by the whole sector, including ourselves so far. We tend to calculate the GLA/capita for the whole country by dividing the total GLA by the total population. This may be a perfect way for western countries and USA where almost everyone has an access to the shopping centres but the AYD dataset suggests that only 56 cities have shopping centres out of 81, and the population is limited with 67 million compared to 75 million when it comes to cities with shopping centres. Therefore the **active GLA/capita** for the whole country is actually 129,5 instead of 115. Although this does not make much difference on country basis and probably it is much right to use for international comparison purposes, it is our duty to show such a discrepancy.

City	Unit	GLA	GLA / 000 Capital
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Kocaeli	9	221.443	135,46
Samsun	6	162.848	130,10
Antalya	14	269.227	128,66

Source: Turkish Council of Shopping Centres

Second quarter was no exception to the debates about the number and density of shopping centers in Turkey, especially after Prime Minister's speech about his intention to develop a shopping centre in the middle of Taksim, one of the main fuelling points of the Gezi Park Movement. This created some small protests against the shopping centres but mainly the uncertainty created by the escalation of the problem plummeted retail activities in June. Despite the Istanbul Shopping Fest, which had been a great success last year, the turnover in retail sector is stated to decrease almost 10% during this period.

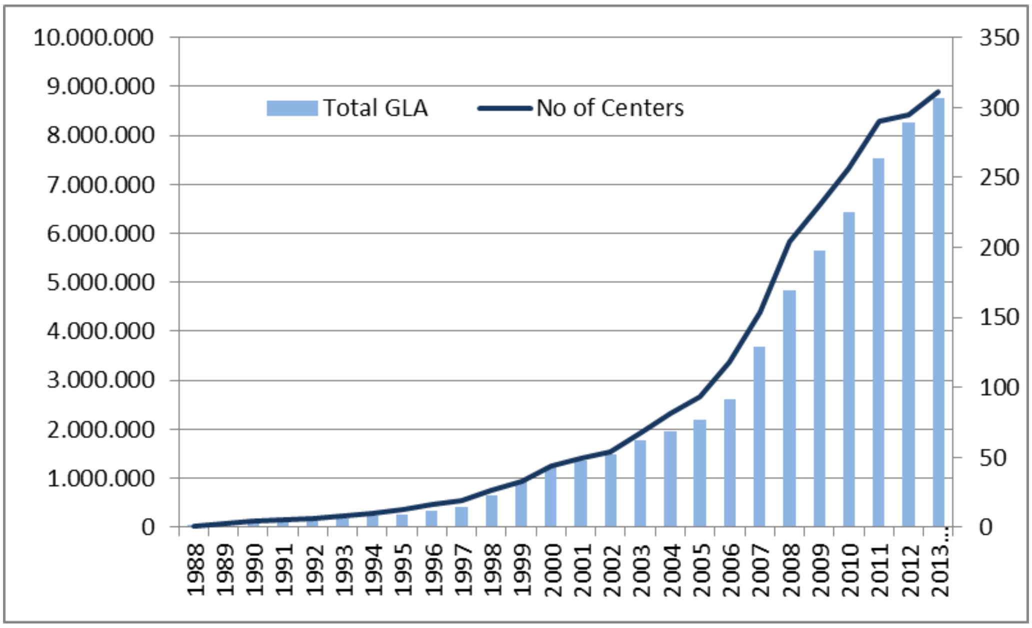
We believe that a movement such supportive of democracy is not against "shopping centres" at all, but just the one to be built in Taksim, as if there is no other place or shopping centre in the whole city. The generation Y, the backbone of the movement, is known to prefer shopping centres for socialisation, just after Facebook and twitter of course. We have declared our own view about the debate in The Alchemy Vol.I. with following sentences:

"Despite the noise, again, about the number and efficiency of the shopping centres we believe that under the rules of the capitalism or at least free economy, we believe that limiting or not permitting new shopping centres by law or authorities will not solve the problems. State Minister Mr. Babacan stated frankly in his MIPIM session that they are

against limiting the number of a development type and size and that this is an issue to be solved within the rules of the investment feasibility, not legal intervention, despite some demands about limiting such development projects.

In our view, the logic of demanding such intervention will only damage the competition, therefore the customer itself at the end. It has never been a sincere argument that the small retailers are crushed by the existence of shopping centres as in Turkey neighbourhood street retail, called "Çarşı", is still extremely strong (Bakırköy, Beşiktaş, Kadıköy, etc) not only for high street purposes like Bağdat Street or Abdi İpekçi, but for daily shopping requirements. It is rational that the end-client prefers to shop from markets in the malls rather than street food & necessity markets, "bakkal" in Turkish, as the increasing shop size brings efficiency and lower costs to the operation. Hence, trying to protect "bakkal" is actually demanding a worse allocation of resources in the economy."

Retail Stock & Pipeline



Source: Turkish Council of Shopping Centres

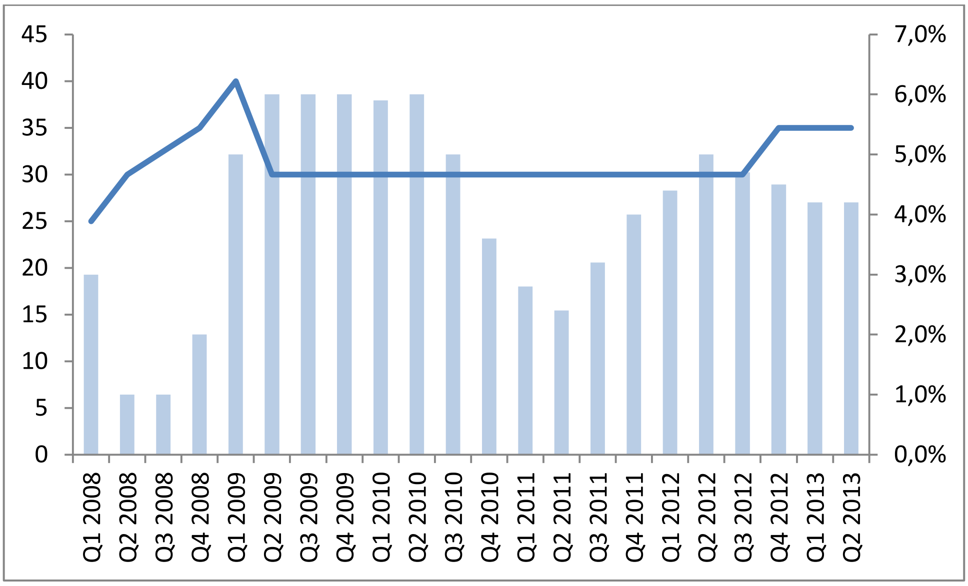
The prime rent still continues to be at the same level with the 2012 YE figure, at € 80 level, however we believe that we will be seeing a higher level as the leasing of the trophy projects such as Zorlu & Emaar Square finishes.

The office market was quieter during the 2nd quarter as most of the transactions were in the form of acquisition negotiations as will be debated in detail in the investment section. We still keep the supply figure unchanged as there are no new completed projects for the first half of 2013. Yet the on-going projects will add an extra of 1,4 million sqm until the end of 2015, carrying the total stock over 4.5 million sqm.

Grade A Offices Supply					
Market	Sub-Market	Current ('000)	Pipeline* ('000)	Future Total	% in Future T.
Europe	CBD	1.188	405	1.593	35,27%
	Non - CBD	848	486	1.334	29,54%
Asia		1.089	500	1.589	35,19%
Total		3.125	1.391	4.516	100,00%

Source: Propin, Mergen Consulting.

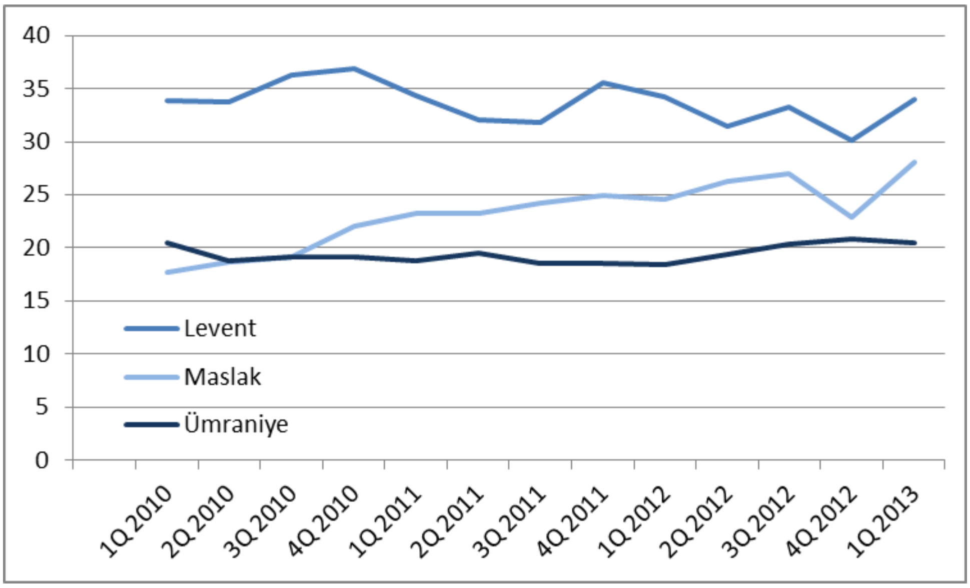
As seen from the table above, CBD holds approximately 38% of the total stock whereas Non-CBD Europe is around 27%. Despite the coming pipeline is almost half of the current stock, the future breakdown is not promising a huge change, meaning that at least for the coming 3 to 5 years, the breakdown of the stock will not experience a dramatic change.



Source: Propin, Mergen Consulting.

The above graph suggests the prime rent and vacancy figures in the CBD. As 2Q did not experience a big change in vacancy or rent levels, we tend to keep the same assumptions intact for this period.

The internal volatility of the rents continues however, especially depending the location and sub-markets of the properties. Below chart shows us the past average rent levels asked by the landlord for the last 13 quarters:



Source: Propin, Mergen Consulting.

As seen from the chart above, the asked rent levels started to move upwards due to the lack of space in certain sub-markets but limited demand keeps the prime rent at these locations stable. In such environment, the vacancy is expected to remain stable as there is no new space offered and the take up demand is very limited. The expected vacancy in the CBD is still around 4-5% levels where as in the periphery this figure goes up to double digits, especially in the non-traditional office areas like Basın Express Road & Airport region. Although close-to-airport locations are much preferred in western countries, lack of mass transportation is still a valid factor for these areas, limiting the decision makers to make their choices.

Such underlying dynamics also keeps the prime rent stable at € 30 / $ 40 levels. Although we have stated a small uptick in our graph, a slight increase to € 35, we must state that these are individual transactions and not yet became the market norm.

Investment Market

2012 was sealed by transactions from the locals as well as the international big funds such as Blackstone and GIC as stated in our previous issue. Although we have witnessed some other negotiations in 2012, these were limited in numbers and mostly statement of an intention rather than real negotiations. On the contrary, the first 2 quarters of the 2013 were active in terms of negotiations in the marketplace although just one deal has been announced as "closed" yet officially. Contrary to the transactional evidence in 2012, the negotiations that we are witnessing or receiving the rumours of are usually between locals and more interestingly, most of them are on the office market. Another interesting observation is that some of these negotiations are in the form of forward purchases, reflecting the trust to the country's economy and the future.

The only deal we hear about to be closed on the retail side is Meydan Umraniye, an ICSC awarded shopping centre on the Asian side owned by Metro and brought to market by PwC Germany. The official teaser states that the centre has a rental income of € 12 million as of 2012 and according to our market knowledge, the expected deal price is € 140 million. We have stated in The Alchemy Vol.I. ***"Although the deal is not yet closed, we are positive about seeing it closed within this year"*** and our recent market information suggests that the centre is about to be bought by a local group at the above stated price, plus VAT, suggesting a yield between 8,25%-8,5%.

Despite the lack of serious rumours on the market, we believe that there are at least 2 more negotiations continuing on the retail side of the market, one of them being a prime asset at a prime location. The Chairman of Turkish Council of Shopping Centres, Mr. Belgü, stated in one of his speeches that he believed the possibility of Middle Eastern investors and Asian investors close some deals this year in the country.

As always stated, Turkish market lacks liquidity and obviously the transactional evidence supporting the assumptions. Yet as we always suggest, agencies engaged in negotiations with both locals and international investors can observe at what levels the deals may be closed. This is the only way to establish transactional evidence on the market.

In this regard, based on such experience, the negotiations that we are currently involved suggest that the prime yield is still 7%, yet the figure is much lower for trophy assets as we believe that the product classification in Turkey is a little bit different from western standards; as there is a big gap between trophy & prime assets where the gap is much less between prime and the following assets.

In this very chapter of The Alchemy Vol. I, we have stated that it is a seller's market, where the developers and the current owners have huge power on the possible buyers as they are not leveraged and traditionally no one puts his real estate on the market or even sells it unless the price is very convincing. This is the underlying reality of the illiquidity in Turkish market, therefore we expect the status quo to continue for a while.

Office market is no exception to establishing a yield level, yet as stated in our previous issue, the only exception being Turkish individuals and corporates prefer investing in office floors. The existence of such demand-supply equilibrium undermines the institutional market on the office side; hence no single transaction of office buildings in the market for a very long period of time. However, interestingly, office market seems more active on the 2Q as we have heard rumours of multiple transactions approaching to the end.

"However, we see that most of such deals are negotiated beyond closed doors between Turkish developers and investors and we may see surprises during 2013 for some important existing buildings and projects. Contrary to the international investors, Turkish large scale investors & corporates are eager to buy vacant buildings and owner-occupier spaces. ". This was one of the statements we have made in The Alchemy Vol.I, in order to describe the main motive behind the owner-occupier demand in Turkish market. It is interesting for us to see that all the deal rumours in the market currently approve this statement.

The recent transaction on the market is the purchase of 10 floors of Torun Towers by Mapfre Insurance to be used as company headquarters. Torun Towers is a well-known office project developed by Torun REIT, in the heart of the CBD. The transaction price is declared as USD 66,7 million for almost 8250 sqm, corresponding to a value of USD 6850 / sqm plus the VAT. This level corresponds to one of the highest transactional values completed for such sqm size. Considering the average expected rent level at USD 40, the deal corresponds to a yield level of 7%, appropriate for such transaction.

The market rumour suggests that Crystal Tower deal is about to be closed positively as well. As known, a financial institution is about to buy the entire building for owner-occupier purposes, at a price of USD 6000 / sqm, but due to certain reasons the deal time extended and could not be concluded yet. However, we believe that the deal will be closed as the property is extremely well located and prestigious. It is also one of the few buildings appropriate for an institutional ownership.

Another information / rumour from the market place is that a long-awaited office project on the Büyükdere Street, to be developed by an institutional investor, is about to be sold to a local group. As the deal is on the project-to-be-developed rather than the end product, the details of the deal are not yet determined.

We also have an information on another owner-occupier office purchase is close to be signed, in a brand new under-construction multi-use project in Maslak. The project is expected to host one of the biggest office complexes in Turkey and our information is that another local group is about to buy a 10,000 sqm for owner-occupier purposes, at an average price of USD 3650 / sqm.

We believe that all these transactions and the on-going negotiations are a statement to the belief in the country's future as locals tend to understand the underlying dynamics and risks much better, as is the case in most of developing countries. Given that the commercial real estate sector in Turkey is heavily dominated by the locals, we find it wise to observe them to understand the future expectations. In this regard, having seen multiple transactions or at least transaction possibilities in one quarter, especially coming from the local investors, should be well interpreted.

It seems like that we are at the dawn of a new era. However, we do not know when we will feel the start of this era, but when once it has started, we will definitely remember these days and talk about it. Hence, it is time for us to look at the developments and review our strategy if needed.

- We have stated that Turkey is a net importer of energy, therefore we would be living with a certain level of CAD. In this regard, we believe that government's last move on Northern Iraqi oil & gas reserves are extremely appropriate. The plan is to buy the natural gas half the price we buy from Russia. In addition to this, contracting growth in the world will keep oil prices between USD 100-120 ranges, limiting the CAD.

- FED decision is very important for Turkey, given that we have benefited from the capital inflows for a very long time and now there is a risk of backflow of this capital, creating the problem of financing. As we have seen the US10Y rates gone up from 1,6140 to 2,4230 in a month's time, we can say that we will be observing much higher interest rates in the near future. Increasing CAD may force the CBRT to increase rates as well. End of easy money and negative real interest rate policy.

- Even considering the above possibilities, World Bank's recent report states an expectation of CAD as 6,9%, still quite manageable.

- The good side of the increasing domestic demand is that it supports the direct tax income in the budget. The VAT income has jumped during the 1H in the budget. Also in the 1Q, the public investments jumped 83%, fuelling the domestic demand as well. This may be a sign of populist economic policies as the election period gets closer.

- The recent events causing political shakeout and other consequences have affected the Tax Peace reform negatively. Government was expecting a cash inflow of USD 30 billion in a very strategic year where the CAD has a chance to grow. The deadline for benefiting from the law ends on July 30th and we will see the amount of fresh cash to be injected then.

- Turkey has paid back the last instalment on the IMF debt and even funded the system USD 5 billion. This is obviously a political benefit rather than financial as the debt was already low. Yet, the 66-year IMF adventure of Turkey has finished at last.

- The new Income Tax code puts additional taxes on land sales of the corporations. In the old system, if a company holds a land for 2 years and then sells it, there was no tax on the profit of this transaction. Yet with the new regime, the government implements increasing levels of tax exemption based on the holding period.

- Turkey became an investment grade country, thanks to the 2nd and 3rd upgrades by Moody's and JCR. Only S&P keeps Turkey out of investment grade. This is expected to support commercial real estate market as well.

- The consequences of Gezi Park actions, so far contained, should be followed closely. We must keep in mind that CBTR had to intervene 6 times in a day by selling USD, after 18 months of inaction.

- The increasing interest rates will create a problem for residential sector as the pricing is very much related to the credit availability. Turkey already has a good level of stock and pipeline projects in the residential; hence this is a risk for the real estate sector.

In the light of these findings, we believe that we do not have much reason to change our long-term bullish stance, putting the clause to the political side. If nothing extraordinary happens, we believe that this turmoil, caused by Gezi and the FED decisions, are rather corrections and the bullish sentiment will come back once the waters run still again.

We keep our positive stance in the commercial real estate market and the only risks we perceive are the widening of CAD, volatility of TRL and the huge stock in the residential sector. We also believe that we will be experiencing some transactions in the 2H of the year as we currently observe lots of negotiations compared to 2012 and before.

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