Herd Instinct or the “Nerd” Instinct?

The seasoned investors or followers of the Turkish market are aware of the recent debate, especially on the retail side of the markets, whether the rents should be in Turkish Lira or any other foreign currency denomination, as is the case on the market.

In the current situation, 80% of the contracts are based in EUR, and the remaining are in USD. Although we see some TRL contracts, these are either idealistic or simply “individual events” in some shopping centres and never considered as a common practice.

In a country where the current account deficit is the soft belly of the economy and supposedly we see huge currency volatility, it is understandable for both sides of the table to run for their own financial hedging. The landlord / developer wants to transfer his short position risk stemmed by the long term financing with FX denominated rental income, where the tenants prefer to pay in TRL as their income is normally in TRL. A recent survey by Jones Lang LaSalle shows that 67% of the participant tenants claimed their request to pay TRL denominated rents. However, this is not based on any scientific research but mostly on a herd mentality and instinctive behaviour. The main assumptions of this herd mentality suggest:

1. TRL is an extremely volatile currency vs. EUR, therefore tenants take the currency risk.
2. Based on Assumption 1, paying EUR denominated rents is disadvantageous for tenants.
3. The new Code of Obligations will be beneficial for tenants as the leases will be indexed to CPI/PPI average.

A critical change such as TRL rents is not much acceptable by developers as their long-term financing is always in EUR or USD terms, hence their rental income expectations. In a world where the long-term financing and development themselves are a risk, an additional short position with a “supposedly” very volatile currency is nothing but a bravery & chivalry.

Careful readers will see that we have used the term “supposedly volatile” for TRL twice on purpose, as this is nothing but the perception about the currency. When you look at the recent 5 years, on monthly changes of the TRL, USD & EUR comparatively, you will see that the volatility of TRL vs. EUR or USD is not greater than the volatility of the EUR/USD parity. As volatility is the definition of risk in finance, we object to accept TRL as “riskier”, therefore we adequately use the term “supposedly volatile”.

Volatility of Selected Exchange Rates			
Period	USD/TRL	EUR/TRL	EUR/USD
2007-YTD	0,04518	0,03738	0,03759
2008-YTD	0,04729	0,03957	0,04045
2009-YTD	0,03571	0,02776	0,03800
2010-YTD	0,03672	0,02652	0,03779
2011-YTD	0,03869	0,02558	0,03176

As seen from the table above, the volatility of EUR/TRL has always been lower than the EUR/USD rate at any period to-date, supporting our thesis that the currency volatility and risk in Turkey is not more (actually much lower) than an international investment carrying a short position in EUR/USD, two “supposedly hard” currencies. One may claim that the volatility of USD/TRL is very high, hence the risk; yet Statistics 101 suggests that this stems from the volatility between EUR/USD as it is the dominating factor. In addition to this, we have already stated that 80% of the rents are EUR denominated, not USD, therefore such suggestion is irrelevant. For the sake of fairness, we must state that the problem of TRL is not the “volatility in the values” but the “spikes in the values” of the currency. TRL tends to depreciate very quickly in times of chaos, yet stabilizes very quickly and remains in a tight band for a long period of time. Therefore, the spikes are flattened in longer term investment, creating lower risks, contrary to the perception.

Having proven the risk in TRL is only perception, we can now analyse the preference of the tenants, paying in TRL denominated rents rather than EUR. Actually, as Assumption 2 and 3 are interlinked, it is much easier to corporate the relevant studies into a single one and reach a scientific result.

For establishing a common ground with the reader and in order to explain our methodology, it would be wiser to dissert our steps and assumptions here.

1. We have gathered the data from CB & other sources on the currency rates, inflations and other economic data.
2. To smooth the effect of EUR/USD volatility, we have also calculated the “FX Basket” as used in the financial environment, corresponding to “EUR 0.5 + USD 0.5”. This is the most common way of such smoothing. Its inflation is calculated by averaging the original inflations of the currencies.
3. The study DOES NOT take into account the discounts and tenant incentives applied during the turbulent times of the TRL depreciation. For a serious comparison, we have to take into account that on average leases are 20% discounted during these times, especially in 2008-2009 period.
4. The study used indexation, therefore the compounding effect is considered. The starting date is always considered 100, and the value has been computed accordingly.

First analyses takes into account different starting years but all end up at YE2011. The main assumption is that the rents are indexed to 3% straightforward, and there is no jump in Y5, whatever the starting year is.

Starting Year	Indexation			
	TRL + Inf.	USD + 3%	EUR + 3%	Basket + 3%
2000	529,35	381,24	530,20	452,62
2001	296,50	174,60	252,30	211,10
2002	227,62	150,07	183,94	167,37
2003	195,92	170,59	174,78	172,89
2004	175,58	172,48	163,73	167,40
2005	165,43	166,78	181,79	174,89
2006	149,55	154,77	151,96	153,16
2007	139,56	181,07	159,72	168,36
2008	127,94	134,86	124,74	128,96
2009	120,43	133,88	120,59	126,04
2010	111,89	125,85	121,92	123,60

As a result, we see that the rents starting from 2005 or later are disadvantageous for tenants if paid in FX rather than TRL in a straightforward 3% indexation. Especially 2007 and 2010 stand out as the troublesome years as these are the periods where TRL depreciated very quickly. 2006,2008 and 2009 may look acceptable for starting years as the difference between a TRL rent and FX rent is not much of a problem. However, If we add the lease discounts applied during 2008-2009 season, it is not fair to say that the tenants look disadvantageous.

For each period of 5 Y				
Periods	Indexation			
	TRL + Inf.	USD + 3%	EUR + 3%	Basket + 3%
2001-2006	353,96	246,32	348,90	295,52
2002-2007	212,46	96,43	157,96	125,38
2003-2008	177,91	111,27	147,46	129,79
2004-2009	162,68	127,42	144,94	137,17
2005-2010	156,92	137,05	134,30	135,44
2006-2011	165,43	166,78	181,79	174,89

The second study compares the 5-year periods dating back from end-2011. Except the last period, 2006-2011, none of these periods seem disadvantageous to tenants, as leasing with TRL + inflation versus FX + 3% fixation is much more troublesome. Still, the main reason of 2006-11 period is the 2 depreciations in

TRL and if we consider the lease discounts applied during 2008-2009 season, it is again fair to say that the tenants did not suffer from the FX leases.

As stated before, a common application in the sector is that the leases are prepared according to the "3% fixed or the inflation of the relevant currency, whichever is higher", which puts a floor to the rental growth of the property. However, this is one of the articles which may be creating a problem for tenants, yet is not objected so far. Especially Eurozone is, or has been, a low-inflationary environment in the past and has overshot 3% inflation only once for the last 10 years. Therefore, this may be one of the real sources of "paying more with FX rent".

For each period of 5 Y				
Periods	Indexation			
	TRL + Inf.	USD + Inf	EUR + Inf	Basket + Inf
2001-2006	353,96	240,76	336,09	286,88
2002-2007	212,46	93,58	150,72	120,69
2003-2008	177,91	110,23	141,68	126,65
2004-2009	162,68	123,45	138,33	131,95
2005-2010	156,92	133,94	126,62	130,08
2006-2011	165,43	160,65	171,52	166,76

The above table shows us the 5-year periods dating back from end-2011, where the indexation has been made with the relevant inflation figures rather than a fixed rate (3%) or a comparison ("whichever is higher"). As the economic theory suggests, the value of goods in different countries equalizes in the long run in normal economies due to inflation differences and currency movements, ignoring the taxes, incentives and other protective precautions. We see that this almost comes into life with such calculation and the difference of TRL rents and FX rents become negligible in the last 5-years period, and the main difference in values is stemming from the volatility between EUR and USD as the value of the basket suggests.

Therefore, under the light of these studies, we may reach a conclusion stating our findings:

1. The difference between "TRL rents indexed to CPI/PPI average" and "FX denominated rents incremented with any method" is in reality negligible.
2. The main difference is stemming from the volatility between USD & EUR, not between TRL and any other FX.

3. The indexation method is also a parameter for the tenants to determine if their lease agreement is advantageous or not. A fixed indexation of 3% on EUR contracts is not advantageous as the EUR inflation has never been over 2.3% for any 5-year period for the last 10 years. Hence, such an indexation increases the real rent paid by the tenants.
4. The currency regime and economic structure had a real change since 2006-2007 period in Turkey. TRL became a “harder currency” and unfortunately the assumptions on the volatility of the TRL are nothing more than belief in a “herd mentality”.
5. As in comparison with any other currency with the same volatility, contracts with higher inflationary rate will always be disadvantageous. Hence, saying that FX denominated rents are and have been disadvantageous to tenants can only be explained by “nerd mentality” as these are not based in any empirical study and will shoot the beholder’s own leg at the end.
6. As stated earlier, our studies do not take into account the discounts and incentives applied during the turbulent times. When added into the model, the retailers will be advantageous vs. their landlords.

In this regard, as a result of our empirical findings, we claim that the FX denominated rents are not hurting the retailers’ balance sheets as stated in the press or sector meetings. On the contrary, we see that they may even be profiting thanks to the landlord incentives and rental discounts during the turbulent times. It is high time that we understand that the FX rents are not the problem but our ignorance and stubbornness to not to hedge is.

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