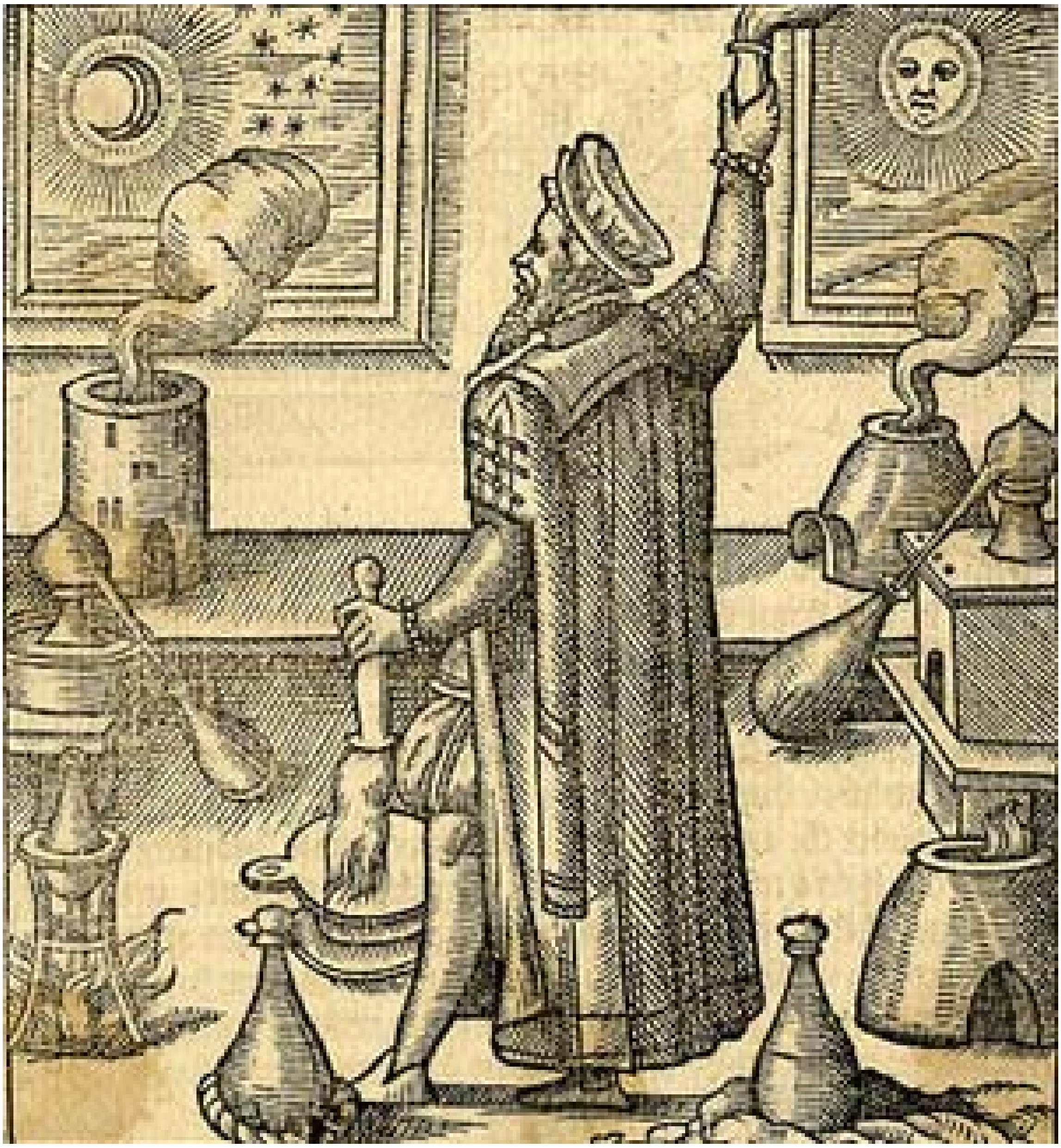
The Alchemy



MERGEN
consulting

The Alchemy

Derived on the ancient arabic word "*al-kimia*", alchemy is the art of turning a common metal into a precious metal, ultimately to gold. The alchemist, during the long process of converting the metals, mixes the ingredients in different ratios and combinations to reach his goal. Yet most philosophers state that the alchemy is a psychological process rather than physical and the alchemist also converts himself to a better human being while experimenting on improving the quality of the processed metals.

Sticking to the physiological side but not neglecting the psychological aspects, we intend to create our own model of "Alchemy", by analyzing the data we already have by adding different ingredients from political, economic, legal and of course from the market "bowls". We intend to create our own formula with different ratios of ingredients, as much as needed, each time and to achieve a level where we can improve our common metal, the data we already have, to a more precious one, an information with an added-value where only the people with eyes to see can understand...

Having a name such strong for a strategy paper is a huge risk that we are aware of, however we believe that forgetting the most important ingredients during the mixture process is a sure way of failure. The Alchemy thus aims to provide you the added-value information from different mixtures of politics, economics, legal and market ingredients; filtered by our know-how and experience in both finance and real estate.

We hope that The Alchemy will be not only an important tool of "information" but also of "commentary", which will help us to provide "a bridge between real estate and finance", an intention not solely stated before by an agent in Turkish Real Estate Market.

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.

Our generation has unfortunately adopted the existence of ethnic terrorism as "given" on this soil. However, it has been a soil of peace and common understanding; a region for harmony of diversities for centuries. Not only ethnically speaking, but these lands have always been a place for harmony of religions too. Therefore, there is always a search for peace and a quest to end the disturbance that we have been living for the last 3 decades.

Now that we have a chance to end all the disturbances, fights, etc , thanks to the recent initiative led by the AKP and supported by most of the population in the country. The imprisoned leader of PKK, Abdullah Öcalan, also declared that they want peace and farewell to arms during his Newroz statement . Although some of the opposition parties, such as CHP and MHP are accusing tthe PM to be in secret deals with the head of the PKK and other leading terrorists, the fact that these parties lost their convincing power for the last 5 years as they have never showed themselves as "opposition" in any kind, leave them isolated even if they are righ in some of their statements and warnings.

It is obvious that politically and sociologically, but most importantly humanly, the disputes coming to an end is extremely important and they are probably the greatest success of AKP so far. But these are not the only important developments that we are witnessing. After years of problematic relations, Israeli Government decided to apologise "suddenly", by the intermediary of US President Mr. Obama, and to pay indemnifications to the families of the victims in the Mavi Marmara incident. In addition to this, the recent 2-hour meeting between the Northern Iraq PM Mr. Barzani and PM Erdoğan provided enough source for a speculation on a possible deal about the sale & transfer of natural resources of Northern Iraq over Turkey. Taken into account the recent dispute between Northern Iraq and the Baghdad administration, as well as the recent initiative to end the ethnical dispute of 3 decades may well lead to a path of such cooperation; extremely beneficial for both sides.

In addition to this, government has chosen 63 “wise people” in 7 different geographic areas, to become an intermediary between government and the people, primarily in this Kurdish opening. These “wise people” are chosen amongst the intellectual elites of Turkey, journalists, academics and artists.

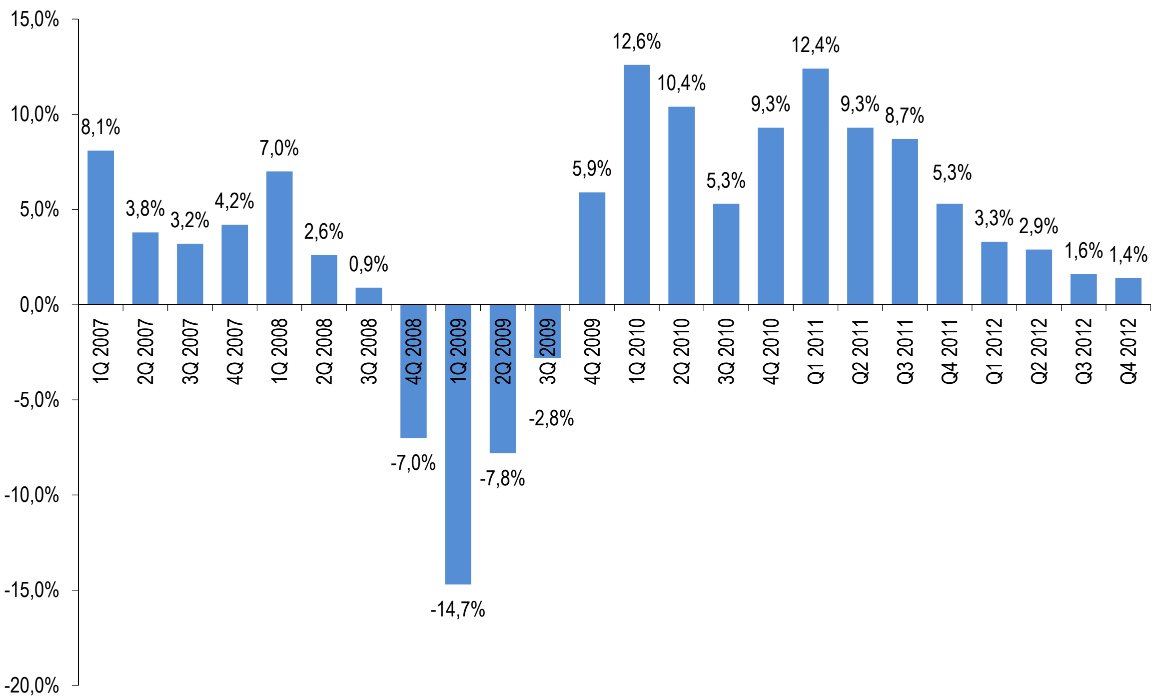
The improvements on the political side during the 1Q 2013 accelerated as if someone has pressed a button and this is obviously a very positive development for the real estate markets. Both developments, especially the dispute coming to an end, will be a major factor in cutting the country’s risk premium for the coming periods. S&P, in the report supporting their recent upgrade, stated that the upgrade decision somehow reflects the improvements on the political side, especially the recent developments on the ethnical dispute and the high hopes in realizing the achievement. We believe that such improvements and especially the peace talks will fuel the ongoing stabiziation in Turkish economy and will definitely effect the markets positively.

Economics

First quarter of 2013 has also been a good period for economic activity as well. Despite the crisis in the world, especially in Europe, Turkey continued its path to become one of the stabilized, safe haven countries in the area. Obviously Turkey has a long way to go before becoming a developed economy, yet the improvements are eye-catching and recently sealed by the credit rating upgrade from S&P side.

During 2011 and 2012,GDP growth was probably the most debated aggregate in Turkish economy. We have always been stating that the Turkish economy and its dynamics have been signaling a soft landing, therefore no sign to panic. The below chart suggests that the Turkish economy landed quite well indeed, and we see no reason for the pattern to change.

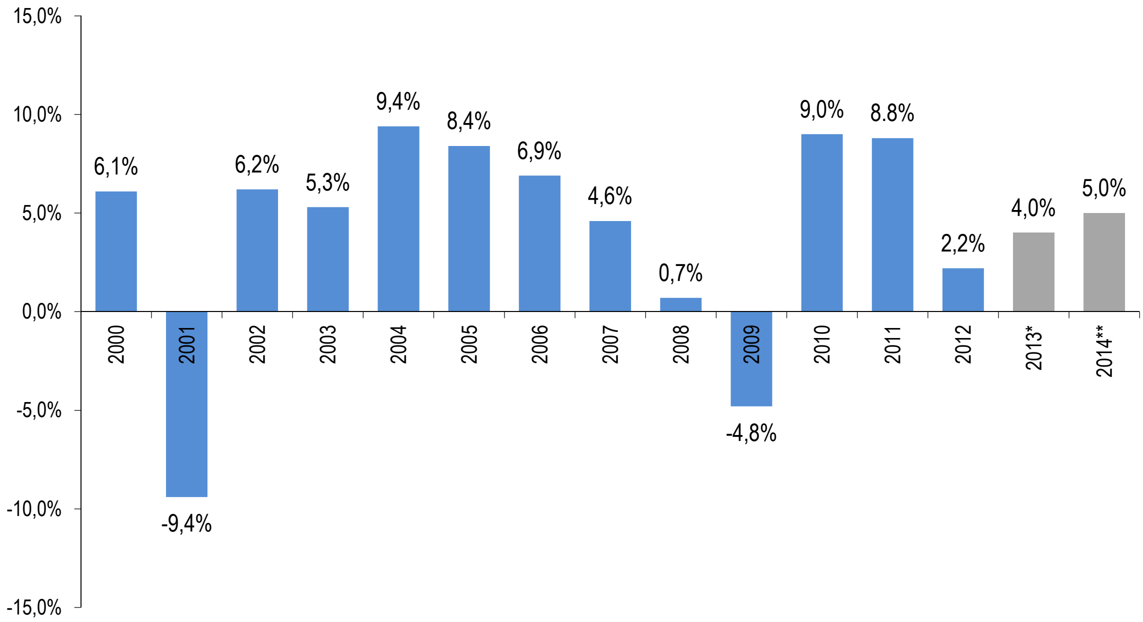
Quarterly Growth Figures 2007-2012



Source: Treasury, Middle Term Programme

Although we have seen alot of noise after the announcement of the 4Q 2012 and the yearly GDP growth figure, we believe that this is not an hard landing scenario as it does not include a stress in the markets or a recession in the economic activity. The good side of the announcements is that the economy administration is aware that the GDP growth figure is well under the expectations and growth is sacrificed for the sake of controlled Current Account deficit and immediate statements are done to satisfy the market; signaling that 2013 will be a year of better growth.

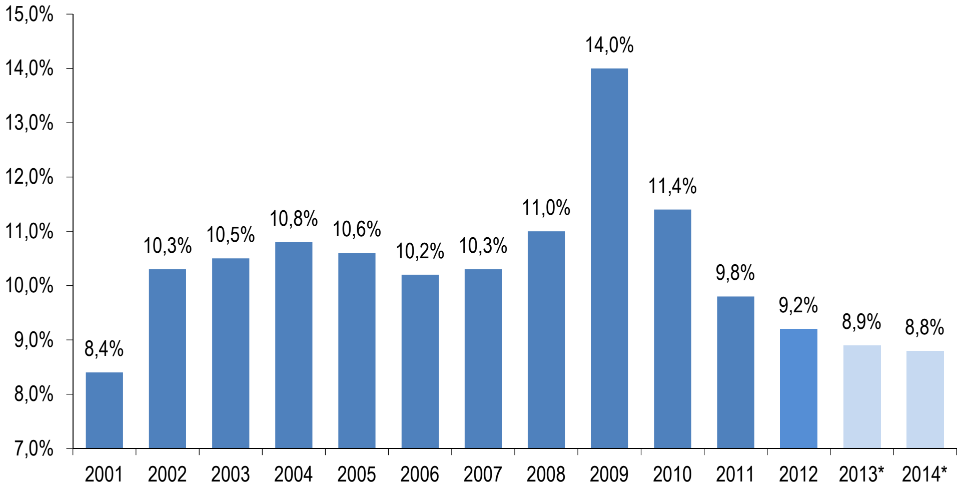
Annual Growth Figures 2000-2014



Source: Treasury, Middle Term Programme

Our biggest argument that this is not an hard landing is strenthened by the fact that the unemployment did not increase as in most of the hard landing cases suggest. The unemployment fell from 9.8% to 9.2% despite the increasing population in the country.

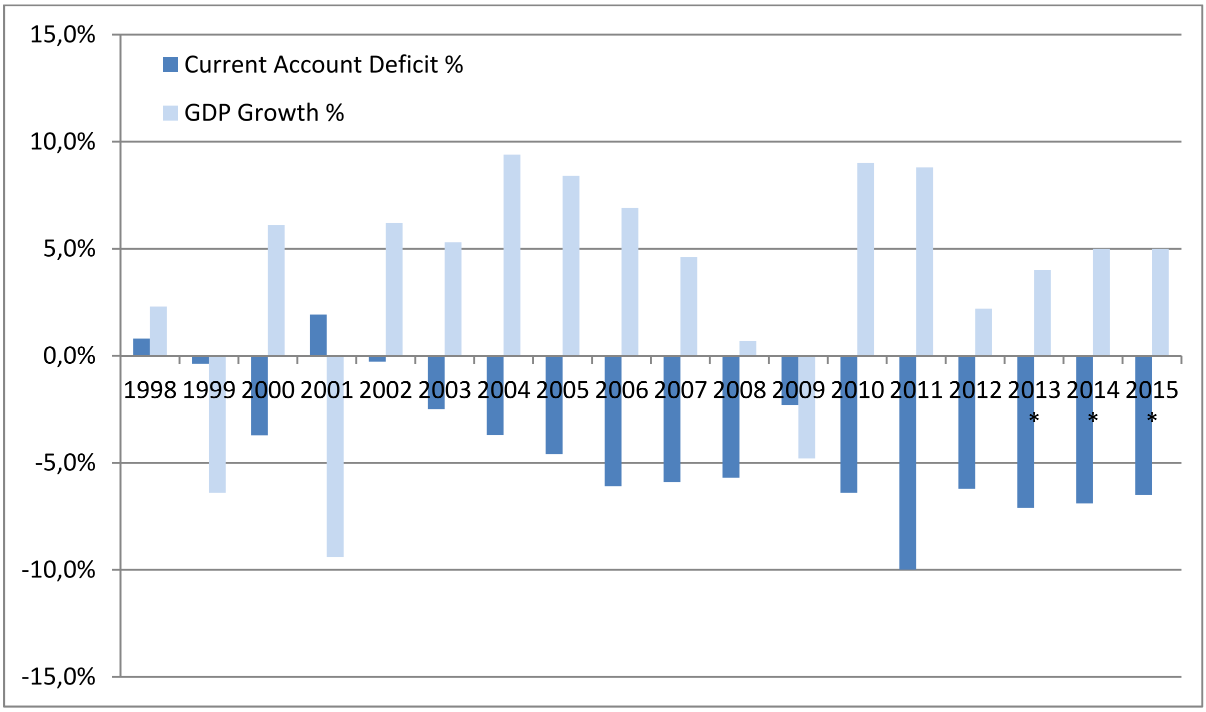
Unemployment 2001 - 2014



Source: TurkStat, Middle Term Programme

As we always state in our conversations and previous personal presentations, although current account deficit is one of the major problems in Turkish economy, we believe that it is a consequence rather than being a cause. As seen from the chart below, the CAD always increases during the periods of GDP growth. 2011 was another year of high GDP growth, hence the CAD growth, therefore the government, in order to prevent over-heating in the economy, preferred to pull the brake to provide sustainability and to prevent a road accident.

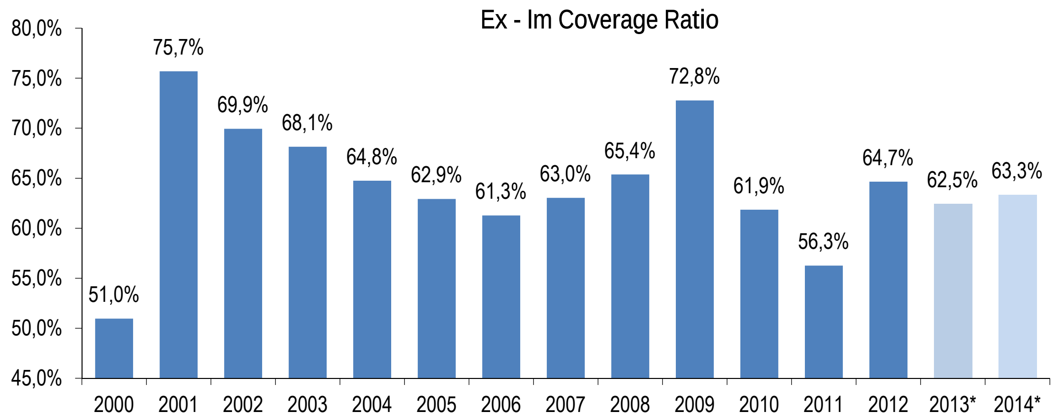
Current Account Deficit vs GDP Growth



Source: TurkStat, Middle Term Programme

The chart above suggests that the CAD and GDP Growth are negatively correlated therefore Turkish economy must have a CAD in order to have a GDP Growth, as this defect is structural and can not be offset easily. Thus, the government's main aim is to provide a sustainable growth (5% on average) with a sustainable CAD.

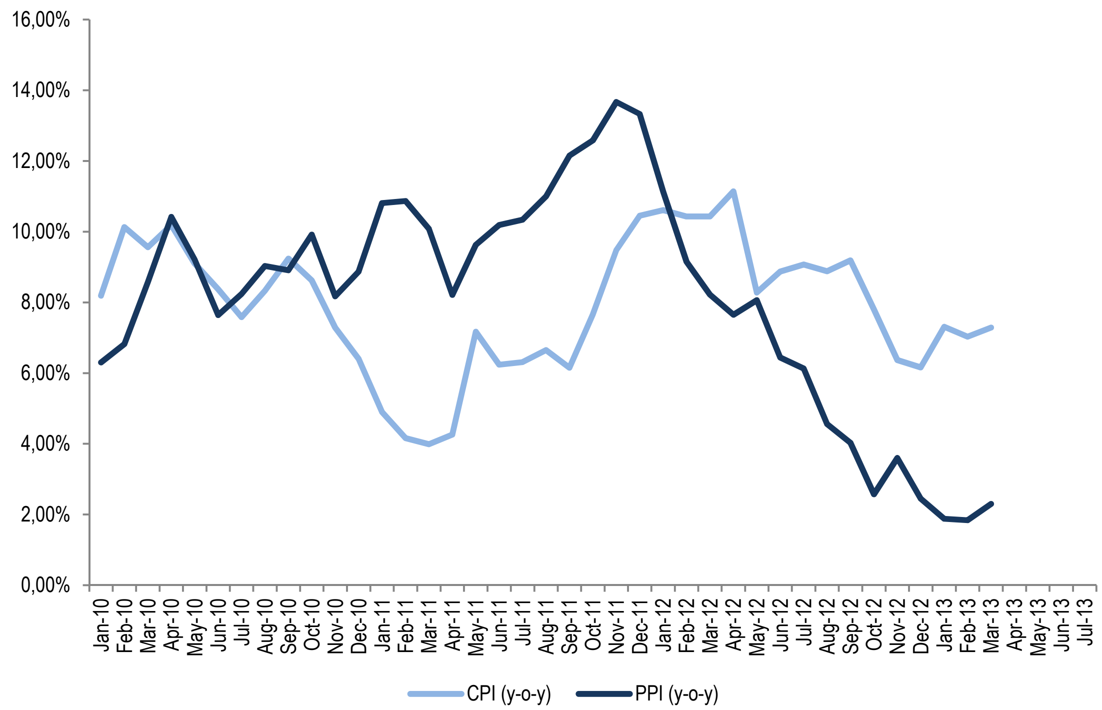
The recent upgrade report from S&P also strengthens our case by stating that the Turkish economy managed to compansate the decrease in domestic demand by the increase in exports, which we believe is quite positive. We always state that the government has now better dispersed and a geographically well-diversified export base.



Source: TurkStat, Middle Term Programme

The contraction in the domestic demand is also seen in the inflation figures. The governement and the state agencies prefer to use the CPI as the common aggregate in inflation expectations and the projections. When we look at bothe the CPI and PPI figures, we see sharp decline in 2012 compared to 2013 figures and the trend still continues as of end 1Q 20913 .

Inflation Figures 2010 - 2013



Source: TurkStat, CBRT

The best indication of the contraction in the domestic demand can be seen by the gap between CPI & PPI where during 2012, but starting from 4Q 2011, the PPI had a huge fall compared to the decrease in CPI, suggesting that the producers can not reflect the price increases as there is not enough demand.

To sum up, after analyzing the main economic aggregates thoroughly, we can state our findings and their effects on the real estate markets as follows:

1. We believe that despite the noise on the market, Turkish economy had a soft landing.
2. The soft landing is positive for the real estate market as this creates no contraction on the economic activity but a control of the biggest threat in Turkish economy, the CAD.
3. 2013 will be a better growth year, as stated by the government & officials.
4. Despite all the noise, Turkey managed to become the coutry with the second biggest GDP growth in Europe, after Estonia. Both the Eurozone and the Greater Europe (27 countries) are expected to have negative growth for 2012.
5. Even if the cap on credit expansion in banking sector will remain, we believe that this will mostly effect the residential sector rather than commercial real estate. However, in his recent speech, the governor of the CB, Mr. Basci, stated that this 15% is not a cap but a reference point; a statement interpreted as the CB's new intention to put some relief on the credit markets to support growth.
6. We do not see a possibility of high depreciation in TRL as it already moved up almost 5% in the 1Q and remained there. However, higher GDP growth and CAD will most likely create some volatility ,yet we still stick to the fact that TRL vs FX volatility will be much less than the EUR/USD volatility as is the fact for the last 3 years.
7. 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 mnost scarce item.
8. 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.
9. The recent S&P upgrade and more expectations of upgrade that we find a little bit greedy, will provide cushion for negative effects coming from the outer world. This also increases the possibility of more foreign investment in Turkey, easing the anxiety of concerns for current account deficit financing.

Therefore, if nothing extraordinary happens on the political side of the coin, we do not expect a big theme change in Turkish economy and we expect the positive and supporting investment conditions to continue during the remaining of 2013.

Commercial Real Estate Markets

As the driving component of the commercial real estate markets in Turkey, Retail continues to be the shining star and dominating more than 75% of the leasable area in the market. With the 9 new openings in 1Q 2013, the retail GLA almost reached 9 million sqm, an important threshold point, where as the offices remained slightly over 3 millions.

As stated above, 9 new shopping centres have been opened in the 1Q 2013 where the breakdown shows that only 3 of them were in Istanbul with 103,000 sqm; continuing to keep the long held 40/60 ratio between Istanbul & rest of Turkey.

Although favored by the new openings, Rest of Turkey still has 60% of the total GLA with 5,36 million sqm, including the 6 new centers having 231,000 sqm added to the stock.

As of 1Q 2013		Active	Under Construction*	Total
Istanbul	Unit	120	29	149
	GLA (sqm)	3,56 mios	1,28 mios	4,84 mios
Rest of Turkey	Unit	226	35	261
	GLA (sqm)	5,36 mios	1,04 mios	6,40 mios
Total	Unit	346	64	410
	GLA (sqm)	8,92 mios	2,32 mios	11,24 mios

Source: Jones Lang LaSalle, Mergen Consulting.

When we look at the pipeline figures, we see that the growth expectation is still intact and the pipeline is still strong. At the end of the 2013, we expect the total GLA to break through the 10 million sqm threshold, with almost 400 shopping centres. Obviously we will experience some delays and maybe some closures in some inefficient centres but we still analyze this data as promising.

With the new openings, Istanbul continued to be the market leader in terms of GLA / 000 Capita figures, increasing to 261 from 254 at the YE 2012. Ankara remained the same with 252 as there is no opening in the city during the 1Q. Overall country figure increased to 119,5 from 115 at the end of 2012.

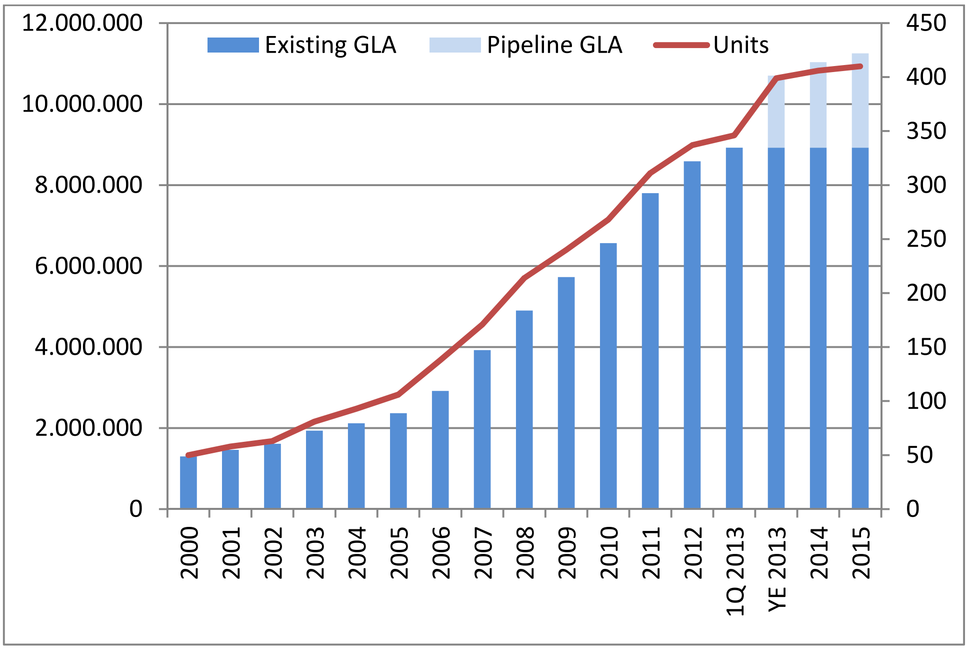
1Q Openings	City	GLA (sqm)
PIAZZA SAMSUN	Samsun	63.000
YAŞAM PARK	Niğde	13.000
BRANDIUM	İstanbul	60.000
ANDERA PARK	Siirt	24.000
NOVADA ATAŞEHİR	İstanbul	23.000
ERASTA ANTALYA	Antalya	54.000
PLATO AVM	İstanbul	20.000
BYZ GARAGE	Kayseri	65.000
SULTAN AVM	Kütahya	12.000

Source: Jones Lang LaSalle

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 neighborhood 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: Jones Lang LaSalle, Mergen Consulting.

For the 1Q, the prime rent still remains at the same level with the 2012 YE figure, at € 80 level, however we are positively inclined to see a higher level as the leasing of the trophy projects such as Zorlu & Emaar Square continues.

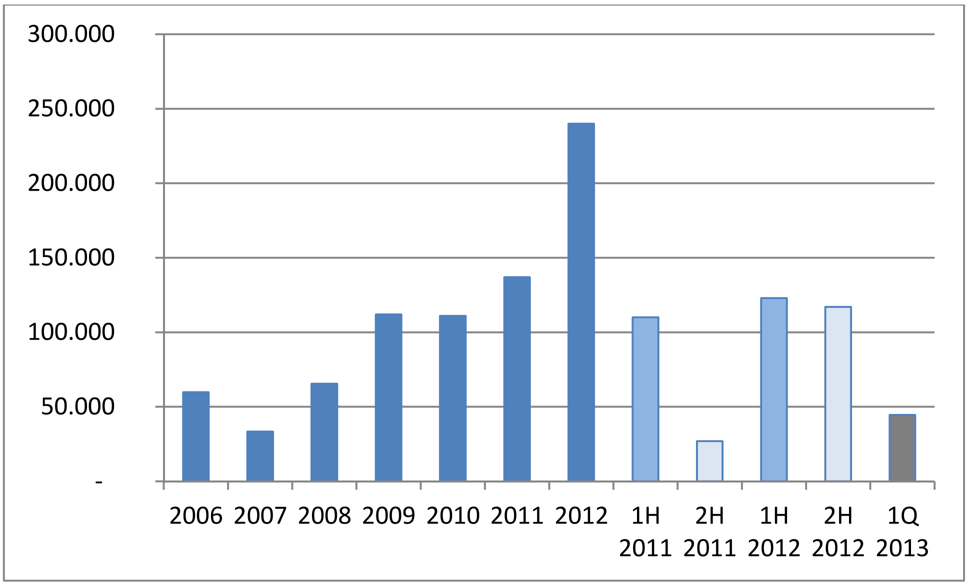
When we turn our focus to the offices sub-market, we see that the soft landing in the economy is also felt here. The supply figures remained unchanged as there is no new projects finished or planned in the last 3 months.

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.

However, according to the JLL figures, we see a take up of 44,584 sqm in the 1Q, a little bit slower considering that last year's 1H was more than 120,000 sqm. Unless the market gets hotter in the 2Q, it will not be possible to reach last year's figure, at least for the 1H 2013.

Office Take Up Volumes



Source: Jones Lang LaSalle, Mergen Consulting.

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.

The said parameters also limits the increase of the prime rent in the sector. The benchmark transactions show that the prime rent still remains around € 30 / $ 40 levels and it seems like that this will be the ongoing figure for a while.

Investment Market

As known by most of our readers, the transactional evidence in the retail sector started by the acquisition of Redevco platform by Blackstone Real Estate group, at an approximate price of € 220 millions during the 3Q 2012. Since then, we have seen more activity in the market as this was a sign of confidence by one of the most reputable private equity groups in the world. The platform, now named Qubicon, consists of 3 shopping centers in Ankara,Erzurum and Manisa and also have pipeline projects in Edirne and Manisa.

The second good news came from the GIC side as after a long deal period, they have concluded the purchase of 50% of Optimum Göztepe in the last days of 2012, for a Gross Asset Value of € 180 millions, corresponding to a yield of slightly over 8% according to our calculations. The well-known sovereign fund also completed the purchase of 50% of Optimum Ankara from Ronesans Group, at a GAV of USD 160 millions, with a slightly higher yield than the previous deal. We believe that Ronesans has benefited both financially and operationally as they have secured another well-known partner after Amstar. In fact, we think that now Ronesans increased its already accepted reputation by having Amstar as development partner and GIC as investment partner. We are sure that this will set a perfect example for a lot of investors considering to enter the Turkish market.

The entrance of Blackstone into the market facilitated the exit of Redevco from the country and the entrance of GIC showed the international arena that Turkish developers such as Ronesans provide international quality products and investment opportunities, also raised the profile of the investment market. As Blackstone entered the market by buying the already exiting Redevco and GIC has bought 50% of the 2 existing assets, in our view, the pricing in these deals can not be taken as benchmarks as qualitative factors dominate the quantitative ones as stated above. Yet, the S&P upgrade, expected to be supported by Moody's in the near future, will definitely add some more make-up to the profile and strengthen our arguments for the market.

Another deal on the market is Meydan Umraniye, an ICSC awarded shopping centre on the Asian side, brought to market by PwC Germany. The official teaser states that the center has a rental income of € 12 millions as of 2012 and according to our market knowledge, the expected deal price is € 140 millions. Although the deal is not yet closed, we are positive about seeing it closed within this year.

The deals that we are currently intermediating still suggests that the prime yield is considered as 7%, however given the financing environment and the international comparison, we see this hard to be realized soon in a deal. We believe that the product classification in Turkey is alittle 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.

As we have always been stated, the low LTV of Turkish developers cause that the yields do not increase during the time of turbulence but simply the market gets frozen. Therefore, even during the worst period of the crisis, we have not seen a double digit yield on the offer side and opportunistic investors could not get any chance of buying at overly discounted prices. The negotiations we are witnessing right now are between 7-7,5% yield levels for prime assets as expected.

The look on the office market is not far from the view of retail markets; 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. As almost all of the stock on the CBD is sold on floor basis, it is impossible to put together a deal for institutional investors in the near future.

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. A perfect example of this reality is the purchase of Maslak 42 stand-alone offices as Turcas-Shell headquarters for an expected price of USD 55 millions. The building comprises almost 15000 sqm GLA in international standards.

As stated previously, the pipeline figures correspond to 44% of the current stock; a huge pipeline to current stock ratio; therefore the strong pipeline still holds the prime rent at current levels. The only reason of not having a decrease is the lack of availability of new space in the traditional CBD. This obviously effects the investment side of the market as well.

To wrap up, we believe that 2013 will be a much better year where both the international and the local investors will be more active. The existence of transactions at the end 2012 and 1Q 2013, and observing the possible ones on the market, we believe that the interest on the investment market will continue to grow, supported by the eye-catching economic aggregates of the Turkish economy. Especially on the end-investor side of the market, we expect the increase to grow faster, thanks to the investment grade expectations.

M E R G E N

c o n s u l t i n g

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