The Alchemy

Volume III

MERGEN

consulting

The Bowl of the Alchemist

Good side of dynamic markets is that an analyst, or a commentator, is almost never out of ammunition to find a subject to talk on. Hence, in every issue, we have the luxury to talk on different important ingredients for our different bowls.

Our forecast that the Turkish markets would be more liquid seems realized as we started to see more and more deals closing. Although still insignificant in volume and unit, we believe that these are the baby steps providing self-confidence to the market and its participants. As the number and size of the deals increase, we will be having a more efficient market.

Starting from this issue, we would be preparing some special reports under the name "Distillery of the Alchemist", about the ideas, developments or debates that we believe is of interest to the real estate sector and its players. "Distillery" is planned to be an irregular section, as we intend to explain our detailed view in a matter of importance, on *ad hoc* **basis, as the necessity arises. We intend to keep this "bowl" a technical one, where empirical works will be dominating our personal beliefs and thoughts; hence the name. We do understand that this section may be boring for some of our followers, as it is for parties that find the related subject interesting and willing to go deeper on the subject; therefore we have placed it just before the "Philosopher's Stone", where we wrap up our ideas and strategies. This issue's distillery is dedicated to "extreme volatility and fragility of TRL and the currency market".**

As always stated, we are happy to hear your views, comments and feedbacks on either this section or the whole Alchemy, which will definitely help us to improve ourselves.

Dr. Kıvanç ERMAN
Founder
Mergen Consulting

Politics

The pages of the first issue of The Alchemy was underlining the importance of the new initiative taken by the government, aiming to establish a long-term peace in south-east region, supporting the rights of the citizens living in that region. Commonly called and publicly known as “Kurdish Initiative”, these series of moves mainly aimed to fill the understanding gap between the citizens of the regions and the government, neglected for more than decades. We have spoken a lot about the “wise men”, expectations and the planned steps to proceed forward. We have summarized the importance of the period as follows:

“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.”

The second issue also contained this educated guess, however in a totally different manner, thanks to the Gezi Park movements. We are aware that using the same paragraph for 3 consecutive issues is not a wise move, whether you are right or wrong, yet thanks to our government succeeding to surprise us on quarterly basis, we underline the same sentences again and again. As remembered, the Gezi Park movements have sealed the second quarter and we observe that things are not improving on the political side unfortunately.

During the third quarter, we have been mostly occupied with the expression of “precious loneliness”, used by the Minister of Foreign Affairs first, and then by the rest of the government officials. This term has been “invented” to underline the value of Turkey despite the faults of the government in Gezi Park and Syria affairs. During the weeks following the Gezi Park incidents, we have seen that Turkey has started to be isolated by the international environment and although it was not at a crucial level, the government declarations regarding the Syria policy gave the expression its true meaning. Aggressive approach of the government in Syria incidents changed the balance between Russia, Iran and Turkey where Turkey has lost an incredible amount of reputation while Iran & Russia did not hesitate to use this vacuum to their benefit. Putin’s not-so-complex but widely supported solution of putting Syria’s chemical weapons under UN surveillance and Iran’s unexpected approach of welcoming this idea created the change of power balance in the close geography.

In addition to this, things did not proceed as well as planned for the government domestically. The environment of peace and brotherhood has been hit by the suspension of retreat of the PKK forces, as most of the promises are not kept in the timeline, as stated by the PKK. However, the cease-fire still continues as the bridges are not yet burnt. In order to show some improvement and to cool the environment a little bit, PM Mr. Erdogan promised to open a new democratization package on the last day of the quarter. While these sentences were written, none of the parties were satisfied and increased their hope due to the package.

Although the EU Commission has welcomed the package, the first reactions to the package basically state that this is the statement of obvious in some areas, namely:

- The use of w,q & x in the language is not prohibited anymore, meaning that Kurdish origin citizens can name their newborns with Kurdish name and spelling. PM Erdoğan called this as "freeing the keyboards". Although legally this is an improvement, lots of Kurdish magazines have been issued with these letters for quite some time.
- Propagandas in elections, etc. in different languages or dialects are allowed, as this is again a technical improvement as this was the current situation in south-east for a very long time, for some slogans at least. However, election speeches of the candidates will be an interesting change.
- The lightest imprisonment penalty for hate crimes based on religion, race and language has been increased from 1 year to 3 years.
- The use of headscarves for public employees have been legalized except Military, Police and Justice, where there is a strict dress code. This also remains as a technical improvement.
- The political parties are allowed to have one co-president. This is another stating the obvious as the first official feedback has come from the "co-president of BDP" via a press conference, as a proof of the fact.

Despite these objections, we also observe that there are some real changes which may have positive effects, mostly moves to please certain ethnic/religious groups:

- Education in private schools is allowed to be in different languages and dialects. Still some lessons are legally to be thought in Turkish. This is a move to satisfy Kurdish citizens' demands.
- Nevşehir University will be re-named as Hacı Bektaş-ı Veli University, a move to please the Alevis, whereas their demand was the recognition of "assembly houses" (Cemevi in Turkish) as a religious practice place.

- Lands of some non-Muslim religious places will be returned to the relevant Trusts, starting with the Assyrian Mor Gabriel monastery. Move for Assyrian minority.
- A Romani institute will be established in a university to work on the Romani Culture. Move for Romani minority.
- Villages may use their historical names, which may be in other languages and dialects.

The biggest “nouvauté” plan we have seen is in the election system. These have been brought as proposals to be debated in the relevant commissions of the parliament:

- The national threshold for the parties to send members to the parliament is currently 10%. This may be kept as is, or can be lowered to 5% or 0%, with certain regional arrangements, such as tight region election system.
- The threshold for political parties to benefit from the Treasury support has been proposed to be lowered from 7% to 3%.

Despite the positive intentions of the package, we observe that two points lack for the success of the package in order to satisfy international and national environment. First, Alevis demand for a long time that Assembly Houses, Cemevi in Turkish, should be recognized as a religious practice place whereas these are still seen as social places by law. As such change may have a repercussion about recognition of Alevis as a different Muslim sect, the government is far from even debating this although it is a more obvious reality than the W, Q & X on the keyboard.

The second demand unsatisfied and underlined by the EU is that the Clergy School in Heybeliada will be remained closed. This is an important sign in recognizing the minority rights however there are certain political problems, especially the attitude of Greece, which blocks the process here.

As stated previously, it is too early to comment on the positive effects of the new package but BDP, the party claiming to represent the Kurdish citizens, officially declared that the contents are far from fulfilling the requirements they have fought for. The Co-President of the party declared that this is just an election package and far from being solution oriented. Some BDP deputies stated that there could be some articles freeing the use of local languages and dialects in public services, however we believe that this is almost impossible as such case will definitely undermine the expression of “official language” and cannot be accepted in a Unitarian state logic. Still we believe that the package is an important step and the expression of the constructive intention of the government, although not widely welcome so far.

As a last comment on the package, the tight region election system favours big parties and nets-off the positive effects of decreasing the threshold.

Other than these developments, the negotiation between Northern Iraq and the state-owned energy company (Turkish Energy Company) still continues, which we believe will be an important achievement to make the country less dependent to the outer world politically and economically. TEC is expected to be established in an off-shore country and will work as an international company entering into JVs with national and international players. We believe that such move will be beneficial for Turkey as the biggest source of CAD is energy & vehicle exportation, the areas where the government is extremely keen to either produce the national replacement or to find a cheaper solution.

Economics

Almost 3 months ago, during our last issue, it was one of the main themes whether Turkey would be soft-landing or not; therefore in the wrap-up pages, we have stated in bullet points as articles 1 & 2:

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.***

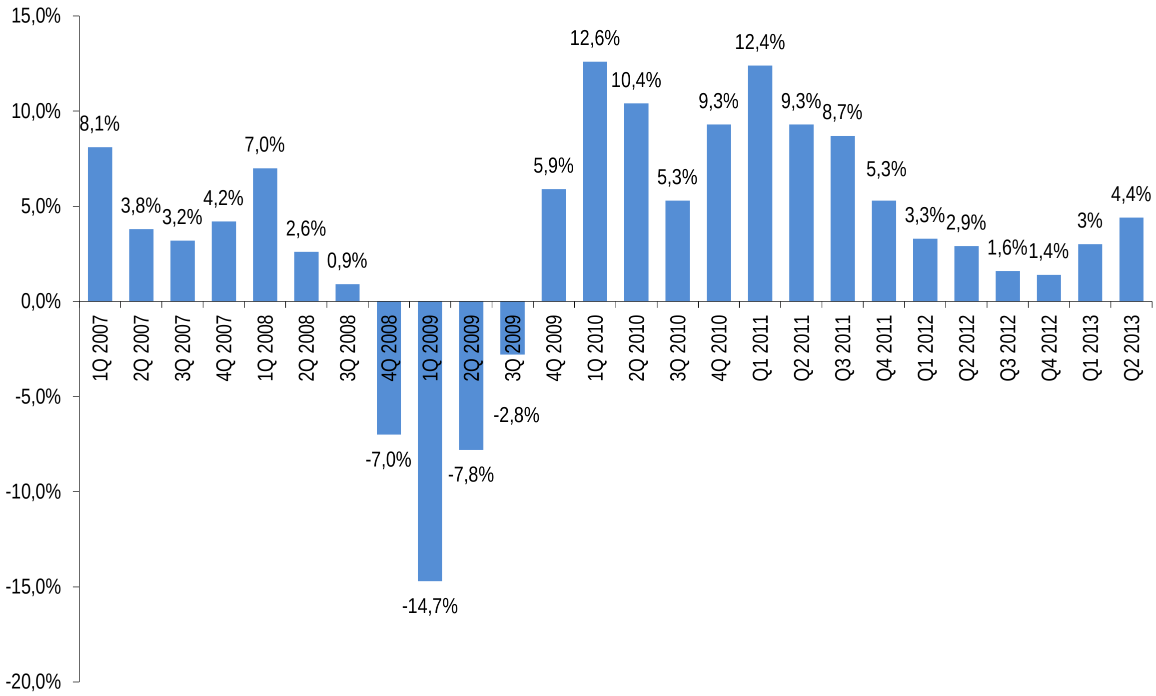
2. ***This landing has been positive for the real estate market so far, yet GDP growth will also bring CAD, to be followed closely. We believe that we need more exports for the CAD comfort, hence growth possibility.***

By stating that the soft landing debate was already over, we have also strongly stated that the debate will be on the size of the growth hence the CAD. It was also no surprise that the FED actions would create some volatility, however the main issue we have debated on these pages were whether this would create problem in Turkish economy or not. Our bullish stance was intact at the end.

As always stated, we are not in a position to launch ourselves as seasoned economists, yet it is all about knowing the underlying dynamics about the market and making educated guesses. The recent growth data, better than expected naturally, strongly supports the thesis of “size of the growth” is the main issue, coupled by the “sustainable CAD” concerns. On the CAD side of the debate, we have provided enough evidence and argument in our previous issue and we would not like to repeat ourselves just to fill pages. Instead, in this issue, our readers will find a short study on the volatility of the Turkish Lira, to see if the currency is really volatile as it has been accused of.

The 2Q growth data was better than expected and normally surprising for most of the economists, especially the ones living abroad and not experiencing the local dynamism. The latter is probably the most important component, as Turkey is the youngest country and has the most advantageous demographics in the old continent. This has self-proven as most of the growth came from the domestic demand in the 2Q, replacing the gap created by lack of international demand. We are aware that this is not a long-term sustainable model, yet we believe that it would be enough to provide a cushion in a world where a new equilibrium is awaited. It has always been the case so far.

Quarterly Growth Figures 2007-2013



Source: Treasury

Despite the government's Middle Term Plan suggests a growth of 4%, most of the international institutions increased their expectations to around 3.5% levels, from lower figures we have stated in our last issue, where we have stated that the government expectations are not easy to reach. However, the summer season also passed better than expected therefore 3Q figures will be holding the key to reach the government target of 4%. Our assumptions are that the growth will remain between these two expectations, if nothing extraordinary happens. As stated in The Alchemy Vol.I. & II., the below chart suggests that the Turkish economy has a strict pattern and we see no reason for this pattern to change.

Annual GDP Growth 2000-2014

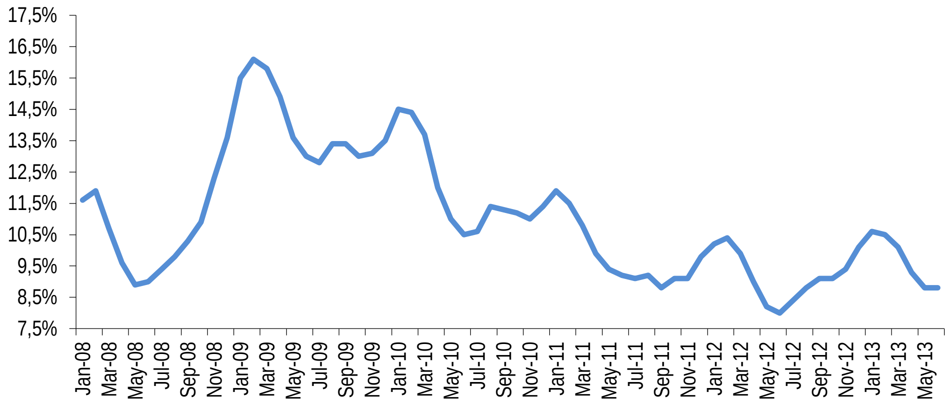
Source: Treasury, Middle Term Programme

As always stated, the growth figure is not the only aggregate that we should be analysing to capture the underlying dynamics. The unemployment, CAD and the inflation will help us to provide further insight and to make educated guesses.

Unemployment was under control for the last quarters we have previously analysed and as traditionally 2Q and 3Q are better situated periods for unemployment, we see no reason to change our positive mood. The below paragraph we have stated in the last issue is a good explanation of the pattern:

"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

The current level of unemployment, although it is the strongest season of the year as stated, makes us believe that the government target of 8.9% in the Middle Term Programme is attainable. We believe this also supports our bullish stance about the economy.

During the last issue, we have stated the below paragraphs to underline the possible effects of the FED decisions and actions, which will lead us to analyse further the volatility in the FX market, the nightmare of every international investor.

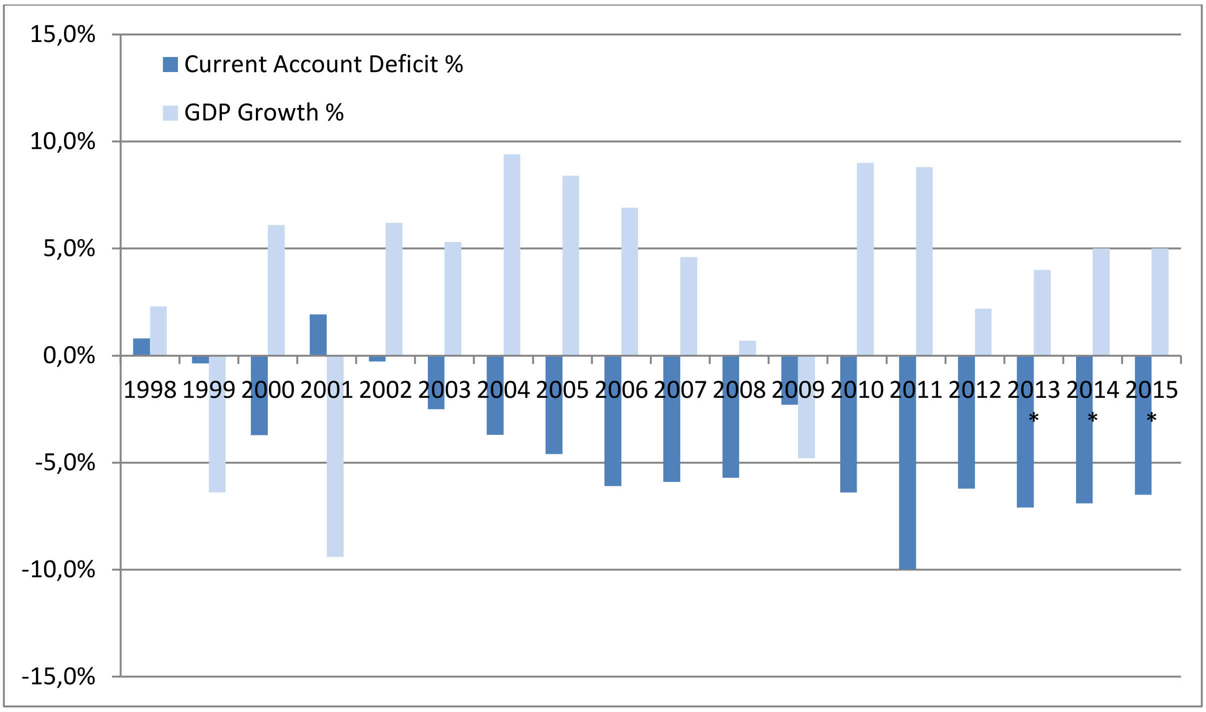
"***Every reader is aware of the fact that FED has decided to finish the asset buy-back programme, creating relief to the world markets for quite some time. This is surely the end of the "easy money" policy and means that the interest rates will go up due to the scarcity of the money, yet we do not think 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."

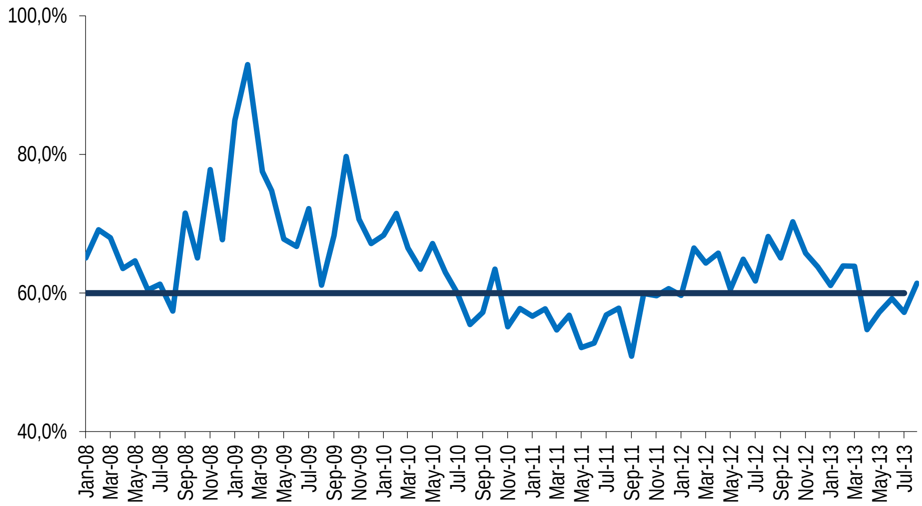
Current Account Deficit vs. GDP Growth



Source: TurkStat, Middle Term Programme

In addition to these sentences, we have also stated 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. We were concerned about the crash in April, yet we have stated that there will be a recovery thanks to the increasing USD / TRL in the following months. The recent data suggest the below chart:

Export – Import Coverage Ratio, Monthly Figures



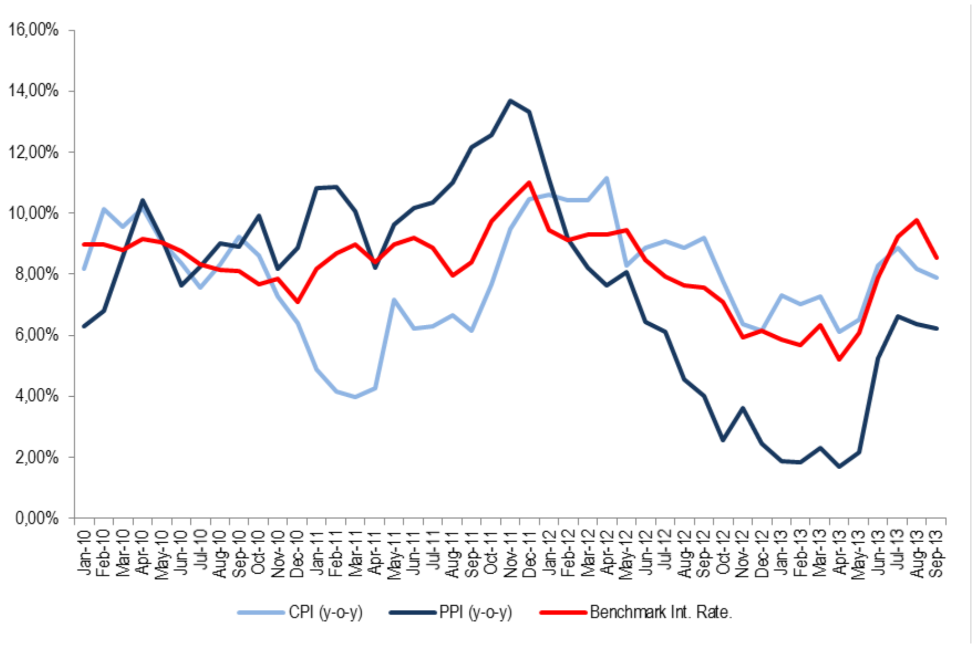
Source: TurkStat, Middle Term Programme

As seen above, the depreciation of the TRL during the period have helped the Ex-Im ratio to recover quickly hence relieving the pressure on the CAD. In order to avoid duplication, we prefer to continue our statements in this issue's special section on the volatility of TRL.

We would also like to note that the net errors and omissions article in the balance of payments was USD 4.8 billion, easing the pressure on the financing of the CAD. It is believed by the market that this money has either entered for the wealth peace opportunity or brought by the wealthy Syrians fleeing from their country. Please also note that the wealth peace opportunity has been extended until the end of October and we expect the majority of the money will enter into the system pretty close to the deadline date. Sale of Yapı Kredi Sigorta shares to Allianz also generated USD 1 billion inflow which may also be effective in the net errors & omissions figure as well.

Focusing back on the economic aggregates side, we observe that the development on the inflation side still continues and we have entered the real interest rate period back again, as we have forecasted in Vol. II. Thanks to the extreme positive mood in the first half of the year, the real interest rates were negative and the benchmark yield has been traded as low as under 5% levels where the 12M inflation expectations were no less than 6.5%. We have always expressed this as an “overshooting” in our private talks and stated in Vol. II. that this started to change due to FED decision and Gezi Park incidents. However, we believe that this is healthier than it looks as negative real interest rate has an effect to disturb the equilibrium in the economy in the long run.

Inflation & Benchmark Rates

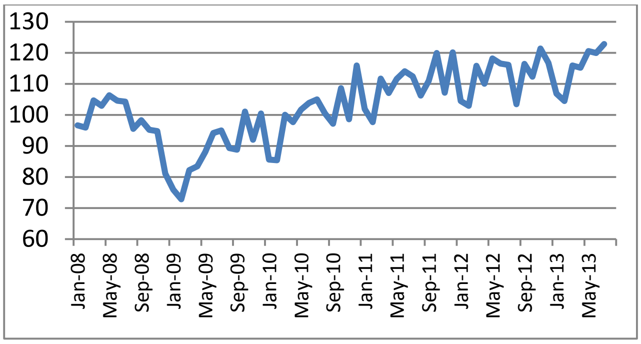


Source: TurkStat, CBRT

The above graph suggests the period of healthier relation between aggregates, although the general level went up. The benchmark interest rate went over the inflation aggregates, as it is supposed to be, and the gap between CPI and PPI compressed to reasonable levels, suggesting a healthier pricing on the producer side. Despite the uptick which took our attention & created concern in the Vol. II., the inflation figures continued to ease for the last 2 months, providing cushion for unexpected volatility.

In the previous issue, we have also stated that the relation between CPI, PPI and benchmark interest rate is becoming more normalized and there may be further interest rate volatility. During the 3Q, we have seen that the rates went over 10% threshold, coupled with the depreciation of the Turkish Lira along the short period of panic, yet the markets came back to senses with FED “after party” statements and CBRT’s wise but not well understood interventions.

Industrial Production Index

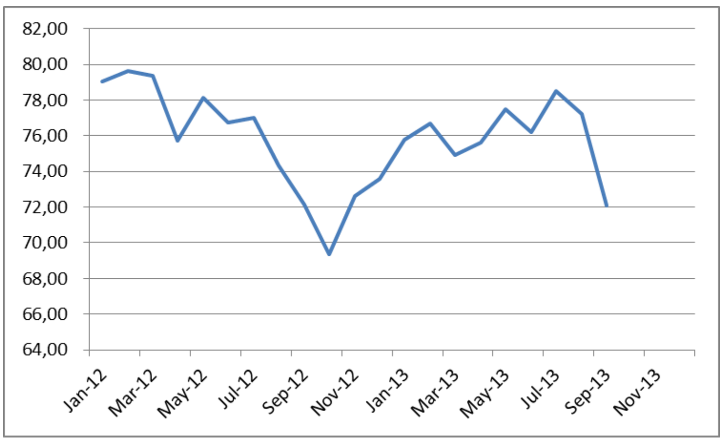


Source: TurkStat, CBRT

Capacity Utilization Rate

As seen from the above charts, capacity utilization rate remains stable where industrial production increases; another combination supporting the healthy growth within the economy. However, the consumer confidence index had a huge crash in September, mostly due to the volatility of the TRL and the recent political developments, which we do not ignore but consider as an after effect rather than a pioneering aggregate.

Consumer Confidence Index



Source: TurkStat, CBRT

Analysing the aggregates, we can summarize our thoughts and implications on our real estate strategy as follows, also self-criticising our main theme we have stated so far:

1. The size of the Turkish economy's growth will be the main issue for the last quarter, as it effects directly the size of the CAD, main weakness of the economy. Although it seems as a paradox for untrained eyes that the strength of the economy creates the weakness, we know that it is a structural state and has a check-valve system via the TRL depreciation. Despite all the noise, we preferred to stick with a minimum of 4% growth, coupled with 6.5 - 7% CAD expectation, which we believe that the market players are also converting into.

2. TRL has depreciated 13% in the first 9 months of the year and tested 2.08 level, from where we have seen international portfolio investors entering the market on the bond market side. This is extremely important as at these levels, portfolio investors are ready to take the risk. Despite all the volatility, Turkish benchmark interest rate did not stay over 10% threshold for a long time and eased back to 8-8.5% levels again.

3. We believe the necessity and benefit of watching the CAD closely but not becoming too paranoid about the data, as even the worst expectation remains around 7% level, quite acceptable for a growth year. The depreciation of the TRL in the first 9 months of the year is expected to ease the burden on the CAD for the remaining of the year.

4. The deadline for the wealth peace opportunity has been extended to October 31. Although we do not expect much of an income as taxation from this regulation, we believe that amount entering the system will be a beneficial tool for the CBRT to ease the pressure in financing the CAD. The figure in net errors and omissions is a good sign of this.

5. Europe and USA economies started to grow again after quite some time. This will be increasing the exports, especially to EU, the biggest export market of Turkey. Coupled with the easing of TRL, this will be supportive for the CAD to be financed. Preliminary effects and increases have already been seen in the export breakdown.

6. The end of the FED buy-back policy seems to be delayed for some time, at least until the end of the year; thanks to the declaration of Mr. Bernanke and the shutdown in US government. This means the continuity of the easy money at least for the last quarter and will be beneficial or at least less harmful for Turkey.

7. As we have stated in our previous issues, both the exporters and the CB seem to be happy with the new equilibrium level of TRL vs. USD & EUR. Although increasing CAD may create some more volatility as stated in Vol.I, we still believe that the TRL vs. FX volatility will be much less than the EUR/USD volatility as proven in our “special bowl”.

8. The low level of leverage in the economy (36%) continues to provide a cushion in a world where debt is the scarcest item and will continue to be so. 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 and 2014.

9. The recent declarations from both Moody’s and S&P at the end of 3Q are quite positive and far from panicking the markets. Both institutions stated that Turkey is far from a balance of payments crisis or a double deficit problem and have enough ammunition against market volatility. They have also stated that the recent moves of the CBRT were not understood at the first place but helped to save the reserves in the middle run.

10. We still believe that the only risk 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.

11. Possible populist policy for the love of upcoming Municipal Elections in 2014 is also another risk that we have to keep an eye on. Our comfort zone is mostly based on the strength of fiscal policies and balances, hence such diversion will make us re-consider our main approach and expectations, although we believe that the government will not be making such a mistake.

In light of these findings, we intend to keep our long-term bullish stance on the economy and the real estate markets, if nothing extraordinary happens on the political side. As stated previously, we will be keeping an eye on CAD without becoming too paranoid and we expect the positive and supporting investment conditions to continue during the last quarter of 2013.

Commercial Real Estate Markets

The 3Q was pretty quiet in terms of commercial real estate activity, but not on the investment side, which we will be debating during the next bowl of ingredients. The opening, take up and other “core” activities were almost negligible, mostly because of the long religious holiday and obviously the summer season.

The major hit came from the delay of opening of Zorlu Centre in Istanbul, 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. 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. The recent information states that the project will have a soft-opening on October 10th, just before the long religious holiday, with almost a month delay compared to the previously stated official timing, pretty much acceptable for such prestigious project.

The AYD dataset suggests that there are only 4 openings in the 3Q with less than 85,000 sqm, most of the size coming from Primemall Gaziantep, opened on the last day of the quarter. Carrefour Maltepe extension has also been completed during this period, adding almost 45,000 sqm to the existing GLA to reach 75,000 sqm. Yet, this activity remains quite limited, considering the first 2 quarters, each having 9 openings with 334,000 sqm and 268,000 sqm consecutively.

3Q 13 Openings	City	GLA (sqm)
Mersin Marina AVM	Mersin	10.500
Palmarina - Port Bodrum	Bodrum	5.250
Pekdemir Bereketli Outlet	Denizli	13.500
Primemall Gaziantep	Gaziantep	55.236

Source: Turkish Council of Shopping Centres

With this addition, the number of shopping centres opened in 2013 reaches to 22, with a total GLA of 686,000 sqm, corresponding to almost 8% of the existing stock. If we also consider the completion of the extension in Carrefour Maltepe, and the planned openings in the last quarter, we may easily state that the existing GLA growth will not be less than 10% during 2013, a promising number for the economy.

The recent stock and its breakdown has become as follows, according to the latest AYD data:

As of 3Q 13		Active	Under Const / Planned	Total
Istanbul	Unit	95	39	134
	GLA (sqm)	3.397.742	1.937.277	5.335.019
Other	Unit	232	60	292
	GLA (sqm)	5.568.795	6.849.659	12.418.454
Total	Unit	327	99	426
	GLA (sqm)	8.966.537	8.786.936	17.753.473

Source: Turkish Council of Shopping Centres

Successful readers & followers of our issues will again catch that the 2Q stock plus the openings will be less than the 3Q stock stated above, but this is mostly due to the adjustments and corrections in the AYD dataset, in terms of improvement. Please also remember our warning in the Vol. II. as *"the AYD figures take into account each and every publicly announced shopping centre project as "pipeline", regardless of the realization possibility or opening time".*

As seen from the above table, despite there was no opening in Istanbul during the 3Q, the extension of Carrefour Maltepe interestingly supported the long-held 40/60 ratio between Istanbul and other cities. However, there are minor changes in the city density table, negligible for the moment. 4Q's expected openings of Zorlu Centre and Forum Gaziantep are expected to change the rankings as of 2013 year end.

Despite our expectation in Vol.II. it seems like that we will not be reaching the 9.5 million sqm stock threshold with 350 centres until the end of 2013.Yet, this does not change the fact of a strong pipeline in the future.

City	Unit	GLA	GLA / 000 Capita
Ankara	34	1.220.317	245,76
Istanbul	95	3.397.742	245,24
Karabük	3	48.248	214,30
Bolu	3	51.067	181,68
Eskişehir	4	123.000	155,75
Muğla	8	126.185	148,25
Bursa	11	383.325	142,60
Kocaeli	9	221.443	135,46
Antalya	15	276.249	132,02
Denizli	5	123.725	130,16

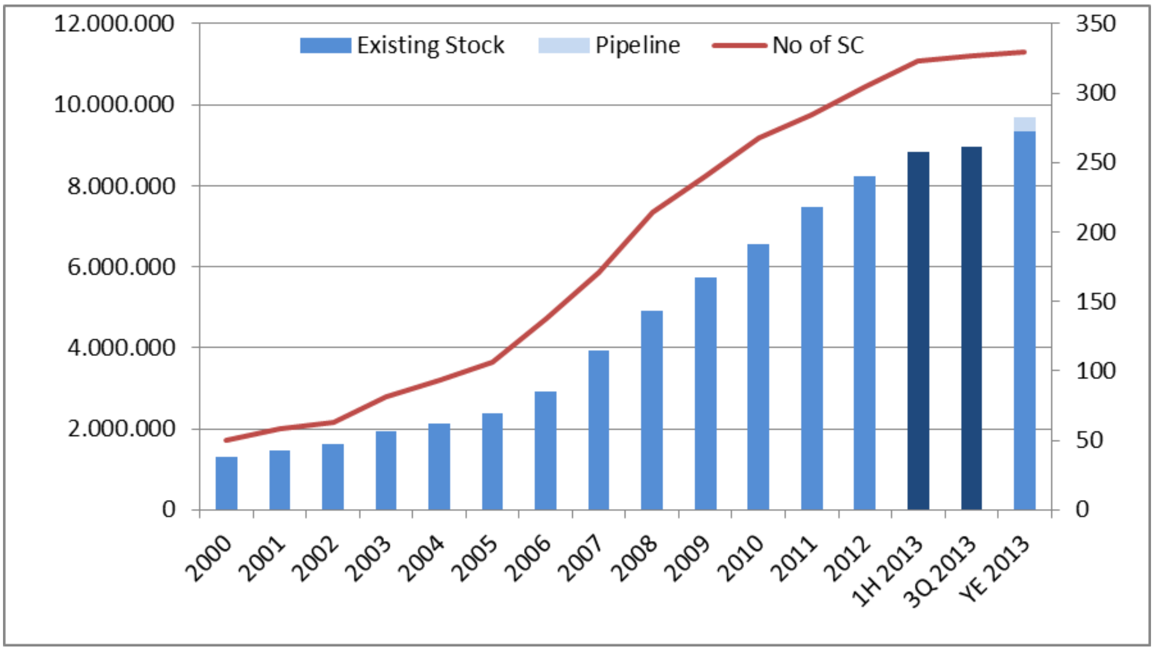
Source: Turkish Council of Shopping Centres

The recent AYD dataset suggests that Ankara became the leader, thanks to the adjustments in the dataset rather than new openings, by a very slight difference. 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.

The updated AYD dataset suggest that the GLA/000 capita is 118.56 for the whole country and 131.70 for the 57 cities having shopping centres. As stated previously, this does not make much difference on country basis and probably it is much right to use the whole country figure for international comparison purposes.

Interestingly, we did not see much chatter on the number and density of shopping centres in Turkey, as is usually the case for some journalists and politicians. However, as a centre of focus project like Zorlu Centre will be opened in the last quarter, we will definitely be hearing some more comments on the necessity and the amount of centres. The approaching New Year and the long religious holiday break-off will be a good answer to those questions though.

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 acted exactly as we have stated and forecasted in the previous issue:

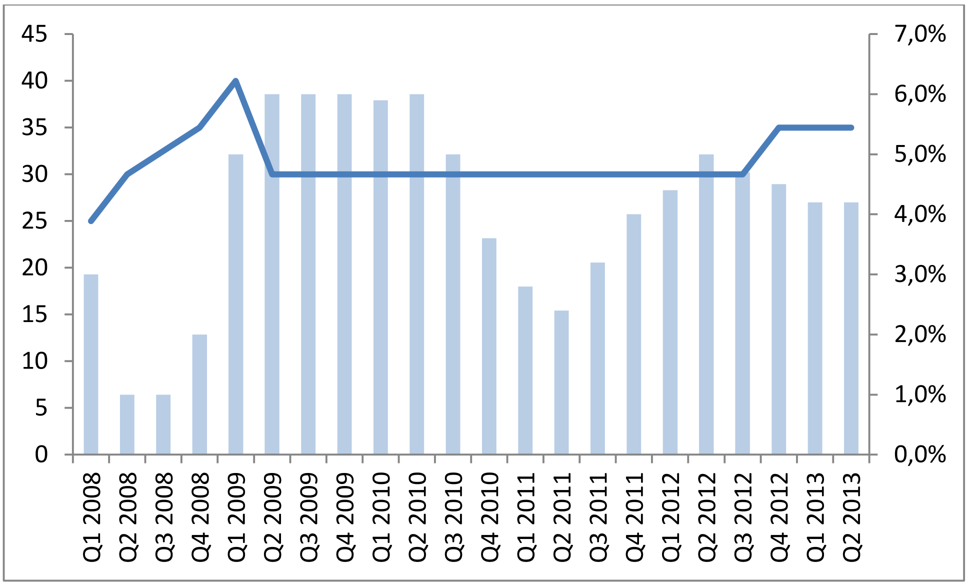
"The office market was quieter during the 2nd quarter as most of the transactions were in the form of acquisition negotiations as will be debated in detail in the investment section. We still keep the supply figure unchanged as there are no new completed projects for the first half of 2013. Yet the on-going 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.

It is true that most of the negotiations were usually acquisition purpose deals and we have seen a couple of deals in this period, although take up is considered to be very limited. In the investment section, we will be focusing these negotiations in detail.

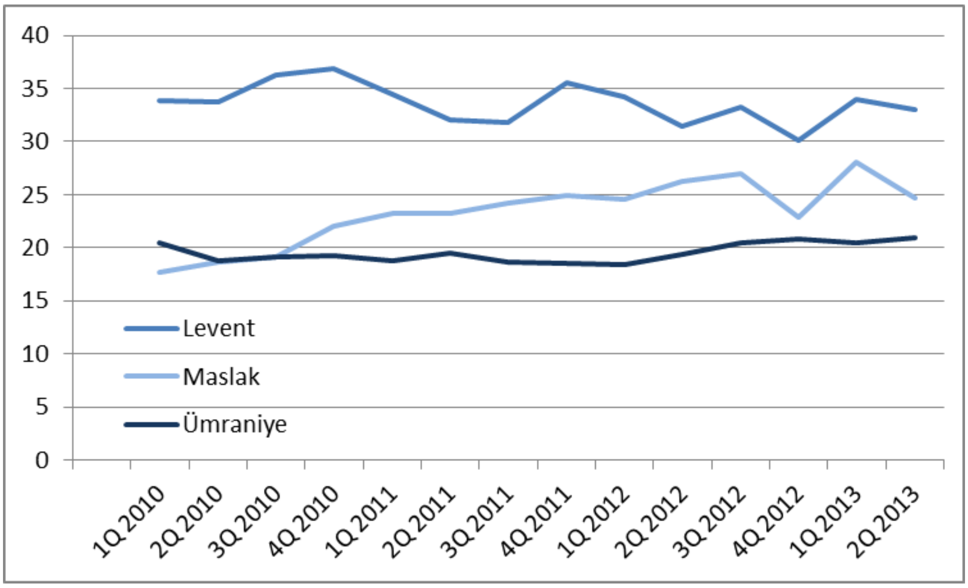
The above table continues to suggest that CBD holds approximately 38% of the total stock whereas Non-CBD Europe is around 27%. Although the coming pipeline is almost half of the current stock, the future breakdown is not promising a huge change, meaning that at least for the coming 3 to 5 years, the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



Source: Propin, Mergen Consulting.

As there is almost no change in the prime rent and vacancy figures in the CBD, we leave the above chart intact, hence we tend to keep the same assumptions intact for this period as well.

The internal volatility of the rents continues as was the case in the last quarter. For the last 14 quarters, the past average rent levels asked by the landlord are as follows:



Source: Propin, Mergen Consulting.

From the chart above, we see that the average rent levels asked are starting to get closer to each other where Maslak continues its uptrend even though in a volatile manner. Umraniye, the rising star of the last couple of years, is also in a steady but continuous uptrend. Levent area has more volatility as the region hosts not much new office space but mostly residential, both due to the municipality's approach and the increasing land prices. 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.

In light of these aggregates, we believe that the prime rent is still stable at € 30 / $ 40 levels. The main reason is that the new and quality stock is coming in cheaper districts under re-urbanization or transformation such as Kağıthane, where due to the perfect location and accessibility, we observe tenants considering to move in this area, both to decrease their rent value and lease better and newer buildings.

As stated previously, the small uptick in our graph, a slight increase to € 35, must be considered as 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%."

These were the exact sentences we have used for the entrance of this section in our previous issue. Our main theme suggested that despite the volatility in the markets, especially the locals started to see this as an opportunity and that they were into buying assets for long-term. Negotiations we have witnessed / participated as well as transactions realized and publicly announced prove our arguments about the new state of the market, where the locals are entering for long term investment motive and contrary to an international investor, they are just looking at the intrinsic value of the property, made of its land price, scarcity and redevelopment / rezoning possibilities, rather than the market value we calculate by rental income and yield.

In this regard, it was no surprise to anyone when Gülaylar Group, one of the major gold jewellery producers of the country, also the owner of City's Shopping Centre in Nişantaşı, has acquired the above mentioned Meydan Umraniye at the exact price stated above. We believe that the yield level, over 8% with these stated figures, is a good entry point for the local investor as there may be further development / rezoning possibility in the future.

The same group is speculated to be in talks to buy the Skymark office development project on Büyükdere Street, currently owned by a consortium led by Pramerica. We have informed our readers with the following paragraph in our previous issue, 3 months ago:

"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."

The negotiations were not only limited with the above projects but we have witnessed 2 surprising transactions during 3Q in the office market, both by the same buyer.

The real estate arm of Pak Holding, the biggest yeast producer of Turkey, also involved in packaging and pharmaceutical sectors, had acquired Telpa building on Büyükdere Street at a record price of USD 69 million for a GLA of 7400 sqm maximum. The price corresponds to USD 9325 / sqm and given the annual rental income, the price level corresponds to 5 – 5.25% yield level, a transaction extremely off-market. The main rationale behind the transaction is the scarcity as well as the re-development possibility in the future.

Same company also recently bought Tekstilbank headquarters, again on Büyükdere Street, at a price of USD 62.7 million. Considering that the GLA of the building, around 10,000 sqm, this deal seem more within market pricing. However, we must also note that the location of Telpa Building is much better as it is in the heart of the CBD.

Considering that Gülaylar and Pak Holding are not the only investors that we observe in the market, we may state that Turkish companies located on advantageous sectors for the last 5 years and secured a huge amount of cash, started to divert these funds into real estate investments. Favori Kuyumculuk, another leading gold jewellery producer in Turkey, has declared that they will be developing a shopping centre in Izmir, with an investment of USD 200 million, with the excess funds they have generated from their main line of business.

In our last issue, we have stated the following words about illiquidity and transactional evidence:

"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."

Obviously both transactional evidence here above do not represent the market, as due to the reasons stated, Turkish investors have a different and longer-term approach to the market. We may consider the sale of Meydan Umraniye at a yield level of 8.25-8.5% slightly under-priced and Telpa building extremely off-market, yet they are the only printing transactions so far. In addition to this, we believe that the incidents of the last couple of months and the related volatility have made the market been more suitable for buyers rather than sellers.

Based on such transactional data and the negotiations that we are currently involved, we continue to 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.

The custom of investing in office floors is basically the worst thing happening in the investment side of the real estate market, as it kills the institutional products an leaves us with the possibility of zombie buildings in the future, where the tenants and landlords cannot make decisions due to multiple ownerships.

The Crystal Tower is still one of the deals expected to be closed within this year. As to be remembered, 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.

At the end of this issue's investment section, I would recall the closing paragraph of the last issue, which we still believe is valid and contribute to the main theme:

"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."

Let's continue to watch locals then…

Distillery of the Alchemist

This section will be dedicated on the “extreme volatility & fragility of the TRL”, a statement we have faced frequently for the last 3 months, especially by the international investors and followers, just after the depreciation of the TRL started following the FED decisions on cutting the asset buy-back programme. We intend to analyse if this expression is true and whether TRL is as much fragile as it has always been stated.

As most of the readers will remember, the shakeout started not only in Turkish market but in all other emerging markets (EM), yet coupled with political disorder at the time of the Gezi Park incidents and the high CAD figures created a negative dissociation from the rest of the EM asset class. This triggered a short-term panic on the markets, pushing the USD/TRL rate up to 2.08 level and the benchmark interest rate over 10% threshold, signalling that the foreign investors are fleeing from the market, probably the worst nightmare of the system as they are essential for the financing of the CAD. In the meantime, everyone awaited a rate increase from the Central Bank (CBRT) yet the governor, Mr. Başçı, insisted to sell USD and preferred to warn the system verbally rather than increasing the rates. Such a bold move created concerns in the markets as well as in the international investment environment, however CBTR, accustomed to apply unorthodox moves since 2008, remained calm during the period.

In our previous issue, we have stated strongly that the balance of payments is not that much troublesome and Turkey has enough reserves to avoid an attack. We have also stated that such attack will require the corresponding amount of TRL, non-existent in the market and despite the debt of the public sector, there is no huge need of FX in the system for the moment. We have also spend quite amount of time explaining that Turkey’s export base is much healthier than 5 years ago and characterised by more diversified buyer and seller structure, therefore Turkey has benefited from the crisis rather than being wounded.

We are not in a position to analyse what has happened during the 3Q on daily basis as we are neither journalists nor securities dealers, yet both S&P and Fitch made declarations at the end of the 3Q on Turkey’s economic situation. CBTR officials also spoke in several meetings about the monetary policy and underlined the important points of the economic policy.

In light of these speeches and statements:

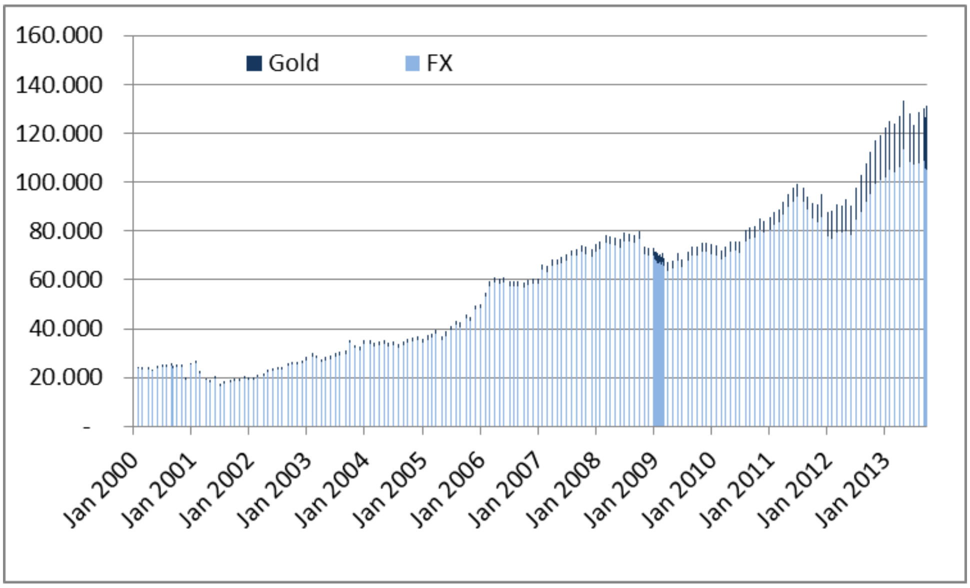
- Turkey's credit rating is preserved as is.
- Both agencies declared that despite the slowing fund flows may effect Turkey's growth performance negatively, there is no expectation of crisis in Turkey, especially stemming from balance of payments.
- Public accounts are extremely healthy with PSBR / GDP at 38% and the average borrowing period has been extended successfully.
- Net capital inflow dependency is a soft belly for Turkish economy and long-term continuation of the deficit in funding may create hard-landing scenario. This may lead a recession in case of a sudden pause in fund inflows. However, they have also stated that during the Lehman crisis and the Euro Crisis, the inflow to Turkey did not stop.
- Agencies also added that the political risk has arisen compared to the period of rating upgrade, yet still within limits.
- Strong banking sector of Turkey, low leverage of the economy and dynamic economic tissue provide cushion.
- Turkey has no risk of double deficit and the public finance balances are in good shape.
- Although CBRT has a proactive attitude, some policy changes are needed for the currency rate.

The CBRT officials, on the other hand, stated:

- The interest rates are immune from the currency moves and will not go up because the market wanted so. The rates will go up only if there will be an inflation risk.
- Long-term currency value and interest rates are always determined by the market.
- Excluding gold trade, CAD is improving on the positive side.
- Banks have no problem in rolling over. The recent roll-over ratio is over 100%.
- CBRT has USD 70 million inflow from exporters on daily basis. The national reserves are around USD 125 billion including gold, extremely satisfying to avoid a speculative attack.
- CBRT has increased the lending rate only, by 125 bps, although not much appreciated by the market.

Most of these arguments are supportive to our main theses of having no risk of extreme TRL depreciation in the markets. As can be seen from the market, the TRL tend to convert to the point, 1.92, indicated by the CBTR governor.

CBTR National Reserves



Source: CBTR.

The above chart shows that the Governor's statements are supported by the facts as the CBTR national reserves are at the highest 2nd level on weekly basis, where the first level was the week when the incidents started. CBTR continued to increase reserves despite the volatility and this supports the Governor's argument that USD is demanded by the corporations trying to buy USD for their next instalments. For those who may think that Turkish corporations have USD 160 billion of debt despite the reserve amount of USD 130 billion, we would like to remind that the emission is not more than USD 60 billion, therefore this is the amount of TRL in the economy thus it is impossible to finish the reserves as you have to pay in TRL for every USD you demand. Such attack will easily be prevented by small rate hike in the economy, hence we do not see any fragility for the currency.

In addition to this findings proving that Turkey is far from having a currency crisis, we would also remind that we have always been stating that TRL is not as volatile as claimed. In order to prove such thesis, we have run our famous (and extremely easy) calculations again, and reached the below findings. To make ourselves much clear, as "standard deviation" is the only measure of volatility (therefore the "risk") in finance, we have calculated the volatility of EUR / TRY, USD / TRY, FX Basket (€ 1 + $ 1) / TRY and EUR / USD; different frequencies of daily, weekly and monthly basis; for different periods of analyses. This study gives us 3 different tables, for each we see the "volatility" therefore the risk, of each currency. FX basket is the formula used by the financial markets to see the real volatility of TRY vs. other currencies, aiming to neutralize the intrinsic volatility between EUR and USD.

The last reminder is that commercial real estate markets in Turkey use EUR denominated rent structure, to be calculated and paid on monthly basis. Therefore, in order to understand the effect of FX volatility on real estate sector, we have to look at monthly EUR / TRY volatility, or FX basket volatility at least.

Daily Volatility of the FX Rates				
Period	USD/TRY	EUR/TRY	FX Basket	EUR/USD
2008 - YTD	0,00891	0,00798	0,00763	0,00715
2009 - YTD	0,00677	0,00600	0,00548	0,00647
2010 - YTD	0,00608	0,00544	0,00487	0,00609
2011 - YTD	0,00578	0,00551	0,00487	0,00569
2012 - YTD	0,00477	0,00470	0,00407	0,00485
2013 - YTD	0,00528	0,00528	0,00471	0,00483

Daily volatility table suggests that out of 6 periods analysed, 5 periods of EUR / TRY has less volatility then EUR / USD, which is the same case for FX basket as well. This is extremely surprising as TRY is considered “risky currency” for a EUR investor where actually the risk undertaken by investing in TRY asset is much lower than investing in USD, on daily basis.

Weekly Volatility of the FX Rates				
Period	USD/TRY	EUR/TRY	FX Basket	EUR/USD
2008 - YTD	0,02012	0,01751	0,01710	0,01502
2009 - YTD	0,01544	0,01427	0,01311	0,01370
2010 - YTD	0,01436	0,01309	0,01192	0,01329
2011 - YTD	0,01350	0,01303	0,01176	0,01221
2012 - YTD	0,01138	0,01129	0,01005	0,01050
2013 - YTD	0,01334	0,01171	0,01133	0,01033

Weekly basis calculations show different results interestingly. According to the results of the study, EUR / TRY has more volatility on weekly basis then EUR / USD, however the basket rate has less volatility 5 out of 6 times, suggesting that the volatility increase in weekly period does not come from the TRY component of the equation but the EUR itself. FX basket having less volatility is obviously normal, however contradictory results such as this one, give us deep insights about the real reasons.

Monthly Volatility of the FX Rates				
Period	USD/TRY	EUR/TRY	FX Basket	EUR/USD
2008 - YTD	0,04728	0,03636	0,03621	0,03791
2009 - YTD	0,03281	0,02746	0,02369	0,03641
2010 - YTD	0,03218	0,02724	0,02442	0,03287
2011 - YTD	0,03065	0,02639	0,02478	0,02670
2012 - YTD	0,02973	0,02520	0,02394	0,02557
2013 - YTD	0,02385	0,02236	0,01991	0,02323

Above table is what matters the most for our study, as the rents are calculated, charged and collected on monthly basis (beginning or end of the month), therefore in order to see the real effect of the currency volatility on commercial real estate, we have to analyse this table. The results of our model suggest that out of all 6 periods, EUR / TRY volatility, therefore the risk, is much less than the volatility of EUR / USD. This is also normally the case for the FX basket, where the intrinsic volatility between different currencies are neutralized.

The results of the study is empirically proven and extremely clear:

- TRY is not a volatile currency for the last 5 years, as argued in the press or by some of the market players. Plus, the accumulated volatility tends to decrease as the starting point gets closer, indicating that the volatility is stemmed from the historic data rather than recent ones.

- EUR / USD is a more volatile parity, compared to EUR / TRY. Therefore, investing in USD asset carries more currency risk than investing in a TRY asset, for a EUR based investor.

- As 80% of the commercial real estate assets are denominated in EUR, such volatility is far from harming the asset quality. If that is the case, USD based assets should be considered riskier, as the logic and the mathematics suggest.

- High volatility of the TRY is not more than a “misperception”. The herd mentality in the market supports the argument but as empirically proven, this is not a reality.

- TRY has spikes and depths, however. As we have always stated, TRY is a currency which is like “diabetes” where the sudden moves like spikes and chutes create more problems than the level of the currency itself. During periods of spikes and chutes, the volatility of TRY may seem high, or more properly, spikes and chutes are low in frequencies but strong in power. Plus, history suggests that sudden TRY depreciations tend to ease slowly, and mostly even below the starting point.

Philosopher's Stone

Turkish markets continue to be dynamic, as is always the case. Although this is mostly perceived or commented as "volatile" by untrained eyes, we have proven that this is not the case. Turkish real estate markets are supported by a sound economy where the fiscal equilibrium is protected by solid reserves and a CBRT knowing what to do, at least so far.

In order to wrap up our findings during this issue, we can simply state below points:

- As stated in the Vol II, 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 secure the oil and gas at a better price in order to effect the CAD positively and break another curse in the Turkish economy.

- The democratization package declared by PM Mr. Erdoğan seems far from fulfilling the demands of different groups. This may create further disturbances during the last quarter on the political side. Approaching municipal elections are also increasing the risk & tension on the political arena.

- Despite the turmoil in the markets created by FED decisions, the recent developments on the markets and the US shutdown will provide more than expected time for the new equilibrium to be understood by all the market players. Despite the fact that Turkey needs foreign financing for the CAD to be financed, we have so far proven that the aggregates are enough appealing for international portfolio investors to bear the risk at certain levels. We also support the government's move on Northern Iraqi natural resources aiming to bring down the CAD.

- The worst scenario on the market regarding the CAD is around 7% still quite manageable for short term.

- We believe in the necessity of close-watching the CAD but we suggest to avoid being too paranoid of the data. CAD is a reality and will happen as long as Turkey grows within this structure.

- As stated in the previous issue, the increasing domestic demand continued to provide a cushion for the economy where we may lack some of the international demand. This will also support the direct tax income in the budget, with VAT income.

- The government expects a cash inflow from Wealth Peace (or Tax Peace) of USD 30 billion in a very strategic year where the CAD has a chance to grow. The deadline has been extended to October 31st and we believe that there will be a significant amount entering. Please remember the USD 4.8 billion in net errors & omissions.

- We have proven above that CBRT has sound FX reserves and Turkish lira is not as volatile, hence risky, as stated by some market players.

- Despite the lack of activity on the commercial real sector core business lines during the 3Q, the total amount of new stock will be around 10%, especially for the retail, proving the local demand.

- The commercial real estate markets were active in terms of acquisitions and negotiations as we have forecasted in Vol. II. We believe that Turkish markets are getting more and more used to commercial real estate trading, which is not much of a custom due to the traditions.

- Although some of the shopping centres started to fix currency rate to determine rent levels, we believe and see that most of the centres do not need such incentives as long as the business continues inside.

- We still see the residential sub-sector as the riskiest sub-sector as it is very much dependant to interest rate environment. Plus, the huge amount of pipeline and the current stock create concerns. Although we believe that certain level of projects are immune to such volatility, mid-class to upper-middle class projects carry certain risks due to interest rate expectations and excess stock.

As a result, we see no reason to change our long-term bullish view on Turkish economy and the commercial real estate markets, as long as nothing extraordinary happens, especially on the political side. We believe that CAD, approaching municipal elections and the stock in residential sector should be closely watched, without being too paranoid, as stated previously. We are sure to have an even better picture in our next issue analysing the whole 2013 in detail.

M E R G E N
c o n s u l t i n g

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