The Alchemy

Volume IV

MERGEN

consulting

The Bowl of the Alchemist

Our veteran readers already have realized that we are late in delivering the Vol. IV of The Alchemy, considering our punctuality in issuing the previous volumes, following the end of each quarter. Actually this is not a delay or a deviation from our punctuality, but a conscious preference due to our London visit we have realized last week. Given the recent political and economic shakeout in Turkey and its financial markets, we found it appropriate in terms of timing to meet with the foreign investors, both in order to explain certain interior aspects of the current turmoil and to benefit from their exterior views and thoughts. Therefore, our special chapter, "Distillery of the Alchemist", will be dedicated to our foreign friends' views and expectations on Turkish markets.

2013 was a very interesting year for everyone. Started with peace talks and ended with a huge turmoil, it proved our thesis of having no trouble of finding a point to write in Turkey. On the contrary, we had so many developments we had to limit ourselves when writing, not to exhaust the readers, yet we were sometimes unsuccessful and filling more than 30 pages. As it is our primary intention to give insight, rather than news and data, this is a trap that we could not avoid. Yet we will do our best to compress the size of the volume for everyone's sake.

In this volume, we will try to summarize the important events of 2013 and will submit our expectations and projections for 2014. As always, we would like to state that we are not the creators of the data but views by using the best set of available data on the market.

As this is the fourth volume of The Alchemy, we have been celebrating our first year of operations as well. We would like to thank you, all of our friends and colleagues, for supporting and sparing time to us. We hope to increase our interaction further in 2014. We wish you a happy, healthy and wealthy 2014.

Dr. Kıvanç ERMAN
Founder
Mergen Consulting

Politics

In the opening of Vol.I, we have used the exact paragraph below, which we have reiterated in Vol. III.:

“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.”

As said at the time, it was definitely not a prophecy but just an educated guess, due to what we were living during those days and is still quite true regarding the turmoil we have witnessed at the end of the year, bringing two power centres in a battle.

2013 started with a brotherhood environment, where the long-lasting dispute with separatist PKK has almost came to an end. As known by the name “Kurdish opening”, the transformation package was actually far from satisfying the needs of the ethnic & religious minorities. Yet it was an important step taken by the government and much welcome by the related parties as a sign of goodwill.

The following apology of the Israeli government considering the Mavi Marmara incidents created a small recovery in relations between and was a very good sign of Turkish government’s increasing influence in the international area.

Deal on sale & transfer of natural gas and oil of Northern Iraq over Turkey was another important point, ignored heavily by economic players & investors. Daily 100,000 barrels of oil is expected to be bought as of 2016. We see this as a perfect step taken, both politically and economically as this is one of the best ways to decrease CAD and increase political influence of Turkish state in the region.

However, Gezi park movement, during the end of 2Q, was extremely important as it was the change of the reputation of the government. It was a turning point for the domestic support of the government as PM Erdogan preferred to be suppressing rather than compromising, changing the general attitude of the government. We now understand that they were merely the beginnings of the battle surfaced on December 17, a fight for power between the "Community", led by Mr Fethullah Gülen, and the AKP government.

It was never a secret that AKP was not actually a homogeneous structure, but mostly a coalition of conservative forces, the biggest being the "Community" and the group led by PM Erdoğan. As we have always stated, PM Erdoğan's attitude and approach changed heavily after May, following the USA visit and the Gezi Park movements. It is widely believed in the written media that the Gezi Park movement was read by him as the preliminary attacks of the Community forces, hence the suppression. The government, as a counter-attack, tried to close the "dershane"s, private auxillary – schools, where the Community is believed to recruit and finance itself the most. Counter-punch of the Community was almost fatal, on December 17, led by prosecutors and police entities accused to be tied to the Community, bringing into public the corruption scandal, forcing 4 ministers to resignation. Needless to say, the Cabinet has been reformed, by kicking out all the ministers other than the ones trusted by the PM himself. This is followed by a further questionable counter-moves from government in terms of democracy, such as reassignment of police chiefs and prosecutors. The last point of extreme measure was to tie the judiciary power to the Ministry of Justice, hence undermining the primary principle of "separation of forces" in a democratic state.

Whatever the underlying reasons are, tightening of democracy in such a way, cannot be understood by foreign players and the international environment as well as the Turkish intellectuals. As we are redacting these paragraphs, it was still a question mark where the extent of this extreme measures will come to an end. Yet we believe, or want to believe, that the common sense will win over at the end.

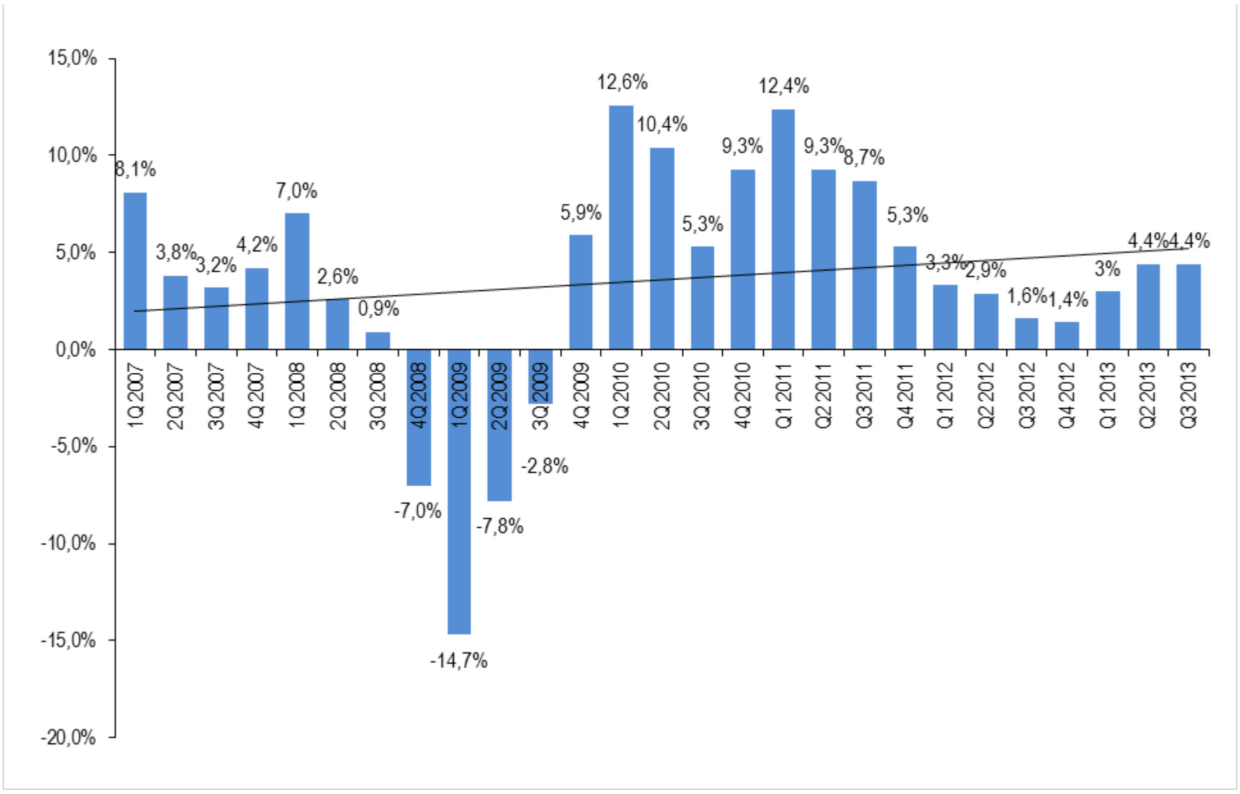
As 2014 is a double-election year, Municipal elections in March and Presidential in August, we believe that we will be hearing more and more noise during the year, especially as the municipal elections approach. This will bring us more volatility and uncertainty during 2014.

Economics

2013 was an interesting year also on the economic front as well. Despite the noise from the market players at the beginning of the year, our long term theme was “Soft landing in 2012, take off in 2013” worked very well. The growth was intact where the unemployment remained quite contained, contrary to the EU countries. This has been approved, although a little bit late, by the S&P’s upgrade in 1Q and Moody’s upgrade to investment grade in May.

Despite the negative effects of the Gezi incidents and the increasing currency rate since then, the growth on quarterly basis continues to remain strong, although we do not know the 4Q data yet. However, the expectations on 2013 growth is no less than 4% for even the most conservative.

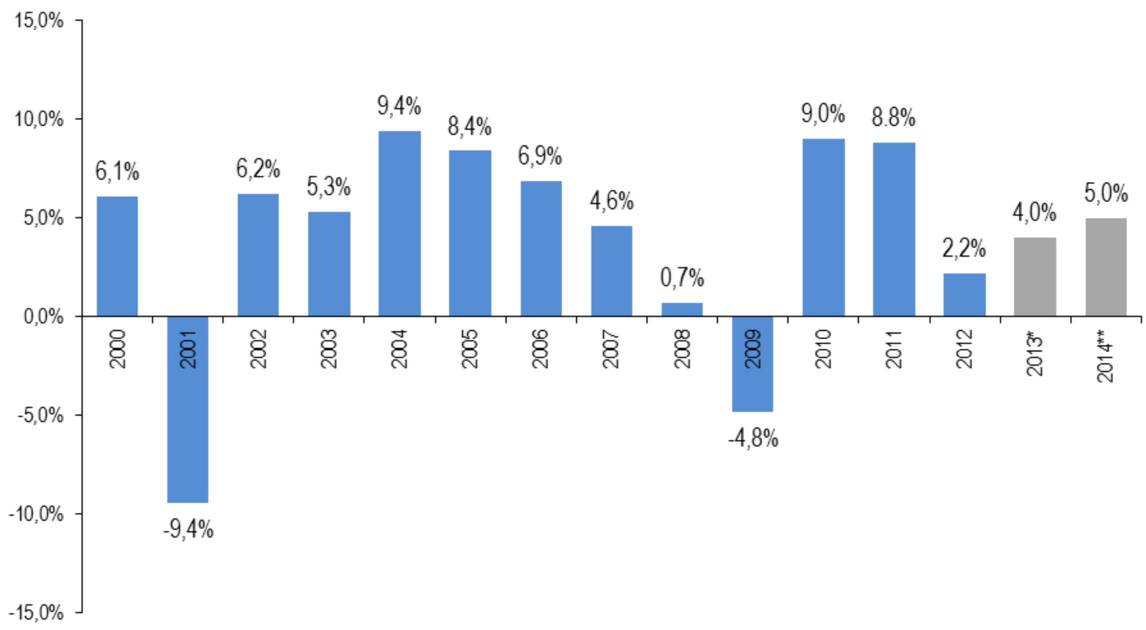
Quarterly Growth Figures 2007-2013



Source: Treasury, Middle Term Programme

Despite the government's ambitious Middle Term Plan suggests a growth of around 5% for 2014, we believe that this is not quite possible given the level of currency and the political turmoil creating an uncertain environment. We expect the growth between 3%-3.5 % for 2014, based on our trusted research houses.

Annual GDP Growth 2000-2014

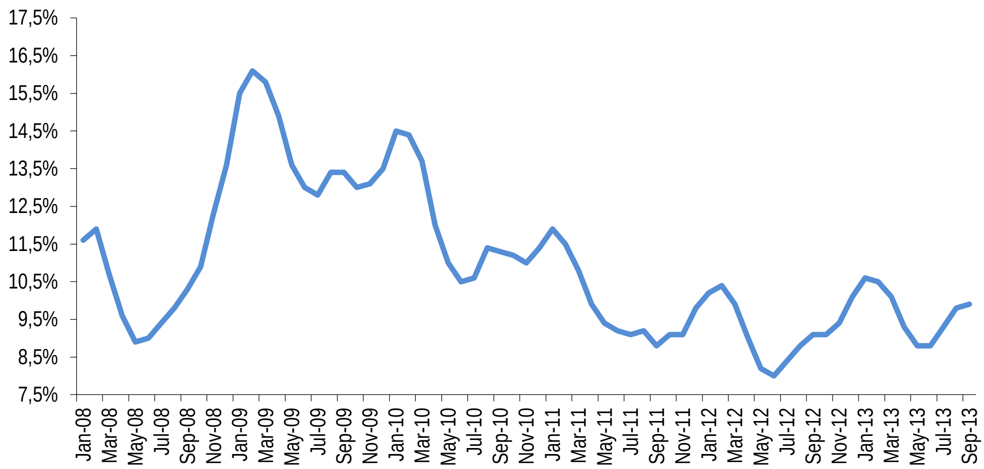


Source: Treasury, Middle Term Programme

During the whole 2013, our biggest argument supporting the soft landing scenario was the lack of increase in the unemployment figures. Despite some uptick in the recent months, Turkey managed to keep unemployment contained in single digit in 2013, as the latest data released was 9.9%, still better than most of the EU countries. We are sure to see some correction in the 1Q, as we have previously stated, traditionally 2Q and 3Q are better situated periods for unemployment, and therefore it will not be self-convincing to say that the correction will be limited.

The below monthly chart supports our thesis above, as one can see that 2Q and 3Q figures are advantageously situated as a pattern in Turkish economy, due to the harvesting season in agriculture. 1Q is always the peak level, as is the year end, therefore we may see a small increase in 1Q 2014 as a seasonal correction and believe that the unemployment will remain at manageable levels during 2014.

Unemployment, Monthly Figures, 2008 – 2013



Source: TurkStat, Middle Term Programme

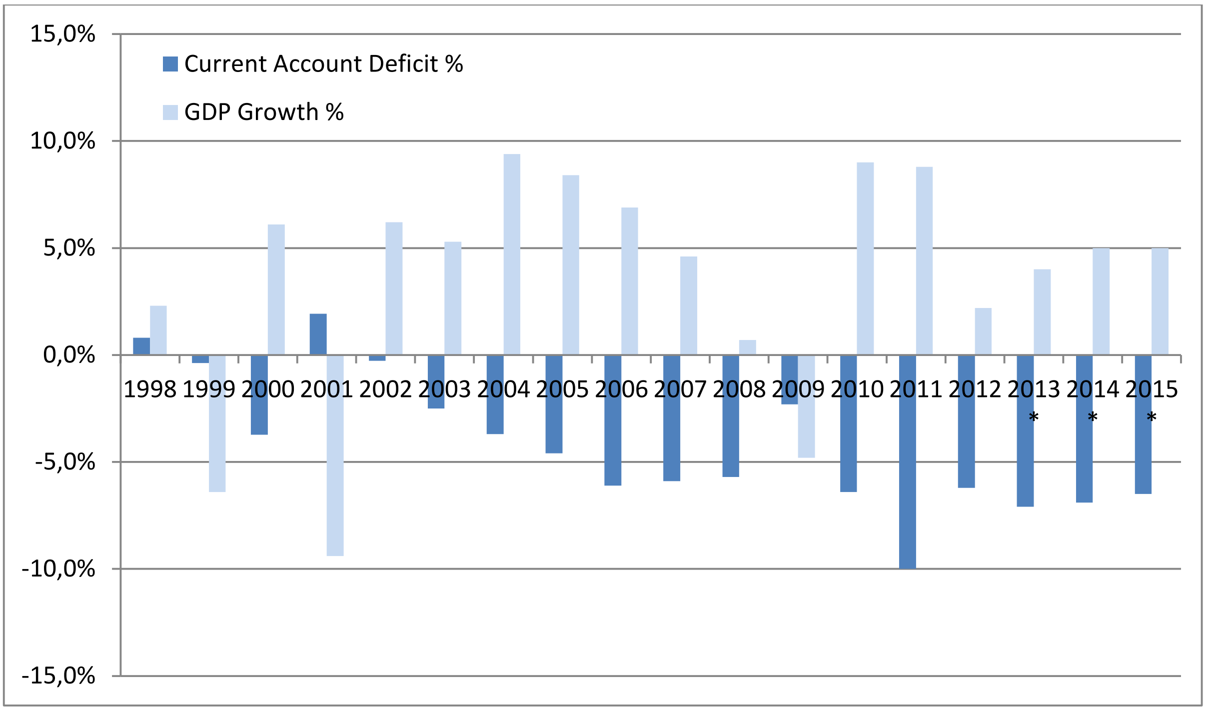
Known by almost all the followers of our issues, as of May, the FED declaration on tapering and the Gezi park movements triggered the volatility in the FX rate. Although our views suggested no market shake off due to FX movement and it worked until the political turmoil at the end of the year. As of Dec 17, Turkey has entered a period of battle between the government and the Community, creating a shake off and a peak in FX rates which could never been projected or expected. This immediately ignited the noise on CAD, one of Turkish economy's soft bellies.

We have previously stated that "***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. *"*

As we have always accepted, CAD is a consequence rather than a cause, therefore the recent hike in currency will surely decrease the CAD in 2014. This will limit the growth albeit moderately. Our main theme in 2013 was an expectation of a good growth rate coupled with high but acceptable CAD for short term, which worked out quite well. For 2014, although it is early to talk certain, we expect the growth to be more moderate (3-3.5%) with a lower CAD thanks to the recent currency peak in the last quarter.

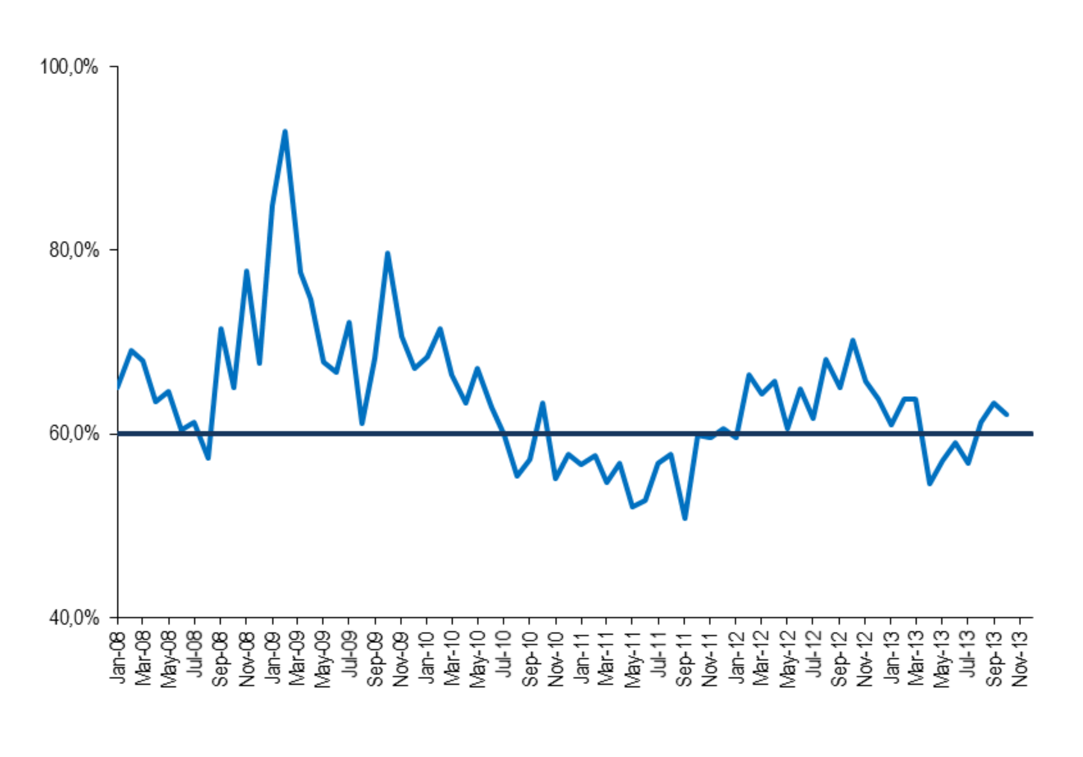
Current Account Deficit vs. GDP Growth



Source: TurkStat, Middle Term Programme

As always stated, the growth of the CAD is one thing, but it is important why it is created and how you finance the gap. We have stated previously that Turkey is a net importer of energy, therefore we always have to purchase oil, natural gas and energy, forcing us to live with a certain level of CAD, due to the export – import coverage ratio of the country, usually between 60-65% levels when healthy and sustainable. Plus, Turkey diversified its export base to new export markets such as Africa, therefore EU is not anymore extremely dominant in exports. We have also observed that the decrease in domestic demand is compensated by increase in exports, which will also be the case during the periods of increasing currency.

Export – Import Coverage Ratio, Monthly Figures

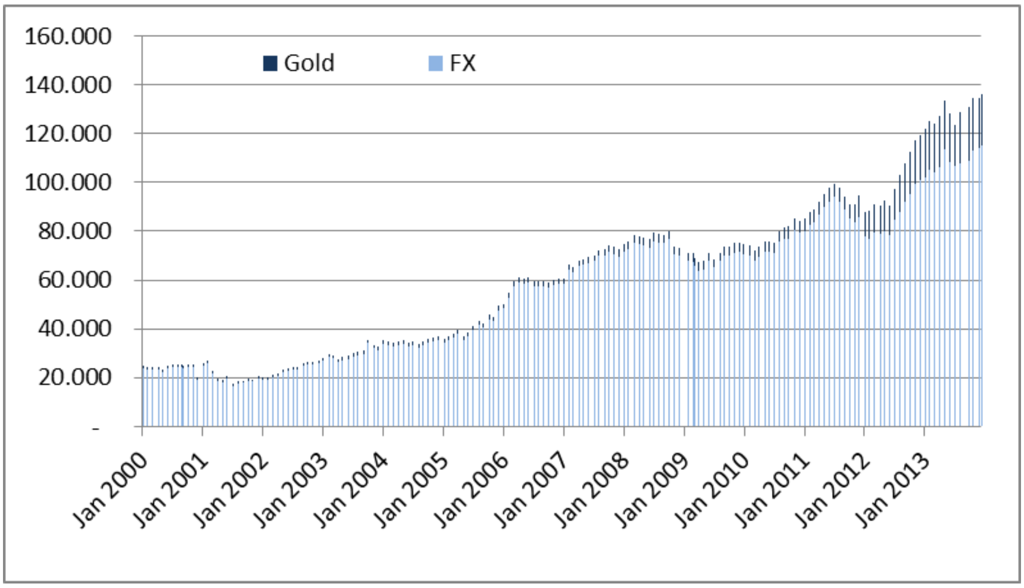


Source: TurkStat, Middle Term Programme

Although one may suggest that there is a downtick in the ratio, we must say that the effects of the recent hike will be reflected to this graph during the 1Q of 2014, as year-end data for 2013.

We have previously stated that one of the main issues to be alerted is the level of portfolio investments, or simply the hot money, which can shift easily especially due to the FED decision. Yet, the major point of focus is the CB reserves to prevent an external attack in such case, which are comforting as well with a level of almost USD 140 billion as of year-end, including the gold reserves of the country. This level suggest that the CB has accumulated an important amount of reserves, unlike the historical experience, corresponding to a level of 18 months of net external trade deficit, comforting for the market players and the rating agencies. Plus, we believe that no logical foreign investor will try to divest from these levels as they would be recording a huge loss at this USD / TRY level.

CBTR Gross Reserve Figures

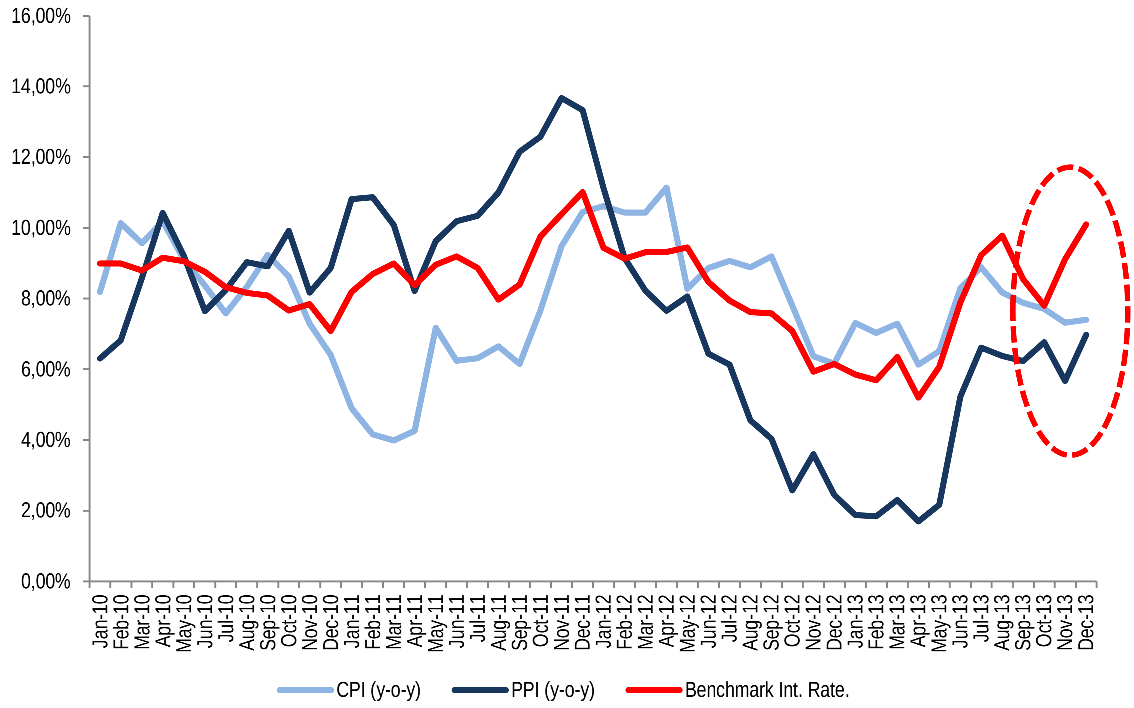


Source: Central Bank of Republic of Turkey

What we always see as comforting is that the PSBR / GDP in Turkish economy is one of the lowest in Europe, with 36%. Yet one may suggest that the private sector borrowing is at extreme levels with a hefty USD 255 billion in total. However, this data also takes into account the financial sector, which is not considered in risk calculations. Therefore, the risk exposure of the non-financial private sector remains at USD 120 billion, out of which only 34.3 billion is short-term, as the 3Q data suggest. As the emission is not more than USD 60 billion in the economy, we see the risk of a fatal currency crisis in the economy almost impossible, considering also the extremely low levels of the interest rate.

Coming back to the economic aggregates, the negative real interest rate at the beginning of the year has been closed and is now positive as we have predicted, as this was not sustainable at all. Yet the real interest rate is almost 3%, still not troubling as the PSBR/GDP is 36% and the growth is around 4%. We also see that the gap between CPI and PPI is almost closed, as we have been expecting, and the benchmark rate has sharply increased for the last 3 months. This reflects the uncertainty and the outflow from the market for the last quarter, due to the FED tapering and the recent political turmoil.

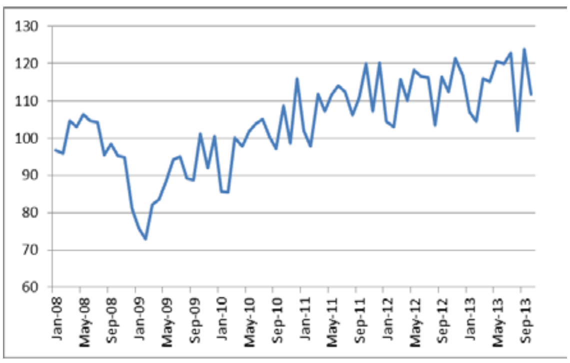
Inflation & Benchmark Rates



Source: TurkStat, Foreks

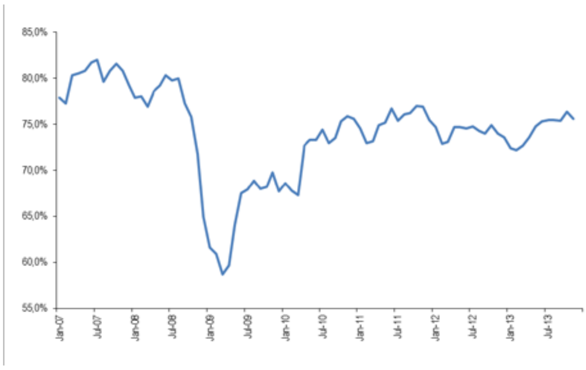
As seen from the graph above, the period of negative real interest rate has ended with sharply increasing benchmark rate due to the Gezi Park riots and the FED decision. The recent incidents also created a new equilibrium level of real interest rate, around 3 % as stated above. It is still positive that the benchmark rate is not skyrocketing over 10% levels, but prefers to remain around, another support to the “normalization of the economy” thesis led by our most favoured economist Dr. Cevdet Akçay, of Koç Financial Services.

Industrial Production Index



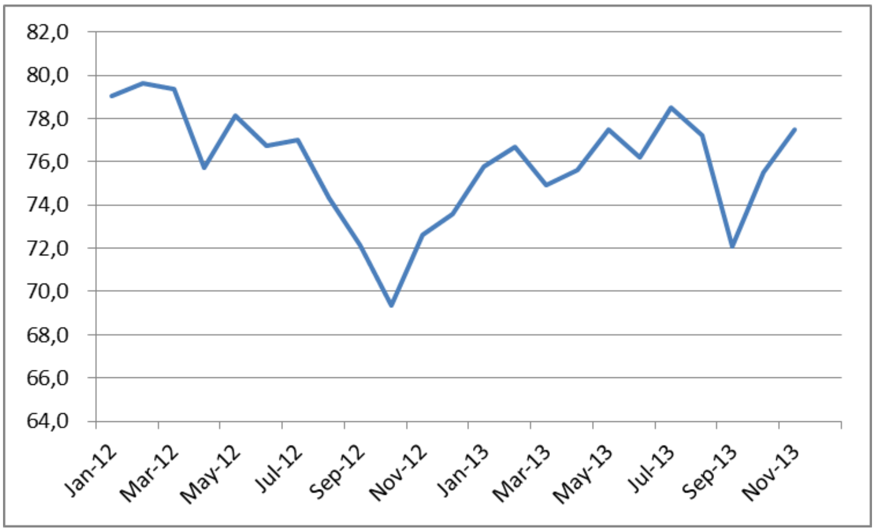
Source: TurkStat, CBRT

Capacity Utilization Rate



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

Consumer Confidence Index



Source: TurkStat, CBRT

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

1. 2013 was a success year, except the currency rate, as it was better than expected and had the best growth in Europe, still keeping the unemployment under control.

2. Our views suggested no market shake off due to FX movement and it worked until the political turmoil at the end of the year. As of Dec 17, Turkey has entered a period of battle between the government and the Community, creating a shake off and a peak in FX rates which could never been projected or expected.
3. 2013 was actually a year of take-off as we have expected and the debate was on "how much take-off" as previously stated. Despite the government ambitious expectations of growth for 2014, we keep our expectations between 3-3,5% range based on our favoured research houses.
4. We expect the CAD to compress at an important level, thanks to the sharply increasing FX rate. Unless we experience a sharp decline in USD/TRY which is not much possible, we do not expect the CAD to remain at 7% levels.
5. Inflation may be expected to wander at these levels. Although the increasing currency will have pass-through effects on the inflation, this will be offset by the demand-limiting character of the currency peak.
6. The low level of leverage in the economy (36%) will likely to continue and will create an immunity in a world where debt is the most scarce item and will be scarcer. Although the level of the private sector FX debts are important, we believe that we are still away from a crisis level as two thirds of this debt is long-term.
7. People on the street are immune from the FX volatility, at least directly, as individuals cannot borrow in FX terms legally. This is extremely important and prevents the panic environment.
8. As was the case in 2013, 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 2014.
9. Despite the political turmoil and the FX volatility, the credit rating agencies declared that they are happy with the current ratings and outlooks and that the current volatility is included in the ratings. We will be worried if the investment grade of the country is suspended or downgraded, however we see this unlikely in the current environment.
10. The only risk we see in the real estate side is the residential sub-sector as usually is the case. 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.

From this point of stand, we see no reason for changing our bullish stance for the economy as well as the real estate markets, as long as the political risk does not escalate. We do accept and expect that the 2014 will be a year of lesser growth but also of a lesser CAD and will be a year of stabilization for a possible second take off after general elections in 2015. We see no reason to cut exposure but we recommend to be cautious and watch the aggregates closer.

Commercial Real Estate Markets

2013 was a year where we have seen some important change in the stock, especially on the retail side of the market. We consider this as normal, given that 2012 was mostly a year where we have seen some hesitations and delays in the sector, either for pipeline starts or openings. As 2012 was a year of soft-landing, we take this slow-down as given, and the take-off in 2013 is the consequence of delays with better leasing & investment environment.

During the 4Q, 7 centres opened with a GLA of 326,216 sqm; well above all the quarters of 2013. There was just one opening in Istanbul, long-awaited Zorlu Centre at last opened its doors to clients, as can be seen from the table below.

4Q 13 Openings	City	GLA (sqm)
Forum Gaziantep	Gaziantep	44.500
Mark Antalya	Antalya	51.000
Next Level	Ankara	30.116
Palladium Antakya	Hatay	39.000
Piazza Urfa	Şanlıurfa	45.000
Taurus Ankara	Ankara	50.000
Zorlu Center	Istanbul	66.600

Source: Turkish Council of Shopping Centres

AYD figures suggest that during the entire year 27 shopping centres opened with a total GLA of almost 900,000 sqm, almost 100,000 sqm over than the 2012 openings and more than 10% of the YE 2012 stock. Out of this figure, 35% of this GLA was in Istanbul with 7 centres, diluting the accustomed 40/60 ratio slightly. We see that the 2H was more active compared to the 1H, thanks to the bigger size centre openings on the 4Q.

PERIOD	TURKEY		ISTANBUL		OTHER	
	Unit	Sqm	Unit	Sqm	Unit	Sqm
1Q	7	221.558	2	78.000	5	143.558
2Q	9	268.600	4	171.800	5	96.800
3Q	4	81.436	0	-	4	81.436
4Q	7	326.216	1	66.600	6	259.616
Total 2014	27	897.810	7	316.400	20	581.410

Such an increase in the total stock can be regarded as normal for a year like 2013, as Turkish market grows on average almost 13-14% in terms of GLA on annual basis for the last 5 years, yet as we are closing to saturation, this must be considered normal for a good year.

As of YE 2013		Active	Under Const / Planned	Total
Istanbul	Unit	96	38	134
	GLA (sqm)	3.463.742	1.871.277	5.335.019
Other	Unit	238	54	292
	GLA (sqm)	5.828.411	6.590.043	12.418.454
Total	Unit	334	92	426
	GLA (sqm)	9.292.153	8.461.320	17.753.473

Source: Turkish Council of Shopping Centres

AYD figures suggest that we have closed 2013 with 334 shopping centres all over Turkey, reaching a total GLA of 9,3 million. After the dilution, Istanbul holds 37% of the total GLA with 96 centres active where the rest of the country holds 5,8 million sqm of retail in 238 centres. Please note that the AYD figures take into account each and every publicly announced shopping centre project as “pipeline”, regardless of the realization possibility or opening time, therefore AYD data has an enormous and scary amount of pipeline but shows a longer-term future as a possibility picture. A simple filtering on these data suggests a pipeline of approximately 2.5 sqm further until the end of 2015.

The notable openings of 2014 were the oversized Vialand project with an entertainment park attached and Zorlu Centre, one of the most awaited shopping centres, opened during 4Q. The project is the centre of attention for public and media since the purchase of the land at USD 1 billion by Zorlu Group at the time and is expected to be the only competitor to İstinyePark in terms of concept and performance, until Emaar Square will be completed on the Asian side of Istanbul. As known, Zorlu Centre is hosting a performance centre, residential units, a Ruffles Hotel and a limited size of offices. The shopping centre is expected to be the focus point where lots of new brands as well as some existing luxury brands will be taking place. Perfect location of the centre fuels the expectations of performance and we already know that the project entered into the “investment lists” of many fund managers even before this expectation is realized.

The recent openings in Ankara, coupled with a single opening in Istanbul during the 2H, gave Ankara the leadership in GLA per 000 capita figures. As of YE 2013, Ankara managed to be the densest city in terms of retail, followed by Istanbul, with 261 to 250 sqm / 000 capita respectively. Karabük and Bolu are in the list due to their small population, where statistically the average size of the centre in these cities is extremely small.

AYD dataset suggest that the GLA/000 capita is 122.87 for the whole country, whereas for 2012 and 2011 this figure was 115 and 103 respectively.

City	Unit	GLA	GLA / 000 Capita
Ankara	36	1.300.433	261,89
Istanbul	96	3.464.342	250,05
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	16	327.249	156,39
Denizli	5	123.725	130,16
TURKEY	**334**	**9.292.153**	**122,87**

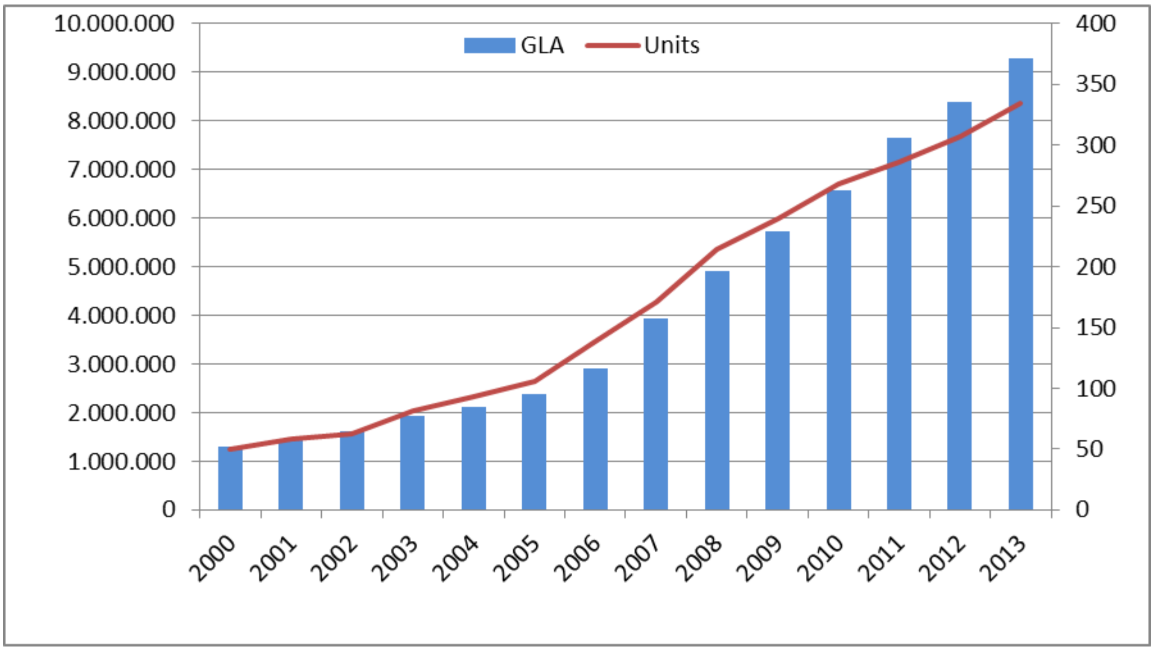
Source: Turkish Council of Shopping Centres

The noise was loud again during the 2013 about the number and density of shopping centres in Turkey. We have declared our own view about the debate in The Alchemy Vol.I. with following sentences:

"Despite the noise, again, about the number and efficiency of the shopping centres we believe that under the rules of the capitalism or at least free economy, we believe that limiting or not permitting new shopping centres by law or authorities will not solve the problems. State Minister Mr. Babacan stated frankly in his MIPIM session that they are against limiting the number of a development type and size and that this is an issue to be solved within the rules of the investment feasibility, not legal intervention, despite some demands about limiting such development projects.

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

Retail Stock & Pipeline

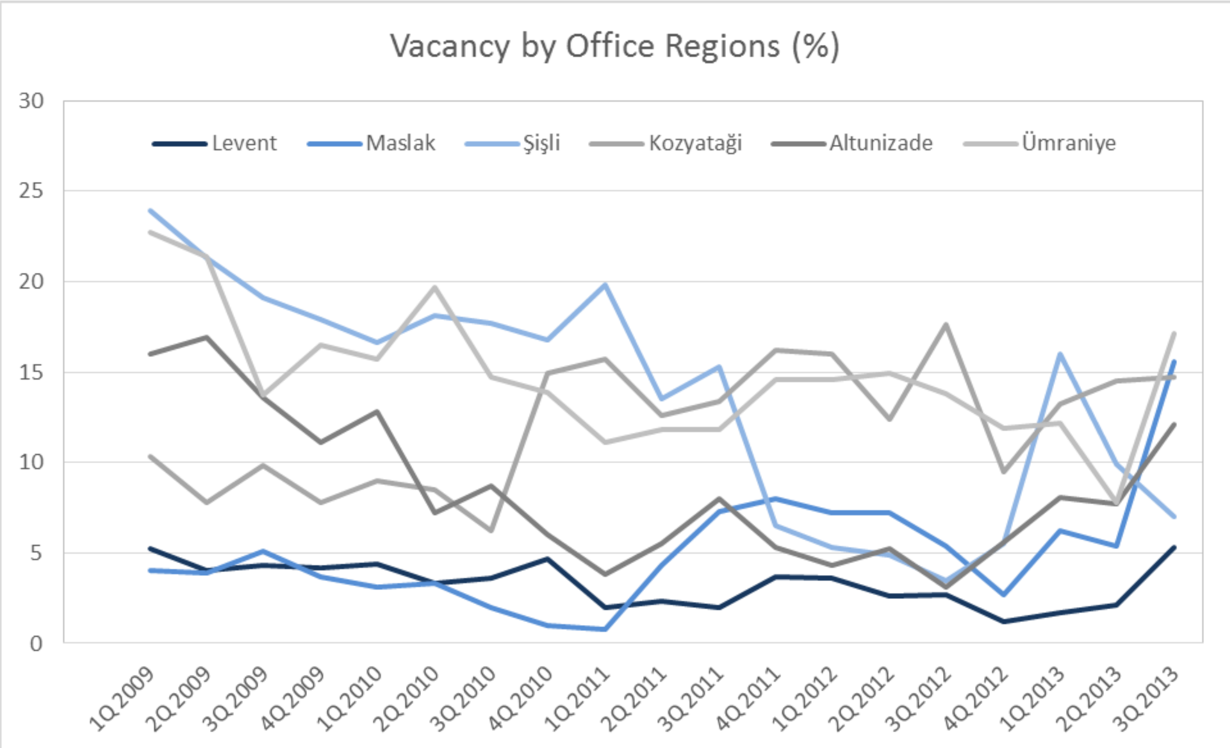


Source: Turkish Council of Shopping Centres

As we have stated in our previous issues, the prime rent increased slightly with the opening of Zorlu Centre, to € 85 level. The current volatility in the FX rates and the currency fixations on the retail market limits the further increase, therefore we believe that we will see the next important hike with the opening of Emaar Square.

The office market was quite active during 2013, both in terms of leasing and acquisitions. The biggest problem in the market is the lack of trustable data as there is no uniformity between the research houses in terms of the available stock and its distribution amongst the regions. We have been so far issuing the data from Propin, one of the most trustable data sources in the market as an active agent, however Colliers, another trustable agent, suggests that the total stock is almost 2/3 of what Propin suggests in their recent report. Therefore, in order to not to be lost in translation, we intend to keep the current grade A stock in Istanbul as 3-3,5 million sqm and the upcoming certain pipeline until 2015 YE as 750,000-1,000,000 sqm. Both data houses suggest that the pipeline is strong, which is important for us, and there will be a supply almost one third of the existing stock in 2 years' time.

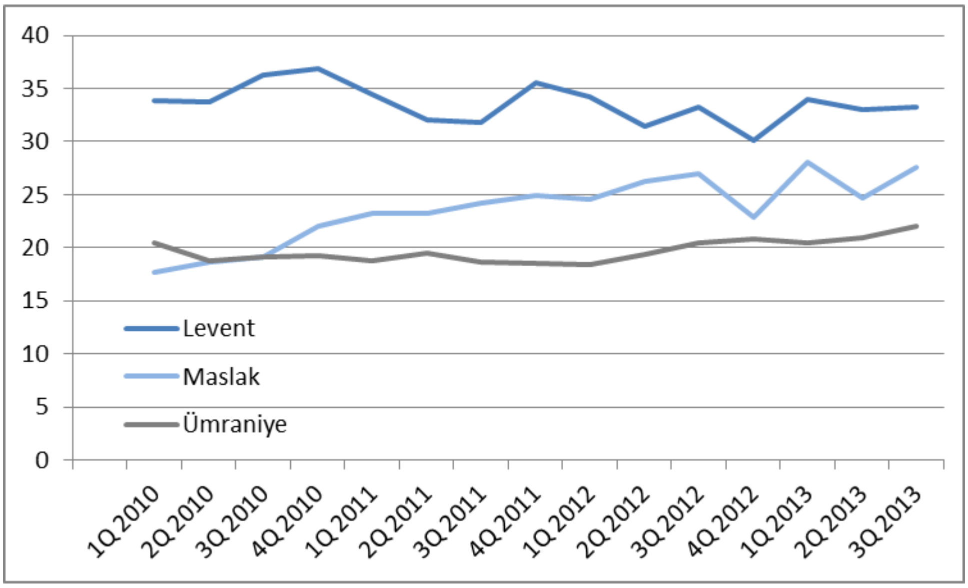
Normally, CBD holds approximately 38% of the total stock whereas Non-CBD Europe is around 27%. Despite the coming pipeline is almost one third of the current stock, the future breakdown is not promising a huge change, meaning that at least for the coming 3 to 5 years, the breakdown of the stock will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



Source: Propin, Mergen Consulting.

The above graph suggests the vacancy figures in the notable office regions of Istanbul. The jump in the vacancy is mostly stemmed from the recently completed projects, especially in Maslak and Umraniye districts, therefore does not signify a crisis but a period of suppression in the rent levels. The expected vacancy in the CBD is still around 4-5% levels in time, despite the current jump due to the new entries, whereas 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 below table supports our above thesis of suppressed rent levels as despite the demand on the market, we do not see a huge increase in the rents due to the completed projects or the coming pipeline. Below chart shows us the past average rent levels asked by the landlord for the last 13 quarters:



Source: Propin, Mergen Consulting.

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

Investment Market

As stated previously, 2012 was sealed by transactions from the locals as well as the international big funds such as Blackstone and GIC. Contrary to the transactional evidence in 2012, we have not seen any transactions in 2013 coming from the international buyers, as 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.

As always stated, Turkish market lacks liquidity and obviously the transactional evidence supporting the assumptions. Therefore, our main suggestion is that the agencies engaged in negotiations with both locals and international investors can observe at what levels the deals may be closed. This is the only way to establish transactional evidence on the market. In this regard, based on such experience, the negotiations that we are currently involved suggest that the prime yield is still 7%, yet the figure is much lower for trophy assets as we believe that the product classification in Turkey is a little bit different from western standards; as there is a big gap between trophy & prime assets where the gap is much less between prime and the following assets.

The only deal 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 the deal price is declared as € 140 million, suggesting a yield around 8,5%. The centre has lost some blood due to the entry of the immediate competition, Buyaka shopping centre, yet the size and location of the site indicates that this is a beneficial investment considering the further development possibilities in the future.

Despite the transactions completed in 2013, office market is no exception to establishing a proper and trustable yield level; yet as stated in our previous issues, 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. However, interestingly, office market seems more active during 2013 as we have seen multiple transactions completed.

2013 started with the purchase of 10 floors of Torun Towers by Mapfre Insurance to be used as company headquarters. Torun Towers is a well-known office project developed by Torun REIT, in the heart of the CBD. The transaction price is declared as USD 66,7 million for almost 8250 sqm, corresponding to a value of USD 6850 / sqm plus the VAT. This level corresponds to one of the highest transactional values completed for such sqm size. Considering the average expected rent level at USD 40, the deal corresponds to a yield level of 7%, appropriate for such transaction.

Crystal Tower deal, suspended almost for a year, has been closed positively as well. As known, Finansbank was in talks 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 until the 4Q. As it is one of the few buildings appropriate for an institutional ownership, we believe that such deal will establish a benchmark for similar transactions.

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

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.

As we have stated previously : ***"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."

As known, the long-awaited office project of Pramerica, Skymark, has been brought to the attention of a limited number of possible local buyers by Jones Lang LaSalle Turkey in the 3Q 2013. Our market information suggests that amongst the bids, a local company has managed to sign the deal, but due to the volatility in the financial markets, the deal is not yet closed awaiting for the financing. The expected price is around USD 125-130 million. As the project has not been openly marketed, we believe that it has low chance of creating a benchmark for similar transactions. As known, Pramerica is trying to cut its exposure in Turkey, they are also trying to sell Terracity, their only shopping centre in Turkey, located in Antalya. Our sources point that the bids are around 9% yield levels, and again for the closed nature of the deal, we find it hard to establish a benchmark for future transactions.

As can be seen from the transactions above, it is not much possible to establish a sound evidence in Turkish markets, neither in retail nor in office markets. As previously stated; ***"Yet 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."***

Although we believe that there will be more foreign capital in the market during 2014 ***(please refer to our "Distillery of the Alchemist" section)***, it seems like it will be wise to watch locals in 2014 as well.

Distillery of the Alchemist

We have stated in our entry section that we have delayed the issue of Vol. IV. on purpose so that we can incorporate the results of our London visit. Coming from the investment banking backgrounds, we believe the wisdom of visiting the players from time to time with a roadshow type of tour, rather than waiting to meet them in MAPICs & MIPIMs, where we can explain our expectations for the future as well as getting their unique views on Turkish markets. As the great author of strategy, Machiavelli, states at the preamble of his famous work, the Prince, ***"Just as artists who draw landscapes get down in the valley to study the mountains and go up to the mountains to look down on the valley,"*** we find it wise to obtain and value other players' thoughts on our market. Thus, we dedicate this section to our London trip, where we benefited from our foreign friends' incredibly valuable thoughts on the market.

We consider ourselves lucky as we have the luxury to meet with 7 different investors in 24 hours' time, presenting our insight on the recent events and getting their views and expectations on the market. We would like to thank each and every of them for their contribution to this piece with their valuable insights. The headlines of our meetings and their results are as follows:

1. Each of our friends came from different background and type of investors, private equity companies, public funds or sovereign wealth funds as well as corporate finance based companies looking for different opportunities.
2. They also scatter in geographical backgrounds as investors, from North America to Europe, Middle East & Asia.
3. Their common point is that either they are heavily invested in Turkey or they are looking to do so for the last couple of years, therefore they know the market and players extremely well.
4. Another common point is that each and every of them is analysing the recent events at a high level of information and intelligence. No one seems panicking for the moment and no one puts Turkey on the shelf.
5. On the contrary, a great majority see the recent events as a hick-up and a power play that will create a new equilibrium, which will be more positive than before. No one expects Turkey to be a sharia or totalitarian country at the end of this story and all expect this to come to an end after the elections.

6. All of the investors agree that as long as there is long-term growth in the economy and the fundamentals are intact, they see no reason to change their bullish stance to the Turkish economy and real estate markets.
7. Only one of the investors, currently not invested but looking for a suitable project for a very long time, is worried about the events and is at a more cautious state than ever. This particular investor wants to see the new order after the elections.
8. One of the major investors stated his belief to the market & economics, yet also said that Turkey was on a road of better regulation, better institutionalisation and better transparency, therefore must not be derailed. Giving the Russia and Hungary example, despite better fundamentals than Turkey, big size investors hesitate to prefer these markets due to these reasons.
9. Same friend indicated that they were very happy with their investments and had no thoughts of selling; on the contrary, they want to buy more assets in the country.
10. Another big investor also stated its interest in some giant sized projects in Turkey.
11. The biggest problem is to find an institutional product with a rational seller. Turkish developers are known by expecting off-market prices and the recent transactions certainly do not help.
12. All but one, reiterated their interest in Turkish real estate market and that they think to increase their exposure as long as they find suitable products.
13. None of our friends expect a crisis of Balance of Payments or any other sort, but all aware of the effects of increasing FX on tenants. Some expect the CB to increase rates or sell USD more aggressively to protect Turkish Lira.

As seen from the valuable insights of our friends, the recent events have normally created some noise and worry on the investors, but they are not in a position to consider fleeing away or decreasing their exposure to the market. They are aware of the locals' increasing activity and consider this as a positive to some extent. They believe that the volatility will be short-lived compared to their investment horizon and looking for opportunities and right products to increase their exposure. For 6 out of 7, finding the right product is currently more important than the current turmoil.

We are happy to see that the valuable thoughts of our friends are supportive of our main investment theme and approach. We thank again each and every of them for the time, cooperation and valuable insights they have provided.

Philosopher's Stone

Turkey never ceases to surprise us. Beginning and end of 2013 are totally different from each other in terms of business environment, yet as long as the fundamentals hold and the investment grade remains intact, we see no reason to change our approach and stance. We are aware that only a fool has the luxury of not checking his own views continuously, therefore we will keep an open mind to see any sign of deterioration. Hence, it is time for us to look at the developments and review our strategy if needed.

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

- Turkey benefits from the current peak of the FX by increasing the exports and decreasing the imports. This increase in net exports coupled with entry of hot money at some point will definitely shrink the CAD and provide cushion for the relative decrease in growth.

- Increasing USD/TRY may force the CBRT to increase rates as well. End of easy money and low real interest rate policy may affect the growth unexpectedly.

- Although we will definitely not be able to reach a growth of 5% as expected in the Middle Term Program, our favoured economists expect a growth of 3-3,5% and a CAD of 6-6,5%, still quite manageable for 2014.

- The bad side of the possibly decreasing domestic demand due to FX is that it undermines the direct tax income in the budget. This may be a sign of contraction in the economy if continues too long.

- The recent events causing political shakeout and other consequences are considered to be in the current rating of the country. If a downgrade occurs, we may be talking about a totally different scenario.

- The extension of the recent events and revealing of further corruption scandals may create more noise, uncertainty or even a downgrade which can advise us to revaluate our main theme. Alternatively, further anti-democratic pressure may do the same effect as well.

- The CB has enormous reserves accumulated for the last 10 years. We see almost no risk of Balance of Payments or a speculative attack as the emission size is much lower than the cash reserves. We believe that size of the private external debt is an issue of profit, not crisis.

- 2014 is a year of double election. Populist policies or further uncertainties may undermine the stability and environment of trust created so far.

- Such FX volatility, historically, tend to continue 6 months on average. After such sharp increases, the USD tends to ease slowly but to the starting points, even under the starting point under certain circumstances. Although we do not expect a 1.80-1.90 level for a while, seeing 2.0 after municipal elections is always a possibility.

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

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

We keep our positive stance in the commercial real estate market and the only risks we perceive are the political fights, possible deterioration in fundamentals on the long run and the huge stock in the residential sector. We also expect more foreign capital investing once we come to a new equilibrium, probably after the municipal elections.

M E R G E N

c o n s u l t i n g

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