TRPE CAPITAL

Investor Update –
Recent Developments and Outlook in Turkey

February 2014

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1. THE FACTS

Political outlook

Upcoming elections: Turkey is preparing to enter a busy electoral cycle beginning with municipal and presidential elections in March and August 2014, respectively, and a general election by June 2015. It is widely expected that the AKP (Justice and Development Party), current ruling party, will succeed in maintaining its hold on power despite the current corruption charges and the de-stability caused by the power struggle between the AKP and Hizmet, the powerful religious movement headed by Fethullah Gulen, a former ally.

The opposition parties are fragmented and have proven fairly ineffective, and opinion polls suggest that the AKP continues to enjoy considerable popular support around the country, albeit with some weakening in its support base.

European Intelligence Unit (EIU) forecast remains that the AKP will maintain levels of support of over 40% of the national vote at the local elections and that it will succeed in having its candidate elected president in the first direct election of the head of state in August 2014. EIU also asserts that AKP will win a fourth term in government at the legislative election due by June 2015. The opposition parties are unlikely to pose a serious challenge to the AKP's dominance.

Economic policy outlook

Fiscal policy: IMF and World Bank expect that the government to keep fiscal policy relatively tight in order to maintain a low level of public debt and avoid encouraging another surge in domestic demand and the high current-account deficit. However, given the recent developments in domestic political arena there is a fair risk that the government might allow fiscal to become looser than is usual in the run-up to elections. OECD and EIU forecast is that the deficit will widen from an estimated 1.2% of GDP in 2013 to about 2.5% of GDP in 2014-15, before narrowing to about 2% of GDP in 2016-18, which is still highly successful compared to fiscal deficit projections of India and Brazil, 4.9% and 3% for the same forecast period. This implies that economic growth will pick up, but gradually and to moderate levels compared with 2010-11, and that fiscal policy will be eased only moderately in anticipation of elections. The government debt/GDP ratio is low, at an estimated 35.7% at end-2013, and is forecast to decline gradually to 31% in 2018, reflecting producing primary surpluses and stronger economic growth later in the upcoming period.

Monetary policy: With consumer price inflation above the official medium-term target of 5%, and the Turkish lira weakening in the last months as a result of the prospect of the Fed tapering its emergency bond-purchasing program as well as a series of elections ahead, the Central Bank recently stated that it will not tolerate any deterioration in the price stability. In order to preserve price stability, the Bank has increased interest rates by 300-400 bps in the latest monetary policy meeting in late January. This decision will help to reduce interest-rate volatility and improve policy predictability. Under this stance, inflation is expected to reach the 5% target by mid-2015 by the Central Bank of Turkey.

Economic forecast

Economic growth: The Turkish economy has shown remarkable performance with its steady growth over the last ten years on an average CAGR of 5%. A sound macroeconomic strategy in combination with prudent fiscal policies and major structural reforms in effect since 2002 has integrated the Turkish economy into the globalized world, while transforming the country into one of the major recipients of FDI in its region.

After a slowdown in 2012 real GDP growth picked up in 2013. IMF, World Bank and OECD expect the Turkish economy's growth in 2013 will be in the range of 3.8%-4%. And going forward, they forecast that the country will grow by 4% per annum on average. As slightly weaker domestic demand growth will be offset by stronger exports, the growth prospects set the lower boundary for the country.

On a separate analysis, for 2015-2018 EIU forecasts a solid acceleration of real GDP growth to about 4.8% a year. There are downside risks to this forecast, notably from weaker capital inflows, especially in the first half of the forecast period.

Inflation: The recent stint of currency weakness is expected to keep consumer price inflation above the Central Bank's year-end target of 4.8% in 2014. IMF expects it to end this year at 7.9% compared with 7.4% in December 2013. Assuming the Central Bank tightens monetary policy further in 2014, it is foreseen that inflation will ease to about 4% towards the end of the forecast period (2014-2018), as more moderate consumer demand growth than in 2013 and only moderate increases or falls in international commodity prices are expected.

Exchange rates: Having mostly affected by the global macro trends in May-December 2013, the external value of the Turkish lira has decreased as escalating domestic upcoming elections exacerbated existing concerns about the potential impact of tapering by the US Federal Reserve. As a result, it is expected that the Turkish lira/US dollar exchange rate to average about 2.18 in 2014 (2.1 previously), compared with an average exchange rate of 1.9 in 2013. The recent interest hike move by the Central Bank would translate into a moderate appreciation in real terms in the short-term. However, as FED tapering takes place gradually over the year, most of the emerging markets' currencies will be impacted and it is widely accepted that the Turkish Lira will receive its fair share of the short-term volatility that will dominate the emerging market currencies.

2. OUR HOUSE VIEW

At TRPE, we are in general agreement with the EIU view on the political outlook, which is to say that AKP or a similar center right conservative party of the same tradition will continue to hold on to power beyond the next general election in July 2015.

The new main scenario is for the current Prime Minister to change the party by laws preventing him from standing in the next general election in order to remain prime minister for an additional term and not to challenge the Presidential Election. This is a change from the previous default scenario, which was assuming a clean swap of roles of the current President and the current Prime Minister

during the election period. However, this new scenario stands to be challenged and may be altered dramatically should the AKP perform poorly in the March election.

In the medium to longer term, we believe that the second half of the year will bring much sought after political stability to the market with the most of the elections behind and the US tapering being instutionalised. We expect the currency to stabilize around the 2.10 TL per USD levels post summer after the Presidential elections.

On the macro front, with the rate hike in interest rates and the depreciation of the currency, growth will take a temporary hit in 2014 and possibly 2015. However, Turkey has a proven track record of bouncing back from crisis with very strong growth, like the banking crisis of 2001 or the global crisis in 2008. We expect that Turkey will to capture its growth rate of around 5% for the medium term (please see Figure I on page 5 for the Turkish economy's performance during and after financial crises and general elections).

3. IMPACT ON LOWER MIDDLE MARKET / SME AND OUR STRATEGY

Against this backdrop, **TRPE Capital strongly believes that the country's fundamental aspects of attractiveness are firmly intact.**

The key impact for mid caps has been the currency exchange volatility, which led to the currency to depreciate around 20% against USD since the beginning of the year. We expect the impact of this consideration to be minimal on the SMEs due to:

- Low levered balance sheet especially in terms of hard currency exposure
- Recent export focus to the immediate region including the neighboring Arab countries
- Less dependency on imported raw materials

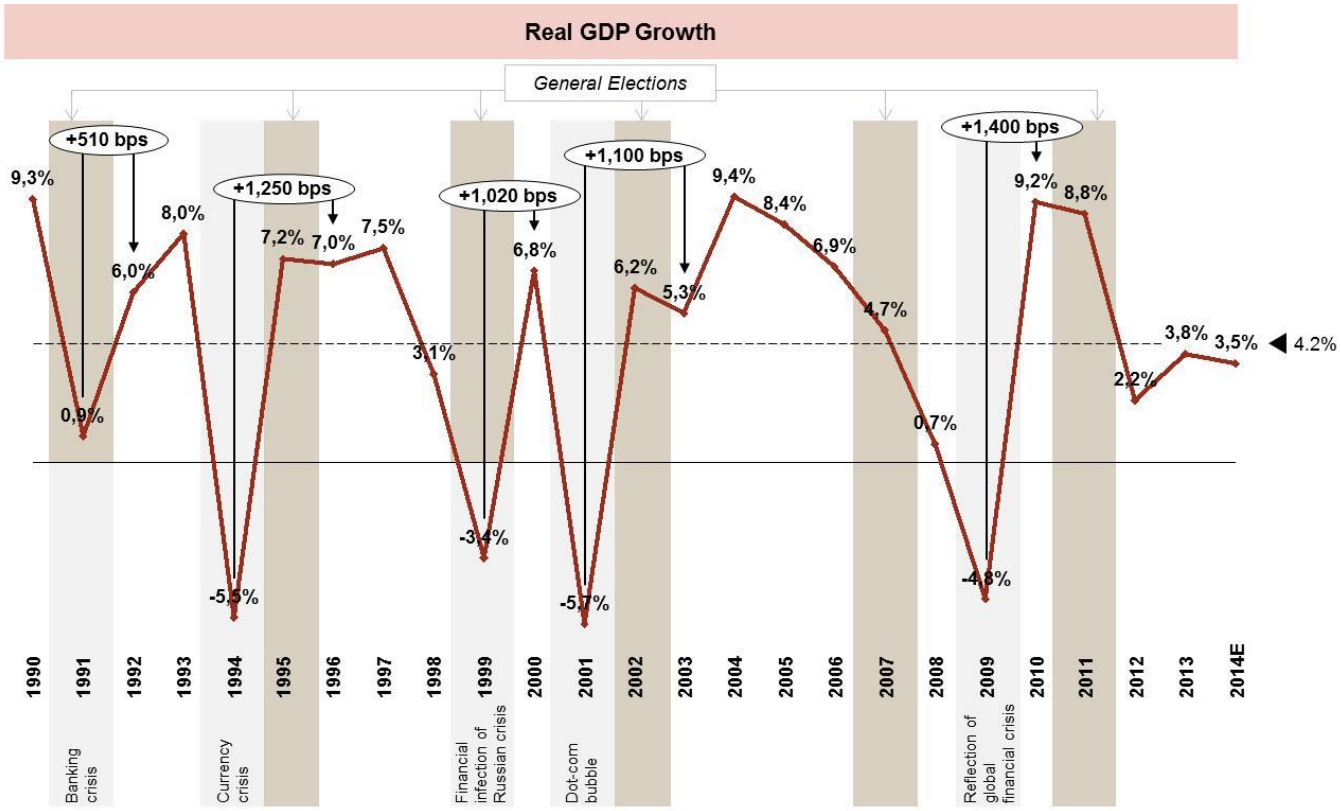
Mid-market companies and SMEs with weak balance sheets or strained working capital conditions will become more vulnerable as the year progresses.

We believe that the current short-term environment is very conducive to selective and aggressive investment opportunities within the SME space with a focus on

- Exporters with strong consumer brand recognition which would benefit from the current FX environment
- Local consolidators who can execute opportunistic accretive acquisitions in their respective sectors
- Sophisticated management teams with strong track-records in FX fluctuation management and previous crisis management

Furthermore, we are observing the entry price dynamics working in our favor with vendors now willing to engage with us at lower entry multiples. Our equity is becoming more valuable by a range of 0.5 to 1.5x of EBITDA when compared to the average of the last two years. Combined with the loss of value in TL, companies are in play for 30% less entry valuation in USD terms. The situation is further emphasized by the rise of the price of debt instruments provided to SMEs by local banks as SMEs seek to institutionalize secular growth levels with exports. We expect the current window to remain open throughout 2014 and may extend through 2015.

Figure I: *Turkey recovered strongly to get back to solid growth path after financial crises and elections during the last two decades*



Source: IMF WEO October 2013, EU Economic and Financial Affairs, TRPE Capital analysis