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LOGBOOK of the TURKISH ECONOMY

TURKISH TARP, BUT HOW?

Fourth Log

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In our previous note[1], we made the case for a Turkish Troubled Assets Restructuring Program (TARP) to restore flow of credit (and hence growth) and established key principles for such a program. In this paper, we propose a multi stakeholder governance model and specific structures for various types of troubled assets. We would like to stress the exponentially increasing cost of delay in taking action for Turkish banking sector, corporates and broader economy.

I. Key principles

Turkey is used to V-shaped recoveries with quick return to significant growth rates immediately after crisis years. The business community hoped for a similar performance in 2019. However, recessions with debt overhangs tend to have U or L shaped recovery patterns, given deleveraging processes.

However, a sustained decline in availability of credit would have meaningful negative implications on Turkish economy (and private sector, in particular). We already started to see these in employment figures – 350k industrial jobs, 250k construction jobs were lost between August 2018 and February 2019, according to TUIK. This is particularly critical for a country given demographics (over 700k individuals entering work force every year, four million refugees' integration to labour market in a sustainable way).

Credit flows cannot be restored through aggressive action by state banks, which have already reached their limits. A comprehensive program balancing multiple needs is needed: (i) clean-up bank balance sheets without completely depleting their equity base; (ii) source new financing; (iii) rehabilitate corporate sector through a combination of new credit lines, operational and financial restructurings and liquidations; (iv) collect proceeds from existing and new lending through paybacks, mergers & acquisitions or asset sales. Unfortunately, these goals are somewhat conflicting, given different priorities of various stakeholders.

II. Competing priorities

Government should have three main goals: (i) ensuring overall stability of the banking system; (ii) restoring credit flows to real sector to return to growth and start creating jobs; and (iii) deploying taxpayer money for a good cause, at acceptable risk/ return levels.

Banks aim to minimize write-downs and limit new lending to protect their equity in the short term and collect maximum available proceeds in the medium-long term. Given their DNA, they will not be aggressively leading operational/ financial restructurings or mergers & acquisitions processes. Corporates would like more of two finite resources: more time to repay their debts and more money, if possible, especially given increasing working capital needs. Moreover, they should be very careful about domino effects, when a large customer's default hurts an entire value chain.

[1] Dalgın, Sak; Logbook of the Turkish Economy, Second Log: Reensuring Flow of Credit to Return to Growth, April 2019

Owners would typically be reluctant to cede control, let alone have their businesses sold (or liquidated).

New investors naturally would try to maximize their return/ risk. This is particularly challenging today, given the already high yields promised by liquid sovereign or bank debt instruments (e.g., Republic of Turkey 23.12.2023 USD bond yields 7.5 percent as of May 21, 2019).

Any proposed solution should be judged against these criteria to test whether it addresses needs of multiple stakeholders (or if it is engineered to serve the needs of only one). But, is there any common ground, at all, to optimize all these needs?

We believe so -- but only if appropriate governance and structuring mechanisms are employed.

III. Governance

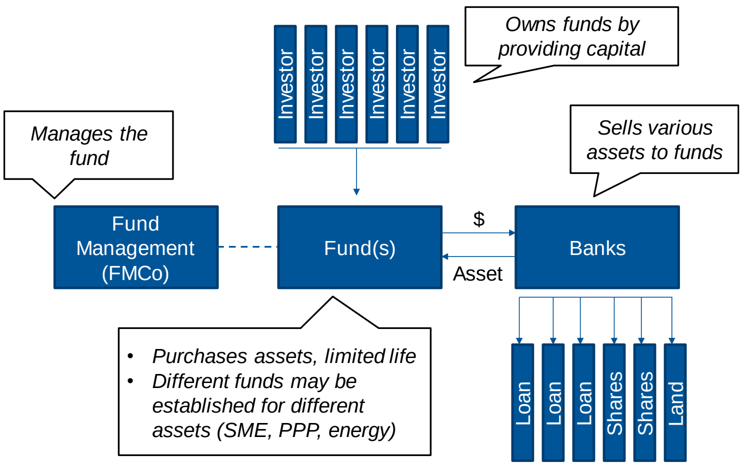
The "Turkish TARP" program will likely include a set of vehicles that would acquire troubled assets from banks at discounts, manage them for several years and realize these assets. The vehicles could be owned/ financed by a combination of the government, banks and new investors. However, there needs to be a clear line between the ownership and management of the assets (as in a traditional fund; limited vs. general partner). This is an essential element of the program, given the need to convince domestic and international investors to help finance the program. As importantly, it is the only feasible way to bring all stakeolders to the same platform.

Government involvement is key given the need to coordinate multiple parties, make certain regulatory changes, reach critical size and mobilize external financing. To start, BRSA's (the banking regulator) position will be key to nudge banks to sell some of their positions, without disproportionately hurting their equity base. It is a highly delicate challenge: delay sales of assets at discounts too much and the financial system is clogged; do that too aggressively and banking system's equity base is wiped out. Once the princinples are agreed, there are a number of areas that requite government action to allow for transfers: debt to equity conversion (and associated VAT), bank board members' personal liabilities if assets are sold at discounts, transfer approvals (EMRA approval for energy assets, competition clearance for almost all) and other tax issues (stamp tax, banks recognition of discounts as expense).

Banks should be part of the system to ensure they retain some "skin in the game", provide funding and partly overcome the pricing issue.

Finally, new investors (likely international, institutional) should be present at the outset. Given the bid-ask spread between traditional private investors and banks, development finance institutions should play a market building role. Their presence would bring fresh capital, send a strong positive signal, and secure a sustainable management structure, as detailed below.

Chart 1. Turkish TARP Overview



In order to bring all these stakeholders to the same playing field, the program's governance structure should rest on three pillars: (i) independence; (ii) competence; and (iii) transparency. Independence. The management team of the program should not report to any single stakeholder. Instead, as in any principal investing case, it should have operational flexibility within the framework established by the owners. A lack of independence would harm the balance among various stakeholders given not fully aligned incentives (e.g., "at what price to acquire loans from banks?"), make hiring high calibre management talent impossible, and inhibit new (international) financing.

Competence. The management should have multiple capabilities, including acquiring assets, overseeing portfolio, (financial/ operational) restructuring, potentially investing additional funds, and realizing investments (e.g., merger & acquisition, sale of collateral). Hiring capable and proven talent, who will run troubled assets with a completely different mindset than a traditional loan officer, is essential.

Transparency. A top notch reporting system (at a minimum quarterly reports, semiannual meetings) is key for all stakeholders, which include government (taxpayer money), banks (regulated entities, some of which are public) and new (likely international, institutional) investors. Assuming stakeholders can be brought together under the governance mechanism above, we can discuss structuring.

IV. Structuring

All troubled assets are not created equal. Different pools of uniform assets should be defined, so that appropriate solutions/ structures could be tailored. Each of these categories would command different discounts in purchases from banks, require different types of management oversight, and attract different investors.

For example, troubled assets may be grouped based on their level of distress: (i) non-performing loans; (ii) watchlisted (category II) loans; and (iii) performing loans that yield below today's interest rate for comparable credit (so should be marked to market at a discount).

Alternatively, they may be grouped based on sector, size and complication: (i) loans backed by direct/ quasi government guarantees (public private partnership infrastructure, renewable energy); (ii) loans to industry leaders, typically involving multiple banks, with effect on entire value chains; (iii) SME loans.

Finally, they may be grouped based on action, such as: (i) simple transfer of risk (e.g., loans backed by direct/ quasi government guarantees or performing loans marked to market at discounts); (ii) restructuring with additional safeguards (e.g., additional governance or economic rights, route to exit) and potentially provision of new financing; and (iii) liquidation through sale of company or assets.

As a start, we believe the initial focus should be on the following three categories: (i) energy loans; (ii) construction loans; and (iii) corporate/ large SME loans.

We did not include loans for public private partnerships (PPP) and smaller segment of the SME loans. Regarding the former, banks may choose to keep them on their balance sheets given their low risk profile (despite potentially yielding below today's market rate). Also, banks may issue bonds backed by PPP loans, as they see appropriate. As such, there is no need to include those assets in a TARP program. Regarding the latter, given their number and average size (1.5 million small & micro business have total outstanding loans of TL 120 billion[2]), they would be better served by commercial banks with branches, than via a fund-like structure such as TARP.

Energy loans. According to Ebru Edin, Garanti Bank's Deputy General Manager, "Turkey's energy sector has $12-13 billion worth of loans that require restructuring, out of a total $70 billion total sector loans"[3] These loans have underperformed given electricity consumption and prices falling well short of original projections, as well as the relatively high debt/ equity ratios. Most of them are backed by corporate guarantees by borrowers' parent companies. Turkish banks are already working on establishing a fund-like mechanism to carve some assets out of their balance sheets. However, any model that fails to bring fresh capital and achieve operational improvements would not have the desired effect. Therefore, synthetic mechanisms to bridge the potential pricing (discount) gap, potential consolidation of operating assets, and a close oversight are needed.

[2] BRSA March 2019 data, for all figures in this section

[3] https://af.reuters.com/article/energyOilNews/idAFI7N22B01U

Offering the TARP vehicle (including government and the new investors) effective super senior positions (e.g., through a slice of management fees) and high yield junior debt positions sitting behind reduced senior debt (post bank haircut) and providing banks equity for their "in kind" contributions, could make a transaction sufficiently attractive for involved parties. Alternatively, the government may issue a guarantee for a pool of transferred loans and hence reduce the discount, but get equity kickers from banks in exchange for reducing the hit on their balance sheets (this may be considered for other loan types mentioned below, as well). A major factor for sustainability of this arrangement is future electricity prices, which have a meaningful element of government involvement.

Corporate/ large SMEs. 20 percent of corporate NPLs are in manufacturing sector (TL 8.1 billion TL, $1.5 billion FX loans). Category II loans are twice the size of NPLs in the broader banking sector; it is safe to assume that is valid for manufacturers, too. Food & beverage, textile, main metal and rubber & plastic constitute 2/3 of the NPL volume. These companies typically owe money to multiple banks (likely with messy collateral structures), need additional working capital financing to jump start/ maintain operations and employ high numbers of people– making them ideal candidates for TARP. Focusing on industry leaders with effect on broader value chains would be key to maintain corporate capacity and employment. Moreover, these companies could be reasonably attractive acquisition candidates in a few years, making realizations rather likely. The government may consider provide leverage to vehicles acquiring assets, potentially by using an impact investing/ blended finance approach. Under this method, performance against pre-determined social impact criteria (e.g., job creation) would be taken into account as an element of total return and thus potentially make the leverage financially more attractive to new investors.

Construction loans. Turkey went through a construction boom over the past decade. No wonder loans to the sector is almost as big as the ones to manufacturing: TL 85.2 billion in TL loans (TL 7.4 bn NPL) and $15.3 billion ($1.3 billion NPL) in FX loans. The sector feeds multiple sectors and employs thousands of people. Moreover, real estate is an important part of Turkish household wealth, given around 60 percent home ownership. Any sustained sharp decline in prices would lead to a decline in consumption due to wealth effect, limiting the positive impact of jumpstarted credit flows. TARP cannot ignore the sector but should essentially focus on the existing stock and incomplete construction, rather than complete new builds. As such, we believe the real impact would mostly be on the wealth effect side, rather than direct employment (save for some specific cases). Spain is a case in point. Regulated price/ m2 of free market homes declined from EUR 1,650 at the beginning of 2012 to EUR 1,450 in the middle of 2014 (the ratio is same as the 13.6 percent real decline in CBRT Residential Price Index between March 2018 and 2019). Spanish banks had to divest their real estate positions. Enter Sareb, which was funded by 54 percent private/ 46 percent public capital, acquired EUR 50.7 billion assets (EUR 107 billion par value), composed of 80 percent loans/ 20 percent properties. Since its inception in 2012, it reduced non-performing loans by 44 percent while value of the property portfolio increased by 9 percent and debt underwritten by public reduced by 30 percent. Regulated price/ m2 of free market homes essentially reached their 2012 levels at the end of 2018. Like Sareb, the Turkish TARP should acquire loans, enforced properties and -on a selective basis- properties still owned by developers. Additionally, aggressively leveraging technology for sell assets (effective conversion of concrete to cash) or entertaining shared office/ living models should be considered.

V. Next steps

We cannot stress enough the urgency of the need to take action. Bank lending is contracting while their valuations are testing historical lows in USD terms. Corporates are almost exclusively focused on survival, let alone considering new investment. Unemployment is soaring. The risk of a negative feedback loop (credit starvation, economic contraction, loss of corporate sector capacity to operate and service debt, impaired bank balance sheets, further credit starvation) is increasing.

Simply arguing that “it is private sector debt, and hence their problem” completely misses this point. What is owed by private sector is the main asset of the banks, and governments are the ultimate risk managers ensuring stability of the financial system.

Therefore, we invite the government, banks and private sector representatives to come together and jointly outline the path forward. Our multiple conversations make us believe international investors could be willing to pursue some opportunities, if such a framework can be established.