Investment Insight

TURKISH CORPORATE BONDS – A FUNDAMENTAL OPPORTUNITY

The macro backdrop in Turkey has been challenging with elevated inflation, balance of payments concerns and presidential elections, which has resulted in significant asset volatility at both the sovereign and corporate levels in the country. However, we believe this provides a compelling opportunity to generate very attractive yields by investing in high-quality companies capable of operating in such an environment.

After a closely contested race, President Recep Tayyip Erdogan won Turkey's presidential election in May, defeating opposition leader Kemal Kilicdaroglu with 52.1% of the vote. The result stretches Mr Erdogan's rule into a third decade but the tight margin of victory indicates a divided country.

Turkey is uniquely positioned geographically between East and West. Its size, population and strategically important location give Turkey major influence in the region. At the same time, it is faced with economic and social challenges including a large current account deficit, a depreciating currency and high inflation, notwithstanding the aftermath of February's devastating earthquake that shook southern Turkey and Syria.

Inflation was the hot topic globally in 2022 as geopolitical tensions triggered higher energy costs and supply-side disruptions raised consumer prices. Inflation rates across the OECD hit a 34-year high of 10.7% in October compared to a year earlier. Turkey topped a list of 38 member countries with inflation peaking at 85.5%. Despite this, its government prioritised the support of economic growth and employment, cutting interest rates when an orthodox monetary policy would have expected it to raise them.

Turkey faces currency woes following President Erdogan's re-election

Deeply negative real interest rates (as inflation is higher than rates) have made it attractive to borrow and spend, rather than save. This supported strong real GDP growth of 11.4% in 2021 and 5.5% in 2022. However, given the high rate of inflation, the policy had ramifications and shook investor confidence.

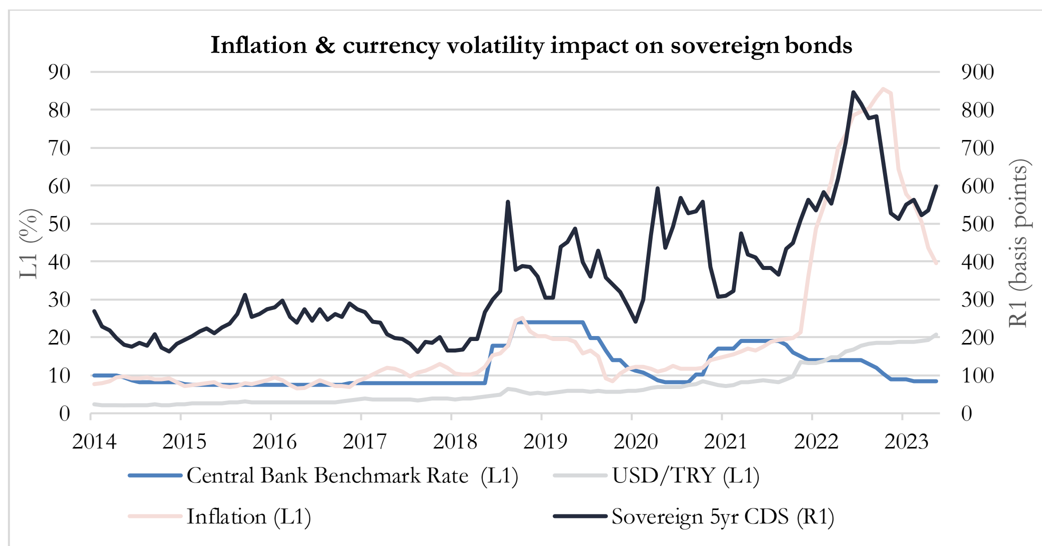
The Turkish lira depreciated by 40.6% in 2022 and there were increased concerns about a balance of payments crisis on the back of a widening current account deficit and depletion of sovereign foreign currency reserves. Partially offsetting these worries were timely capital inflows from neighbours in the Middle East and Russia, reflecting an improvement in relations between the countries and adding a political element to the economic issues.

With interest rates as a policy instrument for inflation off the table, the government turned to other indirect measures targeted at banks and corporates to influence the economy and shore up its balance sheet. In the financial sector, regulatory changes were introduced, including additional reserve requirements and limitations on Turkish lira loans to companies with high hard-currency cash holdings.

Such measures were designed to curb loan growth and the spending boom that had been partly responsible for the inflation effect. Meanwhile, companies saw regulation tighten on export revenue conversion to Turkish lira as the central bank looked to support the currency and bolster foreign currency reserves.

Sovereign volatility has a knock-on impact on Turkish corporate valuations

This challenging backdrop resulted in significant volatility for Turkey's sovereign bond yields and credit default swaps during the year. This volatility had a direct impact on corporate bond yields, which closely track sovereign yields, despite many companies being in better shape. At the time of writing both sovereign and blue-chip company US dollar-denominated bonds yield around 8-9% in USD.



Source: Bloomberg

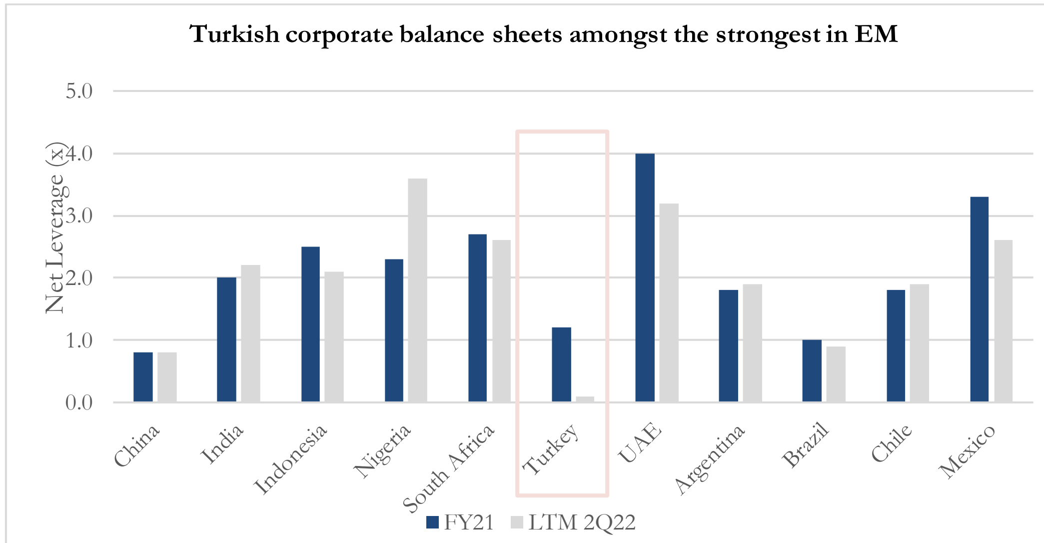
As investors in emerging market hard currency corporate bonds, typically USD-denominated, our focus is on underlying company fundamentals. We believe that macro-driven volatility can be a compelling source of opportunity. We have invested in several high-quality Turkish corporate bonds that were among our top-performing positions in 2022.

This bottom-up approach to investing, focusing on company fundamentals rather than the wider economy, meant we were effectively 'overweight' Turkey compared to the main emerging market corporate benchmark.

Our confidence was bolstered by the fact that over a longer 10-year period, Turkish corporates have generated an annualised return of 5.3% while Turkish sovereign bonds have returned 3.0%, further highlighting the corporate opportunity.

Turkish corporate fundamentals in good shape

Recent earnings reports from the companies that we have invested in have demonstrated their ability to operate successfully in th current challenging environment. This resilience reflects the quality of their management as well as the geographic diversification of their operations and the strength of their balance sheets.



Source: Bank of America

For example, *Sisecam*, one of the largest glass manufacturers in Europe, benefits from important international operations, which account for over 45% of group revenue. A further 18% of revenue is generated from exports from Turkey which combine to provide a natural hedge to its hard currency balance sheet. The company generates and holds hard currency cash balances outside of Turkey that help it to service external debt even in times of stress.

Koc Holdings, the largest conglomerate in Turkey, has also shown resilience in the inflationary environment as it benefits from strong pricing power across sectors. The group is the largest exporter in Turkey with portfolio companies generating over 52% of revenue in hard currency. The group has strong liquidity with a net cash position at the top holding company (the level where we invest) and is therefore well positioned to repay upcoming debt maturities should the primary market remain unconducive to issuing new debt. It has a powerful business model with a diversified revenue base and is well-placed to exploit growth opportunities in Turkey and its major export markets.

Competitive advantage through scale, reach and intellectual property

Largest **industrial & services group**

4 of the **Top 10** Industrial Enterprises[1]

1 Tüpraş
2 FORD OTOSAN
8 Arçelik A.Ş.
10 TOFAŞ

Largest **exporters** within portfolio

3 of the **Top 10** Exporters[2]

1 FORD OTOSAN
3 Tüpraş
6 Arçelik A.Ş.

Largest intellectual **property rights portfolio**[3]

>7,000 trademarks
>2,500 patent families
>4,700 patents
>1,000 industrial design registrations
>4,700 Internet domain names

Largest **distribution network & customer database**

YapıKredi ~800 bank branches
Arçelik A.Ş. Otokoç Otomotiv AYGAZ ~11,000 dealers & after-sales services
TANI >12.5 million customers with data-sharing permission enabling efficient up &
and capitalize on various trends

Source: Koc Holdings

A company with a similar business model based in developed market economies would offer significantly lower yields. That is why we believe Turkey today offers investors an attractive country risk premium for high-quality businesses that have a track record of operating in difficult environments.

Diversified sources of capital are a defining criteria of quality

In addition to strong balance sheets, refinancing risk is also mitigated by the depth of local capital markets. Through 2025, Turkey's corporate debt maturities amount to approximately USD 9 billion, of which around 70% is due to private banks that have access to alternative sources of capital. One of these sources is syndicated loans from the international financial sector. Turkish banks achieved rollover ratios of 75% on average in 2022, demonstrating the continued appetite for Turkish bank risk despite the difficult macroeconomic conditions.

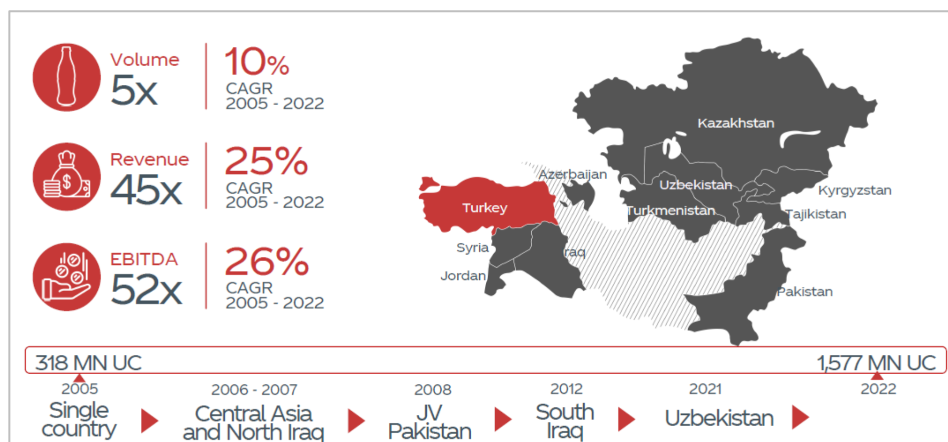
Our focus is on underlying corporate fundamentals, but technical dynamics have also been supportive of Turkish corporate bonds. Their performance has benefited from a combination of strong local investor demand for assets and a negative net supply of new bonds being issued given that the overall high-yield primary market has been all but closed in 2022/23 on the back of the broader market volatility.

With Mr. Erdogan beginning a third five-year term, investors will now look for signs of policy shifts in Turkey. He has promised the new team would have "international credibility", hinting at a possible turn away from unorthodox policy. The appointment of finance minister Mehmet Simsek may provide an important clue. He served as finance minister and deputy prime minister during 2009-18 and was highly regarded by international markets during his tenure.

However, much will depend on Mr. Erdogan's next steps and the situation is likely to remain volatile. We believe any pullback will present opportunities to buy bonds at attractive yields from high-quality companies that have witnessed similar periods in the past and have shown their ability to navigate through successfully.

Coca-Cola Icecek recently presented this opportunity. It is the exclusive bottling and distribution partner of the Coca-Cola Company in Turkey and ten countries mainly in the Middle East.

Coca-Cola Icecek's successful growth track record over nearly two decades



Source: Coca-Cola Icecek

We like the defensive nature of the soft drinks industry, its solid track record, low leverage and large cash balances held in hard currency outside of Turkey. The company has an investment grade credit rating by Fitch and we were able to buy USD bonds maturing in September 2024 at close to an 8% yield - a very attractive risk-adjusted return profile.

Charles Gélinet, CFA
July 2023

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