Sustainable Investment in Turkey

ISSUE BRIEF

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Introduction

To support the growth of sustainable capital flows, IFC's Advisory Services team seeks to influence, support, and enable capital allocation and portfolio management processes, using IFC's own investment practices as a model. IFC is playing its part in supporting the growth of the market by funding the development of enhanced stock market indices and financial instruments and through targeted market research.

Compiling data on the state of development of the sustainable investment industry is important for global investors and investment managers seeking to understand the scale and location of opportunities in the market for sustainable investment products. Although a number of organizations provide this information in developed economies, such data are scarcely available in emerging markets (EM).

IFC thus launched a series of sustainable investment country reports initially covering the largest emerging capital markets attracting global portfolio investors: Brazil, India, and China. Further reports have been added to the series covering Sub-Saharan Africa, the Middle East and North Africa, and Turkey.

This summary version of the report, "Sustainable Investment in Turkey," which may be downloaded in full from IFC's website, was produced by ILLAC, a consultant to IFC and provides a snapshot of the Turkish Sustainable Investment market.

OVERVIEW of SI in TURKEY

As the world's 16th largest economy, Turkey is expected to grow at an average of 4.5 percent until 2015. In addition to being an important economy, Turkey has significance as the largest economy in the process of accession to the European Union (EU). After having experienced boom and boost cycles in the past that involved frequent military interventions, Turkey is now a functioning market economy undergoing a democratic consolidation process. The Turkish economy still faces structural issues. Low savings rates and a current account deficit contribute to a persistent reliance on external finance, and the economy remains vulnerable to changes in external financing conditions. The growth of Turkey's rapidly internationalizing corporate sector depends on its ability to receive sustainable investments and long-term loans from international sources.

The negative consequences of unregulated high growth have recently become more apparent in Turkey thanks to increased transparency and the EU accession process. As a result, the concept of sustainability has gained currency within Turkey's corporate sector, demonstrated by an upsurge in voluntary disclosure and ISE's launch of a sustainability index project.

The growing interest in sustainability and/or corporate responsibility themes among Turkish businesses does not however yet appear to be reflected on the supply side. There are structural reasons for these deficiencies:

- Domestic savings are historically low and directed toward short-term deposits and fixed-income instruments—predominantly government bonds; the equity exposure of local institutional investments is as low as $5 billion.

- The overwhelming dominance of banks in the finance sector and the organization of consumer banking, investment banking, brokerage, pension, and asset management businesses in the form of financial conglomerates are problematic. Asset owners and asset managers are not separated in Turkey. This overlap leads to moral hazard and prevents a competitive fund industry from flourishing.

- The equity market is much smaller than many of the BRIC countries. A market capitalization of $233,997 million at the end of 2009 amounts to approximately 37 percent of GDP. The free float of total equity is much smaller. Moreover, the free float is further restricted through block holdings by major stakeholders. The result is a highly concentrated market where sixteen com¬panies represent 64 percent of total market capitalization and 55.1 percent of total trading volume in 2009. Despite the shallowness of the stock market, individual investors' intensive trading activities keep the stock market highly liquid in Turkey; the daily trading volume was around $1.7 billion in 2010, offering diversification benefits for international investors.

- Although foreign institutional investments have historically dominated equity investments in Turkey amounting to 60 to 70 percent of the free float at the Istanbul Stock Exchange (ISE), these investments are short term with an average holding period of less than a year.

Currently, local private equity (PE) funds—backed up by international development finance institutions (DFIs) and local banks channelling programmed loans from DFIs to local firms with ESG conditionality—are the only two channels of financial capital supply that incorporate the explicit use of ESG factors in financing decisions in Turkey. Our broad estimate of SI in Turkey, based on investments that take ESG issues somewhat into account, is $4 billion, including PE investments (See Figure 2).

SI through portfolio investments has yet to emerge in Turkey. The perception that Turkey - and some other emerging markets - is exposed to high political risks effectively marginalizes ESG risks for investment managers. Liquidity remains a key criterion for investment decisions in Turkey as in some other EM. In the absence of demand, there are no local research firms assessing the ESG risks/performances, no locally available instruments for SI in Turkish assets, and almost no indication of Turkish stocks being included in internationally managed SI-labeled funds. This is in line with the findings of IFC's previous research that managers with shorter horizons are less concerned with ESG issues. International ESG research firms' coverage of Turkish stocks is generally restricted to a broad assessment of the reputational risks associated with large cap firms included in global indices.

FIG. 1 STOCK MARKET INDICATORS IN TURKEY AND IN BRIC

	Exchange	Market Capitalization ($ Millions)	Number of Listed Companies	Market Capitalization to GDP (%)	Stocks Traded, Total Value (% of GDP)	Change in the Index Value (% USD)
Brazil	BM&FBOVESPA	1,337,248	386	74.26	41.30	143.1
China	Shanghai SE	2,704,778	870	100.46	179.67	79.9
China	Shenzhen SE	868,374	830			117.1
India	Bombay SE	1,306,520	4,955	90.01	83.11	98.6
India	National Stock Exchange India	1,224,806	1,453			96.9
Russia	MICEX	736,307	234	69.99	55.45	114.5
Turkey	Istanbul SE	233,997	325	36.58	39.46	101.8

Source: Standard & Poor's, Emerging Stock Markets Factbook and supplemental S&P data and World Bank and OECD GDP estimates. All figures reflect 2009 data. Index returns are computed from the end of 2008 to the end of 2009 and are taken from WFSE (World Federation of Stock Exchanges) historical statistics: Measures of Market Performance and Efficiency.

FIG. 2 ESTIMATE OF SUSTAINABLE INVESTMENTS IN TURKEY (NOVEMBER 2010)

Source	Investments in Equity (TR Billions)	Total SI (TR Billions)
Portfolio Investments		
Portfolio Investments of UN PRI Signatories	1.25	1.25
Portfolio Investments of International Institutional Investors	80.00	1.00*
Private Equity		
Actera	0.75	0.75
Turkven	1.00	1.00
Total (incl. PE)		4.00

(*) 2% of (Total Investments by Foreign International Investors – Holdings by Hedge Funds)
Source: Interviews with Fund Managers.

LOOKING INTO the FUTURE

Turkey has many strengths, including a well-regulated banking sector and pension fund industry, a competent and independent central bank, prospects for sustained growth, a competitive product market, a young population, the political will to make Istanbul a financial center, and, finally but more importantly, the EU accession process. Although there has been a slowdown in the EU accession processes, and the democratization process is facing risks stemming from the complexity of the process, both continue to act as strong drivers for the sustainable development and normalization of Turkey.

Regulatory changes will further provide support for the development of the sustainable investment industry. Deregulation of the energy sector and a heavy reliance on energy imports, which distorts trade balances, provides a basis for attractive investments in energy efficiency and renewable energy projects. Renewable energy legislation enacted in January 2010 will speed up this process. The new Commercial Code, which will come into effect in July 2012, will force privately held companies to reduce informality through mandatory accounting rules and external audits, thereby encouraging listings in the stock exchange and enabling borrowing.

However banks remain the main source of finance for all Turkish companies, and access to external finance remains the single most important issue for the highly leveraged Turkish corporate sector. Debt/equity ratio of the ISE firms at the end of 2009 was 122 percent compared to 32 percent for EM average. On-going regulatory improvements help to improve the picture. Turkey's regulators have taken drastic measures to encourage initial public offerings (IPOs) to help overcome the financing needs of small and midsize enterprises (SMEs) and attract portfolio flows.

In the long term, the growth of domestic institutional investments is the only route to financing Turkey's growth sustainably. A need for regulatory improvements in the fund management industry to foster specialization and competition is apparent and acknowledged by the regulator. On the other hand, although very small, the fast-growing private pension system has the potential to shape the fund management industry. Moreover, there are indications that Turkey may receive investment-grade status following the elections in June 2011 and perhaps earlier—a development that would encourage taking a long-term perspective on investments in Turkish assets.

Notwithstanding these factors, banks will continue to play an increasing role in financing the growth of the Turkish economy in the midterm. The implications of the continued dominance of banks, which also dominate the fund management industry in Turkey, are reflected in our recommendations in the main report. Meanwhile, a number of interventions listed below, can help SI to flourish and add momentum to the emerging interest in "sustainability" observed in Turkey's corporate sector:

- Involving banks in assessing sustainability risks by operationalizing the implementation of ESG conditionality in the channelling of programmed loans from DFIs to Turkish firms and by incorporating sustainability factors into corporate bond ratings

- Improving the information value and accessibility of current corporate governance compliance reporting

- Developing a differentiation framework for sustainable SMEs using the newly launched emerging companies market (GIP)

- Increasing the amount and spread of development finance invested in those PE funds that comply with ESG criteria and extending support to emerging independent local asset management companies in setting up SI-themed PE funds

- Facilitating collaboration between leading pension firms and independent asset management firms to pool pension funds' allowable mutual fund investments in an SI-themed mutual fund

- Supporting the availability of and investors' accessibility to EM firms' ESG disclosures, including those of Turkey, by leveraging existing global platforms and deploying innovative business models in cooperation with global research houses, index builders, and asset managers.

Without the demand for sustainability and sustainable investments, the emerging interest in ESG disclosure in Turkey will not be materially instrumental in improving the ESG performance of Turkish firms; and the current upsurge in voluntary disclosure and sustainability discourse within the corporate sector may remain an inefficient practice.

***Sustainable Investment in Turkey,* full report:** http://www.ifc.org/sustainableinvesting

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