GREECE & TURKEY
UNREALISED POTENTIAL

EU accession dominates Turkey's outlook, while Greece is still weighed down by public debt from the 2004 Olympics. But positive signs from the securitisation markets in both countries offer something to whet the appetites of investors. Laurence Neville reports

The eastern Mediterranean is a disparate region; the principal economies in that part of the world, Greece and Turkey, have seemingly far more to divide them than to unite them. Their common link is the European Union: Turkey appears to be following a path towards EU membership similar to that trod by Greece and investors are eager to gain from convergence within the region.

But investors face tough challenges in gaining non-government fixed-income exposure to Greece and Turkey through the bond and derivatives markets: the vast majority of issuance from both countries is sovereign. Accordingly, there is no credit default swap market other than that for the sovereign credit. And there have been only a handful of locally originated collateralised debt obligations.

Bankers are not optimistic about any significant increase in corporate issuance from Greece – it is, after all, a country of just over 10 million people with a limited number of large companies. But Turkey is viewed as a potentially substantial market: it has a population of 70 million and a diverse, rapidly growing and increasingly sophisticated corporate sector.

Consequently, there is hope that corporate issuance from Turkey will emerge, either internationally or domestically, and there is also an expectation that securitisation will play a larger role in funding Turkish banks. How soon that may happen, though, is open to speculation: Turkey has been hailed as the 'next big thing' for years, and its brush with financial crisis earlier this year may well have delayed issuance further.

Turkey: macro picture

Turkey, like most other emerging market countries, suffered in the turbulence of May and June this year. Its currency lost 22% of its value against the US dollar in two months and interest rates were forced to rise by 425bp to 17.5% in a bid to stem the decline. "After a long period of strength since the crisis of 2001, the latest developments have inevitably left a cloud over the future of the economy," says Edward Parker, head of emerging market European sovereigns at Fitch Ratings in London.

To some extent, Turkey was an unfortunate victim of investor panic that affected economies from Iceland to Argentina earlier this year. However Turkey was hit harder than many other countries, according to Parker, and with good reason. "The country will have a current account deficit of $27 billion this year – the largest of emerging market economies in dollar terms – and in addition concerns about emerging markets coincided with domestic shocks including an increase in political uncertainty and an unexpected pick-up in inflation."

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> Edward Parker, Fitch

Specifically, observers were concerned about the handling of the appointment of a central bank governor, which reinforced fears that Turkey's disinflationary stance – which has been so important in rehabilitating the country in the eyes of investors since 2001 – was about to be revised. Turkey will certainly miss its inflation target of 5% this year: it is expected to be 10% by year-end despite the hikes in interest rates.

Those interest hikes will necessarily slow the economy down, and hopefully remedy the current account deficit. Turkey's economy grew by 7.6% in 2005 but growth in 2006 is expected to be just 4% in 2006 and 3% in 2007. Is there a danger that monetary policy could overshoot and stall the economy? Parker thinks not: "Certainly that has happened in previous cycles. But given the macroeconomic and financial changes that have occurred since the beginning of the decade, coupled with relative political stability, it seems unlikely it will occur this time."

The big question for Turkey – and implicitly for all who invest in Turkish securities – is EU accession. Entry to the European club, first applied for in the 1960s, is by no means guaranteed. There was a major advance last year when talks began between Turkey and the EU about entry but these have since stalled over the subject of allowing Cypriot shipping, along with other European vessels, free entry to Turkey's ports: a move which is due to happen by the end of the year in line with the negotiating framework. Given Turkey's relationship with Cyprus – it continues to occupy the northern half of the island following an invasion in 1974 – this is unlikely to be resolved soon.

However, the Cyprus issue is unlikely to scupper the accession process, according to Parker. "The EU is unlikely to completely suspend negotiations with Turkey over Cyprus because of Turkey's current political and economic sensitivities and because its Western orientation looks even more important against the background of instability in the Middle East region," he says.

As a moderate, secular, democratic and Islamic society on the fringes of the Middle East, keeping Turkey on side is vital for the West, not least because the EU is eager not to provide fuel to growing nationalist and anti-EU sentiment in Turkey. Despite this increase in anti-EU feeling, next year's presidential and parliamentary elections are unlikely to result in a shift in Turkey's pro-EU stance.

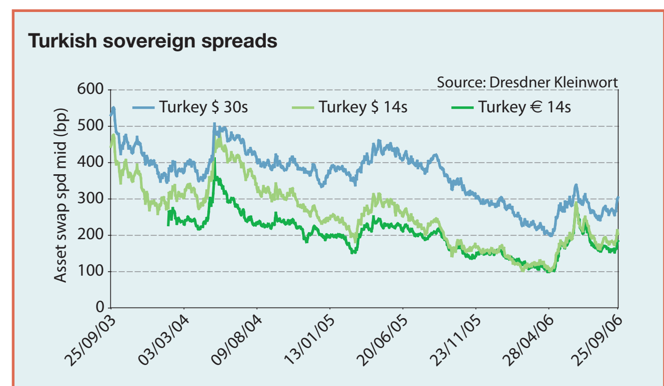
Turkey's rating of BB- with a positive outlook from Fitch reflects the country's EU accession process but also acknowledges that the road to entry will be a long one. "More immediately, the key driver of the rating is the Turkish economy; public finances remain on an improving trend despite the market turbulence in the spring," says Parker.

The macroeconomic picture appears to be improving: the currency has recovered most of its losses since the end of June, while the budget deficit is likely to fall to 2.5% this year and the ratio of public debt to GDP will also fall. "The long-term picture remains one of strengthening public finances, ongoing privatisation and structural reforms combined with rising living standards, which all serve to bolster creditworthiness," says Parker.

International interest

Despite the shakeout in the Turkish lira and government bond spreads, there remains substantial appetite for Turkish risk among yield-hungry international investors. That appetite is not being satisfied by corporate bond issuance, with scarcely more than $1 billion in non-government issuance likely this year compared with the $5–6 billion a year issued by the government.

Turkish sovereign spreads



"Investors want exposure to corporates and banks but issuers in Turkey have yet to see the need for international issuance," says Gilles Franck, head of debt capital markets for eastern Europe, the Middle East and Africa at BNP Paribas in London.

Banks tend to fund themselves largely in the syndicated loan market on a one- or two-year basis and simply roll their debt every year. The banking sector has begun to address the potential risks inherent in this strategy by issuing longer-dated paper in the form of securitised diversified payment right deals.

Nevertheless there has been some interest in non-securitised borrowing amongst banks. "We could see bank capital issuance," says Franck. "So far, we have only seen Finansbank seek to raise tier 2 capital as a means of strengthening its capital base without having to resort to raising equity but others could follow."

The number of international deals from non-bank issuers in Turkey in recent years has been even smaller. In May 2005, Vestel Electronics completed a $225 million seven-year issue, which priced at 150bp over the Turkish government curve. Petrol Ofisi, Turkey's largest fuel distributor, has also come to market while the most recent deal from the country has been for food and chemicals conglomerate Yasar in August.

Yasar's €200 million five-year unsecured bond received a warm welcome from investors, according to Ray Harte, managing director in global banking at Dresdner Kleinwort, sole bookrunner for the deal. "People were interested because it offered something different," he says. "We had to have two teams in London at one point because there was demand for 14 one-on-one meetings in one day."

Many of the buyers were emerging markets funds, as would be expected, but Harte says that there was a second group of buyers. "There were a number of names that we would have seen in deals for Poland and Hungary in 1999," he notes, "people who recognise the opportunities presented by Turkey's stage of development and integration into Europe."

Harte concedes that for at least five years there has been a constant expectation that 'next year' would be the one in which

Greece: a small market with a big government debt problem

At first glance, the Greek economy appears relatively healthy. "There was an assumption that the economy would slow after the Olympics when growth was 4.7% and indeed it did slow, to 3.7% in 2005," notes Chris Price, sovereign analyst at Fitch. "But that pace of expansion has been maintained in 2006 and is likely to be maintained in 2007. It compares favourably with average EU growth of 2%. At the same time inflation is 3.2%, higher than the EU average but still a respectable level."

The Greek government has managed to get its budget deficit under control: from an Olympics-inflated figure of 7% in 2004, it came down to 4.5% in 2005 and is likely to be 3.1%, just shy of the 3% threshold set for eurozone countries. However, public debt – much of it as a result of Athens hosting the XXVIII Olympiad in 2004 – remains a significant problem. It reached 107.5% of GDP in 2005, the highest in Europe along with Italy; even if the government hits its deficit targets it will still be more than 100% by the end of 2008.

The high level of government issuance has combined with a cheap bank loan market to scupper corporate bond issuance. Deals such as Greek mobile telephone operator TIM Hellas's dual-tranche high-yield issue in October 2005 are few and far between. The one market where international investors do have an opportunity to gain non-sovereign exposure to Greece is securitisation, which has been established in Greece since a law permitting the technique was enacted in 2003.

Since then there have been six mortgage deals and one credit card issue with an average size of around €1 billion – a small number of deals by international standards. "It gives the paper a rarity value," notes Ioanna-Victoria Kyritsi, rating analyst in the structured finance team at Standard & Poor's in London. "Certainly what issuance there has been has performed well."

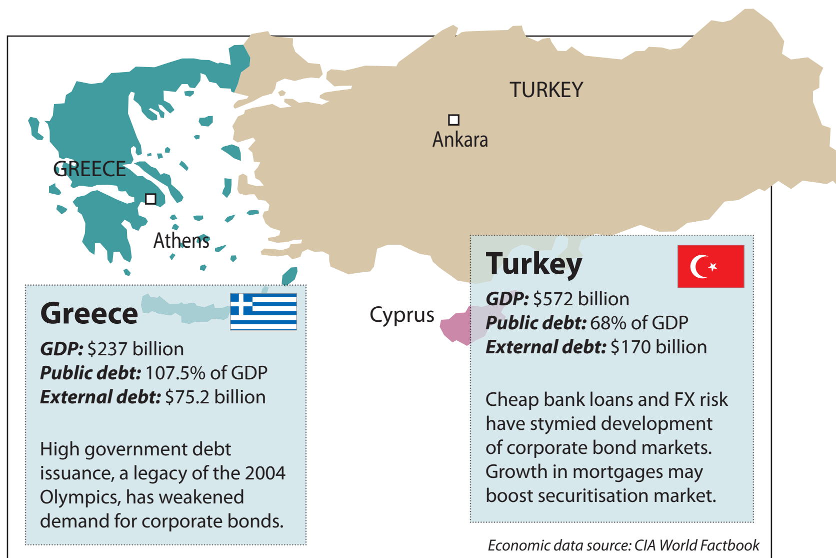
Going out with a bang: the 2004 Athens Olympics have left Greece with public debt at more than 100% of GDP

All of the deals to date have been originated by Greek banks, which dominate mortgage and other consumer lending in Greece. The largest lending bank in Greece, National Bank of Greece, has yet to do its first deal. "The banks have to constantly consider the cost/benefit analysis of securitisation," explains Kyritsi. "A bank such as National Bank of Greece has an enormous deposit base that gives it access to very cheap funds."

Nevertheless, securitisation issuance from Greece is expected to increase, with further credit card deals and potential auto loan issuance. "Credit expansion is a fairly recent phenomenon in Greece but loan portfolios have been increasing in most segments and we expect some of those loans to find their way to the securitisation market," says Kyritsi. Similarly, mortgage issuance should also steadily increase. "There had been fears that the housing market would slump after the boom period in the run-up to the Athens Olympics," says Kyritsi. "But the market has remained steady."

corporate issuance would take off. "We haven't got there yet," he says. "But that doesn't mean it won't come. Turkey has a wealth of decent sized corporates, which are beginning to seek longer-dated funding than the bank funding that they have traditionally accessed. The challenge will be managing the currency exposure, given the volatility of the lira." Swaps are expensive and most borrowing is currently unhedged, which is risky.

"The view from corporates in Turkey – quite fairly – is why should they pay up to borrow in the international markets when they can obtain aggressive funding from domestic banks?" says Franck. "In addition, most people in Turkey believe that the country is an improving credit. Therefore they think it wouldn't make sense to lock in current costs of funding."



However bankers remain confident that corporate deals will take off provided the economic backdrop remains favourable. "Given the yield compression of the Turkish sovereign in recent years, it now makes sense for corporate borrowers to look at the international markets especially as domestic interest rates are rising," says Harte. "Interest from corporates in the international market has obviously fallen in the wake of the events of May and June but there are still at least 10 mandates out there waiting to be acted on."

One London-based banker adds: "The government plans to reduce the issuance of local currency treasury bills, which have undoubtedly crowded out corporate issuance in the local market. Therefore we could see an increase in Turkish corporates using the local market."

There would certainly be significant demand for lira-denominated corporate paper. However the market faces a Catch 22 situation, according to another banker who works with Turkish corporates. "The double-digit returns that attract international investors to lira paper are the very thing that prevents corporates from issuing domestically. There's no real way around that problem at the moment."

Securitisation potential

While bond issuance from Turkey may be dominated by sovereign issuance, the securitisation market at least holds some promise for credit investors: Turkey's population of 70 million and 600% a year growth in mortgage lending makes it a force to be reckoned with. A draft mortgage law was presented to the Turkish parliament in November 2005 and is currently undergoing discussion and amendments, on issues such as prepayment penalties.

"Turkey certainly has long-term potential as a market for securitisation," says Alice Keegan, associate with the London structured finance team at Standard & Poor's. "Six months ago there was strong interest from potential borrowers and investment banks but the volatility in the currency and concerns over the trajectory of the economy have taken the wind out of the sails to some extent. Nevertheless, we expect that Turkish banks will look to securitisation to fund the expansion of their lending in the future."

As international companies take stakes in Turkish banks – General Electric announced the purchase of a 25.5% stake in Turkiye Garanti Bankasi, the third largest publicly traded lender in Turkey, for $1.56 billion in September – the impetus towards using the securitisation markets will increase.

The crucial factor in driving banks to the securitisation market will be the cost of funds. "Turkey's BB- rating means that we may see proposals to structure securitisation deals above the sovereign ceiling for optimal execution," says Keegan. "But more importantly, the cost of swaps from euros or dollar to lira will be vital in deciding whether deals make sense. A swap that takes prepayment risk and converts it into something palatable for international investors is difficult for a currency such as the lira that is so volatile. Usually a borrower would back-to-back such a swap with the arranging bank but given the costs for such a swap from lira, substantial excess returns will have to be available on the loans in order the fund the swap."

BNP Paribas' Franck believes that in addition to the future flow securitisations in foreign currencies, a market is about to develop for local ABS transactions, using lira-denominated assets such as auto and consumer loans as underlying. "We think a lot of the local currency stuff will stay in local currency, and that there will still be significant international interest in such deals, as long as the currency remains stable and EU negotiations stay on track."

There is already a limited kind of securitisation market in Turkey despite the absence of a specific securitisation law. Diversified payments rights (DPR) issues, which securitise future flows on dollar-denominated assets such as loans and credit cards, have been popular with some of the large banks in Turkey. In the year-to-date, there has been around $1.2 billion in DPR issuance from Turkey, according to Franck. These deals come with ratings above that of the sovereign and are often wrapped by monoline insurers. They are usually medium-term instruments with maturities of three to five years.