2
Household consumption continues but for how long?

3
Slump in private investments

4
Challenge of export sophistication

+
Textile and clothing sector 8
Pharmaceutical sector 11
Sector risk assessments 15

May 2015

PANORAMA
CHALLENGES AMID GLOBAL CHANGES

COFACE ECONOMIC PUBLICATIONS

By the Group Economist based in Istanbul

After a decade of well-implemented reforms and high growth rates, the Turkish economy seems to be struggling to maintain the same growth performance.
Coface expects a growth rate of 3.5% this year - still a solid rate, yet below the potential growth rate estimated at 5% and lower than some of the country's peers.
The recovery in the US economy and the Federal Reserve exit strategy have pushed the global economy into a new era. Emerging countries face new challenges due to less available liquidity and structural vulnerabilities. Over the period ahead, the high volatility of the Turkish lira, the recovering but still-fragile growth in Europe and geopolitical risks weighing on the top export markets, are considered as the main challenges for the Turkish economy. Coupled with the general elections in June 2015, these factors are leading to a slowdown in household consumption and investment expenditure.
The textile and clothing sectors are among the most impacted by the developments in the global economy. Regional tensions are also weighing on the export performance of Turkish textile and clothing companies. Coface has increased the textile sector risk assessment to high risk level from medium risk, mainly due to the restrictive impact of the euro's strengthening on export revenues, increasing import and production costs, the fragile recovery in the core market of Europe, losses recorded in Ukraine and Russia and finally deterioration in companies' payment performance. The clothing sector currently stands at medium risk level, but is being closely monitored.
The pharmaceutical sector remains solid, despite heavy regulations and lower profit margins. Coface evaluates the risk level of this sector as low. The sector is benefitting from the greater access of Turkish citizens to healthcare services, higher per capita income and higher pharmaceutical expenditure per capita. Although the reference pricing system puts pressure on prices, which in turn restrains investments in new tech-nologies, the sector still has the strong foundations necessary for steady financial performance. Payment collection is steady, as no delays have been detected in State payments..

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QUOTES BY ECONOMISTS

HOUSEHOLD CONSUMPTION CONTINUES BUT FOR HOW LONG?

SELTEM İYİGÜN

MENA REGION ECONOMIST

Consumption, a main growth driver, is losing momentum...

The Turkish economy recorded a growth rate of 2.9% in 2014 -, below the government end-2014 forecast of 3.3%. Household expenditure contributed 0.9 percentage points (pp) to the growth rate during the period, declining from 3.4 pp in 2013. As household consumption accounts for around 65% of total output, this decline in pace pushed down the country's growth rate from the 4.2% achieved in 2013.

The main reasons behind this slower momentum in household expenditure were the macroprudential tools implemented by the Turkish banking watchdog (BDDK) at the beginning of 2014, in order to curb domestic demand and narrow the current account deficit. These tools limited the number of installments for some goods and imposed higher down payments for auto loans. As a result, the pace of growth of consumer loans declined to 13.7% yoy in 2014, from 28% in 2013. Turkish consumers usually tend to finance their consumption expenditures through consumer loans or credit cards. Between 1994-2013, real wages rose by only 0.9% in the private sector, while they declined by 14.2% in the public sector. Households thus have tendency to use loans to finance their needs. This situation increased the ratio of household debt to disposable income to 55% in 2013, from 7.5% in 2003.

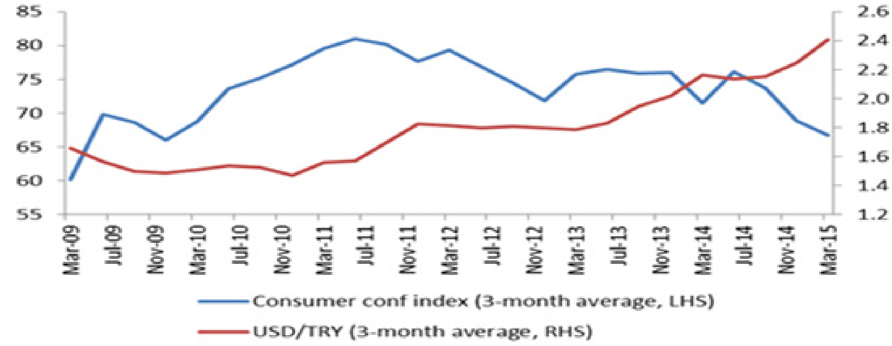
The high volatility of the lira also weighing on consumer behavior, as Turkish people consider the progressive depreciation of the lira as an economic warning sign (because of their experience during the beginning of the 2000s when they became poorer overnight following the violent economic crisis.

Since the start of 2015, the lira has continued its weakening trend against hard currencies such as the dollar and the euro. This is deteriorating consumer sentiment and their willingness to spend. In March 2015, the consumer confidence index hit its lowest level since 2010, at 64.4, while the lira weakened by 13% against the greenback. Subcategories of the consumer confidence index indicate that households are particularly concerned that they will have less possibilities for saving, compared with previous periods. This may decrease the national saving rate, which already hovers at historically low levels (around 13% of GDP). Similarly, retail sales lost some momentum. In the first two months of 2015, the increase in retail sales stood at 3.4% yoy, compared with 8.8% yoy in the same period of 2014. Households especially cut their spending on non-food purchases, with a fall of 2.2% during the time.

The rise in unemployment is another negative factor for consumer spending. Since the recession in 2009, Turkey has created around 5.1 million jobs. The unemployment rate fell to its lowest ever level of 8.1% in June 2013, from 13.1% in 2009. However the slowdown in economic activity raised the unemployment rate to nearly 11% at the end of 2014. Consumers' purchasing power has also been trimmed by the rise in inflation. In 2014, headline inflation stood at 8.2%, up from 7.4% in 2013. The sharp depreciation of the lira at the beginning of 2014 lifted inflation as high as 9.7% in May 2014, due to the pass-through effects. Coface expects inflation to stand at 7.5% yoy at the end of 2015, mainly dragged down by lower oil prices. However, volatility in exchange rates and food prices represent some risks. The speculation and stockpiling behavior of some producers may artificially inflate food prices.

Although, under these conditions, it may be difficult to see a sharp acceleration in household consumption, lower energy prices may lead to a lift for the rest of the year. The higher economic activity expected following the general election in June 2015, may also contribute to job creation and supporting household consumption.

Chart 1: Turkish consumer confidence index vs USD/TRY



Sources:TSI, Reuters, Coface calculations

1 SLUMP IN PRIVATE INVESTMENTS

Investments mostly financed by foreign savings...

Turkey's investment rate stands at around 20% of GDP, far below that of some other emerging countries such as India (35%), China (50%) and Russia (25%). This structural problem stems from the lack of national savings, which makes Turkey dependent on foreign funds in order to invest. As a result, the sustainability of growth performance and the increase in national wealth are damaged. The savings rate fell to a record low level of 12% in 2011. Since then it has slightly improved, yet is still hovering at around 13% of GDP. Many factors are contributing to this situation, including lower interest rates compared to a decade ago, a young population with a willingness to spend and, a high percentage of the population with no bank account (42% of adults according to the World Bank). The low level of savings leaves the country exposed to international shocks.

The lira's weakening raised production costs and squeezed profit margins on higher prices of imported raw materials

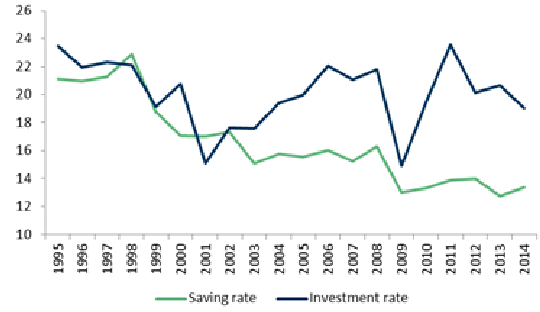
The weak level of private investment has been continuing since the fourth quarter of 2011. In 2012, private investments contracted by 4.9% yoy and grew only 0.5% yoy in both 2013 and 2014. At the same time, public investments accelerated and their share in the total gross fixed capital formation rose to 18% in 2014, from 16.4% in 2012.

Foreign direct investments (FDI) into Turkey have slowed down in recent years. In the 2012-2014 period, total FDI into the country stood at 37.8 billion USD, far below the 62 billion USD in the 2006-2008 period. This trend is partly due to the deceleration of privatizations. In 2014, privatization revenues declined to around 9 billion lira (3.3 billion USD), 50% down from 2013. This led to a deceleration in foreign investment in the country. Other factors - such as political uncertainty, tax and incentive systems and intellectual property rights - appear to be discourag investors from putting their money into Turkey.

Weaker lira weighs on investment expenditure

The exchange rate affects investment expenditures, as during periods of weakness for the lira, companies tend to reduce new investments in order to curb production costs. As the national production system depends heavily on imports of commodity and intermediate goods, the lira's strengthening after the 2008 crisis, enabled companies to produce to lower costs. But the lira's weakening since 2014 resulted in a turnaround in this mechanism.

Chart 2: Turkey's investment and saving rate (%of GDP)



Sources: Thomson Reuters, IMF WEO

The exchange rate also has an impact on investments, as during periods of weakness for the lira, companies tend to reduce new investments in order to curb production costs. This is a result of Turkey's growth model. During the period after the 2008 crisis, Turkey greatly benefitted from the advantages of a globally cheap and abundant liquidity. The lira firmed 30% versus the dollar in 2008-2010. As the national production system depends heavily on imports of commodity and intermediate goods, the lira's strengthening decreased production costs and enabled companies to increase production due to cheaper imports. The stronger lira also allowed the Central Bank to lower its rates. The average interest rates on consumer loans fell as low as to 9.9% in mid-2013, down from the rate of close to 25% in 2008, while it fell to 7.3% from around 12% in 2012 for commercial loans. Coupled with lower rates, globally cheap funds provided by Turkish banks to households resulted in a soaring growth in loans growth. During 2010-2013, personal loans jumped on average by 27% annually, boosting household consumption which in turn supported growth performance. The lira's firming and the large import-content of the consumer prices index (CPI) dragged down inflation. According to the national authorities, a depreciation (or appreciation) of 10% in the USD/TRY rate, has an impact of 1% point on inflation. Thanks to the strong lira, inflation hit its lowest ever level of 3.99% in March 2011.

...badly affected by lira's weakness, regional tensions and, political uncertainty

Clearly, the strength of the lira played a major role in this scenario. However this trend had been partly reversed since the US Federal Reserve's announcement, in May 2013, of its exit strategy. Since then, the lira has started to weaken versus the US dollar amid other emerging currencies. This depreciation resulted in a turnaround in the mechanism described above and increased production costs, which squeezed corporate profit margins because of the higher prices of imported raw materials and intermediate goods. With three elections in 2014 and 2015, companies started to put new investment decisions on hold.

The normalization of the US monetary policy may bring about a possible reduction of capital flows into emerging markets. In the upcoming period, it may therefore become more costly to finance investments for Turkey with money borrowed from abroad.
The lira's depreciation did not only affect production costs. It also added to the foreign currency denominated (fx) debt burden of the Turkish corporate sector. This can be considered as one of the main challenges for the economy in 2015. Turkish corporates' total fx external debt stock stood at 282.2 billion USD in 2014 (35% of GDP). Out of this total, 34.6 billion USD was the short-term fx debt of non-financial companies. On the other hand, as of January 2015, Turkish non-financial companies had an fx exposure (fx assets-fx liabilities) of 177.5 billion USD, according to data from the central bank. However the share of short term net fx position is low – at 10.6 billion USD. Non-financial corporates' FX borrowing from banks increased to 18% of GDP in 2013, up from around 5% in 2008, according to the IMF 2014 article IV consultation report. This relatively high level of fx debt and lack of fx hedging in the corporate sector creates a vulnerability for companies during times of high volatility in financial markets. This reliance on short-term foreign cash to roll over fx debt suggests that any greater depreciation of the lira would increase the debt burden and further reduce new investment initiatives, as it would increase losses in corporate balance sheets. Turkey's total external debt stock stood at 50% of GDP in 2014, raising its vulnerability against a stronger dollar. Yet Turkey is not the only emerging economy suffering from this situation. Other countries such as Peru, Chile, Russia and Indonesia also have a high level of external debt stock, representing respectively 30%, 51%, 37% and 33% of their GDP, according to a PwC report published in May 2015.
Weak growth in European countries and rising regional tensions also limited investments, weighing on export performance. Europe-28 is the premier market for Turkish exports, accounting for around 45% of Turkish goods. Yet between December 2014 and February 2015, Turkish exports to Germany fell, on average, by 8% yoy and to Italy, by 6%. During the same period, exports to the EU-28 area declined, on average, by 2% yoy. Regional turmoil in the Middle East and the crisis between Russia and Ukraine also negatively impacted Turkish exports. In 2014, Turkish exports to Russia declined by 15%, to Ukraine by 21% and to Iraq by 8.8%. Exports to Syria also suffered a sharp decrease, due to the country's civil war.

Chart 3: Turkish non-financial companies fx debt stock (million USD)

Source: Undersecretariat of Turkish Treasury

On the other hand, lower oil prices have been playing a supportive role in the Turkish economy since mid-2014.Turkey imports nearly all of its energy needs - around 60 billion USD per year. This is equivalent to 23% of the country's total imports and 7% of its GDP in 2014. Coface expects average oil prices to stand at 55 USD in 2015.
Political uncertainty is also weighing on Turkish companies' investment decisions. The general election will be held on June 7th, 2015. Once the election is over and the government is formed, investments may progressively recover as political uncertainty is eased. A recovery in European markets would be also positive for Turkish investments, as it would trigger exports. The lira's weakness against the euro (down approximately 13% between late January and end-April), may shift some European orders (mainly in textile, clothing, automotive sectors) to Turkey.

2 CHALLENGE OF EXPORT SOPHISTICATION

Continuously higher need for current account deficit...

The last decade showed that the Turkish economy cannot grow without posting progressively larger current account deficits. In 2011, the deficit reached nearly 10% of GDP, pushing the authorities to engineer a voluntary slowdown. Studies show that the Turkish economy needs progressively more external funds in order to finance growth. In his article "Turkish economic myths", Dani Rodrik, economist and professor of Social Sciences at the Institute for Advanced Study in Princeton, indicated that between 1998 and 2014, an added 1 percentage point growth in Turkey was associated with a 0.4% larger current account deficit as a share of GDP. However since 2005 at any level of growth, the current account deficit is larger by

Higher current account deficits indicates the importance of productivity

Turkey needs to post higher current account deficit to maintain its growth performance. The structure of the deficit shows that the main reason for the external gap comes from the trade balance. Most Turkish exports are of a relatively average level of technology. This reduces competitiveness and contributes to the external gap. The limited export sophistication creates a barrier to increasing the volume and value of exports. Regional geopolitical developments and the slow recovery in Europe also seem to have halted the export performance.

4.5% of GDP.
The structure of the deficit shows that the main reason for the external gap comes from the trade balance. In 2014, the current account deficit stood at 45.9 billion USD (5.7% of GDP), led by a deficit of 63.9 billion USD in the trade balance. The proportion of imports covered by exports stood at 65%. This ratio decreases during periods of solid growth, due to the

The share of manufacturing in GDP has declined

In recent years, Turkey has reoriented investments from manufacturing to the housing sector. Since 2002, the manufacturing sector's share in GDP has progressively declined from 17.6% to around 15.8%, while the share of construction and real estate activities rose from 4.2% to 4.6% and from 8.3% to 9.8%, respectively. As construction activities involve more than 100 sectors, it is an important driver for growth. However its added value remains low and its capacity to generate foreign currency inflows is limited.

import dependence of Turkish manufacturing production. According to research conducted by the Ministry of Economy, Turkey's manufacturing dependence on imports rose to 43% in 2011, from 38% in 2009. This means that to obtain production worth 100 USD, Turkey imports intermediate or capital goods worth 43 USD. The import dependence rate stood at 72% for fertilizers, 69% for iron and steel, 56% for chemicals, 51% for motor vehicles, 43% textiles and 40% for white goods and consumer electronics. In 2014, imports for the manufacturing sector totaled 187.7 billion USD, while exports stood at 147.1 billion USD.
The fact that most Turkish exports are of a relatively average level of technology, contributes to this situation, as it reduces competitiveness. In an IMF research paper of 2012 entitled "Structural Transformation and the Sophistication of Production", countries' "sophistication of exports" levels are measured by the average income and productivity level of their exported products. It demonstrates that export sophistication is an important driver for growth in developing economies. Sophisticated sectors provide more added

The government's 11-step package prioritizes the switch to high tech, production and employment

value and contribute to economic growth through spillover effects. According to the study, Turkey is at the 'middle' stage in terms of sophistication of its exports, lower than some of the other emerging countries such as China. Turkish products which incorporate high level research and development content represent 3% of its total manufacturing exports. As Turkey's export sophistication remains limited, this creates a barrier to increasing the volume and value of its exports. Products with higher added value, using greater skills and technology, are sold at higher prices on the global market. This seems to be one of the reasons that caused stagnation in Turkish exports in 2014 and early 2015, following growth recorded since 2002. Turkey's exports rose to 157.6 billion USD in 2014, up from 36.1 billion USD in 2002, aided by the strong flexibility of its exporters in terms of product and export market diversification. However recent geopolitical developments in the region (Iraq, Syria, Russia, Ukraine etc.) and the slow recovery in Europe seem to have halted this solid performance. This has pushed Turkey to make efforts to increase its manufacturing of higher added value products and thus its share in global trade.

Investments shifting to the construction sector

In recent years, Turkey has reoriented investment expenditure from manufacturing to the housing sector. Since 2002, the manufacturing sector's share of GDP has progressively declined from 17.6% to around 15.8%, while the share of construction and real estate activities rose from 4.2% to 4.6% and from 8.3% to 9.8%, respectively. As construction activities involve more than 100 sectors, the construction sector is an important driver for growth. However its added value remains low and its capacity to generate foreign currency inflows is limited. The number of houses sold to foreigners stood at 2% of total housing sales in 2014. During the period following the global financial crisis, the extraordinary liquidity conditions encouraged Turkish banks to offer mortgage funds in the form of consumer loans, leading to a boom in housing sales. Between 2009 and 2014, sales of homes posted an average compound growth rate of 18.2%. Many households prefer to keep their wealth in real estate or gold, instead of placing it in savings accounts, as they feel better protected against inflation. Yet this way of saving money means that funds do not go into the financial system, where they would be used to finance investments necessary for economic development. The lack of savings and the allocation of existing funds to the construction sector, represent obstacles to better specialization in the manufacturing sector.
The government, aware of the need to overcome these issues, announced a new economic package early in April 2015. The 11-step package prioritizes the switch to high tech, production and employment. The new measures include the expansion of treasury-backed warranties to involve small and medium size enterprises in manufacturing, a 50% rise in tax relief for companies who make investments and facilitation of access to financing for SMEs. The package also introduced the categorization of high-tech invest-ments as priority investments, allocating more incentives to encourage the transformation of production structures. The government also announced it is removing the resource utilization support fund (RUSF), thus lowering companies' input costs (further details in the section 4). The package, worth 7.5 billion lira (2.75 billion USD), has been created to help the economy attain its official end-2015 growth target of 4%. Turkey aims to become one of the ten largest economies in the world by 2023, with exports rising to 500 billion USD and per-capita income growing to 25,000 USD from the current 10,400 USD. Considering that total

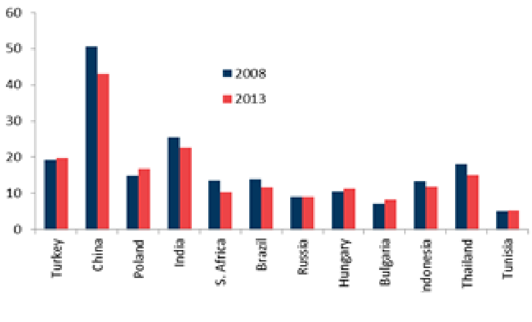
annual exports currently stand at around 160 billion USD, it would be challenging for the Turkish economy to reach 500 billion USD within 9 years. This would require an annual compound growth of approximately 13.7%.

In addition to the government's measures, the European Central Bank's quantitative easing may also help Turkish exports to gain some momentum. In January 2015, the ECB announced that it would expand purchases to include bonds issued by euro area central governments, agencies and European institutions. Combined monthly asset purchases amounting to 60 billion euros are scheduled to be carried out until at least September 2016. Coupled with the fall in oil prices, the ECB's initiative is helping business conditions to improve. Growth forecasts for the region have been upgraded, while business and consumer confidence indexes are slightly picking up. If these improvements continue, they may also assist Turkish companies in increasing their exports to Europe. Although Turkish exporters successfully diversified their export markets and products during the global crisis, Europe-28 is still the country's top trade partner, attracting 43% of its exports in 2014. Turkey's exports to the EU-28 are mainly dominated by durable goods with high sensitivity to economic growth - such as motor vehicles and textiles. Thus an improvement in European economic conditions may boost Turkey's exports over the upcoming period.

Opportunities and challenges...

The increased participation of Turkish SMEs in foreign trade could be considered as another advantage, but the low level of productivity and competitiveness is a challenge. Turkey was ranked 45th out of 144 countries in the World Economic Forum's Global Competitiveness Report of 2014-2015. In the sub categories, Turkey's ranked lower regarding labor market efficiency (131st out of 144), innovation (56th out of 144), institutions (64th out of 144) and technological readiness (55th out of 144). Although the share of SMEs in total exports hovers at around 60%, these companies often suffer from low productivity caused by insufficient equity, lack of feasibility studies, managerial and governance problems and low levels of skills and specialization. In 2012, companies with 1-49 employees accounted for 97% of manufacturing companies, but only for 20% of added value in the manufacturing sector. In the same year, companies with 50-99 employees accounted for 1% of manufacturing companies and 8% of added value. Large companies with over 250 employees accounted for only 0.5% of manufacturing companies but for 54% of added value. Increasing the productivity of SMEs is an important issue, as they contribute to the sustainability of the country's export growth. At this point, having the EU as the main trading partner seems to represent an important advantage for SMEs, as it requires better organization of their production processes. According to research from the World Bank on Turkey entitled "Trading up to High Income" (May 2014), 71% of the Turkish exporters that entered MENA for the first time in 2010 expanded there from the EU. This indicates that exporting to the EU creates a process of technology transfers and "learning by exporting", leading to an increase in productivity.

Chart 4: Index export market penetration, 2014



Sources: World Bank, WITS

Increasing the productivity of SMEs is animportant issue, as they contribute to the sustainability of the export growth

Although market diversification helped Turkish exporters to overcome the negative impacts of the global crisis, new risks in the global economy are putting more pressure on companies to reach new clients. During the global crisis, the share of Turkish exports to the EU-28 fell significantly, to 41.5% in 2013 from around 57% in 2007. During the same period, the share of Turkish exports to the Near and Middle East jumped to 23% from 14%, the share of Asia rose to 8% from 5% and the share of North Africa rose to 6.6% from 4%. According to the World Banks' index of export market penetration, Turkey reached only 20% of its potential markets, suggesting there are still important opportunities to be exploited in terms of export markets. Chart 4 indicates that Turkey's penetration performance in the period after the crisis has been higher than many of its peers, including China and India, but its penetration level is still lower. Turkey's share in total imports to MENA and to the EU-28 both stood at 3% in 2013, so there is still room for further expansion. Nevertheless, the emergence of regional geopolitical risks may put pressure on Turkish exporters to reach new markets through more sophisticated products.

In this respect, the framework agreement reached between Iran and P5+1 countries (China, Russia, the US, France, the UK and Germany) early in April 2015 may provide an important opportunity for Turkish corporates to increase their exports and investments. Iran is a neighboring country and the current penetration level is quite low. The new framework agreement sets the stage for a comprehensive settlement that will alleviate Western countries' concerns about Iran's nuclear weapons' production. In exchange, it will lift economic sanctions on Iran. The two sides have until June 30 to discuss the details of a final agreement. Until that time, the sanctions will remain. A permanent deal would boost Iranian demand for all kinds of products (foods, clothing, automotive, petrochemicals, infrastructure etc.), representing a unique opportunity for Turkish companies.

Although the ECB's expansionary monetary policy is good for the economic growth of the region, its positive impact for Turkish companies could be dampened by the sharp depreciation of the euro. Indeed, 44% of Turkish exports are denominated in euros, while 64% of imports are denominated in US dollars. The depreciation of the euro against the dollar therefore weighs on Turkey's export revenues, while the dollar's appreciation increases the country's production costs, due to its high dependence on imported input. The narrowing of profit margins and declining competitiveness of Turkish goods for European countries are also contributing to the stagnation in investments.

Chart 5: Major Macroeconomic Indicators

	2012	2013	2014	2015 (f)
GDP growth (%)	2.1	4.2	2.9	3.5
Inflation (end-year, %)	6.2	7.4	8.2	7.5
Budget balance (% GDP)	-2.1	-1.2	-1.3	-1.4
Current account balance (% GDP)	-6.2	-7.9	-5.7	-4.8
Public debt (% GDP)	36.2	36.1	33.5	33.6

Source: Coface

However, not all sectors would be similarly affected by the depreciation of the euro against a globally stronger dollar. Some sectors are more heavily linked to the European market, while others have their customer base and suppliers in other regions. For the automotive sector, which has an import dependence of nearly 50%, Europe accounts for approximately 75% of exports and 80% of imports. Therefore, the loss in export revenues may be compensated for by cheaper imports. Europe is also a very important market for the textile and clothing sectors. The high import dependence of the textile industry particularly increases the risks, due to higher production costs. Nearly 50% of Turkey's textile exports and 75% of clothing exports are addressed to Europe. The depreciation of the euro therefore results in serious revenue losses for these sectors. Around 60% of textile imports and 70% of clothing imports come from countries such as China, Indonesia, Vietnam, Bangladesh, India, Pakistan and Egypt. Other sectors, such as the food and furniture industries, seem to have more advantages. Both of these have low import dependence and their exports are mainly denominated in US dollars. The euro's depreciation against the greenback therefore contributes to the competitiveness of these sectors.

INTERVIEW

BERNA KESKIN

MAR REGION – DEPUTY RISK UNDERWRITING DIRECTOR Chief Underwriting Officer Turkey

1-What are the main factors negatively affecting Turkish sectors in 2015?

The principal factors that could affect the Turkish economy in 2015 and 2016 will mainly be related to external variables. The timing of the Fed rate hike and the ECB's quantitative easing program may play important roles in Turkey's macroeconomic trends. Since the fourth quarter of 2014, the Turkish economy has been facing continuous devaluation of the Turkish lira against foreign currencies, which in turn raised risk premiums. While emphasizing external developments, it is also important to accentuate the conditions of Turkey's principal and potential export markets. A positive development for the Turkish economy is the signs of recovery in the European Union, Turkey's biggest export market, in the aftermath of the quantitative easing programme. It should not be forgotten however, that this positive development could be neutralized by a downturn in Greece.
Due to the fact that Turkey is a country with a high level of current account deficit and external debt, it is vulnerable to external shocks. Particularly in times of volatility in exchange rates, the dollarization of debts and high dependence on imported inputs pose threats to manufacturers.

2- Which sectors are mostly affected by these factors and why?

The construction, agro-food, textile and leather industries, which realize exports to Russia and the Ukraine, will be adversely affected by shrinking demand and collection difficulties. These developments will also have repercussions for the domestic market, as the collection difficulties experienced by exporters will spread to Turkish suppliers. High dependence on imported inputs threatens manufacturers in industries such as the plastics and chemicals sectors. The exchange rate between the Euro and the American Dollar should also be taken into account when evaluating the Turkish economy's performance. In the period from the end of 2014 to April 2015, the depreciation of the Euro against the American dollar neutralized the export incomes of those manufacturers who are highly dependent on imported inputs. The relatively specific position of the plastics industry should also be emphasized, as the latest sharp decreases in oil prices (an essential raw material for the industry), pushed companies into a transitional period of adapting prices.
The Saudi-led intervention started in Yemen is another destabilizing factor in the region, which may affect and put upwards pressure on energy prices. Manufacturers would be especially negatively affected by such an increase in energy prices.

3- What are the main risks faced by Turkish textile and clothing companies in 2015?

According to monthly trade data, annual inflation hovers close to 8% and there is uncertainty on the eve of the general elections and the subsequent post-election period in terms of new economic policies. This environment of uncertainty has led to the start of a slowdown in the textile industry. Many textile companies have reported that they are starting to slow down their sales, in order to mitigate risks related to extending terms of trade.
There are also politico-economic challenges in the export markets of Turkish textile companies. Political turmoil in the Ukraine has dragged the Ukrainian economy into a deep recession. The Russian economy has been contracting in the face of sanctions and decreasing energy prices. In the light of recent developments in the Russian economy, a 25% decline occurred in exports of textile products and raw

materials to Russia in 2014. Due to the economic contraction and the volatility in f/x rates, delays in debt collections began to occur. Moreover, the situation has been worsening for Turkish companies who shifted their production to Russia. The ongoing civil war in the North of Iraq, a growing export market, remains another factor of uncertainty in the region. The European Union is the biggest export market for the Turkish textile industry and, thus Euro/American dollar parity is a crucial factor affecting its profitability. Although the industry has increased its export volume, there is a decline in profit margins caused by the recent depreciation of the Euro against the dollar. Nevertheless, the recovery of demand in the Union is of great importance.

Two main Structural Problems for the Textile sector

-Wage costs remain high, due to the high level of taxes imposed on gross wages. This neither encourages employment, nor the transition between services industries and manufacturing. -The incentives implemented on a provincial scale do not provide optimum benefits for manufacturers as, in many cases, it is difficult to see an even distribution of income among provincial districts.

4- How do you assess the general outlook for the Turkish pharmaceutical sector in 2015?

The wholesale drug industry is not deeply affected by recent economic fluctuations and enjoys a stable and sustainable outlook, given the fact that the principal variables are government regulations on exchange rates and public expenditure. Although pharmacies have some problems related to the low level of fixed exchange rates and tight budget policies, the industry has not recently faced a serious downturn.

5- How should Turkish companies react against these challenges? What should they do to manage the risks?

Hedging and efficient cash flow management should be the primary strategy for Turkish companies who are vulnerable to volatility in exchange rates. The need for rational management of exchange rate risks, considering Turkey's high level of current account deficit and dependence on capital inflows, should also be emphasized. In addition to these points, the management of inventories should be improved in order to avoid putting company operations in jeopardy.

3 TEXTILE AND CLOTHING SECTOR

Hit by the euro's weakness, narrower export markets

The Turkish government considers the textile and clothing industries as amongst the most strategic in achieving its target of reaching 500 billion USD worth of exports by 2023. Despite the sharp volatility at the beginning of 2014 and rising geopolitical tensions in the region, Turkey's textile and clothing yoy by 4.6% and 8.5%, respectively. Combined they accounted for 18.5% of total exports (29.2 billion USD). Within the 2023 strategy plan, the export target for the textile and clothing sectors is 72 billion USD (20 billion USD of textile exports and 52 billion USD of clothing exports).
According to the Turkish Statistics Institute's data from 2013, the total number of enterprises in the textile and clothing sectors was 22,682 and 53,226 respectively. As an illustration of their importance for the Turkish economy, together they accounted for 17% of the total added value in the manufacturing sector and 15% of the total production value. According to the Ministry of Iindustry, they provide nearly 12 percent of the country's total employment including informal labor.
Following the elimination of quotas on China's textile and clothing exports in 2005, the competition has intensified. This change in the business environment forced companies to develop their own brands in order to increase their profit margins. The entry of China into the market has, in fact, lowered the advantage of low cost production countries such as Turkey. The majority of Turkish apparel exports are at the final stage of textile production (e.g. knitted and crocheted goods and articles). This indicates that apparel producers are strong in the middle and higher sophistication product areas and confirms the upgrading of Turkey's textile and clothing sectors, according to the World

Chart 6: Concentration level of textile and clothing classes, 2012

	CR_4
Man-made fibres	98.9
Non-woven articles	91.7
Workwear	45.16
Cordage, rope, twine and netting	42.7
Other technical and industrial textiles	32.4
Knitted and crocheted hosiery	22.4
Made-up textile articles	20.3
Other knitted and crocheted apparel	17.3
Other wearing apparel and accessories	14.8
Weaving of textiles	12.7
Preparation and spinning of textile fibres	12
Knitted and crocheted fabrics	10.9
Other outerwear	8.1
Finishing of textiles	7.4
Underwear	5.3

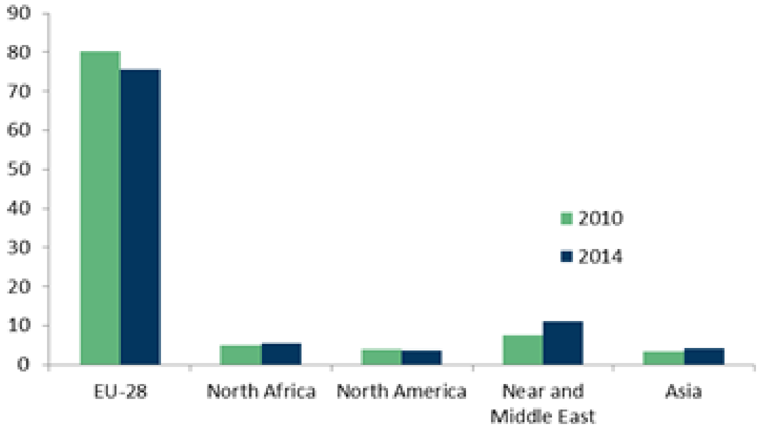
Source: TSI

Bank "Trading up to High Income" report. The level of concentration indicates that competition in the clothing and textile sectors remains relatively well established. The concentration ratio, (CR4), shows the proportion of total output in an industry held by the four largest firms. Concentration level is defined as low if CR4 < 30, medium if 30 ≤ CR4 < 50, high if 50 ≤ CR4 < 70 and finally very high if CR4 ≥ 70. According to chart 6, competition exists in many subcategories. This can be seen as an encouragement for Turkish textile and clothing companies to diversify their products.

Companies without efficient cash management have been negatively affected by the deteriorating conditions, which distort their payment performance

On the other hand, the concentration of export markets for these sectors is high. EU-28 countries remain the main clients, despite a slight diversification in export markets since 2010. Between 2010 and 2014, Turkish textile and clothing exports to the European Union rose 4.3%, on average, to reach 13.7 million euros, accounting for 25.2% of the regions' total imports from Turkey. In 2014, Turkish textile exports accounted for 18.1% of the European Un-ion's total imports, while Turkish clothing exports had a share of 12%.

Chart 7: Export market diversification of Turkish textile and clothing sectors



Sources: TSI, Coface calculations

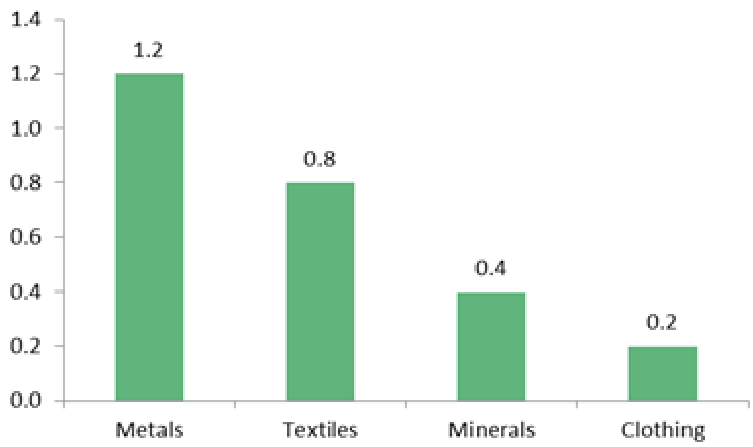
This situation has three major implications. Firstly, this dependence gives European companies "bargaining power" over producers. The big retail companies place the largest part of the orders, allowing them to dominate the market. As producers are dispersed and are usually small or medium size companies, the bargaining power of retailers is reinforced. They ask for the best terms and for price reductions. This means that profit margins in the textile and clothing industries remain tight. The second impact of the European dependence is through the exchange rate. Turkish textile and clothing sectors have been troubled by the euro's weakness against the dollar since the second half of 2014, as 52% of textile exports and 74% of clothing exports were addressed to EU-28 countries. On one hand, the euro's depreciation resulted in an important loss in export revenues. On the other, the dollar's strengthening resulted in an increase of production costs, as these sectors import around 65% of their raw materials and intermediate goods in US dollars. The biggest challenge of 2015 therefore seems to be related to the exchange rates. The third impact comes from the level of European demand. The sluggish recovery in European markets is weighing on Turkish exports. In the first quarter of 2015, Turkish textile exports to Italy declined by 22% yoy, to Germany by 16.8% and to the UK by %18.8%. Data from the General Secretariat of Istanbul Textile and Apparel Exporters' Association (ITKIB) showed that, in total, exports to the EU-28 plunged by 16.4% during the period . Similarly, in the first quarter of 2015, clothing exports to Germany plunged by 23% yoy, to UK by 10.4% yoy, to Spain by %6.2 yoy and to France by 27.7% yoy. In March 2015, the clothing sector's capacity utiliza-tion rate stood at 74.1%, the lowest in the last 39 months.
It should, however, be borne in mind that the impact from EUR/USD rate also plays a role in this decline. In the first quarter of 2015, Turkey's total clothing exports declined 14.8% yoy. ITKIB calculations showed that, adjusted to the EUR/USD impact, this fall eases to 3.9% yoy.

International and domestic challenges remain

The economic consequences of the tensions between the Ukraine and Russia constitute another important challenge for these sectors in 2015. Coface expects Russia's economy to contract by 3% in 2015, due to Western sanctions, lower oil prices and the sharp depreciation of the ruble. The slowdown in the Russian economy dragged down Turkish clothing exports by 45% yoy in the first quarter of 2015. Turkish exporters face serious problems regarding wholesales and collecting payments from customers in Russia. Indeed, many exporters used to send their products to Russian customers in the form of open account transactions, meaning that goods were shipped and delivered before payment. This represents another important risk for Turkish exporters in 2015, as the difficulties they experience with payment collections may weaken their financial performance and deteriorate cash flow management. Turkish retailers who own stores in Russia face problems related to re-pricing issues, because of the ruble's depreciation and the sharp decline in sales due to the lower purchasing power of Russian households. On the other hand, as the majority of the rents in Russia's shopping malls are denominated in USD, the ruble's devaluation adds to the operational costs of Turkish retailers. This situation pushed many retailers to delay new season openings and extend discount periods.
So far in 2015, it cannot be said that domestic demand has compensated for these negative developments in external markets. In the first two months of 2015, retail sales of textiles, clothing and footwear rose by only 4% yoy, the lowest increase since 2011. January-February 2015 production accordingly fell by 11.7% yoy in the textile sector and by 1.2% in the clothing sector, on a calendar adjusted basis.
Political uncertainty is another challenge, as it holds back investments as well as consumer consumption. Economic agents have concerns about the outcome of the elections due in June 2015, as well as on the economic policies of the new government. This has

pushed them to keep investment plans on hold until the end of the elections.
The higher volatility in exchange rates, prior to a possible rate hike from the US Federal Reserve, also increases the risks, as it makes it more difficult for exporters in terms of pricing and managing costs. Companies without efficient cash management have been negatively affected by these deteriorating conditions, which distort their payment performance. Receivables collection has become more difficult, which increases the risk of insolvability.
Amid these challenges, Coface has raised the risk assessment of the textile sector to high risk from medium level. We are also closely monitoring the impact of these developments on the financial performance of clothing companies.
These risks pushed textile and clothing manufacturers to look for alternative markets which could partially compensate for the decline in core export markets and domestic demand. Recent news suggests that producers are prioritizing the US market, as it offers some opportunities for Turkish exporters. The Transatlantic Trade and Investment Partnership (TTIP) between the EU and the US constitutes a very important issue for Turkey. In the bilateral trade between Turkey and the United States, Turkey has a net export position in consumer goods and a net import position in capital and intermediate goods. The Caspian Strategy Institute's publication of January 2015, estimates that the TTIP will decrease production in the textile and clothing sectors by 4.33%. Employment in the manufacturing sector is estimated to fall by 0.69%, added value by 5.18% and corporate profits by 4.9%. The TTIP would give the opportunity to European textile and clothing producers to manufacture goods in low cost countries, put European labels on them and then sell them to the United States exempt from custom tariffs - as would be the case for goods produced in Europe. This situation would create unfair competition for Turkish producers and result in even narrower profit margins. Therefore, the willingness of Turkish producers to strengthen their presence in non-traditional export markets is an important factor in their profitability over the upcoming period. This would additionally enable Turkish producers to take advantage of the strong dollar, as their products would be cheaper.
Separately, exports to neighboring countries such as Iraq and Iran are showing signs of improvement. In the first quarter of 2015, Turkish clothing and textile exports to jumped 139% yoy and 65% yoy, respectively, on the back of the economic revival. This indicates that a possible permanent deal between Iran and P5+1 countries, which progressively eases sanctions on Iran, may be very beneficial for Turkish exporters. However the question of how payments will be transferred currently remains unclear. On the other hand, if the ECB's looser monetary policy helps to accelerate the economic recovery in Europe, it may result in an increase of textile and clothing exports. Turkish producers underline that the lira's weakening against hard currencies, including the euro, may support European demand for Turkish products over the rest of the year. There could thus be a recovery in production.
In April 2015, the Turkish government announced that it had removed the resource utilization support fund (RUSF) in order to lower input costs. This legislation covers 51 goods. Before this decision, any import conducted on credit was subject to the RUSF of 6% of the value of imported goods. If the payment was made in advance in case of an import, no RUSF was applicable. The removal of this special payment can be considered as positive for the textile and clothing industries, as they import the majority of raw materials and intermediate goods necessary for production. The new legislation will also enable producers to pay for these imports in term, relieving importers during a period when funding is becoming progressively more expensive.

Chart 8: Turkey's net exports to the United States (2014, bln USD)



Source: TSI

There are other structural challenges that require more time to be resolved. Higher competitiveness through cost-efficient strategies may help Turkish producers to increase their market shares abroad, as well as their profit margins. Costs related to the labor force, commodity purchases and energy prices are the principal reasons for narrowing profit margins. On the other hand, producers are progressing towards higher added value and designer products, in order to widen profit margins. Many companies are investing in creating brands, as has already been done to some extent in foreign markets such as Russia. However this is still an ongoing process and it will take time for producers to accomplish concrete results. Companies are benefitting from public support, such as the Turquality programme. The Turquality programme aims to encourage branding and production of high added value products, through incentives and organizational, strategic, financial and informative coaching through accredited consultants.

INTERVIEW

DEMET MUTLU

FOUNDER & CEO OF TRENDYOL.COM

1-How do you evaluate recent trends in online shopping sector in Turkey?

Online shopping industry in Turkey is relatively young and growing very fast. Major drivers behind this growth are; young population with high social media engagement, reliable & widespread logistics, deep sourcing capability, strong credit card penetration and increasing share of mobile in internet usage. Everyday an increasing number of internet users discover that they can receive even better goods and services via online platforms and this initiated traditional offline businesses to shift to online platforms. With intense competition it is more important for ecommerce companies to provide good customer service & user experience across all platforms.

2-How do you evaluate your sales in 2014 compared to 2013? What are the reasons of this increase/ decrease? What are your objectives for 2015?

Trendyol grew more than 40%+ yoy in 2014. We continued doing the things that we are best: improving customer experience on our platforms by investing in our mobile apps and websites (sales from mobile more than doubled in 2014), investing in our private labels (sales from private labels grew more than 70% annually) and implementing our data/fact driven CRM programs. We expect to grow 45%+ in 2015.

3-What is the place of your company in Turkish online shopping market in terms of sales and membership?

Trendyol is by far the market leader in fashion ecommerce in Turkey with over a half billion Turkish Liras in sales. We have 8+ million members, which includes more than 80% of women who shop online.

4-Since the start of 2015, we witness a slowdown in domestic economic activity in terms of investment and consumption mainly due to the volatility in exchanges rates and the political uncertainty. How your sales have been affected by these factors so far in 2015?

Our sales have grown more than 45% during the first quarter and we are expecting the same growth to continue throughout the year. There are more than 35 million people online, however only a fraction of it has ever bought something online, which means there's room for growth. Moreover our business is focused on providing a wide range of fashion products at accessible prices, thus even a downturn could help.

5-What are your opinions about the risks and opportunities in Turkish clothing sector and online shopping in the medium term?

Turkey has strong sourcing advantages in textile manufacturing. Fast speed to market and manufacturing high quality items at lower prices attract many global fashion retailers to source in Turkey and it is also a good opportunity for Turkish retailers to scale their business both locally and globally. Today ecommerce constitutes less than 2% of total retail sales in Turkey, which is around 10% for US and above 5% for many European countries. Given recent trends in internet industry and favorable demographics we expect ecommerce market to grow 5-10 times of its current size in the next 5 years.

4 PHARMACEUTICAL SECTOR

Solid performance since the late 2000s...

The Turkish pharmaceutical sector has strong foundations. It was Europe's 6th largest market and the world's 16th largest in 2012, in terms of sales. The country's modernization initiatives, foreign investments and higher demand for healthcare services have all supported the sector's rapid growth during the last decade. Turkey's solid economic growth also played an important role in this performance. At that time the Turkish economy posted an average growth rate of 4.9%, while per capita income rose to 10,404 USD in 2014, from 3,492 USD in 2002. Between 2003 and 2012, pharmaceutical sales posted a CAGR of around 10%. Pharmaceutical expenditure is expected to reach 8.6 billion USD in 2015, a rise of 3.5% compared to 2014, while healthcare expenditure is expected to increase by 3% to 51.7 billion USD, according to the BMI. The major reasons behind this increase are the aging population, higher average life expectancies and easier access to healthcare services. Coface assesses Turkey's pharmaceutical risk level as low.

The value chain in the pharmaceutical sector begins with discovery and R&D activities. This phase includes drug formulation and adjustments, applications for registration and patent registrations. As this requires heavy investments, equivalent to billions of dollars, Turkey does not currently focus on this level.

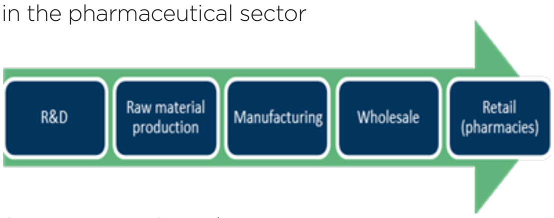
The second phase of the value chain concerns the production of raw materials. According to data from Invest In Turkey, as of 2012, there were 10 companies and 12 raw material production facilities involved in this phase.

The third phase, of manufacturing, includes testing, inspection and allocation of serial numbers. Nearly 300 international and domestic companies operate at this level in Turkey, with more than half of the production facilities being located in Istanbul.

The wholesale phase includes warehouse management, storage, control of lots and serial numbers. Around 200 companies actively operate in this phase in Turkey. Their main role consists of selling drugs to pharmacies.

Retailing, the final phase, includes the pharmacies which sell the drugs to consumers. In Turkey, there are more than 24,000 pharmacies, so it is a very fragmented market.

Chart 9: Value chain organization in the pharmaceutical sector

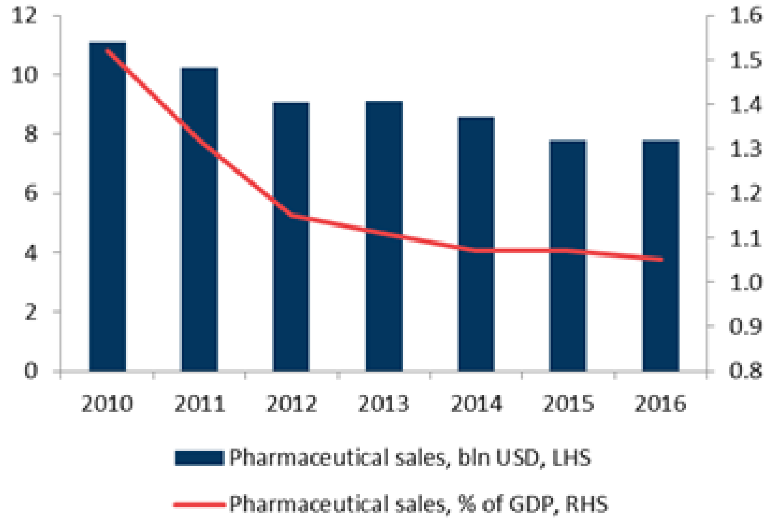


Source: Invest in Turkey

This strong production capacity, coupled with a young and skilled workforce, attracts foreign companies into Turkey. According to official figures, merger and acquisition (M&A) activities totaled 1.7 billion USD between 2006 and 2012. Turkey's growing population, which enjoys easier access to the healthcare system, has supported the arrival of international pharma giants in Turkey.

The government's healthcare transformation programme, initiated in 2005, has played an important role in easing citizens' access to healthcare services (with an estimated 44 million citizens since 2005). Within this transformation programme, the government reduced VAT on drugs from 18% to 8%. In 2012, the government placed the pharmaceutical sector on the "priority list" of investments its incentive programme. Moreover, as Turkey, needs to strengthen its added value products, the government has decided to increase its budget allocation for research and development (R&D) activities to 3%, by 2023. This budget ratio stood at 0.95% in 2013, up from 0.48% in 2003 but still below that of countries such as Russia (1.1%), Czech Republic (1.9) etc.

Chart 10: Turkey's pharmaceutical sales



Source: BMI
*2015 and 2016 figures are estimates

Turkey has been implementing the reference pricing system, in line with EU laws, since 2004. This is regulated by the Ministry of Health and there are currently five reference countries: France, Spain, Italy, Portugal and Greece. According to the regulations, the maximum ex-factory price cannot exceed the lowest ex-factory price of the identical product in the five reference countries. If the product is not authorized in the European Union, the country of origin is used as a reference. In addition, a public discount of 28% (for generics) and 41% (for innovative products without generic equivalents) is then applied to prices. Final retail prices are determined by adding the margins of wholesalers and pharmacies, plus 8% VAT, to the price.

Heavy regulations, lower profits

The major client for pharmaceutical products in Turkey is the Social Security Institute, which purchases around 90% of its drugs. This situation reduces the possibilities for pharmaceutical companies to negotiate prices. As a result of this pressure on prices, pharmaceutical companies have seen their profit margins narrowing. On the other hand, the euro exchange rate within the reference pricing system has been fixed to 1.9595 liras since 2009. Although the exchange currently rate hovers at around 2.92 liras, the Turkish authorities are reluctant to adjust the fixed rate. This is narrowing profits, as nearly 40% of pharmaceutical companies' total production costs come from raw materials. The remainder is divided between quality, production, labor force and supply chain costs.

The weakening lira is causing further increases in costs for drug and raw material importers - an additional factor weighing on profitability.

The high level of competition in the generic drug segment is also putting pressure on prices and negatively affecting profitability. This may lead to equity problems, particularly for local firms.

In parallel, the pharmaceutical sector needs increases in operating capital increases, as companies seek to maintain existing production capacities while inves-

The pharmaceutical sector remains solid, despite heavy regulations and lower profit margins

ting in new technologies.
In summary, the burdensome regulatory environment and complex procedures represent restrictive factors for further growth by decreasing profits. Lower profits in turn restrain investments in new technologies, as these require serious accumulation of capital -, particularly in the pharmaceutical sector.
On the positive side, the State's position of being the sole buyer of drugs could in fact be considered as a type of guarantee for pharmaceutical companies' receivables and the risks of insolvencies are therefore low. As long as pharmacies receive their payments from the State and they, in turn, pay back the warehouses, the payment collection system should remain healthy. No delay from State payments has been detected recently.
The improvements since the late 2000s are continuing to make the sector attractive to international companies. The still relatively low per capita healthcare spending suggests that the market continues to offer opportunities for investors. The expansion of insurance coverage and the population increase support the sector's outlook. As the, currently young, population of Turkey ages, there may be an increase in demand for healthcare services. Turkey is among the strongest economies in the region and it offers a good knowledge base, an efficient infrastructure and proximity to strategic markets for investors

INTERVIEW

LEVENT SELAMOGLU

PHARMACEUTICAL INDUSTRY EXECUTIVE

Can you describe how the pharmaceutical sector is organized in Turkey?

The process starts with research. Actually there is almost no research in Turkey. And the available research is not relevant. But Turkey is making progress. I mean, we cannot discover a molecule but we can take subsequent steps; Turkey should not be underestimated in chemical formula development. Therefore it is exactly where the chain starts. There exists production. However, pharmaceutical raw material is almost not produced at all in Turkey, unfortunately. There are very limited number of facilities, with only 3 or 4 facilities. In the past, this number was much higher, almost 40. You must have a strong chemical industry to produce pharmaceutical raw materials. But our basic chemical industry is not much developed. Therefore we rely on imports for pharmaceutical raw materials. Furthermore, raw material prices declined as China and India came into the play in time. Therefore, these raw materials were started to be imported instead of being produced. However this does not apply to Turkey alone. This is the case for Europe and US as well. But Turkey use to have a better and even more advanced pharmaceutical industry than that of India 20-25 years ago. Since then, pharmaceutical industry turned into a giant industry in India. It became a global actor with huge exports. In Turkey, however, it could not make a headway and even downsized. I believe this is mostly due to inability to produce raw materials. Clinical trial stage follows production. However, this stage is also limited in Turkey. Then marketing and sales stage follows.

How do you view the year 2015 for the pharmaceutical sector? What are the risks?

Our current situation is indeed the extension of the process that started in 2009, when the Government introduced the practice of global budgeting in pharmaceuticals, introduced limits for pharmaceutical expenditures and set these limits on a yearly basis. In Turkey, pharmaceutical prices are referenced in Euro. But the exchange rate has not changed since 2009. The exchange rate applied currently is 1.9595, although the actual rate is above 3. Producers have to import some part of raw materials. Inflation, labor costs, energy costs, etc. are constantly rising. In this sense, the sector is very risky.
But there is no demand elasticity. People buy pharmaceuticals when they get ill. There is not demand problem, but there is only one customer: the government. And prices are fixed. Assessments made without recognizing and knowing the basic dynamics of the industry lead to wrong directions. production technologies have to be upgraded constantly in pharmaceutical industry and the sector has to make investments. Margin may be high in pharmaceutical industry relative to other industries, but enormous funding is needed for research and development expenditures. This requires capital accumulation. nevertheless, all the funds accumulated depleted during the last six years. Profit margin has depleted too. Now, there are not many pharmaceutical companies with profit on balance sheet. This fact increases the need for capital. That's why companies are being sold. Turkish pharmaceutical companies are currently very attractive targets for foreign buyers. The sector is still attractive for foreigners since this is a cyclical sector. Turkey has a large population, the population is aging, access to

healthcare services is expanding, Turkey is geographically well-positioned and thus can make exports. As far as exports is concerned, Turkish pharmaceutical industry enjoys high quality of technology. Foreign companies choose to buy at low prices and don't mind suffering losses for a few years, considering that they can make profits later on. Turkish investors do not have the capacity to fund this any more, as they have run out of money.

How would reference pricing system be affected if Greece leaves Euro?

The reference pricing system originally included five countries, but then it was increased to 27 by a decree. Nobody remembers this. The Government is keeping these five countries as reference countries. But it can replace countries as it wishes. It can increase the number of countries from five to ten as it wishes. Therefore I believe the system would not be affected if Greece leaves Euro.

How do social security deficits affect the industry in Turkey?

I do not think this would affect the industry. The budget for pharmaceuticals is defined: approximately 17 billion TL for 2015.

You mentioned that India had increased its exports share more that Turkey did. How do Turkey's pharmaceutical export dynamics function?

Pharmaceutical exports differ from other exports. You can find customers for pharmaceuticals. This is understandable. But you must get a license to sell an pharmaceutical product in a given country. the Government must permit. This applies to each pharmaceutical product and each formula. For instance, Germany comes and sees the place of production after issuing a license for a pharmaceutical product, and allows it to be sold if it conforms to standards. This process takes 2.5 – 3 years on average. Therefore pharmaceutical export is actually more difficult than how it seems like.
The length of this process causes loss of competitiveness. India made progress in exports because Turkish pharmaceutical industry could not open out to external markets due to the attractiveness of domestic market between mid-1980s and early 2000s. It hid its head in the sand. If we had set the target of becoming a global actor since the outset, we could be twice as big as India today. And this is a fault of our industry. Exports gained importance after 2003 in Turkey. But it was too late, as markets had already been shared. Still, there exists a potential for exports. neighboring markets are the most immediate targets. But the largest pharmaceutical markets in the world are constant: US, EU and Japan. You have to export to these markets if you want to make money on exports. There is some export to EU. There is no export to Japan. Mustafa Nevzat used to export to the US in the past, but it also stopped now.

Who are the risky actors in the sector?

If pharmacies face a congestion, the sector would face a congestion downstream in any case. WE saw its examples in the past, during mid and late-1990s, during financial crises, etc. This is because pharmacies sell also to the government. In Turkey the end user of pharmaceuticals is the government. Pharmacy is just an intermediary. When a pharmacy sells a pharmaceutical, the end user pays for the contribution share. Then the pharmacy sends the prescription to the social security institution, and SGK pays the money to the pharmacy in a given term. If this channel is congested, the pharmacy cannot pay to the warehouse, and in turn the warehouse cannot pay to the manufacturer. Therefore, the primary actors in value chain are the manufacturers and government in Turkey. All other actors along the chain are intermediaries. There have not been significant delays in payments recently. Government mostly pays in time.

What can you tell about licensing and intellectual and industrial property rights in the industry

Licensing process in Turkey is neither faster nor slower than the process in other countries. According to the EU licensing rules, this process takes approximately 210 days. Turkey also follows the EU, but there was no authority issuing a license within 210 days in the EU. The same applies to Turkey as well. I mean, this is not an issue specific to Turkey. From the perspective of protecting intellectual property rights, there is a patent decree adopted by Turkey. It was issued in 1995. Now it is due to the amended. There is a conflict of interest between originator and generic companies. Generic companies want the protection period to be shorter, whereas originator companies want it to be longer. But I do not think there is a problem in this regard in Turkey.

What are the opportunities in the industry?

There are still great opportunities. There are opportunities in the domestic market, but export opportunities are much greater. Turkish pharmaceutical industry must seriously focus on opening out to external markets. there are regions with huge potential, such as Africa. Pharmaceuticals is closely linked to demographics. Pharmaceutical consumption is higher where population is higher. Turkish pharmaceutical industry has one of the lowest unit costs in the world. Therefore, it can be competitive in African market. Furthermore, the industry must focus on innovation front, i.e. research front. But the capital accumulation needed to do this has been depleted.

5 SECTOR RISK ASSESSMENTS

Sector risk assessment			
Sectors	Risk level	Sectors	Risk level
Metals*	Very high risk	Pharmaceuticals	Moderate risk
Food	Medium risk	Electric, electronics, IT	High risk
Chemicals	High risk	Paper	Medium risk
Construction	Very high risk	Automotive	Medium risk
Textile	High risk	Retail	Medium risk
Clothing	Medium risk		

*Except iron and steel

Moderate risk · Medium risk · High risk · Very high risk

Source: Coface

Metal sector (excluding iron and steel): Risk level: very high. The import-dependence on raw material supplies, the decline in commodity prices and the negative impact of exchange rate volatility on borrowing costs, are the main risks faced by companies. Some companies are facing deteriorations in their cash flows, due to the strengthening of hard currencies. This increases input costs. On the other hand, the decline in raw material prices has led to a decline in the sales prices of final products, thus narrowing profits.

Automotive sector: Risk level: medium. Sales increased strongly at the beginning of 2015, following a contraction of 10% in 2014. In the first two months of 2015, sales rose by 33% yoy, while exports rose by 32%. The recovery in European demand is expected to increase car manufacturers' capacity utilization rates. Companies operating in the sector generally have solid financials, which reduces the risks relating to payment performance.

Food sector: Risk level: medium. The greatest risk for food producers is the rise in production costs, due to heavy winter conditions since the beginning of 2015. Small and medium size producers, in particular have been negatively affected by the increases in costs. With regards to hypermarkets, problems have been observed in cash flow management, due to extended payment terms. The growing debts of intermediary food wholesalers, caused by payment difficulties from small enterprises, is creating financial pressure and making companies more vulnerable.

Construction sector: Risk level: very high. This sector represents 6% of GDP and accounts for 7.5% of total employment in Turkey. The construction sector is characterized by faster growth during times of economic growth and by accelerated decline during times of economic slowdown. The Central Bank's sharp interest rate hike at the beginning of 2014, slower economic activity and rising inflation have led to a decline in demand in the housing segment. Low borrowing costs and stability in the labor market, which were among the most important factors fueling the home sales in the past, may be less supportive of the housing segment in the upcoming period. The sharp depreciation of the lira so far in 2015 has increased production costs and reduced the profit margins of small construction companies.

Conclusion

With the robust growth in the US economy, the Fed's exit strategy and the quantitative easing program of the ECB, the global economy is entering into a new era. Amid these new economic conditions, the Turkish economy faces new challenges as it struggles to keep its growth performance as solid as in the past. The continuous depreciation of the lira since the second quarter of 2014 has deteriorated the financial performance of companies who do not have efficient cash flow management systems. This, in turn, has negatively affected their payment performance. This chain of circumstances increases the risk of insolvencies.
Concerns about the outcome of the general election in June 2015, the fragile recovery in Europe and rising tensions in the region are adding to this challenging environment.
The ability to produce higher added value products in order to increase export revenues is another challenge for the Turkish economy. Increasing the market diversification and sophistication of exports have become important subjects for Turkey.
In the current circumstances, risks seem to be increasing for sectors with a higher dependence on imports. Additionally, exporters with euro exposure are also subject to higher risks. The textile and clothing sectors are among the most affected by the recent developments in the global economy. They are also affected by rising regional tensions. Coface has increased the textile sector risk assessment to high risk level from medium risk. The clothing sector currently stands at medium risk level, but is being closely monitored. The pharmaceutical sector remains solid as it benefits from sound fundamentals. Coface assesses the risk level of this sector as low.

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