

**2**  
DETERIORATION IN  
PAYMENT  
PERFORMANCE

**4**  
SECTOR OUTLOOK

**6**  
CONCLUSION

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# PANORAMA

## LOWER LIRA AND HIGHER DEBT: A BAD MIX FOR TURKISH BUSINESS

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By the Group Economist based in Istanbul



**D**uring 2015, Turkey's economy faced several challenges. On the political scene, the country went through two elections in 2015, bringing to four the number of elections over the last two years. After talks to form a coalition government fell through following the June 7 general election, the country returned to the polls on November 1. The combination of greater political uncertainty, security issues and global economic worries caused a sharp depreciation in the lira, which hit its all-time weakest level against the dollar in September.

With Turkey's acute dependence on capital inflows and input imports, its corporates have been negatively affect-

ed by the sharp fluctuations and strong depreciation of the lira. Compounding this, the euro's weakness against the dollar narrowed the profit margins of companies with production costs denominated in USD and revenues in euros. The volume and value of bounced cheques rose, indicating deterioration in payment performance. Rising regional tensions also pulled down export volumes, restricting corporate revenues. These developments weighed on the outlook of sectors such as metals (apart from iron and steel), construction and chemicals, especially during the first three quarters of the year.

With the significant easing of political tensions following the Nov 1 elections, the lira's sell-off has diminished. In the upcoming period, more precise

monetary policies from the US Federal Reserve could reduce the volatility of emerging currencies, including the lira. This, coupled with higher consumer confidence, could improve the sectorial risks. Nevertheless, regional security issues and the vulnerability of the country's economic structure to external developments will continue to weigh on risk levels. This panorama focuses on metals (excluding iron and steel) and the food and textiles sectors, as they are among the most affected ones by the lira's depreciation. Furthermore, recent geopolitical risks - such as tensions between Turkey and Russia, and violence in Syria and Iraq - are also weighing on these sectors and negatively impacting payment performance.



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## QUOTES BY ECONOMISTS

## 1 DETERIORATION IN PAYMENT PERFORMANCE



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### Weaknesses in the lira and the euro against the dollar hit profit margins

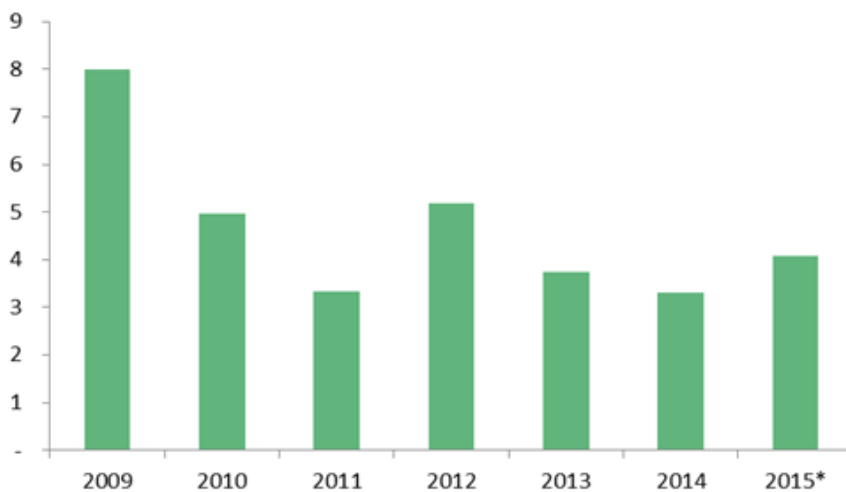
On 24 September, the lira hit an all-time low of 3.07 against the US dollar. This was on the back of continued political ambiguity, aggravated by global risk aversion to emerging countries, in line with uncertainties over the US Federal Reserve's rate hike process. Between January and September 2015, the lira's loss against the greenback grew by 32%, creating a major source of financial instability for Turkish corporates. The nation's production system is heavily dependent on imports of commodities and capital goods and. Therefore, the weakening of the lira has caused an escalation in production costs. The higher prices of imported inputs necessary for production led to a squeezing of corporate profit margins. Expectations for the normalisation of US monetary policy contributed to the depreciation of emerging currencies, including the lira, as investors showed higher risk aversion to countries suffering from structural weaknesses. Even the European currency lost around 12% of its value against the dollar between January and November 2015. This also harmed Turkish corporates, as 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 weighed on companies' export revenues, as they made less money in terms of dollars. Many companies therefore failed to cover their production costs, usually denominated in the dollar currency which progressively appreciated in 2015.

Higher production costs and lower profit margins have led to deterioration in the fiscal situation of Turkish companies, especially those with debts denominated in foreign currencies (representing 75% of the total debt of non-financial companies). Short term foreign currency debt of non-financial institutions stood at 33.6 billion USD, approximately 4.5% of GDP, as of the second quarter of 2015. The value of bounced cheques, an indicator of payment performance, jumped by 38% during the first ten months of 2015, compared with the same period of 2014, while the volume of bounced cheques rose by 13%. This is an important indicator of the financial health of Turkish companies. Usually, during periods of solid economic growth and a strong lira, companies are able to pay their invoices in a short period of time. When growth slows and the lira depreciates, delays in company payments grow longer and the number of unpaid cheques increases.

During the same period, the number of protested bills also grew. In the first ten months of 2015, the value of protested bills jumped by 16.9%, compared to the same period of the previous year.

Chart 1: Amount of bounced cheques/Total amount of cheques (%)



\*January-October 2015

Sources: The Banks Association of Turkey Risk Center, Coface calculations

- (1) A cheque that cannot be processed due to the emitter's lack of funds  
 (2) A bill which is not paid at maturity

### Political uncertainty also weighed on payment performance

Besides the lira's depreciation, in 2015 political uncertainties and the lower contribution of domestic demand to economic growth have also contributed to the trend for companies to delay their payment obligations and retain cash for themselves.

After talks to form a coalition government failed following the June 7 election, the lira's health continued to decline until the elections of Nov. 1. Security issues worsened between the two elections, as Turkey faced a spate of attacks. These included the October 10 suicide bombing in Ankara, which killed 102 people, while hundreds more have been killed since the collapse of a two-year cease-fire process. Geopolitical risks in neighboring countries, such as Iraq and Syria, also threatened Turkey's security situation. The climate of violence negatively affected economic confidence and encouraged companies to retain their cash. During this period, producers faced serious debt collection problems. As of September 2015, the debt collection period had risen to 15 months (up from 8 months in 2014) for the footwear sector, while it rose to 8 months (up from 1 to 2 months for yarn producers), to 6 months (up from 2-3 months) for cement producers and to 6 months from cash payment for goods producers, according to a report published in the *Dunya* newspaper<sup>3</sup>.

In addition, the depreciation of the lira increased the burden for corporates with debts burdened in foreign currencies. Turkey needs foreign savings in order to run its economy, due to the low level of local savings, estimated at around 15% of GDP in 2015. As of the second quarter of 2015, the country's external debt stood at 405.2 billion USD, around 52% of GDP. The main cause for concern relates to Turkey's private sector short-term external debt, which stood at 110.3 billion USD in the second quarter, while the

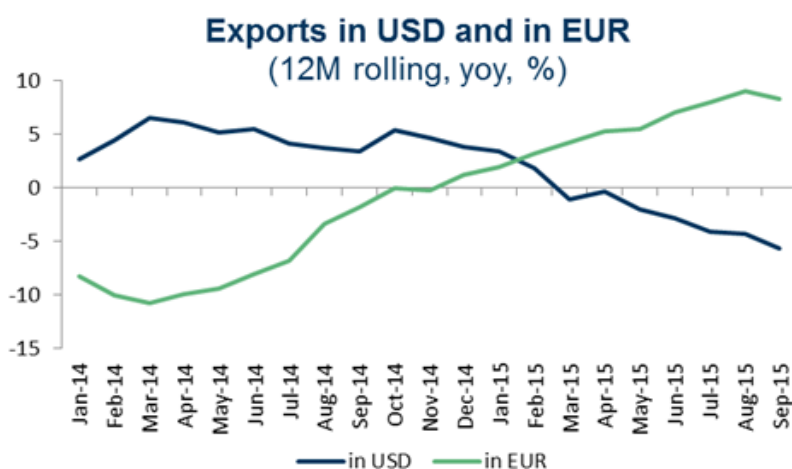
sharp depreciation in the lira is increasing the debt burden. Nevertheless, the risks associated with this level of debt, even if it is high, remain mitigated as, so far, companies have been able to roll-over their debts without facing problems.

The slower pace of growth also impacted the payment and debt collection performance of the Turkish corporate sector. Although in the first half of 2015, the economy posted a stronger-than-expected growth rate of 3.1% compared to a year earlier, early indicators suggested that economic agents had adopted a wait-and-see stance ahead of the elections. On a quarterly basis, seasonal and calendar-adjusted industrial production rose by 1.1% in the third quarter, after increasing by 1.5% in the second quarter. This indicates that production slightly lost momentum during the intra-election period. The consumer confidence index also fell to its lowest level in more than 6.5 years, in September, to 58.52 points, as political uncertainty dampened consumer sentiment. Combined with the record depreciation in the lira, these developments contributed to a squeeze in the markets, restraining companies' abilities to meet their payment deadlines. The lira's depreciation has increased the debt burden of Turkish corporates. Although the share of corporate short-term foreign exchange debt in Turkey's GDP is very low (4.5% as mentioned above), the risks are very high, especially for small and medium sized companies which do not have export revenues. These companies account for 12% of the 9,468 firms in the database of Turkey's Central Bank<sup>4</sup>.

Regional tensions were also a negative contributor to payment performance. In the first nine months of 2015, Turkey's exports to the Middle East and Russia (where exports are paid in USD) fell by 9% and 40%, respectively, from a year earlier. Western sanctions, record low oil prices and the geopolitical turmoil in some of these countries all negatively affected Turkey's exports. The fall in exports was significant in plastics, chemicals, metals (except gold) and clothing, which respectively saw their exports decline by 8%, 16%, 21% and 11% in January-September 2015 period, as compared to a year earlier. This had a negative impact on companies' export revenues.

It is noteworthy that the structure of the Turkish corporate sector plays an important role in the country's vulnerability to foreign exchange volatility. Turkey's corporate sector is dominated by micro and SME-sized enterprises, which account for almost 99.8% of the total number of companies. These companies are generally characterised by a lack of equity capital, which makes them vulnerable to fluctuations in the economy and in the money markets. They do not usually have sufficient financial knowledge or the necessary tools for managing foreign exchange risks. These developments have therefore led to a deterioration in cash flow management for these companies and, as a consequence, delays in payments. These developments are weighing on the industrial outlook. This panorama focuses on challenges and risks in the metals (excluding iron and steel), food and textile sectors.

Chart 2: Turkish exports in USD vs in EUR



Sources: TSI, Coface calculations

(3) <http://www.dunya.com/ekonomi/ekonomi-diger/secim-bahanesiyle-vadeler-ikiye-katlandi-278104h.htm>

(4) CBRT, Governor Basci's Presentation on "Economic Outlook and Monetary Policy", Kayseri, 7/4/2014

## 2 SECTOR OUTLOOK

**Metals sector (excluding iron and steel):** Risk level very high.

Coface mainly evaluates aluminum and copper production under this category.

The Ministry of Industry estimates that over 1,500 enterprises, employing around 30,000 staff, are operating in the aluminum sector. The size of the industry is valued at 4 billion USD (nearly 0.5% of GDP), compared to 130 billion USD globally, based on speeches by representatives from the sector. The construction sector is one of the most important buyers of aluminum. The outlook for construction, on the domestic and international fronts, therefore has an important impact on aluminum production capacity and turnover. Growth in construction has been decelerating since 2013. The annual growth rate declined to 2.2% in 2014, down from 7.4% in 2013, and stood at only 0.4% in the first three quarters of 2015. This slowdown is expected to continue due to the weakness of the lira and higher interest rates on mortgage loans. The weighted average on mortgage loans denominated in lira rose to 14.5% as of October 2015, compared to 9% in mid-2013. This loss of momentum is weighing on the producers of aluminum and copper. Sectors such as defense, transportation, white goods and furniture also use aluminum in their production processes. However risks are particularly growing for the transportation sector, due to the introduction of Russian sanctions which halted Turkish fruit and vegetable exports. These sanctions have reduced business volumes for Turkey's transportation companies and had a negative impact on its metals sector.

Turkey's total aluminum production capacity stands at around 750,000 tons. The most important costs for the aluminum industry are the supply of raw materials (raw aluminum). 90% of the sector's raw material needs are met through imports. Due to Turkey's lack of hot rolling technologies, flats and high alloy goods are imported from Western European countries. This import dependence is the sector's biggest risk, given the volatility of the lira and the fall in commodity prices. The benchmark three-month aluminum price has tumbled by nearly 30% over the past year, to reach a six and a half year low, pressured by oversupply from China.

The same challenges exist for copper producers. The copper sector is a supplier to several other sectors, including the energy, tele-communications, construction, white goods and automotive sectors. The country's copper processing capacity stands at 500 thousand tons, while domestic consumption is close to 400 thousand tons<sup>2</sup>. Raw material imports account for 76% of the sector's total annual imports. Furthermore, the lack of integrated production in Turkey is forcing companies to import the majority of their raw materials. The lira's depreciation is

Sector risk assessment			
Sectors	Risk level	Sectors	Risk level
Metals*	●	Pharmaceuticals	●
Food	●	Electric, electronics, IT	●
Chemicals	●	Paper	●
Construction	●	Automotive	●
Textile	●	Retail	●
Clothing	●		

\*Except iron and steel

● Moderate risk ● Medium risk ● High risk ● Very high risk

increasing the costs of imports, making production more expensive and squeezing profit margins.

These sectors are intensive users of energy in their production processes. In this respect, the fall in international energy prices should be a positive development in lowering production costs - however, the depreciation of the lira has partially offset this advantage. Furthermore, the producers who built up their stocks during the high-price period could face losses, as the selling prices for final products are now lower. Over the upcoming period, commodity prices are expected to fall further, in line with slower growth in the Chinese economy, which is the biggest importer of commodities. The IMF expects that commodity prices will fall further. Copper is forecast to decline to 5,138.7 USD per metric ton in 2016, down from 5,563.3 USD in 2015, while aluminum is expected to fall to 1,619.4 USD per metric ton, down from 1,684.6 USD.

Chart 3: Exports and imports of non-iron sector (millions USD)



Sources: TSI, Coface calculations

Another risk for these sectors is the loss of business contracts for Turkish constructors with other countries, such as Russia and Iraq, etc. due to geopolitical tensions. This would affect aluminum and copper producers, with the fall in demand from constructors reducing their turnover.

**Food sector:** Risk level high.

In line with the better-than-expected growth during the first half of 2015, food production posted an increase of 1.9% in January-September period, compared to a year earlier on a calendar adjusted basis. The food sector is one of the Turkish industries with a higher volume of exports than imports. Net exports for the food and drinks sectors stood at 3.6 billion USD during the first nine months of 2015 and accounted for 7.6% of total exports in 2014. Nevertheless, they were 7% down compared to the same period in 2014.

Although larger food producers have been able to limit the negative impacts of the lira's sharp depreciation on their financial situation, the scenario is different for smaller producers and intermediary food wholesalers. Higher financing costs and foreign exchange losses, due to the lira's depreciation, are weighing on profit margins. This is leading to payment difficulties for small producers, creating financial pressures for wholesalers and making them more vulnerable. Some problems are related to cash flow management, due to the extended payment terms also observed on the hypermarket side.

A new challenge for food producers will be dealing with the outcome of Russian sanctions implemented against Turkey, following the downing of its jet by the latter in November. Russia has enacted bans on imports of Turkish products including fruit, vegetables and chicken. These sanctions should have a limited impact on meat and fruit producers, as exports to Russia only account for 3.5% of total meat exports (659 million USD) and 14.4% of total fruit exports (4.3 billion USD). Vegetable producers, however, may suffer more, as 35.6% of their total exports (1.1 billion USD) are sold to Russia. The fragile recovery of European countries, the sector's main export market, appears to be another risk factor.

Surging regional tensions in Turkey's neighbouring

countries have not made things easier for exporters. After losses in the Syrian market caused by the civil war, local tensions in Iraq have started to impact food exports to the country. Iraq's share of Turkey's total food exports decreased to 18% in 2014, down from 20% in 2013. It fell to 16.8% in the January-September 2015 period.

The economic recovery in Europe may enable exporters to partially offset their losses in Russia and the Middle East. In the longer term, Turkey's rapid urbanisation, young population, changing nutritional habits and growing per capita income are expected to sustain the sector's growth.

**Textile:** Risk level high

The textile sector's production level dipped by 5.6% in the January-September 2015 period; compared to the previous year on a calendar adjusted basis. This marks one of the sharpest falls among all of the sub-categories in the manufacturing sector. Like many other sectors in Turkey, textile producers were also affected by domestic tensions due to political ambiguity, the lira's significant depreciation and regional troubles. Turnover plunged during the first nine months of 2015 compared with the same period of 2014, edging up by only 0.2%. Domestic turnover only increased by 0.3%, while the rise in export turnover was subdued, at just 0.1%.

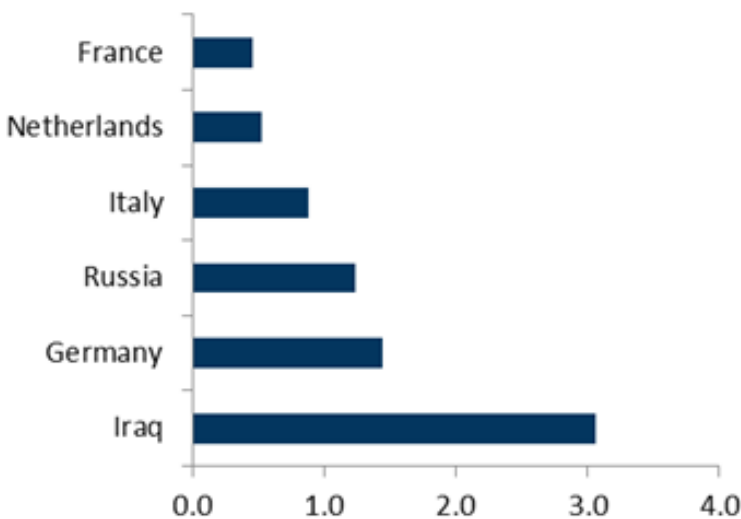
Insufficient domestic production of some raw materials necessary for production (such as cotton, leather and wool), severe international competition and deteriorating production conditions in the domestic agriculture and livestock sectors - compared to the cheaper, continuous and higher quality supply possibilities of imported raw materials - have led to the rising dependence of the textile sector on imported raw materials<sup>6</sup>. The sector was therefore negatively affected by the weakness of the lira in 2015. Normally, the weaker lira should have helped producers by offsetting the negative impacts of higher production costs with higher exports. However textile exports suffered from lower export revenues. In the first ten months of 2015, Turkey's textile exports fell by 12.4% compared to the same period last year. The biggest drops were recorded in exports of knitted materials, which declined by 15.6%. Exports of woven materials and yarn fell by 10.6% and 10.2%, respectively.<sup>7</sup>

This was mainly due to the geopolitical tensions that caused exporters to lose market share in countries such as Iraq and Egypt. The sluggish recovery in Europe also hit textile exports. In the January-October period, exports to the EU-28 (which accounted for nearly 46% of Turkey's total textile exports in 2014) dropped by 10.7% compared to the previous year.

In 2014, western sanctions imposed on Russia, the sharp depreciation of the rouble and high inflation resulted in a significant decline of around 25% in exports to Russia. Russia's share in Turkey's total textile exports thus fell to 8.6% in 2014, down from 12.1% in 2013.

In addition to these challenges that will continue to

Chart 4: Turkey's food exports to major markets (2014, bln USD)



Source: TSI

(6) "Türkiye Tekstil ve Hazır Giyim Sektöründe İthalat Bağımlılığı", 2014, Mehmet Şişman, Erdem Bağcı

"Türkiye İmalat Sanayiinin İthalat Yapısı", 2009, Şeref Saygılı, Cengiz Cihan, Cihan Yalçın, Türknur Hamsicli

(7) "Textile and raw materials sector", Oct. 2015, The General Secretariat of Istanbul Textile&Apparel Exporters' Association

weigh on the textile sector during the next business year, new risks could arise relating to the tensions between Turkey and Russia. In the wake of the downing of the Russian jet by Turkey on Nov. 24, 2015, the Russian government has introduced bans on imports of some Turkish products. So far, textile products have not been included in these sanctions. However if they start to affect this sector too, debt collection may become a major issue for Turkish textile producers, particularly those who work on an open account system, without receivables coverage. Another risk for the sector is the European Union's

introduction of Pakistan into its "New Generalised System of Preferences". This could allow Pakistan to become one of the biggest suppliers of textiles to Europe, by benefitting from tax advantages. According to statements quoted in the media, Pakistan's textile and apparel exports to Europe grew by 18.1 percent and 30.5 percent, respectively, in 2014, after the agreement came into force in January 2014. This increases competition for Turkey, especially in areas such as home textiles, where Turkey is endeavouring to create global brands<sup>8</sup>.

### 3 CONCLUSION

Despite the stronger-than-expected growth performance supported by domestic demand, the Turkish economy faces various challenges arising from the uncertainty in the global economy and growing geopolitical tensions.

Within this backdrop, the payment performance of corporates is deteriorating, especially in sectors such as metals, chemicals, plastics and textiles, which have greater dependence on imports. The slowdown in China and the volatility in foreign exchange markets making cost management challenging. This also brings difficulties in cash flow management, reducing receivables collections. Additionally, producers exposed to troubled zones in Turkey's neighbouring countries may also suffer from weak export performance.

(8) "Pakistan Türk tekstili için tehdit", Dünya, 14/08/2015

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