Private Equity Investments in Turkey

by Onur Alper

Because of Turkey's dynamic and growing economy, huge market size and competitive and skilled labor force with a young population, foreign investors are widely interested in investing in Turkey. In order to improve the investment climate in Turkey and facilitate the flow of private equity investments, the Foreign Direct Investment Law (Law no. 4875) ("**FDIL**") has been enacted. Through this new enactment regarding the Turkish judicial system, foreign investors can freely transfer profits and dividends, execute sale and liquidation proceeds as well as sell and purchase securities on the Istanbul Stock Exchange ("**ISE**") without being subject to any limitations or approvals.

In parallel, with globalization expanding at a rapid pace, Turkish companies are also becoming more international. Turkish companies are trying to expand not only in Turkey but outside Turkey as well, where they are also looking at alternative capital raising and partnership opportunities to extend their businesses. Recognizing these economic and legal developments, this article aims to examine the legal structure of private equity investments, as well as the relevant legislation, specifically, Articles 4 and 18 of Communique Serial: VI, No: 4 on Principles Regarding Investment Companies.

This Communiqué sets the principles regarding the founders and formation procedures of investment trusts, registration to the board and public offering of investment trusts' shares, management and the required qualifications of the managers, scope of activities, portfolio restrictions and disclosure requirements of investment trusts.

According to Communiqué Serial: VI, No: 4 on Principles Regarding Investment Companies, investment companies are capital market institutions established as joint stock corporations on the principle of registered capital with the purpose of managing a portfolio of capital market instruments as well as gold and other precious metals traded on national and international exchanges or other organized markets. Venture capital (investors generally financing seed funding or start-up or early stage companies with a business or product development plan) and private equity (investors preferring to provide funds to ongoing businesses at later stages) are emerging as popular capital raising and/or partnership concepts in Turkey today.

Private equity is a source of investment capital from high net worth individuals and institutions aiming to invest and acquire equity ownership in companies having a high potential for growth which are generally not quoted on a stock market. Depending on the size and objective of the investment, private equity investments may be exercised in different types of transactions such as;

(i) incorporation of a new company,
(ii) mergers & acquisitions,
(iii) asset sale,
(iv) public offering,
(v) spin-off,
(vi) privatization and
(vii) joint venture.

These transactions are mainly governed by provisions of the Turkish Commercial Code (Law no. 6762) ("**TCC**") and the Turkish Code of Obligations (Law no. 818) ("**TCO**"). In addition, the Capital Markets Law and relevant communiqués of the Capital Markets Board ("**CMB**") also apply to transactions involving publicly-held companies and certain restrictions are placed on investment trusts that are regu-

lated under Communiqué Serial VI No: 15 Regarding the Principles about Venture Capital Investment Trusts (**"Communiqué"**) issued by the CMB on March 20, 2003.

Requirements of Article 4

According to Article 4 of the Communiqué, investment trusts must be incorporated in the form of a joint stock company with registered capital. Existing joint stock companies may also apply to the CMB to request their conversion to a venture capital or private equity investment trust and by amending their articles of association accordingly, pursuant to the provisions of the Capital Markets Law and the Communiqué. In order to obtain approval from the CMB:

- The initial capital of the company (or paid-in capital for companies in conversion) must be at least five trillion Turkish Liras,
- The trade name of the company must include the phrase "Venture Capital Investment Trust" (Girişim Sermayesi Yatırım Ortaklığı),
- The company shares must be issued against cash contributions,
- The company's articles of association must comply with the provisions of the TCC, the Capital Markets Law and the Communiqué,
- The board members and the legal person shareholders who own more than ten percent (10%) of the shares of the company must not have any unpaid and due obligations or other similar debts; and must prove the source of their funds,
- A separate application must be made to the CMB to include the activities listed under portfolio operations, and
- At least one of the founders must be a leading shareholder.

Requirements of Article 18

According to Article 18 of the Communiqué, an investment trust;

(i) Cannot make investments in firms where the shareholders have more than ten percent (10%) of the capital or the voting rights or members of board of directors and/or the general director separately or collectively have more than ten percent (10%) of the capital or the voting rights in the corporation,

(ii) Cannot invest more than fifty percent (50%) of its portfolio value in securities other than the ones issued by venture firms and those being operated in secondary markets; investments in venture firms are considered this kind of investment ten (10) years after the investment date,

(iii) Cannot invest more than ten percent (10%) of its portfolio value in securities issued by one (1) firm specified under (ii),

(iv) Cannot have more than five percent (5%) of voting rights or capital of one (1) single firm specified under (ii),

(v) Can invest in securities appropriate to their investment objectives to hedge the portfolio against currency, market and interest rate risks provided that the articles of association has a provision in this regard, this issue is mentioned in disclosure documents and it is approved by the CMB, and for hedging purposes invest in forward, options and futures contracts.

In addition, pursuant to the Law Concerning Protection of Competition (Law no. 4054) and relevant communiqués of the Competition Authority, transactions constituting a merger or an acquisition will be subject to the approval of the Competition Board if the market share and/or turnover thresholds are met and a change of control in management rights occurs as a result of such transaction.

The primary sources of corporate governance regulations are the TCC and regulations of the CMB and the ISE. Special corporate rulings are also applicable to certain sector companies, such as banks and insurance agents. In addition, doctrine and case law also provide a necessary source of mandatory corporate governance rules and standards in Turkish law. There are no statutory obligations to apply, but companies generally show a relaxed attitude to issues such as shareholders' rights, public disclosure, transparency, minority rights, stakeholders' rights, independent auditing and the duties of the board of directors.

Private equity transactions fall under typical disclosure requirements. The board or the selling shareholders are to disclose any development that might have a bearing on the value of the shares, including any significant proposal for investment in the company or any of its notable consolidated subsidiaries.

As a general rule, it is required that public companies disclose in writing any changes that may affect investors' decisions or market value of the underlying securities and all situations relating to the company, its subsidiaries, managers, personnel or any third party having a direct or indirect relationship with the

company via the fastest means of communication, using electronic signature, and on the date such decisions or situations have occurred.

The principles of the CMB regulate the role of stakeholders in corporate governance and encourage active co-operation between companies and stakeholders. They also provide detailed principles concerning shareholders and their rights, for example the right to review company books and accounts, the right to attend general assemblies, minority rights, voting rights, equal treatment rights and financial rights.

Furthermore, taxation considerations generally play an important role in the structuring of a private equity investment. If the seller is a real person, income tax shall not apply if the shares are held for more than one (1) year, while for legal entities this term is two (2) years. The said tax exemption shall not apply if real persons or legal entities acquire a shareholding in a company and then sell it before the said periods. In such a situation, these real persons and legal entities shall be obliged to pay income tax for the difference between the acquisition price they paid and the transfer price they received for such shares.

Conclusion

Taking into consideration the history and background of private equity acquisitions in Turkey, it is evident that no specific industry or type of company has typically been the target of private equity transactions. Turkey is a potentially important place for equity deals, due to its young and dynamic population and unique location bridging Europe and Asia, and it is expected that Turkey will become one of the major countries in the area attracting foreign investment in coming years.

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