



The Traveling Analyst series highlights journeys by Lazard Asset Management's investment professionals and the perspectives such visits have helped them gain.

The insights they gain from company meetings and site visits help generate a coherent picture of companies and the industries in which they operate—insights that simply could not be attained from financial reports, websites, or phone conversations.

THE **Traveling** ANALYST

A PASSAGE TO

Analysts from Lazard Asset Management's Global Research Platform and its



Istanbul

Emerging Markets Equity portfolio team journey to the dynamic, ancient, and modern city of Istanbul and its surrounding areas.

The purpose of these trips was to deepen and broaden our analysts' knowledge of a number of Turkish companies, the industries in which they operate, and their relationships with the European and global markets. The analysts planned to meet with several subsidiaries of multinational companies, examine partnerships between local and global corporations, and meet with local Turkish companies for investment potential. Several analysts commented on the contrasts between Turkey's secular and Islamic cultures. By day, one can hear the muezzin calling people to prayer and see women wearing the hijab. But, at night, there is a more worldly side of Istanbul, with busy restaurants and nightclubs.



GATEWAY **East**, GATEWAY **West**

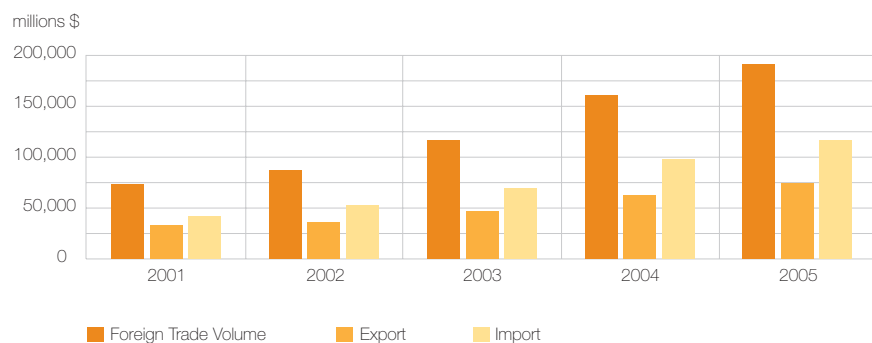
Throughout history, Turkey's significance has been linked with its location. For more than 2,000 years, the land that is modern Turkey has been economically and politically important as a gateway between the European continent and Asia. Modern Turkey continues this economic role, linking Europe, the Middle East, Central Asia, the countries of the Commonwealth of Independent States (CIS), and the larger Baltic region.

The neighboring Caucasus region and Caspian Sea contain huge oil and gas reserves. So, Turkey is benefiting from pipelines traversing the country,

including the two-year-old South Caucasus Baku-Tbilisi-Ceyhan (BTC) pipeline and the soon-to-be-built Samsun-Ceyhan pipeline that will carry Russian and Kazakh oil from the Black Sea coast to Turkey's Mediterranean port of Ceyhan.¹

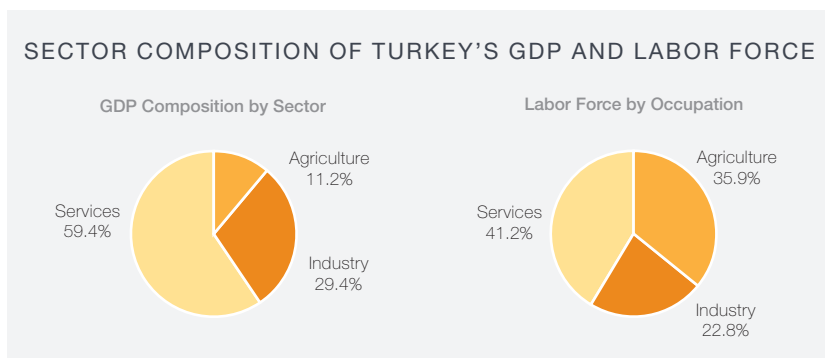
Turkey's location, relatively cheap labor, and proximity to Europe provide it with the opportunity to become a low-cost manufacturing hub. To achieve this, transportation is key, leading Turkey's government to sign a framework agreement to build a railway linking Turkey with Azerbaijan and Georgia, which if completed will be the shortest

BALANCE OF TURKEY'S FOREIGN TRADE (2001 – 2005)



Source: Undersecretariat of the Prime Ministry for Foreign Trade

commercial route between Asia and Europe.² In addition, ocean-freight shipping from Turkey to European ports is far cheaper than the cost of shipping goods from Asia.



Source: As of 2006 (estimated),
CIA—The World Fact Book, April 2007

Source: As of 3Q 2004,
CIA—The World Fact Book, April 2007

Islamic EMPIRE to Secular DEMOCRACY

After the dissolution of the Ottoman Empire at the end of World War I, Mustafa Kemal emerged as the leader of a new Turkish state. Kemal, later acclaimed “Atatürk” (meaning “Father of Turks”), is still the most influential figure in the formation of modern Turkey.

The country he helped rebuild remains unique in its region as a predominantly Muslim country with a secular democracy and a pro-capitalist economy. After Atatürk’s 1938 death, Turkey experienced considerable instability due to tensions between its pro-secular and pro-Islamic factions. As recently as 1997, the military (protector of Turkish secularism) overthrew a popularly elected government considered “too Islamic.” Yet, since 2002 the Islamist AK Party (AKP) has been in power. While the party has clashed with secularists on some cultural issues, most of its policies have been fiscally prudent and pro-reform.

In early 2007, political tensions intensified when foreign minister Abdullah Gül (of the AKP) was nominated as presidential candidate, setting off a wave of secular opposition instigated by a harsh warning from the army. The Constitutional Court annulled the nomination, Gül withdrew, and Prime Minister Recep Tayyip Erdoğan called for

early parliamentary elections in July 2007, in which the AKP won a major victory. Will secular/Islamist tensions boil over? Many see Turkey resolving its political issues by democratic means. Others wonder how far the military will go to uphold Turkish secularism.

TURKEY'S Economy

The traditional thrust of Turkey’s economy has been its own domestic market. But, with renewed interest in EU membership and robust growth in the Eurozone, Turkey’s larger companies are seeking business beyond domestic boundaries, especially from the neighboring CIS/Baltic region. Turkish appliance manufacturers have experienced increased demand from the CIS. Its construction companies are providing services across the Middle East (especially Iraq), and automobile exports have climbed.³ The BTC pipeline underscores Turkey’s importance as an “energy corridor” for Caspian oil producers.⁴ But, the country’s large textile industry faces heavy competition from emerging Asian countries. Lately, domestic demand has slowed, as Turkey’s growth has begun to rebalance from domestic demand to exports. This should improve Turkey’s large current account deficit, if oil prices remain stable (Turkey imports 70 percent of its energy needs).

TURKEY'S ECONOMIC Ups and Downs

Ups: Today Turkey has a fairly open economy and the country is working to adopt the EU’s economic criteria as a step toward convergence. But in 2000, the country was in financial crisis. The sustainability of its currency regime was called into question, and the Turkish lira devalued by 40 percent in February 2001.

Since this crisis, the economy has made a striking recovery. Turkey’s government, working with the International Monetary Fund (IMF), has undertaken policies designed to create greater stability. The country’s budget deficit has been reduced, and its banking industry has been overhauled. Recently, Turkey’s economy has been more flexible, riding out the global market turbulence in 2006 and early 2007.⁵

Downs: Offsetting positive developments are some negative trends. Turkey's widening current account deficit is one of the largest in the emerging markets. The deficit has been exacerbated by Turkey's significant energy imports and its increasing reliance on foreign capital flows, including foreign direct investment, to finance growth.⁶ The deficit is somewhat offset by Turkey's primary surplus (e.g., the country's budget surplus excluding interest payments on its debt). But, Turkey's capital markets are vulnerable to potential capital outflows, given the significant presence of foreign investment in its equity and debt markets.

In 2005, inflation fell to its lowest point in 30 years, at 7.7 percent, but has since climbed to 10.9 percent in the first quarter of 2007.⁷ Can Turkey's central bank credibly ease interest rates, given its aggressive 2007 inflation target of 4.9 percent and record of missing its inflation target two years running? Observers think it unlikely, even though Turkey's high interest rates are suppressing domestic demand.

Much of Turkey is still rural. Small family farms employ over a third of the country's population and contribute more than 11 percent to Turkey's GDP.⁸ Turkey continues to support agriculture in order to stem significant migration of people from the farms to its cities, and perhaps to manage unemployment.⁹

Corporate TURKEY

Our analysts met with a number of Turkey's most prominent companies, including holding companies Koç, Sabancı, and Doğuş, some of their exchange-listed subsidiaries, and joint venture companies. The goal was to understand the focus of developed-market companies in Turkey and to find potential investment opportunities.

Many global companies have expanded their operations into Turkey to benefit from its recent economic trends. The BTC pipeline is owned by a partnership of nine large energy companies, including BP (operating the pipeline) and the Azerbaijani and Turkish state oil companies.

Carrier, a leading global company in heating, ventilation, and air conditioning, is in a partnership with Turkey's Alarko Group. Carrier moved its European manufacturing to Turkey. Now Alarko Carrier operates two Istanbul plants and is benefiting from Turkey's construction boom.

A joint venture between French retailer Carrefour and the Sabancı Group has captured almost 15 percent of Turkey's retail market share. Automobile manufacturing and distribution includes longstanding partnerships, such as Koç Holding's joint ventures with Ford (Ford Otosan) and Fiat (Tofaş) and Doğuş Group's joint venture with Volkswagen (Doğuş Otomotiv).

DRIVING DEMAND: Turkey's Auto Sector

Turkey's automotive industry, which dates back to 1966, now ranks sixth in European automobile production, with 17 percent of Turkey's 2006 exports.³

Foreign multinationals have invested heavily in Turkey's automotive sector. One of the largest is Ford Motor Company's joint venture with Koç Holding, one of Ford's largest and more profitable European production centers, which realized over 18 percent of Turkey's automotive market share in 2005.¹⁰ And 15 other automobile companies have production in Turkey, including Fiat, Honda, Renault, and Toyota.

Meeting with representatives of Doğuş Otomotiv, a partnership between Doğuş Holding and Volkswagen, our analysts learned that Turkey's used car sales have been handled through small-scale "Mom & Pop" outlets, but Doğuş Otomotiv sees used car sales as a growth opportunity. However, Doğuş Otomotiv is exclusively a distributor of automobiles, thus its ambitions may be largely dependent on the major U.S., Asian, and European carmakers for product releases, pricing, and margins that it is able to earn.

Furthermore, Turkey's domestic car market suffers steep taxes on new cars. The consumption tax on luxury models can reach 87 percent of a car's purchase price, and the value-added tax is 18 percent. It should not be surprising then, to learn that Turkey's vehicle density is just 96 vehicles per 1,000

people. Used cars, however, are not taxed, which could be a spur to Doğu Otomotiv's business.

AT AN INFLECTION POINT: The Textiles Sector

Textiles represent Turkey's largest industry, employing about 10 percent of the workforce and accounting for 16 percent of Turkey's industrial production.¹¹ This includes production of yarns, as well as weaving, dyeing, finishing, and manufacturing of clothing.

Textile company Altinyildiz operates one of Europe's largest textile manufacturing facilities and has broadened into clothing manufacturing and retailing. Having toured its Istanbul plant, which converts Australian wool into garments sold on a 60/40 split between local and global markets, our analysts met with Altinyildiz's management to discuss how it competes with low-cost Asian-based producers. Characterizing its competitive advantages as quality of product and process, Altinyildiz has also invested time and capital on designing technologically sophisticated plants in an effort to maximize operating efficiency and reduce labor costs.

hour versus Turkey's \$7.14 per hour.¹² One plant manager has said what most believe: "We either improve quality and productivity and move upmarket, or we die."¹³ Lately, Turkey's textile exports are up, due to a strong euro versus the Turkish lira, a lower special consumption tax, and Europe's quotas on Asian imports. For Europe, Turkey's location is an advantage, since shipping textiles to its factories is fast and cost effective. But this link to Europe has caused wages to rise. And recent positive news does not completely offset the challenges the textile industry faces. External pressures on this important industry, accounting for a third of Turkey's industrial labor, could strain the EU accession process.⁷

Corporate Governance IN TURKEY

Recently, Turkey was the subject of a report, *Corporate Governance in Turkey: A Pilot Study*, the first of its kind for an Organisation for Economic Co-operation and Development (OECD) member country. The OECD Secretary-General stated that market disclosure by listed companies is on the rise, with many of Turkey's corporations adopting international audit and accounting standards, but recommended that Turkey strengthen existing corporate disclosure laws.

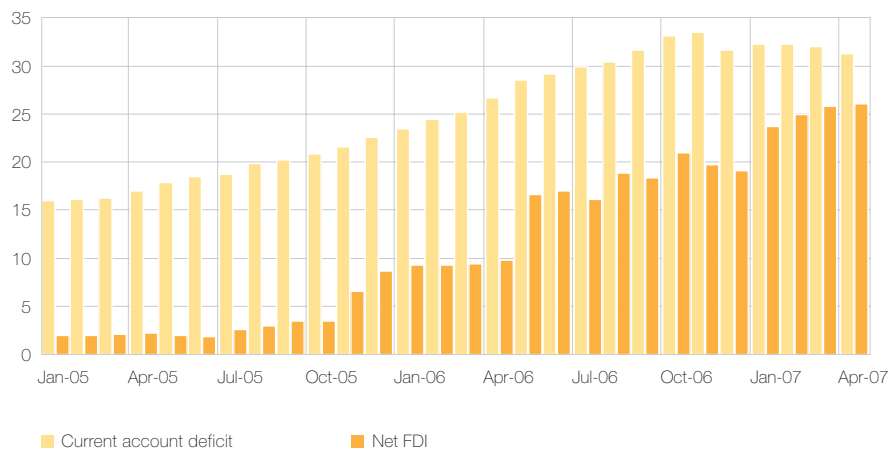
Many see Turkey as having a fairly strong regulatory framework for corporate governance, but it also has many large family-owned conglomerates. The OECD Secretary-General also commented on Turkey's conglomerates' potential issues like cross-ownership between companies and the roles of the controlling shareholders, noting, "Without effective safeguards, there is potential for abuse."¹⁴

AT THE EU's Doorstep

A current member of NATO, Turkey enjoys a customs relationship with the EU and has been working toward EU accession. The 1992 Maastricht Treaty documents the "convergence criteria" that each member of the EU has had to fulfill. Responding to these criteria, Turkey has made significant economic, political, and social reforms, yet accession will take time. Still, many see the direction of Turkey's policy as more important than the exact time it takes for modernization.

CURRENT ACCOUNT DEFICIT AND NET FDI FLOWS

(US\$ bn, 12 month rolling basis)



Source: Turkstat, Haver Analytics, Barclays Capital

Many observers, including some of our analysts, see Turkey's textile industry at an inflection point, especially as its labor cost differential is staggering: the Asian unit labor cost averages 92 cents per

Large family-owned conglomerates continue to dominate Turkey's economy. These conglomerates, like Koç, Sabancı, and Doğuş, own interests in a wide range of businesses, many of which are separately traded on Turkey's stock exchange. The conglomerates' size is helpful for positioning, but if their focus is not on profitability, size may limit their attractiveness as an investment.

Issues to Overcome

Cyprus: In October 2006, EU discussions with Turkey stalled over the divided island of Cyprus (resuming in early 2007). This contentious issue revolves around Turkey's refusal to open its ports and airports to Greek Cypriots until the EU ends its isolation of the Turkish Cypriot state—a state unrecognized by most countries.

Opposition: A stumbling block to accession is opposition from some European leaders. Germany's recently elected Christian Democratic party, led by Chancellor Angela Merkel, has "vowed to do everything possible to wreck Turkey's application."¹⁵ New French President Nicolas Sarkozy is also an opponent. This may be partially based on a perception that as a Muslim nation, Turkey is out of sync with European norms. But Europeans also fear that Turkish workers may flood their labor market and drive wages down.¹⁶

Lack of Support: The Turkish people's support of EU accession has waned, though the government is behind the effort. This change may be caused by a lack of tangible appreciation for the benefits of accession by the ordinary Turkish citizen, given the length of time involved in this process of modernization.

Benefits for Both Sides

Convergence would provide Turkey with access to the EU's open markets. The accession process should stimulate long-term physical investments and foreign direct investment. Convergence could help repair Turkey's contentious relationship with Greece, should the Cyprus issue be resolved. How could the EU benefit? Its major Western European countries currently rely on Eastern European skilled labor. When this labor force is

absorbed, estimated to be around 2015, the EU may then look to Turkey's skilled labor. And, since Russia has been unreliable as an oil and gas supplier, Turkey's proximity to the CIS/Baltic and Middle East is attractive.

CAN TURKEY MAINTAIN ITS Stability?

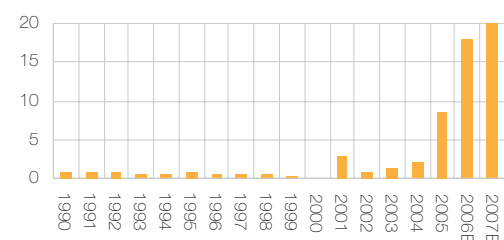
As a relatively stable, secular democracy, Turkey is unique as a gateway between the Middle East and Europe. Recent stability has allowed its business sectors to focus on growth, within and beyond the domestic market. Although progress on EU accession is in the future, many executives with whom our analysts met expressed a desire to access its economic opportunities.

Yet, there are risks involved in investing in the Turkish market. Its macroeconomic framework has improved, but more micro-level reforms are needed to address issues like taxes or labor market inefficiencies. Its corporate governance framework needs improvement. Inflation is expected to miss its annual target again, and its external deficit is still large, despite slowing domestic demand. Many Turkish companies do not have a solid long-term strategy for growth. International competition has threatened industries like Turkey's textile business. And, ever present is the tension between Islamist government and secularist armed forces, a potentially destabilizing factor.

Lazard Asset Management's investment professionals will continue to assess opportunities and risks presented by Turkey's companies, helping to ensure that the research informing the construction of Lazard Asset Management's portfolios is second-to-none.

FDI IS FINALLY FLOWING TO TURKEY

Net Foreign Direct Investment Inflows (US\$ bn)



Source: CBT, Merrill Lynch estimates. As of December 7, 2006

NOTES:

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- 3 "Turkey Ranks Six in European Auto Production," *Turkish Daily News*, April 19, 2007.
- 4 "Turkey Starts Building New Oil Pipeline," *Budapest Business Journal*, April 24, 2007, http://www.bbj.hu/news/news_25637.html.
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- 6 Turkey—2007 Article IV Consultation, Concluding Statement of the IMF Mission, International Monetary Fund, March 9, 2007, <http://www.imf.org/external/np/ms/2007/030907.htm>.
- 7 *CLA – The World Factbook – Turkey*, April 17, 2007 (updated May 31, 2007), <https://www.cia.gov/library/publications/the-world-factbook/geos/tu.html>.
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- 14 *Corporate Governance in Turkey*, speech by Angel Gurría, OECD Secretary-General, October 17, 2006, Organisation for Economic Co-operation and Development, www.oecd.org.
- 15 "Which Turkey?" *The Economist*, March 17, 2005.
- 16 "School Scandals," *The Economist*, July 27, 2006.

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