

IN THE KNOW

Leveraged Finance Newsletter

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MARKET UPDATE: TURKEY

Trying to recover from the currency shock in 2018, the Turkish financial markets are open for business in 2019 stimulated by governmental intervention in the form of changes in the withholding tax rate and the introduction of the Framework Agreement regarding financial restructurings in Turkey. Our newsletter highlights these recent regulatory developments of interest as well as the proliferation of the "Covenanted Eurobond" in Turkey.

Withholding Tax Change - Early Bond Repurchases

Pursuant to a recent Presidential Decree, the withholding tax rate on interest income derived from bonds issued by Turkish resident companies outside of Turkey has been decreased to 0% for bonds 'with a maturity of more than 3 years' (before 21st of March 2019, it was 5 years).

This change is particularly relevant for an issuer that wants to repurchase and/or redeem its bonds prior to maturity through a tender offer, open market purchases or by other means. Under Turkish tax rules, the date of repurchase or redemption of the bonds is considered the maturity date for purposes of determining whether withholding tax is due on the bonds. The following amendments were made to the withholding tax rates applied on the interest that Turkish resident companies pay on notes distributed abroad:

- For notes with maturities of less than one year, decreased from 10% to 7%.
- For notes with maturities of one to three years, decreased from 7% to 3%.
- For notes with maturities of at least three years, 0%. Before the amendment, 0% was applicable only for the notes with maturities of at least five years.

For example, if an issuer were to issue five year bonds on June 30, 2020, a redemption of those bonds prior to June 30, 2023 would trigger the withholding tax, but a redemption on or after June 30, 2023 would not. While this penalty during the earlier period is still more restrictive than in many jurisdictions, the change does provide improved refinancing optionality to issuers as their bonds approach maturity.

Note that the Presidential Decree (which introduces the new withholding tax rates mentioned above) does not expressly provide that the new withholding tax rate is applicable to bonds issued before its effective date (March 21, 2019). Therefore, it is not clear that the buyback and cancellation of a bond issued before the effective date can benefit from the reduced withholding tax rates. We expect this issue could be clarified following submission of a request for a ruling to the Revenue Administration.



The "Covenanted Eurobond"

Debt securities offered by Turkish issuers typically follow the international Eurobond structure ("Investment-grade"-type covenants, English law). Borrowers also turn to the local bank market, which historically has been available to corporates at attractive rates and with limited covenant restrictions.

With pressure on the Turkish sovereign rating and the value of the Turkish Lira, international debt securities issuances (e.g., denominated in US dollars) out of Turkey face more scrutiny by the international investing community. While U.S./European style high yield issuances (full "high yield" covenants, New York law) are infrequent in Turkey, one trend in the market, to establish a balance of market flexibility for issuers and appropriate protections for investors is the "Covenanted Eurobond" (also referred to as a "hybrid" debt security).

The "Covenanted Eurobond" is based on the traditional Eurobond model, with one or more additional incurrence-based covenants included in the terms and conditions, which is designed to address specific investor concerns.

One example of this trend is the recent offering by Turk Telecom of US \$500 million 6.875% Notes due 2025. In that case, a unique post change-of-control debt incurrence leverage test was included in the terms and conditions to provide full flexibility to the current owners to optimize the capital structure but give future protections if and when ownership is transferred.

We expect to see more of these stylized issuances in the future, in both Turkey and other jurisdictions with similar economic and political challenges.



¹For a more in-depth discussion regarding the Turkish Framework Agreement please see our recent article on the Baker McKenzie Global Restructuring & Insolvency website available [here](#).

Restructuring Stressed Turkish Debt ¹

The financial situation in Turkey has increased the level of stressed debt in Turkey to unprecedented levels. Market participants are seeking solutions to ease the growing debt burden.

In August 2018, the concept of "financial restructuring" was introduced in Turkey following the country's currency crisis and became a major agenda item for Turkish financial institutions and regulators. The aptly named "Framework Agreement" that entered into force as a result of the joint efforts of the Banking Regulatory and Supervisory Authority and the Banks Association of Turkey was of particular importance as it set out a new framework for financial restructurings in Turkey.

Some of the key features of the Framework Agreement are:

- Arrangements are only binding on parties who have entered into the Framework Agreement
- Out-of-court contractual procedures for companies approaching distress as well as those in it
- Non-resident banks can join on a case-by-case basis
- Creditors cannot apply to commence the process, only borrowers can initiate
- Applies only to financial debt, not shareholder debt
- Cannot do debt-for-equity swap without shareholder approval

We are aware that the Turkish Banking Association is working on a special type of the Framework Agreement that will be applicable to financial restructurings with SMEs. This will further expand the restructuring initiative; currently, only borrowers with more than TRY 100 million of financial debt can make use of the Framework Agreement.

To date restructurings commenced pursuant to the Framework Agreement have been progressing very slowly and, in most cases, have reached an impasse. This is in part due to the complexity of the untested agreement, uncertainty of implementation under the agreement and the reluctance to date of many international non-resident banks to sign up.

There are several changes which could be made to the legal and tax regimes that might lead to greater adoption of the process such as (i) allowing for the write-down or other restructuring of debt and equity swaps, (ii) broaden the scope of creditors included in order to promote international engagement and a more collective effect, (iii) facilitate the provision of additional funds to the defaulting debtor by reducing barriers to entry for international banks and debt funds in the Turkish market, (iv) facilitating NPL transactions in order to allow distressed companies or banks holding such distressed assets to offload them, and (v) improve enforcement mechanisms to ensure that the path to enforcement is as smooth and efficient as possible, and that proper recourse can be had against debtors and/or their assets.

Other options that remain available to Turkish borrowers and their creditors include consensual restructurings, Chapter 11 filings or the use of the UK Scheme of Arrangement or the legacy Concordat (Turkish Scheme of Arrangement) process. As the focus on financial restructurings in Turkey is a relatively new development, it will be interesting to watch which of these options, each with pros and cons, becomes preferred, and whether the Turkish authorities will continue to make improvements and clarifications to the Framework Agreement to insure its wider adoption and use.

Where to Next?

The Turkish economy has not fully recovered from the 2018 currency shock, but targeted governmental relief such as the changes to the withholding tax regime and the new restructuring framework are evidence of progress. As the benefits of facilitated early bond repurchases and financial restructurings kick in, distressed companies will more readily be able to recover, thereby alleviating pressure on the Turkish financial market. Although external macroeconomic factors will also play a significant role going forward, steps such as these and recent "Covenanted Eurobond" deals in Turkey indicate some reprieve in the storm.



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