CLEARY GOTTLIEB

Paksoy

ALERT MEMORANDUM

Turkish IPOs – Key Issues for Market Participants

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The Turkish IPO market has experienced significant activity in recent years, with 23 IPOs by Turkish companies since January 1, 2014, but the cumulative impact of economic growth and developing capital markets regulation has been tempered by political instability. However, there are signs that the outlook is set to improve, with reports of numerous companies expressing plans to go public in 2016 – 2018.

This memorandum outlines certain of the key international and Turkish legal considerations arising in such transactions, focusing specifically on those involving a *Borsa Istanbul* listing in the context of a global equity offering,[1] which have become increasingly common.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors.

Cleary Gottlieb Steen & Hamilton LLP – London

Pierre Marie Boury
T: +44 20 7614 2380
pboury@cgsh.com

Chrishan Raja
T: +44 20 7614 2224
craja@cgsh.com

Mohamed Taha
T: +44 20 7614 2321
mtaha@cgsh.com

Paksoy Ortak Avukat Bürosu

Omer Collak
T: +90 212 366 4732
ocollak@paksoy.av.tr

Okkes Sahan
T: +90 212 366 4790
osahan@paksoy.av.tr

[1] Typically an equity offering to qualified institutional buyers in the United States under SEC Rule 144A and outside of the United States under Regulation S. Offerings involving domestic and international tranches will be referred to as "dual-tranche offerings"; it is assumed in this memorandum that the international offering will consist of placements to institutional investors only, while the domestic offering will have two components: a public offering to retail investors and a separate placement to institutional investors.

A. DUAL-TRANCHE OFFERING STRUCTURE

Prospectuses

An English language international offering circular (IOC), prepared to an international standard in terms of disclosure, will typically be produced, along with the Turkish prospectus (*izahname*) used for the domestic offering. The *izahname* will contain separate financial statements prepared in accordance with Turkish Financial Reporting Standards (TFRS); these are virtually identical to IFRS. In terms of disclosure, the *izahname* must include all material information contained in the IOC and be substantively consistent therewith; the layout will follow a specific format prescribed by the CMB.

Markets

Under Turkish law, no offering by Turkish companies inside Turkey is permitted without a public offering to Turkish retail investors, which would trigger the requirement for a *Borsa Istanbul* listing.[2] For such Turkish listing, among other requirements, a minimum of two calendar years must have elapsed since the establishment of the issuer, and the total asset value and net revenue of the issuer must be above TRY 11.6 million (approx. USD 3.8 million) and TRY 5.8 million (approx. USD 1.9 million), respectively.[3] The CMB has the authority to increase or decrease these figures annually. Assuming a dual-tranche offering structure is chosen, Turkish law requires that at least 30% of the number of offered shares be allocated to domestic investors (with a minimum of 20% to institutional investors and 10% to retail investors) However, should there be insufficient demand in the domestic market, a greater proportion can be sold to international investors.

There is no prohibition on Turkish companies making solely an international offering (in such circumstances, listing in a foreign jurisdiction), though the potentially burdensome requirements in target listing jurisdictions have made this a rare occurrence to date.[4] However, we note that the European Securities and Markets Authority (ESMA) recently published an opinion (the ESMA Opinion)[5] on Turkish prospectuses, stating that an *izahname* drawn up in line with Turkish laws and regulations can constitute a valid prospectus under the EU Prospectus Directive[6] (without the addition of any wrapper), provided that it contains financial statements in accordance with IFRS. However, the ESMA Opinion acknowledges the continued (and unlimited) discretion of national competent authorities to require further information, either in the prospectus itself or by way of wrapper thereto. This may well increase the number of issuers seeking to obtain dual listings on *Borsa Istanbul* and in Europe, enabling them to conduct public offerings in both jurisdictions. It is not clear, however, how far the practice described above will change, as opposed to merely being further supplemented. We would assume that issuers looking to conduct public offerings/list in European jurisdictions would also wish to market to qualified institutional buyers in the US under Rule 144A. As such, it seems natural that the English language IOC, as opposed to an English translation of the *izahname*, would form the basis of such disclosure, with necessary amendments being made to satisfy the relevant EU Prospectus Directive requirements (as interpreted by the national competent authority in question).

Underwriting Syndicates

For a number of reasons, including Turkish financial intermediary licensing requirements and market practice, in a typical dual-tranche offering there will be two separate syndicates of banks: international and domestic. Domestic syndicates in Turkey consist primarily of one or several lead managers who will coordinate the activities of a broader consortium of

[2] As of January 13, 2016, the dual listing of shares of Turkish or foreign issuers is permitted on *Borsa Istanbul* if such shares are already listed on an exchange in certain foreign jurisdictions.

[3] For Rule 144A transactions, financials for three full years (or for such shorter period as the issuer has been in operation) should be included.

[4] We note that if the number of shareholders of the issuer crosses 500, mandatory regulatory filings to become a public company will be triggered under Turkish law (with requirements to list or become private again within two years).

[5] "ESMA assessment of Turkish laws and regulations on prospectuses," dated February 8, 2016: https://www.esma.europa.eu/sites/default/files/library/2016-268_opinion_on_equivalence_of_the_turkish_prospectus_regime.pdf

[6] Directive 2003/71/EC of the European Parliament and of the Council of November 4, 2003, as amended.

intermediary banks. In sizeable IPOs, the market practice for domestic banks is to provide intermediary services on a best efforts basis (*en iyi gayret aracılığı*), without any actual underwriting commitment, under an "intermediation agreement" signed just before the CMB's approval of the *izahname*. The international syndicate may make a similar undertaking or, in the alternative, underwrite the international tranche on a firm commitment basis under a separate underwriting agreement signed at pricing.

This offering structure closely resembles one that used to be common in global equity offerings, in which typically a separate underwriting agreement would govern each of the tranches to be offered in the several countries in question. As used to be the case in transactions structured in this way, underwriters should consider entering into an intersyndicate agreement to coordinate the offering of the domestic and international tranches, including selling restrictions, settlement procedures, the allocation of commissions, stabilization of the shares offered in each tranche, the re-allotment of shares from one offering to the other and, most importantly, the inter-conditionality of both offerings.[7]

B. PRE-LAUNCH

First Filing with the CMB

The issuer will need to apply to the CMB to amend its articles of association to permit the IPO. This is followed shortly by the filing of the first draft of the *izahname*, which will trigger the start of the CMB's review and will be public. This should typically take place at least eight weeks before the anticipated final approval date (close to launch) to provide sufficient time for review. [8]

This can strain the timetable for global offerings, in which the international underwriters require standard "SAS 72" comfort, as negative assurance thereunder requires audited or reviewed financials no older than 135 days. By way of example of such constraints, an offering off an issuer's audited financials for the year ended December 31 would need to close by the middle of the following May.[9] Based on a typical (two-week) book-building period and T+2 settlement schedule, this would require filing of the *izahname* in early March, within days of the audited financials for the most recent year having become available.[10] This leaves little (if any) time for drafting the sections of the disclosure related to the financial statements, principally the Operating and Financial Review in the IOC and the corresponding section of the *izahname*.

While the first draft of the *izahname* should include up-to-date information, there is no minimum level of detail prescribed by Turkish law. To ensure that the CMB has sufficient time to review the *izahname* in advance of the desired date of final approval, the possibility of filing a partially complete version should be raised with the regulator. This would contain a full discussion of the earliest two (of three) years' financials, with a subsequent filing containing the analysis of the most recent period.[11] Any such interim or subsequent filings will not be made public until the *izahname* is finally approved.

C. LAUNCH

It is important to distinguish between the international and domestic offerings in this context—the former being to institutional investors only (for

[7] Under Turkish law, if the domestic offering is not successful for reasons other than lack of demand (*e.g.*, a termination right in the domestic underwriting agreement is triggered or the *izahname* is not approved by the CMB), then the international offering will have to be discontinued.

[8] The review process of the CMB should not exceed a maximum of 20 business days from the time the filing is complete (in practice, this will be achieved in stages, with the first filing starting the process but being inevitably incomplete due to, *inter alia*, the reasons discussed in this section).

[9] This timing problem will arise regardless of whether the latest financial statements are as of year-end (and so audited) or for an interim period (and so only reviewed), though it may be more pronounced in the former context due to additional time required for auditors to complete their work. By way of background, Statement on Auditing Standards No. 72 provides that auditors may not give negative assurance to underwriters as to changes in specified financial statement line items as of a date 135 days (or more) subsequent to the date of the most recently audited or reviewed financials.

[10] It is important to involve the auditors early on in the process of preparing for the IPO to agree on all comfort-related issues. Specific to the Turkish context, if the issuer's financial statements have not been audited under IFRS, explanations of any non-IFRS measures and the nearest reconciliations thereto may be necessary in the IOC and comfort letters.

[11] General market practice suggests that the CMB is amenable to such an approach, although each transaction will be reviewed on a case-by-case basis.

the purposes of this memorandum) and the latter including a public offer to retail investors and a placement to institutional investors.

Marketing for the domestic offering/book-building takes place using the "final" *izahname*, which is printed and circulated (with a price range) only after approval by the CMB. Domestic book-building will typically coincide with the end of the international offering book-building period, and must be conducted over two to three business days under Turkish law. While Turkish institutional investors may, in line with international practice, place bids across the full spectrum of the price range, Turkish retail investors are, for practical reasons, required to place orders at a price equivalent to the top of the range (the excess amount being reimbursed if the deal prices at a lower figure).

The marketing/book-building for the international offering may start before the final CMB approval if the Preliminary IOC includes appropriate disclaimers that indicate, among other things, that the Turkish *izahname* has not yet been approved by the CMB and no formal orders are taken.

Local Valuation Report and Price Range

One of the domestic lead managers will be required to prepare a valuation report, the purpose of which is to provide a fair market value estimate of the shares (in the form of a price range).[12] The valuation methodology of the report—but not the valuation itself—is reviewed by the CMB, which may require several drafts to be submitted.[13] The report is disclosed to the public on the Turkish Public Disclosure Platform.

Contrary to typical practice in Regulation S/Rule 144A offerings, the price range will need to be included in the preliminary IOC for consistency of treatment between international and domestic investors (as noted above, the final price range will be disclosed to the latter in the *izahname*). The timetable should thus be structured to ensure that approval of the valuation report containing the final price range (coinciding with the approval of the *izahname*, which also includes such range) is received before the launch of the international offering, though that is not always possible, such that this final price range can be included in the preliminary IOC for use in the international roadshow.[14] As a matter of Turkish law, there is a limit to any widening of the price range: the top of the final price range cannot be more than 20% higher than the bottom.

Subsequent Material Disclosure Events

The occurrence of material disclosure events not included in the offering documentation may, as in the international context, necessitate further disclosure to the market in Turkey by way of supplementary *izahname*. The CMB may suspend the offering process in such circumstances, and both international and domestic investors will have withdrawal rights with respect to orders placed. As well as making the international and domestic offerings inter-conditional, the international banks should also consider including a mechanism in the international underwriting agreement for protection in the case of a reduced (as opposed to failed) domestic offering.[15]

D. PRICING

Timing and Upsizing the Deal

The timing of pricing is impacted directly by the Turkish law and practice regarding "upsizing" the deal and stabilization, the former referring to the selling shareholder(s)'s option to increase the size of the offering by up to 20% of the originally intended size (including primary and secondary components).[16] All descriptions relating to the

[12] Other domestic managers or any other Turkish investment banks may also review the valuation report and provide their own analyses, which will, like the valuation report, be made public.

[13] The first draft of the report will contain a valuation range that is in most cases wider than the final IPO price range. The approved version of the valuation report will contain the narrower price range included in the preliminary IOC and *izahname* and used during international and domestic book-building.

[14] This is earlier than the timing prescribed by the Turkish securities laws, which requires publication of the local valuation report at least three days prior to the start of book-building to domestic investors.

[15] This would avoid a situation in which the standard triggering withdrawal rights of Turkish investors does not match up to the conditions precedent to closing in the international underwriting agreement.

[16] Such upsize is not possible in offerings with no secondary component.

offering (for example, in public announcements made in respect of launch) should reflect the possibility of this occurring. In terms of timing, any decision to upsize will occur following the night of pricing, at the end of the international and domestic book-building periods. Book-building is typically scheduled to finish (and the final offering price to be determined) on a Friday. The allocation list is circulated to the issuer (and selling shareholder(s)) on the morning of the following Monday, and the "sale contract" with domestic investors will occur on that day under Turkish law following the approval of such list by the issuer and selling shareholder(s). At this time, the pricing term sheet will be circulated to international investors (and "time of sale" will occur for US securities law purposes). The intervening weekend is used to consider any "upsize" and finalise allocations.

This practice is sometimes referred to in the Turkish market as an "over-allotment," whereas in international practice, this term refers to the creation of a short position, typically settled using a share borrowing, intended to support stabilization activities, with the short position being closed out through market repurchases or the exercise of the "green-shoe" option. While a conventional over-allotment option structure is legally and theoretically possible in Turkey, it is very uncommon in practice.[17] Instead, as described below, a portion of the proceeds from the offering is used to effect stabilizing purchases in the after-market.

Irrespective of any "upsize," stabilization activity may still be carried out under Turkish law within 30 days of closing. Pursuant to a separate stabilization agreement, one of the domestic lead managers, as a stabilization manager, will have exclusive discretionary authority to undertake stabilization activities during the stabilization period. The number of shares that are repurchased in stabilization activities should not, at any one time, constitute more than 20% of the total offer size.

The primary proceeds of the offering may be used for the financing of stabilization activities, provided that such amount used does not exceed 20% of the gross amount of primary proceeds before any upsize. Under CMB regulations, if there are primary and secondary tranches in the offering, initially the proceeds from the secondary offering must be used to finance the stabilization activities, which is what typically occurs. In circumstances where the stabilization activities are funded out of the primary offering proceeds, the amount used may not exceed 20% of the primary proceeds. In such circumstances, consideration would have to be given to the implications of the effectively reduced offering size on use of proceeds and capital resources, particularly as a matter of disclosure.

E. CLOSING

Settlement

Payment for the shares is generally expected to be made in Turkish lira in same day funds. In practice, the syndicates of banks open custody accounts with a recognized Turkish depository for the investors in order to make payments of Turkish lira and take receipt of the shares. Upon settlement, a first-time issuer gains public status and becomes a public company under Turkish law.

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CLEARY GOTTLIEB STEEN & HAMILTON LLP
PAKSOY ORTAK AVUKAT BÜROSU

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[17] There is a general perception in Turkey that, save for fees/commissions, underwriters should not profit from the sale of the shares, a result that is, of course, possible in a conventional over-allotment structure. That said, we note the disconnect between this and the stabilization practice discussed in the next paragraph.