

Venture capital investment in Turkey: market and regulatory overview

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A Q&A guide to venture capital law in Turkey.

The Q&A gives a high level overview of the venture capital market; tax incentives; fund structures; fund formation and regulation; investor protection; founder and employee incentivisation and exits.

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Market overview

1. What are the main characteristics of the venture capital market in your jurisdiction?

With a rising number of start-ups, acquisitions by venture capital investment companies (VCIC) and venture capital investment funds (VCIF) have soared in recent years.

Alongside the Turkish Commercial Code, the Capital Markets Law No. 6362 establishes the ground rules governing venture capital (VC) firms and their investments and the Turkish Capital Markets Board (CMB) is entitled to regulate further matters in detail through secondary legislation, that is, communiqués.

The CMB has issued two communiqués:

- Communiqué on Venture Capital Investment Companies (VCIC Communiqué) governing VCICs (2013).
- Communiqué on Venture Capital Investment Funds (VCIF Communiqué) governing VCIF(s) (VCIF Communiqué) (2014).

These communiqués set out the requirements for the establishment, fundraising activities, and investments of VCICs and VCIFs. There has been a significant increase in the number of VCICs and VCIFs following the issuance of these communiqués.

Venture capital and private equity

There is no clear legal distinction between VC and private equity (PE) investments in Turkey. In practice, PE investments are more generally seen in targets with inadequate financial resources, and therefore with less profitability even if they have good potential, while "venture capital" refers to companies that acquire shares of newly incorporated and promising companies.

Market trends

There has been an undeniable decline in M&A activity in 2019 due to challenges faced in both global and local markets. That said, deals by VC firms and angel investors made up 30% of the total annual deals in 2019 and constituted a significant majority among the financial investor deals. Technology, internet/mobile services, and e-commerce appear to be the most popular sectors, attracting venture investors in 2019 with an average deal size of USD900,000.

Sources of funding

New companies seeking financial resources often return to VCICs and VCIFs. Given that early stage companies do not have the necessary resources and securities to obtain high volume loans, they prefer to cooperate with capital investors for financing. Even though operation risks shift to the capital investors, at such point, investors hope that the portfolio company is undervalued, and after it reaches its full potential, they will be able to exit from the investment by selling the acquired shares for a higher price.

Types of company

VC investing, that is, investing in early stage and start-up businesses, has been on the rise in Turkey in recent years. The number of VC and angel investment deals has risen dramatically in the last few years making up almost 80% of all financial investor deals in 2019.

Technology and mobile services were popular VC sector targets in 2019, whereas PE investments were divided between a number of industries, such as e-commerce, pharmaceuticals, food and beverage, and technology.

The total number and value of PE transactions in 2019 decreased in light of unfavourable market conditions. In 2019, only nine PE transactions took place. In comparison, the number of PE deals in 2013 was 35, with a total value of USD2.1 billion. In terms of invested sectors, there seems to be a shift from manufacturing to technology over the past few years.

Standardised investment terms

There is no requirement or established practice for using standardised transaction agreements or documents for VC investments save for prospectuses or issuance certificates at the fundraising stage.

Tax incentive schemes

2. What tax incentive or other schemes exist to encourage investment in portfolio companies? At whom are the schemes directed? What conditions must be met?

The revenues of VCICs and VCIFs are exempt from corporate tax. Dividends derived from VCICs' shares and VCIFs' participation shares are also exempt from corporate tax.

Share transfers by corporate shareholders who have held the relevant shares for more than two years as well as share transfers by all real person shareholders are exempt from value added tax.

As a general rule, share purchase agreements are exempt from stamp tax.

If the seller is neither a VCIC nor a VCIF, the gain the seller gets from the sale of its shares would give rise to corporate income tax of 20% if the shareholder is a legal entity. (There may be exemptions applicable to 75% of such gains subject to certain conditions provided that the selling shareholder has held printed share certificates representing the sold shares for at least two years.)

If the seller is a real person, the gain would be fully exempt from income tax provided that the sold shares represented by the printed share certificates representing are held by the seller for at least two years. If the shares sold belong to a company publicly traded on Borsa Istanbul, it is sufficient to hold the shares for one year before the sale to qualify for this exemption.

Funding sources

3. How do venture capital funds typically obtain their funding?

VCICs usually finance PE transactions through a combination of equity financing and debt financing. In terms of equity financing, the necessary funds are primarily raised through share capital increases and the sale of issued shares within the context of an IPO or private placement. Debt finance, on the other hand, is raised from a variety of banks and financial institutions. The VCIC Communiqué regulates the limits for indebtedness, and thus the availability of debt finance. A VCIC is permitted to be indebted, provided that the amount of the short-term borrowings with a maturity date (repayment term) of less than one year does not exceed half of its shareholders' equity, as determined in such VCIC's most recent independently audited financial statements, and that the amount of borrowings with a maturity date (repayment term) of one year or more does not exceed twice its shareholders' equity as determined in the most recent independently audited financial statements of the VCIC.

In recent years, VCICs have generally taken the IPO route for fundraising. While Verusaturk had one IPO in 2015, Hedef Girişim launched two separate IPOs in 2015 and 2018 and one is expected from Hub Girişim in 2020, all of which are VCICs incorporated in Turkey. For VCIFs, the only legally viable option is private placement to qualified investors.

Fund structuring

4. What legal structure(s) are most commonly used as vehicles for venture capital funds?

VC activity is carried out either through regulated formations such as VCICs and VCIFs. The VCIC Communiqué and the VCIF Communiqué have enabled the establishment and development of VC activities in Turkey.

5. Do venture capital funds typically invest with other funds?

VCICs and VCIFs are allowed to participate in co-investment activities although it is not commonly seen in practice. In fact, these kind of investments are encouraged by the Istanbul Venture Capital Initiative (ICVI) (Turkey's first ever dedicated fund of funds and co-investment programme) which is supported by European Investment Fund. Investors in ICVI include the:

- Small and Medium Enterprises Development Organisation of Turkey (KOSGEB).
- Technology Development Foundation of Turkey (TTGV).
- Development Bank of Turkey (TKB), Garanti Bank.
- National Bank of Greece Group (NBG).

Investment objectives

6. What are the most common investment objectives of venture capital funds?

The main strategy underlying the concept of VC is to acquire shares in newly formed or undervalued companies and exit from portfolio companies by selling shares through IPOs, private placements or individual sales. On average, a VCIC is expected to exit from a portfolio company after five to ten years when the projected turnover and profit has been achieved. The average life of VCICs or VCIFs varies between seven to ten years.

7. Can the structure of the venture capital fund affect how investments are made?

VC investments can be structured as VCICs or VCIFs as well as offshore VC/PE funds. Generally, offshore funds choose to incorporate a local special purpose vehicle (SPV) to acquire shares in Turkish portfolio companies. As for the exit strategy, the SPV sells its shares to a portfolio company, and following the sale, the SPV is generally liquidated.

VCICs must generally establish their investment portfolio within a maximum of three years of their incorporation (the first VC investment of the VCIC should be realised within 18 months of incorporation) and apply to the CMB with the necessary documents, including the prospectus and information for launching an IPO. The amount of shares subject to the IPO must be at least 25% of the company's issued share capital. If the IPO is launched through an offering of newly issued shares, then the amount of the offered shares should be equal to 25% of the company's total issued share capital following the share capital increase. The same timeline is applicable to private placements (that is, 18 months for the first VC investment and three years for launching a private placement). Private placements are subject to less strict standards than the IPO process.

Fund regulation and licensing

8. Do a private equity fund's promoter, principals and manager require authorisation or other licences?

VCIFs must be founded and managed by portfolio management companies or VC portfolio management companies licensed by the CMB.

VCIFs are represented by the board of directors of the founders, who are subject to certain qualifications (that is, five years' experience in VC investments). Founders should also form an investment committee comprising board members, a general manager and a person with five years of VC experience.

VCICs are incorporated in the form of joint stock corporations, the incorporators/shareholders of which can be real persons or legal entities that are not subject to any licensing requirements. VCICs can be managed by a CMB-licensed

portfolio management company or portfolio managers. There are also certain qualification requirements imposed on members of the board of directors and the general manager (such as VC experience and a university degree).

9. Are venture capital funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions?

Since VCICs and VCIFs are different legal structures, there are fundamental differences in their organisation. VCICs must be incorporated in the form of joint stock corporations, while VCIFs are funds without legal personality. However, both are subject to the authority of the CMB.

Marketing or advertising VCIFs in all kinds of media is prohibited excluding publicity and advertisements directed specifically at qualified investors.

Marketing or advertising VCICs during the IPO stage is allowed subject to certain restrictions. If a VCIC eventually opts for the sale of its shares via a private placement to qualified investors, and decides to make advertisements and announcements to that end, it must explicitly state in the relevant advertisements and announcements that the sale will not be conducted as a public offering but will instead only concern qualified investors. The board of directors of the VCIC would be held liable for any fraudulent or misleading information contained in these advertisements.

10. How is the relationship between investor and fund governed? What protections do investors in the fund typically seek?

For VCIFs, in addition to fund bye laws (*fon içtüzüğü*), issuance certificate (*ihraç belgesi*) and the relevant legislation, the main document governing the relationship between the fund and its investors is the investment agreement (*yatırım sözleşmesi*). There are no organisations that provide guidance or propose "best practices" for funds and the investor/fund relationship; however, as per the VCIF Communiqué, the investment agreement must include at a minimum any matters not covered by the fund bye laws and the issuance certificate. Information on privileged fund participation shares, if any, must be included in the investment agreement (as well as the bye laws and the issuance certificate). The investment agreement must also include principles regarding fundraising conditions (for example, payment terms, payment plans, upper and lower limits, and payment default provisions).

The VCIF Communiqué states that it is possible to include the holders of privileged participation shares in investment committees of the VCIFs and obtain their opinion regarding the selection of the venture enterprises and portfolio managers and the determination of the exit strategies.

Interests in portfolio companies and securities regulation

11. What form of interest do venture capital funds take in an investee company? Are there any restrictions on direct investment in a company's equity securities by foreign venture capital funds? What regulations govern the offer and sale of securities in venture capital transactions?

Forms of interest

Both the VCIF Communiqué and the VCIC Communiqué impose certain portfolio restrictions on VCIFs and VCICs.

VCICs can invest in portfolio companies, participate in their management and provide consultancy services to the same. Subject to certain exemptions, investments in portfolio companies must make up at least 51% of the portfolio value of VCICs. Investments in portfolio companies also cover debt instruments issued by portfolio companies. To diversify their portfolios, VCICs can invest in capital markets instruments that are being traded in secondary markets; reverse repurchase transactions on a stock exchange; Takasbank money market transactions and investment fund participation shares; and participation accounts or deposit accounts both in Turkish lira and foreign exchange. VCICs cannot invest in capital market instruments or monetary market instruments issued by a single company in an amount exceeding 10% of their portfolio value.

For VCIFs, venture investments must make up at least 80% of the portfolio.

Restrictions on direct investment

Although there are no restrictions regarding foreign investors in terms of share purchase transactions, some industries such as the aviation and media sectors may require other specifications regarding the nationality of investors.

Securities regulation

While the Turkish Commercial Code applies to all M&A transactions, specific rules regarding securities and capital markets are provided in the Capital Markets Law and the secondary legislation issued by the CMB. Depending on the target and the purchaser, filings with governmental authorities can also be required (such as the Turkish Competition Authority).

Valuing and investigating investee companies

12. How do venture capital funds value an investee company?

The most preferred valuation methods are asset valuations, historical earnings valuations, future earnings valuations, and discount cashflow valuations.

13. What investigations do venture capital funds carry out on potential investee companies?

In general, investigations undertaken by VCICs or VCIFs during a takeover are not very different from ordinary M&A transactions. It is common for target companies to undergo several due diligence exercises in financial, tax, legal, and technical related matters and businesses.

Legal documentation

14. What are the principal legal documents used in a venture capital transaction?

Before the conclusion of a contract, parties generally draft a memorandum of understanding, the provisions of which are not binding, to lay out the backbone of the contemplated transfer agreement. In addition, parties agree on non-disclosure agreements and exclusivity agreements as well. Usually these matters are incorporated in memorandum of understanding as separate clauses.

Having agreed on the principles, parties negotiate and sign a share purchase agreement, and in partial takeovers, also sign a shareholders agreement to set the rules between shareholders regarding administration of the company.

Every change to the article of association (AoA) must be published in the *Official Trade Registry Gazette*. Since changes made to the shareholder structure require a modification in the AoA, new shareholders and the amount of their contributions to the share capital must be publicly available through the Trade Registry Gazette. As for companies listed in Capital Markets, all new information that might affect investors' positions and decisions must be disclosed on the Public Disclosure Platform (KAP) alongside other information disclosure duties specified in the Turkish Commercial Code.

Protection of the fund as investor

Contractual protections

15. What form of contractual protection does an investor receive on its investment in a company?

Investors in a portfolio company (including VCICs and VCIFs) can have board appointment or board nomination privileges attached to the shares they hold. It is also common for them to have veto rights over certain matters regarding the management of the company.

These protections are usually set out in the shareholders' agreements and the articles of association of the portfolio company.

They can also have share transfer restrictions (such as lock-up periods, exit rights, options, right of first refusal, drag-along or tag-along) and principles regarding management of the portfolio company. Dividend policies (and/or dividend privileges) must be governed in the shareholders agreement to be executed between the VCIC/VCIF and the controlling shareholder (the shareholder with management control) in the relevant portfolio company.

Forms of equity interest

16. What form of equity interest does a fund commonly take (for example, preferred or ordinary shares)?

Investors more commonly prefer holding privileged shares that offer favourable rights regarding dividends or board representation.

Preferred shares

17. What rights does a fund have in its capacity as a holder of preferred or preference shares?

Privileged (preferred) shares under Turkish law can have board appointment/nomination, dividend, or voting privileges.

Management control

18. What rights are commonly used to give a fund a level of management control over the activities of an investee company?

Investors in a portfolio company (including VCICs and VCIFs) can have board appointment or board nomination privileges attached to the shares they hold. It is also common for them to have veto rights over certain matters regarding the management of the company.

Share transfer restrictions

19. What restrictions on the transfer of shares by shareholders are commonly contained in the investment documentation or the company's organisational documents?

Call/put options, lock-up periods, and tag/drag along rights are examples of common share transfer restrictions. Since the incorporation of such restrictions in the company's articles of association is very controversial, they remain as a contractual commitment included in the shareholders agreement.

20. What protections do the investors, as minority shareholders, have in relation to an exit by way of sale of the company?

Minority shareholders mostly have tag/drag along rights under the shareholders agreement.

In addition, according to the CMB legislation, in the event of the acquisition of shares leading to a change of control in the listed company (that is, the acquisition of more than 50% of the shares or voting rights or the right to nominate a majority of the board), the buyer is required to launch a mandatory tender offer for the remaining shareholders.

Also, as a general rule, shareholders holding at least 10% of a company's share capital (5% for listed companies) are deemed minority shareholders and benefit from a number of minority rights (for example, can prevent the release of board members and request liquidation of the company).

Pre-emption rights

21. Do investors typically require pre-emption rights in relation to any further issues of shares by an investee company?

Under Turkish Law, pre-emption rights for newly issued shares already exist for all shareholders and therefore there is no need for investors to require any specific terms.

Consents

22. What consents are required to approve the investment documentation?

A share purchase agreement is entered into between the buyer and the seller and the company itself does not participate in the share purchase agreement. However, following the execution of a purchase agreement, the target's board of directors must pass a resolution approving the relevant share transfer subject to the ordinary quorum requirement under the Turkish Commercial Code (a simple majority). If the target itself constitutes a major asset for the seller, disposal of the target's shares can require the approval of three-quarters of the seller's shareholders.

Costs

23. Who covers the costs of the venture capital funds?

Pursuant to the VCIF Communiqué, overhead costs are covered by the funds' own assets.

Portfolio company management

24. In what ways are founders and employees incentivised? What are the resulting tax considerations?

Compensation packages and equity-based incentive arrangements are used to incentivise key employees or founders that are active in the management of portfolio companies. One possibility, and the most common, is to grant to the management minority shares equal to 1 to 3% of the company's shareholding, together with tag-along rights in favour of the management to ensure a prompt exit, if necessary. Stock options plans are also an option for incentivisation.

Incentives

Tax

25. What protections do the investors typically seek to ensure the long-term commitment of the founders to the venture?

Non-compete provisions incorporated in shareholder agreements are very common and useful to ensure the long-term commitment of shareholders. Despite this, change of control non-compete restrictions surpassing three years risk that being interpreted as unenforceable.

Exit strategies

26. What forms of exit are typically used to realise a venture capital fund's investment in an unsuccessful company? What are the relative advantages and disadvantages of each?

Should the investment fail to generate the expected revenues, investors can pursue an exit plan through put options, if they were negotiated in the shareholders agreement or the share purchase agreement. The fund can also try to negotiate a share sale deal with the company's existing shareholders or other prospective shareholders.

27. What forms of exit are typically used to realise a venture capital fund's investment in a successful company? What are the relative advantages and disadvantages of each?

The generally used form of exit is a trade sale. However, there have been a number of IPOs and secondary buyouts in the previous years.

Advantages and disadvantages

- Trade sales are advantageous because they are relatively easy to arrange.
- IPOs are likely to yield better proceeds for the investor but are more complicated to launch.
- As secondary buyouts are sales between two VCICs, VCICs or PE funds, the negotiation process is likely to move faster, but this type of exit tends to result in lower profits for the parties.

28. How can this exit strategy be built into the investment?

It would be wise to negotiate share transfer provisions such as put and call options or tag/drag along rights in the shareholders agreement by specifying the detailed conditions to secure safe exit from the company. Investors can also acquire preferred shares that offer privileges on dividend distribution to benefit from the profits at a maximum. Board nomination and voting privileges as well as veto rights are also very favourable. It is also useful to build alternatives like IPOs, private placements or trade sales into the shareholders agreement as a potential exit option.

Reform

29. What recent reforms or proposals for reform affect venture capital in your jurisdiction?

There are no current or upcoming reforms or legislations affecting VC companies.

Contributor profiles

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Areas of practice. Corporate and M&A; competition; capital markets.

Recent transactions

- Represented Scientific Games in the establishment of a joint venture between Scientific Games and a member of the Demirören Group.
- Represented Telia Sonera in the sale of the company's subsidiaries throughout the Eurasian region and the acquisition of shares in Fintur Holding.
- Assisted Arcelormittal France in the management buy-out of the one of the Group's Turkish subsidiaries through a 100% share transfer to the subsidiary's former CEO.

Languages. Turkish, English, French

Professional associates/memberships.

- President of International Law Institute (ILI), Istanbul Chapter.
- Board Member of Transparency International- Turkey.
- Board Member of the Corporate Governance Association of Turkey (Türkiye Kurumsal Yönetim Derneği, TKYD).
- Member of the Ethical Values Association, Etik Değerler Merkezi (EDMER).

Publications

- *Chambers & Partners – Global Practice Guides: Data Protection & Privacy 2020, Trends & Development and Law & Practice chapters, March 2020, co-author.*
- *Thomson Reuters – Practical Law, Employees (private company acquisitions) Q&A: Turkey, January 2020, co-author.*
- *IBA European Regional Forum, Turkey Regulates Online Streaming Platforms, December 2019, co-author.*
- *Hergüner Bilgen Özeke Newsletter – An Important but Overlooked Rule: Board Members and Conflicts of Interest, Summer 2019, co-author.*

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Recent transactions

- Assisted Newrest Group Holding in the acquisition of a large company operating in the dining halls and catering operations industry.
- Represented Johnson Controls Holding in the sale of its 48% shareholding stake in Karat.
- Assisting a major investment holding company with their investment in a carbon black plant.

Languages. Turkish, English, French

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- Member of International Law Institute (ILI), Istanbul Chapter.
- Member of the Corporate Governance Association of Turkey (Türkiye Kurumsal Yönetim Derneği, TKYD).

Publications

- *Law Business Research - Getting The Deal Through: Risk & Compliance Management, April 2019, co-author.*
- *Hergüner Bilgen Özeke Newsletter – An Increasingly Popular Tool in M&A Transactions: Warranty & Indemnity Insurance to Optimize Risk Allocation, November 2019, co-author.*
- *Hergüner Bilgen Özeke Newsletter – New Corporate Governance Compliance Report Templates: Efforts to Build Better Investor Confidence and Engagement, April 2019, co-author.*

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Recent transactions

- Assisted in the acquisition of a major personal care products manufacturer
- Carried out the collective execution proceedings of a major infrastructure company.
- Assisted in the acquisition of disputed industrial land.

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Professional associates/memberships. Member of the Lycée Français Privée Saint-Joseph d'Istanbul Alumni Association.

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