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LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY

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Economic outlook for the second quarter 2012

We predict that the Iranian economy will shortly experience another sharp contraction as a result of the implementation of the EU ban on Iranian oil imports, and the US designation of the Central Bank of Iran (CBI).

Following the moves by the UAE government to curtail Iran's access to banking channels in Dubai, and to restrict Iran's access to Dirham trade, Iran has very few banking channels left to access its oil revenue and foreign currency reserves.

We expect that many of the remaining channels, such as Halk Bank in Turkey, will cease to operate by June this year. We also expect that Iran's remaining oil customers in the Far East will cut their purchases of Iranian oil by as much as 40%, and that Turkish and Indian oil refineries will also cut their purchases from Iran. Iran's principal oil import destination, China, has also been cutting its purchases in recent months together with other key importers, Japan and South Korea.

As Iran's customers continue to look for alternative suppliers, with Saudi Arabia increasingly stepping in to fill the gap, Iran has been forced to offer steep discounts, as much as USD 15 per barrel in some cases, in order to cling on to its remaining customers.

Iranian banks previously sanctioned by the EU have also been disconnected from the Society for Worldwide Interbank Financial Telecommunication (SWIFT) network. Without access to SWIFT to process electronic payments,

Iran will need to implement a costly and time consuming new system in order to do business with the vast majority of foreign banks whieh currently use SWIFT. Analysts are predicting that this will severely impact Iran's financial sector, with some even going so far as predicting the collapse of the Iranian economy.

Bleak prospects for the Rial

The CBI has failed to defend the official exchange rate for the Rial and has announced that money exchange houses are free to trade the Rial at the unofficial rate. Our sources in Iran say that the rate currently offered by most exchange houses is around IRR19,000:USD1. The CBI expects the unofficial rate to slip to around IRR25,000:USD1 in the coming weeks. We expect that the Rial could fall to as low as IRR50,000:USD1 over the course of 2012. Outside of Iran, exchange houses in Dubai are being overwhelmed with Rials, and many of them are refusing to trade Rials for USD. Those that are trading are quoting IRR23,000:USD1.

We anticipate that Iranian banks will experience further insolvency problems as customers continue to withdraw Rial-denominated deposits and convert them into foreign currency and gold. We also expect that when, following its sanctioning by the US it loses access to oil revenues, the CBI will have to print Rials to fund the budget, to make subsidy payments, and to prop up the banking sector. We expect that this will cause a sharp increase in inflation which will worsen the outlook for the Rial.

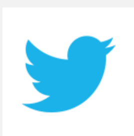
With confidence in the Rial rapidly disappearing as its value when measured against foreign currencies plummets, many savvy businessmen including landlords, bazaaris, and traders are starting to demand payment in USD.

Outlook for Iran's retail banking sector

Non-performing loans (NPLs) in the banking system as a whole totalled USD 50 billion in 2010, according to publicly available information. In March 2011, capital funds held across the banking system, including government-owned development banks and specialized credit institutions, amounted to USD 28 billion. It is unrealistic to think that the banks will suffer a total loss on their NPLs, but if the likely recovery rate is less than 40% (i.e. USD 2O billion) then the banking system is technically insolvent, because if banks wrote down their loan portfolios today to their true value, their capital funds would be wiped out.

We are particularly worried about the health of Bank Saderat as over 24% of its loan portfolio is non-performing. We recommend that investors withdraw their deposits from Bank Saderat. As confidence in the Rial dips further, and as Iranian depositors become aware of the risks that Saderat is insolvent, we expect Saderat to experience further bank runs. As this happens, Saderat would likely impose tough restrictions on depositors which will make it extremely hard to withdraw their deposits from the bank.

At present, Iranian banks are continuing to open Letters of Credit, but with little hard currency to back them with. This has led to problems honouring Letter of Credit, damaging their credibility. It remains to be seen how this will affect exporters willingness to continue to trade with Iran.



Insights – Iran's inability to access its forex reserves

As sanctions bite further, the CBI has lost access to its USD 70 billion of foreign exchange reserves. Iran has up to USD 30 billion in China, but the Chinese government has refused to allow Iran to move any of this money outside of China. Iran can only use these reserves to buy Chinese goods and for barter. Iran has a further USD 15 billion in Japanese bonds which it is also unable to repatriate. Much of its remaining forex reserves are tied up supporting the foreign branches of bankrupt Iranian banks.

Due to these increased difficulties experienced in repatriating foreign currency holdings, and unprecedented public demand for foreign currency, the CBI has seen its reserves depleted by close to USD 25 billion over the last two years. We expect that this trend will accelerate.

Insights – Mobarekeh Steel facing increased difficulties

Iran's domestic industry continues to see a slow-down in output caused by the combined effects of international sanctions, and misguided economic policies imposed by the Ahmadinejad government.

As previously highlighted in issue 6 of VERITY, Mobarakeh Steel, Iran's largest steel producer, has been finding it increasingly difficult to obtain bank loans to finance operations. The increasing difficulties experienced by Mobarakeh Steel are a good illustration of the detrimental effects of sanctions and economic mismanagement on a core sector of the domestic economy. Mobarakeh has seen the costs of certain imported components rise by as much as 500% due to problems experienced in opening letters of credit, the plummeting value of the Rial, and the effects of international sanctions; key suppliers have also severed ties with Mobarakeh due to fears of sanctions breaking or possible reputational damage in dealing with an Iranian company.

On top of this, the government has forced through the hiring of tens of thousands of additional, mostly un-skilled, employees in state-controlled companies, including Mobarakeh Steel, in order to fulfil government promises of creating 2.5 million jobs by the end of Persian year 1390.

At the same time, the government has imposed price-freezes on domestically produced manufactures, meaning that companies have to bear the full cost of the rising price in imports.

The interest rate on business loans has also recently risen to in excess of 30% making them unaffordable for most companies.

Insights – The Unsustainable Targeted Subsidies Plan

Debate in the Iranian Majlis is growing increasingly heated as the budget deficit, blamed largely on the economic policies of President Ahmadinejad, continues to widen. Iran's MPs and analysts can not agree on a definitive figure for the deficit, with estimates ranging from USD 15 billion to USD 37 billion by the end of year 1390.

Although factors such as the effects of international sanctions and a decrease in crude oil production have undoubtedly contributed to the deficit, the main driver would appear to be the introduction of targeted subsidies paid

to individuals to compensate for the increasing cost of petroleum products, electricity, and basic food-stuffs which were previously subsidised by the Government.

The budget set aside to pay for these subsidies to individuals has woefully underestimated their true cost, covering only 42% of the money being paid with the short-fall being taken from holdings in the CBI and ministries, such as that for Health which itself now faces a budget deficit of USD 2 billion.

Worse still, the money being paid to compensate for price rises is insufficient to keep pace with spiralling inflation; and there are now plans in place to increase the prices of water, gas, and electricity, which will only add to the hardship experienced by the lower and middle classes in Iran.

Analysis – Iran's Economy Increasingly Reliant on Barter

Iran's economy is an increasingly complex maze, difficult for even experienced businessmen to navigate. As the CBI experiences ever tightening sanctions, the flow of hard or reserve currencies such as the Euro, USD, Japanese Yen and the GBP continues to shrink, forcing Iranian companies, agriculture producers and the oil sector to accept payment through non-reserve currencies such as the Indian Rupee, Chinese RMB, or through barter.

Non-reserve currencies are not accepted for third party transactions since they are not universally accepted in international commerce. Goods for barter are less liquid and require additional middlemen and their fees. In recent months Iran has accepted up to 45% of the purchase price of oil in Rupee, RMB, or South Korean Won. Bartered goods further weaken Iranian companies since they must accept Indian or Chinese goods that may not meet the high quality standards required for Iranian business or consumers.

As the sanctions against the Central Bank take hold, it will become increasingly difficult for Iran to receive payment for the sale of oil and other products. Iran already discounts its oil price by 10%-15% to attract Chinese and Indian purchasers and the tightening sanctions against the CBI will bring severe penalties on any financial institution that facilitates payments for Iranian goods or services. Iran will become increasingly reliant on barter transactions.

Currency Recommendations

We expect the Japanese Yen to continue to weaken against the USD. The Japanese government is serious about its 1% inflation goal and political pressure to get out of deflation is strong. The Japanese current account continues to deteriorate. Meanwhile, the US economy continues to strengthen and Natural Gas price declines are changing US energy dynamics. The Australian dollar should weaken to around l:USD1. Monetary policy is still tight and Chinese demand for natural resources is moderating.

Buy: USD, Canadian dollar
Sell: Japanese Yen, Australian dollar

Market Recommendations

Sell: Bank Saderat; Continue liquidation of other bank holdings
Sell: Mobarekeh Steel
Strong Sell: Agriculture Stocks
Sell: Oil stocks
Sell: IRR for reserve currencies

Statistics

GDP growth
-2 % (2012 best case estimate)
vs. IMF estimate: 3.4%
vs. CBI estimate: 3.5% – 4.5% (1388)

Inflation
Currently >40%
vs. IMF estimate: 21.6% (by March 2012)
vs. Official figure: 20.6%

Liquidity growth
21% (Official estimate)

Unemployment
Over 35% in much of the country
vs. Official figure: 11.5%

Exchange Rates
USD:Rial
CBI figure: IRR12,260:USD1
vs. Unofficial figure: IRR19,000:USD1