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LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY

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The Rial has further to fall

Following the opening round of discussions between Iran and the P5+1 over Iran's nuclear programme which both sides described as positive and constructive, it was reported that the unofficial Rial exchange rate offered by Exchange Houses has climbed to around IRR16,500:USD1. This marks a rise of some 23% from 19,000, the rate it had stabilized at since the Central Bank of Iran (CBI) removed restrictions on the rate at which the Rial could be traded. The Tehran Stock Index also rose to a record high of 27,241 points following the discussions.

However, it is very likely that this trend will not continue; until a comprehensive settlement is reached on the nuclear issue, US and EU sanctions and restrictions which are due to be implemented in the coming months are likely to proceed as planned. We expect that ahead of the implementation of the Kirk-Menendez/National Defence Authorization Act legislation on July 1st barring any US financial institution from doing business with any foreign financial institution conducting significant financial transactions on behalf of the CBI, the CBI is likely to lose some key banking relationships, most notably in Turkey, which is now processing the majority of Iranian oil revenue. We expect this, and the dramatic fall in Iranian oil sales described below, to cause another sharp collapse in the Rial, possibly taking the Rial nearer to IRR30,000: USD1 – i.e. a 40-50% fall along similar lines to what we saw in December/January when the UAE restricted financial services to Iran.

VERITY Exclusive – The alarming state of Iran's oil sector

Iran, unable to find a willing buyer for its oil, is being forced to utilize its tanker fleet to store 60 million barrels of unsold supplies. With further sanctions imminent, Iran may be forced to significantly reduce its output adding further strain to its already struggling economy.

Iran amassing huge stock piles of oil as US sanctions bite

According to our sources, the National Iranian Oil Company (NIOC) has amassed a stockpile of more than 60 million barrels of crude oil which it has been unable to find a buyer for. The amount has risen sharply in recent months due to mounting international pressure on Iran's key customers. At current market rates, the stockpile represents an unrealized potential income of USD 7 billion for Iran. In addition, Iran has been forced to utilize more than half of its tanker fleet to store the oil due to a lack of on-shore storage facilities.

The key factors behind the accumulation of this stockpile are importers either cancelling or significantly reducing their import quotas from Iran in order to comply with US sanctions targeting the import of Iranian crude oil, combined with the threat of sanctions to banks involved in facilitating oil payments of behalf of Iran. The International Energy Agency has speculated on a 30% decrease in Iran's oil exports by the summer.

In recent weeks;

- Japan announced that it has reduced its imports of Iranian crude oil by close to 80% in April compared to the first two months of 2012.

- China cut its imports by 50% in March compared to a year earlier, while South Korea cut imports by 40% for the same period.

- Across Europe, imports of Iranian crude fell by 75,000 bpd (close to 40%), in April compared with the beginning of the year as the implementation of the EU ban on importing Iranian oil draws closer.

Huge sums owed to NIOC remain unpaid

Iran is experiencing growing difficulties in receiving payments for shipment of the crude oil which it is still managing to ship, particularly from European and Indian buyers who are struggling to find correspondent banks willing to handle payment transactions which are destined for the CBI. Banks which are still handling transactions are charging premiums of 20% on payments for oil which the NIOC is forced to absorb. Despite not receiving payment, the NIOC has continued to ship oil to the majority of these customers. According to our sources, the amount of debt accumulated during the 12 months to March 2012 amounted to in excess of USD 6 billion with close to USD 4 billion owed by Indian refiners alone.

EU measures bring further misery to Iran

EU measures announced in January 2012, and due to be implemented on July 1st prohibit the provision of insurance or reinsurance services for the import, purchase or transport of Iranian crude oil by companies registered in EU member states. Iran's customers have begun to express serious concern over their ability to acquire adequate insurance cover for vessels transporting oil from Iran and have warned that they will have no choice but to cancel shipments if such cover cannot be provided. In an attempt to counter these fears, we understand that the Iranian government is seeking to under-write the insurance for such shipments by setting up its own insurance companies to provide cover for their tanker fleet; however, most mortgage arrangements for shipping vessels clearly state that vessels must be covered by top tier, triple-A rated insurers as a primary condition of the loan covenant. It can only be a matter of time before those companies providing loans to Iran begin to call into question the legitimacy of this cover with serious consequences for Iran's ability to ship its oil.

With little alternative available, the governments of countries such as Japan, South Korea, and India are having to consider providing sovereign guarantees to protect importers against the risk of pollution or personal injury claims. Such guarantees will take several months to implement, meaning that in the interim Iran's ability to sell oil to these customers will likely be seriously restricted. Further, the disruption this will cause for buyers will only make the prospect of relying on Iran for their energy needs even less attractive and encourage them to seek alternative suppliers such as Saudi Arabia.

Future outlook for the oil sector

Recently, Ahmed Qalebani, the Managing Director of the NIOC, announced ambitious plans to increase Iran's oil output by over 50% to 5.1 million barrels per day (bpd) over the next three years. The more likely scenario is that Iran will have to significantly reduce its oil output, especially once the effects of the additional EU and US sanctions, due to be implemented in July, are felt.

According to the latest monthly OPEC report, Iran's crude oil production for March fell to around 3.4 bpd, while Iran's Oil Ministry reported that daily domestic consumption stands at 1.7 bpd, leaving Iran with only around 1.7 bpd for export. This may reflect the fact that Iran's mature oil-fields have begun to decline in production as financial constraints and sanctions have severely limited the technologies available to Iran. According to the Middle East Economic Digest (MEED): "Iran risks becoming a net oil importer if output rates continue to fall". According to MEED, conservative estimates suggest Iran needs to replace at least 300,000 bpd of oil production a year as its fields mature.

The NIOC's failure to find a buyer for much of its oil supply; its inability to receive payment for the oil that it is still shipping; and the premiums charged by correspondent banks willing to handle transactions on behalf of Iran, as well as by any insurer willing to provide cover for Iran's oil tankers, combined will deal a major blow to Iranian government revenues in the coming months. With the introduction of further sanctions, failure to reach a comprehensive settlement with the E3+3 at the next round of negotiations could see this trend continue further, or even be exacerbated as investors loose confidence in Iran's willingness to make the needed concessions.

Market Tips
Heavy Sell recommendation: Oil Production sector (if privately held)
Strong Sell recommendation: Oil Refinery sector (if privately held)
Strong Buy and Hold recommendation: Oil Import Sector (if privately held)

Ahmadinejad's Subsidy Reform measures again causing chaos

The Subsidy Policy Reform Organization (SPRO) confirmed that an additional 280,000 Rials (approx USD 15) were deposited into the accounts of all Iranians registered to receive subsidy payments on the 18th March, signalling the start of the second phase of the Ahmadinejad administration's economic liberalization measures. However; the budget for 1391 has still not been passed by the Majlis having been submitted too late for consideration before Nowruz. In fact, the Majlis passed legislation prior to Nowruz postponing implementation of the second phase of the economic liberalization measures until the summer. This has resulted in recipients being unable to withdraw any of the additional 280,000 Rials deposited for the time being.

This move by the Ahmadinejad administration has been widely condemned by his political opponents. Majlis speaker Ali Larijani warned that the measures could create waves of inflation and do not help either production or employment.

The SPRO has also sent text messages to thousands of what it deems to be middle class or wealthy Iranians asking them to opt out of the subsidy reform programme given their "financial strength".

Rising inflation and "The Year of National Production"

The effects of the Ahmadinejad government's weak economic management, combined with international sanctions linked to Iran's intransigent stance on its nuclear programme have resulted in a rapid rise in inflation in recent months which is now being widely criticised by Iranian MPs and the media despite the government's efforts to down-play this. The Head of the CBI Mahmoud Bahmani, recently identified the accelerating rate of inflation as the single most important political subject for year 1391. The conservative website Batab predicts that, taking into account import delivery lags, the Rial's devaluation on the open market will begin to make an impact in late Spring and Summer, driving the inflation rate up to 50%.

While year 1390 was dubbed the Year of Economic Jihad by the Supreme Leader, he has dubbed the year 1391 as "The Year of National Production and Supporting Iranian Labour and Capital", reflecting the recent slump in domestic output which has led to the loss of tens of thousands of jobs in the production sector. Overall, the Statistics Center of Iran reported that unemployment rose by 2.3% in the first three months of 2012, bringing the official rate to 14.1%.

Statistics

GDP growth
-2 % (2012 best case estimate)
vs. IMF estimate: 3.4%
vs. CBI : 3.5% – 4.5% (1388)*
* Most recent year for which GDP figure has been published

Inflation
Currently >50%
vs. Official figure: 21.5%

Liquidity growth
21% (Official estimate)

Unemployment
Over 35% in much of the country
vs. Official figure: 14.1%

Exchange Rates
USD:Rial estimate for June/July 2012: IRR30,000:USD1
CBI figure: IRR12,260:USD1
vs. Unofficial/Black-market figure: IRR16,500:USD1