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LEADING INDEPENDENT ANALYSIS OF IRAN'S ECONOMY



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ContactUs@VerityIran.com



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Market Tips

Market Overview:

In our last issue, we recommended that investors buy gold. The gold price has since risen above USD 1,792 per troy ounce, driven by instability in the international financial markets. The price is likely to rise further driven by speculative purchasers who are following large purchases made by central banks. However, investors need to exercise caution as further increases will be driven more by speculation than by fundamentals; gold could be vulnerable to a steep correction in the longer term. Platinum is more likely to outperform in the medium term.

Currency Tips:

As we have said in previous issues, we remain negative on the prospects for the Iranian Rial, as we do not believe the Central Bank of Iran (CBI) will be able to defend it at its current level. We expect that the Rial could halve from its current level as the US and European governments ratchet up pressure on the Iranian economy. We therefore recommend that investors switch into USD, which remain fundamentally undervalued over the long term. We remain cautious about the Euro. For more exotic currency ideas, we recommend investors buy/long Norwegian Kroner and Renminbi. We recommend that investors sell/short Euro, GBP and Japanese Yen. The Swiss Franc may be subject to more speculative buying but it is fundamentally overvalued.

Stock Recommendations:

Iran Transfo's woes continue. The Ministry of Energy owes the company USD 330 million, but is unwilling to repay the debt, and the company was added to sanctions blacklists in May 2011 because of its involvement in building the Qom nuclear facility, which means its international trading partners will no longer do business with it.

As a result, the company plans to halve production from September, following a short-term suspension of production. But the situation has deteriorated even further than the company is admitting, and we have heard that it is expected to



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close permanently and lay off its staff once raw materials stocks run out in late 2011. **SELL.**

Insights – Debt owed to the Central Bank of Iran

The CBI is becoming increasingly concerned at the high and escalating levels of debt owed to it by the Iranian government and banks. The Iranian government and government-linked companies owe the CBI USD 25 billion, an increase of over 50% over last year, mainly due to the high cost of the subsidy reform plan. Iranian banks owe the CBI a further USD 34 billion, an increase of 80% over last year. We continue to recommend that investors sell Bank Saderat and Bank Tejarat (both of which may soon be sanctioned).

Insights – Falling Foreign Exchange Reserves and Oil Revenue

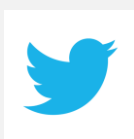
The differential between the official Rial exchange rate and the market rate has persisted (currently 11% but has been close to 20% in recent months), and the CBI's commitment to settling its trades at the official rate is running down its already stretched foreign exchange reserves.

Excessive spending has left no cushion if the oil price or oil production falls, as the Foreign Exchange Reserve Account (FERA) is in deficit. We expect that the international oil price will continue to trend lower in the short term, driven by concerns about a US double-dip recession, persistent economic worries in the Eurozone and restrictive monetary policy in India and China. We expect that the Saudi government will continue to sustain oil production at current levels to fund the generous handouts to the Saudi public in the light of the Arab Spring. At the same time, Iranian oil production is likely to decline by 400,000 barrels per day by the end of 2011, as several phases of the South Pars oil and gas project are running substantially behind schedule, which will also squeeze the budget. The decline in Iranian energy production, coupled with international financial and trade sanctions against Iran, is beginning to show through in the trade figures: exports to Iran from the EU fell by over 7% in the first half of 2011 compared with exports for the same period in 2010, with exports from Iran's two principal European trading partners, Germany and Italy, falling by close to 20%.

The US sanctioning of Tidewater Middle East Co. PLC (Tidewater), predicted in our previous newsletter, has already caused international shipping giant Maersk to withdraw oil business from Iran. It is likely that Tidewater will also be sanctioned by the EU. Iranian trade, which is 85% dependent on shipping, could be severely affected by increased costs leading to higher inflation.

Insights – Expanding IRGC Ownership of the Iranian Economy

The recent decision to appoint Brigadier-General Rostam Qasemi, former head of Khatamolanbia, as Oil Minister is likely to put the Islamic Revolutionary Guards Corp's (IRGC) expanding share of the Iranian economy increasingly in the spotlight. Our estimates are that the IRGC now controls about USD 35–40 billion worth of business per year. Put in context, annual Iranian oil sales are USD 85 billion. The continued shift of economic power to the IRGC is very unpopular in Tehran as many small businessmen are being forced to sell their businesses to the IRGC. The Iranian regime is risking the Iranian economy by allowing the IRGC to dominate critical industries such as crude oil, shipping and finance, making them highly vulnerable to international sanctions: the IRGC is already partly sanctioned by the



UN and sanctioned in its entirety by the EU. The US Treasury's decision to sanction Tidewater is likely to be an opening salvo – we expect that other IRGC-owned companies will soon be designated.

VERITY's Track Record

In its short history, VERITY has built an impressive track record for accurately predicting financial events in Iran:

VERITY 1

- We correctly forecast an impending devaluation of the Rial, which fell by 11% the following week.

VERITY 2

- We correctly predicted that the US Treasury would sanction Tidewater.

VERITY 3

- Following our insight into Iranian government problems meeting subsidy payments, the payments were delayed by two weeks.
- Following our stock recommendation to buy shares in copper, the share prices for Bahonar Copper (BAHN), and National Iranian Copper Industries Co. (NICIC) performed strongly over the past month.

Statistics

GDP growth

-1% (2011 best case estimate)

vs. *IMF estimate* 1%

vs. *CBI estimate* 3.5–4.5% 1388

Inflation

Currently 40%+

vs. *CBI estimate* 15.4%–24%

1390 (Forecast) 70%+

Liquidity growth

24% (2010 estimate)

Unemployment

Over 35% in much of the country

Forex Reserves

> USD 80 billion

Foreign Exchange Reserve Account

(Oil Stabilisation Fund)

< USD 3 billion



Government and private sector debt to banks

USD 29 billion in Dec 2010



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