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Market Tips:

Liquidity crisis in the banking sector:
In the wake of the USD 2.8 billion embezzlement scandal, we have found out from industry insiders that the Dubai branch of Bank Saderat Iran is amassing an unsustainable level of debt, believed to total close to USD 2 billion. It is also known that the bank has exhausted its foreign currency holdings, including USD and Euros. Insiders believe that if UAE regulators were aware of Bank Saderat Dubai's liquidity crisis, its banking licence in Dubai would be withdrawn.

Recommendation: **STRONG SELL BANK SADERAT**

Implications of the Saudi bomb plot:
Following the news of a possible Islamic Revolutionary Guard Corps-Qods Force (IRGC-QF) plot against the Saudi Ambassador in Washington, the international community is likely to dramatically increase financial pressure on Iran. One possibility being actively discussed is a US designation of the Central Bank of Iran (CBI). This is causing serious headaches for Iranian government and banking officials who fear that the Iranian government will no longer be able to receive oil revenues.

It is also highly likely that as a direct response to the IRGC-QF plot the EU and the US will look to sanction IRGC-linked companies. Possible targets are: BAHMAN GROUP (BHMN1); IRAN INDUSTRIAL DEVELOPMENT INVESTMENT (TOSA1); IRAN MINERAL PROCESSING (FRVR1); IRAN TELECOMMUNICATIONS CO. (MKBT1); IRAN TRACTOR FORGING (ATIR1); IRAN ZINC MINES (ROOI1); JABER HAYAN PHARMACEUTICALS (DJBR1); KHARK PETROCHEMICAL (PKHA1); MOBARAKEH STEEL (FOLD1); NORTH DRILLING (HSHM1); SADID PIPE (LSDD1); SAIPA (SIPA1); TIDEWATER (TAYD1) (already US designated).

Steel industry in difficulty:

Since the imposition of UN, EU, and US sanctions against Iran's nuclear program, Iran's banks have become more detrimentally affected by economic shocks. In particular, the banks are undercapitalized and plagued by a large and growing portfolio of non-performing loans (NPLs) in excess of USD 40 billion. These undercapitalized banks cannot supply businesses with sufficient capital and meet market demand thereby hindering the operation of businesses that depend on them. In the past, when Iran's banking sector was endangered by a large portfolio of NPLs, it received a capital injection from Iran's Oil Stabilization Fund. Unfortunately, the Fund can no longer provide capital injection to the banks because the Fund's assets, once valued in excess of USD 70 billion, are now virtually non-existent. The mismanagement and misuse of the Funds assets imperil Iran's steel industry. The steel industry is finding it increasingly difficult to obtain bank loans to finance operations. Every aspect of Iran's economy is affected by international sanctions and economic growth is retarded. The question at hand is whether the government will allocate a sufficient portion of the oil revenues to replenish the Fund and whether banks will recover to enable private businesses to flourish.

Steel Sector Recommendations: SELL

Stock Recommendation: MOBARAKEH STEEL (FOLD1) & KHORASAN STEEL (FKAS1)

Sector recommendation: RECONFIRM STRONG SELL

Insights – Government Liquidity Crisis

This month the CBI again tried to increase interest rates to encourage deposits in the Iranian banking sector, but this was rejected at the last minute by Ahmadinejad who continues to promote an expansionary and therefore inflationary monetary policy. Behind the scenes, the situation is even worse than it seems. It appears that Ahmadinejad has severely depleted government reserves. He has taken USD 16 billion from the National Development Fund (which is currently empty), as well as 120 trillion Rials from Privatisation Funds. The CBI has run out of dollars and is forcing Bank Mellat, a private bank, to supply dollars to the CBI on demand. This means that Bank Mellat is no longer able to discount letters of credit for Iranian customers.

Insights – Continuing problems with the exchange rate

The CBI is increasingly unable to support the exchange rate. Despite their interventions earlier in the month to drive the unofficial exchange rate back to IRR 12,000:USD 1, the rate has slipped back to IRR 13,000:USD 1. We hear that Iranian officials are predicting that the rate will slip to IRR 15,000:USD 1. We think this is too optimistic based on the CBI's current liquidity crisis and IRR 20,000:USD 1 is a more realistic prediction by March 2012.

IRR target revised to IRR 20,000:USD 1

Insights – Iranian oil exports continue to decline and oil price likely to come under further pressure

Because of a shortfall in imported petroleum products, Iran is exporting 2.1 million barrels of crude oil per day (bpd) rather than the 2.5 million bpd that the government claims, which means that the government income from oil sales will decline by USD 14.6 billion. While sanctions and underinvestment continue to be a problem for the Iranian oil sector, Iraq is benefiting from huge levels of investment and rapid increases in production levels. There has also been a quick recovery in Libyan oil production which is predicted to return to 1 million bpd by early 2012. This steep rise in production is likely to dent oil prices and may explain why the Saudis are cutting production.

Statistics

GDP growth
-1% (2011 best case estimate)
vs. IMF estimate 2.5%
vs. CBI estimate 3.5–4.5% 1388

Inflation
Currently 40%+
vs. CBI estimate 15.4%–24%
vs. IMF estimate 22.5%

Liquidity growth
21% (Official estimate)

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