

*Endangered Asiatic Cheetah, Miandasht Wildlife Refuge, North Khorasan province, Iran*

## **Market Overview** \_\_\_\_\_ **2**

The Tehran Stock Exchange (TSE) continued its five-month negative trend and experienced a 3.2% decline in May, resulting in a 13.5% fall since the beginning of 2014. The average P/E of the market stood at 6.6 at the end of May after the height of 8.5 on January 2<sup>nd</sup> 2014, reaching its two-decade average of 6. The auto industry was the best performing sector of the market with 10% increase in its index.

## **Country Overview** \_\_\_\_\_ **5**

Recent trends in the number of foreign tourists visiting Iran and foreign relation developments in Iran will be covered in this section.

## **Economy** \_\_\_\_\_ **7**

Inflation, housing market, and foreign exchange market will be discussed in this section.

In May, the TSE experienced a 3.2% decline for the fifth consecutive month, resulting in a 13.5% fall since the beginning of 2014.

After the exceptional performance of 2013, the TSE is now in a slump with no real sign of improvement in sight. Meanwhile, the Vienna nuclear negotiations have not been able to provide a positive signal for buyers and therefore, demand in the market remains unstable.

The lack of growth in the market stems from three important factors: the first is the continuation of an economic recession in the country, which shows the sluggish pace of development, the second is the stability of the exchange rate which affects the profits of some important sectors on the stock market, and the third is the cautious approach of traders in regards to the possible nuclear agreement; although the general consensus is positive, some vital challenges still remain. Taking into consideration the combination of these three factors, the limited enthusiasm from investors seems logical and it does look like little will change from now until the end of July (which corresponds to the current timeline proposed for a nuclear agreement).

We will now examine in detail a few important sectors that have been volatile this past month:

### Automotive

Although this industry is now facing huge problems, it is possible that political developments can have a great impact on its well being and this is why short term investors favor buying these stocks. These investors have chosen the auto sector over the past year or so due to its potential for improvement and investment environment where news and rumors can cause a real move in prices. In May, the 10% jump in the index of this industry (which resulted in it being the best performing industry on the TSE) was the result of an improvement in production and the possibility of foreign collaboration in the production of new cars. Last month, the news of the government allocating the hard currency at the official exchange rate to automakers in order for them to import materials (which is some 25% less than the unofficial rate), caused a 6% increase in the index in April.

The most influential reason for the growth in the auto sector in May was the announcement of production increases at Iran-Khodro and Saipa to more than 2000 units per day in the past two months; this is 96% more than the same period last year. In comparing this production number to the most challenging days over the past two years (where production had decreased to one third of this current amount), we can see a large improvement. However, although the increase in production has temporarily taken pressure off working capital and liquidity for automakers, the main problems of this sector remain. One of these issues is the huge amount of high interest rate debt that this industry has to banks and the other is that automobile prices have doubled due to exchange rate having tripled over the past few years; this is not profitable since costs of raw material have gone up substantially. Further increase in automobile prices will certainly affect the consumer market and will challenge the domestic market's capacity to absorb more than 1.2 million automobiles. Meanwhile, state officials also don't have a positive outlook on the increase in automobile prices, which is fixed by the government, and the Industries Minister has stressed that prices need to stabilize. That being said, there is some news of the sale of non income generating assets (such as shares of companies and some buildings or land) in the Saipa group and Iran Khodro which can result in the sustainability of growth of this sector in the short run.

Taking into consideration all of the above, we should highlight that a closer look at the financial statements of these automobile companies shows that their current economic and financial situation has a long way to go before reaching normality and stability. Although, this recent positive news may stimulate some price increases, in reality, it will take a much longer time (three to five years) along with substantial monetary relief (some \$1 billion) to reform this sector's financial structure and bring it out of its current dire circumstances.

### Basic Metals

In May, there was a huge decrease in trading of different metals on the Mercantile Exchange. In line with this, most metals supplies either have not

been sold or have met with little demand. The significance and importance of these issues increases when we take a closer look at the regional prices of steel; in looking at the current price of the product and the exchange rates, the price of imported steel counting transportation becomes higher than the price traded on the mercantile exchange. Therefore, it can be said that the weak demand is such that domestic prices are below regional prices and there is no news in the market suggesting a significant demand increase. With regards to copper also, there has been little demand for recent supplies. These factors hint at the struggles in many sectors in the economy, especially in construction. Taking into consideration that the government has limitations in injecting monies into construction (due to the budget deficit) and the change in status of the Mehr Housing Project from development to completion, it seems like the recession in the basic metals market and related products will remain in the short run and as a result, the growth in prices of shares of metals and mining companies will remain weak. With this atmosphere, the shares of the metals sector also experienced challenging times in May and had an average fall of 2.6%.

### Cement Industry

In May, the cement sector did not have a good performance either with a 2.2% decrease in its index. The average price of energy (which is 25% of total costs for cement production in Iran) has increased by 30% during the past month in the midst of the implementation of the second phase of the subsidies reform plan and some problems in production and sales can be seen. In line with this, according to official statistics, during the past year, growth of domestic consumption of cement has been negative for the first time in the past two decades. This has resulted in a record amount of cement exports at 18 million tons and also a record of 14 million tons of unsold cement which is kept at various factories. With Iranian producers impacting prices in the Iraqi market, despite the elimination of Turkish competition, cement prices in the Iraqi market have also faced a big hit of 25% and reached \$75 per ton. The price of exports of cement is now \$50 per ton for producers that are close to the border (in Ilam, Kurdistan and Khuzestan province) and

prices are lower for producers that are further away due to transportation costs. Due to the excess supply of cement in the domestic market, the cement trade union is looking to make a deal with the government to allow a 14% to 22% increase in prices in June.

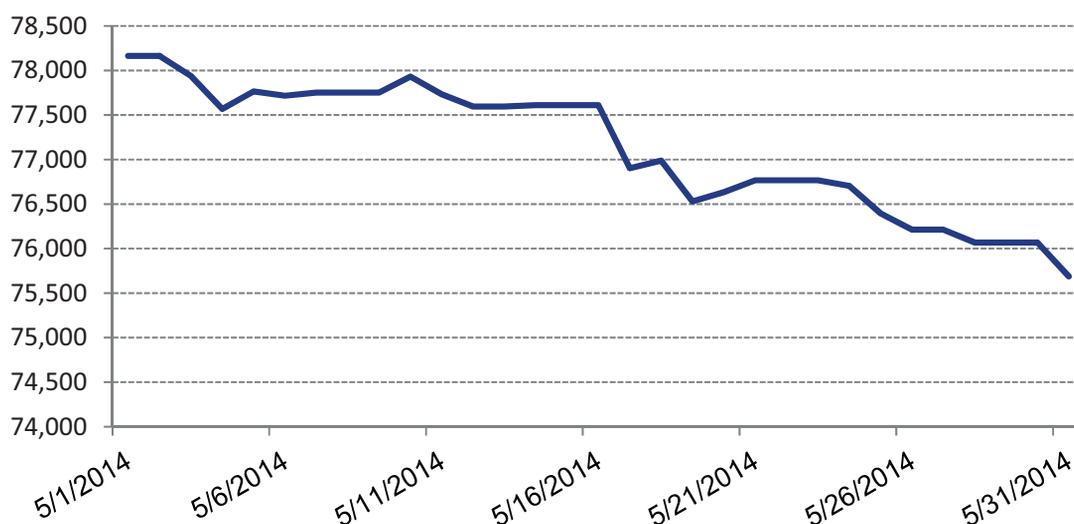
### Investment Companies

In accordance with recent reports from the National Audit Office, from the start of the Iranian year (March 2014), all companies have to report their short term investments at fair value instead of cost. This framework impacts the reported profit of companies even though investment companies have not yet sold those investments and profits have not been realized. From the other side, tax laws don't have a way to deal with this unrealized profit and there is a huge question on whether or not this income will be taxed. Since investment companies have been experiencing an increase in investment values over the past two years, it is expected that there will be a jump in first quarter profits. However, we need to take into account that this is a non-cash income and a onetime event, and that there are major tax concerns.

### Market Valuation

In the end of May, the average P/E of the market reached 6.6 after experiencing a height of 8.5 on January 2<sup>nd</sup> 2014. The P/E of the market after paying dividends in coming AGM's will reach 6; this number is the average equity valuation over the past two decades. Therefore, it can be said that the current price of shares are neither high nor low and the future direction of the market will be determined by company performances as well as the level of investors' optimism. Taking into consideration the timeliness of economic reforms and the stability of macro factors such as the exchange rate and inflation which affect company profits, it seems that in 2014, the predictions for company profits will remain at roughly the same levels of some \$17 Billion. Therefore, in taking into account the relative stability of company profits, the direction of the TSE in the short term will likely be determined by the optimism of investors towards the long term picture, especially in regard to the upcoming nuclear talks in July.

Performance of TSE All-Share Index (May)



Market Statistics (May)

Average P/E	6.1
Trade Volume (\$ Billion)	3.1
Trade Value Monthly Change (%)	- 8
Market Cap (\$ Billion)	142

Top 5 Traded by Value (May)

Rank	Company Name	Turnover Value (\$Million)	% of Total Turnover
1	Iran Khodro Industrial Group Co.	142	9
2	Saipa Co.	102	7
3	Sepahan Oil Co.	77	5
4	Pasargad Bank	63	4
5	Tabriz Oil Refining Co.	54	3

Top 5 Companies by Market Cap (May)

Rank	Company Name	Market Cap (\$Million)	% of Total MC
1	Persian Gulf Petrochemical Industry	15,100	11
2	Bandar Abbas Oil Refining Co.	6,430	5
3	Esfahan's Mobarakeh Steel Co.	5,924	4
4	Tamin Oil & Gas & Petrochemical Inv. Co.	5,521	4
5	Ghadir Investment Co.	4,929	3

All figures quoted in USD in this Newsletter are calculated based on the Central Bank of Iran's official USD/IRR exchange rate of 25,580, as at 31 May 2014. Due to Central Bank's revision on the official exchange rate of the Rial, TSE's market capitalization and trading value in USD have reduced dramatically.

### Surge in number of foreign tourists visiting Iran

In recent months following the Geneva agreement relating to Iran's nuclear program and the improvement of bilateral relations between Iran and many other members of the international community, the country has seen an increased influx of tourists. Even though the number of tourists visiting Iran had increased in recent years due to a sharp devaluation of the Iranian currency, the most recent increases in tourism numbers have been striking.

According to the head of Iran's Cultural Heritage, Handicrafts and Tourism Organization (CHTHO), Mr. Masoud Soltanifar, the number of foreign tourists who visited the country in early April has increased by 150 percent in comparison to the same period last year. This number has risen by 240 percent for the number of European tourists in the same period. Mr. Soltanifar stated that when taking Shia pilgrims into account who visit religious sites in Iran, the number of foreign tourists who have visited Iran from March 2013 to March 2014 have been more than 4 million; each of these contribute \$1,200 on average to the country's tourism revenues.

The number of tour groups that visited Iran from March 21st to April 20<sup>th</sup> this year has been 4,594 which is more than double the same period last year. Furthermore, Mr. Soltanifar also stated that most 4 and 5 star hotels in tourist destinations such as Isfahan, Shiraz, Yazd and Kashan have been fully booked by European tourists for the first six months of the Iranian year (March to September).

Since the election of President Rouhani and a thaw in relations between Iran and other states, international hotel chains have shown interest in returning to Iran; this would be a first since the Islamic Revolution of 1979. Some European airlines have also re-established their flights to Iran and the ones who were already operating are planning to increase the number of flights. International tour agencies have also reported a surge in demand for travel to Iran in recent months and have expressed interest for an expansion of their operations to Iran. Tour operators are

also expecting a larger number of applicants for travelling to Iran after official advisories against travel to Iran have been lifted by some Western states.

This year, the Financial Times placed Iran as one of top destinations for 2014, while many other media outlets have reported on the increased travel opportunities to the country. Iran ranks as one of the world's top tourist destinations in terms of cultural, historical and geographical attractions. However, after the Islamic Revolution in 1979, the 8 year war with Iraq in the 1980's, and the recent disputes between Iran and Western powers regarding Iran's nuclear program, the number of tourists to the country have not lived up to the country's tourism potential.

### Foreign Relation Developments in Iran

In May, EU foreign policy chief Catherine Ashton and Iran's Foreign Minister Mohammad Javad Zarif met in Istanbul to discuss issues regarding Iran and the P5+1 nuclear negotiations. This meeting was unannounced and no representatives from the P5+1 other than Ms. Ashton were present. According to reports, the content of this meeting was a comprehensive study of the progress made regarding nuclear negotiations thus far, as well as laying the groundwork for high-profile talks which were to take place in Vienna on June 16<sup>th</sup>.

Other developments on the nuclear negotiations included direct talks between Iran and the US in Geneva. The two day negotiations came ahead of the planned June 16<sup>th</sup> meeting in Vienna in order to discuss the differences that remain on reaching a comprehensive agreement. According to officials from the Iranian government, a head to head meeting with the Americans was extremely important as most sanctions stem from the US. The meeting began with a five hour session; this was the first time since the 1979 Islamic Revolution that US and Iranian negotiators have held direct, official nuclear talks. Media reports suggest that the two sides have met unofficially before, notably in Oman last year, which helped set negotiations in motion.

Also in June, the Iranian delegation and Russian Deputy Foreign Minister Sergei Ryabkov held discussions on Tehran's nuclear program in Rome. The negotiations took place as part of bilateral discussions between representatives of Iran and the six world powers ahead of the main Vienna meetings set for June 16<sup>th</sup>.

Iran started official talks with six world powers in Vienna on June 16<sup>th</sup> in order to reach a final agreement in regards to its nuclear program. In this three day meeting, both parties hoped to build on the interim deal made in November which promised some sanction relief in exchange for voluntary limitations on nuclear related activities. According to reports, Russia's Deputy Foreign Minister, Sergei Ryabkov, said that the group will have to work extremely hard in order to reach a comprehensive deal by July 20<sup>th</sup>. At the end of the meeting on June 20<sup>th</sup>, Mr. Ryabkov said that they don't yet know what the end deal will be. According to officials from the Iranian side, it is yet not evident whether or not these talks have been successful as there are still a number of steps left which need to be taken before July 20<sup>th</sup>.

The Iranian Foreign Minister, Mr. Zarif, said that Iran is willing to address world concerns regarding its nuclear program while keeping its legal rights. The fifth round of Iranian nuclear talks concluded on the 20<sup>th</sup> of June in Vienna with relative progress on drafting the framework of a final deal, while questions over a number of topics remained.

Another development on Iran's foreign relations this month was President Rouhani's visit to Turkey. Mr. Rouhani was the first Iranian president to go on an official state visit to Turkey in the past 18 years. He went to Istanbul for talks regarding expansion of trade links between the two countries and to improve bilateral ties which have been affected due to disagreements over the Syria conflict. Prime Minister Erdogan and President Rouhani discussed the strengthening of the relationship between the two countries as well as working towards regional stability. President Rouhani stressed that both countries have the same goals which is wanting the Middle East to be free not just of nuclear weapons but of all weapons of

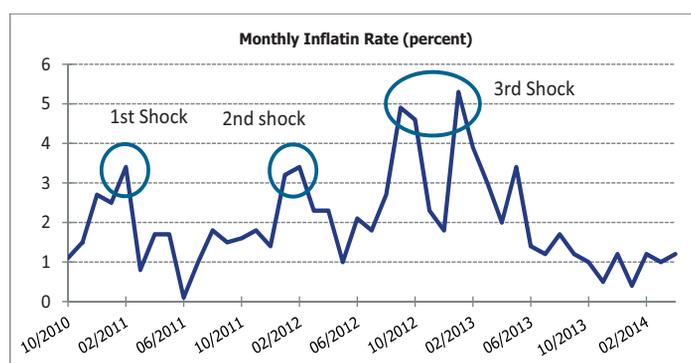
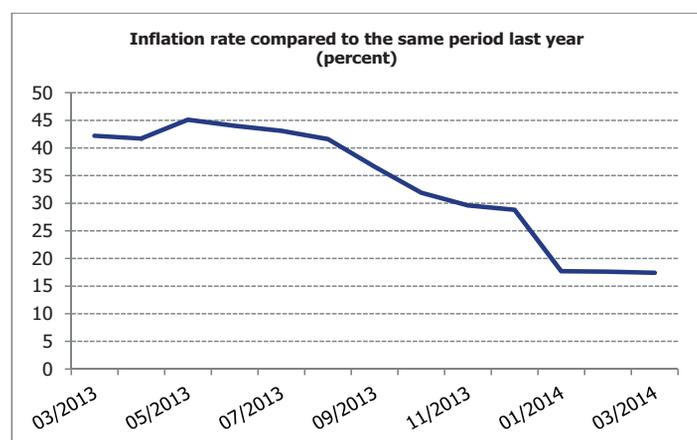
mass destruction. The Turkish Prime Minister also elaborated that his country supports Iran having a peaceful nuclear program and is in strong favor of sanctions being removed. President Rouhani also called for a nuclear free Middle East and stated his willingness to build stronger ties with Turkey.

**Inflation**

According to the Central Bank of Iran (CBI), the average annual inflation rate dropped by 2.2% and stood at 28.4% in April 2014. The point-to-point inflation rate also dropped from 42.2% in May 2013 to 17.2% in April 2014. The monthly inflation rate has been less than 1.5% in the past 11 months. However, the consumer price index reached 190.8 in April 2014, showing an increase of 1.2% compared to the previous month. This is while two major events in the past couple of months had led to expectations of an inflationary shock. In the past two months, the government initiated its second phase of the smart subsidies reform plan and also increased petrol prices by an average of 60%. Contrary to common belief, these events, that were previously anticipated

to have substantial inflationary pressure, did not impact prices as expected.

In the hope of identifying the best economic policies to control inflation, the research centre of the parliament conducted a study recently that examined the causes of inflation in the past few years. The study shows three inflationary shocks in the past three years. The first shock immediately followed the implementation of the first phase of the subsidies reform plan between January and March 2010. The second and third inflationary shocks followed the two instances of exchange rate fluctuations in February 2011 and September 2012. Although the research pinpoints the influence of producer price growth and exchange rate fluctuations on inflation, it conclusively attributes the high inflation rate to international sanctions and the subsidies reform plan.

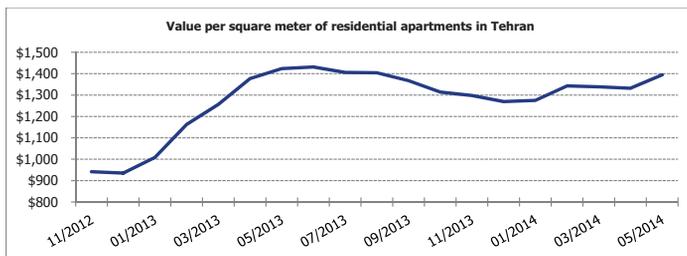


The impact of redistributing cash subsidies from the three highest income deciles of the population to various sectors (percent)					
	Not removing cash subsidies	Allocating the subsidies to the agricultural sector	Allocating the subsidies to the industrial sector	allocating the subsidies equally to all sectors	Allocating the subsidies to the health sector
Increase in production (percent)	24.1	26.51	24.34	24.17	24.34
Increase in income of factors of production (percent)	13.3	14.7	12.25	13.26	14.14
Increase in households' income (percent)	18.82	17.13	14.97	15.6	16.11
Ratio of the income change of the two highest and the two lowest income deciles	2.33	1.75	1.46	1.55	1.62
Ratio of the income change of the highest and lowest income deciles	2.82	2.31	1.93	2.04	2.13

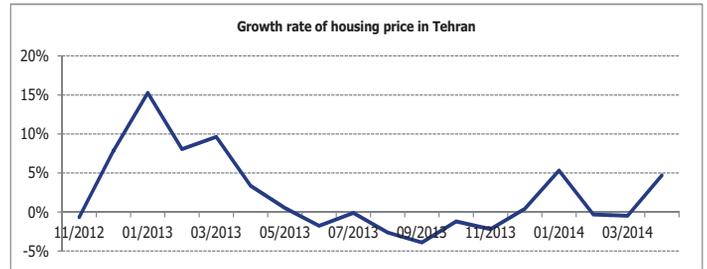
In the second phase of the study, the research centre of the parliament investigated four hypothetical scenarios for allocating cash subsidies of the three highest income deciles of the population to the agricultural sector, industrial sector, all sectors, or health sector. The results show that the worst economic outcome is when the subsidies are distributed equally to all people, as before. The best outcome is achieved if these resources are allocated to the agricultural sector.

### Housing Sector

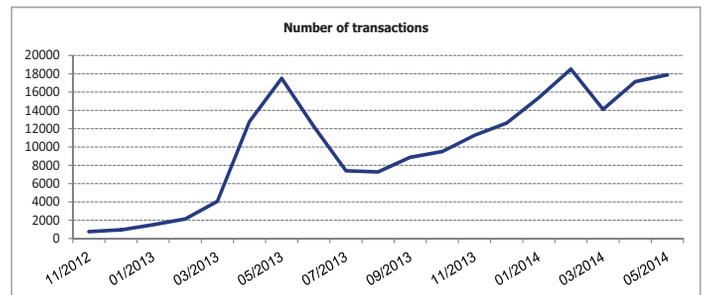
After a year of unstable housing prices, the housing market's fluctuations seem to have dampened in the recent months. In only four months between December 2012 and April 2013, housing prices increased by 52% in Tehran. Prices grew up to a level where they reached almost \$1431 per square meter in June 2013 (1\$=30,000 rials). However, this trend quickly reversed in subsequent months. Between June 2013 and January 2014, housing prices followed a downtrend and dropped to \$1275 per square meter. In the past five months, the fluctuations in the housing prices have been as negligible as \$35 per square meter on average.



Currently, the market is in a period of transformation and seems to be becoming more stable. Based on the most recent data documented by the Ministry of Road and Urban Development, housing prices grew by 6% between March 2013 and March 2014. This is while the point-to-point (housing price) inflation rate was negative every month between November 2013 and March 2014. Although the point-to-point inflation rate has been positive in the past two months, it has remained less than 5%. Housing prices were 3% higher in April 2014 and 2% in May 2014 compared to April and May 2013.

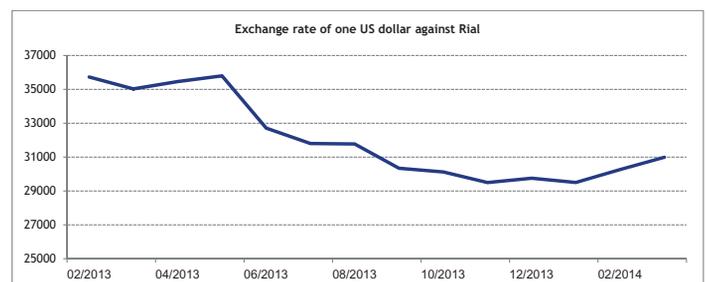


The number of transactions shows a positive correlation with the growth rate of housing prices. In the same period when housing prices were soaring between December 2012 and May 2013, the number of transactions increased from 738 to 17497. Following this increase, the number of transactions dropped to 7403 in July 2013 and remained less than 10,000 until December 2013 while housing prices were decreasing. Trade in the sector gradually went back to its normal level and the number of transactions reached 17883 in May 2014, which is nearly the same as the 17497 signed in May 2013.



### Foreign Exchange Market

The value of the US dollar against the Rial dropped by 11.5% between March 2013 and March 2014. The US dollar has been depreciating in nine of the past thirteen months. This depreciating trend in the exchange rate has been mainly attributed to factors influenced by events such as nuclear talks between Iran and the West. However, supply and demand in the market seem to be supporting this downturn regardless of political developments.



On the supply side, the rise in oil and gas exports and the easing of obstacles for non-oil exports have guaranteed a higher inflow of foreign currencies than in the recent past. On the demand side, the relative stability of the market and the inflation rate has helped manufacturers to utilize their productive capacities while creating a demand for trading companies to increase their imports. However, this rise in demand for foreign currencies is a result of real demand for products not a result of speculative activities. Another factor involved in substantiating the relative calm in the foreign exchange market is the public trust in the government's plans, which has helped prevent speculative behaviour in foreign exchange market. With these factors having a downward influence on demand and the boom in international trade having an upward influence on the supply of foreign currencies, the depreciation of the exchange rate seems to be backed by market laws regardless of psychological factors.

Nonetheless, members of the research centre of the parliament believe this stability is likely to be short-lived unless the government has a guaranteed reserve of foreign currencies. Believing that the exchange rate must be determined by market laws of supply and demand, these members believe the government needs to reduce the gap between the official and unofficial exchange rates if its purpose is to achieve a unified exchange rate system.

## About Turquoise

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Turquoise publishes this electronic newsletter, *Iran Investment Monthly*, with the aim of keeping its recipients updated on the latest macroeconomic developments in Iran, providing an in-depth analysis of the Tehran Stock Exchange as well as introducing new financial products and private equity opportunities to potential investors.

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