



*Train carriage-building workshop of Pars Wagon Company, Arak*

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

This month's market overview will examine the reasons behind the Tehran Stock Exchange (TSE) delivering its best monthly performance in the past nine months. A detailed analysis of the petrochemicals, banking and mining and base metals sectors is provided, along with coverage of two IPOs and bond issuance.

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

The visit of an IAEA inspection group to Tehran and the assassination of another nuclear scientist will be discussed in this edition of Country Overview.

## **Special Report** \_\_\_\_\_ **7**

This report will examine the factional divisions ahead of the upcoming Iranian Parliamentary elections in March.

## **Economy** \_\_\_\_\_ **11**

The Central Bank of Iran's decision to impose a single foreign exchange rate against the US dollar, the liberalisation of deposit interest rates, the EU's decision to embargo Iranian oil and an analysis of the effects of this embargo on Chinese buyers of Iranian oil will all be covered in this section.

## **Turquoise Iran Equity Investments** \_\_\_\_\_ **15**

This section provides data and charts on the performance of Turquoise Iran Equity Investments Class A for the month of January.

This month transpired to be an exceptionally good month for the Tehran Stock Exchange (TSE), with a 6.2% leap in the TSE's main index. This proved to be the best monthly performance since April last year, after several rather challenging months.

The main reason behind this bullish market sentiment was a series of strong Q3 corporate earnings reports. Exporters in particular have been the main beneficiaries of the devalued Rial and the Rial's devaluation on the unofficial foreign exchange market has been significantly helping the balance sheets of these companies.

Despite a notable rise in the profitability of these companies, the opportunity cost has been a sharp fall in their PE ratios, indicating investors' aversion to risk in recent months. The average PE of the overall market looks set to be heading towards a 52-week low of below the 6.0 level in the coming weeks. The ten-year average PE of the market is 5.5 and we look set to see the average PE falling to a similar level in coming months.

**We shall now examine several sectors of the TSE:**

### **PETROCHEMICALS**

This sector, of all the TSE sectors, has the greatest exposure to exports and, as a direct result, has benefitted the most from the devalued Rial. The sector accounts for 7% of the total market capitalisation of the TSE and climbed 9% on the month. Analysts are now revising profit forecasts upwards by between 50-100% for the upcoming Iranian calendar fiscal year. This has made the sector highly attractive as an investment proposition, with a PE ratio of 6 gaining the attention of investors, although risks still remain, largely surrounding problems in receiving payments from overseas buyers in foreign currency. The largest company operating in this sector, Pardis Petrochemical, saw its stock surge 8.5% this month.

### **BANKING**

In the final week of this month, following stern opposition from the Ministry of Economy and

senior government figures, the Money and Credit Council eventually approved measures liberalising the bank interest rate setting mechanism, following the volatility seen on the foreign exchange and gold coin markets. The decision was made to allow banks to raise savings deposit interest rates in the hope of absorbing some of the excess liquidity in the markets and inducing calm to the turbulent investment climate. In the days that followed the announcement to liberalise interest rates, the initial plans were revised and curtailed to only allow up to a 5% increase in 1-5 year savings rates. The Iranian capital market welcomed this important announcement and banking sector stocks were buoyed by this news, closing the month up 6.9% on average. However, in the final few days of the month, as investors grew weary of this decision denting banks' profitability in the medium to long term, growth in banking sector stocks slowed.

### **MINING & BASE METALS**

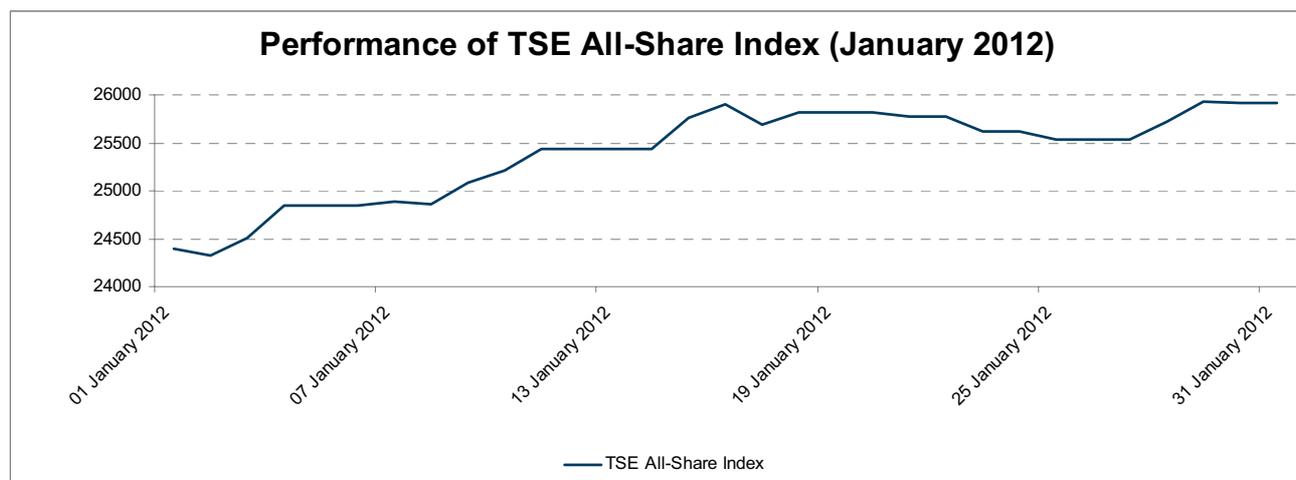
The most important development in this sector this month was the lifting of a previously-imposed suspension on trading in the stocks of the two largest iron ore producers and two holding companies composed of their shareholders. Following this decision, 12% of the market capitalisation of the TSE was returned to trading status and assisted in unlocking some liquidity of mutual funds and institutional investors. The suspension was enforced following proposals by the state obligating these companies to pay \$30 per tonne (\$17 to be paid by iron ore producers and \$13 by steelmakers using the iron ore as a raw material). This fee was imposed as a form of government royalty and was strongly opposed by companies operating in the sector. Following a four-month period of intense lobbying at the highest levels of government, the state eventually backed down on its demands and lifted the suspension it had imposed to penalise non-conformists. The sector index ended the month largely unchanged and all four companies previously suspended resumed trading on the TSE without any significant drop in share prices, despite large numbers of sell-offs from disillusioned investors.

### IPO

This month, after a period of one year that saw no privatisations under Article 44 of the Iranian Constitution, a logistics company named The Persian Gulf Transportation Company was IPOd on the TSE. The IPO took place on 8<sup>th</sup> January 2012, with a market capitalisation of \$42.7m and 5% of the company was offered and sold to the market. This company used to be a profitable firm but, this year, largely due to significant hikes in energy prices following the mass withdrawal of state energy subsidies, was profit neutral. Despite this, the market looked favourably on this stock largely due to the value of the company's assets rather than profitability.

### OTC

The Farabourse had a busy month with a bond issuance and an IPO. The bond issuance was used by the state to fund the manufacture of passenger train carriages and wagons. Around \$40m of bonds were issued and sold within seconds of launch. The bond itself was three-times oversubscribed by investors hungry for fixed income in the current volatile investment climate. The bond is a 4-year coupon paid at a 17% overnight rate. This month's IPO was a real estate construction company named The Tehran Land Company, owned by Maskan Bank, Iran's largest real estate sector creditor. The IPO took place with a market capitalisation of \$57m and 10% of the company was listed with a PE value of 3.8, which proved to be highly attractive to buyers and resulted in a 10% rally in the days that followed the IPO.



Market Statistics	
Average P/E	6.6
Trade Volume (\$ Billion)	1.2
Trade Value Monthly Change (%)	20
Market Cap (\$ Billion)	103

Top 5 Traded by Value			
Rank	Company Name	Turnover Value (\$million)	% of Total Turnover
1	Isfahan Mobarakeh Steel Co.	239	19
2	Pasargad Bank	94	8
3	Mellat Bank	88	7
4	Isfahan Sugar Co.	53	4
5	Ghadir Investment Co.	35	3

Top 5 Companies by Market Cap			
Rank	Name of Company	Market Cap (\$Million)	% of Total MC
1	Telecommunications Co. of Iran	12,202	12
2	National Iranian Copper Industries Co.	7,098	7
3	Isfahan Mobarakeh Steel Co.	6,469	6
4	Pasargad Bank	4,612	4
5	Ghadir Investment Co.	4,233	4

Rate of US\$ vs. IRR (www.cbi.ir)  
January 2012: US\$ 1 = IRR 12,260

### **Natanz Nuclear Scientist Assassinated in Tehran**

This month, an Iranian university professor working at one of the country's main uranium enrichment facilities was killed in Tehran. He was apparently the latest victim in what is widely seen as a covert war against Iran's nuclear programme.

Attackers riding on motorcycles are reported to have attached a magnetic bomb to a car carrying Mostafa Ahmadi Roshan, a 32-year-old chemistry expert from Tehran's Sharif University who held the position of a Deputy Director for Commercial Affairs at the Natanz nuclear plant in central Iran. Ahmadi Roshan's expertise was in making polymeric membranes for gaseous diffusion, part of the process needed for the enrichment of uranium.

Iran's nuclear programme has suffered a series of dramatic setbacks in recent years with the assassinations of its scientists in attacks similar to the one that killed Ahmadi Roshan using an identical modus operandi. In November 2010, Majid Shahriari, a nuclear scientist, was killed, and Fereydoon Abbasi Davani, Iran's current atomic chief, survived an attack by assailants on motorcycles. Last July, Dariush Rezaeinejad, an Iranian academic whose affiliation to the country's nuclear activities is in doubt, was shot by gunmen riding on motorcycles.

Iran described the attack as a terrorist operation and blamed Israel for it. Analysts believe the assassinations are related to each other and are part of a covert war aimed at disrupting Iran's nuclear programme, which Iranian authorities say is for peaceful purposes but many Western governments believe has military applications.

In response to the attacks, Iran has pointed the finger at Israel, the US and Britain. Iran says that Western officials' public endorsement of a covert campaign against its nuclear programme is evidence of their involvement in the attacks. No one has claimed responsibility for this latest attack in Tehran, nor for any of the previous assassinations, but Israel has so far not denied involvement.

Iran has also blamed the International Atomic Energy Agency (IAEA) for the assassination of its scientists, accusing the UN body of revealing the names of its experts to Iran's enemies. Iran's nuclear programme has also been hit by Stuxnet, a computer worm designed to sabotage the country's enrichment of uranium, and its missile programme has been hit by a series of explosions.

In November 2011, an explosion at a military base killed the architect of the country's missile programme along with dozens of its elite revolutionary guards. A similar blast last year hit a missile base in Khorramabad, the nearest location in Iran to Israel.

In defiance of Western pressure, Iran this week began uranium enrichment at Fordo facility, near the holy city of Qom, in an underground, bunker-like site built for protection against possible air strikes.

### **IAEA Group Visits Iran**

Also this month, International Atomic Energy Agency (IAEA) inspectors visited Tehran on a three-day mission to clarify aspects of Iran's nuclear program.

The three days of discussions in Tehran were a rare direct dialogue in the long-running international dispute, which has deepened as the West pursues a punitive embargo on Iranian oil and Tehran threatens retaliation. The visit came amid growing tensions between Iran and Western nations which allege that Iran is using its nuclear program as a covert means of developing weapons. This allegation is strongly disputed by Iran, which claims it needs the technology purely for peaceful power generation and medical research purposes. Foreign Minister Salehi welcomed the delegation and their visits to some of Iran's nuclear sites.

The IAEA stated earlier this month that Iran has begun to produce uranium enriched to as much as 20 percent in the Fordo Fuel Enrichment Plant, near the holy city of Qom. The start of enrichment activities at the site, which is built into the side of a mountain south of Tehran, aroused western suspicions.

Chief Inspector Herman Nackaerts, who was heading the six-member IAEA team, spoke of the visit marking the start of a constructive dialogue with Iran before arriving in Iran. Iran has been open to resuming talks with six world powers frozen for over a year but only to discuss broader international issues, not its nuclear program.

### Iran's Upcoming Parliamentary Elections

Iran has begun gearing up for elections that will represent a showdown between two establishment factions that just three years ago formed a united front against the opposition Green Movement.

The domestic political scene of Iran has, at times, been turbulent during the past year as Iran entered an election cycle ahead of the Parliamentary elections on 2nd March 2012. It may be argued a power struggle has surfaced amongst the conservative principalist factions, reinforced by the reformists' call to boycott the elections. The prominence of this struggle is that it will be decisive in the making of the ninth Parliament and conceivably in the 2013 Presidential race. Thus from a foreign policy perspective the make-up of the next Parliament will carry significant implications for policymakers especially on the future of nuclear talks with Iran, which has once again recently led to escalation of tension in the region.

The aim of this special report is to achieve three objectives: First, to try to shed light on shifting alliances between the principalist factions and challenge their monolithic representations. Second, it will aim to decipher the scope of the rift between President Ahmadinejad and Iran's Supreme Leader Ali Khamenei and argue that it may not be as strong as it is frequently portrayed. Third, it will examine the link between Iranian domestic and foreign policy and make a case against the irrational behaviour commonly attributed to Iranian foreign policymaking.

For such purpose, the focus will be on three events which have reflected most the power struggle between principalists and will aspire to portray the subsequent reactions generated by different factions. These events are the \$2.6 billion banking embezzlement scandal involving the heads of several prominent banks and government officials, the change in the Presidential system debate invoked by the Supreme Leader and the raid on two compounds of the British embassy in Tehran.

It seemed that the inextricable bond between the

Supreme Leader Ali Khamenei and President Mahmoud Ahmadinejad, pronounced by Khamenei during the post-election crisis in 2009, took a blow as events regarding the President's close and controversial aide, Esfandiyar Rahim Mashai unfolded. Mashai's moderate comments on Israel and nationalist interpretation of Islam had already sparked controversy among the conservative principalist elite, culminating in his resignation as Vice-President, suggested by the Supreme Leader in July 2009 shortly after Ahmadinejad announced his new cabinet. In April 2011 Ahmadinejad's removal of the Intelligence Minister Heydar Moslehi from the cabinet on charges of bugging Mashai's offices met immediate reaction by the Supreme Leader who reinstated Moslehi, causing an 11-day walkout by Ahmadinejad from cabinet meetings. Ahmadinejad's intransigence to resist public backing of Moslehi's reinstatement caused further distress among the establishment and caused his summon to the Parliament, which he successfully avoided, and arrests of several figures close to Ahmadinejad and Mashai in early May 2011.

The 'deviant current' (jaryan-e enherafi), as Mashai's circle came to be known amongst the Iranian establishment, rendered the emerging segmentation within the principalist (osulgarayi) camp visible. Following the suppression of the reformist (eslahtalab) Green Movement (jonbash-e sabz) and the house arrest of its leaders Mir Hossein Mousavi and Mahdi Karroubi in February 2011, the reformists announced that they have no intention in participating in March 2012 Parliamentary elections. This opt-out arguably contributed to the division within the principalist camp which made an attempt for a united candidate list in Summer 2011.

#### **The camp broadly consists of three groups:**

The first group is moderate and pragmatic principalists which include Mohammad Bagher Ghalibaf, Mayor of Tehran and Mohsen Rezai, Secretary of the Expediency Council, former Presidential candidate and Revolutionary Guard commander-in-chief. The moderate and pragmatic principalists are commonly deemed as the new

conservatives in the Iranian establishment due to their adherence to liberal economic policies, moderate political ideology and disapproval of radical segments in the regime. It may be argued that these individuals, who are potential rivals in a Presidential race, wish to curb, if not oust, the Ahmadinejad circle from the Parliament ahead of the 2013 Presidential elections. The camp has the implicit backing of former President and current Head of the Expediency Council Ali Akbar Hashemi Rafsanjani, who faces marginalisation efforts driven by President Ahmadinejad. The second group is traditional principalists with links to the Tehran bazaar's historical Islamic Coalition Party (Motalefe) led by Habibollah Asgaroladi-Mosalman and their aligned clerical organisations in the holy city of Qom. The third group is the radicals in and around the Ahmadinejad administration divided broadly into two segments: One group, including Ahmadinejad, wish to see Ahmadinejad's controversial chief-of-staff Mashai replace Ahmadinejad whose term ends in 2013. The other group founded by Ahmadinejad is the Society of the Devotees of the Islamic Republic (Jam'iyat-e Isargaran-e Enghelab-e Eslami) which is distant to Mashai and closer to the Supreme Leader. With a blend of nationalism and populism the group supports developmentalism and claims to fight economic corruption.

Since June 2011, a group named the 7+8 working group whose numbers relate to representatives of different principalist camps, toured the country pursuing a united principalist list for the Parliamentary elections in March 2012. The group was headed by two principalist icons: Chairman of the Assembly of Experts and head of one of the two clerical organisations in Qom, Combatant Clergy Association, Mahdavi Kani and head of the other organisation, Society of the Lectures of Qom Seminary and former chief of the Judiciary, Mohammad Mesbah Yazdi. The United Principalist Front, (Jabha-ye Mottahede Osulgarayan) as the group came to be known, attracted candidates from the Larijani and Ghalibaf camps, traditional principalists and also Supreme Leader loyalists. Pragmatic principalists around the Expediency Council (Chairman Hashemi Rafsanjani and Secretary Mohsen Rezai) opted to retain their core group under the Determination Front (Jabha-

ye Istadeji). Meanwhile Ahmadinejad embarked on a similar attempt with a 'three-person committee', including a former Foreign Minister, Parliamentary Speaker and Secretary General of the Islamic Coalition Party which ultimately came to achieve very little.

There have been defectors from his circle over Mashai who gathered in a group called Stability Front (Jabha-ye Paydari) headed by one of the two initiators of the united principalist list, traditionalist cleric Mesbah Yazdi, who bargained for inclusion in the united list, albeit with little success. Bearing in mind the tumultuous 2009 elections, the Iranian establishment is wary of another round of post-election distress that would portray the regime as weak and illegitimate in a revolt-stricken region.

Historically, Parliamentary elections have been indicative of the results of following Presidential elections. In the 2004 Parliamentary elections, which witnessed the lowest voter turn-out since the revolution, reformist candidates under Mohammad Khatami's leadership dropped to 39 from 189 of a total of 290 seats in the Parliament due to principalist pressure, including the Council of Guardians' limitations on the candidate lists and inner segmentation following Bush's inclusion of Iran in 'axis of evil'. The Presidential elections next year saw Ahmadinejad's victory whose allies, the Islamic Coalition Party, Motalefe and Combatant Clergy Association in Qom dominated the Parliament with 156 MPs. The run-up to the 2008 Parliamentary elections had also been subject to debate as the Council of Guardians prevented eminent reformists to run for Parliament, reducing their number to 130 from a total of 4,500 parliamentary candidates.

The end-result was an increase in the principalist votes by 39, allocating them 195 seats. It must be noted however, the election of Ahmadinejad's rival Ali Larijani as Parliamentary Speaker pointed towards the growing segmentation within the principalist faction.

The next year likewise saw Ahmadinejad clinch the Presidency in the most contested election in the

history of Iran. This year's Parliamentary election is predicted to reflect the power struggle between the principalist factions, consolidated in the relative absence of reformists, and will arguably hint at whose side is closer to the Presidency in 2013.

It may be argued that there were at least three instances where the power struggle between the camps has been most visible: the \$2.6 billion banking fraud and embezzlement scandal involving the heads of several prominent banks and government officials, the public debate that ensued after the Supreme Leader's comments on changing the Presidential system and re-introducing the premiership and the raid on two compounds of the British embassy in Tehran.

### Concluding Remarks

The aim of this Iran Investment Monthly special report has been to summarise the divisions arising during the past year within the principalists as the Iran enters an election-cycle ahead of the ninth Parliamentary elections in March 2012. In the relative absence of the reformists, the wide array of factions within the principalist camp under two principalist icons embarked on an attempt to produce a common slate for the upcoming elections. The collapse of the united principalist list was catalysed by debates surrounding the controversy over Ahmadinejad's chief of staff Rahim Mashai, the embezzlement scandal involving Iran's leading banks and government officials, Supreme Leader's reintroduction of premiership proposal in October and the British embassy raid in December.

Three conclusions may be drawn on these debates regarding the nature of principalist alliances, the relationship between Khamenei and Ahmadinejad and the link between Iranian domestic and foreign politics.

#### 1) Nature of principalist alliances

The run-up to the candidate registration for the ninth Parliamentary elections unraveled the high degree of mobility and amorphous nature of the principalist factions. The moderate and pragmatic

principalists in the Iranian establishment share a common adherence to liberal economic policies, moderate political ideology and disapproval of radical segments in the regime. Despite being rivals, key personalities (Parliamentary Speaker Ali Larijani and Tehran Mayor Ghalibaf) in this faction, in an alliance of convenience, joined the united front led by two traditional principalists leading the two societies in Qom. Another segment, the Expediency Council group, headed by Chairman and former President Hashemi Rafsanjani and Secretary Mohsen Rezai, however retained their group and gave implicit support to the united principalists. Meanwhile the radicals in Ahmadinejad's circle were divided into two around the controversial aide and 2013 Presidential hopeful Mashai and one of the two icons heading the united front, the radical cleric Mesbah Yazdi, opposing Mashai but supporting Ahmadinejad. The latter (Stability Front or Paydari) initially drew criticism from the government however, as the candidate registration deadline approached, it seemed an understanding was reached.

Moreover, one should also bear in mind that the ideological differences between the camps are not clear-cut, as the premiership debate brought long-standing adversaries Ahmadinejad and Rafsanjani together on common ground. It can be argued in the aftermath of the deadline, the number of different projections regarding the make-up of the ninth Parliament, the number of unknown and independent candidates, the reformist call to remain as independents, the unity messages emanating from the office of the Supreme Leader and the Council of Guardians' cull of names from all factions all hint at a degree of fluidity that may have only just begun.

#### 2) Relationship between Khamenei and Ahmadinejad

Although there is a degree of disconcert, the rift between Rahbar-e Mo'azzam Ali Khamenei and President Ahmadinejad over Mashai perhaps is not as strong as both the united principalists and the reformists hoped it would be. There are several indicators to this: In the embezzlement saga in October a motion to summon Ahmadinejad

to Parliament over the case signed by 100 MPs was overturned by the presiding board of the Parliament. There is a distinct possibility that the last minute withdrawal of 14 signatures and also the board's decision were influenced by the Supreme Leader's call for unity in government branches, a call which he repeated in 2010 over a similar case.

### **3) The link between Iranian domestic and foreign politics**

One should not dismiss the recent British Embassy raid in December 2011 as an act of recurrent irrationality portrayed by Iran. At its best, the incident denoted an artificial irrationality brought about by domestic factionalism within the regime, more precisely the principalists. It may be argued in a rational and calculated move the united principalists spearheaded by Tehran Mayor Ghalibaf and Parliamentary Speaker Ali Larijani capitulated on the Revolutionary Guard provoked incident to ensure conservative support, to reinstate long-time mitigated Parliamentary authority and for some pundits to hinder another round of 5+1 talks under the Ahmadinejad administration. The fact that 5+1 talks may resume next month in Istanbul might indicate that this illegal political folly was played down by Western governments and temporarily relieves the international community from feeling that there is still room for diplomacy. However, the 5+1 should not disregard the intensification of sanctions, more recently the European Union's oil embargo, along with the continuing 'regime change' rhetoric will only result in the traditional conservatives ever more strongly clinging to power in Iran.

### Iran Enforces Single Exchange Rate

This month, the Central Bank of Iran (CBI) attempted to enforce a single exchange rate after a period of volatility on the foreign exchange markets. The Central Bank of Iran's (CBI) Governor Mahmoud Bahmani announced that the single fixed rate for the dollar would be 12,260 Rials, reflecting a devaluation of the Rial at the official rate. This rate was declared the only official rate for all transactions and authorised imports, and the CBI reassured the Iranian public that this would be offered to students studying abroad or those travelling.

Iran previously had two official exchange rates: one of 11,300 Rials to the dollar at the bank for state operations and official imports, and a variable rate for businesses and individuals to purchase from foreign exchange offices.

The weakening of the Iranian currency, which slumped in the past few weeks prompted the government in mid-November to set a fixed rate of 14,000, while retaining the official rate of 11,300 Rials. The move subsequently gave rise to a volatile unofficial foreign currency market.

The CBI has placed strong emphasis on the enforcement of the new unified exchange rate and threatened foreign exchange offices with closure if they sell the dollar to individuals at more than five percent above the new official rate. For the time being, the imposed single exchange rate for the Rial against the US Dollar appears to have brought some degree of calm to Iran's foreign exchange market.

### Iranian Bank Interest Rates Raised

This month, Iran raised the interest rate on bank deposits by up to 6 percentage points to curb the depreciation of its currency. Analysts cited the move as being a setback for President Ahmadinejad, who has advocated below-inflation interest rates in order to give cheap loans to the poor. This was the first time his government allowed banks to set interest rates on deposits above the inflation rate, which currently stands at 20.6 per cent according to official figures.

Banks can now pay up to 21 per cent interest on five-year deposits, up from 15 per cent. Should inflation increase, the rate can be readjusted if banks deem it necessary. The decision, announced by the Central Bank of Iran (CBI) and the Ministry of Economy, came after the plunge of the Rial in recent months and the volatility in foreign exchange rates. The government hopes the higher interest rate will induce calm into the currency and gold coin markets. The announcement helped strengthen the Rial by about 7 per cent on the first day of implementation, while the price of gold coins fell by 20 per cent. Bankers welcomed the government's decision, but said it should have come much earlier.

The currency fluctuations are believed to be caused by the imposition of new international sanctions over the country's nuclear programme, which have made the transfer of income from oil sales more expensive because of the high commissions charged for the complex bank transactions used to avoid sanctions. However, opponents of President Ahmadinejad accuse his government of deliberately allowing the currency to lose value because the fluctuations have increased Iran's Rial income, allowing it to fund its populist policies ahead of parliamentary elections in March. The suspicion was fuelled by the President's refusal until now to take any urgent steps to change interest rates.

Shamseddin Hosseini, Iran's Economy Minister, insisted that there was no economic justification for a devaluation of the Rial because Iran's foreign exchange reserves were more than adequate and he claimed these had grown thanks to a steep increase in oil revenues. He blamed the crisis on the flight of foreign exchange from the country and "hoarding".

The government's decision came after some parliamentarians threatened to summon concerned officials should they fail to address the problem. They accused the government of trying to lower its growing deficit by selling dollars in the unofficial market after deliberately increasing the parity rates. Analysts estimate the budget deficit for the current fiscal year, which ends in late March 2012,

to be between \$30bn to \$50bn. The government denies the allegations.

### EU Embargoes Iranian Oil

This month, the European Union (EU) approved a decision to impose an oil embargo on Iran, overcoming misgivings about the economic hardship of its member states to take its strongest measures yet against Iran. The decision by EU foreign ministers at a meeting in Brussels raised the stakes dramatically in the war of wits between Iran and the west.

The EU decided no further oil contracts could be struck between the EU member states and Iran while existing oil delivery deals would be allowed to run until July 2012.

Several countries shared reservations about the move, in particular Greece since it imports 35% of its oil from Iran on very favourable conditions. Given the financial situation in Greece, it was in a difficult position and sought compensatory measures from the rest of the EU, whilst engaging in talks with Saudi Arabia to replace the Iranian supply. The impact of the embargo on countries such as Greece is to be reviewed in May. The review will aim to ensure that weaker EU economies such as Greece, Italy and Spain can find, and afford, new sources of oil.

Iran is OPEC's second biggest oil producer after Saudi Arabia, and about 20% of its oil exports go to Europe. The embargo could cost Iran \$5 billion to \$10 billion in oil revenue for 2012, and more in subsequent years according to analysts. Iran has threatened to close the strait of Hormuz waterway if the oil embargo goes ahead, a move that would choke off global oil supplies and send international tensions soaring.

The oil embargo represents a leap in the sanctions regime against Iran, following four earlier rounds of escalating penalties. Senior EU officials also concede that the move could be risky and destabilize the global oil market, sending oil prices rocketing at a time of extreme economic difficulty in the West.

Analysts believe that the implementation of the embargo balances the need to see that EU countries have reliable energy supplies against not wanting to allow Iran time to find alternative customers for its oil. The U.S. and Europe are leaning on countries such as South Korea and Japan to curb their imports of Iranian oil. The impact of the embargo may hinge on how China, a major importer of Iranian oil, responds.

Brussels stressed that the new punitive measures were aimed at forcing Iran back to the negotiating table over its suspected nuclear activities. Talks between Tehran and the EU collapsed last year in Turkey. EU officials say the Iranians have been sending signals about resuming talks in recent weeks, but that no one takes them seriously.

While all 27 EU states signed up for the sanctions, the oil embargo was agreed by EU ambassadors only hours before the foreign ministers' meeting, indicating the difficulties in striking a deal. Two meetings of the ambassadors last week failed to break a deadlock.

In addition to the oil embargo, the EU also decided to freeze the assets of the Central Bank of Iran (CBI), the conduit of its oil revenue, arguing that the aim was to target the economic lifeline of Iran and choke off funding for the nuclear programme, which many EU states see as representing a strategic threat.

In direct response to the EU decision to embargo its oil, the Iranian Parliament swiftly drafted a bill to block oil deliveries to Europe, which to date has been signed by 150 MPs, and will be put to a vote and later submitted to the Guardian Council for approval. The move was seen as being aimed at denying shakier European economies the six-month transition period envisaged by the EU for finding alternative sources and delivering a blow to countries that have prepaid for Iranian oil but might find buyback terms difficult under fresh economic sanctions targeting Tehran.

### Effects of EU Oil Embargo on China

Many analysts believe EU policymakers are

overlooking how an embargo may strategically reshape the global oil trade in China's favour. Major Chinese oil traders are building businesses that are world-class in terms of volumes traded and the latest oil embargo will help them further their ambitions.

The first Iranian oil embargo beginning in 1979 effectively handed Marc Rich, whose company ultimately became Glencore (one of the world's largest physical oil and commodities traders), the keys to a multibillion dollar oil-trading kingdom. Now China's increasingly global oil trading companies are in a similar position with Chinese firms confident that Beijing values stable and secure oil supplies much more than cooperation with the U.S. on the Iranian nuclear issue.

The EU sanctions, which will affect about 450,000 barrels per day of oil imports to Europe, will likely engender the transfer of billions of dollars in oil earnings from the Iranian government to China's main oil trading firms: Zhuhai Zhenrong, Unipet, Chinaoil, and Sinochem. These firms have become major players in the global physical crude oil market. In 2010, 3 of the 10 largest global crude oil and products traders hailed from China.

Unipet, China's largest oil trader does not publicly report trading volumes past 2006, when it sold 106 million tonnes of crude oil and 14 million tonnes of refined products. Based on the company's trading more than 3 million barrels per day of crude in 2011, one can estimate that Unipet's trading volumes now exceed 150 million tonnes per year, potentially making it a larger oil trader than even Glencore. Unipet's activities in the global oil tanker market suggest it is moving very large volumes of oil. In 2011, the company was the world's second-largest tanker charterer, trailing only Royal Dutch Shell.

Of the Chinese oil traders, Zhuhai Zhenrong may be the best positioned to profit because it has strong relationships in Iran and is also well-insulated from U.S. and European political pressure. The company enjoys Beijing's blessing, has no exchange traded stock, has no U.S. assets, and offers virtually no leverage that could be

exploited by outside interests seeking to pressure it. Sinochem and Unipet have slightly more exposure to external pressure since their parent companies have parts of the company that are publicly traded, but will still enjoy strong political and diplomatic support from Beijing.

All this said, the embargo is likely to trigger significant conflicts within the Chinese government. Once the embargo is in place, Iran will likely need to substantially reduce the price its crude in order to entice Chinese buyers to purchase larger than normal volumes. The question will then concern who enjoys the profits created by the provision of discounted oil. Analysts cite a range of possibilities, with one option being for traders to simply keep shipping the bulk of their oil to Chinese refineries as they have been doing and let the refineries enjoy the windfall of having lower-cost oil supplies. This might be the simplest outcome in domestic political terms, particularly since Chinese refineries have often lost profits under policy restrictions in recent years. However, it is more likely that the Chinese traders will either sell the oil on the international market for cash, or swap it for oil from other countries that can then be sent to China or other markets. For example, if the crude oil spot price were \$100 per barrel and Iran had to discount its oil to \$80 per barrel to entice buyers, a Chinese trader could then swap the Iranian crude to another firm. By swapping its Iranian crude for another oil cargo at market prices (or a higher price than it paid the Iranian sellers), the company can gain "extra" oil relative to what it originally paid in Iran and resell it for a profit.

To make the oil palatable to buyers who want Iranian oil, but do not want to run afoul of U.S. and EU sanctions, traders can blend it with oil from other countries and take other means to disguise the oil's origin. This is common practice when oil thieves sell oil from Nigeria and one also used by Saddam Hussein's government, which at points smuggled up to 480,000 barrels per day of oil into the world market despite UN sanctions. Iran's heavy crude oil, the country's largest export stream at present, is similar in weight and sulfur content to the Ural blend that Russia exports, potentially creating swap or trading opportunities.

Analysts also anticipate that Iran will trim exports of heavy, higher sulfur crude in favour of more valuable lighter oils that have less sulfur and could be more easily blended and sold into the global market.

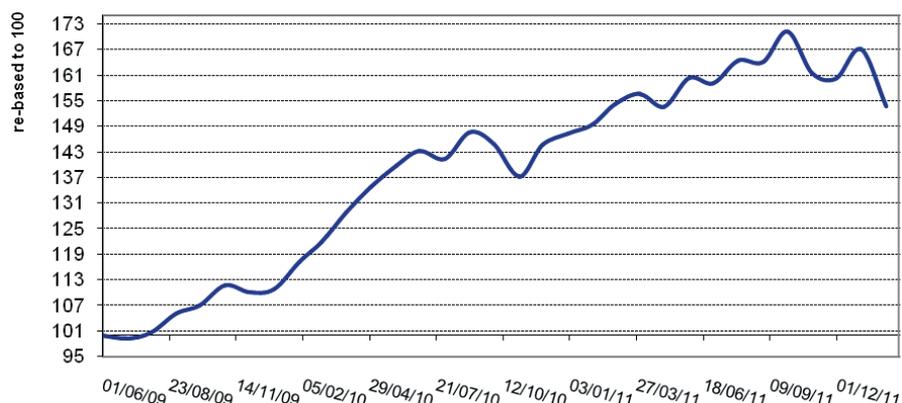
China's refinery operators will not be happy if they have to keep buying crude from the traders at market prices when the traders have been getting discounted Iranian barrels that could have been shipped back to China. Since both sides of the equation have strong political allies, and in some cases are parts of the same corporate constellations (Unipecc is a wholly-owned subsidiary of Sinopec, China's largest oil refiner measured by the amount of oil processed), the politics stand to become contentious: trading bosses may want to maximise their units' profits, as opposed to transferring crude at below-market prices to the company's refineries. Alternatively, if China's domestic market for refined products weakens, firms like Sinopec may sell or swap more of their Iranian crude into the world market.

Policymakers and investors alike must consider how EU sanctions targeting Iran's nuclear program may well help reshape the physical oil trading world in ways that favour China's rising state-backed oil traders. In today's globalised, economically dynamic, and resource-hungry world, unintended consequences can matter tremendously.

**Investment Objective** – The Turquoise Equity Investments seeks superior long-term capital growth by investing in the consumer and commodity potential of Iran, one of the most undervalued emerging markets in the world. Turquoise combines international experience with local expertise in investing in equities listed on the Tehran Stock Exchange (TSE) and other Iranian-based securities. The goal is to provide superior returns, with greater diversification and lower volatility.

<b>Class A</b>		<b>NAV = 153.7</b>
<b>Vehicle Domicile</b> British Virgin Islands	<b>Management Fee</b> 2.0% p.a	<b>Currency</b> Euro (€)
<b>Launch Date</b> 01 June 2009	<b>Carried Interest</b> 20% (High Water Mark Applies)	<b>Minimum Investment</b> €100,000

**Class A Performance (Euro) - As at 31<sup>st</sup> January 2012**



Period	Portfolio Return
Last Month	- 8.0 %
Last 3 Months	- 4.9 %
Last 6 Months	- 6.5 %
Last 12 Months	2.9 %
Since Inception (01 June 09)	53.7 %



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PARTNERS**

## About Turquoise

Turquoise is a boutique investment firm based in Iran. Turquoise creates financial products and offers financial services to select clients and investors who are interested in the Iranian market. Having a qualified and diverse management team with a wealth of international expertise enables Turquoise to benefit from coupling a network of global expertise with an enviable reputation for local knowledge, professionalism and integrity.

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.

*Iran Investment Monthly* is distributed exclusively amongst Iran analysts and potential investors who have worked closely or have been in contact with Turquoise Partners. Subscription to this newsletter is by referral only or through an online request sent to: [info@turquoisepartners.com](mailto:info@turquoisepartners.com)

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