Griffon Capital

Asset Management and Private Equity

Griffon Asset Management

Investor Quarterly Report

September 2017

Portfolio Update

As of 25 July 2017, the GIF Fund SP (Initial Series EUR NAV) had since inception (4 April 2016) returned 5.64%, whereas the TEDPIX (the Tehran Stock Exchange's main total-return index) was down -8.80% in euros and up 0.41% in rials. We attribute this alpha to our high active share (typically between 80-90%) from concentrated stock picks as well as the ability to actively allocate and invest across equities, fixed income and, more recently, derivatives.

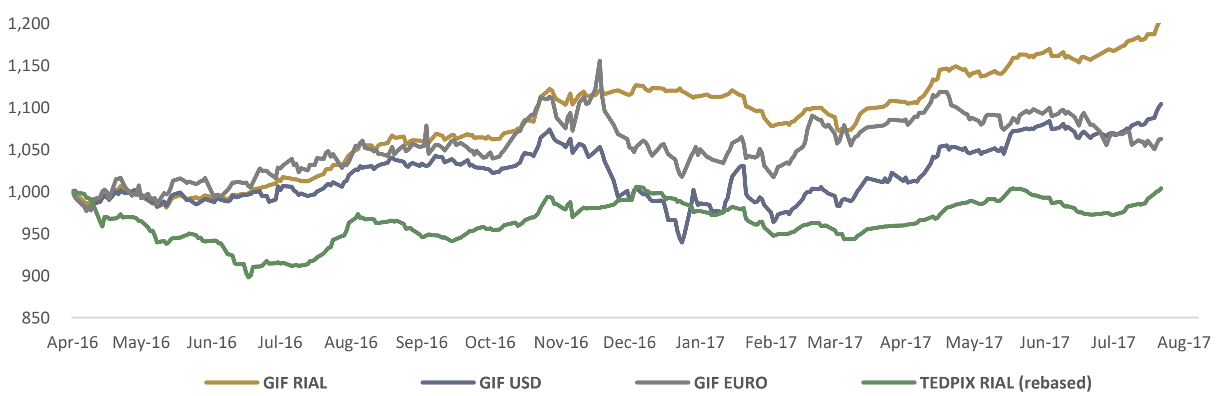
We are sometimes asked why the returns for the stock market have not been higher since the Fund's inception date. One of the main reasons is that the TEDPIX rallied 28.4% from 16 January to 2 April 2016, following the JCPOA announcement on 16 January 2016. Because the GIF Fund SP is an open-ended segregated portfolio company (SPC) registered with the Cayman Island Monetary Authority (CIMA), it could effectively only be launched after sanctions relief came into effect in the Cayman Islands on 17 March 2016. In fact, there was some delay between the coming into force of the removal of sanctions in the EU and its implementation in the Cayman Islands. Launching the Fund before the aforementioned date and entering into related investment arrangements would have meant failure to comply with the Cayman Islands' sanctions regime. Hence the Fund could not and did not participate in the initial post-sanctions sentiment- and liquidity-driven rally. The stock market has been consolidating those sharp gains ever since, occasionally testing – but never besting – the high of 81,537 set on 2 April 2016. Only this August did the TEDPIX set a new high (>83,000), increasing the probability of a new break upwards.

As we noted in the latest (25 July NAV) factsheet, July was a strong month for the Fund in terms of local currency returns (gross rial returns of 4.62%). All of the Fund's top five equity holdings (collectively 40.2% of NAV) posted strong full-year results and dividends for Iranian fiscal year 1395, i.e. 21 March 2016 to 20 March 2017. The top four equity holdings also further upgraded their forecasts for the current Iranian calendar year, 1396 (21 March 2017 to 20 March 2018), on the back of stronger-than-expected Q1 results.

However, given the broad and strong euro rally versus major currencies (the rial also declined -4.0% versus the euro), the Fund's euro-denominated Initial Series NAV advanced 0.21% in July – outperforming the TEDPIX, which declined -0.88% in euros. As of 25 July, our equity exposure stood at 57.0% (versus 75.9% in June); this was due mainly to the Fund's receiving relatively large inflows whilst also maintaining more tactical positions in fixed income. The Fund's flexibility – which allows it to invest across asset classes while patiently building up high-conviction equity positions at attractive stock-specific levels – has continued to help it outperform the TEDPIX.

As we described in our previous Quarterly Investor Report, we continue to increase the *tactical* tilt of the portfolio towards export-orientated companies – which, as low-cost producers, benefit from both new export destinations/trading partners and hard-currency earnings from potential FX weakness. Aside from their respective high earnings-per-share (EPS) growth and dividend yields, the currency hedge these equity investments provide for the Fund is notable: every ~1% weakness in local currency equates to a ~3% increase in net income in these companies. Although we continue to avoid some of the domestic (direct or indirect) interest rate sensitive sectors such as leasing, autos, insurance and cement, we have invested and continue to increase investments in stock-specific opportunities in the banking sector.

Figure 1: Comparative gross performance (GAV): GIF Fund SP v TEDPIX



Sources: TSE, IFB, Codal.ir, Griffon Asset Management, Mirdamad Exchange, Royal Exchange.

Portfolio Update (continued)

Over the last 12 months, Iran's capital markets have continued to be buffeted by opposing forces. Although both corporate earnings and headline macro data (growth, inflation, trade balance, etc.) have impressed, the ongoing domestic liquidity squeeze – caused by the State's domestic payables (gradually becoming securitised into debt), coupled with significant banking sector challenges and much-needed reforms – has been a structural hindrance. This has adversely affected stock market liquidity and valuations (higher risk-free rate, higher WAACs, lower price/earnings ratio, etc.) and has created a large, liquid competing investment opportunity: high real returns from fixed income. The last remaining three listed Islamic Treasury Bills are all scheduled to expire and be redeemed soon; for these, average YTMs are ~20% (versus ~26% in Q1 2017). We expect more Islamic Treasury Bills to be listed on the Iran Fara Bourse (IFB) in Q3 and Q4 2017 [(a)]. We anticipate this "risk-free rate" to hover in the 18-20% range in the short-to-medium term, slightly below the ~20% levels that prevailed for most of 2016. More noteworthy *is the change in real interest rates*, which has improved the risk appetite for equity trading: the rates recently eased from a peak of ~18% (YTM Islamic T-Bills ~26%, inflation ~8%) in Q1 2017 to ~10% (YTM Islamic T-Bills ~20%, inflation ~10%) currently – and there is room for a further decline.

President Hassan Rouhani's second presidential inauguration took place in the first week of August, and new cabinet members have been selected and approved. The pace of scheduled administrative reforms and policy decision making should now accelerate, reversing the recent period of relative inactivity that followed the election on 19 May 2017.

As of 25 July, the Fund consisted of 15 equity holdings, 6 fixed-income instruments and 5 call options (on existing equity holdings). On a harmonic average basis, based on our own proprietary forecasts for 2016–17, the GIF equity portfolio has a forward P/E ratio of 5.5x, an expected dividend yield (DY) of 13.9% and an expected EPS growth of >10% for this Iranian calendar year (21 March 2017 to 20 March 2018).

Most of our highest-conviction equity investments continue to be in the IT, utility, pharma, commodity and banking sectors. To be clear, however, *we are stock pickers – that is, we invest in individual businesses, NOT sectors, and we avoid a broad-brush investment approach*.

Our approach to investment: A reminder by way of example

We believe the type of investor base we attract and retain is of paramount importance. We would remind all our investors, whether existing or prospective, that each of our monthly factsheets contains a link to our Investor Manual, which explains our principles of operation. Our approach to investing is not to try to be extraordinarily prescient, but rather to consistently stick to what we understand well.

For example, whilst 'What's going to change in the next 3-5 years?' is a good (and frequent) question, it is harder to answer than 'What's *not* going to change in the next 3-5 years?' We believe it is better, when possible, to find great businesses in the latter category. Stability and predictability means we better understand the businesses model and its attendant risks and variables – and thus the company's intrinsic value.

By contrast, parts of the technology (depending on subsector/category) and mining sectors generally fall into the "less predictable" bucket given their fast-changing or cyclical nature.

So for example, do we avoid commodity/mining companies? Simple answer: NO.

If/when we take a single stock position(s) in this cyclical and volatile industry, we endeavour to tick most, but not necessarily all, of the boxes on our internal investment checklist (which is 4-5 pages long). For example, the company can be in an extraordinarily dominant (domestic) position and a first-order derivative of industrial production growth in Iran. It is unlikely one can find many monopolies/duopolies with such scale in other countries – that is, companies with sustainably expanding margins and growing earning power (resulting from better management, vertical integration and consolidation of the supply chain, cost efficiency, improved logistics, operational leverage etc.) operating in a country with huge barriers to entry to the domestic market (import tariffs, distribution, scale). This type of investment represents a compelling risk/reward proposition. Yes, the firms are exposed to global commodity pricing, but they are in our opinion mispriced: the upside is not well understood or appreciated, whilst the downside is limited. They are direct beneficiaries of the post-JCPOA, post-sanctions environment in terms of enjoying lower operational costs and higher revenues. Nevertheless, we view them as medium-term, tactical positions: if the facts change, so will our opinions. This stands in contrast to our long-term, buy-and-hold, 'forever' positions – a description that applies to perhaps our top two equity positions, which we may allow to compound year after year.

Risk/reward and position sizing

Our position sizing is based on two factors. The first is an internal positioning risk framework defined by conviction level; the fewer and simpler the variables, the higher the conviction level. The second factor is expected returns, which are a combination of today's value and 'tomorrow's value' (i.e. expected growth), which we assess simultaneously to give us an estimate/range of intrinsic value. There is usually a trade-off between predictability and growth potential, and all we try to do is find opportunities where we believe the market has 'mispriced' the trade-off, whether for fundamental or technical reasons.

(a): In Q1-Q2 2017 an estimated $3bn of Sakhab bonds (similar to Islamic Treasury Bills) were issued by the Government in lieu of arrears to contractors. The instruments are not listed but trade physically at bank branches (mainly at Bank Melli). They are not regulated by the SEO and lack transparency- the YTMs are reportedly notably higher than listed and regulated Islamic Treasury Bills. It is reported that the CBI has put a stop to the OTC trading and delegated supervision to the SEO (Securities Exchange Org- Capital Markets' regulator). It is expected that these bonds will be listed on the IFB or TSE in Q3 –Q4 2017.
Sources: TSE, IFB, Codal.ir, Donya-e-Eghtesad, SEO, Financial Tribune, Griffon Asset Management.

Corporate Earnings

It's been more than 18 months since JCPOA and the sanctions removal. What has happened to corporate earnings?

> *We have been and are investing based on the assumption that the lifting of sanctions, while having a major impact, will likely take years to fully work through the economy and corporate landscape.*

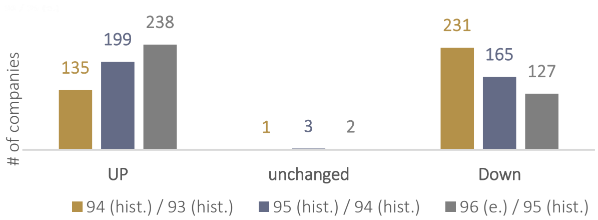
Figure 2: Historic and expected earnings growth based on 367 listed companies

	94 (hist.) / 93 (hist.)	95 (hist.) / 94 (hist.)	96 (e.) / 95 (hist.)
EPS Growth	-33.1%	20.6%	-0.1%

Iranian calendar years: 1393 = 21 March 2014 to 20 March 2015, 1394 = 21 March 2015 to 20 March 2016, 1395 = 21 March 2016 to 20 March 2017, 1396 = 21 March 2017 to 20 March 2018.

There are a total of 590 companies listed in Iran. Figures 2 and 3, which are based on a sample of 367 of these companies (financial statements are checked and capital increases are adjusted for), present tangible evidence that the earnings downgrade cycle has stopped.

Figure 3: Number of earnings upgrades versus downgrades from 367 listed companies



For the historical Iranian fiscal year of 1394 (21 March 2015 to 20 March 2016), 63% of the companies saw their earnings fall year on year. In the year 1395 (21 March 2016 to 20 March 2017), based on now-confirmed full-year results, 45% of companies reported lower earnings year on year, i.e. a 28% reduction in the number of downgrades year on year. For the current year 1396 (21 March 2017 to 20 March 2018), company guidance suggests a continuing positive trend, with 65% (versus 54% in 1395) of the companies forecasting upgrades and 35% (versus 45% in 1395) predicting downgrades on a year-on-year basis.

> *We believe corporate earnings have already troughed: substantially more companies are upgrading earnings, with an actual ~21% EPS growth in 1395. The larger upgrades in 1395 took place in H2, which gives a sense of the conservative nature of some of the initial company guidances. The companies' forecasted guidance for the current year (1396) suggests ~0% EPS growth; this is partly due to the higher base (effect) given the higher upgrades of 1395. Furthermore, as evidenced by the strong Q1s recently announced and as witnessed the previous year, many companies' initial forecasts are conservative and will likely be upgraded in the subsequent quarter(s).*

In Iran's stock markets the financial year runs from March 21 to March 20 for the vast majority of corporates. Listed companies announce quarterly financial results, and half-year and full-year financials are audited. Alongside quarterly results, companies also update their forecasts for the given current/forward year. Whilst a detailed review of each sector is beyond the scope of this report, Figure 4 offers a granular breakdown of earnings momentum at the sector level (over two- and three-year periods) as well as a simple forward P/E ratio for specific sectors alongside their respective PEG ratios (forward P/E ratios divided by expected earnings growth for the year ahead). PEG ratios can be a prompt for grasping "how much growth you get at what price", i.e. price is what you pay and value (or lack thereof!) is what you get; as a rule of thumb, a number between zero and one is desirable. Figure 4 is sorted by industry EPS compound annual growth rate (CAGR) for the Iranian years 1395 and 1396 (21 March 2016 to 20 March 2018), i.e. *the period post JCPOA*; it is based on actual and expected EPS growth rates.

Figure 4: Industry-level earnings growth (historic and expected) and valuations (sample of 367 listed companies)

	95 (hist.) / 94 (hist.)	96 (e.) / 95 (hist.)	EPS CAGR (2yr.)	P/E (96e)	PEG (96e)
Base metals	2166.3%	34.0%	451.0%	10.1	0.3
Sugar & by-products	616.4%	105.8%	255.4%	15.4	0.1
Motor vehicles	851.4%	-21.1%	174.0%	18.8	-0.9
Coal & lignite mining	191.6%	-2.8%	68.4%	11.7	-4.2
Refineries	140.6%	-18.9%	39.6%	6.5	-0.3
Metallic ore	52.2%	14.0%	31.7%	8.1	0.6
Publishing & media	38.3%	6.2%	21.2%	7.5	1.2
Financial intermediaries	14.5%	25.9%	20.1%	6.7	0.3
Oil & gas extraction	3.5%	39.0%	20.0%	7.7	0.2
Leasing	13.7%	18.5%	16.1%	5.4	0.3
Non-metallic ore	-48.8%	160.4%	15.5%	7.2	0.0
Telecommunication	13.3%	8.3%	10.8%	4.9	0.6
Utility	1.9%	19.4%	10.3%	4.2	0.2
Communication (other)	18.1%	2.9%	10.2%	4.1	1.4
IT & computers	22.8%	-1.3%	10.1%	8.4	-6.5
Agriculture	2.3%	13.9%	7.9%	10.2	0.7
Investment companies	15.2%	1.0%	7.9%	10.6	10.1
Pharmaceuticals	8.9%	4.4%	6.7%	6.7	1.5
Insurance companies	-15.1%	32.3%	5.9%	7.5	0.2
Rubber & tyre	41.3%	-22.6%	4.6%	7.6	-0.3
Foods excl. sugar	-16.1%	17.9%	-0.5%	8.7	0.5
Cements, limes & plasters	-48.3%	83.5%	-2.6%	12.0	0.1
Hotel	-15.7%	4.2%	-6.3%	8.3	2.0
Transportation & storage	-16.2%	0.7%	-8.2%	14.7	22.1
Chemicals	-9.7%	-7.3%	-8.5%	5.5	-0.8
Engineering	-7.7%	-15.7%	-11.8%	13.7	-0.9
Retail	-79.6%	42.6%	-46.0%	40.4	-0.2
Metal products	-31.9%	-77.9%	-61.2%	98.4	0.1
Construction & real estate	-53.4%	-70.7%	-63.0%	64.7	0.3
Banking	-190.8%	-131.9%	-302.7%	-27.5	0.9

Sources: TSE, IFB, Codal.ir, Tejarat Farda, Griffon Asset Management.

Banking Sector

In this Quarterly Investor Report, given the importance of and current challenges faced by Iran's banking sector, we decided it would be timely to provide a more detailed review of this industry.

There are 37 authorised domestic banks and credit institutions in Iran. They can be subdivided into 4 categories: State-owned commercial banks, State-owned specialised banks, private commercial banks and private credit institutions. There are 30 banks, of which 19 are listed on the Tehran Stock Exchange (TSE) and the Iran Fara Bourse (IFB).

The banking sector is feeling the unpleasant repercussions of several contributing and negatively compounding factors. These include poor risk management (high NPLs – officially at 11.7% as of December 2016, though reported to have fallen to ~10-11% in H1 2017 – though in reality likely higher if bad loans were not restructured or rolled over); poor asset allocation frameworks (investing heavily in riskier non-core assets as well as lending directed by the State or other benefactors); bloated cost bases (e.g. the largest banks each have >20,000 employees and >1,500 branches, leading to high cost/income ratios of >60-80%); the build-up of government arrears (~$50bn, or ~12% GDP for Iranian fiscal year end 1395, i.e. March 2017); and finally high inflation from historically ultra-loose monetary and fiscal policy and the (until recently) many loosely-regulated financial institutions gathering deposits at very high rates. The intense competition for deposits (rates at ~15-23%) has been a significant factor in driving average banking sector net interest margins (NIMs) into negative territory. About 10-13% (depending on the bank's regulatory compliance) and 1.5% of banks deposits are put aside for the CBI's reserve requirement and general loan loss provisions, respectively. Hence only ~87% of deposits can be allocated for loans and – even given the current official/theoretical CBI-mandated [a] deposit (15%) and lending (18%) caps, which are not strictly adhered to – NIMs are uneconomical (18% lending rate x 87% of total deposits = 15.7%, which is marginally higher than the 15% cost of funding) given the situation is further exacerbated by the high cost/income ratios and additional provisioning. The CBI may reduce the reserve requirement ratio to or below 10% (it is currently 10% for specialized banks and disciplined commercial banks, and up to 13% for other banks), which in theory could free up ~$8bn in direct liquidity and restore cheaper lending capacity. However, the net reserve requirement ratio (the reserve requirement of 10-13% of deposits minus the banks' debts to the CBI) is already very low at 2.1%. This means a reduction of the reserve requirement is not feasible unless the banks' payables to the CBI are first decreased – e.g. by the State reducing its payables to the banks and the banks in turn settling their obligations, in part or in whole with the CBI.

The earning power of the banking sector as a whole is currently limited: the cost of funding is too high, the cost bases too inefficient and lending capacity too constrained. (Even though headline y/y credit growth as of June 2017 appears impressively high at 25.9% for both commercial and State loans, this is in large part because bad loans have been restructured or rolled over). In addition, too large a share of banking assets is illiquid or stuck as NPLs or non-earning/yielding assets, meaning balance sheets also need to be strengthened (the industry-average capital adequacy ratio, or CAR, is estimated at <5%). With the insistent rivalry for bank funding, the second- and third-order consequences are evident in the high deposit rates (at ~15-23%, they are well above the CBI-mandated cap of 15%), elevated interbank rates (~18%) and increased dependence on CBI resources (bank debts to the CBI reached $31.2bn in June 2017, growing 13.2% y/y).

A comprehensive, high-priority Banking Bill is currently being drafted and will ultimately require parliamentary approval. Although it has encountered bottlenecks and administrative delays, some vital actions have already begun. The most essential features include increasing the CBI's supervisory powers (which involves bringing unregulated financial institutions under supervision) and making unlicensed banking a criminal offence. The implementation of International Financial Reporting Standards (IFRS) is also now taking place and banks will be directed to retain profits (i.e. not pay dividends) until they fulfil the prerequisite CAR and raise capital from shareholders. According to the new regulation (most banks are currently on Basel I and the transition is to a new regulatory construct that is similar to Basel II), 8% CAR, on a risk-weighted basis, is obligatory.

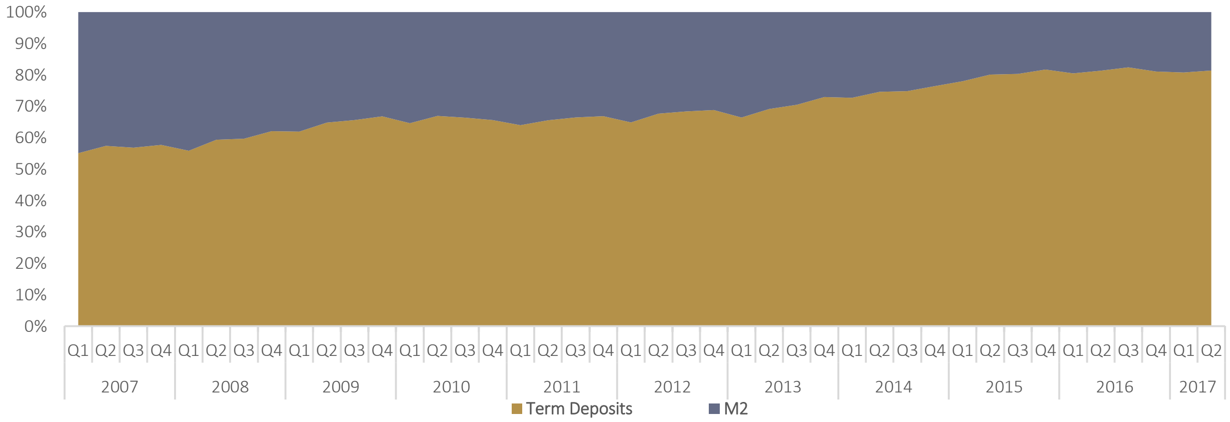
An asset-quality review of all banks is also likely, alongside a recapitalisation of banks. The recapitalisation of State-owned banks has already been announced and is underway (e.g. Bank Melli, the largest non-listed State bank, recently had a capital increase of $2.6bn, raising its CAR to ~6%). The broader recapitalisation plan will use the FX gains (upon the FX unification of the official CBI exchange rate and the free market exchange rate) from legacy State assets via the CBI. The maximum package was set at $12.7bn, and is structured so as not to be inflationary/increase the monetary base. As part of this, the government will reduce and/or settle its dues to the banks (which will in turn reduce their expensive payables to the CBI, which have been incurring a hefty penalty rate of 34%) [a] as well as inject equity to increase CARs. So far ~$3.5bn has been deployed to reduce payables to banks and another ~$4.6bn for capital increases.

With regards to international correspondent banking relationships (CBRs), even though about 200-250 (as of Q1 2017) have been re-established with smaller or medium-sized banks (half the levels of 2006), non-US global/larger banks have remained hesitant to reconnect due to AML/CFT concerns, UBOs, residual primary US sanctions, etc. In mid-2016 FATF suspended countermeasures against Iran in order to assess its progress (over a 12-month period) in bolstering its respective AML and CFT processes, as well its willingness to accept technical assistance in the implementation of the associated Action Plan. The FATF will keep monitoring progress and consider next steps, whilst Iran's goal is to be permanently removed from the counter-measures list.

(a): The CBI recently 'reissued' a directive for banks to reduce their (long term) deposit rates to 15%, whilst providing banks with 18% credit lines.
Sources: CBI, SCI, IMF, World Bank, The Economist, TSE, IFB, Codal.ir, Donya-e-Eghtesad, Griffon Asset Management.

The Macro Backdrop Facing the Banks

Figure 5: Money supply components



Monetary Base = cash (public + banks) + bank required reserves + excess reserves
M2 = M1 + term deposits
M1 = cash (public) + sight deposits
Near money = short term deposits + long term deposits + saving (and other) deposits.

- As Figure 5 shows, the money supply structure in the economy has changed over the past 10 years. This is a manifestation of the pain in the banking industry.
- Money supply growth was ~28% and ~23%, respectively, for Iranian fiscal years 1394 (March 2015 – March 2016) and 1395 (March 2016 – March 2017). The five-year CAGR of money supply is ~28% y/y.
- The monetary base growth rate has declined from a peak of ~36% y/y growth as of April 2013 to ~17% y/y growth for March 2017. The source of growth is no longer the formation of foreign assets (e.g. during high oil prices, or when exports meaningfully exceed imports) but rather CBI lending to the government and banks – an indicator of the liquidity shortage and build-up in State arrears.
- The current and abnormally high real-interest environment of ~10% (assuming that the 'risk free rate' equates to the listed Islamic Treasury Bill YTMs of ~20% and July's CPI inflation reading of 10.3%) [(a)] was brought about by the unusual combination of lower inflation (>40% in 2012 versus the last reading of 10.3% in July 2017) [(a)] and stubbornly high interest rates, owing to the liquidity shortage in the banking sector and domestic State payables and debt.
- One direct consequence of very high real interest rates is the substantial growth of term deposits at banks. Since 2006 term-deposit growth has compounded at an annual rate of ~29% (*when a term deposit yields 20%, it takes three years and eight months for it to double*). In Q1 2007, M1 (cash and sight deposits) formed ~32% of money supply, whereas now (Q2 2017) it is only ~13%. Term deposits as a percentage of money supply stood at ~55% about 10 years ago, versus the current (Q2 2017) ~81%. Real interest rates recently peaked at ~17% in Q1 2017 (Islamic Treasury Bills average YTM ~26% and CPI inflation at ~9%) and have now meaningfully eased to ~10%.

This financial easing resulted from both a reduction in listed Islamic Treasury Bill yields and an uptick in inflation. The more real interest rates ease (preferably, for the economy's sake, more by the lowering of yields/interest rates) the more one should expect increasing outflows from the 'crowded trade' of term deposits – probably towards sight deposits at first.

Inflation outlook and CBI monetary policy

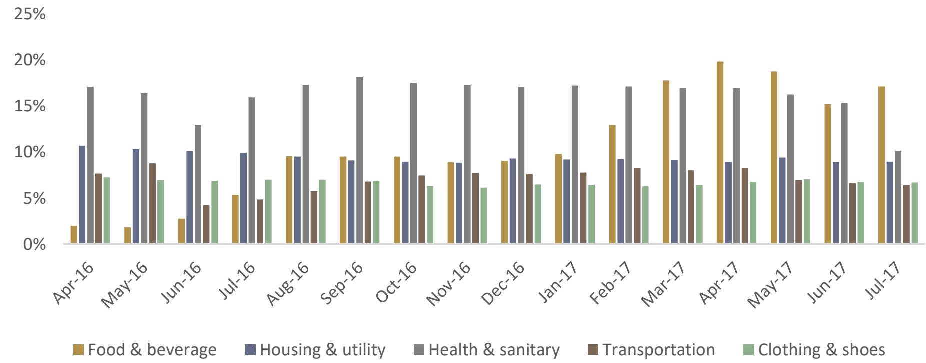
The CBI is keen to maintain a lower-inflation environment (i.e. high single digits) to ensure manageable and effective monetary policy and disciplined fiscal policy, and so far it has persistently pursued and communicated this policy. The CBI has benefitted from increased independence, more supervisory powers and a greater mandate, with a core policy of price and currency stability. The CBI has also been 'helped' by the fact that even though money supply has been growing (the five-year is CAGR ~28%), money velocity has been dropping for the last four years as consumption has decelerated (with consumers less worried about inflation), with money parked into term deposits. That said, the growth in M1/near money (Q/Q basis), a likely lead indicator for money velocity, recently tussled with positive territory – which tells us that money velocity may bottom soon.

Whilst the CBI has effectively managed inflation targeting, control of interest rates has proved more elusive given the prevailing forces triggered by the liquidity shortfalls from the banks and the State. With real interest rates now at ~10% (having peaked at ~17% in Q1 2017), financial conditions appear to have eased (based on the 'risk-free rate' ascertained from listed Islamic Treasury Bill YTMs), but there is still much work to do. Lowering interest rates in this environment is complex and challenging, and a CBI-mandated directive to push interest rates lower has commenced. This will help but will need to be supported by other structural reforms and more cohesive policies.

(a): The most recent CBI data for CPI was for August 2017, at 10.0%- however this was the first month for which the base year was updated from Iranian fiscal year 1390 to 1395.
Sources: CBI, SCI, World Bank, IMF, SEO, Donya-e-eghtesad, McKinsey Global Institute, IMF, Griffon Asset Management.

The Macro Backdrop (continued)

Figure 6: CPI basket



Sector	Weight in Index
Food & beverage	27.38%
Housing & utility	32.82%
Transportation	9.87%
Health & sanitary	6.98%
Clothing & shoes	4.94%

A weaker currency (annual depreciation of 5-8% is reasonable, based on the fundamental domestic/global inflation differential) and would boost export competitiveness by effectively monetising excess industrial capacity and allowing for higher revenues in domestic currency whilst also reducing the budget deficit. This would alleviate the pressure on the State to raise debt and compete for domestic capital to finance its existing deficit, which is forecasted to be 2.9% GDP for this year. Moreover, the increase in the monetary base (CBI lending to the government and banks – i.e. 'money printing' – which, if that money is 'spent' and/or not returned in a timely manner, will be inflationary) seems to be one of the tools that can address the liquidity shortage in the economy, both at the State (and affiliates) and at the banks. This will likely enable interest rates to gradually decline, and the CBI to take a firmer grip on the movement of interest rates.

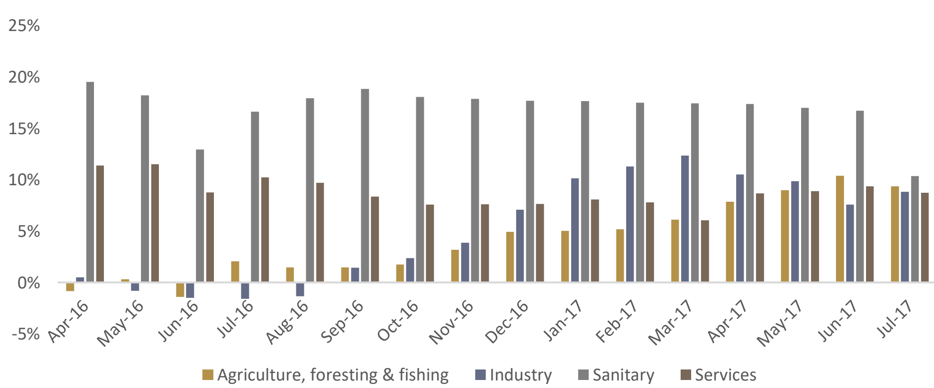
Thus, inflation in the range of 8-13% could be the compromise in the medium term (the IMF forecasts a temporary rise to 11.2% in 2017–18, before a drop back down) – so indeed inflation may move higher before it can return and sustain (high) single digits again.

The extent of the currency depreciation, increase in monetary base, State fiscal policies (e.g. subsidies, housing sector loans, further salary increases and new credit card initiatives) and control (or lack of) of interest rates will in large part determine the inflationary outlook.

With the acceleration of the reforms in the banking sector and the new cabinet now in place, it looks increasingly likely that financial conditions will start easing this year, with the combination of slightly higher inflation and/or the edging lower of interest rates.

A more granular look at inflation – done by examining the CPI and PPI baskets on a monthly basis – also provides clues as to recent drivers and trends. Food and beverage, the largest component at 27.4% of the CPI basket, was the main cause (due to very cold weather and bottlenecks in domestic distribution channels) for the recent increase in CPI from 8.6% low in Q4 2016 to a more recent high of 10.3% in July 2017. The PPI's propensity to be a lead indicator (for the CPI) was witnessed in Q4 2016 with sharper rises, led by the Agriculture component. Hence despite the expectations of slightly higher inflation as described earlier, in the absence of a shorter-term pickup in money velocity (from lower interest rates) or money supply (via the monetary base), inflation could remain at these levels or even tick lower again.

Figure 7: PPI basket



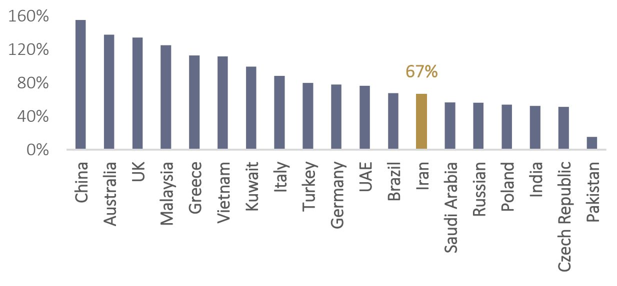
Sector	Weight in Index
Agriculture	17.12%
Industry	51.99%
Sanitary	4.83%
Services	30.89%

Note: The most recent CBI data for CPI was for August 2017, at 10.0%- however this was the first month for which the base year was updated from Iranian fiscal year 1390 to 1395.
Sources: CBI, SCI, Ibena, ICA, Griffon Asset Management.

Banking Sector Players: Increasingly Fragmented

As Figure 8 shows, private sector credit penetration in Iran is higher than in most of the Central and Eastern Europe (CEE) and BRIC countries, whilst below that of Turkey, China and most countries in the Middle East and North Africa (MENA). In other words, in terms of financial intermediation, Iran is more an emerging market than a frontier market.

Figure 8: Total loans to GDP, Iran versus peers (2015)



Moreover, out of the 37 domestic players in this sector, the top five account for around half of all deposits and loans. This makes Iran amongst one of the most fragmented (and competitive) banking sectors in the emerging and frontier markets – where the top five banks generally account for 60–100% of the respective market. Given that even the largest Iranian banks have assets of only ~$45-50bn, the average Iranian bank is very small relative to the size of both the Iranian economy and the regional banks; for example, large Turkish and Gulf Cooperation Council (GCC) banks have assets in excess of $100bn. The Iranian banking sector (and the economy as whole) would benefit from industry consolidation. Of the 37 recognised financial institutions, 29 are considered private sector banks. This category has over the past 10 years continued to increase its already-large market share of the banking industry at the expense of the State-owned banks (commercial or specialised). However, some of the large listed banks categorised as 'private' are nevertheless still under the influence of the State (the State remains a significant shareholder) or a State affiliate. From 2011 to 2016, the private sector banks increased market share in term deposits and loans from 68% to 73% and 50% to 62%, respectively.

Figure 9: Term deposit composition, by bank category

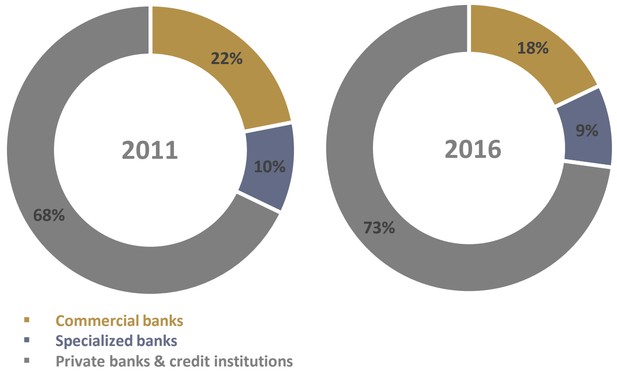
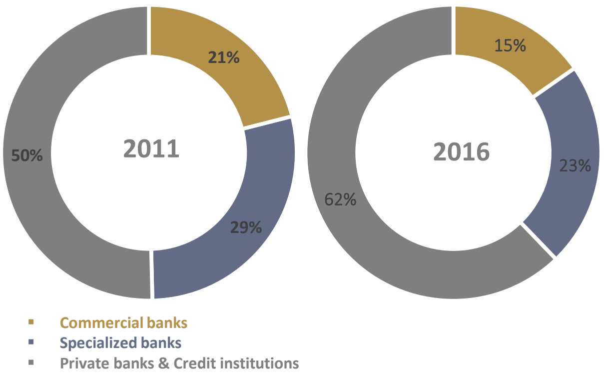


Figure 10: Loan composition by bank category



By further breaking down the term deposit and loan composition of the private sector banks, as per Figure 9 and Figure 10, it is evident that the industry has become further fragmented and competitive. Whilst in 2011 the top five private sector banks constituted 74% of both term deposits and loans, as of 2016 this had dropped to 51% and 58%, respectively.

Figure 11: Private sector banks' term deposit market share

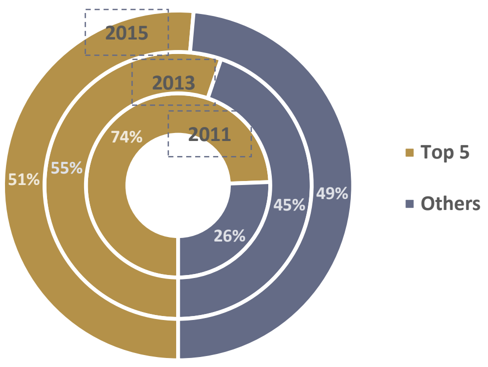
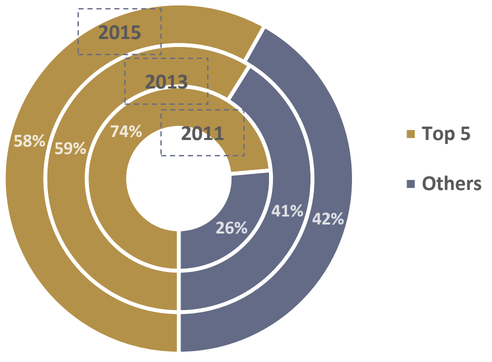


Figure 12: Private sector banks' loan market share



Sources: CBI, IMF, TSE, IFB, Codal.ir, Donya-e-Eghtesad, Griffon Asset Management.

Capital Adequacy and Asset Quality

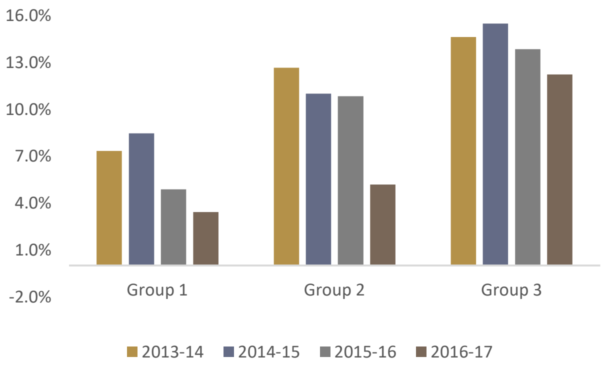
We continue with a focus on the private sector banks, given they have a ~70% market share and are more transparent – they are listed and provide quarterly financial statements, with six-month and full-year audited results. For instance, last available financial statements from Bank Melli (the largest non-listed State-owned bank, by assets and deposits) are from 2013, with no auditor comments or notes. Furthermore, no other non-listed State-owned banks have made financial statements publicly available in recent years.

In our analysis we use a basket of nine banks split into the three groups. They have been filtered for size, with larger banks prioritised and transparency preferred – where the financial statements offer more granular information and auditor comments are more complete:

1. *Group 1* [(a)]*:* The formerly State-owned banks that were privatized and listed on the TSE in 2009. Three of these banks are amongst the top five largest banks in Iran.
2. *Group 2* [(b)]*:* Privately established banks also engaged in relatively disproportional amount of non-core banking activities (e.g. a high concentration of investments in real estate or loans to related parties or specific benefactors).
3. *Group 3* [(c)]*:* Privately established banks focused on conventional and core commercial and retail banking activities.

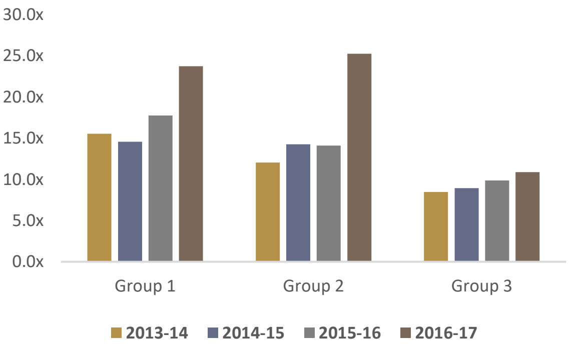
The information and data presented on each group have been calculated on a weighted-average basis of the banks in each respective group. The average banks in Group 1 and Group 2 are materially larger (by assets) than those in Group 3.

Figure 13: Capital adequacy ratio of private sector banks



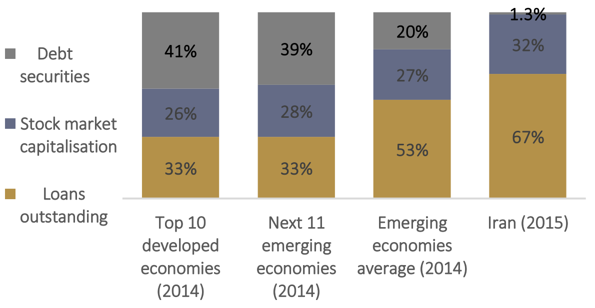
Figures 13 and 14 clearly reveal that Group 1 and Group 2 banks are more levered and less well capitalised. Group 3 banks are better capitalised and have stronger balance sheets. *Why?*

Figure 14: Leverage ratio of private sector banks



Over the last couple of decades, Iran's economy has been driven largely by credit relationships between State-affiliated banks and the State (including State-related/owned entities and those partially privatised). Bank loans have traditionally been (and still are) the primary source of capital, with the State and private sector overly reliant on bank funding. Figure 15 illustrates this point by comparing Iran's financial market composition to that of its peers. Whilst Iran's stock market has grown, its debt market is only just emerging.

Figure 15: Iran's financial asset market composition versus peers [(d)]



Although the formerly State-owned banks (Group 1) were officially privatised in 2009, they are still effectively controlled by the Government or affiliate companies (e.g. boards and CEOs are picked by the State). In the absence of a notable debt market to securitise State payables (until recently, that is – $8-9bn of government bonds issued in 2016 and 2017), these banks, as well as the CBI, have historically 'shouldered the burden' of the State's loose fiscal strategies and poor capital allocation. This has included the responsibility of financing the Government's budget deficits, which have existed every year for the large majority of the last 40 years. The Group 2 banks do not have the State link, and instead have high lending exposure to affiliate companies and/or direct investments in corporations and plants (manufacturing and/or services) of the bank's own benefactor. This has resulted in high concentration risk and/or convoluted cross-shareholding structures. The industry exposure of these banks is predominantly in autos, real estate and mining.

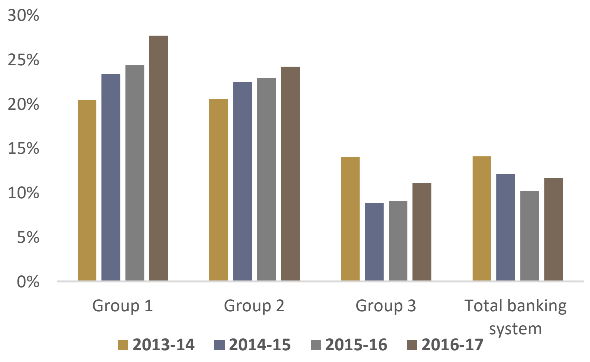
(a) Group 1: Bank Mellat, Tejarat Bank, Bank Saderat . (b) Group 2: Parisian Bank, Bank Pasargad, EN Bank. (c) Group 3: Middle East Bank, Karafarin Bank and Sina Bank.
(d) Figure 15 is from the McKinsey Global Institute report *Iran: The $1 Trillion Growth Opportunity.* It has been adapted to add Iran's profile for comparison purposes.
Note: Although removed from the EU Regulations, Bank Saderat remains designated on the US SDN list and thus the GIF Fund SP does not deal or engage with it or use its services.
Sources: CBI, IMF, TSE, IFB, Codal.ir, Financial Tribune, Griffon Asset Management.

Capital Adequacy and Asset Quality (cont'd)

The Group 3 banks are more conventional banks focused on core banking, with interest income and fee generation the main sources of operational income.

Figure 16 illustrates the deteriorating condition, especially for Group 1 and Group 2, in asset quality. The greater margin of safety of the Group 3 banks has also helped some of them to set up, correspond and transact with international clients and banks at a quicker pace.

Figure 16: NPL ratios of private sector banks

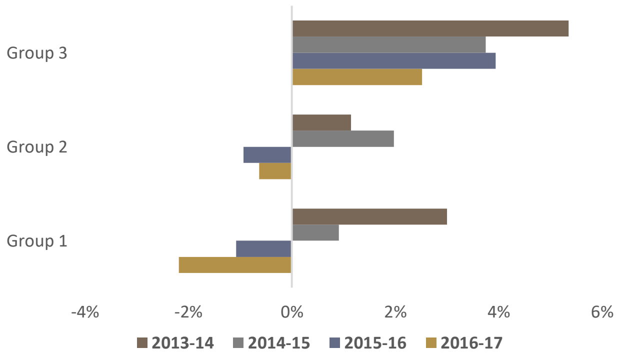


In Figure 16, where applicable we have incorporated auditors comments from the financial statements, particularly for Group 1 banks from 2015 onwards. This includes estimating additional NPLs based on the additional provisioning the (or vice versa) auditor has qualified. This means these estimates (for the three groups/nine banks) are conservative and likely present a more pessimistic case than the headline NPL data provided by the CBI (in Figure 16) for the total banking system.

As Figure 16 illustrates, Group 1 and Group 2 banks have especially high NPL ratios. This needs addressing. Disproportionally large loans influenced or directed by the State (for Group 1) or non-State major shareholders or benefactors (for Group 2) are a major cause. Structurally material changes to corporate governance must be made. This will require banks' operational structures (e.g. departments and functions pertaining to risk, credit and audit) to be upgraded to adhere to disciplined and well-defined frameworks, based on international standards.

Operational income, costs and ROE

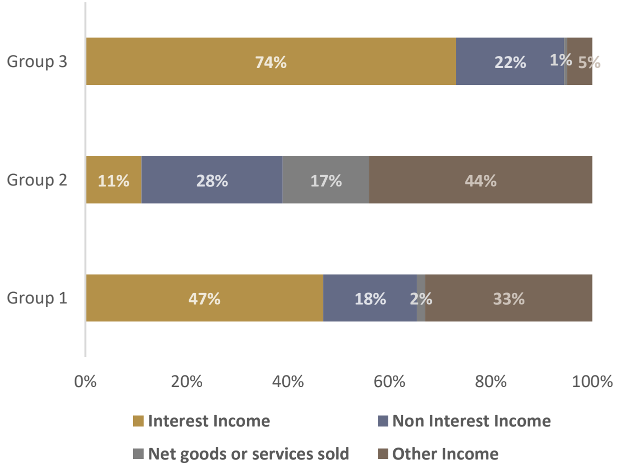
Figure 17: Net Interest Margins of private sector banks



Note: Auditor comments on financial statements applied where applicable (to adjust NPLs and remove non-operational income).

Unsurprisingly, as illustrated by Figure 17 and Figure 18, Group 3 banks, given their focus and more disciplined approach towards conventional and core commercial and retail banking activities, boast 'normal' NIMs with the majority of income (>70%) derived from interest income. On the other hand, Group 1 and Group 2 have loss-making 'core banking' businesses. They have negative NIMs, with non-interest income (e.g. real estate sales), goods and services (e.g. subsidiary manufacturing businesses) and other income (e.g. one-off FX-related gains) forming more than 50% of their income streams.

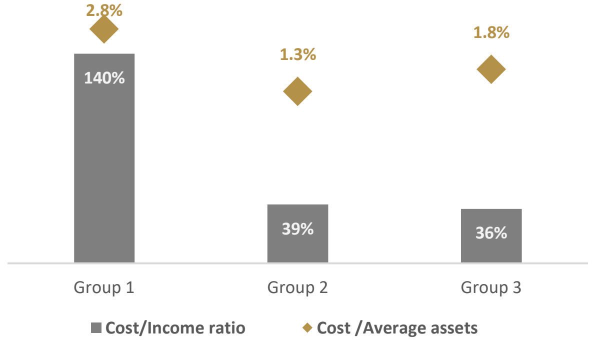
Figure 18: Income composition of private sector banks (2015-16)



Sources: CBI, IMF, TSE, IFB, Codal.ir, Mehr News Agency, Griffon Asset Management.

Capital Adequacy and Asset Quality (cont'd)

Figure 19: Cost/Income ratio of private sector banks in (2015)

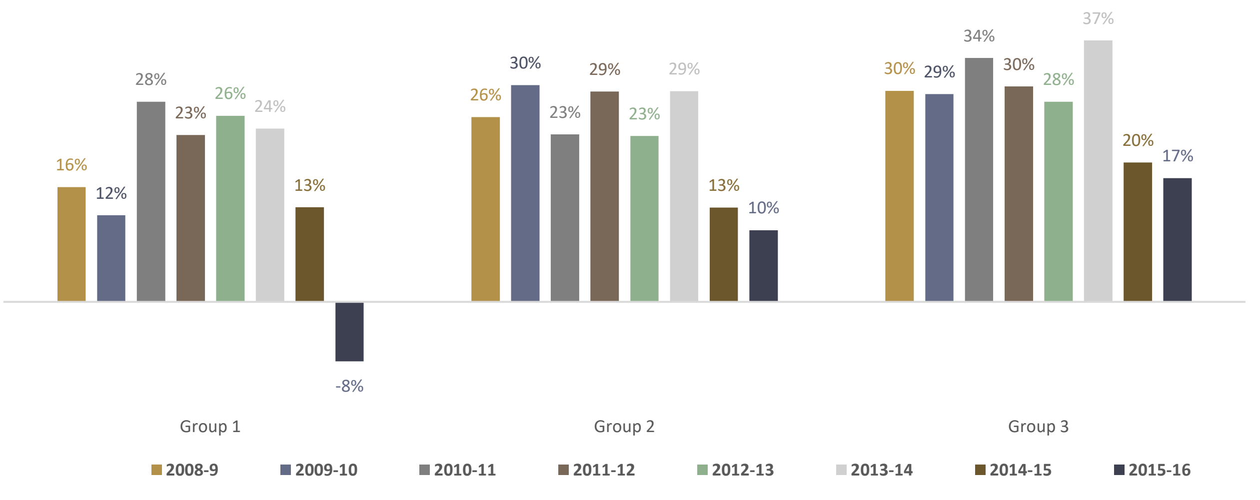


Note: Auditor comments on financial statements applied where applicable (to adjust NPL provisioning and other costs e.g. pension deficits)

The bloated and uncompetitive cost structures of the Group 1 banks is shown in Figure 19. The main causes are excessive numbers of employees (an average of 26,000), branches (an average of 1900) and low productivity. This is partly attributable to the State's influence. Although the cost-to-income ratio of Group 2 is comparable to that of Group 3, what is notable is that the ratio of cost to *average assets* is lower. This would appear to be symptomatic of the higher quality of earnings present within Group 3 banks and the greater leverage (and lower asset quality) prevalent within Group 2 banks.

Figure 20 reiterates the Group 3 banks' higher quality of earnings (consistency of profitability, gauged from ROE) – given their focus on, and more disciplined approach towards, conventional and core commercial and retail banking activities

Figure 20: ROE of private sector banks



Note: Auditor comments on financial statements applied where applicable (to adjust NPL provisioning and income).

Sources: CBI, IMF, TSE, IFB, Codal.ir, Tejarat Farda, Griffon Asset Management.

Banking Sector Comparison: Iran Benchmarked versus EM/FM and EU Banks

Figure 21: Emerging and frontier countries' NPL ratios (2016)

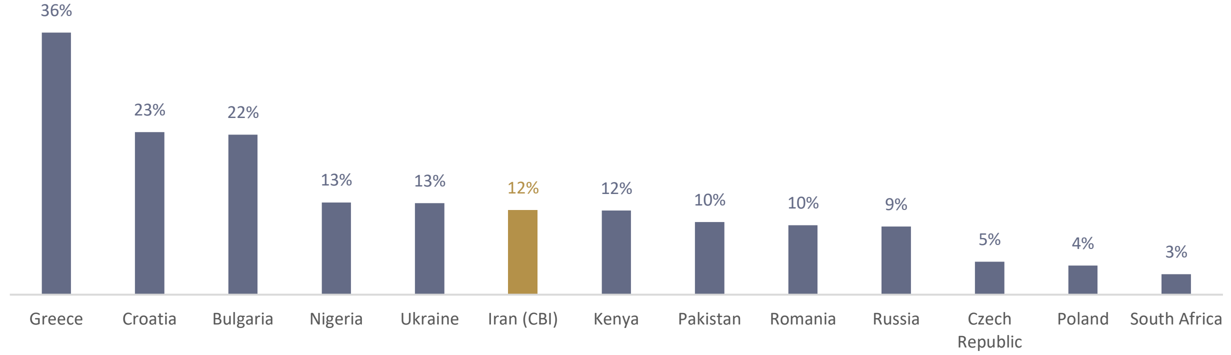


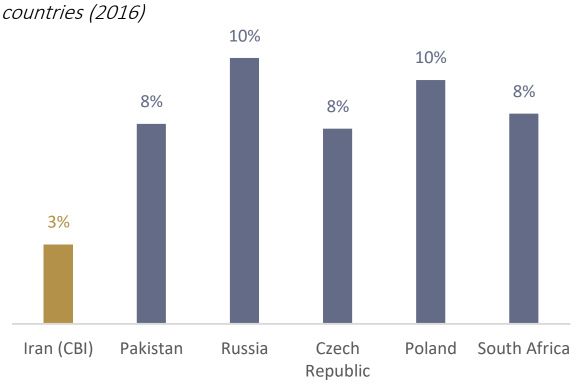
Figure 21 provides perspective for Iran's banking sector NPL ratios within the context of the emerging and frontier markets. Cash coverage of NPLs for Iranian banks (~35%) is lower than EM and FM averages (~ >50%). However, the total coverage (~65%) is more likely comparable and reasonable versus EM and FM peers; in Iran, bank lending is very much collateral-based (mainly in the form or real estate, stock and saving deposits, and historically over-collateralised given the discount/risk coefficients used). Thus there is a need to adjust NPL coverage for the collateral – though the precise value of the collateral is hard to ascertain.

With Figure 22, we switch from EM/FM to that of an Iran-EU comparison. Here both NPLs and coverage ratios are incorporated for the countries – and as mentioned Iran's coverage is adjusted for the estimated collateral factor.

As the figure shows, Iran's relative position is relatively 'comforting'. Although a detailed analysis relative to EU banks is beyond our scope (and competence) here, there is one last fundamental point to add: the critical difference between Iran and EU member banks lies in ease of access to bank funding.

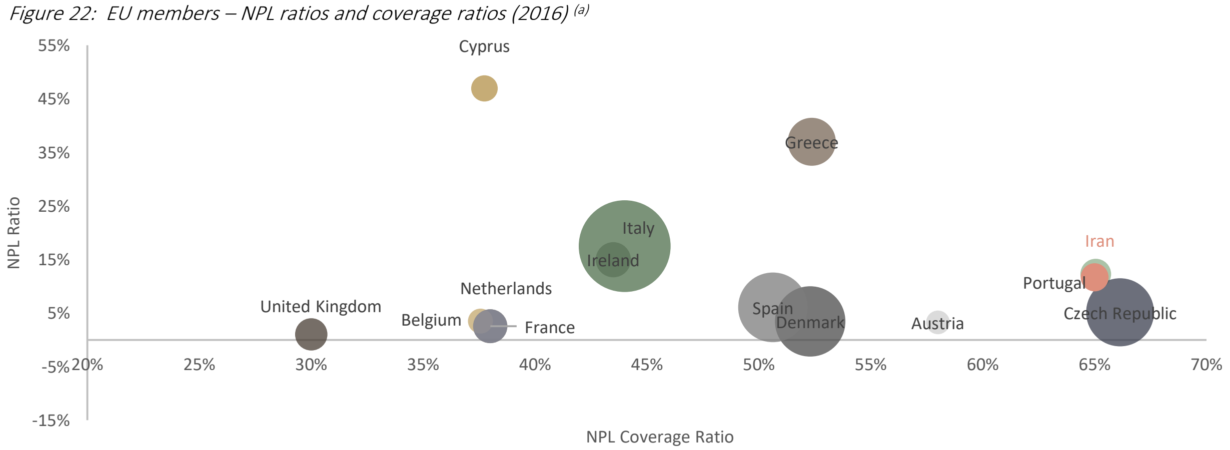
As a result of historically prolonged sanctions, Iran's access to foreign funds remains (at least for now) limited, complex and expensive. By contrast, for EU countries with notable (ongoing and structural) banking problems like Italy, Portugal and Greece, funding is very cheap and firmly in place (at least for now!) given the ECB's mandate and policy for its members.

Figure 23: Capital-to-assets ratio [(b)]: Iran and some emerging peer countries (2016)



As can be seen from Figure 23, the Iranian banking sector needs to be recapitalised. An official schedule has been set for Iranians banks to have CARs of 8% (as per Basel II) within five years.

Figure 22: EU members – NPL ratios and coverage ratios (2016) [(a)]



(a): Figure 23 is from KPMG's 'Non Performing Loans – the actual state of play in the EU'. It has been adapted to add Iran's profile for comparison purposes.
(b): Bank capital to assets is the ratio of bank capital and reserves to assets.
Sources: CBI, IMF, TSE, IFB, Codal.ir, Donya-e-Eghtesad, Financial Times, The Economist, IMF, World Bank, Griffon Asset Management.

Banking Sector Recapitalisation: Top-down Scenario Analysis

It is tempting, in the Iranian context, to avoid taking a top-down view on the banking sector. Given the lack of transparency plaguing many banks' balance sheets and income statements (especially those of State-owned and non-listed banks), one can have more conviction on a bank-by-bank basis. There are banks with high capital adequacy ratios (CARs) of 10-15% and banks that are likely negative. The lack of clarity includes the actual NPLs, other assets, collateral held against loans and the quality of earnings. For example, the CBI's last revision of banks' financial statements included revisions to NPLs recorded, interest rates applied to loans, penalties accrued to the delayed loans, non-operational income, pension related deficits and FX-related gains/losses.

Nevertheless, to analyse the sector as a whole, you need to work with an appropriate margin of error using sufficiently wide ranges – the point being *to be roughly right as opposed to exactly wrong.*

According to the CBI, for Iranian fiscal year-end 1395 (21 March 2017), total banking sector assets were $631bn and Iran's GDP was $406bn – that is, banking assets represented about 155% of GDP. By deducting from bank assets the government's payables to banks (about $50bn), $631bn becomes $581bn, or about 143% of GDP.

Based on CBI banking sector data for the end of 1395, the non-risk asset weighted capital-to-assets ratio of the entire banking sector was 3.1% (versus 4.2% the previous year). The CBI's official recapitalisation schedule envisions the banking sector achieving 8% CAR (the equivalent of Basel II) within five years. The following are three scenarios for recapitalisation:

Lower than expected

CAR @ 3% today, so that meeting the 8% capital adequacy target, would require ~$29.1bn (~7.2% of GDP).

3% CAR is presented as the 'lower than expected' scenario (even though CBI's non-risk-weighted capital-to-assets ratio is 3.1%) because cash and government assets are given zero-risk weights in the CAR calculations. That is, CAR will likely be bigger than the capital-to-assets ratio.

Base case

CAR @ 4% today, so that meeting the 8% capital adequacy target will require $23.2bn (~5.7% of GDP).

4% CAR is presented as the base case – for reference, the basket of nine banks we analysed earlier have an average, risk-weighted CAR of 5.5% (*without* applying auditors' comments).

Higher than expected

CAR @ ~5-6% today, so that 8% capital adequacy will require $11.6bn-$17.4bn (~2.9%-4.3% of GDP).

What factors result in the higher-than-expected scenario? Factors such as higher values of banks' collateral due to improved price and liquidity in the real estate sector, better management and collection of NPLs (or parts thereof), lowering interest rates, and improving interest and non-interest income and increasing profitability within the next few years.

The time frame for recapitalisation could well be shorter (say, two to three years) if the sector refocuses on improving core banking interest income alongside fee income, deleveraging by way of divesting non-core riskier assets, enhanced corporate governance, and so on. In a scenario where the banks' profitability normalises (as a result of earning power normalising – e.g. NIMs revert to historical averages, fee generations kicks in) and/or prices or liquidity (i.e. greater price discovery) in the real estate sector picks up, this could materially accelerate the time frame and reduce capital raising needs.

Non-Performing Loans: Scenario Analysis

The total amount of outstanding loans in the banking sector is $283bn. (This excludes about $50bn in loans made to the government by banks, which are not recorded as non-performing in part or whole). Based on CBI data as of December 2016, NPLs stood at 11.7%. However, if you include other assumptions – for example, the assumption that auditor comments in the financial statements of the largest publicly listed banks also apply to the large, non-listed State-owned banks – a more pessimistic scenario could be envisaged in which banking sector NPL ratios are around 15%.

NPL cash coverage ratios are as high as 60-70% in some banks (e.g. some of the banks in the basket discussed earlier in this report). However, by again applying the auditor comments for the large publicly-listed banks and applying them to the large non-listed State-owned banks, we arrive at a more conservative NPL cash coverage ratio of 35% – which has been used in this scenario analysis.

In Iran, bank lending is very much collateral-based (and, as mentioned in the previous section, historically over-collateralised), so there is a need to adjust NPL coverage for collateral as well. However, the value of the collateral is hard to ascertain. We have assumed an average of 30% coverage, based on the average calculated from the basket of banks assessed earlier in this report.

Better-than-expected NPL scenario:
Recent secondary reports, quoting the CBI suggest the NPL ratio is approaching 10%:

10% NPL ratio = $28.3bn NPLs

65% total coverage = $18.4bn

$9.9bn is not provisioned – shortfall equates to ~2.4% GDP

Sources: CBI, IMF, TSE, IFB, Codal.ir, Griffon Asset Management.

Banking Sector Recapitalisation (continued)

Base case NPL scenario:
The last official CBI data from December 2016, states NPL ratio at 11.7%:

12% NPL ratio = $34.0bn NPLs

65% total coverage = $22.1bn

$12.2bn is not provisioned – shortfall equates to ~2.9% GDP

Worse-than-expected NPL scenario:
Estimating and extrapolating auditor comments from the large publicly listed banks to other banks:

15% NPL ratio = $42.5bn NPLs

65% total coverage = $27.6bn

$14.9bn is not provisioned – shortfall equates to ~3.7% GDP

Recapitalisation: Measures and Possibilities

Below we briefly list some of the choices and methods for (a) recapitalisation (including via deleveraging and increasing profitability) of the Iranian banks as well as (b) adherence to international banking benchmarks and standards. Although >50% of banking industry assets are held by non-State banks, the government would have no direct responsibility for recapitalising these banks. However, much of the list below applies to, or could also benefit (directly or indirectly), the private sector banks:

- Using resources from National Development Fund (NDF).

The NDF's last officially reported NAV was $62.5bn in 2014. We estimate that the value could now be $75-$90bn (based on receiving 20% of the country's oil exports since), and higher if we also assume receipt of 20% of gas exports. Furthermore, the NDF's share of payments from oil and gas export should increase 2% per year and reach 30% by the end of Iranian fiscal year 1400 (i.e. 2021). The possibility of recapitalising the banks using NDF resources was included in the 1395 budget (2016-17) but is not (yet) in the current-year 1396 budget (2017-18).

- Transfer of CBI gains from the FX revaluation/unification.

The recapitalisation of State-owned banks has already been announced and is underway (e.g. Bank Melli, the largest non-listed State bank, had a capital raise of $2.6bn). This is to use the FX gains (upon the FX unification of the CBI official exchange rate and the free market exchange rate) from legacy State assets via the CBI. The maximum package for the State-owned banks was set at $12.7bn, and is structured so as not to be inflationary/increase the monetary base. As part of this, the government will reduce and/or settle its dues to the banks (which will in turn reduce their expensive payables to the CBI, which include a hefty penalty rate of 34%) as well as inject equity to increase capital adequacy ratios. Thus far ~$3.5bn has been deployed to reduce payables to banks, along with another ~$4.6bn for capital increases.

- The Banking Bill (reform also targets IFRS, Basel II, AML/CFT upgrades for removal from FATF watch list) and increased CBI independence – a mandate that includes the ongoing closure and increased regulation of market disruptors, i.e. unregulated credit institutions.
- Appointment of select bigger banks to manage the liquidation of smaller financial institutions, especially troubled credit institutions. There are already two prior cases as well as three more-recently-planned liquidations. This can also be the precursor to greater industry consolidation.
- Enforced retention of profits by banks, i.e. no dividends.
- Expansion of the monetary base (by CBI 'loans' made to the government and/or banks) to inject new capital into the banks (e.g. equity for State-owned banks, and reduction of State payables for non-State-owned banks).
- Issuance of government bonds or Islamic Treasury Bills to banks (which have payables from the State), which can then be used as collateral or 'sold' to the CBI.
- CBI directed / State-ordered subsidised funding and more rigorous enforcement of capped deposit interest rates (with a view to restoring profitability and retained earnings).
- Banks' overdraft balances at the CBI to be treated as loans/facilities – charged at 18%, for example, versus the current penalty rate of 34% incurred for bank debt at CBI.
- New earning powers – especially with regards to more fee generation and FX revenues (again with the CBI's backing, again to increase profitability).
- Lowering the CBI reserve requirements.
- An NPL penalty waiver programme for smaller loans (this CBI led program has already reportedly collected >$1bn)
- State stimulus (reducing payables to State-owned Maskan Bank and/or CBI lending) to reinvigorate the housing and construction sector to facilitate better price discovery for much of the banking sector's collateral.
- Foreign-currency corporate or sovereign debt funding (most likely sovereign guaranteed debt).
- FDI (via debt or stock) and/or FPI (from regional or international financial firms). A recent example is the $8bn financing agreement framework, finalised with the South Korean Export-Import Bank (Korea Eximbank-KEXIM).
- Creating a fully segregated 'bad bank' with a strict framework for NPLs/asset disposals, most likely under the supervision of the CBI.
- The nationalisation of one or more of the larger listed banks.
- An increase in the maximum value of the CBI bank deposit guarantees.

Sources: CBI, IMF, TSE, IFB, Codal.ir, SEO, Financial Tribune, Griffon Asset Management.

Conclusion

When discussing the banking industry in Iran, commentators frequently rely on negative "urban myth" rather than proper analysis. Although a full review of the industry and all its individual players is beyond the scope of this report, it is evident to us – given the tools and measures currently available – that the size of the challenge is smaller (in both absolute and relative terms) than the challenges many banks in developed and emerging markets have faced over the past 10 years.

In other words, there are strong headwinds but they are manageable. Iran, already a large economy, is 'rerating' – whether through reversion of net interest margins (NIMs) to historical averages, a pickup in commercial loans, new consumer credit, increased rates of fees and commissions, FX trades, the lowering of bloated cost/income ratios, revenue from letters of credit and trade finance. Using these and other methods, many of Iran's banks today will likely reaffirm their earning power and scale within two to three years.

On this note it is worth reiterating that we invest in individual businesses, NOT sectors, and that we avoid a broad-brush investment approach. Hence, even though sentiment towards this industry is negative and consensus appears to be shying away from banking exposure, we have found banks that are compelling on a risk/reward basis – that is, businesses whose shares are trading at significant discounts to what we deem their intrinsic value to be.

Investor Quarterly Report

ABOUT GRIFFON CAPITAL

Griffon Capital is an Iran-focused asset management and private equity group established to unlock value from the country's public and private equity markets. Among Griffon's primary objectives is to allow local and international institutional investors the ability to seamlessly access and maximise opportunities in Iran through purpose-built vehicles and investment products spanning traditional and alternative assets.

The Group's strength is rooted in a robust operating platform developed by leading international advisors and are supported by internationally recognised administrators and auditors. Our platform consists of a high calibre team with deep local market expertise and international financial pedigree blended at the board, management and execution levels. This includes a management team steeped in investment banking, wealth and asset management and corporate finance experience. Griffon is also distinguished by on the ground local research and primary thinking and a governance culture defined by global best practices in risk management, compliance and reporting.

Modaberan Homa is fully licensed and regulated by the Securities and Exchange Organization (SEO) of Iran.

Investor Quarterly Report

DISCLAIMER

Please read this disclaimer carefully as it contains important information about the Griffon Iran Flagship Fund SP ("**Fund**"), a segregated portfolio of GIF SPC, its proposed investments in Iran and the current international sanctions and restrictive measures in relation to Iran.

This document is strictly private and confidential, has been prepared by Griffon Asset Management ("**Investment Manager**") and is being provided to investors in the Fund on a confidential basis. This document is for information purposes only and should not be construed as investment advice. All information provided herein is as of the date set forth on the cover page (unless otherwise specified) and is subject to modification, change or supplement in the sole discretion of the Investment Manager. This information is neither complete nor exact and is provided solely as reference material with respect to the Fund.

This material does not constitute an offering of any security, product, service or fund, including the Fund, for which an offer can be made only by the Fund's Confidential Private Placement Memorandum (the "**Confidential Memorandum**"). The terms and risk factors of the Fund are set out in its Confidential Memorandum which is available to qualified prospective investors upon request. The contents hereof are qualified in their entirety by the Confidential Memorandum and subscription agreements of the Fund.

The purchase of shares in the Fund is suitable only for sophisticated investors for whom an investment in the Fund does not constitute a complete investment program and who fully understand and are willing to assume the risks involved in the Fund's investment program. The Class A Shares of the Fund are subject to restrictions on redemption, transferability and resale as provided in the Confidential Memorandum and the Fund's constitutive documents. There is no secondary market for an investor's shares in the Fund and none is expected to develop. There is no obligation on the part of any person to register the shares under any statute.

The performance results of certain economic indices and certain information concerning economic trends contained herein are based on or derived from information provided by independent third party sources. The Investment Manager believes that such information is accurate and that the sources from which it has been obtained are reliable. The Investment Manager cannot guarantee the accuracy of such information, however, and has not independently verified the assumptions on which such information is based.

No reliance may be placed for any purposes whatsoever on the information contained in this document or on its accuracy, completeness or fairness. No representation or warranty, express or implied, is given by or on behalf of the Fund, the Investment Manager or any of their respective affiliates or partners with respect to the accuracy or completeness of the information contained in this document. The aforementioned persons disclaim any and all responsibility and liability whatsoever, whether arising in tort, contract or otherwise, for any errors, omissions or inaccuracies in such information or opinions or for any loss, cost or damage suffered or incurred howsoever arising, directly or indirectly, from any use of this document or its contents or otherwise in connection with this document. Persons reading this document must make all trading and investment decisions in reliance on their own judgement. No statement in this document is intended to be nor may be construed as a profit forecast.

Certain statements in this document constitute forward-looking statements. All statements that address expectations or projections negatively, from forward-looking statements made herein. Due to various risks and uncertainties, actual events or results or actual performance may differ materially from those reflected or contemplated in such forward-looking statements. As a result, you should not rely on such forward-looking statements in making any investment decision. No representation or warranty is made as to the achievement or reasonableness of, and no reliance should be placed on, such forward-looking statements. Nothing in this document should be relied upon as a promise or representation as to the future.

Certain figures contained in this document have been subject to rounding adjustments. Accordingly, in certain instances, the sum or percentage change of the numbers contained in this document may not conform exactly to the total figure given.

This document may include track record information regarding certain investments made and/or managed by the Investment Manager or its affiliates and/or certain other persons. Such information is not necessarily comprehensive and potential investors should not consider such information to be indicative of the possible future performance of the Fund or any investment opportunity to which this document relates. The past performance of the Investment Manager or its affiliates is not a reliable indicator of, and cannot be relied upon as a guide to, the future performance of the Fund.

The Fund will not accept investments from any US Persons (as defined in applicable legislation) or persons whose conduct is subject to US economic sanctions (unless and until such investments are authorised by the relevant US authorities).

This document is only addressed to and directed at: (a) persons in member states of the European Economic Area ("Member States") who are "qualified investors" within the meaning of Article 2(1)(e) of the Prospectus Directive (Directive 2003/71/EC, as amended (including amendments by Directive 2010/73/EU to the extent implemented in the relevant Member State)) provided that the giving or disclosing of this document to such person is lawful under the applicable securities laws (including any laws implementing Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers (the "AIFM Directive")) in the relevant Member State ("Qualified Investors"); (b) within the United Kingdom, to persons who (i) have professional experience in matters relating to investments and who fall within the definition of "investment professionals" in Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (as amended) (the "Order"), or (ii) are persons who are high net worth entities falling within Article 49(2)(a) to (d) of the Order, and/or (iii) persons to whom it may otherwise be lawfully

Investor Quarterly Report

DISCLAIMER (Cont.)

communicated and (iv) are "qualified investors" as defined in section 86 of the Financial Services and Markets Act 2000, as amended; and (c) other persons to whom it may otherwise lawfully be communicated (all such persons referred to in (a) to (c) above together being referred to as "Relevant Persons"). This document must not be made available to persons who are not Relevant Persons. No person should act or rely on this document and persons distributing this document must satisfy themselves that it is lawful to do so. No steps have been taken by any person in respect of any Member State to allow the Shares to be marketed (as such term is defined in the relevant legislation implementing the AIFM Directive) lawfully in that Member State. By accepting this document you represent, warrant and agree that you are a Relevant Person.

The representative of the Fund in Switzerland is Hugo Fund Services SA, 6 Cours de Rive, 1204 Geneva. The distribution of Class A Shares in Switzerland must exclusively be made to qualified investors. The place of performance for Class A Shares in the Fund distributed in Switzerland is at the registered office of the Hugo Fund Services SA.

On July 14, 2015, the P5+1, the European Union, and Iran reached a Joint Comprehensive Plan of Action ("JCPOA"). Subsequently, following confirmation that relevant JCPOA commitments had been delivered, certain of the international sanctions and restrictive measures relating to Iran were eased or lifted on 'Implementation Day', 16 January 2016, including the majority of previous EU and UN sanctions on Iran. While this represented a significant relaxation of the sanctions in place against Iran, a number of important restrictions remain in force (including certain sanctions which may affect financial and investment activity).

In particular, notwithstanding the relaxation of sanctions on 'Implementation Day', certain categories of persons may be prohibited from investing in the Fund. The Fund and Investment Manager's policy is to comply with all applicable sanctions, and not to engage in activity that would be sanctionable under the sanctions applicable to non-US persons. Before making or managing any investments in Iranian securities, the Fund and the Investment Manager will put in place a robust compliance framework based on professional advice with a view to ensuring that its activities and investments are compliant with EU and applicable US sanctions and restrictive measures in force from time to time regarding Iran.

It is the responsibility of the recipient of this document to satisfy itself as to its compliance with the legislation of any relevant jurisdiction or territory, including in particular regarding international sanctions and restrictive measures, and to assess the risk of the imposition of additional sanctions (including under the JCPOA 'snapback' mechanism) that might affect any investment in the Fund or its valuation or liquidity. It is the responsibility of the reader to satisfy themselves that any business activities will not expose them to liability under the laws of any state to which they are subject.

Griffon Capital

T: +98 21 26231278
F: +98 21 26231275
E: info@griffoncapital.com

Unit 101,
No. 38, Golfam Street,
Africa Boulevard,
Tehran,
Iran

www.griffoncapital.com