GriffonCapital
Asset Management and Private Equity

Griffon Asset Management

Investor Quarterly Report

March 2017

Investor Quarterly Report

Portfolio update

As of 26 February 2017, the GIF Fund SP (Initial Series EUR NAV) has since inception (4 April 2016) returned 6.76%, whereas the TEDPIX (Tehran Stock Exchange's main total-return index) is down -3.91% (in euros) and -4.05% (in rials). As we noted in the latest factsheet, February was a strong month for the Fund, with the Initial Series NAV advancing 3.23%, mainly because the Fund outperformed the TEDPIX (due to the Q3 earnings upgrades in most of our core equity holdings) and the rial gained 4.33% versus the euro. As we explained in our November and December 2016 factsheets, the rial's behaviour in the last six months has been consistent with the (partly) seasonal patterns: on a year-on-year basis (as of 26 Feb 2017), the currency is 3.8% weaker versus the euro, having recouped the weakness endured (-9.0%) in November and December 2016.

In February we decreased our equity exposure to 79.3% (from 85.5% in January) to seize further tactical advantage of the elevated (25-26% and higher) domestic bond yields on offer. 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. We also continued to incrementally and tactically tilt the portfolio slightly more towards export-orientated sectors (which depend on external global demand and benefit from FX weakness and/or the expected FX unification) and away from domestic interest-rate–sensitive sectors.

The capital markets have grappled with conflicting factors in the last three to six months. Although both headline corporate earnings and macro data (growth, inflation, trade balance, etc.) have impressed, the ongoing domestic liquidity squeeze – unleashed by State domestic payables coupled with banking sector reforms – is a strong impediment. The immediate consequences for the capital markets have been both a sharp fall in stock-market liquidity and a rise in the yields of the government's Islamic Treasury Bills (from ~20% in Q4 2016 to ~26% in Q1 2017). In the Iranian New Year (21 March 2017 onwards), we do expect the "risk-free rate" in Iran to revert to, or go slightly below, the ~20% levels experienced for most of 2016.

In addition, the market awaits the Iranian presidential election, scheduled to be held on 19 May 2017. Whilst it is too early to call, the market's expectation appears to be that president Hassan Rouhani will be re-elected.

As of 26 February, the Fund consisted of 20 equity holdings and 4 fixed-income instruments. The GIF equity portfolio (on a harmonic average basis, based on our own proprietary forecasts for 2016–17) has a forward price/earnings (P/E) ratio of 6.5x, an expected dividend yield (DY) of 11.8%, and expected EPS growth of over 15% for this Iranian calendar year (21 March 2016 to 20 March 2017).

The majority 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.*

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

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Capital Market Recap

More than 12 months have now passed since the Implementation Day of the JCPOA (Joint Comprehensive Plan of Action) and concomitant sanctions removal. Figure 1 shows the salient stock-market data since 1 January 2016.

Figure 1: Capital market recap, 1 Jan. 2016 to 26 Feb. 2017

	1-Jan-16	27-Aug-16	26-Feb-17
TEDPIX (main index)	61,700.10	77,757.60	77,574.70
TEDPIX % move		*26.0%*	*-0.2%*
IFX (junior market)	683.40	808.30	866.34
IFX % move		*18.3%*	*7.2%*
P/E (e.)	5.5x	7.5x	6.9x
Dividend Yield (e.)	12.7%	10.0%	9.1%
Market value of listed bonds	$270m	$1.76bn	$5.8bn
T-Bills average YTMs	25.0%	21.1%	26.3%

The TEDPIX moved 28.8% higher in 2016, with nearly all of the gain captured in Q1 (+32.0%). The index peaked on 2 April 2016 at 81,537. The stock market's forward P/E expanded by 36.4% from January (5.5x) to August (7.5x) 2016 and contracted by 8.0% from August 2016 to February 2017 (6.9x). This equates to a net P/E expansion of 25.5% in just over 12 months.

We believe Iran's forward earnings discounts of 42% versus the MSCI EM Index (11.9x P/E) and 50% versus the FM Index (13.8x P/E) are too large, given (a) a dividend yield that is 2-3 times greater and (b) the expectation of 4-5% GDP growth for the next few years (base case), which is itself higher than in most other emerging or frontier markets.

There has been an exponential surge in the issuance of bonds in the capital markets (predominantly the government's Islamic Treasury Bills) since January 2016. The YTMs of the State's Islamic T-bills averaged ~20-21% for most of 2016 and spiked to >26% in Q1 2017.

As Figure 2 shows, the capital market's liquidity as measured by the Average Daily Volume Traded (ADTV) shrunk by 31.3% from the Jan. to Aug. 2016 period versus the subsequent 6 month period to Feb. 2017 period.

Figure 2: Capital market recap (1 Jan. 2016 to 26 Feb. 2017)

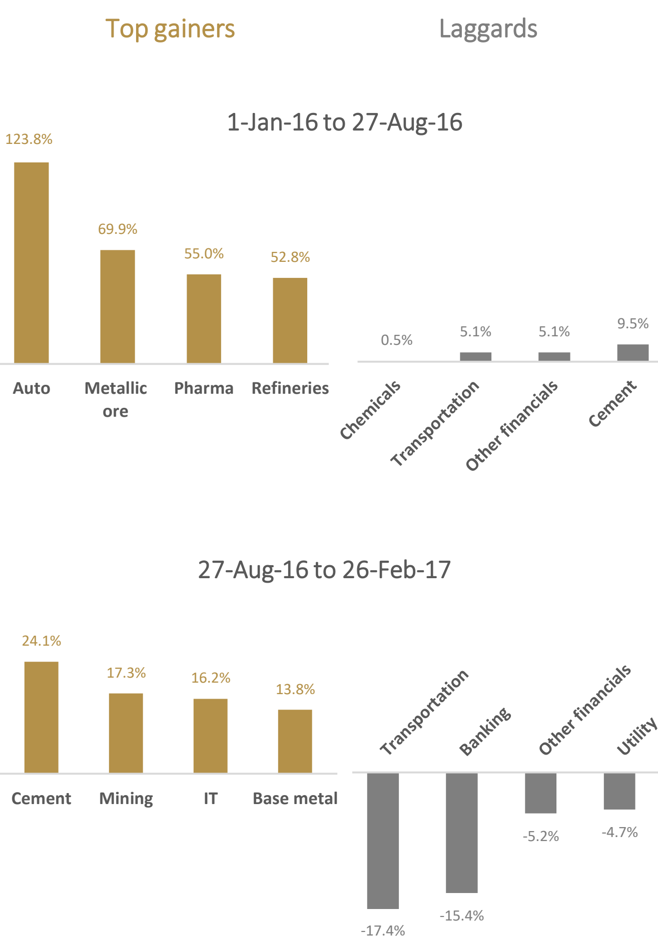
	1-Jan-16 to 27-Aug-16	27-Aug-16 to 26-Feb-17
ADTV	$151.9 m	$104.3 m
Institutional : retail *(% of ADTV)*	43.3% : 56.7%	47.4% : 52.6%
Value of rights issue	$3.0bn	$3.7bn
# of IPO	17	8

Throughout the January 2016 to February 2017 period, retail investors have been more active then institutional investors, though their dominance declined after August 2016 along with the fall in overall market volumes.

In terms of primary and secondary market activity, it was a very busy calendar, with a total of 25 IPOs and $6.7bn of rights issues taking place in the periods described in Figure 2.

As Figure 3 illustrates, from January through August 2016 all the main sectors provided positive returns. The earliest and strongest sector leadership was delivered by the auto sector, though this faded in H2 2016. The commodity space (metal ores, base metals etc.) was a consistent gainer throughout the period. Transportation and banks were the largest drags on the index, whilst the cement industry managed a noteworthy bounce off its H1 2016 lows.

Figure 3: Sector gainers & losers: period 1 Jan. 2016 to 26 Feb. 2017



Sources: TSE, IFB, Codal.ir., MSCI, Griffon Asset Management.

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Corporate Earnings

In the year 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.

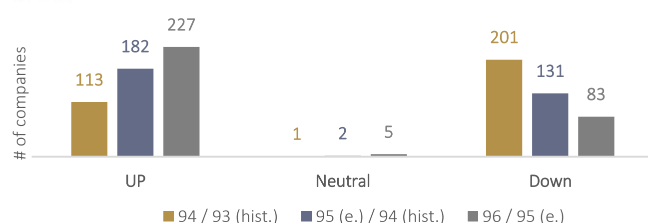
Figure 4: Historic and expected earnings growth based on 315 listed companies

	94 / 93 (hist.)	95 (e.) / 94 (hist.)	96 / 95 (e.)
EPS Growth	-25%	9%	5%

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.

From our sample (data filtered and adjusted for capital increases) of 315 listed companies (there are a total of 644 companies listed in Iran), Figures 4 and 5 present tangible evidence that the earnings downgrade cycle has stopped.

Figure 5: Earnings upgrades versus downgrades from 315 listed companies



For the historical Iranian fiscal year of 1394 (21 March 2015 to 20 March 2016), 64% of the companies saw their earnings fall year on year. In the year 1395 (21 March 2016 to 20 March 2017), based on the recent Q3 results and latest full-year forecasts, 42% of companies are reporting lower earnings year on year, i.e. a 22% reduction in the number of downgrades year on year. For the year ahead, company guidance suggests a continued positive trend, with 72% of the companies forecasting upgrades versus 26% predicting downgrades on a year-on-year basis.

More companies are now upgrading (year 1395: 58% upgrades vs. 42% downgrades) and we estimate the market will have ~9% EPS growth in 1395. Guidance for next year (1396) suggests 5% EPS growth – although, as witnessed this year, many companies' initial forecasts are conservative and will likely be susceptible to upgrades.

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 year. A company's first forecast for the subsequent financial year is usually announced one month before the end of the current year (i.e. mid-February). Whilst a detailed review of each sector is beyond the scope of this report, Figure 6 offers a granular breakdown of the earnings momentum (over a three-year period) at the sector level as well as a simple P/E ratio (forward) for specific sectors alongside their respective PEG ratios (forward P/E ratios divided by expected earnings growth for the year ahead). PEG ratios are a useful prompt for grasping "how much growth you get at what price", i.e. price is what you pay and value (or lack of!) is what you get; as a rule of thumb, a number between zero and one is desirable. Figure 6 is sorted according to the EPS compound annual growth rate (CAGR) for the Iranian years 1394, 1395 and 1396 (21 March 2015 to 20 March 2018); it is based on actual and expected EPS growth rates.

Figure 6: Industry-level historic earnings growth (historic and expected) and valuations (sample 315 listed companies)

	94 / 93 (hist.)	95 (e.) / 94 (hist.)	96 / 95 (e.)	EPS CAGR (3yr.)	P/E (96)	PEG 96
Auto	-55%	454%	81%	65%	17.4x	0.2
Sugar & by-products	-60%	505%	25%	45%	11.3x	0.4
Metal products	-3%	5%	72%	21%	10.8x	0.2
Non-metallic ore	-4%	-12%	97%	18%	5.8x	0.1
Insurance	32%	7%	8%	15%	6.7x	0.8
IT	17%	8%	11%	12%	8.4x	0.8
Utility	14%	7%	14%	12%	4.6x	0.3
other financials	-2%	22%	14%	11%	14.1x	1.0
Leasing	26%	5%	2%	11%	5.1x	2.1
Communication (other)	11%	17%	4%	10%	4.9x	1.4
Pharmaceuticals	11%	4%	6%	7%	7.1x	1.3
Telco	1%	13%	6%	6%	4.8x	0.9
Electric machines	16%	-18%	17%	4%	13.7x	0.8
Refineries	-40%	74%	-1%	1%	7.2x	-5.7
Investment companies	-31%	-26%	77%	-3%	8.0x	0.1
Transportation	-3%	-18%	14%	-3%	12.8x	0.9
Engineering	13%	-23%	1%	-4%	14.3x	18.9
Base metals	-94%	1048%	19%	-6%	10.6x	0.6
Metallic ore	-47%	39%	5%	-8%	7.8x	1.6
Chemicals	-16%	-14%	1%	-10%	6.3x	7.0
Foods	-29%	-7%	8%	-11%	10.1x	1.2
Machinery	-25%	-2%	-8%	-12%	9.7x	-1.3
Rubber & tyre	-45%	26%	-11%	-15%	6.7x	-0.6
Conglomerates	-12%	-16%	-17%	-15%	5.3x	-0.3
Construction & real estate	-36%	-37%	45%	-16%	10.9x	0.2
Ceramics & tiles	-48%	-24%	8%	-25%	14.6x	1.7
Cements, limes & plasters	-57%	-78%	323%	-26%	11.8x	0.0
Banking	-15%	-60%	-57%	-47%	34.7x	-0.6

Sources: TSE, IFB, Codal.ir., SEO, CSDI, Griffon Asset Management, The Economist, IMF.

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Corporate results – notable points

With Q3 corporate results, the positive momentum has continued (from H1) as illustrated in Figures 4, 5 and 6. For Q3, it was mostly "more of the same" as what we concluded from H1 result; like we concluded then, companies are delivering top-line growth alongside operational margin expansion, but the burden of high interest rates weighs heavy on their bottom line and is a headwind for pent-up domestic demand.

Revenue growth

Real (i.e. above inflation) revenue growth – whether driven by price, volume, or both – is becoming prevalent in an increasing number of industries including pharma, commodities, autos, IT, insurance and food.

Capacity utilisation

One of the lowest-hanging fruits following the removal of sanctions was the extensive *idle* manufacturing capacity that Iran's industries (e.g. autos, steel, metals, tyres, petrochemicals) could utilise without the need for growth capex. Increased capacity utilisation (and operational leverage) is indeed visible in most manufacturing-orientated sectors (with the exception of the cement industry). By way of examples, two industries that can further benefit from increased capacity utilisation are autos and petrochemicals. In autos, despite 37.5% year-on-year production growth, spare capacity persists in a country where considerable pent-up demand exists due to a long and overdue "replacement cycle" as a result of the relatively old fleet of 19 million vehicles. In petrochemicals, the provision of more consistent feedstock from the increased usage of the South Pars gas field and new export markets will likely push capacity utilisation higher.

Increase in exports

A healthier relationship between sales and production has also reappeared in manufacturing. Sales growth (in terms of units) has exceeded production growth in many producers, especially where there was a buildup in inventories (e.g. mining and tyres). We think there is a combination of factors at work, such as more-rational production targets, slowly increasing end-user domestic demand, and significantly higher exports. The increase in exports (e.g. the huge increase in Iranian steel exports to EU) is also a direct consequence of sanctions removal, given the increase in the number of available trade partners coupled with the reduction in the cost of doing international business (lower cost of insurance and bank transfers, greater availability of trade finance, etc.).

Debt remains expensive and scarce

Corporate and consumer debt remains prohibitively expensive. The CBI's mandated reduction in bank deposit and lending rates (15% and 18%, respectively) has not (yet) yielded cheaper credit for consumers or corporates. Interest-rate–sensitive sectors (e.g. banks, leasing and construction) are direct casualties, and other overly-leveraged sectors in need of refinancing (e.g. autos) – or even those challenged by growing working-capital requirements due to long cash conversion cycles and outstanding payables (e.g. pharma manufacturers) – are also challenged. Lower interest rates on interest-bearing debt (when it comes) will significantly boost corporate profitability and consumer spending.

Banking sector

The banking sector is today feeling the unpleasant repercussions of several contributing and negatively compounding factors. These include poor risk management (high NPLs, officially at ~11.7% though in reality higher if bad loans were not rolled over); poor asset allocation (by management and State-influenced or directed lending); bloated cost bases (e.g. the largest banks have >20,000 employees and >1,500 branches each, leading to inefficient cost/income ratios of >60%, some closer to 80%); the build-up of government arrears (~$45bn, or ~11-12% GDP); 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 ~15-23%) has driven banking sector NIMs firmly into negative territory. About 13% and 1.5% of banks deposits are put aside for the CBI's reserve requirements and general loan loss provisions, respectively. Hence only 85.5% of deposits can be allocated for loans and – even given the current official and theoretical CBI-mandated deposit (15%) and lending (18%) caps – NIMs are uneconomical (an 18% lending rate X 85.5% of total deposits = 15.4%, which is marginally higher than the 15% cost of funding) and the situation is further exacerbated by the high cost/income ratios. The CBI may well have to further reduce the reserve requirement to below 10% (which could free up $15-$20bn in liquidity) and enable (through regulation) greater fee generation for the banks.

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 (headline credit growth, at 27.3% y/y, appears high, but this is because bad loans have been rolled over). In addition, too large a share of banking assets is illiquid or stuck as NPLs or non-earning assets, meaning balance sheets also need to be strengthened (the industry-average CAR is estimated at <6%, and lower in State-owned banks). With the insistent rivalry for bank funding, the second- and third-order consequences are evident in the high deposit rates (typically ~15-23%, well above the CBI mandated cap of 15%), elevated interbank rates (~19-20%) and increased dependence on CBI resources (bank debts to the CBI reached $33.7bn in February 2017, an increase of 30.5% y/y). *(Continued on next page.)*

Sources: CBI, IMF, TSE, IFB, Codal.ir, Minews, Asrekhodro, Donya-e-eghtesad, Financial Times, Eurofer, The Economist, Griffon Asset Management.

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Corporate results – notable points (continued)

A draft Banking Bill has been proposed and should hopefully be passed by Parliament in the New Year. Its most important features include increasing the supervisory powers of the CBI (by bringing unregulated financial institutions under supervision) as well as making unlicensed banking a criminal offence. The implementation of IFRS is also now taking place, and banks will be directed to retain profits and raise capital from shareholders. An asset-quality review of all banks is also likely, as is a recapitalisation of State-owned banks. The government has also started to issue bonds to reduce its payables to banks, used part of CBI's FX revaluation gain to help settle the banks' debt to the CBI (the ~$9bn settlement yielded a big saving for banks, which were incurring a 34% penalty rate), and is recapitalising State-owned banks (~$5bn). Even though more than 250 correspondent banking relationships have been re-established with smaller or medium-sized banks (still 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. Iranian banks have taken significant measures to address any weaknesses in this field; a favourable outcome is expected with the FATF and will be a prerequisite to reengaging with larger non-US correspondent banks.

On this note it is worth reiterating that *we invest in individual businesses, NOT sectors, and 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 individual investment opportunities 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.*

Correlation Study: *Un*-correlated

Investors often ask us how correlated an investment in Iran's stock market is versus other emerging markets or global risk metrics. It is true that, with about 50% of the stock market (by value) directly or indirectly linked to commodities (petrochemicals 22%, base metals 11%, refineries 6%, metallic ores 5%, etc.), the country's increasing reliance on exports, and the general increase in international trade, Iran's economy is becoming increasingly interlinked with the outside world.

However, from a foreign positioning standpoint, this investment opportunity is undoubtedly *uncrowded* for the simple reason that levels of foreign investment are currently minimal. According to the SEO (the capital market regulator and supervisor), in December 2016 foreign investment in Iran's capital market stood at about $315 million, which represents ~0.3% of total market capitalisation. *This means real diversification of returns will likely persist for a global or regional portfolio until such time as foreign investment significantly increases off its current (very low) base.*

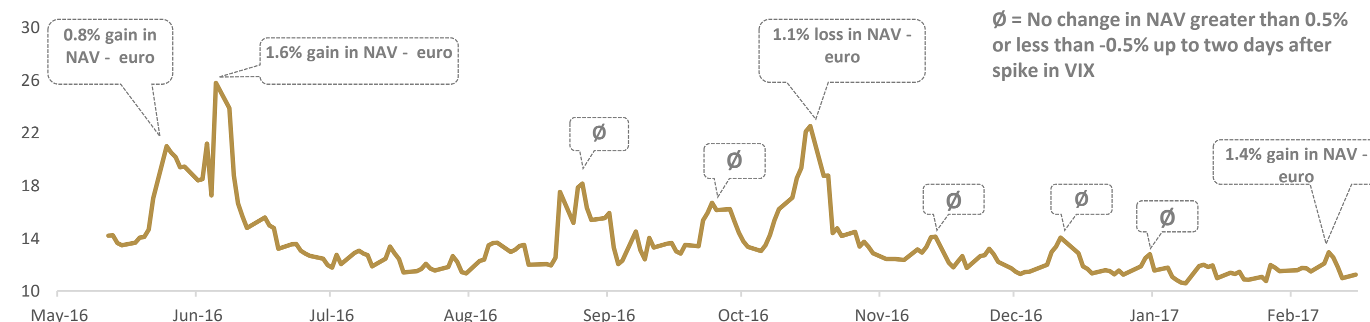
As Figure 7 shows, the TEDPIX's correlation (in euros or respective local currencies) with the MSCI Emerging Markets (EM) and Frontier Markets (FM) Indexes *is very low or non-existent.* The correlation with the EM Index appears to have increased gradually (from a very low base) over the last two years especially, though at 0.23 for the last trailing 12 month period it still is very *Un*-correlated. The correlation with the MSCI FM Index has in fact remained negative for the best part of the last five years.

Figure 7: TEDPIX and EM & FM MSCI Correlation (calculated on a weekly basis in euros and local currencies)

	1 Year	2 Years	3 Years	4 Years	5 Years
EM - TEDPIX - EUR	0.23	0.15	0.10	0.07	0.07
EM - TEDPIX - Local	0.19	0.10	0.07	0.04	0.05
FM - TEDPIX – EUR	-0.20	0.09	-0.07	-0.08	-0.04
FM - TEDPIX - Local	-0.04	0.16	-0.03	-0.02	-0.02

In relation to the Fund's correlation and consequential price reaction to global risk sentiment, Figure 8 (below) illustrates the Fund's daily returns up to two days after spikes in the VIX. Since last May, on the nine days where the VIX has spiked, only once did the Fund's NAV *decline* by > 0.5% – whereas on three occasions it in fact *gained* > 0.5%, and on the remaining five it did not respond (by > 0.5% up or down).

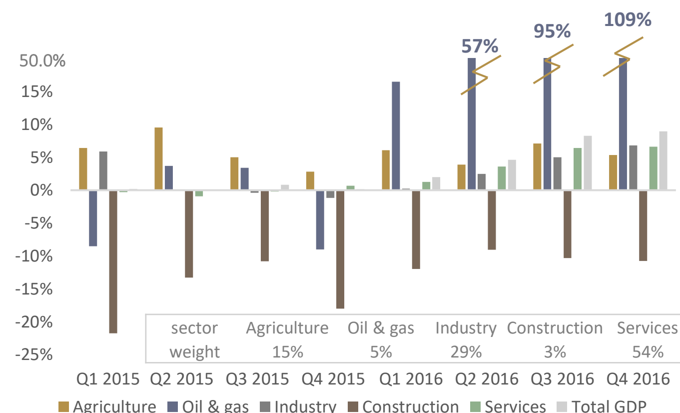
Figure 8: GIF Fund's daily returns versus the global 'risk' measure, the VIX [(a)]



Sources: TSE, IFB, Codal.ir., MSCI, S&P, SEO, CSDI, HSBC, Griffon Asset Management.
(a): VIX is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options.

Iran's top-down update: Macro dashboard

Figure 9: Quarterly GDP growth (y/y) by sector (supply side)



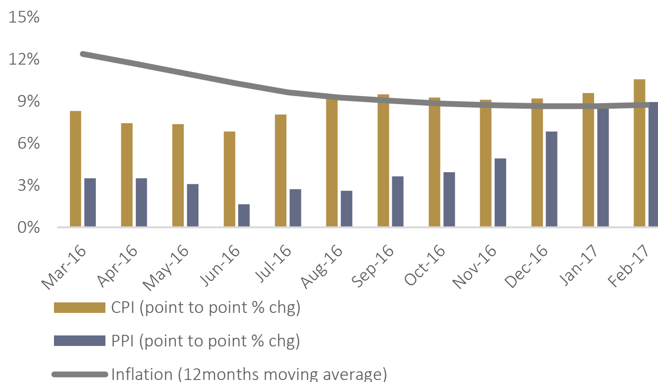
The data in Figure 9 above (supply side contribution to quarterly GDP growth) covers up to 20 December of Q4 2016. GDP growth for the nine months of the current Iranian fiscal year (Q2 to Q4 2016) reached 7.2%. The oil sector recorded by far the highest growth (85.4% in the nine months), fuelling 2.2% of the 7.2% GDP growth. The growth in the larger sectors of services, agriculture and industry all also swung well into positive territory this year, broadening the recovery and contributing 3.1%, 0.8% and 3%, respectively, to the overall nine-month GDP figure.

The main sector that remains a drag on growth is construction, which contracted 11% in the nine months of the Iranian year 1395. Recent construction data (on the number of permits issued, projects in progress and project completions) shows tentative signs of an uptick, and the recent increase in sales of construction materials appears to stem from a shift in demand for smaller housing units. There are also tentative signs of improvement on the demand side in Tehran's housing market (which has endured five years of stagnation), aided by a growing mortgage market off a very low base. House prices are still falling in real terms, however, and the supply glut in larger or luxury housing units and the surge in commercial construction will likely minimise any price increases and limit new builds in these segments.

The IMF projects that GDP growth will stabilise at around 4.5% over the medium term as the recovery spreads further to non-oil sectors, assuming oil production remains at the current OPEC target.

From the demand-side perspective (of GDP), consumption and investments remained weak in 2016. However, given the ample spare capacity (production and labour), expectations of significantly higher FDI in 2017 (announced FDI projects totalled ~$9bn in 2016), and slow but steady increase in the availability of cheaper domestic credit, sustainable growth in non-oil sectors is probable.

Figure 10: CPI and PPI



The recent collapse in inflation – down from a peak of ~45% in 2013 to the recent trough of 8.6% in Nov. 2016 to Jan. 2017 – resulted largely from better management of fiscal policy by the State and of monetary aggregates by the CBI.

As per Figure 10, recent PPI data – given its propensity to lead the CPI, as rises in production costs often reach retail prices with a lag – suggests inflation has bottomed out in the shorter term. Recent monetary easing by the CBI and the minimum wage increase (by 14.5%) further support this. The PPI increased from 3.3% in Aug. 2016 to 4.5% as of the last reading in Feb. 2017. The extent to which PPI can be a gauge for CPI is also determined by the import make-up of the CPI basket (PPI excludes imports), i.e. the greater the portion of the CPI basket that is domestically produced, the greater the correlation between the PPI and CPI. Thus one can also split the CPI basket into tradable and non-tradeable goods; the largest two weights of the CPI basket are Food & Beverage (27.4% & tradeable) and Housing (31.1% & non-tradeable); both increased (6.3% & 9.8% resp. as of Jan. 2017).

Figure 11: PPI basket

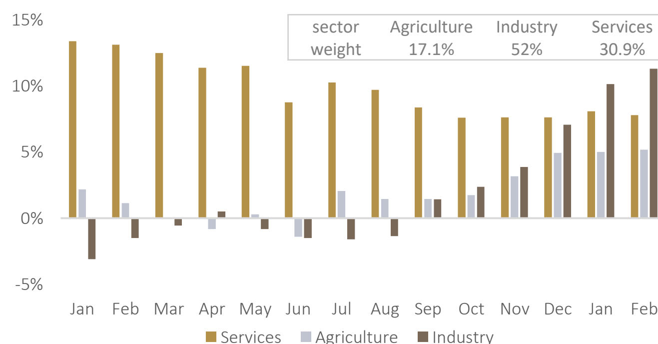


Figure 11 displays the simultaneous and broad move higher in the PPI constituents that occurred as the producer prices in the two sectors of industry and agriculture (69.1% of the PPI basket) accelerated. As it also shows, the services component has ceased its downward trend.

Sources: CBI, SCI, World Bank, IMF, SEO, Donya-e-eghtesad, McKinsey Global Institute, Griffon Asset Management.

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Figure 12: Unemployment

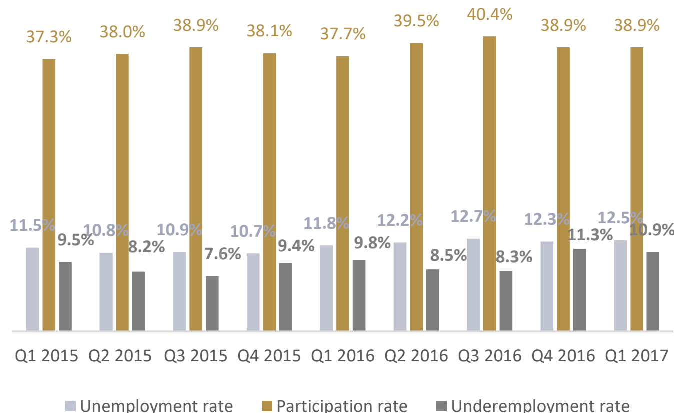
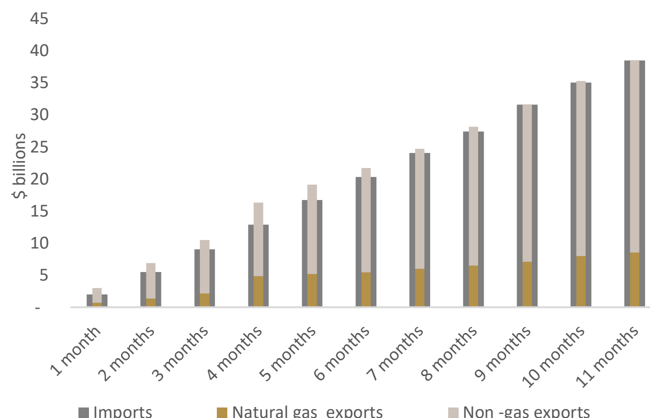


Figure 13: Iranian trade balance (cumulative, ex-oil), fiscal year 1395



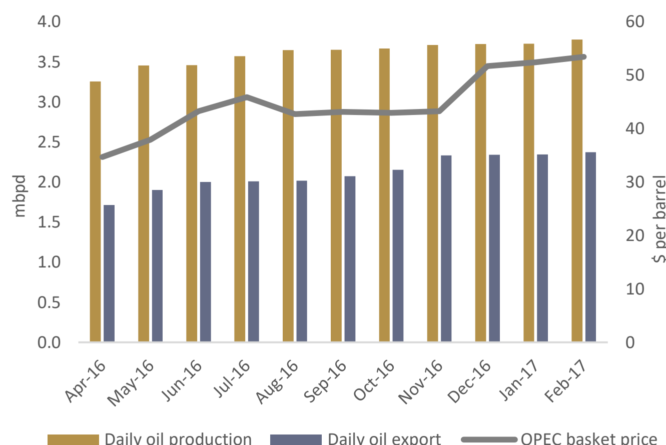
The pace of job creation, though impressive (1.06 million jobs created in Q2-Q3 2016), is still insufficient (1.67 million job seekers in the same period) to stem the rise in unemployment, which stood at 12.5% in Q1 2017. This is driven by the increase in the employment participation rate (since Q1 2016) as more Iranians seek jobs (see Figure 12). The increase in the participation rate is both encouraging and unsettling – encouraging, as it demonstrates that previously inactive individuals are now hopeful and active as the economy recovers; and unsettling, as it is a reminder of how many more jobs still need to be created in an economy where an estimated 1 million university students graduate every year. In particular it is private sector job creation that needs to accelerate. By comparison, labour participation rates in Turkey, Russia and China vary from 50% to 70%. Therefore the labour participation rate in Iran has material upside potential (i.e. spare employment capacity, which is disinflationary). In particular, with male and female participation rates at 65% and 16%, respectively, there is significant potential upside in the female rate.

The unemployment rate in Iran among the youth (defined as between the ages of 15 and 24), at 28.1% in Q1 2017, is particularly notable.

A final note is that *underemployment* – which includes (a) workers who are highly qualified and/or skilled but working in low-paying or low-skill jobs and (b) part-time workers who would prefer to be full time – has remained relatively stable in the last two years.

As shown in Figure 13, the current account remains in surplus. Even ex-oil, the trade balance has been positive, with the largest portion of the non-gas exports being petrochemicals & condensates ($16.4bn in the 11 months for this year). In the medium term, total exports will still likely more than offset any acceleration in imports to accommodate future industry investments and growth, thus maintaining a surplus. Including oil, Iran has been running an average monthly trade surplus of about $2.5bn, which equates to a hefty current account surplus of as high as ~8% of GDP. However, given the pent-up demand for imports (due to sanctions and lack of financing), further gains in the current account surplus should not be expected. A final factor worth noting is the size of the smuggling-driven black market, which is perhaps $12-15bn; this may mean the country's surplus is in reality lower.

Figure 14: Oil production and exports, Iranian fiscal year 1395



Expectations are for oil production to remain at the OPEC targets, which Iran reached in the second half of the current Iranian fiscal year (see Figure 14). So while the oil sector could provide some further growth year on year (particularly for the first half of New Iranian year), its positive impact on GDP will be much more muted compared to the boost already provided in 1395 (21 March 2016 to 20 March 2017).

Sources: CBI, SCI, OPEC, IRICA, JODI, McKinsey Global Institute, Griffon Asset Management.

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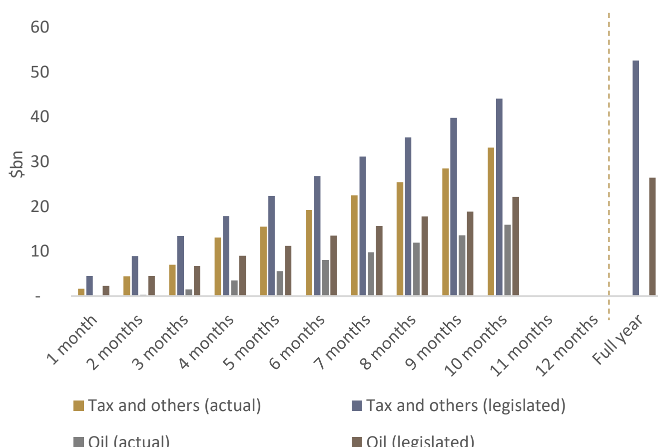
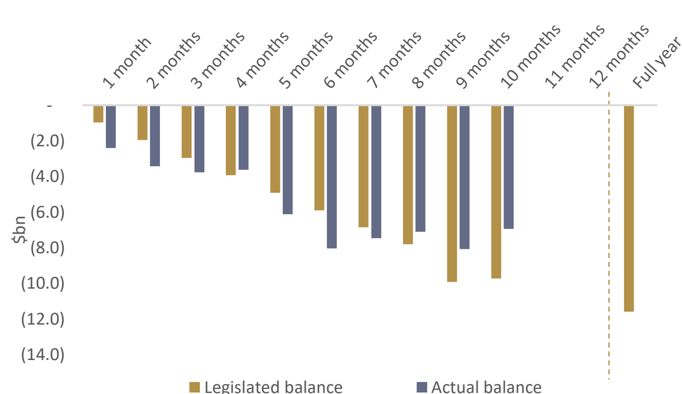
Figure 15: Government revenue, Iranian fiscal year 1395



The Iranian government forecasted a General Budget for 1395 of $98bn, of which 35.3% was to be derived from taxes and 25.3% from oil. In the first nine months of the Iranian year 1395, although oil and tax (and royalty) receipts were expected to be $58.5bn, only $42.1bn was received, a shortfall of $16.4bn (see Figure 15). This is mainly accounted for by a lower oil price, settlement payments to the CBI for advance oil payments, and the ongoing need to overhaul the tax base. Whilst tax revenues are up 28.9% year on year (on a nine-month basis), new taxation directives and codes will continue to increase the tax base (as opposed to increasing tax on those already paying) by improving data collection and addressing those who have been evading or indeed been exempt from paying tax.

Figure 16: Government budget deficit, Iranian fiscal year 1395



For the Iranian year 1395 (21 March 2016 to 20 March 2017) the government had anticipated raising $19.3bn from financial asset sales. In the first nine months it has raised about $11bn, mainly through bonds, to finance its budget deficit, of which about $2.3bn (Islamic Treasury Bills) were listed in the capital markets. This resulted in a "crowding out" effect and – after further T-Bill listings were halted towards the end of the year – concern regarding the capital markets' ability to absorb further issues, especially as foreign portfolio inflow remains muted.

Government expenditure (including both current and developmental/infrastructural spending) grew 18.6% (y/y) in the first nine months of 1395, though remaining 24.0% lower than the legislated amount. As per Figure 16, this has enabled the actual budget deficit ($8.1bn, 2.8% GDP, over nine months) to remain less than the legislated deficit ($9.9bn, 3.4% GDP, over nine months).

Prudent fiscal policy and gradual fiscal adjustments – such as the General Budget's growth for 1396 being no greater than the expected inflation rates of ~10% – will be essential for the following fiscal year, and will likely limit any significant growth in government expenditure. The historical and still problematic issue of State over spending on current expenditures and relative neglect of infrastructural spend, continues to cap longer-term productivity and economic upside.

The Budget Bill for the Iranian Year 1396 is based on the CBI's USD/IRR FX rate of 33,000 and oil at $55 (with 2.42mbd of exports, including condensates). Government revenues and expenditures are forecasted to grow 16.6% and 10.3%, respectively, with a legislated budget deficit of $7.1bn (<2% GDP forecasts).

Whilst Iran's actual and expected budget deficit (as a percentage of GDP) is small by global or regional standards – compare Saudi Arabia at 11.7%, Egypt at 12.4%, Pakistan at 4.6%, Brazil at 6.4%, or Russia at 3.7% – its financing is still burdensome. The option of meaningful foreign financing remains sidelined whilst the State also has other domestic payables (to banks, contractors, pension funds, municipalities and utility providers), estimated at 30-40% of GDP. Hence with the high burden that the cost of local financing creates (>20% domestic interest rates), a relatively low budget deficit becomes exponentially more difficult to achieve.

A more granular assessment of the budget deficit shows that it is the *non-oil* deficit – currently hovering at around 10% of GDP – that poses the biggest challenge for the State. Increasing tax collections from 7.5% to 10% of GDP will help (though requiring a broader tax base and more-effective administration and regulations), but this will still fail to offset modest increases in State developmental (investment) spending and maintaining subsidies. Public debt could rise to ~40% of GDP, given the plans to issue new debt to clear State payables.

In sum, the major factors adversely affecting the non-oil budget deficit are interest payments and the need to increase investment spending, whereas the main levers to alleviate some of the fiscal pressure are subsidies reform, prudent current spending and increased tax income.

Sources: CBI, World Bank, IMF, TSE, Financial Tribune, Bloomberg, The Economist, Financial Times, McKinsey Global Institute, Griffon Asset Management.

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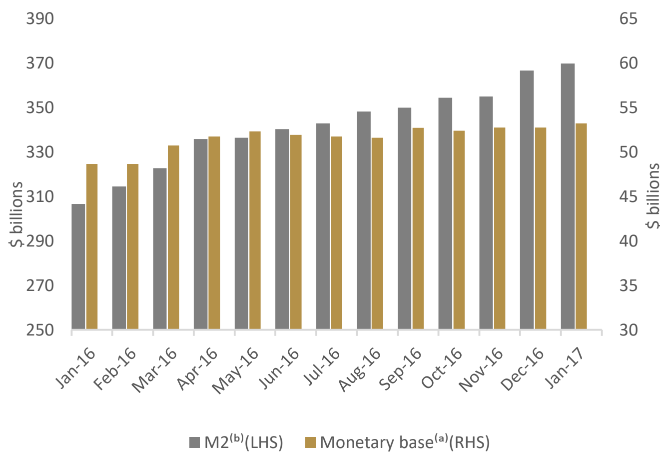
Figure 17: Money Supply components

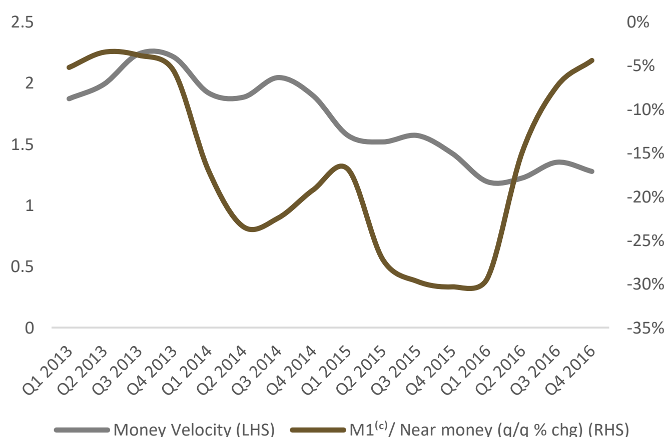


The monetary base (the powerful money multiplier) grew by 11.2% over the first nine months of the Iranian year 1395 (versus 18.7% and 21.1% growth over the comparable period in the two previous years) and 19.4% year over year. The primary and secondary sources of growth for the monetary base were increases in CBI net claims on the public sector and the banks (driven by the government initiative for SME lending, at a time when the banks' ability to lend was limited), respectively.

In addition, M2 grew by 21.4% for the same period, versus growth rates of 19.7% and 26.4% for the previous two years.

Hence the loosening of monetary policy, as indicated by the monetary aggregates, does increase the risk of higher inflation going forward.

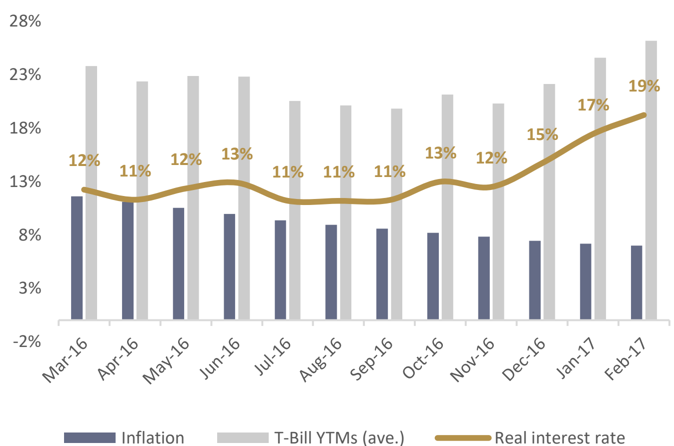
Figure 18: Money Velocity



As per Figure 18, money velocity (money supply x money velocity = nominal GDP) has been trending lower for the last three years (acting as a counterweight to the money supply growth of about 30% year on year).

However, notably M1 (which includes cash and checking deposits) relative to the quasi-money components of M2 (e.g. savings, time deposits, and mutual funds) can be considered a lead indicator of money velocity. The point-to-point percentage change (with data normalised to accommodate seasonal influences) has in 2016 meaningfully reversed what was an aggressive downward trend, and is now approaching positive territory. This would suggest an increase and reversal of the negative trend in money velocity is likely to happen in the Iranian New Year. In simpler terms, historical data (the last 10 years) shows term deposits as a percentage of money supply have been ~65% versus the current ~81%. As and when real interest rates (currently ~17%) revert closer to the lower-inflationary environment (~9%), one should also expect a significant outflow in term deposits (probably to sight deposits initially).

Figure 19: Real interest rates



As Per Figure 19, real interest rates (using Islamic Treasury Bills YTM as the "risk free") in the current Iranian year have fluctuated from a low of 11.2% (August and September 2016) to a high of 19.2% (in February 2017). Part of the current squeeze in rates at this time of year is cyclical (as we approach year end, corporate seasonal imports and inventory levels increase whilst simultaneously financial firms try to deleverage), so the squeeze should relax in the short term in the Iranian New Year. The remaining (and larger) factors for high real rates originate from the instability and competition for deposits in the banking system, State payables (soon to be debt) and the budget deficit (*non-oil* in particular).

(a) Monetary Base = cash (public + banks) + bank required reserves + excess reserves.
(b) M2 = M1 + term deposits.
(c) M1 = cash (public) + sight deposits. Near money = short term deposits + long term deposits + saving (and other) deposits.
Sources: CBI, IMF, Financial Tribune, Bamdad Institute, Griffon Asset Management.

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Figure 20: USD/IRR CBI & free market FX rates (Jan. 2016 – Feb. 2017)

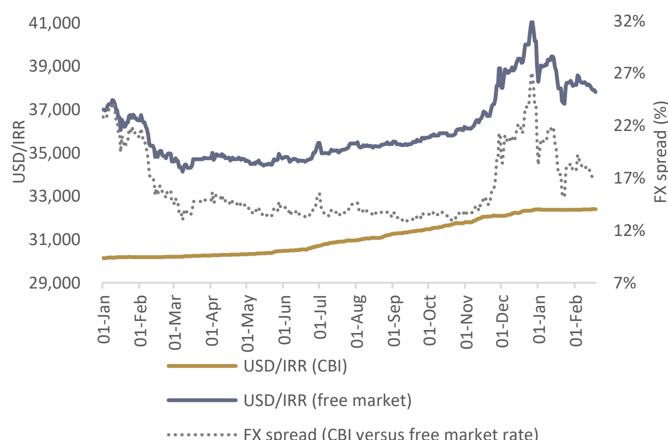
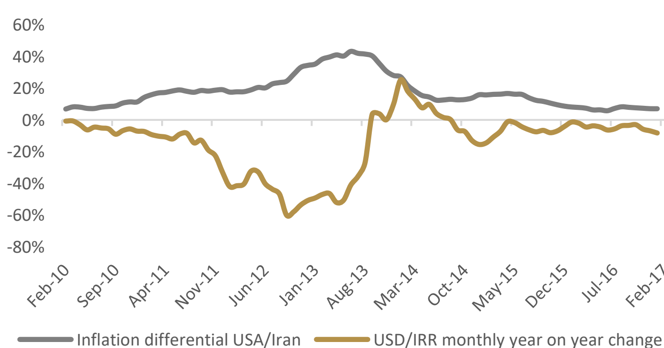


Figure 20 illustrates (for Q4 2016 to Q1 2017) the more recent seasonal pattern for the rial, where weakness in Q4s is followed by recovery in Q1s (repeated over the last two to three years- *see Dec. factsheet*). As we headed into Q1 2017 the rial repeated this behaviour, recovering 8.0% from its December 2016 low (41,100 on 27 December) to close at 37,830 on 26 February 2017.

For the longer-term currency outlook, two of the most important longer-term economic factors to consider are inflation and productivity. The sharp falls in inflation (CPI has fallen from a peak of about 45% in 2013 to 8.6% in Q4 2016) and expected productivity gains (off an extremely low base, with Iran's FDI stock a fraction of its EM peers) will likely mean longer-term currency support and stability (i.e. more akin to gradual annual depreciation in line with inflation differentials to a global basket, as opposed to sharp devaluations). In addition, the positive trade surplus (including and excluding oil) and capital account inflows will be supportive of the local currency. As a counterbalance as the economy fulfils its 4-5% GDP growth expectations in the years ahead, many industries will increase their imports, and consequently foreign currency demand will rise. Last but not least, the CBI now has greater independence and authority as well as increased tools (in policy and reserves) to achieve its core policy of price and currency stability.

Figure 21: USD/IRR free market FX rate and inflation differential



Sources: CBI, IMF, Bloomberg, Mirdamad Exchange, Royal Exchange, Parsi Exchange.

The CBI is also now allowing banks to operate at the free market exchange rate and has already shifted over half of the import categories away from the official CBI rate to the free market rate (Figure 21). In other words, the CBI is already "managing" the unification, and appears set to ensure that it will not be an "overnight" event. With the State's hard currency reserves again growing (sustainably), we believe the State will implement the unification and will do it at a level close to the free market rate – that is, the official rate will face a "devaluation" to close (most if not all) the gap with the free market exchange rate.

Whilst the base case (as per repeated communication from the CBI) for FX unification may have been by Iranian year end 1395 (20 March 2017) or just after, there will be a delay in the unification of the FX rates. In our opinion, the delay could be up to 12 months. One of the fundamental causes for the delay is the lack of sufficient correspondent banking relationships between Iran and the rest of the world (thus limiting the CBI's ready access to reserves and ability to sensibly manage and intervene in the FX market). An important prerequisite for the complete unification of the FX dual structure is fully operational banking channels between Iran's financial system and an adequate number of larger international banks; whilst the connectivity is improving, there is still work to do. The CBI's efforts to reform and harmonise domestic banks with international standards are crucial to achieve this. Other factors to assess, in relation to the viability of FX unification, include the extent to which:

- The CBI has sufficient financial resources (net FX reserves are ~$59bn, the equivalent of ~17 months of imports),
- Inflation has been (sustainably) curbed,
- A currency futures exchange is created (to enable hedging and reducing volatility),
- Fiscal discipline is continued so as to minimise the budget deficit, and
- The government again encourages banks to manage and operate FX transactions by tightening the regulations on FX bureaus (which are much smaller and sometimes lightly regulated).

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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.

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