GRIFFON IRAN FLAGSHIP FUND

GriffonCapital
Asset Management and Private Equity

Griffon Asset Management

Investor Quarterly Report

November 2016

Investor Quarterly Report

Portfolio update

Since inception the Fund (Initial Series EUR NAV, 25 October 2016) is up 9.4% versus the TEDPIX -1.0% (EUR) and -2.6% (IRR). As we noted in the October factsheet, October was a particularly strong period for the Fund, with the Initial Series NAV advancing +4.5%. This was attributable mainly to large advances in two of our top five stock positions (the top five constitute 41.3% of NAV as of October 25) and a "tailwind" of a 2.0% rise in the euro versus the rial (reversing September's "headwind" of a -1.3% drop).

We have continued to gradually increase our equity exposure (from 41.4% in June to 74.1% in October) whilst continuing to take select advantage of the >20% domestic government and corporate bond yields on offer. The Fund's flexibility to invest across asset classes and to build up high-conviction equity positions during the recent market pullback (~11% correction from April to June) has helped it outperform the TEDPIX (the main domestic index). The TEDPIX has now recouped most of its recent loss and, as of October 25, is 3.3% off its April high (reached after a 32% rally from Jan. 1 to Apr. 2, 2016).

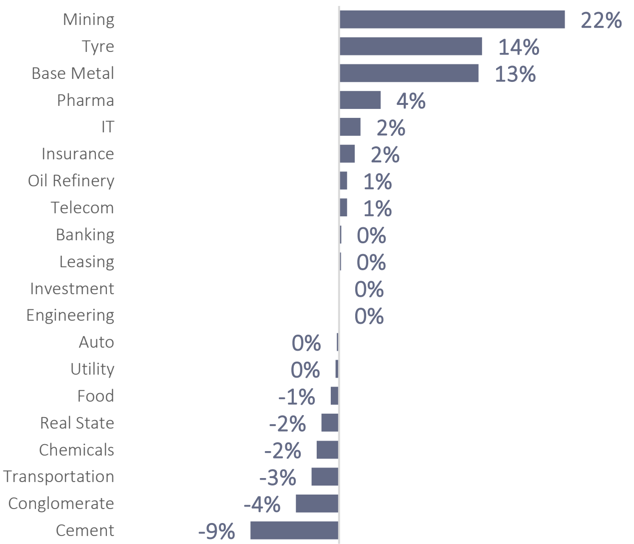
As of October 25, the equity portion of the portfolio consists of 24 companies. The GIF portfolio (on a harmonic average basis, based on our own proprietary forecasts for 2016/2017) has a price/earnings (P/E) ratio of 6.1x, a dividend yield (DY) of 11.9%; and expected EPS growth of 22.3% for this Iranian 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 and tyre sectors. We have also increased investment in and/or are more seriously assessing the opportunities in the banking, cement and commodity industries. However to be clear, *we are stock pickers – that is, we invest in individual businesses, NOT sectors, and we avoid a broad-brush investment approach.*

H1 results: Iranian calendar March-September 2016

Most listed companies have published (unaudited) H1 corporate results. Figure 1, which is based on our top-down screening of 378 companies that announced results (262 of which were H1 results; i.e., they have a 21 March 2016 to-20 March 2017 financial year), shows the respective industry-level EPS upgrades/downgrades.

Figure 1: Industry EPS upgrades/downgrades [(a)]



Whilst the consolidated overview offered in Figure 1 provides an adequate summary, there are outliers in the data coupled with the fact that earnings and balance sheets must be carefully and patiently cleaned such that they are 'normalised' – by, for example, identifying interest bearing payables, removing exceptional or non-operating income, correcting revenue recognition assumptions, and so on). This process enables better assessment of the underlying quality of the businesses and respective earnings.

We now have 80 companies under full research coverage – meaning full models, comparative assessments plus a four-page investment checklist that includes on-the-ground 'scuttlebutt' checks. Our goal is to reach 120 companies in H1 2017.

In addition to Figure 1, we thought it worthwhile to share (in the next two pages) some of our main conclusions regarding the H1 corporate results, as well providing more detailed numbers and thoughts on a handful of sectors. We based this on our own investment universe of approximately 150 companies (i.e., a subset of the 378 companies screened for Figure 1). We have used simple averages (non-weighted) for the quantitative comparisons and all EPS upgrades/downgrades are benchmarked versus the companies' own forecasts from the previous quarter (Q1 2016-17).

Sources: TSE, IFB, Codal.ir., Griffon Asset Management .
(a) EPS upgrades/downgrades (mkt cap. weighted average) based on new company guidance in Q2 2016-17 versus previous guidance in Q1 2016-17, from 378 companies.

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Corporate results – notable points

The following are notable points we observed across the industries.

Revenue growth

Real revenue growth (i.e., at or above the average inflation rate of 10% in the comparable period) occurred in pharma, detergents, commodities (rubber, base metals and iron ore), autos, IT and insurance. The respective share of the volume increase and/or the price increase attributable to top line growth did vary between the industries; for example, in autos the two factors were evenly split.

Capacity utilisation

Increased capacity utilisation (and to some extent positive operational leverage) is visible in most manufacturing orientated sectors, with the exception of cement – where the high fixed costs mean producers are flirting with small profits or losses (the average sale price for H1 hovered around or just above the marginal cost of production). Another industry that can and will likely benefit (next year) from increased capacity utilisation is petrochemicals; the driver here could be the provision of more consistent feedstock resulting from the increased usage of the South Pars gas field.

Sales relative to production (inventory scorecard)

A healthier relationship between sales and production is reappearing in manufacturing. Sales growth (in terms of units) generally exceeded production growth; for example, in the auto sector, the sales/production ratio increased from about 85% to about 95% year-on-year, even with production growing at 14% year-on-year. We think this is a combination of factors such as more rational production targets, increased end-user domestic demand and higher exports. Additionally, in many cases sales exceeded production; this inventory reduction was visible in commodity-related segments of industry such as mining and rubber. This effective inventory wind down, provided one off boosts in sales and earnings and will naturally help corporate liquidity (reduction of working capital and related expenses).

Debt refinancing

In general, notwithstanding the 'inventory destocking' (in the heavier industries) and the expected savings from lower working-capital needs, lower interest rates on long-term interest-bearing debt have not yet started feeding the bottom line. We expect that in some of the larger companies, the refinancing of debt will take place in the second half of this year. New borrowing rates could be as low as 18-22% versus previous loans set at 25-28%, and this will provide a direct boost to net income.

Consumer borrowing

On the demand side, the Central Bank of Iran (CBI)-mandated reduction in bank deposit and lending rates (officially at 15% and 18%, respectively), has not yet manifested in banks offering, directly or indirectly, cheaper credit to consumers. For example, car leasing volumes have not yet benefitted and the recent bank sector rollout of the new credit card scheme appears to be moving slowly.

A brief note on banks

Among the listed banks that published results for H1 of this financial year, loan growth averaged 41% year-on-year (versus 30% for the same period last year). CBI data show that bank loan growth for H1 was 45.4% year-on-year compared to the corresponding period last year. Most of this lending was for the elevated working-capital requirements in the economy.

Some of the larger listed banks have remained suspended since going into the AGM period in July. For a few, the reason for suspension is the discrepancy between last year's audited results and the CBI's negative adjustments. The CBI's revisions relate mainly to differences in recognition of non-performing loans (NPLs), interest rates charged against government debt, non-operational income, and FX-related gains/losses.

In discussions of the banking industry in Iran, some commentators frequently rely on negative "urban myth" rather than proper analysis. Although a full review of the industry and its individual players is beyond the scope of this report (beyond a detailed analysis of a few select banks), we like what we see. We always start with the balance sheet; once satisfied, we will then try to understand the bank's normalised earning power in an economy that is reawakening – whether it be through reversion of net interest margins (NIMs) to historical averages, a pickup in commercial loans, new consumer credit, increased rates of fees and commissions, the lowering of bloated cost/income ratios, revenue from letters of credit (LCs) and trade finance, or other factors.

Recently the Iranian government started to settle about $8 billion in outstanding debt to banks, clearing their debts to the CBI (which incurred a penalty rate of 34%) and yielding a big saving for banks. The CBI has also begun a comprehensive reform of the sector; the new proposed Banking Bill will further strengthen the CBI's supervisory power, and should help restore the banking sector to health with time.

Sources: CBI, IMF, TSE, IFB, Codal.ir, Tejarat Farda, Financial Tribune, Donya-e-eghtesad.

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Sector insights

H1 results: Pharmaceuticals

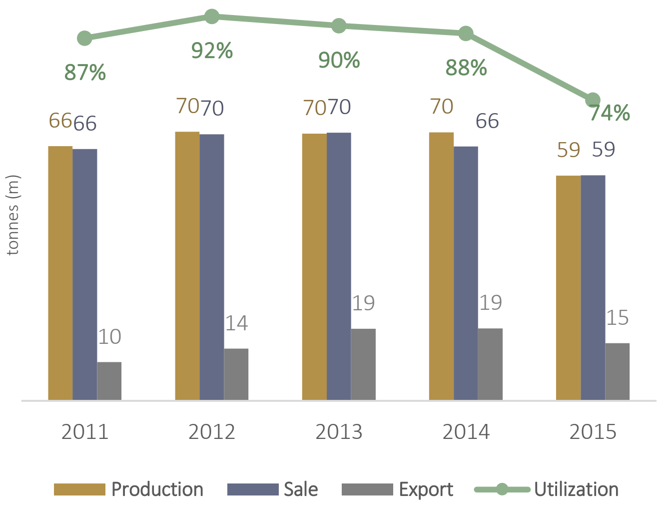
Revenue and earnings before interest and taxes (EBIT) in the pharmaceuticals sector grew 13% and 15% year-on-year, respectively. To break down the increase in revenue between volume/units and price, we will need to wait for audited results. This equates to coverage of 45% and 47% of revenue and EBIT, respectively, as a percentage of the full year guidance previously set by the companies. Although the coverage is less than 50%, this is in line with expectations, as we typically witness an uptick in H2 due to seasonal attributes (though seasonality effect has been lessening due to relative changes and growth in 'non seasonal' drugs). There were earning upgrades and the sector trades on an attractive P/E of 7.1x this year's expected earnings.

Although fragmented and competitive, the pharma sector has continued its steady progress, in line with many of its secular growth characteristics – such as >90% healthcare coverage, the ageing demographic profile, >2-3 years behind leading developed-market drug cycles, significant and long-term increase in illness burdens, and opportunities for export to neighbouring countries). The very cheap local pricing suggests there is long-term pricing power for the industry; when considered in terms of consumption per capita (on a unit basis), Iran is one of the top three pharma consumers in Asia. However, on a value basis, consumption per capita, at ~$35, is approximately 20-25% of per-capita spend in Turkey and less than 10% of per-capita spend in Germany. However there is also reason for caution: margins (domestic EBITDA margins are about 40%, versus GEM peers at 25%) could initially compress as foreign competition enters. That said, the barriers to entry for foreign firms are high; consider, for example, the experience of Novo Nordisk in trying to compete against the cheaper prices of domestic manufacturers. Nevertheless local manufacturers will likely embark upon a capex binge by aligning with Good Manufacturing Practice (GMP) standards , increasing R&D, and improving marketing & packaging.

H1 results: Cement

Revenue and EBIT in the cement sector declined -14% and -45% year-on year, respectively. The sharp fall in EBIT versus the top line stems from the effect of negative operational leverage – that is, the adverse impact of high fixed costs when revenues fall. This equates to coverage of 48% and 42% of revenue and EBIT, respectively, as a percentage of the full year guidance previously set by the companies. In other words, despite the worrying headlines, both the market and company guidance are actively addressing current challenges. However, the earnings downgrade cycle has continued and the sector appears 'expensive', trading on a P/E of 15.4x this year's expected earnings (given the cyclicality of this industry, the current dip in earnings can make the industry appear very expensive; evaluating instead by 'asset' value at this stage of the industry cycle may be more sensible).

Figure 2 : Cement industry data for the last five years



Supply-side behaviour is becoming more rational, it seems, and cement prices have bottomed. Production fell -16% last year and a further -11% year-on-year for H1 this year. Sales volumes declined -11% last year and again declined -9% year-on-year in H1 this year. Although the inventory backlog has not yet started to fall, we expect the rate of inventory accumulation to start falling this year. The sector has been slow to cut back production, whilst domestic prices have collapsed (just year-on-year, they have decreased -9.2%) and inventories (of cement clinker) accumulated are at an estimated 22% of average annual demand over the past five years. There are now tentative signs of price recovery; companies are agreeing to cap production and reduce the excessive discounts offered to buyers. October saw the first notable uptick in the price of cement: average prices were ~$23/tonne in H1 this year (versus an average cost of production of <$20/tonne), whereas in October (the first month in H2 of Iran's financial year) prices averaged about $28/tonne, an increase of approximately 22% over the average of H1. For some perspective, the price of comparable cement in the surrounding countries can vary from $50 to $100 a tonne.

The sizeable and long-term influences for the sector remain State- and private-sector–related spend on infrastructure and construction, as well as the recovery of exports (namely to Iraq).

Sources: TSE, IFB, Codal.ir., Pharmaceutical llia Report, Cement Association Iran, McKinsey Global Institute., syndicate of Iranian Pharmaceutical industries

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(*Cement continued*) The reasons why Iran's cement demand will likely grow and remain elevated include the very low cost of production (it is one of the lowest in the world – and cement pricing is regional due to high transportation costs and wider availability of raw materials), the country's high rate of urbanisation (73% urbanised, a high urbanisation growth rate of 0.8%, and a population growth rate of 1.3%), the lack of building alternatives (such as lumber), and the fact that most of the surrounding countries are net consumers. As an investor, timing the entry precisely at the bottom of cyclical cycles is always difficult, if not impossible. Nonetheless, by taking a longer-term perspective, one can take comfort and maintain conviction when the downside is measurable and limited. For example, when companies avoid meaningful debt (allowing them to live through a downturn), enterprise values are at huge discounts to replacement cost and unit selling prices are below or at the cost of production, which is unsustainable over a reasonable timeframe. We continue to monitor this sector closely.

H1 results: Leasing

The leasing sector delivered a 5% year-on-year increase in net income. This equates to 48% coverage of the net income, as a percentage of the full-year guidance previously set by the companies. There were no earnings upgrades in the sector, which now trades on a low P/E of 5.7x this year's expected earnings.

We were slightly disappointed in the new asset formation by the leasing sector. Given that lease durations are typically 2-3 years, earnings can roll over relatively swiftly if there is insufficient growth in new loans. There could be various reasons for this, such as the temporary effect of new product lines (the first buyers of a new car typically buy in cash) and challenges related to the payables of the auto companies (exchanging vehicles for their respective payables). However, there is typically a seasonal pickup in H2, and some companies in this sector are known to be conservative in guidance. The longer-term drivers for this sector (both for commercial vehicles and cars) remain compelling – principally the pent-up demand overdue from the upcoming cycles for vehicle replacement (the average Iranian car is still more than 11 years old) and upgrading (consumers want better-quality or more premium cars), which will be fueled by the improved availability of credit at lower interest rates. The latter has not yet occurred, however. Given current valuations, respective balance sheets and business models, investing in leasing is in our view, a better way to benefit from the auto sector's expected growth than buying auto manufacturers directly.

H1 results: IT

The IT sector delivered 18% and 28% year-on-year growth in revenue and EBIT, respectively. This equates to ~48% coverage of revenue and 42% of EBIT as a percentage of the full-year guidance previously set by the companies. There were small earnings upgrades despite the relatively strong forecasts. The sector is trading on a P/E of 10.3x this year's expected earnings.

The IT sector encompasses a broad array of companies including payment service providers (PSPs), app developers, value-added services (B2B and B2C) and enterprise software providers. It is an exciting, fast-growing and broad industry. Large parts of it are already a major beneficiary of the country's demographic dividend; both revenues (via innovation) and expenses (via competitive salaries) will benefit from access to approximately 200,000 students studying computer science and computer engineering (with a focus on software). The flip side is that companies in this sector trade on relatively higher multiples (justifiably so, if the growth is sustainable) and will be less predictable than the more established industries. The technology landscape changes fast – as does the competition, which is attracted by the high growth rates and seemingly wide margins; so picking the winners is easier said than done. We are invested in a few companies in this space. The characteristics we look for and sometimes find in parts of the sector include high switching costs, high barriers to entry and a good degree of pricing power.

N.B. We 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. Because the market is naturally a discounting mechanism, an integral part of what we try to do is filter out noise and focus on identifying and understanding the most important variables before the market does. We are less worried if the market disagrees with us today, and more concerned that it will agree with us in the future, after we have made our investments.

Sources: CBI, TSE, IFB, Codal.ir, BMI, ICTNA, Way2Pay, McKinsey Global Institute., Trading economics, World Urbanization Prospects, Automotive World.

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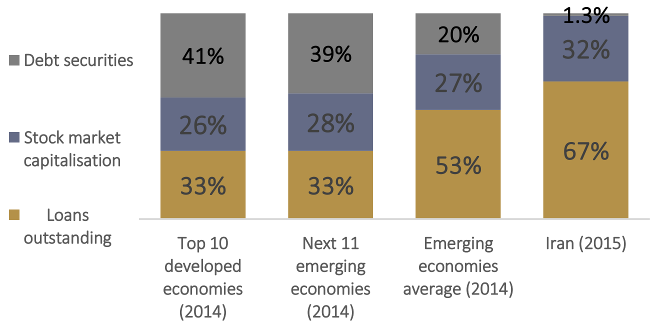
Fixed income in Iran: idiosyncratic and high real returns

In terms of asset allocation, the Fund has maintained a significant weight in fixed income instruments, which represented as much as 58% of NAV in June and close to 25% of NAV in October. Therefore we thought it would be worthwhile to explain the context of, and offer insight on, the domestic fixed income opportunity in Iran.

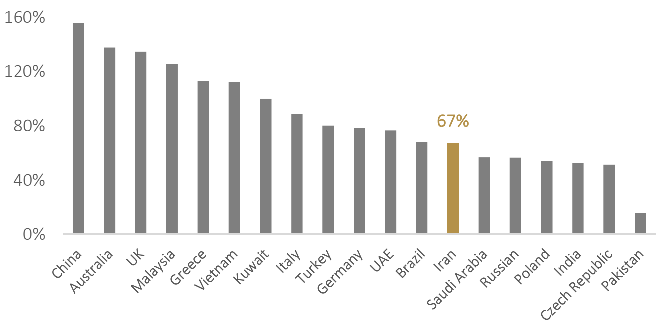
Over the last couple of decades Iran's economy has been driven largely by credit relationships between State-affiliated banks and the State (including State-related/owned entities and those partially privatised). Bank loans have traditionally been (and still are) the primary source of capital, with the State and private sector too reliant on bank funding. Figure 3 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 3: Iran's financial asset market composition versus peers [(a)]



Furthermore, total bank loans increased at a compound annual growth rate (CAGR) of about 17% from 1994 to 2015; commercial bank loans outstanding in 2015 were $216 billion (67% of GDP). As per Figure 4, 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 MENA countries. In other words, in terms of financial intermediation, Iran is more an emerging market than a frontier market.

Figure 4: Total loans to GDP, Iran's banking sector versus peers

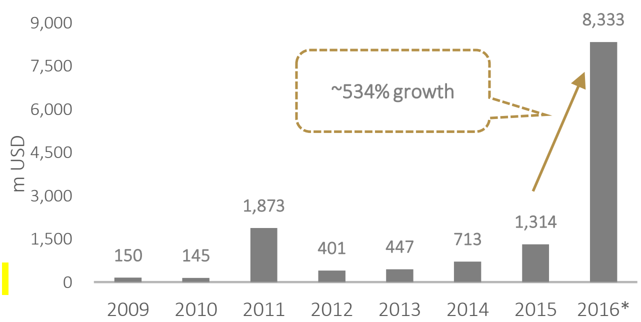


Some banks are currently facing both increased NPLs (from $6.4 billion in 2007 to $27.1 billion in 2015, equating to a ~12% NPL ratio) and a relatively high proportion of (illiquid) non-core assets. They are thus in need of liquidity and, in a few cases, recapitalisation. Unsurprisingly, the banking sector's lending capacity has diminished (from 2011 to 2015 the value of total bank loans fell at a CAGR of -7%) at a time when sanctions increased the working capital requirements of the economy and the fall in domestic money velocity resulted in problematic and lengthy cash conversion cycles for corporates.

Given the circumstances, the State and the private sector require a better balance in the mix of funding options to address their financing requirements:

- The stock market has been helping. The Tehran Stock Exchange, opened in 1967, by 2005 had benefitted hugely from the State's extensive Privatisation Programme. Today there are two stock exchanges with a combined market capitalisation of $118 billion, with balanced retail and institutional participation and an average daily volume of $168 million ytd.
- In contrast, until recently Iran's bond market had shown little sign of growth or promise. Historically unlisted/OTC government bonds have been an important (though still relatively small) vehicle for raising funds for the State. Corporate bonds and listed bonds of note were limited. However, starting in 2015 and accelerating into 2016, the capital markets have witnessed a surge in the issuance of exchange-listed bonds, as demonstrated in Figure 5.

Figure 5: Total issuance in the debt capital markets ($ millions)



** In 2016, the State issued Ijarah securities ($143 million) and Islamic Treasury Bills ($3.4 billion), which were listed on the Iran Farabourse (IFB). The first MBS was also issued ($86 million) and listed on the IFB. Salaf bonds were also listed on the Iran Mercantile Exchange (IME) and Energy Exchange (EnEx).*

Sources: CBI, World Bank, IMF, TSE, Codal.ir, SEO, Financial Tribune, World Development Indicators, McKinsey Global Institute.
(a) Figure 3 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.

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- (*Continued*) The need to enhance funding sources and investment alternatives in the market will likely lead to a more balanced distribution among bank financing, equity financing through the stock markets, and debt financing through the domestic debt market.
- With inflation and interest rates falling significantly and capital market laws and regulations firmly in place, the State, state-owned enterprises (SOEs) and a growing number of private firms can now turn to a robust and well-regulated debt market. Moreover, the fact that debt now costs less than equity creates an economic incentive for corporates to optimise their capital structures by utilising the debt market (a new and additional route to the already-established stock market).

Iran's debt capital market: main instruments and characteristics

The term *sukuk* encapsulates a broad range of bonds issued in Islamic countries. Similar to a bond in Western finance, a sukuk is an Islamic financial certificate that complies with Sharia Islamic law. Because the traditional Western interest-paying bond structure is impermissible under Sharia law, the issuer of a sukuk sells an investor a certificate, then uses the proceeds to construct or purchase (or lease) a tangible asset. The investor has an (partial) ownership right of the underlying asset(s). The issuer is also legally obliged to pay coupons until maturity, by which time the issuer will buy back the sukuk at par value.

The most common instruments in the domestic debt market are sukuks: Musharakah, Ijarah, Istisna, Murabaha, Salaf. Other debt instruments are Islamic Treasury bills, certificates of deposit (CDs) and mortgage-backed securities (MBS)

Figure 6: Current profile of Iran's debt capital market

Market Summary	TSE	IFB	EnEx	IME	Total
Number of bonds	18	47	2	9	76
Market value ($m)	2,424	5,169	96	1,049	8,737
Market share	28%	59%	1%	12%	100%
ADTV ($m) - 1 month	32	36	1.8	11.3	81.1

Debt securities are listed on one of four exchanges: the Tehran Stock Exchange (TSE), the Iran Farabourse (IFB), Iran Mercantile Exchange (IME) and Iran Energy Exchange (EnEx). The debt instruments are most commonly found in the IFB and TSE.

Sukuks (specifically Musharakah bonds) have been the most commonly issued security by corporates and State-related entities.

Islamic Treasury bills (and, more recently, Salafs) have been a fast-growing financing tool for the government.

Figure 7: Key terms and features of domestic Iranian debt instruments

Key Term	Definition
Interest rate	Current range of 16–22 percent annual rate. Bonds trade at their respective clean price (calculated by subtracting the accrued interest, which is calculated on a daily basis).
Coupon payment	Mainly quarterly, rarely monthly; there is also an increasing number of zero coupon bonds (Islamic Treasury bills and Salafs). A schedule for the payment of coupons (and methodology of accrual) is released by the regulator prior to issue. Coupons are paid to investors' bank accounts.
Maturity	Durations range from three months (T-bills) to four years.
Guarantor	In the event of default by the issuer, the guarantor (which can be an investment bank, a commercial bank, another type of financial entity or a State entity) has guaranteed payment of all coupons and the principal (at par). There are currently no credit rating agencies in Iran.
Market maker	The market maker is an investment bank or broker. There are two variations: 'Haraj' (auction) and 'Mozakereh' (negotiated). Auction market-making involves an initial auction (free market price discovery) to set the base price, after which the market maker is obliged to provide two-way liquidity (tranche sizes preset) based on a pre-agreed spread versus market trades. In the negotiated version, the market maker must buy the bond at par but has no obligation to make a market on the offer side. Negotiated bonds are more common.
Trustee	This is typically a financial institution, such as a commercial bank or trust company, that has the fiduciary powers to enforce the terms of a bond indenture. (An *indenture* is a contract between the bond issuer and the bond holder.)
Auditor	A firm appointed to audit and monitor a project.
SPV/SPE	A segregated special purpose vehicle/entity with an asset/liability and legal structure that makes its obligations secure in the event of default or bankruptcy of the issuer.

Sources: CBI, TSE, IFB, SEO, IME, EnEx. ***ADTV = average daily trading volume.***

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Figure 8 : 2015 and 2016 issuance by instrument type ($ millions)

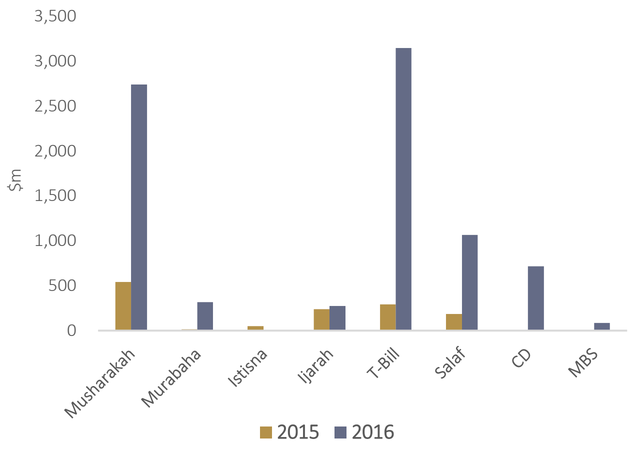
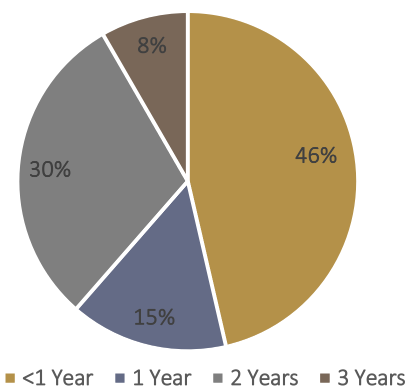


Figure 9 : Maturity profiles of listed debt instruments



Nearly half of all listed instruments have outstanding maturities of 1 year or less, as per Figure 9. As the debt market evolves we would expect increased issuance of instruments with longer maturities.

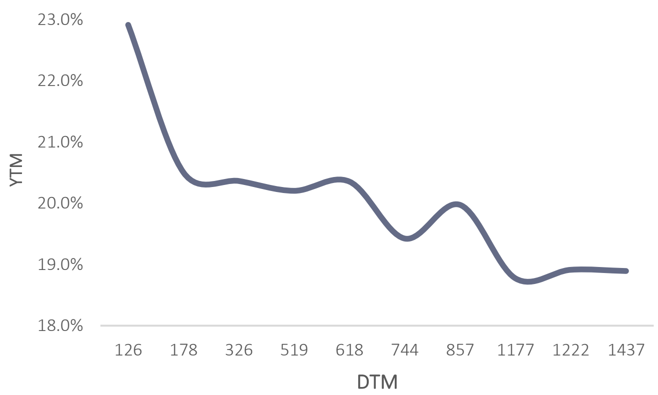
N.B. The rise in Islamic Treasury Bill issuances may initially crowd out private sector borrowing. However, when one considers the domestic money supply, there will be sufficient demand: the money supply is approximately $297 billion, of which interest-bearing term deposits at banks form about 82% ($243 billion), versus a historical average of about 65%; another $30 billion is parked in fixed income funds. Iran's private sector, given its low debt ratio and high savings rate, can fund much of the country's financing and investment needs.

The yield curve in Iran is inverted and gradually flattening…

The shape of a yield curve of an economy provides an insight into future interest rates and economic activity. The most common type is an upward-sloping yield curve whereby longer-dated debt has higher yields than comparable shorter-dated debt (in terms of credit quality). This is typically due to the higher risk associated with longer maturities as well as the expected economic expansion.

As illustrated in Figure 10, the yield curve in Iran is currently inverted.

Figure 10: Iran's yield curve



What does this mean?

The longer-dated debt instruments have a lower yield than shorter-term instruments. This type of yield curve is typically considered a predictor of economic recession.

There are sufficient signs to imply the curve is flattening out…

What does the flattening out process tell us?

In a flat yield curve, the shorter- and longer-term yields are close together. A flat yield curve suggests an economy is in transition, either from growth to recession or vice versa.

In Iran the yields on both shorter- and longer-dated instruments have been falling – but the shorter-dated instruments have been falling faster. This is evident when you consider that the first and second Islamic Treasury bills were issued with yields to maturity (YTMs) of about 26%, whereas the more recent bills have YTMs of 20-22%.

Sources: CBI, TSE, IFB, SEO, IME, EnEx, The Economist, Fipiran.

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We view this gradual flattening of the yield curve as a good lead indicator of how the economy is transitioning. We expect shorter-dated bonds to compress further and faster than longer-dated bonds, such that over the next 12-24 months Iran's yield curve will have fully flattened – and may have even have started to steepen into a more conventional upward-sloping curve.

Caveat: When looking at yield curves, it is important to compare instruments (the shorter and longer maturities) of similar credit quality. In Iran, such a precise comparison is not feasible because of the nascent nature of the bond market and the fact that all bonds are guaranteed (with no credit ratings, bonds are either sovereign-backed or the guarantor is a financial institution). Most of the shorter-dated (<1 year) instruments are Islamic Treasury bills (zero coupon, discounted to par, <12 months maturity, State-issued), whereas most longer-duration bonds are sukuks (e.g. Musharakah and Ijarah) issued by corporates or State-related entities (e.g. municipalities) and guaranteed by financial institutions.

Why do 'risk free' sovereign Islamic Treasury bills have higher yields to maturity (YTMs) than State-related or corporate debt in Iran?

Logic would suggest that Treasury bills are the nearest thing to a risk-free return in a given market and all other investments have higher risk premiums and hence higher expected returns. The status quo in Iran's fixed income market is thus counter-intuitive. In our opinion there are two main factors that explain this:

1. Domestic State payables (not net debt) are an estimated 40% of GDP (this includes government payables to banks and contractors, parts of which may have been rolled over from one year to another). Despite the fact that government debt is relatively low in Iran (reported at 16% of GDP), with a nascent domestic debt market and with no access yet to foreign debt markets, clearing these payment arrears and financing these liabilities (i.e. 'managing cash flow') is challenging in the short term. As a result, a relatively large supply ($3.4 billion thus far) of Islamic Treasury bills coming to market will require a phase of normalisation and price discovery.
2. Non-government issuers have bank guarantees; these issuers and guarantors may be perceived (currently) to have relatively smaller payables (and better cash flow) than the State.

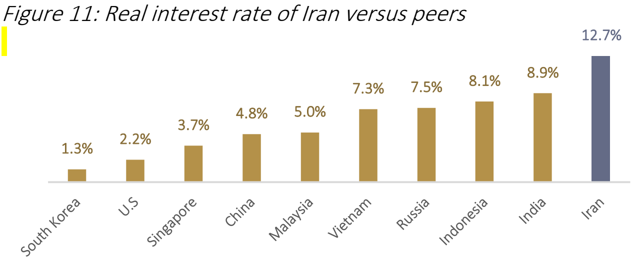
Will Islamic T-bills 'normalise' in the medium term?

1. As of September 2015, there have been 10 tranches of Islamic Treasury Bills issued, with a total face value of $3.4 billion. The first two issues were listed and initially traded with an average YTM of 26%. The government redeemed holders of the first two tranches on time; consequently, YTMs of the remaining and next tranches averaged 22%. Given the State has taken the lead on issuing debt securities to finance its budget (without the usual bank guarantor used by other issuers with other instruments) in the secondary market, the incentives to manage this are strong. Additionally, the mandate and strategy of the issuance (and broader fiscal plans) is logical and transparent, and independent observations (e.g. by the IMF) will increase credibility.
2. Iran's current account (*including* received cash flow) and capital account are improving – due to a quadrupling of oil exports, a positive trade balance ex-oil, unfrozen offshore assets, FDI inflows, asset sales, etc.).
3. Iran's fiscal position is fairly healthy (relatively low debt at about 16% of GDP and a deficit of -2.6%) and its fiscal dependency on oil has declined through such measures as a significant increase in tax collection.
4. The macroeconomic picture is stable and the CBI is increasingly independent:
   - Growth is high and stable (the IMF estimates 4.5% for 2016-17 and 4.1% for 2017-18).
   - Fiscal dominance (wherein monetary policy ensures the solvency of the government or indeed fiscal policy determines inflation) has fallen.
   - Inflation is sustainably low, having fallen from a peak of about 45% in 2013 to 8.7% as per October CBI data.
   - Core monetary policy indicates both price (disciplined control of the monetary base and positive real rates) and currency stability (including the unification of the dual FX rate mechanism in less than six months).
   - The CBI has led banking reforms and now has increased supervisory powers.

Iran: high real rates

Figure 11 shows the high real interest rates in Iran versus those of its peers. (Islamic Treasury bills are used as the risk-free interest rate benchmark because they are a more accurate gauge for lending rates than the lower bank-deposit rates of 15%.)

Figure 11: Real interest rate of Iran versus peers



Sources: CBI, IMF, Financial Times, World Bank, Donya-e-eqtasad, Financial Tribune.

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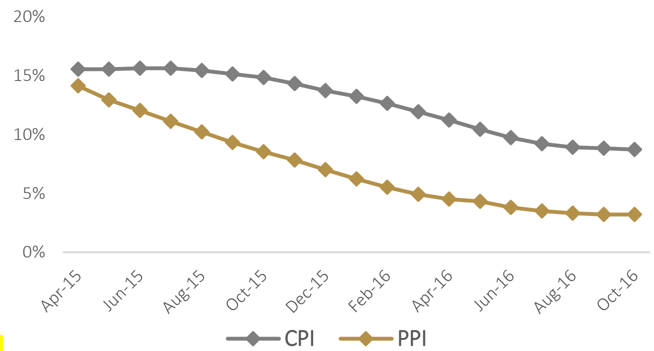
Although Iran continues to have very high real interest rates, inflation is hitting new lows (Figure 12) and we expect real rates to follow suit in the medium term.

Figure 12:Iran's CPI and PPI



October's CPI reading (the year-on-year annual moving average comparison) by the Central Bank of Iran was 8.7%. This could still tick lower, though we expect to see mild inflationary forces slowly reappearing.

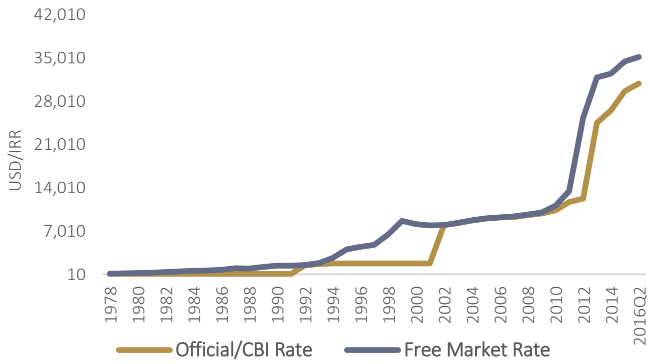
Interest rates continue to fall, with 1-year deposit rates now at 15% versus the 22% official peak a year ago. Lending rates are officially 18%. However, credit remains limited at 18%. We expect this (cheaper) credit to surface slowly as it will be directly influenced by the expected gradual reduction in the State's payables to the banks.

Currency: constructive progress

Currency unification: As shown in Figure 13, Iran currently has two exchange rates: the official/CBI exchange rate and the free market exchange rate. The majority of the economy operates at the free market exchange rate (which is the weaker rate and the same exchange rate that we use to convert the Fund's euros into rials). The stronger official rate has officially been used for imports to benefit strategic industries and core staples. A detailed discussion of the decades-old origins of the dual-rate structure is beyond the span of this report; in brief, hyperinflation, sanctions and preservation of hard currency were all important and interconnected factors.

In 2012, following the severe tightening of sanctions, the difference between the two rates was over 100%. Today the difference is about 14% (see Figure 13), and the CBI is allowing banks to operate at the free market exchange rate. 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 soon and will do it at a level close to the free market rate – that is, the official rate will face a 'devaluation' large enough to close the 14% gap.

Figure 13: The official/CBI and the free-market exchange rates

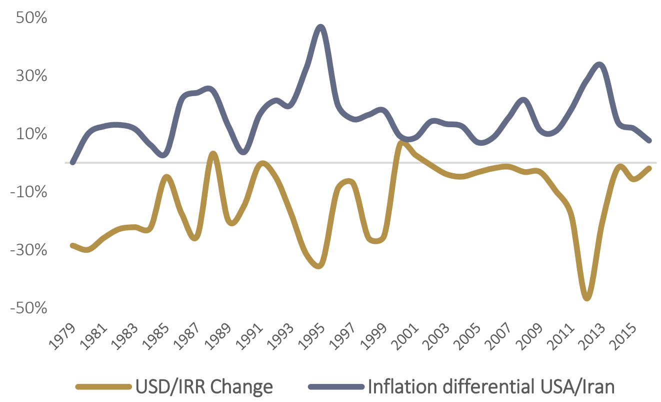


Currency factors

The two most important longer-term economic factors to consider when assessing currency outlook are inflation and productivity.

The currency in Iran can be expected to track a basket of currencies based on variety of factors, one of the most significant being CPI differentials between the respective economies. Because the U.S. dollar has the biggest weight, the US/Iran inflation differential is a major factor. As Figure 14 shows, however, the inflation differential has collapsed.

Figure 14: USD/IRR yearly % change and US/Iran inflation differential



With regard to productivity, Iran has had low productivity across most industries. This is to be expected as Iran's FDI stock in 2014 was estimated to be around $40 billion (10% of GDP). This is very low compared to its emerging peers, whose FDI stocks are on average >25% of GDP. The symptoms of this can be seen in labour productivity data, where Iran again significantly lags (by a factor of 2-3x) the averages of other emerging countries. However, it is now likely that there is low-hanging fruit and, given Iran's global economic reintegration (post-sanctions projected FDI), the jump-start of productivity-led growth should be expected.

Sources: CBI, SCI, The Economist, McKinsey Global Institute, World Bank, Donya-e-eqtesad, OECD.

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(*Continued…*)

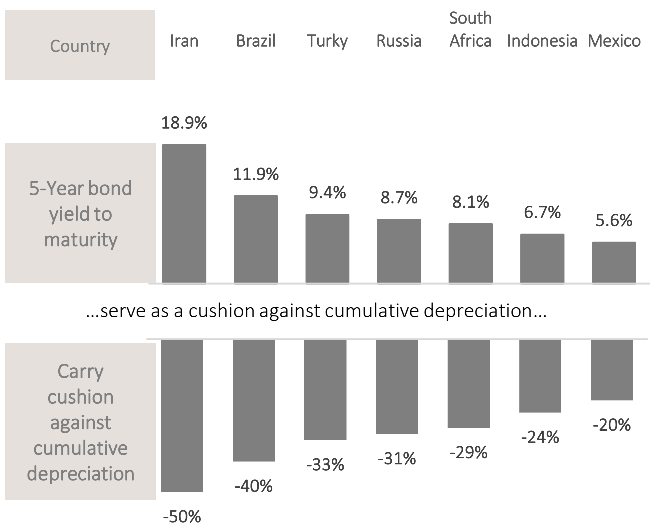
Currency management and stabilisation: The sharp falls in inflation, expected productivity gains, and the positive trade surplus (including and excluding oil) and capital account will be supportive of the local currency. As a counterbalance as the economy fulfils its 4-5% GDP growth expectations in the years ahead, many industries will increase their imports, and consequently foreign currency demand will rise. The CBI now has greater independence and sufficient tools (policy and reserves) to pursue and achieve its core policy of price and currency stability.

The case for optimism:

In August 2016, a PIMCO fixed-income report (*A Constructive Case for Emerging Markets*) made the case that the surge in EM returns means it is (still) a good time to invest in EM debt, albeit with an appreciation of macro risks and a strong emphasis on bottom-up analysis. One section (and chart) that caught our attention was their 'case for optimism' as they explained high EM local bond yields and cheapened currency valuations (see Figure 15):

"EM currencies have adjusted by 30-40% in nominal terms since 2013 and in several cases look to have overshot fundamental fair value. Real yield differentials versus DM have widened, while EM-DM nominal yield differentials are close to all-time highs. This combination provides an important carry cushion for investors and suggests the hurdle rate to lose money on EM local investments is high over a secular timeframe. Indeed, if one buys a 5 year Brazilian bond today yielding 11.9% and holds it to payment at maturity, it would take a 40% devaluation of BRL to lose money (see Figure 15). The power of this high carry compounded over time can potentially be significant."

Figure 15: EM local bonds have a cushion against further mark weakness [(a)]



N.B. We have added Iran's profile based on a four-year local bond (five-year bonds are currently unavailable) to Pimco's original chart. This provides some perspective: An 18.9% local bond yield (versus a peer average of 8.4%), if held to maturity, would require a 50% devaluation (versus a peer-average cushion of -30%) to lose money. We always look for a tangible margin of safety when investing; this passes our test.

According to Bloomberg's Barclays Global Aggregate Index, bonds worldwide lost 3% in October (and continued in November). The last comparable loss was in May 2013, when the U.S. Federal Reserve signaled a slowdown in quantitative easing (QE). Global bond investors in developed markets are now asking questions, given one of the biggest trades in the last decade has been to chase lower yields (even when negative!) and higher bond prices. Whether or not the limits of central bank monetary stimulus for developed economies and support for financial markets has been reached, we don't know. However, the market is correctly questioning its sustainability and gradually forming a consensus on the need for fiscal stimulus. Fortunately, the yields in our investment universe of Iranian domestic debt are real, positive and high.

Macro brief

Back in July, we provided a full macro "dashboard" in our quarterly update. We will not review it in full this quarter; we have already touched on some of the factors worth updating in the fixed-income section of this report. However, two items worth mentioning are money velocity and the unemployment rate.

Money velocity

In July we wrote:

"We believe money velocity will increase. The State's income AND cash flow are improving and, with the sum of 'dormant' domestic payables….slowly decreasing, coupled with other liabilities becoming publicly tradeable (~$10 billion of Treasury bills to be issued this fiscal year) and more affordable (lower rates), prospects are brighter. We expect an increase in money velocity (money supply x money velocity = nominal GDP). Furthermore, with money supply growth at approx. 30% ([although the] monetary base, the powerful money multiplier…is held in much tighter check by the CBI), you understand why and how the liquidity unlock and consequent upside surprises in GDP could come in the 2-5 years ahead."

Figure 16 (next page), tells us that we are indeed about to witness what we described in July. M1 (which includes cash and checking deposits) relative to M2 (which includes M1 as well as 'near money'– e.g. savings and other time deposit, mutual funds, etc.) is a good indicator of money velocity. The point-to-point percentage change (with data normalised to accommodate seasonal influences) recently became positive for the *first time in four years*.

Sources: TSE, CBI, Pimco, Bloomberg, Tejarat farad, ValueWalk
(a) Figure 15 is from Pimco's August 2016 report, A Constructive Case for Emerging Markets. *It has been adapted to add Iran's domestic bond for comparison purposes.*

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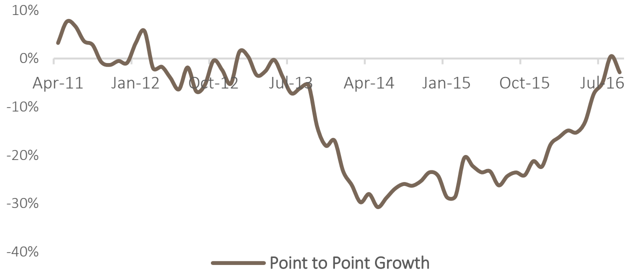
This is consistent with the expectations of high (>4-5%) GDP growth.

Figure 16: M1/(M2-M1) point-to-point change



Unemployment

One would expect strong job growth to be accompanied by an economy growing at approximately 5%. So why is the unemployment rate in Iran increasing?

The reason is more Iranians are seeking jobs: the labour force participation rate is increasing at a faster rate than the economy can absorb the new labour. This is not unusual; during recessionary periods workers typically become discouraged and stop looking for employment, lowering the labour participation rate. Now, with the economic recovery, people are returning to the workplace, driving up the rate.

In Q1 of the current Iranian financial year, the Statistical Centre of Iran (SCI) published a national unemployment rate of 12.2% – a 1.4% increase versus the comparable period last year. The unemployment rate among the youth (defined as between the ages of 15 and 29) stood at 24.9% in Q1, a 2.5% rise versus the same period last year.

The SCI also announced a Q1 labour participation rate (either employed or officially looking for work) of 39.5% (or 25.75 million people), a 1.5% rise compared to last year. 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). In particular, with male and female participation rates at 64% and 15.2%, respectively, there is significant potential upside in the female rate.

Legal update

On sanctions, the latest FAQ update by the Office of Foreign Assets Control of the U.S. Department of the Treasury (U.S. OFAC) was received with interest by the international financial community. One notable change was perhaps the green light to process transactions denominated in USD by financial institutions (including foreign-incorporated subsidiaries of U.S. firms) so long as the U.S. financial system or U.S. persons are uninvolved.

OFAC also made it clear that engaging in transactions with non-designated persons would not be sanctionable only because those persons are minority owned or controlled, in whole or in part, by a designated person.

Separately, the EU and UK delisted Bank Saderat (including all branches and subsidiaries) as well as the London-based Bank Saderat PLC from Regulation (EU) No. 267/2012 and Consolidated List, respectively. This comes despite the fact that Bank Saderat was due to remain listed until October 2023 under the Joint Comprehensive Plan of Action (JCPOA) but its successful appeal at the European Court of Justice provided the grounds for its delisting. The same procedure is expected to be followed by a number of other entities currently listed, with the ultimate result that additional delisting cases might occur in future.

Capital allocation 'award'

When assessing company management teams, we often evaluate their proficiency in allocating capital. This quarter we could not help but admire (from a distance, as we are not invested in the company) Henkel, the German cosmetics and chemicals household products manufacturer. The story is worth telling in two parts:

1: *Get paid to borrow money*: This year Henkel issued bonds in euros (approximately $500 million) with a negative yield – that is, investors in these bonds are guaranteed a loss if they hold to maturity.

2: *Generate double-digit real returns:* Henkel has spent around $200 million on acquisitions in Iran. In mid-2016, Henkel increased its stake in the Iranian detergent company Pakvash (est. 1975); it then purchased a further 30% stake for about $50 million, taking its ownership from 60% to 90%. Henkel has managed to significantly increase its market share after taking over management/operations in the last three years. The company's current market capitalisation is about $160 million and it has about a 30% market share in the dishwashing sub-sector. Despite industry regulation (price controls), revenues have increased by about 257% in dollar terms since 2012 (that's a CAGR of about 37.5%) – *and* EBIDTA margin has expanded from 3% to 16%!

Henkel has also expanded its activities and further increased its market share in the sector with the acquisition of Behdad Chemical Co. (which holds the famous "Tage" brand) at a valuation of ~$140 million.

Reading material

We spend much of our time reading financial accounts, company statements, trade journals, newspapers, country reports and investment-related books. We then spend even more time thinking about what we have read and cross-checking it 'out in the field' with company management, shareholders, customers, suppliers, competitors, etc. When appropriate, we may suggest some of this material for you to read as well. This quarter, we suggest two country reports (can forward should you request) representing independent and objective assessments by international institutions:

- A brief IMF report dated 3 October 2016, titled *Concluding Statement of an IMF Staff Visit*.
- A longer, comprehensive report by McKinsey Global Institute titled *Iran: The $1 Trillion Growth Opportunity*.

Sources: SCI, Tejarat Farda, Financial Tribune, IMF, OFAC, McKinsey Global Financial Institute, Financial Times, The Economist, Reuters ,Codal.ir.

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U.S. election results

Where the U.S. election results are concerned, we remind you to look beyond the rhetoric. The deal Iran struck was with the P5+1 group, which includes not only the United States but also Britain, China, France, Russia, and Germany. In other words, it was a *multilateral* deal, reflected in a UN Security Council resolution, and is not a deal with a single country.

On July 14, 2015, the P5+1, the European Union, and Iran reached a Joint Comprehensive Plan of Action (JCPOA) to ensure that Iran's nuclear program will be exclusively peaceful. 18 October 2015 marked Adoption Day, the date on which the JCPOA came into effect and participants began taking the steps necessary to implement their JCPOA commitments. 16 January 2016 marked Implementation Day, when the International Atomic Energy Agency (IAEA) verified that Iran has implemented the key nuclear-related measures described in the JCPOA.

Other than relating the facts above, commenting on the speculative long-term consequences (not just on Iran but indeed the rest of the world) remains outside of our circle of competence. We will respond the same way as we did to Brexit, in our July quarterly investor report:

"Knowing the boundaries of one's competence, knowledge and abilities is in our view a vital skillset for any investor; it also requires humility so we apologise in advance if we say 'we don't know' to some topics when other 'experts' step forward with confident and absolute answers. Generally as per our investment approach, we strive to be roughly right rather than precisely wrong….*Investing (or not investing) on the basis of predicting the next international disaster is emotional, not rational."*

We will react with equanimity to any potential market volatility.

Sources: State.Gov, Griffon Asset Management .

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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.

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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.

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