Executive Summary

Iran’s historic nuclear deal and the lifting of sanctions should bring the country back into the global community. For investors, it is being heralded as the return of the largest economy to the global system since the breakup of the USSR in 1991.

In this Price Point, Oliver Bell, portfolio manager for T. Rowe Price’s Global Frontier Markets Equity Strategy, and Mark Lawrence, investment analyst for frontier and emerging markets, went on a fact-finding mission prior to the lifting of sanctions and discuss what they found.

Our first trip to the country was a real eye-opener and exposed many of our biases as wrong. From the smooth, welcoming breeze through customs, to our three days of one-to-one meetings and excursions outside the hotel, we realized how many of our conceptions were untrue. Former President Mahmoud Ahmadinejad (personal fortune estimated at US$30+ billion) did much to fuel the fear that Iran was an “evil state,” but everyone we met told us that he was a hard-liner whose time had come and gone. In reality, Iran appeared more like Turkey than Saudi Arabia—Tehran being a very cosmopolitan city with a much more liberal attitude than we expected, with women appearing fully integrated into society.

Importantly, the country is educated, entrepreneurial, and asset rich, but remains cash flow poor because of the sanctions that have been in place since 1979. With those sanctions being lifted, there is much to like as an international investor.

A Brief History Lesson and Some Key Facts

- Originally known as Persia until 1935. The population of 80 million is 90% to 95% Shia and adheres to the Shia interpretation of Islam. It became an Islamic republic in 1979 after the Iranian Revolution when the ruling shah was replaced by the Supreme Leader Ayatollah Ruhollah Khomeini.
Today, Iran’s supreme leader is Ayatollah Ali Khamenei. President Hassan Rouhani came to power in July 2013. The Iranian president is elected for four years and can serve no more than two consecutive terms. He is the second-highest ranking official after the Ayatollah and heads the executive branch of power. However, the supreme leader remains preeminent as Commander-in-Chief of the armed forces and dictates defense, security, and foreign policy.

The Iranian Revolutionary Guard Corps (IRGC) was established in 1979 to protect the revolution. It is Iran’s most powerful security, its military body, and its most influential economic player, with control over an extended network of state or quasi-state companies.

Iran is the world’s largest holder of oil and gas reserves combined (number four in oil, and number one in natural gas).

Demographics: Similar to Nigeria, Egypt, and Turkey, Iran has a large and young population, with 60% under the age of 30.

Well-educated work force: The third-highest number of engineering graduates after the U.S. and Russia.

Highest literacy rate in the Middle East and North Africa (MENA) region at 85% from 2008 to 2012, according to UNICEF, with 99.9% of primary school children enrolled for school from 2008 to 2011.

Strategic location: A part of the Middle East, the Persian Gulf, Central Asia, the Caspian Sea, South Asia and having a huge landmass: 18th largest country in the world.

AN ECONOMY OF SIZE...

Iran is the second-largest economy in the MENA region after Saudi Arabia, with a GDP of US$406.3 billion in 2014 (roughly the same size as Thailand). Iran’s GDP grew by 3% in 2014 after two years of recession, boosted by the Rouhani government’s strategy of reform and foreign engagement. The government has put in place a strategy aiming for an economy unencumbered by sanctions, improved science and technology, reform of some state-owned enterprises, reform of the banking and financial sector, and allocating oil revenues to policy priorities. Public and quasi-state enterprises dominate.

The World Bank viewed the medium-term outlook as positive if nuclear-related sanctions were eased and the government enacted reform. It sees growth decelerating from 3% in 2014 to 1.9% in 2015 (based on the Iranian calendar year, which runs from March). However, now that sanctions have been lifted before the beginning of the 2016 Iranian calendar year, it projects real GDP could rise to 5.8% in 2016 and 6.7% in 2017. The International Monetary Fund (IMF) forecasts real GDP growth of up to 5.5% in 2016/2017 and 2017/2018, settling at around 3.5% to 4% per annum thereafter.

The IMF sees Iran boosting global oil production by 600,000 barrels per day (bpd) in 2016, based on the rollback of EU and UN sanctions, rising to 1.2 million bpd over the medium term. That would be equivalent to approximately half of global oil demand growth in 2016.

Inflation has dropped from a peak of 45% in 2012 to the low teens today due to tough monetary policy. We expect interest rates to fall and potentially one more large adjustment in the Iranian rial/dollar exchange rate from the current R36,300/US$. As banks reconnect to the outside world post sanctions, capital flows should follow, while oil can only increase its importance within the economy.

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1 Sources: Thomson Reuters and Morgan Stanley Research.
...BUT IN NEED OF FINANCE

A number of executives told us that the Iranian government was out of cash and that the country needs to issue more debt. It certainly has a liquidity issue and needs further capabilities in risk management (there are currently no rating agencies) and legal frameworks (bankruptcies and liquidations cannot be easily facilitated) to meet this demand.

Longstanding state involvement and weak governance combined with several years of sanctions has left the banking sector in a relatively weak state. The banks we met with were heavily exposed to non-core assets in real estate, franchises, equities, etc., probably due to restricted investment alternatives imposed by sanctions. Compared with other emerging market and Gulf peers, credit penetration is at the higher end of the range at 67%. However, the sector is highly fragmented, with the five largest banks accounting for just one-third of the system assets. This relatively crowded market may help explain the comparatively low profitability, alongside the apparently elevated level of unproductive delinquent loans.

The Tehran Stock Exchange (TSE) operates two exchanges, with 540 listed companies on the main bourse, US$120 billion market cap, US$40 billion turnover volume per day, and a somewhat staggering 107 brokers. The daily limit up/down is set at 5%. ETFs were launched in 2013, and 11 are currently listed on the TSE. The index trades at 6x P/E (having been as low as 4x to 5x P/E) and an average dividend yield of 14%, but with negligible foreign participation. A huge government-led privatization drive in 2006 put a wide range of corporates back into the private sector. The top 10 listed companies account for 50% of the TSE’s market cap, with seven of those having been registered as part of the government privatization programs.

A RESOURCEFUL NATION

During our visit, it struck us that Iran is already operating pretty well despite sanctions. It has developed smaller-ticket items itself or has shipped from neighboring countries. The shops were fully loaded with goods, many items that you would buy in the West (Figure 1).

Most products are also much cheaper as the Iranian rial (IRR) has undergone two large devaluations—in 2002 by almost 80% (against the U.S. dollar) and in 2013 by 50%, resulting in the overall real depreciation of 50% since 2000. Measured on purchasing power parity (PPP), the value of the rial is 30% of what is implied by the PPP levels calculated by the IMF (goods are 70% cheaper than the comparable basket in the U.S.

RISK AND REWARD

We believe there is money to be made for first movers coming into the market in early 2016. Longer term, the road looks more uneven and the chances of having stranded investments are just as likely. The purpose of the trip was to acquaint ourselves with Iran and its idiosyncrasies, which we have done in part but need more time with companies and government officials to become truly comfortable investing. Although, the quality of meetings we had during our visit was much better than anything we had when we first visited the Gulf Cooperation Council (GCC) back in the mid-2000s. In some ways, it felt like our first trip to Saudi Arabia in 2006/2007.

The banking system does cause concerns as it is undercapitalized and has a high rate of nonperforming loans, and there is no plan for recapitalization yet. However, there is a lot of interest from foreign capital, and many of the Iranian banks are already talking to international banks.

The oil and mining sector dominates the economy and the stock market and is desperate for capital/foreign cooperation. Therefore, there is a narrow, rich seam to play in the stock market, and it may be a crowded trade.

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2 Source: Morgan Stanley Research.
3 Source: Tehran Stock Exchange.
Also, the IRGC is a major force in the economy, with stakes in a wide network of state-owned and quasi-state businesses and influence in the private sector.

**Figure 1: Western Brands Easy To Find**

Issues such as business transparency and corruption are also central in the development of any frontier economy. In transparency terms, Transparency International's 2014 Global Corruption Index ranked Iran 136 out of 175 countries. Meanwhile, in the World Bank’s 2015 Doing Business survey of 189 countries, Iran ranked 130.

However, interest in Iran will only grow going forward because of its reintegration into the global economy, its huge hydrocarbon power, and its positive demographics (which will be key to future growth prospects). Iran has also historically been seen as part of the “Next-11” (a term coined by Goldman Sachs) group of countries that have the potential to become significant emerging market economies.

Institutional investors, however, will probably face some challenges in areas of liquidity and corporate governance. Challenges such as these are not uncommon as markets open up, and there are always areas for experienced investors to uncover neglected companies with healthy or improving operations.

Ultimately, with a focus on quality, investment in Iran could prove rewarding, especially given the very low valuation starting point. In addition, with Iran being one of the last great frontier markets left to invest in, it could potentially provide one of the final pieces of the investment puzzle for some investors.
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