

The promise and peril of Iranian stocks

By *Yaldaz Sadakova*



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o many foreign investors, Iran has been a four-letter word for more than three decades, and the hard-line state has long had a hard time attracting foreign cash.

But with this summer's historic nuclear deal, which calls for lifting international sanctions in exchange for the Islamic Republic curbing its nuclear program, foreign investors are finally eyeing the pariah nation.

And with good reason: it's a large, mostly young country with a strategic location, lots of natural resources and a diversified economy. Its equity market is large, liquid and cheap, but it's mostly inaccessible to foreign investors.

That's expected to change soon, and prospective buyers are positioning themselves.

Investors, though, are going in with their eyes open to the numerous obstacles, such as limited

company transparency, a small number of outstanding shares for trading, a lack of custodial services and high inflation.

One investor interested in Iran's stock market is Voltan Capital Management, a New York City-based asset management firm that specializes in frontier markets. "We tend to think of [Iran] almost as a third-world country, which is absolutely not true; it's a very well-educated, industrialized country," says founder Alison Graham. "We're looking at it but approaching it with caution."

Most foreign entities, like Voltan Capital, aren't yet legally allowed to buy shares on the Tehran Stock Exchange (TSE). Currently, international investors account for less than 3% of the TSE's trading volume.

Still, more foreign buyers are now considering the

Tehran Stock Exchange



ONE COMPANY DOES IT ALL

One company oversees the overwhelming majority of foreign investments on the Tehran Stock Exchange: Tehran-based Turquoise Partners. The company's website says it "manages more than 90% of all foreign portfolio investment" on the stock exchange. The company didn't respond to an interview request.



NO RUSH

Getting ready to trade on the Tehran Stock Exchange (TSE) is no easy matter. Foreign investors must complete reams of paperwork to receive approval from the Ministry of Economic Affairs and Finance. That first step alone takes about 45 days, says Reza Yeganehshakib, a California-based expert at Corr Analytics, a political risk consultancy.

Investors then need to open Iranian bank accounts. The banks act as intermediaries between the government and the TSE. After that, investors have to choose TSE-approved brokers, Yeganehshakib adds.

Iranian equity market because, over the next six to 12 months, they'll likely be able to access the TSE as the nuclear deal takes effect, says Graham.

For example, on June 9—more than a month before Iran and the world powers signed the accord—the TSE's website reported that fund managers from the U.K., Switzerland, France and Russia had visited the Iranian stock exchange to identify potential opportunities.

That same day, quoted by the Islamic Republic News Agency, Reza Soltanzadeh, a member of the foreign investment committee of Iran's Securities and Exchange Organization, described the outlook for Iran's capital market as "absolutely positive."

Promising as the market is, though, investors also see risks.

In Bed With the Regime?

The main concern is company ownership. Says Graham, "If it's large and liquid, it probably has some connection to the government" or the Iranian Revolutionary Guard Corps, a branch of the military created after the 1979 revolution. "We have ethical concerns about being shareholders in companies that are majority-owned by Revolutionary Guard entities [or the government]."

Both the government and the Revolutionary Guards invest in many listed companies across different sectors—and, in some cases, they might own entire businesses, experts say, explaining this monopoly occurs partly because there isn't anyone else with capital to invest. And determining ownership can be tough because it's sometimes murky, Graham adds.

For example, the government owns 82% of SAIPA, Iran's second biggest auto manufacturer, and the Ministry of Industries and Business chooses the CEO and controls the company's policies, explains Reza Yeganehshakib, a California-based expert at Corr Analytics, a political risk consultancy.

And about half of the biggest telecom, Mobile

Telecommunication Company of Iran, belongs to the Revolutionary Guards, he adds.

Even private ownership isn't that private: many private company owners have ties to the government or the Revolutionary Guards, Yeganehshakib notes. "So 100% private [ownership], without having any connection to the Revolutionary Guards and people inside the government, is very rare."

This pseudo-private market resembles early post-Communist markets such as Russia's in the 1990s, explains Marketa Hulpachova, the Berlin-based deputy editor of the Tehran Bureau, an independent news outlet hosted by the *Guardian*.

The other problem with Iran's listed companies, experts note, is that financial disclosures aren't transparent or consistently available in English; so, you may not know exactly what you're buying.

"They haven't been audited by international auditors," Graham says. "They've had to circumvent a lot of global financial regulations throughout the years. This could create a lot of distortions on the balance sheet."

Because of connections to the regime, some Iranian people and companies will remain blacklisted even after sanctions are lifted, says Matthew Spivack, U.K.-based practice leader for the Middle East and North Africa with the Frontier Strategy Group. These lists will likely keep changing, so foreigners should monitor them constantly to figure out which companies are legally okay to invest in, he adds.

Concentrated Market, Small Free Float

While more than 800 companies with a total market cap of about US\$97 billion are listed on the TSE, the Iranian stock market is concentrated. The top 10 companies—including energy firms, telecoms and banks—account for about 50% of the market cap. The top 20 companies represent around 70% of the market cap.

On top of that, many listed companies have few outstanding shares available for trading, notes



AND ON A TOTALLY DIFFERENT NOTE...A GOOD PLACE TO GET A NOSE JOB

Iran is the country with the highest per capita number of nose jobs. In 2013, the *Guardian's* Tehran Bureau reported that about 200,000 Iranians, mostly women, get rhinoplasty every year, making the small Barbie nose (along with tight, trendy clothing) common on Iran's city streets.

"For many, surgery is a reaction to the restrictive rules of the compulsory hijab," the Tehran Bureau wrote. Given that the face is the only part Iranian women can show to the world in public, they want that part to look perfect.

Graham. That's partly because Iranian pension funds and other domestic investors have difficulty buying foreign assets. They buy locally in lieu of investing abroad, Graham explains.

But "those pension funds are quite eager to diversify away from their Iranian holdings, so they would be sellers into the market," Graham says. "The question is, at what price are they going to sell if they believe a lot of foreign money is coming into the Iranian stock market?"

Or, she speculates, potential sellers might decide to hold stocks longer so they can appreciate before they sell. Valuations are currently low because Iranian companies have been starved of global capital, she adds.

International investors also face ownership restrictions. No single foreign entity can hold more than 10% of a listed company's shares. But the TSE's website says investors can apply to have that limit waived, and even fully take over a listed company.

No Global Custodian

Because of the sanctions, no global custodian operates in Iran to provide securities' safekeeping.

For most professionally managed funds, this will be a deal breaker, Graham explains. "They would need one of the global banks to be present in Iran with the proper procedures for share custody."

In the absence of a custodian, the Central Securities Depository of Iran records stock ownership. So if you bought shares today, the Central Depository would simply make a listing on an Excel spreadsheet, where it says you own, say, \$200,000 of Company X, Graham explains.

But she expects a global custodian will enter the Islamic Republic after the sanctions are removed. "Global banks are quite eager to get back into Iran. But it's still early days. There's a bit of a reputational risk."

Inflation

Apart from issues surrounding the TSE, investors eyeing Iranian equities also need to watch macroeconomic risks, such as inflation.

"[Iran's] pension funds are quite eager to diversify away from their Iranian holdings, so they would be sellers into the market"

Thanks to its prudent fiscal approach, President Hassan Rouhani's administration has managed to end hyperinflation, says Spivack. When Rouhani came to power in the summer of 2013, inflation stood at about 45%; now it's about 15%, which, he notes, is still high.

Also, the expectation the Iranian rial will appreciate after the sanctions may not materialize, says Spivack. "It doesn't look like that's the policy the Iranian central bank will take" because it wants to protect the domestic industry. So inflation will remain an issue in the short term, he predicts.

Deal Isn't Crystal Clear

Investors need to be aware of political risks, too. Under the nuclear deal—expected to take effect in the first quarter of 2016—the sanctions can snap right back if Iran is perceived to be violating the terms.

But some of the accord's wording on that point is open to interpretation, Spivack explains. More clarity might emerge soon because the U.S. and the European signatories have to provide follow-up guidance on these issues by Oct. 20, 2015.

It's Not North Korea

And perhaps the most important thing to keep in mind is that getting nuanced analysis about the Iranian economy, and Iran in general, is difficult, cautions Djavad Salehi-Isfahani, an economics professor at Virginia Tech.

"It's a country that is much maligned," and stereotypes abound, he says. One is that the Revolutionary Guards own most listed companies and are the country's ultimate economic elite—which, he says, they aren't exactly, because they're just 200,000 people in a nation of 80 million. If all of them controlled the economy, they'd all be millionaires, when, in fact, many of them are ordinary people, he explains.

"The other stereotype is that Iran is like North Korea, where there's no freedom: remember, Netanyahu once said, 'Too bad young people can't wear jeans there,'" notes Salehi-Isfahani, referring to the faux pas Israel's prime minister, Benjamin Netanyahu, made in a 2013 interview with BBC Persian.

Netanyahu said, "If the people of Iran were free, they could wear jeans, listen to Western music and have free elections." After that interview, Iranians flooded social media with posts about the ubiquity of both jeans and Western music in the Islamic Republic. 📱

Yaldaz Sadakova is associate editor of *Benefits Canada*.
yaldaz.sadakova@rci.rogers.com