ASIAN CAPITAL PARTNERS GROUP

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# IRAN


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# Investment Case : 30 Positive Factors

- Returning to "normality" in concepts and systems as well as in economic and political relationships.
- GDP growth could double to 6% from 2-3% average of last five years.

- World's third largest oil reserves, second largest gas reserves.
- Strategic economic and geo-political location: at heart of 70% of the world's oil reserves.
- 65 mn population is a real market and a significant country: has 200 mn strong hinterland.
- Higher oil prices turning budget into surplus, helping correct major problem.
- Major comparative advantage in fruit and vegetable production as well as tourism
- Long commercial tradition: international accounting standards.
- Strongly developed concept of private property
- A Private sector can build on the real successes of the last 20 years – infrastructure (roads, water, housing, telecommunications), mass education, agriculture and now a falling birth rate.
- Foreign debt only $11 bn.

- Baby Boomers (over 60% of population is under 30 years old) will drive household formation and economic growth, as in East Asia in the 1970s and 1980s, benefitting housing, construction and consumer industries.
- Labour cost relative to skills is very low.
- Low per capita consumption of many products and raw materials - promises significant catch-up potential.
- A classic shortage economy that has underinvested for many years providing industries from autos to glass and textiles to fridges and freezers with instant domestic demand to meet capacity expansion, ensuring profitable returns on investment.

- Reform about to make significant difference to economy and stock market: most difficult initial steps already taken.
- Widely accepted that There Is No Alternative to economic reform.
- Ideologically pro-private sector: state ownership an accident of history. Part of private sector untouched by the revolution.
- Unified exchange rate probable within 2 years.
- Trade liberalisation and interest in joining WTO.
- Growing work force, declining dependency

- A functioning democracy has represented the desire for change in the 1997 presidential and 2000 legislative elections.
- Reformists have captured the presidency and legislature.
- External relationships good again with Gulf states, European Union and Japan.
- Complete end of Iran's isolation expected within two years as the US Embargo is likely to lapse in mid-2001.

- Stock market valuations very attractive. Most companies sell on 3-6X earnings and yield 10-30%; many have 25-35% EPS growth if re-forms accelerate.
- Market capitalisation $4.5 bn, similar to Korea and Taiwan when they first opened to foreign investment in the early 1980s.
- Market broadly representative of the whole economy: about 300 listed companies.
- Attractive collection of dominant companies and emerging growth companies.
- Stock market has functioned continuously since 1969. Left intact by the revolution.

However there are still negatives :

- Institutional resistance to economic and social liberalisation.
- Some political intimidation and opposition to change.
- Over-dependence on oil and gas means erratic revenues, savings and foreign exchange.
- Banking, fiscal, pricing system reform only just begun
- No unified exchange rate.
- Weakness of small/medium business sector long deprived of capital.
- Shortage of private savings limits privatisation scope.
- US hostility undermines Iran's engagement with world commerce.

**Currency**

Forces equally poised

The future of the rial is the proverbial $64,000 question for investors. The worst case is that above average inflation could depress the rate by up to 50% over the next five years. However positive moves in both politics and economics could equally well stabilise the rial if inflation and the deficit are brought under control – as we expect.

Considering that the currency collapsed sharply from 5,000 to over 9,000 in 1998 and early 1999, the rial in the medium term could even have room to appreciate, especially if oil prices remain firm.

Equity yields offset much or all of currency declines

On balance, investors can best use a range of 7,000 – 10,000 to the US dollar in their calculations. High equity yields of 10-30% offset most or all of any likely rial depreciation.

The case for Iran is not dependent oil prices – but they do help. The underlying changes in economics, politics and foreign relations would be compelling even with oil at $15 a barrel.

## A Selection of Stocks

Although the market may seem to be dominated by investment companies, the Tehran Stock Exchange does have a good range of interesting companies by the standards of smaller emerging markets.

We have selected a cross-section of companies which illustrate the breadth of the market, the growth rates, the prospects, the valuations and the background against which Iranian listed companies operate.

By any measure the valuations are cheap. They seem particularly cheap as:

- *economic liberalisation accelerates*
- *political reform becomes entrenched*
- *inflation heads to single digits*
- *discipline returns to government spending and budget surplus returns*
- *currency stabilises in the medium-term: could even appreciate*
- *oil prices remain higher longer then expected*
- *US sanctions expire*

### Earnings and Valuations

| | EPS (Rials) | | | | | | PE | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Financial Year | 1997/8 | 1998/9 | 1999/2000E | % change | 2000/1E | **% change** | 1997/8 | 1998/9 | 1999/2000E | **2000/1E** |
| **Iran Khodro** | 694 | 628 | 624 | (0.6) | 792 | **26.9** | 6.0 | 6.6 | 6.6 | **5.2** |
| **Arak** | 227 | 182 | 712 | 291.2 | 838 | **17.7** | 18.9 | 23.6 | 6.0 | **5.1** |
| **TSB** | 1,053 | 1,149 | 1,198 | 4.3 | 1,438 | **20.0** | 3.7 | 3.4 | 3.2 | **2.7** |
| **Pars Home** | 499 | 824 | 685 | 16.7 | 766 | **11.8** | 8.4 | 5.1 | 6.1 | **5.5** |
| **Borajerd** | 350 | 455 | 277 | (39.1) | 702 | **153.4** | 6.9 | 5.3 | 8.7 | **3.4** |
| **Ghazvin** | 1,462 | 1,524 | 2,476 | 62.5 | 3,122 | **26.1** | 3.6 | 3.4 | 2.1 | **1.7** |
| **Sanati Pars** | 555 | 1,531 | 1,560 | 1.9 | 1,643 | **5.3** | 13.1 | 4.7 | 4.6 | **4.4** |
| **Dashte Morghab** | 174 | 210 | 360 | 71.4 | 663 | **84.1** | 8.0 | 6.6 | 3.9 | **2.1** |

| | Yield % | | | | **Market Cap $ Mn** |
|---|---|---|---|---|---|
| Financial Year | 1997/8 | 1998/9 | 1999/2000E | **2000/1E** | |
| **Iran Khodro** | 12.1 | 12.1 | 12.1 | **12.1** | **346.0** |
| **Arak** | 3.9 | 5.4 | 13.3 | **15.6** | **316.0** |
| **TSB** | 23.2 | 23.2 | 25.5 | **28.1** | **156.7** |
| **Pars Home** | 10.3 | 11.3 | 9.4 | **10.5** | **56.7** |
| **Borajerd** | 11.1 | 8.3 | 10.1 | **25.7** | **20.7** |
| **Ghazvin** | 13.5 | 24.9 | 23.6 | **29.7** | **18.4** |
| **Sanati Pars** | 7.7 | 17.9 | 18.3 | **19.3** | **10.9** |
| **Dashte Morghab** | - | - | - | **-** | **5.2** |

A quick snap shot reveals the following attractive features:

**Iran Khodro**
With 74% of the local car market, Iran Khodro will expand capacity four-fold over the next 6–7 years to a very economic size. Demand already is estimated at double annual output meaning that initial capacity expansion will all be absorbed. Iran has only three million cars in a population of 65 million people. This dominant player, with foreign technology partners, sells on 5.2X current earnings and yields 12.1%.

**Arak Petrochemical**
Enjoys both support and protection from the government and financial discipline from investor Bank Melli. Earnings will nearly treble as exports are now recognised at the market exchange rate. Constant expansion is planned, subject to market and funding: sells on 5.1X March 2001 and yields 15.6%.

**TSB**
A major consumer play with 51% of the processed edible oil market. Strong brands and well positioned as market expands under liberalisation. Has benefited from privatisation and looks likely to continue to do so with its strong balance sheet. Well-regarded pre-Revolution company, sells on 2.7X March 2001 and yields 28.1%.

**Pars Home Appliances**
A leading white goods manufacturer with international designs in a market where despite high tariffs, local demand exceeds output by 30%. Has 80% of freezer and 25% of refrigerator markets. Good export potential within region. Expanding capacity 70%. Sells on 5.5X March 2001 and yields 10.5%.

**Borojerd**
A young company that has defied the odds to be efficient and successful in a losing sector, textiles. Strong brand, half exported (90% to Italy). Moving downstream to capture value added in domestic market where only 40% is supplied locally. With 50% expansion sells on 3.4X March 2001 and yields 25.7%.

**Ghazvin**
A German-based Iranian entrepreneur has built the largest sheet glass company and is expanding into float glass with Pilkington technology. Some 20% of local market is met by imports, export potential to neighbours is significant. Moving downstream into higher value-added products. Sells on 1.7X March 2001 and yields 29.7%.

**Sanati Pars**
Benefitting from cheap raw material this carbon black maker exports half its product. Sanati Pars can double its capacity while only expanding its work force by 10%, thereby driving down unit costs and boosting margins. Sells on 4.4X March 2001 and yields 19.3%.

**Dashte Morghab**
The smallest company in our selection but illustrative of Iran's Taiwan-like SME sector. Strong brand with 25% share of the processed vegetable and fruit market, it enjoys real international competitive advantage from its high yielding soils around Shiraz. Exports already exceed $11 million. Sells on only 2.1X March 2001 even though annual EPS growth of 35 – 50% looks possible over the next three years.

# Iran: By the Numbers

## KEY FACTS

| | |
|---|---|
| Population | 65mn |
| Population Growth % | 2.1 |
| Literacy % | 81 |
| Telephone Lines (per 100 people) | 11.8 |
| Oil Output (mn bpd) | 3.37 |

## GDP Breakdown % (1997)

| | |
|---|---|
| Agriculture | 20.3 |
| Oil | 15.2 |
| Manufacturing/Mining | 21.0 |
| Services | 43.5 |

| ($ bn) | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 (1st Half) |
|---|---|---|---|---|---|---|---|
| Oil & Gas Exports | 14.3 | 14.6 | 15.1 | 19.3 | 15.5 | 9.9 | 7.0 |
| Non-Oil Exports | 3.8 | 4.8 | 3.2 | 3.2 | 3.0 | 3.1 | 1.7 |
| Total Exports | 18.1 | 19.4 | 18.4 | 22.5 | 18.5 | 13.0 | 8.7 |
| Imports | 19.3 | 12.6 | 12.7 | 15.0 | 15.0 | 13.9 | 6.2 |
| Trade Balance | (1.2) | 6.8 | 5.7 | 7.5 | 3.5 | (0.9) | 2.5 |
| Services | (4.5) | (3.1) | (2.2) | (2.6) | (2.5) | (1.8) | (0.6) |
| Current Account | (4.2) | 5.0 | 3.5 | 5.3 | 1.2 | (2.2) | 2.1 |
| Budget Deficit (Rial trln) | na | na | (6.4) | (3.9) | (8.2) | (22.8) | (4.7) |
| Inflation | 22.9 | 35.2 | 49.4 | 23.0 | 17.0 | 20.0 | 21.8 |
| GNP $ bn | 76.7 | 72.8 | 90.0 | 92.0 | 95.0 | 96.5 | na |
| GDP Growth % | 2.3 | 1.8 | 4.2 | 5.0 | 3.2 | 1.6 | na |

*Source : Bank Markazi*

# Overview

## Entering a New Era

**After two decades, Iran now looks as if it is about to enter a new era, not just politically and economically but in terms of its capital market as well. Foreign investment is allowed, but the conditions including the depreciating rial have not been attractive. That could all soon change and GDP growth could double to 6% from the 2-3% average of the last five years.**

Market is cheap 3-6x

Iran has had a stock exchange since 1969, long before South Korea; and foreigners could invest there before they could in Korea, Taiwan or India, let alone in China. With most companies selling on three to six times earnings and expecting annual EPS growth of 25-35% if reforms accelerate, the market is cheap, especially as the currency, in anticipation of further reform, is stabilising more than expected. Iran with a population of 65 mn people and some 300 listed companies that are broadly representative of the underlying economy, looks both like a real country and a real market.

Most difficult initial parts of economic reform completed…

Reform still has far to travel, but the most difficult initial parts have already been navigated. This May's Third Five-Year Plan is a classic text of economic liberalisation. The next few years should see the fulfilment of the promise with the help of a surprisingly large number of factors that will support and strengthen the process. Not the least of these factors is Iran having the world's third largest reserves of oil and gas.

## Where are We in the Process?

…with more major changes likely within the next two years.

Ideas about political and economic change have not emerged overnight. Policies have been moving in that direction for over a decade but what is significant for investors is that major changes are now likely within the next two years. Just as China first unveiled its economic reform package in 1978 but was only able to benefit from it a decade later, so Iran, which first started to liberalise parts of its economy in the early 1990s is about to reap similar benefits. What is striking today is the considerable symmetry in Iran's domestic, foreign and economic policies. Each reinforces the other.

### Politics

Reformers already control presidency and legislature

The May 1997 presidential election and the February 2000 legislative (Majlis) elections have shown unequivocally that there is a strong desire for change. Reformers won about 70% of the popular vote, giving them for the first time the presidency and control of the legislature. The tempo of politics has picked up over the last year with

conservatives trying unsuccessfully to stem the reformist tide. This momentum should continue over the next year with the new reformist Majlis in place: it should culminate in a new era after the presidential election in mid-2001.

Not too much to be expected until after mid-2001 presidential election ... then a new era likely

The re-election of President Mohammad Khatami looks very likely, with the same coalition of reformers, women and young people (voting starts at 15 and about half of the voters are under 30) combining to entrench the progress made to date and to launch the next round of reforms. Not too much should be expected immediately as Iran has a particularly evenly balanced system of political power between the clerical and representative institutions. Prior to the 2001 presidential election Khatami will not want to rock the boat, preferring to continue to build consensus for stability so as to carry both conservatives and reformers in order to ensure that reform strengthens ahead of the election. A victory in 2001 would greatly add to his legitimacy as well as provide an overwhelming mandate for reform.

## Economy

Classic text for liberalisation and growth

The Third Five-Year Plan, launched in May this year, is a classic text for liberalisation and growth in emerging markets. With input even from the International Monetary Fund, the plan covers everything from private and foreign investment to reforming market structures. The key principles include:

- *Encouraging domestic and foreign private investment*
- *Reducing the role of the public sector and reforming administration*
- *Achieving macroeconomic, monetary and fiscal stability*
- *Stabilising state spending and formulating realistic budgets*
- *Outward orientation and increased foreign trade*
- *Boosting non-oil exports*
- *Removing impediments to job creation and encouraging labour export*
- *Reforming market structures, increasing competition, regulating monopolies*
- *Strengthening the rule of law and civil society*
- *Giving national economic needs a role in shaping foreign policy*

Privatisation momentum to pick up

Privatisation started a decade ago, but is expected to pick up momentum in the new Plan, largely because the budget deficit has become a key priority. With the collapse of oil prices, the deficit surged to 6-7% in 1998-99. Already stronger budget discipline has reined in the deficit to 1-2% last year and, with much higher oil prices, a surplus is in prospect this year. Subsidies, the bane of emerging markets and taken to considerable extremes in Iran, are targeted for reform, including wheat and oil prices. Free trade zones, another classic part of the liberalisation canon have already started, giving Iran its own embryonic Shenzhens.

## Market

The market survives from pre-revolutionary times. In terms of development it is very much where Korea and Taiwan were in the early 1980s. Even its market capitalisation of US$4.5 bn is similar in size to Korea in 1981 ($4.8 bn) and Taiwan ($6.7 bn) in 1983 when the first country funds were launched to create access for foreign investors.

## Foreign Relations

Returning to normality

US normalisation may take a couple of years

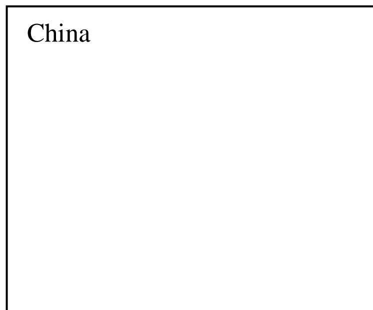
Iran becoming an island of stability

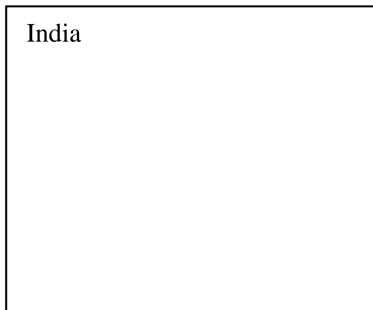
An integral part of returning to normality at home, in both politics and economics, is to restore normal foreign relations. This has now been achieved with the Gulf States, including with erstwhile arch foe Saudi Arabia. Further afield the European Union and Japan have restored full relations and their investment missions to Iran are a regular feature. Relations with the US will take longer and are unlikely to change in a US election year. However, with a new president and the Iran-Libya Sanctions Act expiring in 2001 there is a chance for normalisation within the next two years. Already the World Bank has brushed aside US opposition and decided to restart lending. As an island of stability in a very volatile region (Iran's neighbours include Iraq, Turkey, Afghanistan, Pakistan and the former Soviet republics) Iran is becoming an increasingly attractive and important geopolitical player in the region's equation.

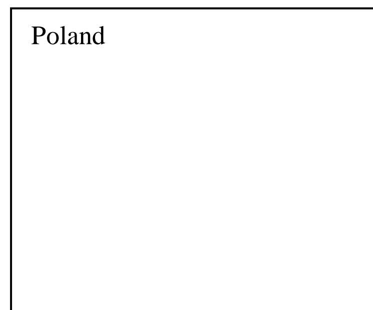
## International Comparisons

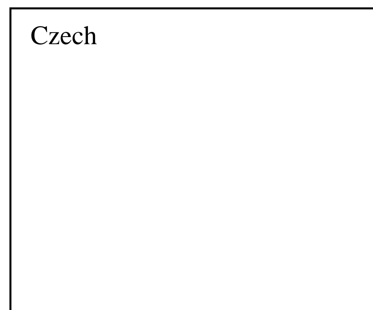
Following the classic emerging market path

In many ways Iran is *sui generis*, but it shares several features with other emerging markets in recent history. Korea and Taiwan in the early 1980s, when their first country funds were launched, have already been mentioned in terms of similarity in market development and size. India in 1991 when Manmohan Singh launched the country on its road to liberalisation, Indonesia in the late 1980s and China in the early 1980s are also obvious parallels in Asia. Outside Asia, Poland and the Czech Republic ahead of privatisation are the obvious comparisons because both were moving back to a free market system with private ownership that had been abolished within living memory. Not all have been total successes but the point for investors in Iran today is that all had very substantial bull runs not just at the start of their emergence as interesting markets, but several times subsequently.




(Insert GDP Charts)
China since 1975, India since 1985 Poland since 1990, Czech Rep since 1992
GDP % growth rate (not GDP size) if possible

# Forces for Change

## Political

Reformers now have the wind at their backs

**Elections***:* With two successful elections behind them the reformers now have the wind at their backs. The 70% endorsement, in turnouts that approached 90%, first of President Mohammad Khatami and then of reformers in the Majlis, sends a very clear message. Even the conservatives are now starting to heed it. Spiritual Leader Ayatollah Ali Khamenei, whilst nominally a conservative cleric, has subtly and at key junctures backed President Khatami, who had once been dismissed as Culture Minister for being too liberal.

Conservative spiritual leader Khameni crucially backs reformer Khatami

**Conservatives:** Khamenei, while himself at the heart of the conservative camp, has crucially backed Khatami and the reformers in the last year, most recently over the Tehran election results and former President Rafsanjani's remarks obliquely criticising Khatami. Rafsanjani, the object of reformers' attacks, has bowed to popular will and did not take up his seat in the Majlis where he had hoped to become Speaker. Instead he heads the Council of Guardians, a position of considerable importance under the old system, but over time, as representative institutions come to the fore, not as important as it once was.

Major agent of irreversible change.

**Media:** Proliferating publications and even TV programmes have transformed Iranian politics and society. Some liberal voices have been suppressed, but almost instantly they reappear under a new guise. The media has played a very similar role to that in Korea, Taiwan, Indonesia and Thailand where it has helped force political and economic change.

## Economic

Socialism, nationalism have had their day

**TINA:** There is no alternative to economic reform. Nationalism and socialism have all been tried, and in the process Iran has fallen from being among the leaders of the Third World, with the likes of Korea and Taiwan (and in reality in some ways was more like a Second World member), to become one of the laggards over the last two decades. People see that nationalist isolationism has served Iran ill. They also see, thanks to low oil prices, how wasteful state ownership and subsidies had become, leading the country straight for the rocks of bankruptcy.

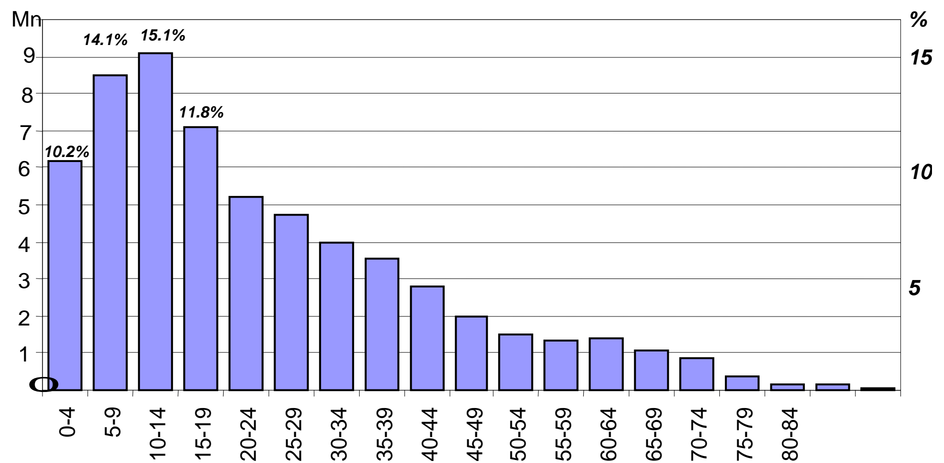
There is no alternative to economic liberalisation

Annual inflation of 20%, a depreciating rial and large unfunded deficits have led to low investment of only 16% of GDP and consequently low GDP growth. If Iran is to reach the 6% GDP it needs in order to create enough jobs to employ the baby boomers, annual exports must rise to $30 bn from $20 bn in 1998 while investment will have to rise to 25% from 16% - still below Asian investment rates.

Single most important problem

**Baby Boomers:** The single most important factor for change is the looming problem of the baby boomers entering the job market. With over 60% of the population under 30 years old and the largest cohort, some 15% being between 14 and 18 years old, the government has a potential major problem on its hands. Unemployment is already 15%, expectations of this 'special' generation are high and some 750,000 new jobs are needed every year in an economy where overstaffing is as rife as in China and India – "There Is No Alternative" to reform and economic liberalisation.

**Population Age Distribution in Iran (1996)**

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- **Liberalisation of trade :** There are moves to reduce tariffs and eliminate import bans. WTO membership is the long-term goal.

- **Exchange rate rationalisation :** Unification of exchange rates to the market rate, except for a few basic food items, should be achieved within 12 months.

# Why Reform Can Succeed

Numerous supporting factors

The need is clear. The forces for change are strong; and fortunately there are numerous factors or strengths that will help economic change materialise. These include:

Secure base for private capital

- **Building on the revolution's successes.** Some very real successes have been achieved in the last two decades. From agriculture and infrastructure – roads, water, housing and telecommunications – to mass education and now a falling birth rate, Iran has created a secure base on which private capital can build, as it has in both India and China.

- **Part of private sector untouched.** Shopkeepers and merchants, the bazaaris, were untouched by the revolution. Indeed many benefited from it. For the rest, access to credit has been difficult, but in the process, as in Korea and Taiwan, a class of hardy small-scale enterprises has been created.

- **Stock market intact.** The stock market was never abolished, as in China. Instead as in India, for over three decades, it just had not been encouraged until recently.

Accident of history

- **State ownership not ideological.** War and flight, not ideology led the state into economic ownership. First the flight of the Shah and his business associates left many abandoned assets. Then during the war with Iraq the state took over the role of main mobiliser and distributor of resources, just as the British government did in the Second World War.

- **International accounting standards intact.**

- **Concept of property rights highly developed.** Even the socialist tendencies of some clergy are motivated by workers' welfare concerns, rather than ideological concerns for state ownership.

Clerics have to be popular

- **Democratic streak in clerical system.** Iranian clerical struggles have long been played out through a democratic process. The individual influence of a cleric has always been directly related to his popular following.

Tired

- **Struggle fatigue.** People are tired of political struggle after 20 years of getting nowhere, just as in China in the 1970s. Similarly they are sceptical of ideology.

Can still change

- **Revolution only 21 years old.** Therefore revolutionary institutions are not so entrenched that they cannot be changed. Also there are plenty of people familiar with the outside world and the market economy. This is in contrast to Eastern Europe and China where the isolated system had been in place for over 40 years and in the Soviet Union over 70.

No break

- **Education continued.** Although some education was affected by the revolution, technical education remained free of ideology. There was no Lost Generation which missed out on the chance of a full education as happened during China's Cultural Revolution.

Like China in early 1980s

- **Demographics.** Iran's demographics are similar to those of China in the early 1980s. A rapidly-growing work force and declining dependency ratio could boost real GDP growth by 6-9% as China has shown. Even if Iran is not the next China, it could achieve 6% growth if it liberalised.

- **Wages.** The rial's depreciation has made skills relative to US dollar cost very attractive.

- **Agriculture.** Growth of 3% has been achieved, despite unfavourable pricing policies.

Not a burden

- **Foreign debt.** One benefit of isolationism has been an improving external balance sheet. Foreign debt has fallen to only $11 bn.

Higher prices will boost confidence

- **Oil Prices.** Should oil prices hold even above $18 per barrel the rial and state finances would receive a major boost. This in turn should encourage the government to relax controls and open up.

# Stock Market Opportunities

The Tehran Stock Exchange provides the necessary infrastructure for stockmarket trading. Founded in 1969 there are about 30 brokerages and 300 listed companies.

Broadly-based market

The market has a broad base, more representative of the underlying economy than many emerging markets.

**Market Capitalisation Sector Breakdown**

| Position | | Rials Bn | $ Mn | % |
|---|---|---|---|---|
| 1 | Investment | 8,707 | 1,061.9 | 23.5 |
| 2 | Petroleum & Chemical Products | 6,411 | 781.8 | 17.3 |
| 3 | Mining & Non Metallic | 5,534 | 674.8 | 14.9 |
| 4 | Chemicals | 4,417 | 538.7 | 11.9 |
| 5 | Foods & Beverages | 4,157 | 506.9 | 11.2 |
| 6 | Machinery & Equipment | 2,515 | 306.8 | 6.8 |
| 7 | Rubber & Plastic Products | 1,506 | 183.6 | 4.1 |
| 8 | Metallic Products | 1,155 | 140.8 | 3.1 |
| 9 | Electrical Equipment | 1,124 | 137.1 | 3.0 |
| 10 | Textile | 740 | 90.2 | 2.0 |
| 11 | Motor Vehicles | 524 | 63.9 | 1.4 |
| 12 | Paper | 153 | 18.6 | 0.4 |
| 13 | Printing & Publishing | 136 | 16.6 | 0.3 |
| 14 | Paper & Wood | 33 | 4.0 | 0.1 |
| | **TSE Market Capitalisation** | **37,117.6** | **4,526.5** | |

$1=8,200 Rls.

**Valuation**

Plenty of scope for P/E expansion

P/E expansion can be expected as inflation declines and the rial stabilises. With P/Es for most leading companies between 3-6 times current earnings there is plenty of scope for expansion. This would be accelerated by the limited free float once foreign investment flows become a factor.

**Growth and Returns**

Leading companies' annual EPS growth could reach 25-35%.

If the current reforms continue as expected, annual earnings growth among leading companies could reach 25-35%. With currency stability an integral part of the process as investor confidence returns, even with some further currency depreciation, annual returns of 20 -25% look possible.

**Companies**

Investors will find in Iran familiar emerging market factors that create for the best companies the opportunity to earn above average returns.

Unmet local demand

- **Shortage economy.** The scope for import substitution or satisfying pent-up demand is substantial. Iran meets only 40% of its textile and 80% of its glass demand: in the protected auto industry, local output only meets an estimated 50% of potential demand in a country of 65 million people, of whom only three million own cars. Installed capacity could rise from 250,000 units to 1 million within 6-7 years. Capturing this unmet demand provides easy and profitable expansion. Instantly higher volume and new technology drive down unit production costs and boosts profit.

Baby boomers will drive growth

- **Household formation.** Iran's baby boomers born in the 1980s will be a major force in economic activity over the coming decade. Just as in East Asia in the 1970s and 1980s they will drive real estate, construction and a whole range of consumption-related industries.

Many opportunities

- **Privatisation.** This provides opportunities for private sector management to grow by acquisition and by turning around poorly managed state owned enterprises. Toseye Sanayeh Behshahr (TSB) has become a successful industrial holding company through privatisation and by stock market listing of its acquisitions.

Historically a nation of traders

- **Industrialisation.** Although Iran has a long private sector tradition, it has been more a nation of traders than of manufacturers. Hence there are still significant opportunities in industrial growth. Core sectors such as autos also stimulate growth in associated industries like tyres, carbon black, glass and electronics. Doodeh-E Sanati Pars and Ghazvin Glass are such examples in Iran.

Adding value

- **Moving up the value chain.** As industrialisation procedes so manufacturers move on from basic production, adding greater value and profit for each unit of output. Ghazvin Glass is an example.

Catch-up potential large

- **Low per-capita consumption.** By many measures the potential for catch up is significant in Iran. Beneficiaries in the market would include TSB where annual edible oil consumption is 15 kg per person compared with 25–30 in Europe. Glass consumption is under 6 kg per person compared with 8 kg in neighbouring Turkey.

Capacity increases drive down unit costs

- **Overstaffing.** Capacity can expand easily and at little extra labour cost when companies are overstaffed. Doodeh-E Sanati Pars can double its capacity with only a 10% increase in workforce, implying a reduction in unit costs and improved margins and profits.

Relatively better off

- **Foreign technology.** Iran's isolation has not been as total as might be imagined. It might not always have the latest technology but relative to the world's centrally planned economies it is better off. Iran Khodro has technology from Peugeot for cars and Mercedes and Hyundai for trucks. Other auto industry technology partners include Nissan, Mazda, Renault and Kia. Ghazvin gets its technology

from Pilkington. Capital goods are frequently sourced from Italy, Switzerland and Germany, helped by their willingness to provide funding and guarantee offtake.

From textiles to fruit and vegtables

- **International competitiveness.** Despite many obstacles, some companies do enjoy international competitiveness. Borojerd exports half its textile output and 90% of it goes to Italy, a major producer in its own right. Iran has exported little of its very high quality fruit and vegetables but the potential exists as Dashte Morghab has proven with $11mn of exports and a target of $50mn within five years. Utilising the soils of Shiraz for vegetables, particularly tomatoes, it practices what constitutes organic farming, earning premium prices in Europe.

Two types of company are potentially attractive to investors.

Positions secure

- **Dominant companies**. Dominant market shares offer both scale and protection. While some may eventually face foreign competition, this is unlikely within five years. Autos for instance are viewed as a core industry that will continue to enjoy government protection. Iran Khodro, with 74% of the auto market, is well placed to capitalise on its dominant position as the market expands. Pars Home Appliances, in a very competitive sector already, has 80% of the home freezer market and 25% of the refrigerator market.

Some of the greatest value

- **Emerging Growth**. Some of the most interesting companies in Iran are those smaller, newer ones that are genuinely private-sector. Seemingly against the odds they have raised capital and managed their resources in a very difficult environment. Like the smaller and medium-sized enterprises that became the backbone of Taiwan's economy and are the most interesting part of India's, they are likely to create the most value for shareholders in Iran.

**Iran: Now the stable one in a dangerous region**

# Assessing Iran's Potential

**Iran's emergence from 21 years of revolution, war, socialism, nationalism and clericalism received added momentum from the sweeping reformist victory in this year's legislative elections. These have underlined the popular desire for change and provided the government of President Khatami with more tools to carry out his agenda of social liberalisation, rule of law, opening to the outside world and privatisation of the economy.**

Iran rejoins the community of nations

Iran is thus well on its way to becoming a "normal" country with concepts and systems familiar to international investors and with normal relations with the developed economies. It can build on past experience with these systems, and look forward to rapid income per capita growth after 20 years of stagnation. Capital inflow will replace outflow and debt repayment, and further develop an already active stock market.

**Parallels to other revolutionary societies**

A useful starting point

Iran is *sui generis*. One could expect nothing else from a civilisation with some 3,000 years of continuous cultural history - longer than anywhere except China. But comparisons provide a useful starting point for considering the ways in which post-revolutionary Iran may evolve and the opportunities for investment it will present.

One can find in Iran parallels with:

- Post-Mao China, with its emphasis on economic development and opening to the outside world rather than on an inward looking, state-dominated ideology. Unlike China, where the party could allow a wide measure of social freedom so long as its political dominance was not challenged, in Iran strict Islamic social codes have been the ideology. But Iran's political system is more flexible and it never lost the concept of private property rights.
- India after 1991 when the pretensions of central planning and belief in the merits of central planning and state ownership of key industries were largely abandoned in favour of private capital and greater openness to foreign trade and capital. However, Iran starts from further back in that the state sector, after the Iran-Iraq war, is relatively much larger than in India.
- Czech Republic, Poland, etc., which were forced by the collapse of the Soviet-led Communist political system to transform ownership structures as well as economic orientation towards the west. In Iran, the Islamic revolution is not being overturned, but it is being profoundly reoriented away from socialism and extreme nationalism.

A relatively recent revolution

Compared with the other above societies, the Iranian revolution is relatively recent - a mere 21 years. This is both an advantage and a disadvantage in considering the pace of change now. On the one hand, revolutionary fervour and ideals are still strong, at least in some ruling quarters. Those who made the revolution are still very much in charge. On the other hand, expertise from pre-revolutionary days is still available, familiarity with the outside world survives, and the post-revolution institutions are not all so entrenched as to be incapable of change.

Not a return to the past

While some may see the current process as a kind of counter-revolution, the future cannot be seen as a return to the past. The process now is not to reject what has happened in the past 20 years, nor to restore the monarchy. It is to identify why post-revolution Iran now needs to evolve in a way which is open to outside ideas, gives freer rein to individual initiatives, and is more accommodating of the diversity which needs to exist if a society of 65 mn people is to recover its dynamism.

Revolution's successes a starting point

The future can also build on some successes of the revolution - major improvements in agriculture, the physical infrastructure of roads, housing and telecommunications, mass education, and, more recently, a dramatic reduction in the birth rate. As in China, these now provide a more secure basis on which private capital can flourish.

**Foreign Relations**

Iran's relations with the rest of the world have undergone major changes since 1979 – and now are doing so again, this time with a marked improvement. Rising nationalism in 1979 was met with US-led isolation of Iran. Now Iran and much of the rest of the world have returned their relations to normal with increasing warmth on both sides. The US, largely for domestic political reasons of its own, is now out of step with the rest of the world in alone maintaining its embargo (which was never imposed in 1979 for the taking of American hostages but in 1995 for supporting Hezbollah in Lebanon against Israel).

Isolation's cost

Nationalism in Iran, as in India, has now acquired a new perspective. In the past, aggressive nationalism sought to limit foreign participation and build local industries behind tariff walls on the assumption that this would make the nation strong. However, many nationalists can now see clearly that isolation has weakened the nation, especially since the decline in oil revenue has exposed the frailties of import-substitution industries originally financed by oil.

Loss of leadership of developing world

It is now realised that industries need constant infusions of new technology as well as some competitive challenge to keep them up-to-date. Today's nationalists can now compare how badly Iran has fared with more open countries which not so long ago were poorer. In the past, nationalism may have been a question of keeping the rich nations and their companies from dominating the local economy. Now it is an issue of preventing the gap with other developing countries widening. Two decades ago, Iran was a leader in the developing world. Now it is anything but. So nationalists in Iran, as in China, now favour an opening to the outside world which will strengthen the nation rather than finding their expression in isolationism and self-reliance.

Khatami tries to mend overseas fences

There is even a modest effort to play up the pre-Islamic history of Iran, much advertised under the shah and with appeal to secular nationalists. The government is promoting get-togethers with other countries representing "ancient civilisations" - Greece, Egypt, Italy and China. This little piece of theatre also represents part of Khatami's foreign policy agenda of mending as many fences as he can - with Europe, with the Gulf states, with some of the Arab world. Almost daily, delegations visit or are received from countries with which Iran till recently had scant links.

US a monumental stumbling block

This is not always easy. The best of intentions can be thrown off course by extraordinarily petty issues - for example, whether French hosts should be allowed to serve wine to non-Muslims at a banquet. Khatami must guard against accusations that he is insufficiently pious. The US of course remains a monumental stumbling block. Conceivably it would be easier for a conservative regime in Tehran to make a decisive move towards the US than for Khatami. They have performed two crucial 180 degree turns in the past as pragmatism got the better of fervour: settling for a peace with Iraq which left the aggressor in power, and reversing a strongly pro-natalist policy which saw the birth rate soar in the 1980s, to a family planning campaign which has almost halved the birth rate.

Decisive move towards Washington not yet

But there is insufficient unity at the top now, and Khatami is not powerful enough, at least not yet, for a decisive move towards Washington. Meanwhile America's knee-jerk Islamophobia and a foreign policy towards Iran centred around Israeli interests limits Tehran's ability to move forward cautiously, despite some not unfriendly remarks by President Clinton.

**Opening to the outside world**

Opening an economic necessity

Opening to the outside world is now seen as an economic necessity by a broad spectrum of the leadership and as desirable by most opinion makers. The ardor of the revolutionaries has cooled so that even those who led the occupation of the US embassy now favour relations with the US. The younger generation is mostly anxious for any contact with an outside world little known except to those - an increasing number - who watch satellite TV, an illegal but little-prosecuted pastime.

Until quite recently, Iran viewed itself as the agent of revolutionary change, the standard-bearer of Islamic revival, the leader in rejecting western values and in the fight against the US surrogate, Israel. There is still a sense of pride in this achievement, as well as a degree of bitterness that the west's backing for Saddam Hussein prolonged a costly war of aggression. Though he was a Shia, Khomeini's influence was felt throughout the Muslim world - and generally viewed as dangerous and disruptive by regimes in power.

Bulwark of stability in a volatile region

But a maturer Iran now sees the advantage of acting - and being seen to act - as a bulwark of stability in a volatile region. With neighbours like Afghanistan, Iraq, Pakistan and the ex-Soviet republics of the Caucasus and central Asia, Iran is already a model of stability. Given this reality, it is bizarre indeed to see the US promoting any route for oil and gas pipelines from the Caspian which does not pass through Iran.

Even the US has now begun a policy shift. March 2000 saw it allow the import of Iranian carpets, caviar and agricultural products. The Iran-Libya sanctions act is due to expire in mid-2001, by which time there will be a new president in the White House unencumbered by past executive orders against Iran. Normalisation of relations can be expected within two years, opening Iran not just to US oil majors and other capital but providing new markets for Iranian products and encouraging the return of Iranians from the US.

There is thus considerable symmetry in the domestic, foreign policy and economic agenda now being pursued by the Khatami government.

Geopolitical hub

Iran has geography on its side too. Not only is Iran at the heart of 70% of the world's oil reserves it also sits in the middle of a region with rapidly growing populations, bordering by land and sea no less than 14 countries, some of which have no sea access. All of them except Turkey, Pakistan and Russia, have relatively small populations and thus limited opportunities for large scale manufacturing. Iran has the potential to play in this region the role that in Southeast Asia Thailand has played, a country of similar population and, till a decade ago, income level. These opportunities do require a change of mindset after years of excessive oil wealth followed by revolutionary isolationism. But they are beginning.

US coming to terms with new Iranian realities

US sanctions remain a huge hurdle, particularly for energy projects. They have also so far deterred the IMF and World Bank from doing more than offer advice – though the World Bank is resuming lending. But it now seems only a matter of time before the US comes to terms with new Iranian realities. Iran as much as Turkey is a gateway to the resource-rich former Soviet nations of the Caspian and the Caucasus. It is reasonable to expect that the two main impediments to Iran-US normalisation will have gone by mid-2001. That is when the US sanctions act expires. By then there will also be a new US president, who is unlikely to renew other sanctions imposed by executive order. Meanwhile, Iran is acting fast to develop relations with Europe and its Arab neighbours. It is also actively wooing Kazakhstan, hoping that the big oil discovery which is believed to have been made in the Kazakh sector of the Caspian eventually will be exported through Iran.

The first signs of a thaw came recently from US Secretary of State Madeline Albright who had no choice but to recognise Iran as the most democratic state in the region and the fact that Iran is fast moving towards genuine political and economic reform.

Instead of looking for a negative reaction against the Islamic Republic as constituted, it is more useful to look at how the forces which combined to overthrow the shah can now be harnessed to create the conditions for more rapid, market-driven development, and a more open society.

**Underpinnings of the revolution**

The original revolution consisted of several elements:

Clergy able to ally with nationalism

**The clerical leadership**, headed by Ayatollah Khomeini, reacting against the uncompromising secularism of the Pahlavi monarchs who were attempting to do in Iran what Ataturk did in Turkey, stripping the veil from women, allowing alcohol and generally encouraging what the clergy viewed as scandalous and un-Islamic ideas and practices. The Shia clergy in Iran had always been more organised than their Sunni counterparts in Turkey and they were also able to ally with nationalism, while Ataturk was the embodiment of Turkish nationalism. The clergy found support, economic and otherwise, from the *bazaaris*, the large merchants whose position in society was being undermined by new capitalists, domestic and foreign, western-trained technocrats, court-linked landowners, etc.

Though Shia Islam is not unique to Iran, it is the centre of Shiism. The historically close identity of Shia Islam with Iran, especially during the glorious Safavid dynasty, has also forged a link between religion and some aspects of nationalism. The clergy has nationwide organisation and the sermon at Friday prayers as its way of communicating with the masses. The clergy never had a single political view. But from the outset they had the agenda of placing religion at the heart of the state and government.

Mossadegh coup, other issues fan nationalism

**The nationalists,** many of them foreign-educated and some secular by instinct, who considered that the country was being sold out to foreign interests. Economic nationalism and anti-multinationalism have a long history in the modern era, beginning with a violent reaction against an 1890 award by a financially-stretched royal government of a tobacco monopoly to the Imperial Tobacco Co. (now part of British-American Tobacco). Then in 1951 came the nationalisation of the British-dominated oil industry by Prime Minister Dr Mossadegh. That led to a failed attempt by the shah to oust Mossadegh and then to the 1953 CIA-sponsored riots which overthrew Mossadegh and returned the shah to power.

For nationalists, Iran had long been prey to western (and Russian) intervention in it its affairs, and the shah was a symbol of this. The post-1973 oil bonanza - the price rose tenfold in a decade - encouraged those who thought Iran could free itself from the oil majors, and their Anglo-American political roots.

Antipathy to excesses of the wealthy

**The left.** This was a diverse group ranging from the organised communists through the academic Marxists, to secular liberals and the Fabian and academic socialists, often from elite backgrounds similar to those who dominated thinking in post-independence India. They were disturbed by the vulgar displays of wealth of the elite, and at odds with the old landowner and new capitalist classes.

City populations soared even faster than jobs could be created - Greater Tehran's population is now around 11mn - giving rise to an urban proletariat and underemployed underclass. Though much of the left was secular, Islam also had a strong tradition of support for the poor and the underdog, and kept close touch with the masses through the mosque and the social role of the clergy. This link was a major factor in the revolution's success.

Democrats thought Shah's ouster would spur liberalism…

**The democrats and assorted centrists** who encompassed a variety of ideological, religious and economic interest groups. They wanted to replace royal autocracy with free elections for a parliamentary representative government, and abolish SAVAK, the shah's notorious security police. They received encouragement from overseas, particularly those in western democracies who believed that removing or sidelining the shah would lead naturally to liberal democracy. In practice, though they had broad support, they proved at least not so focussed or determined, as more extreme groups.

…but not for long

The first post-shah prime minister, Mehdi Barzagan, had as short a stay in office as Alexander Kerensky, his Russian equivalent in 1917. Barzagan's Freedom Movement had a religious as well as nationalist base. Within the clerical system there had long been a streak of democratic sentiment. Rulers needed to justify themselves to the faithful - in particular if they were at odds with the clergy, a recurring theme of Iranian history. The more liberal clergy are now of the view that a narrow and extremist approach is bringing religion into disrepute, particularly among the younger generation - half the population was born after the revolution. They want to develop links with non-Islamic groups such as the Mossadegh nationalists.

These categories are not of course mutually exclusive. But the ideas they represent are all still present, and are more or less visible, in Iran today.

**Clergy-led state consolidates its grip**

The supremacy of the Qom-based senior clergy was established early on, thanks in large part to the standing and determination of Khomeini. But the war with Iraq led Khomeini into a degree of accommodation with more secular elements, such as the army. In the early days of the revolution, the state and religious foundations only took over royal assets, lands and property of those who fled into exile, and foreign owned companies - of which there were not a large number as most foreign presence was as minorities in joint ventures with local partners. But the exigencies of a brutal eight-year war with Iraq propelled Iran towards socialism, the state acquiring control of most industries and major distribution channels and directing them to the war effort.

Going after the anti-revolutionaries

The courts and the *komitehs* were also sometimes used to their own advantage by the well-connected to dispossess individuals alleged to be anti-revolutionary. However, this Iranian form of socialism was never central to the beliefs of the clerical leadership. It as much an accident of history, of the Iraq war, the departure of foreigners and local capitalists, and the state's emphasis on the equal distribution of scarce resources during wartime, which is familiar to those who lived through the wartime and immediate postwar ration-book economy of Britain from 1939 through 1951.

The forces of capital, international trade, etc., may have tended to be viewed with suspicion by the clergy but more on account of their association with the enemies of Islam or their own government rather than for reasons of ideology. Many clerics, including some in Khatami's camp, still entertain socialist ideas but their emphasis is more on workers' welfare than on state ownership. Local private capital began to regain a measure of respectability during Rafsanjani's first stint as president, beginning in 1989. A few privatisations occurred, though this de- nationalisation process subsequently lost momentum due to the recession which followed the foreign debt crisis and fall in oil prices. External isolation added to the woes when the US and the ascendancy of extremist conservative forces also limited Rafsanjani's ability to liberalise the economy.

**Leading the process of change**

Now there are plenty of political considerations, and the economic ones of entrenched interests who oppose significant liberalisation. But it is not an integral part of the ideology of the clerical leadership. Thus, changing attitudes to economic issues is a question of demonstrating benefits to nation and religion while minimising the costs of change to existing interests.

The nationalists, be they secular or religious, by temperament may be as much of a hurdle as the clerics. Opening to the outside world does not just mean making a pragmatic decision to invite in foreign oil companies because their technical expertise or marketing channels. That is a decision that even diehards can live with - though even today there is criticism of the Shell gas deal. Broader market opening of the sort needed for joining the World Trade Organisation runs up against the interests of national capitalists and state enterprises. The high-cost, old-fashioned, state-owned car industry is now highly protected in the same way as India's was in the recent past.

**Democracy surfaces**

Most potent force behind change

The re-emergence of the democratic ingredient of the anti-shah movement is proving the most potent force behind change today. The democratic flowering may seem surprising in a society so rigid in other ways, so beholden to a narrow interpretation of religion. However, there always was in Shia Islam a quasi-democratic strain, that clerical leadership needed to be judged by the faithful. So the 1979 Constitution provided for popular election of both the legislature (Majlis) and president - albeit circumscribed by the power of the Council of Guardians to vet the candidates. The more conservative clerics are unwilling to yield to democratic forces when those conflict with their interpretation of Islam. Yet the bottom line for the Shia clergy is that their individual influence is a function of their popular following.

Two power streams

The electoral element in the system has become the wedge used by advocates of civil society to expand the power of the civil (albeit Islamic) government relative to the self-electing religious leadership. There are in effect two power streams in Iran today. There is that which derives from the Supreme Leader, chosen for life by leading clerics, and the other bodies, such as the Council of Guardians, which vet not only candidates for the Majlis but the laws themselves. The Leader controls the armed forces, the revolutionary committees, the revolutionary guards and the clerical court.

This dichotomy has become more obvious since the surprise May 1997 election of Khatami to the presidency in succession to Rafsanjani. There were divisions between the conservatives, whose presidential candidate was Nateq Nouri, and the centrist Rafsanjani. This created a space for Khatami, who had been sacked as culture minister for being too liberal. This was an accolade as far as the public was concerned. Voter turnout was 90% and Khatami won 69% of the vote. February's Majlis elections showed similar level of backing for candidates identified with pro-Khatami political groups, despite the Council of Guardians disqualifying some well-known reformists from running.

Clergy's schisms played out through democratic process

Struggles for power within the clerical elite are thus to some extent played out through the democratic process. However, there is also another power system which straddles the others: the Expediency Council headed by Rafsanjani, whose role is to iron out disagreements between the other power centres so that decisions can be expedited.

The other element in the revolution, socialism, has mostly lost its appeal in Iran as elsewhere. Nationalised industries and banks, and a bureaucratic method of allocating credit and foreign exchange, have simply been unable to deliver consumer goods. There is a widespread sense across the political and religious spectrum that change in the way the economy operates is badly needed.

Belief survives that state must provide minimum living standard

However, socialist thinking will make it difficult in Iran, as in China and India, to address issues such as overmanning of state enterprises. Nor has socialism as a distributive system entirely failed. Despite the impact on national wealth of war, low oil prices, foreign exchange shortages and isolation, Iran has been able to improve education, housing and health standards and ensure adequate nutrition. There is a belief that the state must deliver a minimum standard of living to all. That is unlikely to go away.

All factions and ideological groups are aware of the huge challenge Iran faces over the next decade of providing jobs for the "baby boom" generation - the period between the revolution and the launch of the family planning campaign a decade ago when Iran had one of the world's highest birth rates.

**The immediate political situation**

Political tempo picks up

The past year has seen a faster political tempo that at times has threatened to spill over into disorder. The focus has been forward- and backward-looking - backward to the murders last year of leading liberal intellectuals. The issue of exposing the culprits has been a focus of campus activity. The murders were an indication of how far some on the right will go to prevent power slipping further towards liberalism. But the ideological conservatives have also used more conventional means of dealing with their opponents. Those jailed on various pretexts included a former interior minister and Khatami associate, Abdollah Nouri. Conservatives have also used their control of the judiciary to close liberal newspapers and extremists have tried to assassinate prominent colleagues of the president. However, the power struggles have mostly remained within constitutional limits.

Khamenei's support for Khatami continues

There are personal as well as ideological issues involved in these cases. Left, right and centre visions are not always simple. It is also clear that despite the opinions of some around him, the Supreme Leader, Ayatollah Khamenei, has been publicly quite supportive of Khatami. Perhaps he senses the way the wind is blowing. Some conservatives will stick to a constitutional path, others will probably not. Meanwhile some erstwhile religious radicals have joined the Khatami camp, whether out of conviction, expediency or because age was mellowing them. The revolutionaries of 1979 are now in their late 40s.

Divisions within the senior clergy are nothing new. Two distinct "parties" came into existence in 1987 - while Khomeini was still alive. One of the most senior and liberal ayatollahs, Montazeri, has been confined in Qom since falling out with Khomeini. What makes these politically important now is that the divisions are more and more in the open because of the explosion of publications representing a wide variety of factions, some of them always pressing freedom of the media to the limit. Even those which are closed down usually manage to reappear with a new name.

Reformers continue to back Khatami

The more radical reformers, including women's groups, may ultimately be aiming for a separation of church and state - not something that can be contemplated under the present order or constitution. But most are prepared to back Khatami and push for gradually enlarging the scope of civil society. Khatami succeeded in persuading the Supreme Leader to replace the head of the judiciary with a respected moderate, Ayatollah Shahroudi, who has deplored the state of the department and promised to make it more professional. Khatami is anxious to broaden his own support base with an "inclusionist" platform. In council elections, new faces such as businessmen, professionals, local celebrities appeared. Some nationalist figures may also come to the fore from the Majlis elections. It is even possible that in the not too distant future some exiles may return and begin to play a role in politics.

**Contending forces**

Muscle of the Ansar-e-Hizbollah

On the fringe of visible politics, there are hidden forces. On the side of revolution are the muscle of the Ansar-e-Hizbollah - Backers of God's party - who attacked students demonstrating in support of a pro-Khatami newspaper closed by the police. Extreme right-wing elements are believed to have been behind the March shooting of one of the president's closest advisors, Saeed Hajjarian, and such intimidation may well continue to plague the nation. However, it is more an indication of extreme conservative frustration than a real threat and is boosting the public reputation of reformers.

Dwindling shah loyalists

Outside the country are the shah loyalists, a dwindling band but itching for revenge. And in and out are left-wing militants of the Mojahedin-e-Khalq (MKO), bitter at being decimated by the religious right early in the revolution, responsible for some assassinations but blamed for others which in some cases were more likely regime supporters getting rid of rivals. Most are now more likely to work from within the system.

The goal for Khatami and centrist clerics must be to keep the reform process moving along fast enough to maintain their own legitimacy, while avoiding a rightist backlash which could in turn incite the students and the left to more vigorous action of their own, reminiscent of 1979.

Iranians tired of political struggle

The latter danger should not be exaggerated. Iranians, like Chinese by 1980, are tired of struggle. Most factions seem prepared to compromise just about enough to ensure that reform does not lead to a disruptive counter-revolution.

The other danger is rightist reassertion of a bankrupt authoritarianism, as happened in Burma a decade ago just when it seemed, in the elections won by Aung San Suu Kyi, that a more open system was emerging after decades of a military-dictated Burmese Road to Socialism. But this looks increasingly remote. Iran has the advantage that a reformer is already in power and there is a degree of consensus about what needs to be done to develop the economy and improve the nation's foreign relations.

Change slow and tortuous

The inordinately complex Iranian constitution, with its bias towards clericalism and its parallel institutions, some of them appointed, makes change slow and tortuous. However the momentum from the Majlis election should carry through till mid-2001 when Khatami himself is up for election and will be hoping for an even stronger mandate. Ultimately even the powers of the Leader for Life are not safe either from constitutional change (via a referendum) or by new blood in the Assembly of Experts, which elects and is supposed to supervise the Leader. The Assembly is itself elected, but in the past, through its veto power on candidates the Guardian Council has ensured conservative clerical control. But that is now likely to change.

In short, despite its complexity the constitution does provide its own avenues for change and Khatami will be trying to build a consensus which avoids frustrating the impatient without alarming those who dislike change but can be convinced of its inevitability.

**The new Majlis**

Contentious Views possible

How much Khatami can now achieve will depend partly on the character of the new Majlis. Though broadly committed to change and to the President, on specific issues members are likely to have widely diverging opinions, especially on economic matters. Some are known to be critical of privatisation and economic reforms, which would cut the deficit, promote employment and attract foreign investment.

But support strong for Khatami

At first at least, the Majlis' emphasis may be to support most of what Khatami wants. His brother, Mohammed Reza Khatami, who topped the poll in Tehran, heads the largest political grouping, the Mosharekat or Islamic Participation Front. And whatever their personal views, most got elected on his reform coat-tails. Some legislators will be out to punish those who have abused their power in the past, bringing to justice those who committed politically motivated crimes. However, on balance there seems to be desire all round to forget the excesses of the past, perhaps with an amnesty along South African lines.

Social and political issues likely to be uppermost

The Majlis' first priorities are likely to be social and political issues on which agreement may be easier. These include reducing the role of special courts and the powers of the Council of Guardians to frustrate democratic systems. But economic issues must be addressed soon too because legislation to activate some reform policies enshrined in the Third Plan is still needed. It remains to be seen whether the Majlis will take its lead from Khatami and remove bottlenecks to change, or be divided, forcing Khatami to build coalitions with moderate conservatives from the Executives of Construction party founded by Rafsanjani.

Although Rafsanjani personally polled badly at the election due to his identification with conservatives and with special economic interests, he remains an influential and pragmatic force and the Executives have a large group in the Majlis. Their support may be needed to push through economic liberalisation - the price being slower change in other areas. Even in the old Majlis, many Khatami supporters lined up against attempts to remove some labour law protection from those working for small enterprises. The Majlis has now passed just such a bill, viewed by most businessmen and economists as necessary to encourage employment. Whether the new Majlis reverses this will be viewed as an important indicator of how it divides on economic issues.

Government likely to seek pragmatic economic decisions

Working in the president's favour will be the scepticism towards all ideologies which could pervade the new Majlis. This will give the government scope to use think-tanks and technocratic advisers to devise pragmatic solutions to economic problems, drawing on international experience and knowledge of how to succeed in the era of globalisation.

A liberalising economic agenda also has non-ideological enemies, notably those who have been able to use their connections and milk a system where access to credit and foreign exchange are centrally controlled.

## Reform and the economy

This brings us to how the economy and its ownership structure will be affected by reform.

- What is the current state of the economy, what forces are shaping it, how rapidly is liberalisation likely to occur, and what will be its impact on the economy and profits?
- What is the structure of ownership and economic power in the country now and how will it be altered by the privatisation agenda and opening to the outside world?

Not badly harmed by the revolution

Iran's economic structure has much in common with other transition economies, such as China. However, it never went through the same degree of socialisation. The rural sector has remained largely in private hands. Small farmers were left alone. Some estates passed from large landlords to religious foundations or state companies but appropriation was on political, not socialist principles. Absentee owners often saw their land taken by tenants with the tacit approval of the revolutionary committees.

Property rights remained in place

In the early days of revolution, when leftists were active in the rural areas, clerics talked of land reform. However, once the leftists had been sidelined, the emphasis shifted to Islam's protection of property rights. Since then, as part of the effort to broaden its appeal and attract home people as well as capital, the government has opened the prospect of at least partial restoration of old property rights.

Parts of private sector untouched

Shopkeepers and local merchants were untouched by the revolution. Indeed, the bigger ones benefited relatively through their connections to the clergy and the new power structure which in turn controlled big business - oil, the industrial sector, foreign trade, foreign exchange and nationwide distribution channels. The *bazaaris* with favoured access to goods in short supply could make huge profits. Their sons found managerial jobs with state companies, perhaps taking the place of those who fled abroad.

The size of the state sector - roughly 60% of the economy and more if the religious foundations are included - is the result of two factors, both of vital but diminishing importance. The obvious one is the post-revolutionary drive to formal state ownership of most large scale industry and commerce. Just as significant, however, is the role of oil. Even were the hydrocarbon sector to be in private hands, it would still, as the dominant source of tax revenue and foreign exchange, give a much larger role to government than occurs in more diversified economies.

Take Malaysia, for instance, never remotely socialist by inclination. Even back in colonial times, but especially in the 1970s and 1980s, its modern, corporatised commodity-export economy generated revenue for the government on a scale which gave the state, whether it consciously wanted it or not, an enormous role in investment decisions, ownership and social policy.

Oil wealth drives up state ownership

Likewise in Iran, particularly after the surge in national wealth which followed the dramatic oil price rises of the 1970s. These financed not just the outrageously conspicuous consumption of the shah's later years but an astonishing transformation of the national infrastructure and the expansion of the industrial base with state-sponsored finance, if not ownership. (In 1962, outside the cities, there had been fewer than 100 kilometres of tarmac roads in the whole country - a stretch leading into Tehran from the west.) Expensive oil's contribution to state coffers later went on to finance Iraq's war of aggression against Iran, whose oil-based foreign exchange reserves helped finance its defence. Since the Iraq war, Iran's economic history has been heavily influenced by the oil price.

A firm price in the early 1990s helped underpin the first moves, under Rafsanjani, away from war-economy socialism and state ownership and a period of rapid reconstruction. When oil prices fell again, a foreign-exchange crisis and renewed austerity brought economic liberalisation to a halt and religious fervour to the fore.

Oil price collapse, political climate force the pace of change

The 1997-1998 price collapse has had the opposite effect, however. It has combined with a new political climate to force the pace of change. The collapse has made it understood (as India learned in 1991) that foreign exchange controls do not solve foreign exchange shortages - but rather merely distort pricing and resource allocation throughout the economy. It has brought home the inefficiency of much state investment and the losses of state enterprises - as in China. Now it is increasingly realised how much was wasted during the buoyant revenue years, and more recently how much a debilitating inflation has been the result of unfunded deficits incurred by a bloated state apparatus.

Non-oil diversification a priority

It is possible - even likely - that the recovery in oil prices in 1999 will slow reform. The urgency to cut subsidies, improve enterprise efficiency, etc., will wane. But it seems unlikely to disappear. It is now recognised that whatever the oil price, the relative role of the hydrocarbon industry and thus its ability to fund other activities is diminishing steadily as the working population and non-oil activities grow. Oil exports are capped by OPEC and gas developments subject to diverse political problems. The future of the Iranian economy is about diversification and the expansion of profitable non-oil industries which do not rely on oil financed government support or access to foreign exchange at artificially low prices.

Meanwhile the oil industry - mainly through the NIOC - provides Iran with a big modern sector encompassing exploration, production, refining, plant construction, pipelines, marketing, petrochemicals, etc., furnishing a platform for corporatisation, stock-market listing and eventually, perhaps, full privatisation. For now, Iran will continue to try to find a path rather similar to China's. The difference is that neither the private sector nor the stock market were wholly abolished, and the policy of moving towards privatisation has been in place for a decade, albeit moving very slowly.

Despite revolution, some trappings of a modern state

Iran also has the advantage that its companies do not carry the baggage of social responsibilities - housing, pensions etc - of their Chinese counterparts. The state pension system is quite well developed and responsibility for health and education rests mainly with central government ministries.

Highly developed concept of property rights

The concept of property rights is more highly developed, never having been changed by the revolution. International accounting principles, until recently a novelty in China, have survived in Iran. Thus, though the nation's economic prospects fall well short of those of China, the prospects for relatively smooth and rapid development of the capital and stock markets is greater.

## The transition from state capitalism

Following a familiar pattern

The process of change from state capitalism to market-driven corporate sector can often seem confused and the distinctions between public and private often blurred. But in broad terms the stages in Iran as in China and elsewhere are roughly as follows:

1. Industries begin as simply offshoots of the relevant ministry, and investment and pricing policies are set according to ministry guidelines, sometimes themselves set by a national plan.

2. Units within industries are given increased policy responsibility - marketing, investment, some pricing.

3. Activities are corporatised at group and, at least in theory, operating unit level.

4. Some operating units acquire outside shareholders, enter into joint ventures, take responsibility for their own financing, profitability etc.

5. Medium-scale groups list on stock exchange. Subsidiaries follow.

6. Ministries (and, in Iran, religious foundations) sell down to minority level.

7. Major government corporations such as telecoms, refining, power follow the listing and privatisation path.

Some already reached penultimate stage

In Iran, the most advanced companies are now moving into stage 6, with the Ministry of Industry in the forefront. However, the breakup and partial privatisation of entities of the Mostazafan & Janbazan Foundation (by far the largest foundation) is still policy rather than reality.

Some resistance to multinationals in resource sector

Though there has been some progress in bringing foreign companies into the oil and gas industries, progress - even on development of the South Pars gas field - has been quite slow despite the National Iranian Oil Company's expertise and experience in dealing with the oil majors. Mining investment has been slow to materialise as interested foreign investors have found terms imprecise and negotiations subject to the layers of bureaucratic obstacles familiar to early investors in China, and still all too common in India. However it is early days and at least Iran has a centralised government so the sort of centre/province conflicts which plagued investors in those countries should not happen.

Privatisation finally picking up pace

Government asset sales have also been much slower than hoped, particularly after last year's Budget Law clarified which companies were eligible for privatisation and which could not be because of the constitution. Article 44 of the Constitution severely limits the role of the private sector. However, in recent months the process appears to have speeded up, with the Industry Ministry in the lead with a published timetable for disposals. The Majlis election result is also likely to make bureaucrats who had been sitting on the fence now take a more positive attitude to asset sales.

Private sector bigger than it looks…

Meanwhile, a purely private sector is beginning to emerge in its own right. In reality it is probably already an iceberg - bigger than it looks. But owners are still nervous. A small-scale private sector is encouraged but in some quarters suspicion still surrounds the notion of large-scale private enterprise, which might excite either envy or concern that it carried political weight which would run counter to the interests of the clerical establishment and its *bazaari* backers.

…but with limited access to credit

As in China, the wholly private sector continues to be disadvantaged in terms of access to credit from the state-owned banks. That suits both the state, which has easy access to credit, and the *bazaaris,* who make good profits lending to the private sector at high rates. True privatisation, though long on the agenda, has so far, again as in China, been limited to small-scale (and sometimes loss-making) enterprises. Most companies that have been corporatised and listed were controlled by the Ministry of Industry. Either the ministry or the state-owned banks (and their investment companies) control most listed companies.

However, from an institutional portfolio investor's standpoint, this is not necessarily a disadvantage for the time being. As in China, the movement towards portfolio investor participation goes hand-in-hand with the retention of majority state ownership. Corporatisation and listing are the primary goal, not complete sale of major businesses. Nor is there any plan for distribution of ownership through the kind of voucher privatisation schemes seen - with very mixed records - in former Soviet-bloc countries.

Wider share ownership should come about through the process by which workers are given shares in companies prior to being listed on the TSE. However, experience to date suggests that they mostly sell these immediately to raise cash.

Industrial rationalisation beginning

The gradualist process may not be the fastest way towards an efficient market economy, but it is one which promises a degree of certainty for investors, and should mean that market opening, tariff cuts and price competition do not proceed at a speed which undermines profits. Meanwhile some industrial rationalisation is beginning to take place, with major groups selling some assets and buying others to gain efficiency and concentrate expertise. (For instance the listed Behshahr group has sold out of pharmaceuticals but is expanding in its key areas of detergents and cooking oil products.)

### Changing structure of state ownership

Bigger role for the market

The structure of state ownership has also been changing, in a way which points to a bigger role for the market. Although the major listed companies are still ultimately controlled by the state or foundations, the principal intermediaries are the investment company arms of the banks, and of some provincial authorities. These are by definition more profit-oriented than ministries, or even the banks themselves. In many cases, these holdings result from debt/equity conversions which are then transferred to the investment companies. There is evidently plenty of scope for such conversions.

"Privatisations" have also often meant the sale of one state company owned by the Industry ministry to another, whether bank or ministry-controlled. This may not be ideal but it is resulting in industrial rationalisation, and the growth of the more commercially-minded state companies. As a recent example, the third-largest carmaker, Pars Khodro, was sold by the Industry Ministry to the second-ranked Saipa following a competitive bidding process.

Investment companies dominate

The negative side is that as a result the investment companies dominate the stock market. The pyramid structure listings - investment companies, industrial holding companies and operating companies - is unhealthy, exaggerating market size and resulting in potential manipulation of prices.

However, at least the mechanisms are in place for further partial privatisation through the stock market. What is still needed is greater confidence on the part of private individuals to invest through the market and thus enable the listing process to speed up while reducing the relative weight of the banks' investment companies.

In theory this ought to be quite easy. Buying shares might seem a better bet than keeping money in the bank (where the rate of return has consistently been well below the rate of inflation). Negative return is not much compensation for the risk-free and (mostly) tax-free advantages of bank deposits. Equities should make sense.

Legal framework to encourage private capital

### Legal system improves

But there are important issues of trust to be overcome, as well as the creation of an improved legal environment to improve the sense of security. President Khatami's emphasis on the legal process is a key element in encouraging private capital. He has also made a move to provide some compensation to those whose assets were nationalised after the revolution. For several years the government has also been trying to attract overseas Iranian capital. Nonetheless, bitterness and suspicion run deep and so private investors remain cautious. Some too are wary of the market's volatility and dominance by a few institutions. Nor are there so far mechanisms such as the Unit Trust of India, with its huge retail sales network, for enticing small savers into equities.

But the potential is there as other reforms are put in place and as foreign investment is again welcomed. Consciousness of the market is increasing, as demonstrated by public participation. The Third Five-year Plan, which began on March 21, the Iranian new year, places major emphasis on separating the state budget from state enterprises.

Firm adherence to constitution

For now, the government's emphasis is on sticking firmly to constitutional paths. The new law, approved by the Council of Guardians, implies a fairly liberal interpretation of the constitution and excludes only a few major entities such as banks, oil, gas and railways from privatisation. Even in these cases it should be possible for up to 49% to be sold. According to Dr Mohsin Nourbakhsh, the governor of Bank Markazi, the central bank, this should be possible in the case of banks as the government would still have control as required by Article 44. However, he notes that interpretation of this article is up to the Council of Guardians.

Even if the Council of Guardians is obstinate, it could be bypassed by the Expediency Council, which by one of the bizarre twists of power reality is able to determine whether it is "expedient", in the national interest, to do so. For example the Expediency Council, headed by Rafsanjani, authorised activities in the Free Trade Zones which are contrary to most interpretations of the Constitution. The Expediency Council is viewed as generally pragmatic and Khatami will need its support when, as seems inevitable, some Majlis legislation is deemed unconstitutional or un-Islamic by the Guardians.

Danger from often-vague constitution

There are of course those who fear that, in this environment of competing institutions and an often-vague constitution, interpretations can change according to the political mood. That is evidently a danger. A constitutional threat to foreign investment exists in Article 81, which reads: "It shall be absolutely prohibited to grant concessions to foreigners for establishing companies and institutions in the areas of trade, industry, agriculture, mines and services". Some may interpret this as a sweeping ban. But in practice the operative phrase is giving foreigners special "concessions" rather than banning them.

At some point it is probable that the constitution itself will be revised - but not yet. The most likely timing is after the next presidential election, in 2001, which should give Khatami a new and stronger mandate.

In practice 49% foreign ownership allowed

The constitutional ambiguity on foreign investment and private ownership issues exists alongside the 1955 Law for the Attraction and Protection of Foreign Investment, and its 1956 implementing regulations. This allows it into any field also open to Iranian private investment. The only restrictions forbid foreign government involvement, or the granting of monopoly or special privileges. In practice, foreign investment is normally viewed as limited to 49%. However, exceptions exist.

Foreign investment does not have to take place within the scope of this law, for which there are various bureaucratic approval procedures. But the law does provide protection, and a guarantee of the right to repatriate capital as well as dividends at the prevailing exchange rate.

Stumbling blocks for business – interpretation of laws

The problems for business, domestic as well as foreign, lie more with implementation than the laws themselves. All too often, officials either ignore or misunderstand the laws, or impose new obstacles for their own benefit. But these are problems familiar to investors throughout the emerging market world. How easily they are overcome will influence the pace of investment, but not its profitability.

As for constitutional issues, they must be judged in accordance with political reality. It would have been foolish to invest in China on the basis of its constitution. The issues to consider is the political direction in which the nation is headed, which will decide how the constitution is interpreted.

More law-conscious than China

Iran is actually a more law-conscious state than China. Khatami's intent is to make it more so, subjecting political institutions to regular, predictable and democratic procedures. In practice this could mean that Iran will be less attractive than China for some opportunistic investors who have been able, especially at the provincial level, to get rules bent to their interests. But Iran's circumstance should make for greater certainty, and present a legal counterbalance to political authority.

The legal and accounting frameworks are especially important for foreign portfolio investors who rely on local intermediaries. These have continued to exist in embryo since the revolution and will be nourished when Iranians start to return from overseas in significant numbers. There are also many well qualified professionals who were forced to keep a low profile after the revolution but who are now finding opportunities to play a role in private sector management.

### The private sector

"Private" sector not so private

The "private" sector is not as private as the word suggests. Though central banks statistics show half of bank credit going to the private sector, much of that is to semi-privatised companies and those controlled by the religious foundations. The initial "privatisations" were often disposals of companies controlled by ministries to the foundations. The largest of these is the Bonyad-e Mostazafan & Janbazan, which is for the deprived and war victims. It controls vast assets, many taken over from the shah's Pahlavi Foundation, including trading companies, factories, hotels, land and what was, until recently, the only non-bank credit institution.

Bonyad almost a state within a state

Critics accuse the Bonyad of being entirely un-transparent and using its preferential access to cheap foreign currency to import goods which undermine local producers, with higher costs, or who must buy imported raw materials or capital equipment using the market exchange rate. The Bonyad is almost a state within a state. Its head reports to the spiritual leader, Ayatollah Khamenei, not to the president. President Rafsanjani tried and failed to get it to privatise or list some assets. His successor will not find it easy either. But market based reform - not just sporadic asset sales - is now part of the overall agenda so in time the Bonyad will have to adapt. Meanwhile, for all their faults and lack of accountability, the foundations are more commercially-minded than the ministries.

Another quasi-private institution which is spurring a more market-oriented attitude is the Social Security Investment Company. This receives 15% of the social security levy paid by some 5m workers. It owns shares - often a majority - in 120 companies, many acquired in lieu of employer contributions. Despite its state background, and political pressures on it to invest in loss-making companies or set up factories in particular

locations, its managers do at least try to make rational investment decisions. It does little share trading but is a major shareholder in listed companies such as Iran Khodro, the leading car company. It encourages companies to list and has also been instrumental in arranging mergers and promoting industrial rationalisation.

Shortage of capital a major problem

Sale to the wholly private sector can only take place if there is private capital as well as a willingness to invest. In Iran today, those with significant amounts of capital are still reluctant to reveal it and those with small amounts have no mechanism for investing. The bigger problem is sheer shortage of capital. Asset sales - rather than just restructurings of debt and equity - are inevitably going to have to be at very low prices, or not at all. That can be hard for the socialist-inclined to accept. However, support for it could be increased if workers can see the merit of holding on to their shares and seeing the prospect of capital gains

The road to dominant private ownership of major industries is a long one. But the process should be self-reinforcing once there are - as in China - accumulation of private savings and the return of flight capital measurable in the hundreds of millions. The mechanisms to move those savings into equities exist in embryo and should develop with demand for them.

Credit institutions an important opening

An important step towards genuinely private business and capital mobilisation is the permission given so far to four groups of genuinely private investors to set up credit institutions. They are being permitted to offer most banking facilities other than current accounts. And now it seems likely that permission to use the word bank will be extended.

The very new credit institutions thus far have tiny capital and low-key presence. But they have been started by respected people who combine banking and market experience with adequate political connections. Before the revolution there were 35 private banks in the country, so experience does exist.

The conversion of the post-revolution elite to the merits of private ownership is gradual but is happening here, as in China. Rafsanjani in particular is associated with it.

Privatisation can be fraught with moral hazards which end up discrediting and hence delaying the process. In the China case (not to mention Russia) well-connected officials often succeeded in privatising state assets while leaving liabilities in public hands. However, in Iran this is less of a potential problem due to the high degree of centralisation, and the relative transparency created by the quasi-plural political environment, and by the fact that much of the privatisation is via the stock exchange and hence open to scrutiny.

Head start in market economy move

The history of the stock market gives Iran a head start in the process of moving towards a market economy. Though circumstances of the economy and ownership are obviously very different, this is a market which is roughly at the same stage as Taiwan's, Korea's or Thailand's were in the early 1980s. What is more, by giving tax breaks to listed companies, it has recognised the importance of the market in meeting other goals. In the Thai case, this was to broaden ownership away from a small clique of families. In Iran it is to dilute state ownership in favour of private ownership. In both cases the controlling shareholders remain the same. The state may be a less efficient capitalist than the family, but it is less likely to abuse the interests of public minorities.

## The state of the economy

Practicality rather than ideology drives policy

The *raison d'etre* of the moves towards privatisation and a market economy is not ideological. It is practical. To extend Deng Xiaoping's famous remark to an Iranian context: "So long as Islam is respected, it doesn't matter whether the cat is black or white so long as it catches mice".

Economy has grown slowly

The grim fact for Iran is over the past five years the economy has grown at an average of only 2-3% a year. In 1998-99 that fell to just 1.6%, according to official figures, and less according to other sources. The outcome for 1999/2000 is not likely to be above 2% despite the pickup in oil prices. This is all at a time when the workforce is expanding at over 3% a year. Labour also continues to migrate from country to city - though this process is slowing as Iran is already 63% urban, double the rate of China.

Since the late1970s, income per head has not grown at all. Partly this can be attributed to war, revolution, low oil prices and rapid population growth, especially in the late 1980s. However, the underlying reasons for the miserable growth record in recent years are found in both the structure and the management of the economy - as well as the impact of low oil prices and US sanctions.

Low growth and high inflation

Low growth has been accompanied by high inflation - in excess of 20% - and a low rate of investment. Oil output has been static and shortage of capital has limited the increase in value-added in the oil industry. Even the best-run oil product entities, like Arak Petrochemical, with access to bank credit and foreign exchange, are desperately short of financial capital to use to the full the human capital of the engineers they already have. Likewise, a visit to almost any listed company shows that projects for expansion of capacity or upgrading of machinery all run far ahead of availability of capital. Investment has been running at only 16% of GDP and much of that has gone into long-gestation infrastructure projects, or the familiar but capital intensive petroleum related businesses.

Record not entirely negative

However, it is worth noting that Iran's record has not been entirely negative. The period of the post-war First Five Year Plan saw rapid growth as oil production recovered and reconstruction fostered a boom, which was further enhanced by foreign borrowing.

Testimony to private sector's vitality

Even the last few years have had their bright spots. Agricultural growth has averaged 3%, despite pricing policies which have not been favourable. Though grain imports have risen, because of a big rise in meat output food import dependence has not increased. There has been a private sector construction boom and bust reminiscent of East Asia's. It may not have been a very efficient use of capital but was testimony to the potential vitality of the private sector. It reflected the desire to invest in real assets rather than inflation-eroded bank deposits and it attracted overseas Iranian capital back to the country, albeit through informal channels. Foreign debt has been steadily reduced, and is now only US$11 bn.

Socio-economic progress

Iran's progress on various socio-economic measurements - literacy, tertiary enrolment, number of doctors, access to safe water, infant mortality, number of telephones - has also continued to be quite impressive. The social security system is well developed - indeed too comfortable for the formal sector relative to the rural and self-employed.

## Some Comparisons

| | Per capita Income ($) | Adult Literacy (%) | Urbanisation (%) | Life Expectancy (yrs) | Phone Lines per '000 | Power Consumption kwh pa | Fertility Rate | TV sets per '000 | Food Production Index (1989-91=100) |
|---|---|---|---|---|---|---|---|---|---|
| **Iran** | **1700** | **73** | **61** | **70** | **107** | **1142** | **2.1** | **148** | **137** |
| China | 750 | 83 | 33 | 69 | 56 | 687 | 1.9 | 270 | 155 |
| Thailand | 2200 | 95 | 21 | 69 | 80 | 1289 | 1.7 | 234 | 107 |
| Egypt | 1290 | 54 | 45 | 65 | 56 | 924 | 3.2 | 127 | 129 |
| Turkey | 3160 | 87 | 73 | 69 | 250 | 1161 | 2.5 | 286 | 106 |
| Mexico | 3970 | 90 | 54 | 72 | 96 | 1381 | 2.8 | 251 | 120 |
| Poland | 3900 | 95 | 65 | 74 | 194 | 2420 | 1.5 | 413 | 85 |

| | Exports | Investment | Infant Mortality | Education Spending |
|---|---|---|---|---|
| | % of GDP | % of GDP | Per '000 | % of GDP |
| **Iran** | **13** | **16** | **32** | **4.0** |
| China | 22 | 39 | 32 | 2.3 |
| Thailand | 47 | 30 | 33 | 4.1 |
| Egypt | 17 | 19 | 51 | 4.8 |
| Turkey | 25 | 25 | 40 | 2.2 |
| Mexico | 40 | 26 | 31 | 4.7 |
| Poland | 25 | 24 | 10 | 5.2 |

Sources: World Development Report, World Bank

Laying foundation for higher growth

To some extent these social improvements reflect non-market priorities. But they also provide a sounder basis for a future economy more geared to investment, industry and private consumption. Transport infrastructure is well developed and, relative to income levels, housing standards are high. Regional income differentials are a problem, but nothing as great as in China or India. Educational standards are high, though partly due to the slow growth of industry there has been inadequate technical and vocational training.

Higher education still suffering from revolution. But no lost generation

The higher-education system went through a period of paralysis after the revolution, when religious fervour dominated. Iran lost tens of thousands of educated people and entrepreneurs to migration. But it did not lose a whole generation of graduates, as China did to the Cultural Revolution and technical education at least has remained free of ideology.

Foreign exchange shortage and deficit constrain the economy

Two chronic constraints have been hobbling this economy: the foreign exchange shortage and the government deficit. The deficit has been due in the first instance to failure to cut back spending sufficiently to adjust for lower oil prices, the source of 65% of revenue. In particular Iran pressed ahead with major development projects such as dams, which at best have only very long-term returns as well as capital intensive petrochemicals. The shortage of private savings meanwhile demonstrated that the deficit was financed to a large extent by borrowing from the central bank. The resultant money-printing created inflation which, given low returns on deposits, further discouraged savings and prompted illegal capital outflow. Meanwhile, other credit mostly flowed to the favoured state sector, and the foundations, which were under little pressure to use it efficiently.

The foreign exchange shortage was the result of two factors - dependence on oil for 80-90% of exports and dependence on imports for food and some other essentials. Many wartime economy controls on essentials remained in place or were brought back to cope with forex crises. Not only was there strict import licensing but access to foreign exchange was subject both to queuing and to differential rates.

This was - and partly remains - necessary to keep costs of imported essentials such as flour and cooking oil at affordable prices. But it has:

- Created a huge gap between the official exchange rate, on which essentials are priced, and the market rate.
- Starved industry of raw materials and spare parts so that many factories operate far below capacity
- Increased the power of the government which has direct access to oil industry dollars.
- Widespread abuse of allocation of foreign exchange created windfall profits for well-connected traders and in many cases enabled non-essentials to be imported at huge profit.

The impact of the shortage was indicated last year when the market (conducted through the TSE) rate rose from 5,000 to 8,500 to the US dollar in a matter of weeks. The collapse in the oil price caused the government to reduce official rate allocations, which drove the free market price through the roof.

Strenuous efforts to devise reforms

The recent past has seen the government make strenuous efforts to devise reforms - with input from the IMF. These are reflected in the current budget, the Third Plan, and in a variety of policy announcements.

Third Plan is more a statement of principles

The Third Plan is more a statement of principles than an old-fashioned socialist plan with detailed investment and production targets. Quantitative targets are few and include doubling non-oil exports and creating 3.5 mn jobs. It also specifically sets aside oil revenues above the US$14 mark for export diversification as well as reserves.

Some of the Plan's principles, such as privatisation, have been stated before. However, coming into force with the March 21 new year, and coming just after the election, it gives a focus for new policies and an agenda for specific legislation. It also

makes the key links between economic policy, foreign policy and domestic social and political issues.

Key principles of the Third Plan

Principles include:

- Encouraging domestic and foreign private investment
- Reducing the role of the public sector and reforming administration
- Achieving macroeconomic, monetary and fiscal stability
- Stabilising state spending and making realistic budgets
- Outward orientation and increased foreign trade
- Boosting non-oil exports
- Removing impediments to job creation and encouraging labour export
- Reforming market structures, increasing competition, regulating monopolies
- Strengthening the rule of law and civil society
- Giving national economic needs a role in shaping foreign policy

Interest in joining the WTO

Although trade agreements are not specifically mentioned, Iran has expressed interest in joining the WTO. It may not yet realise the extent of price reforms it will need to put in place to do so. But as in China, an international goal of this sort is popular and can be used to break down domestic opposition to necessary pro-market changes.

**Deficit**

Tackling budget deficits and achieving a rational pricing structure is a formidable task. The deficit in recent years has averaged 4%, spiking to 6-7% in years such as 1998-99 when oil prices were low. It has mostly been financed by zero-interest-borrowing from the central bank. The government in the year to March 20, however, has shown a much tougher attitude. Sharp cuts in development outlays were made and would have brought the deficit to 1-2% of GDP. Since then, oil revenues have soared so a surplus is now quite likely. In the first half of the year to March 20, the deficit was just Rls1.2 trn against Rls.17.0 trn for the whole preceding year.

**Government Revenue and Expenditure**

| Year beginning March 21 (Rls trln) | 1995 | 1996 | 1997 | 1998 | 1999* |
|---|---|---|---|---|---|
| Oil and Gas | 26.7 | 32.7 | 26.0 | 16.6 | 21.1 |
| Tax | 7.3 | 12.6 | 17.3 | 18.7 | 29.8 |
| Other | 7.6 | 12,0 | 19.2 | 18.5 | 43.3 |
| Total Revenue | 41.6 | 57.3 | 62.6 | 53.8 | 94.2 |
| Current Expenditure | 28.5 | 37.6 | 45.0 | 53.8 | 66.1 |
| Development [1] | 12.9 | 19.2 | 20.5 | 17.7 | 33.0 |
| Balance [2] | -6.4 | -3.9 | -8.2 | -22.8 | -4.7 |

1 Budget *1999 (six months actual)
2 Including deficit in FT obligation

For according to the budget bill for this year, general expenditure has been increased only 13%, well below the inflation rate, mainly through lower real infrastructure spending. However, the corporate sector remains a drain on the state as well as taking the majority of bank credit.

Main problem is excessive unproductive spending

The government's main problem is excessive unproductive spending. But on the revenue side, application of normal taxes to bonyads would be a big addition. With political change, that should eventually be possible.

Elimination of the deficit, or at least financing through public bond issues instead of borrowing from the central bank, and stabilisation, at least for now, of the exchange rate would rein in inflation. The Plan aims for a gradual reduction in inflation to an average of 15.9% over its life. This is unambitious and could be exceeded if currency reform and fiscal rectitude are both achieved early.

It will need determination. Iran's inflation was persistently well over 20% a year even when oil revenues were satisfactory. Now a currency stabilised by improved dollar supply can only remain so if the deficit is held down and credit growth remains restrained.

**Bank Credit Growth (Rls trln)**

| March 20 | Claims on Public Sector | % | Claims on Non-Public Sector | % |
|---|---|---|---|---|
| 1996 | 55.1 | - | 46.9 | - |
| 1997 | 65.9 | 19.7 | 61.4 | 30.9 |
| 1998 | 80.7 | 22.4 | 75.7 | 23.2 |
| 1999 | 104.7 | 29.4 | 101.0 | 33.3 |

* including foundations

**Money Supply Growth (Rls trln)**

| March 20 | M1 | % | M2 | % |
|---|---|---|---|---|
| 1996 | 41.0 | - | 85.1 | - |
| 1997 | 56.3 | 37.4 | 116.6 | 37.0 |
| 1998 | 63.8 | 13.4 | 134.3 | 15.2 |
| 1999 | 83.0 | 30.0 | 170.7 | 27.1 |
| 1999 (September)* | 83.0 | (0.3) | 183.2 | 9.8 |

* Annualised

A ceiling has also been set on state enterprise borrowings, and more leeway given to lend to the private - or at least quasi-private - sector. However, it remains to be seen whether widespread state enterprise reform will be possible before the banking sector which lends to it is first made more accountable. Privatisation would help by attracting (often now hidden) private capital and reducing the burden of state enterprise But it is only part of the problem.

Non-construction capital shortages

A shortage of capital, other than for construction, is evident everywhere one looks in Iran, even in the coddled state industrial sector. Capital to buy machines to raise productivity, modernise factories and to provide working capital for industries with export potential is in demand everywhere. It will remain frustrated till there is easier access to foreign capital, positive interest rates which encourage saving and discourage capital outflow, and exchange rates which help the rational allocation of capital.

**Currency**

Moves to unified exchange rate

Side by side is a gradual move towards a unified exchange rate set primarily by market forces. At present there are several rates ranging from a "base" rate of Rls1,750 through an export rate of Rls3,000, a TSE rate of around Rls8,200 and a free market rate around Rls8,700. (The TSE rate floats but is not entirely free as there is limited access to it)

50% of exports at free market rate

A unified rate was tried before but broke down as a result of weak fiscal policy and collapsing oil prices. But if fiscal policy can hold this time, exchange reform should succeed. Now 50% of export proceeds are being sold through the TSE free market. It is intended to raise this to 75%, leaving only basic food and a few other goods to be imported at the artificially low rate. A greater supply into the free market would mean fewer market distortions and greater stability for the free market rate.

Distortions : food and oil

Even that might change if the government can summon up the courage to provide subsidies for income groups in particular rather than providing, through the exchange rate and direct subsidies, a massive subsidy to all. A coupon rationing system for many foods also needs radical reform. The same applies to petrol, which is the cheapest in the world at around one fourteenth of the international price. Cheap petrol mostly benefits the minority who are car owners, and has fuelled a demand for cars which cannot be met. Cheap energy has yet to become a drawing card for investors considering Iran as an export base. Meanwhile a shortage of refining capacity is necessitating imports.

Important rationalisation

Even to raise the free forex rate to 75% of earnings at market prices is an important rationalisation of the whole structure and would enable Iran to get closer to international norms - a single exchange rate and convertibility on trade account necessary as it starts to think of eventually joining the WTO. It would rationalise pricing and give a better idea of which industries are competitive at reasonable levels of tariff protection. A unified rate would also end the anomaly by which favoured companies are able to get access to foreign currency at one of the administered rates, thus enabling them either to profiteer, or gain unwarranted cost advantage. It is also intended to reduce the scope of import licensing, which has a similar effect

Probable within two years

So long as there is not a dramatic oil price reversal, a unified exchange rate and current account convertibility are probable within two years.

Rial is undervalued

At the free market and now TSE rates, the rial is an undervalued currency. Costs of all locally-produced goods are very low, as are labour costs compared with skill levels. Given the distortions in the system, making projections about future currency value is

hazardous. However, even assuming that the price of oil averages no more than US$15 a barrel over the next five years, it is likely that the currency will depreciate more slowly than inflation, which itself will decline.

The principle reason is that as a higher proportion of foreign exchange is delivered to the free market, the amount converted at artificially low rates will decline. This would raise the cost of currently-favoured imports but increase the supply of free market dollars. The process would also have the secondary effect of making it easier for firms to acquire currency to buy raw materials and machinery.

Enhanced by reduced foreign debt repayments and higher oil prices

The supply of dollars to the market will also be enhanced by reduced foreign debt repayments. The need to repay debt during a period of low oil prices added to Iran's woes. It had to run a current account surplus even when oil prices were very low. Now Iran is nearly over the repayment hump, and the oil price rise of the past year is enabling it to rebuild reserves so that even if oil slumps again it will be able to service debt without needing to starve the economy of foreign exchange.

If the price stays high, it will need discipline to accumulate reserves in a non-inflationary way, and - as provided in the Third Plan - to reserve the additional dollar income for investment, such as in downstream petrochemicals, which will generate future exports.

Reforms would bring in overseas capital

Reform would also bring in foreign and expatriate capital, reversing a process of capital flight which has been going on for years. It would also encourage a huge increase in new remittances from overseas Iranians – similar to what happened in the Philippines when exchange controls were replaced and the currency stabilised.

So though a pick-up in the economy at large would draw in exports to feed factories long starved of new machinery and sometimes of raw materials, the outlook for the currency is quite positive. The current free market rate should at worst fall to Rls9,250 by end 2000 and thereafter decline by not more than 15% in any given year and by not more than a cumulative 50% over the period of the Plan.

Maybe too pessimistic

Even this may be pessimistic. Experience in China and Vietnam and various countries in Latin America has shown that a combination of fiscal discipline and consequent capital inflow can produce currency stability much faster. Alternatively, Iran could opt for a gradual but clear and disciplined move to achieving currency stability similar to Poland's crawling peg exchange rate and gradual inflation reduction.

Ideal time for stabilisation

The circumstances are now ideal - an undervalued currency and rising foreign earnings - to put stabilisation in place. Exchange rate liberalisation also only works in the longer run if there is also gradual elimination of the complex system of administered prices which is supposed to ensure steady margins for industries in which input or output prices are controlled.

Substantial obstacles remain ... but keen awareness of what is needed

There are naturally substantial obstacles still to be overcome on the fiscal front, especially to reduce dependence on oil. The Majlis has been reluctant to reduce subsidies, such as wheat, or sell oil at international prices. Widespread tax exemptions, such as for the foundations, undercut revenue raising. A value-added tax is badly needed. However, there is a keen awareness in government of what needs to be done and progress is being made.

... even by left-leaning Majlis

Even a left-leaning Majlis is expected to accept market mechanisms if non-ideological expert opinion, and the experience of other countries, shows them to be necessary to build the economy. It can be done, as Indonesia showed. Mid-1980s market-oriented reforms over a decade raised the non-oil contribution to exports from 20% to 80%, and spurred both development of the labour-intensive industries such as Iran needs to employ its youth, and other resource-based industries. Macro-economic and currency stability and a welcome for foreign investment can bring quick rewards in savings and investment.

**Outlook**

Fiscal and exchange rate stability are key

Fiscal and exchange rate stability are seen as keys to raising the level of domestic savings - now a miserable 16% of GDP - and attracting back flight capital. Real interest rates must rise. Nominal rates have been static regardless of the fluctuation in inflation. Much of course depends on government, whose strength in turn rests on the President's ability to overcome the conservatives and forces in the Majlis and the Council of Guardians.

The Council has rejected some parts of the Third Plan legislation, saying that sales of airlines, railways and some key manufacturing industries are against the constitution. However, in the end there is likely to be a compromise engineered by the Expediency Council. Meanwhile there is plenty of privatising work in the permitted sectors.

There is scant opposition now to the so-called buy-back deals with foreign companies (Total and most recently Shell) which are bringing new investment, and technology, to oil and gas. The president's opening up to Europe is widely popular and yielding a surge of interest in investment in Iran. Better relations with neighbours has made possible an important gas swop with Turkmenistan and discussions on water sales are underway with Gulf countries.

Workforce growing at 3% p.a. needs foreign markets

Iran even more badly needs the outside world if it is to reduce unemployment - now 15% - while the work force is growing at 3% a year. It is estimated that it needs at least US$30 bn annually in exports and an increase in investment to at least 25% of GDP if GDP is to grow at the 6% needed to bring down unemployment. That compares with just US$20 bn in 1998. Youth is restive and the greater freedoms it wants are also those which in an economic context could help spur development. The largest age cohort is now in the 14-18 bracket, followed by 9-13, after which it falls sharply.

It is possible that the reform will be blunted by the recovery of the oil price, now double that a year ago and far above budgetary assumptions. Certainly if opponents of liberalisation get the upper hand in the new Majlis, buoyant revenues will make it easier for them to slow budget and enterprise reform.

However, for the time being at least, the surpluses are unlikely to be spent, as revenues when the oil price is in excess of US$14 now go into a reserve fund. Additional receipts are also helping rebuild foreign exchange reserves and make payments on debts rescheduled in the past.

Oil prices should stabilise rial

Well managed, the increase in revenues will enable the central bank to keep the rial fairly stable as the free forex market expands. This in turn should bring down inflation gradually - and keep it down so long as there is also budgetary discipline. A crawling peg may prove the best system for the future, giving traders and investors a degree of stability while providing for a gradual reduction in inflation, such as achieved in Poland.

Maximum depreciation 15% ... could even appreciate

Though the free market rate has been stable for nearly a year despite continuing domestic price rises, the free market rial had fallen so far the previous year that even after recovery to Rls8,350 it is very competitive for most purposes. Given oil prices of US$18 a barrel or the rial should depreciate at most 15% by March 2001, and by declining amounts thereafter, to single digits by 2004. However as we said in the Overview forces on the rial are finely balanced. If inflation and the deficit come under control plus oil prices remain high the currency could even appreciate if reform accelerates. It is all a matter of confidence. We see a range of 7,000 to 10,000 to the US.

Managing subsidised prices a problem

The difficulty will be in managing subsidised prices, especially food. These are controlled and their weightings in the inflation index have kept official inflation well below anecdotal estimates. Realistic food pricing cannot happen quickly because it is a cushion for the poor and unemployed.

Concern about unemployment with a work force growing at nearly 3% a year is an impetus for economic reform. But equally these worries, as in China, mean that social stability considerations will come before price reform for essentials.

Widespread sentiment for opening up

Anyway there is widespread sentiment in favour of opening up - not merely doing so unwillingly as a last resort. Arguably a sustained period of US$18 plus oil would make the government more relaxed about giving more freedom to market forces. Iran now has the advantage that thanks to the severe import compression of recent years foreign debt has been reduced to just US$11 bn. Admittedly reserves are low too but the last few months alone have drastically improved the net external position .

**External Debt ($ bn)**

| March 20 | Short-term | Medium and Long-term | Total |
|---|---|---|---|
| 1995 | 4.5 | 17.4 | **21.9** |
| 1996 | 4.6 | 12.3 | **16.8** |
| 1997 | 3.3 | 8.8 | **12.1** |
| 1998 | 6.1 | 8.0 | **14.1** |
| 1999 (June) | 5.8 | 7.3 | **13.1** |
| 2000 (April)* | | | **11.0** |

*estimate

**External Dependence**

| | External Debt $ bn | External Debt % GNP | Total Trade % GNP | Terms of Trade Index |
|---|---|---|---|---|
| 1988 | 5.8 | 4.7 | 19 | 100 |
| 1989 | 6.5 | 5.3 | 24 | 99 |
| 1990 | 9 | 7.5 | 34 | 114 |
| 1991 | 11.3 | 9.1 | 41 | 126 |
| 1992 | 16.1 | 14.5 | 44 | 121 |
| 1993 | 23.5 | 32.7 | 59 | 115 |
| 1994 | 22.7 | 31.7 | 48 | 91 |
| 1995 | 21.9 | 21.6 | 33 | 84 |
| 1996 | 16.8 | 12.6 | 30 | 91 |
| 1997 | 12.1 | 7.6 | 23 | 85 |
| 1998 | 14.1 | 8 | 20 | 75 |
| 1999 | 13.1 | 7.5 | - | - |

Sources: UN, other estimates

Rich in enterprise and skills

Iran's overseas community is not massively rich in capital. Most left with little. Nor does it have the manufacturing and trading talents of the Chinese diaspora. But it is rich in enterprise and professional skills, as evidenced by its standing in host countries. Transferred back home these could dramatically raise the productivity of capital, local or foreign.

The new elite - particularly those among them who have achieved senior management positions by virtue of clerical and family connections, not expertise – may regard overseas Iranians with some suspicion. Indeed, much corporate management is similar to what is found in Chinese state enterprises - people who owe their position to party membership and political reliability.

Attitudes towards returnees changing slowly

But attitudes towards returnees are changing slowly and though they may not be welcome in existing companies, they are a key resource for the new ventures that will blossom with reform and the arrival of foreign capital.

Zealous promotion of free trade zones

The shape of things to come may be foreshadowed by what is now happening in the free trade zones (FTZs). There are three of them, exempt not merely from taxes but from laws on foreign participation. They are small and by some estimations somewhat remote from the main centres of Iran. But the government is promoting them with a zeal which suggests it wants them not just to be islands of freewheeling economic and social activity but to show the way to more liberal policies at large, as was the case with Shenzhen, China's special economic zone near Hong Kong.

Iran’s Shenzhens

Thus far only Kish has made much progress, and that mainly in service industries, not manufacturing. But it is becoming a bridgehead for foreign banks, who can set up branches rather than just have rep offices, and the quality of its hotels show how quickly standards can be raised to international levels once the opportunity is offered.

It may seem too late for the FTZs to be the equal of Dubai, Abu Dhabi and Bahrain for international business in the Gulf. But they can compete in some ways, and anyway offer a gateway to a potentially much bigger catchment area than the Gulf itself.

Very competitive location

A key to investment, especially in manufacturing in the FTZ, as well as Iran generally, is a degree of exchange rate predictability. At the current free-market rate, Iran is in theory a very competitive location, with low costs relative to skills available. It even has competent domestic transport infrastructure. But international links are still woeful and confidence in the predictability of the system still lacking. The people want to open up, but, as in China around 1982, it's not yet clear that enough power-holders want it to.

It will also be vital to keep the exchange rate competitive, whatever the price of oil. This is not just because Iran needs to diversify away from oil exports. Even more vital, it must attract labour-intensive industries of the sort which drove the original growth of East Asia and China.

Current demography similar to 1980s China

The current demography of Iran is similar to that of China in the early 1980s - a rapidly growing workforce but declining dependency ratio. This can be a threat to stability if jobs cannot be created. But given capital, skills and correct policies it can generate high rates of GDP growth - 6-7% a year.

**Conclusion**

6% growth reasonable

The conditions in Iran may not be as favourable as they were for China and some other Asian economies. But even so, it is reasonable to expect that Iran can achieve an average of 6% growth over a 10-year period, led by manufacturing responding to privatisation, rational pricing and access to foreign exchange. The growing workforce (and falling dependency ratio) is an opportunity for rapid increases in consumer demand. More women are joining the work force. Though the level is still low compared with East Asia, it will grow rapidly and further expand the money economy. Increased household disposable income will flow immediately to demand for the products of the industrial companies which dominate (directly or via investment companies) the stock market.

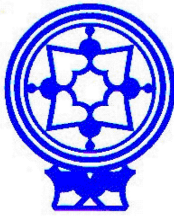
Transformation almost inevitable

Even if, as in India, there is disappointment with the speed of reform and the improvement in the GDP growth rate, the potential opportunities for investors are immense. A transformation of this economy, as of the society, is almost inevitable. The momentum is there, the value is there, the fundamentals are there.

The question is: how long will it take? Inevitably there will be frustrations. Once foreigners start arriving some Iranians will tend, like the Chinese, to assume that they are there to be milked. The attractions of the local market will be over-estimated, as in Vietnam, by national pride. Some bureaucrats will delay projects and maximise their own incomes by changing the rules at crucial moments.

Opportunities for reward greatly outweigh the risks

But such hazards always exist in emerging markets. Iran meanwhile has a unique opportunity to make up for the misfortunes, imposed and self-imposed, of the past 25 years. Whether or not president Khatami is Iran's Deng Xiaoping, the opportunities for reward greatly outweigh the risks. Even if the new Iran ultimately disappoints, there is sure to be a sustained period of local optimism powerful enough to attract foreign and expratriate capital and inspire at least one boom. Already one can smell the buds of it in the air.



# The Tehran Stock Exchange

The continuous existence of the Tehran Stock Exchange through revolution, war and socialism is testimony to the survival of capitalist instincts and mechanisms. It was founded in 1967 with just six companies listed. It grew steadily so that a decade later, just before the revolution, there were 102 listings and a market capitalisation of Rls229 bn.

The nationalisations of the early 1980s saw many of the listed companies disappear into the maw of the state or the religious foundations so that by 1988 only 56 were still listed. Trading meanwhile became effectively moribund.

Revival began a decade ago

Revival began a decade ago when the First Five Year Social and Economic Development Plan saw the utility of the market in channeling savings and facilitating privatisation. By 1995, some 150 companies were listed. They have now grown to around 300. However, most are seldom traded. Many are subsidiaries of larger entities and are listed more for tax reasons - the rate is lower for listed companies - than either to raise capital for themselves or their parents. The top 10 companies account for 35% of capitalisation and 70% of trading volume – very typical of emerging markets.

The principal measurement is the TSE index, a weighted average of all listed companies. However, there are sub-indices and also a Top 50 index.

Turnover has been volatile

Turnover and index performance have been quite volatile, generally reflecting the liquidity situation and outlook for the economy. In particular, 1996 and 1997 saw a boom followed by a bust and even in terms of a fast-devaluing rial the index only recently surpassed that peak. Conditions were especially depressed in 1998 and early 1999, discouraging investors and slowing new listings and privatisation. But the index has been rising on the back of higher oil prices and economic reform expectations.

Low P/Es 3-6x ... could rise quickly to low double digit

Nonetheless, average PE ratios remain in the low single digits, most around 3-6x. A sustained rise in the PE multiple is unlikely till inflation is under control and the currency more predictable. However, both are now likely. A move to the upper single digits found in most Middle East markets will follow. At present only about 2% of institutional funds invested in emerging markets have gone to this region. It has attracted tiny amounts even compared with poorer and under-performing economies such as the Philippines. If foreign institutional investors begin to take a more positive view of the region, a shift into double-digit PE ratios will happen quickly. The very low valuations are particularly striking at a time when companies in the slow-growing western markets are rated so highly.

Very attractive yields

As in many other emerging markets with high inflation, Iranian companies have had to attract capital by paying significant dividends. This has put stocks on high yields which typically vary between 10% and 30%. Foreign investors therefore have a very substantial cushion against currency depreciation which at worst we expect to be 50% over the next five years. Our central case sees the rial fluctuating between 7,000 and 10,000 to the US Dollar. This implies a depreciation of around 20% and an upside of 15%.

Largest regional market after Turkey ... and less dependent on oil

Low market capitalisation makes this region the most susceptible to the arrival of foreign interest. Apart from Turkey, Iran is the largest economy in the region and less dependent on oil than most. It has probably the best prospects for making its industrial base competitive and profitable. In that respect it has much in common with India a decade ago, just prior to the reform agenda of Finance Minister Manmohan Singh or with Poland five years ago just before privatisation took off.

**Top 20 Companies by Market Capitalisation**

| **Company** | **Sector** | **Market Cap (Rls bn)** | **($ mn)** |
|---|---|---|---|
| **1. Sarmayegozari Bank Melli Iran** (Bank Melli Iran Investment Company) | Investment | 1,966.5 | 351.2 |
| **2. Iran Khodro** | Auto | 1,723.3 | 307.7 |
| **3. Sarmayegozari Ghadir** (Ghadir Investment Company) | Investment | 1,077.3 | 192.4 |
| **4. Toseye Sanayeh Behshahr** (Behshahr Industries Development) | Investment | 955.6 | 170.6 |
| **5. Saipa** | Auto | 929.5 | 166.0 |
| **6. Pars Electric** | Household Appliances | 612.2 | 109.3 |
| **7. Sarmayegozari Melli Iran** (Melli Iran Investment Company) | Investment | 584.1 | 104.3 |
| **8. Teraktorsazi Iran** (Iran Tractor Builders) | Machinery & Equipment | 562.5 | 100.4 |
| **9. Polyacrill** | Chemical & By-Products | 513.2 | 91.6 |
| **10. Siman Pars va Koozestan** (Pars and Koozestan Cement Company) | Non-Metallic/Minerals | 412.2 | 73.6 |
| **11.Sana'ati Behshahr** (Behshahr Industrial Company) | Food & Beverage | 407.0 | 72.7 |
| **12. Lavazem Khanegi Pars** (Pars and Household Durables Company) | Machinery & Equipment | 355.3 | 63.4 |
| **13. Sana'ati Khavar** (Khavar Industrial Company) | Auto | 328.1 | 58.6 |
| **14. Sarmayegozari Sepah** (Sepah Investment Company) | Investment | 294.5 | 52.6 |
| **15. Iran Vanet** (Iran Van Company) | Auto | 288.6 | 51.5 |
| **16. Samayegozari Alborz** (Alborz Investment Company) | Investment | 284.5 | 50.8 |
| **17. Siman Tehran** (Tehran Cement) | Non-Metallic/Minerals | 555.0 | 67.7 |
| **18. Sarmayegozari Rena** (Rena Investment Company) | Investment | 282.0 | 50.4 |
| **19. Margarine** | Food & Beverage | 265.0 | 47.3 |
| **20. Paksan** | Chemical & By-Products | 249.2 | 44.5 |

Preparing for the day

Although liquidity may be poor, once Iran's market is deemed sufficiently open to be included in the IFC's investables index, it will make considerable impact. Even after deducting state holdings from market capitalisation, it has enough large companies to qualify for institutional investment. It is hard to predict when that will be. But investors with foresight need prepare for the day.

Some allege that the domination of trading by a few investment companies can result in market manipulation. The amount of corporate information supplied to the investing public is limited. However, as most companies are connected to the state, which is paternalist by instinct, in some way there is also commitment to ensuring that the rights of minorities are to some extent protected.

Free float of many listed stocks is small

The free float of many listed stocks is very small. The absorptive capacity of private investors is small relative to the number of state companies that are being listed. For example when Arak Petrochemical, whose major shareholders are National Petrochemical Co. and Bank Melli Iran Investment Co. was listed last year, only 2% was offered to the public. However, it is evidently better than not to list at all. And at least investors have a large choice of diverse stocks, and can choose between operating companies and holding and investment companies.

The TSE has been a member of the International Federation of Stock Exchanges since 1992. Commissions are 0.5% for either side plus a 0.25% service charge. Settlement is T+5. There is a daily price movement limit for individual stocks of 5%. Short selling is prohibited.

Exchange produces a monthly report

The Exchange produces a monthly report in English and has a website (www.tse.or.ir) from which trading and price data can be obtained. Pricing of new listings is controlled by a Price Evaluation Committee which aims to ensure fair pricing of IPOs and trading and company reporting are subject to surveillance by the Supervision department.

The TSE registers all share transactions but listed companies are responsible for their own share registers.

The TSE also trades Exchange Settlement Certificates, rights granted to exporters to exchange foreign currency at a semi free market rate, and Participation Certificates, which are issued by the government and municipalities and are in effect bonds which conform to Islamic rules.

Companies

# Dominant

### Iran Khodro

Iran's Largest Auto Maker

### Arak Petrochemical

Leader in a Key Sector

### Toseye Sanayeh Behshahr (TSB)

51% of Iran's Edible Oil Market

### Pars Home Appliances

Untapped White Goods Demand, Exporting, Expanding Capacity 70%

# Emerging Growth

### Borojerd

A Winner in the Losing Textile Sector

### Ghazvin Glass

Largest Sheet Glass Maker, Adding Value Downstream

### Sanati Pars

Carbon Black Maker Doubling Capacity for Export

### Dashte Morghab

Strong Brand, 25% of Processed Fruit and Vegetable Market

# Iran Khodro

**Share price: Rls 4,130**

**Iran Khodro is Iran's largest listed company and has a dominant share of the rapidly growing car industry. It is intended by the Iranian government to be one of two or three companies around which the whole industry will be consolidated. There is therefore a clear indication to limit competition for the foreseeable future.**

- Iran has only 3 mn cars for a population of 62 mn. Demand is conservatively estimated at twice production of 250,000 cars per year. Iran Khodro is increasing its capacity to 250,000 for next year, with a target of 1 mn units in 6-7 years.
- Exports are currently limited by the strength of domestic demand, but there is significant scope for increased exports of finished vehicles to nearby countries and of components to Peugeot, with which Iran Khodro has a long-standing relationship.
- Iran Khodro manufactures the most popular car in Iran, the Paykan, a locally produced version of the British Hillman Hunter. It is also producing increasing quantities of the Peugeot 504 and will start production next year of the smaller Peugeot 206, as well as a newly designed, 100% locally sourced, "National Car".
- Still emerging from the state sector, Iran Khodro faces challenges to boost efficiency, manage a dramatic increase in production capacity and the introduction of a number of new models, and compete effectively against other domestic companies tying up with major international auto manufacturers. The strength of domestic demand should provide some leeway, however, and we do not expect barriers to direct competition by international companies to be lowered soon.
- Earnings growth this year will be limited by resistance to higher prices and the impact of inflation on margins, but the substantial boost to volume of output from next year, and economic recovery, should allow for growth to resume from 2000/1.

| Year | 1997/8 | 1998/9 | 1999/2000E | 2000/1E |
|---|---|---|---|---|
| Net Profit (Rls bn) | 474.6 | 429.4 | 427.0 | 541.5 |
| EPS (Rls) | 694 | 628 | 624 | 792 |
| *% EPS growth* | *46.5* | *-9.5* | *-0.6* | *26.8* |
| DPS (Rls) | 500 | 500 | 500 | 500 |
| NTA (Rls) | 929 | 1,537 | 2,161 | 2,953 |
| Price/Book (x) | 4.4 | 2.7 | 1.9 | 1.4 |
| PER (x) | 6.0 | 6.6 | 6.6 | 5.2 |
| % Yield | 12.1 | 12.1 | 12.1 | 12.1 |
| | | | | |
| Shares in Issue (mn) | 684.0 | | | |
| Market Cap. (Rls bn) | 2,824.9 | | | |
| Market Cap. ($ mn) | 346.0 | | | |

# Industry and Company Background

The auto industry in Iran dates to 1967 and the establishment of Iran National to assemble the British-designed Hillman Hunter for sale under the *Paykan* ("Arrow") name. Thirty-three years on, the *Paykan* is not only still in production, but remains the most popular car in Iran, with about 42% of the passenger car market.

Following the Iranian revolution all car manufacturers were nationalised, and Iran National was re-named Iran Khodro ("Khodro" means "Vehicle" in Farsi). The company is now returning to the private sector; it was listed on the Tehran Stock Exchange in 1992 and the government's stake is down to 56%.

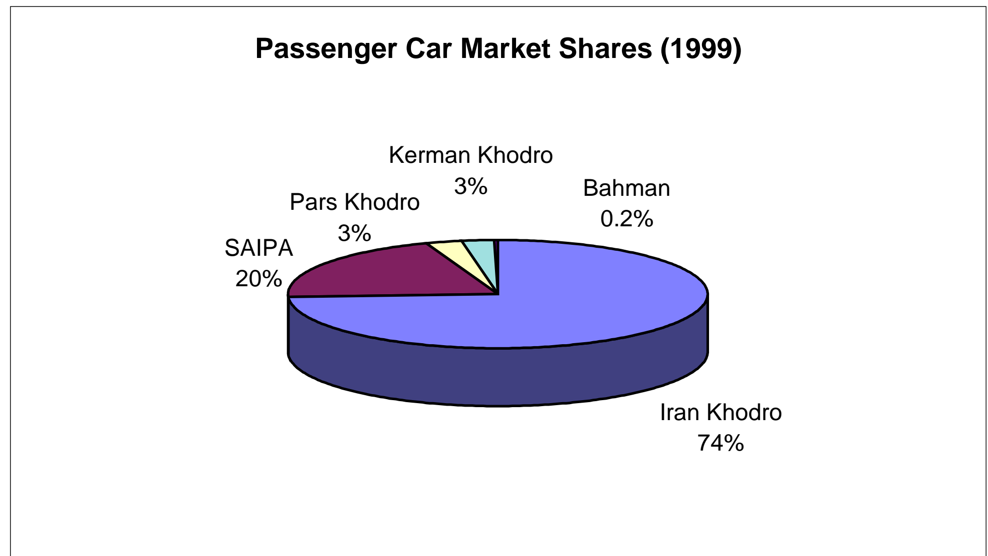
The auto industry is perceived as a highly strategic one in Iran, and it remains highly protected. The import of vehicles is restricted (except for some specialised types not manufactured domestically), although parts for assembly can be brought in. Foreign manufacturers are therefore tying up with Iranian manufacturers. While domestic competition seems bound to increase we do not expect the rules on imported vehicles to be relaxed sufficiently for them to affect the domestic market in the foreseeable future.

At present the US auto manufacturers are not active in Iran, but several major European and Asian ones are. They currently participate through licensing their designs for production by domestic companies, although both Volkswagen and Fiat are reported to have been discussing taking equity stakes in Pars Khodro.

Iran Khodro manufacturers Peugeot cars and Mercedes-Benz and Hyundai Trucks. Saipa has licences from Kia Motors of Korea, Pars Khodro from Nissan and Renault and Bahman from Mazda.

As the chart illustrates, Iran Khodro maintains a dominant position in the car market, being over three times the size of its next largest competitor, SAIPA.

This dominance is repeated in most other segments of the Iranian auto market, with the exception only of the currently insignificant four-wheel drive business, where it is not yet competing.




| Market Segments | Iran Khodro (%) | Segment's Share of Market (%) |
|---|---|---|
| Passenger cars | 74 | 73.1 |
| Pick-up trucks | 46 | 22.2 |
| Mini-buses | 100 | 1.1 |
| Buses | 94 | 0.4 |
| Trucks | 61 | 1.4 |
| Four-wheel drive | 0 | 1.7 |

#includes Iran Khodro Diesel

There is massive excess demand for cars in Iran. Manufacturers can sell their output two years or so ahead of production: in 1998/9 Iran Khodro sold 249,444 vehicles, but delivered only 128,438. Total production capacity in Iran is currently only about 250,000, while the government estimates demand at 500,000 vehicles annually. In fact we believe that demand would be significantly higher than that if the cars were available. Pre-sales are running close to 500,000 even though delivery is two years or more away. (A new *Paykan* can be immediately sold on the black market at a premium of about 25%.) There are only about three million vehicles in Iran, or one per 20 people.

The government has a policy to consolidate the auto manufacturing industry in Iran under two companies: Iran Khodro and Saipa. (The recent flotation of Pars Khodro and discussions with foreign manufacturers about taking a substantial stake suggest that it may be permitted to become a third force.) As part of this policy, in 1999, Iran Khodro acquired 67% of bus and truck manufacturer Khavar Industrial for Rls230 bn, a historic PER of only about 4x. Khavar, which is also listed on the Tehran Stock Exchange, was renamed Iran Khodro Diesel.

## Longer –Term Challenges

The car manufacturing industry in Iran faces a number of challenges in the longer term:

- Managing growth;
- Strengthening management, following years in the public sector;
- Financing expansion as pre-sales are eliminated with increased production;
- Increased competition as production capacity approaches demand;
- Boosting efficiency levels, which significantly lag global best practice;

Many of these issues are still several years away, but all must eventually be addressed by all car companies in the country, including Iran Khodro.

## Production and Sales

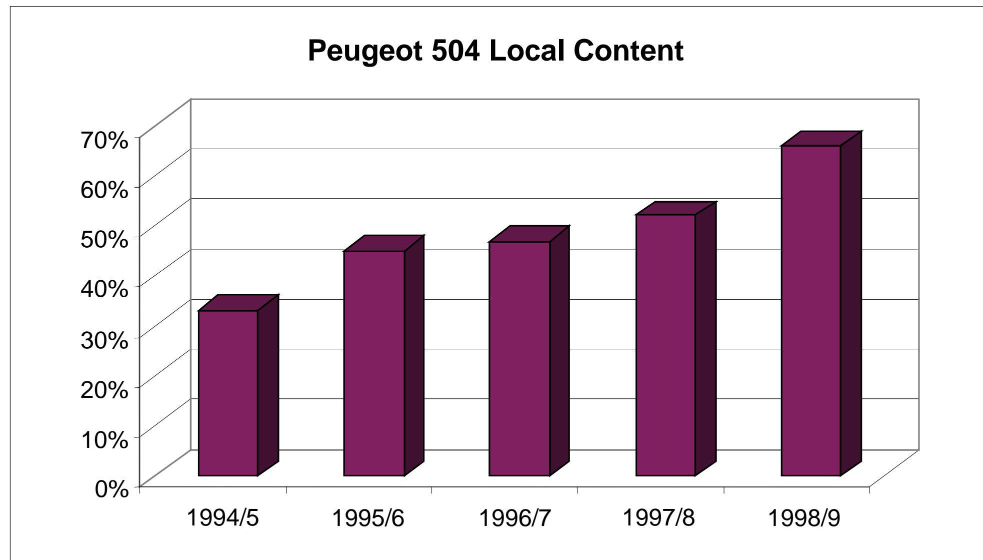
Total production for 1999/2000 will be about 150,000 vehicles (up from 128,000 the previous year); the target for 2000/1 is for a further 52% increase to 228,000. As the chart below illustrates the *Paykan* still dominates sales, remaining by a massive margin the most popular car in Iran.

The reason for the *Paykan's* popularity is its very age. It is a proven design, with no electronics requiring slow and expensive repairs. Spare parts are available throughout the country and any mechanic can carry out maintenance and repair work. It is therefore in many ways an ideal car for Iran, and available in both saloon and pick-up truck versions. A new version of the car that became available from 1998 is the Peugeot RD, which puts a Peugeot body on a *Paykan* chassis and engine. This updates the look and allows for some more modern features without losing the mechanical advantages of the *Paykan*.

Local content for the *Paykan* is over 90%, and continues to increase. At present, for example, there is no manufacture of vehicle glass in Iran. By 2002, however, Ghazvin Glass Co. will be producing it domestically and Iran Khodro has signed a letter of intent to buy 100,000 sets per year.

Iran Khodro has designed a “National Car” (although it will not be sold under that name) with close to 100% local content, which will start production next year, with 5,590 units expected to be produced. Eventual capacity is set at 100,000.

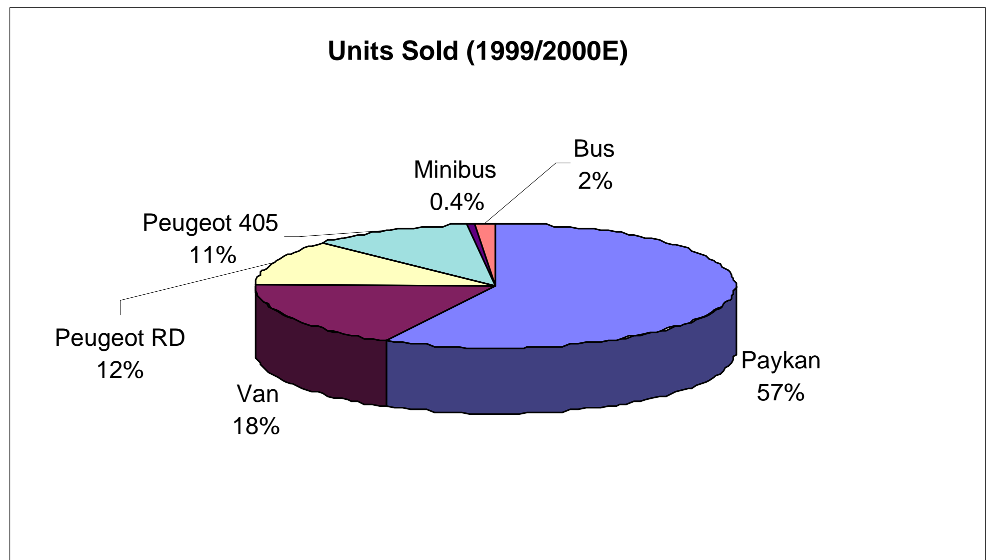
Iran Khodro manufactured a total of about 90,000 Peugeot 405s under a 10-year agreement signed in 1988, renewed in 1998 for a further 10 years. That agreement also included plans to start manufacturing Peugeot 205s in Iran. Iran Khodro has since decided to replace them with Peugeot 206s. The deal with Peugeot targets a September 2001 start date for Peugeot 206 production; with the aim that capacity will eventually reach 120,000 units per year. At present Iran Khodro believes that it is on schedule to start production in January 2001, and expects to start pre-sales in the summer this year. Local content for the 206 will be 70% initially, similar to the 405.




Iran Khodro also manufactures a small number of buses and trucks under licence from Hyundai. All this production will be transferred to subsidiary Iran Khodro Diesel from next year, however.

By the end of March 2001 the company will have production capacity for about 250,000 units per year. This is likely to be the achievable limit for its current factory in Tehran. It is therefore planning a new factory in the city of Ghazvin to accommodate further capacity expansion. The company's 10-year growth plan is for capacity to reach 1 mn vehicles per year in six to seven years time. Implementation will clearly depend on renewed economic growth, the company maintaining its dominance of the local market, and moves to further exploit export markets.

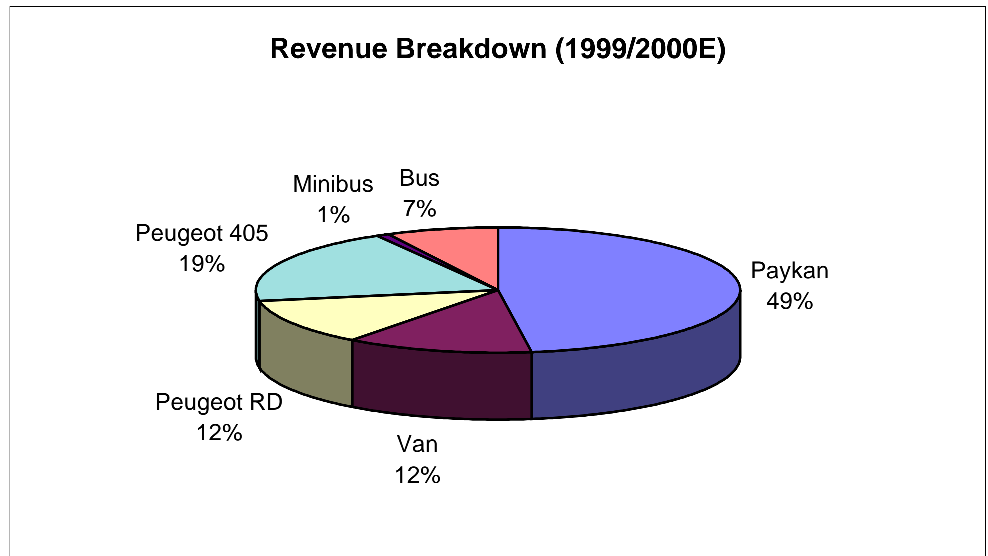
At present the company has limited exports, in view of the strength of domestic demand. In 1999/2000 it expects to have exported about US$40 mn of spare parts (to Peugeot in France) and buses and mini-buses (to regional markets). The company is talking to Peugeot about exporting engines to France, but has reached no agreement yet.




**Production**

| Year | 1997/8 | 1998/9 | 1999/2000E | 2000/1E |
|---|---|---|---|---|
| Paykan | 90,005 | 90,133 | 86,581 | 103,800 |
| Pick-up truck | 11,075 | 19,368 | 26,425 | 25,950 |
| Peugeot RD | 0 | 521 | 17,995 | 41,520 |
| Peugeot 405 | 8,832 | 16,238 | 16,413 | 48,167 |
| Peugeot 205 | 257 | 10 | 0 | 0 |
| Peugeot 206 | 0 | 0 | 0 | 3,928 |
| Minibus | 76 | 197 | 594 | 0 |
| Bus | 390 | 1,971 | 2,285 | 0 |
| National Car | 0 | 0 | 0 | 5,590 |
| **Total** | **110,635** | **128,438** | **150,292** | **228,955** |

The chart shows that while the *Paykan* is also the largest contributor to the company's revenues, it contributes less at this level than to unit sales since it sells for about half the price of the Peugeot 504.




The slow Iranian economy has limited the company's ability to raise prices recently (contributing to the tighter margins). Since we expect a significant economic recovery during the next 2-3 years, this should become less of an issue. We have assumed a 10% increase for the Peugeot 504 in 1379 and a 5% increase for the Paykan. Since inflation is running in excess of 20% there is clear potential for these numbers to move up. Also effective prices should increase as the pre-sale period falls. At present cars are pre-sold two years or more ahead of delivery.

Pre-sales have provided much of the finance for production, since buyers pay 75% cash in advance.

## Expenses and Profitability

Gross margins have fallen, and are expected to be 14% this year, compared with 20% two years ago. This is because of the increased sales of Peugeot cars, where margins are currently about 12%, compared to about 19% for the Paykan, and also because of the impact of increasing costs as a result of inflation and the weak currency.

We assume that margins will slip again next year, because although there are indications of economic recovery the increased proportion of non-Paykan cars and costs of expansion are likely to maintain pressure. There is scope for positive surprises here, though.

**Profit and Loss Account (Rls bn)**

| Year | 1994/5 | 1995/6 | 1996/7 | 1997/8 | 1998/9 | 1999/2000E | 2000/1E |
|---|---|---|---|---|---|---|---|
| Gross Revenues | 690.6 | 1,440.6 | 2,290.6 | 3,446.6 | 4,662.3 | 5,689.9 | 9,854.4 |
| COS | (504.0) | (987.4) | (1,757.5) | (2,758.3) | (3,907.1) | (4,922.0) | (8,781.8) |
| **Gross Profit** | **186.5** | **453.2** | **533.1** | **688.2** | **755.2** | **767.9** | **1,072.6** |
| Sales and Distribution Costs | (11.5) | (41.2) | (37.7) | (47.7) | (85.4) | (104.2) | (198.4) |
| Admin Expenses | (27.3) | (18.3) | (30.5) | (45.8) | (53.5) | (63.2) | (78.9) |
| Other Operating Expenses | (38.8) | (59.4) | (68.2) | (93.4) | (138.9) | (167.3) | (277.4) |
| Operating Income/(Loss) | 147.7 | 393.8 | 465.0 | 594.8 | 616.4 | 600.6 | 795.2 |
| Net Interest Expense | (76.8) | (87.8) | (76.9) | (70.6) | (98.8) | (105.1) | (117.5) |
| Bad Debts | 0 | (5.0) | (0.1) | 0 | 0 | 0 | 0 |
| Others – Net | (23.1) | (6.0) | 202.0 | 123.2 | 180.8 | 198.9 | 202.9 |
| Other Income/(Charges) | (99.9) | (98.7) | 125.0 | 52.6 | 82.0 | 93.8 | 85.4 |
| Income/(Loss) Before Tax | 47.8 | 295.1 | 590.0 | 647.4 | 698.3 | 694.4 | 880.6 |
| Tax | (17.3) | (122.4) | (268.4) | (172.8) | (268.9) | (267.4) | (339.1) |
| Net Income/(Loss) | 30.5 | 172.6 | 321.6 | 474.6 | 429.4 | 427.0 | 541.5 |
| *% Change* | | *466.2* | *86.3* | *47.6* | *-9.5* | *-0.6* | *26.8* |
| EPS (Rls) | 47 | 269 | 474 | 694 | 628 | 624 | 792 |
| *% Change* | | *466.2* | *76.3* | *46.5* | *-9.5* | *-0.6* | *26.8* |
| EBITDA (Rls bn) | 129.2 | 388.4 | 675.3 | 739.9 | 831.4 | 906.8 | 1,221.6 |
| *% Change* | *N/A* | *200.6* | *73.9* | *9.6%* | *12.4* | *9.1* | *34.7* |
| EBIT (Rls bn) | 124.5 | 382.9 | 666.8 | 718.0 | 797.2 | 799.5 | 998.1 |
| *% Change* | *N/A* | *207.4* | *74.2* | *7.7* | *11.0* | *0.3* | *24.8* |
| % Gross Margin | 27.0 | 31.5 | 23.3 | 20.0 | 16.2 | 13.5 | 10.9 |
| % Operating Margin | 21.4 | 27.3 | 20.3 | 17.3 | 13.2 | 10.6 | 8.1 |
| % Net Margin | 4.4 | 12.0 | 14.0 | 13.8 | 9.2 | 7.5 | 5.5 |
| % Effective Tax Rate | 36.2 | 41.5 | 45.5 | 26.7 | 38.5 | 38.5 | 38.5 |

## Financial Position

The company had a debt/equity ratio at the end of 1998/9 of about 72%. We expect from 1991/2 onwards that the company's working capital position will deteriorate as it becomes unable to book so many pre-sales. The debt position should nevertheless remain manageable because of the likely recovery in profit growth.

**Cash Flow (Rls bn)**

| Year | 1998/9 | 1999/2000E | 2000/1E |
|---|---|---|---|
| Profit Before Tax | 698.3 | 694.4 | 880.6 |
| Depreciation | 34.2 | 107.4 | 223.5 |
| Tax Paid | (172.8) | (268.9) | (267.4) |
| Capital Expenditure | (599.3) | (696.0) | (800.0) |
| Investments | (644.0) | 0 | 0 |
| Change in Working Capital | 1,397.8 | 313.8 | (152.5) |
| Dividends Paid | (342.0) | (342.0) | (342.0) |
| Other | (506.7) | 0 | 0 |
| Change in Net Debt | (134.4) | (191.4) | (457.9) |
| Net (Debt)/Cash b/f | (2,519.6) | (2,654.0) | (2,845.4) |
| Net (Debt)/Cash c/f | (2,654.0) | (2,845.4) | (3,303.2) |

**Balance Sheet (Rls trin)**

| Year | 1994/5 | 1995/6 | 1996/7 | 1997/8 | 1998/9 |
|---|---|---|---|---|---|
| **Fixed Assets** | | | | | |
| Land | 0.4 | 4.6 | 4.6 | 8.2 | 8.9 |
| Buildings | 11.9 | 15.9 | 41.8 | 68.2 | 94.8 |
| Installation | 4.0 | 8.6 | 16.1 | 36.0 | 51.9 |
| Machinery & Equipment | 6.9 | 10.6 | 30.8 | 56.5 | 97.0 |
| Tools & Fixtures | 5.6 | 9.3 | 41.2 | 46.1 | 58.7 |
| Vehicles | 3.3 | 2.9 | 4.1 | 5.4 | 6.2 |
| In Transit | 13.8 | 11.5 | 29.7 | 40.7 | 30.8 |
| Under Construction | 34.3 | 133.5 | 187.6 | 386.9 | 864.9 |
| Total Fixed Assets | 80.2 | 197.0 | 355.9 | 648.0 | 1,213.1 |
| | | | | | |
| Investments at Equity | 22.2 | 76.4 | 168.3 | 366.0 | 700.2 |
| Other Investments | 0 | 0 | 302.2 | 548.7 | 858.4 |
| | | | | | |
| **Current Assets** | | | | | |
| Cash & Bank Balances | 79.4 | 59.0 | 213.4 | 24.4 | 296.7 |
| Short Term Investments | 2.2 | 29.2 | 71.7 | 34.0 | 15.8 |
| Accounts Receivable etc | 195.4 | 583.4 | 525.3 | 485.0 | 632.6 |
| Stocks | 995.5 | 1,307.1 | 2,116.7 | 4,369.9 | 3,487.7 |
| Other Current Assets | 134.5 | 504.2 | 827.9 | 1,027.4 | 1,930.7 |
| Total Current Assets | 1,407.0 | 2,482.9 | 3,755.0 | 5,940.7 | 6,363.4 |
| | | | | | |
| **Current Liabilities** | | | | | |
| Short Term Loans | (399.4) | (477.8) | (430.5) | (491.1) | (323.1) |
| Accounts Payable | (215.1) | (4.6) | (9.9) | (22.0) | (113.2) |
| Other Accounts & Notes Payable | (158.3) | (247.7) | (269.9) | (463.6) | (298.3) |
| Accruals | (652.1) | (1,754.2) | (2,165.8) | (3,795.8) | (4,532.9) |
| Total Current Liabilities | (1,425.0) | (2,484.4) | (2,876.1) | (4,772.5) | (5,267.6) |
| | | | | | |
| Other Assets | 23.8 | 24.3 | 24.6 | 49.5 | 139.6 |
| | | | | | |
| **Total Assets** | **108.3** | **296.2** | **1,729.9** | **2,780.4** | **4,007.1** |
| | | | | | |
| Issued Share Capital | 57.0 | 57.0 | 342.0 | 342.0 | 342.0 |
| Reserves | 26.5 | 204.3 | 343.6 | 293.1 | 709.3 |
| Shareholders' Funds | 83.4 | 261.3 | 685.6 | 635.1 | 1,051.3 |
| | | | | | |
| Long Term Debt | 24.8 | 34.9 | 1,044.3 | 2,145.3 | 2,955.9 |
| **Capital Employed** | **108.3** | **296.2** | **1,729.9** | **2,780.4** | **4,007.5** |
| | | | | | |
| **Liquidity Ratios** | | | | | |
| Current Ratio | 1.0 | 1.0 | 1.3 | 1.2 | 1.2 |
| Quick Ratio | 0.3 | 0.5 | 0.6 | 0.3 | 0.5 |
| | | | | | |
| **Gearing Ratios** | | | | | |
| % Net Debt/Equity | 313 | 129 | 132 | 397 | 252 |
| % Net Debt/Capital Employed | 76 | 56 | 57 | 80 | 72 |

**Major Shareholders (%)**

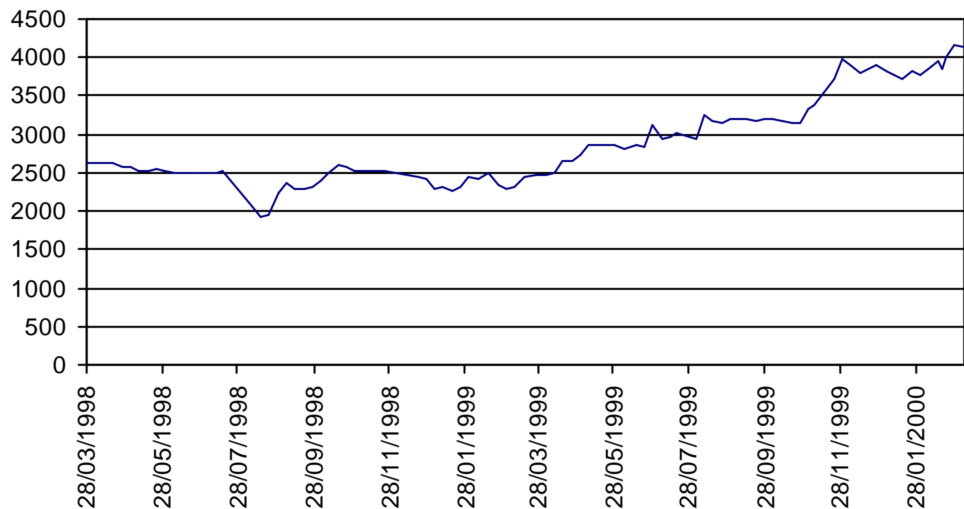
| | |
|---|---|
| Sazman Gostaresh va Nousazi Sanayeh Iran | 56.8 |

(Note: Iranian law does not yet require disclosure of substantial shareholders, so this list may not be complete).

**Capital History (mn shares)**

| Date | Capital Change | New Shares | Balance | Adj. Factor |
|---|---|---|---|---|
| B/f 1995 | | | 57.0 | |
| 5-May-96 | 2:1 rights @ Rls 1,000 | 114.0 | 171.0 | 0.355 |
| 22-Oct-96 | 1:1 bonus | 171.0 | 342.0 | 0.5 |
| Nov-99 | 1:1 bonus | 342.0 | 684.0 | 0.5 |

**Iran Khodro Share Price**



# Mojtameh Petroshimi Arak

## (Arak Petrochemical Company)

**Share price: Rls 4,300**

**Arak Petrochemical operates a naphtha cracking facility, producing polyethylene, ethylene glycol, polypropylene, fuel oils and a variety of other products. The second largest listed company in Iran by market capitalisation, Arak benefits from the government's view of petrochemicals as a key strategic sector for the country. In particular this means access to cheap raw materials (primarily naphtha).**

- The company is 96% owned by the National Petrochemical Corporation and Bank Melli Iran Investment Company. The immediate benefit of this is a combination of government support and protection with BMIIC's financial discipline and understanding of open markets. It does mean that the free float is currently limited, however, and further selling down by both shareholders is likely.
- The company has plans for steady expansion of its production facilities. Again being within the government stable should mean adequate access to financing and foreign exchange - although foreign exchange is no longer available at preferential rates for equipment purchase.
- Earnings will additionally benefit from this year because the company will be allowed to recognise export earnings at the market exchange rate (about US$1=Rls8,000), rather than a lower fixed rate (3,000).

| Year | 1997/8 | 1998/9 | 1999/2000E | 2000/1E |
|---|---|---|---|---|
| Net profit (Rls bn) | 136.4 | 109.4 | 427.4 | 502.7 |
| EPS (Rls) | 227 | 182 | 712 | 838 |
| *% EPS Growth* | *435.7* | *-19.8* | *290.5* | *17.6* |
| DPS (Rls) | 167 | 231 | 570 | 670 |
| NTA (Rls) | 1,104 | 1,057 | 1,199 | 1,367 |
| Price/Book (x) | 3.9 | 4.1 | 3.6 | 3.1 |
| PER (x) | 18.9 | 23.6 | 6.0 | 5.1 |
| % Yield | 3.9 | 5.4 | 13.3 | 15.6 |
| | | | | |
| Share Price | 4,300 | | | |
| Shares in Issue (mn) | 600.0 | | | |
| Market Cap. (Rls trin) | 2.6 | | | |
| Market Cap. ($ mn) | 316.0 | | | |

# Industry and Company Background

The petrochemical industry in Iran is dominated by the National Petrochemical Company (NPC), which owns 51% of Arak Petrochemical. The NPC was established in 1964 as a subsidiary of the National Iranian Oil Company (NIOC). Iran's petrochemical manufacturing facilities were badly damaged during the Iran-Iraq war (1980-88). Its rebuilding was a major part of the first two five-year plans (1989-1994 and 1994-1999) drawn up under President Rafsanjani to plot the reconstruction of the Iranian economy following the cease-fire.

The industry is clearly seen as highly strategic by the Iranian government, in particular in allowing the country to extract additional value from its oil industry by adding value downstream. While a significant amount of the industry's output is exported (about 36% in the case of Arak) the majority is still used domestically, mostly as raw material input to other industries. The current tight government control on process is therefore likely to remain in place for the foreseeable future.

Work began on the facilities that comprise Arak Petrochemical itself in 1985, with production starting in the early 1990s. Bank Melli joined the NPC as an investor in the project in 1987. At that time the venture was owned 51:49% by the NPC and Bank Melli respectively. Following the flotation of the company in 1999, 4% of Bank Melli's stake was sold to the public. The intention is that over time both institutions will sell down their interests.

Arak Petrochemical operates a naphtha cracking facility, producing polyethylene, ethylene glycol, polypropylene, fuel oils and a variety of other products.

## Production and Sales

Arak buys naphtha, its main raw material, directly from the refineries. It uses about 600,000 MT per year, 90% heavy grades, 10% light. In March 2000, it was paying US$150-190 per MT, 30-40% less than the international market price. This price is converted to rials at an exchange rate of Rls2,340:US$1, giving a further 70+% discount. In 2000 the company will pay for its naphtha at a fixed rial rate of 400,000 per MT, very close to the effective rate it currently pays.

Other raw materials are oxygen and ammonia.

The initial operation is an olefin plant, where the naphtha is cracked in a thermal process, producing ethylene, propylene and a mixture of C4 products, as well as pyrolysis gasoline. Further processing leads to the output of the final products shown in the table below.

Total saleable output in 1998/9 was about 465,000 MT, with utilisation over 90%. For the current year (1999/2000) we expect saleable output to reach or slightly exceed nominal capacity.

Expansion plans for 2000/1 are for the start of ethanol amine production, and expansion of capacity for low density polyethylene by about 40%, although this last will be by enhancements to the existing equipment, rather than buying new plant. We expect to see higher effective capacity for a number of the other products as a result of efficiency improvements, rather than substantial capex.

Two major expansion plans are also in planning. The first would double the capacity of the olefin plant at a cost of US$60 mn for imported equipment and Rls150 bn in local spending. Associated with this would be substantial expansion of the plants for high density polyethylene (an extra 30% capacity, costing about US$20 mn and Rls50 bn) and 2-ethylhexanol (to 80,000 MT per year, at a cost of US$20 mn and Rls100-150 bn).

The second project will add a new ethylene oxide plant with annual capacity of 110,000 MT per year (duplicating the existing facility) and substantially increasing output of ethylene glycol and ethanol amines.

Implementation of the new schemes will take two to two-and-a-half years.

| **Product** | **Capacity (MT/year)** | |
|---|---|---|
| | **1999/2000E** | **2000/1E** |
| Polypropylene (PP) | 50,000 | 50,000 |
| High and low density polyethylene | 112,000 | 136,000 |
| Vinyl acetate (VA) | 30,000 | 30,000 |
| 2-ethylhexanol (2-EH) | 50,000 | 50,000 |
| Acetic acid (AA) | 30,000 | 30,000 |
| Ethanol amines | 0 | 30,000 |
| Ethylene glycol (EG) | 100,000 | 100,000 |
| Others | 145,000 | 145,000 |
| - Butene-1 | | |
| - Polybutadiene (PBR) | | |
| - Butadiene | | |
| - C5, C6, C7+ | | |
| - Butanols | | |
| - Ethylene Oxide | | |
| **Total** | **517,000** | **571,000** |

In 1994/5, 32% of output was exported. This has increased to 36%. In the past the company was only able to book export earnings at an exchange rate of Rls3,000:US$1. With effect from 1999/2000, however, earnings will be booked at the TSE ("free" market rate) - currently about 8,000. We estimate that this will add about Rls360 bn to pre-tax earnings this year, turning what would have been an earnings decline (because of higher raw material and labour costs) into a substantial profit rise.

## Expenses and Profitability

The chart on the next page gives a breakdown of expenses for 1998/9, with raw materials the largest single item despite the preferential price the company pays for its naphtha. Despite the subsidy, this is affected by world oil prices and the effect on margins this year would have been to cut the company's profits, had it not been able to change the basis for booking export revenues, as noted above.

**Profit and Loss Account (Rls bn)**

| Year | 1997/8 | 1998/9 | 1999/2000E | 2000/1E |
|---|---|---|---|---|
| Gross Revenues | 920.3 | 905.4 | 1,650.0 | 1,900.0 |
| COS | (524.3) | (553.2) | (898.0) | (1,008.5) |
| Gross Profit | 396.0 | 352.3 | 752.0 | 891.5 |
| Operating Expenses | (82.5) | (91.1) | (100.2) | (110.2) |
| Operating Income/(Loss) | 313.5 | 261.2 | 651.8 | 781.3 |
| Net Interest Expense | (143.1) | (98.1) | (78.8) | (43.4) |
| Others - Net | 28.4 | (3.5) | 50.0 | (5.0) |
| Income/(Loss) Before Tax | 198.8 | 159.6 | 623.0 | 732.9 |
| Tax | (62.5) | (50.1) | (195.7) | (230.2) |
| Net Income/(Loss) | 136.4 | 109.4 | 427.4 | 502.7 |
| | | | | |
| EPS (Rls) | 227 | 182 | 712 | 838 |
| *% Change* | *435.7* | *-19.8* | *290.5* | *17.6* |
| | | | | |
| EBITDA (Rls bn) | 525.9 | 441.4 | 908.9 | 996.5 |
| *% Change* | *N/A* | *-16.1* | *105.9* | *9.6* |
| | | | | |
| EBIT (Rls bn) | 341.9 | 257.7 | 701.8 | 776.3 |
| *% Change* | *N/A* | *-24.6* | *172.4* | *10.6* |
| | | | | |
| DPS (Rls) | 167 | 231 | 570 | 670 |
| *% Change* | *-60.7* | *38.5* | *146.7* | *17.6* |
| % Payout Ratio | 73 | 127 | 80 | 80 |
| | | | | |
| % Gross Margin | 43.0 | 38.9 | 45.6 | 46.9 |
| % Operating Margin | 34.1 | 28.8 | 39.5 | 41.1 |
| % Net Margin | 14.8 | 12.1 | 25.9 | 26.5 |
| % Effective Tax Rate | 31.4 | 31.4 | 31.4 | 31.4 |

**Cash Flow (Rls bn)**

| Year | 1998/9 | 1999/2000E | 2000/1E |
|---|---|---|---|
| Pre-Tax Profit | 159.6 | 623.3 | 732.9 |
| Depreciation | 183.8 | 207.1 | 220.1 |
| Tax Paid | (122.8) | (49.8) | (195.7) |
| Capital Expenditure | (138.4) | (300.0) | (350.0) |
| Change in Working Capital | 158.6 | (26.1) | (8.8) |
| Dividends Paid | (100.1) | (138.6) | (341.9) |
| Other | 133.9 | 0 | 0 |
| Change in Net Debt | 274.5 | 315.7 | 56.7 |
| Net (Debt)/Cash b/f | (846.8) | (572.3) | (256.7) |
| Net (Debt)/Cash c/f | (572.3) | (256.7) | (199.9) |

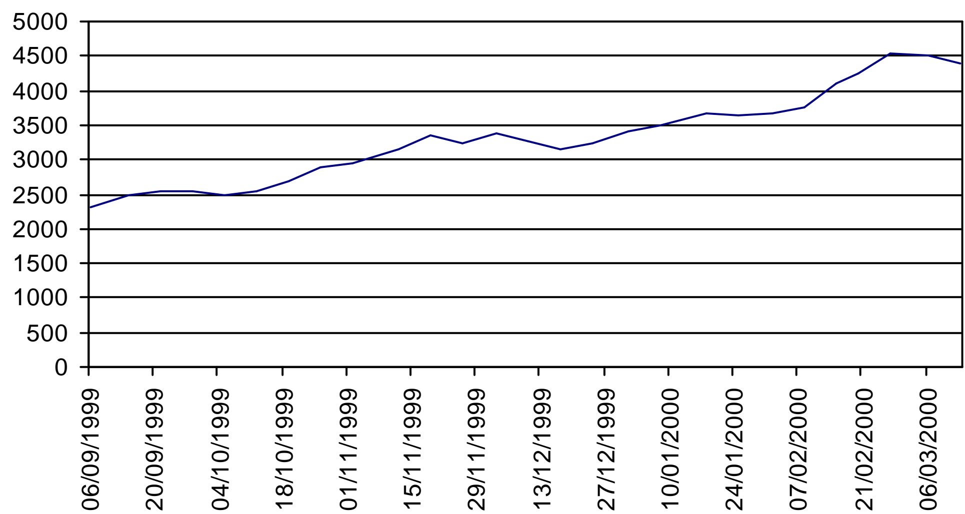
**Balance Sheet (Rls bn)**

| Year | 1997/8 | 1998/9 |
|---|---|---|
| Fixed Assets | | |
| Net Fixed Assets | 1,489.8 | 1,341.2 |
| Projects Under Construction | 98.0 | 138.4 |
| Total Fixed Assets | 1,587.7 | 1,479.7 |
| Investments | 0.1 | 0.2 |
| **Current Assets** | | |
| Cash & Bank Balances | 10.7 | 10.3 |
| Receivable from Subsidiary | 63.9 | 122.7 |
| Accounts Receivable | 16.7 | 29.6 |
| Stocks | 223.3 | 222.4 |
| Payments & Advances | 18.0 | 20.0 |
| Total Current Assets | 332.5 | 405.0 |
| **Current Liabilities** | | |
| Foreign Loans | (229.0) | (227.5) |
| Bank Melli Loans | (156.7) | (204.1) |
| Customer Accounts | (18.1) | (63.7) |
| Accounts Payable | (49.5) | (176.5) |
| Taxation | (122.5) | (49.8) |
| Payable to Subsidiary | (28.8) | (38.9) |
| Payables and Dividends | (40.1) | (138.6) |
| Total Current Liabilities | (644.6) | (899.2) |
| Other Assets | 33.3 | 43.7 |
| **Total Assets** | **1,309.0** | **1,029.3** |
| Issued Share Capital | 600.0 | 600.0 |
| Reserves | 62.3 | 34.0 |
| Shareholders' Funds | 662.3 | 634.0 |
| Foreign Loans | 376.2 | 168.8 |
| Bank Melli Loans | 204.4 | 198.3 |
| Credit from Central Bank | 0.8 | 0.8 |
| Total Long Term Debt | 581.4 | 367.8 |
| Other Liabilities | 65.3 | 27.5 |
| **Shareholders Funds and L-T Liabilities** | **1,309.0** | **1,029.3** |
| **Liquidity Ratios** | | |
| Current Ratio | 0.5 | 0.5 |
| Quick Ratio | 0.2 | 0.2 |
| **Gearing Ratios** | | |
| % Net Debt/Equity | 128 | 90 |
| % Net Debt/Capital Employed | 56 | 47 |

**Major shareholders (%)**

| | |
|---|---|
| National Petrochemical Co. | 51 |
| Bank Melli Iran Investment Co. | 45 |

**Mojtameh Petroshimi Arak Share Price**



# Sherkate Toseye Sanayeh Behshahr

## (Behshahr Industrial Development Company)

**Share price: Rls 3,877**

**Toseye Sanayeh Behshahr (TSB) is a substantial industrial holding company, currently the fifth largest company on the Tehran Stock Exchange (TSE) by market capitalisation. It concentrates primarily on the manufacture of staple foodstuffs, with 60% of profits coming from its edible oil businesses and a further 20% from sugar.**

- The group's core edible oil business comprises three of the four top companies in the sector in Iran, with a combined market share of 51%. The company's brands are strong domestically, positioning it well as the free (non-allocated) portion of the market expands.
- The company maintains strong financial discipline, with effectively no debt. Operating companies have debt, but financial risk is not compounded by adding debt at the holding company level.
- The company has a well-established procedure of acquiring a substantial stake in companies (frequently from government entities as part of the privatisation process), listing them on the TSE (retaining at least 51%) and using the proceeds for further acquisitions. With privatisation likely to accelerate following the recent elections the group should continue to be able to identify attractive acquisition candidates.
- We estimate that the company is trading at a conservatively calculated discount of 14% to the underlying NAV.

| Year | 1997/8 | 1998/9 | 1999/2000E | 2000/1E |
|---|---|---|---|---|
| Net Profit (Rls bn) | 347.5 | 379.2 | 395.3 | 474.6 |
| EPS (Rls) | 1,053 | 1,149 | 1,198 | 1,438 |
| *% EPS growth* | *0.2* | *9.1* | *4.2* | *20.1* |
| DPS (Rls) | 900 | 900 | 990 | 1,089 |
| NTA (Rls) | 1,256 | 1,503 | 1,711 | 2,059 |
| Price/Book (x) | 3.1 | 2.6 | 2.3 | 1.9 |
| PER (x) | 3.7 | 3.4 | 3.2 | 2.7 |
| % Yield | 23.2 | 23.2 | 25.5 | 28.1 |
| | | | | |
| Shares in Issue (mn) | 330.1 | | | |
| Market Cap. (Rls bn) | 1,279.7 | | | |
| Market Cap. ($ mn) | 156.7 | | | |

# Company and Industry Background

TSB is a holding company for about 20 operating companies, most of which are in the food business. It was originally established about 40 years ago, but was taken over by the government following the Iranian revolution and the companies separated. Nine years ago the government re-established the group as part of its moves to promote the private sector. At that point it had eight companies. It has grown mostly by acquisition to its current size. At present it is the fifth largest company by market capitalisation listed on the TSE.

The list below gives the companies as at the end of 1999/2000.

| Name | Business | Shares Held Mn | % Held | Cost (Rls mn) | Share Price (Rls) | Value (Rls mn) |
|---|---|---|---|---|---|---|
| Santti-e Behshahr Co.# | Edible oils | 77.1 | 80.3 | 72,202 | 6,910 | 532,439 |
| Margarine Co.# | Edible oils | 48.0 | 53.3 | 61,681 | 4,100 | 196,693 |
| Pakssan Co.# | Hygene products | 46.1 | 51.3 | 46,145 | 4,800 | 221,496 |
| Basteh bandi-e Iran Co.# | Packaging | 23.3 | 51.6 | 38,912 | 2,900 | 67,605 |
| Shekar Co.# | Sugar | 9.8 | 69.7 | 36,561 | 8,000 | 78,026 |
| Ghand-e Neyshabour Co.# | Sugar | 6.5 | 54.1 | 34,139 | 6,890 | 44,695 |
| Ghand-e Hegmatan Co.# | Sugar | 2.8 | 94.5 | 33,576 | 9,459 | 26,804 |
| Sanatti-e Behpak Co.# | Soya beans | 23.5 | 78.5 | 23,536 | 4,231 | 99,584 |
| Sanatti-e Nab Co.# | Edible oils | 14.0 | 70.2 | 21,157 | 6,171 | 86,585 |
| Daru sazi-e Osveh Co.* | Pharmaceuticals | 4.0 | 66.5 | 16,481 | | 16,481 |
| Behpakhsh Co. | Distribution | 0.2 | 90.0 | 1,799 | | 1,799 |
| Khmirayeh-e Shaoud Co# | Sugar | 0.7 | 70.0 | 700 | | 700 |
| Saktemaani-e Behshar Teh Co. | | 0.5 | 90.0 | 450 | | 450 |
| Computer Co. | Systems | - | 99.7 | 300 | | 300 |
| Sanaye-e Behshahr Investment Co. | | - | 90.0 | 90 | | 90 |
| Shekufeh Bojnurd Co. | | - | 65.0 | 2 | | 2 |
| Golnas Co. | Hygene products | - | | 2 | | 2 |
| Other Investments | | | | 45,829 | | 45,829 |
| | | | | 433,562 | | 1,419,580 |
| Unrealised Profit | | | | | Rls bn. | 986.0 |

*Notes:*
*# Listed on TSE*
** Sold after year end.*

About half of the group's acquisitions come from government entities, which are under pressure to accelerate the privatisation process. The companies are sold through an auction or tender system.

The major activities of the group involve the manufacture of staple foodstuffs, with about 60% of profits coming from the edible oil business and a further 20% from sugar.

Its most recent acquisition (February 2000) is 80% of a zinc and lead company bought from the Industrial and Manufacturing Bank of Iran for Rls170 bn.

The company has a well-established procedure of acquiring a substantial stake in companies (frequently from government entities as part of the privatisation process), listing them on the TSE (retaining at least 51%) and using the proceeds for further acquisitions. With privatisation likely to accelerate following the recent elections the group should continue to be able to identify attractive acquisition candidates.

Having acquired a company, TSB looks to increase profitability by improving its efficiencies. It does not seek, however, to exploit possible synergies between group companies. Thus the various edible oil and sugar companies, which between them dominate their respective industries, compete with each other. They do not try to find economies of scale, nor have common procurement procedures. At present this is probably realistic because of the continued control of the staple food market by government. However, in the longer term we believe the approach will have to change, which will require more direct intervention in the management of the group companies by TSB management than has so far been the case.

## Edible Oil Industry

Vegetable oil is seen as a staple food in Iran, and the market has long been controlled by the government (this extends back to pre-revolution times). The government subsidises oil by providing cheap raw material to manufacturers, by paying some of the processing cost, and by giving vouchers directly to consumers allowing them to buy certain quantities from the allocated market at prices under half the free market level.

The table below gives approximate market shares (allocated market) for four major edible companies in Iran, three of which are controlled by TSB.

| Edible Oil Market Share (%) | |
|---|---|
| Bahshahr Industrial | 31 |
| Margarine Co. | 15 |
| Sanatti-e Nab | 5 |
| Roghan Nabati Pars | 11 |
| Others | 38 |

The majority of the edible oil companies' profits come from the free market, however, which is steadily increasing in size. Three years ago there was no free market (100% allocated). The free market is now about 150,000 MT per year of a total market of 900,000-1,000,000 MT. The total market should continue to grow steadily. Current average per capita consumption of edible oils is about 15 kg per year, up from 10 kg twenty years ago. Per capita consumption is growing at 3-4% per year and the company sees 25 kg as a realistic target level. This is based on typical levels in European countries of 25-30 kg. The USA is way ahead at about 35 kg per person.

The government has set a policy in its current five-year plan to keep the total amount of the subsidy constant for three years. The growth in the market should therefore all be in the free market. How far this commitment remains under the new parliament is not yet clear (parliament has a history of clashing with the government's attempts to reign in the subsidy), but it is probably safe to assume that the free market's share of the total will continue to increase.

One factor behind this will be the growth in domestic manufacture of margarine. There has been very little domestic production until now (two relatively new companies producing only about 10,000 MT per year between them). As discussed below both Margarine Company and Behshahr Industrial are now moving into this area (all of which is free market). Five other (smaller companies, none currently in the edible oils business) have plans for margarine manufacturing facilities. All the outside manufacturers will have to buy edible oils as their raw materials, much of which is likely to be from one or other of the group companies.

### Behshar Industrial Company

Behshahr Industrial, founded in 1954, is the largest edible oil company in Iran. It has about 31% of the allocated market and 35% of the free market. It has capacity of about 1,300 MT per day. Actual output at present is about 1,000 MT per day. It will therefore need limited capital expenditure to maintain market share in an expanding market.

The company has recently started producing industrial margarine for domestic sale. The government does not regulate this market. The table below gives historic and forecast earnings data, as well as output data.

| Year | 1996/7 | 1997/8 | 1998/9 | 1999/2000E | 2000/1E |
|---|---|---|---|---|---|
| Revenue (Rls bn) | 401.9 | 494.8 | 797.7 | 750.0 | 900.0 |
| Pre-Tax Profit (Rls bn) | 82.5 | 121.3 | 179.1 | 160.0 | 200.0 |
| Net Profit (Rls) | 80.3 | 121.3 | 179.1 | 160.0 | 200.0 |
| EPS. (Rls) | 836 | 1,263 | 1,866 | 1,667 | 2,083 |
| PER (x) | 8.2 | 5.4 | 3.7 | 4.1 | 3.3 |
| Output (MT) | 225,492 | 241,501 | 309,892 | 340,000 | 380,000 |

### Margarine Company

Margarine Company is the second largest in the sector in Iran, with a 15% share of the allocated market. It is in the process of a significant expansion in capacity, from the current 500 MT per day to 1,000 MT per day. As it increases its capacity the government should give it an increased share of the allocated market. The expansion will cost about US$10 mn.

The company will also start by the middle of 2000 manufacturing table margarine. This will all be sold on the free market, and the price there is currently about Rls 12,000 per kg, double the free market price for liquid vegetable oils.

| Year | 1996/7 | 1997/8 | 1998/9 | 1999/2000E | 2000/1E |
|---|---|---|---|---|---|
| Revenue (Rls bn) | 181.1 | 316.9 | 453.1 | 440.0 | 530.0 |
| Pre-Tax Profit (Rls bn) | 33.1 | 88.0 | 122.5 | 115.0 | 145.0 |
| Net Profit (Rls) | 33.1 | 88.0 | 122.5 | 115.0 | 145.0 |
| EPS. (Rls) | 552 | 1,467 | 2,041 | 1,917 | 2,417 |
| PER (x) | 7.4 | 2.8 | 2.0 | 2.1 | 1.7 |
| Output (MT)/Day | N/A | N/A | 502 | 540 | 620 |

### Other Businesses

Other core business areas for the company are the sugar industry, and the hygienic products business.

### Sugar

The company owns four sugar companies, which between them contribute about 20% of profits. It is looking at the possibility of acquiring a fifth. The government is deep into the process of removing itself from the sugar market than the edible oil market; the companies are able to sell about 80% of their output on the free market. Consumption is increasing too, with output over the next year set to increase about 25%.

### Hygiene Products

**Paksan Company**, established in 1965, is Iran's largest manufacturer of detergents, soaps, shampoos, toothpaste and related products. It has a market share just over 50% for its "Barf" ("snow") brand in Iran, and exports about 20% of its output, mainly to CIS countries.

The company is looking to strengthen its position further by tying up with one of the world's largest manufacturers in its field. This would allow it to improve its technology, and acquire the use of an international brand. To increase its capacity the company is in the process of building a new manufacturing plant in Ghazvin.

**Profit and Loss Account (Rls bn)**

| Year | 1997/8 | 1998/9 | 1999/2000E | 2000/1E |
|---|---|---|---|---|
| Behshahr Industrial | 93.9 | 143.8 | 128.5 | 160.6 |
| Margarine | 44.7 | 58.7 | 62.4 | 78.6 |
| Paxan | 36.6 | 41.8 | 48.1 | 55.3 |
| Sugar Companies | 61.3 | 68.2 | 83.2 | 99.8 |
| Others | 36.3 | 28.3 | 31.2 | 34.3 |
| Total Investment Income | 272.9 | 340.8 | 353.3 | 428.6 |
| General Expenses | (1.4) | (1.9) | (2.3) | (2.8) |
| Gross Profit | 271.4 | 338.9 | 351.0 | 425.9 |
| Others – Net | 76.1 | 40.3 | 44.3 | 48.8 |
| Income/(Loss) Before Tax | 347.5 | 379.2 | 395.3 | 474.9 |
| Tax | 0 | 0 | 0 | 0 |
| Net Income/(Loss) | 347.5 | 379.2 | 395.3 | 474.6 |

### Financial Position

The company maintains strong financial discipline, with effectively no debt. Operating companies have debt, but financial risk is not compounded by adding debt at the holding company level.

## Valuation

We conservatively estimate the company's net asset value as follows (in Rls):

| | |
|---|---|
| Book NAV @ end 1998/9 | 496.1 |
| Add Un-realised Gains on Investments | 986.0 |
| **Adjusted NAV** | **1,482.1** |
| NAV per Share | Rls 4,490 |
| Current Share Price | Rls 3,877 |
| **% Discount to NAV** | **14** |

This takes no account of the additional value in unlisted assets, which are included at cost, nor of any future deal-making potential.

**Balance Sheet (Rls trin)**

| **Year** | **1997/8** | **1998/9** |
|---|---|---|
| Total Fixed Assets | 3.0 | 1.6 |
| | | |
| Investments | 395.0 | 433.6 |
| L-T Receivables from Subsidiary | 60.0 | 40.0 |
| | | |
| **Current Assets** | | |
| Cash & Bank Balances | 4.2 | 5.8 |
| Accounts Receivable | 434.5 | 531.4 |
| Total Current Assets | 438.7 | 537.1 |
| | | |
| **Current Liabilities** | | |
| Short-Term Loans | (16.0) | (11.4) |
| Accounts Payable | (21.7) | (5.0) |
| Dividends etc | (446.2) | (501.1) |
| Total Current Liabilities | (483.9) | (517.5) |
| | | |
| Other Assets | 2.1 | 2.1 |
| **Total Assets** | **415.0** | **496.8** |
| | | |
| Issued Share Capital | 330.1 | 330.1 |
| Reserves | 84.4 | 166.1 |
| Shareholders' Funds | 414.5 | 496.1 |
| | | |
| **Shareholders Funds and L-T Liabilities** | **414.5** | **496.1** |
| | | |
| **Liquidity Ratios** | | |
| Current Ratio | 0.9 | 1.0 |
| Quick Ratio | 0.9 | 1.0 |
| | | |
| **Gearing Ratios** | | |
| % Net Debt/Equity | 2.8 | 1.1 |
| % Net Debt/Capital Employed | 2.8 | 1.1 |

**Capital History**

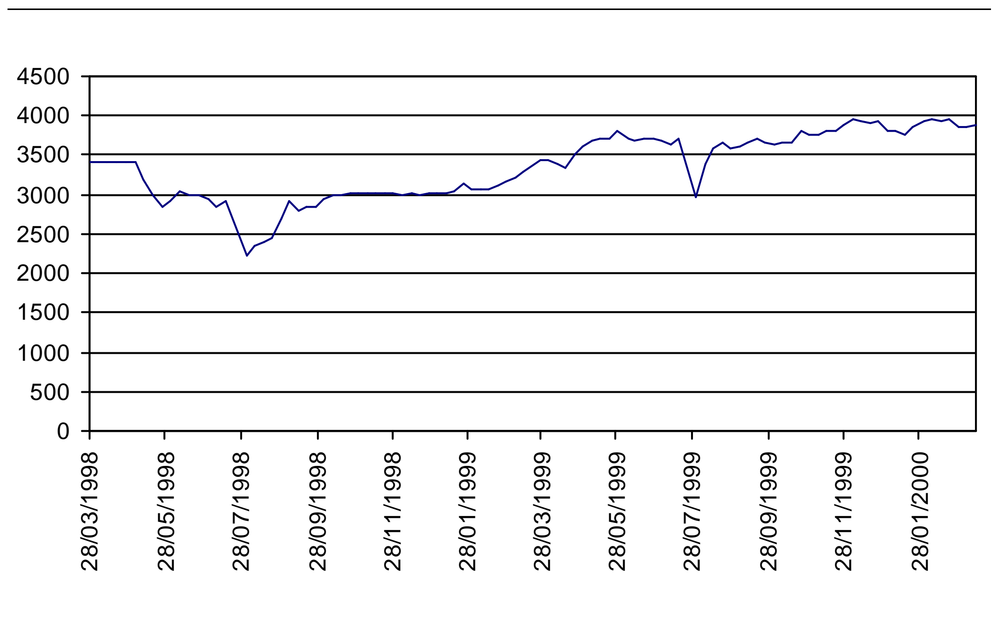
Since 1996/7 the company has had 60.0 mn shares in issue.

**Major Shareholders (%)**

| | |
|---|---|
| Bank Melli Iran Investment Company | 13.8 |
| Iran National Investment Co. | 10.5 |
| Nat. Org. for Development of Ownership of Manf. Units | 6.7 |
| Ghadir Investment Co. | 5.9 |
| Sepah Investment Co. | 2.2 |
| Social Security Investment Co. | 2.0 |
| Iran Insurance Co. | 1.8 |

(Note: there is at present no requirement for full disclosure of significant shareholdings of Iranian companies.)

**Sherkate Toseye Sanayeh Behshahr Share Price**



# Sherate Lavazeme Khanegi Pars

## (Pars Home Appliances)

**Share price: Rls 4,900**

**Pars Home Appliances is one of Iran's largest manufacturer of white goods, with an 80% share of the market for locally made freezers and 25% of the market for refrigerators. There is significant excess domestic demand for fridges and freezers - about 30% of local demand is imported, despite tariffs ranging from 90-120%. Pars Home Appliances is increasing its capacity by 70% to meet this demand.**

- Washing machines represent a new product line for the company. It is building capacity for 200,000 units per year, which would represent 25% of the current market for locally produced machines.
- The company uses international designs. Its washing machines are licensed from Arcelik of Turkey. Its fridges and freezer designs are commissioned from an Italian design company and use Japanese compressors. It is realistic for Pars Home Appliances to grab a significant part of Iran's imported equipment market.
- Exports represent further opportunities for longer-term growth. The company expects its products to be well received in CIS and Gulf countries, and it is considering a manufacturing plant in Kenya. Exports are unlikely to contribute to profits over the next couple of years, however, because of the need to build brand and market position almost from scratch overseas.
- Profitability has been hit by high import costs (60-70%), pushed up by the rial's weakness. Capex for financing new facilities (interest rates up to 25%) can also be expected to hit earnings in 1999/2000 and 2000/1. We expect a more stable rial and recovery in the local economy, together with efficiencies associated with the higher production level, to contribute to a recovery in profits from 2001, however.

| Year | 1996/7 | 1997/8 | 1998/9 | 1999/2000E | 2000/1E |
|---|---|---|---|---|---|
| Net profit (Rls bn) | 26.2 | 53.9 | 89.0 | 73.9 | 82.7 |
| *EPS (Rls)* | 243 | 499 | 824 | 685 | 766 |
| *% Change* | *N/A* | *105.5* | *65.1* | *-16.9* | *11.8* |
| DPS (Rls) | 135 | 432 | 475 | 394 | 441 |
| NTA (Rls) | 860 | 883 | 1,204 | 1,494 | 1,819 |
| Price/Book (x) | 4.9 | 4.8 | 3.5 | 2.8 | 2.3 |
| PER (x) | 17.3 | 8.4 | 5.1 | 6.1 | 5.5 |
| % Yield | 3.2 | 10.3 | 11.3 | 9.4 | 10.5 |
| Shares in Issue (mn) | 108.0 | | | | |
| Market Cap. (Rls bn) | 453.6 | | | | |
| Market Cap. ($ mn) | 56.7 | | | | |

## Industry and Company Background

Pars Home Appliances is one of Iran's largest manufacturers of white goods. The company was established in 1985 and 15% was owned by General Electric of the US until the revolution, manufacturing GE's designs under license. It now manufactures fridges and freezers under its own designs, and washing machines under license from Arcelik of Turkey.

Pars Home Appliances is 77% owned by Pars Electric, a listed manufacturer of colour televisions, computer monitors, and radios.

The company had market share (excluding imports) for refrigerators and freezers of 30% in the first six months of 1999/2000, probably slightly higher now. It has a dominant share, approaching 80% of the rapidly growing market for home freezers, and about 25% of the refrigerator market.

The market in Iran for refrigerators and freezers is about 1.4 mn units per year, about 30% of which is currently met by imports, despite tariffs of 90-140%. (Duty on parts is only about 20%.) The high level of imports reflects both the undercapacity of the local market and the more sophisticated designs available from overseas manufacturers. Pars Home Appliance management therefore believes that it can increase sales significantly by increased production, and by introducing its own modern designs - for which it uses an Italian design firm.

We expect the overall size of the Iranian market to continue to grow rapidly. There are about 600,000 new households per year, and forecast buoyant consumer demand over the next couple of years should ensure that the market grows fast enough to accommodate Pars Home Appliance's new capacity.

All the company's products are already CFC-free, so there will be no costs or disruption to be incurred in complying with CFC-related environmental provisions.

A new venture for the company is its move into washing machines. Its market share was only about 3% for the first half of 1999/2000, having only been in production a few months at that point. When its washing machine facility is completed in a year or so, however, it will have capacity for 200,000 machines per year (400,000 with double shifts), allowing it to make a significant impact in the domestic market (which is currently about 800,000 units in total) with its modern designs.

At present exports are only about 2% of output, because of the strength of the local market. In the long-term exports offer significant potential, especially to CIS countries and Gulf States. The company is also looking at the possibility of establishing a factory in Kenya for the African market. It already exports a few units to Mali, and some other African countries.

## Production and Sales

At present the company has production capacity of about 300,000 units, which is fully utilised. It is in the process of a US$10 mn expansion project that will increase capacity to about 400,000 over the next year, and to 500,000 a year later.

**Production of Refrigerators and Freezers**

| | 1996/7 | 1997/8 | 1998/9 | 1999/2000E | 2000/1E |
|---|---|---|---|---|---|
| Refrigerators | 104,449 | 123,411 | 139,553 | 146,531 | 183,163 |
| Freezers | 65,613 | 136,634 | 148,446 | 155,868 | 194,835 |
| **Total** | **170,062** | **260,045** | **287,999** | **302,399** | **377,999** |

The company started production of its front-load washing machines in July 1998. This year (1999/2000) it expects to make 20,000. As the chart illustrates, freezers generate higher revenue for the company than fridges. On average freezers sell for about one-third more than fridges. The differential is likely to increase over the next couple of years since the company also finds it easier to increase process of freezers. Washing machines offer the greatest potential, however. They sell for about 80% more than freezers.

The company sells its products in Iran through about 250 local distributors. It has very low levels of receivables since the shortage of supply allows it to pre-sell production about a month ahead of delivery.

The company has a long term plan to increase the contribution of exports to its revenues to about 20%, from the current 2%. Management realises that profits will come more slowly, however. The company will initially have to offer its products in new markets at attractive prices, and is typically expecting to be paying advertising costs for its distributor for about two years, as well as providing spare parts. It does not expect to be facing losses from its export markets, however, and will be generating an increasing quantity of useful hard currency. Overall we expect to see growth in revenues of 26% in 1999/2000 and 40% in 2000/1. As we discuss below we do not expect this increase in sales to translate immediately into profit growth.

## Costs and Profitability

Imported raw materials contribute 60-70% of the costs products, and lie behind our expectation that narrowing margins will contribute to a decline in earnings for 1999/2000 and only a slight recovery in 2000/1. Compressors and sheet steel come from Japan, plastic and epoxy resin from Germany and Italy. Steel, plastic and epoxy rein are all becoming available from domestic sources, although not necessarily yet of the same quality. Compressors will have to be imported for the foreseeable future.

The weakness of the rial over the last two years has cut into margins. We do, however, expect that the combination of a strong oil price and a steady reduction in the Iranian rate should allow a margin recovery in 2001/2. By then the company should also be benefiting from lower interest rates (its new facilities have been financed at rates up to 25%). We therefore would expect a significant increase in earnings that year.

The company has about 750 permanent employees, as well as about 300 temporary staff. The increased production capacity should not require a significant increase in staffing levels (although temporary positions may be made permanent), which should also contribute to better margins over the next couple of years. We estimate, however, that labour represents only about 4-5% of non-financial costs for the company.

**Profit and Loss Account (Rls bn)**

| Year | 1996/7 | 1997/8 | 1998/9 | 1999/2000E | 2000/1E |
|---|---|---|---|---|---|
| Gross Revenues | 149.5 | 266.9 | 341.2 | 428.6 | 599.1 |
| COS | (103.5) | (160.7) | (201.0) | (287.2) | (419.4) |
| Gross Profit | 46.0 | 106.2 | 140.1 | 141.4 | 179.7 |
| Operating Expenses | (5.8) | (8.6) | (11.7) | (14.6) | (18.2) |
| Operating Income/(Loss) | 40.2 | 97.6 | 128.5 | 126.9 | 161.5 |
| Net Interest Expense | (4.4) | (9.2) | (6.6) | (29.1) | (51.9) |
| Others – Net | 6.3 | 6.3 | 13.0 | 14.4 | 15.8 |
| Other Income/(Charges) | 1.9 | (2.9) | 6.5 | (14.8) | (36.2) |
| Income/(Loss) Before Tax | 42.2 | 94.7 | 134.9 | 112.1 | 125.4 |
| Tax | (16.0) | (40.8) | (45.9) | (38.2) | (42.7) |
| % Net Income/(Loss) | 26.2 | 53.9 | 89.0 | 73.9 | 82.7 |
| *% Change* | *N/A* | *105.5* | *65.1* | *-16.9* | *11.8* |
| % Gross Margin | 31 | 40 | 41 | 33 | 30 |
| % EBIT Margin | 31 | 39 | 41 | 33 | 30 |
| % EBITDA Margin | 32 | 40 | 42 | 34 | 31 |
| % Pre-Tax Margin | 28 | 35 | 40 | 26 | 21 |
| % Net Margin | 18 | 20 | 26 | 17 | 14 |
| % Effective Tax Rate | 38 | 43 | 34 | 34 | 34 |
| EPS (Rls) | 391 | 877 | 1,249 | 1,038 | 1,161 |
| *% Change* | *N/A* | *124.5* | *42.5* | *-16.9* | *11.8* |
| EBITDA (Rls bn) | 48.3 | 106.6 | 144.9 | 146.3 | 183.9 |
| *% Change* | *0.0* | *120.6* | *35.9* | *1.0* | *25.7* |
| EBIT (Rls bn) | 46.6 | 103.9 | 141.5 | 141.2 | 177.3 |
| *% Change* | *0.0* | *123.0* | *36.2* | *-0.2* | *25.6* |

## Financial Position

We estimate that Pars Home Appliances will have a net debt:capital employed ratio of 46% at the end of 1999/2000, up from 34% a year earlier because of investment in new capacity and associated increases in working capital. At present we expect to see the debt level increasing during the following year for similar reasons. If we have been over-pessimistic about working capital requirements, however, there is scope for some improvement.

Overall the company is in a healthy position, given the limited risk that it will be unable to sell a significant part of the output of its new facilities.

**Cash Flow Forecast (Rls bn)**

| Year | 1998/9 | 1999/2000E | 2000/1E |
|---|---|---|---|
| Pre-Tax Profit | 134.9 | 112.1 | 125.4 |
| Depreciation | 3.4 | 5.1 | 6.5 |
| Tax Paid | (40.8) | (45.9) | (38.2) |
| Capital Expenditure | (13.1) | (20.0) | (10.0) |
| Change in Working Capital | (102.6) | (67.6) | (98.0) |
| Dividends Paid | (46.6) | (51.3) | (42.6) |
| Other | 3.1 | 0 | 0 |
| Change in Net Debt | (61.7) | (67.6) | (56.8) |
| Net (Debt)/Cash b/f | (50.0) | (111.8) | (179.4) |
| Net (Debt)/Cash c/f | (111.8) | (179.4) | (236.2) |

**Balance Sheet (Rls bn)**

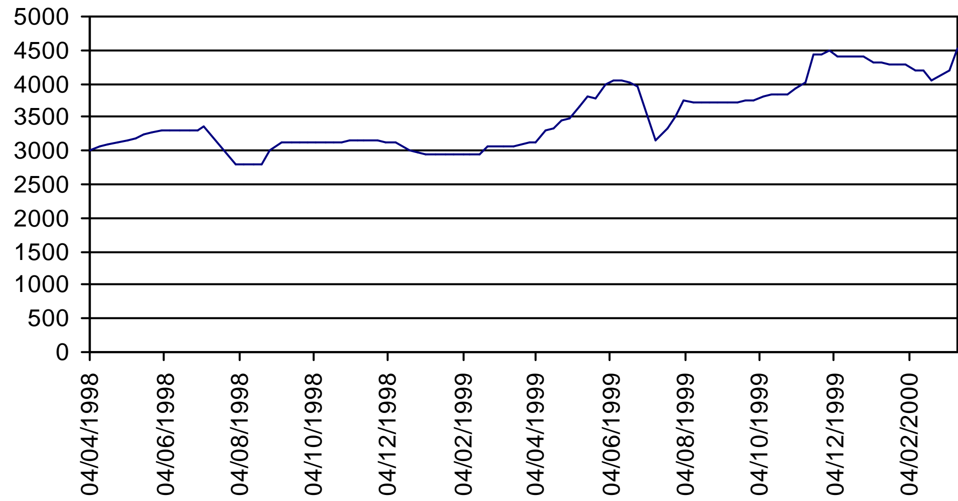
| Year | 1997/8 | 1998/9 |
|---|---|---|
| Net Fixed Assets | 67.1 | 76.8 |
| Investments | 2.7 | 1.4 |
| **Current Assets** | | |
| Cash & Bank Balances | 35.6 | 114.8 |
| Due from Subsidiaries | 0.7 | 14.8 |
| Accounts Receivable | 8.6 | 10.2 |
| Stocks | 153.4 | 259.6 |
| Other Current Assets | 9.0 | 7.6 |
| Total Current Assets | 207.3 | 407.0 |
| **Current Liabilities** | | |
| Short-Term Loans | (53.8) | (66.5) |
| Accounts Payable | (10.8) | (15.9) |
| Due to Subsidiaries | (14.9) | (12.6) |
| Dividend Payable | (46.6) | (51.3) |
| Other Current Liabilities | (40.0) | (48.6) |
| Total Current Liabilities | (166.1) | (194.9) |
| Other Assets | 6.9 | 7.7 |
| **Total Assets** | **117.9** | **298.1** |
| Issued Share Capital | 54.0 | 54.0 |
| Reserves | 41.4 | 76.0 |
| **Shareholders' Funds** | **95.4** | **130.0** |
| Long-Term Debt | 17.7 | 162.2 |
| Other Liabilities | 4.9 | 5.9 |
| Capital Employed | 117.9 | 298.1 |
| **Liquidity Ratios** | | |
| Current Ratio | 1.2 | 2.1 |
| Quick Ratio | 0.3 | 0.8 |
| **Gearing Ratios** | | |
| % Net Debt/Equity | 52.5 | 86.0 |
| % Net Debt/Capital Employed | 34.4 | 46.2 |

**Major Shareholders (%)**

| | |
|---|---|
| Pars Electric | 77 |

(Note: Iranian law does not yet require disclosure of substantial shareholders, so this list may not be complete).

**Sherkate Lavazeme Khanegi Pars Share Price**



# Sherkate Nasaji Borojerd

## (Borojerd Textile Company)

**Share price: Rls 2,405**

**Nasaji Borojerd is a highly profitable and efficient company, in a sector that in Iran is generally neither. It is relatively newly established (eight years old) and is therefore using modern equipment and methods, and produces goods suitable for the modern market. It has always been in the private sector, so efficiency is high - manning levels are half those of many other companies in the industry.**

- Its quality is high, giving it a strong domestic brand-name; the company is already exporting successfully, 90% to Italy. For 1999/2000 nearly half output will have been exported.
- The company is continually expanding capacity. Output for next year (2000/1) should be up 50% over 2000, and it has plans to add significantly to capacity for weaving and finishing.
- It is also moving downstream to allow it to capture more of the value-added in its products, especially for exports.

| Year | 1997/8 | 1998/9 | 1999/2000E | 2000/1E |
|---|---|---|---|---|
| Net Profit (Rls bn) | 24.1 | 31.3 | 19.0 | 48.3 |
| EPS (Rls) | 350.4 | 454.7 | 276.9 | 702.4 |
| *% EPS growth* | *0.0* | *29.8* | *-39.1* | *153.6* |
| DPS (Rls) | 267 | 200 | 244 | 618 |
| NTA (Rls) | 681 | 870 | 903 | 988 |
| Price/Book (x) | 3.5 | 2.8 | 2.7 | 2.4 |
| PER (x) | 6.9 | 5.3 | 8.7 | 3.4 |
| % Yield | 11.1 | 8.3 | 10.1 | 25.7 |
| | | | | |
| Shares in Issue (mn) | 68.8 | | | |
| Market Cap. (Rls bn) | 165.4 | | | |
| Market Cap. ($ mn) | 20.7 | | | |

# Company and Industry Background

The textile industry is generally in a very poor state in Iran, with most companies losing money. This is not for shortage of demand, but because companies are unable or unwilling to produce the types of product currently in demand, and are crippled by inefficiencies, especially over-manning.

Textile demand in Iran is about 1,200 mn metres per year. Only about 40% of this is satisfied by the local manufacturers, however. The balance comes from imports even though there is significant spare domestic capacity. Among the problems are equipment that cannot produce the wider fabric now needed for many purposes, and equipment which is too old to be efficient.

Nasaji Borojerd started production about eight years ago with a weaving facility. Profits from that financed moves into spinning, and then finishing. The company buys raw cotton; spins yarn, and weaves fabric which it then sells in gray or bleached form or after dyeing or printing.

## Output and Sales

The table below shows the company's capacity in the different areas of production. Utilisation is 90% or more for all equipment, with the exception of the new weaving facility which is operating at about 50% capacity. This is because workers are still being trained on the new equipment.

**Capacity (Year End)**

| | 1996/7 | 1997/8 | 1998/9 | 1999/2000E | 2000/1E | Planned |
|---|---|---|---|---|---|---|
| Spinning (tons) | 2,600 | 2,600 | 5,200 | 5,200 | 5,200 | - |
| Weaving (mn m) | 10 | 10 | 10 | 23-4 | 23/4 | +5/7 |
| Finished (mn m) | 15 | 15 | 15 | 15 | 15 | +15 |

The planned new finishing equipment would cost about US$6-8 mn. It will be capable of handling wider fabrics that the current equipment (up to three metres), which is useful for fabric to be used for bed sheets. Since the weaving equipment is already able to produce the wider fabric, the new finishing equipment would therefore increase the value in the existing weaving equipment.

The additional capacity should allow an increase in output for 2000/1 of about 50% compared with the previous year.

The further expansion to the weaving equipment, together with equipment for production of bed sheets and some other equipment to eliminate bottlenecks would cost about SFr 19 mn. The company is currently looking for finance for this equipment.

Additionally the company is considering moving into garment production. It has an Italian client interested in purchasing 4,000 pcs/day (1.2 mn per year) of trousers. If implemented the company estimates that it would double turnover.

At present the company has access to preferential exchange rates for importing equipment: 50% at US$1=Rls3,000 and 50% at US$1=Rls5,000. (Current TSE ("free market) rate is about 8,000.)

The table below gives a historic breakdown of sales, and our estimates for 1999/2000 and 2000/1. Additionally the company is currently negotiating the sale of US$2.5 mn in fabric from inventory, which would add about Rls20 bn to turnover and Rls9-10 bn to profit. Management hoped to be able to complete and book the deal during 1999/2000. We have not assumed that this deal can be concluded, however.

| **Sales (Rls bn)** | **1998/9** | **1999/2000E** | **2000/1E** |
|---|---|---|---|
| Exports | 8 | 40 | 80 |
| Finished | 81 | 64 | 99 |
| Yarn | 15 | 5 | 0 |
| Others | 1 | 1 | 1 |
| **Total** | **105** | **110** | **180** |

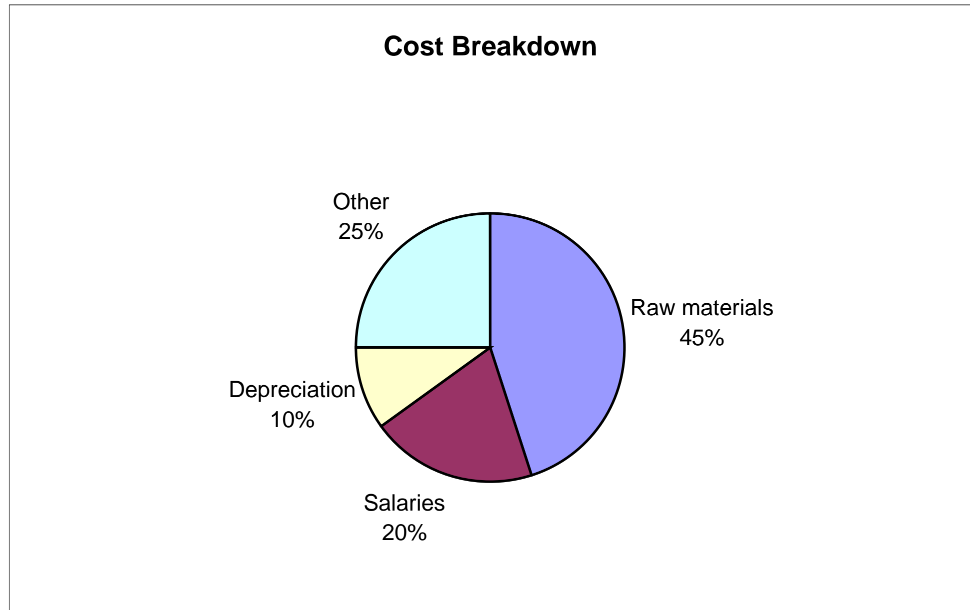
Revenue growth assumes that the growth in exports seen during 1999/2000 can continue. The company assures us that there are no problems with import quotas to its target markets, since Iran exports significantly less than permitted under quota rules, and this situation is unlikely to change quickly.

Domestic selling prices for cotton fabric had been lower than the international market prices, but following weakness in international prices are now comparable. The average price for gray fabric is now US$0.8 per metre (down from $1.0 a year or so ago), $1.2 per metre for bleached fabric.

## Expenses and Profitability

The chart breaks down expenses for the company. All raw materials are sourced domestically. Nasaji Borojerd has about 1,000 employees. As a relatively new company which has never been under state ownership, and which has always expanded, it does not have the legacy of over-manning with which many companies in the textile industry (and many other industries) are struggling. Management suggests that the company's effective manning levels are half those of many competitors.

**Cost Breakdown**




We expect the contribution of depreciation to increase substantially (to close to 40% of the total) over the next few years as the new equipment is installed.

We expect earnings this year to be down on 1998/9, in part this reflects unchanged production levels, lower sales prices internationally and pressures on raw material and labour costs. Mainly, however, it results from interest costs associated with the capital expenditure to increase capacity.

We are looking for a very substantial improvement in 2000/1, however, resulting from the 50% increase in output, higher efficiencies and greater stability in both input and sales prices. Interest expense will continue to increase, because of plans for the further investment in new equipment.

**Profit and Loss Account (Rls trin)**

| Year | 1997/8 | 1998/9 | 1999/2000E | 2000/1E |
|---|---|---|---|---|
| Gross Revenues | 92.0 | 104.2 | 100.0 | 180.0 |
| COS | (49.0) | (58.0) | (56.8) | (97.2) |
| Gross Profit | 43.0 | 46.2 | 43.2 | 82.8 |
| Operating Expenses | (2.1) | (2.9) | (3.4) | (3.9) |
| Operating Income/(Loss) | 40.9 | 43.3 | 39.8 | 78.9 |
| Net Interest Expense | (7.5) | (9.5) | (19.9) | (26.3) |
| Others – Net | 0.3 | 1.3 | 1.5 | 1.6 |
| Income/(Loss) Before Tax | 33.7 | 35.1 | 21.4 | 54.2 |
| Tax | (9.6) | (3.8) | (2.3) | (5.9) |
| Net Income/(Loss) | 24.1 | 31.3 | 19.0 | 48.3 |
| | | | | |
| EPS (Rls) | 350 | 455 | 277 | 702 |
| *% Change* | *N/A* | *29.8* | *-39.1* | *153.6* |
| | | | | |
| EBITDA (Rls bn) | 47.5 | 53.1 | 71.2 | 119.2 |
| *% Change* | *N/A* | *11.8* | *34.1* | *67.4* |
| | | | | |
| EBIT (Rls bn) | 41.2 | 44.6 | 41.3 | 80.5 |
| *% Change* | *N/A* | *8.3* | *-7.5* | *95.0* |
| | | | | |
| DPS (Rls) | 267 | 200 | 244 | 618 |
| *% Change* | *N/A* | *-25.0* | *21.8* | *153.6* |
| % Payout Ratio | 76.1 | 88.0 | 88.0 | 88.0 |
| | | | | |
| % Gross Margin | 46.8 | 44.4 | 43.2 | 46.0 |
| % Operating Margin | 44.4 | 41.5 | 39.8 | 43.8 |
| % Net Margin | 26.2 | 30.0 | 19.0 | 26.8 |
| % Effective Tax Rate | 28.5 | 10.9 | 10.9 | 10.9 |

## Financial Position

The company has a high, though sustainable, gearing level, as a result of its significant capital expenditure. As illustrated by the chart below we expect gearing to stabilise at a net/capital employed level of about 73%.

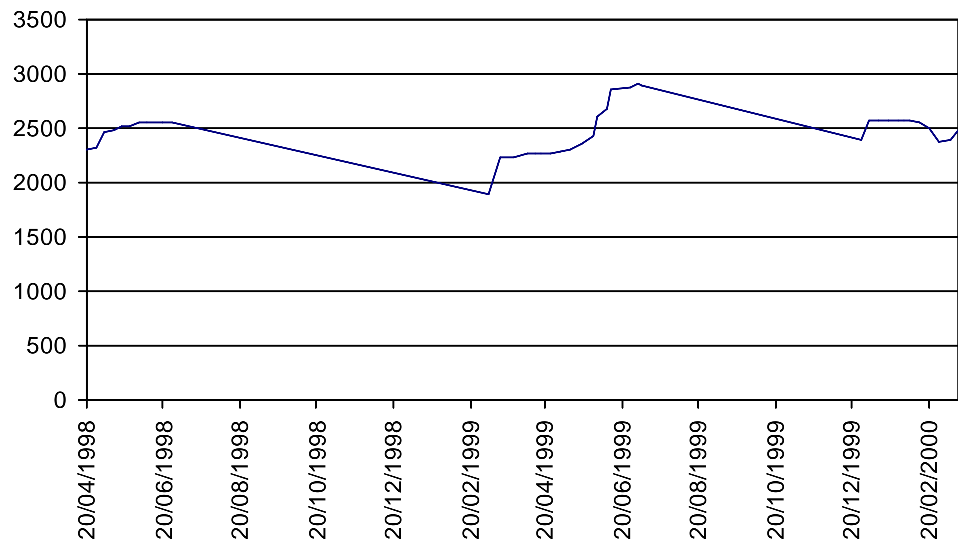
**Cash Flow (Rls bn)**

| Year | 1998/9 | 1999/2000E | 2000/1E |
|---|---|---|---|
| Pre-Tax Profit | 35.1 | 21.4 | 54.2 |
| Depreciation | 8.4 | 29.9 | 38.6 |
| Tax Paid | 0 | (9.2) | (2.3) |
| Capital Expenditure | (50.6) | (116.0) | (27.3) |
| Change in Working Capital | (27.7) | 20.5 | (54.0) |
| Dividends Paid | (18.3) | (27.5) | (16.8) |
| Other | (9.2) | 0 | 0 |
| Change in Net Debt | (62.3) | (80.9) | (7.5) |
| Net (Debt)/Cash b/f | (34.7) | (97.1) | (177.9) |
| Net (Debt)/Cash c/f | (97.1) | (177.9) | (185.4) |

**Balance Sheet (RIs trin)**

| Year | 1997/8 | 1998/9 |
|---|---|---|
| Net Fixed Assets | 81.3 | 122.9 |
| Investments | 0.8 | 1.6 |
| **Current Assets** | | |
| Cash & Bank Balances | 4.0 | 3.3 |
| Short-Term Investments | 0.8 | 1.5 |
| Accounts Receivable | 42.1 | 58.7 |
| Stocks | 61.7 | 66.5 |
| Total Current Assets | 108.6 | 130.1 |
| **Current Liabilities** | | |
| Current Portion of Long-Term Loans | (39.5) | (64.1) |
| Accounts Payable | (21.0) | (14.7) |
| Taxation | (5.4) | (9.2) |
| Dividend Payable | (50.4) | (66.0) |
| Total Current Liabilities | (116.3) | (154.0) |
| Other Assets | 0.3 | 0.2 |
| **Total Assets** | **74.6** | **100.9** |
| Issued Share Capital | 30.6 | 45.8 |
| Reserves | 16.3 | 14.0 |
| **Shareholders' Funds** | **46.8** | **59.8** |
| Long-Term Debt | 0 | 37.8 |
| Other Liabilities | 27.8 | 3.3 |
| Capital Employed | 74.6 | 100.9 |
| **Liquidity Ratios** | | |
| Current Ratio | 0.9 | 0.8 |
| Quick Ratio | 0.4 | 0.4 |
| **Gearing Ratios** | | |
| % Net Debt/Equity | 74.2 | 162.3 |
| % Net Debt/Capital Employed | 42.6 | 61.9 |

**Sherkate Nasaji Borojerd Share Price**



# Sherkate Shisheh Ghazvin

## (Ghazvin Glass Co.)

**Share price: Rls 5,250**

**Ghazvin Glass is the largest manufacturer of sheet glass in Iran and is soon to reinforce its position by establishing a float glass facility twice as large as all those planned by competitors together. The technology for the new plant comes from Pilkington.**

- Demand for glass is strong in Iran, with nearly 20% currently met by imports. The market is growing rapidly, and within that we expect Ghazvin to be able to increase its share.
- Neighbouring countries offer substantial export potential, virtually untapped by Ghazvin Glass at present because of domestic shortages.
- Increased capacity should increase efficiency, especially since the company is over-manned, and is finding this hard to address because of Iran's strict labour laws.
- Ghazvin Glass is moving downstream, with plants newly opened or under construction for tempered glass, laminated glass, mirrored glass and vehicle glass.
- We forecast EPS growth of over 60% for 1999/2000, and a further 26% for 2000/1. That takes no account of the float glass facility, which is still two years away from operation.

| Year | 1997/8 | 1998/9 | 1999/2000E | 2000/1E | 2001/2E |
|---|---|---|---|---|---|
| Net Profit (Rls bn) | 40.9 | 42.7 | 69.3 | 87.4 | 120.2 |
| EPS (Rls) | 1,462 | 1,524 | 2,476 | 3,122 | 4,294 |
| *% EPS Growth* | *34.5* | *4.3* | *62.5* | *26.1* | *37.6* |
| DPS (Rls) | 708 | 1,309 | 1,238 | 1,561 | 2,147 |
| NTA (Rls) | 3,592 | 3,989 | 5,227 | 6,788 | 8,934 |
| Price/Book (x) | 1.5 | 1.3 | 1.0 | 0.8 | 0.6 |
| PER (x) | 3.6 | 3.4 | 2.1 | 1.7 | 1.2 |
| % Yield | 13.5 | 24.9 | 23.6 | 29.7 | 40.9 |
| Shares in Issue (mn) | 28.0 | | | | |
| Market Cap. (Rls bn) | 147.0 | | | | |
| Market Cap. ($ mn) | 18.4 | | | | |

# Corporate and Industry Background

Glass for commercial and industrial use is in short supply in Iran. Total domestic output for 1999/2000 is expected to have been about 300,000 MT, with demand for a further 70,000 MT being met by imports, despite tariffs of 15-20%. All Iranian production at present is sheet glass, rather than the higher-quality float glass predominantly used in more developed economies. This amounts to average annual per capita consumption of 5.5-6 kg, compared with over 8kg in Turkey, for example.

The company started production 32 years ago and was originally an Iranian/US joint venture. The US partner sold out to a Japanese company that completed a significant expansion of its manufacturing facilities (to the current level) just before the Iranian revolution. It was taken over by the state but is now once again is fully private-sector, being 49% owned by a German company controlled by a German-Iranian *bazaari*.

Ghazvin Glass is expected to have produced over 150,000 MT of sheet glass during 1999/2000, giving it a share over 40% of the total market and over 50% of locally manufactured output. The equipment on which this is achieved has a nominal capacity of 121,000 MT per year, a figure which Ghazvin exceeds by about 25% - an indication of the efficiency and technical expertise of the company. Ghazvin Glass management acknowledges, however, that the practical limit for output from this equipment is now close. It therefore plans a significant increase in capacity by buying float glass-making equipment imminently.

Ghazvin Glass at one point achieved a market share of 70-75% of domestically manufactured glass, but lost out as competitors increased capacity (adding machinery for conventional sheet glass manufacture) while Ghazvin was tied up in an earlier, unsuccessful, attempt to buy float glass technology.

There is very little export of glass from Iran at present (probably below 2% of industry output) because of the excess domestic demand.

### Expansion Plans

Ghazvin Glass has recently signed a contract with Pilkington for a float glass manufacturing facility with a nominal capacity of 160,000 MT per year. Some older equipment will then be retired, leaving the company with nominal capacity of 230,000 MT (up 90% from the current level) and likely effective capacity of about 290,000 MT (up a similar amount). The float glass facility will start production in about two years time.

The cost of the float glass project is 60 mn, of which the company expects to pay 15% cash (for which it hopes to be granted a concessionary exchange rate of Rls3,000 to the US dollar by the government - currently under negotiation) and borrow the balance (for which the exchange rate would be the TSE (market) rate.

Ghazvin will not be the first company in Iran with the ability to produce float glass. Indeed two of its competitors have already purchased equipment, although both are still some way from starting production. Their combined float glass capacity will be just half that of Ghazvin Glass, however, which should allow the company to retain its current market share.

When all currently planned expansion is complete nominal capacity in the industry will be as follows:

| | |
|---|---|
| Sheet glass | 260,000 MT |
| Float glass | 240,000 MT |
| **Total** | **500,000 MT** |

230,000 MT of the capacity will be from Ghazvin, 270,000 MT from its competitors.

Current glass consumption in Iran averages just less than 6 kg per year. Ghazvin Glass expects that this will reach 7 kg within three years, probably realistic given that average in consumption Turkey is over 8 kg. Ghazvin tell us that Pilkington's own market research suggests 8 kg per head in three years is realistic This is presumably based in part on an assumed short-term construction boom following recent economic and political developments. Of course population itself is increasing by 2-3% per year. Even 7 kg, however, implies a total market of 460-480,000 MT per year in three years.

In addition, given the export potential of surrounding countries there seems no danger of excess supply in the foreseeable future. 8 kg consumption per head in Iran (total demand well over 500,000 MT) would ensure continued substantial shortages.

### Moving Up the Value Chain

At present about 90% of the glass produced by Ghazvin Glass is used for construction, with the rest incorporated by other manufacturers into vehicles, mirrors and furniture - even though float glass should really be used for all those purposes. As well as increasing total production, Ghazvin therefore sees opportunities to extract greater value from each tonne it manufactures.

The move to float glass is part of this process. Float glass sells in Iran for about US$3 per m2, compared to US$1.2 for sheet glass. Management expects it to generate sales of Rls 300 bn per year once the plant is fully operational.

Additionally the company is adding equipment to process its glass further before sale. It has recently started production of double-glazing (using Austrian technology) and tempered glass (Finnish technology), which it expects to add Rls20 bn to revenues for 2000/1. Vehicle glass should be available in early 2001/2, laminated glass shortly after, followed by reflective glass and mirrors.

Vehicle glass looks the most interesting of these new projects. Ghazvin Glass has signed a letter of intent with Iran Khodro, Iran's largest car manufacturer, to supply 100,000 sets of vehicle glass per year in a deal which Ghazvin Glass estimates should generate Rls70 bn revenue annually. Iran Khodro expects to manufacture 228,000 vehicles in 2000/1, and plans to increase its capacity to 1 mn vehicles per year over the next six to seven years. Most of this increase in capacity will take place at a new factory located in the city of Ghazvin.

Vehicle glass requires float glass, so Ghazvin Glass will initially import (from Malaysia) until its own float glass manufacturing facility is in production. The vehicle glass facility will cost about US$8.5 mn for imported equipment, and an additional Rls30 bn in local spending.

### Revenues

The strong revenue growth expected for 1999/2000 reflects a 26% increase in production over the previous year, as well as substantially higher prices because of tight domestic capacity. We see little opportunity for significantly higher output until the float glass facility comes on in 2001/2. We have assumed a modest 10% increase in sheet glass prices, on the basis of some increase in competition as competitors start float glass production. This may prove unduly conservative if renewed economic and political confidence triggers an early building boom.

Double glazing and tempered glass should add a further Rls 20 bn to turnover, however.

Initial forecasts for 2001/2 revenue suggest that an increase of about 38% should be achievable, coming from a further 10% price rise, and an initial contribution from vehicle glass sales to Iran Khodro.

The company believes that there is also significant long-term potential in the export market, currently virtually unexplored because of the strength of domestic demand for glass. At present under 2% of output is exported, to Azerbaijan and other central European countries. Together with Pilkington, the company is looking at the possibility of exporting its float glass to Russia, CIS countries, the Gulf States and possibly some Far Eastern countries. There is also still demand for sheet glass from Turkey, which no longer makes it, because it is cheaper by 30-40% than float glass.

### Expenses and Profitability

Ghazvin Glass has about 1,250 workers, and management estimates that it is overstaffed by 200-250. Staffing levels are falling (the company has shed over 300 people during the last six to seven years), but the process is slow because of Iran's very strict labour laws. Productivity levels clearly increase with high production, however, so the company should be much closer to an optimum level following the completion of the expansion plans discussed above.

Soda ash is the most important raw material, and is sourced 30% domestically and 70% imported (because of a supply shortage in Iran). Silica sand and dolomite come from the company's own quarries in Iran, and all other raw materials are also available domestically.

We expect some widening of margins over the next couple of years, because of increasing efficiencies and the move to greater value added by the company.

**Profit and Loss Account (Rls bn)**

| Year | 1997/8 | 1998/9 | 1999/2000E | 2000/1E | 2001/2E |
|---|---|---|---|---|---|
| Gross Revenues | 119.8 | 138.5 | 220.0 | 264.4 | 365.6 |
| COS | (68.1) | (79.1) | (125.6) | (148.1) | (204.7) |
| Gross Profit | 51.7 | 59.4 | 94.4 | 116.4 | 160.9 |
| Operating Expenses | (6.5) | (7.7) | (8.9) | (9.8) | (10.8) |
| Operating Income/(Loss) | 45.2 | 51.6 | 85.5 | 106.6 | 150.1 |
| Net Interest Expense | (0.6) | (0.5) | (1.0) | (0.5) | (3.5) |
| Other Expenses | (0.2) | (0.3) | (0.3) | (0.3) | (0.3) |
| Other Income | 2.8 | 2.2 | 2.5 | 3.5 | 4.0 |
| Income/(Loss) Before Tax | 47.2 | 53.1 | 86.7 | 109.3 | 150.3 |
| Tax | (6.3) | (10.4) | (17.3) | (21.9) | (30.1) |
| Net Income/(Loss) | 40.9 | 42.7 | 69.3 | 87.4 | 120.2 |
| | | | | | |
| EPS (Rls) | 1,462 | 1,524 | 2,476 | 3,122 | 4,294 |
| *% Change* | *34.5* | *4.3* | *62.5* | *26.1* | *37.6* |
| | | | | | |
| EBITDA (Rls bn) | 52.9 | 60.1 | 97.0 | 121.3 | 173.5 |
| *% Change* | *N/A* | *13.6* | *61.5* | *25.0* | *43.0* |
| | | | | | |
| EBIT (Rls bn) | 31.4 | 47.8 | 53.6 | 87.7 | 109.7 |
| *% Change* | *37.7* | *52.0* | *12.2* | *63.6* | *25.2* |
| | | | | | |
| DPS (Rls) | 708 | 1,309 | 1,238 | 1,561 | 2,147 |
| *% Change* | *41.7* | *84.8* | *-5.4* | *26.1* | *37.6* |
| | | | | | |
| Payout Ratio | | | | | |
| | | | | | |
| % Operating Margin | 37.7 | 37.3 | 38.8 | 40.3 | 41.1 |
| % Net Margin | 34.2 | 30.8 | 31.5 | 33.1 | 32.9 |
| % Effective Tax Rate | 13.3 | 19.7 | 20.0 | 20.0 | 20.0 |

## Financial Position

Ghazvin Glass is at present in a very strong financial position, with net cash at the end of 1998/9, and also we estimate, at the end of 1999/2000. By the time the float glass manufacturing facility and the vehicle glass facility have been paid for 2002/3 the company will have a debt/equity ratio which we estimate will be 200-300%.

Our estimates assume a return by dividends payouts to their historic levels around 50%, rather than the 86% seen last year.

**Cash Flow (Rls trin)**

| Year | 1998/9 | 1999/2000E | 2000/1E | 2001/2E |
|---|---|---|---|---|
| Pre-Tax Profit | 53.1 | 86.7 | 109.3 | 150.3 |
| Depreciation | 6.5 | 9.4 | 11.6 | 19.8 |
| Tax Paid | (7.2) | (11.9) | (17.3) | (21.9) |
| Capital Expenditure | (34.6) | (35.0) | (108.0) | (140.5) |
| Investments | (2.7) | 0 | 0 | 0 |
| Change in Working Capital | 0.8 | (11.9) | (4.5) | (20.2) |
| Dividends Paid | (19.8) | (36.7) | (34.7) | (43.7) |
| Other | 7.2 | 0 | 0 | 0 |
| | | | | |
| Change in Net Debt | 3.2 | 0.6 | (43.7) | (56.2) |
| Net (Debt)/Cash b/f | 0.6 | 3.8 | 4.4 | (39.3) |
| Net (Debt/Cash c/f | 3.8 | 4.4. | (39.3) | (95.5) |

**Balance Sheet (RIs trin)**

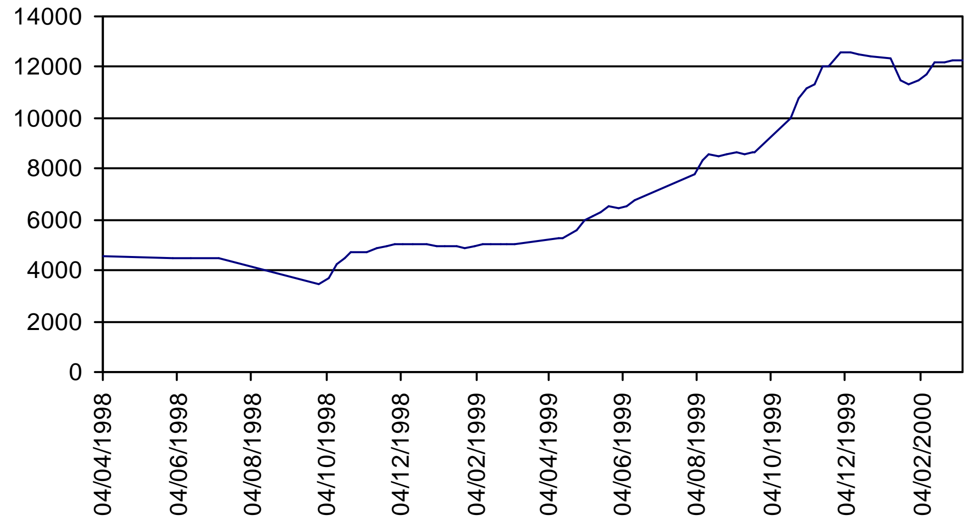
| Year | 1997/8 | 1998/9 |
|---|---|---|
| Net Fixed Assets | 82.2 | 110.4 |
| Investments | 17.1 | 19.8 |
| **Current Assets** | | |
| Cash & Bank Balances | 7.4 | 19.1 |
| Short-Term Investments | 0.2 | 0.2 |
| Receivables | 19.4 | 27.4 |
| Stocks | 38.9 | 51.5 |
| Total Current Assets | 65.9 | 98.2 |
| **Current Liabilities** | | |
| Short-Term Loans | (7.1) | (1.3) |
| Due to Affiliates | (4.4) | (3.8) |
| Accounts Payable | (20.9) | (42.4) |
| Taxation | (8.7) | (11.9) |
| Dividend Payable | (19.8) | (36.7) |
| Total Current Liabilities | (60.9) | (96.1) |
| Other Assets | 3.6 | 3.6 |
| **Total Assets** | **108.0** | **135.8** |
| Issued Share Capital | 14.0 | 28.0 |
| Reserves | 86.6 | 83.7 |
| Shareholders' Funds | 100.6 | 111.7 |
| Long-Term Debt | 0 | 14.1 |
| Other Liabilities | 7.4 | 10.0 |
| **Shareholders' Funds and L-T Liabilities** | **108.0** | **135.8** |
| **Liquidity Ratios** | | |
| Current Ratio | 1.1 | 1.0 |
| Quick Ratio | 0.4 | 0.5 |
| **Gearing Ratios** | | |
| Net Debt/Equity | Net Cash | Net Cash |
| Net Debt/Capital Employed | Net Cash | Net Cash |

**Major Shareholders (%)**

| | |
|---|---|
| Legmaindor & Stunger | 49.2 |
| Mellatt Investment Co. | 8.3 |

(Note: Iranian law does not yet require disclosure of substantial shareholders, so this list may not be complete.)

**Sherkate Shisheh Ghazvin Share Price**



# Doodeh-E Sanati Pars

**Share price: Rls 7,245**

**Doodeh-E Sanati Pars is one of two Iranian manufacturers of carbon black, the raw material for production of car tires. Demand remains very strong for the company's product, both domestically and for export. The rapid growth in the Iranian car manufacturing sector should ensure that domestic sales remain strong, while exports should be supported by the reluctance, for environmental reasons, of many European manufacturers to make carbon black.**

- The major constraint on the company has been limited capacity, and financial constraints on buying new equipment. It is now setting up a buy-back arrangement, however, whereby it will pay for a new facility in carbon black - effectively also guaranteeing a customer for three-quarters of the new output.
- Current over-manning means that the company should be able to double output with only a 10% increase in workforce.
- The raw material for its product is available cheaply from domestic refineries.
- We do not expect significant earnings growth this year or next, but potential rises substantially once the new capacity is in place.

| Year | 1997/8 | 1998/9 | 1999/2000E | 2000/1E |
|---|---|---|---|---|
| Net Profit (Rls bn) | 6.7 | 18.4 | 18.7 | 19.7 |
| EPS (Rls) | 555 | 1,531 | 1,560 | 1,643 |
| *% EPS Growth* | *883.2* | *175.9* | *1.9* | *5.3* |
| DPS (Rls) | 557 | 1,300 | 1,324 | 1,395 |
| NTA (Rls) | 1,102 | 1,280 | 1,516 | 1,763 |
| Price/Book (x) | 6.6 | 5.7 | 4.8 | 4.1 |
| PER (x) | 13.1 | 4.7 | 4.6 | 4.4 |
| % Yield | 7.7 | 17.9 | 18.3 | 19.3 |
| Shares in Issue (mn) | 12.0 | | | |
| Market Cap. (Rls bn) | 86.9 | | | |
| Market Cap. ($ mn) | 10.9 | | | |

# Industry and Company Background

The company, which was founded in 1995, is one of two manufacturers in Iran of carbon black, the raw material for the manufacture of car tyres. Its competitor is Carbon Iran, also listed on the Tehran Stock Exchange. It has nominal capacity of 15,000 MT per year, compared with 40,000 MT per year by Carbon Iran. It is in the process of arranging to double capacity, however.

## Production and Sales

In 1998/9 the company produced 17,650 MT of carbon black, 18% ahead of the nominal capacity of its equipment, and an indication of the efficiency of the company.

The current output level is now close to the practical maximum from the current equipment, even with 24-hour operations, so the company plans additional capex to double its nominal capacity to 30,000 MT per year. Actual effective total capacity should reach about 35,000 MT per year. This does not require a complete duplication of current facilities, but would cost about US$15 mn. The problem for this exercise is finding the financing for the purchase. As a result it has discussed with one potential supplier (a Croatian company) a "buy-back" arrangement whereby the supplier would take payment in the form of the carbon black produced by the new equipment.

This deal, if agreed by the government as seems likely, would absorb 70-75% of the output of the new facility for about five years. As well as saving the company the difficulty of arranging finance in the current difficult circumstances, this arrangement could therefore also be seen as guaranteeing a customer for the majority of the output.

About 50% of sales were exported in 1999/2000, up from 25% in 1998/9.

**Exports by % and Destination**

| | |
|---|---|
| Turkey | 30-35 |
| Canada | 25 |
| Pakistan | 20 |
| Indonesia | 15 |

Exports also go to Spain, Germany and Italy. The company is currently talking to Michelin about a supply contract.

Four years ago export prices were higher than domestic ones. Now they are about 6% lower (12% in the new year because of an agreed domestic price increase taking effect in 2000/1).

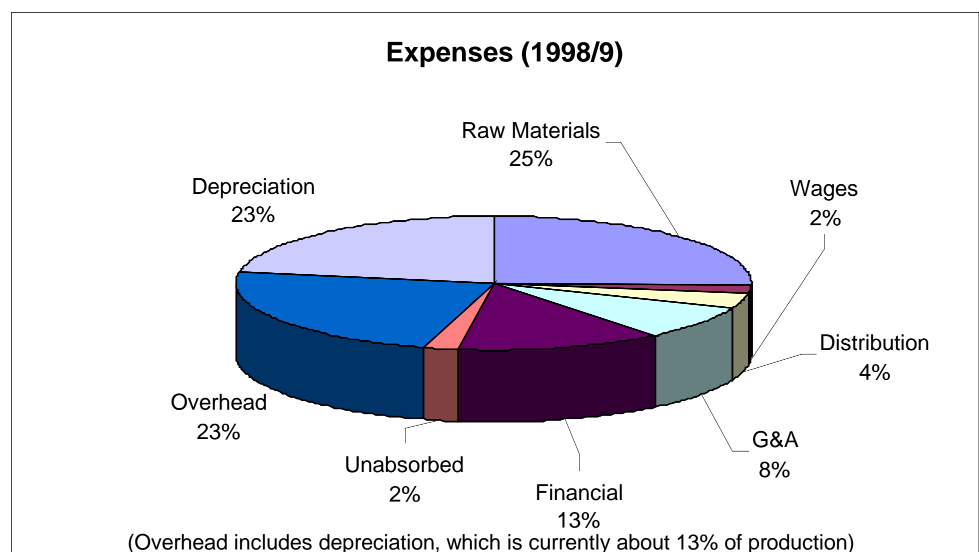
Domestic prices, while not government-set, are agreed each year by Doodeh-e Sanati Pars, Carbon Iran and their customers. It has so far always been possible, however, to increase prices to pass on most of the higher raw material and other costs. Gross margin has increased steadily, from 17% in 1995/6, the first year of profitability, to 51% last year. During 1999/2000, when the cost of raw material surged with a higher oil price, the price was increased again halfway through the year. With effect from the start of 2000/1 prices will be Rls3,300 per kg, compared with Rls2,800 at the start of 1999/2000.

We expect domestic demand to increase sharply with the planned increase in car production. Total vehicles manufactured in 1999/2000 will have been about 250,000. This is likely at least to double over the next three years. Overall we expect that the company will have no problem in finding buyers for all output it can realistically produce from its existing facilities and from the planned expansion.

## Expenses and Profitability

All raw materials are sourced domestically. Only manufacturing equipment has to be imported. About 80% of the raw material comes from Naphtha Pars (a significant shareholder in the company) with the balance coming from listed petrochemical manufacturer Arak Petrochemical. The average price is about US$30 per MT, much lower than the international price, which is about US$100-140.

**Breakdown of Production Cost**



(Overhead includes depreciation, which is currently about 13% of production)

We forecast a fall in gross margins this year, from 51% to 48% as a result of the increased share of exports (where margins are now slightly lower than for domestic sales) and increasing costs, especially for raw materials and labour, and a further drop to 42% in 2000/1. Lower financial costs, as borrowing falls, and tight control of other operating costs should allow for an increase in profitability, albeit a slight one, each year. The prospects for significant earnings growth come for the years 2001/2 and after, once the additional capacity comes on line.

The company was awarded tax exemption status until 2000/1. It therefore has no tax charges for the forecast periods covered by this report, but will again be liable for tax from 2001/2 onwards.

**Profit and Loss Account (Rls bn)**

| Year | 1997/8 | 1998/9 | 1999/2000E | 2000/1E |
|---|---|---|---|---|
| Gross Revenues | 26.5 | 36.8 | 40.3 | 47.6 |
| COS | (16.1) | (18.1) | (20.9) | (27.6) |
| Gross Profit | 10.4 | 18.7 | 19.3 | 20.0 |
| Operating Expenses | (1.7) | (2.6) | (3.1) | (3.7) |
| Operating Income/(Loss) | 8.8 | 16.1 | 16.2 | 16.3 |
| Net Interest Expense | (3.3) | (2.7) | (1.3) | (0.6) |
| Others – Net | 3.0 | 5.0 | 4.0 | 3.6 |
| Other Income/(Charges) | (0.3) | 2.3 | 2.7 | 3.0 |
| Income/(Loss) Before Tax | 8.5 | 18.4 | 18.9 | 19.3 |
| Tax | (1.8) | 0.0 | 0.0 | 0.0 |
| Net Income/(Loss) | 6.7 | 18.4 | 18.9 | 19.3 |
| EPS (Rls) | 555 | 1,531 | 1,578 | 1,609 |
| *% Change* | *N/A* | *175.9* | *3.1* | *2.0* |
| EBITDA (Rls bn) | 11.7 | 24.3 | 23.5 | 23.1 |
| *% Change* | *137.7* | *107.1* | *-3.2* | *-1.8* |
| EBIT (Rls bn) | 11.7 | 21.1 | 20.2 | 19.9 |
| *% Change* | *137.5* | *79.7* | *-4.1* | *-1.7* |
| DPS (Rls) | 557 | 1,300 | 1,340 | 1,367 |
| *% Change* | *N/A* | *133.6* | *3.1* | *2.0* |
| Payout Ratio | 100 | 85 | 85 | 85 |
| % Gross Margin | 39.3 | 50.7 | 48.0 | 42.0 |
| % Operating Margin | 33.1 | 43.8 | 40.3 | 34.2 |
| % Net Margin | 25.1 | 49.9 | 47.0 | 40.6 |
| % Effective Tax Rate | 21.5 | 0.0 | 0.0 | 0.0 |

## Financial Position

The company is in a strong financial position, with debt/capital employed expected to be just 19% by the end of 1999/2000 and single digits by the end of 2000/1. Substantial debt will be associated with the buy-back arrangement planned for the new plant. With ample demand to absorb the additional capacity, however, this should be relatively easily repaid. We would nevertheless not be surprised to see the company, which has never raised new capital from the market, looking at to a rights issue to provide some new funding.

**Cash Flow (Rls bn)**

| Year | 1998/9 | 1999/2000E | 2000/1E |
|---|---|---|---|
| Pre-Tax Profit | 18.4 | 18.9 | 19.3 |
| Depreciation | 3.2 | 3.3 | 3.2 |
| Tax Paid | (1.4) | 0.3 | 0.0 |
| Capital Expenditure | (0.7) | (0.5) | (0.5) |
| Change in Working Capital | (5.0) | (1.6) | (3.4) |
| Dividends Paid | (6.7) | (15.6) | (16.9) |
| Other | 2.4 | 0.0 | 0.0 |
| Change in Net Debt | 10.2 | 4.8 | 2.6 |
| Net (Debt)/Cash b/f | (19.3) | (9.1) | (4.3) |
| Net (Debt)/Cash c/f | (9.1) | (4.3) | (1.7) |

**Balance Sheet (Rls bn)**

| Year | 1997/8 | 1998/9 |
|---|---|---|
| Net Fixed Assets | 23.2 | 20.7 |
| Investments | 2.8 | 0.0 |
| **Current Assets** | | |
| Cash & Bank Balances | 3.1 | 10.1 |
| Short-Term Investments | 0.0 | 0.0 |
| Accounts Receivable | 5.8 | 9.1 |
| Stocks | 10.2 | 12.5 |
| Total Current Assets | 19.1 | 31.7 |
| **Current Liabilities** | | |
| Current Portion of L-T Loans | (3.5) | (2.5) |
| Accounts Payable | (4.2) | (4.7) |
| Taxation | (1.7) | (0.3) |
| Dividend Payable | (6.7) | (15.6) |
| Total Current Liabilities | (16.0) | (23.1) |
| Other Assets | 3.6 | 3.5 |
| **Total Assets** | **32.7** | **32.8** |
| Issued Share Capital | 12.0 | 12.0 |
| Reserves | 1.2 | 3.4 |
| Shareholders' Funds | 13.2 | 15.4 |
| Long-Term Debt | 18.9 | 16.6 |
| Other Liabilities | 0.5 | 0.8 |
| **Shareholders' Funds and L-T Liabilities** | **32.7** | **32.8** |
| **Liquidity Ratios** | | |
| Current Ratio | 1.2 | 1.4 |
| Quick Ratio | 0.6 | 0.8 |
| **Gearing Ratios** | | |
| % Net Debt/Equity | 145.9 | 59.2 |
| % Net Debt/Capital Employed | | |

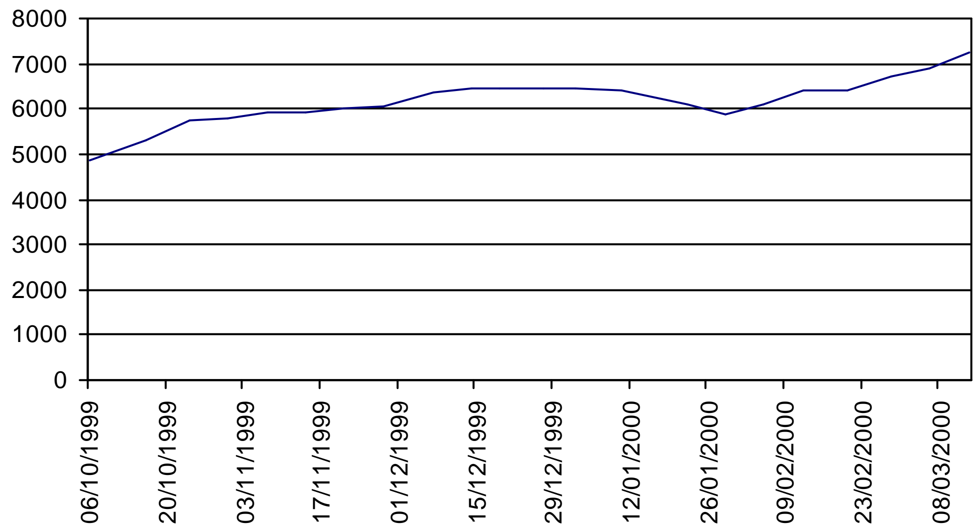
**Capital History**

There have been no changes to the issued share capital of the company in the period covered by this report.

**Major Shareholders (%)**

| | |
|---|---|
| Qadir Investment Co. | 31 |
| Social Security Fund | 44 |
| Bank Melli Iran Investment Company | 20 |

**Doodeh-E Sanati Pars Share Price**



# Dashte Morghab

**Share price: Rls1,394**

**Dashte Morghab has a very strong position in Iran's market for processed vegetable and fruit products, with 25% market share and a well-established and popular brand. Crucially, new management (last two years) also has a firm grasp of the significance of branding and marketing.**

- Expansion has been hampered by poor domestic distribution (reliance on a single government-run distribution company). It has now addressed this by establishing its own majority-owned distribution company, financed initially by its own management. Dashte Morghab sees potential for this to increase domestic sales two- to three-fold in the long term.
- The company also expects to be able to increase effective output by the use of small outside manufacturers as processing facilities, allowing it to meet the increased demand created by improved distribution in a very flexible manner.
- Product quality is also high - up to international standards, providing another new avenue for expansion. Low levels of chemical fertiliser use should enable the company to sell many of its products to European countries as "organic".

| Year | 1997/8 | 1998/9 | 1999/2000E | 2000/1E |
|---|---|---|---|---|
| Net Profit (Rls bn) | 2.2 | 3.2 | 5.5 | 10.1 |
| EPS (Rls) | 174 | 210 | 360 | 663 |
| *% EPS Growth* | *N/A* | *20.9* | *71.5* | *84.0* |
| DPS (Rls) | 49 | 16 | 28 | 52 |
| NTA (Rls) | 1,116 | 1,207 | 1,361 | 1,645 |
| Price/Book (x) | 1.2 | 1.2 | 1.0 | 0.8 |
| PER (x) | 8.0 | 6.6 | 3.9 | 2.1 |
| % Yield | 0.0 | 0.0 | 0.0 | 0.0 |
| Shares in Issue (mn) | 30.0 | | | |
| Market Cap. (Rls bn) | 41.8 | | | |
| Market Cap. ($ mn) | 5.2 | | | |

# Industry and Company Background

Iran grows excellent fruit and vegetables, especially citrus fruits and tomatoes. Farmers in the country have never used large quantities of chemical fertilisers, and are thus inadvertently in tune with the move in more developed economies to "organic" products. Note that Iran has never been a significant exporter of fresh produce since it lacks the infrastructure for sufficiently timely distribution.

Dashte Morghab was founded in 1967. It is well established and its brand name, "1 & 1", is widely known in Iran. It has a market share of about 25%, and is the only substantial company in the market. There are many hundreds of small food manufacturing companies, but without the technology and brand recognition of Dashte Morghab.

Products include fruit juices, tomato paste, tomato ketchup, pickles, and preserves. There are no controls on prices for either the raw materials or the end products of the company.

New management two years ago brought a thoroughly private sector approach to the company, and most significantly a firm grasp of the significance of branding and marketing.

The listed company has three subsidiaries, each operating a food manufacturing facility. These units are each much smaller than the parent company and added together roughly break-even. Since the company does not yet publish consolidated accounts (it will have to do so as from 2000/1) we have no considered the financial impact in this report, but increasing efficiencies in those operations could clearly afford further opportunities for growth.

## Production and Sales

The company buys its raw materials (fruit and vegetables) from farmers, large and small, and co-operatives. Only a small part (about 5%) of packaging materials have to be imported, all the other raw materials can be sourced from within Iran. Farmers are paid 20-30% of the price before harvesting, the balance on delivery. Dashte Morghab has one small farm of its own (150 ha) for a few products which are not available from outside (sweet corn, for example, and for research and development).

The produce is then processed for selling either in bulk form (such as fruit juice concentrate or drums of tomato paste), which is mainly for export, or in final form in jars, cans and tubes for distribution and retail sale.

The table below shows recent and planned production levels.

**Output (MT)**

| | 1997/8 | 1998/9 | 1999/2000E | 2000/1E |
|---|---|---|---|---|
| **Parent** | **18-19,000** | **20,000** | **28,000** | **30,000** |
| Other factories | 11-12,000 | 15,000 | 21,000 | 27,000 |
| Outside | 0 | 0 | 1,000 | 2-3,000 |
| **Total** | **30,000** | **35,000** | **50,000** | **60,000** |

The company's own facilities have capacity of 60,000-70,000 MT per year. To avoid financial constraints, it has no plans at present to increase this. It plans instead to increase its effective capacity by subcontracting processing to smaller companies. The company estimates that there are 300-400 such small food-processing factories. As demand increases it plans to use an increasing number of these, buying the raw materials from farmers and supplying them to the factories for processing. It would advise the companies on technology and quality control to maintain standards.

The major constraint on the company's development has been a highly inadequate distribution system. It has used just one, state-owned distributor. Since the revolution the only big distribution companies in Iran have been government-run. They are inefficient, expensive, and have limited reach. Dashte Morghab believes its products to be available in only about 35-40,000 retail outlets, out of a potential 600,000. Management believes that the long-term potential exists to increase domestic sales two to three times through better distribution.

The company planned to buy a state-owned distributor with the aim of upgrading it, but lost out, and is now in the process of establishing a distribution company from scratch.

The new company, which should be operating by the middle of 2000, will be 51% owned by Dashte Morghab, with the balance held by the management of the distributor. The new company will in turn set up 27 regional distribution companies (three in Tehran, the other 24 covering the rest of the country), each 51% owned by the central company and 49% by their own managements. All the initial capacity will come from the management, with Dashte Morghab only having to put in its contribution after two to three years. The cost and efficiency of the distribution process should improve.

Exports have reached a level of about US$11 mn per year (Rls88 bn at the current exchange rate). These go mainly (70%) to Russia in the form of bulk tomato paste, with the balance going to Europe, mainly Germany, mostly in finished form. The company has targeted exports rising to U$50 mn over the next five years, 80% to European countries. This will require new marketing and distribution arrangements in Europe, an issue that the company is only just starting to address. It believes that the quality of its products fully meets international standards, however.

## Expenses and Profitability

Raw materials are expected to comprise two-thirds of this year's costs. They fluctuate, depending on the harvest. In 1998/9, for example, they were about 72% of costs. Management has greater ability to influence the other cost components, however.

The new distribution arrangements should see distribution costs falling to about 8-9% once the new company is up and running, and further as volumes increase. Administration costs have already fallen from about 10% of total costs to the current 4.5%. Management is targeting 3-4%.

We expect sales to increase about 32% this year, mainly because of higher output. Gross margins should continue their improvement, but increasing working capital needs will take their toll on financing costs. Overall, we expect a 76% increase in profit before tax, with a further 86% increase to come next year.

**Profit and Loss Account (Rls bn)**

| Year | 1997/8 | 1998/9 | 1999/2000E | 2000/2001E |
|---|---|---|---|---|
| Gross Revenues | 96.0 | 94.1 | 125.0 | 150.0 |
| COS | (73.6) | (68.8) | (90.0) | (106.5) |
| Gross Profit | 22.4 | 25.4 | 35.0 | 43.5 |
| Operating Expenses | (15.2) | (15.1) | (16.0) | (16.8) |
| Operating Income/(Loss) | 7.2 | 10.2 | 19.0 | 26.7 |
| | | | | |
| Net Interest Expense | (2.2) | (2.6) | (6.7) | (5.1) |
| Others - Net | 0.2 | (1.4) | (1.5) | (1.7) |
| Other Income/(Charges) | (2.0) | (3.9) | (8.2) | (6.8) |
| | | | | |
| Income/(Loss) Before Tax | 5.2 | 6.3 | 10.8 | 19.9 |
| Tax | (3.0) | (3.1) | (5.3) | (9.8) |
| Net Income/(Loss) | 2.2 | 3.2 | 5.5 | 10.1 |
| | | | | |
| EPS (Rls) – Pre-Tax | 174 | 210 | 360 | 663 |
| *% Change* | *N/A* | *20.9* | *71.5* | *84.0* |
| | | | | |
| EPS (Rls)- Post-Tax | 73 | 106 | 182 | 336 |
| *% Change* | *N/A* | *46.2* | *71.5* | *84.0* |
| | | | | |
| EBITDA (Rls bn) | 8.7 | 10.4 | 19.4 | 26.8 |
| *% Change* | *N/A* | *18.8* | *86.8* | *38.4* |
| | | | | |
| EBIT (Rls bn) | 7.4 | 8.9 | 17.5 | 25.0 |
| *% Change* | *N/A* | *19.2* | *97.0* | *43.2* |
| | | | | |
| DPS (Rls) | 49 | 16 | 28 | 52 |
| *% Change* | *N/A* | *-66.7* | *71.5* | *84.0* |
| Payout Ratio | 67 | 15 | 15 | 15 |
| | | | | |
| % Operating Margin | 7.5 | 10.9 | 15.2 | 17.8 |
| % Net Margin | 2.3 | 3.4 | 4.4 | 6.7 |
| % Effective Tax Rate | 58.1 | 49.3 | 49.3 | 49.3 |

## Financial Position

The company's net debt/capital employed level of 60% is not excessive. Since the plans for capacity expansion and the new distribution system do not require any significant investment over the next couple of years, gearing should actually fall slightly, despite the need for more working capital to pre-pay farmers.

**Cash Flow (Rls trin)**

| Year | 1998/9 | 1999/2000E | 2000/1E |
|---|---|---|---|
| Pre-Tax Profit | 6.3 | 10.8 | 19.9 |
| Depreciation | 1.5 | 1.9 | 1.8 |
| Tax Paid | (4.8) | (3.8) | (5.3) |
| Capital Expenditure | (4.9) | (1.0) | (1.5) |
| Investments | (3.9) | (3.9) | (3.9) |
| Change in Working Capital | 9.7 | (14.2) | (10.0) |
| Dividends Paid | (1.5) | (0.5) | (0.8) |
| Increase in Termination Reserve | 1.2 | 1.2 | 1.2 |
| Other | (0.1) | 0.0 | 0.0 |
| Change in Net Debt | 3.5 | (9.5) | 1.3 |
| Net (Debt)/Cash b/f | (58.7) | (55.2) | (64.7) |
| Net (Debt)/Cash c/f | (55.2) | (64.7) | (63.4) |

**Balance Sheet (Rls trin)**

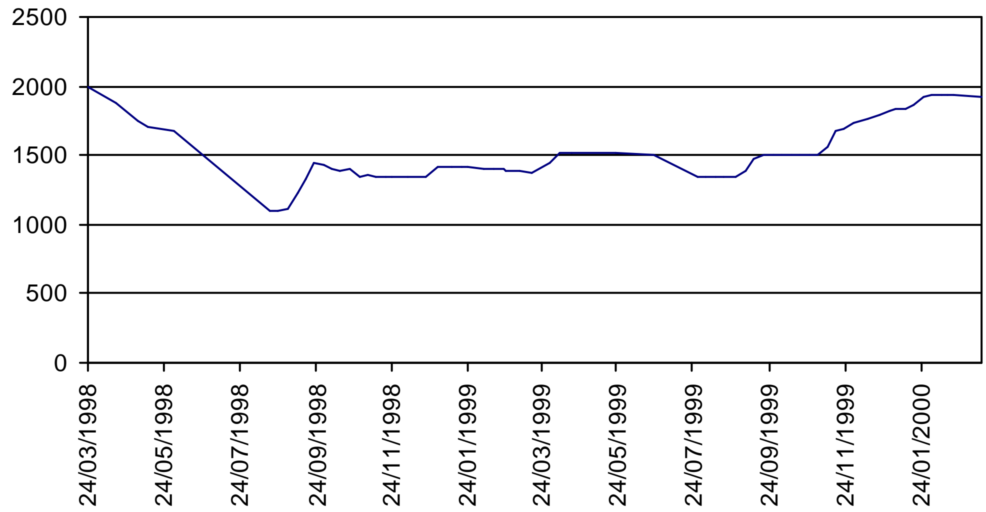
| Year | 1997/8 | 1998/9 |
|---|---|---|
| Net Fixed Assets | 12.6 | 16.0 |
| Investments | 7.0 | 10.9 |
| **Current Assets** | | |
| Cash & Bank Balances | 2.4 | 5.5 |
| Accounts Receivable | 41.0 | 32.5 |
| Stocks | 42.4 | 41.0 |
| Total Current Assets | 85.8 | 79.0 |
| **Current Liabilities** | | |
| Short-Term Loans | (55.4) | (55.7) |
| Accounts Payable | (0.4) | (0.1) |
| Taxation | (5.5) | (3.8) |
| Dividend Payable | (1.6) | (0.5) |
| Total Current Liabilities | (62.8) | (60.2) |
| Other Assets | 0.1 | 0.1 |
| **Total Assets** | **42.7** | **45.8** |
| Issued Share Capital | 30.0 | 30.0 |
| Reserves | 3.5 | 6.2 |
| Shareholders' Funds | 33.5 | 36.2 |
| Long-Term Debt | 5.7 | 5.0 |
| Other Liabilities | 3.4 | 4.6 |
| **Shareholders' Funds and L-T Liabilities** | **42.7** | **45.8** |
| **Liquidity Ratios** | | |
| Current Ratio | 1.4 | 1.3 |
| Quick Ratio | 0.7 | 0.6 |
| **Gearing Ratios** | | |
| % Net Debt/Equity | 175 | 152 |
| % Net Debt/Capital Employed | 64 | 60 |

**Major Shareholders (%)**

| | |
|---|---|
| Bank Melli Iran Investment Co. | 70 |

(Note: Iranian law does not yet require disclosure of substantial shareholders, so this list may not be complete.)

**Dashte Morghab Share Price**



**Notes**