HISTORY

Iran: Open for Business?

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After years of negotiations, there has been a recent breakthrough between Iran, the United States and other world powers about Iran's nuclear program. While the deal certainly was controversial, and is still under debate in the United States, strictly from an investment standpoint, we think it represents an exciting development not only for Iran, but for the Middle East/North Africa (MENA) region. Many investors in the region are excited about the potential for this new market to fully emerge. Development of Iran's capital market and potential opening to investors around the world should contribute to economic development not only in Iran, but also in the region, and could help lower political tensions.

In July, the five permanent members of the United Nations Security Council—the United States, Russia, China, France and the United Kingdom—along with Germany (called P5+1) announced a historic deal with Iran that paves the way for lifting the economic sanctions that were imposed in response to its nuclear planning. The sanctions were intended to keep the country isolated and stifle Iran's economic potential until the nuclear issue could be resolved. While the sanctions have not formally been lifted yet, we are hopeful that their anticipated removal will bring new investment opportunities that were not available to us before.

Iran has a large, thriving stock market already, with more than 400 listed companies and a market capitalization of more than US$100 billion.[1] We have found many good companies in Iran that we believe to be well managed, representing a diverse mix of sectors and industries. Investing in Iran is not only an oil story; agriculture, manufacturing and mining are also key drivers of growth.

We are particularly interested in consumer-oriented stocks as potential investment opportunities, which include retailers, food producers, telecommunication, financials and banking companies. Iran's banking sector, in particular, could benefit as the need for capital in Iran will be most acute. We believe this area—driven by domestic population growth, demographics and increasing disposable income—should be among the first to benefit from a potential removal of sanctions. We also would anticipate some re-investment of oil wealth back into the domestic and neighboring economies, mainly in terms of much-needed infrastructure investment and diversification projects that aim to move economic dependence away from oil.

Looking at emerging markets generally, we also think the Iranian equity markets today look quite attractive in terms of valuations. In addition, we think a number of multinational consumer products companies will likely want to expand in Iran, so that could be another area for investors to consider.

Sensing change on the horizon, Iran has been working to prepare for a potential flood of new investors to its market. Iran's stock exchange has been undergoing improvements in infrastructure, and leaders there are working to comply with international standards in areas such as surveillance and investor protections.

This is encouraging but we think more work still needs to be done to attract international investors. Corruption remains a problem—as it does in many countries around the world—and we would like to see more movement toward privatization, as the majority of listed companies in Iran are affiliated with the state in some fashion.

Sanction Relief Could Stimulate Growth

Iran has experienced a number of setbacks both economically and politically over the past decade that have kept the country from achieving what we feel could be its full potential. We think that could soon change. Iran's economy, at approximately US $400 billion, is the second-largest in the MENA region[2] after Saudi Arabia. Iran has been suffering from high levels of inflation and unemployment, particularly among its youth. We think relief from economic sanctions could accelerate Iran's growth rate by removing barriers to the nation's oil exports, bringing in more foreign capital, and ending the isolation of its banks from the global financial system. A temporary and partial removal of sanctions in 2014 helped the economy rebound to a growth rate of 3%, on the heels of a recession in 2012-2013.[3]

Iran boasts favorable demographics, with a well-educated and youthful population (median age is 28).[4] In our view, the potential lifting of sanctions, and the anticipated new investment, could have a dramatic impact on employment and domestic consumption because new investments will require workers, and those workers in turn will likely have more income to spend.

Pakistan, the United Arab Emirates, Oman and other countries in the region with strong trade links to Iran could also potentially benefit. There is already a thriving exchange between nearby Dubai and Iran, continuing a trading relationship that goes far back in history. A flight from Dubai to Tehran only takes about two hours. In Dubai, there are Iranian schools and branches of Iranian universities where Iranian students can study. An Iranian Business Directory published in Dubai has over 7,000 Iranian companies listed that are operating in Dubai in many fields, including banking, real estate, trading and so on, so money has been flowing from Iran to Dubai.

Of course, politically driven events typically result in a number of uncertainties and potential risks, but we believe our on-the-ground presence in the region helps give us a leg up in identifying and analyzing these opportunities.

A Game-Changer for the Energy Market?

As far as a less-isolated Iran's impact on the price of oil, I don't see it being a big game-changer. While a renewed drop in oil prices in July to $50 a barrel was in part attributed to the nuclear deal, it's important to remember that Iran only holds about 10% of the world's oil supply,[5] and Iran is not a complete newcomer to the market. The country has already been exporting oil. Refiners in Turkey, for example, have been buying oil from Iran. The sanctions on Iran meant it had to accept a lower price for its oil than it would have liked, so the opportunity for Iran to export more oil at higher market prices logically seems attractive to the government. It is impossible to say that more oil exported from Iran will automatically push oil prices down. The speculative element is most critical in determining oil prices in view of the fact that the market can swing wildly at times in the short term, unrelated to the fundamentals of oil supply and demand.

It is our view that the price of oil is more likely to rise than fall over the long term because the steady demand for oil is likely to continue around the world. Since oil began to decline from its peak of over $100 a barrel in 2014, the rig count in the United States has dropped, so we think shale oil from the United States could be less of a factor going forward, which could offset the increase in Iranian oil exports.

While some oil and gas exporters are facing near-term challenges in light of oil's price drop, from an investment standpoint, we are focused on diversified companies in the energy sector—not only those involved in exploration and production but also retailing and refining. We believe commodities in general will continue to be in demand long term; it's a matter of picking the right stocks, meaning the most efficient producers.

In our view, the outlook seems brighter for Iran today than in the past, and we see more potential opportunities ahead. Of course, Iran's future lies in the political process, which can be uncertain and take a long time to implement. In reality, Iran's integration with the international community and a full removal of sanctions could likely be a multi-year process, but as long-term, focused investors, we are optimistic about the opportunities this could create for the region over the coming years.

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What Are the Risks?

All investments involve risks, including possible loss of principal. Foreign securities involve special risks, including currency fluctuations and economic and political uncertainties. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets.

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1. Source: Tehran Stock Exchange, July 2015.

2. Source: The World Bank, as of 2014.

3. Source: IMF World Economic Outlook database, April 2015.

4. Source: CIA World FactBook, July 2015.

5. Source: US Energy Information Administration, 2014.