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TURQUOISE PARTNERS

Hormoz Oil Refinery, City of Bandar Abbas , Southern Iran

Market Overview — 2

December was an important month for the Tehran Stock Exchange as the subsidies reform plan commenced. Surprisingly, the market reacted positively to this development. The positive sentiment in the market was further helped by stability in the global prices of commodities.

Turquoise Iran Equity Investments — 5

This section provides data and charts on the performance of Turquoise Iran Equity Investments Class A for the month of December.

Special Report: Subsidies Reform Plan — 6

A review of the subsidies reform plan and its implications for the Iranian economy will be provided in this section.

Country Overview — 10

The dismissal of Iran's Foreign Minister and the debate over the Central Bank's governance will be discussed in this section.

Economy — 12

New investments in Iran's railways, the liberalisation of insurance premiums, the inauguration of Kish Stock Exchange and Iran's first micro hybrid car will be covered in this section.

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December was a highly important month for the Tehran Stock Exchange (TSE) as the subsidies reform plan finally commenced on 19th December. The reforms target one of the major sources of inefficiency and price distortions in the Iranian economy, and will likely lead to major restructuring in almost all economic sectors. Consequently, throughout the autumn, investors on the TSE have adopted a cautious and defensive approach. This ended up in a surprisingly positive reaction upon the launch of the reform plan (more information on the details and implications of the reform plan is provided in our special report on the subsidies reform plan).

With the initial success of the reform plan during its first days of implementation and the uncertainties surrounding it largely resolved, the market rallied during the final ten days of December. Only 83 points below its historical record of 9th October 2010, the TSE All-Share Index stood at 18855 and is expected to set a new record in the coming weeks. Trading activities also increased over the past month. Besides the launch of the subsidies reform plan, stability in the global commodities market and the success of the largest IPO in the history of the Iranian financial markets, contributed to the bullish sentiment in the market.

Some of the key events and sectors of the market will be analysed below:

The Largest IPO of the Iranian Equity Market

On December 19th, 5.5% of the Mobile Communications Co. of Iran (MCI) shares were offered on the Iranian Over-The-Counter (OTC) market, at a value of $396 million. As a result, MCI's market capitalisation stood at $7.2 billion at IPO, making it the largest company at IPO by market capitalisation. The total market capitalisation of the OTC market increased tenfold as a result of the IPO. The MCI share price increased 7.7% by the end of December, whereas the parent company, Telecommunications Company of Iran (TCI), lost 2.3% of its value following the IPO. TCI's price to earnings (P/E) ratio currently stands at 6. The P/E ratio of MCI stood at 8.6 upon IPO. Given the fact that MCI accounts for approximately 70% of TCI's profits, analysts expect further adjustments in the price of MCI, which will likely bring the P/E ratios of the two companies closer to each other.

Engineering Services

The engineering services sector was the star performer of December. News about a 5% payment by the government for the development contracts awarded in the South Pars gas field was the main reason for the rally. Several companies in this sector, including Iran Marine Industries Co. (SADRA) and Iran Power Plant Management Co. (MAPNA), have won lucrative contracts there. However, there have been severe delays by the government in making payments to these companies. As a result, these companies have faced significant strains in regards to their cash flows.

The sector index gained 11.6% in value.

Automotive

Since 2004, automotive shares have generally been out of favour with investors and experienced a gradual decline in their P/E ratios. Shares of companies in this sector bucked this trend in 2010. The sector index has had a staggering gain of 100% over the year, its largest gain for over six years. However, the recent gains can hardly be attributed to the profitability prospects of the industry. The sale prices of domestically manufactured cars in Iran have been frozen by the government for a number of years, while production costs have increased dramatically. Additionally, experts believe that the removal of subsidies is likely to have an adverse impact on the profitability of the automotive sector for at least the next 2-3 years.

Analysts believe that fierce competition between existing shareholders of Iran Khodro and Saipa, the two largest car manufacturers in Iran, who are aiming to secure board membership (and ultimately, control) of the companies, is the main reason for the price rallies in this sector. Speculative trading has also contributed to the creation of a bubble in the prices and sharp price corrections in this sector seem inevitable in the near future.

Banking and Insurance

While the financial services sector is considered to be among the least effected sectors by the subsidies reform plan, banking and insurance shares performed below expectations in December.

The banking sector index grew 1.7%. This was mainly driven by the recent developments in Parsian Bank, the largest privately owned bank listed on the TSE. The bank will hold its Board of Directors election within the next two months. Competition between shareholders to increase their stakes in the bank pushed the share prices up by 4.1% in December. Except for Parsian Bank and the recently privatised Post Bank, other banks share prices eased slightly over the course of December. The impending banking system reform (as part of the government's comprehensive economic reform plan) and the unofficial news about possible changes in next year's interest rates have increased the uncertainties surrounding banks' profitability prospects.

Insurance shares also had a lackluster performance as a result of an increase in the industry average payouts for health and third-party insurance policies. The insurance sector index declined 4.3% in December, making it one of the worst performing sectors this past month.

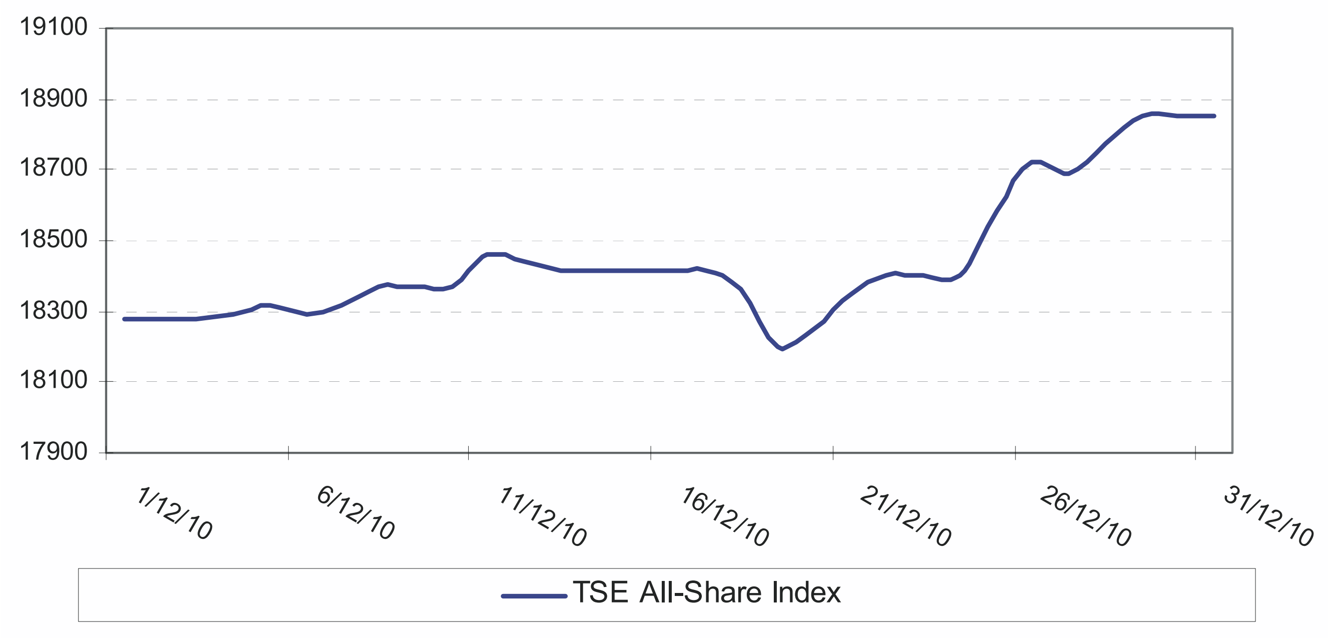
Cement

With the launch of the subsidies reform plan, the cement industry is among the most vulnerable industries to rises in energy prices. While new supportive schemes for the industry may be unveiled in the future, the cement industry is probably going to see a significant squeeze in its profit margins due to the unexpectedly high price adjustments in gasoil and furnace oil.

This view is especially reinforced by the fact that the government has introduced strict price control measures to ensure price stability in the coming months. Consequently, it seems unlikely that the cement producers will be able to compensate for their increased production costs by raising their sale price.

In December, Hegmatan Cement Co., revised down its earnings forecast for the budget for next year by 45%. The cement industry index was down 1.9% in December and with other earnings announcements expected in January, a further retreat in cement shares is expected.

Overall, the TSE experienced a positive month, with the TSE All-Share Index gaining 3.4% in value. Trade volumes also had a 3% increase to stand at $1.58 billion.



Market Statistics	
Performance (%)	3.36
Average P/E	6.33
Trade Value ($ Million)	1,576
Trade Value Monthly Change (%)	3.25
Market Cap ($ Million)	86,690

Top 5 Traded by Value

Rank	Company Name	Turnover Value ($million)	% of Total Turnover
1	Shiraz Petrochemical Co.	924	59
2	Telecommunications Co. of Iran	44	3
3	Karafarin Bank	43	3
4	National Iranian Copper Industries Co.	40	3
5	Post Bank	34	2

Top 5 Companies by Market Cap

Rank	Name of Company	Market Cap ($Million)	% of Total MC
1	Telecommunications Co. of Iran	11,645	13
2	National Iranian Copper Industries Co.	5,253	6
3	Isfahan Mobarakeh Steel Co.	3,913	5
4	Parsian Bank	3,517	4
5	Mellat Bank	2,820	3

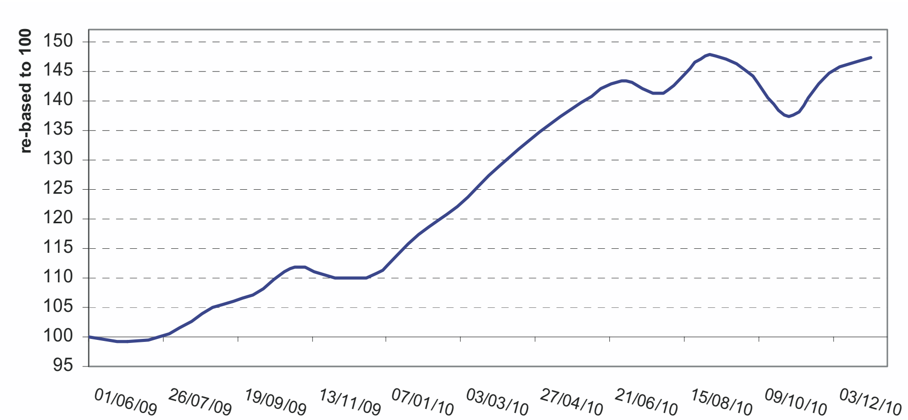
Turquoise Iran Equity Investments

Investment Objective – The Turquoise Equity Investments seeks superior long-term capital growth by investing in the consumer and commodity potential of Iran, one of the most undervalued emerging markets in the world. Turquoise combines international experience with local expertise in investing in equities listed on the Tehran Stock Exchange (TSE) and other Iranian-based securities. The goal is to provide superior returns, with greater diversification and lower volatility.

Class A — *NAV = 147.4*

Vehicle Domicile	Management Fee	Currency
British Virgin Islands	2.0% p.a	Euro (€)
Launch Date	**Carried Interest**	**Minimum Investment**
01 June 2009	20% (High Water Mark Applies)	€100,000

Class A Performance (Euro) - As at 31th December 2010



Period	Portfolio Return
Last Month	1.9 %
Last 3 Months	1.7 %
Last 6 Months	2.9 %
Last 12 Months	33.0 %
Since Inception (01 June 09)	47.4 %

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December 19 was a very important day for the Iranian economy. On Saturday evening, President Ahmadinejad appeared on national television to announce the commencement of the removal of subsidies. The plan for the partial removal of subsidies (also known as the subsidies reform plan) is the most important part of the so-called "economic reform plan". The economic reform plan was introduced in the summer of 2008 and aims to restructure seven key parts of the Iranian economy. It includes reforms in the subsidies regime, the taxation system, the banking sector, customs, productivity and efficiency, nationwide distribution of goods and services, and the national currency.

Among these reforms, the subsidies reform plan is of particular importance. This is because the estimated annual subsidies paid by the government are estimated to be approximately $ 100 billion. The plan will gradually remove all subsidies on fuel, gas, electricity, water, and bread over a five-year period. According to the plan, the government will remove the annual equivalent of $20 billion of subsidies in the first year. Of the proceeds, 50% will be used to provide cash handouts to households, and 30% to compensate for increased production costs in industry and to improve public transport and infrastructure. The remaining 20% will be used for the governement's own increased expenditure.

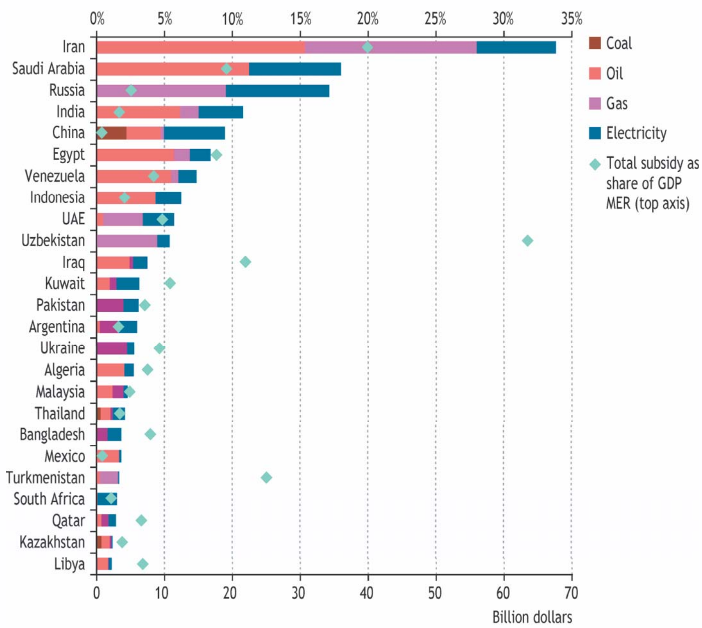
Background

The current subsidies reform plan is not the first of its kind. After the Iran-Iraq war, which ended in 1988, the government of Hashemi Rafsanjani undertook a comprehensive economic reform plan aimed at removing subsidies, reducing the budget deficit and foreign debt, and liberalising the economy. Within a few years, however, inflation surged to around 50%. This, along with an unprecedented increase in foreign debts and the exchange rate, meant that the government was forced to discontinue its liberalisation plans.

As part of the fourth development plan in 2005, President Khatami's administration proposed to the parliament that energy subsidies be removed. The draft plan suggested that the proceeds would be spent on social security, improving infrastructure, and other development plans. The parliament, however, rejected the plan and also passed a bill which required the government to stabilise the prices of eleven key products and services such as petrol, natural gas, and electricity.

The prices remained unchanged until June 2007 when the Ahmadinejad government unveiled a fuel rationing system. This was the first step by the government following the stabilisation of energy and utilities prices, which remained unchanged while the amount of subsidies had surged due to inefficient energy consumption. The plan was also partly driven by the sanctions against Iran and rumors about impending sanctions on fuel imports. According to the plan, private car owners would receive a subsidised quota of 100 litres per month (which was eventually reduced to 60 litres per month) while taxis and other public vehicles would receive a higher quota. Although the rationing plan partially curbed the staggering growth in consumption, Iran was the largest provider of fuel subsidies in the world by 2009, according to the International Energy Agency. Figure 1 shows the amount spent on fossil-fuel consumption subsidies (bottom axis) and its value as a percentage of GDP (top axis).

Figure 1: Economic value of fossil-fuel consumption subsidies by country and type, 2009



Source: IEA, 2010

Implementation

According to the plan, every Iranian citizen who applies to receive cash subsidies and provides a bank account would receive approximately $44 per month. Prior to the commencement of the plan, the government paid $88 (for two months) into the household's bank accounts, but had frozen the amount in the bank accounts until the commencement of the plan. On December 19th, the freeze on bank accounts was lifted and people were allowed to withdraw money from their bank accounts. In addition, the government introduced extensive controls over the prices of goods and services in order to avoid any dramatic increases or any disruptions.

Although a moderate increase in cash withdrawals from ATMs and bank branches were reported, no significant disruption or unrest occurred. Also, transportation costs and most consumer goods costs remained unchanged as a result of extensive controls by officials. Despite disagreements about the method of implementation and the details of price adjustments, political figures with differing political views shared a consensus about the necessity of such an economic plan. Upon the launch of the plan, a handful of political figures expressed their concerns about the consequences of a price shock of such dimensions, while the majority backed the plan. In general, given the staggering level of price increases, the initial phase of the plan can be considered a success, while the mid-term and long-term effects need to be monitored closely.

The first round price adjustments started on December 19, when the prices of gasoline, gas oil, natural gas, LPG, CNG, fuel oil, kerosene, electricity, bread, and water were increased according to the table below:

Table 1: List of commodities and corresponding price changes

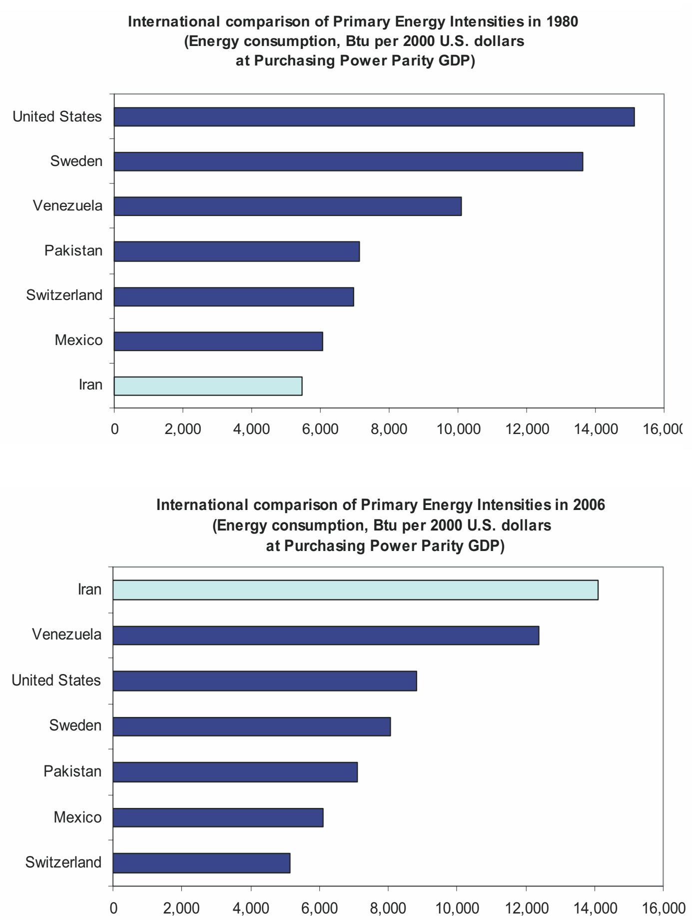
Commodity	Price before increase	Price after increase	Initial* change in consumption	Explanation
Gasoline	10 cents/liter, 40 cents/liter (beyond the quota of 60 liters/month)	40 cents/liter; 70 cents/liter (beyond the quota of 60 liters/month)	-5%	Taxis, ambulances, and other public service cars received a higher quota
Gas oil	1.5 cents/liter	15 cents/liter, 35 cents/liter on the open market	-29%	Vehicles active in public transportation will receive an extra quota
Natural gas	1-1.3 cents/m^3 for households and 0.5 cents/m^3 for power plants	On average 7 cents/m^3 for households and industry and 8 cents/m^3 for power plants	-6.5%	Prices vary according to the regional climate and level of consumption
LPG	Free (only a small fee for testing the cylinders)	10 cents/liter	N/A	
CNG	4 cents/m^3	30 cents/m^3	N/A	
Fuel oil	1 cent/liter	20 cents/liter	N/A	
Kerosene	1.5 cents/liter	10 cents/liter	N/A	
Electricity	On average 1.7 cents/kWh for households	On average 4.5 cents/kWh for households and 4 cents/kWh for industry	-11%	Prices vary according to the regional climate and level of consumption
Bread	Less than 1 cent/Kg of wheat flour	28 cents/Kg of wheat flour		
Water	9 cents/ m^3 for households	25 cents/ m^3 for households	-5%	

* The statistics are based on official statements for the first ten days following price changes

Impacts

The consequences of the implementation of the subsidies reform plan are significant and far-reaching. For years, the Iranian economy has been distorted by low energy prices, which has led to households adopting wasteful lifestyles and manufacturers using highly energy-inefficient production processes. From one of the lowest energy intensity users in the world in 1980, Iran has become one of the major consumers of energy with very high energy intensity. Its consumption puts it ahead of most industrialised countries with high per capita income such as the United States, as depicted in figure 2:

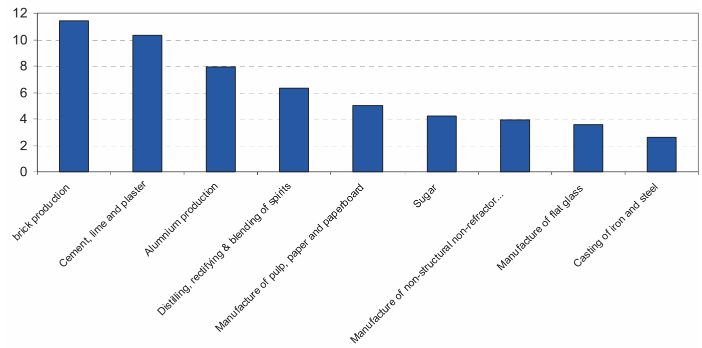
Figure 2: Iran among countries with highest energy intensity



Source: International Energy Annual, 2006

While it is hard to precisely project their mid-term and long-term effects, the reforms are likely to have a multi-faceted impact on households and industry as well as the economy as a whole. First and foremost, the plan aims to increase energy efficiency throughout the economy. Households will probably become more economical in their energy consumption in order to free up more resources for their consumption of other goods and services. Companies will need to improve their energy efficiency by replacing their antiquated production technology and cutting their energy costs. This is especially important for energy-intensive industries such as cement and aluminum as depicted in figure 3:

Figure 3: Energy share in output for different industries in Iran (%)



Another important consequence of the reforms is the direct and indirect increases in production costs. This can potentially lead to an increase in the price levels or a reduction of the profit margin, given that companies will try to either increase the price of their products and services or to keep their prices constant at the cost of a decrease in their profitability. The key concern with the subsidies reform plan lies here, in that the government has so far taken every measure to ensure that the price levels will remain unchanged. This is in order to protect the welfare of the population and control the potential fallout from the deterioration of household's purchasing power. This has put extra pressure on producers. The government has introduced a number of measures to help industry, such as low cost loans for the improvement of production lines and processes. However, another element of such pressure on producers is the unchanged exchange regime of the Central Bank, which puts imported products at an advantage by failing to compensate for the relative increase in production costs of domestic producers.

While the long term benefits of the plan in improving the efficiency and competitiveness of the Iranian economy are widely acknowledged, the short term inflationary impacts cannot be ignored. Setting aside the direct price increases, the cash payments to households are likely to generate significant demand for consumer goods and services, which could lead to further price increases. So far, the government has paid out approximately $4.8 billion to households for two months. Assuming a steady payment stream, this will amount to $30 billion per annum. The government is strongly encouraging households to save and invest the cash handouts, rather than spending it on consumer goods, and has indicated that it will introduce incentives such as preferential interest rates on bank deposits.

There are significant differences between the estimates by domestic and international authorities on the inflationary impact of the reforms. Domestic estimates before the plan's launch ranged between 15 to 70%, whereas the IMF, for example, estimates that inflation will increase to slightly above 20% over the current inflation level in 2011, while it will fall to 5% above the current level in 2012 (it should be noted that the current 12 month average is 10.1%). At a minimum, an overall 10% of additional inflation is expected, based on a 15% price increase in food, a 290% increase in utilities, and a 15% increase in the transportation costs of households. This estimate excludes the effect of an increase in liquidity and the demand pressure for goods and services.

Overall, the removal of subsidies will lead to increased inflation and lower profitability for industry in the short to medium term. However, it will undoubtedly yield major benefits for the economy as a whole in the longer term.

The dismissal of Iran's Foreign Minister by the President and the debate over the Central Bank's governance will be discussed in this edition of Country Overview.

On 13th December, Manouchehr Mottaki, Iran's Foreign Minister, was dismissed from his role during an official trip to Africa via an unexpected letter from President Ahmadinejad. Mottaki had travelled to Senegal in order to develop mutual economic ties with West African countries.

Mottaki was appointed as Iran's Foreign Minister by President Ahmadinejad in 2005. Mottaki's career evolved from serving as a parliamentary member to becoming Foreign Minister. Mottaki has been perceived as having close ties with the conservatives including Ali Larijani, the Speaker of the parliament. Before the 2005 presidential elections, Mr. Mottaki was part of Larijani's campaign and this had allegedly resulted in a certain amount of distrust from President Ahmadinejad. Mottaki's appointment as Foreign Minister is said to have been supported by the Supreme Leader Ayatollah Khamenei.

The relationship between Ahmadinejad and Mottaki has been described as occasionally turbulent over the past 5 years. However, tensions reached their peak earlier this year, when Ahmadinejad appointed personal special envoys to the neighbouring regions. Ahmadinejad's decision resulted in dismay from the foreign ministry and criticism from the parliament. Both argued that these appointments would cause duality and conflict in Iran's diplomatic and foreign policies, and Mottaki even went so far as to threaten to resign. Ahmadinejad's appointments were eventually reversed as a result of intervention from the Supreme Leader.

Mottaki's dismissal came at a time when Iran is planning to hold another round of negotiations with the West in Istanbul over its nuclear programme. Unsurprisingly, Mottaki's dismissal was not welcomed by the conservative camp. For some, the manner in which he was dismissed was considered insulting. Shortly after the dismissal, Akbar Salehi, head of the Atomic Energy Organisation of Iran (AEOI), was introduced as the acting Foreign Minister in a ceremony at which Mottaki was absent. During the ceremony, Rahimi, the Vice President, claimed that the change had been communicated to Mottaki prior to his visit to Senegal. Mottaki, however, strongly rejected this claim.

The general consensus is that Salehi will probably be proposed to the parliament as the permanent Foreign Minister. However, it is not clear whether he will also retain his position as the head of AEOI. Salehi will likely represent Iran during the Istanbul talks in January. During his inauguration ceremony, Salehi stated that his top priority in regards to Iran's foreign policy will be confidence-building. Experts are waiting to see whether there will be any significant changes in Iran's foreign policy, following Salehi's appointment.

In December, the parliament passed a bill which introduces a number of structural changes to the monetary policy making process in Iran. The bill was deemed by the parliament to be a major step towards granting independence to the Central Bank. According to the bill, three key changes to the governance and the operations of the Central Bank were to be implemented. Firstly, the general assembly of the Bank, which currently consists of 5 government officials, would be increased to 11 members; these would consist of 3 government officials, 7 senior economists and the head of Iran's Chamber of Commerce. Additionally, the President would be removed as the Chairman of the assembly. Secondly, the governor of the Central Bank would be selected by the general assembly and endorsed by the President. Currently, the governor is appointed by the President. Thirdly, the structure of the Monetary and Credit Council (which sets out high level monetary policies and directions) would move from being state-dominated to one where the private sector has greater say in the decision making process.

President Ahmadinejad and his cabinet unanimously opposed the bill, arguing that the new bill would hamper the government's ability to oversee the economy. The bill was also rejected by the Guardian Council (which has to endorse every parliamentary-approved bill before it becomes enforceable). The Guardian Council argued that the new bill is in conflict with the Iranian Constitution and that the governance of the Central Bank should ultimately rest with the government.

Given the strong pressure from the government and the Guardian Council's disapproval, the parliament retracted the proposed changes to the general assembly of the Central Bank. It also proposed that the Bank's governor should be nominated by the President and approved by the parliament. However, it insisted on the proposed restructuring of the Monetary and Credit Council. The revised bill was once again rejected by the Guardian Council. Eventually, the bill was referred to the Expediency Council (which acts as an arbitrator and also a policy maker, in the cases of dispute between the parliament and the Guardian Council). The decision of the Expediency Council is not expected until mid-February. Some experts believe that the view of the Expediency Council is likely to be closer to that of the parliament.

New Investments in Iran's Railways

In December, the Road and Transportation Ministry announced that $21.5 billion has been committed by the government for the construction of 14 new railway lines in Iran. The newly approved fifth development plan states that the government is to invest the sum of $8 billion per annum in the development of the country's railway network. According to the ministry, these investments are to be allocated towards the construction of new and the restoration of old railway infrastructure, as well as the application of new technology.

The new developments will be in line with the targets set in the 20 year outlook plan, which commenced in 2005. According to this plan, Iran's railway lines are to reach 25,000 kilometres by the year 2025. This means that approximately 1,000 kilometres of railway lines should be constructed annually. Government officials have stated that Iran has signed a number of contracts with China for the development of 5,000 kilometres of railway lines and that a joint office has been established to coordinate this.

Liberalisation of Insurance Premiums

In December, Central Insurance of Iran (CII), the insurance industry regulator, announced that further liberalisations in insurance premiums will take place next year. Liberalisations will take place in industrial fire insurance, transportation and money transfer insurance. It was added that premiums on third party car insurance and life insurance products will also be liberalised over the next 2-3 years.

Historically, Iran's insurance industry has been very much controlled by state-owned companies. However, over the past few years, many privately owned companies have appeared and 3 state-owned companies have been privatised. CII is currently in the process of implementing some deregulation within the industry and migrating from a tariff-based regulation regime to a prudential-based one, which is in line with the internationally accepted standards such as the Solvency regime.

Currently, third party car insurance comprises 44% of the total insurance industry in terms of premiums generated. Third party is also the most tightly regulated stream of insurance and premiums are set by CII. There are differing views as to what the impact of premium liberalisation on this sector would be. On the one hand, premiums have remained relatively flat for a number of years, while payouts have increased dramatically because of increased costs. As a result, third party car insurance has become a loss making business for most insurance companies. This means that post liberalisation; there would be a tendency for companies to increase premiums. However, on the other hand, the car insurance sector in Iran has become highly competitive and companies are likely to reduce premiums in order to gain market share. CII has indicated that a complete liberalisation of premiums cannot take place until all insurance companies have developed appropriate risk calculation systems.

Inauguration of Kish Stock Exchange

In December, a new stock exchange in the Island of Kish, located in the Persian Gulf, was inaugurated. This comes as part of a major initiative for the development and expansion of the Iranian capital market. The Kish Stock Exchange has been established with the aim of providing an alternative opportunity for listing and raising capital for companies and also helping to attract foreign investment.

Kish Island is a free trade zone and therefore offers many amenities to businesses and investors. It offers a 15 year tax exemption and permits 100% ownership of businesses for foreign investors. In addition, Kish has a more flexible monetary and banking regime and provides investors with various legal guarantees and protection.

In addition to the newly incorporated Kish Stock Exchange, Iran's petroleum exchange is also located on this island. The petroleum exchange was established in 2008, and enables both domestic and also foreign traders to carry out their transactions in a number of currencies including Iranian Rial, Yen and Euro.

Iran's First Micro Hybrid Car

In December, Iran Khodro Co. (IKCO), the Middle East's largest car manufacturer, announced that it will be producing Iran's first micro hybrid car in the next month. The micro hybrid technology shuts off the engine when the car stops and restarts the engine when the driver accelerates. According to IKCO, this new technology could lead to a 10% reduction in fuel consumption and a 20% reduction in fuel emission.

The micro hybrid system is to be integrated into IKCO's Samand brand at production level. This comes in line with IKCO's 10 year strategy to produce more environmentally friendly vehicles. In recent years, car manufacturers in Iran have been strongly criticised for producing inefficient vehicles. They have even been held responsible by environmental activists for the high levels of pollution in Tehran and several other major cities.

CORRECTION NOTICE: Following publication of the 'Iran's Pharmaceutical Industry' article of December's edition, it came to light that the US Dollar figures quoted in this article were incorrect by a multiple of ten and these have since been corrected and republished on our website. For example, the article stated "$30.8 billion worth of drugs and medical products were consumed in Iran ". This figure has now been corrected to $3.1 billion. We apologise for any inconveniences caused.

About Turquoise

Turquoise is a boutique investment firm based in Iran with offices in Tehran and London. Turquoise creates financial products and offers financial services to select clients and investors who are interested in the Iranian market. Having a qualified and diverse management team based both in Europe and in Iran enables Turquoise to benefit from coupling local knowledge and presence with global expertise.

Turquoise publishes this electronic newsletter, *Iran Investment Monthly*, with the aim of keeping its recipients updated on the latest macroeconomic developments in Iran, providing an in-depth analysis of the Tehran Stock Exchange as well as introducing new financial products and private equity opportunities to potential investors.

Iran Investment Monthly is distributed exclusively amongst Iran analysts and potential investors who have worked closely or have been in contact with Turquoise Partners. Subscription to this newsletter is by referral only or through an online request sent to: ramin.rabii@turquoisepartners.com

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