FOCUS ON
Iran, Recovering Lost Time

Produced by the Economic Analysis and Research

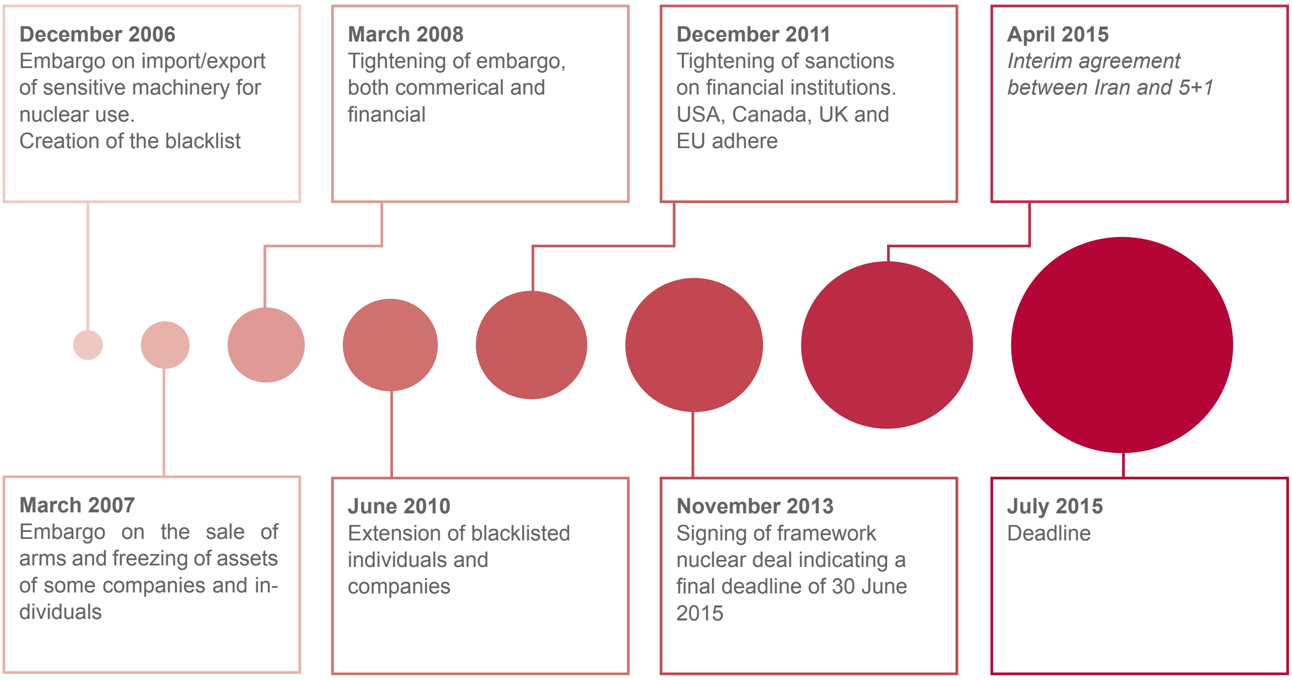
EXECUTIVE SUMMARY

- ***The withdrawal of the current sanctions might, in fact, lead to an increase in Italian exports to that country of almost € 3 billion in the next four years.***
- *Although the tightening of sanctions at the end of 2011 significantly reduced trade between our country and Iran, Italy is still one of the country's principal trading partners.*
- ***Regaining the market shares lost in Iran will be no easy matter****, considering that competitors such as China, India, Russia and Brazil have been subject to fewer restrictions in recent years and have gained important positions within the country.*
- *The sectors offering the best opportunities will be oil&gas, automotive, defense, transport, real estate and all construction-related sectors in general.*
- *The country presents a series of competitive advantages but also a series of risks that Italian companies cannot and must not overlook, not least of which is the system of sanctions still in place.*

NINE YEARS OF SANCTIONS

After months of negotiations (Chart 1) an agreement was reached between Iran and the group of “5+1” (United States, Russia, China, United Kingdom, France + Germany) The agreement provides for the freezing of all sanctions within the year. The sanctions against Tehran have caused a decline in trade between Iran and the rest of the world, though to different degrees between the various partners.

CHART 1. *The course of sanctions Iran*



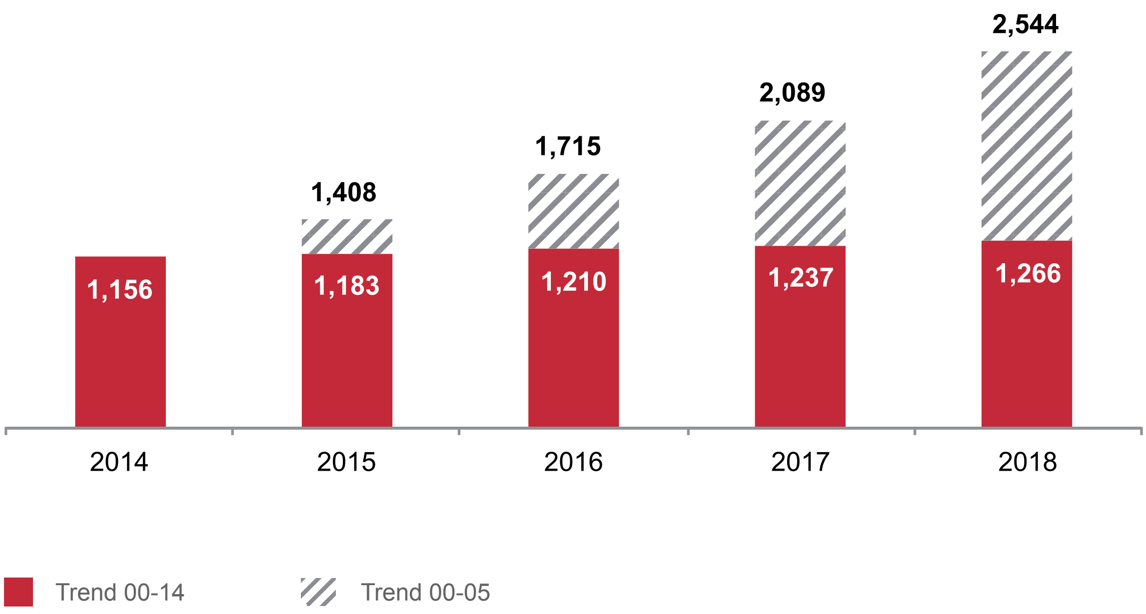
Source: SACE

The agreement of July 14th [01] comes as a consequence of a framework agreement between the 5+1 and Iran in April 2015 calling for the gradual, monitored cancellation of the sanctions and reduction of two-thirds of Iran’s uranium enrichment capacity, controlled by the international inspectors of the International Atomic Energy Agency (IAEA). The agreement, whose details have not yet been disclosed, provides for a freeze on sanctions within one year, with the possibility to restore them within 65 days in case of violations by the Iranian side. In order to enter in force, the agreement will require the approval of the US Congress and Legislative Assembly of Iran, and also a new resolution of the UN Security Council. The end of sanctions will be agreed during the operational phase of the agreement. In exchange, Tehran will accept the possibility of UN inspections in all Iranian nuclear sites, including military ones.

[01] *The deadline for reaching the agreement was postponed twice in a row, originally was set at June 30th and then postponed to July 7th, before concluding on July 14th*

ITALY-IRAN EXPORTS: A POSSIBLE NEW START

SACE believes the sanctions could be gradually removed. The removal of sanctions **might result in a € 3 billion increase in Italian exports to the country in the 2015-2018 period.** If Italian exports could repeat growth like that in the pre-sanctions period (2000-2005), the level of exports could exceed € 2.5 billion in 2018 (Chart 2)[02], returning to a level just above the pre-sanctions peak reached in 2005.



Source: ISTAT; processing by the SACE Research Office

But starting from an artificially low level due to the sanctions, it is likely that, if the sanctions are totally eliminated, the statistical series could rocket upward, with significant annual increases in percentage terms, potentially even greater that those registered in the "golden period" of 2000-2005.

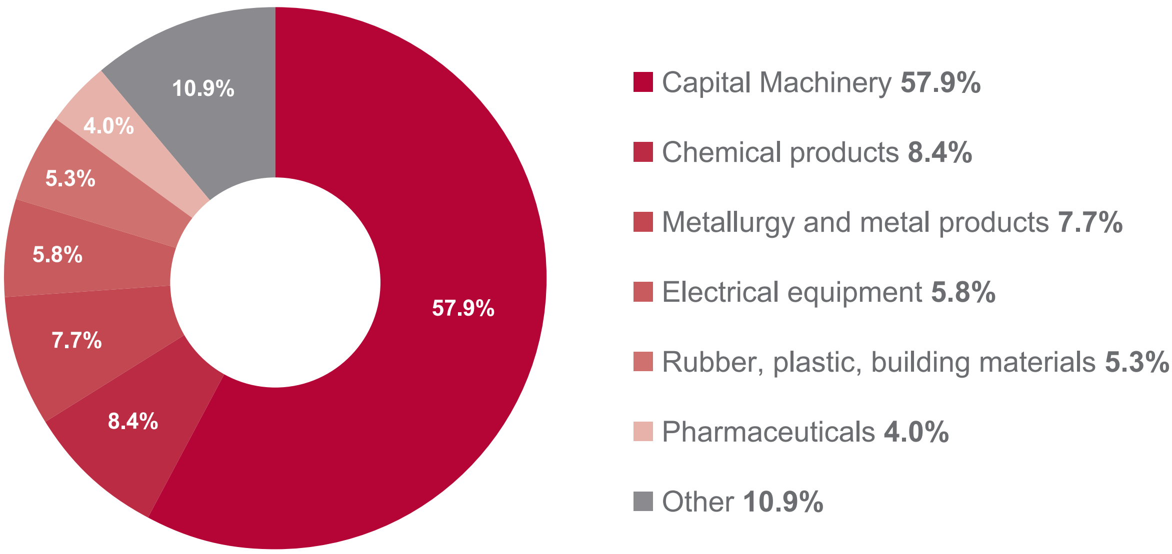
The potential short-term recovery of € 3 billion is still a marginal gain compared to what the Italian system has lost during the sanction period. **Without the sanctions, in fact, Italy might have scored € 17 billion in additional exports in the period 2006-2018**[03].

[02] *This estimate was found by applying the cumulative annual growth rate in the two reference periods (2000-2014 vs. 2000-2005) to the level of Italian exports registered in 2014*

[03] *See the Focus On SACE "Iran - sanctions, Italian exports and prospects"*

The most significant impact came at the end of 2011, when a tightening of the sanctions caused the fall of Italian-Iranian trade from € 7.2 billion to € 1.6 billion in 2014. **The composition of exports to the country has remained stable** with mechanical engineering remaining the lead sector, accounting for 58% in 2014 (Chart 3).

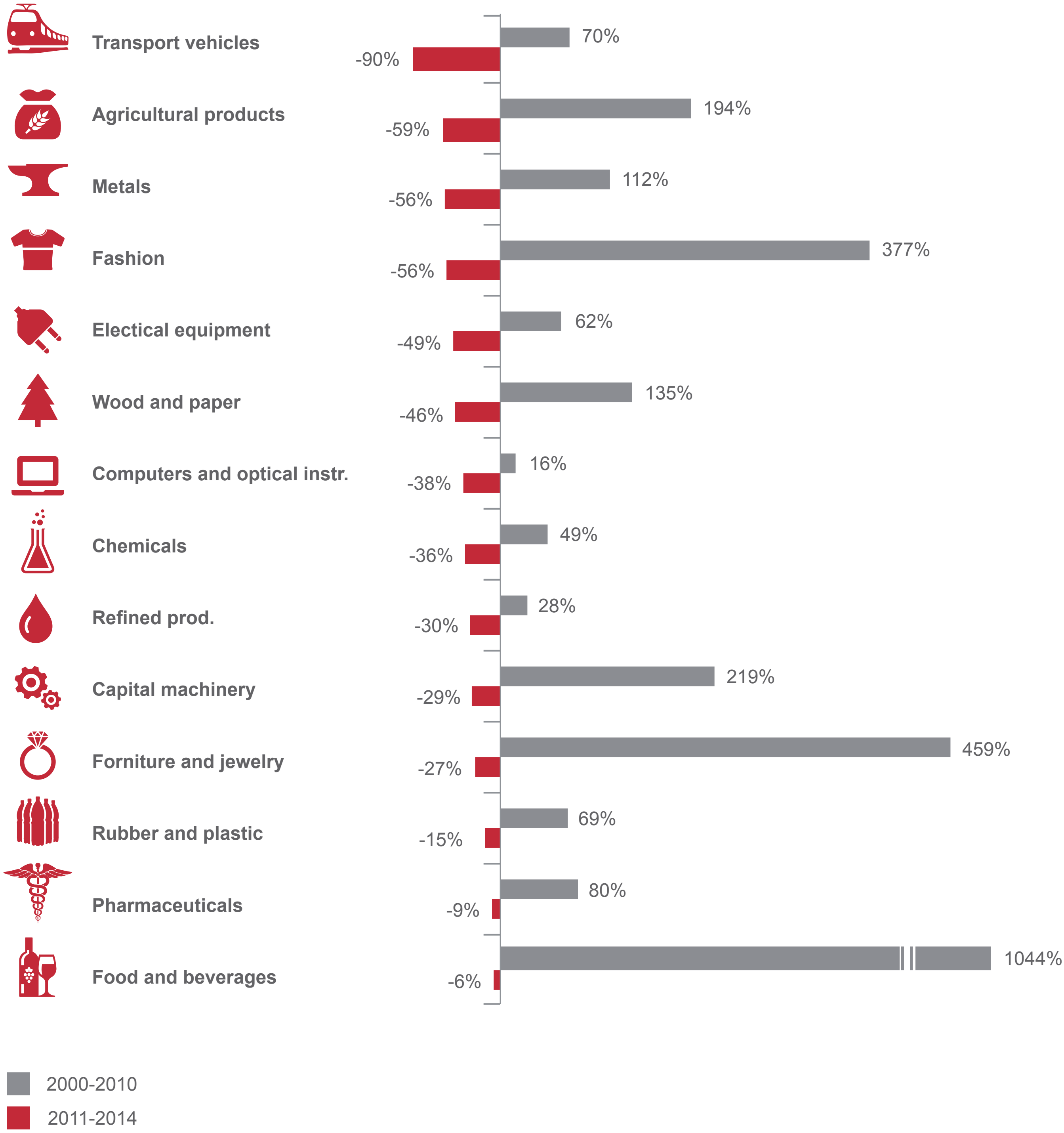
CHART 3. *Composition of Italian exports (in % of the 2014 total)*



Source: ISTAT; processing by the SACE Research Office

Mechanical engineering has, in fact, been the sector most affected: the annual value of goods sold was halved from € 1.3 billion in 2010 to less than € 700 million today. In any case, all the principal sectors of Italian exports showed sharp declines over the past five years (Chart 4): transport vehicles, and agricultural and metallurgical products are those that have suffered the heaviest reductions. The food sector abruptly halted the strong growth trend it had registered in the pre-sanctions period.

CHART 4. *Italian exports by sector (% chg.)*



Source: ISTAT; processing by the SACE Research Office

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WHERE TO DIRECT THE RECOVERY EFFORT

Italy has dropped several places since 2006 but is still the no. 9 exporter to Iran. Regaining the lost market share will not be easy, considering that competitors like China, India, Russia and Brazil have been subject to much lighter restrictions in recent years and have gain important positions within the country.

The reopening of trade with Tehran would undoubtedly produce an immediate advantage for the petroleum sector, the one hardest hit by the international sanctions and the one requiring the greatest investments. Since 2011, Iran's petroleum exports have been halved (from 2.6 to 1.4 million barrels/day). Demand from just the EU has declined by almost 600 million b/d. The volume reductions, funneled to the eastern markets due to the western embargo, and the need to preserve social consensus with public expenditures, helped keep the breakeven price well above $ 100/barrel. The reopening of trade might therefore resuscitate the country's finances, but the current glut of crude on the planet dispels any encouraging forecasts in terms of additional supply. For the medium-long term, however, the country must bring its industry and infrastructure up to adequate levels: the contribution of new technology such as valves, connectors and structures for domestic petroleum processing will be fundamental.

The second sector of opportunity, after oil&gas, is automotive. Iran was a market with 1.5 million vehicle registrations a year before the sanctions were increased in 2011, but now a return to above 2 million units/year is expected if the sanctions are lifted. This is especially true because 14 million old vehicles in circulation will need to be replaced. Leading the return to the country will be PSA and Renault of France, already present with local JVs.

Another strong sector with be the military. The army has weapons dating from Soviet Union days and requires new, more powerful equipment, also considering the regional power role the country is acquiring. Here Russia and China will be strong competitors, partly considering the limits imposed on the western powers by the Arab countries, currently the most active customers in the sector.

Transport also offers good prospects for demand. The sanctions that prevent Iran from purchasing western aircraft since the '70s have are partly responsible for an antiquated, low-quality air fleet. Iran has announced that once the sanctions are lifted, it will begin renewing its fleet with the purchase of 400 aircraft. The same applies to trains and railways. Several British and French manufacturers are at the door with proposals to expand and renew the Iranian rail network.

The sharp demographic growth (there are currently 77 million inhabitants in Iran, expected to rise to 100 million by 2050) **will require adequate housing, both popular and luxury, as well as commercial structures, hotels and offices.** There are numerous fast-developing centers: Isfahan, Shiraz, Mashhad, Tabriz, Yazd and Hamadan, in addition to the capital Tehran. From this standpoint, excellent performance is also expected from building materials and marble and granite processing, raw materials in which the country is rich.

Besides the demand for housing, there is also a growing sensitivity toward new trends in design, especially among Iran's elite. **There are good prospects for the furniture sector, for lighting units, bathroom and kitchen accessories, wood laminates, glass coverings, stairs, windows and doors, ant-seismic materials and boilers.**

OPPORTUNITIES AND RISKS OF INVESTING IN IRAN

Besides an attraction for Italian goods, Iran also offers excellent opportunities for those wishing to invest in that country. The principal advantages for investors are:

- The labor force **is competitive in terms of qualifications and cost.** The average educational level in the country is high (4 million university students, 700,000 degrees each year, half of them in science and engineering) against average wages of **$ 330/month** and relatively favorable employment conditions for employers[04].

- **Significant tax facilitations for foreign investors.** The country has 14 economic zones and 7 free trade zones where foreign investors can enjoy tax exemptions for a period of 20 years, complete freedom in the movement of capital and profits, and no import duties.

- The **demographic potential:** the country is heavily populated with around half of the inhabitants under 30 and a pro capita GDP half that of Italy[05]. This is an important factor from the standpoint of the labor market and the commercial potential of this segment of the population.

[04] *Source: Unioncamere*

[05] *Source: IMP GDP pro capita PPP 2014 Italy: € 35,811 Iran: $ 17,140*

There are some negative factors, but they can be adequately managed with the assistance of people thoroughly acquainted with the local context.

- **The business climate in the country still presents some limitations, despite the improvements**, particularly for starting up production activities, the formalities of title registration, and for obtaining building permits.

- The activities of companies that establish in Iran may be hindered by **widespread corruption** and the **heavy role the state plays** in the various production segments. The principal banks and large public and semi-public companies dominate entire production and commercial sectors of the country, leaving little room for new players approaching the market.

- In addition to the state, **an important economic role is played by the *Pasdaran***, or Revolutionary Guards. Their presence ranges from energy to petrochemicals, from automobiles to laser surgery clinics, from infrastructure to the defense industry, as well as interests in Iran's financial system.

- There are still **high customs barriers** in Iran, particularly where there is local production to protect. This situation is found primarily with consumer goods in general and durable goods in particular. The duties on food products, for example, may be as high as 65%.

- Lastly, we would point out that **the sanctions against the country remain frozen** pending the achievement of a definitive abolition. Companies must be careful to operate in full compliance with the laws and regulations.

CONCLUSIONS

The gradual lifting of international sanctions will revive and revitalize an economy that has been in recession for two years. **Opportunities should be sought in sectors like oil&gas, transport, residential construction, major public works, defense and tourism.**

But companies should bear in mind that, along with these opportunities, they should carefully weigh the risks of doing business in that country. The principal risks: widespread corruption, bureaucracy, high customs barriers, and the timetable that will be decided for eliminating the sanctions in effect.

Last, but not least, companies should be aware of the risks of nonpayment, sometimes due to delays in the availability of currency, at least until the country has fully rejoined the international financial community.

It is precisely in this context of significant, tangible opportunities characterized by substantial risk that the instruments provided by SACE may make the difference for Italian companies interested in Iran: from classic credit insurance instruments for exporters to more innovative **financial instruments** for those who decide to invest directly in the country. And through our advisory services, companies can access the information and experience SACE has gained during long years of relations with Iran.

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