



# Why Mongolia must master its reticence in resources

**The commodity-rich country should have Asia's fastest growing economy, but major mines discovered a decade ago still have no investment agreements in place. The sheer size of the potential windfall has impeded progress, amid laborious revisions to the mining law. Now the government has pledged to step in and negotiate the big projects, but investors are not holding their breath. Chris Wright reports.**

You had to go a long way in September to find anyone who thought it was a good idea to launch a US\$300 million debt programme. Specifically, you had to go to an upstairs side-room of the State Palace in Ulaanbaatar, Mongolia. In world capital market terms, you can't get much further off the beaten track than that.

Here, on September 10, Khan Bank chief executive J. Peter Morrow announced that his bank was growing so aggressively and successfully that it needed international funding to keep up. And if that seemed a contrarian sentiment at the time – this was the week that Lehman Brothers' share price began its final plunge towards bankruptcy – then Morrow certainly wasn't alone.

The following day ING, the sole lead on the global medium-term-note (MTN) programme for Khan Bank, formally opened its first office in Ulaanbaatar. And that night, crowds of foreign bankers and investors were treated to a show of contortionists and throat singers at a party celebrating the launch of a whole new Mongolian investment bank, by Eurasia Capital Management, which earlier this year launched a Mongolia-dedicated fund.

To judge the mood in Ulaanbaatar, it was as if nobody had heard of the credit crunch or the crisis on Wall Street. So what's so special about Mongolia?

Chiefly, the fascination with the country comes down to mining. Although the commodities boom has flagged recently, the last few years have been a very good time to be a quarry for the world. Mongolia has commodities in abundance: 100 billion tonnes of coal reserves (ranked fifth in the world, and with the largest reserves of

coking coal), 1.5 billion barrels of oil reserves, 8% of the world's potential copper, and plentiful gold, silver, uranium and other minerals.

This bounty prompts Tim Condon, ING's chief economist and head of research for Asia, to note: "Mongolia's rich resource endowment should make it Asia's fastest growing economy."

It's already right up there (see chart on next page). GDP growth was 8.4% between 2002 and 2006, 9.9% in 2007, and 10.2% in the first half of 2008. Even allowing for a slow-down in the second half, the official growth forecast for 2008 is 8.7%. That, notes Randolph Koppa, president of the Trade and Development Bank of Mongolia, "is now on par with Asia's strongest: China, India and Vietnam."

## **NATURAL ADVANTAGE**

But has Mongolia blown the advantage of its natural resources? These opportunities have been well known to foreign investors for years, yet the biggest mines look no closer to getting underway than they did then. Take Oyu Tolgoi, which ought to be the poster-child of Mongolian mining.

Discovered in 2001, it is being developed by Ivanhoe Mines and Rio Tinto in the south Gobi desert, and when completed is expected to produce an average of a billion pounds [lbs] of copper and 330,000 ounces of gold per year over 35 years. Peak production rates, reached about six years after initial production, would be higher still, creating one of the world's largest copper and gold producers.

The impact of Oyu Tolgoi on a small economy should be extraordinary. It is expected to be a US\$4 billion build-out taking place over 25

months, suggesting spending of US\$160 million a month; it's likely to involve 10,000 people, with a permanent staff of 5,000 when the mine is built, most of them Mongolian.

Ivanhoe has stated that the mine should produce an average increase of 34.3% in Mongolia's real GDP up to 2043, as well as an average increase in nationwide employment levels of 10.3%, nationwide real per capita disposable income of 11.5%, and a total contribution of US\$7.9 billion to the government. Quite what those figures would end up being depends in part on the final negotiated agreement.

And Oyu Tolgoi is not the only mine: there is Tavan Tolgoi, a US\$2 billion project to mine the world's biggest coking coal deposit, and a number of smaller projects.

Yet getting on for a decade after their discovery, the investment agreements to get them going beyond the exploration stage are still not in place. The problem is, the sheer scale of the potential windfall to Mongolia has prevented it from ever being realised, so severe are the consequences of botching the mining agreements. Before anything can move forward, revisions have to be passed to Mongolia's mining law, which is designed to ensure that the state participates in the benefits of its own minerals.

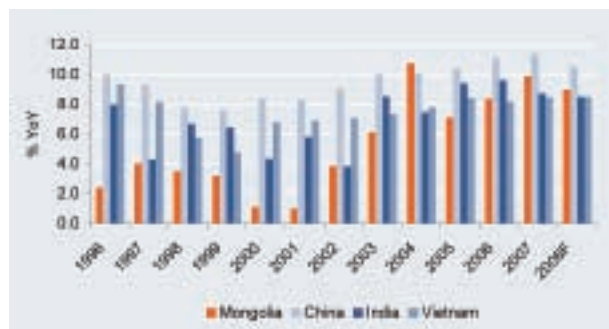
In April, it appeared that Mongolia's parliament was about to pass a series of amendments (see box on page 61), but they could not be pushed through before elections in June, and after that, things appeared to take a considerable turn for the worse. Riots accompanied the June 29 election, killing five and injuring hundreds; key government buildings in the centre of Ulaanbaatar were still burnt-out shells during *Asiamoney's* visit three months later.

Still, the election eventually put in place a coalition between the Mongolian People's Revolutionary Party and Mongolian Democratic Party, both of which support the idea of mining law revisions and an investment agreement for Oyu Tolgoi.

So in the aftermath of the violence, optimism returned. A working group was established to report to parliament on November 15 and this, it was hoped, would be the point when the revisions finally got through.

However, as the interview with Mongolia's president, Nambaryn Enkhbayar, on page 60 shows, even this is going to be time-consuming, and the amendments seem no closer.

## MONGOLIA'S REAL GDP GROWTH



SOURCE: ASIAN DEVELOPMENT BANK; CEIC; ING FORECASTS

## MISSING THE BOAT

One can see why Mongolia wants to get it right: even now, mining accounts for more than 40% of government revenues, and in 2007 accounted for 67% of the US\$500 million in foreign direct investment. Oyu Tolgoi and others would increase the contribution dramatically.

But has Mongolia already missed the boat? The climate for commodities is worsening by the day. Cost projections are rising at Oyu Tolgoi, at the same time that financing is becoming harder. Copper was trading at US\$4 per pound earlier this year; it was at US\$1.50 in early December.

Some of the mining companies, exasperated by delays, have suggested that Mongolia has lost out through its reticence. One is Entrée Gold, which wants to develop a copper and gold project not far from Oyu Tolgoi.

"There is an increasing realisation in Mongolia that they've missed out on an extraordinary [resource] boom and that, if they're not going to miss out altogether, they're going to have to get their skates on," its director and deputy chairman, Michael Howard, the former UK conservative party leader, said in early November.

International fund managers remain guarded. "There have been rumours now for several months about an agreement on ownership levels for these [Mongolian mining] assets," says Evy Hambro at Blackrock in London, who heads arguably the most well-known mining fund management team in the world. "But we've been disappointed in the past and there is every expectation we might be again."

## GROWING BANKING SECTOR

Few nations have seen such a dramatic shift in their banking sector in the last decade as Mongolia. In the early 1990s there was only one bank, the State Bank of Mongolia, which was then broken up into numerous others, all of which failed.

In 2000, when the World Bank came in to help with the restructuring of the banking system, the combined national banking industry was about US\$175 million in size. Today it's almost 20 times bigger.

One person who has seen this change first hand is J. Peter Morrow, who was part of that World Bank team in 2000 and subsequently became CEO of the country's leading bank, Khan Bank (which has its roots in Agricultural Cooperative Bank of Mongolia, formed from that 1991 State Bank break-up but in receivership by 1999).

"Since the system was started again, you'd have to say it's been hugely successful," he says. "There's been growth on average of 15% a year in loans and deposits, problem loans are below 5%, and with the terrific economy in the last eight years the banks have had the profits and reinvestments to build their businesses."

At Khan Bank itself, recent loan growth has been around 70% compounded in loans, and 55% in deposits – a gap that led it to launch the MTN programme described in the main article.

"We're at a stage of development in Mongolia where it's small but growing very rapidly, where internal capital formation cannot keep up with the demand for capital. International funding becomes critical to fill that gap [between loans and deposits], and fill it in a way that is often cheaper than domestic sources of funds, and for longer terms."

Morrow describes the regulatory environment as excellent, with banking laws and regulations that look much like those in western countries, and a system that follows Basel 1 and will switch to Basel 2. The central bank, the Bank of Mongolia (known locally as Mongolbank), has "talented people and is a liberal, favourable, free market banking environment with effective regulation".

But even here, the credit crunch seems to be encroaching. In October Mongolia's cabinet authorised a US\$500 million capital injection into the country's commercial banks, but isn't going to give it until it's needed. But it's for different reasons than elsewhere in the world.

Mongolia's banks still meet the country's prudential requirements, according to the central bank, and bad loans are understood to be below 3% on an industry-wide basis. Instead, the concerns are about a lack of liquidity in mortgage lending. ▲

# Why Mongolia sees a need for speed

**Asiamoney [AM]:** *There has been a lot of talk about progress on Mongolia's mining law. Where do things stand and has there been any progress?*

**Nambaryn Enkhbayar, president of Mongolia [NE]:** The situation now is there are two ways for us to proceed.

One is to set up a working group to update the existing mining legislation, which is being done with parliament. But we see now that it will take some time for all the members of parliament to get into the substance of the law and try to figure out how to make these amendments.

While keeping on doing that I think to save time we need to try and work on several projects one by one. And we will work with interested partners to work on a BOT [build-operate-transfer] project or an OT [operate-transfer] project or other mining projects. That way would be much faster and would bring good results. So this is the second option we are studying.

**AM:** *Will that case-by-case basis help things to progress? Isn't there a desire for foreign companies to have full control over mining operations?*

**NE:** There is, I think, some confusion in the minds of local and foreign investors. The law says that with strategic deposits, if that deposit was discovered by a geological survey financed and conducted by the government, then up to

50% [could be taken by the government], whereas if the survey was financed by foreign investors, up to 34% of that deposit could be taken by Mongolian government.

But there was debate in society when prices for commodities were very high and a lot of radio [stations] criticised the legislation. [They said] all strategic deposits should be taken over 50% by the government.

The working group is now in parliament. But it may not be necessary for us to wait until legislation gets amended. Maybe it's better to use the existing legislation and based on this we'll have to go on a case-by-case basis to develop those projects.

**AM:** *How will that speed things up, given that there have already been major delays under the existing law?*

**NE:** Because before there was no consensus in society. The financial crisis touched us in the way that society has become more pragmatic. Emotions were very high because the copper price was US\$8,000 at the time. Then [the feeling was that] Mongolians should take hold of everything.

Now there is the reality of seeing that copper prices have fallen to US\$3,000 or US\$4,000. People are getting to realise that high prices will not be there forever. So to attract investment you have to be more realistic. I think people will understand that we have to go one by one and try to find the best solution [for] separate purchases.

**AM:** *How much progress is there on that case-by-case basis?*

**NE:** The structure started this Friday [November 28]. Tomorrow [December 4] we are going to give this information to possible investors and financial institutions to see what ideas they have about how to go one by one.

**AM:** *How does that impact the mega-mining projects already there? Can you agree on those on a one-by-one basis?*

**NE:** Yes. It's difficult to compare coal with copper when we need to negotiate separately copper and coal [operations], and copper and gold, and uranium or zinc.

Before the end of this year we will make a start negotiating, right after Christmas or at the beginning of the next year. Hopefully in the first half of the next year we will be able to see the results and sign the documents.

If the [financial] crisis takes two years [to pass], then maybe it's time [enough] for investors to build the facilities, the roads, railroads, power plants and mines. And they will be

able to produce and by that time we hope the prices will have gone up again.

**AM:** *Are there any specific goals you have for the coming year?*

**NE:** We think that at least two big projects like Olyu Tolgoi copper and gold mine and Tavan Tolgoi coking coal purchase could be signed. There is a lot of demand from Russia and Japan and Korea to start uranium projects. Maybe we have to go forward – and France also – to work together on the uranium projects, so we hope that also iron ore projects will be signed.

So it will be China, Russia, the US, Japan and Korea. Mainly companies [from these countries] are expressing interest in developing those projects.

**AM:** *Have falling commodity prices impacted your budget expenditure plans?*

**NE:** Yes. In today's world performance is based not only on what mistakes you have made but on what opportunities you have lost. Unfortunately in the last couple of years we have not been very successful at developing those big projects, so these are opportunities we have lost. But this was a learning process for the country and for investors.

The budget is not very big. It is about meeting our social obligations – our salaries, pensions and taking care of our education and health systems. But when you talk about economic development we have to focus more on bringing in investment. All those big projects demand investment of billions of US dollars and we can see that the GDP in Mongolia is just about US\$6 billion.

**AM:** *It was a surprise to international observers to see the violence breaking out during the election. What did you learn from this?*

**NE:** We learned that real democracy should be based on two pillars. One is freedom, freedom of expression, freedom of life. On the other side, democracy is also [about] responsibility. You have to fulfil what you have promised to do.

Unfortunately for a number of years we were thinking democracy was just [about] freedom. We were not very responsible to our investors; we were not very responsible to move forward with these projects or fight corruption or other issues. When the violence happened it was a turning point, when society kept its freedom but realised that it should be more responsible.

So a good balance of freedom and responsibility, that's what we need and that will make our democracy more mature and responsible and will bring better results. ▲



**NAMBARYN ENKHBAYAR**  
president of Mongolia.

He adds: “We would look to take exposure to some great assets there, but only when there’s clarity.”

Morrow at Khan takes a different view. “You need to back up and understand that it’s enormous amounts of money,” he says. “Think Kuwait and Brunei in terms of what potentially could happen.

“They don’t want it stolen: these are 70-to-100-year projects, so the decisions that are made today are going to be applicable to their great-grandchildren,” he says. “They don’t want to wake up in a few years and say: we did this wrong and screwed up. But the democratic process is coming, I believe, to a head.”

## INCREASE IN OPTIMISM

Instead, it now appears that the government will not wait for the revisions to get through parliament and will instead negotiate the bigger projects, chiefly Oyu Tolgoi and Tavan Tolgoi, on a one-off basis.

On December 4, Mongolia’s parliament established a deadline of February 1, 2009, for completing a draft agreement for Oyu Tolgoi.

Ivanhoe’s president and CEO, John Macken, welcomed the decision in a statement the following day, and increased the sense of optimism three days later by announcing another high-grade discovery of gold and copper at the mine. It is understood that the government is expected to seek a 34% stake in this agreement.

Even with the mining law unresolved, frontier-spirited investors have started to get footholds in the Mongolia market. Alisher Ali Djuanov, managing partner of Eurasia Capital Management, visited Mongolia for the first time in 2007, with what he describes as “limited expectations”. But he liked what he saw: “An economy in an early stage just about to take off. And apart from being a genuine investment story, it’s a back door to China growth.”

So he came back in January with an idea for a multi-asset fund, and raised US\$5 million of seed capital in three hours.

His Mongolia Discovery Fund, which now has US\$20 million under management, invests in local equities, local property, and private equity-style stakes. Additional investments by his other funds total commitments to Mongolia of US\$30 million.

He hopes to bring the Mongolia fund to a soft close at US\$100 million. And in September he announced the launch of Eurasia Capital Mongolia, a dedicated investment banking and brokerage firm, which should have 20 professionals on board within a year covering capital markets, sales and trading, research and investment management.

“There are incredible opportunities,” he says. “More and more Mongolian companies will raise capital locally, and there will be Mongolian assets which find their way into the international capital markets.”

For him, the mining law amendments will be a “mega trigger”, but not one he has to wait to be pulled before committing to the country. “I have had people ask me why am I going ahead and doing these things now, not waiting for certainty on the mining contracts? But this is a process that is irreversible.”

## OPPORTUNITIES AND HEADWINDS

Djuanov was not the first to see the appeal. Mongolia International Capital Corp. (MICC), the first investment banking group in Mongolia, was set up in 2005 as a venture between local Anod Bank and The Balloch Group, a Beijing and Canada-based investment advisory firm launched in 2001 by Howard Balloch, formerly Canada’s ambassador to China.

Euro-China Group, a Swiss investment firm, bought in to MICC in May 2007. Asia Pacific Investment Partners, an emerging markets-focused investment company founded in 2001, today operates out of offices in England’s Oxford, Hong Kong and Ulaanbaatar; its investment portfolio includes a cashmere producer, Moda Mongolia; Mongolian Properties, founded to help foreign and domestic clients looking to rent or buy properties in Mongolia; and some high-end property developments.

And Frontier Investment & Development Partners, best known for its Cambodia-focused private equity fund, is also reported to be planning to raise a Mongolia fund of up to US\$100 million.

But there are worries too. “The challenge is to avoid boom-bust cycles that have bedevilled previous holders of the top spot,” Condon says. And a truly enormous warning sign hove into view this year as inflation hit 34.9% year-on-year in July. Comparisons with countries such as Vietnam and Kazakhstan, where sudden growth has been impeded or completely derailed by headstrong inflation, are irresistible.

Worse, Mongolia is perhaps even more vulnerable because it is so concentrated. One country – China – accounts for nearly 70% of exports. Commodity exports (minerals) accounted for 36% of 2006 GDP. When commodities boom, Mongolia’s terms of trade increase, which can cause inflation. Commodity volatility doesn’t help in the other direction, either: budget projections were built on an estimate of US\$6,700 a tonne for copper, and it has now fallen below US\$3,500.

Domestically, inflation is driven by imported food prices, since 50% of household income is spent on food and Mongolia is only self-sufficient in meat and dairy products. Petroleum imports have an effect, as do civil servant pay increases. According to the Trade and Development Bank of Mongolia, planned capital expenditures were seven times higher in 2008 than 2005, social welfare six times higher and public wages three times higher.

Still, at an individual level, Mongolians do appear to be getting a progressively better deal. According to the Trade & Development Bank, wages have doubled in the past two years, with monthly average household income up 54% to Tug264,000 (US\$210); unemployment is about 2.8%. House values and car usage are increasing.

It’s true that 30% of the population is considered poor, and much of it is still Nomadic: even in the city, much of the population still live in portable tent dwellings called gers. But this is considered part of the Mongolian opportunity.

Kapper says there is a need for 100,000 housing units in Ulaanbaatar alone, as well as infrastructure and the various mining industry supply-chain requirements. He says US\$5 billion of investments is needed in Ulaanbaatar housing alone – 1.5 times the entire assets of the country’s banking sector – and US\$8 billion for infrastructure.

It seems that the investors who step in to provide it will have to be frontier-spirited, and patient. ▲

## REVISING THE MINING LAW

One of the most controversial elements of the proposed mining revisions was a clause allowing the government to seek a stake of up to 51% in key projects. While miners are generally ready to proceed even on those terms, they would certainly prefer not to.

They’re not just concerned about missing out; they fear that governments will be unable to accompany their stake with capital, requiring the other parties to increase the cash they have to contribute up front relative to their stake.

But the worsening global environment may yet work to the advantage of the mining groups, as Mongolia’s senior politicians appear to be stepping back from the 51% clause (the previous draft, one which never quite made it to a vote, had talked about a more palatable 34%).

*Asiamoney’s* interview with Mongolian president Nambaryn Enkhbayar (on facing page) clearly reflects this, saying that the more realistic views among Mongolians represent “the good side of the financial crisis”. And he says that a change in the law giving Mongolians more than 50% ownership “is not yet done and probably will not be done”.

Investors also hope that revisions might include a change to a contentious windfall tax, which stands at 68% on copper concentrate where the price exceeds a certain level, and is similarly onerous on gold.

But the truth is, foreign companies are likely to accept no end of irksome royalties and tweaks in the amendments. They just want to get started. ▲