

Mongolia's golden hoard?

Omni Bridgeway examines the fundamentals behind Mongolia's emerging economy.

The frenzied interest of investors in Mongolia is understandable. The country sits atop vast natural resources and lies alongside one of the hungriest consumers of such resources. However, is it possible that the current boom could end all too soon in a bust?

Mongolia has extensive deposits of coal and minerals such as copper, gold, lead, molybdenum, silver, tungsten and zinc. For example, Tavan Tolgoi is the second-largest coal field in the world, with an estimated 6.5bn tonnes of reserves of coking coal. Mines being developed on Oyu Tolgoi, the copper and gold field, are expected to contribute 30% of Mongolia's GDP upon completion. But far from getting stuck in the 'natural resource curse', Mongolia has positive economic, financial and political reasons to think that this boom will continue – in both the short- and long-term.

Grounds for optimism

Economically, Mongolia's gross debt was only 43% of GDP in 2010, and the IMF expects this to fall to 20% by 2015. Financially, investors have recently noticed the country's potential and have ploughed into Mongolian equities.

For example, Mongolian equities increased by 140% in US dollar terms last year, the best performing equity market in the world last year. Politically, Mongolia's leaders have astutely avoided a resource-targeted land grab by the Chinese and Russians – playing one off against the other, while arranging IPOs that ought to enrich the state, its citizens and businesses ahead of the parliamentary elections in June 2012.

In August 2009, the government's repeal of its 2006 Windfall Profits Tax Law, which targeted foreign mining interests, placated the concerns of many investors – most notably Canada's Ivanhoe Mines, the co-developer with Rio Tinto of Oyu Tolgoi – and underscored the government's openness to business.

Partly driven by this agreement, the spate of recent IPOs has pushed investors into a frenzy to arrange and buy into the narrative of Mongolia's resources, further fuelling China's growth. State-owned enterprises have been part-privatised, with the late 2010 listings of oil company PetroMatad raising \$46.8m on the London Stock Exchange (LSE) and coking coal company Mongolian Mining Corp raising \$650m on the Hong Kong market. Also late last year, two other Mongolian companies were listed in Hong Kong: coal miner SouthGobi Energy and Winsway, a coking coal trader and logistics company.

However, the big prize for all concerned is the IPO of Erdenes Tavan Tolgoi, which is scheduled for early 2012. Despite its potential listing value of between \$2bn and \$5bn for the 30% stake that will be sold to international investors, important questions remain unanswered: which assets will be included, how the mine's infrastructure will be financed and, crucially, how shares will be distributed to citizens and companies.

The Mongolian government's intention is to distribute 10% of the Erdenes TT's shares among the country's three million people – a significant windfall in a country with a GDP per capita of just \$1,500; the government also plans to offer a further 10% of the shares to Mongolian companies at a big discount. The government will retain 50% of the company.





Capital influx

This capital influx looks set to continue thanks to the LSE's strategic alliance with the 20 year-old Mongolian Stock Exchange. Foreign investment currently accounts for between 10% and 30% of the Mongolian exchange's value. With only about 340 companies listed at present, 45 brokers and a turnover of just \$100,000 per day, the prospect of further IPOs and 24-hour trading between London and Ulan Bator could transform the country's access to the capital markets.

Glimpses of this future can be seen in the recent launch of a Mongolian equity tracking index and predictions by experts

Being so entwined with commodity prices renders Mongolia susceptible to booms and busts. The last cycle a few years ago saw runaway inflation, reserves being run down, a weakening of the tögrög – the national currency – and a loss of investor confidence. Prognoses that the recent IPOs are not producing a bubble but rather a bottleneck may prove correct.

But the effect of big projects on the currently small and illiquid stock market does run the risk of a triggering a bubble, reinforced by the immediate domestic wealth for the individuals and companies sharing in the fruits of the IPOs. Infrastructure shortcomings could also cause problems.

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that Mongolian-specific equity funds will emerge shortly.

Such positive fundamentals are not only found in a short-term analysis of Mongolia. A February 2011 report by Citigroup predicts that the country's economy will grow by an average of 8.7% annually over the next 20 years – more than any other economy globally.

This growth will be due to three factors. First: a low base, with real GDP per capita below that of Congo-Brazzaville. Second: favourable demographics, with large growth in the working population expected. Third: a domestic investment boom driven by high investment and savings rates. Furthermore, continuing openness to investment by the government will reinforce these factors.

Despite such a positive outlook on Mongolia's equity markets, clouds hover over its credit markets. A recent report by credit rating agency Moody's outlined the risks facing the country. Mongolian sovereign debt remains risky because of the country's vulnerability to global commodities prices – with the possibility of falling copper prices a particular threat.

Indeed, physical infrastructure deficits, such as the lack of water to wash coal and minerals, and the lack of developed railway and road networks to transport the resources to their markets, could retard development. Financial and governmental infrastructure deficits, such as nascent financial markets and weakening governance and institutional indicators, as identified in a recent World Bank study, could also hinder take-off.

Nevertheless, the long-term forecast for Mongolia looks promising. However, teething difficulties in its attempts to privatise and develop its natural resources, together with vulnerability to global commodity price fluctuations, could mean that investors face the occasional storm along the way.

We invite holders of both defaulted trade debts and rendered arbitral awards relating to Mongolia to contact us for advice.

T. Feunteun on feunteun@omnibrigeway.com
H.J. Rijkens on rijkens@omnibrigeway.com