The 2011 guide to
MONGOLIA

> “We have been early believers in Mongolia”
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Set the scene: what is the opportunity in Mongolia today?

Mongolia has so many things going for it. It is physically located next to China, which has become the de facto engine of growth in the global economy. It has been blessed with natural resources. And you have the government and political system: the country is a true democracy, so as a result there is a good chance of the country being able to manage effectively not only its mineral wealth but also the economic growth that will come with the development of those mineral resources.

So we have been early believers in Mongolia. We opened our office in 2008, in the same week as the Lehman disaster, and even though the timing may not have been perfect, we are still proud of the fact that we saw the opportunity for Mongolia’s growth potential and investment opportunities much earlier than many others. We built the infrastructure, we focused on building relationships with government entities, and with the corporate sector and international investors. Now we have the largest investment bank in the country, well positioned to capitalize on opportunities. The mission for Eurasia Capital is to provide a bridge between Mongolia and the international markets: to give international investors access to Mongolian growth, and to facilitate the entrance of Mongolian companies and banks to raise capital internationally.

What shifts have you seen in the business climate since 2008?

I’ve appeared many times for interviews on Bloomberg, CNBC, Reuters, Al Jazeera and others to talk about Mongolia. And I often get the question: why haven’t we heard about Mongolia before, with its massive resources? The reason was that, for years, the Mongolian government, parliament and public in general have had intense debates about how to develop those resources. It took a long time and was frustrating for foreign investors trying to bring big mining projects into production. The big example was Ivanhoe Mines, which discovered the Oyu Tolgoi deposit a decade ago, yet only signed the landmark agreement allowing it to

“Mining is going to be the largest and most important sector for Mongolia, but there will be other sectors and the opportunity is not going to be confined to mining”
develop it in October 2009. But when we set up here there was no doubt in our mind that the government would decide to develop its strategic projects and large mines. The question was when.

The 2008 crisis hit Mongolia very hard: by the first quarter of 2009 the government was running out of money, foreign exchange reserves were depleted and investors were fleeing. It led to a bailout with support from the IMF and a number of bilateral agreements. But that crisis, in my view, had a silver lining, because it helped the government and public to focus on the key need to develop mineral resources. It became clear they had no luxury to wait and debate further. So we were all relieved when, on 6 October 2009, they finally came to an agreement with Ivanhoe and Rio Tinto. That was a turning point. It was a big sign: this country is ready for business. It was a crucial milestone and the catalyst for a change in investment sentiment towards Mongolia. The country has never looked back since then.

**Where are the opportunities in investment? Everyone knows about the mining, but how about the knock-on effects in the economy?**

One of the main reasons for us spotting the opportunity in Mongolia early on was our early experience in Central Asia, especially Kazakhstan. Our time in frontier markets and Eurasian countries allowed me to see the parallels: that once you have momentum, and the development of world-class resources, you are going to see knock-on effects. Yes, mining is going to be the largest and most important sector for Mongolia, but there will be other sectors and the opportunity is not going to be confined to mining.

In January 2010 we produced a report called Mongolia Outlook 2010 – a historic document in the development of our firm. It was positive and optimistic about Mongolia at a time when the turnaround wasn’t obvious, but we said that Mongolia was going to go through a multi-year bull market: that there would be growth in GDP and in FDI. Beyond that macro vision, we made two important calls which were – this is important – executable investment recommendations.

“The mission for Eurasia Capital is to provide a bridge between Mongolia and the international markets: to give international investors access to Mongolian growth, and to facilitate the entrance of Mongolian companies and banks to raise capital internationally.”
for international investors. The first was that the Mongolian tugrik was going to appreciate thanks to FDI inflows. There is no derivative or spot market, so investors had to initiate bank deposits with Mongolian banks, which at that time were offering 16% on tugrik local currency deposits. Those investors who followed our advice made over 25% return after subtracting all costs, a combination of high deposit rates and the appreciation of the currency.

The second important call was that we recommended investors to start investing in local equities. In January 2010, this was considered an optimistic call: the local market collapsed in 2008 and was also negative in 2009 in dollar terms. But we were confident the worst was behind us and estimated the market would gain 70% that year. In fact, it went up almost double that amount. In 2010 the tugrik was the second best performing currency globally, and the stock market was the best in the world.

From the beginning I have trained our research team to think in such a way as to come up with actionable recommendations. We look at opportunities in the currency markets, in fixed income, in public equities – domestic and international – in private equity, infrastructure and property, then tailor recommendations around them.

We have built indices allowing investors to track performance of Mongolia-related companies listed in countries around the world.

**What funds and businesses have you built to do this?**

Silk Road Management, which started in 2008 as a wealth management advisory firm, is now being transformed into a Mongolia-focused investment management firm. We aim to build the largest such institution in the country. Our first product was the first venture capital and private equity fund focused on Mongolia, the Mongolia Human Capital Fund, which raised $30 million from investors earlier this year. The rationale of this fund is to focus on non-resource sectors where human capital is going to be crucial to the success of the business: areas such as media, healthcare, education, professional services and information technology. These are industries in their infancy that are going to benefit from strong economic growth.

We have plans to launch funds across different asset classes. We intend to launch a publicly-listed Mongolia-dedicated fund. And we have teamed up with a Korean group, Doran Capital Partners, to launch a Mongolia-Korea resources fund and to tap the interest of Korean institutional investors looking for investments in Mongolia. We tailor investment products around the interests of investors.

Eurasia Capital itself has been recognized by several international publications; this year it was named the best investment bank in Mongolia by Euromoney magazine.

“The 2008 crisis ... had a silver lining, because it helped the government and public to focus on the key need to develop mineral resources”
“The outlook is pretty positive”

The development of Mongolia’s economy and infrastructure offers huge opportunities, supported by steady and growing cashflows from mining, says Vice Minister of Finance of Mongolia Ganhuyag Chuluun Hutagt

At a time when the rest of the world is struggling, economic projections for Mongolia are extremely positive. Is the outlook realistic?

The outlook will be as good as the demand for what we are producing. In recent years what we possess in terms of minerals has attracted a lot of investor interest, based on global demand for these commodities: copper, uranium, gold, coal, iron. There will be demand for our products despite what happens with Chinese inflation, the American budget and debt ceiling, and European defaults.

What is a realistic expectation for GDP growth?

It will depend on what’s going to happen in the US and how it will affect production in China, and what appetite China will have for Mongolian commodities. I don’t think the Mongolian government can become too arrogant: I advocate we watch out for negative trends, and manage risks. Consecutive crises have shown that they do have an impact on the Mongolian economy. Despite that, the outlook that is being projected by the international community, our development partners and ourselves is pretty positive. We will have tremendous growth in our economy based on mining and the building of physical infrastructure to make our products more available to international markets: border ports, railways, roads, airports. We are going to need to build new cities in the new mining areas, currently mostly in the Gobi. Most of the business will happen around the mines and in the value chain. We need new power plants, new houses and even here [Ulaanbaatar] with growing incomes we have a minimum of 200,000 people who will need houses and apartments. You don’t need too much imagination to think of the investments behind these numbers in terms of water, sewerage, energy, roads, schools and hospitals. It entails huge business opportunities, but mining can support it only through steady and growing cashflows.

“Mongolia is one of the friendlier environments in which to do business”

“the outlook is pretty positive”
What will be the role of the state in all this investment?

The role of the state is not going to diminish in the near future. At this stage of development the government needs to take a leading role, creating not only the environment and good opportunities for foreign investors, but also intervening in managing the economy, supporting our traditional industries such as agriculture, as we did today [in an issue of bonds to support agricultural producers and SMEs]. We need to help our industries in this tough environment with foreign competitors coming in and cheap imports aggravated by the impact of the strong tugrik. We will need to continue direct involvement, such as the development bank, to build public services. This year we budgeted MNT627 billion for capital investment, and the figure will go above MNT1 trillion this year. Altogether in the past 20 years put together, capital expenditure was only MNT1.6 trillion; in two years we are doing what was done in 20.

What will be the role of the private sector in this?

The private sector has plenty on its plate already. Almost all of the banking sector is in private hands; out of 70,000 registered companies, only 100 are state-owned, although they include the champions.

How do you rate ease of doing business in Mongolia?

We have fared pretty well. Mongolia is one of the friendlier environments in which to do business. Because we are latecomers we can implement some systems immediately: for example, we rank as one of the top countries in terms of extractive industries transparency. If you compare us with some Eastern European countries, we are pretty similar; if you compare us to former Soviet republics, we are way better.

Are you considering a sovereign wealth fund?

We have set up a stabilization fund, which by the end of the year will have MNT180 billion. When it hits 5% of GDP we will start investing it actively; in the meantime it’s in cash. I will do my utmost to make sure the government makes the right choices.

What are its sources of funding?

Any income that is in excess of certain fixed prices for coal and copper. We also have the Human Development Fund; we put revenues from the mines in that fund and will start investing this money outside of the country to protect our economy and insulate it from foreign currency fluctuations, as well as preserving wealth to share with future generations.

“We will have tremendous growth in our economy based on mining and the building of physical infrastructure to make our products more available to international markets”
You said Mongolia is dependent on demand for commodities. What is being done to diversify the economy away from such reliance on mining?

Traditionally Mongolia has been an agrarian economy: livestock and anything related to it like meat, pelts, felt, wool and cashmere. They are all industries of high potential. Food security is a big concern for us; Mongolia has become self-sufficient in terms of wheat, which is a success. We could focus on and develop other industries: our increasingly educated workforce will be able to drive industries such as tourism and financial services to become major contributors to the economy.

The world is watching the forthcoming Erdenes Tavan Tolgoi IPO. How transformative will it be for Mongolian markets?

The current capitalization of the local stock exchange is $2 billion; we are talking about $10 billion in an IPO of one company. That’s the magnitude, and if we decide to float some percentage locally it will have a huge impact. Right now 10% is owned by the Mongolian people and another 10% will be sold to Mongolia-based companies. This will provide a strong incentive for international investors to come in early and take part in the trading of those securities.

What message do you want to give to foreign investors about Mongolia?

It makes sense to get exposed to Mongolia. It is the top opportunity globally in terms of our mineral resources. We possess almost all the elements in the periodic table. We are tripling coal exports this year. The ambition with our partnership with the London Stock Exchange is that one day Asian investors can trade on the Mongolian exchange with their stocks listed in London, on the same platform, the same systems.

Cashflows are exploding, the budget is in surplus and we have record high cash levels in our treasury. We will one day make a decision on sovereign bonds: we are issuing local currency and giving a very good return to our investors. Debt to GDP is just 17%, so we can borrow, and I think we want to borrow to make investments and increase the capacity of the economy.

“Tovan Tolgoi will be a better governed organization because it is owned by individuals, not just the faceless state”
Rapid Economic growth - start of a new era

Last year Mongolia registered one of the highest growth rates in the world, powered by the development of its vast untapped mineral resources. That growth is set to continue, as Mongolia constructs the infrastructure it needs to sell its products on international markets.

Mongolia has experienced rapid economic growth since the global financial crisis. Eurasia Capital, an Ulaanbaatar-headquartered investment bank, estimates that Mongolia became one of the world’s fastest growing economy in 2010 in terms of US dollar GDP growth rate at current prices, with a 44% year-on-year increase, driven by the 12.9% appreciation of the Mongolian tugrik (MNT), the national currency, against the dollar over that period. This means that Mongolia outperformed the BRIC emerging economies as well as all other leading frontier and high-growth economies globally.

Fuelled by investment in the mining sector and a significant increase in exports, real GDP growth reached 6.1% last year, according to official data, versus 2.7% in developed and 7.1% in emerging and developing economies. And it is getting better still: in the first half of 2011 it was up 14.3%, or in nominal terms 29.1%. The second quarter, with 17.3% year-on-year growth, was the fastest expansion since 2005.

Significant investments and demand from China, the major market for Mongolian products, have allowed Mongolia to double coal output to more than 25 million tonnes (Mt) in 2010, up from 13Mt a year earlier. Coal exports increased 2.9 times in 2010, overtaking copper for the first time, and in first-half 2011 Mongolia overtook flood-hit Australia as the largest coal exporter to China. Crude oil production rose 17% to 2.2 million barrels, and iron ore output more than doubled to over 3.2Mt. Major manufacturing industries, such as food and beverages, grew 24% in 2010.

“Mongolia has for so long been under-invested. So when you see a flow of new cash wealth, how much of it do you sterilize and how much do you let trickle into the economy?”

Mongolian foreign trade surpassed its
historical high in 2010. Trade turnover surged 53.5% year on year to $6.2 billion. 2010 was a record year for exports, reaching $2.9 billion, with a 53.8% annual expansion driven primarily by Chinese demand (it bought 85% of Mongolia’s exports), commodity price increases and volume expansion. Record exports have been the primary driver of Mongolia’s impressive economic growth. And they are getting better: mineral exports jumped 72% year on year in the first half of 2011, with coal up 135% and iron ore exports 122%.

Increases in international prices for Mongolia’s major export commodities boosted already substantial export earnings. The price of coal, the largest 2010 export earner for Mongolia, rose more than 14% over 2010, with copper, gold, iron ore and crude oil gaining 28%, 26%, 52% and 8%, respectively.

Eurasia Capital expects Mongolian foreign trade to grow at an even faster rate in 2011. A positive outlook on commodity prices, increased output from existing operations, the launching of new mines and strong growth prospects in major trading partner markets - particularly resource-hungry China - should fuel increased exports from Mongolia. Eurasia now believes that Mongolia should beat its original projection of 10% GDP growth for 2011.

**FDI breaks records**

Foreign direct investment (FDI), which was considered frozen until as recently as 2008, hit a record high of $1.7 billion in 2010, according to official data, further underpinning the economy. This was nearly three times the volume of 2009. The mining sector was the major destination for FDI.

China was for many years the only major direct investor in Mongolia, accounting for $2.5 billion between 1990 and 2010 (60% of total). That is changing. Canadian FDI, the second biggest, increased more than 140 times in 2010 to $147.8 million. Investment from Hong Kong is also climbing.

By sector, geology and mining have attracted $3.15 billion in FDI - 65.3% of the total - since 1990. The majority of this investment has come since 2008, when the mining industry began to entice resources giants from around the world.

The FDI focus for Hong Kong and Canada is mainly on mining and related activities, while South Korean and Japanese investments have targeted trade and service, engineering construction and financial sectors. The biggest investor, China, has followed varied targets covering almost every sector. Infrastructure is likely to attract more FDI in coming years, with 1,100km of railways planned, for example.

Mongolian Government’s efforts to create favourable legal environment to attract foreign investment into country’s growing mineral sector, has stimulated steady growth of foreign direct investment (FDI). As a result “People argue the economy is getting too hot. I say we are nowhere near to that: we are just warming up”
of this continuous effort; Mongolia is at 28th place by protecting investors’ ranking from Doing Business 2011 report by World Bank.

FDI inflows in Mongolia are expected to continue growing. Already in 1H2011 FDI inflows reached US$1.4bn, or up 127% y-o-y. Ivanhoe Mines’ approved US$2.3bn budget for Oyu Tolgoi mine construction in 2011 alone is 3 times greater than the US$758mn budgeted for 2010 and is over one-third of the country’s 2010 GDP. As the country’s economy is growing, more international companies and investors will likely continue investing across various asset classes and industries such as resources, banking, property, fast moving consumer goods and infrastructure.

Remarkably, Mongolia is thriving with limited inflation. Prices rose around 13% last year, and there were concerns from the World Bank that an expenditure plan – including major increases in salaries – could push inflation over the 25% mark. Yet according to N Zoljargal, deputy governor of Bank of Mongolia, the central bank, inflation has instead declined to around 6.5% year on year in June. In any case, he says, Mongolia is an exceptional case when it comes to considering inflation.

“As the country’s economy is growing, more international companies and investors will likely continue investing across various asset classes and industries such as resources, banking, property, fast moving consumer goods and infrastructure.”

“For example, when you see a low of new cash wealth, how much of it do you sterilize and how much do you let trickle into the economy? That is the challenge we faced in 2010, we are facing it now and we will probably live like this for the next few decades.” Last year the bank sterilized around 30% of net inflows in foreign exchange, feeling that it was short term and speculative; this year, it has sterilized far less.

“Yes, inflation is a worry, with banks over-extending credit in the good days; people argue the economy is getting too hot,” he says. “I say we are nowhere
OU GROUP

Oyuny Undra, or OU Group, was one of the first companies to be established in Mongolia’s democratic era. Founded in 1992 with a business importing petroleum products from Russia for wholesale and retail sale in Mongolia, OU Group today is a fully integrated private holding company with multiple business enterprises and over 1,100 employees.

The largest part of the business is mining and mining-related, followed by property (with a focus on high-end commercial and single-family dwellings), financial services and a number of smaller businesses from telecommunications, media, retail operations and consumer products manufacturing.

OU Group owns several mineral deposits, including copper, gold, iron ore, tungsten, lithium, molybdenum, coal, lead, zinc and rare earth metals. It has also established mining related support services such as environmental management and blasting companies. In banking, it owns Mongolian Financial Group, which seeks to be the leading non-banking financial institution in Mongolia, and has a majority stake in TransBank, a fully licensed commercial/retail bank.

Growth in the mining industry in Mongolia is leading to changes in consumption, which OU Group is well positioned to benefit from. “People are starting to demand quality and value for their money,” says Alex Horbasz, COO. “The increase in disposable income in the economy is looking for areas to be spent. This growth is obviously driven by mining.” Yet we are really only at the start of that process. “There is a misperception of how far along a lot of the mining projects are. Tavan Tolgoi is still in the early development stages. When projects like this are further in the development and operational phases, the business opportunities will increase dramatically throughout the economy.”

OU Group reflects a change in the ease of doing business in Mongolia. “I’ve been here six years and seen a real shift,” Horbasz says. “Whereas six years ago the government was taking the lead in providing direction and managing the economy, what you see now is the business community being the growth engine for the economy.”

According to S. Amarsaikhan, Chairman & CEO of OU Group, “The country is on the way to make its historic change of economic and social development. Mongolia is an open window of opportunities, through which one can see and feel a truly democratic country with a government dedicated to take all possible actions to promote a business friendly environment where both foreign and local businesses can compete and grow freely. As the private sectors of the nation are growing so fast, the Mongolian companies are seeking all possible ways of adopting the best corporate governance through exercising international business management practices. We strive to combine our resources with modern technology and the right knowledge to position ourselves strongly in the region.”
near to that: we are just warming up. Everybody has their own temperature."

Indeed, some argue inflation should actually be higher and monetary policy looser. "Economists say that if there is inflation, just take out money from the economy," says Sambuu Demberel, chairman and CEO of the Mongolian National Chamber of Commerce & Industry, and a key economic adviser to Mongolia’s president and prime minister. "It’s nonsense. We need money in circulation: the more money the better. People in real sectors want money to create business and profit, but the majority of SMEs don’t have access to lending. We need decisive action to change our monetary environment to drive the economy."

Rich mineral resources

Mongolia is a home for world class resources, primarily in coal, copper, gold, uranium. Estimates suggest that major 10 strategic resource deposits hold over $1.3 trillion wealth under earth in monetary terms. The country’s flagship jewels are Tavan Tolgoi and Oyu Tolgoi. Tavan Tolgoi, one of the world’s largest untapped coking coal mines, is a vivid example of a world-class resource: it is estimated to contain 6.4 billion tonnes (Bt) of thermal and coking coal worth approximately $390 billion. The government of Mongolia is in the process of finalizing the deal with international bidders. Another world-class mine is Oyu Tolgoi, which is one of the world’s largest undeveloped copper-gold deposits, rivaling Escondida and Grasberg. Oyu Tolgoi contains approximately 37Mt of copper and 1,300 tonnes of gold, with a project cost of $5.9 billion. Based on conservative calculations, the monetary value of the Oyu Tolgoi project is approximately $252 billion, or as much as $424 billion if measured, indicated and inferred resources are taken into account.

Balanced political environment

Mongolia is to hold parliamentary elections in the summer of 2012. The newly elected parliament will oversee the implementation of major mining, infrastructure and industrialization projects, which will define Mongolian politics, economy and society for years to come.
The parliamentary election in 2008 saw a brief period of turmoil, but the formation of a coalition between the two main political parties, the Mongolia People’s Party (MPP) and the Democratic Party (DP), has resulted in a stable, functioning government. Domestically, the coalition government has focused on expanding investments in Mongolia’s vast natural resource wealth, diversifying the economy, job creation and improving living standards. Internationally, the government has maintained good relations with Mongolia’s traditional and strategic partners, Russia and China, as well as expanding relations with other countries such as Australia, Canada, the US, Japan, South Korea and India.

With upcoming elections, the coalition government is eager to start the Tavan Tolgoi coking coal project in partnership with major international mining players. Large mining deals, infrastructure development and poverty reduction will remain recurring themes of the parliamentary elections in 2012. There is a wide political consensus among major political parties about the development needs of Mongolia. Therefore, regardless of the election results, the country can be expected to stay on its current course of resource-driven growth.

“Regardless of the election results, the country can be expected to stay on its current course of resource-driven growth.”
UB BUK JSC

UB BUK is a construction business producing steel and concrete products as well as conducting construction itself. Founded in 1984, the company has a 25,000 square metre total production area and 140,000 square metres in total facilities; it is the largest construction materials producer in Mongolia and at one stage supplied products to 40% of all Ulaanbaatar’s housing.

Currently, BUK has capacity to produce concrete products, ready mixed concrete and metalware. The company’s concrete products manufacturing facilities annually produce 45,000 cubic metres of cavitated concrete slabs, including floor and fence slabs for industrial and civil use. BUK also produces 18,000 cubic metres of concrete and reinforced concrete barrels per year. Its products such as sewage barrels, wells for underground engineering and fixed concrete boarding for bridge bearings are used in municipal and road engineering, and railway construction. Company’s 50 cubic metre per hour capacity processing line manufactures broad line of heavy injection molded reinforced concrete constructions, such as crossbars, bridge beams and spans, girders, road blocks and columns. The line produces railway and road spans with length up to 30 metres, height 1.5 metres and width 1.2 metres. Ready mixed concrete produced by BUK is used in civil and industrial engineering, bridge engineering. Metalware production facilities produce H-beams, metal frame buildings and structures, craneways, steel bridges, steel towers for power transmission lines and other products. H-beams are used for construction of buildings from metal frames with the width of bay up to 24 metres and height up to 35 metres. Production capacity is up to 1,000 tonnes per month.

The construction industry will be an early beneficiary of Mongolia’s economic growth, with opportunities in mining, infrastructure, commercial and residential property, and production facilities. BUK is in the midst of an ambitious expansion plan. It aims to boost its concrete mixture capacity from 9,400 cubic metres in 2010 to 100,000 cubic metres by 2013, as well as more than trebling its concrete slab capacity and increasing concrete pipe production sixfold. It is installing a $500,000 equipment line to increase the speed of concrete production, using German quality control engineering, and is also investing up to $200,000 on forms to produce steel-concrete bridges. Other development plans included a 3,000 cubic metre bitumen storage and an asphalt plant.

To implement its ambitious plans BUK is planning secondary offering of its shares in Mongolian Stock Exchange in the near future. Eurasia Capital estimates UB BUK JSC would need to raise in excess of $15mn to implement its modernization programme. Driven by mining industry investments, construction industry is expected to rally strongly in the coming years. The industry presents one of the best investment opportunities in Mongolia. Gaining exposure to the largest concrete and steel products manufacturer is one of the ways of leveraging mining boom in Mongolia. Since 2006 BUK has been 97% owned by Ulaanbaatar Management.
Despite its relatively tiny size in global market terms, the Mongolian Stock Exchange (MSE) is gaining importance for local and international investors intending to gain exposure to the Mongolian market. Naturally, most of the market is resource-related.

Mongolia has so far this year maintained its title as the world’s best-performing equity market. Having gained 138.4% (173.7% in US dollar terms) last year, the MSE Top-20 Index has continued its global outperformance in 2011, up 42.6% at the time of writing. By comparison, the MSCI Frontier index gained 16.6% in 2010 and is down 11.6% so far in 2011; the MSCI EM Asia index gained 12.9% in 2010 and is down 0.7% year to date; and the Shanghai Composite Index fell 14.3% and 5% respectively.

After the Mongolian Stock Exchange benchmark surged 123.3% within the first two months of the year, hitting 32,955 on 25 February, it went through a significant correction, losing 43.8% by the end of May. This volatility is a function of speculation, low liquidity, a small free float in listed companies, and uninformed investor expectations. Improved investor sentiment driven by the expected launch of Tavan Tolgoi coal mining operations and proposed IPO, the strategic partnership agreement between the MSE and the London Stock Exchange (see box), and a strong outlook for commodities, contributed to the surge and underpin further growth.

The MSE market capitalization grew 2.5 times in 2010, passing the landmark $1 billion in November 2010 and reaching $1.7 billion by July 2011. The top five stocks (coal groups Baganuur, Tavan Tolgoi, Shivree Ovoo and Sharyn Gol, and beverage group

"The combination of expected double-digit economic growth, and the experience of other commodity-linked emerging markets, suggests that the momentum has just begun"
APU) contributed 82.1% of this growth. The combination of expected double-digit economic growth, and the experience of other commodity-linked emerging markets, suggests that the momentum has just begun: the Kazakhstan Stock Exchange’s market capitalization grew 100-fold to $100 billion between 2000 and 2008, while the Qatar Stock Exchange grew 31 times from 1997 to 2007 to $95 billion. Stock market penetration — total market cap representing just 20% of GDP — is relatively low compared to other emerging and even frontier markets, underlining the growth potential.

The MSE, with its huge gains, is still challenged by companies with small free floats and low trading volume. Average daily trading volume was $234,000 from January to 25 February, and $33,000 from then to 30 May. It is likely that the lack of liquidity will remain a concern in the short term.

The Mongolian government has approved a list of state-owned enterprises that are slated for privatization starting this year. These are in mining, mineral processing, construction materials, power distribution and generation, telecommunications and airline industries. Many will pursue a listing locally on the MSE to serve as a vehicle for privatization and then seek additional listings in regional or international markets to raise capital for expansion and modernization.

The leader among these privatizations is the highly anticipated IPO of Erdenes Tavan Tolgoi, expected early next year. The IPO may potentially value the company between $10-15 billion. This government-owned company holds the licence for Tavan Tolgoi, the world’s largest undeveloped coking coal mine. The government will distribute 10% of the company’s shares to Mongolian citizens, with a lock-up period that has not yet been decided, and plans to sell another 10% to Mongolian companies and offer 30% on a combination of domestic and international markets. It should substantially boost MSE market capitalization and liquidity while also

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enfranchising citizens in the capital markets. “The entire population of Mongolia will become shareholders,” says Munkhtushig Dul, deputy director and head of finance and logistics at the MSE. “When that happens, new brokerages will have to develop, as will the capital markets themselves.”

“There are several separate pipelines of new listings,” he adds. “First, there are big strategic mineral deposits, which by law should have no less than 10% listed on the MSE. Then there are many companies with huge assets in Mongolia who are not listed here: we are hoping to repatriate them to create more involvement in the Mongolian markets. And then there are local privately held companies: cell phone companies, food companies, very strong businesses that will need more money.”

There have been no new IPOs on the MSE in the past two years, but it is expected this will change dramatically in the coming years as a number of leading domestic private companies are expected to launch IPOs first internationally and later on the MSE. Mongolian private business groups that are expected to launch IPOs at a group or subsidiary level include MCS Holding, Petrovis Corp, Bodí Group, Newcom Group and Monnis Group. New IPOs, whether from state or private sources, should ease liquidity concerns and therefore volatility.

Many Mongolian companies – now over 20 - have Listed overseas, often instead of domestically, in locations including Toronto, London, Hong Kong and Australia. But the Mongolian authorities do not see this as capital fleeing the country. “I don’t see it as a bad sign,” says D. Bayarsaikhan, Chairman of the Financial Regulatory Commission of Mongolia. “Companies are using the opportunity to raise funding in large amounts.” The hope is that companies that have listed overseas will come to list more of their stock domestically as the Mongolian
market gains in scale and sophistication.

Eurasia Capital believes the outlook for Mongolian equities in the short to long term is very positive. This year, it expects the MSE to retain its title among the top three equity markets, if not the best.

**Flurry of M&A activity**

In recent years Mongolia has seen a flurry of M&A activity, particularly in the resources sector. M&A volumes doubled from 2009 to 2010 to a record level of over $1 billion, most of it in mining, and chiefly coal. An international interest has grown dramatically since the investment agreement on the Oyu Tolgoi (OT) mine was signed in late 2009. The origins of acquiring companies were diverse but Hong Kong and Australia led the charge: Hong Kong was involved in $473 million worth of M&A deals through injections of resource assets into existing publicly listed companies. In 2010 Australian companies not only have managed to buy assets but also were able to hold IPOs on ASX.

This year M&A activity is more vibrant still. Total deal value for the first half of 2011 increased 45% year on year to $636 million, and had reached $690 million by 27 July, 2011. Close to 50% of the announced deals were reached in participation with Australian companies that have strengthened their cash positions during the financial crisis through improved operational efficiencies and high commodity prices. It is expected that if finalized Tavan Tolgoi deal will propel this year’s M&A numbers.

**Bond market kicks off**

Until very recently, not many people knew of the existence of the bond market in Mongolia. But it is becoming more active. The market has been waiting for the right time and conditions while building knowledge, experience, and infrastructure. News about bond issues is not on-and-off anymore; the market is under way.

The government is being cautious in approving new issues, knowing the damage any default would cause to the reputation and credit rating of the market. Government issues have focused on national benefit: for example, in September 2010 it issued a MNT60 billion bond, half of which was offered to the public, to fund the “4,000 Apartments for Public Servants” project. This year, MNT69.96bn bonds were sold to public out of MNT72bn offered for the project funding.

Backed by confidence in Mongolia’s expected growth, the government is planning another offering to support the cashmere and wool sectors, and small-to-medium enterprises.

Through the Development Bank, established in 2010, big industrial, infrastructure and mining projects will be funded and the government will issue MNT800 billion in bonds for necessary funding as new projects come up. The bank also supports
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Currency’s strength reflects confidence in economy

After an impressive 12.9% appreciation in 2010, the Mongolia tugrik (MNT) has been relatively volatile this year, appreciating 1.6% year to date by 4 August. Eurasia Capital believes it will remain a strong currency to hold. This confidence comes from expected capital flows to the large projects in the mining industry and infrastructure: FDI was $1.5 billion in 2010. The revenues from the two mega-projects of Tavan Tolgoi (coal) and Oyu Tolgoi (copper and gold), both under development, will consolidate the tugrik for many years to come. Mongolia’s exports of mineral resources will dramatically increase when the necessary infrastructure, including the rail lines, become ready.

The currency is comparable to other resource-driven currencies, such as the Australian dollar or Brazilian real, which have experienced large appreciation. The tugrik has emerged as a new resource currency and is increasingly correlated to the export commodities. It represents an excellent carry trade opportunity.

SouthGobi Resources’ Ovoot Tolgoi coal mine

those projects by providing guarantees to the loans. Both domestic and international investors can participate.

Corporate bonds will become an interesting area for investors. For most of the companies that intend to tap the debt markets, it is a testing period: they need models to follow, but there have been only 12 issues since 2001. But by waiting, they risk losing out to competitors. Just Agro has made the first move this year to attract bond investors with a MNT30 billion bond offering. If successful, other companies may follow.

Trade and Development Bank (TDB) is the only bank in Mongolia to tap the international bond markets so far, with a $75 million deal in 2009 (successfully repaid), and two new bonds in 2010. Other banks, Khan Bank and Xac Bank, have followed suit and announced smaller debt issues. But bank deposits, offering more than 11% returns in tugrik, remain favoured by many local investors.
Laying the foundations for sustained growth

The mining boom has brought with it a rapid expansion in the property market and the realization that Mongolia must build an infrastructure, both physical and financial, to support exploitation of its natural resources.

"Despite the newfound wealth, more than one third of the Mongolian population lives below the poverty line.

As mining has brought wealth to Mongolia, the property market has experienced speculation and rapid expansion. After the highest ever price for a luxury residential apartment was registered at $8,000/square metre in the new Blue Sky Tower, an April Fool’s joke by a local broker about Donald Trump’s plans to build a 120-storey ‘Trump Tower’ for $1 billion in the centre of Ulaanbaatar was picked up and distributed by some respected online sources.

Residential Property Prices (secondary market)

![Graph](source: Eurasia Capital estimates)

Although Trump is not planning to build a tower in the capital of Mongolia, the property market is poised to benefit from the country’s mining-led economic growth. Already, the residential, office, retail and hospitality property segments have consistently grown over the past few years, with supply struggling to meet demand. The market in Ulaanbaatar stabilized in 2010 following the turmoil of 2008-2009, and has benefited from increased inflows of foreign capital. Industry experts expect a period of accelerated growth.

Residential property prices in Ulaanbaatar have nearly quadrupled since 2002, although the global financial crisis corrected the steep market growth up to Q3 2008. The past year’s strong economic growth, national currency appreciation and speculative inflows of foreign capital have driven residential property prices up by nearly 20% in the capital; the average residential property price in 2010 was around $900/square metre, although much of that can be attributed to the 12.9% appreciation in the value of the tugrik.

Although foreign investors have an impact, the growing number of wealthy Mongolians is also significant, boosted by successful
capital raising by mining companies. Fundamental demand for housing in Ulaanbaatar and nationwide will be a key driver of near-term growth. Since 2005, the population of Ulaanbaatar has increased 22% to 1.16 million, which represents over 40% of the total Mongolian population. More than half of Ulaanbaatar’s inhabitants live in traditional ‘ger’ settlements; others live in old buildings that are deteriorating fast. Facing the need to accommodate its population, the Mongolian government has initiated several measures that stipulate construction of mid-budget accommodation through government support. These initiatives include programmes such as the “100,000 Apartments Project” which aims to alleviate the strains on infrastructure services, social services and pollution.

Despite the newfound wealth, more than one third of the Mongolian population lives below the poverty line. Increasing prices might deter low income earners from buying property. However, 2010 was marked by a revival in the mortgage market as major Mongolian banks have started providing loans to the population, albeit at high rates – currently up to 30%, with required downpayments as high as 50% (but more commonly 30% and sometimes 10% if the construction company takes on some of the risk).

Ulaanbaatar is again crowded with construction cranes, just as before the 2008 crisis. Maybe Donald Trump really will build a Trump Tower in Ulaanbaatar during the next few years.

**Infrastructure**

Mongolia’s mining boom may stutter if the country cannot solve its infrastructure problems. Infrastructure is regularly listed among the major inhibitors of Mongolian growth, and vast investment is needed, probably in excess of the country’s current.

The Concession Law, adopted in 2010, sets the legal framework for private sector participation in the development of infrastructure projects. The government has approved a list of 121 projects in road and railroad construction, power generation and transmission, industrial development, urban development, telecommunications, education and healthcare, inviting private sector investments. Both foreign and domestic companies can participate in the projects individually or jointly. Concessions can be gained via open tender, competitive bidding or direct contract.

The development and expansion of railroad

“To support its mining sector, Mongolia is focusing on extending its railroads to major mining areas within the country, as well as on opening trade corridors and export routes to neighbouring countries.”
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infrastructure is one of the most pressing issues in the Mongolian economy. To support its mining sector, Mongolia is focusing on extending its railroads to major mining areas within the country, as well as on opening trade corridors and export routes to neighbouring countries. In the next five to 10 years, the country is planning to build about 5,700km of new railways, providing easier access to Mongolian minerals and exports to neighbouring and international markets. The railways will be constructed in three stages. The first stage, which has already started, envisages construction of a new 1,100km main rail line from the Tavan Tolgoi coal deposit to Choibalsan, the town connected to Russia by the existing railway. The new main line will intersect with the existing Trans-Mongolian Railway at Sainshand station in Gobi region. The project is in feasibility study stage. It is expected to be completed in the next four to five years.

In the near future, major infrastructure projects in Mongolia may offer numerous investment opportunities. Construction of new railways will create opportunities for investors, construction and operating companies. A new $10 billion development, the Sainshand Industrial Complex near the Chinese border, will be a hub to process raw materials for exports, and should spur investor interest. A number of other government-priority projects will be open for private bidding in the coming years.

Financial services

Mongolia’s banking industry endured a difficult financial crisis in which two banks failed. But there is a sense that it has returned to health on the back of the growing economy. N Zoljargal, deputy governor of The Bank of Mongolia, the central bank, says the banking system has “never been better than it is today. It is very healthy.” Those banks that survived the crisis are now strong. “During the crisis our banks were well managed, beefed up their liquidity, and since then have seen high growth in assets.” Non-performing loans, which at one stage topped 20%, are now around the 6% mark, he says, and “coming down dramatically” as previously troubled businesses in construction and other areas pay back their loans. As Zoljargal says: “If the economy is growing 10%, it’s hard to produce NPLs. You have to be doing something very wrong.”

Some local banks with distinct strategies look healthier still. Chairman of Chinggis Khaan Bank Sergey Gromov – a pioneer investor in Mongolia whose holdings also including the leading brewery APU and

“During the crisis our banks were well managed, beefed up their liquidity, and since then have seen high growth in assets”
Mongolia Development Resources

Mongolia Development Resources is a property development company listed on the Mongolia Stock Exchange. It both develops new properties and invests in existing ones, giving investors diversified exposure to commercial and residential real estate in Mongolia.

“Property will be one of the sectors that will benefit from the growth in the resources industry,” explains Marat Utegenov, executive director. “In Mongolia we are at the beginning of a cycle. We believe property prices are undervalued in Ulaanbaatar, and in the mining towns that are developing. There is room for growth.”

In December 2007, MDR raised over MNT13bn in one of the largest IPOs in the history of the Mongolian Stock Exchange (MSE). The company has transformed from a single infrastructure project owner to a property development and investment company. Currently, it is the largest listed real estate firm in Mongolia, and the only one in the MSE Top 20 index. It has a distinctive shareholder structure, with 85% foreign institutional shareholders, among them Mongolia focused investment funds and other institutions from the US and Switzerland.

There are several reasons for optimism about the property sector, Utegenov says. “We are bullish, because current prices are being achieved with only 5 to 10% of transactions being done with mortgages,” he says. “As banks grow, they will be looking to develop their loan products aggressively, and the first sector they will look at is real estate – both construction companies and individual mortgages. The level of lending to real estate today is the tip of the iceberg.” Additionally, the hundreds of thousands of Ulaanbaatar’s people who live in ‘gers’ – tent structures – are eventually expected to move to permanent housing. Other areas of interest include social infrastructure like private schools and hospitals.

MDR is also building a land bank in the capital and in second tier cities such as Dalanzadgad, the capital of South Gobi, where the major resources projects are. “It is one of the least developed cities so far: the town’s population is around 20,000 and there are barely 30 concrete accommodation buildings there,” he says. “All the rest are gers.” Since companies and local government are obviously expanding, the population will need – and will be able to afford – more housing. “We are making sure we have our footprint there, and in Tsogttsetsii [the town nearest to the Tavan Tolgoi mine] as early as possible.”

MDR is expected to benefit from strong outlook for Mongolian property market as a result of increasing inflows of foreign investments, emergence of new mining towns, mortgage loan penetration growth and improving welfare of Mongolian population. The company is up 42% y-t-d on the MSE, and is one of the Top 3 picks of Eurasia Capital for 2011, which estimates further growth upside of over 35%.
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the insurer Mongol Daatgal, discussed below – says the bank focuses on areas like agriculture and building materials, but not mining. “Agriculture has huge potential,” he says, pointing to the sheer scale of land and the as yet limited use of fertilizer or other techniques.

International players have started to appear in Mongolia, though chiefly with representative offices rather than significant on-the-ground commitment so far. PricewaterhouseCoopers, KPMG and Ernst & Young are also represented.

Eurasia Capital is the nation’s leading investment bank today, and it is likely that this will be a growing part of the market in future. “There will be more of a focus on long-term investment funds and institutional investors in future,” says D. Bayarsaikhan, Chairman of the Financial Regulatory Commission of Mongolia. As the finance ministry interview above explains, two quasi-sovereign wealth funds – the Stabilization Fund and Human Development Fund – are being developed, while a development bank focused on long-term infrastructure has been formed and will soon start lending. The development of new investment, capital markets and securities laws, in varying states of readiness, will help growth.

Another area ready for dramatic growth is the insurance industry. Mongol Daatgal, the country’s first insurer, dates from 1924, but the industry is still in its infancy; only one company provides life insurance, while a handful of others provide property and commercial cover. “It is a very virgin market,” says Batzul Tumur-Ochir, Mongol Daatgal’s CEO. “It only holds 7.4% of GDP, and total premium income in 2010 was just $30 million for the whole industry. People have not understood insurance, or have seen it as a cost in the past; but now the economy is growing because of the mining industry, people have more money from wages and may spend some on insurance.”

On top of general economic growth, legislation will drive the industry too. Mongolia today does not have mandatory insurance for drivers, but this year a new law is likely to change that. “That will automatically give a 30 or 40% increase to the market,” Batzul says. Professional liability insurance will also become mandatory in the near future, while the growth of the mortgage market is also going to feed through to insurance – through corporates and banks, and through individuals. Batzul plans to enter life insurance too within three years, as he also sees momentum for growth there.

Blue Sky Tower, Ulaanbaatar

We need a broad base of promising SMEs to allow double-digit growth to take place in our economy.”
Inside back cover
Eurasia Capital is a pan-regional investment bank with focus on Mongolia and Central Asia.

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