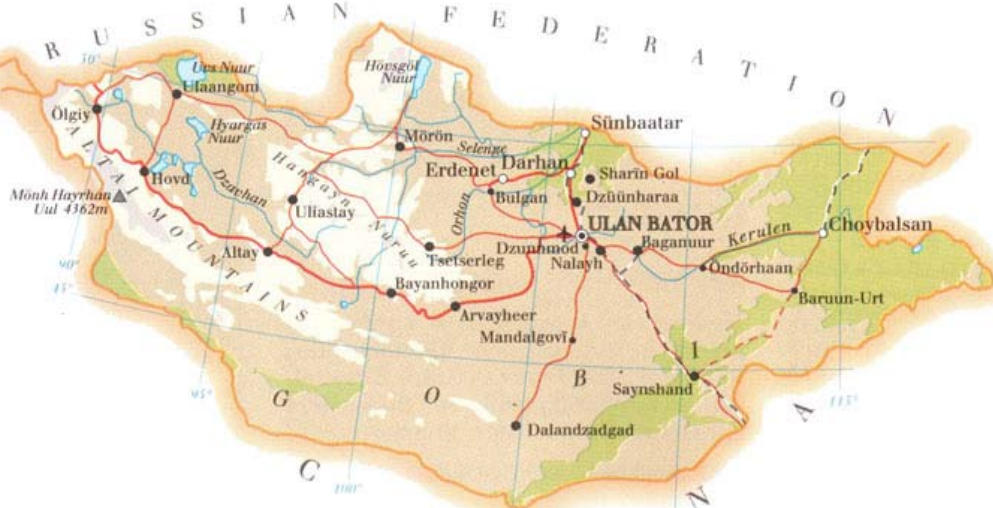


Research Trip to Mongolia March 2011

For many, when I mentioned an extension of the Japan trip to Mongolia, their first question was something to the effect of – “where’s Mongolia?” The answer to that question simply sums up the investment opportunity there, both in terms of pros and cons. First, a little background information...

Mongolia is the 19th largest country in terms of landmass, but has the lowest population density of any place in the world. It is also one of the highest altitude and most remote places in the world. That makes for some really pretty terrain with lots of mountains and steppes. The capital and main city is Ulaan Baatar, and it accounts for over half of the country’s population (which is only 2.6 million).



In many ways, Mongolia reminded me of my first trip to Costa Rica in 1995. The city was not attractive due to litter and unattractive (Soviet block) buildings in need of cosmetic repairs, but the countryside is beautiful. But, it’s not tourism that’s going to shape Mongolia’s future – it’s mining. Growth in gross domestic product (GDP) over the next decade is anticipated to be 20% per year. That said, let’s discuss opportunities in Mongolia as well as potential risks for this emerging market.

Mineral Wealth – (THE) Opportunity

Mongolia sits atop tremendous mineral wealth that is largely untapped. The reason its mineral resources have not been used in the past is part cultural and part accident of history. Culturally, Mongolians have traditionally been herders and nomads without permanent settlements of significance. They are also Buddhist, which means they have a reverence for the land – a cultural shift has begun to allow for the development of these resources. Historically, they have always been between two challenging neighbors (see above), and the Russians used them primarily as a buffer against the Chinese rather than a significant resource for mining. But, they did leave behind some geological infrastructure, including geological testing for minerals that has been used as a base for Mongolian exploration.

The first modern mine to be truly investigated in Mongolia is a copper mine in Erdenet (which means “treasury”). Thirty years ago Erdenet was a steppe, and now it’s the third largest city in Mongolia representing 30% of Mongolian GDP. Of course, this has generated a little more interest in mining from the government.

The next resource to be exploited is the Oyu Tolgoi (OT) mine, a project being conducted by Ivanhoe Mines (a Canadian firm partially owned by the British / Australian mining conglomerate Rio Tinto). OT was originally thought to be primarily a coal mine, but it may turn out to be much more than that... there is also a gold, silver and copper available for exploration, and production will start in 2013. For some perspective on this mine, please visit <http://www.ivanhoemines.com/s/Home.asp> and select either the Oyu Tolgoi movie or the slideshow. Below is just one picture of the impressive project.



The next strategic mine is Tavan Tolgoi (TT) which is estimated to have 5.5 billion tons of coal and is situated 240 km from the Chinese border. Bid selection is underway for the foreign partner to assist with this project. Furthermore, it is anticipated there are at least twelve more mines like Tavan Tolgoi and Oyu Tolgoi (and up to 25 strategic mining resources in country). At present, Mongolia exports about 10 million tons of coal a year, and with the discoveries of these mines it could reach as high as 50 million annually within ten years. If all of this information about untapped resources doesn’t get you excited, then they also have found uranium deposits as well as significant finds of rare earths minerals. But, some challenges remain... 85% of their exports are to China in the form of raw materials, and we will discuss that issue shortly.

An interesting segue from the resources of Mongolia to the politics of the country is how they intend to benefit from these operations. This entire effort is seen as an opportunity to increase GDP per capita in one of the least wealthy countries in the world. When the Mongolian government finds a deposit, they open the process to outside bids for funding and operation of the mine and then retain a 51% ownership in the mine. 10% of total shares will be distributed to the Mongolian people as preferred shares with a minimum of a two year holding period, and 10% will be sold to Mongolian businesses. The remaining allocation owned by the government will be offered through an initial public offering with shares jointly listed in Mongolia and some other global marketplace (typically Hong Kong).

Governance – better than their neighbors (both Opportunity and Risk)

In other Central Asian countries, there remain vestiges of the old “Soviet club”, and Mongolia is the only functioning parliamentary democracy in this part of the world. There are competitive political parties with young, pragmatic leaders who are Western educated. There appears to be a respect for the constitution, and Mongolian citizens are highly independent and do not want to be dominated by outsiders, especially the Chinese (remember, these are the descendants of Ghengis Khan). There are over fifty media outlets in Mongolia, and everyone reads the paper. In addition, there are numerous internet cafes with fast connections all over the city with rates roughly 40 cents per hour.

However, while the government is quite pro-business and politics are reasonably transparent, both of these need to be considered on a relative basis. There is a fair amount of corruption as bureaucrats are paid low wages and there is a lot of potential money coursing through the government’s veins.

Markets – lots of interest, but few options (both Opportunity and Risk)

Access to markets and market liquidity can be both a pro and a con, depending upon one’s perspective. There are a small number of Mongolian mining operations that are traded on international exchanges as the local market is minimally accessible and highly illiquid with poor transparency. The Mongolian Stock Exchange (MSE) has a market cap just over \$2.5 billion with over 300 listed firms. Daily turnover is \$150k, and it is only open two hours daily (maybe one, I received conflicting information).

The market itself is completely closed off to the rest of the world due to its clearing functions which are not transparent. As with any emerging economy, there are issues with trade information being leaked and front-running of trades. At present, they are in negotiations with the London Stock Exchange to upgrade their procedures and technology to conform them more to global standards, which will help address some of these issues.

On the positive side of liquidity issues is the tremendous interest that’s recently been expressed in Mongolia. There are a number of Western institutions attempting to gain access to this market with interest having begun last fall. But, because there are limited ways to deploy capital, a number who are interested are waiting. In many ways, it’s like the water behind a dam... once the dam breaks, the money will rush in. It’s still early for investment, but it won’t be for long.

Infrastructure (Risk)

After so many positive aspects, you may be wondering what the downside is to an investment in Mongolia. First, there’s the infrastructure... overall, it is a disaster. While there are new buildings (and nice structures) all over downtown, the roads are abysmal. And, there is only one major rail line

leading into and out of the country. This is partially a function of the mis-trust of the Chinese by the Mongolian people and the fact that all of Mongolia's population is equivalent to that of a suburb of a major Chinese city.



Transporting the Goods (Risk)

How, then, will they transport all the resources that need to be exported? Right now, coal is the primary export coming from the mines, and it is being sent by truck. Last year, the Russians offered rail discounts to link Mongolia to Korea and Japan via Russian rail and seaports. This is part of a major undertaking by the Mongolian government to link the strategic deposits of the country through 7000 km of rail line. Interestingly, though, Russian rail gauge (width) and Chinese rail gauge are not the same, so shipments directly into China will have to be offloaded and reloaded at a rail terminal on the border. This project, though, is at least seven to eight years away, but it is part of an effort to not so dependent upon China.

Commodities Pricing (Risk)

Let's talk about China for a little... Mongolia is a land-locked country sharing borders with only two countries – Russia and China. For obvious reasons, they are seeking to develop a “third neighbor policy”. As has been mentioned, the vast majority of Mongolian exports are to China, and many of these commodities (especially coal) have their own prices in the northern regions of that country. Mongolians try to link to outside market prices, but as a country without access to ports they have limited pricing power.

China's Growth Story (Opportunity and Risk)

Something else to consider about China and its growth rate... If China is a bubble (we remain China-skeptics, which means we believe Chinese growth will slow from its current rates), then do you want exposure to Mongolia since it is essentially a resource play? Yes and no. Yes because Mongolian export is a residual error to the Chinese (2 – 3% of their annual usage) with low extraction and shipping costs. Mongolia competes directly with Australia / Indonesia (high transportation costs) and internal China. No - because this will open the floodgate for institutional money to flow back out of the market as quickly as it rushed in.

Macro-economic Challenges (Risk)

The Bank of Mongolia provides a monthly report which includes a number of macro-economic details on their English site at <http://www.mongolbank.mn/eng/default.aspx>. The Mongolian economy has grown rapidly since the steep recession, and concerns include the growth of money supply and its potential influence on inflation. While reasonably transparent, the central bank does not always have all the tools needed at its disposal the way other central banks do, and they are quite new at managing an economy.

Interest rates are set competitively by the banks (even though there is a target rate for short-term bills of 11%) because the banks are all trying to increase capital to fund projects. Most borrowings are very short-term, while loans are longer term. One result is a massive duration mis-match for the banking sector which could have significant implications if assets leave the country.

Cultural (Opportunity and Risk)

The role of women in Mongolian society and workforce is distinct among both Asian nations and Mongolia's neighbors. Historically, women have done the business of the family while the men were herding. During the years of Soviet domination, there were generations of men lost as they were forced to participate in Soviet collective farming. In the city, it is readily apparent the dominant role of women in business as most of those going to work in professional occupations are female. They are well-dressed and have an obvious sense of purpose. This contrasts with the men who remain somewhat idle; hopefully, the mining industry will increase the numbers of those who become gainfully employed.

Conclusion

What does Mongolia become in the next fifteen years? Is it like the Nigeria with tremendous resources, but massive corruption and concentrated wealth? Or is it like Saudi Arabia? One comparison was made with Western Australia where there are 2 million people almost twice the landmass as Mongolia. Here, minerals are simply extracted from the ground (no value added), and GDP per capita is \$75,000 per year. Could Mongolia build on extraction model and then become a foreign tax haven / financial center / trade zone? If it can happen in Dubai or UAE, then why not Mongolia?

For the near-term, the most appropriate comparison among the people I spoke with was Kazakhstan... In 2002, there was an oil-driven economic boom that pushed GDP from \$20 billion to over \$100 billion. Commensurate with this was stock market growth and a number of international IPO's for resource companies and banks.

Some significant challenges remain... All these projects that are being undertaken are HUGE, and any one of them is bigger than anything they've done historically (can they get them all done?). In 2012 they will have a Parliamentary election which will be key to determining this future. As projects begin to provide funds for the country to modernize, will they take advantage of their natural resources and raise the standard of living for all Mongolians, or will this country become yet another country cursed with its natural gifts? The answers to these questions will indicate what kind of future they have.