

# Key Takeaways from 'Invest Mongolia 2017 Ulaanbaatar

Between September 4 and 5, Frontier LLC hosted the eleventh annual conference of Invest Mongolia at the Shangri-La Hotel, Ulaanbaatar. The conference was attended by 1100 participants, the largest number to date.

As in past years, Invest Mongolia 2017 brought together speakers from the public and private sectors, international experts and foreign investors. However, this year's conference was even more significant than those in previous years because the Government of Mongolia was a co-organizer, resulting in substantial participation by government officials.

Panel discussions and presentations ranged far and wide, covering the economy, individual sectors and the political environment. Below, we summarize the key takeaways in six sections:

1. **Macro Economic Policy**
2. **The Rule of Law and the investment climate**
3. **Mining Sector Strategy**
4. **Energy Policy**
5. **Transport Infrastructure**
6. **Finance and Banking Sector**

## 1. **Macro Economic Policy**

- First of all, **the economy is in significantly better shape than last year**. A year ago, growth was zero and Mongolia was facing the possibility of default in early 2017. In the first quarter of 2017, GDP grew at an annualized rate of 4.2%. By the end of June, this had accelerated to 5.3%.
- However, this **growth is fragile since it is largely dependent on the increase in coking coal exports to China**.
- **Nevertheless, other positive factors are the recent rise in the price of copper** over the last two months from \$6000 per ton to \$6800 per ton and the increase in **purchases of gold** by the central bank, which at the end of September stood at 15.3 tons compared to 13.9 tons a year previously.
- **Foreign reserves have steadily improved**, supported by multilateral and bilateral support and the refinancing of the \$500 million Development Bank bond. Foreign reserves now stand at \$1.5bn compared to \$1.2bn at the beginning of the year.
- However, **Mongolia's external debt remains unsustainably high**, at 218% of GDP. **This is the main reason why the country's credit rating remains low**. Therefore, **significant improvements in fiscal policy are still necessary**.

- **The success of fiscal reform is essential for sustained recovery in the economy and an improvement in the credit rating.**
- **The agreement with the IMF** and the associated agreements with the Asian Development Bank, Japan, Korea, India and the World Bank give the government **breathing room** to finance its debt and to implement the necessary fiscal consolidation.
- It was encouraging that **the first review from the IMF was positive**. However, **the new government needs to follow through on the work of the last six months in order to receive the next round of financing**. The government needs to be realistic and needs to learn from the mistakes of previous governments.
- **The most important immediate task facing the government is the refinancing of the Chinggis Bond**. This is best achieved through the issue of a new bond.
- **The privatization of state owned companies**, such as Erdenes Mongol, MIAT, and Ulaanbaatar's power plants, is an important way of reducing debt and improving long-term competitiveness. However, to win international investor support, **tangible improvements in the governance of these companies (particularly truly independent and internationally recognized non-executive directors)** are imperative for successful fund raisings.
- **There is also a need for increased corporate transparency and accountability**. This is essential to **maximize true value of State Owned Companies**.
- **Lack of Political stability is a major concern to foreign investors. Even when governments change policy should remain the same.**
- The government should create **a policy priority list** and should consistently adhere to this plan. In particular, **Mongolia needs to establish a long-term vision for the construction of a competitive infrastructure**.
- For the long-term, it is important for Mongolia to reduce its dependence on swings in commodity prices. Mongolia needs to **diversify the economy into non-mining sectors, agriculture, finance, tourism, energy and technology**.
- There should be **minimum state intervention** in business and the private sector.
- In the **agriculture sector, China and Europe** are important potential markets for Mongolian products. Both have strong demand for **high quality, organic foods**, in which Mongolia is strong. However, first of all, Mongolian producers have to **meet international standards**. Obviously, government support will be necessary to complete this task.
- **Technology products: utilizing intellectual capital** are a potentially large contributor to Mongolia's economy, but Mongolia needs to promote an attractive **investment environment** to finance these companies.

- Mongolia is **geographically ideally located strategically to host data and other IT functions**. The necessary regulatory infrastructure needs to be put in place.

## **2. The Rule of Law and the investment climate**

- A commitment to the **Rule of Law**, specifically the adherence to, and implementation of, contracts is essential to investor confidence in Mongolia.
- It is important to **implement law on legislation** that prevents sudden regulatory changes.
- Nothing has undermined investor confidence more than the constant back pedaling on the **OT agreement** of 2009. **Clarity, consistency and transparency** are vital to improve investor confidence. It is unacceptable that every time the government changes there is discussion of changing the terms of the original OT agreement.
- The establishment of the **Investor Protection Council (IPC)** in March of 2017, providing protection to investor rights is an **encouraging step**. The IPC is regarded as one of the most positive achievements of the previous cabinet. We hope that the new Government will build on this and improve the overall investment climate.
- It is important to **operationalize IPC** by creating efficient and transparent system that would address investors grievances and requests within **specified timeframe and accountability** that would be supported by **Information Communication Technology (ICT) tool**. The ICT tool will help to create a database of Investment climate issues, analyze trends and build more solid policies based on evidence and data. That would also help in consistency of policies and law implementation under frequent government changes.
- Developing a **safety net** in putting complaints and grievances against government actions that go against investors rights by creating **Public Private Dialogue (PPD) platform** where IPC can represent the private sector.
- However, understandably, investors who have long term experience of Mongolia **remain skeptical**. Many of them still question whether Mongolia provides the **transparent, consistent and clear rules with good quality** they look for when choosing one investment destination over another. **Tangible proof of the government's commitment to the protection of investor rights supporting the Systematic Response Mechanism** is required. Until then, most of the embassies here need to continue to caution to their investors to conduct **thorough due diligence** before investing in Mongolia.
- In particular, foreign investors require evidence that, in the case of **commercial disputes**, they and their representatives will not be dragged into **criminal court**. **The series of unfortunate incidents** of the last few years, specifically **Khan Resources and South Gobi**, are a **serious deterrent** to foreign investment in

Mongolia. One panelist remarked, "Why would I go to Mongolia and invest my money if I might end up in jail?"

- The lack of protection of the rights of foreign investors and the risk of criminal prosecution is a **real weakness** in the justice system. Each time it happens it is terrible for the individual, and further damages Mongolia's reputation in the eyes of other investors.
- Sadly, despite recent improvements in the economy cited above and some **cosmetic improvements** in the legal environment, foreign investor confidence in Mongolia has seen little improvement. Indeed, the **recent confusion** caused by the change in the prime minister and the cabinet have clearly undermined investor confidence although we find the new cabinet members much more powerful, professional and understandable to the foreigners in general.

### **3. Mining Sector Strategy**

- **The mining sector is the most important sector for the long-term development and growth of the Mongolian economy.** The commodity super cycle may be over but **long-term demand for many of the commodities in which Mongolia is rich will remain strong.**
- Rather than passively relying on support from foreign countries to restore business confidence, **Mongolia needs to take the initiative to establish an attractive legal and regulatory environment** in order to attract high quality investment into this sector.
- According to **CRU research, commodity prices, particularly copper and other base metals, are expected to rise steadily** over the next few years. However, in order to **maximize the profitability of its commodity exports**, Mongolia needs to establish a **competitive physical and regulatory infrastructure.**
- **Transparency and accountability** in government policies and the **coordinated implementation and support** of exploration projects are vital in the mining sector.
- **In particular, a stable tax and royalty system** are important for the growth of the mining sector.
- The government needs to **prioritize the most attractive mining projects.** Specifically, OT, TT, and Gatsuurt should be the primary focus.
- **The first priority should be to bring existing projects into production.** The government should avoid wasting resources on projects, which are unlikely to get funded.
- **Human resource development** is key to the long-term development of the mining sector and the establishment of a **highly profitable mining service sector.** The example of Australia over the last forty years shows how the development of a highly skilled mining service sector can improve profitability and attract foreign investors.

- As part of the development of the mining service sector, Mongolia needs to establish strong **mining exploration companies**, which will ensure a robust **pipeline of high quality projects for the future**.

#### **4. Energy Policy**

- **Mongolia has abundant sources of energy in the form of coal, wind and sunlight.** Yet, despite this, Mongolia currently **imports about 20% of its energy** from China and Russia. **The development of the energy sector is second only to mining for the long-term growth of the economy.** Mongolia should be a massive exporter of energy. China, Japan and South Korea are all eager to import energy from Mongolia.
- **The government needs to set out a long-term program for the development of the energy sector in general, and the renewable energy sector in particular.** The World Bank estimates that Mongolia has the potential to generate some 2.5 Giga Watts annually from sun and wind. The same study estimates that Mongolia has the potential to be one of the world's lowest cost producers of solar and wind energy.
- There have been **dozens of energy projects** discussed in recent years. However, very few of these have come to fruition. The government should prioritize the development of **high quality energy projects**, which achieve the long-term goals of the country's energy policy.
- For this purpose, the government should consider choosing the project, which has the least negative impact on the pollution of Ulaanbaatar. Specifically, in the case of Coal Power Plant Five, the location of the plant should be as far away from Ulaanbaatar as possible.
- The Government should encourage **technological innovation, reduce energy waste** and, as far as possible, **subsidize tariffs** for the use of renewable energy.
- One interesting program for the development of renewable energy in Ulaanbaatar is "**Roof Top Solar.**" The cost of solar technology has declined by some 90% over the last 5 years and will continue to fall, following **Swanson's Law**. Roof top solar offers an affordable long-term solution to Ulaanbaatar's energy problems and to pollution.

#### **5. Transport Infrastructure**

- **The lack of efficient transport infrastructure has been a serious handicap in preventing Mongolia from developing its mineral resources and maximizing profitability.** This needs to be corrected. Compared with the Australian mining industry, for example, mining costs in Mongolia are quite competitive, but transportation costs are several times higher.
- The last ten years have seen various road and railway plans discussed but very few have so far been implemented. The government needs to move ahead with a **concrete, solid plan**.

- China's '**One belt, one road**' initiative provides Mongolia with an opportunity to integrate its transport infrastructure with the rest of the region. The region encompassed by One belt, one road comprises about 40% of total global trade. Under the **CAREC** (The Central Asia Regional Economic Cooperation) transport strategy, some eight projects of \$18 billion are planned over the next five years. It is essential that Mongolia establish itself as a key player in the implementation of One belt, one road.

## **6. The Finance and Banking Sector**

- **The establishment of a strong, well capitalized banking sector and well functioning capital markets is essential to provide finance for the long-term growth of the Mongolian economy.**
- As of the end of September, system wide figures show **the combined ratio of non-performing loans and past due loans to be 16%** of the total loan portfolio, which is the same level as a year ago.
- The IMF program and the associated Asset Quality Review (AQR) offer an opportunity to address the issue of under capitalization of the domestic banking sector by bringing in outside capital. As part of this, the banks should also be encouraged to list either on the domestic stock exchange or overseas.
- Listing one or more of Mongolia's banks on the Mongolia Stock Exchange (MSE) would also provide an opportunity to invigorate the domestic capital market. The market capitalization of the MSE is currently only MNT 2 trillion, or less than 10% of GDP. In other markets a ratio of at least 1 to 1 is more normal.
- The government should also consider incentives for shareholders and require the pension funds to invest at least 1/3rd of their funds in the equity market. This would also encourage other large Mongolian companies to list on the MSE.
- Only with a more efficient capital market will companies have access to outside funds. This could also contribute to a long-term decline in interest rates and a lower cost of capital, which are essential for the sustained growth of the economy.

## BIO of Masa Igata

Founder & Chief Executive Officer, Frontier Securities Mr. Masa Igata, Founder & CEO of Frontier Securities, has more than 30 years of professional experience in Asian financial markets. Prior to establishing Frontier Securities in 2007, he had been a Managing Director at Salomon Brother/Citigroup/Nikko Citigroup in Tokyo leading the company to be the most profitable foreign investment bank in Japan for more than the decade.

After leaving the firm in 2004, Mr. Igata became interested in Mongolia's fast-growing economy, and began to develop close relationships with many Mongolian businesses since then.

Mr. Igata has since invested in Mining, Finance and real estate sector in Japan, Mongolia,

Canada and China through his own companies in each region. In addition, with proven expertise on cross-border capital raising, Mr. Igata has been actively promoting Mongolian investment opportunities to foreign investors and advocating capital market's best practices in Mongolia to ensure and enhance its access to foreign investors through a full range of financial services, corporate access and research.

Hosting Invest Mongolia is one of the service to facilitate himself and investors to access to the Government and the Business. In addition, he has extensively advised the Government of Mongolia, several government agencies and major corporate in Mongolia on fund raising, corporate governance and value enhancement. Mr. Igata is a certified member of the Securities Analyst Association of Japan and director of Prophecy Development which is listed at Toronto Stock Exchange and has significant coal deposits in Mongolia.

