Mongolia: Investing in Asia's New Frontier

Mongolia's vast and untapped mineral reserves have allowed it to be called the "Kuwait of Asia." However, political issues and the lack of infrastructure have hindered the country's ability to reap the rewards of its natural resources that are scattered across its vast expanses. FTI Consulting's Alex Horbasz, based in Ulaanbaatar, shares his views on the country's current and future opportunities.

Since communism collapsed more than 20 years ago, Mongolia's political and economic systems have undergone profound change as this young democracy has moved to a market-driven economy. Foreign investors and advisers who have chartered the country's path of reform and liberalisation have often been surprised by the erratic course of progress, and observers have expressed concern regarding certain shifts in economic and political policy.

However, for the first time in its democratic history, the four most important political positions in Mongolia are in the control of one party – giving hope for a period of political stability. The President, Prime Minister, Chairman of the Great State Khural (Parliament) and the Mayor of the City of Ulaanbaatar are all from the Democratic Party. With no elections due for approximately the next three years, the government will be able to focus on addressing critical issues through objective analysis, rather than by reacting to public sentiment.

Critical to measuring the government's success during this term will be its ability to accelerate development of the Oyu Tolgoi (OT) gold and copper project. This project has been the center of prolonged negotiations between the government and its foreign investors, including British-Australian multinational Rio Tinto. Without rapid progress on this massive project, Mongolia will find it difficult to achieve its much vaunted potential and meaningfully improve the lives of its three million people.

Political Landscape

Of the country's array of political parties, the Democratic Party is the most pro-Foreign Direct Investment (FDI). However, a rising tide of resource nationalism remains an impediment to growth. Therefore, the new government will need to ensure that national interests are seen to be protected. At the same time, it will continue to encourage FDI by creating a more business friendly environment. In the past, whenever laws were found to negatively impact business, government has moved quickly to revisit government policies and laws. Mongolian politicians are very practical and pragmatic.

In recognition that some existing laws and attitudes are hindering both FDI and economic growth, the government called for a special session in September to discuss the current economic crisis prior to Parliament's 2013 Autumn Session which commenced 1 October 2013. Although no major decisions were made, an important consensus was reached by the two major parties (the ruling Democratic Party and the Mongolian People's Party), whereby both agreed to work together in a constructive manner to find solutions to address the outstanding economic issues. In particular, special attention would be placed on ratifying the proposed amendment to the "Strategic Entities Foreign Investment Law" (SEFIL) and related mining regulation and law.

Economic Conditions

In recent years, Mongolia's economy has become one of the fastest growing economies in the world, achieving GDP growth of 17.5% in 2011. This growth was due to two major drivers in the mining sector – coal and iron ore exports to China and a US$6 billion investment in Rio Tinto's OT project. The growth in the mining sector also had a significant spillover effect on other sectors of the economy, most notably in the real estate sector and for the small and medium enterprise (SME) mining services and product providers. However, over the last year there have been factors in the mining sector negatively impacting the Mongolian economy:

- The softening of economic growth in China, resulting in falling commodity prices and a significant decrease in coal export volumes.
- The on-going disputes between the government and Rio Tinto related to the OT project, which have resulted in Phase II (underground mine development) being postponed. Accompanying this development were layoffs of approximately 1,700 employees and an almost 50% drop in FDI as foreign investors adopted a wait and see attitude on how the dispute is resolved, prior to committing to any new investments.

As a result of the above, the current account deficit has grown and the Mongolian Tugrik has depreciated by over 15%.

The slowdown in China's economy has had a drastic effect on Mongolian coal and iron ore exports to China – down by approximately 50%. There is little that the government can do in this area. As the Chinese economy picks up speed, so will Mongolian natural resource exports.

The on-going disputes between the government and Rio Tinto related to the OT project have created uncertainties specific to the project and more generally for FDI. FDI enters a country based on long term contract stability. The current dispute based on a multitude of issues, including budget overruns, accusations of tax evasion, wage variances between

Mongolian and foreign workers, decision making transparency and how to finance Phase II (estimated at US$5 billion), has forced Rio Tinto to reassess its longer term investment strategy for OT. Foreign investors have followed Rio Tinto's lead and placed new investments in Mongolia on hold.

Recognising the negative impact that uncertainty is having on the OT project and the economy, the government is now taking a fast track approach to resolving the situation. It sent the three government board members of OT to Rio Tinto's HQ in London at the end of September to advance discussions. Initial feedback from the meetings has been positive with resolution now anticipated by year end.

Although the Mongolian economy has taken a significant hit, the economy is showing resilience. The downturn in the mining sector has been partially offset by the growth in the agriculture sector which grew 20.6% in 2012. Also, using funds available from the Chinggis Bond (US$1.5 billion) the government has created a mini-boom in the property development and infrastructure construction sectors. It is providing funding to support 8% mortgages for apartments under 80m^2, making new housing for low-medium income families more affordable and improving their standard of living. This initiative is expanding the construction sector and creating new opportunities for construction material suppliers, for both importers and local manufacturers. Chinggis Bond funds are also being used to build essential infrastructure, which is key to developing the mining industry and growing exports.

The overall net effects have been that the 2013 GDP growth forecasts have been revised down by economists to below 10% and the Tugrik continues to be under pressure. However, once the OT disputes are settled and further amendments to the foreign investment and mining laws are ratified by Parliament, the Mongolian economy is expected to achieve GDP growth rates previously forecast by the IFC/World Bank of around 20% per annum.

Business Environment for the Foreign Investor

As a rapidly growing emerging market, Mongolia presents many opportunities for foreign investors. At the same time, there are also many challenges in understanding the local business culture and practices, finding the right partner and appreciating the political and regulatory risks.

In recognition of the need to make Mongolia more FDI friendly, on 3 October 2013 the Great State Khural passed an investment law that ends the application of different rules for domestic and foreign private investors. Mongolia's new law eliminates earlier rules that were perceived as discriminatory against foreigners and sets stable tax periods. The new investment law will take effect immediately and voids the SEFIL, passed in 2012, which limited foreign investment and ownership in the strategic sectors of mining, banking and communications.

The new law contains tax stabilisation measures and provisions (corporate income taxes, VAT and duties) for periods of five to 22 years, based on the size of investment and the location within Mongolia. The new law also contains provisions that will prevent future changes to legislation. To encourage large scale developments, investments of more than US$300 million will be eligible for additional stability conditions. These amendments are intended to provide investors with the confidence and assurance they require. The new law retains the provisions in the SEFIL that apply to foreign government State-Owned Enterprises (SOE). In instances where an SOE aims to hold more than 33% of a company, it will still require government approval.

This is the first of a number of changes to existing laws effecting FDI that we expect to see Parliament pass within the next six months. Some of the expected new laws/amendments will relate to the mining sector – including a redefinition of what is considered to be a "Strategic Deposit" and redefining the "Law with the Long Name" (limiting mining exploration and development of deposits near rivers and forests).

How Can FTI Consulting Assist Companies Looking to Do Business in Mongolia?

Mongolia is filled with significant opportunity but also with substantial risk. With that said, companies that are interested in doing business in Mongolia are well-served when they work with partners that can help them navigate the market and support their business goals.

FTI Consulting has a dedicated on-the-ground team in Mongolia and we offer a full suite of services across several of our practice areas: Global Risk & Investigations, Strategic Communications, Corporate Finance and Economic Consulting. Whether you are interested in researching the market opportunity, identifying and measuring the political risks of doing business or driving visibility and understanding of your company's plan for investing in Mongolia, FTI Consulting is able to help. We can create an integrated team to help you make informed investment decisions and support the success of your efforts in this fast moving market.

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