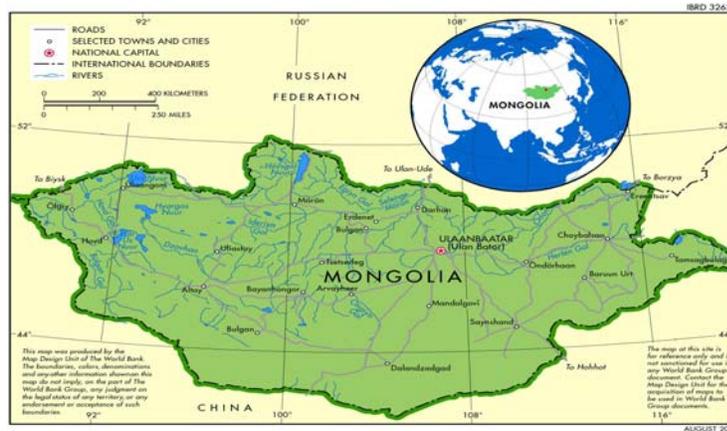




Beyond the Great Wall – Mongolia, the Saudi Arabia of Asia

April 2010

By Ning Ma



“Mongolia? Inner Mongolia?”

“No. I am going to Mongolia, not a province of China.”

“Oh... Wow...Cool...But why would you go there?”

“It is a business trip to meet companies’ managements and get an idea of the equity market.”

“Really? They have a stock market? I thought they had only sheep, cattle and mines....”

Above is the most common conversation I had with my Chinese friends when I told them that I was going to visit Mongolia. Yes, even neighboring Chinese, who were once ruled by Genghis Khan in the 13th century, think Mongolia is just an exotic, small, poor country. In fact, Mongolia is a huge country roughly three times the size of France. It is the 2nd largest landlocked country after Kazakhstan. It is the 7th largest country in Asia and the 19th largest country on the planet.

The country is strategically located between Russia and China. It contains very little arable land (0.76%), as much of its area is covered by steppes, with mountains to the north and west and the Gobi Desert to the south. Though the vast land is so barren that there are no permanent crops, it is blessed with rich mineral resources, including gold, copper, uranium, coal and molybdenum. Mongolia is a democratic country with an established multi-party system, and a current government that is a coalition between the Mongolian People’s Revolutionary Party (MPRP) and the Democratic Party (DP). Mongolia’s business environment is surprisingly good. According to World Bank’s 2009 Survey of Doing Business, Mongolia outperformed the BRIC countries, ranked at 60 in terms of ease of doing business; and the Heritage Foundation gives Mongolia an Economic Freedom score that is higher than Italy, Greece, Portugal as well as all of the BRICs. The country has a population of about 3 million with about half living in or around the capital city of Ulan Bator.

2218 Avenida de la Playa
La Jolla, CA 92037
United States

p 1+858-456-1440
f 1+858-456-2040

www.frontiermkt.com

There is one daily flight from Beijing to Ulan Bator on Air China. The plane is small, but my flight was filled with people from all over the world, mostly on business trips. After only two and a half hours, we arrived in the Chinggis Khaan International Airport, a small facility with only one gate. It is a two story building but has no elevators (I was lucky to have only a small carry-on bag!)



Chinggis Khaan International Airport



Landscape outside Ulan Bator

Upon leaving the airport, I was overwhelmed by the vastness of the land. The mountains, the plateau and the snow seem endless. While people in San Diego were still wearing T-shirts, here in Mongolia it was already winter in October. Winter is always tough both for people's daily lives and for businesses because the temperature goes down to minus 30 degrees centigrade (minus 22 degrees Fahrenheit)! One can only imagine how green and beautiful it is when summer comes, presenting Mongolia a great opportunity to further develop its tourism industry.

Along the road are many small, one-story houses, typical of the homes of roughly 60% to Ulan Bator's residents. They don't have central heating, and in winter, they consume great quantities of coal and wood, producing lots of smoke and pollution. One can literally see black air directly above the city and the smoke fills the cars. Our local broker told me that October was not the real winter yet. Once it gets into December and January, the pollution becomes so severe that people can barely breathe. The government, together with international organizations, are pushing hard to promote higher quality briquettes and establish a special fund to support energy efficiency.



Houses outside Ulan Bator

Ulan Bator is very centralized. Government bureaus, hotels, restaurants, universities, hospitals, stores, banks, museums are all in very short walking or driving distance. On the other hand, there is a definite need to improve the infrastructure. The roads are old and narrow, yet I was surprised to see how many cars, especially SUVs, were on them; big SUVs are preferable because there are practically no paved roads outside the city. The used car market is very popular here, and the cars are relatively cheap; there is one car for every four people.

Most of the buildings are not very tall, but I did see a few newly built, tall and modern buildings in the city. In one of them, Louis Vuitton had just opened its first store, in response to the growing purchasing power

of consumers in Mongolia. Statistically, the country's economy has been growing at 9% on average for the past three years. According to the OECD DAC list, Mongolia is now in the lower middle-income country group.



The first Louis Vuitton store in Mongolia



One of the new and few high rises in Ulan Bator

The day I arrived was evidently a very good day for weddings. A ceremony was even taking place in my hotel. I was fortunate to see the bride, arriving in a fur coat over a beautiful white gown. Contrary to my expectations, the wedding was quite westernized. A live band performed in the lobby, the floor was covered with flower petals and cute kids stood by with baskets of flowers. Some of the older guests wore traditional "Del" (Mongolian traditional clothes), but most of the guests were in modern suits and dresses. Later, traveling through the city, I saw more couples on their way to be married, with groups of fancy vehicles decorated with flowers. Overall, this is much like modern China, where, as incomes have grown, people are having bigger and more luxurious wedding ceremonies which are more adapted to the western culture.



A live band performs prior to a wedding... a growing industry as incomes rise



The beautiful bride

The Mongolia stock market has 378 companies with a market cap of just under US\$500 million. The services sector accounts for 39% of the total market cap, followed by manufacturing 28%, mining 21%, food 11% and construction 1%. Unfortunately, most of the listed companies are small and illiquid, while the larger ones are mostly in the mining sector. Daily trading volume ranges between US\$100,000 to US\$200,000, and yet, amazingly, there are currently 44 stock brokerage firms, with BDSec, the market leader, representing more than 50% of the total trading volume and 70% of the total IPO transactions. The commission rate is a lofty 4.8%. BDSec was hurt badly in the global financial crisis, with trading volume down and no business in the corporate finance sector; today, however, things seem to be improving. They were in negotiations with several companies regarding possible IPOs. People working in BDSec are young and passionate. Several analysts speak fluent English and they knew their companies well. They may be well poised to benefit once the economy recovers, given the government's efforts to develop the capital market.

The banking sector was probably one of the worst hit sectors in Mongolia during the global recession. High inflation made it hard to attract deposits while costs of borrowing went up. Non-performing loans increased to 11.6% mainly as a result of high exposure to the mining sector and construction sector. All banks stopped mortgage lending, which prevented the construction companies from selling their buildings to individual customers. According to Zagal Badamgerel, Senior Dealer at Golomt Bank, the banking sector may not recover until the end of 2010 or even early 2011.

The mining industry is the pillar of the whole economy as it accounts for almost 30% of GDP and 65% of export revenue. It also plays a crucial role in Mongolia's further development. However, the country will need to diversify its economy at some point and the underdeveloped non-mining sectors will follow the growth of the mining industry and may even have higher growth potentials. One example is Gobi, the largest and most internationally well known cashmere company. It normally exports 60-80% of its products to more than 30 countries in the world.



Inside a factory at Gobi

Since 2008, with stronger domestic purchasing power as well as increased marketing efforts, its domestic sales have been growing nicely. I didn't get a chance to talk to their CEO, but I was able to tour their factory and visit one of their stores. The company is very interesting with good growth potential; however, the valuation is simply too high for the time being.

Another interesting name is Spirt Bal Barum – the largest spirit and vodka producer in Mongolia. It has approximately 70% of total spirit market and 40% of the vodka market; and Mongolians love drinking! According to an unofficial survey, each person aged above 21 consumes 9.6 liters of vodka per year. Spirt Bal Barum's total sales went up by 24.3% in 2008 even when consumer spending was significantly reduced. Unfortunately, there is one problem that prevents us from buying it, at least for now. The company is controlled by a large conglomerate who has submitted its delisting request to the Financial Regulatory Commission. According to our local broker, this is not the first time this has happened in Mongolia. There are several large, powerful private conglomerates in Mongolia that control many market leaders in different business sectors. These conglomerates don't understand the importance of the equity market. They just simply don't want to share the profits of their profitable subsidiaries and prefer to keep them private. Fortunately, according to the analyst, the probability of the delisting request being approved is quite low...



Goat and camel display at a store of Gobi's



Consumers at the Gobi store

Conclusion

Overall, we see both opportunities and problems in Mongolia. It is frustrating to see people who don't understand the value and significance of their equity market; too often, minority shareholders' interests are at risk. The managements may not be transparent and some larger companies don't even bother to meet potential investors,; on the other hand, much smaller companies will meet with you, but they haven't started their operations yet. Investor communication is poor, and financial information is hard to obtain.

That said, Mongolia can be thought of as the Saudi Arabia of Asia because of its rich materials resources. KPBS recently had a week-long series of reports on Mongolia covering its economy, politics and culture. Many potential investors around the world are eyeing its mining industry. This includes China, which is aggressively investing in Mongolia, in the hope of fulfilling its rising demand in raw materials.

The Mongolian government used to have a Windfall Profit Tax Law (WPT) that is 68% of revenues when copper price exceeds USD2600/t and when gold exceeds USD500/oz., giving Mongolia one of the highest effective tax rates on mining in the world. On Aug. 25th, 2009, the Parliament amended the WPT which suggests ending the 68% windfall profit tax on copper and gold starting from Jan.1st, 2011. There is no doubt that the change will strongly boost the mining industry and attract more foreign investments. The government just signed the Oyu Tolgoi investment agreement with the strategic investors in October 2009, covering one of the largest copper and gold deposits in the world. The estimated total investment will be more than \$4 billion. Also, the EBRD recently organized the first Europe-Mongolia Investors Forum in London.

Most importantly, the Mongolian government, itself, has begun to realize the importance of its equity market and is taking steps to better develop and regulate the market. A recent meeting of the new Prime Minister with representatives from the capital market, the insurance market and the listed companies was titled "Capital Market – The key to Development". Also, the National Development and Reform Committee is a new government organized forum to discuss protection of minority shareholders' rights and improvement of corporate governance. Finally, trading "hours" were recently expanded from one hour per day to one and a half hours!

Taking all these factors into consideration, we do believe that Mongolia stands a good chance of becoming the fast growing economy in the near future. All we need is patience and hard work to dig up the good values.

About Frontier Market Asset Management

Founded in 2006, Frontier Market Asset Management holds more than 35 years worth of investment experience including work in Emerging and Frontier Markets since 1987. For more information, please contact us at (858) 456-1440.

This is not an offering. An offering will be made only by means of a final offering memorandum and only in those jurisdictions where permitted by law. The fund is subject to a variety of risks, including but not limited to: investments may be volatile depending on the type of hedging techniques employed and subject to stock market risk; investments may be illiquid; an investor could lose all or a substantial amount of any investment in the fund; there is no secondary market for interests in the fund nor is one expected to develop, and there are substantial restrictions on transferring an investment in the fund; fees and expenses of the fund may be higher than those of other investments and will reduce the portfolio return. Consult the fund's offering memorandum for complete risk disclosures and other important information.



The information has been compiled from sources we believe to be reliable, but we do not hold ourselves responsible for its correctness. Opinions are presented without guarantee.