

MONGOLIA: CHALLENGES & OPPORTUNITIES



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Shockwaves the recent commodities slump sent through the Mongolian economy are yet another example of boom and bust cycle dangers. This report takes a quick glance on foreign investments and recent economic developments in Mongolia. The paper notes that despite current economic difficulties, Mongolia has immense economic potential and offers unique opportunities to investors. Unlocking these opportunities is a challenge faced by the Government as well as business in Mongolia.

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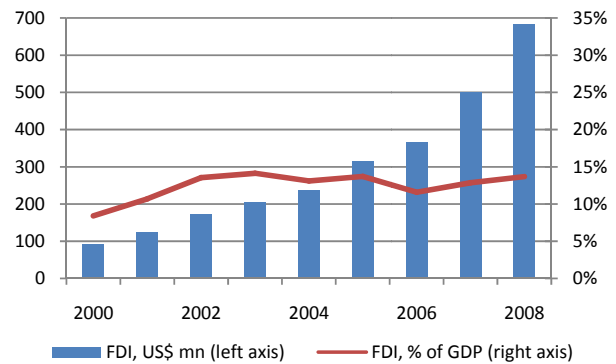
1. ECONOMIC DEVELOPMENT AND ROLE OF FOREIGN INVESTMENTS IN MONGOLIA

Effectiveness of foreign investments on economic development of a country depends on complex macroeconomic and structural conditions. Mongolia was no exception. It was challenging to provide in-depth assessment of foreign investments effect on the Mongolian economy. Especially, the recent commodities market boom and bust distort general picture. The assessment would require longer timeframe and more historical data on capital flows, trade, technology and skills transfer, labour productivity, labour force flow, employment rate changes and so on. Substantial influx of foreign capital and investments, disregarding the Soviet investments, to Mongolia quite a recent phenomenon. The historical timeframe is too short to make any far-reaching country specific conclusions. However, at this stage to a certain extent it was possible to provide rapid assessment and intuitive conclusions on impact of foreign investments on economic development in Mongolia.

Flow of foreign investments is highly sensitive to investment framework adopted by and future growth potential of a country. Normally, foreign direct investments (FDI) is an effective indicator of actual growth potential of any country.

Measured in terms of attracting foreign investments, Mongolia has been quite successful in its transition from planned to market economy. Its investor-friendly climate attracted substantial long-term investments into the country. Since 2000, the country has attracted almost US\$2.7bn in foreign investments.

GDP and FDI

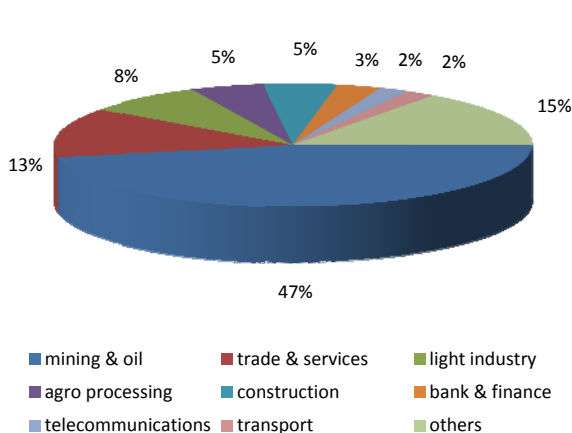


Source: National Statistical Office of Mongolia

In 2006 investment climate has somewhat soured with adoption of new regulations and imposition of 68% windfall profit tax on copper and gold. The Government imposed the tax to encourage processing and cost efficiency, although the extra revenues generated came very handy for increasing social spending.

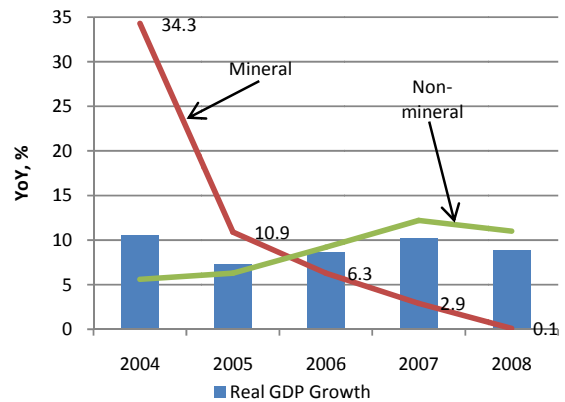
Sharp decline in global commodity prices along with long-delayed major mining projects in the country resulted in suspensions of several potential investments and production cuts. As a result resources sector lost its dominance in income (real GDP) generation for the country.

FDI share by sectors (%)



Source: National Statistical Office of Mongolia

Real GDP Growth by Industry



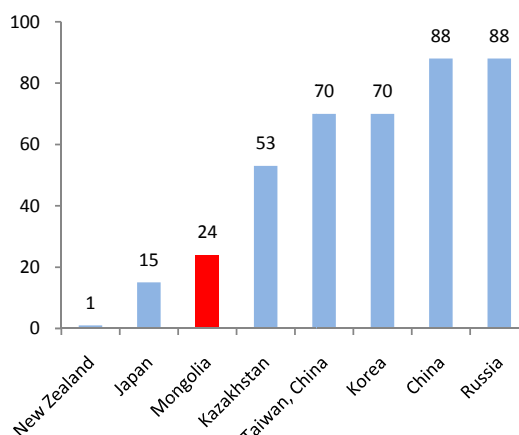
Source: National Statistical Office of Mongolia

Nevertheless, record foreign investments came in two subsequent years on the back of seemingly insatiable global demand for commodities. Overall, Mongolia still remains quite friendly towards investors although the World Bank's Doing Business 2009 downgraded Mongolia's Protecting Investors ranking to 24 from the previous 19. The maximum rate of corporate tax in Mongolia is 20%. Royalties are low at 2.5% for coal and common minerals and 5% for copper and other base metals. The customs tax is only 5% and VAT is 10%. And the income tax for individuals is set at a maximum of 10%. Recently, the Mongolian authorities adopted regulation abolishing windfall profit tax from January 1, 2011.

It is the export potential of Mongolia, which attracts most foreign investors. The Mongolian domestic market itself is too small to warrant any significant inflow of foreign investments. Much of the investment focus in Mongolia mirrors wider global interest in commodities. About 47% of all foreign investments to Mongolia went to the minerals sector. The sector has immense potential to grow with China nearby, a huge minerals consumer.

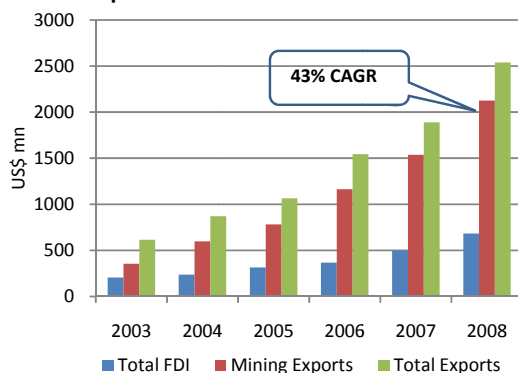
China is the major source of FDI to Mongolia, accounting almost 70% of total inward FDI. In 2008, over 64% of total Mongolian exports went to China, including 100% of coal and copper exports. Trade flows indicate that, among other things, foreign investments ease access to markets of their origination for the host country exports. And expanding trade raises government tax, tariff, royalties and other revenues.

Protecting Investors – Global Rank



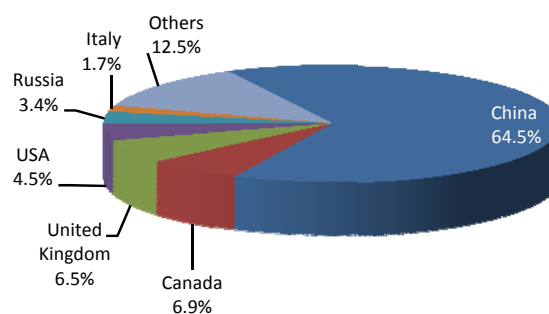
Source: Doing Business 2009, the World Bank

FDI and Exports



Source: National Statistical Office of Mongolia, IMF, Eurasia Capital estimates

Exports (2008, %)



Sources: National Statistical Office of Mongolia

Mongolian export experienced significant growth in value as well as in volumes between 2005-2008. Coal exports went from virtually zero in 2004 to over 4.2mn tonnes in 2008. Supported by flow of FDI, coal production in Mongolia doubled from 2000 to 2008. About 42% of coal production is exported, reflecting that most of the production increase is exported. Coal production and export are projected to grow further with continuing foreign investments flow. Copper export soared 156% in value from US\$326.2mn in 2005 to US\$835mn to 2008. Overall, exports surged 102% in value and 18.4% in volume in 2005-2008.

External trade data provides that the Mongolian mining sector generates 80% of export revenues, meaning the nation is highly sensitive to commodity price fluctuations. But, about 50% of FDI goes to

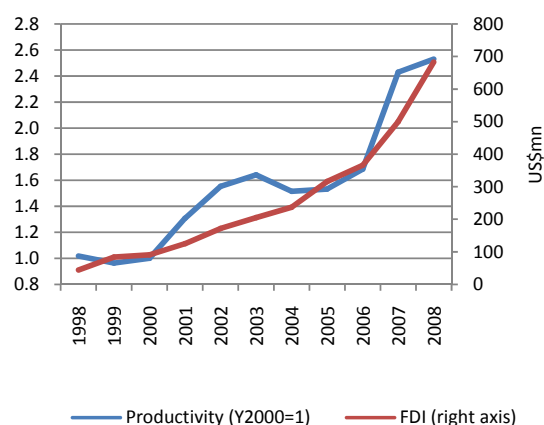
Mongolia's mining sector increasing its share of economy even further. The investments in mining will accelerate with the development of major mining deposits. Thus, Mongolia is facing issues of managing price volatility risks and diversifying economy. The issues, recent crisis proved to be of vital importance for the development of Mongolia.

For developing countries the significance of foreign investment, especially FDI, goes beyond capital formation. Foreign investment may promote economic development by helping to improve productivity growth, expand trade and open new markets. FDI boosts government tax and royalties revenues. Expanding foreign trade brings in export revenues. Investments going into production facilities transfer production technology and know-how. Foreign investment transfers and encourages development of skills, innovative capacity, organizational and managerial processes. In other words, foreign investments not only bring in hardware in the form of equipment and machinery, but also slowly build up skills and human capacity of a host country. Additionally, FDIs as a rule create a new chain of supplies, increasing local suppliers' standards and goods quality. Penetration of foreign companies into local markets, also generates competition. Local companies must either improve or loose out. All the above, in the sound macroeconomic and political environment can become a foundation for a long-term sustainable development.

Assessment of foreign investment influence on the development of Mongolia, requires consideration of three basic commonly accepted benefits – productivity change, trade pattern and technological improvement.

Mongolian labour productivity has grown 35% in 2000-2008. Labour productivity in manufacturing sector grew staggering 153% in the same period. The growth was particularly impressive in 2005-2008 registering a 65.4% increase. These astonishing rates of growth were possible due to an initial low starting point. But only investments to manufacturing, technological and process improvement can explain such a growth. Trade data reveals that between 2005 and 2008 imports of machinery and transport equipment increased 185%, whilst the share in total imports remained steady at 30%. Increasing productivity due to technological, skills and organizational improvement are the common benefits associated with foreign investments.

Change in labour productivity (manufacturing sector)



Sources: National Statistical Office of Mongolia
Aisan Productivity Organisation, Eurasia Capital estimates

Mining sector, as a primary recipient of foreign FDI, provides an example of foreign investment effect. In open-pit mining a stripping ratio refers to the amount of waste rock removed to recover ore. The average strip ratio for open pit coal mining is 4:1, that means to recover one tonne of coal, a miner removes four tonnes of waste rock. In other words, the higher the ratio is, the more expensive the mine operations are. The largest Mongolian mining company Baganuur JSC has a high stripping ratio of about 8:1, the second largest mining company Shivee Ovoo JSC mines at 4:1 ratio and Shariin Gol JSC has an economically prohibitive strip ratio of 10:1. That compares unfavourably with

Estimated income multiplier effects in South American Mines			
Mines	Investment US\$mn	Metal produced	Multiplier
Inti Raymi, Bolivia	200	Gold & Silver	2.79
Yanacocha, Peru	492	Gold	2.53
Antamina, Peru	2,296	Copper & Zinc	1.42
Escondida, Chile	2,300	Copper	5.7
Candelaria, Chile	902	Copper	1.76

Source: World Bank – Mongolia. Mining sector sources of growth study, 2007

internationally listed South Gobi Energy Resources' stripping ratio of 2:1. Though the difference in the age of their mines is important, but of more importance is investment. The mining sector price regulation has lead the Mongolian mining companies to be chronically underinvested and

technologically obsolete. In a competitive environment, the Mongolian companies would have taken measures to improve its technology to remain and/or expand on the marketplace.

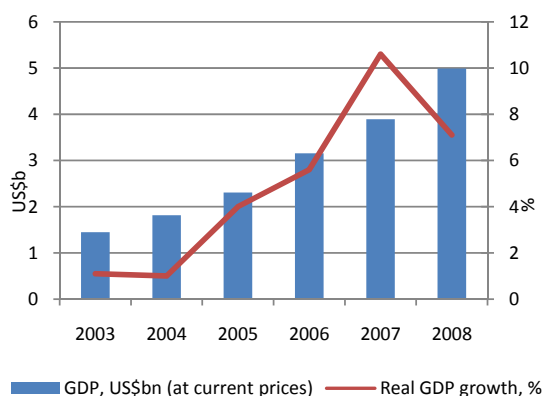
Foreign investments and development of mining deposits will have considerable spill-over effect to the wider economy. Increased mining output and exports raise government fiscal revenues, provide hard foreign currency to improve its balance of payments. Increased mining sector income trickles down via suppliers, subcontractors, service providers, employees and other stakeholders multiplying the income generated in the expansion of the mining production.

2. PRO-CYCLICAL ECONOMY

2.1. WHAT WENT WRONG?

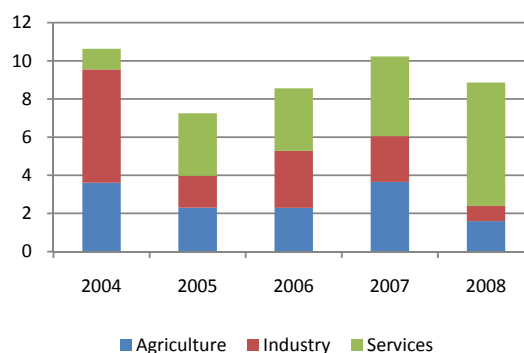
In recent years Mongolia has experienced a sustained period of robust economic growth, fueled by strong global demand for commodities and high prices for its major export products. Mongolia's GDP growth rate averaged 9.1% during 2004-2008. Expanding agriculture and services sectors were the main drivers of growth. Agriculture, albeit relative decline, remained an important sector supporting 40% of population and accounting for 20% of GDP. The sector grew underpinned by fiscal incentives for wheat production and livestock increase. Services sector, roughly accounting for 40% of GDP, was driven by transport and trade. Industry and services developed around mining, manufacturing, transport and agriculture related activities.

GDP growth



Source: IMF, National Statistical Office of Mongolia

Contribution to growth (percentage points)

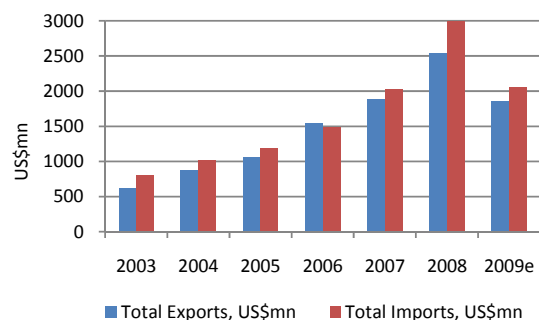


Source: IMF, National Statistical Office of Mongolia

During 2004-2008, GDP per capita grew from US\$639 to US\$1,861 in current prices. High international prices for Mongolian main exports contributed to a budget surplus in 2005-2007. Increasing Government revenues created a strong wealth effect for the population. The Government doubled public sector wages over a period of two years. Social transfer payments were extended to about half the population. Inflation remained low until picking up to 15.1% in 2007 and further increasing 28% in 2008. Expansion in public investment and spending fuelled consumption and surge in construction. Banking sector assets averaged 44%YoY from January 2006 to June 2008. Growth in banking services was supported by expansion in real estate services, wholesale and retail trade, and communication. External trade was experiencing dramatic growth.

Total foreign trade turnover grew from US\$1,890mn in 2004 to US\$5,779mn in 2008. In 2000, export of minerals comprised 35.2% of total exports. In 2004, the share of minerals in the total exports increased to 40.7%. In 2008, mineral exports amounted to 60.3% of total exports, other main export items being precious metals and jewelry 23.7% of total exports and textiles 8.9%. Overall, minerals and metals accounted for 84% of total exports in 2008. Copper alone generated 40% of export revenue. Mineral revenues accounted for more than one-third of the government revenue, a 68% windfall tax on sale of copper and gold being the main source.

Exports and Imports



Source: National Statistical Office of Mongolia, IMF

Amidst all the success of the Mongolian economy, there were many signs of future difficulties. Government expenditures were uncontrollably increasing. Most of the additional revenues were used to make previously targeted social transfers universal, to increase salaries and wages. In 2007, universal social transfers were introduced at a cost of 3.5% of GDP. Public sector wage increase added 2.5% of GDP to the wage bill in 2008. Between 2004 and 2008 social transfers grew from 7.8% to 11.5% of GDP, salaries and wages from 6.7% to 9.3%, new infrastructure investment grew from 3.6 to 9.1% of GDP. Capital expenditures more than tripled since 2005. In 2005-2007 budget surplus was in mere 2-3% despite boom in commodities and fiscal situation became highly sensitive to any reversal in commodity prices. Export structure revealed lack of diversification in Mongolian economy and its apparent tilt to commodities exports, specifically, copper exports. Non-mining fiscal balance deteriorated strongly, rising from 1% of GDP in 2005 to 13% of GDP in 2007. In 2008, public spending totaled to 40.2% of GDP, whereas revenue were at 35.2% of GDP. Driven by large social transfer and consumption, domestic demand ballooned. Since 2000 trade balance was in deficit in all but year 2006. Since 2005, exports as a share of GDP have been flat, resulting in a worsening current account deficit even before commodity prices started to fall. By the end of 2008, the state budget deficit widened to 5% of GDP.

The sudden and catastrophic drop in the price of commodities brought economic downturn to Mongolia. From its peak in mid 2008, the copper price shrank 60% creating severe imbalances in both the fiscal and external accounts. Current account quickly deteriorated to a deficit of 12.9% of GDP. Mineral revenues fell by 10% of GDP. Mineral revenues' share in the total government revenues fell from 39% at the peak in 2007 to about 12.5% in 1H2009. In 1H2009, total foreign trade plunged 44.3%YoY, including exports 40.2%YoY and imports 47.3%YoY. The Government revenues fell 20%YoY, as collection from the windfall profit tax declined 86%YoY, corporate income tax 51%YoY and VAT 19%YoY. As a share of GDP, revenues fell to 2005 levels, but spending was by one-third higher.

Inflation accelerated in August 2008 hitting 34% YoY. Private capital outflows, high inflation and shift of togrog deposits into foreign exchange accounts strained the banking sector, sending banks into stress after a period of rapid credit expansion. The crisis sapped liquidity from the economy. The banks, concerned about the health of other financial institutions as well as borrowers, restricted lending. Nonperforming loans more than doubled from 3.4% of total loans in 2007 to 7.2% in 2008.

The weakening current account put downward pressure on the togrog. The Central Bank of Mongolia attempts to support the national currency led to loss of almost US\$500mn in hard currency reserves between July 2008 and January 2009. The policy was eventually ineffective, as the togrog depreciated by 37% against the US dollar. On the back of deteriorating fundamentals, falling revenues and declining trade, the IMF estimates economic growth rate slowing significantly to 2.7%YoY in 2009 from a previous rate of 8.9%YoY. In 1H2009, the economy contracted 1.3%YoY, whilst in the same period in previous year it grew 13.3%.

Essentially, the Mongolian government policy was extremely pro-cyclical and based on the assumptions of high and relentlessly increasing mineral revenues. The government budget for 2009, adopted in the

fall of 2008, envisaged 6.1% deficit, despite optimistically assuming an average copper price of US\$6,700/tonne for the year. Thus, inevitable hard landing for the Mongolian economy came with the drop in commodity prices.

2.2. RESPONDING TO CRISIS

During the commodity boom years, the government of Mongolia did not develop any comprehensive and clearly set policy to manage commodity price volatility. Policy makers led to ever growing social transfers, increasing consumption and low savings. Thus, Mongolia faced the most severe crisis of the last 75 years unprepared – with high spendings, low savings, deteriorating incomes and high inflation. Yet again the crisis has demonstrated the risks that pro-cyclical fiscal policies pose to a commodity based economy.

Under severe fiscal difficulties, the government of Mongolia requested assistance from the international financial institutions (IFIs), China, Russia, Japan and other countries. The IMF approved a US\$229.2 loan to stabilize the Mongolian economy. ADB, WB and Japan pledged a total of US\$160mn to finance fiscal gap. China and Russia pledged to provide multi-million soft-loans to Mongolia in support of financial system, infrastructure and agriculture.

Currently, Mongolia is undergoing the process of restoring health of government finances with the help of IFIs and main trading partners. Fiscal stabilization is the governments primary short-term concern. In March 2009, the parliament of Mongolia revised the 2009 budget. Assumptions for copper price were lowered to US\$3,400/tonne for the year. Fiscal deficit projected to be US\$204mn over the two years is managed with the financial support of IFIs and foreign countries. Recent recovery of commodity prices is also helping to stabilize the Mongolian economy. In June, a budgetary assumption for copper price was increased to US\$3,995/tonne. Budget deficit is projected to be under 6% in 2009. The process of macro-economic stabilization and fiscal adjustment will continue in 2010 and beyond, requiring a further reduction of the fiscal deficit to 4% of GDP in 2010. The terms of IMF support envisages the following key elements (IMF Press Release No. 09/110, April 01, 2009):

- Fiscal policy: restrain on expenditures and constrain the deficit to 6% of GDP in 2009. The savings will come from postponement of domestically financed capital expenditure plans, wage and hiring freeze, cuts in untargeted social allowance
- Monetary and foreign exchange policy: build up foreign currency reserves to prevent any sudden swings in exchange rates
- Financial sector: strengthen banking system by improving the current framework for deposit guarantees and enhancing bank supervision
- Social protection: overhaul of untargeted system of social transfer programmes.

In response to crisis, the government of Mongolia has developed a medium term economic policy to boost economic growth and sustainability, control inflation, facilitate public and private investment. Thus, the government plans to maintain the macroeconomic stability, keep fiscal deficit under 6%, keep current account sustainable and with surplus in order to increase foreign reserves and ensure economic growth of 8-10% in medium term. The government plans to use revenues from the mining sector to diversify economy and encourage growth in other sectors and to facilitate future growth to develop infrastructure with the help of concessional loans and private sector. To avoid previous mistakes of overspending, increases in wages, pensions and allowances are to be only in line with economic growth and economic rate. Additionally with the help of donor organizations, legal framework restricting budget deficit will be developed.

The government policy of taxing and spending, which prevailed during commodity boom years is giving a way to pro-growth policies of encouraging private sector and investments. Recent commitment to abolish windfall profit tax from January 1, 2011 is a sign of changing policy. Instead of redistributing wealth to population via social transfers, policies generating growth and creating income-generating opportunities for the population provides long-term stability for the government finances.

2.3. BEYOND BOOM AND BUST: MANAGING COMMODITY PRICE VOLATILITY

Commodity exports dependent countries are highly vulnerable to price fluctuations. The recent experience shows that commodity price volatility hurt growth rate of countries like Mongolia. These countries are highly affected by external price shocks. Common recommended approach for them to avoid endless boom and bust cycles is to save up in good years to weather lean years. Overall, the government needs to have enough political will and ability to thread along three fundamental challenges related to bumper commodity revenues: fiscal sustainability, long-term investment and capital neutralisation. Addressing these challenges may not solve deficiencies of inherently cyclical economic structure, but sets a framework, which helps to weather any sudden volatility in prices.

Fiscal sustainability needs to be of utmost concern for the Mongolian government. That is to avoid implementation of policies that lead to fiscal unsustainable commitments. At the peak of commodity boom, increasing social transfers and wages meant that these expenditures in Mongolia was approaching 40% of total government expenditures. With the downturn in revenues, the government faced the need to drastic cuts in expenditures. Be it not for IFIs and some foreign countries to close the fiscal gap, the economic situation would have deteriorated immensely. Prudent monetary and fiscal policies will help to avoid inefficient use of funds. The government needs to keep non-mineral deficit under control. Otherwise, commodity revenues may hurt long term sustainable economic growth of the country.

Commodity boom periods are ideal for planning long term development of the country. Additional revenues available need to be directed to long term infrastructure development investments. Improving infrastructure can bring immense long term benefits in terms of growth, competitiveness, poverty reduction and attracting FDI. Developed infrastructure generally contributes to value addition, improves productivity, creates new jobs and finally enhances quality of life for entire population. Social transfers may have immediate effect on consumption level and be more politically popular. Investments in roads, urban and rural infrastructure, education, health, social development, while avoiding inefficiency, bring real future fruits.

However, the country may not be able to absorb all the revenue generated by the commodities exports without having certain negative consequences. Injection of these large export revenues into the economy may lead to appreciation of the national currency that will hurt competitiveness of other sectors. This may inhibit growth of other sectors and make the country even more vulnerable for future price shocks. Therefore, some of the revenues may be required to neutralize in a national wealth fund. The fund may accumulate revenues for lean times, while providing some specified amount for government expenditures annually. It may invest in foreign assets to sterilize foreign currency inflows and counter national currency appreciation. Or it could make investments into domestic economy nurturing sectors beyond commodities. The fund could be aimed to repay foreign debt. There are many successful examples of wealth funds worldwide. They have different objectives, sources of revenue and cycles, but all of them have in common strict procedures on using funds.

3. MINING AND INFRASTRUCTURE: VIRTUOUS OR VICIOUS CIRCLE

3.1. OVERVIEW

Improving infrastructure is crucial for the development of the mining sector in Mongolia. Existing capacity is outdated and insufficient to facilitate further dynamic expansion of the this sector. Growing urbanization around the capital city Ulaanbaatar and major mining areas, increase in industrial production, real estate construction and foreign trade have caused a significant pressure on supply of infrastructure services. Infrastructure investments remain small. Subsequently, infrastructure is unable to meet increasing demand. Power supply experiences shortages due to increased demand from urban areas and industrial facilities. Questions about supplying power to mining developments have no

definitive answer. Water supply for mining activities is yet another issue faced by the mining sector. Underdeveloped road and railroad system is yet another inhibiting factor in the development of mining sector.

3.2. INFRASTRUCTURE BOTTLENECK

Today's infrastructure capacities do not allow Mongolia to provide sufficient and quality services neither to public nor to business. Only 67% of population has access to power (electricity) and 35% to water. Roads are in poor condition, only 3.5% of road are paved and existing ones need capital repair. The railway network capacity does not match to growing export-import cargo flows. Such infrastructure bottleneck is expected to get further narrowed starting from 2012 when the major mines start production of minerals. About 8,000 jobs are estimated to be

Potential major minerals in Southern Mongolia				
Mineral	Life (years)	Production ('000 tons/year)	Employment Estimate	Start date Estimate
Coal	20-200+	69,000	4700	2003-2015
Copper*	20-50	2,250	5000	2012

*Production figure is for copper concentrate (30% copper)

Source: The World Bank

created in the mine areas, with most of the employees coming from other regions, that will lead to more burden on water, sanitation, electricity and heating supply in the southern regions. More road construction is needed amid increasing number of motor cars and trucks. Transporting multimillion tonnes of the minerals to be mined both for internal use and exports to Russia and China, will further increase pressure on land transport infrastructure, in particular railway transport.

3.3. SHORTAGE IN FINANCING

Mongolian infrastructure sector requires substantial investments to renew existing capacities and build new ones. Mongolia's infrastructure needs US\$8bn over the next decade, Trade and Development Bank CEO said at Mongolia-Asia Investment Forum on March 31, 2009. According to the World Bank estimates, the infrastructure for the Oyu Tolgoi and Tavan Tolgoi projects alone will require an initial investment of more than US\$5bn over the next five years.

According to the Ministry of Roads, Transportation, Urban Development and Construction Mongolia needs US\$10bn for railway network and industrial zone to centrally process minerals of strategic deposits.

The Prime Minister declared that Mongolia is seeking US\$25bn of overseas investments in mining in the next five years to develop its resources. That is US\$5 billion annually for one large-scale mining project every year. The signing of OT deal vital for the above declared plans. Government sees the project as a namecard or template for other projects to be developed by foreign investors. Regarding sources and how investment will be raised in infrastructure, Mongolia is considering the following: a) through product supply arrangement - loans in exchange for supply of mining products; b) through long-term supply contracts - using the contract as collateral and raise investment from financial markets.

Investment needs for Southern Mongolia	
	US\$m
Electricity	2,711
Town development	1,454
Land transport	800
Water resources	262
TOTAL	5,177

Source: The World Bank

The government alone does not have sufficient resources for infrastructure development. Although international financial institutions such as the World Bank and the Asian Development Bank have provided multimillion US\$ investment loans in the sector, Mongolia will still need more investments from private sources, particularly from mining companies coming to the southern mine areas.

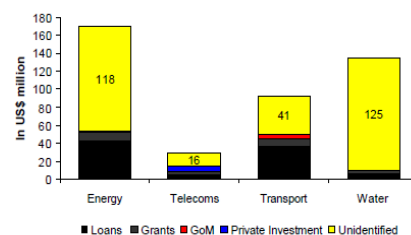
The government, realizing the importance of infrastructure development, has increased capital spending in power, transport and communication over the last recent years. Investments in infrastructure reached a record level in 2007 at 19% of total expenditures (10% of GDP) from 13% (4% of GDP) in 2001-

2006. Between 2006-2008 the capital spending tripled. The public investments amounted to 10% of GDP in 2008, including the state budget finances US\$290mn.

Over 1995–2005, loans, grants, private investment and the government’s investments in infrastructure have averaged US\$128mn per year, including grants 20.3% and loans 68.7%, with government and private resources providing the rest. Assuming that infrastructure investment needs are estimated at US\$427mn per year, existing financing sources leave a gap of US\$300mn per year.

Compared with previous levels, annual road infrastructure investment alone will equal eightfold in absolute terms over the next decade. Total investments needed equal to an annual investment of about 15% of GDP over the coming years, still an unsustainable level without international precedent. The mismatch between available financial resources and proposed investments suggests that plans will have to be combined with regulatory and institutional reform and a greater role for private investments as well as with effective use of budget spending.

Annual investment gap



Source: The World Bank

Mongolia is concerned that underdeveloped infrastructure may hinder development of the mining sector and the economy as a whole locking the country into vicious circle of crumbling infrastructure dragging down mining sector, which in its turn failing to generate enough revenues to finance infrastructure improvements. It is increasingly demanding commitments to develop infrastructure from foreign investors. Launching major mines in the southern region will lead to increased demand for infrastructure services. Besides, government plans to develop value added product processing industries from its reserves, including building copper smelters, which will require unprecedent investments into infrastructure as well as human capital. Given financing constrains of Mongolia, situation offers strong investment opportunities. The nation’s authorities are likely to partner international infrastructure companies in power, water and transport industries. Mongolia is considering using public-private partnership (PPP) scheme in infrastructure development.

3.4. GROWING TOGETHER OR FAILING APART

Under-developed infrastructure may put unnecessary costs on mining companies. South Gobi Energy Resources coal exports exemplifies vicious circle of undeveloped infrastructure putting extra costs on mining sector. The company’s deposit is located 45km to the north from China. Coal from the company deposits is supplied to China by middlemen with truck-fleet. In the 1Q2009 the company had difficulties in transporting the coal as the border crossing to China was only open for limited hours, limiting the amount of coal that could be supplied to the Chinese market. In March, the border crossing resumed normal operations allowing South Gobi to ship more than 115,00 tonnes of coal in the month. The exports grew to 231,000 tonnes in June. The company have plans to increase its exports to 3mn tonnes per year. Construction of railroad, though expensive, will allow to increase annual exports to 15mn tonnes, whilst cutting middlemen truck-transportation companies.

Coal industry potential

But developing infrastructure could offer great investment opportunities. Coal industry has immense potential in infrastructure and exporting something other than coal. Coal production could reach 55 million tonnes per annum.

Given its limited domestic requirements, Mongolia has the potential to become one of the major coal exporters in the world. There is every indication that demand for Mongolia’s coal will increase. In 2008, China’s massive demand for energy changed it from being net coal exporter to a net coal importer. Indonesia, the world’s second largest coal exporter, is suggesting that it will not be able to meet expected demand growth in the Asia-Pacific region as the domestic consumption is increasing.

Electricity generation accounted for 25% of all Asian energy use in 1990, but, in 2006, the International Energy Agency forecast that by 2030 it would rise to 44%. By 2030, Asia is expected to reach 45% of global electricity demand, compared with 20% in 1990. Coal's share in Asian electricity production has been projected by the IEA to rise from 56% in 2004 to 63% in 2030. In China, the country's long dependence on coal has grown as coal-fired plants have been commissioned on a weekly basis. By end-2007, China's 712,290 MW total capacity included 556,400 MW of coal-fired plant which, during 2007, produced 85% of national electricity production. Moreover, much of that capacity was added in recent years, with 2007 alone witnessing coal-fired generation of additional 65,000 MW.

Potential major coal mines in Shouthern Mongolia			
Name	Life (years)	Production ('000 tons/year)	Estimated start date
Tavan Tolgoi	200+	15 000	2012
Uhaahudag	100	10 000	2009
Baruun Naran	20	6 000	2012
Tsagaan Tolgoi	20	2 000	2015
Nariin Sukhait	40	2 000	2003
Ovoot Tolgoi	50	5 000	2008
Sumber	50	5 000	2015
Shivee Ovoo	200+	14 000	2015

It is clear that Mongolia going forward may play significant role in energy market of Asia. Ironically, despite such huge energy potential, in recent years Mongolia is hard pressed to meet the increasing energy demand domestically. Soon the lack of additional electricity capacity may hamper the development of many new mining deposits which are vital for the economy of the country. According to the World Bank estimates, Southern Mongolia may generate about US\$2bn from coking coal export, about US\$1bn from thermal coal export and around US\$2.3bn from copper exports from the Oyu Tolgoi and Tsagaan Suvraga deposits. Therefore, the bottleneck in energy sector may cost the economy about US\$5.3bn per annum.

Obviously, Mongolia needs huge investments in power generation to meet its growing domestic demand. The country can not afford such huge investments without private sector participation. But whether the economic development-infrastructure-mining circle is virtuous or vicious is up to the policy-makers to determine.

4. SMALL CAPS – LARGE STRIDES: TINY MARKET WITH STRONG UPSIDE POTENTIAL

4.1. CAPITAL MARKETS OVERVIEW

Mongolian Stock Exchange (MSE) was established to implement the Initial Privatization Policy on January 18, 1991 by the Government of Mongolia.

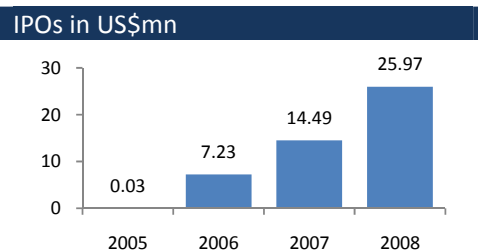
During 1992-1995, 475 state owned entities were successfully privatized offering 96.1 million shares worth MNT8.2bn (US\$7mn) through Mongolian Stock Exchange. The Securities and Exchange Law and Corporate Law adopted in mid-90s paved the way for the development of the secondary market. Twenty nine brokerage firms initially worked on MSE.



Source: MSE

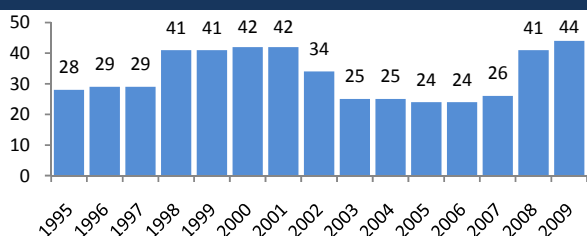
With the start of secondary market activity, shares of over MNT38.8bn (US\$32.1mn) have been traded in 1996-2004. The government bond and corporate bond trading was introduced in 2000 and 2001 respectively. To date government bonds worth of MNT117.9bn (US\$97.5mn), and corporate bonds worth of MNT9.9bn (US\$8.2mn) have been traded.

In 2005-2008, 13 IPOs were made, raising US\$47.7mn. TOP-5 IPOs raised US\$36.6mn (77% of the total). Currently, 44 FRC licensed brokerage houses are trading on MSE. The leading five brokerage houses have accounted for 98.5% of YTD MSE transaction.



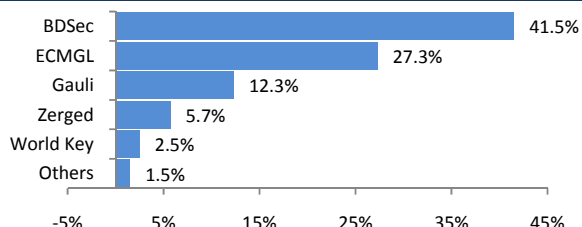
Source: MSE

Number of Brokerage houses at MSE



Source: MSE

Transaction at MSE by brokerages (as of 31.07.09)

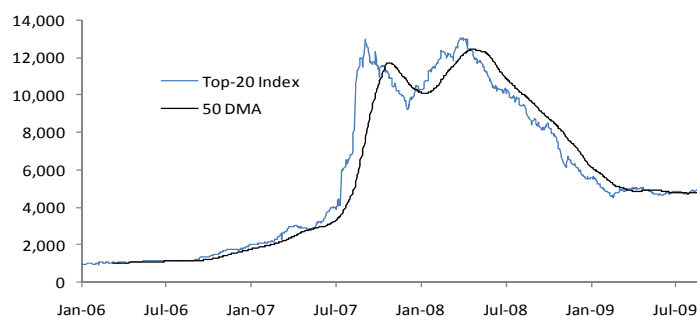


Source: MSE

4.2. EQUITIES MARKET PERFORMANCE

Despite recent recovery in commodities prices, MSE Top 20 Index is still down 1.5% YtD. The index is 57.8% below from its peak in March-April 2008. Currently, the total marketcap of MSE Top 20 companies amount to mere US\$233.5mn. Total marketcap of all Mongolian equities is down over 53% to US\$355.8mn from its peak of US\$760mn in April 2008. Whilst equities elsewhere rallied since March 09, 2009 and copper hit US\$6,500/tonne, Mongolian equities remained anemic and continued their slow slide.

Top-20 Index



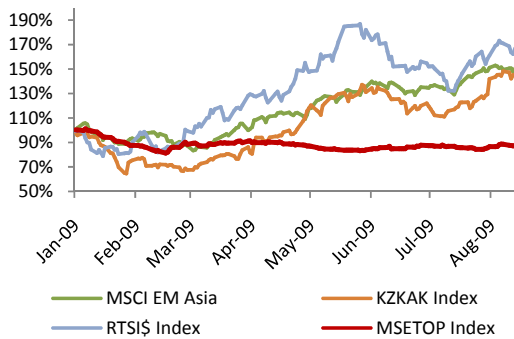
Source: MSE

Low market liquidity registered YtD trading amounts less than US\$8mn in value. It could be explained by insufficient sentiment and appetite among investor for frontier market risks and confidence sapping prolonged negotiations on Oyu Tolgoi agreement.

That contrasts strikingly with the pre-crisis years of investor "hunger" for risk, when MSE Top 20 Index grew on average 34% per annum from 1999 to 2006. Between January and September 2007, the index increased almost seven fold from 2,030 to 13,676. The index retreated to 9,441 by December 2007 and climbed back to 13,074 in late March 2008. Rich mineral reserves and growing outputs in mining sector brought foreign investments in Mongolia on the back of global commodities boom. That boosted trading activity on MSE and fueled sharp increase of its index.

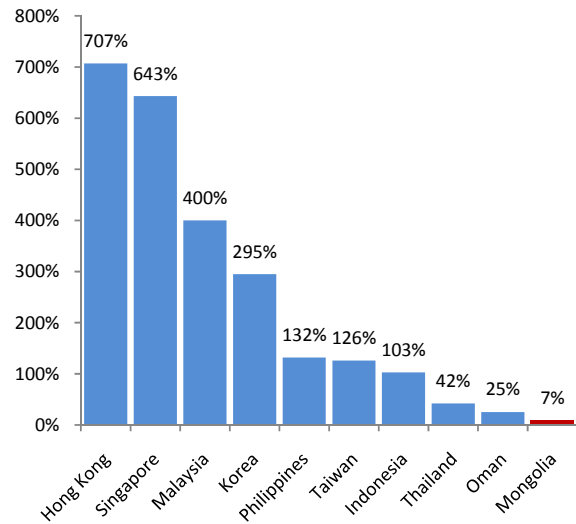
Currently, Mongolian stocks are cheap compared to other markets in terms of P/E. Most of the locally listed companies are substantially undervalued. Total marketcap of MSE amounts to a mere 7% of GDP. The Mongolian capital market penetration rate is too low compared with other countries.

Index Performance (as of 14.08.09)



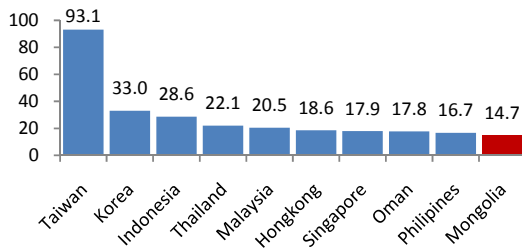
Source: MSE, KASE, RTS, MSCI

Market Capitalization to GDP ratio



GDP for Y2008
Source: Eurasia Capital Mongolia

P/E ratio (as of 31.07.09)

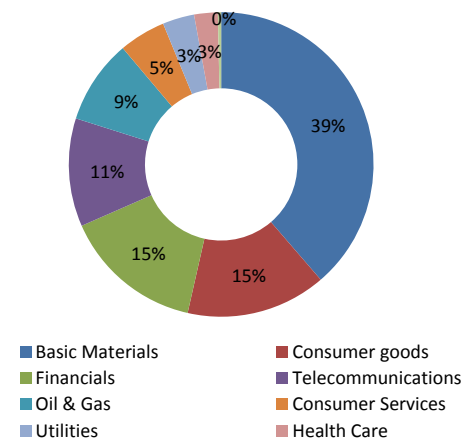


Source: Eurasia Capital Mongolia

Although the Mongolian equities market is small and has limited liquidity, it has strong growth potential. Recent positive news that the Parliament is edging towards approving Oyu Tolgoi investment agreement with Ivanhoe Mines and Rio Tinto has sent MSE Top 20 index up 15% in August 2009. Local companies' equities increased with NIC petroleum company up 47%, Tavan Tolgoi coal company up 46%, Spirt Bal Buram up 41% in August alone. There are also tentative signs of increasing trade volumes on MSE.

The development of massive Oyu Tolgoi copper and Tavan Tolgoi coal projects are expected to bring in over US\$12bn in direct investment into US\$5.2bn Mongolian economy with vast spill-over effects. Signing the Oyu Tolgoi and Tavan Tolgoi deals and adopting pro-business regulatory changes will lead to unprecedented growth in Mongolia's stock market. This will happen through privatization of the state-owned companies by selling shares in the local stock market and IPOs in the local stock exchange by large private business groups and internationally listed companies with major operations in Mongolia. Investors would be interested in purchasing stakes in the companies being privatized, especially in the resources sector. Now the government has a plan to privatise several state-owned companies in the coming years, including in the resources sector such as coal miners Baganuur and Shivee Owoo. Several major business groups such as MCS Group, Newcom Group, Bodi Group, Tavan Bogd Group and Monnis Group, which have attracted multi-million dollar

Marketcap breakdown of Top 20 companies by industry (as of 31.08.09)



Sources: MSE, Eurasia Capital Mongolia

investments from the EBRD and IFC, and private equity firms, are also next major contenders for going public.

5. OPPORTUNITIES IN MONGOLIAN ECONOMY

5.1. PATIENCE PAYS OFF?

During late 90s Mongolia's objective was to attract foreign investment into the mining sector as one of the engines of badly needed economic development. A 1997 Minerals Law was regarded as being one of the most investor friendly in the world and made infant Mongolian mining sector highly competitive at an international level. In 2002, royalty payments for all types of minerals were reduced to 2.5% of gross sales and gold mining royalties were reduced from 12.5% to 7.5% for both hard rock and placer deposits. On the back of attractive legal environment, the Mongolian economy has attracted US\$2.7bn since 2000 in FDI, majority going into the mining sector. Many international mining companies have entered Mongolia, many of them internationally listed. Mongolia became top exploration destinations in the world. This has had positive effect on other sectors in the economy.

Ivanhoe mines has discovered arguably the world's largest undeveloped Oyu Tolgoi (OT) copper-gold deposit. With more than 36mn tonnes of copper and 45mn oz of gold, it has attracted attention of the whole Mongolia and international investors. Estimated capital cost of the project is US\$5bn and estimated export revenue is over US\$2bn annually. But the company could not proceed with the development of the mine due to failing to agree with the government terms of the concession and changes in the legal framework related to project. On May 15, 2006 the Mongolian parliament adopted a windfall profits tax (WPT) that imposed taxes of up to 68% on mining profits in the case of gold, when prices exceed US\$500 an ounce and, in the case of copper, when prices exceed US\$2,600 a tonne.

On July 8, 2006, a revised version of the 1997 law was adopted by the Mongolian parliament that was much less encouraging to foreign investors. The revised law has modified the licensing requirements and license transfer procedures. It gives the Mongolian government the right to hold a stake of up to 34% in strategic mineral deposits found by privately-funded explorations (i.e., deposits that may have an effect on national security, the economic and social development of the country, or that produce or have the potential to produce more than 5% of the country's GDP in any given year). The revised law also increased royalty rates from 2.5% to 5.0%. These actions caused high uncertainty with regards to development of mining sector and much disappointment among foreign investors. The parliament furthermore initiated debate on whether or not to change the 2006 Minerals Law, to allow the government to increase its stake in strategic deposits to 51%.

For six years Ivanhoe Mines negotiated with the government an investment agreement to develop the OT deposit. The company attracted Rio Tinto as a strategic partner. These six years included a top of the mining cycle, when commodity prices reached all time high, with copper reaching 8900/tonne in 2008. This was the time when international investors were willing and financially capable to finance such large projects as Oyu Tolgoi.

And yet it took commodity cycle downside to be optimistic about the project. Mongolia is on the verge of signing Oyu Tolgoi investment agreement with Ivanhoe Mines and Rio Tinto. The new terms of the agreement envisage abolition of 68% windfall profits tax from January 1, 2011. The Government receives 34% stake in the project. The capital the government has to contribute will be no more than US\$817mn, down from the US\$1.7bn earlier proposed by the investors. Investors will not be exempted from paying any tax. The initial amount of the investment in the project shall not exceed US\$4bn.

The parliament has already adopted numerous changes to existing laws in order to pave the way for final approval of the agreement. Mongolian equity markets reacted to recent developments by rallying over 15% in August 2009. The Oyu Tolgoi agreement is considered to become a blueprint for any other future large mining agreements, set a framework for future negotiations, thus eliminating challenges of

developing large deposits in Mongolia. Tavan Tolgoi, a massive coking coal deposit and some others are expected to follow.

5.2. OPPORTUNITIES IN MONGOLIA

Mongolia offers immense opportunities beyond Oyu Tolgoi. It is a resource rich country next to China, generating strong demand for commodities. Beyond Oyu Tolgoi, Mongolia is blessed with numerous other large and medium deposits.

Other deposits and already operating mines also provide great opportunities for investors. For example Hong Kong listed Mongolia Energy Corporation is in the development stage of the Hushuut coal mine in Western Mongolia. Sough Gobi Energy Resources already started production from its Ovoot tolgoi coal mine in Southern Mongolia. Mongolian Stock Exchange listed Baganuur, Shivee Ovoo and Aduunchuluun coal mines, which supply coal to existing Thermal Power Plants, also provide opportunities for the investors eyeing for Mongolia's mineral resources as the state is preparing to privatize number of such mines in coming years. Mongolian Stock Exchange (MSE) Top-20 Index has fallen more than 60% from its peak last year. As global equities markets already bounced back substantially from their bottoms Mongolian market lags behind, thus providing opportunity for investors to invest in undervalued companies listed on MSE.

Apart from mining sector, foreign and domestic investments increased in construction, transport and food and beverage sectors.

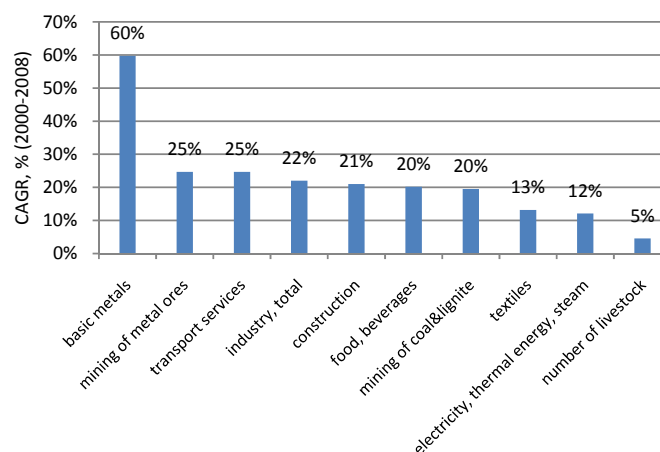
As economic growth picked up in Mongolia so did the construction sector. Almost half of the entire population lives

in Ulaanbaatar city and the need for housing is huge. The residential market of Mongolia (mainly Ulaanbaatar) has consistently grown over the last few years, with supply struggling to meet the high levels of demand. Residential prices of Ulaanbaatar have risen at an average 30% in each of last three years. Over the period of 2002-2008 residential property prices have risen 4 times, although global

Large strategic deposits		
Deposit name	Mineral type	Reserves
Tavan Tolgoi	Coal	6.4bn/t
Nariin Sukhait	Coal	125.5mn/t
Baganuur	Brown coal	600mn/t
Shivee Ovoo	Brown coal	646.2mn/t
Mardai	Uranium	924.6 thousand/t 0.119% U3O8
Dornot	Uranium	16467 thousand/t 0.175% U3O8
Gurvanbulag	Uranium	10560 thousand/t
Tumurtoi	Iron ore	229.3mn/t 51.15% Fe
Oyu Tolgoi	Copper, molybdenum	2300mn/t 1.16% Cu 0.35 gram/tonne Au
Tsagaan Suvarga	Copper, molybdenum	10.64mn/t oxide 0.42% Cu, 0.011%Mo 240.1mn/t sulphat 0.53% Cu, 0.018% Mo
Erdenet	Copper, molybdenum	1200mn/t 0.51% Cu, 0.012% Mo
Burenkhan	Phosphoryte	192.24mn/t
Boroo	Gold	24.523 thousand/t 1.6 gram/tonne Au
Tumurtei	Zinc, lead	7689.4 thousand/t 11.5% Zn
Asgat	Silver	6402.6 thousand/t 351.08 gram/tonne Ag

Source: Laws of Mongolia

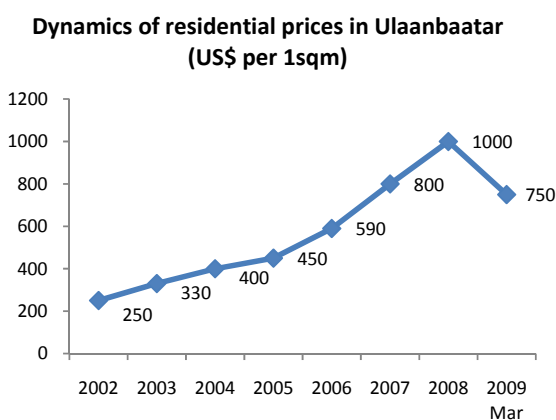
Sectors growth (at current prices)



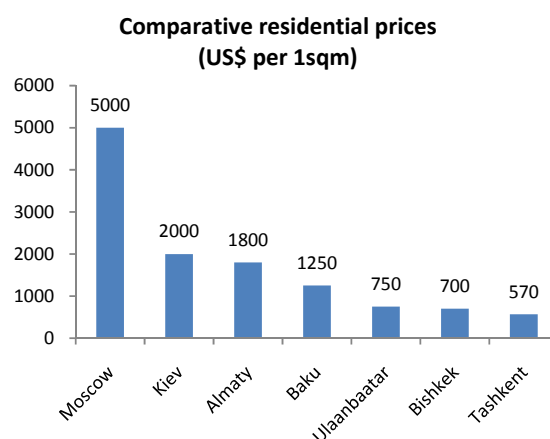
Source: National Statistical Office of Mongolia

financial crisis has since dragged prices back down to January 2007 levels. To take advantage of such opportunities foreign investors, namely Korean and Japanese, invested in the construction sector.

Recent global economic downturn resulted in sharp drop in commodity prices such as copper, as a resource based economy Mongolia was hit hard by decline in commodity prices. Consequently, residential property prices have come down 30% on average. However, recent Parliament approval of the amendment law to abolish 68% Windfall Tax Law and developments around Oyu Tolgoi investment agreement signal turning point and likely to fuel economic growth as the project will bring US\$4bn in investments. Therefore, residential property prices are likely to bounce back and further increase in coming years.



Source: Global Property Guide, Mongolia Properties



Source: Global Property Guide, Krishna magazine, Deltamax Property Frontiers, Eurasia Capital Mongolia estimates

5.3. GAINING ACCESS

Investors may gain access to investment opportunities in Mongolia through

- Foreign public equity hedge funds to local stocks and internationally traded companies with operations in Mongolia
- Foreign private equity funds
- Mongolia-based investment banks and brokerage houses to local stocks
- Mongolia-based Investment banks advising on acquisition of Mongolian companies/assets by foreign companies
- Foreign hedge funds and investment banks with western-style operations have strong local knowledge through their local physical presence.

Currently there are a number of international public and private equity fund management firms (such as Eurasia Capital Management, Firebird, Ost Invest) having investments in Mongolia. These funds through their hedge funds have invested multi-million dollars across many sectors, including in mining, property, telecom and locally listed stocks.

Even global large hedge funds are now keen to explore investment opportunities in Mongolia on optimism that major mining projects will go ahead and the spur economy. (For example: Mark Mobius of Templeton Asset Management Ltd., which oversees about US\$20bn of emerging-market assets, visited Mongolia in April this year and expressed interest in possible investing in Mongolia-listed stocks. According to Mobius, Templeton has bought shares of companies with interests in Mongolia, such as Chinese gold and coal miners.)

Another better way of gaining access to the Mongolian local stocks is through local investment banks. On the back of previous mining boom followed by stock market rocketing in Mongolia some new western-style investment banks, advisors, research and brokerage houses emerged who are able to provide quality services to local and foreign investors eyeing investment opportunities in Mongolia.

These investment banks may also advise on mergers and acquisitions of local and international companies with assets in Mongolia by international strategic companies/investors.

Mongolia's stock market, although small now, has strong upside potential. Multi-billion dollar investments in major mining deals and infrastructure around them will surely boost the economy, increase profitability of local companies and stock markets as well. Other triggers for the stock market are privatization of the state-owned companies by selling shares in the local stock market and IPOs in the local stock exchange by large private business groups and internationally listed companies with major operations in Mongolia.

Another way of getting access to Mongolian economy is through participation in the privatization of state-owned enterprises. Mongolia highly encourages private sector participation and investment, both domestic and foreign. For this reason, the Government of Mongolia's overall policy goal is to accelerate the privatization process and increase private sector participation in the economy.

Since the start of the economic reforms, the Government of Mongolia has implemented a far-reaching privatization program. Starting from almost nothing in 1990, the GDP contribution of the private sector is now more than 80%. Since 1996 almost 1,000 enterprises have been privatized, and today 90% of all enterprises are privately owned.

Recently privatized enterprises include financial companies such as the Trade and Development Bank (US\$ 12.2mn); the Agricultural Bank (US\$ 6.8mn); and Mongol Daatgal, national insurance company (US\$ 5.8mn). The agri-food sector has also seen many formerly state-owned companies go private: Max Impex, largest meat processing and trading company was privatized for US\$ 1.9mn, and APU JSC -- the largest spirit and beverage manufacturing company -- was privatized for US\$ 4.5mn.

The enterprises soon to be privatized include large companies like Mongolia Telecom Company (55% state-owned), Darkhan Makh Expo (21% state-owned), "Mongolroostsvetmet" (51% state-owned), "MIAT Company", Baganuur coal mine, Shivee Ovoo coal mine, Tavan Tolgoi coal mine, Mongolian Stock Exchange and "Mongol Kino Unit". Petroleum stations, airports, and service department of MIAT will also be privatized.

6. CONCLUSION

Recent recovery in commodity prices means that Mongolia is returning on international investors focus. Nearing approval of the Oyu Tolgoi deal has already sent local equity markets upwards. Mongolia offers opportunities for both FDI and portfolio investments. Policy shift in the government from "tax and spend" approach to "create opportunities" is an encouraging sign for investors. The government commitment to abolish windfall profits tax by January 1, 2009 reinforces the optimism about upturn in Mongolia. Overall, Mongolia's regulatory structure is conducive to foreign investments. Although social and physical infrastructure deficiencies impose added costs, but they are not prohibitive to foreign investments, especially considering upturn potential Mongolia's mineral wealth offers.

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COMPANY DESCRIPTION

EURASIA CAPITAL GROUP

Eurasia Capital Group (ECG) is a Singapore-based investment group with primarily focus on Central Asia and Eurasia region. ECG has two main businesses: Eurasia Capital, an investment bank and Eurasia Capital Management, a fund management firm. Eurasia Capital Management (ECM) is focused on investing in emerging markets in Eurasia including Russia, China, Central Asia and Mongolia. With over US\$100mn in assets under management and advisory mandates, ECM invests across various industries (oil and gas, mining, banking, telecom, energy/infrastructure, consumer goods, agribusiness) and asset classes (public securities, private equity and property) through a family of funds as well as managed accounts.