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Mongolia: time to rethink your risk assessment?

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Four years ago, Mongolia's economy was the fastest growing in the world, the stock market was booming and the future looked very bright. This year, the consensus is for growth at no more than 1 per cent and all of the rating agencies have sovereign risk at speculative grade, while warning of possible default on debt obligations in 2017. Even within a troubled emerging market asset class, the case for Mongolia looks grim.

But, while accepting that Mongolia is certainly not for the risk averse, the investment case is worth a second look. Even the rating agencies concede that although the outlook is bad, based on what we assume today, the situation could "change on a dime" this year, and that would send debt yields sharply lower and equities higher.

Mongolia's economy is critically dependant on commodity prices, copper, coal and gold in particular. It is also very tied to the Chinese economy which last year accounted for 85 per cent of all exports. That combination certainly doesn't offer any comfort for investors and justifies a high risk premium. But the reason for the exceptionally high risk assumption, which has the country's 5-year dollar bonds yielding 14 per cent and the 10-year dollar bond yielding over 12 per cent, is because of domestic politics.

What changed over the past four years, long before China worries hit commodity prices, was the main opposition party, the Mongolian People's Party (MPP), campaigning with an anti-foreign investment message in the 2012 parliamentary election. It secured almost 33 per cent of the seats to be the second largest party after the Democratic Party (DP), which won 40 per cent. With such a strong mandate, the MPP has been able to disrupt and delay big mining projects. The biggest project, the Rio Tinto controlled Oyu Tolgoi mine, was suspended in August 2013 because of political obstruction, having spent $6bn in phase 1. Development at one of the world's biggest coking coal mines, Tavan Tolgoi, hasn't even started because parliament has not given permission.

So, what's changing and what may cause a 180 degree turn in risk assessment? The answer is again politics. Obstruction from the MPP caused a collapse in FDI from almost $5bn in 2011 to only $230m last year, and the contagion from that has badly affected all other areas of the economy. Unemployment is officially at 8 per cent, albeit unofficially the figure for under-employment is a lot higher, and the country is running out of money. The government ran a budget deficit equal to 6.5 per cent of GDP last year.

That dire economic circumstance forced the MMP out of the grand coalition last year and allowed the DP-led government to push ahead with approvals for some big projects in the mining, railway and power sectors. The operators of the Oyu Tolgoi mine also reached a new deal and put in place $4.4bn of project finance for phase 2 operations last December. That project now only needs the go-ahead from the board of Rio Tinto to resume. The mine is not only the biggest in Mongolia, as well as the third largest in the world, but it is also viewed as a benchmark indicator for investment conditions in the country.

The board of Rio Tinto is expected to make a decision in the second quarter but prudently may delay to see the outcome of parliamentary elections to be held on June 29. After that, the formula is reasonably straightforward: if the current prime minister's DP and coalition partners win an enhanced majority then projects such as Oyu Tolgoi and Tavan Tolgoi will go ahead.

Given the very long lead time and operating life of these projects, it is not expected that the current weak commodity backdrop will cause serious delays. In that case, the volume of FDI will again rise, albeit slower than was the case in 2010-2012, and have a positive contagion across the economy and to the government's finances.

Even $2bn of FDI in two years would have a very significant positive impact on the economy. Default risk would be off the agenda and bond yields would normalise. Of course, 'normalise' for a country so exposed to commodity and China risk, but that will still be a lot less than the perception today.

And if you really want to roll the dice on a high risk-reward stock, consider Hong Kong listed Mongolian Mining Corporation. The company is expected to default on a $26.6m bond coupon in late March, just as a half dozen other metal and mining sector companies have done in Asia in recent months. The company was valued at $8bn in 2012 and today has a market value of $50m.

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