

Longer Duration GOM MNT Denominated Bond Auctions a “Capital” Idea

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Article 9 of the 2014 Budget Law allows the GOM to issue up to 1,400.0B MNT (~\$792M USD) in MNT denominated bonds, with durations ranging from 12 weeks to 10 years. The Ministry of Finance and the Bank of Mongolia will introduce a Primary Dealer System designed to support these auctions, which will be the basis for the beginning of a true government bond market. While the GOM conducted regular auctions in 2013, duration was limited to 1 year and participants were almost always the banks themselves buying on their own behalf. Of the up to 1,400.0B MNT in bonds the GOM intends to auction in 2014, 400B MNT will be used for maturities, leaving 1,000.0B MNT of “new money” which needs to be found to support the GOM’s plans.

Terms and Amounts of MGB’s to be Auctioned in 1Q 2014

MGB term	Amount
12 week	240,000,000,000.00
28 week	160,000,000,000.00
52 week	60,000,000,000.00
3 year	70,000,000,000.00
5 year	60,000,000,000.00
10 year	10,000,000,000.00
Total	600,000,000,000.00

Source: Bank of Mongolia

What should be clear to all, the GOM, like every other developed and emerging economy, will need capital in 2014. Capital is equity and debt, denominated in MNT, USD, CNY, or other currencies. Debt can be floating or fixed rate, bonds or bilateral loan and potential lenders can of course be local or foreign. Foreign bond buyers can come in several forms, from passive retail buying into a fixed income fund holding GOM bonds, to sophisticated High Net Worth investors, hedge funds, banks and Sovereign Wealth or supranational funds. Tenors can go from

weeks to 50+ years, depending on the buyer's appetite, since those who possess the capital will ultimately dictate the terms for fledgling sellers in need of funding. To manage its economy and growth effectively, Mongolia has to diversify its sources of capital and seek sustainable inflows of investment, vs. "one off" loans from friendly sovereigns, which may have strings attached. 12 month notes in USD do not afford the GOM the ability to plan long term, as they have to almost immediately consider currency and rollover risk, leaving little time for underlying projects to deliver the intended benefits.

Given the current negative sentiment around Mongolia's economy and currency, many are asking why would foreign investors take the duration risk with 10 year MNT denominated bond, when they can buy a 1 year CD at a local bank?

- GOM bonds, or MNT denominated time deposits would both have the investor assume the full risk of further MNT depreciation. Investors then ask themselves when is the risk of further MNT depreciation the highest, in the coming months, or 1.5-2 years? If MNT stabilizes in 2014, then perhaps something sustainable has been put into place structurally. In the long run, few dispute the idea that Mongolia will be running large budget surpluses for years to come, as more mines come online, generating significant royalty income. So for the same accepted risk of depreciation, foreign investors could lock in higher return with GOM MNT bonds vs. short term bank deposits.
- As commodity exports grow and those markets improve, the Mongolian Tugrik may not only stabilize, but appreciate, which will eventually allow Mongolia to be an exporter of capital. Long term interest rates would also drop as Mongolia's finances improve, all of which is quite beneficial to holders of longer term MNT GOM bonds.
- Investors focused on a 12 month time deposit rollover strategy are fully exposed to reinvestment risk. What will interest rates be in 1 year? What will the YTM on a 9 year bond be one year hence, if FDI is once again flowing to Mongolia?
- With MNT time deposits, investors are also fully exposed to the credit risk of the bank they choose, as well as the systematic risk inherent in the Mongolian Banking System, given how small the market is. With MNT GOM bonds, investors avoid both systematic and individual company risk.



What are the benefits to the GOM? Quite a few actually.

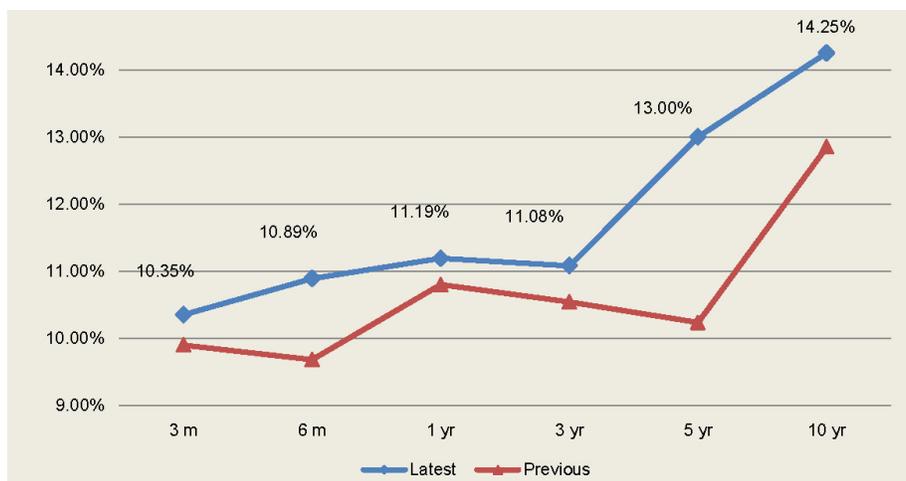
- The GOM's current situation dictates that it will raise capital as it CAN, not as it WISHES. While the GOM has a number of assets which need to be privatized, timing is an issue which will no doubt influence that process. While we expect to see some privatization in the near/medium term, large assets like ETT, MIAT and others need time to improve operations in order to maximize the value to the GOM and its citizens. So for the time being, MNT GOM bonds are critical in bringing much needed capital to the country, while allowing the GOM to sell equity in SOE's in the future at more attractive levels.
- While the Chinggis and Samurai bonds were viewed favorably, access to this kind of credit is not always possible and may be very costly. Furthermore, debt denominated in foreign currencies add additional risk, since further MNT depreciation increases the cost of capital.
- Raising MNT debt and borrowing MNT from local banks reduces overall FX risk for the GOM. A more active MNT bond market, with local banks as primary dealers will prove to be a profitable business, especially when selling long dated bonds. As these operations mature, banks can begin to inventory longer dated maturities, offering buyers the certainty of execution vs. bidding for bonds and risking not getting filled while taking currency risk in pre funded transactions.
- Raising MNT short term debt is neither good for the GOM, nor foreign investors, as risks are squeezed into a shorter time horizon, leaving little or no room for error.
- Longer term MNT bonds allow the GOM to engage much larger investors, EM Fixed Income Funds, International Banks. Sovereign Wealth Funds and Central Banks to name a few. Many of which may be overexposed to debt denominated in developed nations currencies, most notably USD and EUR.

The benefits go well beyond the aforementioned, as each time a foreign investor buys an MNT denominated bond, the investor must first buy MNT with their USD, CNY, EUR, etc. In the case of a 10 year bond, Mongolia will enjoy the benefits of those stable foreign reserves for 10 years! Taken together, the logic is quite clear and would create a positive feedback loop: MNT GOM bonds bought by foreigners greatly increases foreign exchange reserves at Mongol Bank, which supports the value of MNT. As the bond market grows, so do Central Bank foreign reserves, providing even greater support for MNT appreciation, resulting in a self-improving mechanism which may be starting now.

What are the benefits to the Mongolian people and local companies?

- Creating a stable mechanism for GOM financing in MNT will reduce rates and FX exposure in the long term, resulting in higher savings on the GOM's budget, a win/win for all Mongolians
- Once the market for MNT GOM bonds becomes more active, with participation from foreign investors, then an MNT sovereign yield curve will be established from 1-12 months to 2-10 years, becoming a reliable benchmark and economic indicator. As such, it will be easier to price the credit risk of private and corporate borrowers, enabling Mongolian companies to raise MNT debt financing, using a more reliable pricing mechanism.
- Lastly, this is exactly how local bond markets developed around the world, so there's ample precedence to support these efforts by the GOM. Even in a country like Singapore, which has no need to borrow money, conducts regular bond auctions. These auctions provide the pre-requisite reference point private issuers need to issue SGD bonds, which is critical to supporting the corporate bond market there. This would be critical to developing a corporate bond market in Mongolia which does not yet exist.

Mongolian Government Bond Yield Curve Projected out to 10 years



Source: Bank of Mongolia

With nearly \$800M USD worth of MNT GOM bonds to be auctioned, larger investors can now gain exposure to Mongolia's capital markets at attractive rates. Investors with a long term view can now easily put \$50M/\$75M/\$100M USD to work in Mongolia, via a combined fixed income and equity strategy. The 10 year

MNT GOM yield is currently ~14.375%, which is quite attractive even considering currency risk, when viewed over the long term. Investors can now access liquidity via GOM MNT bonds, while simultaneously allocating to high quality local stocks, creating a high yielding portfolio with equity upside. Should investors continue to reinvest interest and dividend payments, not only would that mitigate currency risk, but give them an opportunity to create vast returns and participate in Mongolia's long term growth and prosperity.

The GOM has provided a comprehensive presentation for their plans to develop a more robust MNT Bond market which can be found by following this link: http://mof.gov.mn/wp-content/uploads/2014/03/02.-Government-Bond-Market_monthly_eng.pdf

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