Steppe-ing up

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Countries with economies geared towards exporting natural resources emerged fastest from recent economic turbulence, and few recovered as smartly as Mongolia. Sandwiched between China and Russia, and blessed with abundant mineral reserves, Mongolia recorded GDP growth of 17.3% in 2011. The Mongolia Stock exchange rose 32.6% in 2011, second only to the Caracas exchange.

These kinds of numbers tend to excite foreign investor interest, with mining and law firms leading the way. Mongolias resources, reason its new fans, will require reliable infrastructure to bring them to market. Rising prosperity and better economic growth will also drive infrastructure development.

The evidence for a wave of energy, resources and infrastructure financings is so far scant: One deal, a $155 million financing from a group of development finance institutions for local developer Newcoms 50MW Salkhit wind farm, has closed. Dwarfing Salkhit is the $6.1 billion Oyu Tolgoi copper gold mine, for which Ivanhoe Mines and its controlling shareholder Rio Tinto are developers. At the biding stage is the 450MW, $1 billion CHP5 heat and power project, which would provide a better guide to the countrys infrastructure finance prospects than the larger or smaller deals.

Third and up

Mongolia, sandwiched between China and Russia, has traditionally traded mainly with these two neighbours, and only recently started to court investors from other jurisdictions. First Mongolia signed the Investment Agreement with Ivanhoe Mines for the large Oyu Tolgoi copper-gold project in October 2009 and subsequently revoked the windfall profit tax on natural resource revenues at the beginning of 2011. According to Philip ter Woort, the head of the European Bank for Reconstruction and Developments office in Ulaanbaatar, it has been a day and night difference in terms of perception of investors and interest of investors and companies to actually do something in Mongolia.

The second main initiative has been the countrys third neighbour policy, designed to attract western investment. Mongolia generally receives high marks for its efforts to make it easy to do business there. According to Stephen Tricks, a partner at Clyde & Co, which recently launched an association with local firm Khan Lex Advocates, Officials are willing to meet and talk with western businesses, in a culture where business is still based on personal relationships. One can have a productive meeting with government officials without having to go through many of the hurdles common in neighbouring countries.

Mongolia is, if anything, more responsive to public opinion than many project finance sponsors might like. Mongolias State Property Committee has set up a PPP unit, headed by Zayarbal Batjargal, which is under pressure to demonstrate signs of progress in advance of legislative elections. Its one of the most stressful jobs in project finance right now, jokes one banker working in the country.

Mongolia has had a PPP law since 2010, but the resources boom will sorely tempt Mongolia to move cash in the direction of its electorate at a faster pace than PPP allows. The government has also promised improvements to the countrys occasionally cumbersome permitting process. In late 2011 it briefly proposed increasing its 34% stake in the Oyu Tolgoi project, to the disquiet of both Ivanhoe and other mining investors, before backing down.

Oyu Tolgoi tests lender enthusiasm

The $6.1 billion Oyu Tolgoi mine will be the first test of commercial lender appetite for Mongolian deals, and has had a protracted development history. Ivanhoe mines, which is listed in Toronto and New York, brought in Rio Tinto to manage the development of the project in 2006. In October 2009, Rio paid $388 million to double its stake in Ivanhoe to 19.7%, and had an option to take its stake over 46%.

But the cost of the project has risen sharply. In 2009, Ivanhoe indicated that it was looking for roughly $2 billion in debt for a $3.5 billion mine, but by May 2010, when it mandated the EBRD and International Finance Corporation as lenders on the mine, its cost estimate had increased to $4.6 billion. In June 2010, when Ivanhoe mandated BNP Paribas and Standard Chartered as commercial debt arrangers, Rio paid another $393 million to take its stake to just under 30%.

The outlines of the proposed debt financing are that it would now be about $3.6 billion and would involve $300 million in EBRD and IFC B loans and $1.2 billion in B loans, one of the sternest tests of the two multilaterals syndications capabilities for several years. Export Development Canada and seven other ECAs and commercial banks have been mentioned as potential lenders.

As the projects costs have increased, Ivanhoes desire to prevent Rio Tinto assuming full control have diminished. Rio had asked Ivanhoe to suspend a shareholders rights plan that prevented a Rio takeover, and the two settled in December 2010, with Rio Tinto providing a $1.8 billion loan to Ivanhoe, which would be repaid from a project debt package. In January 2011, Ivanhoe said it was looking for another $1.8 billion bridge, this time from a commercial bank, but on the same terms as the Rio Tinto debt.

But on 18 April, Rio Tinto and Ivanhoe agreed a new funding plan that involved additional bridge financing from Rio, a $1.8 billion equity rights issue by Ivanhoe, with Rio Tinto providing a backstop, and a full completion guarantee from Rio for Oyu Tolgois project debt requirement of up to $4 billion. The agreement gave Rio 51% of Ivanhoe, resulted in the ejection of Ivanhoes chief executive and chief financial officers, and, promises Ivanhoe, will allow it to close financing on the mine before the end of the year, or around the time when its first phase, open-pit operations, is complete.

The key provision is the completion guarantee, which signals that project lenders, unfamiliar with the jurisdiction and Ivanhoe, wanted a project of its size wrapped by a mining major. The alternative, the sale of an equity stake to a large copper buyer with a supportive export credit agency, whether Korean or Japanese, would have required Rios consent.

Rio Tinto has already said it will review Ivanhoes $900 million sale of a stake in South Gobi Resources, which runs an operational coal mine, to Chinas Chalco. The sale has excited some criticism in Mongolia, given its desire to reduce its dependence on Chinese and Russian investment. The Rio Tinto funding also ensures that Oyu Tolgoi will build its own $900 million power plant to power its processing operations, rather than using power imported from China, which also happens to be the destination for 90% of Mongolias exports.

Power comes up with CHP5 and Salkhit

Mongolia has the makings of a robust, if rather carbon-intensive, power sector, thanks to its abundant coal reserves. Ulaanbaatar, famous as the worlds coldest capital city, draws power and heat from three soviet-era coal plants. The three plants, not mention personal lignite-fired stoves, are the source of considerable air pollution. Mongolia lacks cost-effective access to gas or fuel oil, so a new generation of more efficient coal plants is the best, slightly imperfect, way of displacing existing coal capacity and meeting demand growth.

The 450MW, $1 billion CHP5 is the largest potential financing outside the mining sector. It will test sponsor and lender interest in a Mongolian government credit, given that it will benefit from a 25- year offtake contract and operate within the framework of the 2010 PPP law. The Mongolian Ministry of Mineral Resources and Energy and its adviser the Asian Development Bank want to receive final bids for the plant, from four shortlisted bidders, in May. The four groups are Mitsui; Samsung and Korea Southern Power; International Power, Sojitz and Newcom; and Daelim and Lanco.

The composition of the bidding groups suggests that Mongolia will not have to look far for its third neighbour a Korean or Japanese export credit financing is almost a certainty. Market rumour suggests that the initial financing plan for the plan revolved around a Japanese overseas development assistance loan, before the Fukushima earthquake forced a change in Japanese government priorities. An ECA-heavy financing would allow the deal to dodge the question of whether commercial lenders are as enthusiastic about Mongolia as their legal advisers.

A Mongolian government offtake contract can be taken to lenders at least multilateral ones. The first independent power project financing in Mongolia was a wind farm, the $115 million Salkhit project. The $85 million in debt for the project came from the EBRD, with $42.4 million and the Netherlands FMO, with $42.6 million, with Newcom putting up 75% of the equity for the plant and the EBRD the remainder.

Wind is probably the only resource outside coal with which Mongolia is blessed, and the Mongolian government, aware that coal plants tend to attract criticism from non-governmental organizations, has set ambitious renewables targets. Salkhit, which means wind in Mongolian, uses 31 1.6MW turbines from GE, and is located 70km from Ulaanbataar. That even this modest financing might account for 5% of Mongolian power demand highlights the possibilities on offer to developers.

The best of the rest

Behind these two headline power deals stand a long list of tentative projects, up to 130 of them depending on the list being consulted, with transport, in particular road, rail and airports, leading the pack. Solid railway infrastructure will be central to the Mongolian resources story. While Mongolia covers an area the size of western Europe, its railway network is about the size of the Netherlands.

Russian Railways has been the most aggressive suitor, promising to build rail infrastructure to promising mining regions in exchange for rights to exploit deposits. It would also send cargoes to its ports on the Pacific coast, and would be a possible market for coal exports. This fits in which the Mongolian governments willingness to court alternative outlets to China, which has been known to cut off border traffic to make its displeasure at Mongolian policy clear. But the sizes for the more ambitious projects, at up to $5 billion, will stretch the resources of even the more aggressive Russian lenders.

For now, infrastructure assets with resources and cross-border trade angles can often be financed with bilateral sovereign lending. Given that state revenues have expanded to such a degree that pre-election spending binges are now considered the norm, government has few qualms about taking on debt commitments from friendly government development banks. Japan for instance, is lending Mongolia $270 million, over 40 years, at a reported all-in rate of 0.2%, to finance a new international airport for Ulaanbaatar.

The time that it takes to document PPP deals will test the patience of an electorate that has grown quickly used to increased government spending. This impatience partly explains the breakneck speed of the CHP5 procurement, on which the ADB has only been advising for about 10 months.

Another source of infrastructure finance may come from building up a state-owned development lender along the lines of Brazils domestic currency project finance behemoth, BNDES. The sovereign-guaranteed Mongolian Development Bank recently closed a $580 million bond issue, which priced for a very low coupon of 5.75%, and was 10 times oversubscribed.

But BNDES has access to low-cost financing from domestic state- controlled pension funds, and is able to finance an infrastructure project of any conceivable size. Some of the larger Mongolian rail projects, not to mention a proposed 630km highway between Ulaanbaatar and Zamyn, would tax the MDBs capital on their own.

Beyond the success of the CHP5 tender and the Oyu Tolgoi documentation progress, the $3 billion initial public offering of coking coal producer Tavan Tolgoi will be a good indicator of continued business sentiment towards Mongolia. The Mongolian government will list 19% of the producer in Ulaanbaatar, as well as maybe London and Hong Kong, though it has already pushed back a listing date to late in the third quarter in the face of weak global markets. It plans to allocate another 30% of the producers equity to its own citizens for free, and bring in local strategic investment for another 10%.

While the country may be trying to reduce its dependence on China, Chinese demand for raw materials still underpins many of the markets in which Mongolian producers operate. But the Tavan Tolgoi IPO plan at least suggests that the government is thinking creatively about dodging the resource curse. As it emerges from low income status, and loses access to some of the more generous multilateral lending programmes, it looks like its future is closer to Brazil or Australia than blessed-but-poor jurisdictions like the Democratic Republic of Congo.