Executive Summary
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Wild Growth: An Assessment of Erdenes Mongol

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Erdenes Mongol is a multi-faceted state-owned enterprise. The Mongolian government nominally established Erdenes Mongol in 2006 as a holding company to represent its interest in strategic mines, manage mineral licenses, and promote the mining sector. It has since evolved into a complex company with interests not only in mining but also mineral processing, unconventional oil and gas, roads, border crossing facilities, hotels, restaurants, power generation, engine repair, steel, trade promotion and asset management.

Still, its core activities are in holding shares and operating several of Mongolia's largest mines. These include the Oyu Tolgoi gold-copper mine (in which Erdenes Mongol holds 34 percent ownership), the Tavan Tolgoi coal mine (65 percent), the Shivee-Ovoo coal mine (90 percent) and the Baganuur coal mine (75 percent). The company also operates or has stakes in gold, silver and uranium exploration companies.

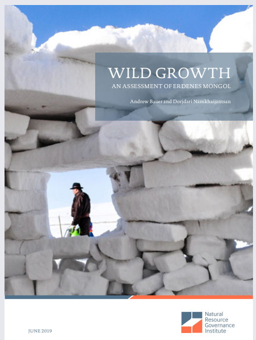
Erdenes Mongol valued its assets at approximately MNT 9.36 trillion (USD 3.9 billion) as of end-2017, 82.5 percent of which is attributable to the company's Tavan Tolgoi coal mine shares. There are other large government owned mines, such as the Erdenet copper and molybdenum mine and the Bor-Undur fluorspar mine, which are managed by separate state-owned enterprises.

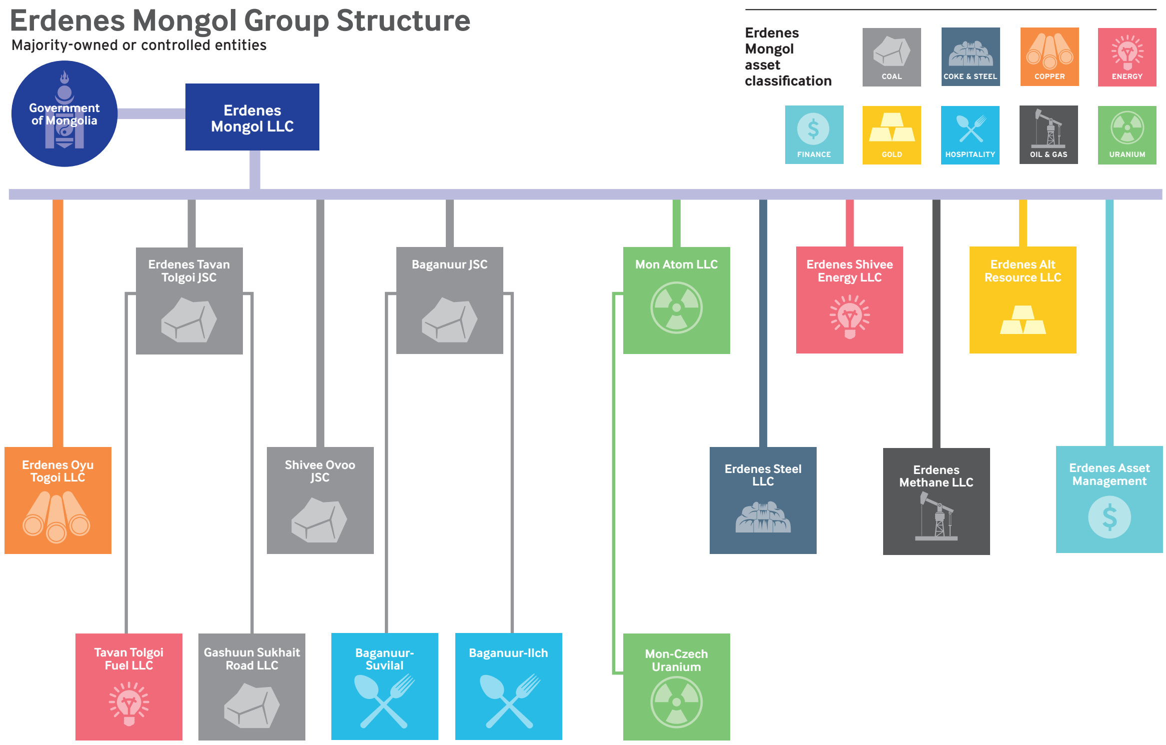
State equity in strategic mineral deposits seemed a more lucrative proposition before the financial crisis and commodity price crash of 2008 and 2009. Mineral price volatility and lower medium-term prices in recent years have dampened excitement among mining sector investors. As a result, the company's payments to government have proven weaker than expected. Weighted by ownership share, Erdenes Mongol's segment of Tavan Tolgoi, Oyu Tolgoi, Shivee-Ovoo and Baganuur as well as the parent company paid only MNT 317 billion (USD 130 million) to the government in taxes, royalties and fees in 2017. Erdenes Mongol has also struggled to attract private investment in its mining assets, which is one of its mandates.

While Erdenes Mongol and its subsidiaries do not publish disaggregated cost information that would be useful for financial analysis, and most of its subsidiaries do not publish any financial information, available data indicate that the company's revenues have been inadequate to cover its costs. As a result, Erdenes Mongol has often required government support from public entities such as the Development Bank of Mongolia. As of the end of 2017, Erdenes Mongol was responsible for MNT 877 billion (USD 361 million) in liabilities for the parent company, Tavan Tolgoi, Shivee-Ovoo and Baganuur.

About this document

This is a summary of the report *Wild Growth: An Assessment of Erdenes Mongol*, available at resourcegovernance.org/erdenes-mongol.





The company is also relatively illiquid. The four entities for which we have financial information—the parent company and three subsidiaries, Erdenes Tavan Tolgoi, Shivee-Ovoo and Baganuur—held a total of MNT 72 billion (USD 30 million) in cash belonging to Erdenes Mongol as of the end of 2017.

From its founding in 2006 until 2015, Erdenes Mongol had not reported any profits. Today, the company is producing a profit for the first time: it declared profits of MNT 41 billion (USD 16.3 million) over three years, 2016 to 2018. The recent increase in coal prices and increased shipment of coal to China from Tavan Tolgoi explain much of the improvement in profitability.

Despite an increase in overall profitability, Erdenes Mongol and its subsidiaries still do not pay regular dividends to the Mongolian treasury. In comparison, most other regional state-owned mining companies such as China's Shenhua Energy, Coal India and Indonesia's Antam regularly pay 30 to 100 percent of their profits to the state treasury as a dividend, which can amount to hundreds of millions or even billions of dollars each year.

Until Erdenes Mongol begins collecting dividends from Oyu Tolgoi around 2035, these improvements in profitability are conditional on coal prices remaining at current levels or above. Reforms are needed to transform Erdenes Mongol into a successful company that generates value for the Mongolian government under modest price scenarios. We propose reforms in four categories: mandate; corporate restructuring; governance and human resources; and transparency and oversight.

MANDATE

Erdenes Mongol's mandate—and more broadly the government's role in the mining sector—have never been clearly defined. Though there is political consensus that benefits from mining have been inadequate to date, there seems to be little analysis or discussion among policymakers on the role of the state versus the private sector in managing strategic mines.

As a result, Erdenes Mongol's expansion and evolution has been a product of organic growth, unencumbered by a strict legislative framework. The company has established new subsidiaries operating in sectors of the economy that require varying skills and expertise.

At the same time, there is no explicit vision on how and under what timeline the company will fulfill its mandate. Policymaking inconsistency has been exacerbated by high levels of turnover at the board and among senior managers, which has coincided with political changes such as elections.

To promote more streamlined government intervention in the mining sector, and to ensure that Erdenes Mongol's commercial decisions provide value-for-money for the Mongolian government, we suggest either a specific law covering Erdenes Mongol or one that covers all state-owned enterprises (SOEs). While legislation is being developed, Government of Mongolia could release a clear policy or resolution that improves Erdenes Mongol governance.

To begin, a mining SOE policy should identify clear goals and performance targets for Erdenes Mongol. An Erdenes Mongol-specific law or an SOE law could include the following elements: mandate and definition; strategic plans; non-commercial activities; shareholding; dividend policy; state liability; sale of assets and equity; role of parliament; role and tenure of management; board of directors; code of conduct; accounting; reporting; and auditing.

CORPORATE RESTRUCTURING

At this time, we do not recommend full or partial privatization of Erdenes Mongol. Erdenes Mongol is largely a holding company rather than a mine operator itself, though many of its subsidiaries are operational entities. As such, more than a company in the traditional sense, it is a body meant to serve the Mongolian government's industrial policy, namely to promote the mining sector and manage the state's mining interests on behalf of the government. This mandate could not be served were Erdenes Mongol a private company.

However, we do recommend subsidiary-by-subsidiary and project-by-project assessments based on commercial viability, need for financing and/or technological expertise and strategic importance, among other factors, to determine whether asset sales or joint ventures may be appropriate. This would also allow Erdenes Mongol to restructure in a manner that ensures that its corporate structure reflects its mandate. It would also encourage subsidiaries to become more profitable.

Erdenes Mongol's relationship with its subsidiaries could also be clarified. At the moment, Erdenes Mongol can expand the sectors and activities in which it operates with ease, generally by establishing new subsidiaries or joint ventures. Recent examples include the establishment of Erdenes Ashid, Erdenes Asset Management, Erdenes Methane and Erdenes Gold Resources. These entities can become government budget liabilities should they take on debts or other financial obligations or if they are used to transfer commercial risk from private sector partners to the public sector. They also risk becoming sources of patronage and divert scarce resources away from key budget priorities such as healthcare, education and productive infrastructure. Thus, as part of its clarified mandate, Erdenes Mongol could define a clear policy for establishing new subsidiaries, for example by limiting subsidiaries or joint ventures to specific activities or sectors and providing due diligence for any prospective commercial undertaking.

GOVERNANCE AND HUMAN RESOURCES

Erdenes Mongol has many of the key institutions necessary for good governance, including a board, subsidiary boards, a clear management structure, audit committee and shareholding structure. At the same time, boards and management of Erdenes Mongol seem politicized given frequent turnover after each election. Criteria for senior appointments remain unclear.

In order to promote integrity and professionalism at the board and senior management levels, we recommend developing clear criteria for appointment of board members and managers. We also recommend an open appointment process, including posting positions and using pre-qualification of applicants and objective hiring criteria. Independent external hiring firms could support this process.

Financial and non-financial performance incentives for senior managers could also be considered. For example, promotions and bonuses could be dependent on meeting performance indicators or passing strict management assessments. Our suggestion is that, should this option be considered, it should be implemented only after SOE transparency and oversight reforms have been enacted.

TRANSPARENCY AND OVERSIGHT

Erdenes Mongol and its subsidiary Baganuur JSC took significant steps towards transparency in 2018 with the production of semi-annual and annual reports, as well as publishing of the audit report by the National Audit Office. While the National Audit Office audits Erdenes Mongol annually, oversight could be strengthened by enhancing parliament's role in publicly overseeing the company and its subsidiaries and by subjecting financial statements to independent external audit.

Notwithstanding the progress, the information made available does not yet meet international reporting standards for SOEs and does not provide sufficient information for assessing company or subsidiary performance. Most importantly, financial information on revenues, expenditures, profits, assets, liabilities and activities is only available for some subsidiaries, and is not sufficiently disaggregated for financial analysis. Thus, it is nearly impossible for parliament, the media or the public to measure performance of Erdenes Mongol projects in order to suggest ways to improve governance and overall profitability. Many of Erdenes Mongol's operations remain shrouded in secrecy.

We recommend that Erdenes Mongol build on its recent successes by following the path set by SOEs such as Chile's Codelco, China's Shenhua Energy and Zijin Mining, Colombia's Ecopetrol, India's ONGC, the Philippines' PNOC and Zambia's ZCCM-IH in disclosing greater information on their finances and activities. Financial statements should also comply with international financial accounting standards.

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