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# **Darkhan Business Survey:**

**September 23 – October 9, 2002**

By  
John Napoleoni

USAID/CHF Supporting Enterprises and  
Economic Development (SEED) Program

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Darkhan, Mongolia  
October 15, 2002

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#### Overview

The USAID/CHF Support to Enterprises and Economic Development (SEED) Program provides small business development services, information, and training to Mongolians living in the peri-urban areas of Darkhan, Erdenet, and Ulaanbaator. This report summarizes interviews conducted September 23 - October 9, 2002 as part of the SEED Program's Rapid Needs Assessment for the Darkhan office. The full results of the Darkhan Rapid Needs Assessment are provided in a separate report<sup>1</sup>.

#### Market Traders

Informal interviews of 30 stall merchants located in Darkhan's central market (known locally as the "birch") were conducted to better understand this segment of the trading economy. Stall merchants displayed a high degree of product specialization, including cigarettes, dry goods, candy, apparel, cosmetics, shoes, gifts, bread, dairy, meat, vegetables, sausages, processed food and eggs.

Sixty-seven percent of those sampled were women, which approximates the apparent gender percentage for the population of stall merchants. Of those interviewed, the large majority had immigrated to Darkhan, with most coming from the western aimags. Seventeen percent had moved to Darkhan within the last three years, while sixty percent had relocated within the last ten years. Many who relocated cited educational opportunities as the reason for coming to Darkhan, while others simply stated that life was better in the city than in their former homelands. Eighty percent of interviewees owned their inventory, while the remaining 20% were employees of the owners and earned a salary or commission. Ninety percent of those interviewed lived in apartments, which provides a rough indication that that, in general, stall traders are somewhat better off than ger district residents. In Darkhan, there are about 15,160 residences, of which 9,055 (60%) are apartments, according to utility company data<sup>2</sup>.

Rental rates for stalls varied by product from 15,000 tugriqs per month for simple exterior apparel stand to 65,000 for a 40 foot container. Rents for a stall inside the main building are twice as much as those on the outside during the summer. During the winter months, interior rents double again to pay for heating. In addition to rent, many stall merchants pay 15,000 tugriqs per month for security guards to protect of their inventory during non-business hours.

Stall merchants indicated that their trading operations provide only a very basic sustenance. Margins are slim, with high turnover food items earning from 10 to 20%, while low volume apparel and shoes earn 50%. All the merchants complained of declining returns in recent years as additional traders dilute the market. Except for a few traders specializing in

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<sup>1</sup> Lassiter, Greg, Margaret Herro, John Napoleoni, and Patrick Somerville, "Darkhan Rapid Needs Assessment: September 23 – October 18, 2002", USAID/CHF SEED Program, Darkhan, Mongolia, October 2002.

<sup>2</sup> Development Alternatives, Inc., "Commercialization Initiatives at Darkhan-Selenge Electric Distribution Network Volume 1. A Report for the USAID Mission to Mongolia, DAI Economic Policy Support Project

locally produced food items, most followed the same formula of buying cheap goods in Ulaanbaatar or China, and selling the goods in Darkhan. This formula assures diminishing future returns as successful product innovation leads to predatory emulation.

Only ten percent of those interviewed said they had ever taken a bank loan to finance operations. This general lack of bank financing is puzzling, considering that local banks consider the stall traders a prime market for loans and a large percentage of total portfolio is loaned to traders. It is theorized that some of the stall merchants prefer to keep information regarding financing private, and as a result, the statistics regarding bank financing are not meaningful. Merchants who cannot secure bank funding or want to avoid high interest payments must travel to China and Ulaanbaatar as often as twice a week, to replace sold stock. This lost time and inherent cost of such frequent restocking was cited as a major business problem.

Issues relating to market traders and retailers:

- **Differentiation** – All the shopkeepers interviewed have competitors nearby who manage virtually identical operations. With few exceptions, not one stall offers inventory that is not sold at a competitor's stall. One notable exception was an apparel stall that sold fashions from Poland. In order to attract customers and create demand, stall operators must generate differentiation of product, service, or presentation.
- **Financial Skills** – All those surveyed equated income with cash flow. While stall merchants understand the concepts of margin, overhead, and could, in their own manner determine the success of product lines and operations, their ability to secure bank credit was limited by their inability to communicate and project results systematically. More complex financial decision-making is beyond the ability of most of those interviewed.
- **Marketing** – Stall operators are price takers, not price makers. Goods are offered without imagination. As a result, inventory is denuded of its intrinsic value and become commodities that sell only on the merit of price. In addition, no effort is made to create a pleasant shopping environment.

## Banking

Over the last several years, the availability of credit in Darkhan has significantly improved after recovery from recent bank failures, at least in part due to free market competition. Four viable and professionally run banks contend for market share:

- **Xac Bank** – Ms. Munkhtor. Xac's development orientation is apparent in its loan clientele. Xac subdivides its loan products into three categories. Large loans from two to 30 million tugrigs are made to several food stores, some restaurants, a cookie factory and a jewelry factory. Medium loans between one to 2 million tugrigs are made to traders and other small business people. Most of Xac's loans are less than 1 million tugrigs and are advanced to small sewing factories, kiosks, and shop owners. Xac will take anything useful as collateral including household appliances, apartments, yurts and automobiles. Xac currently has 500 loans outstanding totaling 200 million tugrigs.
- **Agriculture Bank** – Ms. Chuluuntsetseg. Ag's innovative products such as pensioner and salaried loans have made it a leader in Darkhan, but its dominant position has been challenged by other banks that have copied its strategy. The Ag Bank's role as cash manager for the state's pension systems puts it in a favorable position, relative to the other banks, that must secure an assignment of rights between the Ag bank and client. Half of Ag Bank's 200 million tugrigs loaned per month are made to pensioners and salaried people. The other half are made to traders and small businesses that manufacture products such as clothes, cookies, bread, sausages and food and appears to finance many container and stall traders. Overall, the Ag bank has a strong position in the Darkhan market

- Golomt Bank – Ms. Badamhand. This aggressive private bank has steadily gained market share from the other established banks and now has a strong position in Darkhan. In addition to small business loans similar to those offered by other banks, Golomt is participating in a variety of new loan programs subsidized by The World and Asian Development Bank.
- Trade and Development Bank – Monkhtsatsral. This recently privatized bank concentrates on large-scale loans, focusing on a short list of preferred clients, including gold mines and farmers.

In addition to these major financial institutions, several secondary banks are active in Darkhan including the following:

- Hadgalamj (Savings Bank)
- Post Bank
- Zoos (Coin)
- Erel Bank

Banking operations nationwide are in full recovery. Interest rates are high (from 2.5% to 5%), as are profits. Conservative and risk adverse lending practices, based on new bank regulations, have resolved the bad debt issues that crippled the industry during the 1990s. The banks interviewed indicated that bad debts are at very low levels, and represent less than 1% of loans outstanding. Further, the banking industry in Mongolia has shifted from the risky orientation of servicing only large corporate clients, towards providing small and micro loans to small businesses and individuals. A large percentage of the Darkhan loan portfolio is comprised of low risk consumption loans to pensioners and salaried people.

With two notable exceptions, Darkhan banks prefer and, in most cases, insist that loans are collateralized with real estate, particularly apartments. Movable assets such as automobiles, livestock, inventory, gers, and household goods can be hidden from banks and are otherwise perceived as risky collateral due to valuation issues. As mentioned above, Xac will accept a variety of non-real estate items as collateral, including autos, livestock and household appliances on loans under 100,000 tugriqs. Golomt Bank also advertises that it accepts similar collateral. Unless a client possesses a building or apartment, there is very little opportunity to secure financing from the other commercial banks.

Many who do not possess real estate and are therefore ineligible for bank loans turn to pawnshops as a last resort. Pawn shops charge usurious rates from 6% to 10% per month even though collateral (usually carpets, automobiles or gold jewelry) is secured in advance, resulting in low risk lending. While such collateral is not always easy to sell, some interviewed pawn brokers said they can sell collateral for more than the loan, indicating that clients are receiving less than fair value for goods on deposit.

While the banking industry is in full recovery and appears to be making sensible business decisions, the vast majority of potential clients in Darkhan are ineligible for bank loans due to the strict collateral requirements. There is a great need for the banking sector to provide loans collateralized with assets other than real estate. Even capable small business owners with viable business plans have no hope of securing credit if they do not own an apartment. In particular, the ger district's working poor and SME's have little hope of obtaining credit, even with a viable business proposal.

The banking industry should consider reforming collateral requirements so that a broader base of clients gain access to credit. Possible reforms could include:

- Self collateralized loans – Line of credit borrowings are usually partially self-collateralizing in that a fraction of inventory purchased (typically 50% for American transactions) becomes a component of the collateral formula.

- Alternative collateral – Banks should consider giving collateral value for livestock, automobiles, machinery, equipment, and household appliances, such as Ag Bank’s herder loan program. Controls, such as frequent site visits to loan clients can monitor the viability of the loan and collateral. The banks could also take possession of client’s unutilized assets as collateral for loans, just as pawnshops do. These pawn type loans should have a lower interest rate as non-performance would result in the liquidation of bailed collateral. It would be useful for local banks to work with and loan to pawnshops in order to drive pawnshop rates down for customers who do not have real estate.
- Co-sign – Those who have property could provide the collateral for their children and other relatives that have none. We suspect that such loans already exist, but there seem to be room for expansion.
- Unsecured lending – Banks could make loans using only the citizen’s long established good standing in the community and reputation as security. Loans of this type can be less risky than asset collateralized loans in some cultures, but require a very careful loan review process.
- Cash flow lending –Banks indicated that they already utilize cash flow lending, based on good credit history and favorable cash flow. We would like to see such loans increased for SEED Program SME clients who have received training and consulting services to improve their financial reporting and business plans.

### **Textiles & Apparel**

Recently, Darkhan has experienced strong growth of its textile and apparel industries. Several new factories, most of which are foreign invested Chinese or Korean entities, have begun operations within the last eighteen months. Darkhan’s textile industry now has at least 6 such ventures and employs more than 1000 sewers and knitters.

Virtually all foreign invested factories began business in Mongolia to escape from costly American and European textile import quotas. To prevent a few countries from monopolizing the American trade, the United States has limited textile imports from most Asian countries. Individual textile operators in countries such as China, India, Korea, Pakistan, etc. typically must bid for a share of their country’s quota rights to the American market. One Chinese sewing factory manager in Darkhan complained that a typical textile factory in China must purchase a US textile quota share of \$2.00 per unit for cheap blue jeans, which cost another \$5 per unit to manufacture. However, because Mongolia has preferential trade status with the United States and has unlimited textile import privileges, he saves this \$2 per unit when he produces in Darkhan. Therefore, the US textile quota system encourages foreign corporations to produce garments in Mongolia.

The trend for foreign textile operations to locate in Mongolia began several years ago. Hundreds of new entities have recently exhausted the available labor force in Ulaanbaatar and, as a result, many are relocating to provincial cities such as Darkhan. This represents a window of opportunity for the SEED Program.

However, cross cultural issues between the foreign (predominately Chinese) management and Mongolian work force have prevented the new entities from flourishing. Labor complains of wages as low as \$20 per month and poor working conditions. Management asserts that the Mongolians have not responded well to incentive-based compensation and complain that Mongolian workers produce 33% less than Chinese.

While these cross-cultural issues exist and must be resolved, development of the textile industry in Darkhan represents an opportunity for the local population. Salaries at the textile factories are generally low, but better than the alternative, which, for many young people employed at the factories, is unemployment. The opportunities and issues for the textile industry in Darkhan include:

- Training – Many managers complained that they must train prospective employees – a costly exercise considering many employees receive training, and then work for a competing entity. However, we met one high-end garment producer who preferred to train his own employees—he did not want employees with prior training, which he felt had negative consequences on training potential and internal quality control.
- Mongolian access to textile marketing information – foreign companies that manage textile operations shield their Mongolian employees from market information. For the Mongolian industry to flourish, Mongolian owner / operators must eventually deal directly with high value American and European customers. They seldom have access to these contacts.
- Foreign access to information about the Darkhan labor market – Many foreign operators in Ulaanbaatar and China are frustrated with the competition for employees. Promotional efforts to encourage operators to locate in Darkhan may result in too many enterprises relative to the labor force.
- Sustainability – The American quota system is scheduled to be phased out over the next three years, raising a serious question of sustainability. Mongolia therefore enjoys a temporary preferential status because it does not pay the quota share price that most other Asian countries. Even if new regulations maintain the status quo, the Mongolian textile industry needs a substantial improvement in competitiveness.

The foreign sewing factories are value-added industries, which contrast with Mongolian factories that produce textile raw materials, such as cashmere. Darkhan Nehee is a notable exception, in that it adds value to Mongolian sheepskins by manufacturing coats, mittens, seat covers, slippers and a variety of products for domestic and international markets. Other opportunities exist to process wool, mohair, cashmere and sheepskins into consumer goods and industrial inputs. Unfortunately, most agricultural commodities are exported from Mongolia in the raw state with only minimal value added.

### Cottage Industries

With limited possibilities for securing a good paying salaried job, a majority of ger residents have turned to home subsistence activities, cottage industries, micro enterprises, or small businesses. The occupations, arranged by approximate order of relative size and complexity, include:

- Vegetable gardening
- Hand cart operations
- Horse cart taxi & freight service
- Well water distribution
- Bottle collecting
- Fire wood collecting
- Scrap metal dealing
- Kiosk retailing
- Soup, hoshuur, buuz, and other fast food production and retailing
- Tea shop operations
- Dairy Processing
- Wood cutting & processing
- Trucking & Taxi service
- Pig & Chicken farming
- Butchering
- Sausage Making
- Mitten, Glove and Hat manufacture
- Sewing traditional Mongolian clothing
- Shoe manufacture

- Automobile & home insulation service
- Automobile Repair
- Welding & Black Smithing
- Flour milling
- Construction & Carpentry

While the typical economic situation of ger district residents is difficult, there have been success stories. Vegetable gardening is notable in that it provides a reasonable supplement for many, both supplementing diets and providing limited cash income from market sales of surplus vegetables. Profitability however is limited by the amount of land owned and available resources. When space and working capital allow, gardening is a viable small business. One successful gardener with more than one hectare explained the current year's financial performance:

Revenues (in tugrigs) from vegetable sales	2,700,000
Land Rent	-300,000
Seeds	-100,000
Labor	-200,000
Water	-100,000
Income	2,000,000

Human resources and business operations will require a serious upgrade in skills, management, and organization before the ger community's cottage industries will truly flourish. Needs are many fold and include the following:

- Skills upgrade – the unskilled nature of most commercial activity in the ger community allows for new entrants to constantly penetrate and acquire market share of already over serviced markets – resulting in continuously shrinking margins.
- Organization & co-operation – conventional wisdom suggests that efforts at mobilizing cooperation in Mongolian industry can be a frustrating exercise. Possible applications include organizing home sewing and handicraft makers into a marketing cooperative, joint cultivation of vegetable gardens on neighboring property, and cooperation between two or more apparel manufactures to allow for assembly line type task specialization and increased productivity.
- Value added – Opportunities exist in producing higher value-added products, rather than stopping at initial processing only. Possible applications include vegetable canning and drying for a coop of vegetable gardeners, and linking furniture manufacturers with wood processors.
- Lack of information – A major source of market information is the city market where residents can see first hand what is in demand by local residents, plus the UB market for regional trade items. Other sources, of varying value include television, radio, newspapers, and the media. Little information on future trends and alternative customers exist.
- Access to credit – residents of the ger community still have virtually little opportunity to secure financing, except for family resources and pawn shops.

### Heavy Industry

Darkhan was established with technical assistance from the Soviet Union as a center for heavy industry. Utilizing operations located in densely populated and heavily industrialized Russian and Eastern Europe as a model, Darkhan created large-scale enterprises in the

cement, construction, mining, and electrical generating industries. Built under a centrally planned model, these enterprises are of a scale now inappropriate to the demands of Mongolia's more market oriented economy. Their future is not certain and many seem unviable.

The Cement Factory was established in 1968 with assistance from Czechoslovakia and currently employs more than 300. The factory was purchased from the state by Erel Company in 1998. The factory utilizes wet processing technology that is inherently energy inefficient. While most of the raw materials are produced near Darkhan, the factory manager considers Dorno-Gobi Aimag a superior site due to the limited availability of local gypsum. The scale of the factory is extremely large and runs at full capacity only briefly during the summer construction season. The Erel Company has done well to utilize reportedly 50% of capacity on average. There is hope that growth of the construction sector in Mongolia will increase plant utilization.

The Government of Mongolia with financial and technical assistance from the Government of Japan created the Darkhan Metallurgical Factory in 1994. The mill converts scrap steel into rebar for the construction industry. The scale of the enterprise is quite large relative to the size of Mongolia's market. Export markets are apparently unavailable due to the high cost of industrial inputs and tariff considerations. The scrap industry has exhausted the domestic supply, and the factory cannot acquire needed raw material at viable offering prices. Iron ore is available from Selenge Aimag and the factory manager hopes to convert the factory from scrap, even though the ore mine will most likely require a large investment to initiate operations. The factory utilizes electricity to fire the furnaces, even though coal is available and cheap.

In addition to the above factories, Darkhan has a few partially or totally defunct construction material companies, including a brick factory and some concrete processors. Darkhan and neighboring Selenge are rich in mineral resources including coal, gold, and limestone, and various mining and quarry operations are still active and producing. Darkhan benefits from an extensive railroad network that delivers raw materials from the mines and finished.

To service these enterprises, Darkhan was one of the few places in Mongolia where electric power was generated on a large scale. Heavy industries consumed large quantities of electricity and contributed to the large arrearages that crippled the energy sector during the 1990s. Today, the factories operate primarily at night, due to reduced electricity rates. Darkhan's heavy industry sector has at least one advantage—the electric generating plant has capacity for additional large clients:

The needs and issues related to Darkhan's heavy industries are many fold and include:

- Energy efficiency – The large-scale enterprises consume large quantities of electricity, often inefficiently due to outdated equipment. The government of Japan has recently sponsored a study of the issue, but capital for implementing the upgrades is lacking. Many of the factories that were established during an era of subsidized energy are increasingly less viable given the current and future market reality.
- Downsizing – Many of the large-scale enterprises are too big, given the limited size of the Mongolian economy.
- Selective dismantling – The government should consider selling or closing some loss making enterprises. While Darkhan is currently dependent on its large industries for employment generation, there may be cases when implicit subsidies to large companies to maintain employment may exceed the alternative cost of paying unemployment benefits or of promoting investment in more productive businesses that generate employment.

## Agribusiness

Darkhan's location near Selenge's grain fields has made it the logical center for the flour milling industry. In addition to one large-scale silo and milling operation, several dozen smaller mills have initiated operations over the last several years, plus approximate 200 micro mills.

Several wheat farms located in and around the city supply Darkhan's milling industry. In the last decade, both the total area being farmed and, alarmingly, wheat yields per hectare have decreased. Local agriculture experts cite dilapidated machinery, poor seed, and poor technology for decreasing yields. The grain farms are also vulnerable to weather variability, such as this year's summer drought, that occasionally decimates harvests. Mongolia still is reliant on imported grain and flour. The supply of foreign grain products is a politically sensitive issue as Mongolia's desire to be more self-sufficient is tempered by the high domestic cost of production, resulting in increased consumer market prices for flour if imports are limited. Today, Darkhan's flourmills acquire raw grain from a variety of sources, including domestic farms, imports (largely from Russian and China), and foreign aid programs, whose grain is locally auctioned.

Milling companies, which opened during the mid 1990s, were so successful that the business model was copied exponentially. Today, many of the mills are unviable. Most of the mills operate at only a small fraction of capacity. The market price for grain, low yields, and expensive inputs cannot produce flour that can compete on cost with imported flour. Unless the supply and demand for input grain and finished flour adjusts market prices, the milling industry is in shake out and many of the small mills will cease operations or otherwise consolidate over the relative short term.

In addition to cereals, Mongolia's traditional agrarian economy produces food for local markets as well as a wide variety of non-food livestock commodities including wool, skins, and cashmere. These commodities are produced by nomadic animal herders and are traded in large quantities in all the provincial centers including Darkhan. The distribution and exportation of raw and processed livestock commodities is a major hard currency earner for Mongolia and generates a large percentage of the cash income required for consumption by the herder producers. Agricultural commodities provide a major component of disposable income and economic health.

Most agricultural raw materials are acquired by a few domestic industries located primarily in Ulaanbaatar and increasingly by foreign (primarily Chinese) trading operations for export. Unfortunately, most of the raw materials are exported raw or only partially processed, then undergo additional value added processing in China. The exportation of raw materials represents a lost opportunity, as value added processing generates income and employment for foreign states, rather than Mongolia.

Agribusiness needs and opportunities:

- Alternative production – The flour industry currently has too much capacity given current market prices for grain and flour. Existing mills need to diversify and many of the smaller mills are unlikely to survive.
- Value added – the availability of domestic raw materials such as wool, cashmere and skins represents an outstanding and sustainable opportunity for value added and employment generating enterprises.
- Increased grain production – Both farming acreage and yields are shrinking. Improved practices are needed to improve the supply and reduce the cost of locally produced grains.
- Supporting industries – Opportunities exist for agriculture supporting services such as irrigation, seed & chemical supply, and veterinary supply.

## Construction

During the socialist era, Darkhan was the center of Mongolia's construction industry. The city's heavy industries supplied raw material and building materials, such as bricks and

concrete slabs to a flourishing construction industry. While most of the building material companies have succumbed to market realities and the 1990's shake out of the construction industry, Darkhan is still home to Mongolia's largest construction company. The Russian company Zarubezhstroy employs more than 900 at various construction sites around the country and the company has the capacity to build very large construction projects. The company built most of Darkhan and many large structures throughout Mongolia. In addition, Darkhan is home to dozens of small construction companies, many of which have joined together to form the Darkhan Builders' Cooperative.

The construction industry nationwide has begun to recover and is forecasted to continue a period of strong growth. However, a variety of issues and opportunities remain:

- Many buildings in and around Darkhan have been neglected. Entrepreneurs that secure the rights to dilapidated buildings, and then sell or rent refurbished units to tenants, have initiated a new reconstruction industry. Buildings that housed obsolete enterprises will continue to be converted to practical facilities.
- Housing shortage – The influx of rural migrants and natural population growth has created a severe housing shortage.
- Property values – The cost of an average apartment in Darkhan doubled over the last 12 months. Higher property values will encourage entrepreneurs to build new units and develop real estate.
- Housing Development Initiatives – The Asian Development Bank together with commercial bank implementers will soon initiate new mortgage lending products in Erdenet, Darkhan, and Tov Aimag
- Shortage of mortgage credit – Although the ADB will soon initiate a mortgage-lending program, the shortage of market based long-term capital for housing and other construction projects is a major impediment to the building industry. The insufficiency of long-term credit requires entrepreneurs to fund projects with scarce equity.
- Darkhan, as the traditional heartland of the Mongolian construction industry, is well placed to capitalize on the expected growth of Mongolia's construction sector. The labor market has a wealth of needed skills, and local enterprises have capacity to take on large and small projects. Darkhan's cement factory and building materials companies benefit from construction taking place in Ulaanbaator, as it is a major market for Darkhan building materials.

## Food Processing

A significant number of Darkhan residents engage in food processing. Local products include bread, cookies, meat, dairy, sausage, and a variety of other consumer goods. With a few notable exceptions, most of the production is generated by small businesses.

A few large food-processing plants exist. The Darkhan meat factory is one of three large-scale slaughtering houses in Mongolia. Unlike virtually all Darkhan enterprises, the meat factory also exports, particularly to Russia. The factory is currently processing horsemeat for export to Russian.. However, it is uncertain whether the order will be delivered due to the local outbreak of hoof and mouth disease, and the resulting restrictions placed on Mongolian animal products by Russia. In addition to the Russian market, the meat factory currently exports meat slurry for dog food to Japan. Mongolia will require a major upgrade of both veterinary and sanitary conditions before high value meat export markets can be accessed.

The Darkhan Khuns company is a recently privatized operation that produces a variety of processed food items including soft drinks, candy, aral, yogurt, bread, cookies, vodka, and cream. The factory has recently invested in modern packaging machinery and has the capacity to produce export quality yogurt and other dairy products.