

Summary: After 3 years of self-inflicted pain “*Mongolia is back to business*”, heavy lifting for OT now passed to Rio Tinto.

MONGOLIA ECONOMIC AND MINING SECTOR UPDATE

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This report was written and prepared by MIBG LLC and Resource Investment Capital. The formal cooperation between MIBG LLC and Resource Investment Capital was solidified in 2013 when the two companies merged their securities trading divisions.

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The news foreign investors have been waiting for since 2013

- **Pathway agreed:** On May 18th, Rio Tinto (RT), Turquoise Hill Resources (TRQ) and the Government of Mongolia (GoM) made a joint announcement that a “*pathway*” forward has been agreed for addressing the outstanding shareholder matters that since Aug’13 have stalled the advancement of the underground mine at Oyu Tolgoi (OT). Credit where credit due, this is a huge breakthrough, requiring a step change in leadership and negotiations by the GoM.
- **Manageable milestones remain:** Advancement of OT Stage 2 still requires feasibility study approval and staged permitting (Mongolian responsibilities, but at administration department levels), and, respective board approvals and the largest project financing of its kind in global mining industry (RT/TRQ/OT).

Heavy lifting passed on from the GoM to RT for OT Stage 2

- **Still “when, not if”, but execution risk handed to investor:** We believe the market is still, and rightfully, waiting for delivery and ensuring sustainable progress for Stage 2. However, in our view the GoM re-sanctifying the Investment Agreement has fulfilled the heavy lifting required from the Mongolian side (no other GoM level approvals required), meaning project financing is the key milestone now before construction, and “*could be completed as early as 4Q’15*”¹. Our non-consensus view is that execution risk has more or less been handed from the sovereign to the investor.
- **Foundations set:** Resolution of disputes (eg OT, 106-licenses), legislative reform (various) and agreements with other sovereigns (eg China & \$1b from India for rail last week) supports the GoM and Mongolia as an investment destination regaining creditability and providing the foundations to turnaround the FDI driven economy. Trust takes time to regain, but recent reform provides a better investment environment than that which supported Mongolia becoming the world’s fastest growing economy because of OT Stage 1. Stage 2 is the catalyst for the next cycle.

OT Stage 2 provides the same special situation opportunity as Stage 1 did

- **Precedent of a special situations play:** Given the impact that OT Stage 1 had, with FDI, liquidity and Mongolian asset class valuations generally back to pre Stage 1 levels, Mongolia and asset classes tied to it, in our view effectively become a favorable special situations play, amongst a difficult global and commodity market back drop.
- **Implications to asset classes:** While the risk/reward for TRQ and Entrée Gold has clearly shifted as speculation for Stage 2 resolution has increased, history provides a roadmap for further re-rating and for plays who benefit from Stage 2, Mongolian economic growth and increasing risk appetite (including copper exploration/development).

RELATED RESEARCH:

- Kincora Copper: “Well positioned to benefit from an improving Mongolian landscape & focus on the next potential Oyu Tolgoi”

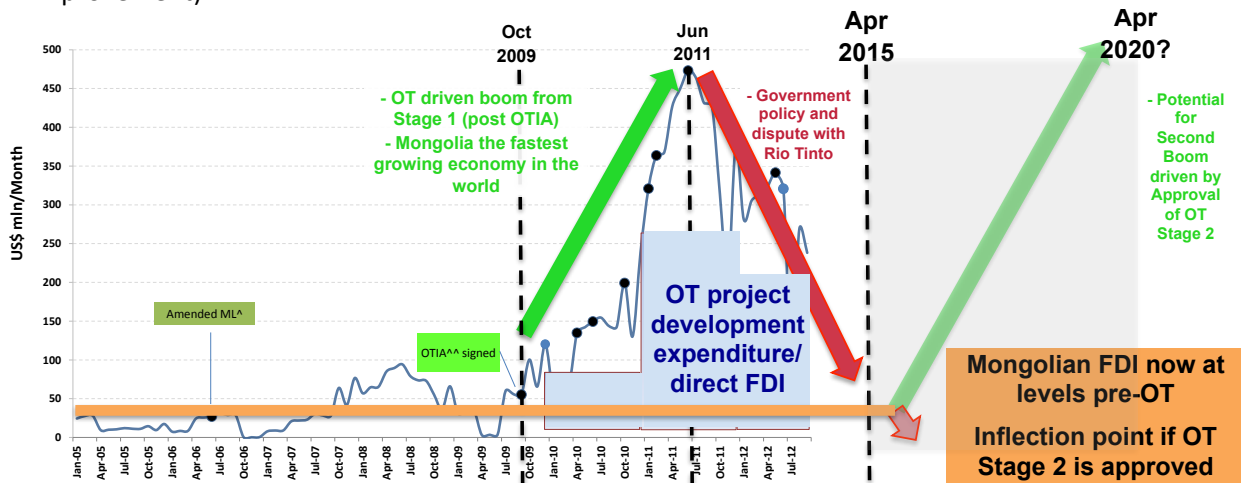
Analysis

- **Background - Mistakes and Damage:** Between 2011-12, a change in Government, restrictive policy, concerns for rule of law and various private sector disputes resulted in an 89% collapse in FDI in 2012-14 to only <\$0.5 billion. GDP contracted from 17.5% (4Q'11) to an ABD forecast of only 3% FY'15 with public debt estimated at >60% of GDP², with Mongolia gaining a “*boy who cried wolf*” reputation for a lack of delivery of various statements and losing creditability. This environment continues to significantly impact investor sentiment towards Mongolia, related asset price valuations and reduced the ability of the declining number of interested groups to gain exposure to high quality projects in Mongolia.
- **Change and Foundations...:** In Nov'14, Ch. Saikhanbileg was appointed PM, forming an unprecedented coalition (73 of 76 seats), with a self-proclaimed mandate for turning the economy around. Foundations required to restore FDI, support new entrants and increase the private sector have and are being put in place - eg: improved Foreign Investment Law & Tax Stabilization (Oct'13); positive revision to the Mineral Law (Jul'14); conclusion of 5 year moratorium for new exploration licenses (Jan'15); resolution of the 106-exploration license dispute (Mar'15); and, resolution of shareholder matters to advance development of OT (May'15), including clarifying certain tax and legal issues in line with the existing investment agreement and to international standards (leading multi-national and project financing syndicate). Such a reformed legislative environment is a marked improvement to that which supported the OT Stage 1 lead boom.
- **... but previously lacking a catalyst:** As stated in our Sep'13 Mongolia report “*legislative change without resolution for OT is hardly going to open the floodgates for FDI or sustainable economic growth (given recent gearing levels of the GoM)*”. In our view the only tool left in the box for the GoM was resolution of OT to change the trajectory of the Mongolian economy, the status quo since 2013 remained the same, with an expected \$6.8 billion of capex of a total \$9 billion of direct Mongolian expenditure in the next 7 years³ now unlocked (refer Exhibit B), noting current invested capital of >\$7 billion for OT and FDI into Mongolia of <\$0.5 billion FY'14, with approval of a project that is expected to represent a third of the economy.

Exhibit A: “The OT effect”

Mongolia’s Foreign Investment Directly Depending on Oyu Tolgoi Project (FDI US\$/mth)

- Mongolia was the world’s fastest growing economy, driven by OT Stage 1.
- Mongolian FDI (and asset prices) is now at levels pre-OT Stage 1.
- Resolution of dispute for OT Stage 2 provides for another period of rapid growth, boom in Mongolian asset prices and improvement in the standard of living for the Mongolian people.
- Improved legislative and investment environment than for Stage 1 cycle (with room still for improvement).



- BIANNUAL BASIS, FDI INTO MONGOLIA COLLAPSED 88.6% IN 2012-2014 FROM \$4.45 BILLION TO <\$0.5 BILLION
- STAGE 2 SUPPORTS A FURTHER \$6.8 BILLION CAPEX OF A TOTAL \$9 BILLION SPEND IN THE NEXT 7 YEARS

Source: Chart by Independent Mongolian Metals & Mining Research, INS, TRQ³, ResCap

OT Resolution Implications for Rio Tinto:

- Confirms project cost for Stage 1 development
- Stage 1 will not pay back existing capex with underground representing ~80% of projects value
- Outstanding tax assessment has been settled for \$30 million respecting the investment agreement
- OT Stage 2 has been described as “by far the best undeveloped growth project that any of the majors has, and it’s in the best commodity – copper”⁴
- OT is RT’s key growth asset to help diversify away its reliance on iron ore at a period of collapsing iron ore prices and a favorable outlook for copper
- Advancement of Stage 2 potentially supports re-recognition for some of the US\$4.7 billion previously impaired by RT relating to OT
- More optimal gearing ratio for OT, currently solely equity, with up to US\$6 billion in project financing³
- In aggregate, the NPV impact to TRQ from the various resolutions to shareholder matters is less than 2% of the overall reserve case value of \$7.4 billion noting the impact of delaying the project is an opportunity cost of \$80 million per month
- Provides motive and catalyst to increase TRQ ownership (noting Stage 2 to be funded by debt, not equity, meaning on-market requirement?) and increased activities in regional South Gobi copper exploration opportunities?

OT Resolution Implications for GoM:

- Signal to the market “Mongolia is open for business” 5
- Reduce dependency on PBOC FX swap (debt) and Chinese investment
- Investors agreed to settlement on disputed items worth up to US\$148 million relating to 4 key issues
- OT is expected to represent a third of the Mongolian economy and the only project/policy that can change Mongolia’s current economic trajectory – for example the agreement unlocks a “\$6 billion capital project that will spend about \$1 billion per year, employ 1,700 people directly and open up a score of business contracts for local companies. Importantly it will triple the revenues of OT, provide additional tax revenues to GoM and turn around Mongolia's macro-economic fortunes, especially regarding FX, interest rates and GDP growth”
- Assists mitigate the risk of default on existing debt, and improves Mongolia’s ability to raise capital
- Supports the worlds largest ever project financing package in the mining industry, up to US\$6 billion3, and the new entrants this financing will bring to Mongolia
- Equitable agreement in-line with international standards from a leading multi-national and project financing syndicate of 15-20 groups, providing confidence and precedents for future investments
- GoM has done well negotiating very hard on certain items, and there is enough in this resolution to be seen by Mongolian political circles and electorate as a “win”, particularly given the opportunity cost and damage this dispute has caused to FDI, the average Mongolians standard of living and investor sentiment. Considerable credit must be given to PM Saikhanbileg and his cabinet to recognizing the importance of Stage 2 in achieving the GoM’s core objective of turning the economy around
- Supports pro-development mandate for the 2016 Parliamentary election cycle and confidence in the current core leadership group, the opposite to previous resource nationalist propaganda and weak leadership that has previously negatively impacted private sector activities pre election
- Prime Minister Ch. Saikhanbileg has stated: “Unlocking OT’s underground mine will have a significant impact on the Mongolian economy, which will benefit Mongolian citizens for generations to come”5

Precedent of a special situations play:

Given the impact that Stage 1 had, with FDI, liquidity and Mongolian asset class valuations generally back to pre Stage 1 levels, Mongolia and asset classes tied to it, in our view effectively becomes a special situations play as Exhibits A & B help illustrate, amongst a difficult global and commodity market back drop. Leverage is potentially improved from reformed legislative environment.

Exhibit B: *OT - the only project or policy left for Mongolia to change the current trajectory of its economy and not be solely dependent on its FX swap with the PBOC *debt) and/or Chinese investment*

Indicative development and spending plan, including estimates of funds that will be spent within Mongolia to fund operating costs, Underground Stage construction and payments to the GoM³

| <i>In USD billions</i> | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 | Year 7 | Total |
|---|------------|------------|------------|------------|------------|------------|------------|------------|
| Capital | | | | | | | | |
| Underground Development capital | 0.3 | 1.1 | 1.0 | 1.1 | 0.7 | 0.5 | 0.1 | 4.7 |
| Sustaining capital | 0.1 | 0.1 | 0.0 | 0.1 | 0.4 | 0.4 | 0.5 | 1.5 |
| VAT and Duties on capital | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.6 |
| Total Capital | 0.4 | 1.2 | 1.1 | 1.3 | 1.2 | 1.0 | 0.6 | 6.8 |
| Estimated Direct Mongolian Spend | | | | | | | | |
| Domestic operating cost expenditure | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.7 | 4.3 |
| Domestic capital cost expenditure | 0.2 | 0.5 | 0.4 | 0.5 | 0.4 | 0.4 | 0.2 | 2.5 |
| Direct payment to Government of Mongolia | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.4 | 2.2 |
| Total Estimated Direct Mongolian Spend | 1.1 | 1.3 | 1.2 | 1.3 | 1.4 | 1.3 | 1.3 | 9.0 |

- BIENNIAL BASIS, FDI INTO MONGOLIA COLLAPSED 88.6% IN 2012-2014 FROM \$4.45 BILLION TO <\$0.5 BILLION

Source: Chart by TRQ³, ResCap

- **Implications to asset classes:** Resolution for the development of the underground, Stage 2, supporting the mining industry's largest project financing, in our view will result in improving investor sentiment towards Mongolia at currently depressed valuations and often unfavourable liquidity given the point in the cycle. While the risk/reward for TRQ and Entrée Gold has clearly shifted as speculation for Stage 2 resolution has increased, reflected in TRQ and Entrée Gold's share prices, history provides a roadmap for further re-rating and indirect beneficiaries of certain asset classes.

Given current global market conditions, in our view investors will increasingly increase exposure to plays that benefit from:

- Resumption of Stage 2 development (eg supply chain, infrastructure construction etc),
- Mongolian economic growth (consumer/retail demand, selected construction/property, financial services etc),
- Strengthening in the MNT (banks/groups with debt in USD/FX, importers etc), and,
- Improving risk appetite towards Mongolia (including the next generation of natural resource projects), as milestones are met towards de-risking Stage 2 development, and in particularly construction.

Economic & Mining Sector Update

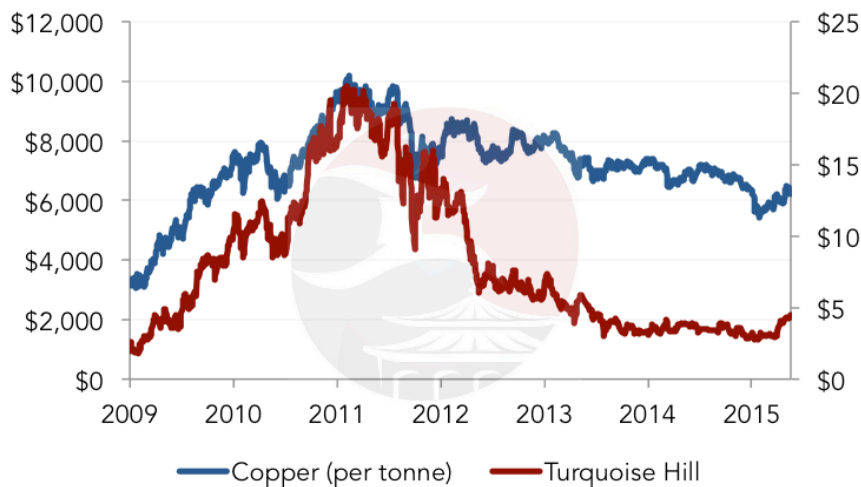
Furthermore, we believe it is possible a bid premium may in the next 12 months again re-emerge for TRQ as RT could seek to gain increased economic interests via on market acquisition of shares (Stage 2 be funded by project financing) in a clear tier 1 asset.

In regards to the mining sector, we expect the markets attention will also refocus on the wider potential for other attractive natural resource projects in Mongolia following significant legislative reform and Mongolia being one of the last under explored frontiers. For example, globally porphyry deposits seldom occur in isolation, rather in significant clusters, and the potential for another Oyu Tolgoi, or at least other major copper and/or gold projects in this proven fertile but underexplored copper belt along the OT trend in the South Gobi are relatively unknown, impacted by Mongolia's legislative history and lack of modern systematic exploration. Recent legislative change provides a number of analogies to Chile's copper industry in the early 1970's or the iron ore potential in Pilbara in the early 2000's, but benefiting from on the doorstep of the world's largest consumer of copper and in one of the world's fast infrastructure growth regions.

TRQ's current market cap is US\$9 billion (@ US\$4.43/sh), relative to current OT capex of over US\$7 billion, noting in Jan-Mar'11 its capitalization was ~US\$18.8 billion (@US\$28.74/sh). However, now OT is in production (first quartile opex from Stage 1 and significantly improving under Stage 2), consensus for copper pricing is favorable and a potential bid premium may in the next 6-18 months again reemerge.

Exhibit C: TRQ share price relative to the copper price

*"TRQ has been oversold based only on the metrics of the copper and gold price. To understand why today TRQ is valued at just \$9B and why the Mongolian economy has suffered while such riches sit on their doorstep we need only turn to - you guessed it - the government"*⁷



Source: Chart by Capitalist Exploits⁷, ResCap

Most investors are aware of the Shell/BG deal, but probably have not noticed a £28m investment in Petro Matad (MATD.LN), a Mongolian Oil and Gas regional ground holder and explorer, by BG just prior.

Advancement of Stage 2, resolution of the 106 license dispute, resumption of issuing new exploration licenses following a 5 year moratorium and the lack of exploration success for new copper projects globally, with a growing consensus for favorable copper prices going forward (similar to iron ore in the early 2000's) and the known geological potential of the South Gobi, supports the market seeking exposure to other plays that provide the possibility for another significant copper discovery(s). In our view Kincora Copper Limited (KCC.CN) is favorably positioned and refer to our May 28, 2015 note for further details.

While some may ask if a rising tide may lift all boats and Mongolian asset classes, as previously discussed, we believe this not to be the case, particularly for the general Mongolian coal sector and those groups/companies with questionable corporate governance. At current price levels, lack of rail and product spec's of most coal operations, the Mongolian coal sector is marginal, if not the majority near insolvent without further capitalization (often significant recapitalization). In our view, coal pricing is capped in the near term by Chinese market dynamics and in the near-medium term from any increased demand likely to be absorbed by increased production by Erdenes Taven Tolgoi (ETT). In regards to the potential tender of the Western block of ETT we believe it is unlikely that progress will be made in the near term given the current economics of the sector (why sell/tender the project at or near the bottom of the coal market?), its complex history, various significant and complex political sensitivities involved, and the limited time to form consensus ahead of the 2016 election.

References

¹ Jeffery Tygesen, CEO of TRQ - May 19th, 2015 conference call

² Fitch Ratings May 18th, 2015 estimate of public debt at the end of 2014. The guarantee of the recently completed TDBM notes adds an estimated 4% of GDP to the government debt stock noting reports that another Mongolian bank, State Bank, is also planning to issue a similar note on behalf of the sovereign

³ May 18th, 2015 *"OYU TOLGOI UNDERGROUND MINE DEVELOPMENT AND FINANCING PLAN"*

⁴ May 19th, 2015 Deutsche Bank analyst Paul Young

⁵ Rio Tinto May 18th, 2015 joint press release with Turquoise Hill Resources and the Government of Mongolia *"Oyu Tolgoi shareholders sign agreement on underground mine"*

⁶ INS May 25th, 2015 Article #9, *"Economy is back to business"*

⁷ Capitalist Exploits May 22nd, 2015 *"Mongolia - Finding its Feet Again"*

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