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Oyu Tolgoi Passes Sovereign Risk Test with Flying Colors

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On April 14, the Mongolian Parliament passed a controversial banking law that would require Oyu Tolgoi (and others) to effectively run all sales revenues through local banks. Not only did this new law violate the Oyu Tolgoi Investment Agreement, it violated Mongolia's own 2013 Investment Law which "guarantees free transfer of funds and revenues across border." Had this happened at any time before the Oyu Tolgoi Underground Project Finance facility was put in place about a year ago, the dispute over this new law would have dragged on for months (if not years) and possibly resulted in another shut down of underground construction. Instead, the law was repealed by a vote in Parliament in only 20 days and by a margin of 36-19. We will go into considerable detail as to how and why this controversial law was repealed as quickly as it was and explain why we view Oyu Tolgoi as perhaps the safest mega project in the emerging/frontier world, where sovereign risk is concerned.

Sovereign Risk Protections

Investors into Oyu Tolgoi's $4.4B Project Finance include the US, Australia and Canada (via respective Ex/Im Banks), the World Bank, IFC, EBRD, along with fifteen or so European Banks. Oyu Tolgoi's Project Finance also enjoys the protection of the World Bank's sovereign risk insurance, known as the Multilateral Investment Guarantee Agency (MIGA). We wrote the following on the subject of MIGA a year ago:

"The enforcement mechanisms for MIGA are both powerful and unique. In situations where a sovereign infringement event occurs, MIGA will pay claims to those possessing their sovereign risk insurance in an expedited fashion and without the need for arbitration. MIGA then through subrogation (i.e. stands in the shoes of investors) pursues the sovereign for recovery. As an arm of the World Bank, MIGA leverages the World Bank's position as lender to encourage the repayment of MIGA guaranteed loans or risk losing future World Bank funding and support. *The significance of this leverage as a deterrent against non-compliance cannot be overstated.*"

http://www.bdsec.mn/wp-content/uploads/2016/05/2016.05.09-OT-De-risked-1st-World-Rules-with-Frontier-Market-Upside.pdf

It is worth reiterating which conditions/actions can trigger a MIGA claim, which are quite comprehensive:

1. **Inability to convert local currency into foreign exchange or transfer funds out of the host country.**

2. **Nationalization and confiscation, and/or Creeping expropriation (i.e. tax regime changes, license terms) and expropriation of funds.**

3. **Losses arising from War, Civil Disturbance, Sabotage, Revolution.**

4. **Politically related business interruption, repudiation of a contract between the investor/project company and the host country authorities.**

5. **Non-enforcement of an arbitration/judicial award, or no recourse to judicial/ arbitral forum, or decision by forum not rendered in reasonable time**

6. **Non-payment of Sub-sovereign obligations and obligations from SOEs, non-honoring of Sovereign Obligations for unconditional financial payment obligations**

Additionally, given that investments by the US, Canada and Australia comprise over $2.0B in OT's Project Finance, any infringement on the OT Investment Agreement becomes a diplomatic issue. This in fact played out recently when US Ambassador Galt gave a rare rebuke over the passage of this controversial law at a Business Council of Mongolia Meeting on April 12:

"We welcomed Parliament's approval of an amended budget last Friday, paving the way for the IMF Board to grant approval of the IMF program on April 28. ***However, our enthusiasm is tempered by Parliament's inclusion of a resolution of potential concern to foreign investors*** – that foreign invested companies would be required to pass sales revenues through Mongolian commercial banks for the stated purposes of "improving the benefit of investment agreements and increasing foreign exchange reserves." ***We strongly encourage BCM to voice opposition to government moves like this that change the rules of the road to the detriment of the investment climate.***"

There were reports in local news that suggested the governments of Australia and Canada were equally vocal on this issue in private meetings with the Mongolian Government.

IMF X-Factor

When we published the aforementioned research note in May of last year about OT Sovereign Risk Protections, the IMF was not yet a part of the conversation. However, in light of the fact that the IMF declined to consider assistance to Mongolia after the passage of this controversial law shows they will play a valuable role in focusing the country's efforts on pro-investment policies, to ensure the viability of their assistance program. This can be seen in the rapid fashion Parliament repealed this law in order to secure funds from the IMF and others. Importantly, once the program is approved and in place (likely next week), the IMF will do a quarterly review of Mongolia's fiscal targets to ensure revenue, spending and fiscal targets are on track. There is little doubt that these reviews will include investment policies, to ensure they are consistent with attracting much needed FDI into the country. Since Oyu Tolgoi will represent the vast majority of FDI into Mongolia in the medium term, it is a sure bet the IMF will be equally intolerant of any future populist legislation which infringes on the OT Investment Agreement.

Rio Tinto's Next Move

It has been an outstanding 12 months for Rio, post the commodity complex bottoming out in early 2016. Iron ore and coal have rallied strongly, allowing the company to generate $8.5B in cash in 2016, with the bulk of that improvement coming in 2H'16. Coal was an exceptional bright spot, as China instituted domestic production cuts, which caused Australian Hard Coking Coal to rally beyond $300/ton last summer, levels not seen since the bull market of 2011. This has allowed Rio to execute on their strategy of divesting coal assets at valuations which would have been unthinkable only a year ago. Specifically, Rio agreed to a deal in January with China's Yancoal Australia to sell its Coal and Allied mine for $2.45B and is rumored to have its Hail Creek and Kestrel mines on the block for $2B each, according to a recent Reuters article:

> **Rio Tinto is expected to soon begin an official sales process for the Hail Creek and Kestrel mines in coal-rich Queensland state, which is bringing "an unprecedented number of people to the table," said one source, whose company is interested in the assets.**
>
> **"There's a lot of interest in a limited number of opportunities in Australian coking coal and that's driving the frenzy for Hail Creek and Kestrel," the source said, speaking on condition of anonymity**
>
> http://www.reuters.com/article/us-australia-coal-m-a-idUSKBN1810UC

In addition, it is widely believed that Rio has their Uranium assets on the block and would also sell Pacific Aluminum at the right price. So it's quite possible Rio will generate $6B-$8B in asset sales and $9B-$10B in cash from operations in 2017, creating a mountain of liquidity, but what to do with all of that cash? Make large scale acquisitions in Iron Ore or Bauxite? Probably not. Buy another company? Few possess Tier 1 assets, with the right underlying product mix. Or in the case of a Freeport which is copper heavy (an attractive attribute), sovereign risk at their Grasberg presents an insurmountable barrier to a risk-averse Rio as an acquisition candidate. Not to mention risks inherent in large scale M&A such as integration, culture, or legacy issues, be them environmental or corruption related.

Rio has repeatedly stated a preference to grow their leverage to copper, yet their present list of assets leaves much to be desired when compared to the company's $66B market cap and heavy reliance on iron ore:

Kennecott Utah Copper - When Robert Friedland stated in his keynote address at Mines & Money in HK this year that ***"Most copper mines today are like little old ladies waiting in bed to die,"*** he probably had Kennecott in the forefront of his mind. Mining at Kennecott began in 1887 and was purchased in 1989 by Rio Tinto Zinc. Kennecott is most notable in recent years as having one of the biggest pit wall failures, occurring in 2013, displacing 150 million tons of debris. The ongoing geotechnical risk of the mine cannot be understated, let alone future legacy environmental costs for reclamation, not the kind of asset you grow a $66B company with.

Escondida Chile - Rio has a non-operating 30% stake in this massive copper mine which saw production fall 66% y/y in 1Q 2017 due to a 43 day labor strike at the mine. While workers returned to work under existing pay/benefits, negotiations for a new contract are set to begin again in September which could result in another work stoppage. Management-Labor relations are generally regarded as "bad," which some regard as a more regional issue, versus something that is overly company specific. In other words, this is a macro concern which every miner in the region are grappling with. Absent meaningfully higher copper prices, Rio and BHP may be in for a costly battle with Escondida labor, which could resurface and extend into 2018.

Grasberg Indonesia - Through a JV with Freeport, Rio has a 40% claim on material mined above an undisclosed threshold, which yielded zero production in 1Q'17 due to issues with the Indonesian government. As a result, Freeport has halted spending on Grasberg underground development, where it is estimated 94% of the mines remaining resource resides. Reuters reported in February that Rio was considering walking away from the project altogether - http://www.reuters.com/article/us-rio-tinto-freeport-mcmoran-indonesia-idUSKBN15O0RS

Oyu Tolgoi

If investors were looking at Rio to grow their portfolio exposure copper via the three aforementioned assets, they would be gravely disappointed so far. Despite appointing former Rio Copper CEO Jean Sebastian Jacques as Rio CEO in 2016, their copper portfolio seems to be moving in reverse. Which brings us to a discussion about Oyu Tolgoi, which is widely regarded as the world's best copper project.

Despite the considerable bad press Oyu Tolgoi and Mongolia have received these last 4 years, context is required when considering the asset as a whole. The OT Investment Agreement was signed in 2009, construction began in 2010 and the mine was in production in 2013, an unheard of timeline in a world where similar Tier 1 assets take 15-20 years to achieve the same milestones. Despite what amounted to a 4-year delay in second phase construction, OT will begin processing some underground ore in 2018, with copper and gold production increasing 320% and 450% 2017-2025, respectively. 2017 will be the trough year for revenue, production and earnings for Oyu Tolgoi. A closer look at TRQ's enterprise value when compared to the company's share of invested capital implies significant negative value creation, despite Phase 2 being fully funded and OT becoming the world's 3rd largest copper mine with underground production.

TRQ Enterprise Value- $3.7B*

Total OT Invested Capital through 2018 (est)- $8B

TRQ share of Invested Capital (66%)- $5.3B

Value Creation- TRQ EV vs. Invested Capital- ($1.6B)

(Note: We calculate TRQ EV less OT Project Finance, as Rio Tinto has issued completion guarantee as part of PF. Furthermore, OT PF was used to payback Rio shareholder loans which were not on balance sheet in previous years)

By any measure, shares of TRQ are dirt cheap, especially since virtually every company has been bemoaning the lack of Tier 1 copper assets globally and the exorbitant valuations they sell for. In fact, it may be instructive to review what Rio management have said in the past on the subject of expanding their leverage to copper and their difficulty in doing so:

"We have indicated that we would like to expand our copper business. We will look at a potential copper acquisition if it is tier one, low cost, but at this stage there are no such projects on the market," Former CEO Sam Walsh 2016

"You're going to have to pay a high price for any high quality asset. The good assets are not easy to come by." CEO Jean-Sebastien Jacques 2015

With major issues plaguing three of their four producing copper assets, a mountain of cash and an appetite for Tier 1 copper assets, what is Rio to do? We think the obvious answer to that question is some version of buying out the TRQ minority. Outside of OT, Rio arguably has only one proven Tier 1 copper asset, that being their 30% interest in Escondida. Rio's 51% of TRQ equity only equates to 6.5% of Rio's Enterprise Value. If we assume Rio makes asset sales of $6B-$8B and generates $9B of cash in 2017, the company could start 2018 with $20B+ of cash on the balance sheet, or nearly 4x their current equity exposure to OT. In view of these numbers and prior management comments regarding Tier 1 copper assets, it would be nonsensical for Rio not to increase their exposure to OT, assuming they are serious about growing their troubled copper business. Doing nothing is probably not an option as BHP have found out via their high profile fight with activist investor Elliot & Associates. Should Rio end the year with $20B in cash (or equivalent deleveraging), it is possible (if not likely) they could also be besieged by activist investors, looking for a large one-time dividend and/or some form of restructuring.

In summary, with OT's sovereign "safety net" having been tested and held firm, investors should discount sovereign risk as a bonafide threat to the OT project. With investments from the US, Australian and Canadian governments to OT PF, along with IFIs including World Bank, EBRD, IFC, not to mention now having the IMF involved, future OT IA infringement is extremely unlikely. The strong recovery in coal prices has opened a window for Rio to sell assets, creating a war chest of cash and an opportunity for a much needed transformation of the company. With 2017 set as the trough year for TRQ revenues ahead of a massive uptick in production for OT in the coming years, we view Rio's acquisition of TRQ a "when" not "if" proposition.

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