Turquoise Hill

Stock Data

Rating	n/a
Price, US$	5.77
Target price, US$	n/a
52Wk Range, US$	5.03-10.14
Mkt cap, US$bn	5.8
Shares outstanding (m)	1,005
Rio Tinto ownership, %	51%

Company Snapshot

Turquoise Hill Resources (TRQ: TSX, NYSE & NASDAQ) is an international mining company focused on copper, gold and coal mines in the Asia Pacific region.

Principal assets include a 66% interest in the Oyu Tolgoi Project, one of the world's largest copper-gold-silver mines on track to begin initial production in southern Mongolia in 2012; a 58% interest in established Mongolian coal miner SouthGobi Resources (SGQ: TSX,1878:HK), which is expanding production and exports to China.

Recent research of note:

- Mongolian mining sector: *"Kincora Copper resumes exploration and Turquoise Hill becomes a potential positive lead indicator for other copper plays"* May 23rd
- Mongolian mining sector: *"Strategic transaction and proposed revision to foreign investment laws - Light at the end of the tunnel for the copper juniors?"* April 18th
- Turquoise Hill Resources: *"Set for imminent milestone or major set-back?"* March 15th

[1] Turquoise Hill Resources Management's discussion of 1Q'13 Results, CFO Christopher Bateman (May 13th)

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Mongolia Mining Sector Update: Election and Oyu Tolgoi commercial production milestones achieved but project financing remains a concern

Despite a relatively uneventful Presidential re-election, ending an uncertain year long political cycle, and Oyu Tolgoi ("OT") successfully entering commercial production, albeit with a slight delay to guidance, Turquoise Hill's ("TRQ") share price continues to remain at only 14% above multi-year lows and well off recent highs, reflective of most other listed companies with Mongolian asset class exposure.

We believe the key reasons for this, beyond weakness in copper and gold prices and waning appetite for the mining sector, relates to ongoing uncertainty regarding its proposed project financing *("expected to be the largest project financing ever in the mining industry[1]")* and concerns raised regarding corporate governance.

These two issues came to light after the US$225m bridge loan with Rio Tinto was announced on June 28th. While a relatively small loan in the scheme of US$6.6bn capital investment to date in OT and TRQ's current market cap of US$5.8bn, it has raised the issue of TRQ minority shareholders dilution, the ability to close the earmarked US$4bn of Phase 2 funding for OT (both due to the Government of Mongolia's required approval and the current state of the capital markets) and the potential economics of the project should this funding not be secured.

The aforementioned bridge loan is due August 12th, providing another line in the sand for a key milestone which we believe will influence investor sentiment and foreign direct investment towards Mongolia in the near to medium term. As such we expect this event to be a visible catalyst for both TRQ's share price and other Mongolian asset classes valuation, which to date, has largely overshadowed the generally positive re-election of incumbent Ts. Elbegdorj as President of Mongolia and commencement of exports from OT.

<u>Commercial production achieved but key risks to OT's economics remain until further funding is secured</u>

Turquoise Hill Resources ("TRQ") has until August 12th to pay back the Rio Tinto ("RIO") bridge facility of up to US$225m (at LIBOR +500bps) required for sustaining operations, which was announced on June 28th. This "funding gap" emerged due to TRQ and RIO missing guidance of first exports and commercial production from OT by the end of June and not securing the proposed US$4bn in project financing which is believed to be (have been?) in place. If the bridge facility is not paid in full, RIO may convert any outstanding amount into common shares at 15% discount of prevailing 5-day VWAP of TRQ on NYSE.

While a relatively small loan in the scheme of US$6.6bn capital investment to date in OT and TRQ's current market cap of US$5.8bn, the delay in project financing has raised concerns regarding TRQ minority shareholders facing both near and longer term dilution, the ability to close the earmarked US$4bn of Phase 2 funding for OT and the potential economics of the project should this funding not be secured. Indeed, the relatively high cost of capital from the bridge facility in our view both highlights and reflects that the terms of the proposed $4bn project financing were not met and there is no certainty they will be in the future (which are subject to approval from the Government of Mongolia) or indeed if that capital/debt is still available given the adverse turn in the debt markets over the last 6-8 weeks (refer Exhibit 2).

If RIO/TRQ can't leverage and optimise the debt profile of OT and significantly ramp up the scale of operations (via increased throughput and grade bearing in mind $6.6bn of capex to date for a relatively small scale lower grade open pit project) then the project returns are materially diminished and TRQ will most likely need further significant amounts of equity financing.

It must be highlighted that this scenario is also not positive for the Government of Mongolia ("GoM") as we believe it will very significantly and adversely impact the timing and amount of future dividends they might receive. The GoM has recently recognized the impact the project has had on the country by naming it the source of the most jobs created and the second-highest taxpayer even before sales commenced. While such project financing appears to be obviously in the GoM's best interests, the recent freezing of OT's bank accounts, two delays to scheduled opening ceremony's for commercial production and RIO/TRQ missing guidance because *"shipping will (only) begin as soon as the Mongolian Government indicated its support for OT to do so"* in our view justifies concerns raises by foreign investors, particularly given the current macro environment.

<u>Presidential election supports a two-year period of productive political policies and economic development</u>

On June 26th incumbent Ts. Elbegdorj was re-elected as President of Mongolia which brings to a close an uncertain year-long political cycle following last years' Parliament election and change in Government with no elections in the coming two years. Elbegdorj narrowly secured the required outright majority, with 50.23%, to avoid a "run-off" vote (which would have seen a two candidate preferred vote on July 10th and would have likely further impacted the start of commercial production from OT). Elbegdorj is only the second President to be re-elected for a second and final term.

Elbegdorj's election agenda was a continued fight against corruption, further reform/improvement to domestic prosperity, his/Mongolia's international reputation and that Mongolia will not discriminate against investors. It is worth noting there was little or no discussion of resource nationalism, or the like, in the lead up to the election, which was regarded as the least "eventful" in Mongolia's democratic history. Elbegdorj's re-election ensures the Democratic Party holds all major political posts until Parliamentary elections in 2016. The President, Prime Minister, parliamentary speaker and Ulaanbaatar mayor are members of the DP, which is the dominant party in the coalition government formed last year.

Elbegdorj in his first term played a relatively active role as President, more so than his predecessors, and in his second and final term he is expected to play a significant role in the development of the New Investment Law (the first component of which has already been implemented), a New Minerals Law (a draft Minerals Policy is scheduled to be discussed in Parliament), implementation of the recently adopted New Security Law and advancement of the key projects which are expected to be a key drivers to Mongolia's future prosperity. The three large projects: Oyu Tolgoi; Erdenes Tavan Tolgoi ("ETT"); and, the proceeds of the Sovereign Bond issues, are expected to be the key driving forces for Mongolia's future Foreign Direct Investment and economic growth, and as such are to be a focus of his and the DP Government's attention.

Fitch Ratings in a statement after the election result commented *"a period of political stability could allow the Mongolian authorities to clarify their plans for the country's mining regime through a new mining law, and its foreign investment regime through amendments to existing laws. These key policy areas have been subject to some uncertainty in recent months, against a backdrop of populist pressure to reassert*

Mongolian ownership of resource assets, especially since last year's parliamentary elections". Over the last 6 months there has been a very clear and sudden realization that the economy and foreign direct investment had materially deteriorated which on April 17th lead Standard & Poor's Rating Services' to downgrade Mongolia's Sovereign credit outlook to negative stating *"the likelihood of a sovereign downgrade for Mongolia within the next six to eighteen months has increased to more than one-in-three as the higher policy risks contributes to deterioration in the external and fiscal profiles*".

Elbegdorj's ambitions are expected to focus on establishing "his" lasting dynasty, envisaged to be built around economic policy reform, a continued fight against corruption, ramp up of production from OT and ETT and less likely to carry the populist sentiment that was a key feature over the last year long election cycle when both side of politics struggled to have a clear majority or mandate.

As Prime Minister N. Altankhyag said at the ceremony celebrating first exports from OT, *"a major development such as OT has not been done in Mongolia in last almost 40 years (since the Erdenet copper mine)".* While current capacity is 1.5 times Erdenet, plans are for OTs expansion in 2018 to be 2.5x and estimated to account for a third of Mongolia's GDP by 2020. The *"start of OT exports is start of new era in Mongolian mining sector"* and a successful last term by Elbegdorj could be remembered as a period where two world class mining projects were truly established, Mongolia embraced the global capital markets (via the new security law and further Sovereign Bond issues) and the development of the Sainshand Industrial Complex (+US$10bn project) become a reality.

While near term risks of further potential political uncertainty and instability have been (narrowly) avoided by the incumbent being re-elected we believe that the DP lead government now has the ambition and ability to undertaken policy to support foreign investment, private sector growth, and further reform.

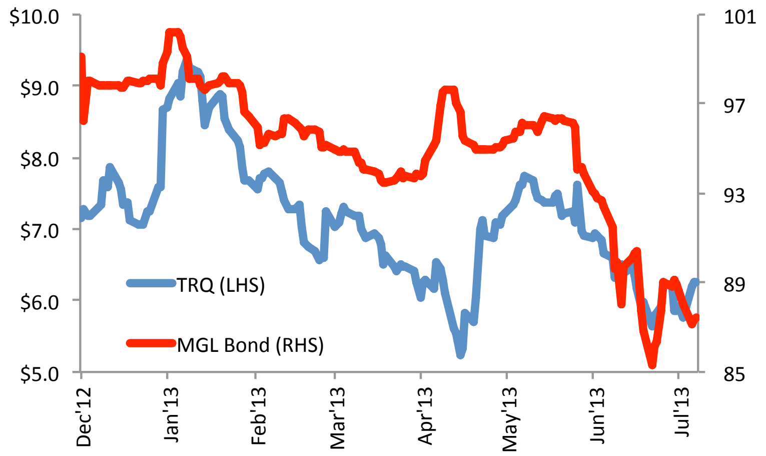
In our view the resolution of the terms required for the proposed project financing of OT for Phase 2 with a unique range of blue chip investors, ranging from IFC/EBRD, a number of the developed nations export agencies, AAA rated and other leading commercial banks, in what is proposed to be the "*largest project financing ever in the mining industry"* would certainly provide the wider capital markets confidence that the Government of Mongolia will support a productive legislative and business environment in the upcoming two year period.

Appendix

OT has been driving foreign investment and a key barometer for the Chinggis Bonds

The price of US$1.5bn Sovereign Bond issue has been closely correlated of late with concerns regarding OT (and the existing OTIA) and the Turquoise Hills share price (TRQ.CN).

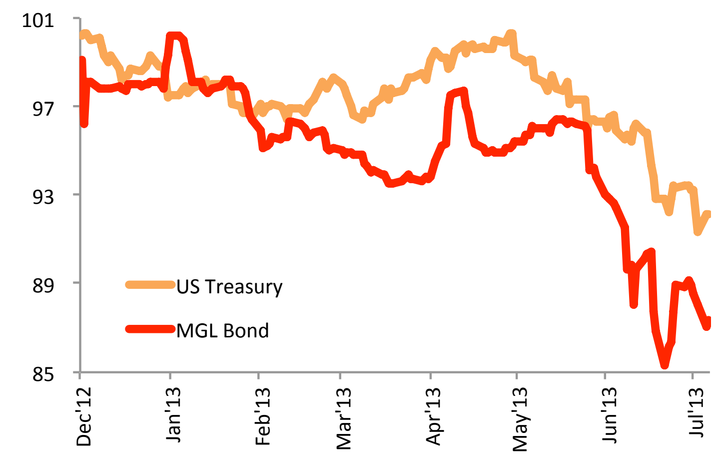
Exhibit 1: TRQ and Mongolia Sovereign ("Chinggis") Bond performance



Source: Bloomberg (pricing July 10th)

Despite OT recently entering commercial production global macro conditions have deteriorated the terms that the Mongolia Government will likely be able to raise further capital

Exhibit 2: The price of the Chinggis bond has been impacted by US Treasury's widening since late May. June was the worst monthly performance for Treasuries since Dec'09.



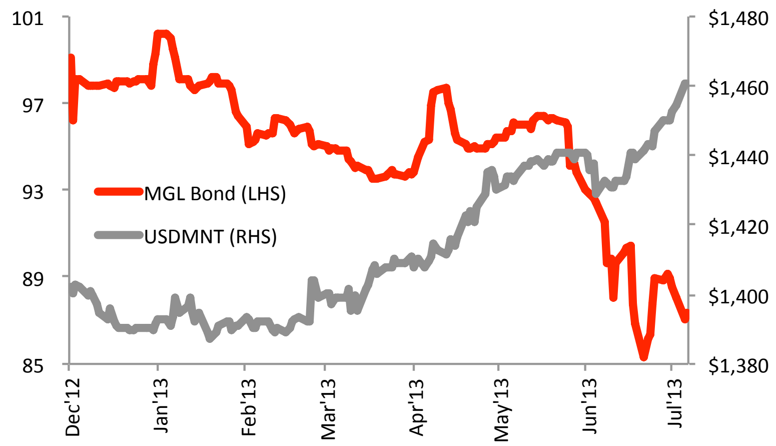
Source: Bloomberg (pricing July 10th)

The rising US Treasury yield in the last 6-8 weeks has recently impacted the price of other bond issues such as the Mongolian Sovereign Bond and the US$/Mongolian Togrog (MNT) exchange rate. Bonds like the Mongolian Sovereign with a 5.125% coupon have a very high correlation to Treasury moves with relatively little buffer to absorb the 10 year Treasury widening from 1.71% to 2.17%, 46 bps as it did during June.

The recent Chinggis bond performance is likely to have also been impacted by the lack of a strong domestic investor base, which can help absorb foreign investor sales such as the recent sell off. Furthermore, given the recent weakening China backdrop, coal price and demand environment (with Mongolia being the largest supply of HCC to China), uncertainty relating to OT, and the Mongolian political issues, are also likely to have had an impact to the price of the Sovereign Bonds.

As one European based Emerging market high yield portfolio manager has recently put it *"the normalization of Treasury yields, if quantitative monetary stimulus abates, is inevitable. Low yielding, longer duration corporate bonds are most at risk but there would also certainly be a knock on effect into the High Yield bond markets and global equities".*

Exhibit 3: The de-rating of the Mongolian Togrog, price of the Chinggis bond and outlook for US Treasury's is likely to have an impact on the terms and ability of the GoM are able to raise further capital going forward



Source: Bloomberg (pricing July 10th)

The exchange rate has also been influenced by recent Bank of Mongolia cuts to interest rates, weakness in the coal price and deteriorating FDI/economic growth, which could hamper the Governments ability to pay back the US$1.5bn Chinggis bond issued last November and the issuance of further bonds, potentially as early as 2H'13, as part of the proposed total US$5bn of total Sovereign Bonds.

Three large projects (OT, ETT and the proceeds of the Sovereign Bonds) are expected to be the key driving forces for Mongolia's future FDI and economic growth. The environment for the current and proposed future Mongolian Sovereign Bonds (and therefore the Governments semi-independence from OT and ETT) appear to have shifted in the last couple of months potentially impacting the required hurdle rate for the planned use of funds in order to repay the principal/interest, particularly bearing in mind how relatively small total Mongolian GDP is (and how reliant it is for continued FDI/the coal price/OT).

Given the relative ease, favourable terms and 'confidence' the original US$1.5bn raising provided, this trend could have a very interesting political dynamic to it and will most likely again highlight the importance/dependence of OT to the Mongolian economy.

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