

Odds on Resolution of Phase 2 at Oyu Tolgoi are going up

October 28, 2013

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In our last note, dated September 10th, we were skeptical about the possibility of near term resolution between OT and the GOM. This opinion was based primarily on the belief that the powers to resolve Phase 2 financing by the OT Board of Directors were limited and that Parliament would likely have to give its approval before moving forward. This no longer seems to be the case. The new OT Board members, led by Erdenes Oyu Tolgoi (EOT) CEO Da.Ganbold, appear to have had a profound effect on negotiations, resolving half the outstanding issues in the first formal meeting. It is our belief considerable progress has been made since then, with another round of talks scheduled for this week. There is clearly a sense of urgency which was not present in prior talks, which we find most encouraging.

A Better Understanding of Phase 2 Financing

Given that Phase 2 financing of \$4B USD is about 40% of Mongolian GDP, public sentiment on the subject was both hesitant and cautious. Some politicians took advantage of this sentiment, attaching huge (and unrealistic) price tags to the total cost of the project and stated, incorrectly, that going forward would severely indebt Mongolia and dilute its interest in the mine. While the full details associated with the \$4B loan facility have not been made public, we're fairly certain that the collateral for the financing specifically excludes Mongolia's ownership in OT and would only encumber the interests of Turquoise Hill (TRQ) and Rio Tinto (RIO) in the project. If Mongolian assets are not pledged as collateral and its citizens are not obliged in any way to pay the debt, this becomes a business decision which will likely be made by the Board of OT, not Parliament.

T-Minus Six Weeks

With the December 12th deadline for Phase 2 financing looming, we are quite encouraged with the pace and tone of negotiations since Da. Ganbold took over as CEO of EOT. Democratic Party Cabinet members, led by Prime Minister Al-tankhuyag, have also been quite supportive of Da. Ganbold's efforts and have publicly voiced their support for the project. We think this support is part of a broader recognition that as goes OT, so goes the Mongolian economy, given that foreign direct investment (FDI) is down nearly 50% in 2013.

Should Phase 2 financing be approved by December 12th, the upside in shares of TRQ from current levels could be staggering. With shares touching \$4 last week for the 1st time since July 31st, we think the market has been pricing in a strong likelihood of a highly dilutive rights offering, which may ultimately not come to pass. With customs issues now resolved with China, TRQ shareholders can now look forward to a profitable year in 2013, with revenues expected to be in the range of \$1.7B USD and estimated earnings of \$220M USD. With a market cap of ~\$4.9B USD, TRQ is trading at a 25% discount to invested capital in the OT project of \$6.5B USD, implying negative value creation. Should TRQ's share count stay constant, which seems increasingly likely, TRQ's stock price would have to trade at \$6.50/share just to be on par with the capital invested in the project, let alone any premium to the investment made in OT so far.

In Conclusion

The mood from the ground in Mongolia is quite positive; in fact, it's the best we've seen in months. The appointment of the new OT Board members, led by Da. Ganbold, was clearly the catalyst for the positive changes we're now seeing. Assuming the same sense of urgency is shared by negotiators from RIO, we think investors should begin to discount a more positive outcome and position themselves accordingly. While it will take some time to restart Phase 2 operations at OT, resolving the longstanding dispute would have a profound impact on investor sentiment towards Mongolia.

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