



July 1, 2013

HBOil (MSE: HBO) - A First Movers Advantage Into The Last Frontier

Waste Oil Recycling

Price target (MNT) 8160; Close (MNT) 335.71

We are initiating coverage of HBO with a Buy Rating and a 3-5 year price target of 8160 MNT per share, a valuation nearly 2400% higher than current levels.

In a move that made international news, HBOil JSC (MSE:HBO) announced on June 18th that they had agreed to acquire, in 2 separate transactions with Singapore's Ninox Energy Limited ("NEL"): (i) 20% of the shares in the capital of KOEC International Inc ("KOECII"), and (ii) 51% of the shares in the capital of Korex Ltd ("Korex"). For avoidance of doubt, and as publicly announced by HBO; HBO is effecting the aforesaid transactions, through the acquisition of shareholdings in NEL's intermediate holding companies, namely; Ninox Hydrocarbons (L) Berhad, and Blacktip Energy Inc.

- KOECII is presently, and will continue to be post-completion of transaction by HBO, 80% owned by Korea Oil Exploration Corporation ("KOEC"); the national upstream oil company of the Democratic People's Republic of Korea ("DPRK" or "North Korea"). KOECII, by the virtue of its founding documents, is the first nationally owned integrated oil company in DPRK, including the authority and rights for: exploration, development, and production of hydrocarbons across the entire Onshore territory of DPRK; refurbishment and expansion of oil processing and refining capacity within DPRK; import of crude oil into DPRK; import and export of refined petroleum products into and from DPRK; and investment in ancillary infrastructure and logistics, in partnership with foreign investors, on BOOT basis.
- Korex, post-completion of transaction by HBO, shall continue to be owned as to 49% by NEL. In May 2010, Korex executed the Production Sharing Contract ("PSC") with KOEC, for the entire offshore territory of DPRK in the Korean East Sea. The PSC covers approx. 51,000 SqKm; encompassing shallow-water, deep-water, and ultra-deepwater areas of the northwest quadrant of the East Sea (also internationally known as the Sea of Japan). In July 2012, Korex completed a 2D seismic survey over 5,300 Km of the East Sea PSC, mostly focused on blanketing the Gulf of East Sea with sufficient detailed seismic that could further enhance and high-grade the company's pre-existing (defined by 1980s and 1990s vintage seismic acquisitions and 2 wells drilled by the Soviets that had significant shows of both oil & gas) inventory of 25 prospects and leads.

Stock chart of HBO JSC





Company introduction

-HBO's deal represents both; the 1st-ever MSE listed company making an overseas acquisition, and Mongolia's 1st-ever, foreign E&P asset acquisition, public or private.

-Mongolia has the best diplomatic relations with the DPRK of any country in the world, while at the same time being Asia's purest form of democracy.

-We view this deal as evidence that North Korea may be "opening up", which would have profound implications for Mongolia, HBO, North Asia, and the world at large.

-Mongolia does not presently have domestic refining capacity of its own and currently has limited oil production, with ~90% of its fuel imports coming from Russia; it is critical that Mongolia gains access to diversified sources of refined petroleum products, simply as a matter of national security.

-Our rating, estimates, and price target assume the completion of the acquisitions by HBO, which is due to close in late July or early August 2013.

HBOil (MSE:HBO) is an MSE listed company and operates a successful waste oil recycling business in Mongolia. With a current market cap of ~\$2M USD, HBO grew revenues and earnings at 67% and ~4000%, '12/'11, respectively, with a P/BV of 1x. Up until this point, Mongolia has been a destination for Foreign Direct Investment, as companies and countries from around the world have recognized the country's vast mineral wealth. The DPRK acquisitions, transform the company in a way that few could have imagined; gaining HBO and Mongolia international recognition, especially among its Asian neighbors.



Mongolia and North Korea Relations

“We will keep the channel warm with North Korea”; said Mongolian Prime Minister S. Batbold, in an interview with Bloomberg Television on 21 July 2012.

Mongolia has by far the best relationship with North Korea of any country in the world, with continuous diplomatic relations having been established 60 years ago. North Korea recently requested (and received) humanitarian food aid from Mongolia and the two countries frequently discuss economic cooperation. In '05, the Deputy Minister of Food and Agriculture for the DPRK visited Ulaanbaatar (UB) to discuss building a joint farm in Mongolia. In '07, the Chairman of the DPRK's Supreme people's assembly visited UB and signed bilateral agreements on trade, marine transport, and labor force exchange. Access to marine transport via the DPRK is regarded to be of “highly strategic” importance for Mongolia. And in '10, an MOU on economic and trade cooperation signed regarding the Rason Municipality (a DPRK Free Trade Zone), with Mongolia's Minister of Roads and Transportation. Mongolia also hosted talks between the DPRK and Japan recently, and is regarded by many, as a critical player in engaging the DPRK with the developed world. The DPRK puts a high value on its relationship with Mongolia, as the last thing that the DPRK wants, is to risk losing its sovereignty and become a part of China; literally or figuratively. The mutual benefits for the DPRK and Mongolia, to collaborate on developing the DPRK's petroleum industry are utterly tremendous, to say the least.

Mongolia, North Korea, and China

Mongolia and the DPRK share the same fear, which is losing their sovereignty by becoming too reliant on China for trade and investment. Should China gain too much influence in either of the two countries, it would likely destabilize the region in a manner not seen since the Cold War. China exerts a massive amount of influence in the DPRK, which is not only rich in natural resources, but also of significant strategic importance on the Asian chessboard of geopolitics. On the one hand, China pours billions into the country to build infrastructure that will benefit them in monopolizing trade with the DPRK; on the other, they vote for UN sanctions against the DPRK and occasionally admonish them for provocative actions and rhetoric against South Korea, Japan, and the US. This dynamic is a victory for China and a losing proposition for the DPRK, as they have been unable to engage non-China FDI, until recently. Mongolia, on the other hand, has been steadfast in its policy to engage 3rd nation partners (i.e. anyone but Russia and China), and has been successful in doing so. We think that DPRK recognizes the benefits of Mongolia's policies and understands the need to attract investments from a diversified range of public or private investors.

UN Sanctions, implications for investors

The UN sanctions related to the DPRK are clear, countries may not engage in activities or business which may enhance North Korea's weapons capability; be it nuclear, biological, or conventional. The acquisitions that HBO is pursuing, in no way violate the UN sanctions. Furthermore, we are aware of no country in the world whose citizens would be precluded from investing in a Mongolian company, with business interests in the DPRK. There are numerous Mongolian companies doing business with the DPRK now, and interest among Mongolian business community is very high. Further, many may be surprised to learn that countless South Korean (public and private) companies are engaged in business with the DPRK, as South Korea accounts for more than 20% (approximately \$1B USD annually) of North Korea's imports and exports. In fact, the European Union is represented 5% of North Korea's imports in 2011. Geopolitics notwithstanding, DPRK is clearly “open for business”; and after the recent liberalization of Myanmar, DPRK truly remains as the last Frontier market!



The business of KOECII

KOECII was incorporated on April 10th, 2013, as a consequence of the implementation of the Joint Venture Agreement (“JVA”) that was executed on October 29th, 2012, by and between KOEC and Ninox Hydrocarbons (L) Berhad (“NHLB”). Pursuant to said JVA, KOECII is owned as to 20% by NHLB, and 80% by KOEC. HBO has agreed to acquire NHLB from NEL, and will essentially invest US\$ 2 million to finance the initial equity capital requirement of KOECII.

The business of KOECII consists of rights and privileges that were documented through the KOECII Shareholders Agreement executed amongst KOEC, NHLB, and KOECII dated June 02nd, 2013, which are as follows:

1. Exploration, development, and production of hydrocarbons throughout onshore DPRK (approx. 120,000 Sq Km), which is about 6x larger than Kuwait in the Persian Gulf.
2. Option to refurbish and operate 2 refineries, with initial preference being the Sungri Oil Refinery, on DPRK’s East Coast (located within the Rason City Special Economic Zone), which is fully integrated into the Russian Railways system.
3. Import crude oil into the DPRK, for processing and refining, with the resultant refined petroleum products to be exported overseas (Mongolia and China being the primary markets).
4. Import and distribute refined products into and throughout DPRK.
5. Design and construct all requisite infrastructure and logistics, on BOOT basis.
6. Invite foreign investors to participate in any and all of KOECII’s ventures listed above.

DPRK Onshore Exploration Assets

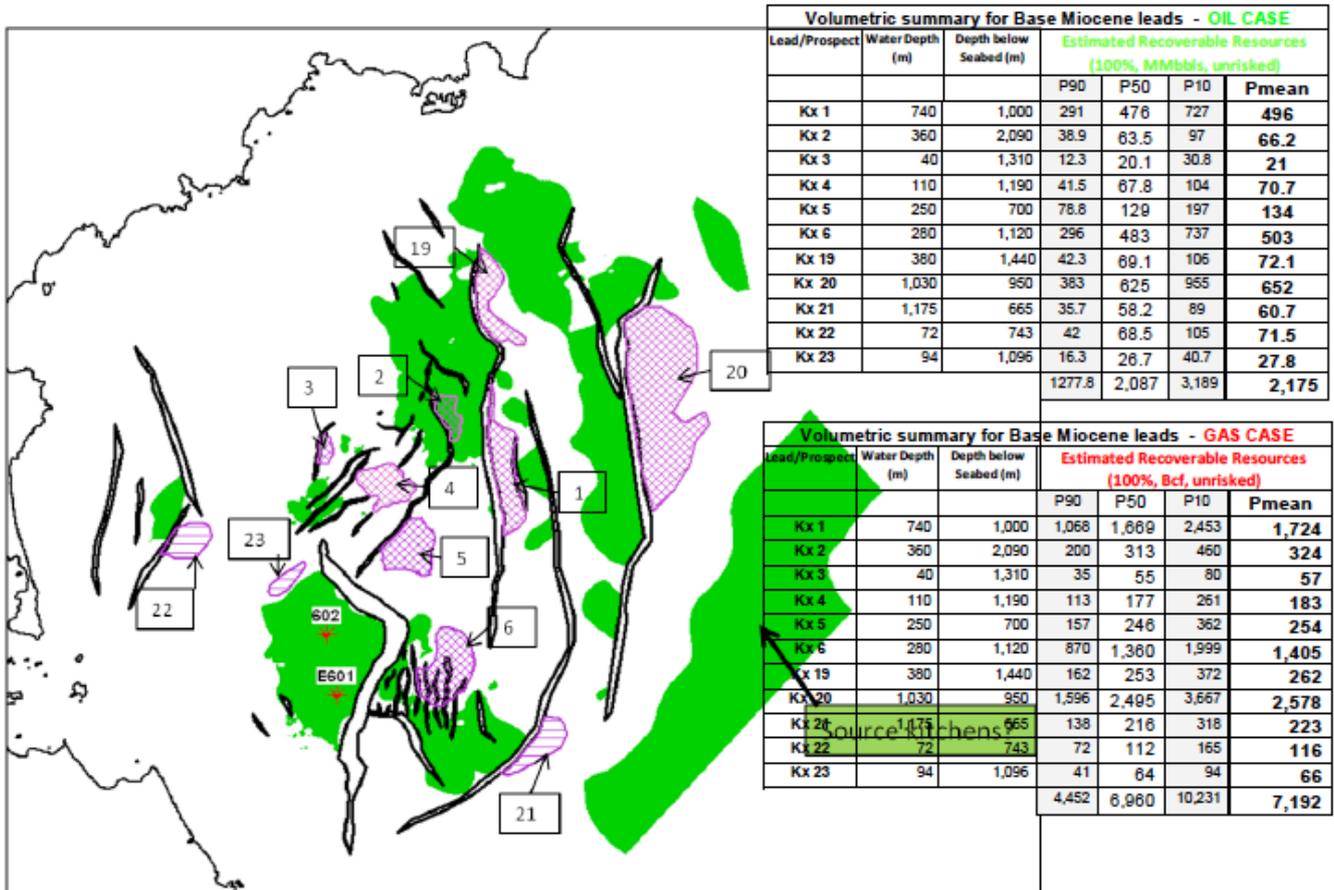
The opportunity for onshore oil and gas discoveries is truly massive, as KOECII JV covers 120,000 SqKm, which is slightly more than either 6 times the size of Kuwait or 10 times the size of Qatar. Only 22 wells have been drilled both offshore and onshore DPRK during the last 28 years, as the DPRK is constrained by capital, technology, and (up to now) lack of a clear strategy to fully integrate its petroleum industry. Two onshore Anju Basin wells (3203 and 3208) tested 38 degrees API, sweet crude oil, with natural flow rates of 75 BOPD per well. In the onshore Pyongyang-Zaeryong Basin, one well had oil shows and across the whole Basin, numerous oil seepages and gas bubbles have been recorded. Finally, in the onshore Techon Basin, a gas discovery of 1-TCF has previously been reported.

The business of Korex/ DPRK Offshore Exploration Asset

As the old adage goes, a picture says a thousand words. The following table illustrates the East Sea story, delightfully and succinctly; 50% of the existing inventory of prospects and leads are estimated to contain recoverable resources of more than 9 Billion Barrels of Oil Equivalent.

Figure 1

Map showing location of source kitchens and Leads/prospects at Base Miocene level



Source: BDBSec Sales & Research

Valuating HBO post KOECII acquisition

We use a sum of the parts approach to value HBO on a pro-forma basis, which accounts for the operating value of the Oil Recycling, Upstream, Downstream, and Trading & Logistics businesses; including a very conservative base case scenario for onshore exploration success. We assume shares outstanding will increase to 45.5M from 9.2M today, to arrive at our price target of 8160 MNT and a market cap of \$261M USD, which would make HBO the largest company on the Mongolian Stock Exchange (MSE). The largest company on the MSE currently, is APU (MSE: APU) at ~\$190M.

Oil Recycling

The oil recycling business of HBO will be a relatively small part of its pro-forma capital structure, but will nonetheless be a valuable asset, which may grow quickly as it expands into DPRK. The manufacturing base in the DPRK is several times that of Mongolia, with zero oil recycling capacity at present time. We assume a long term cash flow rate of 15% and arrive at a valuation of 5.9B MNT, vs. its current market cap of 3.2B MNT.



**Upstream, Downstream,
 and Trading & Logistics**

We have reviewed the business plan for KOECII, and not only find it realistic, but also conservative. For the Upstream, Downstream and Trading segments, we assume KOECII's EBIT ramps to ~50B MNT (\$45.1M USD), adjusted for HBO's 20% interest (via NHLB acquisition); equates 12.78B MNT (\$9M USD). We assume a conservative 10% terminal cash flow growth rate, post 2017, to arrive at a valuation of 50.07B MNT (35.2M USD).

Onshore DPRK

As mentioned earlier, the KOECII JV includes onshore hydrocarbon exploration rights covering 120,000 SqKm, which is slightly larger than 10 times the size of Qatar. Onshore DPRK is one of the world's few remaining "under-explored" onshore hydrocarbons provinces. It would be realistic to believe that onshore DPRK could contain a few billion barrels of oil and several tens of TCF of gas. However, as a base case, we have applied a modest 500M bbls @ \$70/bbl and make no assumptions for natural gas reserves. Since the KOECII's strategy will be to farm-out exploration and production, HBO should receive minimum 4% of the total economics (also conservative) which we DCF over 20 years beginning in 2019. We use a substantial, 60% discount rate, to account for all the risks (perceived and real) associated with doing business in the DPRK and arrive at a valuation of 315.3B MNT (\$222M USD)

Offshore DPRK

Offshore DPRK is highly prospective, including 3 principle basins, all of which contain working petroleum systems. Only 2 wells have been drilled in the Korean East Sea, as stratigraphic test wells; both of which encountered very impressive shows of oil and gas. HBO's proposed acquisition of the East Sea interest described herein-above, would ultimately mean substantially higher levels of hydrocarbons resources and reserves, and if HBO exercises its Option to acquire the 51% shareholding in Korex; then we would have to revise our price target of 8160 MNT, to a significantly higher price expectation.

For investors that feel a 60% discount in our DCF calculation is too severe, we've provided implied price targets at discounts of 50%, 40%, 30% and 20%, respectively. As you can see, the potential upside is truly staggering

Figure 2

Target price

Target Price	Total business value (mil MNT)	Target price per share (MNT)	% return from 200 MNTper share
Implied target price @ 60% discount value	371,214.98	8,160.54	4,080%
Implied target price @ 50% discount value	576,830.67	12,680.66	6,340%
Implied target price @ 40% discount value	968,383.99	21,288.31	10,644%
Implied target price @ 20% discount value	3,791,320.09	83,345.86	41,673%

Conclusion

This is a historic deal for Mongolia, as it moves to secure external sources for oil, and decrease its dependence on Russia and China. The value that this transaction creates is of a larger magnitude than any we are aware of. Our baseline assumptions point to medium/long term returns of 2,400% from current levels, possibly more. We think investors will be surprised by the high level of economic activity that presently exists between the DPRK and its neighbors in the region, notably China, South Korea, and Mongolia. These economic ties, free enterprise zones, and transactions like the one HBO is undertaking, may well be a foundation for the DPRK "opening up", which would have very positive implications not only for the HBO shareholders, but also for eastern Asia and the world at large.

There is an extensive amount of data available to investors relating to HBO's business plan, the DPRK, valuation, and geology. BDBSec can provide access to this data room upon signing an NDA.

Key Risks

- Further international isolation by way of stricter UN sanctions against DPRK.
- Regional hostility, should DPRK initiate aggressive actions towards South Korea, Japan, or the US.
- Changes in the government of DPRK and/or changes in DPRK's economic or national policies.
- Exploration risk, long-term commodity price volatility, and timely execution of HBO's business plan.

Figure 3

Income statement projection (MNT)

	2011 (A)	2012 (A)	2013 (E)	2014 (E)	2015 (E)	2016 (E)	2017 (E)
Amount of sales revenue	183.4	306.4	300.5	408.3	588.3	896.8	1,443.9
Cost of goods sold	(79.0)	85.4	110.6	142.0	188.2	256.8	364.1
Gross profit (loss)	104.4	221.1	189.9	266.3	400.1	639.9	1,079.9
G&A Expenses	64.0	74.4	78.1	114.3	176.5	287.0	490.9
Depreciation expense	13.3	65.5	72.0	79.2	87.2	95.9	105.5
Financial Expenses	24.8	20.3	22.3	24.6	27.0	29.7	32.7
Other expenses	7.7	15.1	16.6	18.3	20.1	22.1	24.3
Total operational expenses	109.8	175.3	189.1	236.4	310.8	434.7	653.4
Major operational profit (loss)	(5.3)	45.7	0.8	29.9	89.3	205.2	426.4
Total sub-operational profit (loss)	6.3	(4.5)	(6.0)	(8.2)	(11.8)	(17.9)	(28.9)
Net profit before tax (loss)	1.0	41.3	(5.2)	21.7	77.6	187.3	397.5
Income tax	0.1	4.6	-	2.2	7.8	18.7	39.8
Net profit after tax (loss)	0.9	36.6	(5.2)	19.6	69.8	168.6	357.8

Figure 4

Free cashflow projections and valuations

From current operation	2013	2014	2015	2016	2017
Free cash flow (mil MNT)	61.2	70.8	110.2	184.3	321.0
Terminal value (mil MNT)	12,305.21				
Discount rate	18%				
NPV of current business (mil MNT)	5,856.74				

From the asset in NK	2013	2014	2015	2016	2017
HBOil Share @ 20% of EBIT (mil MNT)	1,260	3,618	8,460	10,674	12,816
Discount rate	25%				
NPV of business in NK (mil MNT)	50,075.8				

Cashflow from oil trading	2019	2020	2021	...	2033
BOE (million)	500	500	500	...	500
Price (USD)	70	70	70	...	70
Total Sales (million USD)	35,000	35,000	35,000	...	35,000
HBO share @ 4% (mil USD)	1,400	1,400	1,400	...	1,400

NPV of oil trading business	mil USD	mil MNT
60% discount value	222.03	315,282.46
50% discount value	366.83	520,898.16
40% discount value	642.57	912,451.48
20% discount value	2,630.55	3,735,387.58

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