Contrary to the lukewarm investor sentiment towards Mongolia currently, the exploration license activity in and around Oyu Tolgoi (OT) has started to heat up. Kincora Copper recently announced the acquisition of privately held Ibex, creating the largest land bank of exploration licenses in the South Gobi. Entrée Gold retains extremely valuable and strategic land surrounding the Oyu Tolgoi deposit, which is only partially covered by their Joint Venture with Turquoise Hill. Rio Tinto and Turquoise Hill have also been quite active, perhaps beyond what many had thought, which we detail below. What happens in this region in the next 1-2 years will help shape modern mining history, which has recently been obscured by the now resolved dispute between the Government of Mongolia and Rio Tinto over Oyu Tolgoi. Many leading geologists view the South Gobi Desert as the most prospective ground for copper mining in the world today, making the current land grab taking place a high stakes game and something investors should be paying attention to. Investor sentiment towards Mongolia has improved considerably following Rio Tinto giving Oyu Tolgoi its “Notice to Proceed” for construction on the underground mine. Through publicly available data from the Mineral Resource Authority of Mongolia (MRAM), we will try to give investors a better sense of the exploration license activities currently taking place and the strategic implications.

The Pole Position

As the only major mining concern operating in Mongolia, Rio Tinto (via their 51% ownership of Turquoise Hill) controls Oyu Tolgoi, the world’s most significant copper discovery/project of the past 25 years. Following the successful resolution of the dispute surrounding the OT Investment Agreement last May, RIO/TRQ appear to have gone back into expansion mode, as per their FY’15 financial results released on March 17, 2016:

“Exploration during 2015

Oyu Tolgoi’s exploration program focused on near surface targets using geochemical surveys and detailed ground magnetic surveys to identify porphyry style mineralization. In December 2015, Turquoise Hill acquired a second exploration license within 50 kilometers of Oyu Tolgoi.” (Emphasis ours)
While few details were given, we suspect that they are referring to license 19315 in Figure 1 and that “Heruga Resources” is a RIO/TRQ affiliated entity. Heruga Resources, the holder of licenses 19315, 19528 and 20358, is a Singapore registered company, listing Brendan Lane as Director. Turquoise Hill happens to also list a Brendan Lane as VP of Operations & Development, so we are guessing this is probably same person, hence our belief that the two entities are affiliated. Fifty kilometers is supposedly the demarcation between license acquisitions Turquoise Hill shareholders can expect to participate in, versus possibly some other ownership structure. If this is in fact the case and “Heruga” is indeed a RIO/TRQ affiliated entity, then TRQ shareholders are left to wonder about the status of licenses 20358 & 19528, which may be beyond 50 kilometers from Oyu Tolgoi. This same question may be applied to the “waited application” license areas in and around 20358 & 19528. It also seems the “waited application” license areas are being applied for under a combined RIO/TRQ structure, which may represent a new level of cooperation. It had been our understanding the two companies were operating on a separate basis in Mongolia, which may have changed recently. This new structure (assuming it is in fact new) would lend credibility to speculation that RIO intends to eventually acquire the minority shares in TRQ, allowing for a seamless transition in the ownership of future licenses. It is not at all uncommon for license transfer problems to arise post M&A in Mongolia, as the GOM can sometimes take the view it is a taxable event and an opportunity for revenue.

Figure 1
To round out what we suspect to be RIO/TRQ affiliated licenses, there are Asia Gold’s (A prior subsidiary of Ivanhoe) two licenses 12423 & 14455 and of course OT’s 6708, 6709 & 6710. Assuming what we are speculating is correct, RIO/TRQ appear to be locking up the ground surrounding OT and along the stratigraphic sequence, hosting the deposits, which is believed to extend to the northeast.

**Blocking Position**

If RIO/TRQ are in fact in the process of a land grab, then Entrée Gold’s ground at #15225 and 15226 would seem to be essential pieces to that strategy. The Entrée licenses not only surround OT, but capture the open ground of the stratigraphic sequence of the deposit to the North (Hugo North Extension) and South (Heruga). Based on guidance discussed by RIO in conjunction with Oyu Tolgoi’s Notice to Proceed, Entrée’s Hugo North Extension should be in production by around 2025-2027. Entrée estimates that the Hugo North Extension and Heruga could account for between 50-80 years of future Oyu Tolgoi production (Figure 3), representing a considerable portion of the total estimated mine life. It is widely believed that there is additional upside to Entrée’s probable, measured, indicated and inferred resources with further exploration. Despite these valuable attributes, **RIO/TRQ are not in a control position in Entrée equity**, but collectively are the largest shareholder, with a current combined ownership of 18.5%.

**Figure 2**
In 2008, Entrée established a Joint Venture with Ivanhoe, encompassing a majority of the Entrée license area, which focuses on the Hugo North extension and Heruga. This JV was transferred to Oyu Tolgoi LLC, but according to Entrée’s FY 2015 MD&A, the JV has never been executed, though the two entities are operating as if it was:

“While the Entrée/Oyu Tolgoi JV is operating under the terms of the joint venture agreement appended to the Earn-in Agreement, the joint venture agreement has not been formally executed by the parties. There can be no assurance that OTLLC or its shareholders will not attempt to renegotiate some or all of the material terms governing the joint venture relationship.”

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It seems a few interrelated issues have been preventing the JV from being affected, including Entrée transferring their licenses to OTLLC as per the agreement. But the question about whether the GOM is entitled to 34% of the Entrée license economics (like the Oyu Tolgoi Investment Agreement) is an open question and appears to be the central issue preventing the JV from being executed. It appears Entrée is willing to exchange 34% with the GOM, as they refunded Sandstorm Gold part of their investment in Entrée’s future royalties on March 1, to make room for the GOM’s future 34% ownership. Since a deal with the GOM has yet to be struck and elections are looming, it is unlikely any of further progress will be made on this issue until sometime after a new government is in place in early August. This means that resolution is likely on hold until 4Q’16 or 1Q’17, after new ministers are appointed and settle in.
However, we are of the opinion these issues are destined to be resolved, to the benefit of all parties. As such, with a market capitalization of only $45M USD, Entrée appears to be quite cheap in light of its strategic importance and large share of Oyu Tolgoi’s projected mine life. The biggest question in our minds is whether a strategic buyer (Say BHP, Chalco, China Moly, etc.) would attempt a takeover of Entrée Gold, gaining a solid beachhead in the Oyu Tolgoi project. Entrée estimates an after tax NPV of $106M (~$0.70/share) for the Hugo North Lift 1 extension alone, not including Lift 2, nor a contribution from Heruga, which collectively represent decades of future production. Many believe Entrée should have been consolidated years ago and that its strategic value has increased considerably since. With a current market cap of only $48M USD, Entrée is temptingly small during a time when many companies are on the hunt for acquisitions.

**Current and Future Beneficiaries**

Xanadu Mines (XAM AU) and Kincora Copper (KRI CN) stick out as obvious beneficiaries from the increased exploration license activity in the South Gobi Desert, though each are at a different stage of development.

Xanadu has been one of Mongolia’s best performing stocks, rising ~300% after acquiring their flagship Kharmagtai deposit in 2014. Xanadu is perhaps the best example of copper and gold exploration success since the discoveries at Oyu Tolgoi and Entrée Gold. They have been successful in raising capital in an adverse environment and now sport a market capitalization in excess of $100M USD, which is a credit to their assets and management. Should Xanadu continue their strong success in exploration, it will only be a matter of time before a strategic investment is established with a multi-national, or they are acquired outright.

Kincora recently made big news via their merger with privately held Ibex, creating one of the largest exploration land banks in the South Gobi. Kincora has tremendous leverage to any M&A and/or heightened license acquisitions activity in the South Gobi. Kincora now has more than 1400 square kilometers of license area, both to the North of Oyu Tolgoi and very large holdings along the stratigraphic sequence the deposit is believed to run to the northeast with license 14396. The 14396 license is just south of the Tsagaan Suvara copper and molybdenum deposit, where Germany recently issued a $745M USD loan guarantee to build a concentrator complex. Total proven reserves of Tsagaan Suvara are 1.6M tons of copper and 66k of molybdenum.
In summary, we think the activity in the South Gobi will continue to increase, perhaps exponentially. It seems obvious to us that RIO/TRQ will aggressively pursue exploration licenses ahead of what may prove to be an epic land grab, which would mitigate future competition in the region. We believe this consolidation will extend to the equity of both Turquoise Hill and Entrée Gold, given their strategic importance and future financial leverage to Rio Tinto shareholders. Despite copper prices currently trading at seven year lows, strategic acquisitions are taking place at significant premiums to current public market valuations which begs the question, who is the smart money currently? Strategic buyers who are paying up for deals, or fund managers who are underweight mining stocks? Given RIO’s self-described disciplined approach to acquisitions and appetite for tier 1 copper assets, there is only one deal they can do with no risk of being outbid by their strategic competition and that is buying the minority in Turquoise Hill. Barring unforeseen adverse circumstances, the value of Turquoise Hill should increase each year the mine is closer to production, as development is de-risked and the multiple on future cash flows increases. As this occurs, we suspect a large premium will come back into the current players of the South Gobi, which will no doubt attract other multi-national mining concerns to the region.
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