

Mining
 Mongolia

Company Update
 Equity research

January 4, 2010

SouthGobi Energy Resources

We have recently made a site visit to Ovoot Tolgoi mine and met with SouthGobi Energy (SGQ) management to receive updates following the recent successful closing of substantial financing. Our key takeaways from these meetings are that the company will be able to improve substantially its margins by bringing the pricing of their products in line with coal prices in China and going forward the major share of SGQ's production will consist of high quality hard and semi-soft coking coal.

Investment Program: We estimate that over 2010-2012, SGQ's investment program will amount to US\$740mn excluding maintenance expenditures. This includes US\$124mn in 2010, US\$355mn in 2011 and US\$260mn in 2012.

Production Ramp-up: The company is planning to produce 3mn tonnes in 2010 from Ovoot Tolgoi mine and increase it to 9mn tonnes in 2013, with saleable production reaching 7.5mn in 2013. We forecast total saleable coal production to be 13.8mn tonnes in 2015.

Margins Improvements: We forecast significant margins improvements on the back of increase in production, CIC partnership, better sales mix, infrastructure development and hefty increase in mine gate prices. We note in particular that current SGQ's mine gate coal prices are at substantial discount to coal prices in China, adjusted for transport costs.

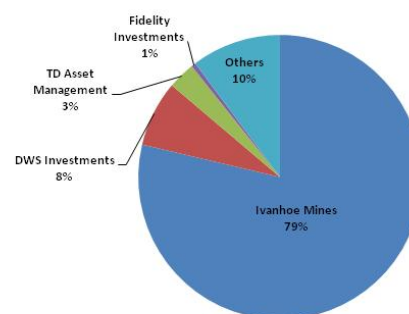
We have increased our target price to CAD24 per share. Our 12-month target price is based on a blended DCF and resource-based valuation approach. We take the average of DCF valuation (CAD21/share) and resource-based valuation EV/Resources (CAD28/share) and reach CAD24/share. This represents **40% upside** to current SGQ's share price of CAD17.1 (Dec 31, 2009). We note that Fushan and MEC are two hard coking coal companies, listed at HKEx and at different stages of development, are traded at over US\$20 per tonne of coal resources. SGQ's current EV/resources is mere US\$4.6, and US\$11.7 in our valuation. Given that hard and semi soft coking coal is expected to make up on average over 75% of total saleable coal produced by SGQ, we believe that there is ample room for the company valuation to increase beyond our projections.

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|--|--|
| Rating | BUY |
| Target Price CAD | 24 |
| Current Price CAD | 17.1 |
| Bloomberg | SGQ CN |
| Mkt Cap US\$ bn | 2.2 |
| Common Shares O/S, mn | 133.4 |
| 52-wk range CAD: | 4.00-17.00 |
| Web: | www.southgobi.com |
| Free Float, shares mn | 18.4 |
| Major Shareholder | Ivanhoe Mines Ltd. (78.7%) |
| Average Daily Trading Volume, 6 months | 28,200 |

Figure 1: Share price performance


Source: Bloomberg

Figure 2: Major shareholders


Source: Company data, Bloomberg

SouthGobi Energy successfully closed a US\$500mn financing from the China Investment Corporation (CIC) in November 2009 and is likely to raise up to US\$400mn at the Hong Kong Stock Exchange in 1Q 2010. We have recently made a site visit to Ovoot Tolgoi, SGQ's flagship mine, and met with SGQ's management to receive updates on their expansion plans. Our key takeaway from these management meetings is that the company will be able to substantially improve their margins by bringing the pricing of their products in line with coal prices in China thanks to improvements in product quality, CIC partnership and infrastructure development. In addition, the major share of SGQ's production will consist of high quality hard and semi-soft coking coal going forward, marking the company's entrance into upstream of the Chinese steel industry. We believe the market has yet to price in these two significant factors leaving big upside in the share price.

Investment Program

We estimate that over 2010-2012, SGQ's investment program will amount to US\$740mn excluding maintenance expenditures. This includes US\$124mn in 2010, US\$355mn in 2011 and US\$260mn in 2012. We note that these numbers are based on current SGQ resource base and company plans, and do not take into account possible future developments once planned exploration programs reveal additional coal resources at SGQ's various exploration properties.

SGQ, Investment Program 2010-12

| | 2010 | 2011 | 2012 |
|--|------------|------------|------------|
| OT Surface | 79 | 42 | 19 |
| Soumber | 0 | 78 | 35 |
| OT Underground | 0 | 50 | 100 |
| Tsaagan Tolgoi | 0 | 23 | 23 |
| Value-Added CAPEX (Beneficiation Facility) | 25 | 80 | 0 |
| Railway (50 km) | 0 | 64 | 64 |
| Exploration | 20 | 20 | 20 |
| Ongoing Maintenance CAPEX | 10 | 19 | 40 |
| Total | 134 | 375 | 301 |

Source: Company Data, EC Estimates

Our estimate of SGQ's investment program includes the following:

- The company's coal production ramp-up requires significant capital spending on mining equipment and expansion of the camp at Ovoot Tolgoi. Third fleet of mining equipment will likely be on Ovoot site in June-July 2010, and fourth fleet will be required in 2011. We expect the capital cost to fully develop Ovoot Tolgoi mine to be in the range of US\$120-160mn.

- The company is planning to construct a coal handling facility by the end 2010 for a cost of US\$25mn, which will process premium and soft coking coal from Ovoot Tolgoi mine. Coal handling plant design is being carried out and the facility will likely to consist of a rotary breaker and a screening facility.
- The hard coking coal from Soumber property as well as thermal coal from Ovoot mine is planned to be washed, and the company intends to build a washing plant with an annual capacity of about 8mn tonnes. The cost of the plant is not expected to exceed US\$80mn.
- We estimate the development of Soumber, Ovoot Tolgoi underground and Tsagan Tolgoi deposits to add another US\$290mn in CapEx in the period of 2011-2013.
- SGQ completed feasibility study on 50km railway which would link Ovoot Tolgoi mine directly to the existing Chinese rail. SGQ is working with Mongolian coal producer MAK, the holder of construction permit, to jointly develop the railway. The initial capacity is planned to be 15mn tonnes and can be expanded to 25mn tonnes. The project is estimated to cost in the range of US\$100-150mn.
- SGQ is going to focus on four primary exploration targets in 2010-2012 with a budget of US\$20mn per year. First target is located some 10km south-west of Ovoot Tolgoi, while other three are located in East and West of Soumber fields. Soumber deposit is a high priority for the management, as it has strong potential to become a high quality hard coking coal deposit.

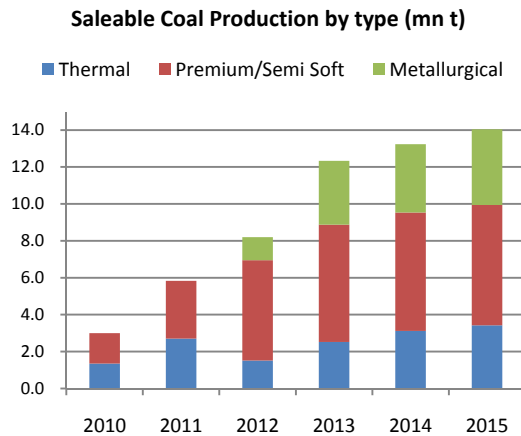
Beyond 2012 we forecast limited capital expenditures mainly related to maintenance work and continued exploration programs.

Production Ramp-Up

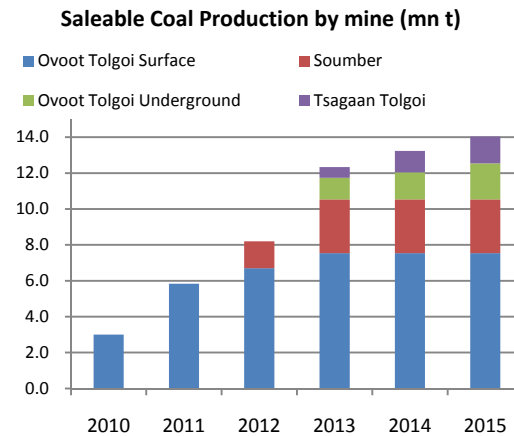
SGQ achieved tangible progress in 2009 at Shivee Khuren (Ceke) customs check point on the border with China. The check point is working now six days a week, 11 hours per day, with a total throughput capacity of about 8mn tonnes. Three dedicated coal lines are expected to be opened at the check point shortly in 2010 which will allow for increased throughput capacity at Ceke, although current throughput is sufficient for coal shipments from SGQ and MAK in 2010. The transition of the check point schedule to 24/7 is approved and is likely to take place in 2H 2010.

The company is planning to produce 3mn tonnes in 2010 from Ovoot Tolgoi and increase it to 9mn tonnes in 2013, with saleable production reaching 7.5mn in 2013. We also expect the Soumber deposit to come into production in 2012 with estimated raw coal production reaching 5mn in 2014. Hard and

semi soft coking coal will make up on average over 75% of total saleable coal production. We forecast total saleable coal production to be 13.8mn tonnes in 2015, as shown in below graph.



Source: Company Data, EC Estimates



Source: Company Data, EC Estimates

Handling facility and wash plant will allow the company to produce high quality semi soft and hard coking coal from Ovoot Tolgoi and Soumber mines. Handling facility will add about 50¢/tonne and coal washing will add about US\$2/tonne to cash costs.

Margins Improvement

We forecast substantial pricing improvements thanks to increase in production, better sales mix, infrastructure development and hefty increase in mine gate prices. We note in particular that current SGQ’s mine gate coal prices are at substantial discount to coal prices in China, adjusted for transport costs. In this respect, we expect SGQ to significantly increase their marketing efforts with a view of eliminating intermediaries and getting directly to end-users. CIC, SGQ’s financial partner, is expected to assist the company, through its subsidiary, to establish direct relationship with end-users.

We model gradual increase in pricing of SGQ’s products in line with production ramp-up, better sales mix, handling and washing facility completion and transport infrastructure development. Our numbers incorporate a 25% adjustment in 2010, 60% in 2011, 85% in 2012 and full coal pricing in China less transport costs in 2013.

We assume transport costs of US\$35/t from Ovoot Tolgoi mine to Qinhuangdao port in China. The World Bank estimated in 2009 that transport costs would be US\$25/t from proposed railway from Gashuun Sukhait border crossing into China to Qinhuangdao port. We use Qinhuangdao, Datong and

Pindingshan thermal, semi-soft and hard coking coal prices as a benchmark for SGQ's products and adjust them for transport costs. We assume 26% increase in coal prices in China in 2010-2015, which we believe to be conservative against consensus of over 30% in 2010-2011 for coking coal and 20% in 2010-2012 for thermal coal.

The Chinese coal market consists of spot and contract markets. There is a price discount between contract and spot prices and discount varies dependent on company and the region where coal is sold. Contract price and volume is set by means of negotiations that take place once or twice a year, while spot price is determined by the market. The average discount has historically hovered around 10%, however it is expected to shrink in the near future due to development of the spot market. We apply 10% discount to thermal coal and 5% to coking coal sold by SGQ. We forecast the thermal coal discount to shrink to 5% in 2012.

SGQ, Coal Price Projections 2010-15 (US\$/t)

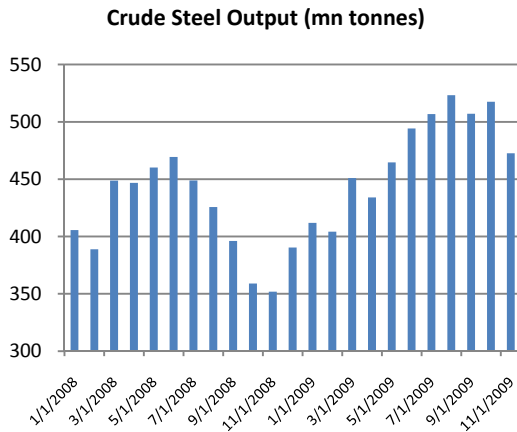
| | Current | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2010-15 Growth Rate |
|---|-----------|-----------|-----------|-----------|------------|------------|------------|---------------------|
| Growth Rate | | 5% | 5% | 5% | 5% | 4% | 3% | |
| Adjusted Benchmark Price Thermal Coal 5360 Kc | 89 | 94 | 98 | 103 | 107 | 111 | 113 | 26% |
| Qinhuangdao 6800 Kc thermal | 112 | 117 | 123 | 129 | 134 | 138 | 141 | 26% |
| Datong Premium Thermal | 101 | 106 | 112 | 117 | 122 | 125 | 128 | 26% |
| Datong Coking Coal | 198 | 208 | 218 | 229 | 238 | 245 | 250 | 26% |
| Pingdingshan Coking Coal | 186 | 196 | 205 | 216 | 224 | 231 | 236 | 26% |
| Transport Cost | 35 | 37 | 38 | 40 | 42 | 44 | 45 | 30% |
| Contract Discount Thermal Coal | 10% | 10% | 8% | 5% | 5% | 5% | 5% | |
| Contract Discount Coking Coal | 5% | 5% | 5% | 5% | 5% | 5% | 5% | |
| Price Projections | | | | | | | | |
| SGQ Thermal Coal Market Price | 22 | 33 | 44 | 56 | 62 | 63 | 64 | 191% |
| SGQ Semi-Soft Coking Coal Market Price | 29 | 51 | 59 | 69 | 75 | 77 | 78 | 167% |
| SGQ Hard Coking Coal Market Price US\$/t | N/A | N/A | N/A | 157 | 179 | 184 | 188 | 18% |
| ASP | 29 | 43 | 52 | 80 | 101 | 101 | 104 | 255% |
| Average Cash Cost | 15 | 16 | 17 | 19 | 21 | 22 | 24 | 59% |

Source: Company Data, EC Estimates

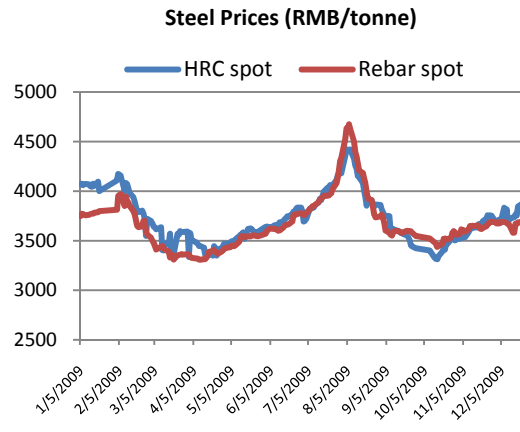
Chinese Coal Market

China's massive US\$589bn stimulus package is having strong impact on the steel industry through substantial increase in fixed assets investments. Chinese steel output has grown by 14% this year and reached record level of over 550mn tonnes on the back of increased government spending on infrastructure

and strong recovery in property markets. Many infrastructure projects are running behind the schedule, with estimates going as far as 70%, which indicates that the full effect of the stimulus package has yet to be felt by the steel industry. In addition, export of machinery, white goods and other steel intensive products is likely to experience recovery from 2010. Chinese steel production is expected to post 5% growth in 2010 and 5% in 2011.

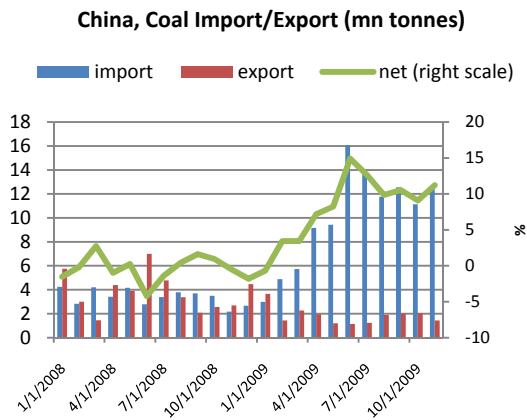


Source: Bloomberg

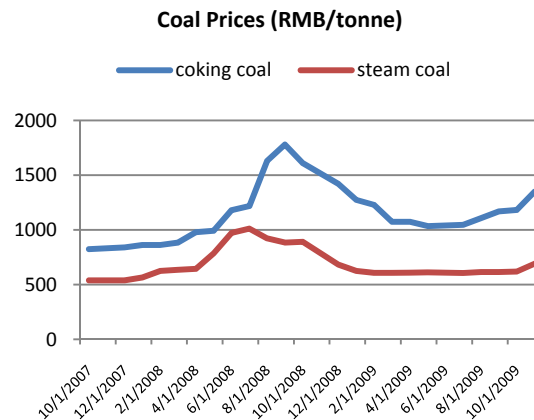


Source: Bloomberg

Against this backdrop, China has turned into net importer of coal in 2009. In 9M2009, the country imported 86mn tonnes of coal, including 26mn tonnes of coking coal, while exported only 14.8mn tonnes. The coking coal import is still an insignificant 5% of total coking coal consumption in China of over 500mn tonnes per year. We believe that increasing Chinese steel production, driven by infrastructure projects, property recovery and export growth, is supportive of a positive coking coal outlook.



Source: Bloomberg



Source: Bloomberg

Coal is likely to remain the main energy source in China for decades to come. However, supply of thermal coal domestically is facing number of challenges resulting in higher costs and tighter supplies. The Government “small mine” policy (requires coal production of 900k tonnes per shaft and 3mn tonnes per company in Shanxi) is having drastic effect on Shanxi province, major coal producing province in China. The coal production from this region has declined about 10% YTD2009. In addition, the People Republic’s Government is planning to increase the resource tax to 5-8% in early 2010 based on revenue from current RMB2-8 per tonne. We believe that coal mining costs will be significantly higher in a short period.

The Government has sanctioned Jiayuguan and Jiuquan as a key power base to link the eastern and western national power grids (Jiajiu project). Jiajiu has been approved by the National Development and Reform Commission for 6 x 600MW plus 10 x 1,000MW coal fired power plants to be completed by 2025 (requiring 25-30mtpa of thermal coal in total). Construction has commenced on Jiajiu’s first two 600MW plants. Gansu province is located in the northwest of China. It borders Mongolia to the north and Xinjiang to the west and lies between Qinghai, Inner Mongolia, and the Huangtu Plateau.

SGQ is strategically located to exploit these opportunities thanks to its high quality coal resources, low mining costs and shorter distance than other coal producers in China.

Valuation

Our updated DCF and resource-based valuation yields us a target price of CAD24 per share. We take the average of DCF valuation (CAD21/share) and resource-based valuation EV/t (CAD28/share) and reach the **12-months target price of CAD24/share**. This represents **40% upside** to SGQ’s current share price of CAD17.1 (Dec 31, 2009). We therefore maintain our **BUY** recommendation.

We note that Fushan and MEC are two hard coking coal companies, listed at HKEx and at different stages of development, are traded at over US\$20 per tonne of coal resources. SGQ’s current EV/resources is mere US\$4.6, and US\$11.7 in our valuation. Given that hard and semi soft coking coal is expected to make over 75% of total saleable coal produced by SGQ, we believe that there is ample room for the company valuation to increase beyond our projections.

Valuation Results

| | Estimated Equity Value (US\$bn) | US\$/share | CAD/share |
|--|---------------------------------|-------------|-------------|
| DCF Valuation | 3.8 | 20.0 | 21.0 |
| Peer Group Multiples (based on EV/Resources) | 5.0 | 27.0 | 28.0 |
| Average | 4.4 | 23.5 | 24.5 |

DCF Valuation

We updated our DCF model with a new CapEx, OpEx, pricing and production numbers mentioned earlier. We project SGQ free cash flow into 6 years (2010-2015) and after that apply terminal value valuation. Our DCF valuation results are outlined below in Table 2. We use 12.25% WACC and 3% terminal growth rate in the valuation model. Our 2009 DCF valuation results in equity valuation of US\$3.8bn or US\$20/share (CAD21/share) at current exchange rate of CAD1.048 per US\$1.

DCF Valuation

| Forecast Year | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | LT |
|--|--------------|-------------|------------|------------|------------|------------|------------|
| EBIT | 32 | 114 | 358 | 794 | 852 | 917 | 709 |
| Less: Taxes | -8 | -29 | -90 | -198 | -213 | -229 | -177 |
| EBIAT | 24 | 86 | 269 | 595 | 639 | 688 | 531 |
| Plus: Depreciation, depletion, and accretion | 13 | 38 | 62 | 67 | 69 | 73 | 21 |
| Less: Capital expenditures | -134 | -375 | -301 | -51 | -55 | -46 | -21 |
| + / - Changes in working capital | -9 | -19 | -45 | -71 | -25 | -27 | -27 |
| Unlevered Free Cash Flow | -106 | -270 | -15 | 539 | 628 | 688 | 504 |
| Discounted FCF @ WACC 12.25% | -95 | -214 | -11 | 340 | 352 | 344 | |
| Sum of Discounted FCF | 716 | | | | | | |
| Growth rate of FCF after year 2013 | 3% | | | | | | |
| Terminal value | 5,446 | | | | | | |
| PV of the TV | 2,722 | | | | | | |
| EV | 3,438 | | | | | | |
| LESS: Debt | -250 | | | | | | |
| PLUS: Cash & cash equivalents | 596 | | | | | | |
| Equity Value | 3,784 | | | | | | |
| Diluted Shares: | 189 | | | | | | |
| Equity Value per Share (US\$) | 20 | | | | | | |
| Equity Value per Share (CAD) | 21 | | | | | | |

Resources-based valuation

Our resource-based valuation confirms DCF results that the company is significantly undervalued and SGQ is trading at 60% discount to its peers in Asia based on EV/Resources valuation metric. Applying the average Chinese and Mongolian coal companies' EV/Resources value of 11.7 to SGQ's resources we get an enterprise value of US\$4.8 bn. We adjust it for SGQ's projected debt of US\$250mn and cash balance US\$598mn in 2010, and arrive at equity value of US\$5bn or CAD28/share, suggesting upside of 67%. In valuing price per share, we estimate the total shares outstanding on fully dilutive basis to be 189mn shares (including possible conversion of CIC US\$250mn into shares and expected equity issuance on the Hong Kong Stock Exchange).

Trading Multiples Valuation

| | Ticker | Price (US\$) | MCap (bn US\$) | EV (bn US\$) | Resources Mt | | | EV/t (US\$) | | |
|-----------------------------------|---------|--------------|----------------|--------------|--------------|--------|--------|-------------|-------------|-------------|
| | | | | | Reserves | M&I | M&I&I | Reserves | M&I | M&I&I |
| China Shenhua Energy | 1088 HK | 4.96 | 97.20 | 102.60 | 7,139 | 17,996 | 17,996 | 14.4 | 5.7 | 5.7 |
| China Coal Energy | 1898 HK | 1.83 | 25.40 | 22.70 | 3,583 | 10,398 | 10,398 | 6.3 | 2.2 | 2.2 |
| Yanzhou Coal Mining | 1171 HK | 2.18 | 14.30 | 12.80 | 3,329 | 3,329 | 3,329 | 3.8 | 3.8 | 3.8 |
| Fushan Int'l Energy Group | 639 HK | 0.99 | 5.40 | 5.70 | 142 | 206 | 206 | 40.1 | 27.7 | 27.7 |
| Hidili Industry Int'l Development | 1393 HK | 1.28 | 3.60 | 2.80 | 330 | 330 | 330 | 8.5 | 8.5 | 8.5 |
| China average | | | | | | | | 14.6 | 9.6 | 9.6 |
| Mongolia Energy Corporation | 276 HK | 0.52 | 3.20 | 3.30 | 0 | 149 | 149 | N.A. | 22.1 | 22.1 |
| Mongolia average | | | | | | | | 0.0 | 22.1 | 22.1 |
| China and Mongolia average | | | | | | | | 14.6 | 11.7 | 11.7 |
| South Gobi Energy Resources | SGQ CN | 16.4 | 2.20 | 1.90 | 114 | 307 | 406 | 16.7 | 6 | 4.6 |
| Premium/Discount (-) | | | | | | | | 18% | -47% | -60% |

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