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Portfolio Strategy | Canada

## Turquoise Hill Revisited

Jul. 29, 2019 4:02 PM ET 14 comments | 3 Likes

by: Aitezaz Khan

### Summary

- TRQ is likely to have a rough H2 2019 due to multiple operational challenges.
- Expected mine CAPEX has increased significantly and RIO may enter into a JV agreement to meet increased funding requirements.
- RIO's lack of interest in buying additional equity stake in TRQ has distressed the stock price.
- TRQ has promising mining potential in the long term but the positive outlook is dwarfed by the risks.

### Thesis

Turquoise Hill Resources (TRQ) has witnessed a significant drop in share price since the publication of Q2 2019 production report. This report highlights that the completion of TRQ's Oyu Tolgoi project will be significantly delayed. In this article, I have analyzed the implications of such a delay on the share prices.

Moreover, TRQ's parent Rio Tinto (RIO) has not yet announced any plans to increase its investment in its flagship copper asset. In my view, this factor is also landing heavily on the stock price. Given TRQ's valuation, one might consider it to be a bargain at current prices, but I don't expect TRQ's prices to witness any significant improvement in the short-to-medium term.

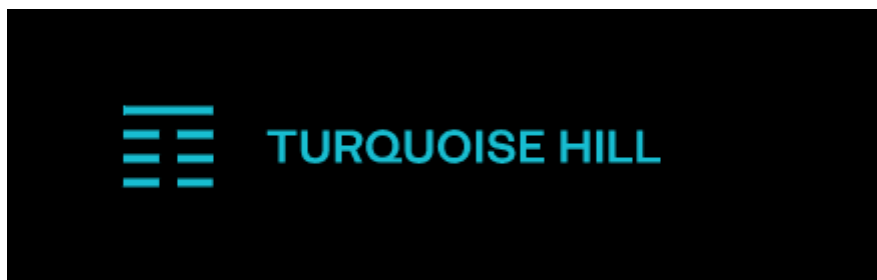


Figure-1 (Source: Company Website)

### The challenges

TRQ's Q2 2019 production report has brought sheer disappointment for the investors. We see that despite witnessing the highest volume of ore mined during the past five quarters, Q2 2019 saw OT (read: Oyu Tolgoi) delivering the most terrible copper grades since Q2 2018. TRQ's gold production profile was no different and Q/Q average gold grades nose-dived from ~0.58 g/t in Q1 2019 to ~0.31 g/t in Q2 2019.

If this would have been a temporary condition, we could have hoped for better times in the medium-to-long term. The dilemma with TRQ is that almost every quarter, more negative catalysts pop-up and hammer the share price to new lows, with a lower likelihood of recovery. TRQ is currently trading at the lower end of its 52-week price range. Given its current PE multiple of 2.5x and PB ratio of 0.123x (Figure-2), the stock appears to be trading dirt cheap.

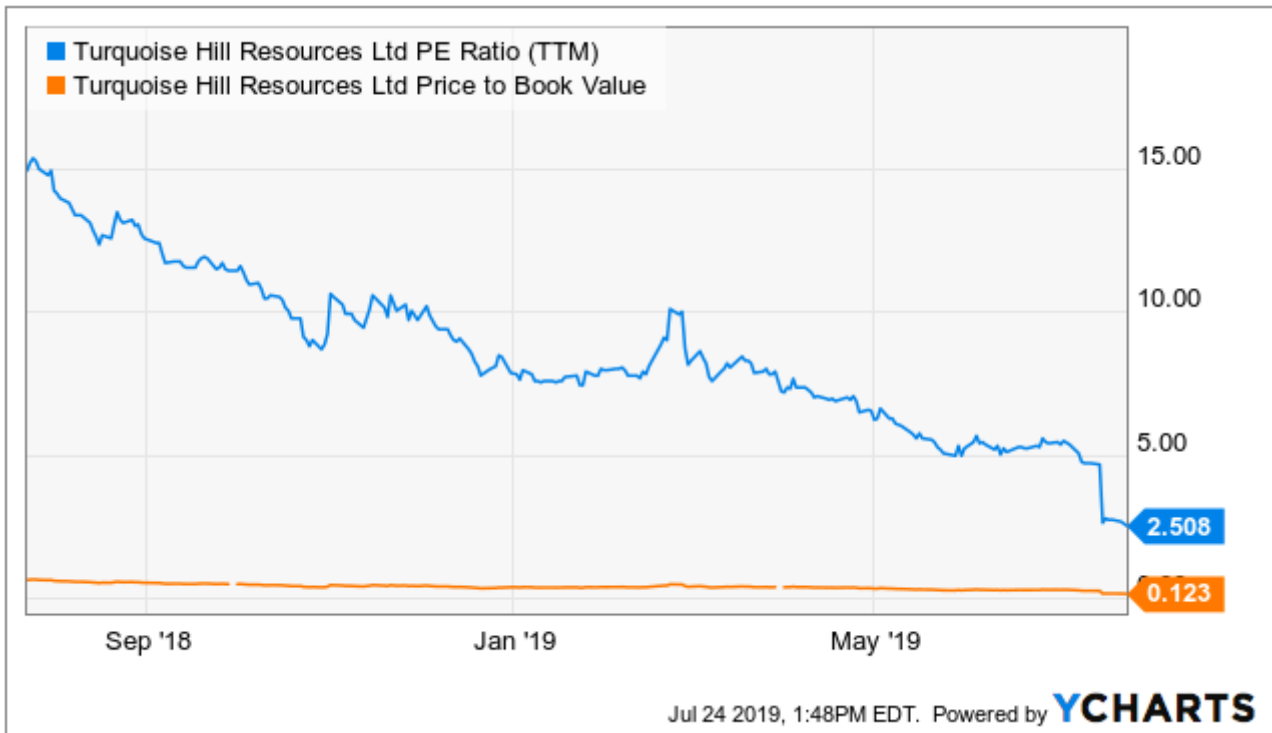


Figure-2 (Source: YCharts)

This idea is reinforced by the fact that TRQ's sole mining asset namely Oyu Tolgoi (which is currently under development) is expected to produce ~550 kT of copper and ~450 Koz of gold during the period from 2025-2030. In fact, as soon as TRQ completes the development of its HNE-1 (read: Hugo North Extension Lift-1) mineralized deposit at OT, its share price would increase manifold. But the question is, when will that happen?

TRQ's operational profile has disappointed the investors for a long time, and there are multi-faceted challenges for the company. A leading challenge for TRQ is timely completion of the mine. TRQ stated in Q2 production report,

Turquoise Hill, in conjunction with Rio Tinto, continues to review mine design options for the completion of the underground development of the Oyu Tolgoi mine and assess the impact on overall cost and schedule for the underground development. Based on these options, preliminary estimates indicate that **sustainable first production could be delayed by 16 to 30 months** compared to the original feasibility study guidance in 2016. This range includes contingency of up to eight months reflecting the unexpected and challenging geotechnical issues, complexities in the construction of Shaft 2, and reflects the detailed work still required to reach a more precise estimate. The **development capital spend for the project may increase by \$1.2 to \$1.9 billion** over the \$5.3 billion previously disclosed. This results in sustainable first production now being expected between May 2022 and June 2023.

The above statement highlights a few problems faced by TRQ. Previously, TRQ has claimed in multiple presentations that its first sustainable production from OT mine will be delivered in FY 2021. In the current production report, TRQ has extended the planned timeline for such completion to lie somewhere between FY 2022-23. Another less obvious red flag is management's caution regarding the underlying mining potential of the OT mine. If investors go through TRQ's previous presentations and then through the more recent presentations of May and June 2019, they will realize that TRQ's management has now begun omitting a table that showed the expected mine production profile for the next 5-8 years. I'm referring to the chart in Figure-3 which no longer appears in current presentations.

## Robust long-term production profile

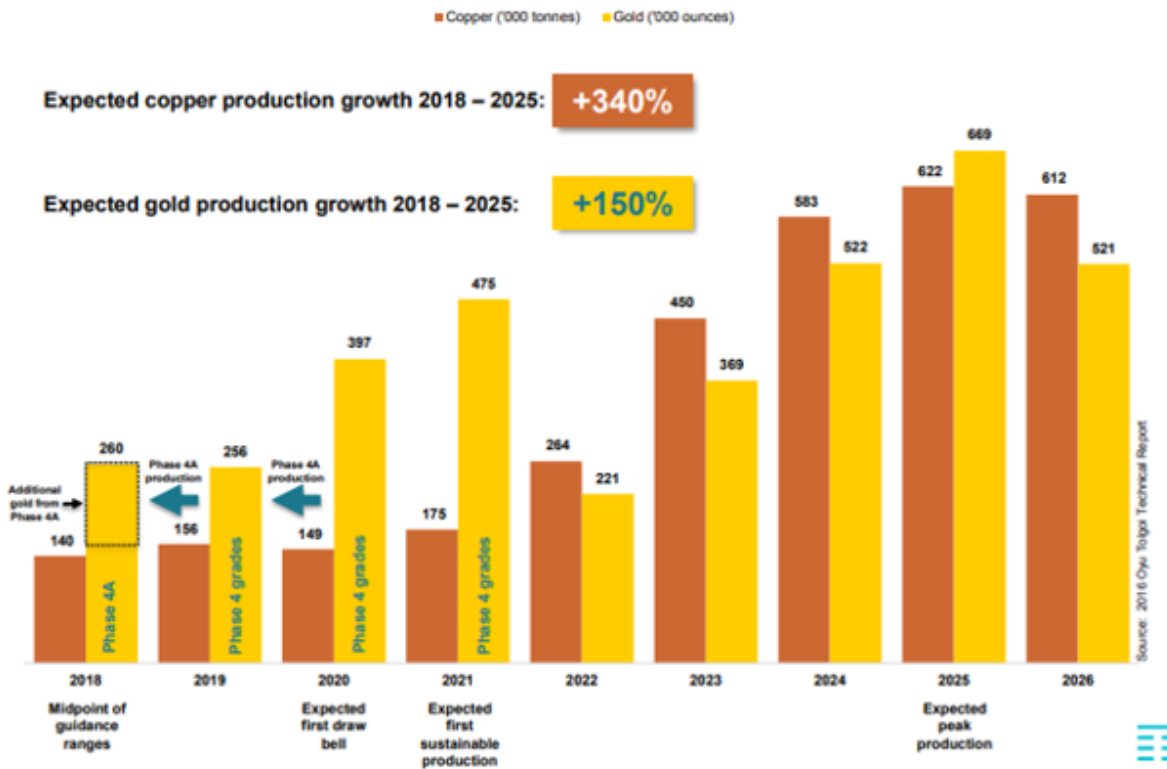


Figure-3 (Source: Previous SA article)

It seems that management itself is uncertain about the production potential of the mine, and is intentionally avoiding its concurrence with the previously announced tentative production estimates. Well, you have been cautioned.

Another issue is the provision of development CAPEX. Previously, this was estimated around \$5.3 BB. Due to poor recovery grades at the mine site, geotechnical challenges, and issues with Shaft-2 construction, TRQ plans to deviate from the initial mine plan. In simple words, it means more CAPEX spending. Management believes that it would incur an additional ~\$1.2-1.9 BB in CAPEX. Due to volatile copper prices, and the more recent poor grades that result in higher mining costs, TRQ cannot fund its CAPEX from operating cash flows. RIO is the mine operator and has provided for CAPEX funds so far. With the expected additional CAPEX piling up, RIO might not want to fund the incremental spend and may search for a joint venture to support mine development. This would mean a further diminution in shareholder value that's already suffered massive dilution due to the expected delays in mine completion.

Next, there's the panic effect associated with TRQ's stock. Against the better expectations of the investors, RIO has not increased its shareholding in the OT property. RIO hasn't disposed of its existing investments either. There are very obvious reasons for RIO not disposing of its investments. The global mining giant is leveraging from strong iron ore

prices but does not want to sell its interest in one of the world's largest copper (and gold)

property. It could be debated as to why RIO has not yet increased its stake in TRQ despite the project's very promising mining potential and given its current shredded prices. Since RIO hasn't provided any official update on this so I'd avoid speculative discussion on the topic.

## My expectations

Due to lower ore grades, production costs will be higher during Q2, on a Q/Q basis. Top-line revenues would be affected due to depressed copper prices that tumbled during Q2 2019 (Figure-2) although the impact will be mitigated to some extent, thanks to the higher gold prices. Consequently, I expect Q2 2019 EPS to miss the target and it may well come out negative (that is, a loss/share).



Figure-4 (Source: Infomine)

From an operational perspective, I expect H2 2019 to be unimpressive. TRQ is transitioning its ore processing from mining Phase 4A to mining Phase 4B and to Phase 6. Consequently, the mining grades (of both copper and gold) are likely to be affected and will reflect negatively on mining costs. Q3 2019 could well be another rough quarter but things could improve slightly in Q4 if Shaft-2 commissioning happens on time (expected October 2019, as per TRQ's management).

## Investor Takeaway

In the preceding discussion, we have seen that TRQ is currently surrounded by multiple challenges, and timely completion of HNE-1 is one of the most significant challenges. Management looks uncertain about the mine completion timeline as well as the underlying resource potential. This situation is alarming for the investors and causing share prices to edge to new lows. Further, the much-awaited acquisition of further stake (in TRQ) from RIO is simply not happening. RIO's silence in the matter is what builds more downside pressure on the share price. Rest assured I don't expect any material upside during H2 2019 due to the operational challenges currently being faced by the company.

**Disclosure:** I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

**Editor's Note:** This article covers one or more microcap stocks. Please be aware of the risks associated with these stocks.

## Comments (14)

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### **FIFOkid**

Truthful analysis from a party who likely has Mongolian roots. I won't touch this because I know that Russian or Chinese operators in Mongolia receive favorable terms over a western one.

30 Jul 2019, 02:06 PM

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### **SantaCI**

If TRQ can assert some independence from RIO the stock will be a huge winner. With the incompetence and corruption at Rio Tinto, I now believe they're a bigger threat to the projects success than the Government of Mongolia

30 Jul 2019, 04:12 AM

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### **lwpcolonel**

Where Is TRQ Heading?

In previous articles the unresolved Tax issue regarding the Mongolian government had been a major hurdle that you cited as needing resolution. How has that aspect of the TRQ disaster played out over the past few months?

Fortunately we had shares in 2 Discretionary accounts. Only the shares which we had sold 'Covered Calls' on however, we found ourselves stuck with them mostly because we had intended to keep them rather than trade them.

29 Jul 2019, 11:39 PM

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### **Aitezaz Khan, Contributor**

Author's reply » TRQ will likely be flat for a year or two. There's no recent update on the Mongolian tax

issue, TRQ paid \$5 MM but the rest is disputed, and case is impending resolution.

Long-term holders have been forced to hold much longer or suffer making losses, but I also doubt the role of GoM which demands more transparency and expects a vote in Parliament (in August) against certain aspects of the OT investment agreement.

<https://reut.rs/2ZpQZ76>

30 Jul 2019, 03:26 AM

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### **MBM69**

TRQ at current levels is one in a life time chance. It reminds me AMD when it was at \$ 1.50 and everyone said to run away from the stock.

29 Jul 2019, 11:28 PM

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### **Gold Lion**

I'm a patient investor. TRQ will be a 30 bagger so I'm happy to buy more lower. In 5 years copper will be double and gold substantially higher. Buy when everyone hates it.

29 Jul 2019, 09:53 PM

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### **apdamico**

I'm a buyer at \$.35!

29 Jul 2019, 07:57 PM

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### **cashewking**

The same bearish analysis again mostly like from a short seller! There are issues for sure but also positives that never get mentioned!

29 Jul 2019, 05:18 PM

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### **dfsmshsm**

Interesting that you don't mention political concerns - that the government might assert that there has been tax evasion, or demand changes to the terms of the mining lease.

29 Jul 2019, 05:15 PM

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### **10210951**

there is just noise from Mongolia, there will be no material change to the IA. there maybe alot more social programs, local employment etc....But what we want is more transparency from TRQ and that minorities will NOT be pushed around anymore...time for Pentwater, Sailingstone, capital group to join forces and speakout loudly!!!!

29 Jul 2019, 06:22 PM

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### **10210951**

hoping that minorities will again push strongly and this time win a few board seats!!! TRQ mgmt is put there to serve the interests of Tinto only.....

29 Jul 2019, 05:03 PM

**MyTurnNow**

Hoping for a big rebound from here. Buying!

29 Jul 2019, 04:44 PM

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**Aitezaz Khan, Contributor**

Author's reply » Your hopes are well placed. But I'd add:

A big but SLOW rebound. Patience is the key, yes.

29 Jul 2019, 10:53 PM

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**redpepper530**

If you look at sales in the last quarter they are substantially higher than production , this should bode well for Q2 financial report.

I believe T.R.Q. is oversold, barring major changes in the agreement with Mongolia, their cash reserves are very decent after Q1 and should be added to in Q2.

29 Jul 2019, 04:25 PM