



"Mongolian Investment Strategy update"

Frontier has revised the model portfolio based on our observations on current economic/ market conditions and policy developments in Mongolia.

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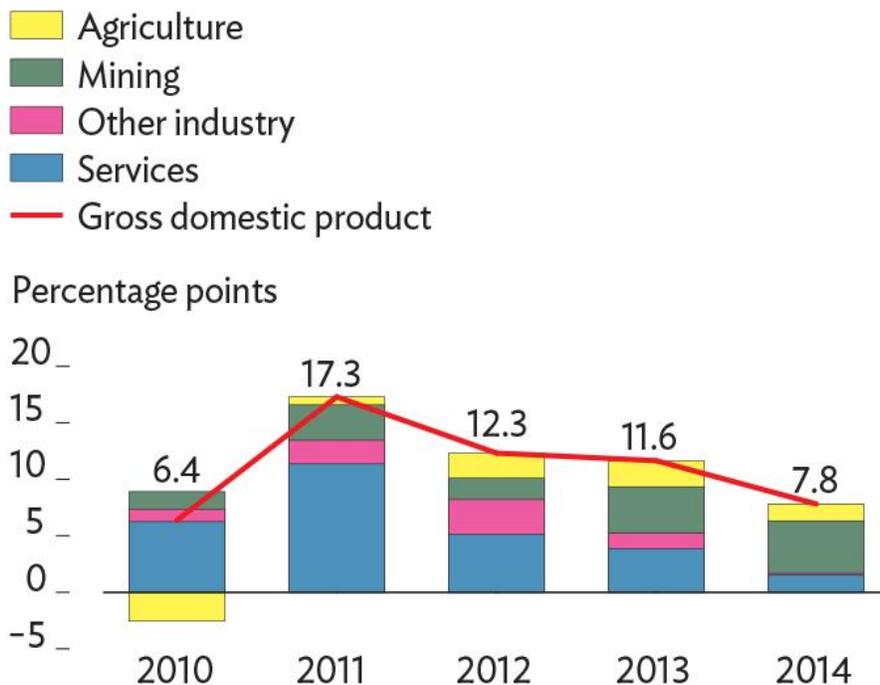
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Our beliefs are based on following assumptions

1. Just recently Asian Development Outlook (ADO) has been released by the Asian Development Bank. According to the report, despite robust growth expected in agriculture and expanded extraction at Oyu Tolgoi (OT), albeit less than in 2014, GDP growth is forecast to slow to 3.0% in 2015 as falling prices for exports are felt and as monetary and fiscal policy are tightened to contain inflationary and BOP pressures. Based on the assumption that Industrial production will grow more slowly than in 2014 as a credit squeeze affects construction and real estate, we are putting more attention to the mining industry.

Sector contribution to GDP



Source: ADO

2. Based on the assumption that Oyu Tolgoi will operate in its full capacity, and expectation of successful negotiation of Tavan Tolgoi deposit takes place, we are increasing the mining shares weighting to the portfolio, with little structural change within mining section. Regarding financing of the underground mine of Oyu Tolgoi project, Sam Walsh, CEO of Rio Tinto has stated that 'Negotiation can wait until the get it right and there is no deadline, since the project is planned to continue for 50 years' during the interview. Therefore we are not fully convinced that the underground expansion of Oyu Tolgoi might not develop in 2015. Share price of Turquoise Hill Resources has been steadily outperformed compared with other mining stocks. Especially share price of Turquoise Hill Resources has been increasing steadily since January 2015. According to the latest release of the company's financial review of 2014, Turquoise Hill recorded net income of \$31.8 million (\$0.02 per share), with losses (including charges for impairment) relating to SouthGobi partly offsetting Oyu Tolgoi's results.



3. We are still cautious about the coal price given the still dull coal business out of Mongolia to China. Coal price in the international market seems not to recover soon, therefore, most of the share price of the coal companies on the decreasing trend. According to the foreign trade data as of February 2015, coal export decreased by 43% year on year in terms of volume value. We, therefore, decreased the weighting of coal shares. On the other hand, gold industry might perform well because of the recent favorable policies by the Government towards the gold mining industry.
4. We are not highly optimistic about real estate sector in general given the weaker trend of the real estate price and lagging nature of the industry when the economy is deteriorating. However, real estate market has been growing steadily by around 2% each year since 2011, despite the slowdown of GDP growth. Based on the expectation that the pace of the growth continue, we are keeping APIP and Nukht village shares at the same level.
5. Financials should be reduced because of the rapidly increasing non-performing loans. However, among the sector, the consolidation and fly to quality will be materialized more quickly than originally anticipated. Therefore, we have added weighting of Khan Bank, added XAC bank to the list and reduced the weighting of non-banking sector.
6. Tourism and hospitality industry should be increasing as the tourism season is approaching. Out of clothing sector, the performance of Gobi Cashmere in 2014 was well and we expect it will go stronger during the tourism season.
7. We are increasing the weighting of USD cash position because of the weaker BOP and worsened credit rating to Mongolia.

1. Mining industry

Oyu Tolgoi news and Turquoise Hill Resources

Morgan Stanley downgraded shares of Turquoise Hill Resources (NYSE:IVN) to an equal weight rating in a research note released on Tuesday morning, 24 March 2015. Analysts at TD Securities upgraded shares of Turquoise Hill Resources to a buy rating in a research note on Tuesday, January 20th. Separately, analysts at Bank of America downgraded shares of Turquoise Hill Resources from a buy rating to a neutral rating in a research note on Tuesday, January 20th. OT has filed a statutory 2015 Oyu Tolgoi Feasibility Study (OTFS 2015) with the Mongolian Minerals Council (MMC). OTFS 2015 is based on the same study as, and is consistent with, the 2014 Oyu Tolgoi Technical Report, which was disclosed by Turquoise Hill in October 2014. However, since the specific commencement date for development of the underground Hugo North block cave is unknown and dependent on resolution of shareholder matters, the OTFS 2015 study reserve case presents the underground without a start date and separate from the open pit. Oyu Tolgoi open pit mine however, performed very well in 2014, recording net revenue of approximately \$1.6 billion in 2014 on sales of approximately 148 400 tonnes of copper in concentrates. In 2015 Oyu Tolgoi is expected to sell 175 000 to 195 000 tonnes of copper in concentrates. Implementation of cost savings and productivity initiatives are still underway, therefore, on the expectation of Oyu Tolgoi performance we are increasing Turquoise Hill Resources weighting to 22%.



Price chart of Turquoise Hill Resources



Source: Bloomberg.com

2. Weaker coal Market

Contract negotiation of strategic investment in Tavan Tolgoi deposit is at the center of attention of the country’s coal industry as well as other international investors.

Despite the fact that demand from China deemed and the price is not getting strong, consortium of Shenhua Energy, Sumitomo corporation and MMC expressed their interest in going into contract with Mongolian Government on investing in the Mongolia’s biggest coal deposit. Building of railway connecting ETT to the Chinese border, which could cut the transportation cost by 15 dollars per ton, is included in the investment requirement. Given the current profitability is very low (around 5USD/ton), the possible reduction of the transportation cost will be very positive to the fundamentals of ETT and the coal industry in Mongolia.

Despite the tax dispute, share price of SouthGobi Resources Company increased almost 100% at the beginning of March, shortly after the announcement private placement for proceeds of up to US\$7.5 million with Novel Sunrise Investments Limited as a proposed new significant investor and strategic partner. However, court decided the tax dispute in favor of tax office, which in this case South Gobi sands stated earlier that SGS will be forced to go into bankruptcy. Therefore, we are no longer keeping South Gobi resources in the portfolio.



3. Other sub sectors

Based on the recent favorable policy for gold miners and lifting up of suspension of mining licenses, we are adding companies with gold assets in Mongolia. As for the commodity market outlook for 2015, zinc price is forecasted to stay strong; therefore we are including Tsairt in the portfolio.

4. New Mineral Law

Government is taking several measures to improve investment climate. Among those, one of the biggest topics for the investment community will be the revision of the mineral law which is expected to pass this summer. The suspension of new mining exploration permits have been lifted as well. New law allows large mining projects by considering a reduction of its equity stake in strategic mines in exchange for higher royalties.

5. Real Estate Market and Construction

Real Estate Market has been growing steadily by around 2% each year since 2011, despite the slowdown of GDP growth. Based on the expectation that the pace of the growth continue, we are keeping APIP and Nukht village shares at the same level. However monthly residential price index is at the lowest level since October 2013 and 5.06% lower on year on year level. Based on the credit availability and slowdown of the economy, we are assuming that the weak trend of real estate still continues, and the price may be still under pressure.

Also infrastructure projects such as Egh river Power plant and highway road to the Khushigt airport is planned to take place in 2015. Therefore, we have decided to keep Asian Pacific Investment Partners (APIP), the holding company of real estate, cement, brokerage and Remicon, cement and concrete producer. On the other hand, as construction industry peak season is approaching, we also are keeping shares of Silicate, JSC.

6. Financials

We have reduced the weighting of Financials to 10% because we are worried that non-performing loans of banks will go up significantly in the next 12 months. By the latest news of Bank of Mongolia, non-performing loan has increased by 10 percent since the beginning of 2015, and by 47 percent on year on year level. Continuously weakening Tugrik will be adversely impacting to the fundamentals of the sector as well. As we mentioned before, consolidation of the sector will be coming earlier than we have expected. So, “Fly to Quality” will be the main theme in the industry in a next two or three years. Therefore, we continue to favor two healthy banks (Khan and Xac) among the banking sector. Xas Bank has just also released its 2014 performance and it recorded 11 billion tugriks of earnings after the tax. On the other hand, we have decreased the weighting of other financials as their financials are weaker and vulnerable to the weak economy.

7. Tourism

We have increased the weighting of Tourism sector because the sector will not be impacted so much by the weak currency and also the peak season of the tourism is near. Therefore, we have increased the weighting of Bayangol Hotel. Bayangol hotel has performed well in 2014 according to the financial statement release and recorded 2 billion tugriks net profit. We increase the proportion.



8. Clothing

We have reduced the weighting of Gobi Cashmere merely with the expectation that it would perform well during the tourism season.

9. MSE Indices

We were bullish on MSE listed stocks after we have confirmed the strong commitment of the Government to restructure the exchange. However the TOP-20 index is on the decreasing trend since July 2014. But we are still optimistic about the Mongolian financial market as it is receiving particular technical assistance in the framework of EPA between Japan and Mongolia.



Source: MSE

10. Cash (USD)

We are increasing the weighting of USD cash position because of the weaker BOP and worsened credit rating to Mongolia. Also we are not particularly optimistic about increase of FDI in near future, which could affect the USD rate significantly.

Conclusion

Based on the above reasons, we have newly created the model portfolio.

We have increased the sensitivity to the upside potential given the increasing favorable policies been implemented in a future.



Model Portfolio	Weight
Mining and quarrying	49% (+4%)
Coal	17% (-3%)
Mongolian Mining Corp.	7%
TavanTolgoi	4%
Baganuur	3%
Prophecy Coal	3%
Copper	22% (+7%)
Turquoise Hill Resources	22% (+7%)
Gold	7% (+2%)
Entree Gold	5% (+2%)
Voyager Resources	2%
Other Metals	3%
Tsairt (zinc)	3%
Real Estate	6% (-2%)
Asia Pacific Investment Partners	3%
Nukht Village	3%
Construction	2%
Cement / Concrete	1%
Remicon	1%
Construction	1%
Silicate JSC	1%
Financials	10% (-3%)
Khan Bank	5% (+1%)
XAC Bank	5%
Tourism	11% (+3%)
Genco Tour Bureau	3% (+1%)
Ulaanbaatar Hotel	4% (+1%)
Bayangol Hotel	4% (+1%)
Manufacturing	11% (+2%)
Food Items	4%
APU	4% (+2%)
Clothing	4%
Gobi	4%
Steel	3%
Khukh steel	3%
Wholesale and Retail Trade	4%
Wholesale and Retail Trade	2%
State Department Store	2%
Bonds	0%
Government Bonds	0%
Corporation Bonds	0%
Cash(MNT)	7% (+2%)
Short Term Instruments	5% (+2%)
Long Term Instruments	2%

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