"The outlook of the Mongolia Coal in 2017"

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The coal prices have risen quite sharply in the 2nd half of last year.
And, that led producers of Mongolian coal to increase their production at higher price.
So, How about 2017?
Although the consensus opinion is still optimistic about the outlook of the coal price and the coal export to China, we are cautious about the outlook.
Below are the studies on the issue and our proposals to overcome the challenges.

#206, Elite Complex B,
Chinggis Avenue 14, 1st khoroo
Sukhbaatar district
Ulaanbaatar,
Mongolia

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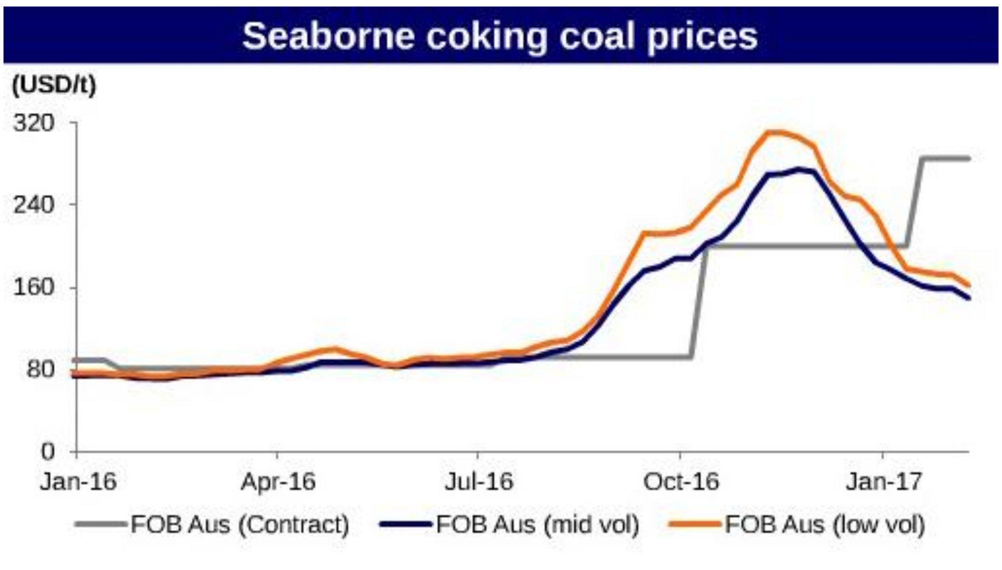
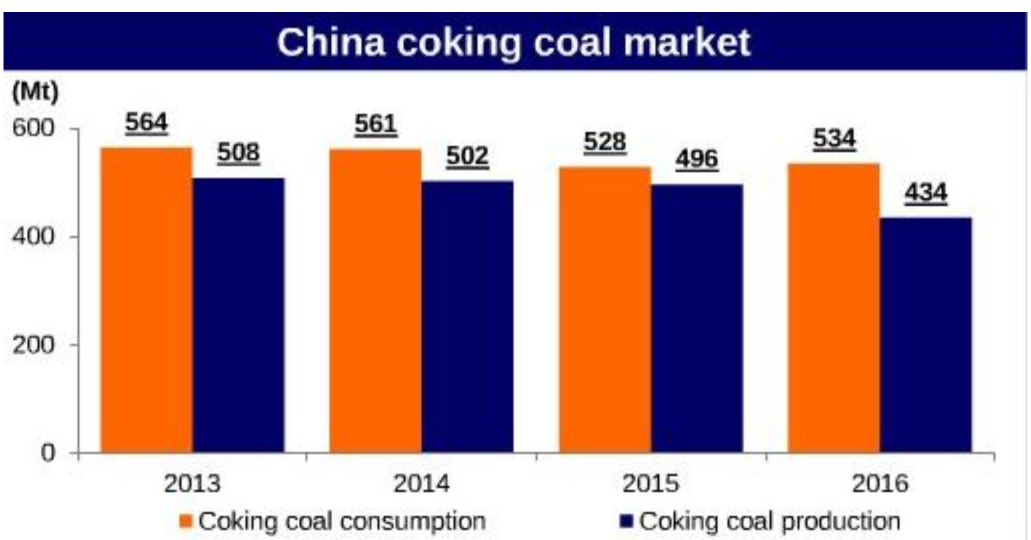
In the 2nd half of 2016, Seaborne coking coal prices have risen 3-4 times in a short period of time.
After that event, the situation on Mongolian coal has dramatically changed favorably.



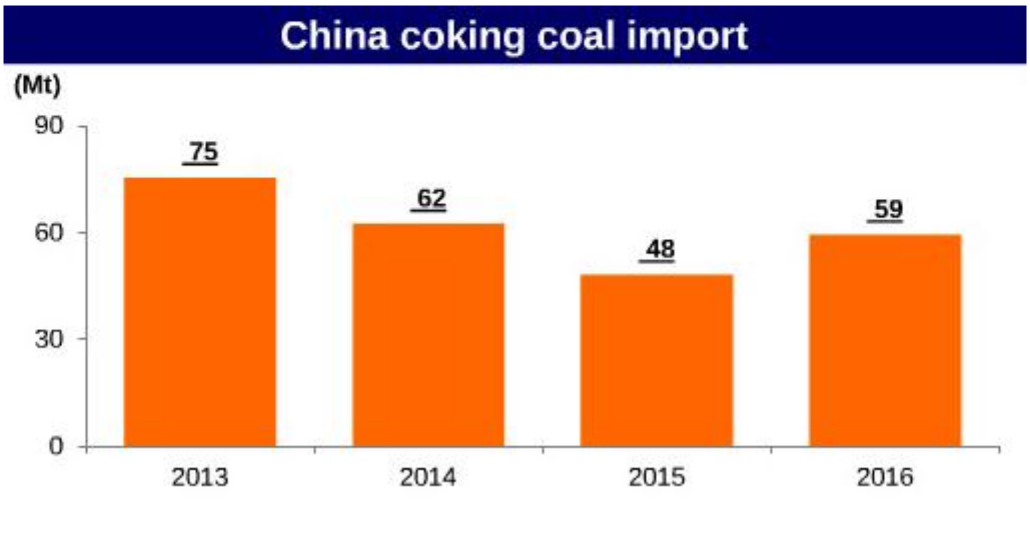
SOURCE: MONGOLIAN MINING CORPORATION

The main reason of the increase was due to the supply shortage rather than the increase of the demand.
Coking coal production in China has been reduced 15% last year due to the limited supply of coal inside china.



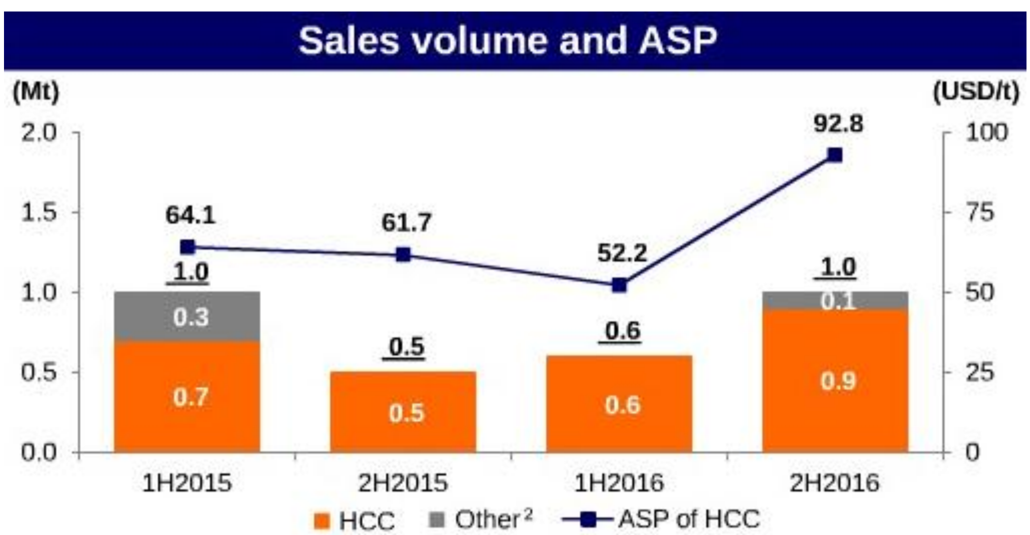
SOURCE: MONGOLIAN MINING CORPORATION

Because of the limited supply, the gap between the consumption and the production in China which has reduced to only 32 Mt in 2015 from 56 Mt in 2013 has widened sharply to 100 Mt in 2016. So, that has given room for the price increase and the imports to grow substantially in the 2nd half of 2016.



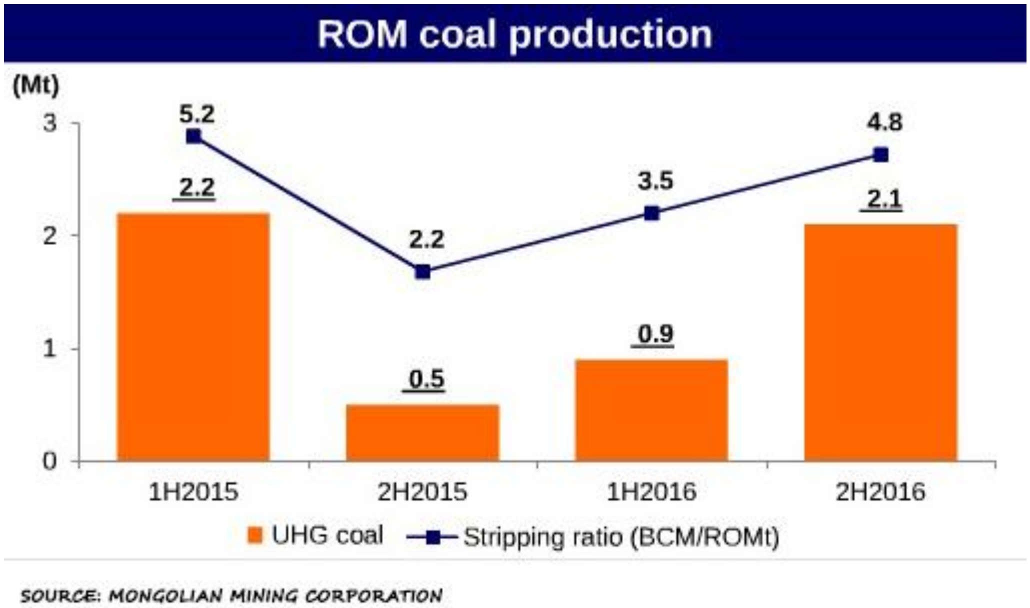
SOURCE: MONGOLIAN MINING CORPORATION

The higher demand to overseas coal including that to Mongolia has benefited Mongolia Coal last year. Speaking of Mongolian Mining Corporation (MCC) as an example, the average selling price (ASP) of Hard Coking Coal (HCC) has increased from 52 USD in the 1st half of 2016 to 93 USD in the 2nd half of 2016. Also the sale volume has almost doubled in the same period.

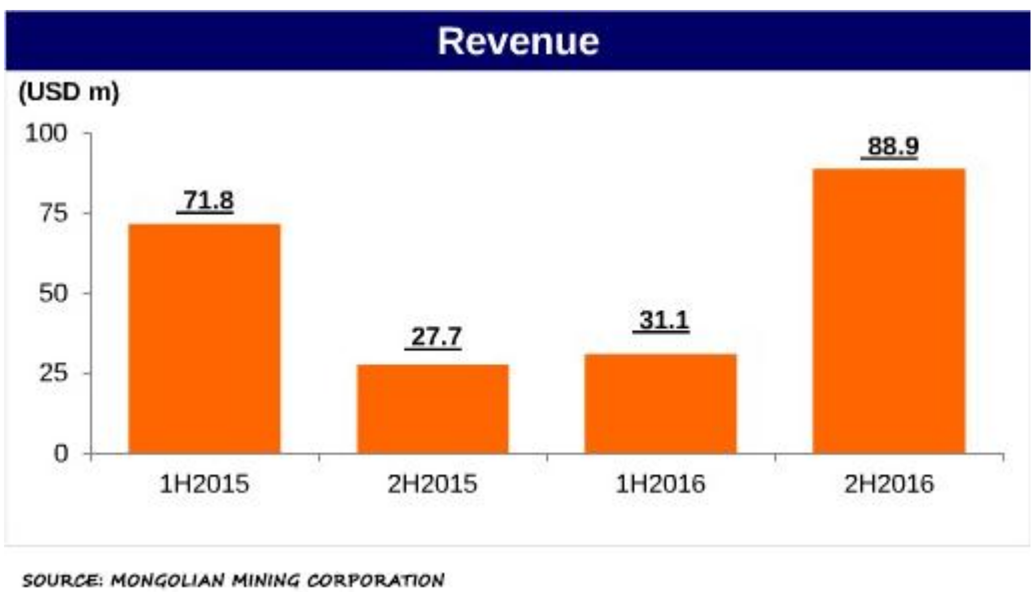


SOURCE: MONGOLIAN MINING CORPORATION

So the production of the major Mongolian coal producer has increased rapidly in 2016.



Therefore, the revenue of the company has almost tripled in the same period.



So, how about 2017?
Will this year be a good year for Mongolian Coal Producers as well?
That depends on the coal price in the world.

According to the Commodity Markets Outlook published last month by World Bank, Coal prices are expected to average $70/ton in 2017(up 6 percent from 2016) due to continued efforts by China to reduce coal supply. We also think that China's coal policy will be a key determinant of coal prices given that the country consumes half of the world's coal output and that coal accounts for nearly two -thirds of the country's energy consumption.

Benefited with the firm coal price, Chinese major coal producers are generating solid earnings. Shenhua, one of the largest integrated coal based energy companies in the world has recently announced their 1st Quarter earnings and has beaten the street consensus on (good cost management and) strong coal price. China Shenhua reported 1Q17 net profit after tax (NPAT) under IFRS at RMB12.9bn rising by 173% YoY(year on year). The strong 1Q17 profit is better than expected. We attribute the earnings beat mainly to the profit increase of coal segment (Gross Profit +441% yoy) due to coal price hike (+57% YoY) and continued cost cuts (unit production cost -6%), which more than enough to offset the profit drops in electricity power business. Shenhua expect earnings outlook remain strong and 1H17 profit likely grow by over 100% with coal price fluctuating at high levels on year on year basis and the strong 1Q17 result.

However, we are not that optimistic about the future outlook of coal price.
According to a coal expert in China, 276-day restriction which has triggered the supply shock of the coal industry in China is unlikely to execute in large scale. We believe the 276-day restriction is still the key for the coal market in Fiscal Year (FY)17. Although the government's attitude was very determined to resume the 276-day rule after the heating season at the start of this year, we believe that the tone has recently softened. So, we think the 276-day restriction is less likely to execute in large scale. In addition, we see coking coal price (HCC) more uncertain than thermal coal as supply control is not so serious for coking as thermal， and more coking coal miners have large scale production and have legal licenses.
So, we are not sure whether the stable coal price, particularly that of HCC can be maintained this year or not.
In this kind of environment, what Mongolian coal producers should do?

We believe keeping the cost competitiveness is the very important for them.
Mongolian coals have great quality of coal. And because they are located at open pit, the mining costs are low.
But, the transportation costs are high. Below is the trend of the transportation cost of MCC.

SOURCE: MONGOLIAN MINING CORPORATION

The cost should be decreased sharply IF the transportation using the trucks should be changed to that of railways.
And, this has been discussed for a long long time and has not been implemented.
We believe Government should work together with major Mongolian coal producers (Erdenes Tavan Tolgoi, Energy Resource, Small Tavan Tolgoi, MAK etc) and seriously think about financing for the new railway to China now to survive even when the coal price is falling!

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FRONTIER Securities
#206, Elite Complex B,
Chinggis Avenue 14, 1st khoroo
Sukhbaatar district
Ulaanbaatar,
Mongolia

Tel: +976 7011 9999
Fax: +976 7011 1991
Email: staff@frontier.mn
Web site: www.frontier.mn