Situation Update

Mongolian Mining Corporation – MMC (975 HK)

Oct 2022

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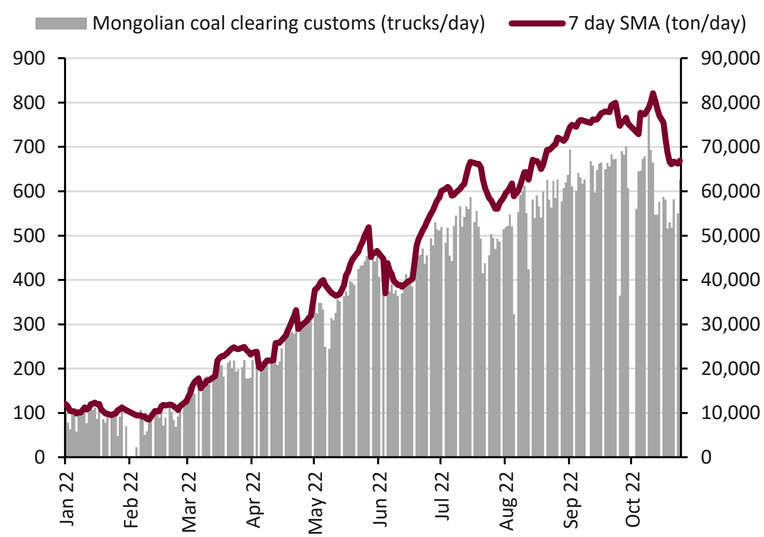
A Recap On The Situation

- We last published a detailed note on Mongolian Mining Corp (MMC) in March 2022 at which point, the company's market cap and enterprise value were just USD 400mn and USD 890m. Despite the improved and now excellent trading environment, the company's market cap and enterprise value are still just USD 300m and USD 760m. The original thesis was based on our observation that Mongolian coal exports were inflecting as border restrictions eased, facilitating sales into an undersupplied Chinese coking coal market at over USD 400/MT.
- They key drivers for a recovery in MMC's stock price were a recovery in volumes and pricing leading a rapid earnings growth and subsequent early retirement of its debt. Additionally, the completion and commissioning of the Tavan Tolgoi – Gashuun Sukhait (TT-GS) rail link would pave the way for reduced dependance on trucking and structurally lower transportation costs. Our original estimates were for FY22 volume of 4m MT at an average price of USD 200/MT with commensurate EBITDA of USD 370mn and valuation of less than 2x EV/EBITDA.
- Fast forward to October 2022 and most of our predictions have played out:
  - The recovery in volumes are generally in line with our expectations and we now expect FY22 HCC sale volume of 3.8 – 4.1m MT (2.2m MT done by 9M22 with 1.5m of that in 3Q22). This is on the back of a strong recovery in trucking volumes across the border exceeding 800+ trucks/day and expected to churn higher towards the end of the year.
  - Pricing has also remained strong - between USD 400-500/MT during May through July 2022 and has since maintained above USD 300/MT. Notably, and beyond our knowledge at the time, MMC was fulfilling committed pre-sales till early Oct 2022 and did not participate in these prices.
  - Our subsequent conversations with MMC since initial publication and what we were able to deduce from public filings indicate the pre-sales were fulfilled at between USD 110-160/MT. We have therefore moderated our estimates reflect the current spot prices and model in USD 180/MT for 2H22 as MMC rolls off the pre-sales.
- The TT-GS rail link commenced operations between Feb and Oct 2022. While the cross-border link directly into China still to be completed, news articles report that technical agreements are in place to make this happen within 1Q23.
- We therefore update our estimate for FY22 EBITDA to USD 315m with USD 130m in FCF which implies a FY22 EV/EBITDA of just 2.0x because the company's market cap and enterprise value of USD 300m and USD 760m is largely unchanged. The name remains equally unloved even in the high-yield market with the Perpetual securities and '24 Notes trading at around 34 and 57 respectively, despite a drastically improved cashflow profile.

Cross Border Trucking Recovery Quicker Than Expected

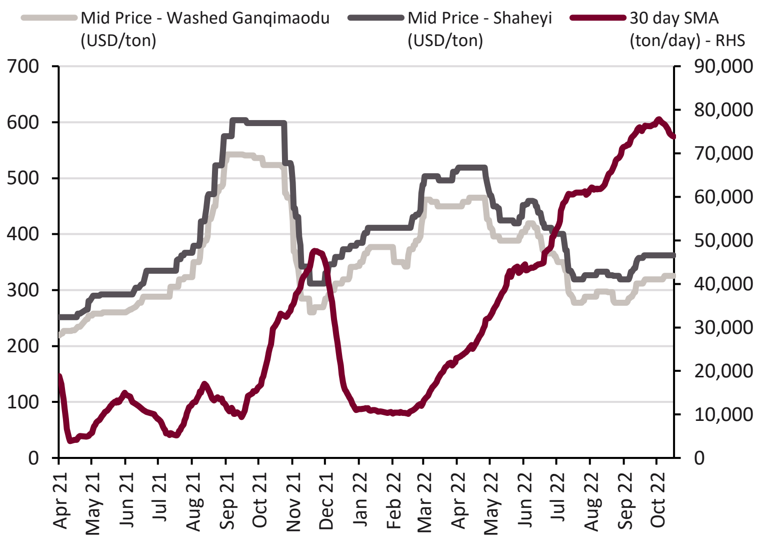
- In our initial update in March, we observed an impending recovery in trucking volumes that we believed, given the landed cost versus seaborne alternative, would reach pre-covid volumes more than 700+ truck per day by end FY22. That level was reached in August and now exceeds 800 trucks per day with authorities targeting 900+ trucks per day by the end of the year. At the end of August, MySteel reported that authorities had set a 2022 year-end target for HCC export volumes through Ganqimaodu of 17m MT, with a run-rate of around half that at the time.
- Achieving the target would minimally require daily throughput in excess of 600 trucks per day on average between Sep 2022 and the end of the year. Recent trucking numbers pulled back from 800+ trucks to about 500+ in the last week due to another spell of Covid-19 afflicting the area. A similar situation was seen in early June 2022 where volume recovered dramatically after a sharp drop.
- The current run-rate of 650+ trucks/day materially exceeds our initial assessment, and our updated estimates indicate that MMC will export about 2.8m MT in 2H22 closing out the year with around c.3.8m MT in volumes assuming 150 tons/truck.
- Updates from MMC point to pre-sales rolling off in the 2nd half of October at which point, MMC's realized prices should more closely reflect current market pricing. Our calculations indicate that pre-sales were conducted at between USD 110-150/ton whereas current market prices for washed HCC are holding steady between USD 280 – 330/ton. Pricing will likely remain strong, bolstered by expectations of a China reopening and recovery amid various other geopolitical stresses contributing to strong commodity prices globally.

Recovery in Ganqimaodu Throughput



Source: SXCoal

Pricing for Washed Coking Coal is Off Lows And Holding Steady

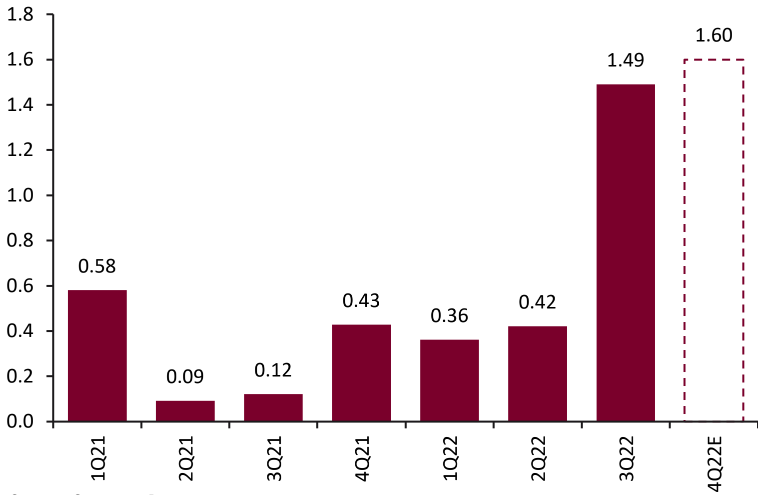


Source: SXCoal

Back Operating at Close to Capacity

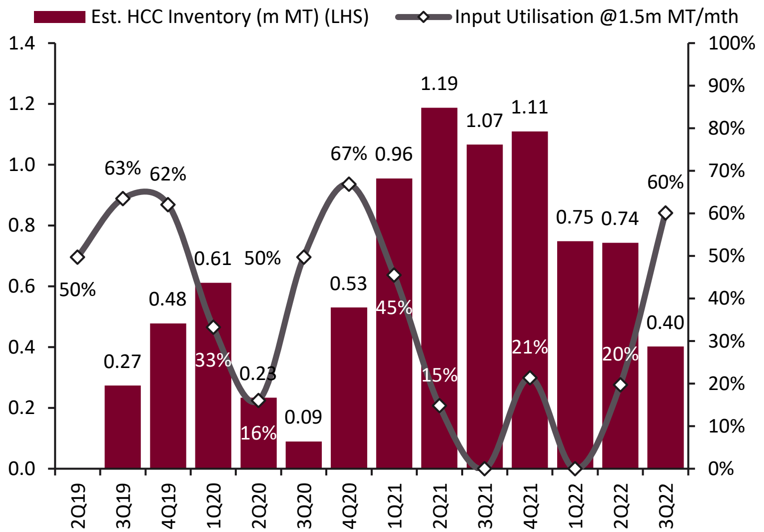
- MMC's sales volume is in excess of current RoM production evident with the sell through rate staying above 100% for longer
- MMC's estimated HCC inventory stockpile has drawn down to 0.3 – 0.4m MT. On that basis, we estimate that 4Q volumes will be between 1.6 to 1.8m MT. The high end of that estimate is close to the wash plant's capacity of 18m MTPA (at 45-50% yield).
- Comments from MMC indicate that they may increase the RoM throughput if they feel comfortable about the border situation normalising. Monetising their stockpile and operating at higher utilisation should also help to improve MMC's liquidity situation.

MMC Quarterly Volume Estimates (m MT)



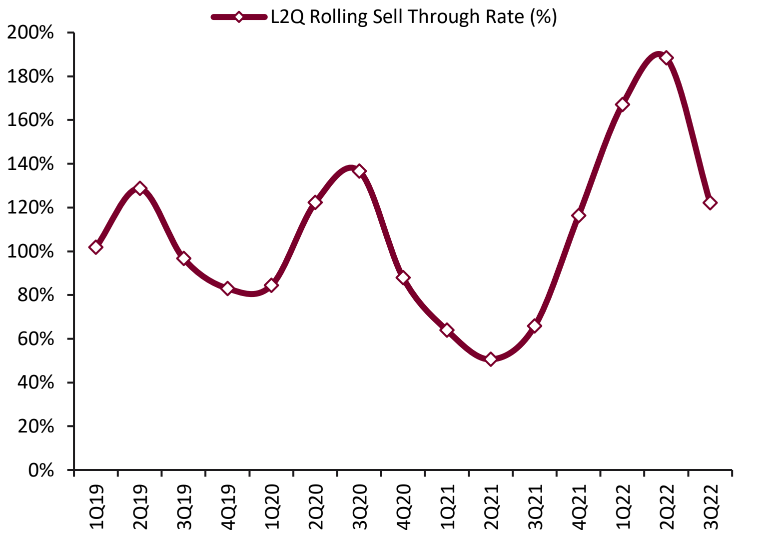
Source: Company Documents

MMC Inventory Estimates



Source: Company Documents

Rolling Last 2 Quarter Sell Through Rate (%)



Source: Company Documents

Rail Link Update: Tavan Tolgoi – Gashuun Sukhait

- Rail development from Tavan Tolgoi directly into the Ganqimaodu land port, while agreed in principle, is pending final design and technical approvals with respect to the rail gauge crossing the border. The TT-GS line is currently operating on Russian 'wide gauge' and the transit terminal is likely be the switching point to Chinese 'standard gauge'.

- As it stands, the TT-GS rail link is operational and brings coal from the mine to Tsagaan Khad (coal export terminal on Mongolia side) which then goes through the traditional customs clearing process via truck. Local articles and blogs have put out a range of dates for when decisions should be made regarding final technical design. Current expectations are that the rail link into Ganqimaodu should be settled by 1Q23 with a caveat that it could happen as soon as 4Q22, or as late as 4Q23.

- We estimate that that the rail line has another 5km to be completed with full integration to the Ganqimaodu land port. Throughput at the port will likely climb beyond 30m MTPA upon completion.

Source: Copernicus Satellite Imagery

Ganqimaodu Land Port Update

- While specifics of the rail connection are still being decided, satellite images show that the Ganqimaodu land port has undergone a significant capacity expansion to deal with the expected increase in throughput.
- More sheds have been constructed since May 2021 (seen in Yellow and Red) along with a truck marshalling yard to the north of the facility. Additionally, what looks like the initial stages of a rail marshalling yard can also be seen under construction north of the sheds.
- Statistics reported by SXCoal indicate that Mongolia was the top coking coal supplier to China for Sep 2022 followed by Russia at 3.21m MT and 2.45m MT, respectively. This makes up 83% of all coking coal imports into China for September. We think this trend is likely to continue with Mongolia taking an even larger share progressively owing to Russian supply being capacity constrained by limited rail infrastructure connecting directly to China.
- As mentioned previously, we believe incremental volumes from USA and Canada will also be limited as China looks to substitute its import sources to more friendly countries.

Source: Copernicus Satellite Imagerys

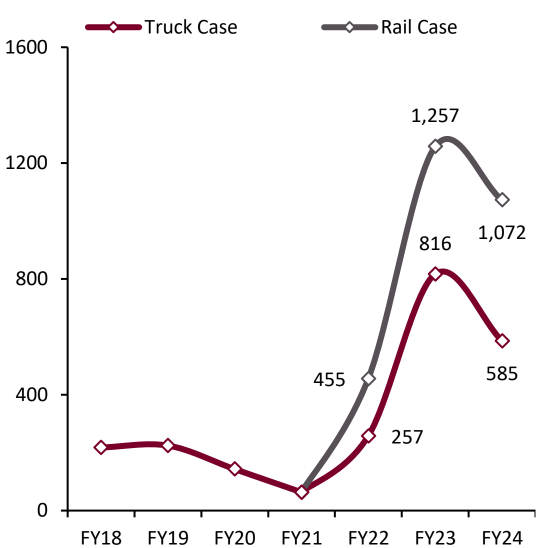
Current Run-Rate Higher Than Previous Bull Case

- MMC's 3Q22 operational update was in line with our updated estimates with 1.49m MT of washed HCC sold. As border restrictions ease, we have noticed that MMC's contribution to border volumes has increased from around 25% to 30% of total throughput.
- At our updated base case of 3.8m MT with an average price of USD 172/t over the year, we now estimate MMC will generate around USD 300m – 400m in EBITDA and USD 180m in FCF, corresponding to a valuation of just 1.5x – 2.0x FY 22 EV/EBTDA.
- Various local news sources have reported that the Tavan-Tolgoi Gashuun Sukhait rail link will export anywhere between 30-50m MT once the final connection over the border and into Ganqimaodu is completed.
- Our bull case estimates show how much of an uplift commissioning of the rail link would add to MMC in terms of both margin and volume. Notably, the wash plant will require significant expansion for this to be realised due to the existing capacity limitation of 18m MT per annum at around 50% yield.

Updated Core Assumptions

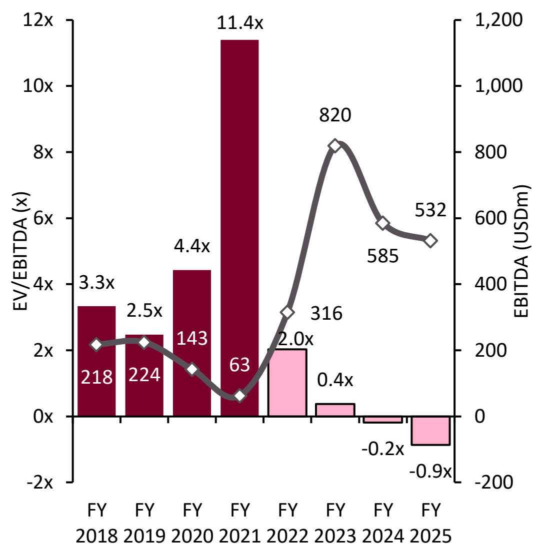
	HCC Price (USD/ton)	All-in Cost/ton	Capacity (Mtpa)	EBITDA (USDmn)
FY 22				
Base Case	170	85	3.8	257
Bull Case	200	80	4	455
FY 23				
Base Case	200	70	7	816
Bull Case	250	65	7.5	1257
FY 24				
Base Case	150	60	7	583
Bull Case	175	45	15	1072

Base Case (Truck) vs Upside Case (Rail)



Source: Wickhams Hill

Base Case EBITDA Target



Source: Wickhams Hill

Updates on MMC's Debt Securities

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- MMC has fully repaid the remaining USD 15mn due of the Sep '22 notes on the 29th of September. With these retired, the company has eliminated the variable interest rate component arising from the contingent value rights (CVR's).

- The USD 440m due Apr '24 notes are vanilla in nature and do not have any special covenants attached to them.

- The perpetual securities limit MMC's ability to pay a dividend to equity holders. We also note that the Sep '22 notes came with an additional debt service requirement where the company was only allowed to repurchase other parts of its capital stack if MMC had more than USD 75mn in cash available.

- In July 2022, as the company's liquidity started improving materially, MMC announced that they had repurchased another USD 22.1m (of notional value) in the perpetual securities at 35 cents on the dollar, reducing the existing notional amount of USD 149m (USD 52m market value). We see this as a positive indication that MMC is driving towards delivering significant shareholder return in the future.

- With the Sep '22 notes retired; we expect MMC to be much more active in repurchasing the remaining debt securities with market liquidity in the securities being the main limitation. Still, the perpetual securities are trading at around 36 and the Apr '24 notes trading at around 58 at the time of writing.

- While MMC likely has enough cash to tender for the remaining securities, we believe their prudence is wise as the market continues to deeply discount the debt, giving the company the opportunity to buy back more of the securities at a deep discount to fair value.

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