Turquoise Hill Resources (Q2 2017 results)

August 1, 2017

Corporate Speakers:

- Tony Shaffer; Turquoise Hill Resources; Head of IR and Corporate Communications
- Jeff Tygesen; Turquoise Hill Resources; CEO
- Owen Thomas; Turquoise Hill Resources; CFO (acting)
- Brendan Lane; Turquoise Hill Resources; VP of Operations and Development

PRESENTATION

Operator: Welcome to the Turquoise Hill Resources Q2 2017 Financial Results Conference Call.

Tony Shaffer: Welcome to our Financial Results conference call.

Yesterday, we released our second quarter 2017 results press release, MD&A and financial statements. These items are available on our Web Site and SEDAR. With me today is our CEO, Jeff Tygesen; Owen Thomas, acting CFO and Brendan Lane, Vice President of Operations and Development.

We'll take your questions after our prepared remarks. This call will include forward-looking statements. Please refer to the forward-looking language included in our press release and MD&A.

I'd now like to turn the call over to Jeff.

Jeff Tygesen: It's been good to see the copper market moving in a positive direction over the last few weeks and how Turquoise Hill's valuation has benefited alongside the upward moving copper prices.

I think this also demonstrates how quickly copper prices can move on potential supply constraints. We are even starting to hear $4.00 copper being discussed. This supports our long-term view that copper prices will not remain at current levels with the expected supply gaps anticipated to start around 2019 to 2020.

Recently, we were actively marketing to investors in June and July and it was good to hear from them their positive sentiment on long-term copper prices as well.

During the second quarter, Oyu Tolgoi had an excellent safety performance with an all injury frequency rate of 0.27 per 200,000 hours worked. With the ongoing increase in the underground workforce, Oyu Tolgoi has done a fantastic job introducing new employees and contractors to our strong safety culture. Underground development continued to progress. Lateral development advanced at a good rate during the quarter and shaft five saw its second highest month of sinking progress in June.

Brendan will provide more detail on underground development later in the call. While we continue to expect production from first draw bell in mid-2020 and sustainable production in 2021. Commissioning of a new crusher is expected to be complete in August, allowing for full utilization of the third development crew. We expect lateral development to increase with the introduction of the third crew. Crews four and five are in training and should be deployed in the second half of the year.

For the first half of 2017, Oyu Tolgoi spent more than $320 million on underground development. Going forward, quarterly spend is expected to continue to increase. At the end of June, Oyu Tolgoi had further capital commitments of $1.1 billion beyond spend to date.

Lastly, open pit operations continue to make the best of low grades and recovery challenges. The concentrator is on target to process 40 million tons this year, which will be a tremendous achievement and a first at Oyu Tolgoi. We expect gold grades and recovery to move up slightly in the second half of 2017. As such, we are maintaining our production guidance for the year. For 2017, Oyu Tolgoi's strategy is to focus on copper in order to maximize copper metal production, because copper share revenue is over 80%, when compared to gold.

Revenue in the second quarter decreased approximately 14% compared to Q1. For reference, first quarter revenue benefited from higher gold production in the latter part of the fourth quarter of 2016.

Operating cash flow for the second quarter was more than $50 million and almost $140 million for the first half of 2017 with Oyu Tolgoi benefiting from strong copper prices. That said, O.T. has worked extremely hard to control operating costs in order deliver positive operating cash flow.

I would note that since 2014, O.T. has removed over $200 million in operating costs. I previously made comments about two numbers to remember for Oyu Tolgoi, which are three and eight. Three years until production from the first draw bell and eight years until significant free cash flow from Oyu Tolgoi.

Our definition of free cash flow includes principal and interest payments for project finance and supplemental debt. Based on feedback from investors, we have a very conservative definition of free cash flow. We are told that depending on how we structure long-term financing for O.T., investors may not include principal repayments in their calculation of free cash flow.

If that was the case, it would like likely result in cash flows in less than eight years. Another major factor in such a calculation would be the price of copper. For example, the price assumed for 2017 in the technical report for the reserve case showed $2.15 per pound. Today, we are $2.80 per pound. Overall, current operations are performing well, despite the lower grade this year. Eighty percent of Oyu Tolgoi's long-term value resides in the underground.

From a near-term perspective, the most important value driver for Turquoise Hill is to deliver on the underground development timetable and production ramp-up schedule. This should enable good cash flow to Turquoise Hill and expected dividends to our shareholders. We are working closely with Rio Tinto to achieve these targets. I'm very happy to the concentrator’s performance history and what the team at Oyu Tolgoi has achieved. With that, I'm going to turn the call over to Owen to discuss the financial aspects of the quarter.

Owen Thomas: Revenue for the quarter was $204 million, decreased approximately 14% over the third quarter of 2017, reflecting lower concentrate sales and lower copper prices. Average copper prices in the quarter decreased by about 3% from the first quarter from $2.65 per pound to $2.57 per pound. Average gold prices for the quarter increased by about 3% from the first quarter, averaging $1,257 per ounce. Concentrate sales decreased approximately 4% over the first quarter.

Gross margin for the quarter was approximately 7%, down from 18% in the first quarter driven by lower sales revenue. Cost of sales included an adjustment of $4.00 million for a reversal of provision against concentrate inventory, reflecting the improved spot prices at the end of the quarter.

Finance costs of $41 million are presented metal amounts capitalized on underground construction for $47 million. Income attributable to Turquoise Hill shareholders in the second quarter was $24 million.

Cash from operating activities of $51 million reflects the impact of lower sales. Interest paid of $107 million includes payment of project finance interest of $99 million. Payment of project finance interest takes place twice yearly in June and December.

Capital expenditure on a cash basis was $205 million in the quarter compared with $148 million in the first quarter and includes $185 million for the underground project. Since January 1, 2016, the total amount spent on underground development is $548 million with capital commitments of $1.1 billion at June 30.

Cash generated from investing activities of $35 million in the second quarter compared with cash used for investment activities of $83 million in the first quarter. The change reflects increases to amounts withdrawn from the related party receivable. The increased withdrawals were needed in order to fund the higher level funds capital expenditure in the quarter and the payment of project finance interest and due to the impact of lower operating cash flows on cash available for reinvestment.

The next realizable value of copper gold stockpiles at the end of the quarter was $96 million, an increase of $15 million from the first quarter, due primarily to reduced estimated conversion costs per ton and increased estimated metal recoveries, both of which positively impacted the value of the medium grade stockpile. And net reversal of the income statement of $40 million was consequently included within operating expenses for the quarter.

In the quarter, we increased the total deferred tax assets recognized from $339 million to $368 million. This was the main driver of an income statement credit for income and other taxes of $24 million. The increase primarily reflects additional Mongolian operating losses and interest charges incurred but Oyu Tolgoi in the second quarter of 2017.

As June 30, Turquoise Hill’s cash balance remained consistent with previous periods at $1.4 billion. C1 costs in the quarter were $1.92 per pound compared to $1.85 per pound in the first quarter, mainly due to lower gold sales revenues in the second quarter.

That concludes my comments and I'm going to turn the call over to Brendan.

Brendan Lane: During the second quarter, the concentrator continue to process ore from Phase six, 4A and stockpile. As noted during first quarter results, Phase six is a challenging ore and complex blending is required for shipping specifications. Also, given the very low grades of gold expected in 2017, Oyu Tolgoi's objective this year, has been to maximize copper production and the resulting revenue.

We do this by using the highest copper grade available, which is currently Phase 6. Phase 6 also has another advantage of being a soft ore, enabling a higher throughput in plant compared to ore from Phase 4 and significant portions of the stockpiles. Oyu Tolgoi continues to perform well in managing this complex ore blending where it’s offsetting factors such as high arsenic and high pyrite level as discussed in previous quarter.

In the second half of 2017, we will continue to mine Phase six as an ore source as we move towards 2018 and a return to a majority of the harder southwest ores of Phase 4. Phase 4 ore will contribute to a slight improvement in gold grades in the second half of 2017 and significantly higher gold grades in the second half of 2018.

Planned concentrator maintenance during the quarter was carried out successfully by an all Mongolian management team without injury and encompassing over 20,000 hours through a temporary increased workforce of nearly 400 people. When taking this five day concentrator shutdown into account in the second quarter, the mill performed at a 40 million ton per annum rate with around a third of the mill feed being the softer ore from Phase 6.

This good plant performance is expected to continue through 2017 with the Phase 6 central zone ore. This also provides an indicator of performance when the Hugo North Lift one blockade eventually becomes a majority of the ore feed to the concentrator.

Moving to the underground. Overall development continues to advance and the workforce has continued to grow with over eight million man hours worked on the project to date. Camp expansion work continued during the quarter with increased deliveries of modular accommodation blocks ready to be installed. When fully complete, new camp will be a world-class large-scale accommodation facility more than 1,800 rooms, 18 buildings [and accounting] for over 5,000 people.

Since the project restart in mid 2016, we've completed over four equivalent kilometers of lateral development. The second quarter featured two of the three best months of underground development since project [restart], beating the previous best month in March 2017. During the quarter, important increased development enablers moved forward, including the mechanical completion of both the higher dewatering system and a new larger underground development crusher.

At the end of July, the crusher was in commissioning and is expected to complete in August, allowing for the full utilization of now deployed third crew. Development to the end of June was effectively carried out by only two crews. The fourth and fifth crews are expected to follow later in the second half of this year, their training currently in progress.

During second quarter, the shaft two [1202] lighting level mass excavation works were completed and sinking activities recommenced towards the 1256 level. The shaft two 1202 lighting station design included mass excavation of approximately 80 meters wide, 34 meters long and 22 meters high.

Shaft 2 will be a multipurpose production, service and [priming intake] ventilation shaft, moving up 30,000 tons per day as well as people and equipment. It will be 10 meters in diameter, concrete lined and sunk to a depth of 1,284 meters. The 60 ton production skips from 1202 and 150 person service cage operating primarily to the main access level of [1256] are designed for simultaneous posting of both ore and personnel. Sinking is expected to be completed in 2017 with [a fit out] planned to occur over 2018.

Process improvement initiatives during second quarter led to increased shaft five sinking rates around 40% compared to the first quarter. The better sinking rates over the last quarter are expected to continue going forward. Shaft 5 is expected to reach it's final depth in early 2018. We continue to expect that the lateral development rate we are currently seeing will provide a buffer to the longer than expected sinking of shaft five.

As such, we don't expect this materially impact the lateral development plan. In the coming quarters, we expect to see a step up in lateral development with July and August being targeted as the largest months since project restart.

Finally, we remain on target for production for the first draw point blast in mid 2020 and sustainable production in early 2021. That concludes my comments. I'll now turn it back to Jeff.

Jeff Tygesen: For the second quarter, open pit operations performed as planned with Oyu Tolgoi focusing on copper production in order to maximize revenue. We expect rate and recoveries to increase slightly in the second half of 2017 and we are maintaining our production guidance. The concentrator is on pace to have a record year. Underground development continues to advance. Lateral development is progressing well and sinking rates for shaft five have improved significantly. We maintain our expectation of underground production from the first draw bell in mid 2020 and sustainable production in 2021. That concludes our prepared remarks.

We are ready to take questions.

QUESTIONS AND ANSWERS

Operator: (Operator Instructions)

Ian Grundy with Scotiabank.

Ian Grundy: Hi, guys. Just a quick follow-up question on an interesting comment Jeff made there about free cash flow and principal repayments. What kind of quantum in the first few years of the ramp-up are you assuming for principal repayments on the debt in terms of that statement about free cash flow to shareholders?

Jeff Tygesen: So the terms of the agreement we have for the project finance have interest-only for the first five years. I think that gives us to mid 2021. It ramps up slowly and then we end up having it all paid off by year 2027. So the first couple of years are low and then ramps up to meet the total payment back by 2027.

Ian Grundy: Okay, that's very helpful. And then if the copper market does surprise favorably versus your expectations and if we did end up in closer to $4.00 a pound environment. How would you think about using any excess cash flow that you get over that time? Would it go to paying down the project finance faster or would you think about repayments to shareholders or expansions? Just if you could give some color there, too, that’d be great.

Jeff Tygesen: Four dollar copper would be great for everybody. We have a fixed payment scheduled currently. That would be an option to consider to repay earlier but one option considered today would probably be looking at any excess cash as a possible dividend earlier. But that would be a good position to be in at $4.00 copper.

Ian Grundy: Yes, certainly agree. That’s it for me. Thank you.

Jeffery Tygesen: Thank you for joining us today. Just a final comment. We continue to advance the underground and Oyu Tolgoi realizing it’s full potential.