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TRQ.TO - Q4 2016 Turquoise Hill Resources Ltd Earnings Call

EVENT DATE/TIME: MARCH 28, 2017 / 3:00PM GMT

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Tony Shaffer

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Craig Hutchison *TD Securities Equity Research - Research Analyst*

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Ralph M. Profiti *Crédit Suisse AG, Research Division - Research Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen. Thank you for joining us today. Welcome to the Q4 and full year results conference call. This call is being recorded and will be available later today for replay.

I would now like to turn the meeting over to Mr. Tony Shaffer. Please go ahead, Mr. Shaffer.

Tony Shaffer

Thank you, operator. I want to welcome you to our financial results conference call.

Yesterday, we released our fourth quarter and full year 2016 results press release, MD&A and financial statements. These items are available on our website and SEDAR.

With me today is our CEO, Jeff Tygesen; CFO, Steeve Thibeault; 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.

Jeffery D. Tygesen - *Turquoise Hill Resources Ltd. - CEO and Director*

Thanks, Tony. We are pleased with what Oyu Tolgoi achieved in 2016 with both the underground project and open pit operations. Starting with safety, Oyu Tolgoi had an industry-leading safety performance for the year. Their All Injury Frequency Rate for both the open pit and underground was 0.22 per 200,000 hours worked. Oyu Tolgoi has improved their AIFR by more than 50% since 2014. The mine's workforce continues to impress me with their commitment to safety.

Moving to the underground project. In May, notice to proceed was approved, and around midyear, underground construction recommenced. At year-end, there were more than 2,000 people in the underground workforce and that number's continued to grow in the first quarter of 2017.

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Cash-basis CapEx was approximately $230 million for 2016 and Oyu Tolgoi had further commitments of approximately $640 million at year-end. CapEx for 2016 was lower than anticipated due to some tenders being open longer than originally planned, allowing for more participation by Mongolian companies.

Oyu Tolgoi signed several large contracts last month, the largest contract being for the material handling system.

For 2017, we expect cash-basis CapEx of $825 million to $925 million. We remain on track for production from the first draw bell in mid-2020 and first sustainable production in early 2021. Brendan will cover underground progress in more detail later on in the call.

Approximately 80% of Oyu Tolgoi's long-term value resides in the underground. Between 2017 and 2025, when the underground is ramping up, copper production is expected to grow by more than 320% and gold production is expected to grow by more than 450%. That is the best growth profile in a year period in the copper space that I'm aware of.

During 2016, open pit operations performed at record levels. We are very proud of what Oyu Tolgoi achieved for the year. Concentrated throughput for 2016 was approximately 38 million tonnes, exceeding nameplate capacity for the first time. Oyu Tolgoi has seen roughly a 90% increase in throughput since production began in 2013.

Annual mine material reached a record high of 97 million tonnes in 2016, and the average daily concentrator rate for the fourth quarter set a record-high of 107,000 tonnes per day. We exceeded copper and gold guidance for the year with 200,000 tonnes of copper and 300,000 ounces of gold.

During the fourth quarter, Oyu Tolgoi processed stockpiled ore from Phases 1 and 2 to balance Phase 6 ore. Phase 6 ore requires blending to meet concentrate shipping ore specifications. For 2017, Oyu Tolgoi will process ore from 3 primary sources: Phase 6, low-grade ore from Phase 4 and stockpiled ore.

Our production guidance for 2017 is 130,000 to 160,000 tonnes of copper and 100,000 to 140,000 ounces of gold. Despite the anticipated lower production for 2017 relative to 2016, we expect Oyu Tolgoi to have positive operating cash flow for 2017. This is due to better copper and gold prices than we previously expected and Oyu Tolgoi's ongoing cost improvements.

For 2016, revenue decreased approximately 25% compared to 2015, mainly due to reduced gold sales and lower copper prices, partially offset by higher gold prices.

Operating cash flow for 2016 was approximately $400 million, which is a decrease of about 40% over 2015. The decrease reflects reduced gold production and lower copper prices.

For context, at the beginning of 2016, copper prices were below $2 a pound, and at best, we are hoping to be cash flow-neutral for the year. We are very happy with our operating cash flow for the year, given we are targeting neutral cash flow at the start of the year.

I'm going to turn the call over to Steeve to discuss the financial aspects of the year.

Steeve Thibeault - *Turquoise Hill Resources Ltd. - CFO*

Thank you, Jeff. As just meant -- as just -- Jeff just mentioned, revenue year-over-year was down due to combination of lower gold sales and falling copper prices.

During 2016, the average copper prices decreased by about 12% from $2.49 per pound to $2.20 compared with 2015 but it recovered significantly in the fourth quarter to end the year at $2.50. Higher gold prices, averaging $1,219 per ounce compared with $1,160 per ounce, partially offset the unfavorable gold volume impact. Copper and concentrate sold was down approximately 6% year-over-year while the volume of total concentrate sold increased slightly compared with 2015.

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Gross margin for the year was 28.4% compared with 40.4% in 2015. The decrease was the result of lower gold revenues. Cost of sales include an adjustment of $2 million for provision against inventory reflecting a lower gold content. We expect this adjustment to continue to be made in 2017 and early 2018 during the period of lower grades.

Income attributable to Turquoise Hill shareholders in 2016 was $211 million, all of which were from continuing operations.

Medium-grade copper-gold stockpiles were fully provided against in the previous recording period due to low forecast metal prices. With copper prices increasing during the fourth quarter, a partial reversal of this provision was recorded. Net charges to the income statement of $13 million have been included within operating expenses for the year after accounting for the partial reversal together with the provision against the carrying value of the metals and supplies.

In the fourth quarter of 2016, Turquoise Hill increased the total deferred tax assets recognized from $165 million to $296 million. The increase reflects stronger taxable income projections driven by improved long-term commodity price forecast and updated technical and operating assumptions. In addition to the increase to the previously recognized amount following a reassessment of the recoverability of operating losses in Mongolia, deferred tax asset now includes an amount relating to the Canadian operating losses, which is expected to be recovered against management services payment receipts and interest income.

Total operating cash cost at Oyu Tolgoi were $775 million below our guidance due to production efficiency and cost reduction programs. Open pit and concentrator operating costs have benefited. Improvements include changes to maintenance programs, lower input prices arising from new contract terms and slower use of consumable. As previously communicated, for 2017, we expect operating cash cost of approximately $720 million.

At the end of 2016, Turquoise Hill cash balance was $1.4 billion. Total capital expenditure on a cash basis for 2016 was $326 million, including $226 million for the underground project. The underground expenditure includes $62 million on prestart activity initiated prior to the May 2016 notice to proceed. The known underground CapEx of $100 million includes $31 million related to the first stripping and $22 million for the tailing storage facility. Actual expenditure were below guidance, mainly due to lower deferred stripping and timing of the JSK road construction.

C1 costs for the year were $1.02 per pound compared to 57 pound -- $0.57 per pound in 2015 due to the impact of lower gold sales, partially offset by general cost reductions. All-in sustaining cost for 2016 were $1.48 compared with $1.37 in 2015 and, again, mainly because of the lower gold revenue.

And that concludes my comments, and I'm going to turn the call over to Brendan.

Brendan Lane - *Turquoise Hill Resources Ltd. - VP of Operations & Development*

Thanks, Steeve. Following the notice to proceed approval in May 2016, the underground construction began shortly after midyear. As I'm sure many of you are aware, the development of Hugo North Lift 1 is a very large, complex, multiyear project, and we are in the early stages of construction. You can consider the project to have 4 main work areas, those being underground development, which includes lateral development and mass excavation; shaft sinking, currently Shafts 2 and 5; construction of supporting infrastructure above and below ground; and the development of the convey-to-surface system.

By the end of 2016, we had completed 1.6 equivalent kilometers of lateral development. When you include the 16 kilometers completed prior to the underground being put on hold in 2013, the project had therefore completed around 18 kilometers by the end of the year. When we reach production from the first draw bell in 2020, we expect approximately 65 kilometers will have been completed.

Lateral development progress has been good thus far and is ahead of schedule, but I would caution you from reading too much into it being ahead of schedule at this point as we are at a relatively low level of plan development, with only 2 active development crews of up to 13 planned. One benefit of good progress, however, is that it provides some breathing room for when other project components at times progress slower than

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anticipated. I was at the site 2 weeks ago and was pleased with this continued rate of above plan lateral development and the preparations to add additional crews in quarter 3 this year.

It was also pleasing to see that the on-site project workforce has now grown to over 3,000 people, and it's integrating well into the existing systems.

Shaft 2 had around 85 meters left to sink at the end of 2016 but is currently focused on the mass excavation connections at level 1,202, the production loading level, before it continues sinking on to level 1,256 and then the final depth of 1,284. Shaft 2 sinking is expected to be complete this year, with the fit-out occurring by mid-2018.

Shaft 5, that will be used for ventilation, had approximately 840 meters left to sink at the end of 2016. When construction of Shaft 5 is complete, it will enable further increase in the number of development crews. Shaft 5 is expected to be completed around the end of 2017, however, at this point, completion could possibly creep into 2018 due to a slower start to construction. We do not expect this to impact timing of production from the first draw bell, which remains forecast in mid-2020.

Infrastructure construction includes crushing and conveying, ventilation, water-handling equipment, power distribution, storage and camp facilities. Some of these areas also started slower than anticipated, as Jeff mentioned earlier, to maximize the national content, which has led to a slower ramp-up of contractors initially but now has been seen by the size of the project workforce that this slower ramp-up phase has now largely passed. That said, the slower start didn't have an impact on lateral development.

Lastly, development of the convey-to-surface system is going well. Bulk excavation was completed by year-end, and in January, development of decline tunnels began. It will be a twin decline: one tunnel for the conveyor and one for surface access.

All told, we are pleased with the underground construction to-date, and we continue to expect production from first draw bell in mid-2020 and first sustainable production in early 2021.

That concludes my comments. I will now turn it back to Jeff.

Jeffery D. Tygesen - *Turquoise Hill Resources Ltd. - CEO and Director*

Thanks, Brendan. In summary, Oyu Tolgoi operated at record levels in 2016 and underground construction is progressing well. The concentrator is performing very well and operating above nameplate capacity. We exceeded production guidance for the year and came in roughly 6% below operating cash cost guidance. Oyu Tolgoi cost savings and productivity initiatives are clearly having a positive impact.

As previously forecast, 2017 and the first half of 2018 are challenging from a grade perspective but Oyu Tolgoi is well positioned to manage this challenge. Looking forward, Oyu Tolgoi has the best growth profile at any current copper mine. As you think about Oyu Tolgoi's future, there are 2 numbers to remember: 3 and 8. We expect production from the first draw bell in 3 years and significant cash flow for Turquoise Hill shareholders in 8 years. Oyu Tolgoi is the best copper project currently in development.

That concludes our remarks. Operator, we're now ready to take questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Ralph Profiti of Crédit Suisse.

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Ralph M. Profiti - *Crédit Suisse AG, Research Division - Research Analyst*

I have 2. Firstly, Jeff, on the joint coal and concentrate road, can you get us a sense of what is the post-suspension performance? And is there going to be a long-term fix needed for when production ramps up to higher levels?

Jeffery D. Tygesen - *Turquoise Hill Resources Ltd. - CEO and Director*

Thanks for that question, Ralph. As you'll recall, at the early part of December last year, we had a pause of shipments due to a safety concern where, at the Chinese border, there was a change in procedure as far as shipping our copper concentrates and how they would merge in with coal being shipped from Mongolia. After working with -- for about a week with the Chinese authorities, we came up with a plan to have the concentrate trucks and the coal trucks merge on the same road inside China for 7 kilometers, and that system has been working very well, and we are catching up on the inventory that was built up for that short, brief period. I think it's a good example of how -- 2 parties recognizing an issue and coming together and coming up with a very good solution. I'm not anticipating, going forward, that there'll be any issues, and there haven't been any since we did the safety pause.

Ralph M. Profiti - *Crédit Suisse AG, Research Division - Research Analyst*

Okay. Yes, great. Brendan, if I can ask a follow-up on your comments about 65 kilometers and the 13 development crews. Can you give us a sense of when exactly or when roughly we'll reach the peak development rate on the underground?

Brendan Lane - *Turquoise Hill Resources Ltd. - VP of Operations & Development*

I think the 13 crews in 2017, the second half of the year, we're going to add 3 additional crews. And then after Shaft 5 is complete, we'll add an additional 2 crews. We will ramp up to 13 crews by about late 2018, I believe.

Operator

Our next question is from Matt Murphy of Macquarie.

Matthew Murphy - *Macquarie Research - Research Analyst*

Sorry if I missed this. Brendan, did you say something on Shaft 5 progress? Just wondering, it looks like around 160 meters progress in Q4, and there's 840 meters to go. So how hard will it be to get that done in '17?

Brendan Lane - *Turquoise Hill Resources Ltd. - VP of Operations & Development*

We're certainly going to be challenged to get it done in 2017. The sinking rate hasn't been where we would like to see it, but the project has been working on programs to improve the sinking productivity. So we should get a better idea of how that develops in the next quarter, and we'll reassess that towards the end of the year. But it could possibly creep into 2018. What's helping mitigate that is the very good performance of the lateral development at the moment. So Shaft 5's important to get the additional crews beyond crew 5 at the end of the year. So if the 5 crews develop as well as the first 2 crews have been going, then that will mitigate if there's any delay to Shaft 5 creeping into 2018.

Matthew Murphy - *Macquarie Research - Research Analyst*

Okay. So is Shaft 5 still the critical path item?

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Brendan Lane - *Turquoise Hill Resources Ltd. - VP of Operations & Development*

I would say the next critical path item is the fit-out of Shaft 2 in mid-2018. That really enables a significant step-up in lateral development, and of course, it is your first pathway to ore out of the underground.

Matthew Murphy - *Macquarie Research - Research Analyst*

Okay, okay. And I have a follow-up, if I may. Jeff, just interested in your thoughts or any comments you had around the Mongolia event at PDAC, and anything you're sort of seeing on the ground in Mongolia post the IMF bailout in terms of growth, in terms of political atmosphere. And particularly interested on some of their comments on bringing in rules on investor protections and so on. I mean, anything that was sort of new to you or moves the needle on your view of risk perceptions?

Jeffery D. Tygesen - *Turquoise Hill Resources Ltd. - CEO and Director*

I'll start with PDAC. Just a general side note, the previous year, there were a lot of empty seats and the -- for this year, in 2017, it was oversubscribed. So it was a packed house. The discussion was planned for -- from 2 to 5; it went from 2 to 6. There was that kind of engagement between the participants and the people presenting. The Mongolian mining minister was there and had a very positive tone to reinforcing the message that they're open for business. In addition, there were 3 members from Parliament that attended the Mongolian sessions. So I -- my takeaway, it was very positive and upbeat. They emphasized OT multiple times. Even other mining companies were emphasizing that OT's position within Mongolia was key, and they were very supportive of development, in general. As far as the IMF bailout, I think people are pleased in Mongolia of the participation with that. There is some austerity measures that they're going to have to go through to meet some of the requirements, but I think, overall, very positive atmosphere. I was there a couple of weeks ago, and the sense that I got from our Mongolian directors on the OT board and talking with folks in general, very upbeat. So my sense is very positive and optimistic.

Operator

(Operator Instructions) Our next question is from Craig Hutchison of TD Securities.

Craig Hutchison - *TD Securities Equity Research - Research Analyst*

I just have a follow-up question on lateral development. The 1.6 kilometers that you did in 2016, what was your original anticipated rate of development?

Brendan Lane - *Turquoise Hill Resources Ltd. - VP of Operations & Development*

I think at the end of 2016, we were about 250 meters ahead of schedule.

Craig Hutchison - *TD Securities Equity Research - Research Analyst*

What's that going to be, I guess -- in terms of percentage terms, what -- I guess, how much faster are you moving than originally anticipated?

Brendan Lane - *Turquoise Hill Resources Ltd. - VP of Operations & Development*

With both 2 crews, we're probably about a month ahead of the lateral development target.

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Craig Hutchison - *TD Securities Equity Research - Research Analyst*

And are you seeing the same thing sort of in Q1 of this year?

Brendan Lane - *Turquoise Hill Resources Ltd. - VP of Operations & Development*

This month-to-date will probably be our best month since we began. So yes, the progress is being maintained at a good clip.

Craig Hutchison - *TD Securities Equity Research - Research Analyst*

Okay. And just in terms of the grade profile, can you give us a sense of how it looks for this year? I know we've got the sort of the grades from the technical report, but are copper grades weighted more to the first half this year? Or is it sort of even throughout the year?

Jeffery D. Tygesen - *Turquoise Hill Resources Ltd. - CEO and Director*

Craig, I'll take this one. It's fairly even through the year. We have 3 sources -- primary sources for ore. We have material coming from Phase 6, which is our high-grade material. However, we have to limit that because it does have some arsenic, and we have to blend that off. So Phase 6 is always #1. And then the 2 other sources are the stockpiles from Phase 1 and 2. And as we're mining through 4A, it has lower grade, but it's pretty uniform through the year. If I had to make a generalization, I would use numbers like 10s and 12s: 12,000 tonnes a month for copper and 10,000 ounces for gold. And it'll go up a little bit and down a little bit, but -- and pushing the mill at 40 million tonnes. So a big part of making our guidance will be hitting the 40 million tonnes.

Craig Hutchison - *TD Securities Equity Research - Research Analyst*

And is that going well, so far to-date?

Jeffery D. Tygesen - *Turquoise Hill Resources Ltd. - CEO and Director*

Going very well. I mentioned that Q4 was a record high for the mill. But in December, we actually hit rates that are the 40 million-tonne rate.

Operator

At this time, there's no other questions on queue. I'll turn it back to Mr. Tygesen for closing remarks.

Jeffery D. Tygesen - *Turquoise Hill Resources Ltd. - CEO and Director*

Well, thank you for joining us today. 2016 was a good year for Turquoise Hill and Oyu Tolgoi. We continue to move toward underground production, and Oyu Tolgoi is realizing its full potential.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program, you may now disconnect. Everyone, have a great day.

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