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ABSTRACT

Entrée Gold Inc. is a junior mining exploration company focused on searching for gold and copper in the south Gobi Desert that has experienced rapid growth during its first three years of operations. The Company was initially formed to take advantage of an opportunity to acquire three strategically located, contiguous mineral concessions adjacent to and surrounding a known gold and copper deposit at the onset of a bull market in gold and base metals. As with many junior mining companies, Entrée’s management were eager to explore the property and hopefully sell the project to another mining company. After three years, a potential suitor has not presented itself. Roles and responsibilities are vaguely defined, reporting structure is unclear and corporate policy and guidelines are virtually non-existent. It is apparent the Company must begin functioning as a sustainable enterprise rather than as a temporary entity expecting to be taken over imminently.
DEDICATION

To my parents who have always believed in me, even when I did not believe in myself, and to my ever patient and supportive friends who encouraged me to take the chance and cheered me along the way. Without all of you, I could not have made it through this incredibly challenging and rewarding experience.
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# TABLE OF CONTENTS

Approval ........................................................................................................................................ ii
Abstract .......................................................................................................................................... iii
Dedication ......................................................................................................................................... iv
Acknowledgements ...................................................................................................................... v
Table of Contents ........................................................................................................................ vi
List of Figures ................................................................................................................................... viii
List of Tables .................................................................................................................................... viii

1 FIRM AND MARKET OVERVIEW ......................................................................................... 1
   1.1 Entrée Gold Inc. ..................................................................................................................... 1
   1.2 History of Entrée Gold Inc. .................................................................................................... 2
      1.2.1 Significant Shareholders ............................................................................................. 6
      1.2.2 Exploration in Mongolia .............................................................................................. 10
   1.3 Products ................................................................................................................................ 12
      1.3.1 Research and Development ......................................................................................... 12
   1.4 Markets .................................................................................................................................. 13
      1.4.1 Supply and Demand ...................................................................................................... 14

2 INDUSTRY AND COMPETITIVE ANALYSIS ..................................................................... 19
   2.1 The Mining Cycle .................................................................................................................. 19
   2.2 Industry Overview ............................................................................................................... 21
      2.2.1 The Need for Exploration ........................................................................................... 24
   2.3 Industry Analysis ................................................................................................................. 24
      2.3.1 Threat of Entry ............................................................................................................ 27
      2.3.2 Rivalry Among Existing Competitors ....................................................................... 29
      2.3.3 Threat of Substitutes .................................................................................................. 32
      2.3.4 Bargaining Power of Suppliers .................................................................................... 33
      2.3.5 Bargaining Power of Customers .................................................................................. 37
   2.4 Industry Attractiveness ....................................................................................................... 38
   2.5 Critical Success Factors ...................................................................................................... 39

3 INTERNAL ANALYSIS ......................................................................................................... 42
   3.1 Strategic Fit Analysis .......................................................................................................... 43
      3.1.1 Product Strategy ......................................................................................................... 44
      3.1.2 Research & Development Expenses ............................................................................ 45
      3.1.3 Structure ..................................................................................................................... 46
      3.1.4 Decision Making ......................................................................................................... 47
      3.1.5 Production .................................................................................................................. 48
      3.1.6 Labour ......................................................................................................................... 49
      3.1.7 Marketing .................................................................................................................... 49
      3.1.8 Risk Profile ................................................................................................................ 50
LIST OF FIGURES

Figure 1.1: Property location within Mongolia ................................................................. 2
Figure 1.2: Lookout Hill property / Ivanhoe properties .................................................. 3
Figure 1.3: Chuquicamata District – northern Chile ....................................................... 4
Figure 1.4: Entrée Gold Inc.-Ivanhoe Mines Ltd. Agreement Area .................................. 7
Figure 1.5: Entrée Gold Inc. exploration areas ............................................................... 11
Figure 1.6: Supply and demand of gold, 2000 - 2004 ..................................................... 15
Figure 1.7: Price of gold, 1900 - 2004 ........................................................................ 16
Figure 1.8: Daily spot price of gold, Euros vs. U.S. Dollars .......................................... 17
Figure 1.9: Copper – inventories and prices ................................................................. 18
Figure 2.1: Industry value chain ..................................................................................... 20
Figure 2.2: 5 year GFMS Base Metal Index .................................................................. 22
Figure 2.3: Exploration expenditures 1996 - 2004 ......................................................... 23
Figure 2.4: Canadian mining financing trend - 1997 - 2004 ........................................... 24
Figure 2.5: Industry analysis ......................................................................................... 27
Figure 3.1: Strategic fit analysis chart .......................................................................... 44
Figure 3.2: Entrée Gold Inc. value chain ...................................................................... 52
Figure 3.3: Organization chart ...................................................................................... 56
Figure 3.4: Entrée company model .............................................................................. 71

LIST OF TABLES

Table 3.1: Financial structure of Entrée Gold Inc. ......................................................... 74
Table 5.1: Recommendations and associated costs ...................................................... 96
1 FIRM AND MARKET OVERVIEW

1.1 Entrée Gold Inc.

Entrée Gold Inc. (Entrée) is a junior mining exploration company currently exploring for gold and copper in Mongolia. As a Vancouver based public company, listed on the TSX Venture Exchange, Entrée relies on equity financing to fund its steadily expanding operations. The Company generates no revenue, using the capital raised from a series of financings completed between July 2002 and July 2005 to cover ongoing exploration programs and related expenses.

Entrée is focused on exploration targets in the Gobi Desert in southern Mongolia. Entrée's primary exploration project, the Lookout Hill property, is located approximately 540 kilometres south of Ulaanbaatar, the capital city of Mongolia. Lookout Hill is comprised of three contiguous mineral concessions that cover approximately 180,000 hectares. The mineral and surface rights to these three concessions are leased from the Mongolian government on an annual basis. Entrée also leases the rights for two additional concessions: Ikh Ulziit Uul, 120 kilometres to the north of Lookout Hill, and Khatsavch, 40 km to the south (see Figure 1.1).
As a junior mining exploration company, Entrance’s goal is to find exploration properties that show enough promise to attract the attention of other mining companies. Ideally, one of these companies will ultimately agree to joint venture or buy the properties, or take over the entire company at a premium, thereby increasing shareholder value and solidifying the reputation of the managers’ ability to generate returns to shareholders. A successful takeover would enable the management team to start another company by attracting investors who believe the same group can repeat the process.

1.2 History of Entrance Gold Inc.

Entrance was formed in 2002 to take advantage of an opportunity to purchase 60% of the exploration rights to a strategically located exploration property in southern Mongolia from a privately owned Mongolian mining company. The property, consisting of three contiguous mineral concessions, encircled a rapidly expanding exploration project that had already been
under exploration by Ivanhoe Mines Ltd. (Ivanhoe) for two years (see Figure 1.2). In addition, the three mining concessions were bordered by other Ivanhoe properties.

Figure 1.2: Lookout Hill property / Ivanhoe properties

It is common practice in the mining industry to stake a claim or acquire mineral rights next to a known deposit or promising exploration target, with the hope that the existing deposit extends onto the acquired ground or that the same rock types will host similar deposits.

The smaller surrounded Ivanhoe property, known as Oyu Tolgoi, contained a copper-gold porphyry deposit that was showing great promise. Copper-gold porphyry deposits are often large, both in area and in terms of the size of the ore body. These types of deposits can occur along several kilometres, containing billions of pounds of copper and millions of ounces of gold.

Porphyry deposit – a large, generally low grade deposit hosting one or more of several elements including copper, gold and molybdenum, 60% of world copper production comes from porphyry deposits. Deposits have an average grade of 0.2-1.0% Cu, 0.05-0.5 g/t Au and/or 0.01-0.05% Mo and typically range in size from 50 - 1000+ million tonnes. (BCYCM, 2005)
For example, Codelco’s Norte Division, located in northern Chile, includes two large open pit mines, Chuquicamata (the largest open pit mine in the world) and Mina Sur, and other satellite deposits, which altogether cover an area over 15 kilometres long and 10 kilometres wide (see Figure 1.3). In 2003, Codelco Norte produced 907,169 metric tonnes (1.9 billion pounds) of copper.

Figure 1.3: Chuquicamata District – northern Chile

Entrée’s Board of Directors (the Board) was comprised of a group of individuals who had each successfully raised capital for advanced exploration projects in the past. These individuals had achieved moderate success within the industry, but none were independently wealthy. The Board members had seen other companies or projects successfully taken over and viewed the opportunity associated withEntrée as being their chance to attain considerable wealth and influence for themselves, and value for their shareholders.
Initial financing was for $300,000 provided by a small group of fifteen investors. The Board then hired a highly regarded geologist on a contract basis to conduct the preliminary evaluation of the property. Based upon this geologist's evaluation and recommendations, an exploration program was conducted in the fall of 2002 and further financing of just over $1 million was arranged in late 2002 and early 2003.

One of the members of the Board was approached to be the president of the company at inception but he had other obligations that precluded his involvement with Entrée. He fulfilled the duties of the president until a suitable candidate was found. In July 2002, the Board elected to contract an experienced exploration geologist to serve as the president, who eventually became a full-time employee in July 2003. During this twelve month period, the Company recognized that it needed to arrange financing to acquire the remaining 40% stake in the exploration rights to Lookout Hill. The continuous encouraging results published by Ivanhoe, along with the discovery of several exploration targets on Lookout Hill, enabled Entrée to raise $14 million in the fall of 2003. This money was used to purchase the outstanding ownership of the exploration rights for the property and provide funds for the upcoming exploration season.

Entrée also hired an exploration manager to oversee the Mongolian operations so the president could concentrate on raising financing in North America. An office was established in Ulaanbaatar, and a full-time administrator was hired to liaise with Mongolian authorities. Until October 2003, the operations in Vancouver consisted of a single office, rented from an unrelated mining company, out of which the president worked with his laptop computer.

Entrée now maintains four locations of operations: the corporate office in Vancouver, the exploration office in Ulaanbaatar, a field camp at Lookout Hill and another field camp at Ikh Ulziit Uul. Over 120 people are employed by the Company on a full or part-time basis. The exploration program for 2005 was budgeted at US$3.9 million but this is expected to increase
significantly due to an influx of over $22 million in June and July, 2005 as a result of the investment of a major mining company in a private placement and the exercise of warrants. The Company currently budgets approximately $100,000 per month for corporate overhead and administrative costs, including legal and investor relations, however this amount will increase slightly as operations expand.

1.2.1 Significant Shareholders

Due to a combination of warrant exercises and investments by major mining companies, Entrée now has over 64 million shares issued and outstanding. Approximately 26% of this amount is held by two mining companies: Ivanhoe, and Rio Tinto plc, through its wholly owned subsidiary, Kennecott Canada Exploration Inc. (collectively, Rio Tinto). Rio Tinto initiated discussions with Entrée in June 2005 which culminated in a private placement of over 6.3 million units of shares and warrants. The private placement closed on July 6, 2005. Ivanhoe, exercising a pre-emptive right as part of an earlier agreement with Entrée, exercised its outstanding warrant and acquired over 1.2 million units of the private placement as well. The agreements with these two large investors are outlined in more detail below.

1.2.1.1 Investment by Ivanhoe Mines Ltd.

In October 2004, Entrée and Ivanhoe signed an Equity Participation and Earn-In Agreement (the Earn-In Agreement) whereby Ivanhoe can earn an interest in 22% of the ground currently held by Entrée (the Agreement Area). Ivanhoe is a publicly traded mining company based in Vancouver, BC and listed on the TSX and the New York Stock Exchange. It has a market capitalization in excess of $2.9 billion and over 300 million shares issued and outstanding. Ivanhoe has a 50% interest in an operating copper mine in Myanmar, its partner being a state-owned enterprise. In addition, Ivanhoe conducts exploration and development activities on properties in Mongolia, China, Australia, Africa and Kazakhstan. Ivanhoe has joint ventures with
three other junior mining companies and strategic alliances with Chinese and Japanese resource companies.

When Entrée was initially approached by Ivanhoe regarding a possible deal, the Company had been considering its next round of financing. At the time of the deal signing, Entrée had approximately $2.5 million in its treasury, which would likely have lasted until summer 2005.

In essence, Ivanhoe must spend US$35 million on exploration of the Agreement Area within eight years to earn up to 80% of any deep discovery made on Entrée’s ground within the specific area (see Figure 1.4). Exploration results from the Agreement Area are shared with Entrée technical staff on a daily basis, and the two companies collaborate on press releases related to the exploration program associated with the Agreement Area.

Figure 1.4: Entrée Gold Inc.-Ivanhoe Mines Ltd. Agreement Area

Source: Entrée Gold Inc., used by permission
As part of the Earn-In Agreement, Ivanhoe purchased 4.6 million units consisting of one Entree share and one two-year warrant for $1.00, a premium to market at the time. This purchase gave Ivanhoe approximately 9% ownership of Entree’s issued and outstanding shares and the potential to own approximately 17%, if the warrant was exercised. In addition, Ivanhoe appointed a person to Entree’s Board. This Earn-In Agreement provided Entree with an additional $4.6 million in operating funds, without having to go to market, but has given Ivanhoe influence over Entree’s decision making, due to the presence of an Ivanhoe representative on the Board. Ivanhoe must also carry Entree to production, meaning that if and when the ore on Lookout Hill is mined, Entree’s share of operating costs must be financed by Ivanhoe. Entree’s share of the development will be deducted from revenue and Entree will be paid from the proceeds. This requirement means that Entree does not have to raise money to finance its share of production and development, a significant factor for a junior mining company when faced with costs that could total hundreds of millions of dollars.

Under the Earn-In Agreement, Ivanhoe also reserved the right to maintain its percentage of ownership of Entree shares, should any future financings take place. Ivanhoe exercised its warrant for 4.6 million shares at $1.10, resulting in proceeds to Entree of just over $5 million when the announcement of the deal with Rio Tinto was made. Ivanhoe then participated in the private placement to maintain its percentage ownership in Entree, purchasing 1,235,489 units at $2.20, adding $2,718,075 to Entree’s treasury. As a result of the additional investment, Ivanhoe now holds 16.2% of Entree’s issued and outstanding shares, and holds a warrant to acquire an additional 1,235,489 shares within two years. Fully diluted, Ivanhoe would own over 11 million Entree common shares.
1.2.1.2 Rio Tinto plc’s Investment in Entrée

Rio Tinto is one of the world’s largest mining companies and has head offices based in Melbourne, Australia and London, England. It has a market capitalization of over US$30 billion and over 1 billion outstanding shares. Rio Tinto acquired an initial 9.9% equity position in Entrée, with the right to increase its ownership position to 19.8% of Entrée’s common shares by exercising outstanding warrants.

The investment was made through a private placement, in which Kennecott purchased 6,306,921 units for $2.20, a premium to market at the time of signing. Each unit consisted of one Entrée common share, one “A” Warrant, and one “B” warrant. Two “A” warrants can purchase one Entrée common share for $2.75 within the next two years; two “B” warrants can purchase one Entrée common share for $3.00 within the next two years. Total proceeds from this private placement were $13,875,226 from Rio Tinto and $2,718,075 from Ivanhoe.

Rio Tinto’s investment also entitles that company to maintain proportional ownership in Entrée. In addition, Rio Tinto has been given the right of first refusal on Entrée’s Ikh Ulziit Uul property, located 120 km north of the Lookout Hill property. The Ikh Ulziit Uul property is located adjacent to Ivanhoe’s Kharmagtaï property, which has been the subject of significant exploration in the last two years.

The investments made by Ivanhoe and Rio Tinto have provided Entrée with sufficient funds to pursue a more aggressive and broader exploration program than was possible before. With over $26 million currently in the treasury, Entrée can expand its current exploration activities and look for potential acquisitions of its own. The share price has reacted favourably to the investments, and all outstanding warrants are currently in the money. Approximately 5.6 million warrants expire in October 2005, with a potential value of $7.4 million. These
warrants are priced at $1.06 and $1.35, and the current share price is over $2.30, therefore it is possible these monies could enter the treasury before the expiration date as well.

1.2.2 Exploration in Mongolia

Entrée identified seven exploration targets on Lookout Hill during its first two field seasons, four of which became part of the Agreement with Ivanhoe (see Figure 1.5). Three targets are currently under investigation: Zone I/II, Zone III and Bayan Ovoo. Drilling conducted in 2004 yielded encouraging results at the Zone I/II and Zone III areas. The third outlying target, Bayan Ovoo, is located in the far west of Lookout Hill and was identified using surface sampling and geophysical surveys. As part of the 2005 exploration program, Entrée is exploring the three areas of interest on Lookout Hill and two more at the Ikh Ulziit Uul project. Exploration at Lookout Hill was originally budgeted at US$3 million with the remaining US$900,000 of the total US$3.9 million budget budgeted for Ikh Ulziit Uul. Both exploration programs are being expanded but final budgets are unavailable at this time.
Subsequent to signing the Agreement, Ivanhoe began exploration work on the Agreement Area in November 2004. The Copper Flats target is the extension of the Hugo North Deposit already identified on Oyu Tolgoi. On April 13, 2005 mineralization was confirmed to extend onto Copper Flats, and assay results were released on April 27, 2005 indicating that the grades of copper and gold were equivalent to or higher than those already seen on Oyu Tolgoi.

In May 2005, Ivanhoe revealed an updated resource estimate for the Oyu Tolgoi deposit. In a press release dated May 4, 2005, they announced that the deposit contained 33 billion pounds of copper and 17 million ounces of gold within Oyu Tolgoi’s property boundary (Ivanhoe, 2005), with the richest part of the deposit in Ivanhoe’s ground open at the boundary with Lookout Hill. Oyu Tolgoi is now recognized as one of the world’s highest grade copper-gold porphyry deposits and as one of the largest deposits as well. This is supported by the recent resource estimate, where the grades for the largest section of the deposit, known as Hugo North, were calculated at
2.15% copper and 0.47 grams/tonne (g/t) gold. Copper-gold porphyry deposits are considered strong deposits when grades reach 1% copper.

The Ikh Ulziit Uul project in the Kharmagtai district, 120 km north of Lookout Hill, is an earlier stage exploration project than at Lookout Hill. The program for 2004 was limited to one geologist supported by a translator, ten labourers and a camp cook. The program for 2005 expanded to include three geologists and over twenty labourers and the associated support personnel but is much smaller than the operations at Lookout Hill. Limited drilling is included as part of the program but the Company’s focus is primarily on drilling and sampling at Lookout Hill. Ikh Ulziit Uul, however, is gaining in importance because of the interest expressed in the project by Rio Tinto.

1.3 Products

Entrée does not intend to develop the Lookout Hill project into an operating mine on its own. The expertise of Entrée’s personnel is better suited to the discovery and exploration of properties that have the potential to become a mine, not to develop, build and operate one. With this in mind, Entrée’s products are its projects, including the research and development data gathered during the exploration programs. Ivanhoe and Rio Tinto have invested in Entrée because they are interested in what may lie within the ground controlled by the Company. The presence of mineralization can only be confirmed by conducting intensive drilling and assaying programs. Ivanhoe is currently doing so on Entrée’s Copper Flats area, as part of its Earn-In Agreement. Entrée is stepping up exploration activities, as a result of Ivanhoe’s and Rio Tinto’s investments, outside the Agreement Area and on Ikh Ulziit Uul.

1.3.1 Research and Development

The data gathered consists of assay results of rock, soil and drill samples that have been analyzed and compiled into a database and plotted in plan and long section to outline a potential
deposit. This data is interpreted and the geological staff prepare reports in which they outline what they believe is the structure of the mineralization. The higher the quality of the data Entrée gathers, and the subsequent interpretation of said data (along with a little luck in actually finding mineralization), the better price Entrée can command during negotiations for selling the project. Typically, the more samples that are taken results in better quality data and more insightful interpretation.

Entrée has been fortunate in the last three years to not only have confirmed the extension to the Oyu Tolgoi deposit, but to have also identified three mineralized zones on Lookout Hill and several potential targets at Ikh Ulziit Uul.

1.4 Markets

Entrée's potential customers for its product are other mining companies, specifically those companies interested in gold and base metal projects. There are over 1,735 mining companies listed on stock exchanges worldwide (Ellingham, 2005). According to a recent Metals Economics Group survey of 1,138 mining companies worldwide, approximately 77% of exploration spending for 2004 was devoted to gold and base metals projects (Metals Economics Group, 2005). Clearly, the world mining exploration industry is focused primarily on discovering and developing gold and base metals projects. This study also noted that the exploration budgets for junior exploration companies had risen 103%, the third consecutive annual increase, and that expenditures for junior companies accounted for almost 45% of total 2004 exploration spending.

Other mining companies are interested in the data gathered by the Company, and whether or not the potential deposit will fit into their portfolio of projects. Operating mines often begin as exploration projects that pass through many hands before successful development. The chances are approximately 1 in 1,000 that an exploration project will be developed by an operating mining company (British Columbia & Yukon Chamber of Mines, 2005). Participants in the mining
industry understand that chances of finding a mineable deposit are remote. Ever optimistic, they also believe in the possibility of finding the next big discovery.

Ivanhoe and Rio Tinto are the type of customers that a junior mining company wants to attract; producing mining companies with large treasuries, searching for reserves. Investments by producing mining companies, especially major companies such as Rio Tinto, signal to the market that they believe the junior company’s exploration projects have potential to become a producing mine someday. Investments by major mining companies support the belief of the junior company managers’ in their project portfolio and reinforces their reputation among their potential customers and in the investment community.

1.4.1 Supply and Demand

Prices for gold and base metals, in terms of U.S. dollars, have steadily risen in the last three years, in part because of a decrease in value in the U.S. dollar and because of increases in global demand for commodities. There is an inverse relationship between the prices of metals and the U.S. dollar, in that as the value of the U.S. dollar decreases the price per unit of the metals increases. The U.S. dollar is not the only reason that prices have been rising, however. On the demand side, as the Chinese economy has expanded, the demand for commodities of all kinds has increased. China is now the world’s third largest importer of minerals (PriceWaterhouseCoopers, 2005). This increased demand has put pressure on the prices for commodities, including gold and base metals.

1.4.1.1 Gold

Gold functions as both a commodity and a store of value, depending on its end use for specific buyers. “All the gold that has ever been mined exists in some form or another and theoretically, the majority of above ground stocks could be [bought and sold] (World Gold Council, 2005a)”. In the following charts shown as Figure 1.6, it is evident that while the
The majority of gold produced is used for jewellery and kept in that form, the yellow metal serves many purposes. Not only is it used for adornment, but is also held by central banks as an asset and backing for currency, it is used in industrial applications and as an investment vehicle.

Concerns about the potential and actual sales of gold by central banks also affect the price of gold. Central banks historically held gold as a backing for their currency, the “gold standard”. The US dollar is now the effective reserve currency of the world, since the gold standard was discontinued in the early 1900’s, and the Bretton Woods agreement and the final two tier system of pegging gold were abandoned in 1968 and 1971, respectively. Due to its wide acceptance as a medium of exchange around the world, the US dollar has become the de facto standard for financial transactions. Following 1971, when the US abandoned its ties to gold, the price of gold increased dramatically (see Figure 1.7), albeit sporadically, as the world moved away from the gold standard.
Central banks now hold approximately 10% of their reserves in gold and have been steadily reducing their holdings since the 1990’s. Bank sales are controlled, however, by the Central Bank Agreement (CBA), the first of which was signed in September 1999. The establishment of an agreement among the central banks regulates the sale of gold by dictating the volume to be sold and the timing of any sales. The first CBA dramatically reduced uncertainty within the marketplace regarding a flood of gold to market. The most recent CBA was signed in September 2004 and covers bank sales to September 2009.

This dual nature of gold, as a store of value and as a commodity, makes it difficult to categorize. Its value and purpose is perceived by the beholder. To further complicate gold’s nature, it is priced and traded in US dollars. The correlation between gold and the US dollar means that a weaker dollar typically results in a higher gold price. Due to currency fluctuations in the last five years, while the gold price has increased in terms of the US dollar, it has not
increased as dramatically related to other currencies. Only recently has the price of gold, for example, increased significantly when compared to the Euro (Figure 1.8).

Figure 1.8: Daily spot price of gold, Euros vs. U.S. Dollars

Adapted from World Gold Council (2005b), used by permission

In addition to the above factors, the market for gold was opened up in China, with the creation of the Shanghai Gold Exchange in 2002 and the subsequent relinquishment of control over trading by the People’s Bank of China in 2003. As China’s economy expands, the amount of disposable income for its citizens will increase and, assuming a similar appetite for gold compared to other industrialized nations, demand for gold will also increase. China currently pegs its currency to the US dollar, which is having the interesting effect of increasing the price of gold in terms of the renminbi, as well (GFMS et al, 2004).
1.4.1.2 Base Metals

Unlike gold, base metals are true commodities, subject to the laws of supply and demand. Base metals are also priced in terms of US dollars, but the price increases seen in the last three years are attributed in large part to increased demand and a reduction in supply, a reaction to the low prices in the late 1990’s. Demand was impacted by the housing boom in the U.S. and the simultaneous growth in China. In recent years, as the supply of copper in the metals exchanges has decreased, the price has risen significantly (see Figure 1.9).

Figure 1.9: Copper - inventories and prices

Adapted from World Gold Council (2005c), used by permission
2 INDUSTRY AND COMPETITIVE ANALYSIS

An industry analysis is necessary to put the challenges facing Entrée into context. The following section outlines the dynamics of the metal mining industry and the critical success factors for companies working within this industry. Entrée in particular is focused on exploring for gold and base metals; therefore the discussion of the industry below is focused around issues with these metals.

2.1 The Mining Cycle

Within the mining industry, the junior exploration companies serve the purpose of feeding the pipeline to the major mining companies. Since major companies are constantly depleting reserves through daily operations, continual replacement of these reserves must be sought. Major companies conduct their own exploration activities but they also obtain properties from mid-tier and junior companies. Figure 2.1, below, is an overview of the industry value chain for the precious and base metal mining industry and represents the stages through which a typical mining project passes.

Four general categories are depicted in Figure 2.1, representing the different types of mining companies. Major mining companies own and operate large producing mines internationally that generate billions of dollars in revenue and cash flow. These firms participate in all components of the industry value chain. Their footprint is depicted as deeper than the other types of mining companies, because they work on a global level and on several operations simultaneously. The firms typically employ more than 5,000 persons, revenue generation is in the hundreds of millions of dollars per year and they have a market capitalization in excess of
$5 billion. Companies such as Placer Dome Inc., Barrick Gold Corporation, and Rio Tinto are representative of major gold and base metal mining companies.

Figure 2.1: Industry value chain

<table>
<thead>
<tr>
<th>Stage</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property Acquisition</td>
<td>Operating mining company / several operating mines / international presence / market cap &gt; $5 billion</td>
</tr>
<tr>
<td>Mid-tier</td>
<td>Small operating company / defined geographic focus / market cap $500 million - $5 billion</td>
</tr>
<tr>
<td>Junior producer</td>
<td>Small operating company or advanced exploration firm / market cap $500 million - $500 million</td>
</tr>
<tr>
<td>Junior exploration</td>
<td>Exploration company / small market cap / market cap $100 million to $300 million</td>
</tr>
<tr>
<td>Event</td>
<td>Footprint on industry value chain</td>
</tr>
</tbody>
</table>

Adapted from Baskett (2003), used by permission

Mid-tier mining companies participate across the industry value chain but as illustrated in Figure 2.1, to a lesser degree than the major companies. Mid-tier firms employ 1,000 to 5,000 persons, operate fewer and smaller mines and exploration projects than the majors, revenue generation is in the tens to hundreds of millions and market capitalization is $500 million to $5 billion. Mid-tier mining companies include Kinross Gold Corporation, Inmet Mining Corporation, and Ivanhoe Mines Limited.

Junior mining companies include even smaller scale producers as well as pure exploration companies. The junior producers typically operate one or two mines generating revenue in the tens of millions, conduct exploration near their mining operations, and employ up
to 1,000 people. Market capitalization for the junior producers ranges from $50 million to $500 million, and includes companies such as Glencairn Gold Corporation, Bema Gold Corporation and Arizona Star Resource Corp.

Junior exploration companies employ 2 – 100 people, focus solely on the exploration of promising prospects and have a market capitalization of $10 million to $200 million. Note there is an overlap in the size of junior producers and junior exploration companies. A large junior exploration firm such as Virginia Gold Mines Inc. manages over 10 exploration projects and carries a market capitalization of about $270 million. Entrée, in contrast, oversees 3 exploration projects and has a market capitalization of approximately $154 million (as of July 6, 2005).

2.2 Industry Overview

The metal mining industry is highly cyclical, dependent on the expansion and contraction of the world economy. Supply tightens as prices decrease. As the economy improves, metal demand increases, and the industry responds to corresponding price increases. It normally takes several years to bring a new mine into production, so there is often a lag between when prices increase and new production comes on line, which further exacerbates the cyclical nature of the industry.

In the last three years, the prices of the major commodities has increased substantially, in some cases trading at the highest prices of the last five or more years. Figure 2.2, below, represents the average increases in the prices of aluminium, copper, lead, nickel, tin and zinc. Equal weighting given to each of the six metals, with the index is based on January 4th, 2000 = 100 (Kitco Inc., 2005 and GFMS Limited, 2005). These increases have been attributed to an increase in and expected ongoing demand from China, and a weaker US dollar (PriceWaterhouseCoopers, 2005).
When metal prices decrease, production retreats and investment in exploration diminishes. Operating companies maximize existing resources and exploration expenses normally allocated to looking for new properties are cut as companies try to lower operating costs. The most recent downturn in the mining industry occurred between 1997 and 2002. In Figure 2.3, exploration expenditures per target mineral are illustrated. Spending was greatly reduced during the last trough for each commodity. Worldwide exploration expenditures peaked in 1997 at $5.2 billion, after which they fell to US$1.9 billion in 2002. Expenditures have recently increased to $3.8 billion in 2004. For 2004, total spent on exploration for gold was $1.8 billion and on base metals, $937 million. (Metals Economics Group, 2005).
There is a direct correlation between metals prices and amount of financing raised to fund exploration activities. Exploration is essential to the discovery of new mines that will replace depleted reserves. When companies struggle to raise capital, exploration expenditures decrease, reducing the chances of finding new deposits.

Increased spending of late has been by both major and junior mining companies, both of which have been able to raise capital in the last three years. Financings for junior mining companies has more than quadrupled, from $365 million in 2002 to $1.79 billion in 2004 as can be seen in Figure 2.4 (Metals Economics Group, 2005).
2.2.1 The Need for Exploration

Even though operating companies are cutting costs and maximizing inputs, they are still mining out their inventory. All mines have finite reserves of ore. There are relatively few substitutes for the materials mined, so demand is persistent, regardless of economic cycles. Therefore, operating companies must constantly seek new sources of mineable resources in order to stay in business. When exploration budgets are slashed, often due to decreased metal prices, the chances of finding new sources of ore are reduced. This is where junior exploration companies step in to fill the void.

2.3 Industry Analysis

Michael Porter, the renowned strategist, states, “The essence of formulating competitive strategy is relating a company to its environment... the key aspect of the firm’s environment is the industry or industries in which it competes (Porter, 1980, p. 3).” The following section uses
Porter’s five forces analysis to evaluate the internal and external factors that impact firms operating within the metal mining industry. The five competitive forces as defined by Porter are: threat of entry, rivalry among existing competitors, bargaining power of suppliers and of customers, and the threat of substitutes.

External factors such as the demand for metals, the state of the world economy and investor confidence have a great impact on the mining industry. In recent years, the US dollar has weakened which has inversely increased the US dollar price of gold and other metals. The real price of gold has risen little in terms of other currencies until recently but the perceived increase in the price has resulted in increased gold exploration. The rise of China has impacted the demand for gold and particularly base metals. The value of most base metals has increased in real terms— not just in relation to the US dollar – reaching all-time highs in the last 24 months. Copper, for example, reached an all time high in real terms on June 17, 2005 amid declining inventories at the metals exchanges and increased demand (Reuters, 2005).

There is also increased demand expected from India, and Japan and the United States are still major importers of metals. These factors combined suggest that demand for base metals will remain strong. Gold is a different matter, in that it is treated as both a commodity and currency. Producing companies will try to hedge against a lower gold price and build a portfolio of projects that are lower cost to explore and develop in the long term. This can be seen already with a resurgence in exploration worldwide, but there is a particular focus on areas such as North America and Australia, which are less risky and more stable.

Underlying the economic factors associated with increased metals prices is the performance of the U.S. dollar. The U.S. dollar is currently expected to decrease in value, setting the stage for still higher metals prices. There is much pressure on the United States to address its expanding budget and current account deficit. The United States has chosen to keep interest rates
low, supporting continued domestic consumer spending. The price of gold, in particular, will be sensitive to currency fluctuations directly related to the performance of the U.S. dollar, since it is priced in that currency.

The world economy is expected to grow at a slower rate than has been seen in the last three years. The following analysis has been prepared in light of the current bull market in the metals industry, much of which resulted from the recent growth in major economies such as China and India. One cannot prepare a proper analysis of the mining industry, however, without addressing the cyclical nature of the industry and its dependence on the world economy. In times of growth, metals prices tend to increase as demand increases and supplies decrease. The mining industry is unable to respond quickly to increased metals prices by increasing supply, however, as it takes many months to increase production at existing facilities and years to develop new projects. As the cycle progresses, high metals prices and abundant sources of financing result in resources such as labour and contractors becoming more scarce. When metals prices fall, funding decreases, labour and contractors are once again available, and the cycle begins again.

Figure 2.5 presents an overview of the five forces analysis of the metal mining industry, particularly as it relates to junior mining companies.
2.3.1 Threat of Entry

Overall Threat of Entry from competitors into the junior mining exploration industry is currently high. There were 137 new mining companies listed on the Toronto Stock Exchange (TSX) and TSX Venture Exchange (TSX-V) in the last three years (Ellingham, 2005). This is a 14% increase in the number of potential competitors in Canada alone. There are many more junior exploration companies in the mining industry compared to major mining companies. As of December 2004, there were over 1,100 listed mining companies on the TSX and TSX-V, which
represent over 50% of the world's public mining companies. Of these 1,100 companies, 219 were listed on the TSX and 890 were listed on the TSX-V. Twenty-eight of the TSX listed mining companies have a market capitalization is excess of $1 billion. The vast majority of the mining companies listed on the TSX-V are junior mining exploration firms (Ellingham, 2005).

Threat of entry is high based on the fact that many new companies are started by people already in the business who dust off old projects and put them into shell companies. Experience, however, is a high entry barrier to people who have never participated in the industry. High value investors with strong reputations may be able to start a new mining company but this has not been done without also attracting personnel with industry experience.

In the last five years, increasing metals prices have encouraged many companies to form, resurrecting projects that were not feasible at lower prices. Recent technological improvements have also made it easier to determine if an exploration project contains potential for mineralization or not. Financing of junior exploration companies has increased as investors view mining as a favourable investment because of the increased activity in the sector. Market capitalization has increased across the industry in the last three years (Ellingham, 2005), and most mining companies have increased exploration activity. Acquisitions are on the rise, with larger companies acquiring smaller ones in order to acquire reserves quickly, rather than growing organically (Metals Economics Group, 2005).

In addition, the cost of entry to form a junior mining exploration company is relatively low, if the principals of the company have the reputation and experience to operate a junior firm, as well as access to capital. The cyclical nature of the industry has resulted in groups of individuals starting new companies during healthy times and shuttering less favourable projects during the lean years. It is common practice to establish a company to focus on a specific project and/or commodity. Therefore, the same management team can oversee several different
companies. When the cycle is in a trough, managers of multiple companies will often mothball the underperforming firms, maintaining them as shell companies until times improve and they can resurrect the companies and projects when capital is flowing more easily.

The burden of regulatory requirements off-sets some of these variables. Scandals within the industry, such as the fraud associated with Bre-X Minerals Ltd., have resulted in the National Instrument 43-101 (NI 43-101), a Canadian policy that contains specific guidelines of what qualifies as a resource, how a company relates any disclosure regarding findings and developments, and requires independent reporting (British Columbia Securities Commission, 2005). All material disclosures must be prepared under the supervision of a Qualified Person, as defined by NI 43-101 as well. The regulatory burden increases even more if a company is listed in the U.S. The advent of the Sarbanes Oxley bill, passed in the U.S. in 2003, has added to the time and resources required to meet these additional regulatory requirements.

Currently, the barriers to entry into the junior mining exploration industry are relatively low, but the barriers increase and decrease as the mining industry moves through the economic cycle.

### 2.3.2 Rivalry Among Existing Competitors

Junior exploration companies compete against each other for properties and for financing, for field supplies and labour, for contractors and consultants and for potential buyers. At first glance, it would appear that because of the sheer number of competitors within the junior mining exploration industry that competition would be fierce. That is not the case. The competition appears to be moderated because exploration companies also cooperate with each other by sharing resources, such as administration or investor relations and even directors. It is not uncommon for a president of one company to be on the Board for two or three other firms, using
his or her reputation to lend credibility to these other companies. In return, this individual is usually awarded a significant amount of stock options in the company.

The industry is relatively small on a global scale. The TSX Group, which includes the TSX and the TSX-V, is the eighth ranked exchange in the world. The majority of publicly traded mining companies in the world are listed on the TSX and the TSX-V, but mining companies account for only 10% of market capitalization on the TSX (Ellingham, 2005). The availability of qualified management personnel therefore is limited because the talent pool is small. Reputation and knowledge is important to the credibility of the company, and while there are classic mining promoters within the industry, they are a dying breed. Availability of reputable managers is more important during lean times, when it is difficult to raise capital and attract the attention of the financial investment community, but it does not diminish significantly during good times, when capital is more plentiful.

By investing in other exploration companies, people within the industry have a vested interest in the success of potential competitors. This phenomenon results in a surprisingly cooperative environment, decreasing firm rivalry. Bidding wars and hostile takeovers certainly take place within the industry but this is more often a result of competition between two or more major mining companies than between two or more exploration firms.

Mining exploration firms also feed off the success of each other. If a large find is made by one firm there is a peripheral benefit to other exploration companies. Shareholders and investors become more optimistic about prospects for other junior companies, major mining companies start paying more attention to what the junior companies are doing and momentum builds within the industry. This phenomenon was present during the mid-1990's when diamonds were discovered in the Canadian arctic and the Voisey's Bay nickel deposit was discovered in Labrador.
During the times when new discoveries are made, competition increases momentarily as a staking rush ensues following a significant find. For example, when diamonds were discovered in northern Canada, many small companies jumped at the chance to acquire the rights to ground anywhere in the vicinity of the initial discoveries. De Beers was rather late to the area, and has since acquired numerous properties and companies in order to gain a presence in the Canadian diamond industry, at a significant cost compared to staking the ground originally. Mining companies watch the mineral titles offices closely, to see if a company will let its title lapse. If this happens by accident or on purpose, another mining company is often ready to rush in and take over a property.

One variable that increases rivalry among competitors is the moderate cost of exit. If a firm is not raising enough capital or increasing shareholder value, it is difficult to cease operations completely, at low cost. This happens most often during a downturn in the cycle. The remaining public company is maintained as a shell, but the properties associated with the firm are sold or the exploration rights are allowed to lapse. The shell company itself can then become a source of revenue, since it can be sold to another company if the listing is still active. It is much more expensive to list a new company than it is to keep a shell going for a few years in the hope that the industry picks up and the company can be reactivated in another form.

A management team that exits the industry too often by shutting down or reducing operations, runs the risk of being perceived as flighty or unreliable. There are people who enter and depart the exploration industry but reputation is an important consideration when it comes time to raise money for the next project. In times of rapid growth, as the exploration industry has been in for the last two years, these considerations seem less important but when times get tough, during a down cycle, credibility of management is crucial.
Exploration companies also buy projects from and sell projects to each other, as well as to junior producer, mid-tier and major mining companies. Properties will often have several owners. Each owner builds on the work done by others before a viable deposit is discovered and/or developed. For example, the Eskay Creek property (now the Eskay Creek Mine) was first staked in 1932 but production of gold and silver did not begin until January 1995, after several different owners worked on the project.

Generally, rivalry among competitors is moderate, increasing during times of hardship and decreasing during times of wealth.

2.3.3 Threat of Substitutes

The potential threat of substitute products to the junior mining industry is low. The time when any technological advances that could greatly reduce the demand for base or precious metals is far into the future. Optical fibre, for instance, has replaced copper wire in part of the distribution system of the telecommunications industry. Copper is also one of the most recycled metals. Worldwide demand, however, has increased in the last three years (International Copper Study Group, 2005). In the long term, technological developments that identify replacements or that may result in a decrease in demand for base metals and precious metals may occur but this poses a low risk of substitution right now.

A point to note, however, is that the supply of capital is essential for continued operations of most junior exploration companies. If shareholders do not see their share price increasing, they can move their money elsewhere. Other sectors with better returns will attract investment away from the mining industry, effectively acting as a substitute for the mining industry.

In addition, junior companies face a threat from major companies integrating backwards. Just as in the mid-1990’s, major mining companies decreased spending on exploration and
reduced the size of their respective exploration departments, so they could expand these
departments once again. By expanding, the major companies could absorb the resources within
the industry and make it much more difficult for junior companies to operate.

2.3.4 Bargaining Power of Suppliers

The bargaining power of suppliers within the junior mining exploration industry is high.
This factor is nonetheless subject to the state of the economy. The most significant variables are
related to investment, access to viable properties and human resources. There is a limit to scale
effects in junior mining. Exploration companies stay small and try to keep costs down by hiring
more consultants and contractors (avoiding the need for large offices, employee benefits and the
associated overhead), rewarding employees with stock options to keep salaries down, and
avoiding long term commitments to office space or equipment purchases.

Investors exercise tremendous power as suppliers of operating capital, particularly during
a downturn in the cycle. Most junior mining exploration companies are publicly traded and rely
on equity financing for funding. A great deal of time and resources of junior mining companies
are spent trying to attract investors and the attention of the financial community to the company.
Investor relations activities are often some of the largest expenditures made by a junior mining
firm, requiring a budget of as much as 25% of the operating capital to sustain. When activity in
the industry decreases due to a downturn in the cycle, access to capital deteriorates.

Market capitalization from 2002 - 2004 for the mining companies listed on the TSX-V
(the vast majority of which are junior mining exploration firms) increased from US $3.0 billion to
US $10.0 billion (Ellingham, 2005). The amount of financing a company can raise directly affects
the size of the exploration program and the amount of data that can be gathered and analyzed. If
a junior mining exploration company does not advance its project through research and
development to increase the project value, thereby increasing shareholder value, it will have a
difficult time raising money on an ongoing basis. The influence of suppliers of capital is substantial. For some companies, investors are powerful enough to demand a change of management or company focus.

Geologists, in particular, exercise substantial bargaining power over potential and existing employers during times of growth. The mining exploration industry experienced a dramatic decrease in expenditures between 1997 and 2002 (Metals Economics Group, 2005). This resulted in many geologists leaving the industry to pursue other careers. So many people left the industry during this time that companies are now having a difficult time finding qualified staff. This trend looks like it will continue into the foreseeable future. The Prospectors and Developers Association of Canada noted in its June newsletter that the mining industry is expected to need 81,000 people to fill positions in the next 10 years, but post-secondary institutions are only able to supply 11,000 people (Prospectors and Developers Association of Canada, 2005).

As the metals prices began increasing in 2002, so too did the need for experienced personnel to conduct exploration programs. Senior geologists, those with 10 or more years experience, are in high demand and can command high rates. This puts increasing pressure on the costs of running a junior mining company as well.

In particularly high demand are geologists who can be “Qualified Persons” as specified in NI 43-101 (British Columbia Securities Commission, 2005). In order to meet the requirements of continuous public disclosure in Canada, mining companies must have their technical information prepared by a Qualified Person. Over time, there is an additional concern within the industry due to demographics. During the last down cycle, fewer people entered the industry and as the baby boomers age, more people are expected to retire than are expected to enter the industry.
There is also a marked shortage of drilling contractors and analytical laboratories. Mining exploration requires the use of drilling contractors that supply the equipment and the personnel to conduct the drilling. The drill core is then submitted to an analytical laboratory for analysis. As exploration activity has increased across the industry, the availability of drilling contractors and access to timely analysis by analytical laboratories has decreased.

The shortage of drilling contractors is of particular concern, as drilling and assaying the drill core is the only way an exploration company can confirm if mineralization indeed exists on its property. For all junior exploration companies, the availability of drills and experienced drill crews is essential for planning exploration programs. If an exploration company cannot secure the services of a drilling company at the appropriate time in the field season, the entire program can be at risk.

This increase in demand for drills and drill crews is reflected in the increased revenues experienced by drilling companies. For example, Major Drilling Co. Ltd., one of the largest drilling companies in the world, reported its highest quarterly earnings in its history in October 2004 (Major Drilling Co. Ltd., 2004). In the same news release, Major Drilling noted that these increased revenues were directly due to the higher margins they were able to charge because of increased demand, further illustrating the degree of power they currently have over mining companies. Conversely, during a downturn, mining companies have more power and rates decrease as availability increases.

Technical specialists, whether working on their own or with consulting firms, are also in high demand, again depending on the stage of the economic cycle. These consultants are hired to perform a wide range of activities, from quality assurance/quality control audits to providing independent analysis of the data gathered. The power of this group is less profound than the previously noted suppliers but its effect is still felt throughout the industry. Consulting rates have
increased in the last few years, much the same as wages and other expenses have increased for junior exploration companies as market conditions have improved.

Other mining companies are also suppliers; suppliers of projects. Projects are often bought and sold, traded, optioned or joint ventured in the junior mining exploration industry. As political environments have changed globally, so too has the availability of potential projects. When Russia exited Mongolia in the early 1990’s, a new mining jurisdiction was opened up for exploration. The Mongolian government recognized that resource development was the first step to increasing independence, and developed one of the most advanced mining acts in the world. The Mongolian government has been supportive of mining exploration and development, resulting in over 30 mining companies now working in the country (Infomine, 2005). Early movers into the country staked claims and then sold their interests to other firms, creating value for their shareholders by being property brokers.

While the political regime in Mongolia is friendly to mining and expected to continue to be supportive, mining companies are also working in jurisdictions under less favourable conditions. Another effect of the mining cycle is that when prices are high, companies are willing take higher risks and explore in countries that are more dangerous or politically volatile. Many African nations have seen increased exploration activity in the last three years, whereas when prices were lower and capital harder to come by, companies focused closer to home, ie. North America and Australia.

An exploration company usually acquires a property from another mining company. Since the potential number of suppliers is so large, comparatively speaking, the power of the group as a whole is diminished but power struggles surface on a smaller scale when a particular company wants to acquire or divest itself of a specific project.
2.3.5 Bargaining Power of Customers

The goal of the management teams for most junior mining exploration companies is to joint venture or sell their exploration project (or company) to other firms, preferably major mining companies. This is the primary way that exploration companies can increase shareholder value. If a well known and highly regarded mining company purchases an interest in or buys a project, credibility is automatically conferred to the seller. Other mining companies, such as other junior or mid-tier companies, are secondary customers. The power of all these customers is substantial.

Exploration companies can only sell their projects (their product) to other mining companies. There are relatively few major mining companies compared to junior firms, concentrating the customer base. For example, there are 28 mining companies on the TSX with greater than $1 billion market capitalization compared to the total of over 200 mining companies listed on the TSX alone, let alone the additional 890 firms listed on the TSX-V (Ellingham, 2005). Exploration companies look to major companies to purchase their projects or the companies outright, if the projects have been subject to extensive exploration programs and deposits have been identified.

As such, the buyers are highly sophisticated, with the ability to conduct comprehensive due diligence if they so choose. In practice, more care appears to be taken during lean times. During an up cycle, companies are more likely to take a chance on a project because they do not want to miss an opportunity that they can capitalize on. In a down cycle, financial resources are scarce and the value of an opportunity is subjected to greater scrutiny.

An exploration company may sell its project to another junior or to a mid-tier firm. This would be the case if a company was changing its strategy, moving away from a specific
geographic area or metal type. Property sales also occur when money gets tight and equity financing is questionable, typically during a down cycle.

While major companies have buying power because of their size and financial resources, they still need to replace reserves to sustain long term operations. Major companies are on the lookout for promising projects that can add to their ever diminishing reserves. It is this knowledge that motivates junior mining companies to continue the search for the next big deposit. It also somewhat reduces the power of the major mining companies during negotiations, if the major is anxious to increase its reserves.

2.4 Industry Attractiveness

Junior mining exploration is risky. It is and probably will always be a high risk, high reward industry. The industry is highly volatile, responsive to external factors such as metals prices which are affected by the worldwide demand for the metals which is in turn influenced by the general state of the economy.

The above analysis of the five factors further illustrates the risk of this industry. During the good times, with increasing demand, reduced supply, and corresponding increasing metals prices, companies readily enter the industry. We see this happening currently, with metals prices the highest they have been in several years. When demand decreases and supply increases sufficiently, and prices go down, raising capital becomes more difficult, the junior exploration industry contracts, market capitalization decreases, and exploration expenditures go down. This was evident between 1997 and 2002, when worldwide exploration spending plummeted from a high of over US$5 billion to less than US$1.5 billion (Metals Economics Group, 2005).

There are few substitutes for the resources that junior exploration firms are searching for, but there are substitutes for where investors can put their money. Junior exploration firms are
constantly challenged with how to attract new investment that allows them to keep operating. As the shareholder returns increase in other sectors, it becomes more difficult to raise needed capital.

The industry seems to attract eternal optimists, who believe the next big discovery is imminent, even though the chances of finding a big discovery are slim. If one is looking to make a safe investment and generate a stable source of income, the junior mining exploration industry is not recommended as a sound place to do that.

2.5 Critical Success Factors

The junior mining exploration industry relies on investor funding to provide the operating capital needed to conduct exploration programs. Junior exploration companies begin their existence selling dreams. The first round of financing is done when there is little evidence of a real asset but the management team has an idea.

Since these junior companies do not generate revenue, they try to increase shareholder value by working on the project, hopefully discovering mineralization, promoting the project so that other investors become interested and ultimately attract the attention of other mining companies that will invest in the company, possibly even buying the project or in extreme cases, buying the company itself.

Experience within the industry is critical and impacts virtually every aspect of working within the business. The cyclical nature of the mining industry demands that a management team recognizes opportunities and takes advantage of the cycle. An experienced management team has a lesser tendency to react to short term changes. The last down cycle was extreme, lasting several years, and during that time, many managers became much more cautious. This is evidenced by mining companies increasing exploration expenditures but keeping operating costs under control
(Metals Economics Group, 2005 and PriceWaterhouseCoopers, 2005) during the commodities bull market that began in 2002.

The ability of the management team to raise money to first proceed and then continue with operations is crucial in the junior mining exploration industry. This requires that the executives and directors of the exploration company have good relationships with brokers, corporate financiers, mining analysts, and personnel at other mining companies.

The reputation and expertise of the exploration company’s executive and directors is important when it comes to evaluating potential acquisitions as well. The ability of the management team to quantify the potential value of a project is critical. More and better qualified projects will be brought to the management teams that have demonstrated success in the past. A junior mining company is deemed successful when it buys promising projects, does enough work to demonstrate the presence of mineralization, sells the projects, maintains and increases the share price, and raises money, using it wisely.

Another key success factor, related again to the reputation of the executive and management, is how information on company developments are communicated to the investment community. Investor relations are important for letting industry analysts and existing investors know what the company is doing and for getting information to potential investors. Companies that do this well tend to have greater longevity within the industry and can access capital, even in tough times.

A company that has a good reputation and a history of success will also be able to attract talented personnel. A shortage of senior geologists means that these people can pick and choose where they work and for whom during the good times. Geologists with proven track records lend their reputations to the companies during the lean times, when the most talented people have a better chance of staying within the industry. It is important to maintain good relationships with
high quality personnel. The industry is faced with the additional challenge of how to attract people to the industry to fill the expected void as the baby boomers retire.

The downturn of the late 1990’s caused many people within the industry to modify the way they approach the business. Investors have become more savvy and demand high quality information, which is also mandated by increasingly rigourous regulatory requirements. Exploration companies, in prior boom times, could increase the share price by simply announcing the beginning of the exploration program. Past scandals and the recent long downturn have caused investors and potential customers to exercise more caution, holding junior companies more accountable for how they spend the money raised.
3 INTERNAL ANALYSIS

Entrée does not have a clearly defined strategy. The company reacts to external forces and adjusts as circumstances demand. The Company began as a low cost explorer in 2002, with one paid employee, a handful of consultants/contractors, a limited field program and enough money to keep the program alive for six months. Results from the first year were encouraging enough to attract shareholder investment that, in the subsequent two years, has seen the company increase market capitalization to over $150 million, and having spent over $20 million on exploration and operations.

As Porter discusses in “What is Strategy?” (Porter, 1996), it is important for companies to align their activities to support their corporate strategies in order to achieve sustainable competitive advantage. Entrée has evolved into a differentiated company with a focus on costs, more by accident than by design. Due to the nature of the ever changing mining industry, the organization must be flexible to respond to fluctuating markets and the influence of outside forces (political, macroeconomic, regulatory). The Company has relied upon equity financing for operating capital, and exploration in Mongolia is costly. It has been difficult for management to plan beyond a twelve month horizon, because the funds have typically not been available to allow for the continuation of operations beyond eight to twelve months. Historically, Entrée’s management has sought funding when results from the exploration program were encouraging. Company management has been sensitive to share dilution and held off on financing until the share price is at a level deemed to be favourable, when possible. This has resulted historically in a chronic underfunding of the Company, and ongoing anxiety over when to seek financing and the Company’s concern with costs. The investment by Ivanhoe, as a result of the Earn-In
Agreement, occurred when Entrée was considering a financing to fund the 2005 exploration program but the share price was depressed after a summer of mediocre results and general market malaise. Ivanhoe made the private placement in the Company at a 25% premium to market.

Entrée’s differentiation arises largely because of its primary exploration project being located in Mongolia and surrounding a known world class deposit. Research and development costs are high, with the type and location of the project dictating the need to use new technology to conduct exploration and the extensive use of consultants to provide input to the management team. Mongolia is a relatively new jurisdiction in which mineral exploration is taking place, so the Company is at the forefront of exploration there. Productivity improvements have been achieved in the last eighteen months, as personnel become better acquainted with how to conduct business in a foreign country that is itself learning how to function as an independent entity on the world stage.

The management team is slowly becoming better organized in terms of decision making and resource allocation. Much of the time, personnel are fire fighting, reacting to the latest set of results internally or to news relating to its project partner, Ivanhoe. Now that the Company is partnered with Ivanhoe on a portion of the project area, decision making authority as it pertains to the agreement property area is shared as well. This puts additional pressure on personnel to make decisions that align with both Entrée interests while meeting the obligations to the partnership agreement with Ivanhoe.

3.1 Strategic Fit Analysis

In order to better understand the alignment of the Company’s activities to the corporate strategy, a strategic fit analysis was conducted (see Figure 3.1).
Figure 3.1: Strategic fit analysis chart

3.1.1 Product Strategy

Mining exploration in Mongolia has only recently been opened to foreign mining companies. Until 1991, the Soviet Union controlled the country and since the departure of the Russians, the Mongolians have been trying to build a democratic nation. Entrée is part of a small group (approximately 30) of mining companies that have taken advantage of the accessibility to land within Mongolia for mining exploration. Prior to the collapse of the Soviet Union, Russian
and Mongolian geologists had mapped much of the country and drilling was conducted in some areas. Access to adequate drilling equipment and personnel was limited, however, and most projects were not advanced. Much of the data gathered only became available for review after the Russians departed.

In terms of product strategy, since the potential of the Oyu Tolgoi deposit was still largely unknown, Entrée was an innovator. Entrée management acted on the opportunity to acquire the rights to the Lookout Hill property in 2002 because it was aware of the work being conducted by Ivanhoe on the Oyu Tolgoi property. The geologists involved knew that copper porphyry deposits could be quite large and cover a large land area, so Entrée management took a chance by purchasing the exploration rights to Lookout Hill and began exploration work to see if the deposit extended onto Entrée’s ground. The work completed on Oyu Tolgoi during the subsequent three years and the recent confirmation of the extension of the deposit onto Entrée’s Lookout Hill property has confirmed the belief of the management team that acquiring Lookout Hill was a good investment. Market capitalization of the Company exceeded $150 million in June 2005, further affirming management’s decision, as did the private placements made by Rio Tinto and Ivanhoe in the same month.

Entrée’s presence in Mongolia and the proximity of its primary project to Ivanhoe’s Oyu Tolgoi property differentiates Entrée from other junior exploration firms. If other firms find major deposits in Mongolia, however, Entrée’s differentiation will decrease. As more work is done and more data is gathered, the chances of finding a mineable deposit increase.

3.1.2 Research & Development Expenses

By its very nature, mining exploration incurs large research and development expenditures. Mining companies conducting exploration are undertaking new research, whether in a known area or, in the case of Entrée, in an area where very little exploration has been done.
Exploration costs are particularly high at the onset of exploring a virgin property, as the personnel learn about the geology of the land and develop their theory as to how the rocks were deposited and where mineralization may lie. Only through spending on research and development can a team of geologists determine what, if any, potential exists on the property.

Entrée’s costs are somewhat higher relative to other firms of a similar size, not only because of the project location but also because of choices made in terms of support and technology. The Company invested heavily in information technology in 2005 to better equip the field geologists with laptop computers, a computer network, a new database and analytical and graphical software. Entrée also chose to invest in a relatively new technology to conduct geophysical exploration of the property. This new technology is costly but was chosen because of its ability to detect mineralization at depths the previous system was unable to reach.

Mongolia is a developing nation, with limited internal transportation infrastructure. Flights to Mongolia are routed through Beijing, Seoul or Tokyo and are only available 4 - 5 days a week in total. Within the country, there is limited domestic air service. Transport to and from Entrée’s project property is therefore very expensive, further contributing to the costs of exploration, in terms of both time and money.

The private placement made by Rio Tinto and Ivanhoe in the June 2005 has provided Entrée with the funds to significantly expand the work programs. Research and development expenses will increase overall but tighter controls are planned to enable management to monitor expenses and schedule resources effectively.

3.1.3 Structure

From the inception of Entrée, the structure of the Company has been decentralized. An office was established in Ulaanbaatar from which the exploration manager and office manager
worked. The president of the Company rented space from another mining firm in Vancouver. An exploration camp was established on Lookout Hill. By necessity, the company structure had to be decentralized. As the Company has matured and grown, and more personnel have been hired and contracted to conduct the exploration program, more bureaucracy has been implemented and the corporate office is slowly exercising more control over company operations. For example, the addition of five geologists during the 2005 exploration season has necessitated the creation of a corporate travel policy so that everyone is aware of the Company’s obligations with regard to transportation to and from the site. There were some misconceptions as to what Entree would pay for with regard to flights and accommodations prior to the establishment of the policy.

As the Company has grown, there has also been resistance to centralization from the field personnel. The first staff members were contract geologists, used to working for extended periods of time away from home. They were accustomed to working independently, with little direction or supervision from senior managers. The ability to work independently and remotely was necessary at the onset of the exploration program. As the program has advanced, however, the need to introduce more controls and establish corporate policy has arisen. In particular, internal controls are essential as part of responsible corporate governance.

3.1.4 Decision Making

There was more autonomy in decision making for the personnel located in the field and in the Ulaanbaatar office in the early days of the Company. As related in the discussion on structure, as the Company has grown and matured, the corporate office in Vancouver has had to implement policy decisions. As Entree has grown, more managers have been hired to oversee daily operations. Personnel formerly used to making decisions on an ongoing basis are now asked to keep their respective manager updated on progress and this is creating some conflicts. Individuals were able and encouraged to make decisions and move on in the early days, but now
that the operations have grown, the impact of individual decisions may affect others so guidance is expected and often required. This aspect of decision making has become magnified in some areas since the Earn-In Agreement with Ivanhoe was signed. Activities related to the Agreement Area are now conducted by Ivanhoe, with input from Entrée staff. Press releases, in particular, have become greatly influenced by the relationship with Ivanhoe. Both companies now allow the other to review press releases announcing results related to the option area before they are issued. This has occasionally created conflict because one party does not give the other party enough notice to properly respond.

The private placement with Rio Tinto is not expected to impact decision making in the same way, as Rio Tinto is simply a shareholder at present, albeit a large one.

3.1.5 Production

In the early days of the Company, employees wore many hats of responsibility. The president provided technical input into the exploration program, the prospectors not only conducted exploration of the property but performed camp management duties, and the exploration manager conducted negotiations with the Mongolian government representatives. As the Company has grown, personnel have had to become more specialized. Activities within the Company, by necessity, are becoming more efficient and costs have been kept down because the basic infrastructure was in place and did not need to be expanded proportionately to the number of new hires. Entrée is slowly realizing some economies of scale as the Company matures but this effect will be limited. Personnel are becoming challenged to meet their current obligations and it is doubtful that adding more projects will result in savings due to scale effects. Entrée is currently expanding its exploration programs due to a large influx of cash. More personnel are needed and must be hired quickly. The associated learning curve for all involved will limit any scale effects in the near term as well.
3.1.6 Labour

Due to its very nature, mining exploration requires the skills of knowledgeable personnel with years of experience. A geologist with extensive experience can interpret the types of rock formations and structure that a less experienced geologist might overlook. This potential oversight could result in the lost opportunity to develop a large deposit. While it is important to train junior personnel, a successful exploration program requires the input of highly skilled professionals.

As time goes on and the program expands, however, more junior geologists and workers can be hired and supervised by the same number of senior personnel. This is the case in the 2005 exploration season, for example, where an additional five geologists were hired for the summer but the number of senior geologists remained the same. The work will become more routine for more people in future, and while specialization of certain individuals will always be necessary, a larger proportion of the staff will be doing non-specialized work.

3.1.7 Marketing

Entrée currently relies upon a pull strategy to reach its potential customers, other mining companies. There is a tension within the marketing of the company, however, because Entrée also needs to attract financial investment in the form of equity financing. To reach potential investors and existing shareholders, Entrée uses a push strategy, trying to reach these parties through an investor relations firm and through relationships with stock brokers and mining analysts.

Advertising in trade publications, participation in industry trade shows and undertaking road shows to meet institutional investors are the primary method used for marketing the company. The investor relations firm works on the push and pull sides of the marketing strategy by liaising with members of the financial and media communities in order to raise the profile of
Entrée and maintaining regular communications with investors that have shown an interest in the Company. Exposure of the Company through these channels also increases its visibility with potential customers that also attend the trade shows, read the trade publications and communicate with the same members of the financial and media communities. Entrée also maintains a website, with sections tailored to the needs of investors and analysts. The website is updated regularly as news is released and results are published.

Road shows are trips made to financial centres where institutional investors cluster. In Canada, Vancouver and Toronto are the key financial centres for mining. In the United States, New York, Denver and San Francisco are the major mining centres. In Europe, London, Geneva, Zurich, and Paris are targeted for mining investment. Road shows are expensive ventures but the possibility of investment by an institution is greater once investment managers have met company executives and heard the story from the management team.

Entrée is still working out the best combination of these activities to support marketing the firm. Rio Tinto’s investment, for example, was initiated after a mining conference where certain individuals had visited Entrée’s booth. These individuals introduced the two companies and received a finder’s fee after the successful closure of the private placement. Attendance at the conference was a key part of making Entrée more visible and open to an approach by another mining company.

3.1.8 Risk Profile

Junior mining is speculative and as such, will always be high risk for investors and employees. Very few exploration properties become operating mines, and the junior companies often move from project to project, hoping to entice investment from the financial community as well as other mining companies.
Entrée is perceived by the market to be of a somewhat higher risk than other junior mining firms because its assets are located in Mongolia. While Mongolia is a sovereign nation with a parliamentary democracy, it is regarded by many as being under the influence of China. This general misunderstanding of Mongolia and its ruling government, legislation and policies has contributed to the perception of risk because investors do not believe that the government will allow assets or revenues to be taken out of the country. As the investment community has learned more about Mongolia, largely due to the efforts of Ivanhoe and junior companies such as Entrée, the perception of risk is easing somewhat but it is still high. There are factions within Mongolia that want to see the government be more protective of Mongolia’s resources and this is causing some concern. In addition, the Mongolian government has yet to negotiate an agreement with Ivanhoe that addresses the issues of provision of power, water and transportation as well as taxation and royalties. Until this agreement is completed, there will be suspicion about what the Mongolian government is willing to do and the risk perception will remain high.

3.1.9 Capital Structure

Entrée is not planning to be in a position of generating revenue so it must rely upon equity financing to procure operating funds. This money can come from the investment of a mining company, such as those made by Ivanhoe and Rio Tinto, or by issuing more shares, both options of which dilute the stock. It is a high risk – high reward venture, where the pay-off will be great for investors if a significant discovery is made, but the chances of failure are high.

Since Entrée was established in early 2002, it has been able to attract financing and investment enough to permit ongoing exploration but until June 2005 did not typically have enough funding to cover more than twelve months of expenses. With over $26 million available as of summer 2005, the Company does not need to do another financing in the foreseeable future.
This is based on current and expected spending. This amount of money has given Entrée management some space to evaluate how best to move forward.

3.2 Entrée Gold Inc. Firm Value Chain

The firm value chain for Entrée is shown in Figure 3.2 below. This chart is based on the model discussed in class (Bukszar, 2005) and as originally outlined by Michael Porter (Porter, 1985). The model has been slightly altered to account for the flow of activities within Entrée, whereby the Service and Marketing and Sales categories have been transposed.

Figure 3.2: Entrée Gold Inc. Value Chain

Based on Porter (1985) and Bukszar (2005)
3.2.1 Primary Activities

In a junior exploration company, the process of activities begins when a property is acquired, either with private investment or more often through equity financing. A field crew is assigned to visit the property, spending weeks and sometimes months, walking the ground looking for signs of geological formations that may indicate mineralization. Rock samples are taken initially from surface, and later by drilling and taking samples from metres below the surface. The samples are then sent to an analytical laboratory for assaying, and the results are plotted on a map. The results are then evaluated by the technical personnel to determine if there is more exploration warranted on the property. Assuming the junior exploration company is a publicly traded firm, technical reports must be prepared and press releases issued to share the findings with company shareholders. Press releases and external technical reports must be filed with the regulatory authorities, as must the company’s financial statements. Once the data or accounting information has been made public, the firm then conducts investor relations activities to share the company progress with potential investors and existing shareholders.

The primary activities outlined above describe the process for Entrée. These activities have been divided into five categories along the Value Chain and are further described below: inbound logistics; operations; outbound logistics; service, and marketing and sales.

3.2.1.1 Inbound Logistics

The initial due diligence exercise for Entrée was conducted by a consulting geologist, originally contracted by the Board. The findings of this geologist were then reviewed by Entrée personnel. The respective box on the chart is multi-coloured, reflecting that this activity is partially outsourced and partially done in-house. The in-house competency is rated as excellent. This ability to conduct effective due diligence and evaluate the promise of a project is a strength within the Entrée team. The projects that have since been acquired have yielded encouraging
results and are the subject of ongoing exploration. Due diligence activities could increase, due to the private placement by Ivanhoe and Rio Tinto. These extra funds can be used to evaluate potential targets and make acquisitions, turning Entrée into a customer within the industry as well as a supplier.

Another activity in which Entrée excels is preparing deals and making property acquisitions. This is also another activity, however, in which outside advice is sought and is therefore indicated by a multi-coloured box. The deals and acquisitions made by Entrée management have resulted in a sustained increase in shareholder value, evidenced by a dramatic increase in market capitalization in the last twelve months. More exploration is required to determine the ultimate potential of the existing projects but with over $26 million at its disposal, Entrée is in a position to evaluate other projects and make acquisitions to complement the existing portfolio. This activity is therefore expected to increase in terms of drawing on time and resources.

Shipping & customs is highlighted as a discrete activity because the Company’s work is largely performed in Mongolia and shipping materials to and from the camp, and the logistics of accomplishing this task effectively, is a critical activity in advance of the actual exploration program. Freight forwarders are used to ship from Canada to Mongolia and internal personnel are constantly learning how to conduct this activity more effectively. This is indicated by the split box showing the activity is outsourced and conducted internally, with the internal competency ranked as good to this point. Entrée does not employ anyone who functions as a logistics manager. Instead the Company relies upon the expertise of its staff and the personnel at the freight forwarding company for advice. Shipping and customs activities are becoming less complicated in terms of working within the system, but more complicated because of the growth of the program and the sheer amount of time and resources involved in supplying the exploration camps now that they employ well over 120 people.
Development of the exploration program is a key activity that must be done prior to mobilization to the field. This activity is done by the internal project team, led by the exploration manager and the technical manager, and is one in which Entrée excels. The project team is highly experienced, comprised of Entrée personnel who rely on selected specialists for input regarding their respective areas of expertise. The personnel that Entrée relies upon have now worked in Mongolia for three field seasons and are familiar with working in the type of geological terrain that is present on the project properties. This experience is essential to the ongoing success of the project, because geology is unique in each setting and the more the geological team knows and understands about the terrain, the more likely the discovery of suitable targets.

Construction of the field camp is necessary before the crew begins the exploration program and begins with the arrival of the camp manager, who is employed by Entrée full-time. The camp manager is joined by the camp cook and assistant camp manager in order to prepare camp for the arrival of the technical team. At this point, the camp manager hires local contract labourers to assist with camp construction and ongoing camp maintenance, as well as translators, cooks and drivers.

In 2005, Entrée constructed a permanent camp whereas in the previous two field seasons, the camp was temporary and broken down at the end of the field season. Camp construction was outsourced to a local firm overseen by Entrée’s camp manager, as indicated by the split box. Component pieces such as trailers and diesel stoves were provided by external suppliers. The internal competency component has been rated as good because although this is the first permanent camp constructed by the company, the personnel involved have experience with setting up remote temporary camps in Mongolia. Once the camp was built, the rest of the field crew was mobilized and the actual operations of the field program began.
3.2.1.2 Operations

Entrée currently employs approximately 120 people, full-time and part-time. The majority of these employees work on the exploration projects in Mongolia. The operations activities of Entrée take place at the exploration properties. All activities at the project sites are overseen by Entrée personnel and this supervision is captured as Project Management. An organization chart is provided as Figure 3.3 to clarify how the Company is staffed.

Figure 3.3: Organization chart

Prepared by author

Project management is an area in which Entrée excels, primarily because the field managers have extensive experience and are highly capable individuals. Since Entrée is such a small company, personnel are expected to wear several hats, and thus assume a variety of responsibilities depending upon the situation. This is changing as the program has expanded but the need has not been eliminated. All Entrée personnel are full-time, with the exception of
summer students and contract labourers, who are hired solely to work during the field season (March through October).

Once the technical crew arrives at camp, they begin to conduct the exploration activities as outlined in the exploration program. The field crew is comprised of full-time Entrée geologists, contract geologists, and consultants. Entrée geologists are supported by the contract labourers, who perform activities such as digging trenches, or drivers who transport the technical team to remote locations throughout the property as well as back and forth to Ulaanbaatar and Oyu Tolgoi.

Other discrete activities include the actual exploration activities, identified as geophysics, drilling, core logging, and sampling, mapping, etc. Geophysics are used to identify potential drill targets. A geophysics crew is contracted to conduct surveys of the property that use electrical and magnetics methods to identify areas of potential mineralization. This activity is shown as outsourced on the Value Chain. The data gathered by the geophysics crew is evaluated by Entrée geologists, with input from the geophysical scientists, to determine where potential drill targets are located.

Drilling is outsourced to a drilling company that is highly experienced in southern Mongolia. Activities are overseen by Entrée geologists. Samples of drill core are taken many metres below the surface. The follow-on activity to drilling is core logging, which is performed by Entrée personnel. This activity has been assigned a competency rating of good, but the system has not yet been perfected. There were glitches last year that are expected to be mitigated by a new process developed during the off-season.

While some of the geologists are working on the drill program, others will be looking for new areas of interest on Entrée’s land holdings. These activities require taking surface samples and mapping the areas of interest. The Entrée team excels at this activity, having uncovered
seven promising target areas in the first two field seasons. This activity is performed by Entrée personnel as well as consultants.

Ongoing camp management is performed in-house and is rated as excellent. Entrée’s project manager oversees camp management and has gained experience during the last three field seasons. There were problems encountered last year that were ultimately rectified and camp construction and management seems to be under better control this year. This competency is important because few firms have constructed permanent camps in southern Mongolia and few people have this experience.

3.2.1.3 Outbound Logistics

The most important materials related to the project are the samples taken from surface and drilling, and the subsequent interpretation of the data. Samples are shipped to analytical laboratories in Ulaanbaatar and Vancouver. These laboratories conduct assays of the samples to determine the presence of different minerals, including gold and copper. These assay results are then compiled into a database, plotted on a regional map and ultimately included in the internal report. Data interpretation of the geophysical information gathered, the regional mapping and the assay results from the surface and drill samples is conducted so that the geological team can determine if mineralization is present and more exploration is needed.

Since the goal of the company is to prove the presence of a mineral resource, this data interpretation is a critical activity for Entrée. This is indicated on the Value Chain as being an activity that is both outsourced and in-house, but one in which Entrée excels. Entrée employs highly experienced geologists and contracts well regarded consulting geologists to conduct the data interpretation. Entrée employs a core group of technical personnel and managers with broad experience, most of whom have worked together on prior projects. To supplement the skill sets of this core group, specialists are hired to provide input related to their areas of expertise. Entrée
sought guidance on the interpretation of the geophysical results because the technology used during the 2005 field season was relatively new and untested by Entrée personnel. Geochemical consultants assist with interpretation of assay results and structural geologists provide input as to the formation of the mineralization and resulting structure of the geological terrain. These specialists are not required to be on hand full-time, but are accessed on an as needed basis. Entrée tends to use the same consultants, to provide continuity and reduce the time required to get them up to speed on the latest developments.

Once the data interpretation has been done, an internal report is prepared to capture the analysis. Entrée prepares high quality reports but they have not been prepared in a timely manner. This has been due to challenges associated with a rotation schedule for the authors of the reports (the geologists) and a long field season, with only a short break between programs. Entrée management did not allow for enough time between field seasons for the technical team to prepare the reports before mobilization for the next program began. This competency has therefore been rated as good rather than excellent.

Shipping & customs, as mentioned before, is also a key component of ensuring the samples are sent reliably to the laboratories and that materials are shipped for safe-keeping during the off-season. Effectively moving the materials is an important part of closing operations for the winter and this activity is again outsourced and managed internally, with the internal competency rated as good. As the team gains more experience, they could excel at this competency but there is still learning that must be done as the program expands.

3.2.1.4 Service

Entrée does not operate in an industry that offers warranty or follow-up service calls to customers. Instead, it must ensure that once data is gathered and interpreted, the results are shared with regulatory authorities and shareholders, meeting regulatory requirements. All public
companies have an obligation to ensure that regulatory requirements are met and this is an activity that absorbs a great deal of cost and time for Entrée personnel. As can be seen on the Value Chain, regulatory activities are outsourced and conducted in-house. The Corporate Secretary is also the firm’s CFO, who is a contractor working part-time for Entrée. The business manager also provides support to the Corporate Secretary and works extensively with outside legal counsel to meet the regulatory requirements. This is illustrated by the multi-coloured boxes, indicating that there is a reliance on external providers and that Entrée’s internal competency in these activities is rated as good.

As part of the regulatory obligations, press releases must be issued if a material change occurs. These press releases are prepared by in-house personnel and outside legal counsel. This competency is rated as good, as the press releases have been commended by the regulatory authorities, however, Entrée tends to make the releases highly technical and they are not always clearly understood by investors, shareholders and other interested parties.

There is a separate category for 43-101 reports, because these are specific reports that must be prepared in a particular format and filed on SEDAR and with the TSX-V. These reports require input from external consultants and in-house personnel and are time consuming to prepare. Preparation of these reports is a regulatory requirement for mining companies based in Canada.

3.2.1.5 Marketing and Sales

Once the information gathered by Entrée has been made public, the Company then shares the information with shareholders and potential investors through various means. The activities identified on the Value Chain are: road shows, trade shows, and website. Road shows are done by the president and CEO of Entrée. Road shows involve going to different financial institutions and investment houses and giving presentations about the company. These visits are arranged by
a consultant who specializes in introducing publicly traded resource companies to investors. This consultant maintains a database of contacts who are interested in investing in different commodity types or geographical locations, who are then invited to attend an information session conducted by executives of the subject company. It gives institutional and sophisticated investors an opportunity to learn about the company and meet the senior managers. Institutional investors are desired by junior exploration companies because their investments tend to be larger than those made by retail investors.

In 2005, Entrée's president went on the road and met with finance and investment firms in London, Geneva and Zurich and completed a trip through Toronto, New York and Boston as well. The experience gained in the last six months has resulted in the creation of a more polished presentation and a better understanding of the information desired by this target audience. A short road show was conducted in 2004 but the follow-up to the meetings was not done effectively. These road shows are a significant portion of the investor relations costs for the year and following up with these potential investors is imperative. They have many choices as to where to invest their money. This competency is rated as good, as Entrée is still learning how to effectively follow up and maximize the opportunity.

Industry trade shows are categorized as a discrete activity because of the cost and nature of taking part in these presentations. Trade shows, usually as part of mining conferences, offer existing and potential investors an opportunity to meet company personnel and ask questions of the management team directly. Entrée has had some success with trade shows, resulting in articles by third-parties being written about the company and interest generated in the firm because of presentations given during the conferences associated with the trade shows. This competency is rated as good because Entrée personnel are still trying to determine the right mix of trade shows to attend and what materials to provide.
Websites are another important source of connecting with existing and potential investors. Entrée’s website is maintained by an external contract graphic designer who is directed by the business manager and external investor relations group. That is why the box is multi-coloured indicating it is outsourced and internally controlled. The website is somewhat out of date and under construction, resulting in an internal competency rating of fair. The company has received favourable review of the website from shareholders and advisors, but it needs to be updated to be more investor friendly and to improve the technical content.

3.2.2 Support Activities

Support activities occur across four broad areas: firm infrastructure, which are activities that affect the entire organization; human resource management, which are activities related to the hiring, training, and compensation of personnel; technology development, which are activities related to improving process and efficiency for Entrée and finally, procurement, which involves those activities entailed in acquiring materials and services that contribute to the final product. In Entrée’s case the final product is the data gathered and synthesized into the reports.

3.2.2.1 Firm Infrastructure

Several activities have been identified as related to firm infrastructure. These activities include: financing, information technology, accounting, legal, and investor relations. On the Value Chain in Figure 3.2, these activities are loosely associated with the primary activities but they generally apply across the firm at a corporate level.

Financing for Entrée is outsourced to brokerage houses such as Canaccord Capital and Salman Partners. These two firms were the underwriters of a large private placement for $12 million in October 2003. For a publicly traded junior exploration firm such as Entrée, financing and due diligence often occur in parallel. In Entrée’s case, the Board raised funds through an initial private placement because they were approached to purchase the Lookout Hill concessions,
which were strategically located around a known deposit in southern Mongolia. The Board raised a small amount of money, which was used to conduct the initial due diligence of Lookout Hill. Financing would not have been done, however, if this opportunity had not been present. Financing affects the firm operations on a macro perspective and is therefore categorized as a "firm infrastructure" activity, while due diligence is the first step in inbound logistics and was described earlier.

Money management is an area of concern after the private placement completed in June 2005. With over $26 million in the treasury, Entrée management must not only determine how to expand the exploration programs and increase the scale of the operations, but also ensure the money is invested wisely before it is disbursed. Entrée’s management is seeking the advice of investment professionals about how best to invest these funds until they are needed.

Entrée has recently contracted a specialist in information technology to implement a server system with a common domain for the field and corporate operations, in an attempt to facilitate data gathering and evaluation, and improve work processes. Until 2005, all field data was kept on individual lap-tops used by Entrée geologists, which were not regularly backed-up. Since Entrée personnel live in disparate locations, gathering the data to prepare the field reports has proven to be challenging. Implementation of the network was outsourced, as indicated on the Value Chain, and the physical maintenance of the system is outsourced as well. This activity has been designated as a firm infrastructure activity because it affects all levels of the operation.

As the Company has grown, there has been a greater reliance on the IT professional who is an outside contractor. Difficulties have arisen when the IT contractor is not available to fix problems on a timely basis due to commitments to other clients. This has led to loss of productivity in Vancouver and Mongolia.
Accounting functions are outsourced, with Entrée’s CFO a consulting accountant that works for the firm part-time. The accounting functions affect firmwide activities as well. Entrée recently implemented a new chart of accounts, in an attempt to streamline coding of expenses and to facilitate quarterly and annual reporting. In addition, field personnel had requested faster feedback regarding ongoing expenses, so the Ulaanbaatar operations and the Vancouver operations have been switched to the same accounting system. Each office was using a different system before, and the translation between systems was slow and unreliable. By outsourcing the accounting function, there have been occasions where regulatory filings have been delayed because the CFO was working with other clients.

Entrée does not employ a bookkeeper, per se; rather the CFO and the business manager, with data entry help from the executive assistant, perform the bookkeeping tasks. As operations have expanded, however, it has become more difficult to keep up with the demand. The CFO works only part-time for Entrée and the business manager has several other areas of responsibility as well. The executive assistant does not have a background in bookkeeping, and is on a steep learning curve.

The cost of legal services are a large expense for Entrée and is another activity that is outsourced, as Entrée does not maintain in-house counsel. Securities lawyers are necessary to advise the company on any deals, regulatory requirements, press releases, other external communications, and exchange applications. Entrée recently became a reporting issuer in the United States, and the application prepared for the SEC in advance of being a reporting issuer required input from two law firms. Property deals that Entrée signed in the last 12 months were reviewed by law firms in Vancouver and Ulaanbaatar.

Until the end of 2003, outside legal counsel fulfilled many of the regulatory requirements and functioned as the Corporate Secretary. The CFO joined the firm in August 2003 and took on
the role of Corporate Secretary in December of that year. The CFO works part-time and is unable to effectively manage the duties of the Corporate Secretary, which are time consuming due to increasing regulatory requirements. In an effort to assist the CFO and reduce legal costs, the business manager has taken on more responsibility for regulatory filings, doing much of the coordination and liaising with legal counsel.

Communicating with potential and current investors is another large expense for Entree. This activity is designated as partially outsourced and in-house, with the in-house competency rated as fair. Entree has contracted an external investor relations firms, based in Toronto, and also communicates with shareholders using internal personnel. Investor relations activities are primarily directed by the business manager, with approval from the president and the Board. This competency is rated as fair because Entree shareholders have been vocal in their criticism in the level of communication from the company and the types of communications that are made by Entree. The website is out of date and printed materials are obsolete because of the speed of change the Company has experienced. The business manager attempts to oversee the investor relations program but this activity is being neglected and requires more attention as the Company expands.

3.2.2.2 Human Resource Management

Entree employs few full-time people, contracting much of its work to external contractors and consultants, as clearly illustrated on the Value Chain. Therefore the issues of primary importance to Entree are hiring and retention of quality personnel, including contractors and consultants, and payroll. The senior managers and most of the technical team were brought into the company by someone already working for or associated with Entree. Relationships are therefore a tremendous resource and Entree personnel rely heavily on people they know from past
experiences when looking for a new hire or a consultant to help with a particular issue or a contractor to provide a specific service.

The few people Entrée does employ are highly skilled. These individuals have been hired based on their experience and level of competency in their areas of expertise. This has resulted in a team that has been relatively effective in supporting the field programs and conducting exploration activities. Unfortunately, there have been conflicts among the staff and without an experienced human resources professional available, these conflicts have escalated, resulting in compromised productivity at times. Human resources issues have fallen under the purview of the business manager, who again has limited time and experience to deal with these issues. The remoteness of the worksite in relation to the corporate office in Vancouver and the exploration office in Ulaanbaatar also contributes to the challenge of dealing with human resources issues. The rotation schedule worked by most of the field crew further exacerbates the problems, with personnel working six weeks in, two weeks out and one week in the Vancouver office. Seldom are all interested parties in the same country together, let alone the same work location. The exploration manager, in particular, has been working a heavy schedule of seven weeks in, three weeks out for almost three years. He spends most of his time in Ulaanbaatar but also visits the camps and works out of the Vancouver office during a portion of his break. On his time off, he is often required to handle work related issues.

Contractors include contract geologists who are hired on an as needed basis, contract labour that provide manual labour for the field operations, drilling contractors, assay laboratories, geophysics companies, and construction contractors to build and maintain the camp. Expenses for these companies and individuals account for almost half of the exploration budget, or roughly $2 million this year alone, based on the current budget. Once hired, consultants and contractors are overseen by the project manager and the exploration manager. Hiring of contractors is done primarily by the president, exploration manager and project managers. The nature of the
requirements dictate who does the hiring, with the president and exploration manager handling contracts for large ticket items, such as geophysical surveys and drilling.

The competency in recruiting and retaining personnel has been rated as good, in light of the human resources issues encountered. Entrée has tried to combine competitive wage rates, though not the highest in the industry, supplemented with a generous option package for permanent staff and external consultants. The competition for qualified personnel is intense in the mining industry at present. Entrée managed to attract and retain highly regarded and competent personnel, despite the challenges, until spring 2005. Wage rates have increased and personnel availability is becoming more limited. The impending expansion of the work programs necessitates hiring additional personnel but Entrée has already been affected by the shortage of available geologists. Entrée made a job offer to a senior geologist that was turned down because of inadequate compensation offered and work location. This individual was offered 10% more than Entrée proposed and the work was based in British Columbia with a shorter work rotation.

Consultants are specific individuals, highly skilled in their particular areas of expertise. The competency in attracting and managing the consultants is rated as excellent. Entrée management has amassed a stable of talent to draw upon that is well regarded within the industry. Entrée has hired a well-known structural geologist for the past three years, for example, to provide insight into the geological formations on its properties. Entrée also contracted a highly regarded geochemist who is an expert in quality assurance/quality control, and designed the quality control system for sample collections and data gathering. This person also certified that the assay laboratories used met industry standards. Other consultants have included geologists who specialize in analyzing thin sections (pieces of rock viewed under a microscope to determine mineralization), geologists with experience in Mongolia, investor relations specialists, network implementation specialists, and graphic designers. Hiring consultants is arranged by whichever manager requires the assistance.
Payroll is outsourced to ADP Canada, with payroll input done by the business manager on a bi-weekly basis. This function was once performed in-house but was deemed to be too time-consuming for in-house personnel. At one point, the cheques were deposited personally by the business manager or the CFO on payday. The ADP system has reduced the time required to perform payroll to less than two hours per month. The business manager is currently responsible for payroll. This time commitment is expected to increase, however, as more staff are hired.

3.2.2.3 Technology Development

As the field programs have expanded, so too has the need for better control of information. While an overall information technology system has been implemented, as described under firm infrastructure, specific activities such as database development and implementation of procedures have been put in place.

Historical and current data are currently being entered into a database with a GIS component that will be used to generate maps and sections of the exploration areas. Entree has contracted an outside expert in database development to prepare the database, with input from Entree personnel. To date, Entree has used Excel spreadsheets and hand-drawn maps to support its exploration activities. The next level is the development of a comprehensive database that can run several scenarios, and include geophysical data along with the mapping, sampling and drill core results. Database development is outsourced but overseen by Entree geologists.

Last year, Entree experienced several procedural challenges in the field that related to how information was recorded and gathered. Since a formal procedure was not in place, individuals used their own methods for recording information such as sample location. These different methods resulted in confusion and lost time and efficiency. This year, the project geologist prepared formal procedures for field staff to follow to reduce and hopefully eliminate confusion. The crew is larger this year, with several new contract geologists on staff, therefore
the procedures should facilitate training as well. As the project expands, tighter controls and standard operating procedures will be required to limit the learning curve for new personnel and alleviate potential problems due to rapid expansion.

3.2.2.4 Procurement

As is obvious by reviewing the Value Chain, Entrée expends a great deal of its time and resources procuring external services, particularly consultants and contractors, to assist with company operations. This is clearly seen on the Value Chain by the number of activities that have an outsourced component.

Entrée does not employ a purchasing agent or have a formal purchasing policy in place. Purchasing requirements are directed by the project managers, most often to the business manager and executive assistant. There is little coordination between the exploration camps regarding ordering supplies or equipment, and miscommunications are frequent. Many of the purchasing requests are for very specific types of small tools or equipment, but the business manager and executive assistant are not geologists so do not always understand what is required. There are inefficiencies in the way the system works currently, and it often takes several days for an order to be prepared and shipped, much to the frustration of the field staff.

3.2.2.5 Value Chain Summary

Based on this analysis, it is apparent that Entrée has great reliance on external service providers to support firm activities. Most of the hiring decisions have historically been made by the president and exploration manager, often after a new financing was done so there was money available to hire additional personnel. The Company was regularly in a position of being understaffed and the staff it did have were doing little planning, but instead reacting to the events at hand.
The firm has a key competency in identifying qualified personnel, both for staff hires and consulting projects. The network of the president and exploration manager, along with input from the Board, enabled Entrée management to hire skilled personnel who helped grow the Company.

Entrée is stronger with the activities related to the scientific and technical side of the firm operations, not surprising considering it is led by a group of scientists, and is weaker on the soft side as it relates to human resources and investor relations. Human resources competency is important to develop, particularly in light of the shortage of qualified personnel within the industry. Investor relations is an important competency for a junior exploration company, as it relies on equity financing to fund ongoing operations and ultimately the sale of the property.

The Company is centred by a key group of people who are supported by outside consultants and contractors. Entrée personnel reach out to the needed resource as required, as illustrated in Figure 3.4:
3.3 Culture

The mining exploration industry lends itself to a frontier mentality, with the geologists often working in remote locations, living in tents and having to bring everything from computer equipment to food with them on location. For Entrée, working in the south Gobi Desert has magnified the frontier mindset of the exploration team. The Lookout Hill field camp is a minimum twelve hour drive over dirt tracks from Ulaanbaatar and a four hour drive from the nearest community airport. The recent agreement with Ivanhoe has provided Entrée personnel with access to the Ivanhoe airstrip and scheduled flights, but those flights only occur twice a week. The Ikh Ulziit Uul camp, established in 2004, is an eight hour drive across the desert from Ulaanbaatar, with no air access available.
The pioneering attitude of the first employees involved with Entrée contributed to the success the Company has enjoyed in recent months. It was necessary for personnel involved to act autonomously initially, because communication was difficult due to the remote location and the uncertainty of working in a foreign country. The original field crew consisted of two prospectors and a contract geologist, supported by 10 local labourers and two translators working on the Lookout Hill property alone. The exploration manager in Ulaanbaatar and the president in Vancouver provided guidance, but the daily decision making was left to the field crew.

The downside of running a lean operation and expecting employees to oversee several activities is that it is difficult for them to step back and evaluate what is being done. Since Entrée has been chronically underfunded and understaffed, there has been much pressure on particularly the senior personnel. The president travels extensively, to and from Mongolia and to financial centres around the world. The exploration manager has been working seven weeks in Mongolia, three weeks at home in British Columbia for three years, with the break time necessarily interrupted by work concerns. Limited time off has been the norm for the business manager, the project manager and technical manager for the field operations. People are getting burned out.

As more people are required to run the operations in Mongolia, the culture is changing and becoming more conservative. More direction is being given by the exploration manager in Ulaanbaatar and from the office in Vancouver. Since there is the availability of reliable satellite telephone service, including internet access, the camp is in closer contact now with the other offices. The Vancouver office, as the corporate headquarters of the Company, is evolving into a more bureaucratic entity, and this difference in the culture between the two locations is creating conflict.

Some of the conflict appears to result from loosely defined roles and responsibilities. The Company has grown so rapidly it has not kept up with formal systems often associated with
larger organizations. The absence of a published organization chart on which employees can see where they fit within the Company and vaguely defined reporting structure has contributed to misunderstandings and conflict. There has been a lack of communication from head office about developments in the company, but this has not been purposeful. More personnel and better systems are required in order to perform all the vital tasks of the firm. Chronic underfunding has led to chronic understaffing which has led to frustration due to lack of proper guidance.

It is also important to note that in the junior mining industry, there is little expectation of a permanent position. The cyclical nature of the industry naturally dictates the level of employment within the industry at a given time. For those individuals familiar with the industry, it is understood that the work is likely temporary so make the most of it while it lasts. This sense of the temporary is known and accepted by participants in the industry.

3.4 Financial Information

Since July 2002, Entrée has raised over $40 million in equity financing and attracted over 2,000 shareholders. The Company has experienced rapid growth in the last three years, from a market capitalization of $300,000 to over $150 million. As a junior mining company, Entrée’s intention is not to build a mine but rather to find a worthy deposit that will be purchased by another mining company. The investments made by mining companies to date have been encouraging and have now provided Entrée with the resources to explore more of its property and evaluate potential acquisitions. Below is a table that outlines the current financial situation of the Company:
Table 3.1: Financial structure of Entrée Gold Inc.

<table>
<thead>
<tr>
<th>Shares Issued and Outstanding</th>
<th>64,916,276 (July 6, 2005)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share Price</td>
<td>$2.38 (July 6, 2005)</td>
</tr>
<tr>
<td>Market Capitalization</td>
<td>$154,500,074 (July 6, 2005)</td>
</tr>
<tr>
<td>Warrants</td>
<td>13,025,880 (avg price - $2.18) = $29,316,378</td>
</tr>
<tr>
<td>Options</td>
<td>8,865,000 (avg price - $1.26) = $11,195,250</td>
</tr>
<tr>
<td>Fully Diluted</td>
<td>86,807,156</td>
</tr>
<tr>
<td>Cash on hand</td>
<td>-$26,000,000 (July 6, 2005)</td>
</tr>
<tr>
<td>Burn rate</td>
<td>$120,000 / month – annual administration $600,000 / month – field operations (7 months) (note: these figures are based on the expectation of an increased field program)</td>
</tr>
</tbody>
</table>

Data source: Entrée Gold Inc.
4 KEY ISSUES

Entrée is in a unique position within the mining industry. It is not often that a small junior exploration company takes a chance on a land position that turns out to host the extension of a deposit the size of Oyu Tolgoi. The fact that the deposit does indeed extend onto Entrée’s ground, and that a deal has been signed that effectively gives Entrée 20% of the value of the ore eventually produced there, has allowed the market to attach a value to Entrée’s holdings. The additional investment by Ivanhoe and Rio Tinto has not only given Entree credibility in the market, evidenced by increased media coverage and a higher market capitalization, it has also provided the funds for Entrée to explore its own properties more aggressively and pursue possible acquisition targets. The investments also reinforced the belief of Entrée’s management in the present project portfolio.

4.1 Overview of Issues

While the faith of the management team and Board has been affirmed, Entrée is still faced with some serious issues. The Company is going through a transition period, from functioning as an essentially temporary enterprise to becoming a more firmly established entity. During the last three years, Entrée has evolved from a start-up financed by $300,000 from the fifteen original investors to become an international organization with operations in two countries, employing 120 people full-time and part-time, with over 2,000 shareholders and a market capitalization of over $150 million.

Entrée’s management and technical team was brought together to find a potential deposit; not to build a mine. The skill set does not exist in-house within the organization to develop any
of its projects beyond the advanced exploration stage. Therefore, any decisions made will be grounded in this knowledge.

Entrière has now reached the enviable stage for a junior exploration company where management’s worries are less about where to get the next financing and more about how to effectively spend the money raised. The most urgent concern is how much to expand the work program and how to find additional skilled personnel to work on its projects. The Company also needs to determine how much, if any, of the treasury should be set aside for possible acquisitions as well as how to invest the money that is not needed in the near term.

The impact of these decisions on the relationships with Ivanhoe and Rio Tinto must also be evaluated. Ivanhoe has a first right of refusal on the Lookout Hill property and Rio Tinto has a first right of refusal on the Ikhi Ulziit Uul property. If the exploration programs associated with these properties yield significant results, Entrière may want to make another deal with one or both of these companies.

Investor relations activities have received scant attention and are in desperate need of improvement. In addition, internal conflicts between field operations and corporate office are becoming time consuming, and human resources issues are impacting operations both in the field and the Vancouver office. There seems to be confusion regarding roles and responsibilities and how the reporting structure works. Very few formal systems exist, with many decisions made on an ad-hoc basis and records are not preserved for future reference.

An evaluation of the key issues has been conducted. The findings are presented in order of perceived importance and guidance is also provided regarding who within the organization should be responsible for addressing specific issues.
4.1.1 Company Vision

Underlying all of the issues is the consideration of what kind of company the management team wants to build. The approach of the management team has been to treat the Company as a project with a finite end, rather than as a lasting enterprise with a long future ahead of it. The management team has been in reactive mode, learning how to function in a foreign country with limited infrastructure, while responding to regulatory and market changes. Senior management has been in an almost constant state of negotiations with successive companies associated with or interested in the project, from the original owner of the Lookout Hill concessions to the most recent deal with Rio Tinto. Now that negotiations have been completed, there is a direct impact on the scope of the exploration programs. Little time has been taken to discuss long-term strategy or define company structure because the outlook for the Company has been changing so rapidly.

Decisions made regarding financing and potential acquisition or divestiture directly impact this outlook. There is a great deal of uncertainty among the management team about how to structure the Company. In addition, many people of influence have different visions of how they foresee Entrée evolving. These differences in vision create short term conflicts around decision making. Resolving these conflicting visions and getting all persons involved with Entrée to focus on a common goal is essential for the future success of the firm.

4.1.2 Corporate Policy Development

The Company has grown so quickly that the management team has not prepared formal policies to guide decision making. Rules are made up on the fly and are inconsistent, depending on the timing and the decision maker. This inconsistency has contributed to human resources conflicts or created extra work for the administrative and accounting support personnel. More clarity is required with regard to accounting, human resources, company travel, expense tracking,
purchasing, and hiring. Simple tasks such as tracking vacation time have not been undertaken and the management team is concerned about establishing policies before a serious problem erupts. This was a concern before the investments made in summer 2005. The expected expansion of the program makes this issue more urgent.

With the impending expansion, it is all the more important for the Company to have a solid foundation. Sound internal policy that provides clear direction is vital to strengthening this foundation. Working on corporate policy goes hand in hand with clarifying company focus. It should be the responsibility of the management team to direct policy development, with input from the project managers. The management team, however, consists of the president, exploration manager, business manager and CFO, all of whom are overloaded. It is in management's best interest to implement change, the challenge will be in the execution.

4.1.3 Program Expansion

With over $26 million in the treasury, Entrée is faced with the challenge of how to use the money to the greatest advantage to its shareholders. The exploration program for 2005 was budgeted for US$3.9 million, and involved exploration and limited drilling at both Lookout Hill and Ilk Ulziit Uul.

Increasing the size of the exploration programs involves determining how much more geophysical surveying, sampling, mapping and drilling should be done, then hiring enough personnel to accomplish the requisite tasks. The appropriate equipment must be sourced and mobilized. Support personnel, such as labourers, translators, and drivers must be hired. This must be accomplished before the cold weather settles in because the field camps are not set up for winter exploration. The Company needs to decide if it wants to continue operations through the winter, in which case the camp must be modified to allow for the extremely harsh climate of the south Gobi in the winter months.
The influence of the program expansion in the field carries over into the Ulaanbaatar exploration office as well as the corporate office in Vancouver. Personnel in the exploration and corporate offices handle the logistics of supplying the camps. As the programs ramp up, more resources will need to be devoted to moving materials and personnel to, from, and between the camps. Activities such as shipping and receiving, supplies purchasing, contracting, recruitment, payroll, and accounting will involve more time and effort than was required before the expected growth. More specialization is going to be required, as each separate activity begins to occupy more time. This will require individuals to focus on specific tasks, where in the past these same individuals were able to oversee more activities concurrently. Responsibility for development of the expanded program again falls on the time-strapped managers, with input from the technical team.

4.1.4 Human Resources Management

Successful execution of the expanded work programs can only be accomplished if enough skilled personnel are available to implement the plan. Recruitment and retention must be top priority for the Company. The rotation schedule must accommodate training of new hires, and ensure adequate coverage in the field. A determination must be made as to what skills are needed and what types of positions should be created within the organization. Then the search for the right personnel to fill the positions must be undertaken. The tight supply of qualified personnel in the mining industry is a serious concern. There is a shortage of qualified personnel in the industry and it is difficult to find new employees, especially people that are willing to work in the Gobi Desert for six to seven weeks at a time, particularly in the middle of the field season.

The Company has also received early indications that it needs to review the compensation package for employees. The limited availability of personnel has already resulted in increased wages and salaries; this will likely continue. Hiring has been done to date as needed,
with little coordination or forethought given to long term planning. Some individuals were hired primarily because they were available, not because they were the best candidate for the job. In other cases, previous relationships were honoured but were not in the best interest of the project.

Entrée has experienced human resources challenges due to the decentralized nature of the Company, as personnel are uncertain about roles and responsibilities. It appears that while management has a clear perception of who should be doing what, the personnel on the ground do not have the same certainty. Conflicts have arisen and the lack of experience with human resources management within the firm has meant that resolution of these conflicts has fallen to the president, the exploration manager and business manager. These individuals travel extensively and with the majority of staff working in Mongolia and living away from Vancouver, resolving human resources issues has been extremely challenging. Management has been reluctant to address human resources issues directly, in part because of the rotation schedule and difficulty in communicating via satellite telephone and e-mail. The personnel working for the Company are highly capable individuals and it is likely some employees will leave if matters are not adequately resolved.

Clarification of roles and responsibilities takes on greater importance as more personnel are hired as well. Misunderstandings have already taken place because it was not clear who had the authority to make specific decisions. These misunderstandings were caused in part due to the rapid growth of the Company, the disparate locations of the persons involved, and exacerbated by the remoteness of the field camps and the rotation schedule.

4.1.5 Investor Relations

During the value chain analysis, the investor relations activities were identified as being only fair competencies for the company. Entrée has contracted an outside investor relations firm to assist with shareholder and media communications. This firm, however, tends to be more
promotional in nature than regulatory authorities permit, and seems to be largely ignorant of
Canadian regulatory requirements with regard to disclosure and promotion of mining companies.
Entrée has purposely chosen to be very conservative in its approach to material disclosure. The
investor relations firm is sometimes frustrated by this.

Responsibility for managing investor relations has been given to the business manager.
The ability of the business manager to effectively use the investor relations firm to Entrée’s full
advantage has been hampered by fulfilling ever-increasing regulatory requirements and the
administrative demands of the Company.

Investor relations activities are often conducted on an ad hoc basis, with little forward
planning. A formal plan does not exist. In addition, the perception of how investor relations
should be handled varies among the Company principals, creating more confusion as to how to
best direct these activities.

The website is woefully out of date, and the Company has grown and changed so quickly
that virtually all printed materials are obsolete. The presentations used during the road shows
have been upgraded and are current but the display booth used for conferences needs to be
modified to reflect the changes to the Company.

The lack of consistent geological support in the Vancouver office has also created
difficulties in answering investor questions, updating Company materials, and providing technical
information to the president and Board.

4.1.6 Impact of Major Shareholders

Entrée was formed to take advantage of an opportunity, with the belief that the Company
could be taken over by another mining company within twelve to eighteen months. Three years
later, two mining companies, each much larger than Entrée, have purchased significant share
positions in the Company instead. The original deal with Ivanhoe was perceived to have limited
the interest of potential suitors by some of Entrée’s shareholders, but the relationship with
Ivanhoe did not deter Rio Tinto from making a substantial investment in Entrée.

The respective deals with Ivanhoe and Rio Tinto, however, are vastly different. Ivanhoe
has a much greater effect on Entrée activities than Rio Tinto is expected to have. Ivanhoe is
actively and aggressively exploring the Copper Flats area. Under the conditions of the Earn-in
Agreement, the data gathered from the extensive drilling program is shared freely with Entrée
geologists. Ivanhoe, however, is still in control of the drilling, even though input from Entrée’s
technical team is provided on a daily basis. Drafts of pertinent press releases are shared between
the companies and coordination of news dissemination is necessary to ensure material
information is disclosed appropriately. The timeliness of information sharing is very tight at
times, and there have been occasions when Entrée was delayed in releasing news after Ivanhoe
issued their press release.

Ivanhoe also has a first right of refusal on Lookout Hill and is interested in the results
generated by Entrée’s own exploration program. Entrée personnel have to be careful to limit
access to information about exploration activities outside of the Agreement Area, as this data is
not bound by the Earn-In Agreement.

Rio Tinto is a major shareholder, with almost 10% of the Company’s outstanding shares,
but it is not a partner in exploration. Rio Tinto, however, is interested in Entrée’s Ikh Ulziit Uul
project and one of the conditions of its private placement was the first right of refusal on this
property. Entrée, however, has no obligation to share information with Rio Tinto about Ikh Ulziit
Uul and any material results must be distributed publicly, without special consideration to Rio
Tinto, regardless of its interest at this time.
It is also important to note that the agreements with both Ivanhoe and Rio Tinto require that both companies vote their respective blocks of shares with Entrée management on matters such as election to the Board, setting the stock option plan and the like.

4.1.7 Potential Acquisitions

The money currently in the treasury will be spent over several months or even years. Some of these funds could be used to acquire interest in other projects owned by other mining companies. Entrée is actively seeking other projects to invest in, but management has been clear that it will only invest in projects that would fit within Entrée’s portfolio. Some of the criteria for evaluation is based on the geographic location of the projects, with the Company wanting to invest primarily in Asia so that Ulaanbaatar could remain a base of operations, possibly for other projects. Other criteria include the type of mineralization, whether the project involves gold or copper, and what underlying arrangements may exist. The Board and technical team have already proved adept at conducting due diligence and making deals. If the right deal is presented, an investment can be made because the funds are available.

Management needs to decide, however, if it is in the Company’s best interest to acquire additional projects and creating additional work for its technical team. The technical team is having difficulty meeting the expectations of management as it is. There is a shortage of experienced personnel which is expected to persist for several years. Management has to determine what the priorities for the Company are: exploring the existing properties or acquiring new ones.

An additional consideration should be the fact that metals prices are at all time highs. Just as Entrée has increased in value, so too have other companies. Thus, any potential acquisitions would be priced at a premium as well. Entrée’s management should be aware that there is a risk to acquiring additional properties in a heated market.
4.1.8 Money Management

While the exploration programs are underway, and due diligence on possible acquisitions are being conducted, the money in the treasury can earn interest. Even at the low interest rates of today, the amount earned on $26 million is substantial. The Company needs to determine what investment options are available for the amount of money remains, after funds are allocated for the expanded programs and possible acquisition targets. Consideration must also be given to the liquidity of the funds. If a promising acquisition opportunity arises, large sums of money may need to be released to close a deal. Management must consider potential penalties and costs with any investment vehicles chosen, to ensure that funds are available when needed.
5 RECOMMENDATIONS

Entrée has several issues that must be tackled concurrently. With the current resources available to the Company, it can be overwhelming to consider how best to address the concerns and progress with implementation. The following recommendations are presented in order of importance but this is not intended to be a serial process. Some of the recommendations can be undertaken at the same time. Many of these recommendations could not be implemented if not for the availability of adequate funds to expand exploration, compensate new hires and additional contractors, and make acquisitions of new projects.

Clarification of the Company vision is an overarching issue that impacts all other decision making. Management has functioned for three years under the premise that the Company could be taken over at a significant premium. For the president and Board, a takeover at $5.00 per share or more would make them each instant multi-millionaires and enhance their reputations within the industry. The downside of this presumption, however, was that establishing a formalized structure of any sort was unnecessary because the Company would not be around for long. While the value of the Company has steadily increased, this lack of formal structure has become a pronounced deficiency and is hindering the expansion process and creating significant pressure on all personnel, including the management team.

With less concern about how to fund the program, management should now concentrate on what kind of a company they want to create. Planning for the future of Entrée as a sustainable enterprise should begin immediately. By making decisions under the premise that the management is building a long-lasting organization, management will be able to continue to
attract talented personnel, track and evaluate progress and meet the demands of shareholders more effectively.

Designing the expanded exploration program can be done by the exploration manager and technical team. Their proposed plan should be presented to the president and Board for approval, but the technical aspects of the program should be determined first. Then the logistics of implementing the expanded program can be addressed, including procuring equipment and personnel.

It is late in the field season and difficult to find personnel and equipment. Geologists are often committed to work in the late winter or early spring, taking the winter off after many months spent in the field. Equipment is allocated by suppliers early in the field season as well. Entree will have to work around the existing schedules of other companies to secure a geophysical crew and equipment, and additional drill rigs and crews.

At the administration level, there are too few support personnel to support the expanding programs and hires must be made in the corporate office to ease bottlenecks in investor relations, purchasing and accounting.

5.1 Long Term

Many of the issues facing Entree’s management are rooted in its past reluctance to plan for a long and sustainable future. After three years of operations, Entree has attracted talented technical personnel but the Company has experienced many growing pains associated with building and growing an organization. To date, the Board has been more interested in a favourable takeover that would increase shareholder value and provide seed money to start over again with a new opportunity than creating a lasting enterprise.
Approaching future decision making from the perspective of growth and building an ongoing concern, however, does not exclude a future takeover. Rather, a focus on a sustainable future can create value for existing and future shareholders because the management and staff will be expected to act in the long-term interest of the organization. A sustainable organization allows the management and Board to approach any potential suitors from a position of strength.

By being more proactive, management and staff can better anticipate challenges and propose plans and actions that further increase the value of the organization. The influx of cash from the investments of Ivanhoe and Rio Tinto has freed Entree’s management from the concern of securing funding. Now, management can concentrate on what is best for the advancement of the Company and the projects in the future.

5.2 **Medium Term**

Once the Company has committed to building and sustaining the organization, management’s focus can be turned to the specifics of how best to address the issues that have arisen because of the rapid growth. Apart from preparing the plan for the technical program, management must address issues such as improving investor relations, human resources management and corporate policy development. Investor relations and human resources have only been given cursory attention, and any type of corporate policy is practically non-existent. Addressing these issues, however, will take time and planning. Staff hires must be made to take the pressure off corporate personnel. Over the next six to nine months, after key hires have been made in investor relations and accounting, the management team should be able to develop better systems in each of these areas.
5.3 Short Term

Entrée has grown and thrived in the last three years, attaining a 700% increase in market capitalization in the last twelve months. Now that adequate funding is available, hiring enough people to do the work, investing in adequate equipment and planning for the future are conceivable and achievable goals. Decisions regarding personnel and equipment made with the long-term view should mean that personnel plan proactively, knowing that any decision they make now will have an impact in the months and years ahead. There is much that should be done in the short term to support the future growth of the Company.

5.3.1 Planning and Expanding

As soon as the private placement was announced, management began sourcing people and equipment. The scale and speed of the expansion is driven by availability of resources. For example, if the Company cannot source more drill rigs, there will not be a need to hire more geologists. Drilling companies were contacted immediately to secure one or more drill rigs and the requisite crews. The number of rigs will depend on what is available in or around the project sites. The original plan was to have the same drill move from Lookout Hill to Ikh Ulziit Uul.

By choosing to advance its own projects, Entrée can concentrate on what lies within its existing holdings. Little exploration has been done to date and increasing the existing exploration program by 50% would allow the Company to contract two additional drills, for a total of three drills that could work at Lookout Hill and Ikh Ulziit Uul concurrently. The existing drill can remain at Lookout Hill and another could be contracted, so that two target areas could be drilled simultaneously. Once a third one has been sourced, it can be sent to Ikh Ulziit Uul. While sourcing the equipment, the Company can also be looking for additional personnel to assist with the expanded program.
It is important to advance both projects because if mineralization is discovered on either property, Entrée’s value should increase for its shareholders. A 50% increase in the program equates to a budget of US$5.85 million and would allow the Company to drill approximately 10,000 additional metres. At this level of spending, Entrée has enough money to fund approximately four years of operations. During that time, the technical team should be able to do enough work to determine whether the project warrants further financing.

Expanding the programs does not entail drilling alone. Additional geophysical surveys can be done, and sampling and mapping activities can be increased using existing resources. One of the contract geologists is available to return to camp and should be sent over as soon as possible. One of the summer students is considering staying on for the fall and winter, rather than returning to school. He should be encouraged to stay, assuming arrangements can be made to hire his replacement shortly and he can return to school next year without jeopardizing his degree.

Potential drill targets are chosen based on the findings from the surveys and the sampling and mapping results. It takes experienced personnel to evaluate these findings and design the drill program. Entrée’s technical team has already identified the priority target areas so there is time to hire additional senior geologists to assist with data analysis and compilation. The increased visibility of Entrée, particularly after making the deal with Rio Tinto, has resulted in the Company receiving unsolicited referrals for personnel from other participants in the industry. The senior geologists and the president should begin interviewing immediately to see if any of these people are suitable candidates for the program.

At the corporate level, as the program expands there will be increased need for purchasing, bookkeeping, accounting and human resources support. The CFO works part-time as does the executive assistant. There is a need for additional personnel to support operation at the administration level. The CFO currently spends much of his time working on tasks that could be
done by someone less specialized. Outsourcing is done for highly specialized tasks that do not require full-time coverage. In-house staff provide project management and perform the tasks that need to be done daily or weekly. In the case of bookkeeping and accounting, regulatory requirements and expansion of the programs has resulted in a workload too great for the CFO and business manager to manage with their other responsibilities. A new hire should be made who can work full-time, and take the pressure off the CFO and business manager to allow them to focus on regulatory requirements and strategic planning. This person could also assist the executive assistant with purchasing and logistics, as servicing the exploration camps has required more time as the projects have expanded as well. The workload for these activities is expected to increase and it is best to hire this person quickly so they can absorb some of the impact of the expansion.

5.3.2 Human Resources Management

The Company also needs to evaluate the hiring process and the compensation package. Since it is expected that several new hires will be made in the next few weeks or months, it is imperative that there is better control of human resources management. It is important to provide personnel with clear guidelines and structure, so that they can make intelligent and informed decisions. The remoteness of the work locations and the extensive travel of the senior managers means that the technical team and field personnel need to be able to make decisions without having to constantly double-check with senior management. On the other hand, senior management needs to be in regular contact with the technical team and field crew to ensure that lines of communication are open.

As part of implementing tighter internal control, employment contracts should be reviewed to ensure the Company has covered all pertinent issues. A labour lawyer specializing in these contracts could review the existing templates relatively quickly and provide feedback to the
Company. A lawyer should be contacted and asked to conduct this review as soon as possible, before much hiring takes place.

While the contract review is taking place, Entrée needs to review the salaries and wages it is offering. One senior geologist has already turned the Company down due to inadequate pay and undesirable work location. A premium must be paid for people to consent to work in Mongolia. Members of the Board work for other mining companies and the business manager has contacts at other firms as well. The Board and the business manager should conduct informal surveys to determine what the rates are for typical positions, to make sure the compensation package is in line with what other companies are offering. When the contract review is done, the appropriate compensation package can then be inserted in the contract template.

As part of the program expansion, a scope of work should be prepared and understood by the technical team. An organization chart should then be prepared so that it is clear which people will be working at which camp and who reports to whom. Roles and responsibilities have been unclear in the past, therefore they should be clearly outlined in the employment contract. Announcements should be made so that everyone knows when a new person is joining the Company. The reporting structure should be made clear to new hires and reiterated to veterans of the program. That way, if there are issues with a specific employee, they can be addressed with the supervisor. Employees will also know to whom they should speak if they are having difficulty.

Senior managers should also be encouraged to elicit feedback from employees on an informal basis, to ensure that new hires are working out and that long-term employees feel free to provide input.
5.3.3 Investor Relations

To support ongoing activities, a comprehensive investor relations program is necessary to target investors and potential customers, as well as explain the benefits of the deal with Ivanhoe. Entrée has improved its investor relations activities in the last twelve months but has been getting more attention due to its location and deal-making, not because of the benefit of its investor relations activities. The website is out of date and changes are happening so rapidly it is difficult to keep the investor kit updated as well. The outsourced investor relations firm is doing a good job of promoting Entrée to the media and handling investor questions but they do not have an innate understanding of the mining industry. In addition, they are based in Toronto and the time difference impacts effectiveness.

The business manager is overloaded with the administrative responsibilities within the Company and it appears to be time to hire a full-time investor relations person to oversee the program and liaise with the outsourced firm. This person could direct the marketing activities and ensure that the website and communication materials are current. This role is gaining in importance and should be filled as quickly as possible.

5.3.4 Major Shareholders

The investments made by Ivanhoe and Rio Tinto have given Entrée freedom from imminent concerns about funding but have spawned issues regarding information sharing, decision making and strategic planning. The nature of the respective agreements with Ivanhoe and Rio Tinto are very different.

Entrée must be careful in how it communicates with Ivanhoe, as it is a partner as well as a significant shareholder. Care must be taken to be an active participant in the exploration of the Agreement Area, but not to reveal information about exploration conducted on the remainder of Entrée’s ground. The exploration teams for the respective companies are in regular contact and
there have been information leaks between the companies. Senior Entrée management must reiterate to the technical team that Ivanhoe’s access to Entrée’s data gathered outside the Agreement Area is not allowed.

In addition, Entrée’s management should be more assertive about the access to data gathered within the Agreement Area. An issue in the past has been the short notice given regarding material information to be issued in press releases, with Entrée’s release following Ivanhoe’s because the data was not provided with enough warning for Entrée to review the data and prepare the appropriate disclosure. The spirit of the Agreement was for Entrée to have access to data concerned with Entrée’s ground. This is a delicate matter, however, because Ivanhoe controls the release of the data and the subsequent analysis. Since one of Entrée’s Board members is from Ivanhoe, Entrée management should formally request the timely disclosure of information in future.

With regard to Rio Tinto, Entrée has no obligation to disclose information regarding any of Entrée’s exploration activities, outside of that already publicly available. Rio Tinto has first right of refusal on Ikh Ulziit Uul, should another company make an offer for the property, but that is all. Rio Tinto is not entitled to any advance disclosure of data that is not public information. Rio Tinto is a shareholder, albeit a significant one but is not a partner like Ivanhoe.

The investments by Ivanhoe and Rio Tinto have increased the sensitivity towards decision making and strategic planning. Both companies are required to vote their share blocks with Entrée’s Board so for all intents and purposes, Entrée controls voting for over 30% of the Company. Such large shareholders, however, increase the pressure on management when considering other acquisitions, major spending or strategic planning. It would be foolhardy for Entrée management to initiate negotiations with another company regarding acquisition or merger, for example, without first considering the possible reaction of its largest shareholders.
While these companies do not have the authority to dictate management decisions, their investment does change the considerations of management. It is essential for Entrée management to maintain this awareness when making universal decisions that impact the future of Entrée.

5.3.5 Potential Acquisitions

The influx of cash has given Entrée the freedom to consider a myriad of options, one of which is the potential acquisition of other properties. The availability of the funds, however, does not mean that Entrée should expand its portfolio of projects immediately. With metals prices at all-time highs, property prices are also at a premium. Careful consideration would have to be given to any potential acquisitions.

The Company can afford to wait for an exceptional opportunity. There has been very little work done on the ground Entrée already holds and the value of the Company can be increased by working on the existing mineral concessions. The Company is largely valued, at present, for the work done by Ivanhoe on the Agreement Area, which confirmed the extension of Oyu Tolgoi mineralization. By making further acquisitions, there is a risk the market would view that as a dilution of the Company interest. Additional acquisitions at this time would require already scarce resources to conduct due diligence and advance yet another exploration program.

Entrée’s management team is certainly capable of conducting reliable due diligence, as has already been demonstrated. The issue at hand is whether the interests of the Company and its shareholders are better served by conducting due diligence on a new project versus trying to increase the value of the existing projects. Considering the level of the metals prices, and the length of time that resources have been in a bull market, it would be prudent to take the time to concentrate on making the most of what Entrée already owns.
In order to stay connected within the market for potential acquisitions, while freeing up Entrée staff to concentrate on the current portfolio, the Company should hire an outside consultant who specializes in property evaluation and due diligence. The in-house expertise is available to conduct these activities, but the individuals who possess this skill set are currently needed to advance the existing projects. By outsourcing the acquisition search, Entrée staff will be available to manage the current expansion.

5.3.6 Money Management

It is not likely that Entrée management would spend $26 million in the next twelve to eighteen months, therefore investment options for the money must be considered. Assuming an exploration program expansion of 50%, the total cost for operations in the next twelve months would be approximately $8.7 million. The approximate burn rate for the next twelve months would then be roughly $730,000 per month. The Company has been conservative with its investments, choosing to sacrifice a small amount of interest for the security of Triple A securities. It is expected that this conservatism will remain, regardless of how much money is available for investment.

It is suggested that the Company invest approximately 95% of the capital required for the expanded program ($8.3 million) in a bank GIC held at its local bank branch. This type of instrument carries an interest rate of between 2.2% and 2.4%, is highly liquid and allows withdrawals with no penalty. This is the financial instrument Entrée has used for the last two years to hold the funds from the last two financings. Since it is held by Entrée’s banking institution, it allows easy transfer to the chequing accounts and minimal hassle when the time comes to move funds. The remaining $400,000 can be held in the chequing accounts to cover imminent expenses. During drilling season, invoices often run into the hundreds of thousands of dollars and keeping enough funds in the chequing account to cover pending payables eliminates the need
for the bank to contact the business manager or CFO for permission to transfer funds, which could delay payment.

The remaining $17.3 million should be invested in safe but higher interest instruments, such as government bonds. Preliminary information gathered from financial institutions indicates that Entrée could invest in a series of bonds, with varying yields and coupons that could generate a small amount of income (roughly 3.5% per year). The instruments are highly liquid and can be sold easily. Once redeemed, it normally takes one or two days to obtain the funds.

5.4 Summary

Some of the recommendations require allocating funds for people and equipment while others need management to spend time on planning and implementation. A summary of recommendations is provided in Table 5.1:

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Responsibility</th>
<th>Timing</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Clarify Company Vision</td>
<td>Board, Senior Management</td>
<td>Begin immediately, ongoing refinement</td>
<td>Time</td>
</tr>
<tr>
<td>2) Expand exploration program</td>
<td>Exploration Manager, Technical Team</td>
<td>Begin planning immediately</td>
<td>50% increase for 2005 = additional US$1.95 million for a total of US$5.65 million</td>
</tr>
<tr>
<td>2a. Prepare scope of work and source equipment</td>
<td>Exploration Manager, Technical Team</td>
<td>Within 30 days</td>
<td>n/a</td>
</tr>
<tr>
<td>2b. Prepare budget</td>
<td>Exploration Manager, Technical Team</td>
<td>Within 30 days</td>
<td>n/a</td>
</tr>
<tr>
<td>2c. New hires</td>
<td>Exploration Manager, Business Manager</td>
<td>Within 30 days</td>
<td>Range $150,000 to $200,000 total annum</td>
</tr>
<tr>
<td>3) Corporate expansion / evaluation</td>
<td>President, Business Manager</td>
<td>Within 60 days</td>
<td>See below</td>
</tr>
<tr>
<td>3a. Hire office manager/bookkeeper</td>
<td>Business Manager</td>
<td>Within 60 days</td>
<td>$55,000 - $66,000/annum</td>
</tr>
<tr>
<td>3b. Hire investor relations coordinator</td>
<td>Business Manager</td>
<td>Within 60 days</td>
<td>$65,000 - $76,000/annum</td>
</tr>
<tr>
<td>3c. Review compensation package for ALL employees</td>
<td>President, Business Manager, CFO</td>
<td>Within 30 days</td>
<td>n/a</td>
</tr>
</tbody>
</table>
Entree has enough money in its treasury to allow the Board and management some breathing room to evaluate the future and create a sustainable organization. The Company owns the rights to large tracts of land that have been largely unexplored but that have considerable potential to host gold and copper mineralization. Hiring additional personnel to help facilitate the exploration program expansion and take the pressure off senior management should allow the Company to enhance the value of its existing portfolio. If an exciting investment opportunity presents itself, Entree management can respond with care and consideration. Focusing on the existing assets at present, however, is the best option in the short term for creating value and expanding the Company.
REFERENCE LIST


