



SouthGobi Energy Resources Ltd.

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL
CONDITION AND RESULTS OF OPERATIONS**

December 31, 2009

(Stated in U.S. dollars)

SOUTHGOBI ENERGY RESOURCES LTD

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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(unaudited)

(expressed in U.S. Dollars)

OVERVIEW

SouthGobi Energy Resources Ltd., (which, together with its subsidiaries, is collectively referred to as the "Company" or "SouthGobi") is an integrated exploration, development and coal mining company. Since acquiring significant coal assets in Mongolia in a series of transactions (the "coal transaction") with Ivanhoe Mines Ltd. ("Ivanhoe"), the Company's strategic focus has been in developing and operating coal mining projects.

The Company's common shares trade on the Toronto Stock Exchange ("TSX") under the symbol SGQ. Upon completion of the International Offering and the Canadian Offering and the secondary listing of the common shares on the Hong Kong Stock Exchange on January 29, 2010, the Company's shares also trade on the Hong Kong Stock Exchange under stock code symbol 1878.

Prior to the coal transaction, the Company was a mineral exploration company with a focus on precious and base metal exploration and development in Mongolia, and elsewhere. The coal transaction was completed in May 2007 and with the sale of its Metals Division to Ivanhoe as of December 30, 2008, the Company's principal focus no longer includes precious or base metals.

The Company owns the following significant coal projects in Mongolia: the Ovoot Tolgoi open pit producing coal mine ("Ovoot Tolgoi Mine"), and two development projects, the Soumber Deposit, and the Ovoot Tolgoi Underground Deposit. The Ovoot Tolgoi Complex comprises the Ovoot Tolgoi Mine together with the Ovoot Tolgoi Underground Deposit.

The Ovoot Tolgoi Mine, strategically located approximately 40 kilometers ("km") from the China-Mongolia border, is the Company's flagship producing asset. The Company commenced mining at Ovoot Tolgoi's Sunset Pit in April 2008 and commenced coal sales in September 2008. The products from the Ovoot Tolgoi Mine include coking, premium and thermal coals, which are being sold to customers in China. Since the commencement of production in late 2008 until December 31, 2009, the Company has sold approximately 1.4 million tonnes of coal from the Ovoot Tolgoi Mine. The Ovoot Tolgoi Mine is covered by a single 9,308 hectare ("ha") mining license and a corresponding permit to mine.

The Soumber Deposit is located approximately 20 km to the east of the Ovoot Tolgoi Mine, which could allow the operations to share existing infrastructure in the event a mine is developed there. Preliminary exploration results show potential for thick seams of coking coal, and a resource has been established confirming the deposit. The Company is planning to do more exploration work on the deposit to fully investigate the feasibility of this project and to prepare for licensing.

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The Company has conducted substantial exploration activities at the Ovoot Tolgoi Underground Deposit and has delineated mineral resources at this project. The Ovoot Tolgoi Underground Deposit is covered by the existing Ovoot Tolgoi Mining License.

In addition, the Company owns the Tsagaan Tolgoi Deposit in Mongolia, which has a mining licence, and prior to December 23, 2009, held an 85% interest in the Mamahak Deposit in Indonesia.

Corporate Developments

Ovoot Tolgoi Complex

Coal shipments from the Ovoot Tolgoi Mine commenced in late September 2008 and continued throughout the fourth quarter of 2008. In January and February 2009, the Company experienced difficulty expediting the movement of its coal shipments through the Mongolia-China border crossing check point at Ceke due to erratic and unpredictable opening hours and sporadic closures. As a result, the Company initiated a production curtailment program in January 2009, decreasing production to preserve cash and to manage stockpiles.

The Company continued coordinating efforts with the Mongolian Government and various agencies to improve border crossing access for coal shipments. On February 24, 2009, in a further effort to minimize costs, the Company shut down production at the Ovoot Tolgoi Mine operation. All production equipment was demobilized, except for coal loading of customer trucks from the coal stockpile.

As discussions continued with the Mongolian Government, border access improved towards the end of the first quarter of 2009. In March 2009, the border crossing check point started operating on a more formal basis, with a schedule of eight hours per day, seven days per week. This resulted in increased shipments for the month of March, with sales of over 115,000 tonnes of coal. In April and May 2009, shipments totaled approximately 152,000 tonnes. In June, the border crossing check point started operating 11 hours per day, six days per week. Total shipments in June were approximately 232,000 tonnes, a new record for the Company. In July 2009, Mongolian and Chinese officials met at the Mongolian-Chinese border and allocated designated gates for coal exports to create an expedited coal border crossing corridor.

With increasing sales and a reduction in its coal inventory, the Company resumed full mining operations effective July 1, 2009, on a 24 hours per day, seven days per week basis. For the third quarter of 2009, total shipments were 457,000 tonnes, and for the fourth quarter of 2009, total shipments were 359,000 tonnes. Total shipments since the mine commenced production have now exceeded 1.4 million tonnes.

Construction of the permanent on-site employee housing facility and permanent maintenance workshop facility were completed during the third quarter of 2009. The Company moved into the workshop/warehouse complex in August 2009 and into the permanent housing facility in September 2009. The mine airstrip surfacing has been completed and final permitting was received for the concrete airstrip.

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On October 12, 2009, the Company announced that it completed a prefeasibility study for the Ovoot Tolgoi Mine resulting in the identification of Proven and Probable Mineral Reserves. The independent estimate prepared by Norwest Corporation ("Norwest") calculated 114.1 million tonnes of proven and probable surface coal reserves at July 1, 2009. Details of the assumptions and parameters used to calculate these coal resources and coal quality estimates are set out in the Technical Report entitled, "Coal Geology, Resources and Reserves Ovoot Tolgoi: A Production Property. Omnogovi Aimag, Mongolia" dated October 21, 2009, and available at www.sedar.com.

Surface Mineable Reserves as of July 1, 2009

Reserve Area	ASTM Coal Rank	Proven (million tonnes)	Probable (million tonnes)	Total (million tonnes)
Ovoot Tolgoi Mine	hvB to hvA*	105.0	9.1	114.1

* hvB to hvA - high-volatile bituminous coal B to A rank based on ASTM D388 standards

Total Surface and Underground Coal Resource Summary as of June 1, 2009

The Company also announced that it had received an updated independent NI 43-101 compliant resource estimate for the Ovoot Tolgoi Complex, prepared by Norwest. Details of the assumptions and parameters used to calculate these coal resources and coal quality estimates are set out in the Technical Report entitled, "Coal Geology, Resources and Reserves Ovoot Tolgoi: A Production Property. Omnogovi Aimag, Mongolia" dated October 21, 2009, and available at www.sedar.com.

The Ovoot Tolgoi Complex surface and underground resources contain measured plus indicated coal resources of 249.8 million tonnes, with an additional inferred coal resource of 33.5 million tonnes as at June 1, 2009.

Resource Area	Type	Resource Limits Depth (metres)	ASTM Group	In-Place Resources (million tonnes)		
				Measured	Indicated	Inferred
Sunrise Field	Surface	Surface to 250m	hvB to hvA*	53.8	15.7	4.9
Sunset Field	Surface	Surface to 250m	hvB to hvA	82.1	19.4	8.1
Sub-Total				135.9	35.1	13.0
Sunrise Field	Underground	250m to 600m	hvB to hvA	11.2	5.2	11.2
Sunset Field	Underground	250m to 600m	hvB to hvA	34.6	27.8	9.3
Sub-Total				45.8	33.0	20.5
Total				181.7	68.1	33.5

* hvB to hvA - high-volatile bituminous coal B to A rank based on ASTM D388 standards

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Ovoot Tolgoi Complex resources are found in two different resource areas, referred to as the Sunrise and Sunset Fields (formerly the South-East and West Fields, respectively). The Mineral Resources are inclusive of the Mineral Reserves.

Soumber Deposit

On October 12, 2009, the Company reported that it had received an initial independent NI 43-101 compliant resource estimate for the Soumber coal project, prepared by Norwest. Details of the assumptions and parameters used to calculate these coal resources and coal quality estimates are set out in the Technical Report entitled, "Soumber Property Umnugobi Aimag, Mongolia" dated October 21, 2009, and available at www.sedar.com.

The Soumber coal project and resource area is estimated to contain initial measured plus indicated coal resources of 21.4 million tonnes, with an additional inferred coal resource of 55.5 million tonnes as at August 11, 2009.

Resource Area	ASTM Coal Rank	Measured (million tonnes)	Indicated (million tonnes)	Inferred (million tonnes)
Soumber	Medium volatile bituminous*	13.1	8.3	55.5
Total		21.4		55.5

*medium-volatile bituminous coal based on ASTM D388 standards

Mamahak Deposit

In April 2008, the Company entered into a Joint Venture Earn-In Agreement with an Indonesian company to explore and develop a coal project in East Kalimantan, Indonesia, known as the Mamahak Coal project ("Mamahak").

As the Company progressed with efforts to prepare for the mining and shipment of the targeted 30,000 tonne trial cargo from Mamahak, the Company became aware of the requirement for additional capital expenditure beyond what was originally budgeted to develop the project. After the initial review of the project expenditures and related budgets, the Company suspended further development work.

On December 15, 2009, the Company announced that it had entered into an agreement to divest the 85% interest in the Mamahak Deposit in Indonesia to Kangaroo Resources Limited ("KRL") for consideration comprising \$1.0 million in cash and 50 million shares of KRL. The sale of the interest in the Mamahak Deposit was completed on December 23, 2009.

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Corporate Activity

On December 31, 2008, the Company announced the sale of its Metals Division to Ivanhoe for \$3 million and other non-cash consideration, with an effective date of December 30, 2008, and a closing date of February 2, 2009. As part of the transaction, the Company obtained a \$30 million working capital credit facility from Ivanhoe.

On February 10, 2009, the Company announced the appointment of Alexander Molyneux as its new President, effective April 27, 2009. Effective October 12, 2009, Mr. Molyneux assumed the dual role of President and Chief Executive Officer. Based in Hong Kong, he was most recently Managing Director, Head of Metals & Mining Investment Banking, Asia Pacific, Citigroup.

On March 20, 2009, the Company announced two new appointments to its Management and Resource Development team: Jess Harding and Stephen Torr.

Jess Harding has been appointed the Company's Vice-President, Evaluations and Project Development. Mr. Harding has more than 15 years' experience in the mining industry and assumes the same role that he presently holds at Ivanhoe. Mr. Harding has a Bachelor of Chemical Engineering from the University of Leeds, UK.

Stephen Torr (P.Geo.), has been appointed the Company's Resource Manager. Mr. Torr has 19 years of experience in the mining industry and currently is the Resource Manager for Ivanhoe. Mr. Torr has a B.Sc. (Hons) Degree in Geology from the University of Southampton and a M.Sc. in Applied Geoscience from the University of Leicester. Mr. Torr has previous experience in estimation of open pit and underground coal resources and will be assuming the role of Qualified Person to oversee future independent resource estimates for SouthGobi.

In June 2009, Jay Gow was appointed the Company's Vice-President, Coal Marketing. Mr. Gow has extensive experience in international and domestic resource marketing, which will be important as the Company develops its international customer base.

In July 2009, the Right Honourable Jean Chretien, the 20th Prime Minister of Canada, was appointed as a senior international adviser to the Company as part of a broader engagement of Mr. Chretien's services by Ivanhoe and certain other companies with which the Company shares access to corporate administrative facilities, employees and service providers. See "Related Party Transactions". Mr. Chretien will advise the Company with respect to international business opportunities in the energy and mineral resource sectors.

In July 2009, the Company and Ivanhoe agreed to increase an existing working capital credit facility from \$30 million to \$60 million. The amended credit facility had an original maturity date of December 31, 2010, was unsecured and had an interest rate of LIBOR plus 750 basis points. The amended facility required repayment in the event that the Company acquired additional financing from a third party source and provided for an extension fee of \$1.5 million payable in the event any portion of the facility was outstanding past March 31, 2010. This additional \$30 million working

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capital facility allowed the Company to continue to fund its expansion plans and current operations in Mongolia and its operations in Indonesia. The outstanding line of credit facility plus interest was repaid and cancelled in November 2009.

On September 8, 2009, the Company announced the appointment of Gavin May as the Company's new Chief Operating Officer. Mr. May has more than 25 years of experience in the coal industry and is uniquely qualified to plan for the next stage of development and build out of the Company's significant projects in Mongolia. He was formerly Chief Executive Officer and Managing Director of Gloucester Coal Ltd., a company listed on the Australian Stock Exchange.

On November 19, 2009, the Company announced financing had been secured from a wholly-owned subsidiary of China Investment Corporation ("CIC"), which will provide \$500 million in the form of a secured, convertible debenture bearing interest at 8.0% (Please see the Liquidity, Financing and Working Capital Resources section for more details).

The Company's common shares began trading on the TSX on December 3, 2009. SouthGobi was previously listed on the TSX Venture Exchange.

On December 23, 2009, the Company announced the closing of the sale of its Mamahak coal project to KRL.

On January 29, 2010, the Company closed a global equity offering of 27 million common shares at a price of Cdn\$17.00 per common share, for gross proceeds of Cdn\$459 million. The Company commenced trading on the Main Board of the Hong Kong Stock Exchange on the same day and became the first Canadian mining company to have dual listings on the Hong Kong Stock Exchange and the TSX.

Effective February 8, 2010, the Company appointed Tony Pearson as the new Vice-President, Corporate Development. Mr. Pearson has an extensive background in infrastructure financing in the mining industry and has held senior positions with the Australian Securities & Investments Commission, Citigroup's Metals and Mining Investment banking team, and Westpac Banking Corporation.

On February 10, 2010, the Mongolian National Chamber of Commerce and Industry selected SouthGobi Sands LLC, a wholly-owned subsidiary of SouthGobi, as the "Local Job Creator of the Year" for 2009. The purpose of this commemorative prize is to encourage and support the hiring of local residents in remote areas of Mongolia.

On February 26, 2010, Citigroup Global Markets Canada Inc. and Macquarie Capital Markets Canada, representatives of the Canadian underwriters of the Company's recently closed global equity offering, partially exercised their over-allotment option and purchased an additional 228,100 common shares of the Company at a price of Cdn\$17.00 per share for gross proceeds of Cdn\$3,877,700.

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As of March 15, 2010, Ivanhoe directly and indirectly, currently owns 105,557,155 common shares representing approximately 65% of the issued and outstanding common shares of SouthGobi.

FORWARD-LOOKING STATEMENTS

Except for statements of fact relating to the Company, certain information contained herein constitutes forward-looking statements. Forward-looking statements are frequently characterized by words such as "plan", "expect", "project", "intend", "believe", "anticipate" and other similar words, or statements that certain events or conditions "may" or "will" occur. Forward-looking statements are based on the opinions and estimates of management at the dates the statements are made, and are subject to a variety of risks and uncertainties and other factors that could cause actual events or results to differ materially from those projected in the forward-looking statements. These factors include the inherent risks involved in the exploration and development of mineral properties, the uncertainties involved in interpreting drilling results and other geological data, fluctuating commodity prices, the possibility of project cost overruns or unanticipated costs and expenses, uncertainties related to completion results of planned exploration and development programs on the Company's material properties, issuance of licenses and permits and the availability of and costs of financing needed in the future and other factors described in this discussion under the heading "Outlook". Except as required by law, the Company undertakes no obligation to update forward-looking statements if circumstances or management's estimates or opinions should change. The reader is cautioned not to place undue reliance on forward-looking statements.

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INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

Transition to IFRS from GAAP

In February 2008, the Canadian Accounting Standards Board confirmed that Canadian publicly accountable enterprises will be required to adopt International Financial Reporting Standards ("IFRS") for financial periods beginning on and after January 1, 2011. In the Canadian Securities Administrators ("CSA") Staff Notice 52-321 – Early Adoption of International Financial Reporting Standards, use of US GAAP and Reference to IFRS-IASB, CSA has indicated that it would be prepared to provide exemptive relief to permit a Canadian reporting issuer to prepare its financial statements in accordance with IFRS for financial periods beginning before January 1, 2011.

As previously disclosed, the Company completed its secondary listing on the Hong Kong Stock Exchange on January 29, 2010. As part of the application process for the secondary listing, the Company was required to provide financial statements under IFRS with three years of comparative data. In order to produce the required IFRS financial statements the Company has produced IFRS financial statements with an IFRS transition date of January 1, 2005. As per Appendix A of IFRS 1 "An entity cannot have more than one set of IFRS financial statements. Therefore, it must have only one starting point for transition to IFRS". In March 2009, the Company was granted exemptive relief by Canadian securities regulatory authorities under Staff Notice 52-321 and has been permitted to adopt IFRS for Canadian reporting purposes for reporting periods beginning on or after January 1, 2009. The Company has adopted IFRS with an adoption date of January 1, 2009, and a transition date of January 1, 2005.

IFRS Conversion

The Company's IFRS conversion plan was comprehensive and addressed matters including changes in accounting policies, restatement of comparative periods, organizational and internal controls and any required changes to business processes. To facilitate this process and ensure the full impact of the conversion was understood and managed reasonably, the Company retained an external third party accounting firm and hired an IFRS conversion project manager. The accounting staff attended several training courses on the adoption and implementation of IFRS. Through in-depth training and the preparation of reconciliations of historical Canadian GAAP financial statements to IFRS, the Company believes that its accounting personnel have obtained a thorough understanding of IFRS. Further, the accounting personnel at the Company's Mongolian and Indonesian subsidiaries are already familiar with IFRS and have been working with IFRS due to either local adoption of IFRS or convergence of local standards to IFRS in those jurisdictions.

In conjunction with the adoption of IFRS, the Company has implemented a new accounting system, which will satisfy all the information needs of the Company under IFRS. The Company has also reviewed its current internal and disclosure control processes and believes they will not need significant modification as a result of the Company's conversion to IFRS.

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Impact of IFRS

IFRS employs a conceptual framework that is similar to Canadian GAAP; however significant differences exist in certain matters of recognition, measurement and disclosure. While the adoption of IFRS will not change the actual cash flows of the Company, the adoption will result in changes to the reported financial position and results of operations of the Company. In order to allow the users of the financial statements to better understand these changes, the Company has provided the reconciliations between Canadian GAAP and IFRS for the total assets, total liabilities, shareholders' equity and net earnings in Note 3 to the annual Consolidated Financial Statements. The adoption of IFRS has had no impact on the net cash flows of the Company. The changes made to the statements of financial position and comprehensive income have resulted in reclassifications of various amounts on the statements of cash flows, however as there has been no change to the net cash flows, no reconciliations have been presented.

In preparing the reconciliations, the Company applied the principles and elections of IFRS 1, with a transition date of January 1, 2005, consistent with those assumed in the documentation for the secondary listing on the Hong Kong Stock Exchange. As the Company has been permitted to adopt IFRS effective January 1, 2009, it will apply the provisions of IFRS 1 as described under the section entitled "Initial Adoption - IFRS 1", with a January 1, 2005, transition date. The Company will also apply IFRS standards in effect at December 31, 2009, as required by IFRS 1.

Initial Adoption of International Accounting Standards

IFRS 1 "First Time Adoption of International Accounting Standards" sets forth guidance for the initial adoption of IFRS. Under IFRS 1 the standards are applied retrospectively at the transitional date of the statement of financial position with all adjustments to assets and liabilities as stated under GAAP taken to retained earnings unless certain exemptions are applied. The Company is not applying any exemptions on first-time adoption.

Comparative Information

The Company has restated all prior period figures in accordance with IFRS.

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CRITICAL ACCOUNTING ESTIMATES

The preparation of financial statements in conformity with IFRS requires the Company to establish accounting policies and to make estimates that affect both the amount and timing of the recording of assets, liabilities, revenues and expenses.

A detailed summary of all of the Company's significant accounting policies is included in Note 4 to the annual Consolidated Financial Statements for the year ended December 31, 2009. Note 3 to the annual Consolidated Financial Statements for the year ended December 31, 2009, provides a review of the significant changes to the reported financial position and results of operations of the Company under Canadian GAAP and IFRS.

The following is an outline of the estimates that the Company considers as critical in the preparation of its consolidated financial statements.

Mineral properties

All direct costs related to the acquisition of mineral property interests are capitalized into intangible assets on a property by property basis. Exploration costs, net of incidental revenues, are charged to operations in the period incurred until such time as it has been determined that a property has economically recoverable reserves, in which case subsequent exploration costs and the costs incurred to develop a property are capitalized into property, plant and equipment ("PPE"). On the commencement of commercial production, depletion of each mining property will be provided on a unit-of-production basis using estimated resources as the depletion base.

The commencement of commercial production is deemed to occur on a determination made by management. Management's determination of when commercial production commences is based on several qualitative and quantitative factors including but not limited to the following:

- the elevation or bench where the coal to be mined has been reached
- the commissioning of major mine and plant equipment is completed
- operating results are being achieved in a consistent manner

However, the production phase does not commence with the removal of *de minimis* saleable mineral materials that occur in conjunction with the removal of overburden or waste material for the purpose of obtaining access to an ore body.

Decommissioning, restoration and similar liabilities (Asset retirement obligation or "ARO")

The Company recognizes provision for statutory, contractual, constructive or legal obligations, including those associated with the reclamation of mineral properties and mineral assets under PPE, when those obligations result from the acquisition, construction, development or normal operation of the assets. Initially, a provision for an asset retirement obligation is recognized as its present value in the period in which it is incurred. Upon initial recognition of the liability, the corresponding asset retirement obligation is added to the carrying amount of the related asset and

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the cost is amortized as an expense over the economic life of the asset using either the unit-of-production method or the straight-line method, as appropriate. Following the initial recognition of the asset retirement obligation, the carrying amount of the liability is increased for the passage of time and adjusted for changes to the current market-based discount rate, amount or timing of the underlying cash flows needed to settle the obligation.

Inventory valuation

Coal inventories are stated at lower of production cost and net realizable value. Production costs include direct and indirect labour, operating materials and supplies, transportation costs and an appropriate portion of fixed and variable overhead expenses, including depreciation and depletion. Net realizable value represents the estimated selling price for inventories less all estimated costs of completion and costs necessary to make the sale.

Materials and supplies inventory consists of consumable parts and supplies which are valued at lower of weighted average cost and net realizable value. Supplies used in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. Net realizable value is defined as the selling price of the finished product less any provisions for obsolescence and costs of completion.

Stripping costs

Stripping costs incurred during the development of a mine are capitalized into PPE. Stripping costs incurred during the commercial production phase are variable production costs that are included in the costs of inventory produced during the period that the stripping costs are incurred, unless the stripping activity can be shown to give rise to future benefits from the mineral property, in which case the stripping costs would be capitalized into PPE.

Future benefits arise when stripping activity increases the future output of the mine by providing access to a new ore body that the previously deferred stripping costs in an area did not give access to. When stripping activities give rise to a future economic benefit, the costs associated with these activities are capitalized into PPE. Capitalized stripping costs are depleted on a unit-of-production basis, using estimated resources as the depletion base.

Income taxes

Current income tax assets and liabilities for the current and prior periods are measured at the amount expected to be recovered from or paid to the taxation authorities. The tax rates and tax laws used to compute the amount are those that are enacted or substantively enacted at the end of each reporting period.

Deferred income tax is provided using the liability method on temporary differences, at the end of each reporting period, between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes.

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Share-based payments

Share-based payment transactions

Employees (including directors and senior executives) of the Company receive a portion of their remuneration in the form of share-based payment transactions, whereby employees render services as consideration for equity instruments ("equity-settled transactions").

In situations where equity instruments are issued to non-employees and some or all of the goods or services received by the entity as consideration cannot be specifically identified, they are measured at fair value of the share-based payment. Otherwise, share-based payments are measured at the fair value of goods or services received.

Equity-settled transactions

The costs of equity-settled transactions with employees are measured by reference to the fair value at the date on which they are granted.

The costs of equity-settled transactions are recognized, together with a corresponding increase in equity, over the period in which the performance and/or service conditions are fulfilled, ending on the date on which the relevant employees become fully entitled to the award ("the vesting date"). The cumulative expense is recognized for equity-settled transactions at each reporting date until the vesting date reflects the Company's best estimate of the number of equity instruments that will ultimately vest. The profit or loss charge or credit for a period represents the movement in cumulative expense recognized as at the beginning and end of that period and the corresponding amount is represented in share option reserve. No expense is recognized for awards that do not ultimately vest.

Where the terms of an equity-settled award are modified, the minimum expense recognized is the expense as if the terms had not been modified. An additional expense is recognized for any modification which increases the total fair value of the share-based payment arrangement, or is otherwise beneficial to the employee as measured at the date of modification.

The dilutive effect of outstanding options is reflected as additional dilution in the computation of earnings per share.

Revenue recognition

Revenue represents the fair value of consideration received and receivable that is derived from the sales of coal. Sales revenues are recognized when the risks and rewards of ownership pass to the buyer, collection is reasonably assured and the price is reasonably determinable. The revenue from sales of coal in the ordinary course of business is recognized when coal is either loaded onto a truck or when it is unloaded at the final destination, depending on the terms of the contract.

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Property, plant and equipment

PPE is stated at cost less accumulated depreciation and accumulated impairment losses. The cost of an item of PPE consists of the purchase price, any costs directly attributable to bringing the asset to the location and condition necessary for its intended use and an initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located.

Depreciation is provided at rates calculated to write off the cost of PPE, less their estimated residual value, using the straight-line method or unit-of-production method.

CHANGE IN ACCOUNTING POLICIES

On January 1, 2009, the Company adopted IFRS. Note 3 to the annual Consolidated Financial Statements for the year ended December 31, 2009, provides a review of the significant changes to the reported financial position and results of operations of the Company under Canadian GAAP and IFRS. The provisions of new and revised standards and interpretations are applicable and effective for the Company's financial year beginning on or after January 1, 2009.

A summary of the new, future and revised standards and interpretations are outlined in Note 2.3 of the annual Consolidated Financial Statements.

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MINERAL PROPERTIES

Qualified Persons

Disclosure of a scientific or technical nature in this MD&A with respect to the Company's Coal Division was prepared by, or under the supervision of Stephen Torr (P.Geol.) and Resource Manager. Mr. Torr is a "qualified person" for the purposes of National Instrument 43-101 of the Canadian Administrators ("NI 43-101").

Mr. Torr was appointed the Company's Resource Manager on March 20, 2009. Prior to March 20, 2009, Gene Wusaty, P.Eng., and Chief Operating Officer was the Company's "qualified person" for the purposes of the NI 43-101.

Coal Group Profile

Mongolia Exploration Licenses

The coal transaction was completed in May 2007, when the Company acquired Ivanhoe's Coal Division, including Ivanhoe's entire interest in the Ovoot Tolgoi Complex (formerly Nariin Sukhait), the Tsagaan Tolgoi Deposit and various coal exploration projects in Mongolia. To complete the transaction, 35 coal exploration licenses held by Ivanhoe, along with other assets and personnel, were transferred to the Company. The Company already owned a further 19 exploration licenses with coal potential, and with the additional 35 licenses, a total of 54 licenses covering an area of approximately 2.1 million hectares ("ha") were then available for coal exploration.

The Company regularly targets and prioritizes a number of licenses on the basis of potential, age, and cost.

As at January 29, 2010, the Company held 18 licenses, including the two mining licenses, which in total cover an area of approximately 784,000 ha.

The 18 licenses are located around the existing mining area in the western part of the South Gobi Province, but also further east, including a substantial holding around another known third-party owned Mongolian coal deposit called Tavan Tolgoi. Out of these 18 licenses, four may be affected by a new Mongolian law that prohibits minerals exploration and mining in certain areas.

Pursuant to the Mining Prohibition in Specified Areas Law, the Mongolian Government was instructed to define the boundaries of the areas in which exploration and mining would be prohibited by October 16, 2009. However, the Mongolian Government has not yet approved and published this information.

A draft list of licenses has been prepared that overlap with the prohibited areas described in the new law based on information submitted by water authority agencies, forest authority agencies and local authorities for submission to the Mongolian Government. The Mongolian

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Government must give its final approval before the final list can be published; licenses may be added or subtracted to the list at any time prior to approval and publication of the final list.

Four of the Company's exploration licenses may be included on the draft list of licenses published by the Mongolian Government, potentially affecting the status of those licenses under the Mining Prohibition in Specified Areas Law.

Activities currently being carried out on these properties include drilling, trenching and geological reconnaissance. The Company has no immovable assets located in any of the potentially affected areas and the loss of any or all of the potentially affected properties would not materially and adversely affect the existing operations or resources.

Unless stated otherwise, the Company has a 100% interest in its coal projects.

Properties in Mongolia

Ovoot Tolgoi Mine

The Ovoot Tolgoi Complex comprises the Ovoot Tolgoi Mine together with the Ovoot Tolgoi Underground Deposit.

The Ovoot Tolgoi Mine is located in the southwest corner of the Omnogovi Aimag (South Gobi Province) of Mongolia. The deposit is within the administrative unit of Gurvantes Soum, 320 km southwest of the provincial capital of Dalanzadgad and 950 km southwest of the nation's capital of Ulaanbaatar.

Ivanhoe first initiated coal exploration in the Ovoot Tolgoi area in October 2004 and extensive exploration programs were also carried out in 2005, 2006 and 2007. Mining operations at the Ovoot Tolgoi property are found in two distinct areas, referred to as the Sunset Pit to the west and the Sunrise Pit to the east.

In 2009, the Company engaged Norwest to complete a new technical report for the Ovoot Tolgoi area incorporating outstanding data obtained from drilling to the end of 2008, reflecting a redesign of the surface mine, updating the resource models and delineating reserves based on a pre-feasibility level of engineering.

On October 12, 2009, the Company announced an independent resource estimate prepared by Norwest under the requirements of NI 43-101. Norwest estimated that the Ovoot Tolgoi Mine contained approximately 114.1 million tonnes of reserves, 135.9 million tonnes of measured resources, 35.1 million tonnes of indicated resources and 13.0 million tonnes of inferred resources. The Mineral Resources are inclusive of Mineral Reserves.

The coal rank at the Ovoot Tolgoi Mine is high volatile B to A bituminous. High volatile B produces between 7,212 to 7,785 kcal/kg and high volatile A produces greater than 7,785 kcal/kg heat output.

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Three coal products are presently being mined or are expected to be produced at the Ovoot Tolgoi Mine; a coking (or metallurgical) coal, a premium coal with applications for semi-soft/PCI coking coal or a high-quality thermal coal, and a thermal coal product for use in power generation.

All three coal types are currently sold directly from the mine without any beneficiation or washing. In-pit sampling and on-site laboratory analysis determines which product is currently being mined and the products are then separately stockpiled and blended to meet specific customer requirements. The Company is currently considering plans for a beneficiation facility.

After obtaining its Permit to Mine on March 31, 2008, the Company started operations at Ovoot Tolgoi in April 2008. Coal shipments began in September 2008. Coal sales to December 31, 2008, were approximately 113,000 tonnes.

Due to erratic and unpredictable Mongolia-China border access, coal shipments in January and February 2009 were lower than expected. Consequently, and in order to preserve cash and manage stockpiles, a production curtailment program was initiated in January 2009 decreasing production to a dayshift basis. This was followed by a full mine shutdown in late February 2009, except for coal loading of customer trucks from coal stockpiles. The mine resumed full mining operations effective July 1, 2009.

In 2009, coal shipments in the first quarter were approximately 127,000 tonnes; in the second quarter approximately 384,000 tonnes; the third quarter approximately 457,000 tonnes; and the fourth quarter approximately 359,000 tonnes. Total shipments since the mine commenced production have now exceeded 1.4 million tonnes.

In order to increase the amount of coal traffic across the border, in July 2009, Chinese and Mongolian authorities agreed to create a designated coal transportation corridor at the Shivee Khuren-Ceke border crossing. This facility is currently under construction and is expected to be operational in 2010. When completed, it will permit coal to be transported across the border through three corridors that are separate from other, non-coal, border traffic. The Company believes that these improvements in the border crossing capacity will allow the Company to continue to substantially increase the amount of coal shipped into China.

The Ovoot Tolgoi Mine's proximity to the Shivee Khuren-Ceke border crossing allows the Company's customers to transport coal by truck on an unpaved road from the mine site to China. The Company is currently studying the feasibility of building additional road infrastructure from the Ovoot Tolgoi Complex to the Mongolia-China border.

A north-south railway line currently connects Ceke with Jiayuguan City in Gansu Province and with the interior of China. Another east-west railway line from Ceke to Linhe, an industrial city in eastern Inner Mongolia, is expected to be operational in 2010. This line is anticipated to have an initial transportation capacity of approximately 15 million tonnes per year, later increasing to 25 million tonnes per year. Using this route coal can be shipped to Baotou and further east to ports on China's Bohai Gulf.

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Since December 2008, the Company has been engaged in various levels of discussions with railway contractors regarding the feasibility of developing a coal railway spur from the Ovoot Tolgoi Mine to the Mongolia-China border.

SouthGobi Sands LLC, a wholly owned Mongolia subsidiary of SouthGobi, employed 317 employees as at December 31, 2009. Of the 317 employees, 41, including expatriates, are employed in the Ulaanbaatar office, 4 in outlying smaller offices including the Ceke border point and 272 at the mine site. Of the total 316 employees based in Mongolia, 310 (98%) are Mongolian nationals and 103 (33%) are residents of the local Gurvantes Soum.

In April 2008, the Company purchased a second fleet of coal mining equipment for the open pit mine, with some equipment commissioned in the fourth quarter of 2009 and the remaining equipment scheduled to be commissioned in the first quarter of 2010. The new shovel and truck mining fleet consists of a Liebherr 996 hydraulic excavator (34m³) and four Terex MT4400 (218-tonne capacity) trucks. The new fleet will supplement the existing mine fleet consisting of a Liebherr 994 hydraulic excavator (13.5 m³) and seven Terex TR100 (91-tonne capacity) trucks.

Additional equipment will be required as production at the mine expands, including larger hydraulic shovels, larger end dump trucks and larger dozers and graders. The Company has entered into an agreement with a Mongolian supplier for a third fleet including an additional larger Liebherr 996 hydraulic excavator (34m³), four Terex MT4400 (218-tonne capacity) trucks and various auxiliary equipment. The third fleet is expected to be delivered in mid-2010, with an additional fourth fleet of equipment likely to be ordered for 2011. The additional larger equipment will increase productivity. However, the Company will continue to employ the smaller initial fleet in areas of thinner seams and to supplement the larger equipment.

The airstrip surfacing project was completed at year end 2008 and was certified in early 2009. The on-site employee housing facility and maintenance workshop building complexes were completed during the third quarter of 2009. Both complexes are now occupied.

Ovoot Tolgoi Underground Deposit

The Ovoot Tolgoi Underground Deposit is contiguous to, and located directly below, the surface mine development. The entire extension of the coal at depth from 250 to 600 m that is designated for potential underground development is located inside the existing Ovoot Tolgoi mining license.

The 2008 exploration program concentrated on the underground located in the Sunset Pit. This drilling was conducted to obtain additional information respecting the structure and quality of the deep underground coal mineralization. The drilling conducted in 2006 and 2007 identified coking and semi-soft coal at depths of between 250 m and 600 m beneath the lower boundaries of the planned open pits at Sunrise and Sunset. The No. 5 coal seam continues to be open at depth and along strike.

On October 12, 2009, the Company announced an independent resource estimate prepared by Norwest under the requirements of NI 43-101. Norwest estimated that the Ovoot Tolgoi

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Underground Deposit contained approximately 45.8 million tonnes of measured resources, 33 million tonnes of indicated resources and 20.5 million tonnes of inferred resources.

Having identified underground resources at the Ovoot Tolgoi Underground Deposit, the Company is investigating the possibility of mining these resources using underground mining methods.

Soumber Deposit

The Soumber Deposit is located approximately 20 km east of the Ovoot Tolgoi Mine. It lies within the administrative unit of Gurvantes Soum in the Omnogovi Aimag (South Gobi Province), approximately 50 km northeast of the Shivee Khuren-Ceke border crossing.

Exploration and drilling programs at Soumber first started in 2005 in the western field. Sixty-two holes were drilled during 2005 and 2006 that confirmed the potential for a significant coal deposit in the area. Between 2007 and 2008, over 121 drill holes, totaling 24,512 m of drilling were completed. In 2009, the Company conducted geotechnical and hydrological programs in the Soumber central field. The exploration geology fieldwork included reconnaissance mapping, trenching, geologic descriptions of drilling returns, geotechnical data, field logs and database development.

Based on the drill hole data distribution, the Soumber coal field can be divided into three prospective areas: central, east and west. The majority of exploration activity has focused on the central Soumber field. The coal occurrence on the Soumber central field can be divided into seven separate seams, or benches of a seam separated by rock interburden. The seams themselves are composed of coal intercalated with numerous rock partings. The coal seams in the Soumber field may not be directly correlative to the Ovoot Tolgoi coal seams.

On October 12, 2009, the Company announced that it had received an initial independent resource estimate for the Soumber Deposit. The coal resources estimated at the Soumber central field are comprised of measured coal resources of 13.1 million tonnes, indicated coal resources of 8.3 million tonnes and inferred coal resources of 55.5 million tonnes. Laboratory data demonstrated that some of the coal benches exhibit potential coking coal characteristics. The coal rank ranges between high to medium volatile bituminous coal, having an average calorific value range of 5,172 to 6,728 kcal/kg. The Soumber Deposit has potential to increase coal resources to the east and to the west as well as at depth. The resource estimate incorporates exploration data up to August 11, 2009, down to a depth of 250 m below surface.

Due to the proximity to the Ovoot Tolgoi Mine, any future mining operation at the Soumber Deposit would likely be able to share common infrastructure with the Ovoot Tolgoi Mine. The Company has initiated mine planning and an application for a mining license, which will be submitted for development of this project. Environmental baseline studies have been completed and general environmental impact assessments have begun. The Company is also studying the feasibility of building a coal preparation plant for the Soumber coal to remove rock partings and produce a hard coking coal product.

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Tsagaan Tolgoi Deposit

The Tsagaan Tolgoi coal field is located in south-central Mongolia. The property is located in the Omnogovi Aimag approximately 570 km south of Ulaanbaatar and 113 km southeast of the provincial capital of Dalanzadgad, and approximately 115 km west of Oyu Tolgoi.

A coal delineation program was first carried out in 2004, but no further work was conducted in 2005. Exploration programs were carried out during 2006 and 2007 to provide the basis for a resource estimate. In February 2008, Norwest estimated 23.4 million tonnes of measured resources, 13.0 million tonnes of indicated resources and 9.0 million tonnes of inferred resources. The coal is of volatile bituminous B to C in rank based on ASTM D388 standards and is suitable for use as a thermal coal. The resources appear to be amenable to surface extraction down to a planned depth of 150 m. Details of the assumptions and parameters used to calculate these coal resources and coal quality estimates are set out in the Technical Report entitled, "Coal Geology and Resources – Tsagaan Tolgoi Property" dated March 25, 2008, and available at www.sedar.com.

Effective August 12, 2009, the Mongolian Government issued a mining license for the Tsagaan Tolgoi coal field. The Technical and Economic Study has been completed, and is currently under government review. Detailed Environmental Impact Assessment is underway and will be submitted following the approval of the Technical and Economic Study.

The nearest in-country rail line is the Trans-Mongolia Railway that runs northwest to southeast and connects Ulaanbaatar to Beijing. The nearest point on this line to the Tsagaan Tolgoi Deposit is approximately 400 km to the east at the Chinese border. Limited infrastructure exists at Tsagaan Tolgoi and will need to be developed prior to any mining operations.

The Tsagaan Tolgoi Deposit is located close to Ivanhoe's Oyu Tolgoi copper and gold project and has the potential to supply coal to any power project that may, in the future, be there.

The Company is not currently planning to develop the Tsagaan Tolgoi Deposit, although the property remains a deposit that could be developed in the future.

Tavan Tolgoi Extension Area

The Tavan Tolgoi Extension Area is composed of seven exploration licenses located east of Dalanzadgad, the provincial capital in the Omnogovi Aimag. These exploration licenses surround the third party-owned Tavan Tolgoi coal project. The Tavan Tolgoi coal field was discovered in the 1950's by a joint Mongolian/Soviet team and is believed to be one of the largest undeveloped metallurgical coal deposits in the world.

A field reconnaissance program was carried out on the Tavan Tolgoi Extension licenses in 2006. The exploration area has been surveyed for copper and gold exploration using BHP Falcon aerial geophysics. The Company has obtained the aeromagnetic and aero gravity survey data and is using the results of the upcoming analysis of the Falcon data to help delineate potential coal

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targets. Exploration work on the extension continued in 2007, 2008 and 2009. A minimum amount of work will be carried out in 2010 to maintain the exploration licenses.

Exploration Program

A number of the exploration licenses are associated with the broader Ovoot Tolgoi Complex and the Soumber Deposit. The Company considers many of these to be prospective exploration properties, which have yet to be fully explored.

The exploration program in 2010 includes drilling, trenching and geological reconnaissance on a number of license areas which are identified as having good potential for coking and thermal coal deposits.

Indonesia Operations and Discontinued Operations

Prior to December 23, 2009, the Company held its 85% interest in the Mamahak Coal project through a joint venture.

As the Company progressed with efforts to prepare for the mining and shipment of the targeted 30,000 tonne trial cargo from Mamahak, the Company became aware of the requirement for additional capital expenditure beyond what was originally budgeted to develop the project. After the initial review of the project expenditures and related budgets, the Company suspended further development works at Mamahak pending a detailed operational review and analysis. The Company recorded an impairment charge of \$15.1 million in 2009 (see Note 6 of the annual Consolidated Financial Statements).

On December 15, 2009, the Company announced that it had entered into an agreement to divest our 85% interest in the Mamahak Deposit in Indonesia to KRL, a mining company focused on the development of a series of coal projects in East Kalimantan, Indonesia, for consideration comprising \$1 million in cash and 50 million shares of KRL. The receipt of shares as partial consideration is a common practice in the mining industry, particularly for companies in the early stages of development, such as KRL, that wish to preserve their capital for use in developing their projects. The sale of the Company's interest in the Mamahak Deposit was completed on December 23, 2009.

Metals Division Profile and Discontinued Operations

On December 31, 2008, the Company announced the sale of its Metals Division to Ivanhoe for \$3 million and other non-cash consideration. The Metals Division consisted of a series of base and precious metal exploration properties in Mongolia and Indonesia, related assets, employees and contracts. As part of the sale transaction, the Company obtained a credit facility from Ivanhoe, providing for loan advances from Ivanhoe up to \$30 million. The credit facility is for a one year term with a one year discretionary extension. The credit facility is unsecured and carries an interest rate equal to LIBOR plus 750 basis points.

The transaction was completed on February 2, 2009, following receipt of regulatory approval.

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SUMMARIZED ANNUAL FINANCIAL RESULTS

(\$ in thousands, except per share information)

	2009	2008	2007
Revenue	\$ 36,038	\$ 3,126	\$ -
Operating loss from continuing operations	\$ (23,321)	\$ (45,854)	\$ (20,979)
Loss from continuing operations ⁽ⁱ⁾	\$ (79,717)	\$ (51,975)	\$ (92,061)
Loss from discontinued operations	\$ (31,088)	\$ (17,601)	\$ (4,676)
Net loss ⁽ⁱ⁾	\$ (110,805)	\$ (69,576)	\$ (96,736)
Loss per share from continuing operations	\$ (0.60)	\$ (0.40)	\$ (1.80)
Loss per share from discontinued operations	\$ (0.23)	\$ (0.14)	\$ (0.09)
Net loss per share	\$ (0.83)	\$ (0.54)	\$ (1.89)
Cash and cash equivalents	\$ 357,342	\$ 10,117	\$ 1,394
Short term investments	\$ 14,999	\$ -	\$ -
Long term investments	\$ 57,070	\$ -	\$ -
Total assets	\$ 560,684	\$ 99,948	\$ 5,610
Total long term liabilities	\$ 543,086	\$ 329	\$ 105,673

(i) Includes the loss of \$45.0 million for the fair value change of the embedded derivative in the CIC convertible debenture

The year ended December 31, 2009, was the first full year of mining operations for the Company. The Company reported its first sales revenue in the fourth quarter of 2008.

Prior to the completion of the coal transaction in May 2007, the Company was a mineral exploration company with a principal focus on precious and base metals exploration and development.

Throughout 2008, the Company continued to explore for precious and base metals, however the purchase of the Coal Division from Ivanhoe transformed SouthGobi into a coal exploration, development and production company with revenue, cost of sales and significantly higher corporate administration and exploration costs. In December 2008 the Company sold its Metals Division to Ivanhoe for \$3 million and other non-cash consideration. The transaction closed on February 2, 2009.

The Company's net loss for 2009 was \$110.8 million or \$0.83 per share compared with \$69.6 million or \$0.54 per share in 2008 and \$96.7 million or \$1.89 per share in 2007.

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The loss from continuing operations was \$79.7 million in 2009 compared to \$52.0 million in 2008. The increase is due to the additional financing costs related to the line of credit facility with Ivanhoe and the CIC convertible debenture. The fair value change of the embedded derivative in the CIC convertible debenture resulted in a loss of \$45.0 million in the year ended December 31, 2009. (See Other Income/Expense section for more details.) The loss from continuing operations excluding the fair value change of the embedded derivative in the CIC convertible debenture is \$34.7 million.

The operating loss from continuing operations decreased to \$23.3 million in 2009 from \$45.9 million in 2008 due to higher revenues and lower exploration expense in 2009.

The net loss in 2009 includes \$31.1 million in discontinued operations for the Indonesia Coal Division ("Mamahak Deposit"). In October 2009, the Company suspended further development works at Mamahak pending a detailed operational review and analysis. As a result of the suspension the Company recorded an impairment charge of \$15.1 million in 2009. In the fourth quarter of 2009, the Indonesia Coal Division was sold to KRL for consideration comprising \$1 million in cash and 50 million shares of KRL.

The Company's total assets at the end of 2009 were \$560.7 million compared with \$99.9 million at the end of 2008 and \$5.6 million at the end of 2007. The Company had \$357.3 million in cash, \$15.0 million in short term investments and \$57.1 million in long term investments at December 31, 2009, compared to cash of \$10.1 million at December 31, 2008. The short and long term investments include money market investments and the Company's investment of \$9.9 million in KRL which was obtained from the sale of the Indonesia Coal Division. The increase in cash and money market investments relate to the CIC financing. The increase in total assets relates to the CIC financing and the continuing development of the Mongolia Coal Division.

The Company's long term liabilities at the end of 2009 were \$543.1 million compared with \$0.3 million at the end of 2008 and \$105.7 million at the end of 2007. The increase in long term liabilities in 2009 relates to the convertible debenture received from CIC in November 2009.

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SELECTED QUARTERLY DATA

(\$ in thousands, except per share information)

QUARTER ENDED	2009				2008			
	31-Dec	30-Sep	30-Jun	31-Mar	31-Dec	30-Sep	30-Jun	31-Mar
Revenue	\$ 9,960	\$ 11,871	\$ 10,667	\$ 3,540	\$ 3,126	\$ -	\$ -	\$ -
Income from mine operations	1,524	3,234	1,528	327	949	-	-	-
Exploration expenses	(739)	(2,149)	(1,743)	(768)	(4,959)	(8,468)	(9,125)	(3,893)
(Loss)/Income from continuing operations	(70,187)	2,224	(5,138)	(6,616)	(11,370)	(18,222)	(9,956)	(12,427)
Income/(Loss) from discontinued operations	1,034	(26,006)	(2,772)	(3,344)	(5,637)	(4,555)	(3,625)	(3,784)
Net loss	(69,153)	(23,782)	(7,910)	(9,960)	(17,007)	(22,777)	(13,581)	(16,211)
Net loss per share	(0.52)	(0.18)	(0.06)	(0.07)	(0.13)	(0.17)	(0.11)	(0.19)

Review of Quarterly Financial Results

The changes in comparative results of operations on a quarter over quarter basis are due primarily to significant fluctuations in the following areas: revenue, exploration expenses, stock-based compensation charges, foreign exchange gains and losses, interest expense, interest accretion on line of credit facility and fair value of embedded derivative on debt. These latter two items are described in Notes 22 and 23 of the annual Consolidated Financial Statements.

The Company incurred a net loss for the three months ended December 31, 2009, of \$69.2 million compared to a net loss of \$23.8 million for the three months ended September 30, 2009, and \$17.0 million for the three months ended December 31, 2008. The change is due to the factors discussed below:

Revenue and cost of sales relate to the Mongolia Coal Division. Revenues increased to \$10.0 million in the fourth quarter of 2009 from \$3.1 million in the comparative quarter in 2008. Revenues however decreased from \$11.9 million in the September 30, 2009 quarter due to lower customer shipments.

In the fourth quarter of 2009, the Company shipped approximately 359,000 tonnes of coal at an average realized selling price of \$29 per tonne. This compares to 113,000 tonnes at an average realized price of \$29 in the fourth quarter of 2008 and 457,000 tonnes at an average realized price of \$28 in the third quarter of 2009. Variability in the realized selling price relates to a change in sales mix in terms of coal quality and changed prices of individual customer contracts.

Cost of sales is comprised of three main components, direct cash costs, mine administration costs and non-cash items. Non-cash items include depreciation, depletion and stock-based compensation. Cost of sales will vary depending on sales volume, production and unit costs which directly affects income from mine operations.

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Direct cash costs per tonne increased to \$16.97 per tonne in the fourth quarter of 2009 compared to \$8.30 per tonne in the fourth quarter of 2008 and \$11.16 in the third quarter of 2009. The increase can be attributed to the lower coal production in the fourth quarter of 2009. Direct cash costs per tonne will fluctuate from quarter to quarter due to variations in production, sales and unit costs. The Company continuously reviews the direct cash costs and believes they are in line with the expected life of mine cash costs of \$15 per tonne as outlined in the Norwest technical report.

Corporate administration expenses in the fourth quarter of 2009 were higher than the September 30, 2009, quarter but comparable to the fourth quarter of 2008. The fourth quarter of 2009 included higher salaries and professional fees, while the September 30, 2009, quarter included higher listing fees and the fourth quarter of 2008 included a foreign exchange loss of \$3.9 million.

Exploration expenses for the three months ended December 31, 2009, were \$0.7 million compared to \$5.0 million for the three months ended December 31, 2008, and \$2.1 million for the three months ended September 30, 2009. Exploration expenses are for the Mongolia Coal Division. Exploration expenses related to the Indonesia Coal Division have been classified as discontinued operations in 2009 and in 2008. Exploration expenses related to the Metals Division have been classified as discontinued operations in 2008. Exploration expenses were lower in the fourth quarter of 2009 as the 2009 exploration program in Mongolia was close to completion at the end of the third quarter of 2009.

Finance costs for the three months ended December 31, 2009, were \$61.9 million compared to \$23,000 for the three months ended December 31, 2008. The significant increase in the fourth quarter is due to the CIC convertible debenture financing and the fair value change of the embedded derivative of \$45.0 million, \$3.0 million for the interest accretion on the convertible debenture, \$4.7 million for interest expense on the convertible debenture and \$9.4 million for transaction costs related to the CIC financing.

Income tax expense for the three months ended December 31, 2009, was \$1.5 million compared to nil in the comparative period for 2008 and an \$8.6 million recovery in the three months ended September 30, 2009.

Discontinued operations for the three months ended December 31, 2009, relate to the disposal of the Indonesia Coal Division. The Company had income in the fourth quarter of 2009 as the impairment of Mamahak of \$23.0 million recorded in the third quarter was reduced to \$15.1 million upon the sale of Mamahak in December 2009.

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RESULTS OF OPERATIONS

	Year Ended		
	December 31, 2009	December 31, 2008	December 31, 2007
Volumes, Prices and Costs			
Coal production (<i>millions of tonnes</i>)	0.67	1.16	-
Coal sales (<i>millions of tonnes</i>)	1.33	0.11	-
Average sales price (<i>per tonne</i>)	\$ 28.97	\$ 29.20	-
Total cash costs of product sold (<i>per tonne</i>)	\$ 16.58	\$ 14.09	-
Direct cash costs of product sold (<i>per tonne</i>)	\$ 14.61	\$ 8.30	-
Operating Statistics			
Total waste material moved (<i>millions of bank cubic metres</i>)	2.27	2.54	-
Strip ratio (<i>bank cubic metres of waste rock per tonne of clean coal produced</i>)	3.36	2.19	-
Operating Results (<i>thousands of dollars</i>)			
Revenue	\$ 36,038	\$ 3,126	\$ -
Cost of sales	(29,425)	(2,177)	-
Income from mine operations	6,613	949	-
Administration expenses	(24,535)	(20,358)	(7,191)
Evaluation and exploration expenses	(5,399)	(26,445)	(13,788)
Operating loss from continuing operations	\$ (23,321)	\$ (45,854)	\$ (20,979)

In 2009, 0.67 million tonnes of coal was produced with a strip ratio of 3.36 compared to 1.16 million tonnes produced in 2008 with a strip ratio of 2.19. Lower production in 2009 was the result of the full mine shut down from March 2009 to July 2009 and the re-configuring of the pit which began in December 2009.

The Company incurred an operating loss from continuing operations for the year ended December 31, 2009, of \$23.3 million compared to \$45.9 million for the same period in 2008. The decrease in the operating loss is due to the factors discussed below.

Revenue and cost of sales relate to the Company's operations in Mongolia. Through early 2009, shipments across the border were limited and as a result the Company initiated a production curtailment program in January 2009. This was followed by a full mine shut down on February 24, 2009, except for coal loading of customer trucks from coal stockpiles.

With increasing sales and a reduction in its coal inventory, the Company resumed full mining operations effective July 1, 2009, on a 24 hours per day, seven days per week basis.

In 2009, the Company shipped approximately 1.33 million tonnes of coal at an average realized selling price of approximately \$29 per tonne. This compares to 0.11 million tonnes of coal shipped in 2008 at an average realized selling price of \$29 per tonne.

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Cost of sales was \$29.4 million in the year ended December 31, 2009, compared to \$2.2 million for the year ended December 31, 2008. The increase in cost of sales relates to the higher sales volume in 2009. In 2008 there were only sales in the fourth quarter compared to a full year of sales in 2009. Cost of sales comprise the cost of the product sold, mine administration costs, equipment depreciation, depletion of stripping costs and stock-based compensation costs.

Direct cash costs were \$14.61 per tonne in 2009 compared to \$8.30 in 2008. The increase in direct cash costs is due to the full mine shut down from March 2009 to July 2009, which resulted in operational costs being expensed. The Company continuously reviews the direct cash costs and believes they are in line with the expected life of mine cash costs of \$15 per tonne as outlined in the Norwest technical report.

Mine administration costs per tonne decreased to \$1.97 per tonne for the year ended December 31, 2009, compared to \$5.79 per tonne for the year ended December 31, 2008. The decrease per tonne is due to the higher sales volume in 2009.

Exploration expenses for the year ended December 31, 2009, were lower than the year ended December 31, 2008. Exploration expenses include expenses for the Mongolia Coal Division. Exploration expenses were higher in 2008 as prior to the commencement of sales in late September 2008, certain operational costs were classified as exploration expense.

Administration expenses for the year ended December 31, 2009, were \$24.5 million compared to \$20.4 million for the year ended December 31, 2008. The increase predominantly relates to salaries and benefits and professional fees. Administration expenses for the year ended December 31, 2009, includes approximately \$10.5 million of stock-based compensation compared to approximately \$3.8 million for the year ended December 31, 2008.

The administration expenses consist of the following major categories broken down for comparative purposes (see Note 8 of the annual Consolidated Financial Statements).

Legal fees for the year ended December 31, 2009, were higher than the year ended December 31, 2008. Legal fees include costs associated with the Company's regulatory affairs including expenses associated with corporate governance, contract negotiations, filing, registration and disclosure. Legal fees increased in 2009 due to higher contract negotiation fees.

Corporate administration fees are slightly higher in the year ended December 31, 2009, compared to the year ended December 31, 2008. The increase predominantly relates to additional administration costs incurred in the Hong Kong office. Certain of the Company's administrative staff and office facilities are provided by Global Mining Management Ltd. (see 'Related Party Transactions') on a cost recovery basis. Accordingly, quarterly fluctuations in the costs of administrative and personnel costs can be expected commensurate with increases or decreases in quarterly corporate activity and the level of personnel employed.

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Professional fees have increased for the year ended December 31, 2009, as compared to the year ended December 31, 2008. Professional fees include the cost of quarterly reviews, internal computer systems training and planning, and accruals for the year-end audit of the Company's financial statements. The increase in 2009 relates predominantly to costs related to the various technical reports for the Mongolia project.

Salaries and benefits, excluding stock-based compensation costs, increased in the year ended December 31, 2009, to \$3.6 million as compared to \$1.8 million for the year ended December 31, 2008. The increase relates to the additional staff and bonuses for the year ended December 31, 2009.

The foreign exchange losses are primarily the result of changes of the U.S. to Canadian dollar ("Cdn\$") and the U.S. to Mongolian Tugrik exchange rates during the period. The higher foreign exchange loss of \$4.7 million for the year ended December 31, 2008, compared to \$1.1 million in 2009 relates to the higher Canadian cash balances in 2008.

Listing fees consist of legal, accounting and professional fees incurred for a secondary listing on the Hong Kong stock exchange. Normally the Company would treat all charges as share issue costs upon a successful equity fundraising. In 2008, uncertainty in the timing of a possible equity financing led to a decision to expense \$6.7 million in listing fees. In 2009, the Company continued with the secondary listing application and in October 2009 achieved milestones that strongly indicated that the secondary listing application would lead to an equity financing. All costs subsequent to this date were capitalized. In 2009, listing costs of \$2.5 million were expensed and listing costs of \$4.6 million were capitalized.

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NON-IFRS FINANCIAL MEASURES

(\$ in thousands, unless otherwise stated)

This Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") refers to certain financial measures, such as "cash costs", which are not standardized measures recognized under IFRS and do not have a standardized meaning prescribed by IFRS. These measures are commonly utilized in the mining industry and are considered informative for management, shareholders and analysts. These measures may differ from those made by other corporations and accordingly may not be comparable to such measures as reported by other mining companies.

Cash costs is the term used by the Company to describe the cash production costs and consists of cost of product, which includes direct and indirect costs of production.

	Year Ended	Year Ended	Year Ended
	December 31, 2009	December 31, 2008	December 31, 2007
Cash costs, continuing operations			
Cost of sales per financial statements	\$ 29,425	\$ 2,177	\$ -
Less non-cash adjustments	(7,405)	(586)	-
Total cash costs	22,020	1,591	-
Coal sales (000's of tonnes)	1,328	113	-
Total cash costs of product sold (per tonne)	\$ 16.58	\$ 14.09	\$ -

	Year Ended	Year Ended	Year Ended
	December 31, 2009	December 31, 2008	December 31, 2007
Cash costs, continuing operations			
Direct cash costs of product sold (per tonne)	\$ 14.61	\$ 8.30	\$ -
Mine administration cash costs of product sold (per tonne)	1.97	5.79	-
Total cash costs of product sold (per tonne)	\$ 16.58	\$ 14.09	\$ -

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EXPLORATION COSTS AND DISCONTINUED OPERATIONS BY DIVISION

(\$ in thousands)

	Year Ended December 31,		
	2009	2008	2007
Mongolian Coal Division	\$ 5,399	\$ 26,445	\$ 13,788
Indonesian Coal Division - Discontinued Operations	15,916	9,740	-
Metals Division - Discontinued Operations	-	7,911	4,676
Total Exploration	\$ 21,315	\$ 44,096	\$ 18,464

Mongolia Coal Division

Exploration costs are charged to operations until such time as it has been determined that a property has economically recoverable reserves, in which case the costs incurred to develop a property are capitalized. Exploration expenditures include consulting-geological, drilling, license fees, office costs and salaries and benefits.

The costs of pre-development, overburden removal and stripping activities, which are incurred in the pre-production stage are expensed as incurred. The Company commenced mining operations in Mongolia on April 2, 2008, and costs incurred for site development prior to the production phase were expensed.

The exploration expenditures in 2009 were \$5.4 million compared to \$26.4 million in 2008. The exploration costs in 2008 were higher as the Company acquired equipment, hired additional personnel and began pre-development activities at the Ovoot Tolgoi Mine. Pre-development of the Ovoot Tolgoi open pit mine site included road construction, site clearing, drainage control and topsoil removal. The 2008 exploration program concentrated on drilling in the Sunset Pit. The exploration continued to expand the extent of the known mineralization in both the underground and surface coal deposits as well as increase the knowledge level of the quality and structure of the deposit. The 2009 exploration program focused on Soumber, Greenfields and Tsagaan Tolgoi. The Soumber exploration program is a full geotechnical and hydrological study and is a follow-up to the exploration activities that were conducted in 2008. Greenfields has also shown new coal occurrences of high quality coal and therefore exploration was also focused on this area.

Indonesia Coal Division – Discontinued Operations

The sale of the Mamahak Deposit is disclosed as discontinued operations in 2008 and 2009. Exploration expenditures were \$15.9 million for the year ended December 31, 2009, compared to \$9.7 million for the year ended December 31, 2008. Exploration costs in 2008 were incurred to carry out geological reconnaissance, licensing, mapping, initial drilling, and a documentation program on the new concession in East Kalimantan. The Company continued exploration activities in Indonesia in 2009 until development work was suspended in October 2009.

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Metals Division – Discontinued Operations

In 2008, the sale of the Metals Division was disclosed as a discontinued operation and its financial position and results were presented as separate items in the consolidated statement of financial position and statements of comprehensive income and cash flows.

The Company explored the Indonesian and Mongolian properties during 2008. The majority of the expenditures incurred were related to ongoing licence fees, drilling, and salaries.

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OTHER INCOME/EXPENSE

(\$ in thousands)

	Year Ended December 31,		
	2009	2008	2007
Fair value change of embedded derivatives in convertible debenture	\$ 44,980	\$ -	\$ -
Fair value change of embedded derivative in line of credit facility	-	7,223	63,286
Interest accretion on convertible debenture	2,972	-	-
Interest accretion on line of credit facility	-	598	6,481
Interest expense on convertible debenture	4,712	-	-
Interest expense on line of credit facilities	1,651	149	1,359
Transaction costs on issuance of convertible debenture	9,399	-	-
Mark to market gain on investments	(843)	-	-
Accretion of asset retirement obligation	40	19	-
Interest income	(77)	(1,868)	(44)
	\$ 62,834	\$ 6,121	\$ 71,082

In November 2009, the Company entered into a financing agreement with a wholly owned subsidiary of CIC for \$500 million in the form of a secured, convertible debenture bearing interest at 8.0% with a maximum term of 30 years. The financing is required primarily to support the accelerated investment program in Mongolia and up to \$120 million of the financing may also be used for working capital, repayment of debt due on funding, general and administrative expense and other general corporate purposes.

The convertible debenture is a hybrid debt instrument, containing a debt host component and three embedded derivatives. The debt host is measured at amortized cost using the effective interest method. The embedded derivatives are measured at fair value and all changes in fair value will be recognized in profit or loss immediately. The transaction costs are allocated on a pro-rata basis between the embedded derivative and the debt host based on the fair value of the embedded derivative and the residual value of the debt host. For the year ended December 31, 2009, the fair value change on the embedded derivative was a \$45.0 million loss, the interest accretion was \$3.0 million, the interest expense was \$4.7 million and the transaction fees were \$9.4 million. The interest expense includes \$3.8 million in cash and \$0.9 million in shares.

In 2009, as part of the sale of the Metals Division, the Company obtained a \$30 million working capital credit facility from Ivanhoe. The credit facility was for a one year term with a one year discretionary extension. The credit facility was unsecured and carried an interest rate equal to LIBOR plus 750 basis points. In July 2009, the Company and Ivanhoe agreed to increase the existing working capital credit facility from \$30 million to \$60 million. The amended credit facility had an original maturity date of December 31, 2010, was unsecured and had an interest rate of LIBOR plus 750 basis points. The amended facility also required repayment in the event that the Company acquired additional financing from a third party source and provided for an extension fee of \$1.5 million payable in the event any portion of the facility was outstanding past March 31, 2010. In November 2009, after receiving the financing from CIC, the Company repaid the \$50 million in principal plus \$1.6 million in interest expense.

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The mark to market gain on investments includes the mark to market on the 50 million shares of KRL, which were received as proceeds for the sale of the Indonesia Coal Division, and certain money market instruments.

On April 26, 2006, in conjunction with the coal transaction, the Company entered into a line of credit facility (the "First Funding Agreement") with Ivanhoe whereby Ivanhoe agreed to make available to the Company an unsecured line of credit of up to \$10 million which was extended to a maximum of \$15 million on June 6, 2007. Attached to the First Funding Agreement was a conversion option which became effective upon the completion of the coal transaction. On January 23, 2008, concurrent with the closing of equity private placements and at the Company's request, Ivanhoe converted the then principal balance of \$30 million into 14,709,701 common shares of the Company. As a result of this conversion the amount due under the First Funding Agreement was eliminated.

Under IFRS, the conversion feature is considered an embedded derivative liability that must be recorded at its fair value upon initial measurement and revalued at each subsequent reporting period. The difference between the debt host component and the principal amount of the loan outstanding is accreted to income over the remaining term of the debt. (Please refer to Note 22 of the annual Consolidated Financial Statements for further details).

The Company recognizes asset retirement obligations in the period in which they are incurred. The liability component is measured at fair value and is adjusted to its present value as accretion expense is recorded.

Interest income was higher in 2008, due to higher cash balances which relate to the completion of the equity financings in early 2008. Lower interest income during 2009 reflects lower average cash balances during this period as well as very low interest rates. The current economic climate has resulted in very low interest rates especially in the United States and rates are not expected to increase in the near term.

In 2009, the Company recorded current income tax expense of \$0.5 million related to its Mongolian operations. The Company believes profitable operations in Mongolia are probable and has therefore recorded a future income tax asset of \$6.9 million related to deductible temporary differences and the carry forward of unused tax losses.

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LIQUIDITY AND CAPITAL RESOURCES

Cash Flow Highlights

(\$ in thousands)

	Year Ended December 31,		
	2009	2008	2007
Cash used in operating activities	\$ (35,230)	\$ (63,588)	\$ (17,008)
Cash used in investing activities	(105,105)	(57,669)	(611)
Cash generated by financing activities	487,332	134,306	18,065
Effect of foreign exchange rate changes on cash	5	(4,103)	(17)
Increase in cash for the year	347,002	8,946	429
Cash balance, beginning of the year	10,340	1,394	965
Cash balance, end of the year	\$ 357,342	\$ 10,340	\$ 1,394

General market conditions

Global economic conditions have improved during 2009. Despite the improvements the Company remains cautious about the speed and strength of the economic recovery. Labour markets continue to be weak, excess production capacity exists in developed economies and China appears to be taking measures to control growth and inflation. Notwithstanding the Company's caution in the short term, the Company expects demand for coal in China and India to grow through 2010 and into the foreseeable future. Management continues to monitor external conditions and their impact on the Company's business plans for the upcoming year.

Cash used in operating activities

At December 31, 2009, the Company had cash resources of \$357.3 million compared to cash resources of \$10.3 million at December 31, 2008.

Cash used in continuing operations was \$16.0 million for the year ended December 31, 2009, compared to \$48.6 million for the year ended December 31, 2008. Cash used in discontinued operations for the year ended December 31, 2009, was \$19.2 million compared to \$15.0 million for the year ended December 31, 2008.

The Company incurred a net loss from continuing operations before tax of \$86.2 million for the year ended December 31, 2009 compared to a net loss from continuing operations of \$52.0 million for the year ended December 31, 2008. Continuation of the Company's build out of the Ovoot Tolgoi mining operation, finance costs and evaluation and exploration costs contributed to the losses in 2008. In 2009, the Company recorded revenue of \$36.0 million compared to 2008 when the Company recorded revenue of \$3.1 million. The higher revenue in 2009 was offset by higher administration expenses, finance costs and interest expense. With the increased activities at the Ovoot Tolgoi site and the operations in Mongolia, accounts receivable, prepaid expenses, and accounts payable increased during the year ended December 31, 2009.

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Accounts receivable include funds due from government taxation authorities (Goods and Services Tax or Value Added Tax). Verification of the collectability of the funds from government taxation authorities was conducted in the fourth quarter of 2008, early 2009 and the fourth quarter of 2009. Payment of accounts receivable due from government taxation authorities in Mongolia could be delayed, and is being used to offset future income taxes payable on account.

In July 2009, Mongolian tax law was amended to preclude producers and exporters of unfinished mineral products from claiming back VAT. The Mongolian government has yet to define what products will qualify as finished mineral products and any VAT amounts impacted will be prospective from the effective date of the law, August 16, 2009. The Company is monitoring the amendments to the tax law regarding current claims for Value Added Tax.

The Company is also closely monitoring collectability of outstanding accounts receivable for current coal sales. Although all accounts are currently in order, unfavorable market conditions may have an impact on future collectability.

Prepaid balances and deposits have increased during 2009. The increase relates to the timing of prepayments for Mongolian exploration licenses, supplies, and insurance.

Coal and supplies inventory have increased to \$16.4 million at December 31, 2009, from \$13.7 million at the year ended December 31, 2008. Coal and supplies inventory is valued at the lower of cost and net realizable value. Coal inventory cost of \$9.6 million includes direct and indirect labour, operating materials and supplies, transportation costs and an appropriate portion of fixed and variable overhead expenses including depreciation and depletion. Supplies inventory consists of consumable parts and supplies.

The Company had a stockpile of approximately 390,000 tonnes of coal inventory at December 31, 2009, and 1.1 million tonnes at December 31, 2008.

Accounts payable have increased in the year ended December 31, 2009, due to increased corporate activity related to the secondary listing on the Hong Kong Stock Exchange.

Cash used for investing activities

Cash used for investing activities was \$105.1 million for the year ended December 31, 2009, compared to \$57.7 million for the year ended December 31, 2008.

The Company's investment in property, plant and equipment was higher during 2008 as the Company prepared the Ovoot Tolgoi Mine for production. Deposits for further mining equipment are included as plant and equipment. The Company incurred expenditures in 2009 for mobile and mining equipment and deferred stripping in Mongolia.

In the fourth quarter of 2009, after the receipt of the proceeds from the CIC financing, the Company invested \$15.0 million and \$47.5 million in short and longer term money market instruments respectively.

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Interest income will increase or decrease depending on the cash position and interest rates. Interest was higher in 2008 due to higher cash balances which related directly to the completion of the equity financings. Lower interest income during 2009 reflects lower average cash balances during this period as well as very low interest rates. The current economic climate has resulted in very low interest rates especially in the United States and rates are not expected to increase in the near term.

Cash provided by financing activities

In November 2009, the Company entered into a financing agreement with a wholly owned subsidiary of CIC for \$500 million in the form of a secured, convertible debenture bearing interest at 8.0% with a maximum term of 30 years. The financing is required primarily to support the accelerated investment program in Mongolia and up to \$120 million of the financing may also be used for working capital, repayment of debt due on funding, general and administrative expense and other general corporate purposes.

On December 31, 2008, the Company announced the sale of its Metals Division to Ivanhoe for \$3 million and other non-cash consideration. As part of the sale transaction, the Company obtained a \$30 million credit facility from Ivanhoe. The credit facility was for a one year term with a one year discretionary extension. The credit facility was unsecured and carried an interest rate equal to LIBOR plus 750 basis points. In July 2009, the Company and Ivanhoe agreed to increase the existing working capital credit facility from \$30 million to \$60 million. The amended credit facility had an original maturity date of December 31, 2010, was unsecured and had an interest rate of LIBOR plus 750 basis points. The amended facility also required repayment in the event that the Company acquired additional financing from a third party source and provided for an extension fee of \$1.5 million payable in the event any portion of the facility was outstanding past March 31, 2010. In November 2009, after receiving the financing from CIC, the Company repaid the \$50 million in principal plus \$1.6 million in interest expense.

In 2008, the Company completed a series of equity financing transactions and received proceeds from the exercise of stock options. The total proceeds net of issue costs were \$140.4 million for the year ended December 31, 2008, compared to proceeds received for the exercise of stock options for the year ended December 31, 2009, of \$3.9 million.

The proceeds from the equity financings in 2008 were used for the initial development of the open-pit coal mine at the Company's Ovoot Tolgoi project, and for additional drilling and engineering focused on the Ovoot Tolgoi site and development of the Indonesia coal project. Proceeds have also been used for investigating new projects, equipment expenditures and for general corporate and administrative purposes. The proceeds were also used to repay amounts advanced under the line of credit facility obtained from Ivanhoe in October 2007.

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Contractual Obligations and Guarantees

In the normal course of business, the Company enters into contracts that give rise to commitments for future minimum payments. The following table summarizes the remaining contractual maturities of the Company's operating and capital commitments at December 31, 2009.

Contractual Obligations	As at December 31, 2009				
	Within 1 year	2-3 years	4-5 years	Over 5 years	Total
Capital expenditure commitments	\$ 17,563	\$ -	\$ -	\$ -	\$ 17,563
Minimum rental and lease payments	1,352	2,014	578	-	3,944
	\$ 18,915	\$ 2,014	\$ 578	\$ -	\$ 21,507

Liquidity, Financing and Working Capital Resources

The Company is an integrated coal exploration, development and production company. Based on proceeds from CIC and the net proceeds from the International Offering, the Company does not anticipate any additional funding requirements in the near future.

In November 2009, the Company entered into a financing agreement with a wholly owned subsidiary of CIC for \$500 million in the form of a secured, convertible debenture bearing interest at 8.0% with a maximum term of 30 years. The financing is required primarily to support the accelerated investment program in Mongolia and up to \$120 million of the financing may also be used for working capital, repayment of debt due on funding, general and administrative expense and other general corporate purposes.

Key commercial terms of the financing include:

- Interest - 8% per annum (6.4% payable semi-annually in cash and 1.6% payable annually in the Company's shares, where the number of shares to be issued is calculated based on the 50-day volume-weighted average price (VWAP);
- Term - Maximum of 30 years;
- Security - First charge over the Company's assets, including shares of its material subsidiaries;
- Conversion price - The conversion price is set as the lower of Cdn\$11.88 or the 50-day VWAP at the date of conversion, with a floor price of Cdn\$8.88 per share;
- Conversion timing - The Company and CIC each have various rights to call conversion of the debenture into common shares. CIC has the right to convert the debenture, in whole or in part, into common shares 12 months after the date of issue. The Company has the right to call for the conversion of up to \$250 million of the debenture on the earlier of 24 months after the issue date, if the conversion price is greater than Cdn\$10.66, or upon the Company achieving a public float of 25% of its common shares under certain agreed circumstances, if the conversion price is greater than Cdn \$10.66;
- Company's normal conversion right - After 60 months from the issuance date, at any time that the conversion price is greater than Cdn \$10.66, the Company will be entitled to require

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conversion of the outstanding convertible debenture in whole or in part, into common shares at the conversion price;

- Representation on the Company's Board - While the debenture loan is outstanding, or while CIC has a minimum 15% direct or indirect stake in the Company, CIC has the right to nominate one director to the Company's Board. The Company currently has eight Board members;
- Voting restriction - CIC has agreed that it will not have any voting rights in the Company beyond 29.9% if CIC ever acquires ownership of such a shareholder stake through exercising the debenture;
- Pre-emption rights - While the debenture loan is outstanding, or while CIC has a 15% direct or indirect stake in the Company, CIC has certain pre-emption rights on a pro-rata basis to subscribe for any new shares to be allotted and issued by the Company for the period which the debenture is outstanding. The pre-emption rights will not apply to new shares issued pursuant to pro-rata public equity offerings made to all shareholders, exercise of stock options and shares issued to achieve a 25% public float;
- Right of first offer - While a portion of the debenture is outstanding, or while CIC has a 15% direct or indirect stake in the Company, CIC has the right of first offer for any direct and indirect sale of Ivanhoe's ownership stake in the Company. As at March 15, 2010, Ivanhoe owned directly and indirectly approximately 105.6 million of the Company's shares, or approximately 65% of the Company's current issued and outstanding shares; and
- Registration rights - CIC has registration rights under applicable Canadian provincial securities laws in connection with the common shares issuable upon conversion of the debenture.

In conjunction with the financing, the Company also entered into a mutual co-operation agreement with a subsidiary of CIC. Under the terms of the agreement, CIC's subsidiary will provide advice and services to the Company on matters that include sales to China, procurement and logistics, and will receive a customary commercial payment for such services based on product sales from Mongolia to China.

On January 29, 2010, the Company announced that it had closed the global equity offering of 27 million common shares of the Company at a price of Cdn\$17.00 per common share, for gross proceeds of Cdn\$459.0 million. The Company's future plans for the proceeds include, expanding the existing production capacity of the open pit mine at the Ovoot Tolgoi Mine, assess, construct and develop the regional infrastructure and the coal transportation infrastructure, completion of technical and engineering assessment, for construction of value added facilities, exploration activities and general corporate purposes, which may include provision of working capital and general exploration, development and acquisition activities.

On March 12, 2010, the Company announced, subject to regulatory approval, a formal request for CIC to convert \$250 million of its convertible debenture into common shares of the Company.

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RELATED PARTY TRANSACTIONS

The Company is a party to a shareholders' cost-sharing agreement with certain other public and private companies, including Ivanhoe (the "Other Companies") pursuant to which the Company and the Other Companies are equal shareholders in Global Mining Management Ltd. ("GMM") and, through GMM, share office space, furnishings and equipment and communications facilities (on a cost recovery basis) and the employment, on a part-time basis, of various administrative, office and management personnel in Vancouver, British Columbia. Costs of the shared office facilities and the shared part-time employees and service providers are recovered from the Company proportionate to the time spent by the shared part-time employees and service providers on matters pertaining to the Company. Certain of the directors and officers of the Company are also officers and directors of GMM. The Company has utilized the services of the GMM staff and office since September 1, 2003 and has incurred costs of \$1.8 million and \$2.5 million for the years ended December 31, 2009, and December 31, 2008, respectively.

On December 31, 2008, the Company announced the sale of the Metals Division to Ivanhoe for \$3 million and other non-cash consideration. The Metals Division consisted of a series of base and precious metal exploration properties in Mongolia and Indonesia, related assets, employees and contracts. As part of the sale transaction, the Company obtained a credit facility from Ivanhoe, which allowed the Company to receive loan advances from Ivanhoe to an aggregate maximum of \$30 million. The credit facility was for a one year term with a one year discretionary extension. The credit facility was unsecured and carried an interest rate equal to LIBOR plus 750 basis points.

In July 2009, the Company and Ivanhoe agreed to increase the existing working capital credit facility from \$30 million to \$60 million. The amended credit facility had an original maturity date of December 31, 2010, was unsecured and had an interest rate of LIBOR plus 750 basis points. The amended facility also required repayment in the event that the Company acquires additional financing from a third party source and provided for an extension fee of \$1.5 million payable in the event any portion of the facility was outstanding past March 31, 2010. In November 2009, the Company after receiving the financing from CIC repaid the \$50 million in principal plus \$1.6 million in interest expense.

OUTSTANDING SHARE DATA

The Company is authorized to issue an unlimited number of common shares without par value and an unlimited number of preferred shares without par value. As at March 15, 2010, 161,770,687 common shares were issued and outstanding. There are also incentive stock options outstanding that are exercisable to acquire 7,380,961 unissued common shares. On a diluted basis, 169,151,648 common shares were outstanding. There are no preferred shares outstanding.

Ivanhoe, directly and indirectly, currently owns 105,557,155 common shares representing approximately 65% of the issued and outstanding common shares of SouthGobi.

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DISCLOSURE CONTROLS AND PROCEDURES

Disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed by the Company in its annual filings, interim filings or other reports filed or submitted by it under securities legislation is recorded, processed, summarized and reported within the time periods specified in the securities legislation and include controls and procedures designed to ensure that information required to be disclosed by the Company in its annual filings, interim filings or other reports filed or submitted under securities legislation is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Management, including the Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures. As of December 31, 2009, the Chief Executive Officer and Chief Financial Officer have each concluded that the Company's disclosure controls and procedures, as defined in National Instrument 52-109 - Certification of Disclosure in Issuer's Annual and Interim Filings, are effective to achieve the purpose for which they have been designed.

INTERNAL CONTROLS OVER FINANCIAL REPORTING

Internal controls over financial reporting are designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with IFRS. Management is also responsible for the design of the Company's internal control over financial reporting in order to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with IFRS.

The Company's internal controls over financial reporting include policies and procedures that: pertain to the maintenance of records that, in reasonable detail accurately and fairly reflect the transactions and disposition of assets; provide reasonable assurance that transactions are recorded as necessary to permit preparation of the financial statements in accordance with IFRS and that receipts and expenditures are being made only in accordance with authorization of management and directors of the Company; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of assets that could have a material effect on the financial statements.

Because of their inherent limitations, internal controls over financial reporting can provide only reasonable assurance and may not prevent or detect misstatements. Furthermore, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

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The Company's management, under the supervision of the Chief Executive Officer and the Chief Financial Officer, has evaluated the effectiveness of the Company's internal controls over financial reporting using the framework and criteria established in *Internal Control-Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on the evaluation, management has concluded that internal controls over financial reporting were effective as at December 31, 2009.

There has been no change in the Company's internal controls over financial reporting that occurred during the most recently completed quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal controls over financial reporting.

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RISK FACTORS

There are certain risks involved in the Company's operations, some of which are beyond its control. These risks can be broadly categorized into: (i) risks relating to its business and industry; and (ii) risks relating to its projects in Mongolia. Additional risks and uncertainties not presently known, or not expressed or implied below, or that are presently deemed immaterial, could also harm the Company's business, financial condition and operating results. Some of the following statements are forward-looking and actual results may differ materially from the results anticipated in these forward-looking statements.

Risks Relating to the Company's Business and Industry

Some of the Company's projects may not be completed as planned, costs may exceed its original budgets and may not achieve the intended economic results or commercial viability.

The Company's business strategy depends in large part on expanding its production capacity at the Ovoot Tolgoi Mine and further developing its other coal projects into commercially viable mines. Whether a mineral deposit will be commercially viable depends on a number of factors, including: the particular attributes of the deposit, such as size, grade and proximity to infrastructure; commodity prices, which are highly cyclical; and government regulations, including regulations relating to prices, taxes, royalties, land tenure, land use, importing and exporting of mineral resources and environmental protection. The Company's current intention to develop mines at the Soumber Deposit and the Ovoot Tolgoi Underground Deposit in the future is based on geological, engineering, environmental and mine planning evaluations. The feasibility of mining at these projects as well as at the Tsagaan Tolgoi Deposit has not been and may never be established. If the Company is unable to develop all or any of its projects into a commercial working mine, its business, financial condition and results of operations will be materially and adversely affected.

The Company's projects are subject to technical risk in that they may not perform as designed. Increased development costs, lower output or higher operating costs may all combine to make a project less profitable than expected at the time of the development decision. This would have a negative impact on the Company's business and results of operations. No assurance can be given that the Company would be adequately compensated by third party project design and construction companies (if not performed by the Company) in the event that a project did not meet its expected design specification.

As with all exploration properties or projects taken on by mining companies, there is a risk that exploration projects will not be converted to commercially viable mines, in part because actual costs from capital projects may exceed the original budgets. As a result of project delays, cost overruns, changes in market circumstances or other reasons, the Company may not be able to achieve the intended economic benefits or demonstrate the commercial feasibility of these projects, which in turn may materially and adversely affect the Company's business, results of operations and growth projects. For example, as the Company progressed with efforts to prepare for the mining and shipment of a targeted 30,000 tonne trial cargo from the Mamahak Deposit, the Company became aware of the need for additional capital expenditure beyond what was originally

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budgeted. Based on these requirements and the revised resource estimates contained in the Mamahak Technical Expert Report, the Company suspended further development works at the Mamahak Deposit pending a more detailed operational review. As a result of the suspension, the Company recorded an impairment charge of US\$23 million in the third quarter of 2009, which brought the value of the Mamahak Deposit assets to zero as at September 30, 2009.

The Company's coal reserves and resources are estimates based on a number of assumptions, and the Company may produce less coal than its current estimates.

The coal reserve and resource estimates are based on a number of assumptions that have been made by the Qualified Persons in accordance with NI 43-101. Reserve and resource estimates involve expressions of judgment based on various factors such as knowledge, experience and industry practice, and the accuracy of these estimates may be affected by many factors, including quality of the results of exploration drilling and analysis of coal samples, as well as the procedures adopted by and the experience of the person making the estimates.

Estimates of the reserves and resources at the Company's projects may change significantly when new information becomes available or new factors arise, and interpretations and deductions on which reserves and resources estimates are based may prove to be inaccurate. Should the Company encounter mineralization different from that predicted by past drilling, sampling and similar examination, mineral resource and/or reserve estimates may have to be adjusted downward. This downward adjustment could materially affect the Company's development and mining plans, which could materially and adversely affect its business and results of operations.

In addition, the rank of coal ultimately mined may differ from that indicated by drilling results. There can be no assurance that coal recovered in laboratory tests will be duplicated under on-site conditions or in production-scale operations in the event that the actual level of impurities is higher than expected or the coal mined is of a lower quality than expected, the demand for, and realizable price of, the Company's coal may decrease. Short term factors relating to reserves, such as the need for orderly development of coal seams or the processing of new or different quality coals, may also materially and adversely affect the Company's business and results of operations.

The inclusion of reserve and resource estimates should not be regarded as a representation that all these amounts can be economically exploited and nothing contained herein (including, without limitation, the estimates of mine lives) should be interpreted as assurance of the economic lives of the Company's coal reserves and resources or the profitability of its future operations.

The Company commenced mining in April 2008 and has recorded operating and net losses and operating cash outflows to date, and therefore the Company's short operating history may make it difficult for investors to evaluate its business and growth.

The Company commenced mining in April 2008 and currently operates one revenue producing mine. In the year ended December 31, 2009, the Company recorded a net loss. As is typical for a start up mining company, the Company has recorded a deficit since inception. Although the Company has no plans to pay dividends in the near future, should such deficits continue and cash

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reserve be depleted, it could adversely affect the Company's ability to pay dividends in the future. Due to the Company's limited operating history, there may not be an adequate basis on which to evaluate the Company's future operating results and prospects. Because the Company's past results may not be indicative of the Company's results in the future, investors may have difficulties evaluating the Company's business and prospects.

The Company does not insure against all risks to which it may be subject in planned operations and insurance coverage could prove inadequate to satisfy potential claims.

For certain aspects of the Company's business operations, insurance coverage, in particular business interruption insurance, is restricted or prohibitively expensive. The Company currently holds its primary insurance policies through Canadian insurance providers to insure its properties. The Company has taken out insurance for risks including commercial general liability, umbrella liability, aviation premises liability, and kidnap and ransom. The Company maintains mining property insurance for all of its mining assets wherever located, property insurance on its office premises and liability insurance for its Directors and Officers. However, no assurance can be given that the Company will be able to obtain such insurance coverage at economically reasonable premiums (or at all), or that any coverage it obtains will be adequate to cover the extent of any claims brought against it.

Exploration, development and production operations on mineral properties involve numerous risks, including environmental risks, such as unexpected or unusual geological operating conditions, rock bursts or slides, fires, floods, earthquakes or other environmental occurrences, and political and social instability. The Company does not maintain insurance against any environmental or political risks. Should any liabilities arise for which it is not insured or insurance coverage is inadequate to cover the entire liability, they could reduce or eliminate the Company's actual or prospective profitability, result in increasing costs and a decline in the value of the common shares and could materially and adversely affect the Company's business and results of operations.

Licences and permits are subject to renewal and various uncertainties and the Company may only renew its exploration licences a limited number of times for a limited period of time.

In Mongolia, the Company's exploration licences are subject to periodic renewal and may only be renewed a limited number of times for a limited period of time. While it anticipates that renewals will be given as and when sought, there is no assurance that such renewals will be given as a matter of course and there is no assurance that new conditions will not be imposed in connection therewith. The Company's business objectives may also be impeded by the costs of holding and/or renewing the exploration licences in Mongolia. Licence fees for exploration licences increase substantially upon the passage of time from the original issuance of each individual exploration licence. The Company needs to assess continually the mineral potential of each exploration licence, particularly at the time of renewal, to determine if the costs of maintaining the exploration licences are justified by the exploration results to date, and may elect to let some of its exploration licences lapse. Moratorium on transfers of exploration licences has been imposed on two separate occasions and there is a risk that a similar moratorium could be imposed such that letting the

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exploration licences lapse may be the only practical option in some circumstances. Furthermore, the Company will require mining licences and permits to mine in order to conduct mining operations in Mongolia. There can be no assurance, however, that such licences and permits will be obtained on terms favorable to it or at all for the Company's future intended mining and/or exploration targets in Mongolia.

In addition, certain provisions of the Land Law of Mongolia enacted on June 7, 2002, and effective from January 1, 2003, (the "Land Law") and the Mineral Law of Mongolia, enacted on July 8, 2006, and effective August 26, 2006, (the "2006 Minerals Law") provide for the revocation of previously granted land use rights, exploration licences or mining licences on the grounds that the affected area of land has been designated as "special needs" territory. The Land Law grants the discretion to declare an area of land for special needs purposes to local governing authorities and identifies various broad categories which qualify as special needs. The 2006 Minerals Law requires the local governing authority that designates an area of land as a special needs territory to compensate the licence holder whose rights or licence status are affected. If any of the Company's land use rights, exploration licences or mining licences in Mongolia are revoked because the underlying land is declared as special needs territory, there is no assurance that the Company will receive adequate compensation or any compensation at all and its business and results of operation might be adversely and materially affected. The Company has had no land use rights or exploration/mining licences revoked to date.

Prolonged periods of severe weather conditions could materially and adversely affect the Company's business and results of operations.

Severe weather conditions may require the Company to evacuate personnel or curtail operations and may cause damages to the project site, equipment or facilities, which could result in the temporary suspension of operations or generally reduce the Company's productivity. Severe weather conditions have not caused any delay or damages to the Company's operations to date. However, there can be no assurance that severe weather will not occur. Any damages to the Company's projects or delays in its operations caused by prolonged periods of severe weather could materially and adversely affect its business and results of operations.

The Company's business and results of operations are susceptible to the cyclical nature of coal markets and are vulnerable to fluctuations in prices for coal.

The Company expects to derive substantially all of its revenue and cash flow from the sale of coal. Therefore, the market price of the shares, the Company's ability to raise additional financing and maintain ongoing operations and its financial condition and results of operations will be directly related to the demand for, and price of, coal and coal-related products. Coal demand and price are determined by numerous factors beyond the Company's control, including the international demand for steel and steel products, the availability of competitive coal supplies, international exchange rates, political and economic conditions in Mongolia, the People's Republic of China (the "PRC") and elsewhere in the world, milder or more severe than normal weather conditions, and production costs in major coal producing regions. The PRC and international coal markets are cyclical and have in the past exhibited significant fluctuations in supply, demand and prices from

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year to year. There has been significant price volatility on the coal spot market. An oversupply of coal in the PRC or a general downturn in the economies of any significant markets for the Company's coal and coal-related products could materially and adversely affect its business and results of operations. In addition, the Company's dependence on Asian markets may result in instability in its operations due to political and economic factors in those Asian jurisdictions which are beyond the Company's control. The combined effects of any or all of these factors on coal prices or volumes are impossible for the Company to predict. If realized coal prices fall below the full cost of production of any of its future mining operations and remain at such a level for any sustained period, the Company could experience losses and may decide to discontinue operations, which could require the Company to incur closure costs and result in reduced revenues.

The Company's coal mining activities are subject to operational risks including equipment breakdown.

The Company's coal mining operations are subject to a number of operational risks, some of which are beyond its control, which could delay the production and delivery of coal. These risks include unexpected maintenance or technical problems, periodic interruptions to its mining operations due to inclement or hazardous weather conditions and natural disasters, industrial accidents, power or fuel supply interruptions and critical equipment failure, including malfunction and breakdown of its shovels, upon which its coal mining operations are heavily reliant and which would require considerable time to replace. These risks and hazards may result in personal injury, damage to, or destruction of, properties or production facilities, environmental damage, business interruption and damage to its business reputation. In addition, breakdowns of equipment, difficulties or delays in obtaining replacement shovels and other equipment, natural disasters, industrial accidents or other causes could temporarily disrupt the Company's operations, which in turn may also materially and adversely affect its business, prospects, financial condition and results of operations.

The unavailability or shortage of reliable and sufficient coal transportation capacity will reduce the Company's coal revenue by causing it to reduce its production volume or impairing its ability to supply coal to its customers.

The Company anticipates that the majority of its coal production from the projects in Mongolia will be exported into the PRC. While the Company expects to sell and deliver most of its coal from the Ovoot Tolgoi Mine at the mine gate, inadequate transportation infrastructure is likely to affect the pricing terms on which it can sell the coal to customers and the willingness and ability of such customers to purchase coal from it. Potential customers are likely to factor in any delays and the costs and availability of transportation in determining the price they are prepared to pay to purchase the Company's coal. Therefore, its mining operations are anticipated to be highly dependent on road and rail services in Mongolia and, to a lesser extent, in the PRC.

In Mongolia, a bottleneck in the transportation of coal from the Ovoot Tolgoi Mine to customers in the PRC may arise if the road connecting the Ovoot Tolgoi Mine to the Shivee Khuren-Ceke border crossing does not have sufficient capacity to support the increased amount of cargo traffic or is affected by external factors such as disruptions caused by bad weather. The opening hours of the Shivee Khuren-Ceke border crossing also affect the Company's ability to expedite the movement of

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its coal shipment. There can be no assurance that there would be any other cost effective means of transporting the coal to the Company's primary market in the PRC. As a result, the Company may experience difficulty expediting the movement of its coal shipments and/or significant cost escalation for the transportation services, which could affect its production and reduce its profitability.

In the PRC, rail and road infrastructure and capacity has in the past been affected by extreme weather conditions, earthquakes, delays caused by major rail accidents, the diversion of rolling stock needed to deliver emergency food relief and seasonal congestion during public holidays. There can be no assurance that these problems will not recur or that new problems will not occur. In any of these circumstances, the customers may not be able to take delivery of the Company's coal, which may lead to delays in payment, or refusal to pay, for the Company's coal and, as a result, the Company's business and results of operations could be materially and adversely affected.

The Company's prospects depend on its ability to attract, retain and train key personnel.

Recruiting, retaining and training qualified personnel is critical to the Company's success. The number of persons skilled in the acquisition, exploration and development of mining properties is limited and competition within the mining industry for such persons is intense, in particular, Mongolian law requires that at least 90% of a mining company's employees be of Mongolian nationality. This provision of the law, coupled with the large number of active mining projects in Mongolia, further limit the number of available personnel and increase competition for skilled personnel. As the Company's business activity grows, it will require additional key financial, administrative, mining, marketing and public relations personnel as well as additional operations staff. If the Company is not successful in attracting such key personnel, or retaining existing key personnel, its business and results of operations could be materially and adversely affected.

In addition, the Company's ability, to train operating and maintenance personnel is a key factor for the success of its business activities, if the Company is not successful in recruiting, training and retaining such personnel, its business and results of operations could be materially and adversely affected.

Competition in the coal industry may hinder development plans and adversely affect the Company's coal sales if it is not able to compete effectively.

Continued growth in mining and mineral exploration activities in Mongolia could create an increasing demand for mining equipment and related services. Shortages of, or higher costs for, equipment and services could restrict the Company's ability to carry out the exploration, development and production activities, increase its costs of operations and adversely affect its future plans.

The Company intends to sell a majority of the coal it produces into the PRC. Competition in the PRC coal industry is based on many factors, including, among others, price, production capacity, coal quality and characteristics, transportation capability and costs, blending capability and brand name. The Company's coal business will most likely compete in the PRC with other large PRC and

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international coal mining companies. Due to their location, some of the Company's PRC competitors may have lower transportation costs than the Company does. The PRC coal market is highly fragmented and the Company faces price competition from some small local coal producers that produce coal for significantly lower costs than the Company due to various factors, including their lower expenditure on safety and regulatory compliance. Some of the Company's international competitors, including the Mongolian coal producers, may have greater coal production capacity as well as greater financial, marketing, distribution and other resources than the Company does, and may benefit from more established brand names in international markets. The Company's future success will depend on its ability to respond in an effective and timely manner to competitive pressure.

There are a number of risks associated with dependence on a limited number of customers and inability to attract additional customers.

The Company depends on a relatively small number of customers. The incremental cost of transporting coal products from the Ovoot Tolgoi Mine and its other coal projects over long distances effectively limits the Company's potential customer base to a relatively proximate geographical area. Additionally, the Company has been selling its coal products only since September 2008. The Company currently has three customers with the largest customer representing approximately 64%, and the remaining customers accounting for 36% of the Company's total sales for the year ended December 31, 2009. The Company's relatively brief history of coal sales makes it difficult to evaluate the strength of its relationships with current customers and its ability to attract additional customers. Accordingly, inability to attract additional customers or the loss of, or a significant reduction in, purchases by any of the limited number of potential customers could materially and adversely affect the Company's future revenue and the economic viability of its exploration and development projects.

In addition, the Company expects to sell the majority of the coal from its Mongolian mining operations to the customers in the PRC. PRC law requires specific authorization to be obtained by entities responsible for the import of coal into the PRC. In the event that the Company's customers, or the agents of such customers who are responsible for importing coal into the PRC on their behalf, fail to obtain and retain the necessary authorizations, their ability to import coal into the PRC may be affected, which could materially and adversely affect the Company's business and results of operations.

The Company's operations are exposed to risks in relation to environmental protection and rehabilitation.

The operations of coal mines involve substantial environmental risks and hazards and the Company's operations are subject to laws and regulations relating to the environment, health and safety and other regulatory matters in Mongolia.

The risk of environmental liability is inherent in the operation of the Company's business. Environmental hazards may occur in connection with the Company's operations as a result of human negligence, force majeure, or otherwise. Claims may be asserted against the Company

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arising out of its operations in the normal course of business, including claims relating to land use, safety, health and environmental matters. The Company is not insured against environmental liabilities and there can be no assurance that environmental liabilities would not materially and adversely affect its business and results of operations.

In addition, the Company is subject to reclamation requirements. The Company's mines contain a finite amount of recoverable resources and will eventually close. The key tasks in relation to the closure of the mines involve (i) long-term management of permanent engineered structures (for example, spillways, roads, waste dumps); (ii) achievement of environmental closure standards; (iii) orderly retrenchment of employees and contractors; and (iv) relinquishment of the site with associated permanent structures and community development infrastructure and programs to new owners. The successful completion of these tasks is dependent on the Company's ability to successfully implement negotiated agreements with the relevant government, community and employees. The consequences of a difficult closure range from increased closure costs and handover delays to ongoing environmental impacts and corporate reputation damage if desired outcomes cannot be achieved, which could materially and adversely affect the Company's business and results of operations.

Environmental legislation is evolving in a manner which will require stricter standards and enforcement, increased fines and penalties for non-compliance, more stringent environmental assessments of proposed projects and a heightened degree of responsibility for companies and their officers, directors and employees. The Company has not incurred any environmental research and development costs to date. The Company may experience increased costs of production arising from compliance with environmental laws and regulations. Should the Company fail to comply with current or future environmental laws and regulations, the Company may be required to pay penalties or take corrective actions, any of which may have a material adverse effect on its results of operations and financial condition.

Foreign currency fluctuations could affect expenses and any future earnings.

The Company is exposed to foreign exchange fluctuations with respect to the MNT, Renminbi and Canadian dollars. The Company's financial results are reported in U.S. dollars. The salaries for local labourers in Mongolia are paid in local currency. Sales of coal into the PRC have been and may continue to be settled in U.S. dollars. Since the Company's headquarters is in Canada, a minor portion of its expenses are in Canadian dollars and the Company holds a portion of its cash in Canadian dollars. As a result, its financial position and results are impacted by the exchange rate fluctuations between the aforementioned currencies and the U.S. dollar.

The Company's results of operations are subject, to a significant extent, to economic, political and legal developments in the PRC.

The Company expects that a majority of coal sales from the Ovoot Tolgoi Mine will be made to customers based in the PRC. Accordingly, the economic, political and social conditions, as well as government policies, of the PRC may affect its business. The PRC economy differs from the economies of most developed countries in many respects, including: (i) structure; (ii) level of

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government involvement; (iii) level of development; (iv) growth rate; (v) control of foreign exchange; and (vi) allocation of resources. The PRC economy has been transitioning from a planned economy to a more market-oriented economy. For the past two decades, the PRC government has implemented economic reform measures emphasizing the utilization of market forces in the development of the PRC economy. Changes in the PRC's political, economic and social conditions, laws, regulations and policies could materially and adversely affect the Company's business and results of operations.

In addition, the PRC government indirectly influences coal prices through its regulation of power tariffs and its control over allocation of the transportation capacity of the national rail system. Any significant downturn in the prices in the PRC could materially and adversely affect the Company's business and results of operations. Additionally, the PRC government could adopt new policies that could shift demand away from coal to other energy sources. Any significant decline in demand for, or over-supply of, coal could materially and adversely affect the Company's revenues from coal export sales.

The interests of the Company's principal shareholder, Ivanhoe, may differ from those of its other shareholders.

As of March 15, 2010, Ivanhoe holds approximately 65% of the Company's issued and outstanding shares. The interests of Ivanhoe may conflict with the interests of the Company's other Shareholders and there is no assurance that Ivanhoe will vote its shares in a way that benefits the Company's minority shareholders. Ivanhoe's ownership interest enables Ivanhoe to elect the entire Board without the concurrence of any of the Company's other shareholders. Accordingly, unless applicable laws or regulations would require approval by the Company's minority shareholders, Ivanhoe is in a position to:

- control the Company's policies, management and affairs;
- subject to applicable laws, regulations and the Articles, adopt amendments to certain provisions of the Articles; and
- otherwise determine the outcome of most corporate actions, including a change in control, merger or sale of all or substantially all of the Company's assets.

The Company believes that third parties may be discouraged from making a tender offer or bid to acquire the Company because of this concentration of ownership.

Information in this document regarding future plans reflects current intentions and is subject to change.

Whether the Company ultimately implements the business strategies described in this document will depend on a number of factors including, but not limited to: the availability and cost of capital; current and projected coal prices; coal markets; costs and availability of drilling services, costs and availability of heavy equipment, supplies and personnel; success or failure of activities in similar areas to those in which the Company's projects are situated; and changes in estimates of project completion costs. The Company will continue to gather information about its projects, and it is

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possible that additional information will cause it to alter its schedule or determine that a project should not be pursued at all. Accordingly, the Company's plans and objectives may change from those described in this document.

Future stock market conditions may change.

There are risks involved with any investment in Common Shares. The market price of the Company's Common Shares may rise or fall depending upon a range of factors and stock market conditions, which are unrelated to the Company's future financial performance. Movements on international stock markets, local interest rates and exchange rates, domestic and international economic and political conditions, as well as government, taxation and other policy changes may affect the stock market. As the Company is a listed company on the TSX and the Hong Kong Stock Exchange, its Common Share price will also be subject to numerous influences including broad trends in the stock market and the share prices of individual companies or sectors.

Future issuances or sales, or perceived possible issuances or sales, of substantial amounts of the Company's Common Shares in the public market could materially and adversely affect the prevailing market price of the Common Shares and the Company's ability to raise capital in the future.

The market price of the Common Shares could decline as a result of future sales of substantial amounts of the Common Shares or other securities relating to the Common Shares in the public market, including sales by its substantial Shareholders, or the issuance of new Common Shares by the Company, or the perception that such sales or issuances may occur. Future sales, or perceived possible sales, of substantial amounts of the Common Shares could also materially and adversely affect the Company's ability to raise capital in the future at a time and at a price favourable to it, and the Company's Shareholders may experience dilution in their holdings upon issuance or sale of additional Common Shares or other securities in the future.

Risks Relating to the Company's Projects in Mongolia

Legislation in Mongolia may be subject to conflicting interpretations, which may have adverse consequences on the Company's business.

The Mongolian legal system shares several of the qualitative characteristics typically found in a developing country and many of its laws, particularly with respect to matters of taxation, are still evolving. A transaction or business structure that would likely be regarded under a more established legal system as appropriate and relatively straightforward might be regarded in Mongolia as outside the scope of existing Mongolian law, regulation or legal precedent. As a result, certain business arrangements or structures and certain tax planning mechanisms may carry significant risks. In particular, when business objectives and practicalities dictate the use of arrangements and structures that, while not necessarily contrary to settled Mongolian law, are sufficiently novel within a Mongolian legal context, it is possible that such arrangements may be invalidated.

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The legal system in Mongolia has inherent uncertainties that could limit the legal protections available to the Company, which include (i) inconsistencies between laws; (ii) limited judicial and administrative guidance on interpreting Mongolian legislation; (iii) substantial gaps in the regulatory structure due to delay or absence of implementing regulations; (iv) the lack of established interpretations of new principles of Mongolian legislation, particularly those relating to business, corporate and securities laws; (v) a lack of judicial independence from political, social and commercial forces; and (vi) bankruptcy procedures that are not well developed and are subject to abuse. The Mongolian judicial system has relatively little experience in enforcing the laws and regulations that currently exist, leading to a degree of uncertainty as to the outcome of any litigation, it may be difficult to obtain swift and equitable enforcement, or to obtain enforcement of a judgment by a court of another jurisdiction.

In addition, while legislation has been enacted to protect private property against expropriation and nationalisation, due to the lack of experience in enforcing these provisions and political factors, these protections may not be enforced in the event of an attempted expropriation or nationalisation. Expropriation or nationalisation of any of the Company's assets, or portions thereof, potentially without adequate compensation, could materially and adversely affect its business and results of operations.

Application of and amendments to legislation could adversely affect the Company's mining rights in its projects or make it more difficult or expensive to develop its projects and carry out mining.

In 2006, the Mongolian Government enacted a new minerals law. The 2006 Minerals Law, which preserves to a limited extent some of the substance of the former 1997 minerals legislation, was drafted with the assistance of legal experts in the area of mining legislation and was widely regarded as progressive, internally consistent and effective legislation. However, the 2006 Minerals Law contains new provisions that have increased the potential for political interference and weakened the rights and security of title holders of mineral tenures in Mongolia. Certain provisions of the 2006 Minerals Law are ambiguous and it is unclear how they will be interpreted and applied in practice. Examples of such provisions include those relating to the designation of a mineral deposit as a Mineral Deposit of Strategic Importance. The Mongolian Government could determine that any one or more of the Company's projects in Mongolia is a Mineral Deposit of Strategic Importance.

In addition, the introduction of new Mongolian laws and regulations and the interpretation of existing ones may be subject to policy changes reflecting domestic political or social changes. For example, on July 16, 2009, Parliament enacted a new law (the "Mining Prohibition in Specified Areas Law") that prohibits minerals exploration and mining in areas such as headwaters of rivers and lakes, forest areas as defined in the Forest Law of Mongolia and areas adjacent to rivers and lakes as defined in the Water Law of Mongolia. Pursuant to the Mining Prohibition in Specified Areas Law, the Mongolian Government was instructed to define the boundaries of the areas in which exploration and mining would be prohibited by October 16, 2009. However, the Mongolian Government has not yet approved and published this information. New exploration licences and mining licences overlapping the defined prohibited areas will not be granted – and previously

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granted licences that overlap the defined prohibited areas will be terminated within five months following the adoption of the law. It is not clear whether such termination will only apply to the overlap areas. The Mining Prohibition in Specified Areas Law provides that affected licence holders shall be compensated, but there are no specifics as to the way such compensation will be determined.

The Mineral Resources Authority of Mongolia ("**MRAM**") has prepared a draft list of licences that overlap with the prohibited areas described in the new law – based on information submitted by water authority agencies, forest authority agencies and local authorities – for submission to the Mongolian Ministry of Mineral Resources and Energy (the "**MMRE**"). Subsequent to the MMRE's approval of this preliminary list, the Mongolian Government must still give its final approval before the final list can be published. During the MMRE's and the Mongolian Government's review of the draft list of licences prepared by MRAM, licences may be added or subtracted to the list at any time prior to approval and publication of the final list.

Four of the Company's exploration licences – included on MRAM's draft list of licences – may be included on the final list published by the Mongolian Government, potentially affecting the status of those licences under the Mining Prohibition in Specified Areas Law. Activities being carried out on these properties include drilling, trenching and geological reconnaissance. The Company has no immovable company assets located in any of the potentially affected areas and the loss of any or all of the potentially affected properties would not materially and adversely affect its existing operations.

As such, there can be no assurance that future political and economic conditions in Mongolia will not result in the Mongolian Government adopting different policies in relation to foreign development and ownership of mineral resources. Any such changes in government or policy may result in changes in laws affecting ownership of assets, environmental protection, labour relations, repatriation of income, return of capital, investment agreements, income tax laws, royalty regulation, government incentive and other areas, each of which may materially and adversely affect the Company's ability to undertake exploration and development activities in the manner currently contemplated. Similarly, any restrictions imposed, or Mongolian Government charges levied or raised (including royalty fees), under Mongolian law for the export of coal could harm the Company's competitiveness.

The Company's ability to carry on business in Mongolia is subject to political risk.

The Company's ability to efficiently conduct its exploration and development activities is subject to changes in government policy or shifts in political attitudes within Mongolia that are beyond the Company's control.

Government policy may change to discourage foreign investment, nationalisation of mining industries may occur or other government limitations, restrictions or requirements not currently foreseen may be implemented. There is no assurance that the Company's assets will not be subject to nationalisation, requisition or confiscation, whether legitimate or not, by any authority or body. The provisions under Mongolian law for compensation and reimbursement of losses to investors

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under such circumstances may not be effective to restore the value of the Company's original investment.

In addition, Mongolia may experience political instability. Such instability could have a material adverse effect on economic or social conditions in Mongolia and may result in outbreaks of civil unrest, terrorist attacks or threats or acts of war in the affected areas, any of which could materially and adversely affect the Company's business and results of operations.

The Mongolian Government could determine that any one or more of the Company's projects in Mongolia is a Mineral Deposit of Strategic Importance.

Pursuant to the 2006 Minerals Law, the Parliament of Mongolia has wide discretion to designate mineral deposits to be Mineral Deposits of Strategic Importance. The Mongolian Government is empowered to participate on an equity basis with the licence holder in the exploitation and/or mining of each Mineral Deposit of Strategic Importance on terms to be negotiated between the Mongolian Government and such licence holder. Details of any minerals reserves must be filed by the relevant licence holder with the Mongolian Government, and those deposits on the Strategic Deposits List represent most of the largest and highest profile deposits in Mongolia. In addition to deposits currently on the Strategic Deposits List (a list of deposits designated by the parliament of Mongolia to be deposits of strategic importance) and the additional Tier 2 Deposits List (a list of 39 deposits designated by the parliament of Mongolia for further investigation by the Mongolian Government in order to determine if any or all of them should be placed on the Strategic Deposits List), the Mongolian Parliament may at any time designate other deposits not yet currently on such Lists to be Mineral Deposits of Strategic importance, add such deposits to either the Strategic Deposits List or the Tier 2 Deposits List and, in the former case, commence negotiations with the relevant licence holder with respect to the terms under which the Mongolian Government will take an interest in such deposit. Whilst the Mongolian Government is in the process of adding the exact location and coordinates for each Mineral Deposit of Strategic Importance, a number of deposits on the Strategic Deposits List are identified by name only with no indication of the latitude and longitude coordinates for the deposit, and it is therefore not always possible to precisely determine the intended geographic area covered by each designated Mineral Deposit of Strategic Importance or to accurately determine whether or not any given licence area is within, or overlaps a Mineral Deposit of Strategic Importance.

Under the 2006 Minerals Law, the size of the Mongolian Government's participation is determined largely by the level of state funding which has been provided for the exploration and development of any deposit, with the Mongolian Government entitled to participate up to 50% in the event that there has been state funding of such deposit and up to 34% if there has not. However the 2006 Minerals Law is very vague as to the details and method by which the Mongolian Government will take its interest and the final arrangements in respect of the Mongolian Government's interest in each Mineral Deposit of Strategic importance, including the amount of compensation to be paid to the licence holder and the actual form of the Mongolian Government's interest are subject to negotiation between the Mongolian Government and the licence holder.

SOUTHGOBI ENERGY RESOURCES LTD.

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(unaudited)

(expressed in U.S. Dollars)

The 2006 Minerals Law also contains provisions requiring any company which holds a Mineral Deposit of Strategic Importance to list no less than 10% of its shares on the Mongolian Stock Exchange. This particular provision of the 2006 Minerals Law has not yet been enforced and it is not clear how it will work in practice.

In recent years there have been a number of proposed amendments to the 2006 Minerals Law suggested by various parties, many of which have centered on amending the 2006 Minerals Law to increase the Mongolian Government's participating interest in excess of 50%. Whilst the 2006 Minerals Law provides that the interest of the Mongolian Government should take the form of an equity interest, based on past practice, and depending on the results of individual negotiations, the interest may be in the form of production or profit sharing or some other arrangement negotiated between the licence holder and the Mongolian Government. There can be no assurance that legislation will not be enacted which further strengthens the Mongolian Government's right to participate in privately held mineral resources in Mongolia.

None of the deposits covered by the Company's existing mining licences or exploration licences are currently designated as Mineral Deposits of Strategic Importance. However, there can be no assurance that any one or more of these deposits will not be so designated in the future, in which case the Company's business and results of operations may be materially and adversely affected.

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(unaudited)

(expressed in U.S. Dollars)

OUTLOOK

The Company believes that demand for commodities is increasing. General economic conditions are showing signs of improvement. It is difficult to reliably forecast commodity prices and customer demand for the Company's products; however the Company's sales and marketing are providing positive results. The Company is continuing to pursue new customers, and maintain strong relations with its current customer base.

The Company's properties in Mongolia are well located in close proximity to China and other major industrializing economies in Asia. Furthermore, the near-term production is in high quality bituminous thermal and coking coals, which the Company anticipates will remain attractive premium products.

The western region of Gansu is one of the Company's key markets and, given the relatively close proximity of the Company's projects to the region, the Company believes that it is well positioned to exploit consumption growth in the area. Power plant expansion, currently underway, in Gansu is expected to increase thermal coal purchases from outside Gansu from approximately 13 million tonnes in 2008 to approximately 55 million tonnes in 2020. Gansu has no production of coking coal and all coking coal used in the steel industry is sourced from other provinces. The Ovoot Tolgoi Mine is located 492 km from Jiayuguan, while mines in the next closest major supply base, Hami in Xinjiang, are located 619 km away.

Furthermore, the Company has conducted a complete market analysis, with an outside consulting group of the coal markets in western Inner Mongolia and Gansu provinces, helping us to further identify potential customers in these provinces.

The success to date and potential for future growth can be attributed to a combination of the Company's competitive strengths, including the following:

- Projects are strategically located close to China, especially to the fast growing Gansu and Inner Mongolia regions;
- Substantial and growing resources and reserves;
- Produce premium quality coals;
- Low cost structure due to favorable geographic and geological conditions;
- Established production with strong growth potential through future expansion of existing mine capacity and development of the Company's priority assets; and
- Experienced management team with strong skills in mining, exploration and marketing and are able to leverage the expertise, experience and relationships of its principal shareholder, Ivanhoe.

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(unaudited)

(expressed in U.S. Dollars)

Mongolia

Revenue was \$10.0 million for the three months ended December 31, 2009, compared to \$11.9 million for the three months ended September 30, 2009. The Company will continue to focus on generating higher sales volume throughout 2010.

On October 12, 2009, the Company announced that independent NI 43-101 estimates prepared by Norwest upgraded the reserves at the Ovoot Tolgoi Complex and the Soumber Deposit:

- Total surface mineable coal reserves as of July 1, 2009, at Ovoot Tolgoi were calculated and estimated to be 105 million tonnes of proven reserves and 9.1 million tonnes of probable reserves;
- Ovoot Tolgoi surface and underground resources as of June 1, 2009, were calculated and estimated to be 181.7 million tonnes of measured resources, 68.1 million tonnes of indicated resources and 33.5 million tonnes of inferred resources; and
- The Soumber resource area is estimated to contain 13.1 million tonnes of measured resources, 8.3 million tonnes of indicated resources and 55.5 million tonnes of inferred resources.

The Company is engaged in ongoing discussions with the Mongolian Government with the objective of establishing a border crossing at the Ceke border point that will be open 24 hours per day, 365 days per year. This should increase daily distribution of Ovoot Tolgoi coal to our customers in China.

The Company continues to develop markets for its premium quality coals. A China based research firm has conducted a complete market analysis of the coal markets in western Inner Mongolia and Gansu provinces, helping us to identify potential customers in these provinces. The target customer base consists of a mixture of distributors and end users of coal, including steel mills, power plants and industrial consumers.

Overview and Objectives

The Company continues to focus its efforts on mining, development and exploration of coking and thermal coal products in Mongolia for supply of quality products to customers in China. As the Company looks forward through the balance of 2010, the Company is encouraged by the positive developments in Mongolia. The Company is making progress with its sales and marketing efforts, continuing to focus on efficiency and prudent financial management and intends to manage production levels to meet anticipated demand for the Company's products.

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The Company's objectives for 2010 are as follows:

- **Grow Ovoot Tolgoi Mine** – The additional capacity of the already commissioned Liebherr 996 fleet should support strong growth in coal availability and sales for 2010 over 2009. Additional Terex MT4400 trucks are planned to be commissioned in the first half of 2010 and an additional Liebherr 996 fleet is expected to arrive before the end of the year.
- **Continue to develop regional infrastructure** – Our immediate priority centers on improving roads in the area around Ovoot Tolgoi Mine and contributing to new road development.
- **Advancing the Soumber deposit** – SouthGobi intends to further define the deposit with continued exploration work whilst also substantially advancing the feasibility, planning and licensing for a mine at Soumber.
- **Value-adding/upgrading coal** – We intend to embark on the construction of our first coal handling/processing facility. This first stage will involve basic coal crushing and screening for Ovoot Tolgoi coals to create a more consistent higher quality product for customers.
- **Exploration** – Further green fields exploration will take place, with the company planning an exploration budget in the order of \$10-20 million.
- **Continuing to focus on production safety, environmental protection, operational excellence and community relations.**

March 22, 2010