GRANT'S

INTEREST RATE OBSERVER®

Vol. 33, No. 10e | Two Wall Street, New York, New York 10005 • www.grantspub.com | MAY 15, 2015

Balance-sheet story

The third time was decidedly not the charm. Perhaps the fourth will do the trick. Pan American Silver (PAAS on the Nasdaq) is once more the topic, and bullish remains the conclusion.

Constant readers will remember Pan American—some none too fondly. Since 2012, when it was the subject of not one, not two, but three bullish *Grant's* analyses, the price of a share of PAAS has plunged by as much as 53%. Through all its vicissitudes (of which chapter and verse in a moment), the company remains a well-financed and well-managed owner of operating and development-stage mines in Mexico and South America. With 151.5 million fully diluted shares at a price of $9.75, Pan Am boasts a $1.5 billion market cap.

To remove any doubt, the shares are a speculation. They are a speculation on the political climate of Argentina. At bottom, they are a speculation on the prices of silver and gold—and the reciprocal of those prices—on the faith of the world's wealth holders in the methods of 21st-century central banking. We erred in 2012 by underestimating the tolerance of moneyed people for radical monetary measures. If the Yellens and Draghis are as smart as they think they are, we stand to be wrong all over again.

Founded in 1994 and headquartered in Vancouver, Pan American operates seven mines in four countries—Mexico, Peru, Argentina, and Bolivia. Its most important development project, called Navidad, is situated in Chubut province, Argentina. This year, if all goes according to plan, Pan American will produce some 26 million ounces of silver and 170,000 ounces of gold, as well as associated quantities of zinc, lead and copper.

As we go to press, silver is quoted at $16.50 an ounce, a price that happens to coincide with Pan American's projected 2015 "all-in sustaining cost per silver ounce sold"—for which, of course, there is an acronym, "AISCSOS"—of between $15.50 per ounce to $16.50 per ounce. While the company can hardly control the price of silver, it has succeeded in driving down its cost of mining it. Last year's AISCSOS came in at $17.88 an ounce.

In a sense, Pan American is a story of comparative balance sheets—its own, on the one hand, vs. the Fed's (and the ECB's and the BoJ's), on the other. Can Pan Am long remain in its customary liquid trim if investors continue to tolerate worldwide QE? Droopy metals prices are the proof of the tolerance.

As to Pan American's finances, March 31 figures show $292.4 million of cash and equivalents, net working capital of $488.5 million, and total debt of $65.3 million. While it is well and good that the company last year generated $124.2 million in net operating cash flow, up from $119.6 million in 2013, and it is cheering that Geoff Burns, the CEO, committed to maintaining the previously high dividend payout "as a sign of our commitment to returning value to shareholders, even during difficult times" in the 2014 annual report, the fact is that these are difficult times. At current silver prices, something had to go, either the dividend or capital spending for growth. The dividend walked the plank; on Monday, the directors chose to reduce it by 60% to $0.05 per share

Reclining twosome

source: The Bloomberg

per quarter. The savings will finance expansion in Mexico.

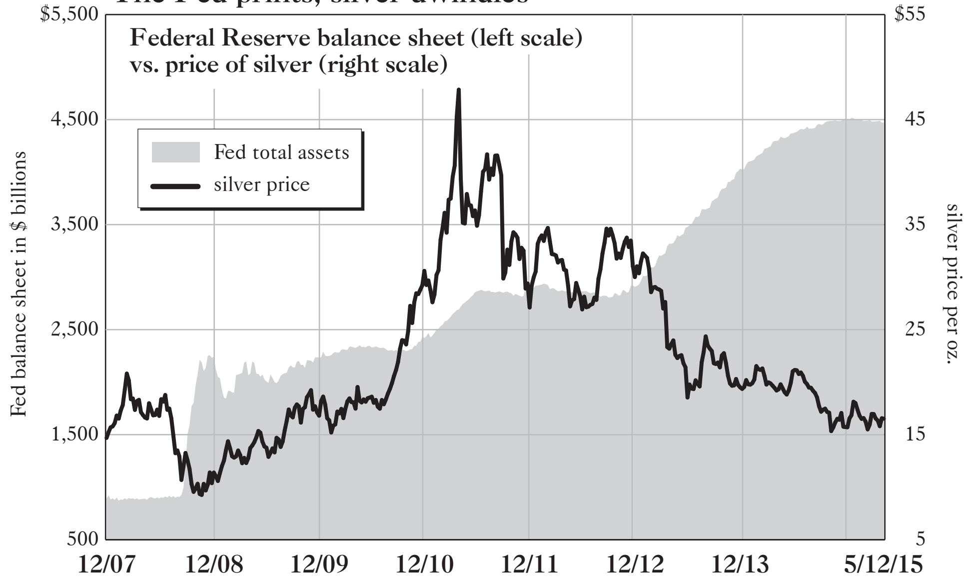
It can't be said that the Street was unprepared for adverse developments. Bloomberg's poll of sell-side analyst ratings shows zero buys, 11 holds and three sells. Goldman Sachs, the leader of the bearish pack, projects a net loss in 2015, 2016, and 2017. It forecasts fiscal year 2016 gold and silver prices of $1,089 an ounce and $16.70 an ounce, respectively, which will serve up a $7 PAAS share price.

Just four years after the silver price touched $49 an ounce, the speculative fires are largely banked in the market for the junior monetary metal. According to the CPM Group, net investment demand declined to 131.6 million ounces in 2014 from an all-time record 190.2 million ounces in 2012, and is likely to dwindle to 102.9 million ounces in 2015; overall fabrication demand is projected to reach 892.7 million ounces. "These purchases should prevent prices from declining significantly during 2015, but this level of investment demand most likely will not be strong enough to drive silver prices sharply higher," quoth CPM's Silver Yearbook. For us, we wonder how the sages know. Let the moneyed world rub the sleep out of its eyes, seeing plain the possible consequences of zero-percent interest rates and QE, and there's no telling where the prices of silver and gold might go.

The supply side of the silver market continues to grow, seemingly without regard to the slipping silver price. "While declines in silver prices have severely eroded the profit margins of silver mining companies for the past couple of years, there has not been any significant cutback in global mine supplies of silver to date," the Silver Yearbook relates. "In part this is because around 75% of silver mine supply comes as by-product at producers who are not excessively concerned about the price of silver, and in part because there has been an increase in the number and total ounces produced from primary mines which came on stream in recent years in response to the strength in prices during the 2000s."

Only 56% of Pan American's forecast 2015 production is expected to derive from silver, with gold and base metals contributing the rest. In the circumstances, some may question just how pure a silver play Pan American really is. In fact, according to the April *GSA-Silver* report, most silver miners present the same kind of production profile as Pan American. As to proven and probable reserves, the company shows 300 million ounces of silver, down from 323 million ounces at the end of 2013, and 2.3 million ounces of gold, down from 2.49 million ounces of gold at the end of 2013. The drop in silver and gold reserves stems from a downward revision in the assumed prices of the two metals, to $18.50 an ounce from $22 an ounce for silver, and to $1,250 an ounce from $1,300 an ounce for gold.

The Fed prints, silver dwindles



source: The Bloomberg

Pan American, to us, is a kind of options *piñata*. There is a central-bank option, a not-unrelated inflation option and an Argentina option. "Out of all of Pan American's assets," colleague David Peligal observes, "the one with the biggest upside happens to be in care and maintenance mode. This is the Navidad development project in Argentina, at which procurement and development have been curtailed since late 2013, pending the conversion of Cristina Fernández de Kirchner to the capitalist faith, or more likely, the expiration of Kirchner's term in office in October. Investors seem willing to overlook that $286.1 million of a nearly $500 million non-cash, after-tax impairment charge last year stemmed from Navidad. Optimists rather imagine a day when this mine, if built, could produce 19.8 million ounces of silver a year (75% of this year's expected production) in its first five years at a $6 per-ounce cash cost. The project won't come cheap—its cost is estimated at $1 billion—and it won't be built at all unless capital controls are removed and politics are improved (as a capitalist would define improvement). Kirchner must depart under the Argentine constitution; who and what follows is the question."

Pan American isn't the only North American mining company that's tapping its foot. Goldcorp, Glencore, and Yamana Gold are awaiting the autumn Argentine elections, too. "Some of the world's biggest miners," according to an April 27 Bloomberg bulletin, "are ready to spend at least $5 billion in Argentina if October's presidential elections herald an easing of capital restrictions."

Accompanying last month's news that Pan American had secured a $300 million bank line was a remark concerning "future business development opportunities." The phrase raked up memories of the company's ill-timed 2012 purchase of Minefinders for the rich sum of $1.26 billion in cash and stock. As any psychic could have foreseen, Pan Am overpaid for Minefinders and its principal asset, the Dolores silver and gold mine in the Sierra Madre Occidental Range of northern Mexico. Then again, while dilution is still dilution, management did pay most of the consideration (all but the $165.4 million cash portion) in PAAS scrip. In 2013, Pan American recorded a non-cash, after-tax impairment charge of $420.4 million, of which $405.6 million related to Dolores. In 2014 came another non-cash, after-tax impairment charge, this one in the sum of $498.7 million, of which $110.8 million concerned Dolores.

"With that said," Peligal notes, "Ross Beaty, chairman and founder of Pan American, has seen many a metals cycle and is clearly no fool. The owner of 2.4 million shares of Pan American's shares (1.6% of the outstanding), he bought 500,000 shares just before Christmas 2014 at prices slightly above today's level. Dolores, operationally improved under Pan American management, is expected to contribute to a 2% to 8% bump up in company-wide 2015 gold production over the 161,500 ounces turned out last year. It is to finance a $112.4 million investment in the same Dolores mine for which the dividend rate was sacrificed. This expansion project, which will be built over the next 24 months, is expected to yield significant savings in operating costs. It's presented—plausibly, we think—as a low risk, organic growth opportunity that should provide attractive returns, even at current metals prices."

Beaten down in dollar terms, Pan American might be, but it commands a 46% valuation premium, based on a calculation of 2015 enterprise value to cash flow, to its silver-mining comps. Hecla Mining (HL on NYSE), a $1.2 billion market-cap company with a 0.3% dividend yield, is at the other end of the silver-miner valuation spectrum. It trades at a 24% discount to the group. Then, again, Hecla shows net debt of $324 million, yields only 0.3%, derives just 32% of forecast 2015 production from silver and has no such potential option as Navidad in its corporate back pocket.

Last week, Janet Yellen observed that valuations in the stock market were "quite high." The miners seem to be an exception. Despite the impairments of the past few years, Pan American still trades below book value. It would be only justice if, in the years to come, PAAS moved to a premium to book while the central banks slid to a well-deserved discount.

•