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Just enough hair

Gold is a speculation on paper money. Silver is a speculation on that speculation. Widows, orphans and college students may avert their eyes. Now in progress is a review of a trio of silver-themed equities (for a bullish analysis of the metal itself, see the June 3 issue of *Grant's*).

We write with a pair of vivid memories. The first is of the 2011–15 bear market in gold and silver. Suffice it to say that the earnings per share of Pan American Silver (PAAS on the Nasdaq) swung to minus $3.60 from positive $3.31, with a synchronous downside lurch in the Pan American share price. The bottoming action in credit instruments in 1990–91 and again in 2008–09 is memory No. 2. At each juncture, the explosive force of the recovery varied inversely with the quality of the security. The hairier, the better, was the rule.

And so it has proved so far in 2016. As the rally in gold and silver has lifted the pall of bankruptcy from marginal producers, the last have become the first. Now what?

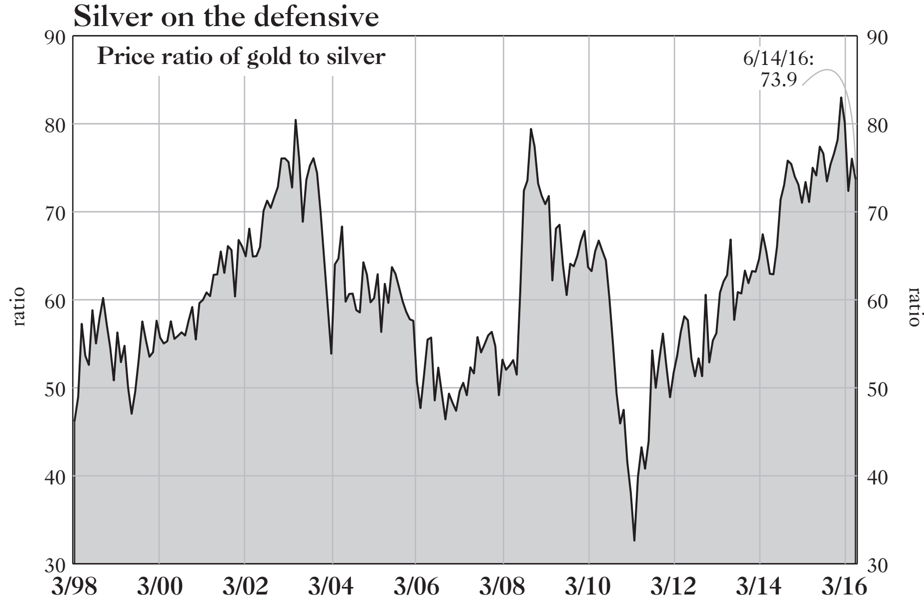
We base the pending security analysis on a familiar macro analysis. It strikes us that the Federal Reserve has missed its market, that it will not be raising the funds rate any time soon and that, in fact, its next move may very well be in the direction of ease. This, too, is a speculation, of course. If a correct one, the dollar exchange rate may retreat, taking with it such prestige as the Federal Reserve has garnered by keeping the lights on in 2008 and working to enrich the politically influential portion of the community that avails itself of zero-percent funding costs.

On the analytical agenda are a trio of mining companies: the aforementioned Pan American, on which we are bullish (and, in the case of your editor, personally long); Tahoe Resources, Inc. (TAHO), on which we are tepidly bullish; and Coeur Mining, Inc. (CDE), on which we are not bullish but which could conceivably continue to deliver the biggest bang for every upside silver buck (as well as the biggest bang for every dollar on the downside).

You'll recall that silver is a leveraged play on gold. If you expect great things from the senior monetary metal, you'll expect proportionally greater things from gold's tag-along junior partner. So far, our three silver equities have acquitted themselves in accordance with the dynamics of recoveries in bank stocks and credit: The more speculative the asset, the more lavish the returns. Pan American, middlingly hairy, has produced year-to-date returns of 134%; Tahoe, as nearly bald as a mining stock can be, has delivered 53%, while the hirsute Coeur has produced 260%. Only Tahoe rates a "buy" recommendation from a majority of the analysts who follow it (14 out of 16); Coeur commands the allegiance of four out of 11, Pan American, only two out of 12 (you'll recall from the prior issue of *Grant's* that not a single question did Pan American's management receive on the first-quarter PAAS conference call).

None of these companies covered itself with glory in the long metals bear

Silver on the defensive



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market. Over the past five years, the share prices of Pan American, Tahoe and Coeur have declined by 48%, 30% and 63%, respectively, even after the tremendous 2016 gains. Just how bad were the wilderness years? Lower spot prices for silver and gold led Tahoe to take an impairment charge of $220 million in 2015, equal to 13% of the $1.7 billion carrying value of mining assets as of the most recent quarter. Pan American and Coeur can only wish that they got off so easily: The former wrote down nearly $1.3 billion between 2013 and 2015, versus net mining assets of just under $1.2 billion last quarter; the latter wrote down $2.6 billion in mining assets, more than triple the amount of such assets currently presented on the balance sheet.

"All-in sustaining cost per ounce" of silver, using either the amount of silver produced or sold, is a rough measure of the operational leverage of a silver and gold miner. It encompasses direct operating expenses, mine-sustaining capital expenditures and environmental reclamation costs. The higher the all-in cost, the greater the relative boost to cash flows afforded by a rise in the price of the relevant metal above that breakeven hurdle.

Compare and contrast the all-in sustaining costs of our three miners in 2015: Pan American, $14.92; Tahoe, $9.11; Coeur, $14.62. Of course, no one metric is definitive. Management can "highgrade"—set aside the best-quality ore for a rainy day—or manage its costs by deferring capex. "A mediocre management team can create greatness out of a great asset," observes Doug Groh, portfolio manager at Tocqueville Asset Management. There are likewise incidents of a mediocre management team flirting with disaster with a leveraged balance sheet and a mediocre deposit.

Mediocre deposits you will find at Coeur—according to data from Garrett Goggin of *Gold Stock Analyst*, the average silver equivalent ore grade at the Coeur mines is 53 grams per metric ton (Goggin converts gold to silver at a ratio of 75:1). Tahoe, with an average of 72 g/t, is only slightly better, though its operations are more cost-efficient than Coeur's. Pan American, like Coeur, is a high-cost producer, but that fact is mitigated by the quality of its ore bodies: an average of 143 g/t.

Vancouver-based Pan American Silver is a familiar name to longtime readers (e.g., see *Grant's*, Feb. 10, 2012). The company boasts a market cap of $2.3 billion on trailing-12-month revenues of $655 million, of which 57% came from refined silver and gold and the remainder from by-product base metals. And that's been about the full extent of the boasting since 2011. Over the past two years, the quarterly dividend has dwindled to 1.25 cents from 12.5 cents a share. And when, after two years of uninterrupted quarterly losses, the company achieved a return to profitability, the grand total of earnings per share amounted to one solitary cent.

Still, holding the monetary views we do and believing as we do in Pan American's management, we're bullish on PAAS. Pan American operates seven mines, of which the biggest, La Colorada and Dolores, are situated in Mexico. If everything goes according to plan, all-in sustaining costs per ounce this year will range between $13.60 and $14.90, down from an average of $14.92 in 2015—at $13.12 an ounce, the first-quarter figure undercut the bottom of the projected range. "Whether or not this drop can stick," observes colleague Alex Hess, "will depend on many things over which management has no control—exchange rates, for instance. Over the longer run, there is more that management can control. By investing in a number of mine-expansion efforts—this year, at a budgeted cost of $135 million—the Pan American front office says it is aiming to reduce all-in costs to an amount between $10.00 and $12.20 by 2018."

For Pan American, there may be a pot of silver at the end of the rainbow. Navidad, a rich, stillborn property in the Argentine province of Chubut, is that sterling vessel. Under the baleful Kirchner government, Navidad has gone undeveloped. Under the successor Macri government, there's a hope that the provincial authorities in Chubut will become more welcoming to foreign enterprise. If it ever does get the green light, says Pan American, Navidad could mill 15,000 metric tons of ore per day, the equivalent of half of the company's daily production in 2015. The mine is estimated to have some 623 million ounces of "measured and indicated resources" of silver (which cannot be converted into reserves, as the property is currently off-limits for mining). If even a portion of these were to become accessible, and turned into reserves, it would mark a major development for Pan American, which has a total of 440 million silver equivalent ounces in reserves across its seven active mines.

Neither to judge by the skeptical analysts nor by the Pan American financials do the hopes surrounding Navidad seem inflated. On the balance sheet, the property is carried at $190 million, equivalent to 16% of corporate mineral assets. It's a presentable balance sheet. As of March 31, net working capital amounted to $384 million, versus $39 million in long-term debt and finance lease obligations. At $3 million, goodwill barely registered. In the past 12 months, insiders have bought a net 211,510 shares at a cost of $1.9 million. (Longtime Chairman Ross Beaty led the charge with the purchase of 200,000 shares for nearly $1.8 million in January at a cost of $8.95 each.)

Tahoe Resources, a 2010 spinout from Goldcorp, is, as noted, the least speculative of our featured trio. The Escobal mine in Guatemala, a high-grade deposit containing no less than 332 grams of silver per metric ton of proven and probable reserves, is the corporate pride and joy. Company-wide, in the first quarter, all-in costs amounted to $5.97 per ounce of silver and $825 per ounce of gold. The March 31 balance sheet (which does not include the April acquisition of Lakeshore Gold) lists $2 billion in assets, of which $1.7 billion are mineral assets, as well as $90 million in cash against $41.3 million in debt and lease obligations; as of March 31, the ratio of current assets to current liabilities stood at 1.7:1.

When the Escobal mine opened in 2014, Tahoe's revenues were running at the annual rate of $350 million. In the 12 months through March 2016, revenues flowed at the rate of $567 million. Gold-related acquisitions are pushing the growth agenda. With the 2015 purchase of Rio Alto Mining Ltd., owner of the La Arena and Shahuindo gold mines in Peru, for a consideration of $874 million, Tahoe is coming perilously close to becoming a gold-and-silver company, rather than, formerly, a silver-and-gold company. In the past 12 months, the junior monetary metal accounted for just 56% of consolidated revenue.

"A single dollar change in the price of silver, or a $100 change in the price of gold, will certainly impact Tahoe's profit and loss," Hess points out, "but is hardly likely to be the difference between survival and insolvency. As a holder of Tahoe, you exchange better assets and a lower cost basis for a share price that doesn't leap out of its skin in response to a move in the price of silver. Thus, to date in 2016, Tahoe is up *just* 53% while the iShares MSCI Global Silver Miners ETF (SLVP on the NYSE Arca exchange) have more than doubled." Maybe the Tahoe C-suite itself is disappointed by the lack of performance. Leaving aside the sales of the now departed head of Canadian mining operations, insiders over the past 12 months sold a net 71,039 shares, for just over $1 million.

If there were such a thing as the Berkshire Hathaway of mining, let us stipulate that Coeur Mining would not be it. Its share price peaked on the eve of the 1987 stock market crash. And as the share price fell, the share count exploded. At year-end 1999, issued and outstanding Coeur shares numbered 2.9 million (split-adjusted). Today, there are 162 million. In the modern era, earnings per share peaked in 2006 at $3; 2013 delivered a loss of $6.65; 2014 a loss of $11.59 and 2015 a loss of $2.83. Revenue has fallen to $540 million in the latest 12 months from $1 billion in 2011.

One might blame the company's biggest mining asset, the Palmarejo complex, situated in Chihuahua, Mexico, where production has fallen to 8.9 million silver equivalent ounces in the most recent 12 months, from 15.4 million silver equivalent ounces in 2011 (Coeur uses a gold-to-silver ratio of 60:1). Revenues out-slid even physical output, dropping to $160 million in the latest 12 months from $513 million in 2011. In another marker of falling production, Coeur's silver-generated revenue last year began to run below its gold revenue; in 2015, silver generated 40% of revenues, down from 52% in 2014 (and 65% in a very different silver market in 2011).

"A great deal, then," Hess points out, "rides on the success of the company's newest expansion efforts, including a shift to higher-grade, but lower-tonnage, underground mining at Palmarejo. On the fourth-quarter earnings call, CEO Mitchell Krebs told dialers-in that among 'the main drivers of the expected positive free cash flow are the lower second half capex [and] rising production rates from the higher-grade, higher-margin Independencia deposit at Palmarejo and the end of the old Franco-Nevada gold royalty at Palmarejo.' The burden of that royalty, which initially covered 400,000 ounces of gold and cost the company some $40 to $50 million in cash flow per year, will be significantly reduced when it rolls off the balance sheet in the third quarter and is replaced by a new streaming arrangement. 'We expect,' said Krebs, 'this will have the effect of reducing what was a $40 million to $50 million a-year annual outflow from the mine's cash flow to something more in the $5 million to $10 million a year range.'"

In years past, under the oft-misguided direction of Dennis Wheeler, one might have assumed that Coeur was in the value-destruction business with a sideline in silver. "Dilution, debt and financial engineering" is the corporate legacy in the three apposite words chosen by Goggin in the April number of the *Gold Stock Analyst*. Certainly, the burden of proof on future performance rests with the company (and with Krebs, who served as Wheeler's CFO from 2008 to 2011), not the skeptics.

On the bright side (or what, at Coeur, will have to pass for the bright side), the insiders bought a net 30,910 shares, for a total consideration of $99,713, in the past 12 months. Then, too, in March, Standard & Poor's upgraded Coeur's senior unsecured debt to B-plus from B, citing "improved prospects . . . for cash-flow generation."

Pan American, then, remains our favorite silver equity. It's got hair, though not too much.

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