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Monetary jumping bean

Pan American Silver Corp. (PAAS on the Nasdaq and the Toronto Stock Exchange) featured glowingly in these pages in February 2012 at a share price of $24.00. Suffice it to say that the ensuing seven lean years have not enhanced your editor's reputation for pinpoint timing. A halving, or worse, of the silver price and the cult of the central bankers (really one and the same phenomenon) have sawed 35% off the share price. We write to reaffirm our bullishness both toward silver and the foremost silver miner.

Whether the central bankers have entered their own long overdue bear market, we can only speculate. As to Pan American, the shares are relatively cheap (especially against cash flow), the balance sheet is A-OK and the market has so far failed to notice the earnings power latent in three of the company's major mineral deposits. For any who prefer a silver play that avoids the risk inherent in even the best-managed exploration and development company, we offer below an inexpensive call option.

Concerning the metal, its calling card is volatility. You'd hardly know it from its extended slumber in the neighborhood of $16 an ounce, but silver customarily outlegs gold both on the upside and the downside. Thus, whereas gold is 35% higher than its post-2009 lows, silver has clawed back only 20% from its lows. If the monetary metals have indeed entered a new bull market, silver will likely show greater percentage gains than its senior sibling.

"Besides the years-long weakness in gold," colleague Fabiano Santin observes, "silver's softness may have something to do with languishing worldwide industrial production—56% is earmarked for use in electronics, brazing alloys and solders. It's true that the digital camera has wiped out much of the demand for film photography, but the photovoltaic sector has more than filled that gap."

Because no bullish analysis of the white metal is complete without reference to the distended ratio of gold prices to silver prices, we dutifully report that gold is 86 times as expensive as silver. It's the highest such ratio in 28 years. Perhaps more pertinent is the fact that China's reported economic growth is generationally slow—the slowest, in fact, in 28 years.

On the supply side, the stars seem to be coming into bullish alignment. In 2018, mine output (85% of total supply) declined for the third consecutive year, to 855.7 million ounces, while scrap (the remaining 15%) sat marginally higher than the decade-low reading of 150 million ounces set in 2015, according to the 2019 World Silver Survey by the GFMS unit at Refinitiv.

"'The restless metal,' the author Roy Jastram styled the junior monetary metal, but that was before the 21st-century volatility famine," Santin points out. "Thus, one may take a flutter on SLV call options at a strike price of $16.00 (equivalent to $17.00 an ounce for silver) expiring on Jan. 15, 2021 for a volatility-quoted value of 24%, which is implicit in the $1.68 price per call option. This is 16% cheaper than the $2.00 price implied by the 29% average volatility (one-year, at-the-money) registered since 2004. If silver were to repeat its 2010–11 performance and jump to the 2011 average of $35.00 an ounce ($32.80-a-share equivalent for the SLV) at expiration,

Cheap to gold

source: The Bloomberg

the call buyer would pocket $16.80, a prospective 10:1 payout ratio."

(The price of SLV diverges from the price of silver because there aren't as many ounces of silver in the trust—356 million—as SLV shares—380 million. The trust sells silver to pay for the fund's 0.5% annual expenses; the process of creating and redeeming shares also contributes to the disparity.)

No long-term investor likes the ticking sound of the options countdown clock. In Pan American Silver shares, you get a perpetual call on a diversified owner of 10 mines operating in Latin America (Peru, Mexico, Argentina, Bolivia) and Canada. Included as well are options—again, with no expiration date—on silver properties awaiting the political and technical green light.

"It's true," Santin observes, "that a price-earnings ratio of 51 hardly looks cheap, but this year's bottom line is depressed by maintenance and exploration costs and assets that are on the threshold of production. Readers looking for stable income should seek other types of securities, or one of the royalty-streaming companies that are less leveraged to future production."

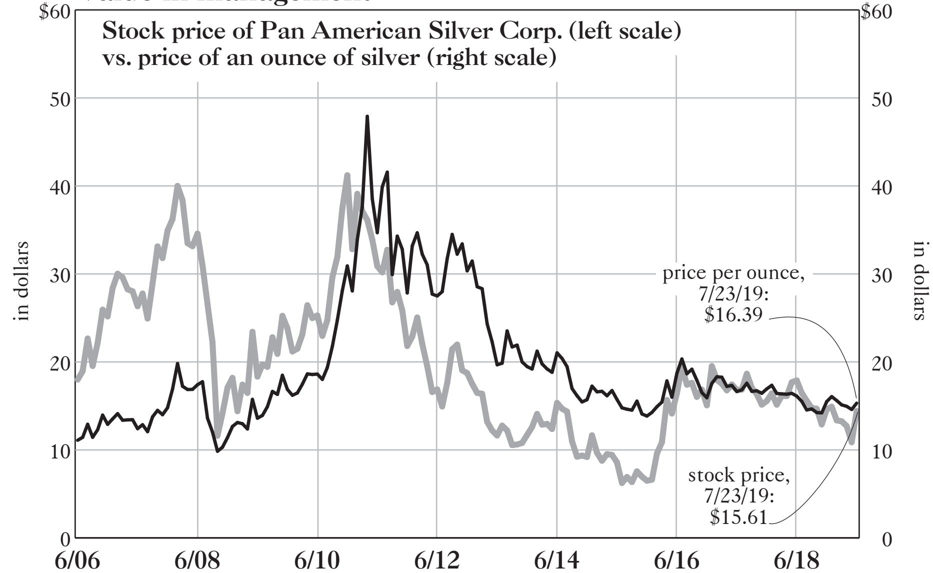
This year, Pan American is expected to turn out 27 million ounces of silver at a cash cost of $0.50 an ounce, which, assuming a silver price of $15.50 an ounce, would bring in $405 million of cash. The stock trades at 11.1 times estimated 2019 cash from operations, not far from peers Hecla Mining Co., Coeur Mining, Inc. and Fortuna Silver Mines, Inc., which change hands at 9.4, 10.4 and 10.2 times, respectively.

One of Pan American's options takes the form of a "major exploration discovery" at the Zacatecas, Mexico-based La Colorada mine, as management characterized that happy occurrence in the 2018 annual report. Facts and figures on the deposit, which contains high-grade silver, copper, lead and zinc, are expected later this year.

"These ore bodies, when they shape up like this, you get a pretty good idea of what it's going to be," Bill Fleckenstein, a former long-time Pan American director and still a shareholder, tells Santin. "It's not likely to be something small, it's likely to be big. You can know with some decently high probability how it's liable to play out, if you know what you're doing."

CEO Michael Steinmann, who joined Pan American in 2004, does know what he's doing. It helps, too, that the board is chaired by Ross J. Beaty, who founded the company in 1994, ran it as CEO for the following decade and holds nearly 3 million PAAS shares.

Value in management



source: The Bloomberg

"They're very solid people," John Hathaway, co-portfolio manager of the Tocqueville Gold Fund, tells Santin. "You have something that's very rare in the precious-metal space, and that's people who know how to create value and actually have financial discipline, which they apply."

The La Colorada mine, acquired in 1998, is the Pan American flagship. It's slated to produce 8.1 million ounces of silver this year at an all-in sustaining cost of $4.00 an ounce; 12 years of mine life remain, geologists estimate. Management reckons that the aforementioned exploration discovery, adjacent to the existing producing portion of La Colorada, is comparable with the Taylor deposit in the southeast of Tucson, Ariz., for which South32 Ltd. last year paid $1.3 billion.

On November 14, 2018, Pan American entered into an agreement to buy Tahoe Resources, Inc. at an enterprise value of $1.1 billion, including the assumption of debt. The transaction doubles Pan American's silver-equivalent reserves to 1.3 billion ounces, from 662 million ounces at the end of 2018.

For *Grant's*, the Tahoe purchase represents a kind of bittersweet homecoming (see the issue dated June 17, 2016). A 2010 spinout of Goldcorp, Inc., Tahoe owned the magnificent Escobal silver mine, boasting deposits of 264 million proven and probable ounces. The property was producing 20 million ounces at all-in sustaining costs of about $9.00 an ounce just two years ago.

Then the Guatemala Supreme Court swooped in to order a halt in production on account of Tahoe's failure to consult with the indigenous Xinca community. By November 2018, Tahoe was a $2.00 stock, down from a high of $27.31 in 2014. And, no, this publication did not anticipate the Guatemala Supreme Court.

When Escobal might reopen, Pan American hasn't said. What it has said is that it will spend a net $14 million a year to sustain Escobal in a state of care and maintenance. It's small change compared with the $500 million that Tahoe invested in the property. Consultation with Guatemala's Ministry of Energy and Mines is in the second stage of a projected four. Management sounds confident that the Xinca people will eventually go along—certainly, the Pan American front office won't forget to talk to them.

"The biggest challenge there would be finding the employees and re-staffing it for operations," Siren Fisekci, vice president of investor relations at Pan American Silver, tells Santin. "Some of the experienced workers that were trained to work in the mine have left the region because there was no employment, and so we'd have to bring back people and retrain them."

Escobal's production alone could bring in more than $110 million in net income at the current silver price, which is more than this year's $65 million of projected earnings and roughly in line with next year's $117 million projection (Escobal, of course, not being included).

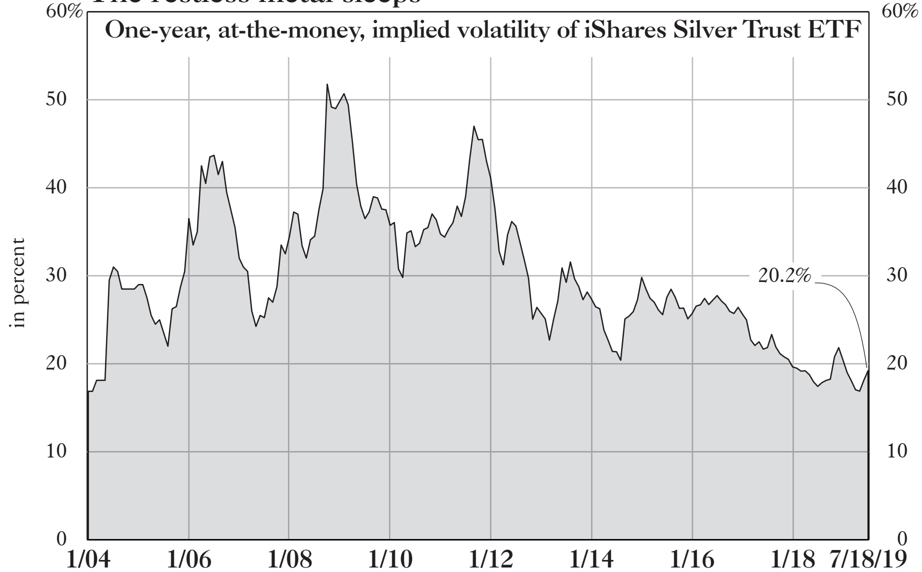
"What better place to mine silver than in the nation named after the metal itself?" Santin asks, and he answers, "Nowhere—that is, if Argentina's public policy follows the enlightened precepts advocated by the the Argentine Chamber of Mining Companies at the 2019 Arminera industry convention."

Mining activity in Argentina could reach $10 billion a year if just a few pending projects come to fruition; this is in line with projections for exports from the Vaca Muerta shale region. Mining was the country's sixth-largest export industry in 2018 with a value of $855 million, far from Argentina's potential or, indeed, from neighboring Chile's $55 billion.

Navidad, one of the world's largest undeveloped silver deposits with 700 million ounces in measured and indicated resources, is a most promising asset for Argentina and Pan American. The catch is the location, the province of Chubut, which banned open-pit mining 16 years ago.

They say that markets make opinions. Perhaps a silver bull market could transform Chubutian politics. The death in late 2017 of the former anti-mining provincial governor, Mario das Neves, cleared the way for the election, and recent re-election, of the incumbent pro-mining governor, Mariano Arcioni. As the Argentine economy deteriorated, support for mining has grown. Thus, since coming to office in December 2015, President Maurico Macri has extinguished a 5% tax on metallic minerals and revoked the capital controls that barred foreign investors from repatriating profits. Legislation to permit mining in certain Chubut zones has been on the back burner for more than a year.

The restless metal sleeps



source: The Bloomberg

Results of the upcoming presidential election (Macri is the candidate to root for; see *Grant's*, June 14) will give Pan American a better idea of how much capital to invest in the Republic of Argentina. If the open-pit legislation were enacted, it would probably take six months to conduct a revised feasibility study (the original was done in 2010) and another two years to construct the mine.

Pan American plans to dispose of Tahoe's Canadian gold mines (Timmins and Bell Creek), which it classifies as held-for-sale and values at $376 million. Management would use the proceeds to pay down $363 million of debt outstanding on March 31, including leases. Cash totaled $121.6 million; working capital, $240 million (excluding cash and items pertaining to the Canadian gold mines). A $165 million credit facility was in place.

Other non-core assets are on the chopping block, too, including a 29% stake in the publicly-traded royalty and streaming company Maverix Metals, Inc., the 29% interest being valued at a market price of $134 million. According to estimates by Hathaway's co-manager, Ryan McIntyre, the sale of a pair of Peruvian assets could raise another $100 million.

Liquidity, then, is ample enough to lift any short- or medium-term anxiety that Pan American will follow the all-too-well-trod mining-company road of issuing stock to lift production with the consequence of diluting the owners.

"We've mechanized the mines in Peru," Fisekci says, "and in addition to doing expansions in Mexico—the La Colorada expansion, the Dolores expansion—we've really reduced our cost to produce. So for 2019, our guidance for all-in sustaining cost on a silver basis is $9.75 to $11.25 per ounce [down from $14.49 in 2015]."

The sell side is marginally well-disposed to this company that, whatever its management's achievements, has been nobody's idea of a hot stock. There are six buys, five holds and one sell. Chairman Beaty accounts for most of net insider transactions; he bought C$2.3 million's worth of stock in May.

"We've seen seven lean years," Santin winds up. "Now—perhaps—will come a few fat ones."

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