Red Flags Rising at McEwen Mining (NYSE:MUX)

Report Date: 14-May-2019

Note: This report was originally commissioned by a private client with a long-term position in McEwen Mining. Following a material news release (contractor fatality) by the company, the client requested fundamental due diligence on the company's prospects.

Red Flag #1: Either the company is adept at hiring inept contractors or has poor operational control at their mine sites. My guess is both

Yesterday, MUX reported a fatality at its Gold Bar development project in Nevada. A contractor's truck driver died because his haul truck overturned.

This follows in the heels of another incident involving a contractor's employees at its Black Fox mine. As Rob so humorously noted in the Q4 2018 call, "*I just like to sort of go off to the side and share with you some of the things that might happen in the mining operations that is very hard to expect or anticipate. And this deals with Timmins and there are three people I think are going to be eligible for winning the Darwin Award.*

At the Black Fox Mine, we bring the ore to surface and we have hired a contractor to crush the ore on the mine site and then truck it to our mill. Several weeks ago, it was quite cold in Timmins, maybe minus 40 degrees, and the conveyors used in the crusher weren't holding the ore very well because they were so cold and these three individuals decided to get a very large blowtorch and focus it on the conveyor way.

Well that was all well and good, until all three of them decided to go to lunch at the same time, and leave this blowtorch on the conveyor. Unfortunately, it caught fire and ignited a large part of the crusher and melted part of its frame and we've been without a crusher for about two and a half weeks.

This stupidity, I cannot begin to describe and that's why I say these are things that are unanticipated. Fortunately, it wasn't our staff, it was the contractors, but I do believe they're Darwin Award candidate."

Red Flag #2: Deteriorating balance sheet and poor financial showing

From the Q3 2018 call: "*So we are investing heavily in growth, in exploration and building roads, hopefully Los Azules, and building the value. In terms of turning profitable, if gold and silver stay where they are today, it's unlikely we will turn a profit next year. But our objective is to be profitable and we're hopeful that our investments that we're making and the expenses we're incurring will generate assets that produce a healthy profit margin in the future.*"

Since that time, the company reported a cumulative (Q4 2018+Q1 2019) net loss of $31.1 million and used up $9.5 million in cash on operating activities. They raised $15 million in a flow-through financing for Black Fox exploration, attempted to raise another $90 million through an at-the-market offering, which fell flat after raising only $1.9 million, causing them to pivot and raise $25 million through a private placement at $1.55 with 3-year full warrants at a strike of $2.

Why the rush to raise capital at any cost?

On August 10, 2018, the Company closed a $50.0 million senior secured three year term loan facility with Royal Capital Management Corp, an administrative agent, and the lenders party thereto. An affiliate of Robert McEwen, Chairman and Chief Executive Officer and the beneficial owner of 23% of the Company's common stock, contributed $25.0 million of the $50.0 million total term loan. The term loan was raised to finance construction of the Gold Bar Mine in Nevada and for general corporate purposes. The principal amount of the term loan bears interest at 9.75% per annum with interest due monthly.

As Rob explains: "*And now, we were with the loss of revenue from the two of our operations, **we were facing a covenant breach** -- a possible covenant breach of our loan. And it came with some penalties, which we really didn't want to have to deal with.*

***We needed to have $10 million of working capital**. **And if we were below that**, at the end of the quarter, the interest rate on the loan would increase from 9.75% to 15% and **we would be technically in a default.** And we didn't want either those events to happen. And so, we then started saying, well, **we got to get some capital quickly** and we looked at a number of alternatives.*"

I find this an ominous sign of things to come. An affiliate of Rob McEwen contributed $25 million at a pretty steep rate, with covenant protection to boot. The 2018 10-K does not disclose the gory details.

From the 10-K Risk Factors:

"**Restrictive debt covenants could limit our growth and our ability to finance our operations, fund our capital needs, respond to changing conditions, and engage in other business activities that may be in our best interests.**

Our credit facility also requires us to satisfy certain financial tests on an ongoing basis. Our ability to comply with these requirements may be affected by events beyond our control, and we cannot assure you that we will satisfy them in the future. ***In addition, these requirements could limit our ability to obtain future financings***, make needed capital expenditures, withstand a future downturn in our business or the economy in general, or otherwise conduct necessary corporate activities. We may also be prevented from taking advantage of business opportunities that arise because of the restrictive covenants under our debt agreement. A breach of any of the covenants in our debt agreements could result in a default under the agreement."

The 2018 Form 10-K was filed on February 20th. By then, MUX was already desperate for additional capital in order to not breach these covenants. And yet, **they do not disclose any material facts related to the credit facility in the 10K filing!** One would have to presume it was intentionally left out in order to mislead investors about the true state of the balance sheet. Seeing as the company tried raising $90 million starting on Nov 8th 2018, there can be no other explanation for such a vague disclosure on what actually turns out to be materially important covenants.

It also makes me question how desperate their capital needs are, if they had to raise capital this way. Has the McEwen charm stopped working when it comes to sweet financing deals?

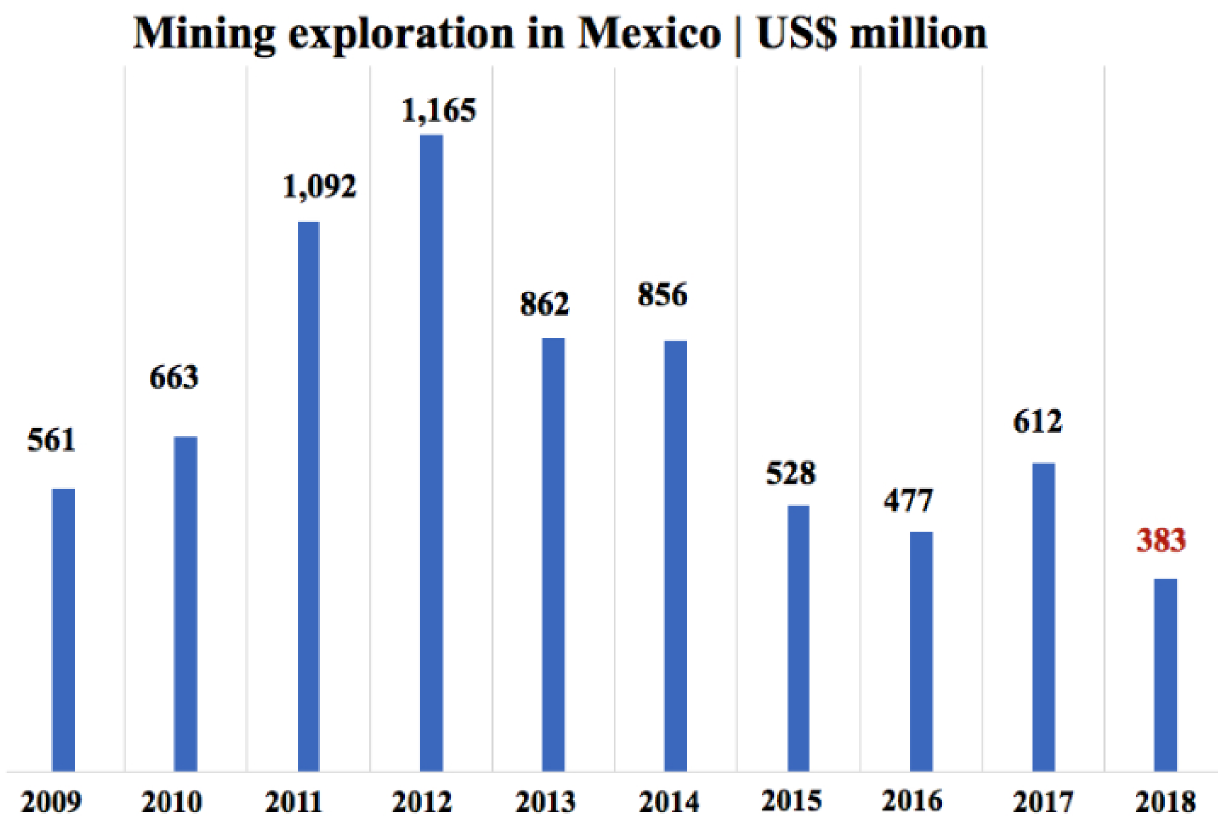
Red Flag #3: Covenant breach likely without yet another financing

As of Q1, the company had working capital of $32.7 million. However, this figure doesn't present the true picture since it includes flow-through funds which are earmarked for Canadian exploration spending in 2019. After backing that out, the true working capital drops to $20.8 million. Gold Bar was expected to achieve commercial production in Q2, and hopefully start contributing to the bottom line. With the recent fatality, the timeline for that is now in question. Meanwhile, the company is losing money on every ounce it pulls out of the ground. The company used $10.8 million in cash in operating activities in Q1. Assuming the same run rate, plus cash used in investing activities at Gold Bar, Los Azules road construction, interest payments, etc., the company will be unable to maintain $10 million in working capital. There is another financing looming, and it couldn't happen at a worse time. If the market reaction to poor Q1 results of the gold miners is any indicator, investors are not in a benevolent mood to throw money at a company which has operational challenges at the only two mines they currently operate.

Red Flag #4: Questionable quality of assets

El Gallo, Mexico

The El Gallo mine in Mexico ceased operations in Q2 2018 and is only producing residual gold from the leach pads. Project Fenix (previously El Gallo 2 silver project) is a dud. The company is looking to sell the asset but so far there appears to be no takers.



Not too surprising given that the political climate in Mexico has taken a turn for the worse. Any offer they do get is going to be at a fire sale valuation.

Los Azules, Argentina

As Rob mentioned in the Q3 2018 call: ""Given the capital cost, we are looking for a joint venture partner. We've had some discussions. The ones we've had had lot of conditional statements attached to them and weren't attractive."

In other words, no major wants to take on the task of building a remote location $2.36 billion mine in Argentina. There are enough such development stage assets sitting on their balance sheets, a result of overpaying for several such uneconomic development stage assets during the bear market. MUX hopes that by building an all-weather road and providing for a power line, they can change that, but I doubt the market will buy that. Having watched Northern Dynasty struggle with a similar problem, that of attracting a JV partner, I doubt MUX will have any better luck.

The only asset which is functioning as intended is the San José mine in Argentina, operated by Hochschild Mining. For Q1 2019, the mine produced 10,600 ounces of gold and 701,000 ounces of silver (MUX's share) at an AISC of $1205/oz and $13.53/oz respectively, <u>contributing a net loss of $2.3 million</u> to MUX.

To sum up, Black Fox and Gold Bar are facing operational difficulties (those inept contractors!), its Mexican assets can't find a bid, its large capex Los Azules project can't attract a JV partner, its equity interest in HOC's mine is generating losses, and the company is hurtling towards a default on its $50 million term loan unless they can complete yet another financing.

How many financings can they do before the stock gets trashed?

How much longer can they ride on Rob McEwen's star power before the numbers start to matter?

At a $540 million market cap, I doubt these risks are priced in. Fortuna Silver, with its history of profitable production and a much better imminent growth profile, is at a market cap of $470 million merely because silver prices fell a bit and Lindero construction got delayed due to rains washing out the road. Hecla Mining and Iamgold fell over 10% on the day they announced poor Q1 results. This is not a market that is forgiving of poor performance.

I see three catalysts that will knock down the shares:

- The company announcing that Gold Bar commercial production will be pushed to Q3 or Q4 as it works to overcome operational difficulties that are not in its control. This will lead investors to question the merit of the project. As John Tumazos remarked, "*So Rob, I think that part of the market concern is just the natural anxiety until Gold Bar is designed, given that some other people dropped the ball and, <u>you never know if the gold comes out till the gold comes out</u>*."
- Further trouble with their crusher, conveyor belt, or other milling equipment at the Black Fox mine
- A financing, which I'm sure is coming based on my analysis of the financial statements. Maybe the stated purpose this time will be to fix Black Fox. Rob would justify it by citing that they bought it for 6 cents on the dollar and so they obviously need to put in capital to fix everything up and undo the damage Primero did

Maybe there is upside, but given the company's poor track record so far, I cannot see any fundamental reason to be long the stock. Rob McEwen has my respect though. At least he hasn't enriched himself while overseeing the company's decline.