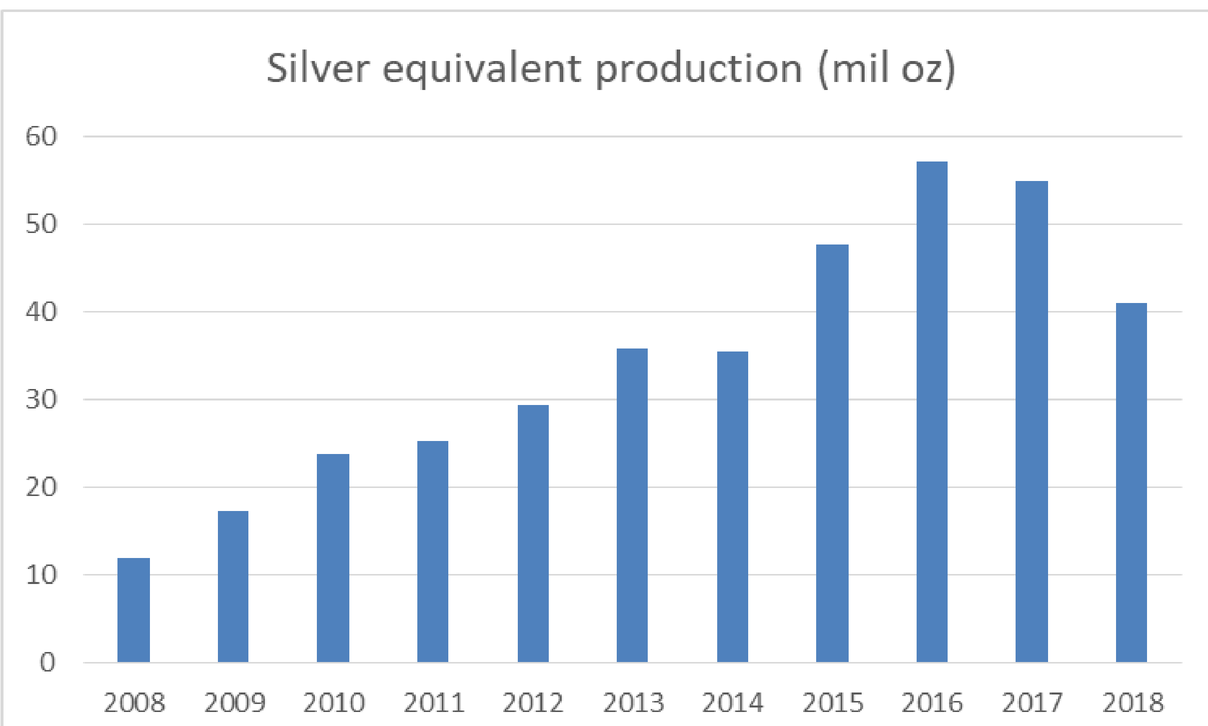
Buy Wheaton Precious Metals (WPM)

Report Date: 10-Dec-2018

Wheaton Precious Metals started out as Silver Wheaton in 2004, pioneering a new business model in the mining space. The company does not own or operate any mines. Instead, it makes an upfront payment to a mining company in exchange for a portion of the mine's production. If you are a copper miner producing by-product silver, the market does not really value the by-product. Investors only care about your copper production, your "all-in" cost of copper production, and expected growth. Although you might also produce a significant amount of silver, the market doesn't account for that in valuing your company. On the other end of the spectrum, investors looking for silver exposure have very few choices. Pan American Silver operates in Bolivia, which to put it mildly is not a country most sane investors would touch.

Silver Wheaton came up with the idea of providing silver exposure by buying up the by-product silver from other miners, in exchange for an upfront payment and an on-going payment per ounce of silver delivered. The upfront payment helps pay for mine construction without diluting shareholders or taking on onerous debt, and the ongoing payment pays for the operational expense involved in producing the by-product silver. By aggregating several such streams, the silver 'production' becomes sizable, the exposure to any one mine is reduced, and since such streaming agreements are for the life of the mine, SLW gets free upside optionality from any exploration or resource conversion that extends mine life. Making such deals made sense not just for copper miners, but also for primary gold and silver miners, due to the 2012-16 resource bear market making it harder to get financing.



Over time, as the company grew, the revenue mix changed such that the revenue from gold streams was almost on par with revenue from its silver streams. In May 2017, Silver Wheaton changed its name to Wheaton Precious Metals to reflect that change. Since then, the company has also acquired palladium (SBGL) and cobalt (Voisey's Bay) streams.

As per the company's Q3 report: The Company has entered into 23 long-term purchase agreements (three of which are early deposit agreements), with 17 different mining companies, for the purchase of precious metals and cobalt ("precious metal purchase agreements" or "PMPA") relating to 19 mining assets which are currently operating, 9 which are at various stages of development and 2 which have been placed in care and maintenance, located in 11 countries. Pursuant to the precious metal purchase agreements, Wheaton acquires metal production from the counterparties for an initial upfront payment plus an additional cash payment for each ounce or pound delivered which is fixed by contract, generally at or below the prevailing market price. Attributable metal production as referred to in this MD&A and financial statements is the metal production to which Wheaton is entitled pursuant to the various precious metal purchase agreements. During the three months ended September 30, 2018, the per ounce price paid by the Company for the metals acquired under the agreements averaged $5.04 for silver, $418 for gold and $169 for palladium. The primary drivers of the Company's financial results are the volume of metal production at the various mines to which the precious metal purchase agreements relate and the price realized by Wheaton upon the sale of the metals received.

Outlook

Estimated average annual attributable production over the next five years is anticipated to be approximately 385,000 ounces of gold, 25 million ounces of silver, 27,000 ounces of palladium and starting in 2021, 2.1 million pounds of cobalt per year.

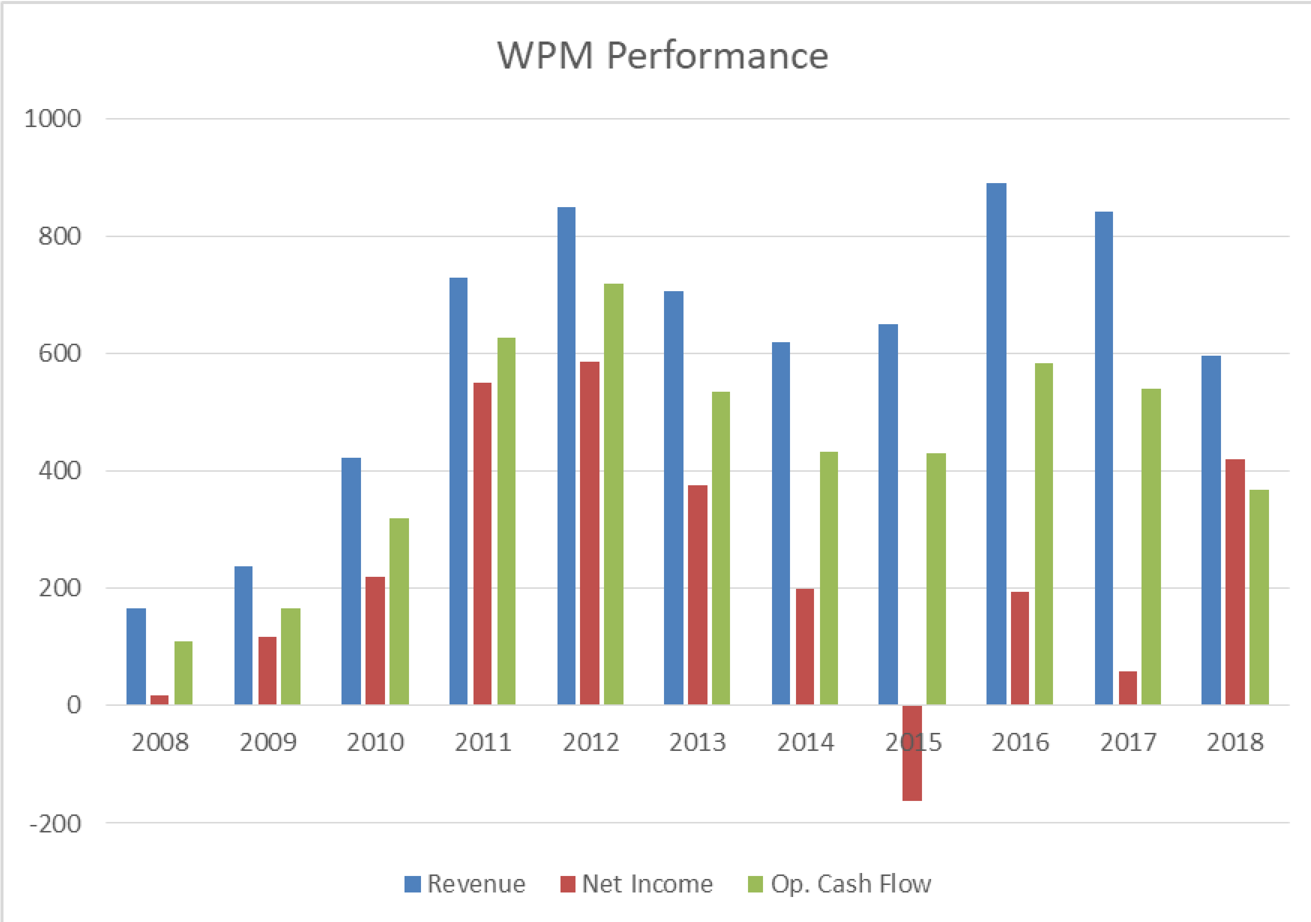
That works out to approx. 59 million silver equivalent ounces per year.

Valuation

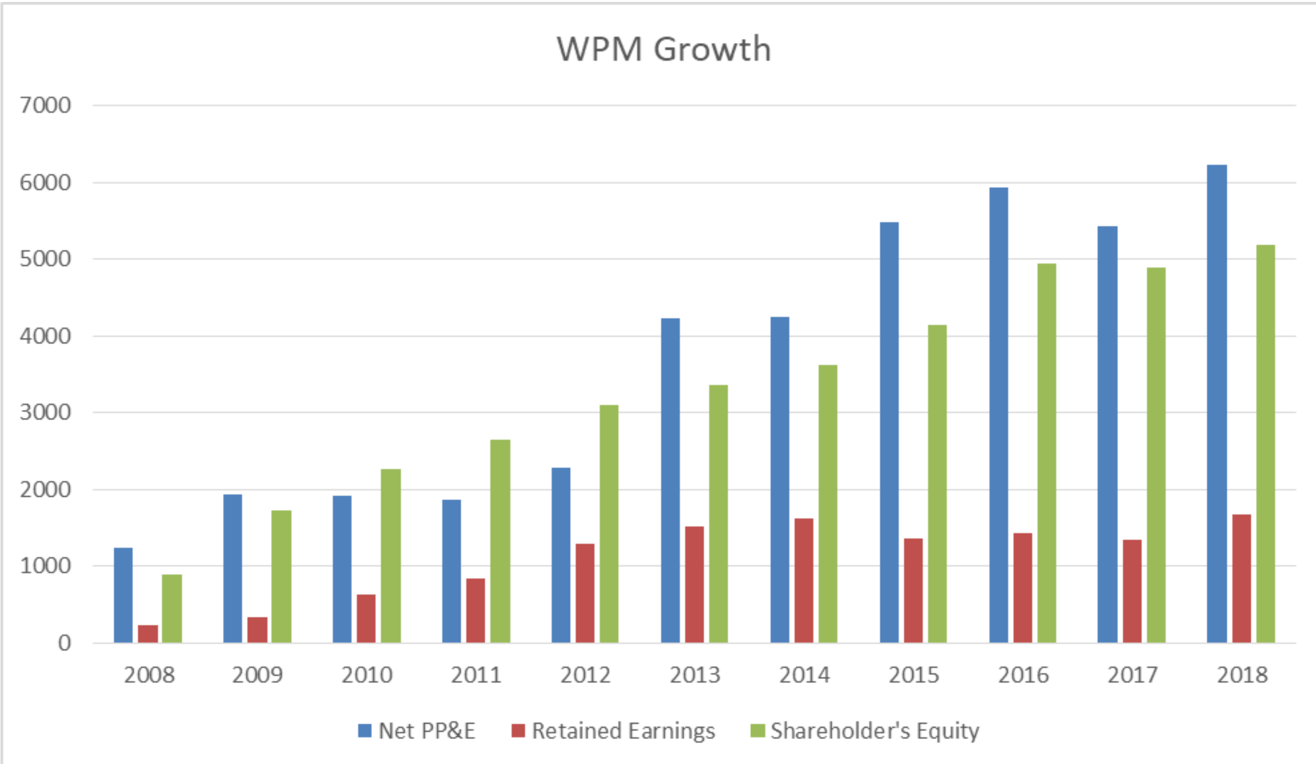
This is the biggest negative. However you slice it, the stock is not cheap.

	TTM	2017	2016	2012
PE	25.4	123.6	36.8	12.2
P/OCF	13.4	13.3	12.3	10.0

The TTM PE is deceptive, since it includes a one-time gain from First Majestic's acquisition of Primero and its San Dimas mine. Even if the company has a pre-tax operating margin of $10 per AgEq oz, the stock is trading at a 12.15x multiple. Again, not cheap. What justifies this valuation?



With the exception of 2015 when the company took a $385 million impairment charge, it has posted GAAP net income every year since 2008! OCF has grown in lockstep with revenue. All this while, the company has also been investing in growth.



Net property, plant and equipment represents its mineral interests, which have grown over 4x, while shareholder's equity has grown 4.8x and retained earnings have grown 6.4x since 2008. Equity growing faster than assets is a good sign. For comparison, Yamana Gold has shown de-growth over the same period, with PP&E at 0.8x, shareholder's equity at 0.63x, and retained earnings decreasing 7.3x ($424 million in 2008 to negative $3.5 billion) over the same timeframe. Yamana destroyed so much equity while destroying the asset side of its balance sheet slightly less because of its incautious use of leverage – it went into the downturn with too much debt and got punished for it (Incidentally, Yamana has one of the lowest AISC/oz among the majors, it could easily have been the top performing quality gold stock had it not been for the debt load).

Wheaton uses leverage as well, but its $1.3 billion debt load is barely 18% of its market cap, and it comes cheap at an effective interest rate of approx. 3.6%. The company has demonstrated that they can use debt wisely, unlike most companies in the mining or oil & gas space. Such a track record does not go unpunished, and the stock is priced to perfection at current production and precious metal prices, which begs the question…

Why own this stock?

(1) *Leverage to precious metals prices*

It is really, really hard to find a well-managed company in this space. WPM offers leverage to precious metals in two ways - the embedded production growth in its portfolio and rising margins from rising metal prices

(2) *New production from development assets and early deposit agreements*

This includes Toroparu, Kutcho, Cotabambas, Keno Hill, Vale's Voisey's Bay, and Barrick's Pascua-Lama.

(3) Ramp up at Salobo

The Salobo mine currently has a mill throughput capacity of 24 million tonnes per annum ("Mtpa"). As per Vale's third quarter 2018 report, in October 2018 Vale's Board of Directors approved the investment in the Salobo III mine expansion (the "Salobo Expansion"). The Salobo Expansion is proposed to include a third concentrator line and will use Salobo's existing infrastructure. Vale anticipates that the Salobo Expansion, which is scheduled to start up in the first half of 2022 with a ramp-up of 15 months, will result in an increase of throughput capacity from 24 Mtpa to 36 Mtpa once fully ramped up.

If actual throughput is expanded above 28 Mtpa, then under the terms of the Salobo PMPA, Wheaton will be required to make an additional set payment to Vale based on the size of the expansion, the timing of completion and the grade of the material processed. The set payment ranges from $113 million if throughput is expanded beyond 28 Mtpa by January 1, 2036 up to $953 million if throughput is expanded beyond 40 Mtpa by January 1, 2021.

Based on Vale's disclosure relating to the size and timing of the Salobo Expansion, the Company estimates that an expansion payment of between $550 million to $650 million would be payable. Given Vale's proposed schedule, this payment would likely be made in 2023 though the actual amount and timing of the expansion payment may significantly differ from this estimate.

Mineral Stream Interests[1]

The following table summarizes the mineral stream interests currently owned by the Company:

Mineral Stream Interests	Mine Owner	Location of Mine	Upfront Consideration Paid to Date [1]	Upfront Consideration to be Paid [1, 2]	Total Upfront Consideration[1]	Attributable Production to be Purchased	Term of Agreement	Date of Original Contract
Silver Interests								
Peñasquito	Goldcorp	Mexico	$ 485,000	$ -	$ 485,000	25%	Life of Mine	24-Jul-07
Constancia	Hudbay	Peru	294,900	-	294,900	100%	Life of Mine	8-Aug-12
Antamina	Glencore	Peru	900,000	-	900,000	33.75% [3]	Life of Mine	3-Nov-15
Other silver interests [4]			880,408	223,300	1,103,708			
Total silver interests			$ 2,560,308	$ 223,300	$ 2,783,608			
Gold Interests								
Salobo	Vale	Brazil	$ 3,059,360	$ -	$ 3,059,360	75%	Life of Mine	28-Feb-13
Sudbury [5]	Vale	Canada	623,572	-	623,572	70%	20 years	28-Feb-13
Constancia	Hudbay	Peru	135,000	-	135,000	50% [6]	Life of Mine	8-Aug-12
San Dimas	First Majestic	Mexico	220,000	-	220,000	variable [7]	Life of Mine	10-May-18
Stillwater	Sibanye	USA	237,880	-	237,880	100%	Life of Mine	16-Jul-18
Other gold interests [8]			400,342	39,100	439,442			
Total gold interests			$ 4,676,154	$ 39,100	$ 4,715,254			
Palladium Interests								
Stillwater	Sibanye	USA	$ 262,120	$ -	$ 262,120	4.5% [9]	Life of Mine	16-Jul-18
Cobalt Interests								
Voisey's Bay	Vale	Canada	$ 390,000	$ -	$ 390,000	42.4% [10]	Life of Mine	11-Jun-18
Total mineral stream interests			$ 7,888,582	$ 262,400	$ 8,150,982			

Closing Remarks

Wheaton has been doing everything right during this bear market. It is a blue-chip among the mining companies, and I want to own the quality ones. If gold re-tests its 2015 low of $1050 before heading higher, the marginal producers and sub-marginal development or advanced exploration companies (i.e. ones at a FS/PFS/PEA stage) are going to get decimated, while WPM won't fall as much. The downside risk to WPM is more limited than the higher beta plays, but I retain exposure to precious metals prices and the company's growth profile. Imo, this justifies the valuation multiple.

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