Interview: Silver Wheaton CEO Randy Smallwood on Corporate Strategy, Debt Ratings, and Pascua Lama

Description

Central banks around the world are printing trillion of dollars in fiat currency in a desperate bid to jumpstart the global economy. Historically, the end result of this game is inflation. In this environment, sometimes the best way to protect your savings is to own hard assets.

But if you want exposure to precious metals, you have to be smart about it. Owning a piece of metal over the long haul isn't the best investment strategy. Mining companies tend to get hit with all kinds of problems that make it difficult for them to keep up with the precious metal prices.

Perhaps you can own a company that invests wisely in mines. Take **Silver Wheaton** (TSX:SLW, NYSE:SLW) for example. This business invests in silver and gold projects around the world. It's known as a "metal streaming company", the largest in the world.

They give miners an up-front payment to finance projects for a piece of their future production. Silver Wheaton doesn't have ongoing capital costs. They don't even need to worry about the labor strikes and cost overruns. And because it's a totally unhedged and levered company, the stock has outperformed the price of precious metals over the past decade.

However, the streaming business model has come under some challenges in recent months. So I sat down with Silver Wheaton President and Chief Executive Officer Randy Smallwood to discuss the latest developments in the industry.

Below is the transcript of our conversation; it has been lightly edited for clarity.

Robert Baillieul: Mr. Smallwood, thanks for taking the time to join me today. Just looking over a lot of the recent deals that Silver Wheaton has done – like with Vale, Hudbay, and Sandspring Resources – you guys have been mostly buying up gold mining streams. Why the shift in strategy? Are you more bullish on gold?

Randy Smallwood: No, we've always been focused on profit. And we tend to think that the streaming model fits the silver business better and we are actually a little more bullish on silver than gold.

Silver is much more volatile than gold. If you're investing near the bottom of the cycle, that tells you silver should outperform on the way up. There's a few other reasons that we're a bit more bullish on silver. But at the same time with precious metals, store of value, etc, those are easily as applicable to gold as they are to silver. We're comfortable in the gold space but we remain silver focused.

Just by pure coincidence the three previous deals we've done have been gold streams. It may be a reflection of the fact that the gold industry is tougher hit than any other sector in the mining space. That being said, two of our last three deals have been with base metals companies so it wouldn't really play into that.

That being said, we're comfortable with precious metals, but still with a focus on the silver side but not scared to have a dilution from gold.

Baillieul: If there's a good deal on the table, just take it.

Smallwood: Exactly, I mean what we're focused on, as I said, is profit. What we want are good quality, low cost assets that will deliver metal to us in all parts of the commodity price cycle.

And so you got to focus on quality first and the commodity and the metal itself is a little bit irrelevant. I mean we're happy in silver and gold. But silver does have a little more appeal to us.

Baillieul: It seems like every other financing deal I've seen recently involves some sort of streaming company, either Silver Wheaton, Franco Nevada (TSX:FNV) or Royal Gold (TSX:RGL). Why are so many mining companies, especially the majors, turning to streaming as a source of financing?

Smallwood: Well they recognize how flexible it is as a source of financing.

Irrespective of S&P's latest confusing opinions that they've let out, it's a risk shared financing method. It's something where we invest into the asset, if the asset fails or if the asset doesn't deliver we don't get our money back. To call it debt is confusing.

It's a very flexible source of financing and I think when the majors look at it compared to issuing shares or adding debt the flexibility of streaming is so much more attractive. And I think that's what's happening is that people are realizing that it does add value. It does free up capital so that they can invest in their core franchises.

Baillieul: I wanted to ask you about that. Earlier this month S&P said this month it will start classifying streaming deals as debt rather than as non-debt financing. Has this change impact any deals? Has that been brought up in any of the conversations you have with miners?

Smallwood: It generally comes up as an issue. There's no doubt that it has had an impact. But generally with the large diversified (ones), companies with the size of something like Vale.

It's something that we're working with to try to educate S&P because we just think that they missed the boat in terms of this conclusion that they have come with. It has been described as basically we invest into these mines and if they don't deliver silver to us then there's no recourse.

We have to make sure of these things. We have completion tests in place for construction projects. But once the project is up and running and has satisfied its completion tests we share the operating risks. Our perspective is we also share in the operating reward in ways that outway the risks. But for some reason S&P hasn't felt that.

It does have an impact. We're trying to work with S&P to educate them a bit more about what streaming is. It's confused us. We want to highlight the fact that **Moody's** came out right afterwards and said they don't agree. So I do think there's some education required there.

Baillieul: The closure of Barrick's (TSX:ABX, NYSE:ABX) Pascua Lama has highlighted a risk in your business model. If we see gold fall another $200 or $300 per ounce, could we see more mine closures?

Smallwood: Well, obviously all of these things are driven on a market basis. When we look at the assets in our portfolio that are under construction, it's one of the reasons why we focus on the lowest cost assets within the respective cost curves and the respective commodities.

So the appeal of Pascua Lama is the ability to produce gold at $200 cash cost. So they'll be incentivized to move that project forward. There's a strong incentive.

This is, once again, why we focus on those high operating margin assets. And that's where we try to make all of our investments.

Also the structures that we set up, in the structure that we have with Pascua Lama, where we continue to receive silver from the other three mines until they have satisfied the completion test or the end date.

It compensate us very well from these delays. We get between 2 and 2.5 million ounces per year of silver until they get Pascua Lama up and running or until the end of 2016. So for deferring the silver, the nine million ounces we would have received from Pascua, we're getting paid 2.5 million ounces. So we're being compensated very well for these delays.

So it reinforces the importance of how we structure our streaming agreements to protect us and our shareholders on these projects. We have a similar system set up with Hudbay at Constancia in terms of if they don't satisfy the completion test we get compensated very well for those delays. Once those assets are up and running then we share full risk with the companies themselves going forward.

So I think the lesson learned out of Pascua and the risk of our structure versus the other development structure out there really highlights the benefits that we have in our stream model.

Baillieul: So in terms of setting up these streaming deals, how important is it to evaluate the person on the other side of the table? Is there anyone you wouldn't pick up the phone for if they happened to call?

Smallwood: The challenge with the streaming agreement is that it's life of mine. Which means that the management team that you're dealing with right now there's no guarantee that that is the same management team that's going to be there five years from now. We have no control over that.

So what we look for is assets that are strong enough to withstand bad management. Now we want good management and we focus on good management. But the trick is to make sure that if the asset does have bad management that they will survive through that and continue to strive.

I know that sounds like an odd statement. It is something that is important to us if it's a construction project. We want to have confidence especially with respect to community relations. Social impact and stuff like this with management teams that work their way through a new mine that they bond with the local community. So it is an area that we do put focus into.

But we better make sure that the assets are strong enough to withstand bad management because there are no guarantees.

Coming up next

In part two of my interview with Mr. Smallwood, we discuss the outlook for precious metal prices and the state of the mining industry.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:WPM (Wheaton Precious Metals Corp.)

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