Is Pan American Silver an Attractive Investment?

Description

Market pundits are betting on a rally in silver this year with a number of indicators highlighting it is undervalued. The key indicator is the price of silver remaining flat for the year-to-date, yet the gold-to-silver ratio continues to widen.

Since the start of 2014, the ratio has gone from 60 to 66, despite gold prices continuing to soften after its rally earlier this year. This indicates silver is underpriced in comparison to gold when the historical correlation between the two precious metals is taken into account.

One company that stands out as a potential play on a rally in silver is the world's second largest primary silver miner, **Pan American Silver** (TSX: PAA)(NYSE: PAAS). Despite the price of silver softening 12% over the last year, Pan America's share price for the same period gained 2%. Whereas many of its peers saw their share prices plunge, **First Majestic Silver's** (TSX: FR) (NYSE: AG) slumped 22% and **Silver Wheaton's** (TSX: SLW)(NYSE: SLW) softened 6%.

This discrepancy may indicate the market has taken a more positive view of Pan American's operations and its future potential in comparison to its peers. Let's take a closer look at Pan American and determine whether it represents an opportune play on a rally in silver.

Softer precious metal prices significantly impacted 2013 performance
Overall, Pan American's 2013 performance, like its peers', was disappointing because of softer precious metal prices, severely impacting margins and profitability. But there were some glimmers of good news. In comparison to the previous year, silver production grew 4%, gold production shot up 33%, and cash costs per ounce of silver produced fell 10%.

Another promising aspect of Pan American's 2013 results was a 2% increase in silver reserves compared to 2012, which hit a record high of 323.5 million ounces. This was contrary to First Majestic, Silver Wheaton, and **Silver Standard Resources** (TSX: SSO)(NYSE: SSRI), which saw their silver reserves fall over the same period by 10%, 5%, and 2% respectively.

Future outlook remains mixed
For 2014, Pan American expects to produce 25.75 to 26.75 million ounces of silver, which is roughly in

line with 2013 production. But cash costs per ounce are expected to rise by between 8% and 17% in comparison to 2013, to between $11.70 and $12.70 per ounce. This can be primarily attributed to Pan American factoring in a lower by-product price for gold of $1,200 per ounce, which is 15% over than the price per ounce of gold realized in 2013.

These cash costs per ounce are also significantly higher than First Majestic's projected 2014 cash costs of $8.67 to $9.12 per ounce, but lower than Silver Standards' $12.50 to $13.50 per ounce. Pan American's cash costs are also significantly higher than Silver Wheaton's, which for 2014 are estimated to be around $5 per ounce. This can be attributed to Silver Wheaton being a precious metals streamer rather than a miner, meaning it does not have the same production overheads.

Low degree of leverage coupled with attractive valuation ratios

However, the key attributes that make Pan American stand out are its solid balance sheet and appealing valuation metrics, particularly in comparison to its peers. Pan American's degree of leverage is particularly low with net debt a modest 0.6 times of both operating cash flow and EBITDA. That figure indicates that the company can comfortably manage its debt load even in the current difficult operating environment.

Its degree of leverage is also significantly lower than many of its peers with net-debt-to-operating-cash-flow less than half of Silver Majestic's 1.4 times and almost a third of Silver Wheaton's 1.7 times.

Even more compelling is that in comparison to its peers, Pan America has some particularly appealing valuation ratios as the table shows.

PAAS Val Ratios 160414

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With an enterprise-value of 5 times silver reserves and 7 times EBITDA, Pan American is far more attractively priced than First Majestic, Silver Wheaton, or Silver Standard.

Appealing and sustainable dividend

Pan American was one of the few precious metal miners not to cut its dividend as precious metal prices collapsed, leaving it with a tasty dividend yield of just under 4%. With Pan American ending 2013 with cash of $250 million, coupled with the ability to continue generating solid operating cash flow in a difficult operating environment, this dividend appears sustainable at this time.

Foolish bottom line

Pan American shapes up as an appealing leveraged play on the possibility of a rally in silver this year. The company has some particularly attractive valuation metrics in comparison to its peers coupled with an appetizing dividend yield. But it is likely any rally in silver will only offer investors limited upside, with the price of gold, a key determinant of silver prices, continuing to slide.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:AG (First Majestic Silver)
2. NYSE:PAAS (Pan American Silver)
3. TSX:FR (First Majestic Silver)
4. TSX:WPM (Wheaton Precious Metals Corp.)

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