



What Drives Silver Wheaton Corp.'s Share Price?

Description

Silver Wheaton Corp. (TSX:SLW)(NYSE:SLW) is the largest precious metal streaming company in the world and derives approximately 75% of its revenue from the sale of silver and 25% from that of gold.

The share price has declined by almost 50% from its \$45 peak in April 2011. What are the key factors you as investors need to analyse when considering an investment in this company? I'll explain.

Overall production costs drive profitability

The company's business model is based on contractual arrangements to purchase, in exchange for an up-front payment, future silver and gold production of mining companies at predetermined prices.

The cash cost at the time of delivery currently averages approximately US\$4 per ounce of silver and US\$400 per ounce of gold. The full cost of sales, including the up-front payment, which is depreciated as production is extracted, currently averages around \$7.18 per ounce of silver and \$1,044 per ounce of gold. Although the margin shrunk as the silver and gold prices declined over the past few years, current prices leave an adequate profit margin.

The spot prices of silver and gold drive revenues

The profit margin achieved by Silver Wheaton is a function of the original up-front payment, the cash cost, the production delivered, and the price realised when the silver or gold is sold. The first three of these factors are either known or reasonably predictable and are simply outcomes of contractual arrangements in place between Silver Wheaton and various metal producers. The fourth factor, namely the prices of silver and gold, are unknown and mostly unpredictable.

Silver Wheaton does not hedge its sales prices, and spot prices therefore indicate the price that the company will receive at the time of sale. The high correlation between the share price of the company and the price of silver is therefore not surprising.

The million-dollar question: Where is the price of silver headed?

The price of silver, though it's been declining for the past three years since it reached a peak of almost \$50 per ounce in April 2011, has been relatively stable around \$20 per ounce for the past year and has averaged around \$10 per ounce over the longer term.

According to the World Silver Survey of 2014 produced by Thomson Reuters GFMS, physical demand for silver in 2013 amounted to 1.08 million ounces, which was 13% more than 2012 and the highest recorded demand level.

Industrial fabrication is the single biggest component of demand constituting around 600 million ounces per year, followed by investment demand in the form of bars and coins and jewelry. The swing factor is wildly fluctuating speculative investment demand in the form of exchange-traded products and holdings of the futures and options exchanges.

Supply in 2013 amounted to 978 million ounces, which was 3% less than 2012 and 9% below the record supply achieved in 2010. Silver mines produced an all-time record of 820 million ounces in 2013 and scrap recovery delivered 192 million ounces.

Despite the substantial shortfall in silver supply in 2013 the average silver price declined by 24% during the year. According to the Silver Survey, this outcome was driven primarily by investor liquidations of silver futures and options positions on exchanges and large-scale sales from investors of physical inventories.

Speculative investment demand renders the price of silver rather unpredictable. However, for what it's worth, commodity stargazers pitch the longer-term forecast for silver at around \$20 per ounce — a price at which Silver Wheaton will continue to have attractive profit margins for the foreseeable future.

Future performance will depend on the silver price

The company's financial performance is highly dependent on the price of silver and, to a lesser extent, that of gold. Unsurprisingly, its share price over time also tends to track the movement of the price of silver. The unpredictability of the price of silver places Silver Wheaton firmly in the high-risk investment category and investors should demand an additional premium for this factor.

CATEGORY

1. Investing
2. Metals and Mining Stocks

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

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