October 14, 2015 – A Big Silver Purchase

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Somewhat lost in the swirl of mining news centering on Glencore last week, was a significant deal in which Franco-Nevada paid Teck $610 million for a 3 million oz annual future silver stream on Teck's share (22.5%) of the Antamina copper mine in Peru. (Coincidently, it is thought that Glencore will soon announce a deal to sell its own 33.75% share of the silver mining stream from the same mine.) This is the first pure silver mining stream purchased by Franco-Nevada, founded by mining legends Seymour Schulich and Pierre Lassonde, who pioneered the concept of royalty arrangements in the gold mining industry.

http://www.franco-nevada.com/wp-content/uploads/2015/10/Franco-Nevada-to-Acquire-a-Silver-Stream-on-the-Antamina-mine-from-Teck-for-US610-million.pdf

For those not completely familiar with silver streaming, it is a financial transaction in which the buyer pays an upfront amount of cash to gain ownership to the future production of silver that flows from a base metals mine for an extended period, often the life of the mine. A relatively recent development, the concept of silver streaming was launched more than ten years ago by Silver Wheaton, still the leader in silver streaming. As can be seen in the Franco-Nevada deal, more companies have entered into this segment of the market

I find it more than interesting that streaming is yet another peculiarity almost unique to silver, although gold has been involved increasingly in streaming deals over the past few years. More than for any other single reason, silver's unique mine production profile, in which it is mostly produced as a by-product of other metals mining makes silver streaming possible. Rather than buying or selling the whole mine itself, a streaming transaction defines and separates the silver (or gold) production from the other metals produced by a mine.

Approximately 70% of the total silver mined in the world comes as a by-product of copper, lead, zinc and gold mine production. That's neither bullish nor bearish for price, just a statement of how silver is produced. As such, silver accounts for only a portion of many mines' total output. With such a high percentage of total silver production coming as a by-product, it is little wonder that streaming has come to focus predominantly on silver (and gold, when it is a by-product metal).

In essence, the seller of the silver stream, usually a base metals mine, gets an upfront payment and agrees to continue mining as before, but earmarks the silver by-product to the buyer of the silver stream for a small additional fixed cost per ounce, typically $4 or less per ounce. (In the deal described above, Franco-Nevada will pay 5% of the spot price of silver for each future oz received). The motivation for the stream seller is the large upfront payment and the smaller allowance for ongoing production. The motivation for the buyer is a low fixed cost future stream of silver which includes exposure to any silver price appreciation without the cost and trouble of actually mining the metal.

In addition, streaming deals have become a method for fairly quick and substantial financing for a mine in times of otherwise hostile general financing conditions, like exist currently. By isolating what is being bought and sold to only the silver by-product output, deals seem easier to arrange, as would appear to be evident in the Franco-Nevada/Teck deal. I suppose it's easier to transact a portion of a mine's output than the entire mine. The ease of streaming deals aside, make no mistake – depending on the future course of silver prices, these are very big bets.

The sellers of silver streams get most of the future income upfront and therefore get no real benefit from higher silver prices in the future. The buyers stand to benefit greatly from higher future silver prices and would not likely enter into such transactions if they believed silver prices would not advance. In many ways, these silver streaming transactions remind me of the gold (and silver) leasing/forward sales of 10 to 20 years ago that ended in financial disaster for most of the mining companies who locked in gold prices under $300 (silver under $5) back then. I don't foresee it will end in similar disaster for the sellers of silver streams because the metal only represents a small percentage of total mine production, but in keeping with what I see for future price levels for silver, I am convinced the sellers will one day regret selling their future silver production at what will turn out to be very low prices.

That's another way of saying that the buyers of silver streams stand to profit mightily if silver prices do what I believe they will do. Please don't take this as investment advice to buy or not to buy silver streamers because, as I hope you know, that is something I strive hard to avoid. All things considered, I think the buyers of silver streams will fare better than the sellers over time, but I don't want to get bogged down on specific company research. My point instead is to see what can be learned from what must be considered mega-transactions involving silver.

$600 million isn't quite the billion dollars that I suggested might be invested into physical silver and, certainly, streaming is a different form of buying physical silver than I outlined; but, in a larger sense, neither the amount nor concept is that far apart from my suggestion. More importantly, the quality of the buyer (remember, we're talking about the House of Lassonde) and the fact that it was Franco-Nevada's first pure silver stream, tells volumes about what this company feels about the current and future price prospects for silver. As I said, no one buys any investment not expected to appreciate in value, not if amount invested is $600, or $600 million or $6 billion (roughly what I believe JPMorgan has invested in physical silver).

While I'm pretty sure Franco-Nevada will do just fine with this silver stream, I can't help but feel that if it had bought 40 million oz of physical silver instead, it would have had a much greater impact on price, given the current tightness in the wholesale silver market and the clear message that would send to potential silver investors. After all, a first-time $610 million investment in silver by a well-respected resource value investor should turn heads. The only reason it hasn't, in my opinion, is because it was in the form of a silver stream and not plain vanilla metal. That's why I'm writing about it today.

Just to be clear, in terms of the actual supply and demand fundamentals for silver, streaming doesn't matter much, as only the ownership of the future silver to be mined changes hands; the actual amount of metal produced mostly remains the same, certainly in the short run. But there are a number of reasonable conclusions about silver that can be taken from this particular transaction as well as silver streaming in general. In a way, I'm kind of kicking myself that I haven't written about silver streaming earlier, as once again it's an issue on the periphery of silver that one must refocus on to get a different perspective.

The first reasonable conclusion, as already discussed, is that a big investor stepped up to the plate to buy silver for the first time, in a form consistent with that investor's usual methodology. Watching so much time pass and silver remain so undervalued and manipulated in price and knowing that the unvarnished flow of data from the world of actual metal screams otherwise, does test one's sanity. You wonder why no one big seems to see what you see, particularly when what you see is based upon easily-verified facts. What do the big guys know about silver that you don't know? Why aren't they buying (at least away from JPM)?

Then, a big guy does buy (at least that's my take) and you doubt yourself and your common sense less. Only the big buyer does it in such a way that it's not exactly clear to everyone and the buying takes a form that doesn't affect the current physical silver market. Still, the message is clear Â? Franco-Nevada sees silver as undervalued and put up $610 million of shareholder money backing its vision for the first time. After 4.5 years of rotten price performance and with prices near six year lows, it's about time a big guy agreed.

Another reasonable conclusion is that there have been many more sellers of silver streams than buyers of such transactions. That's because there are many more base metals mines in the world capable of spinning off silver streams than there were dedicated investors in such streams. While I expect more silver streaming deals in the near future, please know there is a practical limit to such deals and I don't sense tremendous growth after the current spurt plays out, particularly at higher silver prices.

I can't help but think that the number of miners who have spun off silver streaming agreements explains a lot about how base metals miners view silver. I can understand how agreeing to large and otherwise difficult to arrange financing for selling off the rights to by-product silver production could be considered attractive from a base miner's perspective. But to a silver investor who believes silver is the most undervalued metal of all, it looks different; I'd rather spin off the base metals production and concentrate on silver.

At the very least, base metals miners' willingness to spin off silver production explains why these silver producers could care less about its price prospects. That's no great revelation, considering how few of the primary silver miners have spoken up about depressed silver prices. Therefore, it is reasonable to conclude that it is futile to expect the silver by-product miners to advance the case for higher silver prices (not that anyone was).

But the flipside to that futility is that collective sentiment for higher silver prices is so low that even the producers of the majority of metal mined are not only selling it with no hesitation, but selling it far into the future as well. Those selling silver streams can't be convinced of sharply higher silver prices and those sellers are many. Those buying silver streams must feel silver is undervalued and those buyers are few in number. That equation seems quite conducive for higher silver prices in time, but also explains why silver has been overlooked.

Simply put, the sellers of silver streams can't possibly know the real silver story, where those buying silver streams seem more likely to appreciate all the facts. And if the real silver story (tight supplies, manipulated price) is unknown to those producing it, then the real story is most likely unknown in the broader financial world as well. That's one of the things that came to mind when contemplating this silver streaming business.

Compared to when I first entered the commodity brokerage business more than 40 years ago, the number of financial institutions with dedicated research on silver (or other commodities, save energy) has dwindled. I don't even know if Merrill Lynch or Goldman Sachs or JPMorgan even has a dedicated silver analyst. I could be wrong, but I haven't run across any such specific research publicly. There's plenty of information on the Internet, but that's quite different from how it used to be. I understand the change because silver and other commodities represent a much smaller portion of the investment asset world as time has advanced and financial institutions are going to direct resources to where it matters most. This is both good and bad.

It's bad because it has contributed to the issue of price manipulation going unaddressed. If there were dedicated silver analysts at major financial firms, at least the question of silver manipulation, among many such issues, could be addressed. I'm pretty sure, for instance, if there were publicly approachable silver analysts out there, some answers would be forthcoming about key questions of the day, such as why has so much physical silver been shuffled in and out of the COMEX silver warehouses over the past four and a half years and why this unusual turnover has been unique to silver?

But the lack of specific silver research analysts at major financial institutions is also good because it explains how the real silver story has gone unnoticed in the conventional investment world. As I've long pointed out, it's hard to see something if you are not looking. I look intentionally for things in silver that might be unusual in the hopes of uncovering more of what the true story may be. It would be presumptuous and egotistical to say that Franco-Nevada took my advice to dig deeper into the true circumstances in silver and that is what led to their first ever pure silver stream investment; but something must have convinced the company to make such a sizable investment at this time and I would wager that much deep thought preceded the actual decision.

In fact, I've long held that objective analysis and the recognition that would bring to a market as deeply undervalued and manipulated as silver is exactly what the doctor ordered to end both the undervaluation and manipulation. It's always been about having an open and honest debate on the many questions that the regulators won't touch.

Since the CFTC and the CME will not touch the many questions that cry out for transparency, the only remaining solution is a physical silver shortage that will come when enough of the world's investors recognize what a bargain silver has become. Franco-Nevada didn't invest in the type of silver that would immediately contribute to a physical silver shortage but the silver stream they did buy goes some way to validating that silver is undervalued. In time, this can't hurt.

On to other matters. I'm still somewhat shocked about the increase in short selling in SLV and GLD that I reported on Saturday. In the case of SLV, the 8 million share/oz increase in the short position is separate and distinct from the 5 million oz that I calculated was Â?owedÂ? to the trust as a result of net buying on high volume a little way back. That makes a total of 13 million oz effectively owed to the SLV. Since the increase in short selling in SLV was as of September 30, while the 5 million oz I figure that is owed came after that date, I would not be surprised to witness another increase in short selling when the new short report is released in a couple of weeks.

This may be a dangerous (and certainly crooked) game that the short sellers in SLV are engaged in and while it has always seemed to get resolved on a selloff in the past, what makes it more dangerous to the shorts now is if the wholesale (not retail) physical silver market gets tighter.

Price action since the weekly review seems to be in keeping with the market structure revealed in the latest COT report as discussed on Saturday, but please don't take that as something to be fully expected or relied on. Through today, gold has appeared stronger and has penetrated its 200 day moving average convincingly as I write this. Silver appears to be reluctantly following gold higher and is not leading to the upside as is usually the case. You'll remember that gold's COT market structure surprised on the bullish side, while silver came in as fully bearish as anticipated, so this week's price action sort of makes sense.

In reality, however, the last thing anyone should rely on for short term timing predictions is the COT report, which to my mind is tied for last place with every other short term price indicator. In other words, short term price predictions shouldn't be relied upon no matter what the indicator. But investors need to rely on something and the best something, in my opinion, is long term value considerations and the flow of documented evidence.

It still appears that the rally in gold and silver has been driven by managed money buying and that's why it's important to measure that buying and potential buying in trying to understand price movement. It wasn't that long ago that there was a near universal consensus that gold, then at and below the $1100 level, was a cinch to fall below $1000 and even lower. Everything screamed for lower gold prices. The only problem was that the COT market structure, particularly for the managed money traders, was at its most bullish extreme in history. I can't say which way we go in the short term from here, but the reason we're pressing on $1200 is nothing but how the COMEX market structure played out until now.

But it also still appears possible that there is a developing physical tightness in both silver and gold and if that tightness intensifies sufficiently, especially in silver, the paper market structure may be superseded. Therefore, while I am as mentally prepared as possible for a selloff due to COMEX price rigging, given the still depressed silver price and the continued flow of signs of physical tightness, I'm still (more) afraid to reduce long exposure at this time.

Ted Butler

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Silver – $16.15 (50 day moving average – $14.97)

Gold – $1188 (50 day moving average – $1127)

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