The Gold Report

Prepared for the Attack of the Short Sellers: Joe Reagor

Source: Peter Byrne of *The Gold Report* (4/23/14)

Despite the ongoing attack of the short-sellers, the fundamentals of gold and silver production are increasingly robust. ROTH Capital's Joe Reagor tells *The Gold Report* why he believes the price of gold is steaming toward $1,500/oz, with silver prices following in the wake. Reagor highlights several junior precious metals miners in a market that is out to prove the bears on Wall Street wrong.

The Gold Report: Let's talk about the growth and stability of gold and silver sales in Q2/14. What catalysts are on the horizon?

Joe Reagor: The biggest national markets for gold right now are India and China. U.S. investors are bearish on gold and silver. Europeans are more toward neutral. But there are more than 2 billion people living in China and India. They are the largest gold buying market, outweighing the larger financial markets of the U.S. and Europe.

*"**Pretium Resources Inc.** provides a value opportunity."*

Conversely, silver has underperformed gold during the last nine months. The average grade of a solid silver project is 100 grams per ton (100 g/t), while the average grade of a good gold project is less than 1 g/t for open pits. Advancements in recovery technologies mean that the silver-gold recovery ratio is moving toward 100:1. That is a much greater ratio than when I started on The Street, when gold traded at 53:1, and it bodes poorly for silver.

TGR: What's the balance between industrial uses and retail uses for gold?

JR: Gold's only real use is as jewelry. Otherwise, it serves the ups and downs of investment demand and the requirements of banks buying it for reserve purposes. It is used a little bit in dentistry and a little bit in high-end technology, but those applications are not enough to be determining factors of the gold price. The jewelry usage is the largest use, but even that it is not enough to consume the total world gold supply. Normally, the recycling market alone is almost enough to support the jewelry market, especially in recent years with the get-cash-for-gold boom that occurred in the U.S. and in other countries. People were taking old jewelry items and getting $0.85 on the dollar for the gold content.

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In reality, gold investment demand is going to continue to drive total demand, but it might not necessarily drive the price. If we look at most commodities that have an investment demand, when they are at peak, the pricing is determined by demand for investment. And that is what has happened with gold. The price rise toward $1,800/ounce ($1,800/oz) was solely driven by peaking investment demand. But in the current pullback, the valuation is not so much based on investment demand. There are large gold buyers who set a price floor. China creates a floor around $1,200/oz when it buys everything it can get its hands on through Shanghai. But above that, pricing is based on the cost of production. If every gold mine in the world shut down, the price of gold would go up tremendously, counteracting the low price regime essentially instantaneously. The better producers are performing at $1,250/oz all-in cash cost numbers. Most industries need a 20% economic profit margin to survive. That puts the real price of gold at $1,500/oz.

TGR: What about silver?

JR: The cost to produce silver is a bit lower than gold because silver comes with valuable byproducts, such as lead and zinc in some cases. But silver-only mining can still cost in the $20/oz range, so that suggests a rational silver price above $20/oz. It is important for silver miners to concentrate more on producing silver than on producing byproducts, however. For example, Hecla Mining Co.'s (HL:NYSE) Greens Creek would survive at a much lower silver price. The existence of single entity silver mines producing in the $17–20/oz cost range suggests that the price of silver should be about $24/oz.

TGR: Which larger firms do you like in the precious metals mining space?

JR: Agnico-Eagle Mines Ltd. (AEM:TSX; AEM:NYSE) has always been a quality-run company in the midtier space. One of the larger companies that we cover is Pretium Resources Inc. (PVG:TSX; PVG:NYSE). It has been a very controversial story this year. But it now appears that Strathcona Mineral Services Ltd. has stepped away a little too early from Pretium. If it had stayed on for the full 10,000-ton bulk sample that Pretium produced, the situation may have been different. We think that Pretium is a good story because a lot of people lost interest in it after Strathcona got cold feet, prematurely. And this is the type of situation that provides a value opportunity because it has not been perfectly mediated by the market.

TGR: Which companies do you like in the junior gold and silver producer market these days?

JR: We like SilverCrest Mines Inc. (SVL:TSX; SVLC:NYSE.MKT). Its valuation peaked at about $2.60/share, and then it did a Canadian bought deal for $20 million. That resulted in a pullback when people questioned the need for the new money. But management played it safe and used its high valuation to sock away cash for the possibility of future problems, which is a very rational strategy. Our valuation on SilverCrest is $2.50/share. It currently trades around $1.85. SilverCrest is going through a transitional period as it commits to underground mining. As a result, it is going to have a lower production level in Q2/14. But by Q4/14, we should have a full picture of its new mining operation with its combination of underground extraction and blending off its leach pad at the mill.

TGR: Any other juniors that you want to draw our attention to?

JR: Paramount Gold and Silver Corp. (PZG:NYSE.MKT; PZG:TSX) is a great story. Its stock is a play on two assets. The first asset is the San Miguel project, which is adjacent to Coeur Mining Inc.'s (CDM:TSX; CDE:NYSE) Palmarejo project. Coeur has stated publicly that it is looking for high-grade ore sources, and it has one sitting next door to it. There are a number of ways in which this play could work out. There could be an offtake agreement to Coeur, where it mills the ore for Paramount, because Paramount is closer to production than Coeur is on its own discoveries. Or Coeur could buy Paramount and develop and process the ore itself. There is also a less likely scenario in which Paramount could develop the asset on its own. Taking these three scenarios into account, Paramount's share valuation is on the less expensive side in today's market.

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Paramount also has an intriguing asset in Nevada, the historical Sleeper mine that used to produce both gold and silver. Today, it has more than 5 million ounces gold in resources, albeit at very low grades. But it could be a story comparable to Allied Nevada Gold Corp. (ANV:TSX; ANV:NYSE.MKT), which developed a similar asset at a reasonable cash cost by streamlining the production process. As an investment for Paramount, the Sleeper is a kind of call option on the gold price. It bought the mine when the gold price was $1,270/oz. Now, it's $1,300/oz. The property is technically worth more than when Paramount bought it before the strong run-up began in 2010. At the time, it seemed like a great decision. It has yet to arrive at the finish line, but the company continues to show steady advancement toward its goal.

The only other really interesting junior that we follow in the gold and silver space is Solitario Exploration & Royalty Corp. (SLR:TSX). It owns the Mt. Hamilton gold project. We consider that to be an exceptional small-scale project; the company is hoping to develop it by itself. The thing we like about Solitario is that it looks for carried interests in projects because then it can sit back and wait for the money to come in. And if the project proves to be unsuccessful, it did not spend its own money on it. Along those lines, Solitario has a 30% carried interest in a zinc mine in Peru with significant upside. There are no initial costs because its partner is carrying the mine to production.

Carried interests are a great scenario for small companies to take— allowing somebody else to develop their assets. Solitario has taken that approach with a few other assets, too. The firm is still in its early stages, and it is hard to assign a value to it today, but it is positioned to move up the value curve. Solitario can develop value for its shareholders without expensing large amounts of capital today and diluting the shares. It is a unique way of doing business for a mining company.

TGR: Can you take a wild guess at what the prices of gold and silver will be in a year?

JR: A year from now, I expect that the price of gold will be in the $1,500/oz range. My rationale for that is twofold. If we look historically at the last four gold cycles, the recovery the year after the bottom has been strong all four times. In fact, it has averaged 25% more than the average price the year following the bottom of each gold cycle. Our latest bottom was $1,192/oz on June 28, 2013. Applying 25% to that for this year, the price averages out to $1,492/oz. I do not believe that we will fully get there this year, though. For one thing, it is clear that there are forces invested in keeping the gold price down for the immediate future. But $1,500/oz is a doable number, if based solely on the cost of production methodology that I explained.

Silver tends to be more volatile, when it does move. Silver could be significantly higher than our $25/oz number for 2015, which is a bit less than the movement in gold on a percentage basis. That is based on the expectation of a 20% margin on the $20/oz cost producers, of course.

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On the other hand, if enough mining companies manage to save 5% across the board on cash costs, that could move gold and silver prices down by 5% as well. And vice versa. If the cost of mining were to rally up again, that could result in even higher precious metal prices.

The other thing that affects price concerns crisis situations around the world. Currently, the Ukraine issue is important, although it does not look as if the U.S. will become involved there militarily. Military engagement between the U.S. and Russia would be a bad thing for the global economy. But there are goldbugs out there who are betting on gold prices rising due to the possibility of war. The gold price could go up in a war scenario, but I do not advocate that as a rationale for buying gold. On the other side of that coin, when political situations diffuse there can be pullbacks in gold and silver pricing. But timing pullbacks tied to worldwide political issues is very tough to calculate, as are wars.

TGR: You mentioned that there are people with a vested interest in keeping the price of gold down.

JR: The most heavily shorted stock on the Toronto Stock Exchange is Kinross Gold Corp. (K:TSX; KGC:NYSE), and there are a number of other gold companies with large short positions on them. There are also some large-scale trading shorts on gold by the larger banks, which were put into place as gold declined from $1,600/oz to $1,200/oz. There is some concern that some of those might be in the red today, because they were still putting shorts into place when the gold price was around $1,200/oz. If that is the case, it is in the best interests of the short holders to encourage the bear argument against gold. The bearish swaying of the investor mentality causes an additional bear movement on gold that is *not* supported by the fundamentals of gold production. Avoid the bears.

TGR: Thanks a lot, Joe.

JR: Thank you, Peter.

Joe Reagor is a research analyst with ROTH Capital Partners, providing equity research coverage of the natural resources sector. Prior to ROTH, he worked in equity research at Global Hunter Securities and at Very Independent Research, covering a wide array of resources companies including metals (steel and aluminum), mining (gold, silver and *base metals) and forest products (containerboard, OCC, UFS, and pulp). Reagor earned a Bachelor of Arts in economics and mathematics from Monmouth University.*

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