EDISON

# Wheaton Precious Metals

Q3 results

## Good operations offset by prices & finance costs

Metals & mining

**Production of gold, silver and palladium attributable to WPM from its streaming assets were all better than our expectations in Q3, as a result of which the company expects to exceed its previous guidance for FY18. Gold once again surpassed silver as WPM's biggest sales contributor. However, the company's financial performance was restrained by a 122.1% increase in financing costs, as net debt increased by 46.0% after WPM's investment of US$500m in the Stillwater stream earlier this year.**

| Year end | Revenue (US$m) | PBT* (US$m) | EPS* (c) | DPS (c) | P/E (x) | Yield (%) |
|---|---|---|---|---|---|---|
| 12/16 | 891.6 | 269.8 | 62 | 21 | 26.0 | 1.3 |
| 12/17 | 843.2 | 277.4 | 63 | 33 | 25.6 | 2.0 |
| 12/18e | 792.8 | 210.4 | 47 | 34 | 34.2 | 2.1 |
| 12/19e | 844.6 | 216.0 | 49 | 33 | 33.1 | 2.1 |

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

## Forecasts updated for weak gold and silver prices

Notwithstanding positive operational news, continued weakness in the prices of precious metals over the course of the past five months has caused us to revise downwards our silver price forecast from US$15.49/oz Ag to US$14.32/oz for Q418 and from US$22.21/oz to US$15.30/oz (a decline of 31.1%) for FY19, which has had an inevitable knock-on effect on our financial forecasts (see Exhibits 5 & 8).

## Salobo expands again

On 24 October, Vale announced the approval of the Salobo III brownfields mine expansion to increase processing capacity by 50% from H122. We forecast that WPM will make a US$603m payment to maintain its interest of 75% in Salobo's expanded gold output. This compares to its purchase of a 25% stream for c US$820.8m in Aug '17 and US$900m for another 25% stream in Aug '17.

## Cameco tax court victory vs CRA

Although there have been no major developments regarding WPM's dispute with the Canadian Revenue Agency (CRA), in September, Cameco scored a notable victory against the CRA in a similar case involving transfer pricing and overseas subsidiary structures.

## Valuation: C$42.97 in FY20

Assuming no material purchases of additional streams, we forecast a value per share for WPM of US$32.48, or C$42.97 in FY20 at average precious metals prices of US$25.95/oz Ag and US$1,482/oz Au. This valuation excludes the value of 20.9m shares in First Majestic held by WPM, with an immediate value of C$150.4m, or US$0.27 per WPM share. In the meantime, WPM's shares are trading on near-term financial ratios that are cheaper than those of its royalty/streaming 'peers' in at least 83% of financial measures considered in Exhibit 7, and the miners themselves in at least 42% of the same measures, despite being associated with materially less operating and cost risk.

**26 November 2018**

| | |
|---|---|
| **Price** | **C$21.30** |
| **Market cap** | **C$9bn** |
| | C$1.3231/US$ |
| Net debt* (US$m) at 30 September 2018 *Cum-dividend of US$39.9m | 1,261.1 |
| Shares in issue | 443.6m |
| Free float | 100% |
| Code | WPM |
| Primary exchange | TSX |
| Secondary exchange | NYSE |

### Share price performance


| % | 1m | 3m | 12m |
|---|---|---|---|
| Abs | (6.8) | (8.6) | (23.3) |
| Rel (local) | (5.1) | (0.6) | (17.8) |
| 52-week high/low | | C$29.7 | C$20.1 |

### Business description

Wheaton Precious Metals is the world's pre-eminent ostensibly precious metals streaming company, with c 30 high-quality, precious metals streaming and early deposit agreements relating to assets in Mexico, Peru, Canada, Brazil, Chile, Argentina, Sweden, Greece, Portugal and the US etc.

### Next events

| | |
|---|---|
| FY18/Q418 results | March 2019 |
| First quarterly dividend announced | March 2019 |

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***Wheaton Precious Metals is a research client of Edison Investment Research Limited***

## Investment summary

Production of gold, silver and palladium attributable to Wheaton Precious Metals from its streaming assets were all better than our expectations in Q3. As a result, the company expects to exceed its guidance of 355koz Au and 22.5Moz Ag for the full year. Gold once again surpassed silver as WPM's biggest sales contributor, accounting for 58.1% of the total, compared to silver's 40.0%. After being closely correlated in Q218, sales of both gold and silver fell back to close to their long-term averages relative to production (being a 12.1% and a 12.0% under-sale, respectively – see below). However, WPM's financial performance was restrained by continued weakness in precious metals' prices plus a 122.1% increase in financing costs, as net debt increased from US$863.8m at the end of Q218 to US$1,261.1m at the end of Q3 after the company's US$500m investment in the Stillwater gold/palladium stream (see our note, Wheaton Precious Metals: Palladium ex machina, published on 24 July 2018). A full analysis of WPM's Q3 results relative to both Q218 and also Edison's prior expectations is provided in the table below:

**Exhibit 1: Wheaton Precious Metals Q318 results cf Q218 and Q318e, by quarter***

| US$000s (unless otherwise stated) | Q117 | Q217 | Q317 | Q417 | Q118 | Q218 | Q318e | Q318 | Chg** (%) | Diff*** (%) | Diff*** (units) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Silver production (koz) | 6,513 | 7,192 | 7,595 | 7,211 | 7,428 | 6,091 | 4,861 | 5,701 | -6.4 | 17.3 | 840 |
| Gold production (oz) | 84,863 | 78,127 | 95,897 | 96,474 | 79,657 | 85,292 | 92,856 | 101,552 | 19.1 | 9.4 | 8,696 |
| Palladium production (koz) | 0 | 0 | 0 | 0 | 0 | 0 | 5,200 | 8,817 | N/A | 69.6 | 3,617 |
| Silver sales (koz) | 5,225 | 6,369 | 5,758 | 7,292 | 6,343 | 5,972 | 4,861 | 5,018 | -16.0 | 3.2 | 157 |
| Gold sales (oz) | 88,397 | 71,965 | 82,548 | 94,295 | 69,973 | 87,140 | 92,829 | 89,242 | 2.4 | -3.9 | -3,587 |
| Palladium sales (koz) | 0 | 0 | 0 | 0 | 0 | 0 | 5,179 | 3,668 | N/A | -29.2 | -1,511 |
| Avg realised Ag price (US$/oz) | 17.45 | 17.09 | 16.87 | 16.75 | 16.73 | 16.52 | 15.49 | 14.80 | -10.4 | -4.5 | -1 |
| Avg realised Au price (US$/oz) | 1,208 | 1,263 | 1,283 | 1,277 | 1,330 | 1,305 | 1,225 | 1,210 | -7.3 | -1.2 | -15 |
| Avg realised Pd price (US$/oz) | N/A | N/A | N/A | N/A | N/A | N/A | 914 | 955 | N/A | 4.5 | 41 |
| Avg Ag cash cost (US$/oz) | 4.54 | 4.51 | 4.43 | 4.48 | 4.49 | 4.54 | 4.74 | 5.04 | 11.0 | 6.3 | 0 |
| Avg Au cash cost (US$/oz) | 391 | 393 | 396 | 399 | 399 | 407 | 412 | 418 | 2.7 | 1.5 | 6 |
| Avg Pd cash cost (US$/oz) | N/A | N/A | N/A | N/A | N/A | N/A | 165 | 169 | N/A | 2.4 | 4 |
| | | | | | | | | | | | |
| Sales | 197,951 | 199,684 | 203,034 | 242,547 | 199,252 | 212,400 | 193,747 | 185,769 | -12.5 | -4.1 | -7,978 |
| **Cost of sales** | | | | | | | | | | | |
| Cost of sales, excluding depletion | 58,291 | 56,981 | 58,234 | 70,295 | 56,414 | 62,580 | 62,078 | 63,202 | 1.0 | 1.8 | 1,124 |
| Depletion | 63,943 | 59,772 | 61,852 | 76,813 | 57,265 | 62,494 | 70,173 | 64,684 | 3.5 | -7.8 | -5,489 |
| Total cost of sales | 122,234 | 116,753 | 120,086 | 147,108 | 113,679 | 125,074 | 132,251 | 127,886 | 2.2 | -3.3 | -4,365 |
| Earnings from operations | 75,717 | 82,931 | 82,948 | 95,439 | 85,573 | 87,326 | 61,496 | 57,883 | -33.7 | -5.9 | -3,613 |
| **Expenses and other income** | | | | | | | | | | | |
| - General and administrative**** | 7,898 | 9,069 | 8,793 | 8,913 | 9,757 | 11,972 | 8,750 | 8,779 | -26.7 | 0.3 | 29 |
| - Foreign exchange (gain)/loss | | 41 | 163 | 66 | -170 | 26 | | 0 | -100.0 | N/A | 0 |
| - Net interest paid/(received) | 6,373 | 6,482 | 6,360 | 5,778 | 5,591 | 5,659 | 5,797 | 12,877 | 127.5 | 122.1 | 7,080 |
| - Other (income)/expense | 94 | 283 | 1,317 | (10,093) | 2,757 | 466 | | 1,301 | 179.2 | N/A | 1,301 |
| Total expenses and other income | 14,365 | 15,875 | 16,633 | 4,664 | 17,935 | 18,123 | 14,547 | 22,957 | 26.7 | 57.8 | 8,410 |
| Earnings before income taxes | 61,352 | 67,056 | 66,315 | 90,775 | 67,638 | 69,203 | 46,949 | 34,926 | -49.5 | -25.6 | -12,023 |
| Income tax expense/(recovery) | 128 | (556) | (263) | (195) | -485 | -3,224 | | 905 | -128.1 | N/A | 905 |
| Marginal tax rate (%) | 0.2 | (0.8) | (0.4) | (0.2) | -0.7 | -4.7 | 0.0 | 2.6 | -155.3 | N/A | 2.6 |
| Net earnings | 61,224 | 67,612 | 66,578 | 90,970 | 68,123 | 72,427 | 46,949 | 34,021 | -53.0 | -27.5 | -12,928 |
| Avg no. shares in issue (000s) | 441,484 | 441,784 | 442,094 | 442,469 | 442,728 | 443,191 | 443,191 | 443,634 | 0.1 | 0.1 | 443 |
| Basic EPS (US$) | 0.14 | 0.15 | 0.15 | 0.21 | 0.15 | 0.16 | 0.11 | 0.08 | -50.0 | -27.3 | 0 |
| Diluted EPS (US$) | 0.14 | 0.15 | 0.15 | 0.21 | 0.15 | 0.16 | 0.11 | 0.08 | -50.0 | -27.3 | 0 |
| DPS (US$) | 0.07 | 0.07 | 0.10 | 0.09 | 0.09 | 0.09 | 0.09 | 0.09 | 0 | 0 | 0 |

Source: Wheaton Precious Metals, Edison Investment Research. Note: *As reported, excluding exceptional items. **Q318 vs Q218. ***Q318 actual vs Q318 estimate. ****Quarterly forecasts exclude stock-based compensation costs.

From an operational perspective, even those assets that recorded year-on-year reductions in output (eg Penasquito and Antamina) performed close to, or better than, our expectations, with the exception of Sudbury, where scheduled maintenance occurred in August cf June in the prior year, and WPM's 'Other' gold assets (Minto, in particular). Output from Penasquito decreased 36.0% cf

Q317, for example, as a result of a planned transition from higher grade ore in the Penasco pit to lower grade ore from stockpiles during the first three quarters of 2018 in order to facilitate the stripping campaign in the Penasco pit and the pre-stripping campaign in the newly developed Chile Colorado pit and also to accommodate the commissioning of the new Pyrite Leach Project (PLP) circuit. Commissioning of the PLP commenced during Q3 (two quarters ahead of the original schedule), in line with Goldcorp's accelerated timetable, and commercial production is anticipated in Q418. Within this context, the operator of the mine, Goldcorp, noted that production in Q3 was affected by a reduction in mill throughput as much harder low-grade stockpiles were processed during commissioning of the carbon pre-flotation plant (a component of the PLP). However, any production shortfall in Q3 is anticipated to be recouped in Q4 when the mine will re-sequence to both higher grades (from the main Penasco pit) and mill tonnage in the aftermath of the commissioning. The PLP is forecast to add c 1Moz gold and 44Moz silver to production over the current life of the mine, by recovering 40% Au and 48% Ag that currently report to tailings.

Otherwise, Hudbay reported record mill throughput and higher grades at Constancia, while San Dimas benefitted from increased recoveries as a result of the installation of an additional agitator tank in September in order to increase retention times. Finally, Stillwater produced materially more gold and palladium than anticipated in its maiden quarter for WPM, albeit partly as a result of a technicality, whereby Wheaton was entitled to its share of production for which an offtaker payment was received after 1 July 2018, which resulted in reported production in Q3 also including some material processed in Q2.

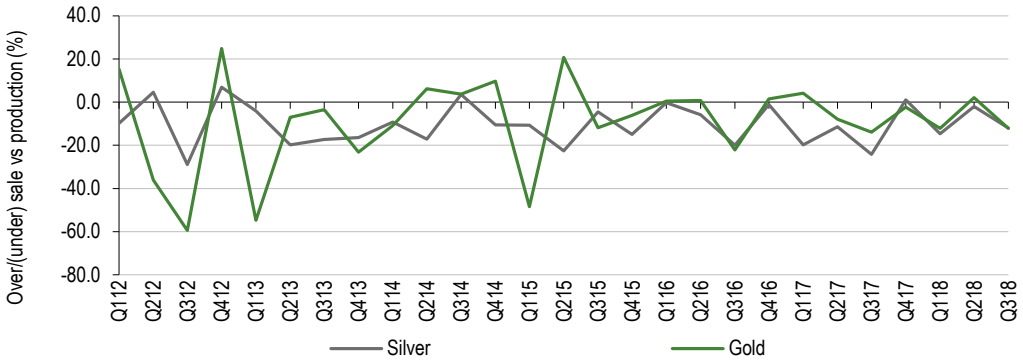
### Minto

Minto produced 2.5Moz of gold attributable to WPM in Q318. As per Capstone Mining's announcement of 11 October, the agreement under which Capstone was to sell its Minto mine to Pembridge Resources has been terminated, as a result of which Capstone has elected to place the mine on care and maintenance while it seeks to preserve and maximise the value of its asset. Edison had expected Minto to produce 12,509oz of gold attributable to WPM in FY19, declining to 2,329oz in FY22. In the light of Capstone's announcement however, these have now been removed from our forecasts (see Exhibits 4, 5 and 8).

## Ounces produced but not yet delivered – aka inventory

After being closely correlated with production in Q218, sales of both gold and silver reverted to close to their long-term averages, being a 12.1% under-sale of gold relative to production (cf a long-term average of 8.8%) and a 12.0% under-sale of silver (cf a long-term average of 10.3%) in Q3:

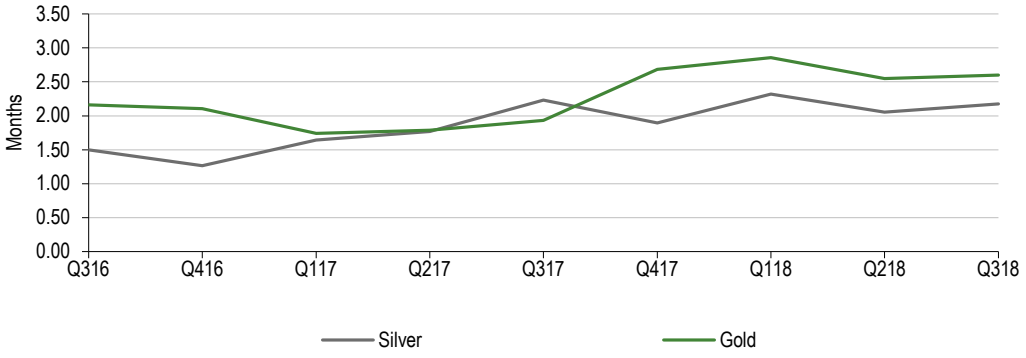
**Exhibit 2: Over/(under) sale of silver and gold as a % of production, Q112–Q318**




Source: Edison Investment Research, Wheaton Precious Metals

As at 30 September, payable ounces attributable to WPM produced but not yet delivered amounted to 4.5Moz silver and 77,100oz gold (cf 4.3Moz silver and 75,600oz gold in June and 4.8Moz silver and 84,400oz gold reported in March). This 'inventory' equates to 2.17 months and 2.60 months of forecast FY18 silver and gold production respectively (cf 2.12 months and 2.59 months in Q218 and 2.48 months and 2.88 months in Q417) and compares with WPM's target level of two months of annualised production for silver, and two to three months of annualised gold and palladium production.

**Exhibit 3: WPM ounces produced but not yet delivered, Q316–Q318 (months of production)**




Source: Edison Investment Research, Wheaton Precious Metals

Note that, for these purposes, the use of the term 'inventory' reflects ounces produced by WPM's operating counterparties at the mines over which it has streaming agreements, but which have not yet been delivered to WPM. It in no way reflects the other use of the term in the mining industry itself, where it typically refers to metal in circuit (among other things), and may therefore (under certain circumstances) be considered to be a consequence of metallurgical recoveries in the plant.

## Medium-term outlook

In the light of the Q3 results, WPM has stated that it is "on track to exceed" its production forecast for 2018 of c 355koz of gold, 22.5Moz of silver and 10,400oz of palladium. Within this context, our forecasts for attributable gold, silver and palladium production in FY18 are now 356koz, 24.8Moz and 14,017oz, respectively (see Exhibits 4 and 5). WPM also estimates average annual attributable production over the next five years to be approximately 385,000oz of gold, 25.0Moz of silver, 27,000oz of palladium and (from FY21) 2.1Mlbs of cobalt per annum. These compare with our expectations, as follows:

**Exhibit 4: WPM precious metals production – Edison forecasts vs guidance**

| | FY18e | FY19e | FY20e | FY21e | FY22e |
|---|---|---|---|---|---|
| **Previous Edison forecast** | | | | | |
| Silver production (Moz) | 24.0 | 22.3 | 23.0 | 23.9 | 23.7 |
| Gold production (koz) | 351 | 385 | 352 | 348 | 353 |
| Cobalt production (klbs) | 0 | 0 | 0 | 2,100 | 2,100 |
| Palladium production (koz) | 10.4 | 27 | 27 | 27 | 27 |
| | | | | | |
| **Current Edison forecast** | | | | | |
| Silver production (Moz) | 24.8 | 22.5 | 23.0 | 21.3 | 23.0 |
| Gold production (koz) | 356 | 372 | 348 | 335 | 344 |
| Cobalt production (klbs) | 0 | 0 | 0 | 2,100 | 2,100 |
| Palladium production (koz) | 14.0 | 27 | 27 | 27 | 27 |
| | | | | | |
| **Company guidance** | | | | | |
| Silver production (Moz) | 22.5 | 25.0 | 25.0 | 25.0 | 25.0 |
| Gold production (koz) | 355 | 385 | 385 | 385 | 385 |
| Cobalt production (klbs) | 0 | 0 | 0 | 2,100 | 2,100 |
| Palladium production (koz) | 10.4 | 27 | 27 | 27 | 27 |

Source: Company guidance, Edison Investment Research forecasts

In the immediate future, silver output from Penasquito attributable to WPM is expected to recover back to its steady-state level of 7Moz as the Chile Colorado pit contributes to mill feed ahead of schedule in CY18 and grades improve once again with mine sequencing. It will also benefit from the development of the Pyrite Leach Project from Q418 onwards, which will add an additional 1.0–1.5Moz of silver attributable to WPM per year. At the same time, mining at Constancia will start at the Pampacancha pit in FY19, which hosts significantly higher gold grades than those mined hitherto and of which WPM will now be entitled to an increased portion.

# Longer-term outlook

## Salobo

On 24 October, Vale announced the approval of the Salobo III brownfields mine expansion, intended to increase processing capacity at Salobo from 24Mtpa to 36Mtpa, with start-up scheduled for H122 and an estimated ramp up time of 15 months. According to its agreement with Vale, if throughput is expanded above 28Mtpa within a predetermined period and, depending on the grade of the material processed, WPM will be required to make an additional payment to Vale, which it estimates to be in the range US$550-650m in FY23, in return for which it is entitled to its full 75% attributable share of gold production. As such, the expansion is equivalent to WPM buying a 37.5% stream for US$603m (Edison estimate) which compares to its purchase of a 25% stream in August 2017 for an estimated consideration of US$820.8m (including re-negotiated warrants and cost inflation terms) and the US$900m it paid in March 2015 (when the gold price averaged US$1,179/oz) for another 25% gold stream from Salobo (see our note, Silver Wheaton: Going for gold, published on 30 August 2016).

## Potential future growth

WPM is ostensibly a precious metals streaming company (plus one cobalt stream). Considering only the silver component of its investible universe, WPM estimates the size of the potential market open to it to be the lower half of the cost curve of the 70% of global silver production of c 870Moz in FY17 that is produced as a by-product of either gold or base metal mines (ie approximately 305Moz pa silver cf WPM's production of 28.5Moz Ag in FY17). Inevitably, WPM's investible universe would be further refined by the requirement for the operations to be located in good mining jurisdictions, with relatively low political risk. Nevertheless, such figures serve to illustrate the fact that WPM's marketplace is far from saturated or mature.

As a consequence, WPM reports that it is busy on the corporate development front. It has the potential for up to six deals with a value in the range US$100-300m, thus fully financeable via the c US$0.74bn available to WPM under its revolving credit facility as at the end of Q318.

While it is difficult, or impossible, to predict potential future stream acquisition targets with any degree of certainty, it is perhaps possible to highlight two that may be of interest to WPM in due course for which it already has strong, existing counterparty relationships:

- the platinum group metal (PGM) by-product stream at Sudbury; and
- the 50% of the gold output at Constancia that is currently not subject to any streaming arrangement.

One further, major project moving closer to fruition is the Rosemont copper project in Arizona (operated by Hudbay), after Coronado National Forest Supervisor Kerwin Dewberry signed the final Record of Decision (ROD) for the Rosemont copper project in June 2017. The ROD outlines the supervisor's decision to select the Barrel Alternative and approve the mine plan of operations once amended, and to amend the 1986 Coronado National Forest Plan by creating a new management area around the mine site. This advance follows a preliminary green light provided by the US Forest Service when the latter announced the release of a draft ROD earlier in the year, saying that the project, as it now stands, meets current law which, in turn, allowed other federal agencies to proceed with permitting requests. Currently, Hudbay is awaiting what could be the final step in getting approval for the mine, which is the Army Corps of Engineers' issuance of a Section 404 permit, which regulates the discharge of fill material into waterways according to the Clean Water Act. The proposed mine is located near a number of large porphyry-type producing copper mines and is expected to be one of the largest copper mines in the US with output of c 112,000t copper in concentrate per year and accounting for c 10% of total US copper production. Total by-product production of silver and gold attributable to WPM will be c 2.7Moz Ag pa and c 16,100oz Au pa, or c 3.9Moz silver equivalent pa. We estimate it will contribute an average c US$0.11 per share to WPM's basic EPS in its first nine years of operations from FY22-30 for an upfront payment of US$230m (equivalent to US$0.52/share) spread over three years.

# Other matters

## General and administrative expenses

WPM is continuing to forecast non-stock general and administrative expenses in the range of US$34–36m for the full year ie c US$8.5–9.0m per quarter, including all employee-related expenses, charitable contributions and additional legal costs relating to WPM's dispute with the CRA. Investors should note that our financial forecasts in Exhibits 5 and 8 exclude stock-based compensation costs.

# FY18 by quarter

In addition to reducing forecast production from the Minto mine attributable to WPM in Q4, we have also adjusted our forecasts to reflect recent falls in the prices of both gold and silver for the remainder of the year.

**Exhibit 5: Wheaton Precious Metals FY18 forecast, by quarter***

| US$000s (unless otherwise stated) | Q118 | Q218 | Q318 | Q418e (previous) | Q418e (current) | FY18e (previous) | FY18e (current) |
|---|---|---|---|---|---|---|---|
| Silver production (koz) | 7,428 | 6,091 | 5,701 | 5,661 | 5,623 | 24,041 | 24,843 |
| Gold production (oz) | 79,657 | 85,292 | 101,552 | 92,856 | 89,516 | 350,660 | 356,017 |
| Palladium production (oz) | 0 | 0 | 8,817 | 5,200 | 5,200 | 10,400 | 14,017 |
| Silver sales (koz) | 6,343 | 5,972 | 5,018 | 5,661 | 5,627 | 22,837 | 22,960 |
| Gold sales (oz) | 69,973 | 87,140 | 89,242 | 92,829 | 89,914 | 342,770 | 336,269 |
| Palladium sales (oz) | 0 | 0 | 3,668 | 5,179 | 5,179 | 10,358 | 8,847 |
| Avg realised Ag price (US$/oz) | 16.73 | 16.52 | 14.80 | 15.49 | 14.32 | 16.11 | 15.66 |
| Avg realised Au price (US$/oz) | 1,330 | 1,305 | 1,210 | 1,225 | 1,213 | 1,267 | 1,261 |
| Avg realised Pd price (US$/oz) | N/A | N/A | 955 | 914 | 1,111 | 914 | 1,046 |
| Avg Ag cash cost (US$/oz) | 4.49 | 4.54 | 5.04 | 4.66 | 4.88 | 4.60 | 4.72 |
| Avg Au cash cost (US$/oz) | 399 | 407 | 418 | 412 | 415 | 408 | 410 |
| Avg Pd cash cost (US$/oz) | N/A | N/A | 169 | 165 | 200 | 165 | 187 |
| | | | | | | | |
| Sales | 199,252 | 212,400 | 185,769 | 206,139 | 195,403 | 811,538 | 792,824 |
| **Cost of sales** | | | | | | | |
| Cost of sales, excluding depletion | 56,414 | 62,580 | 63,202 | 65,414 | 65,809 | 246,485 | 248,005 |
| Depletion | 57,265 | 62,494 | 64,684 | 72,541 | 71,579 | 262,474 | 256,022 |
| Total cost of sales | 113,679 | 125,074 | 127,886 | 137,955 | 137,388 | 508,959 | 504,027 |
| Earnings from operations | 85,573 | 87,326 | 57,883 | 68,184 | 58,015 | 302,579 | 288,797 |
| **Expenses and other income** | | | | | | | |
| - General and administrative** | 9,757 | 11,972 | 8,779 | 8,750 | 8,750 | 39,229 | 39,258 |
| - Foreign exchange (gain)/loss | (170) | 26 | 0 | | | (144) | (144) |
| - Net interest paid/(received) | 5,591 | 5,659 | 12,877 | 5,797 | 14,970 | 22,844 | 39,097 |
| - Other (income)/expense | 2,757 | 466 | 1,301 | | | 3,223 | 4,524 |
| Total expenses and other income | 17,935 | 18,123 | 22,957 | 14,547 | 23,720 | 65,152 | 82,735 |
| Earnings before income taxes | 67,638 | 69,203 | 34,926 | 53,637 | 34,295 | 237,427 | 206,062 |
| Income tax expense/(recovery) | (485) | (3,224) | 905 | | | (3,709) | -2,804 |
| Marginal tax rate (%) | (0.7) | (4.7) | 2.6 | 0.0 | 0.0 | (1.6) | (1.4) |
| Net earnings | 68,123 | 72,427 | 34,021 | 53,637 | 34,295 | 241,136 | 208,866 |
| Ave. no. shares in issue (000s) | 442,728 | 443,191 | 443,634 | 443,191 | 443,634 | 443,075 | 443,297 |
| Basic EPS (US$) | 0.15 | 0.16 | 0.08 | 0.12 | 0.08 | 0.54 | 0.47 |
| Diluted EPS (US$) | 0.15 | 0.16 | 0.08 | 0.12 | 0.08 | 0.54 | 0.47 |
| DPS (US$) | 0.09 | 0.09 | 0.09 | 0.08 | 0.07 | 0.35 | 0.34 |

Source: Wheaton Precious Metals, Edison Investment Research. Note: *Excluding impairments and exceptional gains. **Forecasts exclude stock-based compensation costs. Totals may not add up owing to rounding.

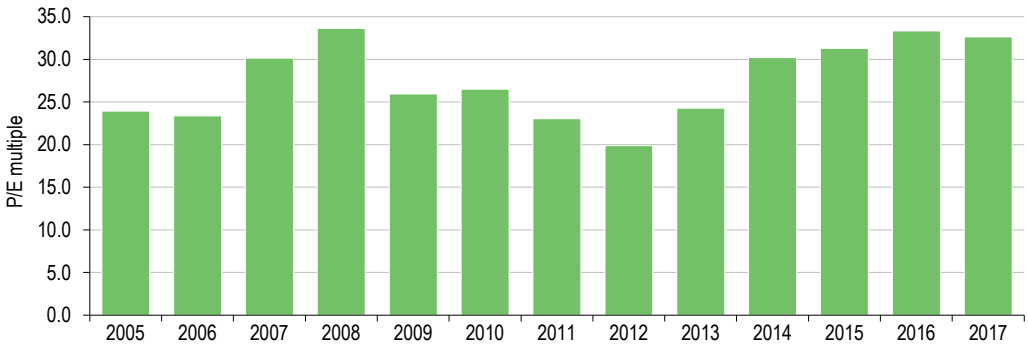
Our forecast basic EPS of US$0.47/share compares with a consensus forecast of US$0.515/share (source: Bloomberg 15 November), within an erstwhile range of US$0.49–0.57 per share.

In the meantime, we adjust our FY19 EPS forecast (see Exhibit 8) to exclude production and sales from Minto and also to reflect a silver price of US$15.30/oz cf US$22.21/oz previously (ie c 30% lower) . Within this context, our US$0.49 basic EPS forecast compares with a consensus of US$0.561 (source: Bloomberg 15 November), within an erstwhile range of US$0.37–0.81.

## Valuation

Excluding FY04 (part-year), WPM's shares have historically traded on a contemporary average P/E multiple of 27.6x current year basic underlying EPS, ie excluding impairments (cf 34.2x Edison or 30.6x Bloomberg consensus FY18e, currently – see Exhibit 7).

**Exhibit 6: WPM's historical current year P/E multiples**




Source: Edison Investment Research

Applying this multiple to our updated EPS forecast of US$1.18 in FY20 (cf US$1.20 in FY21 previously) implies a potential value per share for WPM of US$32.48, or C$42.97 in that year (cf US$33.00, or C$43.25 in FY21 previously). Note that this valuation excludes the value of 20.9m shares in First Majestic currently held by WPM, with an immediate value of C$150.4m, or US$0.27 per WPM share (priced as at 15 November).

In the meantime, from a relative perspective, it is notable that WPM is cheaper than its royalty/streaming 'peers' in 83% (20 out of 24) of the valuation measures used in Exhibit 7 and on multiples that are cheaper than the miners themselves in at least 42% (38 out of 90) of the same valuation measures (effectively irrespective of whether Edison or consensus forecasts are used), despite being associated with materially less operational and cost risk (as WPM's costs are contractually predetermined).

**Exhibit 7: WPM comparative valuation vs a sample of operating and royalty/streaming companies**

| | P/E (x) | | Yield (%) | | P/CF (x) | |
|---|---|---|---|---|---|---|
| | Year 1 | Year 2 | Year 1 | Year 2 | Year 1 | Year 2 |
| **Royalty companies** | | | | | | |
| Franco-Nevada | 54.6 | 49.5 | 1.5 | 1.6 | 24.8 | 21.9 |
| Royal Gold | 44.5 | 33.3 | 1.4 | 1.4 | 16.2 | 14.5 |
| Sandstorm Gold | 66.1 | 44.9 | 0.0 | 0.0 | 14.0 | 11.8 |
| Osisko | 94.0 | 50.0 | 2.1 | 2.1 | 18.9 | 16.8 |
| **Average** | **64.8** | **44.4** | **1.2** | **1.3** | **18.5** | **16.3** |
| **WPM (Edison forecasts)** | **34.2** | **33.1** | **2.1** | **2.1** | **14.8** | **14.5** |
| **WPM (consensus)** | **30.6** | **28.2** | **2.3** | **2.2** | **14.3** | **13.6** |
| **Gold producers** | | | | | | |
| Barrick | 30.2 | 25.6 | 1.0 | 1.1 | 6.8 | 7.1 |
| Newmont | 26.0 | 23.2 | 1.8 | 1.7 | 8.7 | 8.0 |
| Goldcorp | 124.9 | 22.5 | 0.9 | 0.9 | 7.6 | 5.1 |
| Newcrest | 22.2 | 16.6 | 1.3 | 1.6 | 8.9 | 7.7 |
| Kinross | 22.1 | 26.1 | 0.0 | 0.0 | 3.5 | 3.3 |
| Agnico-Eagle | 185.8 | 57.9 | 1.3 | 1.3 | 12.5 | 10.5 |
| Eldorado | -ve | -ve | 0.3 | 0.5 | 6.4 | 4.3 |
| Yamana | 19.5 | 17.5 | 1.0 | 1.0 | 3.8 | 3.6 |
| Randgold Resources | 27.6 | 22.3 | 3.3 | 4.5 | 13.9 | 11.0 |
| **Average** | **57.3** | **26.5** | **1.2** | **1.4** | **8.0** | **6.7** |
| **Silver producers** | | | | | | |
| Hecla | -ve | 71.6 | 0.4 | 0.4 | 9.5 | 6.3 |
| Pan American | 26.3 | 21.5 | 1.1 | 1.5 | 10.4 | 9.4 |
| Coeur Mining | -ve | 45.8 | 0.0 | 0.0 | 10.4 | 4.3 |
| First Majestic | -ve | 41.2 | 0.0 | 0.0 | 14.1 | 7.2 |
| Hocschild | 39.7 | 20.3 | 2.0 | 2.1 | 4.5 | 4.0 |
| Fresnillo | 18.9 | 17.6 | 2.8 | 2.8 | 9.7 | 9.3 |
| **Average** | **28.3** | **36.3** | **1.0** | **1.1** | **9.8** | **6.7** |

Source: Bloomberg, Edison Investment Research. Note: Peers priced on 14 November 2018.

## Financials: Solid equity base

As at 30 June 2018, WPM had US$119.4m in cash (before a dividend of c US$39.9m payable on or about 13 December) and US$1,380.5m of debt outstanding under its US$2bn revolving credit facility (which attracts an interest rate of Libor plus 120–220bp and matures in February 2023), such that it had net debt of US$1,261.1m overall, after US$108.4m (US$0.24/share) of cash inflows from operating activities during the quarter. Relative to the company's Q3 balance sheet equity of US$5,187.2m, this level of net debt equated to a financial gearing (net debt/equity) ratio of 24.3% and a leverage (net debt/[net debt+equity]) ratio of 19.6%. It also compares with a net debt position of US$863.8m as at 30 June 2018 and US$547.4m as at 31 March 2018.

In the aftermath of the Stillwater palladium stream acquisition, we now estimate that WPM's net debt position will be US$1,232.0m by the end of FY18, which will equate to gearing of 24.8% and leverage of 19.9%, and that WPM will be net debt free in early 2021, all other things being equal and contingent on its making no further major acquisitions (which is unlikely, in our view). Self-evidently, such a level of debt is well within the tolerances required by its banking covenants that:

- net debt should be no more than 0.75x tangible net worth (which was US$5,187.2m at the end of Q318 and which we now forecast to be US$4,958.7m at the end of FY18); and
- interest should be no less than 3x covered by EBITDA (we estimate that net interest was covered 22.6x in FY17 and that it will be covered 12.9x in FY18).

We note that the C$191.7m letter of guarantee that WPM has posted regarding 50% of the disputed taxes relating to its dispute with the CRA (see below) has been determined under a separate agreement and is therefore specifically excluded from calculations regarding WPM's banking covenants.

## Canadian Revenue Agency

There have been no further substantive developments regarding WPM's dispute with the CRA since our update note of 15 February 2016, with the exception of Cameco's (CCO) victory against the CRA in the Tax Court of Canada in September 2018 in a case involving similar transfer pricing and overseas subsidiaries' structures as WPM (see below).

In its case, WPM notes that the CRA's position is that the transfer pricing provisions of the Income Tax Act (Canada) in relation to income earned by WPM's foreign subsidiaries should apply "such that the income of Silver Wheaton [sic] subject to tax in Canada should be increased by an amount equal to substantially all of the income earned outside of Canada by the company's foreign subsidiaries for the 2005-2010 taxation years." Should this interpretation be upheld, we would expect it to have potentially profound consequences for Canada's status as a supplier of finance and capital to overseas destinations in general (ie not just for the mining industry).

Moreover, in September, the Tax Court of Canada ruled in Cameco's favour in a very similar case between the uranium miner and the CRA, which centred on Cameco's use of a subsidiary in Switzerland to trade its uranium. Cameco set up its Swiss subsidiary in 1999 and established a 17-year deal whereby the former sold its uranium to the latter at c US$10/lb, which is roughly the level it was trading at at the time, and the latter then on-sold the uranium to end-users. To the extent that the spot price exceeded this level, the Swiss subsidiary was able to record a profit (on which it paid Swiss taxes); to the extent that it fell short, Cameco was able to record a profit (on which it paid Canadian taxes). The background to the case was that the CRA had re-assessed Cameco essentially to attribute to it the profits that had been earned by its Swiss subsidiary, arguing that the sales and purchase contracts involving the Swiss subsidiary were:

- A "sham" that was ostensibly designed to avoid Canadian taxes and that it should therefore be looked through, and
- Did not meet the arm's-length standard contained in Canada's transfer pricing rules, so as to allow the CRA to either completely ignore the contracts or to revise their terms in accordance with what arm's-length parties would have agreed to.

In general, in seeking to reassess tax, tax authorities test two things:

- The governance (structure) of the corporate entities involved in the transactions; and
- The price at which goods and services are sold by one member of a corporate group to another.

Cameco (the appellant) argued that it had acted properly and that its agreements reflected commercial reality at that time.

In his 293-page decision however (and after a 65-day trial) Justice John R. Owen unequivocally rejected the position of the CRA and, in particular, its attempts to use the 2017 edition of the OECD's Transfer Pricing Guidelines to judge such structures. In rejecting the CRA's position, Justice Owen concluded that, "There had been no deception or sham; the related parties did not factually represent the legal arrangements that they entered into in a manner different from what they knew those arrangements to be, nor did they factually represent the transactions created by those arrangements in a manner different from what they knew those arrangements to be. That [Cameco's European subsidiaries] had been expressly authorized by the Swiss and European nuclear regulatory authorities to carry out the transactions certainly helped to support the taxpayer's position that the transactions were not a sham. There was nothing exceptional, unusual or inappropriate about Cameco Canada's decision to incorporate [Cameco's European subsidiaries] and have the foreign affiliates execute certain arm's length transactions. To the extent this decision raises transfer pricing concerns, the traditional transfer pricing rules should address those concerns. Applying the extraordinary remedy of Canada's recharacterization rules was neither warranted nor appropriate in the circumstances. The results derived from applying the comparable uncontrolled price (CUP) method provided the most reliable measure of an arm's length price for uranium and did not warrant a transfer pricing adjustment under Canada's traditional transfer pricing rules because the prices charged by Cameco during the taxation years in question were well within an arm's length range."

Cameco's case was the first time that the government's ability to re-characterise a transaction was tested in court and the ruling went on to clarify that the CRA has to rely on the same information as a company when setting up such subsidiaries and that it cannot use the benefit of hindsight in retrospectively deciding to pursue the Canadian parent company for taxes on profits earned at the subsidiary level.

In our opinion, in our capacity as equity analysts, the implication of the ruling is that, if done correctly (ie the intercompany contract prices are generally comparable to those established in comparable contracts between arm's-length parties entered into at that time), transfer pricing is a sound and legal business practice.

The ruling only covers Cameco's 2003-06 tax years, but clearly sets a precedent for subsequent years and, potentially, similar cases, such as WPM's.

Subsequently, the CRA announced that it is appealing the decision, albeit not the tax court's ruling that the structures and arrangements were "a sham". In its notice of appeal, filed on 25 October, however, the CRA asserted that Justice Owen had "erred in fact and in law" by finding that the section of the Income Tax Act covering transfer pricing did not apply in this case. According to Cameco, the case, which will be heard in the Federal Court of Appeal, will take approximately two years. In the meantime however, Cameco will make an application to recover its costs from the

original case (despite the agency's appeal). It also said that it expects to be refunded the 50% of tax that it has already paid in relation to the 2003-06 tax years and that any action regarding the 2007-2012 tax years, which have also been reassessed by the agency, be suspended until the existing case is resolved (note that its tax years for 2013 onward have not, to date, been reassessed). Cameco states that it is confident of winning the appeal. It also noted that the decisions of the Federal Court of Appeal are subject to appeal by either party to the country's highest court, the Supreme Court of Canada, if the latter agrees that it is merited, in a process that is likely to take another two years.

In 2017, WPM's CEO, Randy Smallwood, was quoted as saying that the company is willing to settle its tax dispute with the CRA via a payment of C$5–10m "with gritted teeth", but that any such payment should be seen as an appreciation of the costs involved in going to a full trial and also of the effect that the issue is having on WPM's share price rating relative to its peers (see Exhibit 7), rather than as any admission of guilt.

In the meantime, WPM remains in the 'case discovery process' with the CRA, designed to provide both sides with the opportunity to arrive at an out-of-court settlement before formal proceedings commence. If a 'principled' settlement cannot be reached, however, the Tax Court of Canada has scheduled the trial for mid-September 2019 for a two-month period.

**Exhibit 8: Financial summary**

| US$'000s | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018e | 2019e |
|---|---|---|---|---|---|---|---|---|
| Dec | IFRS | IFRS | IFRS | IFRS | IFRS | IFRS | IFRS | IFRS |
| **PROFIT & LOSS** | | | | | | | | |
| Revenue | 849,560 | 706,472 | 620,176 | 648,687 | 891,557 | 843,215 | 792,824 | 844,565 |
| Cost of Sales | (117,489) | (139,352) | (151,097) | (190,214) | (254,434) | (243,801) | (248,005) | (262,755) |
| Gross Profit | 732,071 | 567,120 | 469,079 | 458,473 | 637,123 | 599,414 | 544,819 | 581,810 |
| EBITDA | 701,232 | 531,812 | 431,219 | 426,236 | 602,684 | 564,741 | 505,561 | 542,552 |
| Operating Profit (before amort. and except.) | 600,003 | 387,659 | 271,039 | 227,655 | 293,982 | 302,361 | 249,539 | 265,840 |
| Intangible Amortisation | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Exceptionals | 0 | 0 | (68,151) | (384,922) | (71,000) | (228,680) | 245,715 | 0 |
| Other | 788 | (11,202) | (1,830) | (4,076) | (4,982) | 8,129 | (4,380) | 0 |
| Operating Profit | 600,791 | 376,457 | 201,058 | (161,343) | 218,000 | 81,810 | 490,874 | 265,840 |
| Net Interest | 0 | (6,083) | (2,277) | (4,090) | (24,193) | (24,993) | (39,097) | (49,802) |
| Profit Before Tax (norm) | 600,003 | 381,576 | 268,762 | 223,565 | 269,789 | 277,368 | 210,442 | 216,038 |
| Profit Before Tax (FRS 3) | 600,791 | 370,374 | 198,781 | (165,433) | 193,807 | 56,817 | 451,777 | 216,038 |
| Tax | (14,755) | 5,121 | 1,045 | 3,391 | 1,330 | 886 | 2,804 | 0 |
| Profit After Tax (norm) | 586,036 | 375,495 | 267,977 | 222,880 | 266,137 | 286,383 | 208,866 | 216,038 |
| Profit After Tax (FRS 3) | 586,036 | 375,495 | 199,826 | (162,042) | 195,137 | 57,703 | 454,581 | 216,038 |
| Average Number of Shares Outstanding (m) | 353.9 | 355.6 | 359.4 | 395.8 | 430.5 | 442.0 | 443.3 | 443.6 |
| EPS - normalised (c) | 166 | 106 | 75 | 53 | 62 | 63 | 47 | 48.7 |
| EPS - normalised and fully diluted (c) | 165 | 105 | 74 | 53 | 62 | 63 | 47 | 49 |
| EPS - (IFRS) (c) | 166 | 106 | 56 | (-41) | 45 | 13 | 103 | 49 |
| Dividend per share (c) | 35 | 45 | 26 | 20 | 21 | 33 | 34 | 33 |
| Gross Margin (%) | 86.2 | 80.3 | 75.6 | 70.7 | 71.5 | 71.1 | 68.7 | 68.9 |
| EBITDA Margin (%) | 82.5 | 75.3 | 69.5 | 65.7 | 67.6 | 67.0 | 63.8 | 64.2 |
| Operating Margin (before GW and except.) (%) | 70.6 | 54.9 | 43.7 | 35.1 | 33.0 | 35.9 | 31.5 | 31.5 |
| **BALANCE SHEET** | | | | | | | | |
| Fixed Assets | 2,403,958 | 4,288,557 | 4,309,270 | 5,526,335 | 6,025,227 | 5,579,898 | 6,215,876 | 6,011,164 |
| Intangible Assets | 2,281,234 | 4,242,086 | 4,270,971 | 5,494,244 | 5,948,443 | 5,454,106 | 6,090,084 | 5,885,372 |
| Tangible Assets | 1,347 | 5,670 | 5,427 | 12,315 | 12,163 | 30,060 | 30,060 | 30,060 |
| Investments | 121,377 | 40,801 | 32,872 | 19,776 | 64,621 | 95,732 | 95,732 | 95,732 |
| Current Assets | 785,379 | 101,287 | 338,493 | 105,876 | 128,092 | 103,415 | 3,596 | 3,830 |
| Stocks | 966 | 845 | 26,263 | 1,455 | 1,481 | 1,700 | 1,423 | 1,516 |
| Debtors | 6,197 | 4,619 | 4,132 | 1,124 | 2,316 | 3,194 | 2,172 | 2,314 |
| Cash | 778,216 | 95,823 | 308,098 | 103,297 | 124,295 | 98,521 | 0 | 0 |
| Other | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Current Liabilities | (49,458) | (21,134) | (16,171) | (12,568) | (19,057) | (12,143) | (486,452) | (213,180) |
| Creditors | (20,898) | (21,134) | (16,171) | (12,568) | (19,057) | (12,143) | (24,486) | (25,941) |
| Short term borrowings | (28,560) | 0 | 0 | 0 | 0 | 0 | (461,966) | (187,239) |
| Long Term Liabilities | (32,805) | (1,002,164) | (1,002,856) | (1,468,908) | (1,194,274) | (771,506) | (774,310) | (774,310) |
| Long term borrowings | (21,500) | (998,136) | (998,518) | (1,466,000) | (1,193,000) | (770,000) | (770,000) | (770,000) |
| Other long term liabilities | (11,305) | (4,028) | (4,338) | (2,908) | (1,274) | (1,506) | (4,310) | (4,310) |
| Net Assets | 3,107,074 | 3,366,546 | 3,628,736 | 4,150,735 | 4,939,988 | 4,899,664 | 4,958,710 | 5,027,504 |
| **CASH FLOW** | | | | | | | | |
| Operating Cash Flow | 720,209 | 540,597 | 434,582 | 435,783 | 608,503 | 564,187 | 514,822 | 543,773 |
| Net Interest | 0 | (6,083) | (2,277) | (4,090) | (24,193) | (24,993) | (39,097) | (49,802) |
| Tax | (725) | (154) | (204) | (208) | 28 | (326) | 5,608 | 0 |
| Capex | (641,976) | (2,050,681) | (146,249) | (1,791,275) | (805,472) | (19,633) | (892,000) | (72,000) |
| Acquisitions/disposals | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Financing | 12,919 | 58,004 | 6,819 | 761,824 | 595,140 | 1,236 | 0 | 0 |
| Dividends | (123,852) | (160,013) | (79,775) | (68,593) | (78,708) | (121,934) | (149,820) | (147,243) |
| Net Cash Flow | (33,425) | (1,618,330) | 212,896 | (666,559) | 295,298 | 398,537 | (560,487) | 274,727 |
| Opening net debt/(cash) | (761,581) | (728,156) | 902,313 | 690,420 | 1,362,703 | 1,068,705 | 671,479 | 1,231,966 |
| HP finance leases initiated | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Other | 0 | (12,139) | (1,003) | (5,724) | (1,300) | (1,311) | 0 | (0) |
| Closing net debt/(cash) | (728,156) | 902,313 | 690,420 | 1,362,703 | 1,068,705 | 671,479 | 1,231,966 | 957,239 |

Source: Company sources, Edison Investment Research

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