Transcript of
Fortuna Silver Mines Inc
First Quarter 2018 Financial and Operational Results
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Participants

Carlos Baca – Manager, Investor Relations
Jorge Ganoza – President and Chief Executive Officer
Luis Ganoza – Chief Financial Officer

Analysts

Chris Thompson – PI financial
Don DeMarco – National Bank Financial
Trevor Turnbull – Scotiabank

Presentation

Operator
Welcome to Fortuna Silver Mines First Quarter 2018 Financial and Operational Results. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. [Operator Instructions]. As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Carlos Baca, Investor Relations Manager.

Carlos Baca – Manager, Investor Relations
Good morning, ladies and gentlemen. I would like to welcome you all to Fortuna Silver Mines and to our First Quarter 2018 Financial and Operations Results call. Today, we'll be using a webcast presentation, which will be controlled by us. You can download the presentation at our website. Please click on the Investors tab then click on Financials and under Q1 2018, click on Earnings Call webcast.

Jorge Alberto Ganoza, President, CEO and Director; and Luis Dario Ganoza, CFO, will be hosting the call from Lima, Peru.

Before I turn over the call to Jorge, I would like to indicate that this earnings call contains forward-looking information that is based on the Company's current expectations, estimates and beliefs. This forward-looking information is subject to a number of risks, uncertainties and other factors. Actual results could differ materially from our conclusion, forecast or projection in the forward-looking information. Certain material factors or assumptions were applied in drawing a conclusion or making a forecast or projection, as reflected in the forward-looking information. Additional information about the material factors that could cause actual results to differ materially from the conclusion, forecast or projection in the forward-looking information and the material factors or assumptions that were applied in drawing a conclusion or making a forecast or projection, as reflected in the forward-looking information, is contained in the Company's Annual Information Form, which is publicly available on SEDAR.

I would now like to turn the call over to Jorge Ganoza, President, CEO and Co-Founder of Fortuna.

Jorge Ganoza – President and Chief Executive Officer

Thank you, Carlos, and good morning to all. In this first quarter of the year, the Company produced 2.4 million ounces of silver and 15,000 ounces of gold, up 18% and 14% respectively when compared to Q1 2017. The higher production was a result of 25% and 16% increase in silver and gold acreage at the San Jose mine in Mexico. We're starting the year on target to meet and potentially exceed our consolidated annual guidance of 8.3 million ounces of silver and 48,300 gold ounces. By-product zinc and lead production were in line with Q1 of last year.

Silver accounted for 47% of sales, gold for 23% and zinc and lead contributed a combined 30%. Measured against the comparable quarter or realized price for silver was around 5% at $16, gold was up 9% at $1,329 per ounce. We got a boost to sales from the Caylloma mine derived from the significant increase in base metal prices in the period. Zinc was up 23% at $1.55 per pound and lead up 11% at $1.14 per pound. These higher realized metal prices for base metal [indiscernible] with significant improvements in commercial terms for the sale for concentrates, which further boosted our net realized prices.

Sales in the quarter were up 9% at $70 million with an EBITDA of $31.8 million. I want to highlight here a strong 45% margin on EBITDA, something that speaks of the quality and receivings of our business. Adjusted net income was down at 7% at $13 million or $0.08 per share. The drop in adjusted net income is explained by lower tax expenses in 2017. Luis will provide you further details here down through the call.

At the San Jose mine, cash cost per ton of processed ore was $65, being 15% above the $56.85 cash cost for the comparable quarter in 2017 and 7% above annual guidance of $61. The higher cost was due to one-time items related to re-handling in the dry stock [indiscernible] facility, higher transportation cost with increased concentrate shipments and faster execution of community relations programs. Cash cost per ton for the remainder of the year is expected to be in line with guidance.

On an all-in sustaining basis, as we show in the slide, we show a low $4 per ounce net of by-product, which is 39% lower than the comparable quarter. The main driver here for the lower all-in sustaining cost is higher rates, improved commercial transfer sales concentrate and lower sustaining capital expenditures.

At Caylloma, cost per ton of processed ore was $78.68, which was 7% higher than the $73 cash cost for the comparable quarter in 2017 and 3% below our annual guidance of $81. Silver currently accounts only for 13% of sales at Caylloma, therefore the large negative figure for all-in sustaining cost. On a consolidated basis, we show a low all-in sustaining cost of $2.10 per ounce net of by-products.

On the capital investment front, we have a budget for 2018 of $242 million. This is comprised of $10 million allocated to Brownfields exploration, $27 million for mine cap ex, $3 million for new projects and $201 million for Lindero. In Q1, we have executed almost $11 million of this budget where we expect a significant pickup as the year advances, particularly at Lindero as I will show.

This slide as [indiscernible] shows the geographic extent of our ongoing operations and business development initiatives. I will move onto provide you with highlights on our main activities here. At Lindero, we show a 12% on the S-curve [ph] for the physical advance of the project. This is 9 percentage points behind schedule due to a 2-month delay on the start of mass earthworks. This activity is currently underway now.

Mission-critical tasks for the project are on track and as of the end of April, we have committed, through purchase orders or awarded contracts, 50% of all direct capital costs for Lindero. Although, we carry a two-month delay, as I stated, on the start of mass earthworks, this has not translated into a delay on the back end of our project schedule. We're still committed to initiate commissioning activities in Q2 2019 and reaching commercial operations in Q3 of 2019.

On the Brownfields exploration front, we have an aggressive drill program ongoing at our San Jose mine with a 2018 budget of $8 million comprising 45,000 meters of drilling. In Q1, we have executed approximately 11,000 meters of exploration drilling in 3 areas: Magdalena and Victoria vein in the north, and San Ignacio some 800 meters south along strike of the mine. We currently have five drill rigs working from underground drill stations on the northern targets of Magdalena and Victoria.

Following with our Greenfields initiatives in Mexico, we expect Prospero Silver will be reinitiating drill testing of its exploration property package in the coming couple of months. Here, we'll retain the option to select up to two properties for joint venture.

In Argentina, we're very active with our own generative exploration initiative in the province of Salta. We have two new gold and silver prospects under option agreement that we expect to drill in the second half of this year and are also applying for open ground in new areas.

In Serbia, we are currently drilling the Tlamino gold project in the south-central part of the Serbo-Macedonian belt. This is under a JV option agreement with Medgold Resources.

With that, now I will let Luis to take you through the highlights of our financial results.

Luis Ganoza – Chief Financial Officer

Thank you, Jorge. On Slide 14, we recorded net sales of $70.4 million, up 9% from the prior year, as Jorge mentioned, driven by higher precious metal sales and the higher zinc and gold prices. We reported net income of $13.8 million compared to $13 million in 2017 and earnings per share of $0.09 compared to $0.08.

Adjusted net income was down 7% due to a lower effective tax rate in 2017 as our adjusted income before tax, not shown in the slide, was actually 15% higher. Net cash provided by operating activities amounted to $20.1 million, reflecting a strong quarter with a positive impact from changes in the working capital.

Free cash flow for the quarter was $12.2 million and free cash flow excluding the Lindero expenses was $19 million. You can find a reconciliation of free cash flows to net cash provided by operating activities in the appendix of the presentation. Cash equivalents and short-term investments as at the end of March 2018 added up to $217 million.

On Slide 15, when breaking down our sales performance, we had the higher total sales of $5.6 million with $4.5 million of contribution from higher metal volumes, $3.3 million from improved gold and base metal prices and $2.5 million of improved treatment and refining charges. We recorded negative sales adjustments of $2.8 million in the current quarter compared to positive adjustments of $1.1 million in 2017 for a total difference, as shown in the slide, of $4.8 million year-over-year. Also, worth pointing out, we had a visible concentrate inventory at the San Jose mine corresponding to around 8 days of production with a net value of $4.1 million based on realized prices during the quarter.

On Slide 16, our operating income and adjusted EBITDA reflect our stronger sales in the quarter compared to 2017. The impact of higher sales did not translate fully into higher EBITDA, however, due to higher cash cost, a $1 million realized loss on zinc and lead derivative contracts and mill share-based payment expenses in 2017 compared to $1.3 million in the current quarter.

On Slide 17, adjusted EBITDA at Caylloma was up 16%, reflecting mostly stronger zinc and lead prices with EBITDA at San Jose up 4%. The build-up of inventory at San Jose in terms of EBITDA represents around $2.8 million, which would have resulted in a 16% increase over 2017. Unit cash cost at Caylloma and San Jose were 7% and 15% above 2017. Compared to our annual guidance, however, cost were in line at Caylloma and 7% higher at San Jose.

In the case of San Jose, the increase compared to our guidance for the year, as Jorge explained, is related to operational issues of a non-recurring nature. With respect to increase over 2017, excluding these one-time items, cash cost is around 8% above the prior year reflecting mostly higher concentrate transfer tariffs, higher indirect costs and to a lesser degree, higher return cost on the dry [indiscernible] process.

On Slide 18, expenses, total SG&A was $6.9 million up 29% compared to Q1 of 2017, as a result again of [indiscernible] expenses in 2017 on share based payments. Operating mines SG&A was 47% above 2017 but in line with guidance provided on our Q4 2017 earnings call. Our effective tax rate for the quarter was 38%, which compares to 26% in the prior year. The lower rate back in 2017 was related to the appreciation of the Mexican peso and higher inflation rate back then, both of which had an impact on the effected tax rate.

On Slide 19, finally, the Company maintains a strong balance in position with the dollars cash and short-term investments as of the end of the quarter of $270 million and total liquidity close to $300 million considering our expanded credit facility of $120 million. As we have stated before, we believe this puts us in a comfortable position to meet the funding requirements of the Lindero construction.

Back to you, Carlos.

Carlos Baca – Manager, Investor Relations
We would now like to turn the call over to any question that you may have.

Operator
Our first question comes from the line of Chris Thompson with PI Financial.

Q: A couple of quick questions here. The first one looking at the cap ex cost for Lindero, obviously noted that not too much was spent in the Q1, but I guess 50% of the total capital cost was committed. So how do you see— how should we be modeling this on a quarter-by-quarter basis moving forward?

Jorge Ganoza – President and Chief Executive Officer
You should expect to see the impact from all of this committed funds starting to show and coming down into our financials towards the second half of the year. I think third/fourth quarter of the year, we should start— with equipment deliveries and we are already working on the field with one of the largest contracts, which is earth movement and that's a $22 million awarded contract. And, for example, that one is executed through the next 10 months. So, we'll start to see those monies showing in our financials. We also have other large contracts awarded like concrete. Large concrete works should start in the month of June, July. So, second half of the year is where you'll see that bulk of that reflected in our numbers.

Q: Just moving onto San Jose, I know you spoke about the higher unit costs in the quarter. There was also obviously some good grades, head grades. Are we going to expect to sort of back off a little bit or is that sustainable at those sorts of levels?

Jorge Ganoza – President and Chief Executive Officer
As we stated, we have made a shift in the plan for the year, at the beginning of the year. So, this grade should be maintainable. We should be able to maintain these grades and that's why I said we are on target to meet and potentially exceed guidance. We believe that this 15%, 20% higher grades compared to what we guided are sustainable because of the changes we have accommodated in the mine plan for—

Q: Just quickly, Caylloma, obviously, great unit cost. We saw those tick downwards again, sustainable at these sorts of levels throughout the remainder of the year?

Jorge Ganoza – President and Chief Executive Officer
You're asking about sustainability of cash cost?

Q: Unit cost, I would say at Caylloma.

Jorge Ganoza – President and Chief Executive Officer
Yes, cash cost per ton?

Q: Yes.

Jorge Ganoza – President and Chief Executive Officer
Yes, we're not guiding any different.

Q: And then the final question, I've just come off the PanAm call and a fair amount of conversation related to Argentina and peso devaluation and inflation prices. Can you just comment on that relating to I guess costs and expectations at Lindero?

Luis Ganoza – Chief Financial Officer
Well, we monitor closely the impact of inflation and currency depreciation and the net impact on our purchasing power, to put it in simple words, those two are netting themselves out that's what [audio disruption]. The currency is being depreciating, but there has also been significant inflation. So, there has been a spike in currency depreciation over the last weeks and days. Of course, it does not follow by inflation. We can see a short-term benefit, but medium and long term, I don't think what we're seeing is positive for the country as a whole and it can lead to political instability and of course, we don't like that, right.

Operator
Our next question comes from the line of Don DeMarco from National Bank Financial.

Q: Maybe if I could just circle back to a question that the previous caller had and it was on the cap ex spend at Lindero. My question is, how much should we model for Q2? I understand the bulk of the cap ex will be spent in the back-half of the year, but what are you looking at for Q2?

Luis Ganoza – Chief Financial Officer
So, for Q2, we do expect a significant increase with respect to Q1, but as Jorge mentioned, out of the $200 million forecasted for 2018, the bulk of that will be spent in the second half of the year. Given the delay as Jorge mentioned on the pick up on the earthworks in the first [indiscernible] site works, a portion of that $200 million could well spill into 2019. So, if you need a number, I would say, right now, something in the range of $30 million would be reasonable for Q2.

Q: And maybe if you could just provide a little bit more color on that delay. Obviously, the delay has been resolved. You don't expect any further delay, but maybe if you could just shed some light on the reasons for the delay and how it was resolved?

Jorge Ganoza – President and Chief Executive Officer
Lindero is a project that enjoys a tremendous goodwill at our provisional level in Salta, and that's something that we treasure. We have tried to incorporate into the project as many local providers and contractors from the province to the project as we can, but we have seen that a lot of these providers (service providers, contractors) were failing to meet and be competitive in the bidding processes that we were launching. It was a concern to us that we might end up providing local contractors no opportunity to participate in the construction of Lindero.

We identified the mass earthworks as a big opportunity to incorporate a local contractor but we realize that a local contractor from Salta could not tackle this work alone. So, what we fostered was the confirmation of the joint venture of a Salta contractor with a larger contractor from outside of the province, more seasoned with broader financial shoulders and the confirmation of that— we were ready to award a contract on time, on schedule, but realizing that the contract was going to be awarded to someone from outside of the province, we decided to make up [indiscernible], speak with the bidders, ask them to form a joint venture that will incorporate Salta contractor and then we have awarded now the contract to the joint venture.

All of this has been the main source of the delay in the start of earthworks. Earthworks has started. We have equipment moving dirt on site, but there is a two-month delay there. As I explain, we don't expect this two-month delay will translate into a delay in the backend with respect to a commissioning and commercial operations targeted date. As I also stressed, the other tasks of the project have continued to advance within schedule for the most part and all the mission critical tasks are on schedule and show that is a 50% of the funds are committed by now.

Operator
Our next question comes from the line Trevor Turnbull with Scotiabank.

Q: I just wanted to go back to something you talked about with respect to Salta and some of the projects in addition to Lindero that you have. I know that you've got some joint ventures and you inherited a lot of prospective information and land when you took over the project. I was just wondering in terms of what we can look for initially in terms of results, if you could talk about— you said there is some drilling taking place this year. Exactly, which projects might we be keeping our eye open for to, to see the first results of exploration?

Jorge Ganoza – President and Chief Executive Officer
Just a clarification, when we acquired Goldrock, what we had was the earnings concession, which holds Lindero and Arizaro and no more ground came with that acquisition, but we also inherited over 20 years of exploration sampling throughout the province of Salta. Significant geochemical database for rock, soil, sediment, so we are using that data— it's become an important tool to guide our generative efforts.

So, we have an ongoing program outside of Lindero. I can give you a bit of color. We have moved out of the porphyry belt more into the epithermal type terrains higher in the volcanic column. We are looking at the silver and gold prospects. We have two prospects, two projects in [indiscernible] and Nueva Esperanza. These are out of [indiscernible] vein systems with little work carried on them over the years. We have concluded, by now, our first path work on geochemical sampling and mapping. We have identified a drill target and we expect to be drilling probably early in the second half of the year.

Q: And so, those are for epithermal targets and then at Arizaro, are we expecting exploration results or further work to be announced on that this year?

Jorge Ganoza – President and Chief Executive Officer
Yes, we currently have a drill rig turning at Lindero. We are infilling right now a year one of production. What we or year one production blocks are being infilled. Once that rig is concluded with the infilling of year one production for Lindero, we'll move to Arizaro. So, we also expect to be drilling at Arizaro within the next two to three months.

Q: And just as a reminder, how much drilling has been done at Arizaro over the years? How much of a historic database do you have there?

Jorge Ganoza – President and Chief Executive Officer
It's about 20 holes and 8,000 meters of drilling is what being done on Arizaro. As a reminder, when we acquired Goldrock, Goldrock reported 0.5 million ounces of gold in the inferred resources at Arizaro. When we look at that, it was our conservative estimation that even though they had significant results in the drilling, the geologic understanding, the geologic model, had weaknesses and based on that, we decided to takeout those 0.5 million ounces out of our inventory. So, we do not report resources at Arizaro. The expectation of the plan right now is to focus on improving the geologic understanding with a focus on a near surface gold mineralization that can help improve or contribute through potentially a satellite deposit to the Lindero production.

Q: I understand you want to go back and do your own work and you've removed the resource that Goldrock had, but would you have considered what they had delineated to still be open or are you in the process of looking to expand on that original area?

Jorge Ganoza – President and Chief Executive Officer
I have to say first that we are very conservative with our resource evaluations and resource reserve assessments. I have to say that and based on that conservativeness of our technical service group, we decided to take out the inferred resources. There is drilling, you can make a case for the 0.5 million ounces. They are open in several directions. That model was open in several directions, but we believe it requires more drilling to improve the geologic model, not to improve the certainty on some of the grades, but to improve the geologic model and get a better sense for the morphology, continuity of this and that's what we plan to do.

Operator
Ladies and gentlemen, this does conclude today's teleconference. Thank you for your participation. You may disconnect your lines at this time and have a wonderful day.