Transcript of Fortuna Silver Mines
Third Quarter 2018 Financial and Operational Results
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Participants
Carlos Baca – Investor Relations
Jorge Alberto Ganoza – President and CEO
Luis Dario Ganoza – CFO

Analysts
Sherry Deng – Scotia
Chris Thompson – PI Financial

Presentation

Operator
Greetings, and welcome to Fortuna Silver Mines Third 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.

I would now like to turn the conference over to your host, Carlos Baca, with Investor Relations. Please go ahead.

Carlos Baca – Investor Relations
Thank you, Devon. Good morning, ladies and gentlemen. I would like to welcome you all to Fortuna Silver Mines, and to our Third Quarter 2018 Financial and Operations Results call. Today, we will be using a webcast presentation, which will be controlled by us. You can download the presentation at our website, www.fortunasilver.com. Please click on the Investors tab, then click on the Financials tab, and under Q3 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 a 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 and MD&A, which are publicly available on SEDAR. The company assumes no obligation to update such forward-looking information in the future, except as required by law.

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

Jorge Alberto Ganoza – President and CEO
Thank you, Carlos. Along with Luis, our CFO, both of us will be presenting a review of financial results and main activities across our projects and operations in Peru, Mexico, Argentina, and Serbia.

In spite of having the lowest average quarterly silver price in three years, our business results show a robust EBITDA margin of 41%, with free cash flow of $13.5 million. Our liquidity position remains strong at $257 million. This is made of $176 million in cash, and $80 million in undrawn credit facility. Our debt to EBITDA ratio currently stands below 0.5, and once the facility is fully drawn, would move us to a range of 1 on the debt to EBITDA ratio. At Lindero, all major contractors, with the exception of electromechanical and piping, are onsite, before year end, will have been mobilized and working all major contractors. As of the end of the October, the bridge shows physical advance of 26%, 82% of direct capital costs have been committed, and we expect to record approximately $130 million in project expenditures for this year.

On October 11th, we reported an environmental incidence at our San Jose mine in Mexico. Abnormally high rainfall caused a collection fund of our drainage system at the dry stack tailings facility to overflow approximately 1,500 cubic meters of water. The rainwater overflow, dried mud, along with dried tailings fines from open areas in the dry stack for approximately two kilometers into a secondary drainage. This incident did not cause an environmental impact in the way of contamination of soils or bodies of water. Water and soil sampling, and their official established procedures set by PROFEPA, the Mexican Environmental Protection Agency, have been received, and confirmed all elements and pH are within permissible levels. We expect PROFEPA will close investigation of the incident in November. Prior to this, we have been engaged in our neighboring communities, promoting and hosting local stakeholder site visits, so perception does not disconnect from reality here. For operations, we are not interrupted by these incidents.

Our silver production is at 11% as a result of 13% higher grades at San Jose. Gold production is marginally down 6.5%, due to 6% lower head grades at the San Jose mine as well. Zinc and lead production from our Caylloma mine remained essentially flat. We are on a position to exceed annual guidance of 8.3 million ounces of silver and 48,000 ounces of gold for the year.

Silver and gold made 71% of sales in the quarter. We sold silver at an average price of $14.80, and gold at an average price of $1,211 in the quarter. These prices are 12% and 15% lower compared to a year ago respectively.

We recorded sales of $59.6 million, 7% lower, EBITDA of $24 million, 21% lower, but here, I would like to stress again our margins, which remained above 40%, net income of $7 million, or $0.04 per share, which is aligned with analysts' consensus.

We recorded a consolidated all-in sustaining cost, recorded on a silver equivalent basis, of $10.80. This is 3% below previous year, and below our 2018 annual guidance of $11.90. At San Jose, we recorded a cost per ton of $63, which is an increase of 2% against a year ago and is essentially aligned with guidance. At Caylloma, we recorded $88.50 per ton, or 16% higher compared to a year ago. Luis will provide further detail into these variations, which is explained by items that do not reflect a trend. For the year, we expect to reach within 5% of our guidance of $81.30 for the year.

Consolidated capital expenditures year-to-date totaled $65.6 million. Our Brownfields exploration investment of $7.1 million is center at the San Jose mine, where we are drilling with 5 rigs for most of the year. Mine-sustaining capex of $14.5 million, here Caylloma accounts for $8.1 million and San Jose for $6.5 million. This year, Caylloma is expanding its tailings facility with a budget on that one project alone of $5.7 million. And at Lindero, we recorded capital expenditures of $24.5 million in the quarter, and $65.6 million year-to-date. We are seeing a very significant rate of capital expenditure increase for the coming quarter, with approximately $18 million to $20 million per month.

Slide 11, here we show our asset portfolio and leads to show the focus of our capital investment. So, we can move on to Slide 12, provide some further detail and color into Lindero. Our current onsite headcount stands at approximately 600 of an estimated peak of 1,000 towards the end of the year, early next year. The leach pad contract is working on all leach pad related firms, which encompass up to five different activities. The main season and concrete contractor has concluded with site excavations for the primary and tertiary crushing and is now preparing to place concrete for crusher foundations in the first days of December. The platform for the nine-megawatt power plant is concluded, and the power generation contractor is mobilized and working onsite construction. The contractor for the 6.6 kV power distribution line is on site and working.

Water well contractor is on site and drilling additional well, plan to meet the 100-cubic meter per hour industrial water supply we require for the project. And 90% of the owner mine fleet is on site, including 6 100-ton trucks, 2 D9 dozers, graders, etc., and we are working with Komatsu in the assembly of the trucks. All in all, the project has gained significant momentum. The only large contractor that is in the process of mobilizing is for the electromechanical and piping installations, which is planned to be operational onsite by December.

Next slide. On the exploration front, we are basically concluded with the drilling at our Greenfields exploration project for the year in Serbia through our joint venture with Medgold. Our option agreement, not joint venture yet, but we are already in the joint venture agreement with Medgold. We concluded, in October, a five-meter drill program. We are excited about the results. We are waiting for final assays [ph], and we expect we'll be back in Serbia drilling early next year.

In Mexico, through our option agreement and strategic alliance with Prospero Silver, we have concluded drilling 3, 4 different projects, 5,000 meters. We will be assessing these results to see if we select one of these projects based on merits of drilling for our next phase. And in Argentina, we have assembled a portfolio of early stage projects in the province of Salta. We have been drilling two of these projects. We are still pending results, but we are excited about the opportunities that the province of Salta presents to us, and we are very active there looking for more opportunities. We are also concluded, at the last quarter, actually, we did drilling at Arizaro, and we are expecting final results. Arizaro, as you recall, is the nearby porphyry system within 3.5 kilometers of Lindero, where we have the expectations of being able to come up with a satellite deposit tool in there.

With that, we will move on to the review of the financials with Luis.

Luis Dario Ganoza - CFO

Thank you, Jorge. So, on Slide 15, we recorded net sales of $59.6 million, down 7% from the prior year, driven mainly by lower metal prices, as Jorge pointed out. We reported net income of $6.9 million, compared to $10.3 million in 2017, and earnings per share of $0.04 compared to $0.06. Adjusted net income decreased 44% to $7.1 million. As Jorge mentioned as well, we had adjusted EBITDA of $24.2 million, which is down 21% from 2017.

Net cash provided by operating activities was at similar levels as the comparative period, due to positive changes in working capital in the current quarter, compared to negative changes in 2017. Free cash flow, excluding the Lindero construction for the quarter, was strong at $13.6 million, partially aided by the positive changes in working capital in the quarter of $4.6 million. And although not shown in the table, free cash flow year-to-date, excluding the Lindero construction, was $42.2 million.

From Slide 16, we are breaking down our sales performance. We have lower total sales of $4.4 million, driven by lower metal prices year-over-year across all metals. The isolated impact from this growth in prices was $7.6 million and was partially offset by the effect of higher metals sold, silver, lead and zinc in particular, as well as improved treatment and refining charges as shown in the graph.

Slide 17, our adjusted operating income and adjusted EBITDA were 39% and 21%, as I had previously mentioned, year-over-year, reflecting the impact of the lower sales in the quarter, as well as higher cash costs at the Caylloma mine. Adjusted EBITDA at Caylloma was down 27%, reflecting lower base metal prices and higher production cash costs year-over-year. Production cash costs at Caylloma in the quarter was $88.05 per ton, which was 16% above Q3 2017. This large string in cash costs year-over-year is mostly explained by short-term variations, both in the current quarter and in the comparative period. We expect our annual cash cost for 2018 to be only slightly above 2017, and within 3% to 5% of our annual cash cost guidance.

EBITDA at San Jose was down 18%, as a result mostly of lower metal prices. In the case of production cash costs at San Jose, we have seen a modest increase over 2017, which does not fully reflect a trend worth noting in energy costs in Mexico. In the quarter, this effect has been offset by other cost items, but energy tariffs throughout the year had experienced an increase of close to 100%. This is, to a large extent, related to reforms underway in the energy sector geared towards high energy prices, more aligned with demand, and the cost structure of the energy matrix [ph] in the country. We do not have full clarity today as to whether we will see this cost come down to any extent.

On the next Slide, 18, SG&A was $5 million, in line with Q3 2017. Our operating mine's SG&A and corporate SG&A are in aggregate in the $5 million range, which is consistent with what we have been guiding in prior earning calls. We do expect a moderate increase in 2019, in anticipation of the amounts related to our Lindero project.

The next slide, Slide 19, the company maintains a strong balance sheet position with total cash and short-term investments, as of the end of the quarter, of $177 million, and total liquidity of $257 million, considering our expanded credit facility of $120 million. Taking into account the updated capital forecast, we have reported at the Lindero project we continue to deliver adequately funded, considering a range of lightly or potential downside metal price scenario.

Back to you, Carlos. Thank you.

Carlos Baca – President and CEO
Thank you, Luis. We would now like to turn the call over to any questions that you may have.

Operator
Our first question comes from the line of Sherry Deng with Scotia.

Q: On the [indiscernible] Lindero project, could you please remind us what are the indirect capital costs versus the direct capital cost, and what are the breakdowns in terms of total initial capital?

Jorge Alberto Ganoza – President and CEO
We have, in our budget, $180 million in direct capital costs, and $170 million in indirect capital costs.

Q: And with this update, you've guided a capital spending for 2018 to reduce to $110 million to $130 million, as opposed to the $200 million that you guided in the beginning of the year. Could you guys please give us some details on your plans to keep things— while I see you kept the production guidance on track, can you give us more detail on your plans, and what are the changes that you are making to the original plan?

Jorge Alberto Ganoza – President and CEO
Yes. Basically, we had a lot of flexibility in the [indiscernible] schedule. We have been hitting some of that flexibility. But the main driver to get the capital expenditure up, which is aligned with project execution, is having the contractors on site. And as I stressed throughout the presentation, the main contractors, with only one exception, are all on site, are all working. This has created an issue, which has an impact on cost, and is a driver for our guidance to increase capital cost, which is now is that we have overlapping activities compared to our [indiscernible] schedule. So, our headcount, due to this overlapping activity, is going to be up to close to 1,000 people, onsite people today. So that is one of the drivers of higher cost, or higher capex for us.

So, we have the main activities on site, the heavier activities, the bulk of the groundwork, the mass earth movement. And with the contractors on site, we are already seeing the pickup on capital spending, which is directly related to capital execution. We are still looking for first doré in September. We started saying, at the beginning in the third quarter, that we have moved from early in the third quarter to late in the third quarter. So, we are squeezed, squashed against September to deliver first. So, we have been moving within those three months of the third quarter. We are, again, slammed against September now. But the contractors have been mobilized, and that's what you need to pick up pace at the project. You need the contractors on site and the equipment arriving on time, and we are basically there.

Q: All right, thanks. So, what are the things on critical path at this point?

Jorge Alberto Ganoza – President and CEO
On critical path today, we have the crushing station. We need the crushing station to be operational by April. We need that crushing station to be operational by April, and right behind it we have the leach pad. I mean the crushing operation and a pad to place the ore. So those two are currently driving the timeline, however, with two heavier activities of the project, the 18,000 tons per day crushing station is a big animal in relation to the project. So that is a lot of our attention. We have a good contractor there that's providing the resources and advancing, but we are monitoring that closely.

And then the leach pad is another big project. It's a large earth movement exercise with accompanying activities that need the experience, specific, like ground preparation, [indiscernible], liner installation. So that contractor had a difficult start for the project. The leach pad contractor had a very difficult start first getting mobilized, then gaining the pace, getting aligned with the pace that we required. So, we are working closely there with them, and those are the critical paths.

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

Q: Two quick questions, we'll start off with San Jose. Just looking at the trend here and I know that you have, correct me if I'm wrong, adjusted the mine plan slightly so better grade [ph], I guess, maybe sacrificing some ton through the mill. Is this what we can anticipate on a forward-looking basis? I am looking at better grade on the silver, by the way.

Jorge Alberto Ganoza – President and CEO
No, Chris, we do not have a plan that incorporates reducing tonnage at the expense of grade, no. We have seen, and you will likely see a bit early in the quarter, we had some tonnage shortfalls starting in October, due to equipment availability on the part of our contractor. But it's not in our plans to battle lower tonnage with higher grades, no. It's just how the mine is cycling to its reserves.

Q: Just moving on to, kind of very quickly, you did mention that the, I guess work to be done, or continuing to be done on the tailings facility, $5.7 million. Is this happening right now, and when could we expect the capex to be fully paid for this project?

Jorge Alberto Ganoza – President and CEO
The project should be concluded by now, because the rainy season is on us. And it's not, so I think there might be some carry-forward there into January, which is not the most desirable, from the construction perspective. But that is a project that allows us to gain, if I am not mistaken right now, as much as five years in the leach— in the tailings facility, four to five years. So, it's an important project. It's a planned expansion. It was part of the original design. We are executing. Again, we had a slow start with that capital project, but we have also made some changes to the capital projects at Caylloma. So, we have seen a reduction of capital spend, just by the way of how we have prioritized the resources that we have at that mine.

Q: And just one final quick question on Lindero. Obviously very mindful about what's happening, what has been happening in Argentina, by way of inflationary pressures and peso devaluation, you said that you are guiding slightly higher capital costs. I would imagine that, erring on being conservative, and not factoring in much by way of a peso devaluation; is that true?

Jorge Alberto Ganoza – President and CEO

We have not included in our forecast, if that's what you mean, any benefit from exchange rate. I can say that up to the third quarter, we have captured gains due to exchange rate against our original budget of close to $7 million, and we expect to continue to see gains against our budget. Our budget was constructed, and a lot of our contracts have been awarded with pesos in the range of 17 pesos to the dollar, with an exchange rate of approximately 17 pesos to the dollar. So yes, we are benefiting right now from that. That is not in our forecast. We are currently forecasting 10% to 14% higher capital costs for Lindero, but again, that will be offset by exchange rate, gains derived from exchange rate.

Operator
Since there are no further questions left in the queue, I would like to turn the call over to Carlos Baca for closing remarks.

Carlos Baca – Investor Relations
Thank you, Devon. If there are no further questions, I would like to thank everyone for joining us and listening to today's earnings call. We hope you have a good day.