Transcript of
Fortuna Silver Mines, Inc.
Second Quarter 2016 Earnings Call
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Participants

Carlos Baca - IR Director
Jorge Alberto Ganoza - President and CEO
Luis Dario Ganoza - CFO

Analysts

Chris Thompson - Raymond James
Cosmos Chiu - CIBC
Jessica Fung - BMO Capital Markets
Louis James - Casey Research

Presentation

Operator
Greetings, and welcome to the Fortuna Silver Mines Second Quarter 2016 Earnings Call. At this time, all participants are in a listen-only mode. A brief 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, Mr. Carlos Baca, Investor Relations Director for Fortuna Silver Mines. Thank you. You may begin.

Carlos Baca - IR Director
Thank you, Melissa. Good morning, ladies and gentlemen. I would like to welcome you all to Fortuna Silver Mines and to our second quarter 2016 financial and operations results call. Jorge Alberto Ganoza, President and CEO, 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 like to turn your attention also to the webcast presentation we are going to be using in this call and to our forward-looking slide, slide 2.

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

Jorge Alberto Ganoza - President and CEO
Thank you, Carlos, and good morning to all. Both Caylloma and San Jose Mines operated consistently within plan during the quarter. In Q2, the company produced 1.6 million ounces of silver and 9,400 ounces of gold. Silver production was 7% below Q2 2015, and gold production, 4% above. We are well within schedule to meet our guidance for the year of 7 million ounces of silver and 43,000 ounces of gold.

For the quarter, precious metals accounted for 75% of sales, silver representing 54% and gold 22%. The balance is made up of by-product lead and zinc from our Caylloma Mine in Peru. Our realized silver price for the quarter was $16.81 and $1,263 for gold, and this was 12% higher for silver and 5% higher for gold when compared to a year ago.

In terms of production, both Caylloma and San Jose performed largely in line with guidance, with silver production at Caylloma 7% higher than guidance; and at San Jose, production was 2% and 10% higher for silver and gold, respectively.

Something to highlight is our all-in consolidated cash cost per silver ounce net of by-products for the quarter. The all-in sustaining cash cost fee here came in at $9.60 year-to-date, well below the $14.50 of 2015 and also below our 2016 guidance of $11.10.

We had two announcements after the end of the quarter that I want to highlight and bring to your attention. On July 6th, we announced a successful commission of the San Jose Mine and mill expansion to a new processing rate of 3,000 tonnes per day. I want to commend our entire organization for another delivery on time and under budget. The project was delivered in the scheduled 18 months and with savings of $6 million or 18% under budget.

On July 28th, we announced the successful completion of Goldrock Mines acquisition. We are working on the integration of the Argentina subsidiary and are concluding in the coming days with a preconstruction plan and budget for the Lindero Project. The main task identified for this phase of the project is derisking and optimizing the process design in the 2016 feasibility study with respect to the management of copper content in the system. We have 3 tonnes of core samples for further met testing already collected and on their way to the metallurgical lab. It is our objective to be in a position to make a construction decision on Lindero in the first half of next year, probably early in the second quarter.

I will now turn it over to Luis, who will guide you through the financial results.

Luis Dario Ganoza - CFO
Thank you. We have recorded sales of $44.5 million and a net loss of $1.4 million, which, as I will explain, is the result of mark-to-market effects on our stock-based compensation charges.

Sales were 14% above Q2 2015, where silver sold was 7% lower while gold was 4% higher. We had significant increments in lead and zinc sold, however, of 85% and 31%. All in all, the positive impact on our sales comes from higher volume and improved metal prices. Our mine operating earnings was $15.9 million, 53% above Q2 2015, reflecting sales growth and stronger margins at both operations, San Jose and Caylloma.

At San Jose, mine operating earnings increased 32% to $11.6 million and gross margins increased 3 percentage points to 40%. That is mine operating earnings over sales. This increase in margins has to do with higher prices and lower treatment charges paid on our concentrate sales.

At Caylloma, mine operating earnings increased 160% to $4.3 million, driven by lower unit costs of 20% and lower depletion.

Our selling and G&A was $12.3 million compared to $5.5 million in Q2 of 2015. You can see a breakdown of this item in page 11 of our webcast presentation. The source of the large increase is a higher stock-based compensation charge, which went from $1.2 million in the comparative period of 2015 to $8 million in the current quarter. This higher amount is related to the mark-to-market effect of share-based instruments like DSUs and RSUs. As our share price has risen from around $5 at the beginning of the quarter to $9 at the end of the quarter, so has the stock-based compensation charge. Excluding these mark-to-market effects, the charge in Q2 2016 would have been $1.7 million for share-based performance.

Our G&A cash expenses were stable at $4.1 million. Operating income was $3.6 million, 16% below Q2 2015 due to the higher stock-based compensation charges. Our EBITDA for Q2 2016 was $18.6 million, 51% above the $12.3 million recorded in Q2 of 2015.

Our cash flow from operations before changes in working capital and after taxes paid was $12.7 million, up 88% from Q2 2015, reflecting stronger operating results and lower taxes paid. The changes in working capital items, as shown in the cash flow statement and as can be seen in slide 13 of our presentation, reflect a net consumption of cash year-to-date of $24.3 million. This is a reflection of December 2015 sales having been collected in advance within the same month, with a related increase in accounts receivable in the current year. The other relevant item here is a decrease in accounts payable, as our main CapEx projects have come to an end.

Expenditures in mineral properties, plant and equipment was $27.4 million or $20 million net of changes in advances to contractors, again, as shown in slide 13 of our presentation. We expect around $20 million of capital expenditure for the second half of the year, including $7.5 million of brownfields exploration.

Finally, cash and short-term investments was $89.2 million at the end of the quarter, and total liquidity available to the company was $110 million, considering the $20 million revolving facility in place.

Thank you. Back to you, Carlos.

Carlos Baca - IR Director
Thank you, Luis. We would now like to turn the call over to any questions that you may have.

Operator
Thank you. At this time, we'll be conducting a question and answer session. (Operator instructions.) Our first question comes from the line of Chris Thompson with Raymond James. Please proceed with your question.

Q: Congratulations on a good quarter and congratulations on the successful ramp-up at San Jose. A couple of quick questions, just on San Jose to begin with. Maybe can you give us a sense of where we sit as far as exploration, mine site exploration, Jorge?

Jorge Alberto Ganoza - President and CEO
Yes, Chris. We're finished testing La Noria system. We're waiting for final results, but up-to-date, we have mixed results on the drill testing of La Noria. We have intercepted the structure, but we have not been able, up to now, to identify an ore shoot. We're still waiting on final results, but just the program continues and it's coming to an end. We're testing some deeper holes there now.

It's a large vein system. We currently only have access on surface to half, to the northern half of La Noria, and we're working on the permits to surface access to see if we can access this year the southern half of La Noria to continue dual testing the structure.

With respect to our programs, we continue drill-testing the deep portion of the Trinidad Central, and we are waiting on the conclusion of the exploration drift. Towards the end of this third quarter, start of fourth quarter, we should be concluded with the exploratory drift. It's a 1.5-kilometer, a $3 million project, which will allow us to drill test from underground the north extent.

So those are the three areas where we have exploration planned for this year at San Jose through drilling: La Noria, Central Deep and Trinidad North. And the program we're actually most excited about, as you can imagine, is the continuation of Trinidad North, and we are waiting for the infrastructure there to be concluded so we can start drilling.

Q: Great, thanks, Jorge. And just on Trinidad North, I mean, what sort of mill feed split do you sort of envisage as you start ramping up on the Trinidad North and layering it into your mill tonnes?

Jorge Alberto Ganoza - President and CEO
I don't have the exact figure on top of my head right now to give you exact percentages, but it is increasing. And the bulk of production will come from Trinidad North reserves towards 2018, 2019, and that's when our production peaks due to higher grades. Our production in San Jose, if you look at our life-of-mine projections, peaks in 2019, and that's where we start getting into the better zones. So it's gradual, it's gradual. Today, still, the bulk of production comes from the Central zone.

Q: Right. Okay. And then, obviously, milling at 3,000 tonne a day at the moment, have you got a sense of how far you can push the mill throughput at the moment, Jorge?

Jorge Alberto Ganoza - President and CEO
We're already doing 10% higher some days, so nominal capacity is at 3,300; 3,300 tonnes, nominal. So we are already seeing days like that. We're sticking with the 3,000 tonnes per day, but nominal, we're seeing higher throughput days. So we're going to push it without compromising recovery. We're still in that process.

Q: Thanks, Jorge, and then just quickly on to Caylloma, real quickly. Obviously, better silver prices at the moment. Is there potential for adjusting the mine plan to maybe sort of switch it from sort of lower silver to higher silver and the reverse, obviously, on the base metals?

Jorge Alberto Ganoza - President and CEO
That is a good question, and that is a discussion we're embarking on right now. As you know, a little over a year ago, we made the decision to shut down the north end of the production area where we have the silver veins to focus on the deeper portions of Animas, where we have—the mine is better integrated through services.

So we have more productivity, lower costs and lower silver grades but higher base metals. We estimate that the price at which those narrow silver zones to the north start making sense again is around spot prices today, around $20. So we will have to make that call, and it will be probably something that we incorporate into our 2017 plan; I don't envision there is a change we will do in 2016. It's more likely a trade-off exercise we'll embark on and incorporate any change into our 2017 plan.

Q: Great. And then, finally, I noticed that you're running below cost guidance on a per-tonne mill basis at Caylloma. Do you see the Q2 cost being sustainable?

Jorge Alberto Ganoza - President and CEO
We have - we're lagging with some preparation and some infrastructure investment as well that you don't see on the cash cost, but that's why—one of explanations why the all-in at Caylloma came in at $5, so it's a combination. We expect it will be within guidance, slightly below.

Operator
Our next question comes from the line of Cosmos Chiu with CIBC. Please proceed with your question.

Q: Hi, Jorge, Luis and Carlos, a few questions from me here. Maybe first off, just to confirm in terms of the expansion at San Jose. So are you now expecting to average, after even factoring availability, to average over 3,000 tonnes per day for the entire quarter, Jorge?

Jorge Alberto Ganoza - President and CEO
For the quarter, I believe we will be able to do 3,000 tonnes a day, yes. And what I'm saying is that we are seeing clear opportunities to stabilize production beyond 3,000 tonnes per day. But that final figure is going to take us a few months to settle into. As you know, this is an operating plant, you end up finding those marginal gains, you fight for them every day in the mill, right? But we are already seeing clear opportunities to be able to get more out of the 3,000 tonnes per day. So we should have Q3 at 3,000 tonnes per day or better.

Q: Okay. And then maybe on CapEx, earlier this year, you've given out sort of CapEx guidance of about $59 million for 2016. You've done about $30 million so far, and you've talked about the $6 million cost savings. So based on my calculation, there's about $23 million left in terms of CapEx to spend for the rest of 2016. And now that all the expansion CapEx has been completed, is that a good level in terms of sort of like sustaining CapEx, $23 million for six months on a go-forward basis?

Jorge Alberto Ganoza - President and CEO
Our sustaining ongoing basis in the loan it comes and goes every year, depending on who are doing dry stock, [indiscernible] is we're doing $15 million and $20 million on sustaining. For the remainder of the year, we still have some $20 million, $23 million to go.

Luis Dario Ganoza - CFO
Yes. And maybe to complement Jorge, some items of sustaining CapEx for this year will only get addressed in the second half of the year. So that's why probably the reference of $20 million per semester is not entirely valid. So the figure is likely more for the year, $20 million for the year is a better figure going forward.

Jorge Alberto Ganoza - President and CEO
It's a better figure.

Q: Yes. And maybe on cost per tonne, I saw that, in the quarter, it was about $60 per tonne at San Jose. Are there opportunities to lower that cost now that the throughput has increased?

Jorge Alberto Ganoza - President and CEO
Well, we also have, for example, the implementation of the filter plant. So there are wins and losses here, right? If you look at the benefit of the filter plant, of the filter tailings and dry-stacking of those filter tailings, or if you look at cost, the cost compared to what we were doing, which was pumping a slurry, will increase. The benefit is when you look at it from an all-in, sustaining cost perspective, right, when you factor in capital.

So whereas looking at the cost line, yes, we're getting some benefits from the higher expansion, but we're also going to a more expensive cost base for management of tailings. The mine is going a bit deeper. So there are—we believe a good number is $55, $60 is a good fee for the cost projection of San Jose.

Q: Yes, I got you. And maybe switching gears a little bit, just one last question here on the Goldrock and then Lindero. I know, for the permitting, it's fully permitted in terms of environmental permits, but could you remind me once again if there's any other sort of additional permits needed before you can start construction?

Jorge Alberto Ganoza - President and CEO
All material permits are in place. I mean, Goldrock has presented the project as shovel-ready based on the status of their permits and the feasibility, and we concur with that. All major permits are in place. There are some renewals that have to take place and whatnot for minor permits, but the basic, wider comprehensive environmental permits are in place.

Operator
Our next question comes from the line of Jessica Fung with BMO Capital Markets. Please proceed with your question.

Q: So let's continue with Lindero, since we're looking ahead. Can you give us an indication as to what you guys plan to do there over the next 12 months, given that you've provided some guidance that you expect production in the second half of 2018?

Jorge Alberto Ganoza - President and CEO
Yes. Our milestone, more than 12 months, I would say a milestone with our construction decision, which I believe—well, our plan now is to work towards the construction decision. We believe we can be in that position in eight months pretty much, give and take, which is end of Q1, start of Q2. That is our objective, our target.

As you know, the Lindero project has a 2016 feasibility study, and we, through the due diligence process, identified some areas that we believe we would like to derisk and optimize. And as I stated in the call, that's the main area for us to work on now is around process design.

We believe that there are opportunities to derisk and optimize the process design with respect to the corporate content in the system, and we are already working on that. So we are developing a budget and a plan to take us through the next eight months to that construction decision, and that includes metallurgical testing. We already collected the samples, and the samples are, as we speak, on their way to Canada to the met lab we have selected. And those metallurgical tests are designed to help us optimize the process.

We are revisiting several areas of the study, but the main aspect and the long lead aspect of the work we have to carry is in relation to process design.

Operator
(Operator instructions.) Our next question comes from the line of Louis James with Casey Research. Please proceed with your question.

Q: Jorge, Carlos, congratulations on the San Jose ramp-up. You guys are the on-time and under budget guys of the mining world, so really, hats off to you on that. And I realize my question is regarding Lindero, and it's kind of been asked already. You guys are cautious, and you like to under-promise and over-deliver, so I don't want to push you that out. But you guys are on the under budget and on-time guys, and I'm wondering if you could give us a little bit more flavor on the kind of optimization you're looking at.

I mean, I remember, Jorge, when your father first said he could rebuild Caylloma for a few million dollars, I didn't believe him, and then he did. I just have to believe that there's a lot more you guys can do than marginal optimization. So can you give us a little more color there?

Jorge Alberto Ganoza - President and CEO
Well, first, thank you for the kind words, Louis. You're making me nervous now. First, we believe that there needs to be a more—with respect to the risks, we believe there needs to be a more head-on approach to dealing with the copper in the system. And by dealing with the copper in the system, that will open opportunities to do a more aggressive primary leach cycle. I don't want to get into a metallurgy of things because, first, I'm not a metallurgist, and this can get overly complicated. But what we want to do is have the opportunity to do a more aggressive leach cycle compared to what is presented in the feasibility study, and that will help us, we believe, improve metallurgical recovery.

If the metallurgical recovery in the feasibility study is at 68% with a long leach cycle, we believe we can shorten the leach cycle and improve recoveries by dealing effectively with the copper. So we perceive not only that as an opportunity, but also as a risk. Copper needs to be dealt with. The heap leaching technology was developed originally for oxidized epithermal systems in Arizona, in Nevada. This is our goal [indiscernible] with copper. It is not oxidized, so copper needs to be dealt with, and that will require capital, additional capital.

I believe there are other areas where we can try to capture savings, Louis, just in the general infrastructure of the project. This project is not challenged on the infrastructure. There are no large access or energy projects or water projects; it's a flat area that lends itself very well for a heap leach site. So I believe that project lends itself; it's not complicated, it's not infrastructurally challenged. So I believe that is what lends the opportunities to capture eventually, through the engineering and construction, the cost savings that you were mentioning.

And how we tackle the engineering? We all have heard enough of the cost overruns and budget overruns that Argentina has all of us accustomed to, so it's not the easiest place or the cheapest place to build. We are well cognizant of that, so we're being cautious. But the project is a straightforward open pit. It's not challenged by access nor infrastructure. There is nearby power sources through gas, water available, the area is flat. I believe that all those things lend well to allow us to capture opportunities as we build and save on capital.

Q: Okay. Well, I've actually been there, back in the Mansfield days. I went to see Lindero, so I know exactly what you're talking about. I've seen that gas pipeline, and there's no people to move, no village. I get it. It is a great place, and hence my question. So you're being cautious, I'm not going to push you too much on that, but I have to say, I'm expecting to see you over-deliver, and I look forward to that day. Thank you much, gentlemen.

Jorge Alberto Ganoza - President and CEO
Thank you. Thank you, Louis.

Operator
Our next question is a follow-up from the line of Chris Thompson with Raymond James. Please proceed with your question.

Q: Jorge, just a follow-on, actually, from Louis' question. Obviously, under budget at San Jose. Can you give us a sense of how you achieved that?

Jorge Alberto Ganoza - President and CEO
The engineering firm oversized everything, and we said no. It's not—I'm laughing, but it's pretty much like that. The engineering firm oversized everything, and we said no, no, no. We worked closely with them through the design and the engineering. And I don't want to throw mud on our engineering firm because they did a good job, but I believe that you need strong and close owner's representation in the engineering and construction process. And that's what allows you to capture the opportunities to save costs.

Operator
Mr. Baca, there are no further questions. I would like to turn the floor back to you for final remarks.

Carlos Baca
Thank you, Melissa. Any remarks, Jorge?

Jorge Alberto Ganoza - President and CEO
No. Thank you, everybody, for joining us this morning.

Carlos Baca - IR Director
Have a good day. Enjoy.