Transcript of Fortuna Silver Mines, Inc.
Second Quarter 2015 Earnings Call
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Participants

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

Analysts

Rahul Paul – Canaccord Genuity
Chris Thompson – Raymond James
Howie Flinker – Flinker and Company
Matthew O'Keefe – Dundee Capital Markets

Presentation

Operator
Greetings, and welcome to the Fortuna Silver Mines Second Quarter 2015 Earnings Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. If anyone should require operator assistance during the conference, please press star zero on your telephone keypad. As a reminder, this conference is being recorded.

I will now turn the conference over to Mr. Carlos Baca, Investor Relations Manager. Thank you, Mr. Baca. You may now begin.

Carlos Baca – Investor Relations Manager
Thank you, Manny. Good morning, ladies and gentlemen. I would like to welcome you all to Fortuna Silver Mines and to our Second Quarter 2015 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 now like to turn the call over to Jorge Ganoza, President, CEO, and Co-Founder of Fortuna.

Jorge Ganoza – Chief Executive Officer

Thank you, Carlos, and good morning to all. We will be giving you some highlights and walking your through our financial and production results here with Luis. In the first quarter, the company produced 1.67 million ounces of silver and 9,000 ounces of gold, up 3% and 6% respectively when compared against Q1 2014. We expect the large [indiscernible] mine at 35% jump in silver and gold production while the San Jose expansion is completed in mid-2016. We are well within guidance to meet our consolidated forecast for the year of 6.5 million ounces of silver and 35,000 ounces of gold.

Caylloma silver production at 443,000 ounces is lining 25% with respect to our annual guidance due to 24% lower silver grade. This is explained by challenges encountered on level 6 of the Animas Vein related to higher mining dilution and reduced capacity to meet tonnage from this level due to unexpected, adverse, geomechanical conditions on this near surface area. We're analyzing options in the plan to mitigate a drop in silver grade coming from the challenges encountered in level 6 but now expect to see a shortfall of silver in Caylloma of approximately 25% to 30% for the year with respect to guidance.

A positive side to this is that as we have shifted production to levels 10 and 12 of Animas, which holds higher base metal content, zinc production was up 25% in the quarter against guidance. As a result, the economic impact on our margins at Caylloma is marginal, as the mixed metal return value per ton of ore and the polymetallic ore of level 12 versus the silver ore from level 6 is approximately 5% today.

From a consolidated production perspective, the guidance shortfall in silver production from Caylloma is being covered by San Jose which is delivering 10% higher silver grades and 3% to 5% higher mill through put against guidance. San Jose produced 1.2 million ounces of silver and 8,700 ounces of gold, 11% and 9% respectively above production in Q1 2014. The San Jose mine is operating comfortably within its annual plan and has the added flexibility as we advance with preparations to serve 3,000 tons per day next year.

We reported lower operating costs at both of our mines at San Jose. We achieved $58 per ton, down from $64 in Q1 2014. At Caylloma, we achieved $88.55 per ton, down from $91.70 per ton in the comparative quarter. Measured against guidance, Caylloma is in line and San Jose 8% below guidance. At San Jose, lower cost per ton against guidance are explained by a 17% devaluation of the Mexican peso with respect to our budget, partially being offset by higher mining costs related to breakup preparation and haulage.

For the quarter, our consolidated all-in sustaining cash cost net of byproduct decreased to $13 per ounce from $15.77 in Q1 2014. Our guidance for 2015 is for $16.60. We expect to be within guidance for the year due to the scheduled capital investments in the coming quarters related to our filter tailings and dry stack products at San Jose. We continue to work to bring costs down from an all-in perspective closer to $10 mark once we materialize the expansion of San Jose to 3,000 tons per day.

Our capex guidance fee for 2015 is $70 million. The allocation is $56 million to the San Jose mine and $14 million to Caylloma. Where San Jose projects are advancing according to schedule, on the tailings filtering facility and the dry stack, we have an advanced to date of to the end of July of 78%, which is in line with schedule. For the 3,000 ton-per-day expansion, we have an advance of 11%, which is also within schedule. All purchase orders for key equipment have been already placed, and we're starting to see some of that equipment starting to arrive this month and in the coming months.

Moving on to exploration. Our largest exploration project today is at San Jose. We are concluding with our drilling on the north extent of Trinidad north, and we are preparing to initiate drilling the second half of the year on what we are calling a mirror system to the Trinidad north-south vein, which is called La Noria. La Noria is located some 1.5 kilometers to 2 kilometers due west from Trinidad. We have already land agreements in place, and we're working for the environmental approval to start drilling. We expect environmental approval to be granted any day. So, we have done surface work. There is good surface exposure, and we're optimistic with a view of being able to identify new horseshoes in the system at La Noria.

That will be all the operational objects. Luis, do you want to take us through the financials?

Luis Ganoza – Chief Financial Officer

Sure. So for Q2 2015, we recorded sales of $38.9 million, down 12% from Q2 of 2014, a net income of $0.2 million, down from $2.4 million in the same period last year. The main driver for lower income and sales was a lower realized silver price which fell 17% to $16.30 per ounce. This [indiscernible] price effect was partially compensated by higher base metal sold of 40% and 22% for zinc and lead and slightly higher silver and gold sold of 2% and 3%. Silver sold for the quarter was 1.64 million ounces, and gold sold was 8,672 ounces.

Our mine operating earnings was $10.4 million, 36% below Q2 of 2014, mainly as a result of the lower sales and to a lesser degree to higher depletion charges. Gross margin came down from 37% to 27%, reflecting the impact of lower metal prices. This negative effect, however, was partially offset by lower unit costs year-over-year in both of our operating mines, 10% lower at San Jose and 3% lower at Caylloma. Mine operating earnings was further affected by an accumulation of $1 million worth of metal inventory net of cost.

We recorded selling, general and administrative expenses of $5.5 million, a decrease of $3.1 million compared to the prior-year period. The decrease is explained by lower [indiscernible] based compensation charges of $2.1 million, a reduction in corporate expenses of $0.6 million, and a foreign exchange loss in the comparative period of $0.3 million. Operating income was $4.8 million, 37% below Q2 of 2014.

We recorded $4.1 million of income tax for the quarter. Our effective tax rate was 95% for Q2 and 67% year-to-date. We need to bear in mind that income tax expenses are sensitive to the volatility of the exchange rate to the impact the latter has on the deferred income tax liability. So, outside of the foreign exchange effect, the effective tax rate would be 71% for the quarter and 53% for the year.

Finally, net income was $0.2 million or nil cents per share compared to $0.02 per share in Q2 of 2014. Cash flow from operations, before changes in working capital and after taxes paid for the quarter was $6.8 million, compared to $15.1 million in Q2 of 2014. That is a reduction of 55%. A significant portion of this decrease is related to timing issues and the payment of incomes taxes. In the quarter, we paid tax installments of $4.7 million; whereas in 2014, we paid only $0.5 million. Adjusting for this, the reduction in cash flow year-over-year is in the range of 25%, similar to the change in EBITDA which was $12.4 million in the quarter compared to $16.5 million in 2014, a reduction of 25% as well.

Expenditures in mineral properties, plan, and equipment was $16.8 million for the year. This is around 24% of our planned annual capital expenditures. We expect to see this figure rise over Q3 and Q4, as dry stack sales project at San Jose is commissioned and the planned expansion at San Jose, as well, gains momentum.

Moving on to the balance sheet, our total cash position, including short-term investments as of the end of the quarter, was $110 million, an increase of $32.7 million over yearend, reflecting the drawdown of the $40 million term loan with Nova Scotia Bank.

On our payables, we closed 2014 with $9.7 million of income tax payable related mostly to our Mexican operation and closed June of this year with $1.4 million. No tax installments were paid in 2014 in Mexico, so the full income tax incurred in fiscal period of 2014 were actually paid in March of this year. Moving forward, we should expect more of a balance between taxes incurred and taxes paid throughout the year.

Finally, as I already mentioned, and as we discussed in the previous quarter, on April 1st, we drew down the $40 million on the term loan trench of our expanded bank credit facility. The $40 million are structured as a bullet loan with a 4-year term. We have also proceeded to fix the interest rate in the loan for an interest rate swap. This will allow us to add additional financial flexibility to our balance sheet during the expansion phase of the San Jose mine, as well as secure what we regard as very attractive interest rates.

Thank you. Back to you, Carlos.

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

Operator
Thank you. We will now be conducting a question-and-answer session. (Operator instructions.)

Our first question is from Rahul Paul of Canaccord Genuity. Please go ahead.

<Q>: Hi, everyone. You set out a budget for capex in the beginning of the year as particularly with the San Jose project. I understand most of the spending is to be weighted to the second half of the year. Now, is that the only reason for the low spending in the first half of the year? Are you also seeing any savings related to local currency weakness?

Luis Ganoza – Chief Financial Officer
No. With respect to the capital projects, we attribute the impact that a lot of the purchase orders have been placed, and we will start to see that impacting us in the second quarter when we start to receive a lot of equipment and, as I said, the major projects start advancing, which will happen in the second half of the year. On terms of capital projects, the exchange rate, and things, most of it is dollar.

Jorge Ganoza – Chief Executive Officer
Yes. [Audio disruption] timing issue.

<Q>: Okay, thanks. I'm just wondering, can you give us a rough breakdown of how much you plan to spend on capex in Q3 with Q4?

Luis Ganoza – Chief Financial Officer
So, Q3 and Q4, we should pick up, and we are forecasting around $25 million to $30 million for both quarters. That's what we would and should expect to see.

<Q>: Then will most of that be weighted to Q4? Is it going to be evenly spread out?

Luis Ganoza – Chief Financial Officer
We anticipated the bulk of what's still pending from the dry stack project which is a $28 million project, we will see come down in Q3. We've only recorded around $7 million for that project, so the bulk of it we will see in Q3. Probably gives you around $25 million or $30 million in Q3, and in Q4, we should see a balance of the $7 million. That's another $25 million.

Jorge Ganoza – Chief Executive Officer
For the expansion to 3,000 tons per day, which is $12, $13 million this year, we should start to see a pick-up more into Q4.

Luis Ganoza – Chief Financial Officer

Yes.

<Q>: Okay, perfect. That's very helpful. Then just last question from me, it looks like you purchased approximately $35 million worth of short-term investments this quarter. Just wondering if you could provide us a little more color as to what these investments were.

Luis Ganoza – Chief Financial Officer
These were just basically bank term deposits which are between 3 months and 12 months, so nothing fancy.

<Q>: So, it's basically something that we could classify as cash?

Luis Ganoza – Chief Financial Officer
Yes, yes.

<Q>: Just another question, do you hold your cash? In what currency do you hold most of your cash? Is it mostly US, or is it a mix of US with—

Luis Ganoza – Chief Financial Officer
Yes. The bulk of it is in US.

<Q>: So you have the full benefit to whatever fee rising US dollar?

Luis Ganoza – Chief Financial Officer
Yes, yes.

<Q>: Okay, thank you very much. That's all that I had.

Jorge Ganoza – Chief Executive Officer
Thank you.

Operator
Thank you. The next question is from Chris Thompson of Raymond James. Please go ahead.

<Q>: Good morning, guys. Thanks for taking my questions. Congratulations on the quarter. A couple quick questions. Let's start off with Caylloma, first of all, and Jorge, I know we've spoken before about optimization work at Caylloma. Is anything happening on that basis at the moment? Any advancements?

Jorge Ganoza – Chief Executive Officer
Well, we are seeing the benefits. We've been seeing gradually over the last year the benefits of some of the initial things that we have undertaken at Caylloma. As I mentioned, looking at our cost per ton, which is a strong measure of actual cost operations, our cost-per-ton came in at $88.55, which is down from $91 a year ago, no. This is basically in line with our budget. So we expect to continue to see costs on a per-ton basis stabilizing around these levels, around $88, $90. We'll see always costs on a per-ton basis will bounce month-to-month.

What we are seeing today, we believe is we're operating very lean on the administrative side. We are still fighting for some productivity gains, but we're fighting for percent on the bigger cost-per-ton basis. We've had some positive gains this year. For example, instead of trucking our zinc concentrate all the way out to the Caylloma facility, which is 1,000 kilometers away, we are delivering our zinc at [indiscernible], which is only 300, 400 kilometers away, no—so things like that, but the separation, we believe the $88 we're seeing today is something that we will be looking to stay.

<Q>: Thanks, Jorge. So, obviously, you discussed what's happening with the silver grades in the environment, I guess the question is should we be modeling for the back half of this year what you guys delivered, I guess, in the Q2 as far as grade on the zinc and the silver?

Luis Ganoza – Chief Financial Officer
Yes, yes. We are taking a hit on our silver production on the back of the loss of our ability to source the tonnages we originally scheduled in the beginning of the year for that area. Level 6 is the uppermost level of the Animas Vein. It's close to surface. We did in our planning account for challenging geomechanical conditions because of the near surface location of this, but it's been worse than what we planned for, so mining is being painfully slow, and we're also dealing with a broad [indiscernible] with lots of internal barren horses, so we are dealing with internal dilution as well, so bad rock and internal dilution. That is impacting us, and we are moving away from level 6. So, we reckon that for the year our silver production is going to be impacted around 25% to 30% in terms of metal output.

<Q>: Okay. That's perfect. I mean, it's great to have the flexibility that you have though with Caylloma.

Luis Ganoza – Chief Financial Officer
Yes. I would like to highlight that when we look at our margins or net [indiscernible] return and costs, not at margin, at the end of the day, we mine tons and not necessarily ounces. We're seeing a minimal or very marginal impact on the value of the rock that we're mining when we shift from level 6 of Animas to level 12 because of a higher zinc content.

I'm going back to your previous question. There is one optimization project at Caylloma that is ongoing. It has $4.5 million budget attached to it this year, which is improving the classification. We're migrating from cyclones to high frequency screens and changing and increasing the flotation cell capacity. We expect that will allow us to increase as much as two to four percentage points on silver recovery, which will be even more important as we see potentially lower silver grades.

<Q>: Right, that's excellent. That's why, I guess, I was asking early on. Thanks for that. I guess just moving on to San Jose, obviously, we're talking about the dry stack tailing. I mean do you see any operational adjustments, being in current, as you transition over to the dry stack towards the end of this year, beginning of next year?

Jorge Ganoza – Chief Executive Officer
No, no. Everything is going according to plan. We're not seeing any changes in the design. We were very careful. We reached it at a time with experience of others and the challenges that others have faced with implementation, other operators in Mexico and in the neighborhood in general, so we expect a smooth transition. So far in the construction phase, in the selection of equipment, we feel today, I can't say that we feel comfortable, as we still have to see that thing operating, right? But so far, so good.

<Q>: Okay, great. Just quickly, on the expiration there, Jorge. Obviously, you've indicated that you—I guess you sort of concluded the north expansion side for drilling for the moment at Trinidad North. How far outside the resource envelope are you with your drilling there?

Jorge Ganoza – Chief Executive Officer
As much as 200 meters, I believe, we are right now. I would have to confirm that to you, but we've been stepping out really as much as 200 meters due north from the north bound of the shell or research. We've been drilling basically from the same drill chambers. We've been testing this new area set at wide spacing of at least 100 meters or more. We expect now that we are concluding to be publishing results for that drilling this month.

<Q>: Okay, great. Thank you. Then finally, very quickly, just a quick comment, if you would, on labor relationships, union contracts, for instance, for both operations. Where do you sit right now?

Jorge Ganoza – Chief Executive Officer
We have closed annual union negotiations in Peru. We are within budget basically with respect to the commitments agreed to with the union. We charge modest increases in compensation and some other benefits related to operating at high altitude and night shifts and whatnot. Everything is within budget.

I think the team has done, and actually everybody in Caylloma and across the company and across the industry, to make it broader, I think the reality of the environment where we're operating has sunk in with everybody. That was not necessarily the case, for example, two years ago when there was still the hangover from the good old days, from 2010, 2011. But I believe that today everybody is quite cautious of the situation where we are, and everybody has to move in the same direction, right?

<Q>: Thanks. Jorge, thank you very much.

Jorge Ganoza – Chief Executive Officer
Thank you.

Operator
Thank you. Our next question is from Howie Flinker of Flinker and Company. Please go ahead.

<Q>: Thank you. I have a broader question. How could you stay in business with those tax rates?

Jorge Ganoza – Chief Executive Officer
Well, you've got to look at the real sense of the actual, the effective tax rate. You've got to look at the tax rates at our operating subsidiaries. There is a segmented section of our financial statements notes. There is disclosure on the actual income tax rate per operating subsidiary. At the operating subsidiary level, again, outside of distortion from the foreign exchange and the deferred tax portion of the income tax expense, Mexico is in the 36% range year-to-date. But Peru is at a similar level, somewhat higher. So, on the consolidated level, whenever we have a thin operating income due to low prices, as in the current environment, given that we have no operations in Canada, right, and our expenses, a large portion of our corporate expenses are not deductible, well, the effect, of course, is that the consolidated effective tax rate spikes, right?

<Q>: Corporate expenses aren't that big.

Jorge Ganoza – Chief Executive Officer
No, no. So, I mean, again, our typical effective tax rate on an ongoing basis, in a normal situation, will hover between anywhere from 48% and then 52%. We're some are above that, outside of the foreign exchange effect. That is what you should typically expect.

<Q>: Alright. So, let's say 50%. How can you justify investing the next dollar in the next expansion with the guess that the price will be favorable—Because if it was unfavorable, you don't want to do it anyhow—and still be left with 50%, and say we have a reasonable rate of return? How could you justify that? Or do you have to find other places to find gold and silver where you can explore?

Jorge Ganoza – Chief Executive Officer
Well, in the case of our expansion in Mexico, which is our main project, our numbers in spite of that are quite robust. We will be able to not only reduce unit costs, but we will be through the expansion achieving improved

higher grade. Expanding a profitable mine, even in the current price environment, is the best allocation of any available investment surplus.

Luis Ganoza – Chief Financial Officer
The return we're seeing on the expansion project are about 15%.

<Q>: One five?

Luis Ganoza – Chief Financial Officer
Yes.

<Q>: That's pre-tax?

Jorge Ganoza – Chief Executive Officer
That's after tax return?

Luis Ganoza – Chief Financial Officer
Yes.

<Q>: How do you calculate that? What are your numerator and denominator?

Luis Ganoza – Chief Financial Officer
Well, I don't have the financial analysis right in front of me, but if you want to go in detail, we will be happy to have a call with you and go through the numbers, no?

<Q>: Yes, I'm curious. Because when people calculate returns, they frequently leave out some numbers conveniently, and returns are not anywhere near what people say. I've gone through—

Luis Ganoza – Chief Financial Officer
We would be very happy to hold our call and analyze the expansion.

<Q>: Sure, at another time. Yes, by all means. Thank you.

Luis Ganoza – Chief Financial Officer
Basically, a bigger scale, lower effective tax rate, no? The production, lower effective tax rate?

Jorge Ganoza – Chief Executive Officer
Howie, please send an email to info@fortunasilver.com, and I'll reply to you, and we'll arrange a call with Dario, our CFO.

<Q>: What's the first part?

Jorge Ganoza – Chief Executive Officer
info@fortunasilver.com.

<Q>: Okay. I'll do that later. Thank you.

Jorge Ganoza – Chief Executive Officer
Thank you.

<Q>: Thank you.

Operator
Thank you. (Operator instructions.)

The next question is from Matthew O'Keefe of Dundee Capital Markets. Please go ahead.

<Q>: Thanks, operator. Good afternoon. So, I just wanted to follow on the exploration thread a little bit. Obviously, you addressed some of the Trinidad North questions. I was wondering a) what your total budget is, if that's changed this year? Also, you mentioned, this mirror zone, La Noria. I think that's what it was. Could you explain that a little bit? Is there some more compelling reason to be doing more drilling there, and is there a lot of budget allocated to that?

Jorge Ganoza – Chief Executive Officer
That's La Noria.

Luis Ganoza – Chief Financial Officer
With respect to our annual expiration budget, we have a modest budget this year of $4.5 million or $4.1 million, but we are increasing that budget. We are going to be allocating roughly an additional million to initiatives in Caylloma, so that represents a budget increase. Of the $4 million in the budget, $3.5 million were ticketed for San Jose, and only $700,000 for Caylloma, so we are now allocating another $1 million.

It does not sound like a lot, but it is going to help us do very targeted work on some high-grade things that we have identified on the North portion of the Caylloma system aiming to open up some things that can help us with the grade issues we just discussed. These are areas that are close to operational infrastructure and would be easier to incorporate into our plan. At Caylloma, it's not about massive, large programs. I think the work has to be very targeted, as there is no shortage of veins, but you can go broke drilling all the veins at Caylloma. You have to do very targeted work, and that is what we intend to do.

With respect to San Jose, we had in the budget an allocation to drill test La Noria. We're moving forward to that. It's just a parallel north-south running system that was drill tested by a previous explorer in the northernmost portion of the outcropping area with four or five very closely spaced holes. They did encounter the vein with variable grades. I'll say mixed results, nothing really exciting. But in our experience, in general, for us who have explored these epithermal systems, I mean, you hit the structure, you find mixed results. You have to aim for the horseshoes, right?

It is the same at Trinidad. You're out of the shoot, you're in a tighter zone, and you're seeing 100 grams, half a gram gold, 100 gram silver, 50 gram silver. So we have plenty of structure at La Noria. Our surface sampling has allowed us to identify areas with higher metal content. We're going to be drill testing some of those areas the second half of the year.

<Q>: Okay, great. Thanks very much.

Operator
Thank you. We have no further questions at this time. I would like to turn the conference back to management for any closing remarks.

Jorge Ganoza – Chief Executive Officer

Okay. Before I let you go, I would like to announce that we've published our annual report in the website. You can find it in the investors tab under annual reports. Thank you very much for joining us in today's earnings call. We look forward to speaking with you next quarter. Stay well.