Transcript of Fortuna Silver Mines, Inc.
Third Quarter 2014 Earnings Call
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Participants
Carlos Baca – Investor Relations
Jorge Ganoza – President and Chief Executive Officer
Luis Ganoza – Chief Financial Officer

Analysts
Benjamin Asuncion – Haywood Securities Inc.
Chris Thompson – Raymond James
John Kratochwil – Canaccord Genuity
Matthew O'Keefe – Dundee Capital Markets.
Craig Johnston – Scotiabank

Presentation

Operator
Greetings, and welcome to the Fortuna Silver Mines' Third Quarter 2014 Earnings conference call. 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 our host, Mr. Carlos Baca, Investor Relations Manager for Fortuna Silver Mines.

Carlos Baca – Investor Relations
Thank you, Melisa. Good morning, ladies and gentlemen. I would like to welcome you all to Fortuna Silver Mines and to our third quarter 2014 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 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 publically 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. Fortuna had a very robust third quarter in terms of production and financial results. The Company produced 1.8 million ounces of silver and 9,700 ounces of gold in the quarter. This represents a 63% and 116% increase, respectively, when compared to the third quarter of 2013. Production for the first nine months of the year stands at 4.9 million ounces of silver and 26,400 gold ounces. Based on production results for the first nine months we are in a position to exceed our annual guidance of 6 million ounces of silver and 32,000 ounces of gold.

During the quarter precious metals accounted for 82% of sales, silver representing 63% and gold 19%. Additionally, during the quarter at the Caylloma mine we produced 7.1 million pounds of zinc and 4.2 million pounds of lead byproducts. Both our Caylloma and San Jose mines operated consistently during the quarter. At San Jose the rate of 2,000 tonnes per day and at Caylloma 1,300 tonnes per day. At both mines, our teams have captured opportunities to quickly adjust to these new lower price levels and big budgets for production and cost.

At San Jose the mine is adequately developed and prepared ahead of production. This provides a nice flexibility to manage grade. As a result grades for the quarter are up 15% and 16%, respectively, against our budgets for silver and gold. Additionally, the grade profile of the mine improves with that as we know and at level 1,200, which currently is the main source of production, we're already mining in the upper portion of the [indiscernible].

At Caylloma, we have directed a mine towards level 12 of the Animas Vein, our deepest production level, where we find higher zinc and lead grades. As a result, zinc grade is up 11% against Q3 2013 and 21% against our budget at a time when zinc prices are up 21% higher than previous year. While doing this we have been able to sustain silver grade at 180 grams per tonne at this mine in line with the comparable quarter and 7% above that.

Looking at our costs, the costs at our mines remain well under control with $61.50 per tonne at San Jose and $91 per tonne at Caylloma. Cost per tonne measured against Q3 2013 dropped by 15% at San Jose and at Caylloma we saw a slight increase of 5% for both mines. Our consolidated all-in sustaining cash cost net of by-products for the quarter was a low $11.85 per ounce of silver. For the nine months or all inclusive sustaining cost was $15 per ounce of silver, well below our $17 guidance for the year.

All-in sustaining cash cost for the quarter at the Caylloma mine was $13.30. At Caylloma the main driver for the all-in sustaining cost per ounce reduction against the budget of $17 for the year was zinc by-product grade and 7% higher silver grade. Our all-in cost guidance for the year, as I said, at Caylloma $17 per ounce we expect to be closer to $15 fee for the year, as we continue to catch up with a slow start in the first half of the year on our underground development plan due to a change in mine contractor and also we're experiencing higher energy costs.

At San Jose our all-in sustaining cash cost per ounce came in at $9 against a budget of $14 per ounce. The main drivers are our 15% and 16% higher silver and gold grades against mine plan and lower unit costs. Our all-in guidance for the year at San Jose is $14, and we're in target to meet or come below guidance.

We continue moving forward with measures to improve productivity across our organization and adjusting our mine plants to sustain low price environment. Most of this cost and capital allocation measures will be part of our 2015 budgets, but we have already moved to make some staff reductions at corporate. A 20% headcount reduction has been implemented in this last quarter of the year, and at our Peruvian subsidiary in Minera Bateas we have made a 7% reductions in headcount.

With regard to the key project we have on hand right now, which is a feasibility work for the expansion of our San Jose mine to 3,000 tonnes per day, we can report that working with our consultants we have concluded the trade-off studies. We're well into the final stages of the feasibility work for the processing plant, which is a main capital component of this project. We expect to win a position to make a construction decision by year-end.

With respect to exploration, we continue exploring the north extent of the Trinidad Northern discovery; we have concluded the extension of level 1,300 from where we have been drilling for the past year from two drill chambers. We have extended the drift and concluded two additional chambers from where we are currently drilling with two rigs. From this position we can drill test an extent of 250 meters north from the north limit of existing inferred resources. That's going to be the main focus of the drilling from now until year-end. And moving forward into 2015, we'll have likely a reduced exploration budget, but focused on this area as well.

With that, I'll leave it to Luis so he can take us through the review of our financials.

Luis Ganoza – Chief Financial Officer

Thank you. For the third quarter of 2014 we've had record sales of $46.4 million, up 54% from the prior year, net income of $7.8 million compared to a loss of $0.3 million in Q3 of 2013, and cash flow from operations before changes in working capital and after taxes paid of $17.8 million, which is up 135% when compared to the prior year period.

Silver and gold sold in Q3 of 2014 increased significantly as a result mainly of the commissioning of the expansion of the San Jose mine creating 100 tonnes per day in Q4 of last year and 2,000 tonnes per day towards April of this year. Silver sold was 1.8 million ounces, up 63%, and gold sold was 8,751 ounces, up 116%. The realized silver price in our provision of sales for the quarter was $19.14 per ounce compared to $21.20 per ounce in Q3 of 2013. We recorded [indiscernible] sales adjustments of $2.6 million in the current quarter compared to nearly 0.5 million in 2013 related to metal price and assay adjustments.

Our mine operating earnings was $16.7 million, 106% above Q3 of 2013, and our gross margins increased from 27% in the comparative period to 36% in the current quarter. The higher margins are solidly grounded on the operational performance at our mines, which more than compensated for a lower silver price. At San Jose higher grades of 30% and the lower unit cost of 15% increased our margins significantly, and at Caylloma strong zinc production and improved metallurgical recoveries helped compensate the lower silver price.

On the selling and G&A line item, we recorded $3.5 million compared to $5 million in 2013, a reduction of $1.5 million. The breakdown of this line item is provided in page 12 of our MD&A and the decrease is related to a credit of $0.8 million on stock based compensation compared to a charge of $1.3 million in 2013. This credit is related to mark-to-market effects resulting from the performance of the share price during the period. Our G&A excluding stock based compensation foreign exchange effects and worker's participation charges within this line item was $4.1 million in line with what we have guided in the previous quarters.

Our net income for the quarter was $7.8 million, as I've already mentioned, and earnings per share were $0.06. Our effective tax rate for the quarter was 40% and year-to-date the effective tax rate was 47%, which is in line with our expectations for the year. Cash flow from operations before changes in working capital and after taxes paid was $17.8 million, a 135% increase over Q3 of 2013. This same measure of cash flow from operations year-to-date was $49.8 million while total capital expenditures was $31.5 million, which gives the free cash flow measure year-to-date of $18.3 million.

We need to bear in mind, however, that our incurred current income tax for the period is $8.9 million above actual taxes paid. We have disclosure on this on page 16 of the MD&A. With this in consideration free cash flow year-to-date is more in the range of $10 million. Our total cash position including short-term investments as of the end of the quarter was $72.3 million, an increase of $23.2 million over year end 2013.

Thank you and, Carlos, back to you.

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

Operator
(Operator instructions.) Our first question comes from the line of Benjamin Asuncion with Haywood Securities.

<Q>: I've got two questions here, first relating to the G&A disclosure that you had in terms of the corporate cost reduction. Could you give us a sense of what your annualized G&A is? Then also just from a modeling perspective if we can get that broken down by corporate, Mexico and Peru.

Jorge Ganoza – President and Chief Executive Officer
Sure. Based on this quarter, Ben, and as we've been guiding over in the previous calls, our total G&A including cost and corporate is in the range of, has been in the range of $4 million to $4.5 million per quarter. So call it $18 million on a yearly basis, and based on the cost reductions we've implemented, we expect that should come down to around $17 million, so $1 million less of total G&A expenses on a yearly basis. And out of that $17 million, the subsidiary G&A should be in the range of $6 million to $7 million. Those are the numbers we should expect to see moving forward.

<Q>: Then secondly, just following on just the taxes, just given the fact that as I understand, correct me if I'm wrong, you're still in kind of a tax holiday at San Jose in Mexico. Can you give us a sense of so the $8 million that's taxes accrued and can you give us a sense of what the tax payment would be due, in terms of the advance tax payment in January or in Q1 of next year?

Jorge Ganoza – President and Chief Executive Officer
Yes, I mean what's happening is that this is the first year that we're incurring current taxes in Mexico and because it's the first year we're not yet paying tax installments throughout the year, which is what you typically expect. That will change next year, so by year-end we will close with an income tax payable probably in the range of $10 million and that will be a lump-sum payment in March. Starting 2015 incurred income tax should be more similar to the actual taxes paid throughout the year, we shouldn't have such a large variation as we're seeing in this year.

Operator
Our next question comes from the line of Chris Thompson with Raymond James and Associates.

<Q>: Just a couple of quick questions here. Noticed the good low unit costs I guess on a per ton basis at San Jose for the Q3. Are these sustainable at these levels, Jorge?

Jorge Ganoza – President and Chief Executive Officer
Yes, we believe so. We're always subject to see variation quarter-on-quarter, but we're guiding for cost in the low to mid 60s per tonne at San Jose.

<Q>: I guess just a quick question on the expansion, obviously details I would imagine will be provided at the end of the year where we have guidance. Is that correct when you make a production decision?

Jorge Ganoza – President and Chief Executive Officer
Could you repeat that, please?

<Q>: So my understanding is you're going to be making I guess a development decision at the end of the year. Now, if that is positive would we expect guidance to come along with that?

Jorge Ganoza – President and Chief Executive Officer

Yes, of course. It's a key project for the company, and what we expect is that by year-end we can go through the formality of having a construction approval with the Board. Our expectation is that we can do that in early December, if there is a delay we'll go until early January, but we aim to have for 2015 to be a construction year, so that construction decision I don't see any major reasons not to be taken towards the end of the year or early January.

<Q>: Maybe a bit of a pointed question, obviously you're going to incur cap ex, etc., and I guess the scope of the project is going to be governed by the return on capital. Looking at silver prices at the moment, is there a silver price that really doesn't—it make sense to pull the trigger on an expansion decision?

Jorge Ganoza – President and Chief Executive Officer
What we've seen two months ago when we started the process, the budgeting process and we had some three years back from the engineering work we started running our budgets and doing some scenarios on the financial returns of the project of the expansion. We decided to run the budgets and as part of the multiple scenarios we ran with $14, which at that time sounded like ultra-conservative. Well, today it doesn't seem to be ultra-conservative, barely conservative, but at $14 we're still seeing returns in the mid-20s, so low to mid 20s that $14 silver. So it's a very robust project, it makes a world of sense, it's a good use for capital but it also certainly has an impact on our all-in cost and it helps bring our all-in at the San Jose mine well below $10 on a sustained basis, that's what we're seeing.

<Q>: Then my final question Jorge. Just sort of switching gears to Caylloma at the moment, and I realize we spoke about this a couple of weeks ago but can you just outline the sort of operating improvements that might be available for you at Caylloma.

Jorge Ganoza – President and Chief Executive Officer
Yes, we have two areas; one is of course the mine. The mine is even though we cut down on development both our mines, more San Jose driven Caylloma, but still I would say both mines have flexibility in terms of the kind of development we have ahead of production, we're not feeding hand to mouth. We have been able to gear the mine towards a [indiscernible] level of the Animas Vein where we have 7% combined lead zinc resources with 7% combined lead zinc, zinc being more like 4%, 4.5%, still with 2 to 3 ounce silver or a significant with.

So one, we're capturing that opportunity, it's a polymetallic mine and silver is down 20%, but zinc is up 20%, and we've been able to improve our zinc grade with respect to last year by 11% and with respect to our original budget for 2015 by 21%, which has meant that our zinc production for the quarter is up 25% because as we increase head grade we also improve recovery for zinc. That is certainly additional welcome income at a moment like this for that mine and we will continue to focus on that.

At the same time, at the Bateas vein, which is one of the narrow veins which sources high grade, we are in a zone where we are mining a kilo of silver per tonne that has been the contribution of the Bateas vein this quarter has been a modest tonnage of 8,000 tonnes in the quarter, but with the silver grade of almost a kilo. So we're doing smart things I believe but the deposit is also helping.

With respect to the plant moving forward, we have some opportunities to optimize the processing facility that will require capital and we are assessing that capital deployment. Basically, we can improve metallurgical recoveries for silver. Our expectation is as much as three to four recovery points by improving retention time on the lead per [indiscernible]. And by going to a different kind of replacing cyclones by rating high speed, by [indiscernible] screens we could be seeing an increasing throughput capacity from the current 1,300 tonnes per day to 1,450 tonnes per day. Certainly that would be more than an expansion project, we will receive more as an optimization project and so those are the main two things we have at hand.

On the downside we had a dry year this year so our energy costs have gone up higher than budgeted and we are also looking there at a few alternatives with our neighbors to see if we can get more power from the line, but that is already a long story and we are seeing if we can reach a final agreement. But those are the main initiatives at the Caylloma mine.

Operator
Our next question comes from the line of John Kratochwil with Canaccord Genuity.

<Q>: I have two questions, first related to the G&A announcement in the MD&A. I noticed that you said the position of VP Corporate Development has been closed. Does that kind of mean in the near term we shouldn't expect to look at any M&A activities? I know reflecting the current commodity price probably you're not looking at that so strongly, but you've always said that you are open to opportunities. So has that view changed or is that just being taken over by someone else?

Jorge Ganoza – President and Chief Executive Officer
No, we have certainly a focus for the next two years view we see us focused on our most accretive project, which is the expansion of the San Jose Mine. We are fine tuning and fighting the organization and focusing on the two mines we have and the execution of that expansion. Also a reflection of that is that we have made a promotion as well, our corporate manager for project development has been promoted to the position of Vice President of Project Development and that's also a sign of where the focus will be.

Having said that, we are not closed for business. Now, what you will see us doing over the next months and year is scouting the segments of the market using the office of our Vice President of Exploration to assess new opportunities. We all see clearly that there has been complete capitalization in the explorer segment of the industry. We're back to the world of $200,000 financings for the explorers and if you're an explorer with cash for sure you're trading well below your cash. So, we believe there's opportunity there. We're actively looking at some things in that segment, but it's going to be more on that segment of the industry right now more than large corporate transactions.

<Q>: About a year ago you had given just a rough view that within a certain period of time you wanted to be at 14 million ounces silver equivalent. Has that view changed then given where we are today?

Jorge Ganoza – President and Chief Executive Officer
No, and I think we're on a very clear path to make or meet our strategic objective. We believe that with the expansion of the San Jose mine, that mine will be in a position at 3,000 tonnes per day throughput capacity and the kind of research that we have that mine can be in a position to produce around 7 million, 7.5 million ounces, in peak years as much as 8 million ounces of silver annually, plus some 50,000 ounces of gold. The Caylloma mine can continue to contribute at steady state 2 million ounces of silver. So that can take over silver annual production to roughly 9.5 million ounces of silver plus 50,000 ounces of gold. That takes us on a silver equivalent basis to 13 million ounces of silver, and if we do some alchemy and use our by-product lead and zinc and convert it to silver, we're at 14 million, so we're meeting our strategic objective.

<Q>: Then my final question has to do with San Jose. Is there any further updates on talks with the locals on getting the surface access rights there?

Jorge Ganoza – President and Chief Executive Officer
Nothing that I can report. I am planning myself and my Vice President of Operations to go to Mexico before the end of the year and meet with the Governor. We have a good rapport with the authorities, we're just not being able to mobilize, even though we have certain—I believe a key issue surround their support at local level and state level have been discussed, everything is understood. We just need to see that the state government gets

mobilized. I'm sure they have their priorities, but what we want is to go through an assembly with the town being in company of the state government, the representatives of the state government and we're getting difficulties getting dates from them. So we're going to go speak with them and understand what their timing issues are.

<Q>: But I mean at this point it seems more like a timing issue rather than not having much backing from the locals.

Jorge Ganoza – President and Chief Executive Officer
No, our interactions are with the authorities at the municipal level and state level and it's been very supportive and a fluid process. We have good connection I believe with the majority of the town, but we have to go through an assembly and we want to be well prepared by the time that we do this and that requires to be accompanied by the state authorities. We just have to do it right and maybe we'll take time.

Operator
Our next question comes from the line of Craig Johnston with Scotia Bank.

<Q>: First, just on going back to San Jose, thinking about Trinidad North and thinking about when you are looking at developing the decline and bringing Trinidad North into production and if your thinking and timing on that has changed?

Jorge Ganoza – President and Chief Executive Officer
Yes, it has changed somewhat. Two years ago or a year and a half ago, the expansion of the San Jose mine was to 3,000 tonnes per day was not something in the cards. What we had in front of us was an expansion to 1,800, which ended up being 2,000 as we capture opportunities. So our main thinking is how can we benefit from Trinidad North without just having seen it further around the mine plan, how can we impact our annual production. In fact that is why we moved some of our drilling for resource conversion and that's why we have in preparation for mining in 2015 developed resources and reserves. In Trinidad North we currently report roughly 400,000 tonnes in reserves, as silver equivalent in grades close to 500 grams per tonnes equivalent.

But the expansion then came into the cards and we've had some gains from incurred resources as we converted, we mentioned and indicated in the upper levels where we're currently mining, level 1,200. We have enough developed ore that is good for two to two and a half years in the upper levels right now. So we're debating right now the best use of our capital, and that's part of the budgeting process and mine planning we're concluding now because we want to bring Trinidad North forward in time, that means getting more outlays of capital upfront to develop that when we already have two years of developed ore.

So, I believe it will be very likely that as mining Trinidad North in this environment will be somewhat delayed, probably towards 2016. That is one of the scenarios we're seeing as part of our budgeting process and if we do that at the end is because it makes good financial sense.

<Q>: Then thinking grade wise for 2015, and I know you're still in the budgeting process but looking at grades of 239 grams per tonnes in Q3, and then looking at over Q4 and into 2015, any kind of clarity or guidance you could provide on that knowing that say the higher grades from Trinidad North may not be coming until 2016?

Jorge Ganoza – President and Chief Executive Officer
With respect to grades what we're seeing is in the areas where we're mining silver grades in the range of 215, 220 grams, plus gold over 1.5 grams, closer to 1.8, that is the kind of grades we're seeing at [indiscernible] where we're mining. And, again, what we need to balance is the financial return of accelerating development today versus the benefits of just conclude advancing with the accelerated consumption of research as we go to 3,000 tonnes per day. I mean we will be developing Trinidad North. We will be developing the main access, the

question is how much, how meaningful is it going to be to production. I believe that our regional plan of a year ago to start seeing as much as 20% of production, 25% of production coming from Trinidad North in Q1 of 2015 will change. And our reserves grade in the upper portion of the deposit currently stands at around 230 grams, we'll continue to find opportunities to beat a plan so the visibility we have right now is for around 220 grams for 2015. That's a figure that will change and we'll provide guidance, but those are the kind of reserves we have in level 1,200 today.

Operator
Our next question comes from the line of Matthew O'Keefe with Dundee Capital Markets.

<Q>: Question really is looking a bit further ahead that I have, the drop in the silver price here, obviously it's continued to drop and it's been a challenge for mine planning. Clearly you've done a great job in staying ahead of it. I mean the cost cuts that you announced are obviously coming across as proactive which is good, but the next sort of thing that we're going to see in the silver space is everyone is going to be restating their reserves. I'm just wondering what silver price you expect to be using? What impact, if any, do you expect it will have on the mine lives and mine plans at Caylloma and San Jose?

Jorge Ganoza – President and Chief Executive Officer
Well, we use in our last reserve estimates $21 for San Jose and we have updated reserves for resources for Caylloma also $21, which as is part of our practice are published once a year in January-February as we adjust for depletion. We do have reserves and we're seeing our reserves at $21. We can see from the sensitivity of San Jose that the mine is quite resilient to lower prices now as we don't lose a lot of ounces and grade increases significantly moving the cut of from 10 to 20 grams, 30 grams is [indiscernible] lose a lot of tons but grade improved significantly. So that mine is quite resilient.

Caylloma certainly there are risks in Caylloma. Caylloma currently has about 4 million tonnes in reserves, which are more sensible to prices of course. We are benefiting from the higher base metal prices, that's also offsetting lower zinc prices in a way; not completely, but it's offsetting some of the net effect of lower silver prices.

Bear in mind that 80%, 90% of our resources and reserves are on the Animas Vein, which is not particularly silver rich, it's a polymetallic vein. Typically 2 to 3 ounce silver and depending where you are you can see 4% to 7% combined lead zinc, as high as 10% combined lead zinc in some areas. We will be running, we'll wait probably to be closer to year-end to see what prices we're going to use, but sure enough in this environment, whether we end up using what, $17 something like that in that range, $16, $17. It's a tough question, we'll try to be conservative. I believe perhaps in the range of 16, 17 is not a discussion we have entertained yet. Now we run sensitivities on this always.

<Q>: I think your point is well taken earlier that these are high grade mines and pretty resilient to price changes. Thanks for that. Then just one other question on the drilling, are you still drilling at Trinidad North and when are we expecting some additional drill results from there?

Jorge Ganoza – President and Chief Executive Officer
We stopped because of the conclusion of the drill chambers. We restarted a few weeks ago and in this new area we're drilling with two rigs from the underground chambers and again we're going to give coverage to an additional 250 meters from the northern most boundary of our inferred resource shelf. You should see perhaps results before the end of the year.

Operator
(Operator instructions.) Our next question comes from the line of Benjamin Asuncion with Haywood Securities.

<Q>: I've just got a couple of housekeeping questions here. Just in regards to the capital cost that you're talking about at Caylloma with all-in sustaining cost trending up. Can you give me the latest iteration of what capital guidance is by sort of the in-fill mine development and plant upgrades or infrastructure?

Jorge Ganoza – President and Chief Executive Officer
For 2015 you mean?

<Q>: For '14.

Jorge Ganoza – President and Chief Executive Officer
For '14. Our budget for the Caylloma mine was for $10 million for the year, we have executed down to the third quarter, $7 million.

<Q>: And then just sort of following on that just from an optics perspective in fourth quarter and trying to look at some potential noise in earnings. Any thoughts on what you're going to be looking at for valuation tests for Caylloma in terms of carrying values and what the scope of potential impairment charges would look like?

Jorge Ganoza – President and Chief Executive Officer
Not at this stage, Ben, we'll surely be running the usual impairment testing analysis at year-end, in particular given the recent drop in prices and I wouldn't want to [indiscernible] anything at this stage.

Operator
Mr. Baca, there are no further question at this time. I'd like to turn the floor back to you for any closing and final remarks.

Carlos Baca – Investor Relations
Thank you, Melisa. I would like to thank everyone for listening to today's earnings call. We look forward to you joining us next quarter. Have a good day.