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Transcript of
Fortuna Silver Mines
First Quarter 2014 Earnings Call
May 13, 2014

Participants

Carlos Baca – Investor Relations Manager
Jorge Alberto Ganoza -- President and Chief Executive Officer
Luis Dario Ganoza – Chief Financial Officer

Analysts

Chris Thompson -- Raymond James
Benjamin Asuncion -- Haywood Securities
John Kratochwil – Canaccord Genuity Group Inc.
Chris Lichtenheldt -- Dundee Capital Markets

Presentation

Operator

Greetings, and welcome to the Fortuna Silver Mines' First Quarter 2014 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's Instructions) As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Carlos Baca, Investor Relations Manager. Thank you, Mr. Baca, you may begin.

Carlos Baca – Investor Relations Manager

Thank you, Rob. Good morning, ladies and gentlemen. I would like to welcome you all to Fortuna Silver Mines, and to our first quarter 2014 Financial and Operations Results call. Jorge Alberto Ganoza, President and CEO, and Luis Dario Ganoza, Chief Financial Officer, will be hosting the call from Lima, Peru.

Before I turn over the call to Jorge, I would like to indicate that certain information contained or incorporated by reference in this earnings call, including any information as to our strategy, projects, plans, or future financial or operating performance, constitutes forward-looking statements. All statements other than statements of historical facts are forward-looking statements. The words, believe, expect, anticipate, contemplate, target, plan, intend, continue, budget, estimate, will, schedule, and similar expressions identify forward-looking statements.

Forward-looking statements are necessarily based upon a number of estimates and assumptions that, while considered reasonable by the company, are inherently subject to significant business, economic, and competitive uncertainties and contingencies.

Known and unknown factors could cause actual results to differ materially from those projected in the forward-looking statements. We disclaim any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise, except as required by applicable law.

I would now like to turn the call over to Mr. Jorge Ganoza, President, CEO and Co-Founder of Fortuna. Thank you once again to everyone for joining us.

Jorge Alberto Ganoza – President and Chief Financial Officer

Thank you, Carlos, and good morning to all. Fortuna reported a strong first quarter in terms of production costs and financial results. The Company produced 1.5 million ounces of silver and 8,150 ounces of gold, a 55% and 81% increase with respect to the first quarter of 2013. We're on target to meet our annual guidance of 6 million ounces of silver and 32,000 ounces of gold.

Additionally, at the Caylloma Mine we produced 3,000 tonnes of zinc and 1,700 tonnes of lead byproducts.

The growth in silver and gold production comes from the expansion of our San Jose Mine from 1,150 tonnes per day throughput to 1,800 tonnes per day achieved last September. When compared against the first quarter of 2013, San Jose processed 61% more tonnage, with 24% and 17% higher silver and gold grades respectively.

The improvement in grades is consistent with the increasing grade profile of the mine at that reserve and tonnage and grade reconciliation. Reserve, tonnage, and grade reconciliation for the quarter is within acceptable ranges. At San Jose 57% of production tonnage was sourced from the Stokework zone on level 1200, currently under the [indiscernible]. Here grades came in 27% higher for silver and 8% higher for gold when compared to the resource model.

Costs at our mines were well under control and dropping. Our costs per tonne measured against Q1 2013 dropped by 15% at San Jose and 7% at Caylloma, and were in line with budget.

Our consolidated all-in sustaining cash cost, net of byproducts, was $16.50 per ounce silver, in line with our $17 guidance for the year. All-in sustaining cost for the Caylloma Mine was $13, for San Jose $14 per ounce of silver. Both operations reported drops of $10 for all-in sustaining cash cost compared to the first quarter of 2013.

At Caylloma the main drivers for the all-in sustaining cost per ounce reductions were a 7% drop in costs related to the optimization of mine preparation, headcount, and other community relation expenses. On the capital side, the completion of mine camp improvements for $2.9 million, reduction in exploration drilling for $900,000, and reduced underground mine development for $1 million.

Our all-in cost guidance for the year at Caylloma is $17 per ounce of silver. We expect to be closer to this figure for the year as we catch up with the slow start in the first quarter on our underground development plan due to a change in mine contract. At San Jose, our all-in sustaining cash cost per ounce compared to the first quarter of 2013 saw the benefit of 15% lower costs, mainly related to a 65% increase in tonnage throughput and related 102% higher silver and 93% higher gold production. All-in cost guidance for the year at San Jose is $14 per ounce, and we're on target to meet guidance.

On the project side, we have concluded a scoping study for the implementation of dry stock tailings at San Jose. The results of the project is positive. The benefit of

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implementing this project we'll retain storage capacity within company grounds for 10 million tonnes and additional contribution of water to our [indiscernible]. We're moving to develop basic and detailed engineering, aiming to start construction in 2015.

We're also in the process of launching trade-off and feasibility studies for a potential expansion of the San Jose mine to 3,000 tonnes per day. We want to see a robust economic return. The decision to move forward with this expansion project should be taken on the fourth quarter of this year.

On the exploration front, we continue with underground drilling at the Trinidad North discovery with two rigs. Up to the first week of May we have concluded 23 diamond drill holes for a total of 11,300 meters. The plan for the remainder of the year is to extend our underground exploration another 250 meters from the bore northern boundary of drilling. The drill program will continue until year-end.

Additionally, we will be using the end of June as a start-up date to update resources and reserves at San Jose to be published in October. Trinidad North remains open on three directions, to the north, west, and for 300 meters to surface above level 1300. From our latest results, news release dated April 29th, I want to highlight drill hole 364 with 2.5 kilos of silver and 10 grams per tonne gold over an estimated throughway of 3 meters, and drill holes 359 with 880 grams per tonne silver and 4 grams per tonne gold over an estimated throughway of 3.5 meters. These two drill holes currently define Trinidad North as being open to the north and to depth.

With regard to community permits to advanced drill testing of Trinidad from surface to the north, we continue holding advanced conversations with local Ejido authorities. This is a process that takes time, and what I can say at this moment is that we remain optimistic we can obtain a satisfactory agreement with our Ejido neighbors, as we have done in the past.

At Caylloma we continue advancing with a focused exploration drill program targeting veins with potential for Bonanza style silver mineralization. We have tested three targets with 2,000 meters of drilling since the beginning of the year, and we continue with the program.

Now, Luis, can you please move on with a review of our financials.

Luis Dario Ganoza – Chief Financial Officer
Thank you. For Q1 2014 we recorded sales of $45.5 million, up 12% from the prior year; net income of $4.9 million, a decrease of 27% compared to Q1 of 2013; and cash flow from operations before changes in working capital of $16.9 million, up 4% compared to the prior year period.

Silver and gold increased significantly as a result mainly of a commissioning of the expansion of the San Jose mine to 1,800 tonnes per day in the last quarter of last year. Silver sold was 1.6 million ounces, up 57% compared to the previous year, and gold sold was a bit over 8,700 ounces, up 87% compared to the prior year.

The impact of higher metal sold on our sales was offset, though, by a lower price environment when compared to Q1 of 2013. Realized silver and gold prices for Q1 2014 were 33% and 22% lower than the previous year.

Our mine operating earnings was $17.2 million, slightly above Q1 2013 by 3%. The increase in sales did not fully translate into higher mine operating earnings, as our gross margins came down from 41% to 38%, reflecting the impact of lower metal prices. This negative impact, however, was offset to a large extent by lower unit costs at both subsidiaries, 15% lower at San Jose and 7% lower at Caylloma, and higher head grades at San Jose.

We recorded selling and G&A of $7.9 million, an increase of $2.3 million compared to the prior year period. Out of this incremental amount, $1.7 million is related to share based payments, which is mostly explained by mark-to-market effect, and about $0.5 million is related to non-recurring items, mainly incentive performance payment.

Moving forward, on a quarterly basis we expect general and administrative expenses of around $4.2 million and a total amount for the selling and G&A line item out of the financials between $5.2 million to $5.5 million.

Our income before tax was $9.1 million, and that's 1.7 million below Q1 2013 as a result of the higher G&A items I just described.

Now our net income for the period was $4.9 million with an effective tax rate of 46%, which is in line with our expectation for the year.

Earnings per share was $0.04 compared to $0.05 in Q1 2013.

Cash flow from operations before changes in working capital and after taxes paid was $16.9 million, while total capital expenditures was $10 million, which gives us a free cash flow measure in the quarter of almost $7 million. Our total cash position, including short-term investments, as of the end of the quarter was $62.1 million, an increase of $13 million over year-end 2013.

Thank you, and back to you, Carlos.

Carlos Baca – Investor Relations Manager
Thank you very much for listening to us. We would now like to turn the call over to any questions that you may have. Please state your name clearly.

Operator
Thank you. We will now be conducting a question and answer session. (Operator's Instructions) Our first question is from the line of Chris Thompson with Raymond James. Please proceed with your question.

Chris Thompson -- Raymond James
Congratulations on a solid quarter, guys. Couple of quick questions. Just looking at I guess the head grade per tonne they were pretty good for the quarter, arguably higher than guidance for the year. Do you see this is as continuing?

Jorge Alberto Ganoza – President and Chief Financial Officer
Hello, Chris. Our grades against the budget were 13% higher, and this is explained by the fact that roughly half of the production in the quarter came from an Inferred Research zone, and this is a deviation from the annual plan. This has been accommodated in our short-term plan, and I have to say that this [indiscernible] for path of least resistance.

On level 1200 we have accessed an area of Inferred Resources for conversion with underground development, and what we came up with was a zone that in terms of grade and has surprised to the upside, and again a bit of a path of least resistance on the mine side. The team accelerated the development of the area and started implementing production panels, and, sure enough, this area in the model is in

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Inferred category. Grades we are finding, as I explained in the call, came up 27% higher for silver and 8% higher for gold comparing against the Inferred Resource model.

We are adjusting the short-term plan. I would not expect 50% production being sourced steadily through the year from this zone will start declining and grades should start reverting back to our plan. But we had a nice surprise to the upside as we entered this Inferred Resource zone, and we became a bit I would say greedy with these new zone. We pushed it more than we would have liked perhaps.

Chris Thompson -- Raymond James
Great, Jorge, thank you for that. Just a quick question I guess on the dry stack tailings. Do you see this as providing the adequate water against resources to satisfy the jump to 3,000 tonne a day?

Jorge Alberto Ganoza – President and Chief Financial Officer
Yes, and really the dry stack has two very important angles to it. One is that when we made the decision to build this mine back in 2010 we had in total resources, reserves, everything, 5 million tonnes. Today we have 10 million tonnes in total inventories and growing. The tailings facility we designed for back in 2010 was to hold 5 million tonnes, so we need to address the long-term tailing disposal of the mine. This is a way to do it, and we can dispose of almost 10 million tonnes within ground surface rights that we control where we already have a change of land use, which is the main required permit in Mexico. So this is really, on the technical sustainability side, the way to go.

An added benefit is that compared to what we do today is that, yes, for sure we will be able to gain significantly more water by using the dry stack tailings. We currently have a lot of what we call dead water in the tailings facility, and now by going dry stack we will recover all of that water. It certainly supports the balance for 3,000 tonnes per day. That's our initial estimates.

Chris Thompson -- Raymond James
That's great, Jorge. Any idea of capital cost?

Jorge Alberto Ganoza – President and Chief Financial Officer
We're not doing a feasibility study. We're going from scoping to basic engineering, and what we plan to do--this is not a project that was budgeted for 2014, we budgeted engineering, but no construction in 2014--so what we intend to do is develop basic engineering, and with the figures we get from basic engineering seek budget approval at the board level to start making some equipment orders, placing some equipment orders, and what not. The initial figure we have right now for the total upfront capital and initial tailing site facility and everything is in the low to mid 20s, $20 million, $20 million, $25 million. That would be good for two years, three years. It's not upfront, but for initial two years to three years.

In our life of mines, just for reference, in our life of mine budget we accounted for $40 million to deal with the fact that we needed additional tailings facility. So we believe this will, over the life of mine models, gain significant savings, although it will be brought closer to the present.

Chris Thompson -- Raymond James
Right. Wonderful, Jorge. Thank you for that.

Jorge Alberto Ganoza – President and Chief Financial Officer

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Thank you, Chris.

Operator
Thank you. (Operator's Instructions) The next question is from the line of Benjamin Asuncion of Haywood Securities. Please go ahead with your question.

Benjamin Asuncion -- Haywood Securities
Hello. Congratulations, guys, on a good quarter here. Some of my questions were already just answered. Just was wondering, in so far as Trinidad North can you give us a sense out of the number of holes drilled how many are released and kind of what we would be looking at for timing on the next batch of exploration results?

Jorge Alberto Ganoza – President and Chief Financial Officer
Hello, Ben. We would expect to have a release probably late mid-July. I think that would be where continue with the drilling with the two rigs in Trinidad North. We have an additional rig in the South drill testing this Stokework zone and new area to the south on level 1200 that I just talked about. So I would expect that by July, in two months, two and a half months, we can be releasing additional results.

We're getting good advance, about 40 meters per day per rig. So right now we don't have a large number of holes pending, probably one or two, so we will wait until we can make more of a comprehensive release of results.

The other thing worth noting is that we will be making a cut date of last day of June to start working on our updated resource and re-service we mentioned that we'll likely be releasing in late September or October.

Benjamin Asuncion -- Haywood Securities
Okay. And just so far as the expansion that was completed I guess in early April, can you give us a sense of what April average throughput rates are or maybe even sort of May to date in terms of where you are to hitting the 2,000 tonnes a day?

Jorge Alberto Ganoza – President and Chief Financial Officer
We're not up steady 2,000 tonnes per day yet. Gaining that additional 150 tonnes per day, which is what we we're aiming to do, is challenging the team. We believe it is a matter of time. We don't see any material hurdles. Our average throughput for April has been below 2,000 tonnes per day. In May we've already seen days at 2,000 tonne per day with good recoveries in line with what we aim for, which is 89% to 90% for both silver and gold, but we are still having difficulties to keep it steady through. But I am confident that we will get there. There are no material real reasons not to do it; it' s just balancing, managing all the parts, just keeping good recoveries, having a concentrate grade that it's also within plan. So it just is going to take us a few more days, a few more weeks, but no material reasons. We're already achieving some days, some steady days 2,000 and their recoveries and the quality of concentrate that we expect.

Benjamin Asuncion -- Haywood Securities
Okay, perfect, and just a last thing, I might have missed this. You mentioned that the announcement for the expansion to 3,000 tonnes per day was given in fourth quarter concurrent with a board decision at that point in time.

Jorge Alberto Ganoza – President and Chief Financial Officer
Yes. We have not made a decision to move to 3,000 tonnes per day. What we are saying is that we will conduct all the necessary technical and financial analysis to come up with a solid, robust project to take the mine to that level. We expect we will

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be concluding with those studies towards the end of the year, and at that point management will present its recommendations to the board.

Benjamin Asuncion -- Haywood Securities
Okay. And then would we still looking at kind of a modular expansion of the plant?

Jorge Alberto Ganoza – President and Chief Financial Officer
We are going to be carrying trade-off studies as part of this feasibility work, and a lot of those questions will be answered throughout the process, but our initial collective thought here is that this should be a jump to 3,000 tonnes per day. We believe the mine can accommodate it, and just starting a new floatation line we could accommodate it. Probably the main changes will take place in crushing and grinding.

Benjamin Asuncion -- Haywood Securities
Okay. Perfect. Thanks a lot, guys.

Jorge Alberto Ganoza – President and Chief Financial Officer
Thank you, Ben.

Operator
Our next question comes from the line of John Kratochwil with Canaccord. Please go ahead with your question.

John Kratochwil -- Canaccord
Hello. Good morning, guys. Congratulations, again, on the quarter. I had a question; the exploration drift that you're currently driving across, how far advanced is that and is it still seeming to be on track to be completed? I think last guidance you gave was kind of August, September timeline. Is that still on track?

Jorge Alberto Ganoza – President and Chief Financial Officer
We faced a delay due to a ventilation raise bore. We faced a delay due to a ventilation raise bore for the start of the drilling. That has been overcome. Basically, just to give you a bit more color on this, in most of the mine infrastructure we developed East on the footwall of the structure and this raise bore was done on hanging wall of the structure, which is the area where we are drilling from, and the quality of the road, as we expected, was poor, and so the raise boring, the rimming of the raise bore took longer than originally planned. It had to be done slowly and carefully in order not to lose the raise bore.

But that's done, it's concluded; we have all the services and access and ventilations through the raise bore now and we're advancing. So we do not expect any material delays with regard to our end goal of covering those additional 250 meters from the current boundary of drilling before the end of the year. We had a bit of comfort zone and the raise bore took that away, but we're still within our time frames.

John Kratochwil -- Canaccord
Okay. And just to clarify, most of the drill results that we've seen to date since the reserve resource update has been basically from Trinidad North. Is that update on October largely going to be an increase or an update on resources in Trinidad North, or are we expecting something from the Stockwork zone as well?

Jorge Alberto Ganoza – President and Chief Financial Officer
No, we should expect a conversion from the Stockwork zone. So what we should expect to see is growth in Inferred Resources coming mainly from Trinidad North and

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a migration from Inferred to measured and indicated mainly from the Stockwork zones in the main deposit.

John Kratochwil -- Canaccord
I see. Okay. And then final question I had, maybe I misunderstood on the call, but did I hear you say G&A for rest of the year, excluding stock based comp, is going to be in the range of about $4.2 million a quarter?

Jorge Alberto Ganoza – President and Chief Financial Officer
Yes that's accurate.

John Kratochwil -- Canaccord
Yes. Okay. Okay, just wanted to double-check that. Thanks a lot, guys.

Jorge Alberto Ganoza – President and Chief Financial Officer
Yes. Thank you.

Operator
Thank you. (Operator's Instructions) The next question comes from the line of Chris Lichtenheldt of Dundee Capital. Please go ahead with your question.

Chris Lichtenheldt -- Dundee Capital
Good afternoon, everyone. Just a question again on the development at Trinidad. Irrespective of the studies that you are conducting right now looking at an expansion, do you still expect to be in Trinidad North early next year bringing ore out, whether it be for 2,000 tonnes a day or a 3,000 tonne a day mill?

Jorge Alberto Ganoza – President and Chief Financial Officer
Yes. Yes, we're still working for that. The key development for that, Chris, is the deepening of the main decline. We had some minor delays due to priorities in the disposition of equipment as we went through the expansion, but we have retaken the priority on the deepening of the decline and we expect we will be in Q1 starting to source ore from the boundary of Trinidad North.

Chris Lichtenheldt -- Dundee Capital
Okay. Great. Secondly, I just wanted to ask on Caylloma the all-in sustaining costs for the quarter were quite good, in the low $13s. When you look at the silver price environment and the nature of that ore body and the cost you're achieving now can you comment a little bit about how you see next year, maybe even the year after? Going forward at Caylloma can you maintain these sort of costs and production levels?

Jorge Alberto Ganoza – President and Chief Financial Officer
As I stated, we had particularly a good figure of $13 at Caylloma for Q1, but one of the main drivers for that has been a delay in the underground development that has occurred throughout the first quarter, mainly due to a change in the underground contractor. So we prioritized production, and a lot of the development that had to take place was postponed as the team there at the mine went through the phase of readjusting, changing contractor.

So we expect all-in costs to gravitate towards the $17 for the year. What we believe is that in this price environment $17 is reasonable for Caylloma moving forward. We're starting to see some-- We also have to be cognizant that as prices go up we all face severe cost inflation pressures, but as prices come down we also see some deflation taking place, and in some cases I'm surprised to see it coming after I would have expected. So we're seeing cost adjustments to the downside. But in this pricing range I would believe around $17, $16 is reasonable for these mines.

Chris Lichtenheldt -- Dundee Capital
Understandable. Okay. That's great. Thanks a lot.

Operator
Thank you. At this time I will turn the floor back to management for closing comments.

Carlos Baca – Investor Relations Manager
If there are no further questions 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.

Operator
This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.

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