Transcript of Fortuna Silver Mines Inc.
First Quarter 2017 Financial and Operational Results
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Participants
Carlos Baca - IR, Manager
Jorge Ganoza - President, CEO and Director
Luis Ganoza - CFO

Analysts
Chris Thompson - Raymond James

Presentation

Operator
Good day, ladies and gentlemen, and welcome to the Fortuna Silver Mines First Quarter 2017 Financial and Operational Results. All lines have been placed on a listen-only mode. [Operator instructions.]

At this time, it is my pleasure to turn the floor over to your host, Carlos Baca, Investor Relations Manager. Sir, the floor is yours.

Carlos Baca - IR, Manager
Thank you, Julie. Good morning, ladies and gentlemen. I would like to welcome you all to Fortuna Silver Mines and to our first quarter 2017 financial and operational results call. Today, we will be using a webcast presentation which will be controlled by us. You can download the presentation at our website. Please click on the Investors tab and then click on Financials. Under Q1, click on Earnings Call Presentation.

Jorge Alberto Ganoza, President, CEO and Director; and Luis Dario Ganoza, CFO, will be hosting the call from Lima, Peru.

Before I turn over the call to Jorge, I would like to indicate that this earnings call contains forward-looking information that is based on the company's current expectations, estimates and beliefs. This forward-looking information is subject to a number of risks, uncertainties and other factors. Actual results could differ materially from a conclusion, forecast or projection in the forward-looking information. Certain material factors or assumptions were applied in drawing a conclusion or making a forecast or projection, as reflected in the forward-looking information.

Additional information about the material factors that could cause actual results to differ materially from the conclusion, forecast or projection in the forward-looking information and the material factors or assumptions that were applied in drawing a conclusion or making a forecast or projection as reflected in the forward-looking information is contained in the company's annual information form, 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 - President, CEO and Director

Thank you, Carlos, and good morning to all. I will give you a brief introduction for the first quarter results, and then turn the call to Luis who will take you through the financial statements. After that, we'll open the call for questions and answers.

Our results in the first quarter reflect the full impact from the expanded 3,000 ton per day capacity at our San Jose Mine in Mexico. On a consolidated basis, we expanded our silver production by 26% to 2 million ounces and gold production by 42% to 13,200 ounces compared to the same quarter of prior year, as we show in slide 4 of the presentation. Precious metals comprised 74% of sales, with lead and zinc contributing the balance.

In slide 5, we show a strong financial performance in the quarter. Sales increased 52%, and net income increased 400% compared to the same quarter of prior year. It's worth mentioning that net income achieved a quarterly record of $13 million. In terms of cash generation, we increased 218% cash flow from operations before changes in working capital compared to the same quarter of prior year.

We achieved a consolidated all-in sustaining cash cost per ounce of silver net of byproducts of $6, a reduction of 35% compared to the same quarter of prior year and a reduction of 37% compared to our 2017 guidance. When compared to budget and guidance, our all-in sustaining cost benefited mainly from higher production and prices for zinc and led. Zinc provided the main contribution with higher production of 10% and higher prices of 27% compared against budget. Our cash cost per ton at both mines came in line with budget and similar to the comparable quarter of prior year.

Moving on to capital investments on slide 6. Our consolidated CapEx for the period was $9.7 million. The breakdown is $1.9 million to the Lindero project; $2.7 million in brownfields explorations; and $5.1 million of sustaining capital at our two mines.

In slide 8, on brownfields explorations, we carried 13,100 meters of drilling in the first quarter of 2017, and with an execution of approximately $2.7 million. As we stated in the yearend earnings call, Lindero's review and optimization is advancing well and on schedule for a construction decision in the third quarter of the year. We are basically concluded with the metallurgical testing, and we expect we will be in a position to give another update on the advance of metallurgical results and engineering work in the coming weeks.

So, with that, I will let Luis now take you through the financial statements now.

Luis Ganoza - CFO

Thank you, Jorge. So, no to slide 10. We recorded net sales of $64.8 million, up 52% from the prior year, driven by higher metal sales and prices. We reported net income of $13 million compared to $2.6 million in 2016, and earnings per share of $0.08 compared to $0.02. We had an unusually low effective tax rate in the quarter, contributing around $3 million or $0.02 per share to our net results. Higher cash provided by operating activities is, a reflection as Jorge mentioned, of a strong quarter in revenues and margins. And cash equivalents and short-term investments as at the end of March 2017 added up to $191.2 million, which includes the proceeds from the equity financing closed on February 9.

On to slide 11, when breaking down our sales performance, we had higher total sales of $22.1 million with higher contribution from improved metal prices of $11.2 million compared to $7.2 million from higher metal volumes. Worth noting is a participation of zinc and lead to the overall price contribution in the amount of $6.1 million driven by higher lead and zinc prices year-over-year of 31% and 65%. Also contributing to our higher sales was a positive impact of treatment and refining charges of $3.5 million, which reflects improved commercial terms on all of our concentrate products over the prior year.

On to slide 12, our operating income and adjusted EBITDA reflect our strong performance in operating results over the first quarter of 2016. Both operating income and adjusted EBITDA in 2016 were impacted by $5.7 million stock-based compensation charge related for the most part to mark-to-market effects from the performance of our share price back then.

Adjusted EBITDA in Q1 2017 was $30.4 million, driven by significantly improved results at both of our mines. In the case of San Jose, EBITDA increased 56% on the back of higher production, higher silver prices, improved commercial terms and lower unit costs. EBITDA margin over sales showed a slight decrease due to a foreign exchange loss related to the appreciation of the Mexican peso. In the case of Caylloma, higher EBITDA was driven by improved base metal prices and commercial terms.

On slide 13, total selling, general and administrative expenses was $5.3 million, down 45% from first quarter in 2016 as a result of lower stock-based compensation charge. Corporate G&A at $3.2 million was impacted by one-time events and was higher than what we anticipate on a normalized basis. Our effective tax rate for the quarter was 26%, significantly lower than the 45% to 48% range we expect to see on average. The lower rate is related to the appreciation of the Mexican peso of 9% throughout the quarter and the impact this has on the deferred [ph] component of the income tax expense.

Onto slide 14, the company maintains a strong balance sheet position with, as I mentioned, total cash and short-term investment as of the end of the quarter of $191.2 million. We completed an equity financing on February 9th for total net proceeds of $70.9 million, representing an increase in our issued and outstanding shares of 8%. This added strength to the treasury of the company, along with the available debt capacity in our balance sheet will ensure we are in a solid position to meet our funding needs on new projects over the short and medium term without deviating from our conservative capital structure.

And finally, on slide 15, we provide a bridge graph for our cash position in the first quarter of the year including short-term investments. As can be appreciated, free cash flow estimate, starting from EBITDA of $30.4 million and excluding changes in working capital of $10.4 million was in the $8 million range. This is consistent with our expectation for the year under the current price environment and considering our planned capital expenditures at our operating mines.

Thank you and back to you, Carlos.

Carlos Baca - IR, Manager
Julie, we are ready for the Q&A session.

Operator
[Operator instructions.] And we have our first question from Chris Thompson from Raymond James. Chris, state your question.

Q: Just a couple of quick questions. Firstly, obviously, noticed the exploration results from Caylloma last week. Could you just maybe sort of expand on how significant those are in the context of the operation at the moment?

Jorge Ganoza - President, CEO and Director

Yes. Thank you for the question, Chris. Quite important, the Caylloma Mine is centered today on production from the Animas vein. And over the last ten years up to two years ago, production was centered on what we call the central portion of Animas. And the center of gravity of production has been shifting further to the northeast on Animas to this area called Animas Northeast. We have had resources there that support our mine plans. But also bear in mind that we have been shortcutting Caylloma off exploration funding over the last three years as we channeled most of the resources towards the constructions and expansions for San Jose Mine, in an environment depressed prices.

So, we're providing again the adequate level of funding to exploration at Caylloma and focusing on this area to the northeast. We are enjoying what we believe are important expansions of resources in what is to be the new center of gravity for the years to come for this mine.

We're breaking also some old paradigms with this program. There is a basement of sediments and metal sediments in Caylloma called the Yura Group that has been thought to not be a receptive host to mineralization, just the volcanics that conformably sit on top of this package. And results of this program have encountered economic grade mineralization over economic width for mechanized production in the Yura Group in the basement. So, we're excited by the size and extent of this discovery and extension area to existing resources and also excited by the fact that we're encountering economic grade mineralization in the Yura Group which is a basement, which gives us a lot of expectation with respect to the future potential for continued expansion.

Q: Thanks for that, Jorge. And just a final question quickly. Did obviously note you made some strategic investments in some juniors recently. I just wondered if you could just put that in context with regards to the strategy of the company.

Jorge Ganoza - President, CEO and Director
Yes. We have been focused over the last—from the high-level, strategic perspective, we've been mainly focused over the last years on the expansion of our mines. Early on, we acquired the Caylloma Mine and the San Jose project, and we saw a lot of potential and value to be unlocked. And we have been focused on that, adding ounces to our inventories at a cost of cents per ounce from our brownfields exploration success at both sites.

But it is a view today that based on the size of existing resources and reserves, the mine seemed to be at an optimum size. So that prompted us to look outside the farm. That process started about two years ago. Last year, we were able to materialize the Lindero acquisition, which is an advanced development project that brings not only potential for low cost ounces to a production profile but also because of the nature of the deposit, a significantly longer reserve life. This is a large depositary [ph] system that on reserves brings us ten years of reserves versus our high grade underground operations, which although we have high expectations with respect to the potential to increase reserves year-over-year because of their own nature, they carry reserves of five to seven years only.

So, we believe that with these three projects, the two mines and the Lindero project, we are building a strong base of production for the future of the company, but we also need to take care of the lower echelon of the pyramid, which is a bit lonely. We need to see future growth, thinking two, three years from now. And we are taking advantage of opportunities where we see a lower—we are pursuing opportunities that do carry higher geologic risk because of their early stage nature but carry a low financial risk to the company as most of our financial resources will be or we expect will be allocated towards a construction decision, once that is made for Lindero.

But we are looking for these opportunities that are early stage projects that have merit and bear high risk, high potential reward and carry low financial risk to the company at this current time as most of our resources and management focus will be or is being assigned to Lindero over the next 24 months likely. So that's the overall strategy.

Operator
[Operator instructions.] And we have a question from Rayu Garam [ph] private investor. Rayu, state your question.

Q: The Peru operations, it looks like they are continuously outperforming past several quarters. I really appreciate some analysts in the investment community actually have not attributed any value to those operations. Surprisingly, you are outperforming and great actually value creation there. Even recent exploration results continue to prove that there is lot more to go going forward.

My question is we have some exploration activities around in Mexico, San Jose Mine. I wish to know, what's the latest going on there? I understand there are some problems with the accessing from the surface, but management has been doing everything it can to do underground access. So I want to know what's going on and then if anything you can share at exploration, really appreciate that. Thank you.

Jorge Ganoza - President, CEO and Director
Thank you for your questions. With respect to your comments with regards to Caylloma, absolutely, the San Jose since 2010, 2011 has been at the center stage of Fortuna's evolution. Caylloma has been at steady state of operations for a number of years, and San Jose has been the new mine and the one that is growing, overshadowing Caylloma. But Caylloma quietly and unassumingly and steadily has been there and contributing, backing, I'll say in a significant way to the financial results of the company, where EBITDA margin at San Jose in the quarter is over 50%, but Caylloma is in the mid-40s, high 40. So, it's a smaller mine, yes, it is, but showing great performance.

With respect to exploration at San Jose, we have an aggressive drill program for the year, and we have about 30,000 meters budgeted for San Jose in the year if my memory doesn't fail me. Most of the drilling will take place in Trinidad North as we finish the exploration this year. We are currently drilling there with three rigs, and we expect to publish results as we produce an amount that would help give a good picture to investors and analysts with respect to what's going on there.

But, again, we have an aggressive program, over 30,000 meters of drill for San Jose. Most of that is focused on the northern extension, where we today do not have any limitations to access the set targets for the year. Note that is something that we have been battling with in the past due to surface access limitations, but those limitations have been removed as we are basically concluded with the underground tunneling and drifting that allows us to carry the work. So, I look forward to sharing in the near future exploration results with the market.

Q: Thanks, again. I really appreciate the effort management has been putting past, say, several years. And we are a cost leader and also as well as growth leader, and we know that. Of course, the stock is not performing as expected, but I know management will do the right things from time to time. Thank you again and congratulations.

Jorge Ganoza - President, CEO and Director
Thank you for your comments.

Operator
And there appears to be no further questions. I'll turn the call back over to Carlos Baca.

Carlos Baca - IR, Manager
Thank you, Julie. I would like to thank everyone for listening to today's earnings call, and we look forward to you joining us next quarter. Have a good day.

Operator
Thank you. This does concludes today's teleconference. We thank you for your participation. You may disconnect your lines at this time, and have a great day.