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

Analysts
Justin Stephens - Raymond James
Bragam Jerum – Credit Investor

Presentation

Operator
Good day, ladies and gentlemen, and welcome to Fortuna Silver Mines' Third Quarter 2017 Financial and Operational Results Conference Call. All lines have been placed on a listen-only mode and the floor will be opened for questions and comments following the presentation. [Operator instructions].

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

Carlos Baca - Manager of IR
Thank you, Kathy. Good morning, ladies and gentlemen. I would like to welcome you all to Fortuna Silver Mines and to our third 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 and under Q3, click on Earnings Call webcast.

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 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 - President and CEO

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

Our results in the third quarter showed strong performance when compared to what was our historic record quarter in Q3, 2016. Production was 2 million ounces of silver and 13,400 ounces of gold, 4% or 5% below the same quarter prior year as we show in slide 4 of the presentation. On a consolidated basis, 9 months production is 6.2 million ounces of silver and 41,200 ounces of gold, well in line with our annual guidance.

On slide 5, 71% of traditional sales were comprised by precious metals, while 29% were base metal byproduct. We're seeing an increased contribution of byproduct lead and zinc compared to 19% contribution a year ago, which is mainly explained by a 32% higher zinc and 24% higher lead prices.

On slide 6, we show a strong financial performance. Sales were $64 million, net income $10 million with earnings per share of $0.06. In terms of cash generation, cash flow from operations before changes in working capital was $26.2 million with the margin over sales of 41%, highlighting the strong margins of our business.

In slide 7, we achieved a consolidated all-in sustaining cash cost per ounce of silver net of byproducts credits of $6.10, a reduction of 20% compared to the same quarter of prior year and also a reduction of 38% compared to our 2017 guidance. Our all-in sustaining cost benefited mainly from higher byproduct based metal prices. Our business operates within the bottom cost quartile for primary precious metals producers.

Moving on to capital investments in slide 8, our consolidated capex were $39 million for the first nine months of the year. This includes $11.2 million of non-sustaining capex from the Lindero projects and greenfields explorations, $7.8 million of brownfields explorations and almost $20 million of sustaining capex.

On slide 10, as you're aware, we announced the positive construction decision for our Lindero project in South Argentina this past month of September. At Lindero, we're fully permitted by the provision authorities for the construction of 18,750 tonnes per day, open pit heap leach gold mine. We have already launched detailed engineering work, and plan for initial site activities to start in late November with the phased construction of cap facilities that will hold the peak headcount of approximately 600 people during construction. We planned to release a comprehensive outlay on project activities and construction milestones in the coming days.

Under our brownfields exploration programs at the Caylloma and San Jose mines, we have carried 40,000 meters of drilling in the first 9 months of the year at a cost of roughly $8 million. At Caylloma, we have been enjoying substantial [indiscernible] expanding mineralization to the Northeast and to date on ore shoots 4 and 3 of the Animas North East vein. We expect this exploration success will provide for our robust research increase for this mine.

At San Jose, the drill program continues focused on three areas to the North via the limits of the research shale. These areas are the far north target under silica outcrop, the intermediate north zone and the Victoria vein which is a blind discovery of a new vein we made in 2015, late 2015, where we're working to develop resources currently. Ninety percent of underground infrastructure for the execution of the drilling program at San Jose in designated target in the North is in place. So the program is gaining speed, and we look forward to updating the market with results as the program advances.

So for now, with that, I'll let Luis take you through the financial results.

Luis Ganoza - CFO

Thank you, Jorge. So on slide 12 for the third quarter of 2017, we recorded net sales of $64 million, down 2% from the prior year, driven mostly by lower silver prices and slightly lower silver and gold sales. We've reported net income of $10.3 million, compared to $10.2 million in 2016 and earnings per share of $0.06 compared to $0.08. Adjusted net income was $13.1 million compared to $10 million in 2016.

Cash provided by the operating activities was $20.4 million, 30% below the comparative period in 2016, mostly as a result of changes in working capital items. Cash provided by operating activities before changes in working capital, as Jorge had mentioned, was $26.2 million, just 1% below the prior year.

Cash equivalents and short-term investments as of the end of September 2017 was $195.8 million, where most of the increase over year-end 2016 comes from the proceeds from the equity financing closed on February 9, 2017.

On slide 13, when breaking down our sales performance, we see the negative price effect from silver was offset to a large extent by the positive effect on zinc and lead prices. Lower sales related to lower silver and gold sold was $2.6 million and the volume effects in our draft [ph]. Worth highlighting is the impact year-over-year of improved treatment and refining charges of $3.2 million. We expect these terms to continue into 2018.

On slide 14, our operating income was $18.9 million, 11% below Q3 of 2016, as a result of slightly lower sales, higher unit costs at both our operations when compared to 2016 and the higher depletion at our San Jose Mine. In spite of lower operating income, adjusted EBITDA of $30.6 million showed no variation over 2016, as a result of lower share-based compensation charges. Adjusted EBITDA margin over sales remained at similar levels at 48%.

On slide 15, in the case of Caylloma, we recorded higher EBITDA of 43%, driven by strong base metal prices, partially offset by higher unit costs year-over-year of 6%, although only 2% above budget.

In the case of San Jose EBITDA, or I'm sorry, San Jose [ph] EBITDA increased 20% mostly as a result of a reduction in silver price year-over-year of 13%, and higher unit costs of 14%. Compared to budget however, unit costs was 7% higher. This deviation compared to our budget had to do to a lesser extent with certain non-recurring items, as well as a stronger local currency.

Excluding these effects, we estimate cash costs were within 4% to 5% of our budget for the quarter with increase driven by higher local inflation on certain materials and supplies including energy, as well as higher costs related to ground support. We continue to guide for annual cash costs to remain within 5% of our target for 2017.

On expenses, on slide 16, total selling, general and administrative expenses was $5.1 million down 29% from Q3, 2016 as a result of a lower share-based payments charge. Operating mines' SG&A was 18% above 2016 as a result of certain non-recurring items. Year-to-date selling and G&A at our mines remained at similar levels as the prior year.

Corporate G&A was 17% higher than in 2016 at $2.7 million. This amount is within the guidance we provided back in the year and earnings call of May of this year. These higher levels of corporate expenses are a result of the growth of the company and added demands on meeting internal controls requirements under SOX regulation.

On slide 17, we closed the quarter with total cash in short-term investments, as has been mentioned before, of $196 million, an increase of $7.8 million over Q2 of this year, and $4.6 million over Q1. Under the current price environment, we expect our operations to continue to generate free cash flow that will contribute towards the funding of the Lindero Project construction.

On the right-hand side of the slide, we're pointing out total liquidity available of $276 million, including the approved expansion of our credit facility up to a total amount of a $120 million. This will be the main additional component of funding for the construction capital requirements at Lindero.

And finally on slide 18, we provide a bridge graph of our cash position in the first nine months of the year, including short-term investments. As we have guided in the Q2 earnings call, we expect the cash accumulation for the year to take place throughout the second semester, as some of the items related to changes in working capital are related to payments occurring in the first two quarters.

Thank you and back to you, Carlos.

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

Operator
Thank you, the floor is now open for questions. [Operator instructions]. And our first question comes from Justin Stephens from Raymond James. Go ahead, Justin.

Q: Good morning, guys, and congrats on a solid quarter. Just a couple of questions from me. Things are pretty straight and narrow here in most of the operations from the looks of it. But just on the San Jose cash costs, those have been trending up, at least on a per tonne basis. Should we be expecting those more in sort of low-60s range for the fourth quarter and going forward? Or should those come back to the high-50s?

Luis Ganoza - CFO
So this is Luis. We do expect to see cash costs at San Jose to remain, I would say, within $58 to $62 per tonne range; that's what we expect today. As we've mentioned, we're seeing some inflation impacting mostly items like cement, fuel, energy and steel. There are other components, more of a structural nature related to operation itself. And so, that is a range we should expect to see moving forward and into 2018.

Q: Sounds good. And then just over on Caylloma, I notice you guys keep beating us on zinc. Should we be expecting the zinc rates there to stay north of 4% or back into sort of the high 3%s?

Jorge Ganoza - President and CEO
With respect to Caylloma for next year or two, the mining is centered on an area of reserve. We should expect similar grade. What we expect is that as we centered the mine more towards East, Northeast Zone on ore shoots 4 and 3, we can start benefiting from higher lead and zinc rates. But for 2018, the expectation is that rates remain similar to what we're seeing today.

Q: Okay, sounds good. And just on the Lindero side, I notice you guys sort of revised your capex guidance there, for the remainder of 2017. Do you have a rough idea of how fast you expect to wrap things up, capex spending aside at the start of next year? Is it going to be front-weighted or back-weighted to the year there?

Jorge Ganoza - President and CEO
In highest capital demands, we are expecting right now highest capital demand for Lindero to come in Q4 2018. That's what's in our models.

Q: Okay. That's very helpful. Thanks a lot, guys.

Jorge Ganoza - President and CEO
Thank you.

Operator
[Operator instructions]. And our next question comes from Bragam Jerum [ph] from Credit Investor. Go ahead.

Q: Hi, I'm a long-term investor as you probably aware. I've been dialing in four, five years now. So I'm calling to again congratulate you, all the team, one more time for another solid quarter, all friends.

So, today I wish to make a few comments and ask a couple of general questions. So, first comment was, I'm very pleased to learn that the credit facility has been increased, so that's a very positive development this quarter.

And another item I'm really pleased, and extremely encouraging, is Caylloma mine operations as well as the exploration there. The new discovery or the extension of the vein, so that's very, very good development. And the most interestingly all-in sustaining cost, you're budgeting like $10.80 per ounce, and you claim a negative $11 per ounce. So that's an improvement of $22 per ounce from that mine alone, and that is extraordinary by any measure.

And although you claim you are the low acquiring bottom 25% but I believe in my records, and whatever research, Fortuna is coming bottom up the cost curve, everywhere I see it among the public companies.

So, that's my comments. And then on my question related to the exploration activities at all the three sites and three countries, anything you can share, exciting developments, quickly. I really appreciate it. And then I have another general question at the end of your answer about stock valuation.

So, I appreciate your time. Thank you.

Jorge Ganoza - President and CEO
Thank you for your comments and words here for the team. On the exploration front, something I can highlight today two things. One is that based on the exploration results we've been seeing and we already published a news release, it's solely on Caylloma results some weeks ago. I believe there are reasonable expectation and management's priority that we never seen Caylloma with the size and quality of research as we are seeing it today. We plan to release resources in January, February as we do every year updated resources for all of our operations. And our expectation would be that a lot of these exploration success we're seeing will translate into resources.

It's not I will rate it as transformational, but bear in mind that Caylloma usually has been working for 500 years with a very short mine life ahead of it. And what we have been able to show is that this mine continues to have exceptional potential to not only deal with depletion, but add a few more years to its life-of-mine plans.

So, the exploration team has been doing a good job. Remember we've been short funding Caylloma of exploration dollars as we were building San Jose and expanding San Jose. Now that we are opening the budget for exploration once again we are seeing the results. So that is very gratifying with respect to Caylloma.

And with respect to San Jose, all of our exploration in this North area, which is the highest priority area for San Jose exploration right now, is being carried from the underground. Also 2016 and the early part of 2017, we've been developing the main underground [indiscernible] that gives access to this North zone. And we have also been developing a drilling chambers and auxiliary infrastructure that allows us and give us more flexibility to reach other targets in this new area like the Victoria vein.

So drilling from the underground, compared to surface is been painfully slow. And we've been struggling with that no doubt. But as I mentioned 95% of all the underground infrastructure that we needed to be in place is in place.

We have four drill rigs turning; we are pushing to add a fifth one in this North area. And with that, we expect the flow of results of the different targets, we are aiming for, and it speeds up, and we can share results with the market as they can.

So with respect to exploration and our assets that's what I can highlight to you. And with respect to our costs, we came with an all-in sustaining cost for around $6. That certainly positions the company in the lowest quartile. Yes, we're benefiting from increased prices in lead and zinc. We're primarily a precious metals producers, but we cannot deny that having a zinc and lead byproduct these days does provide a nice natural hedge for production, and we're benefiting from that.

Operator
[Operator instructions]. And we do have a question from Bragam Jerum from Credit Investor. Go ahead.

Q: Hi. I have another last comment, a question related to our stock valuation. The management has been consistently performing well, been doing great sort of things with the growth in exploration, and prudent management, cost containment, in all aspects, and still our stock is not behaving topline. This has been my complaint you all of my previous calls as well.

In addition as you just alluded to, we are also a cost leader, no doubt about it. Even if you do not consider zinc and lead aspects, even otherwise we were always a cost leader. So in that background and you've been accumulating cash during bad times and good times and you're positive. We know margin was good, EBITDA margin was good all the time.

So the question is, so after all, the management is working for stockholders as well in addition to other constituents like employees and governments. We have been suffering like you are because management is also holding significant shares. We are also suffering for so many years, and I just want to know what would you do, so that the market recognizes some kind of a specific action.

Because you can see, I've been participating in this call for so long. I am not new. I'm probably one of the largest individual stockholders of the company outside of institutions and management.

So we definitely trust this, because we are a great company and our stock is not performing as it should. I want to know if there is anything you were contemplating in addition to doing the regular great stuff, specific to the stock price improvements. Thank you.

Jorge Ganoza - President and CEO
Thank you for the question. I believe the underperformance of the company compared to the peer group is a feature of the last year. No doubt, the company in a difficult market had to face with a delay in filing financials at the beginning of the year. We also announced an acquisition. We also carried our financing in the beginning of the year. So in a difficult market, I believe that I cannot speak for investors. But from my view is that investors have been observing how we bring about Lindero. Lindero has been a great acquisition for the company for 11% dilution on the acquisition.

We are more than doubling our total resources and have the potential bringing this mine into production, taking our current EBITDA from $115 million, which is what you could project using the current price environment and our projected sales, we are in a position to take that EBITDA to a roughly $220 million.

But my view is that, it is a project that demands significant capital from us in a difficult market and investors are going to wait and see how we advance and achieve our construction plans and deliver the project within the timelines that we set forth. And as we move and achieve the milestone throughout the next 18 months and bring

Lindero successfully into production, the company will unlock that value and our shareholders will be accordingly rewarded. I believe that is the catalyst, the big catalyst, for the company, it successfully bringing Lindero into production which on the initial years has the capacity to double EBITDA for the company, very easy, to put it very simply.

And in a difficult market, again in my perception is that investors are watching us to see how we advance this project and de-risk it as we advance it. That will be my answer to your question.

Operator
And there appear to be no further questions at this time.

Carlos Baca - Manager of IR
Thank you, Kathy. 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 our Q4 2017 year-end call next year. Have a good day.