Transcript of
Fortuna Silver Mines Inc
Second Quarter 2018 Financial and Operational Results
August 9, 2018

Participants

Carlos Baca - Manager of Investor Relations
Jorge Ganoza - President and Chief Executive Officer
Luis Ganoza - Chief Financial Officer

Analysts

Chris Thompson - PI Financial Corp.
Mark Magarian - UBS Financial Services, Inc.

Presentation

Operator
Greetings and welcome to Fortuna Silver Mines Second Quarter 2018 Financial and Operational Results Conference Call. At this time, all participants are in a listen-only mode and a brief question-and-answer session will follow the formal presentation. [Operator instructions]. And as a reminder, this conference is being recorded.

I would now like to turn the conference over to Carlos Baca, Investor Relations Manager. Thank you. Please go ahead.

Carlos Baca - Manager of Investor Relations
Thank you, Brenda. Good morning, ladies and gentlemen. I would like to welcome you all to Fortuna Silver Mines and to our second quarter 2018 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, then click on Financials tab and under Q2 2018, click on Earnings Call webcast.

Jorge Alberto Ganoza, President, CEO and Director; and Luis Dario Ganoza, CFO, will be hosting the call from the City of Salta in Argentina.

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, and MD&A which are publicly available on SEDAR. That company assumes no obligation to update such forward-looking information in the future, except as required by law.

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. Along with Luis, our CFO, we will be presenting results of our business for the second quarter, encompassing our operating lines, development projects and exploration activities in Mexico, Peru, Argentina and Serbia.

Moving on to the highlights slide, highlights for the quarter includes in the first bullet, the strong performance of our mines, which is reflected in the robust 48% consolidated EBITDA margin and $28 million in free cash flow generation before the Lindero CapEx. As of the end of the quarter, our liquidity stands at $278 million with a debt-to-EBITDA ratio below 0.5.

In the third bullet, at Lindero, we recently reported an update of our forecast for initial capital. With 71% of all direct capital costs assigned, we forecast an increment in the range of 10% to 17% in the initial capital from our $239 million budget. We view this variation within the limits of feasibility study levels, and we still carry a contingency plan of $24 million in the forecast figure. And last in the highlights, we have very positive drill results from the expiration program we are funding as part of our 70% earning option agreement with Medgold Resources at the Boseligrad [ph] Silver target in Southeast Serbia.

Moving on to Slide 6. Our consolidated silver production grew by 10% in the quarter to a historic record of 2.3 million ounces. Gold production stayed flat at 14,600 ounces. The growth in silver production is a result of higher silver grades at our San Jose mine in Mexico.

Zinc production grew 8% to 11.4 million pounds and net production stayed essentially flat at 7.2 million pounds. Although we are not modifying our guidance, looking at mid-year production and reserves in the plan for the second half of the year, it is reasonable to expect we can meet or exceed guidance by a margin in the range of 10% for both silver and gold.

Moving on to Slide 7 in the webcast presentation, here we show silver contributed 49% to provisional sales, gold 25%, for a combined precious metals contribution of 74%.

In Slide 8, here we present three key financial metrics. Our sales grew by 15% to $73.7 million. We broke our historic record for EBITDA in the second quarter and the first half of the year. EBITDA in the quarter grew 33% to $35.2 million. Adjusted net income grew 9% to $10 million or $0.06 per share. Luis will be providing detail in the analysis of these figures further in the presentation.

Moving on to Slide 9, we are moving to report all-in costs as a silver equivalent. The increased silver production and good cost performance translate in a drop of 17% in consolidated all-in sustaining cost to $10 per silver equivalent ounce. San Jose reports a drop of 16% to $9, and Caylloma, a drop of 19% to $10. At San Jose, the driver for lower all-in cost is higher silver production, and for Caylloma, 10% lower production cash cost, 20% and 10% higher zinc and lead prices, respectively, and lower execution of [indiscernible], which should start to pick up in the second half of the year.

In Slide 10, our capital expenditures were $19 million in the quarter. $5.1 million in sustaining capital at our mines, $2.3 million in exploration, $1.3 million allocated to new exploration initiatives and $10.3 million in Lindero.

Moving on to Slide 11, at Lindero, we remain on schedule for commercial operations in the third quarter of 2019, although we have moved from early to late in the quarter. We had to abort the acquisition of modules for 350 [indiscernible] from an operation under close renewal in Argentina, which resulted in a delay and slower than planned build up in temporary camp facilities, which in turn delayed the arrival of contractors to site.

Mine equipment started to rise in mid-July, with last arrival scheduled for November. The plan is to have the mine delivering initial ore in March 2019, with a quick ramp up as there is no reversion [ph] to be removed with the highest gold rate portions of the deposit outcropping. As stated earlier, we have assigned $130 million or 71% of the projects' direct capital costs.

With all this information, we forecast a modest increase of 6% on direct costs against our budget. But where we are experiencing a significant increase is in the forecast of construction indirect costs and owners' costs. The main driver for the forecasted rise in indirect costs is a 50% increment for on-site headcount to 950 people. These variations drive our total initial capital estimate of $239 million to an increment between 10% and 17% or $24 million to $40 million.

Main components of indirect costs for these figures come from catering costs, which have grown by $5.5 million, 64% of that attributed to the higher headcount and 34% to the higher food rations cost. Three million dollars in additional camp facilities, $1.6 million associated with higher transport cost at Lindero is located remotely eight hours away from the city of Salta.

Half of the $1.6 million, half of that is due to higher headcounts and the other half is to a shorter rotation on the roster for personnel than we originally estimated, $1.8 million in higher energy costs and $6 million in owners cost G&A. These figures are under final review, as we see opportunity to optimize headcount for certain contractors program to come to site in the fourth quarter, or starting to come to site in the fourth quarter.

We plan to conclude these reviews in the month of August. I want to mention that our forecast still includes a $24 million contingency fund. The project has a typical [ph] advance as of the end of Q2 of 15%, with $38 million spent on the project, of which $31 million came in the second quarter. We are seeing a significant pickup in spending as critical execution is ramping up.

The Arizaro gold project target presents a significant exploration opportunity as we view it as a potential [indiscernible] deposit to Lindero. We are currently drilling a 2,000-meter program to further enhance our knowledge of the [indiscernible] system and evaluate the ability of producing a resource estimation of our own. Arizaro is located within our mining concessions and approximately three kilometers from the crushing station at Lindero.

Goldrock, the previous owner of Lindero, reported an NI 43-101 indicated resource of 340,000 ounces of gold and incurred resources of 230,000 ounces of gold at Lindero and suggest the deposit remains open. We aim to conclude the drilling at Arizaro in the month of August.

On the exploration front, we have drilled approximately 13,000 meters at our mines during the quarter, with the bulk of that drilling at the San Jose operation, but the highlight from exploration activities in the quarter comes from Serbia, where we are currently in a 70% earning option agreement under the Tlamino project, which contains the Barje target.

Medgold is the optioner [ph] incurring the work now. Very encouraging results from first phase of drilling have been published by Medgold on June 11, June 18 and July 5. Here on the presentation, on this slide, we present some of the highlights of the program. This is a very exciting exploration opportunity on silver, gold, thermal [ph] system that's close to surface.

With that now, I'll ask Luis to advance on the presentation, giving you further details on the financial results.

Luis Ganoza - Chief Financial Officer

Thank you, Jorge. So turning on to Slide 14, net sales of $73.7 million, up 15% from the prior year driven by higher precious metal sales and zinc, and lead prices, we reported net income of $11.2 million compared to $8.9 million in 2017 and earnings per share of $0.07 compared to $0.06.

Our strong performance in the quarter didn't fully translate into higher adjusted net income due to a higher effective tax rate in the quarter as I will discuss in the coming slides. Free cash flow, excluding the Lindero construction for the quarter was $9.1 million and although not shown in the slide, $28 million year-to-date.

Onto Slide 15 and breaking down our sales performance. We have higher total sales of $9.8 million with $5.5 million of contribution from higher metal volumes mainly coming from silver, $2 million from improved metal prices, mainly zinc, and $2.7 million of improved treatment and refining charges.

We recorded net sales adjustments of $2.7 million in the quarter, which was $0.5 million higher than the adjustment in our comparative quarter as shown in the bridge chart. Out of the total adjustment, $1.9 million was related to lower metal prices at the closing of June. In the first quarter of 2018, we reported a buildup of concentrate inventory at the San Jose mines corresponding to around eight days of production, one of which has been sold as of the end of June.

Onto Slide 16, our operating income and adjusted EBITDA reflect our stronger sales in the quarter and lower overall costs compared to 2017. Adjusted EBITDA Caylloma was up 47%, reflecting mostly stronger zinc and lead prices, higher zinc production, lower production cash cost. Production cash cost at Caylloma was 10% below last year and 5% below our annual guidance. About half of these cost improvements with respect to annual guidance are related to productivity gains, which we expect will be maintained.

EBITDA at San Jose was up 28%, as a result mostly of higher silver and gold production. In the case of production cash cost, at San Jose, we have a slight decrease over [ph] 2017 and are pretty much in line with our annual guidance. And as Jorge mentioned, both operations showed improved performance from an all-in sustaining cost perspective, which we expect will be maintained as well in the second half of the year in even as the level of sustaining capital expenditures picks up in Q3 and Q4.

Onto Slide 17, on expenses, total SG&A was $8 million, up 38% compared to Q2 of 2017. Our operating mines SG&A and corporate SG&A are in line with guidance provided in March of this during the Q4 2017 earnings call. Share-based payments at $2.4 million include approximately $1 million of mark-to-market effect from stronger performance of our share price in the quarter.

We have recorded a higher effective tax rate than unusual of 55% for Q2 of this year. This is mainly due to two factors: the strong evaluation of the Argentine peso, which has had a negative effect on the deferred tax component of the income tax expense, representing around $1.5 million; and a one-time charge of $1.3 million related to with withholding taxes we expect to pay in 2019 upon the repatriation of funds from our subsidiaries. Excluding these two items, effective tax rate would have been in the range of 44%.

Onto Slide 18, as we have highlighted at the beginning of the presentation, the company maintains a strong balance sheet position with a total cash and short-term investments as of the end of the quarter of $198 million and total liquidity of $278 million considering our expanded credit facility of $120 million. Taking into account the updated initial capital forecast we have reported at the Lindero project, we continue to believe we are adequately funded, considering a range of slightly or potential downside metal price scenarios.

Back to you, Carlos. Thank you.

Carlos Baca - Manager of Investor Relations

We would now like to turn the call over to any questions that you may have.

Operator
Thank you. [Operator instructions]. Our first question comes from the line of Chris Thompson with PI financial.

Q: Hi. Good morning, guys. Just a couple of quick questions. I'll start off with San Jose. Obviously good growth in the Q2 here. I guess, on the back, maybe, correct me if I'm wrong, a slight revision of the mine plant. I guess, the question is, is whether these grades are sustainable at these levels, and then whether that there is going to be any adjustments later on in the foreseeable mine plan.

Jorge Ganoza - President and Chief Executive Officer
Hello, Chris. As I stated, yes, we do expect higher grades to continue in the second half of the year that should lead to a meeting or exceeding guidance by about 10%, that is we are not moving to modified guidance, because we believe our 10% change does not warrant, our variation of 10% does not warrant modifying guidance. But everything indicates, suggests that we are heading in that way based on the mining plan for the second half of the year and what we have delivered this first half of the year.

Moving forward, the reconciliation of reserves to production at this mine has always been very good. So long-term, we continue to see the average grades of the reserves reflecting on production. But on a shorter term, like for the year, we provided guidance based on the plan that is in the start of the year was later modified and the higher grades we're seeing with respect to the original plan and the original guidance are the results of that.

Q: Okay. Thanks for that. Could you just comment on currently what's happening as far as exploration, I guess, expanding towards the Trinidad North area? Give us a little bit of an update there.

Jorge Ganoza - President and Chief Executive Officer
We have five drill rigs turning at San Jose, between four and five, depending what time of the year, drilling that north extension in different parts. We have all the underground infrastructure available. We are hitting structure. We are hitting rate. I cannot report to you at this stage the outlining of coherent or significant area. We are hitting some grades in some area. We are working on resource estimation for the second half of the year, the one we use to update our resources, reserves, and mine plans and budget.

So on the Victoria vein, we are aiming to do a resource. This is the first time we are going to attempt a resource at the Victoria vein. And in the north, we are drilling aggressively, and we will be reporting results as they come and are of significance. But we have not reported the results yet, even though we are drilling already, because we are not seeing results that support areas that are minable yet. It’s a big area. We are dealing aggressively, we are hitting structure, we are seeing mixed results on the drilling, but we need to continue pushing there.

Q: Okay. Great. I guess just a final question as far as Lindero, the CapEx escalation there, I mean, on the cost, et cetera. Are you getting any benefit from peso devaluation?

Jorge Ganoza - President and Chief Executive Officer
We are just currently updating our numbers on that. I'll let Luis give you more color.

Luis Ganoza - Chief Financial Officer
So I mean the short answer is yes. Based on our budget figures and the time of feasibility study, the time it was put together, the real depreciation considering inflation is in the range of 25% to 27%. But that's so far mostly provided at a benefit in terms of overheads, as the construction really started ramping up in the second half of the second quarter. So the [indiscernible] component of our forecast, of our CapEx, is still ahead of us.

Now we don't anticipate that that 27%, 25%, real depreciation of the peso throughout the construction period, which extends up to September of 2019 is likely, so for more reasonable scenarios of, let's say, 10% reappreciation of peso, that is, again, discounting for inflation factors, we should see a benefit in the range of $8 million to $9 million, which is currently not in our forecast figures. So we are not factoring in any benefits from the devaluation.

Q: Okay, all right. So if I can read you correctly on that, you are taking a very conservative stance on peso devaluation?

Jorge Ganoza - President and Chief Executive Officer
Yes, as we've said before, our stance is that of a neutral effect. And as we advance the construction and the spending, we think continue along the trend we've seen, we are likely to see a benefit materially.

Q: Perfect, all right, guys. All right. Thank you. Thank you very much.

Operator
Our next question is come from the line of Mark Magarian with UBS.

Q: Hi guys. Good job on everything this quarter. I just wanted to clarify one point, you made a couple of times away regarding the $24 million contingency in your original Lindero cost plan. You were basically saying that this increase in costs, which you've just reported could well come under that contingency, which was on the original numbers. Is that what I'm hearing?

Jorge Ganoza - President and Chief Executive Officer
Yes, but I believe I should give a bit more clarity on how we manage the contingency. The $239 million initial capital estimate we produced initially, carry about $23 million in the contingency fund and the actual physical execution of it is only starting. The physical advance of the project as of the end of the second quarter is only about 15%.

So our updated forecast comes from having detailed engineering concluded and contracts awarded or very close to being awarded as in the case of electromechanical and pricing contracts. So we have a lot more better information, detailed information coming from the engineering and from actual costs that have been already assigned and awarded, equipment purchase, not before we have quotes for equipment, now the purchase orders are out. That detail, it's coming in our forecast now. And our contingency fund remains at $24 million. So we will start discounting that $24 million as the execution, the physical execution of the project advances. As the project advances, if there are variations in the execution, we will start applying the contingency fund to those variations.

That is how we manage the—so any variation in the execution will not translate automatically or directly over the '17 [ph] 10% variation we are currently forecasting. The contingency fund on the future execution should eat [ph] those differences, start eating those differences, helping us mitigate variations in the actual physical execution. That is how we manage the contingency fund.

Q: Thanks for the clarity. That's fine. Thank you.

Operator
It seems we have no further have no further questions. I'd like to turn the floor back over to management.

Jorge Ganoza - President and Chief Executive Officer
Thank you, Brenda. If there are no further questions, I would like to thank everyone for listening to today's earnings call. And we look forward you joining us next quarter. Have a good day.