Transcript of Fortuna Silver Mines Inc.
Fourth Quarter and Full Year 2018 Financial and Operational Results
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Participants
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Jorge Ganoza – President, Chief Executive Officer and Director
Luis Ganoza – Chief Financial Officer

Analysts
Sherry Deng – Scotiabank
Chris Thompson – PI Financial
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Adrian Day – Adrian Day Asset Management

Presentation

Operator
Good day, ladies and gentlemen, and thank you for joining us for the Fortuna Silver Mines' Fourth Quarter and Full Year 2018 Financial and Operational Results Conference Call. As a reminder, today's meeting is being recorded. [Operator instructions]. All lines have been placed on a listen-only mode and the floor will be open for your questions and comments following the presentation.

And now to get us started with opening remarks and introductions, I am pleased to turn the floor to Investor Relations Manager, Mr. Carlos Baca. Mr. Baca, please go ahead, sir.

Carlos Baca – Investor Relations Manager
Thank you, Jim. Good morning, ladies and gentlemen. I would like to welcome you all to Fortuna Silver Mines and to our fourth quarter and full year 2018 financial and operations results call.

Today, we'll be using a webcast presentation which will be controlled by us. You can download the presentation at our website, www.fortunasilver.com. Please click on the Investors tab then click on the Financials tab and under Q4 2018, click on Earnings Call Webcast. Jorge Alberto Ganoza, President, CEO, and Director; and Luis Dario Ganoza, CFO will be hosting the call from Salta, 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 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 and MD&A

which are publicly available on SEDAR. The 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 Alberto Ganoza, President, CEO and co-founder of Fortuna.

Jorge Ganoza – President, Chief Executive Officer and Director
Thank you, Carlos and good morning to all. I'll give you a brief introduction to our year end results and progress at our Lindero Gold Project in Argentina and then turn the call over to Luis who will take you through the financial statements. After that, we'll open the call for questions-and-answers.

In Slide 4 of the presentation, during 2018, we carried our business with mining operations in Peru and Mexico where our San Jose mine runs among the 14th largest primary silver producers in the world. We're in construction of our third mine in the province of Salta, Argentina.

Apart from Brownfields exploration at our mines and projects, we're currently in exploration for new silver and gold deposits in Mexico, Argentina, and Serbia. Some of these initiatives are carried via strategic investments and joint ventures with junior explorers like Prospero Silver and Medgold. Important to mention is our consistent focus on sustainable low-cost growth and maintaining a high margin business.

Under the 2018 highlights, Slide 5, we pride ourselves of the strong margins of our business. Our adjusted EBITDA for the year is $114 million representing a robust 43% margin over sales. Our margin on mine operating income is 37%. Our free cash flow from ongoing operations before Lindero investment is a strong $55 million.

Liquidity available stands at $243 million including our available credit facilities with a modest debt to EBITDA ratio of 0.7 as of year-end. Our Lindero project has a 40% advance towards completion where 91% of direct capital cost has been committed. Remaining construction capital to completion is $172 million.

On February 14th, we issued a press release informing we received a resolution from the Federal Environmental Protection Agency of Mexico indicating there is no contamination of soil as a result of the overflow of a rain containment pond at the San Jose mines tailings facility, dry stack facility back in October.

Moving on to slide 6. Our mine team delivered another consistent year of excellent performance with silver and gold production 7% and 12% above guidance. Measured against the previous year, silver was up 5% and gold down 4%.

Slide 7, precious metals accounted for 72% of the $263 million in sales for the year. Silver is a precious metal with the largest contribution to sales at 48%. Average realized silver price for the year was $15.70 per ounce and $1,273 per ounce for gold. This is 8% lower for silver and 1% higher for gold when compared to 2017 realized prices.

Comparing against 2017, our sales were down 2%, EBITDA was down 7%, and adjusted net income down 21%. The drop in net income is explained by marginally lower sales, 4% higher cost of sales, and 5% higher selling and G&A. The increase in G&A is mainly related to expanded capabilities in key areas to meet demands of our growing business. These areas include Mexican business administration, technical services, health safety environment, and legal.

Slide 9, all-in sustaining cost reported as core product came in at $10.60 or 11% below budget and guidance. The San Jose mine reported a low $9 per ounce of silver and Caylloma $11.70. San Jose all-in sustaining cost was 11% lower against the previous year explained by lower investments in plant infrastructure and higher metal produced.

Slide 10, we recorded capital expenditures of $113.8 million for the year. The breakdown of this $8.6 million in Brownfields exploration, $24 million in sustaining capital at our mines, 3.6% in Greenfields exploration and $77.5 million at Lindero.

Slide 11, the pyramid in slide 11 presents our asset portfolio. Here, the biggest value catalyst for the company over the next 12 months is the development of Lindero into our third producing mine. Lindero is strategic to the company at various levels. One, it is a mine with gold reserves for 13 years of operations. Two, the production profile offers the opportunity for a quick payback in the initial years as the highest rate portion of the deposit occurs on surface. Three, projected EBITDA margin above 40% is consistent with the portfolio strategy. Four, immediate exploration opportunities to add gold ounces within the Lindero porphyry system and the nearby gold mineralized Arizaro porphyry are relevant and important to us. Once Lindero is in operation, we will be in a position to devote [ph] annual EBITDA.

Slide 12, the construction scheduled for Lindero captures the difficulties faced with the start of activities after the break of Christmas holidays. Start of construction in January, and particularly in early February were severely hampered by abnormal rainfall over segments of the access road some 100 kilometers and 150 kilometers from the project, which limited heavy truck transit and supply of personnel for multiple days.

Since the beginning of March, we are back to project pace with approximately 900 people on site and construction advancing on all key fronts. We plan to initiate commissioning in Q4 and ramp up the project over year-end and into Q1 2019.

On slide 13, we have committed approximately 91% of the project's direct capital cost and have $172 million in construction capex remaining to completion with 40% of the project advanced. Our estimate for total construction capex is $295 million, or 20% increase over our feasibility budget. The $295 million figure carries provisions for the extension in our schedule, contractor standby claims, added provisions for road maintenance for next year and $17 million in contingencies. Although, no one likes to see any deviations from budgets and guidance, we view our costs under control considering we're leaving behind the period of greater uncertainty in the construction.

Over 1.2 million cubic meters in excavations for leach platforms and foundations are 90% to 95% concluded. Massive excavations are always an area of risk for estimations and predictions and it’s basically done. Initial delays on camp availability are over since last year. We have no limitations for contractor mobilization and all major contractors are on site performing in line with our construction plan to date. Procurement and expediting of equipment and materials is also in line with project schedule.

Next, we have a few slides with photo gallery. On Slide 14, in this slide we show the advance on leach pad and solution pond construction. As you can appreciate here, site preparations are basically concluded and the main tasks now are liner installation and placement of forward liner.

On Slide 15, at the crushing site all foundation excavations are 95% concluded and our civil contractor is placing concrete for foundations and building retention walls working in parallel in the areas of primary, secondary and tertiary crushing and agglomeration.

Slide 16, this slide shows progress on the ADR and SART areas.

Slide 17 presents a view of the camp facility. The mine will be run with an owner operated mine fleet. The fleet is made up of six 100-ton trucks, two wheel loaders, one shovel [ph], two [indiscernible] dozers, two blast hole drill rigs, and other ancillary equipment. The entire fleet is on site operational. And as part of our readiness plan, we have an ongoing training program incorporating members of nearby communities. Here, we show a photo of the trainees in front of one of our trucks. We also present a photo of our 8-megawatt power plant which is scheduled to be operational by mid-year.

With that, now I'll turn the call over to Luis who will take you through the financial statements.

Luis Ganoza – Chief Financial Officer
Thank you, Jorge. So on Slide 20, sales for the fourth quarter were $59.4 million, down 21% from 2018 due to lower metals sold and significantly lower metal prices for silver, lead and zinc. The lower metals sold was mostly a quarterly effect as full year metal sold was above 2017 for silver and slightly below for gold.

We reported net income of $2.2 million in the quarter. We have noted the comparability year-over-year of net income is affected by a $21.9 million after-tax impairment reversal at Caylloma in 2017. Adjusted net income for the quarter was $4.4 million compared to $12.3 million in 2017. The reduction was driven mostly by lower sales.

Adjusted EBITDA for the quarter was $22.7 million compared to $34.9 million recorded in 2017 and free cash flow from ongoing operations was $11.8 million compared to $19 million in 2017.

On the same slide, for the full year 2018, we recorded net sales of $268 million, slightly below 2017. We reported net income of $34 million or $0.21 per share. Adjusted net income was $38.3 million, down 21% from 2017, due to a combination, as Jorge mentioned, of lower sales, higher production cost, higher depletion charges at the Caylloma mine as a result of a reversal of impairment in 2017.

Annual EBITDA of $113.9 million was 7% below the prior year. Net cash from operating activities and free cash flow from ongoing operations show an increase over the prior year of 19% and 49%. The increase in spite of lower operating results has to do with negative changes in working capital in the comparative year of 2017. Independent of the change over the prior year, however, we want to stress the free cash flow generation capacity of our business which, in the current metal price environment, stands at levels of around 20% of sales.

We're currently converting close to 50% of EBITDA into free cash flow. We believe these levels are sustainable and consistent with the expected long-sustaining capital expenditure requirements at our mines. Free cash flow from ongoing operations for the full year 2018 was $55.2 million.

When breaking down our sales performance for the quarter, we can see the highest impact came from lower silver and gold sold and lower silver and base metal prices. This was partially offset by improved treatment and refining charges year-over-year.

The next slide, we show the sales breakdown for the full year with the main single negative impact coming from lower silver prices. This was partially offset by improved treatment and refining charges and slightly higher volume effect from silver sold.

On the next slide, our comparative segmented results show a similar pattern at both operations, mainly slightly lower margins for the full year and the stronger drop in margins in the fourth quarter. This is consistent with the stronger price environment in the first half of the year and higher quarterly production throughout the first nine months of 2018.

Cash cost for the full year of both mines, San Jose and Caylloma, was above 2017 in a range of 6% to 7%, although only 3% to 4% above our guidance. In the fourth quarter of 2018, we experienced higher production costs compared to the average of 2018. In the case of Caylloma, we do not regard this as a trend. We expect cash costs to come down in the first quarter of 2019 towards the midpoint of the range provided in our guidance for 2019. In the case of San Jose costs in the fourth quarter of 2018 are consistent with the midpoint of the range provided in our guidance for 2019.

The next slide, we have a breakdown of our G&A. We show higher G&A expenses at the operating mines for the full year. The main reasons were described by Jorge. The increase in the quarter is due, to a large extent, to expenses of a non-recurrent nature. Moving forward, for this line item we expect an average of $2.2 million to $2.4 million per quarter, and for corporate G&A, shown in the second line item, we expect average quarterly expenditures of between $2.8 million and $3 million.

Our effective tax rate for the full year was 50%. This is higher than the average 45% we typically expect to see. The main reason for this had to do with the evaluation of the Argentine peso and the weighted impact of deferred tax calculations, as well as one-time withholding charges. The fourth quarter shows a high effective tax rate of 69%. This was mainly the result of a lower base of income before taxes and the withholding taxes I just mentioned.

And finally, on this slide, we want to highlight, again, our strong cash and liquidity position. We have expanded our credit facility from $120 million to $150 million, of which $80 million remain undrawn. We believe this, along with our positive free cash flow, puts us in a comfortable position to meet the funding requirements of the Lindero construction.

Thank you and back to you, Carlos.

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

Operator
Gentlemen, thank you. Ladies and gentlemen, the floor is now open for your questions. [Operator instructions]. We'll take our first question from Sherry Deng with Scotiabank.

Q: I just wanted to ask, does the $295 million new guided capital include VAT that you expect to get back and, if so, how much?

Luis Ganoza – Chief Financial Officer
The answer is no. It does not include VAT. We estimate we have remaining $30 million to $32 million of VAT associated with the outstanding portion of the cap ex until completion.

Q: How do you expect the timing of receiving these VAT refunds back in full?

Luis Ganoza – Chief Financial Officer
There is a written [ph] opportunity for an early claim of VAT during the construction phase. That is an opportunity that still hasn't materialized due to regulatory issues in Argentina. Even though there has been an amendment in the tax code allowing for this as an incentive to new projects, there is yet no formal procedure to actually go through with this. So we are waiting for that. Outside of that, VAT should be collected once we start the

commercial operations. In the worse-case scenario for that we estimate a period of two years in the case there is no early collection of VAT.

Q: So once commercial production starts, you expect within that two-year period to receive the VAT in full in installments?

Luis Ganoza – Chief Financial Officer
Yes. We believe that's a reasonable expectation.

Operator
[Operator instructions]. We'll go next to Chris Thompson with PI Financial.

Q: Quick question just really related to Lindero here. Just referring to page 4, there's a couple of, I guess, milestones indicated on the slide there. I mean in April, that's when you start, I guess, mine development and equipment installation, October starting commissioning and in December first goal point. I wonder if you could just sort of help us just join the dots by way of expectations for tonnes on stockpile ahead of commissioning and first irrigation?

Jorge Ganoza – President, Chief Executive Officer and Director
Yes. With respect to mine preparation at the orebody [ph] outcrops has a large surface expression outcropping over a significant area. The sequencing of the mine or the startup of the mine is not several months in advance. We will start with a modest stockpile because the mine has a lot of flexibility to access ore very readily. The stockpile, I believe there is a buildup. Don't quote me on the numbers, but I believe we start with about 100,000 pounds [ph] in the first month, but again, we're basically excavating ore and blasting ore right on surface. So the mine has a lot of flexibility.

With respect to irrigation, we plan to initiate ore stacking under the current schedule in early October. That's when we plan to initiate stacking. We have a ramp up curve for stacking that calls for first irrigation, so it's November, December. So pending on that, we should have enough fragment solution for the ADR so it's December year-end but we will be crushing and stacking starting in October, so there we have three months of commissioning with load and ramping up starting in October for Lindero [ph].

Q: Just in relation I guess to the capex that may need to be spent, $172 million, how should we be apportioning that on a quarterly basis this year?

Jorge Ganoza – President, Chief Executive Officer and Director
We should expect the bulk of that in the first semester of 2019, which is when we have one of the major contractor's civil works concluding all of their work. We also have a conclusion of the leach pad, the conclusion of the power station. A lot of things are delivered in the first half of the year, almost all. The work that continues is with electromechanical and piping. So the reasonable expectation is to see the bulk of the figure registered and accounted in the first half of the year.

Q: Jorge, can you just comment on, obviously, this is a very -- you're ramping up obviously construction here. Any issues that really stand out as far as critical items at the moment that you're a little bit more mindful about?

Jorge Ganoza – President, Chief Executive Officer and Director
As I mentioned in the start of this conference call, we battled with three issues most of 2018. Those were one slow buildup of our camp. That was a difficulty that persisted throughout the year. We were consistently behind

the curve with this camp. And to make that up time, we compressed the schedule, compressed activities, which in turn demanded more people offsite, which in turn created more pressure on the buildup of camp. So that is over, it's done.

We are ahead of the curve today. Since the end of 2018, actually since the start of the year, we are in front of the curve with respect to holding capacity for workers on site and that's something important.

Second is the largest task of the project at the start was large earth movement, massive earth movements and excavations. We encountered larger volumes of rock mass than originally estimated. That was a source of delay with respect to our schedule and excavations of the leach pad, but particularly on the excavations of the foundations for the crushing site, primary and secondary and tertiary crushing. In all those areas, we encountered larger volumes than originally estimated by the geotechnical work carried in [indiscernible] phase.

So that is something we have struggled with through 2018 and early in mid-year. And those excavations as I said are concluded and last but not least is getting the contractors on site, performing according to our estimations and the project demand. And today we have all the major contractors on site.

Our schedule feeds on the performance we're seeing on the ground from these contractors, and we see a room for opportunity. Our schedule doesn't have today, looking forward, a lot of float [ph]. We have, as we extended this schedule, provided additional float in the schedule, but these are not large amounts of float productivity. But we are comfortable with the pace we are advancing with and that we have room to accommodate the unforeseen, albeit it's not a large room. We believe the project is at a stage where we have more certainty with respect to performance and the different activities of the quarries.

So the project is an accumulation of problems, and we moved through the problems, we solved them and move on to the next one. The issue is when you get stuck with the same problem over and over and over. I don't see that today and that's something that we struggled with last year as I said with camp and excavations and getting the contractors at the [indiscernible]. Those three key issues are resolved are behind us.

Moving forward, I am seeing the team performing, working with the contractors or EPCM and going through the issues, solving the problems and moving forward. And also I am very optimistic in the way I see the project today.

Q: Just a final maybe housekeeping item here. Can you give us a date for the revised reserves resources company wide?

Jorge Ganoza – President, Chief Executive Officer and Director
Yes. We are aiming to release those this month of March. Our technical services group has been lending support to Lindero and that has crowded their schedule a bit. Originally, we publish earlier than March, but right now, our date is before the end of the month.

Operator
And we'll take our next question from Mohammed Al-Assaf with AVPM [ph].

Q: I'd like to ask a question with regards to customers, because there is a major shift since 2017, since most of the revenue was from Mexico and now it's from Switzerland. I wanted to know what was the reason for this. Also I have a few smaller questions as a follow-up.

Jorge Ganoza – President, Chief Executive Officer and Director

The reason is basically that we are conducting direct exports from Mexico and the jurisdiction of the buyer is Switzerland. So based on the requirements on that particular note where you saw that information that is information that needs to be consigned the jurisdiction of the buyer.

Q: I also have a question with regard to the impairment test. You are forecasting higher prices for gold to 2025. What are the reasons for this?

Jorge Ganoza – President, Chief Executive Officer and Director
We've used a range of long-term prices with which we feel comfortable. The range goes up to $1,313, $1,315. That is one of the factors that has been contemplated, of course, one of the key factors as part of that exercise. And the reason is there is support in the consensus focus of long-term prices for those ranges.

Q: My final question is about your return on tangible equity. I see this year is a little bit lower than the five-year average. How do you see this moving forward?

Jorge Ganoza – President, Chief Executive Officer and Director
Well we are in the construction period. So you have to take that into account. If you adjust for Lindero thinking more in terms of return on assets, you'll probably find us in the range of 13% to 14%. With Lindero, we believe that should improve slightly if not remain within the same range.

Operator
[Operator instructions]. We'll take our next question from Trevor Turnbull with Scotiabank.

Q: I just had a question also with respect to the ramp up, but it's a little different. I was curious with the crushing and grinding circuit in the HPGRs. Do those start to get used, the HPGRs specifically, are they used from the very beginning? And when you first start mining, is the rock a bit softer closer to surface so is the HPGR kind of not going to get tested too much in the beginning and it kind of ramps up as the rock gets harder? Can you just talk a little bit about how those are going to get integrated into the ramp up?

Jorge Ganoza – President, Chief Executive Officer and Director
Yes. We start with the full line, we start with the HPGR of the vat that is the plan. We start primary secondary tertiary agglomeration from where you are stacking. With respect to the question associated to the performance of the HPGR and the conditions of the rock material and surface, we do not identify today a risk on the side of material that can compromise the operation of HPGR if that was your question. We do not have clay material, yes on surface material tends to be a bit softer, but we do not have clays.

Although there is some level of maturation, it's not deep here. So, no, although we have looked at it and it's been part of our discussion, we do not identify that as an issue in the commissioning phase. Now remember we're in the one of the driest parts of the world and the rock will have some level of maturation, but we do not identify as an issue there today.

Operator
Next, we'll hear from Adrian Day with Adrian Day Asset Management. Sir, your line is open.

Q: I was just wondering once Lindero is up and running, what is the sensitivity on your costs to the Argentine peso up and down?

Luis Ganoza – Chief Financial Officer

So, based on our estimate, our operational expenditure structure will carry a sensitivity of around 30% to 35%.

Q: And do you have forecast of the peso, internal forecast?

Luis Ganoza – Chief Financial Officer
Yes. We are working with a base case scenario for our different projections that contemplates the exchange rate at a level of 48 pesos per dollar towards the end of this year. And into 2020, again, based on inflation and our base case scenario more in the range of 54 pesos per dollar towards the end of 2020, with an average exchange rate above 50 pesos per dollar for 2020 which is our first year of operation, right?

Operator
[Operator instructions].

Carlos Baca – Investor Relations Manager
Thank you, Jim. If there are no other questions, 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.