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Transcript of
Fortuna Silver Mines Inc.
Second Quarter 2019 Financial and Operational Results
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Participants

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Luis Dario Ganoza - CFO

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Chris Thompson - PI Financial Corp.
James Huntington - Scotiabank
Ryan Thompson - BMO Capital Markets
George Froley - Pacific Income Advisers

Presentation

Operator
Good day, ladies and gentlemen, and welcome to your Fortuna Silver Mines Second Quarter 2019 Financial and Operational Results Conference Call. All lines have been placed in a listen-only mode, and the floor will be open for your questions and comments following the presentation. [Operator instructions].

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

Carlos Baca - IR Manager
Thank you, Christy. Good morning, ladies and gentlemen. I would like to welcome you to Fortuna Silver Mines and to our financial and operations results call for the second quarter of 2019. Today, we will be using a webcast presentation, which will be controlled by us. To download the presentation, please go to our website at www.fortunasilver.com, click on the Investors tab, then click on the Financials sub tab and under Q2 2019, click on the earnings call webcast link.

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 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, CEO and Director
Thank you, Carlos, and good morning to all. I'll be presenting an introduction to our quarter results and progress on the Lindero gold mine construction 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.

On slide 5 of our presentation, at the time of a surge in price of gold, we are months away from being in a position to increase our annual gold output from approximately 50,000 ounces to 180,000 ounces of gold in addition, today, to 9 million ounces of silver we produce every year. I expect to see a validation of our strategy of being countercyclical on growth and expansion of our footprint in Latin America.

We're coming into the last mile of construction at the Lindero gold project in Argentina, which will complement our San Jose mine in Mexico and our Caylloma mine in Peru as our third operating asset. Lindero has reserves for 15 years of gold production and is accretive to the strong consolidated EBITDA margins of our business.

Slide 6, please. Under highlights for the period, we present another quarter of robust margins and healthy free cash flow from our ongoing mines. Our available liquidity is adequate to meet capital needs. We maintain a reasonable debt level with debt to EBITDA under 2, once the $150 million credit facility is fully drawn.

Lindero, of course, is our large capital project. As of the end of June, we show a total operated advance of 57%. Mission-critical areas for production like power, water, mine feed preparation, operational permits, crushing area are either concluded, being commissioned or well advanced. Critical path is on the crushing circuit, and I will give you further detail further down in the presentation on construction.

Ninety-eight percent of direct capital costs had been committed either through equipment and supply purchases, structure fabrication, contracts or contractor awards. Remaining construction capital to completion is estimated at $82 million. Apart from the typical quarterly updates and construction news releases, we're producing a series of monthly videos that help us show our advance on a regular basis. The videos can be found in our website, and I would like to encourage you to access the videos and follow our progress. We're concluding the production of our [indiscernible]. We're projecting to be pacing ore on the leach pad in Q4 of this year with first gold production in Q1 2020.

On slide 7, under consolidated production for the period, here, we clearly show we are online to meet guidance for the year. And compared to the comparable period, we show no significant deviations.

Next slide, please. Precious metals account for almost 80% of our contribution to sales, and our realized price for silver in the period was close to $15 and $1,311 for gold. With the surge in prices we've seen, as you can imagine, we are expecting to see the benefit in our sales from that on our numbers.

Next slide, please. Under financial highlights, I'll stress here again that in spite of the price environment during the quarter, we still managed to show a robust EBITDA margin of 40%, and we reported net income of $10 million with adjusted net income of $7 million, still showing profitability in this price environment for the quarter.

Next slide. On our costs, our guidance for the year is $10 to $12 all-in sustaining cost on a consolidated basis. We came in at $11.30 consolidated, slightly higher than the comparable period but well within our guidance for the year. Our mines performed well and we will discuss the impact on Caylloma further down in the percentage.

Next slide, please. On capex, the big capital project of course is Lindero. We can give you further detail on Lindero as we advance and getting into the Lindero section of the presentation.

So next slide, please. We always show our asset portfolio through this pyramid where you can see our two producing mines, our development project and our exploration initiatives.

Let's go into Lindero in the next slide, please. This is a summary of our—on slide 13—we're on schedule. We are planning and aiming to replacing ore on the leach pad in the fourth quarter of the year and being in a position to generate sufficient pregnant [ph] solution in the irrigation of a leach pad to be sourcing solution, pregnant solution flow through the ADR in Q1.

Commercial operations, declaration of commercial operations will be a factor of when we can start filling the ADR with a pregnant solution and a smooth commissioning. Again, our plans today, our best plans today call for first doré and start of gold production with our entire circuit without shortcuts to the circuit in Q1 2020.

Next slide, please. Our overall project advance is 57% as of the end of June; 98% of the project's total direct capital costs have been committed. This is an important figure for us because it reduces potential risks to budget. And $216 million of construction spending taking place as of the end of June; that's 72% of our capex forecast. We have $82 million of construction capital remaining to completion. Our total construction capex forecast stands at $298 million, which includes a $10 million contingency figure. And our forecast, of course, does not include potential gains from exchange rate in Argentina.

Next slide, please. Leach pad. We plan to have a leach pad ready to receive ore in September, late September, with funds also coming in, in late September, early October.

Next slide, please. Crushing currently starts on the critical path of the project. We are concluded with the mounting of our crushers, screens in the secondary area. We are now starting with the installation of belt conveyors and ore beams, primary crushing. This is not the most updated picture of the project; it changes by the date. We have started with the construction of a primary crusher beam. The apron feeder is in place, the scaffold is in place now and the primary crusher is being mounted.

Here, we show our HPGR, which is mounted, electrical installation is taking place, so the electrical rooms for the tertiary for HPGR and secondary agglomeration have been placed. And here, we show the installation of the first agglomeration drum. We have two drums for the project. This one has been mounted already, and we are preparing to start mounting the second agglomeration drum in the coming days.

On the upper left photo in the slide, we are placing concrete on the tunnel under the secondary crusher or beam—sorry, stockpile and the tunnel is concluded by now, and the area is prepared. All the large concrete placement on the tunnel is concluded.

Next slide, please. On the left photo, we show the ADR building. The structures have been erected. We are finishing placing flooring on the area, concrete floors. And with that, we will be concluding internal structure installations. We already see some early placement of Ag in the area. And on the right, we show the SART plant. The SART plant is not on the critical path. It does not need to be operational on day one, so it runs behind the ADR, which is also mission-critical, and we need it early in Q1.

Next slide. Our mine has been developed at Cerro Lindero, access roads, and we have prepared three production benches, which are ready to receive blasting any day. We've been waiting for the last inspection of four powder magazines [ph]. That inspection by the local authorities has taken place, and that final permit is expected any day for the operation of the magazines.

Here ancillary facilities or truck shop or camp, we currently have capacity to host roughly 1,300 people on site. That's at peak of construction. We're starting to demobilize contractors by now. Once in operation, Lindero will have an on-site population of around 180 people only.

On the right, our power station is an 8-megawatt fuel generation power, light system. And also, important to mention is that our water system is on the final stages of construction; a 13-kilometer pipeline connecting the well field to the site is concluded. And we are currently halfway with the installation of the pumps and generators on the site of the well field.

With that, I'll let Luis take you through the financial statements now, and we can address your questions later.

Luis Dario Ganoza - CFO
Thank you, Jorge. On slide 22, sales for the second quarter were $67.9 million, down 8% from 2019 due to lower metal prices, partially offset by higher silver sold compared to the prior year. We reported net income of $10.3 million compared to $11.2 million in Q2 of 2018 and adjusted net income of $7.2 million compared to $11.1 million in Q2 of 2018. The main items of the adjustment have to do with foreign exchange and deferred tax credits related to Lindero, which we strip out for adjusted net income purposes. The reduction of 35% in adjusted net income was driven by the lower sales and higher operating costs when compared to the prior year. Our costs for the period, however, are within our range of guidance for 2019.

Adjusted EBITDA was $27.2 million compared to $35.2 million recorded in 2018, and free cash flow from ongoing operations was $15.4 million compared to $9.1 million in the prior year. Free cash flow in the quarter was positively impacted by favorable changes in working capital and lower capital expenditures. Although not shown in the table, year-to-date free cash flow from ongoing operations was $17.2 million. This yields an average of $8.5 million per quarter for the first half of the year.

On slide 23, when breaking down our sales performance for the quarter, we can see the highest impact came from lower silver and base metal prices as well as higher treatment and refining charges. These effects were partially offset by higher silver sold and positive final sales adjustments.

On slide 24, our comparative segmented results show a similar pattern at both operations, mainly lower margins driven by the lower prices and higher operating costs when compared to the second quarter of 2018. EBITDA at San Jose decreased 11%, mainly as a result of higher production cash costs over 2018 as sales were flat year-over-year. Our cost performance showed significant variability in Q2 with production cash costs 14% higher than Q2 2018 for San Jose. When compared to the midpoint of our annual guidance, however, cash costs for the quarter is pretty much in line with a minor deviation of 3%. We expect to close the year within our cash flow's guidance range at San Jose.

EBITDA at Caylloma had a larger fall when compared to 2018 as a result of lower sales related to a drop in base metal prices, higher treatment and refining charges and higher production costs. In a similar fashion at San Jose, Caylloma shows a high variability in cost performance due to an extent to timing issues as cost execution in Q2 of 2018 was significantly below the annual average of that year. Production costs in Q2 of 2019 is 2% above the midpoint of our cash cost guidance for the full year.

On slide 25, G&A is 19% above Q2 2018 for our operating mines. With respect to the upper range of guidance of $2.4 million per quarter provided in our yearend 2018 call, the deviation is below 5%. On a year-to-date basis, this line item is in line with our expectation and guidance.

Corporate expenses are 14% above Q2 2018 and 10% above the upper range of our guidance. This is mostly a temporary effect related to lower invoicing of management fees to the Lindero project in the quarter. Our effective tax rate for the quarter was positively affected by the combined effects of an appreciation of the Argentine peso in the quarter and persistently high inflation in Argentina. When stripping out these effects, the effective tax rate on an adjusted net income basis was 54%.

Finally, on slide 26, on the upper left-hand side of the slide, we show our projected minimum liquidity position throughout the construction period of $18 million to $21 million. We will target a minimum level of $50 million of liquidity, which will involve expanding our debt availability by an additional $30 million. Considering a fully drawn amount of $150 million at peak liquidity needs, this will represent less than 1.9x or 1.8x EBITDA. And once Lindero is in production, the debt ratio will decrease significantly, as shown in the bullets at the bottom of the slide.

With that, I will hand it back to you, Carlos. Thank you.

Jorge Ganoza - President, CEO and Director
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]. We'll go to our first question from Chris Thompson with PI Financial.

Q: Good morning. Thanks for hosting the call. Just a couple of quick questions, really exploration focused. I wonder if you can just update us on what's happening at your mine sites as well as Lindero as far as exploration.

Jorge Ganoza - President, CEO and Director
Okay. At Lindero, Chris, we are, as you can appreciate, focused on the construction right now so no exploration has been taking place at the Lindero site. We did important work on in-fill drilling last year and we saw the benefits of that, but on some exploration drilling on Arizaro, but that was last year. This year, the focus, camp availability, everything has been—priority has been given to construction.

We're active on exploration outside of the brownfields scope of Lindero. We're very active. We've been drilling targets in Salta, early-stage post-discovery, early-stage prospects in the province. We like the province very much. We're very active there but we have nothing to report in terms of results yet.

On Caylloma, we have phased down the exploration due to the fact that we had tremendous success two years ago with the extension and expansion of mineralization on the Animas vein. So the focus on Caylloma today is capital spending to develop infrastructure to bring into production these areas, these additional tonnes and ounces that came through the successful 2016, 2017 exploration programs at Caylloma.

And at San Jose, we have a 20,000-meter drill program this year where we've been focusing mainly on drilling the near boundaries of the mineralized system and resource envelope on the deep end of mineralization, on the north end of mineralization and the south end of mineralization. We have been enjoying success with the drilling. And I think you'd be able to appreciate that once we publish our updated research and see how we are dealing with depletion at that mine. We have not had a standalone discovery or something of that nature that we can report, but I can say that our exploration drilling in the immediate vicinity of this vein system—and as you know, San Jose is not one vein. It's a system of stockworks and vein zones. Going back and working close with them, we've been identifying zones even in the upper levels with additional mineralization that we're bringing to the resource this year.

Q: Thanks for that. Thanks for hosting the call.

Operator
And our next question comes from James Huntington with Scotiabank. Mr. Huntington, your line is open. Please go ahead.

Q: Thanks for taking my call. Just a couple of questions regarding Lindero. Compared to the Q1 MDA, I see the ADR plant and crushing circuits have been delayed about a quarter. Could you give us some color just as to the cause of the delays?

Jorge Ganoza - President, CEO and Director
Yes, yes. I have to say that we have no material source of delay on the ADR or SART. We have had, in the past, particularly at the beginning, at the launch of Lindero, large issues to deal with like camp availability, weather issues at the beginning of this year, issues with the amount of rock excavation for foundation work. Those were large issues that we identified and we've been vocal about at the start of the Lindero construction. But today, what we're seeing is a slight slippage due to resources provided by contractors coming into the project, mainly on the electromechanical contract. I'm here to paint the picture, earthworks work, the bulk of the earthworks is done, concluded and behind us. In a month and a half, two, we are done with the leach pad and that, which is a large contract, is over and done.

Then is concrete structures and placement of concrete, that's in the hands of a large contractor. All the mission-critical areas on concrete are concluded or more than—not concluded, 98% concluded to be more precise. Mission-critical areas on concrete are done. We still have flooring for the office area and other ancillary facilities but nothing that is mission-critical. But we will take in our schedule some 20 to 40 days of delays from the slow ramp-up of that contractor when he came into the project. Today, that contractor is working with other resources we require on-site, is performing, and concrete is not in the mission-critical path.

Right now the big contract and the one that counts in the last mile of the project is electromechanical piping installation. The contractor is on-site. We currently have about 120, 130 direct workers from the contractor on-site. That is, we have a small gap of about 10%, 12% with respect to what the plan calls in terms of manpower and it is those slow or small issues that have an impact in our projections. So we are moving from early Q1 for placement of ore in the leach pad to just saying—sorry, early Q4 to, say, in Q4. And the availability of pregnant solution from the irrigation then is an issue. If we are early in Q4, we should have plenty of time to generate enough solution to send to an ADR that should be ready by early next year. But if we are placing ore in the leach pad instead of early in Q4, late in Q4, it will take a bit more time to generate that pregnant solution to source steady flow to the ADR.

So those are the things that are moving or have potential to move or are gearing our guidance today. We don't have issues with the equipment and I think you can get a sense from that from the typical advance of this project and where we are with the spending on the project.

We have on-site all the equipment, all the steel structures—or not all, but 95% of the steel structures we need. But we are in our schedules. For the last year, we've been working on tight schedules, and we are working hard to foresee all deviations here. But still, we're working within this quarter. So as we are able to place ore in Q4 on the leach pad, as soon as we can generate enough solution, we'll have that ADR ready in Q1 of next year, and we can start running at a steady flow.

We are not planning for shortcuts to produce first doré here. We want to launch our entire circuit, of course, as commissioning demands on stages and whatnot, but we will be producing in a way that when we start producing gold, we can sustain it and we can have a quick move to commercial operations within design parameters. Of course, as you all know, there are risks associated to commissioning and a swift commissioning on the mechanical availability and whatnot. But I can tell you that our plan calls for the entire circuits to come into line and we're not shortcutting to show a first doré photo for the press. We want the entire circuit to come in.

Q: Okay. Great. And just one more thing. Just for commercial production, what are your parameters you're looking for to clear that?

Jorge Ganoza - President, CEO and Director
One, our mechanical, basically, a big component of this is the crushing circuit and stacking circuit. Let me go back. On the mine, we have no issues with being able to source the plant feed at the rate required from the mine, so taking care of. On the plant, on the crushing agglomeration site, as long as we see ourselves well within 85%, within the design parameters, we are okay with ticking that box.

And on the ADR side of things, we need to see gold extraction also within 85% of design parameters on gold extraction from solution. As you know, a leach pad is a bit of a black box but we can get an early sense for because we have rapid extraction curves in our column tests. Within a reasonable time, I believe we can gauge the performance of gold extraction in the heap as well.

Q: And sorry, I should have added to that. Do you have a sort of period for which you have to mine those parameters? Like is it 20 days, 60 days? Do you have any color on that?

Jorge Ganoza - President, CEO and Director
We don't have a set period and for example, the crushing, yes, you would like to see the crushing operations steady for a period of time, 20 days, a month. Now the crushing is starting in October, November. So by December, we should be ticking the box of the crushing circuit. And while we're doing that, you commission the crushing by crushing so that's part of the ramp-up of the stockpiling.

Q: Great. No further questions from me. Thank you.

Operator
[Operator instructions]. We'll take our next question from Ryan Thompson with BMO. Please go ahead.

Q: Thanks for the detailed update on the construction progress there. Can you just kind of help me out with my modeling and just timing of cash flows? You mentioned that there's still some more VAT that has to go out the door. Could you just remind us how we should be modeling that in terms of recovering it? And then how should we be modeling the $25 million of preproduction expenses that you also mentioned in the press release?

Luis Dario Ganoza - CFO

Yes. So in terms of VAT, as of the end of June, we had around $29 million. As we disclosed in the news release, we expect to incur an additional $18 million. So overall, we expect to close the construction phase with around $47 million of VAT to collect; our best estimate today is that we can do it in a period of two years. We don't see any material reason why we—and after commercial production begins in a two-year period, we don't see any material reason why that shouldn't be achievable at this stage.

And with the preproduction, I mean that's comprised of—there's around $5 million of inventory supplies and $20 million of strictly preproduction that will allow us to accumulate a stockpile of ore by the end of that preproduction phase of around 1.9 million tonnes. We will have processed at that time an additional 1.4 million, 1.5 million tonnes. So the preproduction really is related to advance opex, and it is within the range of our unit costs. Those numbers come around, you do the math, $11 per tonne of ore mined and processed. So that's the nature of those expenses.

Q: Okay. So it sounds like it's probably mostly going to be incurred in the fourth quarter and the first quarter of 2020 as well?

Jorge Ganoza - President, CEO and Director
Yes. Yes. That's fair enough, yes.

Q: Thanks. That's helpful. That's all I had. Thanks, guys.

Operator
And our next question comes from George Froley with Pacific Income Advisers. Please go ahead. Mr. Froley, your line is open. Please ask your question now.

Q: Yes. This is George Froley, Pacific Income Advisers in Santa Monica. Have you considered, instead of extending the bank line to do a convertible security for this next piece of money you need to complete the mine?

Jorge Ganoza - President, CEO and Director
We have a suite of options in front of us. First, the nature or need is to give flexibility to the start of operations in Argentina. So we have ample debt capacity to give ourselves an additional, something in the range of $30 million to provide Lindero with that start-up working capital flexibility. And our convertible is something that we would consider within that suite of possibilities. Yes, on some ends, yes.

Q: Great. Once production is up and stabilized like in the second quarter of last year, what would be the daily tonnes through the plant?

Jorge Ganoza - President, CEO and Director
We are expected to be running from after commissioning of the crushing circuit in the fourth quarter of this year at a rate of 18,750 metric tonnes per day.

Q: Wow. Okay. Thank you very much. Congratulations on a successful build. That's a big project. Incredible.

Operator
And with that, there appear to be no further questions, so I will turn this back over to Carlos for any closing remarks.

Carlos Baca - IR Manager

Thank you, Christy. If there are no further 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.