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Transcript of
Fortuna Silver Mines Inc.
Third Quarter 2019 Financial and Operational Results
November 18, 2019

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Luis Dario - CFO

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Garrett Goggin - Gold Stock
George Froley - Pacific Income Advisers
Michael Bills - Davenport

Presentation

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

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

Carlos Baca - IR Manager
Thank you, Dagma. 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 third 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 Q3 2019, click on the earnings call webcast link. Jorge Alberto Ganoza, President, CEO and Director, and Luis Dario, CFO, will be hosting the call from Lima, Peru and Vancouver, Canada respectively.

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. Along with Luis our CFO, we'll be presenting our review of our Q3 financial results and main development across our products and operations in Mexico, Peru and Argentina.

If we go to slide 6, under highlights in the presentation, on financials this quarter is marked by a net loss of $7.7 million mainly driven by an unrealized FX loss of $8.3 million relating to VAT construction receivables in Argentina and exploration write-downs in Mexico. Here we want to stress that on the strength of our two operating mines and improvement of prices, we generated adjusted EBITDA of $19 million with strong free cash flow from ongoing operations of $10.6 million. These financial metrics are in spite of a challenging quarter from an operating prospective as our mine sequencing at San Jose yielded lower grades and we experienced a peak in our quarterly cost for the year. Both our production and cost are expected to be in line with our plan in Q4 and we confirm for full year production and cost guidance.

As of the close of the quarter we reported liquidity of $112 million, which has been enhanced by the successful closing in early October of our convertible debenture for a total amount of $46 million. Management believes the company has a required financial flexibility to meet its capital commitments under various scenarios, in particular as we prepare for to launch our Lindero project into operations early next year. All this while maintaining a modest level of debt once drawn according to our funding plan or debt to EBITDA ratio will stay below 2%.

As of the end of October, we report construction at Lindero is 81% complete, with construction spending at 85% as of the end of Q3. We continue to work with the aim of first gold in Q1 2020.

All of our work was obscured on August 18th with the terrible loss of life of a contractor scoop term operator at our San Jose mine in Mexico. We believe we can mine and operate in an active and free work environment and over the last two years have made significant strides towards that goal. This terrible loss has been difficult for the 4,500 people who come to work every at Fortuna's operations.

In slide 7, we present for the first time in our webcast our main consolidated safety KPIs. These are 12-month rolling figures for the period 2016 to October 2019. You can see in the first two graphs a clear trend of improvement for total recordable incidents and loss time incidents. On the severity rate graph, we see the impact of our August 18 loss but in spite of this we also show a declining trend in severity of actions. It is important to note that during the course of the period represented in the graph we have almost doubled mine hours and complexity with the Lindero construction.

Two years ago the company initiated a move from a reactive health and safety culture to a proactive one with more holistic approach on sustainability. This encompassed producing an agnostic, developing a corporate wide plan, reassessing position profiles and creating new positions in cooperation of a management HSSE committee naming a Chief Safety Officer and creating a sustainability committee of the board. Extractive industries are subject to new and heightened concerns from stakeholders. My message is we hear you loud and clear and we are taking action.

Slide 8, we reiterate our production guidance for the year of 8 million to 9 million ounces of silver and 49,000 to 54,000 ounces of gold. Q3 was particularly short on ounces compared to the previous year but not significantly off when compared to our internal figures. The lower production is attributable to lower grades at the San Jose mine. This is a function of two things: one, areas where the production stops are cycling in the quarter; and two, five days of voluntary stoppage of underground operations as a result of the accident for the investigations and to carry inspections of mine equipment for the status of human safety mechanisms. During the days of stoppage low grade stock piles where sent to the San Jose mill.

Slide 9, 78% of sales in the quarter were attributable to precious metals, 51% to silver, we benefited from peak prices in the last two years for both silver and gold.

Slide 10, inspire of a lower silver and gold production, sales were 3% higher thanks to higher precious metal prices. EBITDA margin of 31% was below run rate for the year due to the impact of share price appreciation on share based payments, higher cash cost at both mines and increased expiration costs. Adjusting for FX in Argentina and exploration write-downs in Mexico, we show a net income of $1.9 million.

Slide 11, here we present all-in sustaining costs for the quarter and nine months. The quarter was impacted by lower production, higher cash cost and lower base metal prices. For the nine months all-in sustaining costs remains within our guidance range and we reiterate our guidance for the year.

Slide 12, our capital projects have advanced largely in line with our plans. With the completion of Lindero construction early next year, we plan to increase again brownfields exploration budgets in Peru and Mexico. Both our Caylloma and San Jose mines are operating on steady sustaining capital levels.

Next slide please. Moving on to Lindero. Lindero is strategic to Fortuna on various fronts. One, it provides for the opportunity of over 50% growth in gold equivalent ounces as shown in the graph. Two, this additional production is planned to be constructive to our 40% EBITDA margin objective at a corporate level. And third, Lindero has reserves for 13 years of operations with potential to increase it, which improves our reserve base profile of our assets in the portfolio, which year-over-year hovers around five years at Caylloma and San Jose.

Slide 14, this is our view of our asset portfolio. The center for attention and capital allocation has been and will continue to be in Lindero over the coming months.

Slide 15, please. Here we present a view of some milestones of our project schedule. We're working towards start placing ore in the leach pad before the end of the year. Because of the Christmas and New Year's holidays we're at risk of slippage into early January if we cannot retain vendor representatives on site. We're working on a plan for this; we aim for first gold in Q1 of next year.

Slide 16, as of the end of October we report an advance of 81% towards project completion. We have committed 99% of capex for the project with $44 million of capex funding remaining. We forecast a capex to completion of $298 million, which is an increase of 21%, with respect to guidance provided two years ago when the construction decision was made. The forecast still includes $4 million in contingency funding.

Next in the slide of the webcast, we show you and share with you recent pictures, photos taken at the Lindero construction site. Slide 17 presents photos of our mining operations. We started drilling and blasting in early September of the first benches. We're currently stockpiling ore in preparation for start of crushing operations. We initiated the night shift three weeks ago, so we're working day shift, night shift now. So the mine is advancing according to a steady plan of ramp up. We have the entire operational and trained personnel on site.

Next slide. Slide 18 shows a series of views of our leach pad, which is complete and ready to receive ore. We also show views of our ponds area next to ADR and also pond construction is complete. We're currently working on electro mechanical installation of ponds and piping in the pond area.

Next slide please. Slide 19, the book of mechanical installation for the crushing [indiscernible] which encompasses primary crushing, secondary crushing, tertiary HPGR crushing and agglomeration is concluded. We are starting the pre-commissioning phase and commissioning phase while we work on final electrical installation. We're currently placing rubber belts on the conveyer frames. We commissioned two weeks ago the transmission line and transformer stations and electrical rooms at the crushing and agglomeration areas.

On the following slide, slide 20, just more views of the crushing and agglomeration area, cement silos, HPGR, all of the mechanical installation is done, and again, work now is focusing on electrical and pre-commissioning.

Slide 21, this is the ADR plant; a view from the outside and the inside. The ADR needs to be operational by February and we're advancing according to plant and schedule, and here we show some of the installations of tanks and pumps, work that's taking place within the building.

Next slide please. Slide 22 is a view of SART plant. The SART plant is not mission-critical for the start of gold production. It needs to be operational early; we expect this will be towards the end of Q1, start of Q2. The SART plant will be ready and operational but certainly it's not mission critical for the start of gold production and it's advancing according to plan on schedule. All the structural steel erection is concluded, and we are now working on mounting of tanks and installation of filters and thickeners.

Next slide, please. On slide 23 we show a panoramic view of the process area where you can see ADR, power plant, truck shop, SART, chemical lab. So Lindero is taking shape rapidly. The mine is operating, crushing and agglomeration area. They are squarely on the critical path for start of crushing operations and stacking up ore, which will allow us to start irrigating, and again ADR and SART need to follow early in next quarter in Q1.

So with that, I will let now Luis take you through a review of our quarterly financial results.

Luis Dario - CFO
Thank you, Jorge. So on slide 25, sales for the third quarter were $61.3 million slightly above from 2018 as a result of higher silver and gold prices, which were partially offset by the lower production in the quarter as Jorge explained. We reported a net loss of $7.7 million compared to net income of $6.9 million in Q3 of 2018, and the loss was driven by an $8.3 million foreign exchange loss on our VAT construction receivable in Argentina in the context of a strong devaluation of the Argentinian peso, following the result of a primary election in the month of August.

Adjusted net income was $1.9 million compared to $9.6 million in Q3 of 2018. The lower adjusted net income was a result of a combination of factors, namely higher share base payments of $1.9 million as we recorded a charge of $1.5 million in Q3 of this year, compared to a credit of $0.4 million in Q3 of 2018; higher cash cost of around $1.8 million; higher spending in exploration and evaluation activities of $1.3 million; and a high effective tax rate in the current quarter of 77%. Adjusted EBITDA was $9.2 million compared to $24.2 million in 2018, and free cash flow from ongoing operations was $10.6 million compared to $13.6 million in the prior year.

On the following slide, slide 26, when breaking down our sales performance for the quarter, we can see the lower metal production had the highest impact when compared to Q3 of 2018. This was true in particular for silver. This effect of lower production was more than offset by the higher realized silver and gold prices, which increased 17% and 23% year-over-year. Also, we have mentioned in previous earnings calls treatment and refining charges in 2019 have deteriorated compared to 2018.

Moving on to the next slide, slide 27. When looking at our segmented results, San Jose shows an improved EBITDA over Q3 2018 as a result of higher silver and gold prices, and in spite of lower production and higher cash cost of 11%. Caylloma's EBITDA decreased 47% compared to a year before as a result of the combination of higher cash cost and lower zinc and lead prices. Cash cost at both our operations were above the high end of our guidance for the year. We expect cash cost for Q4 as well as for the full year to be within our annual guidance range.

The next slide, slide 28, total SG&A of $6.4 million was 38% above 2018 for the quarter, as we had a $1.5 million charge of stock-based compensation in Q3 2019, as I had already mentioned, compared to a credit in Q3 of 2018. Outside of this effect, our general and administrative expenses were in-line with the prior year and guidance provided for 2019. Our effective tax rates for the quarter on an adjusted income basis was 77%, as it was impacted by the combined effects of foreign exchange volatility and withholding taxes. For the full year, the effective tax rate on an adjusted income basis was 55%, still above the expected range of 48% to 50%, due mostly to withholding taxes in the year related to repatriation of funds.

The next slide, slide 29, our liquidity as of the end of September was $112 million, comprised of cash of $72 million and $40 million of available under our bank credit facility. Our projected minimum liquidity position throughout the construction of Lindero has increased to between $55 million and $60 million, as a result of the issue of convertible debentures for gross aggregate receipts of $46 million, closed on October 2nd. As of the end of September, our total debt outstanding was $110 million, representing a debt to EBITDA ratio below 1.5.

With this, I conclude, and I pass it back to you, Carlos. Thank you.

Carlos Baca - IR Manager
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]. Our first question comes from Chris Thompson with PI Financial. Please state your question.

Q: Hi. Good morning, guys. Thanks for taking my questions. Apologies. This is just a general question, but I wonder if you could just talk to, I guess, the Argentinian investment climate moving forward, especially as we've seen a new change in government, with maybe a focus on export taxes.

Jorge Ganoza - President, CEO and Director
Yes. Good morning, Chris. We are in a period of, undoubtedly, a certain level of uncertainty as the new government takes office on December 10th.

We are currently modeling the export taxes that the Macri government implemented towards the end of their mandate, which is today fixed at around 4 pesos to the dollar. We've been looking at what does this mean from the perspective of total tax burden compared to the other jurisdictions where we operate, Peru and Mexico. And in Peru, our overall tax burden hovers around 42%; in Mexico, hovers around 43%; and in Argentina, around 32%. This of course takes into consideration workers' participation, provincial royalties, the retentions in Argentina that were brought into effect by Macri over the last year. That is our view today.

We are cautiously optimistic. We are monitoring closely two things: one is what is the new president-elect saying, what messages is he telegraphing; and second, who is he working with, who are the people he's closely associating himself with to lead this phase of transition as he takes office. The messages that he's sending, and those are readily accessible in the media, give us room to be cautiously optimistic that he recognizes the importance of the oil, gas, mining and agricultural sector as drivers for growth. Second, that he understands that the restrictions and further deepening of capital controls will pose a challenge for him to attract much needed dollars into the country. And third, the people he's working with we understand are regarded as pragmatic on the economic front. So, those are things that we view positively.

Again, we are cautiously optimistic, as a way to put it. The country is in a difficult situation. They will have to sit and negotiate in what will be a difficult negotiation with their international lenders. And we believe Argentina will go through a phase of adjustment and we will need to wait until December 10th to see some of these new measures and actions take place. But today, what we view is what we have in place, and when we compare it to the other jurisdictions where we operate, it still rates favorably. So, that is our view, Chris.

Q: Okay. Thanks for the comprehensive answer there, Jorge. Just one more question on, I guess, where we sit right now with Lindero. When are you going to be starting to place ore—maybe I missed this—on the pad and when will you start irrigating?

Jorge Ganoza - President, CEO and Director
We are working towards launching of the entire crushing circuit before the end of the year. We are today in the pre-commissioning phase, starting the pre-commissioning phase. We're commissioning and pre-commissioning with Hatch Engineering. We have the entire commissioning team onsite working with our people. We commissioned two weeks ago the power generation, power distribution to crushing agglomeration, substations, electrical rooms. We're engaged with that.

I am concerned right now of the holidays, and us, our ability to retain at a critical junction vendor representatives and vendor technicians onsite. If we are pushed into those past December 21st, even though we're working on a plan, I am concerned that there is a risk to launching the circuits with load around those dates. There are operational risks and also safety risks associated with that. So, we are working still to be able to do that before we come into the holiday season, but we're very tight.

If there's a minor slippage and we go into those holiday dates, we need to assess the risks of launching the circuits through the holidays, or we just might have to wait after. But if it's not mid-December, which we are still working for, it will be in early January. But everything that needs to be in place is basically in place. We already initiated pre-commissioning activities. We are working on electrical connections, placing belts from the conveyor frames and doing just minor fixes on the crushing. We are stockpiling ore as the mine is operating every day. So, that is where we are today, Chris.

Q: Great. Again, thanks for the comprehensive answer. Thanks, guys.

Operator
Our next question comes from Garrett Goggin with Gold Stock. Please state your question.

Q: Hi, guys. Your breakdown of your VAT asset over the previous quarter, how come you didn't hedge the peso exposure to that?

Luis Dario - CFO
This is Luis. So, hedging our exposure to our VAT receivable is complicated, and I think risky on its own, given that we can't forecast with sufficient precision the timing of the recovery of that VAT. That's probably the main issue, I would say, the main complexity around any attempt to hedge exposure to a peso on the VAT receivable. I

should say that this is an unrealized loss in terms of US dollars. We do have the option, of course, to use those pesos that we eventually recover to fund the business locally. That, of course, is limited to an extent. That option, compared to just re-patriating the recovery of the [indiscernible] in terms of US dollars eventually is also impacted by the fact that we are still currently experiencing relatively high inflation rates. So, it's not a perfect solution to leave the pesos locally and use them to fund the business, but devaluation has certainly advanced faster than inflation, and it's an option that we have at hand, of course, to reduce the impact of that loss in terms of purchasing power.

Q: Okay. And then, I'm curious, it just seems like an ongoing devaluation that occurred in 2015, happened in '18, happened again in '19. You guys are going to have—how are you going to manage your peso risk going forward?

Luis Dario - CFO
I mean, going forward, the devaluation has worked against us in this context, given the large VAT receivable. But going forward, around 40% of our costs will be incurred in local currency. The devaluation in that context, if anything, will be helpful in terms of our overall cost expressed in US dollars.

Q: Right. Okay. What about the costs associated with re-patriating your funds back to dollars?

Luis Dario - CFO
I mean, today what we know is that any proceeds in US dollars from exporting out of the country will have to be converted into pesos in the very short term. If that is the case, that poses a challenge that needs to be assessed, and we don't have at this stage a well laid out plan to manage the effect exposure. But, it's not clear at this stage either that that's going to continue.

So, as Jorge has expressed, we're currently waiting, as everyone else, to understand and see what's the environment we're going to be facing moving forward. So, I think it's a bit too early to start discussing in detail what should be the plan to address FX exposure.

Q: You think it's too early with production beginning in less than a month and the final decision occurring December 10th? It seems like you might want to have a plan in place with only a few weeks to go.

Luis Dario - CFO
It is our expectation—the emphasis here is that we need to understand what's the environment and what are the rules that we will be facing. And anything that we—the rules that we see today are to the best of our understanding, temporary, and we are expecting to have more information in the beginning of the new year.

Jorge Ganoza - President, CEO and Director
It is clear that we are in a period of uncertainty here, as the new government will likely either maintain or modify economic measures and regimes. So, for us to lay out a plan today will mean potentially very little in December 10th, or December 15th, or January 1st. So, we are monitoring closely all of these developments, but today, we know what the picture is today. But today, as I expressed before, the tax burden what does it represent; the total tax vendor, still at least Argentina, competitive today. We need to access dollars to meet the demands of the business for importation of consumables, capital goods. We have access to that market today if we need to repatriate the capital. If that were to be the case or service debt, we have access to the official dollars in the market.

But again, we believe that there is a potential for all of those things to change, and we just need to be a bit patient here and see what are the rules that the new government is going to set for us. We are not just sitting back. We're monitoring all of this closely, listening to what they are saying, meeting with them in Argentina through the mining chamber, lobbying through the mining chamber, through the Canadian, Argentinian business chamber. So, we are very active. But, in terms of a specific plan, Garrett, we need to wait a bit more.

Q: Okay. That sounds good. I appreciate it. Thanks for the answer.

Operator
[Operator instructions] Our next question comes from George Froley with Pacific Income. Please state your question.

Q: Hi, gentlemen. Congratulations on what you've done so far, and especially doing that convertible. That was a good move. Nobody called me to say thank you for the idea. But anyway, tell me how important the ADR plant is to producing gold. What does it do and why does it start in February? Won't that put production of gold out until February?

Jorge Ganoza - President, CEO and Director
Yes. Thank you for the question. The ADR is mission critical. It is the plant that will manage the extraction of gold from the pregnant solutions. So, it is mission critical for first of all, production. It is aimed to be—currently planned or scheduled to be commissioned and operational in February. And by then, we'll have enough pregnant solution to start running it through the circuit. So, ADR plants are very standard in this type of heap leach operations and are a critical part of the process.

Q: So, there won't really be first gold until February or March?

Jorge Ganoza - President, CEO and Director
What we will have is a solution where we are building an inventory of gold and pregnant solution. But, we need the ADR plant and gold room to extract the gold from the pregnant solutions through the use of carbon columns and others, and produce first, and that is planned for February.

Q: Okay, good. That's all I got. Thank you very much.

Jorge Ganoza - President, CEO and Director
Thank you.

Operator
Our next question comes from Michael Bills [ph] with Davenport. Please state your question.

Q: Good morning. Could you just remind us as we sit here today what the estimated life of San Jose is at roughly the current production rate, and maybe comment on exploration efforts, both successful or unsuccessful, to extend the life of the mine?

Jorge Ganoza - President, CEO and Director
Thank you. Currently, based on research, we are operating about five years of life of mine with some additional resources for another year or two that could potentially be converted to reserves. In terms of exploration, I have to say that the San Jose mine enjoyed tremendous exploration success some 3, 4 years ago, which led us to make a significant expansion into what today ranks among the 12 largest primary silver producers in the world.

Since then, our exploration success has been very limited. We've been able to achieve success locally and marginally in areas within production zones where we've been able to help deal with depletion by bringing new resources through expansion of known areas. We have also discovered two new mineralized structures where we have been able to add over the last couple of years some additional resources. But, in terms of something as large and meaningful like this mine had us accustomed to, no, we haven't had that kind of success.

So, San Jose today is a big mine. It consumes about a million tons of ore every year. Our expiration programs today are mainly geared towards—or have been over the last year geared mainly towards exploring the immediate extensions of known mineralization. And, San Jose is not a simple vein either, a one-structure mineralized feature. It's a series of stock-work zones and coalescing mineralized structures, hanging wall, the stock-work zone, Paloma vein, all of them in one general area.

So, a lot of work has been focused on further exploring the inter-connection and expansions of these related mineralized zones where we have had some marginal success that has helped us deal marginally with depletion. We have 60,000 hectares of exploration ground around our San Jose mine. You will know that surface access to a lot of this ground is challenging in Oaxaca. I will say that today, probably, two-thirds of that ground is not accessible to us on surface. So, we continue working, trying to generate new exploration areas. We're budgeting for next year accessing some of the areas where we do have surface access to further push exploration into these new zones, some of them located a few kilometers away from San Jose mine.

And also, continue our work in the immediate vicinity of San Jose. We have started two years ago to bring more science into the exploration of San Jose. We have advanced with deep structural study and geochemical studies to further understand the mineralization controls from the structural point of view, from the geochemical point of view. We're trying to use all the tools that science puts as a resource in front of us, trying to help bring additional mine life.

But with five years, I think it is what you typically see in underground deposits, in epithermal deposits being mined through underground methods. So, that is where we are. This year, we had a modest budget of around $4 million. For next year, what you will see, some increased budget, probably closer to $8 million on exploration.

Q: Thank you.

Jorge Ganoza - President, CEO and Director
No problem.

Operator
[Operator instructions]. It doesn't look like we have any further questions. I would like to turn the call back over to Carlos.

Carlos Baca - IR Manager
Thank you, Dagma. If there are no additional 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 great end of the year.