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Transcript of
Fortuna Silver Mines
Fourth Quarter and Full Year 2019 Financial and Operational Results
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Participants
Carlos Baca - Investor Relations Manager
Jorge Alberto Ganoza - President, CEO and Co-Founder
Luis Dario - Chief Financial Officer

Analysts
Justin Stevens - PI Financial
Adrian Day - ADAM

Presentation

Operator
Good day, ladies and gentlemen, and welcome to the Fortuna Silver Mines Fourth Quarter and Full Year 2019 Financial and Operational Results Call. After the presentation, there will be a question-and-answer session. [Operator instructions].

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

Carlos Baca - Investor Relations Manager
Thank you, Tom. Good morning, ladies and gentlemen. I would like to welcome you all to Fortuna Silver Mines and to our financial and operational results call for the fourth quarter and full year 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 Q4 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.

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 Alberto Ganoza - President, CEO and Co-Founder
Thank you, Carlos, and good morning to all. As Carlos stated along with Luis, our CFO, we'll be presenting our review of our Q4 and year-end financial results and main developments across our projects and operations in Mexico, Peru and Argentina.

In slide 6 of the presentation, under highlights for the year we're pleased to report strong financial results, with annual adjusted earnings of $28 million, free cash flow from ongoing operations of $34.5 million and a robust EBITDA margin of 37%. Liquidity available stands at $123 million, with a current debt to EBITDA ratio of 1.7. This ratio is expected to peak at 2.4 by midyear before the start of commercial operations at Lindero. As of the end of January, Lindero shows a completion of 89%, with $280 million of construction spending and first doré planned for the end of Q2 2020, as announced in our December construction update.

A year of strong financial results and difficult challenges that we have overcome was tainted by a fatal accident of a mine contractor at our San Jose mine in August. This terrible loss was a blow to our organization at a time when our efforts are showing sustained improvement year-over-year in safety performance indicators, as we will show. We pledge our commitment to a culture and procedures conducive to a safe work environment where all our personnel goes back home safe and sound every day. In the second quarter of this year, we will be releasing our 2019 sustainability report. This is a much improved and comprehensive effort compared to our first published report for 2018. We expect this report will set a solid baseline from which we can benchmark our progress on key areas of environment, social and economic benefit to the communities.

Next slide, please. In slide 7, although, health and safety have always been a priority of Fortuna, starting three years ago, we recognized we could not achieve our objectives without a cultural change. The plans we implemented to this end are rendering strong results, as we can show in these three graphs, which present trends over four years for total recordable injury rates, lost time injury rates and severity rate of injuries across our operations and projects. This is a process of continued learning and improvement across three countries involving over 3,500 people to-date. And as I stated before in this presentation, we pledge our commitment to a culture and procedures conducive to a safe work environment, where all our personnel goes back home safe and sound every day.

Slide 8. For 2019, we met our annual guidance once again and produced 8.8 million ounces of silver and 50,500 ounces of gold. Looking at Q4 production against Q4 of last year, silver production was up 16% and gold essentially flat.

Next slide, please. In slide 9, our realized price for silver in Q4 was $17.30 compared to $14.60 per ounce a year ago. The story is similar for gold, where we realized a price of $1,483 compared to $1,236. We look with anticipation at the price environment this year, particularly for gold, as we plan for a significant increase in annual gold ounces produced, with our Lindero project going into production in the second quarter.

Slide 10. Under consolidated financial highlights for the period, quarter sales, adjusted EBITDA and adjusted net income, were all higher when compared to Q4 2018. Not shown in this slide, but our sales for the year were $257 million. This is 2% lower when compared to 2018. Higher realized silver and gold prices for the year were offset by 7% lower gold production, higher TCRCs and lower byproduct lead and zinc price. Adjusted EBITDA for the quarter was $25 million, yielding an EBITDA margin of 36% and net income at $11 million or $0.07 per share.

Next slide, please. In slide 11, we present our all-in sustaining costs on a [indiscernible] basis for the quarter and year. For 2019, our consolidated all-in sustaining cost is $11.90 per ounce, in line with annual guidance and 13% higher than 2018. The year-over-year increase is explained by higher cash costs at both Caylloma and San Jose

Mine, deteriorated commercial terms for our concentrates and lower realized byproduct prices for byproduct lead and zinc.

Slide 12. Capital investments for the year totaled $215 million, $188 million allocated to the Lindero construction and pre-operation, $20 million in sustaining capital at our two operating mines and approximately $7 million in Brownfields and Greenfields exploration.

Slide 13. This slide presents a pyramid with our current asset portfolio and 2020 guidance for mine and projects. Over the last 2.5 years, we have been doing something that is not very popular in the stock market for mining equities, where investors have been largely sector risk averse, we have been building a mine. It is our view that in our industry to provide shareholders with long-term superior returns on assets and growth, one must consider counter-cyclical strategies for capital allocation, and that is precisely what we have done with the timing for acquisition and development of Lindero.

Short term, it has been difficult and we're not where we need to be yet. We're very close, but not there yet. We have been dealing with inherent complexities of large construction in a remote location in a known mining jurisdiction like Argentina. Despite all this, we're showing a 20% deviation in our capex forecast when compared with guidance provided back in 2017. We plan for Lindero to take our consolidated gold production from 50,000 ounces in 2019 to approximately 110,000 in 2020, and closer to 180,000 in a full year of production. All this at a time when gold price is trending to higher levels, driven by renewed investor interest. At current prices our internal rate of return for Lindero is in the low 20s.

Slide 14. We provided an update to our construction schedule on February 13. We plan to initiate stacking of ore early in the second quarter, we're targeting April, and we expect to see first gold in late May or June. Next slide.

As of the end of January, Lindero reports an advance of 89% storage completion. For February, we're already closer to 92% complete. We forecast construction capex between $314 million to $320 million, an increase of 28% compared to our 2017 guidance, as I stated before. The increase in this figure is largely driven by higher owners' and indirect costs associated to the extension of our construction timeline.

Next slide. Here we're providing a slide regarding conducting business in Argentina under current conditions. We've been addressing questions from shareholders and investors regarding the current business environment in Argentina. Under the current laws and regulations, we have no restrictions on capital repatriations through the use of official FX markets for intercompany debt repayment. Fortuna expects to fund close to $200 million or over $200 million through intercompany debt. So we have the ability to access the official FX market to service this debt.

There has been a step in the right direction taken by Argentinean authorities early this year easing restrictions for repatriation of capital. Today, dividend distributions allowed through official FX markets for up to 30% of invested capital. This is a new regulation that came in effect early this year. There are no restrictions to conduct imports of capital goods and supply through official FX market. So we have the ability to service the requirements of our business, accessing the official FX market. We confirm that.

With respect to the export duties, doré exports are subject to 8% duty and concentrate subject to a 5% duty. Fortuna, through its subsidiary Mansfield in Argentina, has a company tax stability agreement which caps export duties at 5% for Lindero.

Next slide, please. Here we present a series of updated photos for the construction. Pre-production mining at Lindero commenced back in September 2019. We currently have about 1 million tons of mid grade ore in stockpile, and the mine has, the full fleet is operational and I can report that it is achieving, since late February, early March, its designed rate of mining.

Next slide, leachpad and stacking system. Our leachpad is ready to receive ore. We are concluding and finalizing installation and commissioning initiation of pre-commissioning activities on the stacking system.

Next slide, please. Primary, secondary crushing circuits are currently under commissioning with load. We are running ore through primary and secondary crushers as part of commissioning activities.

Next slide. The tertiary crusher, which is the HPGR, or high pressure grinding roll, is under pre-commissioning. The crusher, the HPGR has been launched already without load as part of pre-commissioning activities. We expect to be running the tertiary crushing system with ore in line with primary, secondary and tertiary crushing systems this month.

Next slide. This is a general view of ore processing facilities with ancillary facilities as well, ADR plants, SART plants, our power plants and assay lab. ADR plant is on piping and electrical installation. At this stage, we are expecting commissioning for May of this month. SART plant is the same. Basically mechanical installations are 90% concluded and we are advancing with the piping and electrical.

With that, I'll turn the call to Luis so he can take you through our results for the period.

Luis Dario - Chief Financial Officer
Thank you. On slide 25, as has been discussed by Jorge, we had a strong fourth quarter, driven by higher sales of 16% over Q4 2019. We reported quarterly net income of $19 million compared to $2.2 million in Q4 of 2018. And after adjusting for noncash and certain nonrecurring items, we recorded adjusted net income of $10.9 million, significantly above the $4.4 million in 2018.

As Jorge mentioned as well, adjusted EBITDA increased 11% to $25.1 million. Free cash flow from ongoing operations was $6.4 million, down 46% over 2018, due mostly to timing issues on our sales and trade receivables, as well as an accumulation of VAT receivable at our San Jose Mine.

For the full year 2019, we recorded adjusted net income of $28.4 million, 26% below 2018 as a result of slightly lower sales, higher production cash costs over the prior year and higher share based payment expenses and exploration and evaluation costs. Our annual EBITDA of $95.4 million was 16% below the prior year, and we generated annual free cash flow from ongoing operations for the full year of $34.5 million, which was impacted by an accumulation of VAT receivable in Mexico of around $10 million in the year.

Next slide, slide 26. When breaking down our sales performance for the quarter, we can see the highest impact came from higher silver and gold metal prices, which were 19% and 20% above Q4 2018, as well as higher silver and zinc production.

Moving on to the next slide, slide 27. When looking at our comparative segmented results over Q4 2018, we can see that the strong results in the quarter were driven by the San Jose Mine, which saw improved EBITDA of 34%. As we have discussed, these results were in turn driven by higher sales, which more than offset an increase in production cash costs at both San Jose and Caylloma. Production cash cost at San Jose in Q4 was slightly above our annual guidance range, but we remain within guidance for the full year. At Caylloma, cash cost was in line with guidance both for Q4 and the full year.

On slide 28, the bulk of the increase in total G&A of $9.4 million for the quarter comes from share based payment expenses related mostly to a higher share price. We do have higher G&A expenses at the operating mines for Q4, as shown in the first line item, where the increase is due mostly to expenses of non-recurring nature. Moving forward, we expect an average of $2.5 million per quarter on this line item, and for corporate G&A we expect average quarterly expenditures in line with the amount we see for Q4 of 2019 of $3 million.

Our effective tax rate on an adjusted basis was 23% for the quarter and 46% for the full year. The lower effective tax rate in the quarter reflects higher deferred tax credits related to the recognition of the convertible debenture and the positive impact of movements in foreign exchange affecting our income tax provision.

Although, not included in this slide, there are two additional items pertaining to financials that merit a comment. The first one being the $11 million of investment gains in Q4. These are gains denominated in Argentine pesos and related to trades which constitute part of our strategy to bring dollars into the country as we seek to obtain the best possible exchange rate under current market conditions. We do not expect any further significant gains in relation to this trade in Q1.

The second item pertains to VAT receivable in Argentina. Total VAT incurred as of year-end 2019 on a cumulative basis is $49 million and accumulated foreign exchange losses recorded so far amount to $14.9 million, of which $12 million took place in 2019. We expect to begin collection of VAT as we start generating revenue at Lindero, and even though delaying the schedule does increase our exposure, we do anticipate that once in operation we should be able to recover within a 12-month period.

On our next slide, slide 29, we provide a summary of our liquidity position at year-end and our projection of liquidity over the coming quarters as we transition Lindero towards the commission phase based on the updated schedule for the project. Our liquidity position as of year-end 2019 was $123 million. We expect to maintain a minimum liquidity of between $30 million and $45 million through the start of commercial operations based on our existing credit facility and free cash flow generation. On top of this, we're looking to put in place a short-term completion facility at the asset level as we go fully into the commissioning phase.

With that, I conclude my prepared remarks. 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
Thank you. [Operator instructions]. We'll pause just a moment. And we do have a question coming through from Justin Stevens with PI Financial. Justin, please check your mute button on your phone. We cannot hear you at this time. [Operator instructions]. And Justin, your line is open again. Could you check your mute button, please?

Q: Hello? Can you hear me now? Hello? No?

Operator
Yes, we can hear you.

Q: Okay. Sorry about that. Thanks, guys. You answered most of my questions. I was mostly wondering on power at Lindero, you guys have a power purchase agreement from a contractor, right, so the diesel generation is done at a fixed price per kilowatt hour?

Jorge Alberto Ganoza - President, CEO and Co-Founder
We are responsible for sourcing the fuel for the power generation. So we are currently contemplating price protection or hedging alternatives, taking advantage of where the oil has been trending. So, that's something we're looking at right now—

Q: Yes. If you're sourcing all the diesel for the site, then you could theoretically recognize some of these lower prices and lock them in going forward?

Jorge Alberto Ganoza - President, CEO and Co-Founder
Yes.

Q: Great. Other than that, just the timing on that first doré pour I guess will depend on how quickly you can irrigate after stacking. But the current plan is to stack, you said in April, and then when do you think you'll be irrigating?

Jorge Alberto Ganoza - President, CEO and Co-Founder
Yes, absolutely. The irrigation is a function of available surface area on the ore placed on the leachpad. There are several factors there. One is our ability to have a smooth commissioning and placement of ore from the start on the leachpad. We have a commissioning curve that we are working under.

The delays that we have been encountering, although unfortunate, also creates opportunities and give time for us that we're not just sitting there. So, the primary crushing, the secondary crushing, for example, we are stressing the equipment. We already are advancing with addressing issues that otherwise we would be dealing with in the commissioning phase with the entire site within operation. For example, small spills and corrections on structures and chutes that are typical at the start of commissioning. So, we are gaining time on primary, we're gaining time on secondary, and we're going to start doing the same with tertiary soon.

So, we have a curve for the commissioning and operation ramp up or systems to test start placing ore on the leachpad, and we believe we can start irrigating relatively soon. And as that ore is going to be closer to plastic, we expect we can be generating enough solutions that we can start running our ADR by late May or June.

Q: Okay, that sounds good. And you currently, I'm assuming, you've got everything that you need on-site now, there's nothing that's really outstanding yet on that end?

Jorge Alberto Ganoza - President, CEO and Co-Founder
In terms of supplies, you mean?

Q: Yes, supplies and equipment, everything has been transported to site.

Jorge Alberto Ganoza - President, CEO and Co-Founder
Yes. In terms of equipment, we have everything, in terms of supplies, explosives, we're drilling and blasting every day since September. Cyanide, we have—and due to our concerns on supply chain due to the coronavirus, we are taking action to guarantee our key supplies to site.

Q: And just on the stockpiling, are you still sort of mostly running, moving waste and some of the lower grade ore to expose the higher grade ore, or have you started moving to some of the higher grade ore yet?

Jorge Alberto Ganoza - President, CEO and Co-Founder
We are going to start now building a smaller, higher grade stockpile in preparation, probably a week to two weeks of ore in the higher grade stockpile. Again, the idea was to minimize re-handle in our mine plan. Our mine plan has a unique grade stockpile. We manage for the first year some unique grade stockpile. So we have basically accomplished that through this pre-production phase, we have the primary, the higher grade ore exposed. We're going to start building a small higher grade stockpile, just a small, and then we're going to start slowing down our mining rate until our crushing circuit is ready to start taking load.

Q: And then so once you put the drainage layer on top of the liners of, I'm assuming sort of low grade, the first thing down will be some of that high grade from both the pit as well as that stockpile?

Jorge Alberto Ganoza - President, CEO and Co-Founder
Yes.

Q: Perfect. Well, that is it for me then. Thanks a lot, guys.

Jorge Alberto Ganoza - President, CEO and Co-Founder
Thank you.

Operator
We'll take our next question from Adrian Day with ADAM.

Q: [Audio drops] Lindero. The first one is on San Jose. Obviously you got your stay in court, which was essential, but I don't know if you care to say, are you in negotiations with the Mexican authorities on a potential settlement, or are you just pursuing it in the courts? And then the second question will be on Caylloma. Do you have any sense for the next several quarters what the mix of silver versus zinc, et cetera might be?

Jorge Alberto Ganoza - President, CEO and Co-Founder
Thank you for the questions, Adrian. We are pursuing three lines of action with respect to the royalty claim in Mexico at our San Jose Mine. First, are the legal ones. As you mentioned, we requested an injunction to a court, and our request for an injunction was first admitted by the court. And second, the court issued, first, a temporary stay that, on March 2, moved into a permanent stay of execution. So the DGM and Mexican mining authorities have a period to appeal that, I believe late this week, early next week is the deadline, and that appeal will likely take several weeks, if not months to get resolved. But our legal team in Mexico believes that our arguments are sound and our legal position is strong, and the reflection of that is the continued resolutions we have been getting in this court.

Second, there is a path on what's called in Mexico an administrative court, where we have not filed an injunction, but we have filed a request that the authorities remove the inscription of the royalty from our title. The administrative court is hearing this case. We presented this request in front of that court last year, and that is a process that is ongoing.

And third, directly to your question, is direct negotiations with the authorities. Yes, we would like to have an agreement with authorities where we can settle this out of court. It is our strong view that there is no legal basis for the royalty, but, we would agree to a reasonable settlement at least out of court with authorities. I have personally met already in two occasions with the Secretary of Mines of Mexico. We have had conversations where we have worked towards a plan to achieve this negotiation. The Mexican law allows the authorities to engage in these types of discussions and negotiations and eventual settlements. It is not an easy process, as it involves authorities, not only from the Secretary of Economy and Mines but also other branches of government. But we are working towards that as well. So those are the three [indiscernible] actions we are working on; the judicial courts, the administrative court and an administrative solution with authorities.

With respect to Caylloma, a few years ago we changed the revenue composition of Caylloma by focusing more on base metal zones and leaving behind the silver zones at this mine. Just as a refresher, those silver zones were narrow veins, very labor intensive and with related higher operating costs. So we believe that to return to those narrow veins at Caylloma, that can help increase and even double our silver output from the current close to 1 million ounces that we produce at that mine, would require sustained prices of above $19.

So at this stage, we are monitoring this closely but we're not there yet. So for the year, for 2020 and in our loads, what we have is a metal output from position similar to what you've been seeing over the last years at this mine.

Jorge Alberto Ganoza - President, CEO and Co-Founder
It will be around 20% silver in the revenue composition to-date approximately.

Q: Okay. But there'll be no difficulty going back to those silver rich areas, veins?

Jorge Alberto Ganoza - President, CEO and Co-Founder
There is a period of preparation. If I have to provide a ballpark figure to you, today it likely takes several months to open up and prepare those areas for production back again. It will be measured in months.

Q: Okay. I appreciate that. Thank you.

Operator
[Operator instructions]. We'll pause just another moment. And Mr. Baca, there appears to be no further questions at this time. I'll turn the call back over to you for closing remarks.

Carlos Baca - Investor Relations Manager
Thank you, Tom. If there are no further questions, I would like to thank everyone for listening in to today's earnings, and we look forward to you joining us next quarter. Have a great day.

Operator
Ladies and gentlemen, thank you for joining us today on today's conference call. We appreciate your participation. You may disconnect at this time, and have a great day.