Transcript of
Fortuna Silver Mines, Inc.
Year-End 2015 Earnings Call
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Participants

Carlos Baca - Manager of Investor Relations
Jorge Alberto Ganoza - President and CEO
Luis Dario Ganoza - CFO

Presentation

Operator
Greetings, and welcome to the Fortuna Silver Mines 2015 Year-End Earnings Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. (Operator instructions.) As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Mr. Carlos Baca, Manager of Investor Relations. Thank you, Mr. Baca. You may begin.

Carlos Baca - Manager of Investor Relations
Thank you, Chris. Good morning, ladies and gentlemen. I would like to welcome you all to Fortuna Silver Mines and to our 2015 yearend financial and operations results call. Jorge Alberto Ganoza, President and CEO; 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 our conclusion, forecast or projection in the forward-looking information. Certain material factors or assumptions were applied in drawing our 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 our conclusion or making a forecast or projection as reflected in the forward-looking information is contained in the company's annual information form, which is publicly available on SEDAR.

I would now like to turn the call over to Jorge Ganoza, President, CEO and Co-Founder of Fortuna.

Jorge Alberto Ganoza - President and CEO
Thank you, Carlos and good morning to all. In 2015 we achieved key objectives to continue unlocking the potential of our assets, creating shareholder value. These achievements were underpinned by yet another year of delivery in accordance to guidance and sounds financial performance.

When we look at our business, one of the measures we pay close attention to is mine operating and EBITDA margins over sales, which were 28% and 32% respectively for 2015. The San Jose mine achieved margins of 39% and 49% respectively, which speaks of the quality of the asset and our capability to deliver. For Caylloma mine, [indiscernible] we are in a low metal price environment, but we still managed to achieve a cash balance year with margins of 7% and 19% respectively.

Our cash costs continue to trend down in the line with our budgets and guidelines. Analyzing our cash per ton on San Jose we recorded $58.08, 7% below 2014 and 6% below annual guidance. Caylloma for the year was $85.80, 5% below 2014 and 5% below annual guidance.

We achieved a consolidated all-in sustaining cash cost net of byproducts of $14.50 for 2015, between a capital intensive year due to our expansion in Mexico and optimization of Caylloma. All-in was 11% below guidance and flat with respect to 2014. We have provided guidance of $11 for 2016 of major capital projects in mid-year. We expect all-in cost will continue to trend down in 2017 when we operate at sustaining capital levels with higher annual production as a result of expansion.

The driver for the production growth and cost reduction is expansion, as I mentioned, of the San Jose mine to a new rate of 3000 tons per day. At this rate, San Jose will be in a capacity to produce 7 to 8 million ounces of silver per year and about 50,000 ounces of gold.

The project is advancing according to our schedule of budget, aiming for commissioning in July of this year. At this new rate, for production San Jose will rank among the 13 largest primary silver producers in the world, operating with tier 1 costs.

I will now let Luis take you through the financial statement.

Luis Dario Ganoza - CFO
Thank you, Jorge. So for 2015, we recorded a net loss of $10.6 million, or $0.08 per share compared to net income in 2014 of $15.6 million. The reason for the loss was an impairment charge at the Caylloma mine of $25 million before tax or $17 million after tax. The impairment charge reflects the negative impact of lower metal price assumptions on Caylloma's mine plant and free cash flow generation.

Adjusted net income for the year was $6.7 million compared to $15.7 million in 2014, a 57% reduction attributable to a lower metal price environment. Adjusted earnings per share was $0.05 compared to $0.12 in 2014. Sales for the year were $154 million, 11% below the $174 million recorded in 2014. Realized prices on our provision of sales were $15.65 per ounce for silver and $1,150 per ounce for gold. That is 17% and 7% respectively below 2014.

For zinc and lead, which comprised 17% of our total sales in the year, prices were down 12% and 15% respectively below 2014. These lower prices were partially offset by higher gold sold of 10% and higher zinc and lead sold at 31% and 44%.

Mine operating earnings was $43.5 million, 28% below the previous year as a result of the lower sales. Margins came down from 35% to 28%, reflecting the impact of lower metal prices. The negative impact was partially offset by lower unit costs at both San Jose and Caylloma of 5% and 7% respectively.

Selling, general and administrative expenses were $17.9 million. That is $7.2 million below 2014. A large part of the reduction as a result of a lower stock-based compensation charge in 2015 when compared to the previous year, which was in turn due to mark-to-market effects from the performance of our share price. We also had a $1.5 million reduction of corporate expenses contributing to the lower selling and G&A. Our effective tax rate for the year was 70%, and our effective tax rate at our Mexican operations which is our main contributor to income to date was 39%.

Focusing on the fourth quarter, we recorded a net loss of $17.2 million as a result mostly of the Caylloma impairment. Adjusted net loss was $0.1 million, driven by a foreign exchange charge of $0.8 million and an adjusted operating loss at Caylloma which nonetheless recorded an income tax expense further contributing to the overall adjusted loss for the quarter.

When looking at our segmented results for Q4, the San Jose mine increased operating income by 27% over Q4, 2014, and operating margin increased from 28% to 32% in spite of lower metal prices; however, in terms of our consolidated results, the weak performance of Caylloma, even after adjusting for the impairments, offset most of these gains. The effective tax rate for the quarter was 100%, and the effective tax rate at our Mexican operation was 32%.

Moving forward in 2016 we expect Caylloma to be in a position to contribute to consolidated operating income and net income as the adjustments to the mine length and cost restructuring yield results. In the first month of 2016 we are already achieving stronger base metal production compared to the last quarter of 2015.

Moving on to the cash flow statement, total cash provided by operating activities was $54.8 million. This included approximately a $24 million contribution from changes in working capital and cash payments of income tax of $17.8 million. On the changes in working capital, the largest portion of it comes from an early collection of trade receivables in the month of December and from an increase in accounts payable related to the increased activity on our large CapEx project at the San Jose mine. The $17 million of taxes paid includes $9 million of 2014 taxes paid in March of 2015.

Total cash consumed on capital expenditures was $57.1 million of expenditures, actual expenditures on mineral properties plant and equipment plus $6.7 million of deposits on long-term assets for a total of $63.8 million. Out of this $57.1 million of expenditures on mineral properties plant and equipment, $26 million was spent in Q4 of last year.

For 2016, we have a CapEx budget of $59 million, of which we expect $40 million to be spent in the first eight months of the year. Beyond that we should start seeing positive free cash flow as we commission the expansion of San Jose in early Q3.

Finally, our total cash balance including short-term investments for yearend 2014—I'm sorry yearend 2015, was $108 million, an increase of $30.9 million over yearend 2014, which includes the $40 million draw-down of our term loan in Q2 of 2015.

Thank you. Back to you Carlos.

Carlos Baca - Manager of Investor Relations
We would now like to turn the call over to any questions that you might have.

Operator

Thank you. At this time, we would be conducting a question-and-answer session. (Operator instructions.) And our first question comes from the line of Rahul Paul from Canaccord Genuity. Please proceed with your question.

Q: Hi everyone, congratulations on a very strong 2015. Actually had a question regarding the mill expansion, the San Jose expansion to 3000 tons a day. You mentioned commissioning in July, but how long do you think it would take to ramp up to the 3000 tons?

Jorge Alberto Ganoza - President and CEO
Good morning, and thank you for the question. The mine will be in a position to source at a 3000-ton-per-day rate in Q2. Already we have the development ahead, and we don't see any issues with the mine being able to source 3000 tons per day starting as early as May.

Now, the commissioning we expect to be short. We are installing—this is really a bolt on expansion. We are bringing in a new ball mill which is being mounted as we speak, a new bench of flotation cells, and a new crusher and a new screen in the crusher. So really we don't expect any complicated or long commissioning. We really expect the commissioning project to begin in June, so to drag on from June to July, two months of commissioning. This is the actually third expansion of this nature that we do at San Jose, and the two previous ones have been smooth, and we expect so far smooth a commissioning period as well.

Q: Okay, thanks. And then I guess you would expect it to be operating as for the 3000 tons a day by the end of the year, earlier than that by—

Jorge Alberto Ganoza - President and CEO
We budget to be operating in Q3, probably benefit of 3000 tons per day, start seeing the full benefit of the 3000 tons per day or a greater part of the benefit of the 3000 tons per day in Q3 of this year.

Q: Perfect. And then just moving on bigger picture looking forward, Fortuna, the team has done a great job on the operational side of things, and I guess your focus right now is just completing the San Jose expansion going on, but once that's done by mid-year then you will be generating quite a bit of cash. I guess the question is what would you look to do? What's next going forward? I mean, are you going to spend towards more efforts to excavation or are you going to look at growth opportunities going forward?

Jorge Alberto Ganoza - President and CEO
Well, we've been focused for—to put it into context, our focus for the last decade has been on organic growth. We saw early on a lot of potential in the assets to being unlocked, and that has been the cheapest way and the most efficient and effective way to create shareholder value. Last time we had to access the market to issue shares with future equity for capital was 2010. But right now, we see our assets achieving optimum rates of capacity based on the size of resources that we have.

We will look to book our exploration efforts on the Brownfields. Our exploration budget in 2014 was $4 million. In 2015 it was around $4 million, $5 million as well. 2016, our budget is $8 million. But back in 2011 our budget was closer to $14. So we've being favoring capital projects, infrastructure projects for expansions and in this low price environment cutting our exploration budget to minimum levels.

So one thing, once we come out of this capital intensive phase, we will start giving more funding to our Brownfields exploration, for one. We believe there is tremendous exploration potential in our properties. And something that we like to stress is that we own the camps where we operate. Around San Jose mine, we over 60,000 hectares of continuous ground. There is lots of work to be done there for years to come. It's a similar situation in Caylloma with a smaller land package, but still we control a commanding land position in and around our operation. So that presents strong opportunities for growth.

Second, we are looking at new opportunities outside the firm. For the past two years we've been more active, gradually been more active, I would say, than before. We sense a change out there with respect to the willingness of groups to transact. As we all know and I think that's been probably discussed, we have seen some entrenched groups and really from our angle to some degree an absence of the kind of quality assets visible to us and transactable to us.

As I said early in the presentation, something we look at very closely is what is it that we're bringing the new projects or targets as we intend to bring on, what it's doing to our portfolio? And we look at margins very closely. Is it enhancing our margins? Is it a margin neutral transaction, should be preparing for more margins? And to be honest we have a very high bar with San Jose. So, I can say that we're more active than before. I can say that we are trying to see groups more open to discussions and potential transactions.

I can say that we are actively looking in Latin America and abroad, and our search is driven by quality of asset. And a key question we ask for ourselves even if it's an early stage project is what will these do to our margins? It's not just about size, as we all know, and that's been a driving principle for us since the very early days. The question is what does it do to our margins and the health of our business? We want our business that's strong throughout the cycle.

Q: Perfect. And just a followup on that, I guess, what we've seen in the last year or so has been other silver producers diversifying to increase their weighting towards gold assets. I mean, is that something that you are open to doing or would you rather stay sort of a pure silver company or at least primary silver?

Jorge Alberto Ganoza - President and CEO
No. We will look at gold. We will certainly look at gold. We certainly look at gold, gold-silver, gold-only opportunities, depending on, again, the quality of those ounces will be a key factor.

Q: Okay.

Jorge Alberto Ganoza - President and CEO
And we'll be patient. We'll be patient until we find something that meets our criteria.

Q: Okay. That's all that I had. Thanks a lot, Jorge. Thanks very much.

Operator
Our next question comes from the line of Jessica Fung from BMO Capital Markets. Please proceed with your questions.

Q: Hi. Thanks. Good afternoon everyone. Just wanted to touch quickly on Caylloma and what you guys are planning to do there. Do you view lot of potential there, and how do you expect to get cost down there as well? Thank you.

Luis Dario Ganoza - CFO
With respect to Caylloma, we have been short, but first to talk about exploration, we've been short quite in Caylloma severely on the exploration front for two, three years now. Now, we were able to do that because in the good days we were very diligent with our exploration expanding, and that exploration expanding was quite successful in building a good base of resources and research for this mine.

We have had a change in strategy of Caylloma. We have cut, refocused the mine and concentrated the mining operations in one zone of the main Vein Animas. So, Caylloma has traditionally up until last year operated, early last year 2015, operated on multiple veins, mainly the Animas Vein as a non-core vein and then sourcing high-grade silver from narrow labor-intensive veins in the north part of the mine. That narrow vein mining made sense with silver at around $19. It doesn't make sense with silver at $15, $14. So we close down those areas. That helped bring cost down.

In the Animas Vein we were mining on multiple levels. We decided to concentrate mining on those 13 and 12 for the bulk of production. Those two levels are integrated, so we can achieve better efficiency with the contractor equipment and supervision. So, those are the kind of measures that we are taking. This shift towards the deeper levels of the Animas Vein is the reason why silver production in 2015 and in our 2016 budget is down with respect to what historically we have produced at this mine, which is historically 2 billion ounces.

Now, it's more in the 1.5, 1.2 million ounce level, but as you see our lead and zinc output at this mine has increased significantly. We're producing about 20,000 tons of lead and 20,000 tons of zinc annually. That's our guidance for 2016. That's 25%, 30% above what we have traditionally produced, so even though our silver output is down—even though the sliver output production is down, the net amount of return value per ton is higher, and our margins are improving because the Animas Vein is highly mechanized, well integrated, we're more effective, more efficient, so we're being able to bring cost down per ton and getting the margins we need.

We have also achieved the power interconnection to grid. Caylloma was sourcing 70% of its power from the grid, and the balance was being sourced from self-generation with diesel. Starting February, 100% of the power comes from the grid, so that will help costs in 2016.

And we are also commissioning as we speak the optimization of the plant. We are expecting to through the optimization achieve 1500 tons per day throughput capacity from the current 1300, and we are also expecting that this optimization will allow us to improve metallurgical recovery slightly for sliver as well. So all-in-all, all these changes are reflected in our guidance. Now, we're working. All of these changes that I just described are reflected in our cost guidance, are incorporated in the guidance, and for this year we are expecting Caylloma to contribute cash. We are at the prices in the budgets, we are today in our budget prices. So with these prices for lead, zinc, silver and the actions we've taken, we believe we are in line with budgets and we should have a cash positive year.

Q: Okay. Perfect. Thank you very much.

Operator
Our next question comes from the line of Chris Thompson from Raymond James. Please proceed with your questions.

Q: Good morning, guys. Thanks for taking my questions. And congratulations on a good year. Got a couple of quick questions here, but let's start off when do you hope to announce with revised reserve resources for your projects?

Jorge Alberto Ganoza - President and CEO
That should be out by now, Chris, but we have had competing tasks with the technical service group. We have given priority to the other tasks. So have a small delay with what usually is our publication time, which is February. I expect end of March, mid-April.

Q: Okay. Thanks for that. Just moving on quickly to San Jose, and I might have missed this. I apologize. Can you just remind me again on the CapEx remaining for this year by way of what's required on the ramp-up, obviously the dry stack and the plant [ph]?

Luis Dario Ganoza - CFO

Chris, CapEx for San Jose in 2016 is $46 million; that's budget. Out of that the balance for the expansion from 3,000 tonnes per day is $23 million, and sustaining CapEx in general is a bit below $14 million.

Q: Okay, great. So the $23 would include the money to be spent on the dry stack considering an expansion there obviously. Obviously it is an ongoing thing, as well as the plant?

Luis Dario Ganoza - CFO
We do have, I believe it's $2 million or $3 million of additional CapEx to spend on the dry stack, and it would be within $23 million, yes.

Q: Perfect. Okay. Thanks guys. Thanks. And just moving on very quickly, could you just comment a little bit on what are you seeing right now as far as grade reconciliation at San Jose? I mean, and this is in the context I guess of good grade you guys delivered for much of last year and whether you see an opportunity for that to extend into this year.

Jorge Alberto Ganoza - President and CEO
No. We are seeing globally good grade conciliation, consistent grade conciliation globally. At the mine operating control level, on the monthly basis, gold deposits, we are exposed to some minor variations, but globally the deposit is conciliating well. You know, Chris, that this is a positive grade concentrated. We keep development ahead of production. So we always have good flexibility as well to respond. For example, this year we were able to respond to the shortfall into silver production coming from Caylloma due to the change in mine plant, and we were quick to just increase grades at San Jose, not necessarily because of alleviation in reconciliation, but us being able to access higher grade zones that we had already developed and increased production in those zones.

Q: Okay, great. And just a quick comment on recoveries, if you would. I mean, obviously good recoveries on the gold and the silver in the Q4. Would that be a good proxy to use as an estimate for this year?

Luis Dario Ganoza - CFO
That's a good question because we're seeing recoveries as far as 93%. We have budgeted 92%, and that has been a bit of a discussion there with our operating group, but we have budgeted at 92%, but we're seeing recoveries as far as 93% already.

Q: Al right, well that's great. And just finally, just before we move on to Caylloma very quickly, just a comment on exploration. What's happening right now as far in the context of permitting and drilling, Jorge?

Jorge Alberto Ganoza - President and CEO
With respect to permits and for surface access, I have nothing new to report. With respect to exploration, we have at San Jose three ongoing programs currently. One rig is drill testing the Trinidad [indiscernible] deposit. The central part, the main part of the deposit is testing the deep extent. We call it Trinidad deep. We have mineralization open at the very end, and we're drill testing, trying to pursue that. Then on Trinidad North, we are drifting. We have around 250, 300 meters advance on the drift. This will be the main exploration drift that will give us access to continue testing the north extent of Trinidad North.

We expect to be concluded with the 1500 meters by yearend, and we expect to be drill testing north end of Trinidad North, which has not been tested to date from the drift by yearend. And third, we are drill testing La Noria vein system, which is a parallel vein system to Trinidad [indiscernible]. Where our mine is, it's located approximately 1.8 kilometers due west, and we have there one rig working currently.

Q: Perfect. Excellent. Okay. And then a quick question or two on Caylloma. Obviously, I was listening to the discussion relating to the change in mine plan. Obviously you're focused more on the base metals rather the silver. Jorge, what sort of silver price would make—at what sort of silver price would you consider maybe looking again at mining from some of the high-grade silver zones there? And then how quickly could that be achieved?

Jorge Alberto Ganoza - President and CEO
It can be achieved really quickly. The underground workings are accessible. We don't have water problems or anything like that there, so just ready to bring into operation anytime we decide. And I believe that that price is closer to $19. In 2014, the average price for the year was $19, and we were happily mining there. The issue is 2015 where we started and zinc prices dropped to 16, 15, so the high grades that we see in those narrow veins do come with high variability. So we can be making cuts of a kilo silver and next cut can be 200-, 300-gram silver.

So, when you're mining at $19 you are either making a lot of money or you're just making good money. And with $14, you're either making some money or losing money. And we have no tolerance for losing money, so we decided to shut it down.

Q: Fair enough. Great. Thanks, guys. Congratulations.

Jorge Alberto Ganoza - President and CEO
Thanks.

Operator
Our next question comes from the line of Raghu Guram [ph], private investor. Please proceed with your question.

Q: Yes, thank you. And you know the analyst have asked excellent questions, so I have some minor comments and then few questions. First and foremost, I want to congratulate senior management for doing an excellent job, an exceptional job actually on all fronts, especially maintaining balance sheet strength during an industry downturn, overall cost control, initiating expansion projects for growth as well as Brownfield exploration successes in the last few months, last couple of years at Trinidad North is really remarkable.

And also thanks for your efforts over many years. Fortuna is the lowest cost producer in silver space. Fortuna production cash cost as I see is the lowest in industry, and going forward also our production cost is actually stunningly low, in my opinion, so that's actually unbelievable for me that $1.50, you know, something in that range going forward is really great.

With that, I want to ask a couple of minor questions. First one is how soon you may be able to announce some initial exploration drillings of La Noria to the market?

Jorge Alberto Ganoza - President and CEO
Yes, we are currently drilling with one rig. We will likely be releasing results sometime in April. We are drilling only with one rig, so the advance is kind of low, so we will have likely a batch of results for if not the end of March, April. That's what I would expect.

Q: Yes, thank you. And next two questions are were you able to acquire additional land packages near current operations?

Jorge Alberto Ganoza - President and CEO
In the immediate area of operations, our land packages have not changed materially over the last years at San Jose. We did add one concession last year, which is on the far, far north projection of the system we're currently mining, the Trinidad system. That was a concession we placed for comfort. We have applied for more ground in other areas, both in Mexico and Peru. We have a new concession in South Oaxaca, Southeast Oaxaca. It's an exploration target for carbonate replacement type deposit. And in Northern Mexico, North Central Mexico we

have also applied for some large concessions in some historic camp areas. Now all of that is early, early, early stage work with some official showings, so I would not be inclined to make comments or predictions regarding the potential of that ground until we can do a bit more work.

Q: And actually I think we should also not divulge to the market until the work is done where acquiring should be confidential, telling where we were trying to acquire. Lastly, this may sound a little bit ambitious on my part, but how about initiating a small dividend? Because we are the lowest cost producer, and we have major capital expending done, maybe a small, you know, couple of percent dividend initiation to differentiate Fortuna from the rest of the companies in the space. I think that would go a long way to state the quality of the company. I appreciate if you may reconsider that going forward, and I think I really appreciate your efforts. Thank you.

Jorge Alberto Ganoza - President and CEO
Thank you. And to elaborate more on that last point that you brought, for us, I think the discussion is not if we pay a dividend but when we start paying the dividend. I think management and the board view favorably return to shareholders, and we believe what will be prudent is to end this capital intensive phase and then consider a way to start returning to shareholders. This is a discussion that's already taking place at some level at the board, and I believe the appropriate time would be end of this year, start of next.

Q: Okay, thank you again and congratulations.

Jorge Alberto Ganoza - President and CEO
Thank you.

Operator
Ladies and gentlemen, there are no further questions at this time. I will now turn the conference back over to Carlos for any closing remarks.

Carlos Baca - Manager of Investor Relations
I would like to thank everyone for listening to today's earnings call. We look forward to you joining us next quarter. Have a good day.