CASEY RESEARCH

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Casey Investment Alert #210

Fortuna Silver Mines

BUY — Knowing that silver investors will pay a premium for pure (or nearly so) silver plays, we're always on the lookout for a solid new silver speculation. The problem with the vast majority of these companies is that their resource targets are simply too small for anyone to care about.

FORTUNA SILVER MINES

V.FVI, www.fortunasilver.com

Price	Share: C$1.15	MCap: C$30mm	On: 1/26/06
Shares	SO: 26,046,086	FD: 45,884,497	As of: 1/23/06
Warrants	UnEx: 18,958,411	C$0.345 - C$1.25	Exp: 6/28/07-11/17/10
Options	Open: 880,000	C$0.37-C$1.35	Exp: 11/24/06 -11/17/10
Cash	C$3.5 million	Burn: C$167,000/mo.	As of: 1/23/06

We've been watching Fortuna Silver Mines since it came off the shelf as a shell and retooled itself as an emerging silver developer/producer earlier last year. If we had recommended it back in June at about C$0.70, we'd already have had an opportunity for a double, but the company's main asset, the past-producing Caylloma silver mine in Peru was not very large and didn't look like it ever was going to get very large. The picture has now changed, and management has taken the steps necessary to build a silver play that will catch the attention of the market and, I believe, gives us our shot at a double, or better, in 2006.

People

As mentioned above, Simon Ridgway, one of our serially successful Explorers' League honorees, is a director of the company. Simon is not a passive director; Fortuna shares office space with Radius Gold and other Ridgway companies in Vancouver. In spite of the exploration setback Radius suffered earlier this year in Nicaragua, there's no question about this team's superior technical and financial skills.

Jorge Ganoza Durant, the company's new president, is a Peruvian geological engineer with over a dozen years of exploration and mining experience in Latin America. In fact, Jorge used to be Simon's competitor in Guatemala, actually scooping Simon once on a substantial land package both wanted in the Marimba/Banderas region, but Jorge staked first. When the market turned south in the late 1990s, Simon had the greater financial staying power, and ended up with the land—and Jorge as well, who joined forces with Simon and went off to kick rocks for him in Nicaragua. Jorge was the initial force behind the El Pavon (now Natividad) discovery, among others, in Nicaragua.

Another important member of the Fortuna team is Peter Thiersch. Interestingly enough, Peter served as Fortuna's president over the last 18 months and has just stepped aside for Jorge. Why would he do that? The company says the change allows both men to best use their skill sets, which we're sure is true. Having met Peter, a respected geologist with more than 20 years of experience exploring in North and South America, we suspect he is more comfortable kicking rocks than sitting in bankers' boardrooms, trussed up in a suit. Peter knows Mexico, Guatemala and Peru (having worked in the latter a couple years for Barrick), all places where Fortuna has done business. Peter is also no newcomer to the Ridgway companies, having worked with Simon for the past several years.

When Fortuna picked up the Caylloma silver mine from the Hochschild Group (a private South American mining company) last June, they also hired Jorge Ganoza Aicardi (father of the Jorge above) as V.P. of operations. Jorge Sr. has more than 35 years of experience, mainly in starting and running mines in Latin America—exactly the skill set the company will need if it is to make the transition to producer successfully later this year. During his due diligence trip, Louis James was able to observe Jorge Sr. meeting with various Peruvian suppliers and contractors and was very impressed.

This is important because, as longtime readers know, I usually think it's a bad idea when a junior tries to make the jump to producer; operating a mine is a completely different business from finding a deposit. Most companies making the attempt choke on what they unwittingly bite off. Based on the progress Louis saw—he inspected the existing Caylloma mill, which has been mothballed for 2.5 years, as well as various underground workings—I believe Fortuna will succeed at this transition, and probably do so faster and cheaper than most observers expect. That alone makes this a play worth considering, as the market will typically revalue the company when it becomes a producer, giving it a lot more credit for the resources it has—a double from here, based on this transition alone, would be easy.

Back on the subject of people, Louis met with Fortuna's drillers, exploration geologists, mine engineers, etc. He interviewed people at all levels, from Simon all the way down to the Peruvian laborers in the Caylloma camp (it's helpful on these trips that Louis is fluent in Spanish), and came away very impressed. There are many more good people in the company we could mention, but suffice it to say that this is a strong team.

Property—Have Goods, Will Travel

A year ago, Simon dusted Fortuna off and got it going with a "project of merit," the small, but high-grade Tambor gold project in Guatemala, JVed from Radius. Tambor returned some attention-getting diamond drill intercepts, such as 12.2 g/t gold over 18.3 meters and 72.1 g/t Au over 5.3 meters, but previous JV partner GoldFields was only able to outline 274,000 ounces of gold. There may be more there, but it'll be a long, expensive process finding out how much.

Then, last June, Fortuna announced the acquisition of Caylloma from Hochschild and changed its name from Fortuna Ventures Inc. (hence the FVI symbol) to Fortuna Silver Mines. The deal gave Fortuna a 100% interest in Caylloma, which had 7 million ounces of silver in proven and probable reserves, 14 million ounces in Inferred resources (43-101-compliant), a 350-man camp, a 700 tpd mill and more than 8,000 hectares of mining concessions. There's a 2% NSR on silver produced after the existing 21 million ounces in reserves and resources. The price tag was US$7.55 million and shares and warrants amounting to 10.8% of Fortuna, fully diluted. Fortuna closed the acquisition by making a payment of US$3M, issuing the shares and warrants, and borrowing the remaining US$4.5 million from Hochschild—an indication of the strength of the relationship between Fortuna and Hochschild, a major player in South America. The loan is non-interest-bearing until July 06, after which date it starts accruing at 9%, with no penalty for early payment--basically allowing Fortuna to pay up when they can raise the cash at a higher share price and therefore with less dilution to shareholders. Good terms.

It increasingly appears that the current 21 million ounces of silver are just the tip of a potential iceberg. That's because Caylloma isn't just a mine, it's a whole mining district, consolidated over the years by the Hochschilds, containing about 30 known veins, most of which have never been drilled. It's a district with a lot of history—some 400 years of mining activity going all the way back to the conquistadores—that has already produced 250 million ounces of silver. It's reasonable to wonder how much could be left. And if it is so rich, why would the Hochschilds, who have a good reputation as savvy operators, sell? Furthermore, it takes a lot more expensive work to prove up any large amount of tonnage and contained metal on veins than on a bulk, disseminated target.

Here are the answers from Louis' visit:

1] The Hochschilds see themselves as silver/precious metals miners, with no interest in base metals. The silver reserves and resources in the top-priority Animas vein in the Caylloma package come from a 1-meter-wide stringer grading 10 ounces per tonne silver that occurs within a 10- to 30-meter-wide polymetallic (silver-lead-zinc) vein—grading from two to seven opt silver, 3 to 8 percent lead, and 7 to 12 percent zinc. The Animas vein is easily traced at surface for some 4 kilometers. The company has some diamond drill confirmation over 3,800 meters of strike length and extensive underground confirmation—from diamond drilling and continuous chip sampling—over 1,600 meters of underground drifting. Animas alone could easily double or triple Caylloma's silver reserves.

The polymetallic angle is very important in this play, since Jorge Senior appears to be well ahead of schedule in bringing the mothballed plant back online. The company has said that this would take about 18 months, but from what Louis saw, we believe the plant could be producing concentrate by this summer, at an initial capital expenditure of only about C$500,000 to get up and running, and an all-in cap. ex. of about C$1 million, including the new zinc circuit. As you may recall, I am concerned about how long base metals prices will hold up, but with Caylloma's very short path to production, Fortuna could well cash in before they head down in any major way.

Louis examined drill core from Animas, including one set from which Hochschild reported 1.34 meters of 5.86 ounces per tonne silver. That was in the midst of a 7.55-meter intercept of visually identical mineralization, that turned out to grade 2.52opt Ag, 0.83 g/t Au, 3.25% Pb and 10.78% Zn, (18 opt silver equivalent). He also saw numerous chip sample values painted on the rock walls of the Animas drift, where Hochschild reported one to five or more opt silver. Fortuna has resampled the same areas, confirmed the silver grades, and found double digit percentages of zinc and lead.

In silver equivalent terms, Animas grades over 10 ounces per tonne silver (as much as 20 opt in places), over an average 8-meter width, over a 4 km strike length—and the deposit is totally open at depth. Suppose the vein grades out at an average depth of 300 meters (the deepest hole on the vein already encountered continuous mineralization 300 meters below surface). That could add up to 30 million tonnes of ore, containing more silver equivalent than the entire district has produced in 400 years.

2] Adding the polymetallic ore to the high-grade silver stringer material allows Fortuna to employ bulk mining methods underground, instead of the traditional, expensive and laborious methods of mining narrow, high-grade veins. This is very important because it's a large part of the reason Hochschild was willing to let the property go. They simply didn't care about the polymetallic ore, which should more than pay for itself, essentially giving Fortuna the high-grade silver for free. Fortuna is projecting costs down in the $4/oz range; meaning Animas could be a major cash cow before the end of this year.

3] Animas is just one of many veins in the district, most of which are connected by a 3+ km, cross-cutting adit that will allow the company to bring many “faces” into production in short order, ramping up to mid-tier levels of production in a year or two. Just last week, Fortuna announced a 1.35-meter intercept grading 1.4 kilos per tonne silver and 16.5 g/t gold at the high-grade silver-gold La Plata vein—one of numerous targets that have seen little historical development. Reserves on La Plata currently stand at 52,987 tonnes of 437 g/t silver and 2.33 g/t gold, with additional Inferred resources of 40,243 tonnes at 709 g/t silver and 2.99 g/t gold. Underground at La Plata, Louis saw several 200 to 300 opt assays, and one interval marked on a timber that graded 1,082.7 ounces per tonne silver. Further north, where more of the historic veins were worked, is the Carolina vein, which was never developed because it is low grade where it outcrops, but Fortuna has now intercepted it at depth with high gold and silver grades reminiscent of La Plata.

Speaking of La Plata, Louis says that, after seeing the alteration discoloration above La Plata, he was driven to the top of the ridge to see the exploration drilling along the vein. He saw the 100-meter-wide saddle where the mineralizing fluids stained the surface rock… then looked west across the valley and saw an entire mountain of the same discoloration. This is very significant because the Hochschilds had a theory that the valley bisecting the property was a fault that closed off all the many veins in the historic working area, as well as farther to the south where Animas and La Plata were being developed—all on the east side of the valley. However, Fortuna has found that this is not the case, and that many of the veins do continue on the west side of the valley—possibly including Animas and La Plata. There’s a huge mountain of discoloration and older historic workings on the west side, an obvious new exploration area, but the Hochschilds had an east-focused theory, and they never even scratched the surface on the west side.

In other words, the blue sky over Caylloma doesn’t come from moose pasture of unknown value, but from many known targets in one of four Peruvian silver camps that made the king of Spain the richest man in the world at one time. All Fortuna has to do is follow up with modern exploration techniques, something they aim to do in short order.

That they may increasingly self-finance through near-term production is all to the good; as a recent past-producer, they have all major permits in place, except those that need to be renewed annually, and those have been applied for.

The current round of drilling on Animas is now complete, and results should be announced any day now, with a new 43-101-compliant resource to follow by Q206.

But Wait, There’s More…

On November 16, Fortuna announced that it reached an agreement with Continuum Resources (V.CNU, C$0.225), under which Fortuna can earn a 70% interest in CNU’s 80% share of the San Jose silver-gold deposit in the state of Oaxaca, Mexico. San Jose is a past and current producer with work done on about 800 meters out of a 3 km strike length, to a depth of 130 meters. Recent work has focused on a 400-meter section of this area, known as the Trinidad Zone, where underground channel sampling has returned results up to 10.2 g/t gold and 1,102 g/t silver over a true width of 2.26 meters and 6.52 g/t Au and 482 g/t Ag over 14.8 meters. A 43-101-compliant Inferred resource of 15.8 million ounces of silver equivalent has been calculated for the Trinidad zone, at a 113 g/t Ag cutoff, using $400 gold and $7.50 silver. Fortuna plans to drill the entire 3 km length of the San Jose epithermal system.

The company won't give us any guesses as to what that drilling will encounter, but if the Trinidad Zone goes much deeper (and epithermal systems often do) and the company finds similar mineralization along a substantial portion of the strike length (which it may, as the mineralization outcrops visibly—Louis walked over outcrop more than two kilometers away) San Jose could turn into a 100-million-ounce deposit—or more. And Fortuna's agreement with Continuum covers a number of other prospects in similar geology in Oaxaca.

Observant readers may recognize Continuum as the company that entered into a merger agreement with Hunter Dickinson's Farallon Resources (T.FAN, C$0.77) last summer. That deal fell through, near as we can tell, because CNU's shareholders didn't like the dilution they'd suffer. Is the deal solid this time? Yes. Fortuna just sent CNU a check for C$1 million to cover the 20 cent private placement portion of the San Jose deal, and now must spend C$2 million in the next 24 months. There's also a payment of $0.50 per Measured ounce and $0.35 per Indicated ounce of silver in the new 43-101-compliant resource calculation done after this drilling, which should start in short order.

This is not a cheap deal, but that's to be expected when you buy known resources with size potential—you pay a premium to avoid the highest-risk, early-stage phases of the exploration cycle. Actually, with the per-ounce payments, Fortuna could end up paying more than the market is currently giving CNU for the whole company, so, if the drilling uncovers the potential Fortuna is looking for, we believe there's a very good chance they will buy CNU lock, stock, and smoking barrel. If that happens, it could save Fortuna money and give them the Natividad and other CNU projects "for free".

But CNU's share price could rise with Fortuna's, if the drills find what we're hoping they will, possibly making CNU too expensive for Fortuna to take over. That would make CNU something of a drill play, possibly worth a punt, if you like that sort of gambling, but at least CNU would get the heavy lifting paid for by someone else and be no worse off if nothing comes of it. If CNU gets too expensive, Fortuna will find itself, as Simon says, in the enviable position of having to pay 35 to 50 cents per ounce of silver. Compared to Silver Wheaton's highly profitable contracts giving them silver production from other companies' mines at $3.90/oz, it's a bargain.

Meanwhile, back in Peru, Fortuna just picked up another project within trucking distance of the Caylloma mine and mill. This project hosts the Julia vein, where, again, Hochschild found narrow silver-gold mineralization, but Fortuna looked at the core and saw 20 meters of mineralized breccia with chalcopyrite (a copper-bearing mineral—assays pending). Fortuna may also be about to double their land position in the area, if Hochschild agrees to let Fortuna take its place in a JV it has with Barrick, just north of Caylloma (negotiations are underway).

Over in Guatemala, Fortuna had planned an extensive program of drilling and underground development on the Tambor Gold project. But in keeping with the company's name change and its new primary focus on silver, the company has dropped that option. This makes a lot of sense, as there has been increased political risk in Guatemala, and Tambor just doesn't look to have the size potential that makes it worth foregoing the market premium accorded to pure silver plays. Fortuna won't be completely "pure", but it is becoming a solid silver play. And with the shift to production imminent, not to mention likely high-grade assays from Peru and Mexico, the market could be reevaluating Fortuna in fairly short order.

Politics

The acquisition of a major project outside of Peru makes us feel more comfortable recommending Fortuna. However, even though Mexico is generally a friendly jurisdiction for miners, like most countries, the details vary a lot by region. The state of Oaxaca is one of those in which there has been some unrest lately. There is a lot of poverty and potential for trouble if you don't get the locals on your side. Part of the specific problem for mining companies is that when the socialists communalized all the farm land in Mexico, they did so with little regard for historical ownership claims. Now that land is being reprivatized and many land disputes are breaking out, not only between individuals but between local governments (ejidos). This can vastly complicate surface rights, which have to be negotiated with the ejidos and private land owners (unlike minerals rights, which are granted by Mexico's federal government). So, local politics is reason for caution.

Fortunately, the Ridgway team and Continuum's management have a lot of experience working in Mexico. Even some of CNU's competitors say that CNU appears to have done a good job working with the locals. While there, Louis saw local Mexican explorers dropping by the CNU office, without appointment, offering prospects—clearly the word is out in the area that Continuum is a desirable partner. One must be very careful in this particular region, but I believe management is up to the task.

Back in Peru, Caylloma is not in a heavily populated area like Yanacocha, and it's an area where the only industry, besides a few widely spaced alpaca herders, is mining. The town of Caylloma is half abandoned, with the people keenly eager to see mining return. We are told that even during the Bad Old Days, when Sendero Luminoso guerillas were attacking other mining areas, Caylloma was spared because there was absolutely nothing else there for the people, and they would not let the guerillas in. Combined with the existing permits and operations run by Peruvian nationals, we see Fortuna as best exploration bet in that part of the world.

That having been said, as per CIA #208 on Northern Peru Copper, there is increased political risk in the form of the upcoming presidential election, in which fire-breathing populist candidate Ollanta Humala has just taken the lead. If you don't like this sort of unquantifiable risk, perhaps this isn't the speculation for you. But if Humala makes anti-business noises—or even wins—and sends companies with projects in Peru tumbling, that could be a buying opportunity. Why? Because most observers believe that Peru is too dependent on mining revenue for any politician, of any creed, to change drastically or quickly. In short, if Humala turns out to be a maniac, willing to kill the goose that lays the golden (and silver) eggs, we should have plenty of warning.

Promotion

There's no need to dwell on this, but it's worth remembering that Ridgway companies usually attract a premium, compared to similar peers, and a lot of that has to do with promotional savvy. We expect management to make the most of the attention-grabbing high-grade results they should soon be able to start reporting on a regular basis. It's the sort of stuff the market loves, and they are going to get plenty of it.

Paper and Phinancing

Fortuna has only 26 million shares issued and outstanding, with a fully diluted figure of 45.9 million. Most of that is in the form of 18 million warrants, but none of them expire this year. There was an initial batch of warrants from the Caylloma acquisition at C$0.345 for two years. Since then, 17.4mm worth of shares and warrants have been issued in order to finance the acquisitions and work: a couple million at 75 and 80 cents, but most, some 13.6 million, at $1 and $1.25. The shares from those financings come free trading in February. A lot of that paper is now in the money, or will be if the stock moves up a few percent, and that could have a capping effect. But with no urgent need to sell and serious prospects for lots of good news in the months to come, we expect most people will hold off exercising and selling for some time to come. That gives the company time to build the value necessary to offset any dilution.

Price

Much of the heightened risk of exploration present in so many of our picks is absent from Fortuna. We know they have high-grade ore; it's just a matter of how much and what it will take to get those ounces out of the ground. On the other hand, there is a lot of cheap paper out there, a fair whack of which comes free trading in February. That may explain the recent slump in share price; someone is selling into the volume the last bit of good news from La Plata generated, in advance of the new paper hitting the market.

The smart way to play this is to take a position now and then add to your position if further selling pressure develops, especially over the next month. See if you can get your shares for C$1.35 or less. If it shoots up, be patient. Even if there is news, it will probably back down again, given the pressure from the paper headed for the market.

But there is a lot less downside risk than in most of our picks, so we don't think you can get too hurt on this one at these prices. Fortuna is trading at about half of what other silver companies with similar business plans are getting (such as small producers Endeavor Silver, First Majestic and First Silver), so the potential for joy when Fortuna starts shipping concentrate is clear. Furthermore, as the San Jose acquisition demonstrates, Fortuna is not just about Caylloma; this is an aggressive team, hungry for new deals that will vault them into the mid-tier in the shortest time frame possible. With potentially spectacular assays on the way, if you want to get on this train, you don't want to wait too long.