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Transcript of
Fortuna Silver Mines Inc
2016 Yearend Financial and Operational Results
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Participants

Carlos Baca - Investor Relations Manager
Jorge Ganoza - President, Chief Executive Officer and Director
Luis Ganoza - Chief Financial Officer, Chief Compliance Officer

Analysts

Chris Thompson - Raymond James
Mark Magarian - UBS

Presentation

Operator
Good day, ladies and gentlemen, and welcome to Fortuna Silver Mines 2016 Yearend Financial and Operational Results. All lines have been placed on a listen-only mode and the floor will be open for questions following the presentation. [Operator instructions].

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

Carlos Baca - Investor Relations Manager
Good morning, ladies and gentlemen. I would like to welcome you all to Fortuna Silver Mines and to our 2016 Yearend Financial and Operations Results call. I invite you to please download the webcast presentation we will be using today. After the call is over, it will be posted in our website.

Jorge Alberto Ganoza, President, CEO and Director; and Luis Dario Ganoza, CFO, will be hosting the call from Lima, Peru.

Before I turn over the call to Jorge, I would like to indicate that this earnings call contains forward-looking information that is based on the company's current expectations, estimates and beliefs. This forward-looking information is subject to a number of risks, uncertainties and other factors.

Actual results could differ materially from our 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, which is publicly available on SEDAR.

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

Jorge Ganoza - President, Chief Executive Officer and Director

Thank you, Carlos, and good morning to all. I will give you a brief introduction to the annual results, and then turn the call to Luis. After that, we'll open the call for questions and answers.

Our results in 2016 reflect the strong positive operational and financial impact from the expanded 3,000 tonnes per day capacity at the San Jose mine. On a consolidated basis, we expanded our silver production by 11% to 7.4 million ounces and gold production by 17% to 46,600 ounces compared to a year ago as we show in Slide 4 of the presentation.

Precious metals comprised 78% of sales, with lead and zinc contributing the balance. Also, we show in the following slide, 36% growth in sales and net income of $17.9 million compared to a loss of $10 million in the prior year, driven mainly by a $25 million impairment in 2015, and an increase of 104% in cash flow from operations before changes in working capital.

Also, we achieved a consolidated all-in sustaining cash cost per ounce of silver net of byproduct of $8.40 per year, a reduction of 42% compared to 2015. We not only want to highlight our growth in production, but equally important, our strong focus on being a low-cost miner.

Moving on to capital investments in Slide 6, our consolidated CapEx was $50.7 million in 2016, which includes $23 million of non-sustaining CapEx, mainly related to the capacity expansion at the San Jose mine, $7.9 million of brownfields explorations and $2.2 million in Lindero Project drilling and engineering. On brownfields explorations, we carried 29,000 meters of drilling in 2016, representing approximately $7.9 million. For this year, we expect to double our exploration drilling meters to 61,000 with a budget of $11.5 million. Looking ahead, Lindero's review and optimization is advancing well and on schedule for a construction decision in the third quarter of the year.

So with that, I'll let Luis take you through the financial statements now.

Luis Ganoza - Chief Financial Officer, Chief Compliance Officer

Thank you. I will start by making a brief reference to our disclosure on internal controls in the press release of results and MD&A. This has been the first year of the company filing under Sarbanes-Oxley. And as of yearend, we have disclosed certain material weaknesses preventing us from concluding on the effectiveness of our internal controls over financial reporting. Under the internal controls frameworks, this in turn implies that if a material error or fraud were to occur, there is more than a reasonable chance it would not be detected.

There are a few points we believe are relevant to make around the disclosure before we move on. First of all, as I just mentioned, this has been our first year under Sarbanes-Oxley. And this certainly imposes a much higher bar in terms of formalization of all aspects of the process behind financial reporting. Second is that the weaknesses disclosed have to do for the larger part with insufficient level of documentation and supporting evidence around several of our internal controls, including review controls throughout the accounting process. There have been no incidents of fraud or wrong revenue recognition as part of the issues disclosed.

Up to now, we have operated under a tight and streamlined structure, favoring cost reduction in several areas of the organization, and accounting has been one of them. So this is an issue mostly related to expanding our staffing capacities, documenting of our controls and training to meet the demands of reporting under a SOX environment.

For the disclosure to be complete, I do have to mention there is a related error, which has been disclosed in the yearend MD&A, and it pertains to the wrong classification in Q3 of 2016 of warrants issued upon the Goldrock acquisition as a liability as opposed to equity. This is a complex accounting matter, which was appropriately identified and reviewed with our accounting advisers as of Q3. Nonetheless, a conclusion on the appropriate accounting treatment was wrong.

A final point to make on this is that the company is committed to removing these material weaknesses, and is well advanced in the execution of the necessary remediation actions.

So on to Slide 11, for 2016, we recorded net sales of $210 million, up 36% from the prior year, driven by higher metal sales and prices. We reported net income of $17.9 million, compared to a loss in 2015 as Jorge mentioned, related to a $25 million impairment charge before taxes at Caylloma.

Adjusted net income was $18 million compared to $6.7 million in 2015, reflecting our strong production growth, a more favorable price environment, and good cost performance throughout the year. Higher cash provided by operating activities is a reflection as well of a strong yearend revenues, margins and liquidity.

Cash equivalents and short-term investments as at the end of 2016 added up to $123.6 million.

On to Slide 12, for the fourth quarter, our results over the comparative period reflect the full impact of the expansion at San Jose, with revenue increase of 56% and higher cash provided by operating activities before changes in working capital of 136%. Earnings per share in the quarter was $0.04, impacted by higher income tax provision of around $0.02.

On Slide 13, when breaking down our sales performance, in the left-hand side of the slide we can see the results for the fourth quarter, with higher total sales of $29.9 million and fairly even contribution from a higher metal volumes and prices of $10.4 million and $11.3 million respectively. Worth noting is our participation of zinc and lead to the overall price contribution in the amount of $5.1 million, driven by higher lead and zinc prices year-over-year of 27% and 57%.

On the right-hand side of the slide, we can see the results for the year, with higher total sales of $55.5 million, the strongest contribution coming from higher volumes sold of $27.1 million, driven by increases across all of our metal products. Worth mentioning as well is the positive impact of treatment and refining charges year-over-year, with treatment charges for our concentrate products having improved between 37% and 15%. This is a continuous trend we see into 2017.

In Slide 14, we see the performance of operating income and adjusted EBITDA for the full year. For adjusted EBITDA, we see a strong increase year-over-year of 67%, driven by higher EBITDA margins over sales at both San Jose and Caylloma. In the case of Caylloma in particular, we saw improved production cash costs of 16%, which contributed to a 152% increase in EBITDA. San Jose's increase in EBITDA of 62% was driven by higher sales and operating leverage as a result of the expansion.

In Slide 15, for the quarter, we have a similar pattern, with even higher increase in EBITDA and positive impact on margins over the comparative period as a result of higher impact of prices in the quarter-over-quarter comparison, and the full quarter of expanded production at San Jose in Q4 of 2016.

In Slide 16, expenses, we have a relatively stable corporate G&A for the full year of $9.5 million, although higher expense in the quarter of $2.6 million, up 30% over Q4 of 2015. Moving forward, we should expect corporate G&A expenses per quarter to stay around these levels as a result of the growth of the company and added demands on meeting, amongst other things, internal controls requirements and results regulation.

Our share-based compensation for the full year was significantly above the comparative period, with $14.1 million in 2016, compared to $1.5 million in 2015. This last figure is not actually shown in the slide. Out of this total amount, around $7.5 million is related to the mark-to-market effect from the increase in our share price throughout the year.

This impact is in turn related to cash-settled instruments being used on share-based payment as opposed to share-settled instruments, which are not mark-to-market. Our effective tax rate for the year was 67%, as it was impacted by three main items, the most important being the share-based compensation expense, which is nondeductible.

The mark-to-market impact on share-based payments reflects, to a large extent, an increase in obligations that will be paid in future periods. The impact of the single effect is of 9 percentage points on the effective tax rate. Additionally, impacting our effective tax rate was a one-time withholding tax of $2.7 million recorded in Q4 and the devaluation of the Mexican peso throughout the year, which increases our deferred tax expense.

Outside of these factors, our effective tax rate would be around 47%, more in line with what we expect to see on a more normalized basis. For the quarter, we have a similar effect, with the most impact coming from the withholding tax and the foreign exchange impact.

In Slide 17, we show a cash bridge for both the full year and the fourth quarter at the bottom. The opening and closing balance shown at both ends of the bridge is comprised of cash and short-term investments. As seen in the graph for Q4, we had cash accumulation in the last quarter of the year of $20.4 million. A caveat here is we paid income tax of $5.4 million, but accrued $11.3 million, including the one-time withholding of $2.7 million.

Adjusting for this, plus financing items, free cash flow was more in the range of $10 million to $13 million for the quarter.

To you, Carlos.

Carlos Baca - Investor Relations Manager
We would now like to turn the call over to any questions that you may have. Operator, we're ready for questions.

Operator
Thank you. The floor is now open for questions. [Operator instructions]. Okay. We have our first question from Chris Thompson from Raymond James. Please state your question.

Q: Hi, good morning, guys. Congratulations on a good quarter. I just want to hone in a little bit on the operating costs at Caylloma, on a dollar per tonne basis, they look very attractive, it looks like you brought them down quite a bit. Are they sustainable at these sorts of levels moving forward?

Jorge Ganoza - President, Chief Executive Officer and Director
Hi, Chris. We really believe for the most part, yes. The larger part of those cash flow reductions have to do with the concentration of the operations around the Animas vein, the wide polymetallic vein at Caylloma. So we can expect, certainly, a bit of pickup of certain costs, but nothing back to what we have seen in the prior years. Most of the reduction should be structural and should stay with us moving forward.

Q: Okay, thank you for that, Jorge. Just quickly moving on to Lindero, obviously, we're anticipating, obviously, I would imagine, a development decision Q3, in the interim, some information relating to what's happening as far as optimizing the project, etc. Could you talk a little bit about how you're starting up, with a view, obviously, on the back of—building the projects on the back of a positive development decision?

Jorge Ganoza - President, Chief Executive Officer and Director

Yes. Chris, we are still in the project phase. We have brought in, first, key technical people. This is an open pit, a heap leach that brings certain technical demands that we do not have in-house, for example, with respect to heap leaching. So we have brought in a seasoned project leader for the metallurgical area, who's leading our metallurgical testing and optimization of process design.

We're working also with Mike Bots [ph] on the SART assessment and project development. Mike is a person who has built or participated in the design and evaluation of all the latest SART plants built and operating over the last few years. So we brought in, also, in-house strong competence on heap leaching planning. We have in-house open-pit planning. We have in-house seasoned groups, seasoned individuals on open pit operations, and we are looking to build up those teams from there.

We are scoping alternatives for EPCM. We are in the early stages of putting together a construction plan. We want to get to a construction decision in the third quarter with a construction plan. And in that construction plan, we will also have identified and faced the incorporation of key positions for the actual construction process.

So as you can imagine, this is something that's moving, advancing on several fronts. People are certainly a key component for [audio disruption] technical input. I think we have done that, and we're working along.

Q: Thank you for that, Jorge. And just, finally, just switching gears over to San Jose, quickly. Can you give us a sense of what's happening as far as exploration drilling on the project at the moment?

Jorge Ganoza - President, Chief Executive Officer and Director
Yes. Certainly, we have gone through some level of frustration with the access to the north on surface to continue exploration of the productive ore-shoot where we're mining further to the north. We have stopped pursuing engagement with the community to gain access on surface.

So a year ago, in early 2016, our board of directors approved the recommendation by management to invest $1.5 million. Sorry, it was a $3 million budget to develop a 1,500 meter exploration drift that would give us access to explore the north from the underground. All through 2016, we carried that work. That work is virtually completed.

We have three drilled holes in Trinidad North concluded by now. We're drilling from the underground chambers. That program is picking up speed, and we expect to be releasing results from drilling on Trinidad North, we're going to be drilling throughout the year.

But through 2016, we worked to try to gain surface access. And parallel to that, we were developing the drift. Nothing we can do until we either concluded the drift or gained the surface access. Well, as I said, we stopped pursuing surface access now with the community of Magdalena, and we're just focusing on drilling now that the drift is done.

Apart from that, we have a more aggressive exploration budget this year, both Caylloma and San Jose. We're not only going to be drill testing the north end of San Jose through the drift, as I explained, but also the far south extent of the Trinidad infrastructure, some 1.5 kilometers to 2 kilometers from where we are currently mining to the south.

So we don't have a shortage of structure, in some instances, the limitation in surface access, we have surface access to this area in the south, where we're going to be drilling. We expect to produce results throughout the year. Our drilling budget in 2016 for San Jose was 22,000 meters. That has increased to 31,000 meters in 2017's budget. Our overall drilling budget in 2016 was 29,000 meters; we have increased the overall drilling budget to 61,000 meters. We almost doubled.

Q: All right. Great, Jorge. Thank you for that. Congratulations, guys.

Operator
Thank you. And our next question comes from Mark Magarian from UBS. Please state your question.

Q: Hi, guys. Yes, good quarter, good cash flows. I was wondering, I mean, the previous gentleman asked a lot of relevant questions, but I was also wondering about three-year guidance, and when you guys can expect to kind of reissue that as you had it sort of before, and it got taken away. As things get a little bit more clarity developing right now, when can we expect to see that?

Jorge Ganoza - President, Chief Executive Officer and Director
Yes. Thank you for the question, Mark. We have reserves that—enough reserves, to provide three-year guidance. It's something that we assess and we would prefer to give as most guidance as we can. But there are instances, Mark, where, when we look at beyond year one, let's say, year two, year three, we include, in our internal plans, inferred resources.

When we compare what happens to our reserves-only plan versus a more realistic reserves plan, which in some instances, where we plan to incorporate inferred resources—which by the way, we would convert throughout the year. Sometimes we develop a three-year plan, where year one is consumes-only reserves. Year two consumes 80% reserves, 20% inferred resources, and then, year three consumes 60% reserves and 40% inferred resources. That is something where we have our work cut out for us, and we start doing infield drilling to convert those inferred resources we would be consuming in year two and year three.

And there are points in time where we have the three years of reserves to feed our three-year plan, and we would do that. We would just publish the guidance. But there are times where we have opportunities to bring inferred resources into the plan, and even though we could produce a plan just on reserves, it will deviate from what internally we really would do, which is bring inferred resources from other areas. So it is an operational judgment, and I understand the frustration of not being able to provide a further outlook on guidance.

But I can say one thing, we are committed to providing the best guidance and in terms of the quality of what comes into the plan. We are committed also to showing as much guidance as we can reasonably do without compromising the quality of our plans. So what you should expect if we cannot produce guidance, three-year guidance outlook today, is because the constraints I just explained.

But those constraints are addressed throughout the year with our infield programs and as we execute those infield programs and can bring the reserves that we would really be mining in that sequence of time, we would provide two, three or if we can, four-year guidance. We don't have a problem at all with providing guidance further out than a year, but we would like to see guidance that's reflected solidly on reserves that we really in our planning tend to consume.

And again, as I said before, sometimes we see opportunities to bring inferred resources that at a point in time still need to be converted, like today. So that's what sometimes precludes us from providing the further outlook.

Q: Right. I guess, also, just another note, with approximately close to a third of your market cap on a pro forma basis in cash, and given the stock's performance—a series of issues, obviously, which many are mostly been resolved and various issues with GDXJ rebalancing, it's just been an unfortunate set of events, which have put your stock sort of at a bit of a discount, shall we say, to peers. Have you guys considered, maybe, taking action given your strong cash flows on that basis, where it would be an initiation of a small dividend, which kind of brings in other types of investors or potentially even a small buyback?

Jorge Ganoza - President, Chief Executive Officer and Director
That's something that we assess regularly with the board. We do see a big opportunity—we have a big capital project coming in proximity to a construction decision. That's Lindero. It is my view that as we are able to advance Lindero, we can start unlocking the value of that asset. I think Fortuna is going through that natural curve that we all have seen where a project goes into engineering, construction decision, start of construction, advance of construction, commissioning, production. This is a big project for Fortuna in terms of capital demands.

So I believe, we need to advance Lindero successfully to unlock some of the value. And we will be careful in instituting dividends or buybacks. I'm not saying no, but we'll be careful in light of potential capital demand in the near future. It's certainly something that we are assessing, Mark.

Q: Okay. Great. Well, great job, look forward to see how things develop.

Operator
And there appears to be no further questions at this time.

Carlos Baca - Investor Relations Manager
Thank you, Meg. We look forward to you joining our earnings call next week, where management will review first quarter 2017 financial and operational results. The call will be held on Thursday, May 25th, at noon, Eastern. Have a good day. Thank you for joining us today.