Fortuna Silver Mines

(FVI-TSX)

Stock Rating: **Outperform↑**
Industry Rating: **Outperform**

March 28, 2012
Research Comment
Toronto, Ontario

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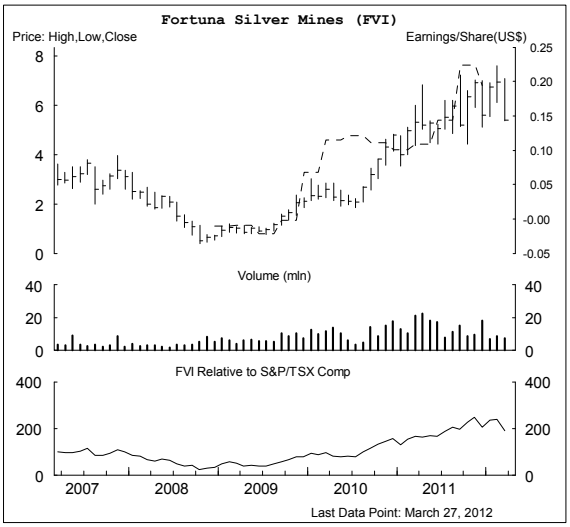
Price (28-Mar)	$4.38	**52-Week High**	$7.58
Target Price	$6.75↓	**52-Week Low**	$4.38



Upgrading to Outperform; Market Pull-Back Overdone

Event

FVI's share price has dropped 22% after the company reported a Q4/11 EPS miss late last week. The share price decline appears to be a reaction to increasing costs, permitting concerns at the Callyoma mine, recent community violence around the San Jose mine, as well as concerns that optimization and expansion programs to reduce costs at both operations will be delayed.

Impact

Potentially Positive. While cost escalation is a reality in the sector, BMO Research sees the Q4/11 EPS miss as an isolated event. FVI has established a solid operator reputation underscored by the successful commissioning of the San Jose mine in Q3/11. The risk to implementing optimization programs appears to be overdone with FVI in a good position to increase production rates at both Callyoma and San Jose in 2013.

Forecasts

BMO Research forecasts 2012 production of 3.6Moz silver, 17.0koz gold at revised co-product cash costs of US$14.14/oz silver (up 27% from BMO Research's previous estimate of US$11.33/oz).

Valuation

Factoring in higher costs and the recent share price decline, FVI is trading at 1.1x its 10% nominal NPV at spot metal prices, a 15% discount to intermediate and junior peers at 1.3x providing an attractive entry point for investors.

Recommendation

BMO Research is upgrading FVI to Outperform, but lowering its target price to $6.75 to reflect recent guidance on operating cost escalation.

(FY-Dec.)	2010A	2011A	2012E	2013E
EPS	$0.10	$0.19	$0.29↓	$0.57↓
P/E			15.2x	7.7x
CFPS	$0.21	$0.44	$0.45↓	$0.81↓
P/CFPS			9.8x	5.4x
Real'd Price (US$/oz)	$20.16	$31.11	$32.50	$40.00
Prod'n (Moz)	3.9	3.8	5.6	6.0
Ttl. Cash Cost (US$/oz)	$7.03	$16.12	$14.14	$13.05
Ttl. Prod. Cost	$8.51	$18.42	$17.42	$17.75

Quarterly EPS	Q1	Q2	Q3	Q4
2010A	$0.04	$0.02	$0.01	$0.03
2011A	$0.05	$0.06	$0.09	$0.00
2012E	$0.05↓	$0.06↓	$0.08↓	$0.11↓

Dividend	$0.00	**Yield**	0.0%
Book Value	$1.83	**Price/Book**	2.4x
Shares O/S (mm)	124.9	**Mkt. Cap (mm)**	$547
Float O/S (mm)	124.9	**Float Cap (mm)**	$547
Wkly Vol (000s)	2,945	**Wkly $ Vol (mm)**	$16.9
Net Debt ($mm)	-$51	**Next Rep. Date**	June (E)

Changes

Annual EPS	Annual CFPS	Quarterly EPS	Target
2012E $0.39 to $0.29	2012E $0.53 to $0.45	Q1/12E $0.07 to $0.05	$7.50 to $6.75
2013E $0.73 to $0.57	2013E $0.90 to $0.81	Q2/12E $0.08 to $0.06	**Rating**
		Q3/12E $0.10 to $0.08	Mkt to OP
		Q4/12E $0.13 to $0.11	

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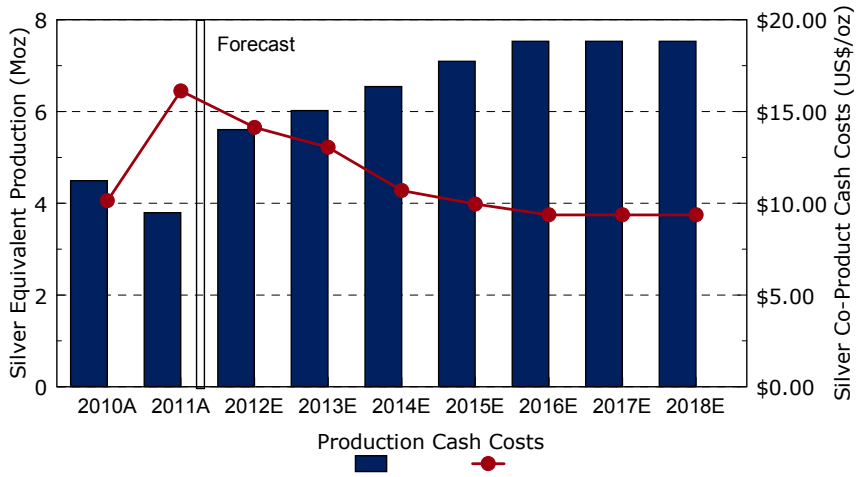
Optimization Programs Have Time to Roll Out

FVI plans to spend US$56M on a combination of mine optimization and expansion at both Callyoma and San Jose. Both programs are expected to unfold through 2012 with increased production to be realized in 2013.

BMO Research forecasts FVI silver equivalent production growth of ~97% to 7.5Moz by 2016E.

Costs are expected to decline ~50% over the same period.

Fig 3: Silver Equivalent Production and Cash Costs (2010A to 2018E)



Source: BMO Capital Market

2013 Operating Costs are Expected to Benefit From Mill expansion to 1.5ktpd

FVI is in the process of implementing an US$8.2M program to increase production rates to 1.5ktpd by 2013 at Callyoma.

At Callyoma, FVI plans to expand mill throughput from the current 1.3ktpd to 1.5ktpd through 2012. Capex to achieve the expansion is estimated at US$8.2M with work focused on expanding the crushing and milling circuits. Importantly, a focus on underground development over the last several years has enabled mining operations to achieve rates of 1.5ktpd.

Expansion to 1.5ktpd should offset increasing site costs that are projected to rise to US$85/t in 2012 from an average US$69/t in 2011. The company indicated that cost inflation for small- to medium-sized mining operations in Peru is averaging 20% to 30% in 2012. BMO Research has yet to incorporate costs synergies related to the Callyoma expansion.

While permits for the new tailings facility are delayed, FVI is in the position to commission the facility once permits are received.

FVI indicated that permits for the new tailings facility (TSF) have been delayed two months and that further delay could risk a temporary postponement in production. The company has stated that permitting will not affect the critical path of the project until June.

Offsetting this risk, FVI has nearly completed (TSF) with the exception of the pumping installations. Once the pumps are delivered, FVI expects commissioning of the tailings facility to require less than a month.

San Jose to Benefit From Expansion and Move to Doré Production

FVI plans to combat increasing costs as San Jose through mine expansion to 1.5ktpd by Q3/13 and construction of a concentrate leaching facility.

To combat increasing costs at San Jose, FVI continues to roll out an expansion strategy that will increase production rates from the current 1ktpd to 1.5ktpd by Q3/13.

In addition, FVI plans to allocate US$12M in 2012 for the construction of a new concentrate leaching facility (CLF) at a remote facility. The company is currently in the engineering and site procurement stage and expects the facility to be operational by the end of Q1/13. Once operational, the CLF will eliminate treatment changes in the range of US$400/t of concentrate and refining charges of US$3.00/oz to US$3.50/oz.

The move to doré production has the potential to substantially lower San Jose costs. Along with the production increases, BMO Research expects co-product cash costs to decline to US$7.64/oz by 2014E (from US$12.06/oz in 2012E). There is also an opportunity for FVI to treat concentrate from other mines in the region, given the current high smelting margins.

Investors appear to have increased the company's risk profile after two deaths occurred in the community of San Jose del Progreso, located a few of kilometres from the San Jose mine. Contrary to claims by community activists, FVI reiterated that there was no connection between the deaths and mine operations.

Earnings Could Surprise to the Upside

BMO Research's 2012 earnings forecast are conservative relative to consensus.

BMO Research now forecasts 2012 EPS of US$0.29 (a decrease of 26% from the previous estimate US$0.39) based on BMO Research metal prices. The earnings revision reflects cost pressures that are impacting not only FVI, but other precious metal producers.

Current BMO Research EPS estimates are at the low end of consensus at US$0.43 and reflect an average silver price assumption of US$30/oz through H1/12. Increasing BMO Research silver price assumptions to the average year-to-date silver price of US$32.68/oz for H1/12 increases BMO Research 2012E EPS by ~7% to US$0.31.

Valuation

BMO Research is lowering the FVI target price to C$6.75 (C$7.50, previously).

Incorporating higher cash cost assumptions, the 10% nominal NPV estimate for FVI using BMO Research metal price assumptions is now US$3.11/sh. Accordingly, the FVI target price has been lowered to C$6.75 (C$7.50 previously), representing 2.1x the 10% nominal NPV.

FVI trades at 1.1x the 10% nominal NPV at spot metal prices, significantly below junior and intermediate silver producer peers at 1.3x.

A revised C$6.75 target represents 2.1x the 10% nominal NPV using BMO Research metal price assumptions.

Fig 1: FVI Valuation Table

BMO Assumptions	Spot	2011A	2012E	2013E	2014E	LT
Silver	31.82	35.23	32.50	40.00	32.00	21.00
Gold	1,663	1,569	1,700	1,700	1,500	1,300
Copper	3.88	4.00	3.80	4.00	3.50	2.75
Zinc	0.92	1.00	0.93	1.20	1.50	1.20
Lead	0.90	1.09	0.98	1.25	1.55	1.30
C$/US$ exchange rate	1.00	1.01	0.96	1.01	1.02	0.96

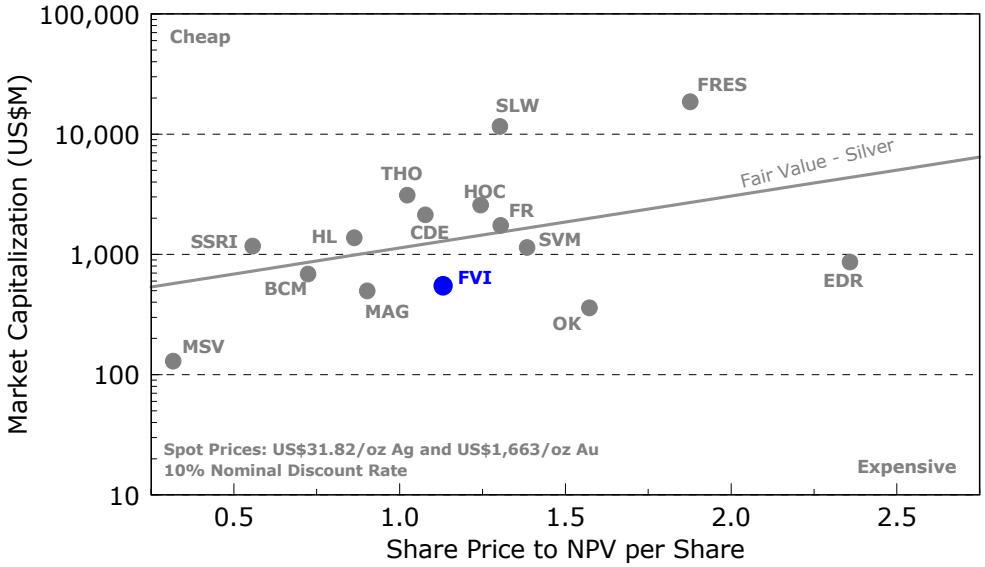
NET PRESENT VALUE		$NPV_{10\%}$, BMO Price		$NPV_{0\%}$, BMO Price		$NPV_{10\%}$, Spot	
	Interest	US$M	($/Share)1	US$M	($/Share)1	US$M	($/Share)1
Caylloma	100%	69.4	0.55	102.5	0.81	55.4	0.44
San Jose	100%	335.0	2.64	584.7	4.61	419.6	3.31
Project NPV		**404.3**	**3.19**	**687.2**	**5.42**	**475.0**	**3.75**
Net Cash[3]		51.3	0.40	51.3	0.40	51.3	0.40
I-T-M Options and Warrants		11.2	0.09	11.2	0.09	11.2	0.09
Corporate Adjustment[2]		(72.9)	(0.57)	(92.0)	(0.73)	(72.9)	(0.57)
NPV of Hedge Book		-	-	-	-	-	-
Total Corporate Adjustments		**(10.4)**	**(0.08)**	**(29.5)**	**(0.23)**	**(10.4)**	**(0.08)**
Corporate NPV	US$	394.0	3.11	657.7	5.19	464.6	3.66
	C$	409.8	3.23	648.6	5.12	483.4	3.81
Multiple to Corporate NPV	2.1x						
12-month Target Price	US$	819.4	6.46				
	C$	**852.5**	**6.75**				

1. Assumes share capital: 126.8 million p.d. shares
2. Includes general and administrative expenses as well as exploration expenses
3. Includes C$33M in net proceeds form an equity financing completed in Q1/10.
All figures in US$ unless noted otherwise

Source: BMO Capital Market

FVI trades at 1.1x the 10% nominal NPV at spot prices, versus peers at 1.3x.

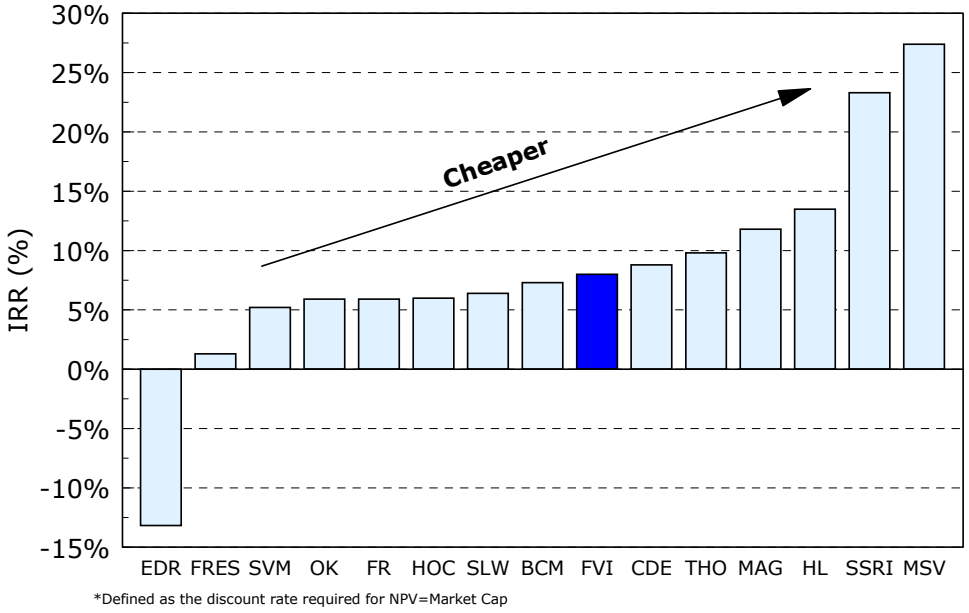
Fig 3: Price to NPV (10%, Spot) vs. Market Capitalization



Source: BMO Capital Market

FVI's mid-range IRR does not reflect its superior management or growth prospects.

Fig 4: Internal Rate of Return (%)



Source: BMO Capital Market

FORTUNA SILVER

As at: 27-Mar-12 **FVI**

Project(s):	Caylloma, San Jose	**Location:**	Peru, Mexico
Recommendation	OP	**Analyst:**	Andrew Kaip
Target Price (C$)	C$ 6.75		
Share Price (US$)	4.38	Share Price (C$)	4.38
Common Shares O/S (M)	125		
Market Cap (US$M)	548	Market Cap (C$M)	547
0% NPV (US$/share)	5.19	Premium/(Discount)	-16%
3% NPV (US$/share)	4.37	Premium/(Discount)	0%
5% NPV (US$/share)	3.94	Premium/(Discount)	11%
10% NPV (US$/share)	3.11	Premium/(Discount)	41%

PRICE ASSUMPTIONS

(December Year End)		2010A	2011A	2012E	2013E	2014E
Exchange Rate	C$/US$	0.97	1.01	0.96	1.01	1.02
Gold	US$/oz	1224	1569	1700	1700	1500
Silver	US$/oz	20.16	35.23	32.50	40.00	32.00
Gold:Silver Ratio		61	45	52	43	47
Copper	US$/lb	3.42	4.00	3.80	4.00	3.50
Lead	US$/lb	0.97	1.09	0.98	1.25	1.55
Zinc	US$/lb	0.98	1.00	0.93	1.20	1.50

FINANCIAL SUMMARY - ANNUAL

(December Year End)		2010A	2011A	2012E	2013E	2014E
EV/EBITDA		12.5	10.2	6.9	3.3	3.3
EPS	(US$)	0.10	0.19	0.29	0.57	0.46
P/E	(x)	45.7	23.2	15.0	7.7	9.5
CFPS	(US$)	0.20	0.44	0.45	0.81	0.68
P/CF		21.7	10.0	9.8	5.4	6.4
FCFPS	(US$)	(0.21)	(0.72)	(0.35)	0.70	0.61
P/FCF		nap	nap	nap	6.3	7.2
Common Shares O/S	**(M)**	122.5	124.9	124.9	124.9	124.9

QUARTERLY

		Q1/12E	Q2/12E	Q3/12E	Q4/12E
EPS	(US$)	0.05	0.06	0.08	0.11
CFPS	(US$)	0.09	0.10	0.12	0.15
FCFPS	(US$)	-0.13	-0.12	-0.08	-0.02

PROFIT AND LOSS STATEMENT - US$M

(December Year End)	2010A	2011A	2012E	2013E	2014E
Mining Revenue	74.1	110.0	182.0	240.0	208.6
Production Costs	22.3	40.0	78.5	77.8	69.2
G&A	14.4	19.8	21.4	21.4	21.4
Exploration and Other Expenses	0.4	1.7	1.6	1.6	1.6
Other Income	-	-	-	-	-
EBITDA	37.0	48.5	78.3	137.4	115.0
Depreciation	6.9	9.1	18.4	28.3	26.6
EBIT	27.4	38.1	59.9	109.1	88.4
Interest expense	(0.4)	0.3	0.1	0.2	0.7
EBT	27.0	38.3	60.0	109.3	89.1
Tax	(14.0)	(18.8)	(26.7)	(40.9)	(34.8)
NPAT (pre-Adjustments)	13.0	19.5	33.3	68.4	54.3
Minority Interest	-	-	-	-	-
After-Tax Non-Operating Items	-	-	-	-	-
Net Income (reported)	13.0	19.5	33.3	68.4	54.3
Net Income (adjusted)	11.7	23.6	36.4	71.5	57.4

Source: BMO Capital Markets

CASH FLOW ANALYSIS - US$M

(December Year End)	2010A	2011A	2012E	2013E	2014E
Net Income	13.0	19.5	33.3	68.4	54.3
Non-Cash Items	8.2	16.0	22.3	32.8	30.8
Cash Flows from Operating Activities	21.1	35.5	55.6	101.2	85.1
Property, Plant and Equip.	(43.6)	(122.8)	(99.7)	(14.0)	(8.8)
Net Investment and Asset Sales	(13.8)	52.9	-	-	-
Other	-	-	-	-	-
Cash Flows from Investing Activities	(57.4)	(69.9)	(99.7)	(14.0)	(8.8)
Proceeds from Borrowings	-	0.0	-	-	-
Repayment of Borrowings	-	(1.2)	-	-	-
Stock, Warrants, Options	74.9	3.7	-	-	-
Other	(1.2)	-	-	-	-
Cash Flows from Financing Activities	73.7	2.5	-	-	-
Net Increase In Cash					
Cash At Beginning of Year	30.8	70.3	38.7	(5.3)	81.8
Cash At End of Year	70.3	38.7	(5.3)	81.8	158.2
Free Cash Flow	(22.5)	(88.5)	(44.1)	87.2	76.4

BALANCE SHEET ANALYSIS - US$M

(December Year End)	2010A	2011A	2012E	2013E	2014E
Cash and Investments	90.8	55.7	11.7	98.8	175.2
Inventories	4.0	11.3	11.3	11.3	11.3
Other	17.0	20.5	19.7	21.6	19.6
Current Assets	111.8	87.5	42.7	131.8	206.1
Fixed Assets	126.8	184.1	265.4	251.2	233.4
Other	4.5	0.0	0.0	0.0	0.0
Total Assets	243.2	271.6	308.1	383.0	439.5
Payables	13.5	17.2	16.0	18.0	15.8
Short Term Debt	1.1	1.7	1.7	1.7	1.7
Other	0.2	4.7	4.7	4.7	4.7
Current Liabilities	14.8	23.6	22.4	24.4	22.2
LT Debt	3.2	2.8	2.8	2.8	2.8
Other	19.3	17.0	17.0	17.0	17.0
Total Liabilities	37.2	43.3	42.1	44.1	42.0
SHAREHOLDERS EQUITY	206.0	228.3	266.1	338.8	397.6
Net Debt to Equity	-42%	-22%	-3%	-28%	-43%

PRODUCTION AND COSTS

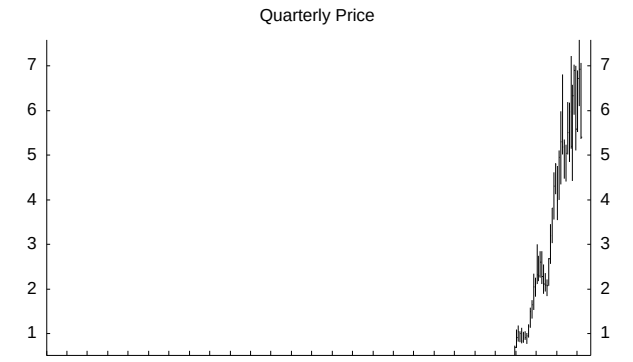
(December Year End)	2010A	2011A	2012E	2013E	2014E
Caylloma					
Silver Production (Moz)	1.9	2.0	1.9	1.2	1.2
Copper Production (kt)	0.5	0.0	-	-	
Lead Production (kt)	9.7	8.9	7.9	6.1	4.1
Zinc Production (kt)	11.9	10.6	9.5	9.7	5.9
Silver Equiv. Production (Moz)	4.5	3.3	3.1	2.3	2.3
Cash Costs (U$/oz)*	10.14	17.04	17.70	21.63	17.53
San Jose					
Silver Production (Mkoz)	-	0.5	1.7	2.7	3.0
Gold Production (koz)	-	4.6	15.1	24.0	25.8
Total Cash Costs (U$/oz)	-	21.23	12.06	9.16	7.6
Total Attributable AgEq Production	4.5	3.8	5.6	6.0	6.5
Total Cash Cost	10.14	16.12	14.14	13.05	10.70

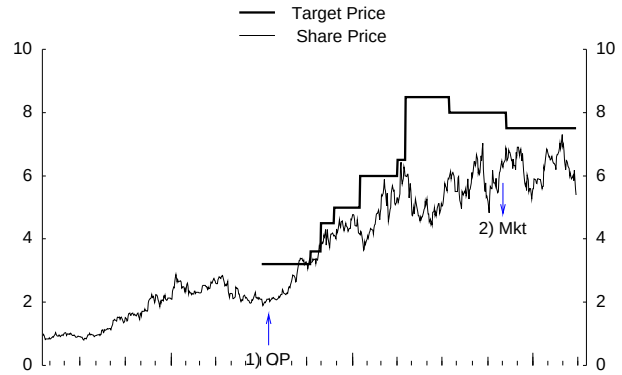
LOM ESTIMATES	**Silver Equiv. Prod'n (Moz)**	**Total Cash Cost* (US$/oz)**
Caylloma	22.0	16.87
San Jose	52.4	7.28
TOTAL	**74.3**	**9.54**

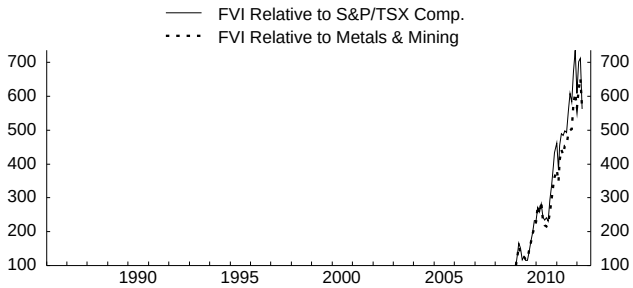
* Silver co-product cash costs

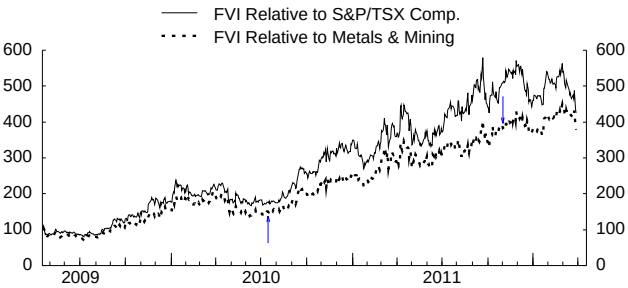
BMO Capital Markets

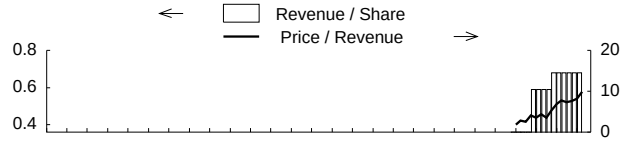
Fortuna Silver Mines (FVI)

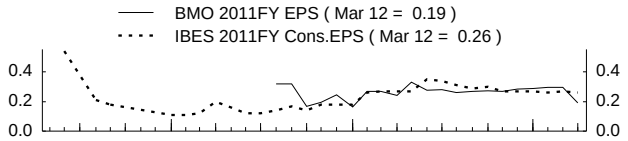


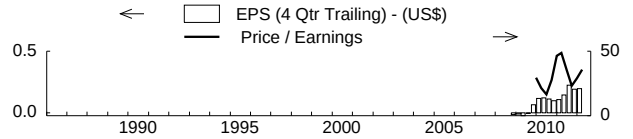


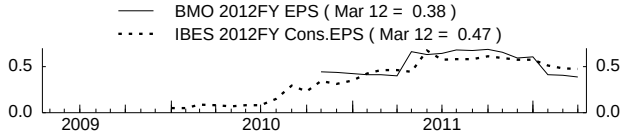












FYE (Dec.)	EPS US$	P/E	DPS $	Yield %	Payout %	BV $	P/B	ROE %
2008	-0.02	nm	0.00	0.0	0	1.27	0.5	nm
2009	0.09	29	0.00	0.0	0	1.25	1.7	7
2010	0.10	46	0.00	0.0	0	1.67	2.9	7
2011	0.19	29	0.00	0.0	0	1.67	3.3	12
Current*	0.20	36	0.00	0.0	0	1.81	3.8	11
Average:		35		0.0	0		2.6	8.6

* Current EPS is the 4 Quarter Trailing to Q4/2011.

FVI - Rating as of 15-Apr-09 = NR

	Date	Rating Change	Share Price
1	15-Jul-10	NR to OP	$2.09
2	1-Nov-11	OP to Mkt	$6.27

Last Daily Data Point: March 27, 2012

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IMPORTANT DISCLOSURES

Analyst's Certification
I, Andrew Kaip, P.Geo., hereby certify that the views expressed in this report accurately reflect my personal views about the subject securities or issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.
Analysts who prepared this report are compensated based upon (among other factors) the overall profitability of BMO Capital Markets and their affiliates, which includes the overall profitability of investment banking services. Compensation for research is based on effectiveness in generating new ideas and in communication of ideas to clients, performance of recommendations, accuracy of earnings estimates, and service to clients.
Company Specific Disclosure
Disclosure 16: A BMO Nesbitt Burns Inc. research analyst has extensively viewed the material operations of this issuer.
Disclosure 17: The issuer has paid or reimbursed some or all of the BMO Nesbitt Burns Inc. analysts travel expenses.

Methodology and Risks to Price Target/Valuation
Methodology: Target prices for senior and intermediate gold producers covered by BMO Research are based on a weighted blend of P/NPV adjusted for market capitalization and EV/EBITDA adjusted for growth.
Risks: Risks to the BMO Research target price include commodity/currency, technical/operating, and litigation/political risks inherent to mining operations; as well as feasibility, permitting and financing risks related to development of growth projects as detailed more completely in the company-specific risk disclosures.

Distribution of Ratings (December 30, 2011)

Rating Category	BMO Rating	BMOCM US Universe*	BMOCM US IB Clients**	BMOCM US IB Clients***	BMOCM Universe****	BMOCM IB Clients*****	Starmine Universe
Buy	Outperform	38.0%	10.3%	40.4%	40.7%	46.2%	56.2%
Hold	Market Perform	60.3%	9.6%	59.6%	56.3%	52.2%	39.4%
Sell	Underperform	1.7%	0.0%	0.0%	3.0%	1.6%	4.4%

* Reflects rating distribution of all companies covered by BMO Capital Markets Corp. equity research analysts.
** Reflects rating distribution of all companies from which BMO Capital Markets Corp. has received compensation for Investment Banking services as percentage within ratings category.
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OP = Outperform - Forecast to outperform the market;
Mkt = Market Perform - Forecast to perform roughly in line with the market;
Und = Underperform - Forecast to underperform the market;
(S) = speculative investment;
NR = No rating at this time;
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Market performance is measured by a benchmark index such as the S&P/TSX Composite Index, S&P 500, Nasdaq Composite, as appropriate for each company. BMO Capital Markets eight Top 15 lists guide investors to our best ideas according to different objectives (Canadian large, small, growth, value, income, quantitative; and US large, US small) have replaced the Top Pick rating.

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