

Recommendation: Buy
Target Price: \$2.90

Sierra Metals Inc. (SMT-TSX) *Cusi Site Tour Highlights Growth Potential*

Current Price	\$2.05	Shares Outstanding (MM)	
52 Wk High	\$2.96	Basic	157.7
52 Wk Low	\$1.80	Diluted	158.0
Cash (MM)	\$33.7	Mngt. & Dir.	85.1
Total Debt (MM)	\$80.6	Market Cap.	\$323.3
NAVPS	\$3.11	Float	\$148.8
Price/NAV	0.7x	EV	\$370.2
Dividend	\$0.06		
Dividend Yield	3.1%		

Fiscal YE Dec. 31		2012A	2013E	2014E
Copper Prod.	(000lb)	15.9	16.2	30.9
Silver Prod.	(MMoz)	2.3	2.6	3.5
Zinc Prod.	(000lb)	59.0	50.0	39.7
Dil. EPS, adj.	Q1	\$0.10	\$0.08 A	\$0.16
	Q2	\$0.10	\$0.05 A	\$0.17
	Q3	\$0.07	\$0.05 A	\$0.17
	Q4	\$0.04	\$0.12	\$0.17
	FY	\$0.32	\$0.31	\$0.67
Dil CFPS, adj.	Q1	\$0.11	\$0.03 A	\$0.12
	Q2	\$0.14	\$0.04 A	\$0.13
	Q3	\$0.10	\$0.03 A	\$0.13
	Q4	\$0.06	\$0.08	\$0.13
	FY	\$0.40	\$0.19	\$0.51
P/C		5.1x	10.9x	4.0x
EV/EBITDA		5.8x	7.3x	3.2x

Unless otherwise denoted, all figures shown in C\$

Investment Thesis:

Sierra Metals is a mid-tier producer operating three silver/copper/zinc/lead mines in Peru and Mexico. In 2011, the company, under its former name Dias Bras Exploration, acquired an 82% interest in its flagship asset, the Yauricocha mine in Peru, for \$280 MM. Sierra Metals has since advanced to production the Bolivar and Cusi mines, both located in Mexico. The company is now focused on completing expansion projects at its Mexican operations by the end of 2013 and cementing its position as a stable, low cost polymetallic producer.

Highlights:

- **Cusi Site Tour**

Last week, we visited Sierra Metals Cusi silver mine and development project in Mexico. The primary purpose of the trip was to highlight the strong resource upside the company sees at site which could add significant growth potential for the future. The site clearly offers the potential for a material increase in resources and likely production expansion in the future.

- **General Update**

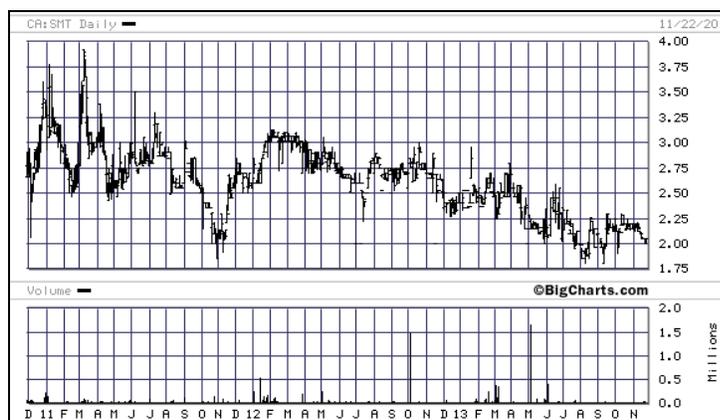
In addition to Cusi, the company provided more general updates on the ramp up of production at Cusi and Bolivar, both of which are moving forward as expected. Cusi is ramping up to 600 tpd by mid-2014 as more ore faces are opened up and the ramp to 2,000 tpd at Bolivar is going well. The company also confirmed that it has decided to expand Bolivar to 3,000 tpd by mid-2015. This has been accretive to our valuation.

- **Upgrading To Buy Rating, Raising Target To \$2.90 From \$2.50**

With the increase in our NAV and more confidence in the exploration potential offered at Cusi, we are currently upgrading our recommendation to Buy from Market Perform and increasing our target to \$2.90 from \$2.50. Higher valuations are possible as resources are defined. Our target is based on a blend of 6.0x our 2014 CFPS and 0.9x our NAVPS estimates, reflecting the medium trading range of the base metal and silver producer peer group.

Company Description:

Sierra Metals is an emerging multi-asset base metals silver producer. The company operates three underground mines in Peru (Yauricocha) and Mexico (Bolivar and Cusi), producing silver, copper, zinc, lead and gold. Sierra Metals is 51% owned by private equity firm Arias Resource Capital.



Source: BigCharts.com, November 22, 2013

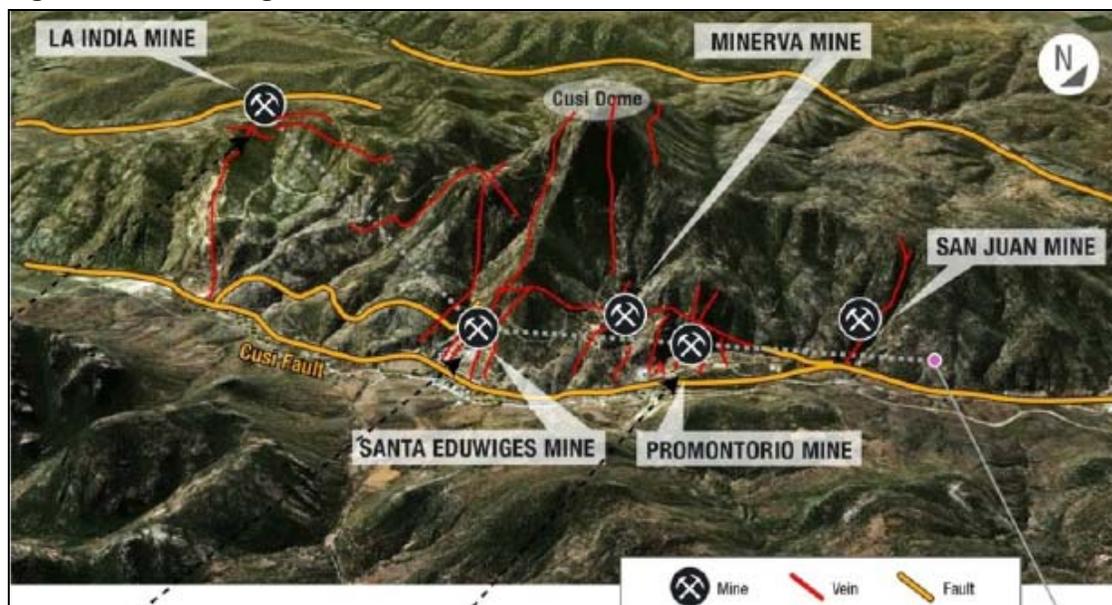
Cusi Site Tour Highlights Upside Potential: Last week, Sierra Metals hosted a site tour of its Cusi silver operations and associated Malpaso mill site. The company views Cusi as not only an operating mine still in the development phase but also the primary source of significant growth potential for the company as more detailed exploration work is carried out. In the company's view, it plans to use the steady state cash flows from the mature Yauricocha mine and the recently expanded Bolivar copper mine to fund exploration at Cusi where it sees the most blue sky potential. Based on the site tour, the potential for significant resource expansion is clearly very high considering the geology of the region but significant work is required to confirm current concepts are valid and economic.

Cusi is located 135 km from Chihuahua, Mexico, and is well supported by good infrastructure (roads, water, grid power), a strong mining history and good local services for the industry. The Cusi site covers 11,670 ha and comprises several past producing access portals or shafts developed to mine the major ore vein structures that are visible on surface. The company views the exploration potential at Cusi as high as the area is yet to be explored aggressively using modern techniques and at depth. Historical production commenced in the late-1600s and has been on and off since then, mainly due to intermittent conflicts that have occurred in the region. The last formal mining in the region appears to have occurred in the 1970s when close to 3,000 tpm of ore was being produced at an average grade of 12-18 oz/t silver.

The mining district is defined by two major faults, the Cusi and Border faults, which are part of a regional NNW fault trend. There is also a number of second order faults trending NE which are filled with silver-rich low sulfidation mineralization. Historical mining focused on near surface high grade outcrops leaving significant room for a more detailed and deeper exploration program to fully define the fault zones and associated veins between exposed areas and at depth as previous miners did not have the necessary pumping capacity to remove water from the mine at deeper levels. This is no longer an issue. In addition, the cut-off grade is much lower than past producers would have used due to improvement in processing technology and the silver price outlook.

Today, the company is focusing its exploration efforts on defining the various vertical and horizontal extents of the various veins structures while at the same time expanding the current modest production profile of the region. Current production comes from two areas, Santa Eduwiges and Promontorio, and the company is in the process of finishing opening up three more areas to increase ore production – Minerva, Candelaria and La Gloria (new ramp). Based upon the geology and other similar mining districts, we believe it is highly likely that the various structures will connect between the current known mineralized areas expanding the resource. That said, to what extent and at what rate is currently difficult to determine. In addition, the depth extension of the resource is expected to be significant. It is estimated that only 20% of the Cusi fault has currently been drilled. The site visit highlighted the potential to extend the known mineralized zones of the various view structures is high with further drilling. Work is focused on extending the ramp to level 9 at Promontorio to increase production and exploration at depth. Significant focus will also be directed to the intersection of the La India and Candelaria veins to explore for a bulk target. Areas where the veins intersect offer the potential for increased tonnage and potential to use bulk mining techniques as opposed to the cut-and-fill approach used primarily in the mine currently.

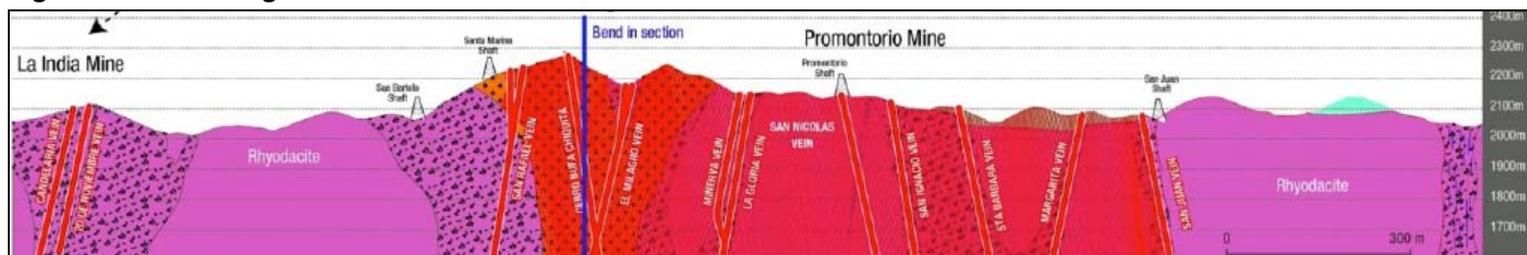
Figure 1: Cusi Mining District



Source: Sierra Metals Inc.

Drilling today is conducted via three surface drills and two underground drills. That said, work is underway to establish an underground drilling platform to more economically follow up on some the robust intersections that have been recorded to date. A new underground drill station should be completed early-2014 and drilling would be undertaken in a 360 degree pattern and also at depth. Surface drilling is difficult due to the terrain and depth needed to get at the correct angle given the near vertical nature of the veins. Drilling to date has encountered numerous areas with grades of over 1,000 g/t silver over minable widths. We noted that despite the age of some of the workings, ground conditions are good with the rehabilitation work that has been conducted by Sierra.

Figure 2: Cusi Mining District Cross-Section



Source: Sierra Metals Inc.

Today Cusi is operating at a relatively modest scale of around 300 tpd of ore extracted from two primary mining areas, Santa Eduwiges and Promontorio, since commercial production was announced in January 2013. Operations continue to be conducted on a small-scale basis, i.e. without a regional mine plan, as more detailed work needs to be done before one can be completed. Based upon current installed capacity and known resources, the company is planning on ramping up production to at least 600 tpd in 2014 and then higher beyond as resources are outlined. It should be noted that the ore produced in 2013 is mainly development ore. Ore from the site is transported 37 km to the Malpaso mill over paved roads. Current capacity at Malpaso is around 400,000 tpd with a further 200-250 tpd available by reactivating a second crushing and floatation circuit on site. Malpaso also has vat leaching capacity from when it treated Bolivar

ores that is being tested on some oxide zones at Cusi but the degree of success is currently uncertain and tests are continuing. This would only add modest production. Minerva is more oxidized and has a high magnesium content and so cannot be processed via floatation; however, vat leaching is being tested to see its potential as the area also has higher gold content.

Today, the Cusi district has a reported indicated resource of 1.38 MMt grading 165 g/t silver and a further 1.65 MMt grading 273 g/t. A new 43-101 is expected to be released in Q1/14 where a significant part of the inferred is expected to be upgraded. Ore is extracted using the Promontorio shaft and via ramp haulage out of Santa Eduwiges and the other zones as they become operational.

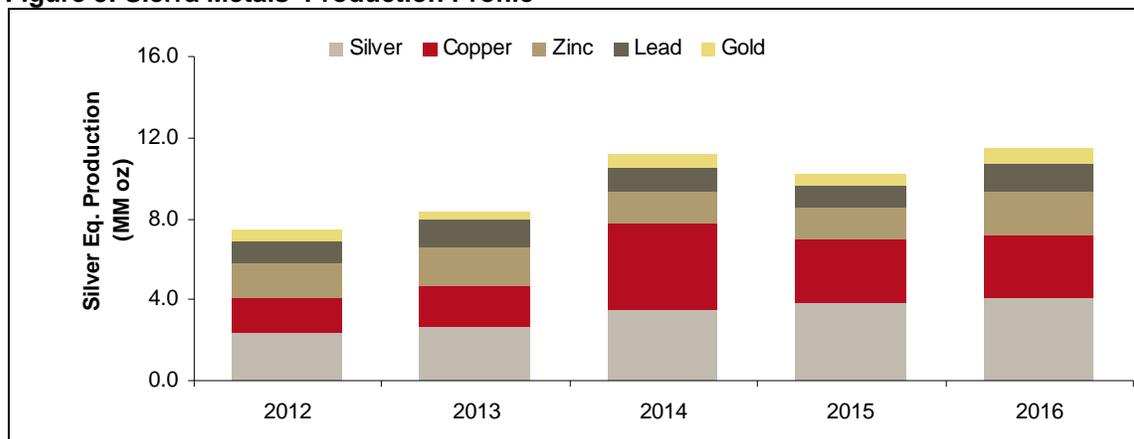
The company is currently forecasting silver production growth from just under 500,000 oz in 2013 to around 900,000 oz in 2014 as throughput rates ramp up and ore grades are sustained, if not improved, as less development rock will be processed. This should result in cash costs declining to around \$10.90/oz from the \$14.96/oz seen in Q3/13 assuming recoveries remain around 75%. We expect the site to ramp up to 600 tpd of ore by mid-2014 with room to grow from activating the second smaller crushing and floatation circuit at Malpaso assuming the mine can deliver the ore. We currently assume rates of close to 1,000 tpd by 2015 with minor modifications. That said, the company believes a more appropriate medium-term target is likely in the 4,000 tpd range which would require a new mill to be built onsite. While significant exploration efforts are needed prior to such an expense being undertaken, the company has secured access to land for a possible mill site in the future, and based on what we saw we believe this is possible but would not expect investors to begin to pay up for this until more definitive exploration work has been completed. That said, this would likely be highly accretive to our valuation assuming grades are sustained.

Other Details: In addition to the tour of the Cusi property, Management provided a general update on the company's other two operations, the Bolivar copper mine in Mexico and the Yauricocha polymetallic mine in Peru. As reported in the Q3 results, operations continue to perform in line with expectation despite the water issues encountered at Yauricocha. The ramp up to 2,000 tpd of ore throughput at Bolivar appears to be going well, and the company indicated rates as high as 2,400 tpd have been seen. At Bolivar, a further expansion to 3,000 tpd has now been confirmed at capital costs of around \$15 MM to be spent in 2014 and 2015. Costs could be lower given recent milling results suggest a smaller mill may be required to reach this level. That said, more time is required to see how sustainable the throughput rates are from the recent expansion. The expanded rate should be available in mid-2015. Costs at Bolivar are expected to decline as soon as the mine is hooked up to the national grid and current contractor diesel gensets can be removed. Copper production is forecast to increase from 9.7 MM lbs in 2013 to 16.5 MM lbs in 2014 with cash costs falling from US\$1.81/lb in Q3/14 to around US\$1.00/lb in 2014 assuming grid power. Further increases in 2015 and beyond are expected with the new expansion. We had been modeling slightly lower 2014 production levels (around 12.5 MM lbs) due to an expected decline in ore grades; however, we appear to have been overly conservative. This has been highly accretive to our valuation given our positive outlook for copper in 2014 for prices to remain elevated.

Yauricocha is at steady-state capacity and we believe the mine life will continue to be extended at depth. Capital costs for the ongoing new underground haulage tunnel and shaft building are now forecast at \$25 MM and \$15 MM in 2014 and 2015, respectively. We expect an updated reserve estimate in early-2014 which we believe will initially increase mine life modestly. While the spending in 2014 and 2015 may seem high based upon current resources, the company expects to expand the resources at depth to extend the mine life. Based on recent drilling, we agree this is highly likely and this new infrastructure is needed to be in place prior to mining the deeper ore zones.

In Figure 3, we outline Sierra Metals' production profile in terms of silver equivalent production. We note that this equates to a copper equivalent production profile of around 80 MM lbs in 2014 and 2015 before growing with the expanded production from Bolivar to around 90 MM lbs. Future growth would come from resource definition and expansion of the Cusi mining district which we have not factored in at this time. We note the decline in 2015 relates to our assumption of lower grades at Bolivar which could be conservative based upon recent results.

Figure 3: Sierra Metals' Production Profile



Sources: Cormark Securities Inc., Sierra Metals Inc.

Valuation: We have updated our valuation for Sierra Metals to take into account the further expansion at Bolivar being confirmed which has enhanced the value of this asset significantly via higher production levels and lower costs and modest adjustments to our assumptions for Cusi. Currently, we have not factored in a major expansion of mill throughput or mine life at Cusi despite the encouraging exploration results and indicators pending more confirmation of resources and more definition of the scale and costs of any future expansion. That said, we believe this is a highly likely scenario but until more details are defined, a formal even speculative valuation is difficult. As such, we see our NAV for Cusi as conservative. With the new debt package, cash flow and cash on hand, the company has the resources to move ahead with its development plans. Our NAV has increased from \$2.50 to \$3.11 as a result of these adjustments. Our 2014 EPS and CF estimates also increased around 10% due to the higher forecast production from Bolivar than we had modeled.

Figure 4: NAV Summary

Mining Assets	Ownership	Discount Rate	Attributable	
			\$MM	\$/share
Yauricocha	82%	10%	\$238	\$1.50
Bolivar	100%	10%	\$166	\$1.05
Cusi	100%	10%	\$135	\$0.85
Total			\$539	\$3.41
Financial Assets				
Cash			\$34	\$0.21
Debt			\$(81)	\$(0.51)
Net Financial Assets			\$(47)	\$(0.30)
Net Asset Value (C\$)			\$492	\$3.11
Net Asset Value (US\$)			\$467	\$2.96

Source: Cormark Securities Inc.

Sierra Metals trades essentially in line with its base metals peers with 4.0x 2014 P/CF and 0.7x P/NAV (peers at around 5.0x 14 CF); however, we now feel a modest premium is justified by its low risk production profile, significant silver credit and exploration potential as outlined on the recent site visit. As production continues to perform as expected, and expansion projects come online, Sierra Metals should trade at a higher end of its peers given its low of development and political risks. More upside will come as the company continues to derisk its longer-term production profile and demonstrate organic growth potential from its highly prospective, near-mine exploration portfolio. We note this remains well below the average multiple of a more pure play silver name and we could see higher valuation for Sierra Metals if the silver price or silver production increases which could result in Sierra Metals being viewed more as a silver play and thus support higher valuations.

Upgrading To Buy From Market Perform, Raising Target To \$2.90 From \$2.50: We continue to see Sierra Metals as on track to achieve steady-state operations in 2014. We view Sierra Metals as a stable, high margin producer with solid operating performance and low cost polymetallic production. While further expansion will require more resources to be defined, we view our NAV as conservative as this expansion is not yet built into our numbers. As exploration results at Cusi demonstrate more resources, we believe a higher valuation will emerge and we see our current valuation as a good base case from which to grow. Further, the strong shareholder base likely provides downside support; however, it does limit liquidity. While resource expansion is not without risk, given the geological setting at Cusi, we see the potential as high but still somewhat speculative at this time. With the increase in our NAV and more confidence in the exploration potential offered at Cusi, we are currently upgrading our recommendation to Buy and increasing our target to \$2.90 from \$2.50. Higher valuation is possible as resources are defined. Our target is based on a blend of 6.0x our 2014 CFPS and 0.9x our NAVPS estimates, reflecting the medium trading range of the base metal and silver producer peer group.

We, Cliff Hale-Sanders and Alec Meikle, hereby certify that the views expressed in this research report accurately reflect our personal views about the subject Company(ies) and its (their) securities. We also certify that we have not been, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

Sierra Metals Inc.

Updated November 22, 2013

Price Chart and Disclosure Statement

*Information updated monthly on or about the 5th of each month.



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<i>Reduce</i>	2%	<i>Reduce</i>	14%
<i>Not Rated</i>	2%		

Recommendation / Target Chg	Date	C\$
	14-Nov-13	2.50 (MP)
	07-Oct-13	2.75 (MP)
	12-Sep-13	2.50 (MP)

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If YES

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Reduce	expected to underperform its peer group

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