

**Recommendation: Buy**  
**Target Price: C\$2.50**

## Sierra Metals Inc. (SMT-TSX) *Esperanza's Proof Of Concept*

Current Price	C\$2.06	Shares Outstanding (MM)	
52 Wk High	C\$2.19	Basic	161.9
52 Wk Low	C\$0.95	Diluted	162.7
Cash (MM)	\$25	Mngt. & Dir.	87.4
Total Debt (MM)	\$85	Market Cap.	C\$333
NAVPS	C\$2.46	Float	C\$153
Price/NAV	0.84x	EV	\$319
Dividend	-		
Dividend Yield	-		

Fiscal YE Dec. 31		2015A	2016E	2017E
Copper Prod.	(MMlb)	23.2	23.9	30.5
Silver Prod.	(MMoz)	3.1	2.8	3.0
Zinc Prod.	(MMlb)	42.1	46.4	44.1
Dil. EPS, adj.	Q1	\$0.03	\$(0.01) A	\$0.05
	Q2	\$0.05	\$0.02 A	\$0.06
	Q3	\$(0.00)	\$0.04	\$0.06
	Q4	\$(0.02)	\$0.04	\$0.06
	FY	<b>\$0.06</b>	<b>\$0.09</b>	<b>\$0.23</b>
Dil CFPS	Q1	\$0.07	\$0.02 A	\$0.05
	Q2	\$0.09	\$0.03 A	\$0.05
	Q3	\$(0.01)	\$0.05	\$0.07
	Q4	\$(0.02)	\$0.05	\$0.08
	FY	<b>\$0.13</b>	<b>\$0.15</b>	<b>\$0.25</b>
P/CF (adj.)		12.1x	10.4x	6.5x
EV/EBITDA (adj.)		12.4x	10.7x	5.5x

### Company Description:

Sierra Metals is an emerging multi-asset base metals and 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.

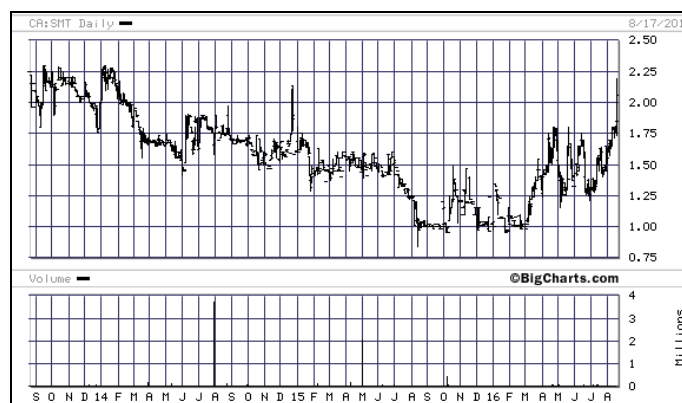
Unless otherwise denoted, all figures shown in US\$

### Investment Thesis:

Sierra Metals stands out for its: (1) historically high margin polymetallic production, (2) low overall debt leverage, and (3) high organic growth potential. After the changes in Management in 2015, we suggest investors revisit the name and are comfortable Yauricocha and the company have now turned the corner operationally.

### Highlights:

- Esperanza – The Value Proposition From Brownfield Exploration**  
 Yesterday, SMT provided an update and hosted a conference call to discuss development plans at all three of its producing mines. For us, the highlights from the call were: (1) Esperanza's maiden resource/reserve is likely to grow and is increasingly important to Yauricocha's mine plan, (2) each mine still offers high brownfield exploration potential (as demonstrated by the Esperanza discovery), and (3) Management has a much better handle on operations after a challenging transitional period late last year.
- Expect Performance To Continue To Improve Into 2017**  
 For Q2, we saw a continuation of the improvement seen in Q1 as Yauricocha's throughput remained at design and EBITDA recovered. However, these improvements were outdone by the updates at the Esperanza zone which is already beginning to feed the Yauricocha mill. With the higher grade (4% CuEq) ore from Esperanza and better metals prices (ex-copper), we now expect to see a much stronger back half to 2016.
- Upgrade To Buy Rating, Increase Target To C\$2.50 From C\$1.95**  
 To Management's credit, the company has done a good job at both improving operations and outlining a clear exploration strategy to add value at each mine. With the shares still trading at a discount (5.5x EV/EBITDA) and much higher confidence in operations and the balance sheet, we are upgrading Sierra Metals to a Buy from Buy (S).



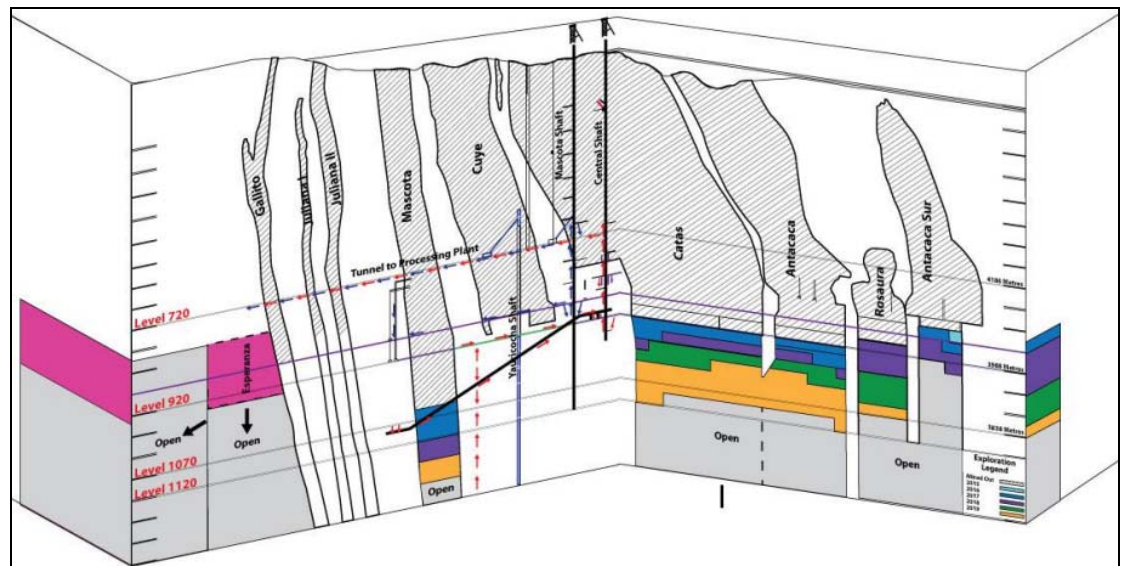
Source: BigCharts.com, August 17, 2016 (Chart C\$)

**Development Update And Conference Call With Management:** Yesterday, Sierra Metals provided an update on its development plans and number of brownfield options being evaluated at all three of its mines. The update comes on the back of the recent Esperanza discovery at Yauricocha and maiden resource/reserve and Q2 results reported earlier this week.

Highlights from yesterday's call and Q2/16 results include:

- ***Yauricocha is turning around after a challenging finish to 2016.*** With number of Management and operational changes in 2015, the normally steady-state mine saw a drop in throughput over 10% below design. Throughput has since recovered as has the overall grade. In Q2/16, throughput was maintained at 2,463 tpd just below design of 2,500 tpd. We are comfortable Management now has addressed the safety and water issues in the Central Mine zone.
- ***Esperanza zone's increasing importance to Yauricocha.*** Earlier this month, Sierra Metals released its maiden resource/reserve at the Esperanza zone and started the processing of the ore which was 100 m from existing infrastructure. The company now expects Esperanza's higher grade (~4% CuEq) and easier to mine ore to make up 10-20% of Yauricocha's mill feed in H2/16. We expect this to rise to around 50% and look for more details from a mine plan expected around year-end.

**Figure 1: Yauricocha – How The Esperanza Discovery Fits In**



Source: Sierra Metals

- ***Esperanza zone's resource hits high end of our estimates.*** The total resource came in at 4.1 MMt (including 2.5 MMt of M&I and reserves of 1.5 MMt) compared to our estimate of 3-4 MMt based on drill results released earlier this year. The grade of 4.2% CuEq (including 3.3% CuEq in P&P) was slightly ahead of the weighted average grade of the drill results released to date (averaged 4.1% CuEq.).

**Figure 2: Esperanza Zone Reserves And Resources**

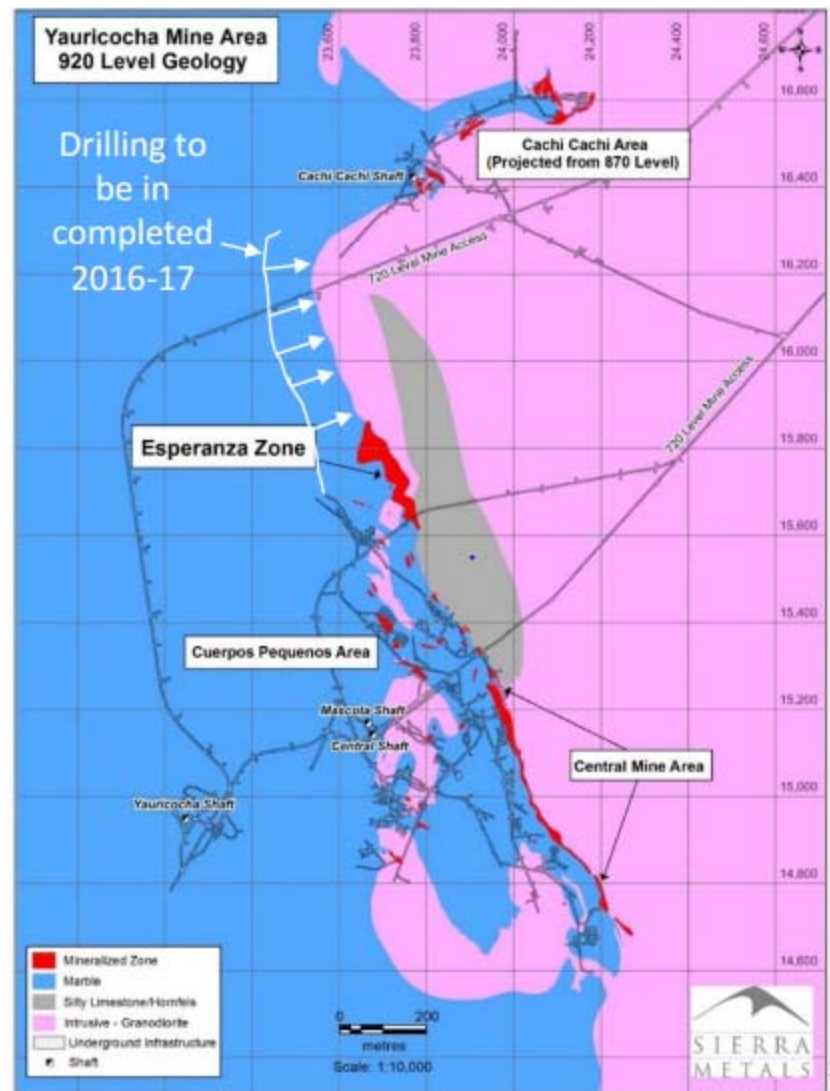
11-Aug-16	Tonnes (000s)	Grade					CuEq. (%)
		Cu (%)	Zn (%)	Pb (%)	Au (g/t)	Ag (g/t)	
P&P	1,520	1.2%	3.1%	1.1%	0.43	51.8	3.3%
M&I	2,534	1.7%	3.2%	1.3%	0.55	68.9	4.2%
Inferred	1,542	1.9%	2.5%	0.9%	0.63	68.9	4.1%

Note: CuEq using \$1.00/lb Zn, \$0.95/lb Pb, \$3.00 Cu, \$1,300/oz Au and \$20/oz Ag.

Source: Sierra Metals, Cormark Securities

- **More drill results coming.** We look for drilling to continue at Esperanza toward Cachi Cachi. Aside from expanding the high grade Esperanza zone, Sierra believes there exists a copper-molybdenum porphyry.

**Figure 3: Esperanza Zone – Connecting The Dots With Cachi Cachi**



Source: Cormark Securities, Sierra Metals

- **At Bolivar focus is more on grade.** While throughput has been expanded twice at Bolivar (now at 3,000 tpd), the focus is on improved copper grades which have declined as ore has transitioned from El Gallo superior to the inferior zone.
- **Increased confidence in balance sheet.** Management reiterated its confidence in its available capital and access to credit. While the company had breached a financial covenants, a waiver was provided and remains comforted given the lower overall leverage ratio (<2.0x net debt to 2016 EBITDA).

**Updated Valuation:** We have updated our model to incorporate the Esperanza zone at Yauricocha, Q2/16 results and our recently revised silver price deck (\$20.00/oz from \$17.00/oz previously).

- **2017 EBITDA:** Increased from \$43 MM to \$56 MM.
- **NAV:** Increased from C\$1.97 to C\$2.46.

**Figure 4: Sierra Metals – NAV Summary**

<b>Mining Assets</b>	<b>Ownership</b>	<b>Discount Rate</b>	<b>\$MM</b>	<b>\$/share</b>
Yauricocha	82%	10%	\$255	\$1.57
Bolivar	100%	10%	\$115	\$0.71
Cusi	100%	10%	\$64	\$0.40
<b>Total Mining Assets</b>			<b>\$434</b>	<b>\$2.68</b>
<b>Financial Assets</b>				
Cash			\$25	\$0.16
Working Capital (ex. Cash, Debt)			\$16	\$0.10
Debt			\$(85)	\$(0.52)
Corporate G&A			\$(91)	\$(0.56)
<b>Net Financial Assets</b>			<b>\$(135)</b>	<b>\$(0.83)</b>
Net Asset Value (US\$)			\$300	\$1.85
<b>Net Asset Value (C\$)</b>			<b>\$399</b>	<b>\$2.46</b>

Source: Cormark Securities

**Upgrading To Buy From Buy (S) Rating, Raising Target To C\$2.50 From C\$1.95:** To Management's credit, the company has done a good job at both turning operating performance around this year and outlining a clear exploration strategy to add value at each mine. With the shares still trading at a discount (5.5x EV/EBITDA) and much higher confidence in operations and balance sheet, we are upgrading Sierra Metals to a Buy from Buy (S). We are also raising our target from C\$1.95 to C\$2.50 which continues to be based on a blend of 7.0x 2017 EBITDA and 0.9x NAV.

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

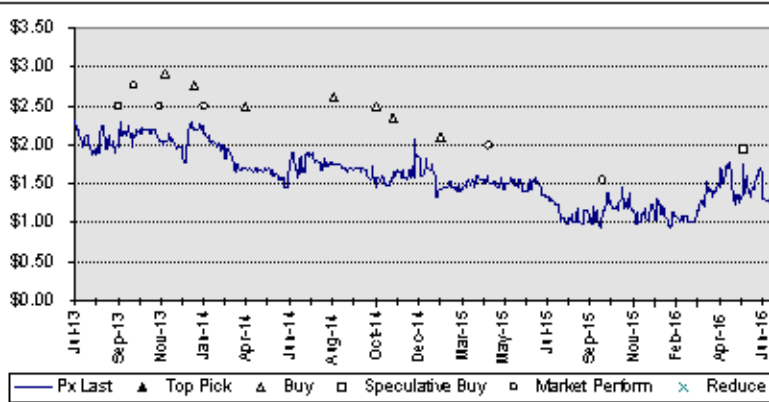


**Sierra Metals Inc.**

Updated August 17, 2016

**Price Chart and Disclosure Statement**

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



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Market Perform	18%
Reduce	1%
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Market Perform	17%
Reduce	0%

**Recommendation / Target Chg**  
Date C\$

17-May-16	1.95 (B-S)
09-Oct-15	1.55 (MP)
09-Oct-15	1.55 (Chng Cover)
11-Aug-15	2.00 (UR.)
14-Apr-15	2.00 (MP)
29-Jan-15	2.10 (B)
14-Nov-14	2.35 (B)
21-Oct-14	2.50 (B)
14-Aug-14	2.60 (B)
28-Mar-14	2.50 (B)
24-Jan-14	2.50 (MP)
09-Jan-14	2.75 (B)
25-Nov-13	2.90 (B)
14-Nov-13	2.50 (MP)
07-Oct-13	2.75 (MP)
12-Sep-13	2.50 (MP)

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2) What type of security is it?

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