

## Sesa Goa

Date  
11/04/2011

Sensex  
19262.54

Nifty  
5785.70

Sector  
Mining

CMP  
Rs.319

Face Value  
Rs.1/share

Equity Capital  
Rs.83.1 cr.

52 Week H/L in Rs.  
494/220.3

Market cap Rs. Cr.  
27746.02

### Share Holding

	Shares	% holding
Foreign	479113619	55.73
Institutions	247938768	28.84
Corp.	29197409	3.4
NRI's	2259315	0.26
Others	1761179	0.2
Public	99432269	11.57
Totals	859702559	100

### Summary

Sesa Goa is the largest producer and exporter of iron ore in the private sector with 95% of profit coming from iron ore sales. Their exports are mainly concentrated to China. The Company has been adversely affected by the Union Budget 2011-12 proposal to raise the export duty on iron ore to ad valorem 20% on lumps and fines. However, it got a relief when Supreme Court lifted the ban on mining of iron ore in Karnataka. But still we expect the EPS to decline 32% in FY12E. Valuations at current levels look expensive as the stock is trading at a P/E of 6.9x and 10.1x on FY11E and FY12E EPS, respectively. In addition, the unrelated diversification by incurring a substantial investment in Cairn Energy presents a significant risk to investors. We recommend a **Sell**.

### Company Description

Apart from iron ore Sesa Goa also produces and exports pig iron and metallurgical coke. It has rich iron ore reserves of 275 million tonnes in Goa and Karnataka. Goa's iron ore is medium grade and easy to extract without blasting and crushing. The iron ore from Karnataka is of high grade but is found in rocky forms which necessitate blasting and crushing.

In 2005, Vedanta Resource, a diversified metal and mining Group listed in London Stock Exchange acquired 51% stake in Sesa Goa from Mitsui and Co. Ltd. In 2009, Sesa Goa acquired 100% stake in Dempo Mining Corporation Pvt. Ltd. which has an iron ore reserve of 70 million tonnes.

### Products

#### Iron ore

Sesa Goa is India's largest producer and exporter of Iron Ore in the private sector, with mining and processing facilities located in Goa, Karnataka and Orissa. Currently it produces 21mt of iron ore. As of FY 2009-10, Iron ore has contributed 88% of total external revenues and 95% of segment profits.

#### Metallurgical Coke

The coke business has contributed 3% of external sales in FY 2009-10. 65% of total production of metallurgical coke is consumed by the Company for its pig iron production and the remainder is sold to customers primarily located in India. The metallurgical coke has an annual production capacity of 280,000 tonnes per annum.

## Pig iron

The Company produces Low-phosphorous foundry grade pig iron with an annual production capacity of 250,000 tonnes per annum. It has contributed 9% to total external sales while its share in segment profit was 4% in FY 2009-10.

## Sector analysis

### The Chinese dominance in Global steel

A large economy with world-class infrastructure and the advantage of cheap labour is driving economic growth, further fuelling mega investments in China. The rapid growth in capital investment in China catalyzed an unprecedented addition to steel capacities in the country. As a result, China dominates the global steel industry, accounting for more than a third of the global steel capacity.

### China's steel equation (CY 2009)

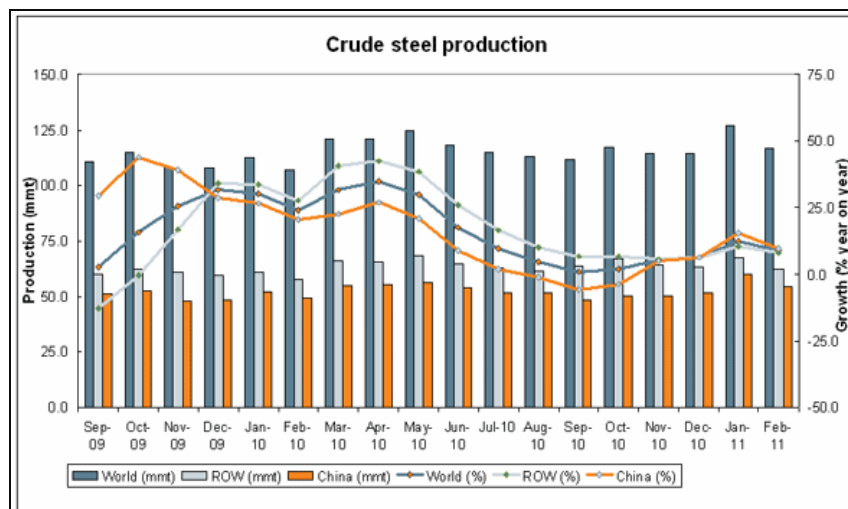
	Capacity	Production	Consumption	Export
Globe(MnT)	1802	1223	1121	319
China(MnT)	716.1	567.8	542.4	24.6
% share	40%	46.40%	48.30%	7.70%

China's net addition to its installed capacity was 39 MTPA taking its cumulative installed capacity to an estimated 716 MTPA, when more than 30% of world steel capacity remained non operational across the globe in CY 2009. Chinese steel manufacturers produced 568 million tonnes of steel in 2009, an increase of 14% from the 500 million tonnes in 2008. Domestic steel consumption grew at 25% from 435 million tonnes in 2008 to 542 million tonnes in 2009 due to sustained demand from the infrastructure, automotive and housing sectors. The increased domestic consumption led to a huge decline in export from 45 mt to 24.6 mt in 2009. China accounted for more than 48% of the global steel demand in CY 2009.

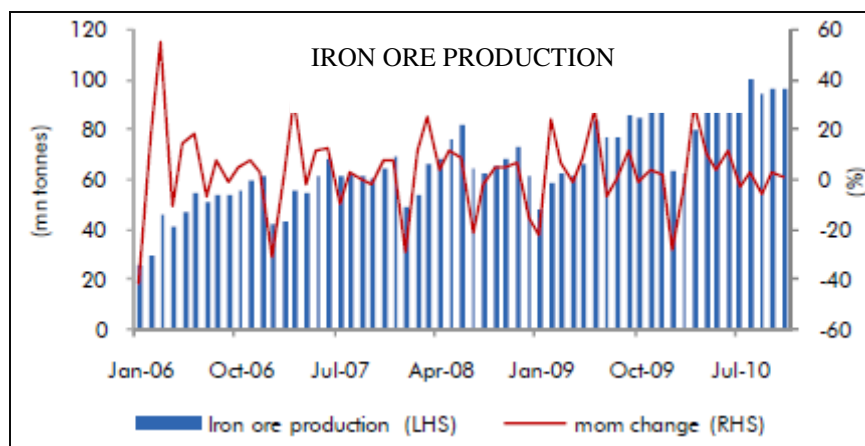
With its increased consumption of steel, its iron ore dependency has also increased. As cost of producing iron ore is high for marginal producers in China, they are dependent on iron ore imports. With 628 million tonnes, China imported 41% more iron ore in 2009 compared to 2008. Therefore, the spot prices of iron ore in China is mainly scrutinized, due to their dominance in Global market.

**Current scenario**

China’s crude steel production for February 2011 was 54.3 mt, up 9.7% compared to February 2010.



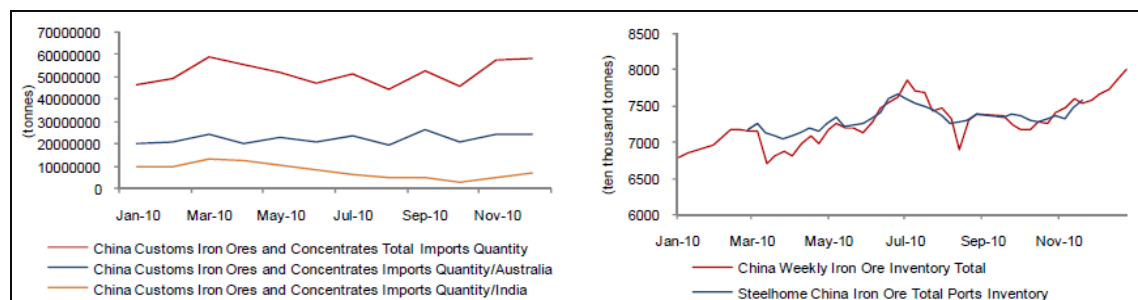
The Australian Bureau of Agricultural and Resource Economics and Sciences expect Chinese crude steel production to increase by 7.5% YOY to 674mn tonnes in CY2011. However ,growth in production of iron ore has remained flat during the past quarter.



Although demand for imported iron ore surged on a QOQ basis, iron ore inventories also recorded a 4 and half year high at 80 mn tonnes which helped in bringing down prices of iron ore for short term. For the first time in five years, contract prices of iron ore, the key raw material for making steel has softened, as Japanese Steel mills that account for about 13% of global iron ore consumption, have cut down their requirements following production cutbacks due to turmoil created by tsunami. As a result, the spot price of iron ore is expected to trade around \$155/tonne in the March-

June quarter. Currently, iron ore is trading at \$ 165/tonne, its lowest since late November.

### Chinese Iron ore Inventory Levels



Though Chinese iron ore production is growing, the average grade is falling every year. Supply from India is expected to come down in 2011 due to rise in export duty of Iron ore to 20% from current rate of 5% thus buttressing the tightening of Global supply. Further, given the prospect of a massive rehabilitation in Japan could increase demand for steel and hence iron ore. Therefore, taking into consideration the above factors we expect the iron ore prices to rebound in the later quarters and remain firm from thereon.

### Company Analysis

#### Quarterly Performance

Rs. in Cr.	Q3FY10	Q4FY10	Q1FY11	Q2FY11	Q3FY11
Sales	1877.9	2403.54	2394.04	924.32	2237.33
total expenditure	853.13	915.89	953.45	614.97	1019.51
EBITDA	1036.02	1503.01	1459.63	303.37	1230.55
EBITDA margin (%)	55.17%	62.53%	60.97%	32.82%	55.00%
Depreciation	22.45	16.64	19.14	19.42	20.76
Interest	25.06	22.65	13.74	14.01	13.39
other income	132.48	129.06	160.94	136.86	129.14
EBT	1120.99	1592.78	1587.69	406.8	1325.54
Tax	290.6	377.67	283.19	18.9	257.25
PAT	830.39	1215.11	1304.5	387.9	1068.29
PAT margin (%)	44.22%	50.56%	54.49%	41.97%	47.75%

- Sesa's production during Q3FY2011 was lower due to extended monsoons and restricted road timings for movement of trucks inside Goa. Further, the state wide ban on export of iron ore from Karnataka also affected the Iron ore volumes of the Company which fell by 20.8% YOY to 5.4 mt.

- But net sales increased by 20% YOY to Rs.2237 cr. due to higher sales realization which increased by \$32/tonne to \$87.6/tonne.
- Company's Iron ore operational margin increased by 300 bps on YOY basis due to crash in sea freights and higher sales realization.
- Profit after tax increased 29% YOY to Rs.1068.29 cr. on account of lower interest and tax expense compared to previous year.
- Sales from Goa declined 18% YOY to 4.2mt (including Dempo) due to extended monsoons and restricted road transport timings. Ban in Karnataka since July 2010 also impacted volume growth.
- Realization for iron ore was US\$87/ton due to higher iron ore prices. Domestic sales increased to 15% of volumes due to an export ban from Karnataka. The realization in the domestic market for Karnataka iron ore is US\$30-35/tonne lower than in export markets.

### **Union Budget 2011-12 Impact**

The Union Budget 2011-12 has proposed raising the export duty on iron ore to ad valorem 20% on lumps and fines. Currently, lumps are taxed at 15%, while fines are taxed at 5% on ad valorem basis. Sesa Goa generates ~90% of its net sales from iron ore exports. Hence, the Budget proposal would result in an increase in the Company's export duty expenses. With the hike in export duty the EBITDA margin will be affected by 23%.

### **Supreme Court lifts ban on Karnataka iron ore**

Supreme Court lifted the ban on iron ore exports from Karnataka earlier banned by the State Government to tackle illegal mining in the state. The ban affected over 100 mines, including that of Sesa Goa. Sesa Goa has a capacity of 6 million tonne per year in Karnataka. The Company had produced 3.5 million tonne of ore in Karnataka in 2009-10.

### **Annulment of Orissa contract**

The third party contract in Orissa had been annulled during third quarter of FY11. Sesa has been producing 2 million tonnes from Orissa through this contract which would not be taken into effect from FY12.

### **Outlook**

- We expect the volumes to grow at 11% and reach 21.7 million tonnes as the Company may fully utilize its Karnataka capacity to normalize its operations in its mine in the State as well as to offset the annulment of Orissa contract.
- We have assumed the spot price of iron ore in China to trade between \$160-180/tonne. We expect the iron ore price to hover around \$160/tonne in Quarter 1 & 2 due to the lag effect of Tsunami in Japan. Quarter 3 & 4 may see a rise in iron ore

to \$180/tonne, driven by the rehabilitation work in Japan and improved demand from China.

- With the Karnataka ban lifted, we expect the the average realization for the year to improve by 12%.
- We expect sales realization to be at \$88/tonne for Q1 and Q2 and to rise to \$99/tonne for the last two quarter with the rise in spot price.
- We expect hike in export duty to 20%, implemented from Q1 of FY12. With the implementation, the expense per tonne will increase to \$12/tonne in Q1 and Q2 and \$15/tonne in Q3 and Q4.

The expected Realization, Expenses and EBITDA for the 4 quarters in FY12 is represented below:

	Spotprice (\$/tonne)	Realization (\$/tonne)	Expenses (\$/tonne)	EBITDA (\$/tonne)
Q1	160	88	55.2	32.8
Q2	160	88	81.5	6.5
Q3	180	99	66.7	32.3
Q4	180	99	66.7	32.3

Under these assumptions, our expected EPS comes out to be 31.5 in FY12, which is a decline of 32% YoY.

### **Risk factors**

- Vedanta, a major stakeholder of Sesa Goa, has staked a claim to buy 40-50% of Cairn Energy's stake in Cairn India from Cairn Energy PLC for up to \$8.48 billion. A separate public offer will be made by Sesa Goa to acquire another 20% in Cairn India for up to \$3 billion. The use of cash in an unrelated business by the Company instead of increasing its own reserves is expected to have a negative impact on Sesa's future growth potential while raising serious corporate governance issues.
- Iron ore inventories in China are at their 4 and half years high at 80 million tones. And inflation which is expected to cross 4% for the next fiscal can be a major impediment to the economic growth rate. The slow growth coupled with high inventory levels could result in spot iron ore prices to come down to unexpected levels.
- Delay in Japan's rehabilitation programme could delay recovery in steel production in that country, which is likely to put additional pressure on iron prices.

### Sensitivity Analysis

In order to quantify the impact of realization change on the profitability of the Company, we have performed a sensitivity analysis. The analysis shows the effect on EPS if the average sales realization per tonne reduces by \$5. The result shows that the EPS reduces by close to Rs.3 for every \$5 reduction in realization. This we believe is detrimental to the Company as we expect realizations to be volatile in FY12 and the recovery of realization largely depends on how soon Japan can recover, which we are unable to estimate as of today.

Average Realization(\$/tonne)	EPS(Rs)
95	31.4
90	28.3
85	25.1
80	22.0

### Valuations

Rs in Crore	FY10	FY11 E	FY12 E
Sales	5803.05	7937.87	8980.69
EBITDA	3144.84	4324.57	2818.77
EBITDA margin(%)	54.19%	54.48%	31.39%
PAT	2639.04	3835.87	2617.07
PAT(%)	45.48%	48.32%	29.14%
no.of outstanding shares	83.09	83.09	83.09
EPS	31.76	46.16	31.49
Price	313	313	313
P/E(X)	10.04	6.9	10.1
EV/EBITDA(X)	8.7	6.9	9.8

### Recommendation

We expect the sales volume to rise by 11%. But with increasing expenditures and the above mentioned risk factors associated with the Company, the downside seems to be more dominant. A sensitivity analysis done by us shows that with every \$5/tonne loss in the realization the EPS falls by 10%. Also, on historical basis the valuation seems to be a bit expensive as the stock is trading at a P/E of 6.9x and 10.1x on FY11E and FY12E EPS. We recommend a **SELL**.

## Financial Projections

Rs in Crore	FY10	FY11 E	FY12E	BALANCE SHEET	FY10	FY11 E	FY12 E
Net sales	5803.05	7937.87	8980.69	Paid Up Capital	83.1	83.1	85
Growth(%)		30.86%	10.17%	Reseves & Surplus	7877.9	12165.43	14497.22
Total Expenditure	2713.45	3613.30	6222.64	Total shareholders equity	7961	12248.53	14582.22
EBITDA	3144.84	4324.57	2818.78	Loan funds	1960.56	1960.56	3331.01
Growth(%)		31.23%	-36.88%	Deferred tax liability	75.02	84.77	95.79
Depreciation	74.5	74.90	52.90	Total	9996.58	14293.86	18009.03
Interest	51.72	63.73	42.56	Net fixed assets	2176.96	2448.48	2753.58
Tax	805.55	897.01	616.25	Capital work in progress	78.74	86.61	95.28
PAT	2639.04	3835.87	2617.07	Investments	4564.85	11249.41	15084.59
Growth(%)		39.75%	-33.71%	Net current assets	3176.03	509.35	75.58
				Total	9996.58	14293.86	18009.03
Key Ratios	FY10	FY11 E	FY12E	working capital ratio	FY10	FY11 E	FY12 E
EBITDA margin(%)	54.19%	54.48%	31.39%	Debtor days	21	17	17
PAT Margin(%)	45.48%	48.32%	29.14%	Creditors days	52	16	16
ROE(%)	33.15%	31.32%	17.95%	Inventory days	31	24	21
ROCE(%)	39.93%	33.11%	17.95%	Working Capital cycle	0.65	25	22
EPS	31.76	46.17	31.50	Depreciation/NFA	0.26	0.27	0.28
P/Ex	10.04	6.9	10.1	Sales/NFA	2.67	3.24	3.26
EV/EBITDA	8.7	6.9	9.8				

## Our Team

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