

Sesa Goa

HOLD
Downgrade from Buy
Rs161

Positives priced in

Reason for report: Recommendation change

Though we are confident on Sesa Goa's ability to push incremental 1-2mnte sales annually in Chinese spot markets on: i) increasing market share at the cost of domestic private miners, ii) leveraging well established dealer and end-user contacts in Chinese markets and iii) given the increased Chinese dependence on imported ore after ~50% closure of domestic capacities, earnings surprise will be hard to come by as: i) margins get diluted since incremental ore is mined from high-cost Karnataka mines and ii) prices remain range-bound in the absence of demand recovery (with Chinese steel makers asking for a 45-50% contract price cut). The stock has run up ~100% in the past three months and trades at historically high FY10E P/E of 7.5x. We downgrade Sesa Goa to HOLD from Buy with revised target price of Rs152/share.

- **While volumes are secured...** We do not expect significant downside risk to our FY10E and FY11E volume estimates of 17mnte and 18mnte respectively based on Sesa's increased market share at the cost of small-scale domestic miners (which form 55-60% of India's export share). Also, at the current iron ore price, 50% of Chinese iron ore capacities are loss making (operational costs at US\$67-70/te). While increased spot exposure due to dealer inventory build-up might be temporary, the management's focus to increase contract sales (at ~20% with 3-4mtpa in long-term contracts) via aggressive marketing push will at least help maintain Sesa's current market share in Chinese exports.
- **...we expect no positive earnings surprise.** We do not expect significant earnings surprise on: i) volumes as incremental volumes will flow in from low-margin Karnataka mines (suffering from high transportation costs), lowering the earnings sensitivity to volumes and ii) prices as we expect spot market prices to remain mostly range-bound within ~US\$60-66/te with little short-term upside, which translates into a blended realisation of US\$44/te for Sesa. However, rupee appreciation (~7% post elections) is a key downside risk.
- **Downgrade to HOLD.** The stock has run up ~100% in the past three months and is currently trading at historically high valuations – at FY10E P/E (cash adjusted) and EV/E of 7.5x and 4.7x respectively. Also, rupee appreciation is a key risk to revenues. While we are not lowering our volume estimates, we do not believe there is significant upside risk to our earnings. We maintain our benchmark valuations of 50% discount to global peers and value Sesa at FY10E EV/E of 4.2x. We downgrade Sesa to HOLD with target price of Rs152/share from Rs141/share.

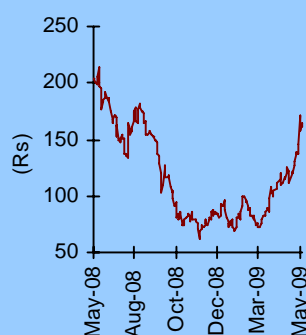
Metals

Shareholding pattern

	Sep '08	Dec '08	Mar '09
Promoters	51.2	51.2	51.2
Institutional investors	24.2	24.2	24.9
MFs and UTI	2.2	1.4	1.6
Insurance Cos.	3.5	3.5	3.5
FII's	18.4	19.2	19.2
Others	24.6	24.6	23.9

Source: BSE India

Price chart



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Market Cap	Rs126.7bn/US\$2.7bn
Reuters/Bloomberg	SESA.BO/SESA IN
Shares Outstanding (mn)	787
52-week Range (Rs)	217/63
Free Float (%)	48.8
FII (%)	19.2
Daily Volume (US\$'000)	16,800
Absolute Return 3m (%)	96.8
Absolute Return 12m (%)	(21.3)
Sensex Return 3m (%)	55.7
Sensex Return 12m (%)	(18.8)

Year to March	FY08	FY09P	FY10E	FY11E
Revenue (Rs mn)	37,923	49,591	39,945	40,964
Net Income (Rs mn)	15,112	19,875	13,947	14,772
EPS (Rs)	19.0	25.0	17.5	18.5
% Chg YoY	133.9	31.5	(29.8)	5.9
P/E* (x)	7.5	4.9	7.5	6.3
CEPS (Rs)	19.6	25.6	18.5	19.6
EV/E (x)	4.8	3.4	4.7	3.9
Dividend Yield	1.4	1.4	1.4	1.5
RoCE (%)	97.1	69.9	36.5	31.4
RoE (%)	79.5	69.3	37.2	28.7

* Cash adjusted

Chinese steel production leading to demand floor for Sesa's iron ore

Chinese crude steel and pig iron production rebounded in Q1CY09 with indications of a reviving Chinese economy. While global steel production declined ~23% in April '09, China continues to record incremental volumes with 7% YoY growth in crude steel in April '09.

Chart 1: Chinese crude steel production

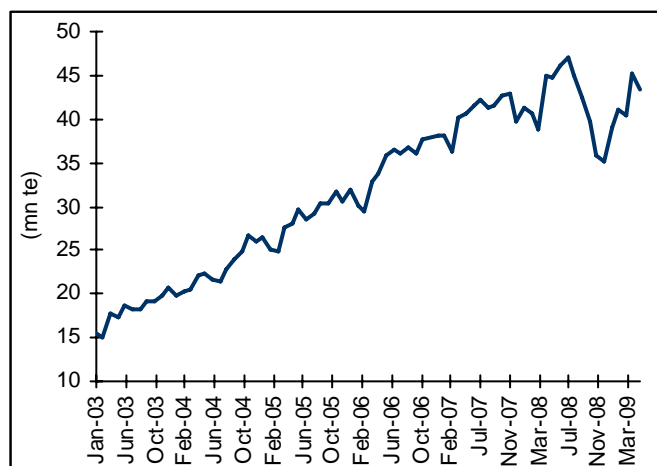
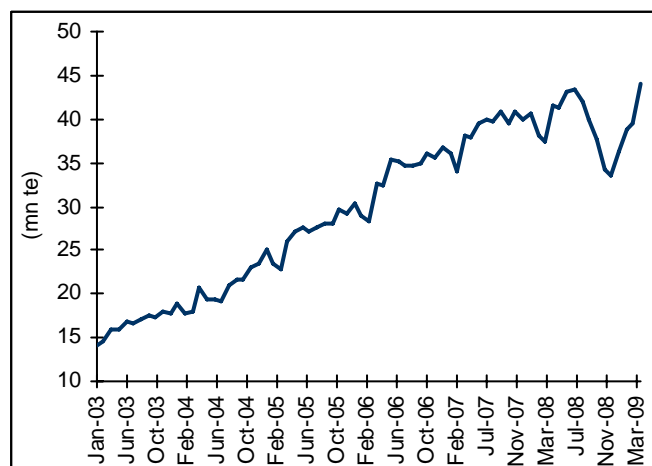


Chart 2: Chinese pig iron production



Source: Bloomberg, I-Sec Research

We have analysed three different growth scenarios for Chinese crude steel production: i) Q1CY09 run rate is maintained for the rest of '09 (implying a meagre 1% YoY growth in Chinese crude steel production in '09), ii) Chinese crude steel production decelerates 5% in '09 and iii) Chinese crude steel production decelerates 10% in '09.

Given a choice case for Chinese import iron ore demand, we consider the percentage of imports supplied by India as a source of demand generation for Sesa. Historically, India has supplied between 20% and 23% of Chinese imports, with the lower and upper ranges forming bear and bull cases for our scenario analysis.

Table 1: Chinese crude steel production and Indian iron ore demand – Scenarios

	Scenario 1	Scenario 2	Scenario 3
	At current run rate of crude steel production		
	(5%)	(10%)	
	2009E	2009E	2009E
Crude steel production (mn te)	507	477	452
YoY growth (%)	1.0	(5.0)	(10.0)
Pig iron production (mn te)	490	445	421
YoY growth (%)	4.5	(5.0)	(10.0)
Demand for dressed ore (mn te)	768	698	661
Domestic iron ore production (mn te)			
Crude ore output	632	632	632
Dressed ore output	234	234	234
Ratio of crude ore/dressed ore	2.7	2.7	2.7
Imported iron ore requirement (mn te)	533	463	427
India's share in Chinese imports			
Bear case (mn te)	107	93	85
Bull case (mn te)	123	107	98

Source: Bloomberg, I-Sec Research

Given that Sesa's exports to China formed ~11% of the total Indian export to China in '08, we factor in the same estimate for '09 as well.

Table 2: Sesa's market share in exports to China

(mnmt)

	Q4FY07	Q1FY08	Q2FY08	Q3FY08	Q4FY08	Q1FY09	Q2FY09	Q3FY09	Q4FY09
Sesa's iron ore sales	4.6	2.2	1.2	4.0	5.0	3.3	1.4	5.4	5.0
Export to China	3.0	1.5	0.8	2.6	3.3	2.1	0.9	3.6	3.3
Sesa's export share	12.6	6.7	5.2	14.2	12.9	6.9	5.6	19.8	10.8

Source: Bloomberg, I-Sec Research

Assuming that Sesa will maintain its '08 export market share to China in '09 as well, we expect a minimum of 9.4mnmt iron ore sales from China to Sesa in '09 (China contributes ~80% to overall sales at present). In our bull-case scenario, China alone can contribute ~14mnmt volumes to Sesa.

Table 3: Sesa's sales from China in '09

(mnmt)

	Scenario 1	Scenario 2	Scenario 3	Average
Bear case	11.7	10.2	9.4	10.4
Bull case	13.5	11.7	10.8	12.0

Source: Bloomberg, I-Sec Research

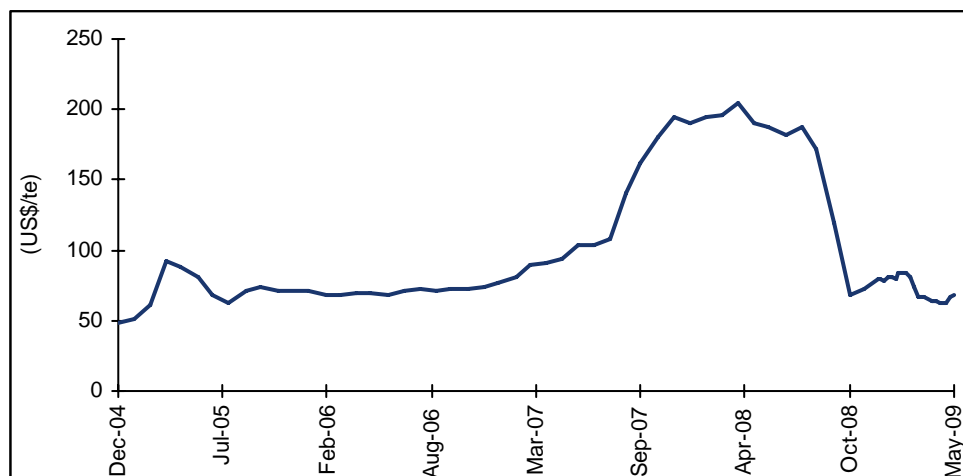
Also, as Sesa features in the lowest cost curve decile globally with US\$27-30/te production cost, it can maintain ~45-50% margins even at US\$45/te iron ore realisations unlike private-party miners in Karnataka (Bellary) and Orissa that are burdened by high logistics and mining costs (forming ~50-60% of India's total iron ore exports). Hence, we believe there is still scope for Sesa to increasingly gain market share at the cost of small domestic miners. Also, five decades of market presence with good end-user connect will help Sesa adapt to customer needs – 3-4mnmt of annual volume contracts increase Sesa's success ratio with changing Chinese demand scenario.

Table 4: Sesa's sales from China in '09 at increased market share of 12%

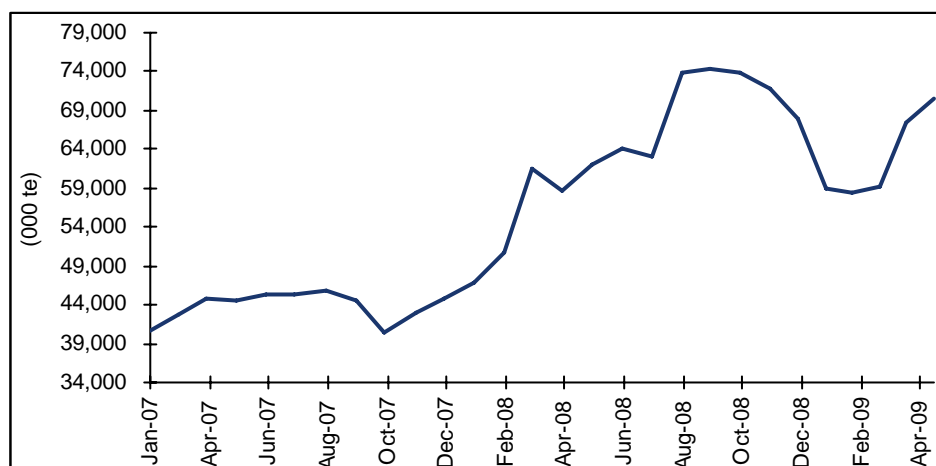
(mnmt)

	Scenario 1	Scenario 2	Scenario 3	Average
Bear case	12.8	11.1	10.2	11.4
Bull case	14.7	12.8	11.8	13.1

Source: Bloomberg, I-Sec Research

Chart 3: Chinese iron ore spot prices have stabilised

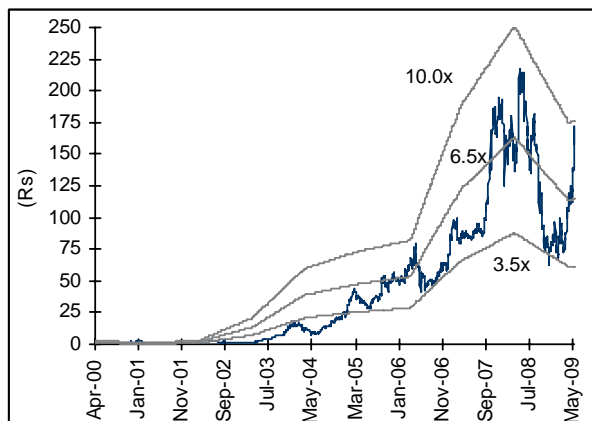
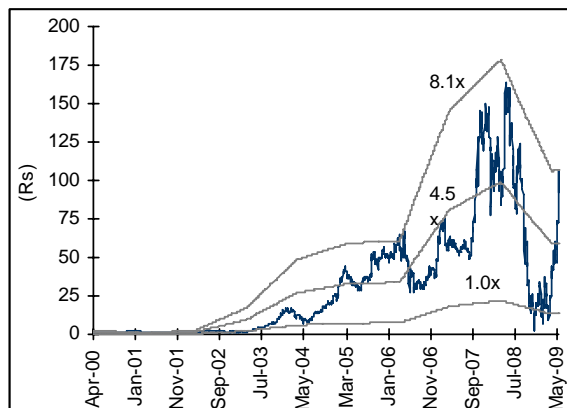
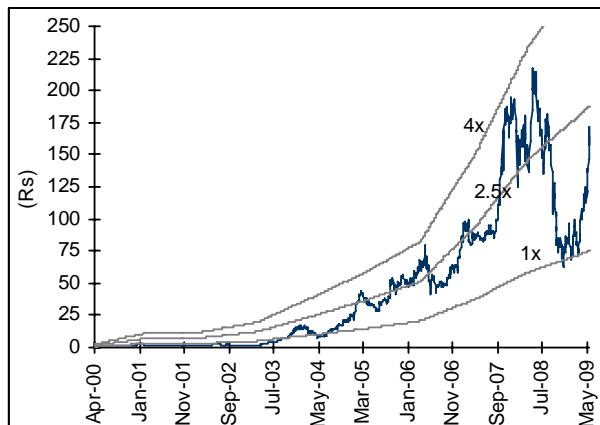
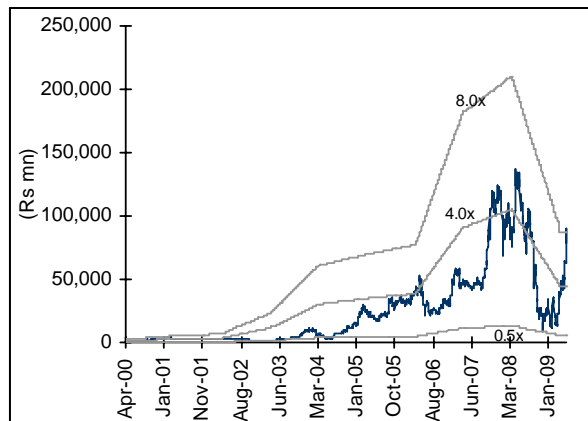
Source: Bloomberg, I-Sec Research

Chart 4: Chinese inventory increasing

Source: Bloomberg, I-Sec Research

Valuations, the key dampener

The stock has run up ~100% in the past three months and is currently trading at historically high FY10E P/E (cash adjusted) and EV/E of 7.5x and 4.7x respectively. Also, rupee appreciation remains the key risk to revenues. While we are not lowering our volume estimates, we do not believe there is significant upside risks to our earnings. We maintain our benchmark valuations of 50% discount to global peers and value Sesa at FY10E EV/E of 4.2x. We downgrade Sesa Goa to HOLD with target price of Rs152/share from Rs141/share.

Chart 5: Valuations at historic highs**P/E bands****P/E bands (cash adjusted)****P/BV bands****EV/E bands**

Source: Company data, I-Sec Research

Summary financials

Table 5: Profit and Loss Statement

(Rs mn, year ending March 31)

	FY08	FY09P	FY10E	FY11E
Operating Income (Sales)	37,923	49,591	39,945	40,964
Operating Expenses	15,194	24,206	23,310	23,421
EBITDA	22,728	25,385	16,635	17,543
% margins	60	51	42	43
Depreciation & Amortisation	500	517	784	879
Gross Interest	28	10	-	-
Other Income	744	2,235	3,527	3,857
Recurring PBT	22,945	27,093	19,377	20,522
Add: Extraordinaries	304	-	-	-
Less: Taxes	7,760	7,150	5,430	5,750
Net Income (Reported)	15,489	19,943	13,947	14,772
Recurring Net Income	15,112	19,875	13,947	14,772

Source: Company data, I-Sec Research

Table 6: Balance Sheet

(Rs mn, year ending March 31)

	FY08	FY09P	FY10E	FY11E
Assets				
Total Current Assets	8,643	6,126	5,613	5,594
of which cash & cash eqv.	210	213	232	191
Total Current Liabilities & Provisions	3,763	10,095	9,016	6,587
Net Current Assets	4,880	(3,969)	(3,403)	(993)
Investments				
of which	20,510	41,722	50,728	59,809
Strategic/Group	-	-	-	-
Other Marketable	20,510	41,722	50,728	59,809
Net Fixed Assets	4,975	9,429	11,732	12,710
of which				
Capital Work-in-Progress	215	260	270	275
Total Assets	30,364	47,182	59,057	71,526
Liabilities				
Borrowings	-	-	-	-
Deferred Tax Liability	664	664	664	664
Minority Interest	-	-	-	-
Equity Share Capital	394	403	403	403
Face Value per share (Rs)	10	1	1	1
Reserves & Surplus*	29,041	46,115	57,990	70,460
Net Worth	29,435	46,518	58,393	70,863
Total Liabilities	30,364	47,182	59,057	71,526

*excluding revaluation reserves

Source: Company data, I-Sec Research

Table 7: Cash Flow Statement

(Rs mn, year ending March 31)

	FY08	FY09P	FY10E	FY11E
Operating Cash flow	14,941	18,225	11,205	11,793
Working Capital Changes	(1,202)	8,852	(548)	(2,451)
Capital Commitments	(490)	(4,958)	(3,087)	(1,857)
Free Cash Flow	13,249	22,119	7,570	7,486
Cash flow from Investing Activities	(11,312)	(19,255)	(5,479)	(5,224)
Issue of Share Capital	-	-	-	-
Buyback of shares	(0)	-	-	-
Inc (Dec) in Borrowings	-	-	-	-
Dividend paid	(2,072)	(2,072)	(2,072)	(2,303)
Extraordinary Items	-	-	-	-
Chg. in Cash & Bank balance	(2)	4	19	(41)

Source: Company data, I-Sec Research

Table 8: Key Ratios

(Year ending March 31)

	FY08	FY09P	FY10E	FY11E
Per Share Data (Rs)				
EPS(Basic Recurring)	383.9	25.0	17.5	18.5
Diluted Recurring EPS	19.0	25.0	17.5	18.5
Recurring Cash EPS	19.6	25.6	18.5	19.6
Dividend per share (DPS)	2.2	2.2	2.2	2.5
Book Value per share (BV)	37.0	58.4	73.3	89.0
Growth Ratios (%)				
Operating Income	71.0	30.8	(19.5)	2.6
EBITDA	136.1	11.7	(34.5)	5.5
Recurring Net Income	133.9	31.5	(29.8)	5.9
Diluted Recurring EPS	133.9	31.5	(29.8)	5.9
Diluted Recurring CEPS	143.8	30.6	(27.8)	6.2
Valuation Ratios (x)				
P/E	7.5	4.9	7.5	6.3
P/CEPS	8.7	7.1	11.5	10.9
P/BV	4.4	2.8	2.2	1.8
EV / EBITDA	4.8	3.4	4.7	3.9
EV / Operating Income	2.9	1.8	2.0	1.7
EV / Operating FCF	7.9	3.2	7.3	7.4
Operating Ratio (%)				
Raw Material/Sales	7.4	5.2	6.0	4.8
SG&A/Sales	17.4	27.1	36.8	36.5
Other Income / PBT	3.2	8.2	18.2	18.8
Effective Tax Rate	33.4	26.4	28.0	28.0
NWC / Total Assets	15.4	(8.9)	(6.2)	(1.7)
Inventory Turnover (days)	166.3	126.3	94.8	90.3
Receivables (days)	36.0	30.1	28.1	24.5
Payables (days)	90.4	152.2	141.2	102.7
D/E Ratio (x)	0.0	0.0	0.0	0.0
Return/Profitability Ratio (%)				
Recurring Net Income Margins	39.1	38.4	32.1	33.0
RoCE	97.1	69.9	36.5	31.4
RoNW	79.5	69.3	37.2	28.7
Dividend Payout Ratio	11.7	8.9	12.7	13.3
Dividend Yield	1.4	1.4	1.4	1.5
EBITDA Margins	59.9	51.2	41.6	42.8

Source: Company data, I-Sec Research

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