

# SESA GOA



Margin squeeze

## EBITDA and PAT ~25% and 16% below expectations

Sesa Goa reported revenue of INR 9.2 bn in Q2FY11, ~8% lower than our expectation of ~INR 10 bn. Sales volume was in line at 2 mt (up 24% Y-o-Y) but blended realisation came in lower at USD 76.5/t (our estimate: USD 80/t). Iron ore cash costs shot up to USD 49/t (from USD 36/t in Q2FY10) led by increase in cost of purchased ore, spares and USD 20/t increase in freight cost at Orissa and Karnataka since March 2010. PAT, thus, came in 16% lower at INR 3.85 bn.

## FY11 volume growth guidance cut to 10% from earlier 20-25%

The company is facing headwinds of the iron ore export ban in Karnataka and logistics challenges in Orissa. Management indicated volume loss of ~1 mt in Q2FY11 due to the Karnataka export ban. Assuming the ban is reversed by next month, management now expects 10% volume growth in FY11 against earlier guidance of 20-25% growth (our assumption: 17%). No guidance has been given for FY12. Continuing ban in Karnataka will entail flat volumes for FY11.

## Deteriorating product mix and lower other income impact profits

The discount of Sesa Goa's blended iron ore realizations to benchmark prices (63 Fe) has widened from 31% in Q2FY10 to ~40% in Q2FY11 reflecting lower grades in the product mix. Other income for Q2FY11 fell ~35% Q-o-Q, though cash declined only 5% Q-o-Q.

## Cairn India open offer awaiting SEBI clearance

Sesa Goa's acquisition of 20% stake in Cairn India through an open offer is still awaiting SEBI clearance. The company has increased its borrowing limit to INR 150 bn. As expected, the debt is for the Cairn India transaction, but the high amount is a surprise.

## Outlook and valuations: Volume growth stutters; maintain 'REDUCE'

We have cut our FY11 and FY12 volume growth assumptions for Sesa Goa to 22.5 mt (earlier 24 mt) and 25.8 mt (earlier 28.8 mt), respectively. After factoring in higher costs but with better-than-expected iron ore prices, we cut our FY11 and FY12 EBITDA estimates by 7% and 13%, respectively. Our fair valuation works out to INR 339/share, a downside of 6% from CMP. We maintain 'REDUCE/Sector Underperformer' recommendation/rating on the stock.

October 19, 2010

Reuters: SESA.BO Bloomberg: SESA IN

### EDELWEISS 4D RATINGS

Absolute Rating	<b>REDUCE</b>
Rating Relative to Sector	<b>Underperformer</b>
Risk Rating Relative to Sector	<b>Medium</b>
Sector Relative to Market	<b>Equalweight</b>

Note:  
Please refer last page of the report for rating explanation

### MARKET DATA

CMP	:	INR 359
52-week range (INR)	:	495 / 266
Share in issue (mn)	:	860.0
M cap (INR bn/USD mn)	:	309 / 6,979
Avg. Daily Vol. BSE/NSE ('000):	:	7,678.0

### SHARE HOLDING PATTERN (%)

Promoters*	:	55.7
MFs, FIs & Banks	:	3.4
FIIIs	:	27.2
Others	:	13.7
* Promoters pledged shares (% of share in issue)	:	NIL

### PRICE PERFORMANCE (%)

	Stock	Nifty	EW Metals and Mining Index
1 month	14.6	3.2	7.2
3 months	8.5	12.6	17.2
12 months	5.0	18.2	12.9

### Financials

(INR mn)

Year to March	Q2FY11	Q2FY10	% Chg	Q1FY11	% Chg	FY10	FY11E
Net revenues	9,183	5,387	70.5	24,131	(61.9)	58,583	88,337
EBITDA	3,398	1,527	122.5	14,596	(76.7)	31,486	43,940
Net profit	3,849	1,665	133.5	13,018	(70.4)	26,291	40,517
Diluted EPS (INR)	4.5	2.0	120.7	15.1	(70.4)	31.6	45.7
Diluted P/E (x)						11.3	7.9
EV/EBITDA (x)						7.9	5.3
ROAE (%)						36.1	34.6

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- Cost pressures take shine away from Y-o-Y increase in realisations

EBITDA for the quarter was INR 3.4 bn (up 122% Y-o-Y, down 77% Q-o-Q). Iron ore cash costs shot up to USD 49/t (from USD 36/t in Q2FY10) due to increase in cost of purchased ore, spares and USD 20/t Q-o-Q increase in freight cost at Orissa and Karnataka since March 2010. Thus, PBIT/t came at USD 23/t.

**Table 1: Snapshot of operational performance**

	Q1FY10	Q2FY10	Q3FY10	Q4FY10	Q1FY11	Q2FY11
<b>Sales volume</b>						
Iron ore (mt)	4.7	1.6	6.8	7.4	5.4	2.0
Pig iron (kt)	71.0	67.0	71.0	70.0	54.0	84.0
<b>Realisation (USD/tonne)</b>						
Iron ore	37	51	55	67	91	77
Pig iron	384	396	425	467	555	511
<b>PBIT (USD/tonne)</b>						
Iron ore	17	13	31	43	59	23
Pig iron	60	110	104	83	126	87

Source: Company

- Key conference call highlights

- Clearances pending for 50 mt expansion

Currently, Sesa Goa has mining approvals for up to 17 mtpa, 6 mtpa and 2 mtpa for its Goa, Karnataka and Orissa mines, respectively. Environmental and other approvals are pending for Goa and Karnataka mines. At Orissa, final EC is pending for mining up to 5 mt and third party agreements with mine owners are to be settled for 5 mt to 10 mt mining capacity.

- Other key points

Out of total sales volume of 2 mt during the quarter, sales from Goa, Karnataka and Orissa were 1 mt, 490 kt and 500 kt, respectively. Dempo sales were 130 kt. Current iron ore inventory is 5.3 mt.

Cash cost of iron ore at Orissa and Karnataka is USD 95/t and USD 40/t, respectively.

Sesa Goa reported exchange gains of INR 364 mn during the quarter. Royalty cost was INR 150-175/t.

Cash on books declined sequentially to INR 75.7 bn from INR 80.5 bn due to dividend payout and increase in working capital expenses.

Management has guided for tax rate of 15-16% and capex of INR 14 bn for FY11.

- Revision of estimates

We have cut our volume for FY11 and FY12 by 6% and 13%, respectively. Given the subsequent recovery in iron prices from July lows, we have increased our iron ore price estimates for FY11 and FY12. We have factored in higher costs in our forward estimates. FY11 tax rate has been cut to 16% from earlier 20% based on company guidance.

**Table 2: Revising down FY12 EPS 13%**

Assumptions	FY11E			FY12E		
	New	Old	% change	New	Old	% change
Iron ore volume (mt)	22.5	24.0	(6.2)	25.0	28.8	(13.3)
Contract realization (USD/tonne)	81.3	74.8	8.6	71.5	67.4	6.1
Spot realization (USD/tonne)	81.3	75.2	8.0	71.5	69.0	3.6
<b>Financials</b>						
Revenues (INR mn)	88,337	87,238	1.3	85,955	92,584	(7.2)
EBITDA (INR mn)	43,940	47,151	(6.8)	41,457	48,046	(13.7)
PAT (INR mn)	40,517	41,432	(2.2)	35,371	40,823	(13.4)
EPS (INR)	45.7	46.7	(2.2)	39.9	46.0	(13.4)

Source: Edelweiss research

- Fair valuation for Sesa Goa at INR 339/share

We have arrived at fair value per share of INR 339 for the company by taking an average of EV/EBITDA and DCF valuation.

**Table 3: Valuation at INR 343/share based on EV/EBITDA valuation**

FY12E EBITDA (INR mn)	41,457
Applicable multiple (x)	5.0
Enterprise value (INR mn)	207,284
Less: FY11 Net debt (INR mn)	(97,265)
Equity valuation (INR mn)	304,550
No. of shares (mn) (incl. FCCB dilution)	887
<b>Total Fair value (INR/share)</b>	<b>343</b>
Current market price (INR/share)	359
Upside (%)	(4.3)

Source: Edelweiss research

Our DCF for Sesa Goa, based on a discount rate of 13%, leads to a value of INR 335/share.

**Table 4: DCF valuation** **(INR mn)**

Sesa valuation	FY12E	FY13E	FY14E	FY15E	FY16E	FY17E	FY18E	FY19E	FY20E
Iron ore volume (mt)	25.0	37.5	45.0	50.0	50.0	50.0	50.0	50.0	50.0
EBITDA/tonne (USD)	36.2	35.3	29.5	27.3	25.0	22.4	22.4	22.5	19.8
FCFF (INR mn)	29,101	41,687	42,021	43,291	39,653	35,457	35,813	36,183	31,922
Growth in FCFF (%)	67.9	43.2	0.8	3.0	(8.4)	(10.6)	1.0	1.0	(11.8)
Discounting factor (x)	0.88	0.78	0.69	0.61	0.54	0.48	0.43	0.38	0.33
Discounted FCFF (INR mn)	25,753	32,647	29,122	26,551	21,522	17,031	15,223	13,611	10,626

PV of future cashflows (INR mn)	192,086
PV of terminal value* (INR mn)	7,780
Value of firm (INR mn)	199,866
Less: FY11 Net debt - post FCCB issuance (INR mn)	(97,265)
Equity value (INR mn)	297,131
No. of shares - incl FCCB dilution (mn)	887
<b>Total fair value for Sesa Goa (INR/share)</b>	<b>335</b>

Source: Edelweiss research

\*Terminal value only for pig iron and met coke businesses

**Financial snapshot****(INR mn)**

Year to March	Q2FY11	Q2FY10	% Change	Q1FY11	% Change	FY10	FY11E	FY12E
Net revenues	9,183	5,387	70.5	24,131	(61.9)	58,583	88,337	85,955
Increase/decrease in stocks	(1,387)	(1,566)	NA	(1,392)	NA	(1,211)		
Raw material costs	871	881	(1.2)	855	1.8	3,459	3,544	4,045
Purchase of ore	1,068	557	91.8	1,471	(27.4)	3,096	4,132	4,783
Staff costs	466	334	39.5	444	4.8	1,691	1,860	2,046
Consumption of stores	614	526	16.8	737	(16.8)	2,437	3,533	3,438
Inland transportation	1,739	1,577	10.3	2,556	(32.0)	8,124	13,044	13,534
Other services	938	729	28.7	901	4.2	3,711	4,494	5,102
Export duty	527	47	1,031.1	1,276	(58.7)	1,476	5,115	4,174
Costs/expenses recovered	(32)	(45)	NA	(87)	NA			
Other expenses	982	822	19.4	2,774	(64.6)	4,315	8,675	7,376
Total expenditure	5,786	3,860	49.9	9,535	(39.3)	27,097	44,397	44,498
EBITDA	3,398	1,527	122.5	14,596	(76.7)	31,486	43,940	41,457
Depreciation	194	202	(4.0)	191	1.5	745	872	1,041
Other income	1,004	893	12.5	1,609	(37.6)	4,260	5,818	7,394
Interest	140	20	607.6	137	2.0	555	470	470
Profit before tax	4,068	2,198	85.1	15,877	(74.4)	34,446	48,416	47,340
Tax	189	503	(62.5)	2,832	(93.3)	8,056	7,747	11,835
Current taxes	189	487	(61.2)	2,832	(93.3)	8,012	-	-
Deferred taxes	-	19	(100.0)	-		44	-	-
Core profit	3,879	1,694	128.9	13,045	(70.3)	26,390	40,670	35,505
Minority interest	30	30	(0.7)	27	9.2	99	153	133
Reported net profit	3,849	1,665	131.3	13,018	(70.4)	26,291	40,517	35,371
Equity capital	860	821		860		831	860	860
No. of shares (mn)	860	821		860		831	887	887
Diluted EPS (INR)	4.5	2.0	120.7	15.1	(70.4)	31.6	45.7	39.9

**As % of net revenues**

Raw material	(5.6)	(12.7)		(2.2)		3.8	4.0	4.7
Employee cost	5.1	6.2		1.8		2.9	2.1	2.4
Consumption of stores	6.7	9.8		3.1		4.2	4.0	4.0
Inland transportation	18.9	29.3		10.6		13.9	14.8	15.7
Other services	10.2	13.5		3.7		6.3	5.1	5.9
Purchase of ore	11.6	10.3		6.1		5.3	4.7	5.6
Export duty	5.7	0.9		5.3		2.5	5.8	4.9
Other expenses	10.7	15.3		11.5		7.4	9.8	8.6
Costs/expenses recovered	(0.3)	(0.8)		(0.4)				
EBITDA	37.0	28.3		60.5		53.7	49.7	48.2
Reported net profit	41.9	30.9		53.9		44.9	45.9	41.2
Tax rate	4.6	22.9		17.8		23.4	16.0	25.0

### ■ Company Description

Sesa Goa is India's largest private sector player in iron ore. In April 2007, Vedanta Resources acquired 51% (controlling stake) in the company from Mitsui & Company, Japan. It has operations in Goa, Karnataka, and Orissa, with an annual processing capacity of 25 mt logistics capacity including third-party mining. The company has access to mining resource of 353 mt , with additional prospecting licenses in Jharkhand. It also operates a pig iron plant of 250,000 tpa and a met coke plant of 280,000 tpa. In FY09, the company exported close to 96% of its iron ore volume, with China accounting for 84% of the total sales volume. For the pig iron unit, 30% of the iron ore requirement is met captively. The entire coke requirement for pig iron is met captively.

### ■ Investment Theme

Sesa Goa's operational cost for the iron ore business is relatively lower due to inherent natural cost advantage of the Indian iron ore mines. Also, its Goa mines are located close to ports, thus, saving the company freight costs. However, the volumes are likely to grow at only 10% in FY11 as against earlier 20%. Costs also have increased for the company thereby putting earnings under pressure. We also expect iron ore prices to soften in FY12.

### ■ Key Risks

- Higher than estimated volumes
- Iron ore prices higher than estimates
- Operational costs turn out to be lower than estimates

## Financial Statements (Consolidated)

<b>Income statement</b>					<b>(INR mn)</b>
Year to March	FY08	FY09	FY10	FY11E	FY12E
Net revenue	38,227	49,591	58,583	88,337	85,955
Materials costs	2,780	2,569	3,459	3,544	4,045
Accretion to stock	(402)	(268)	(1,211)	-	-
Purchase of goods	2,370	2,641	3,096	4,132	4,783
Mining royalty	117	135	1,607	4,744	4,410
Employee costs	685	999	1,691	1,860	2,046
Total SG&A expenses	9,645	18,094	18,456	30,118	29,214
Total operating expenses	15,194	24,170	27,097	44,397	44,498
EBITDA	23,032	25,421	31,486	43,940	41,457
Depreciation & amortization	500	517	745	872	1,041
EBIT	22,533	24,904	30,741	43,068	40,416
Other income	744	2,240	4,260	5,818	7,394
Interest expenses	28	43	555	470	470
Profit before tax	23,249	27,102	34,446	48,416	47,340
Provision for tax	7,760	7,153	8,056	7,747	11,835
Core profit	15,489	19,949	26,390	40,670	35,505
Profit after tax	15,489	19,949	26,390	40,670	35,505
Minority interest	74	68	99	153	133
Profit after minority interest	15,416	19,881	26,291	40,517	35,371
Basic shares outstanding (mn)	787	787	831	860	860
Basic EPS (INR)	1.0	25.3	31.6	47.1	41.1
Diluted equity shares (mn)	787	787	831	887	887
Diluted EPS (INR)	19.6	25.3	31.6	45.7	39.9
Dividend per share (INR)	2.3	2.3	3.2	3.2	3.2
Dividend payout (%)	13.4	10.4	12.0	8.0	9.2
Tax rate (%)	33.4	26.4	23.4	16.0	25.0

<b>Common size metrics</b>					
Year to March	FY08	FY09	FY10	FY11E	FY12E
Operating expenses	39.7	48.7	46.3	50.3	51.8
Depreciation	1.3	1.0	1.3	1.0	1.2
Interest expenditure	0.1	0.1	0.9	0.5	0.5
EBITDA margins	60.3	51.3	53.7	49.7	48.2
Net profit margins	40.5	40.2	45.0	46.0	41.3

<b>Growth ratios (%)</b>					
Year to March	FY08	FY09	FY10	FY11E	FY12E
Revenues	72.4	29.7	18.1	50.8	(2.7)
EBITDA	139.2	10.4	23.9	39.6	(5.7)
PBT	140.7	16.6	27.1	40.6	(2.2)
Net profit	137.9	28.8	32.3	54.1	(12.7)
EPS	138.6	29.0	25.3	44.4	(12.7)

## Metals and Mining

<b>Balance sheet</b>					<b>(INR mn)</b>
As on 31st March	FY08	FY09	FY10	FY11E	FY12E
Equity capital- Voting shares	394	787	831	860	860
Reserves & surplus	29,041	46,370	78,346	125,524	157,627
Shareholders funds	29,435	47,157	79,177	126,384	158,487
Minority interest (BS)	266	334	433	586	719
Secured loans	-	19	444	444	444
Unsecured loans	-	-	19,162	9,399	9,399
Borrowings	-	19	19,606	9,843	9,843
Deferred tax liability	664	664	750	750	750
<b>Sources of funds</b>	<b>30,365</b>	<b>48,175</b>	<b>99,966</b>	<b>137,562</b>	<b>169,798</b>
Gross block	7,696	8,863	27,510	30,610	38,785
Depreciation	2,936	3,422	5,741	6,613	7,654
Net block	4,760	5,441	21,770	23,998	31,132
Capital work in progress	215	489	787	11,687	8,012
Total fixed assets	4,975	5,930	22,557	35,685	39,144
Investments	20,510	31,252	45,649	53,826	85,501
Inventories	3,118	2,642	5,009	6,575	6,404
Sundry debtors	4,725	2,982	3,381	5,099	4,961
Cash and equivalents	210	177	23,918	33,883	32,969
Loans and advances	590	11,032	11,455	16,941	16,485
Other current assets	-	-	396	396	396
Total current assets	8,643	16,833	44,160	62,894	61,215
Sundry creditors and others	1,925	3,376	8,286	10,802	10,521
Provisions	1,839	2,464	4,114	4,041	5,541
Total current liabilities & provisions	3,763	5,840	12,400	14,843	16,062
Net current assets	4,880	10,992	31,760	48,051	45,153
<b>Uses of funds</b>	<b>30,365</b>	<b>48,175</b>	<b>99,966</b>	<b>137,562</b>	<b>169,798</b>
Book value per share (INR)	37.4	59.9	95.3	147.0	184.4

<b>Free cash flow</b>					<b>(INR mn)</b>
Year to March	FY08	FY09	FY10	FY11E	FY12E
Net profit	15,416	19,881	26,291	40,517	35,371
Depreciation	500	517	745	872	1,041
Deferred tax	15	45	44	-	-
Others	(350)	(1,948)	467	153	133
Gross cash flow	15,580	18,495	27,547	41,541	36,546
Less: Changes in WC	(1,714)	2,848	1,037	(6,326)	1,984
Operating cash flow	13,866	21,343	28,585	35,215	38,530
Less: Capex	(674)	(1,471)	(1,490)	(14,000)	(4,500)
<b>Free cash flow</b>	<b>13,192</b>	<b>19,872</b>	<b>27,095</b>	<b>21,215</b>	<b>34,030</b>

<b>Cash flow metrics</b>					
Year to March	FY08	FY09	FY10	FY11E	FY12E
Operating cash flow	13,866	21,343	28,585	35,215	38,530
Investing cash flow	(12,033)	(9,989)	(13,309)	(22,178)	(36,175)
Financing cash flow	(1,836)	(11,390)	25,120	(3,073)	(3,269)
Net cash flow	(2)	(35)	40,396	9,964	(914)
Capex	(674)	(1,471)	(1,490)	(14,000)	(4,500)
Dividends paid	(1,836)	(1,380)	(2,064)	(3,269)	(3,269)
Share issuance/(buyback)	-	-	5,372	-	-



**Profitability & efficiency ratios**

Year to March	FY08	FY09	FY10	FY11E	FY12E
ROAE (%)	67.7	51.9	36.1	34.6	23.3
ROACE (%)	245.8	186.0	86.3	62.4	48.1
Inventory day	235	213	261	275	268
Debtors days	35	28	20	18	21
Payable days	124	196	398	454	441
Cash conversion cycle (days)	146	45	(117)	(161)	(151)
Current ratio	2.3	2.9	3.6	4.2	3.8
Debt/EBITDA	-	-	0.6	0.2	0.2
Debt/Equity	-	-	0.2	0.1	0.1

**Operating ratios**

Year to March	FY08	FY09	FY10	FY11E	FY12E
Total asset turnover	1.6	1.3	0.8	0.7	0.6
Fixed asset turnover	8.2	9.7	4.3	3.9	3.1
Equity turnover	1.7	1.3	0.9	0.9	0.6

**Du pont analysis**

Year to March	FY08	FY09	FY10	FY11E	FY12E
NP margin %	40.3	40.1	44.9	45.9	41.2
Total assets turnover	1.6	1.3	0.8	0.7	0.6
Leverage multiplier	1.0	1.0	1.0	1.0	1.0
ROAE %	67.7	51.9	36.1	34.6	23.3

**Valuation parameters**

Year to March	FY08	FY09	FY10	FY11E	FY12E
Diluted EPS (INR)	19.6	25.3	31.6	45.7	39.9
Y-o-Y growth (%)	138.6	29.0	25.3	44.4	(12.7)
CEPS (INR)	1.0	26.0	32.6	48.1	42.4
Diluted PE (x)	18.3	14.2	11.4	7.9	9.0
Price/BV (x)	9.6	6.0	3.8	2.4	1.9
EV/Sales (x)	7.3	5.4	4.2	2.6	2.3
EV/EBITDA (x)	11.4	9.9	7.9	5.3	4.8
Dividend yield (%)	0.6	0.6	0.9	0.9	0.9
Market cap/Sales (x)	7.8	6.0	5.1	3.5	3.6



Company	Absolute reco	Relative reco	Relative risk	Company	Absolute reco	Relative reco	Relative Risk
Bhushan Steel	BUY	SO	H	Hindalco Industries	BUY	SO	M
Hindustan Zinc	BUY	SO	L	Jindal Steel & Power	HOLD	SP	M
JSW Steel	BUY	SO	H	National Aluminium Company	REDUCE	SU	M
Prakash Industries	BUY	SO	M	Sesa Goa	REDUCE	SU	M
Steel Authority of India	BUY	SP	L	Sterlite Industries (India)	BUY	SP	L
Tata Steel	BUY	SO	M	Usha Martin	BUY	SO	M
Coal India	BUY	SO	L				

## ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

## RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

## RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

## SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return



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### Coverage group(s) of stocks by primary analyst(s): Metals and Mining

Bhushan Steel, Coal India, Hindalco Industries, Hindustan Zinc, Jindal Steel & Power, JSW Steel, National Aluminium Company, Prakash Industries, Steel Authority of India, Sesa Goa, Sterlite Industries (India), Tata Steel, Usha Martin

Sesa Goa



EW Indices



#### Distribution of Ratings / Market Cap

##### Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	116	45	12	176
* 3 stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	110	53	13	

#### Recent Research

Date	Company	Title	Price (INR)	Recos
14-Oct-10	Coal India	One of a kind; <i>Initiating Coverage</i>	225-245	Buy
07-Oct-10	Sterlite Industries	Project issues continue; <i>Company Update</i>	176	Buy
30-Sep-10	Tata Steel	Corus refinancing: Reducing cash flow stress; <i>EdelFlash</i>		

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