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Iron Ore Sector Update

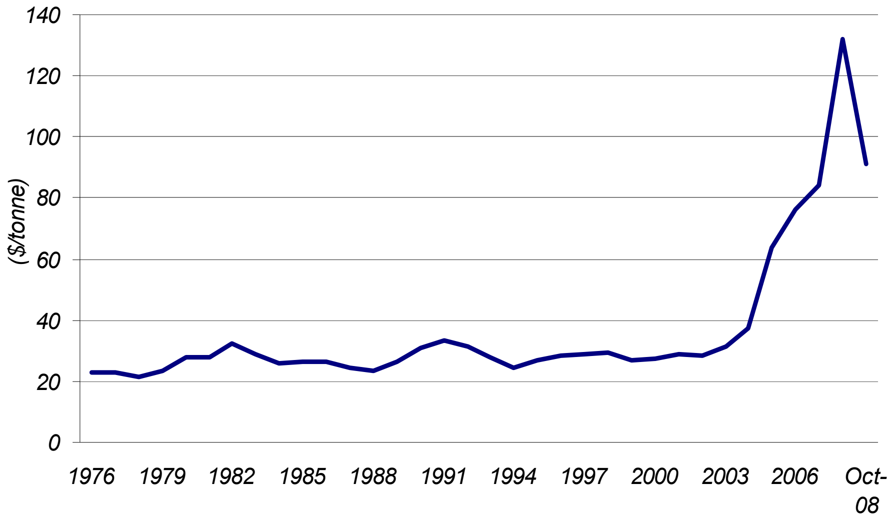
Iron ore – an important input for Steel making- is going through a grind -thanks to the global meltdown which has taken a toll of the Steel prices which in turn had hit a high of $1130/tonne (CIS (Black Sea) HR prices) in Aug-Sept '08 and currently are trading at $475/tonne. It requires 1.6 tonne of iron ore (63.5% Fe content) to produce 1 tonne of Steel through Blast furnace route and accounts for about 24% of the current cost of production of steel ($550/tonne) at the current spot price of $70/tonne.

Iron prices have corrected sharply

Annual contract and Spot Iron ore prices have witnessed a sharp correction off late- post the global financial mess and sharp correction seen in commodities.

Both Annual contract and Spot Iron ore prices have witnessed a sharp correction off late- post the global financial mess and sharp correction seen in commodities.

Iron ore (Annual) Contract prices



Source: www.Econostats.com

The annual contract prices have corrected from a high of $132/tonne in Feb.'08 to $90/tonne seen in Oct.'08. The annual contracts follow a benchmark pricing system wherein one of the big Steel mills agree a percentage change in price with one of the big miners, which then becomes the benchmark and is applied across different grades of iron ore. Iron ore annual contracts for 2005 witnessed a 71.5% increment in iron ore prices, 19% for 2006, 9.5% for 2007 and whooping 96.5% for 2008. An unprecedented sharp correction to the tune of 50%-65% is expected in the 2009 annual contracts.

The spot prices have witnessed a high of $194/tonne and are currently quoting at @ $75/tonne.

Spot iron ore prices has also mirrored the movements in the annual contracts- the spot prices generally enjoy a premium over the contract prices. The spot prices have witnessed a high of $194/tonne and are currently quoting at @ $75/tonne.

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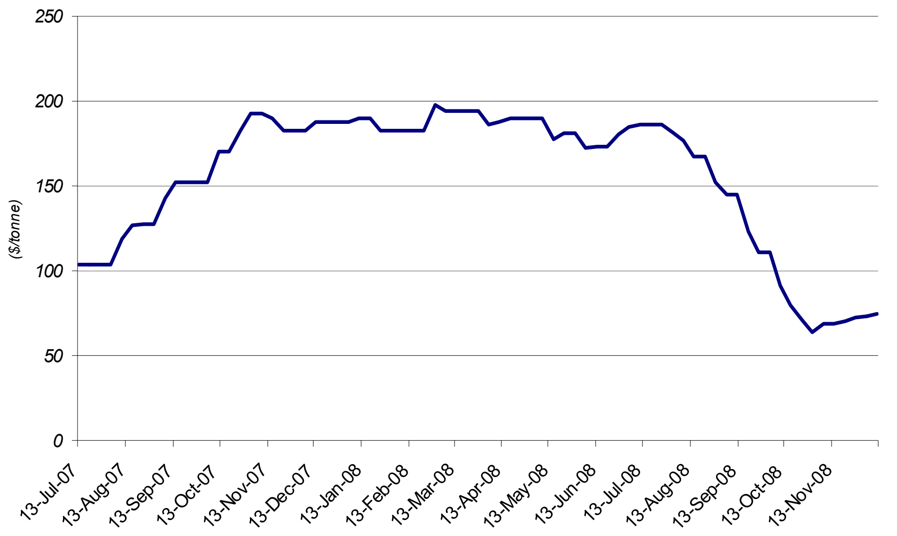
Iron Ore (Spot) prices



Source: Bloomberg

China which produces and consumes 33% of the global steel production was the driving force for the iron ore prices as it lacks the reserves for good quality iron ore and has to import it to keep feeding its Steel mills.

The spurt in the Iron ore price was mainly led by the incremental demand for the end-product viz. Steel from the emerging markets especially the BRIC countries and China in particular. The construction and infrastructure development which accounts for almost 50% of the steel consumption was responsible for the incremental development. China which produces and consumes 33% of the global steel production was the driving force for the iron ore prices as it lacks the reserves for good quality iron ore and has to import it to keep feeding its Steel mills.

Economic Slowdown coupled with credit crunch has affected the business environment adversely- tempering the growth outlook- both global and country specific by vast margins for the near future.

Steel prices- which had touched a high of $1130 /tonne in Aug-Sept.'08 -has been a major casualty of the Global meltdown. Economic Slowdown coupled with credit crunch has affected the business environment adversely- tempering the growth outlook- both global and country specific by vast margins for the near future.

Steel Production

Steel Production (mmt)	2006	2007	2008 (E)	2009 (E)
China	384	438	498	513
Rest of the World	855	894	865	874
Global Production	1239	1332	1363	1387
China's Share (%)	31%	33%	37%	37%

Source: Reliance Money Research

Iron Ore Imports

Iron Ore Imports (mmt)	2006	2007	2008 (E)	2009 (E)
China	326	384	445	454
Rest of the World	439	451	462	474
Global Trade	765	835	907	927
China's Share (%)	43%	46%	49%	49%

Source: Reliance Money Research

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The China Story

China is the major consumer of the iron ore. It accounts for about 50% of the iron ore trade. In CY07 China shared 46% of the global iron ore trade and is expected to share 49% of the iron ore traded for both CY08 and CY09. The annual contracts generally are spread between April to March but on the background of the current developments China Iron and Steel Association (CISA) has been pressing to prepone the contracts to January thus surrendering 3 months of the high priced contracts.

The major Steel makers in China enter into annual contracts with the big three mining majors viz. Vale, Rio and BHP while the rest is procured on both annual contracts and spot markets from Australia, Brazil and India. Out of the total iron ore (104 mmt) exported from India in FY07, 88% was to China. Indian Iron ore exporters enjoyed the freight advantage vis-à-vis the Australians and Brazilians in scenario of high freight charges despite falling short on the quality.

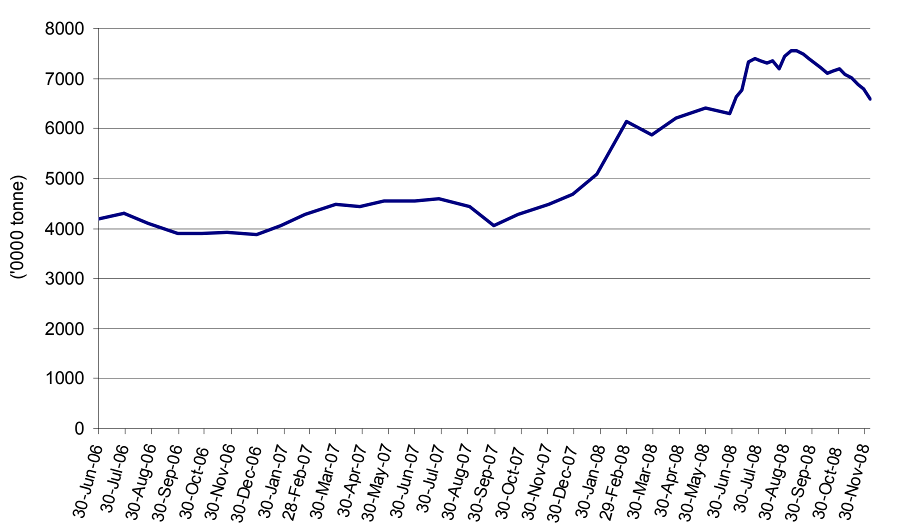
Although, China is expected to produce more Steel in 2009E than in 2008E and import more iron ore, the atmosphere at the time of negotiation of Annual contracts is far different for 2009 negotiation than the 2008 negotiations.

Although, China is expected to produce more Steel in 2009E than in 2008E and import more iron ore, the atmosphere at the time of negotiation of Annual contracts is far different for 2009 negotiation than the 2008 negotiations. Chinese Steel makers are expected to take advantage of the ground reality and squeeze the most from the Iron ore suppliers which will also have its effect on the spot prices.

Deteriorating market conditions seen for steel producers

Flagging demand coupled with credit crunch has caused havoc in the steel industry with steel prices correcting sharply. The Chinese Steel mills which had booked their iron ore consignments at high prices have started reneging on honouring the LC's. The outcome has been rising Iron ore inventory at the Chinese ports.

China Iron Ore Inventory (Port)



Source: Bloomberg

The iron ore inventory had increased from 61 mmt in Mar.'08 to 75 mmt in Sept.'08 and currently has come down to 66 mmt and is far higher than the long term average of 40 mn tonne.

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Expanding Capacity

The big three producers viz. Vale, Rio and BHP contribute 55% of the total Iron ore production and 70% of the sea-borne trade. With sudden spurt in Iron ore prices these along with other smaller players had embarked on massive capacity expansions at prohibitive costs at the time of growing demand. Vale has laid down the plans to enhance the capacity to 420 mmt while Rio-Tinto to 320 mmt by 2012.

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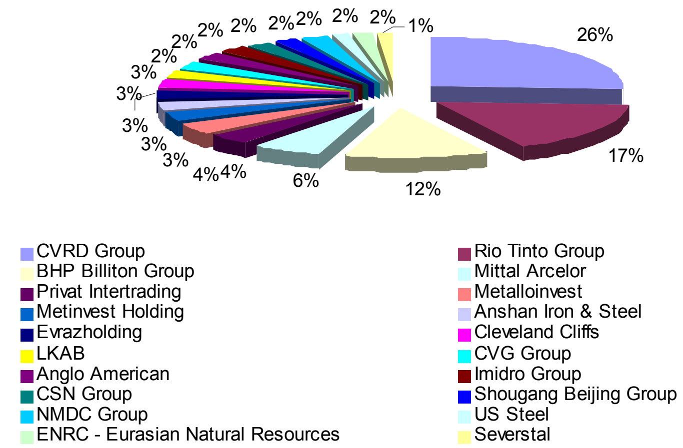
Iron Ore producers



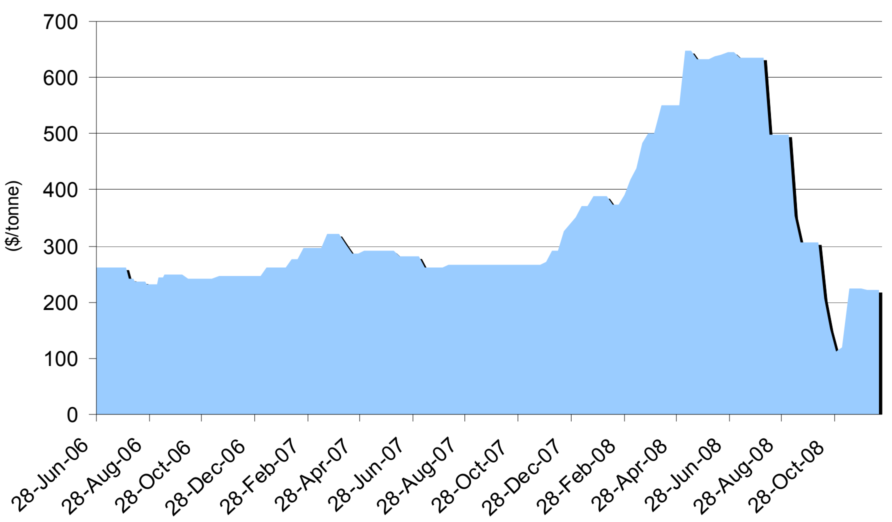
Source: Bloomberg

With sudden sharp cut in prices we expect all the players to go slow on the expansions. In addition, the big players have announced about a 10-15% of the production cut for next 2 quarters. The fall in demand has been steeper than the capacity cuts.

Scrap price fall- Steel production may shift to EAF route

The Steel scrap prices have fallen sharply due to the same reasons of Global meltdown. With the cost of producing Steel through EAF route becoming attractive vis-à-vis BOF route in face of high Iron ore prices, the production will shift to the former route. Globally EAF route is responsible for 34% of the total Steel production although it is only 10% in China. This fact will weigh in the negotiations that are expected in January'09.

Steel H1 Scrap (US East Coast)



Source: Bloomberg

The sharp cut in freight rates has whittled down the Indian exporter's freight advantage over its Brazilian and Australian counterparts.

Falling freight- Indian miners loosing advantage

Baltic Dry Index- an indicator of shipping rates for Dry bulk commodities have nosedived all the way from 11000 odd level to sub-800 level. The freight charge for a tonne of Iron ore from Brazil to China has fallen from $100/tonne to around $25/tonne while that from Australia has come down to $18/tonne from $50/tonne. The sharp cut in freight rates has whittled down the Indian exporter's freight advantage over its Brazilian and Australian counterparts.

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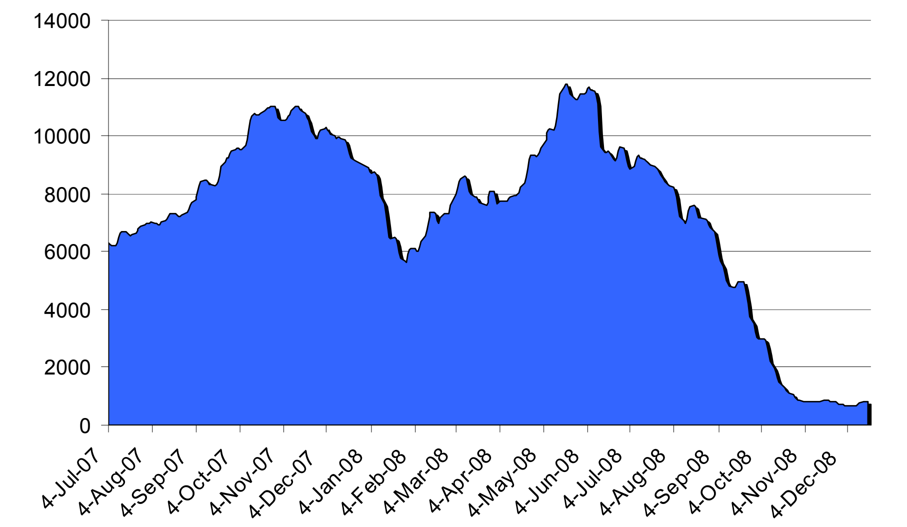
Baltic Dry Index



Source: Bloomberg

Recent Efforts by GoI to pep up Iron ore exports

In first week of Dec.'08, the duty structure was again tweaked to elimination of duty on iron ore fines and reducing the 15% ad-valorem on lumps to 5%.

The iron ore exports industry has always been mangled in the tussle between the Steel producers and the Iron ore exporters. Government of India had imposed a 15% ad-valorem export duty on the Iron ore exports and changed it to Rs. 200/tonne in late Oct.'08. The duty structure was again changed to 8% ad-valorem on fines and 15% ad-valorem on lumps in first half of Nov.'08. Recently, in first week of Dec.'08, the duty structure was again tweaked to elimination of duty on iron ore fines and reducing the 15% ad-valorem on lumps to 5%. The change in duty structure has made Indian iron ore competitive in the Global market.

Cost Break-up for fines @ 8% Export Duty

Exchange Rate (Rs/$)	47.5	47.5	47.5	47.5	47.5
Iron Ore ($/tonne)	45	50	60	70	75
Transportation (Rs./tonne)	325	325	325	325	325
Port Handling	168	168	168	168	168
Spillage Cost	205	205	205	205	205
Export duty (on Realization)- 8%	171	190	228	266	285
Royalty @ Rs. 19/tonne	19	19	19	19	19
Railway Freight (Rs./tonne)*	800	800	800	800	800
Admin. & Selling cost	125	125	125	125	125
Mining Cost	500	500	500	500	500
CSR	15	15	15	15	15
Total Cost (Wet)	2328	2347	2385	2423	2442
Moisture @ 7%	163.0	164.3	167.0	169.6	170.9
Analysis Cost	7	7	7	7	7
Total Dry Cost	2498	2518	2559	2600	2620
Realizations	2138	2375	2850	3325	3563
EBIDTA	-360	-143	291	725	943
EBIDTA (%)	-16.9%	-6.0%	10.2%	21.8%	26.5%

Source: Company / Reliance Money Research

Contd...

Cost Break-up for fines after the elimination of Export duty

Exchange Rate (Rs/$)	47.5	47.5	47.5	47.5	47.5
Iron Ore ($/tonne)	45	50	60	70	75
Transportation (Rs./tonne)	325	325	325	325	325
Port Handling	168	168	168	168	168
Spillage Cost	205	205	205	205	205
Export duty- Nil	0	0	0	0	0
Royalty @ Rs. 19/tonne	19	19	19	19	19
Railway Freight (Rs./tonne)*	800	800	800	800	800
Admin. & Selling cost	125	125	125	125	125
Mining Cost	500	500	500	500	500
CSR	15	15	15	15	15
Total Cost (Wet)	2157	2157	2157	2157	2157
Moisture @ 7%	151	151	151	151	151
Analysis Cost	7	7	7	7	7
Total Dry Cost	2315	2315	2315	2315	2315
Realizations	2138	2375	2850	3325	3563
EBIDTA	-177	60	535	1010	1248
EBIDTA (%)	-8.3%	2.5%	18.8%	30.4%	35.0%

** Assuming 600 kms of transport of Iron ore to port (an approx. distance between Barbill in Orissa and Haldia port (WB), Source: Reliance Money Research*

The EBIDTA margins of Iron ore miners are highly sensitive to the spot prices along with the exchange rate.

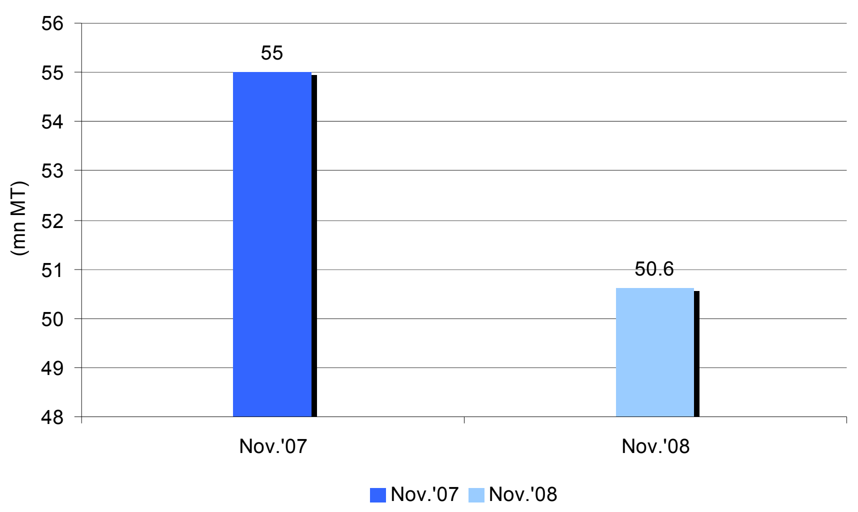
The effect of removal of export tax on the bottom lines of the miners can be seen from the cost structure for the miners given in above tables. With the removal of the export duty, the margins improved substantially. The EBIDTA margins of Iron ore miners are highly sensitive to the spot prices along with the exchange rate. Any fall in the spot prices below $50/tonne will make losses for the Indian Iron ore exporters who are having their cost of production in second and third quartile of cost curve which ranges from $25/tonne to $65/tonne.

The Railway freight is a major cost for the miners as most of the Iron ore mines are located deep in the hinterland far from the ports. Attempts are being made to reduce the burden of haulage charges by the Railways.

The exports of Indian ore have dropped by about 9% (YoY) for the 8 months ended Nov.'08 owing to drop in demand from China- the main importer of Indian ore.

The exports to China in FY08 were 104 mmt and were expected to surpass in FY09. But the global financial debacle has belied all the earlier targets and the annual export target has been revised to about 82 mmt. The exports of Indian ore have dropped by about 9% (YoY) for the 8 months ended Nov.'08 owing to drop in demand from China- the main importer of Indian ore. The miners have hit by both the price and the volumes of export.

Iron ore exports



Source: Bloomberg

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Although, the efforts of GoI to make the Indian iron ore competitive in Global markets have borne fruits, the unfolding Chinese demand would be far more critical to volumes of Indian Iron ore exports.

Although, the efforts of GoI to make the Indian iron ore competitive in Global markets have borne fruits, the unfolding Chinese demand would be far more critical to volumes of Indian Iron ore exports. Any cut in demand will have a negative impact on the prices and hence the margins. Sources tell us that currently Chinese demand is quite robust and they are even procuring the low grade ore for pelletization plants but in future the growth in demand will take a hit at the time when the cycle takes turn as by that time Chinese Steel mills would be well stocked up for their requirements.

The upcoming negotiations for Annual Iron ore will also have an impact on the spot prices. The annual contract prices are expected to have a cut of anywhere in between 50-65% of last year's contract prices which were around $158/tonne. Though a part of it is already priced in the spot prices, further downside cannot be negated.

The annual contract prices are expected to have a cut of anywhere in between 50-65% of last year's contract prices which were around $158/tonne.

Thus, keeping in mind the fluid Global Economic scenario, impending recession/ deflation in developed economies and its impact on Steel and Iron ore industry, dwindling iron ore demand and hence the prices, the margins of companies in this sector would be under pressure. We, maintain a '***Negative***' outlook on this sector.

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Sesa Goa Ltd

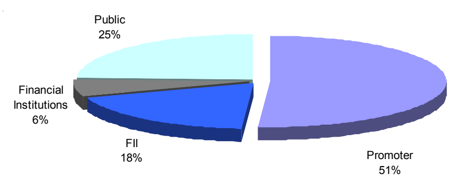
SELL

Price:	**Rs.84**
12M Target Price:	**Rs.66**
% Upside / (Downside)	**(22%)**

Stock details	
BSE Code	500295
NSE Code	SESAGOA
Reuters Code	SESA.BO
Bloomberg Code	SESA.IN
Market Cap (Rs bn)	66.2
Free Float (%)	48.8
52-wk Hi/Lo (Rs)	219.5/60
Avg Daily Vol (BSE)	1942633
Avg Daily Vol (NSE)	4439206
Shares o/s (mn) FV Rs 1	787.2

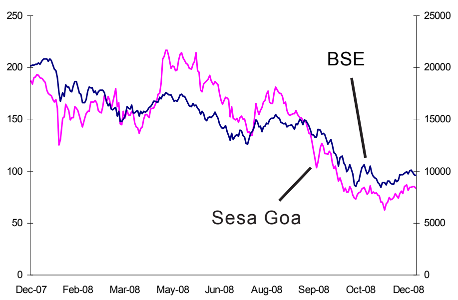
Source:Reliance Money Research

Shareholding pattern (30th Sept 2008)



Source:Reliance Money Research

Stock Performance (Rel to sensex)



Source: Capitaline

Too ambitious a target……

Sesa Goa has embarked on expansion spree with a Sales volume target of 25 mn tonne of Iron Ore by FY11. The company had clocked 12 mn tonne for FY08 and 4.64 mn tonne for H109, the idea of the company missing its targets (about 15 mn tonne) for FY09 looks to be closer to reality in current inclement scenario of flagging Chinese demand which looks to be worsening next year. The Chinese demand for Iron ore had risen 18% for CY07, 16% for CY08 and we assume the growth to drop to 2% for CY09. We have assumed a sale of approx. 12 mn tonne and 13.3 mn tonne for FY09E and FY10E respectively, despite the odds and the price cuts. Secondly, Sesa Goa is mainly into an export of low grade Iron ore i.e. less than 63.5% Fe content, which is a draw back- qualitatively.

Macro and Micro-Indicators are not favourable…..

Indian Exporters have been complaining of arm twisting tactics practiced by the Chinese importers in face of the sudden crash in the spot Iron ore market. Instances of dishonoring of LC's, reneging on contracts and delay in payments have become rampant-of late due to dismal business prospects and tight liquidity. For the first time in six years the 71 Chinese Steel Mills (59% of total steel mills) have recorded losses of RMB 5.84 bn (US$ 0.85 bn) in October '08.

The pain will continue….

China- the major importer of Iron ore is expected to bargain hard in the upcoming Iron ore annual price negotiation expected in January '09. Chinese economy is not expected to fare well in FY10 as it is an export oriented economy depending on the US and European markets who themselves are in the line of fire. Hence the prospects of Steel industry, on which the Iron ore exports depend, do not look very bright in the near medium term.

Recommend a SELL…

We expect Sesa Goa to register a top line of Rs 46.6 bn (up 29.4% YoY), an EBIDTA of Rs 22.8 (Up by just 4.8% YoY) and adjusted EPS of Rs. 22.9 for FY09E and Rs. 42.5 bn (down by 8.8% YoY), an EBIDTA of Rs 18.4 bn (YoY cut of 19%) and an adjusted of EPS of Rs 19 (17% reduction (YoY). We expect the EBIDTA margins to correct by 1150 bps (YoY) in FY09E to 48.9% and down by 550 bps (YoY) in FY10E to 43.4%. The stock is currently trading at a P/E of 4.5x and EV/ EBIDTA of 1.5x for FY10E. Although, the company is quite cash rich, the growth prospects in the near future look capped considering a weaker Chinese market ahead. We, hence, expect the stock to under perform and recommend a SELL with a price target of Rs 66 at which the stock would quote at 0.75x EV/EBIDTA on FY10E. The target price is at 22% below the CMP of Rs 84.

Financials Summary

Rs. Mn

Y/E March	FY07	FY08	FY09E	FY10E
Revenues	20,238	36,022	46,623	42,521
Rev. Growth (%)	14.2%	78.0%	29.4%	-8.8%
EBIDTA	8,611	21,749	22,800	18,453
EBIDTA margins (%)	42.55%	60.38%	48.90%	43.40%
Net Profit	6,047	14,894	18,003	14,987
EPS (Rs.)	7.7	19.0	22.9	19.0
CEPS (Rs.)	8.1	19.5	23.5	19.8
EV/EBIDTA (x)	-0.6	0.2	1.6	1.5
EV/Sales (x)	-0.27	-0.47	0.80	0.66
RoE (%)	43.7%	66.2%	48.8%	29.3%
RoCE (%)	43.6%	66.2%	48.8%	29.3%
P/E (x) @ Rs 84*	10.9	4.4	3.7	4.4
P/CEPS (x) @Rs.84*	10.4	4.3	3.6	4.2

Source: Company / Reliance Money Research

*Note : *Sesa Goa has an expanded equity due to bonus issue in FY09*

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Profit & loss statement (Rs mn)

Year to Mar	FY07	FY08	FY09E	FY10E
Net Sales	20,238	36,022	46,623	42,521
% Growth	14.2%	78.0%	29.4%	-8.8%
EBIDTA	8,611	21,749	22,800	18,453
% Growth	10.0%	152.6%	4.8%	-19.1%
Interest	22	15	1	0
Depreciation	313	426	519	596
PBT	8999	22369	23910	19983
% Growth	11.5%	148.6%	6.9%	-16.4%
Tax	2934	7449	5906	4996
PAT	6064	14920	18003	14987
% Growth	12.4%	146.0%	20.7%	-16.8%
Dividend (%)	400%	450%	250%	250%
EPS (Rs) adjusted*	7.7	19.0	22.9	19.0
BVPS (Rs.) adjusted*	19.1	35.5	55.5	71.7

Balance sheet (Rs mn)

Year to Mar	FY07	FY08	FY09E	FY10E
Equity Cap	394	394	787	787
Reserves	14670	27518	42914	55687
Net worth	15064	27911	43701	56475
Total Loans	0	0	0	0
Deferred Tax Liability	521	535	761	834
Total Liability	521	535	761	834
Net Block	3829	3981	6036	6422
Investments	8678	20004	22004	32004
Inventory	2550	2635	5874	7253
Debtors	2271	4431	7664	10485
Cash Balance	144	132	6693	5957
Total Current Liabilities	2373	3399	4768	6013
NCA	2918	4303	15974	18188
Total Assets	15585	28446	44462	57309

Ratio Analysis

Year to Mar	FY07	FY08	FY09E	FY10E
OPM (%)	42.5%	60.4%	48.9%	43.4%
NPM (%)	29.9%	41.3%	38.6%	35.2%
RoE (%)	43.7%	66.2%	48.8%	29.3%
RoCE (%)	43.6%	66.2%	48.8%	29.3%
Int. Coverage (x)	397	1440	45600	NA
D/E (x)	0.00	0.00	0.00	0.00
Asset Turnover (x)	2.9	4.3	3.5	2.2
Debtors' days	41	45	60	90
Creditors' days	29	34	40	60
Inventory Days	80	67	90	110
Valuation Ratios				
P/ CEPS (x) adjusted*	10.4	4.3	3.6	4.2
EV/ EBIDTA (x)	-0.6	0.2	1.6	1.5
Mkt Cap/ Sales (x)	0.2	0.1	1.4	1.6
CEPS (Rs.) adjusted*	8.1	19.5	23.5	19.8
P/ BV (x) adjusted*	4.4	2.4	1.5	1.2

** Adjusted for bonus and split. Source: Reliance Money Research*

Cash Flow Statement (Rs mn)

Year to Mar	FY07	FY08	FY09E	FY10E
PAT	6064	14920	18003	14987
Depreciation	313	426	519	596
Change in WC	(120)	(1397)	(5110)	(2950)
Operating CF	6257	13949	13412	12634
Investments	(3517)	(11326)	(2000)	(10000)
Capex	(957)	(410)	(2863)	(1229)
Misc. Exp	(54)	(167)	0	0
Investing CF	(4527)	(11903)	(4863)	(11229)
Equity	(17)	(0)	0	0
Others	43	14	226	73
Dividends	(1825)	(2072)	(2214)	(2214)
Debt	(98)	0	0	0
Financing CF	(1897)	(2058)	(1988)	(2141)
Net Change	(167)	(13)	6561	(736)
Opening Cash	311	144	132	6693
Closing Cash	144	132	6693	5957

H109 Performance

(Rs Mn)	H109	H108	% Change (YoY)
Production (mmt)	7.13	4.74	50.4%
Sales Volume (mmt)	4.64	3.43	35.3%
Revenues	21060	7,853	168.2%
EBIDTA	11,637	2,738	325.0%
EBIDTA margins (%)	55.3%	34.9%	
Interest	0.5	0.2	150.0%
Depreciation	197	180	9.1%
PBT	12582	2923	330.4%
Tax	3074	913	236.6%
Net Profit	9508	2,010	373.1%
NPM (%)	45.1%	25.6%	-
Adjusted EPS (Rs.)	12.1	2.6	-

Source: Reliance Money Research

Reliance Money Stock Rating

Rating	Stock Performance
BUY	Appreciate more than 15% in next 12 months
HOLD	Appreciate upto 15% in next 12 months
REDUCE	Depreciate upto 10% in next 12 months
SELL	Depreciate More than 10% in next 12 months

Reliance Money:
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