

## Equities

5 January 2012 | 10 pages

# Sesa Goa (SESA.BO)

## Sell: Still Cloudy

- Company Update
- Target Price Change
- Estimate Change

- **Export duty hike** — Export duty on iron ore has been hiked from 20% to 30% wef from 30 Dec11. We and some parts of the market expected a hike in the fiscal budget, but it has come in earlier. Our global commodities team believes this change is unlikely to have a material impact on global ore prices as the market is fixated on weakening macro events. However, it adds strength to the cost support level we see sitting around \$120-130/t (FOB China). While the Indian iron ore industry is pushing for a roll back, we feel it is unlikely. We cut our target price to Rs159 (from Rs169).
- **Sell: concerns remain** — While one of the major risks (higher export duty) has played out, we believe risk on the value of the ore business continues to be meaningful: 1) Ongoing investigation into Goa mining; 2) uncertainty in Karnataka (Supreme Court hearing on 20Jan2012); 3) draft mining bill (FY14 PAT could fall 5%); 4) SFIO probe. While Cairn India now accounts for 85% (75% earlier) of the stock value limiting downside, we would buy Cairn directly until we have clarity on iron ore mining.
- **Estimate changes** — Our consolidated PAT estimates have been raised by 7-22% for FY12-14 due to the 31-58% increase in associate income (Cairn India's contribution). Excluding associate income, we have raised FY12 PAT by 3%, but cut FY13-14 PAT by 5-6% to incorporate higher export duty, offset to an extent by a weaker rupee and slightly higher volumes. Our TP of Rs159 is based on DCF: Rs25/sh (excl Cairn, Rs41/sh earlier) and Rs134/sh (vs Rs128) for Sesa's 20% stake in Cairn India (based on a 15% discount to Citi's Cairn TP).
- **Sensitivity** — FY13 PAT rises 0.8% for a 1% increase in prices, 0.5% for a 1% rise in volumes; rises 1.4% if Rs/\$ rate depreciates 1% (including Cairn India's PAT).
- **Upside risks** — Higher ore prices/reserves; uninterrupted mining in Goa; restart of Karnataka mining; rupee depreciation; lower duties; upside from Cairn India.

<b>Sell</b>	<b>3</b>
Price (05 Jan 12)	Rs164.30
Target price	Rs159.00
	<i>from Rs169.00</i>
Expected share price return	-3.2%
Expected dividend yield	1.5%
<b>Expected total return</b>	<b>-1.7%</b>
Market Cap	Rs142,793M
	US\$2,701M

### Price Performance (RIC: SESA.BO, BB: SESA IN)



Figure 1. Sesa Goa (Consolidated) – Statistical Abstract

Y/E	Net Profit	EPS	EPS growth	P/E	EV/EBITDA	ROE
	(Rsm)	(Rs)	(%)	(x)	(x)	(%)
31 March						
FY08	15,416	19.6	137%	8.4	4.7	52%
FY09	19,881	25.3	29%	6.5	3.8	42%
FY10	26,291	31.6	25%	5.2	2.7	33%
FY11	42,225	48.6	54%	3.4	1.1	33%
FY12E	30,521	35.1	-28%	4.7	4.9	20%
FY13E	46,454	53.5	52%	3.1	3.9	23%
FY14E	44,508	51.2	-4%	3.2	3.6	19%

Source: Company Reports and Citi Investment Research and Analysis estimates. Price as on 5 Jan 2012.

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Fiscal year end 31-Mar	2010	2011	2012E	2013E	2014E
<b>Valuation Ratios</b>					
P/E adjusted (x)	5.2	3.4	4.7	3.1	3.2
EV/EBITDA adjusted (x)	3.4	1.5	1.5	0.7	-0.6
P/BV (x)	1.7	1.1	0.9	0.7	0.6
Dividend yield (%)	2.0	2.1	1.5	2.4	2.3
<b>Per Share Data (Rs)</b>					
EPS adjusted	31.64	48.58	35.12	53.45	51.21
EPS reported	31.64	48.58	35.12	53.45	51.21
BVPS	95.28	147.40	179.62	228.43	275.29
DPS	3.25	3.50	2.50	4.00	3.75
<b>Profit &amp; Loss (Rsm)</b>					
Net sales	58,583	92,051	77,979	91,370	88,289
Operating expenses	-27,842	-40,952	-43,920	-58,811	-63,497
<b>EBIT</b>	<b>30,741</b>	<b>51,099</b>	<b>34,059</b>	<b>32,559</b>	<b>24,793</b>
Net interest expense	-555	-901	-2,254	-1,579	-529
Non-operating/exceptionals	4,260	5,399	3,216	1,680	2,636
<b>Pre-tax profit</b>	<b>34,446</b>	<b>55,597</b>	<b>35,021</b>	<b>32,660</b>	<b>26,900</b>
Tax	-8,056	-13,372	-9,990	-9,923	-8,190
Extraord./Min.Int./Pref.div.	-99	0	5,490	23,717	25,798
<b>Reported net income</b>	<b>26,291</b>	<b>42,225</b>	<b>30,521</b>	<b>46,454</b>	<b>44,508</b>
Adjusted earnings	26,291	42,225	30,521	46,454	44,508
Adjusted EBITDA	31,486	52,063	35,113	34,060	26,474
<b>Growth Rates (%)</b>					
Sales	18.1	57.1	-15.3	17.2	-3.4
EBIT adjusted	23.4	66.2	-33.3	-4.4	-23.9
EBITDA adjusted	23.9	65.4	-32.6	-3.0	-22.3
EPS adjusted	25.3	53.6	-27.7	52.2	-4.2
<b>Cash Flow (Rsm)</b>					
<b>Operating cash flow</b>	<b>25,713</b>	<b>35,335</b>	<b>31,809</b>	<b>45,109</b>	<b>42,914</b>
Depreciation/amortization	745	964	1,053	1,501	1,681
Net working capital	1,791	-3,037	872	-1,264	-725
<b>Investing cash flow</b>	<b>-14,397</b>	<b>-3,736</b>	<b>-145,103</b>	<b>-3,049</b>	<b>-1,894</b>
Capital expenditure	-1,490	-9,841	-11,744	-4,730	-4,531
Acquisitions/disposals	-17,132	0	-136,575	0	0
<b>Financing cash flow</b>	<b>26,821</b>	<b>-4,197</b>	<b>31,465</b>	<b>-29,520</b>	<b>-19,033</b>
Borrowings	23,806	0	35,000	-27,000	-15,000
Dividends paid	-2,072	-3,387	-3,535	-2,520	-4,033
<b>Change in cash</b>	<b>38,138</b>	<b>27,401</b>	<b>-81,830</b>	<b>12,539</b>	<b>21,987</b>
<b>Balance Sheet (Rsm)</b>					
<b>Total assets</b>	<b>112,382</b>	<b>156,037</b>	<b>213,484</b>	<b>232,460</b>	<b>258,591</b>
Cash & cash equivalent	69,566	96,968	15,138	27,673	49,656
Accounts receivable	3,381	6,830	5,783	6,721	6,485
Net fixed assets	7,812	16,698	27,389	30,617	33,466
<b>Total liabilities</b>	<b>32,772</b>	<b>27,933</b>	<b>57,379</b>	<b>33,933</b>	<b>19,337</b>
Accounts payable	7,268	11,692	6,981	8,870	9,383
Total Debt	19,606	9,995	44,994	17,994	2,994
<b>Shareholders' funds</b>	<b>79,610</b>	<b>128,104</b>	<b>156,105</b>	<b>198,527</b>	<b>239,254</b>
<b>Profitability/Solvency Ratios (%)</b>					
EBITDA margin adjusted	53.7	56.6	45.0	37.3	30.0
ROE adjusted	41.6	40.7	21.5	26.2	20.3
ROIC adjusted	84.5	93.6	47.2	38.9	26.7
Net debt to equity	-62.8	-67.9	19.1	-4.9	-19.5
Total debt to capital	19.8	7.2	22.4	8.3	1.2

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## Estimate Changes

Figure 2. Estimate Revisions – FY12-14E

	FY12E			FY13E			FY14E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Iron ore sales volumes (m tonnes)	15.6	16.1	4%	16.8	17.4	4%	18.6	19.3	4%
Iron ore avg realization (US\$/t)	85	86	1%	82	83	1%	74	75	1%
Iron ore avg realization (Rs/t)	4,066	4,185	3%	4,057	4,289	6%	3,472	3,651	5%
Rs/US\$ rate	47.9	48.6		49.2	51.4		47.1	49.0	
<b>Standalone</b>									
Net sales (Rs bn)	58.4	61.8	6%	68.7	74.5	8%	67.2	72.3	8%
EBITDA (Rs bn)	27.7	27.8	1%	29.2	27.7	-5%	23.3	21.3	-9%
Associate income (Rs bn)	3.9	5.2	31%	14.1	22.3	58%	15.7	24.3	55%
Net profit (Rs bn)	22.9	24.6	7%	32.7	40.1	23%	31.1	38.8	25%
<b>Consolidated</b>									
Net sales (Rs bn)	73.6	78.0	6%	84.1	91.4	9%	81.9	88.3	8%
EBITDA (Rs bn)	34.8	35.1	1%	36.2	34.1	-6%	29.1	26.5	-9%
<b>Net profit before associate income (Rs bn)</b>	<b>24.4</b>	<b>25.0</b>	<b>3%</b>	<b>23.9</b>	<b>22.7</b>	<b>-5%</b>	<b>20.0</b>	<b>18.7</b>	<b>-6%</b>
Associate income (Rs bn)	4.2	5.5	31%	15.0	23.7	58%	16.7	25.8	55%
<b>Net profit (Rs bn)</b>	<b>28.5</b>	<b>30.5</b>	<b>7%</b>	<b>38.9</b>	<b>46.5</b>	<b>19%</b>	<b>36.6</b>	<b>44.5</b>	<b>22%</b>
No. of shares	869.1	869.1	0%	869.1	869.1	0%	869.1	869.1	0%
EPS (Rs)	32.8	35.1	7%	44.8	53.5	19%	42.1	51.2	22%

Source: Citi Investment Research and Analysis

Figure 3. Export Duty Changes

### Export Duty Regime – A Changing Landscape

Feb-07	Specific export duty on all ore grades
Jun-08	15% ad-valorem duty on all ore grades
Oct-08	Rs200/t on fines; 15% ad-valorem duty on lumps
Nov-08	8% ad-valorem duty on fines; 15% ad-valorem duty on lumps
Dec-08	No duty on fines; 5% ad-valorem duty on lumps
Dec-09	5% ad-valorem duty on fines; 10% ad-valorem duty on lumps
Apr-10	5% ad-valorem duty on fines; 15% ad-valorem duty on lumps
Feb-11	20% ad-valorem duty on fines; 20% ad-valorem duty on lumps
Jan-12	30% ad-valorem duty on fines; 30% ad-valorem duty on lumps

Source: Citi Investment Research and Analysis

## Valuation

Our target price of Rs159 is based on DCF – Rs25/sh (excl Cairn) and Sesa's 20% stake in Cairn India (Rs134/sh, based on a 15% discount to Citi's Cairn TP). We do not use PE any longer as Sesa's trading history and valuations for global peers may no longer be comparable as Sesa is no longer a pure iron ore play (post the Cairn stake acquisition) and the deal creates ambiguity about management focus and Sesa's own growth plans. With 85% of the value from Cairn, overall stock sensitivity to ore prospects continues to moderate.

### DCF based valuation

We have modeled DCF cash flows out to FY23 based on existing reserves and resources. We do not account for any terminal value due to lack of visibility on future reserves. Our WACC is 13.5 % which is calculated based on a beta of 1.3 (relative to Sensex), a risk free rate of 8.0% and an ERP of 6%, cost of debt of 6.8%, and a target debt to total capital ratio of 25%. Our DCF calculations yield a price of Rs25/share (excluding Cairn India).

Figure 4. DCF Valuation - Sesa Goa (Excluding Cairn India)

	FY12E	FY13E	FY14E	FY15E	FY16E	FY17E	FY18E	FY19E	FY20E	FY21E	FY22E	FY23E
EBITDA	35,113	34,060	26,474	22,632	20,323	16,381	14,109	11,382	9,846	8,374	6,632	6,265
WC Changes	872	-1,264	-725	516	-486	-392	-845	-687	-837	-895	-911	-1,047
Capex	-11,744	-4,730	-4,531	-4,468	-4,539	-4,530	-3,843	-3,834	-3,574	-3,635	-3,675	-3,769
Cash tax	-9,039	-9,383	-7,357	-6,271	-5,509	-4,235	-3,464	-2,587	-2,075	-1,586	-1,029	-878
FCFF	15,201	18,684	13,861	12,409	9,789	7,224	5,957	4,274	3,361	2,258	1,016	571
Firm Value (Rs m)	40,708											
Net Debt (Rs m)	19,529	Excludes cash from Cairn India										
Market cap (Rs m)	21,179											
No. of shares (m)	869											
<b>Value per share (Rs)</b>	<b>25</b>											

Source: Citi Investment Research and Analysis estimates

Figure 5. WACC Estimation

Risk free rate (%)	8%
Equity risk premium (%)	6%
Beta	1.3
Cost of equity	15.8%
Cost of debt (post tax)	6.8%
Target debt to total capital (%)	25%
WACC (%)	13.5%

Source: Citi Investment Research and Analysis

Figure 6. Valuation Sensitivity

WACC	Derived Price (Rs/share)
11%	28
12%	26
13%	25
14%	24
15%	23

Source: Citi Investment Research and Analysis estimates

## Sesa's 20% holding in Cairn India

Figure 7. Cairn India value per Sesa share

Citi Cairn India target price per share (Rs)	358
Sesa's ownership in Cairn India (m shares)	384
<b>Cairn India value per Sesa share (Rs) – 15% discount</b>	<b>134</b>

Source: Citi Investment Research and Analysis estimates

## Global Iron Ore comps

Global majors are currently trading in a range of 7-9x FY13/CY12PE.

Figure 8. Global Valuations

	YE	Ticker	Rating	MKT Cap (US\$ m)	CMP (LC)	TP (LC)	EPS (LC)		P/E (x)		EV/EBITDA (x)	
							CY12 FY12	CY13 FY13	CY12 FY12	CY13 FY13	CY12 FY12	CY13 FY13
BHP Billiton	30-Jun	BHP.AX	1	120,591	36.2	48	370.6	414.0	10.1	9.1	5.2	4.8
Rio Tinto	31-Dec	RIO.AX	1	28,527	63.2	100	793.3	792.5	8.3	8.3	2.8	2.5
Vale	31-Dec	VALE.N	1	74,459	23.4	33	3.5	3.4	6.7	6.9	4.3	4.3
Fortescue	30-Jun	FMG.AX	1	14,913	4.6	7	0.7	0.6	7.0	8.3	5.2	6.5
Kumba	31-Dec	KIOJ.J	2	20,800	524.5	450	61.9	63.5	8.5	8.3	4.5	4.6

Source: Citi Investment Research and Analysis estimates. Price as on 4 Jan 2012.

## Sesa Goa

### Company description

Sesa Goa, one of India's largest private sector iron ore companies was established in 1954. On 23 April 2007, Vedanta Resources plc purchased Mitsui's 51% stake in it, and it owns ~55% of Sesa Goa. Sesa Goa's mines based in Goa (including Dempo) accounted for ~76% of volumes in FY10, Karnataka for 14% and the balance from Orissa. The majority of its iron ore reserves are in the form of fines. However, as mining was banned in Karnataka by the Supreme Court since August 2011 and Sesa Goa has terminated its third-party contract in Orissa in November 2010, iron ore mining activity by Sesa Goa is only taking place in Goa. Sesa Goa's reserves and resources were 306m tonnes as on 31 Mar11 (excluding Orissa). Sesa Goa's old target was to achieve a production/sales volume in Goa/Karnataka of 40m tpa of iron ore in FY14. Given the above developments, this will be difficult to achieve and we expect production to fall 21% yoy to 14.8mt in FY12 and reach 17.9mt in FY13. In addition to iron ore, Sesa Goa manufactures coke. The merger of Sesa Industries (88% pig iron subsidiary) with Sesa Goa was completed in Feb11. In FY11, iron ore accounted for 91% of Sesa Goa's consolidated net sales, pig iron 7% and met coke 2%. Sesa invested \$2.6bn to acquire 20% in Cairn India in 2011. Sesa Goa acquired 51% stake in Western Cluster, Liberia for US\$90m, (potential resources of 1bn tonnes; ~330mt saleable products). Sesa expects the first shipment in FY14.

### Investment strategy

We maintain Sell on the back of: 1) our cautious view on ore prices – we expect spot prices to average ~US\$130/t in 2HFY12 (vs US\$168/t in 2QFY12) and forecast an 8% yoy fall in spot prices in FY13; 2) a slower clearance process for iron ore mines in India due to illegal mining issues. Only 15% of the value lies with iron ore; Sesa Goa is no longer a pure iron ore play, due to its recent acquisition of Cairn India, an oil play. While one of the major risks (higher export duty) has played out, downside risks remain: 1) volume disruption worries in Goa as there is an ongoing investigation into illegal mining; 2) concerns on Karnataka mining restart as the Supreme Court is yet to announce a decision on which mines will restart in the state; 3) impact of the draft mining bill which is soon to be introduced in Parliament and which seeks to double the royalty payable by non-coal mining companies; if passed in its current form could result in Sesa Goa's FY14 PAT falling 5%; 4) an on-going probe by the Serious Fraud Investigation Office (SFIO). The stock appears cheap and 85% of the value is from its Cairn India holding (20%). However, given the above risks, we recommend buying Cairn India directly, till clarity emerges for iron ore mining.

### Valuation

Our Rs159 target price is based on DCF – Rs25/sh (excluding Cairn) and Sesa's 20% stake in Cairn India (Rs134/sh, based on a 15% discount to Citi's Cairn TP). We do not use PE any longer as Sesa's trading history and valuations for global peers may no longer be comparable. Sesa is no longer a pure iron ore play (post the Cairn stake acquisition) and the deal creates ambiguity and uncertainty about management focus and Sesa's own growth plans. With 85% of the value from Cairn, overall stock sensitivity to ore prospects continues to moderate.

### Risks

Key upside risks to our investment thesis on Sesa Goa are: Higher ore prices/reserves; uninterrupted mining in Goa; restart of Karnataka mining; further rupee depreciation; lower royalty/export duty; upside from Cairn India.

# Appendix A-1

## Analyst Certification

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#### Sesa Goa (SESA.BO)

##### Ratings and Target Price History Fundamental Research

Analyst: Raashi Chopra, CFA  
Covered since April 19 2010



	Date	Rating	Target Price	Closing Price
1	29-Jan-09	3H	*75.00	81.05
2	26-Aug-09	*3M	*203.00	221.15
3	15-Apr-10	3M	*402.00	458.35

	Date	Rating	Target Price	Closing Price
4	21-Jun-10	3M	*327.00	387.60
5	17-Aug-10	3M	*317.00	319.70
6	7-Oct-11	Stock rating system changed		

	Date	Rating	Target Price	Closing Price
7	9-Dec-11	*3	*169.00	175.00

\* Indicates change

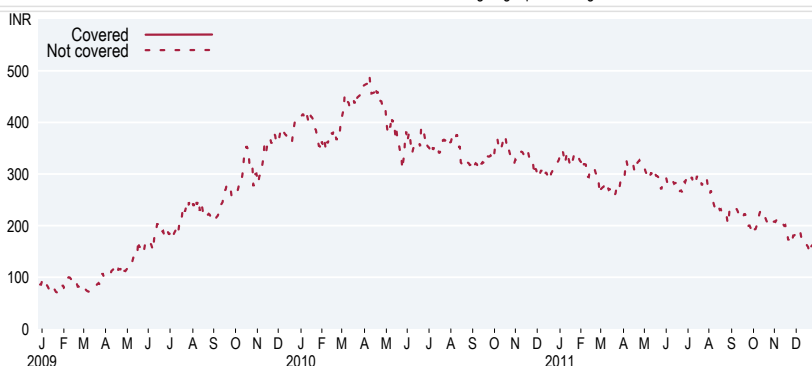
Rating/target price changes above reflect Eastern Standard Time

#### Sesa Goa (SESA.BO)

##### Ratings and Target Price History Best Ideas Research

##### Relative Call (3 Month)

Analyst: Raashi Chopra, CFA  
Covered since April 19 2010



\* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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<i>Data current as of 31 Dec 2011</i>	12 Month Rating			Relative Rating		
	Buy	Hold	Sell	Buy	Hold	Sell
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<i>% of companies in each rating category that are investment banking clients</i>	45%	41%	40%	49%	43%	41%

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