

SESA GOA

INR 3,593

Structural change underway

BUY



Sesa Goa's iron ore business (which contributes ~ 95% of the company's profits) is undergoing a structural change with significant increase in both spot mix and total production volume. Based on discussions with the management, we understand that the contract: spot mix of 70:30 in the previous fiscal (FY07) is moving to a 50:50 mix. To this end, Sesa Goa has stopped selling its incremental production on contract basis i.e., it is being sold only on spot. Considering that current spot realizations (net for the miner) are about 2.0-2.3x that of contract, average realizations are expected to experience a quantum jump of 42% in FY08E and 31% in FY09E. While the management is targeting this mix for the current fiscal (FY08), we are assuming this to materialize only by next fiscal (FY09). Sesa Goa has mining capacity of 15 mtpa, but production was in the 10–11 mtpa range for the past three years up to FY07. The management is undertaking debottlenecking initiatives and is targeting to increase production to 14-15 mtpa in FY09 with a contract: spot mix of 50:50. We are assuming a more modest increase to 13.5 mt by FY09.

Sesa Goa is also looking to expand its pig iron capacity from 0.25 mtpa currently to 1 mtpa, which is expected to be set up by Q2FY10E. Coke capacity will be correspondingly increased from 0.28 mtpa currently to 1.1 mtpa at the same time, since an estimated 65% of the coke produced is consumed captively for pig iron production. We have assumed around 25% capacity utilization in FY10E from the additional capacity of coke and pig iron.

*** Outlook and valuations: Structural changes positive; upgrading to 'BUY'**

Traded iron ore markets are expected to be tight for the next two years considering robust demand outlook and supply side tightness. Further, going forward, we believe the Vedanta Group will attempt to aggressively scale Sesa Goa in multiple ways, including through acquisition of additional iron ore mines. The signs are evident in the way the iron ore business is changing and the proposed expansion of pig iron and coke capacities. Sesa Goa, being a debt-free company with total cash on balance sheet of over INR 10 bn, has enough leveraging capacity to meet expansion plans without fresh equity dilution. Considering all the above, Sesa Goa's EPS is expected to witness robust growth up to FY10E (49% CAGR over FY07 to FY10E). We are, hence, upgrading the stock to 'BUY' from 'REDUCE'. In the current environment for iron ore, we expect Sesa Goa to trade 10-12x our FY09E EPS which is ~INR 433 per share.

Financials (consolidated)

Year to March	FY07	FY08E	FY09E	FY10E
Revenues (INR mn)	22,179	33,548	47,150	60,094
Rev growth (%)	20.2	51.3	40.5	27.5
EBITDA (INR mn)	9,628	15,712	24,237	31,257
Net profit (INR mn)	6,461	10,964	17,027	21,188
Shares outstanding (mn)	39.4	39.4	39.4	39.4
EPS (INR)	164	279	433	538
EPS growth (%)	13.2	69.7	55.3	40.1
P/E (x)	21.9	12.9	8.3	6.7
EV/EBITDA (x)	13.8	8.1	4.7	3.3
ROE (%)	46.9	53.9	53.5	48.4

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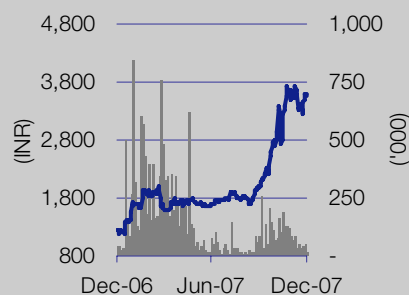
Reuters : SESA.BO
Bloomberg : SESA IN

Market Data

52-week range (INR) : 3,940 / 1,135
Share in issue (mn) : 39.4
M cap (INR bn/USD mn) : 141.4 / 3,581.2
Avg. Daily Vol. BSE/NSE ('000) : 402.2

Share Holding Pattern (%)

Promoters : 51.2
MFs, Fls & Banks : 10.0
Fls : 21.1
Others : 17.7



Our assumptions of contract and spot mix for iron ore sales volume as well as net realizations for FY08E to FY10E are provided in table 1 below. We are assuming a 35% increase in contract iron ore prices for FY09E. Negotiations between major iron ore producers and steel players are currently on and estimates for increase in contract prices range from 30% to 50%. Hence, the risk to our 35% assumption is more on the upside rather than on the downside.

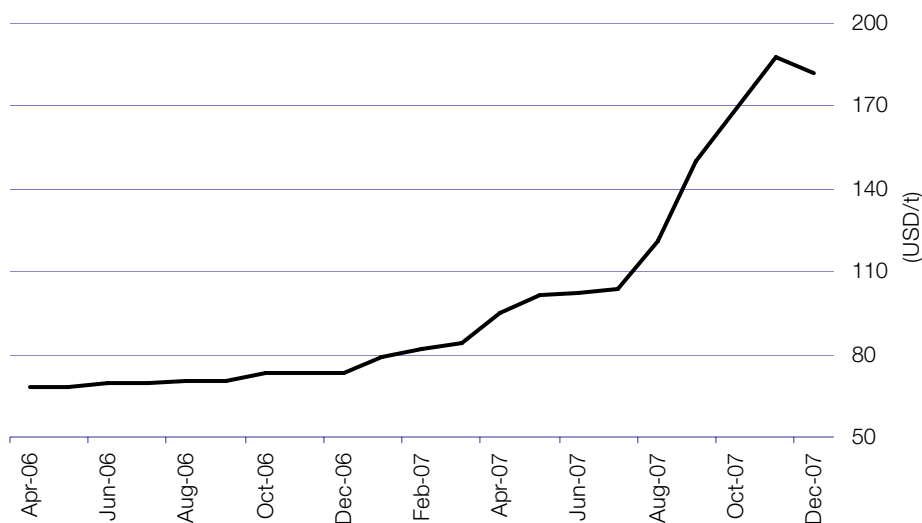
Table 1: Significant increase in average realisations

	FY07	FY08E	FY09E	FY10E
Spot proportion (%)	30	37	48	50
Contract proportion (%)	70	63	52	50
Spot net realisation - USD/t		80	95	95
Incr. in spot realisation (%)			19	0
Contract net realisation - USD/t		43	58	64
Incr. in contract realisation (%)			35	10
Blended net realisation - USD/t	37	57	76	80
Blended net realisation - INR/t	1,624	2,299	3,000	3,142
Incr. in blended realisation (%)		42	31	5

Source: Company, Edelweiss research

China accounts for close to 60% of the company’s iron ore exports and hence, has a major influence on Sesa Goa’s realizations. In this fiscal, China spot prices are up from USD 95/t cif in April 2007 to about USD 182/t cif currently (an increase of 92%) as can be seen from Chart 1 below.

Chart 1: Strong increase in China spot iron ore prices since April 2007



Source: Industry, Edelweiss research

Company Description

Sesa Goa is India's largest private sector player in the iron ore sector. In April 2007, Vedanta Resources Plc, acquired 51% controlling stake in the company from Mitsui & Co., Japan. It has operations in Goa, Karnataka, and Orissa with an annual processing capacity of 15 mtpa—*Goa (8.8 mtpa), Karnataka (2.1 mtpa), and Orissa (4.1 mtpa)*, including third party mining. FY07 production of iron ore was 10.7 mt. The company has access to mining reserves and resources of 207 mt. The company is awaiting a prospecting licence for an iron ore mine in Jharkhand (initial estimates suggest reserves of 50 mt), which may get expedited considering the change in management from Mitsui to the Vedanta Group (however, we are not factoring this in at the moment). It also operates a pig iron plant of 250,000 tpa and a met coke plant of 280,000 tpa capacity.

The company exports close to 95% of its iron ore with China accounting for 60% of the total sale volume. The entire coke requirement for pig iron production is met captively.

Investment Theme

Global iron ore prices are witnessing further increase due to robust Chinese demand and supply side constraints. We expect markets to be tight for the next two years with contract price increase of 35% for next year (corresponds to FY09) and 10% for FY10. Sesa Goa's iron ore business is undergoing a structural change with spot proportion increasing from 30% to 50% and production increasing from 10.7 mtpa in FY07 to 13.5 mtpa in FY09E.

Key Risks

Lower-than-anticipated increase in iron ore prices.

Lower-than-expected iron ore production going forward.

Increase in export duty on iron ore.

Rupee appreciation greater than our estimates.

Financial Statements (Consolidated)

Income statement					(INR mn)
Year to March	FY06	FY07	FY08E	FY09E	FY10E
Net sales & operating income	18,445	22,179	33,548	47,150	60,094
Decrease / (increase) in stock	(336)	132	0	0	0
Consumption of raw materials	2,351	2,472	2,810	3,094	4,456
Purchase of ore	1,604	2,060	2,597	3,360	3,920
Personnel expenses	435	534	615	707	778
Consumption of stores	1,196	1,360	1,845	2,593	3,305
Other expenses	4,569	5,993	9,969	13,159	16,378
Total operating expenses	9,819	12,551	17,836	22,913	28,838
EBITDA	8,625	9,628	15,712	24,237	31,257
Depreciation	296	393	448	454	787
EBIT	8,330	9,236	15,264	23,783	30,470
Interest expenses	42	30	0	0	0
Other income	294	451	1,123	1,666	2,520
Profit before tax	8,582	9,657	16,387	25,449	32,989
Taxes	2,833	3,147	5,340	8,293	11,621
Net profit before minority	5,748	6,510	11,047	17,156	21,368
Minority Interest	36	49	83	129	181
Net profit	5,712	6,461	10,964	17,027	21,188
Shares outstanding (mn)	39	39	39	39	39
Dividend per share (INR)	40	40	55	60	60
Dividend payout (%)	31.2	28.0	22.7	16.0	11.4

Common size metrics- as % of net revenues

Year to March	FY06	FY07	FY08E	FY09E	FY10E
Operating expenses	53.2	56.6	53.2	48.6	48.0
Depreciation	1.6	1.8	1.3	1.0	1.3
Interest expenditure	0.2	0.1	0.0	0.0	0.0
EBITDA margins	46.8	43.4	46.8	51.4	52.0
Net profit margins	31.0	29.1	32.7	36.1	35.3

Growth metrics (%)

Year to March	FY06	FY07	FY08E	FY09E	FY10E
Revenues	20.3	20.2	51.3	40.5	27.5
EBITDA	15.7	11.6	63.2	54.3	40.0
PBT	19.8	12.5	69.7	55.3	40.1
Net profit	20.7	13.2	69.7	55.3	40.1
EPS	20.7	13.2	69.7	55.3	40.1

Balance sheet					(INR mn)
As on 31st March	FY06	FY07	FY08E	FY09E	FY10E
Equity capital	394	394	394	394	394
Reserves & surplus	11,081	15,697	24,236	38,655	59,958
Shareholders funds	11,475	16,091	24,629	39,048	60,352
Secured loans	2	0	0	0	0
Unsecured loans	96	0	0	0	0
Deferred tax liability	604	649	748	904	1,125
Minority interest	144	193	276	404	564
Miscellaneous exp. not written off	0	0	0	0	0
Sources of funds	12,322	16,933	25,652	40,357	62,041
Gross block	5,807	7,219	8,237	8,358	14,479
Depreciation	2,350	2,622	3,070	3,525	4,312
Net block	3,457	4,597	5,167	4,833	10,167
CWIP	615	202	0	0	0
Total fixed assets	4,072	4,799	5,167	4,833	10,167
Investments	4,742	8,454	13,592	25,835	39,526
Loans and advances	333	391	919	1,292	1,646
Inventories	3,321	2,985	5,974	8,397	10,702
Sundry debtors	2,474	2,708	4,596	6,459	8,232
Cash and equivalents	373	212	460	646	823
Total current assets	6,501	6,297	11,949	16,793	21,404
Sundry creditors and others	1,593	1,305	2,757	3,875	4,939
Provisions	1,401	1,312	2,298	3,229	4,116
Total CL & provisions	2,994	2,617	5,055	7,105	9,055
Net current assets	3,507	3,680	6,894	9,688	12,348
Uses of funds	12,322	16,933	25,652	40,357	62,041
Book value per share (BV) (INR)	292	409	626	992	1,533

Cash flow statement					(INR mn)
Year to March	FY06	FY07	FY08E	FY09E	FY10E
Profit before tax	8,582	9,657	16,387	25,449	35,661
Depreciation	296	393	448	454	787
Interest paid	(209)	(413)	-	-	-
Tax paid	(2,657)	(3,236)	(5,242)	(8,137)	(11,400)
Add/Less: Other adjustments	(24)	(17)	83	129	160
(Incr)/Decr in working capital	(1,688)	(239)	(2,966)	(2,609)	(2,482)
Cash flow from operations (A)	4,300	6,145	8,710	15,287	22,726
Net purchase of fixed assets	(949)	(1,117)	(816)	(121)	(6,121)
Net purchase of investments	(1,702)	(3,709)	(5,138)	(12,243)	(13,691)
Add/Less: Other adjustments	226	416	-	-	-
Cash flow from investing (B)	(2,425)	(4,409)	(5,954)	(12,364)	(19,812)
Dividend paid (incl div tax)	(1,559)	(1,800)	(2,509)	(2,737)	(2,737)
Add/Less: Other adjustments	(121)	(96)	-	-	-
Cash flow from financing (C)	(1,679)	(1,896)	(2,509)	(2,737)	(2,737)
Net incr./decr) in cash (A)+(B)+(C)	196	(161)	247	186	177
Opening cash balance	177	373	212	460	646
Closing cash balance	373	212	460	646	823

Ratios

Year to March	FY06	FY07	FY08E	FY09E	FY10E
ROE (%)	60.0	46.9	53.9	53.5	48.4
ROACE (%)	80.0	63.1	71.7	72.1	64.7
Current ratio	2.0	2.3	2.3	2.3	2.3
Debtors (days)	49	45	50	50	50
Fixed assets t/o (x)	4.5	4.6	6.5	9.8	5.9

Valuations parameters

Year to March	FY06	FY07	FY08E	FY09E	FY10E
EPS (INR)	145.1	164.1	278.5	432.6	538.3
<i>Y-o-Y growth (%)</i>	<i>20.7</i>	<i>13.2</i>	<i>69.7</i>	<i>55.3</i>	<i>40.1</i>
CEPS (INR)	153.6	175.4	292.0	447.4	562.9
P/E (x)	24.8	21.9	12.9	8.3	6.7
Price/BV (x)	12.3	8.8	5.7	3.6	2.3
Market cap/Sales (x)	7.7	6.4	4.2	3.0	2.4
EV/Sales (x)	7.4	6.0	3.8	2.4	1.7
EV/EBITDA (x)	15.8	13.8	8.1	4.7	3.3

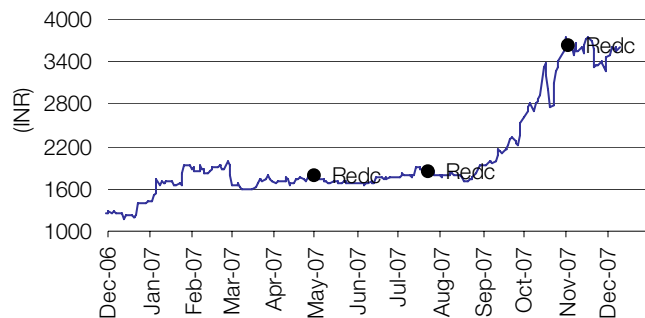
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Coverage group(s) of stocks by primary analyst(s): *Metals & Mining:*

Adhunik Metaliks, Bhushan Steel & Strips, Hindalco Industries, Hindustan Zinc, Jindal Stainless, Jindal Steel & Power, JSW Steel, Monnet Ispat and Energy, National Aluminium Company, Sesa Goa, Steel Authority of India, Sterlite Industries (India), Tata Steel, Usha Martin

Sesa Goa



Recent Research

Date	Company	Title	Price (INR)	Recos
29-Nov-07	Adhunik Metaliks	<i>Riches from the earth... abd above; Company Update</i>	167	Buy
7-Nov-07	Monnet Ispat	IPP financial closure in sight; 395 <i>Event Update</i>		Buy
2-Nov-07	Usha Martin	On track; <i>Result Update</i>	89	Buy
2-Nov-07	Hindalco Industries	Challenges continue; <i>Result Update</i>	188	Reduce

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Accumulate	Reduce	Sell	Total
Rating Distribution*	103	47	22	3	190

* 13 stocks under review / 2 rating withheld

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	96	65	29

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 20% over a 12-month period
Accumulate	appreciate up to 20% over a 12-month period
Reduce	depreciate up to 10% over a 12-month period
Sell	depreciate more than 10% over a 12-month period

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