

OCTOBER 25, 2011
RESULT

Coverage view: **Attractive**

Price (Rs): **211**

Target price (Rs): **215**

BSE-30: **17,255**

A weak quarter. Sesa's reported 2QFY12 EBITDA of Rs2.6 bn declined 14.3% yoy and missed our below-consensus estimate. Realization of US\$84/tonne was lower than our estimate even after accounting for shift in mix of ore towards Karnataka mine. Net income of Rs12.8 mn was further impacted by forex loss of Rs2.3 bn. We model revised iron ore price forecast in our estimates and lower our FY2012-14E earnings estimate by 5-9% and target price to Rs215. Regulatory uncertainty, implementation of mining tax and correction in iron ore prices are additional headwinds. REDUCE.

Company data and valuation summary

Sesa Goa

Stock data

52-week range (Rs) (high,low)	364-189
Market Cap. (Rs bn)	189.0

Shareholding pattern (%)

Promoters	55.1
FIs	24.4
MFs	0.8

Price performance (%)

	1M	3M	12M
Absolute	2.0	(24.9)	(37.1)
Rel. to BSE-30	(4.5)	(17.9)	(26.0)

Forecasts/Valuations

	2011	2012E	2013E
EPS (Rs)	47.0	39.3	39.4
EPS growth (%)	59.8	(16.4)	0.2
P/E (X)	4.5	5.4	5.4
Sales (Rs bn)	92.1	94.9	104.2
Net profits (Rs bn)	42.2	35.1	35.4
EBITDA (Rs bn)	51.5	49.1	49.4
EV/EBITDA (X)	3.7	4.4	3.5
ROE (%)	36.8	19.5	17.6
Div. Yield (%)	1.9	1.9	1.9

A struggle to find positives

Sesa's 2QFY12 EBITDA of Rs2.6 bn (-14.3% yoy) was 16.8% lower than our estimate on account of lower-than-expected realizations at US\$84/tonne versus our estimate of US\$111/tonne. Realization was weak even after accounting shift in mix of ore towards Karnataka mine. Note that yoy EBITDA declined due to (1) export duty increase to 20% on fines as well lumps versus 5% on fines and 15% on lumps in 2QFY11, and (2) decline in iron ore deliveries to 1.55 mn dmt from 1.82 mn tonnes in 2QFY11. Net income of Rs12.8 mn was impacted by Rs2.3 bn of forex losses on FCCBs and overseas borrowings.

Iron ore shipment decline was a function of (1) lower volumes from Goa mines at 0.83 mn tonnes versus 0.92 mn tones, and (2) termination of third-party mining agreement in Orissa. Shipments from Karnataka increased 57.8% yoy to 0.71 mn tonnes.

FY2012E volume guidance maintained at 18 mn tonnes under certain conditions

Sesa maintained volume guidance for FY2012E provided Karnataka operations start by 4QFY12E. Sesa believes there is reasonable progress on the EIA report to be submitted to the Supreme Court by November 6 and is hopeful of starting mining in 4Q. Sesa also provided an update on the progress of the Shah Commission probe into cases of illegal mining in Goa. Sesa has submitted mining details for the past five years and indicated complete compliance on royalty payment and quantum of ore extracted. However, there could be some industry-wide potential action/violation on disposal of waste, encroachment of land and other minor issues which can potentially crop up.

Lower our iron ore price assumptions on fall in prices

We have adjusted our FY2012-14E iron ore price assumptions to US\$150, US\$130 and US\$105/tonne from US\$157, US\$140 and US\$110/tonne earlier. Slowdown in European markets and potential concerns on the strength of demand from China drive the change. We lower our FY2012-14E EPS to Rs36.5, Rs39.4 and Rs33 from Rs40.1, Rs41.6 and Rs34.5 earlier. We lower our target price to Rs215 from Rs230 earlier. We value the core business at Rs118/share. We value the stake in Cairn India at Rs97/share after providing a 20% holding discount. REDUCE.

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Key concerns remain

Sesa continues to face multiple headwinds in the form of (1) potential restriction on mining iron ore in Goa due to several cases of illegal mining. While Sesa is compliant, any action similar to the one in Karnataka will hurt, (2) risk to estimates on iron ore shipments, (3) potential further increase in export duty. Export duty increased to 20% on fines as well lumps in February 2011 versus 15% on lumps and 5% on fines earlier, and (4) imposition of mining tax equivalent to royalty paid. Our FY2013E earnings and EBITDA will reduce by 8.7% and 9.2%, respectively on implementation of the new mining tax. Our fair value will also reduce by Rs20/share.

Balance sheet—net debt increases to Rs33.1 bn

Sesa Goa's long-term debt increased to Rs43.7 bn while net debt increased to Rs33.1 bn. The company took on board additional debt during the quarter in the form of packing credit. Capital expenditure during the quarter amounted to Rs1.5 bn. The company has completed all the formalities and paid the consideration of US\$90 mn on acquisition of a 51% stake in Western Cluster Limited (Liberia). Working capital levels remained high during the quarter as is customary during this seasonally weak monsoon quarter. The company had cash and cash equivalents amounting to Rs10.6 bn and net debt of Rs33.1 bn

Key highlights from 2QFY12 earnings call

- ▶ Total iron ore deliveries for 2QFY12 stood at 1.55 mn dmt despite production at 1.12 mn dmt during the quarter owing to liquidation of inventory. Karnataka accounted for around 0.71 mn tonnes which were entirely sold domestically, while the balance was exported.
- ▶ Coke operations segment reported an EBIT loss of Rs43.1 mn during the quarter. It also included forex loss of Rs250 mn from outstanding payment to coal suppliers.
- ▶ Realization from e-auctions in Karnataka is 7-8% lower than September 2011 quarter realization. Sesa has a total inventory pile-up of 0.8 mn tonnes at Karnataka out of which around ~0.3 mtpa have been sold.
- ▶ The company incurred royalty charges of around Rs325/tonne in 2QFY12 versus Rs230/tonne in 1QFY12.
- ▶ Pig iron production and sales for the quarter was 63 kt and 65 kt, respectively. Volumes were affected during the quarter due to a combination of low availability of iron ore from Karnataka and lower demand from foundries.
- ▶ The 625 ktpa pig iron capacity expansion and associated doubling of metallurgical coke capacity to 560 ktpa are on schedule to be completed during the current quarter.
- ▶ Sesa had acquired a 51% stake in The Western Cluster Project for US\$90 mn in 2QFY12 and has currently applied for an exploration license to carry out a feasibility study, having received ratification from the Legislature of the Republic of Liberia.

Exhibit 1: Interim results of Sesa Goa, March fiscal year-ends (Rs mn)

	2QFY12	2QFY12E	2QFY11	1QFY12	2QFY12E	(% chg.)	
						2QFY11	1QFY12
Net sales	7,841	10,996	9,068	20,947	(28.7)	(13.5)	(62.6)
Total expenditure	(5,297)	(8,087)	(6,150)	(9,615)	(34.5)	(13.9)	(44.9)
(Inc)/Dec in stock	852	—	1,387	1,090	—	(38.5)	(21.8)
Consumption of raw materials	(1,507)	(1,002)	(871)	(974)	50.4	73.1	54.7
Staff costs	(625)	(573)	(466)	(545)	9.2	34.2	14.6
Stores	(719)	(931)	(614)	(913)	(22.7)	17.2	(21.2)
Inland transportation cost	(491)	(858)	(1,739)	(1,203)	(42.7)	(71.8)	(59.2)
Other transportation services	(652)	(938)	(938)	(902)	(30.5)	(30.5)	(27.7)
Purchase of ore	(346)	(325)	(1,068)	(871)	6.6	(67.6)	(60.2)
Export tax	(872)	(1,446)	(527)	(3,454)	(39.7)	65.5	(74.7)
Other expenditure	(938)	(2,114)	(1,346)	(1,922)	(55.6)	(30.3)	(51.2)
Expenses recovered	1	99	32	79	(98.7)	(95.9)	(98.4)
Other operating income	56	215	115	141	(73.9)	(51.4)	(60.4)
EBITDA	2,600	3,124	3,034	11,474	(16.8)	(14.3)	(77.3)
Forex gain/ (loss)	(2,341)	(910)	364	(15)	NM	NM	NM
Other income	504	1,673	1,004	1,521	(69.9)	(49.8)	(66.9)
Interest	(516)	(542)	(140)	(493)	(4.8)	268.4	4.7
Depreciation	(243)	(296)	(194)	(269)	(17.8)	25.2	(9.6)
Pretax profits	4	3,048	4,068	12,217	(99.9)	(99.9)	(100.0)
Extraordinaries	—	—	—	—	—	—	—
Tax	9	(854)	(189)	(3,811)	(101.1)	(104.8)	(100.2)
Net income before minority interest	13	2,195	3,879	8,406	(99.4)	(99.7)	(99.8)
Minority interest	—	—	(30)	—	—	—	—
PAT after minority interest	13	2,195	3,849	8,406	(99.4)	(99.7)	(99.8)
Ratios							
EBITDA margin (%)	33.2	28.4	33.5	54.8	16.7	(0.9)	(39.5)
ETR (%)	NM	28.0	4.6	31.2	NM	NM	NM
EPS (Rs)	0.0	2.5	4.5	9.4	(99.4)	(99.7)	(99.8)
Volume details ('000 tonnes)							
Iron ore sales ('000 dmt)	1,550	1,544	1,817	4,300	0.4	(14.7)	(64.0)
Pig iron	65	58	84	58	11.4	(23.1)	11.4
Realization (US\$/ dmt)							
Iron ore	84	111	84	101	(24.7)	(0.8)	(16.8)
Iron ore EBITDA	34	32	26	56	5.9	30.0	(40.2)
Segmental revenues (Rs mn)							
Iron ore	5,943	7,857	7,124	19,358	(24.4)	(16.6)	(69.3)
Metallurgical coke	1,170	1,540	1,316	1,400	(24.0)	(11.1)	(16.4)
Pig iron	1,866	1,598	1,996	1,631	16.7	(6.5)	14.4

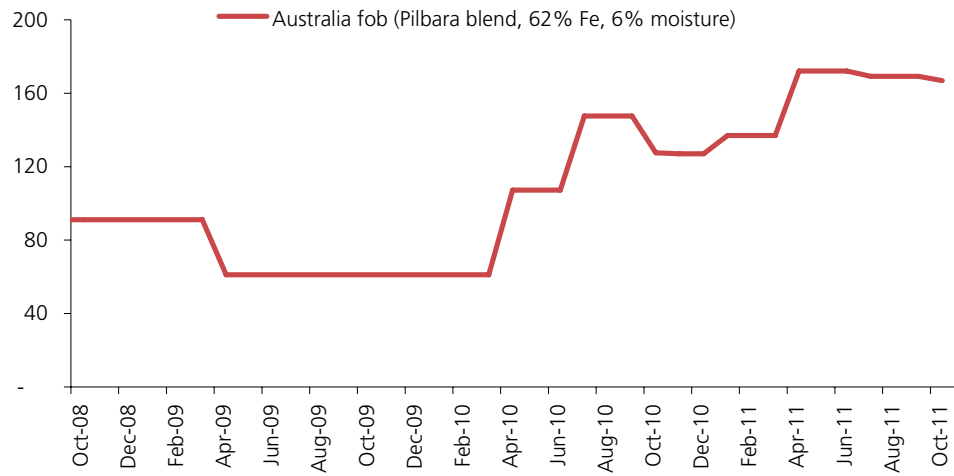
Source: Company, Kotak Institutional Equities estimates

Exhibit 2: Sesa Goa, Change in estimates, March fiscal year ends, 2012-14E (Rs mn)

	Revised estimates			Old estimates			Change (%)		
	2012E	2013E	2014E	2012E	2013E	2014E	2012E	2013E	2014E
Blended iron ore realizations (Rs/tonne)	4,507	3,976	3,127	4,348	4,060	3,106	3.7	(2.1)	0.7
Iron ore volumes ('000 DMT)	16,923	20,534	23,457	17,491	21,238	24,256	(3.2)	(3.3)	(3.3)
Benchmark iron ore price (US\$/tonne)	150	130	105	157	140	110	(4.5)	(7.1)	(4.5)
Net revenues	94,884	104,230	93,498	94,081	107,888	94,685	0.9	(3.4)	(1.3)
EBITDA	49,059	49,373	35,406	50,047	50,974	35,880	(2.0)	(3.1)	(1.3)
PAT	32,671	35,395	29,633	35,864	37,369	31,049	(8.9)	(5.3)	(4.6)
EPS (Rs)	36.5	39.4	33.0	40.1	41.6	34.5	(8.9)	(5.3)	(4.6)
USD INR	47.3	49.8	48.5	44.8	45.6	45.0	5.6	9.0	7.8

Source: Kotak Institutional Equities estimates

Exhibit 3: Australia FOB Pilbara, 62% Fe (6% moisture) price trend (US\$/tonne)



Source: CRU, Kotak Institutional Equities estimates

Exhibit 4: Our DCF-based valuation for Sesa Goa

DCF valuation of Sesa, March fiscal year-ends, 2012E-22E

	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2020E	2021E	2022E
EBITDA	49,059	49,373	35,406	18,376	18,182	17,202	15,424	13,928	12,385	10,788	9,130
Tax expense	(16,092)	(16,031)	(11,213)	(5,407)	(5,272)	(4,877)	(4,214)	(3,646)	(3,062)	(2,459)	(1,837)
Changes in working capital	826	1,703	2,310	(1,122)	(391)	(109)	138	136	134	132	130
Cash flow from operations	33,794	35,045	26,503	11,846	12,519	12,217	11,348	10,419	9,457	8,460	7,423
Capital expenditure	(8,050)	(6,843)	(4,210)	(4,200)	(4,200)	(4,200)	(4,200)	(4,200)	(4,200)	(4,200)	(4,200)
Free cash flow to the firm	25,744	28,203	22,293	7,646	8,319	8,017	7,148	6,219	5,257	4,260	3,223
Discounted cash flow-now	24,370	23,523	16,382	4,951	4,746	4,029	3,165	2,426	1,807	1,290	860
Discounted cash flow-1 year forward	—	26,699	18,594	5,619	5,386	4,573	3,593	2,754	2,051	1,464	976
Discounted cash flow-2 year forward	—	—	21,104	6,378	6,114	5,190	4,078	3,125	2,328	1,662	1,108
Discount rate	13.5%										

	Mar-13
Total PV of free cash flow (a)	71,709
PV of terminal value (b)	—
EV (a) + (b)	71,709
EV (US\$ mn)	1,441
Net debt	(34,491)
Equity value	106,200
No. of shares	899
Implied share price (Rs)	118

	Value	
	(Rs mn)	(Rs/share)
DCF valuation of core business	106,200	118
Add: Value of investments in Cairn India	87,291	97
Arrived market capitalization	193,492	215
Target price (Rs)		215

Source: Kotak Institutional Equities estimates

Exhibit 5: Sesa Goa, Key assumptions (standalone), March fiscal year-ends, 2010-14E (Rs mn)

	2010	2011	2012E	2013E	2014E
Tonnages ('000 dmt)					
Iron ore production	11,543	10,952	9,758	12,495	14,369
Iron ore purchases	5,185	4,029	2,792	2,792	2,792
Iron ore sales	15,177	14,368	12,550	15,287	17,161
Metallurgical coke sales	263	266	344	420	420
Pig Iron sales	270	266	349	500	500
Tonnages ('000 dmt) (consolidated)					
Iron ore production	12,633	13,162	12,189	15,412	17,869
Iron ore purchases	7,445	5,794	4,734	5,122	5,588
Iron ore sales	19,434	18,256	16,923	20,534	23,457
Metallurgical coke sales	263	266	344	420	420
Pig Iron sales	270	266	349	500	500
Realizations					
Weighted average ore realization (Rs/tonne)	2,909	4,665	4,507	3,976	3,127
Average ore realization (US\$/tonne)	53	93	95	80	64
Metallurgical coke prices (Rs/tonne)	13,545	17,731	23,972	23,791	20,472

Source: Company, Kotak Institutional Equities estimates

Exhibit 6: Sesa Goa (consolidated), Profit model, balance sheet and cash flow model, March fiscal year-ends, 2009-2014E (Rs mn)

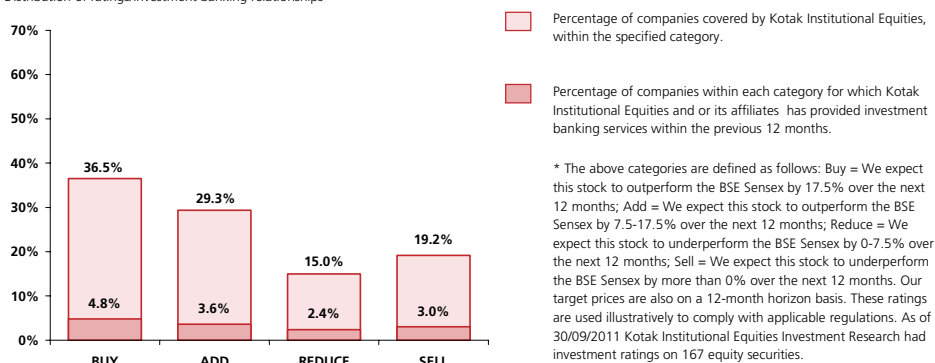
	2009	2010	2011	2012E	2013E
Profit model (Rs mn)					
Net sales	49,591	58,583	92,051	94,884	104,230
EBITDA	25,388	31,448	51,543	49,059	49,373
Other income	2,240	4,260	5,399	5,719	6,536
Interest	(10)	(517)	(381)	(2,789)	(1,851)
Depreciaiton	(517)	(745)	(964)	(1,167)	(1,662)
Profit before tax	27,102	34,446	55,597	50,823	52,395
Taxes	(7,153)	(8,056)	(13,372)	(15,691)	(17,000)
Net profit	19,949	26,390	42,225	32,671	35,395
Minority interest	(68)	(99)	—	—	—
PAT	19,881	26,291	42,225	32,671	35,395
Earnings per share (Rs)	23.9	29.4	47.0	36.5	39.4
Balance sheet (Rs mn)					
Equity	47,157	79,177	128,104	157,231	199,367
Deferred tax liability	664	750	682	682	682
Total Borrowings	19	19,606	9,995	37,180	12,180—
Minority interest	334	433	—	—	—
Current liabilities	5,840	12,400	17,256	11,253	13,577
Total liabilities	54,015	112,366	156,037	206,347	225,806
Net fixed assets	5,930	22,557	31,443	38,326	43,506
Investments	31,252	45,649	87,998	134,704	134,703
Cash	177	23,918	8,970	12,520	26,179
Other current assets	16,656	20,242	27,626	20,796	21,417
Miscellaneous expenditure	0	(0)	—	—	—
Total assets	54,015	112,366	156,037	206,347	225,806
Free cash flow (Rs mn)					
Operating cash flow excl. working capital	18,221	23,922	38,372	28,118	30,522
Working capital changes	3,854	1,791	(3,037)	826	1,703
Capital expenditure	(1,363)	(1,316)	(8,330)	(54,756)	(6,843)
Free cash flow	20,713	24,397	27,005	(25,811)	25,383
Ratios					
Debt/equity (%)	0.0	0.2	0.1	0.2	—
Net debt/equity (%)	(0.7)	(0.8)	(0.8)	0.0	(0.2)
RoAE (%)	52.4	36.1	36.8	19.5	17.6
RoACE (%)	52.4	31.6	32.6	17.7	15.9

Source: Company, Kotak Institutional Equities estimates

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As of September 30, 2011

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