Company

20 July 2010 | 7 pages

Sesa Goa (SESA.BO)

Equity

Sell: 1QFY11 Gains from Prices, Tax Rate; Challenges Ahead

- **1Q beats estimates; but risks ahead** — Sesa Goa reported cons. PAT of Rs13bn, 208% higher YoY driven by a price surge during the quarter. PAT beat consensus and Citi estimates largely due to higher other income (2x our forecast at Rs1.8bn) and lower tax rate (18% vs our 23%). We see challenges both on prices which have declined 18% in a month (with downside risk) and volumes (due to lower demand from China and Sesa's own production constraints). We maintain Sell.
- **Volumes hit; growth targets seem high** — Total iron ore sales volumes grew 15% to 5.4mt (Citi 5.8mt). However on a standalone basis (excl Dempo), volumes fell 10% YoY to 4.2mt. Sales volumes were hit by delayed forest permits (Karnataka), logistic constraints/disruptions in Orissa and Goa. While some issues may be sorted out shortly, risks to Sesa's 20-25% growth target include: mine clearances, agreement renewals (in Orissa) and logistical issues.
- **Prices on a declining trend** — 1Q performance benefited to large extent from a jump in spot iron ore prices (about 75-80% of Sesa's sales). Sesa's average realisations grew 133% to Rs4,086/t ($87) in 1Q. However prices have dropped 33-35% in the past two months, with downside risk as PRC steel output (80-85% of Sesa sales) could fall and Chinese iron ore output has been strong.
- **India-specific risk factors** – 1) A potential ban on iron-ore exports is being debated – but we believe this is unlikely to come through. However the export duty (currently 15% on lumps, 5% on fines) could potentially be raised. 2) The government is trying to aggressively crack down on illegal mining impacting volumes for even those who follow procedures due to delays/disruptions.
- **Sesa's positives** — Given its 50m tpa production target by FY13, Sesa is setting up railway sidings and building road corridors. Tax rate should remain low at 18-20% in FY11. Cash balance is robust at Rs80.5bn (Rs94/share).

Sell/Medium Risk	3M
Price (19 Jul 10)	Rs348.40
Target price	Rs327.00
Expected share price return	-6.1%
Expected dividend yield	1.1%
Expected total return	**-5.0%**
Market Cap	Rs299,520M
	US$6,357M

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

Figure 1. Sesa Goa (Consolidated) – Statistical Abstract

Y/E 31 March	Net Profit (Rsm)	EPS (Rs)	EPS growth (%)	P/E (x)	EV/EBITDA (x)	ROE (%)
FY07	6,431	8.2	14%	40.0	26.1	39%
FY08	15,472	19.7	141%	16.6	10.3	52%
FY09	19,934	25.3	29%	13.7	8.3	42%
FY10E	25,311	30.5	20%	11.4	8.2	30%
FY11E	38,007	42.7	40%	8.1	4.9	28%
FY12E	36,521	41.0	-4%	8.5	4.4	23%

Source: Company Reports and Citi Investment Research and Analysis. Price as on 19 July 2010.

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

Figure 2. Sesa Goa 1Q FY11 results

(Rs m)	1Q FY11	1Q FY10	% chg
Net Sales	23,940	9,986	140%
Expenditure	9,535	5,584	71%
Operating profit	**14,406**	**4,402**	**227%**
Operating profit margin (%)	**60%**	**44%**	
Other income	1,800	881	104%
EBITDA	16,206	5,283	207%
Interest	137.4	20	577%
Depreciation	191.4	152	26%
PBT	15,877	5,110	211%
Tax	2,832	869	226%
% tax rate	18%	17%	
PAT	13,045	4,241	208%
MI	27	18	50%
Reported PAT	**13,018**	**4,223**	**208%**
Eq sh (mn)	859.7	787.2	9%
EPS (Rs)	15.1	5.4	182%
Iron ore production (m tonnes)	6.4	4.7	36%
Iron ore sales (m tonnes)	5.4	4.7	15%

Source: Company Reports and Citi Investment Research and Analysis

Sesa Goa

Company description

Sesa Goa, India's largest private sector iron ore company was established in 1954. On 23 April 2007, Vedanta Resources plc purchased Mitsui's 51% stake in the company, and it currently owns ~56% of Sesa Goa. In June 2009, Sesa Goa acquired 100% of V S Dempo & Co (VSD), an iron ore producer based in Goa. VSD owns/has access to >70m tonnes of iron ore in Goa (taking Sesa Goa's total reserves and resources to 353m tonnes) and its mining assets include processing plant, barges, jetties, transhippers and loading facilities in 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. Over 90% of the ore is exported through ports such as Goa, Chennai, Paradip and Haldia. Sesa Goa is targeting a production/sales volume of 50m tpa of iron ore in FY13. In addition to iron ore, Sesa Goa manufactures coke, while its 88% subsidiary Sesa Industries produces pig iron. In FY09, iron ore accounted for 85% of Sesa Goa's consolidated net sales, pig iron 12% and met coke 3%. 89% of PBIT in FY09 was from iron ore, 8% from met coke and the rest from pig iron.

Investment strategy

We rate Sesa Goa Sell/Medium Risk (3M). Profits are mainly driven by its iron ore business and the company exports more than 90% of its ore, with China the largest market (85% of sales). Spot ore prices have surged 103% in the last year but are down 14% in the last month. We believe that there is further downside based on 1) rising Chinese output; 2) Chinese steel use intensity peaking; 3) steel margin compression. Our China analyst feels current steel output is too high vs. demand; should be scaled back. Traders' inventory is 35% higher than CY09 avg. Sesa Goa is also adversely impacted by the widening discount of 58% Fe grade to 62% grade (70% of its ore is 58% Fe). The discount rose from 17% in FY10 to 31% in late May10 (apparent ban of low grade ore import by China's trading association) and is 25% now. We believe that spot prices will rise 41% yoy for 58% Fe and 56% for 62% Fe. Given its mix, we expect Sesa's FY11 spot prices to rise 45% (vs. 65% earlier) to $78/t.

Valuation

We calculate our TP of Rs327 using a combination of 1) a valuation based on DCF for Sesa Goa and Dempo + EV/EBITDA for Sesa Industries (Rs216/sh) and (2) a 8x core PE (June11) based valuation + cash (Rs400/sh) – with a 40:60 weighting between each methodology. Our DCF value for Sesa Goa standalone is enhanced by 10% to account for potential reserves at Jharkhand (60m tonnes) as we have not accounted for this tonnage in our valuation. We have not taken a terminal value and thus feel a PE value would be justified as it assumes new reserves would replace the ones exhausted. The higher weightage to PE also seems suitable given Sesa Goa's dependence on spot volumes (>80%) and the tendency of the stock price to quickly discount spot iron ore price movements. The 8x PE multiple for Sesa Goa is at the upper end of the current trading range for global majors (6-8.5x). At our TP, Sesa Goa would trade at 7.7x June 11 PE and 4.4x EV/EBITDA.

Risks

We rate Sesa Goa Medium Risk as opposed to the High Risk rating suggested by our quantitative risk-rating system, which tracks 260-day historical share price volatility. Sesa Goa's strong volume growth, low costs (in Goa), EBITDA margins in the range of 45%-55%, potential for cost cutting/synergies from Dempo and net cash position warrant a Medium Risk rating, in our view. Upside risks to our target price include: 1) higher iron ore prices than we expect; 2) significant hike in reserves; 3) competitive acquisitions; 4) low export duties and royalty; 5) depreciation of the rupee versus the US$ vs the appreciation trend that we expect.

Appendix A-1

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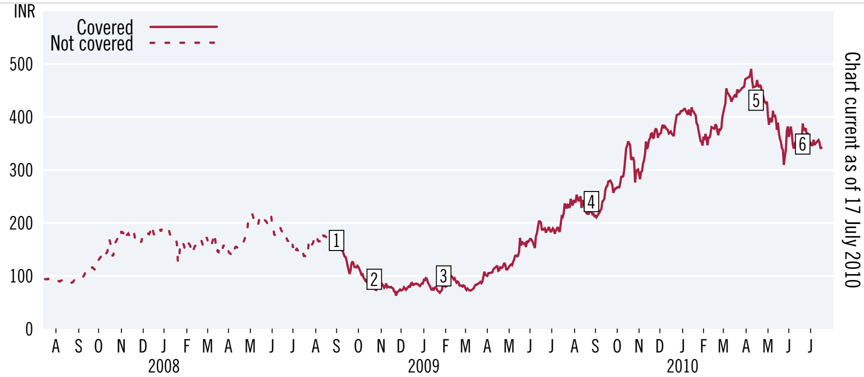
Analyst: Raashi Chopra, CFA
Covered since April 19 2010



	Date	Rating	Target Price	Closing Price
1	1-Sep-08	*3H	*145.00	155.00
2	23-Oct-08	3H	*70.00	76.85
3	29-Jan-09	3H	*75.00	81.05
4	26-Aug-09	*3M	*203.00	221.15
5	15-Apr-10	3M	*402.00	458.35
6	21-Jun-10	3M	*327.00	387.60

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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