

## Industry

4 August 2010 | 6 pages

# Indian Iron Ore Industry

 Equity 

## Illegal Mining Blues

- **Karnataka bans iron ore exports** — The Karnataka government has banned the export of iron ore and transportation of ore out of Karnataka with effect from 29 July 2010, in an attempt to curb illegal mining. The ban follows the earlier ban on iron ore exports from 10 ports in the State (wef 26<sup>th</sup> July). The current export ban should have a more significant impact as Karnataka accounts for ~25% of India's exports of ~110mt while the earlier ban on 10 ports would have affected a very small proportion of volumes. The volume loss for Sesa Goa should offset gains from the 14% jump in iron ore prices (58% Fe, CFR) over the last month.
- **Sesa Goa impacted** — While the ban has been imposed to curb illegal mining, Sesa has also been hit as Karnataka accounts for 17-18% of its volumes. The ban will particularly impact Sesa in 2Q as most of its volumes are from Karnataka and Orissa during the quarter. Volumes from Goa (70% of annual volumes) are negligible in 2Q due to the monsoon. We believe there is downside to Sesa's volume growth target of 20-25%. Our FY11 estimate is +17%. The stock has risen 4% in the last month and we would use this as an opportunity to book profits.
- **Industry body may challenge the ban** — Under the Mines and Minerals (Development and Regulation) Act 1957, the Central Government has empowered State Governments to take action against illegal mining including penalizing transportation of illegally mined minerals. However, it is not clear whether the state has the right to ban iron ore exports given that the ban interferes with India's foreign trade policy and will impact royalties/taxes from iron ore mining. The industry body – Federation of Indian Mineral Industries (FIMI) is planning to contest the ban, but is exploring other options first.
- **India specific risk** — We don't think the ban will last very long as it has impacted legal iron ore mining as well and a solution would be required sooner than later. We however believe that the illegal iron ore mining is clearly on the Government's radar. This may lead to continuing delays and disruptions in getting clearances. There is pressure from the steel industry proposing the ban on export of ore to improve domestic availability. While this does not appear imminent, the export duty (15% on lumps, 5% on fines) could potentially be raised.

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

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## Sesa Goa

(SESA.BO; Rs368.30; 3M)

### 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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Covered since April 19 2010

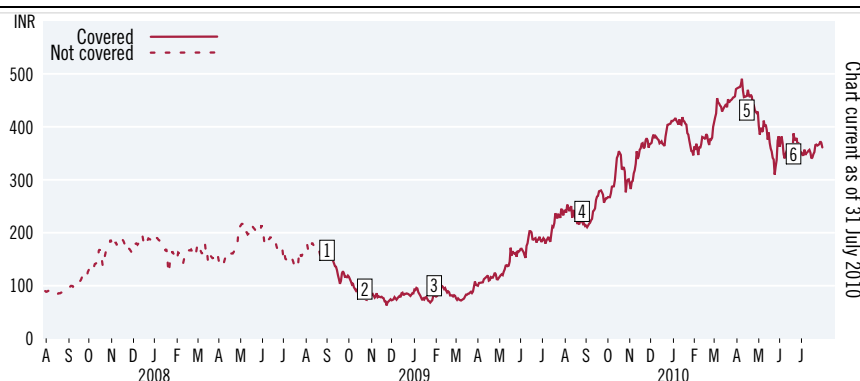


Chart current as of 31 July 2010

|   | Date      | Rating | Target Price | Closing Price |
|---|-----------|--------|--------------|---------------|
| 1 | 1-Sep-08  | *3H    | *145.00      | 155.00        |
| 2 | 23-Oct-08 | 3H     | *70.00       | 76.85         |

|   | Date      | Rating | Target Price | Closing Price |
|---|-----------|--------|--------------|---------------|
| 3 | 29-Jan-09 | 3H     | *75.00       | 81.05         |
| 4 | 26-Aug-09 | *3M    | *203.00      | 221.15        |

|   | Date      | Rating | Target Price | Closing Price |
|---|-----------|--------|--------------|---------------|
| 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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Data current as of 30 Jun 2010

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|--|-----|------|------|
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