

Sesa Goa

29 August 2011

Reuters: SESA.BO Bloomberg: SESA IN

Iron ore mining suspended in Chitradurga, priced in

As anticipated in our report *'Iron ore mining suspension in Chitradurga likely'* dated 22 August 2011, the Supreme Court has ordered suspension of mining in this district of Karnataka. We expect the suspension to last until 31 December 2011, which would result in a 5% and 3% cut in EBITDA and PAT estimates, respectively, for FY12. We revise our TP on the stock downwards from Rs214 to Rs207. However, the stock has corrected 23% since our Sell rating on 24 June 2011 as against an 11% drop in the Sensex during the same period. We believe the stock has already factored in a major portion of the negative news, as it is currently trading at P/E and adjusted EV/EBITDA (after adjusting Cairn India investment at market price) of 3.6x and 1.7x for FY13 compared with the past nine years' average of 5.4x and 2.9x, implying a discount of 30% and 38%, respectively. In view of the ample drop in valuation, we are upgrading the stock from Sell to Hold with a 1% upside from the CMP.

Relief expected in four months: The apex court has directed the survey and demarcation of all mines in Karnataka (order for 99 mines in Bellary district already issued on 6 May 2011). Besides this, it has also directed macro level environment impact assessment (EIA) and submission of reclamation and rehabilitation plan for Chitradurga district. In order to maintain the social balance, the court is proceeding to resolve the matter as soon as possible.

Earnings for FY12 cut, but maintained for FY13: We have cut our FY12 iron ore volume estimate by 7% on mining suspension, which would result in a 6%, 5% and 3% cut in FY12 revenue, EBITDA and PAT estimates, respectively. We expect normalcy to return in 4QFY12 and therefore our FY13 numbers remain unchanged.

Downside limited in case suspension continues until FY13: Our scenario analysis shows there is likely to be a 7% and 23% cut in FY12 and FY13 volume estimates in the case of suspension continuing until FY13. This would lead to a 4% and 12% cut in EBITDA and a 3% and 7% cut in PAT estimates for FY12 and FY13, respectively. In this case, our TP would drop by 9% from Rs207 to Rs188.

Dempo operations - no material impact from recent media reports: Media reports had hinted that Dempo mines faced closure because of improper waste disposal, but the management has indicated a very marginal impact from this. We believe this will hurt future expansion more rather than the ongoing production.

SOTP valuation: Sesa Goa is currently trading at P/E multiples of 4.5x and 3.6x for FY12 and FY13, respectively, while adjusted EV/EBITDA multiples are at 2.3x and 1.7x for the same period, significantly below the past nine years' average multiples of 5.4x and 2.9x, respectively. We marginally revise downwards our core business value estimate from Rs131 to Rs130 and lower Cairn investment value for Sesa Goa from Rs83 to Rs77 due to a drop in Cairn India CMP from Rs270 to Rs253.

Y/E Mar (Rsmn)	FY09	FY10	FY11	FY12E	FY13E
Net sales	49,591	58,583	92,051	86,262	102,987
YoY (%)	29.7	18.1	57.1	(6.3)	19.4
EBITDA	25,421	31,448	52,030	44,674	45,898
EBITDA margin (%)	51.3	53.7	56.5	51.8	44.6
PAT	19,881	26,291	42,135	39,048	49,320
EPS (Rs)	25.3	31.6	48.5	44.9	56.7
YoY (%)	29.0	25.3	53.2	(7.3)	26.3
RoE (%)	42.2	33.2	32.9	23.9	23.7
RoCE (%)	42.4	27.1	31.1	21.8	22.9
P/E (x)	8.1	6.5	4.2	4.5	3.6
Adj. EV/ EBITDA (x)	5.1	3.8	1.7	2.3	1.7

Source: Company, Nirmal Bang Institutional Equities Research

HOLD

Sector: Steel

CMP: Rs204

Target Price: Rs207

Upside: 1%

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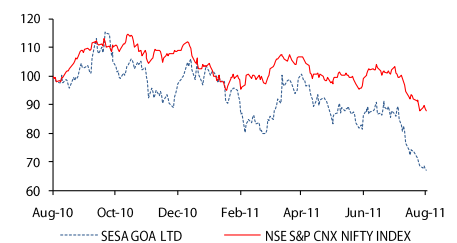
Key Data

Current Shares O/S (mn)	869.1
Mkt Cap (Rsbn/US\$bn)	177.1/3.8
52 Wk H / L (Rs)	384/201
Daily Vol. (3M NSE Avg.)	2,439,695

Shareholding (%)

	1QFY12	4QFY11	3QFY11
Promoter	55.1	55.7	55.7
FII	24.2	24.6	26.9
DII	4.8	4.5	3.4
Corporate	3.2	3.4	2.2
General Public	12.8	11.8	11.9

One Year Indexed Stock Performance



Price Performance (%)

	1 M	6 M	1 Yr
Sesa Goa	(27.1)	(27.9)	(36.5)
Nifty Index	(14.8)	(10.5)	(13.3)

Source: Bloomberg

Exhibit 1: Change in estimates

Description (Rsmn)	Earlier assumption		New assumption		Change (%)	
	FY12	FY13	FY12	FY13	FY12	FY13
Volume						
Iron ore (dmt)	18.6	22.9	17.3	22.9	(6.8)	-
Met coke (tonne)	337,000	512,000	337,000	512,000	-	-
Pig iron (tonne)	323,392	598,750	323,392	598,750	-	-
Realisation (Rs/tonne)						
Iron ore	4,413	3,858	4,416	3,858	0.1	-
Met coke	20,225	19,242	20,225	19,242	-	-
Pig iron	27,026	24,242	27,026	24,242	-	-
Financials (Rsmn)						
Net sales	91,752	102,987	86,262	102,987	(6.0)	-
EBITDA	46,838	45,898	44,674	45,898	(4.6)	-
PAT	40,422	49,372	39,048	49,320	(3.4)	(0.1)

Source: Company, Nirmal Bang Institutional Equities Research

Scenario analysis

Scenario 1: Karnataka operations closed beyond FY13

As stated earlier, we do not believe the iron ore mining suspension will continue for an indefinite period, as it involves very large social costs also in terms of loss of employment in the state. We don't rule out some kind of volume loss due to ongoing investigations. However, our FY13 Karnataka volume estimate is already lower at 5.3mt as compared to FY12 volume guidance of 6.0-7.0mt in a normal operations scenario. Thus, we have already factored the expected volume loss in Karnataka. In this scenario, our TP would drop by 9% from Rs207 to Rs188, which is 8% lower than the CMP.

Exhibit 2: Change in estimates (mining suspension from 26 August 2011 to beyond FY13)

Description (Rsmn)	Earlier assumption		New assumption		Change (%)	
	FY12	FY13	FY12	FY13	FY12	FY13
Volume						
Iron ore (dmt)	17.3	22.9	16.2	17.5	(6.3)	(23.3)
Met coke (tonne)	337,000	512,000	337,000	512,000	-	-
Pig iron (tonne)	323,392	598,750	323,392	598,750	-	-
Realisation (Rs/tonne)						
Iron ore	4,416	3,858	4,432	3,912	0.4	1.4
Met coke	20,225	19,242	20,225	19,242	-	-
Pig iron	27,026	24,242	27,026	24,242	-	-
Financials (Rsmn)						
Net sales	86,262	102,987	81,658	83,327	(5.3)	(19.1)
EBITDA	44,674	45,898	42,942	40,253	(3.9)	(12.3)
PAT	39,048	49,320	37,951	45,792	(2.8)	(7.2)

Source: Company, Nirmal Bang Institutional Equities Research

Scenario 2: Dempo mines closed beyond FY13

As per recent media reports, it appeared that Sesa Goa's Dempo mines are facing issues regarding waste disposal management. However, we do not assume an extreme move like complete mining suspension by the concerned authority, Goa State Pollution Control Board. We believe the final outcome would include corrective measures in order to maintain pollution/wastes under control. However, this would hurt future expansion as the company was looking at increasing its production capacity to 10mt by the end of FY14. Our FY13 volume estimate stands at 5.3mt, which would remain stable in coming years with a marginal upward bias. Assuming an extreme move like complete suspension of Dempo mining operations from 3QFY12 to beyond FY13, it would result in a 19% and 23% volume loss in FY12 and FY13, respectively. This would lead to an 18% and 23% cut in EBITDA and a 13% and 14% reduction in PAT estimates for FY12 and FY13, respectively. In this scenario, our TP would drop by 19% from Rs207 to Rs167, which is 18% lower than the CMP.

Exhibit 3: Change in estimates (Dempo mines closed from 3QFY12 to beyond FY13)

Description (Rsmn)	Earlier assumption		New assumption		Change (%)	
	FY12	FY13	FY12	FY13	FY12	FY13
Volume						
Iron ore (dmt)	17.3	22.9	14.0	17.5	(19.0)	(23.3)
Met coke (tonne)	337,000	512,000	337,000	512,000	-	-
Pig iron (tonne)	323,392	598,750	323,392	598,750	-	-
Realisation (Rs/tonne)						
Iron ore	4,416	3,858	4,424	3,844	0.2	(0.4)
Met coke	20,225	19,242	20,225	19,242	-	-
Pig iron	27,026	24,242	27,026	24,242	-	-
Financials (Rsmn)						
Net sales	86,262	102,987	71,803	82,145	(16.8)	(20.2)
EBITDA	44,674	45,898	36,787	35,309	(17.7)	(23.1)
PAT	39,048	49,320	33,897	42,204	(13.2)	(14.4)

Source: Company, Nirmal Bang Institutional Equities Research

Scenario 3: Both Dempo mines and Karnataka operations closed beyond FY13

We assume a remote possibility of this scenario panning out in the near future i.e. both Dempo mines and Karnataka operations closed on an indefinite basis. This would result in a massive 47% drop in FY13 volume, leading to a 35% and 21% cut in EBITDA and PAT estimates, respectively, for FY13. In this scenario, our TP would drop by 28% from Rs207 to Rs149, which is 27% lower than the CMP.

Exhibit 4: A worst-case scenario (both Dempo mines and Karnataka operations closed beyond FY13)

Description (Rsmn)	Earlier assumption		New assumption		Change (%)	
	FY12	FY13	FY12	FY13	FY12	FY13
Volume						
Iron ore (dmt)	17.3	22.9	12.9	12.2	(25.4)	(46.7)
Met coke (tonne)	337,000	512,000	337,000	512,000	-	-
Pig iron (tonne)	323,392	598,750	323,392	598,750	-	-
Realisation (Rs/tonne)						
Iron ore	4,416	3,858	4,444	3,915	0.6	1.5
Met coke	20,225	19,242	20,225	19,242	-	-
Pig iron	27,026	24,242	27,026	24,242	-	-
Financials (Rsmn)						
Net sales	86,262	102,987	67,200	62,485	(22.1)	(39.3)
EBITDA	44,674	45,898	35,055	29,664	(21.5)	(35.4)
PAT	39,048	49,320	32,801	38,677	(16.0)	(21.6)

Source: Company, Nirmal Bang Institutional Equities Research

Sensitivity analysis of Cairn India investment

Recent turmoil in global markets because of sovereign debt crisis in Europe and rating downgrade of the US by Standard & Poor's had a significant bearing on crude oil prices and thereby on Cairn India's share price. The stock has corrected 32% from its peak in April 2011 and the current market price is 26% below Sesa Goa's average cost of acquisition of Cairn India. The following sensitivity analysis shows Cairn India's value per Sesa Goa share, at various prices. Our back-end calculation depicts the market is giving a 45% discount to Cairn India's one-year forward Bloomberg consensus TP estimate of Rs320.

Exhibit 5: Cairn India value per share of Sesa Goa

		Cairn India share price (Rs)				
		A further 10% drop	A further 5% drop	CMP	Bloomberg TP	Cost
		228	240	253	320	342
Discount (%)	50	50	52	55	70	75
	40	60	63	66	84	90
	30	70	73	77	98	105
	20	80	84	88	112	120
	10	89	94	99	126	135

Source: Nirmal Bang Institutional Equities Research

Exhibit 6: Sesa Goa target price sensitivity

		Cairn India share price (Rs)				
		A further 10% drop	A further 5% drop	CMP	Bloomberg TP	Cost
		228	240	253	320	342
Discount (%)	50	180	182	185	200	205
	40	190	193	196	214	220
	30	200	203	207	228	235
	20	210	214	218	242	250
	10	219	224	229	256	265

Source: Nirmal Bang Institutional Equities Research

Exhibit 7: Upside/(Downside) from CMP

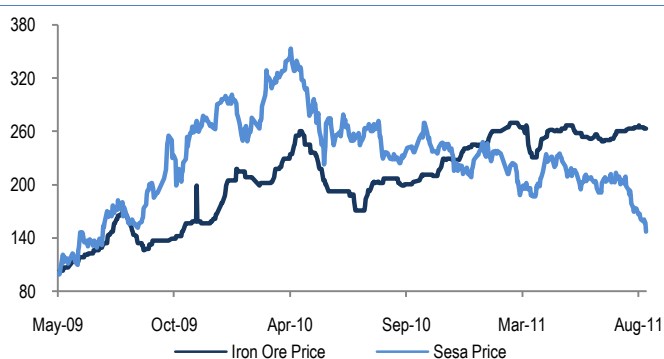
		Cairn India share price (Rs)				
		A further 10% drop	A further 5% drop	CMP	Bloomberg TP	Cost
		228	240	253	320	342
Discount (%)	50	(12.1)	(11.1)	(9.6)	(2.3)	0.2
	40	(7.2)	(5.7)	(4.2)	4.6	7.5
	30	(2.3)	(0.8)	1.1	11.4	14.8
	20	2.6	4.6	6.5	18.3	22.2
	10	7.0	9.5	11.9	25.1	29.5

Source: Nirmal Bang Institutional Equities Research

Sesa Goa stock appears to have discounted a very sharp fall in iron ore prices

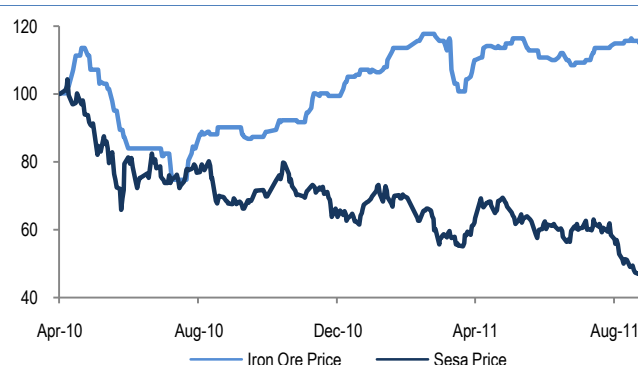
The Sesa Goa stock, being a pure iron ore play, has moved in tandem with iron ore prices. However, from April 2010 onwards iron ore prices have moved up by 15%, but the stock has corrected 67% in the same period. The decline is attributed to various reasons like the expected drop in iron ore prices, lowered volume guidance, closure of Orissa operations, Cairn India acquisition and iron ore mining suspension in Karnataka. We believe the stock has already factored in these negatives and its valuation appears to be attractive. An important point to note here is that our FY13 realisation estimate is 17% lower than 1QFY12 realisation and therefore we see a lower possibility of a downward revision in earnings based on decline in iron ore prices.

Exhibit 8: Iron ore price vs Sesa share price (Indexed)



Source: Bloomberg, Nirmal Bang Institutional Equities Research

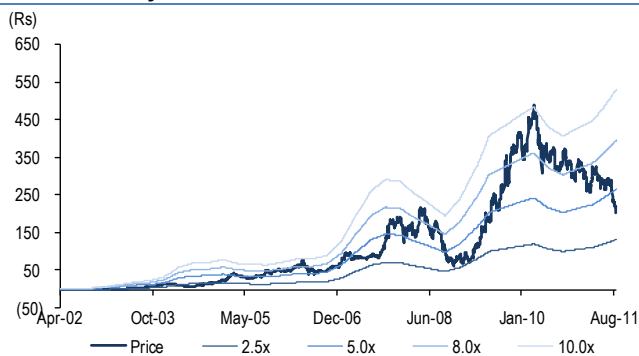
Exhibit 9: Iron ore price vs Sesa share price (from Apr 2010)



Source: Bloomberg, Nirmal Bang Institutional Equities Research

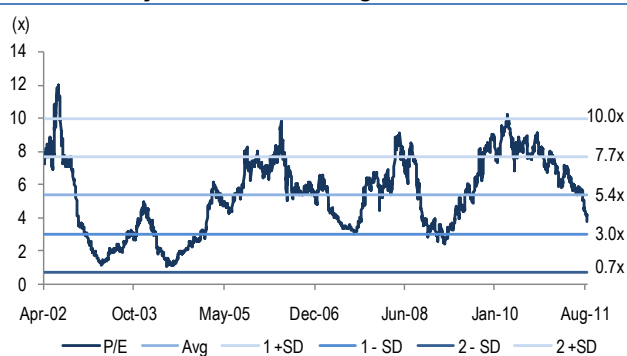
Valuation charts

Exhibit 10: 1-year forward P/E



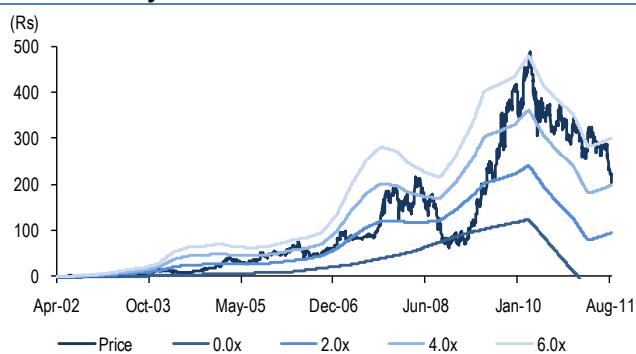
Source: Bloomberg, Nirmal Bang Institutional Equities Research

Exhibit 11: 1-year forward average P/E



Source: Bloomberg, Nirmal Bang Institutional Equities Research

Exhibit 12: 1-year forward EV/EBITDA



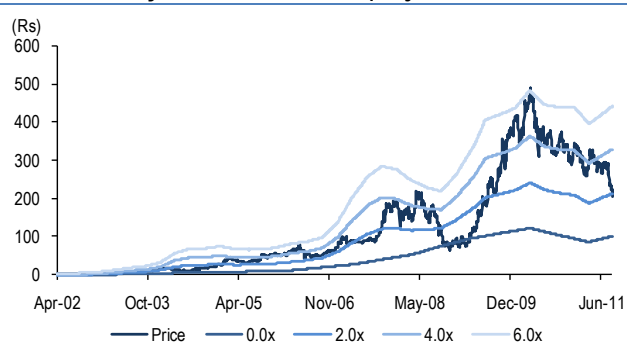
Source: Bloomberg, Nirmal Bang Institutional Equities Research

Exhibit 13: 1-year forward average EV/EBITDA



Source: Bloomberg, Nirmal Bang Institutional Equities Research

Exhibit 14: 1-yr fwd. EV/EBITDA (Adj. Cairn India investment)



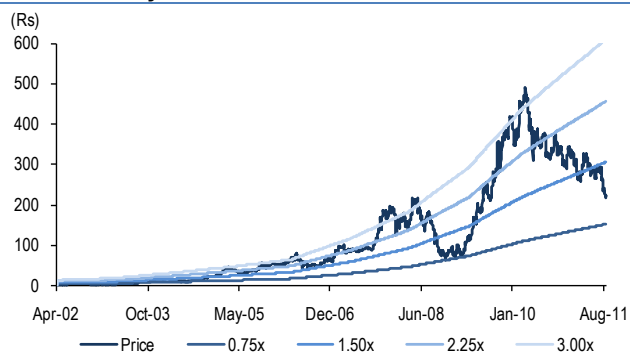
Source: Bloomberg, Nirmal Bang Institutional Equities Research

Exhibit 15: 1-yr fwd. avg. EV/EBITDA (Adj. Cairn India invest.)



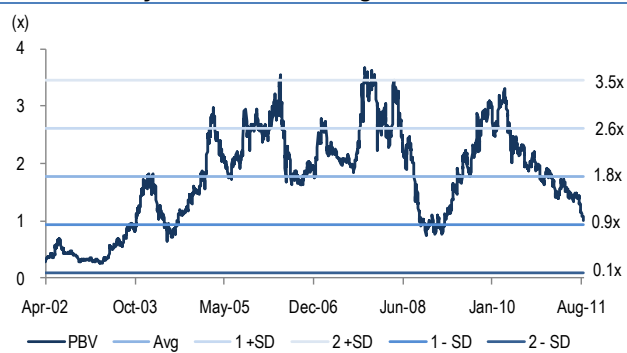
Source: Bloomberg, Nirmal Bang Institutional Equities Research

Exhibit 16: 1-year forward P/BV



Source: Bloomberg, Nirmal Bang Institutional Equities Research

Exhibit 17: 1-year forward average P/BV



Source: Bloomberg, Nirmal Bang Institutional Equities Research

Exhibit 18: Ratings history

Date	Rating	CMP (Rs)	Target price (Rs)
24 June 2011	Sell	265	247
1 July 2011	Sell	282	248
22 July 2011	Sell	278	237
22 August 2011	Sell	223	214
29 August 2011	Hold	204	207

Source: Nirmal Bang Institutional Equities Research

Disclaimer

Stock Ratings Absolute Returns

BUY > 15%

HOLD 0-15%

SELL < 0%

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