

# Stronger headwinds to volumes, cut to Underperform

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## Visibility on volumes blurred, cut to U/P, PO cut to Rs280

Sesa announced the closure of its Orissa ops. (14% of FY12E volumes, 22% of Reserve & Resources) due to inability to renew third party mining contracts. It is already facing volume headwinds due to uncertainty around Karnataka export ban (15% of vols.). Orissa mine closure aggravates volumes concerns. Also, mine life reduces by 4 yrs to ~12 yrs (based on FY11 vols). Hence further de-rating is likely in our view. We cut our EPS & forecast flat in FY12e despite strong iron ore prices. We shift our PO to 0.85x NPV (NPV earlier) to factor in volumes risks from Karnataka iron ore ban and weaker visibility on medium term volume growth.

## Sesa to close Orissa operations, cutting EPS forecasts

Sesa has been unable to renew its third party mining contract for Thakurani mine (R&R 78mn tons) on a long term basis on viable terms. It was operating the mine on short term contracts after its long term contract expired in June 09. We have cut our FY-10-13E vols. est. 8-13% as a result. We cut our FY11-13E EPS by 6-13% and forecast FY11E EPS of Rs44.6 & Rs44.3 in FY12, (below consensus).

## Downside risks from ongoing Karnataka export ban

High Court has recently upheld the Karnataka iron ore export ban, but confusion around the validity period persists. Miners have challenged the verdict in the Supreme Court (SC). SC has issued notice to State Govt. seeking its view. We forecast 3.3mn tons (16% of vols.) from Karnataka in FY12e. We estimate our FY12 EPS could be lower by 14% if ban continues in FY12.

## Further de-rating likely on clouded vols. & lower mine life

Sesa trades at a premium to global avg. of 6.3x FY12E EPS despite muted EPS growth. While multiples appear low, we note Sesa's historical avg. P/E is 5.5x. Thus, further de-rating on volume concerns & lower mine life (14 yrs) is possible. A favorable resolution of the export ban should be positive in our view.

## Estimates (Mar)

(Rs)	2009A	2010A	2011E	2012E	2013E
Net Income (Adjusted - mn)	19,949	25,136	40,128	39,883	43,860
EPS	25.04	29.32	44.59	44.32	48.73
EPS Change (YoY)	27.3%	17.1%	52.1%	-0.6%	10.0%
Dividend / Share	2.24	2.92	4.59	6.46	28.75
Free Cash Flow / Share	25.17	5.55	29.35	29.14	40.40

## Valuation (Mar)

	2009A	2010A	2011E	2012E	2013E
P/E	12.29x	10.49x	6.90x	6.94x	6.31x
Dividend Yield	0.729%	0.949%	1.49%	2.10%	9.34%
EV / EBITDA*	7.02x	5.71x	3.83x	3.51x	3.13x
Free Cash Flow Yield*	7.18%	1.63%	8.79%	9.10%	13.13%

\* For full definitions of *iQmethod*<sup>SM</sup> measures, see page 6.

## Stock Data

Price	Rs307.70
Price Objective	Rs280.00
Date Established	1-Dec-2010
Investment Opinion	C-3-7
Volatility Risk	HIGH
52-Week Range	Rs285.00-Rs495.00
Mrkt Val / Shares Out (mn)	US\$6,035 / 900.0
Average Daily Volume	4,425,348
BofAML Ticker / Exchange	XSGAF / BSE
Bloomberg / Reuters	SESA IN / SESA.BO
ROE (2011E)	42.5%
Net Dbt to Eqty (Mar-2010A)	-13.1%
Est. 5-Yr EPS / DPS Growth	3.0% / NA
Free Float	49.0%

## Key Changes

(Rs)	Previous	Current
Inv. Opinion	C-1-7	C-3-7
Inv. Rating	BUY	UNDERPERFORM
Price Obj.	398.00	280.00
2011E EPS	47.36	44.59
2012E EPS	49.17	44.32
2013E EPS	55.27	48.73
2011E EBITDA (m)	49,564.6	46,526.7
2012E EBITDA (m)	56,770.1	50,826.4
2013E EBITDA (m)	64,958.0	56,863.6

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Refer to important disclosures on page 7 to 9. Analyst Certification on Page 5. Price Objective Basis/Risk on page 5. Link to Definitions on page 5. 10998515

## iQprofile<sup>SM</sup> Sesa Goa Limited

Key Income Statement Data (Mar)	2009A	2010A	2011E	2012E	2013E
<b>(Rs Millions)</b>					
Sales	49,591	58,359	86,236	90,590	96,705
Gross Profit	29,168	36,953	48,526	52,925	59,297
Sell General & Admin Expense	(3,780)	(5,728)	(1,999)	(2,098)	(2,433)
Operating Profit	24,871	30,480	45,736	49,960	55,889
Net Interest & Other Income	2,230	2,712	3,201	5,433	6,768
Associates	NA	NA	NA	NA	NA
Pretax Income	27,102	33,192	48,936	55,393	62,657
Tax (expense) / Benefit	(7,153)	(8,056)	(8,809)	(15,510)	(18,797)
Net Income (Adjusted)	19,949	25,136	40,128	39,883	43,860
Average Fully Diluted Shares Outstanding	797	900	900	900	900

### Key Cash Flow Statement Data

Net Income	19,949	25,136	40,128	39,883	43,860
Depreciation & Amortization	517	745	791	866	974
Change in Working Capital	3,141	(1,163)	(2,647)	(119)	(222)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	(2,264)	(1,154)	(1,918)	(5,427)	(6,760)
Cash Flow from Operations	21,343	23,564	36,354	35,203	37,852
Capital Expenditure	(1,471)	(19,050)	(12,000)	(10,000)	(1,490)
(Acquisition) / Disposal of Investments	(9,647)	0	0	0	0
Other Cash Inflow / (Outflow)	(8,870)	3,229	3,930	5,433	6,768
Cash Flow from Investing	(19,989)	(15,821)	(8,070)	(4,567)	5,277
Shares Issue / (Repurchase)	0	5,339	0	0	0
Cost of Dividends Paid	(1,380)	(2,708)	(4,346)	(6,365)	(29,500)
Cash Flow from Financing	(1,390)	26,395	(5,075)	(6,365)	(29,500)
Free Cash Flow	19,872	4,514	24,354	25,203	36,362
Net Debt	(158)	(10,015)	(33,224)	(81,795)	(95,424)
Change in Net Debt	35	(9,857)	(23,209)	(24,271)	(13,629)

### Key Balance Sheet Data

Property, Plant & Equipment	5,930	24,235	35,444	44,578	45,094
Other Non-Current Assets	41,252	41,252	41,252	41,252	41,252
Trade Receivables	2,982	3,509	5,198	5,460	5,829
Cash & Equivalents	177	34,315	57,524	81,795	95,424
Other Current Assets	3,674	3,783	4,840	4,845	4,852
Total Assets	54,015	107,094	144,258	177,930	192,451
Long-Term Debt	19	24,300	24,300	0	0
Other Non-Current Liabilities	664	664	664	664	664
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	5,840	5,617	6,999	7,153	7,315
Total Liabilities	6,524	30,581	31,963	7,817	7,979
Total Equity	47,491	76,513	112,295	170,113	184,472
Total Equity & Liabilities	54,015	107,094	144,258	177,930	192,451

### iQmethod<sup>SM</sup> - Bus Performance\*

Return On Capital Employed	50.8%	34.1%	34.1%	25.9%	24.6%
Return On Equity	52.1%	40.7%	42.5%	28.2%	24.7%
Operating Margin	50.2%	52.2%	53.0%	55.1%	57.8%
EBITDA Margin	51.2%	53.5%	54.0%	56.1%	58.8%

### iQmethod<sup>SM</sup> - Quality of Earnings\*

Cash Realization Ratio	1.1x	0.9x	0.9x	0.9x	0.9x
Asset Replacement Ratio	2.8x	25.6x	15.2x	11.5x	1.5x
Tax Rate (Reported)	26.4%	24.3%	18.0%	28.0%	30.0%
Net Debt-to-Equity Ratio	-0.3%	-13.1%	-29.6%	-48.1%	-51.7%
Interest Cover	NM	NM	NM	NA	NA

### Key Metrics

\* For full definitions of iQmethod<sup>SM</sup> measures, see page 6.

### Company Description

Sesa Goa is India's largest private sector producer exporter of iron ore with production of 15.3mn tons (FY09E). Vedanta Resources is the owns 51% stake in the Company. It has mining operations in Goa, Karnataka and Orissa and exports 93% of its production. Proved and proven reserves was 180.4mn tons as on March 08. It also has small presence in met coke and pig iron business.

### Investment Thesis

We believe volume headwinds for Sesa Goa has increased to uncertainty around ongoing Karnataka ban, closure of Orissa operations. Also Goa approvals are on hold as the mining policy. This clouds volume outlook in our view. We expect EPS growth to be muted despite our bullish iron ore view. We see scope for further derating on increasing volume concerns and reducing mine life. Hence Underperform.

### Stock Data

Price to Book Value 2.5x

Table 1: Key assumptions and forecast

	FY10	FY11e	FY12e	FY13e
Iron ore volumes (mt)	20.6	20.0	21.0	24.3
y-o-y change	36%	-3%	5%	16%
Blended Realization (Rs/t)	2555	3993	4020	3722
y-o-y change	-11%	56%	1%	-7%
Spot % of Sales	80%	80%	78%	78%
BAS-ML Benchmark Contract (US\$/t)	62	132	135	120
Iron ore spot FOB (US\$/t)	79	136	124	117
FX (INR/US\$)	47.7	45.0	45.0	45.0

Source: Sesa Goa, BofA Merrill Lynch Global Research Estimates

## Downgrade to Underperform

Sesa announced the closure of its Orissa operations (14% of FY12E volumes, 22% of Reserve & Resources) due to inability to renew third party mining contracts. Sesa is already facing volume headwinds due to uncertainty around Karnataka export ban (15% of vols.). We believe closure of Orissa operations further increases concerns around volumes. Also we estimate Reserves and Resources at Orissa mines was 78mn tons. Hence closure of Orissa operations reduces reserves by 22% and mine life by 4 years (based on FY11e volumes). We cut our FY11-12E EPS by 6-10% led by lower vols. & expect flat EPS in FY12e despite our positive iron ore outlook. Also reduced visibility around volume growth and concerns around mine life could lead to de rating of the stock. Our PO of Rs280 set at 0.85x NPV (NPV earlier) due to further volume risks from Karnataka ban implies 9% downside.

### Sesa to close Orissa operations, cutting volumes forecasts

Sesa has been unable to renew its third party mining contract for Thakurani mine (R&R 78mn tons) on a long term basis on viable terms. It was operating the mine on short term contracts after its long term contract expired in June 09. Volumes from Thakurani mine in FY10 was ~ 2mn tons and reserves were ~78mn tons. However, profitability of these mines are lower relative to its low cost Goa mines due to high inland freight cost. We have lowered our volumes forecasts to 20mn tons (-8%) in FY11 & 21mn tons (-13%) in FY12.

### Downside risks from ongoing Karnataka export ban

High Court has recently upheld the Karnataka iron ore export ban. The court has directed the State Govt. to put in place a regulatory mechanism to check illegal mining in six months. However confusion around the validity period persists. Miners have challenged the verdict in the Supreme Court (SC). SC has issued notice to Karnataka Govt. seeking its stance on the issue. We forecast 3.3mn tons (16% of vols.) from Karnataka in FY12e. We estimate our FY12E EPS could be lowered by 14% if ban continues in FY12 assuming our base case price forecasts.

### Further de-rating likely on clouded vols. & lower mine life

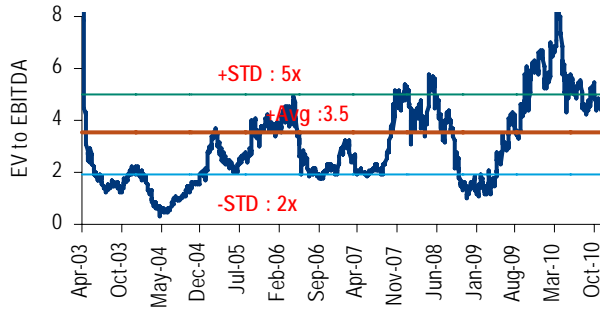
Sesa trades at 7x FY12E EPS at a premium to global avg. of 6.3x FY12E EPS despite muted EPS growth. While valuations multiple appear low, we note Sesa's historical avg. P/E is 5.5x. Thus, scope for further de-rating on volume concerns & lower mine life (14 yrs) exists. A favorable resolution of the export ban should be positive in our view.

Table 2: Change in earnings forecast

	FY11E			FY12E			FY13E		
	New	Old	% chg	New	Old	% chg	New	Old	% chg
Revenue	86,236	93,441	-8%	90,590	104,336	-13%	96,705	112,494	-14%
EBITDA	46,527	49,565	-6%	50,826	56,770	-10%	56,864	64,958	-12%
Margins	54%	53%		56%	54%		59%	58%	
Depreciation	791	791	0%	866	866	0%	974	974	0%
Interest	(3,201)	(3,201)	0%	(5,433)	(5,562)	-2%	(6,768)	(7,081)	-4%
PBT	48,936	51,974	-6%	55,393	61,465	-10%	62,657	71,065	-12%
Tax	8,809	9,355		15,510	17,210		18,797	21,319	
PAT	40,128	42,619	-6%	39,883	44,255	-10%	43,860	49,745	-12%
EPS	44.6	47.4	-6%	44	49	-10%	49	55	-12%

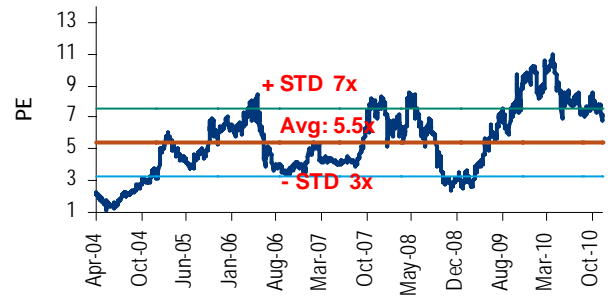
Source: Sesa Goa, BofA Merrill Lynch Global Research Estimates

Chart 1: Sesa Goa EV/EBITDA (FY1) bands



Source: Sesa Goa, BofA Merrill Lynch Global Research Estimates

Chart 2: Sesa Goa historical P/E (FY1) bands



Source: Sesa Goa, BofA Merrill Lynch Global Research Estimates

Table 3: Iron Ore : Global Comparable valuations

Company	Currency	Stock Price	Mkt Cap USD m	P/E		EV/EBITDA		P/BV	
				FY11E	FY12E	FY11E	FY12E	FY11E	FY12E
Sesa Goa	INR	307.7	5,759	6.9	6.9	3.8	3.5	2.4	1.6
Atlas Iron	AUD	2.9	1,529	5.5	5.7	4.0	2.8	2.4	1.7
Vale	USD	28.8	165,726	9.8	6.4	6.8	4.8	2.1	1.7
Rio Tinto	USD	82.2	129,823	10.1	7.4	6.8	4.7	2.7	2.0
Ferroexpo	USD	356.2	3,256	6.9	4.8	5.4	3.8	3.7	2.1
<b>Average</b>				<b>7.8</b>	<b>6.3</b>	<b>5.2</b>	<b>3.9</b>	<b>3.4</b>	<b>2.4</b>

Source: BofA Merrill Lynch Global Research Estimates

## Price objective basis & risk

### Sesa Goa Limited (XSGAF)

Our PO of Rs280 is set at 0.85x FY12E NPV due to downside risks to volumes owing to Karnataka ban, slow pace of approvals in Goa and weaker visibility on medium term volume growth. Our NPV assumes a WACC of 12.5% and a terminal growth of 0%.

Downside risks to our valuation are - lower iron ore prices due to lower-than-expected global steel output and ramp up in Chinese mines output. Lower-than-expected volume growth and adverse regulatory policy changes including mining tax pose downside risks to our earnings and PO.

## Link to Definitions

### Basic Materials

Click [here](#) for definitions of commonly used terms.

## Analyst Certification

I, Bhaskar.N.Basu,CFA, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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### APR - Metals & Mining Coverage Cluster

Investment rating	Company	BofAML ticker	Bloomberg symbol	Analyst
BUY	China Coal Energy Ltd.	CCOZF	1898 HK	Yongtao Shi
	China National Building Material Co Ltd.	CBUMF	3323 HK	Yongtao Shi
	China National Materials	XFCHF	1893 HK	Yongtao Shi
	Fushan International Energy	YULKF	639 HK	Yongtao Shi

APR - Metals & Mining Coverage Cluster

Investment rating	Company	BofAML ticker	Bloomberg symbol	Analyst
	Hidili	XHILF	1393 HK	Yongtao Shi
	Hyundai Steel	XHDUF	004020 KS	Elli Lee
	JSW Steel	XJWJF	JSTL IN	Bhaskar.N.Basu,CFA
	POSCO	PKXFF	005490 KS	Elli Lee
	POSCO -A	PKX	PKX US	Elli Lee
	Sterlite Industries India Limited	XTNDF	STLT IN	Bhaskar.N.Basu,CFA
	Sterlite Industries India Limited	SLT	SLT US	Bhaskar.N.Basu,CFA
	Winsway Coking Coal Holdings Limited	XWNYF	1733 HK	Yongtao Shi
	Zhaojin Mining Industry Company Limited	ZHAOF	1818 HK	Timothy Bush
<b>NEUTRAL</b>				
	Anhui Conch-H	AHCHF	914 HK	Yongtao Shi
	China Shenhua Energy Ltd.	CUAEF	1088 HK	Yongtao Shi
	Hindalco	HNDFF	HNDL IN	Bhaskar.N.Basu,CFA
	Shougang Concord International	SCGEF	697 HK	Colin Liang
<b>UNDERPERFORM</b>				
	Angang Steel	ANGGF	347 HK	Colin Liang
	Dongkuk Steel	DKUSF	001230 KS	Elli Lee
	Jindal Steel and Power Limited	XJDLF	JSP IN	Bhaskar.N.Basu,CFA
	Maanshan Iron & Steel	MAANF	323 HK	Colin Liang
	NALCO	NAUDF	NACL IN	Bhaskar.N.Basu,CFA
	Sesa Goa Limited	XSGAF	SESA IN	Bhaskar.N.Basu,CFA
	Steel Authority of India	SLAUF	SAIL IN	Bhaskar.N.Basu,CFA
	Tata Steel	TAEF	TATA IN	Bhaskar.N.Basu,CFA
	Yanzhou Coal	YZCHF	1171 HK	Yongtao Shi
	Zijin Mining Group Co Ltd.	ZIJMF	2899 HK	Timothy Bush

iQmethod<sup>SM</sup> Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	$\text{Total Assets} - \text{Current Liabilities} + \text{ST Debt} + \text{Accumulated Goodwill Amortization}$
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
<b>Quality of Earnings</b>		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
<b>Valuation Toolkit</b>		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales} + \text{Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

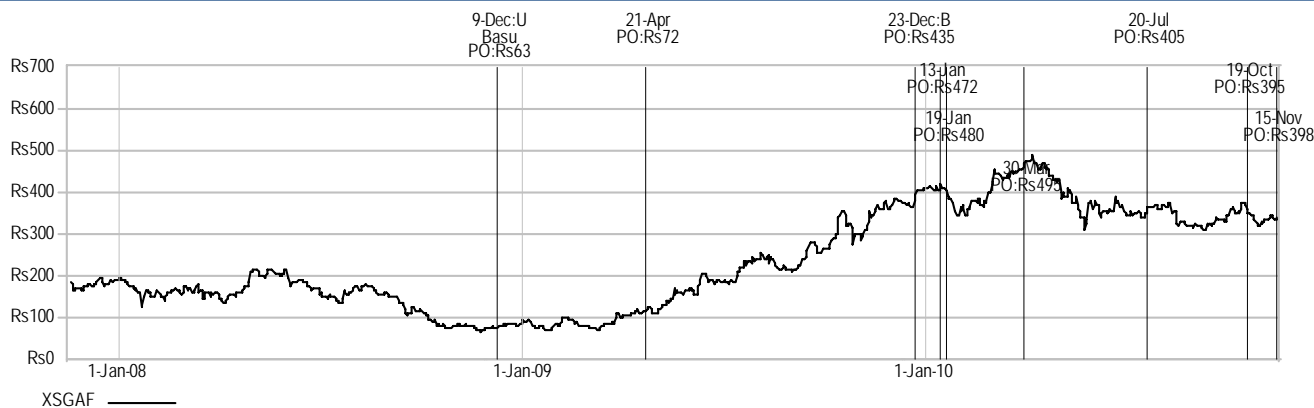
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## Important Disclosures

### XSGAF Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid, NR: No Rating

\*Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of October 31, 2010 or such later date as indicated. BofA Merrill Lynch price charts do not reflect analysts' coverage of the stock at prior firms.\*

### Investment Rating Distribution: Non-Ferrous Metals/Mining & Minerals Group (as of 01 Oct 2010)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	86	58.11%	Buy	21	28.77%
Neutral	38	25.68%	Neutral	11	35.48%
Sell	24	16.22%	Sell	1	4.76%

### Investment Rating Distribution: Global Group (as of 01 Oct 2010)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1948	54.31%	Buy	821	46.73%
Neutral	891	24.84%	Neutral	397	49.07%
Sell	748	20.85%	Sell	259	37.16%

\* Companies in respect of which BofA Merrill Lynch or one of its affiliates has received compensation for investment banking services within the past 12 months. For purposes of this distribution, a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

\* Ratings dispersions may vary from time to time where BofAML Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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