

Sesa Goa / Sterlite Industries

11 September 2012

Iron Ore Mining Halted in Goa; Cut TP, Retain Buy

The Goa government has stopped mining activity at all 90 iron ore mines in the state to review their operations as per recommendations made by the Shah Commission. This will impact Sesa-Sterlite (the combined entity) as it has 14mt of iron ore capacity in Goa. There is no time-line for restarting the mines, but going by what is happening in neighbouring Karnataka, we believe it may take 6-12 months to restart operations. On a positive note, the government has allowed trading and transportation of iron ore, which should enable Sesa Goa (SGL) to sell around 3.8mt of its inventory (as of end-June 2012) over the next few months. We cut Sesa Goa's EBITDA estimates by 51% and 33% for FY13E and FY14E, respectively, while PAT estimates, excluding Cairn India's profits, have been cut by 56% and 36%, respectively, for the same period. We retain our Buy rating on Sesa Goa with a revised TP of Rs191 (down 17% from the earlier TP of Rs230), which is 19% higher than CMP. Consequently, our revised TP on Sterlite Industries (India) stands at Rs115 (down 17% from the earlier TP of Rs138), which is 22% higher than the CMP and hence we retain our Buy rating on Sterlite Industries.

Steep cut in earnings estimates: We have cut our iron ore volume estimates by 39% and 21% for FY13E and FY14E, respectively, as we expect the matter to be resolved only by the end of 1QFY14. We have also cut our realisation assumptions by 12% and 9%, respectively, for the same period due to a significant drop in global iron ore prices. We have also fine-tuned our estimates on pig iron and coke oven segments based on recent updates. The above factors led to 51% and 33% reduction in EBITDA estimates for FY13E and FY14E, respectively, while PAT estimates, excluding Cairn India's profits, have been cut by 56% and 36% for the same period.

Goa's economy depends on iron ore: We also like to acknowledge that, unlike Karnataka, iron ore mining contributes extensively to Goa's gross domestic product and exchequer and any delay in resuming mining operations will impact state's financials as well.

Impact on Sesa-Sterlite: For Sesa-Sterlite, the iron ore segment accounted, prior to our earnings downgrade today, for 10% and 7% of EBITDA estimates for FY13E and FY14E, respectively. Earnings downgrade of SGL led to 5%/3% cut in Sesa-Sterlite's FY13E/FY14E EBITDA estimates, respectively, while PAT estimates have been cut by 8%/4% for the same period. A more important point to note is that iron ore operations accounted for a significant portion of standalone cash generation, which has escalated the cash fungibility issue.

Valuation: Sesa-Sterlite trades at a P/E multiple of 4.2x and 3.8x FY13E and FY14E respectively, while the EV/EBITDA multiple stands at 4.5x and 4.1x for the same period. Due to rising pressure on cash fungibility on account of a sharp drop in SGL's earnings, we have increase holding company's discount from 10% to 15%. We have also cut our iron ore segment EV/EBITDA multiple from 4.0x to 3.0x as we fear a cap on iron ore output in Goa, as witnessed in Karnataka. We retain our Buy rating on Sesa Goa with a revised target price of Rs191 (down 17% from the earlier TP of Rs230). Consequently, our revised TP on Sterlite Industries (India) stands at Rs115 (down 17% from the earlier TP of Rs138), which is 22% higher than the CMP and hence we have retained our Buy rating on it.

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Sesa Goa
BUY
Sector: Non-ferrous

CMP: Rs160

Target Price: Rs191

Upside: 19%

Sterlite Industries
BUY
Sector: Non-ferrous

CMP: Rs94

Target Price: Rs115

Upside: 22%

Exhibit 1: Change in our earnings estimates (Sesa Goa)

Description (Rsmn)	Earlier assumptions		New assumptions		Change (%)	
	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E
Volume (tn)						
Iron ore (mt)	14.8	16.3	9.0	12.9	(39.2)	(20.9)
Met coke	253,000	456,000	103,000	344,000	(59.3)	(24.6)
Pig iron	256,748	523,750	207,373	411,250	(19.2)	(21.5)
Realisation (Rs/tn)						
Iron ore	4,822	4,199	4,261	3,841	(11.6)	(8.5)
Met coke	21,849	21,384	20,437	17,230	(6.5)	(19.4)
Pig iron	31,456	29,442	31,652	29,444	0.6	0.0
Financials (Rsmn)						
Net sales	78,475	81,128	42,436	59,173	(45.9)	(27.1)
EBITDA	27,699	21,422	13,646	14,255	(50.7)	(33.5)
PAT before profit of associates	16,516	14,654	7,335	9,357	(55.6)	(36.2)
PAT after profit of associates	32,222	29,301	23,041	24,004	(28.5)	(18.1)

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 2: Change in combined entity's financials (proforma)

Description (Rsmn)	Earlier assumptions		New assumptions		Change (%)	
	FY13E	FY14E	FY13E	FY14E	FY13E	FY14E
Net sales	779,342	820,399	743,303	798,445	(4.6)	(2.7)
EBITDA	281,236	286,190	267,183	279,023	(5.0)	(2.5)
PAT after MI	121,511	129,041	112,330	123,743	(7.6)	(4.1)

Source: Company, Nirmal Bang Institutional Research

Exhibit 3: Combined entity's valuation

(Rsmn)	EBITDA (FY14E)	EV/EBITDA Multiple (x)	EV	Net cash/(debt) adj. with CWIP	Market capital	Working interest	Final value
Parent company							
Copper	19,231	5.0	96,154				
Zinc International	11,777	4.0	47,108				
Power	15,336	6.0	92,014				
VAL	9,219	6.0	55,313				
Sesa Goa	14,255	3.0	42,764				
Total EV	69,817		333,352	466,841	(133,489)	100%	(133,489)
Subsidiaries							
Hindustan Zinc	74,502	5.0	372,510	233,938	606,448	65%	393,585
BALCO	12,934	5.0	64,672	(40,853)	23,819	51%	12,148
Cairn India	121,218		546,722	162,072	708,794	59%	417,480
Total value of subsidiaries							823,212
Holding company discount							15%
Net value of subsidiary							699,730
Total market capital							566,242
Equity share capital							2,965
Target price (Rs) – SGL							191
Target price (Rs) – Sterlite							115

Source: Company, Nirmal Bang Institutional Equities Research

Ratings track - Sesa Goa

Date	Rating	Market price (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
25 October 2011	Sell	205	173
3 January 2012	Sell	157	146
27 January 2012	Sell	200	164
27 February 2012	UR	227	-
17 April 2012	Buy	185	241
20 June 2012	Buy	177	230
11 September 2012	Buy	160	191

Ratings track - Sterlite Industries (India)

Date	Rating	Market price (Rs)	Target price (Rs)
17 April 2012	Buy	106	144
26 April 2012	Buy	108	140
20 June 2012	Buy	94	138
11 September 2012	Buy	94	115

Disclaimer

Stock Ratings Absolute Returns

BUY > 15%

HOLD 0-15%

SELL < 0%

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