KSL - Sector Update

KHANDWALA SECURITIES LIMITED

Metals & Mining

September 07, 2010

Iron Ore

'Dream Run' Beginning of the End

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Executive Summary

Dream Run Appears near to End

Iron ore producers have enjoyed a dream run in last 5-6 years on back of unquenched ore requirement from China. This has resulted in massive capacity addition from mining companies along with given impetus to all steel players to scout for captive iron ore resources. Higher iron ore prices has also resulted in robust jump in Chinese iron ore production, at a time, when steel industry is rappelling from over capacity. Apart from this, even the Chinese government wants to slowdown their overheating economy, which would spell for sizeable slowdown in Chinese steel industry for obvious reasons. We would like to point out that slowdown in Chinese economy is more harmful for iron ore industry than steel sector due to its influence on global iron ore trade.

China: Double Edge Sword

China, the largest consumer, producer and importer of iron ore, is becoming the biggest threat to the iron ore industry. On one side, the country is witnessing slowdown in steel production on account of government calibrated slowdown and overcapacity, while on the other side, the iron ore production is just roaring thanks to the burgeoning prices. The net impact is sizeable slowdown in Chinese imports. To put into perspective, China's imports accounted for 66% of global iron ore trade for CY09.

Massive Expansion in the Hindsight

Unprecedented jump in profitability of iron ore business has given a lot of impetus to new iron ore mining capacity addition. Top three players in the industry are expected to witness nearly 70% capacity addition, while small players are also planning to add sizeable capacity in next couple of years. Apart from this, many African and Latin American countries also want to get a pie in this super profit and these countries are putting their natural resources on the work, which can be visible from Bolivian government, which has given 20 bn tonne mining reserve to JSPL. The recent hike secured by iron ore players for quarterly contracts should provide further impetus to new and old mining projects to enhance production.

Steel Players are jumping in the Fray

Although, we are not utterly bearish on steel demand and production except Chinese and we continue to expect capacity addition in steel market across the globe especially in Indian and emerging market. We would keep in mind that new capacity addition in India is coming with captive iron ore, while all large players are also scouting vigorously for iron ore resources. Companies like Areclor-Mittal and Corus has said categorically to increase their captive iron ore share in total requirement.

Consolidation: The only Threat to Our Assumption

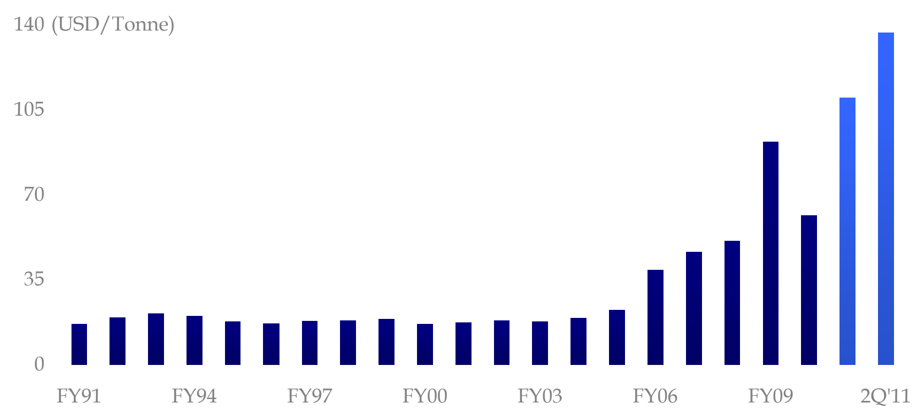
Considering above factors, we believe, iron ore industry is moving towards cyclical slowdown, which can run for couple of years. Nevertheless, we would not like to assign a number in terms of iron ore price decline as we believe consolidation in the industry remains the biggest risk to our assumption. This was visible from the fact that China, despite largest importer of iron ore, has no power to influence the pricing as well as pattern of trade. However, we believe, the consolidation would only help in containing the downside rather than averting the slowdown.

Dream Run Coming to an End

After remaining stable for more than a decade, iron ore prices started rising on back of burgeoning demand from Chinese steel industry. The golden run, which started from FY04, continued abruptly till FY08. Barring the FY09, prices remained very strong and touched all time high in FY10, at the time, when steel prices were no where near their peak. The iron ore prices continued to touch new high even after sifting to quarterly contracts during FY11. Nevertheless, iron ore contract price is expected to signed at ~ 10% lower compared to Jul-Sep quarter largely on back of softness in spot iron ore prices.

In last couple of months, iron ore prices witnessed very sharp correction from a high of $186/tonne in May'10 to a low of $124/tonne in the middle of July month largely on back of looming crisis in Euro zone area and China tightening. However, in last couple of weeks, iron ore prices have rebounded very strongly to $155/tonne on back of robust economic data from developed countries and deceleration in China tightening. Comparatively, steel prices in the world have remained stable in last couple of weeks, admittedly, the drop in steel prices also remained lower compare to iron ore prices. The more important question needs to be asked about the future of iron ore prices. We would like to retain our view of long term cyclical downturn in iron ore prices largely on the following factors. We believe it would be a matter of time before prices start factoring the expected supply and start their downward trend.

Iron Ore Contract Price



Source: Khandwala Research, Bloomberg

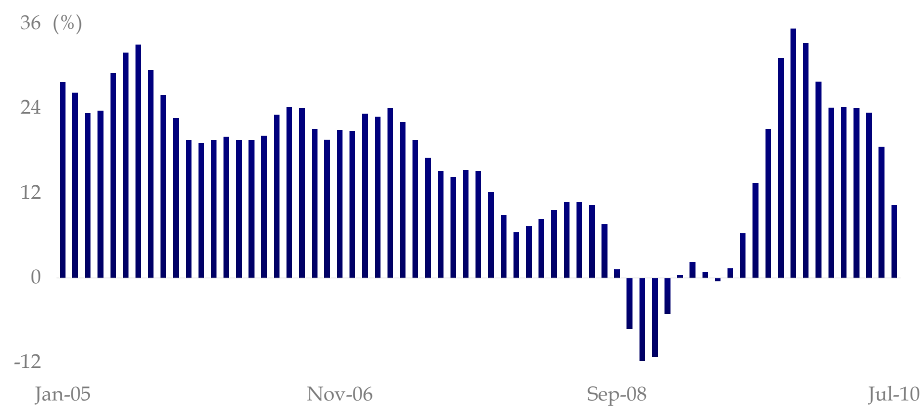
China – Double Edge Sword

Slowing Growth in Chinese Steel Production ………

Chinese government has categorically admitted that it would like to curtail the inefficient steel production and the industry seems to suggest that this number can be as high as even 100 MT (~ 1.7 time of India's steel capacity and ~ 7% of global steel capacity). Although, the government has not met with much success on this, we can't go on assuming the low possibility of happening this. The recent government tightening on housing segment coupled with removal of 9% export rebate is the significant steps taken in this direction. The recent announcement of power cut in the biggest steel making province is also aimed at lowering steel production.

We expect Chinese steel production growth to moderate considerably on back of above stated reasons. The initial sign of moderation in growth is largely visible as three months rolling average production growth in Jul'10 remains the lowest in last one year. Although, we are not entirely pessimist on steel production and we expect the absolute production to remain stable in the range of 50-55 tonne per month for next 2-3 years.

China Steel Production Growth (3 Months Rolling)



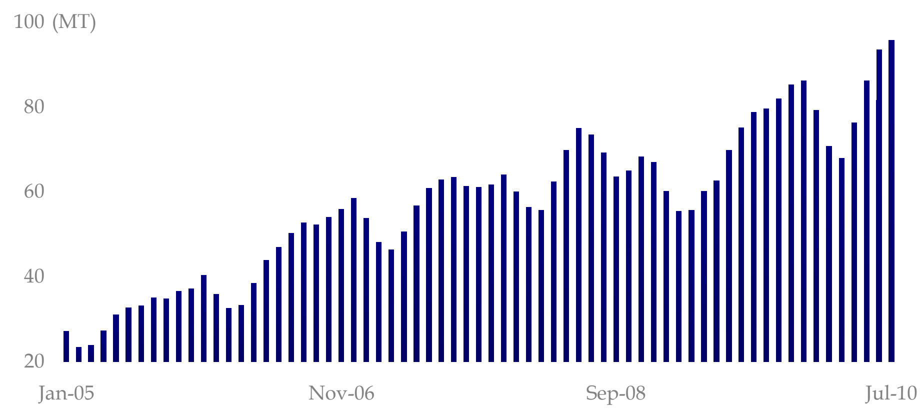
Source: Khandwala Research, Bloomberg

………Rising Iron ore production in China

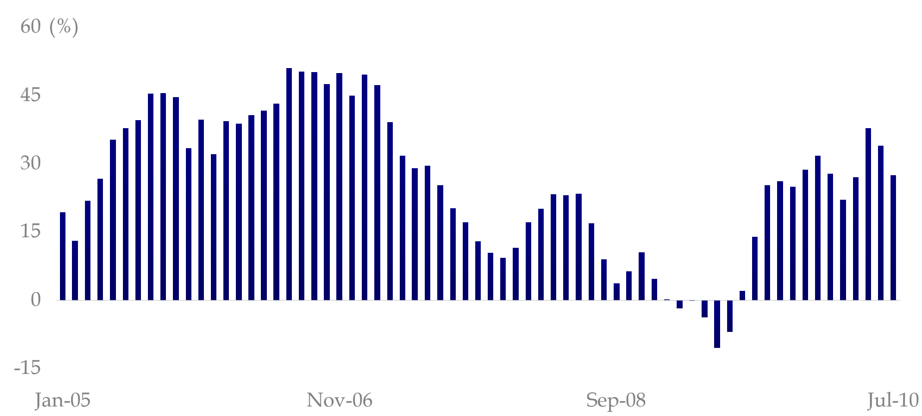
Apart from moderation in steel production, the country is witnessing very gigantic jump in domestic iron ore production. Though, the iron ore seems to be of low grade, however, robust prices make them viable even after considering beneficiation charges. The three months rolling production average in July remained the highest ever production in the country at the same time depicting 27% growth from last year. As stated earlier, the basic reason for higher production appears to be robust iron ore prices, which are resulting in profitable operation for even inefficient players.

The dynamics of iron ore market in China remain much more vibrant than steel market, since country still import over 50% of its iron ore requirement, unlike steel, which is under great fear of overcapacity. We expect Chinese iron ore producers to continue achieve strong production growth, as they would require years to match the country's iron ore requirement.

China Iron Ore Production (3 Months Rolling Average)



China Iron Ore Production Growth (3 Months Rolling)

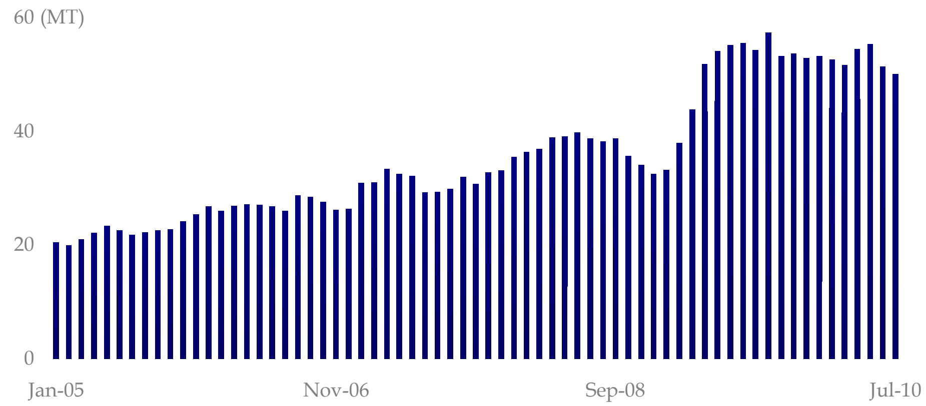


Source: Khandwala Research, Bloomberg

Net Impact: Slowing Iron ore Imports from China

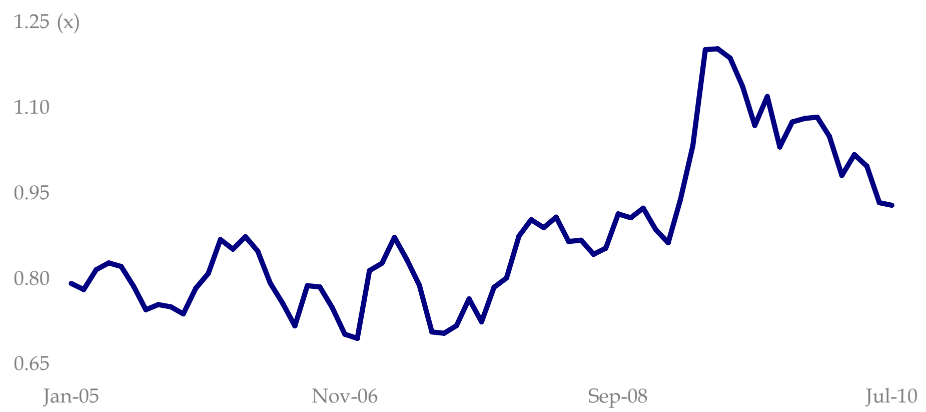
The above two factors have resulted in sizeable slowdown in Chinese iron ore imports. The latest three month average for Jul'10 remained the lowest since Apr'09 and this is 10% lower from last year. We need to remember that China accounted for 66% of total global imports for CY09. A marginal slowdown in Chinese imports can have serious impact on global trade and iron ore prices. We expect this trend of lower imports and higher production to continue, which should be enough to call catastrophe in the iron ore market.

China Iron Ore Imports (3 Months Rolling Average)



Source: Khandwala Research, Bloomberg

China Imports/Steel Production Ratio (3 Months Rolling Average)



Source: Khandwala Research, Bloomberg

Massive Expansion in Iron Ore capacity

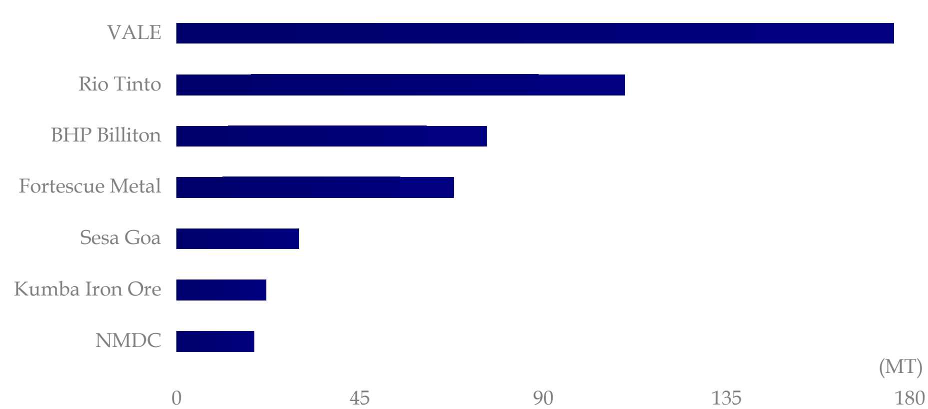
The dream run in the iron ore sector has enable sector companies to achieve super profit in last couple of years. Even, the industry has been able to pass the worst economic crisis, since 1930 great depression, with relatively less pain compared to their counterparts as iron ore prices remain much higher than their mining cost. The recent hike secured by iron ore players for quarterly contracts should provide further impetus to new and old mining projects to enhance production.

Mammoth capacity addition from mining players………

First and foremost, very few mines got closed during the downturn as compared to 15-20% capacity cut across other metals. This compelled several players to invest heavily in the further expansion of iron ore mining segment. Vale, the largest players in the iron ore mining, would raise their mining capacity from 324 MT to 500 MT in next five years. Apart from this, Rio Tinto has announced a capex plan to increase iron ore capacity from 220 MT to 330 MT by 2015, while BHP Billiton have announced a capacity expansion from 129 MT to 205 MT in the same period.

Many middle size companies like Kumba Iron Ore and Fortescue Metal Group plans to hike their iron ore capacity by 22 MT and 68 MT respectively in next 2-3 years. Several smaller companies are planning to start new mines and many old mines have also become viable considering higher prices. Even domestic companies like Sesa Goa and NMDC plan to raise their iron ore mining capacity to 50 MT, while JSPL is developing one of the largest iron ore mine of 20 BT in Bolivia. JSW Steel has also resumed its Chile iron ore mining project due to higher prices.

Some major capacity addition plan by iron ore major in next 5 year



Source: Khandwala Research, Bloomberg

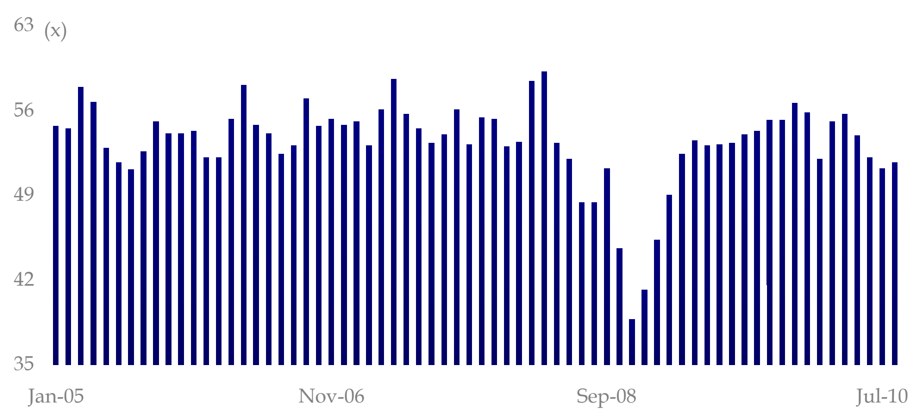
………as well as steel players for captive sources

Apart from this, the unprecedented rise in raw material prices in last couple of years has forced many steel companies to vigorously scout for iron ore integration. Major steel players like Arcelor-Mittal and Corus are also planning to substantially increase their iron ore sourcing from captive resources. Although, there is going to be large steel capacity addition in India, we should consider that all these plants would come with their captive iron ore mines. The absence of mining grant has been one of the principle reason for the delay in all greenfield projects. This all would result in substantial rise in iron ore supply, while demand scenario continues to remain lackluster with fear of China steel overcapacity.

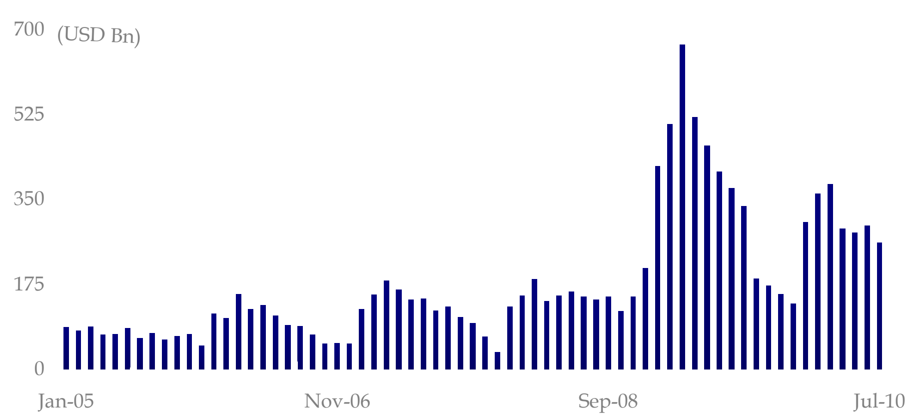
China's Slowdown is More Damaging for Iron ore than Steel sector

Considering the aforesaid factors, it is important to note that Chinese slowdown is worse for iron ore industry than steel industry. There are empirical evidences of Chinese economy slowdown, which are visible in Chinese PMI and Chinese new loans. China new loan dipped 28% for last twelve month compared to preceding period. Chinese PMI has also moderated considerably in the last couple of months.

China PMI



China Loans



Source: Khandwala Research, Bloomberg

Consolidated Industry - The only Risk to Our Assumption

We are assuming a cyclical slowdown in iron ore sector for next couple of years, which we assume the market would realize in next couple of months. Although, we suggest iron ore prices would be in downward trend, however putting a number to the downside appears to be difficult. The significant risk to our assumption remains the nature of highly consolidated iron ore industry. Unlike steel industry, where top three players contribute less that 20% of total steel production, top three iron ore players constitute very large portion of the industry. Though, top three players' contribution in terms of production remained at moderate 24% for CY09, their share in global trade stands at mammoth 60-70%. The fine tuning among larger player and collective negotiation procedure should prevent the industry from going into downward spiral.

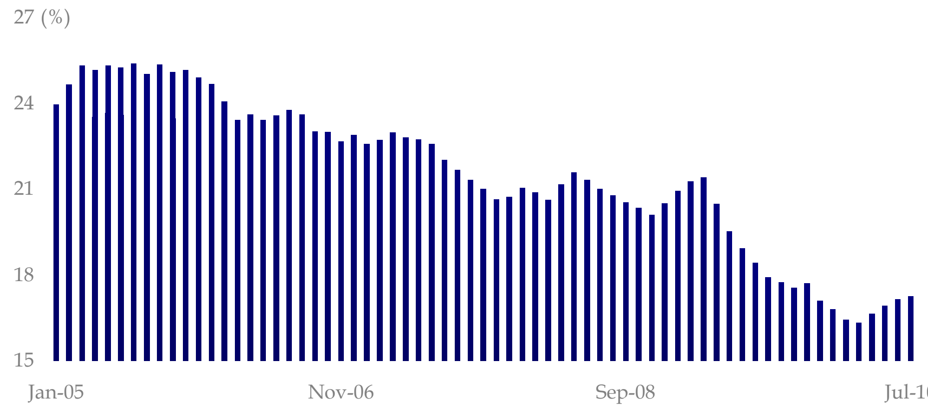
Visible from Inferior Chinese Power

The consolidation power can be clear from the fact that despite being largest consumer of iron ore, China doesn't have any power to influence the trade. For FY10, China tried hard to get over 40-50% drop in long term iron ore contract prices, however, raw material suppliers went on to settle 33% lower prices on iron ore contracts with Japanese steel makers. Chinese players didn't even sign the long-term contracts and relied on spot market. This year also, despite strong reservation about quarterly contracts, the raw material companies went on to sign the contracts with Japanese steel companies for iron ore contracts. This implies that iron ore players hold strong in terms of their fine-tuning and industry consolidation.

Indian players losing market share in China's imports

Apart from cyclical slowdown, Indian iron ore exports are facing the issue of losing market share in China imports despite being having closest proximity to the country. The China's iron ore import requirement had been primarily fulfilled with three major countries namely Australia, India and Brazil, which accounted for 83-86% of China iron ore imports. India, which accounted for 25% of china's total iron ore imports in CY05, fell as low as 17% in CY09. This gap was filled by countries such as Brazil, South African and some other smaller countries. This trend can partially be attributed to reluctance by iron ore exports to engage in long term contracts, while government thrust to discourage iron ore exports through export tax also remain the possible overhang.

India's Market Share in China Imports (12 Months Rolling)



Source: Khandwala Research, Bloomberg

Expected to Decline in Future also………

Description (MT)	CY08	CY09	CY10E	CY11E
Iron ore Imports				
European Union 27	161	90	131	142
Japan	140	106	130	140
China	444	628	637	692
Korea, Rep. of	50	44	50	54
Chinese Taipei	16	12	20	21
World Imports	**895**	**951**	**1,032**	**1,106**
Iron ore Exports				
Australia	309	362	396	422
Brazil	282	266	290	330
India	101	105	97	90
Canada	28	31	32	30
South Africa	33	45	47	51
Sweden	8	20	20	20
World Exports	**895**	**951**	**1,032**	**1,106**

Source: ABARE, Khandwala Research

Moving to Index based Pricing from Quarterly Contracts

In order to get the maximum benefit of robust demand from China, iron ore industry lured to change from annual contract to quarterly contracts. Vale, leading player, is talking to change from quarterly based pricing to index based pricing. This reflects that last quarter average would serve as a benchmark for next quarter pricing. However, this would still be very early to consider this as a viable option. Despite regular efforts, steel industry has not been able to move to index pricing like LME and the same can be apply to the iron ore industry due to various grade of products. The second school of thought suggest that few lakhs tonne iron ore contracts can't form a base for the entire iron ore sector pricing. There need to be a proper free market, where a wide number of players can participate for the better price discovery.

Sesa Goa Limited (SGL)

Ratings			
LTP	320	Recommendation	REDUCE
Target	310	Risk	MEDIUM

Bloomberg Consensus	
(BUY/HOLD/SELL)	15 / 07 / 11

Sensex	Nifty	BSE Metals
18,645	5,604	16,007

Codes

BSE	NSE	Bloomberg	Reuters
500295	SESAGOA	SESA IB	SESA.BO

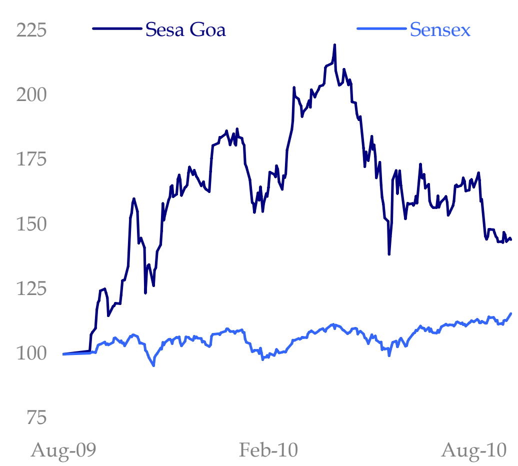
	Sensex	JSW Steel
52 Wk: Hi/Lo	18,620/15,331	494/218
Life High	21,207-Jan 08	494-Apr 10
P/E	22.16	10.04
P/BV	3.53	3.37
Dividend Yield (%)	1.13	0.98
Mkt Cap (INR Mn)	68,484,997	274,674
Equity (INR Mn)	-	860

***- TTM standalone basis Capitaline**

Share Holding Pattern %	Mar-10	Jun-10
Foreign	26.75	27.49
Institutions	3.43	3.43
Corporate	1.15	1.78
Promoters	57.03	55.73
Public & Others	11.65	11.58

Returns %	Abs	Relative to	
	Perf	Sensex	BSE Metals
1 Month	-12.32	-15.08	-15.79
3 Months	-5.25	-17.45	-20.50
1 Year	44.26	28.62	24.04

Relative Price Performance



Volume Growth Looks Stretch after Cairn Acquisition

SGL's aims to reach 50 MT iron ore production in FY14 through organic and inorganic route looks stretch after company exhausted its cash reserve for Cairn's acquisition. On top of it, the company is also facing difficulties in ramp up existing business particularly Orissa and Karnataka. Goa operations were also less encouraging owing to drop in iron ore volume after adjusting for Dempo during the quarter.

This deal would require SGL to take a sizeable amount of debt, which would tie the company hand in going for large acquisition. The management commentary of not able to find a right target seems to suggest that there are not right companies available.

Market attach a sizeable discount to Unrelated Investment

Although, the deal would be EPS accretive from the very first year, market seems to be not convinced about the utilization of cash reserves. We have indicated a discount of 20% from the fair value of Cairn share should be an appropriate measure to value this investment. This results in ~ Rs 40/share decline in our target price.

We expected Cash to come handy in cyclical downturn

In the last couple of months, we believed that massive cash accumulation would help the company to secure strategic assets at a very reasonable price due to cyclical slowdown in the sector. The deployment of cash in unrelated business without majority was the least outcome, Sesa investor would like to have seen.

Subdued Iron ore Prices keeps the stock muted despite low multiple

SGL is trading at EV/EBITDA multiple of 3.6x for FY11 and FY12 relatively, which is low considering global peers. However, subdued iron ore prices would continue to keep the stock performance muted.

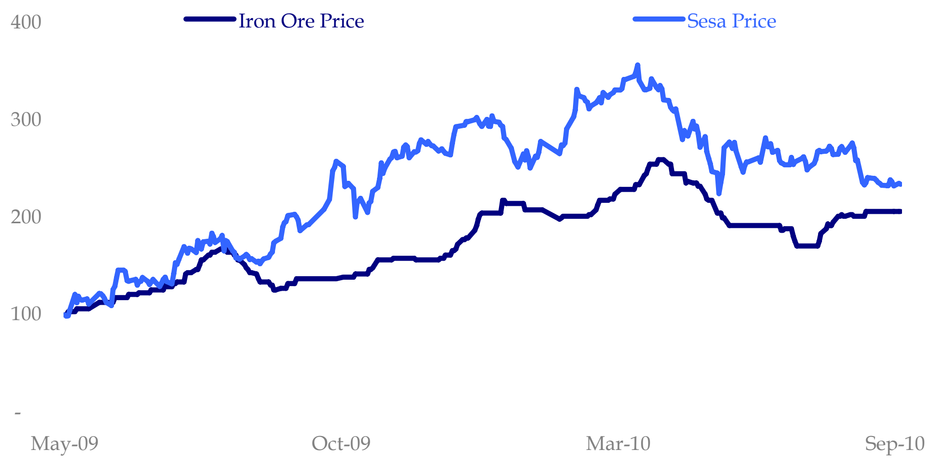
Valuation

The road for Sesa in Cairn India deal is still far from clear and therefore we would continue to assume that SGL would get 10% through open offer and remaining 10% through Vedanta. At this point, we would like to stick at our earlier indicated target price of Rs 310/share, retaining our REDUCE rating.

Financial Summary

(INR Mn)	FY2008	FY2009	FY2010	FY2011E	FY2012E
Net Sales	38,227	49,591	58,583	95,509	90,269
EBITDA	23,032	25,421	31,448	51,584	44,370
PAT	15,416	19,881	26,291	43,466	38,841
EPS (INR)	19.6	25.3	31.6	48.9	43.7

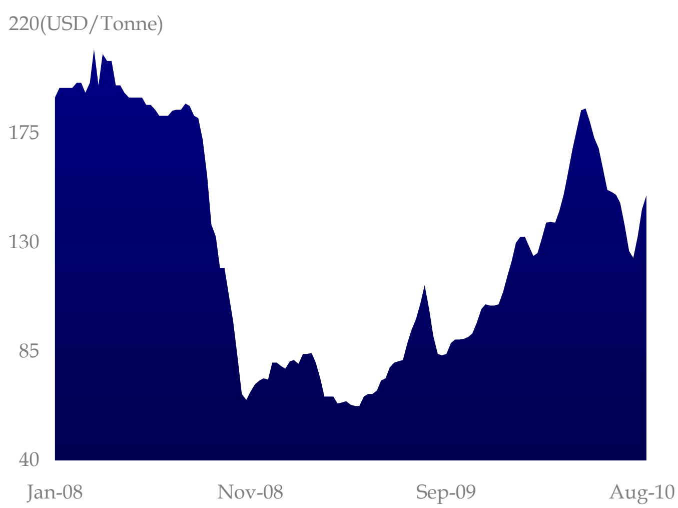
Sesa Goa Price Mirroring Iron Ore Price



Source: Khandwala Research, Bloomberg

Iron Ore Prices (63% Grade)

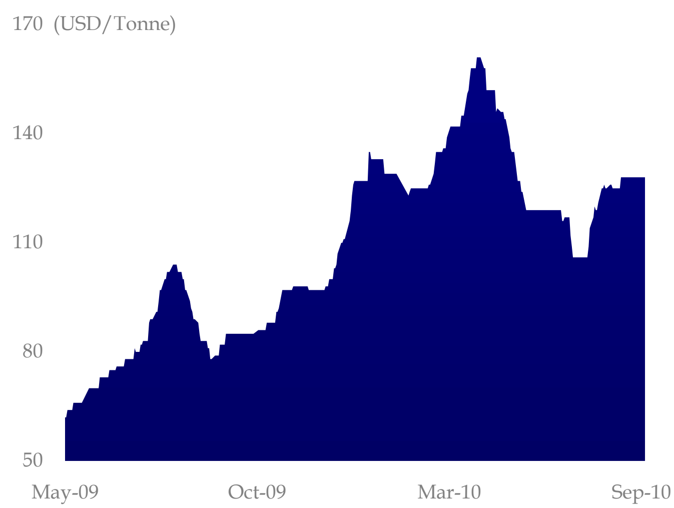
Iron ore prices have seen very sharp volatility in last couple of months with strong surge and correction and again sharp rebound.



Source: Khandwala Research, Bloomberg

Iron Ore Prices (58% Grade)

The price of 58% grade iron ore has also moved in tandem with 63% grade price. Sesa Goa majority iron ore dispatches remain in this grade.



Source: Khandwala Research, Bloomberg

Financials

Profit & Loss Statement

Description (INR Mn)	FY2007	FY2008	FY2009	FY2010	FY2011E	FY2012E
Income from Operation	22,179	38,227	49,591	58,583	95,509	90,269
EBITDA	9,628	23,032	25,421	31,448	51,584	44,370
EBITDA Margin	*43.9%*	*60.3%*	*51.3%*	*53.7%*	*54.0%*	*49.2%*
EBIT	9,236	22,533	24,904	30,703	50,731	43,479
PBT	9,657	23,249	27,102	34,446	54,999	49,969
PAT after MI	6,461	15,416	19,881	26,291	43,466	38,841
EPS (INR)	8.2	19.6	25.3	31.6	48.9	43.7

Balance Sheet

Description (INR Mn)	FY2007	FY2008	FY2009	FY2010	FY2011E	FY2012E
Share Capital	394	394	787	831	890	890
Reserves Total	15,697	29,041	46,370	78,346	136,751	171,429
Total Debt	-	-	19	19,606	444	444
Other Liabilities	842	930	998	1,183	1,369	1,592
Total Liabilities	**16,933**	**30,365**	**48,175**	**99,966**	**139,454**	**174,354**
Total Fixed Assets	4,799	4,975	5,930	7,823	14,770	24,129
Investments	8,454	20,510	31,252	45,649	45,649	45,649
Net Current Assets	3,680	4,880	10,992	31,760	64,301	89,843
Miscellaneous Expenses	-	-	-	14,734	14,734	14,734
Total Assets	**16,933**	**30,365**	**48,175**	**99,966**	**139,454**	**174,354**

Key Ratios

Description	FY2007	FY2008	FY2009	FY2010	FY2011E	FY2012E
EPS (INR)	8.2	19.6	25.3	31.6	48.9	43.7
CEPS (INR)	8.7	20.2	25.9	32.5	49.8	44.7
Book Value (INR)	20.4	37.4	59.9	95.3	154.7	193.7
P/E (x)	38.9	16.3	12.7	10.1	6.5	7.3
Price/BV (x)	15.6	8.5	5.3	3.4	2.1	1.6
EV/PBITDA (x)	25.2	10.0	8.7	6.9	3.6	3.6
ROCE (%)	40.6	52.7	42.4	27.1	32.4	22.6
ROE (%)	40.2	52.4	42.2	33.2	31.6	22.5

Analyst Certification

Each of the analyst(s) named certify, with respect to the companies or securities they analyse that: (1) all the views expressed in this report accurately reflect his/her/their personal views about any and all of the subject companies and securities; and (2) no part of his/her/their compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

KSL Ratings

Target Price refers to one year unless specified; LTP: Last Trading Price

BUY: Expected return >15%

ADD: Expected return 0-15%

REDUCE: Expected decline 0-15%

SELL: Expected decline >15%

Company Risk is based on the systematic risk of the stock. (1-year Beta)

HIGH: >1.2

MEDIUM: 0.8-1.2

LOW: < 0.8

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Short-term trading based on technical indicators is a risky and skill oriented practice, which may result into huge losses or profits. It is not advisable to trade a stock if it reaches the target price first and then comes within recommended range. Target prices are just indicative based on the various technical parameters. Actual stock prices may come nearer or breach those levels. Always follow stop losses to avoid larger losses.