INDIA

BUY

Aarti Drugs

Result Update 17 May 2018

Pharma

Benefit of vertical integration; maintain Buy

We maintain our Buy rating on Aarti Drugs (ADL) and revise the TP to Rs960 (earlier TP Rs940) based on 16x March'20 EPS of Rs60.1. AIL's Q4FY18 results exceeded our expectations. The pharma major's revenue grew 3% YoY, margin improved 260bps to 17.1% and net profit grew 10% YoY. That said, the company is likely to benefit from vertical integration which is likely to drive future growth. We expect margins to improve post the launch of new products and additional capacities of Ciprofloxacin and Metformin APIs coming on stream. Key risks to our assumptions include slowdown in the domestic pharma market and regulatory risks for its manufacturing facilities.

- **Revenues grew 3%YoY:** ADL's revenue grew by 3% YoY to Rs3.31bn from Rs3.20bn and was impacted by massive explosion in one of its neighbouring units. ADL's unit manufacturing quinolones was affected by explosion resulting in three deaths and was shut for over 20 days during Q4FY18. The company manufactures Norfloxacin, Ofloxacin and Levofloxacin at this unit, for which the production was re-started after necessary repairs. As per the management, the loss of revenue was ~2% of FY18 revenues. The management indicated that the raw materials, work in process , finished goods and loss of profit was duly insured.
- **Margin grew by 260bps YoY:** ADL's EBIDTA margin in Q4FY18 grew by 260bps YoY to 17.1% from 14.5% due to re-stocking by trade after successful implementation of GST. The company's material cost grew by 260bps to 62.5% from 59.9% due to the rise in prices of crude based chemicals. Personnel cost increased by 10bps to 4.6% from 4.5%. Other expenses declined by 530bps to 15.8% from 21.1% due to cost rationalisation and absence of excise duty. We expect margin improvement due to capacity addition and benefits of vertical integration to formulations.
- **Net profit grew by 10%YoY:** ADL's net profit grew 10% YoY to Rs240mn from Rs219mn due to margin improvement. Other income declined by 64%YoY to Rs8mn from Rs22mn. The company's tax rate grew to 37.3% from 28.7% of PBT. ADL would be able to pass the increase in material cost to its customers with a time lag of 1-3 months. The company is poised for rapid growth which would be led by its APIs and focused marketing thrust.
- **Recommendation and key risks:** We maintain our Buy rating on ADL with a TP of Rs960 based on 16x March'20E EPS of Rs60.1. We have revised FY19E and FY20E EPS upwards by 6% and 5% respectively. We expect ADL to perform well due to capacity expansion, new product launches and presence in the high-margin formulations. Key risks to our assumptions are a slowdown in the domestic market and regulatory risks for its manufacturing facilities.

Y/E Mar (Rs mn)	Q4FY18	Q4FY17	YoY (%)	Q3FY18	QoQ (%)	Q4FY18E	% Var.
Total Revenues	**3,307**	**3,202**	***3.3***	**3,354**	***(1.4)***	**2,800**	***18.1***
Raw material cost	2,066	1,919	*7.7*	2,124	*(2.7)*	1,810	*14.1*
Employee cost	151	143	*5.6*	150	*0.7*	140	*7.9*
Other expenses	524	677	*(22.6)*	540	*(3.0)*	450	*16.4*
EBIDTA	**566**	**463**	***22.2***	**540**	***4.8***	**400**	***41.5***
EBIDTA margin (%)	*17.1*	*14.5*	-	*16.1*	-	*14.3*	-
Depreciation	102	92	*10.9*	100	*2.0*	105	*(2.9)*
Interest	89	86	*3.5*	91	*(2.2)*	100	*(11.0)*
Other income	8	22	*(63.6)*	1	*700.0*	1	*700.0*
PBT	383	307	*24.8*	350	*9.4*	196	*95.4*
Prov. For tax	143	88	*62.5*	117	*22.2*	65	*120.0*
Adj. PAT	**240**	**219**	***9.6***	**233**	***3.0***	**131**	***83.2***

Source: Company, Centrum Research Estimates

Target Price	Rs960
CMP*	Rs567
Upside	*69.3%*
Previous Target	Rs940
Previous Rating	Buy

Price Performance (%)*

	1M	6M	1Yr
ARTD IN	*(0.1)*	*6.5*	*6.6*
Nifty	*1.3*	*3.9*	*12.1*

Key Data	
Bloomberg Code	ARTD IN
Curr Shares O/S (mn)	23.6
Diluted Shares O/S(mn)	23.6
Mkt Cap (Rsbn/USDmn)	13.4/197.4
52 Wk H / L (Rs)	785/447.8
5 Year H / L (Rs)	874.9/75.1
Daily Vol. (3M NSE Avg.)	11168

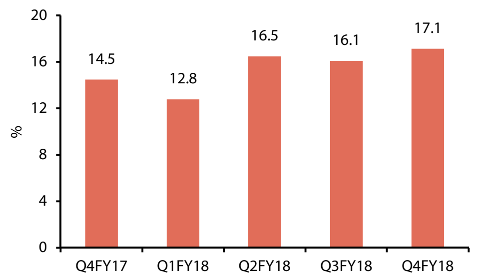
**as on 16th May 2018 ; Source: Bloomberg, Centrum Research*

Shareholding pattern *(%)*

	Mar-18	Dec-17	Sept-17	Jun-17
Promoter	*62.5*	*62.4*	*62.5*	*62.7*
FIIs	*0.8*	*0.7*	*0.7*	*0.7*
DIIs	*4.6*	*4.6*	*4.5*	*4.5*
Others	*32.1*	*32.3*	*32.3*	*32.1*

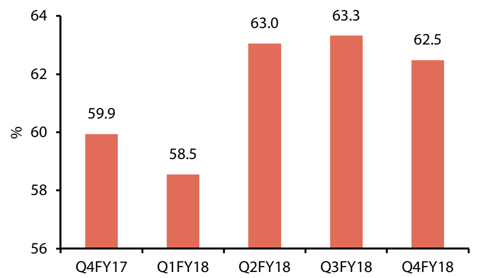
*Source: BSE, *as on 16th May 2018*

Trend in EBIDTA margin (%)



Source: Company, Centrum Research

Trend in material cost (%)



Source: Centrum Research

Earnings Revision

Particulars (Rs mn)	FY19E			FY20E		
	New	Old	Chg (%)	New	Old	Chg (%)
Sales	14,769	14,769	*0.0*	17,542	17,542	*0.0*
EBITDA	2,450	2,375	*3.2*	2,978	2,898	*2.8*
EBITDA Margin (%)	*16.6*	*16.1*	*50bps*	*17.0*	*16.5*	*50bps*
PAT-adj.	1128	1,065	*5.9*	1406	1,338	*5.1*

Source: Centrum Research Estimates

Ranjit Kapadia, *Ranjit.kapadia@centrum.co.in; 91 22 4215 9645*

Y/E Mar (Rs mn)	Revenue	YoY (%)	EBITDA	EBITDA (%)	Net profit	YoY (%)	DEPS (Rs)	RoE (%)	RoCE (%)	P/E (x)	EV/EBITDA (x)
FY16	11,349	*3.7*	1,748	*15.4*	686	*(11.1)*	29.3	*20.6*	*12.8*	20.2	10.8
FY17	11,952	*5.3*	1,869	*15.6*	818	*19.2*	35.0	*21.6*	*12.2*	16.0	9.5
FY18	12,437	*4.1*	1,985	*16.0*	823	*0.6*	35.2	*19.2*	*10.7*	16.1	9.3
FY19E	14,769	*18.8*	2,450	*16.6*	1,128	*37.1*	48.3	*22.7*	*13.0*	11.7	7.4
FY20E	17,542	*18.8*	2,978	*17.0*	1,406	*24.6*	60.1	*23.8*	*14.9*	16.0	9.1

Source: Company, Centrum Research Estimates

Manufacturing impacted

One of the manufacturing units of ADL at Tarapur was adversely affected due to the massive explosion in adjoining unit of Novaphene Specialties Private Limited on 8th March'18. Three of the employees of ADL died in the explosion. As per the management the revenue loss was ~2% of annual revenues.

The management indicated that all raw materials, work in process, finished goods and loss of profit was duly insured. The management estimates insurance claim of Rs100-150mn from this incidence.

US FDA inspection update

US FDA inspected one of the ADL's manufacturing unit at Tarapur in December'17. US FDA has issued form 483 containing 5 observations. ADL completed the remedial measure for three observations and submitted the response to US FDA. For pending two observations, the company will furnish laboratory data for 5 years by June'18.

Valuation & key risks

We maintain our Buy rating on ADL and have revised our TP to Rs960 (earlier Rs940) based on 16x March'20E EPS of Rs60.1. We have revised our FY19E and FY20E EPS upwards by 6% and 5% respectively. We expect ADL to perform well due to its diversified API portfolio and benefits of vertical integration.. Key risks to our assumptions are a slowdown in the domestic market and regulatory issues for its manufacturing facilities.

Exhibit 1: Earning Revision

	FY19E			FY20E		
Particulars	**Current**	**Earlier**	***Chg(%)***	**Current**	**Earlier**	***Chg(%)***
Sales	14,769	14,769	*0.0*	17,542	17,542	*0.0*
EBIDTA	2,450	2,375	*3.2*	2,978	2,898	*2.8*
EBIDTA margin (%)	*16.6*	*16.1*	*50bps*	*17.0*	*16.5*	*50bps*
Net profit	1128	1,065	*5.9*	1406	1,338	*5.1*

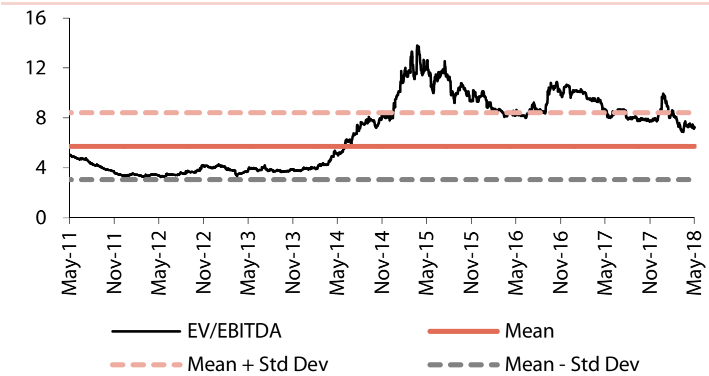
Source: Centrum Research Estimates

Exhibit 2: Sensitivity Analysis

Sensitivity to key variables – FY19E	% change	% impact on EBITDA	% impact on EPS
Sales	*1*	***6.0***	***13.1***
Material cost	*1*	*(3.7)*	*(8.1)*

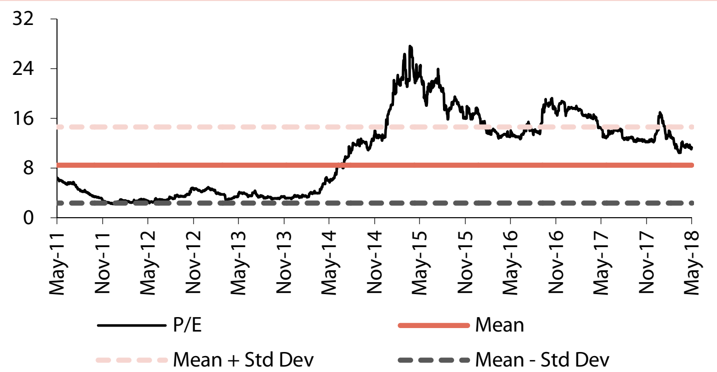
Source: Company, Centrum Research Estimates

Exhibit 3: 1 year forward EV/EBITDA chart



Source: Bloomberg, Company, Centrum Research Estimates

Exhibit 4: 1 year forward P/E chart



Source: Bloomberg, Company, Centrum Research Estimates

Exhibit 5: Comparative Valuations

Company	Mkt Cap (Rs mn)	*CAGR FY17-FY19E (%)*			*EBITDA Margin (%)*			PE (x)			EV/EBITDA (x)			*RoE (%)*			*Div Yield (%)*		
		Rev.	*EBITDA*	*PAT*	*FY17*	*FY18*	*FY19E*	*FY17*	*FY18*	*FY19E*	*FY17*	*FY18*	*FY19E*	*FY17*	*FY18*	*FY19E*	*FY17*	*FY18*	*FY19E*
Aarti Drugs	**13,254**	***11.2***	***14.5***	***17.4***	***15.6***	***16.0***	***16.6***	**16.0**	**16.1**	**11.7**	**9.5**	**9.3**	**7.4**	***21.6***	***19.2***	***22.7***	***2.2***	***2.1***	***2.3***
Granules India	27,432	*21.0*	*18.7*	*20.9*	*20.8*	*19.3*	*20.0*	20.3	19.2	12.8	10.5	9.5	6.8	*20.0*	*13.2*	*15.3*	*0.8*	*0.9*	*1.3*
Laurus Labs *	48,996	*14.8*	*16.2*	*17.3*	*21.9*	*21.1*	*22.4*	23.7	25.5	18.9	15.2	13.0	10.8	*17.9*	*13.0*	*14.9*	*0.3*	*0.3*	*0.3*
Neuland Labs *	11,164	*4.0*	*1.0*	*1.0*	*15.4*	*11.6*	*14.5*	25.7	44.9	21.2	11.6	18.3	14.7	*16.2*	*6.8*	*9.5*	*-*	*0.3*	*0.5*

*Source: Company, Centrum Research Estimates, Prices as on 16th May 2018 *Bloomberg Estimates*

Quarterly financials, Operating Metrics and Key Performance Indicators

Exhibit 6: Quarterly Financials

PARTICULARS Rs mn	Q1FY17	Q2FY17	Q3FY17	Q4FY17	Q1FY18	Q2FY18	Q3FY18	Q4FY18
P & L								
Total revenues	3,158	3,422	3,102	3,202	2,772	3,193	3,354	3,307
Material cost	1,913	2,069	1,905	1,919	1,623	2,013	2,124	2,066
Personnel cost	126	132	127	143	136	143	150	151
Other expenses	638	715	648	677	659	511	540	524
Total expenses	2,677	2,916	2,680	2,739	2,418	2,667	2,814	2,741
EBIDTA	481	506	422	463	354	526	540	566
Other income	-	6	9	22	1	1	1	8
PBDIT	481	512	431	485	355	527	541	574
Interest	100	88	91	86	89	80	91	89
Depreciation	96	97	99	92	98	101	100	102
Profit before tax	285	327	241	307	168	346	350	383
Tax provision	86	106	63	88	54	110	117	143
PAT before EO items	199	221	178	219	114	236	233	240
Growth (%)								
Revenues	*11.3*	*25.4*	*15.4*	*1.8*	*(12.2)*	*(6.7)*	*8.1*	*3.3*
EBIDTA	*8.8*	*18.8*	*(2.3)*	*1.1*	*(26.4)*	*4.0*	*28.0*	*22.2*
Net Profit	*14.4*	*40.8*	*4.7*	*17.7*	*(42.7)*	*6.8*	*30.9*	*9.6*
Margin (%)								
EBIDTA	*15.2*	*14.8*	*13.6*	*14.5*	*12.8*	*16.5*	*16.1*	*17.1*
Profit before tax	*9.0*	*9.6*	*7.8*	*9.6*	*6.1*	*10.8*	*10.4*	*11.6*
Net margin	*6.3*	*6.5*	*5.7*	*6.8*	*4.1*	*7.4*	*6.9*	*7.3*

Source: Company, Centrum Research

Exhibit 7: Key performance indicators

Key performance indicator	FY16	FY17	FY18	FY19E	FY20E
Revenue growth %	*3.7*	*5.3*	*4.1*	*18.8*	*18.8*
Material cost (%)	*67.6*	*65.3*	*62.9*	*61.5*	*61.5*

Source: Centrum Research Estimates

Financials -standalone

Exhibit 8: Income Statement

Y/E March (Rs mn)	FY16	FY17	FY18	FY19E	FY20E
Revenues	**11,349**	**11,952**	**12,437**	**14,769**	**17,542**
Material cost	7,668	7,805	7,827	9,080	10,785
% of revenues	*67.6*	*65.3*	*62.9*	*61.5*	*61.5*
Employee cost	448	528	579	709	825
% of revenues	*3.9*	*4.4*	*4.7*	*4.8*	*4.7*
Other Expenses	1,485	1,750	2,046	2,530	2,954
% of revenues	*13.1*	*14.6*	*16.5*	*17.1*	*16.8*
EBIDTA	**1,748**	**1,869**	**1,985**	**2,450**	**2,978**
EBIDTA margin (%)	*15.4*	*15.6*	*16.0*	*16.6*	*17.0*
Depreciation & Amortisation	366	385	401	458	522
EBIT	1,382	1,484	1,584	1,992	2,456
Interest Expenses	480	364	350	375	450
PBT from operations	902	1,120	1,234	1,617	2,006
Other income	50	40	11	16	20
PBT	952	1,160	1,245	1,633	2,026
Tax provision	266	342	422	505	620
Effective tax rate (%)	*27.9*	*29.5*	*33.9*	*30.9*	*30.6*
Net profit	686	818	823	1,128	1,406
Minority interest	-	-	-	-	-
Reported net profit	686	818	823	1,128	1,406
Adj. Net profit	**686**	**818**	**823**	**1,128**	**1,406**

Source: Company, Centrum Research Estimates

Exhibit 9: Key Ratios

Y/E March (Rs mn)	FY16	FY17	FY18	FY19E	FY20E
Growth Ratios (%)					
Revenues	*3.7*	*5.3*	*4.1*	*18.8*	*18.8*
EBIDTA	*2.9*	*6.9*	*6.2*	*23.4*	*21.6*
Adj. Net Profit	*(11.1)*	*19.2*	*0.6*	*37.1*	*24.6*
Margin Ratios (%)					
EBIDTA margin	*15.4*	*15.6*	*16.0*	*16.6*	*17.0*
PBT from operations margin	*7.9*	*9.4*	*9.9*	*10.9*	*11.4*
Adj. PAT margin	*6.0*	*6.8*	*6.6*	*7.6*	*8.0*
Return Ratios (%)					
RoCE	*12.8*	*12.2*	*10.7*	*13.0*	*14.9*
RoE	*20.6*	*21.6*	*19.2*	*22.7*	*23.8*
RoIC	*12.5*	*11.9*	*10.7*	*13.0*	*15.0*
Turnover ratios (days)					
Gross Block Turnover (x)	1.6	1.5	1.4	1.6	1.7
Debtors	107	91	110	109	109
Creditors	59	60	76	77	77
Inventory	57	64	82	80	78
Cash Conversion Cycle	105	95	115	112	110
Solvency Ratio					
Debt-Equity	1.3	1.1	1.1	0.9	0.8
Net Debt-Equity	1.2	1.1	1.1	0.9	0.8
Current Ratio	2.2	2.1	2.2	2.1	2.1
Interest Coverage Ratio	0.3	0.2	0.2	0.2	0.2
Gross Debt/EBIDTA	2.6	2.4	2.6	2.1	1.7
Per Share (Rs)					
FDEPS (adjusted)	29.3	35.0	35.2	48.3	60.1
CEPS	45.0	51.5	52.4	67.9	82.5
Book Value	152.9	171.2	194.9	229.9	276.2
Dividend	6.8	10.7	1.0	2.0	2.5
Dividend Payout (%) (incl. buyback)	*28.0*	*36.4*	*34.5*	*27.2*	*22.9*
Valuations (x) (Avg Mkt Cap)					
PER	20.2	16.0	16.1	11.7	16.0
P/BV	3.9	3.3	2.9	2.5	3.5
EV/EBIDTA	10.8	9.5	9.3	7.4	9.1
Dividend Yield (%)	*1.3*	*2.2*	*2.1*	*2.3*	*1.4*
5-yr Avg AOCF/EV yield(%)	*2.8*	*4.3*	*4.1*	*4.9*	*3.8*

Source: Company, Centrum Research Estimates

Exhibit 10: Balance Sheet

Y/E March (Rs mn)	FY16	FY17	FY18	FY19E	FY20E
Share capital	242	239	236	234	232
Sh. Application money	-	-	-	-	-
Reserves & surplus	3,332	3,763	4,319	5,139	6,224
Total shareholders Funds	3,574	4,002	4,555	5,373	6,455
Total Debt	4,497	4,463	5,083	5,050	5,120
Minority interest	-	-	-	-	-
Deferred tax Liab.	404	718	809	500	520
Total Liabilities	**8,475**	**9,183**	**10,447**	**10,923**	**12,095**
Gross Block	7,255	8,514	9,116	9,803	10,724
Less: Acc. Depreciation	2,320	2,706	3,092	3,533	4,035
Net Block	4,935	5,808	6,024	6,270	6,689
Capital WIP	340	143	285	110	120
Net Fixed Assets	**5,275**	**5,951**	**6,309**	**6,380**	**6,809**
Investments	46	119	108	116	133
Inventories	1,783	2,098	2,782	3,247	3,748
Debtors	3,317	2,968	3,735	4,400	5,220
Loans & Advances	241	324	236	285	325
Cash & Bank Balance	48	42	43	87	130
Other assets	312	411	666	479	530
Total Current Assets	**5,701**	**5,843**	**7,462**	**8,498**	**9,953**
Trade payable	1,849	1,970	2,587	3,100	3,700
Other current Liabilities	545	659	667	771	860
Provisions	153	101	178	200	240
Net Current Assets	**3,154**	**3,113**	**4,030**	**4,427**	**5,153**
Total Assets	**8,475**	**9,183**	**10,447**	**10,923**	**12,095**

Source: Company, Centrum Research Estimates

Exhibit 11: Cash Flow

Y/E March (Rs mn)	FY16	FY17	FY18	FY19E	FY20E
CF before WC changes	1,745	1,887	1,990	2,458	2,988
Working Capital Changes	(212)	72	(993)	(375)	(723)
CF from Operations	**1,333**	**1,745**	**669**	**1,658**	**1,735**
Adj OCF (OCF-Interest)	853	1,381	319	1,283	1,285
Change in fixed assets	(997)	(1,071)	(756)	(529)	(951)
Adj. FCF (AOCF-Capex)	(144)	310	(437)	754	334
CF from Investing	**(988)**	**(1,070)**	**(739)**	**(529)**	**(958)**
CF from Financing	**(333)**	**(682)**	**(255)**	**(965)**	**(952)**
Net change in Cash	**12**	**(7)**	**(325)**	**164**	**(175)**

Source: Company, Centrum Research Estimates

Appendix A

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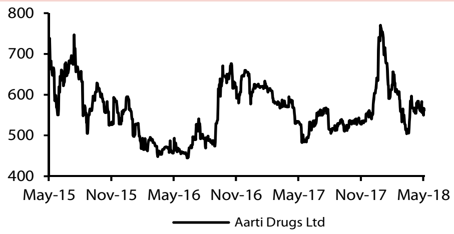
Aarti Drugs chart



Source: Bloomberg, Centrum Research

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		Aarti Drugs	Granules India
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Hold	Upside between -20% to +20%	Upside between -15% to +15%	Upside between -10% to +10%
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