

Leadership position in selected APIs; maintain Buy

We maintain our Buy rating on Aarti Drugs (ADL) and retain the TP to Rs910 based on 16x March'20 EPS of Rs56.8. ADL is the market leader in 9 out of 10 APIs manufactured by the company. 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 in place. Key risks to our assumptions include slowdown in the domestic pharma market and regulatory risks for its manufacturing facilities.

- **Market leader in selected APIs:** ADL is the market leader in 9 out of top 10 APIs manufactured by the company. The company is pioneer in achieving production and operational efficiencies. ADL is the lowest cost producer and the same is achieved through continuous process improvement. The promoters being qualified chemical engineers, the company derives technological advantage compared to its competition. ADL caters to all major domestic pharma companies and works on import substitution. Only 5 out of 10 products manufactured by ADL are produced in China and hence the Chinese competition is limited to 5 products only.
- **Presence across therapeutic categories:** ADL has presence in anti-infective, gastrointestinal, anti-diabetic, NSAIDs and antifungal therapeutic segments. In the anti-infective segment, ADL is the largest producer of Ciprofloxacin and Norfloxacin in India. ADL is the largest manufacturer of Metronidazole and Metronidazole benzoate in the gastrointestinal segment. The company is one of the largest manufacturers of Metformin HCl in anti-diabetic segment. ADL is the largest producer of Celecoxib-NSAIDs in India. The company is the largest producer of Ketoconazole and Itriconazole-antifungal drugs in India.
- **Vertical integration:** ADL derives the benefits from the presence over the entire value chain from intermediates-->API->Formulations. ADL derives ~13% of its revenues from the formulations business. The company's formulation manufacturing facility is located at Baddi in Himachal Pradesh. The formulation business is growing at 15% per annum. ADL has tied up with the European distributor on profit sharing basis. ADL supplies APIs for the formulation business at prevailing market rates.
- **Recommendation and key risks:** We maintain our Buy rating on ADL with a TP of Rs910 based on 16x March'20E EPS of Rs56.8. ADL is likely to benefit from depreciation of rupee against the dollar. We expect ADL to perform well due to capacity expansion, new product launches and presence in the high-margin formulations. ADL is likely to benefit from economies of the scale. Key risks to our assumptions are a slowdown in the domestic market and regulatory risks for its manufacturing facilities.

Target Price	Rs910	Key Data	
CMP*	Rs564	Bloomberg Code	ARTD IN
Upside	61.4%	Curr Shares O/S (mn)	23.6
Previous Target	Rs910	Diluted Shares O/S(mn)	23.6
Previous Rating	Buy	Mkt Cap (Rsbn/USDmn)	13.3/180.3
Price Performance (%)*		52 Wk H / L (Rs)	785/490.7
	1M 6M 1Yr	5 Year H / L (Rs)	874.9/88.9
ARTD IN	(6.9) 3.7 10.1	Daily Vol. (3M NSE Avg.)	33707
Nifty	(7.4) 5.3 7.6		

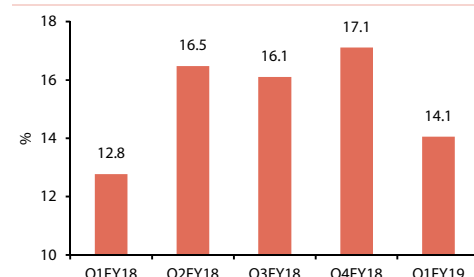
*as on 3rd October 2018; Source: Bloomberg, Centrum Research

Shareholding pattern (%)

	June-18	Mar-18	Dec-17	Sept-17
Promoter	62.5	62.5	62.4	62.5
FIs	0.9	0.8	0.7	0.7
DIs	4.7	4.6	4.6	4.5
Others	31.9	32.1	32.3	32.3

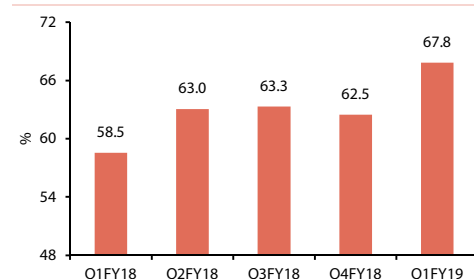
Source: BSE, *as on 3rd October 2018

Trend in EBITDA margin (%)



Source: Company, Centrum Research

Trend in material cost (%)



Source: Centrum Research

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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	15,299	23.0	2,267	14.8	1,039	26.2	44.4	21.1	12.2	12.7	8.0
FY20E	18,298	19.6	2,819	15.4	1,327	27.7	56.8	22.9	14.1	9.9	6.5

Source: Company, Centrum Research Estimates

In the interest of timeliness, this document is not edited.

Centrum Equity Research is available on Bloomberg, Thomson Reuters and FactSet

Other developments

We recently interacted with Aarti Drugs (ADL). The details of interaction are as follows:

Company background

Aarti Drugs (ADL) is the market leader in 9 out of top 10 products manufactured by the company. ADL is pioneer in achieving production and operational efficiencies. The company is the lowest cost producer and the same is achieved through continuous process improvement.

Promoters

The promoters currently hold 62.5% of the shares. The promoter's holding is divided as follows:

Gogri family 50% of promoter's holding, Patil family 25% and Savla family 25%. Prakash Patil is Chairman and Managing Director and looks after operations. Harshit Savla looks at Taxation and formulation business.

Major products

The major APIs manufactured by the company includes: Ciprofloxacin, O-floxacin, Metronidazole, Metronidazole benzoate, Metformin HCl, Celecoxib, Ketoconazole, Itraconazole, Diclofenac sodium etc. ADL is the largest producer of Ciprofloxacin in India and exports 40% to emerging markets. The company faces competition from 3 Chinese players and two domestic players namely: Godavari and Sreepathi.

- ADL is the largest manufacturer of O-floxacin in India. The company was facing competition from China for this product. ADL approached the Government Authorities and was successful in implementing anti-dumping duty of \$3.6 per Kg from material imported from China.
- The company is the largest producer of Metronidazole and Metronidazole benzoate in India. ADL exports ~22% of this product to various countries.
- ADL is one of the largest producer of Metformin HCl in India. The company faces competition from USV, Granules India and Wanbury.
- The company is the largest producer of Celecoxib in India. The patent for the same as expired and the product has become generic.
- ADL is the largest producer of Ketoconazole-antifungal drug. The company exports the intermediate of Ketoconazole to China. ADL has developed Itraconazole-another powerful antifungal drug. The company faces competition from Piramal Enterprises in the domestic market.
- The company is one of the major producers of Diclofenac sodium and faces competition from J.B. Chemicals & Pharmaceuticals and Amoli Drugs.
- ADL is the largest producer of Norfloxacin in India.

Manufacturing facilities

ADL's manufacturing facilities are located at Tarapur, Maharashtra and Sarigam-Gujarat. It's formulation facility is located at Baddi, Himachal Pradesh.

Domestic business

ADL enters into monthly contracts for its APIs in the domestic market.

Formulations

ADL derives ~13% of its revenues from the formulation business. This business is growing at 15% per annum. ADL has tied up with the European distributor on profit sharing basis. The company supplies API at market rate for the formulation business.

Exports

ADL is selling its products through distributors in Mexico and Brazil. The company receives 96-97% export proceeds in dollar terms and would benefit from rupee depreciation against the dollar. ADL has slowed down its exports to Turkey due to currency fluctuations.

ADL has secured coverage under ECGC policy for exports. The company has 3 months pending orders for exports. ADL's 35% of revenues come from exports. Export margins are higher than the domestic business.

Competition

Out of ADL's top 10 products, only 5 are manufactured in China and hence, the competition from China is restricted to 5 products. Currently, ADL has 4 products registered in China.

Rupee depreciation

The depreciation of rupee against \$ is likely to benefit the company.

US FDA issues

ADL's Tarapur facility was re-inspected by US FDA. The company was issued form 483 with 5 observations and submitted its response in June'18. The company has received EIR from US FDA. This facility is approved by EU GMP.

ADL has filed DMFs with US FDA for the following products: Celecoxib, Ciprofloxacin, Metronidazole.

Capex

ADL spends ~Rs1.00bn on capex per annum. Out of this, 30-35% is maintenance capex from internal accrual. The balance 70% of capex from new projects is funded through 75% loans and 25% from internal accruals.

Rise in demand

ADL has witnessed good demand pick up for its products due to lower imports from China. The company has achieved better export realisation due to weakening of rupee against the dollar and has witnessed 27% YoY volume growth in exports due to additional regulatory approval from its customers. ADL has achieved 52% growth in domestic volumes due to low base in Q1FY18 due to GST impact. The company has higher focus on lifestyle segments due to higher margins. The anti-infective portfolio accounted for 34% of revenues during Q1FY19.

Buyback of shares

ADL had buyback of 0.275mn equity shares of Rs10 each at Rs875 per share aggregating to Rs240mn during FY18. The Buyback in FY17 was Rs300mn.

Valuation & key risks

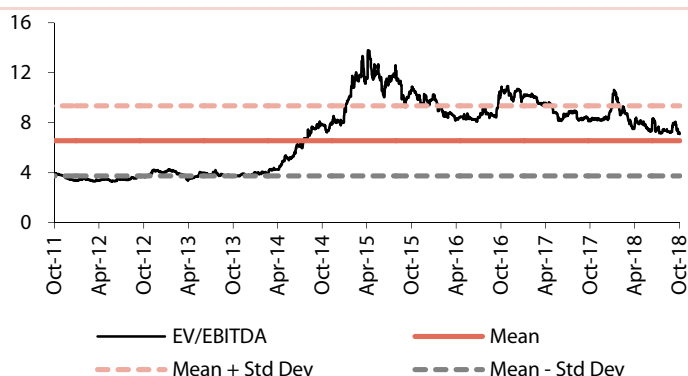
We maintain our Buy rating on ADL with TP of Rs910 based on 16x March'20E EPS of Rs56.8. We expect ADL to perform well due to its diversified API portfolio, benefits of vertical integration and slowdown in API manufacturing in China due to environmental issues. ADL is the market leader in 9 out of the 10 products manufactured by it. Key risks to our assumptions are a slowdown in the domestic pharma market and regulatory issues for its manufacturing facilities.

Exhibit 1: Sensitivity Analysis

Sensitivity to key variables – FY19E	% change	% impact on EBITDA	% impact on EPS
Sales	1	6.7	14.7
Material cost	1	(4.5)	(9.8)

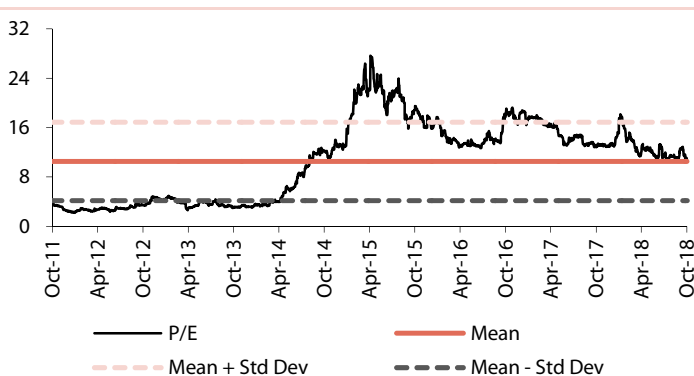
Source: Company, Centrum Research Estimates

Exhibit 2: 1 year forward EV/EBITDA chart



Source: Bloomberg, Company, Centrum Research Estimates

Exhibit 3: 1 year forward P/E chart



Source: Bloomberg, Company, Centrum Research Estimates

Exhibit 4: Comparative Valuations

Company	Mkt Cap (Rs mn)	CAGR FY18-FY20E (%)			EBITDA Margin (%)			PE (x)			EV/EBITDA (x)			RoE (%)			Div Yield (%)		
		Rev.	EBITDA	PAT	FY18	FY19	FY20E	FY18	FY19	FY20E	FY18	FY19	FY20E	FY18	FY19	FY20E	FY18	FY19	FY20E
Aarti Drugs	13,184	21.3	19.2	27.0	16.0	14.8	15.4	16.1	12.7	9.9	9.3	8.0	6.5	19.2	21.1	22.9	2.1	2.3	2.5
Granules India	24,892	16.7	20.6	47.2	16.5	15.9	17.6	25.1	11.4	8.7	14.4	10.2	8.2	12.0	15.6	18.0	0.9	1.7	1.9
Laurus Labs *	45,084	NA	NA	44.2	20.8	NA	NA	33.4	20.2	13.6	16.5	NA	NA	12.1	14.0	NA	0.3	0.3	0.3
Neuland Labs *	11,246	21.0	63.5	116.8	9.5	12.6	17.3	106.1	38.0	15.0	25.5	17.6	10.5	2.2	5.6	9.8	0/0	0.2	0.5

Source: Company, Centrum Research Estimates, Prices as on 3rd October 2018 *Bloomberg Estimates

Quarterly financials, Operating Metrics and Key Performance Indicators

Exhibit 5: Quarterly Financials

Particulars (Rs mn)	Q2FY17	Q3FY17	Q4FY17	Q1FY18	Q2FY18	Q3FY18	Q4FY18	Q1FY19
P & L								
Total revenues	3,422	3,102	3,202	2,772	3,193	3,354	3,307	3,743
Material cost	2,069	1,905	1,919	1,623	2,013	2,124	2,066	2,539
Personnel cost	132	127	143	136	143	150	151	149
Other expenses	715	648	677	659	511	540	524	529
Total expenses	2,916	2,680	2,739	2,418	2,667	2,814	2,741	3,217
EBIDTA	506	422	463	354	526	540	566	526
Other income	6	9	22	1	1	1	8	9
PBDIT	512	431	485	355	527	541	574	535
Interest	88	91	86	89	80	91	89	94
Depreciation	97	99	92	98	101	100	102	104
Profit before tax	327	241	307	168	346	350	383	337
Tax provision	106	63	88	54	110	117	143	103
PAT before EO items	221	178	219	114	236	233	240	234
EO items	0	0	0	0	0	0	0	0
PAT after EO items	221	178	219	114	236	233	240	234
Growth (%)								
Revenues	25.4	15.4	1.8	(12.2)	(6.7)	8.1	3.3	35.0
EBIDTA	18.8	(2.3)	1.1	(26.4)	4.0	28.0	22.2	48.6
Net Profit	40.8	4.7	17.7	(42.7)	6.8	30.9	9.6	105.3
Margin (%)								
EBIDTA	14.8	13.6	14.5	12.8	16.5	16.1	17.1	14.1
Profit before tax	9.6	7.8	9.6	6.1	10.8	10.4	11.6	9.0
Net margin	6.5	5.7	6.8	4.1	7.4	6.9	7.3	6.3

Source: Company, Centrum Research

Exhibit 6: Key performance indicators

Key performance indicator	FY16	FY17	FY18	FY19E	FY20E
Revenue growth %	3.7	5.3	4.1	23.0	19.6
Material cost (%)	67.6	65.3	62.9	66.9	67.1

Source: Centrum Research Estimates

Financials - consolidated

Exhibit 7: Income Statement

Y/E March (Rs mn)	FY16	FY17	FY18	FY19E	FY20E
Revenues	11,349	11,952	12,437	15,299	18,298
Material cost	7,668	7,805	7,827	10,230	12,285
% of revenues	67.6	65.3	62.9	66.9	67.1
Employee cost	448	528	579	619	725
% of revenues	3.9	4.4	4.7	4.0	4.0
Other Expenses	1,485	1,750	2,046	2,183	2,469
% of revenues	13.1	14.6	16.5	14.3	13.5
EBIDTA	1,748	1,869	1,985	2,267	2,819
EBIDTA margin (%)	15.4	15.6	16.0	14.8	15.4
Depreciation & Amortisation	366	385	401	458	522
EBIT	1,382	1,484	1,584	1,809	2,297
Interest Expenses	480	364	350	375	445
PBT from operations	902	1,120	1,234	1,434	1,852
Other income	50	40	11	25	35
PBT	952	1,160	1,245	1,459	1,887
Tax provision	266	342	422	420	560
Effective tax rate (%)	27.9	29.5	33.9	28.8	29.7
Net profit	686	818	823	1,039	1,327
Minority interest	-	-	-	-	-
Reported net profit	686	818	823	1,039	1,327
Adj. Net profit	686	818	823	1,039	1,327

Source: Company, Centrum Research Estimates

Exhibit 8: Key Ratios

Y/E March	FY16	FY17	FY18	FY19E	FY20E
Growth Ratios (%)					
Revenues	3.7	5.3	4.1	23.0	19.6
EBIDTA	2.9	6.9	6.2	14.2	24.3
Adj. Net Profit	(11.1)	19.2	0.6	26.2	27.7
Margin Ratios (%)					
EBIDTA margin	15.4	15.6	16.0	14.8	15.4
PBT from operations margin	7.9	9.4	9.9	9.4	10.1
Adj. PAT margin	6.0	6.8	6.6	6.8	7.3
Return Ratios (%)					
RoCE	12.8	12.2	10.7	12.2	14.1
RoE	20.6	21.6	19.2	21.1	22.9
RoIC	12.5	11.9	10.7	12.1	14.2
Turnover ratios (days)					
Gross Block Turnover (x)	1.6	1.5	1.4	1.6	1.8
Debtors	107	91	110	105	104
Creditors	59	60	76	74	74
Inventory	57	64	82	77	75
Cash Conversion Cycle	105	95	115	108	105
Solvency Ratio					
Debt-Equity	1.3	1.1	1.1	1.0	0.9
Net Debt-Equity	1.2	1.1	1.1	1.0	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	2.3	1.9
Per Share (Rs)					
FDEPS (adjusted)	29.3	35.0	35.2	44.4	56.8
CEPS	45.0	51.5	52.4	64.0	79.1
Book Value	152.9	171.2	194.9	226.1	269.0
Dividend	6.8	10.7	1.0	2.0	2.5
Dividend Payout (%) (incl. buyback)	28.0	36.4	34.5	29.6	24.2
Valuations (x) (Avg Mkt Cap)					
PER	20.2	16.0	16.1	12.7	9.9
P/BV	3.9	3.3	2.9	2.5	2.1
EV/EBIDTA	10.8	9.5	9.3	8.0	6.5
Dividend Yield (%)	1.3	2.2	2.1	2.3	2.5
5-yr Avg AOCF/EV yield(%)	2.8	4.3	4.1	4.8	5.5

Source: Company, Centrum Research Estimates

Exhibit 9: 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	5,050	6,056
Total shareholders Funds	3,574	4,002	4,555	5,284	6,287
Total Debt	4,497	4,463	5,083	5,250	5,470
Minority interest	-	-	-	-	-
Deferred tax Liab.	404	718	809	500	520
Total Liabilities	8,475	9,183	10,447	11,034	12,277
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	137
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	198	308
Other assets	312	411	666	479	530
Total Current Assets	5,701	5,843	7,462	8,609	10,131
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	4,538	5,331
Total Assets	8,475	9,183	10,447	11,034	12,277

Source: Company, Centrum Research Estimates

Exhibit 10: Cash Flow

Y/E March (Rs mn)	FY16	FY17	FY18	FY19E	FY20E
CF before WC changes	1,745	1,887	1,990	2,282	2,839
Working Capital Changes	(212)	72	(993)	(375)	(723)
CF from Operations	1,333	1,745	669	1,587	1,666
Adj OCF (OCF-Interest)	853	1,381	319	1,212	1,221
Change in fixed assets	(997)	(1,071)	(756)	(529)	(951)
Adj. FCF (AOCF-Capex)	(144)	310	(437)	683	270
CF from Investing	(988)	(1,070)	(739)	(527)	(957)
CF from Financing	(333)	(682)	(255)	(765)	(797)
Net change in Cash	12	(7)	(325)	295	(88)

Source: Company, Centrum Research Estimates

Appendix A

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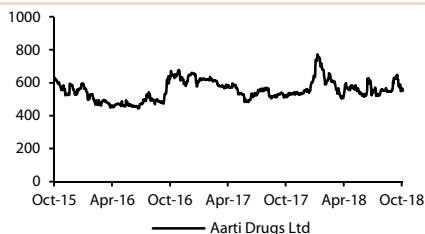
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Aarti Drugs chart



Source: Bloomberg, Centrum Research

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Rating	Market cap < Rs20bn	Market cap > Rs20bn but < 100bn	Market cap > Rs100bn
Buy	Upside > 20%	Upside > 15%	Upside > 10%
Hold	Upside between -20% to +20%	Upside between -15% to +15%	Upside between -10% to +10%
Sell	Downside > 20%	Downside > 15%	Downside > 10%

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