

19 May 2020

Aarti Drugs

China disruption and local API sourcing to drive growth; retaining a Buy

Aarti's Q4 sales slipped ~2% y/y as operations were hurt in the last 10 days of the quarter by the Covid'19-related shutdown. The gross margin expanded 704bps y/y to 37% on higher realisations as prices of key APIs rose 10-15% and on benefits from the cost-rationalisation. The 15.9% EBITDA margin expanded 368bps y/y; absolute EBITDA grew 27.5% to ₹713m. Adj. PAT shot up 104.7% to ₹507m, driven by the better operating performance and lower tax rate. We expect revenue/PAT to clock 13.7%/20.3% CAGRs over FY20-22. We retain our Buy rating, with a higher target price of ₹1,028.

Covid'19-related shutdown took a toll on results. Aarti's API sales were down 5% to ₹4bn as manufacturing and sales were curtailed in the last 10 days of Q4. Barring this, the company increased the proportion of antibiotics products to 44% in FY20 (41% in FY19), mainly due to higher ciprofloxacin, ofloxacin and norfloxacin sales.

Apt to benefit from supply disruption. Prices of key APIs rose 10-15% as supplies from China have yet to resume in full swing. The company is evaluating contract manufacturing of products in shortage due to issues of supply from China. It expects prices to hold at these levels till global supplies are normal. Considering the new capacities and higher realisations we expect API revenue to register a 14.1% CAGR over FY20-22.

Formulations growth uninterrupted. In Q4 formulations grew 26.5% to ₹495m, driven by export formulations as the company was establishing its marketing presence and filing products in different territories..

Valuation. Aarti Drugs is currently in a sweet spot as it will benefit from opportunities arising out of China and is the prime candidate to benefit from the government's push for indigenous API manufacturing. We retain our Buy rating, with a higher price target of ₹1,028, based on 12x FY22e EPS. Risks: Delay in the ramp-up of the recently-added capacity; more-than-expected competition in generic APIs.

Key financials (YE Mar)	FY18	FY19	FY20	FY21e	FY22e
Sales (₹ m)	12,626	15,609	18,061	20,645	23,350
Net profit (₹ m)	823	872	1,380	1,660	1,996
EPS (₹)	34.9	37.0	59.2	71.3	85.7
PE (x)	14.5	21.4	13.4	11.1	9.2
EV / EBITDA (x)	8.7	11.3	8.5	7.1	5.8
PBV (x)	2.6	3.4	2.8	2.3	1.9
RoE (%)	19.2	17.5	23.1	22.7	22.1
RoCE (%)	10.4	10.3	14.5	16.3	17.3
Dividend yield (%)	0.2	0.1	0.3	0.5	0.8
Net debt / equity (x)	1.2	0.9	0.6	0.3	0.2

Source: Company, Anand Rathi Research

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Rating: **Buy**

Target Price: ₹1,028

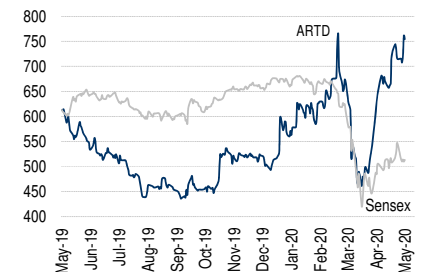
Share Price: ₹792

Key data	ARTD IN / ADRG.BO
52-week high / low	₹874 / 419
Sensex / Nifty	30029 / 8823
3-m average volume	\$0m
Market cap	₹20bn / \$310m
Shares outstanding	23.3m

Shareholding pattern (%)	Mar '20	Dec '19	Sep '19
Promoters	61.4	61.6	61.6
- of which, Pledged	0.0	-	-
Free float	38.6	38.4	38.4
- Foreign institutions	1.1	0.8	0.6
- Domestic institutions	4.8	4.8	4.7
- Public	32.7	32.7	33.0

Estimates revision (%)	FY21e	FY22e
Sales	-	-
EBITDA	1.9	(2.9)
PAT	18.5	11.4

Relative price performance



Source: Bloomberg

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Research AnalystShikha Jain
Research Analyst

Quick Glance – Financials and Valuations

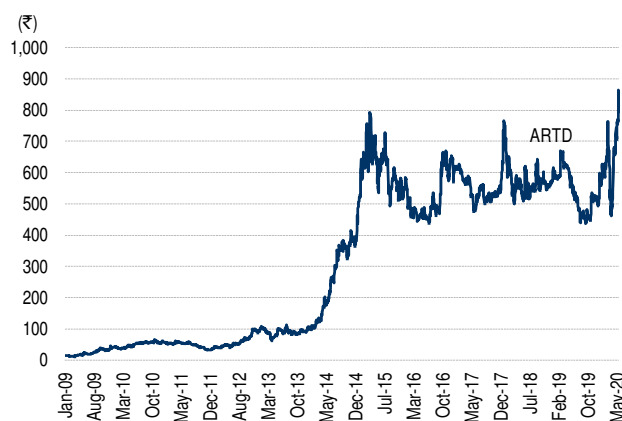
Fig 1 – Income statement (₹ m)

Year-end: Mar	FY18	FY19	FY20	FY21e	FY22e
Net revenues	12,626	15,609	18,061	20,645	23,350
Growth (%)	-2.0	23.6	15.7	14.3	13.1
Direct costs	7,827	10,600	11,790	13,387	15,200
SG&A	2,814	2,936	3,653	4,274	4,717
EBITDA	1,985	2,074	2,618	2,985	3,433
EBITDA margins (%)	15.7	13.3	14.5	14.5	14.7
- Depreciation	401	426	488	519	577
Other income	11	24	15	27	31
Interest expenses	350	400	337	279	225
PBT	1,245	1,310	1,853	2,214	2,662
Effective tax rate (%)	33.9	31.5	23.7	25.0	25.0
+ Associates / (Minorities)	-	-	-	-	-
Net income	823	898	1,414	1,660	1,996
Adjusted income	823	872	1,380	1,660	1,996
WANS	24	24	23	23	23
FDEPS (₹ / sh)	34.9	37.0	59.2	71.3	85.7

Fig 3 – Cash-flow statement (₹ m)

Year-end: Mar	FY18	FY19	FY20P	FY21e	FY22e
PBT (adj. for int.exp. / other income)	1,584	1,686	2,175	2,466	2,856
+ Non-cash items	401	426	488	519	577
Oper. prof. before WC	1,985	2,111	2,663	2,985	3,433
- Incr. / (decr.) in WC	968	281	-209	226	72
Others incl. taxes	328	326	533	553	665
Operating cash-flow	689	1,505	2,338	2,206	2,695
- Capex (tang. + intang.)	755	693	472	729	1,200
Free cash-flow	-67	811	1,867	1,476	1,495
Acquisitions	-	-	-	-	-
- Div. (incl. buyback & taxes)	267	114	70	93	140
+ Equity raised	-3	-	-3	-	-
+ Debt raised	668	-390	-1,194	-1,014	-350
- Fin investments	-12	17	9	20	31
- Misc. (CFI + CFF)	341	277	569	252	194
Net cash-flow	1	13	21	97	780

Source: Company, Anand Rathi Research

Fig 5 – Price movement


Source: Bloomberg

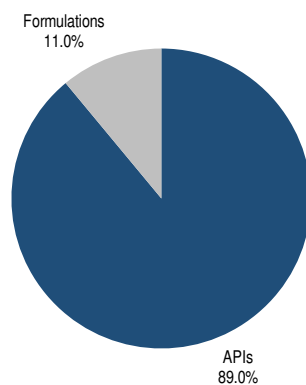
Fig 2 – Balance sheet (₹ m)

Year-end: Mar	FY18	FY19	FY20P	FY21e	FY22e
Share capital	236	236	233	233	233
Net worth	4,554	5,434	6,525	8,092	9,949
Debt	5,463	5,072	3,878	2,864	2,514
Minority interest	-	-	-	-	-
DTL / (Assets)	809	898	807	807	807
Capital employed	10,826	11,405	11,210	11,763	13,270
Net tangible assets	5,979	6,220	6,423	6,404	7,041
Net intangible assets	45	29	15	35	41
Goodwill	-	-	-	-	-
CWIP (tang. & intang.)	284	327	122	332	312
Investments (strategic)	108	124	134	154	184
Investments (financial)	-	-	-	-	-
Current assets (ex cash)	7,435	7,799	8,995	8,933	9,677
Cash	43	56	76	173	954
Current liabilities	3,068	3,150	4,555	4,268	4,940
Working capital	4,367	4,649	4,440	4,665	4,738
Capital deployed	10,826	11,405	11,210	11,763	13,270
Contingent liabilities	567	747	-	-	-

Fig 4 – Ratio analysis

Year-end: Mar	FY18	FY19	FY20P	FY21e	FY22e
P/E (x)	14.5	21.4	13.4	11.1	9.2
EV / EBITDA (x)	8.7	11.3	8.5	7.1	5.8
EV / Sales (x)	1.4	1.5	1.2	1.0	0.9
P/B (x)	2.6	3.4	2.8	2.3	1.9
RoE (%)	19.2	17.5	23.1	22.7	22.1
RoCE (%) - after tax	10.4	10.3	14.5	16.3	17.3
ANDA filings					
DPS (₹ / sh)	1.0	1.0	2.5	4.0	6.0
Dividend yield (%)	0.2	0.1	0.3	0.5	0.8
Dividend payout (%) - incl. DDT	32.5	12.7	5.0	5.6	7.0
Net debt / equity (x)	1.2	0.9	0.6	0.3	0.2
Receivables (days)	108	107	99	90	85
Inventory (days)	80	58	66	49	48
Payables (days)	75	57	67	57	60
CFO :PAT%	83.7	172.6	169.5	132.8	135.0

Source: Company, Anand Rathi Research

Fig 6 – Revenue break-up (Q4 FY20)


Source: Company

Result highlights

Fig 7 – Quarterly financials

₹ m)	Q1FY19	Q2FY19	Q3FY19	Q4FY19	Q1FY20	Q2FY20	Q3FY20	Q4FY20	% yoy	% qoq	FY19	FY20	% yoy
Sales	3,743	3,474	3,801	4,591	4,054	4,775	4,735	4,496	(2.1)	(5.0)	15,609	18,061	15.7
Gross profit	1,203	1,157	1,273	1,376	1,363	1,611	1,633	1,665	20.9	1.9	5,620	6,642	18.2
<i>Gross margins (%)</i>	32.2	33.3	33.5	30.0	33.6	33.7	34.5	37.0	704bps	254bps	36.0	36.8	77bps
EBITDA	526	470	519	559	547	683	675	713	27.5	5.7	2,074	2,618	26.2
<i>EBITDA margins (%)</i>	14.1	13.5	13.6	12.2	13.5	14.3	14.3	15.9	368bps	161bps	13.3	14.5	121bps
Finance expenses	94	97	105	103	93	85	84	75	(27.8)	(11.0)	400	337	(15.6)
Depreciation	104	106	107	108	118	121	124	125	15.5	1.1	426	488	14.5
Other income	9	1	2	12	1	2	3	10	(20.3)	292.0	24	15	(38.6)
PBT	337	267	308	398	336	479	431	607	52.7	40.9	1,310	1,853	41.4
Tax	83	70	74	99	91	134	139	170	71.3	22.2	413	439	6.3
<i>Effective tax rate (%)</i>	30.7	32.5	32.3	31.1	33.3	32.5	35.5	3.1	-2808bps	-3245bps	31.5	23.7	-781bps
Adjusted PAT	234	181	209	248	225	323	303	507	104.7	67.4	872	1,380	58.3

Source: Company, Anand Rathi Research

Fig 8 – Revenue assumption

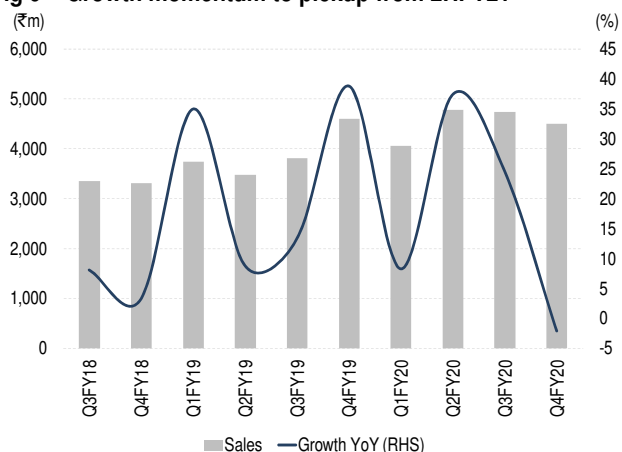
	FY21e	FY22e
APIs	17,504	19,804
<i>% of sales</i>	84.8	84.8
<i>Y/Y%</i>	11.0	13.0
Formulations	1,958	2,213
<i>% of sales</i>	9.5	9.5
<i>Y/Y%</i>	10.0	12.0
Specialty chemicals	652	756
<i>% of sales</i>	3.2	3.2
<i>Y/Y%</i>	14.0	16.0
Intermediates	203	235
<i>% of sales</i>	1.0	1.0
<i>Y/Y%</i>	16.0	16.0
Total	20,645	23,350

Source: Company, Anand Rathi Research

Concall Highlights

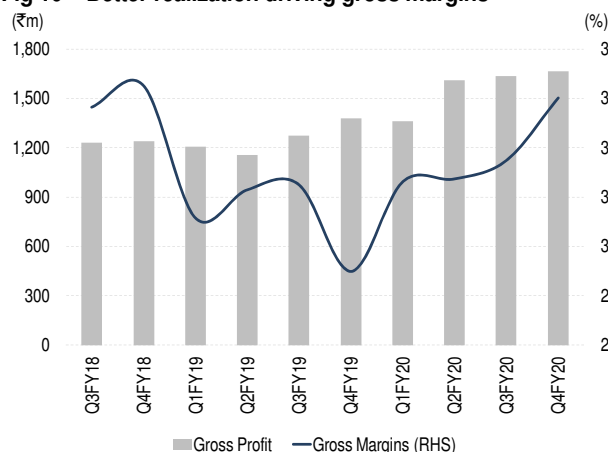
- During the quarter domestic API revenue grew 1.3% y/y and export API revenue declined 14.9% y/y due to unavailability of cargo. Formulations revenue grew 26.5% y/y.
- API contributed 89%, of which 64% was from the domestic market, the rest from exports. Formulations contributed 11% to revenue, of which 49% was export revenue.
- In FY20 anti-infective APIs contributed 44% (41% in FY19) to API sales, anti-protzoal 16%, anti-inflammatories and anti-diabetes 10% each and anti-fungals 7% to overall sales.
- The top 10 products currently contribute ~70-75% of revenue.
- The gross-margin expansion was mainly due to better realisations, fall in crude prices, a better product mix and greater efficiency.
- Forex loss was ₹90m and taken as part of raw material cost.
- Aarti has reduced its reliance on Chinese raw materials quite drastically and now sources only 15-20% of its raw material from China, compared to 40-50% earlier.
- Higher employee expenses was due to payment of labour contract and more employees due to facility addition
- Other expenses increased due to capacity expansion and higher manufacturing expenses (zero discharging, i.e. evaporating liquid waste).
- On 31st Mar'20 the debt-equity ratio came down to 0.58x due to continuous improvement in working capital.
- During FY20 the company increased capacity for anti-inflammatory and anti-diabetic the rapirs.
- Due to the ongoing shut-down production has been curtailed to a certain extent and most of its plants are operating at 70%.
- Its present range of drugs includes 4-5 products which are part of the 53 drugs for which the government of India is providing incentives to promote indigenous manufacturing. These (including floxacins) contribute 15%-20% of revenue.
- Management said FY21 revenue growth would be 10-15% and driven by both volumes and price hikes.
- The EBITDA margin post settlement of the Covid-19 pandemic is expected to return to prior levels of 15%-16%.
- For FY21 capex plan is of ₹700m-1000m, of which it would spend ₹300m 400m for specialty chemicals.
- Management said that domestic margins are significantly higher than exports and expects exports to grow faster.
- Tax rate for FY21 is expected to be ~25%.

Fig 9 – Growth momentum to pickup from 2HFY21



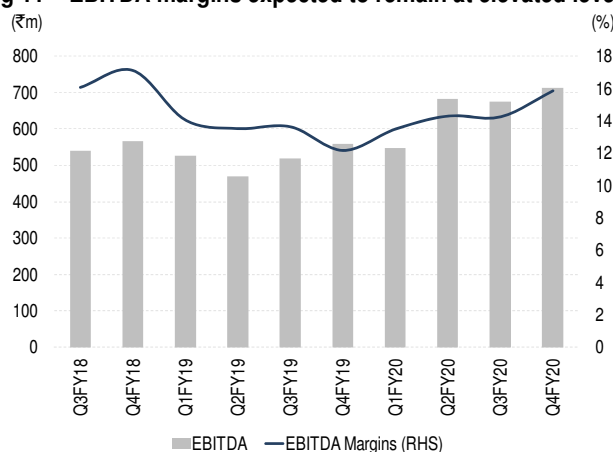
Source: Company, Anand Rathi Research

Fig 10 – Better realization driving gross margins



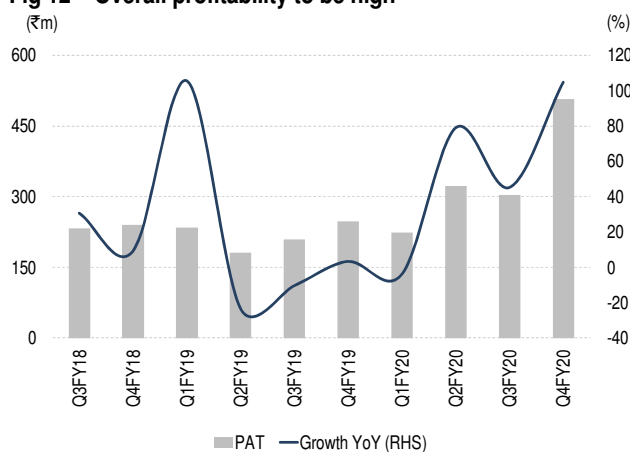
Source: Company, Anand Rathi Research

Fig 11 – EBITDA margins expected to remain at elevated level



Source: Company, Anand Rathi Research

Fig 12 – Overall profitability to be high



Source: Company, Anand Rathi Research

Valuations

We raise our FY21e/FY22e PAT 18.5%/11.4%; on account of the better-than-expected Q4 FY20, higher export formulations business and lower-than-expected tax-rate guidance.

Fig 13 – Change in estimates

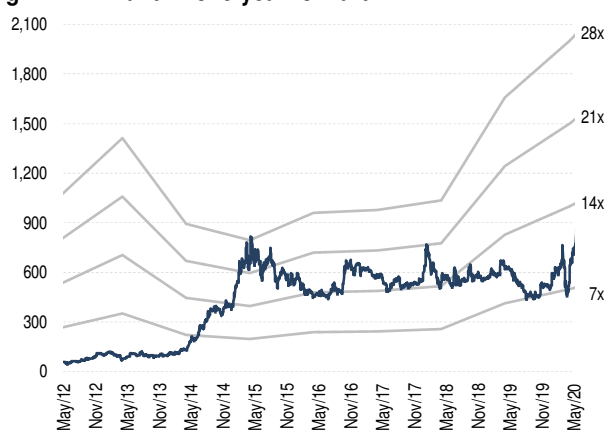
₹ m	Old estimates		New estimates		Change (%)	
	FY21e	FY22e	FY21e	FY22e	FY21e	FY22e
Revenue	20,645	23,350	20,645	23,350	-	-
EBITDA	2,929	3,536	2,985	3,433	1.9	(2.9)
PAT	1,401	1,791	1,660	1,996	18.5	11.4

Source: Anand Rathi Research

Aarti Drugs is in a sweet spot as it will benefit from opportunities arising out of China. It has started contract manufacturing of a few products which are in shortage and is further evaluating a few more. Besides, its key products feature in the list of 53 drugs for which the government is keen to boost indigenous manufacturing. Favorable macros along with recent additions in capacity for diabetes and specialty chemicals will help Aarti's earnings to grow 20% over FY20-22.

At the CMP of ₹792, the stock trades at 11.1x and 9.2x its FY21e and FY22e earnings respectively. We expect revenue and PAT CAGRs over FY20-22 of respectively 14.4% and 31.8%. We retain our Buy recommendation on the stock, with a higher price target of ₹1,028, based on 12x (earlier 10x) FY22e EPS.

Fig 14 – PE Band – one-year-forward



Source: Bloomberg, Anand Rathi Research

Fig 15 – Standard deviation – one-year-forward



Source: Bloomberg, Anand Rathi Research

Risks

- Delay in the ramp-up of the recently-added capacity.
- More-than-anticipated competition in generic APIs.

Fig 16 – Key data

	RATING	CMP (₹)	TP (₹)	M Cap (₹ bn)	EPS			PE (x)		EV / EBITDA		RoE (%)		RoCE (%)	
					FY20e	FY21e	FY22e	FY21e	FY22e	FY21e	FY22e	FY21e	FY22e	FY21e	FY22e
Aarti	Buy	792	1028	18.4	59.2	71.3	85.7	11.1	9.2	7.1	5.8	22.7	22.1	16.3	17.3
Ajanta	Hold	1403	1268	122.4	48.6	59.8	70.4	23.5	19.9	14.4	12.3	18.8	19.1	18.7	19.0
Alembic	Buy	880	780	166.0	45.8	43.1	43.3	20.4	20.3	12.7	11.9	23.0	19.8	15.3	13.9
Alkem	Hold	2363	2897	282.6	95.3	105.1	133.2	22.5	17.7	18.8	14.7	18.7	20.5	19.5	21.5
Cadila	Hold	324	328	331.7	13.0	15.9	18.2	20.4	17.8	13.2	11.6	14.6	15.3	9.9	10.8
Dishman	Buy	75	227	11.7	18.5	21.1	23.2	3.5	3.2	3.3	3.0	15.3	15.1	11.7	11.9
Eris	Hold	472	500	65.0	21.2	25.0	25.2	18.9	18.7	15.1	14.1	22.5	18.5	23.9	19.5
Granules India	Buy	155	210	39.4	13.7	17.1	19.2	9.1	8.1	6.5	5.7	21.8	20.3	16.0	15.8
Indoco Remedies	Sell	210	170	19.4	2.9	6.9	9.7	30.6	21.6	14.1	11.4	9.0	11.8	8.2	10.3
Ipca Labs.	Buy	1597	1900	201.7	50.8	74.0	79.2	21.6	20.2	14.9	13.6	22.8	20.1	19.8	18.2
JB Chemicals	Buy	610	633	49.0	36.1	37.6	45.2	16.2	13.5	9.6	7.6	17.2	18.1	16.6	17.5
Natco Pharma	Hold	588	649	106.6	25.6	23.8	25.3	24.7	23.2	19.0	17.3	10.8	10.5	10.2	10.0
Neuland	Hold	405	476	3.6	27.7	23.5	36.9	17.2	11.0	7.6	6.0	4.1	6.1	4.7	6.1
Pfizer	Hold	4201	4665	192.2	106.0	116.6	129.2	36.0	32.5	26.3	23.3	15.0	14.8	15.2	15.0
Suven Pharma	Buy	310	403	39.4	23.9	27.2	35.4	11.4	8.7	6.8	4.9	29.0	30.1	26.4	27.6
Torrent Pharma	Hold	2499	2378	422.9	55.2	65.3	84.9	38.3	29.4	14.9	12.7	19.8	22.8	13.9	16.7
HCG	Buy	105	90	9.3	-9.6	-6.6	0.1	NM	NM	6.3	4.6	NM	NM	5.6	11.2

Source: Company, Anand Rathi Research

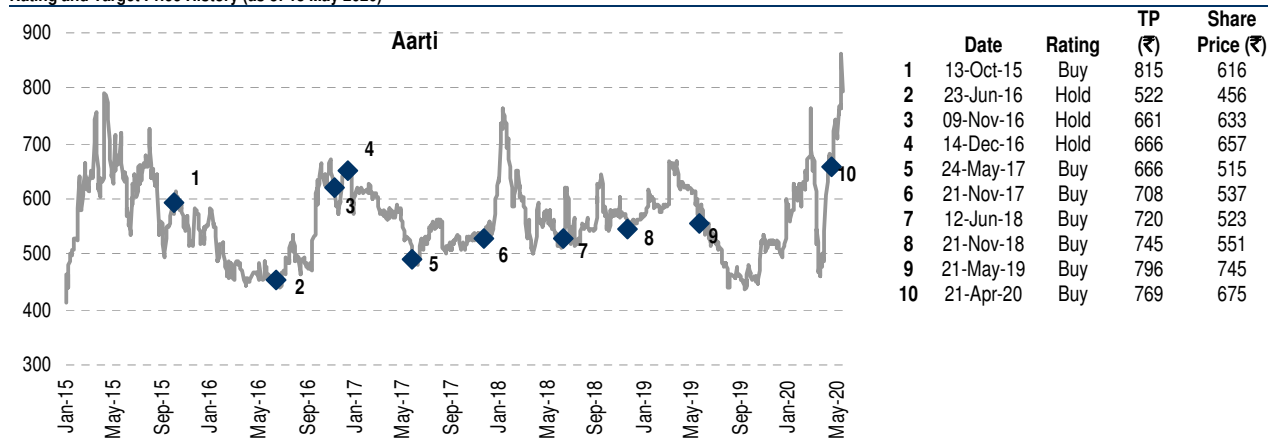
Appendix

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Ratings Guide (12 months)

	Buy	Hold	Sell
Large Caps (>US\$1bn)	>15%	5-15%	<5%
Mid/Small Caps (<US\$1bn)	>25%	5-25%	<5%

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