

Aarti Industries Ltd.

Adequate compensation to offset loss due to termination of contract

Termination of contract comes as a surprise to the street

- The company had entered into Rs 40 bn sales contract with a global agrochemical player over a period of 10 year for supply of high-value agrochemical intermediary with application into Herbicides.
- The contract was expected to generate incremental revenues of Rs 4 bn per annum over the next 10 years.
- This contract was highly margin accretive to the company with nearly 40% EBITDA and 19-20% PAT margins.
- Sudden termination of contract from the global client comes as a shock to the street because in last conference calls management was confident on commercializing the operations of the said contract by H2FY21. Also, there was no sign from the management regarding any uncertainty of the contract in previous conference calls.

Penalty compensation to offset negative impact on estimated earnings

- Since, the global client has terminated the contract, the management of Aarti has disclosed the penal compensation amount which global client is liable to pay, in the range of \$120-130mn.
- Management has stated that approx. \$20mn each would be received in FY21E & FY22E and \$80-90mn will be received by starting of FY23E.
- Aarti had received some advances for incurring capex of Rs 4 bn (Of which 85% is completed) and this will be set-off against the penal compensation amount.
- At this point in time, it is difficult to comment on whether the client will pay the estimated compensation in full. As per management, this is already vetted by client.
- Hence, as of now we are taking into account that penal amount would be received by Aarti as stated by the management.
- Delay in receiving compensation/any cut in estimated compensation will have an impact on our projected FY21E & FY22E.

The Way forward

- Despite termination of contract, management is confident that intermediate can be used for other applications or can be used to forward integrate and sell to API manufacturers.
- Management is confident of ramping the plant to optimum utilization levels in the next 3-4 years. We believe effective margins will be lower as against 40% from this business in future. However, it would be additional earnings if they get stated compensation.
- The company will scout for new clients for the intermediate in the next 2 years.
- Management has clearly stated that this contract termination will have no impact on other deals of Rs 100 bn and other businesses continue to function smoothly. The company maintains strong and healthy relationship with all its customers.

Valuation

- We have factored in stated compensation in our projections. As per management, the contract officially terminates in March 2022. Aarti is liable to supply the intermediary to its customer. Therefore, till FY22E Aarti will get the benefit of the contract.
- We assign a forward PE multiple of 22x (earlier 24x) to its FY22E earnings and arrive at a target price of Rs 968 per share which is an upside of 4.8% from current levels. We assign **HOLD** rating on the stock.
- We have reduced our target multiple considering the uncertainty around getting actual amount of compensation & capacity utilization and profitability of the said capex, post termination of deal. Also, near term headwind like tie up with new clients to supply this intermediary remains a key challenge.

Y/E Mar (Rs mn)	Revenue	YoY (%)	EBITDA	EBITDA (%)	Adj PAT	YoY (%)	FDEPS (Rs)	RoE (%)	RoCE (%)	P/E (x)	EV/EBITDA (x)
FY18	38,061	20%	6,991	18.4%	3,330	5%	20.5	20.1	12.6	23.3	14.8
FY19	41,676	9%	9,651	23.2%	4,917	48%	30.2	18.1	13.5	22.4	18.7
FY20	41,863	0%	9,773	23.3%	5,361	9%	30.8	17.4	13.3	32.0	19.4
FY21E	42,735	2%	10,472	24.5%	5,250	-2%	30.1	15.2	12.2	30.7	18.0
FY22E	57,282	34%	14,003	24.4%	7,664	46%	44.0	19.1	15.2	21.0	16.6

Source: Company, EISEC Research Estimates



East India Securities Ltd
Excellent | Investment | Solutions

Rating: **HOLD** Upside/(Downside): **4.8%**
Current Price: **924** Target Price: **968**

Market data

Bloomberg:	ARTO IN
52-week H/L (Rs):	1192 / 668
Mcap (Rs bn/USD bn):	158/ 2.1
Shares outstanding (mn):	174.2
Free float:	27.4%
Avg. daily vol. 3mth (3M Avg – in '000):	475
Face Value (Rs):	5
Group:	S&P BSE 500

Source: Bloomberg, EISEC Research

Shareholding pattern (%)

	Mar-20	Dec-19	Sep-19	Jun-19
Promoter	47.2	48.3	48.3	48.9
FIIs	8.3	7.5	7.7	7.8
DIIIs	16.6	16.6	16.4	15.9
Public/others	27.4	27.6	27.3	27.4

Source: BSE

Price performance (%)*

	1M	3M	12M	36M
S&P BSE 500	7.7	6.7	-15.1	-3.4
Aarti Industries	-9.9	14.6	8.5	97.4

*as on 16th June 2020; Source: AceEquity, EISEC Research

Aditya Khetan

Equity Research Analyst
+91 22 6192 5343
adityak@eisec.com

Awanish Chandra

Head of Research
+91 22 6192 5345
awanishc@eisec.com

Analyst call highlights:

- **Contract Highlights:** The contract was for Rs 40 bn sales spreaded over 10 years with revenues of Rs 4 bn per annum. The contract was highly margin accretive with around 40% EBITDA and 19-20% PAT margins.
- **Reason for contract termination:** As per management, the reason is the customer's change in strategy. They now are looking to focus on the final formulation and would like to source the Active Ingredient rather than their original plan to manufacture it. Management believes increase in global capacities as the major reason for termination of the contract by the customer.
- **Penalty Compensation:** As per management, penalty compensation is \$120-130mn and expects \$20mn each in FY21 & FY22. A final bullet payment of remaining \$80-90mn will be received at the beginning of FY23. The company has also recieved some advances towards the same previously which will be get offset while receiving compensation from client. However, management refused giving indication on quantum of advance.
- **Accounting adjustment for penalty compensation:** Management has said the penalty compensation amount which is to be received starting from FY21 will flow from revenues and it will not account as exceptional income.
- **Demand outlook:** Management has given strong demand outlook for the intermediate. Management believes despite termination of long-term contract they are confident to sell their product to other clients.
- **Capex incurred:** Management stated the capex of the deal was Rs 4 bn and 85% has been completed till FY20 and remaining 15% is expected to complete by H1FY21.
- **Other applications of intermediary:** Management is confident of utilizing the intermediary for other end use applications. Also, they said the opportunity might be small, approx. 15-20% for other end use applications. Further evaluations will be done by the company on this side.
- **No impact on other businesses:** Management clarified that the other contract of Rs 100 bn is intact and there is no impact there and relation with other customer for other product continues to be normal.
- **Promoter selling shares:** Management clarified that promoters are selling shares in the open market for charitable purposes. Historically, promoters have done good amount of charity and in this lockdown and COVID-19 phase they continue with the same intention

Financial Statements

Profit & Loss	FY18	FY19	FY20	FY21E	FY22E
YE March (Rs mn)					
Revenues	38,061	41,676	41,863	42,735	57,282
% Growth	20.3	9.5	0.4	2.1	34.0
Raw Materials	21,815	21,566	20,563	20,118	28,082
% of sales	57.3	51.7	49.1	47.1	49.0
Employee	1,901	2,428	3,052	3,365	3,604
% of sales	5.0	5.8	7.3	7.9	6.3
Other Expenses	7,353	8,030	8,474	8,779	11,593
% of sales	19.3	19.3	20.2	20.5	20.2
EBITDA	6,991	9,651	9,773	10,472	14,003
EBITDA margin (%)	18.4	23.2	23.3	24.5	24.4
Depreciation	1,462	1,627	1,852	2,483	2,721
EBIT	5529	8024	7921	7989	11283
Finance cost	1,317	1,825	1,248	1,431	1,424
PBT from opera	4,212	6,199	6,673	6,558	9,859
Other Income	78	21	88	89	91
PBT	4,290	6,220	6,762	6,648	9,950
Tax-Total	829	1,178	1,294	1,263	2,090
Tax Rate (%)	19.3	18.9	19.1	19.0	21.0
Reported PAT	3,461	5,042	5,468	5,385	7,861
Extraordinary	0	0	0	0	0
Minority Interest	-132	-124	-107	-135	-197
Adjusted PAT	3,330	4,917	5,361	5,250	7,664
PAT Margin	8.7	11.8	12.8	12.3	13.4
% Growth	5.4	47.7	9.0	-2.1	46.0

Source: Company, EISEC Research Estimates

Key Ratios	FY18	FY19	FY20	FY21E	FY22E
YE March					
Growth ratios (%)					
Revenue	20	9	0	2	34
EBITDA	7	38	1	7	34
Adjusted PAT	5	48	9	-2	46
Margin Ratios (%)					
EBITDA	18.4	23.2	23.3	24.5	24.4
PBT from operations	11.1	14.9	15.9	15.3	17.2
Adjusted PAT	8.7	11.8	12.8	12.3	13.4
Return Ratios (%)					
ROE	20.1	18.1	17.4	15.2	19.1
ROCE	12.6	13.5	13.3	12.2	15.2
Turnover Ratios (days)					
Gross block turnover ratio (x)	1.9	1.9	1.7	1.3	1.5
Debtors	63	68	66	70	65
Inventory	125	131	148	155	145
Creditors	60	47	61	70	70
Cash conversion cycle	128	151	153	155	140
Solvency Ratio (x)					
Net debt/equity	1.1	0.5	0.5	0.4	0.3
Debt-equity	1.2	0.8	0.6	0.6	0.5
Interest coverage ratio	4	4	6	6	8
Gross debt/EBITDA	2.7	2.2	1.9	1.8	1.4
Current Ratio	1.1	1.3	1.0	1.3	1.6
Per share Ratios (Rs)					
Adjusted EPS	20.5	30.2	30.8	30.1	44.0
BVPS	102	156	176	198	230
Dividend payout %	24.4	19.5	26.0	26.5	27.3
Valuation (x)*					
P/E (adjusted)	23.3	22.4	32.0	30.7	21.0
P/BV	4.7	4.3	5.6	4.7	4.0
EV/EBITDA	14.8	18.7	19.4	18.0	16.6
Dividend yield %	1.2	1.4	0.6	0.6	0.7

Source: Company, EISEC Research Estimates

Balance Sheet	FY18	FY19	FY20	FY21E	FY22E
YE March (Rs mn)					
Equity Share Capital	407	436	871	871	871
Reserves & Surplus	16148	26712	29863	33669	39157
Shareholders' Fund	16555	27147	30734	34540	40028
Total loan funds	19208	21056	18105	19080	18980
Deferred Taxes Liabilities	1774	1930	2110	2440	2789
Other Non Current Lia	640	2032	5509	5900	6200
Total Liabilities	38176	52166	56458	61960	67997
Net Block	19962	21454	24676	32193	37472
Capital WIP	4362	7946	14176	9898	4949
Goodwill	17	13	9	9	9
Long term Investments	472	332	370	415	476
Other Non Current Assets	2252	3064	4045	4588	4870
Total Non Current Asset	27066	32808	43276	47103	47776
Inventories	7473	7718	8357	8543	11156
Other Current Fin Asset	2248	1907	1357	2051	2750
Trade receivables	6548	7760	7534	8196	10201
Cash and cash equivalent	321	8042	2473	3717	5776
Other current assets	260	344	328	353	473
Total Current Assets	16849	25771	20049	22860	30355
Trade payables	3575	2793	3452	3858	5386
Other current liabilities	1853	3196	3016	3562	4125
Short term Provisions	310	424	399	583	624
Total Current Liabilities	5739	6413	6867	8003	10134
Net Current Assets	11111	19358	13182	14857	20221
Total Assets	38176	52166	56458	61960	67997

Source: Company, EISEC Research Estimates

Cash Flow	FY18	FY19	FY20	FY21E	FY22E
YE March (Rs mn)					
Operating profit before WC changes	6,970	9,661	9,757	10,427	13,898
Changes in working capital	4,337	8,669	12,659	10,123	10,874
Tax Paid	-988	-1,307	-1,638	-1,263	-2,090
Cash flow from operations	3,349	7,362	11,021	8,860	8,784
Adj. OCF (OCF - Interest)	2,033	5,537	9,773	7,429	7,361
Capex	-4,481	-4,224	-5,061	-10,000	-8,000
Adj. FCF	-2,448	1,312	4,712	-2,571	-639
Cash flow from investments	-6,104	-7,970	-11,241	-5,766	-3,112
Cash flow from financing	2,791	8,329	-5,349	-1,850	-3,614
Net change in cash	36	7,721	-5,569	1,244	2,059

Source: Company, EISEC Research Estimates

Disclaimer

East India Securities Limited (hereinafter EISEC), a publically listed company, registered as Research Analyst with SEBI (Registration No. INH300003231). EISEC is engaged in broking services, distribution and marketing of financial products, and in the normal course of business, EISEC prepares and shares research data and reports periodically with clients, investors, stake holders and general public in compliance with Securities and Exchange Board of India Act, 1992, Securities And Exchange Board Of India (Research Analysts) Regulations, 2014 and/or any other applicable directives, instructions or guidelines issued by the Regulators from time to time.

Research report is a written or electronic communication that includes research analysis, research recommendation or an opinion concerning securities or public offer, providing a basis for investment decisions. The views expressed therein are based solely on information available publicly/internal data/other reliable sources believed to be true. The information is provided merely as a complementary service and do not constitute an offer, solicitation for the purchase or sale of any financial instruments, inducement, promise, guarantee, warranty, or as an official confirmation of any transactions or contract of any kind.

Research data and reports published/ emailed/ text messaged via Short Messaging Services, Online Messengers, WhatsAppetc/transmitted through mobile application/s, including but not limited to FLIP™, Video Widget, telephony networks, print or electronic media and or those made available/uploaded on social networking sites (e.g. Facebook, Twitter, LinkedIn etc) by EISEC or those recommendation or offers or opinions concerning securities or public offer which are expressed as and during the course of "Public Appearance" are for informational purposes only. The reports are provided for assistance and are not intended to be and must not alone be taken as the basis for an investment decision. The user assumes the entire risk of any use made of this information. Though disseminated to clients simultaneously, not all clients may receive the reports at the same time. EISEC will not treat recipients as clients by virtue of their receiving this report.

The reports include projections, forecasts and other predictive statements which represent EISEC's assumptions and expectations in the light of currently available information. These projections and forecasts are based on industry trends, circumstances and factors which involve risks, variables and uncertainties. The actual performance of the companies represented in the report may vary from those projected. The projections and forecasts described in this report should be evaluated keeping in mind the fact that these-

- are based on estimates and assumptions
- are subject to significant uncertainties and contingencies
- will vary from actual results and such variations may increase over a period of time
- are not scientifically proven to guarantee certain intended results
- are not published as a warranty and do not carry any evidentiary value.
- are not based on certain generally accepted accounting principles
- are not to be relied on in contractual, legal or tax advice.

Prospective investors and others are cautioned that any forward-looking statements are not predictions and may be subject to change without notice. Reports based on technical analysis is focused on studying charts of a stock's price movement and trading volume, as opposed to focusing on a company's fundamentals and as such, may not match with a report on a company's fundamentals.

Though we review the research reports for any untrue statements of material facts or any false or misleading information, , we do not represent that it is accurate or complete and it should not be relied on in connection with a commitment or contract whatsoever. Because of the possibility of human, technical or mechanical error by our sources of transmission of Reports/Data, we do not guarantee the accuracy, adequacy, completeness or availability of any information and are not to be held responsible for any errors or omissions or for the results obtained from the use of such information. EISEC and/or its Affiliates and its officers, directors and employees including the analysts/authors shall not be in any way responsible for any indirect, special or consequential damages that may arise to any person from any inadvertent error in the information contained in the reports nor do they take guarantee or assume liability for any omissions of the information contained therein. Information contained therein cannot be the basis for any claim, demand or cause of action. These data, reports and information do not constitute scientific publication and do not carry any evidentiary value whatsoever.

The reports are not for public distribution. Reproduction or dissemination, directly or indirectly, of research data and reports of EISEC in any form is prohibited except with the written permission of EISEC. Persons into whose possession the reports may come are required to observe these restrictions. Opinions expressed therein are our current opinion as of the date appearing on the report only. Data may be subject to update and correction without notice. While we endeavour to update on a reasonable basis the information discussed in the reports, there may be regulatory, compliance, or other reasons that prevent us from doing so.

The reports do not take into account the particular investment objectives, financial situations, risk profile or needs of individual clients. The user assumes the entire risk of any use made of this information. Each recipient of the reports should make such investigation as deemed necessary to arrive at an independent evaluation of an investment in the securities of companies referred to in such reports (including the merits and risks involved).

Certain transactions - futures, options and other derivatives as well as non-investment grade securities - involve substantial risks and are not suitable for all investors. Investors may lose his/her entire investment under certain market conditions. Before acting on any advice or recommendation in this material, investors should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice. The price and value of investments referred to in research reports and the income from them may fluctuate. Transaction costs may be significant in option strategies calling for multiple purchase and sales of options. Foreign currencies denominated securities are

subject to fluctuations in exchange rates that could have an adverse effect on the value or price of or income derived from the investment. Investors in securities such as ADRs, the value of which are influenced by foreign currencies effectively assume currency risk.

The recommendations in the reports are based on 12 month horizon, unless otherwise specified. The investment ratings are on absolute positive/negative return basis. It is possible that due to volatile price fluctuation in the near to medium term, there could be a temporary mismatch to rating. For reasons of valuations/return/lack of clarity/event we may revisit rating at appropriate time. The stocks always carry the risk of being upgraded to buy or downgraded to a hold, reduce or sell. The opinions expressed in the reports are subject to change but we have no obligation to tell our clients when our opinions or recommendations change. The reports are non-inclusive and do not consider all the information that the recipients may consider material to investments. The reports are issued by EISEC without any liability/undertaking/commitment on the part of itself or any of its entities.

Recipients of the research reports should assume that entities of EISEC may receive commission, brokerage, fees or other compensation from the company or companies that are the subject of the reports. We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of reports/data/material, may, from time to time have 'long' or 'short' positions in, act as principal in, and buy or sell the securities thereof of companies mentioned therein or be engaged in any other transaction involving such securities and earn brokerage or other compensation or act as market maker in the financial instruments of the company/ies discussed therein or act as advisor or lender/borrower to such company/ies or have other potential conflicts of interests with respect to any recommendation and related information and opinions.

We further undertake that-

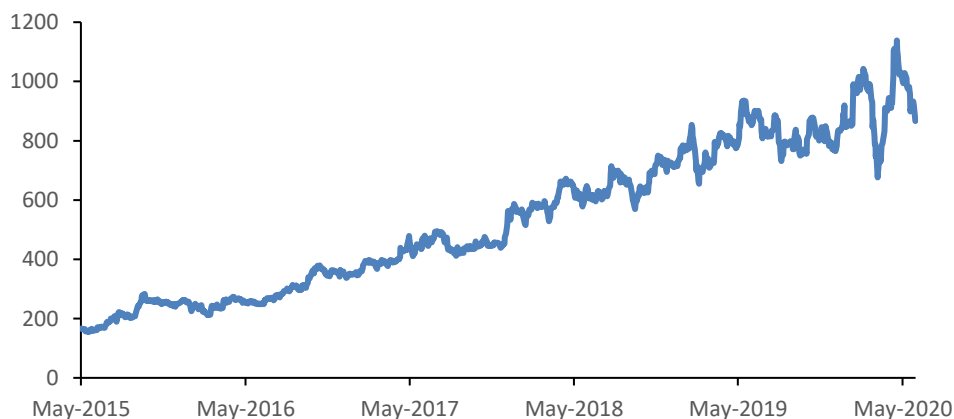
- No disciplinary action has been taken against the research analyst or EISEC by any authority in connection with their respective business activity.
- EISEC, Research analysts, persons reporting to research analysts and their relatives may have financial interests and material conflict of interest in the subject company.
- EISEC, Research analysts, persons reporting to research analysts and their relatives may have actual/beneficial ownership of 1% or more in the subject company's securities, at the month immediately preceding the date of publication of this research report.

Past performance is not a guide for future performance, future returns are not guaranteed and investors may suffer losses which may exceed their original capital.

The securities described herein may not be eligible for sale in all jurisdictions or to all categories of investors. The countries in which the companies mentioned in this report are organized may have restrictions on investments, voting rights or dealings in securities by nationals of other countries. Distributing/taking/sending/dispatching/transmitting this document in certain foreign jurisdictions may be restricted by law, and persons into whose possession this document comes should inform themselves about, and observe any such restrictions. Failure to comply with this restriction may constitute a violation of any foreign jurisdiction laws.

The user should consult their own advisors to determine the merits and risks of investment and also read the Risk Disclosure Documents for Capital Markets and Derivative Segments as prescribed by Securities and Exchange Board of India before investing in the Indian Markets.

Aarti Industries Ltd.



Source: ACEEquity, EISEC Research

Analyst holding in stock: **NO**

Key to EISEC Investment Rankings

Buy: Upside by >15%, Accumulate: Upside by 5% to 15%, Hold: Downside/Upside by -5% to +5%, Reduce: Downside by 5% to 15%, Sell: Downside by >15%

East India Securities Ltd. (<http://www.eisec.com/>)

Office: - 201, Garnet Palladium, Pandit Motilal Nehru Marg, Panch Bawadi, Behind Express Zone, Malad East, Mumbai – 400097

Disclosure of Interest Statement		
1	Business activities of East India Securities Ltd (EISEC)	East India Securities Ltd (hereinafter referred to as "EISEC") is a registered member of NSE (All Segments), MCX-SX (Currency Derivatives Segment) and BSE (All segments), Depository Participant of NSDL & CDSL.
2	Details of Disciplinary History of EISEC	EISEC has not been debarred/ suspended by SEBI or any other regulatory authority from accessing or dealing in securities market on behalf of clients.
3	Registration status of EISEC:	EISEC is registered with SEBI as a Research Analyst (SEBI Registration No INH300003231)
		Aarti Industries Ltd.
4	Whether Research analyst's or relatives' have any financial interest in the subject company and nature of such financial interest	No
5	Whether Research analyst or relatives have actual / beneficial ownership of 1% or more in securities of the subject company at the end of the month immediately preceding the date of publication of the document.	No
6	Whether the research analyst or his relatives has any other material conflict of interest	No
7	Whether research analyst has received any compensation from the subject company in the past 12 months and nature of products / services for which such compensation is received	No
8	Whether the Research Analyst has received any compensation or any other benefits from the subject company or third party in connection with the research report	No
9	Whether Research Analysts has served as an officer, director or employee of the subject company	No
10	Whether the Research Analyst has been engaged in market making activity of the subject company.	No
11	Whether it or its associates have managed or co-managed public offering of securities for the subject company in the past twelve months;	No
12	Whether it or its associates have received any compensation for investment banking or merchant banking or brokerage services from the subject company in the past twelve months;	No
13	Whether it or its associates have received any compensation for products or services other than investment banking or merchant banking or brokerage services from the subject company in the past twelve months;	No

Member (NSE and BSE)

Single SEBI Regn No.: INZ000190836

Research Analyst

SEBI Registration No. INH300003231

Website: www.eisec.com

Investor Grievance Email ID: mail@eisec.com

Compliance Officer Details:

Sumeet Kejriwal 033-40205901; Email ID: sumeetk@eisec.com

East India Securities Ltd. (CIN: U67120WB1995PLC072026)	
Registered Office Address DA-14, Saltlake City, Sector-1, Kolkata-700064	Corporate Office & Correspondence Address 201, Garnet Palladium, Pandit Motilal Nehru Marg, Panch Bawadi, Behind Express Zone, Malad East, Mumbai – 400097