Sharekhan by BNP PARIBAS

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Stock Update

Aarti Industries Limited

Robust Q1; Growth guidance maintained

Specaility Chem	Sharekhan code: AARTIIND	Result Update

3R MATRIX	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)		✓	

\+ Positive = Neutral - Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 951**	
Price Target: **Rs. 1,155**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

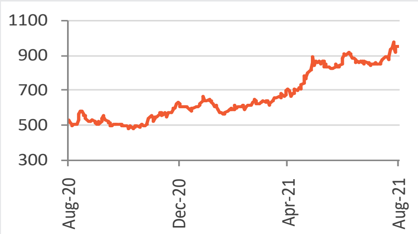
Company details

Market cap:	Rs. 34,483 cr
52-week high/low:	Rs. 987/484
NSE volume: (No of shares)	7.6 lakh
BSE code:	524208
NSE code:	AARTIIND
Free float: (No of shares)	20.0 cr

Shareholding (%)

Promoters	45
FII	12
DII	14
Others	30

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	11.7	9.6	58.0	78.8
Relative to Sensex	7.8	-0.3	51.9	36.3

Sharekhan Research, Bloomberg

Summary

- Strong Q1FY2022 results with a 4%/21%/24% beat in revenue/operating profit/Adjusted PAT at Rs1,317 crore/Rs314 crore/Rs176 crore, up 8.9%/20.6%/32% q-o-q led by strong performance of specialty chemical segment.
- Specialty chemical's revenue/EBIT increased strongly by 12.5%/13.1% q-o-q led by volume growth of 9-10% q-o-q and price hikes (pass-through of input & freight cost) helped sustain EBIT margin at 18.8%. Pharmaceutical revenues rose by 7.3% q-o-q but EBIT margin contracted 138 bps q-o-q to 19.8%.
- Management stayed upbeat on growth prospects and maintained guidance for revenue/PAT growth of 25-35% for FY2022E and a 2x increase in earnings by FY24 versus FY21. Cumulative capex plan of Rs4500-5000 crore by FY24E remain intact and would drive next phase of growth.
- We expect strong a 33% CAGR in PAT over FY21-24E and expect RoE to improve to 21.4% (versus 16.3% in FY21). Favourable dynamics of Indian specialty chemicals sector to support premium valuations. Hence, we maintain a Buy on the stock with a revised PT of Rs. 1,155.

Aarti Industries Limited reported stronger-than-expected revenue growth of 8.9% q-o-q (versus estimate of 4.8% q-o-q growth) to Rs. 1,317 crore in Q1FY2022 led by volume growth across products and price hikes (to pass on a rise in raw material costs and freight costs). Revenue from the specialty chemicals segment grew by 12.5% q-o-q to Rs. 1,263 crore (includes $4.5 million towards shortfall fee for cancelled first long-term contract) led by volume growth of 9-10% q-o-q on higher utilization and ramp-up of new facilities (chlorination at Jhagadia and the Phase 2 unit at Dahej SEZ) and revenue from pharmaceuticals segment witnessed decent 7.3% q-o-q growth to Rs. 240 crore. OPM also surprised positively with 333 bps beat at 23.8% (up 231 bps q-o-q) due to better-than-expected gross margin at 53.7% (flat q-o-q versus estimate of 81 bps q-o-q decline) and better absorption of operating cost ((opex flat q-o-q versus 8.9% q-o-q increase in revenues) on account of higher operating leverage given better utilization of newly commissioned capacities. The specialty chemical segment's EBIT margin was flat q-o-q at 18.8% as company was able to pass on increase in raw material cost while Pharmaceutical EBIT margin declined by 138 bps q-o-q to 19.8% due to higher inventory of finished products given logistic issues and change in product mix. Adjusted PAT (post forex gains) at Rs. 176 crore (up 32% q-o-q) was 24% above our estimate of Rs143 crore due to higher-than-expected revenue growth and a sharp beat in margins. The management commentary indicated that discretionary demand in the specialty chemical segment is back to pre-COVID levels and even above pre-COVID level for some product categories while higher volumes from regulated markets, value added products and introduction of new intermediates would aid growth in the pharma segment. The management is upbeat on growth prospects with focus on new chemistries and value-added products (VAP) and maintained its revenue/PAT guidance of 25-35% y-o-y growth for FY2022E. Medium-term revenues/EBIT/PAT is guided to increase by 1.7x-2x by FY2024E over FY2021 and long-term revenues to grow by 2.5-3.5x while EBIT/PAT to grow by 3-4x by FY2027E over FY2021 supported by continuous capex of Rs. 1,500 crore over FY2022E-FY2023E and the overall capex of Rs. 4,500-5,000 crore by FY2024E. We believe that Aarti Industries would benefit immensely from the favourable dynamics of the Indian specialty chemicals sector supported by the China Plus One strategy by global companies, import substitution in domestic markets and rising domestic demand for specialty chemicals. Hence, we maintain a Buy rating on Aarti Industries with a revised PT of Rs. 1,155. At CMP, the stock trades at 34.5x FY2023E EPS and 28.3x FY2024E EPS.

Key positives

- Strong-than-expected revenue growth of 8.9% q-o-q largely led by volume/pricing growth in the specialty chemical segment.
- Sharp 333 bps beat in OPM at 23.8% (up 231 bps q-o-q) due to better-than-expected gross margin at 53.7% and higher operating leverage.
- Maintained FY2022E revenue/PAT growth guidance of 25-35% and medium-term revenue/EBIT/PAT growth guidance of 1.7x-2x by FY2024E over FY2021.

Key negatives

- Contraction in pharma EBIT margin by 138 bps q-o-q to 19.8%.

Our Call

Valuation – Maintain Buy on Aarti Industries with a revised PT of Rs. 1,155: We maintain our FY2022-FY2024 earnings estimates. Robust guidance of 2x/4x increase in earnings by FY2024E/FY2027E over FY2021 reinforces confidence in terms of sustained long-term high growth potential for Aarti Industries. We thus expect a strong revenue/EBITDA/PAT CAGR of 28%/32%/33% over FY2021-FY2024E led by high capex intensity over the next couple of years. We believe that Aarti Industries would benefit immensely from strong growth outlook for Indian specialty chemical sector (expected to grow at 9% CAGR over 2019 to 2025) supported by the China Plus One strategy by global companies, import substitution in domestic markets (identified opportunities of ~$1 billion) and rising domestic demand for specialty chemicals. Moreover, favourable dynamics for the Indian specialty chemicals sector to support premium valuation. Hence, we maintain a Buy on Aarti Industries with a revised PT of Rs. 1,155. At CMP, the stock trades at 34.5x FY2023E EPS and 28.3x FY2024E EPS.

Key Risks

- Slowdown in demand and delay in commissioning of facilities for multi-year contracts can affect revenue growth momentum.
- Adverse commodity prices and currency movements might affect margins.

Valuation (Consolidated) Rs cr

Particulars	FY20	FY21	FY22E	FY23E	FY24E
Revenue	4,186	4,506	5,783	7,423	9,502
OPM (%)	23.3	21.8	22.7	23.3	24.0
Adjusted PAT	536	523	735	1,001	1,220
y-o-y growth (%)	9.1	(2.4)	40.5	36.1	21.9
Adjusted EPS (Rs.)	14.8	14.4	20.3	27.6	33.7
P/E (x)	64.3	65.9	46.9	34.5	28.3
P/BV (x)	11.7	9.8	8.2	6.7	5.5
EV/EBITDA (x)	36.9	37.3	28.2	21.3	16.8
RoCE (%)	14.8	12.4	15.7	18.0	19.5
RoE (%)	19.3	16.3	19.1	21.5	21.4

Source: Company; Sharekhan estimates

Note: We have adjusted FY20-FY24E EPS for bonus issue of 1:1

Robust Q1 as strong-than-expected revenue growth and better margin led to 24% beat in PAT

Aarti Industries reported strong Q1 numbers with a revenue growth of 8.9% q-o-q (versus estimate of 4.8% q-o-q growth) to Rs. 1,317 crore led by volume growth across products and price hikes (to pass on raw material cost hikes and higher freight cost). Revenue from specialty chemicals segment grew by 12.5% q-o-q to Rs1,263 crore (includes $4.5 million towards shortfall fee for cancelled first long-term contracts) led by volume growth of 9-10% on higher utilisation and ramp-up of new facilities (chlorination at Jhagadia and the Phase 2 unit at Dahej SEZ) and revenue from pharmaceuticals segment witnessed a decent 7.3% q-o-q growth to Rs. 240 crore. OPM also surprised positively with 333 bps beat at 23.8% (up 231 bps q-o-q) due to better-than-expected gross margins of 53.7% (flat q-o-q versus estimate of 81 bps q-o-q decline) and better absorption of operating costs (opex flat q-o-q versus 8.9% q-o-q increase in revenues) on account of higher operating leverage given better utilization of newly commissioned capacities. Specialty chemical EBIT margin was flat q-o-q at 18.8%, while Pharmaceutical EBIT margin declined by 138 bps q-o-q to 19.8% due to higher inventory of finished products given logistics issues.

Q1FY2022 conference call highlights

- **Maintained FY22 and medium to long-term growth guidance:** The management has maintained its 25-35% revenue/PAT growth guidance for FY2022. The company has also reiterated the medium-term growth guidance of revenues/EBIT/PAT of 1.7x-2x by FY2024 over FY2021 and long-term growth guidance for revenues at 2.5-3.5x, while EBIT/PAT at 3-4x by FY2027 over FY2021. The sustained high growth outlook is very positive and would be supported by a Rs. 1,500 crore capex over FY2022-23 and overall capex of Rs. 4,500-5000 crore by FY2024.
- **Capex plan -** The company has maintained the guidance for cumulative capex of Rs. 1,500 crore over FY2022-FY2023, out of which Rs295 crore was spent during Q1FY2022. The capex requirement will be supported by the recent QIP of Rs. 1,200 crore, internal and external borrowing. The company has also planned for an additional capex of Rs. 3000-3500 crore over FY22-24 for a pipeline of projects of which Rs. 2500-3000 crores would be for chemicals and Rs. 350-500 crore would be for the pharma business. This would drive EBITDA margin to 25-30% and drive growth for FY25 and beyond.
- **Near-term projects -** The upcoming project lined up for commissioned includes projects related to second (expected in Q2FY2022) and third long-term (expected in Q3FY202) contracts, NCB expansion and pharmaceutical capacity expansion (additional capacities of API's and intermediates to be commissioned in H2FY2022).
- **Long-term projects (over FY2023-2024) -** These includes introduction of new products in the chlorotoluene value chain, speciality chemical products, additional custom manufacturing would be explored, universal multipurpose plant (UMPP) would be set up, existing pharma plants would be expanded, and existing pharma APIs and intermediates would be improved. The company is planning to launch over 40 products for chemicals and 50+ products in pharma which would drive growth from FY2025 and beyond. Most of the new products will have an EBITDA margin of 25-30%.
- **Speciality chemicals -** Continued volume expansion in the speciality chemical business due to return of demand from established markets led to revenue growth of 12.5% q-o-q at Rs1,263 crores and stable margin of 18.8% (up 10 bps q-o-q). Revenues was also higher due to pass on for higher input costs & logistics costs and includes income recognition of ~$4.5 million towards the shortfall fees in respect of the first long term contract. The discretionary demand has come back to pre COVID-19 level and also above pre-COVID-19 level for some products. The chemicals segment has significant growth opportunity and will continue to be capex mode and not looking for FCF over next 5-7 years.
- **Pharma Business -** Margins of the Pharma business declined 138 bps q-o-q to 19.8% due to higher inventory of final product, which could not be shipped due to logistics issue. However, outlook for pharma business is positive as higher volume from regulated markets, value added products and new introduction of intermediate would drive growth.
- **Long-term contracts -** With the second and third long-term contracts expected to get commissioned in H2FY2022 and thus any meaningful contribution would be seen in FY2023. For the first long term contract, product validation is going on and thus any meaningful ramp-up would be visible in FY2024E.

- **Production update -** Production of nitro chlorobenzene at 18,155 MT in Q1FY2022 versus 19,100 MT in Q4FY2021 and 13,170 MT in Q1FY2021. For hydrogenated products at 2,920 tonnes per month in Q1FY2022 versus 1,935 tonnes per month in Q4FY2021 and 2,050 tonnes per month in Q1FY2021. Nitrotoluene production stood at 3,440 MT in Q1FY2022 versus 2,935 MT in Q4FY2021 versus 2,140 MT in Q1FY2021. Overall capacity utilisation stood at 82-85%.
- **Other updates -** 1) Raw material and freight costs were largely passed through with a short time lag of one month in the domestic market and one quarter in the exports market. 2) Finance costs were 77% higher q-o-q at Rs. 38 crore due to MTM impact on unhedged ECBs, due to a steep depreciation in the Indian Rupee. 3) The company aims at a net debt level of Rs. 1,600-1,700 crore by March 2022.

Results (Consolidated) Rs cr

Particulars	Q1FY22	Q1FY21	Y-o-Y (%)	Q4FY21	Q-o-Q (%)
Net Sales	**1,317**	**937**	**40.5**	**1,209**	**8.9**
Gross Profit	707	490	44.1	651	8.6
Operating profit	**314**	**182**	**72.4**	**260**	**20.6**
Other Income	0.1	0.2	(77.3)	0.0	400.0
Depreciation	69	52	31.9	66	4.5
Interest	38	25	51.2	22	77.1
PBT	**207**	**105**	**97.3**	**173**	**19.6**
Tax	42	22	93.1	34	24.3
Reported PAT	**165**	**82**	**101.4**	**136**	**21.1**
Adjusted PAT	176	127	39.2	134	32.0
EPS (Rs)	4.5	2.3	101.4	3.8	21.1
Margin (%)			**YoY (BPS)**		**QoQ (BPS)**
Gross profit margin (GPM)	53.7	52.3	135	53.8	(14)
Operating profit margin (OPM)	23.8	19.4	442	21.5	231
Net profit margin (NPM)	12.5	8.7	379	11.3	127
Tax Rate	20	21	(44)	19	76

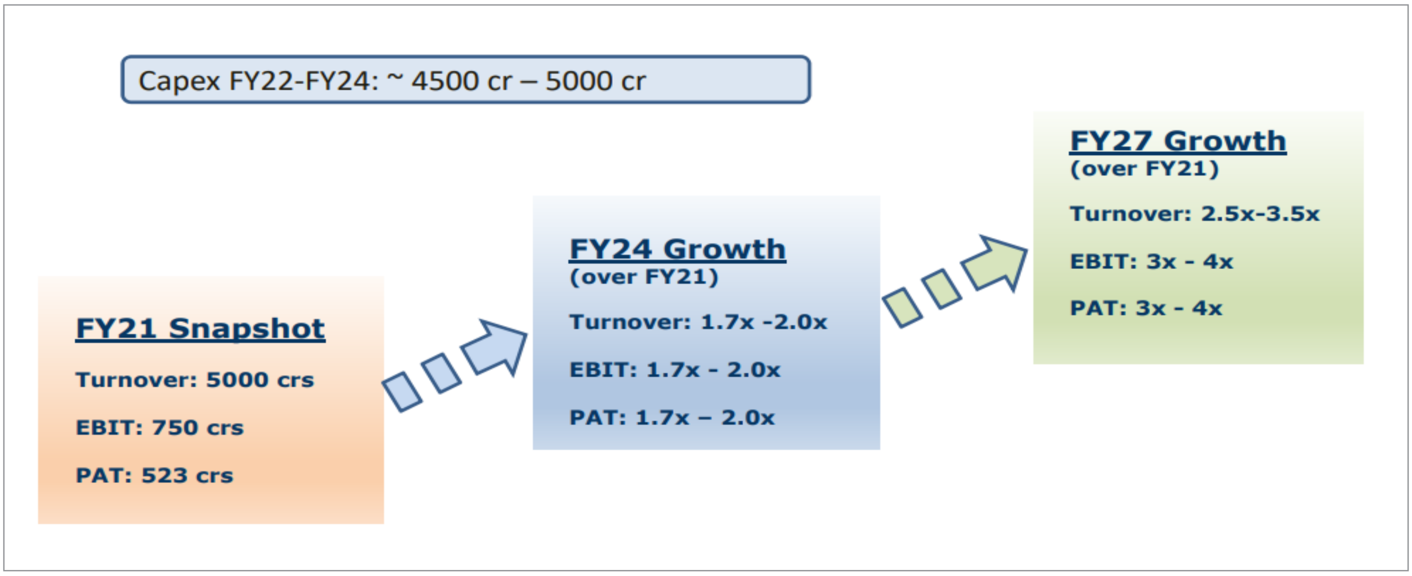
Source: Company; Sharekhan Research

Segmental performance Rs cr

Particulars	Q1FY22	Q1FY21	Y-o-Y (%)	Q4FY21	Q-o-Q (%)
Segmental Revenue					
Specialty Chemicals	1,263	841	50.2	1,123	12.5
Pharmaceuticals	240	194	23.7	224	7.3
Less: GST	187	98	90.8	137	35.8
Net revenue	**1,317**	**937**	**40.5**	**1,209**	**8.9**
Segmental EBIT					
Specialty Chemicals	237	130	83.0	210	13.1
Pharmaceuticals	48	45	5.2	47	0.4
Total EBIT	**285**	**175**	**62.8**	**257**	**10.8**
Segmental EBIT margin (%)			**BPS**		**BPS**
Specialty Chemicals	18.8	15.4	336	18.7	10
Pharmaceuticals	19.8	23.3	(349)	21.2	(138)
Overall EBIT margin	**21.6**	**18.7**	**297**	**21.3**	**37**

Source: Company; Sharekhan Research

Management maintained medium to long term growth guidance for Revenue, EBIT and PAT



Source: Company

Outlook and Valuation

■ **Sector view - Structural growth drivers to drive sustained growth for specialty chemicals space in medium to long term**

We remain bullish on medium to long-term growth prospects of the specialty chemicals sector, given a massive revenue opportunity from the perspective of import substitution (India's total specialty chemical imports are estimated at $56 billion), potential increase in exports given China Plus One strategy by global customers and favourable government policies (such as tax incentive and production-linked incentive scheme similar to the pharmaceutical sector). In our view, conducive government policies, product innovation, massive export opportunity and low input prices would help the sector witness sustained high double-digit earnings growth for the next 2-3 years.

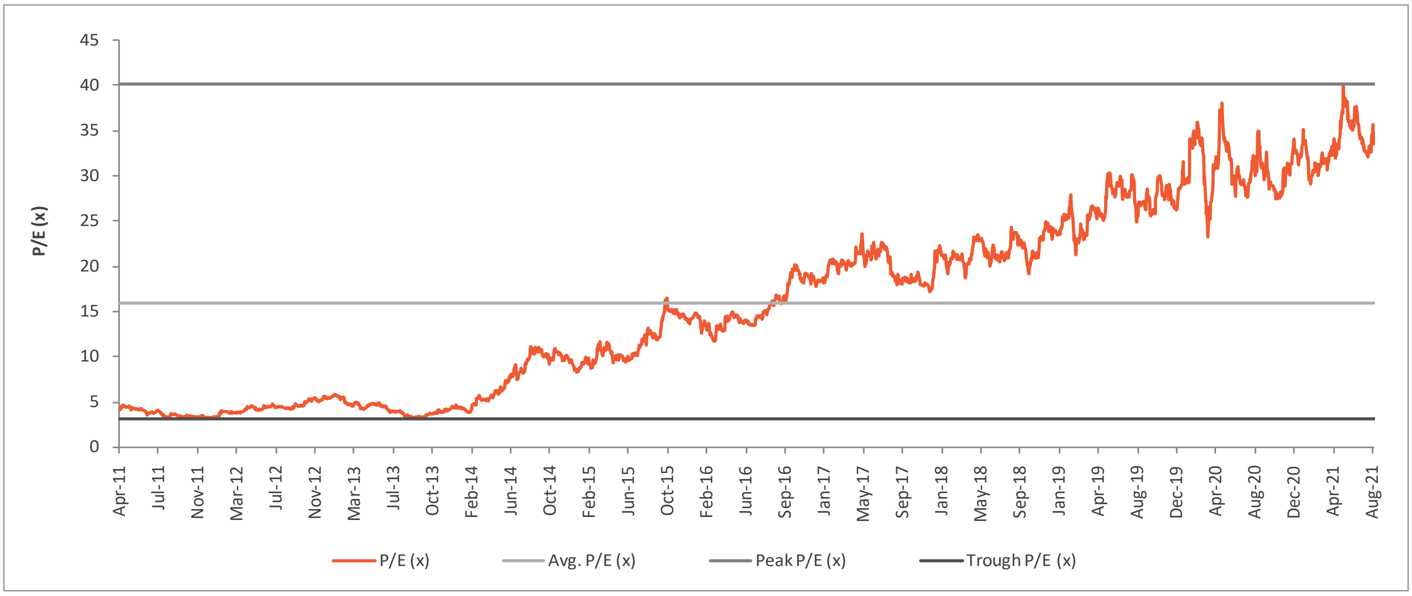
■ **Company outlook - Long-term growth intact supported by capex in right space**

The company is investing in the right areas to build capabilities and enhance client engagements. Growth is expected to be largely driven by - i) growth in global markets, ii) import substitution, and iii) customer de-risking. Issues arising out of China such1) stringent regulatory environment and 2) the COVID-19 pandemic (outbreak of COVID-19 in China and its spread to other regions) have provided opportunities for Indian players to scale up their business as global players are looking for long-term relationships with suppliers who can supply quality products on a sustainable basis. Aarti's management has guided for a 25-35% y-o-y growth each in revenue and PAT for FY2022.

■ **Valuation - Maintain Buy on Aarti Industries with a revised PT of Rs. 1,155**

We maintain our FY2022-FY2024 earnings estimates. Robust guidance of 2x/4x increase in earnings by FY24/FY27 over FY2021 reinforces confidence in terms of sustained long-term high growth potential for Aarti Industries. We thus expect a strong revenue/EBITDA/PAT CAGR of 28%/32%/33% over FY2021-FY2024E led by high capex intensity over the next couple of years. We believe that Aarti Industries would benefit immensely from strong growth outlook for Indian specialty chemical sector (expected to grow at 9% CAGR over 2019 to 2025) supported by the China Plus One strategy by global companies, import substitution in domestic markets (identified opportunities of ~$1 billion) and rising domestic demand for specialty chemicals. Moreover, favourable dynamics for the Indian specialty chemicals sector to support premium valuation. Hence, we maintain a Buy on Aarti Industries with a revised PT of Rs. 1,155. At CMP, the stock trades at 34.5x FY2023E EPS and 28.3x FY2024E EPS.

One-year forward P/E (x) band



Source: Sharekhan Research

About company

Aarti is a leading specialty chemicals company in benzene-based derivatives with a global footprint having integrated operations and high level of cost optimisation. The company has been setup by first-generation technocrats in 1984 and its pharmaceutical business spans across APIs, intermediates, and Xanthene derivatives. The company has strong R&D capabilities, with three R&D facilities and a dedicated pool of over 170 engineers and scientists. The company has 11 plants located in western India with proximity to ports; specialty chemicals are manufactured in all plants; and four of the plants are approved as pharma-grade (2 USFDA and 2 WHO/GMP). The company is also coming up with two project sites at Dahej SEZ and the fourth R&D centre at Navi Mumbai.

Investment theme

Aarti is investing in the right areas for building capabilities and richer client engagements, which would create a long-term moat in a booming industry. Expanding capacity for Nitro chlorobenzene (NCB) by 33,000 MTPA at a capex of Rs. 150 crore in two phases is expected to be operational by FY2021 and FY2022. Multi-year growth levers are getting stronger; the company has signed the third multi-year contracts worth $125 million with global players for 10 years, though small in size but bring in new capabilities for long-term growth (the second multi-year contract is with the global player in the specialty chemical space for Rs. 10,000 crore for 15 years). The company expects significant growth prospects in sight, led by expansion and diversification plans and concerns over supplies from China.

Key Risks

- Slowdown in demand offtake and delay in commissioning of facilities for multi-year contracts can affect revenue growth momentum.
- Adverse commodity prices and currency movements might impact margins.

Additional Data

Key management personnel

Rajendra Vallabhaji Gogri	Chairman cum Managing Director
Rashesh Chandrakant Gogri	Vice Chairman cum Managing Director
Renil Rajendra Gogri	Executive Director
Kirit Ratilal Mehta	Executive Director
Parimal Hasmukhlal Desai	Executive Director
Manoj Mulji Chheda	Executive Director
Hetal Gogri Gala	Executive Director
Chetan B Gandhi	Chief Finance Officer (CFO)
Raj Sarraf	Company Secretary & Compliance Officer

Source: Bloomberg

Top shareholders

Sr. No.	Holder Name	Holding (%)
1	HDFC Asset Management Co. Ltd	4.0
2	Aditya Birla Sun Life Trustee Co. Pvt. Ltd	1.9
3	Life Insurance Corp of India	1.8
4	Aditya Birla Sun Life Asset Management Co. Ltd	1.5
5	Vanguard Group Inc.	1.2
6	HDFC Life Insurance Co. Ltd	1.2
7	Baron Emerging Markets Fund	1.0
8	BlackRock Inc.	0.7
9	L&T Mutual Fund Trustee Ltd/ India	0.7

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

Sharekhan

by BNP PARIBAS

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