

21 November 2018

Aarti Drugs

Backward integration to support margins; retaining a Buy

Rating: **Buy**

Target Price: ₹745

Share Price: ₹551

Fuelled by product launches, expanded capacity and market-share gains in its products, Aarti's revenue and PAT would clock 14% and 21% CAGRs over FY18-21. Also, supported by price rises and volume growth, its API business would improve. We maintain our Buy recommendation, with a higher price target of ₹745.

API business momentum to continue. The company's APIs cover the therapeutic categories of anti-inflammatories, cardio-protectants, antifungals, antibiotics, antidiabetics, sedatives and vitamins. To diversify, the company continues to focus on different therapies; at present, antibiotics brings ~35% to its API segment revenue. It has recently completed the expansion of capacity for one of its key antifungal molecules. We believe that, with the expanded capacities in place, higher prices and volume growth would boost value growth, and expect a ~16% API revenue CAGR over FY18-21.

Expects operating margins to improve gradually. During H1 FY19, disruptions to supply of a few key raw materials and a change in processes led to production shortages in the API division. The company is largely backward integrated for most of its products and aims to have all of its top-10 products backward integrated in the next one to two years. We believe the considerable effect of stabilised prices and backward integration would be evident in the operating margin from Q4 FY19.

Valuation. We reduce our FY19e and FY20e EBITDA respectively 8.2% and 4.3%, due to lower-than-expected gross margins because of the raw-material-supply disruptions. We roll forward our estimates to FY21 and retain our Buy recommendation on the stock, with a revised price target of ₹745 (earlier ₹720), based on 12x FY21e EPS. **Risks:** Delay in the ramp-up of the recently-added capacity and more-than-expected competition in generic APIs.

Key financials (YE Mar)	FY17	FY18	FY19e	FY20e	FY21e
Sales (₹ m)	12,881	12,626	14,349	16,441	18,839
Net profit (₹ m)	818	823	896	1,152	1,463
EPS (₹)	34.3	34.9	38.0	48.8	62.0
PE (x)	16.8	14.5	14.5	11.3	8.9
EV / EBITDA (x)	9.8	8.7	8.7	7.2	6.0
PBV (x)	3.4	2.6	2.4	2.0	1.7
RoE (%)	21.9	19.2	18.0	19.4	20.4
RoCE (%)	11.6	10.4	10.4	11.8	13.0
Dividend yield (%)	-	0.2	0.4	0.5	0.5
Net debt / equity (x)	1.2	1.2	1.0	0.8	0.7

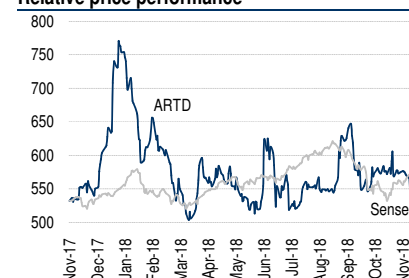
Source: Company, Anand Rath Research

Key data	ARTD IN / ADRG.BO
52-week high / low	₹785 / 475
Sensex / Nifty	35197 / 10590
3-m average volume	\$0.3m
Market cap	₹13bn / \$180.3m
Shares outstanding	24m

Shareholding pattern (%)	Sep '18	Jun '18	Mar '18
Promoters	62.4	62.5	62.5
- of which, Pledged	-	-	-
Free float	37.6	37.5	37.5
- Foreign institutions	0.9	0.9	0.8
- Domestic institutions	4.6	4.7	4.6
- Public	32.1	31.9	32.2

Estimates revision (%)	FY19e	FY20e
Sales	0.6	0.0
EBITDA	(8.2)	(4.3)
EPS	(11.6)	(5.1)

Relative price performance



Source: Bloomberg

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Quick Glance – Financials and Valuations

Fig 1 – Income statement (₹ m)

Year-end: Mar	FY17	FY18	FY19e	FY20e	FY21e
Net revenues	12,881	12,626	14,349	16,441	18,839
Growth (%)	13.0	-2.0	13.6	14.6	14.6
Direct costs	7,805	7,827	9,327	10,588	11,869
SG&A	3,207	2,814	2,927	3,337	3,956
EBITDA	1,869	1,985	2,095	2,515	3,014
EBITDA margins (%)	14.5	15.7	14.6	15.3	16.0
- Depreciation	385	401	432	477	522
Other income	40	11	12	13	14
Interest expenses	364	350	376	382	386
PBT	1,160	1,245	1,299	1,669	2,120
Effective tax rate (%)	29.5	33.9	31.0	31.0	31.0
+ Associates / (Minorities)	-	-	-	-	-
Net income	818	823	896	1,152	1,463
Adjusted income	818	823	896	1,152	1,463
WANS	24	24	24	24	24
FDEPS (₹ / sh)	34.3	34.9	38.0	48.8	62.0

Fig 3 – Cash-flow statement (₹ m)

Year-end: Mar	FY17	FY18	FY19e	FY20e	FY21e
PBT (adj. for int.exp. / other income)	1,484	1,584	1,663	2,039	2,493
+ Non-cash items	385	401	432	477	522
Oper. prof. before WC	1,869	1,985	2,095	2,515	3,014
- Incr. / (decr.) in WC	-97	968	45	582	931
Others incl. taxes	271	328	403	517	657
Operating cash-flow	1,694	689	1,647	1,416	1,426
- Capex (tang. + intang.)	1,064	755	980	980	980
Free cash-flow	631	-67	667	436	446
Acquisitions					
- Div. (incl. buyback & taxes)	-0	27	57	71	85
+ Equity raised		-3	-	-	-
+ Debt raised	-39	668	-248	50	50
- Fin investments	-9	-12	11	12	13
- Misc. (CFI + CFF)	607	582	364	370	372
Net cash-flow	-6	1	-13	34	25

Source: Company, Anand Rathi Research

Fig 5 – Price movement



Source: Bloomberg

Fig 2 – Balance sheet (₹ m)

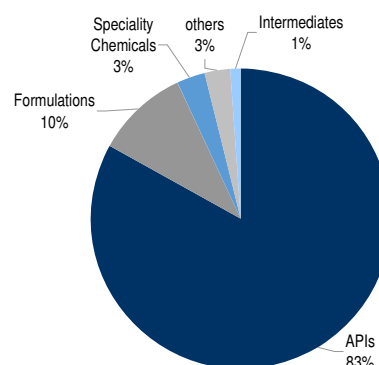
Year-end: Mar	FY17	FY18	FY19e	FY20e	FY21e
Share capital	239	236	236	236	236
Net worth	4,001	4,554	5,394	6,475	7,852
Debt	4,795	5,463	5,214	5,264	5,314
Minority interest	-	-	-	-	-
DTL / (Assets)	718	809	809	809	809
Capital employed	9,514	10,826	11,417	12,548	13,976
Net tangible assets	5,750	5,979	6,545	7,066	7,542
Net intangible assets	61	45	48	50	52
Goodwill	-	-	-	-	-
CWIP (tang. & intang.)	143	284	264	244	224
Investments (strategic)	119	108	118	130	143
Investments (financial)	-	-	-	-	-
Current assets (ex cash)	5,796	7,421	8,059	9,147	10,525
Cash	42	43	30	63	89
Current liabilities	2,396	3,053	3,646	4,153	4,599
Working capital	3,399	4,367	4,412	4,994	5,925
Capital deployed	9,514	10,826	11,417	12,548	13,976
Contingent liabilities	627	567			

Fig 4 – Ratio analysis

Year-end: Mar	FY17	FY18	FY19e	FY20e	FY21e
P/E (x)	16.8	14.5	14.5	11.3	8.9
EV / EBITDA (x)	9.8	8.7	8.7	7.2	6.0
EV / sales (x)	1.4	1.4	1.3	1.1	1.0
P/B (x)	3.4	2.6	2.4	2.0	1.7
RoE (%)	21.9	19.2	18.0	19.4	20.4
RoCE (%) - after tax	11.6	10.4	10.4	11.8	13.0
DPS (₹ per share)	-	1.0	2.0	2.5	3.0
Dividend yield (%)	-	0.2	0.4	0.5	0.5
Dividend payout (%) - incl. DDT	-0.0	3.3	6.3	6.2	5.8
Net debt / equity (x)	1.2	1.2	1.0	0.8	0.7
Receivables (days)	84	108	102	103	106
Inventory (days)	59	80	80	80	80
Payables (days)	56	75	68	68	65
CFO : PAT %	207.1	83.7	183.8	123.0	97.4
FCF : PAT % - incl. M&A payout	77.1	-8.1	74.4	37.9	30.5

Source: Company, Anand Rathi Research

Fig 6 – Revenue break-up (H1 FY19)



Source: Company

Result highlights

Fig 7 – Quarterly financials (₹ m)

Quarterly results (YE Mar)	Q2 FY18	Q2 FY19	% Y/Y	Q1 FY19	% Q/Q	H1 FY18	H1 FY19	% Y/Y
Sales	3,193	3,474	8.8	3,743	(7.2)	5,965	7,217	21.0
Gross profit	1,179	1,157	(1.9)	1,203	(3.9)	2,329	2,360	1.3
Gross margins (%)	37	33	-364bps	32	114bps	39	33	-635bps
EBITDA	526	470	(10.6)	526	(10.7)	880	996	13.3
EBITDA margins (%)	16.5	13.5	-293bps	14.1	-53bps	14.7	13.8	-94bps
Finance expenses	80	97	21.2	94	3.4	170	191	12.8
Depreciation	101	106	5.7	104	2.2	199	210	5.8
Other income	1	1	25.0	9	(89.1)	2	10	580.0
PBT	345	267	(22.6)	337	(20.7)	513	605	17.9
Tax	87	70	(19.3)	83	(15.3)	126	153	21.1
Effective tax rate (%)	31.7	32.5	79bps	30.7	180bps	31.8	31.5	-30bps
Adjusted PAT	236	181	(23.5)	234	(22.8)	350	414	18.5

Source: Company, Anand Rath Research

Fig 8 – Sales assumption

(₹ m)	FY19e	FY20e	FY21e
APIs	11,897	13,681	15,733
% of sales	82.9	83.2	83.5
Y/Y %	17.0	15.0	15.0
Formulations	1,446	1,619	1,813
% of sales	10.1	9.8	9.6
Y/Y %	4.0	12.0	12.0
Specialty Chemicals	436	502	577
% of sales	3.0	3.1	3.1
Y/Y %	44.0	15.0	15.0
Intermediates	570	639	715
% of sales	4.0	3.9	3.8
Y/Y %	(1.0)	12.0	12.0
Total	14,349	16,441	18,839

Source: Company, Anand Rath Research

Other highlights

- During Q2 FY19, its antibiotic therapeutic category contributed ~35% to standalone sales; antiprotozoals 20%, anti-inflammatories 12%, antidiabetics 10%, antifungals 8%.
- During Q2 FY19, API exports grew ~20% y/y; domestic sales, ~7.5% y/y. Formulations revenue, however, declined, 13% y/y. Lower capacity utilisation and lack of execution of export orders led to profits in formulations coming lower in the quarter than in the corresponding quarter last year.
- Disruptions in supply of few key raw materials and change of processes for existing products had led to production shortages in its APIs. This resulted in increasing manufacturing expenses in the quarter.
- As production fell short in Q2 FY19, some demand in antibiotics could not be fulfilled.
- Management guided to ₹1bn capex in FY19.
- Domestic contract-manufacturing revenue contributed ~85-90% to formulations revenue. The company has about 129 registrations in 10 countries; management expects contribution from exports at ~50% in the next few years.
- Management said that the company is working on its tender businesses in a couple of countries and is targeting some molecules where it has backward integration.

Valuations

We reduce our FY19e and FY20e EBITDA respectively 8.2% and 4.3% due to the lower-than-expected gross margins because of the raw-material-supply disruptions. We expect Aarti to register ~14% and ~21% revenue and PAT CAGRs respectively over FY18-21, driven by market-share gains in existing API products and the recently-added capacity.

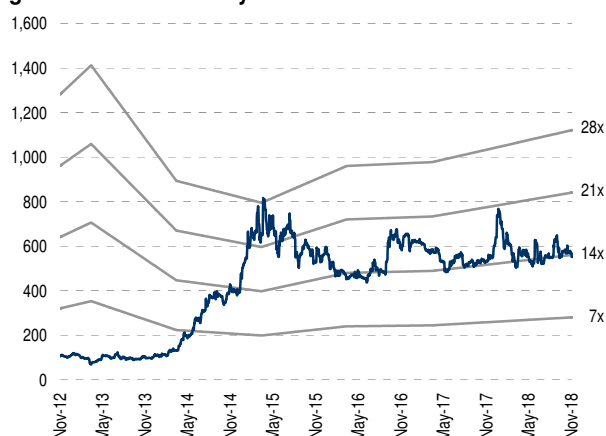
Fig 9 – Change in estimates

(₹m)	Old estimates		New estimates		Change (%)	
	FY19e	FY20e	FY19e	FY20e	FY19e	FY20e
Revenue	14,259	16,436	14,349	16,441	0.6	0.0
EBITDA	2,281	2,630	2,095	2,515	(8.2)	(4.3)
PAT	1,014	1,213	896	1,152	(11.6)	(5.1)

Source: Anand Rathi Research

At the CMP of ₹551, the stock trades at 14.5x, 11.3x and 8x FY19e, FY20e and FY21e earnings respectively. We roll forward our estimates to FY21 and retain our Buy recommendation on the stock, with a revised price target of ₹745 (earlier ₹720), based on 12x FY21e EPS.

Fig 10 – PE Band – one-year-forward



Source: Bloomberg, Anand Rathi Research

Fig 11 – Standard deviation – one-year-forward



Source: Bloomberg, Anand Rathi Research

Risks

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

Fig 12 – Key Data

	RATING	CMP	TP	M Cap	PE (x)			PE (x) Bloomberg			EV/EBITDA			RoE (%)			RoCE (%)		
					(₹)	(₹)	(₹bn)	FY19e	FY20e	FY21e	FY19e	FY20e	FY21e	FY19e	FY20e	FY21e	FY19e	FY20e	FY21e
Aarti	Buy	551	745	13.0	14.5	11.3	8.9	13.3	11.1	NA	8.7	7.2	6.0	18.0	19.4	20.4	10.4	11.8	13.0
Ajanta	Hold	1,120	1,240	98.6	22.3	18.7	16.3	21.4	17.4	16.3	14.9	12.5	10.7	20.0	20.3	20.0	19.8	20.1	19.8
Alembic	Hold	565	617	106.5	20.1	19.4	17.4	24.8	20.9	17.0	13.7	12.4	10.8	21.9	19.4	18.8	16.2	14.7	15.1
Alkem	Buy	1942	2392	232.2	26.3	20.2	17.1	25.5	19.9	17.6	18.8	14.6	12.3	17.0	19.2	19.7	16.6	18.7	19.3
Cadila	Buy	356	435	364.5	20.4	18.0	16.4	20.5	18.0	16.2	14.3	12.5	11.2	19.1	18.9	18.1	12.9	13.2	13.2
Dishman	Buy	231	346	37.3	14.1	11.6	9.6	17.1	13.2	11.0	8.9	7.6	6.4	5.1	6.0	6.9	4.7	5.3	6.1
Eris	Buy	678	879	93.2	26.6	22.0	18.5	27.0	21.7	17.3	21.3	17.4	14.2	33.8	29.7	26.7	28.4	28.5	27.9
Granules India	Buy	102	158	25.9	12.2	10.2	7.7	13.0	10.0	8.0	9.4	7.2	5.5	15.2	15.8	17.8	8.0	8.4	10.3
Indoco Remedies	Hold	162	190	14.9	NM	19.8	13.6	24.5	17.8	NA	21.8	9.7	7.8	NM	10.8	14.3	1.4	10.1	12.9
Ipca Labs.	Buy	758	893	95.7	24.0	18.6	15.3	22.8	16.6	15.5	14.7	11.7	9.5	13.9	15.6	16.4	11.9	13.5	14.5
Natco Pharma	Buy	735	930	135.6	17.9	20.0	19.4	14.9	15.9	18.0	13.0	14.0	13.3	22.3	16.9	15.2	21.3	16.3	14.8
Neuland	Hold	539	587	6.9	79.9	18.5	13.8	24.0	11.8	8.0	18.4	9.5	7.7	1.5	6.4	8.0	2.4	5.5	6.6
Pfizer	Hold	2830	3540	129.5	29.7	25.6	22.4	28.7	24.4	22.2	17.9	15.0	12.8	15.4	16.0	16.3	15.3	15.9	16.2
Suven Life Sciences	Hold	247	281	31.4	24.9	23.2	21.5	24.3	19.8	15.2	15.6	14.1	12.7	15.5	14.8	14.3	14.8	14.2	13.8
Torrent Pharma	Hold	1,657	1,865	280.4	36.9	28.1	22.9	33.4	24.0	19.8	16.9	14.5	12.6	15.7	18.6	20.4	10.4	12.5	14.1
HCG	Hold	230	235	20.0	-373.1	78.8	43.7	155.8	66.8	48.6	18.7	14.8	11.8	-1.0	4.9	8.2	5.4	5.0	6.6

Source: Company, Anand Rathi Research

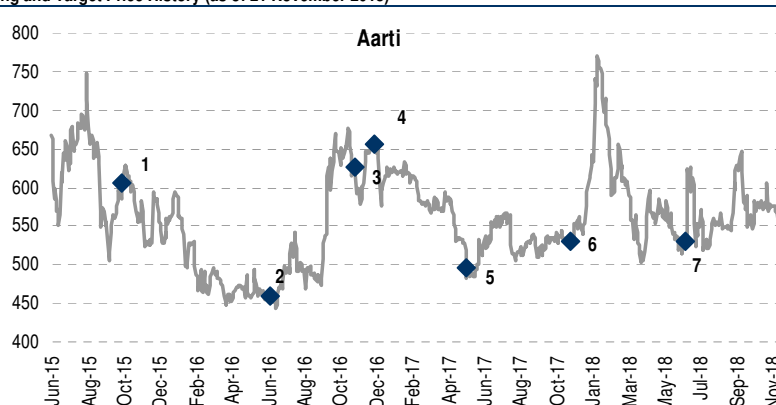
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	Date	Rating	TP (₹)	Share Price (₹)
1	13-Oct-15	Buy	815	616
2	23-Jun-16	Hold	522	456
3	09-Nov-16	Hold	661	633
4	14-Dec-16	Hold	666	657
5	24-May-17	Buy	666	515
6	21-Nov-17	Buy	708	537
7	12-Jun-18	Buy	720	523

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