

28 July 2020

Aarti Drugs

Stellar quarter, China disruption unleashes tremendous growth opportunity; retaining a Buy

Rating: **Buy**

Target Price: ₹2,090

Share Price: ₹1,748

As a prominent partner of pharma companies seeking to diversify supplies from China, Aarti's Q1 sales grew 34% y/y. A better product mix and higher realisations on key APIs (prices rose 10-15%) led to a 772bp gross-margin expansion. The EBITDA margin swung to a record 24.6% (a 1,110bp expansion). Absolute EBITDA grew 145% to ₹1.3bn. The better operating performance and lower tax rate rocketed adj. PAT 281% to ₹855m. On such a strong Q1, we raise our FY21e/22e/23e EPS 43.5%/29.5%/28.9%. We expect revenue/PAT to clock 18.9%/34.5% CAGRs over FY20-23. We retain our Buy rating, with a higher target of ₹2,090.

API continues to be backbone of growth. On strong demand for Indian APIs and Aarti's higher realizations, its API sales rose 28% to ₹4.6bn. The share of antibiotics climbed to 46% of Q1 FY21 sales (44% the year prior), mainly on more sales of ciprofloxacin, ofloxacin and norfloxacin. New capacities and higher realisations are likely to lead to an 18% CAGR in API sales by FY20-23.

Aptly placed to benefit from supply de-risking. The production-linked ₹100bn incentive scheme announced by the Indian government will benefit those like Aarti. It has shortlisted a basket of products it plans to manufacture under this scheme. It is also evaluating contract manufacturing of specialty products, earlier manufactured in China.

Formulations growth uninterrupted. Its formulations business shot up 91% to ₹817m, driven by higher demand from institutional clients. Management expects formulations sales of ₹2.5bn-2.8bn in FY21.

Valuation. Now in a sweet spot, Aarti Drugs will benefit from opportunities arising out of China. Besides, it is a prime candidate to benefit from the government's push for indigenous API manufacturing. We retain our Buy rating, with a higher target of ₹2,090, at 15x FY23e EPS. **Risks:** Delay in the ramp-up of recently-added capacity; more-than-expected competition in generic APIs.

Key financials (YE Mar)	FY19	FY20	FY21e	FY22e	FY23e
Sales (₹ m)	15,609	18,061	22,371	26,183	30,339
Net profit (₹ m)	872	1,380	2,373	2,619	3,355
EPS (₹)	37.0	59.2	101.9	112.4	144.0
PE (x)	47.3	29.5	17.2	15.5	12.1
EV / EBITDA (x)	22.1	17.0	10.9	9.8	7.5
PBV (x)	7.5	6.2	4.6	3.6	2.8
RoE (%)	17.5	23.1	31.0	26.1	26.0
RoCE (%)	10.3	14.5	21.8	20.6	21.8
Dividend yield (%)	0.1	0.1	0.2	0.3	0.3
Net debt / equity (x)	0.9	0.6	0.3	0.1	-0.1

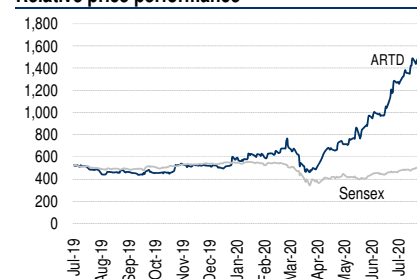
Source: Company, Anand Rathi Research

Key data	ARTD IN / ADRG.BO
52-week high / low	₹1811 / 419
Sensex / Nifty	37935 / 11132
3-m average volume	\$2.6m
Market cap	₹41bn / \$543.3m
Shares outstanding	23m

Shareholding pattern (%)	Jun '20	Mar '20	Dec '19
Promoters	60.5	61.4	61.6
- of which, Pledged	0.0	0.0	-
Free float	39.5	38.6	38.4
- Foreign institutions	1.8	1.1	0.8
- Domestic institutions	5.1	4.8	4.8
- Public	32.6	32.7	32.7

Estimates revision (%)	FY21e	FY22e	FY23e
Sales	8.4	11.2	11.8
EBITDA	32.2	23.3	24.5
PAT	43.5	29.5	28.9

Relative price performance



Source: Bloomberg

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Quick Glance – Financials and Valuations

Fig 1 – Income statement (₹ m)

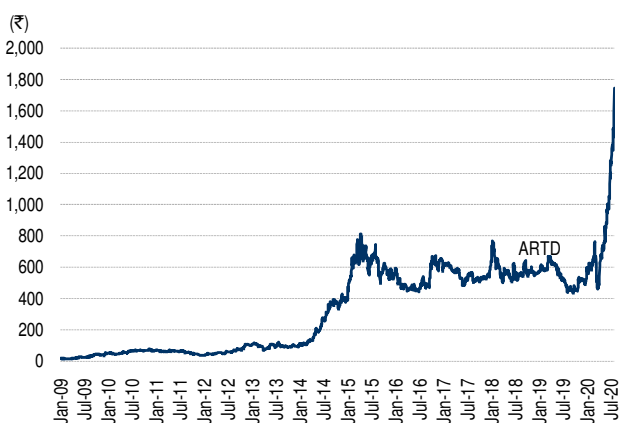
Year-end: Mar	FY19	FY20	FY21e	FY22e	FY23e
Net revenues	15,609	18,061	22,371	26,183	30,339
Growth (%)	23.6	15.7	23.9	17.0	15.9
Direct costs	10,600	11,790	13,994	16,819	19,315
SG&A	2,936	3,653	4,429	5,079	5,743
EBITDA	2,074	2,618	3,948	4,284	5,281
EBITDA margins (%)	13.3	14.5	17.6	16.4	17.4
- Depreciation	426	488	531	598	647
Other income	24	15	27	31	35
Interest expenses	400	337	279	225	196
PBT	1,310	1,853	3,165	3,492	4,474
Effective tax rate (%)	31.5	23.7	25.0	25.0	25.0
+ Associates / (Minorities)	-	-	-	-	-
Net income	898	1,414	2,373	2,619	3,355
Adjusted income	872	1,380	2,373	2,619	3,355
WANS	24	23	23	23	23
FDEPS (₹ / sh)	37.0	59.2	101.9	112.4	144.0

Fig 3 – Cash-flow statement (₹ m)

Year-end: Mar	FY19	FY20	FY21e	FY22e	FY23e
PBT (adj. for int.exp. / other income)	1,686	2,175	3,417	3,686	4,634
+ Non-cash items	426	488	531	598	647
Oper. prof. before WC	2,111	2,663	3,948	4,284	5,281
- Incr. / (decr.) in WC	281	-209	641	452	292
Others incl. taxes	326	533	791	873	1,118
Operating cash-flow	1,505	2,338	2,516	2,960	3,871
- Capex (tang. + intang.)	693	472	800	1,400	1,000
Free cash-flow	811	1,867	1,716	1,560	2,871
Acquisitions					
- Div. (incl. buyback & taxes)	114	70	93	140	140
+ Equity raised	-	-3	-	-	-
+ Debt raised	-390	-1,194	-1,014	-350	-350
- Fin investments	17	9	-	-	-
- Misc. (CFI + CFF)	277	572	252	194	160
Net cash-flow	13	21	356	876	2,220

Source: Company, Anand Rathi Research

Fig 5 – Price movement



Source: Bloomberg

Fig 2 – Balance sheet (₹ m)

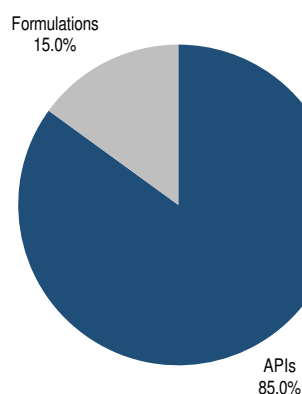
Year-end: Mar	FY19	FY20	FY21e	FY22e	FY23e
Share capital	236	233	233	233	233
Net worth	5,434	6,525	8,805	11,284	14,500
Debt	5,072	3,878	2,864	2,514	2,164
Minority interest	-	-	-	-	-
DTL / (Assets)	898	807	807	807	807
Capital employed	11,405	11,210	12,476	14,606	17,471
Net tangible assets	6,220	6,423	6,646	7,461	7,830
Net intangible assets	29	15	36	43	48
Goodwill	-	-	-	-	-
CWIP (tang. & intang.)	327	122	147	127	107
Investments (strategic)	124	134	134	134	134
Investments (financial)	-	-	-	-	-
Current assets (ex cash)	7,799	8,995	9,613	10,838	11,746
Cash	56	76	433	1,308	3,529
Current liabilities	3,150	4,555	4,533	5,306	5,922
Working capital	4,649	4,440	5,081	5,532	5,824
Capital deployed	11,405	11,210	12,476	14,606	17,471
Contingent liabilities	747				

Fig 4 – Ratio analysis

Year-end: Mar	FY19	FY20	FY21e	FY22e	FY23e
P/E (x)	47.3	29.5	17.2	15.5	12.1
EV / EBITDA (x)	22.1	17.0	10.9	9.8	7.5
EV / Sales (x)	2.9	2.5	1.9	1.6	1.3
P/B (x)	7.5	6.2	4.6	3.6	2.8
RoE (%)	17.5	23.1	31.0	26.1	26.0
RoCE (%) - after tax	10.3	14.5	21.8	20.6	21.8
ANDA filings					
DPS (₹ / sh)	1.0	2.5	4.0	6.0	6.0
Dividend yield (%)	0.1	0.1	0.2	0.3	0.3
Dividend payout (%) - incl. DDT	12.7	5.0	3.9	5.3	4.2
Net debt / equity (x)	0.9	0.6	0.3	0.1	-0.1
Receivables (days)	107	99	90	85	80
Inventory (days)	58	66	47	47	43
Payables (days)	57	67	55	57	54
CFO : PAT%	172.6	169.5	106.0	113.0	115.4

Source: Company, Anand Rathi Research

Fig 6 – Revenue break-up (Q1 FY21)



Source: Company

Result highlights

Fig 7 – Quarterly financials

(₹ m)	Q2 FY19	Q3 FY19	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20	Q4 FY20	Q1 FY21	% Y/Y	% Q/Q
Sales	3,474	3,801	4,591	4,054	4,775	4,735	4,496	5,447	34.3	21.1
Gross profit	1,157	1,273	1,376	1,363	1,611	1,633	1,665	2,251	65.2	35.3
Gross margins (%)	33.3	33.5	30.0	33.6	33.7	34.5	37.0	41.3	772bps	431bps
EBITDA	470	519	559	547	683	675	713	1,340	144.8	87.9
EBITDA margins (%)	13.5	13.6	12.2	13.5	14.3	14.3	15.9	24.6	1110bps	874bps
Finance expenses	97	105	103	93	85	84	75	66	(29.6)	(12.0)
Depreciation	106	107	108	118	121	124	125	124	4.8	(0.9)
Other income	1	2	12	1	2	3	10	13	NM	28.6
PBT	267	308	398	336	479	431	607	1,163	245.7	91.5
Tax	70	74	99	91	134	139	170	294	223.7	73.3
Effective tax rate (%)	32.5	32.3	31.1	33.3	32.5	35.5	3.1	26.5	-675bps	2345bps
Adjusted PAT	181	209	248	225	323	303	507	855	280.6	68.5

Source: Company, Anand Rathi Research

Fig 8 – Revenue assumption

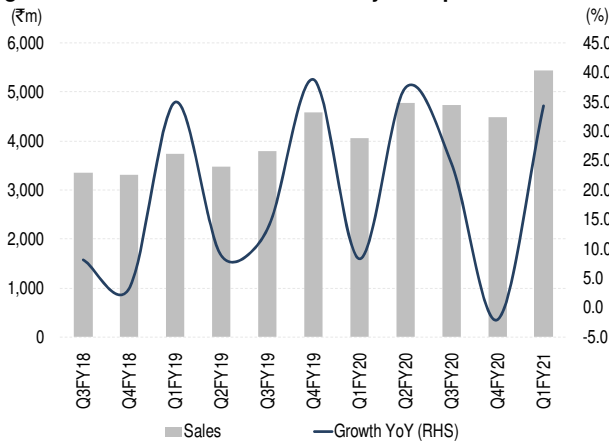
	FY21e	FY22e	FY23e
APIs	18,368	21,467	24,694
% of sales	82.1	82.0	81.4
Y/Y %	20.7	16.9	15.0
Formulations	2,797	3,357	3,961
% of sales	12.5	12.8	13.1
Y/Y %	60.0	20.0	18.0
Specialty chemicals	674	782	1,056
% of sales	3.0	3.0	3.5
Y/Y %	20.0	16.0	35.0
Intermediates	203	235	273
% of sales	0.9	0.9	0.9
Y/Y %	16.0	16.0	16.0
Total	22,371	26,183	30,339

Source: Company, Anand Rathi Research

Concall Highlights

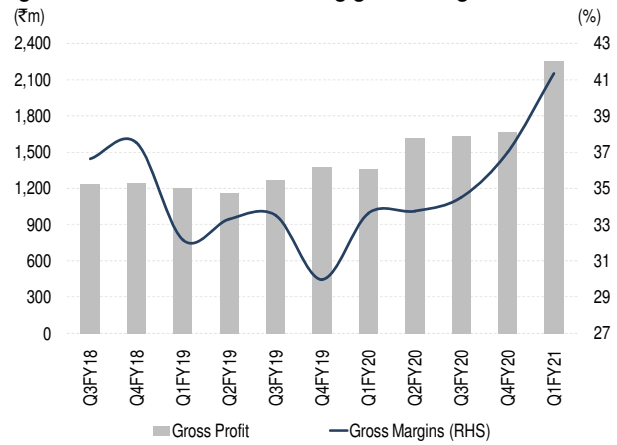
- API revenue contributed 85% to overall consolidated revenues. Within APIs share of domestic revenue was 65.1%, while export was 34.8%.
- API sales to domestic market was 28.2%, export growth at 29.1%.
- 50% API revenue growth was driven by volume growth.
- Formulations revenue was 15% of consolidated revenue and grew 89.5% y/y, due to higher exports (~50% of formulation sales).
- Within API therapeutics, antibiotics brought 46% to revenue, antiprotozol 16%, anti-inflammatory 13%, anti-diabetic 10%, anti-fungal 5%, specialty & intermediate 5%.
- Anti-inflammatory therapy revenue grew 13% y/y (vs. 10% a quarter back).
- Good realisation in selling price led to the higher gross margin.
- The company has scaled up its anti-diabetic and anti-inflammatory capacities, which would give the necessary impetus to revenue growth in FY21, along with growth in export formulations.
- Revenue deferred in Q4 FY20 to Q1 FY21 amounted to ₹150m (₹50m-60m formulations, ₹100m APIs).
- Management spoke of FY21 EBITDA margin of ~18-20%. The higher Q1 margin was driven by the Chinese disruption and the greater proportion of institutional orders. However, the similar institutional orders are not expected ahead and management talked of ₹500m-800m of institutional orders.
- Planned capex for the next three years is ₹3bn-4bn (mainly for backward integration).
- Additional capex is planned to introduce products in anti-diabetics toward end-FY21.
- Formulations subsidiary Pinnacle recorded healthy growth in Q1 FY21. Management said that for the coming quarter the company has orders and Q1 FY21 growth was exceptionally high. Export growth will be driven by the addition of markets and products.
- Current utilisation for formulations is ~ 70-80%.

Fig 9 – Growth momentum boosted by disruption in China



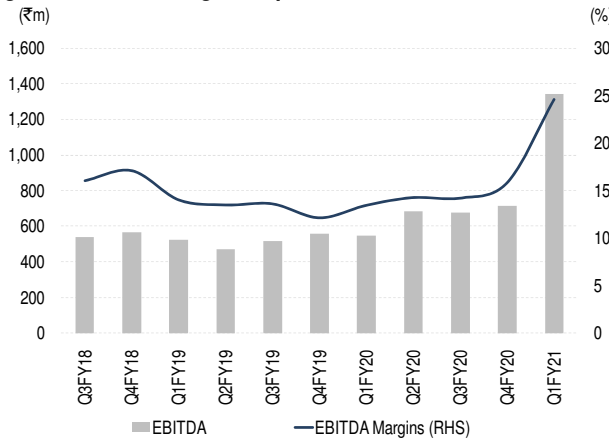
Source: Company, Anand Rathi Research

Fig 10 – Better realisations driving gross margins



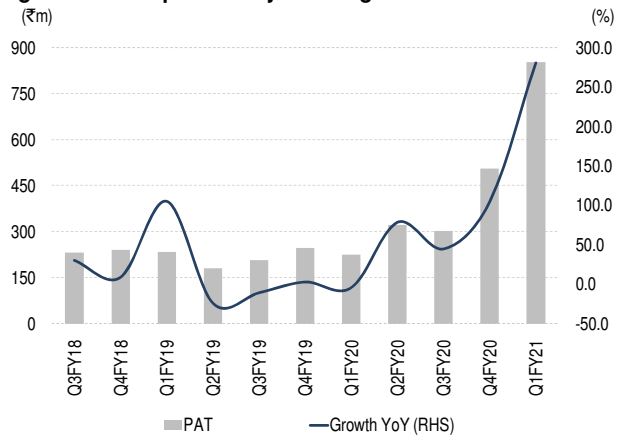
Source: Company, Anand Rathi Research

Fig 11 – EBITDA margins expected to be elevated



Source: Company, Anand Rathi Research

Fig 12 – Overall profitability to be high



Source: Company, Anand Rathi Research

Valuations

We raise our FY21e/FY22e/FY23e EBITDA 32.2%/23.3%/24.5% and PAT 43.5%/29.5%/28.9% on account of the better-than-expected Q1 FY21 and higher export formulations business.

Fig 13 – Change in estimates

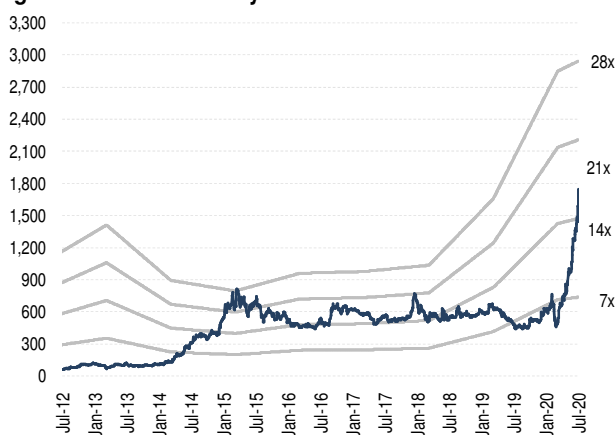
₹ m	Old estimates			New estimates			Change (%)		
	FY21e	FY22e	FY23e	FY21e	FY22e	FY23e	FY21e	FY22e	FY23e
Revenue	20,645	23,546	27,135	22,371	26,183	30,339	8.4	11.2	11.8
EBITDA	2,985	3,475	4,242	3,948	4,284	5,281	32.2	23.3	24.5
PAT	1,654	2,022	2,603	2,373	2,619	3,355	43.5	29.5	28.9

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 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 and the recent capacity additions for diabetes and specialty chemicals will help earnings grow 33% over FY20-23.

At the CMP of ₹1,748, the stock trades at 15.5x and 12.5x its FY21e and FY22e earnings respectively. We expect revenue and PAT CAGRs over FY20-23 of respectively 18.9% and 33.0%. We retain our Buy recommendation on the stock, with a higher target price of ₹2,090, based on 15x FY23e 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 (%)		
					FY21e	FY22e	FY23e	FY21e	FY22e	FY23e	FY21e	FY22e	FY23e	FY21e	FY22e	FY23e
Aarti Drugs	Buy	1747	2090	40.7	101.9	112.4	144.0	17.2	15.5	12.1	10.9	9.8	7.5	31.0	26.1	26.0
Ajanta	Hold	1484	1614	129.1	58.1	73.7	89.7	25.5	20.1	16.5	14.4	12.3	13.3	18.8	19.1	20.1
Alembic	Hold	964	985	181.7	45.6	46.6	53.0	21.1	20.7	18.2	15.8	14.8	12.9	24.3	21.0	20.4
Alkem	Hold	2454	2532	293.4	97.1	115.1	126.7	25.3	21.3	19.4	18.6	15.6	13.8	17.7	18.5	17.9
Zydus Cadila	Hold	356	393	364.8	15.1	17.5	19.6	23.6	20.4	18.1	14.5	12.7	11.2	14.3	15.3	15.6
Eris	Hold	425	484	58.5	24.7	25.0	24.2	17.2	17.0	17.6	14.6	13.4	12.3	22.9	18.9	15.4
Granules India	Buy	293	312	74.6	17.5	21.8	27.2	16.8	13.5	10.8	9.9	7.9	6.1	21.8	22.4	23.0
Indoco Remedies	Sell	204	180	18.8	6.8	10.0	12.1	29.9	20.5	16.9	11.5	9.0	7.6	8.9	11.7	12.6
Ipca Labs.	Buy	1739	1990	219.7	68.1	80.5	90.7	25.5	21.6	19.2	16.8	14.0	12.1	21.5	21.0	19.7
JB Chemicals	Sell	722	720	57.8	37.5	43.7	49.8	19.2	16.5	14.5	12.4	10.3	8.6	18.9	19.2	19.2
Natco Pharma	Hold	718	712	130.7	27.3	29.3	33.4	26.3	24.5	21.5	18.8	16.8	14.8	12.5	12.1	12.4
Neuland	Hold	708	585	9.1	31.3	39.0	44.7	22.6	18.1	15.8	7.6	6.0	7.0	4.1	6.1	7.1
Pfizer	Hold	4371	4449	199.9	110.3	122.9	132.0	39.6	35.6	33.1	27.1	24.1	21.8	14.1	14.1	13.7
Suven Pharma	Buy	577	695	73.4	28.9	34.9	41.3	20.0	16.5	13.9	15.9	12.8	10.1	37.3	34.3	31.7
Torrent Pharma	Hold	2300	2964	389.2	62.4	80.2	98.5	36.8	28.7	23.4	19.7	16.4	16.4	20.2	23.4	24.4

Source: Company, Anand Rathi Research

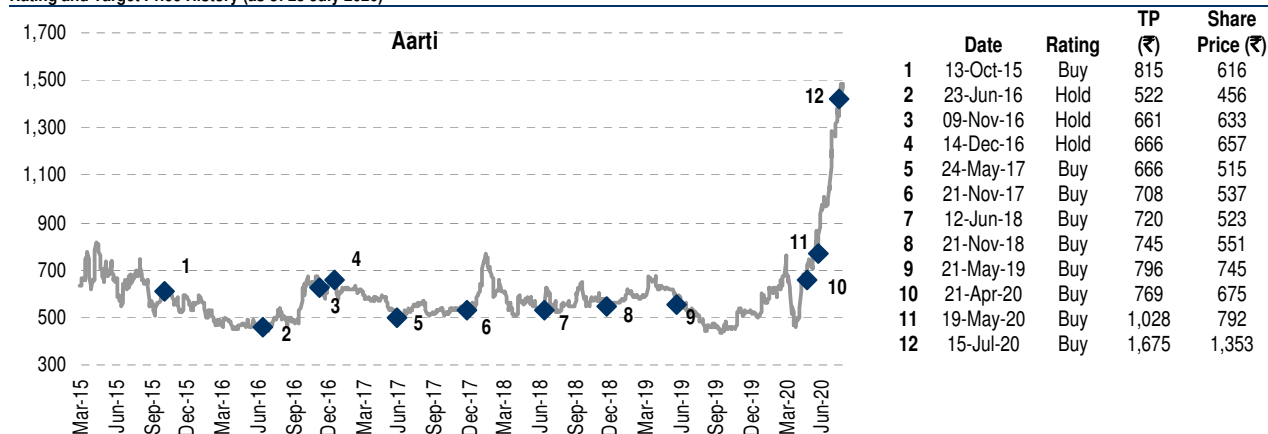
Appendix

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