

28 October 2020

## Aarti Drugs

Capex plans improve visibility beyond FY23; retaining a Buy

Driven by strong domestic demand for API and traction in formulations, Aarti's Q2 sales shot up 21.1% to Rs5.8bn. Higher realisation and lower overheads led to its EBITDA margin expanding 583bps to 20%. Absolute EBITDA grew 70% to Rs1.2bn. The better operating performance and lower tax rate boosted adj. PAT 133% to Rs752m. On such a strong Q2, we raise our FY21e/22e/23e EPS 13.9%/13.9%/7.1%. Revenue/PAT would clock 18.9%/37.6% CAGRs over FY20-23. After a strong Q1 FY21 the stock has run up 58% (adjusting for the split) and now trades at 22.3x/18.6x/14.4x FY21e/FY22e/FY23e earnings. We retain our Buy rating and raise our target to Rs813 based on 18x FY23e earnings.

**Traction in API to continue.** Aarti's API sales grew 21% to Rs5.1bn as the cost difference in sourcing APIs from India vs China is narrowing. The share of sales of antibiotics in Q2 was 44% while the contribution of anti-inflammatory APIs increased to 12%. New capacities and higher realisations are likely to lead to a 19% CAGR in API sales by FY20-23.

**Capex plans improve growth visibility.** Aarti has envisaged Rs6bn capex (equivalent to the current net block), to be implemented in the next 3-4 years and could add sales of Rs15bn on full commercialisation. Management is confident that the present capacity can generate peak sales of Rs25bn-26bn.

**Formulations growth uninterrupted.** The formulations business shot up 45% to Rs694m, driven by greater demand from institutional clients. The company plans to raise metformin capacity 3x to 3,000 tons in the near term.

**Valuation.** Strong traction in API and formulations is expected to boost growth over FY20-23. After that, management has identified seven growth projects which will be key drivers beyond FY24. At the CMP of Rs644, the stock trades at 22.3x/18.6x/14.4x FY21e/FY22e/FY23e earnings. **Risks:** Delay in capacity addition; keener competition in generic APIs and deterioration in API pricing.

Key financials (YE Mar)	FY19	FY20	FY21e	FY22e	FY23e
Sales (Rs m)	15,609	18,061	22,371	26,559	31,401
Net profit (Rs m)	872	1,380	2,689	3,219	4,163
EPS (Rs)	37.0	59.2	28.9	34.5	44.7
PE (x)	17.4	10.9	22.3	18.6	14.4
EV / EBITDA (x)	31.4	24.4	14.3	12.0	9.2
PBV (x)	11.0	9.2	6.8	5.2	4.0
RoE (%)	17.5	23.1	35.0	31.6	31.3
RoCE (%)	10.3	14.5	24.4	24.8	26.2
Dividend yield (%)	0.2	0.4	0.6	0.9	0.9
Net debt / equity (x)	0.9	0.6	0.3	0.1	-0.1

Source: Company, Anand Rathi Research

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Rating: **Buy**

Target Price: Rs813

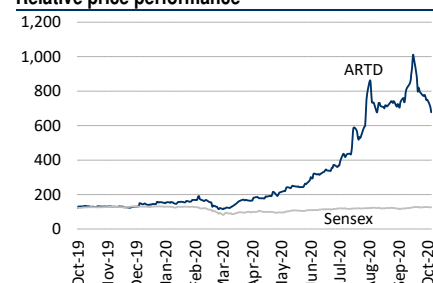
Share Price: Rs644

Key data	ARTD IN / ADRG.BO
52-week high / low	Rs1,027 / 105
Sensex / Nifty	40522 / 11889
3-m average volume	\$16.8m
Market cap	Rs63bn / \$856.2m
Shares outstanding	93m

Shareholding pattern (%)	Sep '20	June '20	Mar '20
Promoters	60.2	60.5	61.4
- of which, Pledged	-	-	-
Free float	39.8	39.5	38.6
- Foreign institutions	2.2	1.8	1.1
- Domestic institutions	2.2	5.1	4.8
- Public	35.5	32.6	32.7

Estimates revision (%)	FY21e	FY22e	FY23e
Sales	-	1.4	3.5
EBITDA	10.7	19.1	21.3
PAT	13.3	22.9	24.1

### Relative price performance



Source: Bloomberg

**Abdulkader Puranwala**  
Research Analyst

## Quick Glance – Financials and Valuations

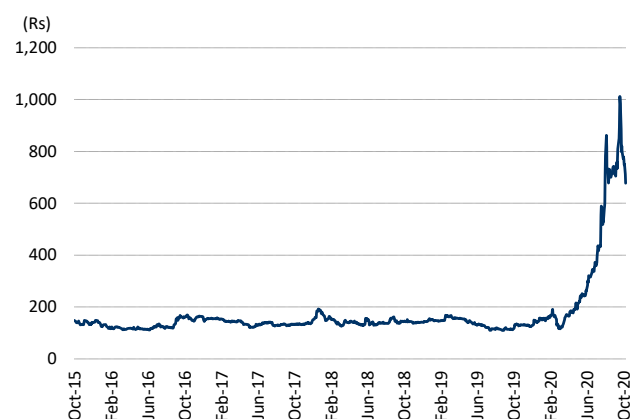
**Fig 1 – Income statement (Rs m)**

Year-end: Mar	FY19	FY20	FY21e	FY22e	FY23e
Net revenues	15,609	18,061	22,371	26,559	31,401
Growth (%)	23.6	15.7	23.9	18.7	18.2
Direct costs	10,600	11,790	13,796	16,568	19,469
SG&A	2,936	3,653	4,206	4,887	5,526
<b>EBITDA</b>	<b>2,074</b>	<b>2,618</b>	<b>4,369</b>	<b>5,104</b>	<b>6,405</b>
EBITDA margins (%)	13.3	14.5	19.5	19.2	20.4
- Depreciation	426	488	531	617	694
Other income	24	15	27	31	35
Interest expenses	400	337	279	225	196
PBT	1,310	1,853	3,586	4,292	5,551
Effective tax rate (%)	31.5	23.7	25.0	25.0	25.0
+ Associates / (Minorities)	-	-	-	-	-
Net income	898	1,414	2,689	3,219	4,163
Adjusted income	872	1,380	2,689	3,219	4,163
WANS	24	23	93	93	93
FDEPS (Rs / sh)	37.0	59.2	28.9	34.5	44.7

**Fig 3 – Cash-flow statement (Rs m)**

Year-end: Mar	FY19	FY20	FY21e	FY22e	FY23e
PBT (adj. for int.exp. / other income)	1,686	2,175	3,838	4,487	5,711
+ Non-cash items	426	488	531	617	694
Oper. prof. before WC	2,111	2,663	4,369	5,104	6,405
- Incr. / (decr.) in WC	281	-209	656	535	405
Others incl. taxes	326	533	896	1,073	1,388
Operating cash-flow	1,505	2,338	2,816	3,496	4,613
- Capex (tang. + intang.)	693	472	800	1,800	1,600
Free cash-flow	811	1,867	2,016	1,696	3,013
Acquisitions	-	-	-	-	-
- Div. (incl. buyback & taxes)	114	70	373	559	559
+ Equity raised	-	-3	699	-	-
+ 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	1,076	592	1,943

Source: Company, Anand Rathi Research

**Fig 5 – Price movement**


Source: Bloomberg

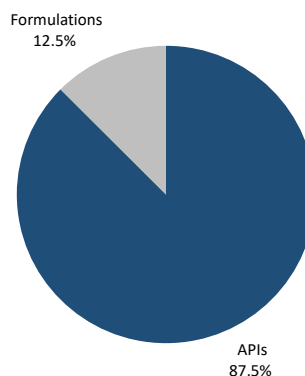
**Fig 2 – Balance sheet (Rs m)**

Year-end: Mar	FY19	FY20	FY21e	FY22e	FY23e
Share capital	236	233	932	932	932
Net worth	5,434	6,525	8,841	11,501	15,105
Debt	5,072	3,878	2,864	2,514	2,164
Minority interest	-	-	-	-	-
DTL / (Assets)	898	807	807	807	807
<b>Capital employed</b>	<b>11,405</b>	<b>11,210</b>	<b>12,513</b>	<b>14,823</b>	<b>18,077</b>
Net tangible assets	6,220	6,423	6,646	7,840	8,759
Net intangible assets	29	15	36	45	53
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	9,568	10,888	12,061
Cash	56	76	454	1,046	2,989
Current liabilities	3,150	4,555	4,473	5,257	6,026
Working capital	4,649	4,440	5,096	5,631	6,035
<b>Capital deployed</b>	<b>11,405</b>	<b>11,210</b>	<b>12,513</b>	<b>14,823</b>	<b>18,077</b>
Contingent liabilities	747	-	-	-	-

**Fig 4 – Ratio analysis**

Year-end: Mar	FY19	FY20	FY21e	FY22e	FY23e
P/E (x)	17.4	10.9	22.3	18.6	14.4
EV / EBITDA (x)	31.4	24.4	14.3	12.0	9.2
EV / Sales (x)	4.2	3.5	2.8	2.3	1.9
P/B (x)	11.0	9.2	6.8	5.2	4.0
RoE (%)	17.5	23.1	35.0	31.6	31.3
RoCE (%) - after tax	10.3	14.5	24.4	24.8	26.2
ANDA filings	-	-	-	-	-
DPS (Rs / sh)	1.0	2.5	4.0	6.0	6.0
Dividend yield (%)	0.2	0.4	0.6	0.9	0.9
Dividend payout (%) - incl. DDT	12.7	5.0	13.9	17.4	13.4
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	46	41
Payables (days)	57	67	54	55	53
CFO : PAT%	172.6	169.5	104.7	108.6	110.8

Source: Company, Anand Rathi Research

**Fig 6 – Revenue break-up (Q2 FY21)**


Source: Company

## Result highlights

**Fig 7 – Quarterly financials**

(Rs m)	Q1 FY19	Q2 FY19	Q3 FY19	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20	Q4 FY20	Q1 FY21	Q2 FY21	% Y/Y	% Q/Q
Sales	3,743	3,474	3,801	4,591	4,054	4,775	4,735	4,496	5,447	5,781	21	6
Gross profit	1,203	1,157	1,273	1,376	1,363	1,611	1,633	1,665	2,251	2,199	37	-2
Gross margin (%)	32.2	33.3	33.5	30.0	33.6	33.7	34.5	37.0	41.3	38.0	431bps	-329bps
EBITDA	526	470	519	559	547	683	675	713	1340	1164	70	-13
EBITDA margin (%)	14.1	13.5	13.6	12.2	13.5	14.3	14.3	15.9	24.6	20.1	583bps	-446bps
Finance expenses	94	97	105	103	93	85	84	75	66	71	-17	7
Depreciation	104	106	107	108	118	121	124	125	124	126	4	1
Other income	9	1	2	12	1	2	3	10	13	3	NM	-77
PBT	337	267	308	398	336	479	431	607	1163	971	103	-17
Tax	83	70	74	99	91	134	139	170	294	237	77	-19
Effective tax rate (%)	30.7	32.5	32.3	31.1	33.3	32.5	35.5	3.1	26.5	22.5	-1001bps	-401bps
Adjusted PAT	234	181	209	248	225	323	303	507	855	752	133	-12

Source: Company, Anand Rathi Research

**Fig 8 – Revenue assumption**

(Rs m)	FY21e	FY22e	FY23e
<b>APIs</b>	<b>18,368</b>	<b>21,843</b>	<b>25,755</b>
% of sales	82.1	82.2	82.0
Y/Y %	20.7	18.9	17.9
<b>Formulations</b>	<b>2,797</b>	<b>3,357</b>	<b>3,961</b>
% of sales	12.5	12.6	12.6
Y/Y %	60.0	20.0	18.0
<b>Specialty chemicals</b>	<b>674</b>	<b>782</b>	<b>1,056</b>
% of sales	3.0	2.9	3.4
Y/Y %	20.0	16.0	35.0
<b>Intermediates</b>	<b>203</b>	<b>235</b>	<b>273</b>
% of sales	0.9	0.9	0.9
Y/Y %	16.0	16.0	16.0
<b>Total</b>	<b>22,371</b>	<b>26,559</b>	<b>31,401</b>

Source: Company, Anand Rathi Research

## Concall Highlights

### Q2 FY21 performance drivers

- Q2 FY21 growth in APIs was driven by the domestic market which grew 20.8% while export growth was 5.8%.
- Formulations grew 48.4%, mainly driven by the product mix.
- API contribution to sales in Q2 FY21 was 88%, 12% came from formulations.
- Within APIs, domestic sales accounted for 66.2%, exports were 33.8%.
- In Q2 FY21 antibiotics contributed 44% to API sales, anti-protozoal 15%, anti-inflammatory 12%, diabetes 10%, anti-fungals 7% and the balance from other APIs.
- Nimesulide and Diclofenac are driving strong growth in anti-inflammatory API sales. The anti-inflammatory sales contribution went up from 10% last year to 12% now.
- D/E now is 0.47x.
- Current capacity utilisation: 75-80%.

### Capex plans

- In the near term, the company expects to scale up capacity of diabetes (APIs and formulations) and anti-inflammatory APIs.
- The company plans to start manufacturing gliptins APIs (diabetes) by end-FY21. It is also in the process of expanding metformin capacity from 1,100 MT currently to 3,000 MT.
- FY21 capex could be ~Rs1bn (Rs450m incurred in H1 FY21).
- In the next 3-4 years the company plans to incur capex of Rs6bn, of which Rs1.5bn-2bn would be for the PLI scheme, the rest would be to increase capacity of integrated products.
- The company has close to seven projects in the pipeline, for which it will incur the planned capex. Nearly 60% of the projects are API-based (diabetes); the balance is to manufacture sulfonated and chloro-sulfonated products and some intermediates.
- Each of these projects will take 18-24 months to complete and commence production.
- These seven projects will have the potential to add Rs15bn in sales (2.5x asset turn) with good margins.

### Guidance

- Current capacities can generate sales of Rs25bn.
- FY21 PAT growth: 80-90%.
- The EBITDA margin of 18-20% now looks achievable.
- In H1 FY21 cash-flows were affected as receivables had gone up. The company is confident of improving its cash-flows in H2 FY21 and expects to generate ~Rs2bn in operating cash-flows in FY21.

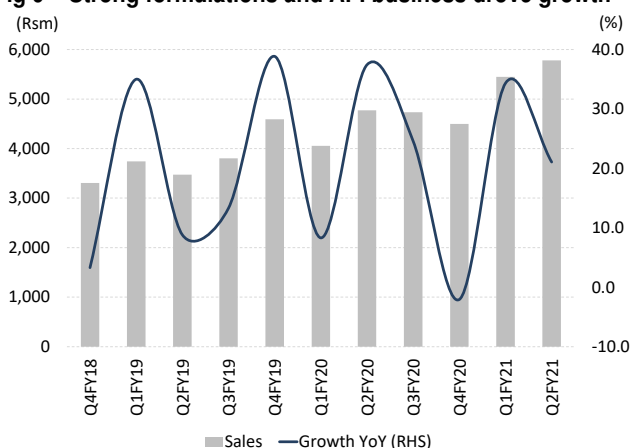
### APIs and the PLI scheme

- API prices are now stabilising. The highest prices were seen in the Jun quarter. Some benefit though may be seen in the Dec quarter as well.
- Under the PLI scheme, the government will allow export of APIs/intermediates manufactured at the plants under the scheme.
- The PLI scheme enrolment might be done through a 100% subsidiary of the company.

### Fund raising

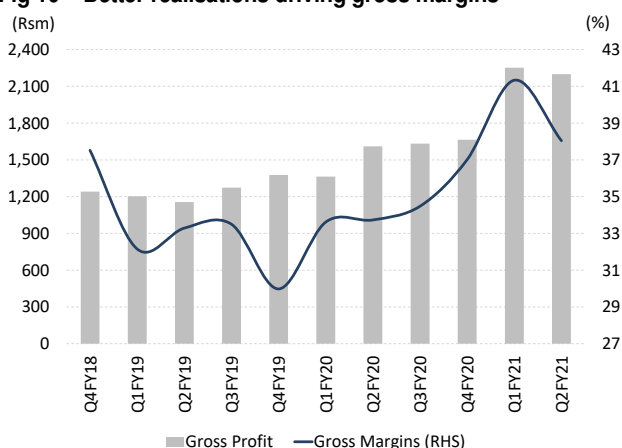
- The Board of Directors has passed a resolution to raise up to Rs3.5bn through debt or equity. Aarti does not have any immediate plan to raise these funds, but will do so if its internal accruals do not suffice to fund the capex plans.

**Fig 9 – Strong formulations and API business drove growth**



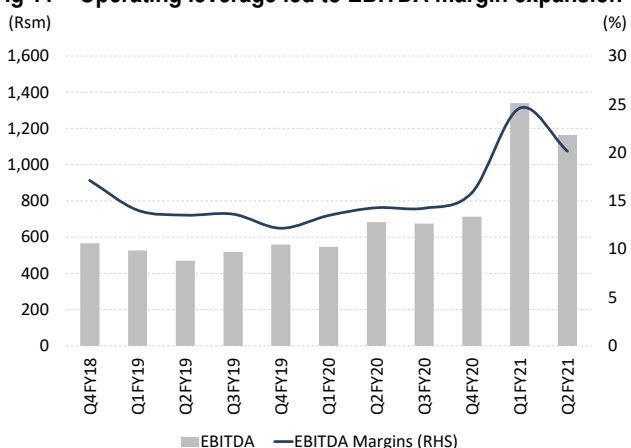
Source: Company, Anand Rathi Research

**Fig 10 – Better realisations driving gross margins**



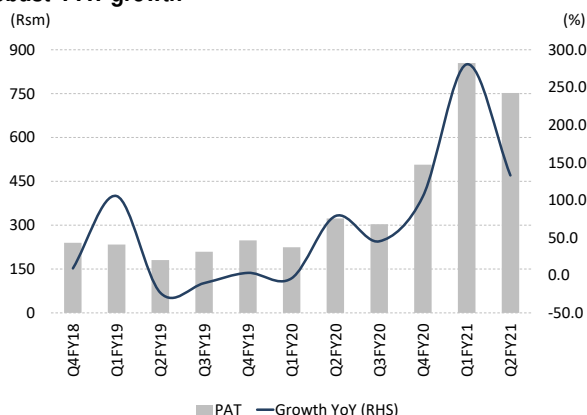
Source: Company, Anand Rathi Research

**Fig 11 – Operating leverage led to EBITDA margin expansion**



Source: Company, Anand Rathi Research

**Fig 12 – Better operating performance, lower tax rate led to robust PAT growth**



Source: Company, Anand Rathi Research

## Valuations

We raise our FY21e/FY22e/FY23e EBITDA 10.7%/19.1%/21.3% and PAT 13.3%/22.9%/24.1% on account of the better realisation in Q2 FY21 and subsequent stability in realisation for H2 FY21.

**Fig 13 – Change in estimates**

Rs m	Old estimates			New estimates			Change (%)		
	FY21e	FY22e	FY23e	FY21e	FY22e	FY23e	FY21e	FY22e	FY23e
Revenue	22,371	26,183	30,339	22,371	26,559	31,401	0.0	1.4	3.5
EBITDA	3,948	4,284	5,281	4,369	5,104	6,405	10.7	19.1	21.3
PAT	2,373	2,619	3,355	2,689	3,219	4,163	13.3	22.9	24.1

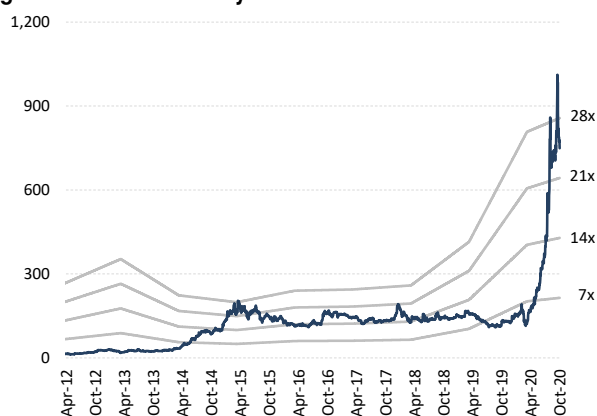
Source: Anand Rathi Research

Aarti has envisaged capex of Rs6bn, almost equivalent to its current net block. It has identified seven projects on which it will incur expenditure over the next 3-4 years. Nearly 60% of these are API-based (diabetes and others); the balance is to manufacture sulfonated and chloro-sulfonated products and some intermediates.

At the peak of its present capacity it can generate sales of Rs25bn. Further benefits would arise from the new formulations block and be good enough for an over 20% CAGR in the next 2-3 years. Beyond that, the new capacity would drive growth.

At the CMP of Rs644, the stock trades at 22.3x/18.6x/14.4x FY21e/FY22e/FY23e earnings. We expect revenue and PAT CAGRs over FY20-23 of 20.2% and 44.5% respectively. We retain our Buy rating and raise our target to Rs813 based on 18x FY23e earnings.

**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 – Valuation Summary

Company	RATING	CMP (Rs)	TP (Rs)	M Cap (Rs bn)	EPS (Rs)			PE (x)			EV / EBITDA (x)			RoE (%)		
					FY21e	FY22e	FY23e	FY21e	FY22e	FY23e	FY21e	FY22e	FY23e	FY21e	FY22e	FY23e
Aarti Drugs	Buy	644	813	60.0	28.9	34.5	44.7	22.3	18.6	14.4	14.3	12.0	9.2	35.0	31.6	31.3
Ajanta	Hold	1,604	1,614	140.7	57.8	73.2	87.8	27.8	21.9	18.3	17.3	14.0	11.5	18.1	19.8	20.4
Alembic	Hold	1,011	1,140	198.8	59.3	50.4	63.4	17.1	20.1	16.0	12.5	13.1	10.4	28.9	19.0	20.6
Alkem	Hold	2,652	3,145	317.0	106.0	123.9	136.8	25.0	21.4	19.4	18.8	15.9	14.1	19.2	19.6	18.9
Zydus Cadila	Hold	426	391	436.2	15.1	17.5	19.6	28.3	24.4	21.8	17.1	15.1	13.4	14.3	15.3	15.5
Eris	Hold	492	565	66.8	24.2	26.0	27.9	20.4	18.9	17.6	16.1	14.3	12.6	23.0	20.9	19.2
Granules India	Buy	392	338	97.0	20.6	25.3	30.4	19.0	15.5	12.9	12.5	10.0	8.1	24.7	24.5	23.8
Indoco Remedies	Sell	253	190	23.3	7.5	10.3	12.5	33.6	24.6	20.3	13.7	11.0	9.5	9.7	12.0	12.9
Ipca Labs.	Buy	2,075	2,300	262.2	87.6	90.8	103.5	23.7	22.8	20.1	16.9	15.8	13.5	26.9	22.4	21.0
JB Chemicals	Sell	1,022	760	79.0	43.4	45.9	50.7	23.5	22.2	20.2	15.8	14.5	12.7	21.6	19.8	19.1
Natco Pharma	Hold	929	851	169.1	28.1	31.0	75.7	33.1	30.0	12.3	26.2	22.8	9.3	12.8	12.7	26.3
Neuland	Hold	1,216	880	15.7	36.7	44.5	53.0	33.2	27.3	22.9	14.7	12.8	11.3	6.5	7.4	8.2
Pfizer	Hold	5,013	4,713	229.3	112.4	123.1	131.6	44.6	40.7	38.1	32.8	29.9	27.3	14.4	14.3	13.8
Suven Pharma	Buy	342	380	87.1	14.8	17.8	21.1	23.2	19.2	16.2	19.8	16.2	12.9	38.1	34.8	32.0
Torrent Pharma	Buy	2,654	3,080	449.2	68.7	85.6	104.2	38.6	31.0	25.5	19.8	17.2	14.9	22.5	24.5	25.8

Source: Company, Anand Rathi Research

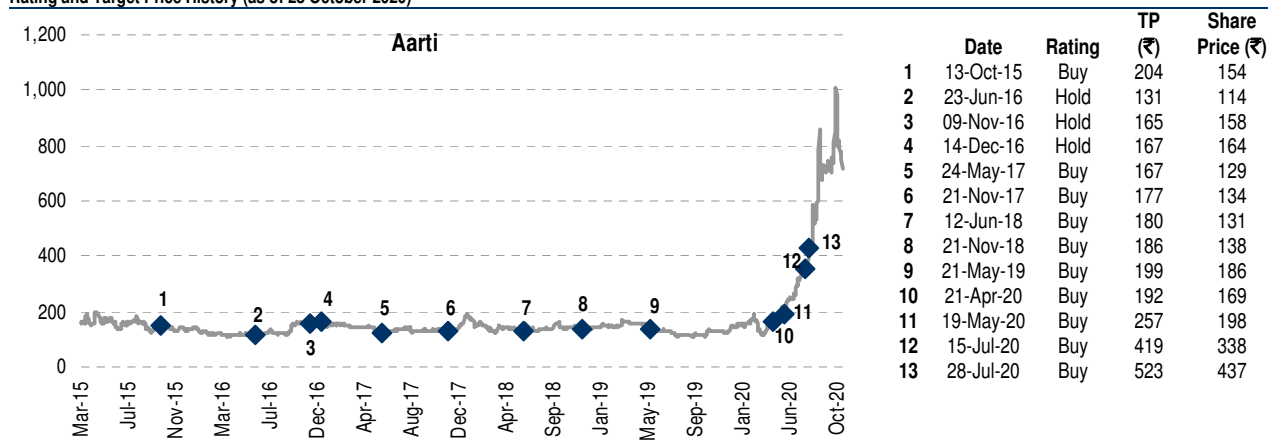
## Appendix

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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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