ANANDRATHI

India I Equities

Specialty Chemicals
Company Update

Change in Estimates ☑ Target ☑ Reco ☑

10 August 2020

Neogen Chemicals

Mixed Q2, strong outlook; upgrading to a Buy

Rating: **Buy**
Target Price: Rs800
Share Price: Rs619

Supported by strong user-industry demand and better utilisation, Neogen's Q2 revenue and EBITDA grew respectively 6% and 5% y/y. We are positive on the long-term outlook for the company and expect revenue/EBITDA/ PAT to clock 32%/34%/49% CAGRs over FY21-23, driven by coming expansions, rising demand for pharma and agro intermediates and focus on value-added products. Further, the company entered into long-term contracts, providing future revenue assurance. We are upgrading our recommendation on the stock to a Buy with a target of Rs800 (earlier Rs660), valuing it at 27x FY23e EPS.

Mixed Q2 performance. On positive demand from user-industries, Neogen's Q2 revenue grew 6.3% y/y, 7% q/q, to Rs820m. Its gross margin expanded 266bps y/y, 336bps q/q, to 41.5%, supported by a better product mix. Is EBITDA margin contracted 30bps y/y (though q/q up 115bps) to 18.8%, curtailed by higher operating expenses. Despite revenue and EBITDA growth, profit slipped 4.2% y/y, though q/q up 20.6%, to Rs74m due to higher depreciation and interest expenses.

Expansion to cater to mounting demand. To cater to growing demand, Neogen is coming out with further capex of Rs550m for organic chemicals, expected to be commissioned in FY22. This would add Rs1.5bn-1.75bn revenue. The ongoing expansion of organic reactor capacity is on schedule and expected to commence in Q4 FY21. Management maintained its guidance of Rs4.5bn revenue in FY22.

Valuation. We roll forward our valuation to FY23 and upgrade the stock to a Buy with a higher target of Rs800 (earlier Rs660), at an implied multiple of 27x FY23e EPS and 18x FY23e EV/EBITDA. The company is trying to shorten its working-capital cycle at the new capacities at Dahej. **Risks:** Slow growth in underlying sectors such as pharma; lengthening of clients' product lifecycles; high working-capital and debt.

Key financials (YE Mar)	FY19	FY20	FY21e	FY22e	FY23e
Sales (Rs m)	2,391	3,061	3,535	4,605	6,193
Net profit (Rs m)	209	287	309	462	682
EPS (Rs)	9.0	12.3	13.3	19.8	29.2
PE (x)	69.0	50.4	46.7	31.3	21.2
EV / EBITDA (x)	36.0	27.2	25.0	19.3	14.4
PBV (x)	20.6	9.2	7.9	6.5	5.2
RoE (%)	34.7	25.3	18.3	22.9	27.2
RoCE (%)	15.1	14.9	12.3	13.9	16.1
Dividend yield (%)	0.2	0.3	0.3	0.5	0.7
Net debt / equity (x)	1.7	0.9	1.0	1.1	0.9

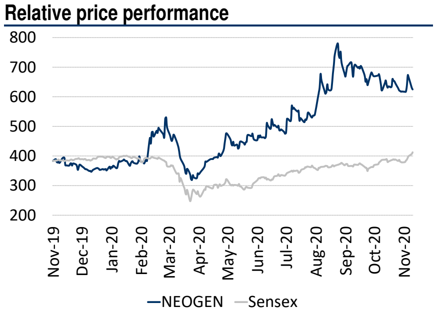
Source: Company, Anand Rathi Research

Key data	NEOGEN IN NEOE .BO
52-week high / low	820 / 303
Sensex / Nifty	43188 / 12606
3-m average volume	$0.4m
Market cap	15bn / $196.6m
Shares outstanding	23m

Shareholding pattern (%)	Sep'20	Jun'20	Mar'20
Promoters	64.3	64.3	70.0
- of which, Pledged	-	-	-
Free float	35.7	35.7	30.0
- Foreign institutions	4.8	4.8	0.6
- Domestic institutions	16.2	17.0	17.7
- Public	14.7	13.9	12.3

Estimates revision (%)	FY21e	FY22e
Sales	0.5	3.0
EBITDA	0.5	2.9
EPS	1.1	(7.2)

Relative price performance



Source: Bloomberg

Nav Bhardwaj
Research Analyst

Bhawana Israni
Research Associate

Quick Glance – Financials and Valuations

Fig 1 – Income statement (Rs m)

Year-end: Mar	FY19	FY20	FY21e	FY22e	FY23e
Net revenues	2,391	3,061	3,535	4,605	6,193
Growth (%)	***48.3***	***28.1***	***15.5***	***30.3***	***34.5***
Direct costs	1,407	1,841	2,139	2,763	3,716
SG&A	549	640	742	967	1,300
EBITDA	**434**	**581**	**654**	**875**	**1,177**
EBITDA margins (%)	*18.2*	*19.0*	*18.5*	*19.0*	*19.0*
- Depreciation	28	52	80	114	127
Other income	5	1	7	9	12
Interest expenses	119	119	154	173	180
PBT	292	410	428	597	882
Effective tax rate (%)	*28.5*	*30.3*	*28.0*	*23.0*	*23.0*
+ Associates / (Minorities)	1	1	2	2	3
Net income	209	287	309	462	682
Adjusted income	209	287	309	462	682
WANS	23	23	23	23	23
FDEPS (₹ / sh)	9.0	12.3	13.3	19.8	29.2
FDEPS growth (%)	*90.7*	*36.8*	*7.9*	*49.4*	*47.6*
Gross margins (%)	*41.1*	*39.9*	*39.5*	*40.0*	*40.0*

Fig 2 – Balance sheet (Rs m)

Year-end: Mar	FY19	FY20	FY21e	FY22e	FY23e
Share capital	201	233	233	233	233
Net worth	702	1,562	1,825	2,218	2,798
Debt	**1,200**	**1,373**	**1,923**	**2,473**	**2,573**
Minority interest	-	-	-	-	-
DTL / (Assets)	49	56	56	56	56
Capital employed	**1,951**	**2,992**	**3,805**	**4,747**	**5,427**
Net tangible assets	827	1,102	1,814	2,240	2,408
Net intangible assets	1	3	3	3	3
Goodwill	-	-	-	-	-
CWIP (tang. & intang.)	4	27	85	195	100
Investments (strategic)	5	6	6	6	6
Investments (financial)	-	-	-	-	-
Current assets (ex cash)	1,607	2,395	2,669	3,293	4,242
Cash	20	15	29	18	24
Current liabilities	514	557	802	1,009	1,356
Working capital	1,093	1,838	1,867	2,284	2,886
Capital deployed	**1,951**	**2,992**	**3,805**	**4,747**	**5,427**
Contingent liabilities	83	-	-	-	-

Fig 3 – Cash-flow statement (Rs m)

Year-end: Mar	FY19	FY20	FY21e	FY22e	FY23e
PBT before OI and Interest	292	410	428	597	882
+ Non-cash items	28	52	80	114	127
Oper. prof. before WC	320	462	507	711	1,009
- Incr. / (decr.) in WC	433	745	29	417	602
Others incl. taxes	75	124	120	137	203
Operating cash-flow	**(188)**	**(407)**	**359**	**157**	**205**
- Capex (tang. + intang.)	176	353	850	650	200
Free cash-flow	(364)	(760)	(491)	(493)	5
Acquisitions					
- Div. (incl. buyback & taxes)	36	56	46	69	102
+ Equity raised	1	33	-	-	-
+ Debt raised	378	173	550	550	100
- Fin investments	1	1	-	-	-
- Misc. (CFI+CFF) (adj OI & int)	(25)	(606)	(2)	(2)	(3)
Net cash-flow	2	(5)	14	(10)	6

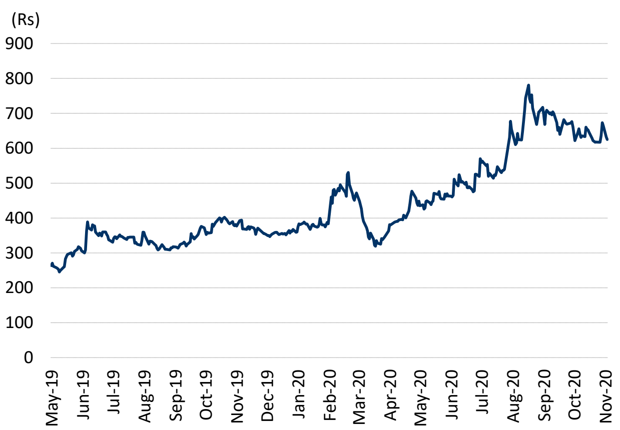
Source: Company, Anand Rathi Research

Fig 4 – Ratio analysis

Year-end: Mar	FY19	FY20	FY21e	FY22e	FY23e
P/E (x)	69.0	50.4	46.7	31.3	21.2
EV / EBITDA (x)	36.0	27.2	25.0	19.3	14.4
EV / Sales (x)	6.5	5.2	4.6	3.7	2.7
P/B (x)	20.6	9.2	7.9	6.5	5.2
RoE (%)	34.7	25.3	18.3	22.9	27.2
RoCE (%) - after tax	15.1	14.9	12.3	13.9	16.1
RoIC	15.2	15.0	12.4	13.9	16.1
DPS (Rs / sh)	1.5	2.0	2.0	3.0	4.4
Dividend yield (%)	0.2	0.3	0.3	0.5	0.7
Dividend payout (%) - incl. DDT	14.4	16.3	15.0	15.0	15.0
Net debt / equity (x)	1.7	0.9	1.0	1.1	0.9
Receivables (days)	93	90	80	84	88
Inventory (days)	188	257	229	201	176
Payables (days)	111	71	102	99	99
CFO : PAT %	(89.9)	(142.2)	116.0	33.9	30.0

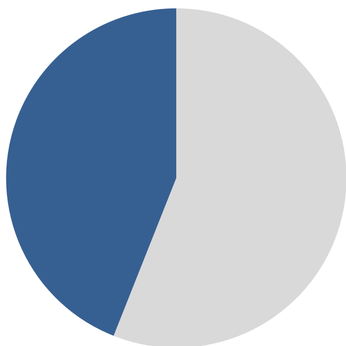
Source: Company, Anand Rathi Research

Fig 5 – Price movement



Source: Bloomberg

Fig 6 – Revenue break-up (Q2 FY21)



Source: Company

Company Update

Financial highlights

- Driven by better product mix and greater demand for new products from customers, new and old, Neogen's Q2 revenue was up 6.3% y/y, 7% q/q, to Rs820m.
- Revenue from organic chemicals rose 6% y/y, 2% q/q, to Rs671m. Growth was soft as the company is operating at optimal levels.
- Revenue from inorganic chemicals increased a good 10% y/y, 36% q/q, to Rs149m driven by scaling up of capacity utilisation, post-expansion.
- The gross margin expanded 266bps y/y, 336bps q/q, to 41.5%, the highest in the last eight quarters due to a better product mix.
- Despite the higher gross margin, the EBITDA margin contracted 30bps y/y (though q/q up 115bps) to 18.8%, curtailed by higher operating expenses.
- The company incorporated various measures to maintain business continuity, resulting in greater expenditure (Rs6.3m) on employee benefits and Rs7.8m in other expenses in H1.
- Despite revenue and EBITDA growth, profit slipped 4.2% y/y, though q/q up 20.6%, to Rs74m, due to higher depreciation and interest expenses.
- Depreciation grew 33.2% y/y, 6% q/q, to Rs17m, owing to capitalisation of capacity. Finance cost was 40.6% higher y/y, 11.4% q/q, to Rs37m, related to capex last year and a onetime impact of Rs5.5m in Q2

Fig 7 – Quarterly trend

Particulars (Rs m)	Q2 FY19	Q3 FY19	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20	Q4 FY20	Q1 FY21	Q2 FY21	% Y/Y	% Q/Q	H1 FY20	H1 FY21	% Y/Y
Income	**573**	**632**	**798**	**644**	**771**	**823**	**823**	**766**	**820**	***6.3***	***7.0***	**1,415**	**1,585**	***12.0***
RM costs	329	387	468	383	472	490	497	474	480	*1.7*	*1.2*	854	954	*11.6*
Employee expenses	26	32	30	39	47	47	40	47	54	*16.7*	*16.5*	86	101	*18.0*
Other expenses	118	109	137	108	105	127	128	110	131	*24.8*	*19.5*	213	241	*13.1*
EBITDA	**100**	**104**	**163**	**115**	**148**	**160**	**158**	**136**	**154**	***4.7***	***13.9***	**263**	**290**	***10.4***
Depreciation	7	9	7	9	13	14	17	16	17	*33.2*	*6.0*	22	33	*50.8*
Interest	30	30	34	32	26	32	29	33	37	*40.6*	*11.4*	58	70	*20.5*
Other income	2	2	1	0	0	0	0	0	0	*(24.6)*	*(29.0)*	1	1	*9.9*
PBT	**65**	**68**	**122**	**74**	**109**	**114**	**112**	**87**	**101**	***(7.4)***	***16.1***	**183**	**188**	***2.5***
Tax	15	25	35	20	32	33	39	27	29	*(10.0)*	*8.4*	52	55	*6.5*
PAT	49	43	88	54	77	81	73	60	72	*(6.4)*	*19.5*	131	132	*0.9*
Profit from Asso.	1	0	(0)	0	0	1	0	1	2	*NA*	*102.2*	0	2	*NA*
Consol PAT	**50**	**43**	**87**	**55**	**77**	**82**	**73**	**61**	**74**	***(4.2)***	***20.6***	**132**	**135**	***2.6***
EPS (Rs)	**2.2**	**1.9**	**3.7**	**2.3**	**3.3**	**3.5**	**3.1**	**2.6**	**3.2**	**(4.2)**	**20.6**	**5.6**	**5.8**	**2.6**

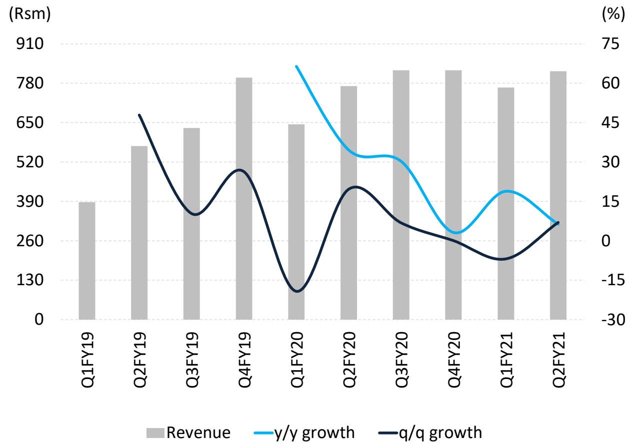
Source: Company

Fig 8 – Quarterly trend, as percent of sales

Particulars	Q2 FY19	Q3 FY19	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20	Q4 FY20	Q1 FY21	Q2 FY21	% Y/Y	% Q/Q	H1 FY20	H1 FY21	% Y/Y
Gross margins	**42.6**	**38.7**	**41.4**	**40.6**	**38.8**	**40.5**	**39.6**	**38.1**	**41.5**	***266***	***336***	**39.6**	**39.8**	***20***
Employee costs	4.6	5.0	3.8	6.1	6.0	5.7	4.9	6.1	6.6	*59*	*54*	6.0	6.4	*32*
Other expenses	20.5	17.3	17.2	16.7	13.6	15.4	15.5	14.3	16.0	*237*	*167*	15.0	15.2	*14*
EBITDA margins	**17.5**	**16.4**	**20.4**	**17.8**	**19.1**	**19.4**	**19.2**	**17.7**	**18.8**	***(30)***	***115***	**18.6**	**18.3**	***(26)***
Depreciation	1.2	1.3	0.9	1.4	1.6	1.6	2.1	2.1	2.1	*42*	*(2)*	1.5	2.1	*53*
Interest	5.3	4.7	4.2	4.9	3.4	3.9	3.5	4.3	4.5	*110*	*18*	4.1	4.4	*31*
Other income	0.3	0.4	0.1	0.0	0.1	0.0	0.0	0.1	0.0	*(2)*	*(2)*	0.1	0.1	*(0)*
PBT margins	**11.3**	**10.7**	**15.3**	**11.5**	**14.1**	**13.9**	**13.6**	**11.4**	**12.3**	***(183)***	***97***	**13.0**	**11.9**	***(110)***
Effective tax rate	24.0	36.3	28.5	26.9	29.4	28.9	35.0	30.6	28.5	*(82)*	*(204)*	28.4	29.5	*111*
PAT margins	**8.6**	**6.8**	**11.0**	**8.4**	**10.0**	**9.9**	**8.8**	**7.9**	**8.8**	***(119)***	***92***	**9.3**	**8.4**	***(92)***

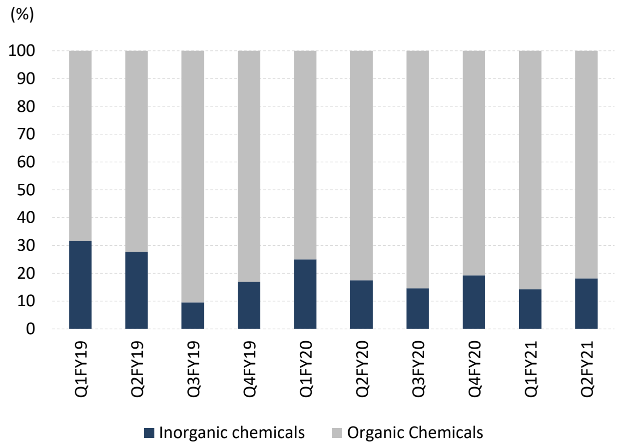
Source: Company

Fig 9 – Quarterly revenue trend



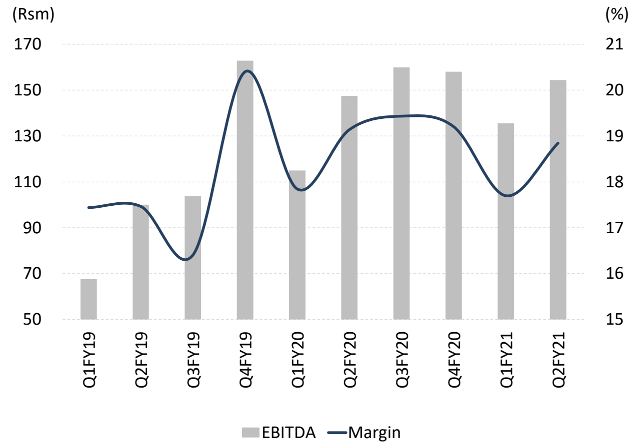
Source: Company

Fig 10 – Revenue contribution



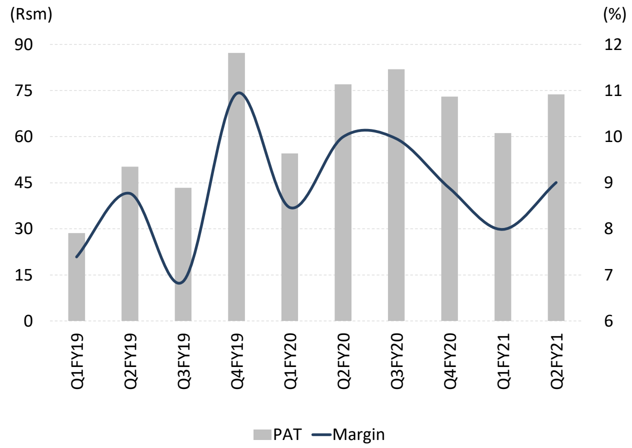
Source: Company

Fig 11 – EBITDA and margin trends



Source: Company

Fig 12 – Profit trend



Source: Company

Concall Highlights

- Revenue growth was driven by a better product mix, greater demand for new products from customers, new and old.
- Higher employee costs and other expenses in H1 resulted in additional expenditure for the company, of Rs14.1m, leading to a slight drop in EPS.
- Investment in working capital reduced significantly in Q1.
- All manufacturing plants are operating at optimal levels.

Long-term contracts

- The company was working on some molecules for global innovators. Of the 6-7 projects, it has secured long-term contracts from two customers (annual revenue potential: Rs300m-500m each). For others, the company has completed R&D or is at the pilot-trial stage. The trial stage would start in future.
- The company expects to generate Rs600m-1bn revenue from both contracts.
- Management said that in the early years of the contract the margin would be at current level and improve in future considering better operating leverage.

Update on Capex

Inorganic chemicals

- Utilisation scaling up.

Organic chemicals

Phase I

- Despite being faced with logistical and manpower issues, the company said it would start its organic chemicals plant from Q4 FY21.
- Capex: Rs600m-700m
- Expected revenue: Rs1.5bn-2bn
- Management says the plant would achieve optimum utilisation in the first year of commissioning
- The company will take a long-term loan to fund the capex.

Phase II

- To cater to growing demand and supply (the long-term contracts), the company is expanding its organic chemicals capacity at Rs550m.capex.
- At peak utilisation, it expects to generate Rs1.5bn-1.75bn additional revenue.
- Capex would be funded by long-term debt
- The net D/E ratio is 0.82x, which would be increase to 1.25x. The company expects it to decline to below 1x once revenue is generated from the new projects.

Maintenance capex

- FY21 capex would be Rs850m; Rs750m on doubling of organic chemicals capacity.

- FY22 capex would be Rs650m. Besides phase II, the company is expecting another Rs100m on maintenance and debottlenecking capex in FY22.

Outlook

- The company has maintained its FY22 revenue guidance at Rs4.5bn. Management clarified that it has revenue potential of Rs5bn, of which it would achieve Rs4.5bn
- It said demand for organic products would be better than for inorganic products on the strong demand from pharmaceutical and agrochemical industries
- The company is expecting to benefit from the new APIs announced by the Indian government.
- It expects that the business is well-set to benefit from the structural advantages enjoyed by India as a leading supplier of chemical products to global innovators.
- The expected EBITDA margin would be +/-1% from the present 18.5%, considering utilisation, cost-efficiencies and product-mix.

Change in estimates

Fig 13 – Change in estimates

	Old estimates		New estimates		Change (%)	
(Rs m)	FY21e	FY22e	FY21e	FY22e	FY21e	FY22e
Revenue	3,517	4,472	3,535	4,605	*0.5*	*3.0*
EBITDA	651	850	654	875	*0.5*	*2.9*
PAT	306	498	309	462	*1.1*	*(7.2)*

Source: Anand Rathi Research

Valuation

To arrive at the potential value of Neogen, we use the DCF method. The 10% WACC used has been arrived at as follows.

Fig 14 – WACC

Equity (FY20) (Rs m)	1,562
Cost of equity (%)	*11*
Debt (FY20) (Rs m)	1,373
Cost of debt (%)	*9*
Weighted average cost of capital (%)	*10*

Source: Anand Rathi Research

To arrive at future cash-flows, we assume a 5% terminal growth rate.

Fig 15 – Present value of FCFF

	FY21e	FY22e	FY23e	FY24e	FY25e	FY26e	FY27e	FY28e	FY29e	FY30e	FY31e	FY32e
EBIT	581	770	1,062	1,245	1,421	1,705	2,046	2,455	2,946	3,535	4,242	5,090
EBIT (1-t)	419	593	818	959	1,094	1,313	1,575	1,890	2,268	2,722	3,266	3,920
Depreciation	80	114	127	136	145	153	160	168	177	185	195	204
WC changes	(29)	(417)	(602)	(395)	(606)	(665)	(730)	(801)	(879)	(965)	(1,059)	(1,163)
Capex	(850)	(650)	(200)	(200)	(200)	(210)	(221)	(232)	(243)	(255)	(268)	(281)
FCFF	(380)	(360)	143	500	433	590	785	1,025	1,322	1,687	2,134	2,680
PV of FCFF	(346)	(297)	107	341	268	332	401	476	558	647	743	848

Source: Anand Rathi Research

DCF-based valuation

Fig 16 – Target price (Rs m)

Present value	4,078
Terminal value	16,742
Debt	(2,573)
Cash	421
Total value	18,668
No. of shares (m)	23
Target price (Rs)	**800**

Source: Anand Rathi Research

We roll forward our valuation to FY23 and upgrade the stock to a Buy with a higher target of Rs800 (earlier Rs660), at an implied multiple of 27x FY23e EPS and 18x FY23e EV/EBITDA.

Risks

- Delay in implementing capex.
- Protracted global slowdown, leading to continuing deceleration in key consumer sectors: agro-chemicals and pharmaceuticals.
- Neogen's exports (incl. 16% deemed exports) comprise 50% of its sales, exposing it to global trade and unfavourable fluctuations in international currencies. This makes it considerably dependent on exports in a world faced with rising protectionism.
- Failure to shorten the inventory-holding period at Dahej.

Appendix

Analyst Certification

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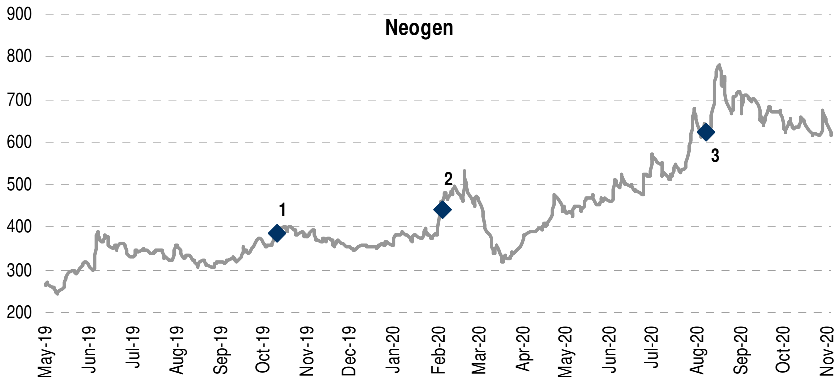
Important Disclosures on subject companies

Rating and Target Price History (as of 11 November 2020)



	Date	Rating	TP (₹)	Share Price (₹)
1	18-Oct-19	Hold	425	382
2	11-Feb-20	Hold	500	439
3	14-Aug-20	Hold	660	624

Anand Rathi Ratings Definitions

Analysts' ratings and the corresponding expected returns take into account our definitions of Large Caps (>US$1bn) and Mid/Small Caps (<US$1bn) as described in the Ratings Table below:

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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