

27 January 2021

## Aarti Drugs

*Fresh investments, better realisations to boost profits; retaining a Buy*

Rating: Buy

Target Price: Rs.848

Share Price: Rs.696

**Aarti's Q3 FY21 margins surpassed our expectation. Its EBITDA margin expanded 569bps to 19.9%, driven by better realisations in APIs and import-duty imposition on key products such as ciprofloxacin. Sales grew 12% to Rs.5.3bn. The API division contributed 87% to sales and grew 13.1% to Rs.4.6bn. Formulations sales were up 5.2% to Rs.697m. Through organic growth and capacity addition, Aarti expects sales to record a 15% CAGR over FY21-26 to Rs.45bn and the EBITDA margin to scale up to 24-25%. We raise our FY21e/FY22e/FY23e EPS 8%/7.6%/5.2%. We retain our Buy rating and raise our target to Rs.848 (earlier Rs.813) based on 18x FY23e earnings.**

**Management aims at Rs.45bn sales by FY26.** On its current API capacity the company could achieve sales of Rs.25bn. Further, the new capacities for seven projects could add Rs.15bn in sales on full commercialisation (Rs6bn capex with 2.5x asset turn). Stable API realisations and the greater contribution from the higher-margin business are likely to lift EBITDA margins to 24-25%.

**Momentum in APIs unhurt.** Driven by strong domestic and international demand, API sales grew 13.1% to Rs.4.6bn. The share of sales of antibiotics in Q3 was 44% while the contribution of anti-inflammatory APIs rose to 14%. New capacities and better realisations would lead to an 18% CAGR in API sales over FY20-23.

**Formulations growth uninterrupted.** Formulations grew 5.2% to Rs.697m. The company plans to raise metformin capacity to 2,000 tonnes a month by next year, which can be scaled up to 3,000 tonnes in 2-3 years.

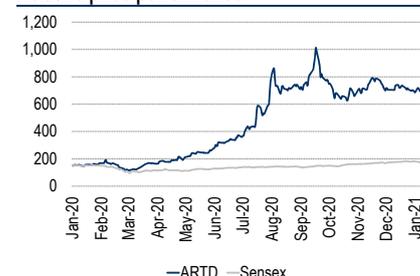
**Valuation.** The strong base-business momentum and fresh investment in the margin-accretive business are likely to boost sales/EBITDA/PAT 19%/36.4%/47% over FY20-23. At the CMP of Rs.696, the stock trades at 22.3x/18.7x/14.8x FY21e/FY22e/FY23e earnings. **Risks:** Delay in capacity addition; keener competition in generic APIs and deterioration in API pricing.

Key data	ARTD IN / ADRG.BO
52-week high / low	Rs.1027 / 105
Sensex / Nifty	47410 / 13968
3-m average volume	\$8.3m
Market cap	Rs.65bn / \$889.4m
Shares outstanding	93m

Shareholding pattern (%)	Dec'20	Sept '20	June '20
Promoters 60.	2	60.2	60.5
- of which, Pledged	-	-	-
Free float	39.8	39.8	39.5
- Foreign institutions	3.1	2.2	1.8
- Domestic institutions	1.7	2.2	5.1
- Public	35.1	35.5	32.6

Estimates revision (%)	FY21e	FY22e	FY23e
Sales -2.7		-2.9	-3.1
EBITDA 4.6		5.1	3.8
PAT 8.	0	7.6	5.2

### Relative price performance



Source: Bloomberg

Key financials (YE Mar)	FY19	FY20	FY21e	FY22e	FY23e
Sales (Rs m)	15,609	18,061	21,770	25,796	30,420
Net profit (Rs m)	872	1,380	2,905	3,463	4,380
EPS (Rs)	9.4	14.8	31.2	37.2	47.0
PE (x)	74.4	47.0	22.3	18.7	14.8
EV / EBITDA (x)	33.7	26.2	14.6	12.3	9.6
PBV (x)	11.9	9.9	7.2	5.4	4.1
RoE (%)	17.5	23.1	37.3	33.0	31.6
RoCE (%)	10.3	14.5	25.8	25.8	26.5
Dividend yield (%)	0.1	0.4	0.6	0.9	0.9
Net debt / equity (x)	0.9	0.6	0.2	0.1	-0.1

Source: Company, AnandRathi Research

Abdulkader Puranwala  
Research Analyst

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## Quick Glance – Financials and Valuations

**Fig 1 – Income statement (Rs m)**

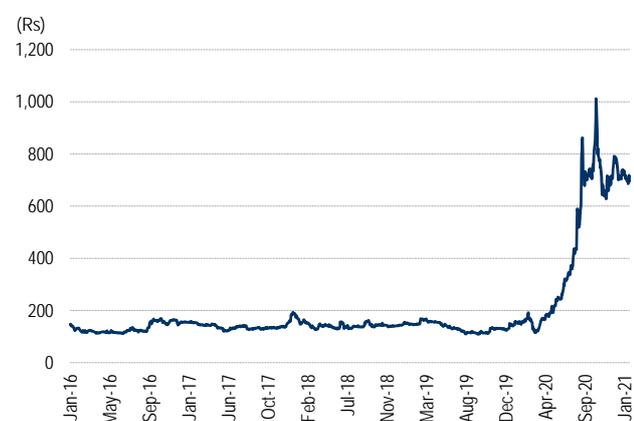
Year-end: Mar	FY19	FY20	FY21e	FY22e	FY23e
Net revenues	15,609	18,061	21,770	25,796	30,420
<i>Growth (%)</i>	23.6	15.7	20.5	18.5	17.9
Direct costs	10,600	11,790	13,215	15,762	18,477
SG&A	2,936	3,653	3,984	4,669	5,293
<b>EBITDA</b>	<b>2,074</b>	<b>2,618</b>	<b>4,571</b>	<b>5,364</b>	<b>6,650</b>
<i>EBITDA margins (%)</i>	13.3	14.5	21.0	20.8	21.9
- Depreciation	426	488	501	606	702
Other income	24	15	46	53	61
Interest expenses	400	337	243	194	168
PBT	1,310	1,853	3,871	4,617	5,840
<i>Effective tax rates (%)</i>	31.5	23.7	25.0	25.0	25.0
+ Associates / (Minorities)	-	-	-	-	-
Net income	898	1,414	2,904	3,463	4,380
Adjusted income	872	1,380	2,905	3,463	4,380
WANS	93	93	93	93	93
FDEPS (Rs / sh)	9.4	14.8	31.2	37.2	47.0

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

Year-end: Mar	FY19	FY20	FY21e	FY22e	FY23e
PBT (adj. for int. exp./ other inc.)	1,686	2,175	4,068	4,758	5,948
+ Non-cash items	426	488	501	606	702
Oper. prof. before WC	2,111	2,663	4,569	5,364	6,650
- Incr. / (decr.) in WC	281	-209	554	507	382
Others incl. taxes	326	533	968	1,154	1,460
Operating cash-flow	1,505	2,338	3,047	3,703	4,808
- Capex (tang. + intang.)	693	472	800	2,200	2,000
Free cash-flow	811	1,867	2,247	1,503	2,808
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	197	141	108
Net cash-flow	13	21	1,363	453	1,791

Source: Company, Anand Rathi Research

**Fig 5 – Price movement**



Source: Bloomberg

**Fig 2 – Balance sheet (Rs m)**

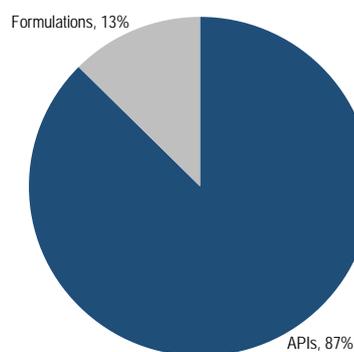
Year-end: Mar	FY19	FY20	FY21e	FY22e	FY23e
Share capital	236	233	932	932	932
Net worth	5,434	6,525	9,056	11,960	15,780
Debt	5,072	3,878	2,864	2,514	2,164
Minority interest	-	-	-	-	-
DTL / (Assets)	898	807	807	807	807
<b>Capital employed</b>	<b>11,405</b>	<b>11,210</b>	<b>12,727</b>	<b>15,281</b>	<b>18,752</b>
Net tangible assets	6,220	6,423	6,676	8,280	9,588
Net intangible assets	29	15	36	47	56
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	9,262	10,522	11,622
Cash	56	76	740	1,193	2,983
Current liabilities	3,150	4,555	4,268	5,020	5,739
Working capital	4,649	4,440	4,994	5,501	5,884
<b>Capital deployed</b>	<b>11,405</b>	<b>11,210</b>	<b>12,727</b>	<b>15,281</b>	<b>18,752</b>
Contingent liabilities	747	-	-	-	-

**Fig 4 – Ratio analysis**

Year-end: Mar	FY19	FY20	FY21e	FY22e	FY23e
P/E (x)	74.4	47.0	22.3	18.7	14.8
EV / EBITDA (x)	33.7	26.2	14.6	12.3	9.6
EV / Sales (x)	4.5	3.8	3.1	2.6	2.1
P/B (x)	11.9	9.9	7.2	5.4	4.1
RoE (%)	17.5	23.1	37.3	33.0	31.6
RoCE (%) - after tax	10.3	14.5	25.8	25.8	26.5
ANDA filings	-	-	-	-	-
DPS (Rs / sh)	1.0	2.5	4.0	6.0	6.0
Dividend yield (%)	0.1	0.4	0.6	0.9	0.9
Dividend payout (%) - incl. DDT	12.7	5.0	12.8	16.1	12.8
Net debt / equity (x)	0.9	0.6	0.2	0.1	-0.1
Receivables (days)	107	99	90	85	80
Inventory (days)	58	66	46	45	41
Payables (days)	57	67	53	54	51
CFO : PAT%	172.6	169.5	104.9	106.9	109.8

Source: Company, Anand Rathi Research

**Fig 6 – Revenue break-up (Q3 FY21)**



Source: Company

## Result highlights

**Fig 7 – Quarterly financials**

(Rs m)	Q2 FY19	Q3 FY19	Q4 FY19	Q1 FY20	Q2 FY20	Q3 FY20	Q4 FY20	Q1 FY21	Q2 FY21	Q3 FY21	% Y/Y	% Q/Q
Sales	3474	3801	4591	4054	4775	4735	4496	5447	5781	5303	12.0	-8.3
Gross profit	1157	1273	1376	1363	1611	1633	1665	2251	2199	2065	26.5	-6.1
<i>Gross margins (%)</i>	33.3	33.5	30.0	33.6	33.7	34.5	37.0	41.3	38.0	38.9	446bps	90bps
EBITDA	470	519	559	547	683	675	713	1340	1164	1058	56.7	-9.1
<i>EBITDA margins (%)</i>	13.5	13.6	12.2	13.5	14.3	14.3	15.9	24.6	20.1	19.9	569bps	-19bps
Finance expenses	97	105	103	93	85	84	75	66	71	50	-40.8	-29.5
Depreciation	106	107	108	118	121	124	125	124	126	127	2.3	0.7
Other income	1	2	12	1	2	3	10	13	3	20	700	590
PBT	267	308	398	336	479	431	607	1163	971	904	109.7	-6.9
Tax	70	74	99	91	134	139	170	294	237	243	74.7	2.4
<i>Effective tax rates (%)</i>	32.5	32.3	31.1	33.3	32.5	35.5	3.1	26.5	22.5	24.7	-1079bps	222bps
Adjusted PAT	181	209	248	225	323	303	507	855	752	679	123.9	-9.8

Source: Company, Anand Rathi Research

**Fig 8 – Revenue assumption**

(Rs m)	FY21e	FY22e	FY23e
<b>APIs</b>	<b>17,008</b>	<b>20,244</b>	<b>23,860</b>
<i>% of sales</i>	78.1	78.5	78.4
<i>Y/Y%</i>	17.7	19.0	17.9
<b>Formulations</b>	<b>2,940</b>	<b>3,528</b>	<b>4,163</b>
<i>% of sales</i>	13.5	13.7	13.7
<i>Y/Y%</i>	48.0	20.0	18.0
<b>Specialty chemicals</b>	<b>650</b>	<b>754</b>	<b>1,018</b>
<i>% of sales</i>	3.0	2.9	3.3
<i>Y/Y%</i>	20.0	16.0	35.0
<b>Intermediates</b>	<b>419</b>	<b>486</b>	<b>564</b>
<i>% of sales</i>	1.9	1.9	1.9
<i>Y/Y%</i>	16.0	16.0	16.0
<b>Total</b>	<b>21,770</b>	<b>25,796</b>	<b>30,420</b>

Source: Company, Anand Rathi Research

## Concall Highlights

### Q3 FY21 performance drivers

- Q3 FY21 API growth was driven by 13.5% and 13.7% y/y growth in domestic and export APIs, respectively. Formulations grew 5.2% y/y.
- The API contribution to sales was 87%, 13% from formulations.
- 66% of API growth was driven by volume growth due to good demand across therapies.
- Antibiotics contributed 44% to API sales, anti-protazole 13%, anti-inflammatory 14%, diabetes 10% and anti-fungals 7%, the balance coming from other APIs.
- Contribution from anti-inflammatory has increased from 10% of sales last year to 13% in Q3 FY21 mainly due to sales of products like Nimesulide and Diclofenac.
- The margin in anti-inflammatory is better than the company's margin whereas anti-diarrhoea margins contracted due to less demand.
- Debt-to-equity in Dec'20 was 0.4x.
- Debt in Dec'20 was Rs.3.34bn, of which term loans were Rs.1.86bn.

### Capex plans

- The company will fund its greenfield projects through internal accruals and debt.
- It has expanded its anti-inflammatory capacity and is in the process of commissioning its anti-diabetic production line (for gliptins).
- It is ramping up its R&D facilities in API and formulations to support future growth.
- The current Metformin capacity is 1,100 tonnes a month. Phase 1 of the expansion will take it to 2,000 tonnes, phase 2 (in 2-3 years) to 3,000 tonnes.
- Rs.1.2bn-1.5bn capex plans are related to the PLI scheme.

### APIs and the PLI scheme

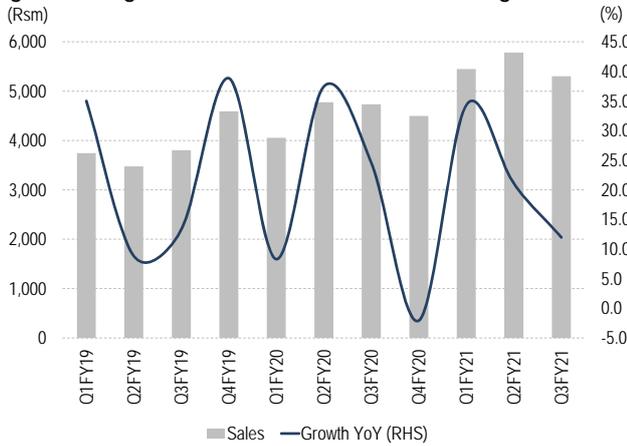
- API pricing has stabilized; the company doesn't see any price erosion as per the market scenarios.
- The government has imposed an anti-dumping duty of \$1.5-3 a kg on imports of Ciprofloxacin in India.
- One of the products applied for under the PLI scheme has sales potential of Rs.600m-650m.
- So far, the company has applied for three products under the scheme and is likely to apply for one more.

### Guidance

- Margins in chloro-sulfonated products and exports of metformin would be higher.
- Demand for anti-protazole and anti-inflammatory is expected to stabilise, post-vaccinations.
- Export growth guidance for FY21: 12%-15%.

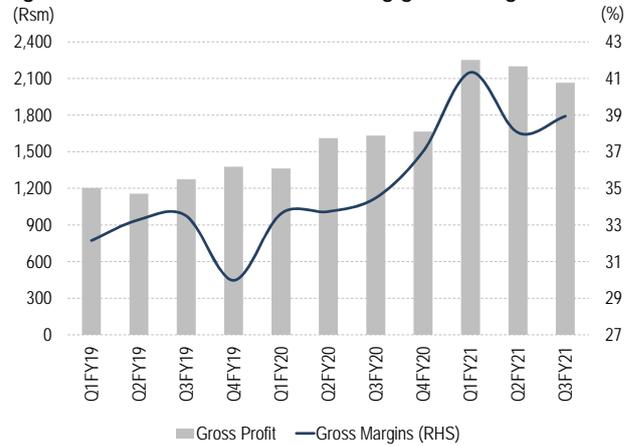
- FY22 volume growth expected: 10%.
- The 19-20% EBITDA margin seems achievable for the near term. In the long term 24-25% margins may be achievable
- The brownfield and greenfield expansions (Rs.6bn) would help to a Rs.45bn top-line in the next five years.

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



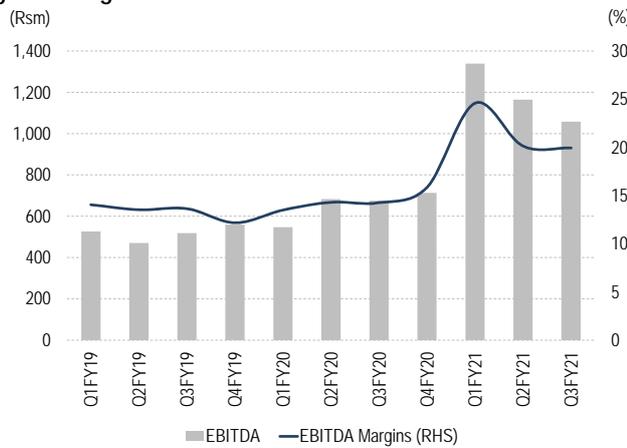
Source: Company, AnandRathi Research

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



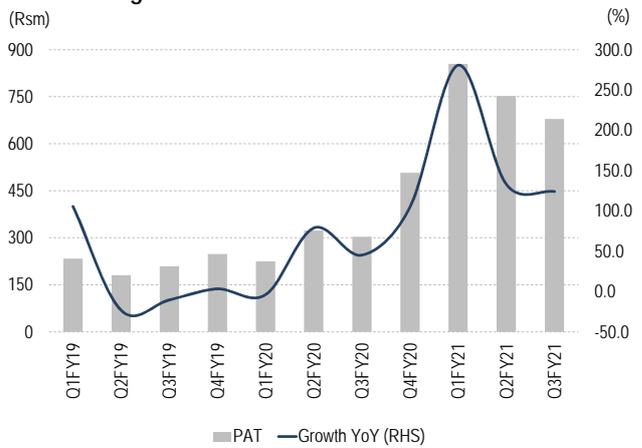
Source: Company, AnandRathi Research

**Fig 11 – EBITDA margin grew 569bps y/y on account of better gross margin**



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 4.6%/5.1%/3.8% and PAT 8%/7.6%/5.2% on account of the better realisations and capacity additions.

**Fig 13 – Change in estimates**

Rsm	Old estimates			New estimates			Change (%)		
	FY21e	FY22e	FY23e	FY21e	FY22e	FY23e	FY21e	FY22e	FY23e
Revenue	22,371	26,559	31,401	21,770	25,796	30,420	-2.7	-2.9	-3.1
EBITDA	4,369	5,104	6,405	4,571	5,364	6,650	4.6	5.1	3.8
PAT	2,689	3,219	4,163	2,905	3,463	4,380	8.0	7.6	5.2

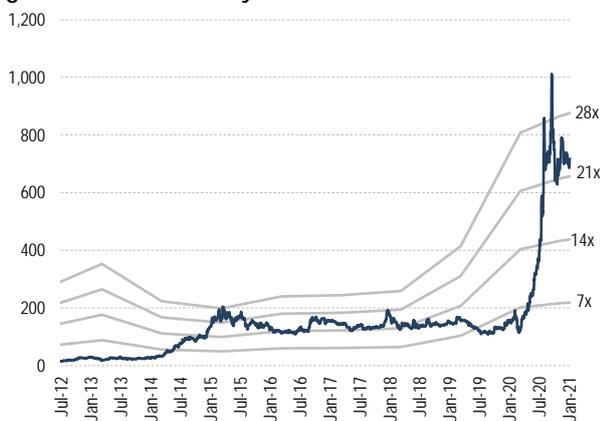
Source: Anand Rathi Research

Aarti has planned Rs.6bn capex, 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 Rs.25bn. Further benefits would arise from the new formulations block and suffice for an over 15-17% CAGR in the next 2-3 years. Beyond that, the new capacity would drive growth.

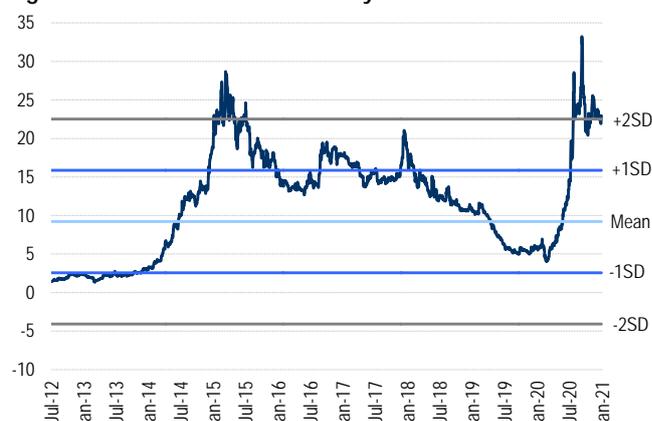
At the CMP of Rs.696, the stock trades at 22.3x/18.7x/14.8x FY21e/FY22e/FY23e earnings. We expect revenue and PAT CAGRs over FY20-23 of 19% and 47% respectively. We retain our Buy rating and raise our target to Rs.848, based on 18x FY23e earnings.

**Fig 14 – PE Band – one-year-forward**



Source: Bloomberg, AnandRathi Research

**Fig 15 – Standard deviation – one-year-forward**



Source: Bloomberg, AnandRathi 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 (Rsbn)	EPS (Rs)			PE (x)			EV / EBITDA (x)			RoE (%)		
					FY21e	FY22e	FY23e	FY21e	FY22e	FY23e	FY21e	FY22e	FY23e	FY21e	FY22e	FY23e
Aarti Drugs	Buy	696	848	64.8	31.2	37.2	47.0	22.3	18.7	14.8	14.6	12.3	9.6	37.3	33.0	31.6
Ajanta	Buy	1,734	1,980	152.1	69.4	82.9	98.0	25.0	20.9	17.7	16.1	13.6	11.4	21.4	21.7	21.8
Alembic	Hold	952	1,120	187.2	58.8	54.0	62.2	16.2	17.6	15.3	12.2	12.2	10.2	28.7	20.3	20.1
Alkem	Hold	3,060	3,171	365.8	125.7	128.9	144.1	24.3	23.7	21.2	18.3	17.2	15.0	22.5	19.9	19.4
Zydus Cadila	Hold	462	430	473.3	18.9	19.9	21.4	24.4	23.3	21.6	16.9	16.0	14.6	17.7	16.8	16.2
Eris	Hold	611	565	83.0	24.9	26.3	28.2	24.5	23.2	21.7	19.6	17.9	16.1	23.7	21.0	19.2
Granules India	Buy	355	455	88.0	20.6	25.3	30.4	17.2	14.0	11.7	11.4	9.1	7.4	24.7	24.5	23.8
Indoco Remedies	Sell	320	229	29.5	9.1	11.4	14.3	35.3	28.2	22.4	14.7	12.3	10.0	11.6	12.9	14.2
Ipca Labs.	Hold	1,944	2,380	245.7	89.7	91.1	105.8	21.7	21.3	18.4	15.5	14.7	12.3	27.4	22.4	21.4
JB Chemicals	Sell	1,017	805	78.6	45.3	46.6	53.1	22.4	21.8	19.2	15.1	14.2	12.1	22.5	20.0	19.8
Natco Pharma	Hold	885	946	161.0	33.1	36.7	84.5	26.8	24.1	10.5	20.3	17.8	7.6	15.0	14.9	28.9
Neuland	Hold	1,384	1,042	17.9	49.5	49.7	65.1	28.0	27.8	21.3	13.9	13.5	11.1	8.6	8.1	9.7
Pfizer	Hold	4,706	5,460	215.3	112.0	122.4	136.7	42.0	38.4	34.4	26.9	26.7	23.5	14.3	14.2	14.3
Suven Pharma	Buy	469	375	119.4	14.2	17.2	20.3	33.0	27.3	23.1	26.5	22.0	17.9	36.8	34.0	31.4
Torrent Pharma	Buy	2,646	3,080	447.9	68.7	85.6	104.2	38.5	30.9	25.4	19.8	17.2	14.8	22.5	24.5	25.8

Source: Company, AnandRathi Research

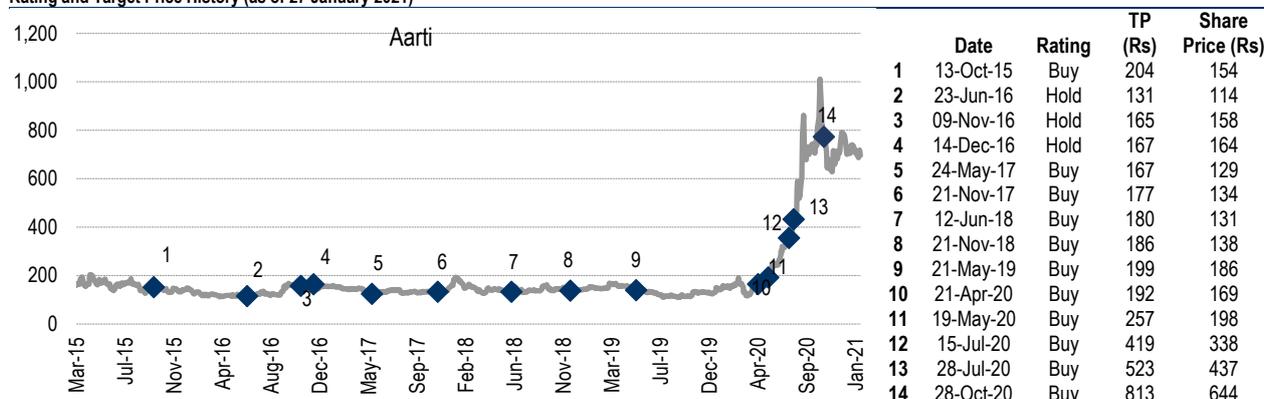
## Appendix

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	Buy	Hold	Sell
Large Caps (>US\$1bn)	>15%	5-15%	<5%
Mid/Small Caps (<US\$1bn)	>25%	5-25%	<5%

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