

Discretionary demand back, large capex underway and a possible demerger of Pharmaceuticals business

- Aarti Industries reported sales in-line with our estimates at Rs 11.8bn, up by 9.5% YoY.
- Gross margin improved by 300 bps YoY, and 340 bps QoQ to 54.1% owing to better pass-through and higher value added products in the mix (~76% in 3QFY21 against 72% in 3QFY20).
- EBITDA beat our estimates reporting a 12.1% YoY growth to Rs 2.85bn. PAT too, beat our estimates growing by 18.5% YoY to Rs 1.69bn owing to lower interest costs (down by 39.8% YoY to Rs 173mn) and lower tax rate compared to 3QFY20 at 19.2%.

Outlook and valuation

Given the large capex planned, the company could generate incremental sales of ~Rs 31.2-39.0bn, with RoCE's of 20-25%. The company is also working on new chemistries like Chloro-toluenes which broadens the company's product portfolio. Aarti Industries is also expected to receive ~Rs 6.0bn from the termination of contract (proceeds of which will be invested in capacity additions). Also, the facility for the same long-term contract could potentially derive another stream of revenues as it is set to commission in 4QFY21 – which could be further used to integrate forward in the value chain. We like Aarti Industries focus on R&D (looking at Chloro-toluenes, photo-chlorination as next legs of growth), efficient capital allocation (RoCE to improve to 16.0% in FY23E) and continuous focus on capex led growth. We have fine-tuned our estimates, and await clarity on the demerger of Pharmaceuticals business. We maintain our buy rating on the stock with a target price of Rs 1,547/share (25x FY24E EPS).

Q3FY21 Result (Rs Mn)

Particulars	Q3FY21	Q3FY20	YoY (%)	Q2FY21	QoQ (%)
Revenue	11,868	10,836	9.5	11,726	1.2
Total Expense	9,018	8,294	8.7	9,184	(1.8)
EBITDA	2,850	2,542	12.1	2,543	12.1
Depreciation	587	470	24.7	550	6.6
EBIT	2,263	2,072	9.2	1,993	13.6
Other Income	4	4	16.2	0	975.0
Interest	173	287	(39.8)	222	(22.0)
EBT	2,094	1,788	17.1	1,772	18.2
Tax	403	361	11.5	337	19.6
RPAT	1,692	1,427	18.5	1,435	17.9
APAT	1,692	1,427	18.5	1,435	17.9
			(bps)		(bps)
Gross Margin (%)	54.1	51.1	303	50.7	339
EBITDA Margin (%)	24.0	23.5	55	21.7	233
NPM (%)	14.3	13.2	109	12.2	202
Tax Rate (%)	19.2	20.2	(98)	19.0	22
EBIT Margin (%)	19.1	19.1	(5)	17.0	207

CMP	Rs 1,159
Target / Upside	Rs 1,547 / 33%
NIFTY	13,635

Script Details

Equity / FV	Rs 871mn / Rs 5
Market Cap	Rs 202bn
	USD 3bn
52-week High/Low	Rs 1,366/ 668
Avg. Volume (no)	3,41,890
Bloom Code	ARTO IN

Price Performance	1M	3M	12M
Absolute (%)	(6)	14	17
Rel to NIFTY (%)	(3)	(2)	5

Shareholding Pattern

	Jun'20	Sep'20	Dec'20
Promoters	47.5	47.6	47.3
MF/Banks/FIs	16.2	15.8	14.6
FII's	7.4	7.5	9.0
Public / Others	29.0	29.2	29.1

Valuation (x)

	FY22E	FY23E	FY24E
P/E	25.0	21.7	18.8
EV/EBITDA	16.2	14.4	12.6
ROE (%)	20.2	19.9	19.7
RoACE (%)	14.3	14.3	14.7

Estimates (Rs mn)

	FY22E	FY23E	FY24E
Revenue	59,916	69,075	77,958
EBITDA	14,026	15,858	18,089
PAT	8,094	9,298	10,727
EPS (Rs.)	46.5	53.4	61.6

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Capex update

The company is carrying ~Rs 14.0bn of CWIP out of which ~Rs 7.0bn will be capitalised in FY21 and the balance in FY22. Over the said capex, the company plans to incur ~Rs 10.0-12.0bn capex over the subsequent years. The management expects to derive asset turns in the range of ~1-1.5x with RoCE's of 20-25%. The long term contracts are said to commission in 1HFY22 (LT-2) and 2HFY22 (LT-3) respectively. Bulk of the capex is expected to yield results in FY23E and beyond, we believe that the blended RoCE's of the company are expected to be reach ~17% by FY24E.

Demerger of a ripening Pharmaceuticals business

The company has constituted an internal committee of directors to evaluate the feasibility of a demerger of the pharmaceuticals business (19.6% of 9MFY21 sales, 24.2% 9MFY21 EBIT Margin). Citing that their specialty chemicals and pharmaceuticals businesses are not complementary, the management believes Pharmaceuticals business could be better operated under a separate administrative arm. We await more clarity from the management on its valuation.

Exhibit 1: Actual vs DART Estimates Rs Mn – Q3FY21

Particulars	Actual	Estimated	Variance	Comments
Revenue	11,868	11,800	0.6%	In line
EBITDA	2,850	2,514	13.3%	Higher than expected gross margin
EBITDA Margin(%)	24.0	21.3	271	
PAT	1,692	1,382	22.5%	Lower than expected interest expenses and tax rate

Source: DART, Company

Exhibit 2: Change in Estimates

Particulars (Rs mn)	FY21E			FY22E			FY23E			FY24E		
	New	Old	Chg.(%)	New	Old	Chg.(%)	New	Old	Chg.(%)	New	Old	Chg.(%)
Revenue	47,112	47,112	-	59,916	57,162	4.8	69,075	71,573	(3.5)	77,958	76,127	2.4
EBITDA	10,122	9,651	4.9	14,026	12,338	13.7	15,858	16,497	(3.9)	18,089	16,389	10.4
EBITDA Margin(%)	21.5	20.5	100.0	23.4	21.6	182.4	23.0	23.0	(9.1)	23.2	21.5	167.4
PAT	5,355	5,131	4.4	8,094	6,891	17.5	9,298	10,201	(8.9)	10,727	9,997	7.3
EPS(Rs)	30.9	29.6	4.4	46.7	39.8	17.5	53.6	58.9	(8.9)	61.9	57.7	7.3

Source: DART, Company

Concall Highlights

Specialty Chemicals

- Specialty Chemicals segment grew by 3.5% to Rs 10.78bn due to higher demand in the domestic market which is back to pre-covid levels. Also, export market is witnessing good demand from Textile, Pigment, Engineering Polymer and Automobile sectors.
- Specialty chemicals EBIT margins increased sequentially by ~360bps to Rs 224mn as higher share of products were sold in regular markets as compared to non-regular markets.
- 76% contribution was from value added products vs 72% in Q3FY20.
- PDA volumes are expected to further increase with rising demand in Dyestuff and Engineering polymer segment.
- 15-20% revenue CAGR is expected in specialty chemicals segment for the upcoming years.

Volumes (Q3FY21)

- Nitro Chloro Benzene- 16,830 vs 14,900 MTPA (Q3FY20)
- Hydrogenated Products- 2,740 vs 2,330 MTPA (Q3FY20)
- Nitro Toulene Products- 3,600 vs 1,667 MTPA (Q3FY20)
- PDA- 1,560 vs 1,260 MTPA (Q3FY20)

Pharmaceutical Segment

- Pharmaceutical margins expanded by 340bps YoY to 23.8% due to higher volumes leading to operating leverage.
- The segment has grown by 18% CAGR in last 5 years and management expects its Sales and PAT for next 5 years to grow at 18% and 25% CAGR respectively.
- Company will not benefit from PLI scheme as the government currently has only come out with notifications on certain APIs in which the company isn't present.

Capex

- Company has done capex of Rs 3.65bn in Q3FY21.
- Company has done a capex of Rs 8.91bn as of 9M-FY21.
- Company has guided capex of Rs 10-12bn each for next 4-5 years. Specialty Chemicals: Rs 8-10bn and Pharmaceuticals: Rs 1.5-2bn. Revenues from FY22 is expected to grow by 12-15% CAGR with Roce increasing to 20-25%.
- Out of Rs 10-12bn capex, Rs 3bn is expected to be maintenance capex every year.
- In Specialty chemicals, the company plans to do further benzene chain addition, Chloro Toulene Chain addition and some debottlenecking in current capacity.
- Aarti Industries to be the 1st company in India to manufacture Chloro Toulene and it has Rs 10bn market in India and will be completely substituting the imports.
- In Pharmaceuticals, plan to add new facility on the land already bought in Dahej for APIs.
- NCB expansion capex is Rs 1.5bn and is expected to complete by end of FY22.
- Planned capex of Rs 18bn till FY22 is expected to generate incremental revenues of Rs 20-25bn and EBITDA of Rs 4-6bn over FY23 and FY24.
- Company doesn't foresee to generate FCF for next 3-4 years as it currently believes to be in sweet spot of capex mode.

Operational Highlights

- R&D facility in Navi Mumbai is running at full capacity utilization.
- Higher freight rates have not impacted the profitability of the company as they have cost pass through model.
- Lower availability of containers has not affected the company's supplies as they have good relationship with the shipping companies.

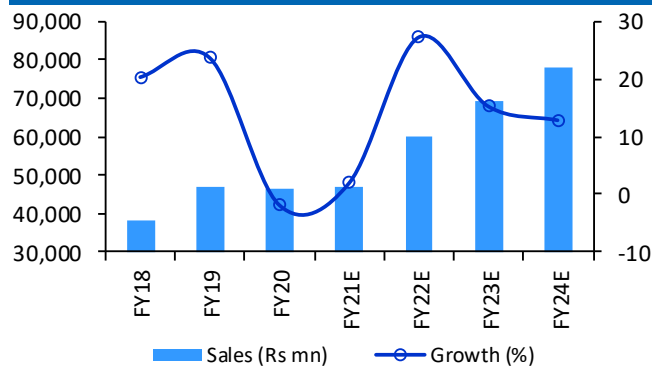
- Also, the company did not benefit from low cost inventory due to having fixed cost plus margin model.
- Exports to china has come down sequentially from 20% in Q2FY21 to 11% in Q3FY21 due to higher demand from Domestic market.
- As of Q3FY21, the company has Domestic to Export share of 60:40.
- Gross debt as of 9MFY21 is Rs 25bn and aims to have peak Debt/Equity of 0.7-0.9x.

Corporate Restructuring

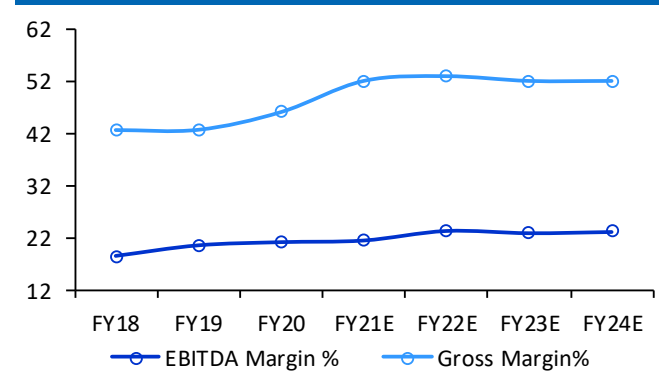
- Board of the company is evaluating demerging the Pharmaceutical business due to higher growth visibility in the segment.
- Pharmaceutical and Specialty Chemical segment has very less in common and therefore eliminating the synergy factor.
- Company might consider in the future to merge its sister company Aarti Drugs with the de-merging Pharma entity (providing demerging goes through).

Long term contracts

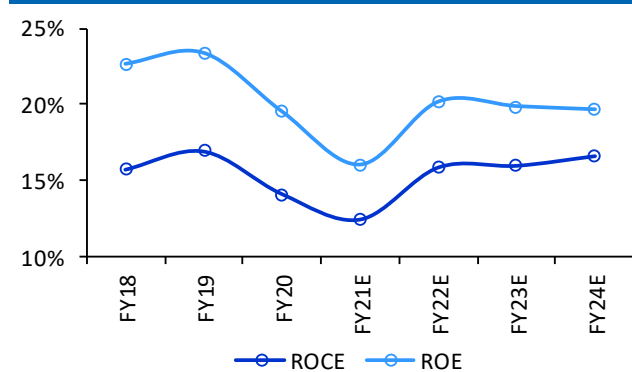
- 1st long term contract plant is to be commissioned in Feb, 2021.
- 2nd long term contract plant is to be commissioned by H1FY21.
- 3rd long term contract plant is expected to be commissioned in H2FY21.
- Long term cancelled contract accounting will be done in similar manner as Q3FY21 in upcoming quarters.

Exhibit 3: Sales and Sales Growth


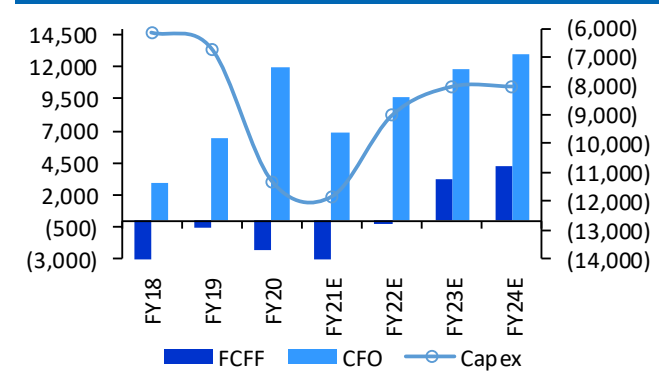
Source: DART, Company

Exhibit 4: EBITDA/Gross Margin


Source: DART, Company

Exhibit 5: ROCE vs ROE (%)


Source: DART, Company

Exhibit 6: Cash Flows Profile (Rs mn)


Source: DART, Company

Profit and Loss Account

(Rs Mn)	FY21E	FY22E	FY23E	FY24E
Revenue	47,112	59,916	69,075	77,958
Total Expense	36,990	45,891	53,217	59,870
COGS	22,614	28,219	33,156	37,420
Employees Cost	3,663	4,212	4,717	5,378
Other expenses	10,714	13,459	15,343	17,072
EBIDTA	10,122	14,026	15,858	18,089
Depreciation	2,313	2,506	2,814	3,122
EBIT	7,808	11,520	13,044	14,967
Interest	992	1,432	1,476	1,640
Other Income	11	36	42	49
Exc. / E.O. items	0	0	0	0
EBT	6,828	10,124	11,611	13,375
Tax	1,366	1,924	2,206	2,541
RPAT	5,355	8,094	9,298	10,727
Minority Interest	107	107	107	107
Profit/Loss share of associates	0	0	0	0
APAT	5,355	8,094	9,298	10,727

Balance Sheet

(Rs Mn)	FY21E	FY22E	FY23E	FY24E
Sources of Funds				
Equity Capital	871	871	871	871
Minority Interest	946	946	946	946
Reserves & Surplus	36,181	42,350	49,513	57,897
Net Worth	37,053	43,221	50,385	58,768
Total Debt	22,040	26,040	26,840	27,340
Net Deferred Tax Liability	2,110	2,110	2,110	2,110
Total Capital Employed	62,149	72,317	80,281	89,165

Applications of Funds

Net Block	37,391	45,905	51,111	56,008
CWIP	11,000	9,000	9,000	9,000
Investments	370	370	370	370
Current Assets, Loans & Advances	23,437	28,255	31,764	36,400
Inventories	9,166	11,165	12,871	14,526
Receivables	8,327	10,262	11,831	13,352
Cash and Bank Balances	489	712	958	1,631
Loans and Advances	5,120	5,691	5,615	6,337
Other Current Assets	334	425	490	553
Less: Current Liabilities & Provisions	10,049	11,213	11,964	12,614
Payables	3,134	4,297	5,049	5,698
Other Current Liabilities	6,915	6,915	6,915	6,915
<i>sub total</i>				
Net Current Assets	13,387	17,042	19,800	23,786
Total Assets	62,149	72,317	80,281	89,165

E – Estimates

Important Ratios

Particulars	FY21E	FY22E	FY23E	FY24E
(A) Margins (%)				
Gross Profit Margin	52.0	52.9	52.0	52.0
EBIDTA Margin	21.5	23.4	23.0	23.2
EBIT Margin	16.6	19.2	18.9	19.2
Tax rate	20.0	19.0	19.0	19.0
Net Profit Margin	11.4	13.5	13.5	13.8
(B) As Percentage of Net Sales (%)				
COGS	48.0	47.1	48.0	48.0
Employee	7.8	7.0	6.8	6.9
Other	22.7	22.5	22.2	21.9
(C) Measure of Financial Status				
Gross Debt / Equity	0.6	0.6	0.5	0.5
Interest Coverage	7.9	8.0	8.8	9.1
Inventory days	71	68	68	68
Debtors days	65	63	63	63
Average Cost of Debt	4.7	6.0	5.6	6.1
Payable days	24	26	27	27
Working Capital days	104	104	105	111
FA T/O	1.3	1.3	1.4	1.4
(D) Measures of Investment				
AEPS (Rs)	30.7	46.5	53.4	61.6
CEPS (Rs)	44.0	60.8	69.5	79.5
DPS (Rs)	7.0	8.0	9.0	9.9
Dividend Payout (%)	22.7	17.1	16.8	16.2
BVPS (Rs)	212.7	248.1	289.2	337.3
RoANW (%)	16.0	20.2	19.9	19.7
RoACE (%)	11.2	14.3	14.3	14.7
RoAIC (%)	13.9	17.3	17.3	17.9
(E) Valuation Ratios				
CMP (Rs)	1159	1159	1159	1159
P/E	37.7	25.0	21.7	18.8
Mcap (Rs Mn)	2,01,981	2,01,981	2,01,981	2,01,981
MCap/ Sales	4.3	3.4	2.9	2.6
EV	2,23,532	2,27,309	2,27,864	2,27,690
EV/Sales	4.7	3.8	3.3	2.9
EV/EBITDA	22.1	16.2	14.4	12.6
P/BV	5.5	4.7	4.0	3.4
Dividend Yield (%)	0.6	0.7	0.8	0.9
(F) Growth Rate (%)				
Revenue	2.0	27.2	15.3	12.9
EBITDA	3.6	38.6	13.1	14.1
EBIT	(1.4)	47.5	13.2	14.7
PBT	1.0	48.3	14.7	15.2
APAT	(2.2)	51.1	14.9	15.4
EPS	(2.2)	51.1	14.9	15.4

Cash Flow

(Rs Mn)	FY21E	FY22E	FY23E	FY24E
CFO	6,804	9,711	11,897	12,974
CFI	(11,525)	(10,024)	(8,733)	(8,710)
CFF	2,737	536	(2,917)	(3,591)
FCFF	(4,720)	(313)	3,163	4,264
Opening Cash	2,473	489	712	958
Closing Cash	489	712	958	1,631

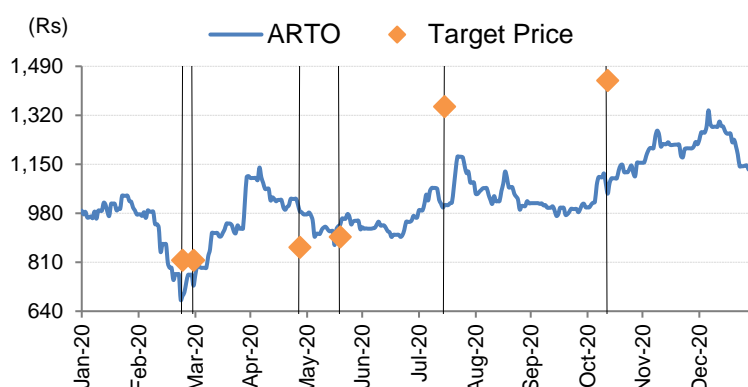
E – Estimates

DART RATING MATRIX

Total Return Expectation (12 Months)

Buy	> 20%
Accumulate	10 to 20%
Reduce	0 to 10%
Sell	< 0%

Rating and Target Price History



Month	Rating	TP (Rs.)	Price (Rs.)
Mar-20	Buy	817	693
Mar-20	Reduce	817	729
May-20	Reduce	862	987
Jun-20	Reduce	898	940
Aug-20	Buy	1,350	1,008
Nov-20	Buy	1,441	1,048

*Price as on recommendation date

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