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Powered by the Sharekhan 3R Research Philosophy

Aarti Industries Limited

Strong Q3; Eyeing right growth opportunities

Specaility Chem	Sharekhan code: AARTIIND	Result Update

3R MATRIX	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)		✓	

\+ Positive = Neutral - Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 1,159**	
Price Target: **Rs. 1,355**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

Company details

Market cap:	Rs. 20,188 cr
52-week high/low:	Rs. 1364/662
NSE volume: (No of shares)	3.6 lakh
BSE code:	524208
NSE code:	AARTIIND
Free float: (No of shares)	9.2 cr

Shareholding (%)

Promoters	47
FII	9
DII	15
Others	29

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	-5.0	16.1	20.1	18.4
Relative to Sensex	-1.9	-0.7	-2.6	5.3

Sharekhan Research, Bloomberg

Summary

- Q3FY2021 results were strong with a 16%/19.4% beat in operating profit/adjusted PAT at Rs. 285 crore/ Rs. 155 crore led by strong OPM of 24% (401 bps above our estimate) as gross margins surged to 54% (up 303 bps y-o-y).
- Specialty chemicals' EBIT margin rose sharply by 356 bps q-o-q to 20.5% (close to pre-COVID-19 level) led by higher share of VAP at 76% versus 72% in Q2FY21 and normalisation of discretionary demand; pharmaceutical EBIT margins were also resilient at 23.8% (up 338 bps y-o-y).
- Recent recovery in specialty chemicals and ongoing capex of Rs. 2,500 crore over FY2021E-FY2022E to drive EBITDA/PAT CAGR of 21%/24% over FY2020-FY2023E. Management is also looking to demerge pharma business and list it separately that could help unlock value.
- We believe Aarti Industries would be a key beneficiary of China plus one factor and import substitution in domestic markets for specialty chemicals. Hence, we maintain a Buy rating on the stock with a revised PT of Rs. 1,355.

Aarti Industries Limited reported a 9.5% y-o-y and 1.2% q-o-q increase in revenue to Rs. 1,187 crore, below our estimates of Rs. 1,228 crore. Revenues from specialty chemicals segment grew by 2.9% y-o-y to Rs. 1,029 crore and that of the pharmaceuticals segment increased by 31.8% y-o-y to 232 crore. Gross margins rose sharply by 303 bps y-o-y and 339 bps q-o-q to 54.1%, substantially above our estimate of 49%. This reflects a strong recovery in revenues from regular high-margin discretionary segments (such as automobiles). Resultantly, OPM at 24% (up 55 bps y-o-y) was also 401 bps above our estimate of 20% and thus operating profit was up by 12.1% y-o-y and q-o-q to Rs. 285 crore (16% above our estimates). Specialty chemical EBIT margin witnessed improvement of 356 bps q-o-q to 20.5% (close to pre-COVID-19 level) led by rise in share of value-added products (VAP) to 76% versus 72% in Q2FY2021 and higher demand from discretionary segments while Pharmaceutical EBIT margin was also resilient at 23.8% (up 338 bps q-o-q; down 170 bps q-o-q). Adjusted PAT at Rs. 155 crore (up 8% y-o-y; up 15.9% q-o-q) was also significantly above our estimates of Rs. 130 crore led by solid margin performance, lower interest costs (down 40% y-o-y) and lower-than-expected effective tax rate of 19.2% (versus assumption of 20%). We have adjusted a reported PAT of Rs. 165 crore (up 18.2% y-o-y; up 17.8% q-o-q) by forex gain of Rs. 10.4 crore versus forex loss of Rs. 3.5 crore in Q3FY2020. The management commentary is positive with respect to improved demand visibility in specialty chemical segment (domestic demand reached pre-COVID-19 level and export gaining traction) while pharma segment outlook is promising with sustainable revenue/EBIT CAGR guidance of 18-20%/25% over the next 2-3 years supported by commercilaisation of ongoing APIs. The management is also considering demerger of pharma business and has constituted an internal committee of to evaluate the feasibility of the same. The company has capex plan of Rs. 2,500 crore over FY2021E-FY2022E would drive a strong 15-20% revenue CAGR in the next 2-3 years and capex is expected to have a much higher RoCE of 20-25% (driven by rise in share of value-added products). We believe that Aarti Industries would be a key beneficiary of the China plus one factor, import substitution in domestic markets and rising domestic demand for specialty chemicals. We maintain our Buy rating on Aarti Industries with a revised PT of Rs. 1,355. At CMP, the stock trades at 26.9x FY2022E EPS and 19.7x FY2023E EPS.

Key positives

- Better-than-expected EBIT margin of 20.5% (up 356 bps q-o-q) for specialty chemical business led by higher gross margins.
- Robust 31.8% y-o-y revenue growth in pharma segment with resilient EBIT margin at 23.8% (up 338 bps y-o-y).

Key negatives

- Sharp rise in operating cost with an 8.8% y-o-y jump in employee costs and a 23.4% y-o-y rise in other expenses.

Our Call

Valuation – Maintain Buy on Aarti Industries with a revised PT of Rs. 1,355: We have raised FY2021-FY2023 earnings estimates to factor in higher margins (strong Q3FY2021 margin performance and rising share of value-added products) and lower interest costs. A sharp recovery in specialty chemicals segment and continuous outperformance of pharma segment would result in strong Q4FY2021 while ongoing capex plan of Rs. 2,500 crore (expected to earn superior RoCE) over FY2021E-FY2022E gives us confidence with regards to strong medium to long term earnings growth prospects. We thus expect a strong EBITDA/PAT CAGR of 21%/24% over FY2020-FY2023E. Also, Aarti Industries would be a key beneficiary of China plus one factor by global customers, rising domestic demand for specialty chemicals and import substitution (identified opportunities of ~$1 billion). Hence, we maintain a Buy on Aarti Industries with a revised PT of Rs. 1,355 (reflects higher valuation multiple and upgrade in earnings estimate). At CMP, the stock trades at 26.9x FY2022E EPS and 19.7x FY2023E EPS.

Key Risks

- Slowdown in demand and delay in commissioning of facilities for multi-year contracts can affect revenue growth momentum.
- Adverse commodity prices and currency movements might affect margins.

Valuation (Consolidated) Rs cr

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Net Sales	4,168	4,186	4,506	5,528	6,932
OPM (%)	23.2	23.3	23.5	24.5	24.7
Adjusted PAT	492	536	572	749	1,026
y-o-y growth (%)	47.7	9.1	6.6	31.0	36.9
Adjusted EPS (Rs.)	28.4	30.8	32.8	43.0	58.9
P/E (x)	40.8	37.7	35.3	26.9	19.7
P/BV (x)	7.6	6.8	5.8	4.8	3.9
EV/EBITDA (x)	22.2	22.3	21.0	16.4	12.8
RoCE (%)	17.8	14.7	13.4	15.3	18.3
RoE (%)	23.4	19.1	17.7	19.5	21.9

Source: Company; Sharekhan estimates

Significant beat in PAT led by better-than-expected margin and lower interest cost

Q3FY21 revenue rose by 9.5% y-o-y and 1.2% q-o-q to Rs. 1,187 crore, below our estimates of Rs. 1,228 crore. Revenues from specialty chemicals segment grew by 2.9% y-o-y to Rs. 1,029 crore and that of pharmaceuticals segment increased by 31.8% y-o-y to 232 crore. OPM at 24% (up 55 bps y-o-y; up 233 bps q-o-q) was significantly above our estimate of 20% due to better-than-expected gross margin of 54.1% (up 303 bps y-o-y; up 339 bps q-o-q). Consequently, operating profit was up by 12.1% y-o-y and q-o-q to Rs. 285 crore, above our estimate of Rs. 246 crore. Specialty chemical EBIT margin witnessed improvement of 356bps q-o-q to 20.5% while pharmaceutical EBIT margin was also resilient at 23.8% (up 338 bps q-o-q; down 170 bps q-o-q). Adjusted PAT (post forex gains) at Rs.155 crore (up 8% y-o-y, up 15.9% q-o-q) was also above our estimate of Rs. 130 crore led by beat in margins and lower-than-expected interest costs (down 40% y-o-y).

Q3FY2021 conference call highlights

- **Specialty chemical segment -** The management indicated that domestic demand for specialty chemicals recovered to pre-COVID-19 levels and sales to regular market (discretionary high-margin sectors like automobiles) also normalised. Exports demand is improving and is expected to reach pre-COVID-19 levels by end of Q4FY2021. The margin for specialty chemical segment reverted back to normal level (EBIT margin of 20.5%) supported by recovery in regular market. Demand outlook remains strong, supported by a recent recovery and margin would remain resilient given the rising share of high-margin value-added products (76% in Q3FY2021 versus 72% in Q2FY2021). Capacity utilisation stands at 90% across plants. The company has recognized $5 million in revenues as compensation of cancellation of a long-term contract.
- **Pharma segment (focus on demerger and robust growth outlook) -** The board of directors of the company has constituted an internal committee of directors to evaluate the feasibility for demerger of pharma and allied activities. The key rationale behind the demerger is that pharmaceuticals has totally different manufacturing process, products and customer base and the demerger would help tap growth upcoming growth opportunities. After the demerger is announced, it would become a separately listed pharma company. We highlight here that the pharma business accounts for 19% of consolidated revenues and 22.4% of consolidated EBIT. Outlook for the pharma segment is very promising and the management expects 18-20% revenue CAGR and EBIT CAGR of 25% over next 2-3 years. The company will progressively commercialise ongoing APIs and Intermediates in the next 2-3 quarters, which would help sustain strong growth momentum.
- **Capex guidance -** The company has guided for a capex of Rs. 1,000-1,200 crore for FY2021 and it has already spent Rs. 891 crore in 9MFY2021. Of the total capex plan, ~80% would be spent on specialty chemicals (focus to expand downstream capacities in benzene chain and de-bottlenecking activities) and the remaining amount would be spent in pharma (setting up new intermediate facility at Dahej and ongoing API expansions).
- **Long term growth outlook -** The management has guided for 15-20% revenue CAGR over next 2-3 years supported by capex plan of Rs. 2,500 crore over FY2021E-FY2022E. The new capex would have a higher RoCE of 20-25% as focus would be mainly on high-margin value-added products. Moreover, the company is working on a new product chlorotoluene (imports substitution), which could have a revenue potential of Rs. 1,000 crore. For FY2021, the management expects to maintain PAT at FY2020 levels despite weak Q1FY2021.
- **Volumes in specialty chemical segment - NCB:** 16,830 mt versus 14,900 mt in Q3FY2020. **Hydrogenation** – 2,740 mt/month versus 2,030mt/month in Q3FY2020. **Nitro-toluene** volumes at 3,600 mt versus 1667mt in Q3FY2020. **PDA** volumes at 520 mt/month versus 420 mt/ month in Q3FY2020.
- One multi-year contract (10-years) has got delayed to H2FY2022 (from earlier target of Q4FY2021) due to COVOD-19. The plant for a cancelled multi-year contract will start in February 2021 and the company is looking to market the products in different markets.
- Revenue mix for domestic/export segments is at 60%/40% level currently and both are growing a reasonable pace.
- A large NCB capacity has been shut down in China and this has benefited realisation and margins. Share of China in export revenues has declined to 11-12% versus 20% in Q2FY2021.
- Current capital work in progress (CWIP) is at Rs. 1,400 crore (90% is specialty chemical and 10% is pharma). Out of this, 50% is expected to be capitalised in Q4FY2021.
- Gross debt is slightly lower than Rs. 2,500 crore and the company is aiming for a debt/equity (D/E) ratio of 0.7-0.9x.

Results | Rs cr

Particulars	Q3FY21	Q3FY20	y-o-y (%)	Q2FY21	q-o-q (%)
Net Sales	**1,187**	**1,084**	**9.5**	**1,173**	**1.2**
Gross Profit	642	553	16.0	595	8.0
EBITDA	**285**	**254**	**12.1**	**254**	**12.1**
Other Income	0.4	0.4	16.2	0.0	975.0
Depreciation	59	47	24.7	55	6.6
Interest	17	29	(39.8)	22	(22.0)
PBT	**209**	**179**	**17.1**	**177**	**18.2**
Tax	40	36	11.5	34	19.6
RPAT	**165**	**140**	**18.2**	**140**	**17.8**
Adjusted PAT	**155**	**143**	**8.0**	**134**	**15.9**
Margin (%)			**YoY (BPS)**		**QoQ (BPS)**
Gross Margin	54.1	51.1	303	50.7	339
EBITDA margin	24.0	23.5	55	21.7	233
Net Profit	13.9	12.9	102	12.0	197

Source: Company; Sharekhan Research

Segmental performance | Rs cr

Particulars	Q3FY21	Q3FY20	y-o-y (%)	Q2FY21	q-o-q (%)
Revenue					
Specialty Chemicals	1,029	1,001	2.9	1,056	(2.6)
Pharmaceuticals	232	176	31.8	222	4.8
Total revenue	**1,261**	**1,177**	**7.2**	**1,278**	**(1.3)**
EBIT					
Specialty Chemicals	210	205	2.5	179	17.9
Pharmaceuticals	55	36	53.7	57	(2.2)
Total EBIT	**266**	**241**	**10.1**	**235**	**13.1**
EBIT margin			**BPS**		**BPS**
Specialty Chemicals	20.5	20.5	(7)	16.9	356
Pharmaceuticals	23.8	20.4	338	25.5	(170)
Overall EBIT margin	**21.1**	**20.5**	**56**	**18.4**	**268**

Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector view - Structural growth drivers to propel sustained growth for the specialty chemical sector over the medium to long term

We remain bullish on medium to long-term growth prospects of the specialty chemicals sector, given a massive revenue opportunity from the perspective of import substitution (India's total specialty chemical imports are estimated at $56 billion), potential increase in exports given China Plus One strategy by global customers, and favourable government policies (such as tax incentive and production-linked incentive scheme similar to the pharma sector). In our view, conducive government policies, product innovation, massive export opportunity and low input prices would help the sector witness high double-digit earnings growth trajectory on a sustained basis in the next 2-3 years.

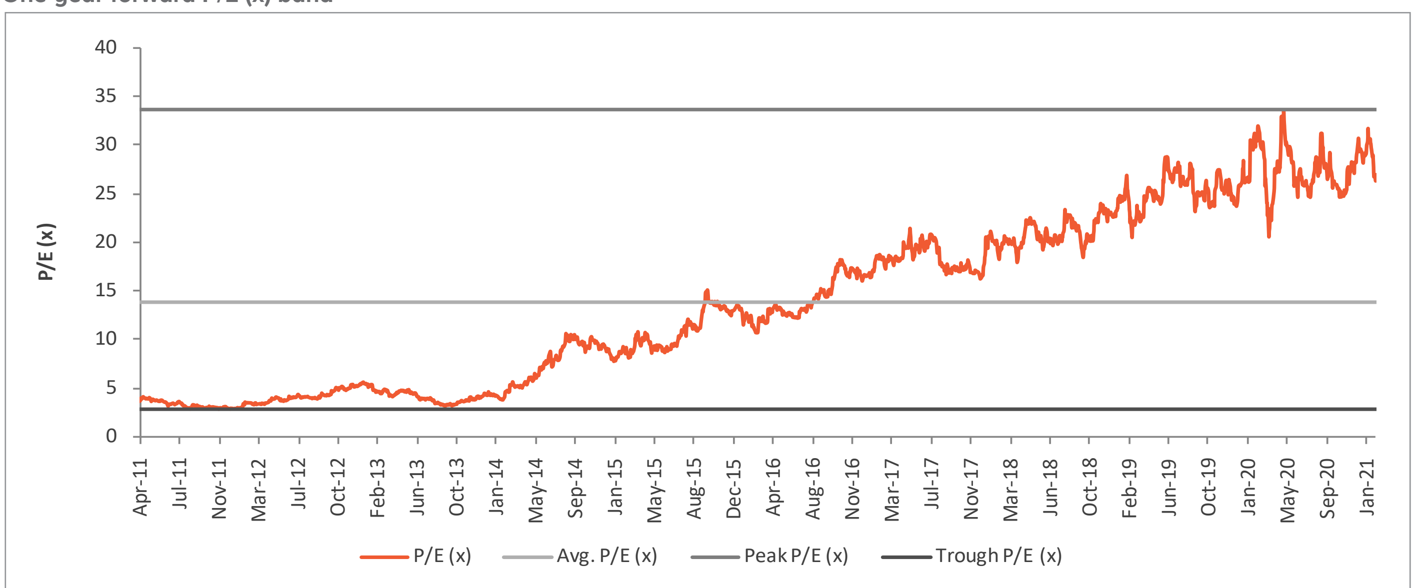
■ Company outlook - Long-term growth intact supported by capex in right space

The company is investing in the right areas to build capabilities and enhance client engagements. Growth is expected to be largely driven by i) growth in global markets, ii) import substitution, and iii) customer de-risking (given China plus one factor). The management has guided for flat y-o-y profit for FY2021 and expects growth to pick-up in FY2022-FY203E led by recovery and commencement of new capacities and capex program of Rs. 2,500 crore.

■ Valuation - Maintain Buy on Aarti Industries with a revised PT of Rs. 1,355

We have raised FY2021-FY2023 earnings estimates to factor in higher margins (strong Q3FY2021 margin performance and rising share of value-added products) and lower interest costs. A sharp recovery in specialty chemicals segment and continuous outperformance of pharma segment would result in strong Q4FY2021 while ongoing capex plan of Rs. 2,500 crore (expected to earn superior RoCE) over FY2021E-FY2022E gives us confidence with regards to strong medium to long term earnings growth prospects. We thus expect a strong EBITDA/PAT CAGR of 21%/24% over FY2020-FY2023E. Also, Aarti Industries would be a key beneficiary of China plus one factor by global customers, rising domestic demand for specialty chemicals and import substitution (identified opportunities of ~$1 billion). Hence, we maintain a Buy on Aarti Industries with a revised PT of Rs. 1,355 (reflects higher valuation multiple and upgrade in earnings estimate). At CMP, the stock trades at 26.9x FY2022E EPS and 19.7x FY2023E EPS.

One-year forward P/E (x) band



Source: Sharekhan Research

About company

Aarti is a leading specialty chemicals company in benzene-based derivatives with a global footprint having integrated operations and high level of cost optimisation. The company has been setup by first-generation technocrats in 1984 and its pharmaceutical business spans across APIs, intermediates, and Xanthene derivatives. The company has strong R&D capabilities, with three R&D facilities and a dedicated pool of over 170 engineers and scientists. The company has 11 plants located in western India with proximity to ports; specialty chemicals are manufactured in all plants; and four of the plants are approved as pharma-grade (2 USFDA and 2 WHO/GMP). The company is also coming up with two project sites at Dahej SEZ and the fourth R&D centre at Navi Mumbai.

Investment theme

Aarti is investing in the right areas for building capabilities and richer client engagements, which would create a long-term moat in a booming industry. Expanding capacity for Nitro Chloro Benzene (NCB) by 33,000 MTPA at a capex of Rs. 150 crore in two phases is expected to be operational by FY2021 and FY2022. Multi-year growth levers are getting stronger; the company has signed the third multi-year contracts worth $125 million with global players for 10 years, though small in size but bring in new capabilities for long-term growth (the second multi-year contract is with the global player in the specialty chemical space for Rs. 10,000 crore for 15 years). The company expects significant growth prospects in sight, led by expansion and diversification plans and concerns over supplies from China.

Key Risks

- Slowdown in demand offtake and delay in commissioning of facilities for multi-year contracts can affect revenue growth momentum.
- Adverse commodity prices and currency movements might impact margins.

Additional Data

Key management personnel

Rajendra Vallabhaji Gogri	Chairman cum Managing Director
Rashesh Chandrakant Gogri	Vice Chairman cum Managing Director
Renil Rajendra Gogri	Executive Director
Kirit Ratilal Mehta	Executive Director
Parimal Hasmukhlal Desai	Executive Director
Manoj Mulji Chheda	Executive Director
Hetal Gogri Gala	Executive Director
Chetan B Gandhi	Chief Finance Officer (CFO)
Raj Sarraf	Company Secretary & Compliance Officer

Source: Bloomberg

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	HDFC Asset Management Co Ltd	4.4
2	Aditya Birla Sun Life Trustee Co Pvt Ltd	1.6
3	Aditya Birla Sun Life Asset Management	1.5
4	Axis Asset Management Co Ltd/India	1.3
5	Vanguard Group Inc/The	1.2
6	HDFC Life Insurance Company Ltd	1.1
7	Alchemie Financial Services Ltd	1.1
8	L&T Mutual Fund Trustee Ltd/India	1.0
9	DSP Investment Managers Pvt Ltd	1.0
10	Franklin Resources Inc	0.8

Source: www.bseindia.com

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Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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