

28 July 2021

Aarti Drugs

Margin dent temporary, long-term growth trajectory unhurt; retaining a Buy

Rating: **Buy**

Target Price: Rs.844

Share Price: Rs.674

Raw-material price rises and a higher share of domestic sales dented Aarti's gross margin 966bps to 31.7%. Certain maintenance costs pulled down the EBITDA margin more, to 1,085bps. Revenue grew 6.5% to Rs5.8bn on 6.7% growth in formulations, and 38.5% in specialty chemicals. API sales were up 3.9% to Rs4.5bn. Via better utilisation of capacities and addition of products, Aarti is on track for 18% revenue growth in the next 4-5 years. We cut our FY22e/FY23e EPS 18.6%/11.1% to factor in the temporary rise in raw-material prices. We retain our Buy rating and lower our target to Rs844 (earlier Rs949) on 20x FY23e earnings.

Near-term EBITDA margins to move up to 18-19%. The Q1 EBITDA margin was lower, at 13.7% compared to 20%+ in FY21. The contraction was chiefly due to the 100-250% hike in 20-22 raw materials due to the second Covid-19 wave. Prices of a few raw materials are softening as the supply situation has eased; management expects to return to 35-36% gross margins.

Guidance of 18% sales CAGR over FY21-26 intact. Despite the challenges in Q1 FY22, the API business grew 3.9%, backed by 13.2% volume growth in India. Management also talked about a nominal price hike in APIs, the benefit to be reflected from Q3 FY22. The company is on track with its capex plans and is set to achieve sales of Rs40bn-45bn in the next 4-5 years.

Formulations, better API products will increase profitability. On greater volume growth (existing products) and launches of such as tenaliglipatin and vildagliptin, we expect the API business to grow 16.5% over FY21-23 while formulations will grow at 15%. Besides, operating leverage will help restore margins by FY23.

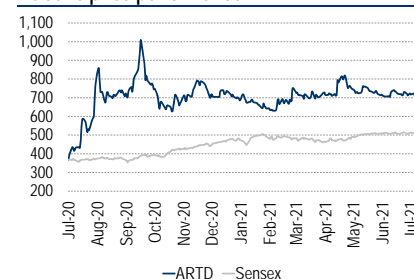
Valuation. Fresh investment in the margin-accretive businesses and easing raw-material prices would boost sales/EBITDA/PAT 16.2%/16.1%/18.5% over FY21-23. At the CMP of Rs674, the stock trades at 22.5x/16x FY22e/FY23e earnings. **Risks:** Delay in capacity addition; keener competition in generic APIs and deterioration in API pricing.

Key data	ARTD IN / ADRG.BO
52-week high / low	Rs.1027 / 414
Sensex / Nifty	52444 / 15709
3-m average volume	\$7m
Market cap	Rs.63bn / \$840.3m
Shares outstanding	93m

Shareholding pattern (%)	Jun'21	Mar'21	Dec'20
Promoters	60.1	60.2	60.2
- of which, Pledged	0.0	0.0	0.0
Free float	39.8	39.8	39.8
- Foreign institutions	2.6	3.0	3.1
- Domestic institutions	2.0	1.6	1.7
- Public	35.3	35.2	35.1

Estimates revision (%)	FY22e	FY23e
Sales	(4.4)	(4.6)
EBITDA	(17.4)	(10.4)
PAT	(18.6)	(11.1)

Relative price performance



Source: Bloomberg

Key financials (YE Mar)	FY19	FY20	FY21	FY22e	FY23e
Sales (Rs m)	15,609	18,061	21,548	24,622	29,097
Net profit (Rs m)	872	1,380	2,802	2,811	3,933
EPS (Rs)	9.4	14.8	30.1	30.2	42.2
P/E (x)	16.8	8.2	23.1	22.4	16.0
EV / EBITDA (x)	9.5	5.8	15.6	14.8	10.7
P/BV (x)	2.7	1.7	7.1	5.5	4.3
RoE (%)	17.5	23.1	35.8	27.4	30.1
RoCE (%)	10.3	14.5	24.3	21.3	25.7
Dividend yield (%)	0.6	2.1	0.6	0.9	0.9
Net debt / equity (x)	0.9	0.6	0.4	0.2	0.0

Source: Company, Anand Rath Research

Abdulkader Puranwala

Research Analyst

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Quick Glance – Financials and Valuations

Fig 1 – Income statement (Rs m)

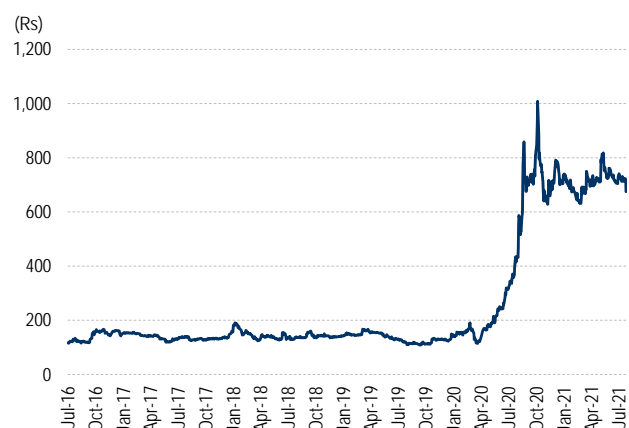
Year-end: Mar	FY19	FY20	FY21	FY22e	FY23e
Net revenues	15,609	18,061	21,548	24,622	29,097
<i>Growth (%)</i>	<i>23.6</i>	<i>15.7</i>	<i>19.3</i>	<i>14.3</i>	<i>18.2</i>
Direct costs	10,600	11,790	13,210	16,123	18,408
SG&A	2,936	3,653	3,966	4,137	4,801
EBITDA	2,074	2,618	4,371	4,363	5,888
<i>EBITDA margins (%)</i>	<i>13.3</i>	<i>14.5</i>	<i>20.3</i>	<i>17.7</i>	<i>20.2</i>
- Depreciation	426	488	499	507	607
Other income	24	15	45	63	72
Interest expenses	400	337	230	170	109
PBT	1,310	1,853	3,690	3,748	5,244
<i>Effective tax rates (%)</i>	<i>31.5</i>	<i>23.7</i>	<i>24.0</i>	<i>25.0</i>	<i>25.0</i>
+ Associates / (Minorities)	-	-	-	-	-
Net income	898	1,414	2,804	2,811	3,933
Adjusted income	872	1,380	2,802	2,811	3,933
WANS	93	93	93	93	93
FDEPS (Rs / sh)	9.4	14.8	30.1	30.2	42.2

Fig 3 – Cash-flow statement (Rs m)

Year-end: Mar	FY19	FY20	FY21	FY22e	FY23e
PBT (adj. for int. exp./ other inc.)	1,686	2,175	3,875	3,856	5,281
+ Non-cash items	426	488	499	507	607
Oper. prof. before WC	2,111	2,663	4,373	4,363	5,888
- Incr. / (decr.) in WC	281	-209	1,754	-939	444
Others incl. taxes	326	533	931	937	1,311
Operating cash-flow	1,505	2,338	1,689	4,366	4,133
- Capex (tang. + intang.)	693	472	785	2,200	2,000
Free cash-flow	811	1,867	904	2,165	2,133
Acquisitions	-	-	-	-	-
- Div. (incl. buyback & taxes)	114	70	373	559	559
+ Equity raised	-	-3	-	-	-
+ Debt raised	-390	-1,194	-473	-1,319	-650
- Fin investments	17	9	39	-	-
- Misc. (CFI + CFF)	277	572	(2)	108	37
Net cash-flow	13	21	21	180	887

Source: Company, Anand Rathi Research

Fig 5 – Price movement



Source: Bloomberg

Fig 2 – Balance sheet (Rs m)

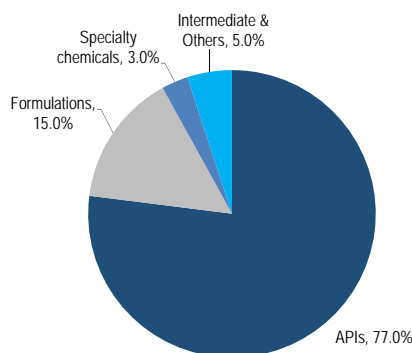
Year-end: Mar	FY19	FY20	FY21	FY22e	FY23e
Share capital	236	233	932	932	932
Net worth	5,434	6,525	9,134	11,386	14,760
Debt	5,072	3,878	3,405	2,087	1,437
Minority interest	-	-	-0	-	-
DTL / (Assets)	898	807	771	771	771
Capital employed	11,405	11,210	13,311	14,244	16,968
Net tangible assets	6,220	6,423	6,651	6,310	7,693
Net intangible assets	29	15	3	37	46
Goodwill	-	-	-	-	-
CWIP (tang. & intang.)	327	122	193	2,193	2,193
Investments (strategic)	124	134	173	173	173
Investments (financial)	-	-	-	-	-
Current assets (ex cash)	7,799	8,995	10,543	10,249	11,208
Cash	56	76	98	278	1,165
Current liabilities	3,150	4,555	4,350	4,995	5,510
Working capital	4,649	4,440	6,193	5,254	5,697
Capital deployed	11,405	11,210	13,311	14,244	16,968
Contingent liabilities	747	-	-	-	-

Fig 4 – Ratio analysis

Year-end: Mar	FY19	FY20	FY21	FY22e	FY23e
P/E (x)	16.8	8.2	23.1	22.4	16.0
EV / EBITDA (x)	9.5	5.8	15.6	14.8	10.7
EV / Sales (x)	1.3	0.8	3.2	2.6	2.2
P/B (x)	2.7	1.7	7.1	5.5	4.3
RoE (%)	17.5	23.1	35.8	27.4	30.1
RoCE (%) - after tax	10.3	14.5	24.3	21.3	25.7
ANDA filings	-	-	-	-	-
DPS (Rs / sh)	1.0	2.5	4.0	6.0	6.0
Dividend yield (%)	0.6	2.1	0.6	0.9	0.9
Dividend payout (%) - incl. DDT	12.7	5.0	13.3	19.9	14.2
Net debt / equity (x)	0.9	0.6	0.4	0.2	0.0
Receivables (days)	107	99	94	85	80
Inventory (days)	58	66	70	48	42
Payables (days)	57	67	56	59	53
CFO : PAT%	172.6	169.5	60.3	155.3	105.1

Source: Company, Anand Rathi Research

Fig 6 – Revenue break-up (Q1 FY22)



Source: Company

Result Highlights

Fig 7 – Quarterly financials

(Rs m)	Q4FY19	Q1FY20	Q2FY20	Q3FY20	Q4FY20	Q1FY21	Q2FY21	Q3 FY21	Q4 FY21	Q1 FY22	% Y/Y	% Q/Q
Sales	4,591	4,054	4,775	4,735	4,496	5,447	5,781	5,303	5,018	5,800	6.5	15.6
Gross profit	1,376	1,363	1,611	1,633	1,665	2,251	2,199	2,065	1,822	1,837	(18.4)	0.8
Gross margins (%)	30.0	33.6	33.7	34.5	37.0	41.3	38.0	38.9	36.3	31.7	-966bps	-463bps
EBITDA	559	547	683	675	713	1,340	1,164	1,058	809	797	(40.5)	(1.5)
EBITDA margins (%)	12.2	13.5	14.3	14.3	15.9	24.6	20.1	19.9	16.1	13.7	-1085bps	-239bps
Finance expenses	103	93	85	84	75	66	71	50	44	42	(35.9)	(3.7)
Depreciation	108	118	121	124	125	124	126	127	123	124	0.3	1.1
Other income	12	1	2	3	10	13	3	20	10	16	28.6	67.0
PBT	398	336	479	431	607	1,163	971	904	652	647	(44.4)	(0.9)
Tax	99	91	134	139	170	294	237	243	156	162	(44.9)	3.7
Effective tax rates (%)	31.1	33.3	32.5	35.5	3.1	26.5	22.5	24.7	20.9	24.5	-198bps	367bps
Adjusted PAT	248	225	323	303	507	855	752	679	516	488	(42.9)	(5.5)

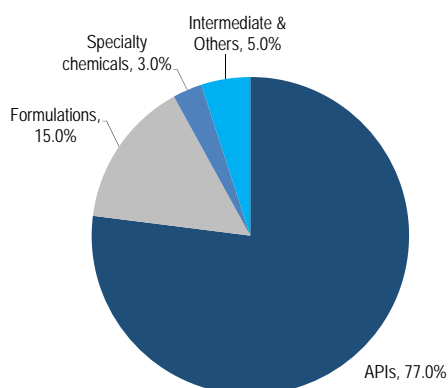
Source: Company, Anand Rath Research

Fig 8 – Segment performances

	Q1 FY21	Q4 FY21	Q1 FY22	% Y/Y	% Q/Q
API	4,296	3,921	4,464	3.9	13.8
% of sales	78.9	78.2	77.0		
Formulation	811	617	865	6.7	40.2
% of sales	14.9	12.3	14.9		
Specialty chemicals, intermediates & others	340	479	471	38.5	(1.7)
% of sales	6.2	9.5	8.1		
Total	5,447	5,017	5,800	6.5	15.6

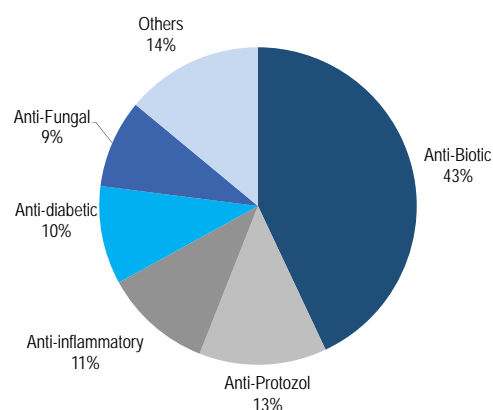
Source: Company, Anand Rath Research

Fig 9 – Segment revenue break-up (Q1FY22)



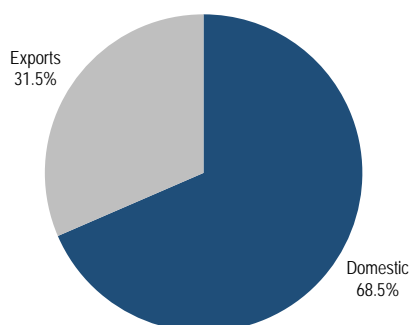
Source: Company, Anand Rath Research

Fig 10 – API therapeutic break-up (Q1FY22)



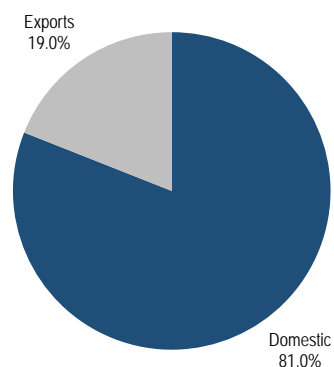
Source: Company, Anand Rath Research

Fig 11 – API revenue-mix (Q1FY22)



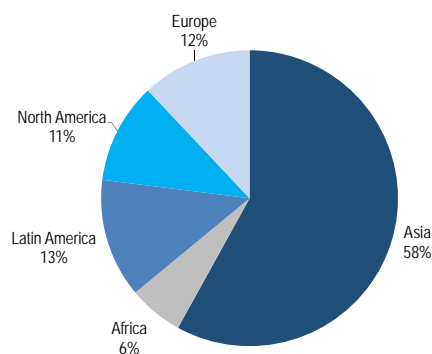
Source: Company, Anand Rathi Research

Fig 12 – Formulations revenue-mix (Q1FY22)



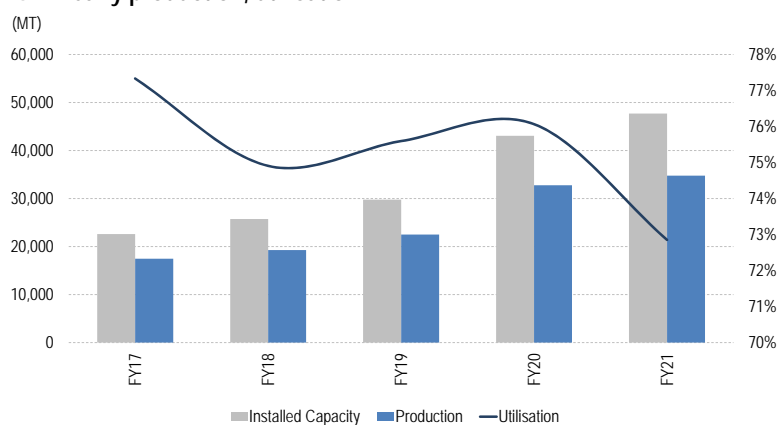
Source: Company, Anand Rathi Research

Fig 13 – Geographic mix (FY21)



Source: Company, Anand Rathi Research

Fig 14 – Yearly production, utilisation



Source: Company, Anand Rathi Research

Fig 15 – Revenue assumption

(Rs m)	FY21	FY22e	FY23e
APIs	17,047	19,611	23,118
% of sales	79.1	79.6	79.4
Y/Y%	18.3	15.0	17.9
Formulations	2,847	3,189	3,763
% of sales	13.2	13.0	12.9
Y/Y%	36.6	12.0	18.0
Specialty chemicals	840	941	1,271
% of sales	3.9	3.8	4.4
Y/Y%	75.3	12.0	35.0
Intermediates	210	248	288
% of sales	1.0	1.0	1.0
Y/Y%	(41.8)	18.0	16.0
Others	603.3	633.5	658.8
% of sales	2.8	2.6	2.3
Y/Y%	(16.5)	5.0	4.0
Total	21,548	24,622	29,097

Source: Company, Anand Rathi Research

Concall Highlights

Q1 FY22 performance

- In Q1 FY22 API revenue from India was 69%, exports 31%
- API volume growth in India was 13.2% y/y.
- Revenues from the acute therapies were lower due to lockdowns in most part of the country.
- Price rise in 22 raw materials along with higher crude-oil prices, eating into the gross margin.
- Raw-material prices mainly increased due to lockdowns at the manufacturers in China and the USA, certain accidents at the plants of US suppliers and a demand-supply mismatch.
- The EBITDA margin is expected to return to normal in a few quarters and will hold at around 18%.
- It is on the course to convert most of the plants at Tarapur to zero-liquid discharge.
- Container-freight charges have risen considerably, which also raises costs and affects margins.
- Due to better operational efficiencies and debottlenecking, the capex investment might come down but the target of greater capacities will be intact.

Capex plans

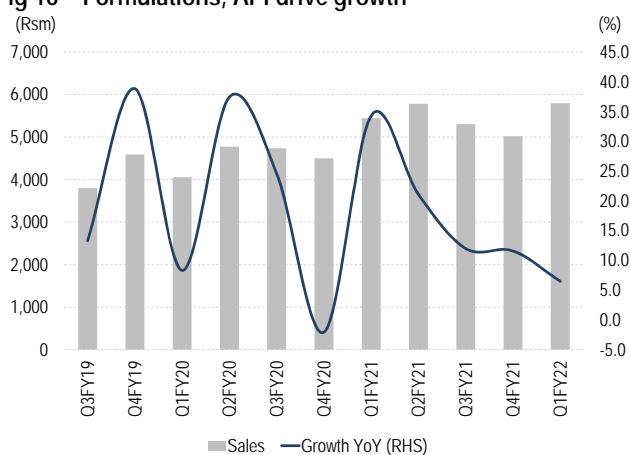
- For Q1 FY22, the company incurred Rs480m capex and has planned an outlay of Rs1.5bn-2bn for FY22.
- Gliptin was launched recently; clopidogrel has been doing well and has the potential to become a blockbuster product for the company. For this, the company is coming up with multi-purpose facility which will add up to Rs700m-900mn revenue.
- The specialty-chemicals greenfield expansion will begin in a few months. Till then, the company has a brownfield expansion at Tarapur which will increase capacity by 400 MT.
- It is expanding in oncology for the formulations division, spending ~Rs550m. The plant will be commercialised in the next two years.

Guidance

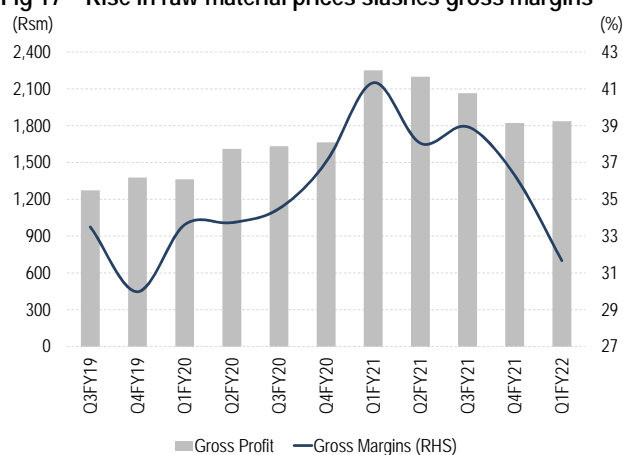
- The company expects 15% volume growth for the next 4-5 years; Formulations divisions would grow faster at 15-20%.

Financials

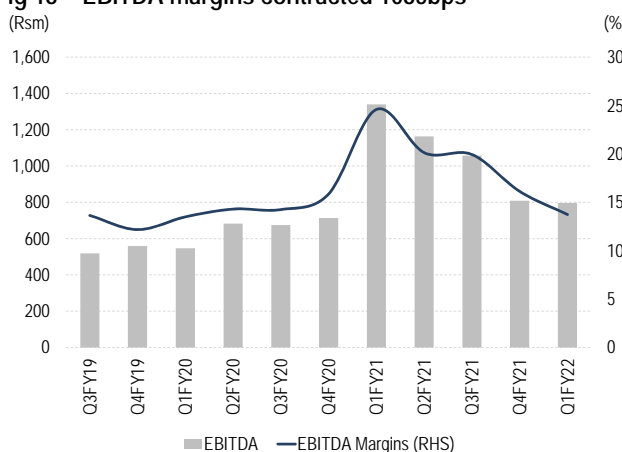
- In Q1 FY22, the company had a net D/E of 0.54x.
- The company completed its share buyback of Rs600m in Q1 FY22.

Fig 16 – Formulations, API drive growth

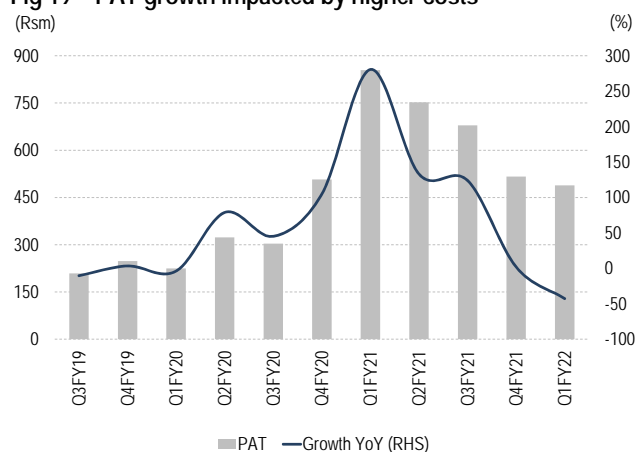
Source: Company, AnandRathi Research

Fig 17 – Rise in raw-material prices slashes gross margins

Source: Company, AnandRathi Research

Fig 18 – EBITDA margins contracted 1085bps

Source: Company, AnandRathi Research

Fig 19 – PAT growth impacted by higher costs

Source: Company, AnandRathi Research

Valuations

Raw material price increase may escalate till Q2 and lower growth is expected in API segment, to factor in higher raw material prices and lower API growth we cut down our revenue by 4.4%/4.6% for FY22e/FY3e, EBITDA by 17.4%/10.4% for FY22e/FY23e and PAT by 18.6%/11.1% for FY22e/FY23e

Fig 20 – Change in estimates

(Rs m)	Old		New		Change (%)	
	FY22	FY23	FY22	FY23	FY22	FY23
Revenue	25,760	30,498	24,622	29,097	(4.4)	(4.6)
EBITDA	5,280	6,571	4,363	5,888	(17.4)	(10.4)
PAT	3,455	4,424	2,811	3,933	(18.6)	(11.1)

Source: AnandRathi Research

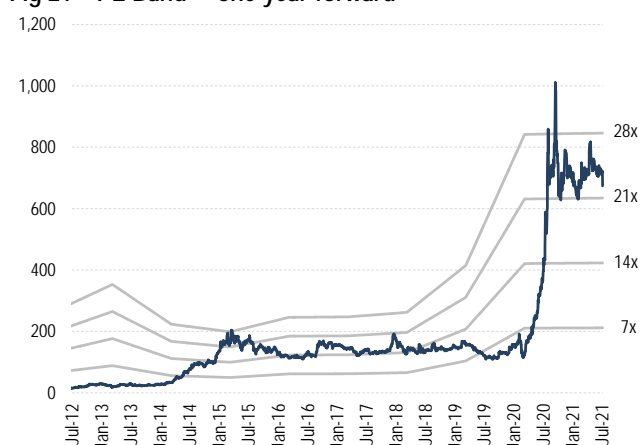
Higher raw material prices had dented Aarti Drugs' margins. Ahead, though prices are now softening, there may be some impact in Q2 FY22. With prices of final API products intact and the company passing on cost escalation to customers, we expect full recovery in EBITDA margins from Q3 FY22.

For its API division, Aarti planned Rs5.5bn capex, almost equivalent to its current net block. It has identified seven projects on which it will incur expenditure in the next three years. Nearly 60% of these are API-based (diabetes and others); the balance is to manufacture sulfonated and chloro-sulfonated products and some intermediates.

Capacity additions and better utilisation of existing capacities are likely to fetch an 18% sales CAGR over FY21-26. The company aims to improve its product mix by scaling up chronic APIs and add products in formulations.

At the CMP of Rs.674, the stock trades at 22.5x/16x FY22e/FY23e earnings. We expect revenue and PAT CAGRs over FY21-23 of 16.2% and 18.5% respectively. We retain our Buy rating and lower our target to Rs844, based on 20x FY23e earnings.

Fig 21 – PE Band – one-year-forward



Source: Bloomberg, AnandRathi Research

Fig 22 – 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 23 – Valuation Summary

Company	RATING	CMP	TP	M Cap	EPS (Rs)			PE (x)			EV / EBITDA (x)			RoE (%)		
		(Rs)	(Rs)	(Rsbn)	FY21	FY22e	FY23e	FY21	FY22e	FY23e	FY21	FY22e	FY23e	FY21	FY22e	FY23e
Aarti Drugs	Buy	674	844	62.8	30.1	30.2	42.2	22.4	22.3	16.0	15.6	14.8	10.7	35.8	27.4	30.1
Ajanta	Buy	2327	2192	189.0	75.2	90.2	108.5	30.9	25.8	21.4	15.4	15.4	12.7	23.4	23.5	23.1
Alembic	Hold	796	955	179.0	59.9	38.6	46.7	13.3	20.6	17.0	7.0	16.2	12.2	28.2	14.0	15.2
Alkem	Hold	3372	3177	402.9	132.6	129.8	144.5	25.4	26.0	23.3	16.8	20.0	17.4	23.4	19.6	19.1
Zydus Cadila	Sell	577	515	656.4	21.7	21.4	23.4	26.6	27.0	24.7	20.7	19.0	17.1	19.0	15.9	15.7
Eris	Hold	743	710	100.7	26.2	28.6	32.2	28.4	26.0	23.1	18.3	20.6	17.7	24.7	22.4	21.2
Granules India	Hold	371	392	92.0	22.2	20.4	24.2	16.7	18.2	15.3	11.3	11.5	9.6	27.4	21.1	20.9
Indoco Remedies	Sell	443	313	42.4	10.1	13.0	17.2	43.9	34.1	25.7	20.0	16.3	13.1	12.8	14.5	16.5
Ipca Labs	Hold	2180	2240	264.2	81.3	84.4	101.8	26.8	25.8	21.4	18.2	17.0	13.8	24.7	20.6	20.8
JB Chemicals	Hold	1807	1648	139.7	58.0	58.0	58.0	31.2	31.2	31.2	16.1	16.1	16.1	27.6	27.6	27.6
Natco Pharma	Hold	1015	1172	195.3	24.2	34.7	86.0	41.9	29.3	11.8	31.7	22.2	9.1	11.2	14.5	30.1
Neuland	Sell	2003	1501	26.8	62.5	69.5	91.6	32.0	28.8	21.9	19.1	16.9	12.9	10.8	10.8	12.8
Pfizer	Buy	6020	6037	271.8	108.8	123.7	141.9	55.3	48.7	42.4	27.5	34.7	29.9	17.2	21.8	21.4
Suven Pharma	Buy	495	560	120.9	14.2	17.2	20.0	34.8	28.8	24.8	27.3	22.5	18.7	35.8	32.5	29.8
Torrent Pharma	Buy	3084	3664	508.4	74.0	79.4	98.2	41.7	38.8	31.4	22.1	19.4	16.5	23.5	21.6	23.5

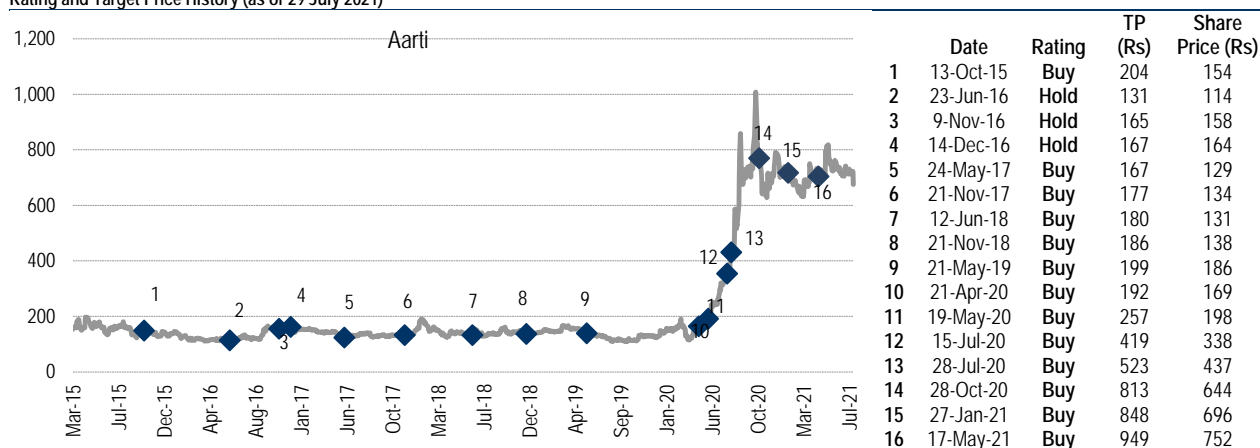
Source: Company, AnandRathi Research

Appendix

Analyst Certification

The views expressed in this Research Report accurately reflect the personal views of the analyst(s) about the subject securities or issuers and no part of the compensation of the research analyst(s) was, is, or will be directly or indirectly related to the specific recommendations or views expressed by the research analyst(s) in this report. The research analysts are bound by stringent internal regulations and also legal and statutory requirements of the Securities and Exchange Board of India (hereinafter "SEBI") and the analysts' compensation are completely delinked from all the other companies and/or entities of Anand Rathi, and have no bearing whatsoever on any recommendation that they have given in the Research Report.

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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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