Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Aarti Industries Ltd

High capex intensity creates long growth runway

Speciality Chem	Sharekhan code: AARTIIND
Reco/View: **Buy** ↔	CMP: **Rs. 976** / Price Target: **Rs. 1,155** ↔

↑ Upgrade ↔ Maintain ↓ Downgrade

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		↔	

ESG Disclosure Score NEW

ESG RISK RATING 35.34

Updated Nov 08, 2021

High Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

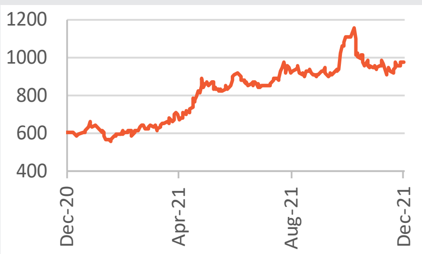
Company details

Market cap:	Rs. 35,371 cr
52-week high/low:	Rs. 1,168 / 537
NSE volume: (No of shares)	10.9 lakh
BSE code:	524208
NSE code:	AARTIIND
Free float: (No of shares)	20.2 cr

Shareholding (%)

Promoters	44
FII	12
DII	15
Others	29

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	3.9	5.1	7.5	60.2
Relative to Sensex	5.8	4.1	(4.5)	32.7

Sharekhan Research, Bloomberg

Summary

- The recent rise in price of some of the key products in the NCB value chain, easing of freight charges and liquidation of high-cost inventory in pharma business bodes well for improvement in EBIT margin of specialty chemical/pharma segment to 20%/18-20% by Q4FY22 as compared to 16.4%/14.8% in Q2FY22.
- Management has guided for a high capex plan of Rs. 4,500-5,000 crore over FY22E-24E, which would double Aarti Industries gross block to >Rs. 10,000 crore by FY24E and provides longevity to the earnings growth cycle. Management has guided for PAT growth of 1.7x-2x/3x-4x by FY24E/FY27E over FY21.
- The management is planning to demerge the pharma business into a separate company and list it on the stock exchanges, which could unlock value for Aarti Industries and remain key near-term catalyst.
- We maintain a Buy on Aarti Industries with an unchanged PT of Rs. 1,155 as high capex intensity would drive sustained high earnings growth and China plus one strategy would strengthen global scale (from current position of top-3 global producers of Nitro Chloro Benzene and Di-Chloro Benzene).

Aarti Industries Limited has seen prices of some of its key products in the NCB value chain rise and demand from high margin discretionary sectors has already recovered above pre-Covid level. Additionally, international freight costs have also cooled off recently while liquidation of high cost finished goods inventory in Pharma business is also largely over now. Thus, we expect EBIT margin for its specialty chemical/pharma business to recover to over 20%/18-20% by Q4FY22 versus 16.4%/14.8% in Q2FY22. We expect Aarti Industries to be one of the biggest beneficiaries of China plus one strategy by global companies and import substitution in India and thus continued high capex intensity (Rs. 4,500-5,000 crore over FY22E-24E) to drive earnings growth (expect 33% PAT CAGR over FY21-24E).

- **Specialty chemical margins to improve as prices of key products in NCB chain rises, pharma margin on recovery mode:** Prices of some of Aarti Industries' key products in NCB value chain (~20% of overall revenues) have risen amid supply chain issues in China and demand from high-margin discretionary sectors (automotive, aviation, real estate, textile, electronics, etc) has also recovered above pre-COVID levels. In addition, international freight costs have also eased recently (although that is yet to sustain) supported by improved availability of containers. Thus, we expect margins of the specialty chemical business to see improvement and reach 20% plus level by Q4FY2022 as compared to 16.4% in Q2FY2022. In pharma segment, the company has largely liquidated high cost finished goods inventory and is on track to commercialise new API/intermediate products in H2FY22. This bodes well for recovery in pharma margins to 18-20% from 14.8% in Q2FY22.
- **Aggressive capex plan to drive growth; PAT growth guidance of 1.7x-2x/3-4x by FY24E/FY27E over FY21:** The company has spent capex of ~Rs. 3,258 crore over FY19-21 but revenue contribution remained low given weak demand due to overall slowdown and COVID-19. However, with demand recovery in site we believe that this capex would drive strong growth over FY21-24E. Additionally, the company has embarked an aggressive capex plan of Rs. 1,500 crore over FY22E-23E largely for two long term contracts and another Rs. 3,000-3500 crore over FY22E-24E for new chloro toluene value chain, setting up universal multipurpose plants (UMPP), custom manufacturing and expansion and introduction of new range of pharma APIs & Intermediates. The capex would enable Aarti Industries to launch 40+ products for specialty chemicals and 50+ products for the pharma and drive earnings growth over FY21-27E (guidance of 1.7x-2x increase revenue/EBIT/PAT by FY24E and 2.5x3.5x/3x-4x/3x-4x by FY27E).
- **Demerger of pharma business to unlock value:** The company's board approved the demerger of the pharma business and allied activities of Aarti Industries Limited into Aarti Pharmalabs Limited with effect from July 1, 2021. The process would take 9-12 months for all the necessary approval. The pharma business' demerger plan could unlock value and is key near-term catalyst for Aarti Industries.

Our Call

Valuation – Maintain Buy on Aarti Industries with an unchanged PT of Rs. 1,155: We expect strong revenue/EBITDA/PAT CAGR of 28%/32%/33% over FY2021-FY2024E, led by ramp-up of new capacities and sustained high capex intensity. We believe Aarti Industries would benefit immensely from strong growth outlook for the Indian specialty chemical sector supported by the China Plus One strategy by global companies, import substitution in domestic markets (identified opportunities of ~$1 billion), and rising domestic demand for specialty chemicals. Moreover, favourable dynamics for the Indian specialty chemicals sector are likely to support premium valuation. Hence, we maintain Buy on Aarti Industries with an unchanged price target (PT) of Rs. 1,155. At the CMP, the stock trades at 35.3x its FY2023E EPS and 29.0x its FY2024E EPS.

Key Risks

1) Slowdown in demand off-take and delay in commissioning of facilities for multi-year contracts can affect revenue growth momentum. 2) Adverse commodity prices and currency movements might impact margins.

Valuation (Consolidated) Rs cr

Particulars	FY21	FY22E	FY23E	FY24E
Revenue	4,506	5,783	7,423	9,502
OPM (%)	21.8	22.7	23.3	24.0
Adjusted PAT	523	735	1,001	1,220
y-o-y growth (%)	(2.4)	40.5	36.1	21.9
Adjusted EPS (Rs.)	14.4	20.3	27.6	33.7
P/E (x)	67.6	48.1	35.3	29.0
P/BV (x)	10.1	8.4	6.9	5.7
EV/EBITDA (x)	38.2	28.9	21.8	17.2
RoCE (%)	12.4	15.7	18.0	19.5
RoE (%)	16.3	19.1	21.5	21.4

Source: Company; Sharekhan estimates

Specialty Chemicals – Margins to improve on better pricing for key products of NCB value chain, and rationalization of freight cost; management eyeing over 25% revenue growth in FY22

The management has indicated that margin for specialty chemicals segment is expected to improve gradually to over 20%+ as one-fifth of product portfolio is seeing high price led by supply disruption in China, demand environment from high margin discretionary space (automotive, aviation, real estate, textile, electronics, etc) is also above pre-COVID level and higher utilization for new plants would help absorb fixed cost. In addition, international freight costs are also declining (although is yet to be seen that the trend is sustainable) as container availability witnessing improvement. Demand environment remains strong in both domestic and exports market and management expects revenue from specialty chemical segment to grow by over 25% in FY2022 led by recovery in demand and ramp-up of recently commissioned plants (chlorination capacity increased to 175 ktpa from 110 ktpa, Phase-1 unit at Dahej SEZ) and likely start of second long term contract in H2FY22.

Pharma segment – Revenue growth seen at 20% for FY22; margin to recover as high-cost inventory gets liquidated

The company will be progressively commercializing ongoing APIs and intermediates in the next few quarters, which would help sustain strong growth momentum. These include APIs and intermediates for innovators and generic companies for varied applications such as anti-cancer, anti-asthma, anti-hypertensive drugs, oncology therapies. The company will also look at Xanthine derivatives for applications such as in beverages, and for nutraceutical and other pharma applications. The company expects pharma segment to witness 20% revenue growth in FY22 while margins are expected to recover 18-20% as the company has largely liquidated high-cost inventory, taking price hikes and international freight cost also getting rationalized.

Higher capital intensity to drive long term growth

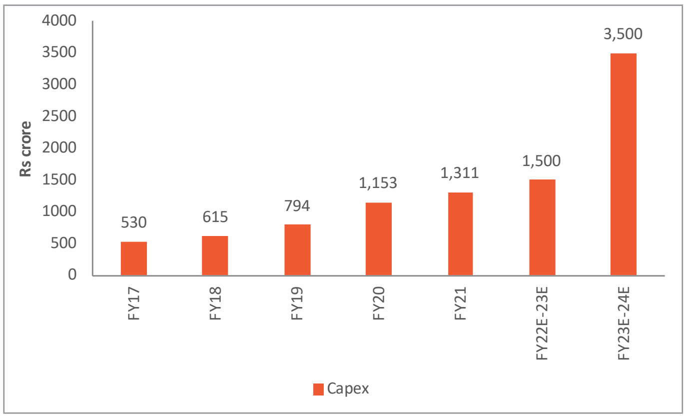
Capex during FY2019-2021: Aarti Industries spent ~Rs. 3,258 crore over FY2019-FY2021 to expand existing capacities, contract manufacturing projects, new Chlorination Unit at Jhagadia, Phase 1 Unit at Dahej SEZ for agrochemical intermediates & Specialty Chemical, Phase 2 Unit at Dahej SEZ for agrochemical intermediates and new Research & Technology Centre at Navi Mumbai. These projects are yet to fully contribute to revenue as the demand has been low on account on COVID-19 pandemic.

FY2022-23 capex guidance of Rs. 1,200-1,500 crore: The management has guided for Rs. 1200-1500 crore for FY2022-23 and the focus would be largely on: 1) Unit for second long-term contract at Dahej SEZ, 2) Unit for 3rd Long Term Contract at Jhagadia, 3) NCB Capacity Expansion at Vapi and 4) pharma business - USFDA capacity expansion for API unit at Tarapur and Intermediates unit at Vapi.

FY2022-24 capex guidance of Rs. 3,000-3,500 crore: The capex would be focused on introducing Chloro Toluene value chain, Setting up Universal Multipurpose Plants (UMPP), Newer range of Value Added products & Other Specialty Chemicals, Expansion & Introduction of new range of Pharma APIs & Intermediates,

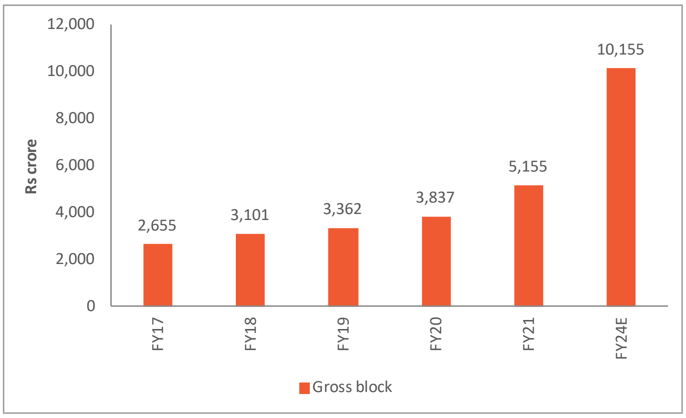
Medium to long-term growth guidance: The management guidance is very encouraging with medium term revenues/ EBIT/PAT to increase by 1.7x-2x by FY2024 over FY2021 and long-term revenues to by 2.5-3.5x, while EBIT/PAT to grow by 3-4x by FY2027 over FY2021. The sustained high growth outlook is very positive and would be supported by a continuous capex of Rs. 1,500 crore over FY2022-FY2023 and overall capex of Rs. 4,500-5,000 crore by FY2024. The management has indicated that major risk to growth guidance is depreciation of the Yuan against Indian rupee.

Aggregate capex plan of Rs. 4,500-5,000 crore over FY22-24



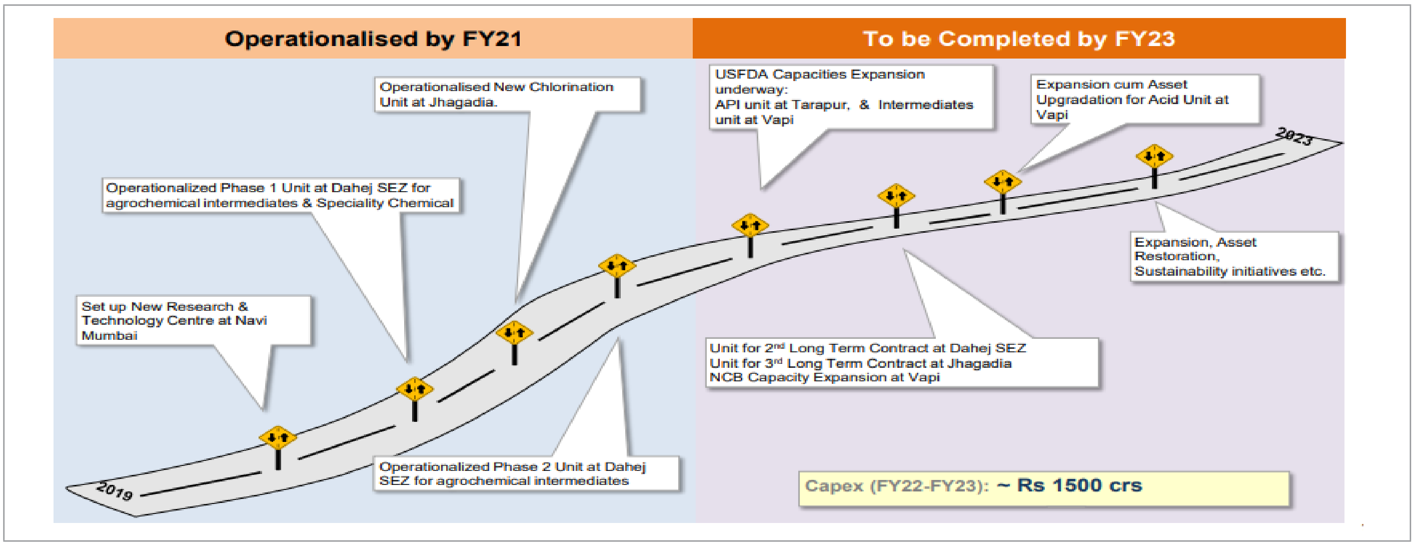
Source: Company, Sharekhan Research

Gross block to double over FY21-FY24E



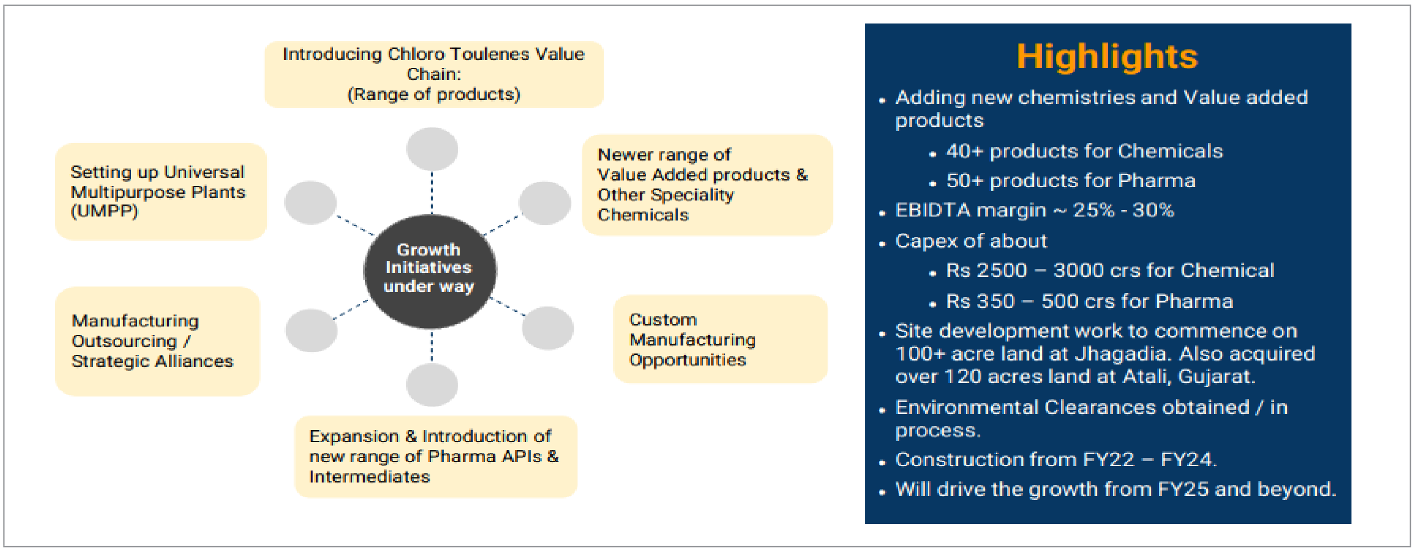
Source: Company, Sharekhan Research

Major Projects: FY19 - FY23



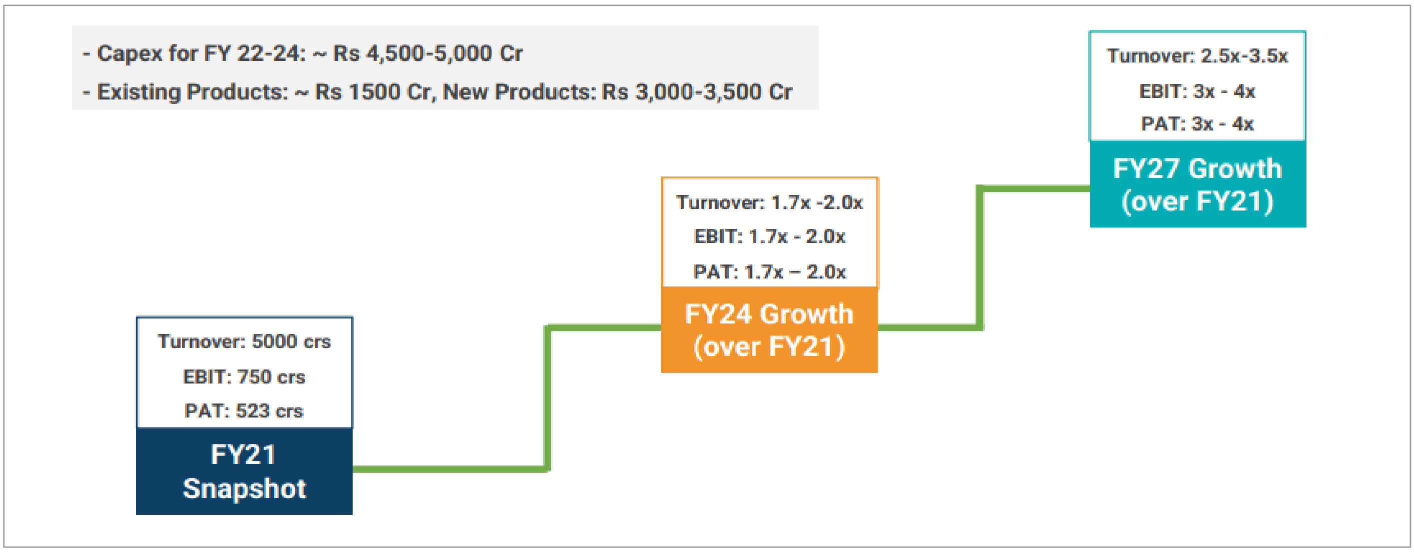
Source: Company

Future Growth Projects: FY22-24



Source: Company

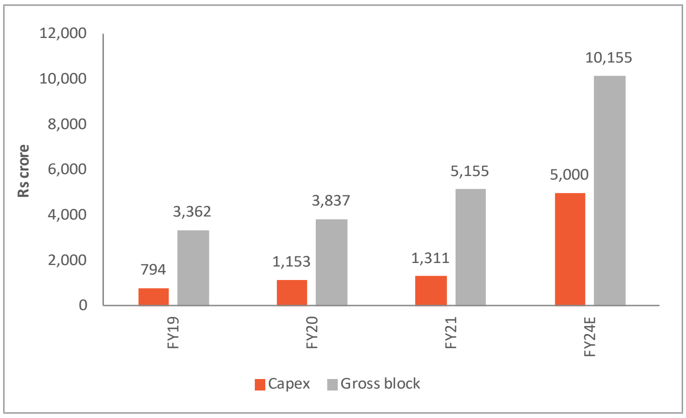
Growth guidance - aggressive capex to fuel medium to long term growth



Source: Company

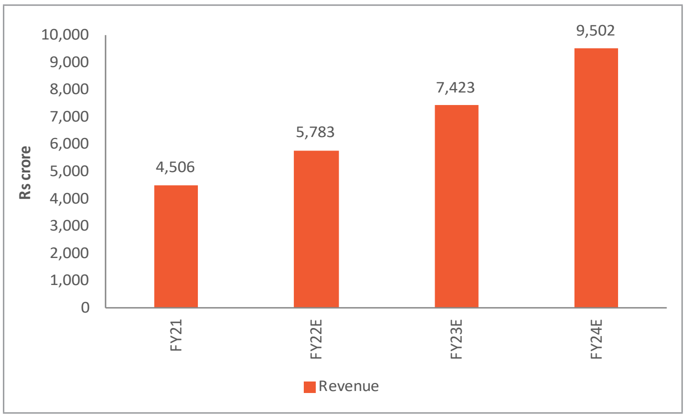
Financials in charts

High capex intensity to double gross block by FY24E



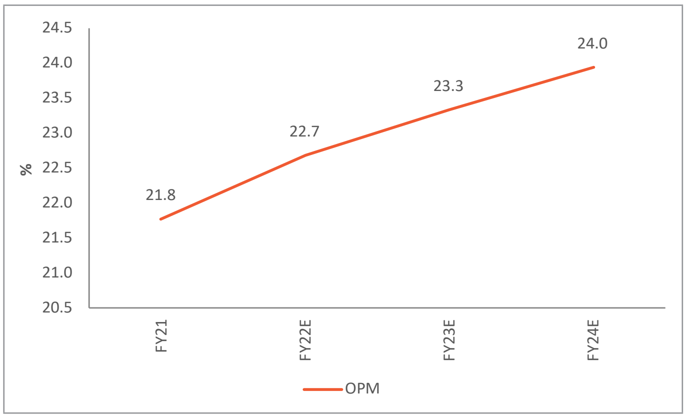
Source: Company; Sharekhan Research; Note: Rs. 5000 crore capex over FY22E-24E

Revenue to clock 28% CAGR over FY21-24E



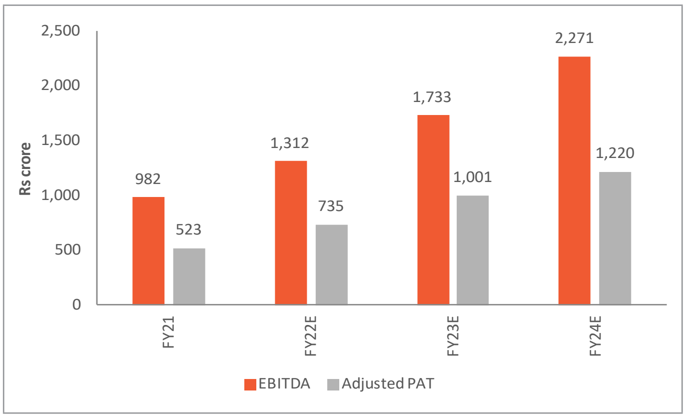
Source: Company, Sharekhan Research

Margin to improve on high value addition/capacity ramp-up



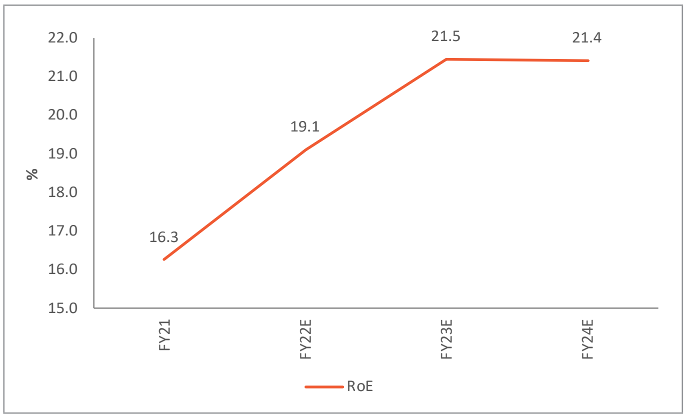
Source: Company, Sharekhan Research

EBITDA/PAT to post 32%/33% CAGR over FY21-24E



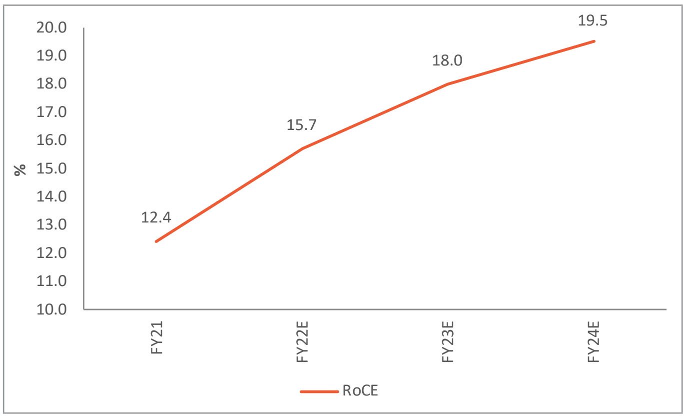
Source: Company, Sharekhan Research

RoE trend



Source: Company, Sharekhan Research

RoCE trend



Source: Company, Sharekhan Research

Outlook and Valuation

■ **Sector outlook – Structural growth drivers to drive sustained growth for specialty chemicals space in medium to long term**

We remain bullish on the 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 pharmaceutical sector). In our view, conducive government policies, product innovation, massive export opportunity, and low input prices would help the sector witness sustained high double-digit earnings growth for the next 2-3 years.

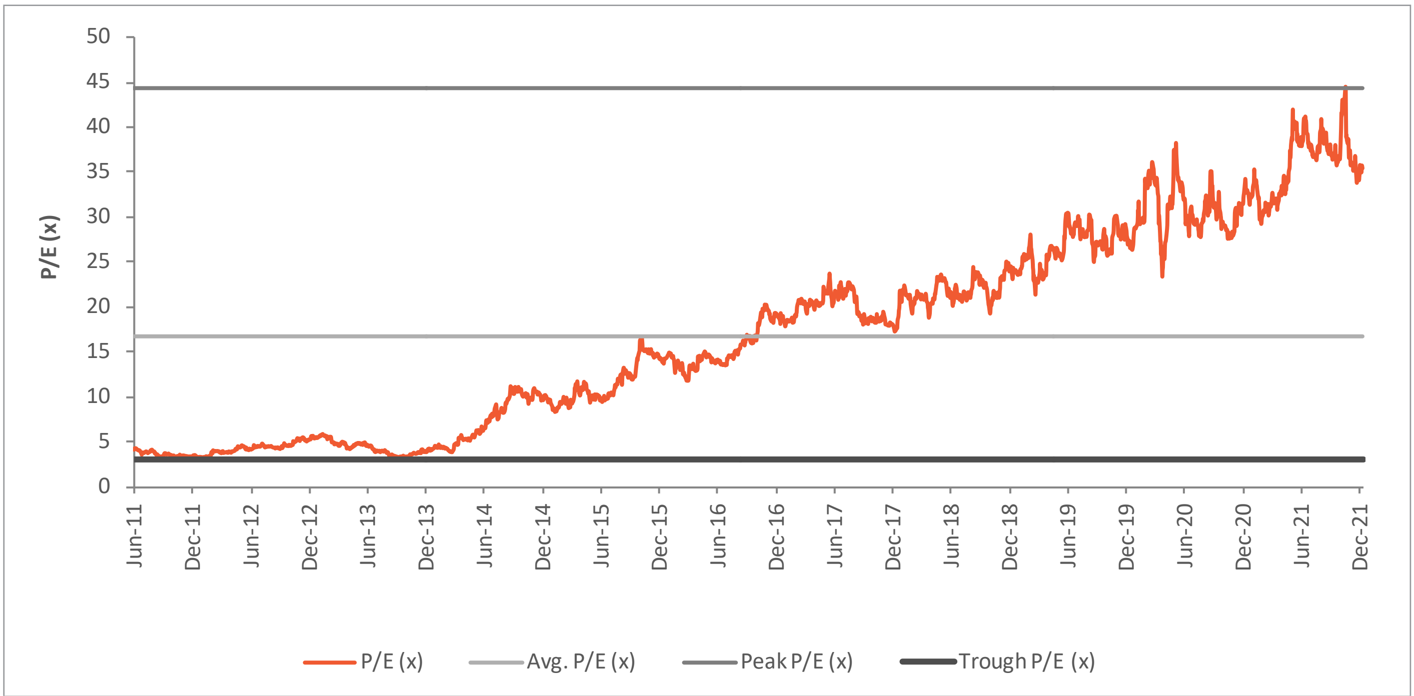
■ **Company outlook – Long-term growth intact supported by capex in right segments**

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. Issues arising out of China such as 1) Stringent regulatory environment and 2) the COVID-19 pandemic (outbreak of COVID-19 in China and its spread to other regions) have provided opportunities for Indian players to scale up their business as global players are looking for long-term relationships with suppliers who can supply quality products on a sustainable basis. Management has guided for 25-35% y-o-y growth each in revenue and PAT for FY2022.

■ **Valuation – Maintain Buy on Aarti Industries with an unchanged PT of Rs. 1,155**

Robust growth guidance of 2x/4x increase in earnings by FY2024E/FY2027E over FY2021 reinforces confidence in terms of sustained long-term, high-growth potential for Aarti Industries. Thus, we expect strong revenue/EBITDA/PAT CAGR of 28%/32%/33% over FY2021-FY2024E, led by high capex intensity in the next couple of years. We believe Aarti Industries would benefit immensely from strong growth outlook for the Indian specialty chemical sector supported by the China Plus One strategy by global companies, import substitution in domestic markets (identified opportunities of ~$1 billion), and rising domestic demand for specialty chemicals. Moreover, favourable dynamics for the Indian specialty chemicals sector are likely to support premium valuation. Hence, we maintain Buy on Aarti Industries with an unchanged PT of Rs. 1,155. At the CMP, the stock trades at 35.3x its FY2023E EPS and 29.0x its FY2024E EPS.

One-year forward P/E (x) band



Source: Sharekhan Research

About company

Aarti Industries 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 Industries is investing in the right areas for building capabilities and richer client engagements, which would create a long-term moat in a booming industry. The company has planned capex of Rs4500-5000 crore over FY22-24 and expects PAT to grow by 3-4x by FY27E versus FY21. The company dominant position in global Nitro Chloro Benzene and Di-Chloro Benzene makes it one of the biggest beneficiaries of China plus one strategy by global companies and import substitution in India. Potential demerger of pharma business into a separate company to help unlock value for Aarti Industries.

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: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	HDFC Asset Management Co. Ltd	3.4
2	Life Insurance Corp of India	3.3
3	Aditya Birla Sun Life Trustee Co. Pvt. Ltd	1.9
4	Aditya Birla Sun Life Asset Management Co. Ltd	1.8
5	Vanguard Group Inc.	1.8
6	Baron Capital Inc.	1.3
7	Baron Emerging Mrkts Fund	1.3
8	HDFC Life Insurance Co. Ltd	1.2
9	BlackRock Inc.	0.8
10	William Blair & Co. LLC	0.7

Source: Bloomberg

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

Sharekhan

by BNP PARIBAS

Know more about our products and services

For Private Circulation only

Compliance Officer: Mr. Joby John Meledan; Tel: 022-61150000; email id: compliance@sharekhan.com;

For any queries or grievances kindly email igc@sharekhan.com or contact: myaccount@sharekhan.com

---

Registered Office: Sharekhan Limited, 10th Floor, Beta Building, Lodha iThink Techno Campus, Off. JVLR, Opp. Kanjurmarg Railway Station, Kanjurmarg (East), Mumbai – 400042, Maharashtra. Tel: 022 - 61150000. Sharekhan Ltd.: SEBI Regn. Nos.: BSE / NSE / MSEI (CASH / F&O / CD) / MCX - Commodity: INZ000171337; DP: NSDL/CDSL-IN-DP-365-2018; PMS: INP000005786; Mutual Fund: ARN 20669; Research Analyst: INH000006183;