Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

Result Update

Aarti Industries Ltd

Strong Q1; long-term growth guidance intact

Speciality Chem	Sharekhan code: AARTIIND		
Reco/View: Buy ↔	CMP: **Rs. 815**	Price Target: **Rs. 1,000** ↔	

↑ 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 July 08, 2022

High Risk

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

Source: Morningstar

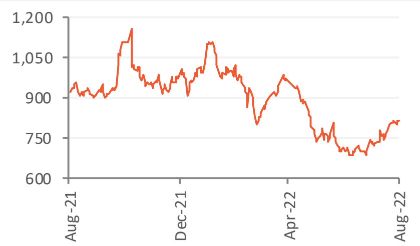
Company details

Market cap:	Rs. 29,537 cr
52-week high/low:	Rs. 1,168/669
NSE volume: (No of shares)	7.8 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	11.8	10.0	-17.5	-12.1
Relative to Sensex	1.7	-2.1	-19.5	-20.2

Sharekhan Research, Bloomberg

Summary

- Q1FY23 operating profit/adjusted PAT of Rs. 369 crore/Rs. 219 crore, up 18%/24% y-o-y beat our estimate led by a strong volume growth of 15-20% y-o-y, resilient absolute margins on price hikes and a lower tax rate. We have adjusted reported PAT of Rs. 189 crore for negative forex impact of Rs. 30 crore.
- Specialty chemical/pharma segments' revenues grew strongly by 44%/48% y-o-y to Rs. 1,766 crore/Rs. 407 crore led by volume growth and price hikes on pass of RM/logistic cost. Although OPM of 18.7% (largely in-line) declined by 510 bps/59 bps y-o-y/q-o-q, but the company was able to maintain absolute delta margins.
- High single-digit EBITDA growth for FY23 is maintained as management sees slowdown in domestic textile and FMCG sector. It reiterated revenue/PAT growth guidance of 1.7-2x by FY24 versus FY21 as fixed cost for new projects to be absorbed in FY23. Guided for 70%+ utilization for first/second long-term contract by FY24-end.
- We maintain a Buy on Aarti Industries with an unchanged PT of Rs. 1,000. We believe it would be a key beneficiary of the China plus One strategy and a massive capex would drive strong earnings growth. Pharma business demerger could unlock value and is a key near-term catalyst.

Aarti Industries Limited's performance was good in Q1FY23 with stronger-than-expected revenue growth of 49.8% y-o-y and 12.3% q-o-q to Rs. 1,972 crore (5.6% above our estimate) led by 15-20% y-o-y volume growth and a 25-30% y-o-y rise in realisation on price hikes to pass on higher raw material/logistics costs. Specialty chemical segment's revenues increased by 44% y-o-y to Rs. 1,766 crore supported by a higher volume trajectory, ramp-up of first/second long term contracts and price hikes however; shortage of nitric acid continue to affect growth. Revenue from pharmaceutical segment grew by 48% y-o-y to Rs. 407 crore led by higher demand trajectory for key products from generic pharma/Xanthine businesses and healthy realisations. Although OPM of 18.7% (largely in-line) declined by 510 bps/59 bps y-o-y/q-o-q, the company was able to maintain absolute delta margin (i.e. per kg margin) and thus operating profit grew strongly by 17.7% y-o-y and 8.9% q-o-q to Rs. 369 crore, 4% above our estimate of Rs. 355 crore. Specialty chemical/pharma EBIT increased by 7.7%/45.7% y-o-y to Rs. 250 crore/Rs. 76 crore. PAT (adjusted for negative forex impact of Rs. 30 crore) at Rs. 219 crore (up 24.3% y-o-y; up 12.7% q-o-q), was 12% above our estimate of Rs. 196 crore reflecting beat in operating profit and lower-than-expected tax rate of 19% (versus assumption of 20%).

Key positives

- Stronger-than-expected revenue growth of 50% y-o-y led by volume growth and price hikes.
- Robust pharma EBIT margin of 18.7%, up 153 bps q-o-q.

Key negatives

- Gross margin declined sharply by 935 bps/318 bps y-o-y/q-o-q to 44.3%.

Management Commentary

- Management maintained high single-digit EBITDA growth for FY23 as it is seeing demand slowdown (especially from textile and FMCG sector in domestic market) and would look to revise guidance post Q2FY23. FY24 would witness strong EBITDA growth as fixed cost for new projects is expected to be absorbed in FY23.
- Company maintained medium-term growth guidance of revenue/EBITDA/PAT of 1.7x-2x for FY24 over FY21 and long-term growth guidance for revenue at 2.5x-3.5x, while EBITDA/PAT growth at 3x-4x by FY27 over FY21.
- First/second long-term contract started and has witnessed ramp-up in Q1FY23; management guided to further ramp-up in utilisation to over 70%+ by FY24-end. It commenced commercial production at USFDA approved API facility at Tarapur in early Q2FY22.
- Capex for third long-term contract, NCB capacity expansion, and other projects are on track, and expected to be commissioned in a phases starting in the latter part of FY23. Capex guidance of Rs. 4,500-5,000 crore (including Rs. 1,500 crore for existing products and Rs. 3,000-3,500 crore for new products) over FY23E-24E.
- NCLT hearing for pharma demerger concluded on August 01, 2022 and it expects the order to be issued soon. The company would take necessary actions to make demerger effective immediately.

Revision in estimates – We maintain our FY2023-FY2024 earnings estimate.

Our Call

Valuation – Maintain Buy on Aarti Industries with an unchanged PT of Rs. 1,000: 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 a strong revenue/EBITDA/PAT CAGR of 22%/25%/26% over FY2022-FY2024E, led by high capex intensity over the next couple of years. We believe that Aarti Industries would benefit immensely from a strong growth outlook for the Indian specialty chemical sector supported by the China Plus One strategy of 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 a Buy rating on the stock with an unchanged price target (PT) of Rs. 1,000. At the CMP, the stock trades at 38x its FY2023E EPS and 26.7x its FY2024E EPS.

Key Risks

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

Valuation (Consolidated) Rs cr

Particulars	FY21	FY22	FY23E	FY24E
Revenue	4,506	6,369	7,256	9,512
OPM (%)	21.8	20.7	20.2	21.9
Adjusted PAT	523	697	777	1,105
y-o-y growth (%)	*(2.4)*	*33.2*	*11.5*	*42.1*
Adjusted EPS (Rs.)	14.4	19.2	21.4	30.5
P/E (x)	56.4	42.4	38.0	26.7
P/BV (x)	8.4	5.0	4.5	4.0
EV/EBITDA (x)	32.2	23.9	21.9	16.1
RoCE (%)	12.4	13.7	12.3	15.2
RoE (%)	16.3	14.8	12.4	15.7

Source: Company; Sharekhan estimates

Strong growth sustained in Q1 led by volume growth and resilient margin despite high cost

Q1FY23 performance was good with stronger-than-expected revenue growth of 49.8% y-o-y and 12.3% q-o-q to Rs. 1972 crore (5.6% above our estimate) led by 15-20% y-o-y volume growth and a 25-30% y-o-y rise in realisation on price hikes to pass on higher raw material/logistics costs. Specialty chemical segment's revenues increased by 44% y-o-y to Rs. 1,766 crore supported by a higher volume trajectory, ramp-up of first/second long term contracts and price hikes however; shortage of nitric acid continues to affect growth. Revenue from pharmaceutical segment grew by 48% y-o-y to Rs. 407 crore led by higher demand trajectory for key products from generic pharma/Xanthine businesses and healthy realisations. Although OPM of 18.7% (largely in-line) declined by 510 bps/59 bps y-o-y/q-o-q, the company was able to maintain absolute delta margin (i.e. per kg margin) and thus operating profit grew strongly by 17.7% y-o-y and 8.9% q-o-q to Rs. 369 crore, 4% above our estimate of Rs. 355 crore. Specialty chemical/pharma EBIT increased by 7.7%/45.7% y-o-y to Rs. 250 crore/Rs. 76 crore. PAT (adjusted for negative forex impact of Rs. 30 crore) at Rs. 219 crore (up 24.3% y-o-y; up 12.7% q-o-q), was 12% above our estimate of Rs. 196 crore reflecting beat in operating profit and lower-than-expected tax rate of 19% (versus assumption of 20%).

Q1FY2023 key conference call highlights

- **Inflationary headwinds affect demand from certain sectors:** Inflationary environment is posing some challenges for the company and they are witnessing a softness in demand from domestic textile and FMCG companies; yet the company has posted strong revenue growth led by high volumes due to new capacities and ramp-up in production and also due to firm selling prices. Company has managed to pass on input costs but with a time lag, which has led to drop in the gross margins during the quarter.
- **Growth guidance unchanged:** The management reiterated its guidance for high single digit growth in EBITDA for FY23. Management has maintained its revenue/EBITDA/PAT growth guidance of 1.7-2x for FY24 and maintained long-term growth guidance of 2.5-3.5x in turnover and 3-4x growth in EBITDA/PAT for FY27 over FY21.
- **Backward integration for Nitric Acid:** Planned capex of Rs. 150-200 crore for its key raw material nitric acid with a capacity of 225-250 TPD (expected by Q4FY24). Management expressed some concerns over the availability of nitric acid in H2FY23 but expects supply to normalise in FY24.
- **Update on long-term contracts:** The project related to the first and second long-term contract has started seeing volume ramp up and utilisation levels are expected to increase to ~70%+ by FY24-end. Third long-term contract will be commissioned in Q2FY23.
- **Tarapur API facility commencement and Pharma demerger update:** Commenced commercial production at the new block of the USFDA approved API facility at Tarapur in early Q2, which would further strengthen the company's niche offerings in Pharma and lead to positive contribution in subsequent quarters. NCLT hearing for pharma demerger concluded on August 01, 2022 and expect the order to be issued soon. The company would take necessary actions to make demerger effective immediately.
- **USFDA observations on Dombivali facility:** In June 2022, company received two USFDA observations for its Dombivli facility under regulation 483. Company is confident of addressing the same and obtaining the EIR. With that, the Dombivali facility will be the company's third USFDA site.
- **Capex:** Capex stood at Rs. 200 crore in Q1FY23 and the management guided for a capex of Rs. 1,500 crore in FY23. FY23-24, company will have a capex plan of about Rs. 2500-3000 crore for chemicals and Rs. 350-500 crore for pharmaceuticals, which will drive the growth from FY25 and beyond.

- **Production updates:** Production of nitro-chlorobenzene stood at 20,515 MT versus 19,551 MT in Q4FY22. Production of hydrogenated products stood at 3,295 MT/month versus 3,029 MT /month in Q4FY22. Nitro-toluene production stood at 5,252 MT versus 5,155 MT in Q4FY2022. Production of PDA was at 370 MT/month. In Q1FY23, Capacity utilization rates were at 100% for nitro-chlorobenzene and 70% for Nitro-toluene.
- **Others:** Finance cost increased by Rs. 30 crore led by significant rupee depreciation during the quarter.

Results (Consolidated) Rs cr

Particulars	Q1FY23	Q1FY22	YoY (%)	Q4FY22	QoQ (%)
Revenue	**1,972**	**1,317**	**49.8**	**1,756**	**12.3**
Total expenditure	1,603	1,003	59.8	1,417	13.1
Operating profit	369	314	17.7	339	8.9
Other Income	0.4	0.1	660.0	0.2	123.5
Depreciation	87	69	26.1	77	12.0
Interest	50	38	30.1	31	62.7
PBT	**233**	**207**	**12.8**	**231**	**0.8**
Tax	44	42	5.7	38	17.6
Reported PAT	189	165	14.7	194	(2.4)
Adjusted PAT	**219**	**176**	**24.3**	**195**	**12.7**
Reported EPS (Rs.)	**5.2**	**4.5**	**14.7**	**5.3**	**(2.4)**
Adjusted EPS (Rs.)	6.0	4.9	24.3	5.4	12.7
Margin (%)			**BPS**		**BPS**
OPM	18.7	23.8	(510)	19.3	(59)
NPM	9.6	12.5	(293)	11.0	(145)
Tax Rate	19.0	20	(126)	16	270

Source: Company; Sharekhan Research

Segmental performance Rs cr

Particulars	Q1FY23	Q1FY22	YoY (%)	Q4FY22	QoQ (%)
Revenue					
Speciality Chemicals	1,766	1,228	43.8	1,629	8.4
Pharmaceuticals	407	276	47.8	388	4.8
Less: GST	201	187	7.7	262	(23.4)
Total Revenue	**1,972**	**1,317**	**49.8**	**1,756**	**12.3**
EBIT					
Speciality Chemicals	250	232	7.7	246	2.0
Pharmaceuticals	76	52	45.7	67	14.2
Total EBIT	**327**	**285**	**14.7**	**312**	**4.6**
EBIT margin			**bps**		**bps**
Speciality Chemicals	14.2	18.9	(475)	15.1	(89)
Pharmaceuticals	18.7	19.0	(27)	17.2	153
Overall EBIT margin	**16.6**	**21.6**	**(506)**	**17.8**	**(123)**

Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector View – Structural growth drivers to drive sustained growth for specialty chemicals 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 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 costs would help the sector witness sustained high double-digit earnings growth for the next 2-3 years.

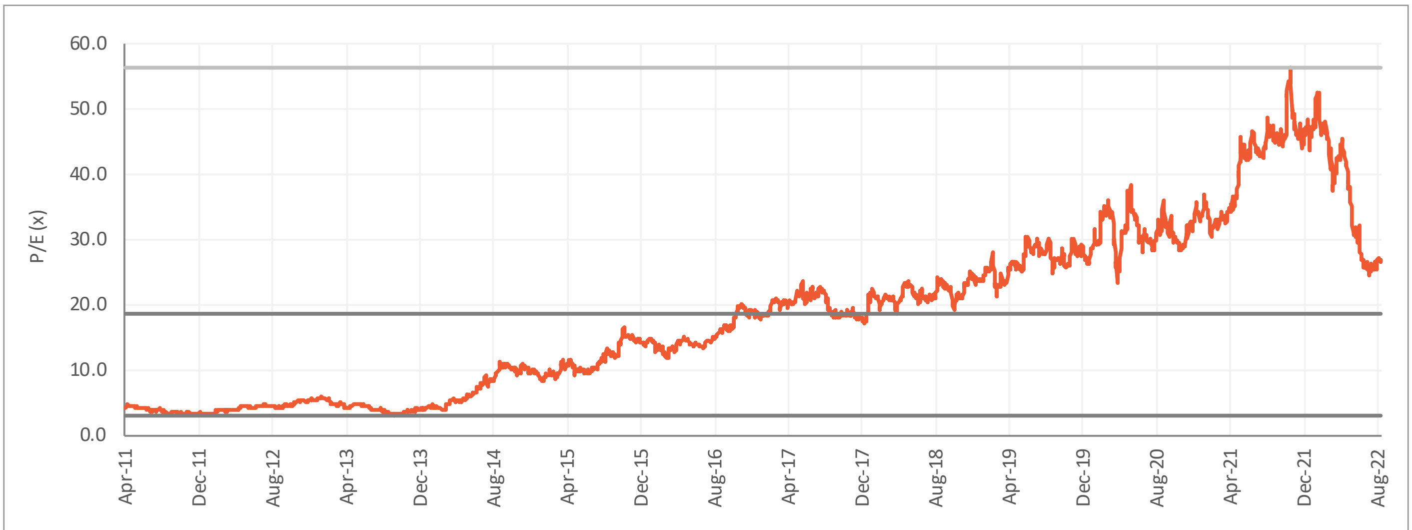
■ Company Outlook – Long-term growth intact supported by capex in the right space

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. 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 offer quality products on a sustainable basis.

■ Valuation – Maintain Buy on Aarti Industries with an unchanged PT of Rs. 1,000

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 a strong revenue/ EBITDA/PAT CAGR of 22%/25%/26% over FY2022-FY2024E, led by high capex intensity over the next couple of years. We believe that Aarti Industries would benefit immensely from a strong growth outlook for the Indian specialty chemical sector supported by the China Plus One strategy of 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 a Buy rating on the stock with an unchanged price target (PT) of Rs. 1,000. At the CMP, the stock trades at 38x its FY2023E EPS and 26.7x 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. Expanding capacity for Nitro chlorobenzene (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 they 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 affect margins.

Additional Data

Key management personnel

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

Source: Company Website

Top shareholders

Sr. No.	Holder Name	Holding (%)
1	Life Insurance Corp of India	4.3
2	HDFC Asset Management Co. Ltd	2.9
3	Baron Capital Inc.	2.8
4	Aditya Birla Sun Life Trustee Co. Pvt. Ltd	1.8
5	Vanguard Group Inc.	1.8
6	Aditya Birla Sun Life Asset Management Co. Ltd	1.8
7	HDFC Life Insurance Co. Ltd	1.2
8	BlackRock Inc.	0.8
9	Norges Bank	0.7

Source: Bloomberg (old data)

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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