Stock Update

Result Update

Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Aarti Industries Ltd

Subdued Q2; downgrade to hold as valuation limits upside

Specaility Chem	Sharekhan code: AARTIIND	
Reco/View: Hold ↓	CMP: **Rs. 677**	Price Target: **Rs. 730** ↓

↑ 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 Updated Oct 08, 2022	35.34

High Risk

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

Source: Morningstar

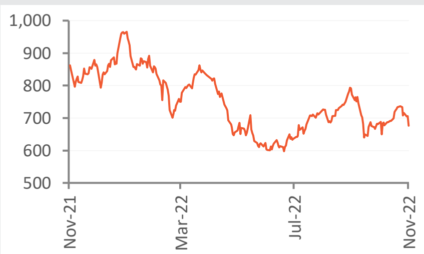
Company details

Market cap:	Rs. 24,534 cr
52-week high/low:	Rs. 1,031/617
NSE volume: (No of shares)	8.2 lakh
BSE code:	524208
NSE code:	AARTIIND
Free float: (No of shares)	20.2 cr

Shareholding (%)

Promoters	44
FII	12
DII	15
Others	0

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-1.7	-6.8	0.4	-21.6
Relative to Sensex	-7.8	-9.6	-13.7	-24.8

Sharekhan Research, Bloomberg

Summary

- We downgrade our rating on Aarti Industries to Hold with a revised PT of Rs. 730, given limited upside potential as valuation of 32x its FY24E EPS largely factors in expectation of earnings recovery over FY2024-FY2025. H2FY23 earnings outlook is muted while capex is likely to remain high with potential rise in debt.
- Q2FY2023 results were muted with a 5%/8% q-o-q decline in operating profit/PAT to Rs. 267 crore/Rs. 124 crore amid muted revenue growth, steep contraction of 455 bps/164 bps y-o-y/q-o-q in OPM to 15.8%, maintenance shutdown at Jhagadia unit, and rise in depreciation/interest cost.
- Subdued revenue growth was due to demand slowdown for certain products from the dyes/pigment industry. Management expects recovery for dyes from Q3FY2023 and that for pigments from Q4FY2023. Prior-period financials have been restated to reflect the demerger of the pharma business into Aarti Pharmalabs (aims to list by December 2022).
- Management's FY2023 EBITDA guidance of Rs 1,100 crore would mean flat q-o-q EBITDA in H2FY2023. Management is expected to continue with its capex plan despite slowdown as it is confident of long-term demand visibility and has guided for 25% EBITDA CAGR over FY2023E-FY2025E.

Aarti Industries Limited (Aarti) reported subdued Q2FY2023 performance with muted revenue/operating profit of Rs. 1,685 crore/Rs. 267 crore, up 4.6%/down 5.1% q-o-q due to demand pressure for certain products for the dyes/pigment industry and lower volumes (Rs. 15 crore impact) due to three-week shutdown for Jhagadia unit. Operating profit margin (OPM) contracted by 455 bps y-o-y/164 bps q-o-q to 15.8%, but the company was able to maintain absolute per unit margin as it passed on elevated raw-material price to customers. PAT declined by 17% y-o-y and 8.2% q-o-q to Rs. 124 crore due to higher finance cost (up 3x y-o-y due to Rs. 20 crore MTM FX impact in respect of unhedged ECBs) and rise in depreciation cost (up 27% y-o-y), given addition of new capacities partially offset by slightly lower tax rate of 17.2% (down 105 bps y-o-y). Aarti has restated its prior-period financials to reflect the demerger of the pharma business into Aarti Pharmalabs Limited from the appointed date of July 1, 2021.

Key positives

- Maintained absolute per unit gross margin supported by pass-through of high raw-material price.
- Management has guided for 25% EBITDA CAGR over FY2023E-FY2025E and is expected to reach Rs. 1,700 crore in FY2025.

Key negatives

- Muted revenue growth of 4.6% q-o-q due to demand slowdown from the dyes/pigment industry.
- OPM under pressure with a sharp decline of 455 bps y-o-y/164 bps q-o-q to 15.8%.

Management Commentary

- FY2023 EBITDA guidance of Rs. 1,100 crore implies flat q-o-q EBITDA for H2FY2023, given subdued demand from the dyes/pigment industry. Management has guided for a 25% EBITDA CAGR over FY2023E-FY2025E and expects it to reach Rs.1,700 crore in FY2025.
- Q2FY2023 witnessed subdued demand from end-user industries of dyes and pigments. Management expects demand from the dyes/pigment industry to witness recovery from Q3FY2023/Q4FY2024.
- Capex guidance of Rs. 1,100 crore-1,200 crore/Rs. 1,000-1,200 crore for FY2023/FY2024 and not looking to slowdown capex as management has long-term demand visibility for its products. Debt would increase going forward due to capex plan.
- The company announced ~Rs. 200 crore project to expand its ethylation capacity from 7,000-10,000 MTPA and expects it to be commissioned in H1FY2025. The company will also spend on debottlenecking its nitrotoluene capacity from 30,000 to 45,000 MTPA.

Revision in estimates – We have revised our FY2023-FY2024 earnings estimates to reflect post-merger financials and management guidance. We have also introduced our FY2025 earnings estimates in this report.

Our Call

Valuation – Downgrade Aarti Industries to Hold with a revised PT of Rs. 730: Uncertainties in global economic growth outlook and near-term subdued demand from the dyes/pigment industry would keep Aarti's earnings under pressure in FY2023 (expect PAT to decline by 20%), given high exposure to exports/discretionary. Moreover, valuation of 32x/28x its FY2024E/FY2025E EPS largely factors in potential strong earnings recovery with our expectation of 24%/29% EBITDA/PAT CAGR over FY2023E-FY2025E (led by commissioning of new capacities) and ignores near term weak return profile, and likely increase in debt, given aggressive capex plans. Hence, we downgrade Aarti to Hold (from Buy) with a revised price target (PT) of Rs. 730.

Key Risks

- Faster-than-expected ramp-up for facilities and multi-year contracts, strong demand recovery from the dyes/pigments industry, and lower raw-material cost could improve revenue growth/margin and are key upside risks to our earnings estimate and valuation.
- Slowdown in demand, delay in commissioning of facilities for multi-year contracts, adverse commodity price, and currency movement are key downside risks.

Valuation (Consolidated) Rs cr

Particulars	FY21	FY22	FY23E	FY24E	FY25E
Revenues	4,506	5,454	6,924	8,298	9,443
OPM (%)	21.8	20.3	15.5	17.6	17.5
Adjusted PAT	523	659	527	774	878
y-o-y growth (%)	*(2.4)*	*25.9*	*(20.0)*	*46.9*	*13.4*
Adjusted EPS (Rs.)	14.4	18.2	14.5	21.4	24.2
P/E (x)	46.9	37.2	46.5	31.7	27.9
P/BV (x)	7.0	5.4	5.0	4.5	4.0
EV/EBITDA (x)	27.1	24.0	25.2	19.3	17.1
RoCE (%)	12.4	12.7	10.1	12.2	12.3
RoE (%)	16.3	14.3	11.2	14.9	15.1

Source: Company; Sharekhan estimates; Note: FY2022 P&L and balance sheet numbers have been restated to reflect the demerger of the pharma business from the appointed date of July 1, 2021

Muted Q2 revenue growth amid demand softness in certain industry segments; Weak margin performance

The company reported subdued Q2FY2023 performance with muted revenue/operating profit of Rs. 1,685 crore/Rs. 267 crore, up 4.6%/down 5.1% q-o-q due to demand pressure for certain products for the dyes/ pigment industry and lower volumes (Rs. 15 crore impact) because of three-week shutdown for Jhagadia unit. OPM contracted by 455 bps y-o-y/164 bps q-o-q to 15.8%, but the company was able to maintain absolute per unit margin as it passed on the elevated raw-material price to customers. PAT declined by 17% y-o-y and 8.2% q-o-q to Rs. 124 crore due to higher finance cost (up 3x y-o-y because of Rs. 20 crore MTM FX impact in respect of unhedged ECBs) and rise in depreciation cost (up 27% y-o-y), given addition of new capacities, partially offset by slightly lower tax rate of 17.2% (down 105 bps y-o-y). Aarti has restated its prior-period financials to reflect the demerger of the pharma business into Aarti Pharmalabs Limited from the appointed date of July 1, 2021.

Q2FY2023 key conference call highlights

- **Demand outlook:** Outlook for H2FY2023 is muted as demand for dyes and pigments is weak, given challenges in the textile and printing sectors. Demand for dyes is recovering in Q3, but demand for pigments is still weak and the company is hopeful of recovery in demand in FY2024. The demand for agrochemicals and additives has been strong.
- **Inflationary headwinds put margins under pressure:** Q2 margins were under pressure due to increased rawmaterial, utility, and freight costs. The Company passed on costs but with a time lag, which has led to a drop in margins during the quarter. Raw-material and freight costs are expected to decline in Q3 and export margins are likely to improve as raw-material cost pass-through has a three-month lag in exports versus one month for the domestic business.
- **Production updates:** Production of nitro-chlorobenzene stood at 20,276 MT in Q2FY2023 versus 20,515 MT in Q1FY2023. nitrotoluene production stood at 4,950 MT in Q2FY2023 versus 5,252 MT in Q1FY23. Production of PDA was at 242/month in Q2FY2023 versus 370 MT/month in Q1FY2023. The drop in production was due to three-week maintenance shutdown in Jhagadia plant, and the company incurred an additional cost of Rs. 15 crore towards it.
- **Project updates:** NCB capacity expansion is expected to be completed by Q1FY2024. Chloro-toluene project is expected to be commissioned by H2FY2025-FY2026. The third long-term project is expected to be commissioned by the end of Q3. Other projects in Vapi are likely to be commissioned in the next four quarters and should meaningfully contribute to FY2024 revenue. Concentrated nitric acid plant for captive use will be commissioned in Q4FY2024 and the company will need more time to formulate a comprehensive strategy for nitric acid management.
- **Capex guidance:** Capex stood at Rs. 577 crore in H1FY2023 and management has guided for a capex of Rs. 1,100 crore-1,200 crore in FY2023. Collective capex for FY2024 and FY2025 would be Rs. 3,000 crore. Capex will not slow down as the management has long-term demand visibility. Debt will increase going forward, as capex requirements will exceed the cash flow from operating activities. The company has announced ~Rs. 200 crore project to triple its ethylation capacity from 7,000-10,000 MTPA and expects it to be commissioned in H1FY2025. The company will also spend on debottlenecking its nitrotoluene capacity from 30,000 to 45,000 MTPA.
- **EBITDA and tax guidance:** Management has given an EBITDA guidance of Rs. 1,100 crore for FY2023, which means H2FY2023 EBITDA will be largely flat versus H1FY2023 due to muted demand. Management expects EBITDA of ~Rs. 1,700 crore by FY2025 at a CAGR of 25%. The company expects tax rate to be 18-21% going forward.

- **Others:** 1) Aarti Pharmalabs is likely to be listed by December 2022. 2) About Rs. 1,200 of gross block and ~Rs. 700 crore-800 crore of net block were transferred to the pharma division. Gross block of specialty chemicals business was ~Rs. 5,000 crore in FY2022. 3) The company said there was no significant impact of nitric acid shortages in Q2 as demand has declined and additional capacities are coming up. 4) Exports share in total revenue stood at 50% and VAPs contributed to 78% of total revenue. 5) The decline in raw-material prices will bring down the working capital, however DSO will remain fairly stable.

Results (Consolidated) — **Rs cr**

Particulars	Q2FY23	Q2FY22	YoY (%)	Q1FY23	QoQ (%)
Revenue	**1,685**	**1,256**	**34.2**	**1,610**	**4.6**
Total expenditure	1,418	1,001	41.7	1,329	6.7
Operating profit	**267**	**255**	**4.8**	**282**	**(5.1)**
Other Income	0.0	0.5	(96.1)	0.4	(94.7)
Depreciation	73	57	27.0	72	1.6
Interest	44	14	202.6	45	(1.8)
PBT	**150**	**184**	**(18.0)**	**166**	**(9.2)**
Tax	26	34	(22.8)	30	(13.8)
Reported PAT	**124**	**150**	**(17.0)**	**136**	**(8.2)**
Reported EPS (Rs.)	3.4	4.1	(17.0)	5.3	(35.7)
Margin (%)			**BPS**		**BPS**
OPM	15.8	20.3	(445)	17.5	(164)
NPM	7.4	11.9	(456)	8.4	(103)
Tax Rate	17.2	18	(105)	18.2	(92)

Source: Company; Sharekhan Research

Outlook and Valuation

- **Sector View – Structural growth drivers to drive sustained growth for specialty chemicals in the 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 – Muted near-term outlook on subdued demand; Capex to drive long-term growth**

Outlook for H2FY2023 is muted as demand for dyes and pigments is weak, given challenges in the textile and printing sectors. This coupled with higher interest and depreciation cost would result in a 20% y-o-y decline in FY2023 PAT. Despite demand slowdown, the company is continuing with its capex plan and has guided for 25% EBITDA CAGR over FY2023E-FY2025E. Although near-term outlook is muted, the company is investing in the right areas to build capabilities and enhance client engagements. Long-term growth is expected to be largely driven by - i) Growth in global markets, ii) Import substitution, and iii) China plus one opportunity.

- **Valuation – Downgrade Aarti Industries to Hold with a revised PT of Rs. 730**

Uncertainties in global economic growth outlook and near-term subdued demand from the dyes/pigment industry would keep Aarti's earnings under pressure in FY2023 (expect PAT to decline by 20%), given high exposure to exports/discretionary. Moreover, valuation of 32x/28x its FY2024E/FY2025E EPS largely factors in potential strong earnings with our expectation of 24%/29% EBITDA/PAT CAGR over FY2023E-FY2025E (led by commissioning of new capacities) and ignores near term weak return profile, and likely increase in debt, given aggressive capex plans. Hence, we downgrade Aarti to Hold (from Buy) with a revised price target (PT) of Rs. 730.

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 set-up 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 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. However, slowdown in dyes and pigments industry would keep H2FY23 earnings muted and valuation of 32x FY24E EPS provides limited upside. Thus, we downgrade Aarti to Hold.

Key Risks

- Faster-than-expected ramp-up for facilities and multi-year contracts, strong demand recovery from the dyes/ pigments industry, and lower raw-material cost could improve revenue growth/margin and are key upside risks to our earnings estimate and valuation.
- Slowdown in demand, delay in commissioning of facilities for multi-year contracts, adverse commodity price, and currency movement are key downside risks.

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 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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