21 November 2022

Aarti Industries

Rating: **Buy**
Target Price: Rs.800
Share Price: Rs.670

RM sourcing secured; capex execution to drive revenue growth; Buy

Aarti had entered into a 20-year agreement to secure nitric acid from Deepak Fertilisers valued at ~Rs80bn w.e.f. 1st Apr'23 and specifications based on formula-linked pricing. This secures its RM and enables it to focus on growth opportunities, and introduce value-added products and value chains for niche applications. We are positive on Aarti's long-term performance and expect its revenue/EBITDA/PAT to clock 14%/24%/ 28% CAGRs over FY23-25 on utilisation picking up at the recently commissioned capacities, the start of revenue from long-term contracts and the rising share of downstream and value-added products. The key short-term moniterables are demand slowdown in discretionary end-user industries, the challenging business environment (higher RM and utility costs) and volatile margins.

Focus shifted to forward-integration opportunities on secured RMs. Due to business and production losses on non-availability of nitric acid, Aarti had earlier planned a 200-250tpd plant to manufacture nitric acid. However, it entered into a multiple-year agreement with Deepak Fertilisers for the latter supply it nitric acid. This would allow it to focus on forward-integrated opportunities and channel resources, effectively enabling it to drive research-driven long-term and high-growth avenues.

Outlook. Management guided to a muted H2 FY23 on the demand slowdown in the dye and pigment sectors, expected to continue for some time due to the inflationary trend and low offtake. The company is positive about the long-term performance as multiple capex plans (+Rs30bn over FY23-FY25) are coming on stream in a phased manner to add capacity in the chloro-toluene value chain, set up multi-purpose plants, value-added and specialty products and custom manufacturing. We maintain our Buy rating at a revised TP of Rs800, valuing the company at 33x FY25e (adjusting for the hiving off of the pharma business). **Risks:** Capex delay; a slow ramp-up of added capacities and delay in LT contracts

Key financials (YE Mar)	FY21*	FY22	FY23e	FY24e	FY25e
Sales (Rs m)	45,061	60,855	66,349	75,338	86,199
Net profit (Rs m)	5,235	5,544	5,359	6,701	8,761
EPS (Rs)	14.4	15.3	14.8	18.5	24.2
P/E (x)	46.4	43.8	45.3	36.2	27.7
EV / EBITDA (x)	27.1	15.3	23.8	19.3	15.8
P/BV (x)	6.9	5.4	4.9	4.4	3.9
RoE (%)	16.2	22.7	10.4	12.7	14.8
RoCE (%)	10.2	16.4	8.6	9.7	10.7
Dividend yield (%)	0.4	0.5	0.3	0.4	0.5
Net debt / equity (x)	0.7	0.4	0.5	0.6	0.5

*Source: Company, Anand Rathi Research *FY21 numbers include pharma business performance*

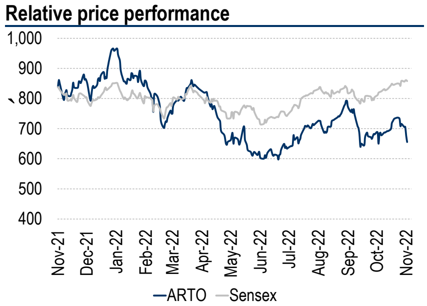
Key data	ARTO IN / ARTO.BO
52-week high / low	Rs976 / 584
Sensex / Nifty	61145 / 18160
3-m average volume	$8.5m
Market cap	Rs243bn / $2964.6m
Shares outstanding	363m

Shareholding pattern (%)	Sep'22	Jun'22	Mar'22
Promoters	44.2	44.2	44.2
- of which, Pledged	-	-	-
Free float	55.8	55.8	55.8
- Foreign institutions	12.1	11.8	12.5
- Domestic institutions	15.0	15.1	14.9
- Public	28.7	28.9	28.5

Estimates revision (%)	FY23e	FY24e
Sales	NA	NA
EBITDA	NA	NA
EPS	NA	NA

**Not comparable as new estimates post considering pharma business hive off*

Relative price performance



Source: Bloomberg

Bhawana Israni
Research Analyst

Quick Glance – Financials and Valuations

Fig 1 – Income statement (Rs m)

Year-end: Mar	FY21*	FY22	FY23e	FY24e	FY25e
Net revenues	45,061	60,855	66,349	75,338	86,199
Growth (%)	**7.6**	**-13.1**	**-5.2**	**13.5**	**14.4**
Direct costs	21,286	28,545	37,819	42,190	47,409
SG&A	13,960	15,109	17,251	18,835	21,550
EBITDA	**9,815**	**17,201**	**11,279**	**14,314**	**17,240**
EBITDA margins (%)	21.8	28.3	17.0	19.0	20.0
- Depreciation	2,313	2,464	2,987	3,783	4,256
Other income	7	8	13	15	17
Interest expenses	864	1,023	1,630	2,110	1,990
PBT	6,646	13,722	6,675	8,436	11,011
Effective tax rate (%)	19.5	13.6	19.0	20.0	20.0
+ Associates / (Minorities)	118	2	-	-	-
Net income	5,235	11,857	5,407	6,749	8,809
Adjusted income	5,235	5,544	5,407	6,749	8,809
WANS	363	363	363	363	363
FDEPS (Rs / sh)	14.4	15.3	14.9	18.6	24.3
FDEPS growth (%)	-2.3	-16.6	-18.7	24.8	30.5
Gross margins (%)	52.8	53.1	43.0	44.0	45.0

Fig 2 – Balance sheet (Rs m)

Year-end: Mar	FY21*	FY22	FY23e	FY24e	FY25e
Share capital	871	1,813	1,813	1,813	1,813
Net worth	35,029	45,160	49,756	55,492	62,980
Debt	27,421	22,040	27,171	35,171	33,171
Minority interest	122	7	7	7	7
DTL / (Assets)	2,339	1,796	2,502	2,502	2,502
Capital employed	**64,912**	**69,002**	**79,436**	**93,173**	**98,660**
Net tangible assets	35,925	36,376	45,904	60,636	67,380
Net intangible assets	1	-	-	-	-
Goodwill	-	-	-	-	-
CWIP (tang. & intang.)	12,979	13,030	12,515	9,000	3,000
Investments (strategic)	635	283	283	283	283
Investments (financial)	-	-	-	-	-
Current assets (excl. cash)	22,754	28,878	32,511	36,916	42,238
Cash	4,123	1,736	2,023	1,706	2,999
Current liabilities	11,505	11,300	13,801	15,369	17,240
Working capital	11,249	17,577	18,710	21,547	24,998
Capital deployed	**64,912**	**69,002**	**79,436**	**93,173**	**98,660**

Fig 3 – Cash-flow statement (Rs m)

Year-end: Mar	FY21*	FY22	FY23e	FY24e	FY25e
PBT before OI and Interest	7,502		8,292	10,531	12,984
+ Non-cash items	2,313		2,987	3,783	4,256
Oper. prof. before WC	9,815		11,279	14,314	17,240
- Incr. / (decr.) in WC	(870)		1,133	2,836	3,451
Others incl. taxes	1,062		1,268	1,687	2,202
Operating cash-flow	9,623		**8,878**	**9,791**	**11,587**
- Capex (tang.+ intang.)	12,357		12,000	15,000	5,000
Free cash-flow	(2,733)		(3,122)	(5,209)	6,587
Acquisitions					
- Div. (incl. buyback & taxes)	1,088		811	1,012	1,321
+ Equity raised	-		-	-	-
+ Debt raised	6,442		5,131	8,000	(2,000)
- Fin investments	265		-	-	-
- Misc. (CFI+CFF) (adj OI &int)	706		910	2,095	1,973
Net cash-flow	1,650		288	(317)	1,292

Source: Company, Anand Rathi Research

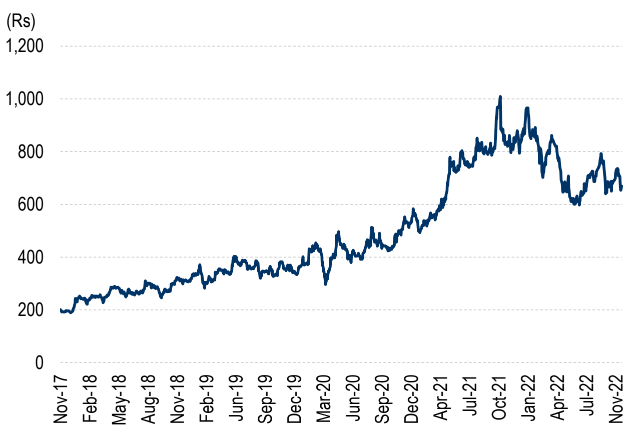
**FY21 numbers include pharma business performance*

Fig 4 – Ratio analysis

Year-end: Mar	FY21*	FY22	FY23e	FY24e	FY25e
P/E (x)	46.4	43.8	44.9	36.0	27.6
EV / EBITDA (x)	27.1	15.3	23.8	19.3	15.8
EV / Sales (x)	5.9	4.3	4.0	3.7	3.2
P/B (x)	6.9	5.4	4.9	4.4	3.9
RoE (%)	16.2	22.7	10.5	12.8	14.9
RoCE (%) - after tax	10.2	16.4	8.6	9.8	10.8
RoIC	10.8	16.9	8.8	10.0	11.1
DPS (Rs / sh)	3.0	3.5	2.2	2.8	3.6
Dividend yield (%)	0.4	0.5	0.3	0.4	0.5
Dividend payout (%) - incl. DDT	10.0	10.7	15.0	15.0	15.0
Net debt / equity (x)	0.7	0.4	0.5	0.6	0.5
Receivables (days)	64	65	66	66	66
Inventory (days)	160	119	102	104	106
Payables (days)	99	45	43	43	43
CFO : PAT %	183.8	395.6	164.2	145.1	131.5

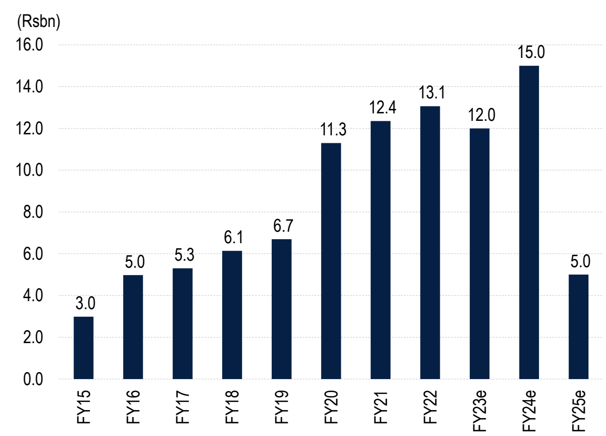
Source: Company, Anand Rathi Research

Fig 5 – Price movement



Source: Bloomberg

Fig 6 – Capex of over Rs55bn over FY21-FY25e



Source: Company

Update on ongoing Capex

Key projects

- H1 capex was Rs5.8bn
- Targeted capex for FY23: ~Rs10-12bn
- The company is aiming to capitalise Rs10bn capex, comprising the third long-term contract, some specialty chemicals blocks and nitro-chloro-benzene in H2 FY23.
- De-bottlenecking nitro-toluene capacity by 50% to take it to 45,000 tons in FY25
- Rs2bn capex to triple ethylation capacity from ~10,000 tons, expected to come on stream in H1 FY25
- New initiatives such as the chloro-toluene project are expected to be commissioned in H2 FY25 and FY 2026.

Long-term contracts

- The first long-term contract operating at 25% now, 70% expected next year.
- Utilisation at the second long-term contract is being ramped up gradually.
- The third long-term project is expected to be commissioned by this quarter's end.

Outlook

- The company expects demand to improve from Q4 FY23 as the high-cost input scenario is likely to soften in Q3.
- Management expects greater demand in the dye segment from Q3 based on discussions with customers, while demand for pigments would be muted for some time. De-stocking of pigments is ongoing.
- Management expects Rs11bn EBITDA in FY23 based on the H1 performance and demand outlook for H2. The EBITDA would be flattish in H2 vs H1. Furthermore, expenses related to new capacities are expected to rise (on commissioning in H2 FY23).
- Per management, the full benefit of various ongoing projects would be evident in FY24 and FY25. While a volume ramp-up of the new capacity will come in the next two years, fixed costs will not generally rise to that level, thereby resulting in strong gross profit-to-EBITDA conversion from FY24. With this volume ramp-up, a 25% EBITDA CAGR is expected over FY24-25.

Update on the pharma business being hived off

Considering the strong opportunities, the company plans to hive off its pharma business into a separate entity. The split from Aarti Industries to Aarti Pharmalabs was approved by the NCLT. The hived off entity is expected to be listed in Dec'22.

Valuation

Change in estimates

Fig 7 – Change in estimates

	Old		Revised		Change %	
(Rs m)	FY23e	FY24e	FY23e	FY24e	FY23	FY24
Revenue	80,648	93,212	66,349	75,338	NA	NA
EBITDA	15,726	20,507	11,279	14,314	NA	NA
PAT	8,760	11,616	5,359	6,701	NA	NA

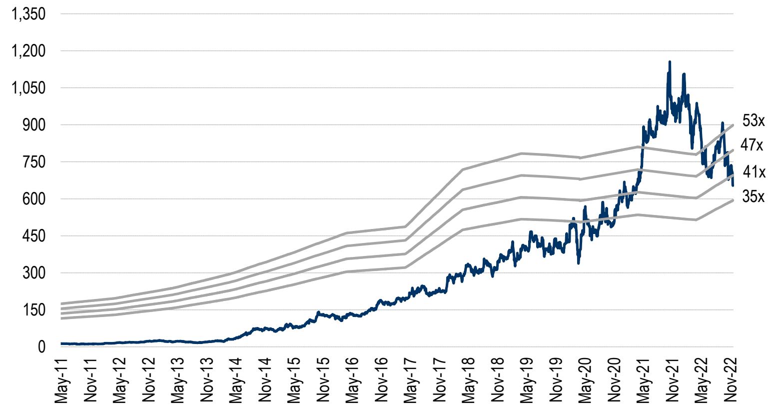
*Source: Anand Rathi Research *Not comparable as new estimates post considering pharma demerger*

Per management, the external environment continues to be challenging aggravated by high costs both of raw materials and utilities, a moderate slowdown in some end-user industries related to textiles combined with severe forex fluctuations and other global uncertainties. Work is underway to create newer chemical value-chains and introduce high-potential products to expand the addressable market opportunity while catering to greater demand from key customers.

The company is capitalising on opportunities created by changes in the Indian chemicals sector. The R&D-led product profile combined with added gains from existing value-chains would improve business value in future.

We expect revenue, EBITDA and PAT to clock 14%, 24% and 28% CAGRs over FY23-25 respectively. Further, the hiving off of the pharma business has enabled the company lay more emphasis on its core speciality chemicals business, auguring well for the future. Further, more revenue from value-added products and better utilisation would support margins in future. We maintain our Buy rating on the stock, at a revised TP of Rs.800, valuing the company at 33x FY25e (adjusting for the pharma business split-off).

Fig 8 – One-year-forward PE band



Source: Anand Rathi Research

Risks

- Commodity prices movement
- Delay in implementing the planned capex

Appendix

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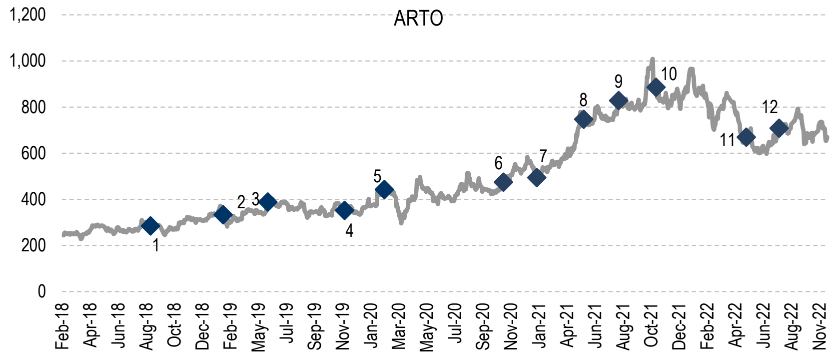

	Date	Rating	TP (Rs)	Share Price (Rs)
1	29-Aug-18	Buy	800	660
2	11-Feb-19	Hold	850	768
3	24-May-19	Hold	925	900
4	17-Nov-19	Hold	800	795
5	14-Feb-20	Buy	600	506
6	13-Nov-20	Buy	663	551
7	31-Jan-21	Buy	693	580
8	20-May-21	Buy	990	851
9	10-Aug-21	Buy	1,075	922
10	2-Nov-21	Buy	1,230	959
11	31-May-22	Buy	1,065	762
12	11-Aug-22	Buy	960	815

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