Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

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 23.0

Updated Jun 08, 2023

Medium Risk

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

Source: Morningstar

Company details

Market cap:	Rs. 16,717 cr
52-week high/low:	Rs. 852/445
NSE volume: (No of shares)	10.8 lakh
BSE code:	524208
NSE code:	AARTIIND
Free float: (No of shares)	20.4 cr

Shareholding (%)

Promoters	44
FII	12
DII	15
Others	29

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	2.7	-9.3	-14.6	-43.4
Relative to Sensex	2.6	-15.4	-23.3	-54.1

Sharekhan Research, Bloomberg

Stock Update

Result Update

Aarti Industries Ltd

Weak Q1, uncertain earning outlook

Speciality Chem	Sharekhan code: AARTIIND
Reco/View: Hold ↔	CMP: **Rs. 461** / Price Target: **Rs. 500** ↓

↑ Upgrade ↔ Maintain ↓ Downgrade

Summary

- Q1FY24 consolidated revenues of Rs. 1,414 were down 12% q-o-q as revenue was impacted by high channel inventory, lower raw material prices and excessive supply from China. OPM declined by 93 bps q-o-q to 14.3% as the lower capacity utilisation, loss of competitiveness due to Yuan depreciation and weak demand from some key industries led to lower profit margins.
- Within key end-user industries, textiles are experiencing a prolonged downturn, agrochemical segment is seeing destocking, which may take another 2-3 quarters to clear, and polymers & additives are amid a downturn which might bottom out in H2FY24.
- Weak industry demand will lower capacity utilization, which would impact operating leverage, return ratios and cash generation. Recovery would be more gradual, thus capex cycle seems to be at wrong time of industry slowdown. Management has withdrawn its FY25 EBITDA guidance of Rs. 1700 crore. We cut our FY24E/F25E EPS by 25%/20%.
- We maintain a Hold rating on Aarti Industries with a revised PT of Rs. 500 given muted earnings outlook (expect 25% PAT degrowth in FY24) amid a challenging demand/pricing environment.

Q1FY24 consolidated revenues of Rs. 1,414 were down 12% q-o-q as pricing came under pressure due to high channel inventory and lower raw material prices. OPM fell by 93 bps q-o-q to 14.3% but was 49 bps above our estimate of 17.4% as the lower capacity utilization and weak demand from some key industries led to lower profit margins. Consequently, operating profit declined by 19.8% q-o-q to Rs. 202 crore, which was 1.8% below our estimate of Rs. 206 crore. PAT fell by 53.4% q-o-q to Rs. 70 crores and was 0.9% below our estimate of Rs. 70 crores as miss in revenue was mostly offset by higher-than-expected operating profit and lower tax rate of 3% versus our estimate of 20%.

Key positives

- Nitrotoluene volumes increased by 77.6%/52.2% on y-o-y/q-o-q .

Key negatives

- Muted revenues given subdued demand from dyes/pigment industry.

Management Commentary

- As inventory levels are correcting across the globe, the demand for company's product witnessed sharp demand contraction in the months of May and June. Due to prevailing macro headwinds, the management expects FY24 performance to be weaker than expected. However, management remains confident about long-term growth and expects FY25 to be crucial year as new capacities comes online.
- Lower demand from China has led to excessive volume exported to India that drives up supply.
- Weak demand from some key industries (dyes, pigments, agrochemicals, & auto) and lower capacity utilization led to lower profit margins. Management expects margin to recover from H2FY24 onwards.
- Project updates – 1) The company has commercialized its expanded NCB capacity and 2) The company has operationalised its power generation unit with the capacity of 13 MW.

Revision in estimates: We have lowered our FY24/FY25 earnings estimate by 25%/20% to factor in lower revenue and margin assumption due to demand pressure.

Our Call

Valuation – Maintain Hold on Aarti Industries a revised PT of Rs. 500: Uncertainties in global economic growth outlook and near-term subdued demand across major end-user industries given inventory destocking would keep earnings of Aarti Industries under pressure in FY24 (we expect a 25% y-o-y decline in PAT) given high exposure to exports/discretionary. Weak demand and macroeconomics challenges makes earnings environment uncertain and Aarti's valuation of 42x/27x FY24E/FY25E EPS seems high. Hence, we maintain our Hold rating on Aarti Industries with a revised price target (PT) of Rs. 500.

Key Risks

- Faster-than-expected ramp-up of facilities and multi-year contracts, strong demand recovery from dyes/pigments industry and lower raw material cost could improve revenue growth/margin and are key upside risks to our earnings estimates 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	FY22	FY23	FY24E	FY25E
Net Sales	5,454	6,619	6,778	8,075
OPM (%)	20.3	16.5	14.8	18.0
Adjusted PAT	659	547	410	638
y-o-y growth (%)	25.9	(17.0)	(25.1)	55.9
Adjusted EPS (Rs.)	18.2	15.1	11.3	17.6
P/E (x)	26.0	31.4	41.9	26.9
P/BV (x)	3.8	3.5	3.4	3.1
EV/EBITDA (x)	17.6	18.2	21.0	14.5
RoCE (%)	12.5	10.2	8.3	10.5
RoE (%)	14.3	11.6	8.2	12.0

Source: Company; Sharekhan estimates

Q1 in-line; Long term growth story intact

Q1FY24 consolidated revenues of Rs. 1,414 were down 12% q-o-q as pricing came under pressure due to high channel inventory and lower raw material prices. OPM fell by 93 bps q-o-q to 14.3% but was 49 bps above our estimate of 17.4% as the lower capacity utilization and weak demand from some key industries led to lower profit margins. Consequently, operating profit declined by 19.8% q-o-q to Rs. 202 crore, which was 1.8% below our estimate of Rs. 206 crore. PAT fell by 53.4% q-o-q to Rs. 70 crores and was 0.9% below our estimate of Rs. 70 crores as miss in revenue was mostly offset by higher-than-expected operating profit and lower tax rate of 3% versus our estimate of 20%.

Q1FY2024 key conference call highlights

- **Demand outlook:** Volume decline of 10%-12%, pricing pressure and lower raw material prices led to decline in revenue. Demand for products used in additives and products, which are part of long-term contracts, remain robust. Around 70% of Aarti Industries sales goes to exports and domestic company, which target global markets. As inventory destocking took hold in key end user industries across the globe, the demand for company's product witnessed sharp demand contraction in the months of May and June. As higher interest rates make it expensive for companies to keep inventory hence many companies across the market are reducing their inventory level. Due to prevailing macro headwinds, management expects FY24 performance to be weaker than expected. However, management remains confident about long-term growth and expects FY25 to be crucial year as new capacities comes online.
- **Impact of China Slowdown:** Lower demand from China has led to excessive volume been exported to India. This leads to excessive supply. Moreover, depreciation of Chinese currency visa vis Indian Rupee led to reduced competitiveness of Indian manufacturers. Thus, a Chinese slowdown led to margin contraction in few product categories.
- **Margin Outlook:** Weak demand from some key industries (dyes, pigments, agrochemicals, & auto) and lower capacity utilization led to lower profit margins. Management expects Q2FY24 margins to remain around levels of Q1FY24, with gradual recovery in H2FY24. Also, energy prices have moved up in Q2FY24, which has led to higher prices for key materials like Benzene. The company has robust pricing mechanism and pass on the higher raw material prices to customers.
- **Margin guidance:** The management has withdrawn earlier EBITDA guidance of Rs. 1700 crore for FY25.
- **New capacity:** The company has commercialized its expanded NCB Capacity. The company has also operationalised its power generation unit with the capacity of 13 MW.
- **Long-term capex:** The management is working on Zone 4 project initiatives and remains confident about starting production in a phased manner from FY25.
- **Tax rate:** Higher Tax depreciation and exemptions resulting into lower tax liability. Management guided 10% tax rate for FY24.
- **Volume number:** Production of nitro-chlorobenzene stood at 17293 MT in Q1FY24 versus 20515 MT in Q1FY23. Nitrotoluene production stood at 9327 MT in Q1FY24 versus 5252 MT in Q1F23.

Results (Consolidated) Rs cr

Particulars	Q1FY24	Q1FY23	YoY (%)	Q4FY23	QoQ (%)
Revenue	1,414	1,610	(12.2)	1,656	(14.6)
Total expenditure	1,212	1,329	(8.8)	1,404	(13.7)
Operating profit	202	282	(28.2)	252	(19.8)
Other Income	-	0.4	(100.0)	-	#DIV/0!
Depreciation	89	72	24.0	84	6.0
Interest	40	45	(10.2)	33	21.2
PBT	72	166	(56.8)	135	(47.0)
Tax	2	30	(93.3)	(14)	(114.3)
Reported PAT	70	136	(48.7)	149	(53.4)
Reported EPS (Rs.)	1.9	5.3	(64.1)	4.1	(53.4)
Particulars (%)			(BPS)		(BPS)
EBITDA margin	14.3	17.5	(320)	15.2	(93)
Net Profit	4.9	8.4	(350)	9.0	(408)
Tax Rate	2.8	18.2	(1,536)	-10.4	1,317

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), a 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, a massive export opportunity, and lower 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 growth but at wrong of industry demand slowdown**

Near term outlook 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 costs would in muted FY24 PAT. Despite a demand slowdown, the company is continuing with its capex plan and guided robust growth over long term. Although the near-term outlook is muted but 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) the China Plus One opportunity. However, capex cycle seems to becoming at wrong time of demand slowdown in chemical industry.

■ **Valuation - Maintain Hold on Aarti Industries a revised PT of Rs. 500**

Uncertainties in global economic growth outlook and near-term subdued demand across major end-user industries given inventory destocking would keep earnings of Aarti Industries under pressure in FY24 (we expect a 25% y-o-y decline in PAT) given high exposure to exports/discretionary. Weak demand and macroeconomics challenges makes earnings environment uncertain and Aarti's valuation of 42x/27x FY24E/FY25E EPS seems high. Hence, we maintain our Hold rating on Aarti Industries with a revised price target (PT) of Rs. 500.

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. Although the company expects significant growth prospects, led by expansion but near-term challenges are visible for growth from discretionary end-users (50% of revenues of Aarti Industries) while massive capex plan would keep CWIP high and thus impacting return ratios. Moreover, weak demand and macroeconomics challenges makes earnings environment uncertain and valuation also seem high.

Key Risks

- Faster-than-expected ramp-up for facilities and multi-year contracts, strong demand recovery from dyes/pigments industry and lower raw material cost could improve revenue growth/margin and are key upside risk 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

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Life Insurance Corp of India	6.8
2	Morgan Stanley	3.13
3	HDFC Asset Management Co Ltd	2.77
4	Aditya Birla Sun Life Asset Manage	2.68
5	Vanguard Group Inc/The	1.71
6	JPMorgan Chase & Co	1.05
7	Alchemie Financial Services Ltd	1.03
8	Baron Capital Inc	1.02
9	BlackRock Inc	0.89
10	Dimensional Fund Advisors LP	0.54

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

DISCLAIMER

This information/document has been prepared by Sharekhan Ltd. (SHAREKHAN) and is intended for use only by the person or entity to which it is addressed to. This Document may contain confidential and/or privileged material and is not for any type of circulation and any review, retransmission, or any other use is strictly prohibited. This information/ document is subject to changes without prior notice.

Recommendation in reports based on technical and derivatives analysis is based on studying charts of a stock's price movement, trading volume, outstanding positions, as opposed to focusing on a company's fundamentals and as such, may not match with a report on a company's fundamentals. However, this would only apply for information/document focused on technical and derivatives research and shall not apply to reports/documents/information focused on fundamental research.

This information/document does not constitute an offer to sell or solicitation for the purchase or sale of any financial instrument or as an official confirmation of any transaction. Though disseminated to all customers who are due to receive the same, not all customers may receive this report at the same time. SHAREKHAN will not treat recipients as customers by virtue of their receiving this information/report.

The information contained herein is obtained from publicly available data or other sources believed to be reliable and SHAREKHAN has not independently verified the accuracy and completeness of the said data and hence it should not be relied upon as such. While we would endeavour to update the information herein on reasonable basis, SHAREKHAN, its subsidiaries and associated companies, their directors and employees ("SHAREKHAN and affiliates") are under no obligation to update or keep the information current. Also, there may be regulatory, compliance, or other reasons that may prevent SHAREKHAN and affiliates from doing so. This document is prepared for assistance only and is not intended to be and must not alone be taken as the basis for an investment decision. Recipients of this report should also be aware that past performance is not necessarily a guide to future performance and value of investments can go down as well. The user assumes the entire risk of any use made of this information. Each recipient of this document should make such investigations as it deems necessary to arrive at an independent evaluation of an investment in the securities of companies referred to in this document (including the merits and risks involved) and should consult its own advisors to determine the merits and risks of such an investment. The investment discussed or views expressed may not be suitable for all investors. We do not undertake to advise you as to any change of our views. Affiliates of Sharekhan may have issued other recommendations/ reports that are inconsistent with and reach different conclusions from the information presented in this recommendations/report.

This information/recommendation/report is not directed or intended for distribution to, or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject SHAREKHAN and affiliates to any registration or licensing requirement within such jurisdiction. The securities described herein may or may not be eligible for sale in all jurisdictions or to certain category of investors. Persons in whose possession this document may come are required to inform themselves of and to observe such restriction.

The analyst certifies that the analyst might have dealt or traded directly or indirectly in securities of the company and that all the views expressed in this document accurately reflect his or her personal views about the subject company or companies and its or their securities and do not necessarily reflect those of SHAREKHAN. The analyst and SHAREKHAN further certifies that either he or his relatives or Sharekhan associates might have direct or indirect financial interest or might have actual or beneficial ownership of 1% or more in the securities of the company at the end of the month immediately preceding the date of publication of the research report. The analyst and SHAREKHAN encourages independence in research report/ material preparation and strives to minimize conflict in preparation of research report. The analyst and SHAREKHAN does not have any material conflict of interest or has not served as officer, director or employee or engaged in market making activity of the company. The analyst and SHAREKHAN has not been a part of the team which has managed or co-managed the public offerings of the company, and no part of the analyst's compensation was, is or will be, directly or indirectly related to specific recommendations or views expressed in this document. Sharekhan Ltd or its associates or analysts have not received any compensation for investment banking, merchant banking, brokerage services or any compensation or other benefits from the subject company or from third party in the past twelve months in connection with the research report.

Either SHAREKHAN or its affiliates or its directors or employees / representatives / clients or their relatives may have position(s), make market, act as principal or engage in transactions of purchase or sell of securities, from time to time or may be materially interested in any of the securities or related securities referred to in this report and they may have used the information set forth herein before publication. SHAREKHAN may from time to time solicit from, or perform investment banking, or other services for, any company mentioned herein. Without limiting any of the foregoing, in no event shall SHAREKHAN, any of its affiliates or any third party involved in, or related to, computing or compiling the information have any liability for any damages of any kind.

Forward-looking statements (if any) are provided to allow potential investors the opportunity to understand management's beliefs and opinions in respect of the future so that they may use such beliefs and opinions as one factor in evaluating an investment. These statements are not a guarantee of future performance and undue reliance should not be placed on them. Such forward-looking statements necessarily involve known and unknown risks and uncertainties, which may cause actual performance and financial results in future periods to differ materially from any projections of future performance or result expressed or implied by such forward-looking statements. Sharekhan/its affiliates undertakes no obligation to update forward-looking statements if circumstances or management's estimates or opinions should change except as required by applicable securities laws. The reader/investors are cautioned not to place undue reliance on forward-looking statements and use their independent judgement before taking any investment decision.

Investment in securities market are subject to market risks, read all the related documents carefully before investing. The securities quoted are for illustration only and are not recommendatory. Registration granted by SEBI, and certification from NISM in no way guarantee performance of the intermediary or provide any assurance of returns to investors.

Client should read the Risk Disclosure Document issued by SEBI & relevant exchanges and the T&C on www.sharekhan.com

---

Registration and Contact Details: Name of Research Analyst - Sharekhan Limited, Research Analyst Regn No.: INH000006183. CIN): - U99999MH1995PLC087498. Registered Office: The Ruby, 18th Floor, 29 Senapati Bapat Marg, Dadar (West), Mumbai – 400 028, Maharashtra, INDIA. Tel: 022-6115000.

Correspondence/Administrative Office: Gigaplex IT Park, Unit No 1001, 10th Floor, Building No.9, TTC Industrial Area, Digha, Airoli-West, Navi Mumbai – 400 708. Tel: 022 61169000 / 61150000, Fax No. 61169699.

Other registrations of 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.

Compliance Officer: Ms. Binkle Oza; Tel: 022-62263303; email id: complianceofficer@sharekhan.com

For any complaints/grievance, email us at igc@sharekhan.com or you may even call Customer Service desk on - 022- 41523200/022 - 33054600