Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Aarti Industries Ltd

Strong Q2 amid difficult times

Speciality Chem	Sharekhan code: AARTIIND
Reco/View: Hold ⇔	CMP: **Rs. 510** — Price Target: **Rs. 545** ↑

↑ 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 23.0
Updated Aug 08, 2023

Medium Risk

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

Source: Morningstar

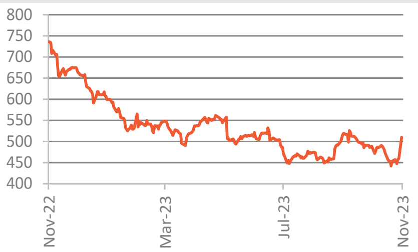
Company details

Market cap:	Rs. 18,493 cr
52-week high/low:	Rs. 744/438
NSE volume: (No of shares)	13.7 lakh
BSE code:	524208
NSE code:	AARTIIND
Free float: (No of shares)	20.5 cr

Shareholding (%)

Promoters	44
FII	11
DII	16
Others	30

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	8.0	7.4	-8.1	-30.7
Relative to Sensex	8.9	8.9	-13.3	-36.9

Sharekhan Research, Bloomberg

Summary

- Q2 PAT grew by 30% q-o-q to Rs. 92 crore (34% above estimate) reflecting a sharp rise in margins and tax benefit.
- Stellar earnings recovery was led by improvement in volumes and stable-to-better realisations for certain products. OPM rose 181 bps q-o-q rise to 16.1%. Demand from dyes, polymers, pigment spaces recovered; agrochem is still seeing challenges of destocking while some recovery was for specific molecules.
- H2 to be better with FY24 EBITDA guidance of Rs. 950-1,000 crore while FY25 would be normal as impact of destocking would ease. Capex planned at Rs. 2,500-3,000 over FY24-26 and debt to rise, peaking in FY26.
- Q2 gives hope of gradual recovery but we would wait for one quarter to assess sustainability of recovery trend and to turn constructive on Aarti. We maintain Hold rating on Aarti Industries with a revised PT of Rs. 545. High capex to mean rise in debt

Q2FY24 results was strong led by improved volume and stable-to-better realisation for certain products, which led to a 181 bps q-o-q rise in OPM to 16.1% (381 bps above our estimate) and thus operating profit grew by 16% q-o-q to Rs. 234 crore (15% above our estimate). PAT rose by a robust 30% q-o-q to Rs. 92 crore (beat of 34%) given robust margin expansion & tax benefit. Aarti benefited from higher tax depreciation and exemptions resulted into lower tax liability and accrual of deferred tax assets of Rs. 9 crore. However, interest costs rose 45% q-o-q on account of mark-to-market/revaluation loss of ~Rs. 12 crore with respect to unhedged long-term loans.

Key positives

- Sharp beat of 381 bps in OPM 16.1%, up 181 bps q-o-q.

Key negatives

- Nitrotoluene production fell 19% q-o-q to 7,560 mt.

Management Commentary

- FY24 EBITDA guidance of Rs. 950-1000 crore implies an 18-29% growth for H2FY24 versus H1FY24. FY25 EBITDA guidance of Rs. 1700 crore (+- 5-15%) as inventory destocking expected to normalise.
- Aarti is witnessing a gradual demand recovery q-o-q, it will take few more quarters for normalized demand across various end segments/product lines. Discretionary sectors (dyes, pigments, polymers) saw a q-o-q recovery.
- Capex guidance of Rs. 1,200-1,300 crore for FY24 versus H1FY24 capex of Rs. 575 crore.
- Management does not expect much contribution from long-term contracts in FY24.
- **Production** - Nitro-chlorobenzene stood at 19,014 tonnes versus 17,293 tonnes in Q1FY24. Nitrotoluene production stood at 7,560 MT versus 9,320 MT in Q1FY24. Production of PDA was at 316 MT/month.
- **Other updates –** 1) Looking for opportunities in sunrise sectors, 2) balanced contribution from both regular and non-regular markets, 3) Commercialised Phase 1 of scale-up of Acid Unit Revamp, 4) EBITDA to grow by ~ 20-25% CAGR driven by FY26 beyond, 5) net debt of Rs. 2,723 crore to stay stable in FY24 and should rise over FY25-26 with peak in FY26.

Revision in estimates: We fine-tuned our FY24 earnings estimate and increased FY25 earnings to factor gradual demand/margin recovery. We have also introduced our FY26 earnings estimate in this report.

Our Call

Valuation – Maintain Hold with revised PT of Rs. 545: Q2 results give hope of a gradual demand recovery but we would wait for one quarter to assess sustainability of recovery trend and to turn constructive on the stock. Having said that, headwinds related to inventory destocking in agrochemical space and demand pressure from export markets persist though some improvements have been seen, but would take another 1-2 quarters for normalisation. Hence, we maintain a Hold rating on Aarti Industries with a revised PT of Rs. 545. At CMP, the stock trades at 26x/19x FY25E/FY26E EPS.

Key Risks

- Faster-than-expected ramp-up of facilities and multi-year contracts, strong demand recovery from dyes/pigments industry and lower raw material costs could improve revenues/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

Parameter	FY22	FY23	FY24E	FY25E	FY26E
Revenue	5,454	6,619	6,428	8,137	9,795
OPM (%)	20.3	16.5	15.9	18.7	19.7
Adjusted PAT	659	547	419	718	996
y-o-y growth (%)	25.9	(17.0)	(23.4)	71.3	38.8
Adjusted EPS (Rs.)	18.2	15.1	11.6	19.8	27.5
P/E (x)	28.1	33.8	44.1	25.8	18.6
P/BV (x)	4.1	3.8	3.6	3.3	2.9
EV/EBITDA (x)	18.8	19.4	21.9	14.7	11.9
RoCE (%)	12.5	10.2	7.8	11.3	13.6
RoE (%)	14.3	11.6	8.3	13.4	16.6

Source: Company; Sharekhan estimates

Margin beat & lower tax outgo led to earnings beat

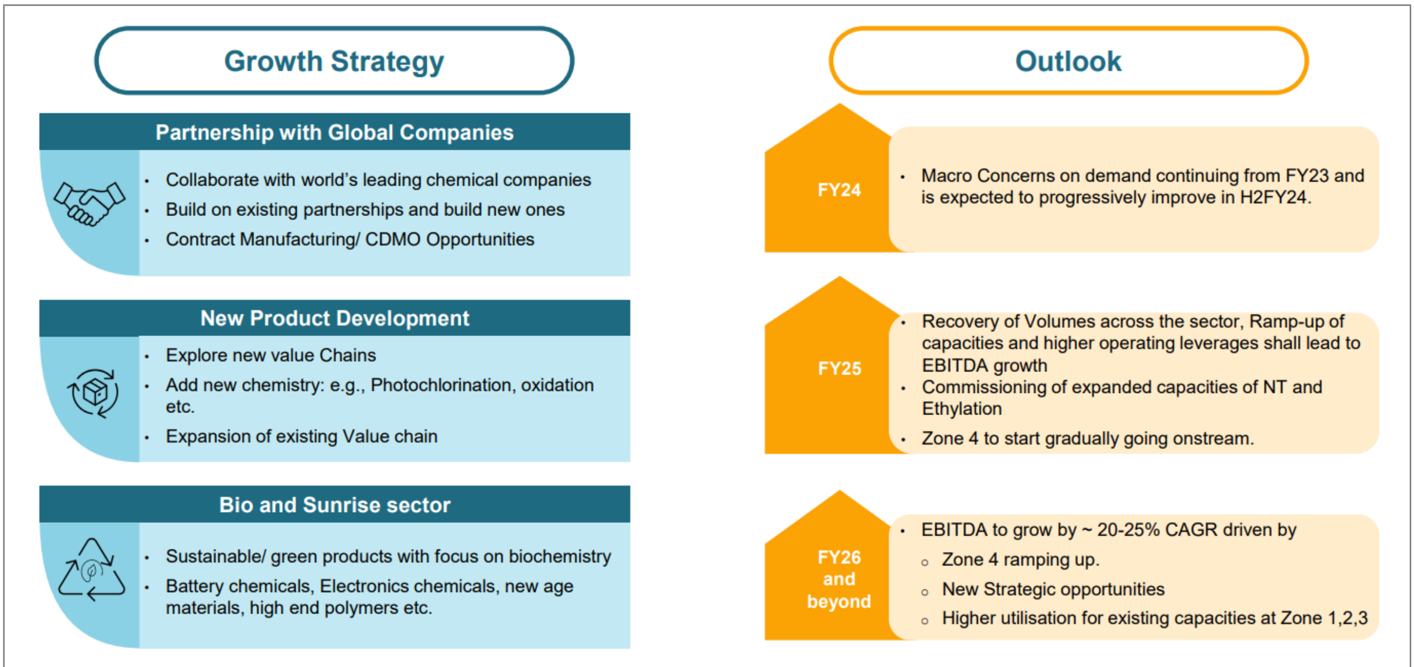
Q2FY24 results were strong led by improved volume and stable-to-better realisation for certain products. Consolidated revenue of Rs. 1,454 crore (up 3% q-o-q) was 12% below our estimate of Rs. 1,660 crores. OPM improved by 181 bps q-o-q to 16.1% and was 381 bps above our estimate of 12.3% led by beat in gross margin at 41.2% (up 143 bps q-o-q) and lower-than-expected other expenses. Consequently, operating profit of Rs. 234 crore (up 16% q-o-q) was 15% above our estimate of Rs. 204 crore. Consolidated PAT increased by 30% q-o-q to Rs. 92 crores and was 34% above our estimate led by sharp margin beat and tax benefit partially offset by higher interest cost. Aarti benefited from higher tax depreciation and exemptions resulted into lower tax liability and also accrual of deferred tax assets of Rs. 9 crore. However, interest cost increased by 45% q-o-q led by mark-to-market/revaluation loss of ~Rs. 12 crore with respect to unhedged long-term loans.

Results (Consolidated) Rs cr

Particulars	Q2FY24	Q2FY23	YoY (%)	Q1FY24	QoQ (%)
Revenue	**1,454**	**1,685**	**(13.7)**	**1,414**	**2.8**
Total expenditure	1,220	1,418	(14.0)	1,212	0.7
Operating profit	**234**	**267**	**(12.4)**	**202**	**15.8**
Other Income	-	-	NA	-	NA
Depreciation	93	73	27.4	89	4.5
Interest	58	44	31.8	40	45.0
PBT	**83**	**150**	**(44.7)**	**73**	**13.7**
Tax	(9)	26	NA	2	NA
Reported PAT	**92**	**124**	**(25.8)**	**71**	**29.6**
Reported EPS (Rs.)	2.5	3.4	(25.8)	2.0	29.6
Margin (%)			**BPS**		**BPS**
OPM	16.1	15.8	25	14.3	181
NPM	6.3	7.4	(103)	5.0	131
Tax Rate	(10.8)	17.3	NA	2.7	NA

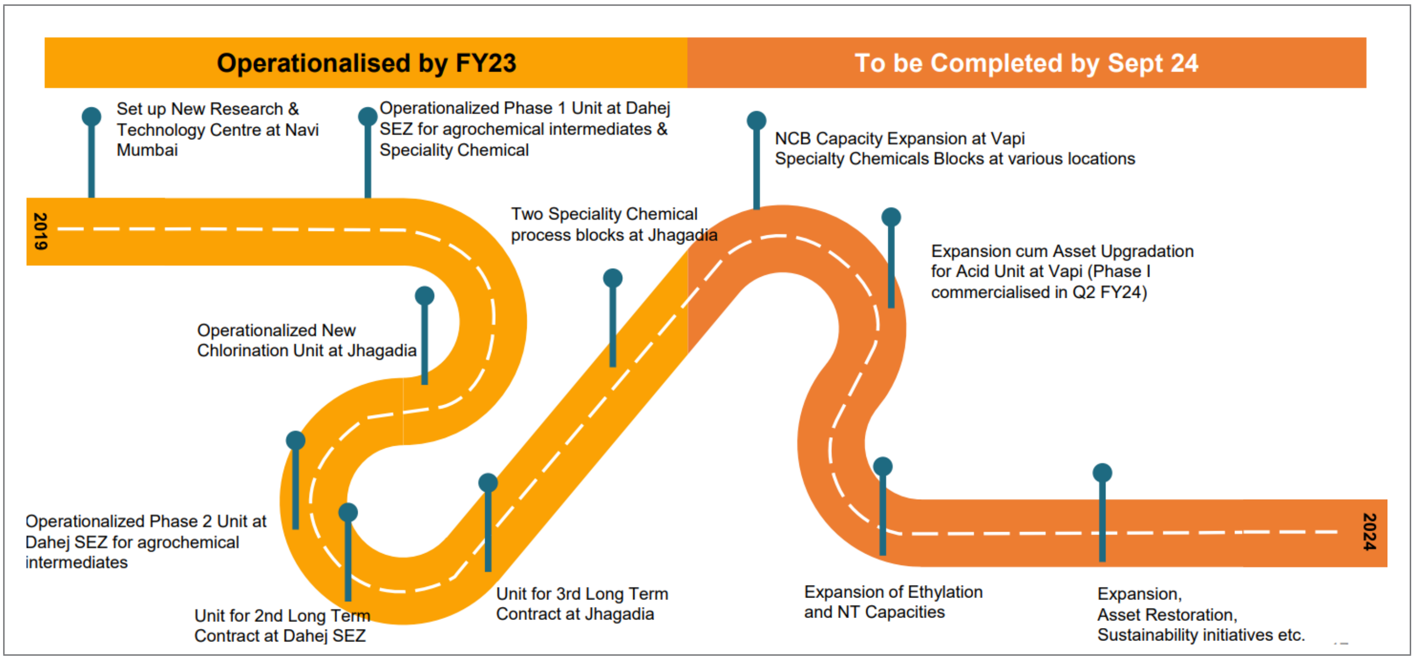
Source: Company, Sharekhan Research

Growth strategy and outlook



Source: Company

Major projects – FY19-H1FY25



Source: Company

Outlook and Valuation

■ Sector Outlook – Structural growth drivers to drive sustained growth

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, 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 – Weak demand muted near-term outlook; capex to drive long-term growth

The near-term outlook is weak 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 demand slowdown, the company is continuing with its capex plan and guided for robust growth over long term. Yet, 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) The China Plus One opportunity.

■ Valuation – Maintain Hold on Aarti Industries a revised PT of Rs. 545

Q2 results give hope of a gradual demand recovery but we would wait for one quarter to assess sustainability of recovery trend and to turn constructive on the stock. Having said that, headwinds related to inventory destocking in agrochemical space and demand pressure from export markets persist though some improvements are seen but would take another 1-2 quarters for normalisation. Hence, we maintain a Hold rating on Aarti Industries with a revised PT of Rs. 545. At CMP, the stock trades at 26x/19x FY25E/FY26E EPS.

About the 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 demand challenges still persist. Massive capex plan would mean rise in debt level while high CWIP high would impact return ratios in FY24.

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: Bloomberg

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Life Insurance Corp of India	6.8
2	Morgan Stanley	3.1
3	HDFC Asset Management Co Ltd	2.8
4	Aditya Birla Sun Life Asset Manage	2.7
5	Vanguard Group Inc/The	2.1
6	JPMorgan Chase & Co	0.9
7	Alchemie Financial Services Ltd	1.0
8	Baron Capital Inc	1.0
9	BlackRock Inc	0.9
10	Dimensional Fund Advisors LP	0.5

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

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