BUY

Aarti Industries

Near-term volatility could lead to sequential decline in Q2 EBITDA

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Specialty Chemicals ▸ Company Update ▸ **September 24, 2024**

TARGET PRICE (Rs): 675

We retain BUY on steep price correction, and cut our TP to Rs675/sh (30x Sep-26 EPS). Aarti has posted sequential improvement in EBITDA over the past four quarters, led by demand recovery in discretionary spends like textiles, dyes, pigments, polymers, etc, and strong contribution from the energy business (led by a single product—MMA). However, it withdrew its FY25 EBITDA guidance of Rs14.5-17bn after the Q1 results, due to i) deferral in agro chemicals market recovery, ii) volatility in the energy business, iii) Chinese dumping leading to pricing pressure. We believe this view is largely owing to lower than expected volumes in MMA due to near-term macro volatility (August exports data shows 70% decline in MMA volume). We build-in Rs12.5/16.4/18.8bn (vs Rs14.6/19/22bn) EBITDA for FY25/26/27E, to factor in the margin volatility.

Aarti Industries: Financial Snapshot (Consolidated)

Y/E Mar (Rs mn)	FY23	FY24	FY25E	FY26E	FY27E
Revenue	66,186	63,720	77,447	94,578	106,805
EBITDA	10,890	9,760	12,545	16,400	18,758
Adj. PAT	5,453	4,160	4,742	7,126	8,931
Adj. EPS (Rs)	15.1	11.5	13.1	19.7	24.7
EBITDA margin (%)	16.5	15.3	16.2	17.3	17.6
EBITDA growth (%)	0.0	(10.4)	28.5	30.7	14.4
Adj. EPS growth (%)	(17.1)	(23.7)	14.0	50.3	25.3
RoE (%)	11.6	8.1	8.6	11.8	13.2
RoIC (%)	11.6	9.4	9.0	11.0	12.2
P/E (x)	38.1	49.9	43.8	29.1	23.3
EV/EBITDA (x)	21.5	24.4	19.7	15.1	12.9
P/B (x)	4.2	3.9	3.6	3.3	2.9
FCFF yield (%)	(0.1)	(0.4)	(2.3)	0.7	4.0

Source: Company, Emkay Research

Mono Methyl Aniline (MMA) volumes to witness seasonality

The Energy business has now become relatively large for Aarti (~35-40%, based on our calculations), led by strong volumes from MMA. Management highlighted that this business is bringing additional volatility to the business performance, as it is linked to external factors like crude, gasoline cracks, and naphtha cracks, which have their own element of volatility. MMA has strong long-term potential to scale up volumes, as it a preferred octane booster in terms of characteristics and is competing with MTBE on price. Company is doing sampling for this octane booster and, as the end use horizon expands, volumes could be scaled up exponentially. Once product acceptance improves, this could contribute significantly to achieving the EBITDA targets envisaged by the company.

Agrochem recovery to push back by a Quarter

Aarti has been witnessing positive demand momentum in key end-use applications like pharma, polymers, additives, dyes, and pigments. However, in agrochemicals, demand recovery could be pushed back by a Quarter as there are only small green shoots of demand recovery as of now. Most global MNCs operating in the agchem space have guided for recovery from CY25; hence we believe Q4 should be better vs entire H2. Indian agrochemical companies are guiding for recovery from H2, but we believe this would be pushed back by a Quarter.

Overall volume growth to remain strong for FY25

Company maintained its volume growth guidance of 20-30%, but highlighted that pressure on margins persists. This is mostly owing to Chinese competition, which continues to dump products in global markets due to their domestic overcapacity situation. Volume growth will largely be led by improvement in utilization of existing capacities and commissioning of new nitro-toluene capacities. Management maintained its mid-to-long-term target of delivering 20-25% EBITDA CAGR over the next 5 years (2.5-3x growth on the FY24 base).

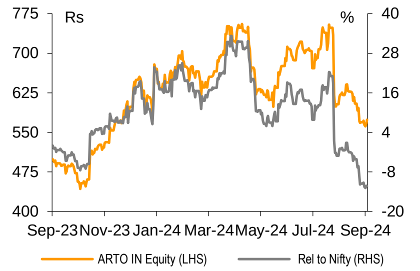
Target Price – 12M	Sep-25
Change in TP (%)	**(15.6)**
Current Reco.	BUY
Previous Reco.	BUY
Upside/(Downside) (%)	17.7
CMP (20-Sep-24) (Rs)	573.8

Stock Data	Ticker
52-week High (Rs)	770
52-week Low (Rs)	438
Shares outstanding (mn)	362.5
Market-cap (Rs bn)	208
Market-cap (USD mn)	2,489
Net-debt, FY25E (Rs mn)	38,984
ADTV-3M (mn shares)	2
ADTV-3M (Rs mn)	1,338.0
ADTV-3M (USD mn)	16.0
Free float (%)	-
Nifty-50	25,791
INR/USD	83.6
Shareholding, Jun-24	
Promoters (%)	43.2
FPIs/MFs (%)	10.6/18.6

Price Performance

(%)	1M	3M	12M
Absolute	(7.7)	(19.5)	13.0
Rel. to Nifty	(11.6)	(26.4)	(12.8)

1-Year share price trend (Rs)



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Investment Thesis

Aarti's technical capabilities, low-cost manufacturing edge, willingness to invest, and consistently strengthening relationships with customers have helped the company grow its EBITDA ~12x over FY07-23. Aarti is among the most scalable chemical companies in India, given: i) its presence across a wide range of products – from basic to specialty, having diverse end-use applications; ii) integrated manufacturing leading to cost efficiencies and supply chains independent of China; and iii) favorable macro factors like depreciation of the INR versus RMB, import substitution, and 'China+1'.

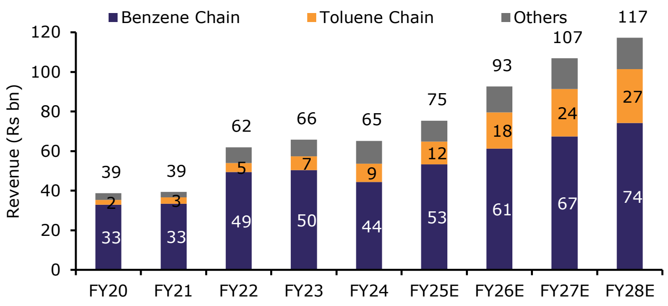
Aarti's first-generation technocrat promoters built a global scale benzene derivatives business, and the second generation is now scaling up benzene & toluene derivatives. We expect mono methyl aniline (MMA) and methyl ethyl aniline (MEA) to be significantly large and scalable products for Aarti over the next few years. While the core portfolio is seeing relatively subdued demand currently, we believe the core portfolio of Para Di Chloro Benzene (PDCB), Para Nitro Chloro Benzene (PNCB), and other products within the aniline chain will start delivering significant delta to the overall EBITDA of the company, once demand recovers.

The company is well-positioned for growth in coming years, supported by its low-cost manufacturing advantage and relationships with global customers. Expansion of existing value chains and entering newer value chains will aid earnings momentum. Once these value chains are established, they will largely become a cash cow, and the next leg of growth will be driven by establishing universal MPP and value-added products. Moreover, entering more downstream products will lead to margin expansion and improve the quality of earnings.

Generally in high-growth chemical companies, a large part of the OCF is reinvested in capex; thus, there is very low FCF generation. We believe such companies are in the midst of an investment cycle seeing strong growth opportunities. Similarly, Aarti has undergone capex of ~Rs10-12bn in asset replacement, refurbishment, etc, as these plants were >20 years old and required refurbishment to enhance their useful lives. At the same time, the first long-term contract with capex of Rs8bn is lying in the gross block but not contributing to revenue. We believe a large part of this non-revenue generating capex is largely behind and, because the company is at the early phase of this replacement capex cycle, return ratios will optically look lower for it. However, going forward, return ratios are expected to improve on account of ramp up in existing value chains and long-term contracts.

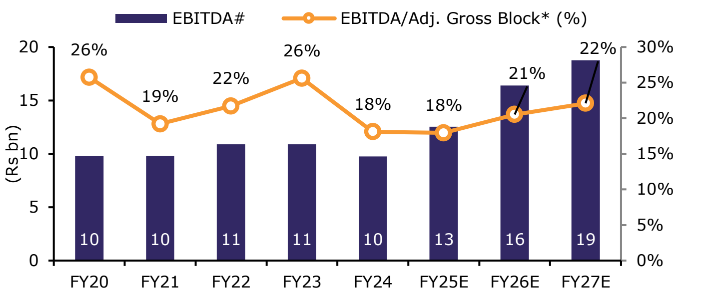
A large part of the capex spent in the last five years has not contributed to Aarti's EBITDA due to i) cancellation of the first long-term contract, ii) spends on asset refurbishment/replacement, which are non-revenue generating, and iii) availability issues in nitric acid hindering volume growth. After a stagnant EBITDA growth over FY19-23, Aarti is now poised for a sharp EBITDA growth, along with RoCE improvement. We expect Aarti's revenue/EBITDA/PAT to register ~19%/24%/29% CAGR over FY24-27E. We believe Aarti is well poised for demand recovery in the chemicals space, once inventory destocking is over, with multiple tailwinds favoring its businesses. Also, we expect Aarti to gradually ramp up its EBITDA over the next few quarters, followed by contribution from the chlorotoluene chain from FY26E. We maintain BUY on Aarti, while revising down our target price to Rs675/share (from Rs800 earlier), valuing the stock at 30x its Sep-26E EPS, as the growth is largely back ended for FY26-27E.

Exhibit 1: Toluene chain to start ramping up sequentially, followed by rebound in the benzene chain



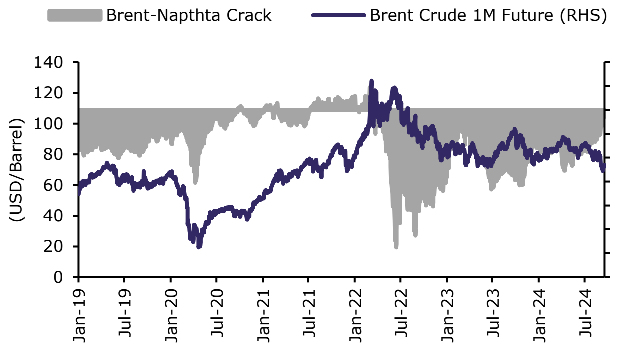
Source: Company, Emkay Research

Exhibit 2: Adj Gross Block/EBITDA to start improving, once demand recovers; to reach 22-25% at peak by FY27E/28E



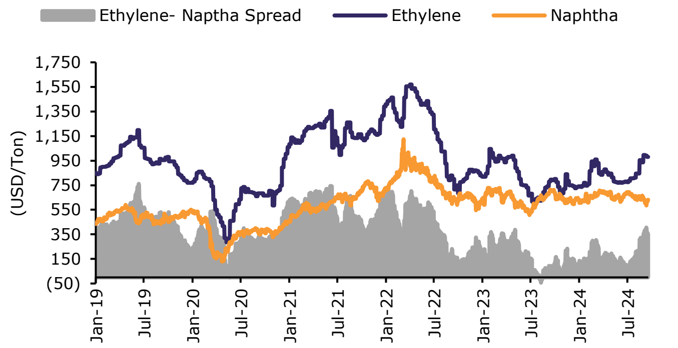
*Source: Company, Emkay Research; Note: *Gross Block adjusted for first long-term contract and replacement/refurbishment capex to the tune of Rs20bn; #FY20-22 contains pharma business EBITDA of ~Rs1.5-2bn; the pharma business has now been demerged*

Exhibit 3: Brent-Naphtha cracks reducing difference in naphtha toward gasoline…



Source: Bloomberg, Emkay Research

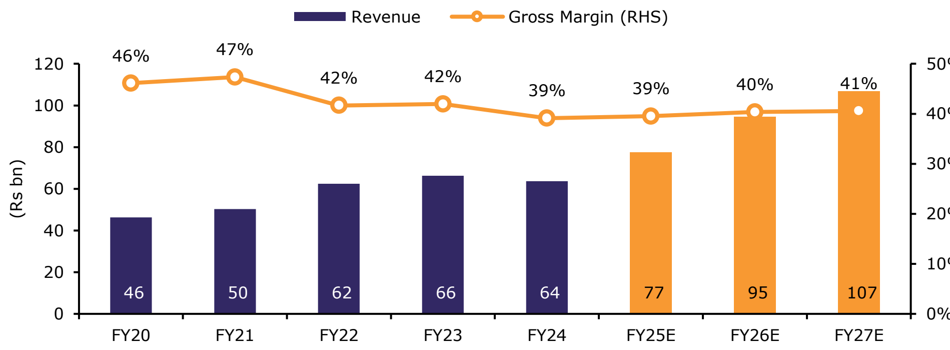
Exhibit 4: …supplemented by improving Ethylene-Naphtha spreads



Source: Bloomberg, Emkay Research

Revenue growth will be driven by recovery in the core portfolio, nitrotoluene expansion, and contribution from long-term contracts

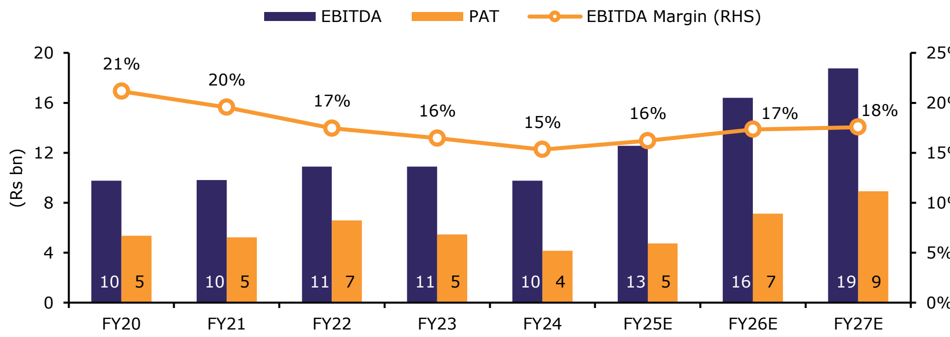
Exhibit 5: Revenue CAGR to clock at 19% over FY24-27E



Source: Company, Emkay Research

We build-in marginally higher margins, as operating leverage will kick-in once volumes see growth

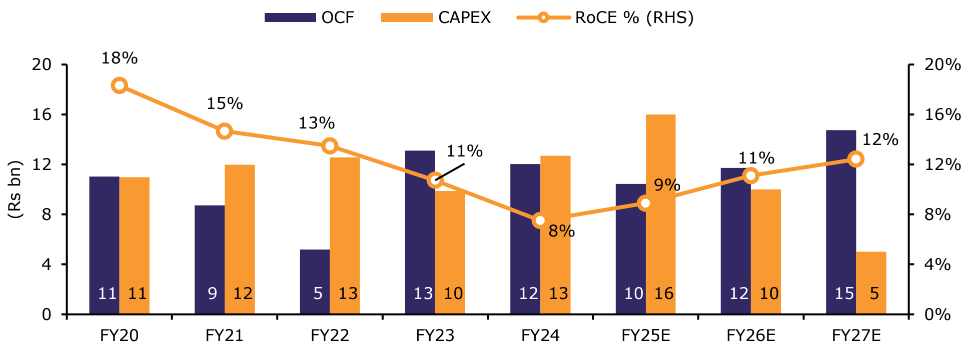
Exhibit 6: Volume recovery, coupled with higher operating leverage, will lead to EBITDA growth



Source: Company, Emkay Research

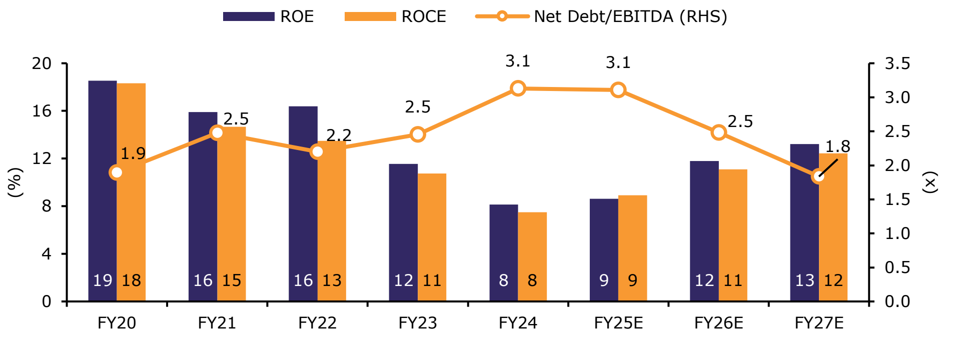
Capex to be funded by a mix of debt and internal accruals; debt to peak by FY26E

Exhibit 7: Company to generate enough OCF after the end of the capex cycle in FY25-26E



Source: Company, Emkay Research

Exhibit 8: Return ratios to rebound with focus on capacity utilization



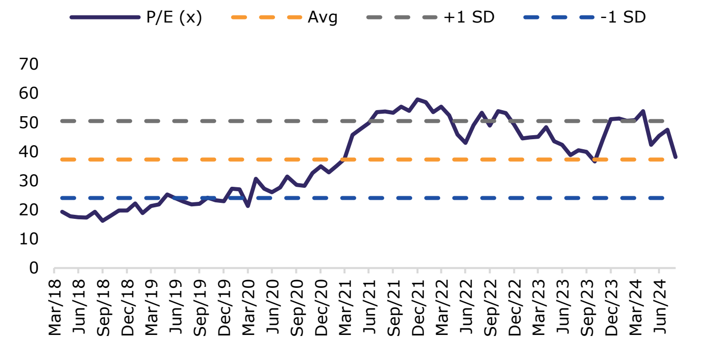
Source: Company, Emkay Research

Exhibit 9: Specialty Chemicals companies – Peer valuations, a comparison

Peer (Domestic)	Ratings	P/E (x)			EV/E (x)			RoE (%)		
		FY25E	FY26E	FY27E	FY25E	FY26E	FY27E	FY25E	FY26E	FY27E
SRF	ADD	42	31	26	24	19	17	14	17	17
PI Industries	REDUCE	42	37	33	28	24	21	18	17	16
Gujarat Fluorochemicals	SELL	74	50	40	29	21	17	10	14	15
Deepak Nitrite	ADD	46	36	33	33	33	26	16	18	17
Aarti Industries	BUY	44	29	23	20	15	13	9	12	13
Navin Fluorine International	REDUCE	48	36	31	35	26	23	14	16	16
Anupam Rasayan India *	ADD	49	27	20	25	16	13	6	10	13
Epigral	BUY	27	20	18	14	11	10	23	24	22
Tata Chemicals	NR	33	23	22	13	11	10	4	5	5
Atul	NR	46	35	28	25	20	17	9	11	12
Vinati Organics	NR	50	38	37	33	26	23	16	19	18
Clean Science & Technology	NR	54	42	29	38	30	21	23	24	28
Fine Organic Industries	NR	37	34	30	27	24	22	21	19	19
Aether Industries	NR	85	58	37	54	37	23	7	10	13
Jubilant Ingrevia	NR	45	32	25	23	17	14	9	12	14
Archean Chemical Industries	NR	23	16	12	15	10	8	20	24	24
Deepak Fertilisers & Petrochem	NR	18	14	10	9	8	6	9	9	17
Laxmi Organic Industries	NR	52	42	29	24	19	14	8	10	13
Sudarshan Chemical Industries	NR	38	28	24	18	15	13	15	18	18
Neogen Chemicals	NR	93	62	46	43	28	16	8	11	14

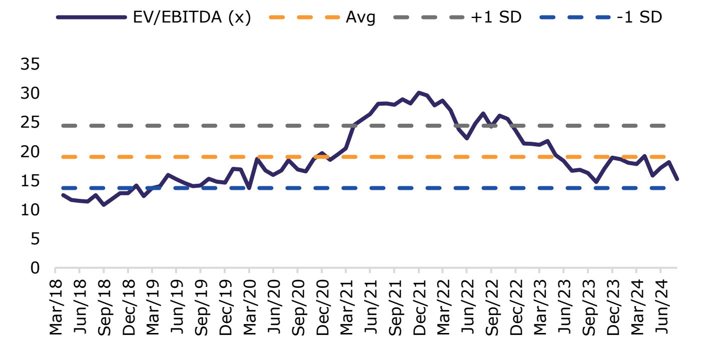
Source: Bloomberg, Emkay Research; Note: *Standalone

Exhibit 10: One-year forward P/E



Source: Bloomberg, Emkay Research

Exhibit 11: One-year forward EV/EBITDA



Source: Bloomberg, Emkay Research

Aarti Industries: Consolidated Financials and Valuations

Profit & Loss

Y/E Mar (Rs mn)	FY23	FY24	FY25E	FY26E	FY27E
Revenue	**66,186**	**63,720**	**77,447**	**94,578**	**106,805**
Revenue growth (%)	6.1	(3.7)	21.5	22.1	12.9
EBITDA	**10,890**	**9,760**	**12,545**	**16,400**	**18,758**
EBITDA growth (%)	0.0	(10.4)	28.5	30.7	14.4
Depreciation & Amortization	3,105	3,780	4,550	5,272	5,689
EBIT	**7,786**	**5,980**	**7,995**	**11,128**	**13,069**
EBIT growth (%)	(7.6)	(23.2)	33.7	39.2	17.4
Other operating income	0	0	0	0	0
Other income	9	80	80	80	80
Financial expense	1,683	2,110	2,497	2,824	2,642
PBT	**6,111**	**3,950**	**5,579**	**8,384**	**10,507**
Extraordinary items	0	0	0	0	0
Taxes	659	(210)	837	1,258	1,576
Minority interest	0	0	0	0	0
Income from JV/Associates	0	0	0	0	0
Reported PAT	**5,453**	**4,160**	**4,742**	**7,126**	**8,931**
PAT growth (%)	(17.1)	(23.7)	14.0	50.3	25.3
Adjusted PAT	**5,453**	**4,160**	**4,742**	**7,126**	**8,931**
Diluted EPS (Rs)	**15.1**	**11.5**	**13.1**	**19.7**	**24.7**
Diluted EPS growth (%)	(17.1)	(23.7)	14.0	50.3	25.3
DPS (Rs)	**2.5**	**1.5**	**1.3**	**2.0**	**2.5**
Dividend payout (%)	**16.6**	**13.0**	**10.0**	**10.0**	**10.0**
EBITDA margin (%)	16.5	15.3	16.2	17.3	17.6
EBIT margin (%)	11.8	9.4	10.3	11.8	12.2
Effective tax rate (%)	10.8	(5.3)	15.0	15.0	15.0
NOPLAT (pre-IndAS)	**6,946**	**6,298**	**6,796**	**9,459**	**11,109**
Shares outstanding (mn)	362.0	362.0	362.0	362.0	362.0

Source: Company, Emkay Research

Balance Sheet

Y/E Mar (Rs mn)	FY23	FY24	FY25E	FY26E	FY27E
Share capital	1,813	1,813	1,813	1,813	1,813
Reserves & Surplus	47,388	51,080	55,348	61,762	69,800
Net worth	**49,201**	**52,893**	**57,161**	**63,574**	**71,612**
Minority interests	7	7	7	7	7
Deferred tax liability (net)	(528)	(1,440)	(1,440)	(1,440)	(1,440)
Total debt	**28,740**	**31,840**	**39,839**	**41,249**	**34,598**
Total liabilities & equity	**77,421**	**83,300**	**95,567**	**103,391**	**104,777**
Net tangible fixed assets	48,287	55,875	67,325	72,053	71,364
Net intangible assets	322	615	615	615	615
Net ROU assets	303	530	530	530	530
Capital WIP	10,962	12,290	12,290	12,290	12,290
Goodwill	0	0	0	0	0
Investments [JV/Associates]	172	230	230	230	230
Cash & equivalents	**2,007**	**1,300**	**855**	**528**	**161**
Current assets (ex-cash)	23,531	24,410	27,564	33,435	37,625
Current Liab. & Prov.	7,861	11,420	13,311	15,760	17,508
NWC (ex-cash)	**15,670**	**12,990**	**14,252**	**17,674**	**20,117**
Total assets	**77,421**	**83,300**	**95,567**	**103,391**	**104,777**
Net debt	26,733	30,540	38,984	40,721	34,437
Capital employed	77,421	83,300	95,567	103,391	104,777
Invested capital	**64,279**	**69,480**	**82,192**	**90,342**	**92,096**
BVPS (Rs)	135.9	146.1	157.9	175.6	197.8
Net Debt/Equity (x)	0.5	0.6	0.7	0.6	0.5
Net Debt/EBITDA (x)	2.5	3.1	3.1	2.5	1.8
Interest coverage (x)	0.2	0.3	0.3	0.3	0.2
RoCE (%)	**10.5**	**7.5**	**9.0**	**11.3**	**12.6**

Source: Company, Emkay Research

Cash flows

Y/E Mar (Rs mn)	FY23	FY24	FY25E	FY26E	FY27E
PBT	6,111	3,950	5,579	8,384	10,507
Others (non-cash items)	3,105	3,780	4,550	5,272	5,689
Taxes paid	(909)	(910)	(837)	(1,258)	(1,576)
Change in NWC	3,224	1,768	(1,262)	(3,422)	(2,443)
Operating cash flow	**13,098**	**12,040**	**10,446**	**11,720**	**14,739**
Capital expenditure	(13,268)	(12,988)	(16,000)	(10,000)	(5,000)
Acquisition of business	109	(58)	0	0	0
Interest & dividend income	9	80	80	80	80
Investing cash flow	**(13,298)**	**(13,100)**	**(15,920)**	**(9,920)**	**(4,920)**
Equity raised/(repaid)	3	0	0	0	0
Debt raised/(repaid)	3,061	3,100	7,999	1,410	(6,651)
Payment of lease liabilities	0	0	0	0	0
Interest paid	(1,683)	(2,110)	(2,497)	(2,824)	(2,642)
Dividend paid (incl tax)	(906)	(540)	(474)	(713)	(893)
Others	(3)	(100)	0	0	0
Financing cash flow	**472**	**350**	**5,028**	**(2,127)**	**(10,186)**
Net chg in Cash	272	(710)	(445)	(326)	(367)
OCF	13,098	12,040	10,446	11,720	14,739
Adj. OCF (w/o NWC chg.)	16,322	13,808	9,184	8,298	12,296
FCFF	(170)	(948)	(5,554)	1,720	9,739
FCFE	(1,844)	(2,978)	(7,970)	(1,024)	7,177
OCF/EBITDA (%)	120.3	123.4	83.3	71.5	78.6
FCFE/PAT (%)	(33.8)	(71.6)	(168.1)	(14.4)	80.4
FCFF/NOPLAT (%)	**(2.4)**	**(15.1)**	**(81.7)**	**18.2**	**87.7**

Source: Company, Emkay Research

Valuations and key Ratios

Y/E Mar	FY23	FY24	FY25E	FY26E	FY27E
P/E (x)	38.1	49.9	43.8	29.1	23.3
P/CE(x)	24.3	26.2	22.4	16.8	14.2
P/B (x)	4.2	3.9	3.6	3.3	2.9
EV/Sales (x)	3.5	3.7	3.2	2.6	2.3
EV/EBITDA (x)	21.5	24.4	19.7	15.1	12.9
EV/EBIT(x)	30.1	39.8	30.9	22.3	18.5
EV/IC (x)	3.6	3.4	3.0	2.7	2.6
FCFF yield (%)	(0.1)	(0.4)	(2.3)	0.7	4.0
FCFE yield (%)	(0.9)	(1.4)	(3.8)	(0.5)	3.5
Dividend yield (%)	0.4	0.3	0.2	0.3	0.4
DuPont-RoE split					
Net profit margin (%)	8.2	6.5	6.1	7.5	8.4
Total asset turnover (x)	0.9	0.8	0.9	1.0	1.0
Assets/Equity (x)	1.6	1.6	1.6	1.6	1.5
RoE (%)	**11.6**	**8.1**	**8.6**	**11.8**	**13.2**
DuPont-RoIC					
NOPLAT margin (%)	10.5	9.9	8.8	10.0	10.4
IC turnover (x)	1.1	1.0	1.0	1.1	1.2
RoIC (%)	**11.6**	**9.4**	**9.0**	**11.0**	**12.2**
Operating metrics					
Core NWC days	86.4	74.4	67.2	68.2	68.7
Total NWC days	**86.4**	**74.4**	**67.2**	**68.2**	**68.7**
Fixed asset turnover	1.2	0.9	0.9	1.0	1.0
Opex-to-revenue (%)	25.5	23.8	23.3	23.0	23.0

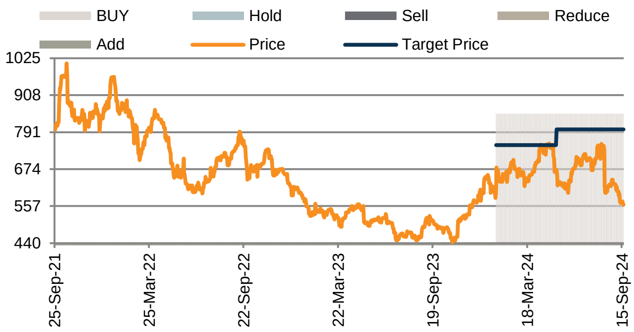
Source: Company, Emkay Research

RECOMMENDATION HISTORY - DETAILS

Date	Closing Price (INR)	TP (INR)	Rating	Analyst
27-Aug-24	640	800	Buy	Meet Vora
13-Aug-24	621	800	Buy	Meet Vora
14-Jul-24	706	800	Buy	Meet Vora
07-Jun-24	635	800	Buy	Meet Vora
13-May-24	669	800	Buy	Meet Vora
07-Apr-24	696	750	Buy	Meet Vora
26-Feb-24	672	750	Buy	Meet Vora
09-Feb-24	663	750	Buy	Meet Vora
18-Jan-24	612	750	Buy	Meet Vora

Source: Company, Emkay Research

RECOMMENDATION HISTORY - TREND



Source: Company, Bloomberg, Emkay Research

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ADD	5-15% upside
REDUCE	5% upside to 15% downside
SELL	<15% downside

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