21st August 2020 | CMP – ₹1172/- | View – **ACCUMULATE ON DIPS**

Company Background

Incorporated in 1984, Aarti Industries Ltd is the leading producer of Benzene based basic and intermediate specialty chemicals in India, manufacturing ~120 products in chemistry of benzene, aniline, sulphuric acid, toulene etc. Company is preferred partner of choice for more than ~1000 customers globally and supplies benzene based intermediates and pharmaceuticals to manufacturers of dyes, pigments, agrochemicals, automobile etc. Company's business is diversified across 2 segments such as specialty chemicals and pharmaceuticals each contributing 84% and 16% respectively to company's overall revenue as of FY20.

Important Statistics

M.Cap (₹ crore)	20,419
52 Week H/L (₹)	₹1,229/662
NSE Code	AARTIIND
BSE Code	524208

Investment Arguments

- **Specialty Chemical segment to benefit from environmental issues in China –** Company's specialty chemicals business grew ~10% CAGR over FY15-20 with EBIT margins expanding from 17% to ~22% during same period on the back of consistent expansion in existing products and addition of downstream derivative products. However, company's specialty chemical segment revenues degrew by ~3% YoY in FY20 impacted on account of Covid-19 (topline to the extent of 9-10% was lower due to COVID-19), while EBIT margins expanded to ~22% despite Covid-19 disruption. We believe there might be near term pain in this segment due to the coronavirus led outbreak however ensuing disruptions could become a structural advantage for AIL as leading global players would look to accelerate shifting their supply chain to India thus benefitting AIL's specialty chemicals division.
- **Pharmaceutical segment resilient in long term –** Company's pharmaceutical business grew ~20% CAGR over FY15-20 with EBIT margins expanding from 11% to 16.4% during same period on the back of improved utilization (60% in FY15 to 80% in FY19),higher demand for API intermediates and shift in business from China to India. Company's pharmaceutical segment' s revenue grew in lower single digits ~4% YoY in FY20 impacted on account of Covid-19, however EBIT margins improved to ~16.5% driven by higher contribution from regulated markets and value added products. Management guided strong revenue and volume growth going ahead, on the back of higher demand from API markets, supply disruptions in China and expansion in pharmaceutical business which is expected to come on stream during FY21E.
- **High Entry barriers – makes it competitive over its peers –** Company's longer approval cycle extending from 3 months to 2 years depending on customer's requirements including complex products and strong technological knowhow provides edge over its competitors. Further, a manufacturing plant requires a number of end products to make it economically viable, AIL with its high chemical expertise and strong R&D ensures high quality thus making it leading manufacturer in benzene chemistry.
- **Long term contracts strengthens earnings visibility over long term** – Company signed 3 contracts valuing, ₹40,000mn for 10 years - 1st contract, ₹100,000mn over 20 years – 2nd contract and $125mn for 10 years – 3rd contract in FY18 and FY19 respectively. Company commenced operations for first multi-year contract of ₹40,000mn for a 10 year with global agrochemical player in Q4FY20, however, the global client suddenly terminated the contract owing to change its strategy. The termination triggered a take or pay clause embedded in contract and company is expected to receive $40mn in FY21-22E

Financials

(₹ mn)

Particulars	FY18	FY19	FY20
Revenues	38,061	41,676	41,863
EBITDA	6,991	9,651	9,773
EBITDA Margin (%)	18.4%	23.2%	23.3%
Net Profit	3,330	4,917	5,361
EPS (₹) ^	19.1	28.2	30.8
RoE (%)	20.1%	18.1%	17.4%
RoCE (%)	15.8%	16.9%	16.5%
P/E (x)	57.2	41.5	38.1
EV/EBITDA (x)	16.3	22.5	22.5
P/BV (x)	5.8	7.5	6.6

^ EPS post bonus issue

Shareholding pattern (%)	June'20
Promoter	47.5%
FII	7.4%
DII	16.2%
Public & Others	29.0%

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and remaining \$80-90mn compensation in FY23E. Management guided termination of the contract does not affect existing relationship with the customer and company will continue to supply intermediates going forward. The facility for second multi-year contract of ₹100,000mn spread over 20 year will be commissioned in 2HFY21E at a capex of ₹2700mn and revenue generation is expected to be ₹5,000mn with PBT margin of 10%. While the facility for third multi-year contract of \$125 mn (₹9375mn) for a 10 year period is expected to be commissioned by H2FY22E at a capex of \$18 mn (₹1350mn). We believe, these multiyear contracts to benefit company's financials going ahead.

- **Sustained focus on value added products to aid margin –** Aarti Industries Ltd's overall EBITDA margins expanded from ~16% in FY15 to ~23% in FY20 led by increasing proportion of high value added products (contribution of downstream high value added products increased to 70% now). We expect with higher capacity utilisation, increasing demand for pharmaceutical segments, newer downstream chemistries and positive operating leverage, margins to expand going ahead especially post FY21E.
- **Improved operational efficiencies to hold return ratios and improve D/E –** EBITDA margins of the company spiked over FY15-19 (from 16% in FY15 to 23% in FY20), due to backward/forward integration of its specialty chemicals products, increasing share of value-added product offerings, strong demand for pharmaceutical products, higher capacity utilization etc. Despite huge investments to cater to growing demand in specialty chemicals and pharmaceuticals segment, AIL managed to maintain its return ratios; RoE at 18% and ROCE at level of ~16-17% over FY15-FY20. Going forward, we expect RoCE, ROE to remain at levels of 17-18% respectively over the FY20-22E period given the strong topline growth expectations and positive operating leverage.
- **Q1FY21 numbers subdued, growth expected from H2FY21E –** In the quarter, revenue was lower by 9.7% YoY to ₹9373mn, primarily due to lower revenue in specialty chemicals while pharmaceuticals saw a marginal increase. Ease in input cost pressures led to gross margin expansion of 115 bps YoY to 52.3%, while gross profit was lower by 7.7% YoY to ₹4900mn. Adverse operating leverage resulted in EBITDA margin contraction of 467 bps YoY to 19.4%, leading to lower EBITDA, which stood at ₹1820mn. PAT degrew by 41% YoY to ₹819mn on account of lower operating profit coupled with higher depreciation (up 20.3% YoY).

  Management guided, to tap growth opportunities its capex plans are intact and it plans to spend ₹10,000-20,000mn for FY21E–FY22E which includes, ₹1350mn for multiyear contract, ₹1500mn for pharma, ₹1500mn for NCB expansion, ₹5,000mn for debottlenecking, ₹20,00mn – maintenance capex etc. Also, it indicated, chlorination expansion and NCB phase 1 expansion would be completed by H2FY21E and H1FY22E respectively.

  Management has guided for single-digit growth in revenue and EBITDA, however PAT is expected to remain flat for FY21E and major bounce back to be from FY22E.

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Outlook

Company reported subdued numbers in Q4FY20 and Q1FY21 due to supply disruption, demand slowdown which affected company's specialty segment the most. We believe, the long term story remains intact and growth to be largely driven by import substitution, customer de-risking, 2 long term contracts, robust growth from pharmaceuticals etc. Company' s deleveraged balance sheet, dominance in business, strong customer relationships and good return ratios further comforts us and makes it a good bet. **At CMP of ₹1172, Aarti Industries Ltd trades at ~38x FY20 EPS and ~22x FY20 EV/EBITDA and is justified given its long term growth story thus we recommend investors to *'ACCUMULATE on dips'*.**

Consolidated Financials

(₹ mn)

Particulars	Q1FY21	Q4FY20	Q1FY20	YoY	QoQ
Net Sales	**9,373**	**10,762**	**10,384**	**-9.7%**	**-12.9%**
Raw Material Consumed	4,470	5,561	5,071	-11.9%	-19.6%
Employee costs	897	785	695	29.1%	14.2%
Other expenses	2,187	2,226	2,117	3.3%	-1.7%
Total Expenditure	7,553	8,572	7,883	-4.2%	-11.9%
EBITDA	**1,820**	**2,189**	**2,501**	**-27.2%**	**-16.9%**
EBITDA Margin	**19.4%**	**20.3%**	**24.1%**	**-467bps**	**-93 bps**
Depreciation	520	493	432	20.3%	5.5%
EBIT	**1,300**	**1,697**	**2,069**	**-37.2%**	**-23.4%**
EBIT Margin	**13.9%**	**15.8%**	**19.9%**	**-606bps**	**-190bps**
Interest	253	340	310	-18.3%	-25.5%
Other income	2	4	25	-91.1%	-47.6%
PBT	**1,049**	**1,361**	**1,784**	-41.2%	-22.9%
Tax	217	257	365	-40.5%	-15.7%
PAT	**832**	**1,104**	**1,419**	-41.4%	-24.6%
Minority Interest	13	-	(37.9)	NA	NA
Consol PAT	**819**	**1,104**	**1,381**	**-40.7%**	**-25.8%**
PAT Margin	**8.7%**	**10.3%**	**13.3%**	**-456bps**	**-152bps**
EPS (₹)	4.70	6.33	7.93	-40.7%	-25.8%

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Disclosure of Interest Statement Aarti Industries Ltd. as on August 21st, 2020

Name of the Security	Aarti Industries Ltd.
Name of the analyst	Yogita Desai
Analysts' ownership of any stock related to the information contained Financial Interest Analyst : Analyst's Relative : Yes / No Analyst's Associate/Firm : Yes/No	NIL No No No
Conflict of Interest	No
Receipt of Compensation	No
Way2Wealth ownership of any stock related to the information contained	NIL
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