Aarti Industries Ltd.	
No. of shares (m)	174.2
Mkt cap (Rs crs/$m)	17328/2349.7
Current price (Rs/$)	995/13.5
Price target (Rs/$)	1110/15.1
52 W H/L (Rs.)	1229/668
Book Value (Rs/$)	175/2.4
Beta	0.6
Daily volume NSE (avg. monthly)	188260
P/BV (FY21e/22e)	5.1/4.3
EV/EBITDA (FY21e/22e)	18.5/15.2
P/E (FY21e/22e)	33.4/26.9
EPS growth (FY20/21e/22e)	0.7/-1.9/24.2
OPM (FY20/21e/22e)	23.3/24.3/25.7
ROE (FY20/21e/22e)	19.2/16.3/17.4
ROCE(FY20/21e/22e)	12.6/11.8/12.9
D/E ratio (FY20/21e/22e)	0.7/0.6/0.5
BSE Code	524208
NSE Code	AARTIIND
Bloomberg	ARTO IN
Reuters	ARTI.NS

Shareholding pattern	%
Promoters	47.6
MFs / Banks / FIs	15.8
Foreign Portfolio Investors	7.5
Govt. Holding	0.0
Public & Others	29.2
Total	**100.0**

As on Sep 30, 2020

Recommendation

ACCUMULATE

Analyst

KISHAN GUPTA, CFA, FRM

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Company Brief

AIL is one of India's leading manufacturers of chemicals and pharmaceutical intermediates: dyestuff; pigment; agro chemicals; speciality chemicals; API.

Quarterly Highlights

- Strangled by pandemic induced lockdown which all but decimated supply networks and brought factory production to a grinding halt in April and some part of May, Aarti report 50% drop in its speciality chemicals production in April, thus precipitating some 11% decline in its gross speciality chemicals revenues (consolidated) in Q1 (yoy). Whence speciality chemicals EBIT plunged by a distressing 39.2% not least due to lower sales and higher expenses on account of commissioning of first phase of Dahej SEZ and R&D Centre at Navi Mumbai in Q4, thus little protected by recognition of Rs 38 crs shortfall fees related to cancellation of a long term supply contract - EBIT margins on gross sales slid to 15.4% from 22.6%.
- Yet its pharmaceuticals business remained resilient as ever -though helped by the pandemic too - for it reported 1.6% growth in sales and no belittle growth in EBIT (41.6%) galvanized by higher revenue contribution of regulated markets and value added products. Wherefore EBIT margins surged to a seemingly record 23.3% from 17.4% in Q4 and just 16.7% in the same quarter a year ago. The gut-wrenching pandemic has scarcely dented Aarti's API supplies to developed markets, thus strengthening its resolve to focus on off-patented generics in regulated markets.
- Not least due to disproportionate contribution of the speciality chemicals business, overall operating profit nosedived by 27.2% to Rs 181.99 crs from Rs 250.11 crs in the year ago period - OPM, as a result, stripped off by 500 bps to 19.4%. Post tax earnings too walloped for it skid by an alarming 40.7% to Rs 81.85 crs. Stress in production of key chemicals such as NCB (13000 mt Vs 16100 mt) and nitro toulene (2140 mt Vs 2750 mt) little doubtedly underscores the impact of pandemic on Aarti's production lines.
- The stock currently trades at 33.4x FY21e EPS of Rs 29.79 and 26.9x FY22e EPS of Rs 37. Cancellation of the long term contract for supply of an agrochemical intermediate has left little dependency on reliability of such contracts on future revenue streams; though annual compensation of some $20 mn would doubtlessly support margins - OPMs are estimated to rise to 25.7% next fiscal from 23.3% in FY20. Yet little tenacity of earnings momentum to drive return on capital, which continues to stagger, needs more perusal. On balance we advise accumulating the stock with revised target of Rs 1110 (previous target: Rs 890) based on 30x FY21e earnings.

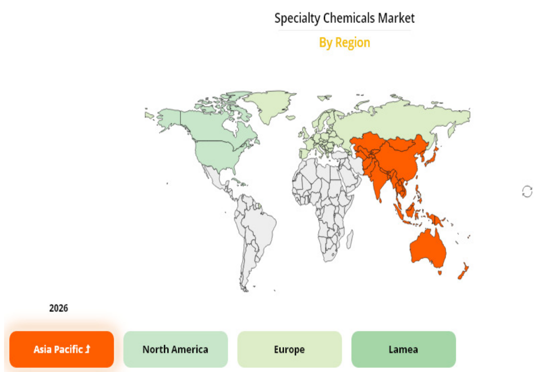
Consolidated (Rs crs)	FY19	FY20	FY21e	FY22e
Income from operations	4167.56	4186.31	4265.96	4884.08
Other Income	2.11	8.83	3.15	3.65
EBITDA (other income included)	967.20	986.17	1039.31	1258.66
Profit after MI	490.38	529.28	519.03	644.70
EPS(Rs)	30.16	30.38	29.79	37.00
EPS growth (%)	49.5	0.7	-1.9	24.2

Outlook & Recommendation

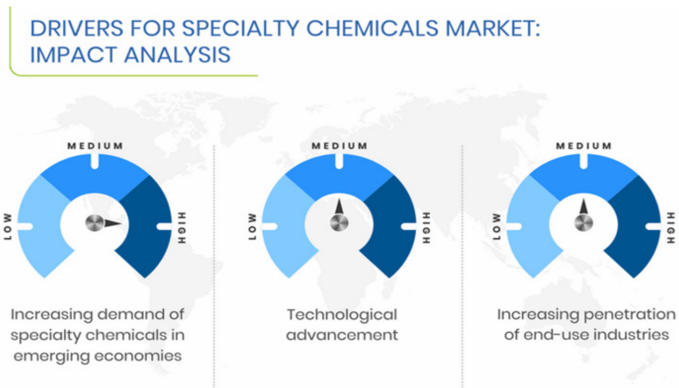
Global Specialty Chemicals Update

According to a report by Grand View Research, Inc, the global specialty chemicals market is estimated to grow by 3.7% CAGR to $844.2 bn during 2016-27 periods not least due to higher performance achieved by the application of specialty chemicals when compared to their conventional counterparts. Increasing disposable income, growing awareness, higher healthcare and construction spending, infrastructural development, and population growth are factors likely to increase the product sales across end-use industries such as construction, personal care, and cosmetics, pharmaceutical and nutraceuticals, food, automotive, and electronics.

The industry would get a further fillip from growing consumer demand for energy that has driven the product consumption in oil & gas end use. Yet competition among the players is intensely rising all thanks to increased participation in R&D along with new and innovative product launches. The report further contends that compliance with the national and international norms for sustainable manufacturing and distribution along with acquiring certifications such as USDA and GMP could pose challenges to manufacturers in domestic as well as offshore businesses. Further, halts in trade, supply chain disruptions and industrial slowdown caused by the impact of Covid in some of the major economies such as US, Iran and China are likely to add to industry woes in 2020.



Source: Allied Market Research



Source: Prescient Strategic Intelligence

Another report published by Allied Market Research a couple of months back predicts a growth of 5% in global specialty chemicals market from 2020 to 2027. The report contends that the industry has strived to reduce its dependence on petrochemicals and has focused on bio-based or renewable materials. This would have a medium impact on the industry. Increasingly chemical manufacturers are focusing greater attention on innovation and various R&D processes to meet customers' demands.

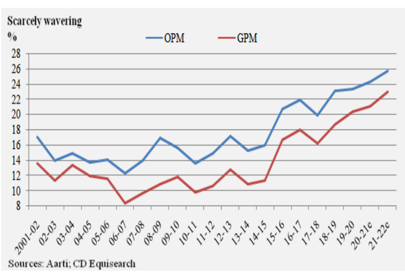
The introduction of new and advanced products in the end-user industries such as smart phones, tablets, and wireless devices with developed and better technologies supports the specialty chemicals market for electronic chemicals. In addition, in the automotive electronics market, technological development focuses on the introduction of highly efficient automated products. Far greater efforts are made by chemical manufacturers to include specialty chemicals for numerous end-user industries such as oil & gas, construction, printing inks, and cosmetics among others.

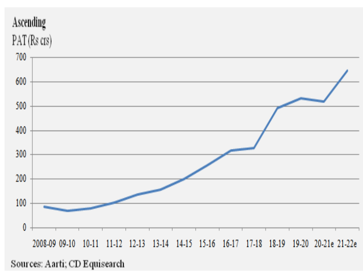
According to a industry report, the key markets of USA, China, Japan Canada and Europe will drive some 3.6% CAGR growth in global specialty coatings market - these markets accounting for a combined market size of $32.7 mn in 2020 is projected to reach $41.9 mn by 2027. By estimates China will remain the fastest growing market in this group of countries/regions, while Latin America would see a growth of 5.1% CAGR during the projected period.

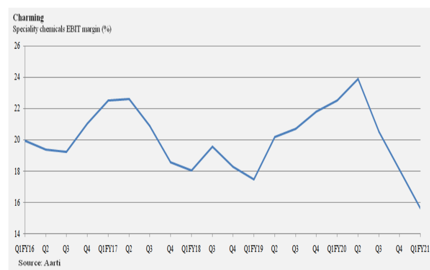
Financials & Valuation

Partially benefitted by closure of Chinese factories on account of tighter environmental standards and India's scalable manufacturing infrastructure and lower labour cost, India's specialty chemicals industry is estimated grow by 12-13% over the next few years (Source: Industry reports) with growing usage in agrochemicals, pharmaceuticals, automobiles and textiles. China's competitive edge has been gradually reduced not least due to rising lower cost, appreciation of Chinese yuan, trade rift with US and supply disruptions due to Covid-19. India's specialty chemicals industry is not expected to least benefit due to lower penetration of specialty chemicals when compared to developed economies like the US and the UK.

Seemingly undeterred by global economic slowdown and Covid-19, Aarti has all but tinkered its expansion plans for it plans to spend Rs 1000-1200 crs annually over the next few years; though we have factored somewhat lower figure in our model largely due to project work disruptions, labour migration issues and delays in equipment supplies caused by Covid -19. Most of the capex in the current fiscal would be channelized in commissioning the first phase of NCB capacity expansion at Jhagadia, execution of long term contracts at Dahej and Jhagadia, chlorination and speciality chemical complex at Jhagadia and boosting capacities of APIs and pharmaceutical intermediates at various locations. Most of the capex next fiscal is projected to flow in chlorination projects and in enhancement of capacities of downstream value added products.

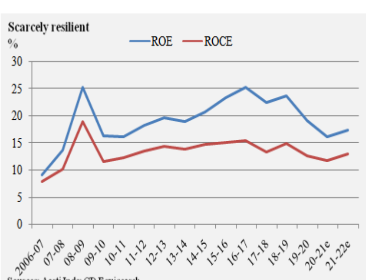


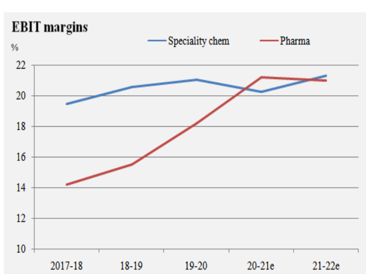


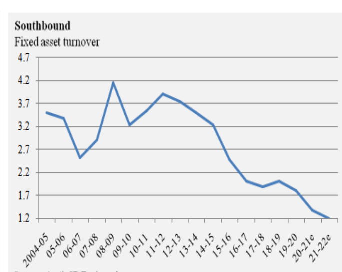


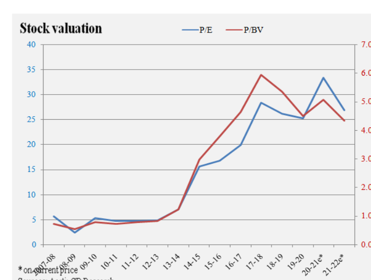
Despite no small addition of fixed assets, asset turnover ratios are barely showing any resilience, thus straining retun on capital ratios - ROE has decidedly fallen from 25.3% in FY17 to 19.2% in FY20 with no respite in sight for the same is further estimated to dwindle to 17.4% in FY22, casting little validity on its focus on value-enriching processes such as high-value chlorination, hydrogenation, ethylation and ammonolysis. Aarti's pharmaceuticals business though would gain support from its strategy to enrich its file of APIs and to penetrate further in to some key therapies such as antihypertensive, cardiovascular, oncology and corticosteriods - thence pharma business margin is estimated to swell from 18.2% in FY20 to 21% in FY22.

Pandemic related risks aside, Aarti's is little protected from external risks ranging from perceptible slowdown in discretionary consumer spending in automobiles, aviation and textiles to cross currency volatility to cancellation of supply contracts. One such risk came to fore this fiscal when a ten year high value agrochemical intermediary supply contract amounting to some Rs 4000 crs was cancelled by a global agrochemical major citing some change in strategy. Under the guarding provisions for compensation under the contract, Aarti is estimated to receive compensation in the range of $120-130 mn over the next few years.









The stock currently trades at 33.4x FY21e EPS of Rs 29.79 and 26.9x FY22e EPS of Rs 37. Constricted by the pandemic, Aarti would see no puny stress in earnings for we have abjectly slashed our EPS estimate for current fiscal by some 20% on lower revenues. Commencement of supplies of long term contracts coupled with commissioning of NCB capacity would little subdue earnings next fiscal for the same is estimated to rise by 24.2% on 14.5% growth in revenues - earnings would scarcely be stymied by annual accrual of $20 mn shortfall fees on account of cancellation of a long term supply contract. Weighing odds, we advise accumulating the stock with revised target of Rs 1110 (previous target: Rs 890) based on 30x FY21e earnings. For more info refer to our March report.

Cross Sectional Analysis

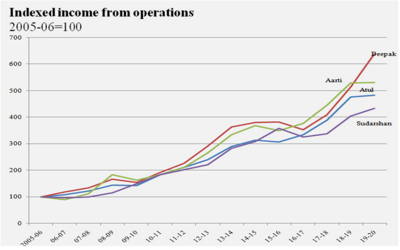
Company	Equity (Rs crs)	CMP (Rs crs)	Mcap (Rs crs)	Inc. from ops. (Rs crs)	Profit (Rs crs)	OPM (%)	NPM (%)	Int. coverage	ROE (%)	Mcap / IO	P/BV	P/E
Aarti Inds.	87	995	17328	4085	473	22.3	11.8	6.0	16.5	4.2	5.7	36.6
Atul Ltd	30	6108	18117	3670	602	23.4	16.4	79.2	18.8	4.9	5.2	30.1
Deepak Nitrite	27	745	10163	3853	583	25.0	15.1	7.7	41.1	2.6	6.1	17.4
SudarshanChem	14	458	3174	1654	105	14.4	6.4	10.0	16.9	1.9	5.0	30.1

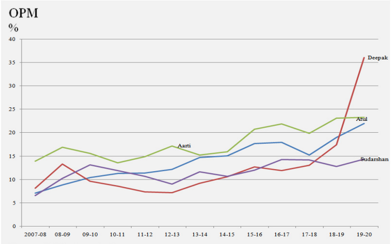
calculations on ttm basis; Aarti income from operations approximated
Companies not truly comparable due to product dissimilarity

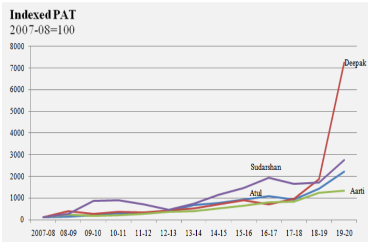
Deepak Nitrite's most imposing performance products took the biggest cut in revenues last quarter (at 76%) not least due to no puny demands suppression in paper and textiles industries, thus reversing the demand-supply dynamics of this business segment. Thence, its EBIT barely insignificantly declined to Rs 6.50 crs from Rs 75.38 crs in the March quarter. Its IPA plant which was commissioned in April reached peak utilization of some 110% during the quarter. Buoyed by exports, DNL's phenolics business surprisingly posted over 16% growth in EBIT though on 34% drop in revenues.

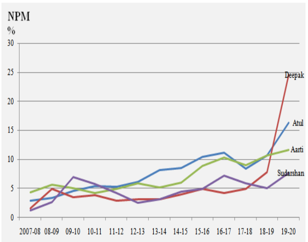
Sudarshan Chemical posted no small rebound in business activity in Q2 for it showed 1% growth in revenues (yoy) and 21.7% growth (q-o-q) partially helped restoration of production with the month of September logging the highest ever production volume. Aided by cost optimization and increased efficiencies, operating profit jumped 2.1% to Rs 67.69 crs and OPMs swelled to 15.8% from 15.6% in the year ago period. Gross margins improved too helped by improved pricing and stable raw material prices. Sudarshan expects the demand pick up to sustain as the domestic economy further reopens to pre-Covid levels.

No restricted rise in business activity explains unhindered surge in revenues of both life science chemicals (Rs 348 crs Vs 271 crs in Q1) and performance and other chemicals (Rs 690 crs Vs Rs 420 crs) in Q2 of this fiscal. Despite reporting marginal drop in revenues Atul's most worthy performance and other chemicals business showed 12.2% growth in its EBIT, a no mean feat considering its EBIT was just Rs 85.55 crs in Q1 - now Rs 159.36 crs. Overall operating profit rose not unremarkably by 16.4%, while PBT, hindered by lower other income, rose by just 10%. Little wavered by lower earnings, Atul reported higher free cash flows in the first half at some Rs 244 crs (Rs 204 crs last year), though somewhat supported by lower capex - consolidated capex at Rs 146 crs Vs Rs 208 crs in the first half of last fiscal.









Financials

Quarterly Results - Consolidated

Figures in Rs crs

	Q1FY21	Q1FY20	% chg.	FY20	FY19	% chg.
Income from operations	**937.33**	**1038.41**	**-9.7**	**4186.31**	**4167.56**	**0.4**
Other Income	0.22	2.47	-91.1	8.83	2.11	318.5
Total Income	**937.55**	**1040.88**	**-9.9**	**4195.14**	**4169.67**	**0.6**
Total Expenditure	755.34	788.30	-4.2	3208.97	3202.47	0.2
EBIDTA (other income included)	**182.21**	**252.58**	**-27.9**	**986.17**	**967.20**	**2.0**
Interest	25.32	31.00	-18.3	124.78	182.54	-31.6
Depreciation	51.99	43.21	20.3	185.21	162.68	13.8
PBT	**104.90**	**178.37**	**-41.2**	**676.17**	**621.97**	**8.7**
Tax	21.70	36.45	-40.5	129.42	117.80	9.9
PAT	**83.20**	**141.92**	**-41.4**	**546.75**	**504.17**	**8.4**
Minority Interest	1.34	3.79	-64.6	10.68	12.44	-14.1
PAT post MI	**81.86**	**138.13**	**-40.7**	**536.07**	**491.73**	9.0
Extraordinary Item	0.00	0.00	#DIV/0!	6.79	1.35	402.4
Adjusted Net Profit	**81.86**	**138.13**	**-40.7**	**529.28**	**490.38**	**7.9**
EPS (F.V. 5)	4.70	7.97	-41.0	30.38	30.16	0.7

Segment Results

Figures in Rs crs

	Q1FY21	Q1FY20	% chg.	FY20	FY19	% chg.
Segment Revenue						
Speciality Chemicals	840.85	944.35	-11.0	3864.95	3979.70	-2.9
Pharmaceuticals	194.27	191.14	1.6	755.74	725.81	4.1
Total	**1035.12**	**1135.49**	**-8.8**	**4620.69**	**4705.51**	**-1.8**
Less GST	97.79	97.08	0.7	434.38	537.95	-19.3
Net	**937.33**	**1038.41**	**-9.7**	**4186.31**	**4167.56**	**0.4**
Segment EBIT						
Speciality Chemicals	129.62	213.29	-39.2	814.11	819.57	-0.7
Pharmaceuticals	45.31	31.99	41.6	137.46	112.68	22.0
Total	**174.93**	**245.28**	**-28.7**	**951.57**	**932.25**	**2.1**
Interest	25.32	31.00	-18.3	124.78	182.54	-31.6
Other Unallocable Exp. (net of income)	44.71	35.91	24.5	150.61	127.74	17.9
PBT	**104.90**	**178.37**	**-41.2**	**676.17**	**621.97**	**8.7**

Income Statement - Consolidated

Figures in Rs crs

	FY19	FY20	FY21e	FY22e
Income from operations (net)	**4167.56**	**4186.31**	**4265.96**	**4884.08**
Growth (%)	18.7	0.4	1.9	14.5
Other Income	2.11	8.83	3.15	3.65
Total Income	**4169.67**	**4195.14**	**4269.11**	**4887.73**
Total Expenditure	3202.47	3208.97	3229.80	3629.07
EBITDA (other income included)	**967.20**	**986.17**	**1039.31**	**1258.66**
Interest	182.54	124.78	136.28	137.36
EBDT	**784.66**	**861.39**	**903.03**	**1121.30**
Depreciation	162.68	185.21	233.37	291.30
Tax	117.80	129.42	140.63	174.30
Net profit	**504.17**	**546.75**	**529.03**	**655.70**
Minority interest	12.44	10.68	10.00	11.00
Net profit after MI	**491.73**	**536.07**	**519.03**	**644.70**
Extraordinary item	1.35	6.79	0.00	0.00
Adjusted Net Profit	**490.38**	**529.28**	**519.03**	**644.70**
EPS (Rs.)	30.16	30.38	29.79	37.00

Segment Results

Figures in Rs crs

	FY19	FY20	FY21e	FY22e
Segment Revenue				
Speciality Chemicals	3979.70	3864.95	3907.48	4493.60
Pharmaceuticals	725.81	755.74	801.08	897.21
Total	**4705.51**	**4620.69**	**4708.56**	**5390.82**
Less GST	537.95	434.38	442.61	506.74
Net	**4167.56**	**4186.31**	**4265.96**	**4884.08**
Segment EBIT				
Speciality Chemicals	819.57	814.11	791.61	956.85
Pharmaceuticals	112.68	137.46	169.71	188.42
Sub Total	**932.25**	**951.57**	**961.32**	**1145.26**
Interest	182.54	124.78	136.28	137.36
Other Unallocable Exp. (net of income)	127.74	150.61	155.38	177.90
PBT	**621.98**	**676.18**	**669.66**	**830.00**

Consolidated Balance Sheet

Figures in Rs crs

	FY19	FY20	FY21e	FY22e
SOURCES OF FUNDS				
Share Capital	43.33	87.12	87.12	87.12
Reserves	2587.44	2891.64	3349.69	3933.41
Total Shareholders Funds	**2630.77**	**2978.76**	**3436.80**	**4020.53**
Minority Interest	83.95	94.62	104.62	115.62
Long term debt	814.80	580.84	338.51	139.40
Total Liabilities	**3529.52**	**3654.22**	**3879.93**	**4275.55**
APPLICATION OF FUNDS				
Gross Block	3361.80	3837.04	5337.04	6337.04
Less: Accumulated Depreciation	1215.12	1368.55	1601.93	1893.21
Net Block	**2146.68**	**2468.49**	**3735.12**	**4443.83**
Capital Work in Progress	794.57	1417.64	800.00	600.00
Investments	33.16	37.01	37.01	37.01
Current Assets, Loans & Advances				
Inventory	771.79	835.68	810.61	851.14
Sundry Debtors	776.04	753.44	767.87	830.29
Cash and Bank	804.20	247.29	82.46	8.81
Other Assets	225.08	168.46	174.64	181.13
Total CA & LA	**2577.11**	**2004.87**	**1835.59**	**1871.38**
Current liabilities	1889.75	1876.47	2136.45	2368.34
Provisions	42.42	39.91	43.25	46.18
Total Current Liabilities	**1932.17**	**1916.38**	**2179.70**	**2414.52**
Net Current Assets	644.94	88.49	-344.11	-543.14
Net Deferred Tax (net of liability)	-193.01	-211.00	-231.00	-251.00
Other Assets (Net of liabilities)	103.19	-146.40	-117.08	-11.15
Total Assets	**3529.52**	**3654.22**	**3879.93**	**4275.55**

Key Financial Ratios

	FY19	FY20	FY21e	FY22e
Growth Ratios				
Revenue (%)	18.7	0.4	1.9	14.5
EBIDTA (%)	37.8	1.3	6.3	21.1
Net Profit (%)	49.5	7.9	-1.9	24.2
EPS (%)	49.5	0.7	-1.9	24.2
Margins				
Operating Profit Margin (%)	23.2	23.3	24.3	25.7
Gross Profit Margin (%)	18.8	20.4	21.2	23.0
Net Profit Margin (%)	12.1	12.9	12.4	13.4
Return				
ROCE (%)	14.8	12.6	11.8	12.9
ROE (%)	23.8	19.2	16.3	17.4
Valuations				
Market Cap / Sales	3.3	3.2	4.1	3.5
EV/EBIDTA	15.8	15.6	18.5	15.2
P/E	26.2	25.2	33.4	26.9
P/BV	5.3	4.5	5.1	4.3
Other Ratios				
Interest Coverage	4.4	6.4	5.9	7.0
Debt-Equity Ratio	0.9	0.7	0.6	0.5
Current Ratio	1.3	1.0	0.8	0.8
Turnover Ratios				
Fixed Asset Turnover	2.0	1.8	1.4	1.2
Total Asset Turnover	1.4	1.2	1.1	1.2
Debtors Turnover	5.8	5.5	5.6	6.1
Inventory Turnover	4.2	4.0	3.9	4.4
Creditors Turnover	10.1	10.3	9.6	9.9
WC Ratios				
Debtor Days	62.7	66.7	65.1	59.7
Inventory Days	86.6	91.4	93.0	83.6
Creditor Days	36.3	35.5	38.1	36.9
Cash Conversion Cycle	112.9	122.6	120.0	106.4

Cumulative Financial Data

Figures in Rs crs	FY11-13	FY14-16	FY17-19	FY20-22e
Income from operations	5223	8295	10653	13336
Operating profit	808	1440	2318	3269
EBIT	627	1179	1889	2566
PBT	403	807	1458	2167
Profit after MI & associate profit	315	612	1133	1693
OPM (%)	15.5	17.4	21.8	24.5
NPM (%)	5.5	7.2	11.0	12.9
Interest coverage	2.8	3.2	4.4	6.4
ROE (%)	17.1	21.5	20.5	17.2
ROCE (%)	11.9	14.4	13.6	13.7
Debt-equity ratio*	1.1	1.1	0.9	0.5
Fixed asset turnover	3.2	2.9	2.1	1.3
Debtors turnover	5.1	5.8	5.5	5.5
Inventory turnover	4.0	4.8	4.4	4.1
Creditors turnover	8.1	8.6	9.5	9.8
Debtors days	71.9	62.9	66.8	65.9
Inventory days	90.2	76.5	83.2	88.3
Creditor days	45.3	42.5	38.4	37.2
Cash conversion cycle	116.7	96.8	111.6	117.0

FY11-13 implies three years ending fiscal 13; *as on terminal year

Skewed growth revenue pattern underline Aarti's cumulative revenues during FY20-22e period for much the growth is estimated next fiscal with higher supplies from long term contracts. OPMs during the projected period of FY202-22e would be little restrained by recognition of $20 mn shortfall fees annually arising from the cancellation of a long term contract - OPMs estimated to rise to 24.5% compared to 21.8% in FY17-19 period. Anything but rising debt would put a lid on interest coverage ratio which is projected to further improve to 6.4 from 4.4 (see table).

Yet little robust recognition of speciality chemicals revenues partially due to pandemic and not least due to slowdown in demand for polymers globally - aviation, polymers, to name a few - would no less brutally impair the fixed asset turnover - estimated to decline to 1.3 from 2.1 - though some of the ravaging is veiled by growing revenue share of margin enriching value added products. But little of this subtlety in product profile maneuvering of speciality chemicals business would succor return on capital for ROE is expected to decline not unharshly in the ensuing period -17.2% for FY20-22e period from 20.5%. Cash conversion cycle though is expected to marginally improve (see table).

Financial Summary – US dollar denominated

million $	FY19	FY20	FY21e	FY22e
Equity capital	6.3	11.6	11.8	11.8
Shareholders funds	369.8	392.8	463.7	540.4
Total debt	347.1	278.3	288.9	283.2
Net fixed assets (incl CWIP)	425.2	515.5	614.9	683.9
Investments	4.8	4.9	5.0	5.0
Net current assets	82.7	9.4	-49.0	-78.4
Total assets	499.7	482.4	523.7	575.0
Revenues	596.3	590.6	578.4	662.3
EBITDA	138.1	137.9	140.9	170.7
EBDT	112.0	120.3	122.4	152.0
PBT	88.8	94.2	90.8	112.5
Profit after MI	70.2	74.7	70.4	87.4
EPS($)	0.43	0.43	0.40	0.50
Book value ($)	2.13	2.25	2.66	3.10

income statement figures translated at average rates; balance sheet and cash flow at year end rates; projections at current rates(Rs 73.75/$). All dollar denominated figures are adjusted for extraordinary items.

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buy: >20%	accumulate: >10% to ≤20%	hold: ≥-10% to ≤10%	reduce: ≥-20% to <-10%	sell: <-20%

Exchange Rates Used- Indicative

Rs/$	FY17	FY18	FY19	FY20
Average	67.09	64.45	69.89	70.88
Year end	64.84	65.04	69.17	75.39

All $ values mentioned in the write-up translated at the average rate of the respective quarter/ year as applicable. Projections converted at current exchange rate. Cumulative dollar figure is the sum of respective yearly dollar value.