

AARTI INDUSTRIES

Opportunity in adversity

India Equity Research | Midcap Chemicals

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2020

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The notable feature of Q4FY20 results of Aarti Industries (AIL) is the termination of a large contract—annual revenue of INR4bn for ten years (40% EBITDA margin)—by a customer. This may affect medium-term profitability, but we do not see it as having major impact on AIL's growth visibility. On the contrary, AIL may use this as an opportunity to forward-integrate into AI (active ingredient) manufacturing driven by its technical capability as well as strong tie-ups with customers. The compensation of USD120–130mn will defend our FY21/22 estimates; moreover, it provides a windfall of INR5–6bn, which could be utilised for additional capex. Keeping our estimates unchanged and not factoring in cash flows on account of termination, we believe the recent correction in the stock is an opportunity; we reiterate 'BUY' with a TP of INR1088 (25x FY22 EPS).

Contract termination; no impact on capability

AIL has informed that it has received a notice from a customer to terminate the contract to manufacture intermediates for agrochemical AI as its customer is no longer interested in manufacturing of this AI on its own. The contract with capex of INR4bn by AIL for a ten-year period was expected to yield annual revenue of INR4bn and 40% EBITDA margin (annual EBITDA INR1.6bn). We believe that as there are no slippages from AIL, it does not affect AIL's capability and future growth visibility.

Benefits from termination? Forward integration and windfall

Since AIL is likely to receive a compensation of USD120–130mn from the customer (cash flow of USD20mn each in FY21 and FY22, and USD80mn in FY23), it will not impact profitability for the next two years. We believe the cash flows thus received are higher than the expected NPV (post tax cash profit for ten years) and that the windfall of ~INR5bn in FY23 is likely to be used for future capex. AIL will continue to utilise this asset and may exploit this opportunity to forward-integrate into manufacturing AI.

Outlook and valuation: correction is opportunity; maintain 'BUY'

We continue to repose our faith in AIL's chemical manufacturing capability. Hence, we believe the correction in the stock offers an investment opportunity; we reiterate 'BUY' with a TP of INR1088 (25x FY22 PE). The stock is trading at 19.5x FY22E EPS.

EDELWEISS RATINGS

Absolute Rating	BUY
Investment Characteristics	Growth

MARKET DATA (R: ARTI.BO, B: ARTO IN)

CMP	: INR 869
Target Price	: INR 1,088
52-week range (INR)	: 1,192 / 662
Share in issue (mn)	: 174.2
M cap (INR bn/USD mn)	: 151 / 1,821
Avg. Daily Vol. BSE/NSE ('000)	: 156.8

SHARE HOLDING PATTERN (%)

	Current	Q3FY20	Q2FY20
Promoters *	47.7	48.2	48.3
MF's, FI's & BKs	16.6	16.7	16.4
FII's	8.3	7.5	7.7
Others	27.4	27.6	27.6
* Promoters pledged shares (% of share in issue)	:	NIL	

PRICE PERFORMANCE (%)

	BSE Midcap Index	Stock	Stock over Index
1 month	(2.0)	(2.6)	(0.6)
3 months	(24.4)	0.1	24.5
12 months	(24.6)	7.3	32.0

Financials

(INR mn)

Year to March	FY19	FY20	FY21E	FY22E
Net revenue	47,055	46,207	42,087	52,121
EBITDA	9,651	9,773	10,913	14,199
Adjusted Profit	4,917	5,361	5,379	7,527
Diluted EPS (INR)	28.4	30.9	31.0	43.4
Diluted P/E (x)	30.6	28.1	28.0	20.0
EV/EBITDA (x)	17.4	17.1	15.6	11.5
ROAE (%)	23.1	18.9	16.9	20.4

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Conference call: Key highlights

AIL to evaluate various opportunities for plant asset utilisation

AIL has multiple options to use this plant:

- For the next two years, there is still a contractual arrangement to manufacture this product and supply it to the customer. However, the customer has an option to not take delivery, but it will have to compensate USD20mn EBITDA each for FY21 and FY22.
- On termination after two years, AIL will have the option to sell this intermediate in the open market. Since there are many global manufacturers for this AI, AIL is confident of ramping up plant utilisation and find customers for this intermediate. However, profitability may be lower than the current contract.
- AIL is exploring forward integration opportunity to get into manufacturing of AI by utilising this intermediate. AIL has adequate capability and customer connect to manufacture AI. With low cost manufacturing capability, we believe that AIL will be able to garner market share in this product.
- If there is no demand for this product, AIL has an option to use these assets for manufacturing other chemicals with modification to the plant.

Windfall of INR5–6bn to be used for future capex

AIL is likely to use final compensation of USD80mn due in Q1FY23 towards additional capex. Given strong growth opportunity in chemical manufacturing, this additional cash flow would help AIL drive future growth. AIL will receive USD20mn in FY21 and USD20mn in FY22 as in lieu of supplies to this customer.

Dicamba global demand remains strong

AIL is of the view that recent re-registration issues faced by Dicamba for particular uses are unlikely to have overall impact on demand for this molecule globally. Overall uses of Dicamba is likely to remain stable. This is important as the AI for which AIL was making the intermediate is AI for Dicamba. There were concerns that demand for AI may also come down with the fall in demand for Dicamba, and that AIL's contract with its global customer may come under question. Now, with this contract terminated, this risk has been put to rest once and for all. AIL will now be able to sell the product to other customers globally or may utilise this plant for making other chemicals.

Company Description

AIL incorporated in 1975, is a well-diversified chemicals company headquartered in Mumbai. It is one of the largest producers of Benzene-based basic and intermediate chemicals in India and manufactures 125 products with chemistry of benzene, aniline, sulphuric acid, toluene and methanol. AIL is one of the leading global suppliers of dyes, pigments, agrochemicals, pharmaceuticals and rubber chemicals. Benzene accounts for ~60% of the company's revenues, while aniline and sulphuric acid compounds contribute ~12% to revenues. With start of the Dahej facility, AIL will also enter toluene chemistry. AIL's manufacturing units are located in Gujarat and Maharashtra. It has three different business segments:

- Specialty chemicals – largest manufacturer of specialized pigment & paint Intermediates in India and leading player globally. Also, manufactures intermediates for agrochemicals and produces Single Super Phosphate fertilizer. Earlier part of two segments
 1. Performance chemicals - accounts for ~65% of total revenues
 2. Agri-intermediates & Fertilizers segment - accounts for ~20% of total revenues
- (2) Pharmaceuticals - has backward integrated facilities for most APIs
- (3) Home & personal care – currently at low margins, AIL plans to alter mix and explore new markets

Investment Theme

Integrated, flexible, diversified operations: Superior R&D, process flexibility and integration operations equips AIL to offer more than 125 products with applications and customer base across multiple industries.

Cost competitiveness: Backward and forward integration and commercial viability of by-products enables AIL to enjoy cost competitiveness.

Preferred supplier for global customers, MNCs: AIL is a preferred supplier for global customers, as exports contribute ~50% to revenue with incremental capex on anvil to enhance standing in the export market.

Key Risks

Benzene Prices: AIL's passes on the cost changes with one quarter lag to customers, any increase in Benzene prices may lead to lower earnings temporarily. We however see lower risks over a longer period as the same is passed on to customers.

Environmental Regulations: Environment regulations in India are becoming stringent and there are risks of further tightening of these laws, which will lead to increased costs for chemical companies. Aarti has invested in having zero-discharge facilities for Jhagadia and a unit in Vapi.

Financial Statements

Key Assumptions

Year to March	FY19	FY20	FY21E	FY22E
Macro				
GDP(Y-o-Y %)	6.1	4.8	-	6.0
Inflation (Avg)	3.4	4.3	3.5	4.0
Repo rate (exit rate)	6.3	4.4	3.0	4.0
USD/INR (Avg)	70.0	70.7	75.0	73.0
Company				
Financial assumptions				
Spec chem rev gwth(%)	33.3	(2.9)	(20.0)	10.0
Pharma chem rev gwth(%)	30.5	4.1	18.0	10.0
Spec chem EBIT margin(%)	20.6	21.1	24.5	24.7
Pharma EBIT margin(%)	15.5	18.2	21.0	21.0
Interest(% of Avg loans)	7.1	-	8.5	7.9
Tax rate (%)	18.9	19.1	19.0	19.0
Capex (INR mn)	6,702	11,305	14,000	7,000
Trade payables days	74.4	181.4	75.0	75.0
Inventory days	104.5	122.5	120.0	100.0
Receivables days	60.2	59.5	70.0	60.0

Income statement

(INR mn)

Year to March	FY19	FY20	FY21E	FY22E
Net revenue	47,055	46,207	42,087	52,121
Cost of mat. Consumed	26,946	24,907	20,202	26,061
Employee costs	2,428	3,052	3,510	4,212
Other Expenses	8,030	8,474	7,463	7,649
Total operating expenses	37,404	36,434	31,175	37,922
EBITDA	9,651	9,773	10,913	14,199
Depreciation	1,627	1,852	2,402	2,948
EBIT	8,024	7,921	8,511	11,251
Less: Interest Expense	1,825	1,248	1,793	1,859
Add: Other income	21.00	88.4	75.00	75.00
Profit Before Tax	6,220	6,762	6,792	9,466
Less: Provision for Tax	1,178	1,294	1,291	1,799
Less: Minority Interest	124	107	123	141
Reported Profit	4,917	5,361	5,379	7,527
Adjusted Profit	4,917	5,361	5,379	7,527
Shares o/s (mn)	173	173	173	173
Basic EPS (INR)	28.4	30.9	31.0	43.4
Diluted shares o/s (mn)	173	173	173	173
Adj. Diluted EPS (INR)	28.4	30.9	31.0	43.4
Adjusted Cash EPS	38.5	42.2	45.6	61.2
Dividend per share (DPS)	5.0	5.0	8.0	8.0
Dividend Payout Ratio(%)	21.3	19.6	31.2	22.3

Common size metrics

Year to March	FY19	FY20	FY21E	FY22E
Cost of revenues	57.3	53.9	48.0	50.0
EBITDA margins	20.5	21.2	25.9	27.2
EBIT margins	17.1	17.1	20.2	21.6
Net Profit margins	10.7	11.8	13.1	14.7

Growth ratios (%)

Year to March	FY19	FY20	FY21E	FY22E
Revenues	23.6	(1.8)	(8.9)	23.8
EBITDA	38.0	1.3	11.7	30.1
EBIT	45.1	(1.3)	7.4	32.2
PBT	45.0	8.7	0.5	39.4
Adjusted Profit	47.7	9.0	0.3	39.9
EPS	38.5	9.0	0.3	39.9

Balance sheet (INR mn)				
As on 31st March	FY19	FY20	FY21E	FY22E
Share capital	433	871	871	871
Reserves & Surplus	25,872	28,917	32,618	38,466
Shareholders' funds	26,306	29,788	33,489	39,338
Minority Interest	840	946	1,069	1,210
Long term borrowings	8,148	5,808	5,808	5,808
Short term borrowings	15,863	12,297	16,297	16,297
Total Borrowings	24,011	18,105	22,105	22,105
Long Term Liabilities	2,032	5,509	5,509	5,509
Def. Tax Liability (net)	1,930	2,110	2,348	2,679
Sources of funds	55,118	56,458	64,520	70,841
Tangible assets	21,454	24,676	36,273	40,325
Intangible Assets	13	9	9	9
CWIP (incl. intangible)	7,946	14,176	10,000	10,000
Non current investments	332	370	370	370
Cash and Equivalents	8,042	2,473	4,028	11,039
Inventories	7,718	8,357	7,605	3,570
Sundry Debtors	7,760	7,534	8,072	8,568
Loans & Advances	4,971	5,402	5,402	5,402
Other Current Assets	344	328	328	328
Current Assets (ex cash)	20,793	21,621	21,406	17,867
Trade payable	2,793	3,452	4,151	5,355
Other Current Liab	668	3,415	3,415	3,415
Total Current Liab	3,461	6,867	7,566	8,770
Net Curr Assets-ex cash	17,332	14,754	13,839	9,097
Uses of funds	55,118	56,458	64,520	70,841
BVPS (INR)	151.8	171.8	193.2	226.9

Free cash flow (INR mn)				
Year to March	FY19	FY20	FY21E	FY22E
Reported Profit	4,917	5,361	5,379	7,527
Add: Depreciation	1,627	1,852	2,402	2,948
Interest (Net of Tax)	1,480	1,009	1,452	1,506
Others	552	873	626	751
Gross cash flow	7,298	15,152	10,774	17,474
Less: Changes in WC	1,278	(6,057)	(914)	(4,742)
Less: Capex	6,698	11,301	9,824	7,000
Free Cash Flow	600	3,851	951	10,474

Cash flow metrics				
Year to March	FY19	FY20	FY21E	FY22E
Operating cash flow	7,298	15,152	10,774	17,474
Financing cash flow	6,959	(9,470)	529	(3,537)
Investing cash flow	(6,537)	(11,251)	(9,749)	(6,925)
Net cash Flow	7,721	(5,569)	1,555	7,012
Capex	(6,698)	(11,301)	(9,824)	(7,000)
Dividend paid	(1,049)	(1,049)	(1,678)	(1,678)

Profitability and efficiency ratios				
Year to March	FY19	FY20	FY21E	FY22E
ROAE (%)	23.1	18.9	16.9	20.4
ROACE (%)	18.2	16.0	16.3	19.0
Inventory Days	103	118	144	78
Debtors Days	55	60	68	58
Payable Days	43	46	69	67
Cash Conversion Cycle	115	132	143	70
Current Ratio	8.3	3.5	3.4	3.3
Gross Debt/EBITDA	2.5	1.9	2.0	1.6
Gross Debt/Equity	0.9	0.6	0.6	0.5
Adjusted Debt/Equity	0.9	0.6	0.7	0.6
Net Debt/Equity	0.6	0.5	0.5	0.3
Interest Coverage Ratio	4.4	6.3	4.7	6.1

Operating ratios				
Year to March	FY19	FY20	FY21E	FY22E
Total Asset Turnover	1.0	0.8	0.7	0.8
Fixed Asset Turnover	2.3	2.0	1.4	1.4
Equity Turnover	2.2	1.6	1.3	1.4

Valuation parameters				
Year to March	FY19	FY20	FY21E	FY22E
Adj. Diluted EPS (INR)	28.4	30.9	31.0	43.4
Y-o-Y growth (%)	38.5	9.0	0.3	39.9
Adjusted Cash EPS (INR)	38.5	42.2	45.6	61.2
Diluted P/E (x)	30.6	28.1	28.0	20.0
P/B (x)	5.7	5.1	4.5	3.8
EV / Sales (x)	3.5	3.6	4.0	3.1
EV / EBITDA (x)	17.4	17.1	15.6	11.5
Dividend Yield (%)	0.6	0.6	0.9	0.9
EV	167,005	166,775	169,343	162,473

Peer comparison valuation

Name	Market cap (USD mn)	Diluted P/E (X)		EV / EBITDA (X)		ROAE (%)	
		FY21E	FY22E	FY21E	FY22E	FY21E	FY22E
Aarti Industries	150,708,000	28.0	20.0	15.6	11.5	16.9	20.4
Fine Organic Industries Ltd	60,305,107	33.6	26.0	21.8	17.1	26.3	28.2
Galaxy Surfactants Ltd	46,785,138	23.0	21.3	13.7	12.2	21.2	19.4
SRF	207,504,396	29.4	21.9	14.8	12.0	13.5	15.8
Median	-	28.7	21.6	15.2	12.1	19.0	19.9
AVERAGE	-	28.5	22.3	16.5	13.2	19.5	20.9

Source: Edelweiss research

Additional Data

Directors Data

Chandrakant V. Gogri	Chairman Emeritus	Rajendra V. Gogri	Chairman & Managing Director
Rashesh C. Gogri	Vice Chairman & Managing Director	Shantilal T. Shah	Vice Chairman
Parimal H. Desai	Whole Time Director	Manoj M. Chheda	Whole Time Director
Hetal Gogri Gala	Whole Time Director	Renil R. Gogri	Whole Time Director
Kirit R. Mehta	Whole Time Director	Ramdas M. Gandhi	Independent Director
Laxmichand K. Jain	Independent Director	Vijay H. Patil	Independent Director
K.V.S. Shyam Sunder	Independent Director	P.A. Sethi	Independent Director
Bhavesh R. Vora	Independent Director	Prof. Ganapati D. Yadav	Independent Director
Priti P. Savla	Independent Director		

Auditors - Gokhale & Sathe

Holding – Top10

	Perc. Holding		Perc. Holding
HDFC Asset management	7.94	L&T Mutual Fund	1.62
Axis AMC	1.61	DSP Investment Managers	0.95
Franklin Templeton Asset Management	0.86	Sundaram mutual fund	0.81
Vanguard Group Inc/The	0.63	Dimensional Fund Advisors	0.58
Morgan Stanley	0.54	Blackrock	0.36

**as per last available data*

Bulk Deals

Data	Acquired / Seller	B/S	Qty Traded	Price
No Data Available				

**as per last available data*

Insider Trades

Reporting Data	Acquired / Seller	B/S	Qty Traded
03 Jul 2019	Chandrakant Vallabhaji Gogri	Sell	121000.00
25 Jun 2019	Chandrakant Vallabhaji Gogri	Sell	16500.00
18 Jun 2019	Nikhil Holdings Private Limited	Sell	40000.00

**as per last available data*

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Coverage group(s) of stocks by primary analyst(s): Midcap Chemicals

Aarti Industries, Fine Organic Industries Ltd, Galaxy Surfactants Ltd, Solar Industries, SRF

Recent Research

Date	Company	Title	Price (INR)	Recos
26-May-20	Aarti Industries	Weak show, but sector tailwind intact; <i>Result Update</i>	1,010	Buy
14-Feb-20	Fine Organics	Commissioning of new plant drags profitability; <i>Result Update</i>	2,228	Hold
13-Feb-20	Aarti Industries	Growth visibility to continue to drive valuations; <i>Result Update</i>	971	Buy

Distribution of Ratings / Market Cap

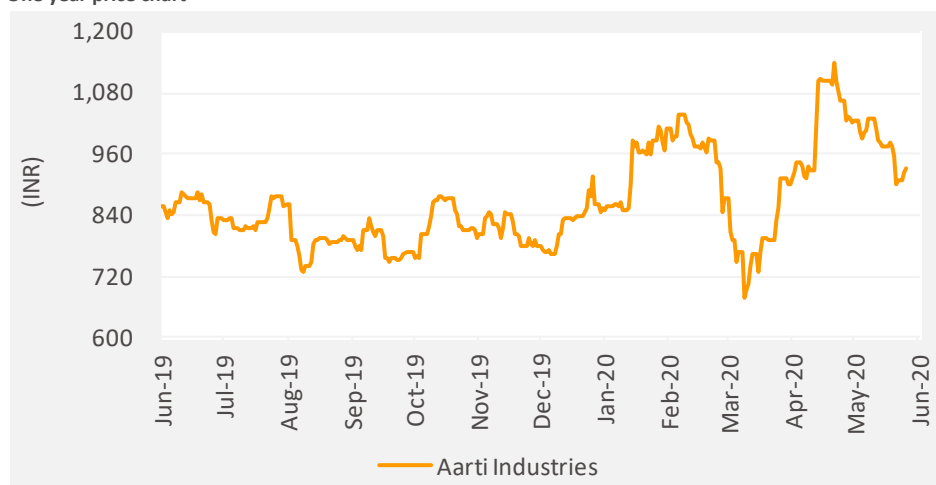
Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	161	67	11	240
* 1stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	156	62	11	

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period

One year price chart



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