Initiating Coverage

Aarti Industries Ltd

21 FEB 2019

AXIS DIRECT

AXIS SECURITIES

Buy

Target Price: 1599

CMP	: Rs. 1309
Potential Upside	: 22%

MARKET DATA

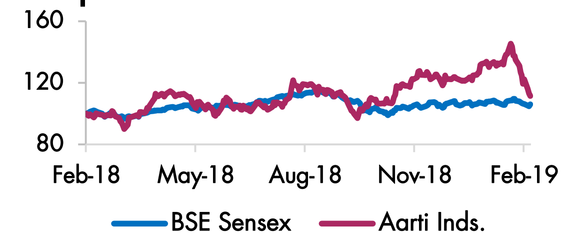
No. of Shares	: 8.13 Cr.
Market Cap	: Rs. 10,642 Cr.
Free Float	: 46%
Avg. daily (6mth)	: 40,939
52-w High / Low	: Rs. 1,808/Rs. 1,041
Bloomberg	: ARTO:IN
Promoter holding	: 52.7%
FII / DII	: N.A.

Aarti Industries Ltd

Specialty Chemical

"A Sustainably Growing Chemistry"

Price performance



Financial Summary

Y/E March	Sales (Rs Cr)	PAT (Rs Cr)	EPS (Rs)	Change (%)	P/E (x)	RoE (%)	RoCE (%)	EV/EBITDA	DPS (Rs)
FY17	3163	316	38.5	24.7	-	25.5	18.2	-	0.1
FY18	3806	346	42.6	10.7	-	23.4	16.6	1.24	1.2
FY19E	4994	463	55.2	29.6	23.7	24.8	18.3	1.08	1.2
FY20E	5918	561	67.1	21.6	19.5	23.6	18.3	0.96	1.2
FY21E	7117	701	84.2	25.5	15.5	23.4	18.8	0.83	1.2

Source: Company, Axis Securities. CMP as on 20th Feb 2019

Shareholding pattern

	Dec18	Sep18
Promoters	52.7	53.1
FPIs	4.4	4.2
MFs / UTI	14.4	13.9
Public	25.4	25.6
Others	3.1	3.2

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Investment Rationale

Incorporated in 1984, **Aarti Industries Ltd. (AIL)** is a leading Indian manufacturer of Chemical & Pharmaceutical intermediates with a global footprint. It operates primarily in 3 segments viz. Specialty Chemicals (78% of sales), Pharmaceuticals (15% of sales) and Home & Personal Care (7% of sales). It is one of the largest producers of benzene based derivatives in India and has **17 manufacturing plants & 200+ products.** Globally, it ranks in **top 4 position for 75% of its products** with 25-40% market share globally in various products. It exports to 60+ countries, constituting ~45% of revenues and is a preferred partner of choice for**1000+ customers** globally.

We expect revenues to increase at 23% CAGR over FY18-21E; earnings to grow at 27% CAGR to be driven by

- Growth in the specialty chemical (SC) sector, both globally & domestically, to aid demand for AIL's products
- Growth in the cash cow SC business from increasing utilization and expanding capacities
- Higher utilization in the recently started Toluene derivative business (very few domestic manufacturers) as the demand for these products, mostly fulfilled by imports, remains high
- Three Multi year deals which provide a long term & sustainable visibility for future revenues & margin growth
- Growth in the pharma business on account of revival in global pharma industry, better regulatory/compliance framework and AIL's strong & in-depth R&D

We initiate coverage with BUY rating and a target price of Rs. 1599 i.e. ~22% upside (implies ~19x FY21E)

Investment Rationale

Growth in Specialty Chemical Industry

- Global and Indian SC industry is expected to grow at a CAGR of **5.6%** and **13%** respectively over FY17-25E.
- With crackdown in China owing to pollution norms and corporates looking for geographical de-risking, India has become a preferred market for supplies of specialty chemicals; hence, a higher demand for these chemicals.
- AIL to benefit from this increased demand due to its technical expertise, wide product range, large base of end-use industries and strong relationship with its clients.
- We expect AIL's specialty chemical segment to grow at **22%** CAGR over FY18-21E.

Well Diversified Portfolio & Global Presence

- AIL has a wide portfolio of over 200+ products across 17 manufacturing units.
- Only domestic player to have products till the 6th level derivative of benzene chemistry.
- None of its products contributes >9% to the revenues showing that it is not overly dependent on one product.
- Large customer base (1000+ customers), with very low revenue concentration from top clients; its largest customer contributes only 8-9% of its revenues.
- Exports constitute ~45% of total revenues, with supplies to 60+ countries.
- All these indicate that Aarti Industries has a deep rooted presence in both the domestic and global markets.

Benzene business; the cash cow

- The benzene derivative segment production currently functions at **~90% utilization.**
- The company is capable of producing the entire value chain of Benzene up to the 6th derivative (only player in India).
- It is constantly working to ramp up its capacities in different product lines via debottlenecking, greenfield and brownfield expansions.
- With demand for specialty chemicals set to increase, we expect the utilization to reach 95% in 1-2 years and with expansion in capacities, the company is poised to grow both in terms of revenues and profits.

Investment Rationale

Toluene value chain to drive growth

- Nitration unit commissioned in FY18 to produce Nitro Toluene (NT) & its downstreams with **30,000 TPA capacity**.
- Dedicated unit to manufacture ethylene derivatives with a capacity of 8000-10000 TPA.
- The toluene segment is a highly untapped market in India catered mostly through imports.
- Current NT utilization is at ~40%. AIL is one of the very few domestic producers of Toluene value chain production in India. We expect the company to benefit and the NT utilization to reach ~90% in 2-3 years on account of its chemical competence, import substitution and the absence of any major domestic competition in the segment.

Multi Year Deals provide revenue visibility

- AIL recently signed **3 multi-year deals**:
  - ~Rs.4,000 cr contract with a global agrochemical company for a term of 10 years; to be commissioned by Q4FY20.
  - ~Rs.10,000 cr contract for a period of 20 years with a major specialty chemical conglomerate; to be commissioned by CY20.
  - ~Rs. 900 cr contract for 10 years with a global chemical conglomerate starting Q4FY21.
- The units for first two are being setup in Dahej SEZ which is eligible for tax incentives.
- This order book provides AIL with a long term & sustained revenue visibility and will help the company to generate higher margins and improve its ROCE.

Pharma at an inflection point

- For AIL, Pharma segment has grown at a CAGR of 24% in the last 5 years and its contribution to the revenues has risen from ~9% to ~15% in the same period.
- However, the profit margins have been comparatively low in the segment due to higher fixed costs.
- With AIL consistently investing in R&D due to increased API demand on account of recent revival in domestic pharma industry and better compliance/regulatory framework, we expect Pharma segment revenue to grow at a CAGR of **30%** over FY18-21E.
- With fixed costs already factored in, any rise in volumes will boost the segmental profits.

Investment Rationale

High Entry Barriers

- Approvals can take b/w 3 months to 2 years depending on the customer and product chemistry involved. Larger corporates & complex chemistries take more time for approvals.
- Reaching out to a large set of customers is also difficult as quality of the product is of paramount importance.
- A manufacturing plant requires a number of end products for it to be economically viable. To ensure high quality, it requires high chemical expertise, regulatory approvals and high R&D capex.
- Each reaction produces multiple co-products, necessitating multiple relationships with multiple customers – thereby creating a meaningful entry barrier for back integration.

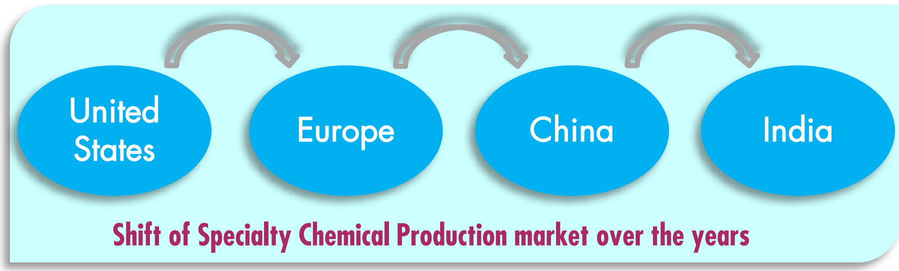
AARTI INDUSTRIES LIMITED

Foray into Newer Chemistries

- AIL has continuously expanded its product range & their production capacities, both vertically & horizontally.
- It has a complete value chain of Benzene and Toluene derivatives & has constantly expanded capacities.
- Recently entered into Nitro Toluene production and its downstream ethylation, quadrupled Phenylene Diamines (PDA) capacity.
- Currently expanding chlorination capacity and setting up a new R&D lab.
- Plans to launch 12 new APIs in the next year and to enter the Chloro Toluene value chain in the next few years.
- This would aid the company to cater to a larger set of customers.

Specialty Chemical Sector

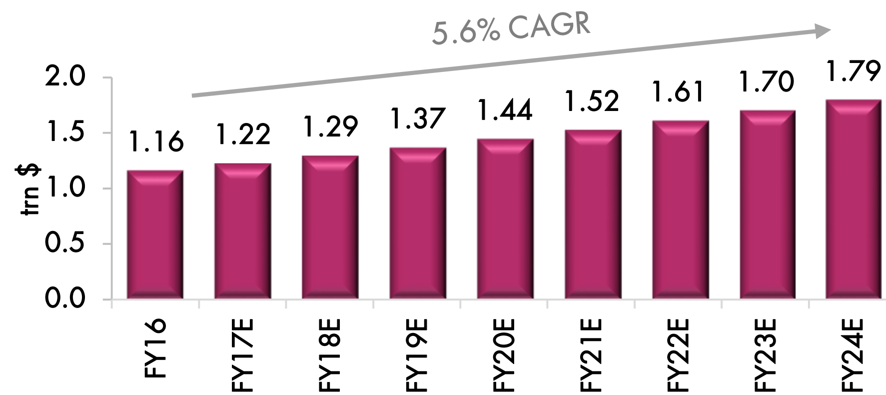
The Story of Specialty Chemicals (SC) Industry



- Various countries have led the SC business at different time periods. The market was led by US till late 1980s and gradually moved to Europe which dominated mainly through exports.
- With trade liberalisation, technology transfer, reduction in economic barriers and rapid economic growth in developing countries, the industry expanded rapidly in Asia, with China contributing a major part of this expansion due to their low labour costs, lower energy and regulatory costs & a highly-developed basic chemicals segment.
- Although, China's SC market has now started to face the brunt of stricter regulatory norms in terms of pollution, labour reforms etc. causing slowdown in the Chinese chemicals industry.
- This has benefitted India as the demand moved to this region on account of its low capital and operating cost competencies, availability of feed stock and skilled manpower, better manufacturing standards and compliance of regulatory frameworks, stronger IP protection, etc.
- India now has the opportunity to emerge as the fastest growing market for SC by establishing itself in the international market by building capability, global client base and encashing the exports opportunity.

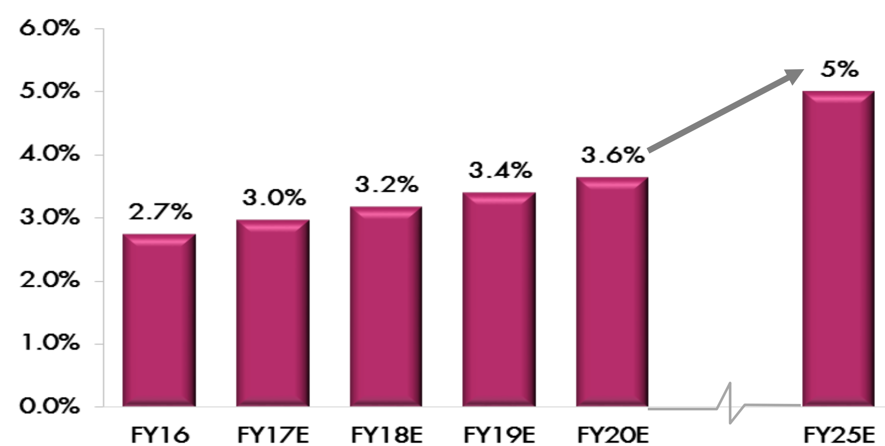
Source: Company, Axis Securities.

Global Specialty Chemical Sector



Source: Company, Grand View Research, Axis Securities

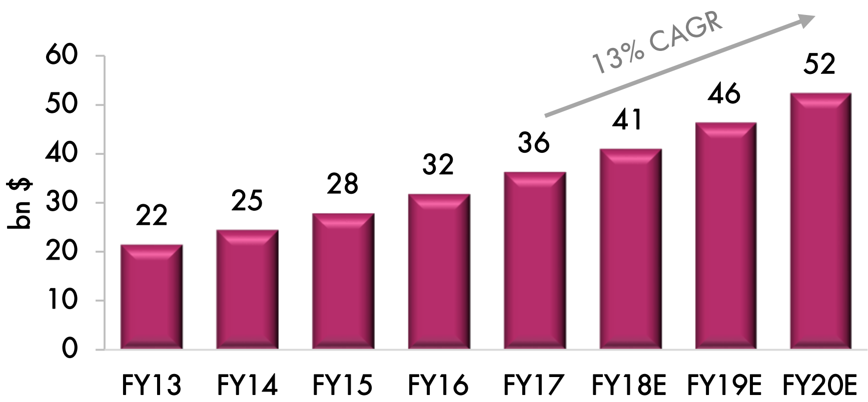
India to constantly gain share in Specialty Chemicals Market



Source: Axis Securities

Specialty Chemical Sector

Indian Specialty Chemical Sector

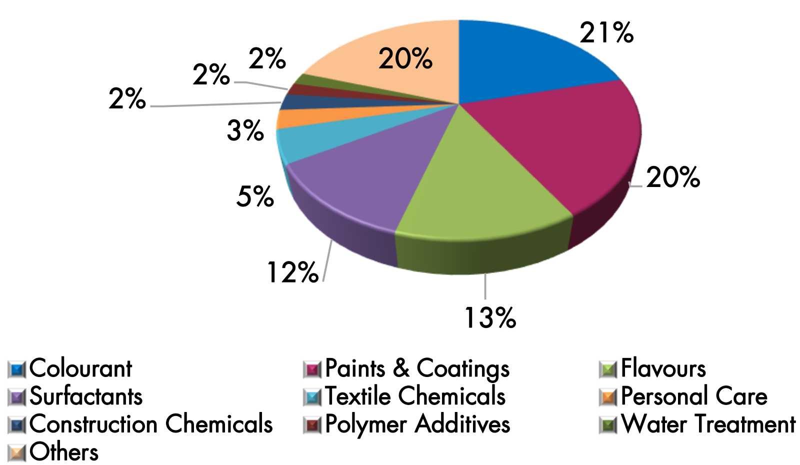


Source: TSMG-FICCI, Company, Axis Securities.

India to head the industry growth

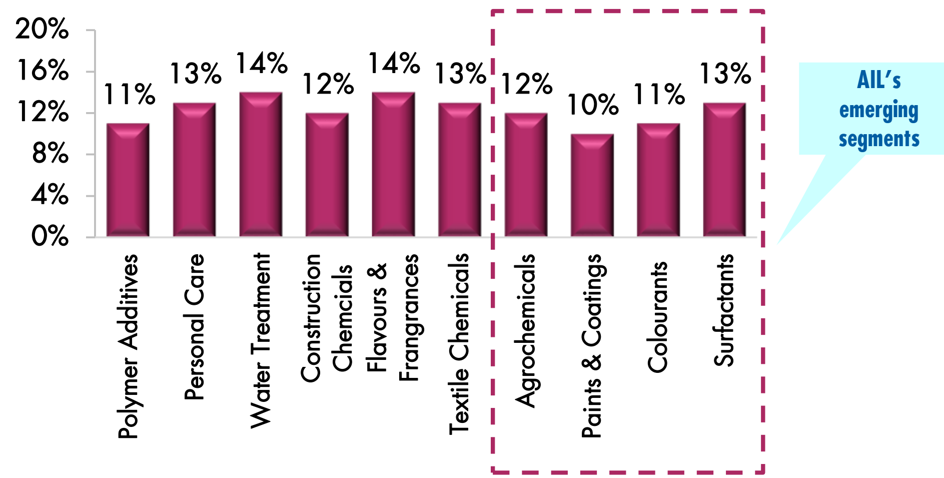
- India is the 6th largest producer and the 6th largest consumer of chemicals worldwide. Still, it only contributes ~3% of the total global production of Specialty chemicals; providing a huge scope for growth.
- The Indian specialty chemicals industry has grown at a CAGR of 14% over the last 5 years and is expected to continue to grow at a similar rate & at a much faster rate than global growth rate.
- The factors driving growth of Indian specialty chemicals market include the presence of well established basic chemical industry, large base of end-use industries & increasing demand from these, competitive cost of manufacturing & technological advancements.

Breakdown of Specialty Chemical Segment by value (India)



Source: India Ratings, Axis Securities.

Growth Projection for Key Segments of Specialty Chemicals Sector

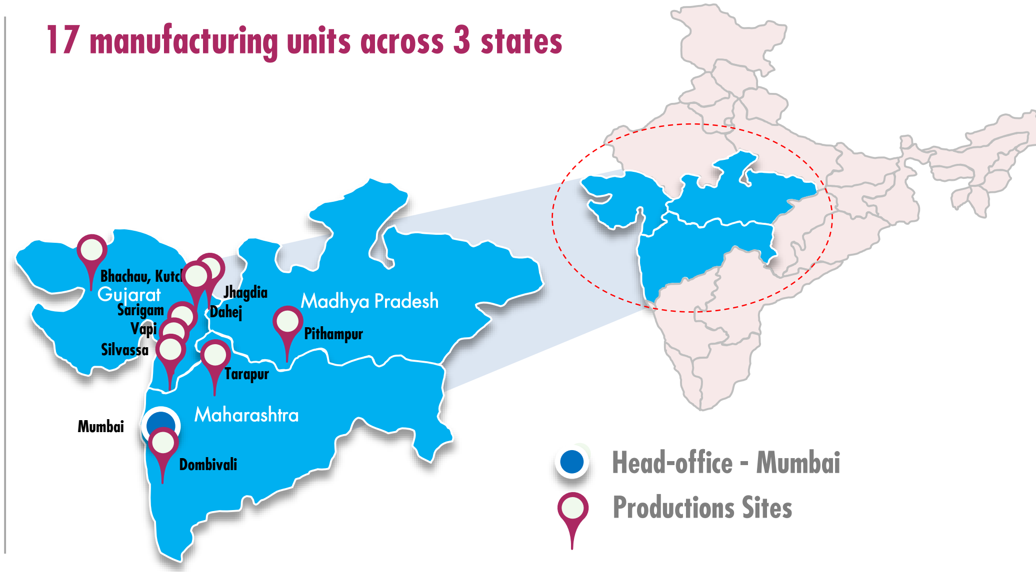


Source: India Ratings, Axis Securities.

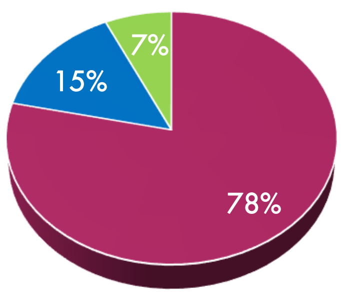
Aarti Industries Ltd.: Company Info

- Incepted in 1984 as Aarti Organics Pvt. Ltd. and headquartered in Mumbai (India), AIL is amongst the largest producers of Benzene-based basic and intermediate chemicals in India.
- It owns businesses engaged in large scale production of various chemicals like benzene intermediaries, pharmaceuticals, surfactants etc. and is one of the leading suppliers to global manufacturers of Dyes, Pigments, Agrochemicals, Pharmaceuticals & Rubber chemicals throughout the world. It is known for its chemical competence, scale-up engineering competence and cost effective value added products.
- It has 17 manufacturing plants in India spread across Gujarat, Maharashtra and Madhya Pradesh. It also has 3 R&D centres with a fourth centre to be set up by FY19.

17 manufacturing units across 3 states

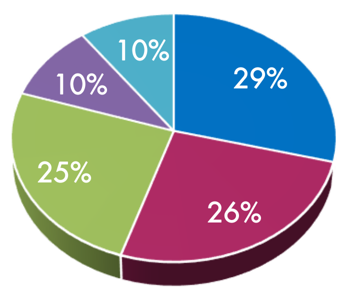


Revenue Breakup (%)



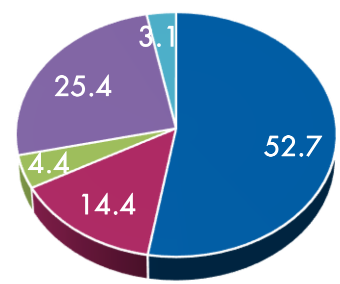
Specialty Chemicals | Pharma | HPC

Diversified Global Presence (Export Breakup)



Rest of World | North America | Europe | China | Japan

Shareholding (%)



Promoters | Mutual Funds | FPI | Public | Others

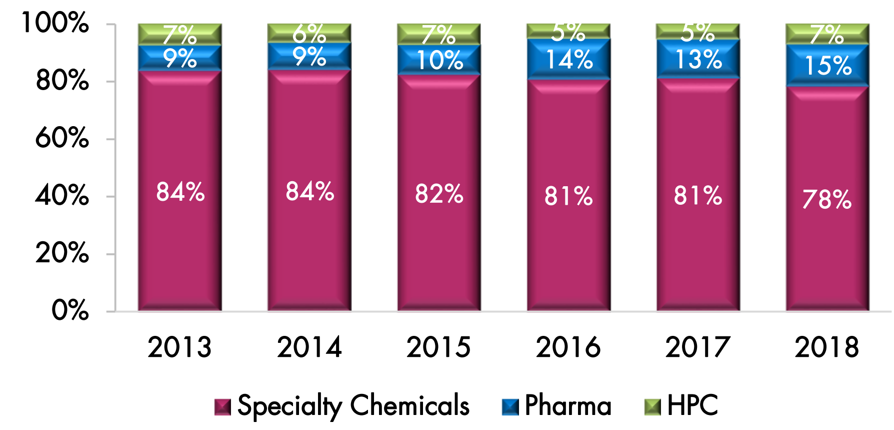
Source: Company, Axis Securities.

Segmental Overview

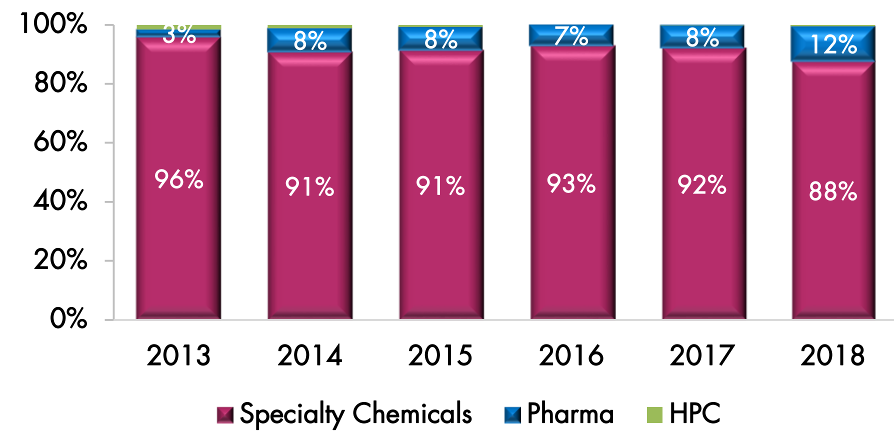
	Specialty Chemicals	Pharmaceuticals	HPC
Revenue Contribution	78%	15%	7%
Key end users	Agrochemicals, Polymers & Additives, Dyes, Pigments, Paints, Printing Inks, Pharma Intermediates, Rubber Chemicals	Active Pharmaceutical Ingredients (APIs) Intermediates for innovators and generic companies	Non-ionic surfactants
Applications	In pesticides, insecticides, aircrafts, automobiles, bullet proof jackets, electronic jackets, fuel additives etc.	Used in anticancer, anti-asthma and anti-hypertensive drugs as well as oncology therapies, steroids etc.	Concentrates for shampoo, hand wash, dish wash, oral care etc.
Key customers	BASF, Eastman, DuPont, Clariant, UPL, Sojitz, Solvay, Coromoandel, FMC, Huntsman, DOW	Sun Pharma, Lupin, Dr.Reddy's, Cipla, Zydus, Sandoz, Pfizer, Sanofi	Unilever, CalvinCare, Dabur, 3M, Innospec
Key Products	Nitro Chloro Benzene chain, Nitro Toluene chain, Phenylene Diamene, Calcium Chloride	Benazepril, Budesonide, Ciclesonide, Bicalutamide, Ifosfamide, Desonide, Phenylepherine	Sulfoccinate, Sulfolon SCS/P, Sulfocare SB 25/C, Sulfosml, Sulfosmo
Competitors	Seya Industries, Deepak Nitrite	Granules India, IOL Chemicals	Galaxy Surfactants

Source: Company, Axis Securities.

Segmental Revenue Breakup



Segmental EBIT breakup



Journey from a local player to "Global Partner of Choice"

1984-90

- **1984** - Aarti Organics Pvt Ltd Incorporated
- **1986** - Commenced 1,200 TPA unit for NCB in Sarigram, Gujarat
- **1990** - Set up additional unit in Vapi to manufacture NCB with a capacity of 4,500 TPA

1990-2000

- **1992** - Public Issue of 8,70,000 Equity shares at a premium of Rs.36 per share
- **1994** - Merged Salvigor Labs, producers of DMS and Sulphuric Acid and their downstream products into Aarti
- **1994** - Changed name from Aarti Organics Ltd to Aarti Industries Ltd
- **1995** – Bonus issue of equity shares (1:1)
- **1998** – Set up Alchemie (Europe) Ltd., a subsidiary in UK for marketing and distribution

2001-2010

- **2001** - Commenced production in Jhagadia; Pioneered hydrogenation process based Swiss technology
- **2002** – Merged Alchemie Organics into AIL
- **2006-08** – Expanded NCB and Sulphuric Acid Capacity, received USFDA approval for API unit at Tarapur
- **2009** – Merged Surfactants Specialities Pvt Ltd (HPC)
- **2010** – Custom Synthesis division (Vapi) received USFDA approval
- **2010** - Commissioned sulfonation unit at Pithampur

2013

- Merged manufacturing division of Anushakti Chemical & Drugs Ltd into AIL

2016

- Scaled NCB capacity to 75,000 TPA from 57,000 TPA
- Expanded caffeine capacity
- Setup Aarti USA Inc. for marketing and distribution in USA

2017

- Commenced Calcium Chloride facility and 2nd Phase of PDA facility at Jhagadia
- Commenced multipurpose Ethylation unit at Dahej SEZ, Gujarat
- Operationalized co-generation and solar plants
- Buyback of 12 lakh equity shares at Rs. 800 per share

2018

- Commissioned greenfield Nitro Toluene facility at Jhagadia
- Signed the two multi year deals
- Buyback of 8.2 lakh equity shares at Rs. 1,200 per share

Source: Company, Axis Securities.

Marquee Customer Base

Agro Intermediates and Fertilizers	Polymers and Additives	Pigments, Paints, Printing Inks & Dyes	Pharma & other Specialty Chemicals
BASF, Coromandel, Gharda Chemicals Limited, Syngenta, FMC, Dow, UPL, DuPont, Bayer, Makhteshim Agan	BASF, Sojitz, Solvay, Everlight, Ticona, Chemipro, Toray, DuPont, Teijin, DIC	BASF, Eastman, SunChemical, Clariant, Sudarshan, Archroma, Micro Inks, Flint Ink, Huntsman	Cipla, 3M, Dr.Reddy's, Sun Pharma, Zydus, Innospec, Dabur
20-25% of revenues	15-20% of revenues	15-20% of revenues	15-20% of revenues

AIL has long term relationships with its customers. More than 75% of the customers have 5+ years of business relationship with AIL

Source: Company, Axis Securities

Experienced Management Team

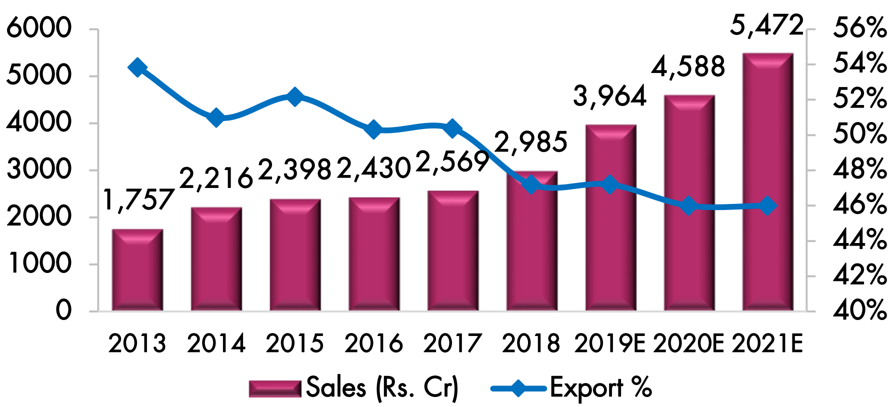
Mr. Rajendra Gogri *Chairman & M.D*	▪ Founder Director; became Chairman & M.D. in 2012 ▪ Portfolios – Speciality Chemicals, Strategic Planning, Financial Management
Mr. Rashesh Gogri *Vice Chairman & M.D*	▪ Founder Director; Production Engineer; became Vice Chairman & M.D. in 2012 ▪ Portfolios –Speciality Chemicals, Head – Pharma
Mr. Shantilal Shah *Vice Chairman*	▪ Founder Director; non-executive Vice Chairman of the Company since April, 1990. ▪ Expertize lies in marketing, finance and administrative function in the Chemical Industry.
Mr. Parimal Desai *Director*	▪ Whole-time Director of the company since September, 1984. ▪ Portfolios: Technical and Research & Development, Head- Home & Personal Care Segment
Mr. Manoj Chheda *Director*	▪ Whole-time Director of the company since November, 1993. ▪ Commerce graduate from Mumbai University; 25 years experience in purchase & marketing of chemicals
Mr. Chetan Gandhi *Chief Financial Officer*	▪ Chartered Accountant; has been with the company since 2001, as CFO since 2014

AIL has an experienced management team. Most of its promoters are first generation technocrats.
5 of 6 Promoters Directors are engineers. 3 of 4 Founder Promoters are chemical engineers.

Source: Company, Axis Securities

AIL Specialty Segment

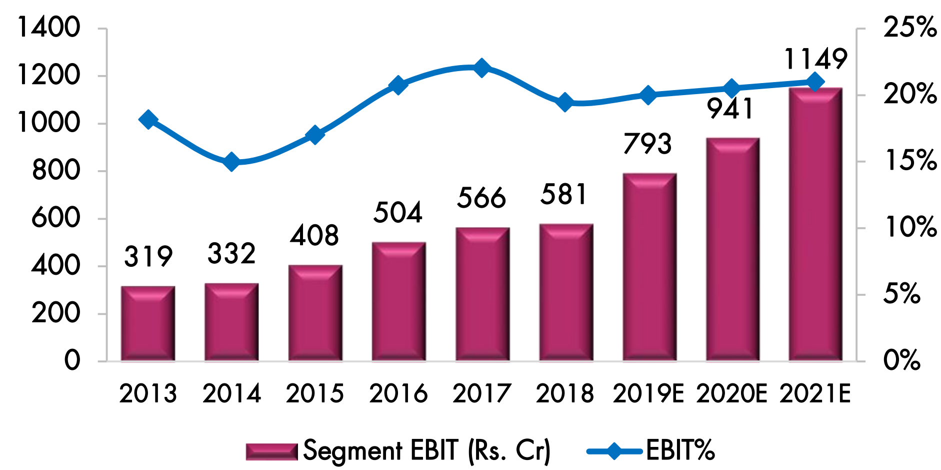
SC Segment to grow at a CAGR of 22%



- The specialty chemicals segment contributes the largest portion to the company's revenue (78%) and EBIT (88%).
- The revenues in the segment have grown at a CAGR of 11% over FY13-FY18 & EBIT at a CAGR of 13% over the same period.
- The contribution of export has reduced due to the rise in domestic demand as a result of import substitution caused by the slowdown in the Chinese industry.
- The company follows cost-plus pricing model wherein the input costs (which is dependent on crude oil prices) are passed on to the customers with a lag of 2 months; hence the company is able to protect its margins against any volatility in the raw material prices.

- The growth in revenues has largely been due to consistent expansion plans of the company in its existing product line and addition of new value added products to its portfolio.
- The recently commissioned Toluene value chain is fully functional and is expected to reach peak utilization in next 2-3 years.
- Further, AIL is currently working on scale-ups in capacity expansion of the existing products and addition of newer downstream derivative products. It is also working on the introduction of Chloro Toluene chain.
- Considering these and other growth opportunities in the chemicals space, we expect AIL's specialty chemical segment revenue to grow to Rs. 5472 cr by FY21E implying a CAGR of 22% over FY18-21E.

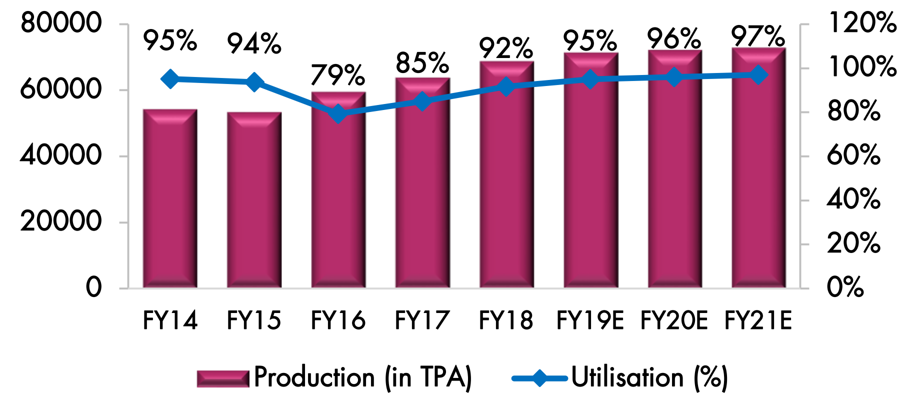
Segmental EBIT to grow at a CAGR of 26%



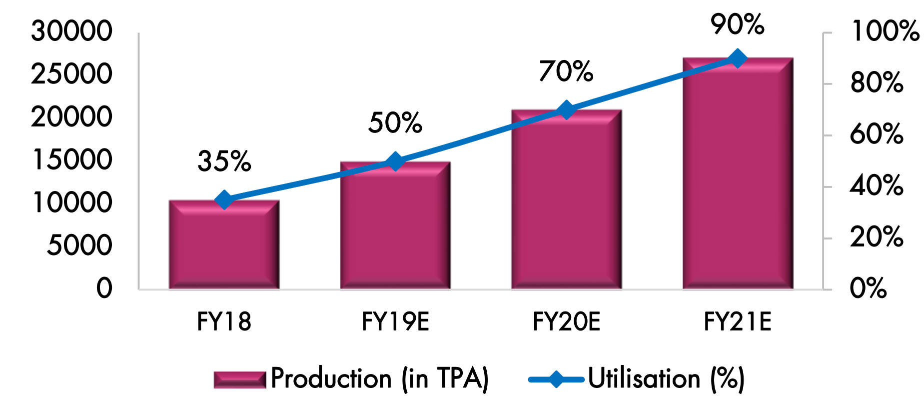
Source: Company, Axis Securities.

NCB and NT: The Key Products

Nitro Chloro Benzene (NCB)



Nitro Toluene (NT)

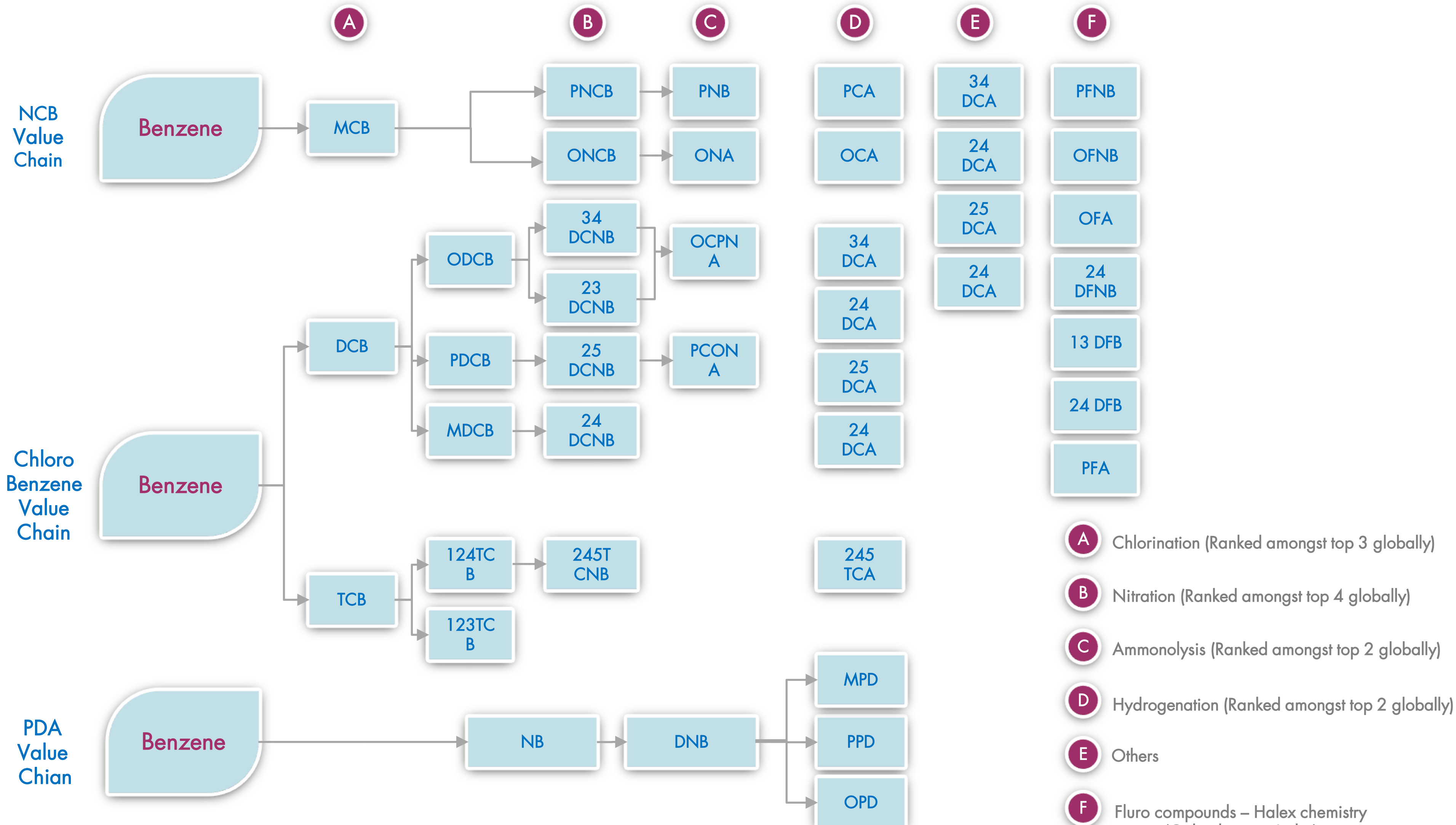


- AIL is the largest producers of NCB and its downstream derivatives in India and one of the leading global manufacturers with a 25-40% global market-share across various products. It has a production capacity of 75,000 TPA, increased from 57,000 TPA in FY16. It is one of the few players to have a value chain till the sixth derivative. It is the only Indian company to produce benzene based flouro compounds.
- The company is operating at a utilization rate of ~92% and we expect it rise to 95% by FY19 end.
- In order to cater to the increasing demand, the company is currently working on further scale-ups in capacity of NCB and its derivatives and it is also planning to add newer NCB based downstream derivative products. These are under planning stage at the moment and will drive the revenue growth post FY19 once implemented.

- The company started production of Nitro-Toluene and its value chain in Q3FY18 with a capacity of 30,000 TPA. It is currently working at a utilization rate of ~50%.
- Nitro Toluene market is highly untapped in India. Most of the demand is fulfilled via imports. AIL is one of the few players to have a complete value chain of NT. It is currently targeting only domestic market and is gaining ground at a brisk pace with companies preferring a domestic supplier & AIL leveraging its existing relationship with its clients.
- Strong demand is expected due to import substitution and AIL using its client relationships to cross sell its Toluene based products due to which the utilization is expected to reach optimum levels in the next 2-3 years.
- AIL also plans to gradually ramp up the downstream value chain.

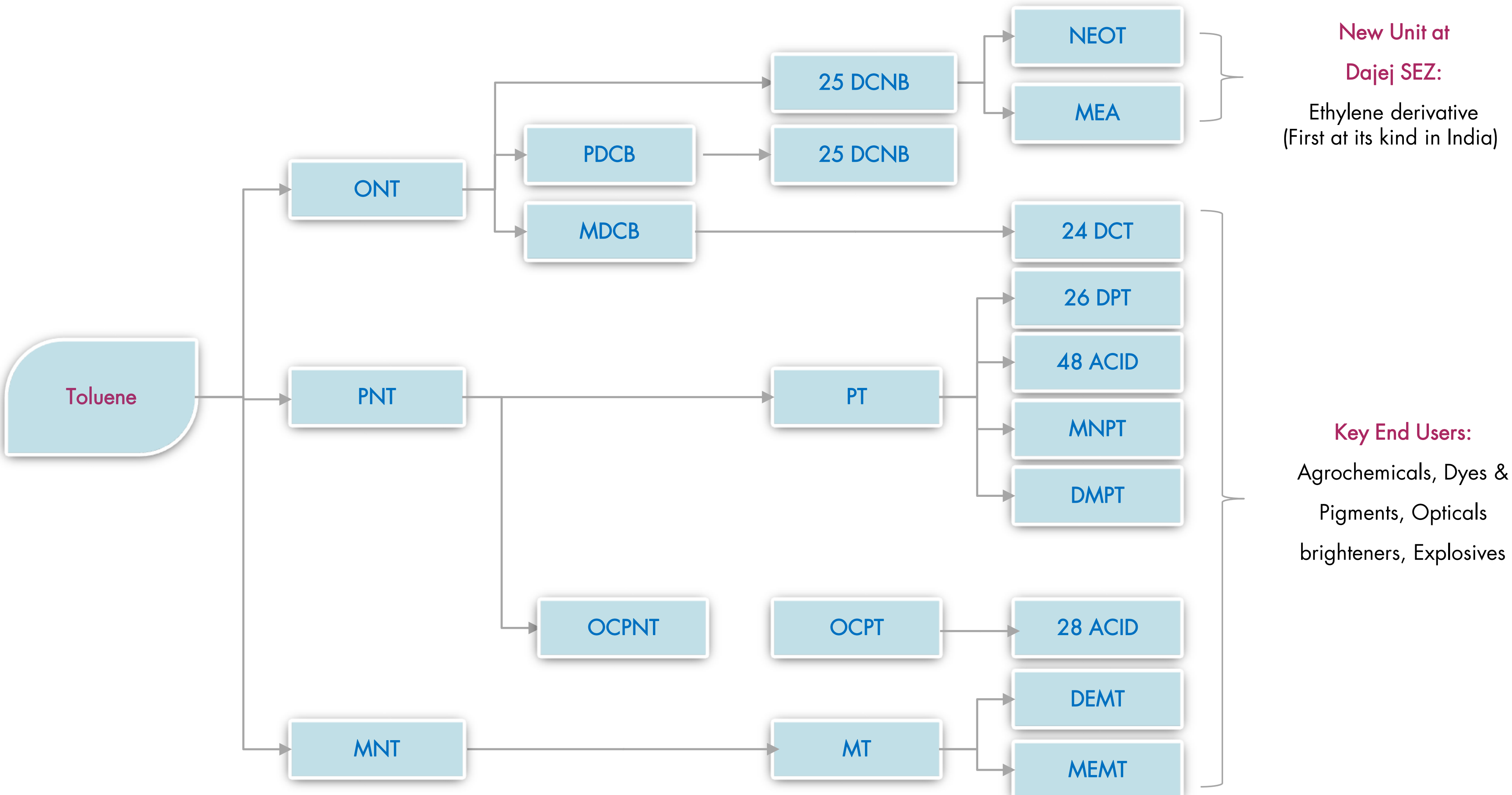
Source: Company, Axis Securities.

Only player to produce upto 6th derivative of Benzene value chain



Source: Company, Axis Securities.

Foray into a highly untapped Toluene value chain



Source: Company, Axis Securities.

Other products in the SC Segment

Phenylene Diamines (PDA) value chain

- PDA is a benzene derivative and is used in dyes, textiles, polymers, photography, specialty additives and as antioxidants.
- AIL is the only Indian company involved in the manufacturing of PDA. From 3,000 TPA capacity in FY15, it quadrupled its PDA capacity to 12,000 TPA in FY17.
- This expanded capacity will cater to the demand of high growth industries of engineering polymers and specialty additives and establish AIL as the only supplier of PDA for the Indian MNCs looking for import substitution.

Chlorination and Calcium Chloride

- AIL is the 3rd largest player in chlorination globally. It has a chlorination capacity of 1,10,000 TPA and is working on expanding it to 1,75,000 TPA by FY19 end.
- This will help the company to introduce a new range of chlorinated products.
- The company also has a 30,000 TPA capacity Calcium Chloride unit which was set up in FY17. It produces high quality Calcium Chloride granules from diluted by-product HCL, most of which is exported to the global markets.

Ethyation

- In FY17, AIL commissioned its Ethylation unit with 8,000-10,000 TPA capacity of ethylene derivatives, used in agrochemicals and specialty additives.
- It was set up by adopting Swiss tech. at the Dahej SEZ, making it the first company to procure ethylene by a pipeline & operate a greener ethylation process.
- The company expects to achieve full utilization in next 3-4 years; currently around 35-40%. Growth in agrochem. industry will drive demand for ethylene derivatives.

Source: Company, Axis Securities.

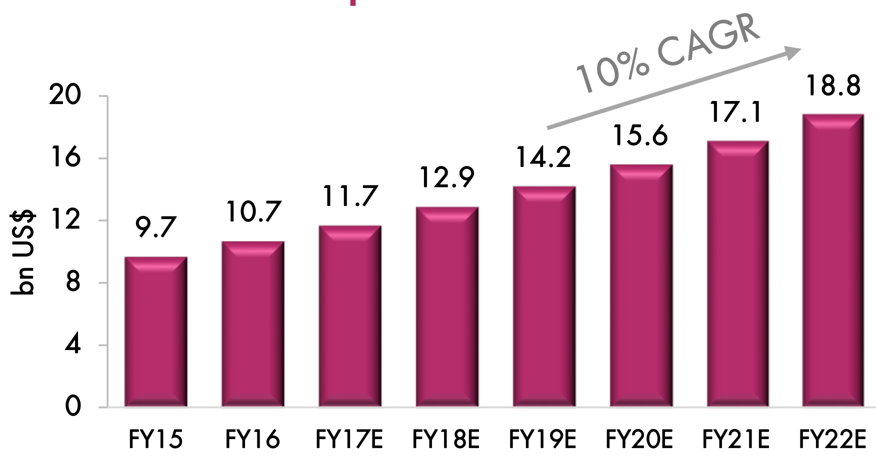
Multi year deals to provide revenue visibility

	Contract 1	Contract 2	Contract 3
Contract Value	$620 mn (~Rs. 4000 cr)	$1.54 bn (~Rs. 10,000 cr)	$125 mn (~Rs. 900 cr)
Contract term	10 years	20 years	10 years
Customer	Fortune 500 Agrochemical Company	Fortune 500 Specialty Chemical Company	Global Chemical Conglomerate
Chemical to be supplied	Herbicide intermediate chemicals	Specialty Chemical Intermediate	High value Specialty Chemical Intermediate
Annual revenue to be generated	$ 62 mn	$ 76 mn	$12.5 mn
Capex	$ 62 mn	$ 35-40 mn* (Provided by customer)	$15 mn
Commissioning	Q4FY20	CY2020	Q4FY21
Production unit	Dahej SEZ (Eligible for tax incentive)	Dahej SEZ (Eligible for tax incentive)	Gujarat

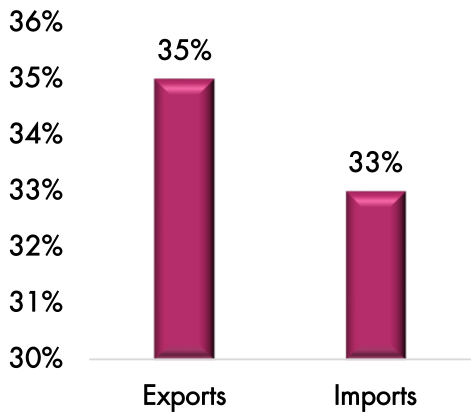
Source: Company, Axis Securities. * To be adjusted by the customer against supply

- AIL, on the back of its strong customer relationship and technical expertise, signed two multi-year deals in FY18 and one in FY19.
- The product required in the first contract is part of the existing benzene value chain that requires developed technology which AIL had in-house.
- For the second and third contract, AIL was finalized due to its strong SHE practices, robust manufacturing & operations and IP governance.
- This provides AIL with a long term and sustained revenue visibility and will help the company generate higher margins and improve its ROCE.
- We expect the first two deals to contribute 4% of the revenues in FY21E.

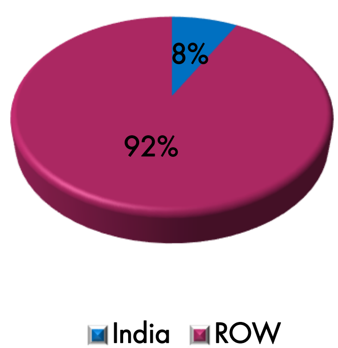
Indian API Domestic Consumption Market FY15-FY22



India API Market Trade (%), FY16



Share of India in Global API Market (%) FY16



Source: ASSOCHAM, Axis Securities.

China Slowdown to benefit the Indian API manufacturers

- For APIs and API intermediates, China had been a traditional source of supply. It alone accounts for ~55-60% of the API market.
- However, stricter compliance with pollution norms and tighter regulatory processes has led to slowdown in the Chinese API market which has impacted supply of several APIs & intermediates.
- Indian companies manufacturing these products have thus benefited from import substitution.
- AIL, having been in the business for several years, already has a wide range of products in the segment, is a preferred supplier to many Pharma companies. We expect AIL to further benefit from this Chinese slowdown.

- The global prescription drug sales is expected to grow at a CAGR of 6.4% over FY18-24E. With recent revival in the Indian Pharma industry, growth is expected to be higher in the Indian market.
- This growth will be driven by rising healthcare expenditure, increasing disposable income, growing geriatric population, increasing incidences of chronic diseases, patent expiry of major drugs and increased consumption of generic drugs.
- The API business is poised to get a boost with this growth in the Pharma sector, slowdown in Chinese industry and with the invention of new generation of APIs. India currently holds ~8-10% of global share in API business which is expected to increase over the next few years.

AIL Pharma Segment: At an Inflection Point

Pharma Business

Active Pharma Ingredients (APIs)

- 48 commercial APIs
- 12 new APIs under development
- Own backward integrated facilities for most APIs
- Distinct advantage having dedicated USA, Japan and EU approval for Steroids and anit-cancer products
- Scaled up to 9 lines from 4 lines

Pharma Intermediates for Innovators & Generics Cos.

- CRAMs activity focused on Intermediates
- Dedicated 70 scientist working in separate R&D block for intermediates
- Developed 15+ APIs intermediates
- Offering end to end solution from process development till manufacturing

Xanthine Derivatives (Caffeine & Others)

- Doubled capacities to cater to demand for Cola/ Energy Drinks manufacturers

- AIL's pharma business, which comprises API, intermediate and Xanthine derivatives, currently accounts for 15% of total revenues. It focusses on off patented generics where competition is relatively less.
- AIL has 4 pharma manufacturing units, of which, 2 are USFDA and 2 are WHO-GMP approved.
- In FY18, exports contributed ~45% of the revenues, out of which 60% is derived from the developed markets of US and EU.
- Key end user industries: Global Generic Pharmaceutical Companies, Innovator and Large Pharmaceuticals MNCs, Branded Generic Indian Pharma Companies.
- The company has dedicated manufacturing plants for Xanthine derivatives with a capacity of 3,600 TPA for its flagship product, caffeine used in beverages.
- Aarti is focusing on high-margin therapy areas such as oncology and diabetology for the expansion of the intermediate as well as API business. Aarti is also targeting 20-25 small molecules, which will help it capitalize on the patent cliff and the outsourcing trends over the next 6-7 years.

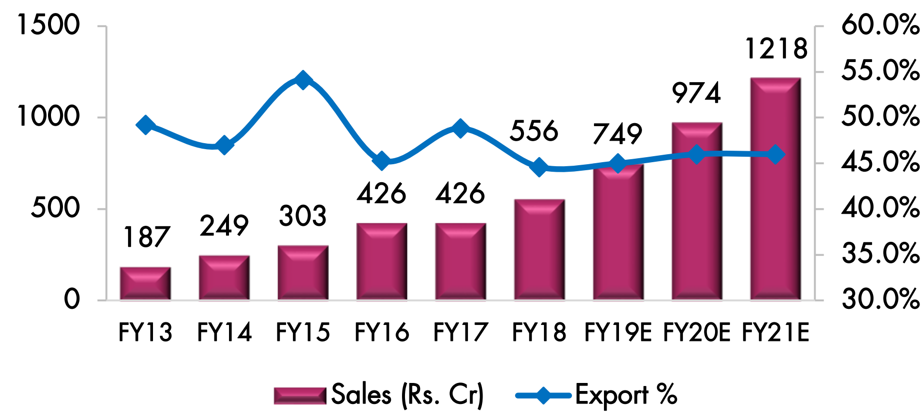
Pharma is the fastest growing business for Aarti Industries. With capacities in place and utilization set to increase on account of higher demand and diversified product mix, pharma would be the next growth driver for AIL.

Source: Company, Axis Securities.

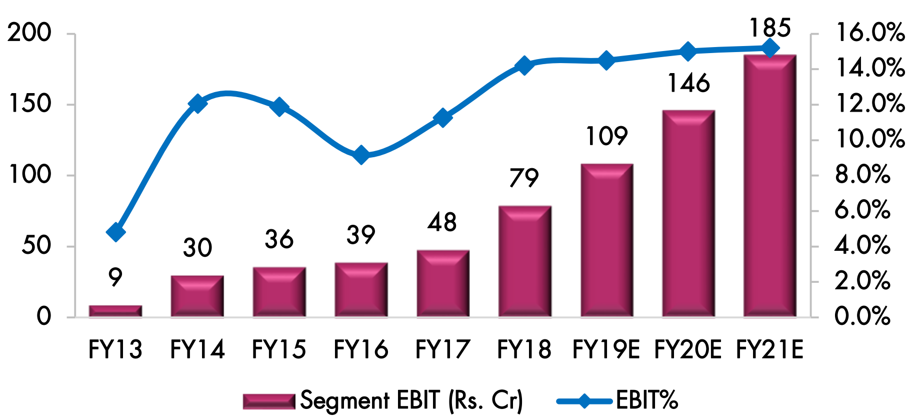
AIL Pharma Segment: At an Inflection Point

- The pharma business is the fastest growing segment for AIL with revenues growing at a CAGR of ~24% over FY13-18 and EBIT growing even faster at a CAGR of ~54% over the same period.
- However, the pharma segment has not been able to contribute significantly to the bottomline. It contributes ~12% of company's EBIT.
- The EBIT margin has been low over the years because there are various substantial fixed costs associated with the Pharma business as it is working capital intensive and AIL is investing extensively on capacity expansion and development of newer products.
- However, there has been improvement in the EBIT margin in the last two years due to higher utilisations.

Pharma Segment to drive revenue growth



Segmental margins to improve

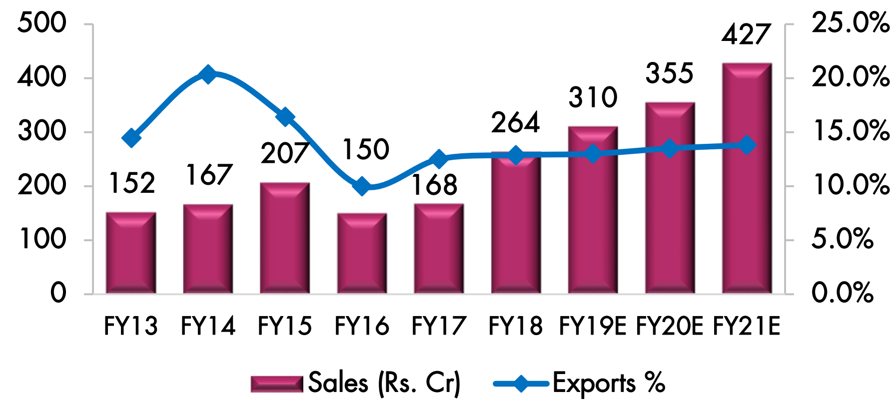


Source: Company, Axis Securities.

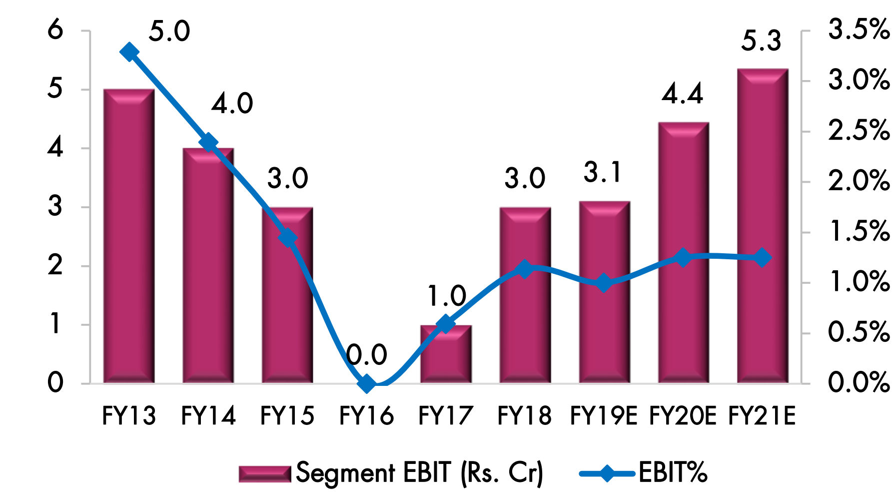
- With most of the fixed costs now factored in, utilisation set to increase and most of the APIs being backward integrated, we expect the margins and ROCE to expand further
- With the recent revival in the global pharma industry and crackdown in the Chinese API industry due to the pollution norms and stricter regulatory requirements, AIL's pharma business is expected to benefit from rising demand, import substitution, its focus on exports to regulated markets along with higher utilisation which in turn will help the company boost their volumes and margins.
- We expect AIL's pharma segment revenue to grow to Rs. 1218 cr by FY21E implying a CAGR of 30% over FY18-21E.

HPC Demerger

Revenue growth to remain subdued



Contribution to profits expected to continue to be low



Source: Company, Axis Securities.

- AIL entered into the Home & Personal Care business in 2009 with the acquisition of Surfactants Specialities Pvt Ltd.
- The company has 2 manufacturing facilities at Pithampur (M.P.) and Silvassa and manufactures non-ionic surfactants which include concentrates for shampoo, hand wash, dish wash, oral care etc.
- The contribution of the HPC segment has been pretty marginal with just 7% of the revenues; contribution to the bottomline, on the other hand, has been almost negligible. Although there was a significant growth in the revenues in FY18 due to higher volumes and better product mix, profitability still escaped the segment.
- It is a relatively low margin business. The primary reason for this is that surfactant manufacturers have very low bargaining power with their customers who compete on pricing. This contracts the margins of the suppliers which has affected AIL.
- AIL's management has announced to divest the HPC business into a separate entity, to focus on the high margin specialty chemical business. It expects this divesture to improve the performance of the business.
- We believe that this demerger will not have any material impact on AIL as its contribution to the overall business and capital employed is pretty low.
- We have included HPC revenues in our estimates for now but will update it post the demerger.

Q3FY19 – Excellent quarter led by the SC segment

Quarterly Performance

Rs Cr	Q3FY19	Q3FY18	% Change (YoY)	Q2FY19	% Change (YoY)
Sales	**1268**	**990**	28	**1300**	(2)
Other Inc	0	1		0	
Total Revenue	**1268**	**991**	28	**1300**	(2)
Expenditure					
Net Raw Material	747	577	29	794	(6)
Personnel	62	46	37	53	18
Other Exp	212	189	12	210	1
Total Expenditure	**1021**	**812**	26	**1057**	(3)
EBIDTA	**247**	**179**	38	**242**	2
Interest	42.4	33.7	26	51.3	(17)
Depreciation	40.6	34.2	19	38.9	5
PBT	**164**	**111**	48	**152**	8
Tax	31.5	20.5	54	29.3	8
PAT	**132.7**	**90.2**	47	**122.9**	8
Oth. Comprehensive Income (net of taxes)	30.5	5.9		(19.6)	
Total Comprehensive Income	**163.1**	**96.1**	70	**103.3**	58
EPS (Rs.)	16.3	11.0	47	**15.1**	8

Source: Company, Axis Securities

- Aarti Industries reported an excellent set of quarterly results for 3rd quarter of FY19. Company reported 28% Y-o-Y growth in Sales mainly on the back of volume growth, 38% Y-o-Y growth in EBIDTA and 47% Y-o-Y growth in profit after tax for Q3FY19. The growth was led by volume growth in the Specialty Chemicals segment. The volume growth for Q3FY19 was 8%.
- The EBITDA margin was up 84 bps Q-o-Q and the PAT margin was up 100 bps Q-o-Q driven by the passing through of raw material prices and improvement in product mix towards value added products.
- The specialty chemicals business grew 31%, pharma business grew 23% and HPC business grew 8% on an yearly basis.
- Management announced to increase the NCB capacity from 75,000 MTPA to 1,08,000 MTPA via debottlenecking with an investment of Rs. 150 cr. The current NCB capacity utilization stands at ~92%.
- The first multi-year deal will be commissioned by 2nd half of FY20 and the second deal will be commissioned in the first quarter of FY21.
- With the company expanding its product portfolio and its existing capacities and the shift in demand from China, it is expected to continue its steady growth.
- We expect the specialty chemicals and pharma segment to witness robust growth with pharma being the outperformer.

Strategic Advantages

Diversified Portfolio

- ✓ 200+ products
- ✓ Wide range of products helps penetration into new geographies and acquire new customers

Cost plus Pricing Model

- ✓ Variation in RM costs are passed on to customers, hence EBITDA is not affected.
- ✓ Savings by way of yield improvement, cost reduction initiatives etc. are retained by the company.

High Entry Barrier

- ✓ High approval time
- ✓ Requires intensive R&D and high chemical knowhow
- ✓ Reuires multiple products to set up a manufacturing plant

Global Partner of Choice

- ✓ 1,000+ customers with supplies to over 60 countries
- ✓ Globally ranks at 1st–4th position for 75% of its portfolio.
- ✓ Won 3 multi year deals due to strong relationship with customers

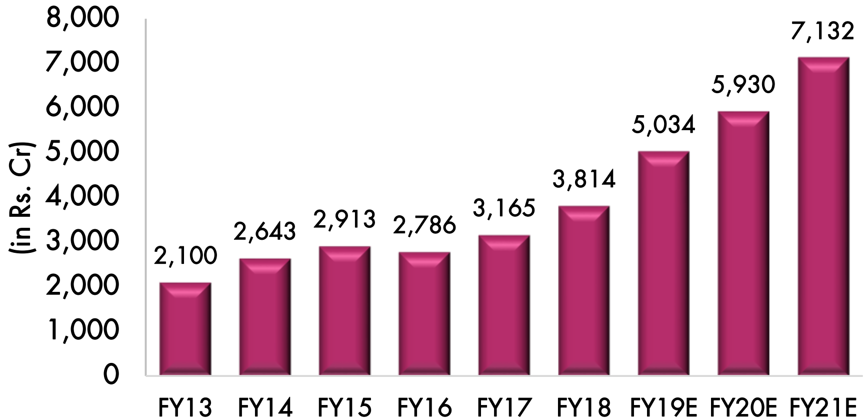
R&D Investments

- ✓ 3 R&D centres; 4th to come up in FY19.
- ✓ ~Rs. 70 cr capex done in last 2 years.

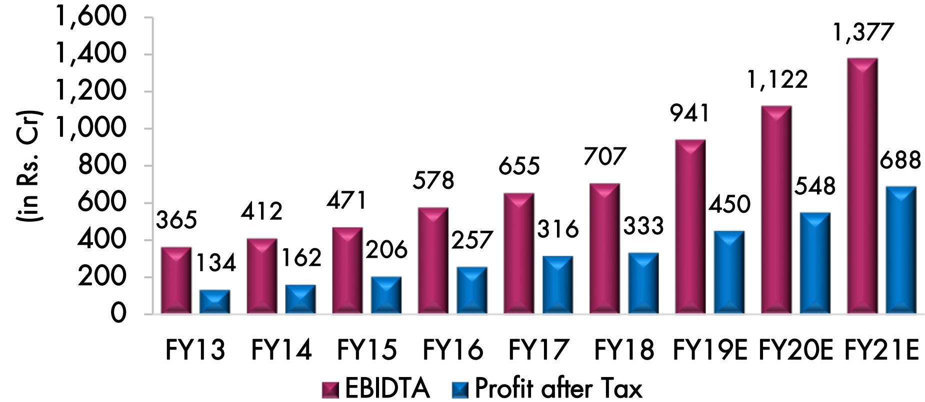
Source: Company, Axis Securities.

Efficient Financials

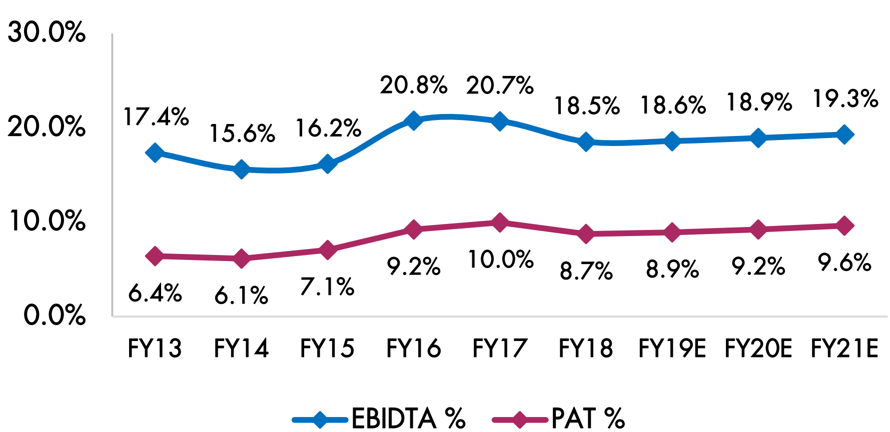
Revenues to grow at a CAGR of 23% on back of growth in both SC and Pharma Segments



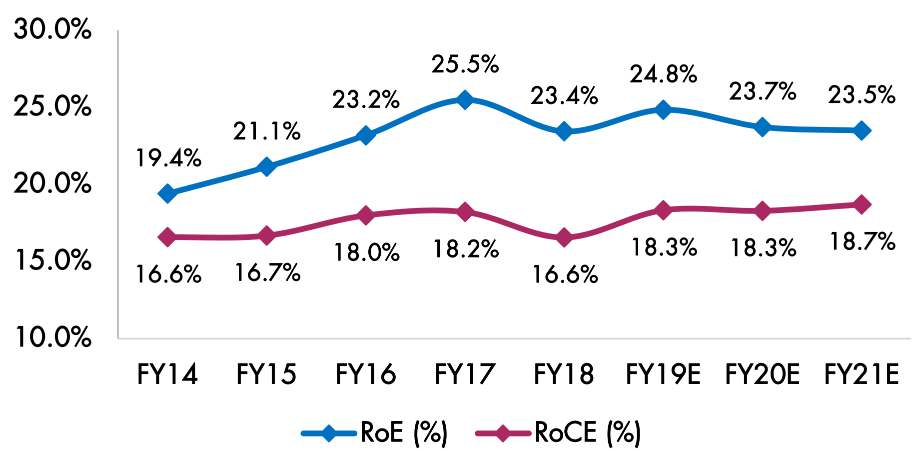
Bottomline to remain strong



Margins to improve due to the margin expansion in Pharma segment



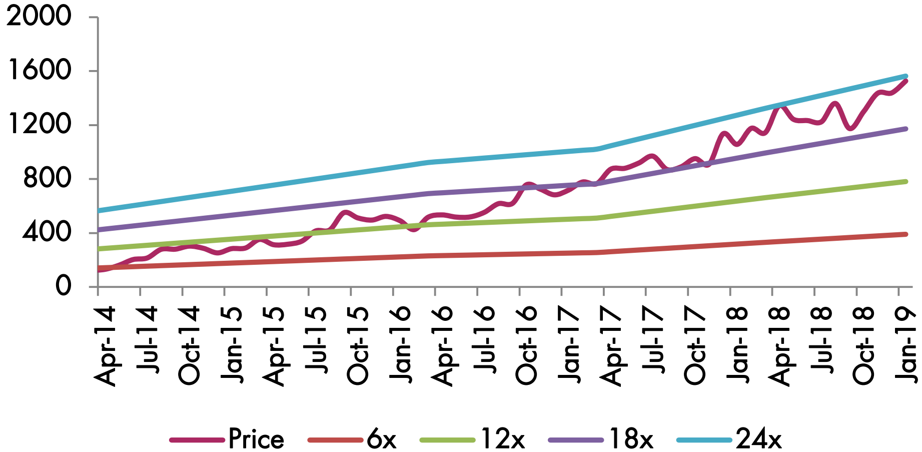
Return Ratios to remain steady



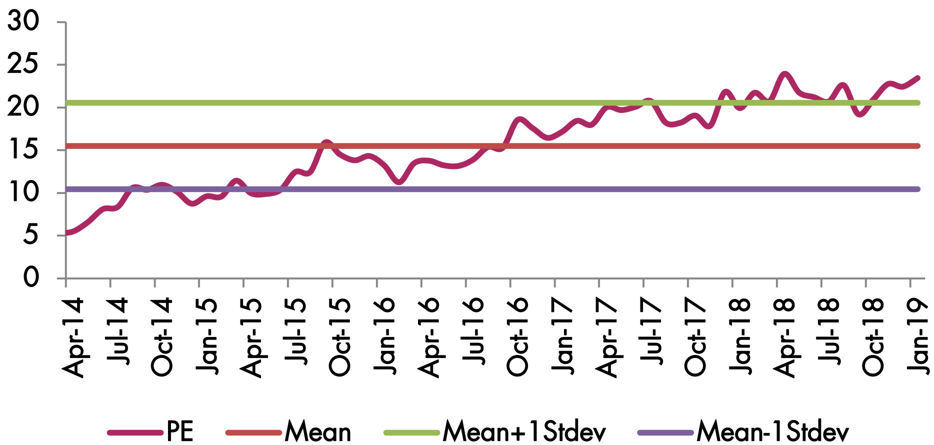
Source: Company, Axis Securities.

Valuation

P/E Band



12mth fwd P/E (x)



Source: Company, Axis Securities.

Valuation

- We estimate AIL to post revenues at a CAGR of 23% and profits at 27% over FY18-FY21E
- AIL is well positioned in the global market with marquee customer base, robust margins, strong balance sheet and diversified product portfolio
- We value AIL at 19x FY21E given the growth prospects to arrive at a target price of Rs 1,599 (22% upside)

Key Risk & Concerns

- ~45% of the company's revenue come from exports so sharp forex fluctuation can affect the earning in near term
- Some of the businesses of the company are functioning at optimum utilization. Any delay in the ramp up of capacities might affect the revenue growth.
- Since raw materials of AIL are mostly crude derivatives, any steep fluctuation in crude oil prices might have a temporary impact on the earnings.

Financials (Consolidated)

Profit & Loss (Rs Cr)

YE March	FY17	FY18	FY19E	FY20E	FY21E
Net sales	**3,163**	**3,806**	**4,994**	**5,918**	**7,117**
Other operating income	2	8	11	12	15
Total income	3,165	3,814	5,004	5,930	7,132
Cost of goods sold	2,326	2,886	3,773	4,464	5,346
Contribution (%)	26.5%	24.2%	24.4%	24.6%	24.9%
Advt/Sales/Distrn O/H	184.3	220.6	290.2	343.4	412.9.3
Operating Profit	**655**	**707**	**941**	**1,122**	**1,373**
PBIDT	**655**	**707**	**941**	**1,122**	**1,373**
Depreciation	123	146	186	221	272
Interest & Fin Chg.	117	132	176	201	230
Pre-tax profit	**416**	**429**	**578**	**701**	**872**
Tax provision	88	83	116	140	174
(-) Minority Interests	12	13	13	13	13
PAT	**316**	**333**	**429**	**548**	**684**

Source: Company, Axis Securities.

Balance Sheet (Rs Cr)

YE March	FY17	FY18	FY19E	FY20E	FY21E
Total assets	**3,018**	**3,754**	**4,482**	**5,382**	**6,377**
Net Block	1,697	1,998	2,436	2,901	3,446
CWIP	269.5	436.2	461.5	576.0	649.7
Investments	47.0	47.2	47.2	47.2	47.2
Wkg. cap. (excl cash)	976	1,240	1,494	1,804	2,182
Cash / Bank balance	28.5	32.1	42.5	54.4	51.8
Misc. Assets	0.0	0.0	0.0	0.0	0.0
Capital employed	**3,018**	**3,754**	**4,483**	**5,382**	**6,377**
Equity capital	41.1	40.7	40.7	40.7	40.7
Reserves	1,321	1,538	1,988	2,536	3,221
Pref. Share Capital	0.0	0.0	0.0	0.0	0.0
Minority Interests	63.9	77.0	90.0	103.0	116.0
Borrowings	1,436	1,921	2,150	2,450	2,700
Def tax Liabilities	155.4	177.4	213.2	252.4	299.1

Financials (Consolidated)

Cash Flow (Rs Cr)

YE March	FY17	FY18	FY19E	FY20E	FY21E
Sources	**172**	**708**	**832**	**898**	**1,096**
Cash profit	567	624	825	982	1,199
(-) Dividends	1	12	12	12	12
Retained earnings	567	612	813	970	1,186
Issue of equity	(0.6)	(0.4)	0.0	0.0	0.0
Change in Oth. Reserves	8.8	(22.4)	13.0	13.0	13.0
Borrowings	203	485	229	300	250
Others	(605)	(366)	(223)	(387)	(353)
Applications	**172**	**708**	**832**	**896**	**1,096**
Capital expenditure	223.5	669.6	650.0	800.0	890.0
Investments	28.6	0.3	0.0	0.0	0.0
Net current assets	(79.6)	34.2	171.5	84.3	208.9
Change in cash	(0.5)	3.6	10.4	11.8	(2.5)

Ratio Analysis (%)

YE March	FY17	FY18	FY19E	FY20E	FY21E
Sales growth	**13.8**	**20.3**	**31.2**	**18.5**	**20.3**
OPM	**20.7**	**18.5**	**18.8**	**18.9**	**19.3**
Oper. profit growth	13.4	7.8	33.1	19.3	22.7
COGS / Net sales	73.5	75.8	75.6	75.4	75.1
Overheads/Net sales	5.8	5.8	5.8	5.8	5.8
Depreciation / G. block	4.6	4.7	5.0	5.0	5.2
NPM	10.0%	8.7%	9.0%	9.2%	9.6%
Net wkg.cap / Net sales	0.25	0.24	0.23	0.24	0.25
Net sales / Gr block (x)	1.2	1.2	1.3	1.3	1.4
RoCE	**18.2**	**16.6**	**18.3**	**18.3**	**18.8**
Debt / equity (x)	1.05	1.22	1.06	0.95	0.83
Effective tax rate	21.2	19.3	20.0	20.0	20.0
RoE	**25.5**	**23.4**	**24.8**	**23.6**	**23.4**
Payout ratio (Div/NP)	0.3	3.7	2.8	2.3	1.8
EPS (Rs.)	**38.5**	**41.0**	**55.3**	**67.4**	**84.2**
EPS Growth	24.7	6.5	35.0	21.8	24.9
CEPS (Rs.)	53.4	58.9	78.2	94.5	117.6
DPS (Rs.)	0.1	1.2	1.2	1.2	1.2

Source: Company, Axis Securities.

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Instead of a company visit, we have done a conference call with the company's management.

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