

Aarti Industries Ltd.

Demerger will lead to focussed approach in chemical business

We analyse Aarti Industries residual business post demerger and potential valuation of its demerged entity. Carving out the pharma business, the residual business (i.e speciality chemicals) contributed 82% to the revenue as on FY22 with almost similar contribution at the EBIT level. Being the largest player in benzene derivatives, the company now plans to further integrate into existing businesses and setting up its foot into newer business. Aarti speciality chemical business is on a strong growth phase backed by increased NCB volumes, commercialization of long term contracts & strong demand from its key end user industries. Raw material sourcing remains a key challenge which could impact volume recovery in the long term if not resolved. Also, higher inflation impacting global economies could have material impact on the exports business which contributes almost 45% of Aarti revenue. The speciality chemicals business (excluding pharma) is currently trading at 29.2x Sept 24. We value the stock on 30x and arrive at target price of Rs 703 per share which is an upside of 2.6% from current valuations.

Demerger details:

Swap ratio is 1 fully paid up equity share of Rs 5 each of Aarti Pharmedicals for every 4 fully paid up equity shares of Rs 5 each held in Aarti Industries. The demerger would be carved out in Aarti Pharmedicals which would be independently listed on the stock exchanges.

Rationale for demerger:

The demerger would allow focussed approach towards scale & growth opportunities of both the businesses.

Are there any existing synergies between speciality chemicals & pharma business?

As per our view, there is no integration between pharma and specialty chemicals business except for basic raw materials like sulphuric acid and dimethyl sulphate.

Near term issues continue to impact volume recovery

The company is facing supply issues in one of its major raw material Nitric acid and this has impacted its volume growth of the company since FY21. The major reason attributable to this shortage is (a) Lack of existing supplies in the domestic market (b) Robust rise in demand of nitric acid (c) Plant shutdown in china impacting import supply. To counter this issues, the company plans to commission in house nitric acid concentration plant with a capex of Rs2bn which is expected in H2FY24 to reduce its dependence on third party sourcing. The new concentration plant will convert weak nitric acid to concentrated nitric acid.

Global recession increases chances of major dent in export business

Aarti's export business contributes 45% as on FY22 which could be significantly impacted by recession in the global economy. Almost 55% of the export revenue comes from North America & Europe, 12% China, 7% Japan and remaining RoW. Europe and China are struggling with problems like gas supply issues & covid restrictions which keeps global supply limited and this favours India despite recession impact. However, demand has started tapering off at the global level and this could have major dent on Aarti export business. Considering the volatile environment globally, at this juncture exports might remain sluggish but the domestic business would continue to perform better.

Long term plan to scale up speciality chemical business

The company already being the largest player in benzene derivatives now looking to aggressively expand into newer businesses. The company plans to incur Rs13-14bn annually into speciality chemicals from FY22-25E. The major capex is in the downstream chemistries of benzene & NCB business, chlorotoluene value chain, Acid division in the speciality chemical segment & setting up UMPP plants.

Valuation of residual entity & demerged business

Based on our calculations, the residual business which includes speciality chemicals is currently trading at 29.2x Sept 24 EPS. We value the stock on 30x and arrive at target price of Rs 703 per share which is an upside of 2.6% from current valuations. Since, the demerged pharma business would be listed on the stock exchanges, it should trade at Mcap in the range of Rs46-54bn or Rs 514-595 per share.



Rating: **REDUCE** Upside: **2.6%**
Current Price: **685** Target Price: **703**

| Market data

Bloomberg:	ARTO: IN
52-week H/L (Rs):	1031/617
Mcap (Rs bn/USD bn):	246.5/2.9
Shares outstanding (mn):	362.5
Free float:	28.9%
Daily vol. (3M Avg.):	1.1mn
Face Value (Rs):	5
Group:	S&P BSE 500

Source: Bloomberg, SMIFS Research

| Shareholding Pattern (%)

	Jun 22	Mar 22	Dec 21	Sep 21
Promoter	44.2	44.2	44.2	44.2
FII's	11.8	12.5	12.3	11.9
DII's	15.1	14.9	14.5	14.0
Public/others	28.9	28.4	29.0	29.9

Promoter Pledging

Pledge share	0.0	0.0	0.0	0.0
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Source: AceEquity

| Price performance (%)*

	1M	3M	12M	36M
S&P BSE 500	-2.8	6.3	-3.2	59.3
Aarti Industries	-21	-6.5	-31.8	71.8

*as on 20th Oct 2022; Source: AceEquity, SMIFS Research

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Y/E Mar (Rs mn)	Revenue	YoY (%)	EBITDA	EBITDA (%)	PAT	YoY (%)	EPS	RoE (%)	RoCE (%)	P/E (x)	EV/EBITDA (x)
FY20	45,061	8%	9,815	22%	5,235	-2%	15.0	14.9	9.2	43.8	25.5
FY21	63,895	42%	13,183	21%	7,844	50%	36.1	13.3	10.3	39.7	24.8
FY22	82,792	30%	15,063	18%	8,029	2%	22.1	12.0	9.2	33.9	19.8
FY23E	93,918	13%	18,337	20%	9,789	22%	27.0	12.9	9.8	27.8	16.5
FY24E	1,03,720	10%	21,721	21%	11,873	21%	32.8	13.6	10.5	22.9	13.9

Source: Company, SMIFS Research Estimates, Note: The table above is inclusive of both chemicals & pharma business numbers, hence numbers and valuations are not comparable

Pharma Background:

The company business model is break down into 35% from API and remaining 65% from non API business (Intermediates & Xanthine derivatives). The company is backward integrated for most of the APIs. The company has 5 manufacturing units, as also an R&D lab dedicated to this business. Almost 55% of the revenues from pharma business are exports to US, Europe & Japan. The pharma portfolio comprised of 48 commercial APIs, with 33 EUDMFs & 28 US DMF. It has 12 API's under development. The API manufacturing facility is USFDA & EUGMP accredited with dedicated production blocks for Steroids and Oncological APIs. Aarti being backward integrated in the pharma business helped to sustain the downturn in pharma cycle during FY15-19 and currently In the Xanthine derivatives segment the company has flagship product called Caffeine with an installed capacity of 3600 TPA which caters majorly to high end beverages.

Long term plan to scale up pharma business:

The company's long-term strategy is enhancing the company's position in the pharmaceutical segment by focusing on adding new chemistries and value added products. The company plan to add 50+ new products in the business with an approx. capex of Rs3.5-5bn. During expansion the company is focussed on strengthening its manufacturing capability and plans to increase the manufacturing capacity by 1,200 KL with installation of 240 reactors under 10 manufacturing blocks in the next 5 years. We believe Aarti Pharma business Revenue/EBIT CAGR is expected to grow at 17%/26% respectively from FY22-24E.

Speciality chemical business to grow backed by strong:

The company has started commercialization of its capacities in API's & intermediates business at Tarapur facility which will lead to contribute to revenue in the coming quarters. Improving product mix towards higher value-added segments will increase its presence in key regulated markets and improve the growth trajectory going ahead. The off-patented approach is paying off well to drive growth. The new API capacity commercialization has started and would contribute to revenues from the next quarter once capacity ramps up faster. Management seems confident of regaining its 20%+ margins over the coming quarters. Management guidance of 15-25% growth for the next 2-3 years is on track on the back of stronger volumes from API & intermediates segment. De-bottlenecking in caffeine business will increase its presence further into key markets.

Fig 1: Aarti Pharma business

(Rs in mn)

	FY17	FY18	FY19	FY20	FY21	FY22	FY23E	FY24E	FY25E
Pharma Revenue	4261	5562	7258	7557	9523	12999	15974	18384	21909
Growth		31%	30%	4%	26%	37%	23%	15%	19%
Pharma EBIT	481	792	1127	1375	2110	2203	2650	3150	3750
EBIT Margins	11.3%	14.2%	15.5%	18.2%	22.2%	16.9%	16.6%	17.1%	17.1%
Capital Employed in pharma business	5720	7328	8454	8610	11138	14306	15806	17306	18806
Pre tax ROCE	8%	11%	13%	16%	19%	15%	17%	18%	20%

Source: Company, SMIFS Research Estimates

Aarti pharma revenue & operating profits has reported very strong performance over FY16-22 growing at 3x in revenue & 6x in EBIT with improving margins over the years. The healthy growth in revenue was led by company's entering into new therapeutic areas and ramping up existing products in intermediates segment. Stronger operating profit led to improvement in Pharma ROCE from 7% in FY16 to 15% in FY22.

Fig 2: Pharma Capex details

Pharma Projects Pipeline	Location	Type	Expected timeline
Pharma API capacity	Tarapur	Brownfield	Commercialized in Q1FY23
Pharma API intermediate	Atali	Greenfield	Expected in FY24
Capacity expansion for USFDA approved API facility	Tarapur	Brownfield	Commercialized in Q1FY23

Source: Company, SMIFS Research

The company is also putting up a new greenfield expansion at Atali for pharma intermediates as well as APIs. The company has also acquired ~120 acres land at Atali Gujarat and obtained environmental clearance.

Demerger calculations

Fig 3: Pharma business Financials

(Rs in mn)

	FY23E	FY24E	FY25E
Pharma EBIT	2650	3150	3750
Finance cost	324	376	400
Pharma PBT	2326	2774	3350
Tax @21%	465	555	670
Pharma PAT	1860	2219	2680

Source: Company, SMIFS Research Estimates

Fig 4: Valuing pharma business

	Bear Case	Base Case	Bull Case
P/E assigned on Sept 24 PAT	17	19	22
Mcap (Rs in mn)	41646	46546	53895
Price per share	460	514	595

Source: Company, SMIFS Research Estimates

Fig 5: Residual business (Speciality Chemicals) financials

(Rs in mn)

	FY23E	FY24E	FY25E
Speciality Chem EBIT	8786	10655	12779
Finance cost	973	1069	1138
Speciality Chem PBT	7812	9586	11641
Tax @21%	1562	1917	2328
Speciality Chem PAT	6250	7669	9313

Source: Company, SMIFS Research Estimates

Fig 6: Valuing Speciality Chemicals business

	Bear Case	Base Case	Bull Case
P/E assigned on Sept 24 PAT	20	27	30
Mcap (Rs in mn)	169813	229248	254720
Price per share	468	632	703

Source: Company, SMIFS Research Estimates

Financial Statements

Income Statement					
YE March (Rs mn)	FY21	FY22	FY23E	FY24E	FY25E
Revenues	45,061	63,895	82,792	93,918	1,03,720
Raw Materials	21,286	32,938	46,323	49,063	52,391
% of sales	47.2	51.6	56.0	52.2	50.5
Personnel	3,714	4,421	5,338	6,446	7,783
% of sales	8.2	6.9	6.4	6.9	7.5
Other Expenses	10,246	13,353	16,067	20,072	21,825
% of sales	22.7	20.9	19.4	21.4	21.0
EBITDA	9,815	13,183	15,063	18,337	21,721
Other Income	7	8	8	7	7
Depreciation & Amortization	2,313	2,885	3,635	4,538	5,199
EBIT	7,509	10,306	11,436	13,805	16,529
Finance cost	864	1,143	1,298	1,445	1,538
Core PBT	6,639	9,155	10,130	12,354	14,984
Exceptional items	0	6,104	0	0	0
PBT	6,646	15,267	10,138	12,360	14,991
Tax-Total	1,293	2,194	2,028	2,472	2,998
Tax Rate (%)	19.5	14.4	20.0	20.0	20.0
Reported PAT	5,352	13,073	8,110	9,888	11,993
Minority Interest	-118	-2	-81	-99	-120
Adjusted PAT	5,235	7,844	8,029	9,789	11,873

Source: Company, SMIFS Research Estimates

Key Ratios					
YE March	FY21	FY22	FY23E	FY24E	FY25E
Growth Ratio (%)					
Net Sales	8	42	30	13	10
EBITDA	0	34	14	22	18
Adjusted PAT	-2	50	2	22	21
Margin Ratios (%)					
Gross Profit	52.8	48.4	44.0	47.8	49.5
EBITDA	22	21	18	20	21
EBIT	16.7	16.1	13.8	14.7	15.9
Core PBT	14.7	14.3	12.2	13.2	14.4
Adjusted PAT	11.6	12.3	9.7	10.4	11.4
Return Ratios (%)					
ROE	14.9	13.3	12.0	12.9	13.6
ROCE	9.2	10.3	9.2	9.8	10.5
Turnover Ratios (days)					
Gross block turnover (x)	0.9	1.0	1.0	0.9	0.9
Adj OCF / Adj PAT (%)	1.5	0.5	1.1	1.3	1.2
Inventory	160	156	145	145	145
Debtors	64	79	70	65	65
Creditors	99	54	55	55	55
Cash conversion cycle	126	182	160	155	155
Solvency Ratio (x)					
Debt-equity	0.9	0.4	0.5	0.5	0.4
Net debt/equity	0.7	0.4	0.5	0.4	0.4
Gross debt/EBITDA	3.1	2.0	2.2	2.0	1.8
Current Ratio	3.7	5.3	4.5	4.4	4.4
Interest coverage ratio	8.7	9.0	8.8	9.6	10.7
Dividend					
DPS (Rs)	1.5	1.5	1.7	2.0	2.5
Dividend Yield (%)	0.2	0.2	0.2	0.3	0.3
Dividend Payout (%)	10.0	4.2	7.7	7.4	7.6
Per share Ratios (Rs)					
Basic EPS (reported)	60.1	72.1	44.3	54.0	65.5
Adj EPS	15.0	21.6	22.1	27.0	32.8
CEPS	21.7	29.6	32.2	39.5	47.1
BV	100.9	163.2	184.7	210.0	240.5
Valuation (x)*					
P/E (adjusted)	43.8	39.7	33.9	27.8	22.9
P/BV	6.5	5.2	4.1	3.6	3.1
EV/EBITDA	25.5	24.8	19.8	16.5	13.9
EV / Sales	5.6	5.1	3.6	3.2	2.9
EV / Core PBT	37.7	35.7	29.5	24.4	20.3

Source: Company, SMIFS Research Estimates

Balance Sheet					
YE March (Rs mn)	FY21	FY22	FY23E	FY24E	FY25E
Source of funds					
Capital	871	1,813	1,813	1,813	1,813
Reserves & Surplus	34,280	57,339	65,146	74,299	85,369
Shareholders' Fund	35,151	59,152	66,959	76,111	87,182
Total loan funds	30,339	26,499	32,449	36,128	38,448
Other Liabilities	4,584	4,903	6,353	7,206	7,958
Total Liabilities	70,073	90,553	1,05,760	1,19,445	1,33,588
Application of funds					
Gross Block	51,555	62,719	80,781	1,00,843	1,20,905
Net Block	35,925	44,177	58,664	74,246	89,167
Capital WIP	12,979	14,904	11,694	6,867	2,795
Investments	635	731	1,335	1,417	1,504
Other non current assets	3,202	4,179	4,901	5,849	6,613
Inventories	9,357	14,113	18,402	19,491	20,813
Sundry Debtors	7,937	13,905	15,878	16,725	18,471
Cash and bank balances	4,123	2,568	1,071	1,296	1,025
Other current assets	2,259	2,150	2,183	2,574	3,011
Total Current Assets	23,676	32,737	37,535	40,085	43,319
Sundry Creditors	5,763	4,901	6,980	7,393	7,895
Other current liabilities	580	1,274	1,388	1,626	1,916
Total Current Liabilities	6,343	6,175	8,369	9,019	9,810
Net Current Assets	17,333	26,562	29,166	31,067	33,509
Total Assets	70,073	90,553	1,05,760	1,19,445	1,33,588

Source: Company, SMIFS Research Estimates,

Cash Flow					
YE March (Rs mn)	FY21	FY22	FY23E	FY24E	FY25E
Operating profit before WC changes	9,766	19,235	14,990	18,244	21,608
Net Change in working capital	9,693	7,377	12,063	16,912	19,337
Tax Paid	-966	-2,670	-2,028	-2,472	-2,998
Cash flow from operations	8,727	4,708	10,035	14,440	16,339
Adj. OCF	7,863	3,565	8,737	12,995	14,801
Capex	-14,311	-11,226	-18,000	-20,000	-20,000
Adj. FCF	-6,448	-7,661	-9,263	-7,005	-5,199
Cash flow from Investment	-13,221	-13,055	-15,516	-15,374	-16,135
Debt	7,459	-2,663	5,898	3,329	1,970
Interest and lease	-864	-1,143	-1,298	-1,445	-1,538
Dividend	-451	-1,269	-616	-725	-906
Cash flow from Financing	6,145	6,792	3,984	1,159	-474
Net change in cash	1,650	-1,555	-1,497	225	-271

Source: Company, SMIFS Research Estimates, Note All the tables mentioned above is inclusive of both chemicals & pharma business numbers, hence numbers and valuations are not comparable

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Analyst holding in stock: **NO**

Key to SMIFS Investment Rankings

Buy: Return >15%, Accumulate: Return between 5% to 15%, Reduce: Return between -5% to +5%, Sell: Return < -5%

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