

Aarti Industries Ltd.

Robust Q3, Long term growth story intact

Q3FY23 revenue of Aarti Industries grew by 15.4% YoY & declined by mere 1% QoQ to Rs16.7bn. Higher volumes & ramp up of long-term contracts led to stronger revenue on YoY basis. Also value added contribution during the quarter stood at 81% which offsetted some decline of weak demand from dyes, pigments, FMCG which led to gross margin decline of mere 46bps on QoQ basis to 41.5% in Q3FY23. Despite gross margin decline of 46bps QoQ, EBITDA margin expanded by 146bps QoQ to 17.3% in Q3FY23 mainly because of lower other expenses. Lower power & freight cost has helped in bringing down overall other expenses. We believe Aarti is on a multi year growth cycle & new projects like NCB capacity expansion, multipurpose plants will drive growth by FY25 & new chlorotoluene value chain, nitro-toluene capacity expansion, ethylation business expansion will drive growth beyond FY25E with stonger margin profile. Considering the strong growth outlook & reasonable valuation post correction in the stock price provides comfort for investors to ride on the growth story, therefore, we upgrade to BUY rating on the stock.

Revenue growth to remain strong going ahead

- We expect the company's long term growth to remain strong around 19% CAGR from FY22-25E majorly led by ramp of long term contracts & new chemistries kicking in.
- Core business excluding long term contracts might remain subdued in FY24E but post commercialization of NCB capacity expansion, Nitro-toluene de-bottlenecking, Multipurpose plants & Ethylation units debottlenecking, the growth visibility looks far superior for the next 5 years. Hence, we believe Aarti is on a multi year growth cycle.

Operating margins better than estimates, Cost pass through will improve the margins going ahead

- The company reported better than expected EBITDA margin on sequential basis by 146bps to 17.3% in Q3FY23 vs 15.8% in Q2FY22 majorly because of cost pass through of raw material prices & lower other expenses. Although, the recent correction in majority of its raw material prices might benefit the company in the coming quarters, slowdown in demand from dyes & FMCG sector is a key thing to watch out for, however, initial green shoots in demand is visible which seems positive for the coming quarters.
- We feel that Aarti has been successfully able to pass on its raw material cost and has proven its mettle in an environment wherein other players are struggling.
- Hence, we expect that the company would be maintaining its gross margins from hereon & even improve to around 50-55% in the coming years on the back of ramp up of long-term contracts & better product mix.

Valuation

- Currently, the stock is trading at FY25E P/E of ~20x. We value the stock on forward P/E multiple of 25x and, thereby, arrive at target price of Rs 681 per share which offers upside of 24% from current valuations.
- Therefore, we upgrade to **BUY** from earlier **REDUCE** rating on the stock.

Y/E Mar (Rs mn)	Q3FY23	Q3FY22	YoY (%)	Q3FY23	QoQ (%)	Q3FY23E	YoY (%)
Revenue	16,677	14,449	15.4	16,850	-1.0	17,509	-4.8
Operating cost	13,790	11,864	16.2	14,180	-2.8		
EBITDA	2,887	2,586	11.7	2,670	8.1	2,620	10.2
EBITDA margin (%)	17.3	17.9	(58) bps	15.8	146 bps	15.0	(235)bps
Depreciation	821	572	43.4	729	12.6		
Interest	470	236	99.3	437	7.4		
Other Income	2.8	1	250.0	0.2	1300.0		
PBT	1,599	1,778	-10.1	1,504	6.3		
Taxes paid	234	837	-72.1	259	-9.9		
Reported PAT	1,365	941	45.1	1,245	9.7		
Minority Interest	0	-1	-100.0	0	NA		
Consolidated PAT	1,365	941	45.2	1,245	9.7	1,210	12.8

Source: Company, SMIFS Research, Q3FY22 numbers excludes onetime payment of shortfall fees Rs6312.5mn

Y/E Mar (Rs mn)	Revenue	YoY (%)	EBITDA	EBITDA (%)	PAT	YoY (%)	EPS	RoE (%)	RoCE (%)	P/E (x)	EV/EBITDA (x)
FY20	45,061	7.6	9,815	21.8	5,235	-2.4	15.0	14.9	10.3	43.8	25.5
FY21	54,751	21.5	11,097	20.3	6,418	22.6	17.7	13.7	10.4	39.7	29.3
FY22*	66,079	20.7	10,606	16.1	5,382	-16.2	14.8	10.3	8.1	37.0	20.9
FY23E	87,635	32.6	15,833	18.1	9,139	69.8	25.2	15.1	12.0	21.8	14.3
FY24E	92,533	5.6	17,282	18.7	9,872	8.0	27.2	14.2	11.6	20.2	13.1

Source: Company, SMIFS Research Estimates, *FY22 numbers exclude one time benefit of shortfall fees



Rating: **BUY**

Upside: **24%**

Current Price: **550**

Target Price: **681**

Earlier recommendation

Previous Rating:	BUY
Previous Target Price:	703

Market data

Bloomberg:	ARTO: IN
52-week H/L (Rs):	968/505
Mcap (Rs bn/USD bn):	193.7/2.4
Shares outstanding (mn):	362.5
Free float:	29.1%
Daily vol. (3M Avg.):	0.61mn
Face Value (Rs):	5

Source: Bloomberg, SMIFS Research

Shareholding pattern (%)

	Dec-22	Sept-22	June-22	Mar-22
Promoter	44.2	44.2	44.2	44.2
FII's	12.1	12.1	11.8	12.5
DII's	14.6	15.1	15.1	14.9
Public/others	29.1	28.6	28.9	28.4

Pro.Pledging

Pledging	0.0	0.0	0.0	0.0
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Source: BSE

Price performance (%)*

	1M	3M	12M	36M
NIFTY 50	-0.5	-2.0	1.4	46.4
NIFTY 500	-2.2	-3.8	-1.0	49.3
Aarti Industries	-9.5	-28.5	-48.7	12.5

*As on 08th Feb 2023; Source: Ace Equity, SMIFS Research

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Analyst Call Highlights

- **Demand outlook:** The demand of speciality chemicals has witnessed headwinds in the quarter and company has been able to mitigate the volatility with better product mix. A set of end user industries like textiles, FMCG, dyes & pigments are witnessing slack of demand and expected pickup by Q1FY24. Value added segments contribution for the quarter has been 81% during the quarter which was roughly 65-70% over the last few quarters. Management expects current volatility in demand across end user industries will become more stable and grow sustainably in 2025.
- **Capex plans:** The overall capex from FY22-24 is assumed to be around Rs22-25bn. The major capex is in the downstream chemistries of benzene & NCB business, chlorotoluene value chain, Acid division in the speciality chemical segment.
- **Signed long term agreement of nitric acid with DPFCL:** The company has signed a long-term binding contract with Aarti Industries for offtake and supply of Nitric Acid, valued at over Rs80bn. The deal is for 20 year period with specific volume commitments.
- **Strong EBITDA guidance for FY25E:** Management guidance for EBITDA CAGR is around 25% for the next 2 years backed by commercialization of large deals and new projects which are getting commissioned over the coming years.
- **Volume numbers for Q3FY23:** NCB – 18199 tonnes, Nitro-toluene – 7528 TPM, Hydrogenation – 2995 TPM.
- **Commercialization of 3rd long term contract has been done. All 3 long term contracts are operational now.**
- **Foray in newer business:** The company is looking for opportunities in Chlorotoluene and other chemistries going ahead to diversify itself further into the value chain, expanding ethylation capacity at a capex of Rs2bn.

Valuation and Recommendations

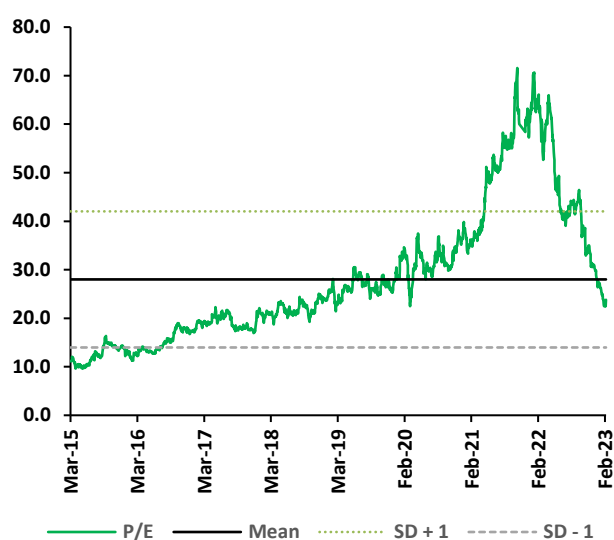
Currently, the stock is trading at FY25E P/E of ~20x.

We value the stock on forward P/E multiple of 25x and, thereby, arrive at target price of Rs 681 per share which offers upside of 24% from current valuations.

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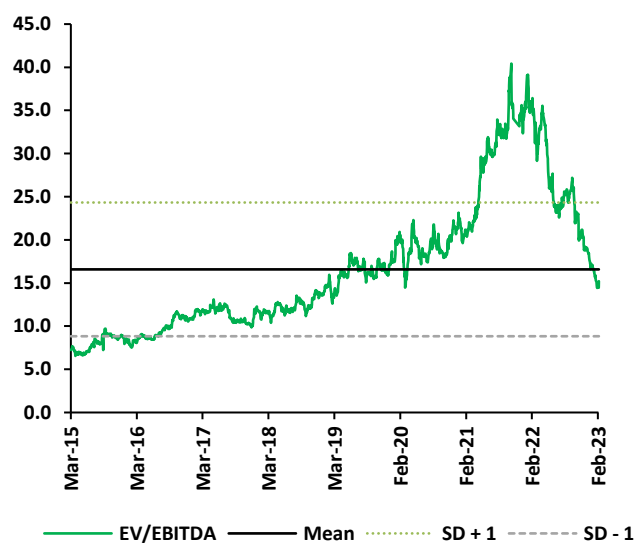
Risk to our call is unforeseen impact on the demand and sharp decline in spread.

Fig 1: 1-year forward P/E



Source: AceEquity, SMIFS Research, FY22 EPS is excluding the one time gain component

Fig 2: 1-year forward EV/EBITDA



Source: AceEquity, SMIFS Research

Quarterly financials, operating metrics and key performance indicators

Fig 3: Quarterly Financials

Y/E March (Rs mn)	Q4FY21	Q1FY22	Q2FY22	Q3FY22*	Q4FY22	Q1FY23	Q2FY23	Q3FY23
Net Sales	12,094	13,168	12,559	20,762	17,556	19,720	16,850	16,677
Raw Materials	5,586	6,101	6,623	8,057	9,218	10,981	9,781	9,757
Employee Costs	976	995	731	955	1,201	1,214	928	927
Other Expenditure	2,928	2,934	2,656	2,852	3,747	3,832	3,471	3,107
EBITDA	2,603	3,138	2,549	8,898	3,391	3,693	2,670	2,887
Depreciation	656	686	574	572	772	865	729	821
Interest	216	383	145	236	306	498	437	470
Other Income	0	1	5	1	2	4	0	3
PBT	1,731	2,070	1,835	8,091	2,314	2,334	1,504	1,599
Tax	337	419	336	837	377	443	259	234
<i>Tax rate (%)</i>	<i>19.5</i>	<i>20.2</i>	<i>18.3</i>	<i>10.3</i>	<i>16.3</i>	<i>19.0</i>	<i>17.2</i>	<i>14.6</i>
Reported PAT	1,393	1,651	1,500	7,254	1,938	1,891	1,245	1,365
Minority interest	-32	-2	1	-1	-0	-	-	-
Consolidated PAT	1,361	1,649	1,500	7,253	1,937	1,891	1,245	1,365
YoY Growth (%)								
<i>Revenue</i>	<i>12.4</i>	<i>40.5</i>	<i>7.1</i>	<i>74.9</i>	<i>45.2</i>	<i>49.8</i>	<i>34.2</i>	<i>-19.7</i>
<i>EBITDA</i>	<i>18.9</i>	<i>72.4</i>	<i>0.2</i>	<i>212.3</i>	<i>30.3</i>	<i>17.7</i>	<i>4.8</i>	<i>-67.6</i>
<i>PAT</i>	<i>23.3</i>	<i>101.4</i>	<i>7.0</i>	<i>338.9</i>	<i>42.3</i>	<i>14.7</i>	<i>-17.0</i>	<i>-81.2</i>
QoQ Growth (%)								
<i>Revenue</i>	<i>1.9</i>	<i>8.9</i>	<i>-4.6</i>	<i>65.3</i>	<i>-15.4</i>	<i>12.3</i>	<i>-14.6</i>	<i>-1.0</i>
<i>EBITDA</i>	<i>-8.7</i>	<i>20.6</i>	<i>-18.8</i>	<i>249.1</i>	<i>-61.9</i>	<i>8.9</i>	<i>-27.7</i>	<i>8.1</i>
<i>Adj. PAT</i>	<i>-17.6</i>	<i>21.1</i>	<i>-9.0</i>	<i>383.5</i>	<i>-73.3</i>	<i>-2.4</i>	<i>-34.2</i>	<i>9.7</i>
Margin (%)								
<i>EBITDA</i>	<i>21.5</i>	<i>23.8</i>	<i>20.3</i>	<i>42.9</i>	<i>19.3</i>	<i>18.7</i>	<i>15.8</i>	<i>17.3</i>
<i>PAT</i>	<i>11.3</i>	<i>12.5</i>	<i>11.9</i>	<i>34.9</i>	<i>11.0</i>	<i>9.6</i>	<i>7.4</i>	<i>8.2</i>
<i>Gross</i>	<i>53.8</i>	<i>53.7</i>	<i>47.3</i>	<i>61.2</i>	<i>47.5</i>	<i>44.3</i>	<i>42.0</i>	<i>41.5</i>
<i>Employee cost as % of sales</i>	<i>8.1</i>	<i>7.6</i>	<i>5.8</i>	<i>4.6</i>	<i>6.8</i>	<i>6.2</i>	<i>5.5</i>	<i>5.6</i>
<i>Other expenses as % of sales</i>	<i>24.2</i>	<i>22.3</i>	<i>21.1</i>	<i>13.7</i>	<i>21.3</i>	<i>19.4</i>	<i>20.6</i>	<i>18.6</i>

Source: Company, SMIFS Research, *Indicates the quarter includes one time benefit of shortfall fees Rs6312.5mn

Fig 4: Change in Estimates

	New Estimates			Old Estimates			Change(%)		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Revenue	66079	87635	92533	66818	75534	81811	-1%	16%	13%
EBITDA	10606	15833	17282	11876	14512	17198	-11%	9%	0%
EBITDA Margin	16.1%	18.1%	18.7%	17.8%	19.2%	21.0%	(172) bps	(115) bps	(235) bps
PAT	5382	9139	9872	6250	7669	9313	-14%	19%	6%

Source: Company, SMIFS Research Estimates

Financial Statements

Income Statement					
YE March (Rs mn)	FY21	FY22	FY23E	FY24E	FY25E
Revenues	45,061	54,751	66,079	87,635	92,533
Raw Materials	21,286	28,545	36,438	46,856	48,051
% of sales	47.2	52.1	55.1	53.5	51.9
Employee cost	3,714	3,570	4,498	5,667	6,843
% of sales	8.2	6.5	6.8	6.5	7.4
Other Expenses	10,246	11,540	14,537	19,280	20,357
% of sales	22.7	21.1	22.0	22.0	22.0
EBITDA	9,815	11,097	10,606	15,833	17,282
Other income	7	8	8	7	7
Depreciation & Amortisation	2,313	2,442	2,748	3,246	3,743
EBIT	7,509	8,664	7,866	12,594	13,545
Finance cost	864	1,023	1,071	1,054	1,081
Core PBT	6,639	7,632	6,787	11,533	12,458
Exceptional items	0	6,104	0	0	0
PBT	6,646	13,744	6,795	11,540	12,464
Taxes	1,293	2,194	1,359	2,308	2,493
Effective tax rate (%)	19.5	16.0	20.0	20.0	20.0
Reported PAT	5,352	11,550	5,436	9,232	9,972
Minority Interest	-118	-2	-54	-92	-100
Adjusted PAT	5,235	6,418	5,382	9,139	9,872

Source: Company, SMIFS Research Estimates

Key Ratios					
YE March	FY21	FY22	FY23E	FY24E	FY25E
Growth Ratio (%)					
Net Sales	7.6	21.5	20.7	32.6	5.6
EBITDA	0.4	13.1	-4.4	49.3	9.2
Adjusted PAT	-2.4	22.6	-16.2	69.8	8.0
Margin Ratios (%)					
Gross Profit	52.8	47.9	44.9	46.5	48.1
EBITDA	21.8	20.3	16.1	18.1	18.7
EBIT	16.7	15.8	11.9	14.4	14.6
Core PBT	14.7	13.9	10.3	13.2	13.5
PBT	14.7	25.1	10.3	13.2	13.5
Adj PAT	11.6	11.7	8.1	10.4	10.7
Return Ratios (%)					
ROE	14.9	13.7	10.3	15.1	14.2
ROCE	10.3	10.4	8.1	12.0	11.6
Turnover Ratios (days)					
Gross block turnover (x)	1.0	1.1	1.2	1.3	1.2
Adj OCF / Adj PAT (%)	150.2	120.4	48.7	46.0	102.5
Inventory	160	119	110	115	115
Debtors	64	73	70	75	85
Creditors	99	45	35	35	35
Cash conversion cycle	126	147	145	155	165
Solvency Ratio (x)					
Debt-equity	0.9	0.6	0.5	0.5	0.4
Net Debt-equity	0.7	0.4	0.4	0.4	0.4
Gross Debt/EBITDA	3.1	2.5	2.7	1.8	1.6
Current Ratio	1.0	1.1	1.5	1.7	1.9
Interest Coverage Ratio	8.7	8.5	7.3	11.9	12.5
Dividend					
DPS (Rs)	1.5	1.5	1.7	2.0	2.5
Dividend Yield (%)	0.3	0.2	0.3	0.4	0.5
Dividend Payout (%)	10.0	8.5	11.5	7.9	9.2
Per Share Ratios (Rs.)					
Basic EPS (reported)	60.1	63.7	29.7	50.4	54.5
Adj EPS	15.0	17.7	14.8	25.2	27.2
CEPS	21.7	24.4	22.4	34.2	37.6
BVPS	100.9	129.6	143.5	167.2	192.0
Valuation (x)					
P/E (adjusted)	43.8	39.7	37.0	21.8	20.2
P/BV	6.5	6.5	3.8	3.3	2.9
EV/EBITDA	25.5	29.3	20.9	14.3	13.1
EV / Sales	5.6	5.9	3.4	2.6	2.5
Adj Mcap / Core PBT	27.7	41.9	28.3	17.2	15.8
Adj Mcap / Adj OCF	23.4	41.4	73.2	47.0	19.5

Source: Company, SMIFS Research Estimates

Balance Sheet					
YE March (Rs mn)	FY21	FY22	FY23E	FY24E	FY25E
Source of funds					
Equity Share Capital	871	1,813	1,813	1,813	1,813
Reserves & Surplus	34,280	45,169	50,196	58,799	67,801
Shareholders' Fund	35,151	46,982	52,009	60,611	69,613
Total loan funds	30,339	27,675	28,179	27,747	28,441
Other Liabilities	4,584	4,903	5,917	7,847	8,286
Total Liabilities	70,073	79,559	86,105	96,206	1,06,340
Application of Funds					
Gross Block	51,555	50,000	61,062	72,124	83,187
Net Block	35,925	36,376	44,691	52,507	59,826
Capital WIP	12,979	14,904	9,666	7,595	5,816
Investments	635	731	1,335	1,417	1,504
Other Non-Current Assets	3,202	4,179	3,848	5,498	5,817
Inventories	9,357	9,341	10,981	14,763	15,139
Sundry Debtors	7,937	10,915	12,673	18,007	21,549
Cash & Bank Balances	4,123	10,085	6,167	145	675
Other current assets	2,259	2,150	1,679	2,523	2,694
Total Current Assets	23,676	32,492	31,500	35,438	40,057
Sundry Creditors	5,763	3,526	3,494	4,493	4,608
Other current liabilities	580	5,597	1,441	1,756	2,073
Total Current Liabilities	6,343	9,123	4,935	6,249	6,681
Net Current Assets	17,333	23,369	26,565	29,189	33,376
Total Assets	70,073	79,559	86,105	96,206	1,06,340

Source: Company, SMIFS Research Estimates

Cash Flow					
YE March (Rs mn)	FY21	FY22	FY23E	FY24E	FY25E
Operating profit before WC changes	9,766	17,207	10,559	15,747	17,189
Net chg in working capital	9,693	10,943	5,052	7,570	13,687
Tax paid	-966	-2,194	-1,359	-2,308	-2,493
Cash flow from operating activities (a)	8,727	8,749	3,693	5,262	11,194
Adj OCF	7,863	7,726	2,622	4,207	10,114
Capital expenditure	-14,311	-11,226	-11,000	-11,000	-11,000
Adj FCF	-6,448	-3,501	-8,378	-6,793	-886
Cash flow from investing activities (b)	-13,221	-4,915	-6,428	-9,073	-9,371
Debt	7,459	2,753	504	-431	694
Interest & lease	-864	-1,023	-1,071	-1,054	-1,081
Dividend	-451	-544	-616	-725	-906
Cash flow from financing activities (c)	6,145	2,128	-1,183	-2,211	-1,293
Net chg in cash (a+b+c)	1,650	5,962	-3,918	-6,023	530

Source: Company, SMIFS Research Estimates

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