Aarti Industries Ltd	
No. of shares (m)	83.32
Mkt cap (Rs crs/$m)	4363/649.8
Current price (Rs/$)	524/7.8
Price target (Rs/$)	651/9.7
52 W H/L (Rs.)	587/375
Book Value (Rs/$)	134/2.0
Beta	0.7
Daily volume (avg. monthly)	39610
P/BV (FY17e/18e)	3.3/2.8
EV/EBITDA (FY17e/18e)	8.6/7.5
P/E (FY17e/18e)	14.7/12.5
EPS growth (FY16/17e/18e)	34.5/17.2/17.8
OPM (FY16/17e/18e)	20.6/20.3/20.0
ROE (FY16/17e/18e)	23.8/24.5/24.4
ROCE(FY16/17e/18e)	15.0/15.7/16.3
D/E ratio (FY16/17e/18e)	1.1/1.0/0.8
BSE Code	524208
NSE Code	AARTIIND
Bloomberg	ARTO IN
Reuters	ARTI.BO

Shareholding pattern	%
Promoters	54.8
MFs / Banks / FIs	12.4
Foreign	3.3
Govt. Holding	0.0
Total Public	29.5
Total	**100.0**

As on Mar 31, 2016

Recommendation

BUY

Analyst

KISHAN GUPTA, CFA, FRM

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Quarterly Highlights

- Despite production headwinds resulting from short supply of nitric acid, Aarti reversed course to report a marginal increase (+3.1%) in income from operations last quarter, the first such increase in last five quarters. Pharmaceuticals business bucked the trend for it posted 46.6% growth in revenues to Rs 119.83 crs ($17.9m) compared to Rs 81.75 crs ($12.2m) in the same quarter a year ago. That helped it gain 500 bps overall revenue share. Speciality chemicals business continued to plod along not least due to sharp fall in prices of key inputs -benzene and other crude oil derivatives (concentrated nitric acid, aniline, phthalic anhydride etc). Benzene price, for instance, has now plummeted for at least eight straight quarters and is now more than a half smaller at Rs 40 per kg.
- Yet value addition has paid off as Aarti's speciality business turnover (standalone) has just flat lined in last two years. EBIT has ballooned to Rs 469 crs ($69.9m) last fiscal from Rs 333 crs ($49.6m) two years back. That's partly reflected (lower prices too buttressed margins) in its gut-wrenching margins - 21.3% for FY16, an increase of over 450 bps.
- Still that outcome is not devoid of its share of setbacks. Short supply of nitric acid in Q4 hit production of NCB and other nitrated compounds, impacting turnover by some Rs 20 crs ($3.0m); though Aarti mollified the impact by churning out more non-benzene products - aniline; sulphur and alcohol based products. In Q3 of FY15 speciality chemicals volume growth slipped to 5-7%, thanks to inventory reduction drive of some clients. Defying expectations, its speciality chemicals volume growth plunged to a dreadful 10% last fiscal from 12% in FY14.
- Sparked by the commissioning of the caffeine plant and record API shipments, its pharmaceuticals business grew by an astonishing 26.4% (volume growth ~20%) last fiscal; though margins slid 168bps to 10.1%. Technical issues plagued production of home & personal care chemicals (HPC) , which showed up in a dramatic fall (-36.3%) in turnover.
- The stock currently trades at 14.7xFY17e EPS of Rs 35.67 and 12.5xFY18e EPS of Rs 42. Precipitated by recovery in crude oil prices (read: benzene prices), earnings would surge annually by 17.5% over the next two years. Propitious internal accruals would also help it deleverage the balance sheet. Weighing odds, we retain our buy rating on the stock with revised target of Rs 651 (previous target: Rs 553) based on 15.5xFY18e earnings (peg ratio: 0.9) over a period of 9-12 months.

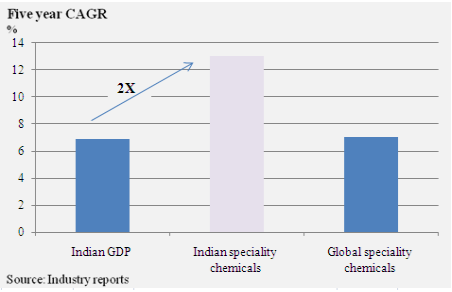
Consolidated (Rs crs)	FY14	FY15	FY16	FY17e	FY18e
Income from operations	2632.49	2907.96	2779.62	3218.91	3735.53
Other Income	10.97	9.01	5.94	6.14	6.35
EBITDA (other income included)	412.45	474.70	578.20	660.28	752.57
Profit after MI & associate profit	155.51	200.50	253.68	297.19	349.99
EPS(Rs)	17.55	22.63	30.45	35.67	42.00
EPS growth (%)	3.6	28.9	34.5	17.2	17.8

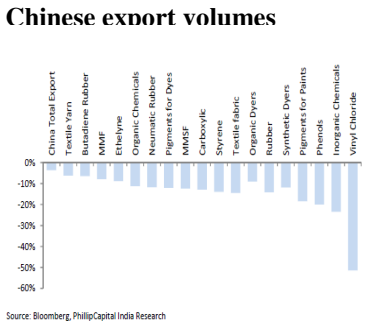
Outlook & Recommendation

Chinese chemical firms badgered

Changing dynamics of global speciality chemicals industry in past year or so has reinvigorated fortunes of Indian speciality chemical manufacturers. Tellingly, strict implementation of environment control regulations in China has led to shutdown of plants across the country, benefitting Indian players the most. Industry reports suggest that China chemical exports could fall for second year in a row which could open up huge export opportunities for Indian manufacturers, particularly producers of polymers, dyes & pigments, textile chemicals and agro chemicals. Reports also indicate that India's share in global specialty chemical industry is estimated to grow 6-7% in 2023 from 2.8% in 2013 with market size in excess of $80 bn.

Reports further presage that the Indian speciality chemicals industry - worth $25 bn and growing at 12%- could be worth $33.2bn by 2019. Apart from factors such as low cost labour and raw material availability, increasing sophistication of Indian players in product innovation, branding and innovation would help matters too. Further low per capita consumption of chemicals in India, strong GDP growth and rapid progress in key user industries domestically would stimulate industry growth



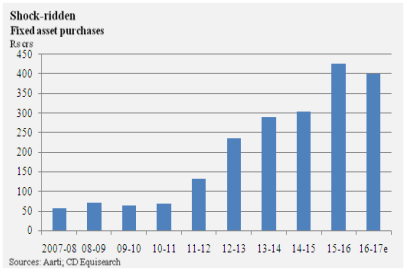


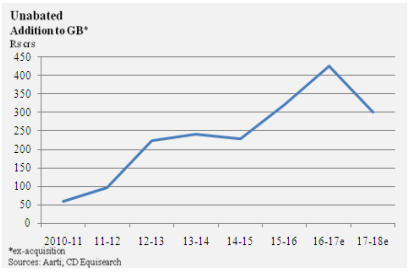
Yet product innovation and robust R&D processes holds key, reckons Deepak Bhimani, president of Indian Speciality Chemical Manufacturers' Association (ISCMA), and CMD, Navdeep Chemicals. He also posits that Indian companies have to adopt inter-disciplinary approach to research. Collaboration with global firms to jointly manufacture speciality chemicals should not be overlooked. Sensing growing state intervention favoring state owned firms in China and rising labor costs, MNCs are de-risking their sourcing arrangements by adding other developing economies - that bodes well for India.

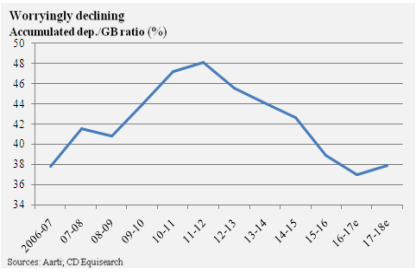
Capex

If the record sums invested in capital projects is anything to go by, Aarti's infatuation for higher operational capacities is showing no signs of distress. For the fourth consecutive year it has ploughed more than Rs 200 crs ($29.8m) in erecting buildings, plant & machineries et. al.(see chart). After having successfully completed the second phase of NCB expansion last November - 66000 tpa to 75000 tpa, it is now racing against time to commence the ethylation unit at Dahej, nitration unit (capacity 30000 tpa) at Jhagadia, new calcium chloride capacity of 30000 tpa at Jhagadia and last phase of PDA capacity expansion - from 450 tpm to 1000 tpm - latest by first half of current fiscal.

Impact of last fiscal's asset capitalization of over Rs 300 crs ($44.7m) - first phase of PDA capacity expansion from 250 tpm to 450 tpm; debottlenecking capacities of pharmaceuticals and HPC businesses - would doubtless burnish volumes this fiscal. Projects slated to commence in the next two years include chlorination complex at Jhagadia, acid re-concentration plant at Vapi, API and pharma intermediate de-bottlenecking and expansion at Vapi and Tarapur and co-generation power plant at Jhagadia and Kutch.







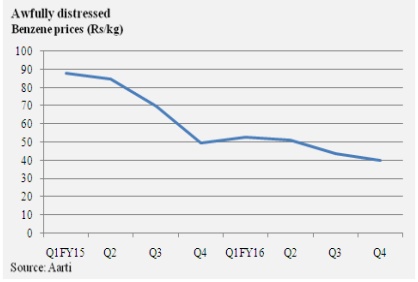
Risks

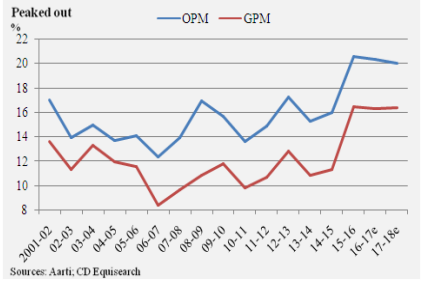
Sharp decline in global crude oil prices has trampled the turnover growth of most chemical companies. Aarti is no exception for its income from operations plummeted 5.4% last fiscal hastened by inexorable fall in benzene prices - price per kg fell to Rs 40 at the end of Q4, down 19% y-o-y. Volume growth of speciality chemicals suffered too - slid to the lowest in at least three years.

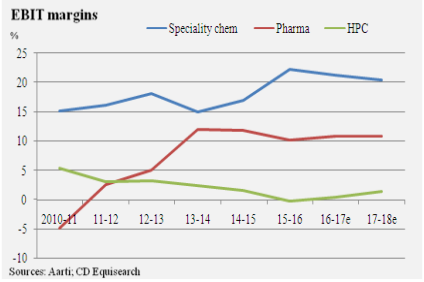
Given its allegiance to foreign markets (50% of turnover) Aarti is exposed to sharp volatility in currency markets. Though it hedges both trade related and financial operations, its modicum of security - it hedged just 8.5% of its annual trade related operations of Rs 1826 crs ($268.5m) in FY15 compared to less than 1% a year back. It also expensed foreign exchange loss of Rs 17.83 crs ($2.6m) that year as against Rs 21.22 crs ($3.1m) a year ago.

Financials & Valuation

Effect of softening crude oil prices rubbed off on material margin last fiscal - 45.2% Vs 37%. Indeed margin (standalone) has now expanded for five straight quarters - not a mean feat - on backdrop of sclerosis in production of HPC chemicals and recent disruption in supply of nitric acid. Yet margin gains are fiendishly difficult to sustain. Crude oil price have scraped the bottom rising over 50% at some point. Speciality chemicals volume growth dropped last fiscal to 10% - at least a three year low. With supply of nitric acid remaining constricted in Q1, any runaway increase in volumes are hard to come by. Despite talk of backlash of Chinese chemical firms disrupting their exports, Aarti's overseas shipments have barely gained momentum- tumbled 6.7% last fiscal.



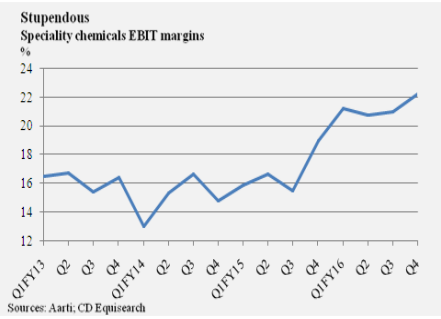


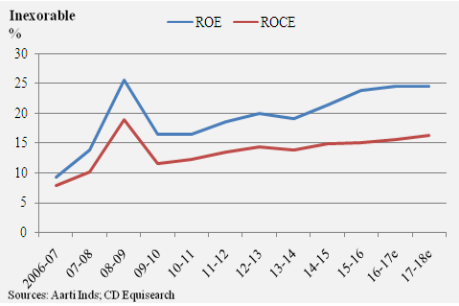


Still shipments to China soared, taking its revenue share to 16% from 8% in FY15. Revenue slice of Western economies though conspicuously decreased from 77% to 49%, thus opening up new export markets. Aarti reckons that API exports to US and EU would escalate post approval of few commercial products in US - no less salient to mention the benefits accruing from a dozen new APIs which are in development stage right now.

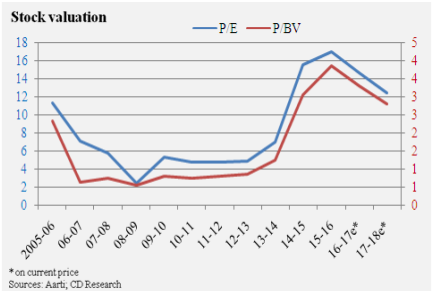
Vitalized by commencement of nitration unit (nitro toluene & down streams) and ethylation unit at Dahej, the leaden-footed speciality chemicals business recouped some lost ground. Thanks to some bump up in benzene prices, its revenues are projected to rise annually by a dazzling 16.4% over the next two years, though margins would tail off. It asserts that good monsoons would incite off take of superphosphate fertilizers, while pick up in rural spending would spur demand of dyes and construction chemicals. Yet given its gargantuan capital investments, particularly in speciality chemical assets, Aarti can ill-afford to face the spectre of slump in global demand for speciality chemicals.

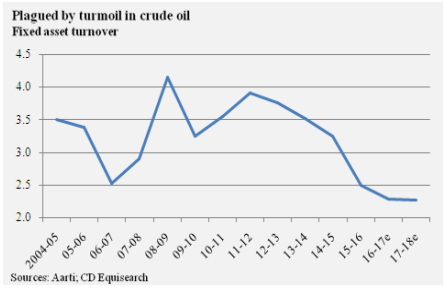
To support its capital hungry pharmaceutical business - capital deployed has more than doubled in last three years - Aarti deferred its demerger plan in May. Record margin -goaded by its prized product pricing model - has swayed return on capital despite sheenless asset utilization rate. Yet incremental gains in return on capital would remain elusive not least for record capitalization of fixed assets and marginal stress in operating margins. Efficiency in inventory management could stifle lengthening of cash conversion cycle over the next two years.





The stock currently trades at 14.7xFY17e EPS of Rs 35.67 and 12.5xFY18e EPS of Rs 42. Although earnings are projected to advance by 17.5% on average over the next two years, perceptible risks abound. Clampdown on Chinese chemical firms could fail to discernbly dent their exports, presumbaly hurting Indian speciality chemical exporters the most. Impregnable effect of random events - like nitric acid supply disruption; technical issues in HPC business, calling off the demerger plan - cannot be loosely dismissed. Yet Aarti's strong foothold on benzene chemistry (contributes two-thirds to total business) and agile production outfit have helped it effectively manage stressors (sign of anti-fragility) - somewhat manifested in 22.9% growth in operating profits last fiscal. Weighing odds, we retain our buy rating on the stock with revised target of Rs 651based on 15.5xFY18e earnings (peg ratio: 0.9) over a period of 9-12 months. For more info, refer to our February report.

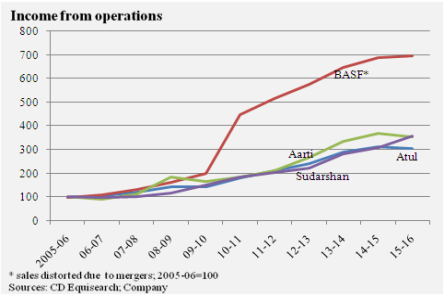


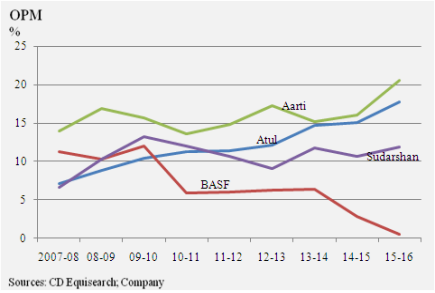


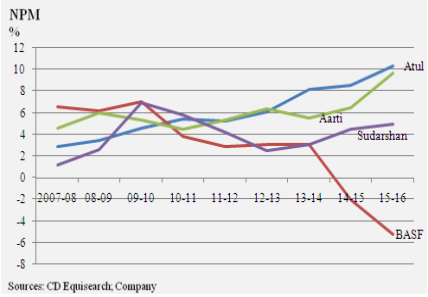
Cross Sectional Analysis

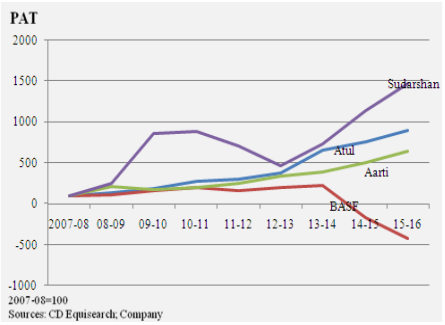
Company	Equity*	CMP	Mcap*	IO	Profit*	OPM	NPM	Int. coverage	ROE	Mcap / IO	P/BV	P/E
Aarti Inds.	42	524	4363	2780	257	20.6	9.6	4.1	24.1	1.6	3.9	17.0
Atul Ltd	30	2128	6311	2601	269	17.8	10.4	15.5	18.4	2.4	4.1	23.4
BASF India	43	1098	4753	4752	-248	0.5	-5.2	-1.5	-21.4	1.0	4.1	-
Sudarshan Chem	14	215	1485	1409	70	11.9	5.0	3.9	24.3	1.1	4.7	21.2

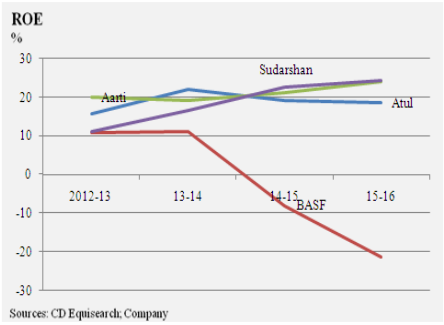
*figures in crores; calculations on ttm basis
Companies not truly comparable due to product dissimilarity











All dollar values in the write up stated at current exchange rates

Financials

Quarterly Results -Standalone

Figures in Rs crs

	Q4FY16	Q4FY15	% chg.	FY16	FY15	% chg.
Income from operations	**698.72**	**677.48**	**3.1**	**2717.01**	**2870.65**	**-5.4**
Other Income	8.11	3.83	111.7	9.64	5.45	76.9
Total Income	**706.83**	**681.31**	**3.7**	**2726.65**	**2876.10**	**-5.2**
Total Expenditure	561.91	558.94	0.5	2186.81	2414.17	-9.4
PBIDT (other income included)	**144.92**	**122.37**	**18.4**	**539.84**	**461.93**	**16.9**
Interest	28.34	32.00	-11.4	115.90	137.48	-15.7
Depreciation	25.43	20.86	21.9	92.69	78.65	17.9
PBT	**91.15**	**69.51**	**31.1**	**331.25**	**245.80**	**34.8**
Tax	21.55	16.75	28.7	78.82	58.00	35.9
PAT	**69.60**	**52.76**	**31.9**	**252.43**	**187.80**	**34.4**
Extraordinary Item	0.00	2.64	-100.0	0.00	2.81	**-100.0**
Adjusted Net Profit	**69.60**	**50.12**	**38.9**	**252.43**	**184.99**	**36.5**
EPS (F.V. 5)	8.35	5.66	47.7	30.30	20.88	45.1

Segment Results

Figures in Rs crs

	Q4FY16	Q4FY15	% chg.	FY16	FY15	% chg.
Segment Revenue						
Speciality Chemicals	542.34	553.85	-2.1	2202.13	2360.65	-6.7
Pharmaceuticals	119.83	81.75	46.6	383.13	303.20	26.4
Home & Personal Care Chemicals	36.55	41.88	-12.7	131.75	206.80	-36.3
Total	**698.72**	**677.48**	**3.1**	**2717.01**	**2870.65**	**-5.4**
Segment EBIT						
Speciality Chemicals	120.71	105.14	14.8	469.09	395.16	18.7
Pharmaceuticals	14.01	8.30	68.8	38.80	35.81	8.3
Home & Personal Care Chemicals	-0.43	0.89	-148.3	-0.24	3.27	-107.3
Total	**134.29**	**114.33**	**17.5**	**507.65**	**434.24**	**16.9**
Interest	28.34	32.00	-11.4	115.90	137.48	-15.7
Other Unallocable Exp. (net of income)	14.80	12.82	15.4	60.50	50.96	18.7
PBT	**91.15**	**69.51**	**31.1**	**331.25**	**245.80**	**34.8**

Financials

Income Statement - Consolidated

Figures in Rs crs

	FY14	FY15	FY16	FY17e	FY18e
Income from operations	**2632.49**	**2907.96**	**2779.62**	**3218.91**	**3735.53**
Growth (%)	25.6	10.5	-4.4	15.8	16.0
Other Income	10.97	9.01	5.94	6.14	6.35
Total Income	**2643.46**	**2916.97**	**2785.56**	**3225.05**	**3741.88**
Total Expenditure	2231.01	2442.28	2207.36	2564.77	2989.31
EBITDA (other income included)	**412.45**	**474.70**	**578.20**	**660.28**	**752.57**
Interest	117.84	137.97	116.97	131.15	134.91
EBDT	**294.61**	**336.73**	**461.23**	**529.13**	**617.66**
Depreciation	88.52	81.98	98.50	117.62	136.47
Tax	54.03	61.03	94.63	98.76	115.49
Net profit	**152.06**	**193.72**	**268.10**	**312.75**	**365.71**
Minority interest	0.51	1.74	11.22	12.1972	12.20
Profit/loss of associate	10.88	13.90	-	-	-
Net profit after MI	**162.43**	**205.88**	**256.88**	**300.55**	**353.51**
Extraordinary item	6.92	5.37	3.20	3.36	3.53
Adjusted Net Profit	**155.51**	**200.50**	**253.68**	**297.19**	**349.99**
EPS (Rs.)	17.55	22.63	30.45	35.67	42.00

Segment Results

Figures in Rs crs

	FY14	FY15	FY16	FY17e	FY18e
Segment Revenue					
Speciality Chemicals	2216.67	2397.96	2264.74	2620.82	3066.15
Pharmaceuticals	248.98	303.20	383.13	459.76	524.12
Home & Personal Care Chemicals	166.84	206.80	131.75	138.34	145.25
Net sales	**2632.49**	**2907.96**	**2779.62**	**3218.91**	**3735.53**
Segment EBIT					
Speciality Chemicals	332.62	408.09	503.64	556.92	628.56
Pharmaceuticals	29.75	35.81	38.80	49.42	56.34
Home & Personal Care Chemicals	4.11	3.27	-0.24	0.69	2.18
Sub Total	**366.48**	**447.17**	**542.20**	**607.04**	**687.08**
Interest	117.84	137.97	116.97	131.15	134.91
Other Unallocable Exp. (net of income)	42.55	54.45	62.50	64.38	70.98
PBT	**206.09**	**254.75**	**362.73**	**411.51**	**481.20**

Consolidated Balance Sheet Figures in Rs crs

	FY14	FY15	FY16	FY17e	FY18e
SOURCES OF FUNDS					
Share Capital	44.30	44.30	41.66	41.66	41.66
Reserves	826.46	972.11	1072.75	1273.82	1512.80
Total Shareholders' Funds	**870.76**	**1016.40**	**1114.41**	**1315.48**	**1554.46**
Minority Interest	4.26	5.86	52.09	64.28	76.48
Long term debt	255.25	419.06	526.76	591.76	666.76
Total Liabilities	**1130.27**	**1441.33**	**1693.26**	**1971.52**	**2297.71**
APPLICATION OF FUNDS					
Gross Block	1477.03	1685.10	2060.00	2485.00	2785.00
Less: Accumulated Depreciation	650.80	718.16	801.03	918.65	1055.11
Net Block	**826.23**	**966.94**	**1258.97**	**1566.35**	**1729.89**
Capital Work in Progress	117.44	192.97	300.00	275.00	100.00
Investments	117.24	139.20	18.37	18.37	18.13
Current Assets, Loans & Advances					
Inventory	606.12	551.73	495.19	569.47	669.13
Sundry Debtors	443.21	438.98	523.40	575.74	633.31
Cash and Bank	14.85	33.71	28.99	24.37	38.16
Other Assets	160.66	173.24	152.22	157.07	180.32
Total CA & LA	**1224.84**	**1197.67**	**1199.80**	**1326.65**	**1520.91**
Current liabilities	1157.41	1053.76	1102.59	1180.03	1057.32
Provisions	29.90	34.05	20.37	58.46	65.25
Total Current Liabilities	**1187.31**	**1087.81**	**1122.96**	**1238.49**	**1122.56**
Net Current Assets	37.53	109.86	76.84	88.16	398.35
Net Deferred Tax (net of liability)	-84.66	-102.66	-127.06	-156.06	-190.11
Other Assets (Net of liabilities)	116.49	135.02	166.14	179.71	241.45
Total Assets	**1130.27**	**1441.33**	**1693.26**	**1971.52**	**2297.71**

Key Financial Ratios

	FY14	FY15	FY16	FY17e	FY18e
Growth Ratios					
Revenue (%)	25.6	10.5	-4.4	15.8	16.0
EBIDTA (%)	10.6	16.0	22.8	14.3	14.0
Net Profit (%)	16.0	28.9	26.5	17.2	17.8
EPS (%)	3.6	28.9	34.5	17.2	17.8
Margins					
Operating Profit Margin (%)	15.3	16.0	20.6	20.3	20.0
Gross Profit Margin (%)	10.8	11.3	16.4	16.3	16.4
Net Profit Margin (%)	5.5	6.5	9.5	9.6	9.7
Return					
ROCE (%)	13.8	14.8	15.0	15.7	16.3
RONW (%)	19.1	21.2	23.8	24.5	24.4
Valuations					
Market Cap / Sales	0.4	1.1	1.6	1.4	1.2
EV/EBIDTA	5.2	9.2	9.7	8.6	7.5
P/E	7.0	15.6	17.0	14.7	12.5
P/BV	1.2	3.1	3.9	3.3	2.8
Other Ratios					
Interest Coverage	2.7	2.8	4.1	4.1	4.5
Debt-Equity Ratio	1.2	1.2	1.1	1.0	0.8
Current Ratio	1.0	1.1	1.1	1.1	1.4
Turnover Ratios					
Fixed Asset Turnover	3.5	3.2	2.5	2.3	2.3
Total Asset Turnover	2.6	2.3	1.8	1.8	1.7
Debtors Turnover	6.0	6.6	5.8	5.9	6.2
Inventory Turnover	4.2	4.2	4.2	4.8	4.8
Creditors Turnover	7.5	7.9	8.0	7.8	8.0
WC Ratios					
Debtor Days	60.5	55.4	63.2	62.3	59.1
Inventory Days	87.4	86.5	86.6	75.8	75.6
Creditor Days	48.8	46.2	45.8	46.7	45.4
Cash Conversion Cycle	99.1	95.7	103.9	91.4	89.3

Cumulative Financial Data

Figures in Rs crs	FY07-09	FY10-12	FY13-15	FY16-18
NCB production (MT)	84592	104679	155702	199515
Income from operations	3056	4424	7637	9734
Operating profit	458	650	1229	1973
EBIT	366	504	982	1626
PBT	208	324	631	1243
PAT after MI	151	249	490	901
Dividends	45	78	152	303
OPM (%)	15.0	14.7	16.1	20.3
NPM (%)	5.0	5.0	6.1	9.6
Interest coverage	2.3	2.8	2.8	4.2
ROE (%)	16.1	17.2	20.3	23.4
ROCE (%)	12.4	12.0	14.6	15.8
Debt-equity ratio*	1.3	1.1	1.2	0.8
Fixed asset turnover	3.1	3.5	3.6	2.4
Debtors turnover	5.1	4.4	6.0	6.1
Inventory turnover	5.2	4.7	4.9	4.2
Creditors turnover	12.9	9.9	10.0	8.1
Debtors days	71.8	83.3	60.6	60.3
Inventory days	69.6	77.2	75.0	86.1
Creditor days	28.4	36.9	36.4	45.3
Cash conversion cycle	113.1	123.6	99.2	101.2
Dividend payout ratio (%)	29.4	34.4	31.8	32.1

FY07-09 implies three years ending fiscal 09; *as on terminal year

As manifested by the surge in its margins over the years, Aarti has moved up the value chain by adding more value added products to its offerings. Introduction of hydrogenated products helped it launch high margin products in polymers, agrochemicals and pigments in the global market. Diversification into toluene chemistry by way of introduction of nitro toluene and derivatives is expected to further spur margins. Yet output of Aarti's hydrogenated products has failed to take off. After growing annually by 19% in two years ending fiscal 2014, production has come to a stuttering halt - grew by 4.5% on average in last two years.

Save a minor setback in FY14, NCB production has grown amazingly well in last five years - average annual growth 14.1%. Cumulative turnover has grown by 2.5x to Rs 7637 crs ($1137.3m) in FY13-15 period from Rs 3056 crs ($455.1m) in FY07-09 period, while profit after tax has advanced by 3.25x. Despite overall business diversification, speciality chemicals business still accounts for over eight-tenths of revenues; though in last few years it has ceded some ground to pharmaceuticals business.

Despite Aarti Industries being hyperbole on seeking working capital and asset utilization efficiencies, gains are marginal if any. Its fixed asset turnover after remaining flat (~3.5) for last six years is projected to decline to 2.4 in FY16-18 period (partly due to incessant fall in crude oil prices). Its cash conversion has not dramatically improved either - 99 days in FY13-15 from 113 days in three years ending FY09. Inventory days would swell to 86 days in FY16-18 from 75 days in preceding three year period and 70 days in FY07-09 period. Still return on capital ratios has steadily gained not least due to mammoth rise in OPMs. Barring HPC business, both speciality chemicals and pharmaceuticals business have seen staggering increases in EBIT margins over the years - 700 bps rise in speciality chemicals in last five years; 15% in pharmaceuticals.

Financial Summary – US dollar denominated

million $	FY14	FY15	FY16	FY17e	FY18e
Equity capital	7.4	7.1	6.3	6.2	6.2
Shareholders' funds	144.9	162.4	168.0	195.9	231.5
Total debt	172.9	192.1	194.6	207.3	193.87
Net fixed assets (incl CWIP)	157.0	185.3	235.0	274.2	272.5
Investments	19.5	22.2	2.8	2.7	2.7
Net current assets	6.2	17.6	11.6	13.1	59.3
Total assets	188.1	230.3	255.3	293.6	342.2
Revenues	435.2	475.6	424.6	479.4	556.3
EBITDA	66.6	76.5	87.7	97.7	111.4
EBDT	47.1	53.9	69.8	78.2	91.3
PBT	32.5	40.5	54.8	60.7	71.0
Profit after MI & associate profit	25.7	32.8	38.8	44.3	52.1
EPS($)	0.29	0.37	0.47	0.53	0.63
Book value ($)	1.64	1.83	2.02	2.35	2.78

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

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