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17 June 2019

Aarti Drugs

Steady growth; retaining a Buy

Rating: **Buy**
Target Price: ₹796
Share Price: ₹532

We recently met the management of Aarti Drugs to discuss its expansion plans, past obstacles and the path forward. With added capacities in a few of its therapies, we expect its revenue/PAT to clock 14.5%/32% CAGRs over FY19-21. We maintain our Buy rating, with an unchanged target of ₹796.

Added capacities to boost API business. The company's API range covers therapies such as antibiotics, anti-inflammatories, cardioprotectants, anti-diarrhoeals, anti-fungals, anti-diabeties, etc. Capacities have been recently added in all these, except antibiotics. The company will become the largest producer of Metformin once issues with the technology to produce on a large scale are solved. It now manufactures 550-600 tonnes a month, whereas after the technology is in place it will manufacture 1,000 tonnes a month. Ciprofloxacin, which is one of its top 10 products, has a 40-50% global market share; growth, though, has been flat. The company plans to push growth by capturing competitors' market shares. Considering the new capacities and volume growth, we expect a 15% revenue CAGR in APIs over FY19-21.

Expect traction in formulations. To boost its formulations business, the company acquired Pinnacle Life Sciences in 2015. At present, this comprises a small part of its business (9.6% of sales). The company has filed dossiers in Europe and in emerging markets in the last few years. We expect this business to clock a 12% revenue CAGR over FY19-21.

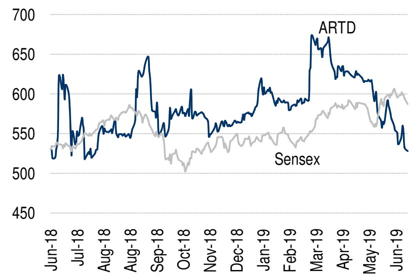
EBITDA to expand by FY21. We expect the operating margins to expand 192bps by FY21, with a 22.5% EBITDA CAGR over FY19-21, supported by stabilising raw material prices and a better product mix.

Valuation. We retain our Buy rating, with an unchanged price target of ₹796, based on 12x FY21e EPS. **Risks:** Delay in the ramp-up of the recently-added capacity; more-than-expected competition in generic APIs.

Key data	ARTD IN / ADRG.BO
52-week high / low	₹707 / 475
Sensex / Nifty	38961 / 11672
3-m average volume	$0.2m
Market cap	₹12bn / $178.1m
Shares outstanding	24m

Shareholding pattern (%)	Mar'19	Dec '18	Sep '18
Promoters	62.3	62.3	62.4
- of which, Pledged	-	-	-
Free float	37.7	37.7	37.6
- Foreign institutions	0.5	0.4	0.9
- Domestic institutions	4.5	5.0	4.6
- Public	32.8	32.3	32.1

Relative price performance



Source: Bloomberg

Key financials (YE Mar)	FY17	FY18	FY19	FY20e	FY21e
Sales (₹ m)	12,881	12,626	15,609	17,879	20,482
Net profit (₹ m)	818	823	898	1,203	1,564
EPS (₹)	34.3	34.9	38.1	51.0	66.3
PE (x)	16.8	14.5	14.0	10.4	8.0
EV / EBITDA (x)	9.8	8.7	8.3	6.7	5.5
PBV (x)	3.4	2.6	2.3	1.9	1.6
RoE (%)	21.9	19.2	18.0	20.1	21.4
RoCE (%)	11.6	10.4	10.7	12.8	14.3
Dividend yield (%)	-	0.2	0.2	0.5	0.6
Net debt / equity (x)	1.2	1.2	0.9	0.7	0.6

Source: Company, Anand Rathi Research

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Quick Glance – Financials and Valuations

Fig 1 – Income statement (₹ m)

Year-end: Mar	FY17	FY18	FY19	FY20e	FY21e
Net revenues	12,881	12,626	15,609	17,879	20,482
Growth (%)	***13.0***	***-2.0***	***23.6***	***14.5***	***14.6***
Direct costs	**7,805**	**7,827**	**10,600**	**11,890**	**13,436**
SG&A	3,207	2,814	2,936	3,433	3,933
EBITDA	**1,869**	**1,985**	**2,074**	**2,557**	**3,113**
EBITDA margins (%)	*14.5*	*15.7*	*13.3*	*14.3*	*15.2*
- Depreciation	385	401	426	465	500
Other income	40	11	62	65	68
Interest expenses	364	350	400	412	415
PBT	1,160	1,245	1,310	1,744	2,266
Effective tax rate (%)	*29.5*	*33.9*	*31.5*	*31.0*	*31.0*
+ Associates / (Minorities)	-	-	-	-	-
Net income	818	823	898	1,203	1,564
Adjusted income	818	823	898	1,203	1,564
WANS	24	24	24	24	24
FDEPS (₹ / sh)	34.3	34.9	38.1	51.0	66.3

Fig 2 – Balance sheet (₹ m)

Year-end: Mar	FY17	FY18	FY19	FY20e	FY21e
Share capital	239	236	236	236	236
Net worth	4,001	4,554	5,434	6,567	8,045
Debt	4,795	5,463	4,715	4,765	4,785
Minority interest	-	-	-	-	-
DTL / (Assets)	718	809	898	898	898
Capital employed	**9,514**	**10,826**	**11,047**	**12,229**	**13,728**
Net tangible assets	5,750	5,979	6,220	6,503	6,751
Net intangible assets	61	45	29	31	32
Goodwill	-	-	-	-	-
CWIP (tang. & intang.)	143	284	328	308	288
Investments (strategic)	119	108	124	139	160
Investments (financial)	-	-	-	-	-
Current assets (ex cash)	5,796	7,435	7,873	9,017	10,432
Cash	42	43	56	51	61
Current liabilities	2,396	3,068	3,582	3,819	3,996
Working capital	3,399	4,367	4,291	5,198	6,436
Capital deployed	**9,514**	**10,826**	**11,047**	**12,229**	**13,728**
Contingent liabilities	627	567			

Fig 3 – Cash-flow statement (₹ m)

Year-end: Mar	FY17	FY18	FY19	FY20e	FY21e
PBT (adj. for int.exp. / other income)	1,484	1,584	1,648	2,091	2,613
+ Non-cash items	385	401	426	465	500
Oper. prof. before WC	1,869	1,985	2,074	2,557	3,113
- Incr. / (decr.) in WC	-97	968	-76	907	1,238
Others incl. taxes	271	328	326	541	702
Operating cash-flow	1,694	689	1,824	1,109	1,172
- Capex (tang. + Intang.)	1,064	755	693	730	730
Free cash-flow	631	-67	1,131	379	442
Acquisitions					
- Div. (incl. buyback & taxes)	270	267	28	71	85
+ Equity raised		-3	-	-	-
+ Debt raised	-39	668	-748	50	20
- Fin investments	-9	-12	17	15	21
- Misc. (CFI + CFF)	337	341	325	347	347
Net cash-flow	-6	1	13	-4	9

Source: Company, Anand Rathi Research

Fig 4 – Ratio analysis

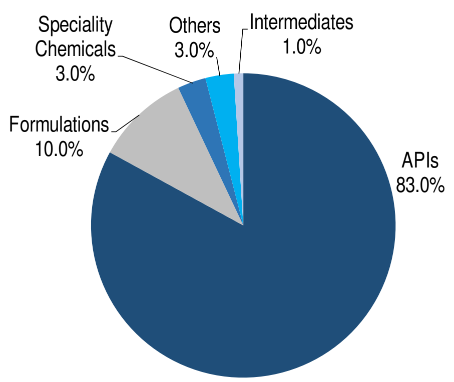
Year-end: Mar	FY17	FY18	FY19	FY20e	FY21e
P/E (x)	16.8	14.5	14.0	10.4	8.0
EV / EBITDA (x)	9.8	8.7	8.3	6.7	5.5
EV / Sales (x)	1.4	1.4	1.1	1.0	0.8
P/B (x)	3.4	2.6	2.3	1.9	1.6
RoE (%)	21.9	19.2	18.0	20.1	21.4
RoCE (%) - after tax	11.6	10.4	10.7	12.8	14.3
ANDA filings					
DPS (₹ / sh)	-	1.0	1.0	2.5	3.0
Dividend yield (%)	-	0.2	0.2	0.5	0.6
Dividend payout (%) - Inc. DDT	33.0	32.5	3.2	5.9	5.4
Net debt / equity (x)	1.2	1.2	0.9	0.7	0.6
Receivables (days)	84	108	107	108	109
Inventory (days)	59	80	58	58	58
Payables (days)	56	75	57	51	47
CFO : PAT %	207.1	83.7	203.2	92.2	75.0

Source: Company, Anand Rathi Research

Fig 5 – Price movement

Source: Bloomberg

Fig 6 – Revenue break-up (FY19)



Source: Company

Management meet highlights

API

- FY19 gross margins were hit by higher raw-material prices on the shuttering or shifting of companies in China, resulting in lower supplies of some intermediates, and pushing up prices.
- From mid-Feb'19 company was able to pass on the price rises in absolute terms to its customers.
- Its top-20 API products brought 90% to sales; its top-10, 74%. (standalone basis).
- The company follows a stock-and-sale model. It does not, however, enter into long-term supply contracts except with a few MNCs. Nevertheless, it will not fix API prices for the full year as, depending on situations, it can revise a contract.
- Of its top-10 products, nine are backward-integrated. Metformin is not since the raw material can be easily procured from China.
- Its capacity for Cipro (its biggest product, which comprises 18% of standalone sales) is 140 tonnes a month. Global growth in eiprofloxacin is flat. The company aims to capture competitors' shares in order to grow the molecule.
- It will be the largest producer of metformin in the world with capacity of 1,000 tonnes a month once teething problems with the technology are solved. It now produces 550-600 tonnes a month of metformin bringing 10% to standalone sales.
- Management said it would not be adding capacity in antibiotics. Capacity has already been added in anti-diabetics, anti-inflammatories, anti-diarrhoeal and anti-fungals. FY21 capex to be ~₹1bn.
- The company has a JV in China to manufacture metrodinazole, for which there are no other Indian manufacturer in the RoW.
- Management guided to sales of ₹1.5bn for FY20.
- At steady raw material prices it can enjoy 15-16% operating margins.

Specialty chemicals

- The company manufactures 15-20 products.
- It has 60,000 sq. metres to expand this segment. It has already expanded its Tarapur plant, and a greenfield project in Gujarat is expected in FY21.

Formulations

- To focus on this segment, started in 2010, it acquired Pinnacle in 2015.
- It has started registration of generics outside India, as well as exports last year.

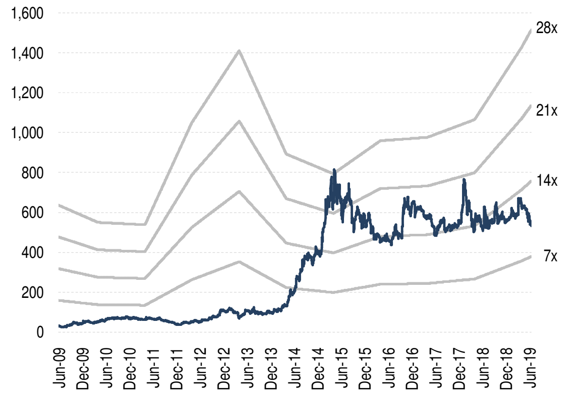
Overall business

- Management says it will focus on profit more than revenue even as it rationalises low-margin formulation products.
- It expects the FY20 operating margin to expand 100bps.
- Cost of debt is 9.12%.

Valuations

At the CMP of ₹532, the stock trades at 10.4x and 8x respective FY20e and FY21e earnings. We expect revenue and PAT CAGRs over FY19-21 of respectively 14.5% and 32%. We retain our Buy recommendation on the stock, with a price target of ₹796, based on 12x FY21e EPS.

Fig 7 – PE band – one-year-forward



Source: Bloomberg, Anand Rathi Research

Fig 8 – Standard deviation – one-year-forward

Source: Bloomberg, Anand Rathi Research

Risks

- Delay in the ramp-up of the recently-added capacity.
- More-than anticipated competition in generic APIs.

Appendix

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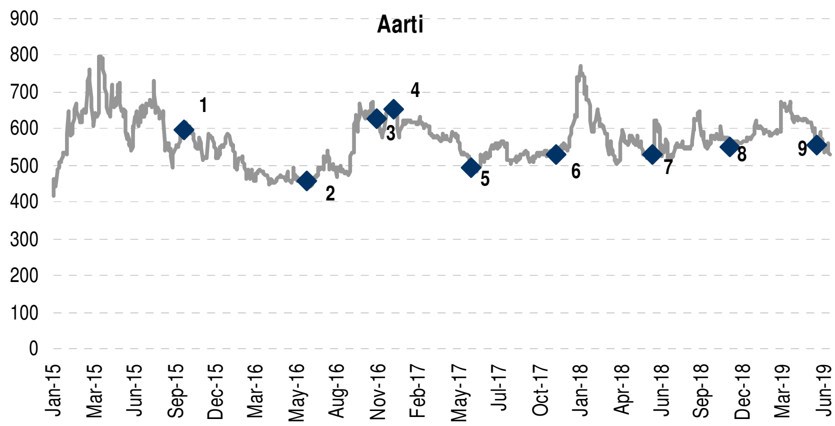

	Date	Rating	TP (₹)	Share Price (₹)
1	13-Oct-15	Buy	815	616
2	23-Jun-16	Hold	522	456
3	09-Nov-16	Hold	661	633
4	14-Dec-16	Hold	666	657
5	24-May-17	Buy	666	515
6	21-Nov-17	Buy	708	537
7	12-Jun-18	Buy	720	523
8	21-Nov-18	Buy	745	551
9	21-May-19	Buy	796	745

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