

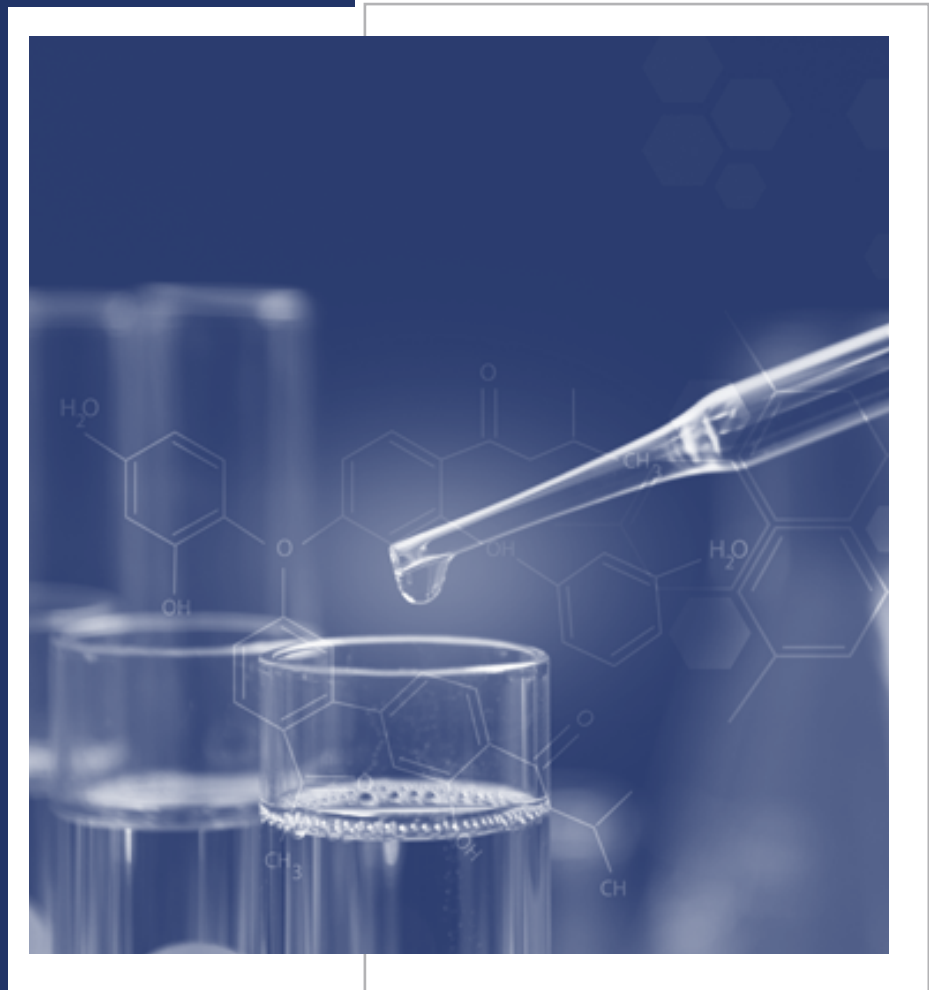


LAKEWATER
Nurturing Visions and Values

AARTI INDUSTRIES

NSE: AARTIIND - 1,206.00 INR (as on 24 Dec, 2020)

-LAKEWATER ADVISORS



Highlights

- Indian chemical industry size is expected to reach ~ \$300 billion by FY25E with an anticipated growth of 9% CAGR.
- Speciality chemical segment revenues are expected to grow at 19% CAGR in FY20-23E.
- Aarti Industries is a leading player in speciality chemical due to strong chemistry prowess, backward integration, larger products basket, which is backed by continuous innovation and holding a leadership position in its key products.

Economy Introduction

Year 2020 has been a rare disaster in its first half with coronavirus pandemic. This resulted in the economy's downfall and witnessed BSE Sensex at ~ 25,981. However, the end of the year isn't as fatal as the start and the economy is getting back on track. With Pfizer's Covid vaccine being approved, the equity sentiments are positive and a couple of equities are touching its 52 week high. In fact, at the time of writing this report, the BSE Sensex was trading at its all-time high and almost at the verge of touching the 47,000 mark.

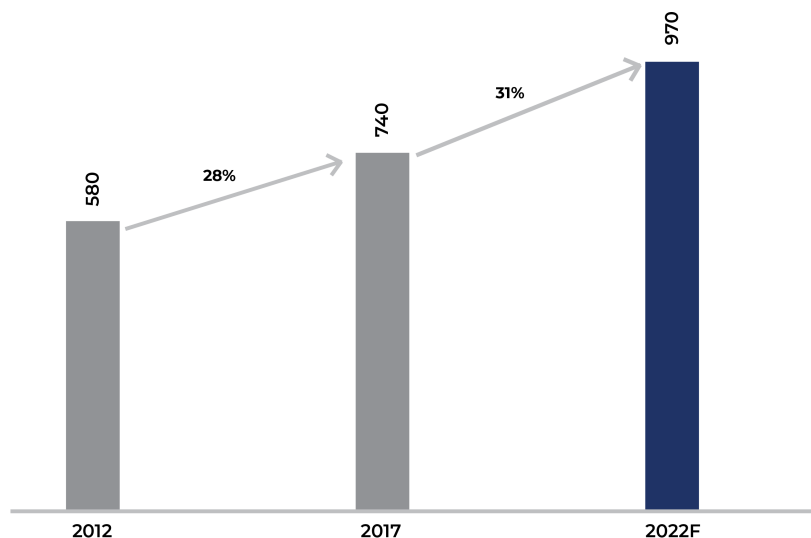
Industry Overview

The global chemicals market stood ~\$3.7 trillion in 2017 and grew at CAGR ~4% over 2004-18. With globalization, there has been a shift in the global chemical industry from Europe and the US to China. With the recent proliferating in developing economies after trade liberalization, China is leading the sector.

However, with recent stipulations worldwide, there have been disruptions in the supply chain with China. With supply chain disturbances and uncertainty in China, India comes across as a tough alternative with respect to production quantity, quality of raw materials, technology and government policies. Even if a conservative 5% of global speciality market share (which stands at \$800 billion) is transferred to India, it would translate into approximately \$8 billion.

With strong visibility within current and emerging applications, the speciality chemicals market is expected to grow upto \$970 billion by 2022. According to a recent report, it is anticipated that Indian chemical industry has the potential to reach \$300 billion by the financial year 2025 with an expected 9% CAGR. And when the country's speciality chemical is concerned, which is presently valued at around \$32 billion, it is anticipated to touch \$65 billion mark by 2025.

Global Speciality Chemicals Market



Source: aarti-industries.com

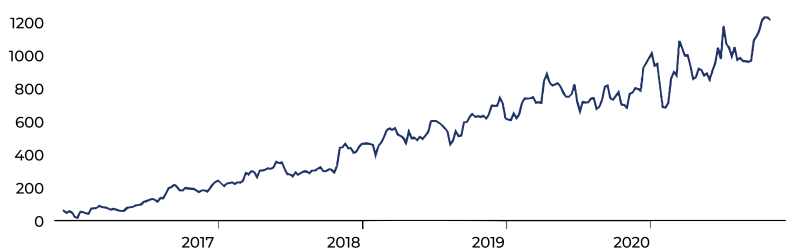
In fact, the Indian speciality chemical sector has been one of the best performing sectors this year, even though some major ones suffered the pandemic brunt. The first six months of the current year saw 24 major acquisitions of Indian companies by the international players in this space.

The FDIs, over the last few years are now being allowed to transact under automatic route (except hazardous chemicals), due to which, the segment has come across as a safe bet and has managed to deliver an impressive double-digit return over the past five years. An increase in demand is expected in near future. As a consequence of this positivity, Lakewater has positive sentiments for Aarti Industries Limited and recommends it for your equity portfolio.

Aarti Industries

Aarti Industries Limited (Aarti Industries) is one of the leading and competitive benzene-based speciality chemicals producers in the world. The company is regarded as rare in the global speciality chemicals sphere, since it combines process chemistry competence (recipe focus) with scaled up engineering competence (asset utilisation). Using its combined strengths of Innovation and Sustainability, Aarti Industries have been providing customized chemical and API solutions and services that have propelled their growth since 1984. Furthermore, over the last decade, the company has seen its conversion from an Indian company serving global markets to a fundamentally global company choosing to produce out of India.

Aarti Industries Ltd
NSE: AARTIIND



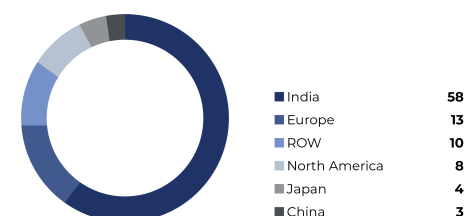
Source : Yahoo Finance

The company has a significant presence among speciality chemicals, Home & Personal Care Chemicals, and Pharmaceuticals business segments. ~ 85% of the overall revenue is derived from its chemical segment, and the rest from the pharmaceutical segment. With a strong and de-risked portfolio of 200+ products, it ranks among the top 5 companies globally and exports to over 60 countries.

Business by Segment (%)



Business by Geography (%)



Key Strengths

The Company is mapped globally due to its high safety policies and ensured customer confidence along with business sustainability. Furthermore, the company's portfolio being a multiproduct, multi-geography, multi-customer and multi-industry one, makes it "Global Partner of Choice" for various global and domestic customers. Now, Let's throw more light on its key strengths.

• Strong Visibility

The company is an ideal partner for customers of various industries for benzene-chain based solutions due to solid chemistry prowess, backward integration, larger product portfolio that is supported by constant innovation and holding a leadership position for its key products. In India, it is the only player, to have products until the sixth level derivative of benzene chemistry. It also expects to leverage on its existing clientele to promote its toluene and other derivatives.

Maximum contracts of Aarti Industries are long term cost+ contracts that suggest healthier control on the overall cost structure. Three multiyear CRAMs contracts were signed recently. It is due to this strong order book visibility, Aarti Industries is in an aggressive approach to develop. Attention is being given to value-added products (~75% of FY20 revenues), integrated model and better operating leverage. All this factors are likely to improve its margin profile.

• R&D and Innovation

Operating in the research intensive sectors - chemicals and pharmaceuticals industries, Aarti Industries has focused on enhancing its Research & Development (R&D) capabilities. The knowledge driven company has capitalized on superior technology across various processes/chemistries and created a strong pipeline of niche for itself.

Aarti Industries has four R&D facilities in western India, which innovate and develop new specialty chemicals as well as active pharmaceutical ingredients (APIs). Quite recently, Aarti Industries has operationalized the Aarti Research and Technology Centre (ARTC) in Navi Mumbai. These R&D centres enable better yield and margins due to higher levels of innovation in the product profile and thereby creating opportunities. This also supports revenue from downstream products, apart from the large range of high-end value-added products.

• Long-lasting Relationships Established Globally

The multi-product, multi-geography and multi-industry methodology has shaped significant diversification in revenues and thereby limited risks. This diversification approach has safeguarded the company as no single product or customer shall account for more than 8% of revenues.

The framework of comprehensive manufacturing practices has buoyed the product portfolio with its high quality standards and regulatory compliance. This along with the integrated operating model has led the company's transformation from speciality chemicals supplier to a 'Global Partner of Choice'.

• Extensive Range of Growth Opportunities

Ever since 1984, it has been growing manifold and now deals with a product portfolio of more than 200 products. The company has 17 manufacturing units and 2 USFDA approved units. Based on its presence across various end-use applications and a larger customer base, the Company has created a wide range of growth opportunities and currently exports over 40% of its products to various global locations including North America, Europe, China and Japan. Further, a high level of backward and forward integration across all key value chains empowers the company to benefit from the global trend of vendor consolidation and long-term supply contracts.

Another reason why Aarti Industries's growth opportunities are secured is due to its high entry barriers. Aarti Industries is on the edge as compared to its peers, due to longer approval cycle extending from 3 months to 2 years.

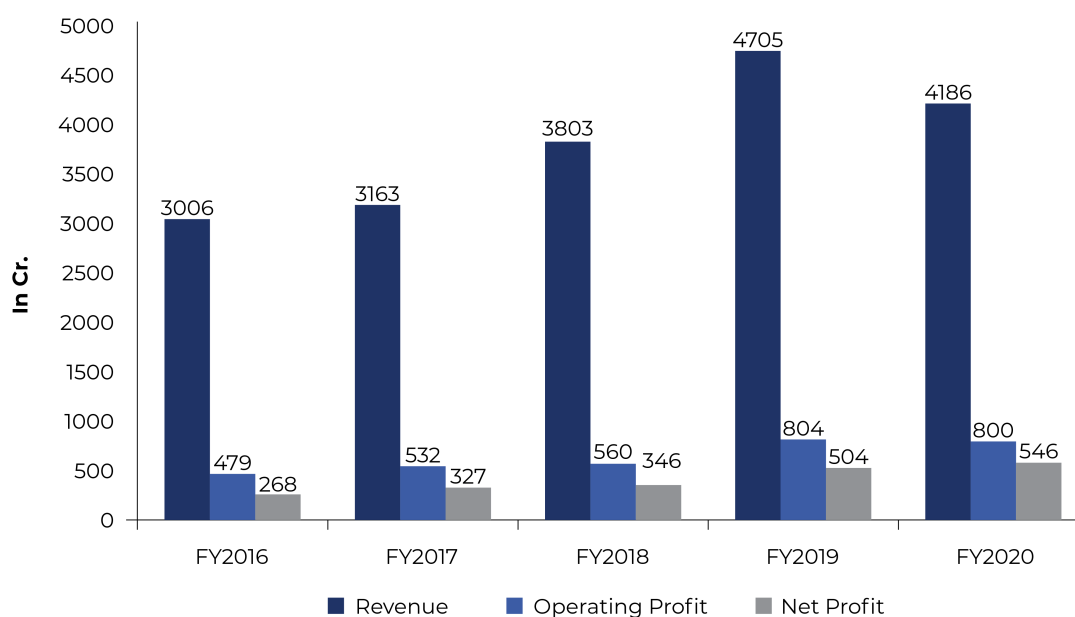
• Specialty Chemical segment to benefit from environmental issues in China

Company's specialty chemicals business grew ~10% CAGR over FY15-20 with EBIT margins expanding from 17% to ~22% alongwith steady expansion in existing products and addition of downstream derivative products. However, due to Covid-19, company's specialty chemical segment revenues got hit and de-grew by ~3% YoY in FY20, while EBIT margins expanded to ~22% despite the pandemic. Initially, it looked a temporary pain but due to the coronavirus speculation, a structural advantage gave birth for Aarti Industries, as leading global players are looking to shift their supply chain to India thus benefitting Aarti Industries' specialty chemicals division.

It's noteworthy, that In addition to a strong organic growth strategy, Aarti Industries Limited also makes use of inorganic growth strategy. Over the years, for both its business segments of chemicals and pharmaceuticals, the company has focused on backward integration.

Financial Statements

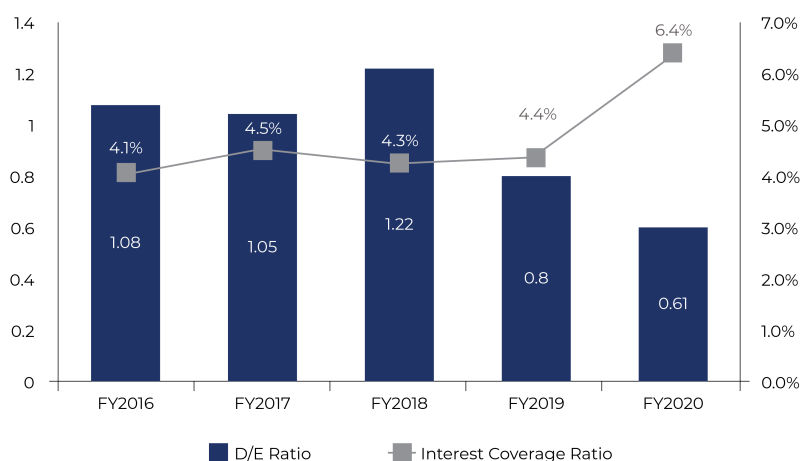
Aarti Industries has witnessed an increasing trend over the past few years in its financial statements. The revenues have registered a CAGR of 8.65% in the period 2015 to 2020; the Net Profit has almost doubled during this period.



The speciality chemicals segment of the company has registered close to 10% growth in the last 5 years. The operating margin for this segment, which stood at 17%, 5 years ago, stands at 22% today. This indicates the increasing operational efficiency of the segment.

When it comes to the pharmaceutical segment, the picture is even better. During the period 2015-2020, the revenues generated from the segment grew at a CAGR of around 20%. On the back of impressive and increasing capacity utilization which stands at 80% currently, shifting business from China to India and substantial demand for API intermediaries, the EBIT margins have increased from 11% to more than 16%. The segment has clearly shown remarkable resilience to the pandemic in this fiscal, which is evident from the fact that the EBIT margin this fiscal, has been 16.5%.

The company has a strong cash-flow generating capability from its core operations. Its cash-flow from operations has improved significantly in the past 2 years. Given that its Current Ratio has been above the mark of 1.0 in these years, it has a good liquidity position. Moreover, its debt levels have been decreasing over the last 5 years and stands at less than 40% of its total assets, indicating comfortable leverage position. Because of the company's reducing interest expenses due to decreasing debt and its increasing operating profits, it currently has a strong Interest Coverage Ratio.



Source: Aarti Industries Annual Report

Although the stock has a high PE ratio of more than 40, it is justified because of its strong fundamentals.

Threats

- A cause of concern for Aarti Industries Limited is its reducing Asset Turnover Ratio in the last 5 years. This apparently suggests that the assets of the company may be turning inefficient, or even obsolete, which may soon require the company to rethink its capital expenditure plans. As the company has a comfortable debt position on its balance sheet, it may consider taking on additional debt financing for such plans.
- Although the coronavirus pandemic has led to de-growth in the speciality chemicals business of Aarti Industries by negatively impacting its supply chains, the same cannot be expected to continue for long. The proper execution of the multi-year contracts which the company has with its important customers is bound to improve the future revenue streams of Aarti Industries.
- The company has all its manufacturing facilities concentrated in the western region of the country. It must consider expansion into newer geographic segments. Around 40% of the revenues of the company come from outside India which exposes it to currency risks, interest rate risks and geopolitical risks. It must continue its hedging activities for the mitigation of such risks.

Conclusion

With an established history of more than 3 decades in the Indian chemicals space, Aarti Industries Limited has come a long way with its myriad products. Since inception, unwavering focus is there in four major areas: technical know-how, Research and Development (R&D), customer centricity and sustainability.

Due to this, the chemical industry is bound to make break through, and the pharma industry already turned out to be a sweet spot in this Covid19 phase.

Although, FY21 can be muted, FY22 looks promising. The growth looks sustainable due to both internal (Expansion plans) and external (Shift from China) factors. Lakewater recommends Aarti Industries and keeps it in portfolio, as market is now being regulated, and with Aarti Industries' key market being recovered, growth shall propel in near future.



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