

India

REDUCE (no change)

Consensus ratings*:	Buy 7	Hold 8	Sell 9
Current price:	Rs455		
Target price:	Rs435		
Previous target:	Rs625		
Up/downside:	-4.4%		
InCred Research / Consensus:	-10.4%		
Reuters:	ARTI.NS		
Bloomberg:	ARTO IN		
Market cap:	US\$1,983m	Rs164,813m	
Average daily turnover:	US\$7.0m	Rs582.8m	
Current shares o/s:	362.5m		
Free float:	60.5%		
*Source: Bloomberg			

Key changes in this note

- Lower TP to Rs435; retain REDUCE rating.



Source: Bloomberg

Price performance	1M	3M	12M
Absolute (%)	(3.3)	(10.0)	(33.8)
Relative (%)	(1.2)	(14.5)	(40.3)

Major shareholders	% held
Promoter & Promoter Group	39.5
Morgan Stanley	3.1
HDFC Asset Management	2.7

Analyst(s)

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Aarti Industries

Demand headwinds in commodity chemicals

- Aarti Industries is a producer of commodity chemicals whose demand is linked to the global macroeconomic cycle and hence, is witnessing a slowdown.
- On the one hand, it is likely to face revenue pressure because of demand slowdown and on the other, rising raw material costs will squeeze its margins.
- An EPS decline in on the cards in FY24F. Even FY25F EPS may remain well below the FY23 level. Consensus EPS cut is likely. We retain REDUCE rating.

Volatility in margins across portfolios

A significant portion of Aarti Industries' exports is driven by two key products, namely PDCB (para-dichlorobenzene) and MMA (mono methyl aniline). Both these products are experiencing a decline in realization and spreads, ultimately leading to a reduction in EPS. Across the broader product portfolio, including di methyl sulphate (DMS), ortho nitro aniline (ONA), di methyl phthalate, and di chloro aniline, we have observed a trend of lower realization and we believe this trend will persist. The demand for these commodity-nature products has remained weak, and the volatility in raw material (RM) prices has further compounded the challenges. Consequently, the product spreads have become quite erratic. Once the situation stabilizes, it is likely that the spreads of most products will decline because most of the products manufactured by Aarti Industries are commodity chemicals.

Capex hurts balance sheet, cash flow

While Aarti Industries secured equity capital (QIP) for its capex, the debt component of the capex is exerting pressure on the balance sheet. The company intends to undertake a capex of Rs 25-30bn over the next two years. With a low cash flow expected from the business, the balance sheet will witness increased leverage. Net debt is projected to rise over the next couple of years, as operating cash flow falls well below the capex level, leading to a deterioration in the consolidated net debt-to-EBITDA ratio.

We value the stock at 30x FY25F EPS to arrive at a lower TP of Rs435

Aarti Industries has maintained a consistent trading pattern above +1 SD on its one-year forward EPS in the recent past. Despite this, the absence of earnings growth and the presence of product volatility raise concerns that could potentially result in a derating of the stock. Our valuation approach involves using a multiple of 30x (representing +1 SD of the long-term mean) on the one-year forward EPS, resulting in a lower target price of Rs435, down from Rs625 earlier. Our REDUCE rating on the stock remains unchanged. The possibility of a recovery in product portfolio prices poses an upside risk to our EPS estimates.

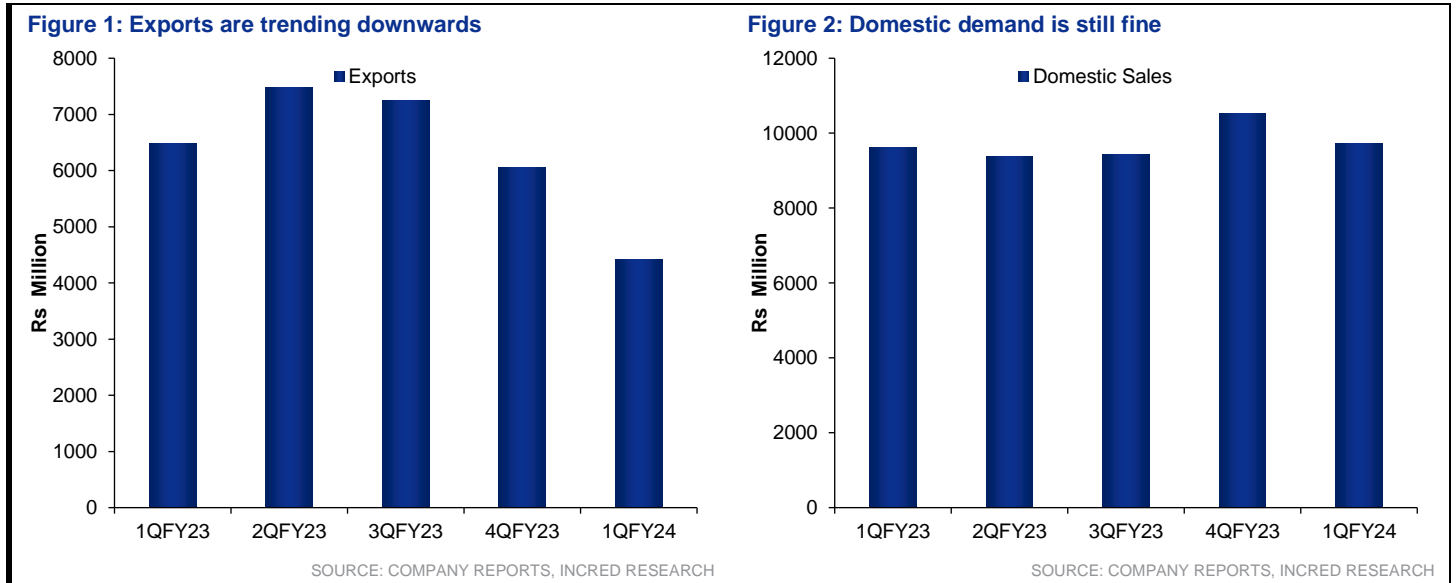
Financial Summary

	Mar-22A	Mar-23A	Mar-24F	Mar-25F	Mar-26F
Revenue (Rsm)	70,000	66,186	68,171	74,989	83,987
Operating EBITDA (Rsm)	19,288	10,890	11,324	13,215	14,826
Net Profit (Rsm)	13,074	5,452	4,381	5,250	6,298
Core EPS (Rs)	36.1	15.0	12.1	14.5	17.4
Core EPS Growth	149.8%	(58.3%)	(19.7%)	19.9%	20.0%
FD Core P/E (x)	12.61	30.23	37.62	31.39	26.17
DPS (Rs)	3.5	2.5	2.5	2.5	2.5
Dividend Yield	0.77%	0.55%	0.55%	0.55%	0.55%
EV/EBITDA (x)	9.56	17.59	17.75	15.78	13.82
P/FCFE (x)	(14.97)	(824.89)	44.40	27.81	79.66
Net Gearing	33.1%	54.3%	68.7%	76.8%	64.3%
P/BV (x)	2.79	3.35	3.13	2.89	2.64
ROE	27.8%	10.1%	8.6%	9.6%	10.5%
% Change In Core EPS Estimates			(0.53%)		
InCred Research/Consensus EPS (x)					

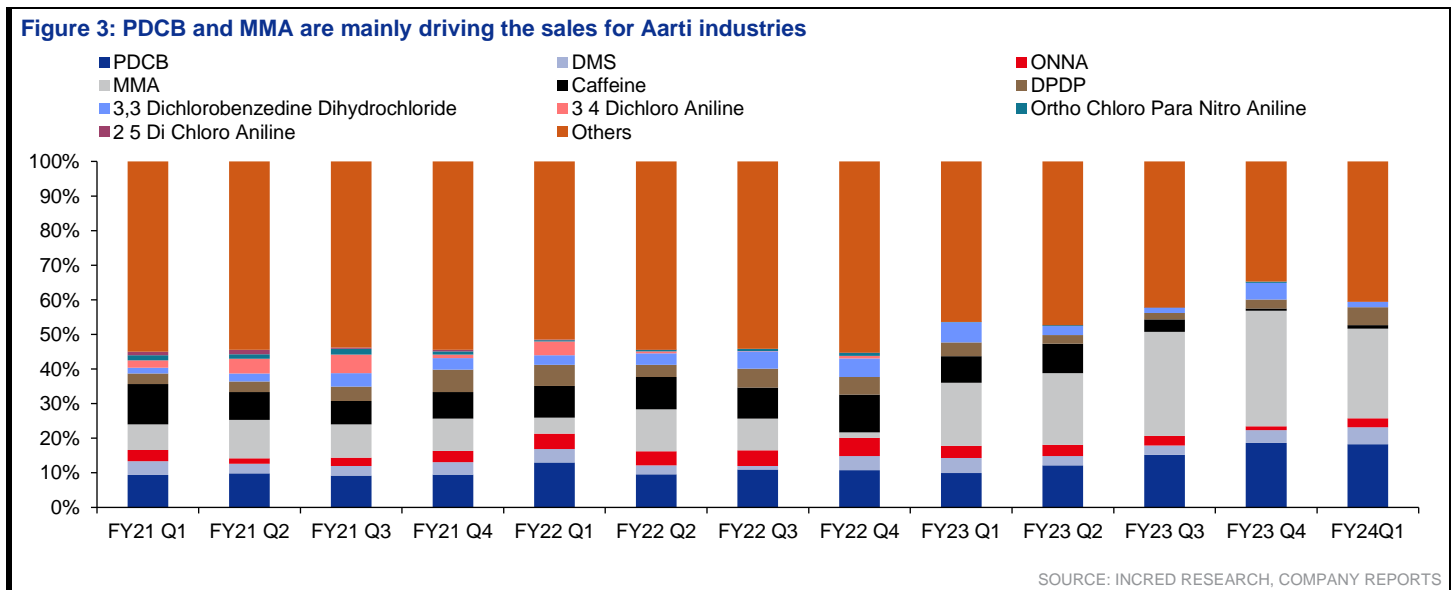
SOURCE: INCRED RESEARCH, COMPANY REPORTS

Demand headwinds in commodity chemicals

Export demand is declining



Aarti Industries' export sales are increasingly driven by PDCB and MMA



PDCB (para-dichlorobenzene) is a low grade commodity chemical... >

Para-dichlorobenzene (PDCB) is a colourless solid with a strong odour. It is a chlorinated aromatic hydrocarbon compound that is used as a fumigant insecticide and repellent. It is also found in deodorant blocks made for trash cans and toilets.

Here are some of the uses of para-dichlorobenzene:

- Mothballs and moth crystals:** PDCB is the active ingredient in most mothballs and moth crystals. It is used to repel moths and other insects that can damage clothing and other materials.
- Deodorizer blocks:** PDCB is also found in deodorant blocks made for trash cans and toilets. It helps to control odour and prevent the growth of mold and mildew.

- Fumigation:** PDCB can be used to fumigate enclosed spaces to kill insects and pests. It is often used to treat homes for termites.
- Other uses:** PDCB has also been used as a solvent, a degreaser, and a fire retardant.

...and MMA (mono methyl aniline) is no different ➤

Monomethyl aniline, also known as N-methylaniline, is an organic compound with the chemical formula C7H9N. It is a colourless-to-brown viscous liquid with a weak ammonia-like odour. It is insoluble in water but soluble in organic solvents such as ethanol and ether.

Monomethyl aniline is a derivative of aniline, which is a primary aromatic amine. It is made by reacting aniline with methanol.

Monomethyl aniline is used as a latent and coupling solvent and is also used as an intermediate for manufacturing dyes, agrochemicals and other organic products. It is also used as a gasoline additive to improve fuel economy and reduce emissions.

Ortho nitro aniline (ONA) is another important product which is also commodity chemical in nature ➤

Ortho nitro aniline (ONA), also known as 2-nitroaniline, is an organic compound with the chemical formula C6H4NO2NH2. It is a derivative of aniline, carrying a nitro functional group in position 2. It is a yellow-orange solid with a strong odour. ONA is insoluble in water but is soluble in organic solvents such as ethanol and ether.

ONA is mainly used as a precursor to o-phenylenediamine, which is used to make dyes, pigments, and pharmaceuticals. It is also used to make antioxidants and UV absorbers.

The realization of almost all products is coming down ➤

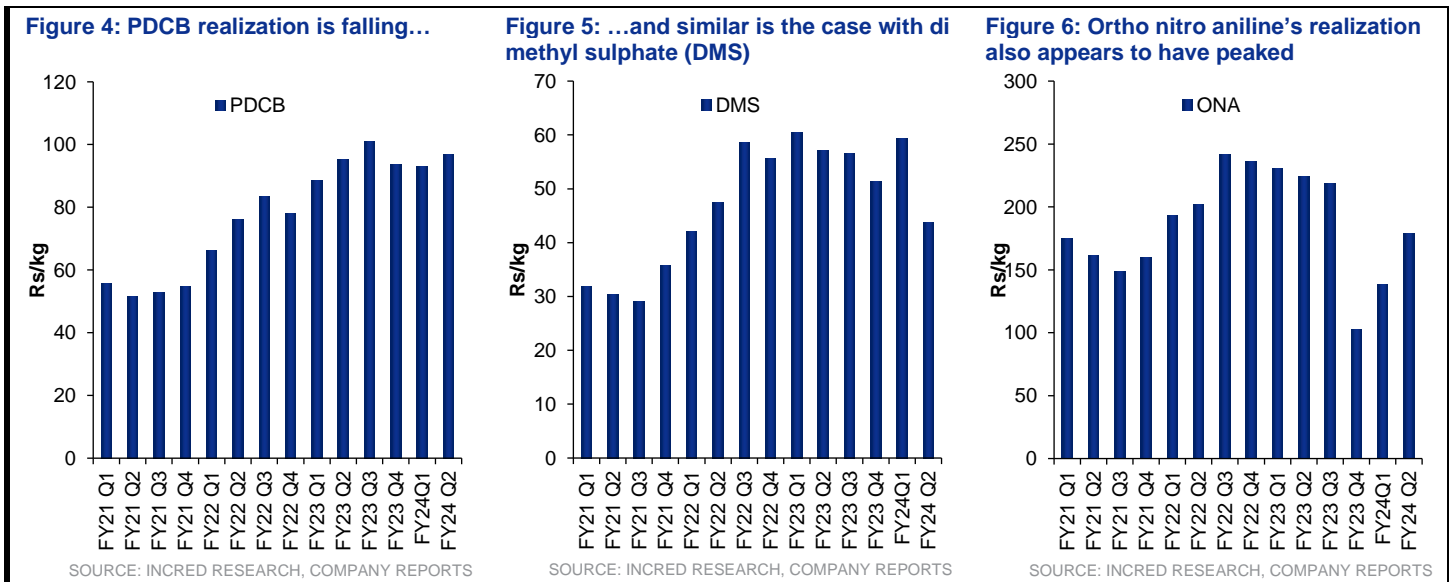
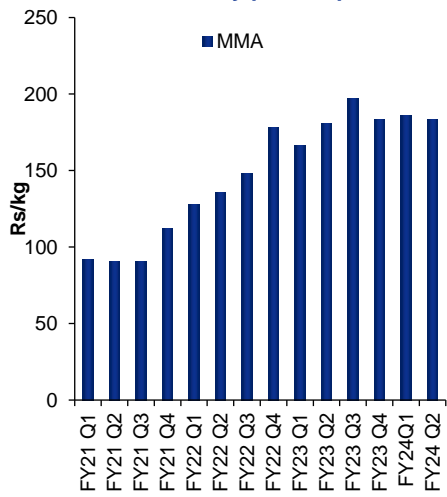
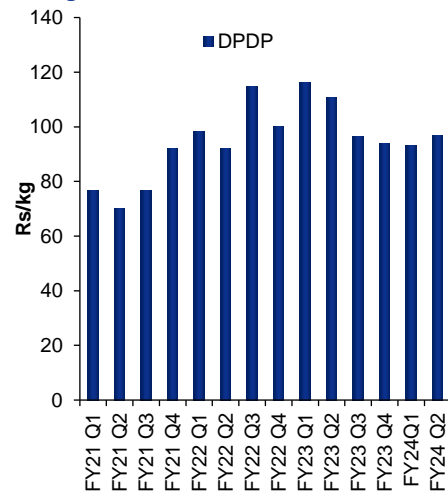


Figure 7: Mono methyl aniline's realization is also way past its peak...



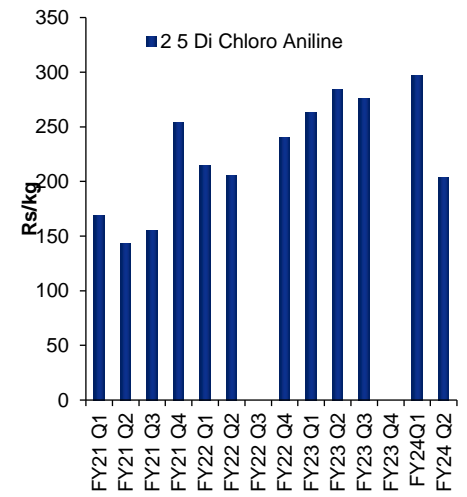
SOURCE: INCRED RESEARCH, COMPANY REPORTS

Figure 8: ...that of di methyl phthalate is falling...



SOURCE: INCRED RESEARCH, COMPANY REPORTS

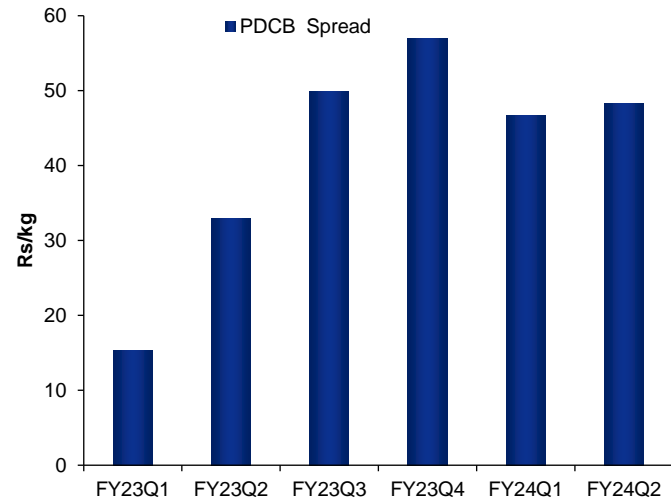
Figure 9: ...and similar is the case with di chloro aniline



SOURCE: INCRED RESEARCH, COMPANY REPORTS

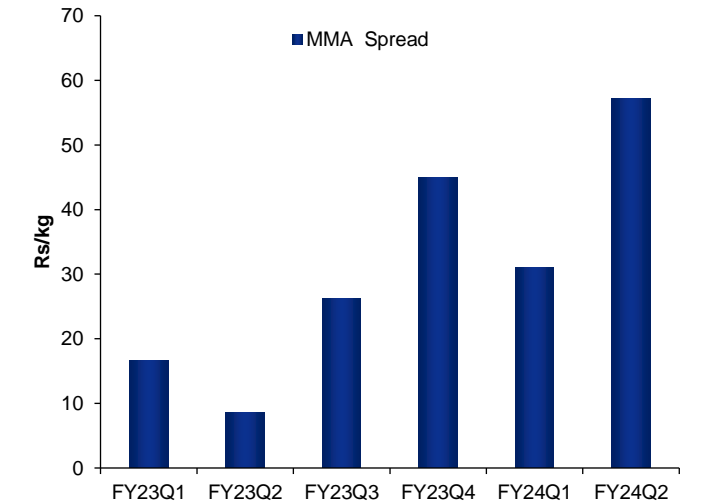
Spreads of major products are all over the place ➔

Figure 10: PDCB's spreads over raw material are falling...



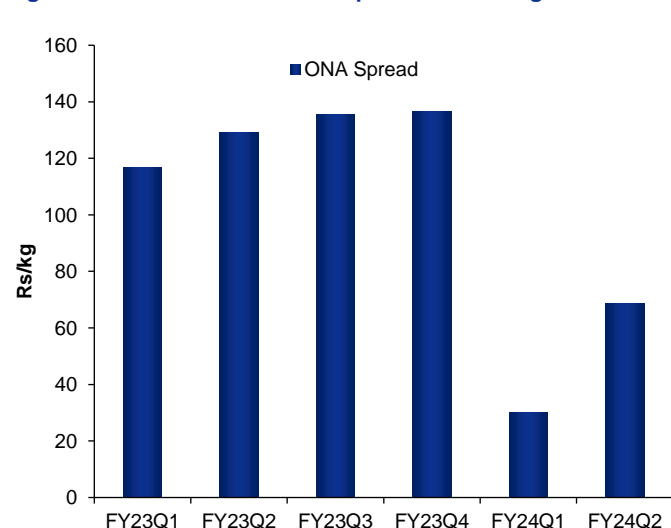
SOURCE: COMPANY REPORTS, INCRED RESEARCH

Figure 11: ...but that of MMA are up



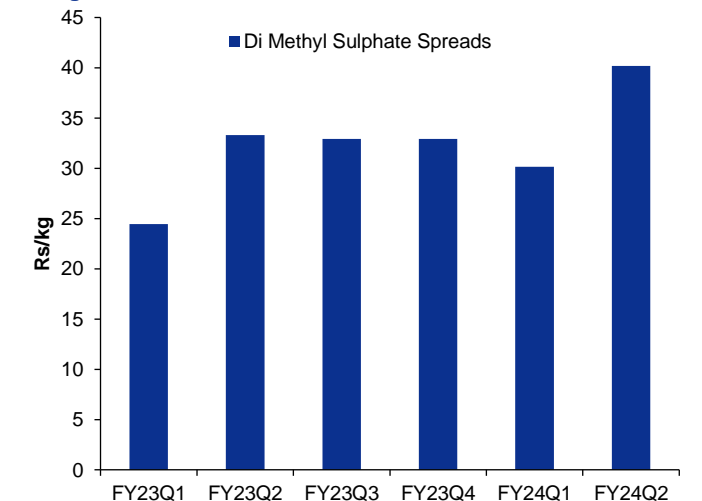
SOURCE: COMPANY REPORTS, INCRED RESEARCH

Figure 12: Ortho nitro aniline's spreads are falling...



SOURCE: COMPANY REPORTS, INCRED RESEARCH

Figure 13: ...but that of di methyl sulphate are showing strength



SOURCE: COMPANY REPORTS, INCRED RESEARCH

More often than not, this kind of volatility is a sign of demand problem ➤

The demand for commodity chemicals has been weak and their raw material prices volatile. This led to product spreads being all over the place. Once things stabilize, the spreads of most products will decline because almost all products manufactured by Aarti Industries are commodity chemicals.

Prices of benzene, the key raw material, will rise as crude oil prices are becoming stronger ➤

As shown in our earlier report [IN: Chemicals - Overall - Demand declines, RM pressure will follow](#), benzene prices are likely to rise, which will exert pressure on product margins.

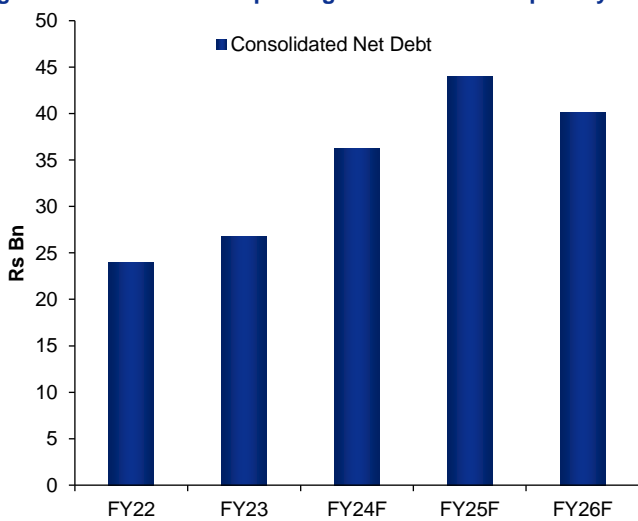
Balance sheet is stretched

While the company got equity capital (via the QIP route) for its capex at 70x one-year forward EPS, the debt part of the capex is hurting the balance sheet.

Balance sheet debt to rise ➤

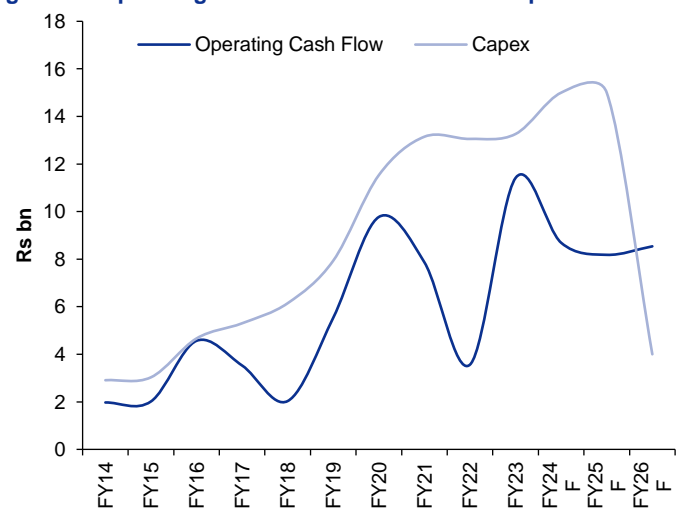
Aarti Industries plans to incur a capex of Rs25-30bn over the next two years. The cash flow from the business will be low, which means the balance sheet will get leveraged. For a commodity business, this is a deadly combination that will erode the returns to shareholders.

Figure 14: Net debt to keep rising over the next couple of years



SOURCE: INCRED RESEARCH, COMPANY REPORTS

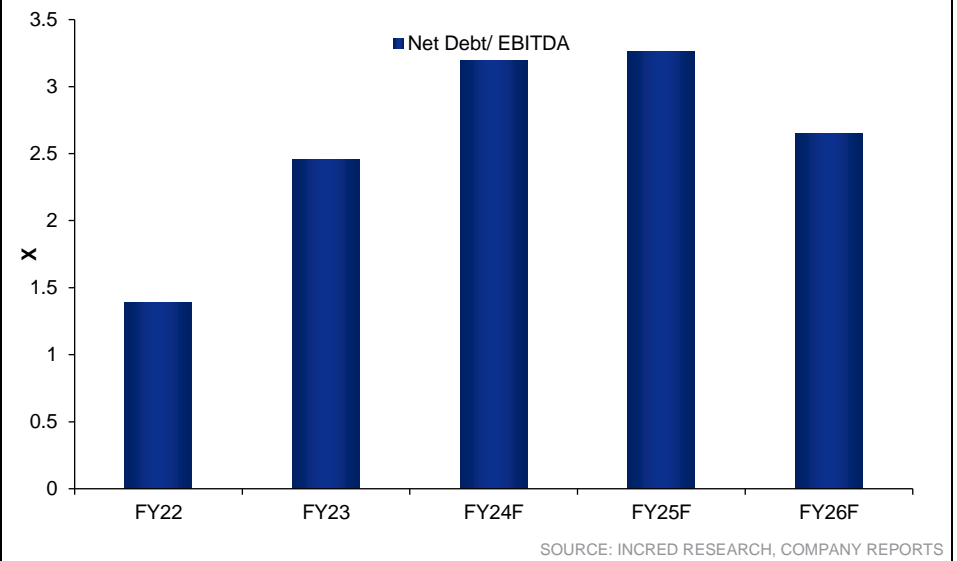
Figure 15: Operating cash flow to be well below capex



SOURCE: INCRED RESEARCH, COMPANY REPORTS

Consolidated net debt/EBITDA ratio to rise ➤

Figure 16: Consolidated net debt/EBITDA ratio to rise



Valuation rich because of anaemic earnings and a stretched balance sheet; retain REDUCE rating

Aarti Industries is likely to witness a 20% decline in EPS in FY24F before recovering in FY25F. The P/E ratio is stretched as the balance sheet is deteriorating and the company continues to incur the already committed capex.

Figure 17: Aarti Industries trades near +1SD of its long-term mean valuation; it may not get derated further but an EPS-driven stock price decline is on the cards

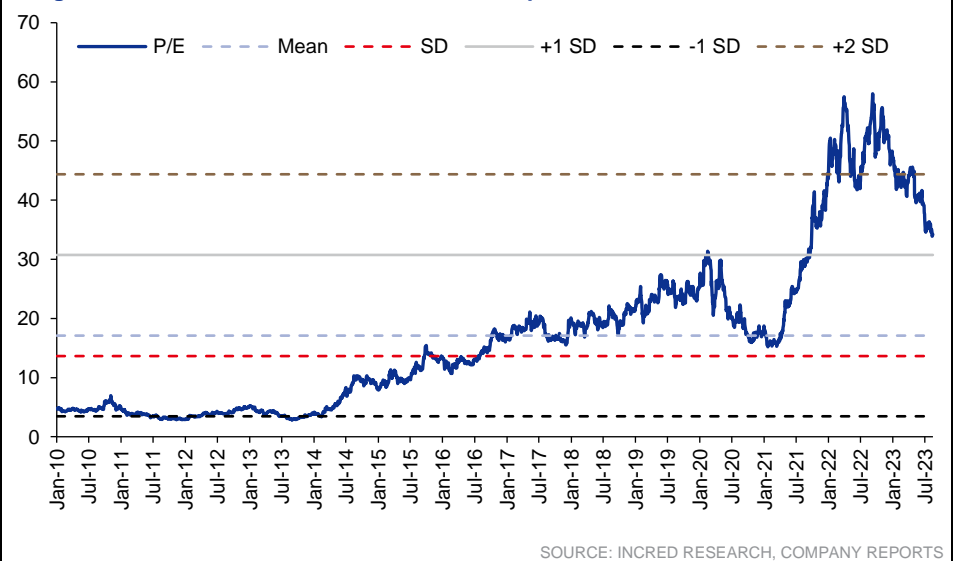


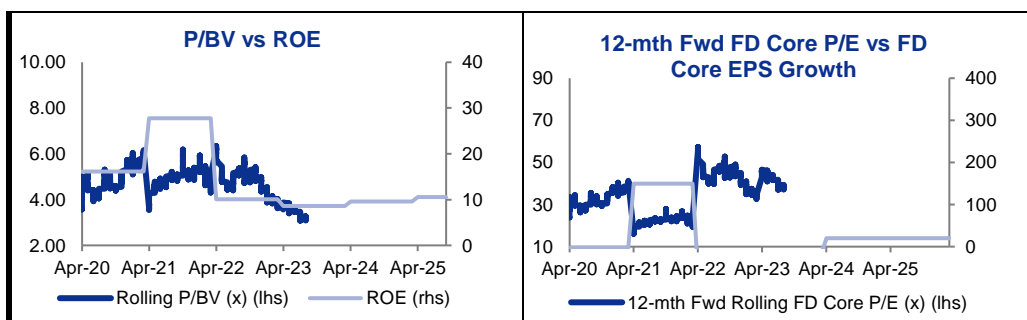
Figure 18: We value the stock at 30x (+1 SD of the long-term mean) one-year forward EPS to arrive at a target price of Rs435

Target Price Methodology

Item	Unit	Valuation
FY24F EPS	Rs/Share	12.1
FY25F EPS	Rs/Share	14.5
P/E Multiple	x	30.0
Target Price	Rs/Share	435

SOURCE: INCRED RESEARCH, COMPANY REPORTS

BY THE NUMBERS



Profit & Loss

(Rs mn)	Mar-22A	Mar-23A	Mar-24F	Mar-25F	Mar-26F
Total Net Revenues	70,000	66,186	68,171	74,989	83,987
Gross Profit	37,061	27,769	29,314	32,995	36,954
Operating EBITDA	19,288	10,890	11,324	13,215	14,826
Depreciation And Amortisation	(2,885)	(3,105)	(4,097)	(4,397)	(4,607)
Operating EBIT	16,403	7,785	7,227	8,819	10,220
Financial Income/(Expense)	(1,143)	(1,683)	(2,025)	(2,581)	(2,736)
Pretax Income/(Loss) from Assoc.					
Non-Operating Income/(Expense)	8	9	9	9	9
Profit Before Tax (pre-EI)	15,268	6,111	5,211	6,246	7,492
Exceptional Items					
Pre-tax Profit	15,268	6,111	5,211	6,246	7,492
Taxation	(2,194)	(659)	(830)	(995)	(1,194)
Exceptional Income - post-tax					
Profit After Tax	13,074	5,452	4,381	5,250	6,298
Minority Interests					
Preferred Dividends					
FX Gain/(Loss) - post tax					
Other Adjustments - post-tax					
Net Profit	13,074	5,452	4,381	5,250	6,298
Recurring Net Profit	13,074	5,452	4,381	5,250	6,298
Fully Diluted Recurring Net Profit	13,074	5,452	4,381	5,250	6,298

Cash Flow

(Rs mn)	Mar-22A	Mar-23A	Mar-24F	Mar-25F	Mar-26F
EBITDA	19,288	10,890	11,324	13,215	14,826
Cash Flow from Invt. & Assoc.					
Change In Working Capital	(11,858)	3,118	210	(1,949)	(2,572)
(Incr)/Decr in Total Provisions					
Other Non-Cash (Income)/Expense	(61)	(9)		646	
Other Operating Cashflow	(4,189)	(126)	372	599	357
Net Interest (Paid)/Received	(1,143)	(1,683)	(2,025)	(2,581)	(2,736)
Tax Paid	2,670	909	830	995	1,194
Cashflow From Operations	4,708	13,098	10,713	10,926	11,069
Capex	(13,050)	(13,263)	(15,000)	(15,000)	(4,000)
Disposals Of FAs/subsidiaries					
Acq. Of Subsidiaries/investments					
Other Investing Cashflow	(5)	(35)			
Cash Flow From Investing	(13,055)	(13,298)	(15,000)	(15,000)	(4,000)
Debt Raised/(repaid)	(2,663)		8,000	10,000	(5,000)
Proceeds From Issue Of Shares	11,867	3,061			
Shares Repurchased					
Dividends Paid	(1,269)	(906)	(906)	(906)	(906)
Preferred Dividends					
Other Financing Cashflow	(1,143)	(1,683)	(2,025)	(2,581)	(2,736)
Cash Flow From Financing	6,792	472	5,069	6,512	(8,642)
Total Cash Generated	(1,555)	272	781	2,438	(1,573)
Free Cashflow To Equity	(11,010)	(200)	3,712	5,926	2,069
Free Cashflow To Firm	(7,204)	1,483	(2,263)	(1,493)	9,805

SOURCE: INCRED RESEARCH, COMPANY REPORTS

BY THE NUMBERS...cont'd

Balance Sheet					
(Rs mn)	Mar-22A	Mar-23A	Mar-24F	Mar-25F	Mar-26F
Total Cash And Equivalents	2,568	2,007	521	2,960	1,621
Total Debtors	13,905	9,405	13,074	14,381	16,107
Inventories	14,113	10,311	11,206	12,327	13,806
Total Other Current Assets	2,150	2,870	2,147	2,158	2,173
Total Current Assets	32,737	24,593	26,949	31,826	33,707
Fixed Assets		58,182	72,333	82,937	82,330
Total Investments	731	172	172	172	172
Intangible Assets					
Total Other Non-Current Assets	4,177	2,863	1,861	1,215	980
Total Non-current Assets		61,216	74,366	84,324	83,482
Short-term Debt	12,872	22,393	22,393	22,393	22,393
Current Portion of Long-Term Debt					
Total Creditors	4,901	3,075	3,922	4,314	4,832
Other Current Liabilities	5,597	2,365	5,570	5,668	5,798
Total Current Liabilities	23,370	27,833	31,886	32,376	33,023
Total Long-term Debt	9,304	6,347	14,347	24,347	19,347
Hybrid Debt - Debt Component					
Total Other Non-Current Liabilities	2,400	2,421	2,400	2,400	2,400
Total Non-current Liabilities	11,704	8,768	16,747	26,747	21,747
Total Provisions	2,502				
Total Liabilities	37,576	36,601	48,633	59,123	54,771
Shareholders Equity	59,145	49,201	52,675	57,019	62,411
Minority Interests	7	7	7	7	7
Total Equity	59,152	49,208	52,682	57,026	62,418

Key Ratios					
	Mar-22A	Mar-23A	Mar-24F	Mar-25F	Mar-26F
Revenue Growth	39.4%	(5.4%)	3.0%	10.0%	12.0%
Operating EBITDA Growth	96.5%	(43.5%)	4.0%	16.7%	12.2%
Operating EBITDA Margin	27.6%	16.5%	16.6%	17.6%	17.7%
Net Cash Per Share (Rs)	(54.09)	(73.75)	(99.91)	(120.77)	(110.67)
BVPS (Rs)	163.16	135.72	145.31	157.29	172.17
Gross Interest Cover	14.35	4.63	3.57	3.42	3.74
Effective Tax Rate	14.4%	10.8%	15.9%	15.9%	15.9%
Net Dividend Payout Ratio	9.7%	16.6%	20.7%	17.3%	14.4%
Accounts Receivables Days	56.95	64.27	60.18	66.82	66.25
Inventory Days	130.04	116.03	101.06	102.27	101.40
Accounts Payables Days	(59.09)	(37.89)	(32.87)	(35.80)	(35.49)
ROIC (%)		10.0%	7.9%	8.6%	9.8%
ROCE (%)	22.4%	9.6%	8.6%	9.1%	9.8%
Return On Average Assets			6.8%	7.2%	7.7%

SOURCE: INCRED RESEARCH, COMPANY REPORTS

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any other material conflict of interest at the time of publication of the research report or at the time of public appearance	NO	NO
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