30th Sep'18

Alpha report – Initiation note

Aarti Drugs Ltd (NSE Code – AARTIDRUGS)

Dear Members,

We have released 30th Sep'18: Aarti Drugs Ltd (NSE Code – AARTIDRUGS) – Alpha/Alpha Plus stock for Sep'18. For details and other updates, please log into the website at the following link - http://katalystwealth.com/index.php/my-account/

Note: For any queries, mail us at info@katalystwealth.com

Date: 30th Sep'18

CMP – 546.50 (BSE); 550.00 (NSE)

Rating – Positive – 4% weightage; this is not an investment advice (refer rating interpretation)

After a slight pull back in the last 1-2 months the markets have again started correcting. One of the problems today is that while broader markets have corrected to reasonable levels, the SENSEX and NIFTY are not reflecting the same due to run up in certain large caps. So, if at all the large caps start correcting, the small and mid caps will take further beating.

As mentioned last time there's nothing to suggest that stocks can't correct further or if we have already bottomed out; however the odds are more favourable for the long term investors and the staggered purchases over the course of next few months could be the best way to capitalize both on the correction and avoid the trap of trying to time the markets.

Introduction

Aarti Drugs (ADL) is a part of well known Aarti group of industries. The Company is engaged in the manufacturing of Active Pharmaceutical Ingredients (APIs), Pharma Intermediates, Specialty Chemicals and also manufactures formulations through its wholly-owned subsidiary- Pinnacle Life Science Private Limited.

The company has a long standing track record in the bulk drugs industry and has been supplying products to demanding domestic and international customers.

As on date, we like several points about this company and they are as below:

Increasing promoter holding – In the last 6-7 years the promoters have increased their holding in the company from 54.83% to 62.48% through open market purchases and buy-backs.

Backward integration through manufacturing of intermediates – Considering the recent environmental issues in China, the company has been trying to reduce dependence on imports by way of backward integration. It has backwardly integrated for the manufacture of intermediates required for the manufacturing of Ciprofloxacin, Enrofloxacin, Oflaxacin, Levofloxacin, Norfloxacin, Nimesulide, Celecoxib and Ketoconazole.

Capacity expansions without much strain on balance sheet – In the last 4 years the company has expanded its capacities by more than 75% and that too without any major strain on balance sheet and equity dilution.

The company has spent around 300 crore on capacity expansions; however the absolute debt has increased by only 168 crore while the debt equity ratio has improved from 1.5 to 1.2.

Probable benefits from environmental issues in China – India is largely dependent on imports from China for APIs and the related intermediates. With several factories getting shut in China, the prices of intermediates and APIs have increased substantially.

Aarti Drugs, with its core focus on development of APIs and now reduced dependency on imports from China, could benefit from both higher demand and prices for APIs.

Reasonable valuations – Last but not the least, the stock is currently trading around 13-14 times trailing twelve months earnings while during the last 5 years it has traded in the range of 11 times to around 20 times earnings.

In case of really bad markets, the downside might be limited at around 15-20%.

Basic details

What are APIs – Active pharmaceutical ingredients or APIs can be defined as the chemicals used to manufacture pharmaceutical drugs. The active ingredient (AI) is the substance or substances that are biologically active within the drug and is the specific component responsible for the desired effect it has on the individual taking it.

Any drug or medication is composed of two components. The first is the API – which is the central ingredient. The second is known as the excipient, which is the inactive substance that serves as the vehicle for the API itself. If the drug is in a syrup form, then the excipient is the liquid that has been used to make it as such.

Coming back to Aarti Drugs Limited, it was established in the year 1984 and forms part of Aarti Group of Industries. The Company has presence over the entire pharma value chain starting from chemicals to intermediates to APIs and lastly formulations.

The company has 12 facilities with total production capacity of 25,714 MTPA and also has robust R&D Division at Tarapur in close vicinity to manufacturing locations.

Company's Clientele includes MNCs viz. Abbott, Sanofi- Aventis, Merck, Teva, Searle, Pfizer, Bayer, Clariant, etc. Domestic clientele includes companies like Cipla, Alkem Laboratories, J. B. Chemicals and Pharmaceuticals, etc.

In terms of revenue contribution in FY 18, on standalone basis APIs and their allied intermediates contributed around 97% to the sales while the rest 3% came from Specialty chemicals.

Within the API Segment:

1. Antibiotic category contributed 37.66%,
2. Anti-diarrhoeal around 20.64%,
3. Anti-inflammatory around 10.94%,
4. Followed by Anti-fungal, Anti-diabetic and Cardioprotectant therapeutic categories.

On a Consolidated basis, Formulations accounted for 11.17% of the total sales.

Leading producer – ADL is one of the leading producers of the following drugs:

Metformin – Metformin is an oral diabetes medicine that helps control blood sugar levels. Metformin is used together with diet and exercise to improve blood sugar control in adults with type 2 diabetes mellitus.

Fluoroquinolones – Fluoroquinolones are antibiotics that are commonly used to treat a variety of illnesses such as respiratory and urinary tract infections. These medicines include ciprofloxacin (Cipro), gemifloxacin (Factive), levofloxacin (Levaquin), moxifloxacin (Avelox), norfloxacin (Noroxin), and ofloxacin (Floxin).

Tinidazole – Tinidazole is an antibiotic that is used to treat certain types of vaginal infections (bacterial vaginosis, trichomoniasis). It is also used to treat certain types of parasite infections (giardiasis, amebiasis).

Ketoconazole – Topically administered ketoconazole is usually prescribed for fungal infections of the skin and mucous membranes, such as athlete's foot, ringworm, candidiasis (yeast infection or thrush), jock itch, and tinea versicolor.

Nimesulide – Nimesulide is a nonsteroidal anti-inflammatory drug (NSAID) with pain medication and fever reducing properties.

Metronidazole – Metronidazole is an antibiotic that is used to treat a wide variety of infections. It works by stopping the growth of certain bacteria and parasites. This antibiotic treats only certain bacterial and parasitic infections.

Certified and cGMP compliant plants – With nearly three decades of manufacturing experience and strength of several manufacturing facilities, ADL has today transformed into multi-tonne, multi-location GMP complaint with the state of the art facilities.

The company's manufacturing units are spread across Tarapur, Maharashtra and Sarigam, Gujarat. ADL's facilities are cGMP approved with certifications like USFDA, WHO GMP, EUGMP, TGA and ISO and are currently capable of making over 50 + bulk actives, several key intermediates/specialty chemicals. ADL has two R&D centers; one is located at MIDC Industrial area, Tarapur and the other at Turbhe, Navi Mumbai.

Capacity expansion – In line with the increasing demand and to reduce dependence on imports of key starting raw materials the company has also been expanding its capacities at regular intervals.

Production details (MT)	FY 14	FY 15	FY 16	FY 17	FY 18
Installed capacity	14460	15065	18584	22582	25714
Production	11482.07	12069.01	14287.6	17463.01	19261.47
Capacity utilization (%)	79.41%	80.11%	76.88%	77.33%	74.91%
Captive	2357.53	2637.23	2716.6	4052.7	3924.77
Net Production	9124.54	9431.79	11571	13410.31	15336.71

Source: Aarti Drugs Annual Reports

As can be seen from the above illustration, in the last 4 years the company has expanded its capacity by more than 75% and utilization levels in FY 18 were just short of 75%.

Anticipating higher demand, the management has outlined growth CAPEX of ~ 68 crore for FY 19.

Exports – Exports account for around 35-40% of the sales of the company. The company has been exporting to more than 100 countries and is planning to expand its presence in existing geographies with special focus on Europe, South East Asia and Latin America.

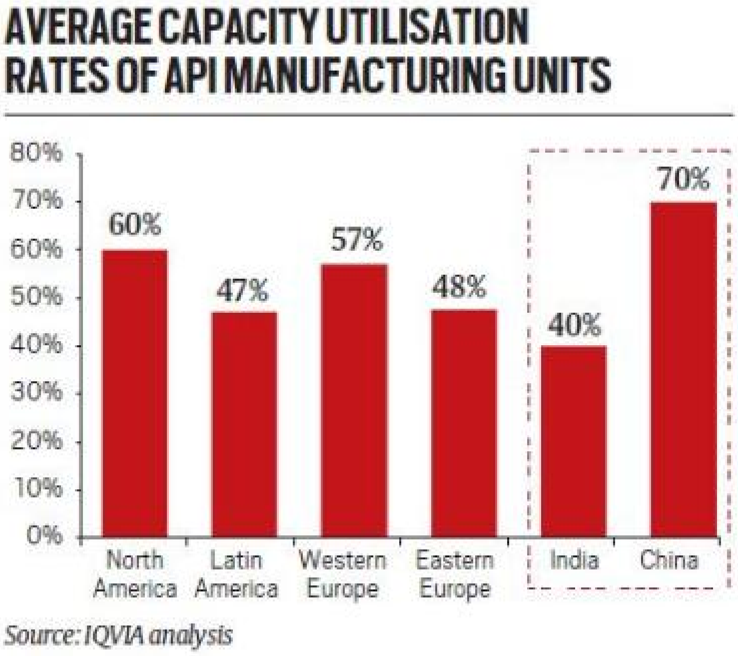
The Top 10 export countries for ADL are – Brazil, Mexico, Pakistan, Bangladesh, Turkey, Netherlands, Indonesia, Vietnam, Spain and Sudan.

Exports	FY 11	FY 12	FY 13	FY 14	FY 15	FY 16	FY 17	FY 18
Exports (in cr.)	215.37	280.71	322.19	395.68	411.71	389.19	425.68	446.42
Exports as % of sales	43.38%	42.58%	39.06%	40.79%	37.62%	34.29%	35.62%	35.90%

Source: Aarti Drugs Annual Reports

Since March 2015, US FDA has banned exports to the US from one of ADL's manufacturing facilities in Tarapur (Maharashtra); however, its impact is limited as exports to the US account for less than 1% of total sales.

Low cost producer of APIs – As per one of the studies, average capacity utilization rates of API manufacturing units in India is around 40% against 70% in China.



Source: Indianexpress

From the illustration shown above, we know that ADLs capacity utilization has consistently been above 70% and the management has already chalked out plans for further expansion.

ADL is able to achieve such high utilization rates on account of its scale of operations and backward integration capabilities.

What further helps the company are its R&D programmes that are focused on improvement of existing production processes by enhancing yields and reducing costs by optimization of reaction parameters, reaction re-engineering and implementing cost effective routes of synthesis.

Backward and forward integration – Company derives sales majorly from APIs and as a backward and forward integration measure it has started manufacturing key starting raw materials and formulations.

ADL has backwardly integrated for the manufacture of intermediates required for the manufacturing of Ciprofloxacin, Enrofloxacin, Oflaxacin, Levofloxacin, Norfloxacin, Nimesulide, Celecoxib and Ketoconazole.

Company’s subsidiary Pinnacle Life Science Private Limited is engaged in the manufacturing of formulations and sells generic formulations to its existing and new customers. The formulations business contributed 11% to the consolidated sales of the company.

Promoters/Management

Like several Indian companies, Aarti Drugs is largely an owner operated business with men at the helm of the affairs of the company being technocrats.

Company's CMD & CEO, Mr. Prakash M. Patil, holds a degree of B.E. – Chemical from Institute of Chemical Technology (ICT) [formerly known as University Department of Chemical Technology]. He has more than 40 years of experience in the field of Chemical & Pharmaceutical Industry. Similarly, company's MD, Mr. Rashesh C. Gogri holds a Production Engineering degree from Mumbai University. He has more than 16 years of experience in field of production, marketing and project implementation in chemical industry.

In owner operated companies it is important from shareholder's perspective that owners have high stake in the company and in the case of Aarti Drugs the promoters own more than 62% stake in the company. In fact what is good is that since several years now the promoters have been increasing their stake in the company through open market purchases and buy-backs.

Operating Performance

Particulars (in cr.)	FY 11	FY 12	FY 13	FY 14	FY 15	FY 16	FY 17	FY 18
Income from operations	496.42	659.26	824.84	969.94	1094.27	1134.88	1195.17	1243.63
Gross profit	155.39	205.7	269.57	307.41	344.17	368.17	414.72	460.97
Gross profit margin (%)	31.30%	31.20%	32.68%	31.69%	31.45%	32.44%	34.70%	37.07%
Op expenses as % of revenue	-18.69%	-19.49%	-18.20%	-16.79%	-16.24%	-17.40%	-19.06%	-21.11%
Operating Profit	62.62	77.19	119.43	144.54	166.41	170.73	186.88	198.48
Operating profit margin (%)	12.61%	11.71%	14.48%	14.90%	15.21%	15.04%	15.64%	15.96%
Other Income								
Interest income and other income	0.08	3.08	0.91	1.81	3.26	4.96	4.00	1.05
Finance charge	-13.48	-22.67	-28.03	-33.49	-38.93	-43.88	-36.42	-34.96
Depreciation	-17.74	-24.21	-25.98	-28.12	-31.02	-36.53	-38.46	-40.06
Profit Before tax (PBT)	31.48	33.39	66.33	84.74	99.72	95.28	116.00	124.51
Profit After tax (PAT)	22.47	22.46	45.24	60.79	77.25	68.72	81.8	82.31

Source: Aarti Drugs Annual Reports

Aarti Drugs has performed well over the years with steady growth in sales and profits while maintaining a healthy balance sheet.

Between FY 11 and FY 14 the company grew its sales at a CAGR of 25% and profits at a CAGR of 39%. Since FY 14 the growth in sales and profits has slowed down to 6.5% CAGR and 8% CAGR respectively.

Production details (MT)	FY 14	FY 15	FY 16	FY 17	FY 18
Installed capacity	14460	15065	18584	22582	25714
Production	11482.07	12069.01	14287.6	17463.01	19261.47
Capacity utilization (%)	79.41%	80.11%	76.88%	77.33%	74.91%
Captive	2357.53	2637.23	2716.6	4052.7	3924.77
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Source: Aarti Drugs Annual Reports

Despite 14% CAGR in volumes over the last 4 years, the growth has been moderate due to one-off events such as slow demand in Q1 of FY 18 in the run-up to implementation of Goods and Services Tax Act, fire at one of its plants in Q4 of FY 18 and lower than expected product realizations in FY 17.

As far as operating margins of the company are concerned, they have hovered largely in the range of 11-16%. What is noteworthy is that in the last 2 years the gross margins of the company have expanded from 31-32% to around 37% in FY 18, while at the same time the operating expenses (as a % of sales) have also inched up by around 400 basis points. We believe this could be on account of higher share of in-house manufacturing of key starting raw materials i.e. intermediates. While the gains haven't been much, the company has still been able to maintain and gradually improve its operating margins on year on year basis.

As the company still imports 40% of its raw materials from China, major fluctuations can impact its operating margins in the short term.

Important Numbers	FY 11	FY 12	FY 13	FY 14	FY 15	FY 16	FY 17	FY 18
ROAE (%)	15.10%	13.49%	23.56%	26.52%	27.64%	20.99%	21.91%	19.24%
Cash Flows from operations	12.77	19.11	44.27	61.94	65.66	89.4	138.33	34.8
Net working capital	131.63	184.73	224.7	253.07	311.74	325.13	309.47	392.94
Sales to working capital	3.77	3.57	3.67	3.83	3.51	3.49	3.86	3.16
Net Debt	240.26	292.97	317.63	374.29	444.32	478.58	475.32	541.98
Debt to Equity ratio	1.56	1.69	1.54	1.51	1.45	1.39	1.20	1.20

Source: Aarti Drugs Annual Reports

Besides maintaining decent growth in sales and profitability, ADL has also done well on other important metrics like return ratios, cash flows, balance sheet management, etc.

As can be seen from the above illustration, over the years the debt equity ratio of the company has improved from 1.56 to 1.20 while still maintaining Return on average equity at around 20% or more. Similarly, barring FY 18 the company has consistently maintained Sales to working capital ratio of more than 3.50. Even for FY 18, the decline in ratio is on account of higher stocking of inventory and it could probably be on account of disruption in China.

In the above illustration the reported Cash flows from operations have been adjusted for interest payments and therefore present a true picture of cash flow generation from operations and here as well the company has done reasonably well.

In our view, with expanded capacities in place, improvement in utilization rates, higher API prices and new launches in the space of both APIs and formulations, the company is likely to sustain 15% + CAGR in sales and profitability for the next few years.

Valuations

From the above sections we know that Aarti Drugs is a well managed company operating in the business of bulk drugs and formulations. The company has a long standing history of operations with reasonable growth in sales and profits across the years.

Over the last few years the company has managed to grow volumes at the rate of 14% per annum and considering the recent surge in the prices of APIs, the volume + value driven growth of the company could be higher over the next few years.

In keeping pace with the demand the company has been expanding capacities at regular intervals and that too without straining its balance sheet much. The company is also working on backward and forward integration through manufacturing of key starting raw materials and formulations and the same can be margin accretive in the longer run.

We also know that in the last 6-7 years the promoters have increased their stake in the company by more 7% and keep increasing their stake year on year.

Thus, considering the above factors we believe the valuations are reasonable at around 13-14 times trailing twelve months earnings while during the last 5 years it has traded in the range of 11 times to around 20 times earnings.

In case of really bad markets, the downside might be limited at around 15-20%.

Risks and Concerns

US FDA has banned exports to the US from one of ADL's manufacturing facilities in Tarapur (Maharashtra); while the contribution from US is minuscule, the ban does raise credibility issues.

In the past the company has faced closure of certain units on the directions of Maharashtra Pollution Control Board (MPCB). Such closures in future can impact the profitability of the company.

While company could pass on higher raw material prices to its customers in FY 18 and continues to increase captive manufacturing of intermediates for its APIs, it still imports around 40% of its raw material from China and any major fluctuation could impact its margins in the short term.

Chemical based industries are being regulated across the world as their discharge impacts the environment. While the company is working on zero effluent discharge, any further tightening will both increase the cost and may even cause disruptions in the operations of the company.

Disclosure: I don't have any investment in Aarti Drugs and have not traded in the stock in the last 30 days.

Best Regards,

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Rating Interpretation

Positive – Expected return of ~15% + on annualized basis in medium to long term for investment recommendations and in short term for Special situations
Neutral – Expected Absolute return in the range of +/- 15%

Negative – Expected Absolute return of over -15%
Coverage closure – No further update on the stock
% weightage – allocation in the subject stock with respect to equity investments

Short term – Less than 1 year
Medium term – Greater than 1 year and less than 3 years
Long term – Greater than 3 years

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Details of Associates: Not Applicable

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