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November 2019

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Company Name	: AARTI DRUGS
BSE Code	: 524348
Time Duration	: 2 years
CMP	: ₹507.40 (as on 06 Nov., 2019)
Target Price	: ₹715

Our Upstream Pick for the month of November is Aarti Drugs. The company is engaged in the manufacturing of active pharmaceutical ingredients (APIs), pharma intermediates, and specialty chemicals. It also manufactures formulations through its wholly owned subsidiary- Pinnacle Life Science Private Limited. Products under APIs include Ciprofloxacin Hydrochloride, Metronidazole, Metformin HCL, Ketoconazole, Ofloxacin, and Diclofenac derivatives, whereas, specialty chemicals includes Benzene Sulphonyl Chloride and Methyl Nicotinate.

We have chosen Aarti Drugs as our Upstream Pick as the company has been reducing its dependency on Chinese raw materials by setting up a backward integration. This move would not just help the company reduce risk of supply interruption but also would aid in expanding margins. Moreover, it is also focusing on new filing in the overseas market, which is a high margin business.

Strong API business

The company's API portfolio consists of 50+ API molecules with monthly API capacity of 2480MT. Within the API segment, antibiotic therapeutic category contributes to around 41 per cent, anti-protozoals around 17 per cent, anti-inflammatory around 13 per cent, followed by anti-diabetic, antifungal and cardio-protectant therapeutic categories as of FY19.

During Q2FY20, the domestic sales of the API segment grew by approximately 46.5 per cent and the exports rose by 26.57 per cent. The entire growth of the API segment was driven by the volume growth. In the same quarter, the revenue of the formulation segment increased by approximately 29.75 per cent on year-on-year (Y-o-Y) basis.

Pinnacle Life Science to capitalize the core API strengths

Pinnacle Life Science Private Limited (PLSPL), a wholly owned subsidiary of Aarti Drugs, capitalizes the core API strengths of its parent company and engineers most of its formulations in a cost-effective way. PLSPL contributes around 9.7 per cent to Aarti Drugs' revenue and has opened more avenues of exports for the company. It started operating commercially in Latin America and selective African markets with new registration for export and government tenders.

Setting up raw material plant would drive margins

Aarti Drugs imports around 35 per cent of its raw material from China due to price advantage. The last year's environmental issues in China caused the shortage of a few raw materials, which led to increased input costs and severely affected margins. To deal with this, the company is setting up a plant to produce CPA, a major raw material, itself, thereby, decreasing reliance upon China. This step is expected to aid the margins going ahead.

Exports to further drive the growth

As of FY19, Aarti Drugs' exports unit contributed around 38 per cent to the total revenue. The company posted 27.33 per cent Y-o-Y growth in its export revenue in the last fiscal. It expects to file new drug master files (DMFs) and update the existing ones in FY20 with global regulatory authorities. This would help increase exports of generic APIs to the regulated markets with better margins.

With 14 per cent share, India is the largest exporter of pharma formulations in the global market. The country stands at twelfth position in terms of export value and touched an overall valuation of US\$12.92 bn in FY19. India's strong position in the pharmaceutical market is also anticipated to provide enormous opportunities to the company. The export business is marginally lucrative for the company, which in turn would boost its profitability.

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Expansions

Aarti Drugs has recently expanded its anti-diabetic facility which will double the capacity and make the company one of the largest metformin players in the world. In Antiprotozoal, the company has further increased its capacity to curtail the imports. The civil construction is in place for its multipurpose facility of vitamins/anti-inflammatory segment to target the highly regulated markets, where proposed installed capacity can contribute 35 crores-50 crores per annum.

Strong financials

Looking at the recently concluded quarter Q2FY20, the consolidated revenue came in at Rs. 477.5 crore as against Rs. 347.41 crore in the corresponding quarter last year, registering 37.4% yoy increase. The EBITDA for the quarter grew by 45.4% yoy to Rs. 68.3 crore as against Rs. 46.99 crore in the corresponding quarter last year, with a corresponding margin expansion of 78 bps. EBITDA margin for the quarter stood at 14.3%. The PAT for the quarter came in at Rs. 32.31 crore as against Rs. 18.05 crore in the corresponding quarter last year, yoy increase of 79%.

Outlook

Aarti Drugs' return ratios, viz. ROCE and ROE, stand at comfortable levels of 17.4 per cent and 18.34 per cent, respectively. The company has reduced its debt recently, which has resulted in the D/E of 0.83x in September 2019 against 0.9x in March 2019. Its focus on high margin export business, coupled with backward integration and expansion, bodes well. The stock is trading at TTM P/E of 12.33x. Considering the abovementioned factors, we see a potential upside of 41 per cent with a target price of Rs. 715 over a period of two years.

Inc/Exp Statement(Consolidated) (Rs in Crore)

Description	201903	201803	201703	201603	201503
Net Sales	1560.94	1243.63	1195.17	1139.84	1096.88
Total Income	1567.12	1244.68	1199.18	1139.84	1097.53
Total Expenditure	1350.03	1041.76	1004.68	960.02	924.51
PBIDT	217.09	202.92	194.49	179.82	173.02
PAT	89.75	82.31	81.80	68.72	77.25
Dividend %	10.00	10.00	10.00	67.50	130.00
Adj. EPS(Rs)	38.06	34.90	34.29	28.38	31.90

Quarter On Quarter (Consolidated) (Rs in Crore)

Particulars	201909	201906	Q on Q Var%	201809	Y on Y Var%
Net Sales	477.50	405.43	17.78	347.41	37.45
Total Expenditure	409.20	350.72	16.67	300.42	36.21
PBIDT (Excl OI)	68.30	54.71	24.84	46.99	45.35
PAT	32.31	22.45	43.92	18.05	79.00
PBIDTM% (Excl OI)	14.30	13.49	6.00	13.53	5.69
PBIDTM%	14.34	13.51	6.14	13.55	5.83
PATM%	6.77	5.54	22.20	5.20	30.19
Adj. EPS(Rs)	13.87	9.64	43.88	7.65	81.31



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