Specialty Chemicals

A balanced equation

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Edelweiss
Ideas create, values protect

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Executive Summary

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India's specialty chemicals industry has clocked 12% growth over FY07–18. In spite of rising environmental concerns and sharpening cost focus, the sector has sufficient dry powder to sustain this pace led by: 1) burgeoning underlying demand from end-user industries; 2) outsourcing opportunity from the West; and 3) emerging export and import substitution opportunities due to the clampdown on chemicals manufacturing in China. While these drivers create a conducive environment for the entire chemicals universe, we argue specialty chemicals players – owing to strong entry barriers and high growth visibility (10–15% end-user industry growth) – are poised to benefit the most. Moreover, the industry has, in order to capture the promising potential, prudently increased capex by 60%-plus cumulatively over FY19–21 versus FY16–18, which we believe would pay rich dividends.

However, current valuations seem to be factoring in strong optimism and turning a blind eye to potential risks (hazardous nature, tightening environmental norms, etc) inherent to industry like chemicals. Hence, though structurally positive (highlighted in our report *The right chemistry*) on the sector, we remain cognizant of its frothy valuations and await a better price opportunity. Valuation concerns underpin our 'HOLD' recommendation on Aarti Industries. Despite the pick-up in the global agrochemicals market, we are downgrading PI Industries and SRF to 'HOLD' primarily due to their sharp run-up recently. We are also initiating coverage on: a) Galaxy Surfactants with 'BUY' as we see exaggerated short-term concerns undermining its strong business model; and b) Fine Organics with 'HOLD' due to the rally in its shares. We have also featured SH Kelkar and Vinati Organics in this report.

Chemicals: Strong structural growth opportunity

The domestic chemical industry is estimated to clock 9.3% CAGR over FY18-25, outpacing the global counterpart's 5.5% CAGR. We envisage this outperformance to be driven by several catalysts: i) **burgeoning domestic demand**: India's most valuable resource is its domestic market—10-15% p.a. spurt in key end-user industries is estimated to propel the chemical market; ii) **import substitution**: Improvement in supply chain solutions & technology is bound to spur manufacture of petrochemical intermediates; iii) **low per capita consumption**: India's per capita chemical products' consumption at 1/10th the world average indicates huge untapped potential; and iv) **policy push**: Government's *Make in India* initiative encouraging local production entails the potential to spark huge investments in India.

Burgeoning outsourcing opportunities: China's pain is India's gain

We believe, uncompetitive cost structures in the US & Europe and stringent pollution control norms / high effluent treatment cost will continue to drive the outsourcing opportunity. Rising environmental concerns and strict government actions have taken the sheen off China's chemical industry. MNCs are now de-risking their sourcing arrangements and looking to add an Indian source—a major positive for Indian companies. Domestic players, underpinned by strong relationships with global players/MNCs, score high on tapping this opportunity. Moreover, China contributes 35-40% to the global chemical industry (~USD2tn) and the recent clamp down on the country's chemical manufacturing offers further growth opportunity to India. Given its large size, even a minuscule shift of trade flow from China to India can accelerate the latter's growth manifold.

Specialty chemicals: Promising USD87bn opportunity by FY25E

The domestic chemical industry was valued at USD163bn in 2018, of which the specialty chemical industry constituted USD35.9bn (~22%). We estimate the latter to catapult to USD86.5bn by FY25 driven by: i) robust 10-15% growth in end-user industries like home & personal care, packaging, polymer, adhesives, etc; ii) emerging export opportunities led by clamp down in China & outsourcing opportunity from the West fuelling exports & import substitution; iii) domestic companies' sustained R&D investments entrenching their global leadership in certain products or processes; iv) presence in diversified segments mitigating the risk of single-sector dependency; and v) forward-integration enhancing players' utilisation of by-products and ensuring stable margins.

Strong entry barriers and aggressive capex ensure sustainable growth

Strong entry barriers in the form of lengthy & stringent product approvals / registration process, vendor acquisition, customer stickiness, adherence to and consistency in achieving end results, among others, ensure sustainable growth for specialty chemical companies. Driven by robust growth visibility and emerging opportunities, companies have accelerated their capex plans. India's chemical sector (other than fertiliser) attracted FDI investment of USD1.3bn in FY18, ~3% of the total FDI inflow. Further, domestic and overseas companies are investing in either greenfield or brownfield projects across the value chain—upstream, petrochemicals, commodity chemicals, specialty chemicals and even in downstream chemistries. The aggregate capex of our specialty chemical universe at INR61.7bn over FY19-21E is likely to be 60% higher compared to INR37.7bn over FY16-18.

Current divergence in valuations favours high growth companies

We believe, the chemical/specialty chemical sector offers strong structural growth opportunity over the medium to long term driven by multiple growth drivers. However, valuations of these companies already factor the optimism and these potential growth drivers are dwarfing risks related to the sector like hazardous manufacturing process resulting in fire, human casualties, frequent plant closure, etc. The sector also faces regulatory risk like further tightening of pollution norms in India and strict adherence requiring companies to accelerate their capital spending, which could impact profitability.

This optimism is also reflected in divergence of valuations of specialty chemical companies. While players with high growth potential in the near term driven by disruption in China (AIL, SRF, PI—riding aggressive capex) are trading at 20-40% premium over the industry average, slow but steady growth players like Galaxy Surfactants (derive growth from FMCG industry and enjoy strong entry barriers) are trading at 15-20% discount. We believe, these companies with green and clean chemistries (generally catering to FMCG, personal care industries) should also enjoy premium to other players.

Key risks

Chemical/specialty chemical remain global commodities and are, therefore, prone to risk of currency and commodity cycle. As a large part of raw material/intermediates is crude derivatives, volatility in crude prices significantly impacts earnings of companies. Moreover, although the sector has reaped benefits of clamp down on chemical manufacturing in China over the past one-three years and continues to do so, uncertainty on China continuing to tighten its pollution norms poses a serious risk and weakens predictability of earnings of companies.

Top picks

Though confident of strong growth prospects (highlighted in our note, **The right chemistry**), we are cognizant of frothy valuations after the recent run up in stocks by 30-40%. Hence, we await a better price opportunity.

We recommend 'HOLD' on AIL and downgrade PI & SRF to 'HOLD' primarily due to the recent run up in the stocks despite pick up in the global agrochemical market. We also **initiate coverage** on R&D and innovation driven companies: a) **Fine Organics:** Strong beneficiary of application-based capabilities in plastic additives and food emulsifiers with **'HOLD'** due to sharp run up in the stock price; and b) **Galaxy Surfactants:** Enjoys leadership in performance and specialty surfactant markets where its strong relationships with MNCs is supporting growth globally. We recommend **'BUY'** as we see exaggerated short-term concerns undermining the strong business model. The report also features other industry leaders like **SH Kelkar** and **Vinati Organics**.

Table 1: Recommendation table

Company	Reco.	CMP (INR)	Mcap (INR Bn)	TP (INR)	Upside (%)	Target multiple (P/E)	EPS CAGR (FY19-21E)	ROCE (FY19)	Investment rationale
Aarti Industries Ltd	HOLD	1,716	149	1,851	8%	25	24	18	Aarti Industries (AIL), India's largest specialty chemical player is the biggest beneficiary of growing opportunity in specialty chemicals due to its diversified presence. To cash in on the burgeoning opportunity, AIL is doubling capex over FY18-21E to INR31bn
Fine Organic Industries Ltd	HOLD	1,421	44	1,535	8%	30	12	44	Fine Organics Industries (FOIL) is a leading player catering to global markets in various oleochemical-based additives used in plastic, polymer, food emulsifiers, cosmetics, etc. A niche, but expansive product basket, diversified customer base, stringent & lengthy product approvals and in-house developed technology underpin the company's dominant position in the global market
Galaxy Surfactants Ltd	BUY	1,200	43	1,405	17%	22	13	29	Galaxy Surfactants (GSL) is India's leading manufacturer of surfactants and other specialty ingredients for home & personal care (HPC). A 200 plus product portfolio in fast-growing oleochemicals, clientele including MNCs and regional players with leading presence in high growth potential markets of India & Africa, Middle East and Turkey (AMET), place GSL ideally to benefit from structural growth opportunity
PI Industries Ltd	HOLD	1,193	165	1,276	7%	30	25	25	PI Industries' (PI) CSM business (65% of sales) is strong beneficiary of uptick in the global agrochemical cycle. Further rise in enquires from customers burgeoning order book (USD1.3bn) supports growth. To capture the potential opportunities, the company has increased capex to INR3bn p.a. over the next two-three years. New product launches and a concentrated basket of specialty products is likley to drive its domestic business
SRF Ltd	HOLD	2,972	171	2,983	0%	SOTP	20	15	SRF is well diversified with a presence in refrigerant gases and speciality chemicals (34% of EBIT), packaging films (36%) and technical textiles (32%). The company is a strong beneficiary of the pick-up in global agrochemicals and expects the segment to grow 40–50% in FY20. Furthermore, doubling of capacity by FY20 is expected to drive a 20% top-line CAGR in the fluorochemical business

Source: Edelweiss research

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Chart 1: Global specialty chemical industry to clock 5% CAGR

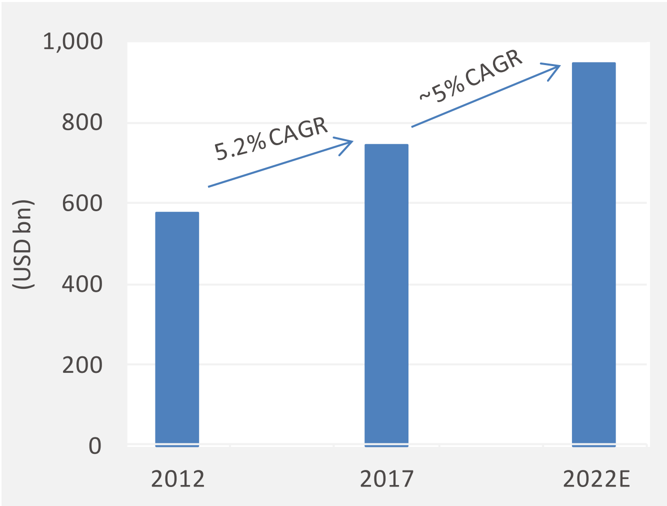
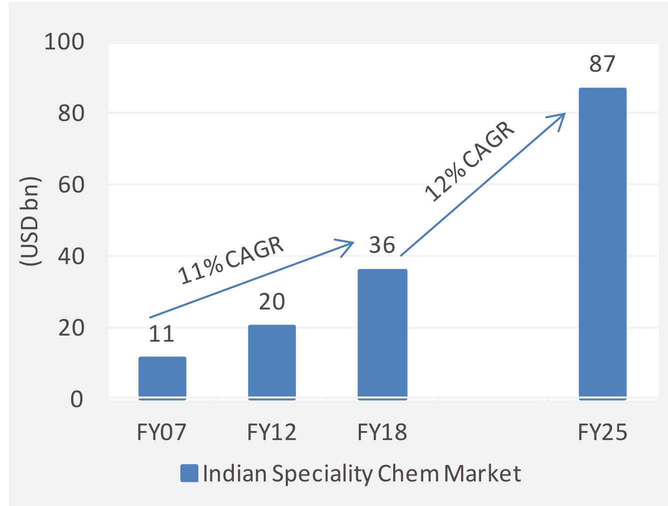


Chart 2: Indian specialty chemical industry to post 12% CAGR



Source: FICCI, Edelweiss research

Chart 3: Industry size and growth for specialty chemicals

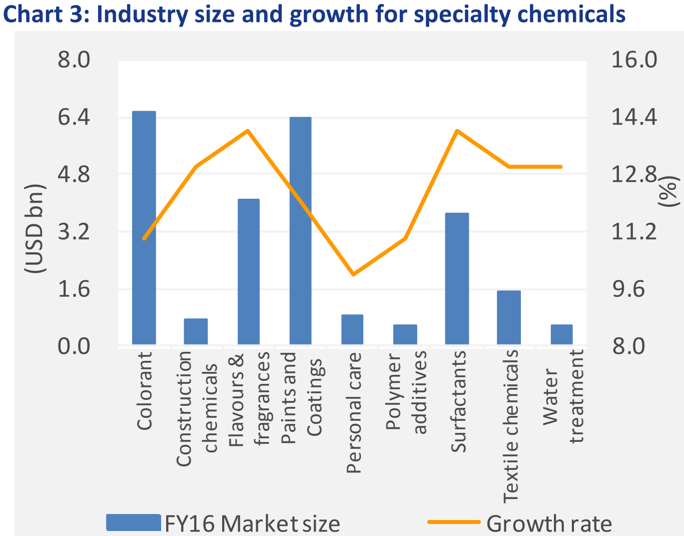
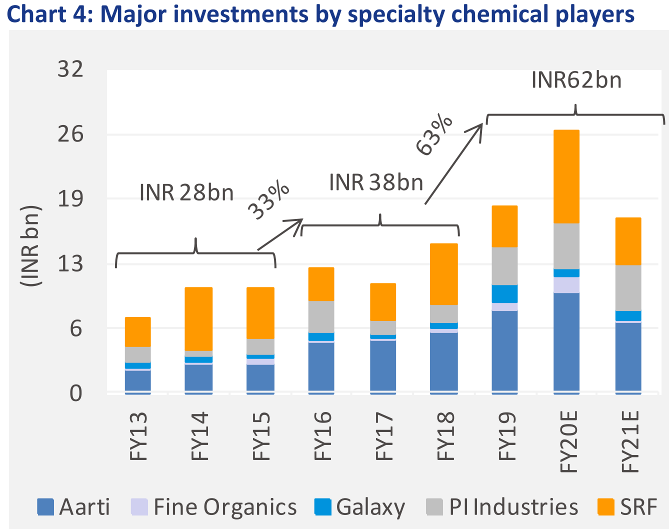


Chart 4: Major investments by specialty chemical players



Source: FICCI, Company, Edelweiss research

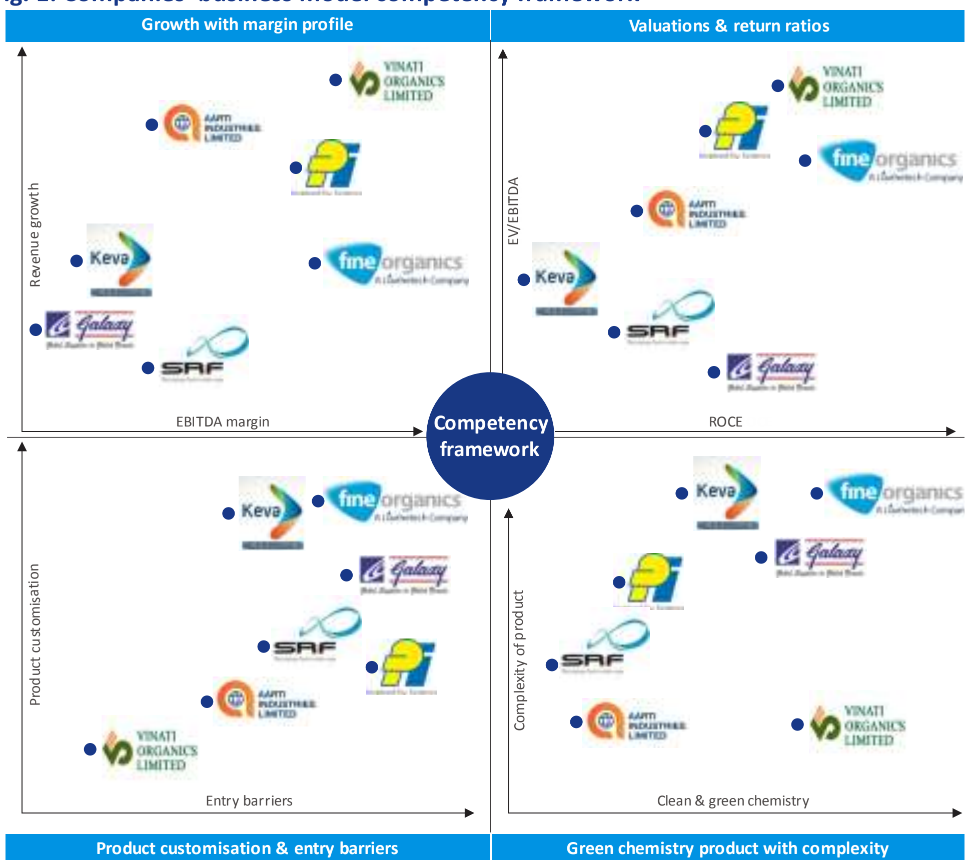
Investment Thesis

Opportunity in divergence

Specialty chemical companies have a distinguished and differentiated business model. Players like Galaxy Surfactants, Fine Organics, SH Kelkar, among others, catering to user industries like FMCG, HPC and food ingredients, enjoy **strong entry barriers and higher level of product customisation**. This creates a resilient business model with stable growth.

Companies following **green chemistry** like vegetable oil-based oleo chemical derivatives—Galaxy Surfactants, Fine Organics—are better placed than petrochemical-based players like AIL, SRF, PI, etc. Companies with commodity nature of products like Vinati Organics and AIL face tough competition compared to those with **complex processing** like Fine Organics, Galaxy Surfactants and PI.

Fig. 1: Companies' business model competency framework



Source: Edelweiss research

We believe, riding strong growth opportunity and enhanced visibility driven by capex, AIL, Vinati Organics, PI and SRF (chemical segment) entail higher growth potential in the near term and enjoy high EBITDA margin. However, Galaxy Surfactants, Fine Organics and SH Kelkar offer stable revenue stream as growth in their respective user industries remains limited. We have tried to map this competency framework with growth and valuations and identify opportunities where there is divergence in this framework.

Diversified business models are better placed

We believe, companies like AIL, which cater to diversified user industries, are better placed than those with concentration in one sector like SRF and PI who have suffered in the past due to weakness in the global agrochemical market. Further, companies like Galaxy Surfactants and SH Kelkar have clocked sustained revenue growth by virtue of being linked with stable FMCG / personal care focused companies.

Table 2: Companies' business model

Parameters	Aarti Industries	Fine Organics	Galaxy Surfactants	PI Industries	SH Kelkar	SRF	Vinati Organics
User industry	Diversified user industry with presence in agrochemicals, pigments, inks, polymers, pharma, etc	Catering to plastic & polymers, food, bakery and confectionary industries	Focused player on performance and specialty surfactants mainly catering to home & personal care industry	Business includes domestic formulation in agrochemicals and specialty chemicals is concentrated towards agrochemicals	Focused player in flavours and fragrance industry catering to FMCG industry largely home & personal care segment	Conglomerate with presence in packaging film, technical textile, refrigerant gases and specialty chemicals is concentrated towards agrochemicals	Product focussed company catering primarily to pharma and paints and coatings industry
Chemistry / Expertise	Presence in various chemistries like Benzene, chlorination, nitration, hydrogenation, toluene etc	Application based oleo chemical derivatives	Application based oleo chemical derivatives	Various chemistries with strong process reengineering capabilities	Application based various inputs	Focused on fluorine based chemistry	Product focussed approach / chemistry
Growth opportunity	Large - due to diversified product basket and capabilities in various chemistries	Moderate growth in domestic market. However, expansion in global markets can provide high growth	Moderate growth in domestic market. However, expansion in global markets can provide high growth	Moderate due to high concentration of agrochemicals industry	Moderate growth in domestic market. However, expansion in global markets can provide high growth	Moderate due to high concentration of agrochemicals industry	Moderate to high product concentration and significant market share in current products
Diversification	Diversified large product basket with 125+ products, 650+ clients	Very diversified large product basket with 400+ products marketed to 650 direct customers and 130 distributors in 70+ countries	Very diversified large product basket with 200+ product grade, 1750+ clients in 75+ countries	Basket of 30-40 products catering to leading global agrochemicals	High entry barriers due to presence in FMCG / consumers segment	Basket of 30-40 products catering to leading global agrochemicals - intermediaries	Basket of 15-20 products catering to pharma, water treatment chemicals. and paints and coatings industry

Source: Edelweiss research

Table 3: Companies with end-user industries

	Agro-chemicals	Flavours and fragrance	Pharma - CRAMS / Pharma	Polymer additives	Food additives	Surfactants	Colorants (including dyes and pigments)	Personal Care	Construction Chemicals	Paints and Coatings
Aarti Industries	✓		✓	✓		✓	✓	✓		✓
Fine Organics				✓	✓					
Galaxy Surfactants						✓		✓		
PI Industries	✓									
S H Kelkar		✓						✓		
SRF	✓		✓							
Vinati Organics			✓							

Source: Edelweiss research

Valuations

Rerating, sustained earnings spur specialty chemicals' strong returns

Specialty chemical companies have generated strong returns over the past one-five years spearheaded by robust earnings spurt and the sector's rerating. FY13-19 EPS CAGR for AIL stood at 24%, 17% for PI and SRF's was at 32%. The strong earnings growth is also reflected in increase in valuation multiple as current one-year forward P/E for the sector (AIL, PI, SRF) has jumped to 24x from 16x over FY14-16. Rising growth visibility driven by solid growth in user industries and burgeoning exports opportunity led by production clamp down in China are driving the sector's rerating.

Chart 5: Key chemical company's 5 year stock performance

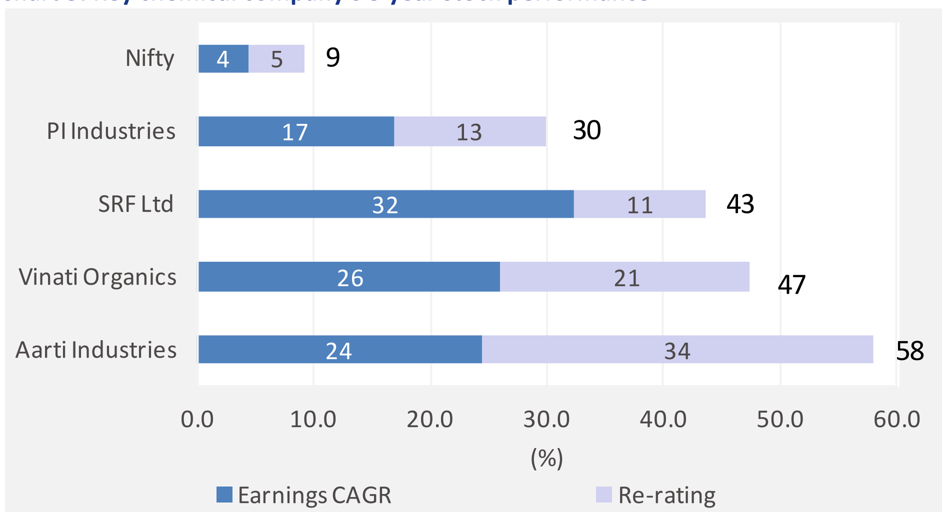
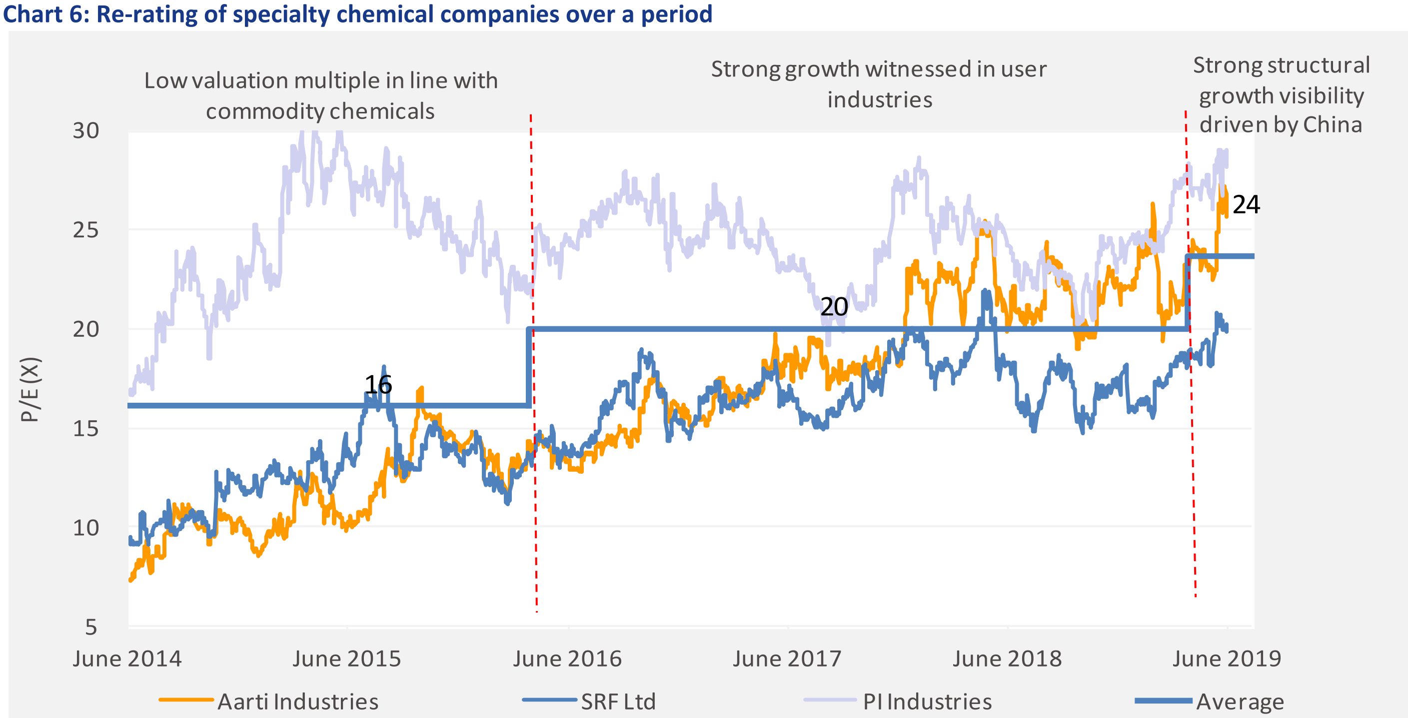


Chart 6: Re-rating of specialty chemical companies over a period



Note: n.a.- not available

Source: Bloomberg, Edelweiss research

P/E based valuation to capture earnings growth momentum

We have used P/E multiple-based valuation approach given momentum in earnings growth. We have assigned different P/E multiples for each company based on its competency framework, growth opportunity and return ratio. However, we have also looked at the EV/EBITDA multiple of these companies and compared it with global peers.

As the specialty chemical sector is likely to witness strong structural growth opportunity, we have also used three-stage DCF model for validating our target price. Our DCF model captures estimated FCF for explicit period of FY19-21E, five years of high growth phase over FY22-26 and five years of moderate growth over FY27-31.

DCF valuations imply 15-23% growth and PEG>1

Our DCF analysis indicates that current stock prices are factoring much stronger growth of 20-22% in the high-growth phase (FY22-26) versus 10-14% reported over FY14-19. Though we acknowledge that structural changes in the sector will help companies grow at a faster pace, we believe sustaining 20-22% revenue CAGR could be challenging.

As these companies also entail strong earnings growth, we have looked at PEG ratios of these companies— most players' PEG >1. This also reflects that current valuations are factoring strong optimism in the sector.

Chart 7: DCF implied growth rate at target price

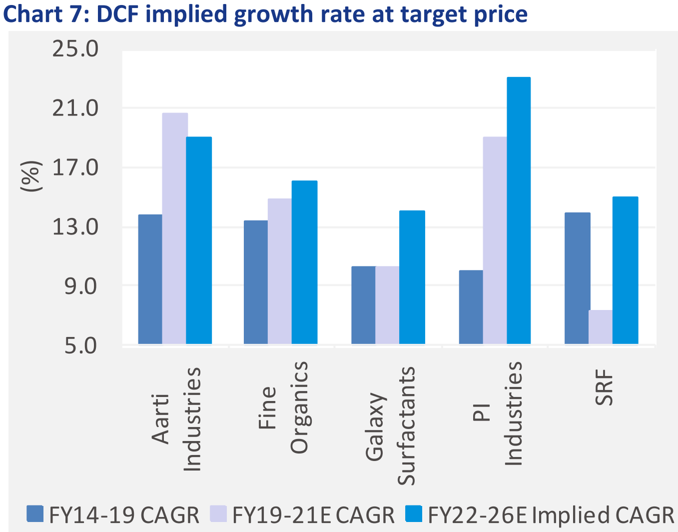
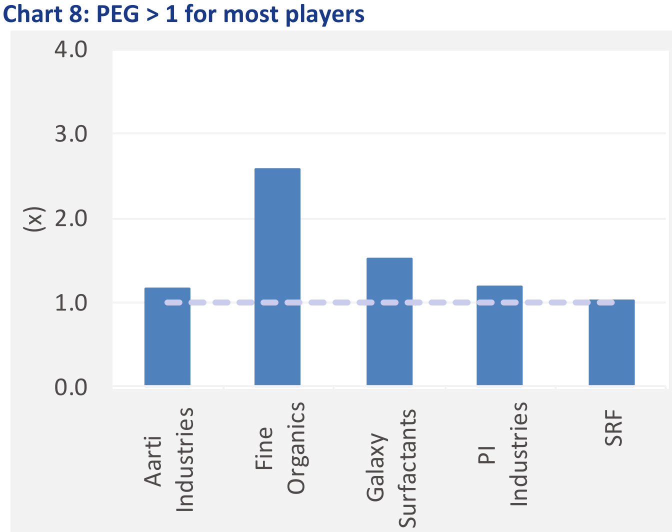


Chart 8: PEG > 1 for most players



Source: Edelweiss research

Structural growth story at expensive valuation

As we remain confident about strong growth opportunity in the specialty chemical space, we are cognizant of the sector's expensive valuation, which has inched up further over the past three months with stock returns of 30-40%. **Though we find clear opportunity in Galaxy Surfactants ('BUY'), we believe current valuations of AIL ('HOLD'), Fine Organics ('HOLD'), PI (HOLD) and SRF ('HOLD') are factoring near-term growth potential.**

Though recovery in global agrochemicals has enhanced earnings growth visibility in SRF and PI in the near term, we believe companies with diversified user industries like AIL are better placed in the long term to benefit from the structural growth. Fine Organics, with its niche product portfolio, will continue to grow post commissioning of its new plant.

Currently, companies with high margin (EBITDA margin of >20%) and high return ratios (ROCE of >25%) like PI, Vinati Organics and Fine Organics are trading at lofty valuations (FY20E P/E of >30x). However, relatively lower revenue growth (12-15%) and lower margin (EBITDA margin of 12-15%) players like Galaxy Surfactants and SH Kelkar with strong entry barriers and green chemistry are trading at a discount (FY20E P/E of <20x) and thus offer attractive investment opportunity. Players with high growth potential like AIL, PI and SRF offer strong earnings growth (FY19-21E EPS CAGR of >20%), but the same is factored in current valuations.

Table 4: Valuation snapshot

			Mcap		P/E (x)			ROCE (x)		CAGR % (FY19-21)		
Company	**CMP (INR)**	**TP (INR)**	**(INR Bn)**	**Reco.**	**FY19**	**FY20E**	**FY21E**	**FY19**	**FY21E**	**Sales**	**EBITDA**	**PAT**
Companies under coverage:												
Aarti Industries	1,716	1,851	149	HOLD	30.8	27.3	20.2	18.4	19.3	20.6	18.2	23.6
Fine Organic Industries	1,421	1,535	44	HOLD	32.0	30.6	25.5	43.8	33.3	14.8	10.2	12.1
Galaxy Surfactants	1,200	1,405	43	BUY	22.3	20.4	17.4	28.7	25.6	10.2	10.2	13.1
PI Industries	1,193	1,276	165	HOLD	40.1	30.9	25.6	25.4	27.1	19.1	23.3	25.1
SRF Ltd	2,972	2,983	171	HOLD	25.8	21.0	17.9	14.9	18.1	7.3	16.2	20.2
Companies not under coverage:												
SH Kelkar*	138	n.a.	20	n.a.	22.5	19.6	16.4	7.1	10.4	14.4	26.4	17.2
Vinati Organics*	2,108	n.a.	108	n.a.	38.3	32.7	27.1	30.7	40.1	26.2	22.7	19.0

Source: Company, Bloomberg, Edelweiss research

*Note: * Bloomberg estimates*

Our recommendations

Aarti Industries (MCAP INR148.7bn; CMP: INR1,716; TP: INR1,851; HOLD)

AIL, India's largest specialty chemical player, has been the biggest beneficiary of burgeoning opportunity in specialty chemicals. To cash in on the burgeoning opportunity, AIL is doubling capex over FY18-21E to INR31bn. Led by accelerated capex and two large products (~INR9bn revenue p.a.) commissioning in FY20/21, the company enjoys strong growth visibility with FY19-21E EPS CAGR of 24%. That said, while strong structural growth in specialty chemicals is apparent, a sharp run-up in the stock limits upside potential in the near term. Hence, maintain **'HOLD'** with target price of INR1,851, based on 25x September 2020E EPS.

Fine Organics (MCAP INR43.6bn; CMP: 1,421; TP: INR1,535; HOLD)

Fine Organics (FOIL) is a leading player catering to global markets in various oleochemical-based additives used in plastic, polymer, food emulsifiers, etc. A niche, but expansive product basket, diversified customer base, stringent & lengthy product approvals and in-house developed technology underpin the company's dominant position in the global market. We believe, FOIL's higher market share in the oleochemicals additives space and above industry ROCE of 35% plus demand premium valuation. We value the stock at 30x September 2020E EPS and arrive at TP of INR 1,535. However, due to limited upside, we initiate with **'HOLD'.**

Galaxy Surfactants (MCAP INR42.5bn; CMP: 1,200; TP: INR1,405; BUY)

Galaxy Surfactants (GSL) is India's leading manufacturer of surfactants and other specialty ingredients for home & personal care (HPC). We believe: 1) a 200 plus product portfolio in fast-growing oleochemicals; 2) diversified geographical footprint & clientele including MNCs and regional players; and 3) leading presence in high growth potential markets of India, Africa, Middle East and Turkey (AMET), place GSL ideally to benefit from the structural growth opportunity. Moreover, we envisage healthy return ratios (ROCE of 25% plus) coupled with robust earnings growth (13% CAGR over FY19-21E) to keep the valuation multiple high. Hence, we initiate with **'BUY'** and September 2020E target price of INR1,405 (22x P/E).

PI Industries (MCAP INR164.6bn; CMP: INR1,193; TP: INR1,276; HOLD)

PI Industries' (PI) CSM business (64% of FY18 sales) has reported muted growth over the past two years due to sluggish global agrochemical demand. However, management is confident of growth bouncing back in the segment led by: a) uptick in the global agrochemical cycle; b) rise in enquires from customers; and c) burgeoning order book (USD1.3bn). To capture the potential opportunities, the company has increased capex to INR3bn p.a. over the next two-three years. Bolstered by strong earnings growth (19% EPS CAGR over FY18-21E), 25% ROCE and overall optimism in specialty chemicals, we believe the stock should trade at a premium multiple. We recommend **'HOLD'** with TP of INR 1,276 based on 30x Q2FY21E EPS.

SRF (MCAP INR170.8bn; CMP: INR2,972; TP: INR2,983; HOLD)

SRF is well diversified with presence in refrigerant gases and specialty chemicals (34% of EBIT), packaging films (36%) and technical textiles (32%). The company is a strong beneficiary of the pick up in global agrochemicals and estimates the segment to grow 40–50% in FY20. However, the packaging films and technical textiles businesses may face margin pressure with new capacity additions in Q2/Q3FY20 and weak demand, respectively. Nevertheless, with chemicals picking up, we expect overall PAT CAGR to spike from 13% over FY17–19 to 20% over FY19–21E. We believe, while current valuation factors near-term growth potential, long structural growth opportunities will sustain. We recommend **'HOLD'** with SOTP-based TP of INR2,983.

Table 5: Financial summary

Company	Reco.	CMP (INR)	Mcap (INR Bn)	TP (INR)	Upside (%)	CAGR % (FY19-21) Sales	EBITDA	PAT	RoCE (%) FY19	FY21E	RoE (%) FY19	FY21E
Aarti Industries Ltd	HOLD	1,716	149	1,851	7.9	21	18	24	18.4	19.3	22.1	20.7
Fine Organic Industries Ltd	HOLD	1,421	44	1,535	8.0	15	10	12	43.8	33.3	30.4	25.9
Galaxy Surfactants Ltd	BUY	1,200	43	1,405	17.1	10	10	13	28.7	25.6	23.9	21.3
PI Industries	HOLD	1,193	165	1,276	7.0	19	23	25	25.4	27.1	19.5	21.1
SRF Ltd	HOLD	2,972	171	2,983	0.4	7	16	20	14.9	18.1	17.2	18.2

	Revenue (INR Mn)			EBITDA (INR Mn)			PAT (INR Mn)			Capex (INR Mn)		
Company	FY19	FY20E	FY21E	FY19	FY20E	FY21E	FY19	FY20E	FY21E	FY19	FY20E	FY21E
Aarti Industries Ltd	50,142	58,544	72,910	9,706	10,705	13,563	4,834	5,455	7,378	8,209	10,000	7,000
Fine Organic Industries Ltd	10,603	11,858	13,973	2,302	2,330	2,794	1,363	1,426	1,711	818	1,500	300
Galaxy Surfactants Ltd	27,630	30,538	33,581	3,534	3,780	4,292	1,910	2,085	2,443	1,802	924	1,000
PI Industries	28,409	34,114	40,272	5,764	7,184	8,762	4,102	5,317	6,415	3,668	4,500	4,500
SRF Ltd	76,927	79,695	88,556	13,790	16,491	18,623	6,601	8,132	9,533	3,964	9,000	4,500

	Gross Margin (%)			EBITDA Margin (%)			Net Debt Equity (x)			Fixed asset turnover (x)		
Company	FY19	FY20E	FY21E	FY19	FY20E	FY21E	FY19	FY20E	FY21E	FY19	FY20E	FY21E
Aarti Industries Ltd	41.1	40.6	41.0	19.4	18.3	18.6	0.5	0.5	0.4	1.5	1.4	1.5
Fine Organic Industries Ltd	38.2	37.0	37.0	21.7	19.6	20.0	0.0	0.1	-0.1	4.4	3.7	3.4
Galaxy Surfactants Ltd	29.5	28.7	28.8	12.8	12.4	12.8	0.3	0.1	0.0	2.9	2.8	2.7
PI Industries	45.4	46.2	46.9	20.3	21.1	21.8	-0.1	-0.1	-0.1	2.1	2.0	1.9
SRF Ltd	43.3	47.9	47.9	17.9	20.7	21.0	0.7	0.6	0.4	1.2	1.1	1.1

	EPS (INR)			EV/Sales (x)			EV/EBITDA (x)			P/E (x)		
Company	FY19	FY20E	FY21E	FY19	FY20E	FY21E	FY19	FY20E	FY21E	FY19	FY20E	FY21E
Aarti Industries Ltd	55.8	62.9	85.1	3.2	2.9	2.3	16.8	15.7	12.3	30.8	27.3	20.2
Fine Organic Industries Ltd	44.4	46.5	55.8	4.1	3.7	3.1	18.9	18.9	15.4	32.0	30.6	25.5
Galaxy Surfactants Ltd	53.9	58.8	68.9	1.6	1.4	1.3	12.7	11.7	9.9	22.3	20.4	17.4
PI Industries	29.7	38.6	46.5	5.7	4.8	4.0	28.2	22.6	18.4	40.1	30.9	25.6
SRF Ltd	115.0	141.6	166.0	2.6	2.5	2.2	14.5	12.1	10.4	25.8	21.0	17.9

	Sales CAGR (%)				EBITDA CAGR (%)				PAT CAGR (%)			
Company	1 Year	3 Year	5 year	10 year	1 Year	3 Year	5 year	10 year	1 Year	3 Year	5 year	10 year
Aarti Industries Ltd	31.7	18.6	13.8	13.1	38.8	19.3	19.3	11.9	45.2	23.5	24.4	24.5
Fine Organic Industries Ltd	22.6	15.6	23.2	n.a.	45.3	16.6	28.8	n.a.	42.9	21.2	30.2	n.a.
Galaxy Surfactants Ltd	13.5	15.3	10.2	n.a.	22.8	14.9	10.4	n.a.	20.9	23.0	20.2	n.a.
PI Industries	25.0	11.0	10.0	19.0	17.0	10.0	15.0	25.0	12.0	10.0	17.0	33.0
SRF Ltd	37.6	18.8	13.9	14.2	70.2	12.7	22.2	13.7	99.4	15.4	32.4	16.8

Source: Company, Edelweiss research

Note: CMP as on 19th June 2019

Table 6: Sector snapshot

	Agrochemicals	Colorants (including dyes and pigments)	Construction Chemicals	Flavours and fragrance	Paints and Coatings	Personal Care	Polymer additives	Surfactants	Water treatment Chemicals
Industry									
Industry size in FY16 (USD mn)	4,700	6,543	746	4,106	6,364	871	573	3,700	570
Growth forecast (FY16-21E)	6%	11%	12%	14%	10%	13%	11%	13%	14%
Growth drivers	Exports, Food demand	Textile, Global colorants, Paints and coatings	Real estate and Infrastructure	Packaged food and HPC segment	Automotive and Real estate	HPC segment	Consumer durables, Automobile and Real Estate	HPC segment	Urbanization, and waste water management
Customers									
Key End applications	Food Industry	Textile	Infrastructure, real estate	Personal care, food processing	Automotive, Construction etc.	Cosmetics, Bath shower, Hair care etc.	Pipes, automotive	HPC	Industrial and municipal water
Customer stickiness	High	Moderate	Moderate	Very High	Moderate	High	High	Moderate	High
Impact of consumer standard on growth	Low	Low	Moderate	High	Low	High	High	Moderate	Moderate
Factors related to competitive intensity									
No of suppliers for same product	For generics, there are multiple suppliers	Multiple suppliers with focus on quality and consistency	2 to 3 suppliers with lead supplier catering 70-80% of requirement	Single suppliers catering 90-100% of requirement	Multiple suppliers with focus on quality and consistency	1 to 3 suppliers with lead supplier catering 70-80% of requirement	2 to 3 suppliers with lead supplier catering 70-80% of requirement	2 to 3 suppliers	2 to 3 suppliers with lead supplier 50%+ share
Major Domestic players	Rallis, UPL, Bayer Crop science, PI Industries, Dhanuka, SRF	Aksharchem, Bodal , Meghmani, Sudarshan , Atul, Clariant chemicals	Fosroc India, SIKA India, BASF Construction	S H Kelkar, Sachee Aromatics, Synthite, Camlin Fine	BASF Coatings India	Sami lab, Vivimed Labs, Galaxy Surfactants, Fine Organics, Aarti Industries	Fine organics, Plastiblends, Aarti Industries, Croda	Galaxy, Aarti Industries, BASF, Ultramarine & pigments, Sunshield Chemicals	Chembond, Ion Exchange
Entry Barriers	Strong	Moderate	Strong	Very strong	Strong	Very strong	Very strong	Strong	Strong
Financial factors									
EBITDA margins	Moderate	Moderate	Moderate	High	Moderate	High	High	Moderate	Moderate
Working capital intensity	Moderate	Moderate	Moderate	High	Moderate	Moderate	Moderate	Moderate	Moderate
Fixed capital intensity (Asset turn)	High	High	Low	Low	Low	Low	Low	High	Low
Production factors									
Raw material availability issues	Moderate	Low	Low	High	Low	Low	Low	Low	Low
Product Differentiation	Low	Low	Moderate	High	Low	High	High	Moderate	Moderate
Benefit of economies of scale	Low	High	Moderate	Low	High	Low	Low	High	Low
Regulatory approvals	High	Low	Low	Low in fragrance High in flavors	Low	Moderate	Low	Low	Moderate
Processing complexity	Moderate	Low	Moderate	High	Low	High	High	Moderate	Moderate

Source: Edelweiss research

The domestic chemical industry is estimated to clock 9.3% CAGR over FY18-25, outpacing the global counterpart's 5.5% CAGR

Catalysts In Place To Spur Chemicals' Demand

India's chemical industry, valued at USD163bn in FY18, contributes ~3.5% to the global chemical industry. India is one of the fastest-growing countries in the chemical industry with 9.3% CAGR over FY18-25E versus 5.5% globally. It not only benefits from burgeoning export opportunities, but will also benefit from stability in prices on account of lower dumping from China and replacement of imports. Further, faster end-user industry growth and low penetration of specialty chemicals are likely to bolster growth.

India's large economy is under-represented in chemical space

The chemical industry is pivotal in industrial and agricultural development of a country. It provides building blocks for several downstream industries such as textiles, papers, paints, soaps, detergents, among others. Covering 80,000 plus products, this industry services a large number of end-use application industries. This industry is estimated to employ more than 2mn in India.

Fig. 2: Indian chemical industry overview

- ~ USD 163 bn
- 3.5% of world's imports
- 1.2% of national GVA
- >80,000 products
- Est. CAGR 9% for next five years
- Employs >2mn

Source: FICCI, Edelweiss research

Contributes mere 3.5% to global chemical industry

India's chemical industry was estimated at USD163bn in FY18 and contributes ~3.5% to the global chemical industry. While the global chemical industry is expected to post 5.5% CAGR over FY18-25E, India is estimated to grow at a faster clip of 9.3% CAGR led by low per capita consumption of chemicals in various industries. India ranks 14th in exports and eight in imports of chemicals (excluding pharmaceutical products) globally. The country's chemicals trade balance is negative with imports being significantly higher than exports.

Chart 9: Global chemical industry to clock 5.5% CAGR

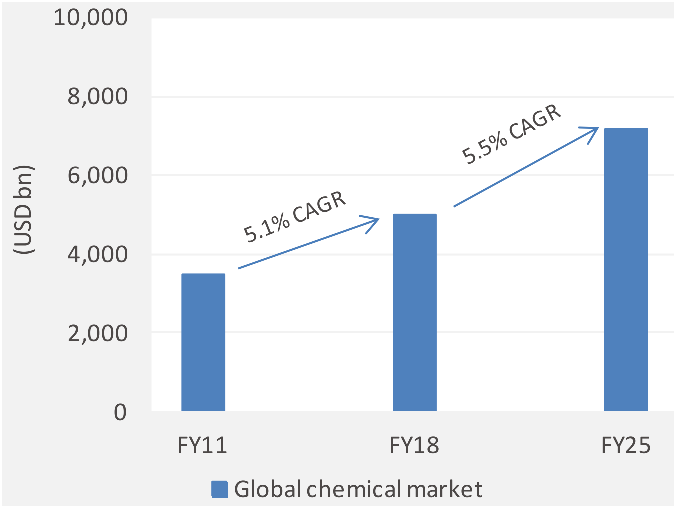
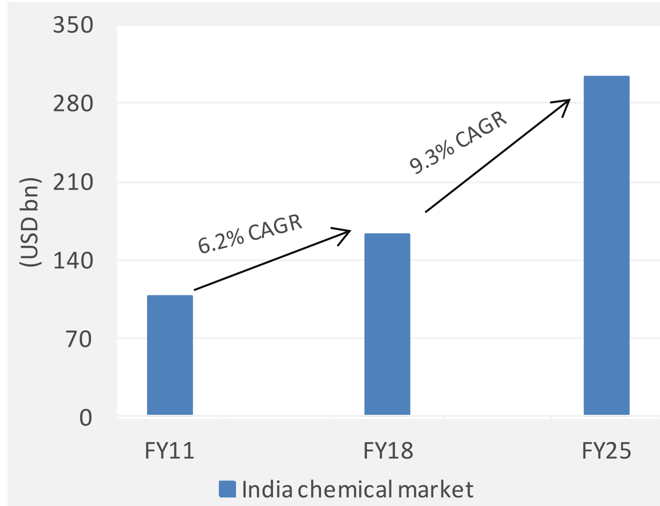


Chart 10: Indian chemical industry to post 9.3% CAGR



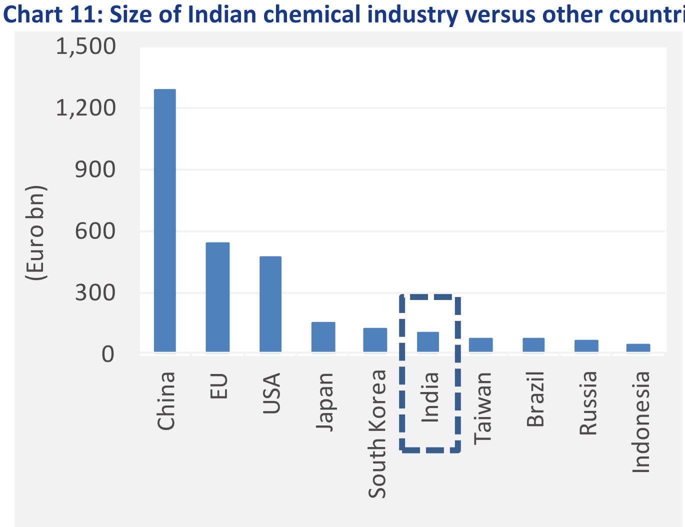
Source: FICCI, Edelweiss research

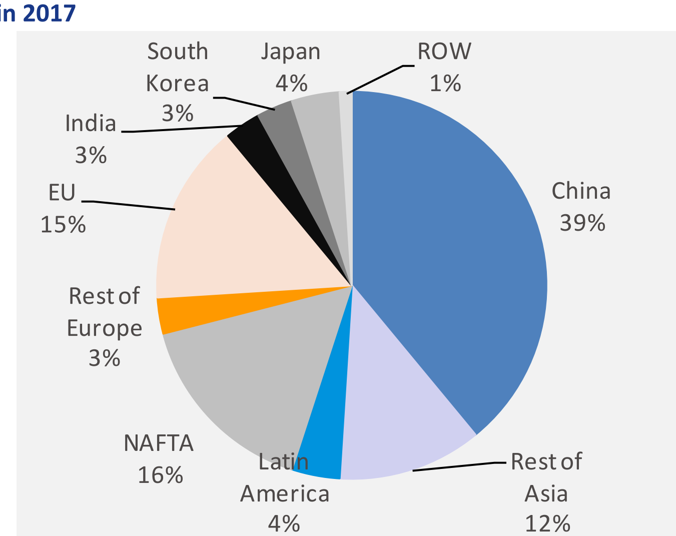
India has the potential to become the fourth largest chemical producer in the world if it sustains ~12% growth for a decade

One of the fastest growing

India is one of the fastest growing markets in the chemical industry with respect to production as well as sales. Currently, it ranks third in Asia and is the sixth largest market in the world with respect to output after US, China, Germany, Japan and Korea. As per industry estimates, India has the potential to become the fourth largest chemical producer in the world if it sustains ~12% growth for a decade.

Chart 11: Size of Indian chemical industry versus other countries in 2017





Source: FICCI, Industry, Edelweiss research

India gains on all accounts

India not only benefits from rising export opportunities, but also from stability of prices on account of lower dumping from China. Further, faster end-user industry growth and low penetration of speciality chemicals in India will bolster growth. Exponential growth expectations led by favourable macro-economic factors in pharmaceutical and personal & home care products also presents a humungous growth opportunity for associated specialty

10-15% p.a. growth in key end-user industries is expected to drive India's specialty chemical market

Improvement in supply chain solutions & technology is bound to spur manufacture of petrochemical intermediates

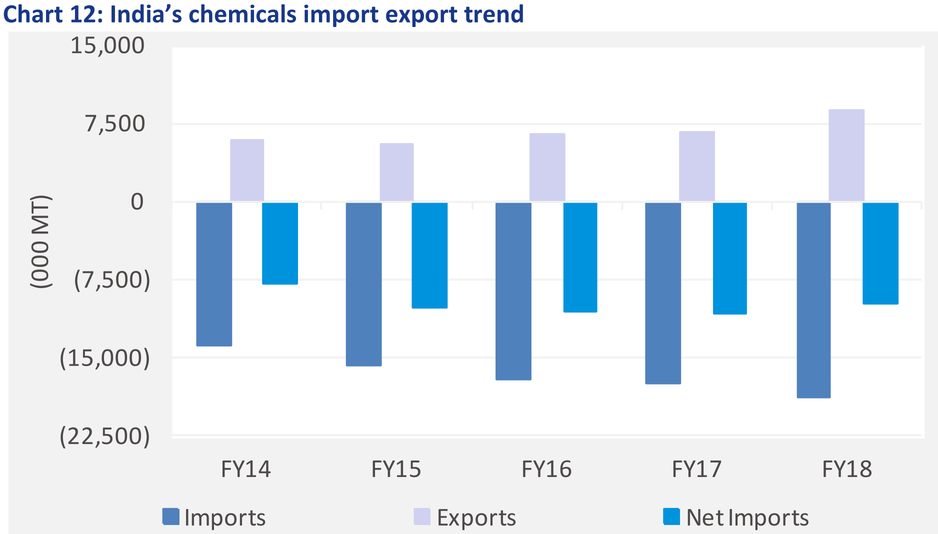
India's per capita chemical products' consumption at 1/10th the world average indicates huge untapped potential

chemical manufacturers. Following are the multiple growth drivers in place for domestic chemical companies:

1) **Rising domestic demand:** Healthy and consistent increase in GDP and purchasing power have rendered India the largest self consuming economy. Therefore, India's most valuable resource is its domestic market. Hence, increase in GDP and population will result in consumption-driven growth in key end markets over the next decade and an increased need for better products and services. 10-15% p.a. growth in key end-user industries is expected to drive India's specialty chemical market.

2) **Import substitution**: India is still deficit in a majority of the petrochemical intermediates and is highly dependent on imports. Every year, it imports more than USD13bn worth of petrochemicals, primarily for want of feedstock. With better supply chain solutions and technology, there exists an opportunity to manufacture petrochemical intermediates in India. For example, Deepak Phenolics has set up a plant in Dahej to manufacture phenol and acetone, both currently being imported in large quantities. Industry estimates indicate that India will fall short by 25-30MMTPA by 2025, implying an additional import cost of INR1,500-2,000bn (USD24-32bn per year).

Chart 12: India's chemicals import export trend



Source: FICCI, Edelweiss research

3) **Low per capita consumption across product categories:** The current per capita consumption of chemical products in India is about 1/10th the world average, indicating the yet untapped demand potential. Moreover, within the chemicals segment, penetration of specialty chemicals is abysmally low. With sharpened focus on improving products, usage intensity of specialty chemicals within end markets such as consumer durables, food additives and surfactants will rise over the next decade.

Chart 13: Lowest agrochemicals consumption per hectare

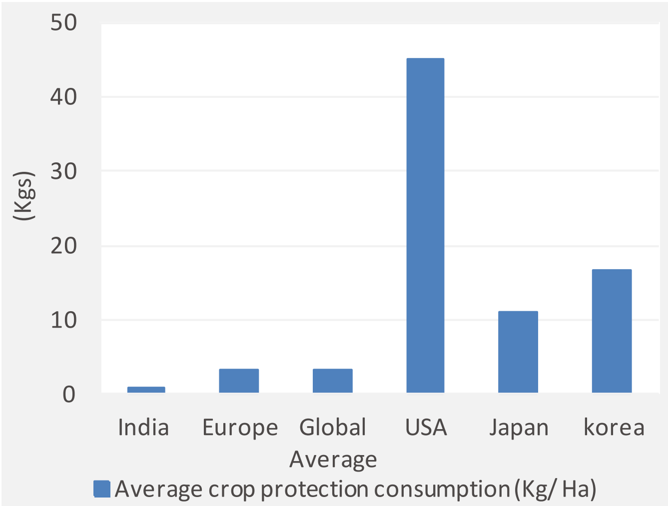


Chart 14: Lowest per capita plastic consumption

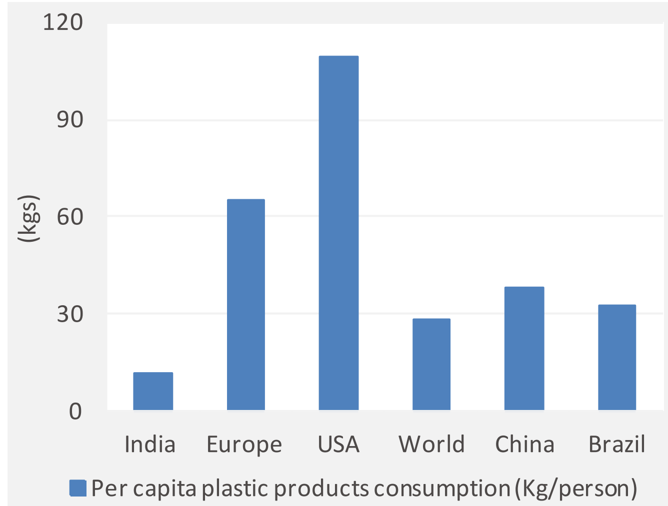


Chart 15: Lowest per capita personal care consumption

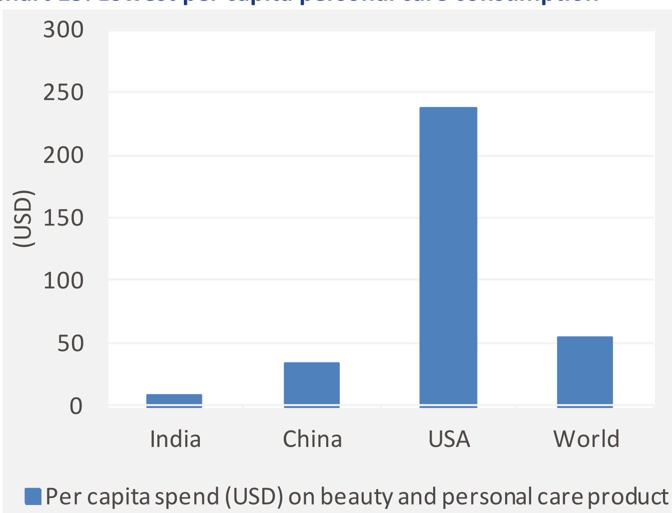


Chart 16: Lowest per capita paint consumption

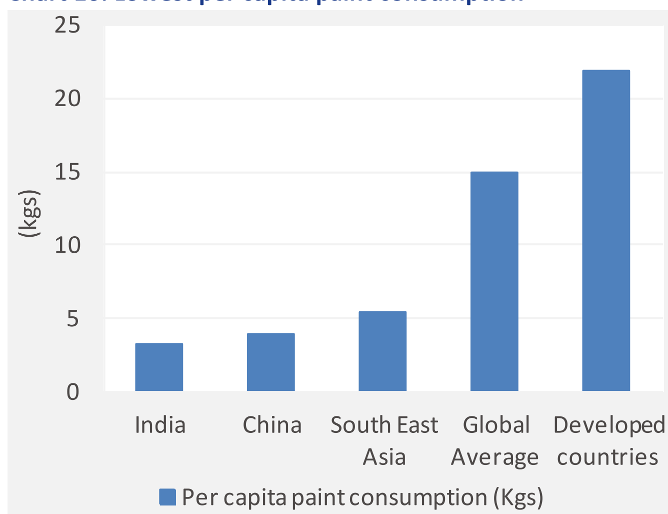


Chart 17: Lowest per capita packaged food consumption

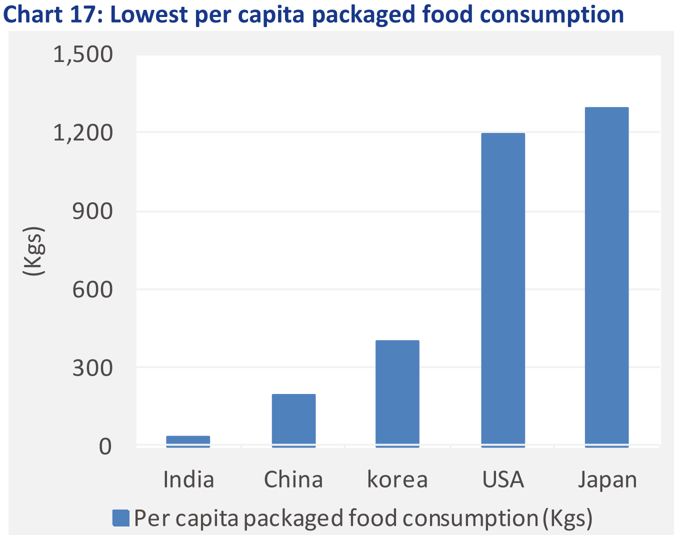
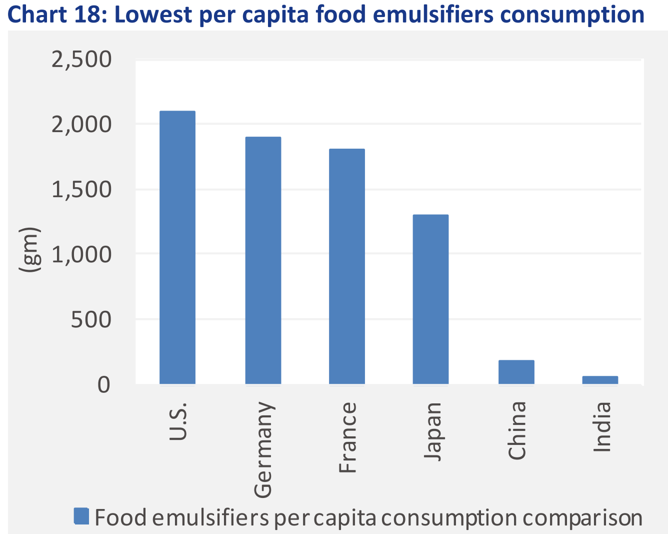


Chart 18: Lowest per capita food emulsifiers consumption



Source: FICCI, Industry, Edelweiss research

Government's *Make in India* initiative encouraging local production entails the potential to spark huge investments in India

India's overall EODB ranking catapulted to 77th in 2018 from 100th in 2017

India's ranking in global competitive index improved to 40 in FY18 from 60 in FY14

India's ranking in global innovation index jumped to 57 in 2018 from 76 in 2014

4) **Government initiatives:** Adherence to COP21, Make in India, AMRUT, Smart City Mission and Swachh Bharat will require chemicals, and manufacturing them in India will be a significant contributor to the exchequer and save foreign exchange. Under its umbrella campaign *Make in India* with the objective of making business environment conducive to invest and grow, the Government of India has implemented several structural reforms such as GST and amended the land acquisition act and increased transparency. As a result, India saw quantum leap in its relative position in EODB rankings, its global competitiveness ranking and global innovation ranking. Encouraging local production entails the potential to spark huge investments in India.

Table 7: Improving India's EODB ranking

Sr No.	Indicator	2017	2018	*Change (%)*
1	Construction Permits	181	52	*129.0*
2	Trading Across Borders	146	80	*66.0*
3	Starting a Business	156	137	*19.0*
4	Getting Credit	29	22	*7.0*
5	Getting Electricity	29	24	*5.0*
6	Enforcing Contracts	164	163	*1.0*
Overall rank		**100**	**77**	***23.0***

Source: World Bank, Edelweiss research

Table 8: Improvement in global competitiveness index ranking

	Brazil	Russia	India	*China*	*South Africa*
2013-14	56	64	60	*29*	*53*
2014-15	57	53	71	*28*	*56*
2015-16	75	45	55	*28*	*49*
2016-17	81	43	39	*28*	*47*
2017-18	80	38	40	*27*	*61*

Source: World Economic Forum, Edelweiss research

Table 9: Scaling up global innovation index

	Brazil	Russia	India	*China*	*South Africa*
2014	61	49	76	*29*	*53*
2015	70	48	81	*29*	*60*
2016	69	43	66	*25*	*54*
2017	69	45	60	*22*	*57*
2018	64	46	57	*17*	*58*

Source: World Economic Forum, Edelweiss research

India ranks 11 in per capita Co2 emission (6% global Co2 emission)

Fig. 3: Government's key initiatives to have positive impact

Initiative	Government Support	End-use industries benefited	Business Impact[1]
Make in India	100% FDI under automatic route	Pharma, Textiles, Automobiles, etc	Boost Chemical industry growth >9%
Swachh Bharat	Financial target of INR 30,000 cr. for FY19 (USD 4.48 Bn)	Surfactants & Water Treatment Chemicals	Surfactants & water treatment chemicals estimated to grow at 15%
Smart Cities	Funding of INR 2.04 lakh cr. (USD 30.44 Bn)	Construction chemicals	Market for construction chemicals expected to grow at 15%
Agricultural Reforms & Farmer's Welfare	Budget estimation of INR 57,600cr. in FY19 (USD 8.36 Bn)	PVC & Agro-chemicals	Market for PVC expected to grow at a CAGR of 12% & agrochemicals by 7.5%
Goods & Services Tax	GST implemented with effect from 1st July 2017	Chemicals & Petrochemicals All End use Industries	Improving efficiency, logistics cost reduction & improving speed to market

Source: FICCI

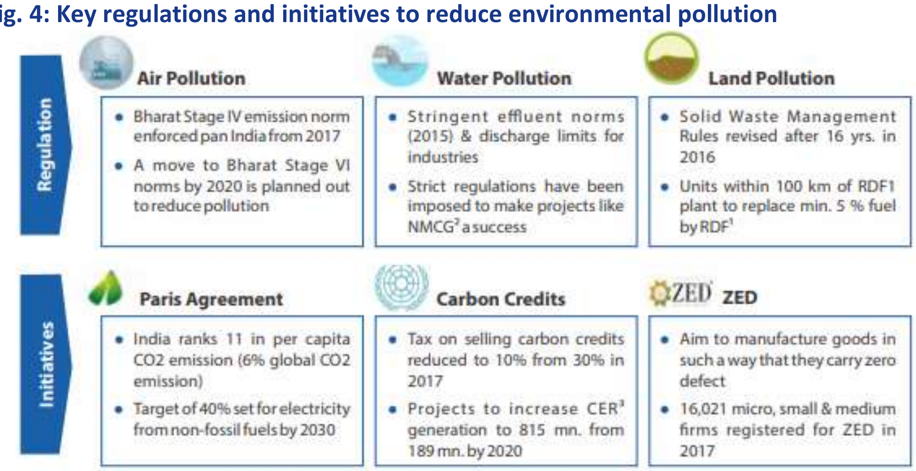
Table 10: Impact of Make in India on the chemical sector's growth

Feedstock	- Duty rationalisation: partially addressed (import duty on ethane, propane, butane, reformate reduced to 2.5% from 5%) - Higher availability of feedstock and focus on alternate feedstock
Infrastructure	- Higher focus on R&D and skill development infrastructure - Comprehensive programme for treatment of chemicals under "Swachh Bharat Abhiyaan"
Regulations	- Setting up of "Reverse SEZs" - Introduction of tax incentives to catalyse R&D investments in priority areas

Source: FICCI, Edelweiss research

5) **Environment compliance:** India became the 62nd nation to join the Paris Agreement in October 2016. The agreement requires member countries to make binding commitments to curb carbon dioxide (CO2) emissions. The Government on India has taken a firm stance to mitigate negative impact of development on the environment. Key pro-environmental regulations and initiatives by the government to curb air, water and land pollution are:

Fig. 4: Key regulations and initiatives to reduce environmental pollution



Notes :1) RDF: Residue Derived Fuel 2) National Mission for Clean Ganga 3) Certified Emission Reduction

Source: FICCI

6) **Burgeoning investments in chemical sector:** India's chemical sector (other than fertiliser) attracted FDI investment of USD1.3bn in FY18, ~3% of the total FDI inflow. Domestic and overseas companies are investing in either greenfield or brownfield projects in this industry. Investments are being made across the value chain of chemicals industry – upstream, petrochemicals, commodity chemicals, specialty chemicals and even in downstream chemistries. The aggregate capex of our specialty chemical universe at INR61.7bn over FY19-21 is likely to be 63% higher compared to INR37.7bn over FY16-18. Some of the key investments announced in chemical and petrochemical sectors over the past two years in India reflect confidence of players in India's potential.

Table 11: List of major investments in petrochemicals sector

Investment Greenfield /Brownfield	Investor Company	Investment Value (USD mn)	Project Year	Announcement
Greenfield	Saudi Aramco, Indian PSUs	44,000	Mega Refinery	2018
Greenfield	Reliance	9,500	Refinery	2017
Greenfield	HPCL + GAIL	5,700	Petrochemical Complex	2017
Brownfield	Sabic	4,300	Petrochemicals (50% stake in OPAL)	2018
Greenfield	IOCL	1030	Ethylene Glycol & Polypropylene	2018
Greenfield	Sanmar	61	H2O2, PVC	2017
Greenfield	HMEL	3,000	Petrochemical Complex	2017
Brownfield	BPCL	4,000	Refinery	2018

Source: Company, FICCI, Edelweiss research

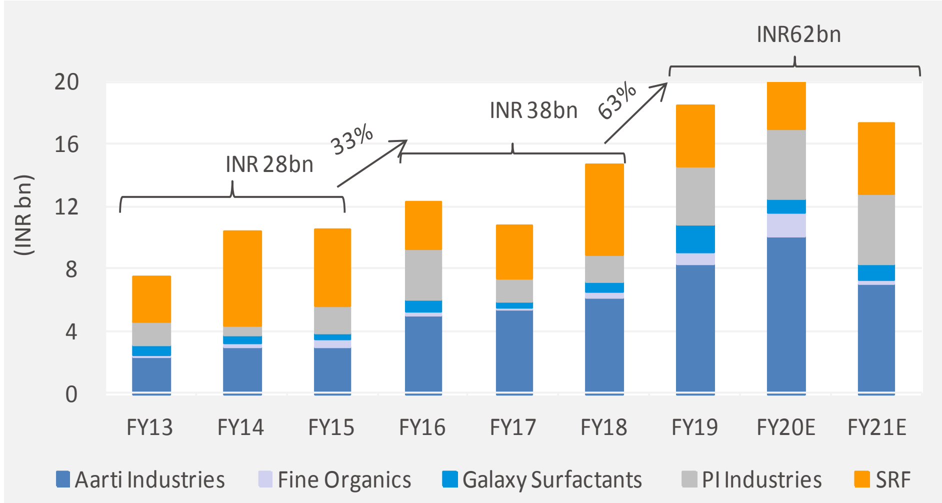
Table 12: List of some investments in commodity chemicals sector

Sector	Investment Greenfield /Brownfield	Investor Company	Investment Value (INR Mn)	MTPA	Commissioning
Phenol	Greenfield	Deepak Nitrite	14,000	2,00,000	Nov-18
Soda ash	Brownfield	GHCL	3,000	1,00,000	Mar-21
Carbon black	Greenfield	Phillips Carbon Black	9,000	1,50,000	Sep-20
Carbon black	Expansion	Himadri Specialty Chemicals	10,000	2,00,000	n.a.
Adhesives	Greenfield	Pidilite Industries	2,200	1,00,000	Feb-20

Source: Company, Edelweiss research

The aggregate capex of our specialty chemical universe at INR61.7bn over FY19-21 is likely to be 63% higher compared to INR37.7bn over FY16-18.

Chart 19: Sharp increase in investments by specialty chemical players



Source: Company, Edelweiss research

Table 13: List of major investments in downstream chlorine sector

Company	Capacity (TPA)	Commissioning
CPW		
Grasim	51,750	FY18
Andhra Sugar	7,300	FY19
Lords Cholr Alkalie	99,000	FY20
GACL	34,500	FY20
Anhydrous Aluminium Chloride (AAC)		
GACL	16,500	FY20
Kutch Chemicals	36,000	FY20
Chloromomethane		
GACL	21,900	FY19
Meghmani Organics	40,000	FY18
Andhra Sugar	49,129	FY19
SRF	40,000	FY18
Chloro Toluene		
GACL	39,600	FY20
Stable Bleaching Powder		
Grasim	42,750	FY19
DCM Shriram Ltd	20,400	FY20

Source: Company, CRISIL, Edelweiss research

Emerging Outsourcing Opportunities From West

Rising environmental concerns and stringent government policies are triggering consolidation and uncertainty in China's chemical industry. This is compelling global innovators to revisit their outsourcing strategies, entailing huge opportunities for Indian players with unique business models.

Globally, manufacturing is shifting East

The global chemical industry was valued at USD5tn in FY18 and is estimated to grow at 5.5% p.a. till FY25

The global chemical industry was valued at USD5tn in FY18 and is estimated to grow at 5.5% p.a. till FY25 fuelled by demand from end-user industries. The industry is increasingly shifting East in line with the shift of its key consumer industries—automotive, electronics, etc.—to leverage higher manufacturing competitiveness of emerging Asian economies and to serve soaring local demand. China, as result of this shift, is the largest contributor with 35-40% share, followed by the European Union (17%) and North America (16%), to the global chemical industry.

Chart 20: Global competitiveness index FY18 rankings

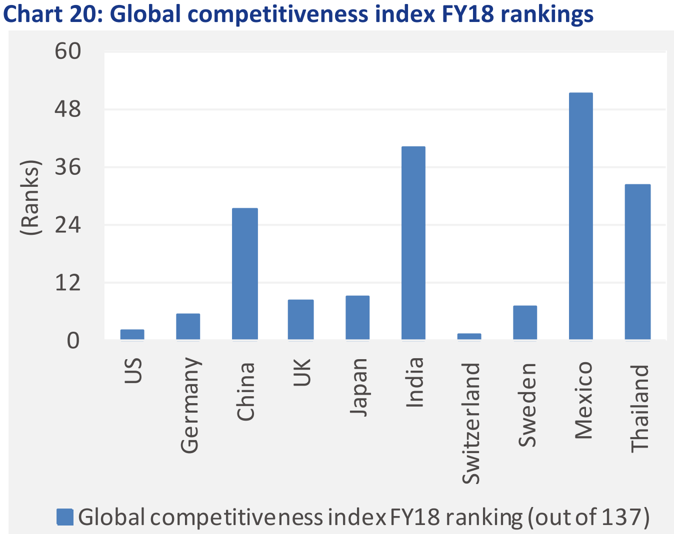
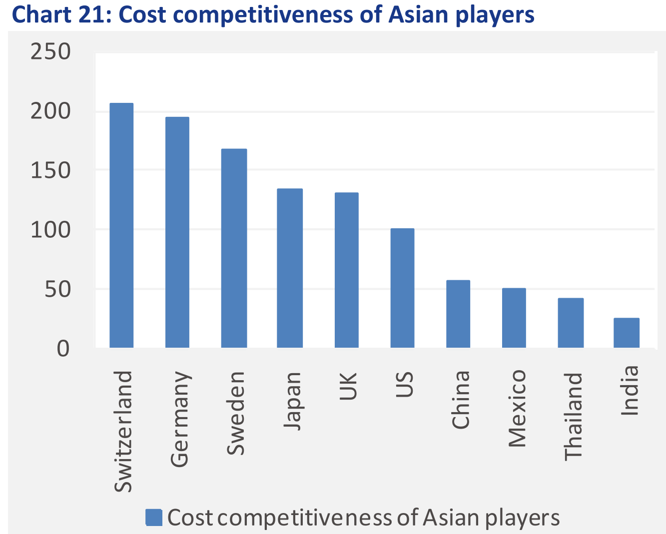


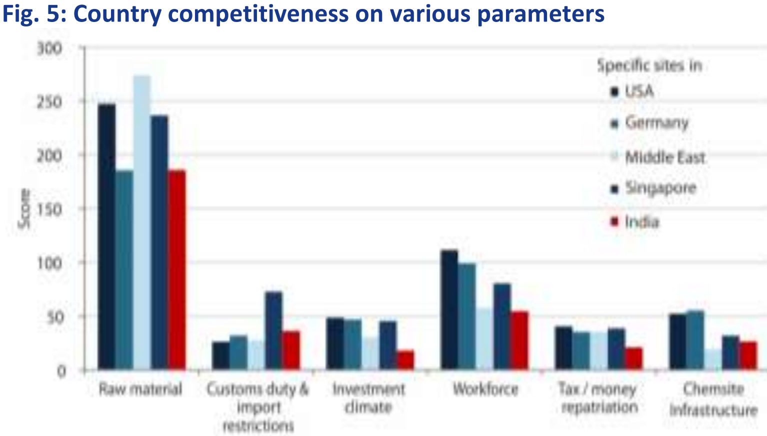
Chart 21: Cost competitiveness of Asian players



Note: BCG global manufacturing cost competitive Index 2014 for labour (US used as base index)

Source: World economic forum, BCG group, Edelweiss research

Fig. 5: Country competitiveness on various parameters



Source: FICCI, Edelweiss research

MNCs are de-risking their sourcing arrangements and want to add an Indian source, which is a major positive for Indian companies

MNCs are de-risking their sourcing arrangements and adding a Indian source

Rising environmental concerns and strict government actions are leading to consolidation and uncertainty in China's chemical industry. This has compelled global innovators to revisit their outsourcing strategies, thereby offering opportunities for Indian players with their unique business models. MNCs are, thus, de-risking their sourcing arrangements and want to add an Indian source, which is a major positive for Indian companies. This is being witnessed across specialty chemicals and pharma intermediates.

Table 14: Investments by various MNCs in India

BASF to partner with Adani to evaluate investment in acrylics value chain in Mundra, India
According to the MoU, BASF and Adani want to establish a joint venture with an investment totalling about EUR2 bn (approximately INR 160bn), in which BASF will hold majority. This will be BASF's largest investment in India to date.
Management Commentary
"BASF's intention to invest in a major new site for the acrylics value chain in India clearly demonstrates our strong and long-term commitment to our Indian customers. Together with the Adani Group, we would have the opportunity to provide our customers with high-quality chemicals and support them in growing their business. With our production powered by renewable energy, we would be able to minimize our impact on the environment," said Dr. Martin Brudermüller, Chairman of the Board of Executive Directors, BASF SE.
China Synthetic Rubber Corp plans to invest in Gujarat
China Synthetic Rubber Corporation (CSRC), a Taiwanese synthetic rubber maker, is interested in setting up a carbon black manufacturing unit in Gujarat. The company is looking for a 100- acre plot near a port area and will invest INR 10bn to build the plant.
Management Commentary
Quoting D Thara, vice-chairman and managing director of Gujarat Industrial Development Corporation (GIDC), the report said, "The company has approached the state government and it is keen to setup manufacturing unit. Currently, it is looking for appropriate land for the project. This will attract investment of approximately INR10bn in Gujarat."
AXALTA opens new coating plant at Savli
Axalta, a leading global supplier of liquid and powder coatings, has recently inaugurated its new coating manufacturing plant at Savli, Vadodara in Gujarat, India. The new plant will double Axalta's coating manufacturing capacity for coatings products of light vehicles, commercial vehicles, and industrial segments. The company will invest close to USD 70 mn in the country over the next five years.
Management Commentary
"These facilities and the significant investments made in the past couple of years are in sync with Axalta's strong commitment to India to deliver innovative and comprehensive coating solutions to our customers in every sector of the automotive market and in other industry sectors. I am confident that Axalta's global expertise in coatings will play a significant role in India, catering to our customers' specific coatings requirements," said Mr. Charlie Shaver, Chairman and CEO.
Air Products to invest over USD 100 mn for setting up six units
Air Products and Chemicals, industrial gases producer, will invest up to USD 100 mn in India for setting up six units for liquid oxygen and nitrogen production.
Management Commentary
Richard Boocock, President, Industrial Gases–Middle East, India, Egypt and Turkey, at Air Products, was quoted as saying by Business line: "The new plants are currently at various stages of implementation and will be completed by the end of 2019 calendar year."

Source: Company, Edelweiss research

China's Pain Is India's Gain

There is a significant change in China's government policy from 'growth at any price' to 'sustainable growth without impacting environment'. As a result, capex and opex costs of Chinese players have ballooned, rendering them less competitive in exports market vis–a-vis Indian players.

Clamp down in China offers strong growth opportunity for India

China: Biggest chemical manufacturer in the world

China accounts for 35-40% of the global chemicals sales

China accounts for 35-40% of the global chemicals sales, making it the largest market in the world. It was able to become the largest market led by availability of cheap labour, electricity, lower tax rates, significant export incentives, high operating leverage since capacities were operating at high utilisation rates, savings due to lower environmental compliance and low interest cost.

Changing dynamics pressurising industry

China's government policy has undergone significant change from 'growth at any price' to 'sustainable growth without impacting environment'

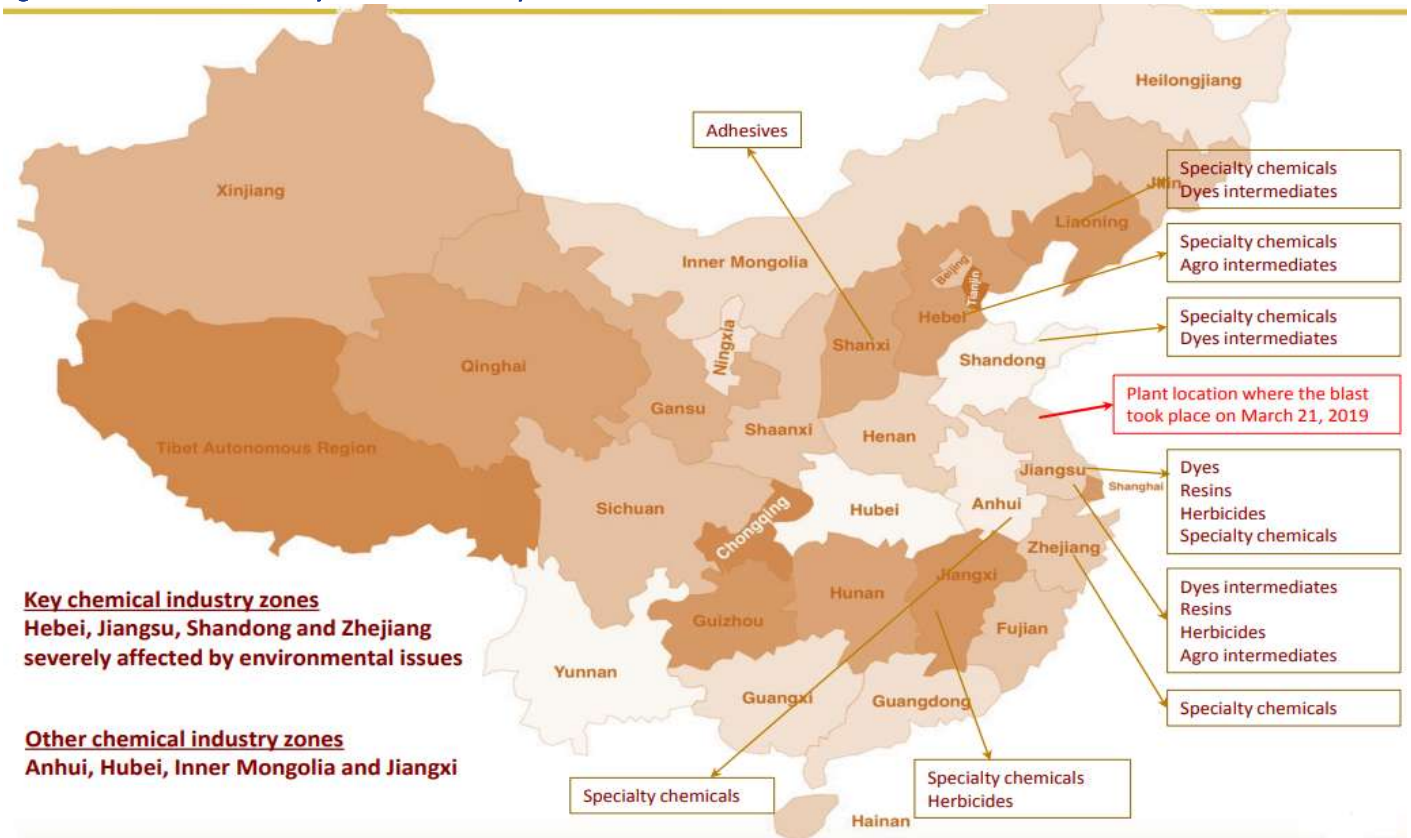
China's government policy has undergone significant change from 'growth at any price' to 'sustainable growth without impacting environment'. Around 375 polluting facilities across various manufacturing segments, including dyes and textiles, were shut down in 2014 due to higher cost involved in regulatory compliance. Further, stricter environmental norms were implemented from January 2015, which continue to get stringent. Following are the actions taken by the government:

- Hired thousands of environmental officers to keep a check on polluting industries or companies
- Strict penalties for not adhering to environmental norms
- Shift towards gas-based power plants from coal-based ones
- Compulsory effluent treatment plants
- **Mandatory for all polluting industries to operate from dedicated chemical parks (from current 50% of plants to 90%), away from habitat**: Small- to mid-size chemical plants to relocate by 2020 end. All larger plants must relocate by 2025 end and must start the process by no later than 2020
- **Restriction on number of existing chemical parks**: For example, Shandong province has announced the goal of halving the number of chemical parks in the province to less than 100. By 2020 end, the number of chemical producers in Jiangsu will fall to 2,000 and to 1,000 by 2022. Further no new plant or expansion permitted for investment < INR10bn
- Taxes to be levied on polluting industries based on pollution type, location and severity

By 2020 end, the number of chemical producers in Jiangsu will fall to 2,000 and to 1,000 by 2022

As a result of the above guidelines, capex and opex costs for China's chemical companies have jumped, dimming their competitive edge in the exports market. Industry data indicates that in 2017, 40% of the chemicals capacity was temporarily shut down in China for safety inspections and over 80,000 units were charged and fined for breaching emission limits

Fig. 6: China's situation in key chemical industry zones



Source: Atul Industries presentation, Edelweiss research

The Government of China is keen to protect Yangtze river and has declared no factories can be established within 1 km of the river.

In a new development, the Government of China is keen to protect Yangtze river and has declared some areas of the river as a protective zone. No factories can be established within 1 km of the river. This will impact the chemical industries set up in this region.

Fig. 7: Yangtze river protection

Source: Atul Industries presentation, Edelweiss research

India wresting market share from China

Regulatory changes in China have led to a favourable scenario for Indian players. India has remained in China's shadow for long in the global chemical specialty market. Although China clocked strong growth in the specialty chemical segment, significant regulatory issues by way of higher pollution, labour reforms, etc., have increased its costs.

India is gaining share led by its own structural benefits and the spillover effect of China's waning competitiveness

India, on the other hand, will be able to emerge as a fast-growing specialty chemicals hub on account of its low capital and operating cost competencies, availability of feed stock and skilled manpower, better manufacturing standards and compliance of regulatory frameworks, strict environment policy in place, stronger IP protection, among others.

Thus, gradually, India is gaining share led by its own structural benefits and the spillover effect of China's waning competitiveness. As a consequence, import of specialty chemicals from China to India has declined. Besides, Indian manufacturers have started steadily capturing markets in China and other countries. Thus, Indian companies focussed on specialty chemicals with better compliance standards are expected to be major beneficiaries.

China's chemical industry is stagnating due to tightening pollution control, rising labour costs and strengthening of the Chinese Yuan against the USD

Shutdowns in China: China's chemical industry is stagnating due to tightening pollution control, rising labour costs and strengthening of the Chinese Yuan against the USD. This is encouraging exports from India, it being the closest international surrogate for chemical products globally.

In China, environmental regulations have become more stringent and tighter compliance norms have been imposed. On the other hand, in India, compliance has been stringent since the past few years. These compliance norms require additional investments in an effluent treatment plant (ETP), which translates in to increased costs for manufacturers, along with general increase in labour and other costs in China.

Specialty Chemicals: Highest Potential Segment

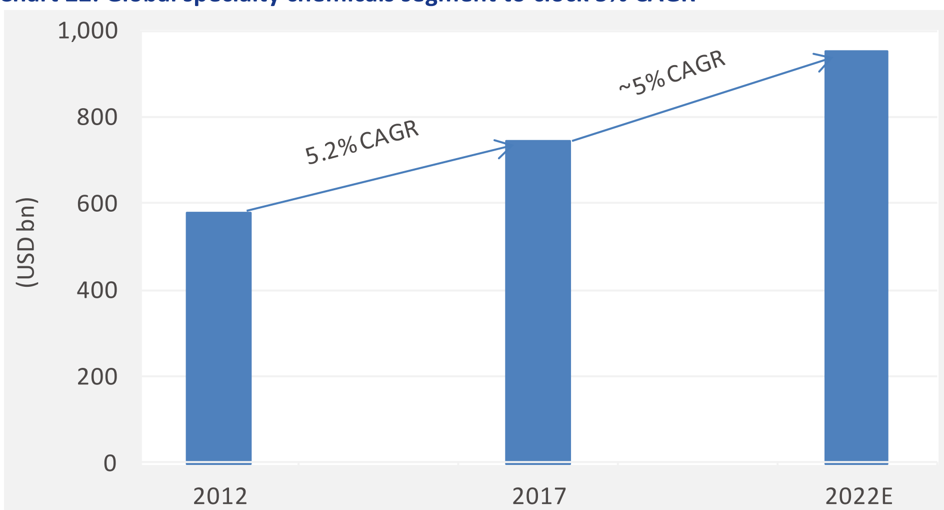
India's chemical industry was valued at USD163bn in 2018, of which the specialty chemical segment's share stood at 22%. While globally the specialty chemical market is estimated to grow at 4-6%, the domestic industry is estimated to post 12% CAGR. We believe, current environment is more conducive for specialty chemical players on account of healthy growth opportunities in India and globally.

Specialty chemicals globally is valued at USD745bn in 2017 and this market is estimated to clock 4-6% CAGR to USD900-1,000bn, similar to the 5% CAGR over the past five years.

Global specialty chemical market to log 4-6% CAGR by 2022

Within global chemicals, specialty chemical is a key segment, valued at USD745bn in 2017. By 2022, this market is estimated to clock 4-6% CAGR to USD900-1,000bn, similar to the 5% CAGR over the past five years. This steady pace will be led by sustained demand in end-user industries like personal care, construction chemicals, etc. Rapid industrialisation in India and China is expected to drive demand for specialty chemicals. The APAC region, with a share of 45-50%, was the key contributor to the global specialty chemical market in 2017, followed by North America and Western Europe.

Chart 22: Global specialty chemicals segment to clock 5% CAGR



Source: FICCI, Edelweiss research

India's chemical industry was valued at USD163bn in 2018, of which the specialty chemical industry stood at USD35.9bn, accounting for ~22% of the chemical industry

Specialty chemicals account for ~22% of chemical industry in India

India's chemical industry was valued at USD163bn in 2018, of which the specialty chemical industry stood at USD35.9bn (*source: FICCI Specialty chemicals report*) accounting for ~22% of the chemical industry. Specialty chemicals are targeted at specific end-user applications and include polymer additives, personal care ingredients, water treatment chemicals, construction chemicals, paints & coatings, colorants, among others. These are R&D intensive, high value and low volume chemicals.

Chart 23: India's chemical industry break-down

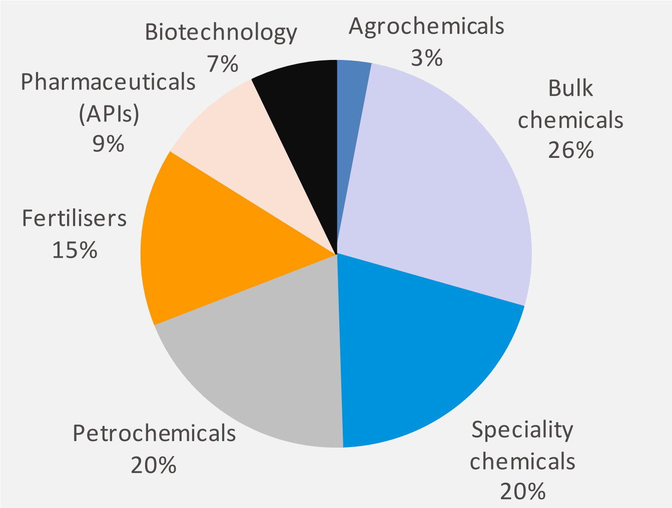
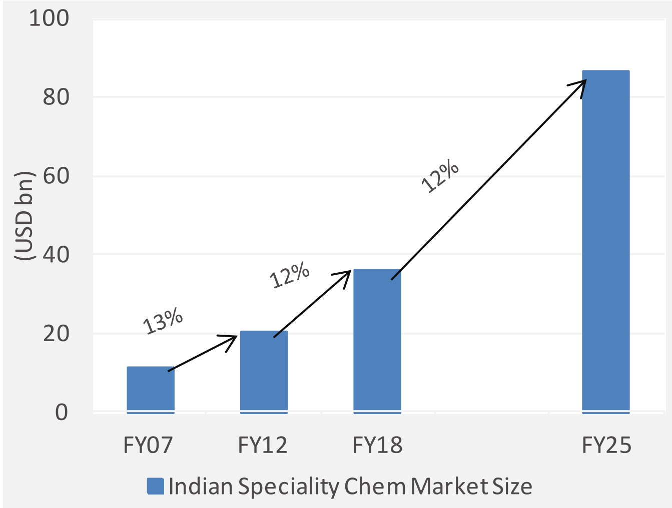


Chart 24: Potential specialty chemicals industry size by FY25



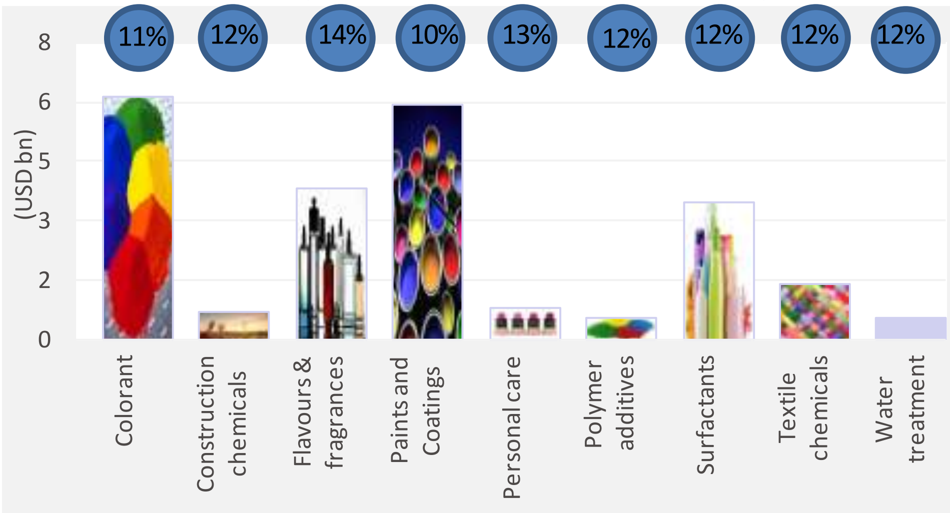
Source: Industry, Edelweiss research

End-user industries for specialty chemicals segment are clocking robust 11-14% CAGR

Strong growth opportunity in specialty chemicals

The specialty chemical segment derives its growth from the underlying growth in user industries. In India, some of the user industries are expected to clock strong growth driven by increasing application, changing consumption behavior and growing per capita incomes. With strong underlying growth in user industries, chemical players are expected to report robust spurt.

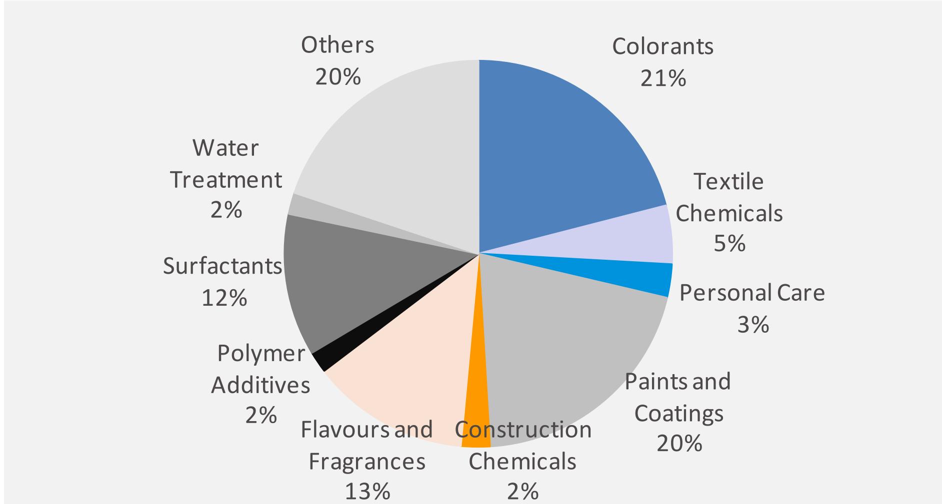
Chart 25 : Industry size and growth rates across specialty chemical segments



Note: Industry growth rate across sectors in circle
Source: FICCI, Edelweiss research

Companies with strong R&D and access to a large customer base have edge over others

Chart 26: Specialty chemicals segment breakdown



Source: FICCI, Edelweiss research

Specialty chemicals better placed than commodity chemicals

We believe, the current environment is more conducive for specialty chemical players riding strong growth opportunities in India and globally. As, on one hand, robust growth in user industries in India will support growth, on the other, emerging opportunities in exports led by clamp down in China and outsourcing opportunity from West are expected to spur growth in exports and import substitution. Commodity chemicals compete on pricing and economies of scale.

Application / functional ingredient players will benefit from low penetration of emerging categories in India, but their strong dependency on FMCG / consumer companies limits their growth potential. Companies with strong R&D and access to a large customer base will have edge over others.

Table 15: Base chemicals versus specialty chemicals versus R&D base functional ingredients

Differentiation	Base chemicals / Commodity chemicals	Specialty chemicals	Application / R&D base functional ingredients
Market structure	Large number of players	Few players	Selected suppliers only
Type of product	Standard products	Customised products	Fully customised to meet consumer requirement
Growth opportunities for supplier	Large growth opportunity as market size is big	Moderate growth as new customer addition / new product addition takes time	Limited growth opportunity as supplier every time has to provide its customer a new solution or add new customer
Sales	Sold by "specification", defined purity	Sold by "performance/impact", not composition	Helps customers achieve them desired end product
Value/volume	Generally medium to high volume products with low price realisations	Generally low to medium volume products with high price realisations	Very low volume products with high price realisations
Base of differentiation	Pricing	- R&D capability - Quality consistency - Timeliness of delivery	- R&D capability - Ability to solve customers' problem
Role of customer/seller	Selection of chemical done by customer	Seller provides required "solution" to meet customer application needs	Customer gives the problem and supplier provides the solution
Customer stickiness	Low - Customer looks for lower cost suppliers, as products are standardised	Moderate - Customer approval systems and process are highly elongated - Tedious approval processes with quality and consistency requirement - Switching supplier is difficult due to long approval processes	High - Product cannot be easily substituted
Nature of contract	Short term contracts / open market prices	Long-term volume contracts with clauses for pass through of escalation de-escalation	Long-term contracts with strong one to one relationship between supplier and buyer
Core strategy for success	Cost leadership strategy	High process R&D capability	Strong one to one relationship between supplier and buyer
Margin profile	Volatile margins depending on chemicals cycle	Stable margins due to escalation de-escalation clauses in contract	Very high margin
Benefits of scale economies	Significant due to standardised products	Limited due to large number of low volume high value products	No scale benefit as volume remains very small

Source: FICCI, Industry, Edelweiss research

For a specialty chemical company to develop a competitive position globally, innovation is the key to future growth and profitability

Innovative product baskets underpinned by strong R&D capabilities

Being knowledge-driven, the specialty chemical industry focuses on R&D. Hence, improvement in processes and improving efficiency are mantras for success. Further, for a specialty chemical company to develop a competitive position globally, innovation is the key to future growth and profitability. Many Indian companies are thus constantly investing in innovation and are global leaders in certain products or processes.

Some of the Indian companies are world's largest chemical producers

Table 16: Companies with their USPs

Company	Leadership position
Aarti Industries	Globally ranks at 1st – 4th position for 75% of its portfolio Ranked amongst top 3 players globally in Chlorination Ranked amongst top 4 players globally in Nitration Ranked amongst top 2 players globally in Ammonolysis Ranked amongst top 2 players globally in Hydrogenation
Fine Organics	Pioneer and largest manufacturer of oleochemical-based additives in India One of six global players in the food additives industry One of five global players in the plastic additives industry
Galaxy Surfactants	Amongst leading surfactant producers for home and personal care with 60% market share in India Strong presence globally with 70-80% market share in Egypt and 35-40% market share in Africa Leading producer of SLS with more than 60% market share Leading producer of SLES with 55-60% market share Leading producer of preservatives with ~17% market share Amongst the largest producers of Alkyl Sulphates
S H Kelkar	Ranked amongst top 4 players in Indian F&F industry with 12% market share Ranked amongst top 3 players in Indian fragrance industry with 20.5% market share Ranked amongst top 5 players in Indian flavour industry with 2% market share
SRF	More than 50% market share in domestic refrigerant market
Vinati Organics	65% global market share of IBB 55% global market share of ATBS 70% global market share of IB

Source: Company, Edelweiss research

Presence in diversified segments, forward integration: Key to success

Specialty chemical companies present in diversified user industry segments mitigate the risk of single-sector dependency

Specialty chemicals cater to the needs of various sectors with varied specific requirements and customisation. We believe, companies with presence in diversified segments mitigate the risk of single-sector dependency. They also cater to a larger customer base and enjoy leadership in their respective field of specialisation.

Moreover, forward-integration helps companies in better utilisation of by-products and ensures stable margins. Companies equipped with these characteristics have an edge over others and are likely to benefit from the sustained growth opportunity in the sector.

Table 17: Companies with end user industries

	Agro-chemicals	Flavours and fragrance	Pharma - CRAMS / Pharma	Polymer additives	Food additives	Surfactants	Colorants (including dyes and pigments)	Personal Care	Construction Chemicals	Paints and Coatings
Aarti Industries	✓		✓	✓		✓	✓	✓		✓
Fine Organics				✓	✓					
Galaxy Surfactants						✓		✓		
PI Industries	✓									
S H Kelkar		✓						✓		
SRF	✓		✓							
Vinati Organics			✓							

Source: Company, Edelweiss research

Players from our universe:
PI Industries – 90% of revenues
Aarti Industries – 20-25% of revenues
SRF Ltd – 10% of revenues

Other players: Atul, Gharda Chemicals, UPL, Rallis, Bayer crop science, etc

Key user segments

1) Agrochemicals

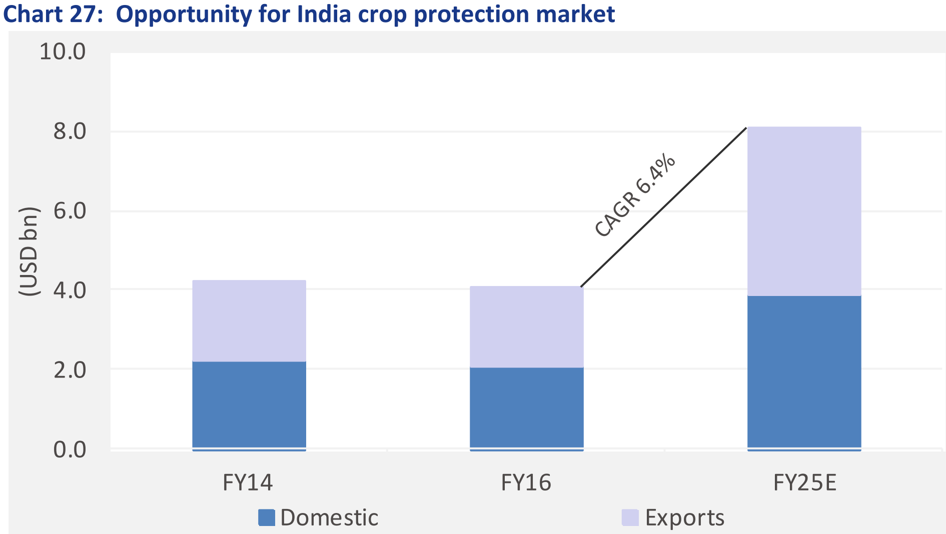
Indian agrochemicals market at USD4.1bn remains stagnated over last 2-3 years due to weakness in domestic as well as global agrochemical consumption. However global agrochemical markets have picked up in H2FY19 and likely to remain strong in FY20 as indicated by commentary of global leaders. With growing outsourcing opportunity and concern on manufacturing in China, Indian players are likely to benefit. Further with strong pipeline of 26 products getting off patented by FY22, we expect that CRAMs players will be at advantageous position.

India / global agrochemical markets faced weak demand

Indian agrochemicals market is expected to touch USD8.1bn by 2025 clocking a CAGR of 6.4%

India's agrochemical market at USD4.1bn (including USD2bn exports in 2016, according to a FICCI report) has witnessed weak growth over the past three-four years on account of muted domestic demand and slower exports. While weak agri prices in domestic & global markets and unfavourable monsoon in India have adversely affected domestic demand, consolidation in the global market, slowdown in Brazil and weak global demand for agrochemicals have taken a toll on exports. However, the pickup in global agrochemical cycle bodes well for the Indian agrochemicals market, which is expected to touch USD8.1bn by 2025 clocking a CAGR of 6.4%.

Chart 27: Opportunity for India crop protection market



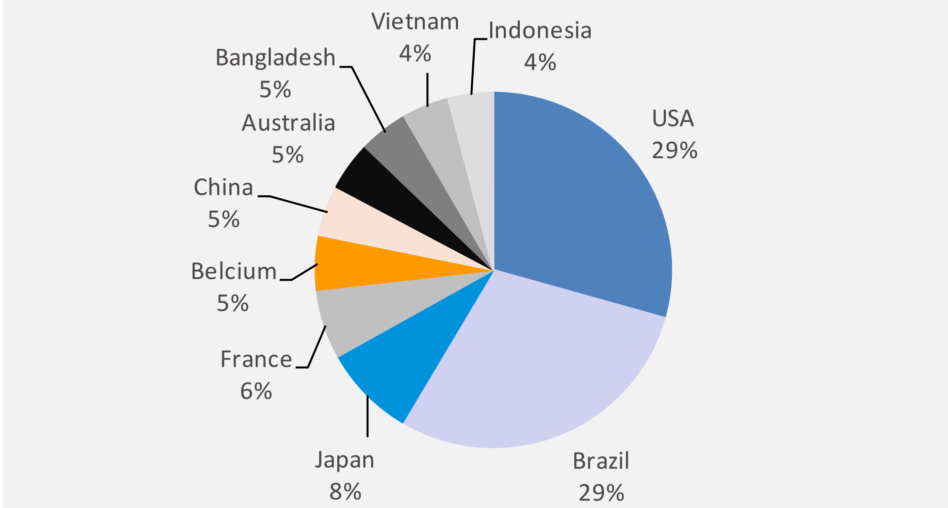
Source: Industry, Edelweiss research

Attractive export opportunity for India

India is the fourth-largest producer of agrochemicals worldwide after US, Japan and China

India is the fourth-largest producer of agrochemicals worldwide after US, Japan and China and has emerged as the 13th largest exporter of pesticide globally. In addition to exports to the top eight countries—US, Brazil, France, Japan, Australia, Belgium, China and Netherlands—which contribute ~50% to total agrochemical exports, manufacturers could also explore countries in South East Asia, Latin America and select countries in Middle East and Africa.

Chart 28: Country wise agrochemicals exports



Source: Industry, Edelweiss research

During CY18, reported cotton acreage was 25% higher in Brazil, leading to robust demand for insecticides

Global agrochemical market perking up

Commentaries of leading global players indicate that demand is reviving, particularly in LATAM. During CY18, reported cotton acreage was 25% higher in Brazil, leading to robust demand for insecticides. In Europe, adverse weather conditions impacted sowing. Delayed crop sowing coupled with drought-like situation affected overall consumption of agrochemicals.

Table 18: Key highlights by global agrochemical innovators in CY18

Companies	Key Highlights (Full Year CY18)
BASF	• Agriculture segment clocked slower sales growth of 2% YoY as cereal and soyabean yields in Europe, North & South America as well as South Africa were negatively impacted by an unusually long dry period • Agricultural output remained flat in West Europe and fell significantly in East Europe. The company recorded substantial losses from North America • Apart from weather-related issues, trade conflict with China negatively impacted US' soyabean exports to China • Strong upward trend in Asia
Dow Dupont	• Organic sales growth of 6% in crop protection was driven by new product sales, which were partly offset by currency pressure • Seed sales fell 4% on account of reduced planting/ sowing in US, Canada and LATAM
Bayer Monsanto	**Bayer increases sales and earnings - leader in agriculture after acquisition** • Latin America continues to perform well and sales were up 17%. Growth was primarily driven by improved performance in herbicides coupled with the company's effort in normalising channel inventory. The company recorded positive sales growth of 8% in North America and 10% in Asia Pacific region, all on a currency and portfolio adjusted basis • Adverse weather conditions across Europe and loss of registration in France impacted the company's performance in the region • Sales benefitted from service agreements with BASF on divested businesses • **Glyphosate litigation:** Recent studies conducted by the National Cancer Institute-supported Agricultural Health Study found no association between glyphosate-based products and non-Hodgkin lymphoma at any level of exposure
Syngeta	• Sales in Europe were impacted by delayed crop season in the region due to drought situation. This affected fungicides sales in the region. However, good sales growth in the seed segment along with improved product mix in East Europe mitigated the impact • Crop protection sales in North America were up 2% YoY driven by new product launches. Seed sales fell 3% YoY due to weak demand across the region with decline in corn and soya acreage • Latin America: Sales volume in crop protection rebounded to normal level after a difficult 2017. While crop protection sales grew 20% YoY, seed sales jumped 55% YoY followed by acquisition of Nidera. Increased acreage of soya and cotton helped drive demand. • Asia: Recovery in South Asia led to sales growth of 1% with seed sales growth of 6%. Farmers' shift to higher-value products helped the company realise 6% growth from China

Source: Company, Edelweiss research

Uncertainty pertaining to the trade dispute between China and the US coupled with lower commodity prices across the region could limit sales growth in the region

Global outlook: LATAM momentum to sustain; crop prices a concern

Global players' commentaries reflect improved demand outlook in LATAM. This is driven by higher cotton & soyabean acreage in Brazil and improved wheat sowing in Argentina. Players operating in NAFTA region are expected to benefit from improved corn acreage. However, uncertainty pertaining to the trade dispute between China and the US coupled with lower commodity prices across the region could limit sales growth in the region.

Table 19: Region wise outlook on agrochemicals industry

Region\Companies	BAYER	FMC
LATAM	Expect growth momentum to be driven by the region on account of increase in soyabean acreage	Expect LATAM region to grow in low to mid single digits. Growth to be driven by diamides, pre-emergent herbicides growth along with expansion in Brazil
EMEA	Expect growth to be sluggish due to stringent regulatory requirements along with income stress among farmer fraternity	Expect flat to low single digit growth. Growth to be aided by new product introductions. Expect new products to provide incremental sales growth of 1.5% or USD70mn in 2019
North America	Lower prices of agricultural commodities and uncertainty related to trade dispute between US and China to drag overall growth	Expect flat to low single digit growth. Growth to come from increase in corn acreage and normalised pest pressure
Asia	Expect Growth momentum to be driven by the region on account of increase in soybean acreage	Expect flat to low single digit growth. Normal monsoon along with improved product portfolio in India to drive growth

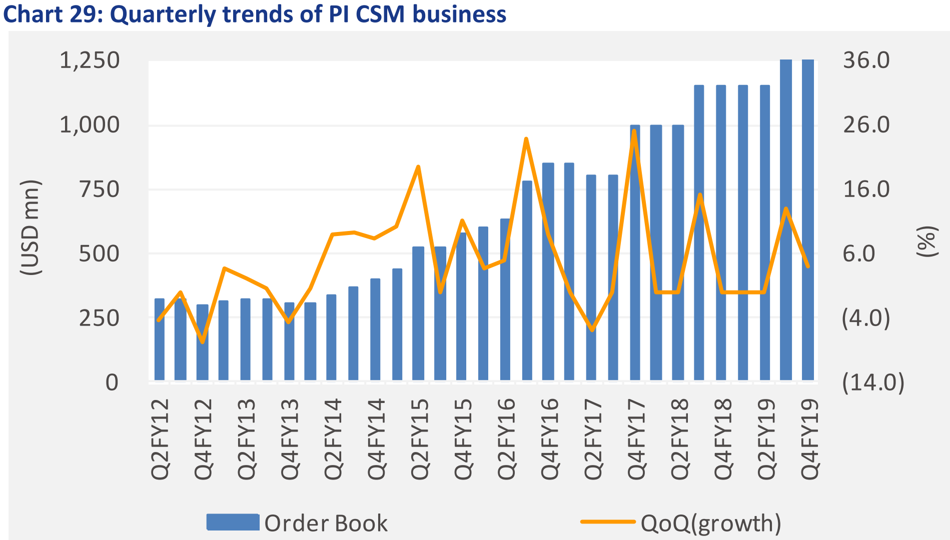
Source: Company, Edelweiss research

Domestic manufacturers optimistic on exports

Key domestic players in agrochemical exports (PI Industry, SRF, Aarti, etc) have given positive commentaries after weak FY18

Key domestic players in agrochemical exports (PI Industry, SRF, Aarti, etc) have given positive commentaries after weak FY18. PI and SRF have witnessed strong pickup in growth in Q4FY19 from their CSM / chemicals business and have shared encouraging outlook on growth in the near term driven by burgeoning customer enquiries and improvement in the global agrochemical industry.

Chart 29: Quarterly trends of PI CSM business



Source: Company, Edelweiss research

Table 20: Outlook towards exports by key specialty chemical companies

Company	Global Outlook
PI Industries	PI Industries has a strong order book value of USD 1.3bn.With the uptick in global agrochemical cycle, PI Industires expect the export segment to continue to grow at more than 20% in the years to come.
Rallis India	Rallis India obsereved a 36% growth in exports in FY19. With sharp uptick in demand for chemical intermediates, management has announced to double capacity for key export molecules.
Aarti	Aarti Industries expects the bullish trend in the exports segment to continue. Backed by strong order book and the increasing number of queries, company expects to continue to deliver strong performance.
SRF	SRF has observed an increase in number of queries for Chemical and Refrigerants segment. Increase in global demand is expected to yield a strong performance for SRF over next few years.

Source: Company, Edelweiss research

Significant opportunity: 26 active ingredients to go off patent by 2022

Till 2022, 26 agrochemical AI will lose their patent protection including 13 herbicides, four insecticides, eight fungicides

Till 2022, 26 agrochemical AI will lose their patent protection including 13 herbicides, four insecticides, eight fungicides. Bayer holds the most—seven—products with patents expiring in the ensuing five years, the same numbers as from Japanese companies. Amisulbrom from Nissan Chemical Industries, Pyrimsulfan from Ihara Chemical Industry, Pyroxasulfone from Kumiai Chemical Industry, Flubendiamide & Pyrifluquinazon from Nihon Nohyaku, Fenpyrazamine & Metofluthrin from Sumitomo Chemical will lose their patents protection in the period.

Table 21: Technical ingredients going off-patent by 2022

Active Ingredient	Inventor Company	Category
Aminopyralid	Dow AgroSciences	Herbicide
Amisulbrom	Nissan Chemical Industries	Fungicide
Chlorantraniliprole	DuPont	insecticide
Cyprosulfamide	Bayer CropScience	saFener
Fenpyrazamine	Sumitomo Chemical	Fungicide
Flubendiamide	Nihon Nohyaku	insecticide
Flucetosulfuron	LG Chem Investment	Herbicide
Fluopicolide	Bayer CropScience	Fungicide
Isotianil	Bayer CropScience	Fungicide
Mandipropamid	Syngenta	Fungicide
Metamifop	Dongbu Hannong Chemicals	Herbicide
Metofluthrin	Sumitomo Chemical	insecticide
Metrafenone	BASF	Fungicide
Orthosulfamuron	Isagro	Herbicide
Penflufen	Bayer CropScience	Fungicide
Pinoxaden	Syngenta	Herbicide
Pyrasulfotole	Bayer CropScience	Herbicide
Pyrifluquinazon	Nihon Nohyaku	insecticide
Pyrimsulfan	Ihara Chemical Industry	Herbicide
Pyroxasulfone	Kumiai Chemical Industry	Herbicide
Pyroxsulam	Dow AgroSciences	Herbicide
Saflufenacil	BASF	Herbicide
Tembotrione	Bayer CropScience	Herbicide
Thiencarbazone	Bayer CropScience	Herbicide
Topramezone	BASF	Herbicide
Valifenalate	Isagro	Fungicide

Source: Chemspec, Edelweiss research

China is playing a pivotal role in the global pesticide market as China is playing a pivotal role in the global pesticide market

China situation: Environmental norms impacting growth

China has been the world's largest pesticide export country. Due to high quality of pesticide products, it exports pesticides to over 180 countries including six continents. China is playing a pivotal role in the global pesticide market as it primarily produces generic products in the form of technical and over 70% of the global demand for pesticide technical is produced in China. However, rising pollution levels across the country have forced authorities to take measures against non-environment compliant players. This has impacted overall agrochemical production.

Chart 30: Agrochemicals export comparison China v/s India

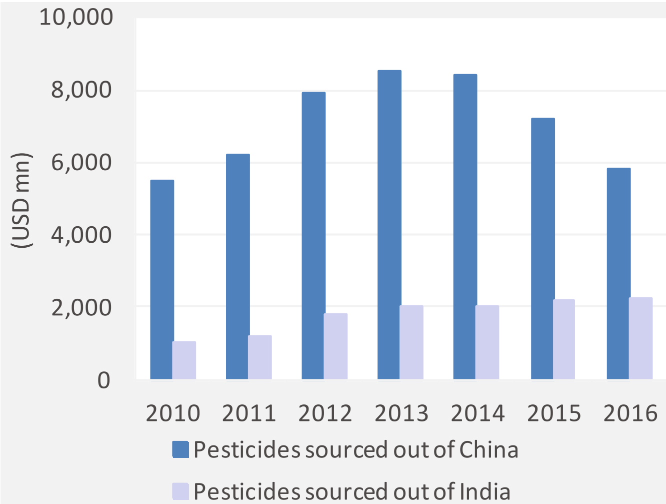
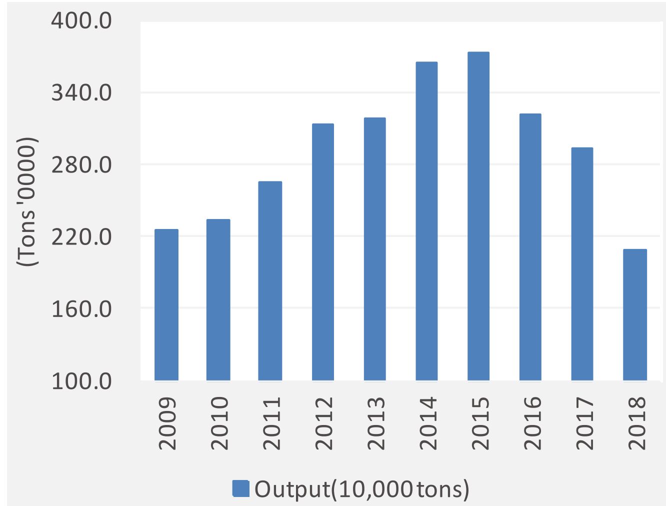


Chart 31: Production level of chemicals in China



Source: Chemspec, Edelweiss research

Prices of many technicals in China's agrochemical industry have jumped 20-50% over the past 12 months

Supplies to remain under pressure

Prices of many technicals in China's agrochemical industry have jumped 20-50% over the past 12 months. This is attributable to production cuts, new pollution control norms and industry consolidation. Our interaction with players in China indicates that supplies will remain under pressure as authorities continue to implement new policies to curb pollution.

Players from our universe: Aarti Industries – 15-20% of revenues

Other players: Aksharchem, Bodal , Meghmani, Sudarshan , Atul, Clariant chemicals, Kiri dyes, etc

2) Colorants

The market size of the India's colorants industry was pegged at USD6.5bn in FY16 and estimated to post 11% CAGR over FY16-25 driven by high growth in the textile industry. Also, many Chinese plants have shut down due to implementation of stringent environmental laws. This has led to shift of supply from China to India, boosting exports.

Colours have an inherent element of value addition to a wide variety of products like textiles, leather, paper, food products, cosmetics, plastics, paints, inks, etc. The colorants market is sub-categorised in to dyes and pigments.

Fig. 8: Classification of colorants

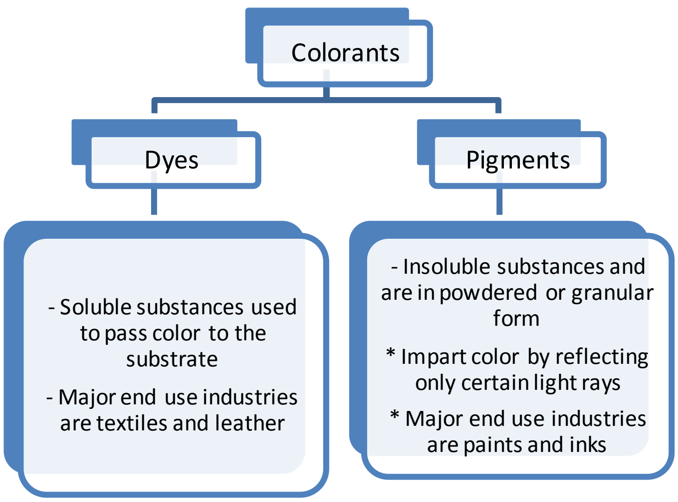
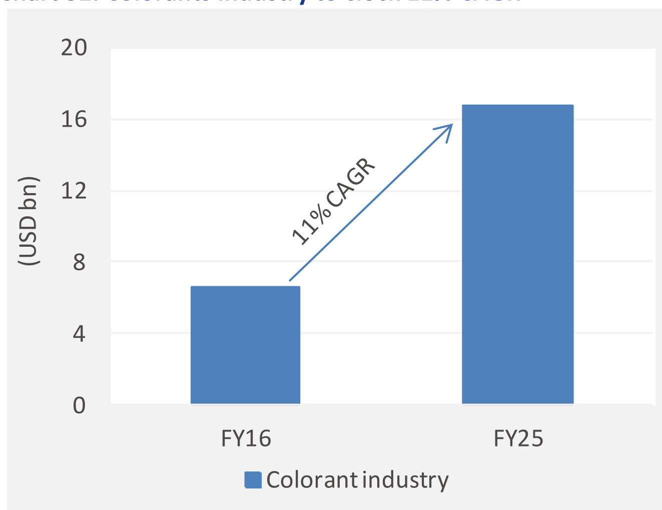


Chart 32: Colorants industry to clock 11% CAGR



Source: FICCI, Edelweiss research

Colorants industry at USD6.5bn in FY16 is estimated to register 11% CAGR over FY16-25

Colorants industry to clock 11% CAGR over FY16-25E

The market size of India's colorants industry was estimated at USD6.5bn in FY16. In FY16, exports contributed 80% plus to total consumption, which highlights the tremendous growth potential of the overall industry. The market size of the overall colorant industry is estimated to register CAGR of 11% driven by high growth in the textile industry. Also, many plants in China have been shut due to implementation of stringent environmental laws, which again leads to shift of supply from China to India, leading to overall growth of the segment.

Key players: Atul, Fosroc, SIKA India, BASF, etc

3) Construction chemicals

Although construction chemicals account for 2-5% of project cost, the benefits realised are far greater. The market for construction chemicals is expected to clock 12% CAGR to USD2bn in FY25, primarily led by government's infrastructure development initiatives.

Construction chemicals are chemical compounds used in construction activities, be it residential, non-residential or non-building. Although construction chemicals account for 2-5% of a project cost, the benefits realised are far more than the increase in the cost of project. Some of these chemical products help minimise the quantity of cement and water used in construction. The market is largely driven by concrete admixtures, which accounted for 42% of the total market, followed by flooring and waterproofing chemicals.

Chart 33: Construction chemicals product share

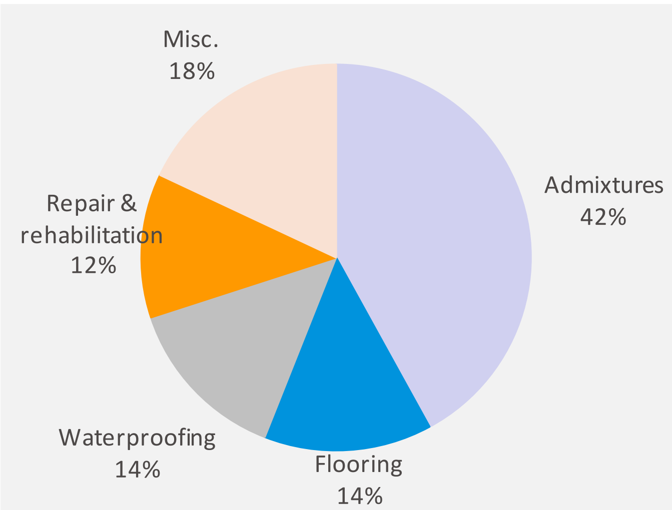
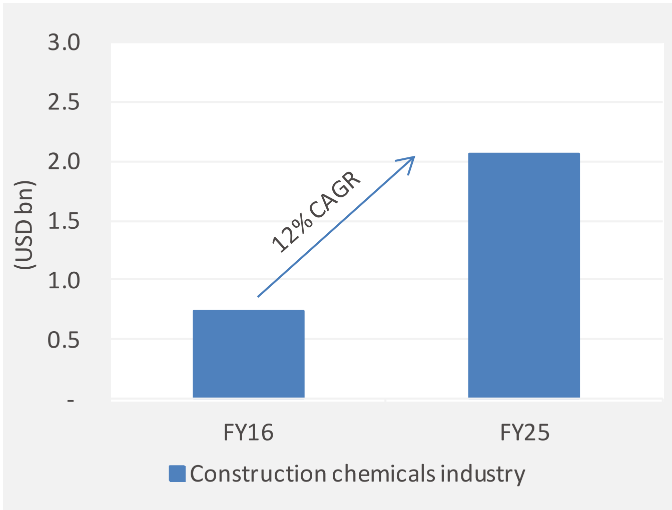


Chart 34: Construction chemicals industry to post 12% CAGR



Source: FICCI, Edelweiss research

Construction chemicals market is expected to clock 12% CAGR to USD2bn by FY25

Construction chemicals market to clock 12% CAGR

The market, boosted by investments in the construction sector, has posted CAGR of 13.8% in the past. The top 5 players account for 50% of the market; the balance being accounted for by small and unorganised players. Fosroc, SIKA India and BASF SE are the leading players in India. The market for construction chemicals is expected to post CAGR of 12% to USD2bn in FY25. Government's initiatives towards infrastructural development are one of the major factors driving the growth of the construction chemicals industry.

Players from our universe:
SH Kelkar – 100% of revenues

Other players: Givaudan, IFF, Firmenich, Symrise, Goldfield, Aarva chemicals, Camlin Fine, Sachee Aromatics, Synthite etc

The global fragrance & flavour industry is expected to post CAGR of 5% to USD31.5bn by 2021

Top 10 companies in the fragrance & flavour industry accounted for ~79% of the industry's sales in 2017 compared to 64% in 2000

While the Indian flavour industry is expected to register 11% CAGR, the fragrance industry is expected to clock 9% CAGR over CY17-21E

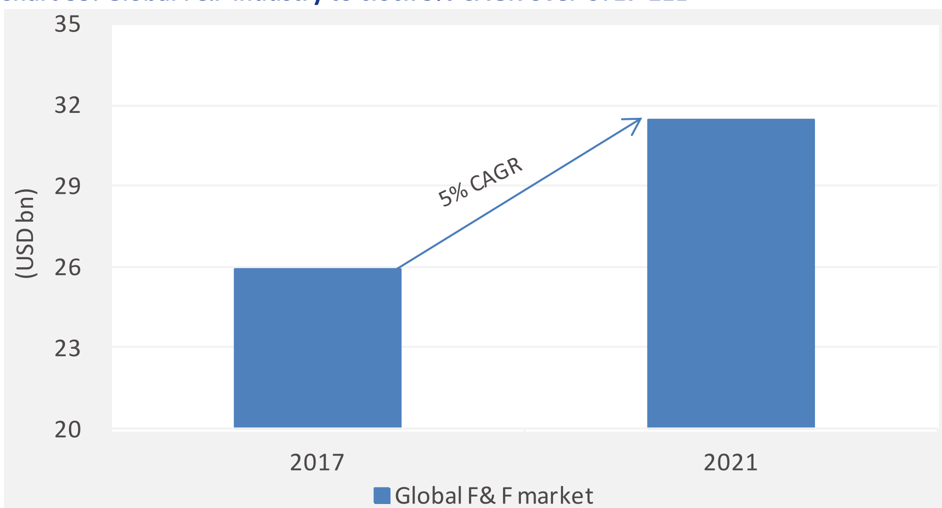
4) Flavours & fragrance industry

The global fragrance & flavour market size to reach USD31.5bn by CY21E, 5% CAGR over CY17-21. Growth in India is expected to be higher at 10.2% CAGR over CY17-21E. Of this, the flavour industry is expected to clock 11% CAGR to INR43bn by CY21 and the fragrance industry to clock 9% CAGR to INR39bn by CY21.

Global flavours & fragrance industry to post 5% CAGR

The global fragrance & flavour industry is estimated to be worth USD25.9bn with an almost equal split between fragrance and flavour markets. As per industry estimates, the global fragrance & flavour industry is expected to post CAGR of 5% to USD31.5bn by 2021.

Chart 35: Global F&F industry to clock 5% CAGR over CY17-21E



Source: S H Kelkar company presentation, Edelweiss research

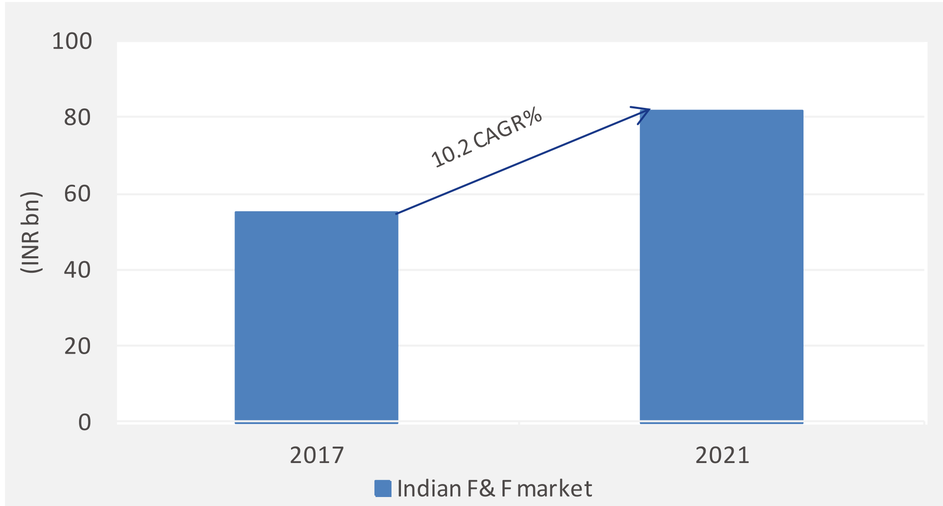
Rising consolidation in global F&F industry

Fragrance & flavour products are, in many cases, key components in a wide variety of FMCG products. While the global fragrance & flavour industry is highly fragmented with thousands of players, there is increased consolidation among larger companies. Top 10 companies in the industry accounted for ~79% of the industry's sales in 2017 compared to 64% in 2000. Companies like Givaudan SA, Firmenich, International Flavors & Fragrances and Symrise AG, individually hold a market share of 10% plus. Large players continue to consolidate for scale and a differentiated product portfolio. Top 4 players control 58% of the market.

Indian flavours & fragrance industry to post 10% CAGR

The total market size of India's fragrance & flavour industry is estimated at INR55bn with an almost equal split between the fragrance and flavour markets for CY17. The fragrance & flavour industry is expected to reach IN82bn by CY21E, clocking 10.2% CAGR. Of this, the flavour industry is expected to grow at a faster clip of 11.2% to INR43bn by CY21E. On the other hand, the fragrance industry is estimated to grow at a healthy rate of 9.2% to INR39bn by CY21.

Chart 36: Indian F&F industry to clock 10% CAGR over CY17-21E



Source: S H Kelkar company presentation, Edelweiss research

Chart 37: Fragrance market to clock 9% CAGR over CY17-21E

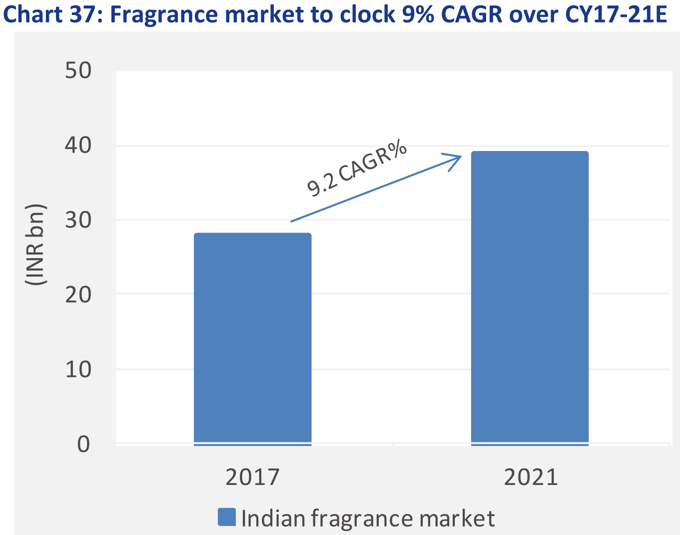
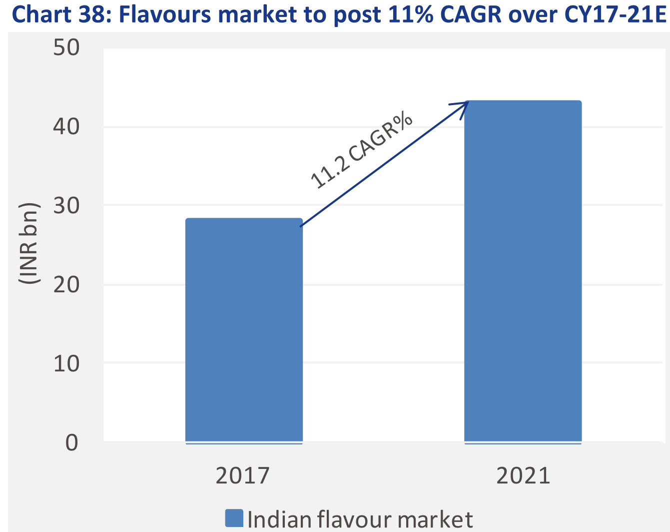


Chart 38: Flavours market to post 11% CAGR over CY17-21E



Source: S H Kelkar company presentation, Edelweiss research

Players from our universe:
Fine Organics– 30% of revenues

Other players:, Camlin Fine, Kerry group, Danisco, Palsgaard, Riken Vitamin, Taiyo

In CY16, overall global food emulsifiers market was pegged at USD2.8bn and is estimated to clock 4.1% CAGR over CY16-21

5) Food additives

Credence Research estimates the global food emulsifiers market size to reach USD3.4 bn, 4.1% CAGR over CY16-21, driven by higher 4.6% CAGR in the Asia Pacific region. Growth in India is expected to be higher at 10-12% CAGR over CY16-21.

Any substance added to food can be broadly termed as food additive. In a stricter sense, any substance that is intended to affect the characteristics of food is a food additive. This includes any substance used in production, processing, treatment, packaging, transportation and storage of food. Food additives are used to preserve, flavour, blend, thicken and colour foods. These additives are strictly regulated and monitored by the government to ensure health of people.

Global food emulsifiers market estimated at USD2.8bn in CY16

In CY16, overall global food emulsifiers market was pegged at USD2.8bn. Europe is the largest consuming region with 33% share of the global market. Among products, mono and di-glycerides and natural emulsifiers were the largest categories. Credence Research (as cited in CRISIL Research Report) estimates the market size to reach USD3.4bn by CY21, 4.1% CAGR, over CY16-21, driven by higher growth in the Asia Pacific region (accounts for 26% of global share), which is expected to post 4.6% CAGR.

Within the Asia Pacific region, emerging economies such as China and India are estimated to post higher growth. Europe is also expected to propel demand by posting 4.2% CAGR. Within Europe, key markets Germany and France will continue to post steady CAGR over the next five years. Among product categories, mono & di-glycerides and natural emulsifiers are expected to drive demand.

Chart 39: Global emulsifiers market to clock 4% CAGR

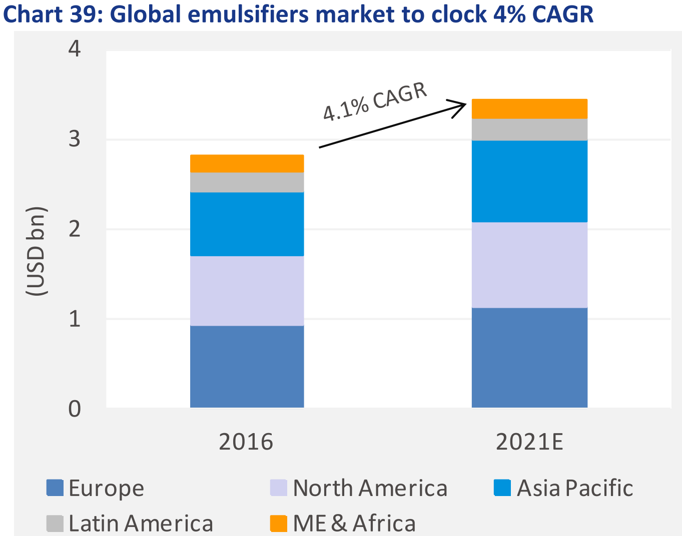
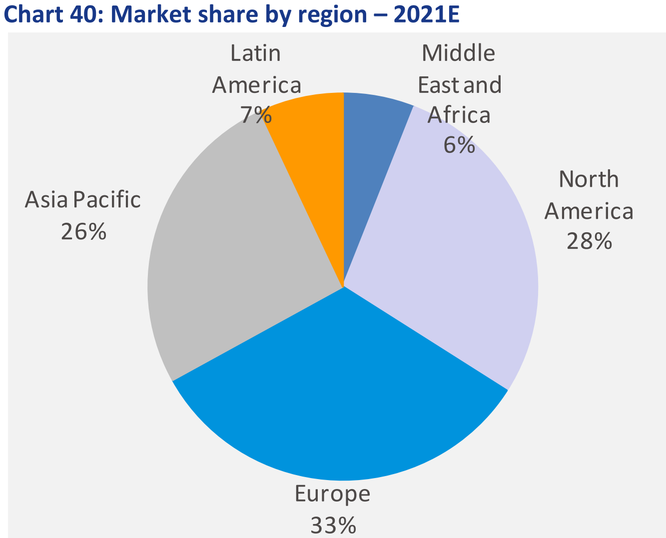


Chart 40: Market share by region – 2021E



Source: CRISIL research, Fine organics DRHP, Edelweiss research

Key growth drivers globally

- Rising awareness among food processors about advantages and applications of food emulsifiers in various applications like the bakery & confectionary industry and dairy, as well as high consumption of ice creams, biscuits, mayonnaise, chocolates, bread, coffee, soft drinks, etc.

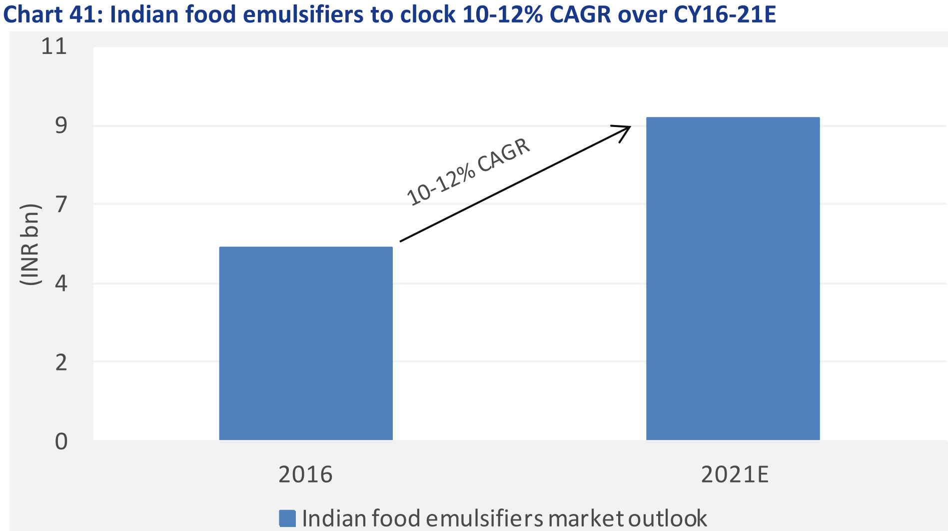
- Burgeoning population, higher economic growth & disposable incomes and changing lifestyles of emerging nations in Asia such as India, China and Vietnam, leading to high growth of packaged and convenience foods, which require food emulsifiers to sustain quality for longer hours and for enhanced taste, colour and appearance.
    - Rise in health awareness and quality consciousness of consumers in developed nations.
    - Modern lifestyles have increased demand for healthy packaged and convenience foods. This has led to high consumer demand for trans-fat products, which is driving food processors to use emulsifiers to reduce calories and fat content.
    - Growing population and rising concerns regarding food quality and safety. Emulsifiers can aid in the decrease of salt and sugar content without changing texture and taste of food and associated products.

India's food emulsifiers market to reach INR9bn by CY21

India's food emulsifier market at INR5-6bn in 2016 is expected to clock 10-12% CAGR over CY16-21E driven by healthy growth in convenience and packaged food segments, especially premium food segments

India's food emulsifiers market was pegged at INR5-6bn in 2016. Between CY16 and CY21, CRISIL Research estimates it at INR9bn, 10-12% CAGR, driven by healthy growth in convenience and packaged food segments, especially premium food segments. Changing lifestyles and hectic work schedules are expanding the market for processed and packaged convenience foods. The booming organised retail sector further extends the reach of processed foods.

Chart 41: Indian food emulsifiers to clock 10-12% CAGR over CY16-21E



Source: CRISIL research, Fine organics DRHP, Edelweiss research

CRISIL Research estimates the Indian cosmetics industry to clock 10-12% CAGR over FY17-22 vis-à-vis global average of 4.0-4.5% CAGR

CRISIL Research expects domestic SBR and PBR to post CAGR of 6-7% over FY17-22E versus 3-4% CAGR globally

CRISIL Research forecasts the paints and coatings industry to register 8-10% CAGR over FY17-22E

Cosmetic and pharmaceutical additives: Overview and demand outlook

Cosmetic and pharmaceutical additives are ingredients added to cosmetics and related pharmaceutical products to achieve certain and, at times, different structures like creams, gels, pastes, lotions, solutions, varnishes, sticks, powders and aerosols. Cosmetic additives demand growth in India will depend on growth prospects of the end-user cosmetics sector. CRISIL Research estimates the cosmetics industry's revenue of INR24-25bn in FY17 to post 10-12% CAGR over FY17-22 vis-à-vis 8-10% CAGR over FY12-17. Volume growth will largely be contributed by rural areas through increasing penetration and marketing initiatives. At the global level, CRISIL Research expects the cosmetics industry to post 4.0-4.5% CAGR over FY17-22. Growth will be driven by a rise in disposable incomes, changing lifestyles and rising demand for skin & sun care products due to varying climatic conditions.

Rubber additives: Overview and demand outlook

Additives are used to make elastomers meet performance parameters of specific applications. Compounded rubber has many unique characteristics that are not present in other traditional material such as dampening properties, high elasticity and abrasion resistance. Consequently, rubber is used in applications such as tyres, conveyor belts, dock fenders, building foundations and a wide range of domestic appliances. CRISIL Research expects Styrene-butadiene Rubber (SBR) and Poly-butadiene Rubber (PBR) domestic demand to clock CAGR of 6-7% between 2016-17 and 2021-22. At the global level, CRISIL Research estimates SBR and PBR demand to post 3-4% CAGR over the next five years driven by healthy growth in automobile production in Asia.

Paint and coating additives: Overview and demand outlook

Primary components in coating material such as paints are binders, pigments, extenders, solvents and additives. Other than these key ingredients, additives in a paint composition also have a major influence on various paint properties. The typical proportion of a single additive in a formulation is generally ~1.5% of total quantity of the coating formulation.

Paints and coatings additives demand growth in India will depend on the growth prospects of end-use paints and coatings sector. CRISIL Research forecasts the paints and coatings industry to register 8-10% CAGR between 2016-17 and 2021-22. At the global level, CRISIL Research expects the paints industry to be driven by rising construction spending, rapid urbanisation, rising household consumption expenditure and accelerating economic growth.

Players from our universe: Aarti Industries

Other players: Atul, BASF Coatings India

Decorative paints account for 73% of the total paint industry while Industrial paints accounts for remaining 27% share

6) Paints and coatings

India's paint industry, valued at USD6.4bn, is highly consolidated with 65% market captured by the organised sector. The industry is estimated to clock 10% CAGR over CY16-25 led by low per capita paint consumption in India, strong growth in the automotive industry, etc.

India's paint industry can be broadly classified in to two segments:

1. **Decorative paints:** This segment primarily caters to residential and commercial buildings and accounts for 73% of the total paints industry. On the basis of product composition, decorative paints are of two kinds—water based and solvent based. In the decorative segment, Asian Paints is the market leader, followed by Berger and Kansai Nerolac.

2. **Industrial paints:** This segment includes paints used in automobiles, auto ancillaries, consumer durables, containers, etc. This segment requires technological expertise and, therefore, it is largely catered to by the organised sector. It accounts for 27% of the overall market. Kansai Nerolac is the market leader in industrial paints, followed by Berger and Asian PPG.

Chart 42: Decorative paints - breakdown by segment

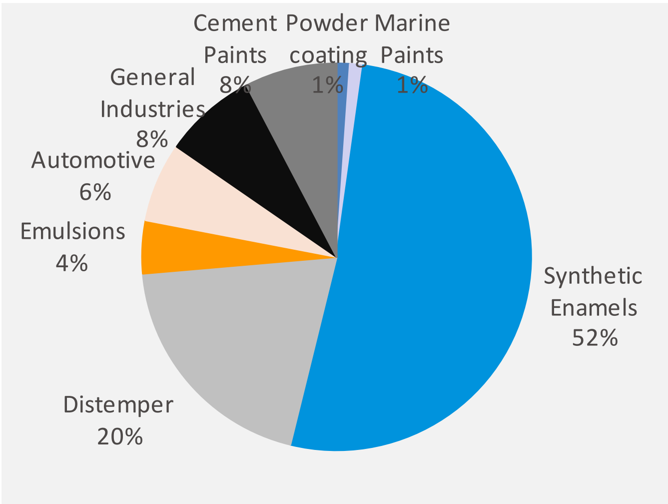
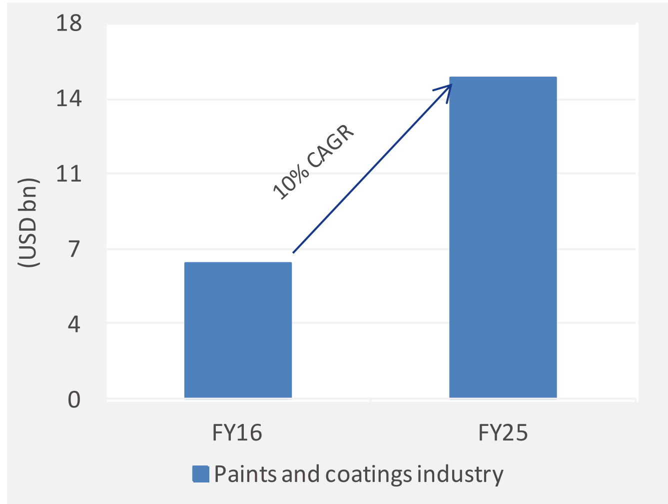


Chart 43: Paints and coatings industry to clock 10% CAGR



Source: FICCI, Edelweiss research

Indian paint industry at USD4.6bn is expected to post 10% CAGR over FY16-25E

Paints and coatings market to post 10% CAGR

India's paint industry is valued at USD6.4bn. The industry is highly consolidated with 65% market captured by the organised sector. It is expected to post CAGR of 10% over FY16-25E led by low per capita paint consumption in India, strong growth in automotive industry, etc.

7) Personal care ingredients

Players from our universe: Galaxy Surfactants, Fine Organics, Aarti Industries

Other players: BASF, Sami lab, Vivimed Labs, S H Kelkar, DSM, and Merck

India's personal care ingredients market was pegged at USD871mn in FY16 with active ingredients accounting for 40% of the total market. The personal care ingredients market has posted 11.8% CAGR and is estimated to clock 13% CAGR to USD2,617mn by FY25 led by rising incomes, increased availability and wider product portfolios of companies.

The market for personal care ingredients is broadly classified in to commodity, fine chemical, and specialty chemical ingredients. Specialty ingredients are further classified as active and inactive ingredients based on their functionality in consumer products.

Inactive ingredients: Personal care inactive ingredients provide physical and processable properties to a formulation as opposed to active properties. These include surfactants, preservatives, colorants and polymer ingredients.

Active ingredients: Personal care active ingredients add active property to a product that results in benefits to the end user as opposed to the formulation. These include anti-ageing ingredients, exfoliators, conditioning agents and UV agents.

Fig.9: Classification of personal care ingredients

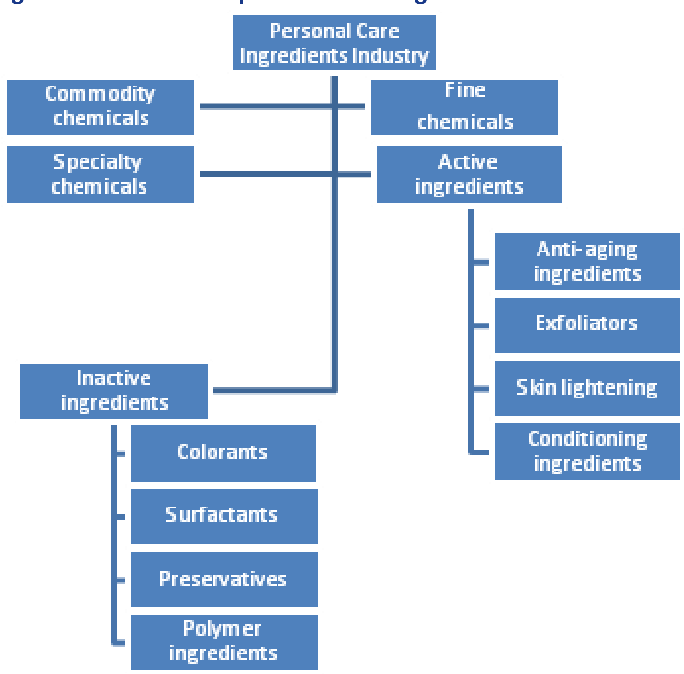
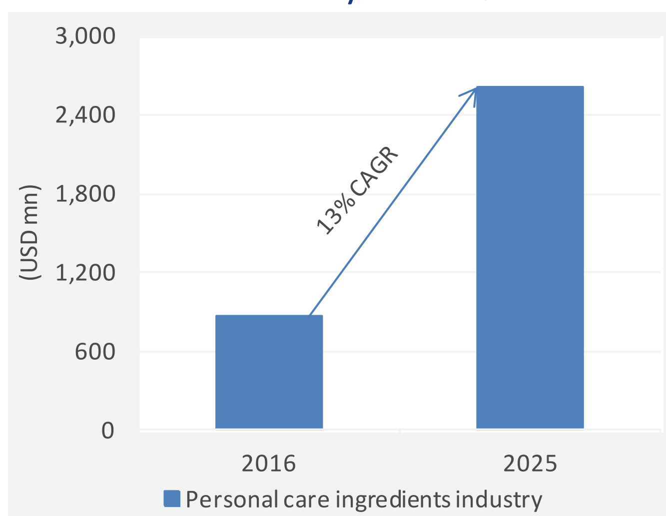


Chart 44: Personal care industry to clock 13% CAGR



Source: FICCI, Edelweiss research

Personal care ingredients industry to post 13% CAGR

India's personal care ingredients market is estimated to post 13% CAGR to USD2,617mn by FY25

India's personal care ingredients market was valued at USD871mn in FY16 with active ingredients accounting for 40% of the total market. The market has clocked 11.8% CAGR in the past. Rising incomes, increased availability and wider product portfolios of companies have led to growth in personal care products and thereby personal care ingredients. The personal care ingredients market in India is expected to grow at 13% to USD2,617mn by FY25.

Players from our universe:
Fine Organics – 70% of revenues
Aarti Industries – 15-20% of revenues

Other players: Plastiblends, Croda, Emery, PMC Biogenix, Peter Greven

Plastic additives comprise less than 1% of the total weight of the end product

8) Plastic additives

Plastic additives comprise less than 1% of the total weight of an end product. Mordor Intelligence estimates global plastic additives market to touch USD30bn, 6% CAGR over CY16-21, driven by higher 7% CAGR in the Asia Pacific region. Further, growth in India is expected to be higher at 8-10% CAGR over CY16-21.

Plastic additives are specialty chemicals added to the base polymer or plastic resins to enhance certain properties, improve processing or merely change its colour. Additives can also be used to improve the characteristics of polymers such as strength, lustre, durability or heat sensitivity. Plastic additives comprise less than 1% of the total weight of the end product.

Global plastic additives market pegged at USD22bn in CY16

In CY16, overall global plastic additives market was estimated at USD22bn. Asia Pacific is the largest consuming region with 53% share of global market. Among end-user sectors, the packaging sector dominated plastic additives off take with 25% share of global market. Among end-user plastic types, polyethylene category was the largest with 16% share.

Chart 45: Region-wise market share (2016)

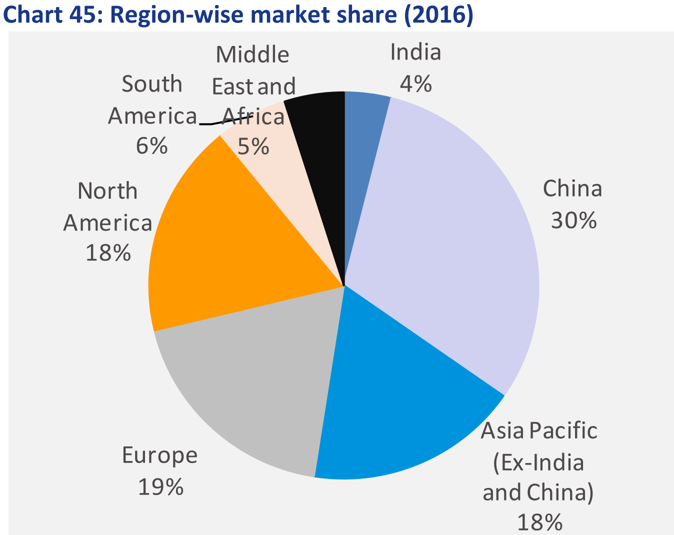
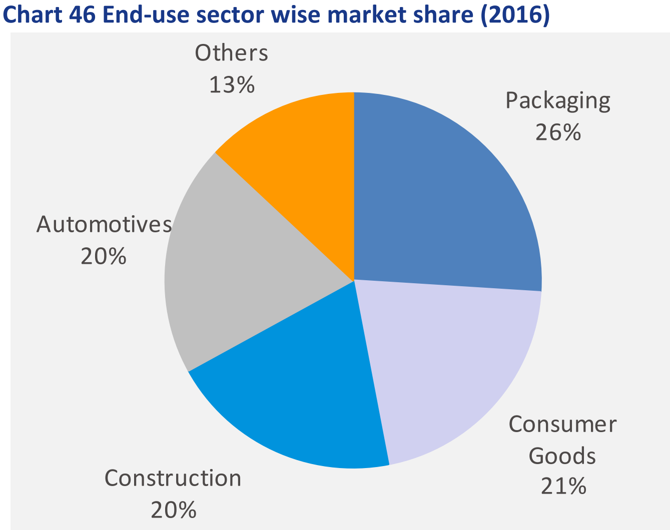


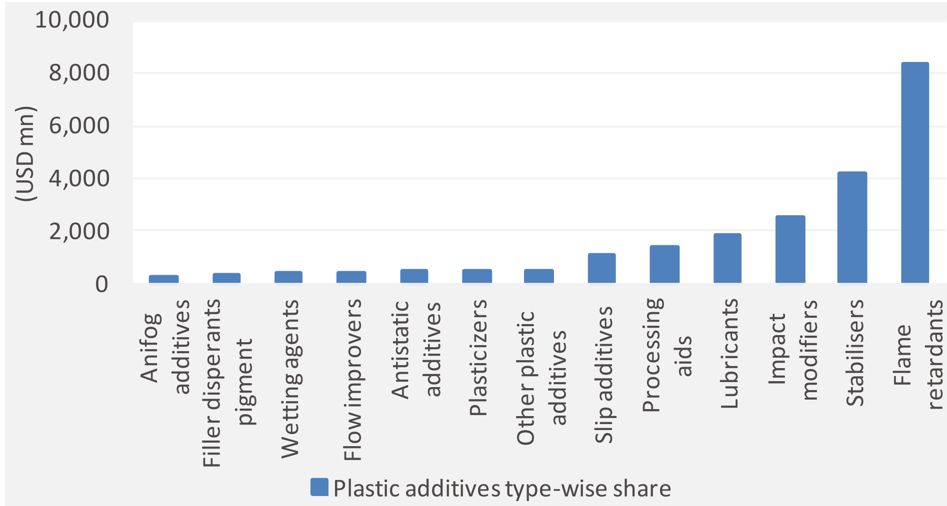
Chart 46 End-use sector wise market share (2016)



Source: CRISIL research, Fine organics DRHP, Edelweiss research

Global plastic additives market is pegged at USD30bn, a 6.0% CAGR over CY16-21

Chart 47: Type wise plastic additives (2016)



Source: CRISIL research, Fine organics DRHP, Edelweiss research

Global plastic additives market estimated at USD30bn by CY21

Mordor Intelligence estimates the global plastic additives market to reach USD30bn, a 6.0% CAGR over CY16-21, driven by higher 7% CAGR in the Asia Pacific region. Within the region, China and India are expected to record higher CAGR of 8.0% and 6.4%, respectively. Steady recovery in the Europe and US economies is also expected to aid demand for plastic additives from these regions.

Chart 48: Global plastic additives market to clock 6% CAGR

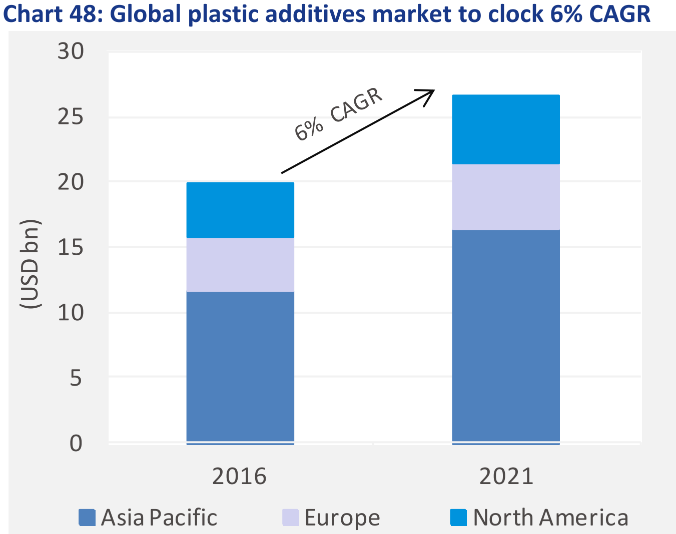
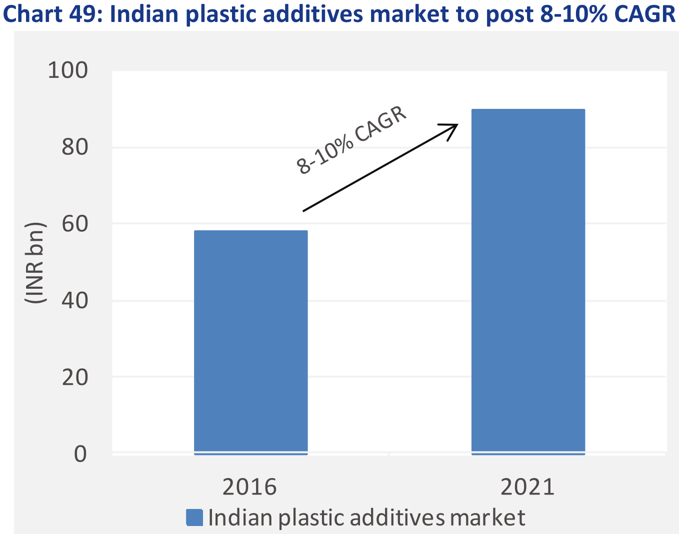


Chart 49: Indian plastic additives market to post 8-10% CAGR



Source: CRISIL research, Fine organics DRHP, Edelweiss research

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India's plastic additives market was pegged at INR55-60bn in CY16 and is expected to clock 8-10% CAGR

Indian plastic additives market to clock 8-10% CAGR to INR90bn

India's plastic additives market was pegged at INR55-60bn in CY16. Over CY16-21, it is estimated to jump to INR90bn, 8-10% CAGR, driven by increased usage in the polymer (PE, PP, and PVC) sector. CRISIL Research expects premium packaging segments to drive growth of plastic additives.

9) Surfactants

Surfactants, an application-driven segment, accounts for 11.9% of total specialty chemicals market. The surfactants market, pegged at ~USD31bn in 2015, is projected to clock CAGR of 4.4% to USD45bn in 2024. Asia Pacific is expected to become the largest market by 2024 and will also be the fastest growing, clocking 5.8% CAGR (2015-24).

Players from our universe:
Galaxy Surfactants – 100% of revenues
Aarti Industries – 5-10% of revenues

Other players: BASF Ltd, Ultramarine & pigments, Sunshield Chemicals

Surfactants: One of the key specialty chemical segments

Surfactants, an application-driven segment, accounts for 11.9% of total specialty chemicals market. They are primarily used in households, industrial & institutional cleaning, personal care and various industrial applications such as textile processing, food industry, paints & coatings, oil fields, etc.

Asia Pacific to lead growth in global surfactants market

Surfactants market at USD30.65bn in 2015 is expected to clock CAGR of 4.4% to USD45.16bn in 2024

The surfactants market, pegged at USD30.65bn in 2015, is projected to clock CAGR of 4.4% to USD45.16bn in 2024. In terms of volumes, the surfactants market is 16.35mt (2015), which is expected to post CAGR of 3.9% to 22.97mt till 2024. Asia Pacific is expected to become the largest market by 2024 and will also be the fastest-growing clocking 5.8% CAGR (2015-24).

Table 22: Global surfactants market by region

Region	2015 (USD bn)	2018 (USD bn)	2024 (USD bn)	CAGR (%)
Western Europe	7.7	8.5	10.5	3.6
North America	8.7	9.8	12.2	3.8
Japan	2.6	2.9	3.5	3.4
Asia Pacific*	8.0	9.4	13.2	5.8
Rest of the World	3.7	4.3	5.7	5.0
Total	**30.7**	**34.9**	**45.2**	**4.4**

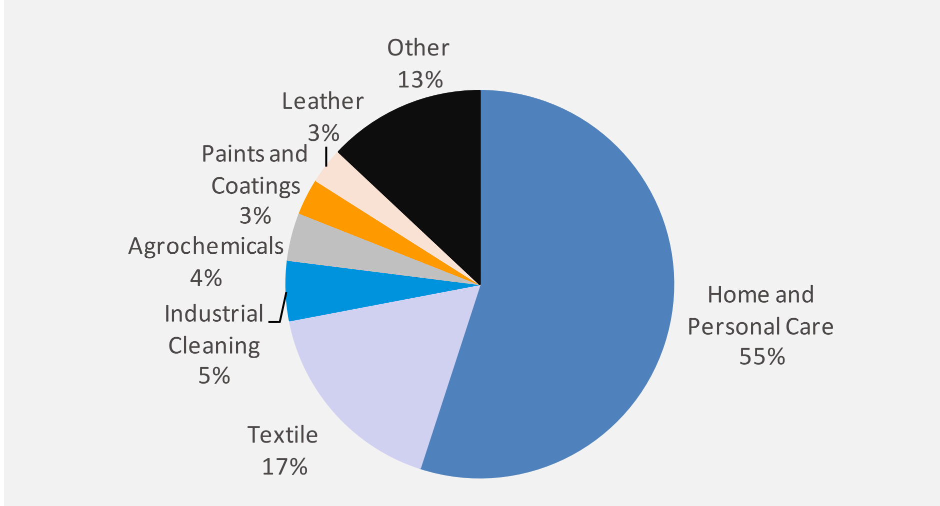
*Note: *excluding Japan, Source: Galaxy Surfactants DRHP, Edelweiss research*

Personal care market to drive demand, followed by household cleaning market

Household cleaning accounts for largest application for surfactants, accounting for 35% of global surfactants consumption in terms of value

Household cleaning accounts for largest application field for surfactants and accounts for 35% of global surfactants consumption in terms of value. Making up 20%, personal care is the most lucrative application field and the fastest-growing for surfactant suppliers. The personal care market is expected to be the fastest-growing segment with CAGR of 5.9% and 7.6% globally and India, respectively, driving overall growth of the surfactants industry.

Chart 50: Breakdown of surfactants segment (% share)



Source: Galaxy Surfactants DRHP, Edelweiss research

Table 23: Global surfactants market by application industry

Sales*	Segments	2015 (USD bn)	2018 (USD bn)	2024 (USD bn)	CAGR (%)
Household Cleaning	Detergents and soaps, detergent additives, laundry detergents, dishwashing products, and other household cleaners	10.7	11.9	14.5	3.4
I & I Cleaning	Commercial and industrial sector, public sector and Institutions and the government	2.0	2.2	2.7	3.6
Personal Care	Hair care, skin care and cosmetics	6.1	7.3	10.3	5.9
Industrial Application	Textile/leather industry, oil industry, gasoline/fuel additives, agrichemicals, etc	9.8	11.2	14.7	4.6
Others		2.0	2.3	3.0	4.5
Total		**30.7**	**34.9**	**45.2**	**4.4**

*Note: *Figures as in 2015* *(Source: "Global Surfactant Market – 4th Edition" by Acmite Market Intelligence)*

Source: Galaxy Surfactants DRHP, Edelweiss research

Table 24: Indian surfactants market by application industry

Sales	2015 (USD bn)	2018 (USD bn)	2024 (USD bn)	CAGR (%)
Household Cleaning	0.42	0.5	0.7	**5.1**
I & I Cleaning	0.11	0.1	0.2	**5.4**
Personal Care	0.24	0.3	0.5	**7.6**
Industrial Application	0.45	0.5	0.8	**6.2**
Others	0.13	0.2	0.2	**5.8**
Total	**1.35**	**1.61**	**2.28**	**6.0**

Source: Galaxy Surfactants DRHP, Edelweiss research

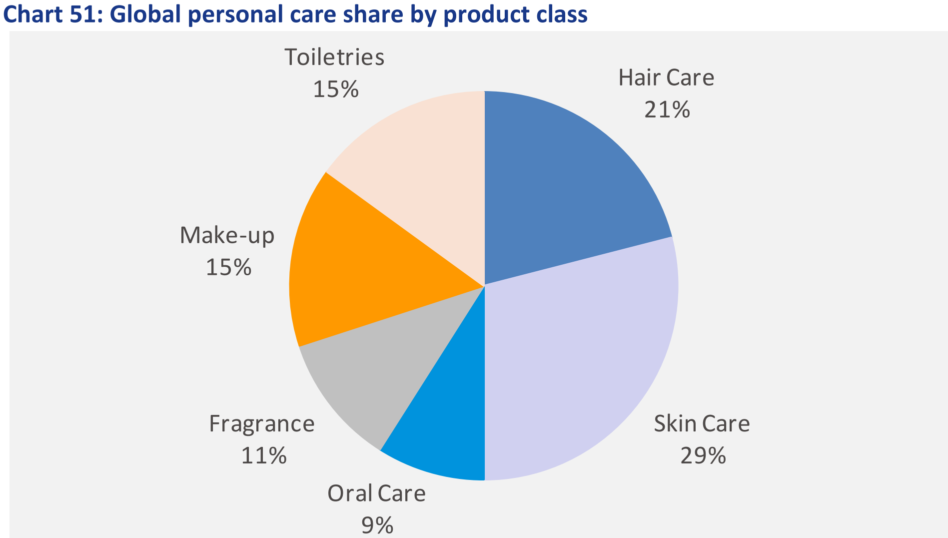
Personal care: One of the most attractive end-user applications industry

The personal care market continues to expand, demonstrating that unlike other markets, cosmetics and toiletries have escaped any major hit from the economic recession. Rising awareness of new formulations is also creating new opportunities for specialty personal care ingredients. With increased consumer awareness of sun exposure's side effects, the use of UV absorbers has extended to a rising number of skin care products, ranking them among the rapidly growing markets. The use of surfactants in personal care products falls in to three major categories:

- **Skin care:** Surfactants used in skin care may be categorised as "rinse off" and "leave-on" products. Conventional surfactants in rinse off categories provide effective cleansing. These are used in products like shower gels, face wash and body wash.
- **Hair care:** There are two major developments in hair care: (i) the search for mild surfactants; and (ii) search for conditioning agents. Also, a combination of surfactants with other ingredients can result in special characteristics of shampoos. Surfactants used in shampoos are normally a "gelled" surfactant solution.
- **Oral care:** The oral care market is dominated by toothpaste, which accounts for 60% of the global oral hygiene business.

Globally, hair and skin care segment accounts for 50% of the personal care industry

Chart 51: Global personal care share by product class



Source: "Global Beauty Ingredients: New Strategic Segments for Growth" by Kline & Company

Skin care is expected to be the fastest growing category clocking 6.7% CAGR over 2018-24E

Asia Pacific is the fastest growing personal care market and expected to clock 7.7% CAGR over 2018-24E

Indian personal care market is expected to clock 7.9% CAGR over 2018-24E

The use of oleo chemicals is increasing at fast pace and currently accounts for ~50% of the total surfactants manufactured

Table 25: Personal care market

Personal care market by type				
Sales	**2015 (In USD bn)**	**2018 (In USD bn)**	**2024 (In USD bn)**	**CAGR (%)**
Body/Hand Wash	30.1	34.2	44.1	4.3
Shampoo/Hair Care	45.2	51.8	67.9	4.6
Skin Care	58.1	70.8	104.8	6.7
Cosmetics	45.2	54.8	80.1	6.5
Others	36.6	43.3	60.6	5.7
Total	**215.3**	**254.9**	**357.5**	**5.8**
Personal care market by region				
Region#	**2015 (In USD bn)**	**2018 (In USD bn)**	**2024 (In USD bn)**	**CAGR (%)**
Western Europe	53.8	61.7	80.9	4.6
North America	59.2	68.5	91.3	4.9
Japan	22.6	25.9	33.7	4.5
Asia Pacific*	56.0	70.1	109.4	7.7
Rest of the World	23.7	28.8	42.2	6.6
Total	**215.3**	**254.9**	**357.5**	**5.8**
Personal care market of India, Africa and Middle East				
Region	**2015 (In USD bn)**	**2018 (In USD bn)**	**2024 (In USD bn)**	**CAGR (%)**
India	11.4	14.3	22.5	7.9
Africa	8.5	9.4	11.4	3.4
Middle East	9.6	10.8	13.8	4.2
Total	**29.4**	**34.4**	**47.8**	**5.5**

Source: Global Surfactant Market – 4th Edition by Acmite Market Intelligence

*Note: *Figures as in 2015*

Increasing use of oleochemicals in surfactants

In terms of raw material, surfactants are prepared from various feedstock, which is either petrochemicals or oleochemicals. Petrochemicals are derived from either crude oil, natural gas or coal. Oleochemicals used in surfactant production are derived from either palm oil, palm kernel oil or coconut oil. The use of oleochemicals in the surfactants sector is rising as the advantages and opportunities offered by natural oil and fat-based products are further explored and promoted. Currently, ~50% of surfactants are produced from oleochemicals compared to only one-fourth in 1970s.

Players from our universe: Aarti Industries

Other players: Atul, Chembond, Ion Exchange

Coagulants and flocculants form the largest segment in water treatment chemicals with 38% market share

10) Water treatment chemicals

Coagulants and flocculants form the largest segment with 38% market share, followed by biocides and disinfectants with 19% share. Water treatment chemicals market is estimated to post 14% CAGR to USD1,853mn in FY25 led by increased awareness about quality of drinking water and its impact on health.

Water treatment chemicals are used for a wide range of industrial and in-process applications such as reducing effluent toxicity, controlling Biological Oxygen Demand (BOD) & Chemical Oxygen Demand (COD) and disinfecting water for potable purposes. Coagulants and flocculants form the largest segment with 38% market share, followed by biocides and disinfectants with 19% market share.

Chart 52: Water treatment product share

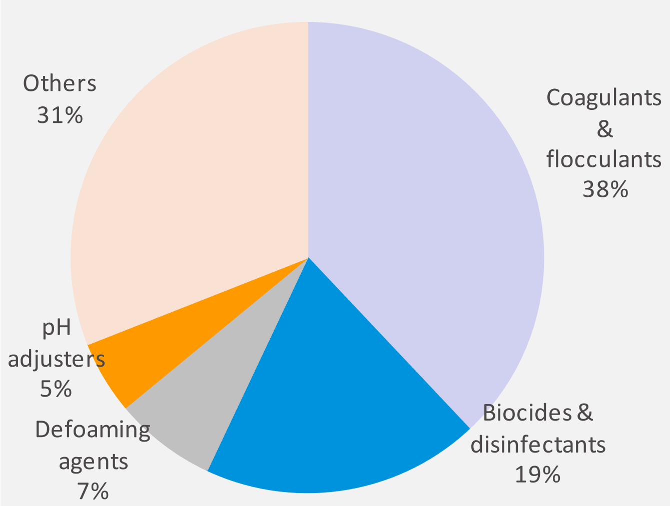
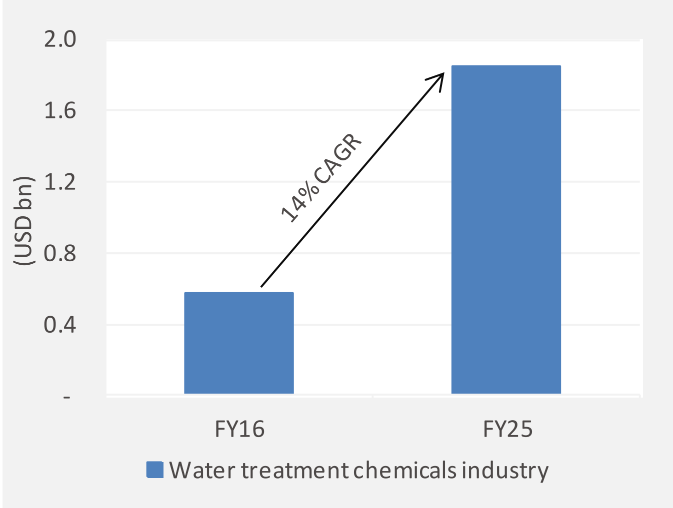


Chart 53: Indian water chemicals industry to clock 14% CAGR



Source: FICCI, Edelweiss research

Water treatment chemical market is expected to clock 14% CAGR to USD1,853mn in FY25

Water treatment chemical market to post 14% CAGR

As of FY16, India's water treatment chemicals market was estimated at USD570mn. On the industrial side, the largest end-use sector is power and energy. Given the power deficit faced by India and the upcoming power projects, this sector will continue to drive growth. The tightening of environmental norms on industrial effluents and their strict implementation by the Central Pollution Control Board is also fuelling growth in water chemicals. Thus, the market for water treatment chemicals is expected to clock CAGR of 14% to USD1,853mn in FY25. Increased awareness about quality of drinking water and its impact on health is also driving growth.

Risk and Concerns

Raw material sourcing: Availability of reasonably priced raw materials from countries like China, where a lot of factories have been shut, can be a concern as it can disrupt supplies. Further, most of the specialty chemical companies do not enter long-term supply contracts with any of their raw material suppliers and typically source raw material from third-party suppliers and the open market. Absence of long-term contracts at fixed prices thus exposes these companies to the volatility of raw material prices caused by a variety of factors such as market fluctuations, shutdown of plants impacting availability, currency fluctuations, consumer demand and regulatory sanctions. Accordingly, supply disruptions and volatility in key raw material prices are key risks to profitability.

Exchange risk: Exports constitute a large portion of revenues for specialty chemical companies. Significant appreciation in the currency could impact growth as competitive advantages vis-à-vis China could reduce thereby slowing the pace of shifting of volumes from China to India. Further, some of the products are priced on IPP which could be impacted by significant currency appreciation. Moreover, although the companies have pass on agreements, short term volatility arising from exchange rate fluctuations may not be able to pass on all such losses to its customers.

Slowdown of end-user industry: Specialty chemical companies cater to various end-user industries like paints & coatings, textile, specialty polymers, agrochemicals, construction chemicals, etc. Slowdown in growth of any of the end-user industries could impact the sector's overall growth. Case in point is the prolonged slowdown in global agrochemicals space impacting SRF, which is highly dependent on one segment. Thus, only a company with a diversified business model will easily withstand slowdown in one of the end-user segments.

China's comeback in chemicals: Although exit of China has given India significant advantage and fuelled its exports multi-fold, China's come back in the chemicals space could impact India materially. Companies in China are investing significantly in pollution controlling equipment and relocating them away from cities. Thus, China's come back can lead to slower-than-expected growth for India's chemical companies and put aggressive capex made by these companies at risk. Nevertheless, if China does come back, its cost of production will be significantly higher than earlier, helping Indian companies maintain their competitiveness.

Execution risk: India's chemical companies are in significant capex mode—capex has jumped multi-fold compared to historical trend. Thus, any delay in execution of this capex or order inflows can materially impact financials of companies.

Volatility in oil prices: Although specialty chemical companies work on the cost-plus model, sharp moment in raw material prices could take some time (generally a quarter's lag) to pass on. Thus, sharp increase in raw material prices could lead to lower earnings.

The Aggregate capex of our specialty chemical universe at INR61.7bn over FY19-21E is likely to be 60% higher compared to INR37.7bn over FY16-18

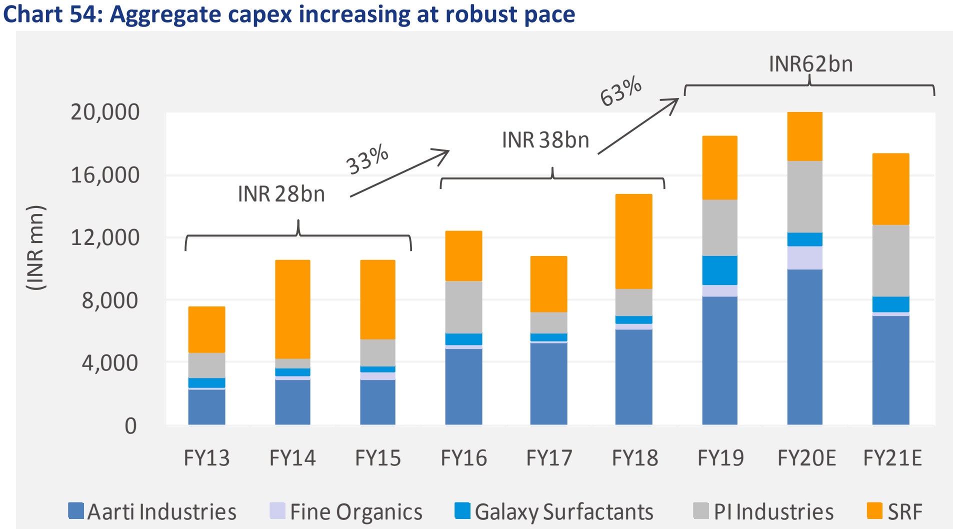
Financial Outlook

Conducive environment and enhanced growth visibility have spurred companies to scale up their capex—to catapult ~60% over FY19-21E. We envisage higher capex to translate in to revenue CAGR of 13% and PAT CAGR of 21% over FY19-21E. Further, we expect cash flow generation of specialty chemical companies to improve significantly from FY21 led by waning of capex intensity.

Domestic industry in capex mode to benefit from strong growth ahead

In line with strong growth visibility from end user industry, increased enquiries from customers and opportunity to tap growth from domestic market, exports and import replacement domestic companies have accelerated their capex plans. The aggregate capex of our specialty chemical universe at INR61.7bn over FY19-21 is likely to be 60% higher compared to INR37.7bn over FY16-18. Historically also increased capex between FY16-18 by 33% over (FY13-15) has led to EBITDA growth by 10% CAGR (FY15-18).

Chart 54: Aggregate capex increasing at robust pace

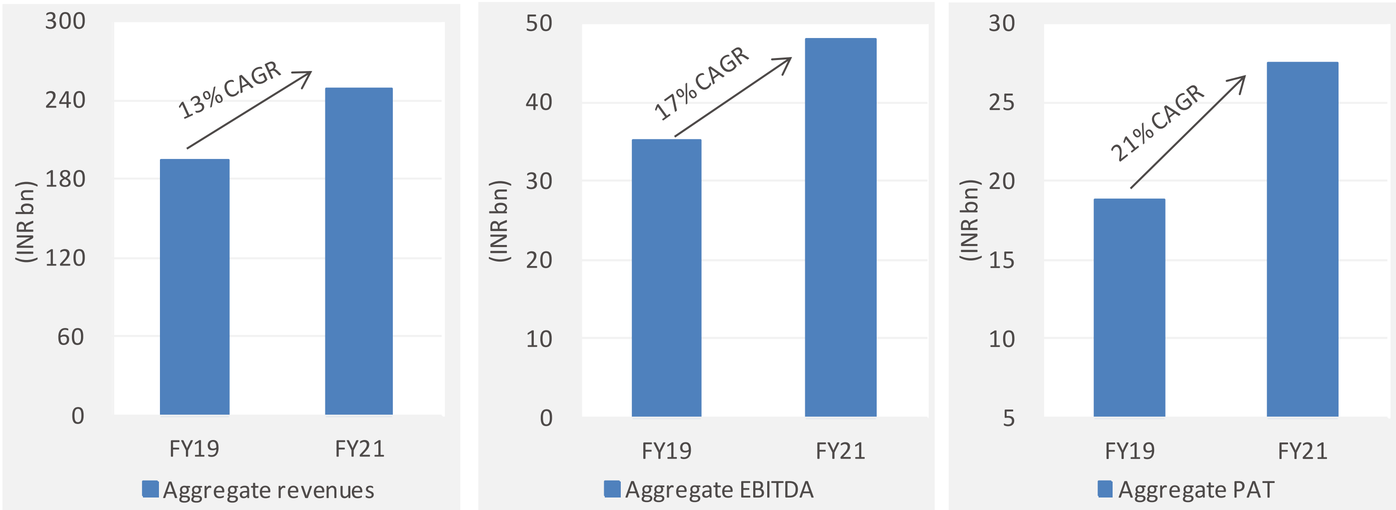


Source: Company, Edelweiss research
*Note: * SRF's only chemical's business capex*

Operating leverage to boost profitability

While aggregate revenue of specialty chemical companies is estimated to clock 13% CAGR over FY19-21, higher than 11% CAGR over FY16-18, EBITDA is expected to increase at a much faster pace of 17% compared to 2% in the past. The higher profitability will be led by increase in share of value-added products by most companies, rising utilisations ushering benefits of operating leverage, comparative faster increase in demand as opportunities are moving towards India and companies reap benefit of constant innovation and R&D done in the past three-four years. Consequently, we estimate PAT to post 21% CAGR over FY19-21 versus 4% CAGR over FY16-18.

Chart 55: Operating leverage to drive PAT growth by 21% CAGR

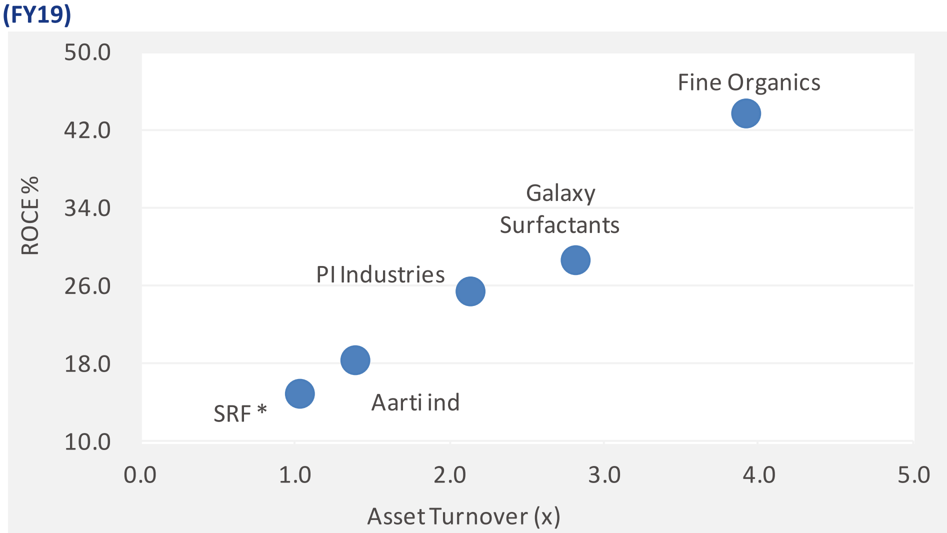


Source: Company, Edelweiss research

Higher asset turns leads to strong returns

Specialty chemical companies works on average asset turnovers of ~2x and ROCE of ~25%. Companies like Fine organics with strong asset turns of ~4x is enjoying ~40% ROCE. On the other hand, due to significant capex and slowdown in global agrochemicals cycle, SRF's asset turns have fallen to 0.5x (last three years average) and subsequently its ROCE have come down to 11%.

Chart 56: Higher asset turns leads to robust returns for specialty chemical players (FY19)



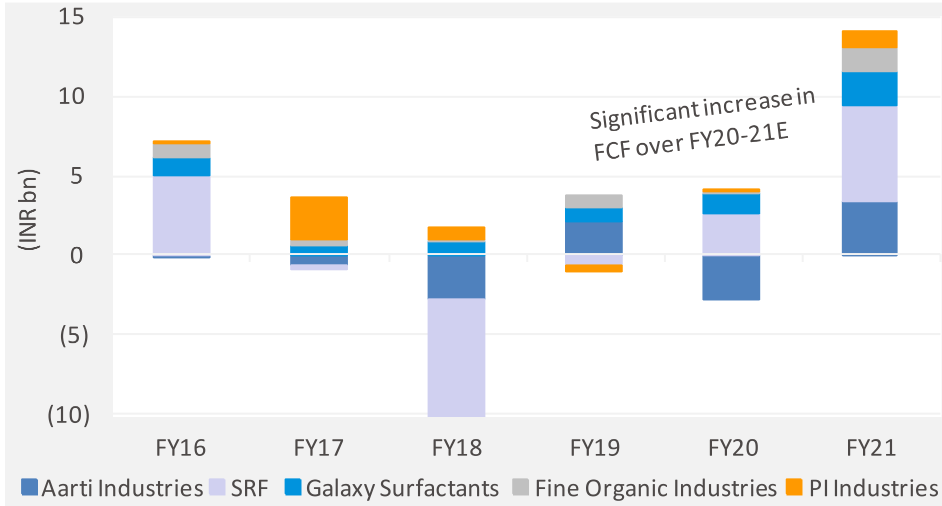
Source: Company, Edelweiss research

*Note: * SRF's only chemical's business margins and ROCE*

Free cash flow generation to improve

Investments by specialty chemical companies have catapulted over the past few years, which has brought down their asset turns. Further, to meet the sustained investments in working capital to cater to the burgeoning demand, the industry's free cash flow generation has remained limited. However, going ahead, with waning of capex intensity, we envisage cash flow generation of these companies to improve.

Chart 57: FCF generation to improve going ahead



Source: Company, Edelweiss research

Table 26: Companies' FCF (Free cash flow) generation framework

	Growth potential	FCF (pre capex)	Capex FY19-21	Reinvestment oportunity	Inorganic growth opportunity	FCF post capex	Margin volatility
Aarti Industries	High	High	High	High	Low	Low	High
Fine Organic	Moderate	High	Low	Moderate	High	High	Low
Galaxy Surfactants	Moderate	Moderate	Moderate	Low	High	High	Low
PI Industries	High	High	High	High	Moderate	Moderate	Moderate
SRF	High	High	High	High	Low	Low	High

Source: Edelweiss research

Valuations and Recommendation

- **Factoring the strong growth opportunity, valuations have already soared to all-time high with the sector trading at FY21E P/E of 21x and EV/EBITDA of 12.5x.**
- **Hence, investors have turned a blind eye to potential risks, inherent to the chemicals sector.**
- **Though we are convinced about the structural growth opportunity, in light of frothy valuations we recommend a cautious approach.**
- **Led by valuation concerns, we recommend 'HOLD' on AIL and downgrade PI and SRF to 'HOLD' primarily driven by recent run up in the stocks despite pick up in the global agrochemical market.**
- **We initiate coverage on Galaxy Surfactants with 'BUY' and Fine Organics with 'HOLD'.**

Speciality chemical players have rerated over past five years

Specialty chemical companies have generated strong returns over the past five years spearheaded by robust earnings spurt and the sector's rerating. Earnings growth (FY13-19) for our coverage universe was healthy with Aarti Industries (24%), PI Industries (17%) and SRF (32%) gaining momentum. While stock returns were significantly higher indicating strong re-rating of the sector during the same period. The average multiple for the sector has increased to one-year forward P/E of 21x in FY18-19 from 19x in FY16-18 and 16x in FY14-16.

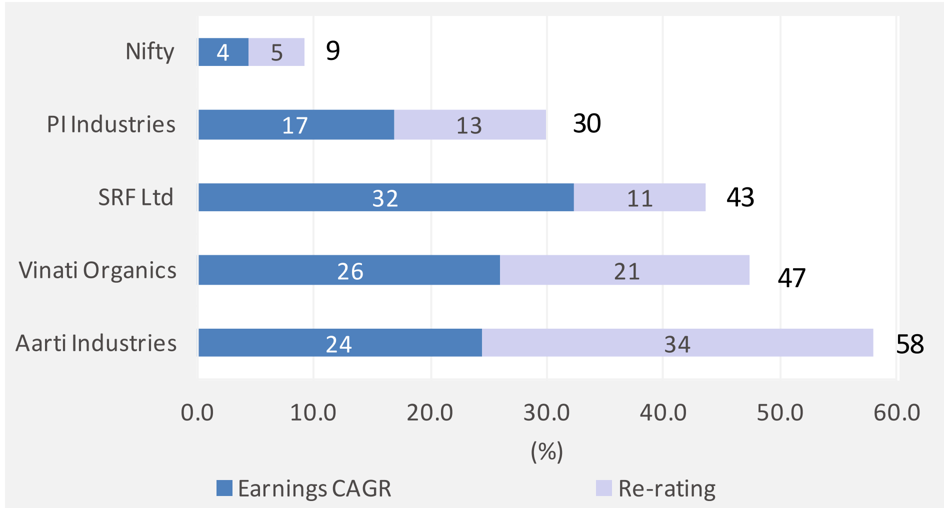
Table 27: Stock price returns

% Change Price	CMP	1 month	3 month	6 month	1 year	3 Year	5 Year	10 Year
SENSEX Index	39,113	(0.6)	1.9	9.4	10.8	13.7	9.3	10.4
MIDCAP Index	71,976	3.8	(0.5)	6.1	1.5	(0.2)	2.3	9.8
Aarti Industries	1,716	5.7	17.4	18.7	39.5	51.3	55.1	49.6
Fine Organics	1,421	2.8	11.4	20.1	n.a	n.a	n.a	n.a
Galaxy Surfactants	1,200	15.1	7.8	0.3	(2.7)	n.a	n.a	n.a
PI Industries	1,193	7.9	18.9	42.1	54.7	21.2	29.9	63.0
S H Kelkar	138	(12.5)	(15.1)	(20.9)	(38.8)	(13.0)	n.a	n.a
SRF Ltd	2,972	1.8	23.7	38.6	61.7	34.2	43.6	42.9
Vinati Organics	2,108	12.6	28.7	29.0	110.8	60.5	47.4	56.9

Source: Bloomberg

Note: Returns over 1 year are annualised; n.a.- not available

Chart 58: Key chemical company's 5 year stock performance

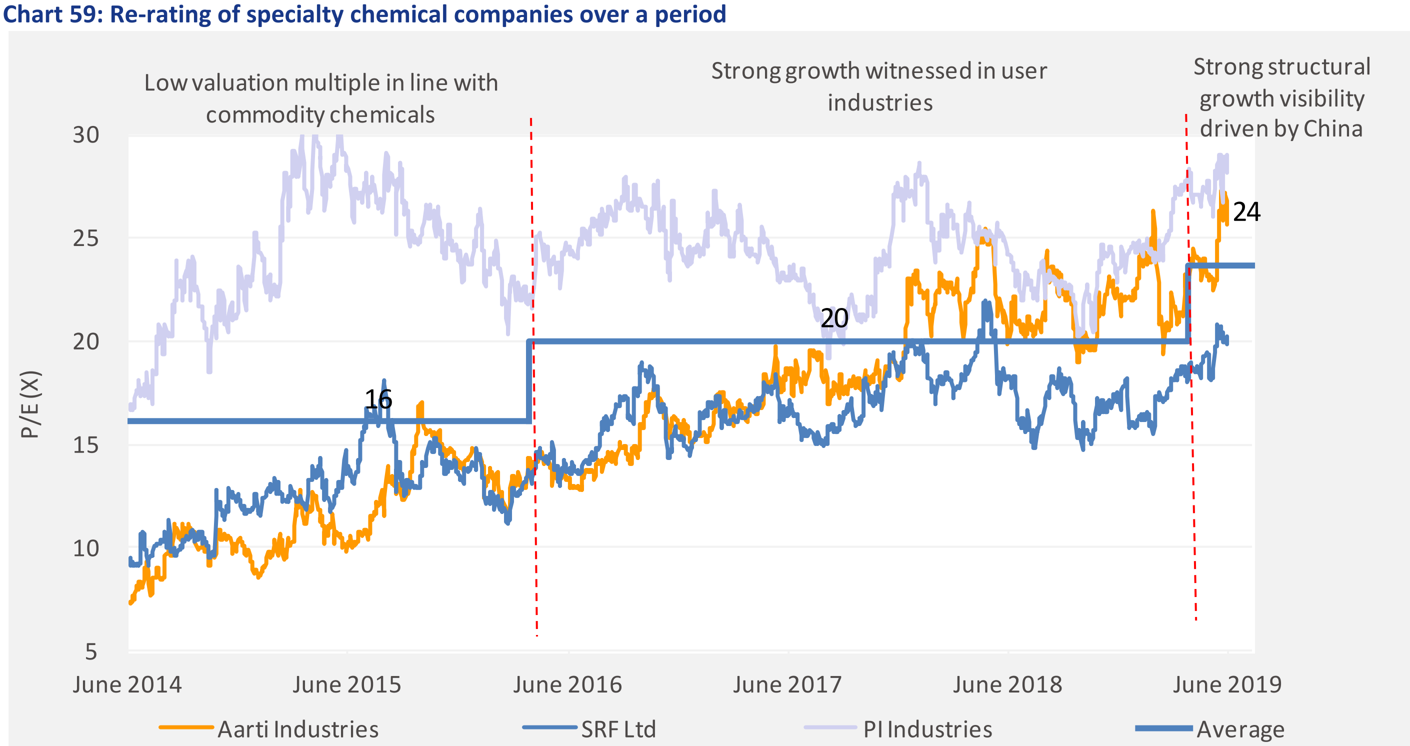


Bloomberg, Edelweiss research

Structural growth drivers in place to drive rerating

We believe the sector's improved growth visibility had initially been driven by robust spurt in end-user industries. Now, it's been driven by India gaining advantage over other countries, primarily China.

Chart 59: Re-rating of specialty chemical companies over a period



Source: Bloomberg, Edelweiss research

Valuations must consider complex nature of industry

In our view, the knowledge and process-driven specialty chemical sector enjoys strong entry barriers and benefits from high degree of customer stickiness. This is also reflected in stable margins of industry players, unlike commodity chemicals, where margins suffer from cyclicality of products. Specialty chemical players are also put through stringent approval processes by customers, which take one–five years, akin to regulatory approvals in case of pharma, agrochemicals or the food industry. While these high value/low volume products contribute a small percentage to the total cost of the end product, they enjoy strong customer stickiness.

Table 28: Base chemicals versus specialty chemicals versus R&D base functional ingredients

Differentiation	Base chemicals / Commodity chemicals	Specialty chemicals	Application / R&D base functional ingredients
Market structure	Large number of players	Few players	Selected suppliers only
Type of product	Standard products	Customised products	Fully customised to meet consumer requirement
Growth opportunities for supplier	Large growth opportunity as market size is big	Moderate growth as new customer addition / new product addition takes time	Limited growth opportunity as supplier every time has to provide its customer a new solution or add new customer
Sales	Sold by "specification", defined purity	Sold by "performance/impact", not composition	Helps customers achieve them desired end product
Value/volume	Generally medium to high volume products with low price realisations	Generally low to medium volume products with high price realisations	Very low volume products with high price realisations
Base of differentiation	Pricing	- R&D capability - Quality consistency - Timeliness of delivery	- R&D capability - Ability to solve customers' problem
Role of customer/seller	Selection of chemical done by customer	Seller provides required "solution" to meet customer application needs	Customer gives the problem and supplier provides the solution
Customer stickiness	Low - Customer looks for lower cost suppliers, as products are standardised	Moderate - Customer approval systems and process are highly elongated - Tedious approval processes with quality and consistency requirement - Switching supplier is difficult due to long approval processes	High - Product cannot be easily substituted
Nature of contract	Short term contracts / open market prices	Long-term volume contracts with clauses for pass through of escalation de-escalation	Long-term contracts with strong one to one relationship between supplier and buyer
Core strategy for success	Cost leadership strategy	High process R&D capability	Strong one to one relationship between supplier and buyer
Margin profile	Volatile margins depending on chemicals cycle	Stable margins due to escalation de-escalation clauses in contract	Very high margin
Benefits of scale economies	Significant due to standardised products	Limited due to large number of low volume high value products	No scale benefit as volume remains very small

Source: Edelweiss research

Current frothy valuations are rewarding growth rather than resilient business models…

We believe, current valuations are rewarding growth rather than resilient business models, reflected in divergence of valuations of specialty chemical companies. While players with high growth potential in the near term driven by disruption in China (AIL, SRF, PI—riding aggressive capex) are trading at 20-40% premium over the industry average, slow but steady growth players like Galaxy Surfactants (derives growth from FMCG industry and enjoys strong entry barriers) are trading at 15-20% discount. We believe, these companies with green and clean chemistries (generally catering to FMCG, personal care industries) should also enjoy a premium to other players.

Chart 60: Competency framework on business model

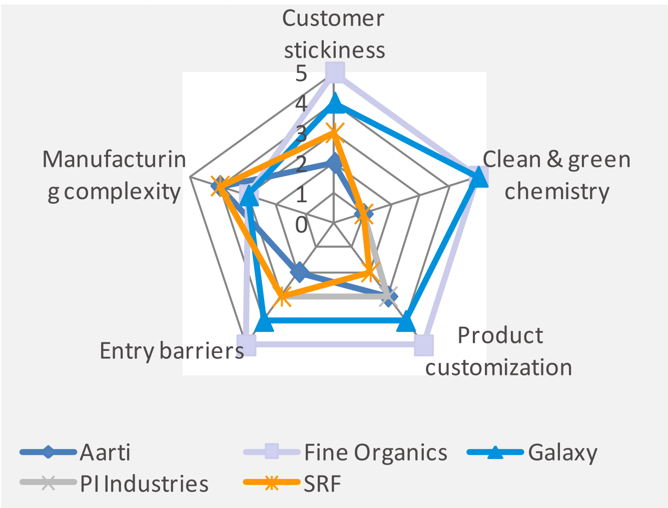
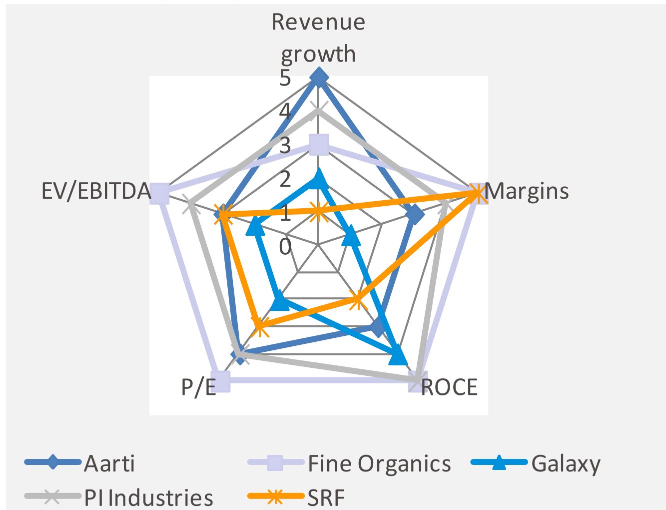


Chart 61: Competency framework on valuation and returns



Source: Company, Edelweiss research

Note: Scores are given with 5 being highest

…ignoring potential risk which limits further re-rating

We are confident about the strong structural growth opportunity in the chemical sector and believe that a few domestic players are well placed to reap the benefit. However, current valuations seem to be factoring the strong optimism and turning a blind eye to potential risks (hazardous nature, tightening environmental norms, etc) which are inherent to sectors like chemicals.

DCF valuations imply 15-23% growth and PEG>1

We have used three-stage DCF analysis to reverse calculate implied growth at our target price. Our three stage DCF model includes explicit estimates for FY19-21E, five years of high growth phase from FY22-26 and five years of moderate growth phase from FY27-31. Base assumptions for our DCF analysis include WACC of 12% and terminal growth rate of 6%. Our high growth phase (FY22-26) assumes strong growth opportunity during this period mainly led by conducive growth opportunity in the sector. Moderate growth phase (FY27-31) captures structural growth opportunity and have assumed 15% growth for companies. The implied growth in high growth phase is the most critical for the valuations and significantly high implied growth reflects concern on current valuations of the stock.

Table 29: DCF Valuation snapshot (%)

Company Name	WACC	Revenue CAGR FY14-19	Revenue CAGR FY19-21E	DCF - High Growth FY22-26E	DCF - Low Growth FY27-31	EBITDA margins	Terminal Growth	Share of Terminal Value
Aarti Industries	12.0	14.0	21.0	19.0	15.0	19.0	6.0	77.0
Fine Organic Industries	12.0	13.0	15.0	16.0	15.0	20.0	6.0	65.0
Galaxy Surfactants	12.0	10.0	10.0	14.0	14.0	13.5	6.0	67.0
PI Industries	12.0	10.0	19.0	23.0	15.0	22.0	6.0	71.0
SRF	12.0	14.0	7.0	15.0	10.0	21.0	6.0	65.0

Aarti industry and PI industry are factoring strong growth

Implied growth (for high growth phase) for companies in our universe ranges from 15-23%. High implied growth in companies like PI Industries (23%) and Aarti Industries (19%) are higher than achieved growth in FY14-19 at 10% in PI Industries and 14% in Aarti Industries. However growth for both the companies is likely to pick up between FY19-21E on back of improved industry scenario.

Galaxy & Fine organics implied growth at 14-16% looks reasonable

Implied growth at 14% for Galaxy Surfactant and 16% for Fine Organics looks achievable given stable growth nature of the industry. These players primarily derive their growth from FMCG industry. For SRF, implied growth at 15% is also on higher side but company has achieved 14% revenue growth in FY14-19.

Chart 62: DCF implied growth rate at target price

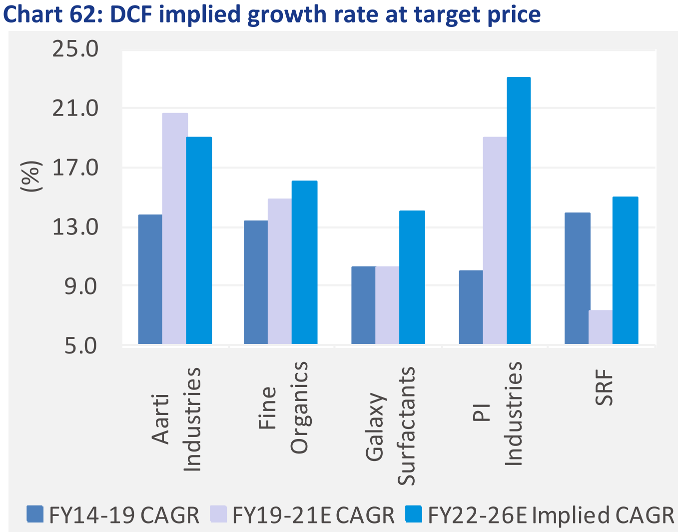
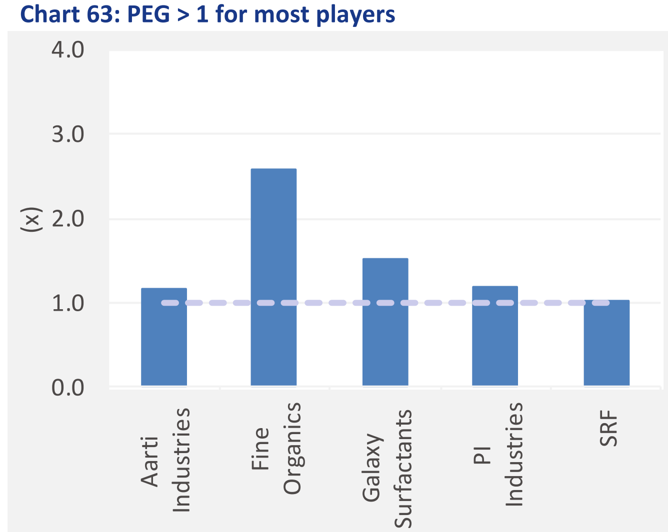


Chart 63: PEG > 1 for most players



Source: Company, Edelweiss research

As these companies also entail strong earnings growth, we have looked at PEG ratios of these companies— most players' PEG >1. This also reflects that current valuations are factoring strong optimism in the sector.

P/E based valuation to capture earnings growth momentum

We have used P/E multiple-based valuation approach given momentum in earnings growth. We have assigned different P/E multiples for each company based on its competency framework, growth opportunity and return ratios. However, we have also looked at the EV/EBITDA multiple of these companies and compared it with global peers.

Table 30: Valuation rationale

Company	TP (INR)	Target Multiple P/E (x)	FY19-21E EPS CAGR (%)	FY19 ROCE (%)	FY16-19 P/E (x)	FY12-15 P/E (x)	Industry average P/E (x)	Industry average post tax ROCE(x)	Valuation rationale
Aarti Industries Ltd	1,851	25	24	18	19	8	22	17.0	Our target multiple at 25x is 30% premium to its last 3 years average and 15% premium to industry average. We believe AIL to command premium valuations given AIL's leadership and strong growth visibility
Fine Organic Industries Ltd	1,535	30	12	44	NA	NA	22	16.0	Though earnings growth in near term remain low, FOIL's superior ROCE, higher asset turnover and niche product portfolio will enjoy premium valuations. We assign 30xP/E
Galaxy Surfactants Ltd	1,405	22	13	29	NA	NA	20	11.5	GSL's FMCG linked business model with stable growth and ROCE higher than the industry should enjoy premium over industry. We assign 22xP/E
PI Industries Ltd	1,276	30	25	25	25	17	22	17.0	PI's higher than industry average ROCE and strong EPS CAGR will demand premium valuation. We value at 30x multiple which is 20% premium to its last 3 years average
SRF Ltd	2,983	SOTP	20	15	17	8	22	17.0	SRF's strong earnings growth and potential ramp up in ROCE will demand higher valuations. We value it at SOTP based on EV/EBITDA of 14x to chemical, 7x technical textile and 6x packaging

Source: Edelweiss research

Concerned by valuations, recommend cautious approach

Though we remain structurally positive on the sector (highlighted in our latest report, "The right chemistry"), we remain cognizant of frothy valuations and wait for a better price opportunity. **We recommend 'HOLD' on Aarti Industries and also downgrade PI Industries and SRF to 'HOLD' primarily driven by recent run-up in stock prices despite pick up in the global agrochemical market.**

We also **initiate coverage** on R&D and innovation driven companies: a) **Fine Organics:** Strong beneficiary of application-based capabilities in plastic additives and food emulsifiers with **'HOLD'** due to sharp run up in the stock price; and b) **Galaxy Surfactants:** Enjoys leadership in performance and specialty surfactant markets where its strong relationships with MNCs is supporting growth globally with **'BUY'** as we believe exaggerated short-term concerns are undermining the strong business model. The report also features other industry leaders like SH Kelkar and Vinati Organics.

Table 31: Recommendation

Company	CMP (INR)	TP (INR)	Mcap (INR Bn)	Reco.	P/E (x) FY19	P/E (x) FY20E	P/E (x) FY21E	ROCE (x) FY19	ROCE (x) FY21E	CAGR % (FY19-21) Sales	CAGR % (FY19-21) EBITDA	CAGR % (FY19-21) PAT
Companies under coverage:												
Aarti Industries	1,716	1,851	149	HOLD	30.8	27.3	20.2	18.4	19.3	20.6	18.2	23.6
Fine Organic Industries	1,421	1,535	44	HOLD	32.0	30.6	25.5	43.8	33.3	14.8	10.2	12.1
Galaxy Surfactants	1,200	1,405	43	BUY	22.3	20.4	17.4	28.7	25.6	10.2	10.2	13.1
PI Industries	1,193	1,276	165	HOLD	40.1	30.9	25.6	25.4	27.1	19.1	23.3	25.1
SRF Ltd	2,972	2,983	171	HOLD	25.8	21.0	17.9	14.9	18.1	7.3	16.2	20.2
Companies not under coverage:												
SH Kelkar*	138	n.a.	20	n.a.	22.5	19.6	16.4	7.1	10.4	14.4	26.4	17.2
Vinati Organics*	2,108	n.a.	108	n.a.	38.3	32.7	27.1	30.7	40.1	26.2	22.7	19.0

*Note: * Bloomberg estimates*

Source: Company, Bloomberg, Edelweiss research

Table 32: Comparative industry valuations

Company Name	M Cap (USD bn)	FY19-21E Sales CAGR (%)	FY19-21E PAT CAGR (%)	FY19 EBITDA margin (%)	P/E (x) FY19	P/E (x) FY20E	P/E (x) FY21E	EV/EBITDA (x) FY19	EV/EBITDA (x) FY20E	EV/EBITDA (x) FY21E	Post Tax RoCE-FY19
Fine and Fragrance Players											
Givaudan SA	25.9	7.1	14.7	20.7	36.7	30.5	27.9	24.4	21.3	19.7	14.1
Symrise AG	13.5	9.0	17.2	20.2	40.8	34.1	29.7	20.6	18.1	16.4	10.0
S H Kelkar	0.3	14.4	17.2	12.7	22.5	19.6	16.4	17.4	12.8	10.9	7.1
Average		**9.6**	**12.8**	**16.3**	**28.2**	**26.1**	**23.6**	**18.8**	**17.4**	**15.7**	**8.3**
Median		**9.0**	**17.2**	**19.9**	**29.6**	**25.4**	**24.1**	**20.6**	**17.7**	**16.1**	**7.3**
Food and Plastic Additives Players											
Fine Organics	0.6	17.1	13.4	21.7	32.0	30.7	24.9	18.9	18.2	14.9	26.2
Kerry Group	21.1	6.3	15.8	13.7	32.7	26.9	24.4	22.3	19.2	17.7	12.0
Evonik	13.1	(1.3)	2.5	15.2	12.3	12.4	11.7	6.9	6.8	6.4	9.8
Average		**7.4**	**10.6**	**16.9**	**25.7**	**23.3**	**20.3**	**16.0**	**14.7**	**13.0**	**16.0**
Median		**6.3**	**13.4**	**15.2**	**32.0**	**26.9**	**24.4**	**18.9**	**18.2**	**14.9**	**12.0**
Surfactants Players											
BASF	64.2	3.7	11.0	14.9	13.3	11.8	10.8	8.3	7.8	7.1	8.6
Clariant	6.5	4.3	17.9	12.2	17.0	13.6	12.2	9.9	7.5	6.7	8.2
Kao	38.2	3.7	5.8	18.0	26.4	25.2	23.6	15.5	14.4	13.5	20.0
Galaxy	0.6	12.0	15.4	12.8	22.3	19.6	16.7	12.7	11.4	10.0	19.4
Kuala Lumpur Kepong	6.3	4.5	11.6	9.7	32.5	29.6	26.1	16.7	15.2	14.1	6.3
Saudi Kayan	5.0	-2.4	-20.2	39.2	12.9	24.3	20.2	7.9	9.4	9.2	6.4
Average		**4.3**	**6.9**	**17.8**	**20.7**	**20.7**	**18.3**	**11.8**	**10.9**	**10.1**	**11.5**
Median		**4.0**	**11.3**	**13.8**	**19.6**	**22.0**	**18.5**	**11.3**	**10.4**	**9.6**	**8.4**
Indian Specialty Chemical Players											
Aarti Industries	2.1	16.4	20.8	19.4	29.8	26.1	20.4	16.8	14.7	11.9	16.4
SRF Ltd.	2.5	13.0	23.9	17.6	26.6	21.4	17.3	14.8	12.3	10.5	11.6
Atul Limited	1.7	14.4	16.9	19.0	27.1	23.3	19.8	15.2	13.5	11.5	17.5
PI Industries	2.4	20.0	25.0	20.3	40.1	31.5	25.7	28.2	22.4	18.2	19.5
Vinati Organics	1.6	26.2	19.0	36.4	38.3	32.7	27.1	26.6	21.6	17.7	30.7
Solar Industries	1.5	20.0	20.8	20.4	38.1	31.9	26.1	21.8	17.6	14.7	19.3
Advanced Enzyme Technologies	0.3	13.5	17.6	43.4	16.4	14.1	11.8	10.0	8.8	7.5	19.4
Navin Fluorine International Ltd	0.5	13.4	18.9	22.1	24.0	19.8	17.0	15.4	13.0	11.0	15.6
Average		**17.1**	**20.4**	**24.8**	**30.1**	**25.1**	**20.7**	**18.6**	**15.5**	**12.9**	**18.7**
Median		**15.4**	**19.9**	**20.3**	**28.5**	**24.7**	**20.1**	**16.1**	**14.1**	**11.7**	**18.4**
Indian Commodity Chemical Players											
Phillips Carbon Black Ltd	0.3	6.1	0.5	17.5	5.1	5.5	5.1	4.0	4.2	3.9	19.3
Sudarshan Chemical Industries	0.3	17.3	6.3	14.5	15.5	17.1	13.8	11.7	9.7	8.2	11.3
Bodal Chemicals Ltd	0.2	10.1	12.8	16.6	8.7	7.4	6.8	5.6	4.8	4.3	15.5
Balaji Amines Ltd	0.2	21.3	13.2	20.5	10.3	8.7	8.0	7.2	5.8	5.0	17.8
Alkyl Amines Chemicals	0.2	15.3	17.5	19.4	19.3	17.4	14.0	10.8	9.5	7.8	19.1
NOCIL Ltd	0.3	15.3	8.7	29.0	10.3	10.1	8.7	5.8	5.9	5.1	20.5
GHCL Ltd	0.3	6.3	13.1	22.7	6.6	5.7	5.1	4.5	4.0	3.7	14.7
Deepak Nitrite Ltd	0.5	25.8	40.2	15.3	21.6	12.9	11.0	11.7	7.0	6.3	11.2
Tata Chemicals Ltd	2.2	9.3	(1.9)	18.7	11.1	12.9	11.6	9.3	8.1	7.4	7.9
Average		**14.1**	**12.3**	**19.4**	**12.1**	**10.8**	**9.4**	**7.8**	**6.6**	**5.8**	**15.3**
Median		**15.3**	**12.8**	**18.7**	**10.3**	**10.1**	**8.7**	**7.2**	**5.9**	**5.1**	**15.5**

Source: Bloomberg

Chart 64: Aarti Industries: P/E Valuations

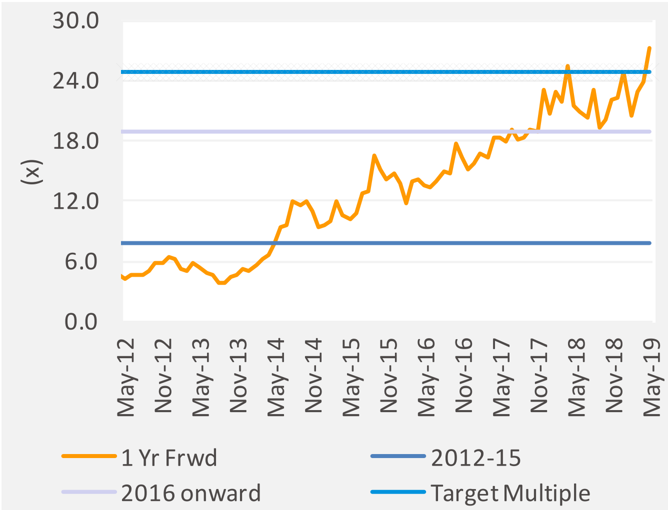


Chart 65: Aarti Industries: EV/EBITDA Valuations

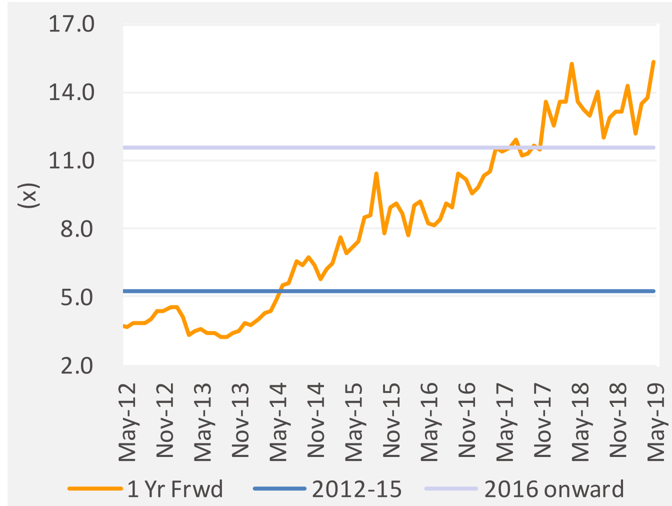


Chart 66: PI Industries: P/E Valuations

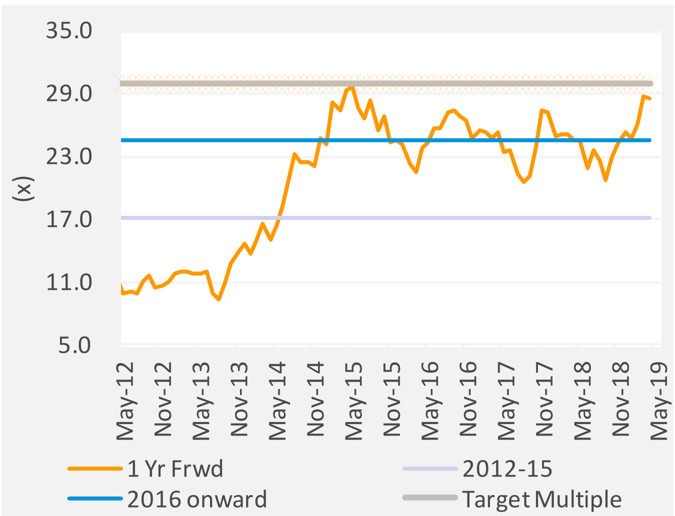


Chart 67: PI Industries: EV/EBITDA Valuations

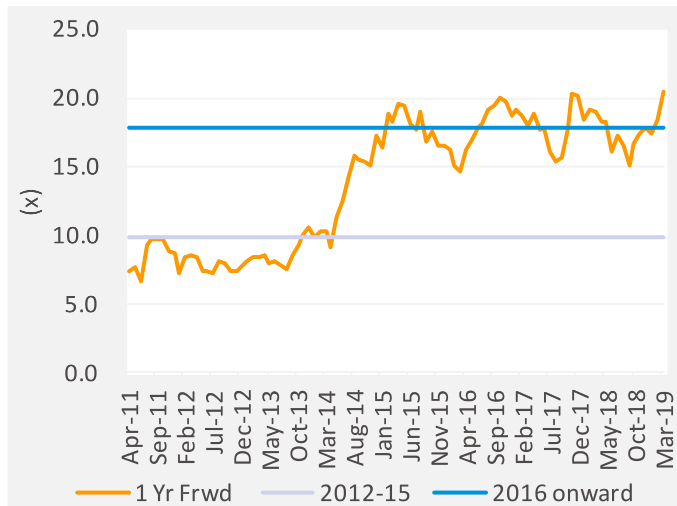


Chart 68: SRF Ltd: P/E Valuations

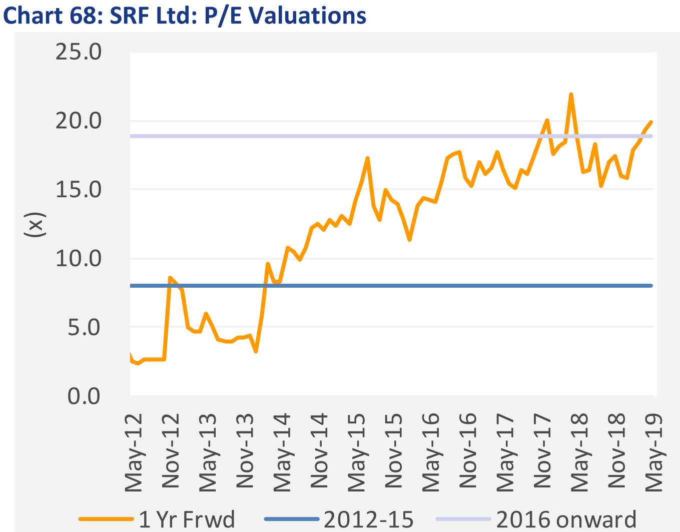
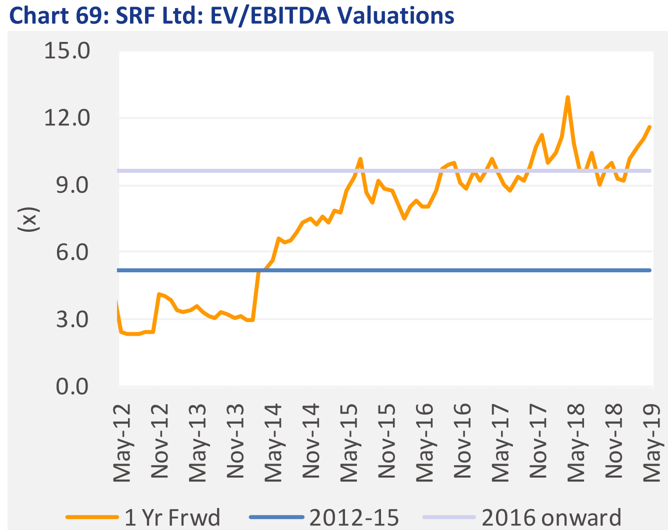


Chart 69: SRF Ltd: EV/EBITDA Valuations



Source: Company, Edelweiss research

Chart 70: Vinati Organics: P/E Valuations

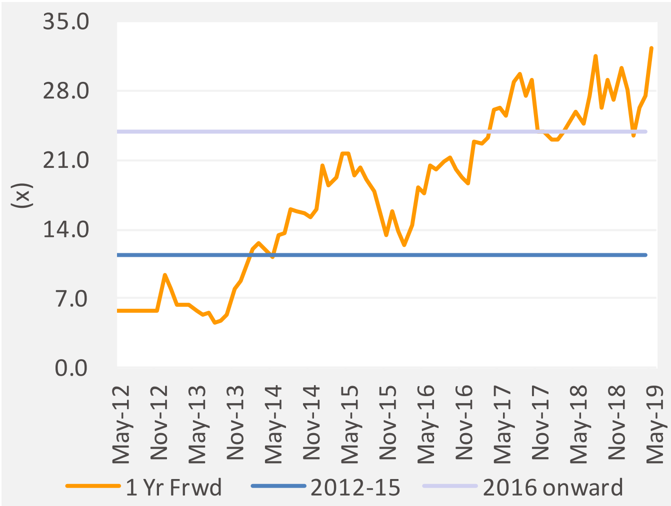
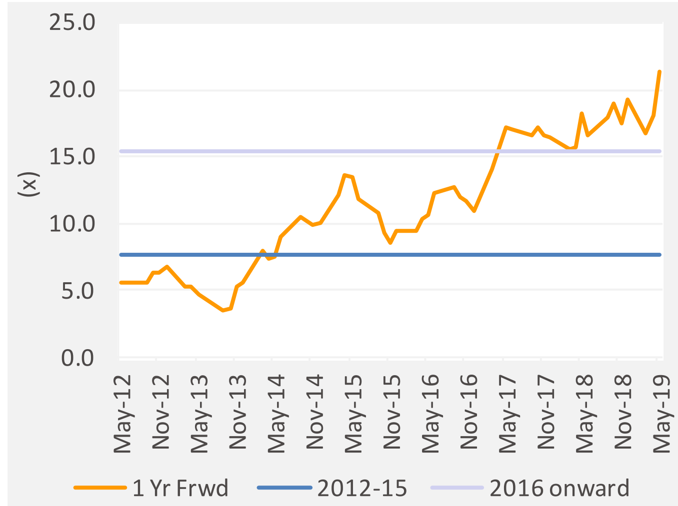


Chart 71: Vinati Organics: EV/EBITDA Valuations



Source: Company, Edelweiss research

Chart 72: SH Kelkar: P/E Valuations

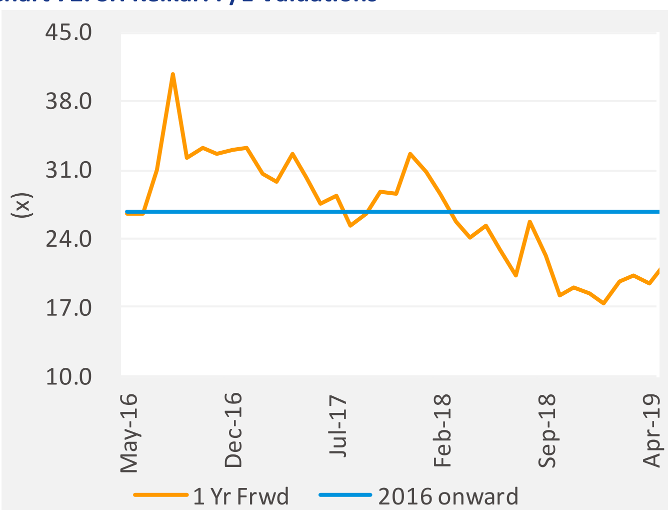
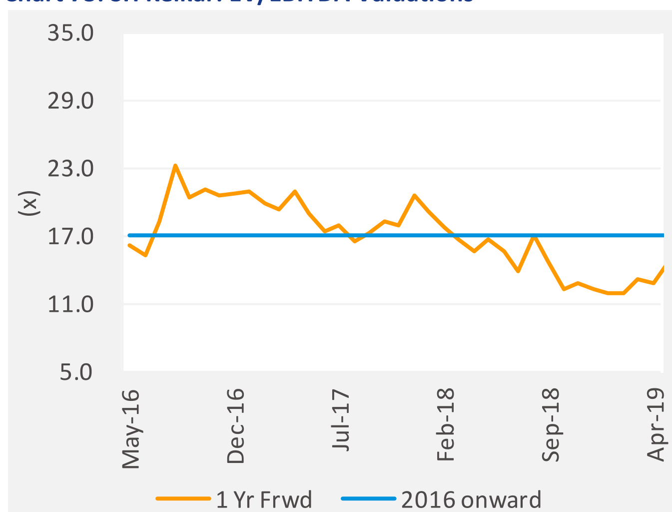


Chart 73: SH Kelkar: EV/EBITDA Valuations



Source: Bloomberg

Table 33: Differentiated business model

Company	Key business model	% of revenues	Unique proposition
Aarti Industries	Specialty chemical	80	Large product basket with presence in various chemistries Ability to sell by products / co products strengthening its business model
	Pharma	14	Presence in API, Intermediates & Caffeine - catered to global generic companies, innovators & large pharma companies
	HPC	6	Large opportunity, but struggling due to low focus
Fine Organic	Plastic additives	65	Leading position in concentrated product basket like slip additives, polymer additives
	Food additives	20	Leading position in bakery and confectionary in emulsifier with strong connect with global MNCs / domestic FMCG players
	Specialty additives	15	Large basket of products used in personal care, etc
Galaxy Sufactants	Performance surfactants	63	High entry barriers business with strong relations with global MNCs in home and personal care and leadership position in India
	Specialty care products	37	Application & R&D focus with high level of customisation
PI Industries	Agrochemical domestic formulations	35	Strong product portfolio of 25-30 products with concentration of specialty molecules
	Specialty chemicals	65	Process and R&D focus with strong connect with global agrochemical players
SH Kelkar	Flavours & fragrance		Strong connect with global / domestic FMCG companies
SRF	Technical textile	27	Commodity nature, but cost efficient business model
	Packaging films	35	Commodity nature, but strong presence in value added portfolio
	Refrigerant gases	19	Undisputed leader in refrigerant gases
	Specialty chemicals	13	Product basket of 20+ products in agrochemical intermediates / technicals having relationships with leading global players
Vinati Organics	Specialty commodity chemicals		Cost led leadership in three - four products

Source: Company, Edelweiss research

Table 34: Financial & valuation summary

Company	Reco.	CMP (INR)	Mcap (INR Bn)	TP (INR)	Upside (%)	CAGR % (FY19-21) Sales	EBITDA	PAT	RoCE (%) FY19	FY21E	RoE (%) FY19	FY21E
Aarti Industries Ltd	HOLD	1,716	149	1,851	7.9	21	18	24	18.4	19.3	22.1	20.7
Fine Organic Industries Ltd	HOLD	1,421	44	1,535	8.0	15	10	12	43.8	33.3	30.4	25.9
Galaxy Surfactants Ltd	BUY	1,200	43	1,405	17.1	10	10	13	28.7	25.6	23.9	21.3
PI Industries	HOLD	1,193	165	1,276	7.0	19	23	25	25.4	27.1	19.5	21.1
SRF Ltd	HOLD	2,972	171	2,983	0.4	7	16	20	14.9	18.1	17.2	18.2

Company	Revenue (INR Mn) FY19	FY20E	FY21E	EBITDA (INR Mn) FY19	FY20E	FY21E	PAT (INR Mn) FY19	FY20E	FY21E	Capex (INR Mn) FY19	FY20E	FY21E
Aarti Industries Ltd	50,142	58,544	72,910	9,706	10,705	13,563	4,834	5,455	7,378	8,209	10,000	7,000
Fine Organic Industries Ltd	10,603	11,858	13,973	2,302	2,330	2,794	1,363	1,426	1,711	818	1,500	300
Galaxy Surfactants Ltd	27,630	30,538	33,581	3,534	3,780	4,292	1,910	2,085	2,443	1,802	924	1,000
PI Industries	28,409	34,114	40,272	5,764	7,184	8,762	4,102	5,317	6,415	3,668	4,500	4,500
SRF Ltd	76,927	79,695	88,556	13,790	16,491	18,623	6,601	8,132	9,533	3,964	9,000	4,500

Company	Gross Margin (%) FY19	FY20E	FY21E	EBITDA Margin (%) FY19	FY20E	FY21E	Net Debt Equity (x) FY19	FY20E	FY21E	Fixed asset turnover (x) FY19	FY20E	FY21E
Aarti Industries Ltd	41.1	40.6	41.0	19.4	18.3	18.6	0.5	0.5	0.4	1.5	1.4	1.5
Fine Organic Industries Ltd	38.2	37.0	37.0	21.7	19.6	20.0	0.0	0.1	-0.1	4.4	3.7	3.4
Galaxy Surfactants Ltd	29.5	28.7	28.8	12.8	12.4	12.8	0.3	0.1	0.0	2.9	2.8	2.7
PI Industries	45.4	46.2	46.9	20.3	21.1	21.8	-0.1	-0.1	-0.1	2.1	2.0	1.9
SRF Ltd	43.3	47.9	47.9	17.9	20.7	21.0	0.7	0.6	0.4	1.2	1.1	1.1

Company	EPS (INR) FY19	FY20E	FY21E	EV/Sales (x) FY19	FY20E	FY21E	EV/EBITDA (x) FY19	FY20E	FY21E	P/E (x) FY19	FY20E	FY21E
Aarti Industries Ltd	55.8	62.9	85.1	3.2	2.9	2.3	16.8	15.7	12.3	30.8	27.3	20.2
Fine Organic Industries Ltd	44.4	46.5	55.8	4.1	3.7	3.1	18.9	18.9	15.4	32.0	30.6	25.5
Galaxy Surfactants Ltd	53.9	58.8	68.9	4.9	4.1	3.4	1.6	1.4	1.3	22.3	20.4	17.4
PI Industries	29.7	38.6	46.5	5.7	4.8	4.0	28.2	22.6	18.4	40.1	30.9	25.6
SRF Ltd	115.0	141.6	166.0	2.6	2.5	2.2	14.5	12.1	10.4	25.8	21.0	17.9

Company	Sales CAGR (%) 1 Year	3 Year	5 year	10 year	EBITDA CAGR (%) 1 Year	3 Year	5 year	10 year	PAT CAGR (%) 1 Year	3 Year	5 year	10 year
Aarti Industries Ltd	31.7	18.6	13.8	13.1	38.8	19.3	19.3	11.9	45.2	23.5	24.4	24.5
Fine Organic Industries Ltd	22.6	15.6	23.2	n.a.	45.3	16.6	28.8	n.a.	42.9	21.2	30.2	n.a.
Galaxy Surfactants Ltd	13.5	15.3	10.2	n.a.	22.8	14.9	10.4	n.a.	20.9	23.0	20.2	n.a.
PI Industries	25.0	11.0	10.0	19.0	17.0	10.0	15.0	25.0	12.0	10.0	17.0	33.0
SRF Ltd	37.6	18.8	13.9	14.2	70.2	12.7	22.2	13.7	99.4	15.4	32.4	16.8

Source: Company, Edelweiss research

COMPANIES

INITIATING COVERAGE

India Midcaps

FINE ORGANICS INDUSTRIES

Growth and valuations: A fine balance

Edelweiss
Ideas create, values protect

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India Equity Research| Specialty Chemicals

Fine Organics Industries (FOIL) is a leading player catering to global markets in various oleochemical-based additives used in plastic, polymer, food emulsifiers, cosmetics, etc. A niche, but expansive product basket, diversified customer base, stringent & lengthy product approvals (creating strong entry barriers) and in-house developed technology underpin the company's dominant position in the global market. We believe, FOIL's higher market share in the oleochemicals additives space, presence in fast-growing markets, above industry ROCE of 40% plus demand premium valuation. We value the stock at 30xPE (Q2FY21 EPS) and arrive at TP of INR 1,535. However with limited upside at current level, we initiate with 'HOLD'

Global player in niche oleochemicals market

FOIL is the largest manufacturer of oleochemical-based niche additives in India. It is among the five largest global players in polymer additives (70% of revenue) and among leading global players in specialty food emulsifiers. Though characterised by application / functionality based low volume, these products are critical ingredients for customers. FOIL, underpinned by its R&D and innovation focus, process technology improvement and specialised skills, has developed a large product basket.

Customer sticky model to benefit from product/capacity expansion

The company's solution-based approach creates customer stickiness and creates strong entry barriers. Moreover, to leverage its existing customer base and product portfolio in cosmetics, food, plastics, etc, FOIL is doubling capacity over the next two years. Anchored by product innovation, it is also entering new lucrative categories like feed nutrition additives, etc., which will sustain growth.

Outlook and valuation: Burnished prospects; initiate with 'HOLD'

We estimate FOIL to clock 18-20% EBITDA margin and ROCE, significantly surpassing the industry average, driven by its robust business model and in-house R&D. We expect FY19-21E revenue and PAT to jump 15% and 12%, respectively, riding capacity expansion. The company's strong return ratios, in our view, should enjoy premium valuation. However, given the recent run-up in the stock, we initiate coverage with **'HOLD'** and target price of INR1,535.

Financials

Year to March	FY18	FY19	FY20E	FY21E
Net revenues (INR mn)	8,647	10,603	11,858	13,973
EBITDA (INR mn)	1,584	2,302	2,330	2,794
Adj. profit (INR mn)	953	1,363	1,426	1,711
Adj. diluted EPS (INR)	31.1	44.4	46.5	55.8
EPS growth (%)	22.4	42.9	4.7	20.0
Diluted P/E (x)	45.7	32.0	30.5	25.5
EV/EBITDA (x)	27.7	18.9	18.9	15.4
ROCE (%)	37.7	43.8	33.2	33.3

EDELWEISS RATINGS

Absolute Rating	**HOLD**
Investment Characteristics	Growth

MARKET DATA *(R: FINO.BO, B: FINEORG IN)*

CMP	: INR 1,421
Target Price	: INR 1,535
52-week range (INR)	: 1,648 / 735
Share in issue (mn)	: 30.7
M cap (INR bn/USD mn)	: 44 / 625
Avg. Daily Vol. BSE/NSE ('000)	: 63.9

SHARE HOLDING PATTERN (%)

	Current	Q4FY18	Q3FY18
Promoters *	75.0	75.0	75.0
MF's, FI's & BKs	15.9	14.5	15.2
FII's	5.5	5.5	4.4
Others	3.6	5.0	5.4

** Promoters pledged shares (% of share in issue) : NIL*

RELATIVE PERFORMANCE (%)

	Sensex	Stock	Stock over Sensex
1 month	1.6	1.4	(0.2)
3 months	3.8	11.3	7.5
12 months	NA	NA	NA

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June 19, 2019

Investment Rationale

FOIL has a portfolio of 400 plus products used in polymer, food and others industries

Diversified product basket with large customer base

FOIL, with a legacy of over 48 years, is the largest manufacturer of oleochemical-based additives in India and one of the few players globally with 400 plus products. These products are marketed to over 650 direct customers and 130 distributors in 70 plus countries. It caters to diversified industries like food, polymer, cosmetics, coatings, etc.

Diversified product basket: FOIL has a range of 400 plus products used in plastic, food and others industries. The company is present in a wide range of oleochemical-based additives in India and has huge first-mover advantage alongside various other competitive advantages over global players.

Fig. 1: Diversified product portfolio across specialty additives

Food Additives	Helps food to get the desired aesthetic structure and texture along with maintaining quality an freshness. Enhances shelf life of bakery products and keeps them safer from spoiling or from becoming toxic due to unwanted growth of bacteria, yeast and moulds
Polymer Additives	Reduces friction between polymer products & other surfaces they come in contact with. Converts water droplets formed on polymer films into continuous transparent layer. Dissipates the build electrical charges on polymer materials. Used as flow improvers & mould release agent in PVC pipes
Specialty Additives	Used in niche applications like reducing fat in high-quality biscuits or to make high-quality sponge with good volume, structure, sliceability and shelf life
Emollients for Cosmetics	Enables manufacturing of products with different structures like creams, gels, pastes, lotions etc. Aids in achieving long term physical stability for transport and storage. Increases sensory perception and the chemical stability of the sensitive active agents
Rubbers & Elastomers	Added to improve compounding & processing of rubber. Used in various types of rubbers for applications such as tyres, conveyor belts, dock fenders, automotive parts, hoses, shoe soles, etc
Additives for Coatings	Used as anti-settling agents, emulsifiers, thickening/anti-sagging agents, wetting and dispersing agents, defoamers, biocides and anti-mar waxes for use in paint and coating applications. Capable of improving the appearance and durability of a coating
Feed Nutrition Additives	Replaces harmful antibiotics and improves feed efficiency and imparts several technical advantages to end products

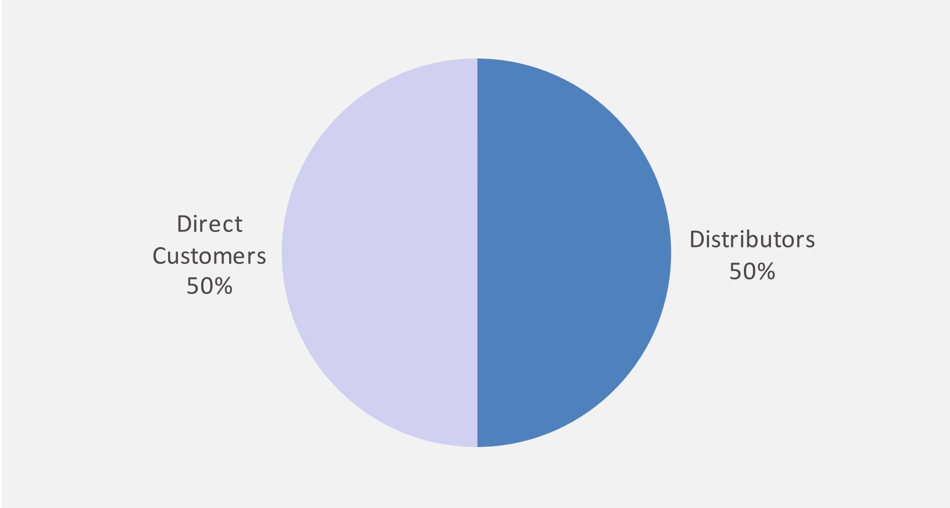
Source: Company, Edelweiss research

As on March 31, 2019, FOIL had more than 650 direct customers and 130 distributors in 70 plus countries

Diversified customer base: FOIL's clientele comprises direct customers and distributors. As on March 31, 2019, the company had more than 650 direct customers and 130 distributors (sell FOIL's products to over 5,000 customers) in 70 plus countries. No single customer contributes more than 4% to revenue. Its direct customers are MNC, regional & local players, including Ampacet and Parle. It also has an extensive distribution network in India and worldwide.

It is present in over 70 countries across Asia, Africa and Middle East

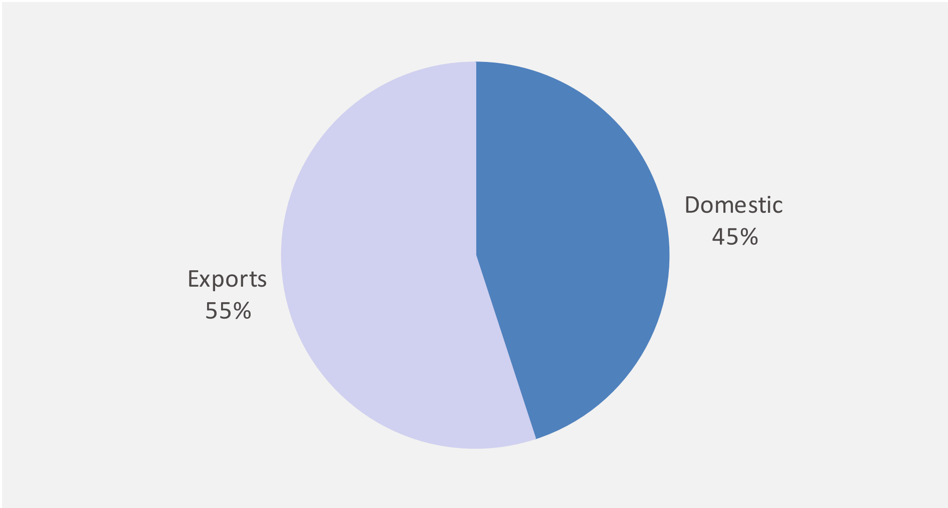
Chart 1: Well diversified sales mix (FY19)



Source: Company, Edelweiss research

Diversified geographical footprint: The company has presence in over 70 countries and caters to companies across Asia, Africa, Europe and the Middle East. FOIL's global network of sales and representative facilities helps prune dependence on any single product or geography.

Chart 2: Well diversified geographical sales mix (FY19)



Source: Company, Edelweiss research

Diversified consumer user industries: The company's wide range of specialty plant-based additives find application in a host of industries including food, plastic, cosmetics, paints & coatings, lube additives, wires & cables, coatings and other specialty applications.

Chart 3: Growth for end users of polymer additives industry

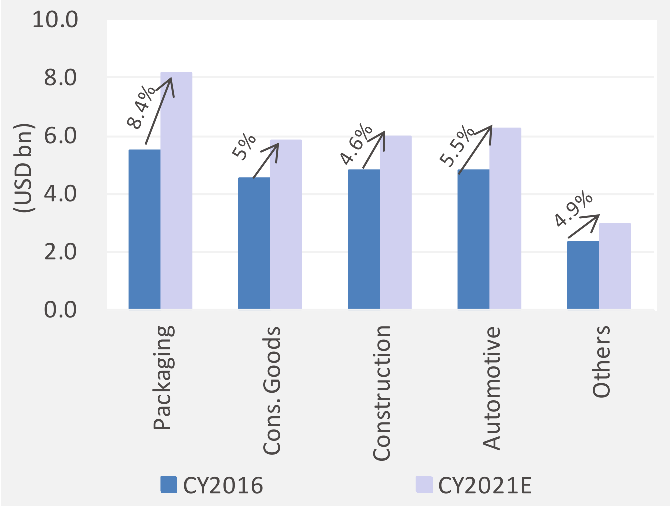
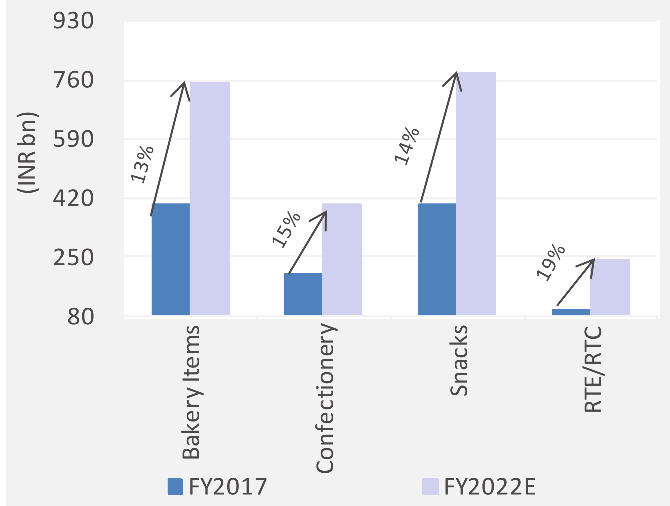
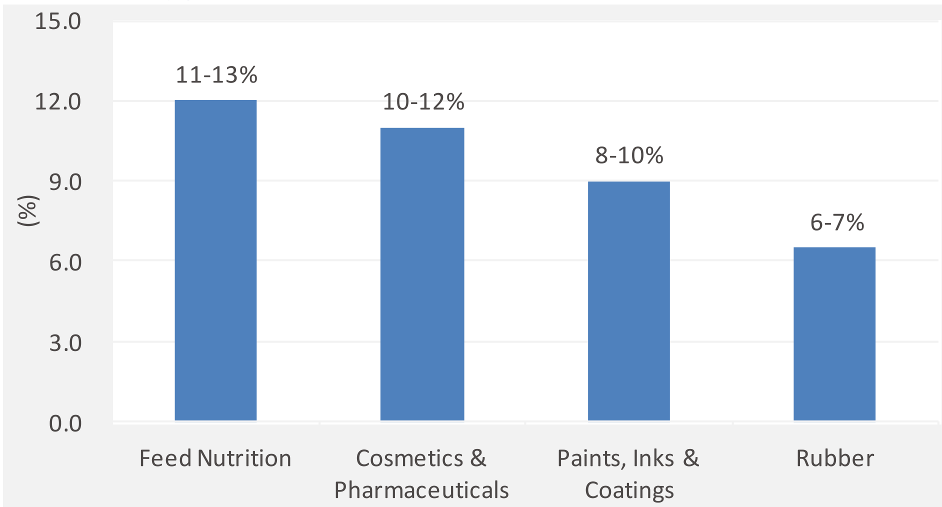


Chart 4: Growth for end use sectors of food emulsifiers



Source: CRISIL research, Edelweiss research

Chart 5: Healthy growth in end-user industries



Source: CRISIL research, Edelweiss research

The product portfolio diversity enables FOIL to provide customised solutions to MNC FMCG players which market a host of products across diverse geographies.

Sticky business model with high entry barriers

FOIL's in-house developed technology, processes and solution-based approach to customers creates stickiness and strong entry barriers. These have propelled the company in to the six global players' club in the food additives industry and among the five global players in the polymer additives industry. Further, shift to oleo chemicals additives is driving growth.

Multiple entry barriers in place – product formulations, process technology and preference for established players

Solution-based, rather than mere product offering, approach: USP

FOIL follows solution-based business model, rather than offering products from its existing portfolio, underpinned by its strong application-based R&D capabilities. This results in strong vendor-customer relationships and increases customers' dependency on the company's solutions, forging long-term relationships. Further, there are multiple entry barriers in the global oleochemical-based additives industry, such as product formulations, process technology and preference for established players.

Fig. 2: FOIL well established to benefit from favourable industry dynamics

Limited players	• Limited meaningful players competing globally
Highly regulated	• Additives account for <1% weight in end user product • Any defect in the company's products will result in a disproportionately large amount of finished products being defective • Eco- friendly green oleo-derived additives a key focus area • Stringent quality paramters & regulations governing the industry • Human healthy and and environmental converns are key
Very high entry barriers	• Complex technology & manufacturing processes create multiple entry barriers - Mostly Proprietary • Product formulations, innovations and process technology - Time (3-5 years to approve additives) & Capital intensive process to generate business • Established players enjoy premium positioning with customers due to consistent quality and product delivery
Significant customer stickiness	• Customers value long-term trust built over the years with existing suppliers • Lengthy and expensive product approval processes lead to high switching costs for customers • Customers rely on established suppliers as performance ingredients are critical to their end products

Source: Company, Edelweiss research

Table 1: FOIL - Strengths

Areas	Description
Largest in India and amongst few in the world	Pioneer and largest manufacturer of oleochemical-based additives in India One of 6 global players in the food additives industry One of 5 global players in the polymer additives industry
Technocrat Management	Strong technocrat promoters with deep understanding about oleochemical chemistry Promoters have a combined experience of more than 150 years in oleochemicals
Strong R & D capabilities	Infrastructure spread over area of 5,000 sq. mts. Dedicated team of 17 including scientists and technicians Equipped with modern pilot plant for distillation and reaction facilities Five patents for process, applications and products Developed and launched 30 products since April 1, 2018
In House Design and engineering capabilities	Ensures confidentiality and attracts minimum competition Low capital expenditure & quick commissioning ensure low payback and high ROCE Fungible manufacturing process ensures optimum capacity utilisation (currently over 90%) High asset turns (net asset turns of 7-8 times and gross asset turnover of 3.5 times) Fully automated process leading to limited manual interface and thus consistent products
Leader in innovation	First to introduce slip additives in India - currently largest player with 40-45% market share in the Development of Antistat to replace corrosive amine based agents First in India to develop Beverage Cloudifier as a BVO replacement In-house technology for Slip Additives for Polymer Industry
Strategically located manufacturing units	FOIL's production facilities are located in close proximity to the Jawaharlal Nehru (Nhava Sheva) Port near Mumbai. As these are largely export-oriented units it helps the company reduce freight

Source: Company, Edelweiss research

High-value/low volume products contribute a small percentage to the total cost of end product, but enjoy high level of client stickiness

Sticky customer base cuts volatile earnings risk, ensures stable margin

In our view, FOIL benefits from strong entry barriers and high degree of customer stickiness. This is also reflected in its healthy margin. The industry is also complex in nature as it goes through a stringent regulatory approvals process akin to the food industry. FOIL supplies critical material used in these industries. These high-value/low volume products contribute a small percentage to the total cost of the end product, but enjoy high level of client stickiness.

Table 2: Key industry characteristics

Key Industry Factor	Comments
New product development and product formulations	* Typically requires high R&D expenses * Only large scale players can afford * Product formulations kept confidential
Capex costs	* Process design costs are very high
Process technology	* Only a few players have proprietary technology and not sold to other new players
Customer product approval process	* Lengthy (3-5 years) and costly, so customers prefer approved suppliers
Quality conscious customers	* Additives are typically under 2% weight in their application materials. Hence customers prefer consistent quality over the additive prices
Availability of raw material	* Raw material availability and procurement costs are crucial to be competitive
Access to markets	* Nearness of manufacturing plants to emerging markets will give logistics cost advantages

Source: CRISIL research, Edelweiss research

CRISIL estimates the domestic oleochemicals market to grow at 10-15% over 2016-20

Oleochemicals replacing petrochemicals: Structural growth opportunity

Oleochemicals have become essential in a variety of industries such as coatings, surfactants, plasticisers, lubricant additives (slip and anti-block additives), etc. In recent years, there has been rapid increase in natural fatty acid derivatives usage as additive material in several industries by replacing potentially harmful petrochemicals. With rising demand for environment-friendly products, oleochemical products are being readily accepted in the market bolstered by rising population and rapid economic growth. CRISIL estimates the domestic oleochemicals market to grow at 10-15% over 2016-20.

Table 3: Comparison of oleochemical based additives with petrochemical based additives

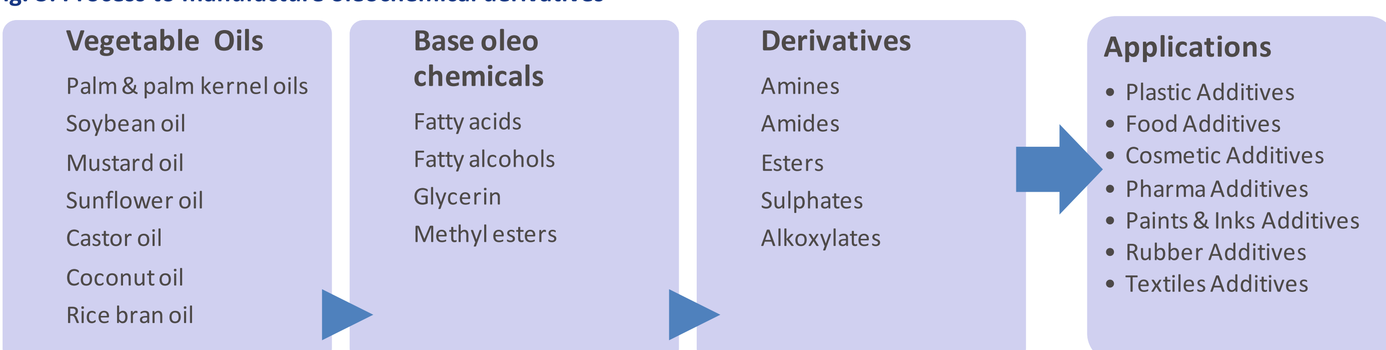
Parameter	Oleochemical based additives	Petrochemical based additives
Type	Natural	Synthetic
Raw material sources	Vegetable oil derivatives	Crude oil derivatives
Sustainability	Yes, as raw materials are from sustainable sources	No, as raw materials are derivatives of fossil fuels
Biodegradable	Yes	No
Environment	Friendly, as raw materials are made from vegetable oils	May cause pollution as raw materials are derivatives of fossil fuels

Source: CRISIL research, Edelweiss research

Presence in highest margin oleochemicals value chain

Oleochemicals-based value chain starts with the plantation stage, which involves investing in land and growing palm trees. Then various oil-like palm kernel, soyabean and mustard oil are extracted. These oils are then used to make raw material including fatty acids and fatty alcohols required by players like FOIL. The company uses this raw material to manufacture oleochemical derivatives. This is the highest margin segment apart from plantation stage where margins vary depending on factors like yield and crop prices based on the demand-supply dynamics in the industry.

Fig. 3: Process to manufacture oleochemical derivatives



Source: CRISIL research, Edelweiss research

Key consumer industries in high growth phase

FOIL caters to diversified industries like food, polymer, cosmetics, paints & coatings, lube additives, wires & cables, coatings and other specialty applications. Its two primary end user industries—food emulsifiers and polymer additives—are expected to grow at a healthy pace of 10-12% and 8-10%, respectively over CY16-21E.

Indian food emulsifiers market to post 10-12% CAGR over CY16-21E versus CAGR of 4.1% globally

Food emulsifier market to clock 10-12% CAGR

Any substance added to food can be termed broadly as food additive. In a stricter sense, any substance that is intended to affect the characteristics of food is a food additive. The global food emulsifiers market is estimated to post 4.1% CAGR over CY16-21 to USD3.4bn driven by higher growth in the Asia Pacific region (accounts for 26% global share), which is expected to register 4.6% CAGR. India, one of the fastest-growing food emulsifier markets, is estimated to post 10-12% CAGR over CY16-21 to INR9bn driven by healthy spurt in convenience and packaged food segments, especially premium foods.

Chart 6: Global food emulsifier market to post 4% CAGR

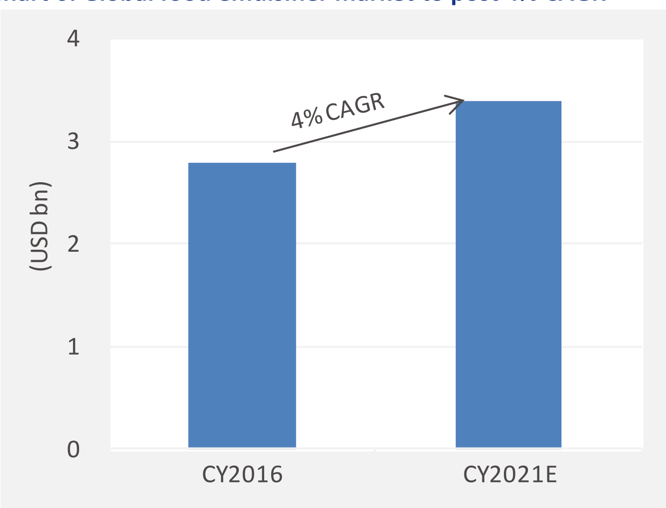
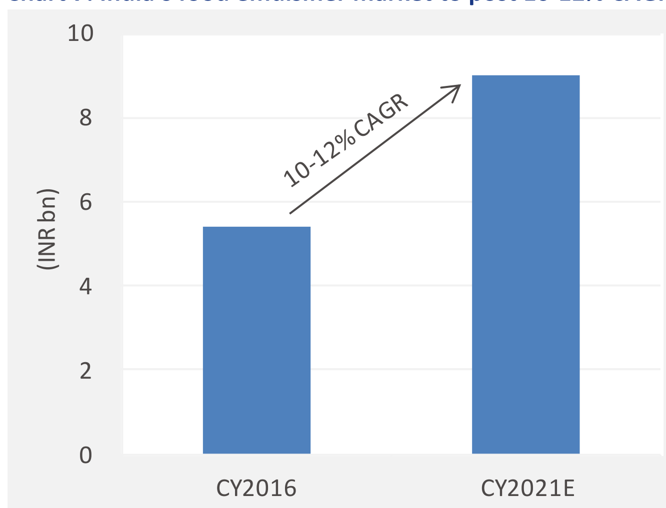


Chart 7: India's food emulsifier market to post 10-12% CAGR



Source: Industry, Edelweiss research

Key growth drivers globally

- Rising awareness among food processors about advantages and applications of food emulsifiers in various applications like bakery & confectionary industry and dairy, as well as high consumption of ice creams, biscuits, mayonnaise, chocolates, bread, coffee, soft drinks, etc.
- Growing population, higher economic growth & disposable incomes and changing lifestyles of emerging nations in Asia such as India, China and Vietnam are leading to high growth of packaged and convenience foods. These require food emulsifiers to sustain quality for longer hours and for enhanced taste, colour and appearance.
  - Rise in health awareness and quality consciousness of consumers in developed nations.
  - Modern lifestyles have spurred demand for healthy packaged and convenience foods. This has led to high consumer demand for trans-fat products, which is driving food processors to use emulsifiers to reduce calories and fat content.

Indian plastic additives market to post 8-10% CAGR over CY16-21E versus CAGR of 6% globally

- ○ Burgeoning population and rising concerns regarding food quality and safety. Emulsifiers help cut salt and sugar content without changing texture and taste of food and associated products.

Indian plastic additives market to post 8-10% CAGR over CY16-21E

The overall global plastic additives market is estimated to post 6% CAGR over CY16-21 to USD30bn driven by higher 7% CAGR in the Asia Pacific region. India, one of the fastest growing markets, is expected to register 8-10% CAGR over CY16-21 to INR90bn spurred by healthy growth in the premium packaging segment.

Rising substitution by polymer material, development of new polymer additives and increasing preference for non- toxic polymer additives are likely to drive demand for natural derivatives like vegetable oil-based oleochemical derivatives.

Chart 8: Global plastic additive market to clock 6% CAGR

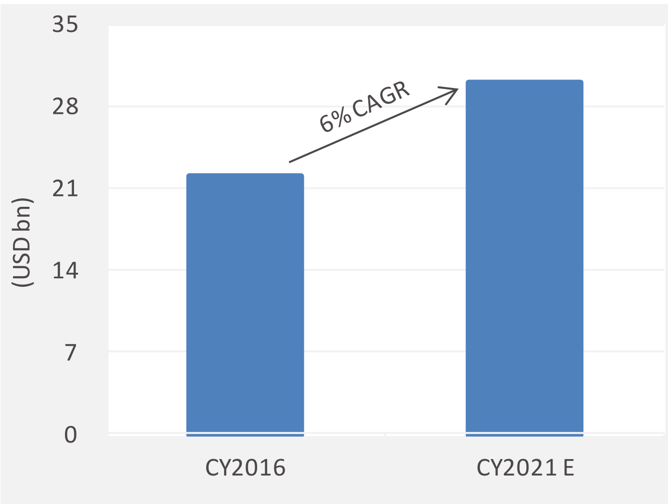
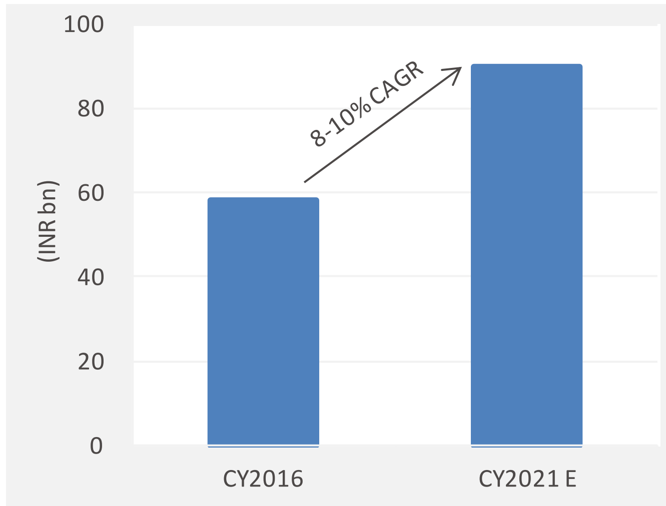


Chart 9: India's plastic additive market to clock 8-10% CAGR



Source: Industry, Edelweiss research

Capacity expansion to boost growth in FY20-21E

FOIL is doubling its capacity over the next two years, which is expected to accelerate growth over FY20-21. Focusing on product innovation, the company is also entering a few new categories like feed nutrition additive to sustain momentum. Further, expanding product basket will help the company move up the value chain.

FOIL is currently working at >90% utilisation and capacity addition is likely to drive growth going forward

Capacity addition will drive growth

FOIL is currently working at more than 90% utilisation, which is close to optimum capacity utilisation. Typically, after adding capacity, the company reaches optimum utilisation in three-five years. It first tests the feasibility of its products and then depending upon the success and visibility of the same, adds capacity. In order to serve existing direct customers & distributors, secure new direct customers & distributors and expand its products in new markets, FOIL is expanding capacity in India as well as globally. Following are its capacity expansion plans:

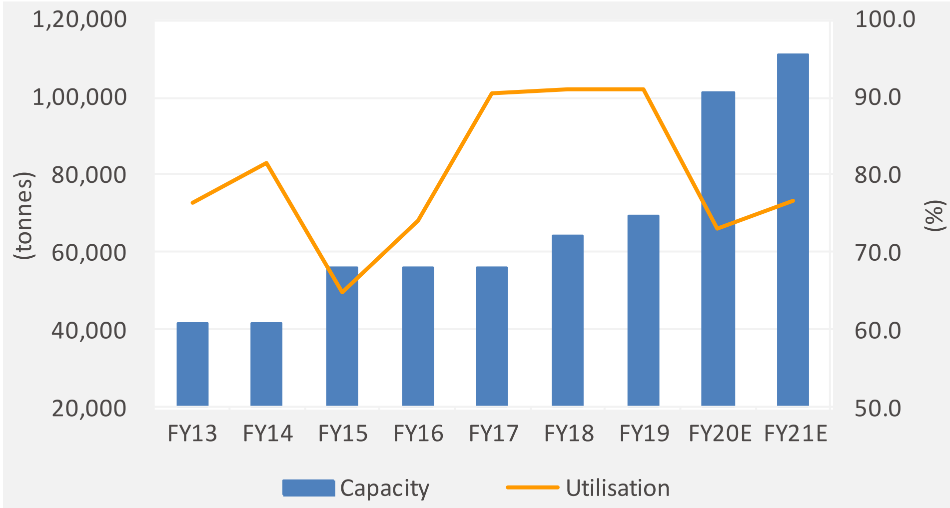
Table 4: Summary of capacity expansions

	Third Ambernath Facility	Fine Add Ingredients (Leipzig, Germany)	Patalganga Facility (Maharashtra)	Fine Zeelandia Facility (Patalganga)
Capacity (tonnes per annum)	32,000	10,000	10,000	10,000
JV or Owned	100% Owned	50:50 JV with Adcotec	100% Owned	50:50 JV with Zeelandia International
Commissioning	Q1FY20	FY22*	Q2FY21*	Commenced production in Q3FY19
Estimated Total Cost**	INR1,300 mn	EUR 18 mn	n.a.	INR600 mn
Equity	30%	30%		38%
Debt	70%	70%		62%
Products	Specialty additives for food, plastic, feed nutrition industry	Specialty food emulsifiers and other food additives	Food additives for export and growing domestic markets	Premixes for bakery and confectionary products and pan release agents

Source: Company, Edelweiss research

*Note: * Subjected to all necessary approvals, ** the cost is as per RHP. There may be some escalations on this cost; n.a – Not available*

Chart 10: Increasing capacity over the years



Source: Company, Edelweiss research

Third Ambernath facility with 32,000 tonnes capacity to start operations in Q1FY20

Third Ambernath facility likely to be completed in Q1FY20

FOIL is currently working on construction of third Ambernath facility of 32,000tonnes, which is likely to be commissioned in June 2020. It will produce a mix of feed additives, slip additives, plastic additives and other specialty additives like cosmetics, coatings, etc. This capacity is likely to reach optimum utilisation in the next three-five years led by healthy order visibility in domestic as well as exports markets.

Germany facility with 10,000 tonnes capacity to start operations in FY22

Capacity expansion in Germany to expand geographical presence

The company is setting up a 10,000 tonne plant in Leipzig (Germany) in a 50:50 JV with Adcotec to manufacture food additives for European customers. In this JV, Adcotec's role will be to market the food additives as technology; the plant and machinery will be provided by FOIL, for which it will be entitled for royalty. The capacity is likely to be commissioned in FY22 and will help the company expand its presence in the European market. The delay in commissioning of capacity is mainly because the company has not yet received approval from Germany authority and will take 1-1.5 years for commissioning post the approval.

Patalganga facility with 10,000 tonnes capacity to start operations in Q2FY21

Patalganga facility to cater to food additives demand from exports and domestic market

FOIL is adding 10,000tonnes capacity at Patalganga (Maharashtra). The capacity is likely to be commissioned by Q2FY21 and will help the company cater to food additives demand from exports and domestic markets. The delay in commissioning of capacity is mainly because the company is yet to receive EC from the government and it takes 9-12 months for commissioning the plant post receiving approvals.

Expanding product basket to help move up the value chain

In order to move up the value chain, FOIL in a 50:50 JV with Zeelandia International (part of the Royal Zeelandia Group), has set up a 10,000tonnes plant to manufacture baking pre-mixes in Patalganaga, India. These pre-mixes will be largely sold via distributors and marketed to five star hotels, large niche & high-quality bakeries and quick service restaurants. FOIL has got the technology from Zeelandia and will take care of marketing this product in India and nearby markets like Sri Lanka and Bangladesh. The plant commenced production in Q3FY19 and is likely to take 3-3.5 years to reach optimum utilisation.

Preparing for future growth

Apart from these capacity expansion plans, FOIL has also acquired another land parcel for an additional facility in Ambernath (12acres) which will cater to burgeoning demand for oleochemical derivatives. The company has paid INR242mn for this plot and is yet to receive possession of the land from MIDC. It is yet to finalise other details of this project.

Expansion in high-margin new specialty products to drive margin

FOIL is planning to sharpen focus on increasing sales of higher-margin specialty products, which is expected to drive the bottom line. The company is targeting to expand its product range to encompass:

- **Specialty feed nutrition additives:** FOIL recently developed and commercialised specialty feed nutrition additives. The company aims to target selected Western and European markets by eliminating use of harmful antibiotics in animal and poultry feed.
- **High margin specialty additives for cosmetics and coatings industries:** The company has a range of other specialty additives used in industries apart from polymer and food industries like cosmetics, coatings and other applications. In cosmetics, additives act as emollients and are used as a base product for creams and lotions for skin care applications. Due to limited capacity, FOIL was not been able to scale up these additives. However, with capacity expected to be commissioned in Q1FY20, the company will be able to enhance share from other specialty additives.

Focus on R&D to keep product pipeline strong

Sustained focus on R&D is likely to keep the company's product pipeline strong

FOIL has developed several new products—Acetem, Datem and Lactem—and processes such as in-house technology for production of fatty amides for the polymer industry. The company is currently conducting R&D for new products for various industries like coatings, polymers and other specialty applications like biodegradable plastic polymers and new organic anti-block additives.

Further, it is also conducting research in new technologies for chemical processing to minimise energy costs. These sustained R&D efforts are likely to keep the company's product pipeline strong. Following are a few of FOIL's achievements in innovation and R&D:

Table 5: Intellectual property

Title	Priority	Filing
A bio based plasticizer with improved properties and processing characteristics of polymer	IN	Feb-15
A natural based monoglyceride with improved odour and flavour	IN	Nov-15
Application of an ester additive from bioderived raw material	IN	Sep-16
A glycerol derivative for polymer application	IN	Apr-17

Source: Company, Edelweiss research

Revenue to clock 15% CAGR over FY19-21E led by capacity expansion

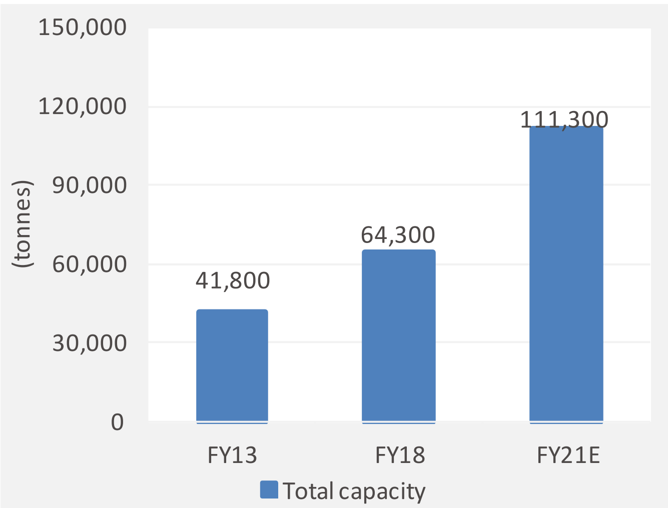
Financial Outlook

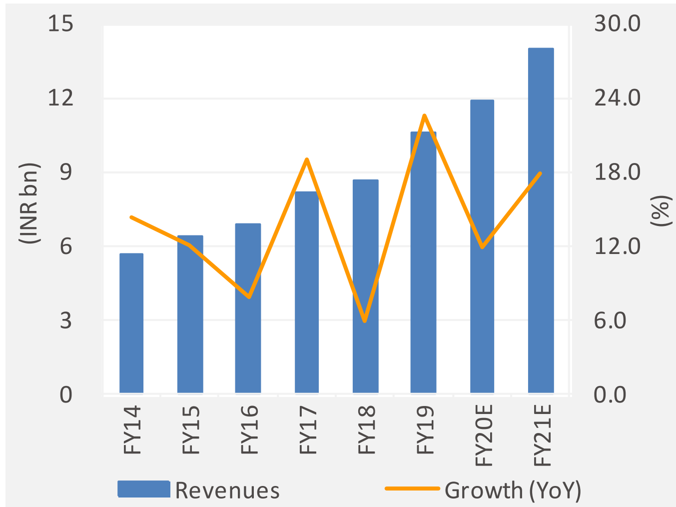
Capacity expansion to drive 15% revenue CAGR

We estimate revenue to clock 15% CAGR over FY19-21 (13% CAGR over FY14-19) as capacity expansion spurs volume spurt. Apart from addition of the 5,000tonne second Ambernath facility (received MIDC's approval on May 21, 2018) and commencement of operations at the 10,000tonne Fine Zeelandia unit from Q3FY19, the company has following expansion plans:

- Third Ambernath Facility of 32,000tonne likely to be completed by Q1FY20
- Capacity expansion in Germany by 10,000tonnes in food additives by FY22
- Patalganga capacity expansion by 10,000tonnes in food additives by Q2FY21

Chart 11: Capacity addition to drive 15% revenue CAGR over FY19-21E





Source: Company, Edelweiss research

Increasing sales of higher-margin specialty products to drive EBITDA and PAT growth of 10% and 12% CAGR respectively

PAT to post 12% CAGR over FY19-21E

Focus on increasing sales of higher-margin specialty products like pre-mixes and entry in the feed nutrition segment are expected to drive EBITDA and PAT growth of 10% and 12% CAGR respectively over FY19-21E. EBITDA margin is, therefore, likely to remain healthy at 18-20%.

Chart 12: EBITDA to clock 10% CAGR over FY19-21E

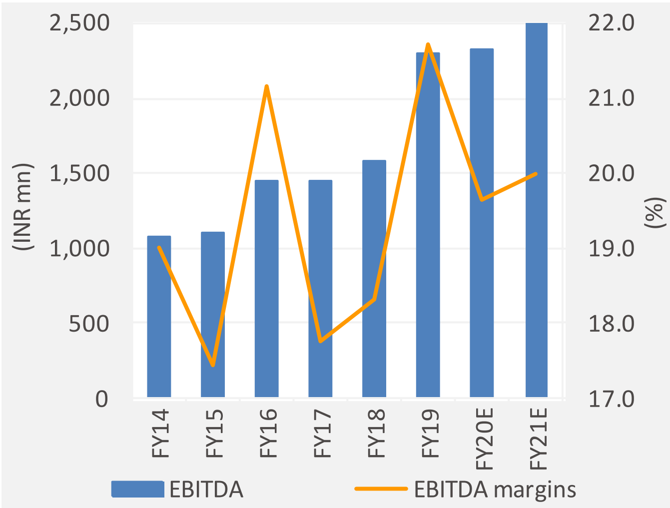
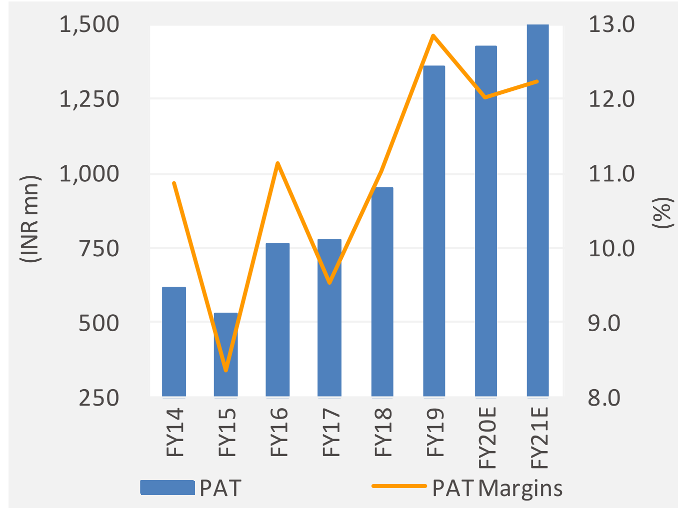


Chart 13: PAT to post 12% CAGR over FY19-21E



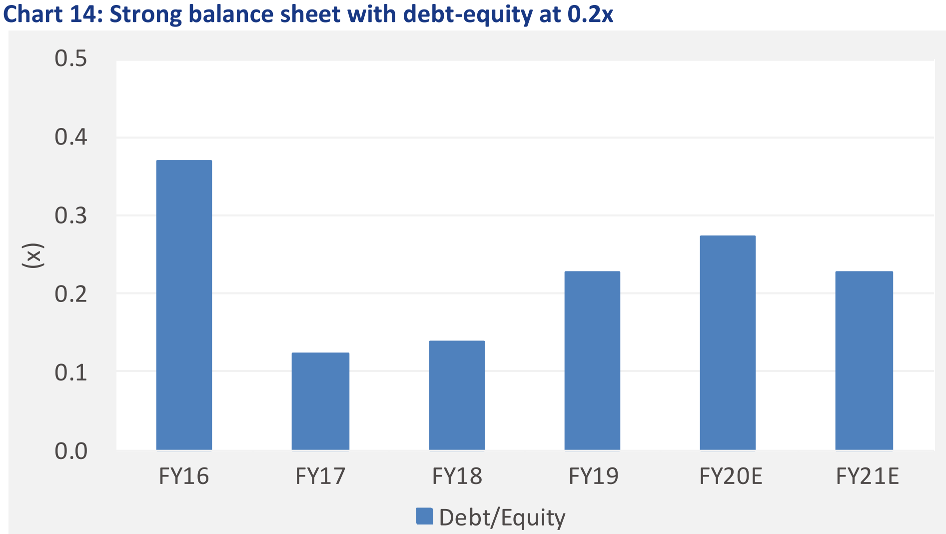
Source: Company, Edelweiss research

FOIL's balance sheet remains healthy with debt-equity of 0.2x at FY19 end

Balance sheet to remain deleveraged

FOIL's balance sheet remains healthy with debt-equity of 0.2x at FY19 end. The company has been funding its capex primarily via internal accruals, which results in sustenance of a healthy balance sheet. Further, it resorts to debt for only capacity expansion and pays it back within three-four years—the time required to reach optimum utilisation rate.

Chart 14: Strong balance sheet with debt-equity at 0.2x



Source: Company, Edelweiss research

Higher asset turns result in strong return ratios—ROCE of 40% plus in FY19 versus industry average of 15-20%

Asset-light business model generating higher returns

FOIL's asset-light business model enjoys fixed asset turnover of 3-4x, which is one of the highest in the industry. Higher asset turns result in strong return ratios—ROCE of 40% plus in FY19 versus industry average of 15-20%.

Chart 15: Asset turnover significantly higher than industry

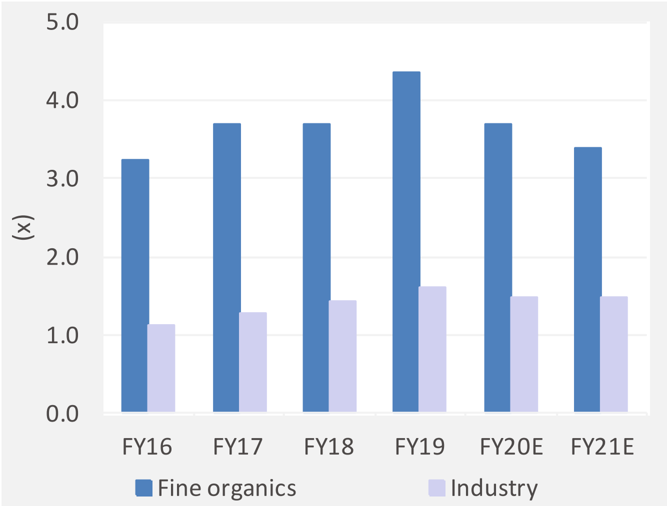
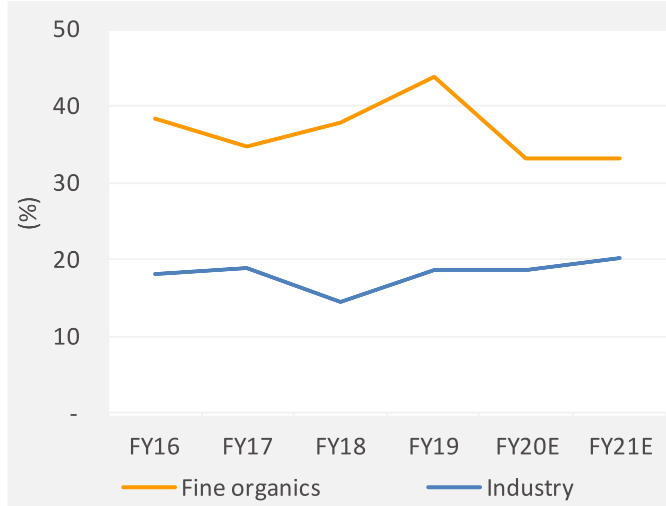


Chart 16: ROCE significantly higher than industry



Source: Company, Edelweiss research

Valuations

- **FOIL is estimated to clock revenue and PAT CAGR of 15% and 12% over FY19-21, respectively, driven by capacity addition and robust growth in end-user industries.**
- **The company's business model is underpinned by tough entry barriers and high level of customer stickiness. It's in-house developed manufacturing technology results in high asset turnover of 3-4x versus industry average of 1.5x and ROCE upwards of 40% versus industry average of 19% as on FY19.**
- **FOIL deserves premium valuations vis-à-vis peers as the company manufactures oleo chemicals additives which globally enjoy premium valuations.**
- **However, given the recent run-up in the stock, we initiate coverage with 'HOLD' recommendation and September 2020 target price of INR1,535 (30x P/E).**

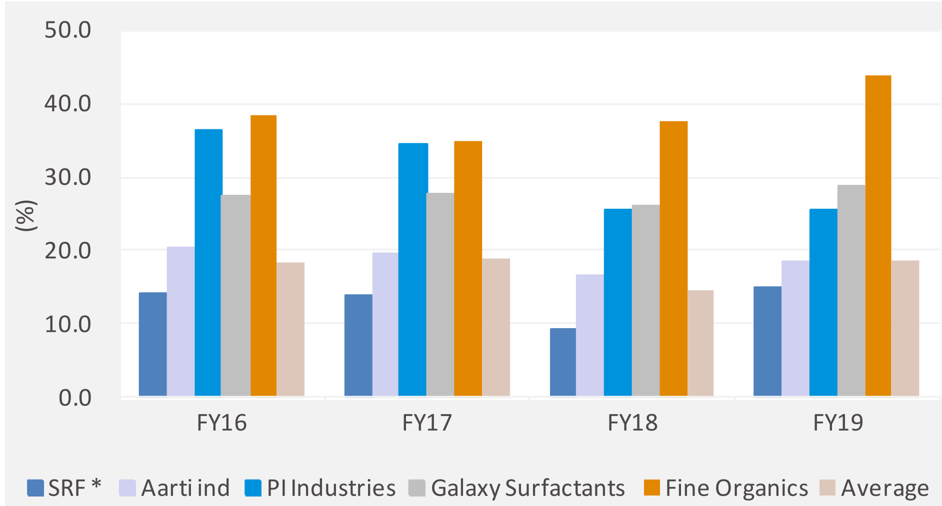
Initiate coverage with 'HOLD'

We are initiating coverage on FOIL and value the stock at 30x Q2FY21E EPS and arrive at target piece of INR1,535. We believe, presence in green chemistry with higher market share in the oleochemicals additives space, presence in fast-growing markets and significantly high return ratios (ROCE of 40% plus) justify the company's premium valuation multiple. Globally as well food additive players enjoy premium valuation over other specialty chemical companies. This premium is justified by the unique space and the segment's high growth potential along with superior return ratios. The company's business model has a strong moat bolstered by high entry barriers driven by R&D and customer stickiness.

Further, its in-house developed manufacturing technology leads to higher asset turnover (3-4x versus industry average of 1.6x in FY19). This leads to higher PAT margin (>12% versus industry average of 10% in FY19) as well as superior ROCE of 40% plus—higher than the industry average of 19% in FY19.

However, constrained by capacity, we expect FOIL's revenue and PAT to report CAGR of 15% and 12%, respectively, over FY19-21E. Though we remain confident about the company's unique positioning in the niche segment and strong long-term growth opportunity led by R&D capability and strong customer base, we perceive limited upside at current price as the stock has run-up 70% (post listing in July 2018). Hence, we recommend **'HOLD'**.

Chart 17: ROCE compared with industry



Source: Company, Edelweiss research

*Note: *SRF's ROCE are of chemicals division*

Table 6: Peer comparison - Valuation snapshot

Company Name	M Cap (USD bn)	FY19-21E Sales CAGR (%)	FY19-21E PAT CAGR (%)	FY19 EBITDA margin (%)	P/E (x) FY19	P/E (x) FY20E	P/E (x) FY21E	EV/EBITDA (x) FY19	EV/EBITDA (x) FY20E	EV/EBITDA (x) FY21E	Post Tax RoCE-FY19
Valuations of food and plastic additives players											
Fine Organics	0.6	17.1	13.4	21.7	32.0	30.7	24.9	18.9	18.2	14.9	26.2
Kerry Group	21.1	6.3	15.8	13.7	32.7	26.9	24.4	22.3	19.2	17.7	12.0
Evonik	13.1	(1.3)	2.5	15.2	12.3	12.4	11.7	6.9	6.8	6.4	9.8
Average		**7.4**	**10.6**	**16.9**	**25.7**	**23.3**	**20.3**	**16.0**	**14.7**	**13.0**	**16.0**
Median		**6.8**	**12.0**	**16.0**	**28.8**	**25.1**	**22.4**	**17.5**	**16.4**	**14.0**	**14.0**
Valuations of other Indian specialty chemical players											
Aarti Industries	2.1	16.4	20.8	19.4	29.8	26.1	20.4	16.8	14.7	11.9	16.4
SRF Ltd	2.5	13.0	23.9	17.6	26.6	21.4	17.3	14.8	12.3	10.5	11.6
Atul Limited	1.7	14.4	16.9	19.0	27.1	23.3	19.8	15.2	13.5	11.5	17.5
PI Industries	2.4	20.0	25.0	20.3	40.1	31.5	25.7	28.2	22.4	18.2	19.5
Vinati Organics	1.6	26.2	19.0	36.4	38.3	32.7	27.1	26.6	21.6	17.7	30.7
Galaxy Surfactants	0.6	12.0	15.4	12.8	22.3	19.6	16.7	12.7	11.4	10.0	19.4
S H Kelkar	0.3	14.4	17.2	12.7	22.5	19.6	16.4	17.4	12.8	10.9	7.1
Navin Fluorine	0.5	13.4	18.9	22.1	24.0	19.8	17.0	15.4	13.0	11.0	15.6
Average		**16.2**	**19.6**	**20.0**	**28.9**	**24.3**	**20.1**	**18.4**	**15.2**	**12.7**	**17.2**
Median		**14.4**	**18.9**	**19.2**	**26.9**	**22.4**	**18.6**	**16.1**	**13.3**	**11.3**	**16.9**

Source: Bloomberg

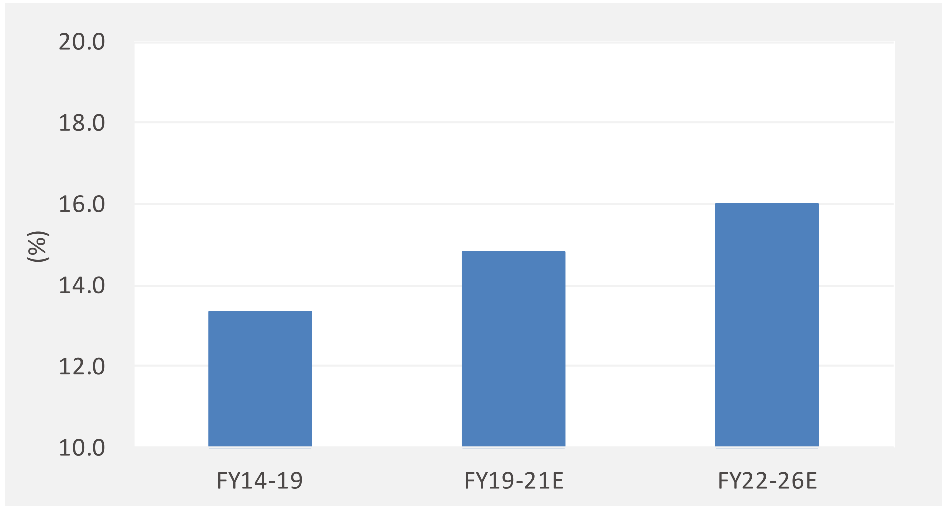
Our DCF analysis indicates stock is factoring moderate growth

For FOIL, though we have used P/E based valuation metrics for arriving at target price as it better captures earnings growth momentum, we have also used reverse DCF model to calculate the implied growth built in at our target price.

As we believe that recent favourable industry scenario offers higher growth potential, we have factored in five years of high growth (FY22-26) and five years of moderate growth (FY27-31). We have used 12% WACC and terminal growth of 6%.

At our target price of INR1,535, the stock is factoring 16% growth in high growth phase of FY22-26 and 15% during the moderate growth (FY27-31) phase. Though growth in high growth phase is higher than the 15% revenue CAGR posted during FY12-19, we believe it can be achieved given FOIL's niche product basket and capacity expansion plan.

Chart 18: DCF – Historical and implied revenue growth rate



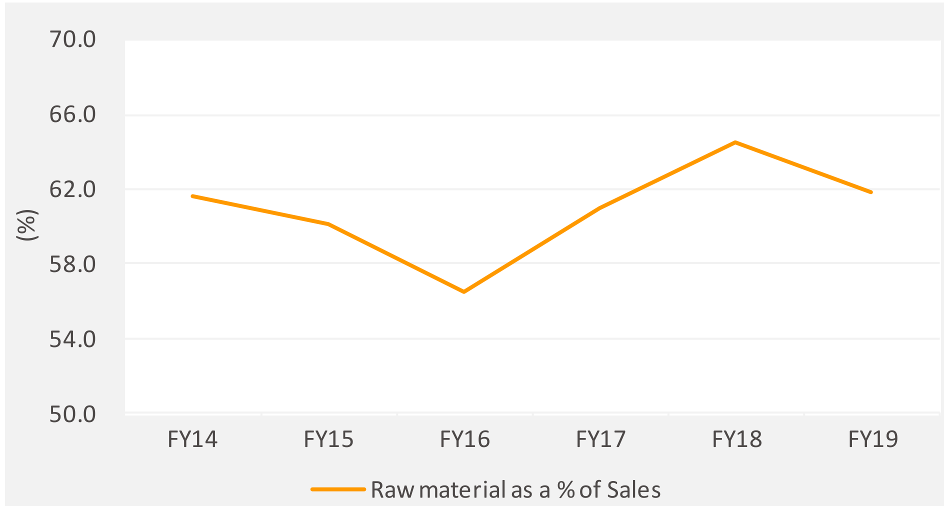
Source:Edelweiss research

Key Risks

Raw material prices

FOIL's largest expense, by far, is the cost of raw material which is derived from vegetable oils, including rapeseed oil, palm oil, palm kernel oil, sunflower oil, castor oil, soybean oil and rice bran oil. The company does not enter in to supply contracts longer than six months, which exposes it to the risk of increase in the cost of raw material.

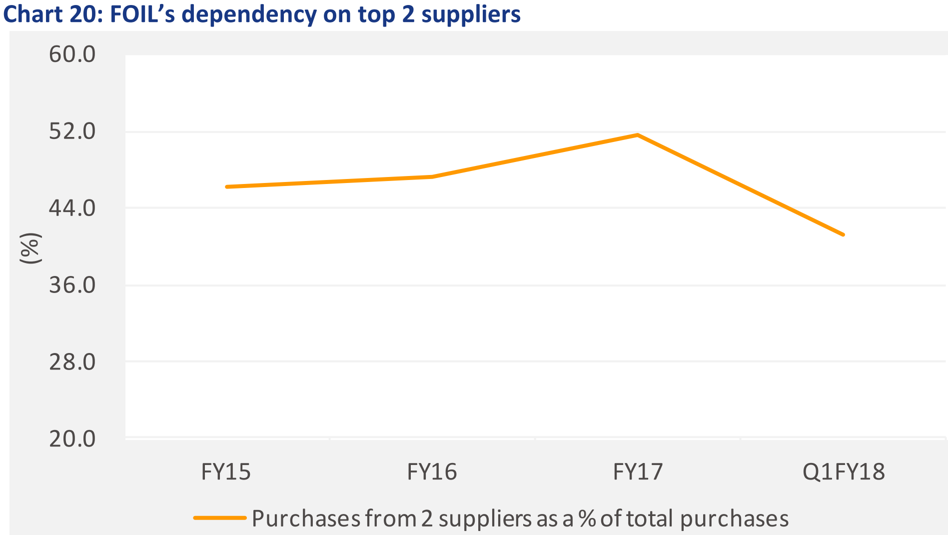
Chart 19: Raw material as % of sales



Significant dependence on suppliers

The company is highly dependent on its top two suppliers, which constituted 52% of total purchases in FY17. Further, FOIL does not enter in to supply contracts of more than six months. If its current suppliers fail to supply, there is no guarantee that the company can identify alternate supplies at similar cost in the future. Thus, disruption in raw material supply could dent FOIL's manufacturing operations, which could adversely affect the company's business, results of operations and financial condition.

Chart 20: FOIL's dependency on top 2 suppliers

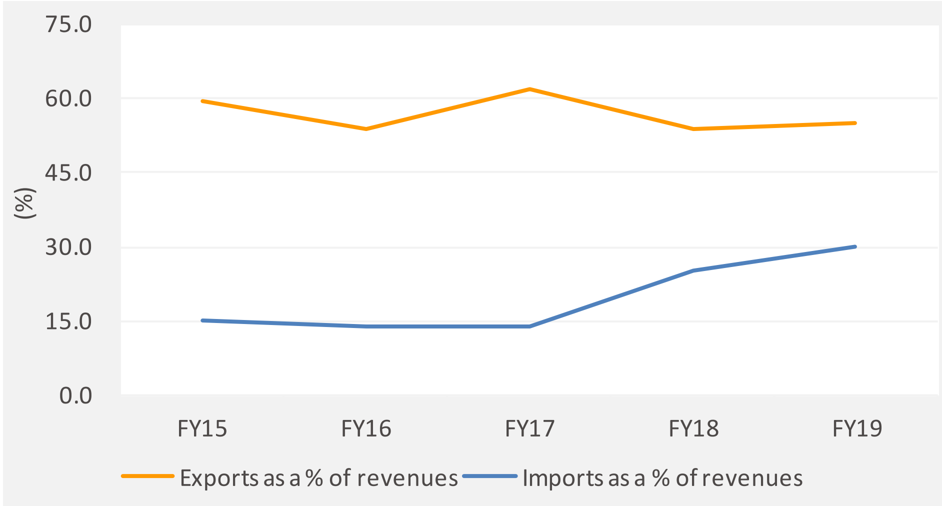


Source: Company DRHP, Edelweiss research

Foreign currency fluctuation

Most of FOIL's sales to overseas customers are denominated in foreign currency, predominantly USD. Even for FY19, revenue from operations from sales to foreign customers accounted for 55% of total revenue. Appreciation of INR decreases the INR proportion of revenue from sales made in foreign currency and thus poses a risk to the company's profitability.

Chart 21: Revenues impacted by foreign exchange fluctuations



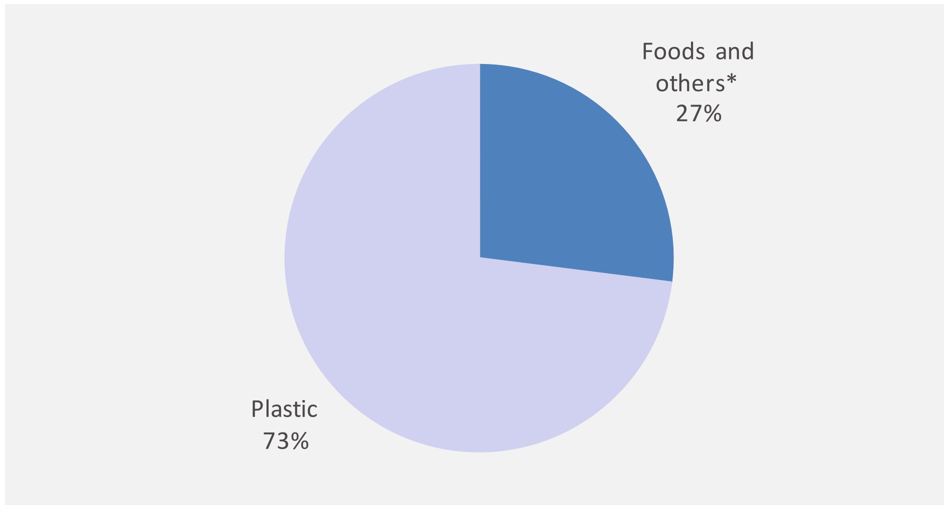
Source: Company, Edelweiss research

Company Description

Global player in niche oleochemicals market

Set up in 1970, FOIL was established by Mr. Ramesh Shah, a Mumbai-based businessman with experience in chemical trading, and Mr. Prakash Kamat, a technocrat from the Institution of Chemical Technology (formerly UDCT). The company is the largest Indian manufacturer of oleochemical-based additives and a strong player globally (*Source: CRISIL Research Report*). It produces a wide range of specialty plant-based additives used in the food, polymer, cosmetics, paint, ink, coatings and other specialty application industries. The company's products fall primarily in two segments— plastic and food.

Chart 22: Revenue share (March 31, 2017)



*Note: *Comprises cosmetics, printing inks, coated papers, lube additives, wires and cables, coatings and other specialty applications*

Source: Company DRHP, Edelweiss research

FOIL has been able to drive its growth riding product innovation, process technology improvement, increase in scale, specialised skills/knowledge, a diverse customer base and a strong management team. As a result, it has achieved its current scale, which includes more than 400 different products with 650 plus direct customers and 130 plus distributors from over 70 countries as on 'March 31, 2018. Some of its marquee customers are Hindustan Unilever, Parle Products, GSK and Borealis.

Flexible and strategically located production facilities

The company's three production facilities have the ability to manufacture a wide range of products and are strategically located in close proximity to the Jawaharlal Nehru (Nhava Sheva) port near Mumbai. As FOIL is largely export-oriented, this location helps reduce freight and logistics cost. Moreover, its fully automated plants ensure that it continues to produce high-quality products as well as minimizes the number of employees required to operate them, thereby pruning expenses.

Table 7: FOIL's current capacity

Facility	Capacity (tonnes per annum)	Comments
Dombivali	8,400	Started in 1973, this was the first facility of the company as a partnership firm. On Nov 30, 2017, FOIL purchased machines and stock of this facility
Badlapur	6,400	This facility consists of two plots - smaller facility started operation in 1988 while the larger facility started operation in 2000
First Ambernath	49,500	Started in 2006, this is currently the largest facility for FOIL
Second Ambernath	5,000	
Total	**69,300**	

Source: Company, Edelweiss research

Major milestones

Table 8: Major events and milestones

Fiscal	Particulars
1970	Established as 'Fine Organic Industries', a partnership firm by Late Shri Ramesh Shah and Shri Prakash Kamat
1973	Commissioned first food additives facility in Dombivli
1988	Set up second facility in Ambernath
1995	Incorporated Oleofine Organics (India) for expanding the capacity for polymer additives
2002	Incorporated the company under the name of Fine Organic Industries (Mumbai)
2005	Research and development centre was established in Mahape, Navi
2006	Fatty acid esters facility was commissioned in First Ambernath Facility
2008	Polymer additives facility was commissioned in first Ambernath facility
2010	Polymer additives capacity was expanded in first Ambernath facility
2012	Food additives facility was commissioned in first Ambernath facility
2014	Joint venture was signed with Zeelandia International, a Netherlands based bakery premix manufacturer
2015	Additional food and polymer additives capacity was commissioned in first Ambernath facility
2017	Sub-leasing of general plant and machinery at Dombivli, MIDC
2018	Joint venture agreement was signed with Adcotec, a German company, for application, development, marketing, distribution and sales activities of food and food additives

Source: Company, Edelweiss research

Key management personnel

Table 9: Key management personnel/ Directors

Name	Profile
Prakash Damodar Kamat, Executive Director and Chairman	He holds a master's degree in science from Institute of Chemical Technology (formerly UDCT), University of Bombay. He joined the Group in 1970 and was appointed as a Director of the Company on May 24, 2002. He has work experience in product development, process technology and research and development. He received the distinguished alumni award in 1999 from the UDCT for his commitment and depth of knowledge of paints, plastics, oils, textiles, metal working and food industries in India and overseas. He is a co-founder of the Company and has played a key role in developing several products, processes and leading engineering research and development.
Mukesh Maganlal Shah, Managing Director	He holds a bachelor's degree in science from the University of Bombay. He joined the group in 1973 and played a key role in establishing the quality control, sales and marketing departments at the Company. He formed and guided a team of sales and marketing professionals that helped the organization's products reach customers across India and find applications beyond the food industry. He has been associated with the Company since inception.
Jayen Ramesh Shah, Executive Director and Chief Executive Officer	He holds a master's degree in science from the University of Bombay. He joined the Group in 1986 and was instrumental in creating a vendor-partner network needed to support the Company. He played a key role in developing and managing channel partners for the organizations products in India. He has experience in procurement, vendor development and business development. He has been associated with the Company since inception.
Tushar Ramesh Shah, Executive Director and Chief Financial Officer	He holds a bachelor's degree in science from the University of Mumbai. He joined the Group in 1989 and led several change management initiatives like the introduction of enterprise resource planning, customer relationships management and financial systems that has helped the Company in scaling up operations. He played a key role in the development of the Company's first slip additive manufacturing facility. He has helped in setting up offices in North America and Europe. He has been associated with the Company since inception
Bimal Mukesh Shah, Executive Director	He holds a bachelor's degree in science from Purdue University and a master's degree in management from Boston College. He joined the Group in 2009. Under the mentorship of Prakash Damodar Kamat, Bimal Mukesh Shah has transitioned into a position to lead several initiatives for upcoming projects, processes and additional capacities. He has experience in operations, instrumentation and projects.
Nikhil Dattatraya Kamat , Senior Vice President – operations	He holds a masters degree in science from the University of Bombay. He has work experience in production planning, handling technical, and regulatory work.
Mayukh G. Warawdekar, Senior Vice President – research and development	He holds a master's degree in physical chemistry and a doctor of philosophy degree in science from the University of Bombay. He has experience in research and development and specialty chemicals
Vijay Gopal Prabhu, Senior Vice President- Quality Assurance	He holds a master's degree and a doctor of philosophy degree in science from the University of Bombay. He has work experience in research and development and quality assurance in food and polymer additives, peroxides, organometallic compounds and metal extraction by sovex systems. He retired on March 31, 2017 and continues to work on a fixed term contract starting from April 1, 2017 to March 31, 2019.
Pooja Gaonkar, Company Secretary	She holds a bachelor's degree in law from the University of Bombay and is an associate of The Institute of Company Secretaries of India. She has work experience in companies law. Previously she worked with Calyx Chemicals and Pharmaceuticals Limited

Source: Company, Edelweiss research

Financial Statements

Key Assumptions

Year to March	FY18	FY19	FY20E	FY21E
Macro Assumptions				
GDP(Y-o-Y %)	7.2	6.8	6.8	7.1
Inflation (Avg)	3.6	3.4	4.0	4.5
Repo rate (exit rate)	6.0	6.3	5.3	5.0
USD/INR (Avg)	64.5	70.0	72.0	72.0
Company Assumptions				
Total capacity (tonnes)	64,300	69,300	101,300	111,300
Production (tonnes)	58,530	63,063	74,049	85,363
Utilisation (%)	91.0	91.0	73.1	76.7
Sales volumes (tonnes)	56,296	60,540	69,798	80,057
Volume growth (%)	15.2	7.5	15.3	14.7
Realisation (INR/tonne)	153,592	175,144	169,890	174,537
Realisation growth (%)	-8.0	14.0	-3.0	2.7
Financial assumptions				
Gross margins (%)	35.5	38.2	37.0	37.0
Employee (% of net rev)	6.0	5.9	6.4	6.2
Other expenses (% of net rev)	11.2	10.6	11.0	10.8
Depreciation (% of Avg GFA)	8.6	7.2	8.5	8.0
Int (% of avg G.debt)	6.7	2.2	6.5	6.5
Tax rate as % of PBT	36.9	41.0	35.0	35.0

Income statement (INR mn)

Year to March	FY18	FY19	FY20E	FY21E
Net revenues	8,647	10,603	11,858	13,973
Raw material costs	5,578	6,552	7,471	8,803
Employee Benefits Expense	516	628	753	867
Other expenses	968	1,121	1,304	1,509
Total expenses	7,062	8,301	9,528	11,178
EBITDA	1,584	2,302	2,330	2,794
Depreciation & amortization	200	175	273	329
EBIT	1,384	2,128	2,056	2,465
Less: Interest Expense	32	18	90	106
Add: Other income	160	198	228	274
Add: Exceptional items	0	0	0	0
Profit Before Tax	1,512	2,308	2,194	2,633
Less: Provision for Tax	559	945	768	921
Reported Profit	953	1,363	1,426	1,711
Less: Excep. Items (Net of Tax)	0	0	0	0
Adjusted Profit	953	1,363	1,426	1,711
No. of Sha. outstanding (mn)	31	31	31	31
Adjusted Basic EPS	31.1	44.4	46.5	55.8
No. of dil. Sha. outstand. (mn)	31	31	31	31
Adjusted Diluted EPS	31.1	44.4	46.5	55.8
Adjusted Cash EPS	37.6	50.1	55.4	66.6
Dividend per share	9.0	13.3	14.0	16.7
Dividend Payout Ratio (%)	0.3	0.3	0.3	0.3

Common size metrics - as % of revenues

Year to March	FY18	FY19	FY20E	FY21E
Materials costs	64.5	61.8	63.0	63.0
Staff costs	6.0	5.9	6.4	6.2
S G & A expenses	11.2	10.6	11.0	10.8
Depreciation	2.3	1.6	2.3	2.4
Interest Expense	0.4	0.2	0.8	0.8
EBITDA margins	18.3	21.7	19.6	20.0
Net Profit margins	11.0	12.9	12.0	12.2

Growth metrics (%)

Year to March	FY18	FY19	FY20E	FY21E
Revenues	6.0	22.6	11.8	17.8
EBITDA	9.3	45.3	1.2	20.0
PBT	25.2	52.6	(4.9)	20.0
Adjusted Profit	22.4	42.9	4.7	20.0
EPS	22.4	42.9	4.7	20.0

Balance sheet (INR mn)

As on 31st March	FY18	FY19	FY20E	FY21E
Share capital	153	153	153	153
Other Equity	3,803	4,849	5,848	7,045
Total shareholders funds	3,956	5,002	6,001	7,199
Long term Borrowings	0	928	928	928
Short term Borrowings	536	202	702	702
Total Borrowings	536	1,130	1,630	1,630
Long Term Liabilities & Prov.	0	39	39	39
Deferred Tax Liability (net)	(48)	(2)	(2)	(2)
Sources of funds	**4,443**	**6,170**	**7,668**	**8,866**
Net Block	881	778	2,005	1,975
Capital work in progress	317	1,063	1,063	1,063
Intangible Assets	3	3	3	3
Total Fixed Assets	1,200	1,845	3,071	3,042
Non current investments	106	100	100	100
Cash & bank balances	124	1,092	1,185	2,038
Inventories	891	893	1,126	1,326
Sundry Debtors	1,465	1,556	1,787	2,106
Loans & Advances	10	0	0	0
Other Current Assets	1,416	1,537	1,537	1,537
Total Current Assets (Ex Cash)	3,782	3,986	4,449	4,969
Trade payable	699	534	819	965
Other Current Liab. & ST Prov.	69	318	318	318
Total Current Liab. & Provis.	768	852	1,137	1,283
Net Current Assets (ex cash)	3,014	3,134	3,312	3,686
Uses of funds	**4,443**	**6,170**	**7,668**	**8,866**
Book value per share (INR)	129	163	196	235

Free cash flow

Year to March	FY18	FY19	FY20E	FY21E
Reported Profit	953	1,363	1,426	1,711
Add: Depreciation	200	175	273	329
Interest (Net of Tax)	20	11	58	69
Others	(86)	8	31	37
Less:Changes in WC	570	(40)	179	373
Operating cash flow	518	1,596	1,611	1,773
Less: Capex	394	818	1,500	300
Free cash flow	**124**	**777**	**111**	**1,473**

Cash flow statement

Year to March	FY18	FY19	FY20E	FY21E
Operating cash flow	518	1,596	1,611	1,773
Investments cashflow	(506)	(818)	(1,500)	(300)
Financing cash flow	(37)	200	(18)	(619)
Net cash Flow	(25)	977	93	854
Capex	394	818	1,500	300

Profitability & liquidity ratios

Year to March	FY18	FY19	FY20E	FY21E
ROAE (%)	26.3	30.4	25.9	25.9
ROCE (%)	37.7	43.8	33.2	33.3
Debtors Days	54	52	51	51
Payble Days	44	34	33	37
Cash conversion cycle (days)	70	67	68	65
Current Ratio	5.1	6.0	5.0	5.5
Gross Debt/EBITDA	0.3	0.5	0.7	0.6
Gross Debt/Equity	0.1	0.2	0.3	0.2
Net Debt/Equity	0.1	0.0	0.1	(0.1)
Interest Coverage Ratio	43.9	115.7	22.9	23.3

Operating ratios

Year to March	FY18	FY19	FY20E	FY21E
Total asset turnover(x)	2.1	2.0	1.7	1.7
Fixed asset turnover(x)	9.3	12.7	8.5	7.0
Equity turnover(x)	2.4	2.4	2.2	2.1

Valuation parameters

Year to March	FY18	FY19	FY20E	FY21E
Adjusted Diluted EPS (INR)	31.1	44.4	46.5	55.8
Y-o-Y growth (%)	*22.4*	*42.9*	*4.7*	*20.0*
Adjusted Cash EPS (INR)	37.6	50.1	55.4	66.6
Diluted P/E (x)	45.7	32.0	30.5	25.5
Price/BV (x)	11.0	8.7	7.3	6.1
EV/Sales (x)	5.1	4.1	3.7	3.1
EV/EBITDA (x)	27.7	18.9	18.9	15.4
Dividend yield (%)	0.6	0.9	1.0	1.2

Additional Data

Directors Data

Mr. Prakash Damodar Kamat	Executive Director and Chairman	Mr. Mukesh Maganlal Shah	Managing Director
Mr. Jayen Ramesh Shah E	Executive Director and Chief Executive Officer	Mr. Tushar Ramesh Shah	Executive Director and Chief Financial Officer
Mr. Bimal Mukesh Shah	Executive Director	Mr. Prakash Krishnaji Apte	Independent Director
Mr. Kaushik Dwarkadas Shah	Independent Director	Mr. Mahesh Pansukhlal Sarda	Independent Director
Mr. Parthasarathi Thiruvengadam	Independent Director	Ms. Pratima Umarji	Independent Director

Auditors - B Y & Associates

**as per last available data*

Holding Top -10

	Perc. Holding		Perc. Holding
SBI Mutual Fund	5.91	IDFC Mutual Fund	4.07
Reliance Capital Trustee	2.35	Goldman Sachs	1.97
Principal Financial Group	0.85	Axis AMC	0.00
Union Mutual Fund	0.33	Birla Sun Life Insurance	0.30
Edelweiss AMC	0.30	Tata AMC	0.21

**as per last available data*

Bulk Deals

Data	Acquired / Seller	B/S	Qty Traded	Price
02-Jul-19	Goldman Sachs India Fund	Buy	279,041	815

**in last one year*

Insider Trades

Reporting Data	Acquired / Seller	B/S	Qty Traded
No Data Available			

**in last one year*

India Midcaps

INITIATING COVERAGE

GALAXY SURFACTANTS

Resilient business model at reasonable valuations

India Equity Research| Specialty Chemicals

Edelweiss
Ideas create, values protect

Galaxy Surfactants (GSL) is India's leading manufacturer of surfactants and other specialty ingredients for home & personal care (HPC). We believe: 1) a 200 plus product portfolio in fast-growing oleochemicals; 2) diversified geographical footprint & clientele including MNCs and regional players (creating strong entry barriers); and 3) leading presence in high growth potential markets of India & Africa, Middle East and Turkey (AMET), place GSL ideally to benefit from structural growth opportunity. Moreover, we envisage healthy return ratios (ROCE of 25% plus) coupled with robust earnings growth (13% CAGR over FY19-21E) to keep the valuation multiple high. Hence, we initiate with 'BUY' and September 2020 target price of INR1,405 (22x P/E).

Diversified operations, green chemistry brighten prospects

GSL's portfolio comprises over 200 product grades, marketed to 1,750 plus customers in over 75 countries, including leading MNCs, regional and local players. A diversified product portfolio, clientele and geographical footprint eliminates dependence risk and insulates the company from volatility. Further, it specialises in oleochemical-based products (~70% of portfolio), which are based on green chemistry and benefiting from shift from petrochemical-based ingredients.

Presence in fast-growing markets to fuel growth

The company's established customer relationships and robust product portfolio create strong entry barriers. Moreover, its leading presence in fast-growing markets like India (37% of revenue) and AMET (31%) will help GSL surpass industry growth. In other mature markets, the company is planning to leverage existing relationships to enhance presence in specialty care products, where currently it has minuscule market share.

Outlook and valuation: Gaining ground; initiate with 'BUY'

We estimate GSL's strong FMCG linked structural growth model (12-15% volume growth), stable margin (12-13% EBITDA margin) and return ratios (ROCE of 20% plus) to command premium over specialty chemical companies. We initiate coverage on the stock with **'BUY'** and September 2020 target price of INR1,405 (22x P/E).

Financials

Year to March	FY18	FY19	FY20E	FY21E
Net revenues (INR mn)	24,339	27,630	30,538	33,581
EBITDA (INR mn)	2,877	3,534	3,780	4,292
Adj. profit (INR mn)	1,580	1,910	2,085	2,443
Adj. diluted EPS (INR)	44.6	53.9	58.8	68.9
EPS growth (%)	*7.1*	*20.9*	*9.2*	*17.1*
Diluted P/E (x)	*26.9*	*22.3*	*20.4*	*17.4*
EV/EBITDA (x)	*15.7*	*12.7*	*11.7*	*9.9*
ROCE (%)	26.0	28.7	25.7	25.6

EDELWEISS RATINGS	
Absolute Rating	**BUY**
Investment Characteristics	Growth

MARKET DATA *(R: GALX.NS, B: GALSURF IN)*	
CMP	: INR 1,200
Target Price	: INR 1,405
52-week range (INR)	: 1,405 / 885
Share in issue (mn)	: 35.5
M cap (INR bn/USD mn)	: 43 / 611
Avg. Daily Vol. BSE/NSE ('000)	: 17.5

SHARE HOLDING PATTERN (%)

	Current	Q4FY18	Q3FY18
Promoters *	70.9	70.9	70.9
MF's, FI's & BKs	9.3	8.2	8.3
FII's	3.1	3.1	3.2
Others	16.7	17.8	17.6

** Promoters pledged shares (% of share in issue) : NIL*

PRICE PERFORMANCE (%)

	Sensex	Stock	Stock over Sensex
1 month	1.6	15.7	14.1
3 months	3.8	9.3	5.5
12 months	11.8	(2.9)	(14.7)

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June 19, 2019

Investment Rationale

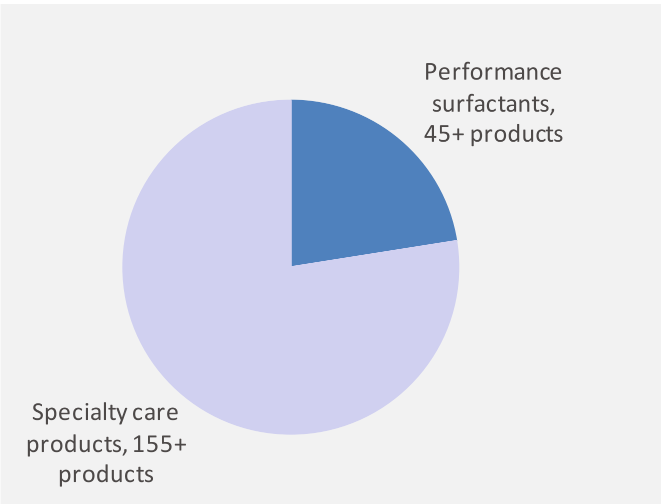
Highly diversified operations eliminate dependence risk

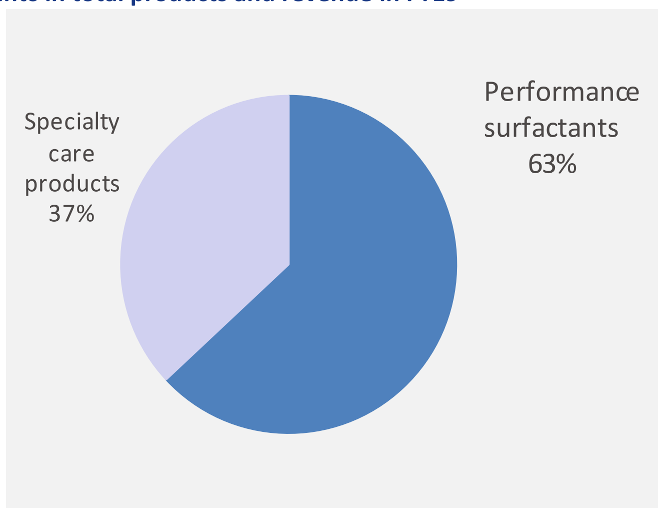
GSL is India's leading surfactants manufacturer with over 200 product grades, marketed to 1,750 plus customers in 75 plus countries. A diversified product portfolio, clientele and geographical footprint eliminates dependence risk and insulates it from volatility.

GSL's diversified product portfolio comprises 200 grades, of which 155+ are specialty care products

Diversified products: GSL's product portfolio comprises over 200 product grades, of which 155 plus (including amphoteric surfactants, cationic surfactants, UV filters, preservatives, preservative blends, surfactant blends) are specialty care products and 45 plus product grades (including anionic, non-ionic surfactants) are performance surfactants. GSL is the largest consumer ingredient manufacturer in India for consumer companies, rendering it a one-stop shop for the HPC industry. A diversified product portfolio enables the company to provide integrated customised solutions to a wide array of customers—established MNCs as well as emerging players in local markets.

Chart 1: Share of specialty care products and performance surfactants in total products and revenue in FY19





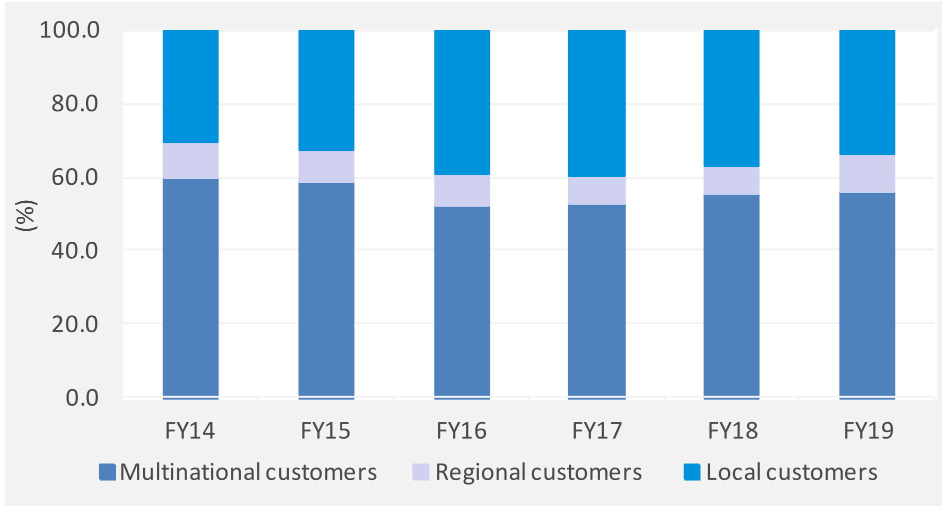
Source: Company, Edelweiss research

GSL has evolved from being a local to global supplier with over 1,750 customers in 75 plus countries

Diversified customer base: Over the years, GSL has evolved from being a local supplier to FMCG companies in India to a global supplier to FMCG players across major geographies. The company has 1,750 plus customers in over 75 countries including Colgate-Palmolive (India), Dabur India, L'ORÉAL and Unilever. It derives 56% revenue from MNCs, 10% from regional and 34% from local FMCG companies. GSL enjoys strong relationships spanning 10 years plus with each of its top 5 customers and five years plus with each of its top 10 customers.

GSL has presence in over 75 countries across major geographies such as India, AMET, Asia Pacific, Americas and Europe

Chart 2: Diversified customer base across MNCs, regional and local customers



Source: Company, Edelweiss research

Diversified consumer user industries: GSL's products find application in a host of consumer-centric personal & home care products including shampoos, conditioners, body wash formulations, soap bars, liquid soaps, toothpastes, laundry detergents and dishwashing products. The company understands consumers' preferences along with ability to deliver integrated solutions for the HPC value chain equip GSL to adapt to changing customer needs quickly and efficiently.

Diversified geographical footprint: GSL has presence in over 75 countries and caters to FMCG companies across major geographies such as India, AMET, Asia Pacific (APAC), Americas (North & South) and Europe. The company's global network of manufacturing, sales and representative facilities cuts dependence on any single product or geography.

Charts 3: 65% of revenue from exports

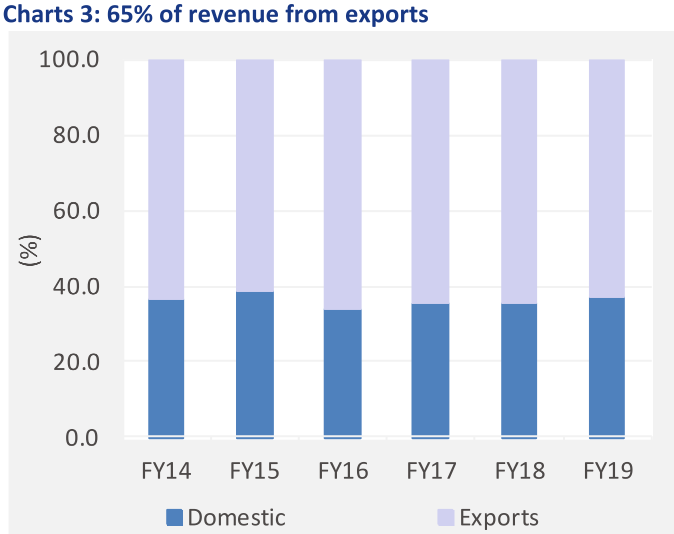
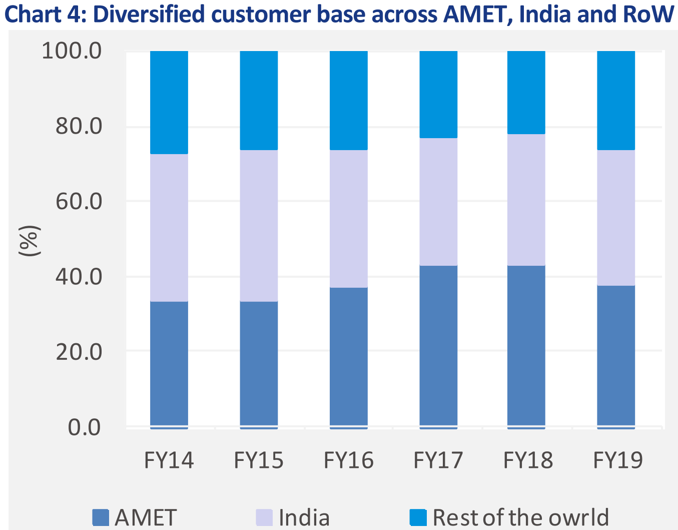


Chart 4: Diversified customer base across AMET, India and RoW



Source: Company, Edelweiss research

Table 1: Healthy growth across different geographies

Region#	2015 (In USD bn)	2018 (In USD bn)	2024 (In USD bn)	CAGR (%)
Western Europe	53.8	61.7	80.9	4.6
North America	59.2	68.5	91.3	4.9
Japan	22.6	25.9	33.7	4.5
Asia Pacific*	56.0	70.1	109.4	7.7
Rest of the World	23.7	28.8	42.2	6.6
Total	**215.3**	**254.9**	**357.5**	**5.8**

*Note: *excluding Japan; Source: ("Global Surfactant Market – Custom Research for Galaxy Surfactants Limited" by Acmite Market Intelligence)*

Its products find application in the entire spectrum of 'mass', 'mass-tige' and 'prestige' socio-economic segments

Diversified price points: The company's products find applications in products designed for end-users in the entire spectrum of 'mass', 'mass-tige' and 'prestige' socio-economic segments. Further, its products cater to basic needs such as personal hygiene and sanitation wherein relatively inelastic demand from customers' end products helps ensure demand for products manufactured by GSL. It also bolsters the company's ability to withstand economic downturns that could affect specific geographies.

Table 2: Key strengths

Areas	Description
Manufacturing units	Global network of manufacturing, sales and representative facilities helps prune dependence on any single product or geography Seven) strategically-located manufacturing facilities, of which five are located in India and two are located overseas Of five manufacturing facilities in India, three are located at Tarapur, Maharashtra, one is located at Taloja, Maharashtra, and one is located at Jhagadia, Gujarat
Research & Development	In house R&D team of 63 professionals comprising doctorates, chemists and engineers Well-equipped R&D centre, pilot plant at Tarapur, Maharashtra; product applications centre for proteins at Denville, USA
Customers	More than 1,750 customers in over 75 countries GSL enjoys relationships in excess of 10 years with each of its top 5 customers
Management	First generation technocrats with proven track record High quality workforce led by a team which is a powerful blend of technological and operational expertise, management and vision
Scale	Amongst leading surfactant producers for home and personal care with 60% market share in India Strong presence globally with 70-80% market share in Egypt and 35-40% market share in Africa Leading producer of preservatives with ~17% market share Amongst the largest producers of Alkyl Sulphates
Strong product pipeline	GSL has been granted 56 patents since 2002 Currently, 12 patents in USA, and 8 patents in India and 9 patents in RoW are being maintained by GSL The company has applied for an aggregate of 31 patents (16 in India, 5 in the USA and 10 in RoW)
Approvals	Global certifications, environment approvals in place

Source: Company, Edelweiss research

Maintaining dominant position in India and AMET region

We expect GSL's revenue growth momentum to sustain and the company to maintain its dominant market share in India led by focus on the surfactants business—competitors have diversified businesses with surfactants contributing minuscule portion to overall revenue and profitability. Moreover, strong presence in fast-growing markets like India (37% of revenue) & AMET (31%), established customer relationships and robust product portfolio will help the company surpass industry growth.

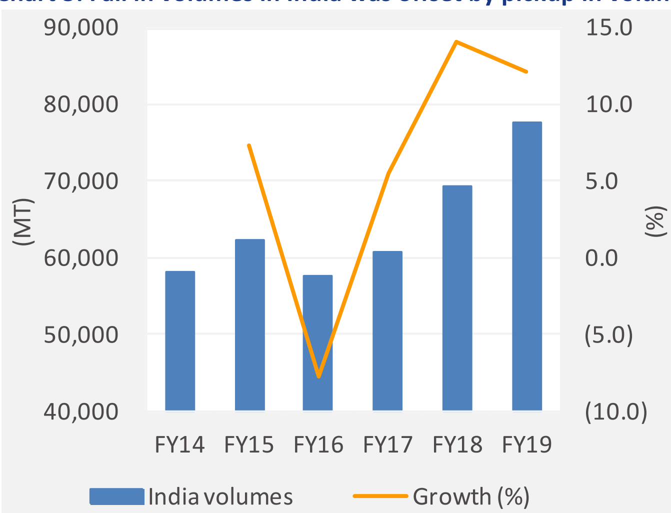
With BASF's entry in 2014, GSL's market share dipped from 70-80% to 60% currently

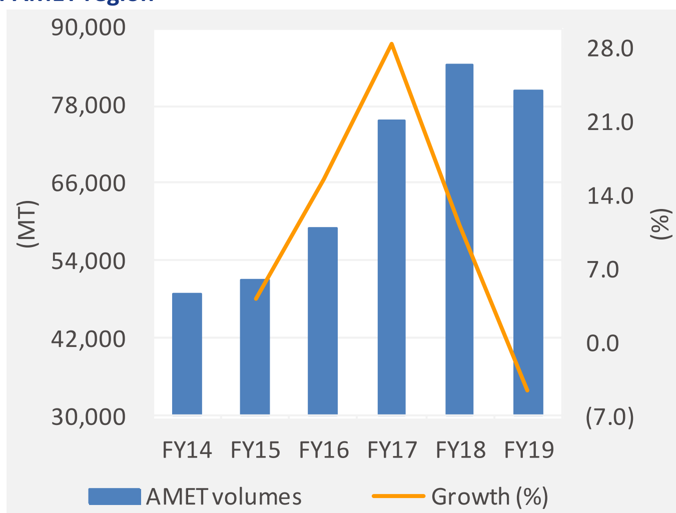
FY14-16 growth impacted by BASF's Dahej plant

BASF commissioned its first 100,000 mtpa sulphonation plant at Dahej in October 2014. This huge capacity enabled the company to aggressively wrest share in India—GSL's market share has dipped to 60% currently from 70-80% earlier. Hence, GSL's India volumes were stagnant over FY14-16.

However, the AMET region's 10% CAGR (with stabilisation of Egypt operations) offset the volume dip in India, helping GSL clock overall 4% volume CAGR over FY14-16.

Chart 5: Fall in volumes in India was offset by pickup in volumes of AMET region





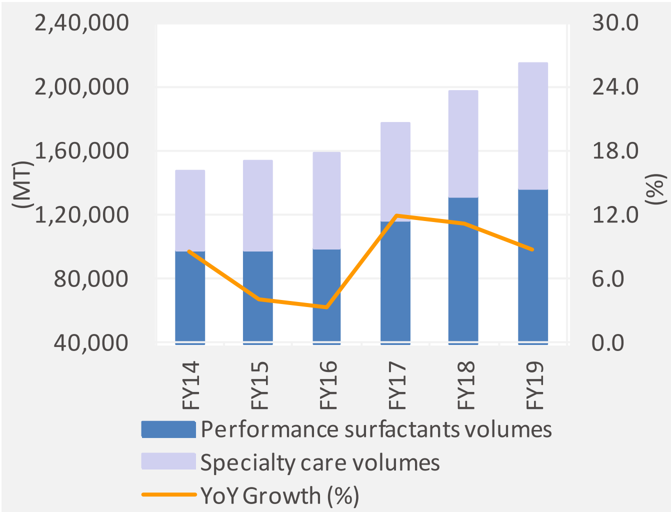
Source: Company, Edelweiss research

GSL's India volumes gradually recovered—13% CAGR over FY17-19, reflecting market share gains

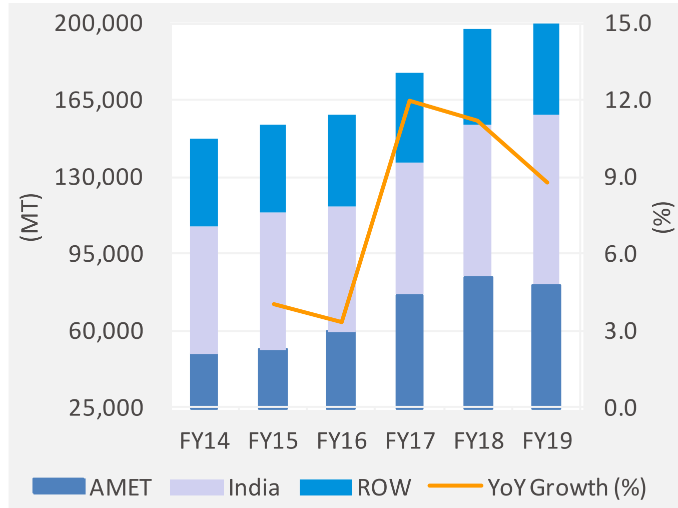
Growth back on track from FY17

Although due to some technical issues at the Dahej plant, BASF was unable to sabilise its production in initial years; according to the management the plant has now stabilised. Nevertheless, even GSL's India volumes have gradually recovered—up 13% CAGR over FY17-19 which led to overall volume CAGR of 10% over FY17-19, reflecting market share gains by GSL.

Charts 6: Recovery in volume growth since FY17



Charts 7: Volumes on the rise

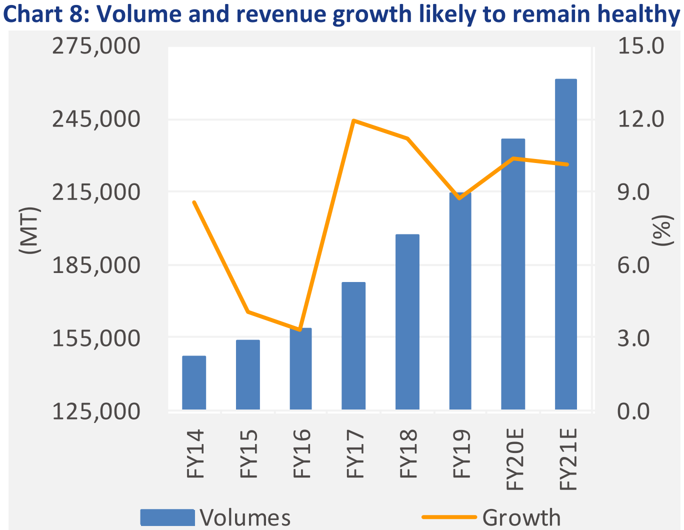


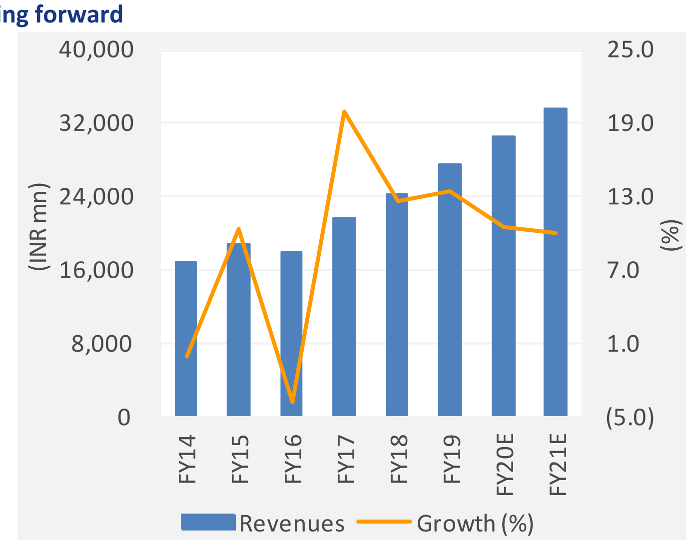
Source: Company, Edelweiss research

Market share gains likely to sustain

We expect the FY17-19 revenue growth momentum to sustain and GSL to maintain its dominant market share in India. This is because the company is well placed compared to competitors in terms of focus on its surfactants business—competitors have diversified businesses with surfactants contributing a minuscule portion to overall revenue and profitability.

Chart 8: Volume and revenue growth likely to remain healthy going forward





Source: Company, Edelweiss research

With manufacturing base in Egypt, GSL has a strong market share of 75-80%

AMET: Robust opportunities

GSL has a manufacturing base in Egypt, wherein the company has 75-80% market share. It largely manufactures performance surfactants at this facility and thus benefits from healthy demand in the AMET region. Its plant is located in Suez, close to the port, helping the company export to 40 plus countries. GSL also exports to Africa where most of the demand is met via imports and thus enjoys 35-40% market share. Its closest competitor BASF also

After clocking healthy 15% CAGR over FY14-18, GSL's AMET volumes fell by 5% in FY19 due to significant slowdown in Egypt

has a manufacturing base in Turkey. However, proximity to port lends GSL a strong competitive advantage.

Egypt slow, but green shoots in rest of AMET

GSL's AMET volumes had posted 15% CAGR over FY14-18. However, in FY19, volumes fell 5% YoY due to significant slowdown in Egypt. Two major reasons for the slowdown in Egypt are:

- Broad-based slowdown in end-user demand.
- Down trading by consumers wherein local players gained at the expense of MNCs.

Although demand from rest of the AMET region has started to perk up from Q3FY19, Egypt continues to remain tepid. Demand recovery in the former can be attributed to new customer acquisitions by GSL, consolidation and market share gains in existing geographies and better performance of new locations.

Multiple growth drivers in place

GSL's end-user industries include personal & home care segments which are growing at a fast clip. The company is planning to leverage its existing relationships in specialty care products to exploit cross sell opportunities. Further, capacity expansion at minimal cost and rising operating leverage are expected to propel growth.

Revenue to register 10% CAGR over FY19-21E led by volume spurt as all the growth drivers are in place

GSL's revenue has posted 10% CAGR over FY14-19 led by 8% volume spurt. The company's volume and revenue are expected to increase by 10% CAGR each, over FY19-21E led by:

- **Strong growth in end-user industries:** GSL's end-user industries primarily includes personal & home care segments, wherein we expect buoyant growth to sustain. The company's ability to supply a bouquet of products and regular launch of products are expected to keep growth momentum intact.

Table 3: Healthy growth in home and personal care industry in India and globally

	India					*Global*				
Sales*	**% share**	**2015 (USD bn)**	**2018 (USD bn)**	**2024 (USD bn)**	**CAGR (%)**	**% share**	**2015 (USD bn)**	**2018 (USD bn)**	**2024 (USD bn)**	**CAGR (%)**
Household Cleaning	30.4	0.4	0.5	0.7	**5.1**	34.0	10.7	11.9	14.5	**3.4**
I & I Cleaning	8.1	0.1	0.1	0.2	**5.4**	6.4	2.0	2.2	2.7	**3.6**
Personal Care	18.6	0.2	0.3	0.5	**7.6**	20.9	6.1	7.3	10.3	**5.9**
Industrial Application	33.5	0.5	0.5	0.8	**6.2**	32.2	9.8	11.2	14.7	**4.6**
Others	9.3	0.1	0.2	0.2	**5.8**	6.5	2.0	2.3	3.0	**4.5**
Total		**1.4**	**1.6**	**2.3**	**6.0**		**30.7**	**34.9**	**45.2**	**4.4**
Home & Personal care	**49.1**	**0.7**	**0.8**	**1.1**	**6.0**	**54.9**	**16.9**	**19.2**	**24.8**	**4.4**

*Note: *Figures as in 2015; Source: "Global Surfactant Market – 4th Edition" by Acmite Market Intelligence)*

Source: Industry, Edelweiss research

- **Strong growth in existing markets:** GSL has presence across emerging as well as matured markets. The company's strong manufacturing capability, established customer relationships and robust product portfolio position it to exploit opportunities in the personal & home care segments in high growth India and AMET regions.

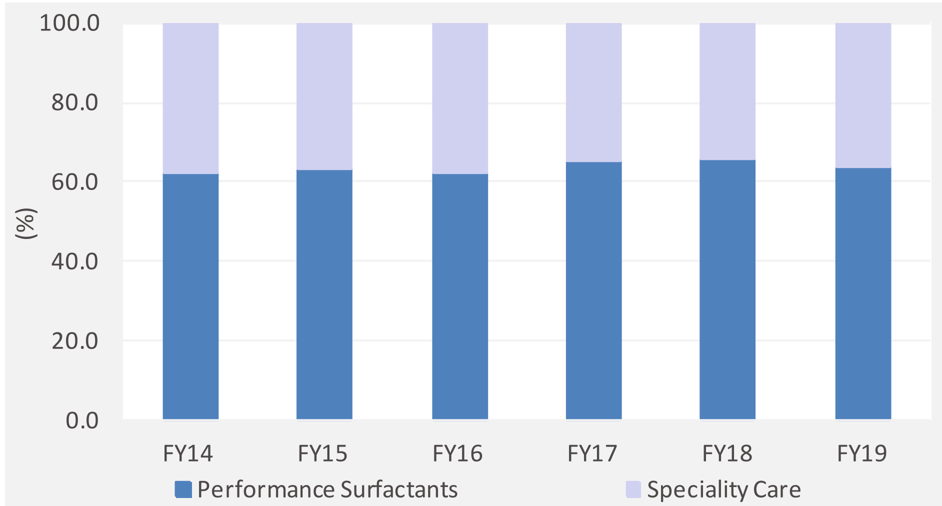
- **Leveraging existing customer base to expand product basket:** GSL has established long-standing relationships with customers via various strategic endeavours, which it intends to leverage by capitalising on the significant cross-selling opportunities that its diversified product portfolio offers.

The company's customer base has increased from over 1,200 in FY13 to 1,750 plus in FY19, a CAGR of 6.5%

- **Expanding customer base with new client additions across geographies:** The company's customer base has increased from over 1,200 in FY13 to 1,750 plus in FY19, a CAGR of 6.5%. It has sales offices in India, Egypt & US, and representative offices in the Netherlands and Turkey. Going forward, the company intends to leverage its sales & marketing network, diversified product portfolio and industry standing to establish and expand its customer base. The company is constantly adding customers across geographies. In FY19, GSL added 30 customers and expanded reach to 10-12 countries.

- **Growing specialty care products along with performance care products:** GSL's specialty care products have historically clocked higher margins vis-à-vis performance surfactants. Although the market for specialty care products has historically been higher in mature markets, demand for these products is growing at a robust pace in emerging markets as well. This benefits an established player like GSL, which is currently catering to this market armed with a wide range of performance surfactants and specialty care products. Thus, the company will continue to grow its specialty care products in mature markets by monitoring evolving consumer preferences and undertaking product innovations.

Chart 9: Share of specialty care products stood at 37% FY19

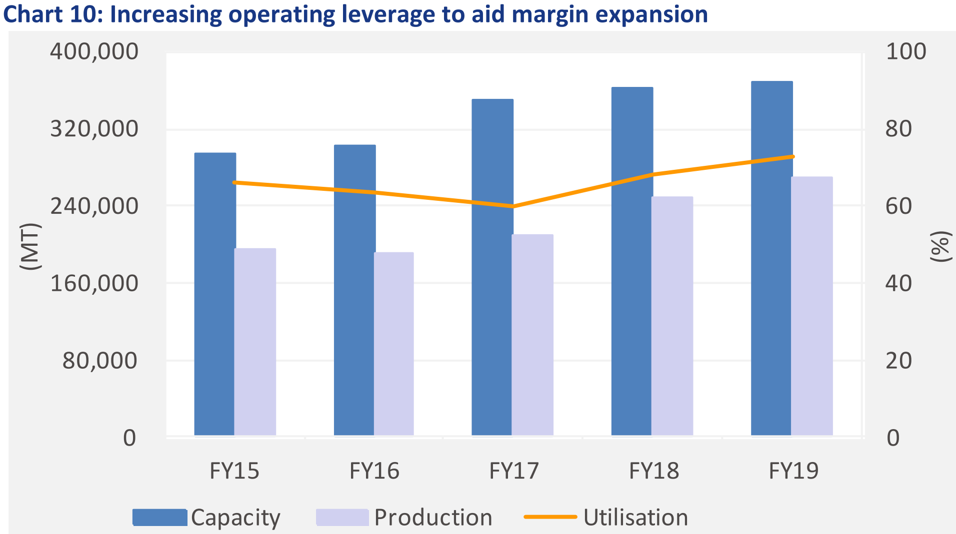


Source: Company, Edelweiss research

In FY19, GSL's capacity utilisation stood at 73% providing strong opportunity for operating leverage

- **Strong operating leverage in place:** The company enjoys significant operating leverage as it expands capacity keeping an eye on the medium- to long-term view on demand and market dynamics. In FY19, GSL's capacity utilisation stood at 73%.

Chart 10: Increasing operating leverage to aid margin expansion



Source: Company, Edelweiss research

- **Rising market share in developed markets:** GSL's growth in mature markets like US and Europe will be driven by market share gains via offering a wide range of specialty care products. The company intends to capitalise on the significant investments made to enhance its manufacturing capability and portfolio of specialty care products to cater to demands of these mature markets.

Brownfield expansion at minimal cost provides significant headroom for future growth

- **Future capacity expansion at minimal cost:** As on 31st March 2019, the company's aggregate installed capacity stood at 368,095MTPA. It can expand capacity in the future at minimal cost via debottlenecking and brown field expansion. GSL has access to additional land at existing manufacturing facilities at Jhagadia (Gujarat) and Suez (Egypt), which provides significant headroom for future growth. The company recently completed a brown-field expansion at Jhagadia for performance surfactants which was operational from 1st April 2019. The company further plans to incur INR1.0-1.25bn capex in FY20.

Exports contributed ~65% to the company's revenue in FY19

- **Export opportunities encouraging:** In addition to domestic sales, GSL's manufacturing facilities in Suez, Egypt and New Hampshire (US) enable it to cater to international demand. The company has also set up sales offices in India, Egypt and US, and representative offices in the Netherlands and Turkey to enable it to market its products in these regions.

  Exports contributed ~65% to the company's revenue (up from 61% in FY13) in FY19. We believe, with strong positioning and healthy association with various MNCs, its exports business will continue to offer attractive growth opportunities. The company has even set up a representative office in China for direct presence in the burgeoning market.

- **Inorganic growth opportunities:** While GSL's acquisition of Tri-K Industries in US in FY10 significantly enhanced its specialty care products portfolio and technological capabilities, it also extended its reach in a developed market like US. Any such inorganic growth opportunities can significantly help GSL surpass industry growth.

High entry barriers, R&D focus model: Strong MOAT

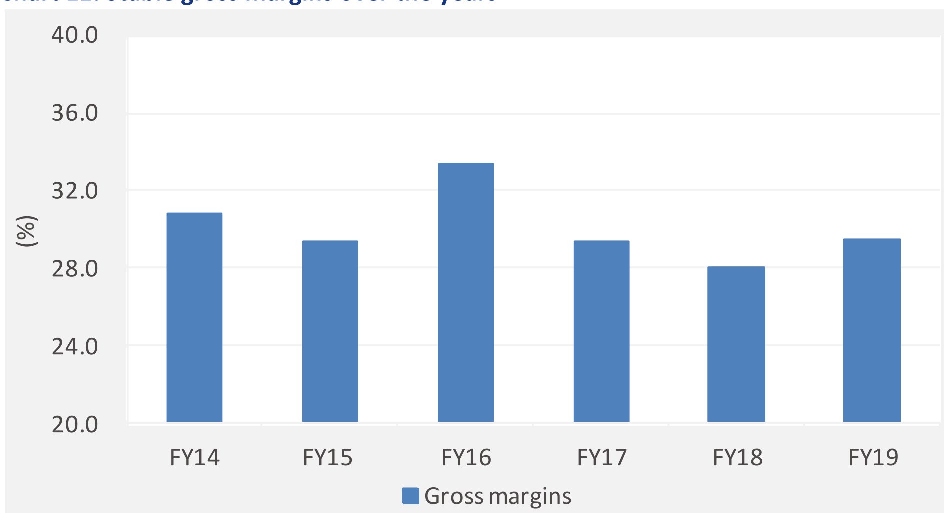
GSL has developed a strong business model with established customer relationships and robust product portfolio that creates strong entry barriers. Moreover, the company has a sticky customer base with raw material cost pass on agreements ensuring stable margins and returns.

Laurly alcohol (fatty alcohol) accounts for 50-55% of GSL's total raw material requirement

Immune to raw material price volatility

Laurly alcohol (fatty alcohol) accounts for 50-55% of GSL's total raw material requirement. Historically, laurly alcohol prices have remained volatile; however, GSL's stable gross margin indicates that the company works on pass through contracts with minimum off take agreements for majority of its customers. Typically, customer contracts are volume contracts with pricing being decided on quarterly basis.

Chart 11: Stable gross margins over the years



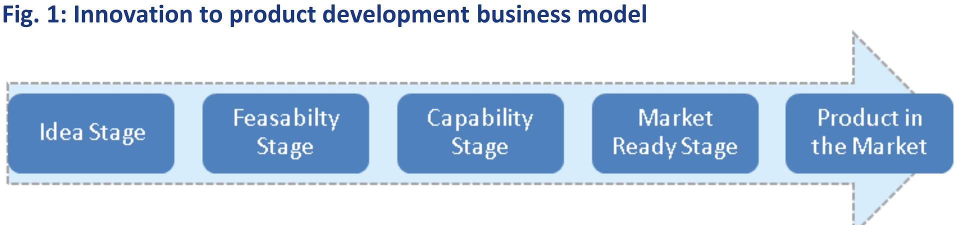
Source: Company, Edelweiss research

Strong innovative pipeline with 60 patents granted since 2002; it has already applied for 26 new patents

Proven R&D capabilities with unwavering focus on innovation

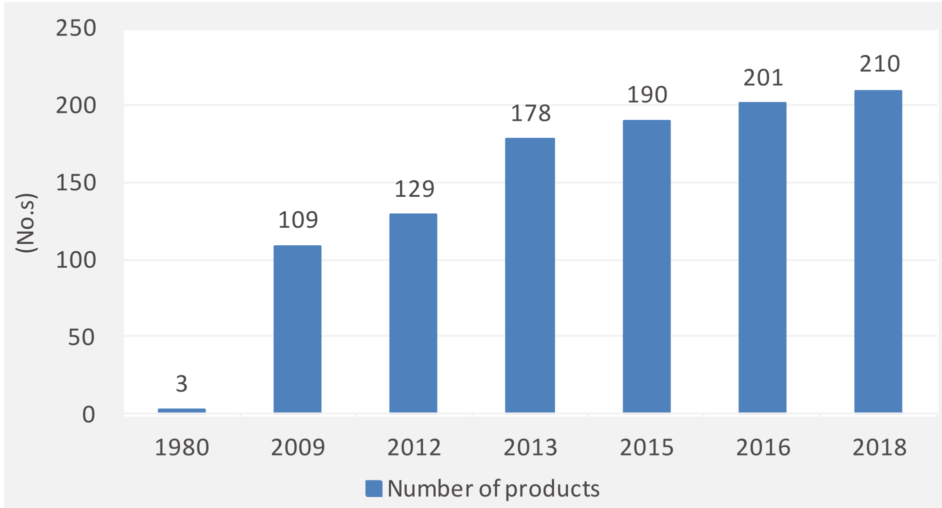
GSL's focus on R&D has been a significant growth catalyst. The company has adopted an innovation funnel model for product development. This enables it to customise products in line with expectations and preferences of customers, whilst ensuring shorter lead times and higher margins. This has also led to strong innovative pipeline with 60 patents granted since 2002; it has already applied for 26 new patents. The company, via its consumer–to-chemistry strategy, is planning to develop products focusing on mild surfactants, UV filters, non-toxic preservative blends, syndet TBB and proteins.

Fig. 1: Innovation to product development business model



Source: Industry, Edelweiss research

Chart 12: Number of products over the years



Source: Company, Edelweiss research

Table 4: Galaxy's innovation

Product	Galaxy's Success
Green Catalyst for Amino Acid Surfactants	GSL's R&D at Galaxy used their mastery in Chemistry and came with a breakthrough in Fatty Acid Chloride manufacturing by use of the finished product itself as catalyst. This "Green Chemistry Process" of manufacturing Fatty Acid Chloride has challenged the Amino Acid Industry globally and has won Galaxy global patent for this marvel
Galaxy Syndet Noodles	Galaxy's Syndet Noodles are helping several manufacturers in India and in the International market, to create premium Bathing Bars without spending much time on product development. GSL's varied offerings with differentiated benefits help them to launch innovative Syndets with specific benefits.
GalSoft GLI-21	GLI 21 provides high foam volume and quality due a synergistic combination of Acyl Isethionate and Acyl Glutamate which cannot be achieved through physical blending of these products. The unique patented manufacturing process of making both the Acyl Isethionate & Acyl Glutamate together is an art
Galguard Trident	GSL's innovative trick apart from selection of the molecules was in the way the company arranged them as a "Micro Emulsion" so that Phenoxyethanol, Capryloyl Glycine and Undecylenoyl Glycine coexist in a stable and happy housing without coming in to contact with each other in its offering. That's the innovation and hence a global patent
Transparent Bathing Bar (TBB)	The R&D Team at Galaxy, through their brilliant "Disruptive Innovation" in 2001 came up with "TBB Flakes" (Transparent Bathing Bar Flakes) and made Transparent Soaps accessible to small manufacturers and thus made Transparent Soap in to a cottage industry item. Thus was born several competitors to Pears through the "Disruptive Innovation" of Galaxy.

Source: Company, Edelweiss research

New project technology group spearheads in-house engineering and project execution capabilities

Strong in-house project execution team ensures cost efficiency

GSL has set up a New Projects Technologies (NPT) group, which spearheads in-house engineering and project execution capabilities. The in-house team has executed various projects cost-efficiently and timely. Going forward as well, the company will continue to rely on the NPT group's in-house expertise to periodically review existing manufacturing facilities, identify scope for expansion or de-bottlenecking and undertake projects to enhance production capabilities.

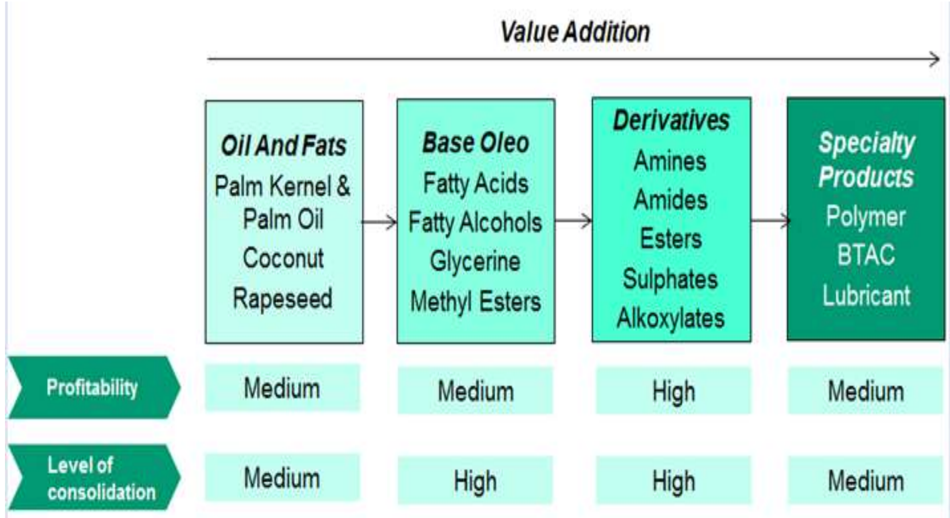
Offering customised and integrated solutions to end users

GSL consistently monitors, analyses and adapts to changing consumer preferences across diverse geographies. The company helps its customers address evolving market demands by undertaking collaborative product development. This enables it to offer customised and integrated solutions that cater to the unique demands of a diversified customer base.

Presence in most profitable oleo-chemicals value chain

According to a Tata Strategic Management Group study, the oleo-chemicals derivatives chain is the most profitable segment in the entire oleo-chemicals value chain. Further, as per the study, the level of consolidation is also high in this segment keeping competitive intensity low. GSL operates in the oleo-chemicals derivatives chain and has thus clocked stable margin over the years.

Fig. 2: GSL's presence in the most profitable oleo-chemicals value chain



Source: Tata Strategic database, FICCI, Edelweiss research

Sticky customer base cuts volatile earnings risk, ensures stable margin

GSL is a manufacturer and supplier of key chemical intermediate products that find usage as inputs for further processing. Lifecycle of its customers is linked to that of customers' product, which may be several years or even decades in case of some products. The business model involves working closely with customers in innovating and developing technologies that can be applied effectively to enhance operational efficiency and performance of the customer's end products.

Technical & specialised nature of the business, sustained R&D, meeting pre-qualification, stringent quality benchmarks and certification serve as entry barriers to new players

Thus, the technical & specialised nature of the business, sustained R&D, meeting pre-qualification, stringent quality benchmarks and certification serve as entry barriers to new players in the market. Product approval in case of certain products can be less than a year, in certain cases one-two years and even more for certain products. As a result, customers are particularly sticky.

Beneficiary of shift to oleochemicals and premiumisation

GSL is garnering benefits of rising usage of oleo-chemicals surfactants in the home & personal care industry, which accounts for ~70% of the company's product portfolio. Further, high growth in under-penetrated premium category products and rising usage of performance surfactants in premium applications are potent growth catalysts.

Use of oleochemicals in surfactants industry is rising led by higher advantages offered by natural oil- and fat-based products compared to petrochemical-based products

Rising use of oleochemicals surfactants in home & personal care industry

Over the past few years, the use of oleochemicals in the surfactants industry has been rising led by higher advantages offered by natural oil- and fat-based products compared to petrochemical-based products. Further, usage of oleo-surfactants is higher in low penetrated mid- to high-end home and personal care products which are wresting market share from conventional products. This can also be seen from slowing demand for LAB—raw material for LABSA, petrochemical-based surfactants.

Table 5: – Globally new product category share much larger than in India

New product categories	Old product categories	New product category consumption as a % of old product category consumption: Global	Indian
Body washes and shower gels	Bar soaps	82%	1%
Liquid soaps	Bar soaps	33%	3%
Styling agents	Shampoos	33%	8%
Fabric softners	Bar and hand wash detergents	110%	1%
Automatic detergents	Bar and hand wash detergents	478%	24%
Face wash	Bar soaps	111%	12%

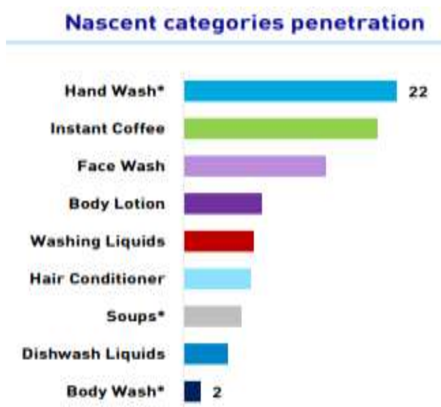


Table 6: Low per capita FMCG consumption in India ensures strong growth potential

Country	Per Capita Consumption (USD)
India	**29**
India Urban	**64**
India Rural	**14**
Indonesia	56
China	117
Philippines	156
Thailand	367

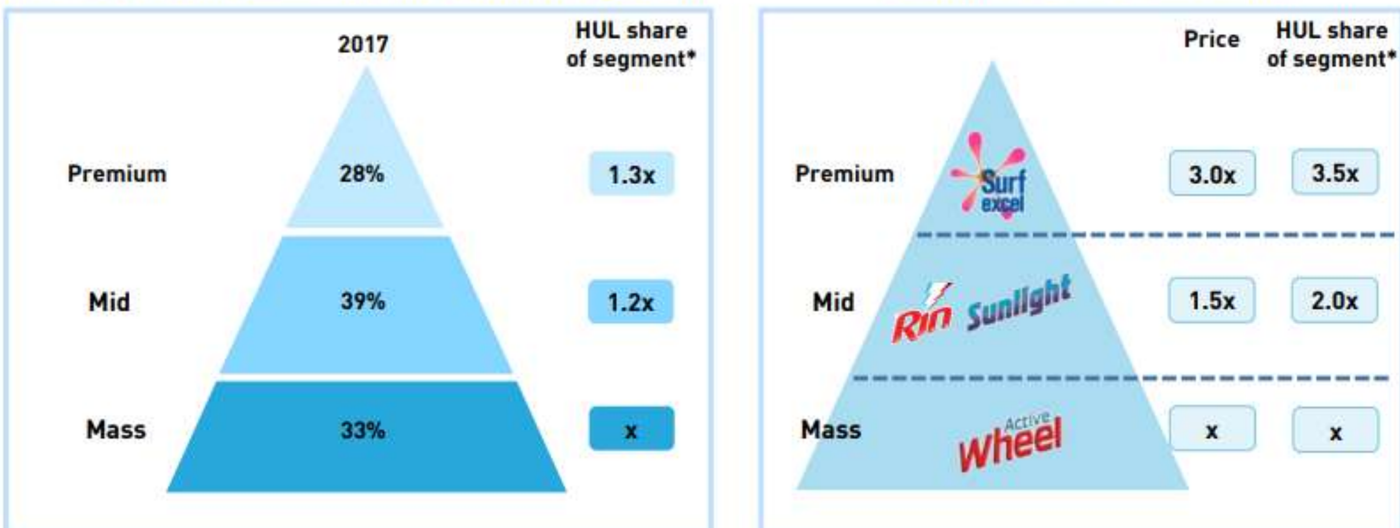
*Source: HUL, Source: HUL, *Source: Nielsen MAT Sep'18 (Urban + Rural Industry), Edelweiss research*

Rising usage of performance surfactants in premium applications

Use of performance surfactant like SLS is on the rise in applications like oral care and premium laundry care. Thus, with rising premiumisation of end user products, usage of performance surfactants is also likely to go up.

Fig. 3: Rising premiumisation to drive growth for oleochemical derivatives

Fig. 4: Market growing faster in the premium segment like fabric solutions



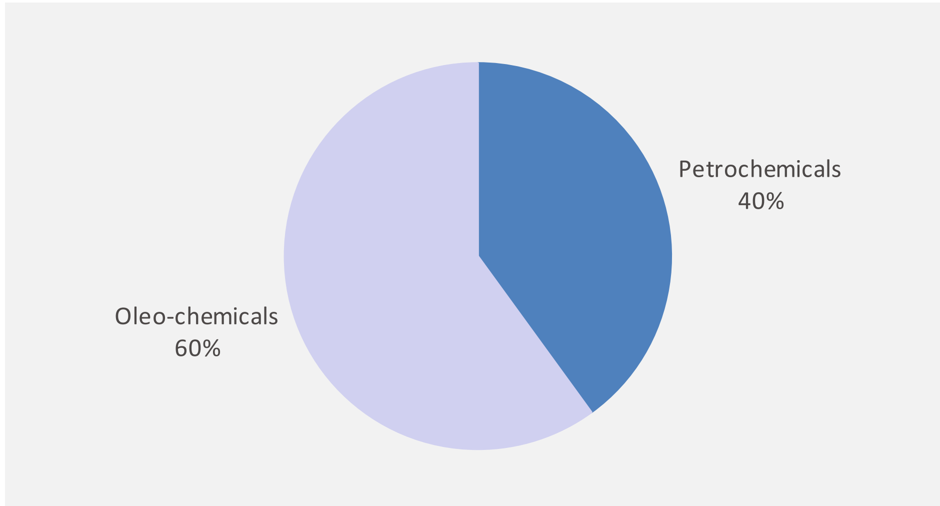
*Source: HUL, *Source: Nielsen MAT Sep'18 (Urban + Rural), Edelweiss research*

As per CRISIL Research, the global LAB industry has grown at a steady ~3% over the past five years

Demand for LAB slowing in developed countries

As per CRISIL Research, the global LAB industry has grown at a steady ~3% over the past five years led by strong demand from Asia-Pacific region. Global demand for LAB was estimated at 3.6mt in 2017, up from 3.1mt in 2012. However, growth saturated in developed markets of Europe and US—mere ~1% over 2012-17. Majority of the detergent sales in these countries are in premium categories which can be seen from the fact that 60% of US surfactants' sales are based on oleo chemicals. With rising demand for environment-friendly products, natural surfactants products are easily accepted in the market. Hence, we believe, growth in oleochemicals surfactants will drive faster growth of GSL.

Chart 13: 60% of US surfactants sales are based on oleo chemicals



Source: Industry, Edelweiss research

GSL expected to benefit from shift

GSL manufactures oleochemicals-based surfactants (~70% of product portfolio) and is hence will be beneficiary of this shift from petrochemicals to oleochemicals and high growth in under-penetrated premium category products. Thus, the company's volume growth is likely to be stronger than the industry average.

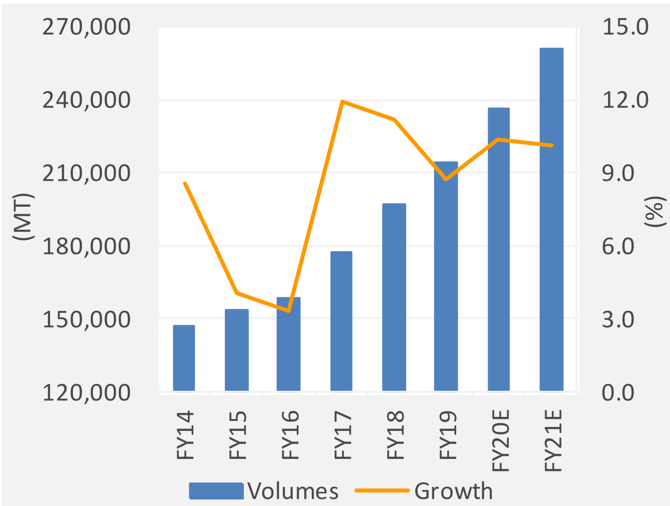
Over FY14-19, GSL reported 10% revenue CAGR led by 8% increase in volumes

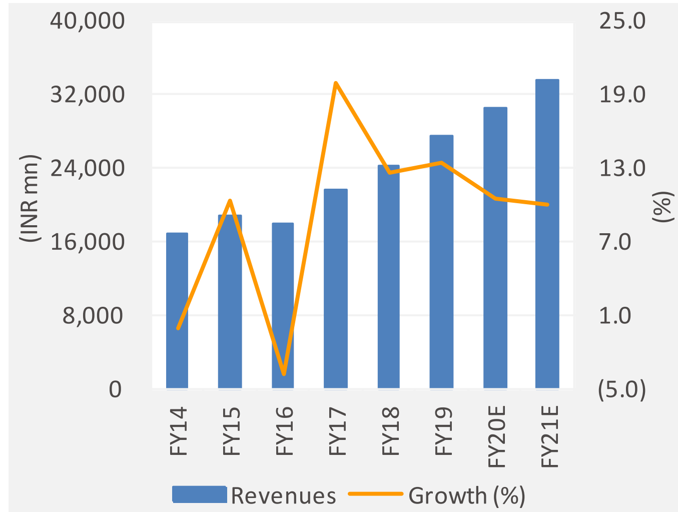
Financial Outlook

Robust performance and specialty chemicals to boost volume surge

Over FY14-19, GSL reported 10% revenue CAGR to INR27.6bn. Price volatility, primarily due to input cost fluctuation, impacted the company's revenue growth. However, the more important factor in the company's context is volume-led growth, which has clocked 8% CAGR over the same period. We expect volume to post 10% CAGR over FY19-21E driven by spurt in performance and specialty chemicals.

Chart 14: Volume and revenue growth likely to remain healthy going forward



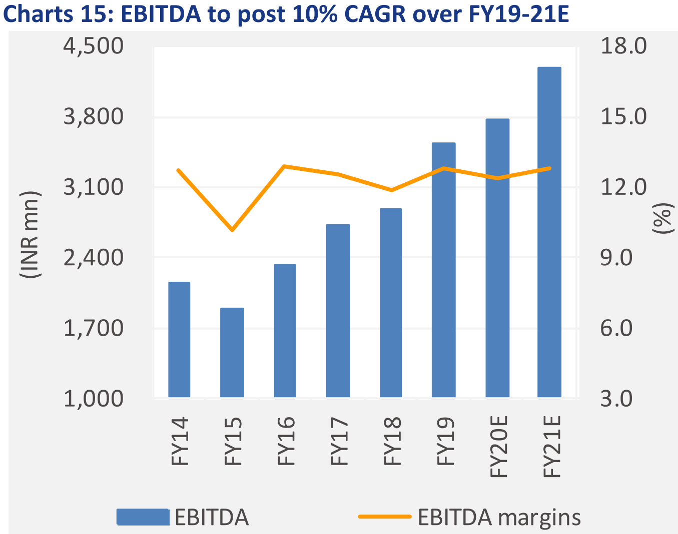


EBITDA/PAT to register 10%/13% CAGR over FY19-21E

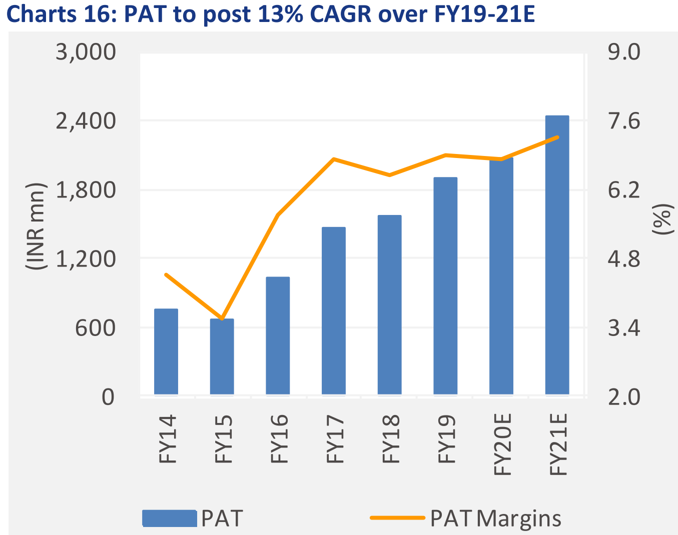
Operating leverage to drive 13% PAT CAGR

We estimate GSL's EBITDA to post 10% CAGR over FY19-21 similar to revenue growth over the same period. The EBITDA growth will also be driven by rising share of high margin specialty products—share in total revenue to jump to 39% in FY21E from 37% in FY19. Further, PAT growth is likely to be higher at 13% CAGR over the same period.

Charts 15: EBITDA to post 10% CAGR over FY19-21E



Charts 16: PAT to post 13% CAGR over FY19-21E



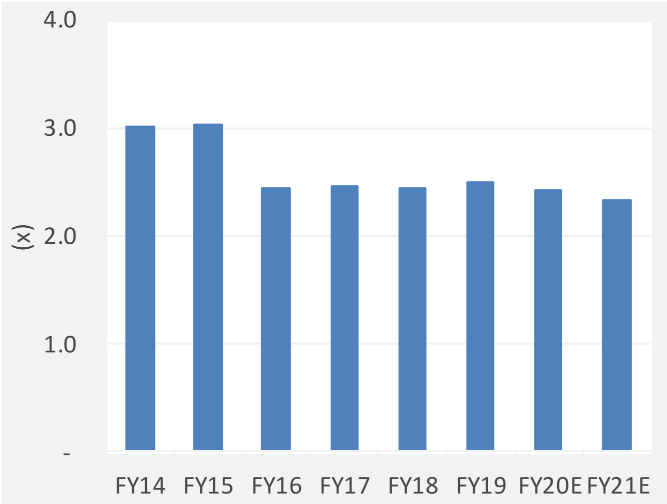
Source: Company, Edelweiss research

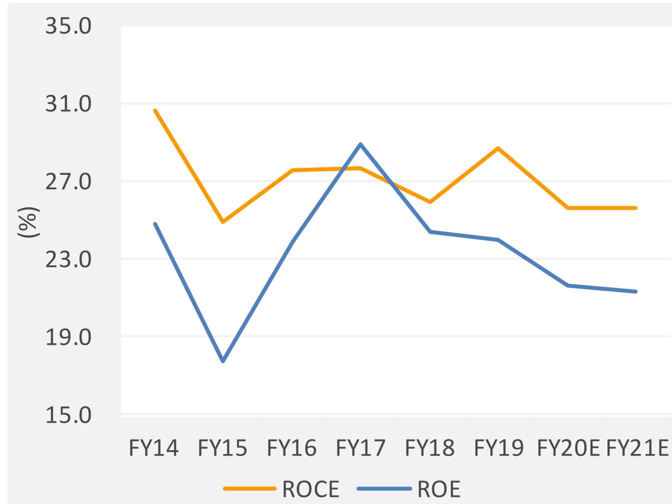
With sustained strong asset turns of ~2.5x, the company's ROCE is likely to remain healthy at 26-28%

Asset-light business model generating higher returns

GSL's asset-light business model enjoys higher asset turnover of ~2.5x, which results in strong return ratios. Going ahead, with sustained strong asset turns of ~2.5x, the company's ROCE is likely to remain healthy at 26-28%.

Chart 17: Higher asset turns drives strong returns





Source: Company, Edelweiss research

Valuation

- **GSL is estimated to clock EPS CAGR of 13% over FY19-21E driven by strong growth in end-user industry, new client additions across geographies and burgeoning share of high margin specialty care products.**
- **A robust business model bolstered by high entry barriers, customer stickiness and healthy margin has ensured consistency in return ratios over the past five years—RoE has averaged 23.9%.**
- **GSL deserves premium valuations vis-à-vis peers as it manufactures oleo chemicals surfactants (enjoy valuation premium globally) and as its growth is linked with FMCG industry ensuring stable growth and returns.**
- **Factoring the same, we initiate with 'BUY' and September 2020 target price of INR1,405 (22x P/E).**

Initiate with 'BUY' as valuations do not factor solid business model

We initiate coverage on GSL with 'BUY' recommendation and September 2020E target price of INR1,405 (22x P/E). We believe, current valuations are ignoring the company's stable and steady growth profile with high return ratios (ROCE >25%). Our competency framework indicates clear value in the stock given strong entry barriers and product customisation. GSL's clean portfolio based on oleochemical based derivative is likely to enjoy premium valuations. We estimate the company to post 13% EPS CAGR over FY19-21.

Steady growth and stable returns business demands premium valuation

GSL's customers operate within the consumer-centric personal & home care segments where a number of its products enjoy a strong position in the ingredients value chain. Accordingly, it benefits from high growth in the FMCG industry, which is largely unaffected by economy cycles. We like GSL because of its leading position in home & personal care ingredients market and its strong business model that is bolstered by high entry barriers, high level of customer stickiness, robust margin, healthy return ratios and high process & knowledge-dependency.

We believe, akin to global players in the surfactants market, GSL should also enjoy premium valuation over other specialty chemicals players. Further, the company operates in the oleochemicals market which is growing at a rapid pace by replacing potentially harmful petrochemicals with natural surfactants.

The company clocked 10% revenue CAGR over FY14-19 with 11-13% EBITDA margin; RoCE and RoE averaged a robust 27.6% and 23.9%, respectively, during the period. We estimate the company to report revenue and PAT CAGR of 10% and 13% over FY19-21, respectively. A commendable factor has been the consistency in return ratios over the past five years—RoE has averaged 23.9%.

Table 7: Peer comparison - Valuation snapshot

Company Name	M Cap	FY19-21E Sales CAGR	FY19-21E PAT CAGR	FY19 EBITDA margin	P/E (x)			EV/EBITDA (x)			Post Tax
	(USD bn)	(%)	(%)	(%)	FY19	FY20E	FY21E	FY19	FY20E	FY21E	RoCE-FY19
Valuations of surfactants players											
BASF	64.2	3.7	11.0	14.9	13.3	11.8	10.8	8.3	7.8	7.1	8.6
Clariant	6.5	4.3	17.9	12.2	17.0	13.6	12.2	9.9	7.5	6.7	8.2
Kao	38.2	3.7	5.8	18.0	26.4	25.2	23.6	15.5	14.4	13.5	20.0
Galaxy	0.6	12.0	15.4	12.8	22.3	19.6	16.7	12.7	11.4	10.0	19.4
Kuala Lumpur Kepong	6.3	4.5	11.6	9.7	32.5	29.6	26.1	16.7	15.2	14.1	6.3
Saudi Kayan	5.0	-2.4	-20.2	39.2	12.9	24.3	20.2	7.9	9.4	9.2	6.4
Average		**4.3**	**6.9**	**17.8**	**20.7**	**20.7**	**18.3**	**11.8**	**10.9**	**10.1**	**11.5**
Median		**4.0**	**11.3**	**13.8**	**19.6**	**22.0**	**18.5**	**11.3**	**10.4**	**9.6**	**8.4**
Valuations of other Indian specialty chemical players											
Aarti Industries	2.1	16.4	20.8	19.4	29.8	26.1	20.4	16.8	14.7	11.9	16.4
SRF Ltd.	2.5	13.0	23.9	17.6	26.6	21.4	17.3	14.8	12.3	10.5	11.6
Atul Limited	1.7	14.4	16.9	19.0	27.1	23.3	19.8	15.2	13.5	11.5	17.5
PI Industries	2.4	20.0	25.0	20.3	40.1	31.5	25.7	28.2	22.4	18.2	19.5
Vinati Organics	1.6	26.2	19.0	36.4	38.3	32.7	27.1	26.6	21.6	17.7	30.7
Galaxy Surfactants	0.6	12.0	15.4	12.8	22.3	19.6	16.7	12.7	11.4	10.0	19.4
S H Kelkar	0.3	14.4	17.2	12.7	22.5	19.6	16.4	17.4	12.8	10.9	7.1
Navin Fluorine	0.5	13.4	18.9	22.1	24.0	19.8	17.0	15.4	13.0	11.0	15.6
Average		**16.2**	**19.6**	**20.0**	**28.9**	**24.3**	**20.1**	**18.4**	**15.2**	**12.7**	**17.2**
Median		**14.4**	**18.9**	**19.2**	**26.9**	**22.4**	**18.6**	**16.1**	**13.3**	**11.3**	**16.9**

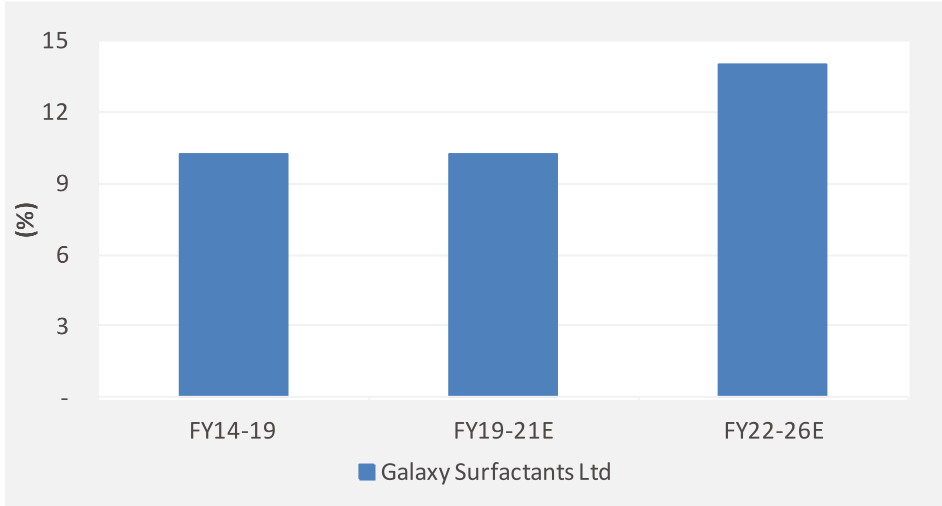
Source: Bloomberg

Our DCF analysis indicates strong upside

For GSL, though we have used P/E based valuation metrics for arriving at target price as it better captures earnings growth momentum, we have also used reverse DCF model to calculate the implied growth built in our target price.

Our reverse DCF model indicates moderate growth of 14% in FY22-26E at our target price of INR1,405. This company has achieved revenue growth of 10% CAGR in FY14-19, we believe GSL's FMCG linked business model and its presence in high growth regions will help it sustain stable growth. We have used 12% WACC and terminal growth of 6%.

Chart 18: DCF – Historical and implied revenue growth rate



Source: Edelweiss research

Chart 19: 1 year forward PE chart

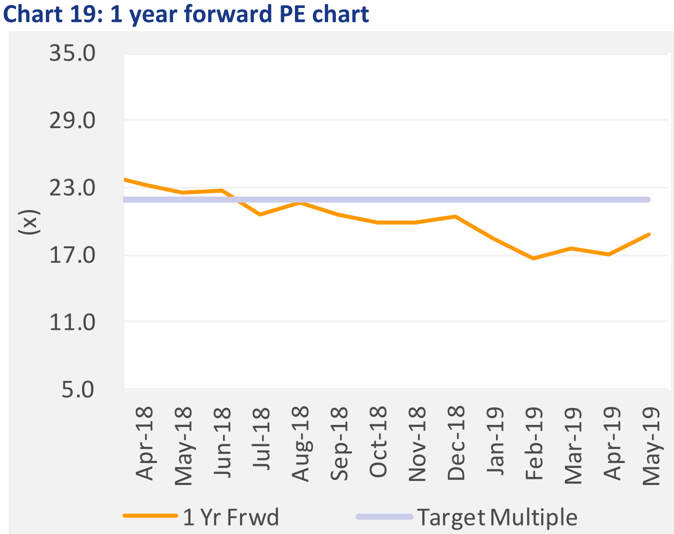
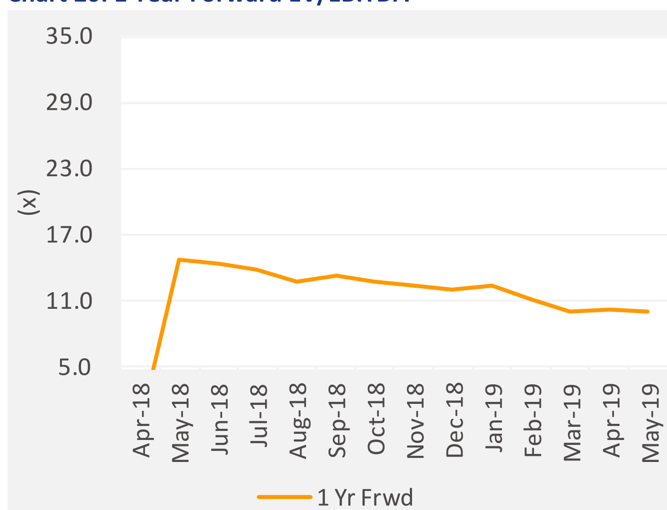


Chart 20: 1 Year Forward EV/EBITDA



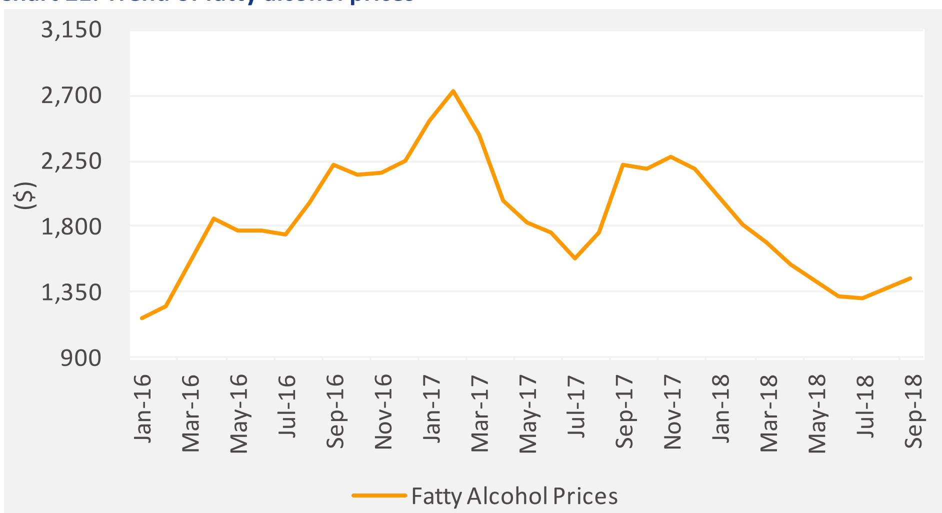
Source: Bloomberg, Edelweiss research

Key Risks

Absence of long-term raw material supply contracts

GSL typically enters in to raw material contracts with two-three suppliers for different time periods or with third party suppliers or buys in the open market. The company's performance products group depends primarily on lauryl alcohol, which is purchased from South East Asia. For its specialty care products group, GSL requires fatty acids, phenols, DMAPA and PAA, which it sources from India, South East Asia, US and Europe. Absence of long-term contracts exposes the company to the risk of availability of raw material, price fluctuations and currency volatility. Hence, increase in cost of or a quality shortfall in raw material could adversely affect the company's business and results of operations.

Chart 21: Trend of fatty alcohol prices



Source: Industry, Edelweiss research

Significant dependence on top customers

The company derived 60%, 54%, 55% and 55% of total revenue in FY15, FY16, FY17 and FY18, respectively, from top 10 customers. Tenure of contracts with pivotal customers varies according to customer and product. Since the company does not have long-term contractual arrangements with most of its significant customers, loss of any of these customers or any adverse impact on business of these customers could adversely impact GSL's revenue.

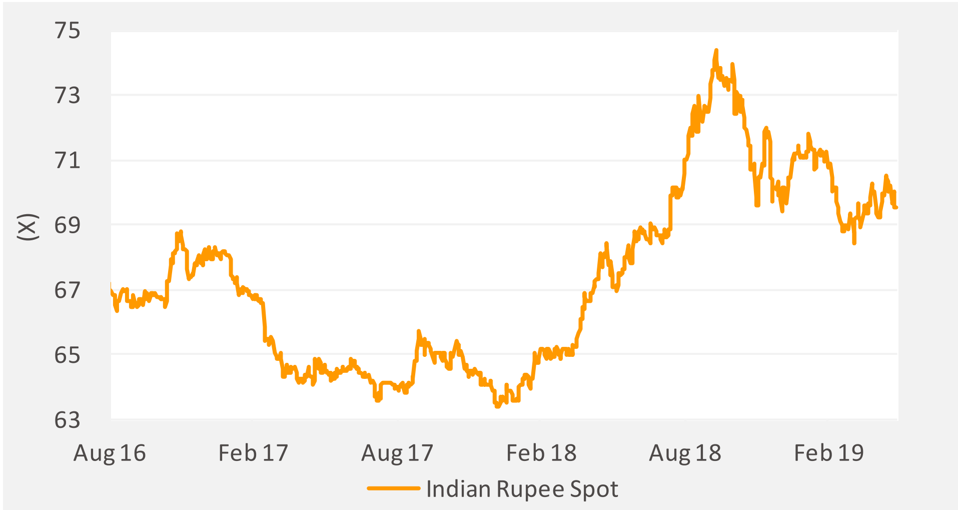
Over dependence on single supplier

GSL and other industry players are significantly dependent on a single supplier for ethylene oxide, which is one of the key raw materials for the company—accounted for 6.8% and 7.3% of aggregate cost of material consumed in FY17 and H1FY18, respectively. Thus, the company's dependence on a single supplier could constrain its ability to negotiate sourcing arrangements. Further, any disruption in supply of the aforesaid raw material could disrupt GSL's manufacturing operations, which may have a material adverse effect on its business, results of operations and financial condition.

Foreign currency fluctuation

GSL imports major raw material like lauryl alcohol from South East Asia. Further, the company also generates significant sales via export and sales outside India. Thus, fluctuations in foreign currency could impact the company's performance—a strong INR will negatively impact GSL's revenue and vice versa.

Chart 22: INR/USD trend



Source: Industry, Edelweiss research

Discontinuation of export promotion scheme

The company currently avails benefits under certain export promotion schemes with respect to a manufacturing facility at Jhagadia (Gujarat), which is an Export Oriented Unit (EOU). As per the same, GSL is required to export goods of a defined amount, failing which, it may have to pay the government a sum equivalent to the duty benefit enjoyed by the company along with interest. Thus, any reduction or withdrawal of benefits or GSL's inability to meet any of the conditions will adversely affect its business, results of operations and financial condition.

Company Description

A leading manufacturer of surfactants

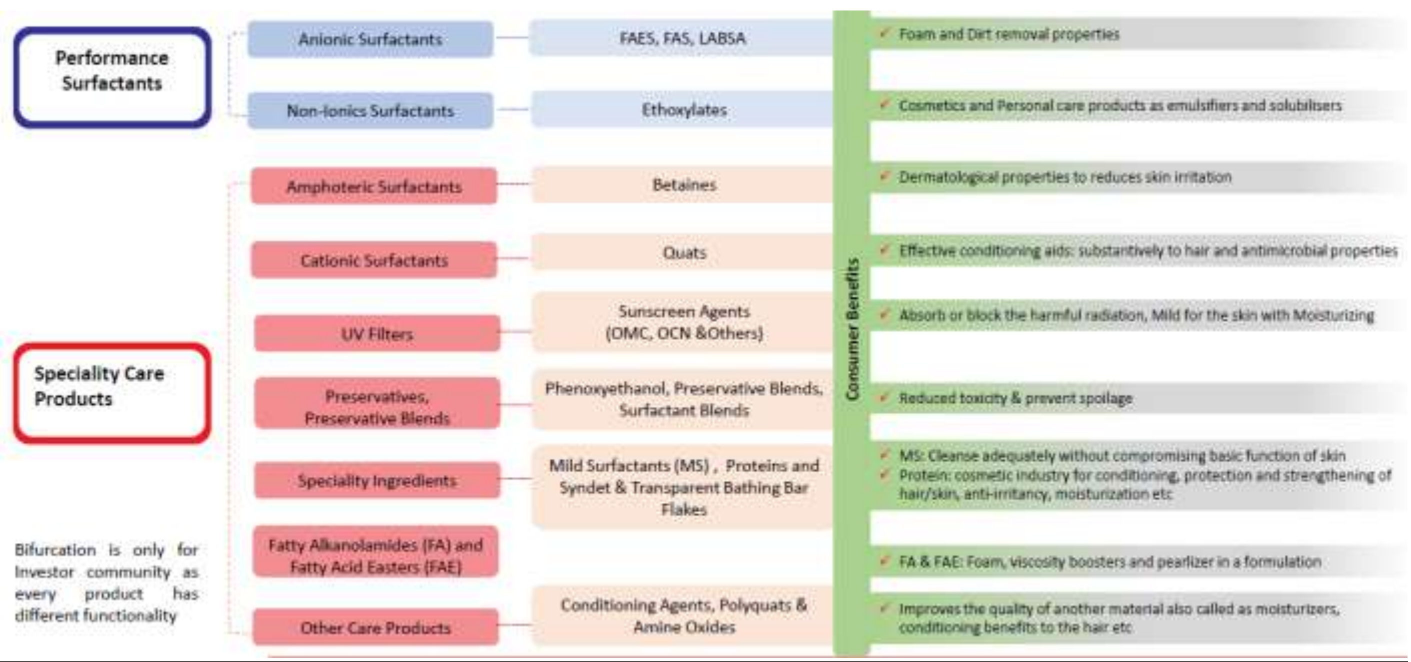
GSL is India's leading manufacturer of surfactants and other specialty ingredients for personal & home care industries. The company's products find application in a host of consumer-centric personal & home care products including skin care, oral care, hair care, cosmetic, toiletries and detergents. Since incorporation in 1986, GSL has expanded and diversified its product portfolio, client base and geographical footprint.

Diversified business model

The company's customers include some of the leading MNC, regional and local players in home & personal care industries. GSL's product portfolio comprises over 200 product grades, which are marketed to more than 1,750 customers in over 75 countries. Its products are organised in the following two groups:

- **Performance surfactants**: This group comprises over 45 product grades and includes anionic surfactants and non-ionic surfactants.
- **Specialty care products**: This group comprises over 155 product grades and includes amphoteric surfactants, cationic surfactants, UV filters, preservatives, preservative blends and surfactant blends; specialty ingredients such as mild surfactants, syndet and transparent bathing bars & proteins, fatty alkanomides & fatty acid esters and other care products.

Fig. 5: Product portfolio



Source: Company

Fig. 6: Diverse range of products

Source: Company

Strategically located production facilities

Currently, GSL has seven strategically-located manufacturing facilities, of which five are in India and two overseas. The company has also set up one pilot plant at Tarapur (Maharashtra) for scaling of new products and processes from lab-scale to plant scale. Many of its key customers have audited and approved GSL's manufacturing facilities and processes, which have helped the company establish its credentials and reliability as a supplier of high-quality products and customised solutions. This has also enabled it to win recurring business as well as attract new customers.

Table 8: GSL's manufacturing location details

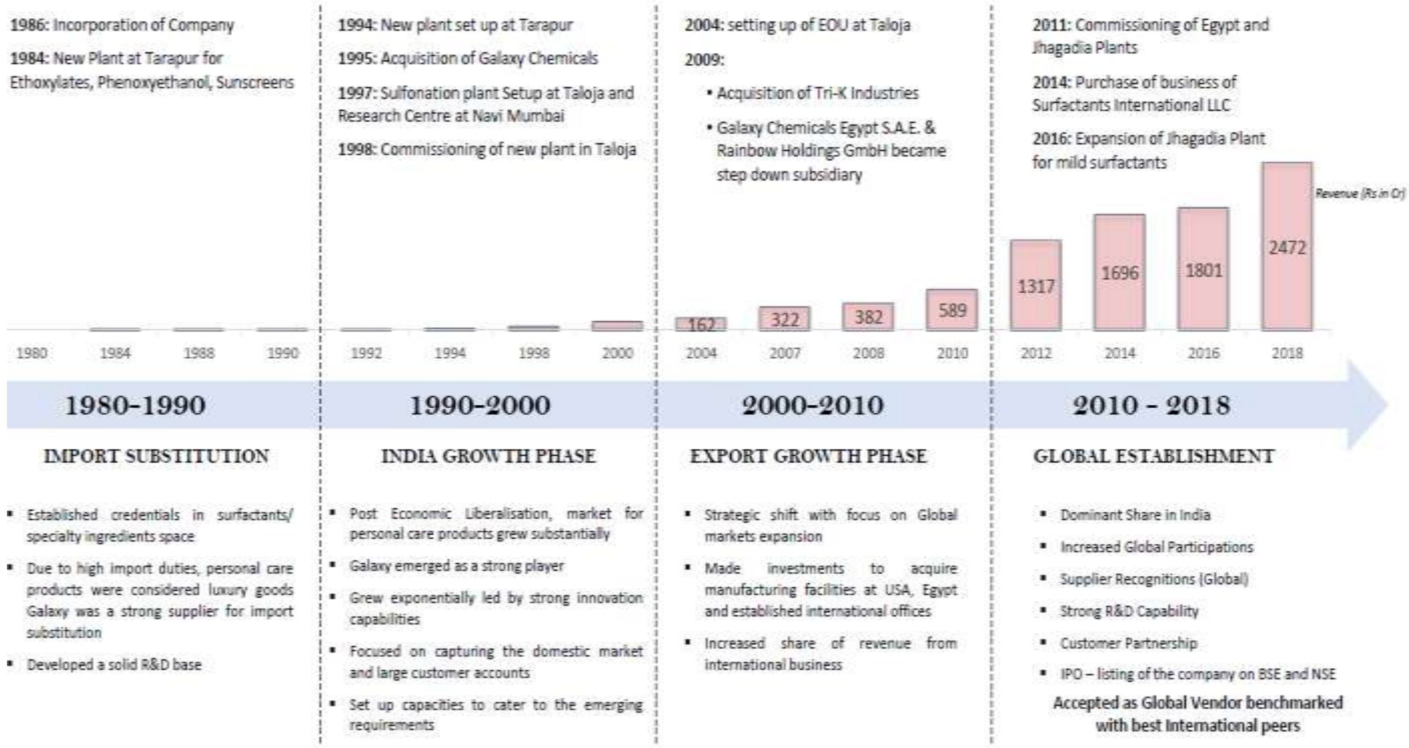
Location	Unit	No. of facilities	Aggregate capacity (MTPA)
Tarapur, Maharashtra, India	Manufacturing	3	31,995
Tarapur, Maharashtra, India	Pilot plant	1	n.a
Taloja, Maharashtra, India	Manufacturing	1	1,60,500
Jhagadia, Gujarat, India*	Manufacturing	1	83,500
Suez, Egypt*	Manufacturing	1	91,500
New Hampshire, USA	Manufacturing	1	600
Total capacity			**3,68,095**

*te: *Environmental clearances for expansion and additional land available at Jhagadia and Suez plants*

Source: Company, Edelweiss research

History

Fig. 7: Major events and milestones



Source: Company

Key management personnel

Table 9: Key management personnel/ Directors

Name	Profile
Mr. Shekhar Ravindranath Warriar , Chairman and a Non-Executive Independent Director	He has been associated with GSL since June 29, 2007. He was a fellow member of The Institute of Cost Accountants of India. He has been associated with Hindustan Unilever for more than 30 years in various capacities. He was the former Managing Director - Foods Division, Executive Director (Beverages) and Divisional Vice President Commercial for Detergents at Hindustan Unilever
Mr. Unnathan Shekhar , Managing Director	He has been associated with GSL since May 20, 1986. He holds a Bachelors Degree in Chemical Engineering from the University Department of Chemical Technology, Mumbai, and a Post Graduate Diploma in Management from Indian Institute of Management, Calcutta. He has over 30 years of experience in the chemical manufacturing industry
Mr. Kasargod Ganesh Kamath , Executive Director (Finance) and the Chief Financial Officer	He has been associated with GSL since September 10, 2004. He is a qualified Company Secretary from The Institute of Company Secretaries of India and a Cost Accountant from the Institute of Cost and Work Accountants of India. He was also an associate of The Institute of Bankers, London and The Indian Institute of Bankers. He also holds a Bachelor of Laws (LL.B.) degree from the Mangalore University. He joined the company in 2004 as General Manager – Finance and Company Secretary. He joined the Board in 2017. He has more than 20 years of experience in the banking and financial sector
Mr. Natarajan K. Krishnan, Executive Director and the Chief Operating Officer	He has been associated with GSL since April 21, 1993. He holds a Bachelor's Degree in Commerce from University of Mumbai and is a Cost Accountant from the Institute of Cost and Works Accountants of India. He completed the Advanced Management Programme from the Harvard Business School in May 2016. Since joining GSL in April 1993, he has headed diverse functions including Finance, IT, Business Creation, Business Commercial, Global Sourcing and Supply Chain and was designated as Chief of Operations
Mr. Gopalkrishnan Ramakrishnan, Non-Executive Director	He has been associated with GSL since May 20, 1986. He holds a Masters Degree in Commerce from University of Mumbai. He is a 'fellow member' of The Institute of Chartered Accountants of India and the Institute of Cost and Works Accountants of India. He is also a qualified Company Secretary from The Institute of Company Secretaries of India. He has over 30 years of experience in Personal and Home Care in the area of Business Creation and Marketing
Mr. Shashikant R Shannhag, Promoter, Non-Executive Director	He has been associated with GSL since 1986. He is a qualified Cost Accountant from the Institute of Cost and Work Accountants of India. He has over 30 years of experience
Dr. Nirmal Koshti, a Non-Executive Director	He holds a Ph. D. in Organic Chemistry (University of Mumbai) and has several years of post-doctoral research experience in academia (University of East Anglia, England, New Mexico State University and Texas A & M University, USA). He has been associated with GSL since inception and has been looking after research and development since then

Source: Company, Edelweiss research

Table 9: Key management personnel/ Directors (Contd.)

Mr. Vaijanath Kulkarni, Non-Executive Director	He has been associated with GSL since June 17, 1995. He holds a Bachelors Degree in Chemical Engineering from Shivaji University, Kolhapur. He started his career with GSL as a Chemical Process Engineer and has been associated with the company for the past 20 years. He is currently the managing director of Galaxy Chemicals (Egypt) S.A.E
Mr. Subodh Satchitanand Nadkarni , Non-Executive and Independent Director	He has been associated with GSL since August 16, 2002. He holds a Bachelors Degree in Commerce from University of Mumbai. He was a 'fellow member' of The Institute of Chartered Accountants of India and The Institute of Company Secretaries of India. He has more than 30 years of experience in the field of strategy, leadership, finance, commerce, project management, sales, marketing, human resources management and general administration. Currently, he is the President (Asia Pacific, Australia), Rotating Equipment Services Division of Sulzer Singapore Pte Ltd. (Singapore)
Mr. Melarkode Ganesan Parameswaran, Non-Executive and Independent Director .	He has been associated with GSL since September 24, 2005. He holds a Bachelors Degree in Chemical Engineering from the Indian Institute of Technology, Madras and a Post Graduate Diploma in Management from Indian Institute of Management, Calcutta. He is also a PhD from Mumbai University and has completed the Advanced Management Program from Harvard Business School. He has over 30 years of experience in marketing and advertising industry. He is also a member of Advisory Committee for SEBI Investor Protection and Education Fund
Ms. Nandita Gurjar , Non-Executive and Independent Director	She has been associated with GSL since February 1, 2015. She holds a Bachelor's degree in Arts and Master's degree in Psychology from Osmania University. She is also an alumnus from the Harvard Business School having completed the Advanced Management program in 2014. She has over 20 years of experience in the field of Information Technology and Human Resource. Currently, she is an Advisor to start-ups in the HR technology space and to Great Place Research & Consultancy Private Limited

Source: Company, Edelweiss research

Financial Statements

Key Assumptions

Year to March	FY18	FY19	FY20E	FY21E
Macro Assumptions				
GDP(Y-o-Y %)	7.2	6.8	6.8	7.1
Inflation (Avg)	3.6	3.4	4.0	4.5
Repo rate (exit rate)	6.0	6.3	5.3	5.0
USD/INR (Avg)	64.5	70.0	72.0	72.0
Company Assumptions				
Total sales vol. (tonnes)	197,429	214,711	236,958	260,949
Volume growth (%)	11.2	8.8	10.4	10.1
Performance vol. (tonnes)	130,596	135,337	148,059	163,161
Volume growth (%)	13	4	9	10
Specialty vol. (tonnes)	66,833	79,374	88,899	97,789
Volume growth (%)	7.6	18.8	12.0	10.0
Financial assumptions				
Gross margins (%)	28.1	29.5	28.7	28.8
Employee (% of net rev)	6.0	6.0	5.8	5.7
Other exp. (% of net rev)	10.2	10.7	10.5	10.3
Depreciation (% of Avg GFA)	5.5	5.1	6.5	6.5
Int (% of avg G.debt)	9.8	11.0	10.0	10.0
Tax rate as % of PBT	27.8	31.0	29.0	29.0

Income statement (INR mn)

Year to March	FY18	FY19	FY20E	FY21E
Net revenues	24,339	27,630	30,538	33,581
Raw material costs	17,511	19,481	21,774	23,910
Employee Benefits Expense	1,460	1,646	1,778	1,920
Other expenses	2,491	2,969	3,207	3,459
Total expenses	21,462	24,096	26,759	29,289
EBITDA	2,877	3,534	3,780	4,292
Depreciation & amortizatior	485	512	711	801
EBIT	2,392	3,022	3,069	3,492
Less: Interest Expense	306	300	182	151
Add: Other income	101	47	50	100
Add: Exceptional items	0	0	0	0
Profit Before Tax	2,188	2,769	2,937	3,441
Less: Provision for Tax	607	859	852	998
Reported Profit	1,580	1,910	2,085	2,443
Less: Excep. Items (Net of Ta:	0	0	0	0
Adjusted Profit	1,580	1,910	2,085	2,443
No. of Sha. outstanding (mn)	35	35	35	35
Adjusted Basic EPS	44.6	53.9	58.8	68.9
No. of dil. Sha. outstand. (mr	35	35	35	35
Adjusted Diluted EPS	44.6	53.9	58.8	68.9
Adjusted Cash EPS	58.3	68.3	78.9	91.5
Dividend per share	8.4	9.1	10.6	12.5
Dividend Payout Ratio (%)	0.2	0.2	0.2	0.2

Common size metrics - as % of revenues

Year to March	FY18	FY19	FY20E	FY21E
Materials costs	71.9	70.5	71.3	71.2
Staff costs	6.0	6.0	5.8	5.7
S G & A expenses	10.2	10.7	10.5	10.3
Depreciation	2.0	1.9	2.3	2.4
Interest Expense	1.3	1.1	0.6	0.4
EBITDA margins	11.8	12.8	12.4	12.8
Net Profit margins	6.5	6.9	6.8	7.3

Growth metrics (%)

Year to March	FY18	FY19	FY20E	FY21E
Revenues	12.6	13.5	10.5	10.0
EBITDA	6.0	22.8	7.0	13.6
PBT	5.5	26.5	6.1	17.1
Adjusted Profit	7.1	20.9	9.2	17.1
EPS	7.1	20.9	9.2	17.1

Balance sheet (INR mn)

As on 31st March	FY18	FY19	FY20E	FY21E
Share capital	355	355	355	355
Other Equity	6,833	8,413	10,121	12,122
Total shareholders funds	7,188	8,767	10,476	12,477
Long term Borrowings	722	892	892	892
Short term Borrowings	2,197	1,640	1,640	1,640
Total Borrowings	2,919	2,532	2,532	2,532
Long Term Liabilities & Prov.	73	110	110	110
Deferred Tax Liability (net)	277	320	320	320
Sources of funds	**10,457**	**11,729**	**13,438**	**15,439**
Gross Block	8,843	10,068	11,818	12,818
Net Block	4,399	5,112	6,151	6,350
Capital work in progress	249	826	0	0
Intangible Assets	69	75	75	75
Total Fixed Assets	4,717	6,013	6,226	6,426
Non current investments	1	0	0	0
Cash & bank balances	276	257	1,025	2,561
Inventories	3,456	3,513	4,176	4,585
Sundry Debtors	4,182	4,268	4,853	5,060
Loans & Advances	3	37	37	37
Other Current Assets	1,919	1,592	1,592	1,592
Total Current Assets (Ex Casł	9,561	9,410	10,658	11,275
Trade payable	3,278	3,059	3,579	3,930
Other Current Liab. & ST Pro	819	892	892	892
Total Current Liab. & Provis.	4,097	3,950	4,471	4,822
Net Current Assets (ex cash)	5,464	5,459	6,187	6,453
Uses of funds	**10,457**	**11,729**	**13,438**	**15,439**
Book value per share (INR)	203	247	296	352

Free cash flow

Year to March	FY18	FY19	FY20E	FY21E
Reported Profit	1,580	1,910	2,085	2,443
Add: Depreciation	485	512	711	801
Interest (Net of Tax)	221	207	129	107
Others	(1,517)	93	53	44
Less:Changes in WC	(673)	87	728	266
Operating cash flow	1,442	2,635	2,251	3,128
Less: Capex	559	1,802	924	1,000
Free cash flow	**883**	**833**	**1,326**	**2,128**

Cash flow statement

Year to March	FY18	FY19	FY20E	FY21E
Operating cash flow	1,442	2,635	2,251	3,128
Investments cashflow	(534)	(1,808)	(924)	(1,000)
Financing cash flow	(897)	(929)	(558)	(593)
Net cash Flow	12	(102)	768	1,536
Capex	(559)	(1,802)	(924)	(1,000)

Profitability & liquidity ratios

Year to March	FY18	FY19	FY20E	FY21E
ROAE (%)	**24.4**	**23.9**	**21.7**	**21.3**
ROCE (%)	**26.0**	**28.7**	**25.7**	**25.6**
Inventory Days	69	65	64	67
Debtors Days	57	56	55	54
Payble Days	60	59	56	57
Cash conversion cycle (days)	66	62	63	63
Current Ratio	2.4	2.4	2.6	2.9
Gross Debt/EBITDA	1.0	0.7	0.7	0.6
Gross Debt/Equity	0.4	0.3	0.2	0.2
Net Debt/Equity	0.4	0.3	0.1	(0.0)
Interest Coverage Ratio	7.8	10.1	16.9	23.1

Operating ratios

Year to March	FY18	FY19	FY20E	FY21E
Total asset turnover(x)	2.4	2.5	2.4	2.3
Fixed asset turnover(x)	5.4	5.7	5.4	5.3
Equity turnover(x)	3.8	3.5	3.2	2.9

Valuation parameters

Year to March	FY18	FY19	FY20E	FY21E
Adjusted Diluted EPS (INR)	44.6	53.9	58.8	68.9
Y-o-Y growth (%)	*7.1*	*20.9*	*9.2*	*17.1*
Adjusted Cash EPS (INR)	58.3	68.3	78.9	91.5
Diluted P/E (x)	26.9	22.3	20.4	17.4
Price/BV (x)	5.9	4.9	4.1	3.4
EV/Sales (x)	1.9	1.6	1.4	1.3
EV/EBITDA (x)	15.7	12.7	11.7	9.9
Dividend yield (%)	0.7	0.8	0.9	1.0

Additional Data

Directors Data

Mr. S Ravindranath	Chairman, Non-Executive Independent Director	Mr. U Shekhar	Managing Director
Mr. K Ganesh Kamath	Executive Director (Finance) & CFO	Mr. K Natarajan	Executive Director & COO
Mr. G Ramakrishnan	Non-Executive Director	Mr. Sudhir Patil	Non-Executive Director
Mr. Nirmal Koshti	Non-Executive Director	Mr. Vaijanath Kulkarni	Non-Executive Director
Mr. Subodh Nadkarni	Non-Executive Independent Director	Mr. M G Parameswaran	Non-Executive Independent Director
Ms. Nandita Gurjar	Non-Executive Independent Director	Mr. Uday K Kamat	Non-Executive Director
Mr. Ravi Venkateswar	Executive Director		

Auditors - Deloitte Haskins & Sells LLP

**as per last available data*

Holding Top -10

	Perc. Holding		Perc. Holding
SBI Mutual Funds	6.86	ICICI Prudential Life Insurance	1.29
Kotak Mahindra AMC	1.16	Reliance Capital Trustee	1.13
Axis AMC	0.73	Matthews International Capital Management	0.49
Daiwa AMC	0.31	ICIC Prudential AMC	0.14
Credit Agricole Group	0.13	Canara Robeco AMC	0.11

**as per last available data*

Bulk Deals

Data	Acquired / Seller	B/S	Qty Traded	Price
8-Feb-18	Sbi Mutual Fund	BUY	253000	1704.5

**as per last available data*

Insider Trades

Data	Acquired / Seller	B/S	Qty Traded	Price
No Data Available				

*as per last available data

India Midcaps

COMPANY UPDATE

AARTI INDUSTRIES

Diversified player with high growth visibility

India Equity Research| Speciality Chemicals

Edelweiss
Ideas create, values protect

Aarti Industries (AIL), India's largest specialty chemical player, has been the biggest beneficiary of the burgeoning opportunity in specialty chemicals. Successfully leveraging its benzene-based chemistry to other processes & chemistries has helped the company have a diversified business model, large product basket and integrated plant operations. To cash in on the burgeoning opportunity, AIL is doubling capex over FY18-21E to INR31bn. Led by accelerated capex and commissioning of two large products (~INR9bn revenue p.a.) in FY20/21, the company enjoys strong growth visibility with FY19-21E EPS CAGR of 24%. That said, while strong structural growth in specialty chemicals is clearly visible, a sharp run-up in the stock limits upside potential in the near term. Maintain 'HOLD' with target price of INR1,851 based on 25x September 2020E EPS.

Harnessing diversified business model to tap opportunities

AIL has successfully tapped the burgeoning growth in specialty chemicals underpinned by: a) presence in multiple user industries like agrochemicals, polymers, pharma etc.; and b) well integrated plant operations combining various chemistries (benzene, toluene, etc). Over the years, the company has scaled up the value chain leading to margin expansion—FY16-19 average EBITDA margin at 19% versus 15.8% over FY12-15

Aggressive capex and strong order inflow bolster visibility

The company is doubling capex over FY18-21E to INR31bn (INR16bn in FY14-17) to tap emerging growth opportunities and rising customer enquiries. Though AIL has managed to grow (FY09-19 revenue CAGR 13%) via internal accruals, it recently raised INR7.5bn through QIP to harness rising investment opportunities. It has already bagged three long-term contracts entailing INR10bn revenue p.a.

Outlook and valuation: Valuation concern; maintain 'HOLD'

Given the favourable dynamics in specialty chemicals and AIL's strong positioning & higher growth visibility (FY19-21E EPS CAGR of 24%), the stock should trade in a higher valuation band. However, given the sharp run-up in the stock limits upside potential in the near term. Hence, we maintain **'HOLD'** with target price of INR1,851 based on 25x September 2020 EPS estimate.

Financials **(INR mn)**

Year to March	FY18	FY19	FY20E	FY21E
Net revenue	38,061	50,142	58,544	72,910
EBITDA	6,991	9,706	10,705	13,563
Adjusted Profit	3,330	4,834	5,455	7,378
Diluted EPS (INR)	41.0	55.8	62.9	85.1
Diluted P/E (x)	42.1	30.9	27.4	20.3
EV/EBITDA (x)	23.1	16.9	15.8	12.4
ROAE (%)	22.5	22.1	18.2	20.7

EDELWEISS RATINGS	
Absolute Rating	**HOLD**
Investment Characteristics	Growth

MARKET DATA *(R: ARTI.BO, B: ARTO IN)*	
CMP	: INR 1,716
Target Price	: INR 1,851
52-week range (INR)	: 1,899 / 1,100
Share in issue (mn)	: 86.7
M cap (INR bn/USD mn)	: 149 / 2,142
Avg. Daily Vol. BSE/NSE ('000)	: 76.7

SHARE HOLDING PATTERN (%)

	Current	Q3FY19	Q2FY19
Promoters *	52.7	52.7	53.0
MF's, FI's & BKs	14.3	14.3	13.9
FII's	4.5	4.5	4.2
Others	28.5	28.5	28.9

** Promoters pledged shares (% of share in issue) : NIL*

PRICE PERFORMANCE (%)

	BSE Midcap Index	Stock	Stock over Index
1 month	(6.3)	(3.4)	2.9
3 months	0.4	0.3	(0.1)
12 months	(11.6)	19.7	31.3

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A well balanced mix of domestic and exports operations provides the company natural hedge

Specialty Chemicals

Diversified product portfolio imparts stability to operations

AIL is a supplier to leading chemical companies across the globe, with the largest customer contributing to less than 5% of sales. Further, a balanced mix of domestic and exports operations provides the company natural hedge. High level of diversification across products and geographies provides significant de-risking advantage.

Chart 1: Geographically well diversified revenues (FY19)

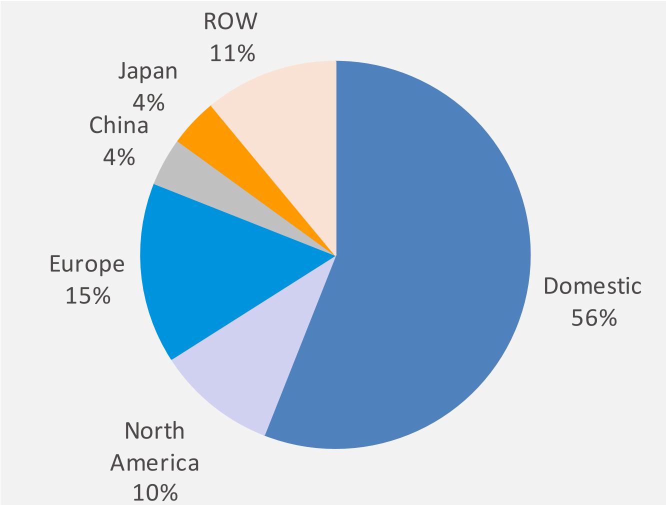
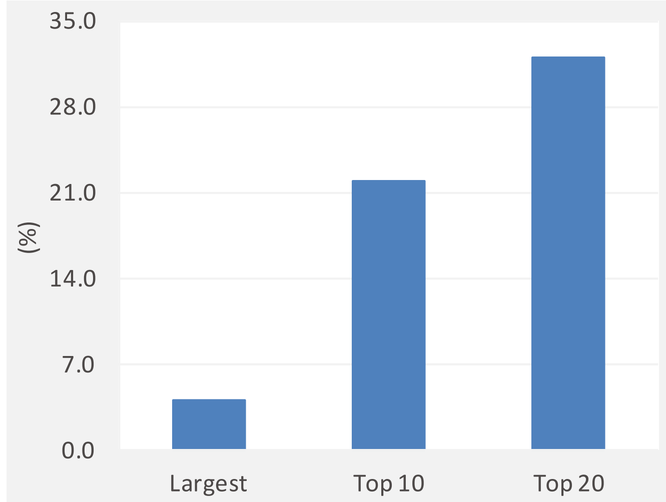


Chart 2: Largest customer contributes less than 5% of sales



Source: Company, Edelweiss research

Strong growth drivers in place

Burgeoning demand from end-user industries

The company is well placed to benefit from strong domestic demand across different industries. A well diversified end-user industry base helps AIL clock sustainable growth in the domestic market and reduces dependency on any cyclical industry.

Table 1: Diversified end user industries

Segments	End user industries	Product cycle	FY18-23E CAGR
Agrochemicals	Pesticides, Insecticides, Fungicides, Herbicides, Nutrients	Agrochemical cycle	7-9%
Dyes & pigments	Printing inks	Normal business cycle	10-12%
Polymer & Additives	Aircrafts, Automobiles, Cruise Liners, Aircrafts, Bullet-proof jackets, Electronic proof jackets	Normal business cycle	7-9% / 10-11%
Pharma	Intermediates used in drugs catering to anti-cancer, anti -asthma and anti -hypertensive drugs oncology therapies	Non-cyclical	12-13%
Others	Fuel additives, rubber chemicals		

Source: Company, Industry, Edelweiss research

China's pain is India's gain

AIL is well placed to benefit from burgeoning opportunities, particularly on account of shifting of manufacturing base from Western countries to emerging economies like India and China. With cost pressures and environmental concerns leading to high number of shutdowns in China, India is in a sweet spot to capitalise on this opportunity. Further, need to diversify supply risk from China is leading to more orders for Indian chemical companies. Moreover, India is expected to benefit from import substitution as currently many agro intermediates are being directly imported from China.

In FY19, clampdown in China lifted AIL's EBIT by INR500mn

The company also benefits from long-standing relationships with domestic customers who are setting up or expanding capacities in downstream products, as the structural shift of global demand continues to favour consistent Indian suppliers. Many of AIL's domestic customers are also creating facilities to manufacture products that substitute imports in to the country, which will benefit AIL. In FY19, revenue jumped by 33% YoY driven by volume growth of 8% YoY and a clampdown in China, which lifted EBIT to the tune of INR500mn in FY19.

Increasing contract manufacturing

The INR40bn contract is expected to commence from H2FY20 and the INR100bn contract from Q4FY20/Q1FY21

In FY18, AIL had secured two multi-year contracts of INR40bn and INR100bn to supply high-value agrochemical intermediate over 10 and 20 years, respectively. The INR40bn contract is expected to commence from H2FY20 and the other from Q4FY20/Q1FY21. Both these contracts enhance revenue visibility and reaffirm our stance that AIL is well poised to leverage such outsourcing opportunities going ahead. These contracts together can add INR1.5bn to total EBIT once the projects scale up.

New projects on track; enhances visibility

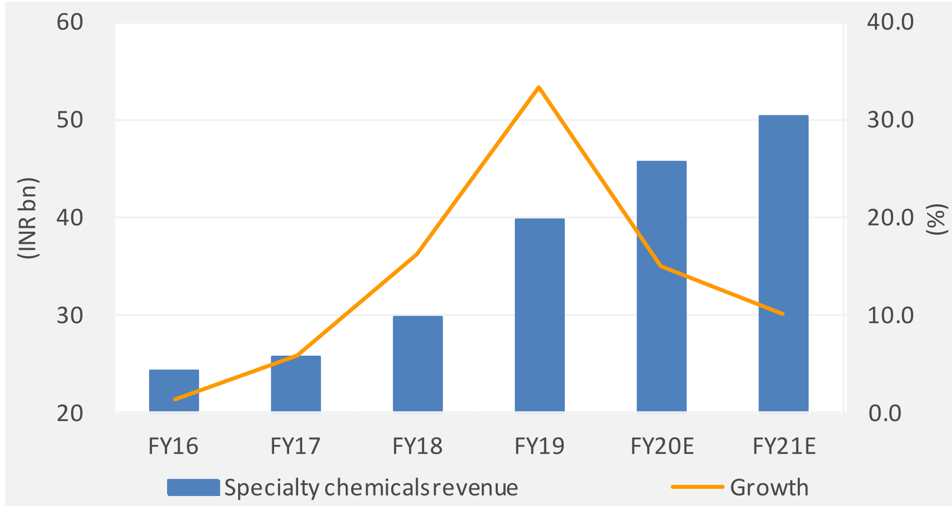
AIL is planning INR17-18bn capex cumulatively over FY20-21. Majority of the capex—INR7.0-7.5bn—is likely to be spent on projects with large deals. The additional capex is likely to be used for R&D labs, zero discharge plants, maintenance capex and various de-bottlenecking in specialty chemicals and pharma segments. In the specialty chemicals segment, AIL is expanding in to new product value chains (toluene) and new reaction capabilities (ethylene).

Table 2: Key expansion projects undertaken

Project	Location	Capacity Details	Commissioning	Objective of Capex
Nitro -Chloro Benzene	Vapi	Expanded from 57 to 75 ktpa and further expanding to 108 ktpa	FY16	Diversifying further in benzene value chain
Phenylene Diamines	Jhagadia	Expanded from 5 to 12 ktpa	FY17	Strengthen presence
Nitro -Toluene	Jhagadia	Set up a 30 ktpa plant	FY18	Entry in Toluene chain
Ethylation	Dahej	Set up a 8 to 10 ktpa plant	FY17	Increase of agrochemicals intermediates

Source: Company, Edelweiss research

Chart 3: Specialty chemical's revenue to post 12% CAGR



Forward integration to scale up utilisation of existing units

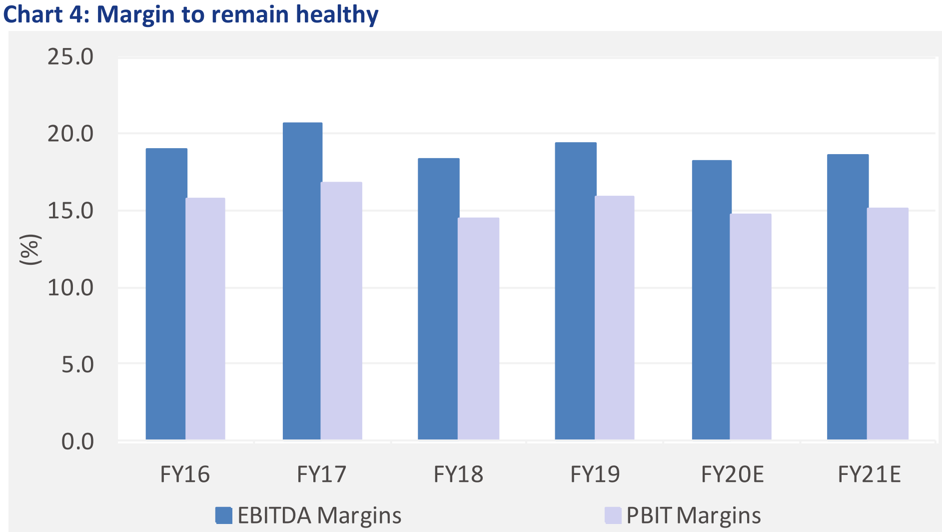
Presence in downstream products reduces the impact of crude volatility and provides stable and healthy margins

AIL is scaling up its operations in benzene as well toluene based value chain. The strategy is to focus on downstream high-margin value-added products even though their volumes are lower. With expansion in chlorination, the company will be able to scale up even its calcium chloride facility with availability of HCL, which is a by-product of chlorination.

Presence in downstream products is also likely to offset the crude volatility for AIL as impact of raw material reduces down the chain. The company derives cost benefits from its integrated facility due to significant value addition, which along with improving EBITDA margin, reduces the impact of price volatility in chemicals.

Further, AIL's strong client relationships will help it cross sell its value-added products. We believe, a large client base, extensive integrated processes, cost efficient solutions and expertise in handling varied chemistries will help AIL replicate its success in other chemistries.

Chart 4: Margin to remain healthy



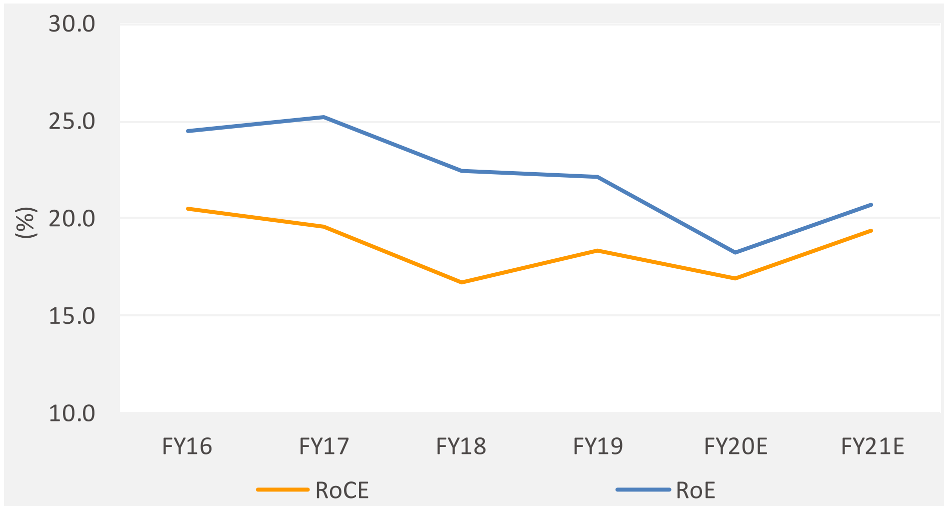
Source: Company, Edelweiss research

One of the most competitive benzene-based specialty chemical players – amongst the top-4 players globally for 75% of its portfolio products

Focus on value-added segment to enhance returns

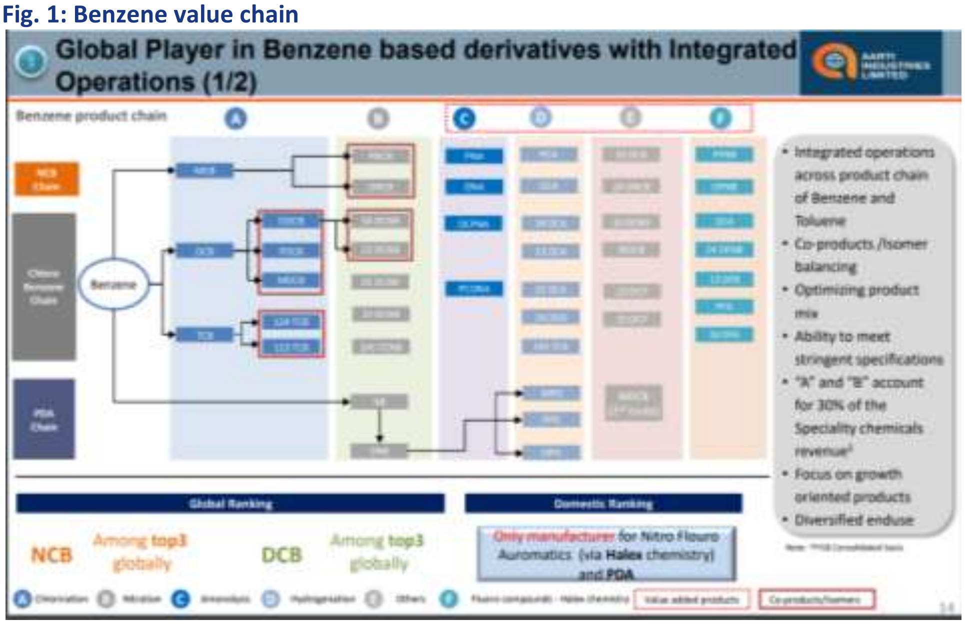
AIL is one of the most competitive benzene-based specialty chemical players and figures among the top-4 players globally for 75% of its portfolio products. Over the past decade, the company has constantly upgraded from batch to continuous process, leading to high fuel efficiency, rise in yields, decline in inventory cost and higher productivity. Further, the company continues to focus on downstream high-margin value-added products even though their volumes are lower. Presence in downstream products offsets the crude volatility for AIL as impact of raw material reduces down the chain. Augmenting its presence in value-added segment thus helps reduce competitive pressure.

Chart 5: Return ratios to improve in FY21E



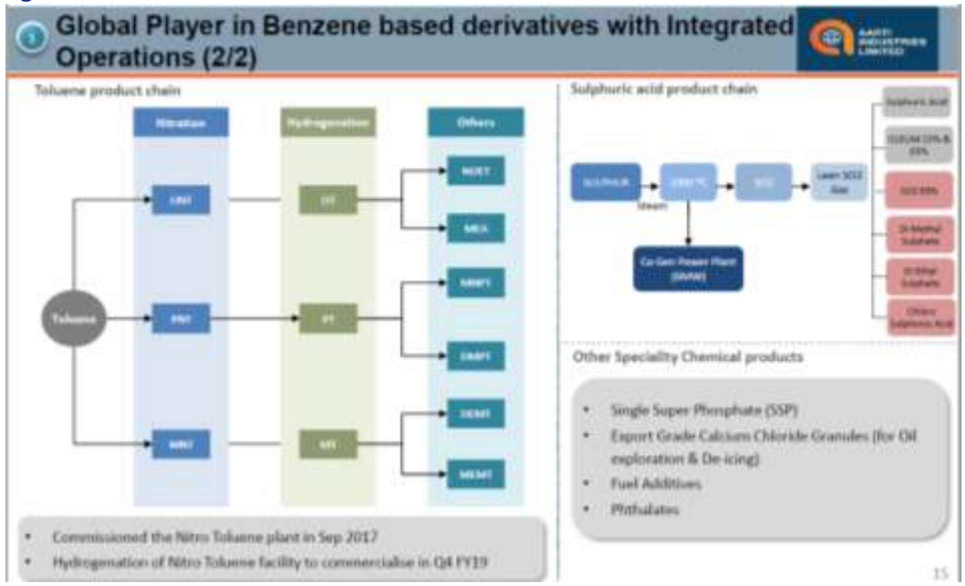
Source: Company, Edelweiss research

Fig. 1: Benzene value chain



Source: Company

Fig. 2: Toluene value chain



Source: Company

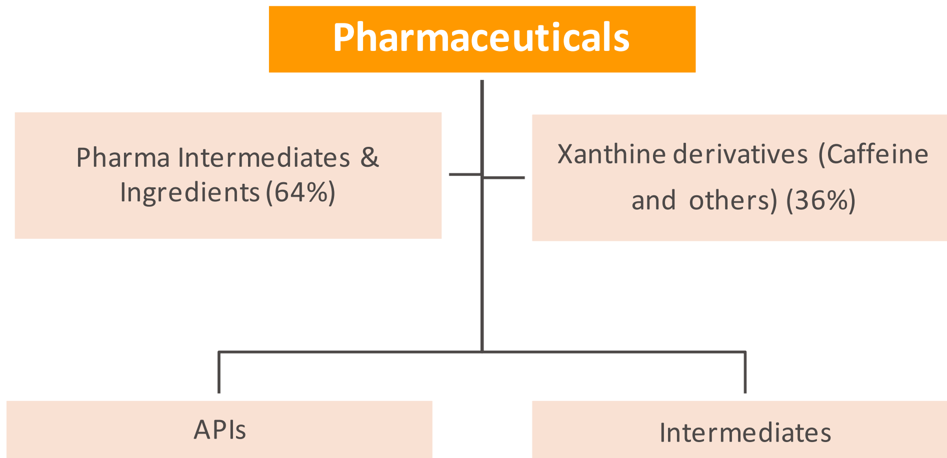
Pharma division accounted for 14% of revenue and 17% of total EBIT in FY19

Pharma

APIs account for major revenue share

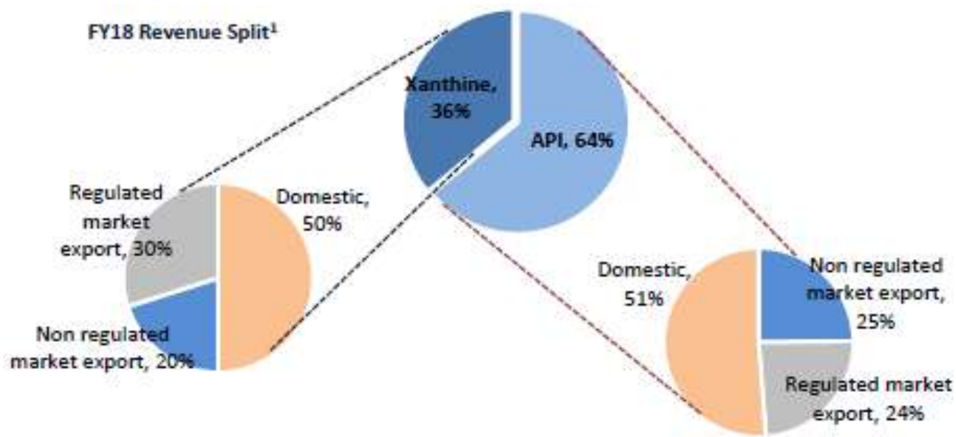
AIL's pharma division accounted for 14% of revenue and 17% of total EBIT in FY19. The segment caters to global generic companies, innovators and large pharma companies along with branded generic Indian pharma companies. The company is backward integrated for most of its APIs and has USFDA approved manufacturing facility for upcoming generic APIs.

Fig. 3: Pharmaceutical segments



Source: Company, Edelweiss research

Fig. 4: Diversification across products and geographies



Source: Company

AIL is confident of healthy double digit growth with higher bottom-line growth as the company reaps benefits of operating leverage

Benefits from improved performance across verticals

Performance of all verticals—API, intermediates and caffeine—of the pharma segment has started to improve. AIL is confident of healthy double digit (>20-25%) top-line growth led by improved prospects across markets with higher bottom-line growth as it reaps benefits of operating leverage. Growth in this segment will largely be led by:

- India's API market (domestic and exports) is expected to post strong growth, which will benefit AIL significantly.
- The company's focus on off-patented generics to be supplied in regulated markets, which we believe will drive growth.
- Supply disruptions in China (due to pollution related shutdowns) are expected to offer great opportunity for Indian exporters, including AIL.
- Transition towards specialty products and high value APIs.

Chart 6: India's API market to post strong growth

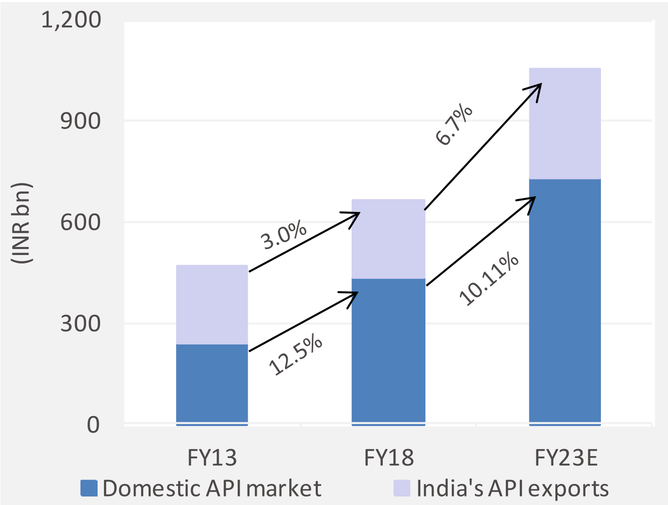
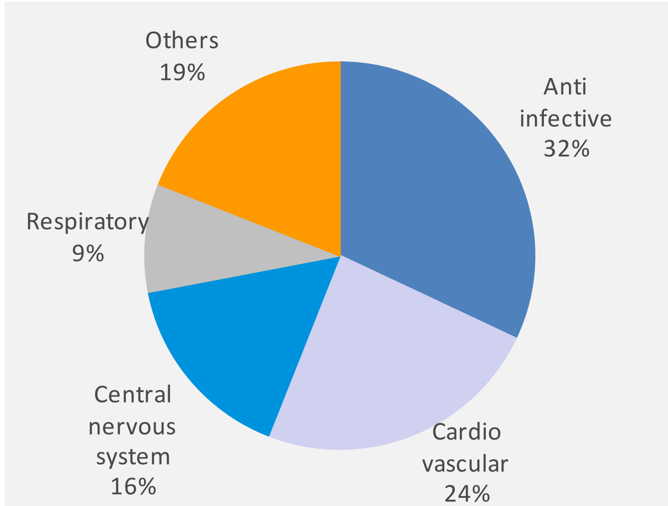
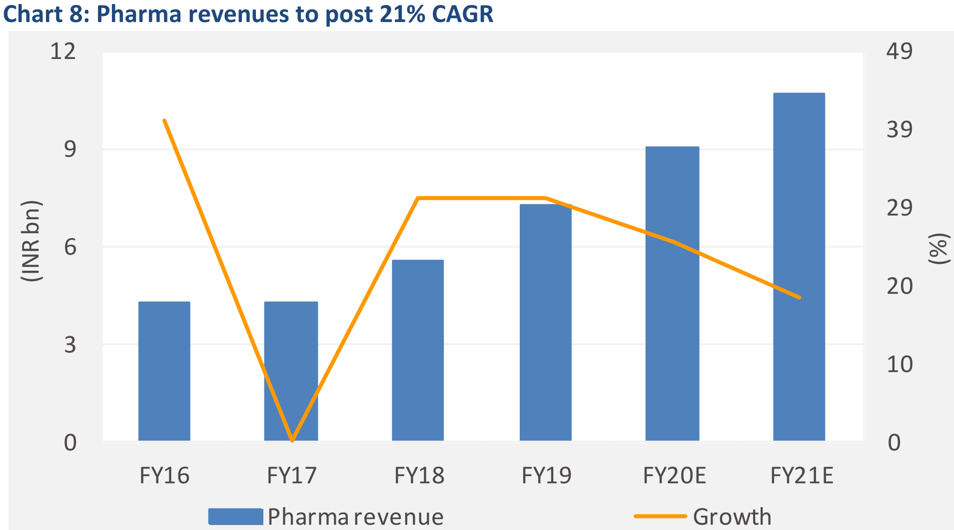


Chart 7: API's share by application (FY18)



Source: Company, Edelweiss research

Chart 8: Pharma revenues to post 21% CAGR



Source: Company, Edelweiss research

Financial outlook

AIL plans to spend INR17-18bn over FY20-21 mainly on large deals, maintenance, specialty chemical de-bottlenecking and pharma segment

Ongoing capex enhances revenue visibility

Over FY15-19, AIL has completed capex of INR27.6bn, of which INR19.6bn was spent in the last three years. The company's capex intensity has increased significantly as it is planning to spend INR10bn in FY20E and INR7bn in FY21E. This is much higher than earlier guidance of INR6.5-7.0bn capex p.a.

However, in light of burgeoning opportunities in specialty chemical and pharma segments, AIL has continued to revise its capex guidance upwards. Going ahead, majority of the capex is likely to be spent on: i) ~INR7bn on large deals; ii) INR4.0-4.5bn on maintenance; iii) INR1.5-2.0bn on pharma; and iv) INR2-3bn for specialty chemical de-bottlenecking.

Chart 9: Robust capex to continue

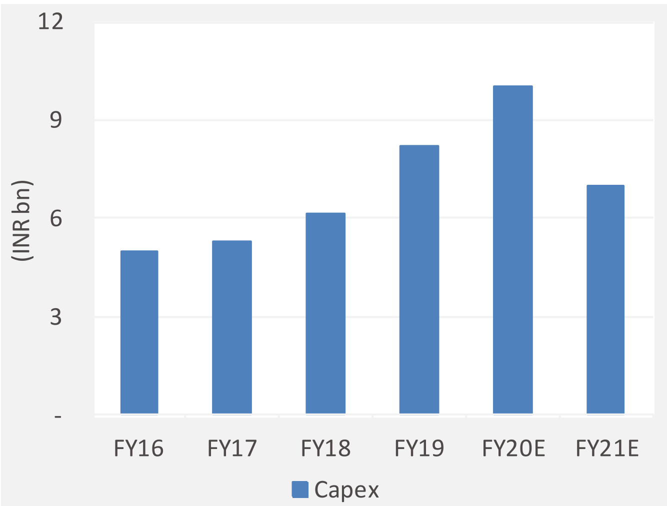
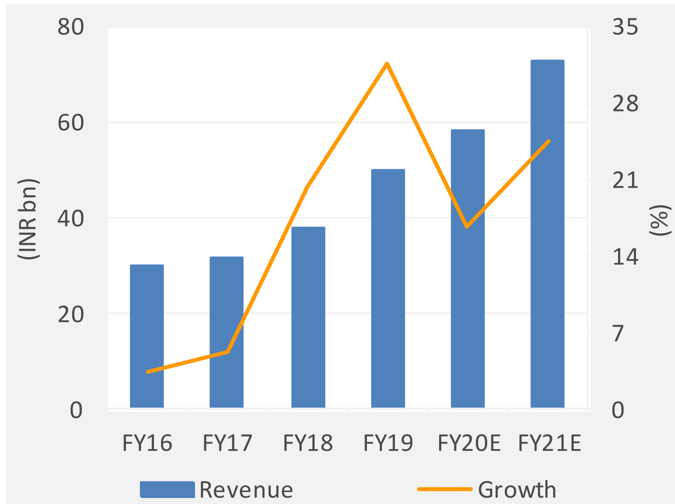


Chart 10: Revenue to post 21% CAGR over FY19-21E



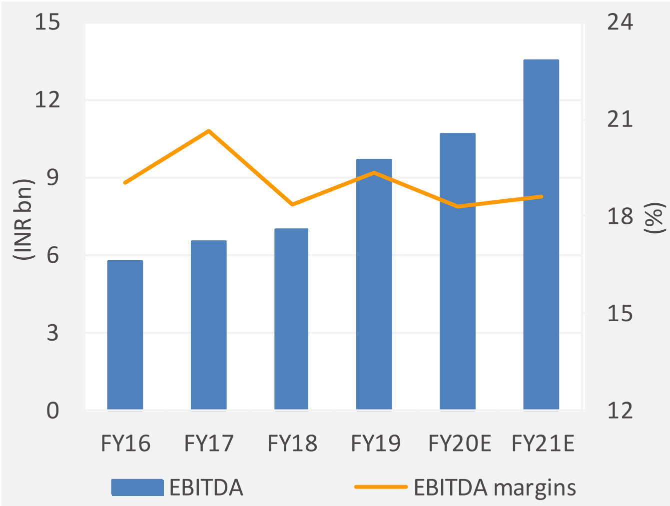
Source: Company, Edelweiss research

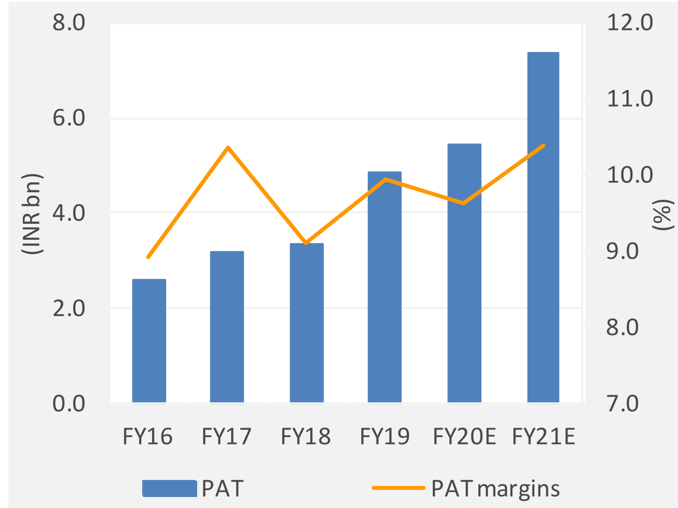
FY21 EBITDA/PAT is likely to grow at 27% / 35%, as benefits of strong capex will start to reflect

New capacities are still ramping up providing operating leverage

While AIL is estimated to clock 21% revenue CAGR over FY19-21, EBITDA and PAT CAGR is likely to be at 18% and 24%, respectively. The growth is likely to be much higher in FY21 with EBITDA and PAT growth of 27% and 35%, respectively, as benefits of strong capex will start to reflect. The rising utilisation is likely to bring operating leverage along with increasing share of new value-added products, which spur EBITDA and PAT. A part of this value addition can be attributed to disruption in China's chemical industry, which is leading to increase in AIL's market share in a few product categories.

Chart 11: EBITDA and PAT to post 18% and 24% CAGR over FY19-21E





Source: Company, Edelweiss research

Valuations

P/E-based target multiple to factor earnings growth momentum

We value AIL based on P/E multiple and assign target multiple of 25x to arrive at September 2020E target price of INR1,851. We believe, the stock has consistently rerated over the past three years (FY16-19) at an average of 19x versus FY12-15 average of 8x. This significant rerating has been led by robust earnings momentum and increased visibility. **Though our target multiple of 25x is at a 30% premium to previous three years' average, we believe the conducive growth environment in the sector and AIL's strong presence in diversified user industries will continue to enjoy premium.**

However, at target price of INR1,851 we see limited upside at CMP and hence recommend **'HOLD'.**

Chart 12: 1 year forward PE chart

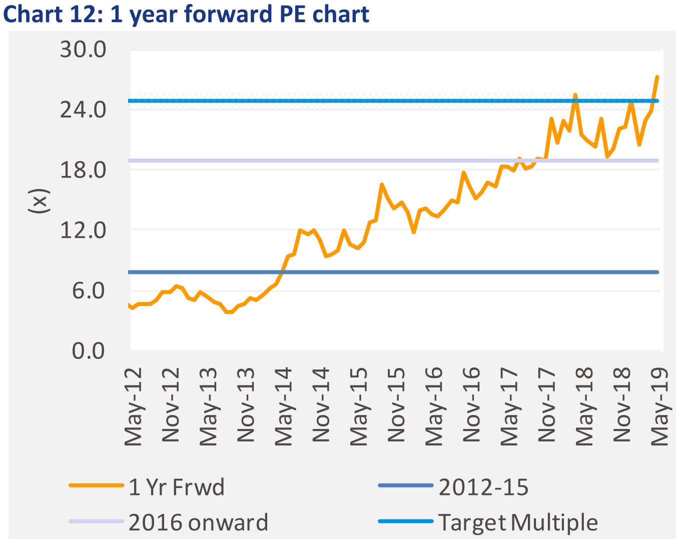
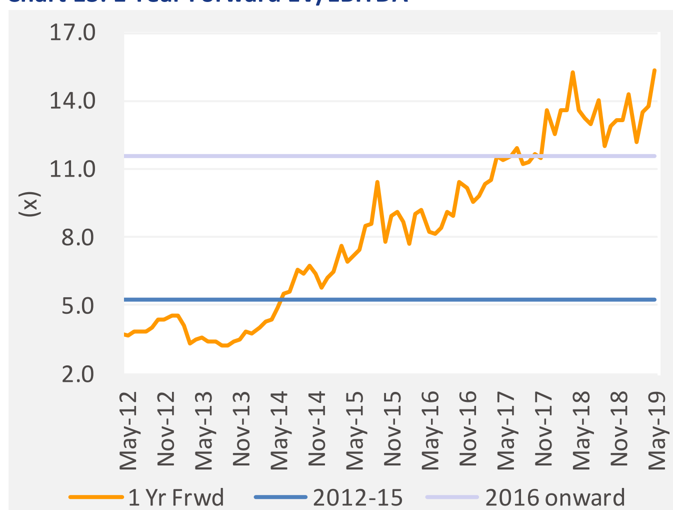


Chart 13: 1 Year Forward EV/EBITDA

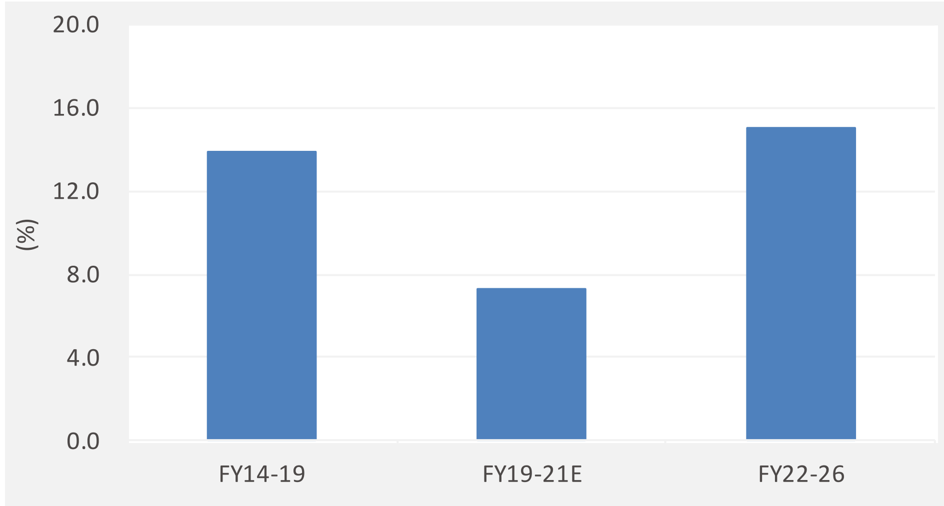


Source: Bloomberg

Our DCF factors high implied growth

For AIL, our reverse DCF model implies growth rate of 19% in our high growth phase of FY22-26 at target price of INR1,851. While the company has posted 14% revenue CAGR over FY14-19, growth is likely to accelerate over FY19-21E to 21% as we perceive strong growth visibility. We **believe it can clock 19% growth in its high growth phase as the company enjoys leading position in specialty chemicals.** We have used 12% WACC and terminal growth of 6%.

Chart 14: DCF – historical and implied growth rate



Source: Edelweiss research

Company Description

AIL incorporated in 1975, is a well-diversified chemicals company headquartered in Mumbai. It is one of the largest producers of Benzene-based basic and intermediate chemicals in India and manufactures 125 products with chemistry of benzene, aniline, sulphuric acid, toluene and methanol. AIL is one of the leading global suppliers of dyes, pigments, agrochemicals, pharmaceuticals and rubber chemicals. Benzene accounts for ~60% of the company's revenues, while aniline and sulphuric acid compounds contribute ~12% to revenues. With start of the Dahej facility, AIL will also enter toluene chemistry. AIL's manufacturing units are located in Gujarat and Maharashtra. It has three different business segments:

- Specialty chemicals – largest manufacturer of specialized pigment & paint Intermediates in India and leading player globally. Also, manufactures intermediates for agrochemicals and produces Single Super Phosphate fertilizer. Earlier part of two segments
    1. Performance chemicals - accounts for ~65% of total revenues
    2. Agri-intermediates & Fertilizers segment - accounts for ~20% of total revenues
- (2) Pharmaceuticals - has backward integrated facilities for most APIs
- (3) Home & personal care – currently at low margins, AIL plans to alter mix and explore new markets

Investment Theme

Integrated, flexible, diversified operations: Superior R&D, process flexibility and integration operations equips AIL to offer more than 125 products with applications and customer base across multiple industries.

Cost competitiveness: Backward and forward integration and commercial viability of by-products enables AIL to enjoy cost competitiveness.

Preferred supplier for global customers, MNCs: AIL is a preferred supplier for global customers, as exports contribute ~50% to revenue with incremental capex on anvil to enhance standing in the export market.

Key Risks

Benzene Prices: AIL's passes on the cost changes with one quarter lag to customers, any increase in Benzene prices may lead to lower earnings temporarily. We however see lower risks over a longer period as the same is passed on to customers.

Environmental Regulations: Environment regulations in India are becoming stringent and there are risks of further tightening of these laws, which will lead to increased costs for chemical companies. Aarti has invested in having zero-discharge facilities for Jhagadia and a unit in Vapi.

Financial Statements

Key Assumptions

Year to March	FY18	FY19	FY20E	FY21E
Macro				
GDP(Y-o-Y %)	7.2	6.8	6.8	7.1
Inflation (Avg)	3.6	3.4	4.0	4.5
Repo rate (exit rate)	6.0	6.3	5.3	5.0
USD/INR (Avg)	64.5	70.0	72.0	72.0
Company				
Financial assumptions				
Spec chem rev gwth(%)	16.2	33.3	15.0	10.0
Pharma chem rev gwth(%)	30.5	30.5	25.0	18.0
H&P EBIT margin(%)	57.2	17.2	20.0	15.0
Spec chem EBIT margin(%)	19.5	20.6	20.3	20.3
Pharma EBIT margin(%)	14.2	15.5	16.5	16.5
H&P EBIT margin(%)	1.0	(0.7)	5.0	7.0
Interest(% of Avg loans)	5.7	-	7.9	7.8
Tax rate (%)	19.3	19.2	19.0	19.0
Capex (INR mn)	6,142	8,213	10,000	7,000
Tr. Pay. % of cost(%)	16.4	10.7	17.0	17.0
Inventory % of costs	34.3	28.0	31.0	31.0
Debtors % of revenues	15.5	16.0	16.0	16.0

Income statement (INR mn)

Year to March	FY18	FY19	FY20E	FY21E
Net revenue	38,061	50,142	58,544	72,910
Cost of mat. Consumed	21,815	29,518	34,775	43,017
Employee costs	1,901	2,539	3,427	4,284
Other Expenses	7,353	8,380	9,636	12,046
Total operating expenses	31,069	40,436	47,839	59,347
EBITDA	6,991	9,706	10,705	13,563
Depreciation	1,462	1,715	2,070	2,504
EBIT	5,529	7,991	8,635	11,060
Less: Interest Expense	1,317	1,843	1,744	1,777
Add: Other income	77.7	21.00	60.35	75.00
Profit Before Tax	4,290	6,169	6,951	9,358
Less: Provision for Tax	829	1,183	1,321	1,778
Less: Minority Interest	132	153	175	202
Reported Profit	3,330	4,834	5,455	7,378
Adjusted Profit	3,330	4,834	5,455	7,378
Shares o /s (mn)	81	87	87	87
Basic EPS (INR)	41.0	55.8	62.9	85.1
Diluted shares o/s (mn)	81	87	87	87
Adj. Diluted EPS (INR)	41.0	55.8	62.9	85.1
Adjusted Cash EPS	60.6	77.3	88.8	116.3
Dividend per share (DPS)	1.0	1.0	8.0	8.0
Dividend Payout Ratio(%)	3.0	2.2	15.4	11.4

Common size metrics

Year to March	FY18	FY19	FY20E	FY21E
Cost of revenues	57.3	58.9	59.4	59.0
EBITDA margins	18.4	19.4	18.3	18.6
EBIT margins	14.5	15.9	14.7	15.2
Net Profit margins	9.1	9.9	9.6	10.4

Growth ratios (%)

Year to March	FY18	FY19	FY20E	FY21E
Revenues	20.3	31.7	16.8	24.5
EBITDA	7.0	38.8	10.3	26.7
EBIT	4.1	44.5	8.1	28.1
PBT	3.2	43.8	12.7	34.6
Adjusted Profit	5.4	45.2	12.9	35.3
EPS	6.5	36.2	12.9	35.3

Balance sheet (INR mn)

As on 31st March	FY18	FY19	FY20E	FY21E
Share capital	407	433	433	433
Reserves & Surplus	15,378	27,188	31,803	38,343
Shareholders' funds	15,784	27,621	32,237	38,776
Minority Interest	770	923	1,098	1,300
Long term borrowings	9,083	8,448	7,448	6,448
Short term borrowings	11,748	12,908	12,236	15,688
Total Borrowings	20,830	21,356	19,684	22,136
Long Term Liabilities	-	2,032	6,147	7,656
Def. Tax Liability (net)	1,774	2,003	2,350	2,818
Sources of funds	**39,159**	**53,935**	**61,516**	**72,686**
Tangible assets	19,962	22,832	30,762	35,259
Intangible Assets	17	13	13	13
CWIP (incl. intangible)	4,362	7,990	5,000	2,500
Non current investments	472	647	200	200
Cash and Equivalents	321	8,042	1,529	4,850
Inventories	7,473	8,251	10,780	13,335
Sundry Debtors	5,908	8,047	9,367	11,666
Loans & Advances	4,500	4,537	10,538	13,124
Other Current Assets	260	344	410	510
Current Assets (ex cash)	18,140	21,179	31,095	38,635
Trade payable	3,575	3,158	5,912	7,313
Other Current Liab	541	3,611	1,171	1,458
Total Current Liab	4,116	6,769	7,083	8,771
Net Curr Assets-ex cash	14,024	14,411	24,013	29,864
Uses of funds	**39,159**	**53,935**	**61,516**	**72,686**
BVPS (INR)	194.1	318.7	372.0	447.4

Free cash flow (INR mn)

Year to March	FY18	FY19	FY20E	FY21E
Reported Profit	3,330	4,834	5,455	7,378
Add: Depreciation	1,462	1,715	2,070	2,504
Interest (Net of Tax)	1,062	1,490	1,413	1,439
Others	528	714	794	932
Gross cash flow	3,394	10,398	4,245	7,910
Less: Changes in WC	2,988	(1,646)	5,487	4,343
Less: Capex	6,138	8,209	7,010	4,500
Free Cash Flow	**(2,744)**	**2,189**	**(2,765)**	**3,410**

Cash flow metrics

Year to March	FY18	FY19	FY20E	FY21E
Operating cash flow	3,394	10,398	4,245	7,910
Financing cash flow	2,705	5,686	(4,256)	(163)
Investing cash flow	(6,063)	(8,363)	(6,503)	(4,425)
Net cash Flow	36	7,721	(6,514)	3,322
Capex	(6,138)	(8,209)	(7,010)	(4,500)
Dividend paid	(98)	(105)	(839)	(839)

Profitability and efficiency ratios

Year to March	FY18	FY19	FY20E	FY21E
ROAE (%)	22.5	22.1	18.2	20.7
ROACE (%)	16.7	18.4	16.9	19.3
Inventory Days	110	97	100	102
Debtors Days	53	51	54	53
Payable Days	55	42	48	56
Cash Conversion Cycle	109	106	107	99
Current Ratio	4.5	4.3	4.6	5.0
Gross Debt/EBITDA	3.0	2.2	1.8	1.6
Gross Debt/Equity	1.3	0.7	0.6	0.6
Adjusted Debt/Equity	1.3	0.8	0.6	0.6
Net Debt/Equity	1.2	0.5	0.5	0.4
Interest Coverage Ratio	4.2	4.3	5.0	6.2

Operating ratios

Year to March	FY18	FY19	FY20E	FY21E
Total Asset Turnover	1.1	1.1	1.0	1.1
Fixed Asset Turnover	2.1	2.3	2.2	2.2
Equity Turnover	2.5	2.2	1.9	2.0

Valuation parameters

Year to March	FY18	FY19	FY20E	FY21E
Adj. Diluted EPS (INR)	41.0	55.8	62.9	85.1
Y-o-Y growth (%)	*6.5*	*36.2*	*12.9*	*35.3*
Adjusted Cash EPS (INR)	60.6	77.3	88.8	116.3
Diluted P/E (x)	42.1	30.9	27.4	20.3
P/B (x)	8.9	5.4	4.6	3.9
EV / Sales (x)	4.2	3.2	2.9	2.3
EV / EBITDA (x)	23.1	16.9	15.8	12.4
Dividend Yield (%)	0.1	0.1	0.5	0.5
EV	160,790	162,960	167,977	167,309

Additional Data

Directors Data

Chandrakant V. Gogri	Chairman Emeritus	Rajendra V. Gogri	Chairman & Managing Director
Rashesh C. Gogri	Vice Chairman & Managing Director	Shantilal T. Shah	Vice Chairman
Parimal H. Desai	Whole Time Director	Manoj M. Chheda	Whole Time Director
Hetal Gogri Gala	Whole Time Director	Renil R. Gogri	Whole Time Director
Kirit R. Mehta	Whole Time Director	Ramdas M. Gandhi	Independent Director
Laxmichand K. Jain	Independent Director	Vijay H. Patil	Independent Director
K.V.S. Shyam Sunder	Independent Director	P.A. Sethi	Independent Director
Bhavesh R. Vora	Independent Director	Prof. Ganapati D. Yadav	Independent Director
Priti P. Savla	Independent Director		

Auditors - Gokhale & Sathe

Holding – Top10

	Perc. Holding		Perc. Holding
HDFC Asset management	7.64	L&T Mutual Fund	2.44
DSP Blackrock	2.04	L&T Invst Mgmt	1.53
Sundaram mutual fund	0.91	Dimensional Fund Advisors	0.81
Capital group	0.74	Vanguard Group Inc/The	0.63
Franklin Templeton Asset Management	0.58	Axis AMC	0.48

**as per last available data*

Bulk Deals

Data	Acquired / Seller	B/S	Qty Traded	Price
No Data Available				

**as per last available data*

Insider Trades

Reporting Data	Acquired / Seller	B/S	Qty Traded
18 Jun 2019	Nikhil Holdings Private Limited	Sell	40000.00
13 Jun 2019	Nikhil Holdings Private Limited	Sell	31321.00
09 Jan 2019	Chandrakant Vallabhaji Gogri	Sell	20000.00
22 Nov 2018	Chandrakant Vallabhaji Gogri	Sell	22810.00
19 Nov 2018	Chandrakant Vallabhaji Gogri	Sell	18000.00

**as per last available data*

India Midcaps

COMPANY UPDATE

PI INDUSTRIES

CSM business back on track; limited upside

India Equity Research | Speciality Chemicals

Edelweiss
Ideas create, values protect

PI Industries' (PI) CSM business has reported muted growth over the past two years due to sluggish global agrochemicals demand. However, it has picked up in H2FY19 (up 39% YoY) and we estimate it to post solid growth in FY20 driven by rise in customer enquires and burgeoning order book (USD1.35bn). Moreover, to capture the potential opportunities, the company has increased capex to INR3bn p.a. over the next two-three years. Also, product launches and a concentrated basket of specialty products will ensure growth in the domestic market. Bolstered by strong earnings growth (19% EPS CAGR over FY18-21E) and 25% ROCE, we remain positive on the stock. However, at our September 2020E target price of INR1,276 (30x P/E), we see limited upside. Hence, downgrade to 'HOLD'.

CSM: Global turnaround to drive growth

PI's CSM segment (65% of FY19 sales) segment is gaining steam. An uptick in the global agrochemical cycle attributable to increased spending by global innovators on patented products remains the key driving factor. We, bolstered by a robust USD1.3bn order book, are confident of sustaining the growth momentum (20%+ in near term). The company has announced further capex and will be commissioning two more plants (in addition to two commissioned recently) by March 2020.

Domestic: Product launches key trigger

The company outperformed peers in the domestic market in FY19. While PI's launches over the past two years have been successful in delivering incremental growth, existing products also continue to perform well. It launched seven new products in a span of two years. With a strong product pipeline in place, we are upbeat on company delivering double digit growth in the domestic agri space and outpacing the industry.

Outlook and valuation: Valuation concern; downgrade to 'HOLD'

We expect PI to ride the strong pick up in global agrochemicals and new product launches in the domestic market. Factoring the company's solid execution track record, growth opportunity in the CSM business and robust >25% ROCE, we value the stock at 30x P/E. However, at our September 2020E TP of INR1,276, we see limited upside from the current level. Hence, we downgrade to **'HOLD'** from 'BUY'.

Financials

Year to March	FY18	FY19	FY20E	FY21E
Net revenues	22,771	28,409	34,114	40,272
EBITDA	4,935	5,764	7,184	8,762
Adjusted Profit	3,675	4,102	5,317	6,415
Adjusted Diluted EPS	26.7	29.7	38.6	46.5
EPS growth (%)	*(20.2)*	*11.6*	*29.6*	*20.6*
Diluted P/E (x)	44.8	40.1	30.9	25.6
EV / EBITDA (x)	32.8	28.2	22.6	18.4
ROACE (%)	25.6	25.4	27.0	27.1

EDELWEISS RATINGS

Absolute Rating	**HOLD**
Investment Characteristics	Growth

MARKET DATA *(R: PIIL.BO, B: PI IN)*

CMP	: INR 1,192
Target Price	: INR 1,276
52-week range (INR)	: 1,230 / 676
Share in issue (mn)	: 138.0
M cap (INR bn/USD mn)	: 165 / 2,328
Avg. Daily Vol. BSE/NSE ('000)	: 151.5

SHARE HOLDING PATTERN (%)

	Current	Q3FY19	Q2FY19
Promoters *	51.4	51.4	51.4
MF's, FI's & BKs	19.3	19.3	19.1
FII's	13.1	13.1	13.1
Others	16.2	16.2	16.4

** Promoters pledged shares (% of share in issue) : NIL*

PRICE PERFORMANCE (%)

	BSE Midcap Index	Stock	Stock over Index
1 month	(6.3)	1.4	7.8
3 months	0.4	22.0	21.5
12 months	(11.6)	18.1	29.7

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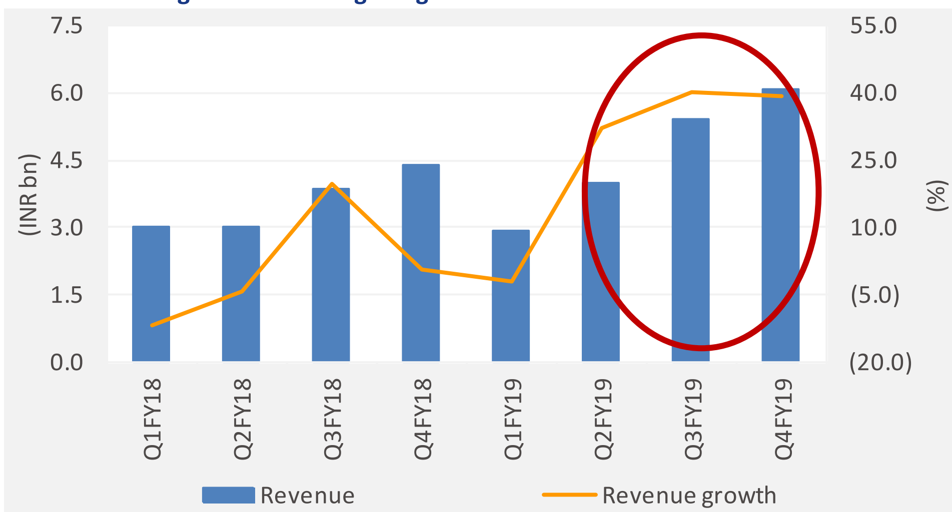
June 19, 2019

CSM: Gaining traction; industry outlook strong with robust order book

PI's CSM business (65% of revenues in FY19) has been affected from last 2 years due to weakness in global agrochemical demand. Though the company has seen continuous build up in its order book which notched up to US$1.35bn by Q4FY19 (5.1x order book-to-sales ratio compared to average of 4.1x over the past five years), however continuous deferment of orders has led to poor revenue growth.

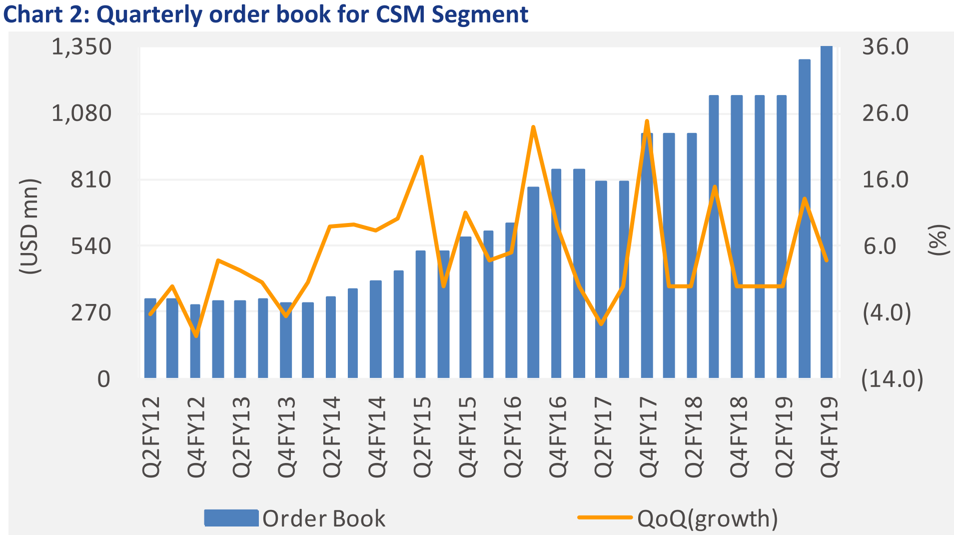
We have witnessed pick up in its CSM business from Q2FY19 with quarter showing YoY revenue growth of 32% in Q2FY19. The growth continues in H2FY19 with CSM sales posting 39%yoy growth

Chart 1: CSM segment sustaining the growth momentum



Pick up in execution also hinges on improvement in the global agrochemical cycle. Though global commodity prices are muted, signs of turnaround in the global agrochemical cycle are apparent given the lower inventory and also potential increase in outsourcing opportunities after conclusion of mega mergers.

Chart 2: Quarterly order book for CSM Segment



Source: Company, Edelweiss research

R&D has picked up pace; focus on new chemistry blocks and structures

PI, in order to enhance its opportunities, is focusing on work areas like fluorination, phosgenation, carboxylation, etc. Also, in FY18, the company's R&D team synthesised 48 new development molecules, of which 13 were scaled up successfully for next stage of development and four molecules were commercialised during the year.

Chart 3: R&D spends have picked up over past three years

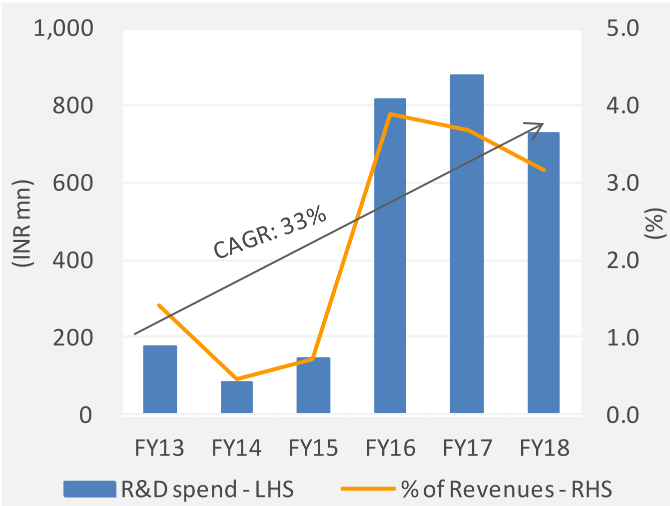
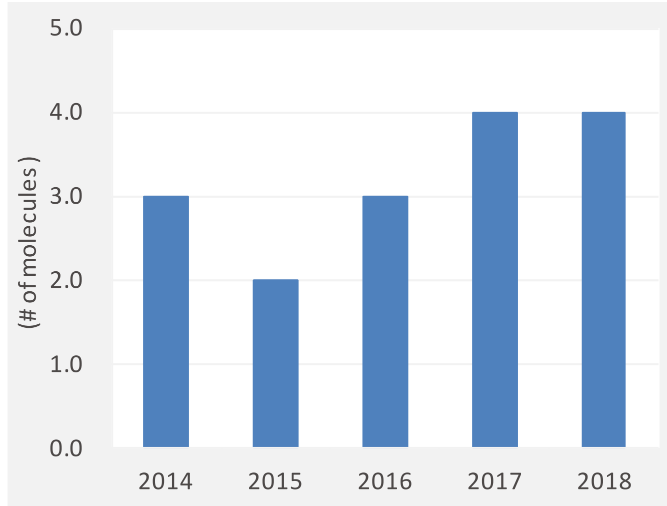


Chart 4: Export molecules commercialisation trend robust

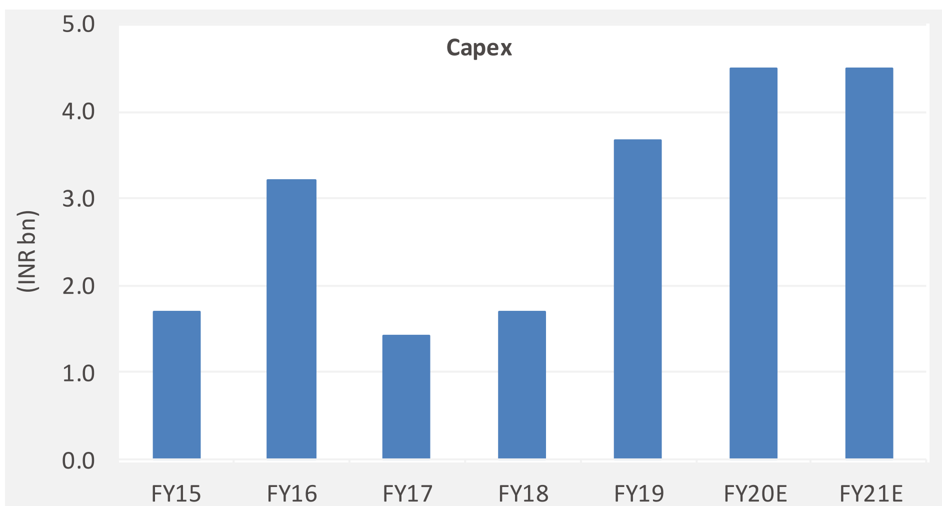


Source: Company, Edelweiss research

Beefing up to capture potential opportunities through capex

PI has chalked out an aggressive INR3bn/year capex plan for the next two-three years. The company has also added capacities at Jambusar (two new plants) and initiated construction of a couple of plants, which are expected to be commissioned in 2020. Management is confident of achieving 1.5-1.6x turnover with 90-95% utilisation level within 18 months.

Chart 5: Aggressive capex plans on the back of robust order book and visibility

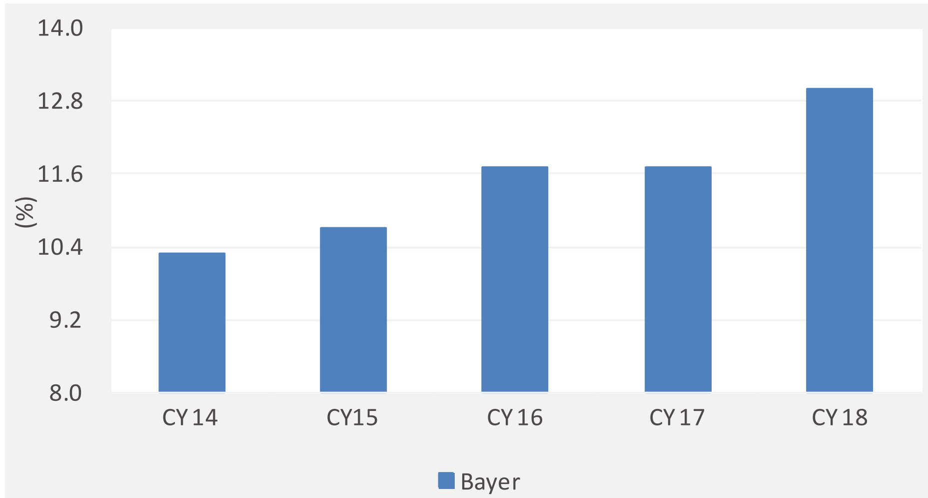


Source: Company, Edelweiss research

Global innovators focusing back on R&D

R&D expense of global innovator Bayer has been on an upward trajectory. This can be attributed to sharpening focus of MNCs on introducing new products in the market. In CY18, the ratio of Bayer's R&D expense to sales in the crop science division was 13%. The upward growth trajectory in R&D by global innovators bodes well for CSM players.

Chart 6: Bayer CropScience—Ratio of R&D expenses to sales



Source: Company, Edelweiss research

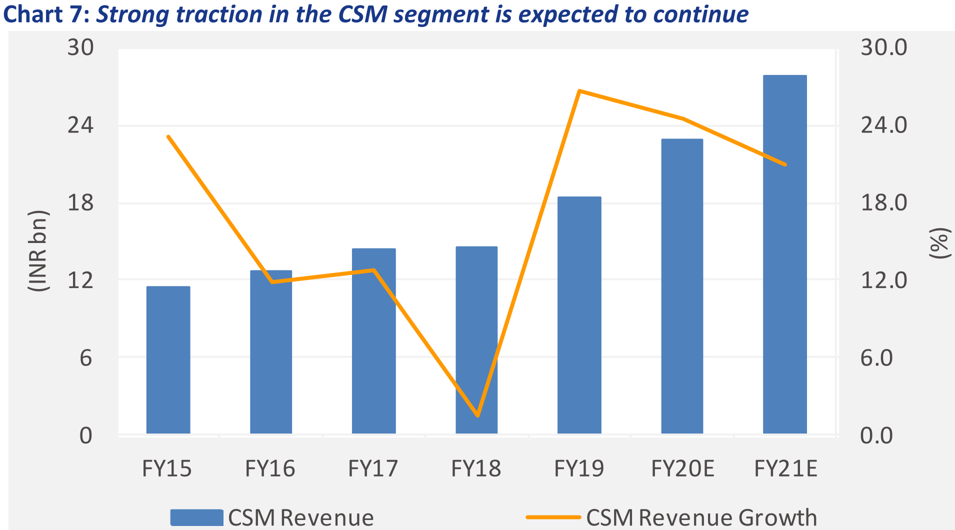
Table 1: Global performance—Performance of innovators by region

	FMC		BAYER		BASF		Syngeta	
	CY17	CY18	CY17	CY18	CY17	CY18	CY17	CY18
Europe	2.0	4.9	3.5	(3.0)	4.4	6.5	2.1	0.2
Asia Pacific	4.8	4.6	3.1	9.7	4.4	13.0	(31.4)	4.0
North America	9.6	15.9	8.2	7.5	14.2	13.0	5.9	0.8
LATAM	(0.2)	18.5	(20.9)	17.1	(9.2)	24.3	58.1	25.4

**FMC and Bayer: Like to Like Comparison*

Source: Bloomberg, Edelweiss research

Chart 7: *Strong traction in the CSM segment is expected to continue*



Source: Company, Edelweiss research

Table 2: Global innovators—Key highlights (CY18)

Companies	Key Highlights (Full Year CY18)
BASF	• Agriculture segment clocked slower sales growth of 2% YoY as cereal and soyabean yields in Europe, North & South America as well as South Africa were negatively impacted by an unusually long dry period • Agricultural output remained flat in West Europe and fell significantly in East Europe. The company recorded substantial losses from North America • Apart from weather-related issues, trade conflict with China negatively impacted US' soyabean exports to China • Strong upward trend in Asia
Dow Dupont	• Organic sales growth of 6% in crop protection was driven by new product sales, which were partly offset by currency pressure • Seed sales fell 4% on account of reduced planting/ sowing in US, Canada and LATAM
Bayer Monsanto	**Bayer increases sales and earnings - leader in agriculture after acquisition** • Latin America continues to perform well and sales were up 17%. Growth was primarily driven by improved performance in herbicides coupled with the company’s effort in normalising channel inventory. The company recorded positive sales growth of 8% in North America and 10% in Asia Pacific region, all on a currency and portfolio adjusted basis • Adverse weather conditions across Europe and loss of registration in France impacted the company’s performance in the region • Sales benefitted from service agreements with BASF on divested businesses • **Glyphosate litigation:** Recent studies conducted by the National Cancer Institute-supported Agricultural Health Study found no association between glyphosate-based products and non-Hodgkin lymphoma at any level of exposure
Syngeta	• Sales in Europe were impacted by delayed crop season in the region due to drought situation. This affected fungicides sales in the region. However, good sales growth in the seed segment along with improved product mix in East Europe mitigated the impact • Crop protection sales in North America were up 2% YoY driven by new product launches. Seed sales fell 3% YoY due to weak demand across the region with decline in corn and soya acreage • Latin America: Sales volume in crop protection rebounded to normal level after a difficult 2017. While crop protection sales grew 20% YoY, seed sales jumped 55% YoY followed by acquisition of Nidera. Increased acreage of soya and cotton helped drive demand. • Asia: Recovery in South Asia led to sales growth of 1% with seed sales growth of 6%. Farmers' shift to higher-value products helped the company realise 6% growth from China

Source: Company, Edelweiss research

Domestic agri input: Outperformance to sustain

PI has outperformed peers in the domestic market in FY19. New products launched by the company over the past two years have been successful in delivering incremental growth, while existing products continue to perform well. The company has launched seven new products in a span of two years. With a strong product pipeline in place, management remains upbeat on delivering double digit growth in the domestic agri market. PI has been one of the fastest-growing companies in the domestic agri space. While FY19 has been a moderate year for agri input players, PI’s top line surpassed the industry average.

Table 3: Performance of domestic agrochemical companies

Company	Q1FY17	Q2FY17	Q3FY17	Q4FY17	FY17	Q1FY18	Q2FY18	Q3FY18	Q4FY18	FY18	Q1FY19	Q2FY19	Q3FY19	Q4FY19	FY19
Bayer Cropscience	8,212	11,038	6,625	2,153	28,028	6,980	12,320	4,797	3,002	27,099	8,318	11,041	6,210	1,288	26,857
UPL	11,940	9,090	5,600	4,340	30,970	11,180	9,970	6,140	4,600	31,890	12,480	10,770	4,860	5,056	33,166
Rallis India	2,603	4,933	3,066	3,283	13,885	2,436	5,485	3,573	3,491	14,984	3,524	6,132	3,882	3,177	16,715
PI Industries	3,434	2,281	1,649	1,699	9,062	2,848	2,591	1,517	1,874	8,830	3,114	3,244	1,671	1,951	9,979
Dhanuka Agritech	2,003	3,124	2,118	1,588	8,833	2,080	3,480	2,215	1,851	9,626	2,130	3,834	2,168	1,927	9,945
Insecticide India	2,739	4,136	1,591	1,760	10,225	3,119	4,165	1,759	1,689	10,733	3,189	4,583	2,157	1,989	11,919
Total (INR mn)	**30,931**	**34,602**	**20,648**	**14,824**	**101,004**	**28,642**	**38,012**	**20,001**	**16,507**	**103,162**	**32,755**	**39,604**	**20,949**	**15,387**	**108,582**

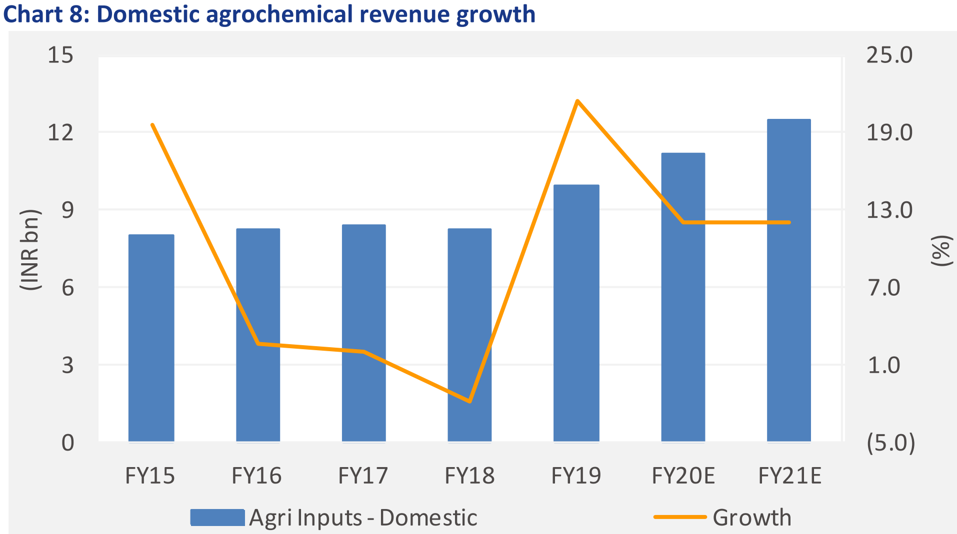
Revenue growth(%	Q1FY17	Q2FY17	Q3FY17	Q4FY17	FY17	Q1FY18	Q2FY18	Q3FY18	Q4FY18	FY18	Q1FY19	Q2FY19	Q3FY19	Q4FY19	FY19
Bayer Cropscience	7.9	9.2	21.0	(52.1)	1.2	(15.0)	11.6	(27.6)	39.4	(3.3)	19.2	(10.4)	29.5	(57.1)	(0.9)
UPL	13.2	8.7	7.5	(5.9)	7.8	(6.4)	9.7	9.6	6.0	3.0	11.6	8.0	(20.8)	9.9	4.0
Rallis India	2.1	17.2	7.4	0.5	7.8	(6.4)	11.2	16.5	6.3	7.9	44.7	11.8	8.7	(9.0)	11.6
PI Industries	26.9	(2.2)	5.0	(2.0)	8.6	(17.1)	13.6	(8.0)	10.3	(2.6)	9.3	25.2	10.1	4.1	13.0
Dhanuka Agritech	11.0	15.6	2.8	(8.9)	6.3	3.9	11.4	4.6	16.5	9.0	2.4	10.2	(2.1)	4.1	3.3
Insecticide India	(4.0)	11.8	2.8	(1.2)	3.5	13.9	0.7	10.6	(4.0)	5.0	2.3	10.0	22.6	17.8	11.1
Total (%)	**10.2**	**10.2**	**10.3**	**(15.9)**	5.4	**(7.4)**	**9.9**	**(3.1)**	**11.4**	**2.1**	**14.4**	**4.2**	**4.7**	**(6.8)**	**5.3**

Source: Company, Edelweiss research

Product mix to improve with new launches

PI's product portfolio has transitioned. The company's strategy behind new product launches has started yielding results. The revenue mix, which earlier was concentrated on *Nominee Gold* has diversified. *Nominee Gold*, though a market leader in rice herbicide, is seeing signs of stagnation. However, the company's *Osheen* and *Virbant* brands have performed well and evinced good response from farmers.

Chart 8: Domestic agrochemical revenue growth

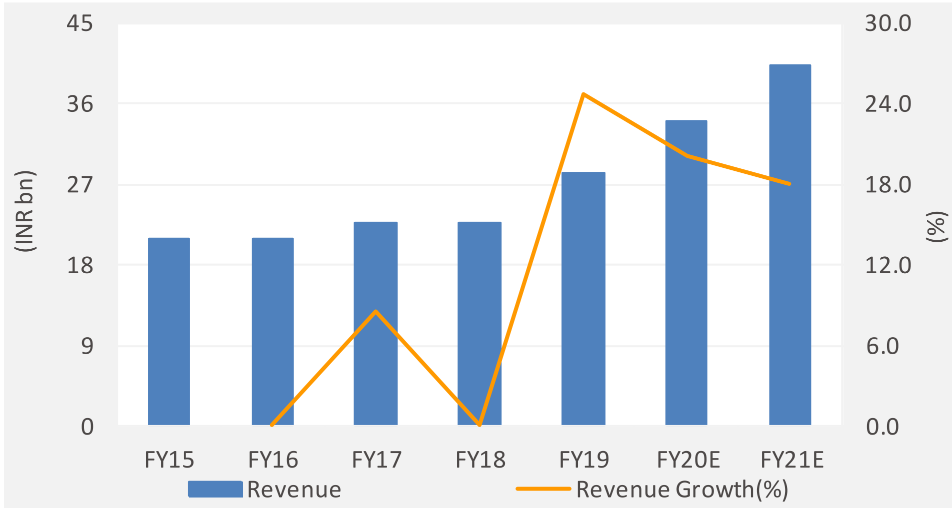


Source: Company, Edelweiss research

Financial Outlook

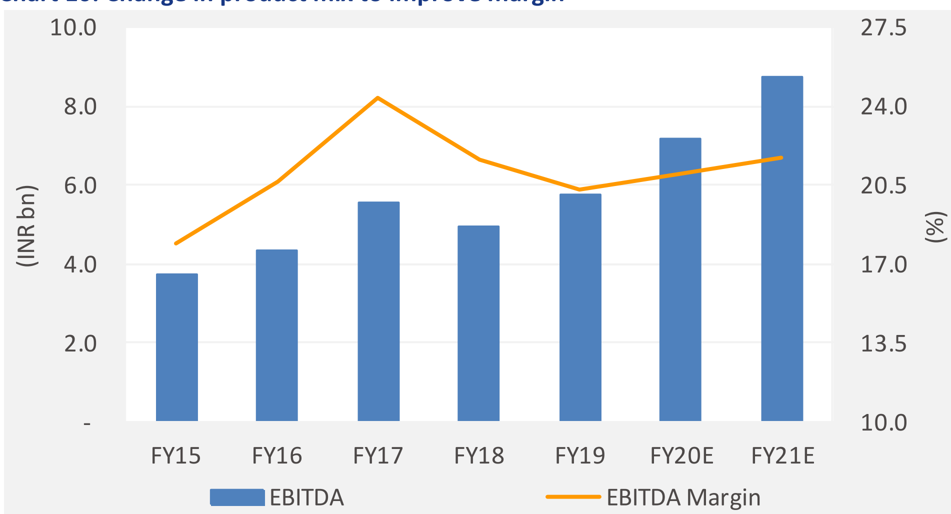
PI's revenue growth over FY15-18 was tepid on account of weak global agricultural outlook. However, recent uptick in the global agri cycle augurs well for the company's CSM business. With a healthy USD1.3bn order book, we expect the CSM business to remain the primary growth driver, clocking sales CAGR of 12% over FY19-21E. The improvement in margins is likely to be provided by change in product mix.

Chart 9: CSM segment to drive revenue growth over FY19-21E



Source: Company, Edelweiss research

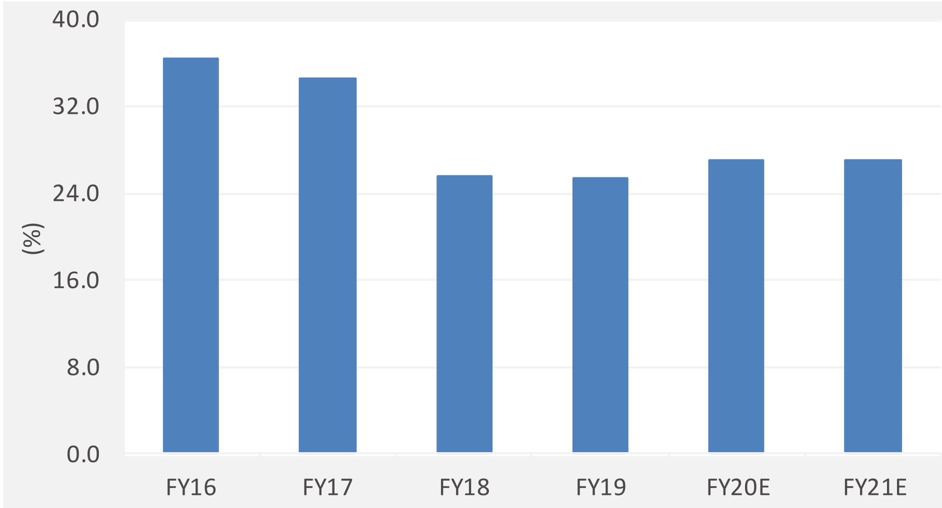
Chart 10: Change in product mix to improve margin



Source: Company, Edelweiss research

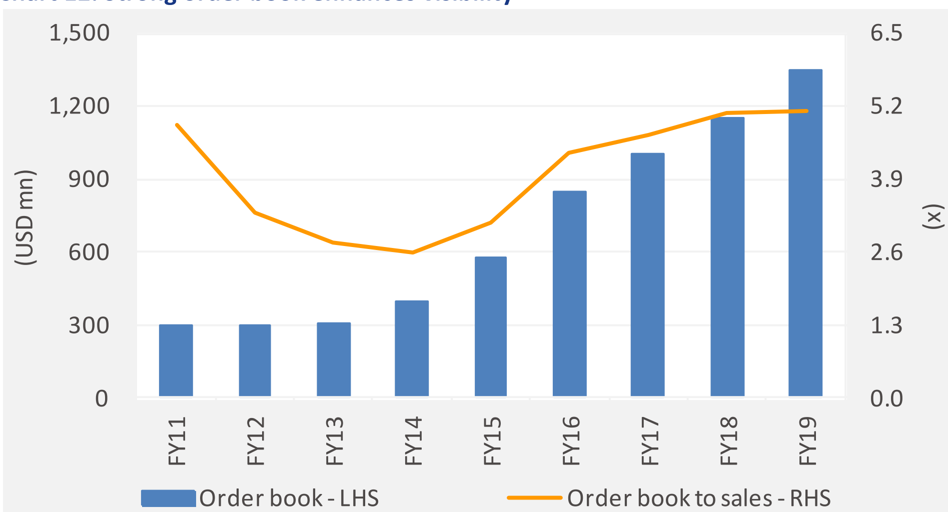
PI has been maintaining a strong order book. The company current order book stands at USD 1.35bn. The company maintains a healthy ROCE of more than 25%.

Chart 11: ROCE to remain stable as capex will pick-up



Source: Company, Edelweiss research

Chart 12: Strong order book enhances visibility



Source: Company, Edelweiss research

Outlook and valuation: Valuation concern; downgrade to 'HOLD'

We expect PI to ride the strong pick up in global agrochemicals and new product launches in the domestic market. Factoring the company's solid execution track record, growth opportunity in the CSM business and robust >25% ROCE, we value the stock at 30x P/E. However, at our September 2020E TP of INR1,276, we see limited upside from the current level due to sharp run up in the stock. Hence, we downgrade to **'HOLD'** from 'BUY'.

Chart 13: P/E Valuation Chart - PI Industries

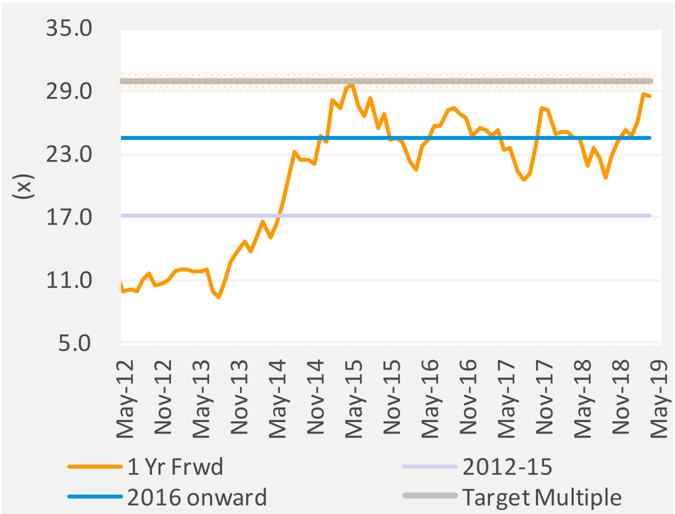
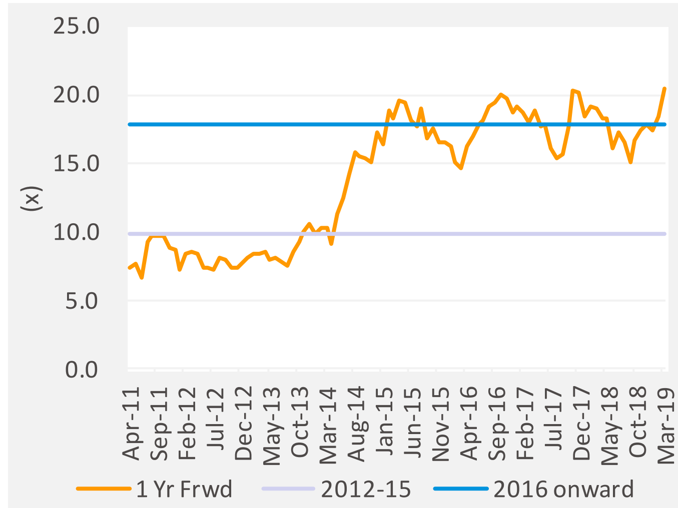


Chart 14: EV/EBITDA Valuation Chart – PI Industries



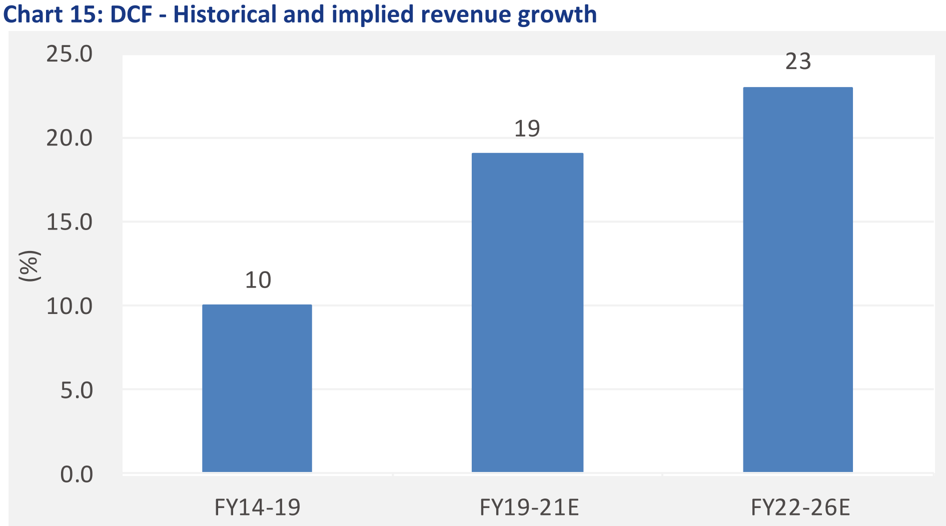
Source: Company, Bloomberg, Edelweiss research

DCF model implies 23% revenue growth

For PI, we have used P/E based valuation metrics to arrive at target price as it better captures earnings growth momentum. We have also used the reverse DCF model to calculate the implied growth built in at our target price. As we believe that recent favourable industry scenario offers higher growth potential, we have factored five years of high growth (FY22-26) and five years of moderate growth (FY27-31). We have used 12% WACC and terminal growth of 6%.

Implied revenue growth in our three stage DCF model for FY22-26 (high growth phase) works out to 23% in revenue at our target price of INR1,276. Though implied growth at 23% looked stretched given PI has delivered 10% revenue CAGR in FY14-19, we believe favourable industry scenario, pick up in global agrochemicals and accelerated capex are likely to facilitate this growth.

Chart 15: DCF - Historical and implied revenue growth



Source: Company, Edelweiss research

Company Description

Incorporated in 1947, PI (erstwhile Pesticides India) focuses on agri-input, custom synthesis and polymer compounding with strength of over 1,100 employees. The company currently operates three formulation and two manufacturing facilities as well as five multi-product plants across Gujarat and Jammu, and one R&D unit in Rajasthan at Udaipur. PI is one of India's leading players in the agri-input industry, primarily dealing in agro-chemicals, specialty fertilisers, plant nutrients and seeds. The company has exclusive rights with several global corporations for distribution in India and is constantly evaluating prospects to further expand its product portfolio. The company has a strong product portfolio as a result of exclusive tie-ups with leading agro-chemical, pharmaceutical and fine chemical companies around the world.

Investment Theme

PI is the preferred partner for global MNCs for custom synthesis on account of its competencies in process research and manufacturing, coupled with its non-compete and IP driven business model. The company has built a strong order book of USD1bn to be executed within the next three-four years and incurred capex of ~INR1.8bn on the Jambusar plant. EBITDA margin is likely to expand owing to improving product mix, higher operating leverage and sale of the low-margin polymer business.

Key Risks

Any execution delay in setting up new capacities is likely to impact growth in the custom synthesis business.

India's agriculture is largely dependent on monsoon. Hence, poor monsoon could be a demand dampener for the agri-input division.

On account of low liquidity in the stock, it could act volatile.

USD/INR volatility may impact export revenue as well as margin.

Financial Statements

Key Assumptions

Year to March	FY18	FY19	FY20E	FY21E
Macro				
GDP(Y-o-Y %)	6.7	7.1	7.1	7.3
Inflation (Avg)	3.6	3.7	4.0	4.5
Repo rate (exit rate)	6.0	6.3	5.8	5.8
USD/INR (Avg)	64.5	70.0	72.0	72.0
Company				
Raw Material (% net rev)	51.3	54.6	53.8	53.1
Other exp (% net rev)	16.3	15.8	15.8	15.8
Employee cost (% of rev)	10.7	9.3	9.3	9.3
Agri prod rev gwth (%)	(1.9)	21.4	12.0	12.0
Custom synth rev gwth(%)	1.4	26.6	24.5	21.0
Tax rate as % of PBT	21.0	23.7	22.0	22.0
Capex (INR mn)	1,697	3,668	4,500	4,500
Net borrowings (INR mn)	(2,439)	(1,912)	(2,064)	(3,541)
Debtor days	76	76	77	78
Inventory days	138	116	117	119
Payable days	102	104	109	109
Cash conversion cycle	112	89	85	88
Interest Exp (% of Debt)	1.0	1.0	1.0	1.0
Dep. (% gross block)	7.3	6.9	6.9	6.9

Income statement (INR mn)

Year to March	FY18	FY19	FY20E	FY21E
Net revenue	22,771	28,409	34,114	40,272
Materials costs	11,690	15,502	18,367	21,402
Gross profit	11,081	12,907	15,746	18,870
Employee costs	2,431	2,647	3,173	3,745
Other Expenses	3,715	4,496	5,390	6,363
EBITDA	4,935	5,764	7,184	8,762
Depreciation	830	930	1,177	1,488
EBIT	4,105	4,834	6,007	7,274
Less: Interest Expense	53	50	-	-
Add: Other income	602.5	595.00	810.00	950.00
Profit Before Tax	4,654	5,379	6,817	8,224
Less: Provision for Tax	979	1,277	1,500	1,809
Reported Profit	3,675	4,102	5,317	6,415
Adjusted Profit	3,675	4,102	5,317	6,415
Shares o /s (mn)	138	138	138	138
Adjusted Basic EPS	26.7	29.7	38.6	46.5
Diluted shares o/s (mn)	138	138	138	138
Adjusted Diluted EPS	26.7	29.7	38.6	46.5
Adjusted Cash EPS	32.7	36.5	47.1	57.3
Dividend per share (DPS)	4.0	4.0	4.0	4.0
Dividend Payout Ratio(%)	15.0	13.4	13.4	8.6

Common size metrics

Year to March	FY18	FY19	FY20E	FY21E
Cost of goods sold	48.7	45.4	46.2	46.9
EBITDA margins	21.7	20.3	21.1	21.8
EBIT margins	18.0	17.0	17.6	18.1
Net Profit margins	16.1	14.4	15.6	15.9

Growth ratios (%)

Year to March	FY18	FY19	FY20E	FY21E
Revenues	-	24.8	20.1	18.1
EBITDA	(11.1)	16.8	24.6	22.0
PBT	(8.7)	15.6	26.7	20.6
Adjusted Profit	(20.0)	11.6	29.6	20.6
EPS	(20.2)	11.6	29.6	20.6

Balance sheet (INR mn)

As on 31st March	FY18	FY19	FY20E	FY21E
Share capital	138	138	138	138
Reserves & Surplus	19,110	22,716	27,368	33,119
Shareholders' funds	19,248	22,854	27,506	33,257
Long term borrowings	463	99	-	-
Total Borrowings	463	99	-	-
Long Term Liabilities	416	480	563	612
Def. Tax Liability (net)	(267)	(141)	(141)	(141)
Sources of funds	**19,860**	**23,292**	**27,928**	**33,728**
Gross Block	11,996	14,811	19,311	23,811
Net Block	9,906	11,791	15,114	18,126
Intangible Assets	279	350	350	350
CWIP (incl. intangible)	691	1,544	1,544	1,544
Total net fixed assets	10,876	13,685	17,008	20,020
Non current investments	11	172	172	12
Cash and Equivalents	2,902	2,011	2,064	3,541
Inventories	4,520	5,357	6,429	7,491
Sundry Debtors	5,268	6,618	7,846	9,263
Loans & Advances	76	104	109	122
Other Current Assets	2,344	3,460	3,862	4,478
Current Assets (ex cash)	12,208	15,539	18,246	21,353
Trade payable	3,687	5,130	5,878	6,849
Other Current Liab	2,450	2,985	3,684	4,349
Total Current Liab	6,137	8,115	9,562	11,198
Net Curr Assets-ex cash	6,071	7,424	8,685	10,155
Uses of funds	**19,860**	**23,292**	**27,928**	**33,728**
BVPS (INR)	139.6	165.7	199.5	241.2

Free cash flow (INR mn)

Year to March	FY18	FY19	FY20E	FY21E
Reported Profit	3,675	4,102	5,317	6,415
Add: Depreciation	830	930	1,177	1,488
Interest (Net of Tax)	42	38	-	-
Others	(311)	(482)	(810)	(950)
Less: Changes in WC	1,756	1,289	1,178	1,421
Operating cash flow	2,480	3,299	4,507	5,531
Less: Capex	1,697	3,668	4,500	4,500
Free Cash Flow	**783**	**(369)**	**7**	**1,031**

Cash flow metrics

Year to March	FY18	FY19	FY20E	FY21E
Operating cash flow	2,480	3,299	4,507	5,531
Financing cash flow	(1,060)	(1,079)	(764)	(665)
Investing cash flow	(1,805)	(3,234)	(3,690)	(3,390)
Net cash Flow	(385)	(1,013)	53	1,477
Capex	(1,697)	(3,668)	(4,500)	(4,500)
Dividend paid	(552)	(665)	(665)	(665)

Profitability and efficiency ratios

Year to March	FY18	FY19	FY20E	FY21E
ROAE (%)	20.7	19.5	21.1	21.1
ROACE (%)	25.6	25.4	27.0	27.1
Inventory Days	138	116	117	119
Debtors Days	76	76	77	78
Payable Days	102	104	109	109
Cash Conversion Cycle	112	89	85	88
Current Ratio	2.5	2.2	2.1	2.2
Debt/EBITDA (x)	0.1	-	-	-
Debt/Equity (x)	-	-	-	-
Adjusted Debt/Equity	-	-	-	-
Net Debt/Equity	(0.1)	(0.1)	(0.1)	(0.1)
Interest Coverage Ratio	77.5	96.7	-	-

Operating ratios

Year to March	FY18	FY19	FY20E	FY21E
Total Asset Turnover	1.2	1.3	1.3	1.3
Fixed Asset Turnover	2.3	2.5	2.5	2.4
Equity Turnover	1.3	1.3	1.4	1.3

Valuation parameters

Year to March	FY18	FY19	FY20E	FY21E
Adj. Diluted EPS (INR)	26.7	29.7	38.6	46.5
Y-o-Y growth (%)	*(20.2)*	*11.6*	*29.6*	*20.6*
Adjusted Cash EPS (INR)	32.7	36.5	47.1	57.3
Diluted P/E (x)	44.9	40.2	31.0	25.7
P/B (x)	8.6	7.2	6.0	5.0
EV / Sales (x)	7.1	5.7	4.8	4.0
EV / EBITDA (x)	33.0	28.3	22.7	18.4
Dividend Yield (%)	0.3	0.3	0.3	0.3

Peer comparison valuation

	Market cap	Diluted P/E (X)		EV / EBITDA (X)		ROAE (%)	
Name	(USD mn)	FY20E	FY21E	FY20E	FY21E	FY20E	FY21E
PI Industries	2,328	31.0	25.7	22.7	18.4	21.1	21.1
Bayer Cropscience	1,680	23.5	20.5	13.7	11.5	16.3	16.5
Dhanuka Agritech	268	13.8	12.5	9.5	8.5	19.5	19.3
Rallis India	412	14.8	12.3	9.5	7.9	14.4	15.8
UPL	6,356	15.3	13.0	9.1	7.9	17.8	17.9
Median	-	15.3	13.0	9.5	8.5	17.8	17.9
AVERAGE	-	19.7	16.8	12.9	10.9	17.8	18.1

Source: Edelweiss research

Additional Data

Directors Data

Mr. Narayan K. Seshadri	Independent Non-Executive Chairman	Mr. Mayank Singhal	Managing Director and CEO
Mr. Rajnish Sarna	Executive Director	Mr. Arvind Singhal	Additional Director, Non Independent - Non Executiv
Mr. Ravi Narain	Independent Non-Executive Director	Mrs. Ramni Nirula	Independent Non-Executive Director
Dr T.S. Balganesh	Additional Director, Independent Non-Executive Director	Mr. Pravin K. Laheri	Independent Non-Executive Director

Auditors - B.D. Gargeiya & Co, S.S. Kothari Mehta & Co.

*as per last available data

Holding Top -10

	Perc. Holding		Perc. Holding
Jackson National Asset Mgmt	5.11	UTI Asset Mgmt	3.36
Prudential ICICI Asset Mgmt	4.45	DSP Blackrock Investment Manager	1.44
SBI Fund Management	3.99	Stitching Depository	1.41
Cartika Capital	3.5	Kotak Asset Management	1.3
Franklin Resources	3.5	Vanguard	1.28

Bulk Deals

Data	Acquired / Seller	B/S	Qty Traded	Price
No Data Available				

*as per last available data

Insider Trades

Reporting Data	Acquired / Seller	B/S	Qty Traded
24 May 2019	Junichi Nakano	Sell	17000.00
20 Dec 2018	Junichi Nakano	Sell	15000.00

*as per last available data

India Midcaps

COMPANY UPDATE

SRF

Time to cash in on chemical investments

India Equity Research| Speciality Chemicals

Edelweiss
Ideas create, values protect

SRF's chemical business is a strong beneficiary of the pick-up in global agrochemicals and, therefore, expected to grow 40–50% in FY20 in our view. Doubling of capacity in refrigerant gases in FY20 would further boost segmental profit. We expect the chemical segment EBIT to effervesce by 75% in FY20. However, packaging films (40% of FY19 EBIT) and technical textiles (29%) may face margin pressure with new capacity additions in Q2/Q3FY20 and weak demand, respectively. Nevertheless, with activity in chemicals picking up, we expect overall PAT CAGR to spike from 13% over FY17–19 to 20% over FY19–21E. That said, we believe current valuations driven by a 25% run-up in the stock over three months limits near-term upside potential although we remain confident about long-term growth prospects. Downgrade to 'HOLD' with an SoTP-based TP of INR2,983.

Chemicals: Investments in place, time to reap benefit

SRF invested over INR28bn in the chemicals business over the past five years. Investments in specialty chemicals stood at INR18bn with revenue of INR10bn in FY19. With global agrochemicals slowing, the segment's underperformance has pressured overall profitability (EBIT margin down to 15.7% in FY19 from 24% in FY16). A likely pickup in global agrochemicals and doubling of refrigerant gas capacity would drive segmental revenue/EBIT CAGR of 25%/48% over FY19–21E in our view.

Technical textiles and packaging films may slow down

The favourable cycle in technical textiles and packaging films over the past two years helped SRF push up overall profitability and overcome weakness in the chemicals business. The focus on moving up the value chain in these businesses has abated cyclical volatility and helped generate steady cash flow. That said, given cyclicality of these industries, margins in the packaging films and technical textiles divisions may reel given capacity additions in Q2/Q3FY20 and weak demand, respectively.

Outlook and valuation: Valuation concern; downgrade to 'HOLD'

We believe momentum in the chemical segment's revenue is likely to sustain along with a gradual pickup in margin. That said, while strong structural growth in specialty chemicals is clearly visible, a sharp run-up in the stock limits upside potential in the near term. Downgrade to **'HOLD'** with an SoTP-based TP of INR2,983 (September 2020E EV/EBITDA multiple unchanged—technical textiles: 7x, C&P: 14x, packaging: 6x).

Financials **(INR mn)**

Year to March	FY18	FY19	FY20E	FY21E
Net revenue	55,890	76,927	79,695	88,556
EBITDA	8,104	13,790	16,491	18,623
Adjusted Profit	3,310	6,601	8,132	9,533
Adjusted diluted EPS (INR)	57.6	115.0	141.6	166.0
Diluted P/E (x)	52.7	26.4	21.5	18.3
EV/EBITDA (x)	25.1	14.8	12.3	10.7
ROAE (%)	9.8	17.2	18.2	18.2

EDELWEISS RATINGS

Absolute Rating	**HOLD**
Investment Characteristics	Growth

MARKET DATA *(R: SRFL.BO, B: SRF IN)*

CMP	: INR 3,040
Target Price	: INR 2,983
52-week range (INR)	: 3,049 / 1,530
Share in issue (mn)	: 57.5
M cap (INR bn/USD mn)	: 175 / 2,450
Avg. Daily Vol. BSE/NSE ('000)	: 451.2

SHARE HOLDING PATTERN (%)

	Current	Q3FY19	Q2FY19
Promoters *	52.3	52.3	52.3
MF's, FI's & BKs	9.3	9.3	10.4
FII's	19.2	19.2	18.7
Others	19.2	19.2	18.6

** Promoters pledged shares (% of share in issue) : NIL*

PRICE PERFORMANCE (%)

	BSE Midcap Index	Stock	Stock over Index
1 month	(6.3)	(0.6)	5.8
3 months	0.4	9.9	9.4
12 months	(11.6)	9.1	20.7

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June 19, 2019

Chemicals – Both refrigerants and specialty chemicals ready to fire

Specialty chemicals contribution slides to 34% from 51% in FY16

The chemicals business contributed 32% to overall revenue and 34% to overall EBIT in FY19. Specialty chemicals contributed 40% to the overall chemicals business during the year, down from its peak of 56% in FY16. Global slowdown in agrochemicals sector that makes up more than 80% of the overall specialty chemicals business impacted SRF's performance.

Chart 1: Chemicals contributed 32% to total revenue in FY19

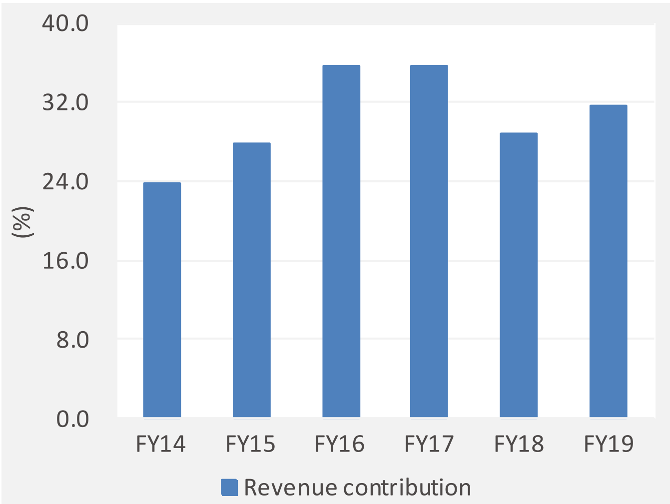
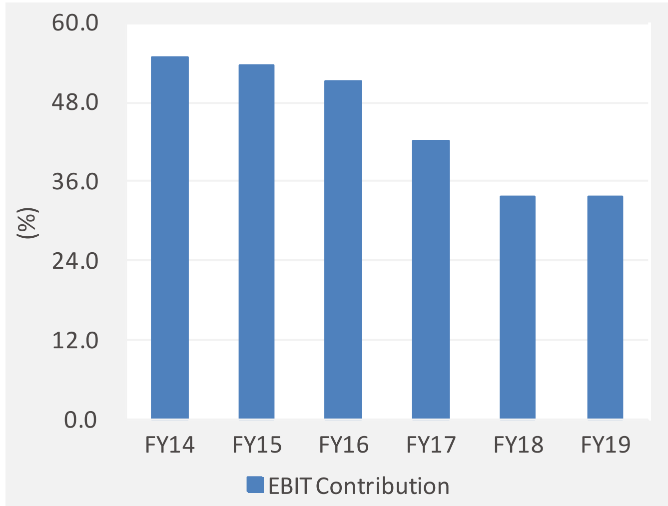


Chart 2: Chemicals contributed 34% to total EBIT in FY19



Source: Company, Edelweiss research

Margins in chemicals business dropped from 24% in FY16 to 15.7% in FY19 owing to subdued performance and continued investments

Muted agrochemicals, continued investments tamp down margins

The chemicals business used to clock an EBIT margin upward of 20% until FY16. Its margins dropped from 24% in FY16 to 15.7% in FY19 owing to a subdued performance and continued investments. The subdued performance stems from the slowdown in the agrochemical industry, which in turn was impacted by declining crop prices, adverse climatic conditions in Brazil and many other Asian countries, and higher channel inventories—all of which dented expenditure on agrochemicals.

Chart 3: EBIT margin declined to 15.7% in FY19

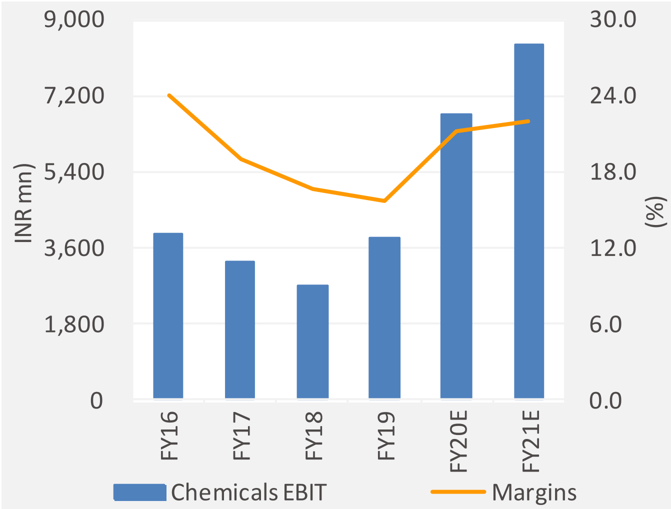
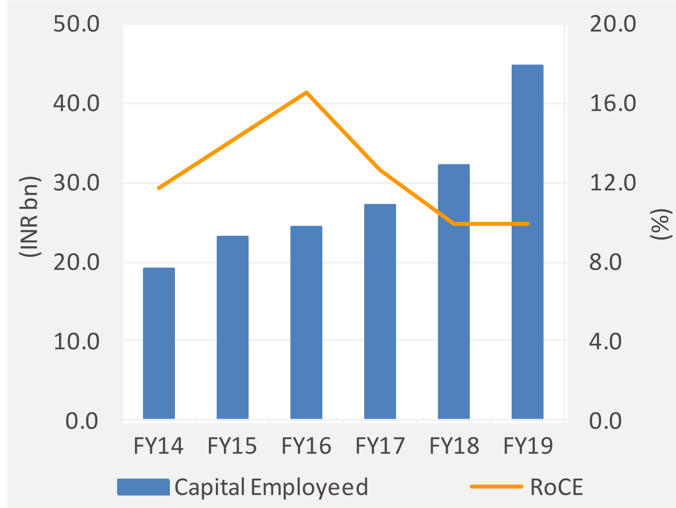


Chart 4: ROCE of chemicals segment dropped to 10% in FY19



Source: Company, Edelweiss research

SRF's Chemical segment EBITDA margins are highest in the industry

Despite a sharp 840bps-fall over FY16–19, SRF's chemical business EBITDA margins of 25% are still the highest in the industry. The performance/margins of this segment were impacted by the slowdown in global agrochemicals over the past two–three years. Inventory levels have moderated in the wake of a pickup in demand and the industry is poised for strong growth in coming years.

Chart 5: EBITDA margin highest in industry

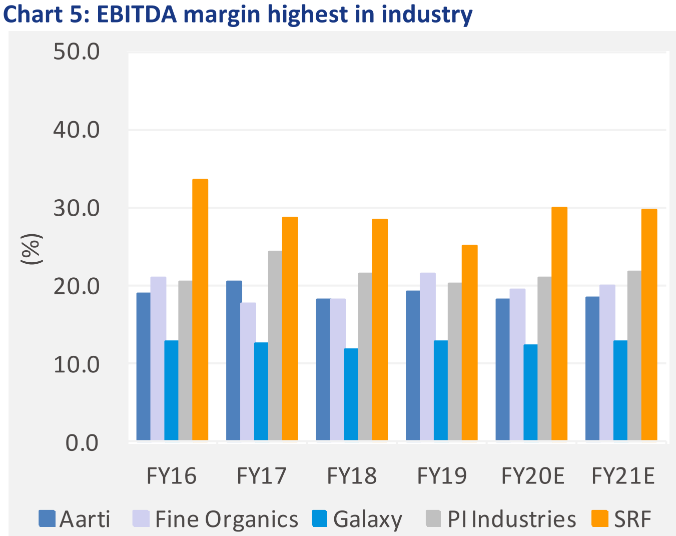
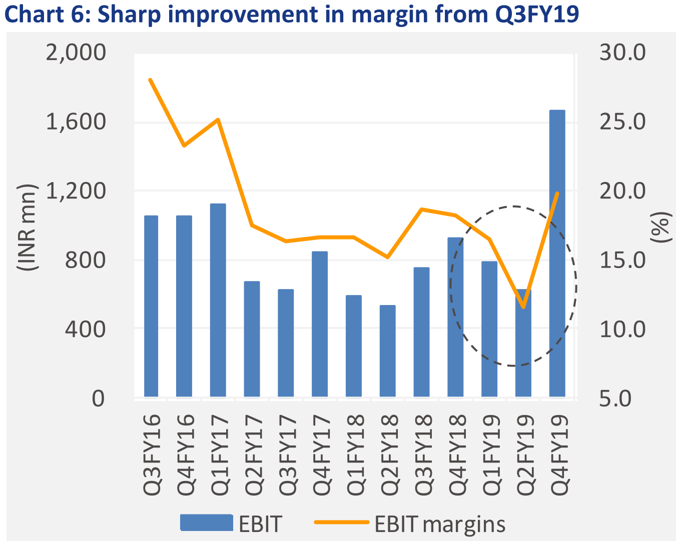


Chart 6: Sharp improvement in margin from Q3FY19



Source: Company, Edelweiss research

In fact, management has acknowledged the pick-up in specialty chemicals business with strong revenue growth seen in both Q2FY19 and Q3FY19. The segment's EBIT margin too improved to 19.8% in Q4FY19 from the bottom of 11.6% in Q2FY19. Continued growth in this business is driven by optimum utilisation of the chloromethane plant, increase in prices across products, and a gradual pick-up in agrochemicals demand globally.

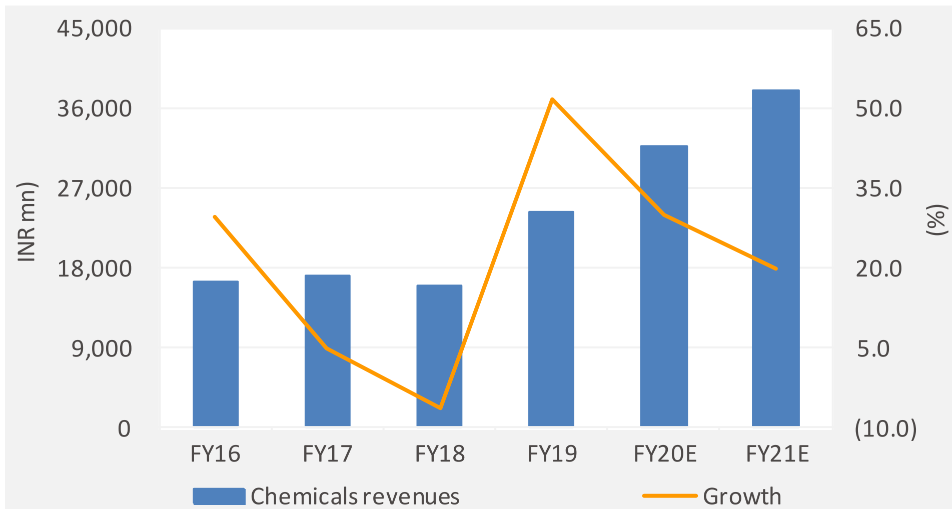
In FY20, the company is confident of 40–50% uptick in specialty chemicals and 20% YoY in fluorochemicals

We believe SRF is set to benefit from a potential recovery in the agro market given its robust product pipeline, healthy product approvals and investments in building up capabilities over the past two–three years. Total investment in specialty chemicals business stands at INR18bn, which has potential to generate revenue of INR18–25bn with 18–20% EBIT margin. In FY19, specialty chemicals business's revenue stood at INR10bn with an EBIT margin of 15.7%.

Management confident of robust growth in FY20

In FY19, the chemicals segment clocked solid growth of 52% YoY led by optimum utilisation of the chloromethane plant, increase in prices across products and a gradual pickup in agro-chemicals' demand globally. Going ahead, management is confident of a 40–50% uptick in specialty chemicals and 20% YoY in fluorochemicals (led by capacity addition in refrigerants by June/July, 2019 in contrast to currently constrained capacity) in FY20. Followed by a pickup in revenue and improvement in utilisation, SRF is confident the segment's EBIT margin would improve. The strong growth outlook is premised on a promising order book in the specialty chemicals business.

Chart 7: Chemicals revenue to clock 25% CAGR over FY19–21E



Source: Company, Edelweiss research

Table 1: Capacity expansions in chemicals business

Date of announcement	Description	Amount (INR Mn)	Commissioning
May, 2014	Setting up of Multipurpose Plant 2	1,400	Mar-15
Aug, 2014	Setting up of specialty chemical plant at Dahej	1130	Mar-15
Feb, 2015	Enhancing the R&D capability at Bhiwadi	250	Nov-16
May, 2015	Setting up of dedicated plant for manufacturing of specialty chemicals for pharma sector at Dahej	486	Jan-16
Aug, 2015	Setting up a R-134a pharma grade manufacturing at Dahej	260	Mar-16
Aug, 2015	Converting HFC134a plant at Bhiwadi into a swing plant to produce both HFC 134a and HFC 32.	120	Mar-16
Apr, 2016	To set up a pilot plant for new generation HFO 1234yf	n.a	n.a
Aug, 2016	Expanding Chloromethane capacity by 40,000 TPA	1,650	Dec-17
Aug, 2016	Setting up Multi-Purpose Plant	1,800	Dec-17
Aug, 2016	‘Electrochemical Research Facility’ at Bhiwadi	68	n.a
Nov, 2016	New facilities and production of new products in existing multi-purpose plant and setting up of cGMP plant	1,280	Mar-18
May, 2017	Setting up facility to produce agrochemicals at Dahej	2570	Nov-18
Aug, 2017	Seting up of facility to specialty chemicals (P-33) for Agro -industry at Dahej	850	n.a.
Nov, 2017	Doubling refrigerants capacity	3800	April/May 2019
Feb, 2018	Dedicated facility to produce P34, Carbon Monoxide (CO) generation and Ethylene pipeline	810	n.a.
Feb, 2019	Manufacture of agrochemical intermediates and associated plants (MPP plant)	1400	Sep-19

Source: Company, Edelweiss research

Packaging films – Cyclical upturn

Cyclical business – Profile upgrading from commodity to specialty

Packaging films business contributed 34% to overall revenue and 40% to overall EBIT in FY19

The packaging films business contributed 34% to overall revenue and 40% to overall EBIT in FY19. The packaging films industry is generally cyclical with great volatility in margins. For SRF too, margins have ranged from negative 10–15% in the past to positive 15–16% currently.

SRF is focussed on specialty films, which account for 70% of overall revenue and has 15% higher margin on average than commodity films

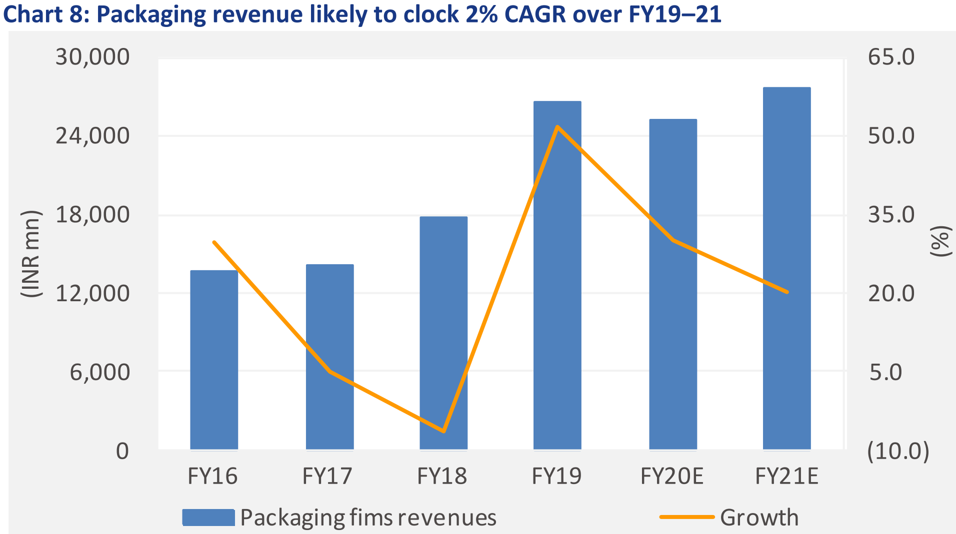
For the last three–four years, SRF's margin has been consistently healthy driven by the shift in mix towards specialty grade, which commands a 15% higher margin on average than commodity films. The current mix of specialty and commodity films for SRF is 70:30. Management expects the share of specialty to increase further.

Capacity addition driving growth

SRF has been incurring capex over the last three–four years to expand capacity (both BoPP and BoPET), which is driving growth. In fact, over the past five years (FY14–19), the division's revenue has expanded at a CAGR of 25% and EBIT doubled as margins climbed from -1% in FY14 to 15.5% in FY19.

Over FY14–19, SRF's packaging films revenue expanded at a CAGR of 25% and EBIT doubled as margins rebounded from -1% in FY14 to 15.5% in FY19

Chart 8: Packaging revenue likely to clock 2% CAGR over FY19–21



Source: Company, Edelweiss research

Commissioning of the BOPET plant in Hungary is expected in March 2020; the Thailand plant is expected to come on stream in September 2020

In February 2018, the board of directors approved setting up of a BOPET film line and a metalliser in Hungary at an estimated cost of EUR58mn. In July 2018, the board also approved the second BOPET film line and a resin plant to be set up at a cost of USD60mn in Thailand. The new line will have capacity of 40,000MTPA and lodge SRF among the top ten polyester film producers globally. Thus, apart from healthy growth in the domestic market, management is targeting growth in other global markets.

The BOPP market continues to be oversupplied, and BOPET margins too could come under pressure once supply increases in Q2FY20/Q3FY20

Table 2: Packaging films – An overview of capacity addition

Category	Investment (INR bn)	Location	Commissioning
BOPET	3.6	Indore	Feb-16
BOPP	2.7	Indore	Dec-17
BOPET	4.8	Eastern Europe	Mar-20
BOPET	4.1	Thailand	Sep-20

Source: Company, Edelweiss research

Margins at cyclical peak; capacity additions may pressure margins

In FY19, packaging films' revenue increased at 49% YoY along with margin expansion of 260bps YoY to 15.5%. The increase in margins was driven by a healthy contribution from new capacities, uptick in the contribution of value-added products, and favourable demand-supply in the BOPET division.

The BOPP market continues to be oversupplied, and BOPET margins too could come under pressure once supply increases in Q2FY20/Q3FY20. All in all, we estimate margins would inch down to 14% in FY20E and 13.5% in FY21E from 15.5% in FY19. A continued uptick in the value-added mix is likely to keep margins in good stead.

Chart 9: Capacity addition to build up margin pressure

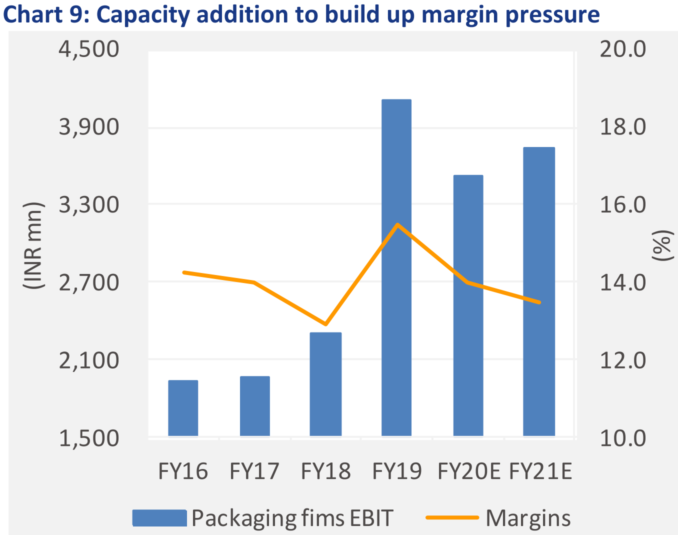
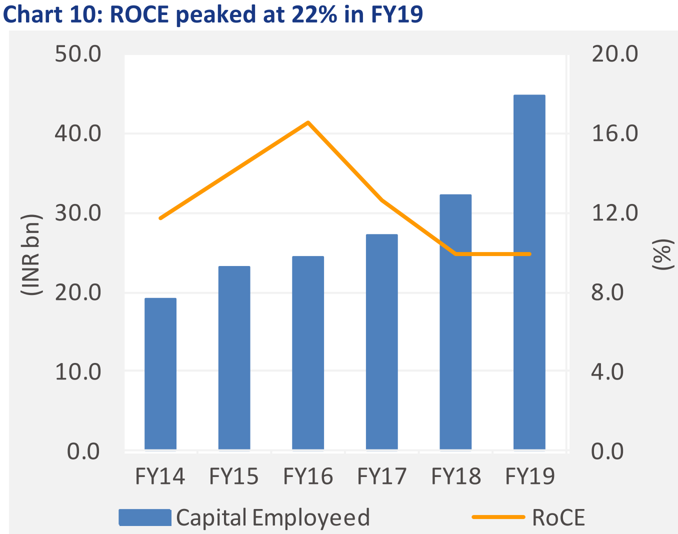


Chart 10: ROCE peaked at 22% in FY19



Source: Company, Edelweiss research

Technical textiles contributed 27% to overall revenue and 26% to EBIT in FY19

Margin improvement in this segment is led by a step-up in import duty on radial tyres from 10% to 15%, increase in end-product prices and better demand-supply scenario

In FY19, the company was running at full capacity utilisation; hence, for further growth, it is expanding capacity in Manali and Gwalior at capex of INR800mn (to be incurred over FY20–22E)

Technical textiles – Steady cash generator

Value-added products, favourable demand-supply driving revenue growth

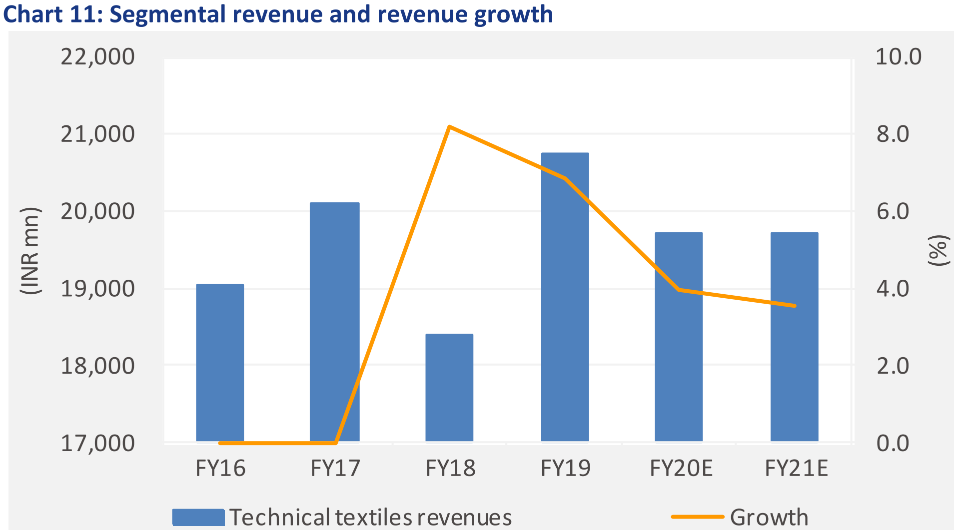
Technical textiles contributed 27% to overall revenue and 26% to EBIT in FY19. From FY11–19, the segment's EBIT margin consistently rose from 10% to 14.4% amid favourable demand-supply and an uptick in the value-added mix. Margins in this segment are benefitting from: 1) a step-up in import duty from 10% to 15% on radial tyres; 2) increase in input cost, which has pushed up prices of end-products; and 3) a better demand-supply scenario.

Key highlights of the technical textiles segment's performance are:

NTCF: The NTCF segment has retained its market leadership despite tough competition and increasing 'radialisation' in the bus and truck segment. The NTCF facility is running at optimal utilisation with continued strong demand. In addition to healthy demand, the introduction of anti-dumping duty on tyre imports from China and a higher import duty on nylon tyre cord fabric (NTCF) have partially driven up domestic off-take.

Belting fabrics and polyster yarn: Higher sales of value-added products contributed to a healthy performance in both the belting fabric and polyster yarn businesses. The company has achieved full capacity utilisation in polyester yarn while competition from Chinese imports is hurting the performance of belting fabrics.

Chart 11: Segmental revenue and revenue growth



Source: Company, Edelweiss research

Margins likely to slide from peak

In Q4FY19, the technical textiles segment posted revenue growth of merely 4% YoY owing to lower sales volumes due to contraction in the automotive segment. Furthermore, due to inventory losses (INR50–60mn) on account of price volatility in key raw materials, margins slid by 270bps YoY to 11.7%.

In FY19, the company was running at full capacity utilisation and clocked the highest production numbers. To exploit potential growth in technical textiles, the board approved in February 2019 a proposal to set up spinning and textile capacity at Manali and Gwalior at INR800mn (to be incurred over FY20–22E).

However, management guided that a slowdown in auto sales can impact volumes in the technical textiles business as some tyre companies have already undertaken production cuts. We believe margins in this segment have peaked and are, hence, likely to exhibit softness hereon. Therefore, we estimate margins would decrease to 13.5% in FY20E and 13% in FY21E.

Chart 12: Segmental EBIT and EBIT margin

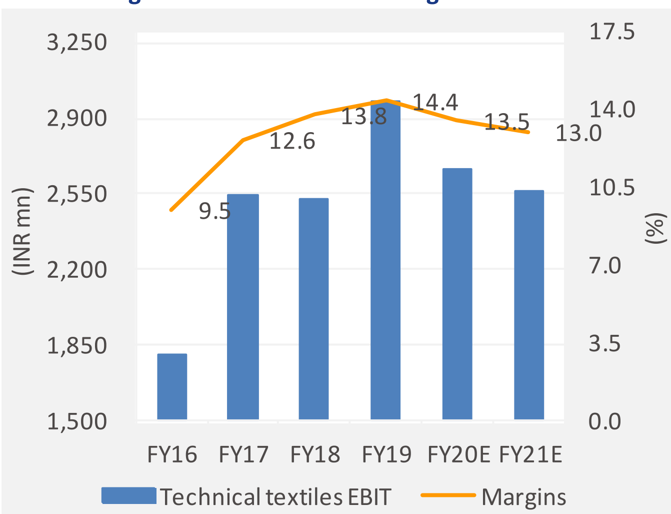
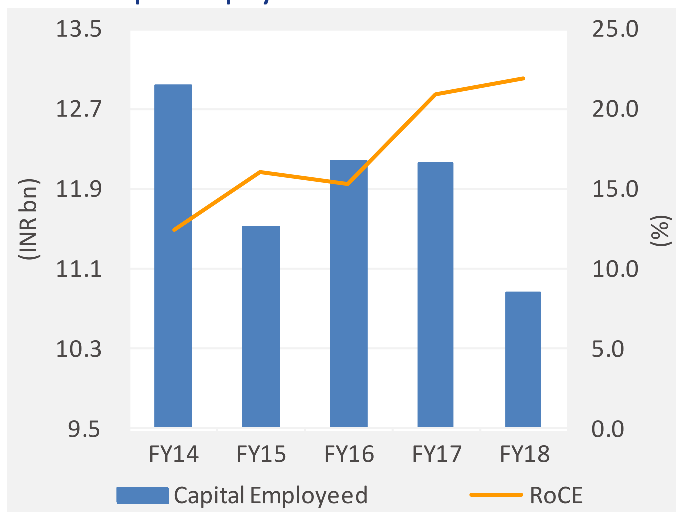


Chart 13: Capital employed and ROCE



Source: Company, Edelweiss research

Financials

Earnings likely to flare up led by chemicals segment

Investments in refrigerant gases (with capacity set to double by FY20), revival in the agro-chemical industry and capacity expansion in packaging films are expected to drive up revenue at a CAGR of 7% over FY19–21E. Furthermore, improvement in the chemicals segment's margins led by operating leverage is expected to lift EBITDA CAGR to 16%.

Chart 14: Revenue CAGR of 7% over FY19–21E

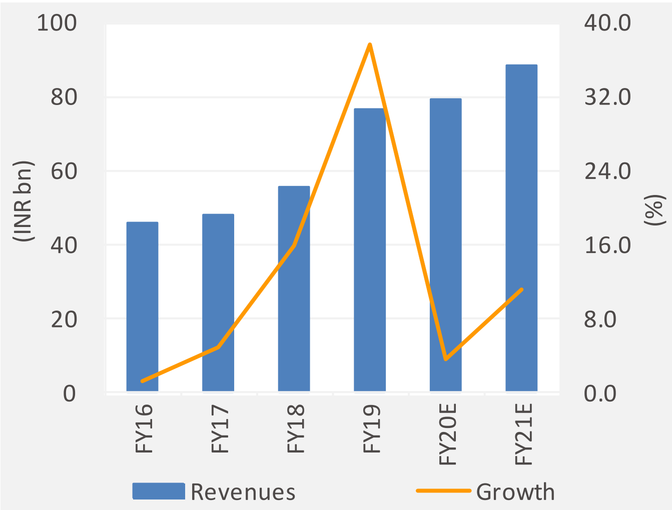
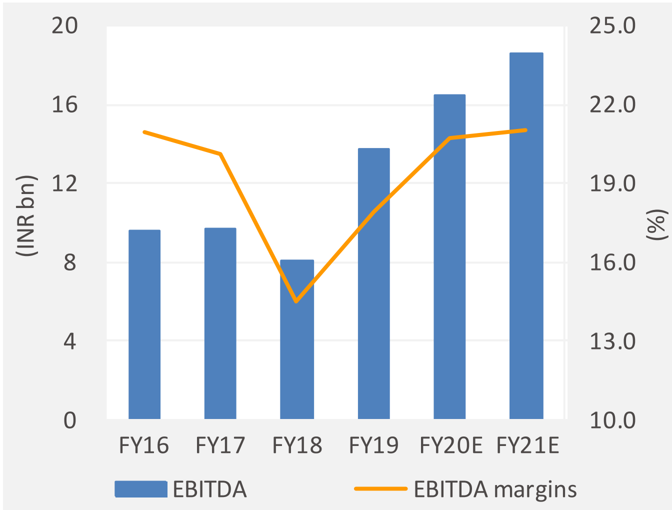


Chart 15: EBITDA CAGR of 16% over FY19–21E



Source: Company, Edelweiss research

Chart 16: Revenue contribution

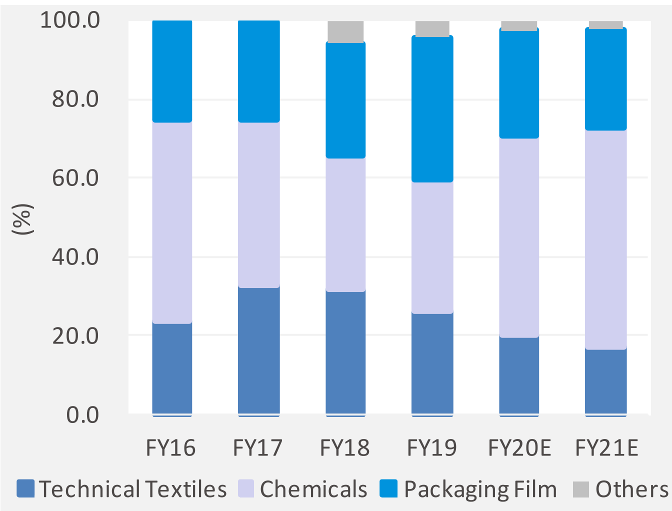
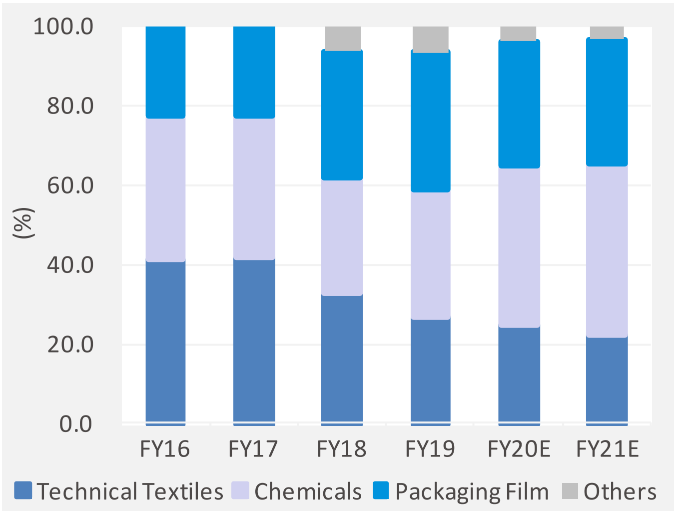


Chart 17: EBIT contribution

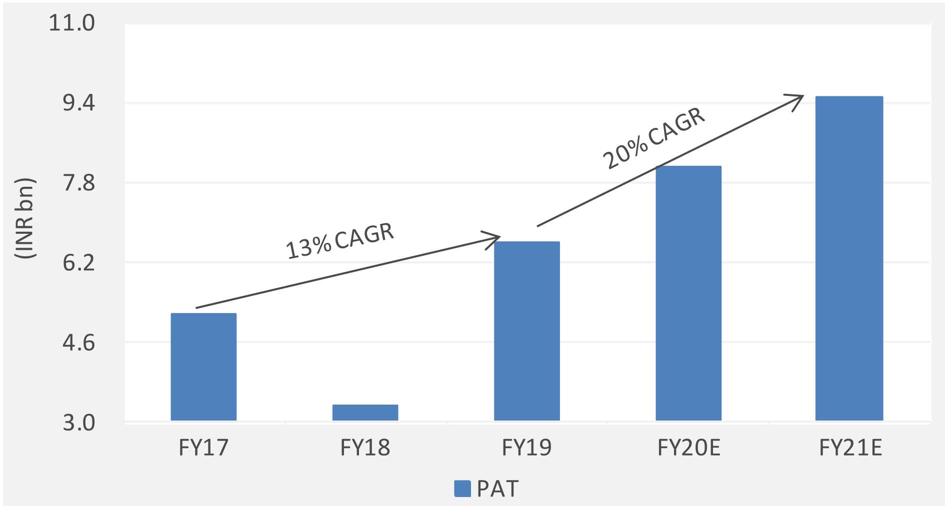


Source: Company, Edelweiss research

FY19–21E PAT CAGR of 20% versus 13% over FY17–19; furthermore, with slowing capex, RoCE would double from 9% in FY18 to 18% in FY21E

As the company is seeing robust growth in the chemicals segment, we expect its FY19–21E PAT to expand at a CAGR of 20% versus a 13% CAGR over FY17–19. Furthermore, with capex slowing over FY20–21E and operating leverage kicking in, we estimate SRF's ROCE would double from 9% in FY18 to 18% by FY21E.

Chart 18: Earnings CAGR of 20%



Source: Company, Edelweiss research

Chart 19: ROCE set to improve

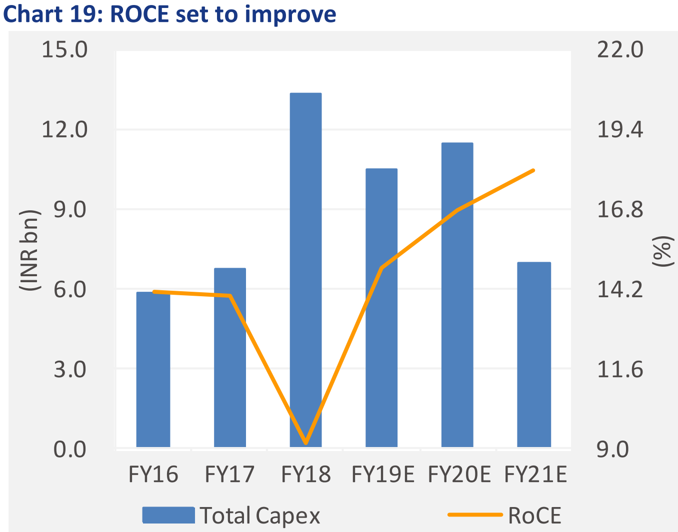
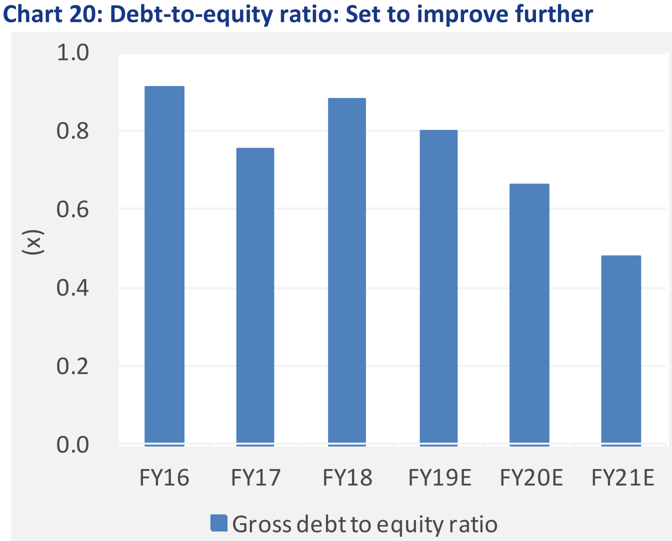


Chart 20: Debt-to-equity ratio: Set to improve further



Source: Company, Edelweiss research

Valuation

SoTP-based valuation to value multiple businesses

We value SRF based on an SoTP methodology due to its varied businesses, which yields a target price of INR2,983. We value the chemicals and polymers business – including refrigerant gases and specialty agrochemicals – at 14x EV/EBITDA (Q2FY21), which is in line with other specialty chemical companies such as PI Industries. To capture the high growth potential of the segment, we assign a greater 14x EV/EBITDA multiple to specialty chemical business. To technical textiles and packaging films businesses, we have assigned EV/EBITDA of 7x and 6x, respectively, given their volatile nature due to their association with commodities, and cyclicality.

Table 3: SOTP valuation

	FY20E EBITDA (INR mn)	FY21E EBITDA (INR mn)	Forward EV (INR mn)	EV/EBITDA (x)
Technical textiles	3,171	3,087	22,194.3	7
Chemicals & polymers	9,513	11,366	133,183.9	16
Packaging films	4,292	4,655	25,753.5	6
Total (INR mn)	16,491	18,623	196,789	
FY20E EV (INR mn)	196,789			
FY19 Net Debt (INR mn)	25,493			
SRF Equity Value (INR mn)	171,295			
SRF number of shares (mn)	**57**			
SRF TP (INR)	2,983			
CMP (INR)	2,972.0			
% upside	0			

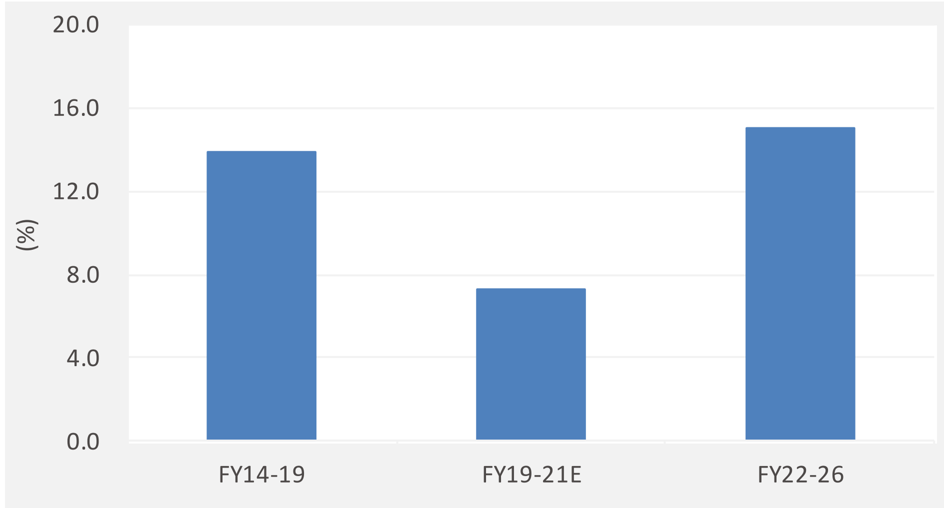
Source: Edelweiss

Note: Price target based on Sep'2020

DCF analysis factors 15% implied growth

We have also used a reverse-DCF model to calculate the implied growth built into our target price. At our target price of INR2,983, we are projecting overall revenue growth of 15% over FY22–26E in our three-stage DCF model. Growth at 15% is broadly in line with 14% revenue CAGR over FY14–19. However, a large part of revenue growth is likely to be driven by the chemicals business, wherein the company has invested aggressively. Given the strong growth opportunity in refrigerant gases and global specialty chemicals, we believe that implied growth of 15% built into our DCF is easily achievable.

Chart 21: DCF – Historical and implied revenue growth rate



Source: Edelweiss research

Chart 22: 1 year forward PE chart

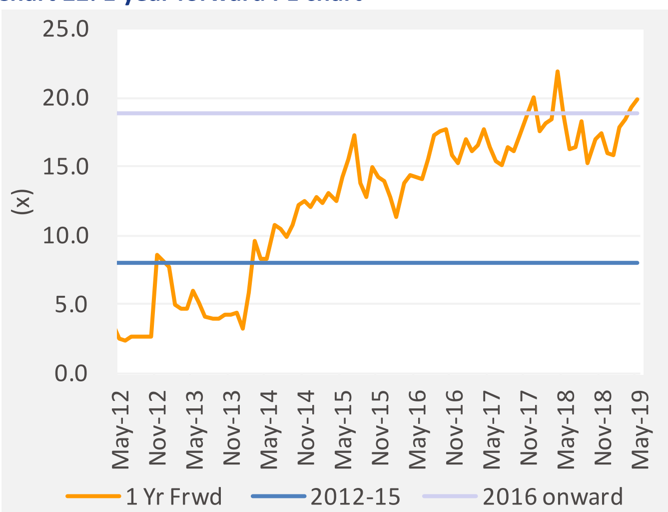
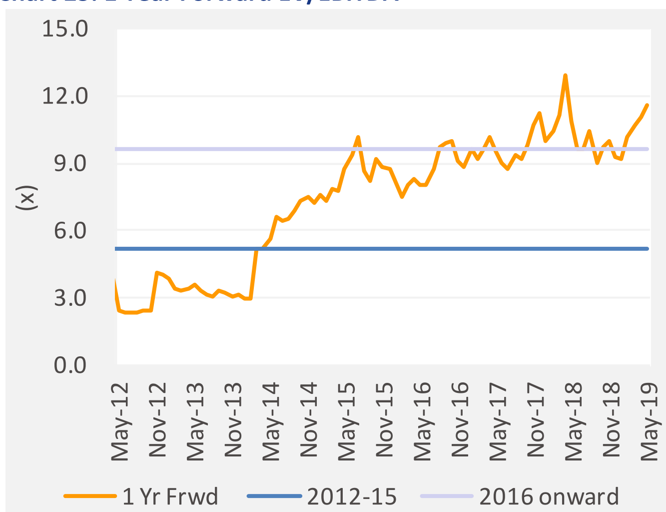


Chart 23: 1 Year Forward EV/EBITDA



Source: Bloomberg

Company Description

SRF is a multi-business entity manufacturing chemical-based industrial intermediates. It commenced operations as Shri Ram Fibres in 1970 when its parent company DCM decided to set up a separate entity to manufacture nylon tyre cord fibres. Its business portfolio covers technical textiles, fluorochemicals, chloromethanes, specialty chemicals, engineering plastics and packaging films. SRF does business with 75 countries and has 9 facilities in India and 2 each in Thailand and South Africa. The company's business is divided into 3 divisions: (1) technical textiles, (2) chemical & polymers; and (3) packaging films.

Investment Theme

Car/refrigerator sales to spur fluorochems; R&D to drive specialty: Capacity utilisation in SRF's fluorochemicals business is anticipated to surge, riding spurt in sales of refrigerators & cars and import substitution. Moreover, R&D investments, cornerstone of SRF's commendable success in high entry barrier specialty chemicals, have yielded handsome dividends—filed 145 patents so far for R&D and technology, of which nineteen have been granted. With a strong products pipeline and focused capex (INR25bn to be incurred over next three-four years), we expect the division to post strong revenue CAGR of 25% over FY19-21E, and catapult its revenue/EBITDA share going forward.

Technical textiles: Cash cow; Packaging: Consumption growth play - SRF has been channelising technical textiles' ~INR2.2bn/year FCF to finance incremental capex in other divisions. We estimate packaging films to clock 2% revenue CAGR over FY19-21 as plants are operating at optimum utilisation and capacity additions are planned in H2FY21.

Key Risks

Limited product life cycle: There is a risk of early phase out of the molecule due to availability of a subsitiute or development of some other molecule in the other market.

Pace of launch of new molecules: SRF faces inventory risk as the timing of launch of a molecule is determined by client campaign. Also, this leads to volatility risk on quarterly basis as when a molecule is launched profitability shoots up significantly.

Financial Statements

Key Assumptions

Year to March	FY18	FY19	FY20E	FY21E
Macro				
GDP(Y-o-Y %)	7.2	6.8	6.8	7.1
Inflation (Avg)	3.6	3.4	4.0	4.5
Repo rate (exit rate)	6.0	6.3	5.3	5.0
USD/INR (Avg)	64.5	70.0	72.0	72.0
Company				
Technical Textile	(9)	13	(5)	-
Chemicals & Polymers	(6.4)	51.8	30.0	20.0
Packaging Films	26.5	48.9	(5.0)	10.0
Technical Textile EBIT margins	13.8	14.4	13.5	13.0
Chemicals & Polymers EBIT margins	16.7	15.7	21.2	22.0
Packaging Films EBIT margins	12.9	15.5	14.0	13.5
Capex (INR mn)	13,327	10,495	11,500	7,000
Debtor days	44	41	47	45
Inventory days	108	91	110	108
Payable days	112	102	119	110

Income statement (INR mn)

Year to March	FY18	FY19	FY20E	FY21E
Net revenue	55,890	76,927	79,695	88,556
Materials costs	30,320	43,596	41,524	46,141
Employee costs	4,740	5,159	5,675	6,243
Other Expenses	12,726	14,381	16,004	17,549
Total operating expenses	47,786	63,137	63,204	69,933
EBITDA	8,104	13,790	16,491	18,623
Depreciation	3,158	3,669	4,147	4,510
EBIT	4,946	10,122	12,344	14,113
Less: Interest Expense	1,239	2,016	1,805	1,522
Add: Other income	688.00	401.4	600.00	650.00
Profit Before Tax	4,858	8,269	11,139	13,241
Less: Provision for Tax	1,200	1,853	3,008	3,707
Add: Exceptional items	463	(238)	-	-
Reported Profit	3,659	6,416	8,132	9,533
Exceptional Items	349	(185)	-	-
Adjusted Profit	3,310	6,601	8,132	9,533
Shares o /s (mn)	57	57	57	57
Adjusted Basic EPS	57.6	115.0	141.6	166.0
Diluted shares o/s (mn)	57	57	57	57
Adjusted Diluted EPS	57.6	115.0	141.6	166.0
Adjusted Cash EPS	106.2	174.1	213.8	244.6
Dividend per share (DPS)	12.0	15.0	18.0	20.0
Dividend Payout Ratio(%)	22.7	15.7	14.9	14.1

Common size metrics

Year to March	FY18	FY19	FY20E	FY21E
Materials costs	54.2	56.7	52.1	52.1
Staff costs	8.5	6.7	7.1	7.0
S G & A expenses	22.8	18.7	20.1	19.8
Depreciation	5.7	4.8	5.2	5.1
Interest Expense	2.2	2.6	2.3	1.7
EBITDA margins	14.5	17.9	20.7	21.0
Net Profit margins	5.9	8.6	10.2	10.8

Growth ratios (%)

Year to March	FY18	FY19	FY20E	FY21E
Revenues	15.9	37.6	3.6	11.1
EBITDA	(16.4)	70.2	19.6	12.9
PBT	(26.1)	70.2	34.7	18.9
Adj. net profit	(35.7)	99.4	23.2	17.2
EPS	(35.7)	99.4	23.2	17.2

Balance sheet (INR mn)

As on 31st March	FY18	FY19	FY20E	FY21E
Share capital	584	585	585	585
Reserves & Surplus	35,061	40,708	47,630	55,820
Shareholders' funds	35,645	41,293	48,215	56,405
Long term borrowings	19,073	21,613	20,613	15,613
Short term borrowings	12,346	11,274	11,274	11,274
Total Borrowings	31,418	32,887	31,887	26,887
Long Term Liabilities	676	566	956	1,063
Deferred tax (net)	2,914	3,420	3,420	3,420
Sources of funds	**70,654**	**78,166**	**84,478**	**87,775**
Gross Block	58,424	67,009	78,509	85,509
Net Block	50,048	54,965	62,317	64,807
Capital work in progress	5,588	7,536	7,536	7,536
Intangible Assets	1,168	1,129	1,129	1,129
Total Fixed Assets	56,804	63,630	70,983	73,472
Non current investments	1	1	1	1
Cash and Equivalents	2,184	2,994	3,393	3,076
Inventories	9,584	12,250	12,875	14,306
Sundry Debtors	6,807	10,288	10,360	11,512
Loans & Advances	460	452	317	353
Other Current Assets	7,616	9,267	6,855	7,618
Current Assets (ex cash)	24,465	32,256	30,407	33,788
Trade payable	10,442	13,824	13,167	14,631
Other Current Liab	2,359	6,891	7,139	7,932
Total Current Liab	12,801	20,715	20,306	22,563
Net Curr Assets-ex cash	11,664	11,541	10,102	11,225
Uses of funds	**70,654**	**78,166**	**84,478**	**87,775**
BVPS (INR)	620.8	719.1	839.7	982.3

Free cash flow (INR mn)

Year to March	FY18	FY19	FY20E	FY21E
Reported Profit	3,659	6,416	8,132	9,533
Add: Depreciation	3,158	3,669	4,147	4,510
Interest (Net of Tax)	933	1,564	1,318	1,096
Others	(1,302)	(1,836)	(1,318)	(1,096)
Less: Changes in WC	1,914	(13)	(1,830)	1,017
Operating cash flow	4,533	9,826	14,108	13,027
Less: Capex	13,327	10,495	11,500	7,000
Free Cash Flow	**(8,794)**	**(668)**	**2,608**	**6,027**

Cash flow metrics

Year to March	FY18	FY19	FY20E	FY21E
Cash flow from ops	4,533	9,826	14,108	13,027
Financing cash flow	6,627	462	(2,209)	(6,344)
Investing cash flow	(13,077)	(10,495)	(11,500)	(7,000)
Net cash Flow	(1,917)	(206)	399	(316)
Capex	(13,327)	(10,495)	(11,500)	(7,000)
Dividend paid	(829)	(1,008)	(1,209)	(1,344)

Profitability and efficiency ratios

Year to March	FY18	FY19	FY20E	FY21E
ROAE (%)	9.8	17.2	18.2	18.2
ROACE (%)	9.2	14.9	16.8	18.1
Inventory Days	108	91	110	108
Debtors Days	44	41	47	45
Payable Days	112	102	119	110
Cash Conversion Cycle	40	30	39	43
Current Ratio	2.1	1.7	1.7	1.6
Gross Debt/EBITDA	3.9	2.4	1.9	1.4
Gross Debt/Equity	0.9	0.8	0.7	0.5
Adjusted Debt/Equity	0.9	0.9	0.7	0.5
Net Debt/Equity	0.8	0.7	0.6	0.4
Interest Coverage Ratio	4.0	5.0	6.8	9.3

Operating ratios

Year to March	FY18	FY19	FY20E	FY21E
Total Asset Turnover	0.9	1.0	1.0	1.0
Fixed Asset Turnover	1.2	1.4	1.3	1.4
Equity Turnover	1.7	2.0	1.8	1.7

Valuation parameters

Year to March	FY18	FY19	FY20E	FY21E
Adj. Diluted EPS (INR)	57.6	115.0	141.6	166.0
Y-o-Y growth (%)	*(35.7)*	*99.4*	*23.2*	*17.2*
Adjusted Cash EPS (INR)	106.2	174.1	213.8	244.6
Diluted P/E (x)	52.7	26.4	21.5	18.3
P/B (x)	4.9	4.2	3.6	3.1
EV / Sales (x)	3.6	2.6	2.5	2.2
EV / EBITDA (x)	25.1	14.8	12.3	10.7
Dividend Yield (%)	0.4	0.5	0.6	0.7

Additional Data

Directors Data

Arun Bharat Ram	Chairman	Ashish Bharat Ram	Managing Director
Kartik Bharat Ram	Dy Managing Director	K. Ravichandra	Director
Vellayan Subbiah	Non-Executive Director	Vinayak Chatterjee	Non-Executive Director
Pramod Bhasin	Non-Executive Director	Tejpreet S. Chopra	Non-Executive Director
L. Lakshman	Non-Executive Director	Meenakshi Gopinath	Non-Executive Director

Auditors - Deloitte Haskins & Sells

**as per last available data*

Holding – Top10

	Perc. Holding		Perc. Holding
Amansa Holdings	7.73	Kotak Mahindra AMC	4.31
DSP Blackrock	2.55	Stiching Dep Apq	1.84
Dimensional Fund Advisors	1.37	Aditya Birla Asset Management	1.01
Canara HSBC Oriental Bank of Commerce	1.14	Reliance Nippon Life Asset Management	0.89
Alternative investment	0.87	Vanguard	0.80

**as per latest available data*

Bulk Deals

Data	Acquired / Seller	B/S	Qty Traded	Price
No Data Available				

**as per last available data*

Insider Trades

Reporting Data	Acquired / Seller	B/S	Qty Traded
No Data Available			

**as per last available data*

COMPANY PROFILE

SH KELKAR

The growth scent

India Equity Research| Speciality Chemicals

Edelweiss
Ideas create, values protect

SH Kelkar (SHK) is a prominent player in the fragrance and flavour (F&F) industry and is among the top three fragrance manufacturers in India. The company has positioned itself as a global player by acquiring stake in global company Creative Flavours & Fragrances SpA. Sticky nature of business, diverse customer base and long-term relationships are strong moats for the business. SHK has targeted backward integration in order to eliminate uncertainties related to procurement of key raw material. Overall, though the company's performance has taken a hit due to increase in input costs from China, ramping up of new facility at Mahad is likely to reap operational benefits. 'NOT RATED'.

Leading player in niche market

SHK is among the largest Indian origin F&F companies with 21% market share in fragrance and 12% in flavour. Being an early entrant in the F&F space, the company has established long-standing relationships with domestic as well as MNC customers. Further, it is looking to expand in emerging markets via organic and inorganic means. With 9,700 plus products in its portfolio, the company is well placed among the top three domestic fragrance manufacturers.

Backward integration to boost margin

SHK has set up the world's largest facility at Mahad to manufacture Tonalid (key ingredient in fragrance products) to reduce dependence on import of raw material. Furthermore, in line with this strategy, the company has acquired 67% stake in China-based Anhui Ruibang Aroma.

Outlook and valuation: Positive; 'NOT RATED'

Though SHK seems to have bounced back from the overhang of rising input costs via capex towards backward integration, addition of new customers is expected to provide 15% topline growth in near term. The stock is trading at a CMP of INR 134, with 19x PE for FY20. The stock is **'NOT RATED'.**

Financials

Year to March	FY16	FY17	FY18	FY19
Net revenues (INR mn)	9,249	9,805	10,210	10,436
EBITDA (INR mn)	1,511	1,669	1,581	1,321
Adj. profit (INR mn)	731	1,048	939	885
Adj. diluted EPS (INR)	5.1	7.2	6.5	6.1
Diluted P/E (x)	27	18	21	22
EV/EBITDA (x)	*9.9*	*8.9*	*9.9*	*11.5*

EDELWEISS RATINGS

Absolute Rating	**NOT RATED**

MARKET DATA *(R: SHKE.BO, B: SHKL IN)*

CMP	: INR 138
Target Price	: NA
52-week range (INR)	: 248 / 109
Share in issue (mn)	: 144.6
M cap (INR bn/USD mn)	: 20 / 285
Avg. Daily Vol. BSE/NSE ('000)	: 221.6

SHARE HOLDING PATTERN (%)

	Current	Q4FY19	Q3FY19
Promoters *	56.9	56.7	56.8
MF's, FI's & BKs	4.6	3.2	2.1
FII's	20.2	22.5	20.2
Others	18.3	17.6	20.9

** Promoters pledged shares (% of share in issue) : NIL*

PRICE PERFORMANCE (%)

	Sensex	Stock	Stock over Sensex
1 month	1.6	(12.7)	(14.3)
3 months	3.8	(15.4)	(!9.2)
12 months	11.8	(39.3)	(51.1)

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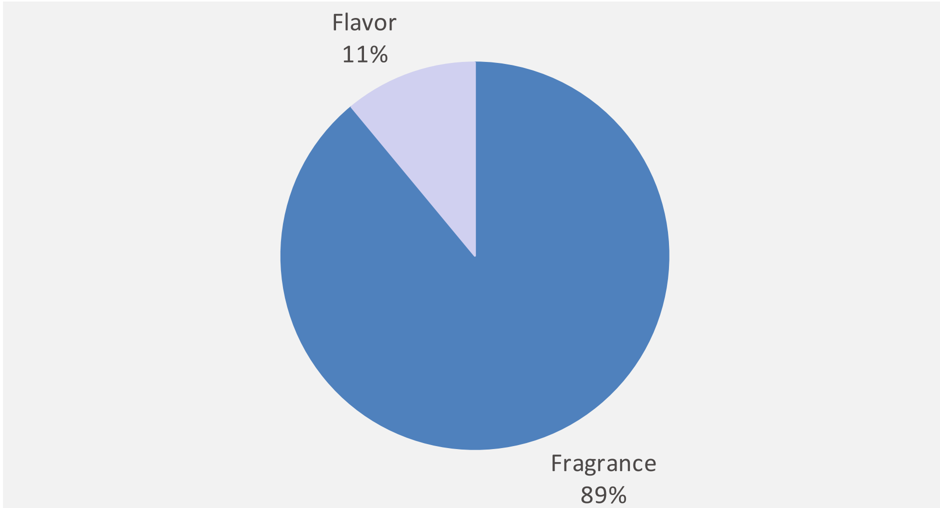
June 19, 2019

Key player in fragrance & flavour industry

SHK is the largest Indian-origin F&F company in India. The company is amongst the top three fragrance manufacturers across India with 21% plus market share. The company is also among the top 10 players in the flavour industry with 12% plus market share. With more than 9,700 products in its portfolio, SHK has a presence in over 40 countries.

While the company's SHK, Cobra and Keva brands enjoy a strong brand equity among domestic customers, the acquired *Creative Flavours & Fragrances SpA* brand has opened the gateway to European markets. SHK currently caters to major geographies such as Asia, Africa and the Middle East.

Chart 1: Fragrance accounts for 89% of sales



Source: Company, Edelweiss research

Diversified product basket with large customer base

SHK's product basket constitutes an important part in the FMCG domain. Since growth of the F&F segment is directly correlated to growth in the FMCG segment, the industry is considered a proxy of FMCG. SHK being one of the prominent players in the F&F industry has remained aggressive in expanding its global presence.

Till date, the company has more than 3,600 customers in the fragrance segment including long-term relationships with global MNCs, HUL, Helen Curtis, etc., as well as with domestic players like Marico, Godrej, Wipro, among others. Further, in the flavour segment, the company has a wide product portfolio and a client base of more than 500 including FMCG leaders, domestic companies and global corporate. Being a supplier of different variants catering to global as well as domestic customers, cuts dependence on a single elemental fragrance / flavour molecule.

Table 1: Customer profile

Customer Profile	Key Players	Revenue Share(%)
International Customers MNC's Domestic FMCG companies	HUL, Britannia, Helen Curtis, WIPRO, Godrej,	65%
Branded small pack customers	Traders and Resellers	35%

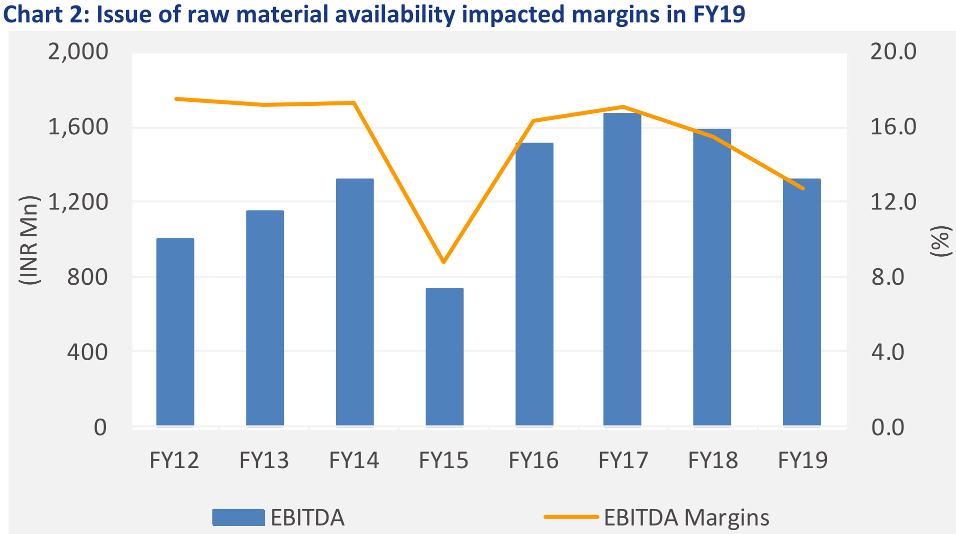
Source: Company, Edelweiss research

Sticky business model with high entry barriers

Being manufacturer and supplier of key ingredients, SHK typically enjoys a prolonged customer lifecycle. F&F products supplied to MNCs and domestic players are of recurring nature. The sticky nature of the business thus acts as a moat for the company. Since FMCG companies derive growth from product launches, SHK with four creation and development centres along with more than 9,700 products under its portfolio is well placed to avail to partner to firms for supplying key ingredients.

The ingredients being supplied by the company are of critical nature for the success of FMCG products. Though the value and volume composition in the finished product may be of small proportion, the criticality of quality of ingredients can act as a significant influencer to end customers.

Chart 2: Issue of raw material availability impacted margins in FY19

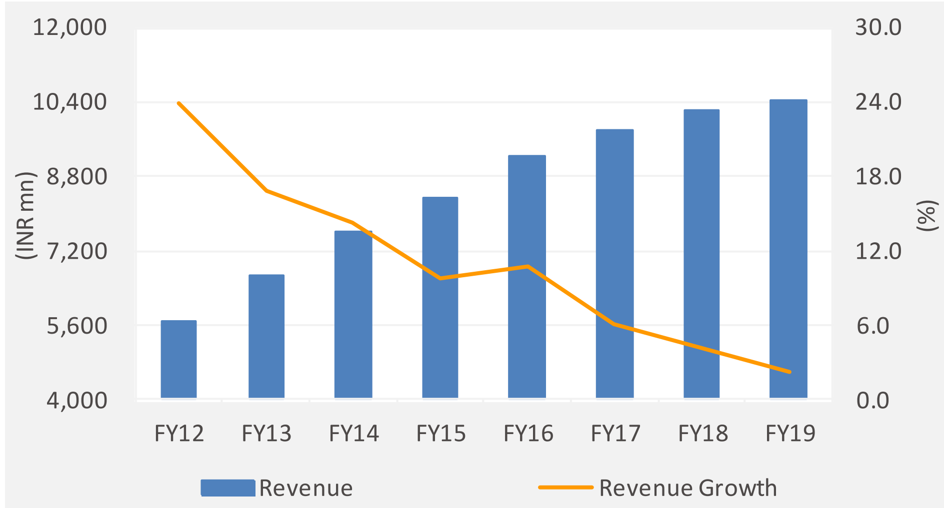


Source: Company, Edelweiss research

Expansion in new geographies to boost top line

Though SHK enjoys significant domestic presence, it is looking to expand in emerging markets via organic and inorganic routes. Currently, exports contribute 30% to the company’s overall revenue. It has presence in South-East Asia including Indonesia, Thailand and Singapore. Revenue from this region has grown 16% driven by strong performance in the Indonesia market; management expects the trend to sustain backed by introduction of innovative products catering to product segments such as Industrial paints, fine fragrance and fabric cleaner.

Chart 3: Exit from Citrus business take a toll on revenue growth

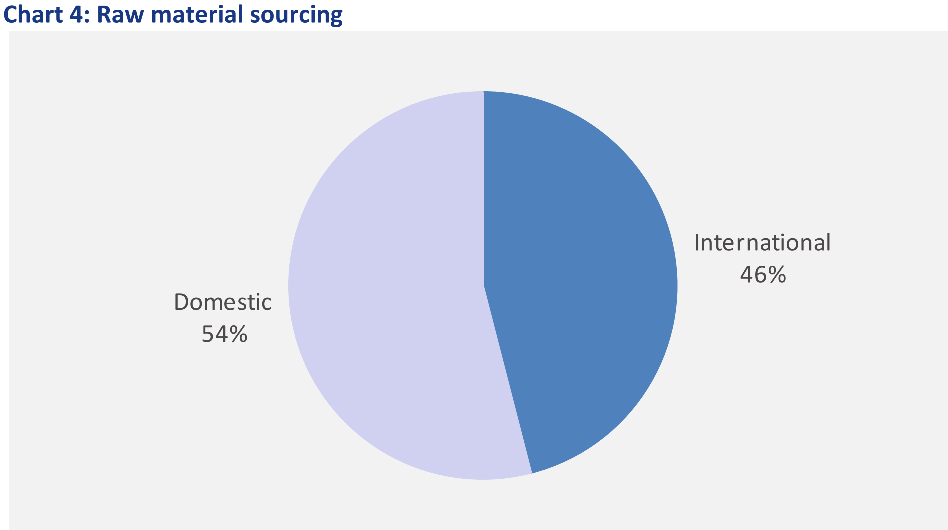


Source: Company, Edelweiss research

Diversified raw material sourcing ensures stability in operations

SHK consumes ~1,500 products as raw material procured from international and domestic markets. 46% of the total procurement is from international suppliers, largely from Indonesia, Germany, Brazil, China and US; balance 54% supplies are from domestic players including ~250 ingredients sourced from the company's owned facilities. Diversified raw material sourcing reduces dependence on any single supplier and ensures stability in operations.

Chart 4: Raw material sourcing



Source: Company, Edelweiss research

Table 2: Key ingredients in F&F

Sr. No.	Volume and Value Wise (%)	Raw Material
1	25	Alpha-Pinene or Turpentine derivatives
2	25	Petrochemicals
3	25	Citrus Oil
4	25	Aroma extracts

Source: Company, Edelweiss research

Long-term partnerships eliminate availability hurdles

The company, being in the market for more than 90 years, has established long-term partnerships (20 years plus) with key suppliers. On net basis, 35% of SHK's raw material requirement is met by the top 10 suppliers. The company hedges itself against significant volatility in supply and prices of key raw material by strategic investments in inventory on periodical basis.

Creating value via inorganic growth

SHK aims to expand its footprint in the global market. In line with the objective, the company recently acquired 51% stake in Italy-based Creative Flavours & Fragrances (CFF). The acquisition will strengthen SHK's global product offering (particularly in fine fragrances and fabric care segments) and would help in gaining access to the European markets. At present, SHK caters to major geographies such as Asia, Africa and the Middle East

It has also acquired 67% stake in China-based Anhui Ruibang Aroma. The acquisition will give it access to another Tonalid manufacturing facility enabling SHK consolidate its market leadership in the segment.

Table 3: Acquisitions done by SHK via inorganic route

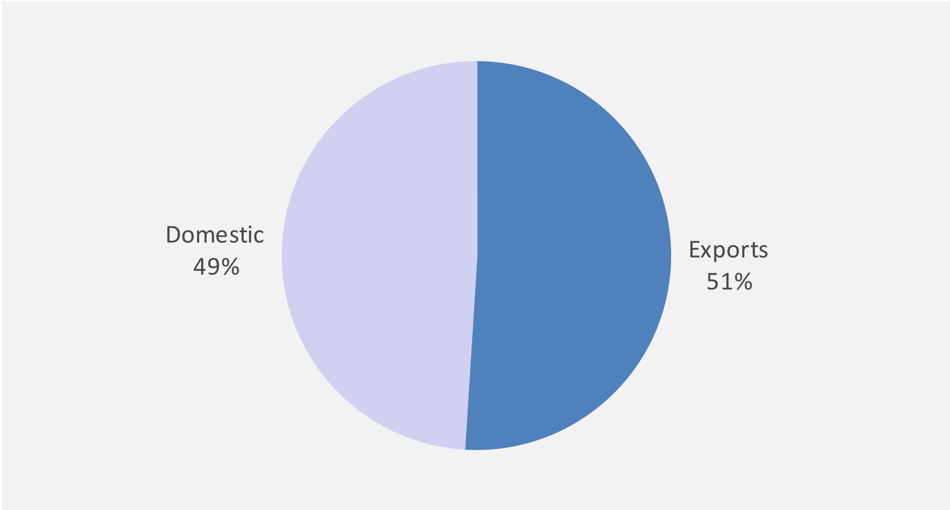
Name of Company	Description
Flavours & Fragrances S.p.A (CFF)	To strengthen global product offerings, particularly in Fine Fragrances and Fabric Care segments
China-based Anhui Ruibang Aroma	Provides access to another Tonalid manufacturing facility - to enable SHK to consolidate its market leadership in the segment
Rasiklal Hemani Agencies Pvt. Ltd	Expansion of Marketing and field Activities in Northern Region
Gujarat Flavours Pvt. Ltd (GFPL)	The company, through its affiliate Keva Flavours Pvt. Ltd, would acquire the flavour unit of the GFPL, marketed under the brands Three Birds and Wheel.
Tanishka Fragrance Encapsulation Technology	Technology transfer agreement
VN Creative Chemicals Pvt. Ltd.	Flexibility in backend manufacturing operations and leverage existing presence in low cost and high quality centre
Saiba Industries Private Limited	Mark a presence in Dairy Category due to its product offering in Saffron, Cardamom and other traditional flavours
Purandar Fine Chemicals Pvt. Ltd.	Business of manufacturing and trading of aroma ingredient (manufacturing facility at Jejuri)-180 tons

Source: Company, Edelweiss research

Company Description

SHK is the largest Indian-origin F&F company. It has a long standing reputation in the fragrance industry underpinned by 96 years' experience. Its fragrance products and ingredients are used as raw material in personal wash, fabric care, skin & hair care, fine fragrances and household products. Its flavour products are used as raw material by producers of baked goods, dairy products, beverages and pharmaceutical products. The company offers products under *SHK, Cobra* and *Keva* brands.

Chart 5: FY19 flavour segment's revenue break down



Source: Company, Edelweiss research

Table 4: Plant locations

Facility	Unit	Capacity
Vapi, Gujarat	Multi-purpose	2064 TPA
Mahad, Maharashtra	Musk	1200 TPA
Mumbai, Maharashtra	Multi-purpose	Unit I: Fragrance – Capacity: 5,400 TPA Unit II: Fragrance – Capacity: 6,600 TPA Unit II: Flavour – Capacity: 7,500 TPA
Vashivali, Raigad, Maharashtra	Multi-purpose	Fragrance – Capacity: 10,342 TPA Flavour - Capacity: 3,000 TPA
Taihe, China	Musk unit	400 TPA
Milan, Italy	Multi-purpose	5,000 TPA
Barneveld, Netherlands	Multi-purpose	1,650 TPA

Source: Company, Edelweiss research

Table 5: Company Milestones

Year	Description
1922	Year of incorporation of company
1978	Aroma Ingredients division, K.V. Arochem was launched in Vapi, India.
1984	Foray into International marets by launching International Fragrance division
2007	Commissioned manufacturing unit in Vaishali in India
2011	Keva acquired PFW Aroma Ingredients B.V.
2012	Keva acquired Saiba Industries - a company which started in 1960 and went on to become the leading ethnic flavour manufacturers.
2015	First Indian Flavour and Fragrance company to get listed on exchange
2016	Keva acquired the flavour business of High-Tech Technologies
2017	Acquisition of fragrance encapsulation technology from Tanishka Fragrance Encapsulation Technologies LLP.
2018	Acquisition of 51% ownership stake in Creative Flavours & Fragrances SpA (CFF), an Italian company, headquartered in Milan, Italy.
2018	Acquired 67% stake in China-based Anhui Ruibang Aroma

Source: Company, Edelweiss research

Management overview

Mr. Ramesh Vaze, Managing Director and Chairman: Mr. Ramesh Vaze is the MD and Chairman of the group and has been associated with the company for over 40 years. He holds a Bachelors degree in Science from the University of Mumbai and is also a trustee of the Kelkar Education Trust. He was appointed MD of the company in August 2010.

Mr. Kedar Vaze, Chief Executive Officer: Mr. Kedar Vaze is a third generation founder-family member and is associated with Keva since 21 years. He has worked as Chief Technology Officer and Chief Operating Officer in the group before being appointed CEO in October 2014. He has a number of F&F patents to his name. He has done his M.Sc. (Chemistry) from IIT Bombay and subsequently attended Global Managers Program at Stanford University, US.

Mr. B Ramkrishnan, Director - Corporate Strategy: Mr. B. Ramkrishnan took over as Director Strategy effective October 2014, stepping down from the CEO's position. He is currently responsible for long-term strategy development, M&A and capital raising activities of the group. He has been associated with Keva since October 2010. Prior to Keva, he was the CEO of Privi Organics and also headed the flavours business of Givaudan. Mr. B Ramkrishnan holds a degree in Chemical Engineering.

Financial Statements

Income statement				(INR mn)
Year to March	FY16	FY17	FY18	FY19
Net revenues	9,249	9,805	10,210	10,436
Raw material costs	5,147	5,358	5,629	5,908
Employee Benefits Expense	1,119	1,225	1,252	1,281
Other expenses	1,473	1,553	1,748	1,927
Total expenses	7,738	8,136	8,629	9,115
EBITDA	1,511	1,669	1,581	1,321
Depreciation & amortization	297	194	238	312
EBIT	1,214	1,475	1,343	1,009
Less: Interest Expense	216	62	40	140
Add: Other income	105	116	257	279
Add: Exceptional items	0	0	(129)	0
Profit Before Tax	1,103	1,528	1,432	1,149
Less: Provision for Tax	372	480	506	270
Add: Share of profit from assoc.	0	0	13	6
Reported Profit	731	1,048	939	885
Adjusted Profit	731	1,048	939	885
No. of Shares outstanding (mn)	145	145	145	145
Adjusted Basic EPS	5.1	7.2	6.5	6.1
No. of dil. shares outstand. (mn)	145	145	145	145
Adjusted Diluted EPS	5	7	6	6
Adjusted Cash EPS	7	9	8	8
Dividend per share	3	0	0	0
Dividend Payout Ratio (%)	50%	0%	0%	0%

Common size metrics - as % of revenues

Year to March	FY16	FY17	FY18	FY19
Materials costs	55.6	54.6	55.1	56.6
Staff costs	12.1	12.5	12.3	12.3
S G & A expenses	15.9	15.8	17.1	18.5
Depreciation	3.2	2.0	2.3	3.0
Interest Expense	2.3	0.6	0.4	1.3
EBITDA margins	16.3	17.0	15.5	12.7
Net Profit margins	7.9	10.7	9.2	8.5

Growth metrics (%)

Year to March	FY16	FY17	FY18	FY19
Revenues	10.7	6.0	4.1	2.2
EBITDA	105.0	10.4	(5.3)	(16.5)
PBT	18.9	38.5	(6.3)	(19.8)
Adjusted Profit	6.3	43.5	(10.4)	(5.8)
EPS	(2.7)	43.5	(10.4)	(5.8)

Balance sheet				(INR mn)
As on 31st March	FY16	FY17	FY18	FY19
Share capital	1,446	1,446	1,446	1,446
Other Equity	5,714	6,671	7,123	7,187
Total shareholders funds	7,161	8,117	8,569	8,634
Long term Borrowings	296	92	482	700
Short term Borrowings	559	652	1,161	2,640
Total Borrowings	855	744	1,643	3,340
Long Term Liabilities & Prov.	57	18	19	29
Deferred Tax Liability (net)	10	33	82	179
Sources of funds	**8,083**	**8,912**	**10,313**	**12,289**
Gross Block	2,421	2,970	3,790	4,693
Capital work in progress	181	24	356	154
Intangible Assets	0	50	246	222
Total Fixed Assets	2,454	3,038	3,978	4,858
Non current investments	0	0	1,089	1,097
Cash & bank balances	1,176	1,051	254	424
Inventories	3,352	3,502	3,480	3,739
Sundry Debtors	2,288	2,170	2,766	2,845
Loans & Advances	575	778	63	89
Other Current Assets	183	192	1,166	1,400
Total Current Assets (Ex Cash)	6,398	6,642	7,475	8,072
Trade payable	1,633	1,107	1,556	1,343
Other Current Liab. & ST Prov.	313	713	927	819
Total Current Liab. & Provisions	1,946	1,820	2,483	2,162
Net Current Assets (ex cash)	4,452	4,822	4,992	5,911
Uses of funds	**8,083**	**8,912**	**10,313**	**12,289**
Book value per share (BV) (INR)	50	56	59	60

Free cash flow

Year to March	FY16	FY17	FY18	FY19
Reported Profit	731	1,048	939	885
Add: Depreciation	297	194	238	312
Interest (Net of Tax)	143	43	26	107
Others	(32)	(14)	43	64
Less:Changes in WC	275	248	212	819
Operating cash flow	864	1,023	1,033	548
Less: Capex	258	383	1,208	833
Free cash flow	**606**	**641**	**(174)**	**(285)**

Cash flow statement

Year to March	FY16	FY17	FY18	FY19
Operating cash flow	864	1,023	1,033	548
Investments cashflow	(770)	(1,038)	(1,636)	(618)
Financing cash flow	(236)	(159)	277	1,563
Net cash Flow	(142)	(174)	(326)	1,493
Capex	(258)	(383)	(1,208)	(833)

Profitability & liquidity ratios

Year to March	FY16	FY17	FY18	FY19
RoAE (%)	11.9	13.7	11.3	10.2
RoACE (%)	17.0	18.8	16.8	11.6
Debtors Days	20	25	15	3
Payble Days	40	35	53	54
Cash conversion cycle (days)	131	142	122	122
Current Ratio	1.1	1.0	1.0	0.9
Net Debt/Equity	(0.5)	(0.4)	(0.4)	(0.4)
Interest Coverage Ratio	5.6	23.7	33.8	7.2

Valuation parameters

Year to March	FY16	FY17	FY18	FY19
Adjusted Diluted EPS (INR)	5.1	7.2	6.5	6.1
Y-o-Y growth (%)	*(2.7)*	*43.5*	*(10.4)*	*(5.8)*
Adjusted Cash EPS (INR)	7.1	8.6	8.1	8.3
Diluted P/E (x)	27.3	19.0	21.3	22.6
Price/BV (x)	2.8	2.5	2.3	2.3
EV/Sales (x)	1.7	1.6	1.6	1.5
EV/EBITDA (x)	10.2	9.2	10.3	12.0
Dividend yield (%)	1.8	-	-	-

Operating ratios

Year to March	FY16	FY17	FY18	FY19
Total asset turnover(x)	1.2	1.2	1.1	0.9
Fixed asset turnover(x)	3.3	3.4	2.8	2.2
Equity turnover(x)	1.5	1.3	1.2	1.2

India Midcaps

COMPANY PROFILE

VINATI ORGANICS

Concentrated product basket with global leadership

India Equity Research| Speciality Chemicals

Do vote the Edelweiss Experience! AsiaMoney Poll

Edelweiss Ideas create, values protect

Vinati Organics' (VOL) distinct business model is characterised by a concentrated product basket with global leadership. The company's two key products (70% of revenue)—2Acrylamido-2-Methylpropane Sulfonic Acid (ATBS) and Isobutyl Benzene (IBB)—enjoy ~65% global market share. VOL has achieved this scale and global leadership underpinned by its R&D-driven innovation, clean & green chemistry, process technology and backward & forward integration. This has helped the company clock higher than industry margin (36% EBITDA margin in FY19) and return ratios (46% ROCE in FY19). 'NOT RATED'.

Niche products with leading market share

VOL has built formidable capacity in its key end products—IBB, isobutyl (IB) and ABTS—leading to low cost of operations. The company is a global leader in IBB, which is used in the Ibuprofen drug, with 65% global market share. ATBS, a versatile monomer with multiple uses, also commands 65% global market share. In IB—used as an intermediate—VOL is the leader in the domestic market with 70% share. These three products contribute ~80% to the company's revenue.

Product launches to drive growth

While for growth, VOL is dependent on sustained launch of products, near-term growth is likely to be driven by capacity expansion (includes expansion in ATBS) and forward integration in existing products. The company is working on quite a few new products—Para Amino Phenol (PAP, an intermediate for paracetamol), is a case in point. Management believes, successful launch of these can accelerate growth.

Outlook and valuation: Gaining ground; 'NOT RATED'

Though VOL continues to focus on R&D and new products, in the near term management is confident of 30-35% revenue growth driven by capacity expansion in ATBS and existing products while maintaining margin. VOL is **'NOT RATED'** as we do not have coverage on the stock.

Financials

Year to March	FY16	FY17	FY18	FY19
Net revenues (INR mn)	6,323	6,408	7,297	11,081
EBITDA (INR mn)	2,081	2,178	1,973	4,036
Adj. profit (INR mn)	1,329	1,403	1,439	2,825
Adj. diluted EPS (INR)	25.8	27.2	28.0	55.0
Diluted P/E (x)	82	78	75	38
EV/EBITDA (x)	*52.1*	*49.6*	*54.3*	*26.4*

EDELWEISS RATINGS	
Absolute Rating	NOT RATED

MARKET DATA *(R: VNTI.BO, B: VO IN)*	
CMP	: INR 2,108
Target Price	: NA
52-week range (INR)	: 2,216 / 909
Share in issue (mn)	: 51.4
M cap (INR bn/USD mn)	: 108 / 1,552
Avg. Daily Vol. BSE/NSE ('000)	: 36.8

SHARE HOLDING PATTERN (%)

	Current	Q4FY18	Q3FY18
Promoters *	74.0	74.0	74.0
MF's, FI's & BKs	6.6	6.6	6.5
FII's	3.6	3.5	3.5
Others	15.8	15.9	16.0

** Promoters pledged shares (% of share in issue) : NIL*

PRICE PERFORMANCE (%)

	Sensex	Stock	Stock over Sensex
1 month	1.6	12.5	10.9
3 months	3.8	29.1	25.3
12 months	11.8	116.2	104.5

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June 19, 2019

World's largest ATBS and IBB manufacturer

VOL is a global leader in specialty chemicals with 65% market share in IBB and ATBS. Along with these two primary products, the company is the largest manufacturer of IB in India with 70% market share. IB is used primarily for captive consumption as raw material for ATBS.

Table 1: VOL—Product portfolio

Product	Market position	Application / End Usage	Relevance
Isobutyl Benzene (IBB)	Largest manufacturer in the world with 65% market share	Pharmaceutical	It is the primary raw material for Ibuprofen and widely used drug across the US, Europe and Asia
2-Acrylamido 2 Methylpropane Sulfonic Acid (ATBS)	Largest manufacturer in the world with 65% market share and the only manufacturer in India	Water treatment chemicals, emulsions for paint and paper coatings, adhesives, textile auxiliaries and acrylic fibre, detergents and cleaners, oil field, mining chemicals and construction chemicals	It is used to manufacture dispersants in water chemicals It acts as an important ingredient to manufacture polymers for Enhanced Oil Recovery (EOR) It is important for giving dye receptability for acrylic fibre
Isobutylene (IB)	Largest manufacturer in India with 70% market share	Agro-based chemicals, food additives and anti-oxidants	It is used as an intermediate
High Purity- Methyl Tertiary Butyl Ether (HPMTBE)	Largest manufacturer in India	Pharmaceuticals and organometallic compounds	It is used as a specialty solvent
N-Tertiary Butyl Acrylamide (TBA)	Only manufacturer in India	Thickeners, personal care, water treatment and metal working fluid	It is an important ingredient to increase viscosity of coatings and solutions
N-Tertiary Octyl Acrylamide (TOA)	Only manufacturer in India	Personal care, adhesives and enhanced oil recovery	It is an important ingredient in personal care products like hair gel and creams

Source: Company, Edelweiss research

To benefit from competitor's exit, the company is expanding its ATBS capacity from 26,000MTPA to 38,000MTPA by July 2019

ATBS reaping benefits of competitior's exit

ATBS, one of VOL's key products, is benefitting from exit of competitor Lubrizol. This has led to VOL's market share catapulting to 65% currently from 45% two years ago. Riding robust spurt in the segment, the company is expanding its ATBS capacity from 26,000MTPA to 38,000MTPA by July 2019. Hence, management expects ATBS volumes to jump 50% over FY19-20.

Aggressive capacity expansion to drive growth

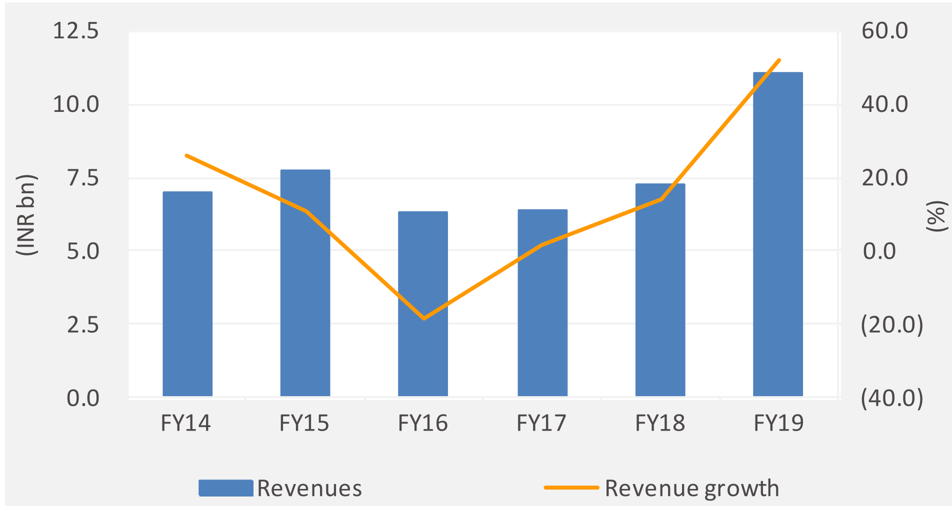
VOL has lined up ~INR3bn capital expenditure. Management estimates robust spurt in FY20 driven by: (1) 50% plus increase in ATBS volumes over FY19-20 led by capacity expansion from 26,000MTPA to 38,000MTPA by July 2019; (2) 30% IBB volume spurt riding low base (in H1FY19 one of its key customers had shut down); and (3) commissioning of 35,000MTPA butyl phenol plant by June 2019. Riding these, management expects overall revenue to jump 30-35% in FY20.

VOL has a concentrated product portfolio—three products contribute ~80% to revenue

VOL is looking at import substitution opportunity as ~25,000MTPA PAP demand is currently met via imports

Strong R&D with competitive capex cost helps the company clock superior EBITDA margin

Chart 1: Revenue clocked 15% CAGR over FY14-19



Source: Company, Edelweiss research

Focused product approach

VOL has a concentrated product portfolio—three products contribute ~80% to revenue. Unlike other specialty chemical players, the company adheres to stringent criteria while expanding its product portfolio: i) it should be niche product entailing process technology advantage for VOL; and ii) it should have synergy benefits. Further, the company aims to be amongst the top 3 manufacturers and the lowest cost producers in the world in each of its products.

PAP: Huge potential opportunity

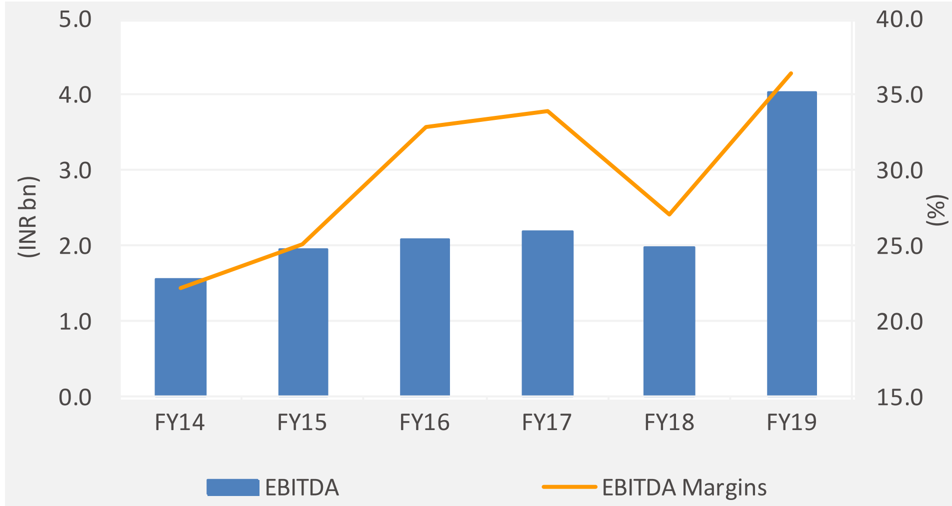
VOL has been working on a new product Para Amino Pheno (PAP) for many years. PAP is a n-1 intermediate used to manufacture paracetamol—one of the most widely used analgesics (pain reliever) and antipyretic (anti-fever) drugs. While 80% plus of PAP is used worldwide to manufacture paracetamol, 7% is used as a rubber antioxidant and 5% in dyes. Though VOL has achieved end results at the lab stage, the product has not been commercialized as yet.

India's current ~25,000MTPA PAP demand is met via imports. VOL is eyeing import substitution via cost leadership in the product. According to management, if successful, this product entails revenue potential of INR7bn with capex of INR5bn.

Cost leadership in key products leads to strong margins

VOL focuses on green technology with both its plants being zero effluent. Strength in R&D is combined with capacity expansion at a competitive cost per tonne, enabling the company to price products attractively even while maintaining superior margins. The focus is on volume dominance and in spite of not resorting to price hikes, it has maintained margin. This is a derivative of longer tenure contracts with customers with inbuilt raw material price increase pass-through.

Chart 2: EBITDA registered 10% CAGR over FY14-19



Source: Company, Edelweiss research

Margins and returns best among peers

VOL enjoys highest profit margin (EBITDA margin of 36% and PAT margin of 25.5%) compared to peers. Higher margins and asset turnover (3-4x) lead to higher return ratios, with RoCE of over 45%. The company also has the strongest balance sheet among peers, with zero debt.

Chart 3: Highest EBITDA margin amongst peers

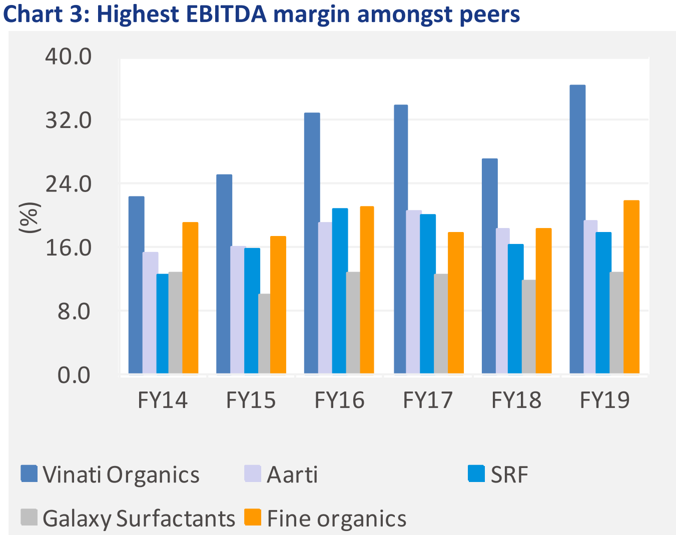
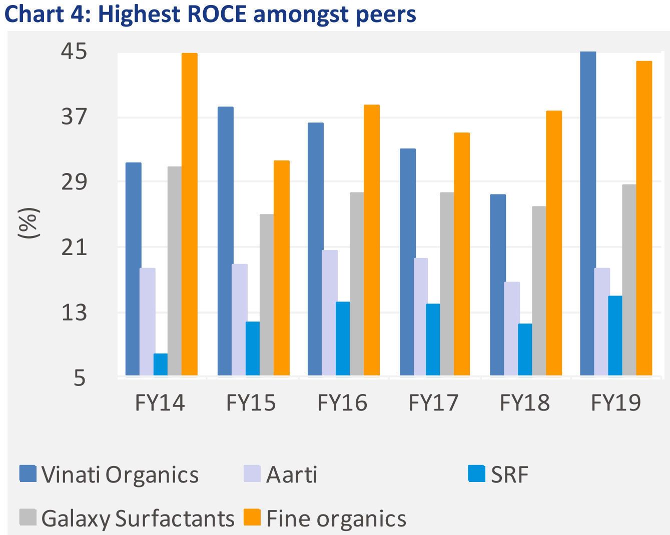


Chart 4: Highest ROCE amongst peers



Source: Company, Edelweiss research

Company Description

VOL, established in 1989, is a specialty chemical company focusing on manufacture of specialty chemicals and organic intermediaries. The company produces aromatics, monomers, polymers and other specialty products. With limited product focus, VOL has emerged the world's largest producer of IBB & ATBS and the largest manufacturer of IB & HP MTBE in India. It has manufacturing operations at two locations in Maharashtra—Raigad and Ratnagiri—and it adheres to green practices to minimise adverse effects on the environment.

Table 2: Plant locations

Facility	Plant 1	Plant 2
Location	Mahad - Raigad, Maharashtra	Lote – Ratnagiri, Maharashtra
Distance from nearest port (JNPT)	140 km	210 km
Year of establishment	1989	2002
Products Made	IBB and NBB	ATBS, NaATBS, TBA, IB, HP MTBE, DAAM
Certification	ISO 9001:2008; ISO 14001:2004 and OHSAS 18001:2007	ISO 9001:2008; ISO 14001:2004 and OHSAS 18001:2007
Cutting-edge technology	InstitutFrancais du Petrole (IFP) France	National Chemical Laboratories (NCL), Pune (for ATBS) and SaipemSpA, Italy (for IB)

Source: Company, Edelweiss research

Table 3: Milestones

1989	VOL came into existence
1992	IBB plant at Mahad came on stream with 1,200 MT production capacity
1996	IBB capacity expanded to 3,000 MT
1997	IBB capacity expanded to 5,000 MT
2002	ATBS plant at Lote started operations with 1,000 MT production capacity
2006	IBB capacity expanded to 10,000 MT. ATBS capacity increased to 3,600 MT
2007	Started n-tertiary Butylacrylamide (TBA) production
2008	IBB capacity expanded to 14,000 MT
2009	ATBS capacity expanded to 12,000 MT. TBA capacity increased to 500 MTA
2010	Isobutylene plant came on stream with a capacity of 12,000 MT
2011	HP MTBE plant commissioned with a capacity of 7,000 MT
2012	Commissioned the HP MTBE plant with a capacity of 6000 MTPA
2013	Completed construction of DAAM plant, de-bottlenecked IBB capacity to16000 TPA and completed ATBS expansion to 26,000 MTPA
2014	Invested INR200 mn in zero discharge and wastage facility
2015	Development of multiple new products like PTBT, PTBBA
2016	Gained a gold medal from EcoValdis CSR evaluation program
2017	Announced capex on Butylated Phenols, PAP and IBAP
2018	Announced de-bottlenecking of ATBS capacity from 26,000 MTPA to 30,000 MTPA

Source: Company, Edelweiss research

Management overview

Mr Vinod Saraf, Managing Director: Mr. Vinod Saraf is the founder of VOL. Prior to starting his own venture, Mr. Saraf worked for about 25 years in textiles and petrochemicals industries.

Ms. Vinati Saraf Mutreja, Executive Director: Ms. Vinati Saraf Mutreja is an experienced financial consultant having worked for leading companies in New York before joining VOL in 2006. She holds a dual degree – Bachelors of Science in Economics (Finance) from The Wharton School and Bachelors in Applied Science, Biotech and Pharmaceutical Development from the School of Engineering and Applied Sciences (University of Pennsylvania).

Ms. Viral Saraf Mittal, Director - Corporate Strategy: Ms. Viral Saraf Mittal has rich experience of working with Citi Bank and Ernst & Young. She joined VOL in 2009. She holds a Bachelors of Science degree in Economics (Finance and Management) from The Wharton School, University of Pennsylvania. She is responsible for formulating corporate strategies at VOL.

Financial Statements

Income statement (INR mn)

Year to March	FY16	FY17	FY18	FY19
Net revenues	6,323	6,408	7,297	11,081
Raw material costs	2,963	3,005	3,776	5,251
Employee Benefits Expense	359	419	490	542
Other expenses	920	805	1,059	1,252
Total expenses	4,242	4,230	5,324	7,045
EBITDA	2,081	2,178	1,973	4,036
Depreciation & amortization	185	216	234	274
EBIT	1,896	1,962	1,739	3,762
Less: Interest Expense	79	28	12	9
Add: Other income	62	125	307	500
Profit Before Tax	1,879	2,060	2,034	4,252
Less: Provision for Tax	550	657	595	1,428
Add: Share of profit from assoc.	6	7	8	8
Reported Profit	1,329	1,403	1,439	2,825
Adjusted Profit	1,329	1,403	1,439	2,825
No. of Shares outstanding (mn)	52	52	51	51
Adjusted Basic EPS	26	27	28	55
No. of dil. shares outstand. (mn)	52	52	51	51
Adjusted Diluted EPS	26	27	28	55
Adjusted Cash EPS	29	31	33	60
Dividend per share	4	0	2	2
Dividend Payout Ratio (%)	16%	0%	7%	4%

Common size metrics - as % of revenues

Year to March	FY16	FY17	FY18	FY19
Materials costs	46.9	46.9	51.7	47.4
Staff costs	5.7	6.5	6.7	4.9
S G & A expenses	14.5	12.6	14.5	11.3
Depreciation	2.9	3.4	3.2	2.5
Interest Expense	1.2	0.4	0.2	0.1
EBITDA margins	32.9	34.0	27.0	36.4
Net Profit margins	21.0	21.9	19.7	25.5

Growth metrics (%)

Year to March	FY16	FY17	FY18	FY19
Revenues	(18.3)	1.4	13.9	51.9
EBITDA	7.2	4.7	(9.5)	104.6
PBT	6.8	9.6	(1.3)	109.1
Adjusted Profit	12.5	5.6	2.6	96.3
EPS	12.5	5.6	3.0	96.3

Balance sheet (INR mn)

As on 31st March	FY16	FY17	FY18	FY19
Share capital	103	103	103	103
Other Equity	5,305	6,697	7,864	10,410
Total shareholders funds	5,408	6,800	7,967	10,513
Long term Borrowings	133	0	0	0
Short term Borrowings	288	23	152	37
Total Borrowings	421	23	152	37
Long Term Liabilities & Prov.	0	182	32	29
Deferred Tax Liability (net)	492	695	809	846
Sources of funds	**6,321**	**7,700**	**8,959**	**11,425**
Gross Block	4,756	4,836	4,966	5,426
Capital work in progress	248	74	349	1,912
Intangible Assets	54	45	35	26
Total Fixed Assets	4,067	4,750	4,917	6,657
Cash & bank balances	750	666	1,370	1,003
Inventories	447	651	822	924
Sundry Debtors	1,148	1,405	1,771	2,440
Loans & Advances	902	635	192	119
Other Current Assets	40	104	727	1,133
Total Current Assets (Ex Cash)	2,537	2,796	3,512	4,616
Trade payable	223	327	634	531
Other Current Liab. & ST Prov.	810	183	206	320
Total Current Liab. & Provisions	1,033	511	841	851
Net Current Assets (ex cash)	1,504	2,285	2,672	3,765
Uses of funds	**6,321**	**7,700**	**8,959**	**11,425**
Book value per share (BV) (INR)	105	132	155	205

Free cash flow

Year to March	FY16	FY17	FY18	FY19
Reported Profit	1,329	1,403	1,439	2,825
Add: Depreciation	185	216	234	274
Interest (Net of Tax)	56	19	9	6
Others	179	(713)	(614)	(2,617)
Less:Changes in WC	73	(380)	(316)	(1,060)
Operating cash flow	1,675	1,304	1,383	1,548
Less: Capex	732	1,141	725	2,023
Free cash flow	**943**	**164**	**658**	**(475)**

Cash flow statement

Year to March	FY16	FY17	FY18	FY19
Operating cash flow	1,675	1,304	1,383	1,548
Investments cashflow	(721)	(268)	(388)	(1,670)
Financing cash flow	(502)	(451)	(299)	(1,158)
Net cash Flow	451	585	697	(1,280)
Capex	(732)	(1,141)	(725)	(2,023)

Profitability & liquidity ratios

Year to March	FY16	FY17	FY18	FY19
RoAE (%)	27.3	23.0	19.5	30.6
RoACE (%)	36.2	33.0	27.4	45.7
Debtors Days	70	73	79	69
Payble Days	27	33	46	41
Cash conversion cycle (days)	104	106	104	90
Current Ratio	3.2	6.8	5.8	6.6
Gross Debt/EBITDA	0.2	0.0	0.1	0.0
Gross Debt/Equity	0.1	0.0	0.0	0.0
Net Debt/Equity	(0.1)	(0.1)	(0.2)	(0.1)
Interest Coverage Ratio	24.1	71.3	143.6	398.5

Operating ratios

Year to March	FY16	FY17	FY18	FY19
Total asset turnover(x)	1.4	1.3	1.5	2.1
Fixed asset turnover(x)	1.6	1.4	1.4	1.6
Equity turnover(x)	1.3	1.0	1.0	1.2

Valuation parameters

Year to March	FY16	FY17	FY18	FY19
Adjusted Diluted EPS (INR)	25.8	27.2	28.0	55.0
Y-o-Y growth (%)	*12.5*	*5.6*	*3.0*	*96.3*
Adjusted Cash EPS (INR)	29.3	31.4	32.5	60.3
Diluted P/E (x)	81.8	77.5	75.3	38.3
Price/BV (x)	20.1	16.0	13.6	10.3
EV/Sales (x)	17.1	16.9	14.7	9.6
EV/EBITDA (x)	52.1	49.6	54.3	26.4
Dividend yield (%)	0.2	-	0.1	0.1

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Coverage group(s) of stocks by primary analyst(s): Speciality Chemicals

Aarti Industries, Fine Organics, Galaxy Surfactants, PI Industries, Solar Industries, SRF

Recent Research

Date	Company	Title	Price (INR)	Recos
23-May-19	**Aarti Industries**	Overwhelming valuation; growth intact; *Result Update*	1,697	Hold
20-May-19	**PI Industries**	Spectacular spurt; outlook benign; *Result Update*	1,106	Buy
14-May-19	**SRF**	Chemicals business on a roll; *Result Update*	2,600	Buy

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

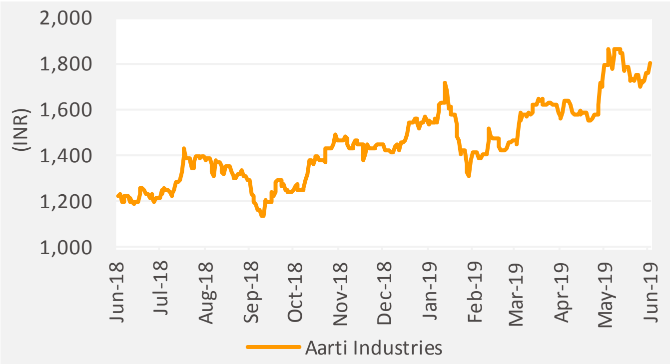
	Buy	Hold	Reduce	Total
Rating Distribution* * 1stocks under review	161	67	11	240

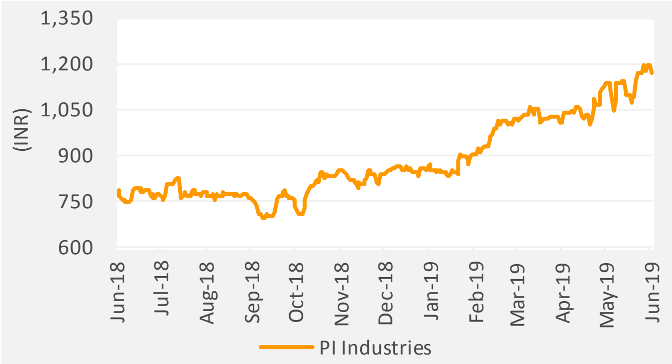
	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	156	62	11

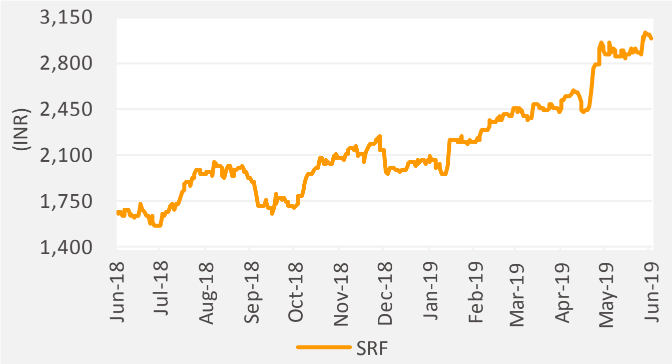
Rating Interpretation

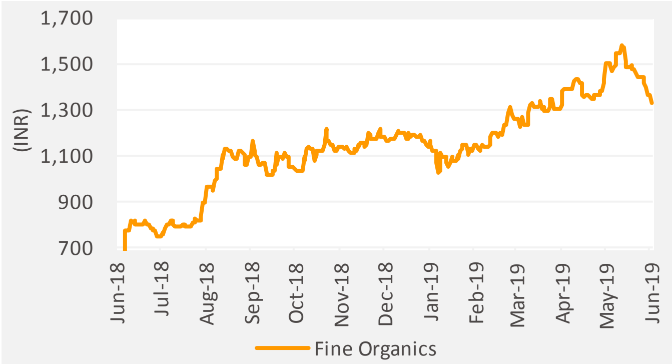
Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period

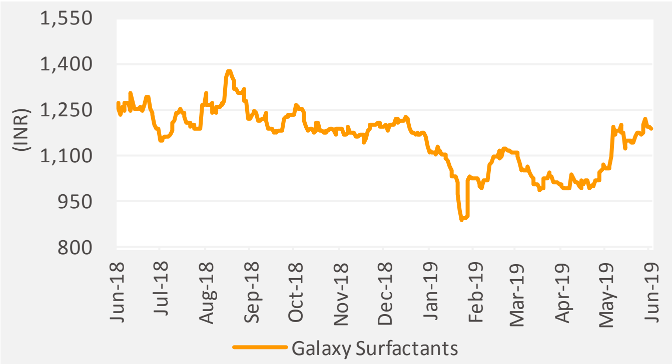
One year price chart











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