

06 October 2015

Initiating Coverage (BUY)

Aarti Drugs

CMP INR 626

Target Price INR 808

Stock Details	
Industry	Pharmaceuticals
Bloomberg Code	ARTD IN
BSE Code	524348
Face Value (Rs.)	10.00
Market Cap. (Rs. Mn)	15,159.90
52wk. High/Low (Adjusted) ((Rs.)	874.00/334.13

Shareholding Pattern Jun '15	
Promoter (%)	59.96
FII (%)	0.15
DII (%)	2.06
Public - Other (%)	37.82
No. of Share Outstanding (mn)	24.22

Valuation Summary				
	FY 14A	FY 15A	FY 16E	FY 17E
P/E (x)*	05	20	18	16
EV/EBITDA (x)*	1.57	9.81	9.10	8.27
P/BV (x)*	0.64	4.99	4.77	4.43

*Based On CMP on Reco Date for FY 15 and
Market Price as on 1st Apr is taken for FY14

Key Financial				
Rs. Mn	FY 14A	FY 15A	FY 16E	FY 17E
Net Sales	9,717	10,872	12,871	15,442
EBITDA	1,473	1,696	2,071	2,503
Net Profit	617	776	985	1,223
EPS (Rs.)*	25.5	32.0	40.7	50.5

*Unadjusted for any bonus issue

Key Ratios				
	FY 14A	FY 15A	FY 16E	FY 17E
EBITDA Margin (%)	15.2	15.6	16.1	16.2
EBIT Margin (%)	12.3	12.8	13.4	13.7
Net Pro. Margin (%)	6.4	7.1	7.7	7.9
Debt/Equity (x)	0.31	0.50	0.31	0.27
RoNW (%)	26.9	28.0	29.2	30.0
RoCE (%)	17.7	17.8	19.0	21.2

We recommend 'BUY' on Aarti Drugs for a target of INR 808 - valuing the company at P/E of 16x FY17E Earning.

Positioning high on both the domestic and global pharma industry:

Aarti Drugs is engaged in manufacturing of high qualities APIs, Pharma Intermediates and specialty chemicals and highly positioned its products across domestic and international markets. Exports to over 97 countries with strong presence in regulated markets including Brazil, Mexico, Netherland & Spain and its Clientele includes MNCs viz. Abbott, Sanofi-Aventis, Merck, Teva, Searle, Pfizer, Bayer and Clariant. Exports constituting 38% of its revenues. The company's domestic clients comprise all major formulation companies like Cipla, Dr Reddy's, Cadilla, Ranbaxy, Glaxo, Alembic, etc. The company is the market leader in most of its top 10 products thereby enabling it to enjoy economies of scale. Over the last decade, the company has gained scale by growing its revenues from INR 2,000mn to over INR 10,000mn at an annual growth of ~16%.

Driving profitability by focusing on high value products:

Strategically allocating much of its incremental capex towards high value import substitute products in segments of Antibiotic, Antifungal, Cardio and Antidiabetic. These new products margin will be in line with those of other categories however owing to their higher realizations the company will be able to increase its asset turnover thereby driving the return ratios. Over the last few years, the company has increased its ROCE from 6.4% in FY12 to 17.4% in FY15 which we expect to rise to 21.2%/22.7% by FY17/18E.

Planning rapid expansion to drive 19% revenue growth over FY15-17E:

Planning to incur an annual capex of around INR 1,000mn in coming years to unfold the opportunities in domestic and global market. We expect the company to grow its revenues and profits at 19% and 21% respectively over FY15-17E.

VALUATIONS AND VIEW:

Given the visibility of high growth prospects in the long term with its strong product base ranging from API, Steroids, Pharma Intermediates and Speciality Chemicals, its position in the domestic and global pharmaceutical industry, aggressive expansion plans in high value segments, a 21% CAGR in profits over FY15-17E along with consistently expanding return ratios and dividend payout of 30%; we value the business at 16.0x FY17E EPS and recommend a BUY rating on the stock with a target price of INR 808 per share.

RISK & CONCERNS:

Volatile Crude Oil Prices: Variation in crude oil prices would always be area of concern. Aarti Drugs Limited “ADL” has already installed greener technologies like briquette fired boilers, economizers etc. to save power and fuel costs, which reflects in the financial result of the Company. ADL was able to cope up with these pressures due to strong operational efficiency and increased market share of its products.

Volatility of exchange rate: Extreme volatility of exchange rate of rupee against US dollar can have significant impact on ADL operations because approximately 40% of its total revenues consist of exports. However, natural hedge mitigate the risk to large extent due to the imports. ADL has a strict FOREX policy of hedging all of its foreign currency loans to mitigate the risk of volatility of exchange rate.

Adverse pricing action under DPCO: Any action by the government under the DPCO (Drug Price Control Order) to add more drugs under the price control mechanism could act as a dampener for the sector which could have an impact on the company as well. However, since ADL has a basket of over 35 products, it shall be able to wither such an impact in case it were to happen.

Import alert: One of ADLs' Tarapur facility was issued an import alert in March 2015. However this won't have any major impact on the company as US forms less than a percent of the company's revenue. Further, the import alert was issued due to data integrity reasons as USFDA requires the minutest of details to be furnished. We believe the company follows robust manufacturing practices as audits are carried out by its customers on one-third of the days on an average.

Q1 FY16 RESULT HIGHLIGHTS: Strong Revenue Growth in line with expectations:

Achieved a turnover of Rs. 2636.70 mn, a growth of 1.53% YoY for the 1st quarter of FY 2016 as against Rs. 25978.00 mn in the corresponding quarter of the previous year. Revenues at this level do not portray the actual numbers. In an attempt to bifurcate revenues between APIs, Intermediaries & Formulations, the company has set up a subsidiary where it shall transfer its formulations business in a gradual manner. During the quarter, the company transferred INR ~250mn of formulations revenue to this subsidiary. Adjusting for this transfer, the company achieved revenues of INR 2880mn (+11% YoY). Managements of the company already indicated that the revenue impact of new capacity would kick in from 3QFY16 and thus 1H would remain flattish YoY, however the performance of 1QFY16 has been a positive surprise.

In Q1 FY16, Net profit stood at Rs. 170.50 million from Rs. 172.30 million over the corresponding quarter last year. EBDITA stood at Rs. 435.10 million compared to Rs. 398.50 million in the corresponding quarter of the previous year, rising by 9.18% YoY.

The company has reported an EPS of Rs. 7.04 for the 1st quarter as against an EPS of Rs. 14.23 in the corresponding quarter of the previous year.

From 3QFY16 onwards it has plan to start the sale of high value products initially in the anti-diabetic segment viz. Metformin and later in antibiotic and antiprotozoal segments and thus the company is likely to witness major growth in topline.

Q1 FY16 Performance Highlight (Standalone Basis)							
(in Million)	1Q FY15	2Q FY15	3Q FY15	4Q FY15	1Q FY16	YoY (%)	QoQ (%)
Revenue	2,597.00	2,862.70	2,610.80	2,783.70	2,636.70	1.53%	-5.28%
Other Income	--	--	6.4	--	--		
Total Income	2,597.00	2,862.70	2,617.20	2,783.70	2,636.70	1.53%	-5.28%
Expenditure	-2,198.50	-2,438.60	-2,173.00	-2,354.60	-2,201.60		
As a % of Sales	84.66%	85.19%	83.23%	84.59%	83.50%		
Interest	-98.2	-94.4	-98.6	-97.6	-102.9	4.79%	5.43%
PBDT	300.3	329.7	345.6	331.5	332.2		
As a % of Sales	11.56%	11.52%	13.24%	11.91%	12.60%		
Depreciation	-74.1	-74.6	-77.1	-80.9	-86.7		
PBT	226.2	255.1	268.5	250.6	245.5	8.53%	-2.04%
As a % of Sales	8.71%	8.91%	10.28%	9.00%	9.31%		
Tax	-53.9	-67.7	-41.1	-62	-75	39.15%	20.97%
Net Profit	172.3	187.4	227.4	188.6	170.5	-1.04%	-9.60%
As a % of Sales	6.63%	6.55%	8.71%	6.78%	6.47%		
Equity	121.1	121.1	121.1	242.2	242.2	100.00%	0.00%
EPS (Rs)*	14.24	15.49	18.79	7.79	7.04	-50.56%	-9.63%
CEPS (Rs)*	20.35	21.64	25.14	11.13	10.62		
OPM %	15.34	14.81	17.01	15.41	16.5		
NPM %	6.63	6.55	8.71	6.78	6.47		

*Unadjusted for bonus issue

COMPANY BACKGROUND:

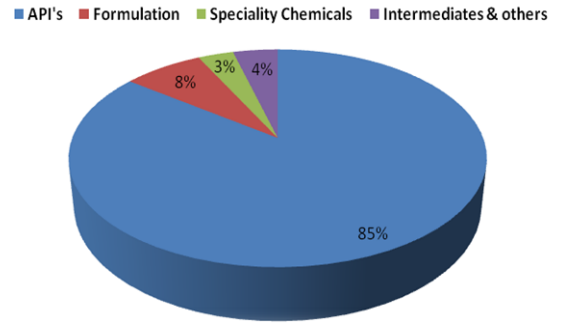
Part of the \$ 650 million Aarti Group of Industries, Aarti Drugs Limited is an India-based company engaged in pharmaceutical business established back in 1984.

- Engaged in manufacturing of APIs, Pharma Intermediates and specialty chemicals with 10 multi-ton, multi-location GMP compliant facilities. Manufactures vitamins, anti-arthritis, anti-fungal, antibiotics, angiotensin converting enzyme (ACE) inhibitors, anti-diabetic, anti-cholinergic, sedatives and anti-depressant drugs. Its products include active pharmaceutical ingredients (APIs) and steroids, pharma intermediate and specialty chemicals. APIs include Anti-inflammatory, Cardioprotectant, Antidiarrhoeals/Antiprotozoals, Antifungals, Antiarthritis/Osteoporosis, Antibiotic, Alzheimer's treatment, Antidiabetic, AntiBPH, Sedative and vitamins. Its pharma intermediate includes Antiprotozoal, Celecoxib, AntiBiotic, Clopidogrel, Diclofenac, Ketoconazole, Nimesulide, Raloxifene, Zolpidem and Telmisartan. Its specialty chemicals include Benzene Sulphonamide, Benzene Sulphonic acid, Benzene Sulphonic acid methyl ester and Benzene Sulphonyl chloride, N-Methyl Methane Sulphonamide and Ortho para toluene Sulphonamide, among others.
- 8 facilities located in Industrial MIDC Tarapur, Maharashtra - 120 kms away from Mumbai 2 facilities located in Industrial GIDC Sarigam, Gujarat - 160 kms away from Mumbai
- Markets products over 94 countries with strong presence in regulated markets including Brazil, Mexico, Netherland & Spain
- Clientele includes MNCs viz. Abbott, Sanofi- Aventis, Merck, Teva, Searle, Pfizer, Bayer and Clariant
- Comprehensive product portfolio with a strong presence in Anti-biotic, Anti-Protozoal, Anti-inflammatory, Anti-fungal, Anti-diabetic, Cardio-protectant, Vitamins, Anti-arthritis, Sedatives therapeutic groups
- Successfully commissioned centralized state-of-the-art R&D centre at Tarapur MIDC in close vicinity to manufacturing locations
- Various products are registered with various authorities like USFDA, COS, IDL, JAPAN ACCREDITATION, TGA, COFEPRIS, ANVISA, WHO-GMP, EUGMP
- It has developed 30 new molecules in the past five years

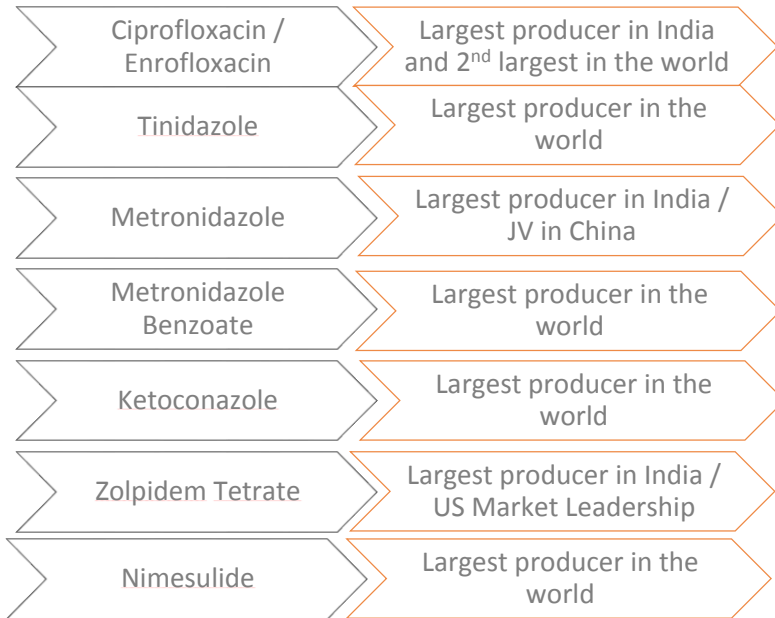
Business Overview

- Aarti Drugs is domestic market share leader in most of its top 10 products
- Export Clientele is well diversified with the topmost client contributing to only 3.77% of total export sales
- Top ten export clients contributes to only 24.80% of total export sales
- Top ten products contributes to around 60% of the total sales

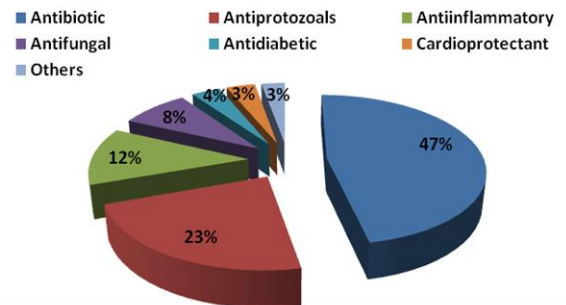
Segmentwise Sales For FY 14-15



Product Specific Leadership

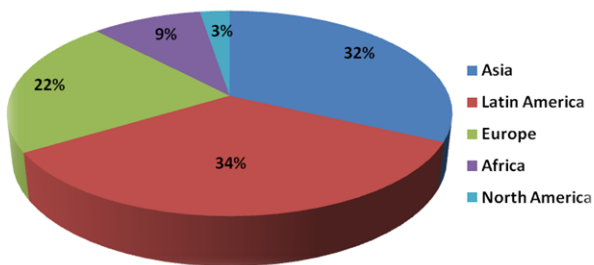


Therapeuticwise Sales for FY 14-15



Geographic Presence

Regionwise Export Sales for FY 14-15



TOP 10 EXPORT

Country	Country
BRAZIL	TURKEY
MEXICO	BANGLADESH
NETHERLANDS	SPAIN
EGYPT	CHINA
IRAN	PAKISTAN

Regulated	60%
Semi-Regulated	10%
Non - Regulated	30%

FUTURE BUSINESS STRATEGY:

Anti Diabetic:

- Received EC approval in April'15. Commercial operations will start by end of 1st Qtr
- Expected revenues of installed capacity would be ~150 cr per annum as per ROW market pricing. Designed for highly regulated markets. Layout has been designed for doubling the existing installed capacity

Antibiotic (3 more Fluoroquinolones):

- First in India to manufacture from basic intermediates. In-house technology. Already established market player in this category (existing sale of 135 cr per annum)
- Expected revenues of installed capacity would be around 450 cr per annum as per ROW market pricing. Will be designed for regulated markets. Would be commissioned by 1st quarter of next financial year

Antiprotozoal:

- Double the capacity of existing products to curtail the imports. Existing technology and Chinese JV.
- Established competitive edge worldwide and sole Indian player.
- Expected revenues of installed capacity would be around 80 cr per annum as per ROW market pricing. Would be commissioned by end of current financial year.

Vitamins / Anti-Inflammatory:

- Multi-purpose facility under construction. Targeting highly regulated markets
- Installed capacity will give revenues of around 50 Cr/ 35 Cr per annum as per product selection - Currently on HOLD

R&D product pipeline:

- Strong pipeline of products under R&D for future growth
- Identified some APIs with specialized applications but have volume markets

Formulations:

- Small existing business wherein we extend the service than just being a mere API supplier
- Provide toll manufacturing of formulations
- Small acquisition on the way to formulate these products in-house for better service

Tie-ups:

- Tied up with European distributor on profit sharing basis. Already 3 dossiers are ready, under stability study. Strategy would be to engage in our own APIs
- Partnered with USA company on formulation revenues wherein we would be supplying API at cost

Consolidation of existing Anti-biotic:

- Growth story continues
- 50 TPM -> 100 TPM (2013-14)-> 135 TPM (2014-15) -> 150 TPM (current) -> 300 TPM
- Further backward integration

INDUSTRY OVERVIEW:

The global pharmaceutical market is expected to reach \$ 1.3 trillion by 2018, due to increased global spending driven by population growth, an aging population, and improved access in pharmerging markets. CAGR of pharmerging market will be 8 to 11% by 2018. Due to globalization, pharmerging countries increased from 5 to 21 and healthcare improvement will continue to be their priority. Many of these countries are implementing healthcare reforms to ensure universal coverage. The developed market – led by the United States, the major five European markets and Japan had been the primary drivers of increased growth, while the 21 pharmerging countries will increase their contribution to growth over next five years and account for nearly 50% of absolute growth in 2018.

The Indian pharmaceutical industry accounts for about 1.4% of the global pharmaceutical industry in value terms and 10% in volume terms. It's revenue is expected to expand at a CAGR of 14.5% from the year 2009 to year 2020, by nearly \$ 55 billion. The generic market is expected to grow to \$ 26.1 billion by 2016 and has immense potential for growth. India is the fourth largest

player by value with market share of Asia-Pacific. Indian pharmaceutical industry accounts for the second largest number of Abbreviated New Drug Applications (ANDAs) and is the world leader in Drug Master Files (DMFs) application with US. Indian pharmaceutical industry has many advantages in terms of efficient cost of production, good R&D technical work force for process improvements, lower healthcare costs, diversified array of products viz., over 60,000 generics brands across 60 therapeutic categories comprising of more than 500 different APIs. Economic prosperity, increased drugs affordability and increasing penetration of health insurance along with government initiatives like 'pharma vision 2020' will propel India to become a global leader as a end-to-end drug manufacturer. The government of India is committed to setting up robust healthcare and delivery mechanisms.

Domestic Market and Trends:

The domestic formulation market has witnessed a healthy growth in demand during the past five years. Going forward, this trend is expected to continue broadly based on growing population, increasing health awareness and an increasing per capita income leading to a large overall healthcare spend. The market is expected to grow with a CAGR of 14% to reach a size of US \$47.06 billion by 2018. Indian bulk drug industry has grown as a direct offset of formulation growth world-wide.

Aarti Drugs Limited (ADL) has a strong regulatory framework and cGMP level documentation which is now a standard requirement of most of the big Indian pharmaceutical companies. High process efficiency and high standard for quality has created good brand name for ADL in the space of Antibiotic, Anti-diabetic, Antifungal, Antidiarrheal, Anti-inflammatory and Antihypertensive therapeutic segments. Indian pharmaceutical market is growing fast due to penetration of health services in rural areas of the country. There is also a shift in demand from drugs treating hygiene related diseases to drugs treating lifestyle related diseases in the urban sector. ADL has carried out the capital expenditure for constructing new facilities for three antibiotic products (Fluoroquinolones) and its intermediates, and doubling the capacity of one of its major Anti-protozoal product. Both these projects shall be commercially operational by the first two quarters of the year 2015-16.

Export Market and Trends:

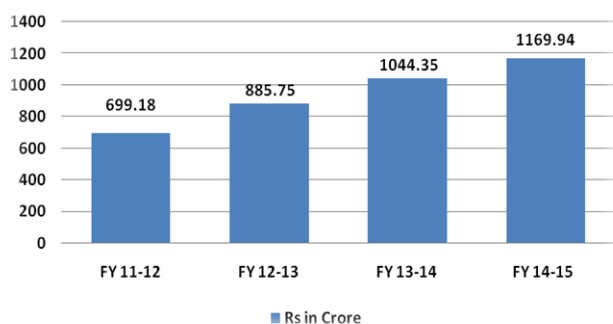
Indian bulk drug companies have filed 49% of the overall drug master filings (DMFs) made in the US in 2013, which will help Indian pharmaceutical companies to capitalize further on export opportunities in regulated and semi-regulated markets. The ministry of commerce targets to export \$ 25 billion worth of pharmaceuticals in 2016. Indian drugs are exported to more than 200 countries in the world, with US as a key market. In terms of value, exports of pharmaceutical products increased at a CAGR of 26.1% to USD 10.1 billion during FY 2006-13. The Americas accounted for around 34% of Indian pharma exports In FY 13, followed by Europe 26% and Asia 20%. Exports to Africa increased at a CAGR of 21% from 2009-13. The global generics market has grown at a phenomenal pace in past few years, and is expected to grow over the next five years.

Significant portion of bulk drugs manufactured in India is exported as compared to developed countries, where bulk drugs are primarily manufactured for captive consumption. Environmental Clearance (EC) for the new Anti-diabetic facility took more than required time due to change in government policies related to public hearing in the year 2014-15. However, EC has been obtained recently and subsequently we have also received WHO-GMP, unlocking the export potential of this Anti-diabetic drug. We expect to get more regulatory approvals for European markets as well in future.

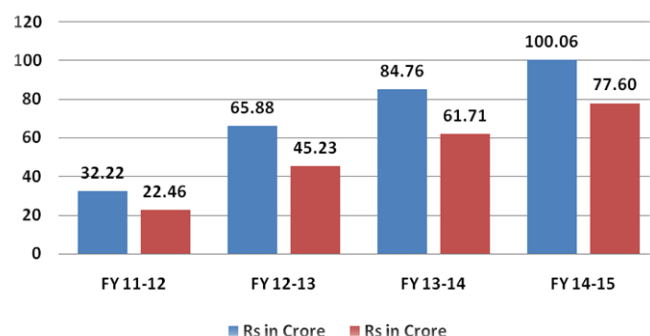
ADL management has addressed concerns of Import alert received in March 2015 for its USFDA approved unit. Management have taken corrective action and responded to the satisfaction of the authority and expect their feedback soon. Have also appointed a US based consultancy firm to resolve this issue. Total sales to North American continent from this facility is little below 1% of the total sales of ADL, hence its impact on the company financials is not expected to be significant. However, other facilities of ADL continue to maintain cGMP certifications like COFEPRIS, ANVISA, TGA, WHO GMP and ISO resulting in growth in the year 2014-15.

FINANCIAL OVERVIEW

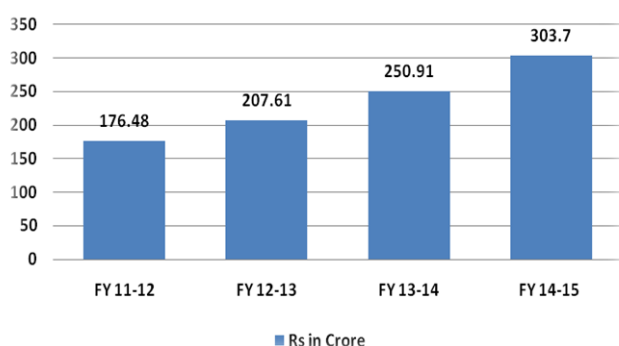
Turnover



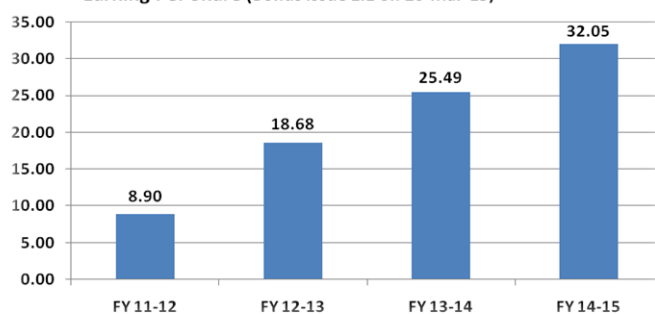
Profit Before Tax & profit After Tax



Networth



Earning Per Share (Bonus Issue 1:1 on 26-Mar-15)



Income Statement (Standalone)

Y/E Mar (Rs mn)	FY 12A	FY 13A	FY 14A	FY 15A	FY 16E	FY 17E	FY 18E
Net Sales	6,593	8,248	9,699	10,845	12,839	15,407	18,180
Other Operating Income	31	9	18	27	33	35	39
Expenditure	5,821	7,054	8,254	9,183	10,808	12,946	15,264
EBITDA	803	1,203	1,464	1,690	2,064	2,496	2,955
Depreciation	242	260	281	307	347	381	432
EBIT	561	944	1,182	1,383	1,718	2,115	2,523
Interest Expenses	227	280	335	389	393	474	520
PBT	334	663	847	994	1,325	1,641	2,003
Tax	98	206	240	225	346	425	515
Other Income	-	-	0	6	6	6	6
Extraordinary Items	(12)	(4)	9	-	-	-	-
Net Income Before Adjustment	225	452	617	776	985	1,223	1,494
Minority Int./Income from Assoc.	-	-	-	-	-	-	-
Adjusted PAT	225	452	617	776	985	1,223	1,494

Balance Sheet (Standalone)

Y/E Mar (Rs mn)	FY 12A	FY 13A	FY 14A	FY 15A	FY 16E	FY 17E	FY 18E
Equity share capita	121	121	121	242	242	242	242
Reserves & surplus	1,644	1,955	2,388	2,795	3,478	4,179	5,216
Share Warrants	-	-	-	-	-	-	-
Misc Expenditure	-	-	-	-	-	-	-
Net worth	1,765	2,076	2,509	3,037	3,720	4,421	5,458
Minority Interest	-	-	-	-	-	-	-
Share Application Money	-	-	-	-	-	-	-
Loan Funds	669	807	766	1,515	1,147	1,209	989
Net deferred tax liability	245	275	310	350	350	350	350
Other Long-term Liabilities	77	100	115	120	142	171	201
Long-term Provisions	-	29	-	3	3	4	5
Total Liabilities	2,756	3,287	3,701	5,025	5,363	6,155	7,003
Net block	2,765	3,038	3,808	4,448	5,117	5,956	6,550
Investment, Loan & Adv.	92	77	117	154	168	183	203
Total Current Assets	3,269	4,082	4,572	5,067	5,961	7,185	8,360
Current Liabilities & Provisions	3,370	3,910	4,797	4,644	5,882	7,170	8,110
Net Current Assets	(101)	172	(224)	423	78	16	250
Total Assets	2,756	3,287	3,701	5,025	5,363	6,155	7,003

Cash Flow (Standalone)

Y/E Mar (Rs mn)	FY 15A	FY 16E	FY 17E	FY 18E
Operating Cash Flow	1,068	1,203	1,378	1,695
Cash Flow from Investments	(1,023)	(1,001)	(1,204)	(1,006)
Cash Flow from Financing	(55)	(205)	(126)	(676)
Net Changes in Cash	(10)	(3)	47	14
Opening Cash	44	34	32	79
Closing Cash Balance	34	32	79	93

Peer Comparison (Top 7 companies in the same business)

Company	CMP (Rs)	P/E	Mcap (Rs Cr)	Div Yld (%)	NP Qtr (Rs Cr)	Qtr Profit Var (%)	Sales Qtr (Rs Cr)	Qtr Sales Var (%)	CMP/BV
Sun Pharma. Indus.	898	44.3	216,065	0.14	479	(29.57)	6,522	3.31	9.4
Lupin	2,083	40.7	93,698	0.36	525	(15.96)	3,074	(6.38)	10.0
Dr Reddy's Labs	4,180	31.1	71,298	0.48	626	13.67	3,758	6.83	6.8
Aurobindo Pharma	766	28.0	44,606	0.29	432	4.09	3,264	12.75	8.0
Cipla	640	33.4	51,406	0.31	690	107.74	3,467	44.36	4.4
Cadila Health.	2,081	33.5	42,610	0.58	353	47.12	2,378	17.71	9.3
Torrent Pharma.	1,578	28.4	26,822	0.71	449	75.39	1,886	72.71	9.1
Aarti Pharma.	626	19.5	1,516	1.27	17	(1.10)	263	1.42	4.9

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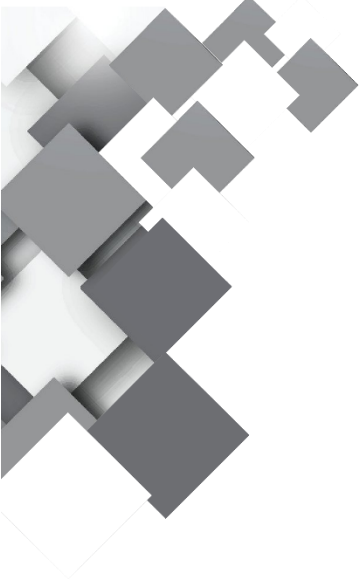
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