



## First Choice Vendor of Bulk Drugs

Part of the USD 500 million Aarti Group of Industries, Aarti Drugs Ltd (ADL) was established way back in 1984.



**Aarti Drugs Ltd (NSE Code: AARTIDRUGS) – Alpha/Alpha + stock recommendation for Feb'14**

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## Company Snapshot (As on 24<sup>th</sup> Feb'14)

**Current Market Price** – Rs 220.10

**Dividend yield** – 5.25%

**BSE Code** – 524348

**NSE Code** – AARTIDRUGS

**Market capitalization** – Rs 266.5 cr.

**Total Equity shares** – 1.21 cr.

**Face Value** – Rs 10.00

**52 Weeks High/Low** – Rs 262.10/Rs 129.30

Particulars (in cr.)	FY 08	FY 09	FY 10	FY 11	FY 12	FY 13	TTM
<b>Income from operations</b>	312.57	376.67	471.86	496.5	662.34	825.75	909.11
<b>Gross Profit</b>	100.31	124.51	154.29	155.47	208.78	270.47	297.29
<b>Gross Profit margin (%)</b>	32.09%	33.06%	32.70%	31.31%	31.52%	32.75%	32.70%
<b>Operating Profit</b>	39.30	56.91	72.07	62.69	80.26	120.33	138.88
<b>Operating Profit margin (%)</b>	12.57%	15.11%	15.27%	12.63%	12.12%	14.57%	15.28%
Depreciation	9.63	11.04	13.52	17.74	24.21	25.98	27.24
<b>EBIT</b>	29.67	45.87	58.55	44.95	56.05	94.35	111.64
<b>EBIT Margin (%)</b>	9.49%	12.18%	12.41%	9.05%	8.46%	11.43%	12.28%
Interest cost	11.84	22.72	14.74	13.48	22.67	28.03	31.88
<b>Profit Before tax</b>	17.83	23.15	43.81	31.47	33.38	66.32	79.76
Profit before tax margin (%)	5.70%	6.15%	9.28%	6.34%	4.86%	7.98%	8.77%
Tax expense	4.76	8.10	17.71	9.00	9.76	20.64	26.68
<b>Net Profit</b>	13.07	15.05	26.10	22.47	22.46	45.24	53.08
<b>Cash flows from operations</b>	11.82	38.20	28.20	12.92	19.11	46.28	
<b>Return on Avg. equity</b>	12.67%	13.14%	19.99%	15.10%	13.49%	23.56%	24.32%

Dear Members,

In Aarti Drugs we get a bulk drugs manufacturer with steady growth across the years, continuously improving performance on various financial parameters, good dividend yield of more than 5% and low valuations of 5 times earnings and EV/EBIT of 5.28.

Besides, what instills further confidence in the stock is the fact that promoters of the company have been continuously increasing their stake with regular purchases from open market. Two years back promoters had 54.83% stake in the company and the same now stands increased to 59.65%.

### **Aarti Drugs Ltd – Basic details**

Aarti Drugs Limited (ADL), incorporated in 1984 is part of Rs 3,000 crore Aarti Group of Industries and is engaged in manufacturing and sale of Active pharmaceutical ingredients (APIs), advanced intermediates and specialty chemicals. ADL manufactures drugs in therapeutic segments such as anti-arthritis, anti-fungal, antibiotics, anti-diabetic, sedatives, anti-depressant, anti-diarrhea and anti-inflammatory.

**Certified and cGMP compliant plants** – With nearly three decades of manufacturing experience and strength of nine manufacturing locations, ADL has today transformed into multi-tonne, multi-location GMP compliant with the state of the art facilities. The company's 9 manufacturing units are spread across Tarapur, Maharashtra and Sarigam, Gujarat. ADL's facilities are cGMP approved with certifications like USFDA, WHO GMP, EUGMP, TGA and ISO and are currently capable of making over 50 bulk actives, several key intermediates/specialty chemicals.

ADL has two R&D centers; one is located at MIDC Industrial area, Tarapur and the other at Turbhe, Navi Mumbai. The company's R&D programmes are focused on improvement of existing production processes by enhancing yields and reducing costs by optimization of reaction parameters, reaction re-engineering and implementing cost effective routes of synthesis.

Further, ADL is also working on new APIs which are blockbuster molecules in their respective therapeutic segments and are expected to go off-patent within next 5 years.

**Low cost producer of APIs** – In general, the cost of manufacturing is lower in China than in India; however ADL has been able to keep its costs to minimum possible and aggressively compete with Chinese competitors. Moreover, global players prefer Indian manufacturers to Chinese due to documentation and quality issues. Furthermore, ADL has customer audited and FDA approved facilities which give it an edge over competition throughout the world.

ADL enjoys good brand name in the space of Antibiotic, Anti-diabetic, Anti-fungal, Anti-diarrheal, Anti-inflammatory and Antihypertensive therapeutic segments due to its large scale production capacities and thereby competitive prices for its customers.

As per the management, the company has already planned capital expenditure for constructing new facilities, few of which will start giving production output in the coming year and will cater to ever increasing Anti-diabetic segment.

**Focus on regulated and semi-regulated markets** – Exports amount to nearly 35-40% of ADL's sales and the company is constantly growing its presence in regulated markets by offering series of products from its USFDA, TGA certified, as well as Japanese accredited plants. With the focus being to access potential US generics business, ADL has already commissioned and made operational its new multipurpose manufacturing facility strictly designed and built in accordance with USFDA requirements.

ADL has fourteen USDMFs assigned and eight European COS approvals, which have opened up opportunities in North American & European markets and the Company will be filling around 20 DMF's (Drug Master File) with global regulatory authorities within the next 2 years. This is expected to increase its presence in the profitable US market for supply of API's to its generic customers/partners.

Besides the regulated markets of US and Europe, the company is also working on growing its market share in semi-regulated markets of South East Asia and Latin America. Recently, ADL also got cGMP certification from ANVISA of Brazilian authorities and

COFEPRIS of Mexican authorities to cater to Latin American market in two of its major products.

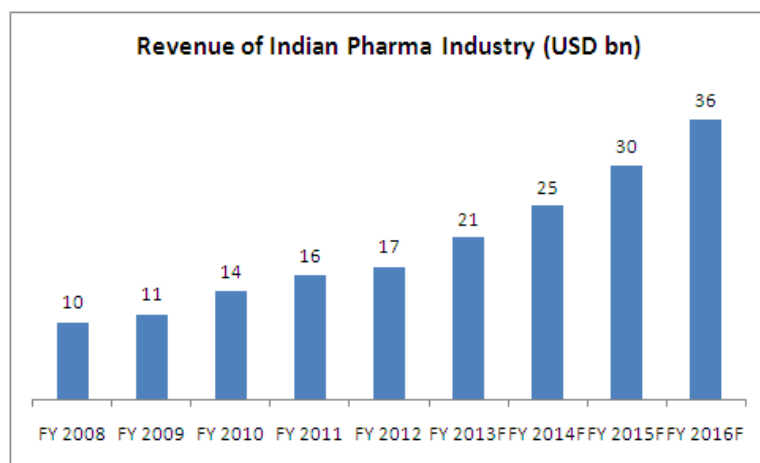
Within domestic market, ADL has a diversified client mix including customers like Cipla, Dr Reddy's Laboratories, Cadilla Healthcare, Ranbaxy Laboratories, Alembic, Unichem Laboratories, Unimark Remedies, Glaxo Smithkline, Deepak Fertilizers & Petrochemicals etc.

**Growth plans** – As per the management, the company's R&D programs are currently focused on new products amongst therapeutic categories such as Antipsychotic, Antitussive, Antifungal, Antihypertensive, Anticonvulsant, Alcoholism treatment and Anti-inflammatory. These products would be launched in a time-horizon of 2-4 years depending upon patents. Company will continue to do R&D on APIs that are off patents and will work on non-infringing synthesis routes.

The company recently expanded the capacities of its existing products in Anti-Biotic, Anti-Diabetic, Anti-Fungal, and Anti-Diarrhea segments. This has given an impetus to sales volumes and it is now planning to expand the capacity of its Cardio-protectant, anti-biotic, anti-diabetic and lifestyle related drugs.

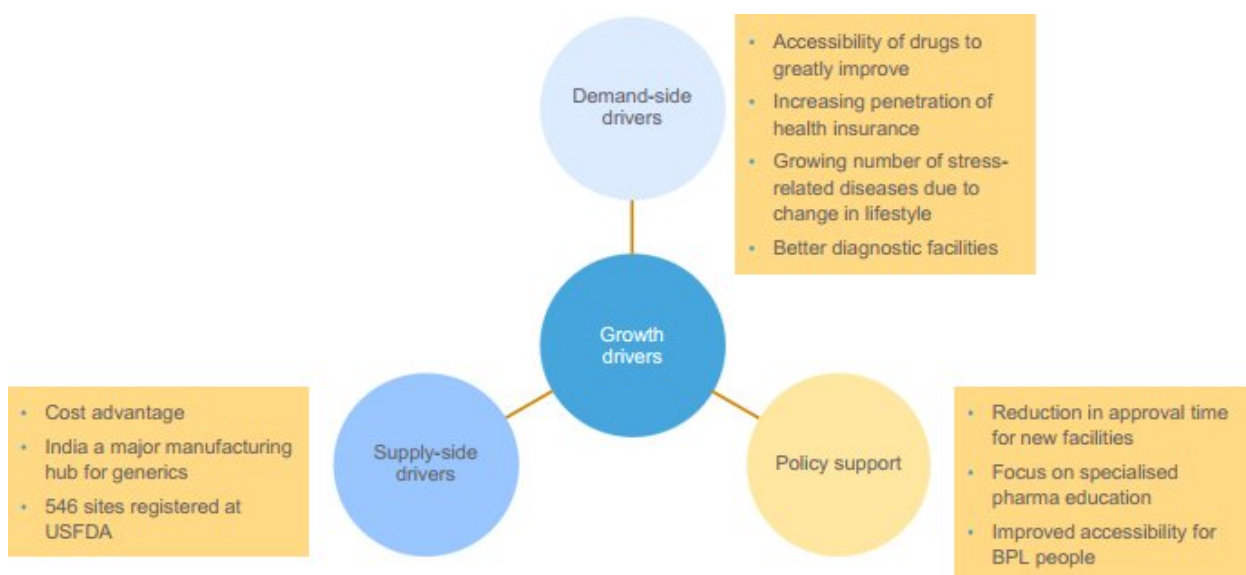
## **Overview of Indian Pharmaceutical industry**

The Indian pharmaceutical industry ranks among the top five countries by volume (production) and accounts for about 10% of global production. The market is primarily driven by exports to regulated as well as semi-regulated markets. Currently, India exports drugs to more than 200 countries and vaccines and biopharmaceutical products to about 151 countries. Rising use of generics, low cost of skilled manpower and innovation are some of the main factors supporting exports growth while domestic market growth has been driven by increased access to healthcare, improved infrastructure and greater penetration of pharmaceutical companies into tier 1 cities and rural areas.



The products manufactured by the Indian pharmaceutical industry can be broadly classified into **bulk drugs (active pharmaceutical ingredients - API)** and **formulations**. Bulk drug is an active constituent with medicinal properties, which acts as basic raw material for formulations. Formulations are specific dosage forms of a bulk drug or a combination of bulk drugs.

**Factors influencing growth of the industry** – The Indian pharmaceutical industry ranks 14th in the world by value of pharmaceutical products. With a well-established domestic manufacturing base and low-cost skilled manpower, India is emerging as a global hub for pharma products and the industry continues to be on a growth trajectory. Some of the major factors that would drive growth in the industry are as follows:



**Increase in domestic demand:** More than half of India's population does not have access to advanced medical services, as they usually depend on traditional medicine practices. However, with increase in awareness levels, rising per capita income, change in lifestyle due to urbanization and increase in literacy levels, demand for advanced medical treatment is expected to rise. Moreover, growth in the middle class population would further influence demand for pharmaceutical products.

**Rise in outsourcing activities:** Increase in the outsourcing business to India would also drive growth of the Indian pharmaceutical industry. Some of the factors that are likely to influence clinical data management and bio-statistics markets in India in the near future include: 1) cost efficient research vis-à-vis other countries 2) highly-skilled labour base 3) cheaper cost of skilled labour 4) presence in end-to-end solutions across the drug-development spectrum and 5) robust growth in the IT industry.

**Growth in healthcare financing products:** Development in the Indian financial industry has eased healthcare financing with introduction of products such as health insurance policy, life insurance policy and cashless claims. This has resulted in increase in healthcare spending, which in turn, has benefitted the pharmaceutical industry.

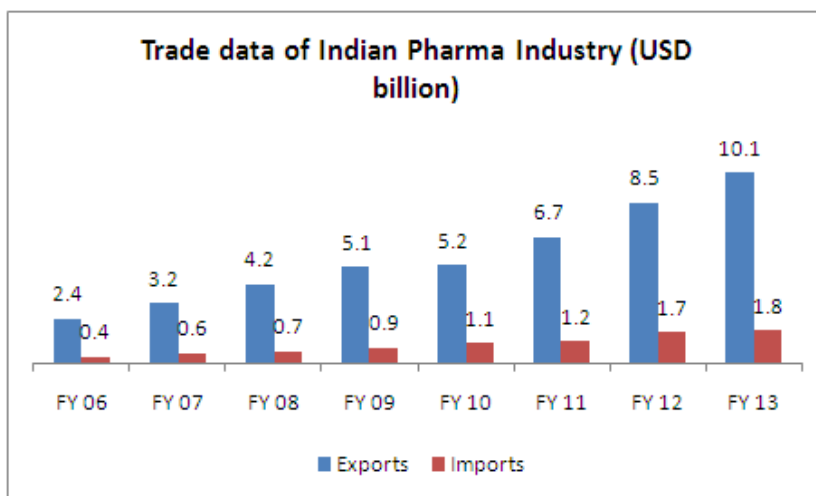
**Demand in the generics market:** Over the next few years prescription drugs worth about USD 100 billion are expected to go off patent, mostly from the US. Prior experience of Indian pharmaceutical companies in generic drugs would provide an edge to them.

**Demand from emerging segments:** Some of the emerging segments such as contract research and development, bio-pharma, clinical trials, bio-generics, medical tourism and pharma packaging are also expected to drive growth of the Indian pharmaceutical industry.

**Foreign trade in pharmaceutical products** – As mentioned above, the Indian pharmaceutical industry's growth has been fuelled by exports. Its products are exported to a large number of countries with a sizeable share in the advanced regulated markets of the US and Western Europe. India currently exports drug intermediates, active pharmaceutical ingredients, finished dosage formulations, bio-pharmaceuticals and



clinical services to various parts of the world. The top five export destinations of Indian pharmaceutical products are USA, Germany, Russia, UK and China.



India is the largest provider of generic medicines across the globe; India's generic drugs account for 20 per cent of global generic drug exports (in terms of volumes). In terms of value, pharmaceutical products exports have increased at a CAGR of 26.1 per cent to USD 10.1 billion during FY06–13. During the same period, pharmaceutical products imports rose at a CAGR of 25.4 per cent to USD 1.8 billion.

### Indian API industry on high growth trajectory

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

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

As per various research reports, Indian active pharmaceutical ingredient (API) industry is now in an enviable position, striking while the iron is hot and is all set to corner \$ 60 billion windfalls coming from the patent expiry of drugs. The companies are looking to garner substantial gains from the regulated markets of the US and EU which are facing increasing pricing pressures due to presence of low cost providers in developing markets, spare capacity for large pharma companies and backward integration by certain generic companies.

**Patent expiry to drive growth** – API manufacturers in India are likely to benefit as market dynamics have undergone a major change. The patent expiry provides a significant opportunity for supply of APIs to manufacturers of generic drugs. There are also increased opportunities in outsourcing of bulk drugs by multinational pharmaceutical companies.

The API sector in India stands to gain from the research-based processes, low cost operations and availability of skilled manpower. The global economic slowdown has increased the growth possibilities particularly for API from the emerging economies such as India and China. The slowdown has restricted the growth of innovative sector in developed economies such as the US and Europe, which has helped to fuel the growth in India and China.

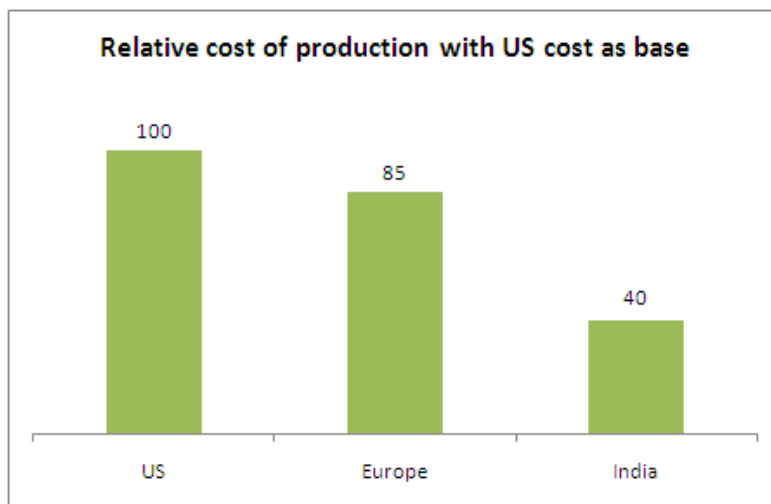
The role of Indian API manufacturers in the global pharmaceutical supply chain is gradually evolving with increasing presence in synthesis and manufacture of late stage intermediates and APIs. Traditionally, innovators have frequently opted to perform final stages of API synthesis in-house or partner with specialized European suppliers while outsourcing early stage intermediates to Indian manufacturers. However, in recent times, the reputed track record of Indian companies in supplying quality products coupled with complex synthesis capabilities has enabled increasing participation in supply of late stage intermediates to innovator companies.

**API Outsourcing** – According to Deloitte report on Life Sciences Outlook ‘Optimism tempered by reality in a new normal’, the companies are altering their business models as they increasingly source APIs from low-cost locations globally.

Today, the greatest concentrations of API manufacturers are located around Asia, specifically in India and China. This has led to more and more companies to outsource API manufacturing to such places, which has the main benefit of eliminating the need to invest in highly expensive equipment and infrastructure – which on top of everything can also be complicated to install and maintain. A good example can be found with AstraZeneca, which manufactures 85% of its APIs but is currently in the process of withdrawing from all API production in favor of outsourcing.

According to Boehringer Ingelheim, countries such as India and China which now supply over 40% of APIs used in the US will double that figure to a whopping 80% in the next 10 years.

**Cost efficiency and competency shall help India gain a large share of outsourcing –** India's cost of production is nearly 60 per cent lower than that of the US and almost half of that of Europe. Labour costs are 50–55 per cent cheaper than in Western countries and the cost of setting up a production plant in India is 40 per cent lower than in Western countries.



As far as competency is concerned, India has the largest number of USFDA-approved manufacturing plants outside the US, more than 2,600 FDA-approved drug products, 546 USFDA-approved company sites and 857 companies holding market authorizations with UKMHRA.

**API Industry raring to scale higher peaks** – The API industry is now gearing up to scale higher peaks of growth. There are efforts to develop novel APIs and in order to reach out to newer horizons, Indian API industry is also opting for environmentally-friendly production processes. There are several efforts to go green, reduce carbon footprint and reduce electricity consumption and water. The companies have also measures in place to decrease hazardous waste they produce. Research is on for improving the processes, bring down waste from API synthesis by going in for fewer chemical reactions, disposing off solvents and look for efficient means to improve to save and protect the environment.

There is also increased focus on the development of High Potency Active Pharmaceutical Ingredient (HPAPI). In order to keep abreast with the changes, API manufacturers are using various novel technologies to reduce the processing time as well as to yield more production. The HPAPI compounds are highly effective due to the targeted therapy. The market of North America is the largest and accounts for major share followed by Europe. At the same time Asia is growing at a higher CAGR compared to North America & Europe.

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## Aarti Drugs – Performance Snapshot

Particulars (in cr.)	FY 08	FY 09	FY 10	FY 11	FY 12	FY 13	TTM	5 Years CAGR
Income from operations	312.57	376.67	471.86	496.5	662.34	825.75	909.11	21.50%
Total COGS	212.26	252.16	317.57	341.03	453.56	555.28	611.82	
Gross Profit	100.31	124.51	154.29	155.47	208.78	270.47	297.29	22.00%
Gross Profit margin (%)	32.09%	33.06%	32.70%	31.31%	31.52%	32.75%	32.70%	
Operating Profit	39.3	56.91	72.07	62.69	80.26	120.33	138.88	25.10%
Operating Profit margin (%)	12.57%	15.11%	15.27%	12.63%	12.12%	14.57%	15.28%	
Depreciation	9.63	11.04	13.52	17.74	24.21	25.98	27.24	
EBIT	29.67	45.87	58.55	44.95	56.05	94.35	111.64	26.03%
EBIT margin (%)	9.49%	12.18%	12.41%	9.05%	8.46%	11.43%	12.28%	
Interest Cost	11.84	22.72	14.74	13.48	22.67	28.03	31.88	
Profit before tax	17.83	23.15	43.81	31.47	32.22	65.88	79.76	29.87%
Profit Before tax margin (%)	5.70%	6.15%	9.28%	6.34%	4.86%	7.98%	8.77%	
Tax Expense	4.76	8.1	17.71	9	9.76	20.64	26.68	
Net Profit	13.07	15.05	26.10	22.47	22.46	45.24	53.08	26.20%
Cash Flows from operations	11.82	38.2	28.2	12.92	19.11	46.28		
Return on Avg. Equity	12.67%	13.14%	19.99%	15.10%	13.49%	23.56%	24.32%	

Aarti Drugs has a decent operating performance track record for the past 6 years and for the period before that. During the last few years there's been a steady improvement in the performance of the company on various financial parameters and if the company is able to maintain the same, it will be good for the re-rating of the stock from current levels of 5 times earnings.

Financial parameters	FY 07	FY 08	FY 09	FY 10	FY 11	FY 12	FY 13	TTM
Operating profit margin (%)	12.19%	12.57%	15.11%	15.27%	12.63%	12.12%	14.57%	15.28%
Sales/total capital	0.98	0.99	1.26	1.48	1.24	1.40	1.56	1.57
Sales/working capital	2.42	2.57	3.29	3.62	3.04	3.07	3.35	3.32
EBIT/Total Capital	9.29%	9.82%	14.97%	18.97%	12.50%	12.81%	18.82%	20.17%
Return on Avg. Equity	14.01%	12.67%	13.14%	19.99%	15.10%	13.49%	23.56%	24.32%
Debt/Equity	1.98	1.88	1.49	1.26	1.56	1.69	1.54	1.53

There are some important points about the performance of Aarti Drugs and those are as below:

- The sales of the company have been growing at a steady pace of 20% on annualized basis. For FY 14, the company is likely to close the year with 15% growth in sales at ~950 crores. There was 1 month loss of production at 3 units of the company in Oct-Nov'13 due to notices by pollution control authority. The production has resumed again at all the units.
- In FY 11 and FY 12, the company spent heavily on capacity expansion and expanded its gross and net block by 50% between Mar'10 and Mar'12. While it is enjoying the fruits of capacity expansion now, during the two years its performance got impacted from all corners. First, it could not utilize its assets properly and suffered loss of production as the expansion was carried out in existing facilities. Second, while the assets could not be utilized properly, operating expenses and depreciation charges had already started increasing and lastly the company had also taken debt to fund the expansion which resulted in higher interest outgo.
- Despite dealing in bulk drugs where the competitive intensity is very high and pricing power low, the gross margins of the company have been very steady in the range of 31.3%-32.7%
- The company has been steadily improving its performance on various parameters, be it asset utilization, margin expansion, working capital intensity, debt equity ratio, etc. The company is now generating more sales per unit of capital involved (check Sales/total capital), operating margins have improved from 12% to around 15%, debt-equity ratio has improved from 2 to around 1.5 and the returns on capital employed and the returns on equity have also improved to around 20%.
- As will be seen in the "Shareholding pattern" section, what further complements the improvement in performance of the company is the fact that promoters of the company have been very actively increasing their stake through open market purchases.

## Valuations

At around current price of 220-225 the stock is available at 5 times earnings and EV/EBIT of 5.28 (here we are taking in EV/EBIT to factor in the effect of debt and interest component). The stock offers good dividend yield of more than 5% and recently promoters of the company also made purchases around current price of 210-220.

In the past the stock has traded at 7-8 times earnings, though for a short duration. We believe, unless the company again embarks on a very high CAPEX path and there's major deterioration in debt equity ratio of the company from 1.5, the risk of de-rating in valuations from current levels is very low.

At the same time, considering the continuous improvement in the quality of operations, steady purchases by the promoters and the long term prospects of the API industry, we believe there's scope for re-rating of the stock to 8-10 times trailing earnings.

## Shareholding pattern

	Dec'13	Sep'13	Jun'13	May'13	Dec'12
<b>Promoter and Promoter Group</b>	<b>59.52%</b>	<b>58.51%</b>	<b>58.34%</b>	<b>57.43%</b>	<b>57.15%</b>
India	59.52%	58.51%	58.34%	57.43%	57.15%
Foreign					
<b>Public</b>	<b>40.48%</b>	<b>41.49%</b>	<b>41.66%</b>	<b>42.57%</b>	<b>42.85%</b>
Institutions	--	0.59%	0.63%	0.63%	0.63%
FII	--	0.59%	0.63%	0.63%	0.63%
DII	--	--	--	--	--
Non-Institutions	40.48%	40.90%	41.03%	41.94%	42.22%
Bodies Corporate	1.47%	1.52%	1.37%	2.05%	2.57%
Custodians					
<b>Total</b>	<b>1,21,08,550</b>	<b>1,21,08,550</b>	<b>1,21,08,550</b>	<b>1,21,08,550</b>	<b>1,21,08,550</b>

From a passive investor's perspective it's important for the ones running the company to have high ownership as it aligns their interest in line with those of minority shareholders

and in the case of Aarti Drugs the promoters own 59.65% equity stake (increased from 59.52% at the end of Dec'13) in the company.

As can be observed from the above illustration, despite already having high stake in the company, promoters have been continuously making open market purchases.

We believe promoters increasing stake in their own company is almost always a positive. As they are involved in day-to-day operations of the company, they are unlikely to make purchases unless they are optimistic about the prospects of the company.

### Dividend Policy

Dividend Payout ratio						
	Mar'08	Mar'09	Mar'10	Mar'11	Mar'12	Mar'13
Dividend Payout ratio	16.12%	23.34%	22.65%	26.92%	28.02%	26.75%

The company has consistently been paying out ~25% of its profits in the form of dividends and has an uninterrupted history of dividends since 2003.

Considering the outstanding debt on the books of the company, we believe that dividend payout policy of the company is slightly liberal and dividend payout should be lower at ~10%.

For FY 14 the company has already paid dividend of Rs 7.5/- per share and we expect the company to pay a final dividend of Rs 4.5/- per share. The dividend yield at around current price is 5.45%



## Risks & Concerns

- Though company has reduced debt equity ratio to around 1.5, absolute debt is still high at around 340 crores. Increase in debt equity ratio from 1.5 can result in de-rating of the stock.
- In Sep'13 the company received a warning letter from USFDA for its manufacturing site at Tarapur. The company has already submitted an initial response to USFDA in this regard and has hired a US based FDA consultant to further enhance the quality systems to avoid such things in future.
- In the past the company has suffered loss of production due to environmental issues and notices by Pollution control authority for shutting operations at some of its units.

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