Deepak Nitrite – BUY

16 May 2018

Recommendation upgrade

IIFL Institutional Equities

Primed for an earnings explosion

Deepak Nitrite (DNL) is moving closer to realizing a quantum jump in earnings over the next 2-3 years, driven primarily by the imminent commissioning of its new phenol capacity and supported by healthy growth prospects in the rest of the business. Our estimates imply a tripling of EPS over the next two years. If phenol spreads sustain for any length of time near their current levels (US$850/t), they could drive further upside to earnings. We raise our target P/E to 18x (from 15x), still at a discount to peer valuations, as well as our March-2019 target price to Rs305 (18x FY20ii EPS); upgrade to BUY.

Phenol project near commissioning: Management hopes to commission the project by late-July, and sees an encouraging response from customers, boosting confidence in a successful ramp-up in capacity utilization. Management targets a 70-75% utilization rate in FY19 itself. Meanwhile, phenol spreads have widened sharply (currently US$850/t vs. projected spreads of ~US$600/t). At current spreads, the project's Ebitda potential stands doubled; so, even if they sustain for a few months, they could boost earnings substantially.

Promising outlook for remaining business: Regulatory approval for a backward integration project in the Fine & Specialty Chemicals segment has now been received; this could help boost segment Ebitda margins 200-250bps by FY20. Demand growth in Basic Chemicals is strong, prompting capacity expansion. Supply disruptions in China are opening up further opportunities. The Performance Products segment is also seen turning profitable in FY19.

We would accumulate the stock on any weakness: Given the medium-term growth opportunities – such as downstream expansion into phenol derivatives – available to DNL, we expect valuations to move closer to peer averages once the successful commissioning of the phenol project is demonstrated (likely by 2Q FY19). With the FY20ii P/E of 15x at a ~20% discount to peer averages, we would accumulate on any weakness.

Company update

CMP	Rs251
12-mth TP (Rs)	305 (22%)
Market cap (US$m)	503
Enterprise value(US$m)	540
Bloomberg	DN IN
Sector	Chemicals

Shareholding pattern (%)

Promoter	44.7
FII	11.1
DII	13.8
Others	30.4

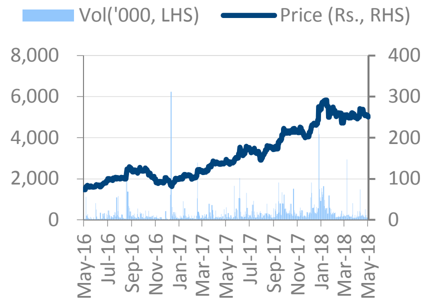
52Wk High/Low (Rs)	299/132
Shares o/s (m)	136
Daily volume (US$ m)	1.1
Dividend yield FY18ii (%)	0.5
Free float (%)	55.4

Price performance (%)

	1M	3M	1Y
Absolute (Rs)	(0.6)	(5.8)	69.2
Absolute (US$)	(4.5)	(11.3)	60.8
Rel.to BSE Midcap	3.1	(1.4)	62.4

Cagr (%)	3 yrs	5 yrs
EPS	3.3	12.8

Stock performance



Financial summary (Rs m)

Y/e 31 Mar, Consolidated	FY16A	FY17A	FY18A	FY19ii	FY20ii
Revenues (Rs m)	13,729	13,604	16,762	32,254	39,017
Ebitda margins (%)	*12.0*	*10.2*	*11.7*	*12.7*	*15.2*
Pre-exceptional PAT (Rs m)	627	473	670	1,335	2,326
Reported PAT (Rs m)	627	978	790	1,335	2,326
Pre-exceptional EPS (Rs)	5.9	4.0	5.1	9.8	17.1
Growth (%)	*15.4*	*(31.0)*	*26.1*	*92.3*	*74.3*
IIFL vs consensus (%)				*NA*	*NA*
PER (x)	**42.8**	**62.1**	**49.2**	**25.6**	**14.7**
ROE (%)	*15.3*	*8.0*	*8.2*	*13.6*	*20.4*
Net debt/equity (x)	1.1	1.0	0.9	1.4	1.1
EV/Ebitda (x)	19.5	26.5	21.1	11.9	8.1
Price/book (x)	5.7	4.1	3.6	3.3	2.7

Source: Company, IIFL Research. Priced as on 15 May 2018

Abhijit R. Akella, CFA | abhijit.akella@iiflcap.com
91 22 4646 4654

Ankur Shah | ankur.shah@iiflcap.com
91 22 4646 4657

Figure 1: 4Q FY18 standalone results summary

Rs m, except per share	4QFY17	3QFY18	4QFY18	YoY
Total income from operations	**3,514**	**3,711**	**3,929**	**12%**
Cost of goods sold	(1,961)	(2,187)	(2,340)	19%
Gross margin	44.2%	41.1%	40.5%	(373) bps
Employee benefits expense	(279)	(346)	(330)	18%
% of income	(8)%	(9.3)%	(8.4)%	(45) bps
Other expenses	(871)	(657)	(770)	(12)%
% of income	(24.8)%	(17.7)%	(19.6)%	518 bps
Ebitda	**402**	**521**	**489**	**22%**
Ebitda margin	11.4%	14.0%	12.5%	101 bps
Depreciation and amortization	(117)	(130)	(134)	14%
% of income	(3.3)%	(3.5)%	(3.4)%	(7) bps
Operating income	285	391	356	25%
Operating margin	8.1%	10.5%	9.1%	93 bps
Other income	9	6	65	653%
Finance costs	(83)	(90)	(111)	34%
Exceptional items	42	0	0	(100)%
Profit before tax	253	307	309	22%
Pbt margin	7.2%	8.3%	7.9%	66 bps
Tax expense	(42)	(104)	(106)	152%
Effective tax rate	(16.6)%	(33.8)%	(34.3)%	(1,768)bps
Net profit	**211**	**203**	**203**	**(4)%**
Net margin	6.0%	5.5%	5.2%	(84)bps
Adjusted net profit	**176**	**203**	**203**	**15%**
Adjusted EPS	**1.46**	**1.56**	**1.51**	**3%**

Source: Company, IIFL Research

Figure 2: 4Q FY18 standalone segmental information

Rs m	4QFY17	3QFY18	4QFY18	YoY
Revenues:				
Basic Chemicals	1,837	1,892	1,975	7%
Fine & Specialty Chemicals	989	1,224	1,212	23%
Performance Products	751	674	820	9%
Total revenues	**3,577**	**3,790**	**4,006**	**12%**
Less: Inter-segment revenue	(62)	(78)	(77)	23%
Net Sales/Income from Operations	**3,514**	**3,711**	**3,929**	**12%**
Ebit:				
Basic Chemicals	285	283	285	0%
Ebit margin	15.5%	15%	14.4%	(106) bps
Fine & Specialty Chemicals	146	271	301	107%
Ebit margin	14.7%	22.1%	24.8%	1008 bps
Performance Products	(7)	(13)	(28)	NM
Ebit margin	(0.9)%	(1.9)%	(3.5)%	(257) bps
Total Ebit	**424**	**541**	**557**	**32%**
Less: Interest	(83)	(90)	(111)	34%
Less: Other unallocable	(88)	(144)	(137)	56%
Pbt	**253**	**307**	**309**	**22%**

Source: Company, IIFL Research

Figure 3: FY18 consolidated results summary

INR m	FY17	FY18	% YoY
Revenue	13,604	16,762	23%
Ebitda	1,382	1,962	42%
Ebitda margin	10.2%	11.7%	154 bps
Reported net profit	978	790	(19)%
Adjusted net profit	473	790	67%

Source: Company, IIFL Research

Stage set for margin expansion in Fine & Specialty Chemicals (FSC) segment

The FSC segment benefitted from a low year-ago base as its Roha facility was impacted by a fire incident. Operations at the facility fully resumed only in May 2017, with just partial availability of the capacity during the first seven weeks of 4Q FY17. Revenue grew 23% YoY in 4Q FY18, while Ebit more than doubled YoY, as margins expanded by >10ppt YoY, driven by normalization of operations as well as favorable product mix.

The company has received the long-awaited regulatory approval for its backward-integration facility for specialty agrochemicals. This is expected to improve margins of the segment by at least 200-250bps. Management expects the facility to begin operations from June 2018 and achieve full capacity utilization in FY19. The company is also looking to invest in a few agrochemical and pharma products, which too should improve margins of the segment.

Bulk Chemicals segment continues to see healthy demand

Bulk Chemicals segment's revenue grew 7% YoY, driven by volume growth with higher demand from customer industries. Due to issues in China, management indicated that the company's domestic customers have seen increased demand for its products, as a result of which demand for DNL's bulk chemicals has seen positive traction. Segment Ebit was flat YoY as margins fell by 106bps YoY.

Management confident about turnaround in Performance Products segment

Segment revenue grew 9% YoY, while Ebit loss expanded YoY in 4Q FY18. Though the segment improved performance in FY18 with 25% YoY revenue growth and reduced Ebit loss of Rs80m (vs. Rs139m YoY), it missed management guidance of achieving PBT-level break-even in FY18. However, the company is confident of delivering positive Ebit for the segment in FY19, driven by improved demand for OBA (optical brightening agents) and efforts to realign focus away from papers industry towards textiles & detergents and across geographies.

Phenol project in pre-commissioning stages

DNL's phenol/acetone project is into its pre-commissioning activities. Management has mentioned that phenol demand in India is growing 9-10% YoY, which is better than 7-8% YoY annual growth envisaged by the company earlier while conceiving the project earlier. In addition, phenol prices have firmed up globally, as a large global facility in the US (Shell's 300,000 ton capacity) has been shut down, while downstream capacities have come up in China that have led to greater captive consumption of Chinese phenol capacity. Management mentioned that phenol spreads have significantly gone up in the past six months, and currently stand at ~US$850/t, at which the company can make Ebitda of Rs5.5-6b at peak utilization.

Management expects the plant to be commissioned by end-July 2018, and is confident of achieving 70-75% capacity utilization in FY19. At peak utilization, the project's working capital guidance was Rs4.5-5b.

Brownfield expansion planned to boost growth

DNL has planned brownfield expansion projects across the Bulk Chemicals and the Fine & Specialty Chemicals segments, at an investment of ~Rs600m, to take advantage of opportunity provided by issues in China. Management expects these brownfield expansion projects to start contributing by end-2QFY19.

Figure 5: Summary of estimate changes

Rs m, except per share	New	Old	% change
FY19ii			
Revenue	32,254	33,410	-3%
EBITDA	4,100	4,690	-13%
Net profit	1,335	1,466	-9%
EPS	9.8	11.2	-13%
FY20ii			
Revenue	39,017	38,938	0%
EBITDA	5,927	6,051	-2%
Net profit	2,326	2,415	-4%
EPS	17.1	18.5	-8%

Source: Company, IIFL Research

Valuation summary

We cut our FY19/20ii EPS estimates by 13%/8% respectively, post the 4Q FY18 earnings. The phenol-acetone project, along with ramp up in DNL's other new products, should lead to a substantial increase in the company's scale of operations as well as help further diversify its revenue stream. We raise our target one-year forward P/E to 18x (previously 15x), which is at ~30% discount to the current one-year forward P/E. Our March 2019 target price is revised upwards to Rs305 (previously Rs215). Upgrade to BUY.

Figure 6: Valuation comparables

Company name	Mcap (US$m)	CMP (Rs)	FY19E P/E	FY20E P/E	FY19E EV/EBITDA	FY19E P/B	FY19E ROE (%)	FY18-20E EPS Cagr
Deepak Nitrite	502	251	25.6	14.7	11.9	3.3	13.6	83.1%
Aarti Industries	1,554	1,301	25.6	21.0	14.9	5.3	23.2	23.0%
Atul	1,238	2,840	20.8	17.9	11.8	3.2	16.7	29.5%
Vinati Organics	726	961	26.2	19.8	16.9	5	21.2	31.6%
SRF	1,887	2,236	23.7	20.5	13.4	3.2	14.4	18.5%
Navin Fluorine	540	745	20.8	18.5	13.4	3.3	16.8	8.3%
Average			**23.8**	**18.7**	**13.7**	**3.9**		

Source: Company, IIFL Research

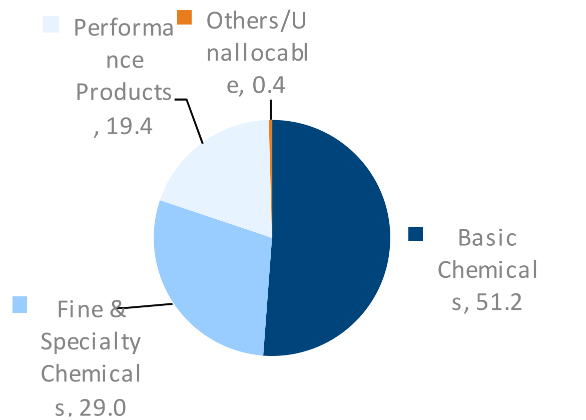
Background: Founded in 1970 by Mr. C. K. Mehta and managed now by his son Mr. Deepak Mehta, Deepak Nitrite (DNL) is one of India's leading chemical companies. DNL manufactures almost a hundred products across three major categories: bulk and commodity chemicals, fine and specialty chemicals, and optical brightener agents. DNL holds strong market positions in India in several of its chosen niches within the chemical industry. The company's internal R&D has recently helped add successful new products to its line-up. DNL's global distribution network spans more than 30 countries and has helped scale up exports to c.40% of revenue. The company has five manufacturing plants and an R&D facility, all in India, and plans to set up a new phenol plant at Dahej.

Management

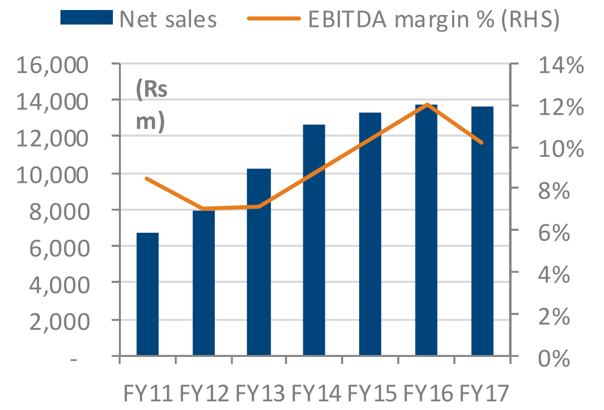
Name	Designation
C. K. Mehta	Chairman-Emeritus
D. C. Mehta	Chairman & MD
A. C. Mehta	MD

Source: Company

Revenue Break-up (%) - FY17



Revenues & EBITDA margin trend, FY10-



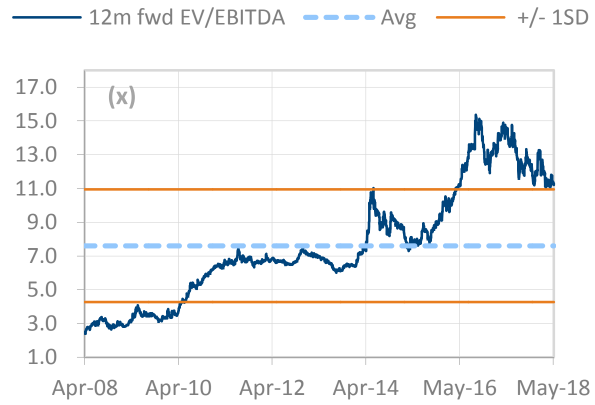
Assumptions

Y/e 31 Mar, Consol	FY16A	FY17A	FY18A	FY19ii	FY20ii
Revenue					
Basic Chemicals	6,746	6,962	7,470	8,017	8,709
Fine & Specialty Chemicals	3,934	3,748	4,632	5,287	6,024
Performance Products	2,737	2,618	2,993	3,289	3,744
Phenol and acetone	0	0	0	15,980	20,896
Ebit					
Basic Chemicals	796	881	1,066	1,185	1,309
Fine & Specialty Chemicals	972	824	1,148	1,401	1,626
Performance Products	-87	-139	-81	82	187

Source: Company, IIFL Research

PE Chart

EV/Ebitda



Financial summary

Income statement summary (Rs m)

Y/e 31 Mar, Consolidated	FY16A	FY17A	FY18A	FY19ii	FY20ii
Revenues	**13,729**	**13,604**	**16,762**	**32,254**	**39,017**
Ebitda	1,647	1,382	1,962	4,100	5,927
Depreciation and amortisation	(395)	(427)	(526)	(1,170)	(1,198)
Ebit	1,252	955	1,436	2,930	4,729
Non-operating income	16	49	124	70	70
Financial expense	(376)	(341)	(451)	(1,064)	(1,553)
PBT	891	663	1,109	1,936	3,246
Exceptionals	0	705	0	0	0
Reported PBT	891	1,368	1,109	1,936	3,246
Tax expense	(262)	(388)	(318)	(601)	(919)
PAT	629	979	790	1,335	2,326
Minorities, Associates etc.	(2)	(1)	0	0	0
Attributable PAT	**627**	**978**	**790**	**1,335**	**2,326**

Ratio analysis

Y/e 31 Mar, Consolidated	FY16A	FY17A	FY18ii	FY19ii	FY20ii
Per share data (Rs)					
Pre-exceptional EPS	5.9	4.0	5.1	9.8	17.1
DPS	1.0	1.0	1.3	1.6	1.6
BVPS	44.1	61.2	70.0	75.9	91.1
Growth ratios (%)					
Revenues	3.4	(0.9)	23.2	92.4	21.0
Ebitda	19.7	(16.1)	41.9	109.0	44.5
EPS	15.4	(31.0)	26.1	92.3	74.3
Profitability ratios (%)					
Ebitda margin	12.0	10.2	11.7	12.7	15.2
Ebit margin	9.1	7.0	8.6	9.1	12.1
Tax rate	29.4	28.4	28.7	31.0	28.3
Net profit margin	4.6	7.2	4.7	4.1	6.0
Return ratios (%)					
ROE	15.3	8.0	8.2	13.6	20.4
ROCE	12.7	7.8	9.2	13.6	18.2
Solvency ratios (x)					
Net debt-equity	1.1	1.0	0.9	1.4	1.1
Net debt to Ebitda	3.2	5.3	4.2	3.5	2.3
Interest coverage	3.3	2.8	3.2	2.8	3.0

Source: Company, IIFL Research

Balance sheet summary (Rs m)

Y/e 31 Mar, Consolidated	FY16A	FY17A	FY18A	FY19ii	FY20ii
Cash & cash equivalents	65	145	482	276	565
Inventories	1,210	1,358	3,254	4,042	4,844
Receivables	3,132	3,603	4,118	8,355	10,073
Other current assets	1,372	2,378	2,313	2,315	2,316
Creditors	2,108	2,664	7,295	7,211	8,502
Other current liabilities	251	119	115	115	115
Net current assets	**3,421**	**4,701**	**2,757**	**7,662**	**9,181**
Fixed assets	6,297	9,398	15,421	17,650	17,652
Intangibles	0	0	0	0	0
Investments	866	1,166	318	318	318
Other long-term assets	0	0	0	0	0
Total net assets	**10,583**	**15,266**	**18,496**	**25,630**	**27,151**
Borrowings	5,288	7,437	8,820	14,820	14,270
Other long-term liabilities	566	657	454	454	454
Shareholders' equity	**4,729**	**7,171**	**9,221**	**10,356**	**12,427**
Total liabilities	**10,583**	**15,266**	**18,496**	**25,630**	**27,151**

Cash flow summary (Rs m)

Y/e 31 Mar, Consolidated	FY16A	FY17A	FY18ii	FY19ii	FY20ii
Ebit	1,252	955	1,436	2,930	4,729
Tax paid	(188)	(162)	(318)	(601)	(919)
Depreciation and amortization	395	427	526	1,170	1,198
Net working capital change	259	(495)	2,285	(5,111)	(1,230)
Other operating items	(45)	(235)	1,342	70	70
Operating cash flow before interest	1,673	491	5,271	(1,541)	3,848
Financial expense	(372)	(342)	(451)	(1,064)	(1,553)
Non-operating income	9	9	0	0	0
Operating cash flow after interest	**1,310**	**158**	**4,819**	**(2,605)**	**2,294**
Capital expenditure	**(865)**	**(2,412)**	**(6,548)**	**(3,400)**	**(1,200)**
Long-term investments	(838)	(960)	848	0	0
Others	0	(163)	0	0	0
Free cash flow	**(393)**	**(3,377)**	**(881)**	**(6,005)**	**1,094**
Equity raising	807	1,464	0	0	0
Borrowings	(254)	2,160	1,383	6,000	(550)
Dividend	(125)	(167)	(165)	(201)	(255)
Net chg in cash and equivalents	34	80	337	(206)	289

Disclosure : Published in 2018, © IIFL Securities Limited (Formerly 'India Infoline Limited') 2018

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We submit that no material disciplinary action has been taken on IIL by any regulatory authority impacting Equity Research Analysis.

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Name, Qualification and Certification of Research Analyst: Abhijit Akella (PGDM), Abhishek Murarka (PGDM), Abhishek Sharma (PGDM), Ameya Karambelkar (PGDM), Amit Tiwari (MBA), Ankur Shah (PGDM), Anupam Gupta (PGDBM), Arash Arethna (PGDM), Avi Mehta (PGDBM), Balaji Subramanian (PGDM), Devesh Agarwal (PGDBM), G.V. Giri (MBA), Harshvardhan Dole (B.Tech, PGBDA), J. Radhakrishnan (CWA, CFA), Joseph George (Chartered Accountant, Chartered Financial Analyst), Krithika Subramanian (Chartered Accountant), Kunal Shah (PGDM), Mohit Agrawal (Chartered Accountant), Nayan Parakh (Chartered Accountant), Parneet Virk, Percy Panthaki (Chartered Accountant), Rahul Jeewani (PGDM), Renu Baid (MMS - Finance), Rishi Jhunjhunwala (Chartered Accountant), Sameer Gupta (PGDM), Suraj Chheda (PGDM), Urvil Bhatt (Chartered Accountant)

IIFL Securities Limited (Formerly ‘India Infoline Limited’), CIN No.: U99999MH1996PLC132983, Corporate Office – IIFL Centre, Kamala City, Senapati Bapat Marg, Lower Parel, Mumbai – 400013 Tel: (91-22) 4249 9000 .Fax: (91-22) 40609049, Regd. Office – IIFL House, Sun Infotech Park, Road No. 16V, Plot No. B-23, MIDC, Thane Industrial Area, Wagle Estate, Thane – 400604 Tel: (91-22) 25806650. Fax: (91-22) 25806654 E-mail: mail@indiainfoline.com Website: www.indiainfoline.com, Refer www.indiainfoline.com for detail of Associates.

Stock Broker SEBI Regn.: INZ000164132, PMS SEBI Regn. No. INP000002213, IA SEBI Regn. No. INA000000623, SEBI RA Regn.:- INH000000248

Key to our recommendation structure

BUY - Stock expected to give a return 10%+ more than average return on a debt instrument over a 1-year horizon.

SELL - Stock expected to give a return 10%+ below the average return on a debt instrument over a 1-year horizon.

Add - Stock expected to give a return 0-10% over the average return on a debt instrument over a 1-year horizon.

Reduce - Stock expected to give a return 0-10% below the average return on a debt instrument over a 1-year horizon.

Distribution of Ratings: Out of 215 stocks rated in the IIFL coverage universe, 120 have BUY ratings, 4 have SELL ratings, 66 have ADD ratings and 24 have REDUCE ratings

Price Target: Unless otherwise stated in the text of this report, target prices in this report are based on either a discounted cash flow valuation or comparison of valuation ratios with companies seen by the analyst as comparable or a combination of the two methods. The result of this fundamental valuation is adjusted to reflect the analyst’s views on the likely course of investor sentiment. Whichever valuation method is used there is a significant risk that the target price will not be achieved within the expected timeframe. Risk factors include unforeseen changes in competitive pressures or in the level of demand for the company’s products. Such demand variations may result from changes in technology, in the overall level of economic activity or, in some cases, in fashion. Valuations may also be affected by changes in taxation, in exchange rates and, in certain industries, in regulations. Investment in overseas markets and instruments such as ADRs can result in increased risk from factors such as exchange rates, exchange controls, taxation, and political and social conditions. This discussion of valuation methods and risk factors is not comprehensive – further information is available upon request.