Atul

10 February 2014

Time Horizon – 12 Months

ANANDRATHI

V A L U E P I C K

Buy ₹409 **Reco: Buy** **Target ₹548** **Nifty Level 6065**

- Atul Ltd. (Atul) is a diversified Company, which manufactures colors, specialty & other chemicals and sells its products to industries such as aerospace, agriculture, automobile, construction, flavour & fragrance, paint & coatings, paper, personal care, pharma and textiles. It operates through its 6 business divisions viz. colors, aromatics, crop protection, bulk chemicals & intermediates, pharmaceuticals & polymers.

- Its colors division is the largest supplier of dyestuffs in India. Company exports nearly 50% of its production to different geographies worldwide, while its aromatic division is one of the world's largest manufacturers of p-cresol, p-anisic aldehyde, p-anisic alcohol, which are used mainly by flavour & fragrance, personal care and pharmaceutical industries.

- Its crop protection division is among the world's five leading manufacturers of 2,4-D range of chlorophenoxy derivatives with close to 12% market share, while in bulk chemicals & intermediates division, the Company has leadership position in India in key products like resorcinol with 32% market share & Chlorosulphonic acid (CSA) with 14% market share.

Key Matrix			
CMP	409	PE	9
52 W H / L	475 / 280	EV/EBIDTA	5.41
Market Cap (Rs. Mln)	12188	P/BV	1.61
Average 3 m Volume(000)	54	EV/Sales	0.73
BSE Code	500027	NSE Code	ATUL
Shareoutstanding	29.7 Mln	Float	14.8 mln

- The Company has reduced its operational net working capital & borrowings significantly during FY13. Going forward, the Company is expected to continue its efforts to reduce the cost and further improve working capital cycle. On business strategy front, Atul plans to focus on high margin products, new strategic business verticals, expanding its product portfolio & brand business.

- The Company has good track record of paying regular dividend in the past and total dividend of 30% paid during FY13, which works out to 1.5% yield at current price.

- At the CMP of Rs. 409, the stock is available at a very attractive valuation of 7.4x its FY15E EPS of Rs. 55. Our DCF based target of stock is 548.

Company Description

Atul ltd, a Lalbhai group company which also owns Arvind Mills, is the largest supplier of Dye stuffs in India. It is engaged in the manufacturing and marketing of specialty and other chemicals and colors, it markets the specialty chemical like Agro chemical, Agro products, pharmaceuticals, polymer, other chemicals and aromatic compounds and cresols, it's products are sold across the globe and having reasonable market share many of its products.

The Company commenced its business with just a few dyestuffs, the know-how of which was brought from foreign companies.

Over the years, Atul formed joint ventures with companies American Cyanamid Corp (1952), Imperial Chemical Industries plc (1955) and Ciba-Geigy Ltd (1960) namely, Cyanamid India Ltd, Atic Industries Ltd and Cibatul Ltd respectively.

Consequent to worldwide divestment of dyes and polymers business by ZENECA plc(formerly a part of ICI plc) and Ciba Ltd respectively, Atic Industries Ltd and Cibatul Ltd were merged into Atul in 1995 and 1998 respectively.

The Company operates through its six business divisions, namely aromatics, bulk chemicals & intermediates, colors, crop protection, pharmaceuticals & intermediates and polymers.

Atul manufactures over 1000 products reaching to more than 3500 customers. The Company has three manufacturing sites in India and four overseas subsidiary companies. It has about 2300 employees. Atul also has offices in the USA, the UK, Germany, China and Vietnam that service its international customers.

Investment Thesis

❖ Diversified Product Mix

✓ Colors

The key products made by this division are textile dyes, paper dyes & pigments, which are used by textile, paper and paint & coatings industries. This division has about 550 products & close to 1350 customers globally. Atul is the largest supplier of dyestuffs in India. Its competitors are based in China, India, & in European countries.

The division possesses excellent and versatile facilities to manufacture different colorants & intermediates.

Due to sluggish demand during FY13, the colors division de-grew by 3.5% to Rs. 3300 mn, however going forward, with introduction of new value added products as required by the dyestuff and textile industries, the demand is expected to improve.

✓ Aromatics

Atul is one of the world's largest manufacturers of p-cresol, p-anisic aldehyde, p-anisic alcohol, which are used mainly by flavour & fragrance, personal care and pharmaceutical industries. Its main competitors are based in China & India. Dominated mainly by MNCs, end users in these industries are doing well & offer good growth potential. Atul has a global leadership in its key products, which are commodity plays by nature and therefore exposed to volatility in margins. Atul is exploring growth possibilities by introducing value-added products used in the above industries by leveraging synergy and strengths.

During FY13, this division grew by a strong 40% to Rs. 6580 mn. The division is also exposed to variations in exchange rates, as exports constitute a significant portion of sales.

✓ Crop Protection

The main products of the division are herbicides, insecticides & fungicides, which are used mainly in the crop protection segment of the agriculture industry. The division is among the world's five leading manufacturers of 2,4-D range of chlorophenoxy derivatives and Indoxacarb with 12% and 7% market share respectively. Its competitors are based across the world & also in India. In recent times, the agriculture industry has performed well, due to robust demand and higher realizations by the farmers for their products.

During FY13, this division Revenues grew by 13% to Rs. 3870 mn. Atul enjoys cost leadership in some key products, given its backward integration and economies of scale. However, its existing product portfolio is not comprehensive for export and has limited market accessibility.

Hence, the Company is exploring new products with synergy and market potential and planning to introduce new products coming off patent. The performance of agriculture industry is also linked to weather, which is unpredictable.

- ✓ **Bulk Chemicals & Intermediates**

The main products of the segment are resorcinol, CSA, Oleum 65% & SO3, which are used in varied industries like dyestuff, paper, pharma, textile and tyres & rubber, and also for captive consumption. The division faces stiff competition in some of its products from large manufacturers based in China, India, Japan and the US. The Company has leadership in India in key products like resorcinol with 32% market share (2% Global Share) & CSA with 14% market share.

During FY13, Revenues in this division grew by 15% to Rs. 1230 mn. The Company is exploring the possibility of expanding its capacities and introducing selected value-added downstream products. It also introduced products based on hydrogen.

- ✓ **Pharmaceuticals & Intermediates**

The Company manufactures API intermediates in this division, which are used mainly by pharmaceutical and aerospace industries. Its main competitors are based in China, India and in other countries. The division has backward integration and possesses good infrastructure and has the ability to meet the emerging needs of the customers. Atul is relatively a new entrant in pharmaceutical industry and has still to establish itself in terms of reputation and size. Company has 40 products and around 100 customers in this segment. Company's has three product group category under this segment known as Pharma intermediates and APIs (market share <1%), Phosgenated intermediates (market share <1%), and sulfones (market share around 45%).

During FY13, Revenues in this division grew by 7.5% to Rs. 1140 mn. There are immense opportunities for products in this segment, and the segment is expected to grow rapidly in the near future because of low base and high growing market.

- ✓ **Polymers**

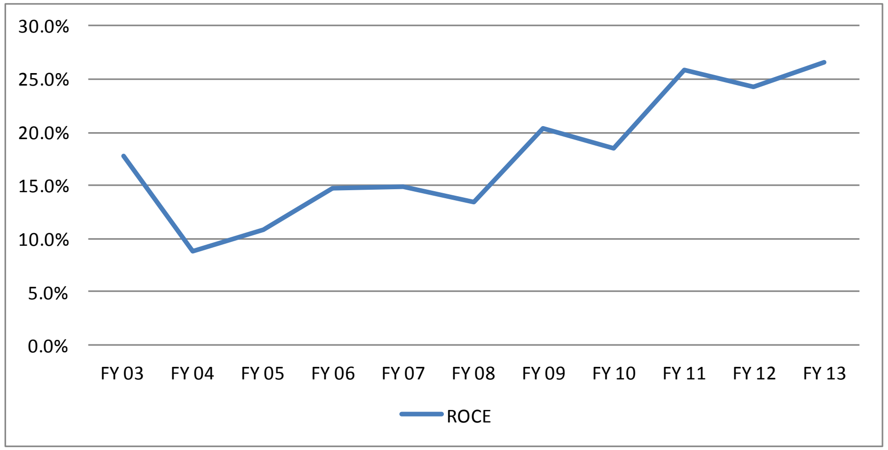
There are two broad product category under this segment epoxy resins and branded products.

Epoxy are used mainly by the construction and paint & coatings, power transmission, wind energy and automotive industries. Epoxy has almost 300 products and 500 direct customers in this segment. There are large capacities installed by established companies operating world-wide, which are well integrated. The division is well established in the domestic marketplace in terms of quality and reach and command around 18% market shares in domestic market.

Branded products are used by footwear, handicraft, jewelry, automotives, art and craft, furniture. Company has 24 branded product and which is distributed through 565 distributors. Atul has almost 10% market share under this segment.

During FY13, this division de-grew by 5% to Rs. 3860 mn due to sluggish local demand of the product. The Company is among the two large producers in India. However, it has a small capacity compared to world standards. The division is exploring new products based on synergy and strengths.

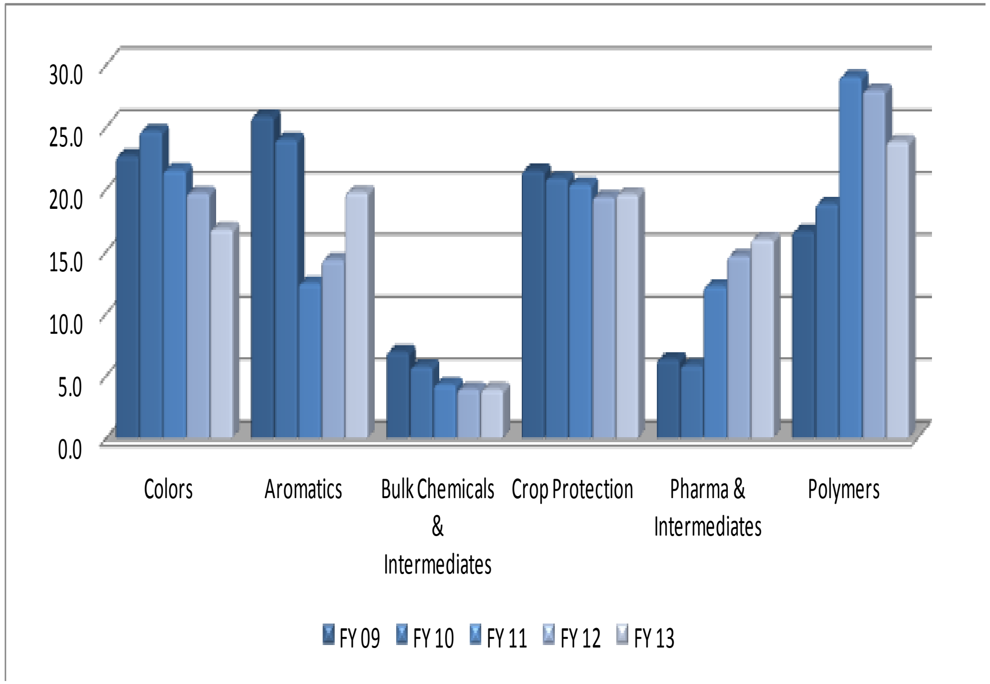
Improving profitability – upward ROCE



Source- ACE equity, AR and Anandrathi Research

Atul has changed the product mix and strategy from FY 09 onwards which is reflecting in company's upward ROCE. Company is able to improve its ROCE over the years which is the main reason for stock re-rating.

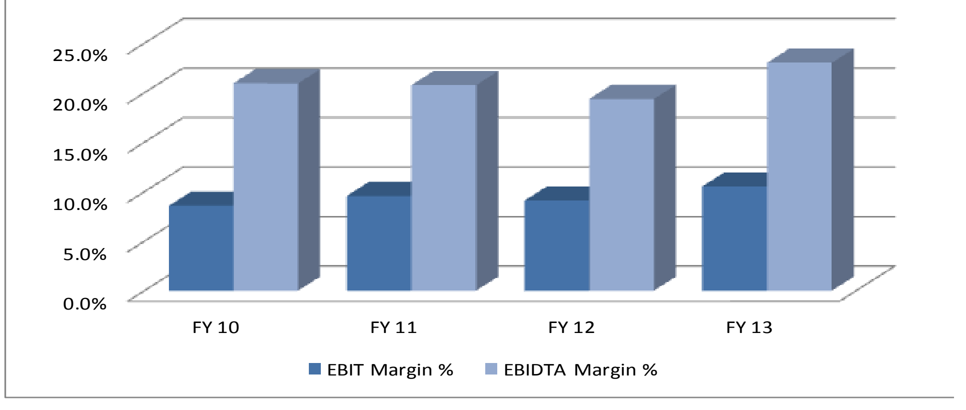
Healthy Revenue Mix is driving ROCE and EBIDTA Margin



Source- Ace equity, AR and Anandrathi Research

Healthy revenue mix is driving margin and other return ratios. Pre 2009, Atul's focus was colors and bulk chemical and & intermediates which was the main cause of low margin and low ROIC. Post 2009 Atul has changed the strategy which is visible through its revenue mix in pre and post 2009 period. Color and bulk chemicals are low margin products while pharma and agro-chemicals are high margins business which helped Atul to improve its profitability post 2009.

Going forward we expect Atul will continue to focus on Agri, pharma and polymer space. We believe there is further scope of improvement in revenue mix given an opportunity in pharma and agri space. We believe higher contribution from pharma, agri-chemical and polymer space will help company to improve margins and ROIC going forward.

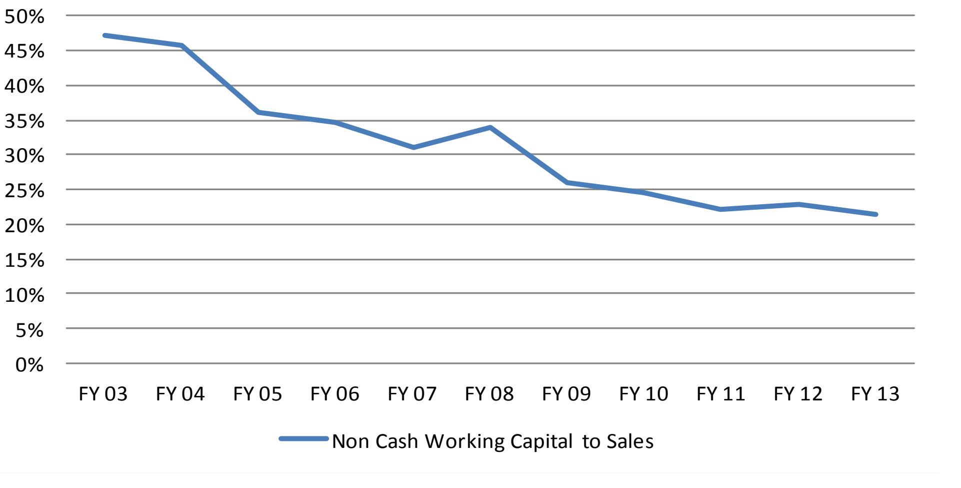


Source- Ace equity, AR and Anandrathi Research

Improvement in working capital cycle

Company is continuously focusing on improvement of its working capital cycle. In FY03, Atul's non cash working capital to sales ratio was around 50% and In FY 13, working capital to sales stood at 21% which clearly reflects company's robust collection and inventory management policy. Company has continuously improved its working capital cycle in last 10 years.

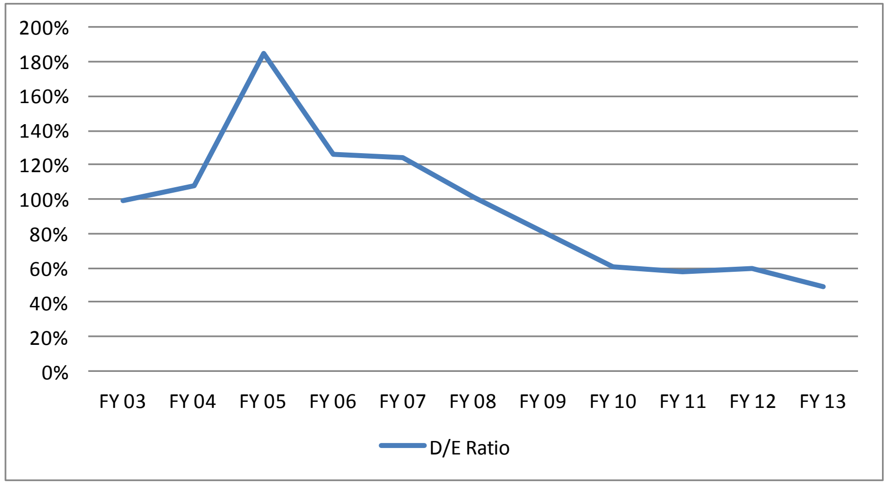
Improvement in working capital also helped Atul for expansion without taking any huge debt during these period. Healthy working capital also helped company for generation of free cash flow.



Source- Ace Equity, AR and Anandrathi Research

Debt Equity Ratio

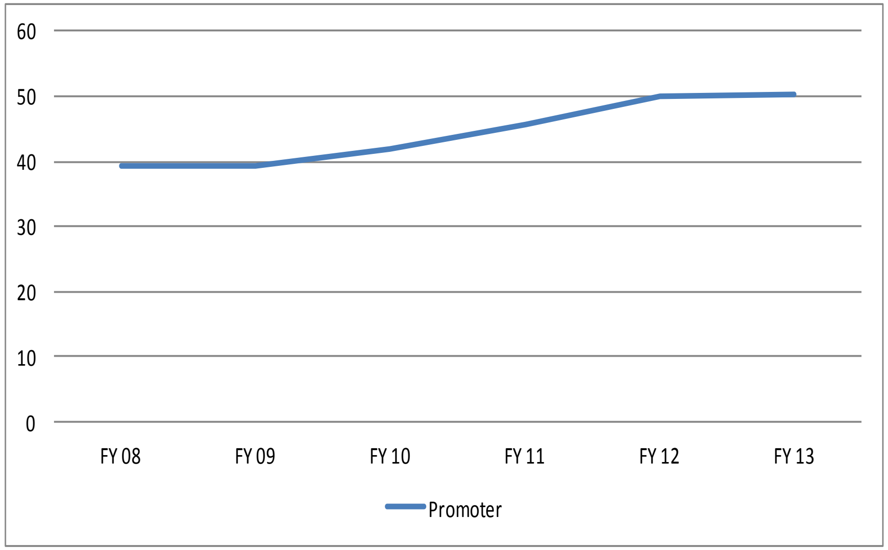
Continuously declining in debt equity ratio also indicates that company's thrust towards proper capital allocation. Atul's D/E ratio was 100% in FY 03 and 180% in FY 05. Since FY 05 Atul's D/E ratio is continuously declining. In FY 13 Atul D/E stood at 0.49 and further reduced to 0.44% in Sep, 13. We expect in next three-four years company will be debt free.



Source- Ace equity, AR and Anandrathi Research

Promoters are increasing stake – Giving confidence

Promoters are continuously increasing stake in the company. In last 5 years they have increased almost 12% stake which reflects promoter's confidence towards the future growth of business. Promoter's stake stood at 39% in FY 08 and currently stands at 50.58%.



Source- Ace equity, AR and Anandrathi Research

Healthy Investment Book

Atul has huge investment book. Company's investment consists of Arvind, Wyeth, BASF, ICICI Bank, Jain Irrigation and Nagarjuna Oil Refinery.

Total Investment value based on market price is approx. Rs. 1765 mln which is roughly 20% of current market cap of the company.

Investment Book			
Company Name	No of Shares	Market Price	Market Value (Rs. Mln)
Arvind Ltd.	4127471	148	610.9
Wyeth Ltd.	1369895	712	975.4
BASF India Ltd.	261396	611	159.7
ICICI Bank Ltd.	19823	961	19.0
Jain Irrigation Systems Ltc	4200	63.5	0.3
Nagarjuna Oil Refinery Lt	31500	3.35	0.1
Market Value of Investments (7th Feb,2014)			**1765**

Financials & Valuation

Income Statement (Rs. In Mln)	FY 12a	FY 13a	FY 14e	FY 15e
Net Sales	17,924.0	20,428.8	22,924.6	24,917.6
Raw Material cost	10,690.1	11,581.7	12,996.6	14,053.5
Gross Profit	**7,233.9**	**8,847.1**	**9,928.0**	**10,864.1**
Power & fuel	1,670.9	2,151.0	2,413.8	2,623.6
Employee Cost	1,216.6	1,347.3	1,511.9	1,643.3
Other Manufacturing Expenses	1,417.1	1,690.2	1,896.7	2,061.6
General and Administration Expenses	238.2	282.6	317.1	344.7
Selling and Distribution Expenses	178.6	137.6	154.4	167.8
Miscellaneous Expenses	441.5	570.7	640.4	696.1
Depreciation	440.2	513.7	576.5	626.6
EBIT	**1,630.8**	**2,154.0**	**2,417.2**	**2,700.3**
EBIDTA	**2,071.0**	**2,667.7**	**2,993.6**	**3,326.9**
Finance Charges	433.1	348.8	458.5	425.4
Other non core Expenditure	191.1	176.3	-	-
Other Income	294.1	181.0	379.1	220.1
EBT	1,300.7	1,809.9	2,337.8	2,495.0
Tax	350.3	583.0	731.3	780.5
Net Income	950.4	1,226.9	1,606.5	1,714.5
MI	2.5	(0.7)	(1.0)	(1.0)
Share from Associate	(41.9)	(82.3)	(82.3)	(82.3)
Net Income Consolidated	**911.0**	**1,143.9**	**1,523.2**	**1,631.2**

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Balance Sheet (Rs. In Mln)	FY 12a	FY 13a	FY 14e	FY 15e
Share capital	296.8	296.8	296.8	296.8
Reserve & Surplus	6,243.8	7,245.6	8,540.3	9,926.8
Net Worth	6,540.6	7,542.4	8,837.1	10,223.6
MI	44.4	58.4	59.4	60.4
Deferred Tax Liability	227.7	272.8	272.8	272.8
Total Debt	3,924.0	3,700.2	3,209.4	2,491.8
Long Term Provision	35.4	51.3	51.3	51.3
Current Liabilties				
Trade Payables	2,688.3	2,916.1	3,272.4	3,543.0
Other Current Liabilities	608.5	634.6	712.1	771.4
Short Term Provisions	517.9	462.0	518.4	561.6
Total Liabilities	**14,586.8**	**15,637.8**	**16,933.0**	**17,976.0**
Net Block	4,436.3	5,061.3	5,190.3	5,659.9
Capital WIP	659.1	651.5		
Intangible assets under development	2.8	7.8	7.8	7.8
Non Current Investments	749.4	667.1	667.1	667.1
Long Term Loans & Advances	380.8	391.7	391.7	391.7
Other Non Current Assets	254.6	309.4	309.4	309.4
Current Assets				
Inventories	3,331.5	3,664.8	4,112.5	4,470.1
Sundry Debtors	3,588.8	3,516.8	3,946.4	4,289.5
Cash and Bank	186.4	148.6	706.4	669.6
Other Current Assets	171.9	200.4	458.5	244.4
Short Term Loans and Advances	825.2	1,018.4	1,142.8	1,238.0
Total Assets	**14,586.8**	**15,637.8**	**16,933.0**	**17,947.4**

Cash Flow Statement (Rs. In Mln)	FY 12a	FY 13a	FY 14e	FY 15e
EBT	1,300.7	1,809.9	2,337.8	2,495.0
Adjustement				
Add- Depreciation	440.2	513.7	576.5	626.6
Interest Expenses	433.1	348.8	458.5	425.4
Less -Other Income	(294.1)	(181.0)	(379.1)	(220.1)
Other Adjustment	100.7	227.4		
Cash flow from operation before WC ch‹	1,980.6	2,718.8	2,993.6	3,326.9
Change in WC	(674.7)	(285.0)	(769.7)	(208.6)
Cash Flow after change in WC	1,305.9	2,433.8	2,224.0	3,118.3
Taxes Paid	(419.8)	(545.9)	(731.3)	(780.5)
Cash Flow From Operation (A)	886.1	1,887.9	1,492.7	2,337.8
Cash Flow from Investment Activities				
Purchase of Fixed Assets	(1,335.1)	(1,060.8)	(705.4)	(1,096.2)
Sale of Fixed Assets	64.2	21.8		
Other Investment Income	231.3	(140.7)	379.1	220.1
Cash flow from Investing Activities (B)	(1,039.6)	(1,179.7)	(326.3)	(876.1)
Cash flow from Financinag Activities				
Dividend Paid	(164.2)	(154.5)	(228.5)	(244.7)
Tax On Dividend	(27.9)	(26.2)	(38.8)	(41.5)
Interest Paid	(433.1)	(348.8)	(458.5)	(425.4)
Proceed/ redemption from Borrowings	786.8	(242.1)	(490.8)	(717.7)
Cash flow from Financing Activities (C)	161.6	(771.6)	(1,216.5)	(1,429.3)

DCF Valuation

Year	ROIC	EBIT (1-T)	Growth Rate	Reinvestment	FCFF	Cost of Capital	Discounting Factor	PV
TTM 12 months (Y)	15.5%	1692.5						
Y+1	15.5%	1833.3	8.32%	56%	798.2	13%	0.88	706.4
Y+2	15.5%	1985.8	8.32%	56%	864.7	13%	0.78	677.2
Y+3	15.5%	2151.1	8.32%	56%	936.6	13%	0.69	649.1
Y+4	15.5%	2330.0	8.32%	56%	1014.5	13%	0.61	622.2
Y+5	15.5%	2523.9	8.32%	56%	1098.9	13%	0.54	596.5
Y+6	12.0%	2724.7	7.96%	66%	918.2	12%	0.48	443.4
Y+7	12.0%	2931.6	7.59%	63%	1076.9	12%	0.43	465.1
Y+8	12.0%	3143.5	7.23%	60%	1250.0	11%	0.39	485.5
Y+8	12.0%	3359.2	6.86%	57%	1437.7	11%	0.35	504.9
Y+9	12.0%	3577.6	6.50%	54%	1639.7	10%	0.32	523.5
Terminal Value	10.50%	3810.11		62%	1451.5	41470.6	PV of terminal Value	13240.0
							PV of Frim Value	18913.8
							(-)Debt	3551.00
							(+)Cash	64.80
							(+)Investment Book @ 50 % Discount	882.5
							Intrinsic Value	16310.09
							Current Market Cap	12162
							Upside %	**34.1%**

We value the company on DCF model. We have observed that company's reinvestment rate (Net CAPEX+ Change in Working Capital) has been around 55-56% in last 4-5 years after change in revenue mix. Therefore we assume the same reinvestment rate for next 5 years. Along with the growth, ROIC also will move towards the industry average hence reinvestment rate will also change correspondingly. We assume that in long run growth will converge towards risk free rate (Proxy growth of the economy).

We have used bottom up beta and mature market risk premium + default spread of India (country risk premium) to arrive at cost of capital. Since company is part of chemical companies hence business beta has to be adjusted accordingly. In the long run we believe mature market premium along with default spread will narrow down and accordingly the cost of capital at terminal year will be 10%. Atul's Post tax operating ROIC has been continuously improving because of change in revenue mix however we have not considered that impact in our valuation. On the contrary we have assumed that company's ROIC will move lower and converge towards industry average in long run.

Since company has been generating consistent free cash flow, we prefer to use DCF valuation. Our intrinsic value of the Atul equity per share is around Rs. 515 which is around 26% upside from CMP. Atul also holds investment book valued at Rs. 1765 mln and we valued it at 50% discount and arrived at value of Rs. 33 per share. Hence our expected value of Atul is Rs. 548.

We believe stock is currently undervalued as market is not reflecting correct value of Atul's operating business. We will recommend to buy the stock at CMP for an upside of 34.1% from current market price.

Key Statistics	FY 12a	FY 13a	FY 14e	FY 15e
Sales Growth %	15.24	13.97	12.22	8.69
EBIDTA Growth%	10.5%	28.8%	12.2%	11.1%
EPS	30.71	38.57	51.36	55.00
EBIDTA Margin %	11.6%	13.1%	13.1%	13.4%
PAT Margin %	5.1%	5.6%	6.6%	6.5%
ROCE	21.1%	24.8%	27.2%	28.4%
ROE	13.9%	15.2%	17.2%	16.0%
ROIC (post Tax)	12.2%	13.8%	15.1%	15.8%
Valuation Ratio				
PE	13.32	10.60	7.96	7.44
EV/EBIDTA	7.55	5.86	5.22	4.70
EV/Sales	0.87	0.77	0.68	0.63
P/BV	1.94	1.67	1.42	1.22
Dividend Yield	1.1%	1.0%	1.5%	1.6%

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Key Concern

Further slowdown in an economy

Company's various segments are dependent on economy growth of the country hence any slowdown in domestic and global economy will have negative impact on company's financial performaqnce.

Spike in interest rate

Our DCF valuation is based on number of variable and discounting rate is derived from India's 10 year Government securities alongwith vis a vis equity risk premium which depends on mature market interest rate. Any spike in interest rate either in India or mature market will reduce the value accordingly.

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Disclaimer