EQUENTIS

THINKING FUTURE

Independent Equity Research

Investment Summary

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DEEPAK NITRITE LIMITED (DNL)

<u>Disclaimer:</u> This note has been prepared for the first time in August 2019 and is refreshed as and when deemed necessary. We would be tracking our recommended companies on regular basis. Any event update on the company or update in 15-18 months or 5-year target prices would be conveyed to clients accordingly.

Quantitative Factors - Checklist

Sr. No.	Aspect (Consolidated)	Required Criteria for Equentis 5x5 strategy	FY16-19*	Condition Met? (Y/N)	FY19-24E	Condition Met? (Y/N)
			Actual Value (Historical)		Future Value (Forecasted)	
1	Top-line CAGR	20-30% CAGR over 5-year period	*25.3%*	**Y**	*16.3%*	**Y**
2	EBITDA CAGR	25-35% CAGR over 5-year period	*35.5%*	**Y**	*20.2%*	**Y**
3	PAT CAGR	30-40% CAGR over 5-year period	*40.4%*	**Y**	*27.4%*	**Y**
4	RoCE	At least 15% with increasing bias	*10.9%*	**N**	*27.2*	**Y**
5	D/E Ratio	Around 1-1.5xs with declining bias	*0.97*	**Y**	*0.42xs*	**Y**
6	Working Capital Intensity	Less than 25-30% of net sales	*14.9%*	**Y**	*Average 12.8%*	**Y**
7	Dividend Payout	15-20%	*21.8%*	**Y**	*Average 18.9%*	**Y**

Note - Above – Blue, In-Line – Green, Below – Red

****Note: Historical Value has been provided for 3Yrs (FY16-19) instead of 5Yrs (FY14-19) as DNL has started reporting consolidated numbers from FY15.***

- While projecting financial performance of DNL over the next five years (FY19-24E), we prefer to err on the side of caution rather than penciling very high growth rates. DNL is yet to ramp up its Phenol and Acetone segment by entering into downstream derivatives. Hence, for now, we have taken conservative estimates w.r.t. Revenues, EBITDA and PAT performance over the next five years. We will be closely observing events, quarterly results, etc. in the company and shall modify our estimates on the upside whenever we deem fit.

Qualitative Factors - Checklist

Sr. No.	Aspect	Comment	Required criteria for Equentis 5x5 strategy met? (Y/N)
1	Management pedigree, track record and integrity	• Deepak Nitrite was founded in 1970 by Mr. C. K. Mehta and is currently run by his son Mr. Deepak Mehta, who is the Chairman and Managing Director. The Group has interests spanning across the entire chemical and fertilizer space in India with total group revenues of $700mn. • Mr. Deepak Mehta has been at the helm of company affairs for the past 40 years. He has also been the Chairman of the National Chemicals Committee at FICCI. Board of Directors of the company includes some very eminent persons from the corporate world – namely Mr. Sudhin Choksey (Managing Director of Gruh Finance), Mr. Sudhir Mankad (Retired IAS officer who has served in senior positions with the Government of Gujarat and Government of India), Dr. Sivaram (eminent scientist and 2006 Padma Shree Award winner) Mr. Sanjay Asher (Senior Partner with Crawford Bayley).	Y
2	Ownership Profile	• As on 30th June, 2019, Promoter family and group companies / entities collectively own 44.85% in the company with NIL shares pledged. • Institutional holding stands at 27.05% amongst which FII holding stands at 10.73% and DII at 16.32%. • SBI Magnum Multicap Fund (1.82%), Franklin India Smaller Companies Fund (4.24%), IDFC Sterling Value Fund (3.34%), L&T Mutual Fund Trustee Ltd (2.24%) are some of the marquee investors.	Y
3	Business USP and Market Leadership	• In order to address the huge untapped opportunity in Phenols and Acetones, DNL floated a wholly-owned subsidiary Deepak Phenolics Limited (DPL) in FY15. DPL has set up a green field plant to manufacture phenol and acetone at Dahej, Gujarat. The capacity of phenol plant is 200,000 MTPA and that of acetone is 120,000 MTPA. DPL will also be manufacturing 260,000 MTPA of cumene which is a feedstock for phenol and acetone. • DNL is the only fully integrated OBA player in the industry which gives the Company a competitive edge over other players. Company has diversified its focus on export markets and end-user industries to accelerate growth and is a market leader in the Rs. 5bn domestic optical brightening agent (OBA) market. • DNL has been manufacturing chemicals for nearly five decades. Over the years, the company has grown to become a market leader in the domestic market for inorganic intermediates (sodium nitrite), nitro toluenes and fuel additives. It is also among the top three global players for xylidines, cumidines and oximes.	Y
4	Past strategies towards acquisitions, capital allocation, fiscal prudence, capital spends, cash flow mgmt, dividend payouts, bonus, concern for minority s/hs	• Recently, DNL entered into the phenol acetone segment through its subsidiary Deepak Phenolics Ltd and this has been a game changer for the company. Within a year of commercializing its operations, Deepak Phenolics Ltd was able to achieve good profitability and 100% capacity utilization. • Now the company is looking to undertake further capacity addition to enter the downstream derivatives of the phenol acetone chain. • Also DNL has undertaken a project for commissioning of power plant to cut on power supply fluctuations. The commissioning of power plant is expected to bring in additional cost savings. • Company has rewarded its investors with average dividend payouts of 23.2% over the past five years.	Y
5	Succession Planning	• Deepak Nitrite was founded in 1970 by Mr. C. K. Mehta and is currently run by his son Mr. Deepak Mehta, who is the Chairman and Managing Director. He has also been the Chairman of the National Chemicals Committee at FICCI. • Board of Directors of the company includes some very eminent persons from the corporate world – namely Mr. Sudhin Choksey (Managing Director of Gruh Finance), Mr. Sudhir Mankad (Retired IAS officer who has served in senior positions with the Government of Gujarat and Government of India), Dr. Sivaram (eminent scientist and 2006 Padma Shree Award winner) Mr. Sanjay Asher (Senior Partner with Crawford Bayley).	Y

I. INVESTMENT THESIS

Recommendation – BUY	Internal Rating Score – 3.71 out of 5
15-18M Review Price – Rs. 431 - 462	Upside: 25 - 34%
5yr Review Price - Rs. 688 – 737	Upside: 2.0xs – 2.1xs
ISIN	INE288B01029

A. Sector Outlook

Chemical industry is the mainstay of industrial and agricultural development of the country and provides building blocks for several downstream industries such as textiles, papers, paints, soaps, detergents, pharmaceuticals, varnish etc. The global chemical industry has been expanding at a steady pace over the past couple of years. The US was the original home to innovation and production of chemicals and specialty chemicals. The industry then gradually transitioned to Europe, followed by developing countries such as China. In the recent times, Emerging Asian markets have become a new manufacturing hub for global chemical giants largely led by China where chemical sales have increased manifold.

Global Economic Scenario:
The International Monetary Fund (IMF) has predicted that over the next decade, reverse globalisation will make the playing field of global economies uneven, resulting in reduced ability to leverage existing competitive advantages. The consequences of escalating trade actions between China and USA has resulted in higher prices in China and the U.S., less purchasing power for consumers in these countries, higher input costs, heightened financial market volatility, and possibly higher interest rates. This is expected to have a ripple effects in integrated markets. Trade tensions, including the imposition of tariffs by large economies, have resulted in a material impact on global commodity markets, leading to trade diversion and widening price differentials among countries.

Asia to drive Global Economic Growth:
Asia is seen driving the global economy with economies such as India, Indonesia, Malaysia, China, Philippines, and Turkey leading the way. India is expected to grow at a faster pace than other growing economies in the world, with structural reforms and higher investments driving economic activity. China's robust economic growth engine seems to have slowed down as it faces pressures such as the trade war with the U.S., a global economic slowdown and a decline in domestic consumption.

Indian Economic Scenario and Domestic Chemical Industry:
In 2019, while the first half witnessed strong growth trends, growth in the second half was impacted by a liquidity crisis in the BFSI sector as well as global macro-economic events. Even as growth moderated, India remained the fastest growing large economy in the world.
The domestic chemical sector continues to maintain its strong performance trajectory, driven by the increasing competency of Indian players across the globe as disruption in China's chemical market continues to persist. The basic chemical players stand to benefit from high demand volumes and strong commodity chemical prices globally aiding them to sustain higher margins and higher volumes.

Key Growth Enablers:
The chemical industry is expected to be the key contributor and a catalyst in achieving the target of US$ 1 Trillion manufacturing economy by 2028, from the current US$ 380 Billion. With nearly US$ 15 Trillion of Chinese exports in chemicals and plastics subject to US tariffs, India is set to gain market share in the global chemical industry, estimated to be around US$ 4.7 Trillion. Significant opportunities lie ahead for Indian chemical companies arising out of emerging possibilities in US-China trade war as well as shutting down of capacities in China. The domestic industry is also tapping the intermediates opportunity and exploiting meaningful demand. Given the mature market conditions of China, India is expected to be the next engine of growth rendering opportunities to players engaged in the chemical value chain – extending from agrochemicals, dyes, pigments, and specialty chemicals, which sees the strongest tailwinds along with petrochemicals at the same time.
Further, Indian chemical companies are enhancing capabilities and investing greater amounts in R&D to elevate their offerings. India continues to gain traction from major countries and is likely to grow multi-fold in the coming decade. Specialty chemical companies have witnessed a sharp increase in demand for their products over the last few years. In the years ahead, the demand for Specialty Chemicals is expected to grow in line with gains in the industrial and construction sectors. Specialty chemical players, with presence across the value chain, have observed significant improvement in their operating margins.

Future Industry Outlook:
The Indian chemical industry is 3rd largest producer in Asia and 6th largest by output in the world. It covers more than 80,000 commercial products. The sector has now moved from commodity based (sourcing of raw/refined chemicals) to

need based (manufactured as per needs) and the industry is collaborating with manufacturers to create value-based products. However, there is a greater need to invest in technology platforms, R&D, and IPR, in order to differentiate, create greater customer value, and develop strategic partnerships with customers.

India is an ideal destination for Chemical manufacturing. Development of strong Intellectual Property regime backed by R&D focus is picking up pace, development of infrastructure is being made to enable chemical and manufacturing industry – warehouses, waste management facilities, ports etc. A complete revamp of the current Petroleum, Chemicals & Petrochemicals Investment Regions (PCPIRs) policy will encourage effective and long-term investments in the sector and boost margins for Indian chemical players. Currently, roughly 50% of the country's demand for Poly Vinyl Chloride (PVC) is being met by imports. The current per capita consumption of chemicals is very low at 1/10th of global average. This is expected to increase in the coming decade with India's expanding middle class creating an unparalleled end-user market.

Further, China's excessive restrictions on its chemicals industry has already made MNCs start thinking about India as an alternate source, resulting in rapid flow of foreign direct Investment (FDI) into India. With nearly US$ 15 Trillion of Chinese exports in chemicals and plastics subject to US tariffs, India is set to gain market share in the global chemical industry, estimated to be around US$ 4.7 Trillion. Significant opportunities lie ahead for Indian chemical companies arising out of emerging possibilities in US-China trade war as well as shutting down of capacities in China. We believe this could lead to consolidation and improve the operating efficiency of the fragmented Indian industry.

Snapshot of Indian Chemical industry:

India's Chemical industry is majorly broken down in the following categories:

Sr. No	Segments	Comprises of
1	Base Chemicals	Petrochemicals, man-made fibres, industrial gases, fertilisers, chlor-alkali, other organic & inorganic chemicals.
2	Specialty Chemicals	Dyes and pigments, leather chemicals, construction chemicals, personal care ingredients & other specialty chemicals.
3	Pharmaceuticals	Active Pharmaceutical Ingredients (APIs) & formulations.
4	Agrochemicals	Insecticides, herbicides, fungicides & other crop protection chemicals.
5	Biotechnology	Bio-pharma, bio-agri, bio-services & bio-industrial products

B. Detailed understanding on Business segments of DNL:

Broadly, the business segments of DNL can be categorized into 4 major segments:

Segments	Description	Product Portfolio	User Industries
Basic Chemicals	High volume and low margin products	Nitrites, Nitro Toluidines, Fuel Additives	Colorants, Rubber Chemicals, Explosives, Dyes, Pigments, Food Colors, Pharmaceuticals, Petrol and Diesel Blending and Agrochemicals.
Fine & Specialty Chemicals	Low volumes and high margin niche products that are customized to specific customer requirements.	Specialty Chemicals like Xylidines, Oximes, Cumidines etc.	Agro Chemicals, Colorants, Pigments, Pharmaceuticals and personal wellness.
Performance Products	Only fully integrated manufacturer of OBA in the world with vertical integration from toluene to para nitro toluene (PNT) and further into DASDA and OBA.	Optical Brightening Agent (OBA) and its raw material Diamino Stilbene Disulfonic Acid (DASDA).	Paper, Detergents and textiles
Phenol & Acetone	→ Phenol is a versatile industrial organic chemical used to produce a wide variety of chemical intermediates. → Acetone is predominantly used in the production of pharmaceuticals. It is also a co-product of the phenol manufacturing process.	Phenol, Acetone and their derivatives	→ **Phenol:** Laminates, paints, auto lining, adhesive. → **Acetone:** Healthcare, paint, acrylic, inks.

Source: *Company Website*

I) Basic Chemicals (BC) Segment: Strong Entry barriers and to benefit from China's environmental issues

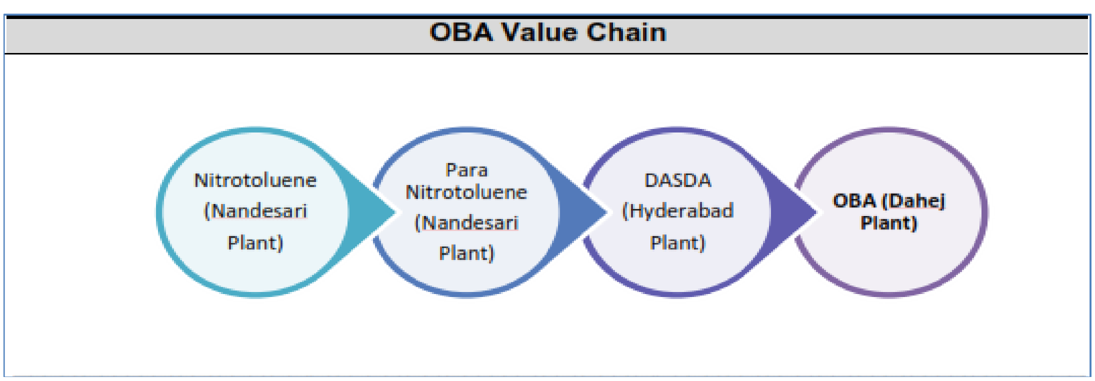
- BC is a commoditized segment which is characterized by high volumes and moderate margins. BC can be further classified in organic chemicals such as nitro toluene, ortho toluene and inorganic chemicals such as sodium nitrites and sodium nitrates.
- **Sodium Nitrite:** Sodium Nitrite is the intermediary used in dyes/pigments, pharma, food colorants, electroplating and specialty chemicals. Raw materials used consists of caustic soda and ammonia. DNL commands a market share of 75% in this segment.
  Nitro Toluene: Nitro Toluene are used as an intermediary in colorants, rubber chemicals, dyes, agrochemicals, explosives etc. Nitro Toluene is prepared by nitration of toluene. Para Nitro Toluene, Meta Nitro Toluene and Ortho Nitro Toluene are by-products produces by nitration of toluene. DNL uses Para Nitro Toluene produced in the process into forward integration for performance product DASDA.
  Fuel Additives: Fuel additives are compounds formulated to enhance the quality and efficiency of fuels. Fuel Additives act as anti-oxidizing agents and are useful in the improvement of cetane thereby reducing emissions, and improving the overall quality of different types of fuels like gasoline, diesel, aviation turbine fuel and lubricants.
- Cost leadership is the foremost competitive advantage required to drive growth and profitability in this segment as these chemicals are high-margin high-volume products with greater price sensitivity.
- The User Industries for Basic Chemicals include Colorants, Rubber chemicals, Explosives, Dyes, Pigments, Food colors, Pharmaceuticals, Petrol & diesel blending and Agrochemicals.

***Source**: Company Website*

- Basic chemicals demand has increased as a result of Chinese shutdowns. With a strong entry barrier due to the high costs of setting up operations, and DNL's effective logistics management, the basic chemical segment is expected to report sustained growth.

II) Performance Products (PP) Segment: Successful turnaround, further improvement to enable growth

- Performance Products are application chemicals, it consists of two products - Optical Brightening Agent (OBA) and its precursor, DASDA.
- DNL enjoys 75% market share for OBA and 60% market share for DASDA in India.
- DNL is the world's only fully-integrated manufacturer of OBA, with vertical integration from Toluene to Para Nitro Toluene and further into DASDA and OBA.



***Source**: Company Website*

- OBA is used as a brightening agent in the paper, textile and detergent industries.

***Source**: Company Website*

- **DASDA (Diamino Stilbene Disulfonic Acid):** The global production of DASDA at 57,700mtpa (US$ 14bn) grew at a 7% CAGR between FY11-16. Plant shut down in China due to environmental issues led to short supply of DASDA in global markets causing an unexpected 3-4X hike in DASDA prices. DNL could take advantage of this price hike which helped DNL to post superior margin growth. The prices are expected to stabilize in H2FY20.
- DNL ventured into OBA in FY14. This division met with initial headwinds and was not profitable. Due to the strategic initiatives undertaken by the company DNL was able to successfully turnaround this division in Q3FY19.

III) <u>Fine and Specialty Chemicals (FSC) segment: Higher demand from key application industries</u>

- The Fine & Specialty Chemicals segment consists of specialized and niche products created from various processes and requiring technical skills and expertise.
- Under this segment, DNL manufactures Specialty Chemicals such as Xylidines, Oximes, Cumidines etc amongst others.
- Products in the respective, segment are customized as per requirements of the client and typically manufactured in low volumes, as they enjoy higher value.
- User Industries for Fine & Specialty Chemicals include Agro-chemicals, Colorants, Pigment, Pharmaceuticals and personal wellness

***Source**: Company Website*

IV) <u>Phenol & Acetone: Key growth driver</u>

- Deepak Phenolics Ltd. (DPL), a wholly-owned subsidiary of Deepak Nitrite Ltd, commenced commercial production at its new phenol and acetone plant on November 1, 2018. It quickly ramped up its capacity utilization to more than 80% and turned profitable during first quarter itself.
- DPL incurred capex of INR 1,400cr for this facility and has capacity to manufacture 200,000 MTPA of phenol and 120,000 MTPA of its co-product acetone.
- **Phenol:**
  It is also referred to as Carbolic acid or monohydroxy benzene, is a versatile industrial organic chemical. It is used to produce a wide variety of chemical intermediates, including Bisphenol-A, Phenolic resins, Cyclohexanone and Aniline. It is consumed in laminates, Automobile, foundry, paints, rubber, surfactants, pharma, Agro-chemicals etc. Phenolic Resins industry accounts for 76% of Phenol consumed in India.
- **Acetone:**
  Acetone is predominantly used in the production of pharmaceuticals, paints, adhesives and thinners etc. Acetone is a by-product of phenol manufacturing process, as a result, stronger demand for phenol has resulted in oversupply of acetone globally.

- Over the past many years, the demand of the phenol and acetone was largely supported by imports as there were no major producers in the domestic market. To fill this demand supply gap, DNL established a plant for the same at Dahej with huge capex.

C. Investment Summary

- ***Phenol and acetone project to be major growth driver for DNL:*** In order to address the huge untapped opportunity in Phenols and Acetones, DNL floated a wholly-owned subsidiary Deepak Phenolics Limited (DPL) in FY15. DPL has set up a green field plant to manufacture phenol and acetone at Dahej, Gujarat. The capacity of phenol plant is 200,000 MTPA and that of acetone is 120,000 MTPA. DPL also be manufactures 260,000 MTPA of cumene which is a feedstock for phenol and acetone. At a total outlay of Rs. 14bn, the project is funded through a combination of debt and equity. Technology for Phenol and Acetone has been sourced from Kellogg, Brown & Root International, Inc and technology for Cumene has been sourced from UOP Honeywell. Globally, more than 60% of Phenol project has used technology from these two giants.
  On the back of commissioning of its phenol and acetone project, the management has outlined an ambitious revenue target of $1bn (Rs. 65,000mn @ Rs. 65/USD) over the next 2 – 3 years (FY21 or FY22), implying Revenue CaGR of 40-50%.

  DPL aims to serve India's present demand for Phenol and Acetone from this facility and is expected to benefit from strong demand growth in these products. Local availability of Phenol and Acetone is expected to boost the production of downstream intermediates, which will diversify the applications for these products and further expand the overall market in the country. In the first few months of commercialization, the plant achieved the highest utilization level of 100%. The operations are expected to standardize at 85% utilization levels going forward.

- ***Focus on undertaking downstream derivatives expansion:*** Deepak Phenolics Ltd (DPL), the wholly owned subsidiary of DNL is planning to undertake manufacturing of Acetone derivative which is expected to come on stream by Q4FY20. The management's focus in shifting to value added from commodity products augurs well for the company as this is expected to improve the margins going forward. Also DNL has undertaken a project for commissioning of power plant to cut on power supply fluctuations. The commissioning of power plant is expected to bring in additional cost savings.

- ***Diversified Product Portfolio:*** Supply disruptions in China are expected to continue in the medium term, thus acting as tailwinds for the growth of Indian Chemical Industry. DNL manufactures a range of intermediates which finds application in several industries including Colorants, Petrochemicals, Agrochemicals, Rubber, Pharmaceuticals, Paper, Textile, Detergents, Fine & Specialty Chemicals etc. DNL has also developed expertise in multiple chemical processes including Nitration, Alkylation, Nitrogen Oxides Absorption, Hydrogenation, Sulphonation, Condensation, Diazotization and Oxidation. DNL is a preferred supplier to some of the leading chemical companies like BASF, CIBA, Monsanto, Bayer Crop Science etc. DNL is in a better position due to diversification as it mitigates risks in the event of downturn in one of the product lines.

- ***Improving product mix and efficiency to drive Performance Products business and strategic turnaround of OBA Division:*** DNL is the only fully integrated OBA player in the industry which gives the Company a competitive edge over other players. DNL is one of the few suppliers in the world with an integrated Toluene-OBA-DASDA facility. Company has diversified its focus on export markets and end-user industries to accelerate growth and is a market leader in the Rs. 5bn domestic optical brightening agent (OBA) market. The OBA facility at Dahej became operational in FY13. The plant achieved EBITDA breakeven in Q2FY18 after facing initial headwinds largely related to operations and turned profitable in FY19. Moreover, development of new high-margin chemicals has spearheaded surge in DNL's fine and specialty chemicals business. The company is focused on expanding its footprint in high-value intermediates, especially for the pharma API and personal care industry. Improving product mix and efficiency will help DNL to have superior margins going forward.

- ***Strong Technical Skills:*** DNL possesses high levels of technical expertise in the areas of Nitration, Hydrogenation, Oxidation, and Diazotization. DNL's presence in the chemical industry for several decades has facilitated it to develop multiple technical capabilities and provide niche chemistries to its customers.

Basis the above growth opportunity and DNL's strong positioning; over FY19-24E our key estimates on consolidated basis are as follows –

1. Turnover increase by ~2xs.
2. EBITDA increase by ~2.5xs.
3. PAT increase by ~3.7xs.
4. Cumulative CAPEX Rs. ~15bn.
5. Cumulative Free cash flows from operations of Rs. ~17.4bn.
6. Avg. Cash & Liquid Investments portfolio of Rs. 2.37bn.
7. Average Gearing 0.45xs.
8. Average Working Capital Intensity 12.8%.
9. Average Dividend Payout ~19% of PAT.
10. Avg. RoCE of ~25.6%.

Key assumptions for Base Case Forecasts over FY19-24E

Particulars (Consolidated)	3yr CaGR (FY16-19)	3yr CaGR (FY19-22E)	5yr CaGR (FY19-24E)
Revenue	25.3%	22.3%	16.6%
EBITDA	35.5%	30.1%	20.4%
PAT	40.4%	39.5%	29.8%
Cum. Capex (Rs. Mn)	(8,952)	(11,500)	(17,400)
Avg. Operating Income/Gross block (xs)	2.14	1.79	1.73
Avg. D/E (xs)	0.97	0.64	0.44
Avg. Div. Payout (%)	21.8%	15.7%	15.7%
Avg. Working Cap. Intensity (%)	14.9%	13.3%	12.8%
Avg. ROCE (%)	10.9%	25.7%	25.6%
Avg. ROE (%)	11.3%	28.1%	26.2%
Cum. FCFF (Rs. Mn)	(5,934)	2,300	3,172
Avg. Cash & Liquid Investments (Rs. Mn)	774	436	475

Deepak Nitrite Ltd	FY16	FY17	FY18	FY19E	FY20E	FY21E	FY22E	FY23E	FY24E	CAGR FY19-24E
EPS (Rs.)	5.4	3.2	5.7	12.7	30.3	30.9	34.7	42.6	47.1	*29.9%*
YoY (%)		*-40.6%*	*77.0%*	*124.3%*	*138.0%*	*2.0%*	*12.2%*	*22.8%*	*10.6%*	
P/E	**65.5**	**110.1**	**62.2**	**27.7**	**11.7**	**11.4**	**10.2**	**8.3**	**7.5**	

Source*: Equentis Research*

1. Topline –

5yr Topline CaGR (FY19-24E) estimated at ~17% which is expected to be led by growth in Performance Products (PP) segment. DNL is expected to benefit from change in product mix in OBA segment which should be more of structural in nature. Also DNL has benefitted from the elevated prices of DASDA which is expected to normalize going forward. The Fine and Specialty Chemicals (FSC) segment is expected to demonstrate improved performance due to cyclical nature of business. The Basic Chemicals segment is also expected to display stable performance. With the commissioning of new Phenol-Acetone plant which touched 100% capacity utilization within first few months of commercialization, topline is further expected to get a boost.

2. EBITDA –

5yr EBITDA CaGR (FY19-24E) estimated at ~20% outpacing the topline CaGR. EBITDA Margins are expected to improve due to better realizations, better product mix, optimum capacities with streamline processes and developments in China markets. Also management's focus to enter into value added derivatives space of Phenol and Acetone rather than being a pure commodity player is further expected to give fillip to the margins. Also the cost efficient strategies undertaken by the management can improve EBITDA Margins going forward.

3. **<u>Capital Expenditure & Funding–</u>**

DNL is undertaking capex for development of downstream derivatives which is expected to contribute towards topline and margins from FY21 onwards. Apart from this, DNL is also setting up power plant to cut on the power supply fluctuations. In Q2FY20 concall, management has guided that capex for FY20 will be Rs.4000mn.

4. **<u>Working Capital –</u>**

- Debtor days stood at 78 days of sale in FY19. We estimate the same to be at around 78 days over next 5 years.
- Inventory days stood at 56 days of sale in FY19. We estimate the same to be in line with FY19 levels.
- Current liabilities stood at 83 days of sale in FY19. We estimate the same to be in line with FY19 levels.
- Overall working capital intensity as measured by Net working capital as % net sales stood at 18.8% in FY19. In our forecasts we estimate the same in the range of 11.7–14% of net sales over next 5 years.

5. **<u>Interest expense and depreciation –</u>**

In-line with the above assumptions of capex and cash flows and similar levels of working capital intensity, we estimate gearing of the company which stood at 1.07xs FY19 to steadily decline over the next 5 years and reach NIL by FY24. FY19 saw a spike in gearing ratio due to commissioning of new plants but management has conveyed that the DNL is completely comfortable with this ratio.
Accordingly, we are expecting interest expense to remain miniscule while depreciation is estimated at 4.9-6.7% as % of Gross Block.

6. **<u>Tax Rates –</u>**

Tax as % of PBT stood at 35.2% in FY19. With the slashing of Corporate tax to 25.17% benefit is expected to accrue to DNL as it will improve profitability and will have positive impact on EPS.

7. **<u>Non-op income & expenditure –</u>**

We have assumed nominal non-op income at Rs. 150mn in line with the past. There is no non-op expense assumed. Our sense is that management will utilize cash for growth opportunities rather than investing in treasury.

8. **<u>Share count –</u>**

Has been assumed at current levels of 136mn shares. DNL in January 2018 had come up Qualified Institutional Placement (QIP) funding to complete a key portion of the equity for the new Phenol Acetone project. QIP saw participation from marquee domestic institutional investors such as ICICI Lombard General Insurance Company, Birla Sun Life Insurance Company, Reliance Mutual Fund, Birla Mutual Fund, ICICI Prudential Mutual Fund, IDFC Mutual Fund & L&T Mutual Fund

9. **<u>PAT CaGR –</u>**

Based on the assumptions, we estimate PAT CaGR of ~27.4% over our forecasted period of FY19-24E. There could be upside risks to our estimates on PAT CaGR led by EBITDA Margins higher than our estimates.

10. **<u>Dividend Pay-out –</u>**

Dividend as % of PAT stood at ~19% in FY19. We estimate the same to be at around 19% over next 5 years.

11. **<u>Return ratios –</u>**

Based on the above assumptions, we estimate average ROA in next 5 years to be 16.3% and with EBITDA margin expected to improve, average RoCE is expected to be ~27.2% in 5 years.

12. **<u>Other BS items –</u>**

Conservative assumptions have been made towards new investments at subsidiary level in FY20, in case management decides to invest on strategic purposes to grow non-standalone business. Long-term loans & advances – not material and no change expected.

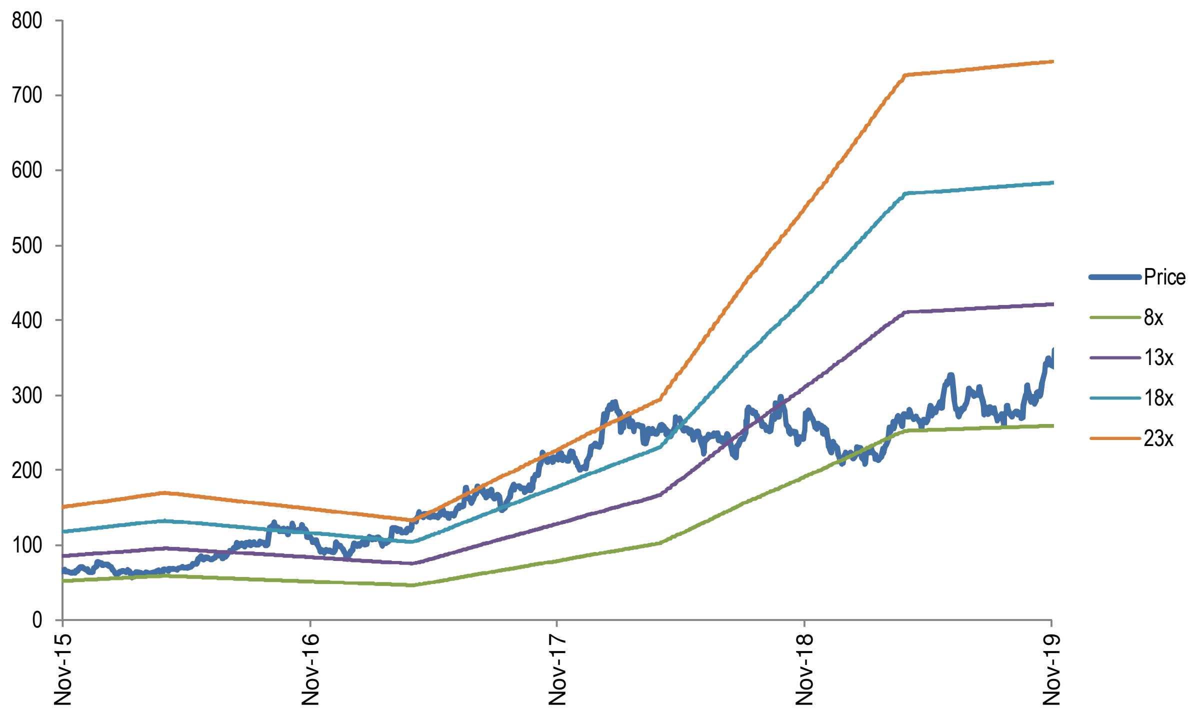
13. **<u>Off-balance sheet & Contingent liabilities –</u>**

As per FY19 Annual Report of DNL, there are contingent liabilities worth Rs. 0.38bn on consolidated books of the company. The break-up of contingent liabilities on FY19 books is as follows:

	Contingent Liabilities and Commitments	FY19	FY18
I)	**Claims against the company not acknowledged as debts in respect of**		
a)	Matters relating to Income Tax from AY 2012-13 is being contested at various levels of Tax authorities.	5.9	9.9
b)	Matters relating to Sales Tax/VAT from AY 2005-06 to FY 2013-14 is being contested at various level of Indirect Tax authorities.	15.9	8.6
c)	Matters relating to Excise duty from FY 1998-99 to FY 2016-17 is being contested at various level of Indirect Tax authorities.	29.2	47.9
d)	Bank Guarantees:		
	- Financial	170.3	147.9
	- Performance	159.4	271.792
e)	Disputed Labour Matters	Amount Not ascertainable	Amount Not ascertainable
	Total	**380.6**	**486.1**

Valuation

❖ *Deepak Nitrite Limited - PE Chart*



Source: *ACE Equity, Equentis Research*

❖ *Valuation – 15-18M*

Particulars (Consolidated)	15-18 Month Valuation					
	FY19	FY20E	FY21E	FY22E	FY23E	FY24E
Normalised PAT (Rs. Mn.)	1,737	4,122	4,204	4,718	5,795	6,410
YoY (%)	*124.3%*	*137.3%*	*2.0%*	*12.2%*	*22.8%*	*10.6%*
Share Count (Mn.)	136	136	136	136	136	136
EPS (Rs.) on latest share count	12.7	30.2	30.8	34.6	42.5	47.0
PE (xs) @ CMP of Rs. 346	27.1	11.4	11.2	10.0	8.1	7.4

We attach a multiple of 14-15xs to DNL's FY21E EPS to arrive at the intrinsic value range of Rs. 431-Rs. 462/ – implying potential upside of 25% - 34% over the next 15 – 18 months. We have a BUY rating on the stock.

❖ *Valuation – 5 Years*

FY19 EPS (Rs.)	EPS CaGR	FY24 EPS (Rs.)	Attach PE Multiple (xs)						Upside (xs)					
			12	13	14	15	16	17	12	13	14	15	16	17
12.73	26%	40.44	485	526	566	607	647	687	1.4	1.5	1.6	1.8	1.9	2.0
12.73	28%	43.75	525	569	612	656	700	744	1.5	1.6	1.8	1.9	2.0	2.2
12.73	**30%**	47.27	567	615	**662**	**709**	756	804	1.6	1.8	**1.9**	**2.1**	2.2	2.3
12.73	**32%**	51.02	612	663	**714**	**765**	816	867	1.8	1.9	**2.1**	**2.2**	2.4	2.5
12.73	34%	55.01	660	715	770	825	880	935	1.9	2.1	2.2	2.4	2.5	2.7
12.73	36%	59.24	711	770	829	889	948	1,007	2.1	2.2	2.4	2.6	2.7	2.9
Average 5yr target price range (Rs.)					**688**	**737**								
Average 5yr upside (xs)					**2.0**	**2.1**								

***Disclaimer** - Our 5yr. Target prices are rolling estimates. These factor in changes in accounting period, estimates v/s actual performance and changes in current valuation multiples periodically. Accordingly, our target prices in latest reports may be different from the ones published at the time of Initiating coverage.*

Recommendation

DNL is favorably positioned to capture opportunities emerging across the chemicals and specialty chemicals landscape. The Greenfield project of the Company for manufacture of Phenol & Acetone started commercial operations less than a year back and is reporting positive EBITDA and PAT and is poised to become domestic market leader for Phenol & Acetone through its subsidiary Deepak Phenolics Ltd. Though the performance of Phenol and Acetone segment was impacted by slowing economic growth globally and the subdued activity in automotive and real estate sector in India. The outlook for Phenol remains favorable as the product is finding new applications resulting in increased local demand. Also the demand from the end user industry is expected to improve going forward. The downstream project for Acetone is progressing well and production is expected to commence by the end of this financial year. All this expected to provide sustained and profitable growth for the company.

As regards BC and PP segments, the company continued to show resilient performance in these segments. Going forward, these segments are expected to have sustained growth over the near term due to planned capacity expansions undertaken by the management and product realizations and extensions. As regards BC and PP segments, the company continued to show resilient performance in these segments. Going forward, these segments are expected to have sustained growth over the near term due to planned capacity expansions undertaken by the management and product realizations and extensions.

FSC segment continue to witness pressure. DNL is taking strategic positions on key products in FSC portfolio to enhance margin performance. DNL is also taking measures to enhance volumes going forward. FSC is expected to deliver an improved performance on the back of new product launches and capacity augmentation.

We expect revenue CAGR of 16% and PAT CAGR of 27% over FY19-24E. We assign a BUY rating to the stock.

Going ahead, we expect DNL to benefit strongly from healthy outlook of India Chemical industry which is growing at the rate of 8-10% annually. The growth is particularly expected to come from sub-sectors like specialty chemicals and agro-chemicals. To aid this industry further, the government is working on a draft chemical policy which would focus on meeting the rising demand of chemicals from domestic industry and reduce dependence on imports. Setting up of PCPIRs (Petroleum, Chemicals & Petrochemical Investment Regions) is another step to promote investment in this sector and make the country an important hub for both domestic and international markets

Near-term Catalysts

- There has been decline in exports from China due to shutdown of multiple plants due to crackdown by the government. Also with trade war going on between US and China, India stands to gain from this trade war. DNL can be beneficiary to this.
- Commencement of acetone-phenol plant will help address the supply deficit for these 2 compounds in India thereby reducing imports. Also management's focus to enter downstream derivatives of Phenol and Acetone can beneficial for DNL as it is expected to improve margins.
- Ramp-up in sales of high-margin pharma, personal care and agrochemical intermediates. Also DNL is contemplating to add more pharmaceutical products into its portfolio.
- Improving margins in OBA as capacity utilization in the project improves

Risks to the recommendation

- The profitability in the acetone-phenol business is closely linked to the spread between global prices of acetone-phenol and benzene propylene which can impact earnings.
- Delay in order flow or slower ramp-up in new product-mix could impact growth.
- Acetone-phenol project, being driven by import substitution demand, may face price competition from major exporting countries such as China and Thailand.

II. PEER COMPARISON

Historical Performance

Description	Aarti Industries Ltd.	Atul Ltd.	Deepak Nitrite Ltd.	Navin Fluorine International Ltd.	SRF Ltd.
Net Sales (FY18) - Rs. Mn.	50,142	40,378	26,999	9,959	76,927
3yr CaGR (%)	18.6%	15.9%	25.3%	13.6%	18.8%
5yr CaGR (%)	13.8%	10.4%	16.3%	15.4%	13.9%
EBITDA (FY18) - Rs. Mn.	9,706	7,668	4,139	2,184	13,552
3yr CaGR (%)	19.0%	18.4%	35.5%	22.7%	12.0%
5yr CaGR (%)	19.3%	16.1%	29.9%	27.0%	21.8%
EBITDA Margin (FY18) (%)	19.4%	19.0%	15.3%	21.9%	17.6%
3yr Avg (%)	19.5%	17.4%	12.4%	22.3%	18.0%
5yr Avg (%)	18.7%	17.0%	11.9%	19.3%	18.1%
PAT (FY18) - Rs. Mn.	4,834	4,360	1,737	1,491	6,416
3yr CaGR (%)	23.5%	16.7%	40.4%	21.3%	14.3%
5yr CaGR (%)	24.4%	14.7%	35.3%	17.8%	31.6%
PAT Margin (FY18) (%)	9.9%	10.7%	6.4%	14.8%	8.3%
3yr Avg (%)	9.8%	9.9%	5.9%	17.3%	8.8%
5yr Avg (%)	9.0%	9.6%	5.3%	14.8%	8.4%
RoCE FY18 (%)	18.5%	27.2%	17.0%	21.7%	14.1%
3yr Avg (%)	18.5%	23.1%	13.5%	24.7%	13.2%
5yr Avg (%)	19.0%	24.6%	14.8%	20.9%	13.2%
RoE FY18 (%)	24.0%	17.4%	17.4%	14.4%	16.7%
3yr Avg (%)	24.6%	16.1%	14.4%	17.7%	15.9%
5yr Avg (%)	23.8%	18.6%	16.9%	15.4%	15.8%
D/E (FY18) -- xs	0.9	0.0	1.1	0.0	0.9
3yr Avg -- xs	1.1	0.0	1.1	0.0	0.8
5yr Avg -- xs	1.1	0.1	1.2	0.1	0.9
Dividend Payout Ratio - 5yr avg (%)	28.6%	10.4%	21.7%	31.4%	23.8%
TTM P/E (xs)	26.16	21.26	12.88	28.01	21.84
P/BV (x)	5.00	4.20	3.68	4.01	4.05
Promoter shareholding (%)	48.3%	44.7%	45.6%	31.0%	52.3%
% of Pledged Shares - Promoter	0.0%	3.9%	0.0%	4.4%	0.0%
R&R FII (%)	7.7%	7.2%	9.4%	17.1%	18.5%
R&R DII (%)	16.4%	23.2%	16.5%	17.9%	11.9%

INVESTOR EDUCATION SECTION

BEYOND NUMBERS – FROM THE FUND MANAGER'S DESK

In our quest to ensure that our clients stay course on the path of 'Wealth Creation" and not get unduly guided by near-term stock price swings (positive or negative), we have incorporated this section, through which we summarize the essence of our investment thought process; which in real world is mostly driven beyond numbers.

While in our reports and analysis, forecasting of earnings and valuation framework, form integral part of the investment process; however, every day and all over, we have seen that a stock could give the forecasted one- year return, in say a few trading sessions and thereafter test one's patience, or the converse, that a stock corrects significantly with prolonged period of under-performance and then in a matter of say a quarter makes up for all this.

In a nutshell, if one's investing decisions are routinely guided by stock price behavior, then one will surely end up in a vicious cycle of making some gains and some losses, which mostly even out. This is certainly not the path for steady long-term wealth creation.

This leads us to the next question, that – "What is really needed for long-term wealth creation"?

In our opinion, the answer simply is ***"CONVICTION"***; with respect to the size of the business opportunity, the capability of the management team and top leadership to successfully innovate, scale-up and keep building sustainable competitive advantages, their philosophy of balancing growth and risks, level of transparency and overall approach towards all stakeholders.

Hence, while investing, if one keeps in mind, all these points and remains steadfast, then, as long as the underlying investment thesis is not broken, irrespective of certain periods of underperformance and outperformance; over the medium to long-term, wealth creation through compounding will be the end-product.

OUR HUNCH ON DEEPAK NITRITE NEAR-TERM STOCK PULSE

- ***To put it in perspective, we have given the estimated 15-18M as well as 5-year target based on our assumptions and financial projections covered in "Key assumptions for Base Case Forecasts over FY19-24E" section of this report. However, the stock may take a beating in the near-term, if the following must happen, which cannot be covered in the financial projections today, despite our best efforts.***

Stock price Dampeners –

Negative Factors	Probability	Reasons
Profitability linked to spreads	High	The profitability in the acetone-phenol business is closely linked to the spread between global prices of acetone-phenol and benzene propylene which can impact earnings.
Competition from Chinese players	Moderate	The crackdown on polluting industries has resulted in supply disruption of necessary chemicals manufactured and exported from there. If the things were to normalize in China, it could have some impact on DNL.
Volatility in Raw Material prices	High	Raw Materials forms a major component in the chemical processes. Volatility in raw material prices is one of the main challenges faced by chemical industry companies.
Regulatory Issues	Moderate	Chemical companies always have inherent problem of regulatory hindrance. Any change in regulatory norms can have significant impact on the company's future. They also require number of approvals and have to maintain quality standards.

- ***The stock may show a huge upside in a much shorter period than expected, if the following were to happen; which too can't be covered in our financial projections at this stage.***

Stock price Catalysts –

Positive Factors	Probability	Reasons
Anti-dumping duty by the government	High	The Anti-dumping duty imposed by the government has been positive for DNL as it reduced the imports which resulted in acceptability for DNL's products. Also governments vision of making India the manufacturing hub of chemicals and petrochemicals to cut down imports of chemicals augurs well for the company.
DNL's decision to enter value-added segment	Moderate	DNL's plan to enter downstream derivatives of Phenol and Acetone can improve the margins and profitability going forward. DNL's decision to enter value-added segment rather than being a pure commodity player can benefit the company.

Conclusion – We will be keenly tracking the stock for any positive development as well as to understand if the company is facing any challenges in the business. As of now, assuming that overall market sentiments remain favorable and going by the management's commentary on turnaround of its new businesses and improving capacity utilization across its plants; we think there is high probability of improvement in performance metrics of the company.

Financial Summary

Consolidated (INR mn)	FY-15	FY-16	FY-17	FY-18	FY-19	FY-20E	FY-21E	FY-22E	FY-23E	FY-24E	3yr CAGR (FY16-19)	3yr CAGR (FY19-22E)	5yr CAGR (FY19-24E)	
Net Revenues	13,272	13,729	13,707	16,515	26,999	42,078	45,594	49,420	53,584	58,117	*25.3%*	*12.9%*	*16.6%*	**CaGR**
YoY		*3.4%*	*-0.2%*	*20.5%*	*63.5%*	*55.8%*	*8.4%*	*8.4%*	*8.4%*	*8.5%*				
EBITDA	1,366	1,664	1,363	1,984	4,141	8,182	8,389	9,119	9,630	10,476	*35.5%*	*17.1%*	*20.4%*	**CaGR**
YoY		*21.8%*	*-18.1%*	*45.5%*	*108.8%*	*97.6%*	*2.5%*	*8.7%*	*5.6%*	*8.8%*				
EBITDA margins	*10.3%*	*12.1%*	*9.9%*	*12.0%*	*15.3%*	*19.4%*	*18.4%*	*18.5%*	*18.0%*	*18.0%*	*12.4%*	*18.8%*	*18.5%*	*Average*
Reported PAT	529	627	963	790	1,737	4,122	4,204	4,718	5,795	6,410	*40.4%*	*22.1%*	*29.8%*	**CaGR**
YoY		*18.6%*	*53.5%*	*-18.0%*	*119.8%*	*137.3%*	*2.0%*	*12.2%*	*22.8%*	*10.6%*				
PAT margins	*4.0%*	*4.6%*	*7.0%*	*4.8%*	*6.4%*	*9.8%*	*9.2%*	*9.5%*	*10.8%*	*11.0%*	*6.1%*	*9.5%*	*10.1%*	*Average*
FCFF	1,153	315	459	(4,250)	(2,143)	1,418	2,219	3,263	4,264	4,695	-5934	6900	15859	Cumulative
Debt:Equity	1.38	0.92	0.84	0.98	1.07	0.84	0.64	0.45	0.24	0.09	*0.97*	*0.64*	*0.45*	*Average*
Asset turns	-	0.07	0.04	0.05	0.08	0.17	0.15	0.15	0.18	0.19	*0.06*	*0.16*	*0.17*	*Average*
ROCE	*0.0%*	*13.8%*	*7.6%*	*9.0%*	*16.1%*	*27.6%*	*24.8%*	*24.8%*	*24.6%*	*26.0%*	*10.9%*	*25.7%*	*25.6%*	*Average*
RoE	*0.0%*	*15.3%*	*7.1%*	*9.5%*	*17.4%*	*33.3%*	*26.7%*	*24.3%*	*24.5%*	*22.4%*	*11.3%*	*28.1%*	*26.2%*	*Average*
Net working capital/Net sales	*16.4%*	*11.8%*	*13.9%*	*12.1%*	*18.8%*	*14.0%*	*13.3%*	*12.7%*	*12.1%*	*11.6%*	*14.9%*	*13.3%*	*12.8%*	*Average*
Capex/Net sales	*0.0%*	*-5.1%*	*-0.3%*	*-39.9%*	*-8.6%*	*-9.5%*	*-8.8%*	*-7.1%*	*-5.4%*	*-5.2%*	*-16.3%*	*-8.5%*	*-7.2%*	*Average*
EBIT/Gross Interest Expense	3	3	2	3	4	6	6	7	-	-	*3.12*	*6.03*	*6.03*	*Average*
Shares o/s (mn)	105	116	131	136	136	136	136	136	136	136				
EPS (Adjusted for stock split)	**5.07**	**5.41**	**7.38**	**5.79**	**12.73**	**30.31**	**30.91**	**34.69**	**42.61**	**47.13**	*33.0%*	*22.2%*	*29.9%*	
P/E		**-**	**-**	**-**	**-**	**9.44**	**8.89**	**7.92**	**6.45**	**5.83**				
EV:						60,166	59,507	57,815	54,539	50,949				
- M. cap						48,783	48,783	48,783	48,783	48,783				
- Add: debt						11,785	11,159	9,503	6,267	2,720				
- Less: cash and cash equivalents						402	435	472	511	555				
EV/EBITDA						**7.35**	**7.09**	**6.34**	**5.66**	**4.86**				
BVPS						103	128	157	191	229				
P/BV						**-**	**-**	**-**	**-**	**-**				
Dividend payout - as % of PAT	*23.8%*	*26.8%*	*19.6%*	*27.0%*	*18.9%*	*18.9%*	*18.9%*	*18.9%*	*18.9%*	*18.9%*				

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