Adi Finechem

11 February 2016

Visit note - Not rated

IIFL Institutional Equities

Niche player, now in strong hands

- Adi Finechem's (AFL) recent acquisition by Fairfax India opens up new growth opportunities for the company through M&A, besides providing greater resources for continued organic growth.
- A niche producer of oleochemicals and nutraceuticals, AFL is now eyeing opportunities for expansion into newer areas within the broader chemical industry, supported by its new parent's backing.
- AFL's unique raw material sourcing strategy and technical expertise are the foundation underpinning its differentiated and profitable business model, which generates attractive return ratios.
- AFL's raw materials are by-products generated by vegetable oil refiners, giving AFL a cost advantage. Utilizing these by-products as raw material requires technical expertise, creating entry barriers.
- The company has just expanded its manufacturing capacity by 50% to 45,000 MT, which it hopes to fully utilize in the next 2-3 years. AFL is targeting a 25% Cagr in sales and Ebitda over the next five years.
- AFL's financial performance was affected post FY14 by a crash in prices of tocopherol (its key nutraceutical product) and by loss of production due to a capacity expansion and facility improvement exercise. Earnings growth should resume here onwards.

IIFL's score-card for unrated companies

Key Positives	Score of 1-5 (with 5 as most positive)	Key Risks	Score of 1-5 (with 5 as most risky)
Industry growth potential	✓✓✓	Regulatory	×
Dominant position within the industry	✓✓✓	Corporate Governance	××
Balance-sheet strength, profitability ratios	✓✓✓	Competition (including possible foreign)	×××
Execution track record of management	✓✓✓✓	Liquidity (trading volume)	××××

CMP	**Rs220**
Market cap (US$m)	**45**
Enterprise value(US$m)	**49**
Bloomberg	**ADFI IN**
Sector	**Mid-cap**

Price performance (%)

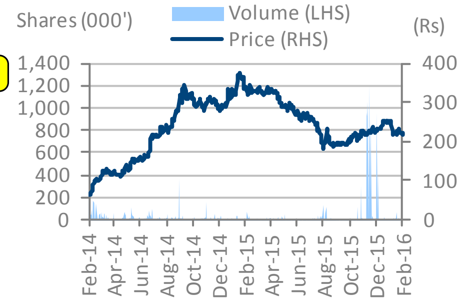
	1M	3M	1Y
Absolute (Rs)	-12.3	-1.3	-34.6
Absolute (US$)	-13.9	-3.5	-39.4
Rel. to Sensex	-7.6	6.4	-18.4

Cagr (%)	**3 yrs**
EPS	15.3

Shareholding pattern (%)

Promoter	62.5
FII	4.1
DII	3.4
Others	30.0
52Wk High/Low (Rs)	373/175
Shares o/s (m)	14
Daily volume (US$ m)	0.4
Dividend yield FY14ii (%)	0.0
Free float (%)	37.5

Stock performance



Financial summary (Rs m)

Y/e 31 Mar, Consolidated	FY12A	FY13A	FY14A	FY15A
Revenues (Rs m)	972	1,231	1,518	1,506
Ebitda margins (%)	*15.1*	*14.0*	*21.8*	*16.5*
Pre-exceptional PAT (Rs m)	74	86	187	137
Reported PAT (Rs m)	74	84	187	137
Pre-exceptional EPS (Rs)	6.5	7.5	13.5	9.9
Growth (%)	*21.4*	*16.0*	*80.4*	*(26.7)*
PER (x)	**34.0**	**29.3**	**16.2**	**22.2**
ROE (%)	*35.8*	*31.4*	*47.8*	*26.3*
Net debt/equity (x)	1.2	0.7	0.6	0.5
EV/Ebitda (x)	11.0	8.1	1.7	13.4
Price/book (x)	10.6	8.1	6.4	5.3

Source: Company, IIFL Research. Priced as on 10 February 2016

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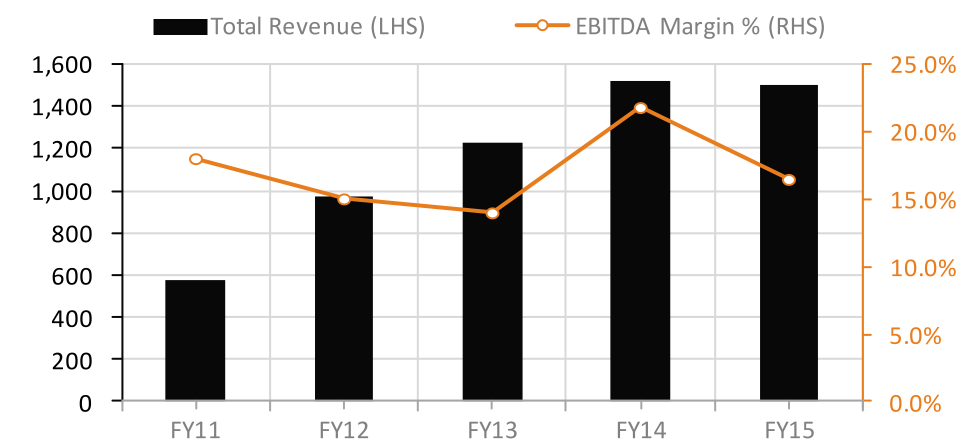
Long history, but improvement in performance post 2010

Adi Finechem's origins date back to 1985, when the company was incorporated as H K Agro Oil by Mr. Nahoosh Jariwala, currently the Managing Director, and his cousin Mr. Rajan Harivallabhdas. The company's original business was processing rice bran oil. Over the years, the focus shifted to producing fatty acids and tocopherol. In 2010, Mr. Rajan Harivallabhdas exited the business by selling his stake to three of Mr. Jariwala's schoolmates, Mr. Utkarsh Shah, Mr. Bimal Parikh and Mr. Hemant Shah, and the company was renamed Adi Finechem (AFL).

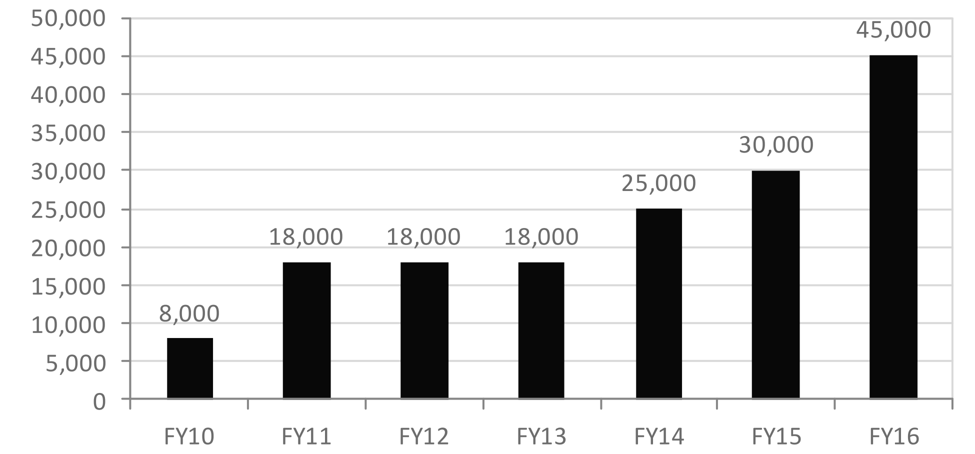
Figure 1: Improved performance post change in ownership



Source: Company, IIFL Research

Post the change in ownership, financial performance improved markedly, as Mr. Jariwala with the backing of his friends successfully implemented several initiatives to improve operating efficiencies and drive growth. Manufacturing capacities have increased more than five-fold since the change in ownership, from 8,000 MT in FY10 to 45,000 MT in FY16. Production in FY15 was 23,374 MT, implying capacity utilization of 85% on the year's average capacity. Ebitda margins have been in the range of 14-18%, barring a one-off spike in FY14 due to tightness in the tocopherol market.

Figure 2: Production capacity has increased five-fold since FY10

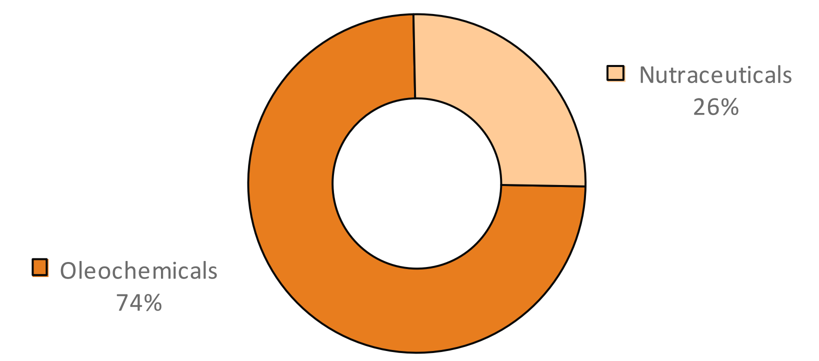


Source: Company, IIFL Research

Niche producer of oleochemicals and nutraceuticals

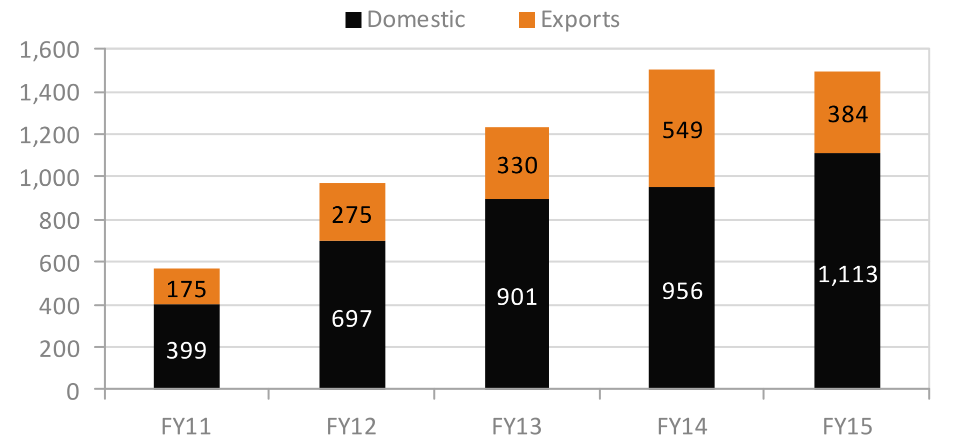
AFLhas two business divisions: oleochemicals (74% of FY15 revenue) and nutraceuticals (26%).

Figure 3: Breakdown of FY15 company revenue (total Rs1.5b)



Source: Company, IIFL Research

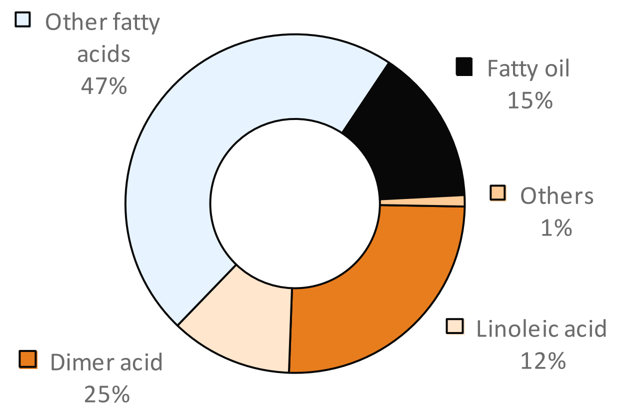
Figure 4: Breakdown of revenues



Source: Company, IIFL Research

In the nutraceuticals division, the main product is mixed tocopherol concentrate (25% of FY15 revenue). In oleochemicals, top products are dimer acid.

Figure 5: Breakdown of oleochemical revenue (74% of company revenue)



Source: Company, IIFL Research

Figure 6: End-use applications of AFL's products

Product	Application
Linoleic acid	Paints and inks
Dimer acid	Paints, inks, epoxy hardeners
Monomer acid	Paints and resins
Distilled fatty acid	Liquid soap, textiles, low value paints
Palmitic acid	Amines, amides, soap
Tocopherol	Natural Vitamin E

Source: Company, IIFL Research

Competitive differentiator: unique sourcing of raw material

AFL's raw materials are by-products generated by vegetable oil refiners. The process of refining the oils of soybean, sunflower, corn and cotton generates not only prime oil, which is converted into edible oils, but also the by-products acid oil and deodorizer distillate, which AFL uses as raw material.

Figure 7: AFL's raw materials are by-products of vegetable oil refining

Product	Proportion %	Uses
Prime oil	c.98.5%	Edible oils
Acid oil (AO)	c.1.25%	Oleochemicals, e.g., palmitic, linoleic, dimer, monomer acids
Deodorizer distillate (DOD)	c.0.25%	Mixed tocopherol, distilled fatty acids

Source: Company, IIFL Research

These by-products are generated in very small proportion (only c.1.5% of the overall oil volume processed). AFL buys these by-products directly at the factory-gate of refineries scattered across India. It has long-standing relationships with these vegetable oil refiners and claims that it purchases c.60% of all acid oil and c.90% of all deodorizer distillate produced in India. AFL's top ten suppliers provide c.75% of the company's requirement, while the largest (Adani Wilmar) contributes c.30%.

Payment to the supplier is made in cash, either in advance or on the spot upon delivery. The quality of raw material is not standardized, so AFL has through experience learnt about quality differences across clients and the right price to pay to each supplier. In addition, AFL's manufacturing equipment needs constant tweaking to produce the desired quality of end-product using varying grades of raw material. The entire business model is therefore difficult to replicate for a competitor.

This unique business model gives AFL a significant cost advantage, because its raw materials are cheaper than those used by the competition, which uses refined oils. Besides, in its two biggest products, tocopherol and dimer acid (together c.45% of company revenue), AFL is the sole or dominant producer in India. For these reasons, AFL is confident in its ability to sell out its entire production. In addition, the company's use of environmentally-friendly raw materials positions it favourably from a longer term perspective.

Product profiles

Oleochemicals are organic (carbon-containing) compounds, and as such are analogous to petrochemicals, but are instead derived from plant and animal fats. Oleochemicals include basic substances such as fatty acids, fatty acid methyl esters, fatty alcohols, fatty amines and glycerol, as well as derivatives of these basic substances. AFL so far only manufactures basic substances in oleochemicals. Its top two products are dimer acid and linoleic acid, which are profiled below. Besides these, the company also produces other basic substances including monomer acid, palmitic acid, distilled fatty acid, glycerine, etc. All of these are derived from the oils of commodities like soybean, sunflower, corn and cotton.

- **Dimer acids** are mainly used as polymer building blocks. They contribute to the heat and hydrolytic stability, water repellence and pigment wetting properties of the final polymers (polyamides, polyesters, epoxy resins) based upon these natural polymerized fatty acids. AFL is the only manufacturer in India and supplies c.3,500 MT out of India's total requirement of 10,000 MT. Key application industries are industrial paints, inks, lubricants, epoxy hardeners, and textiles.
- **Linoleic acid**, also sold under the name 'soya fatty acid', is a carboxylic acid used in making quick-drying oils, useful in paints and varnishes. Other applications include cosmetics, inks, amines, and lubricants. AFL is one of the lowest cost manufacturers.

Nutraceuticals is a broad term used to describe any food product that provides extra health benefits. AFL's main offering in this category is mixed tocopherol concentrate. **Tocopherols** are a class of compounds with vitamin E activity. AFL produces natural tocopherols, produced from vegetable oils. These have certain advantages over synthetic tocopherols in terms of longer persistence in the body, lower risk of allergic reactions, etc. AFL supplies tocopherols to the largest consumers in the world including ADM, BASF, and Cargill. Applications include food, pharmaceuticals, and cosmetics.

Figure 8: List of clients

Segment	Marquee clientele
Oleo Chemicals	Asian Paints, Micro Inks, Arkema
Nutraceuticals	BASF (US), ADM (US), AOMC (Argentina), RIKEN (Japan), Cargill Inc. (US)

Source: Company, IIFL Research

Addressable opportunity is large

The size of the global oleochemical industry is estimated at over \$20b, or c.13-14m MT. A majority of this is represented by palm oil derivatives, which are not produced by AFL. Yet, the remaining opportunity size runs into several billions of dollars, which is large considering AFL's tiny revenue base of c.\$20m. The global oleochemical industry is expected to grow to \$30b by 2020, driven by demand for new applications, including innovative and sustainable products. Asia Pacific is the largest and fastest growing oleochemical market accounting for c.42% of global market volumes, thanks to plentiful availability of key raw materials. The Indian oleochemical industry is also well-positioned with abundant raw material supply, low manpower cost and improving infrastructure, which will be key growth drivers. Besides, the nutraceuticals market further increases AFL's addressable market opportunity. Also, AFL has not yet entered into derivatives of basic oleochemical substances, which could potentially generate better margins.

Financial performance

AFL posted strong growth in revenue and profit until FY14, but encountered headwinds beginning FY15. The company's financial performance in FY14 was boosted by a surge in prices of tocopherol globally, which has since corrected sharply by more than 70% off the peak. In addition, in 1H FY16, the company's operations were affected by a capacity expansion and facility improvement exercise, which led to some loss of production. AFL embarked on an exercise to upgrade the production facilities and make them compatible with requirements of customers in the US, and had to incur one-time costs for this purpose. A combination of all these factors led to a sharp drop in profit in 1H FY16. However, earnings growth resumed in 3Q FY16.

Figure 9: AFL's financial performance was affected post FY14

Rs m	FY14	FY15	YoY %	9M FY15	9M FY16	YoY %
Revenue	1,518	1,506	-0.8%	1,130	1,092	-3.3%
Ebitda	331	249	-25.0%	194	137	-29.5%
Margin %	21.8%	16.5%	-532 bps	17.2%	12.5%	-464 bps
Net profit	187	137	-26.7%	107	56	-47.4%

Source: Company, IIFL Research

Figure 10: Earnings growth resumed in 3Q FY16

Rs m	1H FY15	1H FY16	YoY %	3Q FY15	3Q FY16	YoY %
Revenue	765	709	-7.3%	372	394	6.0%
Ebitda	135	66	-51.6%	59	71	21.5%
Margin %	17.7%	9.2%	-846 bps	15.8%	18.1%	231 bps
Net profit	77	51	-33.8%	30	37	25.5%

Source: Company, IIFL Research

Sale of stake to Fairfax India

On November 4, 2015, AFL announced that its promoters would enter into an agreement with Fairfax India Holdings, an arm of Fairfax Financial Holdings (Canada), to sell a 44.7% stake to Fairfax at a price of Rs212 per share. Further to the share purchase agreement with the promoters, Fairfax also made an open offer to acquire an additional 26% in AFL for an identical price of Rs212. The offer closed on February 5, 2016. Under the open offer, Fairfax managed to acquire only 847 additional equity shares of AFL, as the open offer price of Rs212 was below the prevailing market price. Post the conclusion of the open offer, Fairfax now holds 44.7% of the paid up share capital of AFL.

Figure 11: Shareholding pattern post stake sale and open offer

Shareholders	No. of shares held	Percentage holding
FIH Mauritius Investments Ltd.	6,160,930	44.66%
Other promoters	2,460,000	17.83%
Public shareholders	5,173,070	37.50%
Total	**13,794,000**	**100.00%**

Source: Company, IIFL Research

Mr. Nahoosh Jariwala remains AFL's Managing Director and the next largest shareholder after Fairfax. Mr. Jariwala has so far run the business with support from the other promoters, who invested in the company in 2010 with a limited time horizon in order to enable Mr. Jariwala to execute his plans for the company. The sale to Fairfax allows the co-promoters to cash out their investments while remaining involved with the company as non-executive directors. Fairfax will appoint two directors on AFL's board.

Aggressive growth plans for the future

AFL's management recently announced that the company is targeting a 25% Cagr in sales and Ebitda over the next five years. For this purpose, the company plans Rs1b in capex over the next five years to: (a) increase capacity, (b) reduce per unit manufacturing cost, (c) increase efficiency, (d) upgrade current product streams, and (e) add new products.

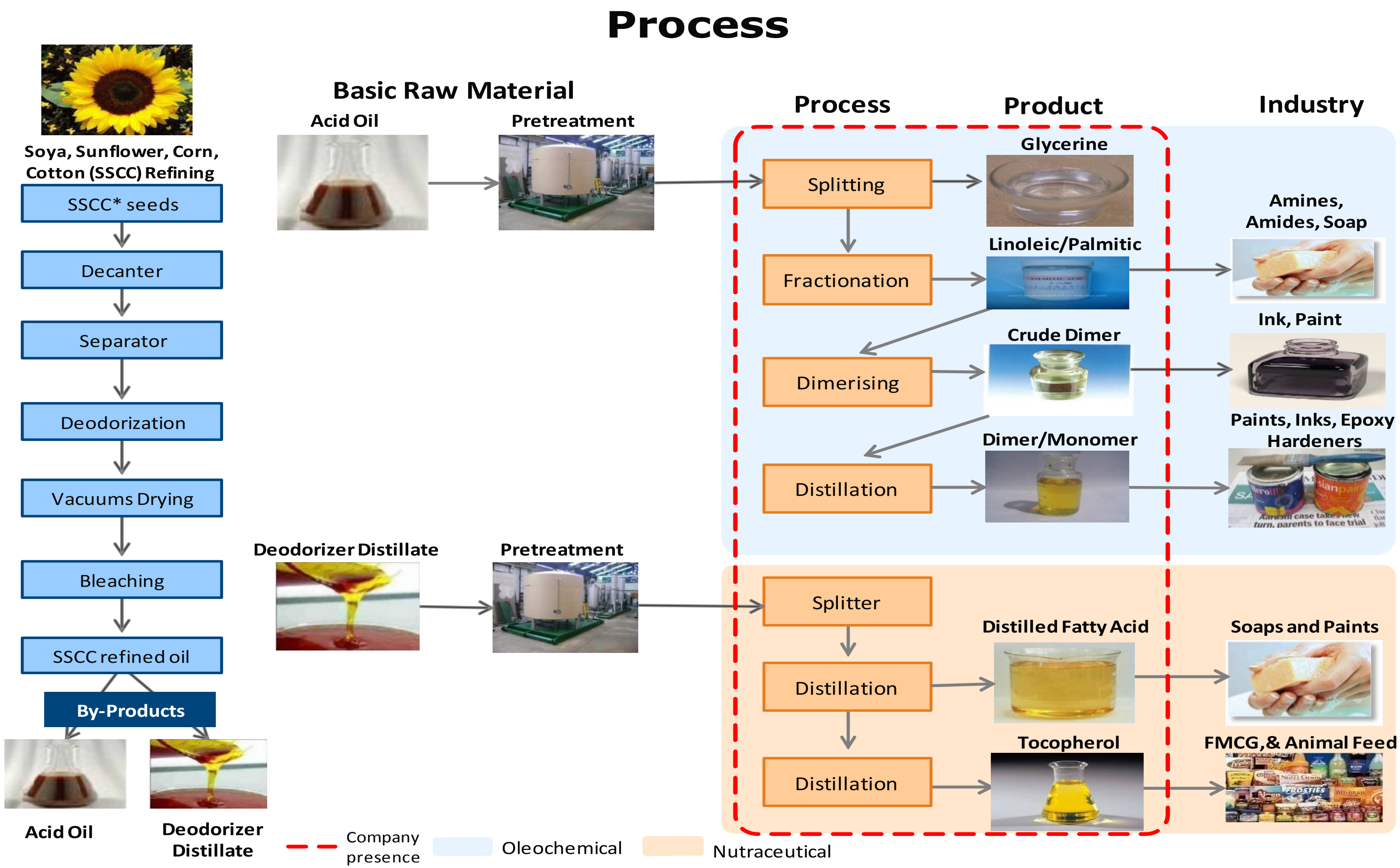
The immediate areas of focus for the next 2-3 years are: 1) to achieve full utilization of the expanded capacities of 45,000 MT, and 2) to establish a greenfield facility to manufacture higher grades of nutraceuticals. AFL's expanded capacity of 45,000 MT comprises 36,000 MT of oleochemicals and 9,000 MT of nutraceuticals. While oleochemical volumes should ramp up relatively fast, nutraceutical volumes may take longer, given the soft industry environment.

A back-of-the-envelope calculation suggests that if AFL meets its growth targets, net profit could be c.Rs400m in five years.

Risks/concerns

- Softness in the world market for tocopherol could continue to weigh on AFL's growth and profitability.
- Competition from the entry of large oleochemical producers such as Wilmar into the Indian market could potentially put AFL's raw material sourcing and/or pricing at risk.
- AFL has so far successfully scaled up its unique business model. However, going forward, it will need to demonstrate that its unique raw material sourcing model is further scalable, both in terms of the ability to procure increasing amounts of raw material and the ability to assure of end-product quality despite the variations in grades of raw material.
- The company will also need to manage the usual growing pains that small companies experience on the path to greater scale.
- AFL has plans for M&A to expand into newer areas within the chemical industry, following its acquisition by Fairfax. Such acquisitions create execution and integration risk, especially since AFL may have limited experience in segments of the chemical industry other than oleochemicals and nutraceuticals.

Figure 12: Manufacturing Process



Source: Company, IIFL Research

Figure 13: Board of Directors

Name	Comments
Mr. Utkarsh Shah (Chairman)	Mr. Utkarsh Shah holds a bachelor degree in Science. He has served on the advisory committee in various State Government Corporations and Boards. He was the president of Gujarat Chamber of Commerce in 1998 to 1999.
Mr. Nahoosh Jariwala (Managing Director)	Mr. Nahoosh Jariwala is one of the two original founders of AFL. He is associated with the company since more than 20 years. He holds a Commerce Degree. He has more than 25 years of experience in chemical manufacturing and trading of various textile products.
Mr. Bimal Parikh (Executive Director)	Mr. Bimal Parikh holds a Degree in Chemical Engineering and engaged in manufacture of dyes & chemicals since last 30 years. In 2001 he was the President of Gujarat Dyestuff Manufacturing Association. He was Honorary Secretary of the Gujarat Chamber of Commerce.
Mr. Hemant Shah (Whole time Director)	Mr. Hemant Shah is a Commerce Graduate and involved in business of logistics, garments, trading of minerals, and retailing since 25 years. He is a Senior Executive Member of numerous trade organisations like Gujarat Chamber of Commerce, Confederation of Indian Industry, Ahmedabad Management Association etc.
Mr. Jayesh Shah	Mr. Jayesh Shah is a Commerce Graduate and Chartered Accountant and holding the position of Director and Chief Financial Officer of Arvind Limited. He is associated with Arvind Limited since July, 1993. He has distinguished academic career and has extensive administrative, financial, regulatory and managerial expertise.
Mr. Kalpesh Patel	Mr. Kalpesh Patel is Executive Director of Nirma Limited having annual turnover of more than Rs. 7,000 crores. He has rich all round experience of independently handling a large manufacturing unit and is a known figure amongst the business community.
Mr. Ganpatraj Chaudhary	Mr. Ganpatraj Chaudhary is the Managing Director and overall in charge of operations in M/s. Riddhi Siddhi Gluco Biols Limited, a company listed on Bombay Stock Exchange, promoted by him and his family.
Mr. Nitin Patel	Mr. Nitin Patel is the Chairman of M/s. Shree Bhagwati Flour and Foods Private Limited and is also associated with M/s. Shri Bhagwati Flour Mills Private Limited. He is associated with the food industry since last 35 years
Mr. Bhavin Shah	Mr. Bhavin Shah is currently working with Equirus Securities Private Limited, Merchant Banker, as a Managing Director and Chief Executive Officer and has set up Institutional equities business. He is an expert on IPO matters and managed and got the success of IPO of TD Power in spite of negative market opinions. He was also associated with JP Morgan, Hong Kong and India as head of Asia-Pacific Technology Research and Global Sector Leader. He has also worked in Credit Suisse First Boston, Hong Kong as a Director (Head, Asia-Pacific Technology Research).
Ms. Sonal V. Ambani	Ms. Sonal Ambani holds a Bachelor's Degree in Chemistry, an MBA in Marketing & Finance and a Ph. D. in Business Management. She has worked as an Assistant Vice President in Morgan Stanley Dean Witter. She is a sculptor at an art aficionado and act as a Director and Curator of Samara Art Gallery.

Source: Company, IIFL Research

Note: 1) Mr. Rajen N. Jhaveri is CFO and CS of the company.

2) Post stake sale to Fairfax, Mr. Harsha Raghavan and Mr. Sumit Maheshwari will represent Fairfax on the Board of Directors of the company.

Financial summary

Income statement summary (Rs m)

Y/e 31 Mar, Consolidated	FY12A	FY13A	FY14A	FY15A
Revenues	**972**	**1,231**	**1,518**	**1,506**
Ebitda	146	173	331	249
Depreciation and amortisation	(20)	(23)	(26)	(22)
Ebit	127	150	305	226
Non-operating income	3	4	6	7
Financial expense	(21)	(25)	(27)	(27)
PBT	108	129	284	206
Exceptionals	0	(3)	0	0
Reported PBT	108	126	284	206
Tax expense	(34)	(42)	(97)	(69)
PAT	74	84	187	137
Minorities, Associates etc.	0	0	0	0
Attributable PAT	**74**	**84**	**187**	**137**

Ratio analysis

Y/e 31 Mar, Consolidated	FY12A	FY13A	FY14A	FY15A
Per share data (Rs)				
Pre-exceptional EPS	6.5	7.5	13.5	9.9
DPS	0.0	0.0	0.0	0.0
BVPS	20.8	27.0	34.3	41.2
Growth ratios (%)				
Revenues	69.4	26.7	23.3	(0.8)
Ebitda	41.4	18.0	92.0	(25.0)
EPS	21.4	16.0	80.4	(26.7)
Profitability ratios (%)				
Ebitda margin	15.1	14.0	21.8	16.5
Ebit margin	13.0	12.2	20.1	15.0
Tax rate	31.7	33.6	34.2	33.4
Net profit margin	7.6	6.8	12.3	9.1
Return ratios (%)				
ROE	35.8	31.4	47.8	26.3
ROCE	31.2	30.5	46.8	27.1
Solvency ratios (x)				
Net debt-equity	1.2	0.7	0.6	0.5
Net debt to Ebitda	1.9	1.2	0.9	1.2
Interest coverage	6.0	6.0	11.5	8.3

Source: Company data, IIFL Research

Balance sheet summary (Rs m)

Y/e 31 Mar, Consolidated	FY12A	FY13A	FY14A	FY15A
Cash & cash equivalents	(63)	(23)	0	1
Inventories	95	99	157	133
Receivables	141	154	213	156
Other current assets	34	59	61	51
Creditors	1,100	2,478	1,767	2,974
Other current liabilities	(1,038)	(2,406)	(1,693)	(2,856)
Net current assets	**145**	**217**	**359**	**222**
Fixed assets	273	284	444	694
Intangibles	0	0	0	0
Investments	64	23	0	0
Other long-term assets	0	0	0	0
Total net assets	**483**	**524**	**803**	**916**
Borrowings	211	180	291	288
Other long-term liabilities	34	36	40	61
Shareholders' equity	**238**	**308**	**473**	**568**
Total liabilities	**483**	**524**	**803**	**916**

Cash flow summary (Rs m)

Y/e 31 Mar, Consolidated	FY12A	FY13A	FY14A	FY15A
Ebit	127	150	305	226
Tax paid	(40)	(35)	(81)	(55)
Depreciation and amortization	20	23	26	22
Net working capital change	(79)	(22)	(138)	120
Other operating items	3	4	9	8
Operating cash flow before interest	30	120	122	321
Financial expense	(21)	(25)	(27)	(27)
Non-operating income	0	0	0	0
Operating cash flow after interest	**9**	**95**	**96**	**295**
Capital expenditure	**(70)**	**(51)**	**(191)**	**(255)**
Long-term investments	0	0	0	0
Others	(64)	41	23	0
Free cash flow	**(125)**	**85**	**(72)**	**40**
Equity raising	0	0	0	0
Borrowings	70	(34)	108	(17)
Dividend	(11)	(11)	(13)	(22)
Net chg in cash and equivalents	(66)	40	23	1

Source: Company data, IIFL Research

Disclosure : Published in 2015, © India Infoline Ltd 2015

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SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, i.e. a positive return of 10%+.

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