

Chemicals

Opportunities galore for Indian CDMO players

We had the opportunity to interact with Mr Manish Shah, Managing Director of OC Specialities Pvt. Ltd. The company operates in two primary businesses: Contract Development and Manufacturing Organisation (CDMO) and distribution. Within the CDMO segment, the company offers end-to-end coordination ranging from early-stage development to commercial production. It has one R&D centre in Mumbai and a manufacturing facility in Solapur. Additionally, OC Specialities is actively involved in the distribution of chemicals, specialty chemicals, and agrochemicals.

The CDMO and Contract Research and Manufacturing Services (CRAMS) sectors in India are experiencing significant shifts and presenting new opportunities. There has been a notable uptick in inquiries from Japan, while challenges in Europe are expected to drive business toward India due to its cost advantage coupled with the “China plus one” strategy adopted by MNCs in CDMO and CRAMS. China's increased chemical capacity and market strategy of dumping chemicals into market has implications for global supply dynamics, particularly with its heavy reliance on government incentives. Further, the battery chemical sector is expected to see robust demand. However, challenges such as the “Red Sea” issue are impacting timelines and costs could intensify with the demand rebounding, especially in the US and Europe.

■ CRAMS and CDMO:

- The CDMO specialty chemicals business in India is poised to enjoy an advantage over China owing to stringent intellectual property (IP) compliance and labour cost advantage. Innovators are reluctant to give business to Chinese vendors in CDMO as they have a history of crashing prices. The CDMO business is an opportunity for every Indian chemical company operating in CDMO business as each company is a niche in its domain. CDMO projects are taken based on R&D in which India has an edge over China.
- **Entry barriers:** In the CDMO business, the transition from product synthesis in the laboratory to scaling it up for commercial production is a complex and laborious process. Understanding and solving the problems of customers requires strategic design thinking. In product development stages from lab to commercial level, outcomes are unpredictable and test the patience and investment appetite. R&D and process development are critical parts of CDMO; hence, skilled manpower is essential. These demands of CDMO business make the entry into the business challenging for new entrants.
- **Japanese demand:** There has been a significant surge in inquiries from Japanese innovators, reflecting a growing interest from Japanese companies in prioritising India as a sourcing hub for molecules. They are keen on shifting their ongoing molecules to India. Vendor approval time has been reduced from 4-5 years earlier to less than two years now, streamlining the process.
- **Escalating costs in Europe:** Rising costs are compelling European CDMO players to shut down operations. Most of these projects are expected to come to India, given its cost advantage. The intensity of new projects from American innovators has come down.
- The product offering in CDMO is quite niche and products are patented. Initially, patented products command high prices but as they become off-patent, prices typically drop and this benefit is passed on to customers. However, this reduction is compensated either on a value or volume basis.

Company	RECO	CMP*	TP (INR)
Aarti Industries	ADD	686	733
Aether Industries	BUY	798	1,124
Alkyl Amines	SELL	1,902	1,836
Ami Organics	ADD	1,114	1,201
Clean Science and Technology	SELL	1,398	1,037
Deepak Nitrite	SELL	2,142	1,448
Fine Organic	SELL	4,210	3,842
Galaxy Surfactants	BUY	2,351	3,529
Navin Fluorine	BUY	3,131	4,014
Neogen Chemicals	BUY	1,236	2,127
NOCIL	ADD	259	288
SRF	ADD	2,617	2,449
Sudarshan Chemical	REDUCE	649	487
Vinati Organics	SELL	1,469	1,416

* CMP is as on 1 April 2024

Nilesh Ghuge

nilesh.ghuge@hdfcsec.com
+91-22-6171-7342

Harshad Katkar

harshad.katkar@hdfcsec.com
+91-22-6171-7319

Prasad Vadnere

prasad.vadnere@hdfcsec.com
+91-22-6171-7338

Akshay Mane

akshay.mane@hdfcsec.com
+91-22-6171-7338

- The nature of contracts has evolved in the CDMO industry. In the past, contracts were typically structured as 'take or pay' agreements. However, the current trend is towards contracts without the 'take or pay' clause.
- Generally, CDMO with innovators is secured but with generic it is price sensitive.
- Overall broader market in CRAMS is good but products which are expected to go off-patent will have an impact on volume and prices. Prices have decreased currently owing to slowdown in the market, which has impacted the realisation but margins have improved as raw material cost has fallen.

Chinese Chemical Industry Dynamics

- Chinese companies have increased their capacity by 1.5x to 2x in the past two years. Environmental regulations are stricter near Beijing and Shanghai region while they're more relaxed in Inner Mongolia.
- Following the Russia-Ukraine war, there has been widespread anticipation of supply chain disruptions and geopolitical uncertainty, prompting many to hold stocks. However, contrary to expectations, the disruptions did not materialize as anticipated. Subsequently, China sought to capitalize on this situation, driven by a liquidity crisis, resulting in an influx of Chinese chemicals being dumped into the market.
- Chinese chemical manufacturers are selling products at their cost price. They are earning margins primarily due to government incentives of about 10-12% in the form of tax incentives and employee benefits. However, we believe this is not sustainable in the long run.
- Globally, the inventory destocking phenomenon is expected to continue for the next two quarters and domestically the phenomenon is over and demand is expected to rebound.

China +1 strategy to stay

- All European plants with a market share of 25-40% in agrochemical intermediates are expected to close down gradually due to higher costs in euros and decreasing costs in developing countries. This makes it challenging for companies to sustain operations in Europe.
- Prices in India are about 15-20% higher than Chinese prices. Still, US consumers are ready to pay this premium over Chinese prices as they need a secondary option.
- All the new molecules are being launched from India. The registration process in India is smooth and approval takes less than a year compared to China where approvals could take up to three years. Also, China's registration process is cumbersome because of preference given to domestic manufacturers and data demanded by authorities.
- Chinese players are opening plants in Vietnam, Malaysia and Thailand while global players are reluctant to give business. The US eventually will impose sanctions on such companies over the exemption of duties. Also, this strategy is not cost-effective, as they have to follow environmental norms and send experts to run the plant; also, by-products cannot be used efficiently domestically as there is no supply chain established.

Battery chemical demand and Red Sea issue

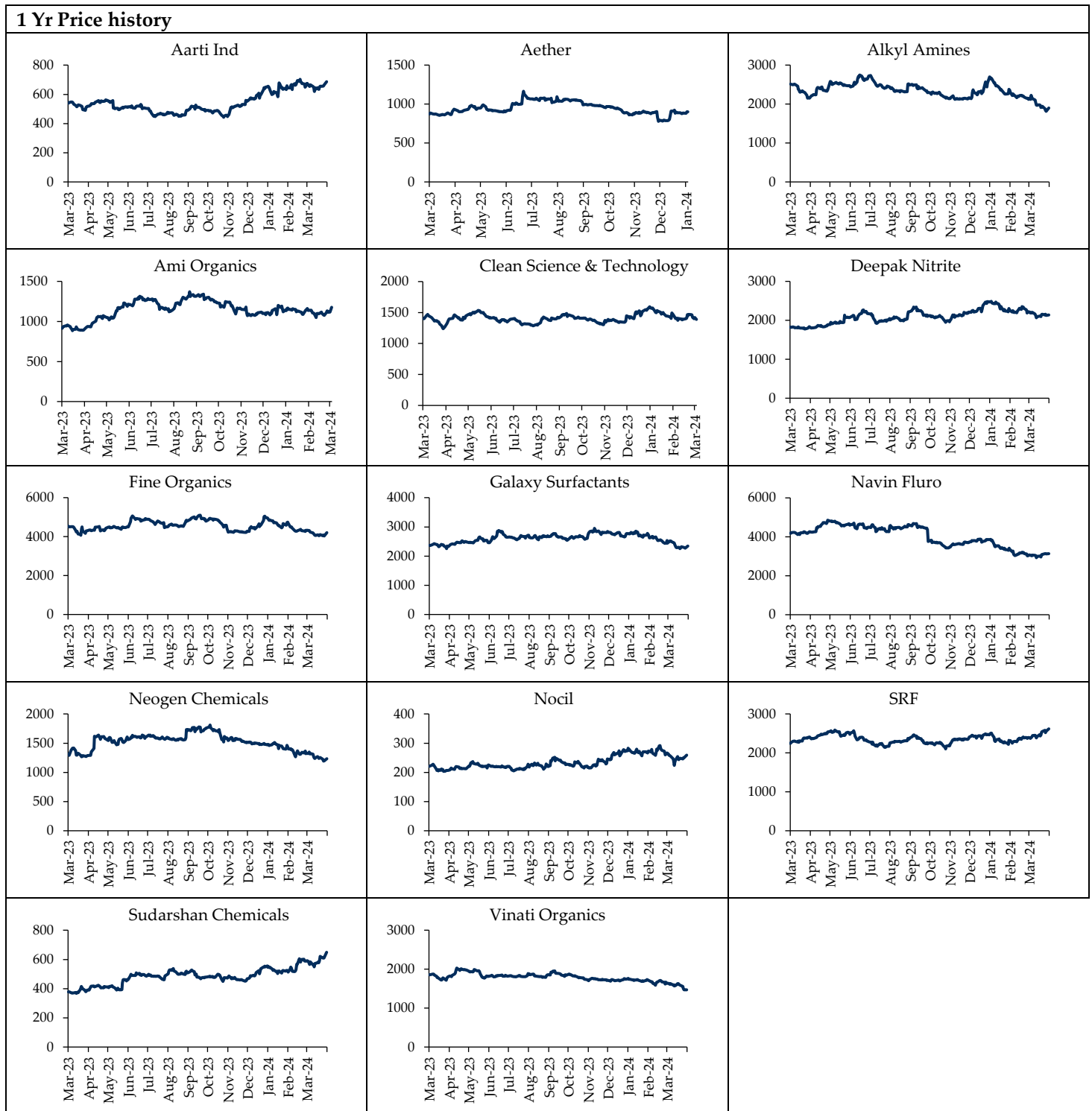
- Battery chemicals are expected to have good demand especially battery molecules related to LiPF₆.
- The Red Sea issue has extended timelines by an additional 20 days, leading to increased costs. While the inventory issue for end-users in India has no major impact, challenges persist in the US and Europe. Once demand rebounds, the Red Sea issue is anticipated to have a more significant impact, potentially exacerbating challenges in supply chains.

Valuation summary

Company	MCAp (INR bn)	CMP (INR)	RECO	TP (INR)	Adj EPS (INR/sh)				P/E (x)				P/BV (x)				ROE (%)			
					FY23	FY24E	FY25E	FY26E	FY23	FY24E	FY25E	FY26E	FY23	FY24E	FY25E	FY26E	FY23	FY24E	FY25E	FY26E
Aarti Industries	249	686	ADD	733	15.0	8.8	17.3	27.8	45.6	77.8	39.6	24.7	4.9	4.6	4.2	3.7	11.6	6.3	11.5	16.4
Aether Industries	106	798	BUY	1,124	9.8	8.7	12.8	19.1	81.1	92.2	62.5	41.8	9.2	5.4	5.0	4.5	16.0	6.8	7.7	10.5
Alkyl Amines	97	1,902	SELL	1,836	44.7	33.3	45.2	65.0	42.5	57.2	42.1	29.3	10.3	9.2	8.1	6.9	21.2	13.7	16.5	20.5
Ami Organics	41	1,114	ADD	1,201	22.9	20.4	31.6	41.7	48.7	54.5	35.2	26.7	6.4	5.8	5.1	4.3	14.9	11.9	16.3	18.5
Clean Science and Technology	143	1,348	SELL	1,037	27.8	22.6	31.3	38.5	48.5	58.5	41.9	36.3	13.7	11.5	9	8	33.2	21.6	24.8	24.8
Deepak Nitrite	292	2,142	SELL	1,448	62.5	57.7	86.9	108.8	34.3	37.1	24.6	19.7	7.6	6.5	5.3	4.4	22.9	17.7	22.4	22.9
Fine Organic	129	4,210	SELL	3,842	201.6	130.2	132.3	158.9	20.9	32.3	31.8	26.5	8.4	7.2	6.0	6.0	49.4	23.0	19.2	21.1
Galaxy Surfactants	83	2,351	BUY	3,529	107.5	86.0	104.2	128.1	21.9	27.3	22.6	18.4	4.9	4.4	3.8	3.3	22.0	15.2	16.3	17.5
Navin Fluorine	155	3,131	BUY	4,014	74.7	46.8	79.4	122.1	41.9	66.9	39.4	25.6	7.4	6.7	6.0	5.1	18.4	10.1	15.4	20.7
Neogen Chemicals	33	1,236	BUY	2,127	20.0	17.6	30.0	52.7	61.7	70.3	41.2	23.4	6.7	6.2	5.5	4.6	10.8	8.7	13.5	20.4
NOCIL	43	259	ADD	288	8.9	7.4	11.2	13.9	29.0	35.0	23.0	18.7	2.9	2.8	2.6	2.4	10.0	7.8	11.2	12.9
SRF	776	2,617	ADD	2,449	72.6	47.4	61.9	90.6	36.0	55.3	42.3	28.9	6.7	5.9	5.2	4.5	22.8	12.8	14.9	18.8
Sudarshan Chemical	45	649	REDUCE	487	6.5	14.0	23.8	28.9	100.4	46.4	27.3	22.5	4.3	4.0	3.6	3.3	5.4	11.3	17.7	19.4
Vinati Organics	151	1,469	SELL	1,416	40.8	34.4	44.9	59.2	36.0	42.7	32.7	24.8	8.9	8.0	6.8	5.8	20.7	15.0	17.1	19.2

Note: CMP is as on 1 April 2024

Source: Company, HSIE Research



Rating Criteria

- BUY: >+15% return potential
- ADD: +5% to +15% return potential
- REDUCE: -10% to +5% return potential
- SELL: > 10% Downside return potential

Disclosure:

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HDFC securities Limited, I Think Techno Campus, Building - B, "Alpha", Office Floor 8, Near Kanjurmarg Station, Opp. Crompton Greaves, Kanjurmarg (East), Mumbai 400 042 Phone: (022) 3075 3400 Fax: (022) 2496 5066

Compliance Officer: Murli V Karkera Email: complianceofficer@hdfcsec.com Phone: (022) 3045 3600

For grievance redressal contact Customer Care Team Email: customer care@hdfcsec.com Phone: (022) 3901 9400

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HDFC Securities**Institutional Equities**

Unit No. 1602, 16th Floor, Tower A, Peninsula Business Park,

Senapati Bapat Marg, Lower Parel, Mumbai - 400 013

Board: +91-22-6171-7330 www.hdfcsec.com