

# DIVI'S LABORATORIES

## One-offs take a toll; conviction remains strong

India Equity Research | Pharmaceuticals

Divi's Laboratories (Divi's) posted a softer than expected Q4FY19, following which the stock declined ~10%, as it was trading at a 22% premium to the sector. Though top-line grew 15% YoY, EBITDA margin declined to 33% led by: i) unfavourable product mix; ii) bunching up of CSR expenses; and iii) higher starting material costs from China. However, management has guided for ~15% top-line growth and margin to revert to 38% run rate in FY20. The company has increased capex from INR15.0bn to INR16.9bn to include modernisation of utilities at the EOU unit. Divi's has also moved up its project completion target from CY20 to FY20 and is expected to start accruing economic benefit in FY21. Factoring the Q4FY19 miss, we revise down FY20/FY21E EPS 12%/5%. Maintain 'BUY' with TP of INR1,830 (25x September 2020E EPS).

### Margin impacted by one-offs

EBITDA margin declined to 32.7%, as: i) low margin generics accounted for 59% as Naproxen sale was 18% of overall revenue against 15%; ii) increase in raw material price due to China disruption; and iii) higher other expenses due to bunching up of INR300mn donation expense (~3% of sales) in Q4FY19. Management has guided for ~15% sales growth and EBITDA margin of ~38% in FY20 as business normalises. However, it expects sales growth to accelerate to 20% once new capacities come on stream.

### Healthy long-term growth outlook

Following the lifting of the import alert and normalisation of operations at unit-I & II, Divi's revenue has sustained above the INR12bn mark, indicating that it remains a CRAMs vendor of choice. Also, the company is making aggressive capex of ~INR17bn to cater to larger opportunities in Big Pharma and capitalise on new ones arising from China supply disruptions. In addition to debottlenecking at unit I & II, it has commenced brownfield expansion at two SEZ sites and a modernisation project, all of which are expected to commission by FY20 end. Aggressive capacity addition and emerging opportunity from China supply disruption provide strong long-term growth outlook.

### Outlook and valuation: Strong trajectory; maintain 'BUY'

Earlier capacity concerns are waning as Divi's is on track with capex plans to capitalise on upcoming opportunities in the US and China. We maintain 'BUY/SO' with TP of INR1,830 (25x September 2020E earnings).

Financials		(INR mn)						
Year to March	Q4FY19	Q4FY18	% change	Q3FY19	% change	FY19	FY20E	FY21E
Net revenue	12,564	10,880	15.5	13,429	(6.4)	50,303	57,793	69,098
EBITDA	4,111	3,865	6.4	5,233	(21.4)	19,209	22,749	28,051
Adj. dil. EPS	11.1	9.3	19.7	15.4	(28.1)	50.1	60.8	75.1
P/E (x)						31.8	26.2	21.2
ROAE (%)						20.7	21.3	22.2

EDELWEISS 4D RATINGS	
Absolute Rating	BUY
Rating Relative to Sector	Outperform
Risk Rating Relative to Sector	Medium
Sector Relative to Market	Equalweight

MARKET DATA (R: DIVI.BO, B: DIVI IN)	
CMP	: INR 1,593
Target Price	: INR 1,830
52-week range (INR)	: 1,775 / 995
Share in issue (mn)	: 265.5
M cap (INR bn/USD mn)	: 423 / 4,479
Avg. Daily Vol.BSE/NSE('000)	: 932.3

SHARE HOLDING PATTERN (%)			
	Current	Q3FY19	Q2FY19
Promoters *	52.0	52.0	52.0
MF's, FI's & BK's	14.9	14.9	17.2
FII's	20.0	20.0	17.1
Others	13.0	13.0	13.7
* Promoters pledged shares (% of share in issue)			NIL

PRICE PERFORMANCE (%)			
	Stock	Nifty	EW Pharma Index
1 month	(4.0)	(2.6)	(4.4)
3 months	(1.9)	3.1	(1.3)
12 months	38.9	5.2	2.5

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## Other highlights

### Quarter performance:

- Revenue grew 15%. Custom synthesis contributed 41% and generics business contributed 59% to revenue.
- For the quarter, Carotenoids revenue came at ~INR900mn, up ~40% YoY.
- Divi's clocked EBITDA margin of 32.7%, down primarily due to unfavourable mix, higher starting material costs and bunched up donation expenses.
- Other income comprised forex loss of INR74.3mn; adjusted for which, PAT grew 20%.

### Guidance:

- Revenue growth of 10-15% in FY20; in FY21 and beyond to be 20% plus.
- EBITDA margin to revert to 38%.

### Capex:

- Divi's is on track with capex plans it had announced following the Q2FY19 result:
  - The company expects to complete total capex by FY20 end.
- Divi's has a planned capex of INR16.9bn, of which:
  - A brownfield SEZ unit at Unit-2 near Visakhapatnam named as DCV SEZ unit, with an investment of ~INR6bn.
  - Another SEZ project at Unit-1 near Hyderabad called Chandra SEZ with an investment of ~INR6bn.
  - Debottlenecking programmes at Unit 1 as well as Unit 2 with an aggregate investment of INR3bn.
  - An expansion programme and modernisation of utilities at EOU unit with investments of INR1.9bn.

**Table 1: Actual versus estimates**

	Q4FY19 Actual	Q4FY18	YoY Growth (%)	Edel estimate	Deviation from Actual (%)
Net Revenue	12,564	10,880	15.5	13,382	(6.1)
Cost of revenue	5,030	4,076	23.4	4,846	3.8
Gross profit	7,535	6,803	10.8	8,616	(12.5)
Gross margin (%)	60.0	62.5	-256bps	64.4	-441bps
EBITDA	4,111	3,865	6.4	5,112	(19.6)
EBITDA margin (%)	32.7	35.5	-281bps	38.0	-526bps
Depreciation	423	388	9.2	450	(5.9)
PBT	4,104	3,961	3.6	4,837	(15.2)
Income tax expense	1,210	1,345	(10.0)	1,209	0.1
Tax rate (%)	29.5	33.9	-446bps	25.0	449bps
Reported PAT	2,894	2,616	10.6	3,628	(20.2)

Source: Company, Edelweiss research

## Financial snapshot

(INR mn)

Year to March	Q4FY19	Q4FY18	% change	Q3FY19	% change	FY19	FY20E	FY21E
Net revenues	12,564	10,880	15.5	13,429	(6.4)	50,303	57,793	69,098
Raw material costs	5,030	4,076	23.4	4,802	4.7	18,252	21,015	25,187
Gross profit	7,535	6,803	10.8	8,627	(12.7)	32,051	36,777	43,911
Other expenses	2,041	1,681	21.5	2,030	0.6	7,069	7,391	8,130
EBITDA	4,111	3,865	6.4	5,233	(21.4)	19,209	22,749	28,051
EBITDA margin	32.7	35.5		39.0		38.2	39.4	40.6
Depreciation	423	388	9.2	425	(0.3)	1,689	2,055	2,495
EBIT	3,688	3,477	6.1	4,808	(23.3)	17,520	20,693	25,555
Interest	1	(2)	(158.8)	25	(96.0)	35	30	30
Other income	417	482	(13.4)	346	20.7	1,556	1,712	1,883
Add: Prior period items								
Add: Exceptional items	-	-		-		309	-	-
Profit before tax	4,104	3,961	3.6	5,129	(20.0)	19,041	22,375	27,409
Provision for taxes	1,210	1,345	(10.0)	1,334	(9.3)	5,023	5,384	6,642
Minority interest								
Reported net profit	2,894	2,616	10.6	3,795	(23.8)	14,018	16,992	20,767
Adjusted Profit	2,948	2,464	19.7	4,099	(28.1)	13,302	16,151	19,926
Diluted shares (mn)	265	265		265		265	265	265
Adjusted Diluted EPS	11.1	9.3	19.7	15.4	(28.1)	50.1	60.8	75.1
COGS	40.0	37.5		35.8		36.3	36.4	36.5
Gross profit	60.0	62.5		64.2		63.7	63.6	63.5
R&D	-	-		-		0.7	0.8	1.0
Total expenses	67.3	64.5		61.0		61.8	60.6	59.4
EBITDA	32.7	35.5		39.0		38.2	39.4	40.6
Reported net profit	23.0	24.0		28.3		27.9	29.4	30.1
Tax rate	29.5	33.9		26.0		26.4	24.1	24.2

### Company Description

Divi's is well-positioned in the USD45bn global contract manufacturing market as a research-focused, contract manufacturing player. The company services 20 of the top 25 global companies with over 100 projects in the pipeline. It collaborates with innovator companies through the early drug development stage to the commercialisation stage. Divi's revenues are derived from custom synthesis of APIs/intermediates (44% of FY18 sales) for innovator companies while generic exports make up the balance. It is the largest manufacturer of peptide reagents and is a leader in products such as Naproxen Sodium (anti-inflammatory drug) and Dextromethorphan (cough suppressant).

### Investment Theme

Divi's early-mover advantage in CRAMS, strict adherence to IPR norms and strong relationships with pharma majors marked its transformation from an API player to a successful India-based CRAMS player. By virtue of its long-standing presence, the company has managed to gain a foothold in this segment. Thus, it will be a key beneficiary of increased outsourcing opportunities underpinned by its expertise in complex chemistry, cost efficient processes and relationships with global pharma majors. With ~87% exposure to appreciating currencies, Divi's is a key beneficiary of the INR depreciation. In addition, the China API/intermediates opportunity is timely since Divi's is on track to reap the benefits of capacity expansion by FY20.

### Key Risks

- Currency realisations have a high-beta impact on the company's margin as exports contribute about 87% to revenue. Depreciation of key export currencies, i.e. USD and EUR versus INR, could pose a risk to our call
- Rebound in China supply and consequent tapering of the China opportunity could pose risk to our call

## Financial Statements

## Key Assumptions

Year to March	FY18	FY19	FY20E	FY21E
<b>Macro</b>				
GDP(Y-o-Y %)	6.7	7.1	7.1	7.3
Inflation (Avg)	3.6	3.7	4.0	4.5
Repo rate (exit rate)	6.0	6.3	5.8	5.8
USD/INR (Avg)	64.5	70.0	72.0	72.0

## Income statement

(INR mn)

Year to March	FY18	FY19	FY20E	FY21E
Net revenue	39,128	49,463	56,952	68,257
Other Operating Income	840	840	840	840
Income from operations	39,968	50,303	57,793	69,098
Materials costs	15,341	18,252	21,015	25,187
Employee costs	4,561	5,423	6,182	7,047
Total SG&A expenses	6,292	7,069	7,391	8,130
EBITDA	13,458	19,209	22,749	28,051
Operating profit	13,458	19,209	22,749	28,051
EBIT	12,033	17,520	20,693	25,555
Less: Interest Expense	13	35	30	30
Add: Other income	1,134.4	1,556.3	1,711.93	1,883.12
Profit Before Tax	13,154	19,041	22,375	27,409
Less: Provision for Tax	3,543	5,023	5,384	6,642
Add: Exceptional items	280	309	-	-
Reported Profit	9,611	14,018	16,992	20,767
Exceptional Items	199	225	-	-
Adjusted Profit	8,571	13,302	16,151	19,926
Shares o /s (mn)	265	265	265	265
Adjusted Basic EPS	32.3	50.1	60.8	75.1
Diluted shares o/s (mn)	265	265	265	265
Adjusted Diluted EPS	32.3	50.1	60.8	75.1
Adjusted Cash EPS	37.7	56.5	68.6	84.5
Dividend per share (DPS)	10.0	10.0	11.5	14.2
Dividend Payout Ratio(%)	33.3	22.8	21.6	21.8

## Common size metrics

Year to March	FY18	FY19	FY20E	FY21E
Materials costs	38.4	36.3	36.4	36.5
Staff costs	11.4	10.8	10.7	10.2
S G & A expenses	15.7	14.1	12.8	11.8
Operating expenses	66.3	61.8	60.6	59.4
R & D cost	0.8	0.7	0.8	1.0
Depreciation	3.6	3.4	3.6	3.6
Interest Expense	-	0.1	0.1	-
EBITDA margins	34.4	38.8	39.9	41.1
Net Profit margins	21.4	26.4	27.9	28.8

## Growth ratios (%)

Year to March	FY18	FY19	FY20E	FY21E
Revenues	(4.7)	26.4	15.1	19.8
EBITDA	(7.6)	42.7	18.4	23.3
PBT	(6.5)	44.8	17.5	22.5
Adjusted Profit	(25.5)	55.2	21.4	23.4
EPS	(25.5)	55.2	21.4	23.4

Balance sheet		(INR mn)			
As on 31st March	FY18	FY19	FY20E	FY21E	
Share capital	531	531	531	531	
Reserves & Surplus	58,717	69,041	81,524	96,924	
Shareholders' funds	59,248	69,572	82,054	97,455	
Short term borrowings	631	1,056	1,056	1,056	
Total Borrowings	631	1,056	1,056	1,056	
Def. Tax Liability (net)	1,917	2,188	1,000	1,000	
<b>Sources of funds</b>	<b>61,945</b>	<b>72,948</b>	<b>84,260</b>	<b>99,690</b>	
Gross Block	30,176	32,780	38,780	47,080	
Depreciation	1,425	1,689	2,055	2,495	
Net Block	19,962	20,878	24,822	30,627	
Capital work in progress	1,198	4,919	4,919	4,919	
Total Fixed Assets	21,160	25,797	29,741	35,546	
Non current investments	969	2,207	-	-	
Cash and Equivalents	20,018	15,136	26,159	25,365	
Inventories	13,507	17,723	16,822	24,581	
Sundry Debtors	10,144	11,634	11,771	16,280	
Other Current Assets	1,682	2,006	2,207	2,428	
Current Assets (ex cash)	25,334	31,365	30,802	43,289	
Trade payable	4,112	4,923	5,480	6,987	
Other Current Liab	1,764	2,447	2,776	3,335	
Total Current Liab	5,876	7,370	8,256	10,323	
Net Curr Assets-ex cash	19,458	23,995	22,546	32,967	
<b>Uses of funds</b>	<b>61,945</b>	<b>72,948</b>	<b>84,260</b>	<b>99,690</b>	
BVPS (INR)	223.2	262.1	309.1	367.1	

Free cash flow		(INR mn)			
Year to March	FY18	FY19	FY20E	FY21E	
Reported Profit	9,611	14,018	16,992	20,767	
Add: Depreciation	1,425	1,689	2,055	2,495	
Interest (Net of Tax)	10	26	23	23	
Others	(4,405)	3,156	(754)	(3,275)	
Less: Changes in WC	2,684	4,537	(1,449)	10,421	
Operating cash flow	3,957	14,351	19,765	9,589	
Less: Capex	2,557	6,326	6,000	8,300	
<b>Free Cash Flow</b>	<b>1,400</b>	<b>8,025</b>	<b>13,765</b>	<b>1,289</b>	

Cash flow metrics					
Year to March	FY18	FY19	FY20E	FY21E	
Operating cash flow	3,957	14,351	19,765	9,589	
Financing cash flow	(2,242)	(2,521)	(4,839)	(4,496)	
Investing cash flow	(2,557)	(6,326)	(6,000)	(8,300)	
Net cash Flow	(842)	5,503	8,926	(3,207)	
Capex	(2,557)	(6,326)	(6,000)	(8,300)	
Dividend paid	(3,200)	(3,200)	(3,668)	(4,526)	

Profitability and efficiency ratios					
Year to March	FY18	FY19	FY20E	FY21E	
ROAE (%)	15.2	20.7	21.3	22.2	
ROACE (%)	23.1	29.2	29.1	30.2	
Inventory Days	318	312	300	300	
Debtors Days	89	80	75	75	
Payable Days	95	90	90	90	
Cash Conversion Cycle	312	302	285	285	
Current Ratio	7.7	6.3	6.9	6.7	
Gross Debt/EBITDA	-	0.1	-	-	
Gross Debt/Equity	-	-	-	-	
Adjusted Debt/Equity	-	-	-	-	
Net Debt/Equity	(0.3)	(0.2)	(0.3)	(0.2)	
Interest Coverage Ratio	904.7	500.6	689.8	851.8	

Operating ratios					
Year to March	FY18	FY19	FY20E	FY21E	
Total Asset Turnover	0.7	0.7	0.7	0.7	
Fixed Asset Turnover	2.2	2.4	2.5	2.5	
Equity Turnover	0.7	0.8	0.8	0.8	

Valuation parameters					
Year to March	FY18	FY19	FY20E	FY21E	
Adj. Diluted EPS (INR)	32.3	50.1	60.8	75.1	
Y-o-Y growth (%)	(25.5)	55.2	21.4	23.4	
Adjusted Cash EPS (INR)	37.7	56.5	68.6	84.5	
Diluted P/E (x)	49.4	31.8	26.2	21.2	
P/B (x)	7.1	6.1	5.2	4.3	
EV / Sales (x)	10.3	8.3	7.0	5.8	
EV / EBITDA (x)	30.0	21.3	17.5	14.2	
Dividend Yield (%)	0.6	0.6	0.7	0.9	

## Peer comparison valuation

Name	Market cap (USD mn)	Diluted P/E (X)		EV / EBITDA (X)		ROAE (%)	
		FY20E	FY21E	FY20E	FY21E	FY20E	FY21E
Divi's Laboratories	6,741	26.2	21.2	17.5	14.2	21.3	22.2
Cipla	6,602	25.5	22.8	11.9	11.6	11.1	11.3
Glenmark Pharmaceuticals	2,268	13.1	11.7	8.5	7.7	17.9	17.0
Ipca Laboratories	1,695	19.7	15.8	12.7	10.0	17.4	18.3
Natco Pharma	1,278	13.7	13.1	9.0	7.6	17.0	15.6
Torrent Pharmaceuticals	3,722	26.7	21.0	13.1	11.4	18.9	20.9

Source: Edelweiss research

## Additional Data

### Directors Data

Murali K Divi	Chairman & Managing Director	N V Ramana	Executive Director
Madhusudana Rao Divi	Director (Projects)	Kiran S Divi	Whole time Director
G Suresh Kumar	Independent Director	Ranga Rao Ravipati	Independent Director
K V K Seshavataram	Independent Director	Nilima Motaparti	Whole-time Director
Dr. Ramesh B V Nimmagadda	Independent Director	Dr. S Ganapaty	Independent Director

Auditors - P V R K Nageswara Rao & Co

*\*as per last annual report*

### Holding – Top10

	Perc. Holding		Perc. Holding
SBI Funds Management Pvt Ltd	4.67	Axis Asset Management Co Ltd/India	1.60
Pinebridge Investments LP	3.89	HDFC Life Insurance Co Ltd	1.55
Reliance Capital Trustee Co Ltd	3.30	HDFC Asset Management Co Ltd	1.36
Norges Bank	1.73	Abu Dhabi Investment Authority	1.32
Government Pension Fund - Global	1.73	BlackRock	1.18

*\*in last one year*

### Bulk Deals

Data	Acquired / Seller	B/S	Qty Traded	Price
30 Nov 2018	INTEGRATED CORE STRATEGIES (ASIA) PTE.LTD.	SELL	1886001	1438.98

*\*in last one year*

### Insider Trades

Reporting Data	Acquired / Seller	B/S	Qty Traded
18 Mar 2019	N. Chandrika Ramana	Sell	16585.00
11 Oct 2018	K. Mallaiah	Buy	20725.00
23 Aug 2018	N. Chandrika Ramana	Sell	19000.00

*\*in last one year*

Company	Absolute reco	Relative reco	Relative risk	Company	Absolute reco	Relative reco	Relative Risk
Aurobindo Pharma	HOLD	SP	H	Biocon	REDUCE	SU	H
Cadila Healthcare	BUY	SO	M	Cipla	REDUCE	SU	L
Divi's Laboratories	BUY	SO	M	Dr.Reddys Laboratories	BUY	SO	M
Glenmark Pharmaceuticals	HOLD	SU	H	Ipca Laboratories	HOLD	SP	H
Lupin	BUY	SP	M	Natco Pharma	BUY	SO	M
Sun Pharmaceuticals Industries	REDUCE	SU	M	Torrent Pharmaceuticals	HOLD	SP	M

## ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

## RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
Sector Underperformer (SU)	Stock return < 1.25 x Sector return
	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

## RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

## SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return





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**Coverage group(s) of stocks by primary analyst(s): Pharmaceuticals**

Aurobindo Pharma, Biocon, Cadila Healthcare, Cipla, Divi's Laboratories, Dr.Reddys Laboratories, Glenmark Pharmaceuticals, Ipca Laboratories, Lupin, Natco Pharma, Sun Pharmaceuticals Industries, Torrent Pharmaceuticals

**Recent Research**

Date	Company	Title	Price (INR)	Recos
22-May-19	<b>Cipla</b>	Performance boosted by one-offs; <i>Result Update</i>	553	Reduce
20-May-19	<b>Torrent Pharma</b>	Growth elusive at expensive valuations; <i>Result Update</i>	1,654	Hold
17-May-19	<b>Dr. Reddy's Laboratories</b>	Performance on track; strong outlook; <i>Result Update</i>	2,745	Buy

**Distribution of Ratings / Market Cap**

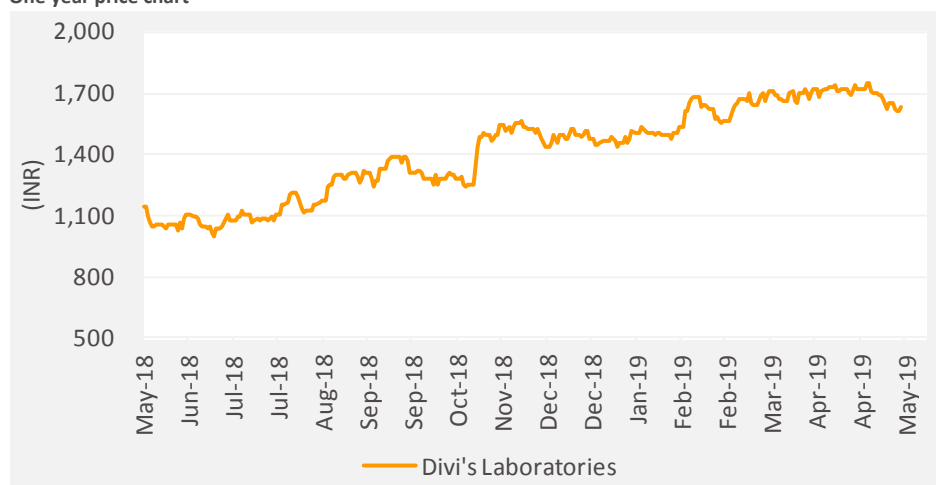
**Edelweiss Research Coverage Universe**

	Buy	Hold	Reduce	Total
Rating Distribution*	161	67	11	240
* 1stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	156	62	11	

**Rating Interpretation**

Rating	Expected to
<b>Buy</b>	appreciate more than 15% over a 12-month period
<b>Hold</b>	appreciate up to 15% over a 12-month period
<b>Reduce</b>	depreciate more than 5% over a 12-month period

**One year price chart**



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