RESULT UPDATE

DIVI'S LABORATORIES

Capacity constraint impeding growth

India Equity Research| Pharmaceuticals

Edelweiss
Ideas create, values protect

Divi's Laboratories' (Divi's) Q4FY17 sales, EBITDA and PAT fell 3%, 9% and 19% YoY, respectively. Capacity constraint led to muted top line and cost escalation due to remedial measure impacted profitability. Management has revised down FY18 revenue guidance to single digit versus ~10-15% earlier. In Q3FY17, the company had received import alert on Unit-II with exceptions to most of its key products. Divi's is engaged with consultants and has responded to USFDA with detailed corrective actions plan. However, key risk is that not only could other regulated market agencies extrapolate FDA's view on Unit-II, but Unit-I, which is due for inspection, could also come under FDA's close scrutiny. Further, the company has been unable to initiate fresh capex at Kakinada due to local political issues, whereas current capacity is running almost full. Ergo, we rule out any meaningful growth over the next 2 years. Maintain 'HOLD' with target price of INR585 (15x FY19E EPS).

Earnings belie estimates; FY18 number revised down

Revenue fell 3% YoY, against our 10% growth expectation. FY17 sales grew 8% YoY versus 13-14% guidance. While generic and custom synthesis segments declined 5% and 3%, respectively, carotenoids grew 19% (mix 51%, 44% and 5%), respectively. Gross margin jumped ~322bps YoY, but fell 356bps QoQ. EBITDA declined 9% YoY to INR3.6bn. Q4FY17 had a one-off forex loss of INR290mn, adjusted for which Q4FY17 EBITDA slipped 3% QoQ. Adjusted PAT dipped 13% YoY. Divi's has revised down FY18 growth guidance to single digit compared to 10-15% earlier.

Risks outweigh possible upsides

Post the import alert, customers may shift from Divi's to alternate suppliers to derisk, thereby worsening the import alert's impact. Moreover, additional risks can play out over time, including: (i) negative view on this facility extrapolated by other regulated market agencies, resulting in adverse actions by them; and (ii) FDA's scrutiny could extend to Unit-I, as was the case with other Indian companies facing import alerts.

Outlook and valuations: Risks ahead; downgrade to 'HOLD'

We believe Divi's will witness earnings pressure and recurring negative news flow, if risks play out in turn impacting the stock. We maintain '**HOLD/SP**' with a TP of INR585.

Financials **(INR mn)**

Year to March	Q4FY17	Q4FY16	% Chg	Q3FY17	% Chg	FY17	FY18E	FY19E
Net revenues	10,667	11,034	(3.3)	9,765	9.2	41,063	42,072	44,514
EBITDA	3,620	3,992	(9.3)	3,808	(4.9)	14,460	13,764	14,378
Adjusted Profit	2,825	3,234	(12.6)	2,678	5.5	11,502	10,158	10,607
Adjusted Diluted EPS	10.6	12.2	(12.6)	10.1	5.5	43.3	38.3	40.0
Diluted P/E (x)						12.6	14.2	13.6
EV/EBITDA (x)						8.9	9.2	8.5
ROAE (%)						23.8	17.8	16.4

EDELWEISS 4D RATINGS

Absolute Rating	**HOLD**
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 545
Target Price	: INR 585
52-week range (INR)	: 1,382 / 540
Share in issue (mn)	: 265.5
M cap (INR bn/USD mn)	: 145 / 2,243
Avg. Daily Vol.BSE/NSE('000)	: 1,303.9

SHARE HOLDING PATTERN (%)

	Current	Q3FY17	Q2FY17
Promoters *	52.1	52.1	52.1
MF's, FI's & BK's	14.2	14.6	13.5
FII's	17.2	19.8	20.9
Others	16.5	13.5	13.5

** Promoters pledged shares (% of share in issue) : NIL*

PRICE PERFORMANCE (%)

	Stock	Nifty	EW Pharma Index
1 month	(13.2)	3.1	(9.5)
3 months	(28.1)	8.1	(11.7)
12 months	(49.7)	17.6	(12.1)

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Table 1: Actual versus estimates

	Q4FY17 Actual	Q4FY16 Actual	*YoY Growth (%)*	Edel estimate	*Deviation from Actual (%)*
Net Revenue	10,667	11,034	*(3.3)*	12,028	*(11.3)*
Cost of revenue	4,210	4,711	*(10.6)*	4,823	*(12.7)*
Gross profit	6,456	6,323	*2.1*	7,235	*(10.8)*
Gross margin (%)	60.7	57.4	*332bps*	60.1	*58bps*
EBITDA	3,620	3,992	*(9.3)*	4,586	*(21.1)*
EBITDA margin (%)	33.9	36.2	*-224bps*	38.0	*-409bps*
Depreciation	314	292	*7.6*	400	*(21.4)*
PBT	3,505	3,851	*(9.0)*	4,381	*(20.0)*
Income tax expense	912	631	*44.5*	964	*(5.4)*
Tax rate (%)	26.0	16.4	*963bps*	22.0	*401bps*
adjusted PAT	2,825	3,234	*(12.6)*	3,417	*(17.3)*

Source: Company, Edelweiss research

Financial snapshot **(INR mn)**

Year to March	Q4FY17	Q4FY16	% change	Q3FY17	% change	FY17	FY18E	FY19E
Net revenues	10,667	11,034	*(3.3)*	9,765	*9.2*	41,063	42,072	44,514
Raw material costs	4,210	4,711	*(10.6)*	3,506	*20.1*	15,340	16,056	16,992
Gross profit	6,456	6,323	*2.1*	6,259	*3.2*	25,723	26,016	27,523
Other expenses	1,837	1,344	*36.7*	1,469	*25.0*	6,165	7,546	7,986
EBITDA	3,620	3,992	*(9.3)*	3,808	*(4.9)*	14,460	13,764	14,378
EBITDA margin	33.9	36.2		39.0		35.2	32.7	32.3
Depreciation	314	292	*7.6*	310	*1.6*	1,233	1,515	1,754
EBIT	3,306	3,700	*(10.7)*	3,499	*(5.5)*	13,227	12,248	12,624
Other income	209	173	*20.8*	185	*13.3*	749	800	1,000
Interest	10	22	*(53.2)*	4	*136.4*	23	25	25
Add: Prior period items								
Add: Exceptional items						(1,181)		
Profit before tax	3,505	3,851	*(9.0)*	3,679	*(4.7)*	13,954	13,023	13,599
Provision for taxes	912	631	*44.5*	996	*(8.4)*	3,349	2,865	2,992
Minority interest								
Associate profit share								
Profit- Discontinued Ops								
Reported net profit	2,593	3,220	*(19.5)*	2,683	*(3.4)*	10,604	10,158	10,607
Adjusted Profit	2,825	3,234	*(12.6)*	2,678	*5.5*	11,502	10,158	10,607
Diluted shares (mn)	265	265		265		265	265	265
Adjusted Diluted EPS	10.6	12.2	*(12.6)*	10.1	*5.5*	43.3	38.3	40.0
Diluted P/E (x)	-	-		-		12.6	14.2	13.6
EV/EBITDA (x)	-	-		-		8.9	9.2	8.5
ROAE (%)	-	-		-		23.8	17.8	16.4
COGS	39.5	42.7		35.9		37.4	38.2	38.2
Gross profit	60.5	57.3		64.1		62.6	61.8	61.8
R&D	-	-		-		1	1	1
Total expenses	66.1	63.8		61.0		64.8	67.3	67.7
EBITDA	33.9	36.2		39.0		35.2	32.7	32.3
Reported net profit	24.3	29.2		27.5		25.8	24.1	23.8
Tax rate	26.0	16.4		27.1		24.0	22.0	22.0

Company Description

Divi's Laboratories is well-positioned in the USD45bn global contract manufacturing market as a research focused, contract manufacturing player. Divi's services 20 of the top 25 global companies, with over 100 projects in the pipeline. The company 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 FY16 sales) for innovator companies, while the balance is derived from generic exports. It is the largest manufacturer of peptide reagents and has leadership in products such as Naproxen Sodium (an anti-inflammatory drug) and Dextromethorphan (a cough suppressant).

Investment Theme

Divi's early mover advantage in CRAMS, strict adherence to IPR norms and strong relationship with pharma majors marked its transformation from an API player to a successful CRAMS player from India. By virtue of its long standing presence, the company has managed to establish itself in this segment. Divi's will be a key beneficiary of increased outsourcing opportunities driven by its expertise in complex chemistry, cost efficient processes and relationship with global pharma majors.

Key Risks

Higher dependency on top five products, top five clients

Project delays/failures at customer end

Currency volatility could hurt earnings

Financial Statements

Key Assumptions

Year to March	FY16	FY17	FY18E	FY19E
Macro				
GDP(Y-o-Y %)	7.2	6.5	7.1	7.7
Inflation (Avg)	4.9	4.8	5.0	5.2
Repo rate (exit rate)	6.8	6.3	6.3	6.3
USD/INR (Avg)	65.0	67.5	67.0	67.0
Sector				
IPM growth (Y-o-Y) %	12.0	12.0	12.0	12.0
Company				
India sales (INR mn)	4,491	4,647	4,611	4,880
EBITDA margins (%)	0.4	0.4	0.3	0.3
USD/INR (Avg)	65.0	67.5	67.0	67.0
Capex (USD mn)	31	63	60	67
Net debt to equity (x)				

Income statement **(INR mn)**

Year to March	FY16	FY17	FY18E	FY19E
Gross revenues	38,260	41,262	42,239	44,700
Net revenue	37,975	40,952	41,922	44,364
Other Operating Income	74	110	150	150
Income from operations	38,049	41,063	42,072	44,514
Materials costs	15,041	15,340	16,056	16,992
Employee costs	3,612	4,687	4,287	4,716
R&D Cost	309	410	419	444
Total SG&A expenses	4,913	6,165	7,546	7,986
EBITDA	14,174	14,460	13,764	14,378
Operating profit	14,174	14,460	13,764	14,378
EBIT	12,992	13,227	12,248	12,624
Add: Other income	974.4	748.9	800.00	1,000.00
Less: Interest Expense	38	23	25	25
Add: Exceptional items	340	(1,181)	-	-
Profit Before Tax	13,928	13,954	13,023	13,599
Less: Provision for Tax	2,671	3,349	2,865	2,992
Reported Profit	11,258	10,604	10,158	10,607
Exceptional Items	275	(898)	-	-
Adjusted Profit	10,983	11,502	10,158	10,607
Shares o /s (mn)	265	265	265	265
Adjusted Basic EPS	41.4	43.3	38.3	40.0
Diluted shares o/s (mn)	265	265	265	265
Adjusted Diluted EPS	41.4	43.3	38.3	40.0
Adjusted Cash EPS	45.8	48.0	44.0	46.6
Dividend per share (DPS)	10.0	10.0	9.2	9.6
Dividend Payout Ratio(%)	28.3	30.0	28.8	28.8

Common size metrics

Year to March	FY16	FY17	FY18E	FY19E
Operating expenses	62.7	64.8	67.3	67.7
Materials costs	39.5	37.4	38.2	38.2
Staff costs	9.5	11.4	10.2	10.6
S G & A expenses	12.9	15.0	17.9	17.9
R & D cost	0.8	1.0	1.0	1.0
Depreciation	3.1	3.0	3.6	3.9
Interest Expense	0.1	0.1	0.1	0.1
EBITDA margins	37.3	35.2	32.7	32.3
Net Profit margins	28.9	28.0	24.1	23.8

Growth ratios (%)

Year to March	FY16	FY17	FY18E	FY19E
Revenues	22.4	7.8	2.4	5.8
EBITDA	21.6	2.0	(4.8)	4.5
PBT	29.9	0.2	(6.7)	4.4
Adjusted Profit	28.9	4.7	(11.7)	4.4
EPS	28.9	4.7	(11.7)	4.4

Balance sheet (INR mn)

As on 31st March	FY16	FY17	FY18E	FY19E
Share capital	531	531	531	531
Reserves & Surplus	42,402	53,043	60,272	67,820
Shareholders' funds	42,933	53,574	60,803	68,351
Short term borrowings	414	357	357	357
Long term borrowings	5	-	-	-
Total Borrowings	419	357	357	357
Def. Tax Liability (net)	731	1,228	1,000	1,000
Sources of funds	**44,199**	**55,313**	**62,288**	**69,843**
Gross Block	22,156	24,594	28,594	33,094
Depreciation	1,182	1,233	1,515	1,754
Net Block	14,388	15,592	18,076	20,822
Capital work in progress	2,639	4,436	4,436	4,436
Total Fixed Assets	17,027	20,028	22,512	25,258
Non current investments	-	-	-	-
Cash and Equivalents	8,760	17,094	18,003	22,192
Inventories	12,078	13,199	12,106	14,673
Sundry Debtors	8,809	8,985	8,893	10,026
Other Current Assets	619	825	825	825
Current Assets (ex cash)	21,508	23,011	24,129	27,964
Trade payable	2,327	3,839	1,067	4,124
Other Current Liab	2,451	2,399	2,706	2,863
Total Current Liab	4,778	6,237	3,773	6,988
Net Curr Assets-ex cash	16,730	16,774	20,356	20,976
Uses of funds	**44,199**	**55,313**	**62,288**	**69,843**
BVPS (INR)	161.7	201.8	229.1	257.5

Free cash flow (INR mn)

Year to March	FY16	FY17	FY18E	FY19E
Reported Profit	11,258	10,604	10,158	10,607
Add: Depreciation	1,182	1,233	1,515	1,754
Interest (Net of Tax)	31	17	20	20
Others	2,402	(8,299)	(2,465)	(2,832)
Less: Changes in WC	4,493	44	3,582	621
Operating cash flow	10,379	3,512	5,645	8,928
Less: Capex	3,957	4,234	4,000	4,500
Free Cash Flow	**6,422**	**(722)**	**1,645**	**4,428**

Cash flow metrics

Year to March	FY16	FY17	FY18E	FY19E
Operating cash flow	10,379	3,512	5,645	8,928
Investing cash flow	(4,135)	(4,234)	(4,000)	(4,500)
Financing cash flow	(6,241)	(2,713)	(3,183)	(3,051)
Net cash Flow	3	(3,435)	(1,538)	1,376
Capex	(3,957)	(4,234)	(4,000)	(4,500)
Dividend paid	(6,390)	(3,185)	(2,929)	(3,059)

Profitability and efficiency ratios

Year to March	FY16	FY17	FY18E	FY19E
ROAE (%)	28.2	23.8	17.8	16.4
ROACE (%)	35.6	28.7	22.7	21.0
Inventory Days	288	301	288	288
Debtors Days	78	79	78	78
Payable Days	56	73	56	56
Cash Conversion Cycle	310	307	310	310
Current Ratio	6.3	6.4	11.2	7.2
Gross Debt/EBITDA	-	-	-	-
Gross Debt/Equity	-	-	-	-
Adjusted Debt/Equity	-	-	-	-
Net Debt/Equity	(0.2)	(0.3)	(0.3)	(0.3)
Interest Coverage Ratio	343.7	587.9	489.9	505.0

Operating ratios

Year to March	FY16	FY17	FY18E	FY19E
Total Asset Turnover	0.9	0.8	0.7	0.7
Fixed Asset Turnover	2.8	2.7	2.5	2.3
Equity Turnover	1.0	0.8	0.7	0.7

Valuation parameters

Year to March	FY16	FY17	FY18E	FY19E
Adj. Diluted EPS (INR)	41.4	43.3	38.3	40.0
Y-o-Y growth (%)	*28.9*	*4.7*	*(11.7)*	*4.4*
Adjusted Cash EPS (INR)	45.8	48.0	44.0	46.6
Diluted P/E (x)	13.2	12.6	14.2	13.6
P/B (x)	3.4	2.7	2.4	2.1
EV / Sales (x)	3.6	3.1	3.0	2.8
EV / EBITDA (x)	9.6	8.9	9.2	8.5
Dividend Yield (%)	1.8	1.8	1.7	1.8

Peer comparison valuation

	Market cap	Diluted P/E (X)		EV / EBITDA (X)		ROAE (%)	
Name	**(USD mn)**	**FY18E**	**FY19E**	**FY18E**	**FY19E**	**FY18E**	**FY19E**
Divi's Laboratories	2,243	14.2	13.6	9.2	8.5	17.8	16.4
Glenmark Pharmaceuticals	2,714	14.7	14.9	10.2	10.1	23.5	19.0
Ipca Laboratories	981	19.4	15.0	11.2	9.3	12.6	14.5
Torrent Pharmaceuticals	3,211	17.2	15.1	11.5	9.6	26.8	25.4
Median	-	16.0	14.9	10.7	9.5	20.6	17.7
AVERAGE	-	16.4	14.7	10.5	9.4	20.2	18.8

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	President & Director
G Suresh Kumar	Director	Ranga Rao Ravipati	Director
K V K Seshavataram	Director	S Sridevi	Director

Auditors - P V R K Nageswara Rao & Co

**as per last annual report*

Holding – Top10

	Perc. Holding		Perc. Holding
Motaparti nilima	20.34	Kiran divi satchandr	17.33
Divi kiran satchand	17.33	Divi murali	5.86
Divi swarna latha	5.27	Latha divi swarna	5.27
Reliance capital tru	4.7	Divis biotech pvt lt	3.01
Icici prudential ass	1.73	Hdfc life insurance	1.7

**in last one year*

Bulk Deals

Data	Acquired / Seller	B/S	Qty Traded	Price
29 Mar 2017	Credit Suisse (Singapore) Ltd A/C Credit Suisse (Singap	Sell	1129113	635.00
29 Mar 2017	Valiant Mauritius Partners Ltd	Buy	1129113	635.00

**in last one year*

Insider Trades

Reporting Data	Acquired / Seller	B/S	Qty Traded
29 Dec 2016	DIVI MADHUSUDANA RAO	Buy	20000.00
18 Aug 2016	SRI RAMACHANDRA RAO DIVI	Sell	50000.00

**in last one year*

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

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
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	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, 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
29-May-17	**Cadila Healthcare**	Waiting for Moraiya clearance with bated breath; *Result Update*	444	Buy
26-May-17	**Sun Pharma**	Poor near-term guidance, but specialty closer to fruition; *Result Update*	568	Buy
25-May-17	**Cipla**	Another quarter misses the mark; *Result Update*	504	Hold

1Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	161	67	11	229

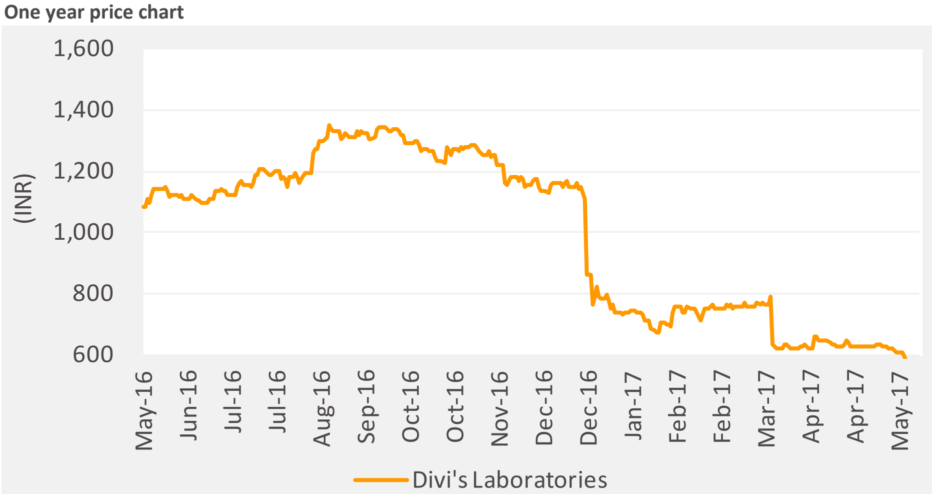
* 1stocks under review

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	156	62	11

Rating Interpretation

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

One year price chart



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