Divis Laboratories Limited

Sturdy Growth prospects

Pharmaceuticals	Sharekhan code: DIVISLAB	Company Update

3R MATRIX

	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)		✓	

\+ Positive = Neutral - Negative

What has changed in 3R MATRIX

	Old		New
RS	+	↔	+
RQ	+	↔	+
RV	=	↔	=

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 3,494**	
Price Target: **Rs. 4,500**	↔

↑ Upgrade ↔ Maintain ↓ Downgrade

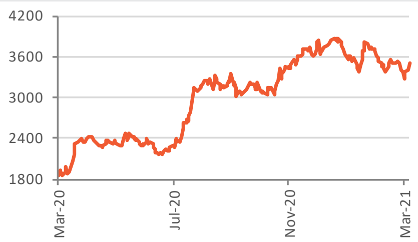
Company details

Market cap:	Rs. 92,745 cr
52-week high/low:	Rs. 3,913 / 1,633
NSE volume: (No of shares)	13.8 lakh
BSE code:	532488
NSE code:	DIVISLAB
Free float: (No of shares)	12.8 cr

Shareholding (%)

Promoters	52.0
FII	18.9
DII	18.8
Others	10.36

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	1.3	-5.3	11.3	88.7
Relative to Sensex	0.7	-13.1	-21.6	-3.9

Sharekhan Research, Bloomberg

Summary

- Divis Laboratories Limited (Divis) is expected to benefit from strong growth in the global active pharmaceutical ingredients (API) space.
- Divis has identified new growth avenues, which include entry in the contrast media manufacturing and identification of next 10 molecules which have gone off patent. The new avenues could drive the company's growth ahead.
- Divis strict adherence to IPR norms, proven delivery capability through the development cycle, commercial supply track record, backward integration and strong relationship with pharma majors are key advantages.
- We re-iterate Buy recommendation on the stock with an unchanged PT of Rs. 4,500.

Divis Laboratories Limited (Divis) is expected to benefit from strong growth likely in the global active pharmaceutical ingredients (API) space, driven by multiple factors. Increasing preference for biologics for disease management, key drugs going off patent, outsourcing opportunities, and higher regulatory approvals would be key growth drivers for the API industry, which is expected to report a high single-digit CAGR over the next 6-7 years. In addition to this, there are immense opportunities that have emerged for API players such as Divis, as pharma giants across the world look to tide over the pandemic. Supply reliability and quality are factors that have taken precedence over pricing, which pharma companies world over are looking for. Moreover, the company has identified new areas, which would fuel growth going ahead. Divis has identified its next set of 10 molecules, which have gone off patent and offer a sizeable growth opportunity. Moreover, the company is aggressively foraying in the contrast media space, which offers a potential market size of $4 billion- $6 billion. Secondly, the company has concluded its Rs. 1,800 crore capex plan at DC SEZ and DCV SEZ coupled with de-bottlenecking existing capacities, which provide ample visibility to cater to increased demand and in the process would lead to operational efficiencies. Moreover, Divis is planning to invest Rs. 600 crore towards Kakinada plant over the next 2-3 years, but the work is expected to commence post resolution of the issues with locals. Of the Rs. 400 crore capex announced for the custom synthesis business, Divis has commenced production at one streams and is on track to achieve completion for others. The fact that the company has lined up substantial investments towards capacity expansion points towards strong growth visibility. Divis strict adherence to IPR norms, proven delivery capability through the development cycle, commercial supply track record, and strong relationship with pharma majors are key advantages. We believe Divis could also benefit from its backward-integration initiatives and planned new product launches. Sales and profit are expected to post a sturdy 26% and 36% CAGR, respectively, over FY2020-FY2023.

Our Call

Valuation – Maintain Buy with a PT of Rs. 4,500: Divis has identified new growth avenues in addition to existing ones, which could drive the company's growth. Divis has shortlisted the next 10 set of molecules and has forayed in contrast media manufacturing, which would also be a key growth driver for the company. Moreover, expectations of high single-digit growth in the global API industry are expected to benefit established players such as Divis. The company has concluded its major expansion plans, which provide ample growth visibility. Further, transient logistics issues could exert pressure on margins, though the same are expected to be set off by benefits of leverage attributable to strong demand environment. We expect Divis to reap benefits of backward integration, capacity expansion, and emerging opportunities in the API and custom synthesis space. At the CMP, the stock trades at rich valuations of 36x and 28.5x its FY2022E/FY2023E EPS, respectively; and given the strong growth prospects, we expect rich valuations to sustain. Moreover, over a span of past three months, the stock has underperformed the Sensex and BSE Healthcare Index by 13% and 3%, respectively, while the stock price has corrected by almost 10% in the past two months, which provides a good entry point for investors. We re-iterate Buy recommendation on the stock with an unchanged PT of Rs. 4,500.

Key Risks

1) Adverse regulatory changes; 2) Delay in completion of capex plans.

Valuation (Consolidated) Rs cr

Particulars	FY2019	FY2020	FY2021E	FY2022E	FY2023E
Net sales	4946.3	5394.4	6861.8	8712.1	10729.5
Operating Profit	1871.8	1822.2	2744.7	3511.0	4345.5
OPM (%)	37.8	33.8	40.0	40.3	40.5
PAT	1321.7	1294.5	1965.0	2574.4	3249.6
EPS (Rs)	49.8	48.8	74.0	97.0	122.4
PER (x)	70.2	71.6	47.2	36.0	28.5
EV/EBITDA (x)	46.5	48.1	32.1	24.8	19.6
ROCE (%)	24.9	22.6	28.4	29.6	29.5
RONW (%)	19.0	17.7	22.1	23.2	23.2

Source: Company; Sharekhan estimates

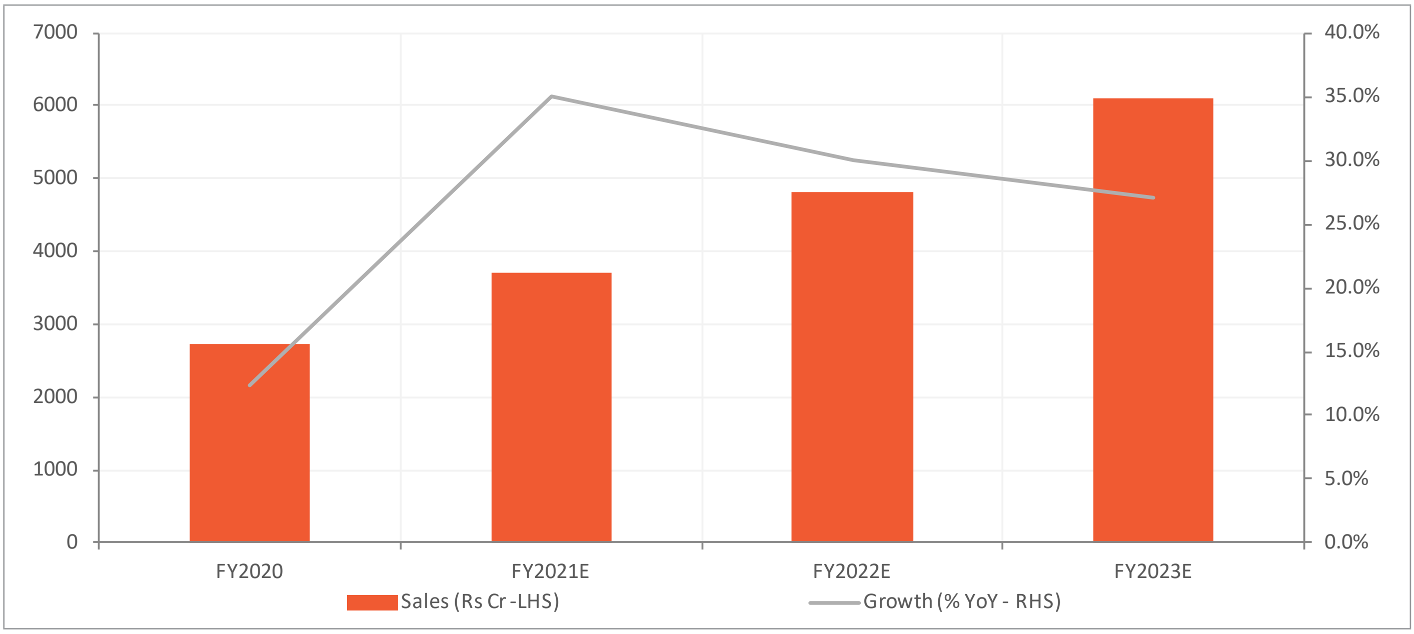
Global API industry to grow in high single digits, pointing at a sturdy demand scenario:

The global API industry is poised to grow at a healthy pace going ahead, driven by multiple factors. Increasing preference for biologics for disease management, key drugs going off patent, outsourcing opportunities, and higher regulatory approvals would be the key growth drivers of the API industry. Based on this, industry reports point at a high single-digit CAGR for the API industry globally over the next 6-7 years, as compared to around mid-single digit growth estimated earlier. Divis has emerged as a dominant, independent API provider globally, with leading market shares globally for its APIs, with dominant market share in several high-volume products. There are immense opportunities that have emerged for API players such as Divis, as companies world over look to tide over the pandemic. Supply reliability and quality are factors that have taken precedence over pricing, which pharma companies world over are looking for. Players such as Divis, one of the leading manufacturers of intermediates/APIs, are witnessing strong demand traction and could potentially be one of the key beneficiaries from the above triggers.

Divis to benefit significantly from new opportunities; Capacity expansion provides visibility:

Divis is a leading player in the API space globally and is expected to benefit significantly from the opportunities in the space. Moreover, the company has identified new areas, which would fuel growth going ahead. Divis has identified the next set of 10 molecules, which have gone off patent and offer a sizeable growth opportunity. Moreover, the company is aggressively foraying in the contrast media space. Contrast media is a substance used to improve the inside images of the body produced by ultrasound, MRI scans, X-ray, and CT scans. It allows doctors/practitioners to distinguish between normal and abnormal tissues. The market size for this product is slated to be significant at around $4 billion to $6 billion globally, and management classifies this as a high-volume segment and is expected to be one of the key growth drivers. Moreover, substantial capacity expansion plans, which will be completed by the end of FY2021 provides ample visibility on the company's ability to meet incremental demand, thus pointing towards market share gains. We believe recent capacity additions by Divis will enable it to add significant market share across its existing products and enable it to gain traction in the new top 10 molecules identified. We expect API sales to report a strong 31% CAGR over FY2020 to FY2023.

API Segment Sales – Growth trends

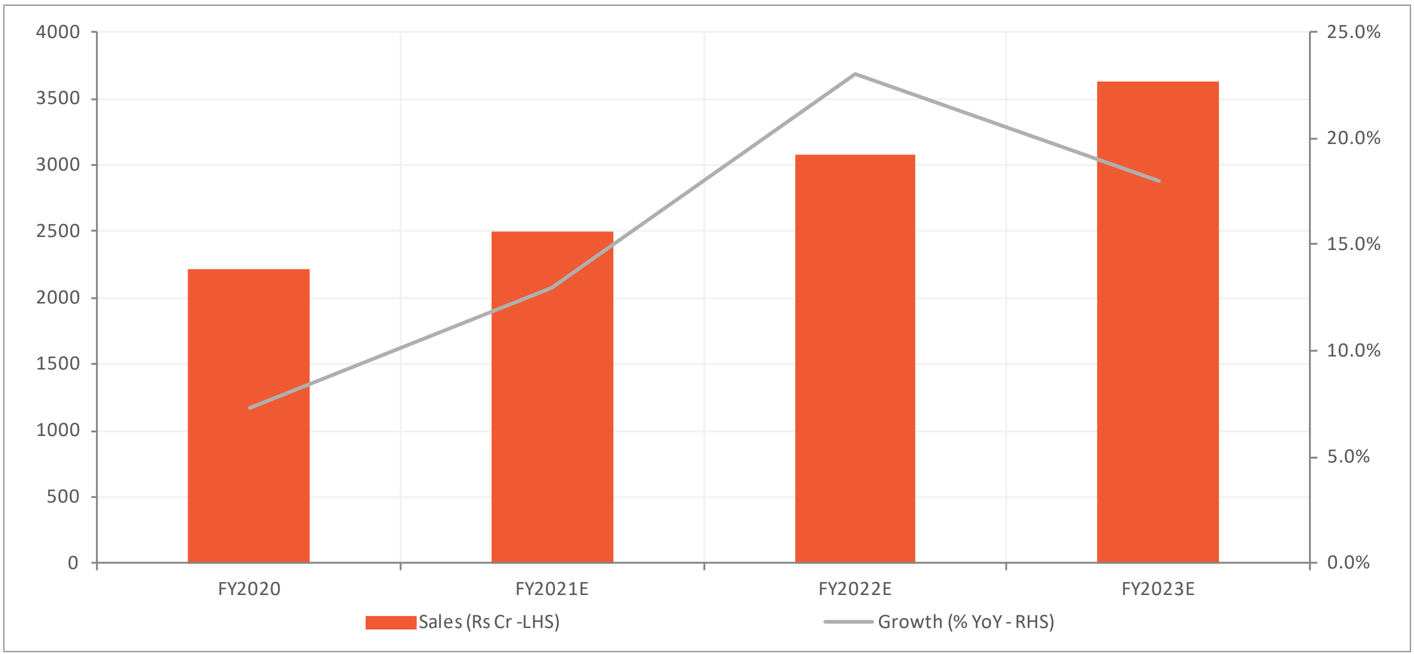


Source: Company, Sharekhan estimates

Custom synthesis segment gaining traction backed by strong demand environment:

Divis, over the year, has emerged as a preferred partner for several of its key customers (which are big global pharma companies) for synthesis projects, with expertise in scaling up high tonnage products. The custom synthesis business is a margin accretive one, but at times it is lumpy in nature. Divis is experiencing strong demand traction, especially from its clients in European region. The company has projects in hand from these customers and, hence, is able to deliver. Strong R&D capabilities and India cost arbitrage along with IP adherence are some legacy strengths will drive incremental assignments from MNCs. Management has announced capex of Rs. 400 crore, which it plans to complete by 1HFY22. As the company would be putting up block, expanded capacities need not be going through the regulatory approval process and, hence, can commence commercial production up on completion. We expect expanded capacities to start contributing to revenue from FY2022, while full benefit from the same is likely to be reflected in FY2023. Divis' strict adherence to IPR norms, proven delivery capability through the development cycle, commercial supply track record, and strong relationship with pharma majors are key advantages that would drive growth of the custom synthesis sales. We expect the segment's sales to report a double-digit CAGR over FY2020 to FY2023.

Custom Synthesis Segment Sales – Growth trends



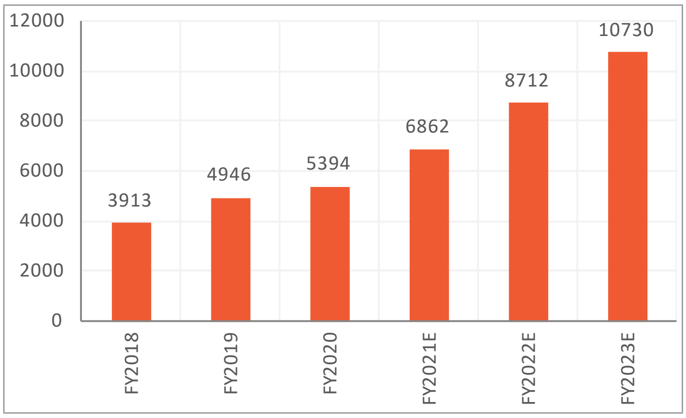
Source: Company, Sharekhan estimates

Capacity expansion plans provide ample visibility on topline growth:

Divis has almost concluded a Rs. 1,800 crore capex plan, which involves de-bottlenecking of existing plants as well as setting up new units. Divis has invested Rs. 1,200 crore towards setting two units (Rs. 600 crore each). For 9MFY2021, the company has capitalised Rs. 1,000 crore, while the balance is likely to be done by the end of FY2021. Of the two units, DCV SEZ is being set up at an already approved facility and, hence, it need not go through the approval process. So, up on completion, the unit can commence commercial production. The second one at DC Sez would be required to go through the regulatory approval process, which could take some time. Moreover, Divis plans to invest Rs. 600 crore in the Kakinada facility over the next 2-3 years. The company has all the required regulatory approvals in place; but due to local protests, there could be a delay in commencement of construction. To resolve the issues, the state government of Andhra Pradesh has formed a committee that is in discussions with the State Pollution Control Board to resolve the issue. Once the approval is in place, the company would commence the construction work. Continuous capacity expansion plans lined up by the company would enable it to cater to incremental demand. Moreover, anticipating strong demand traction in the custom synthesis business, Divis is investing Rs. 400 crore towards putting up a new block, which is likely to be ready by 1HFY2022. De-bottlenecking measures being implemented are likely to increase capacity by 25%-30% and are largely completed. Collectively, strong demand traction in place coupled with expanded capacities coming on stream would result in a strong 26% topline CAGR over FY2020-FY2023.

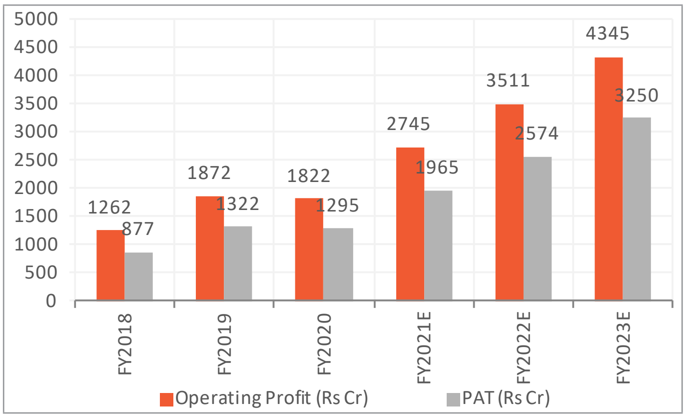
Financials in charts

Sales Trends (Rs Cr)



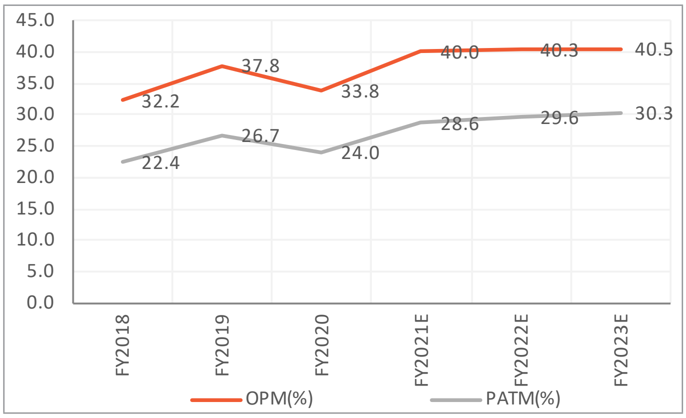
Source: Company, Sharekhan Research

Operating Profit - PAT Trends



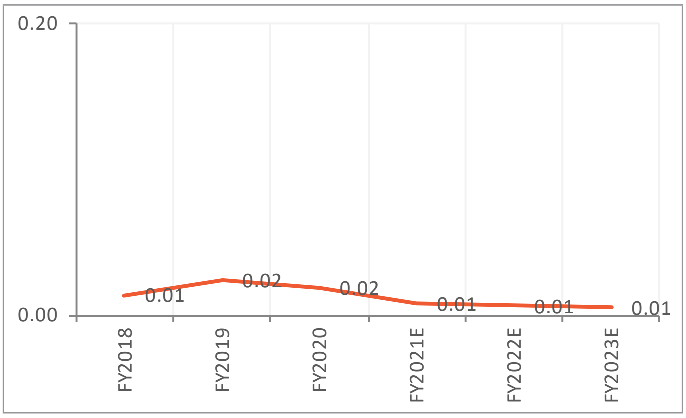
Source: Company, Sharekhan Research

Margin Trends



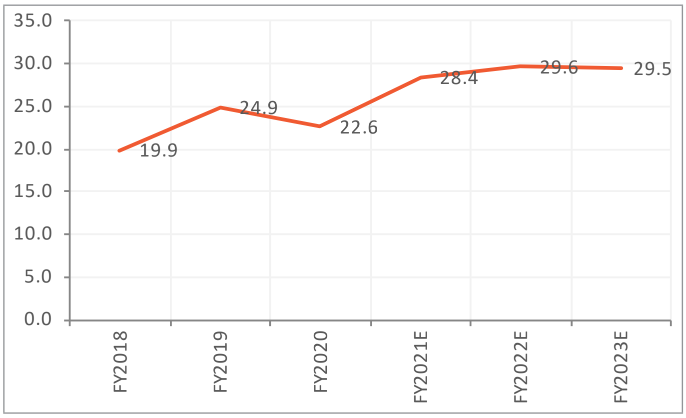
Source: Company, Sharekhan Research

Improving Leverage (D:E)



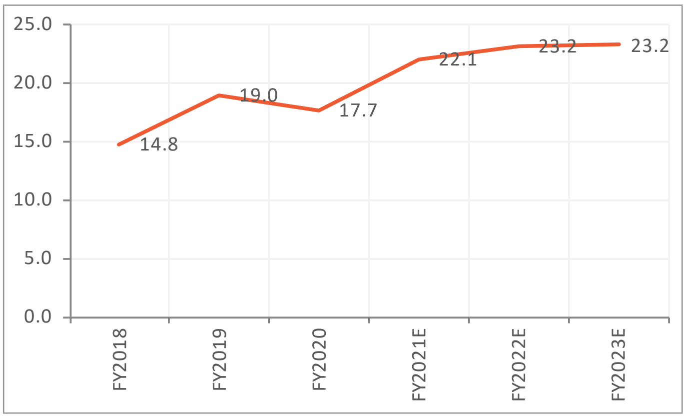
Source: Company, Sharekhan Research

RoCE Trend (%)



Source: Company, Sharekhan Research

Return ratios to improve (RoE-%)



Source: Company, Sharekhan Research

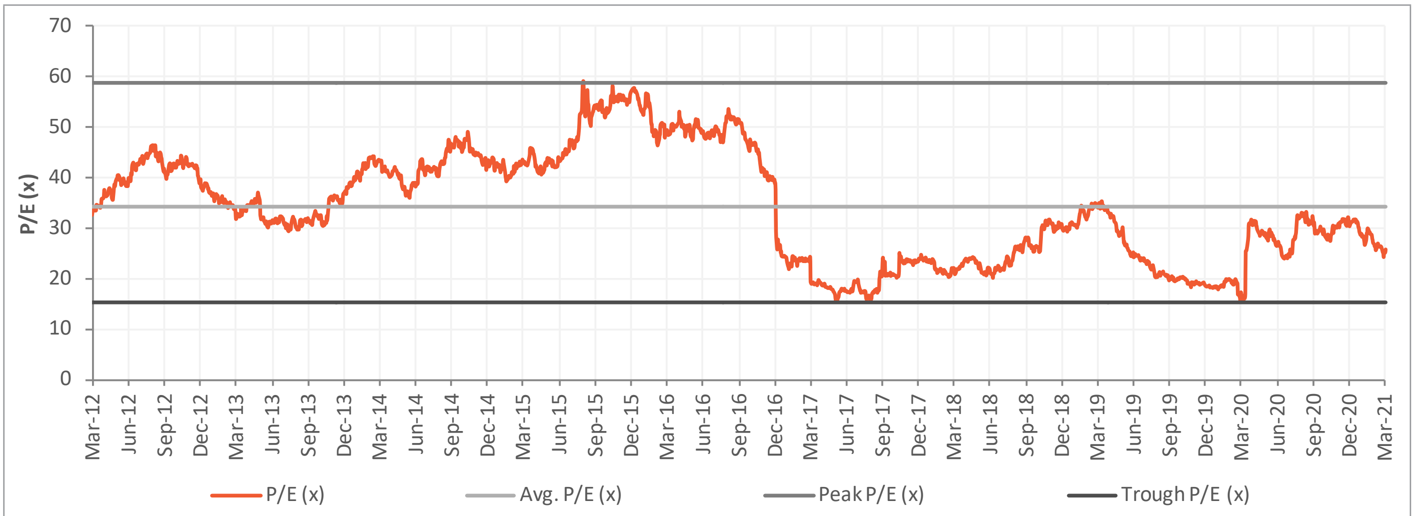
Outlook and Valuation

■ **Sector View: Growth momentum to improve:** Indian pharmaceutical companies are better placed to harness opportunities and report healthy growth going ahead. Indian companies are among the most competitive ones globally and hold a sizeable market share in most developed as well as other markets. Moreover, other factors such as easing of pricing pressures (especially in the US generics market), rise in product approvals, and plant resolutions by the USFDA coupled with strong growth prospects in domestic markets and emerging opportunities in the API space would be key growth drivers. This would be complemented by strong capabilities developed by Indian companies (leading to a shift towards complex molecules and biosimilars) and commissioning of expanded capacities by select players over the medium term. Collectively, this indicates a strong growth potential going ahead for pharma companies.

■ **Company outlook - Robust earnings growth:** Divis' long-term growth opportunities are robust and the company is well-placed to capitalise on the same. Immense opportunities lie ahead in the custom synthesis business. Similarly, growth levers in the generic API space are promising. The hunt by global companies for alternative procurement source for API/bulk drugs is expected to benefit API-centric players such as Divis. The new areas of contrast media manufacturing and the next set of 10 molecules (which have gone off patent) would also complement growth going ahead. Consequently, the company is in the midst of a substantial capacity expansion plan across its facilities for both the API as well as custom synthesis business. With expanded capacities likely to go on stream by FY2022, Divis would be best placed to cater to increased demand. Moreover, the company has recently announced plans to enter the contract media manufacturing space and is evaluating plans to tap the opportunity. With a substantial global market size of $4 billion-6 billion, this space has the potential to provide substantial growth opportunities.

■ **Valuation - Maintain Buy with a PT of Rs. 4,500:** Divis has identified new growth avenues in addition to existing ones, which could drive the company's growth. Divis has shortlisted the next 10 set of molecules and has forayed in contrast media manufacturing, which would also be a key growth driver for the company. Moreover, expectations of high single-digit growth in the global API industry are expected to benefit established players such as Divis. The company has concluded its major expansion plans, which provide ample growth visibility. Further, transient logistics issues could exert pressure on margins, though the same are expected to be set off by benefits of leverage attributable to strong demand environment. We expect Divis to reap benefits of backward integration, capacity expansion, and emerging opportunities in the API and custom synthesis space. At the CMP, the stock trades at rich valuations of 36x and 28.5x its FY2022E/FY2023E EPS, respectively; and given the strong growth prospects, we expect rich valuations to sustain. Moreover, over a span of past three months, the stock has underperformed the Sensex and BSE Healthcare Index by 13% and 3%, respectively, while the stock price has corrected by almost 10% in the past two months, which provides a good entry point for investors. We re-iterate Buy recommendation on the stock with an unchanged PT of Rs. 4,500.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer valuation

Particulars	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)			EV/EBIDTA (x)			RoE (%)		
				FY20	FY21E	FY22E	FY20	FY21E	FY22E	FY20	FY21E	FY22E
Solara Active Pharma Sciences	1241	3.5	4457	38.4	20.1	16.9	19.0	12.0	10.0	10.5	16.8	16.8
Divis Laboratories	3,494.0	26.5	92,745.0	71.6	47.2	36.0	48.1	32.1	24.8	17.7	22.1	23.2

Source: Company, Sharekhan estimates

About company

Divis, based in Hyderabad, India, has two manufacturing units and is among the top pharmaceutical companies in India. Divis is the leading manufacturer of APIs, intermediates, and registered starting materials offering high-quality products with the highest level of compliance and integrity to over 95 countries. Advanced manufacturing facilities both in Hyderabad and Vizag have been inspected multiple times by USFDA, EU GMP (U.K., Slovenia, German, and Irish authorities), HEALTH CANADA, TGA, ANVISA, COFEPRIS, PMDA, and MFDS health authorities.

Investment theme

Divis' long-term growth opportunities are intact and the company is well placed to capitalise on the same. Immense opportunities lie ahead in the contract research and manufacturing space (CRAMS). Similarly, growth levers in the generic API space are promising. The hunt by global companies for alternative procurement source for APIs/bulk drugs is expected to benefit API-centric players such as Divis. Measures taken by the government to boost API manufacturing in India and reduce dependence on imports are likely to substantially benefit companies such as Divis. With expanded capacities likely to go in stream by FY2022, Divis would be best placed to cater to increased demand.

Key Risks

- Adverse regulatory changes
- Regulatory compliance risk
- Forex volatility

Additional Data

Key management personnel

Dr. Murali K. Divi	Managing Director
N.V. Ramana	Executive Director
Dr. Kiran S. Divi	Whole time Director and CEO
Ms. Nilima Motaparti	Whole time Director – Commercial

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	SBI Funds Management Pvt Ltd	4.7
2	Axis Asset Management Co Ltd/India	3.1
3	Norges Bank	1.65
4	GOVERNMENT PENSION FUND - GLOBAL	1.59
5	Reliance Capital Trustee Co	1.47
6	PineBridge Investments LP	1.14
7	Vangaurd Group Inc	1.07
8	BlackRock Inc	1.04
9	UTI Asset Management Company	0.94
10	HDFC Asset Management Company	0.88

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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Compliance Officer: Mr. Joby John Meledan; Tel: 022-61150000; email id: compliance@sharekhan.com;

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